April 24, 2013

Experimentation & Interesting Times Ahead

Bottom Line:

Despite continuing concerns over a weak global economy, ongoing structural issues in Europe and US budget uncertainty (debt ceiling & sequestration), the global stock market had one of its best quarterly gains in many years. The most influential factor in this was the very strong first quarter performances from the US and Japanese stock markets. To maintain momentum we continue to see asset purchases from the US Federal Reserve, the European Central Bank, the Bank of England and more recently the Bank of Japan. Japan has been in the headlines with its unprecedented stimulus targeted to reverse the course of a long entrenched pattern of deflation. The word "unprecedented" has received a lot of ink in our past missives, but the bounds of economics have ventured in to the realm of experimental. We have also witnessed increased political uncertainty in the Eurozone with a hung parliament election in Italy, followed by the highly publicized bailout and cash confiscation in Cyprus.

Although we have seen some strong equity returns in parts of the world this past quarter, we are also encountering many investor sentiment measures (often a contrarian indicator) near or surpassing all-time highs. Although our short-term positive stance remains in place, we see the amber caution light blinking. We have seen some economic improvement in the US, but overall global economic weakness remains front and center.

Economic Overview:

There continues to be a growing disparity between Canada and much of the rest of the developed world. The TSX Composite index was up 2.5% on the first quarter, but sunk underwater by early April. In fact, the TSX has been treading water with the 12,000 mark for over three years now. It finished December 31, 2009 at roughly 11,750 and at current is just above 12,000. The more aggressive TSX Venture Exchange has performed very poorly – down steeply last year and again in the first quarter of 2013. Even our Loonie has come under pressure this year, falling below par with the US greenback.

Canada's economy is in fair shape with GDP growth hovering within an annualized range of 1.5% to 2.0%. When comparing our economy with the likes of the US, UK, Europe and Japan, we have a lot to feel good about. The US is posting slightly better GDP growth than us, but the rest of those countries are doing their best to just avoid or dig themselves out of a recession. Over the calendar year of 2012, GDP fell by 0.5% across the euro area. Canada's employment situation is quietly improving. One could argue that our unemployment level of 7.2% is significantly better than the US number of 7.6%. There are so many US residents that have simply stopped looking for work and thus have dropped out of the calculation for unemployment statistics. The number of people not in the labor force soared by 663,000 to a record 90 million Americans who are simply no longer looking for work. This brings the US labor force participation rate down to 63.3%, the lowest since 1979. The unemployment level in Euro area is considerably worse, currently sitting at 12%.

We know that Canadian banks are in much better shape as was proven through the financial crisis of 2008/2009. During the crisis, very large banks in the US and Europe required government bailouts whereas Canadian banks were able to withstand the liquidity crunch.

Lastly, we have a government that is running a small and declining budget deficit, with a goal of eliminating that deficit in the next two or three years. Several other developed nations are having a very difficult time getting their budget deficits under control, much less getting them eliminated. In terms of government debt, we are in pretty good standing as well at roughly 85% debt/GDP compared with 102% debt/GDP for the US and 212% for Japan. Canada continues to be one of the healthiest economies globally with a strong financial and fiscal situation.

So in terms of a country, we have a lot of be proud of. Why then is our stock market and currency lagging? Certainly being a commodity driven economy has been a factor. But we need to recognize another factor: Canada has resisted the temptation to participate in aggressive monetary stimulus (aka Quantitative Easing or QE). The other major countries mentioned have embarked on QE programs since the financial crisis and they are continuing today at the same pace, or in some cases an accelerated pace. The belief is that all the extra money adds liquidity to the financial system, acting as a stimulant for the economy. In past commentaries we have defended this belief and we continue to do so – we believe that the rather weak recovery out of the 2008/2009 recession would have been much weaker if it weren't for this stimulus.

However, we also believe that it isn't a great long-term strategy. There are consequences to the accommodative policies of central banks around the world. This level of money printing is truly an extraordinary occurrence and is very much indicative of the weak situation that the economies of the major developed countries find themselves in. Canada, on the other hand, may not be posting big growth numbers in our economy, stock market or currency, but we are standing on our own two feet without the help of artificial stimulus from our central bank, and without a government running a massive budget deficit.

<u>Japan's Abenomics:</u>

In our January commentary, we talked about the turnaround we believed was beginning in Japan. The new prime minister of Japan, Shinzo Abe, had promised an aggressive fiscal and monetary stimulus program with the goal of finally kick starting their economy and pushing down the value of the yen to make their exports more competitive. What has followed since January has been truly remarkable. The Bank of Japan Governor Kuroda has announced a QE plan for the next two years much greater than even the QE plan the US has in place. They plan to ‘print’ approximately 75% of the money that the US is ‘printing’, on an economy only roughly one third the size of the US.

During the first quarter of 2013, the value of the yen has dropped approximately 9% to the US dollar. Meanwhile, the Nikkei stock market increased by roughly 18% on the hopes that these bold, but very experimental policies will actually jolt the Japanese economy back to life.

As alluded to above, there are big risks to a strategy like this. However, Japan is facing a ‘do or die’ situation. Their economy has been stuck in neutral for many years and their housing market and stock market have been in a slow decline since 1989. The Japanese government debt is now well over 200% of GDP (generally governments get very nervous at 90 – 100%). So Japan, akin to a gambler, has “doubled down” and is “all in” on this bet, intent not to be the first to blink. It will be interesting to watch this experiment of epic proportions. The neighboring Chinese are known for the proverb, “May you live in interesting times”. Often treated as both a blessing and a curse, we are hopeful that the former trumps the latter.

<u>Gold loses its glitter:</u>

A major story over the first few months of 2013, and especially just recently, has been the price of gold. We have never been ‘gold bugs’. There are many people out there that believe gold is still going to $5,000/oz but we have never been in that camp. What we do believe is that gold is more of a currency than a commodity. As such, in this environment of central banks actively devaluing their currencies, we continue to like the concept of holding a small part of a portfolio in gold.

At the moment, much of the financial world is in a ‘risk on’ mode. The financial markets have taken a relaxed, almost complacent, attitude towards risk, feeling that the globe is in a much better state. In turn, investors lose interest in hedge assets like gold.

If we look past the short-term weakness in the price of gold, we feel that it is still sensible to have a small exposure to gold bullion. Historically, when financial markets change from their happy mood, it usually happens very quickly and without much warning. It therefore behooves investors to have a proactive hedge in place rather than react to events when they unfold.

The Markets & Our Strategy:

The US Equity markets posted double digit gains in the first quarter, with the Dow enjoying its best Q1 performance in fifteen years while the S&P500 had its best quarter in a year. Both the Dow and the S&P500 surpassed their 2007 all-time highs. The US equity markets remain the lone wolf to reach that feat. The Nikkei also continues to soar of late, primarily on the back of aforementioned stimulus measures, with an 18.7% return (11.5% in Cdn$) on the quarter. The big gains mostly stop there however, with the MSCI Europe (US$) only posting a 2.05% gain and our TSX Composite up 2.54%. Of note, the TSX Composite is still 19% below its all-time price peak in June 2008.

Equity Markets				
Canada	**Level**	**Wkly Chg (%)**	**YTD**	**YTD C$**
S&P/TSX Composite	12750	-0.1%	2.5%	2.5%
S&P/TSX 60	731	-0.2%	2.5%	2.5%
S&P/TSX Small Cap	585	-0.7%	-0.1%	-0.1%
US	**Level**	**Wkly Chg (%)**	**YTD**	**YTD C$**
Dow Jones	14579	0.5%	11.3%	13.9%
S&P 500	1569	0.8%	10.0%	12.7%
Nasdaq	3268	0.7%	8.2%	10.8%
Russell 2000	952	0.6%	12.0%	14.7%
International	**Level**	**Wkly Chg (%)**	**YTD**	**YTD C$**
DAX	7795	-1.5%	2.4%	1.9%
FTSE 100	6412	0.3%	8.7%	4.2%
Nikkei	12336	0.0%	18.7%	11.5%
MSCI EAFE	1675	-0.7%	4.4%	6.9%
MSCI World	1435	0.2%	7.2%	9.8%
MSCI EM	1033	1.7%	-2.1%	0.2%

Fixed Income			
Indices / Rates	**Level**	**Wkly Chg (%)**	**YTD**
DEX Universe Bond	900	0.2%	0.7%
DEX Real Return Bond	530	0.6%	-1.8%
Mer Lynch US High Yield Master II	979	0.1%	2.9%
LIBOR 3-month	0.2826%	-0.7%	-7.6%
Government Bond Yields	**3-mo T-bill**	**10-yr Bond**	**30-yr Bond**
Canada	0.98	1.872	2.5
US	0.06	1.85	3.103
Spread	0.92	0.022	-0.603

Source: TD Asset Management as of March 31 2013

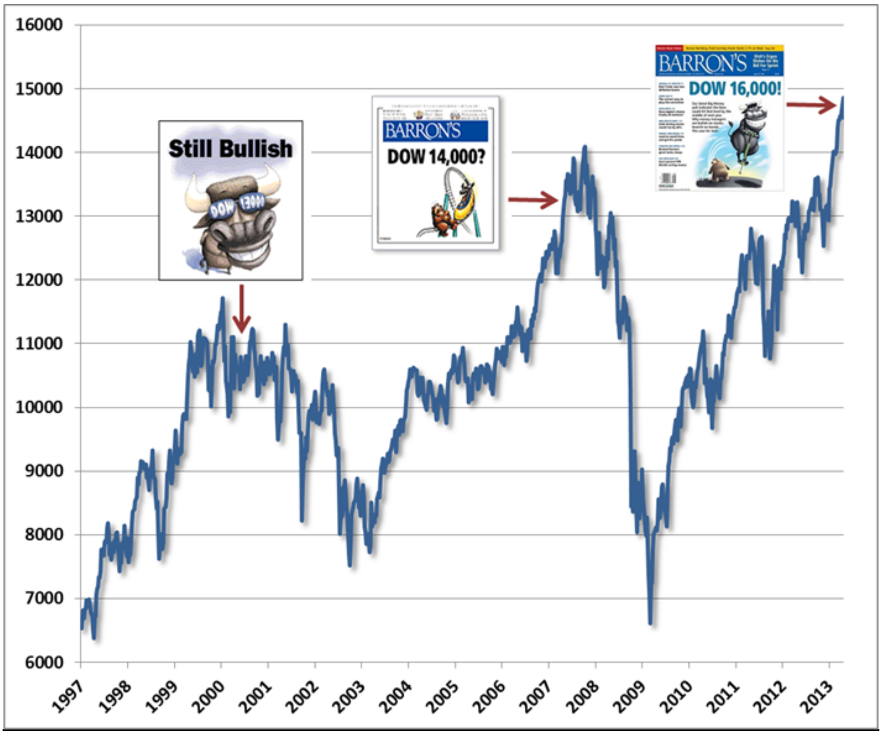
The Canadian bond market had a respectable 0.7% return while we continue to see high yield spreads* in the US pushing near new lows as investors search for income.

On the currency front, our Canadian dollar lost 2.5% against the US dollar while the Euro lost close to 3%. The biggest currency move we saw this past quarter was the Yen falling close to 9% against the US dollar.

In commodities, Gold was down close to 5%, however, more recently we have witnessed a monumental drop in the price of bullion. We normally try to stick to comments about the past quarter, but it is worthwhile in this case to highlight the fact that on April 15th gold suffered its largest one-day dollar drop since January 1980 and the second largest in its history. Moving the other direction, we saw the price of oil climb close to 6% on the quarter.

* Yield spreads refer to the additional interest rate received on a high yield corporate bond (aka “junk bond”) over short term US treasury bills. Low spreads infer complacency towards macroeconomic risk.

To add a bit of humorous perspective to where the US stock market is sitting, this chart shows the covers of a major financial magazine at various junctures in the past. The humor comes from this quote from well-known fund manager and market strategist John Hussman: "Rule o' Thumb: When the cover of a major financial magazine features a cartoon of a bull leaping through the air on a pogo stick, it's probably about time to cash in the chips."



Source: John Hussman, Hussman Funds, www.hussmanfunds.com

In terms of investment strategy, we continue to approach our portfolios with a 'SIRP' mindset (a term coined by economist David Rosenberg which stands for 'safety and income at a reasonable price'). This is mostly a repeat from past commentaries. We still prefer to invest in good preferred shares yielding between 4% and 6% from companies like Artis REIT, Enbridge, Brookfield and Bell Alliant. We also continue to favor the investment characteristics of Canadian corporate convertible debentures yielding between 5% and 7% - some of our favorites being Western One Equity 8.0%, Chemtrade Logistics 6.0%, Exchange Income Corp 5.75%, and Artis REIT 6%. In the equity side of the portfolio, we continue to own REITs like Pure Industrial REIT and have recently acquired two other names. We also continue to like solid dividend paying stocks like BCE, Enbridge, Atco, Arc Resources and Constellation Software.

We believe income to be a crucial part of total return in this environment, and we continue to focus on capital preservation and risk-adjusted returns. Last quarter we discussed one particular theme of beginning to add to Japanese equities (currency hedged). We believe this strategy is still worthy of pursuing, although with its recent jump we are likely to see a short term pull back near term.

Our economic and investment research never stops, and we strive to stay at the forefront in this area to ensure our clients are well educated and well informed. It is our promise to continue this hard work and together we can navigate through these most interesting times.

Respectfully - **Your Milestone Team**