Quadrant
ASSET MANAGEMENT

QAM Update
October 2012

The QAM letter that highlights recent developments that we think either affect the markets or are important to understanding them.

"Don't fight the Fed" – Wall Street Adage

QE3: from here to infinity

Central Banks once again took matters into their own hands during the month of September and decisively entered (once more) into the fight to stimulate economic activity and employment.

The European Central Bank released its plan to do "whatever it takes" to protect the Eurozone from collapse. The Outright Monetary Transactions scheme is basically a commitment by the ECB to buy as much debt as necessary of up to three years in maturity from any member country that requests it and accepts certain conditions (mainly economic reforms in the fiscal front). With no action taken as yet, the undertaking to act has had a significant positive impact on sentiment, causing borrowing rates for economically weaker Eurozone countries to drop significantly.

The U.S. Federal Reserve Bank (the "Fed") launched another stimulus program on September 13th, announcing it will buy US$40 billion of mortgage-backed securities per month and will continue to purchase assets until the outlook for jobs improves substantially.

There is no set amount in this new round of Quantitative Easing (QE3). If the Fed continues for one year, it will inject US$480 billion into the economy.

To put things in perspective, it is worth comparing this new Fed stimulus program with the previous two.

QE1 started in November 2008 and concluded in March of 2010. The Fed purchased US$175 billion of agency debt securities and US$1.25 trillion of mortgage-backed securities in addition to purchases of Treasuries. Around US$90 billion per month was injected into the system.

For QE2, the Federal Reserve purchased US$600 billion in Treasury securities starting in November 2010 and concluding in June of 2011. For this round US$75 billion per month have been injected.

It should be noted that the "QEs" are not an increase in government spending, and associated increases in government deficits. Rather, they represent the Fed borrowing and investing the proceeds in select financial assets in order to impact interest rates and access to borrowing. None the less, all this money being pumped into the system will eventually drive up inflation providing a clear edge to equities relative to fixed-income instruments.

That was also the perception of market participants as the 10-year break-even rate, the yield difference between a 10-year Treasury note and 10-year TIPS (inflation protected bonds), jumped to 2.76% (the highest since May 2006) immediately after QE3 was announced. This metric suggests that, on aggregate, market participants expected the U.S. inflation rate to average 2.67% per year for a decade.

But by the end of September the 10-year break-even rate was close to 2.38% back to where it stood before the Fed's QE3 release as doubts have mounted over whether the Fed's stimulus will be effective and the usual macro concerns became center of mind for investors.

Negative sentiment and worries around the November U.S. election, resolution of the fiscal cliff, the ongoing concerns about the fiscal problems of countries in the Eurozone and moderating growth in China weighted more (or at least the same) on market performance than fundamentals and strong monetary policies.

Coordinated Central Bank activity should eventually drive up inflation expectations to the detriment of Fixed-Income instruments and to the benefit of equity prices and other real assets. That is the goal of the Fed as it follows its dual mandate of stable prices and maximum employment.

The fight is not over yet.

Q3/2012 in Perspective

Performance as of September 30, 2012
(CAD)

	3 months	1 year	3 years	5 years	10 years
S&P/TSX Composite Index	7.00%	9.20%	5.50%	0.20%	9.80%
S&P 500 Index	2.70%	22.10%	10.00%	0.80%	3.00%
MSCI EAFE Index	3.30%	7.30%	-0.30%	-5.00%	3.60%

Government of Canada Benchmark Bond Yields

	30-Sep-12	30-Jun-12	30-Sep-11
2 year	1.06%	1.03%	0.88%
10 year	1.73%	1.74%	2.15%
30 year	2.32%	2.33%	2.77%

Source: Bloomberg / UF

Interest rates continue to be at historic lows. Given the massive monetary stimulus, we believe inflationary pressures will eventually emerge, putting upward pressure on interest rates. Equities are one of the best hedges to inflation as corporations and its managers are capable of transferring input costs increases onto their clients.

We remain positively inclined to equities. We believe that positive economic data that has already started to materialize will accelerate after the US presidential election in November. Even though we think a correction is possible in the next few months we observe that valuations are reasonable,

corporations are solid from a financial point of view and liquidity in the system and at the corporation level is supportive.

We continue to believe that long-term investors are going to be well served by investing in a well diversified portfolio that reflects their risk tolerance, time horizon, and income & liquidity needs.

25th Anniversary

This month of October marks the 25th anniversary of Black Monday. On Monday October 19, 1987 stock markets around the world crashed. The crash began in Hong Kong and spread west to Europe, hitting the United States after other markets had already declined by a significant margin. North American markets dropped by 23%.

Following the stock market crash, a group of eminent economists from different countries met in Washington, D.C. in December 1987, and envisaged that “the next few years could be the most troubled since the 1930s”.

Reality didn’t follow their predictive powers. The DJIA was positive for the 1987 calendar year. The DJIA regained its August 25, 1987 closing high of 2,722 points two years later. The 90’s witnessed one of the most prosperous times in the Western World history and investors enjoyed one of the most important bull markets ever.

Academicians and market researchers put the blame for the decline onto the introduction of program trading, overvaluation, illiquidity, and market psychology among other causes. 25 years later there is still no clear explanation of why it happened. We share this historical perspective as a reminder to each of us to keep a balance between long term perspective and short term events and forecasts that may create the risk of needless detours in a long term strategy.

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