“It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity...” (Charles Dickens, A Tale of Two Cities).

It was the best of times...
1. Equity markets are at or near all time highs
2. Bond markets are at all time highs
3. Low inflation
4. U.S. corporate profits/GDP are at record highs
5. Confidence returns
6. Central Banks are in control and have an exit strategy
7. Gold price drop suggests stability has returned
8. U.S. Dollar strength

It was the worst of times...
1. High unemployment in the EU
2. Countries are bankrupt – first Greece, now Cyprus, maybe Slovenia, Spain or Italy
3. Banks in Europe are technically insolvent, supported by the ECB and confident it will continue
4. Growth in Government debt continues to outpace GDP growth with no end in sight
5. Central Banks’ balance sheets are soaring and are being used to finance Government deficits – a form of off-balance sheet financing
6. Over 41% of Americans are enrolled in at least one Federal assistance program (food stamps, medicaid, disability, social security, subsidized housing) and the numbers are growing.
7. The real U.S. unemployment rate jumps to 11.6% when you factor in those no longer looking for work and no longer considered part of the labour force. They are now living off of various welfare entitlement cheques.
8. If that were not enough, consider the Q1 2013 statistics for the BRIC’s (Brazil, Russia, India and China). Leading in GDP growth, not printing money and Q1 Equity markets declining: Brazil -8%, Russia -3%, India -3%, China -9%.
Europe is in recession and unemployment continues to rise in the peripheral European countries while youth unemployment soars. The Italian election results did not produce a clear winner other than to ensure austerity is out. After passing rigorous EU stress tests, only 18 months earlier, Cypriot banks are now deemed insolvent and in need of a bailout. Fed Chairman, Ben Bernanke, remains in control of financial markets, committing the Fed to additional rounds of quantitative easing. China’s GDP unexpectedly slowed to 7.8% in the 4th quarter of 2012, the lowest level in 13 years. Meanwhile, Russia and China are moving forward to expand strategic partnerships in oil and technology, which also includes setting up a new bank to rival the World Bank and International Monetary Fund (IMF). Japan declares an all-out war on deflation and continues to squabble with China over ownership of the Senkaku Islands. North Korea puts its military in combat mode threatening U.S. and South Korean targets. The central banks of Europe, U.S., U.K and now Japan remain committed to providing just enough free money to sedate the equity markets into a false sense of security. Western Governments, starved for cash, are paying closer attention to revenue enhancing opportunities and to greater international cooperation to combat tax evasion.

With most of Europe in recession and the Chinese economy slowing, the central banks, led by the U.S. Federal Reserve (Fed), have once again stepped in with additional rounds of quantitative easing, announcing the purchase of $85 billion per month in mortgages and U.S. Treasuries. With U.S. 4th quarter GDP growth coming in at a paltry .4%, the Fed’s balance sheet is set to balloon to over $4 trillion by year end. As the Fed attempts to print its way to prosperity, the markets have picked up on the Fed’s willingness to accommodate the “risk-on” trade and continue to enable the U.S. Government to spend beyond its means. As evidenced by the fiscal cliff drama, Congress has once again proven that they are the problem and nothing is going to change until the next crisis arrives. There is currently no leadership in Washington capable or willing to do what is required, and until such time, the Fed is in complete control. Common sense suggests that this cannot go on forever, however, given the problems in Europe and Japan, the U.S. will be the primary beneficiary of international capital flows seeking a perceived safe haven.

Japan

To gain a better perspective on the consequences of avoidance, one need only look to Japan. The postwar Japanese economy experienced tremendous growth from 1950 to 1989. Their export led economy was booming, interest rates were falling and money was pouring in to take advantage of the rising stock market, which saw the Nikkei rise 4 fold from 1984 to 1989, peaking at 38,957. The value of Nippon Telephone was worth more than all of the stocks traded on the German stock exchange. The real estate market had an equally impressive run in which the Tokyo Imperial Palace was estimated to be valued at a price that exceeded the value of all real estate in California. In an attempt to cool the speculation, the Bank of Japan (BOJ) raised interest rates, which dampened speculation, but sent the economy and real estate market into a deflationary collapse under the mountain of debt. Consumers and businesses retrenched and adjusted to the deflationary environment by boosting savings and reducing spending. Rather than write off or restructure the debts, they were absorbed within the balance sheets of the financial institution. The total amount of Japanese debt now stands at approximately $11 trillion USD, most of it owed to its citizens.

After two decades of deflation, the newly elected Government of Shinzo Abe has declared war on deflation and is prepared to start its own version of quantitative easing by printing Yen, hoping to devalue the currency and boost exports while it continues to fund a massive debt that has now surpassed the 1 Quadrillion Yen level. Japan has reached the end of its rope. The Bank of Japan unleashed the world’s most intense burst of monetary stimulus, promising to inject about $1.4 trillion USD into the economy in less than two years; a radical gamble that is sure to send the yen much lower and bond yields to record lows. They have resorted to money printing in order to pay back their citizens, fund their entitlement programs and hopefully revive their struggling corporations. This may become the blueprint for what awaits the U.S. and Europe in the not so distant future.
Europe

It was only a few short weeks ago that the elites in Europe were out in numbers telling the world that the worst had passed. By now, most should have come to realize that Luxembourg Prime Minister Jean-Claude Junker was not kidding when he said in May 2011, “When it becomes serious, you have to lie”. Case in point, Cyprus. Up until a few weeks ago, the tax haven was on no one’s radar screen. Having passed the most recent bank stress test, Cypriot banks were deemed to have been solvent, yet within a very short period of time, they were found to be insolvent. The terms of the bailout should send shivers down the spines of anyone holding assets in an EU bank and this one event will likely prove beyond all doubt that one should not rely on official statements surrounding the Euro crisis or the state of the banking industry.

Depositors in Cypriot banks holding more than 100,000 Euros will be hit with a deposit tax ranging from 40-60%. Deposit tax is a polite way of saying you will not be getting all of your money on deposit back. This marks the first time the EU has moved away from its 100% guarantee and it may threaten the only remaining measure in place to prevent bank runs; confidence. The primary source of revenue for Cyprus was their banking industry and now the EU is sending a strong message to this tax haven island that they have no banking industry and they now have no future. Who is next? What are the rules going forward? Right or wrong, the risks of contagion and the message that is being sent to other EU members are troublesome. This is a very significant event, but you would not know it based on the response from the equity markets, which remain in a quantitative easing induced stupor.

The inability of Italy to elect a Government and the surprising strength of the anti-Euro party, led by comedian, Beppe Grillo, have put a death knell into the austerity movement championed by the defeated government of Mario Monti. Germany now stands alone. With elections looming in the fall, Angela Merkel’s government will be put to the test. Given the upcoming German elections, it would not be wise to underestimate the implication of what is taking place in Italy or Cyprus. The results may prove unsettling to financial markets, which have adopted a rather perverse view: the worse it gets, the better it is for equities, as central banks will be ready to inject the patient with additional liquidity. Jens Wideman, President of the Bundesbank, provided further insight when he stated “Believing that everything is okay now simply because the situation on the financial markets has eased is an illusion and does not help matters: it reduces the pressure to act to deal with the imbalances that continue to prevail”. March 18, 2013. http://www.bundesbank.de/Redaktion/EN Interviews/2013_02_18_weidmann_focus.html

BRIC Countries

What is equally puzzling is that the BRIC countries (Brazil, Russia, India and China), who are not engaging in money printing and have growing economies, have seen their equity markets decline 3 - 9% in the first quarter of 2013. It begs the question, if you are a country with a major trading currency (USD, Euro or Yen) and own a printing press, do credit ratings matter? Do underlying fundamentals matter? Since capital must find a home, countries with large debt markets will benefit from capital flight even if their underlying fundamentals are weak. Equity markets in countries with fiscal imbalances engaged in quantitative easing rise, while equity markets in countries with stronger economies, but who do not engage in quantitative easing, decline.

How long will the BRIC countries put up with the devaluation of their foreign reserves? Should we be surprised to find that they are working towards creating their own development bank that will compete with the World Bank and the IMF? They are expanding trade with each other and entering into swap agreements for trade in currencies other than U.S. dollars. We are not suggesting that the U.S. dollar is going to disappear anytime soon, but if more countries look for alternatives to a devaluing U.S. dollar, the need to hold vast amounts of USD for trading purposes will decline.
China

One must pay close attention to China. The first state visit of the newly appointed Chinese leader, Xi Jinping, was to Russia to work on strategic partnerships involving oil and technology. That was followed by state visits to resource rich countries of Africa. In Africa, Xi attended the fifth summit of the BRIC countries. China requires vast amounts of resources (oil, copper, iron ore) and is seeking strategic partnerships which will fuel its growing economy. Although they may eventually become the largest economy in the world, in order to supplant the USD as the reserve currency, they will need to have confidence in their own currency, financial system and rule of law.

China has been the largest buyer of gold for several years, however, Russia edged them out last year. Although western central banks have been net sellers of gold over the past 20 years, a major shift is underway and we continue to see steady net accumulation from central bank purchases, led by the BRIC countries. It is believed that most western central banks have leased out their gold to the bullion banks, who have in turn sold it and must eventually return it. This practice has been going on for years and it has the potential to become problematic as countries request that their gold be returned. For example, under pressure from its citizens, Germany has called for the audit and return of its gold holdings held in the U.S. and U.K. Interestingly, this will take up to 7 years for delivery, suggesting that it has, in fact, been lent out and can only be returned if it is repurchased at today's prices and delivered. Needless to say, the lower the price, the better for the bullion banks who are offside on this trade.

### Net Central Bank Purchases of Gold – 2012

![Net official sector transactions](chart)

Source: Thomson Reuters GFMS, World Gold Council

As most of Europe remains in recession, fourth-quarter profit at European corporations fell 5.2% from a year earlier, while revenue inched up just 0.5%. In the U.S., corporate profits rose 3.3% and hit an all-time high of 11.1% of GDP, as corporations take advantage of low interest rates to refinance balance sheets and borrow funds for share buybacks while they continue to right size their operations further. What is increasingly hard to rationalize is that rising corporate profits are not translating into rising family incomes. The average U.S. family income has fallen from $55,000 in 2007 to $51,500 in 2013, while the number of Americans turning to the Government for assistance continues to rise, as 41% of Americans take advantage of entitlement spending, which now exceeds revenue from taxes.
Markets

There is a distinct pattern that has emerged. The central planners are underwriting the risk of equity ownership. Any declines in equity prices over a 3 month period are usually countered by verbal intervention from central banks, such as European Central Bank's Mario Draghi's statement that, “we will do whatever it takes to preserve the Euro”.

Japan's finance minister said in February of 2013 that he wants to see the Nikkei rise by 17% to 13,000 by the end of March, 2013. So far, any significant declines in equity markets brought on by crisis or economic weakness are met with more rounds of quantitative easing. When the unpredictable becomes predictable, something is going to change.

It is not clear how central banks will be able to withdraw the monetary stimulus, if at all. What is becoming clear are the potential outcomes:

- Rising deficits combined with rising taxes
- Negative interest rates for the next decade
- Asset price inflation, especially in emerging markets, commodities and other risk assets
- Leveraged speculators benefiting at the expense of savers

The Fed’s suppression of interest rates has led more investors and speculators alike to re-allocate capital from the safety of zero yielding cash into higher yielding equities. The argument is that dividend yields on stocks are far superior to bonds and therefore offer better returns.
Governments penalized those who have saved while they reward the risk takers. Under current policies, the transfer of wealth from savers to speculators will continue until such time that the Fed stops monetizing the debt. How long can this continue?

**A Tale of Two Incomes**

**United States (billions)**

**Interest Income**

We have maintained that the S&P 500 has been in a secular bear market since the tech bubble collapse of 2000. It was followed by the housing bubble leading up to the 2008 financial crisis. It is now pushing through the upper range that has defined this secular bear market. Although it is our belief that this will not end well, we acknowledge that the coordinated forces of quantitative easing amongst the major currencies (of the U.S., Europe and Japan) will continue to be the primary driver of equity markets. Capital flows will also play a part, as problems in Europe benefit the U.S. while short term capital seeks the safety and liquidity of the USD. The Cypriot banking collapse is the canary in the mine shaft, as it has proven, beyond all doubt, that one cannot trust or rely on the words or prognostications of politicians and regulators. One week everything is fine, the next it is not.
A tale of two worlds | April 2013 bulletin

The Fed has monetized 50% of US debt since 2009

Debt issued
Fed Purchases

Source: Edelweiss Holdings Ltd. research

What could derail the QE party?

- Currency devaluations leading to trade wars
- Capital controls spreading from Cyprus to Luxembourg to Spain
- War – North Korea / South Korea – China / Japan – Arab Spring

Real and Nominal S&P 500

Last Points - Real 12/12: 616, Nominal 01/13: 1480

Source: Haver Analytics

Nominal S&P 500
Real S&P 500 (deflated by CPI 1982-84 prices)
Gold

As the price of gold corrects, there are many who believe the secular bull market has come to an end. A similar view was expressed back in 2008 when gold corrected from $1000 to $681 per ounce. Depending on one’s entry point, the corrections can be unnerving to say the least. Someone who bought at $400 in 2004 has a completely different perspective than someone who bought in 2007 at $1000 and watched it fall 30% to $712 by late 2008. Similarly, those who bought in 2011 at $1900 have a completely different perspective than those who bought in 2008 at $1000.

The primary reason gold has risen in value is a direct result of the instability in the financial system and a non-confidence vote in fiscal and monetary policy. Nothing has really changed. In fact, as the situation in Europe and Japan deteriorates further, capital flees to the perceived safety of the USD. A rising dollar pressures gold in the short run, but does not change the underlying premise that the U.S. is simply not prepared to address the fiscal imbalances. Until such time, gold will once again reassert itself, just as it did in 2008.

We continue to believe that investors should maintain a core holding in gold and silver for two reasons:

1. Governments continue to avoid dealing with the fiscal imbalances and continue to rely on central banks to fund their deficits.
2. The euro crisis is entering a new phase, as depositors in peripheral Europe may face the same fate as those in Cypriot banks.

Gold equities have been extremely disappointing, as they have outpaced the decline in the underlying commodity. Although they now trade at compelling valuations, the negative sentiment is overwhelming. Having relied on our long run bullish view on gold, we underestimated the extent of the decline in the gold equities. Rightfully so, the negative sentiment towards the sector and the management of these companies is at an all-time high due to cost pressures, the focus on production rather than profitable production, poor management decisions and country risk.

This has contributed to the negative sentiment that still grips the sector. However, valuations are at all-time lows. Management of gold companies are rethinking their business models. No longer consumed with increasing gold production, many are rationalizing operations and are now focused on producing profitable ounces and returning profits to shareholders in the form of dividends tied to the price of gold. We are seeing fundamental changes in the way gold companies are being run and although it has not yet been reflected in the equity prices, we are seeing a noticeable increase in insider buying. The valuations and negative sentiment are at an extreme and that represents opportunity.

Portfolio

We have increased exposure to Japanese equities and trimmed positions in the utilities based on valuation. Our defensive position in cash and exposure to commodities detracted from overall performance. A general disregard by investors toward equity valuations and a search for yield at any cost pushed equity markets to the well-defined upper end of the range which defines this secular bear market.

The correction in precious metals is running its natural course as investors move to the sidelines, and although we cannot predict when it will exhaust itself, we believe it is in its final stages. We will continue to look for selective opportunities but if they do not present themselves, we will remain patient and wait.

Summary

The U.S. economy remains feeble. European economies are in serious decline. Japan has hit the debt wall. The Federal Reserve is pumping in $85 billion per month into the system to keep the economy from rolling over. Unemployment is
soaring in the EU. 41% of Americans are receiving entitlements. Depositors in Cyprus have had their money taken away. North Korea threatens war against South Korea and the U.S. The Middle East remains a potential hotbed and equity markets are at all-time highs. More easing please.

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