Review and Commentary – 2013

2013 by all measures was a good year for equity investors. Developed countries' equity indexes performed positively and most economies around the globe showed improvement along with the potential for continued growth in 2014. European economies have stabilized, Euro bond yields decreased and fund flows into their equity markets are increasing. The US economy continues to gain momentum and despite a modest reduction in Quantitative Easing announced by the US Federal Reserve at the December FOMC meeting, equity markets appear to be fairly valued. A significant proportion of investors remain cautious and remain underinvested in equities- this is a constructive sign from our perspective for equities in the early part of the 2014. Canadian equity markets underperformed their US counterparts the extent to which we had not properly predicted. However, when comparing the major indexes in Canada to the US, it is important to remember than the TSX/SP is heavily weighted in gold shares which had one of the worst annual performances in decades. We would think with the global economic recovery on track, Canadian equity markets will improve comparatively on both a relative and absolute basis in 2014.

Our predictions for last year were;

1) **The TSX/SP Composite will have another positive year and Energy and Materials will provide positive returns.**
2) **China's economy will continue to improve further strengthening commodity prices and world growth.**
3) **US politicians will continue to marginalize the interests of their country versus their own self-interests and not appropriately balance their own fiscal affairs subjecting their country to minimal economic growth in 2013.**
4) **Mid and long term bonds in Canada and the US will underperform equities again and we would weight a 50% chance the long bond will provide a negative return in 2013.**

Not a perfect record but respectable. The TSX/SP did have a positive year again and while Energy posted gains of close to 13%, materials did not. Materials were down significantly losing approximately 30% of which gold shares were a significant contributor (down 44%).

China's economy did improve but was sporadic. The growth rate estimate for 2013 by the Chinese government of 7.5% which is set to be released later this month should exceed estimates but not without lingering concerns. However, many expectations of a much worse outcome were prevalent. The government of the world's second largest economy continues to struggle and it would appear that the Chinese economy continues to recover, albeit unevenly, from a well - engineered soft landing. Commodity prices in general did not get the lift we had predicted but results were mixed. Spot prices for natural gas, iron ore and lumber were up while copper and crude oil were down. Precious metals took a considerably larger hit with gold and silver's performance being the poorest in decades.

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For just over two weeks in October the US government did shut down. While it may be impossible to accurately predict the effect on the US economy, or for that matter economies around the globe, it certainly wasn't positive. Without doubt the reflection of these actions cast an uncomplimentary shadow over the US democratic process and strengthened the growing perception that the US political system is run by elected representatives more interested in their own political welfare than that of the constituents they represent. This shut down may have had some benefit in that the most recent December negotiations were concluded with an agreement prior to the deadline.

The bond market posted a negative return in 2013. Long bonds in Canada, as measured by the Canada 4% due in 2041 posted an annual loss of 11.9%. Mid- term bonds in Canada and the US also posted losses though Canada's returns were relatively better than those south of the border (measured in local currencies). Flow of funds from bonds to equities became more evident in 2013 and should carry forward in 2014. According to a joint study by Bloomberg and ICI on exchange traded funds, over 160 billion US dollars poured into equity ETF's while about 80 billion US dollars exited bond ETF's in 2013. This was the highest level of equity purchases since 2000.

We expect the following for 2014;

Equities will provide better returns than long term bonds and cash combined.

Long bonds in Canada and the US will be down marginally, providing a total return close to 0%.

Global economies will continue to grow but interest rates will not move up significantly.

The Canadian dollar will end the year close to or better than present levels.

Another important influence in equity prices is the recent uptick by companies purchasing their own shares back. According to data compiled by FactSet, S&P 500 companies repurchased $448 billion dollars of their own stock in the 12 month period ending September 2013. Future equity prices depend on many things, few less influential than the level of interest rates. While Central Banks, particularly the US Federal Reserve, continue to favour a moderate pace of retreat from quantitative easing, it doesn't appear that recent growth predictions for the US economy would warrant a dramatic increase in interest rates from present levels. Thus, continued rotation into equities from bonds, a dwindling supply of stock and relatively benevolent interest rate environment, should favour equities in 2014.

Thank you for your continued confidence and all our best in the New Year.

Stodgell Investment Management Ltd.