Investment Commentary

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Contact Us

Stonebrooke Asset Management Ltd.

WaterPark Place
20 Bay Street
Suite 1205
Toronto, Ontario
M5J 2N8
Tel: 416-850-2172
Email:
info@stonebrooke.ca

Summary - 2007

2007 was a volatile year in the financial markets. Returns were again greatest outside of North America, specifically in the emerging and developing markets. In Canada the S&P/TSX index managed to gain 9.8%, while in the U.S. the S&P 500 index advanced by a modest 5.4%, (-10.5% in Cdn funds).

The Canadian dollar exploded upwards vis-à-vis the U.S. reaching a high of almost 1.10. It ended the year back down at 1.02 a remarkable16% gain for the year.

Commodity prices again made headlines. Oil closed at $96.00 U.S., up from $61.05 at the start of the year. Metal prices; copper, nickel, and zinc; and grain prices such as corn and wheat all advanced higher over the year. Gold bullion closed up at $833.00 in U.S. dollars.

It was a meager year for the bond markets. The Scotia Capital Universe index which serves as a broad measure for Canadian bonds posted a return of just 3.7%, as interest rates were almost unchanged.

The *R* Word

Suddenly there is a considerable amount of debate about a possible U.S. recession this year. David Rosenberg, chief economist at Merrill Lynch is certain in his views; placing the odds at 100% in 2008, and even suggesting a recession may have already begun. The stock market appears to agree as it has been very turbulent since the start of the year. The problems in the U.S. banking sector are getting worse as bad loans spread beyond the subprime mortgage area. The holiday retail sales picture has not provided comfort as final sales are estimated to be below last year's figures. A slowdown in the U.S. is definitely in progress. A recession is a strong possibility.

The coming U.S. recession/slowdown will likely spread to Canada and elsewhere in the world. As significant trading partners, Asia and Europe rely on the U.S. for their export growth. Exports to the U.S. are a very significant component of our economy. It will be impossible to escape the fallout

Decoupling Theory

The financial markets have been firmly holding to the view that if the U.S. economy falters at least the rest of the world, where growth is quite strong, can support the global economy. This is known as the "*decoupling theory*". In other words the world doesn't need the U.S. to keep on growing. With the start of the New Year, financial markets around the world are showing no signs of decoupling. All are declining in a coordinated fashion.

Fred Smith, chief executive of Federal Express is certainly not a believer. Quoting Smith, *"Growth elsewhere helps cushion the shock but nothing can displace a slowdown in the U.S. I don't care how optimistic people are about China or anything else; the U.S. is still 25% of the world's economic activity so when it slows down it is going to have an effect."* According to Stephen Roach, chief economist of Morgan Stanley in Asia, *"American consumers spent close to $9.5 trillion over the last year. Chinese consumers spent around $1 trillion and Indians spent $650 billion. It is almost mathematically impossible for China and India to offset a pullback in American consumption."*

Proponents of the decoupling theory are convinced that a downturn in the U.S. will not have a big global impact and the U.S. will still be able to thrive with a stronger export trade and a strong and growing presence in foreign markets. A boom in U.S. exports will help but is unlikely to make much difference.

Exports account for only about 10% of US GDP. Also, many industries have already outsourced production overseas and therefore the manufacturing base in the U.S. is severely depleted.

Trade is intertwined and cannot be easily dislodged and quickly replaced by new growth in domestic or other markets. Command economies such as China are probably better equipped to deal with sudden change as they redirect their efforts to encourage domestic spending. It will not, however, happen overnight. We expect the wishful thinking to be replaced by the hard reality that the huge appetite for growth in China and India will at best only cushion a U.S. economy headed for recession.

This brings into question the outlook for the U.S. dollar and its safe haven status. During past global downturns, foreign capital in predominately private hands from countries with free and convertible currency regimes would place their money in the U.S. Today, foreign capital is already in U.S. dollars, having accumulated after years of rising U.S. trade deficits. Sovereign Wealth Funds are an example of how quickly the dollars have accumulated.

The U.S economy is weakened by the ongoing mess in the investment banking sector. A U.S. recession cannot possibly be good news for the currency if investment dollars can find other more financially attractive areas of the globe to invest. On a relative basis the longer-term economic potential of a still very vibrant Asia will attract investment at the expense of a deteriorating and debt-ridden U.S.

economy.

Many are now voicing concerns that the U.S. may spiral into a period of deflation much like what happened in Japan after their “bust” in the early 1990’s. The experience in Japan was unique. They had two bubbles implode at the same time – a stock market and a property bubble. Arguably, the U.S. has at least separated their asset bubbles. Stock prices peaked back in 2000, and then not all industry sectors reached record levels. The U.S. can now concentrate on limiting the damages of its real estate bubble. It will not be easy but a deflation on the scale of what occurred in Japan is not realistic.

The good news is that U.S. authorities are moving at break-neck speed in an attempt to fix the problems. This proactive surge on the part of the U.S. Treasury, the Fed and the White House is actually quite astonishing. They are motivated to act and probably capable of fixing what is wrong to some degree and in calming markets. That doesn’t mean we can sound the all clear. It just means that *a major plunge* in the economy and financial markets is less likely.

Bank Bailout

The U.S. banking sector overstretched with many investment banks leveraging $1 of capital to support $30 of loans. The loans and/or securities held carried all kinds of exotic structures. It was a house of cards.

The foreign bail-out of U.S. investment bankers is on a scale that is truly historical. China Investment Corp. has agreed to buy 10% of Morgan Stanley. Citigroup needed to sell a 5% stake to Abu Dhabi and Merrill Lynch is seeking equity funding for up to 10%.

Like private equity and hedge funds before them, Sovereign Wealth Funds are now viewed with great optimism. Not only have they arrived to bail out the U.S. banking sector, their massive pile of U.S. dollars may even shore up the entire stock market.

The fact they have plenty of U.S. dollars to spend is certainly true, and so is their desire to invest for a higher return. The investments they have made so far in the troubled U.S. banks will earn them handsome returns (the Citigroup deal yields 11%). But with an already high concentration of U.S. dollars they will also look to diversify into other currencies and countries. Overall, their effect on either the U.S. stock market or the U.S. dollar may not be advantageous.

For the U.S. banking industry the recent fallout will mean that over the next few years they will have to sell assets and raise capital to repair their balance sheets. In addition, it is estimated at least $1 trillion *of hidden assets* held in “special purpose entities” must come back onto their balance sheets. Banks will need to raise even more capital to cover these assets and prepare for more losses - or else seek regulatory help.

The Federal Reserve can be counted on to continue reducing interest rates and provide liquidity to stabilize the financial sector. While we do not know how deep the problems are, we do know that with their need for capital the banks cannot possibly provide the same volume of lending to the economy as in the past. A decline in credit growth is therefore assured and will be a big factor in slowing the economy. Arguably, mortgage lending, the major borrowing activity in the past five years, is no longer the growth business it was.

The U.S. economy is weakening and inflation is rising. The Chairman of the Federal Reserve, Ben Bernanke, faces a real dilemma. He must somehow lower interest rates, guard against inflation and protect the dollar. The screams to do something are deafening from the media, the bankers, and especially the politicians in this heated election year. Even French President Nicolas Sarkosy has weighed in. On a recent trip to the U.S. he warned Congress by saying, "*The dollar can't remain someone else's problem. If we aren't careful, monetary disarray could morph into economic war. We would all be victims."* We do not envy Ben.

Valuations

Long-term performance in stocks ***is a function of valuations***. To quote Benjamin Graham, considered the father of modern finance, *"In the short-term the market is a voting machine. In the long term it is a weighing machine."* By weight he meant valuation. The long term bull market that started in 1982 owes most of its performance to a rise in valuation levels as investors increased the amount they were willing to pay for corporate earnings. This is expressed in the average P/E ratio (stock price divided by earnings), having risen from under ten times earnings to over thirty times. Given that today's valuations are still at the upper range of historical observation, it cannot be said that investors are buying companies at bargain basement prices. This is not to say that stocks are bad investments. Anything can happen in the short-term and stocks have been known to stay expensive for long periods of time.

Understanding valuation is important as most investors look at markets in isolation without any points of reference. Even the majority of investment professionals managing large pools of money are susceptible since they utilize a relative investment management approach. This means that most will ride the markets up and down and only tinker at the margins. These funds are too big and the peer pressures to perform are too great for much deviation from the standard indices used to measure stock performance. A relative value investment style is fine as long as the stock market follows along on an upward positive trend. However, this is more likely to happen when valuations are low. In today's more richly valued environment, in part because interest rates are so low, the chances of long-term success using a relative approach is greatly reduced.

Our approach in this market environment is to keep traditional stock positions closer to minimum levels and to have a higher exposure in gold stocks. The simple logic in this is that stocks as financial instruments are still highly desired and therefore on the expensive side. Gold is still relatively unknown and as a hard physical asset is in short supply. The public is barely aware of the ongoing rise in the price of Gold. They are not in the market. From our point of view, the preferred investments are those in areas that are relatively under-owned.

Equity Strategy

It was a difficult year to make any meaningful gains in North American markets. The two major industry groups on the Toronto stock exchange, Energy and Financials, had disappointing results. To make any significant returns last year, portfolios would have had to own one or two of the companies that received "take-over bids", be skewed to the developing markets, or have taken higher risks investing in the small group of "hot" technology stocks like Apple, Google or Rim.

Average returns in the U.S. stock market were negative in Canadian dollar terms as our Loonie appreciated by about 16%. From an investment point of view it was best to stay home and not cross the border.

Looking beyond the current ominous headlines, there will be some opportunities to pick up good quality companies at reduced prices. Investors are concerned and are in one of those moods when good news is not rewarded and bad news is dealt with swiftly and painfully. On a selected basis, we will be buying when prices fall. Valuations will be more attractive as companies' trade closer to their book values and at more reasonable price to sales ratios. Balance sheet soundness is also an important consideration and we will be seeking those firms with the financial strength that can manage any slowdown effectively.

Over the longer term it will be absolutely necessary to invest in companies whose fortunes are tied to the Asian growth story. The most obvious is the commodity producers, even though this sector is plagued with a history of cyclicality that can at times be unnerving. Should the prices of oil and base metals stay relatively firm in 2008, the recovery cycle could be absolutely breathtaking as investors adjust their thinking and recognize that profitability in the resources sector is sustainable. The adjustment in valuations could potentially give these companies the appeal of growth stocks. This is simple economics 101. If the earnings are solid and a company can grow for a long period of time with reliable profit margins, investors will not hesitate to pay up.

The Chinese market itself is alluring yet valuations, even after the recent decline of 25% in the Shanghai index, are still too high for our liking. To buy requires a certain leap of faith. China is an important emerging economy with a phenomenal growth rate. The transition towards a full market economy is proceeding and Beijing is committed to expanding capital markets and the role of the stock exchange. It is preparing to allow more state-owned companies to go public and to allow greater access to foreign firms. At some stage this year it will be worth the risk to step in and put a toe in the water.

The price of Gold bullion is rising strongly. As interest rates are lowered Gold will continue to strengthen. The mining stocks should also rise in tandem, although being financial assets they are still vulnerable in any major stock market sell-off. Ultimately, Gold stocks will be valued on the basis of proven and probable reserves in the ground. Over time the share prices should follow the price of Gold bullion higher.

We are not forecasting a certain peak price level for Gold bullion. To do so requires either some knowledge that the global monetary regime will change and give Gold a role to play or the willingness to speculate on the final outcome of the forces of supply and demand.

We do know that the current price rise has been a lot less volatile when compared to 1980, the prior peak in Gold. At that time Gold spiked quickly above $800 US for all of two days. It declined fairly quickly as well and never had a monthly close over the $800 level. In contrast, today the price of Gold is firm and gives the appearance of being under relatively steady accumulation. We believe the ultimate peak in Gold is still many years away.

We are looking with more interest at the Canadian banks. On the whole they have not experienced any severe loan problems. They were not as aggressive as their U.S. counterparts in the mortgage market. Their balance sheets appear to be in reasonable shape and they offer attractive dividend yields. Still, there is less transparency than we are comfortable with. With the current instability in the markets we would rather wait and see their financial results over the next quarter or two to be on the safe side.

Overall, we suspect the rot in the U.S. financial services sector will continue to unnerve investors around the world. It is best to stay with a defensive strategy until markets provide better values and/or after the global economy weathers some of the storm clouds on the horizon. This means having lower portfolio exposures to the stock market.

Volatility is providing opportunities for those that are trading oriented. It is ridiculous to trade for the sake of trading, but to trade around some core positions is a sound tactical strategy and can help to manage risk effectively. We will be looking to do so if the opportunities are compelling and then only with smaller amounts of capital at any one time. We expect continued bursts of volatility throughout 2008 as financial markets toss and turn and exaggerate both positive and negative short-term news events. It should be an eventful year and it will be important not to get caught up in the emotions and to make sure portfolio capital is protected.