April 16, 2012

Third Times a Charm: *Should markets ready for QE3*?

Bottom Line:

We enter the second quarter of 2012 with much the same feeling as we began the year – cautious. The first quarter was positive for the equity markets in general, and mostly neutral for bonds and commodities. To be sure, we are always grateful when the stock market increases, but we always want to keep our wits about us. In doing so, we try to gauge the underlying motivators for the markets movements, in either direction. Last quarter we indicated that our leading indicators were forecasting some rougher seas ahead. These indicators have not allowed us to push the all clear button, and therefore, based on the weight of evidence available to us, our position remains unaltered.

Economic Overview:

When we look at the bigger picture, we look back over the past few years and notice a pattern. When the markets bottomed out in March of 2009, the US government launched a previously unfathomable program of bailouts and stimulus. Not having the actual money to do so, they introduced the world to a newly coined term, Quantitative Easing, which is essentially creating vast amounts of US dollars and injecting that cash into the banking system. The first round of Quantitative Easing, commonly known as QE1, was quite successful in pulling the world back from the brink. Equities and commodities rallied strongly until April 2010, when QE1 was coming to an end. The government's (and market's) hope was that by then, the economy would be back on its feet and government intervention would no longer be necessary.

Unfortunately, that wasn't the case and the stock market suffered a fairly major decline from April to August 2010. At that point, the US Federal Reserve introduced the idea of QE2, a second round of 'money-printing'. On that news, the market bottomed out and started an upswing that continued throughout QE2 ending in April 2011. Again, the markets took a severe hit from April to October of 2011. During this time period, the US Federal Reserve embarked on a lighter version of QE that they called Operation Twist, but it was really the European Central Bank that turned on the monetary taps this time. Technically the ECB is not allowed to print money, but they found a creative way to 'invent' roughly $1 Trillion Euros to lend to the European banks. This way the ECB ensured that banks have enough cash to pay off the hundreds of billions of their own maturing debt and at the same time keep operating and loaning to businesses so that the credit crunch does not choke off economic growth. It also hoped that banks would use some of that money to buy government bonds (i.e. lend to European governments) to effectively east the debt crisis (deemed LTRO – Long Term Refinancing Operations). Perhaps not surprisingly, the markets have breathed a sigh of relief and the markets have lifted.

So in observing the trend over the past few years, we can see a pattern emerging. In a continuing effort to support the now three year old economic recovery, governments including the UK, US, Europe and Japan are being relied upon for stimulus. Each time a major creation and injection of new money occurs, we see that money finding its way into more easily traded assets, like stocks, commodities and corporate and government bonds. We have to ask the question – will this rally too fizzle out once the 'sugar-high' wears off from this latest European money printing operation? Will the markets experience a subsequent 'sugar crash'?

> *"These high wild hills and rough uneven ways*
> *Draw out our miles and make them wearisome;*
> *But yet your fair discourse hath been as sugar,*
> *Making the hard way sweet and delectable."*
> - William Shakespeare -

The answer to both questions is speculation; however, the answer is probably yes. Therefore, the next question becomes, will the governments continue to 'turn on the taps' when needed to support investment asset values? Will we see QE3 at some point? For the foreseeable future, the answer to those questions is probably also yes. It seems that the major central banks of the world are prepared to do whatever is necessary to keep the financial system flush with cash. The hope is that at some point, these economies gain some traction on their own and reduce the need for government stimulus.

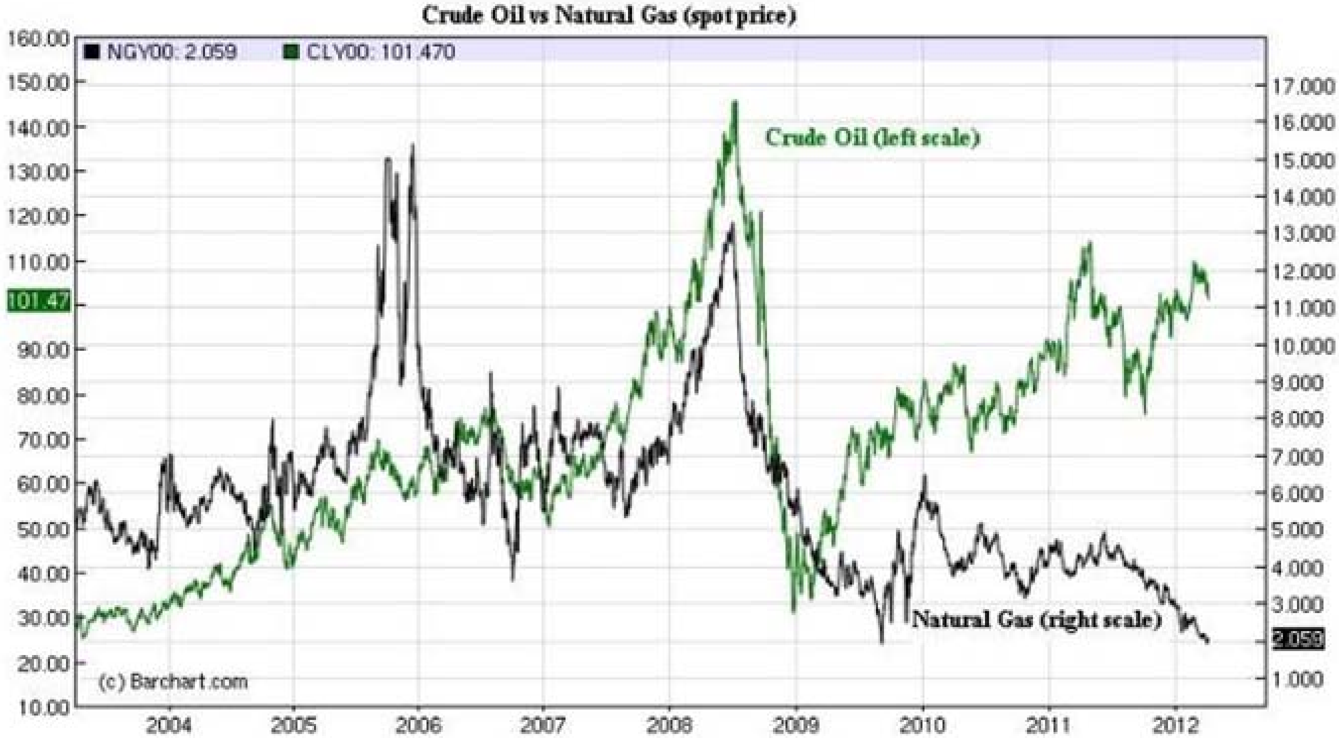
We have used the word hope a few times thus far. As a well-known market strategist Jeff Saut says, 'the stock market is simply fear, hope and greed…only loosely connected to the business cycle'. The market is clearly in hope mode at the moment. We take the management of our clients' nest egg much too seriously to rely on hope, so we prefer to subscribe to a management style coined by Canadian economist and strategist David Rosenberg: SIRP. This stands for Safety and Income at a Reasonable Price. We continue to like that fit this description include government bonds, solid corporate bonds, preferred shares and some dividend paying equities.

<u>A word on Oil & Gas:</u>

Being located in Calgary, we feel the need from time to time to comment on our view of the oil and gas market and/or oil and gas stocks.

Remember the 'old days' when gas and oil were supposed to trade at a 6:1 ratio? Even in recent years prior to the economic crisis, the oil-to-gas ratio ranged from 6:1 to 10:1. With oil currently just over $100 and natural gas at $2, that works out to be a 50:1 ratio. Times are pretty good in Alberta right now, but it seems like a 'feast or famine' situation. Companies that are more natural gas weighted have found it very difficult in this environment; companies that are very oil focused have mostly thrived.

Making a forecast here is quite difficult, however we can offer our observation based on the charts. The chart for oil looks reasonably healthy from a technical analysis standpoint – not overly strong, but at least we can say it is in an uptrend. Keep in mind that oil is highly correlated to the overall equity markets, so if the market rolls over and enters a weak phase (or worse), oil will likely follow suit.



Source: Global Macro Monitor, April 5, 2012

The chart for natural gas is quite the opposite. Since the 2008 we have seen prices fall dramatically from US$13 to US$2/MMBtu. The good news is that it likely can't go to zero, so at some point the price will level out and find some support.

For those investors wishing to try to pick a bottom and make money on any type of natural gas resurgence, it might be wise to use an exchange-traded fund (ETF) that tracks the price of the commodity, rather than trying to buy an individual natural gas stock. The reason we suggest this is that if natural gas does bottom out, but stays below $2 or $3 for an extended period of time, individual companies still may not be able to be profitable for a long period of time. On the other hand, the ETF tracking the price will immediately increase along with any type of jump in the actual price of natural gas. As a caveat, with many commodity ETFs, one always has to be aware of contango* risk, and thus they need to be monitored closely.

*Contango risk: market condition wherein the price of next month's futures contract is trading above the near term contract at maturity.

The Markets & Our Strategy:

Here is a price performance summary of global equity and North American bond markets so far in 2012:

	Level	Wkly Chg	YTD	YTD C$
S&P/TSX	12392	-0.6%	3.7%	3.7%
DOW JONES	13212	1.0%	8.1%	5.6%
S&P 500	1408	0.8%	12.0%	9.4%
NASDAQ	3092	0.8%	18.7%	15.9%
RUSSELL 2000	830	0.0%	12.1%	9.5%
NIKKEI 225	10084	0.7%	19.3%	8.1%
MSCI EAFE	1553	-0.2%	10.0%	7.4%
MSCI WORLD	1305	-0.2%	10.4%	7.8%
MSCI EM	1041	-0.1%	13.6%	11.0%

	Level	Wkly Chg	YTD
DEX Universe Bond	862.4	0.7%	-0.1%
DEX Real Return Bond	519.1	0.4%	-1.1%
Mer Lynch US High Yield Master II	865.6	0.1%	5.1%

Source: TD Asset Management

What is not telling from this short time frame though is the poor performance of global equity markets over the past twelve months. The MSCI World Index is down 1.7% and would be far worse if not for the U.S. equity markets performing relatively well. Our own S&P/TSX Composite is down 12.2% and the MSCI EAFE (Europe, Asia and Far East) Index is down 9.1%. This is in combination with high volatility, especially the second half of last year. The Canadian equity market has struggled due to Energy and Metals markets which make up a large weighting of the TSX.

What we do know is that, in combination with strong equity market performance in the first quarter, volatility came down to a level not seen since 2007. This, in combination with most sentiment indicators at very high levels, also keeps us in a defensive posture. Many of our leading indicators are in agreement with this stance. We believe that the 'SIRP' investment theme that we have been discussing for some time now will continue to serve our clients well.

We would like to thank our clients for their continued trust in us.

Respectfully,

- **Your Milestone Team**