October 16, 2012

# QEternity

***Bottom Line:***

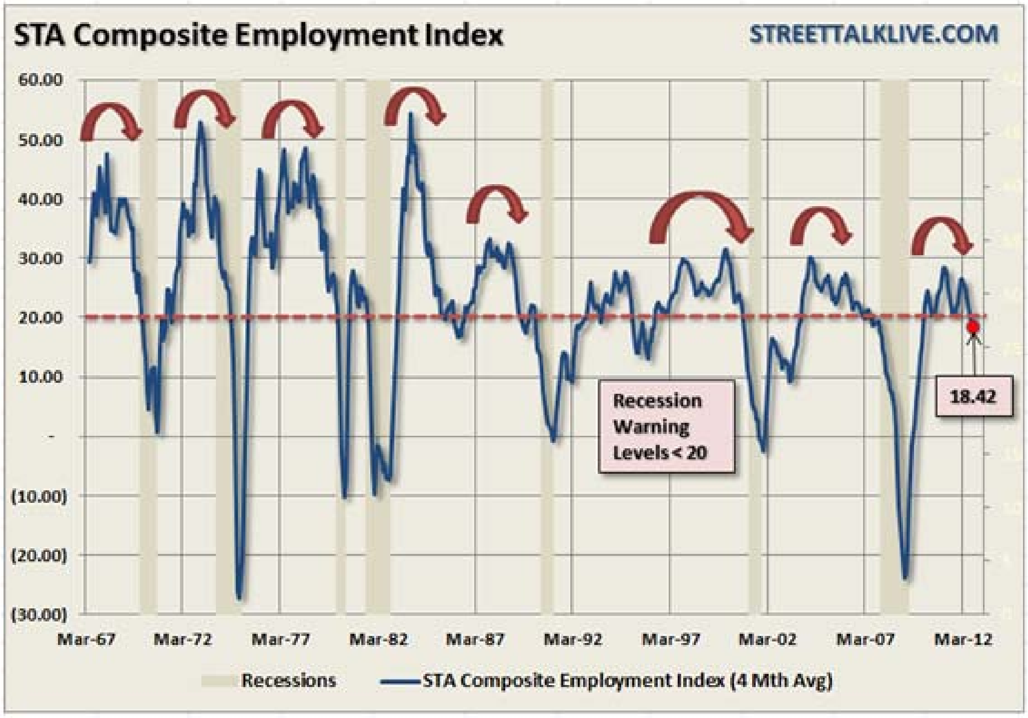
The third quarter was generally very positive for equity markets around the world. Investors were willing to assume more risk as challenges in Europe appeared less imminent. The TSX Composite crossed into positive territory by finishing the quarter up 3.0% year-to-date. We entered 2012 with a cautious tone due to our belief that the global economic environment was decelerating. The slowing growth has proven to be the case; however, it hasn't translated into negative equity markets as world markets are positive thus far.

Overall, the global economy is sluggish, with larger regions such as China slowing down or even experiencing negative growth like the European Union. The US has been able to produce positive growth but at a historically very slow pace when compared to previous cycles. However, this anemic growth has not been enough to absorb the excess capacity that still exists in the country. Canada on the other hand has been showing steady economic performance, albeit still at a slower pace.

***Economic Overview:***

The key driver over this quarter was central bank intervention. Reflecting on our April 2012 Market Commentary, entitled "Third Time's A Charm: Should markets ready for QE3?", our belief then was that the global economy was slowing and the US Federal Reserve would feel compelled to step in with another round of Quantitative Easing. Over the spring and summer, the economic numbers continued to disappoint (jobs, GDP growth, manufacturing, and income) and the markets became more and more hopeful for Fed intervention. The Q1 GDP growth for the US was 1.7% and the Q2 GDP growth slowed to just a revised 1.3%. The ISM Manufacturing Index had been below 50 (signaling contraction) for three of the last four months. We had also seen recent negative core retail sales and durable good orders as well as tumbling industrial production. Overall, the economic data from the US has been deteriorating the last few months, but they are still in a slow growth mode.

In previous missives we have emphasized that an enduring recovery would be all about jobs, and the US employment picture continues to be soft. A compelling chart on the following page depicts the index of the employment subcomponents of the Chicago Fed National Activity Index, Chicago ISM, several Fed regional manufacturing indices, ISM surveys and the NFIB small business report. A reading below 20 has historically flagged a recession warning.




*Source: StreetTalkLive.com*

Simultaneously, the world continued its focus on the problems in Europe. The unemployment rate of 11.4% for the Eurozone as a whole is much higher than North America at 7.8%. For specific Eurozone members, that number gets much worse: Spain and Greece are at 25.1% and France is at 10.6% according to their latest reports. GDP growth in Europe is also much slower (actually contracting as a whole), with several countries already in recession. The UK has now had three quarters of negative GDP despite the economic spinoff benefits of hosting the summer Olympics. Even Germany, the economic engine of the Eurozone, posted GDP growth of just 0.3% in the second quarter.

Add to this the ongoing debt problems in Greece, Spain, Italy and Portugal. For these countries, the debt markets are very skittish with bond investors of the world demanding higher and higher interest rates to compensate them for the risk associated with lending to these governments. The 10-year government bond yields in Spain and Italy have oscillated between 5% and 7% for almost two years. The 10-year government bond yield in Portugal has been above 10% for an extended period of time and only recently has it dipped below that level whereas Greece is at 17.5%. For context, a 6% or higher cost of borrowing is generally considered the line in the sand demarking whether a country is headed for trouble or not.

On July 26, 2012 Mario Draghi, the President of the European Central Bank struck first. Confidently, he announced the ECB would “do whatever it takes to preserve the Euro”. Although lacking details on the measures that would be undertaken, the markets reacted euphorically to this news. Subsequently, he expanded on this by committing to buying up bonds of struggling countries, essentially lending money to these governments at much lower interest rates than the bond market was demanding.

Then on September 13, 2012 Ben Bernanke, head of the US Federal Reserve, made an announcement that surprised the markets. Rather than just announcing another round of bond buying known as Quantitative Easing (QE), he went a step further by keeping it open-ended. The US Fed will essentially commit to as much as $40Billion per month in QE for as long as it takes to get unemployment down, so long as inflation stays under control. This was a blockbuster announcement, leading us to conclude that all the Fed's chips are now on the table. They are running out of tools in their toolbox for stimulating this economy.

***In Defense of Central Banks…?:***

Periodically we have written that we believe the world to be in a long deleveraging process from the massive debt build up that peaked in 2007. Many had a hand in this from the consumer that spent the equity in their home, to eye watering, debt-driven, corporate takeovers, and to governments that ran significant budget deficits in a time where surpluses should have been the order of the day. Debt itself isn't necessarily a bad thing when used to finance a significant project or large purchase by spreading the cost over a number of years. However, when your borrowing costs begin to exceed your income, wages in the case of a consumer and GDP in the case of a country, it becomes a slippery slope towards the dark side.

Many people have been highly critical of central bank response to the debt crisis that began in 2008. They believe that printing money is akin to ruining and debasing a currency. Where there are several historical cases where this has been proven out, it isn't always the case. In fact, money printing is a fairly typical, although not a palatable, response to periods like the one in which we find ourselves.

The reason is that the money supply of a country is defined as currency plus debt. In other words, as debt around the world was increasing for many years, so was the money supply. A simple example is a person who buys a new vehicle for $50,000 with no money down. In effect, that person has printed $50,000 in new money, with no help from Ben Bernanke or Mario Draghi. By extension then, paying off debt reduces the money supply.

If you recall the first half of the 2000s in the US, as home prices were increasing rapidly, many American consumers were able to refinance their homes (increase their mortgage) and use that newly printed cash to spend on other consumer items. This led to a steady increase in the money supply in the US without any Fed intervention. The result was a slowly falling US dollar; the Canadian dollar slowly crept up from $.69 in January 2000 to well over parity by mid-2007. The Euro was at $.97 to the US dollar in January 2000 and slowly increased to $1.60 by mid-2008. Since the debt crisis erupted, the US Federal Reserve has increased its balance sheet by an immense $2 Trillion dollars and yet the US dollar has been essentially going sideways since then (very volatile, but more or less flat to the C$ and actually has gone up against the Euro).

How can this be? Doesn't money printing debase a currency? The truth is that the money supply in the US has not been growing post-2008 the way it did pre-2008. The US Federal Reserve is just trying to keep the money supply from shrinking as more individuals and corporations do their best to 'clean up their balance sheets' by paying down debt (or defaulting).

So are we defending central bankers? Yes and no. It is true that left unchecked, money printing can have very negative long-term consequences which makes this process very tricky over the coming years. Loose monetary policy can be good for stimulating an economy when needed during a typical business cycle. However, left for too long, this can over-stimulate an economy and lead to much higher levels of inflation.

What we need now is a more proactive fiscal policy response. Whereas monetary policy is the responsibility of the central bank, fiscal policy (taxes and spending) is the responsibility of the politicians. Both Mario Draghi and Ben Bernanke have spoken out recently expressing that they can only do so much. The politicians need to step up with effective fiscal policy to improve the economy by getting small businesses to invest capital and hire again and get deficits under control.

In the US, this has proven difficult due to bipartisanship. Hopefully, the US election in November can help to alleviate this and get the government back to a place of ‘getting something done’. Europe is a more complex situation: at least the US has one federal government for 50 states. The Eurozone has 17 different governments sharing a currency and trade union. They have only been sharing a currency for a dozen years, but there are centuries of very different cultures and governing policies entrenched that make it difficult to achieve a sufficient level of political cooperation to enact the kind of fiscal policy and structural changes that Europe needs to get through this.

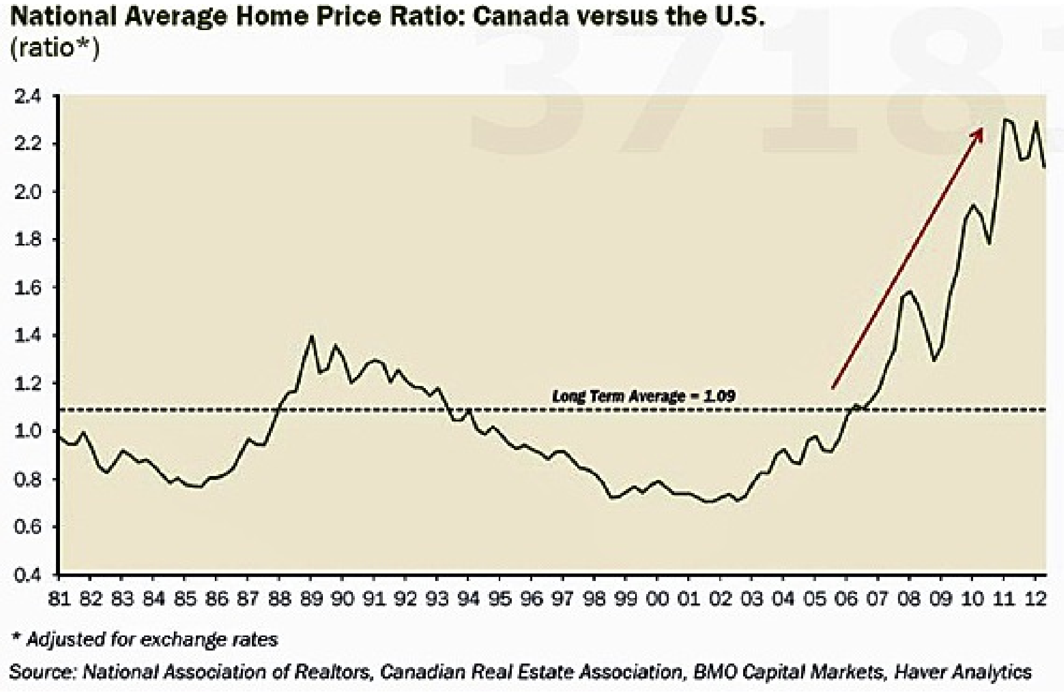
## ***Real Estate:***

Closer to home, much has been made in the media about the ‘bubble’ in Canadian real estate. Unfortunately, a lot of the talk centers on Toronto and Vancouver whereas Canada is much too geographically and economically diverse to be viewed that homogeneously. We would like to contrast three residential real estate markets: the United States, Canada and Calgary. While these three markets have many similarities, the divergences have become very pronounced.

The US housing price meltdown has been widely publicized. The broadest and most followed measure is called the Case-Shiller 20-City Home Price Index. On a seasonally adjusted basis, this index topped out in April 2006 and declined not only during the 2008/2009 Great Recession, but continued falling afterwards as well. By the most recent bottom recorded in January 2012 (but no one can be sure if it has actually bottomed yet), the average house price across these 20 cities had declined by 34%. Since then, this index has posted six consecutive months of rising prices which, by some accounts, is the beginning of a new long-term uptrend.

In Canada, we have had a much different story, a story that has garnered much attention from politicians as well as economists in Canada and abroad. Across Canada, prices did drop in the 2008/09 recession, however it was much shallower. Almost as soon as the recession ended, Canadians went shopping again, lured by historically low interest rates and encouraged by how well our banking system and economy had held up in the recession (relative to other developed countries). Add to this the emergence of foreign buying interest in the major markets of Toronto and Vancouver and before long prices had surpassed their pre-recession peaks.

Below is an interesting chart of the home price ratio of Canada versus the US. Note that historically the average home prices had been close to parity but Canada is now north of two times higher. There is no doubt that Toronto and Vancouver are large parts of this disparity, with recent ratios as high as three and four times respectively. However, the overall Canadian market is still richly valued compared to the US from this long-term average price perspective.




The Canadian government, concerned about the increase in home values as well as record levels of household debt, has enacted a total of four rounds of increased regulation on the housing market. It is far too early to tell, but early indications are that some of the froth has come out of the market in these cities. Sales volumes there have decreased dramatically from a year earlier and prices look to have been easing back as well.

If we take a closer look at the Calgary market, we see a bit of a different picture emerging than either the US or the rest of Canada. The Calgary housing market peaked out sixty-two months ago in July 2007. The market had become quite expensive on many metrics commonly used to compare values between cities and countries (price of a house vs. rental income earned on that house; average house price vs. average household income). Prices began to fall before the recession hit, but certainly the global recession accelerated the decline. By the end of the recession in mid-2009, prices for single family dwellings (SFD) had declined about 15%. There was a bit of a recovery and then the market essentially went flat for a couple of years. Recently however, activity has been picking up and prices for SFD's in May of 2012 came within one percent of the all-time peak in July 2007. As of September, the average price for SFD's in Calgary is down 7.4% from the peak over five years ago.

The upshot of this is that during this time, Calgary seems to have worked off a lot of its over-valuation. Our local economy is doing pretty well although not like the heady pre-recession days. The median household income in Calgary is approximately $90,000, well above the $70,000 average income in Canada. Secondly, residential rental rates have slowly crept up while housing prices have been roughly flat, greatly improving price to rent ratios. This is encouraging news for landlords that previously found their margins compressed when tenants vacated to become aspiring homeowners. Thirdly, interest rates on mortgages are much lower now than they were in the spring of 2007 (roughly 5% on a five year fixed mortgage then vs. roughly 3% today), again reinforcing more affordability compared with 2007. Lastly, the population of Calgary continues to increase, which lends some demographic support to housing prices. The population in 2007 was 1,020,000 and in 2012 it is 1,120,000, representing a 9.8% increase.

To summarize our take on the real estate market, we would have to agree that in the major centers like Toronto and Vancouver, the real estate market appears to be over-valued and due for a correction. In the United States, prices would appear to represent good value, although trying to pick a bottom can be very difficult as they continue to deal with a huge backlog in foreclosed homes. In Calgary, we certainly wouldn't consider homes cheap, but at least we seem to be in the more reasonably priced category. This should give Calgarians a bit more comfort with the rash of news reports of a housing bubble in Canada.

***The Markets & Our Strategy:***

Below is the price performance summary of global equity and North American bond markets up to September 30th, 2012.

**Equity Markets**

| Canada | Level | Wkly Chg (%) | YTD | YTD C$ |
|---|---|---|---|---|
| S&P/TSX Composite | 12317 | -0.5% | 3.0% | 3.0% |
| S&P/TSX 60 | 703 | -0.5% | 3.2% | 3.2% |
| S&P/TSX Small Cap | 601 | -2.1% | -2.3% | -2.3% |
| **US** | **Level** | **Wkly Chg (%)** | **YTD** | **YTD C$** |
| Dow Jones | 13437 | -1.0% | 10.0% | 5.9% |
| S&P 500 | 1441 | -1.3% | 14.6% | 10.3% |
| Nasdaq | 3116 | -2.0% | 19.6% | 15.2% |
| Russell 2000 | 837 | -2.1% | 13.0% | 8.9% |
| **International** | **Level** | **Wkly Chg (%)** | **YTD** | **YTD C$** |
| DAX | 7216 | -3.2% | 22.3% | 16.9% |
| FTSE 100 | 5742 | -1.9% | 3.0% | 3.2% |
| Nikkei | 8870 | -2.6% | 4.9% | -0.5% |
| MSCI EAFE | 1511 | -2.9% | 7.0% | 3.0% |
| MSCI World | 1312 | -2.0% | 10.9% | 6.8% |
| MSCI EM | 1003 | -0.4% | 9.4% | 5.4% |

**Fixed Income**

| Indices / Rates | Level | Wkly Chg (%) | YTD |
|---|---|---|---|
| DEX Universe Bond | 891 | 0.6% | 3.3% |
| DEX Real Return Bond | 539 | 0.9% | 2.8% |
| Mer Lynch US High Yield Master II | 922 | -0.6% | 12.0% |
| LIBOR 3-month | 0.3585% | -2.9% | -38.3% |
| **Government Bond Yields** | **3-mo T-bill** | **10-yr Bond** | **30-yr Bond** |
| Canada | 0.98 | 1.728 | 2.319 |
| US | 0.08 | 1.634 | 2.824 |
| Spread | 0.90 | 0.094 | -0.505 |

*Source: TD Asset Management*

The third quarter produced strong results across most equity markets around the world. We continue to see the US equity market outpace both our market and most other developed global markets. If you look at the MSCI EAFE index (Europe, Asia, Far East), it is right in line with our

TSX Composite, but far behind the double digit returns of the S&P500 this year. This is a continuation of last year, where the TSX Composite was down 11% and the S&P500 was up slightly. It is difficult to attribute this disparity to strong economic growth in the US as one could argue that the Canadian economy has been stronger in general.

There are many upcoming important events for the US, including their election and issues surrounding their “Fiscal Cliff”. We will be watching closely and hopeful we see stabilization of their economy and that fiscal policies will be enacted to improve growth going forward. We are also very attentive to the situation in Europe and the unintended consequences that come as a result. Until then, our strategy for many quarters now, being one of safety and income at a reasonable price (‘SIRP’), a term coined by economist David Rosenberg, will continue. Within this framework, we do see some good pockets of opportunity and continue to exploit them. We believe this strategy to be the most prudent one in the current market environment.

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

Respectfully,

- **Your Milestone Team**