June 30, 2009

Less Bad Equals a Whole Lot Better

Investors have been on a long bumpy journey over the past two years as the world's financial markets experienced their worst storm since the great depression. At times this crisis was overwhelming with projections of no end in sight. Fear of continued capital depreciation fueled more fear resulting in further asset depreciation. Fear feeding on itself.

The dust has now settled and calls for an end to this severe recession are surfacing. A rally in March was extended into this quarter with significant rebounds occurring in equity markets worldwide. Was this a vote of confidence that the world's economies have bottomed out or simply smart money feeding on oversold security valuations?

We believe it was both. From an economic standpoint, we are not out of the woods by any stretch of the imagination. The "good news" however, is that "bad news" is less severe. Economies are still shrinking; however they are falling at a rate of decline much lower than a few months ago. Economic forecasts have been nudged upward lately suggesting that the end of the recession is in sight. While this is gratifying news, we expect a rather slow recovery stretching well into 2010.

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Business inventories play an important role in an economic cycle. Over the past year businesses have been burning off existing inventories, and in due course these inventories need to be "restocked" to satisfy consumer appetite – when it returns. The U.S. consumer is a key contributing component of economic recovery, and they continue to labour under the weight of debt, poor housing prices, and significant layoffs. Consumer confidence has improved, however a move back to the abundance of leveraged spending by consumers is unlikely to return.

We expect interest rates to remain at these historically low levels until an economic recovery seems certain and the massive flow of stimulus cash threatens to fuel inflation. We expect the market to react, and often over react, to any news that supports or threatens the sustainability of an economic recovery.

Equity prices have enjoyed a nice upward move. Stocks and commodities have rallied on the prospect of better times ahead. We have witnessed investors moving back into equities from cash and fixed income positions. The Canadian equity component of Brownstone portfolios gained on average more than 25% this quarter. While improved portfolio returns are overdue and most welcome, we are cautious as to relative valuations of equities under this environment and intend to manage portfolio risk through stock selection, sector analysis and cash weightings.

We fully expect economic news to continue to improve in due course, but not without hiccups along the way, as the battered world economies struggle to regain lost footing.

Suite 300, 229 11th Avenue SE, Calgary AB T2G 0Y1

Brownstone Asset Management