CELERNUS ABSOLUTE GROWTH FUND

Commentary – Sept/Oct 2012

Feelings. Nothing more than… feelings (and a little candy)

On July 26th, European Central Bank President Mario Draghi proclaimed his intention to do 'whatever it takes' to save the 17 nation euro currency. Credit default swap spreads fell to 15-month lows as confidence in the region's banking system was priced back in. Equity markets read constructively into the statement as well, rallying a swift 4%.

September 6th: Enter Draghi again. This time unveiling the much-awaited rescue plan that would save the Eurozone from what many thought was the brink of disaster. Similar to July, Draghi was talking big, with the 'Outright Monetary Transactions' plan calling for the ECB to potentially purchase unlimited amounts of sovereign bonds, conditional upon sovereigns first requesting help from Europe's bailout fund and committing to economic reforms. The S&P 500 staged a cool 2% rally and then stopped dead in its tracks.

September 13th: Enter Federal Reserve Chairman Ben Bernanke. His announcement that the Fed's Open Markets Operations desk would immediately begin buying $40 billion in mortgage backed securities (MBS) per month was received with open arms. The S&P 500 drove another 2.7% higher over the next two days.

So here we sit – post Hallowe'en – digesting copious amounts of refined sugar as well as the handi-work of the central bankers. QE3 (Quantitative Easing) is upon us. Like the Hallowe'en candy, quantitative easing might be pleasant at first, but it likely won't make anyone any healthier.

The walk down easing street isn't so easy.

Quantitative Easing is central-bank code for 'printing money.' A central banker's key monetary tool is the lowering of interest rates. If an economy proves particularly unresilient, this tool can be rendered ineffective.

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Top 10 Equity Holdings

AGU:CA	Agrium Inc.
HUM	Humana Inc.
PRU	Prudential Financial Inc.
HCG:CA	Home Capital Group Inc.
CMI	Cummins Inc.
UNH	UnitedHealth Group Inc.
M	Macys Inc.
ANV:CA	Allied Nevada Gold Corp.
ASH	Ashland Inc.
FCX	Freeport-McMoRan Copper & Gold

Fund Overview

The Celernus Absolute Growth Fund aims to provide long term growth of capital with below average volatility. The fund seeks to actively protect capital and manage risk. Equity selection combines a value-orientation with a robust quantitative framework. Net equity and currency exposure are dynamically managed to further mitigate risk.

Manager
Celernus Investment Partners Inc.
AUM
10.4 million
Minimum investment
$25,000
Advisory fee
0.85%
Performance fee
20%
High water mark
Yes
Subscriptions
Weekly
Redemptions
Weekly
Prime Broker
National Bank Correspondent Network (NBCN)
Auditor
BDO Canada LLP
Administrator
Convexus Managed Services
Lawyer
WeirFoulds LLP
FundSERV code
C1P100A
Eligible accounts
RSP, RESP, TFSA, cash

Contact Information

GORDON MARTIN, MBA
Managing Partner, Portfolio Manager
gmartin@celernus.com

Celernus Investment Partners Inc.
10 Four Seasons Place
Suite 1027
Toronto, Ontario
M9B 6H7

416.649.5827
fax 1.855.870.7464
www.celernus.com

The U.S. Fed has maxed out its capacity to marginally influence the economy through its key tool.
In other words, the economy does not appear to be able to profitably allocate further borrowed dollars, regardless of how cheap those dollars might be. Bernanke recognizes this. However, he also notes that the economy is operating at an unacceptably high 8.3% unemployment rate. Furthermore, it is doing so during the fourth year of the presidential cycle when there will likely be little political will to materially alter policy, even if it might help alleviate the employment gap.
With this in mind, the Federal Reserve elected to buy bonds… and lots of them.

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The announcement of the monthly $40 billion mortgage bond buyback brings the total commitment of bond purchases, when combined with existing programs, to $85 billion a month. This program will continue until the Fed 'sees substantial improvement in the labour market.'

We expect that, at some point in the future, Bernanke and the Federal Reserve will see improvement in the employment situation. When that time comes, we're not convinced that this improvement will have had much to do with the asset purchases that are currently being pursued.

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The continued buying of bonds (i.e creation of money) floods the economy with more dollars. The greater the number of dollars, the less they are worth. This means that tangible assets (i.e. assets that you drop on your feet and it hurts like food, oil or metals) cost more. This becomes a drag on the accounts of people that save their money, because the rate of return that they receive on their saved dollars declines. It is also a drag on spenders which, let's face it, are most of us, because the amount of goods that we are able to purchase with our devaluing dollar decreases. It is fairly clear how quantitative easing can hurt the average Joe but, can it help him?

At the press conference that coincided with the Fed's announcement of more asset purchases, Bernanke weighed in on the potential efficacy of monetary policy tools – particularly the purchase of mortgage backed securities. He suggested that mortgage rates and corporate borrowing rates would decline, which would, in turn, drive more borrowing and ultimately, spending – particularly spending on homes and home-related goods. Bernanke suggested that, 'to the extent that the prices of homes begin to rise, consumers will feel wealthier, they'll begin to feel more disposed to spend." He also noted that improving stock prices tend to make people more willing to spend. So the intention appears to be to stimulate aggregate demand for goods by helping people 'feel' wealthier. This augmented demand would, in theory, improve corporate outlooks which would generate more hiring, thus reducing the rate of unemployment. It appears that Bernanke's take on kick-starting the economy is that the best way to do it is help people feel confident.
In doing so, the Fed would effectively unblock one of its key monetary transmission mechanisms, the credit channel.

We believe it is fair to say that one of the greatest obstacles standing in the way of the Fed's desired outcome of better employment and overall economic activity is that, once money leaves the hands of the Fed and is received by the banks, the Fed effectively loses control. Monetary policy can be extremely accommodating. Liquidity can be as near to perfect as it has ever been. But it's difficult to make potential lenders lend and even more difficult (we're learning) to make potential borrowers borrow.

Banks have tightened their lending policies. Interestingly, that doesn't seem to make much of a difference because, in aggregate, individuals and corporations don't seem to want to borrow. Bernanke's solution? If we feel better, we will borrow it. If we borrow it, we will spend it.

In reality, we don't maintain a lot of confidence that the purchase of $40 billion in mortgage-backed securities per month will have the effects that the Fed desires. What it will likely do is continue to raise commodity prices, bloat the country's balance sheet and render the process of an eventual exit (at some point the Fed will seek to sell the bonds that it purchased) awfully messy. The costs of trying to make consumers feel good appear terribly burdensome.

As equity market prices continue to drift south, we are seeing an increasing number of stocks whose valuations are implying growth rates that are likely lower than what will actually be realized.

Earnings season is in full swing and, thus far, the results have been lukewarm. Positive earnings surprises are tracking at about a 63% rate.
This compares poorly to the previous quarter's 67.5% beat rate and even less positively to Q3 2011's approximate 70% rate of positive surprise. What is particularly disappointing is that this weak 63% follows a broad-based spate of negative earnings revisions that drove quarterly earnings expectations markedly lower. In other words, the market has had difficulty beating reduced expectations.

We recognize that the equity market rally off of the late-spring lows has been very much liquidity driven and has climbed the 'wall of worry' in textbook fashion. From a longer-term perspective, we are less worried about the next 5% and more worried about the next 50%.

All is not lost. As equity market prices continue to drift south, we are seeing an increasing number of stocks whose valuations are implying growth rates that are likely lower than what will actually be realized. Said differently, some stock valuations are pricing in future bad days that may not be quite as bad as currently expected. Not all, but some. We are also entering a time of year that has seasonally proven constructive to broad-based equity prices as well as the price of gold. On top of this, history has shown that the appetite for equities has proven particularly resilient during the final quarter of a U.S. presidential election year.
We would suggest that the post-election selloff represents somewhat of a knee-jerk reaction – particularly in light of the derivative improvements in economic data. So, while the next 50% in the markets commands much of our focus, there appears to be a gentle breeze, supported by economic data, at the back of the market vis-à-vis the next 5%-10%.

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But as we become more mindful of the next 50%, we remind that one characteristic of the Celernus Absolute Growth Fund is its capacity to meaningfully hedge its assets under management. As equity markets become well-owned and fully valued, we will seek to decrease our net long position through the short sale of securities that we believe are overvalued with fundamentals that have the potential to deteriorate.

We maintain a lot of confidence in the long-term prognosis for the world's economies, believing that the journey through difficult days will breed innovation from the best and brightest – innovation that will begat new knowledge, productivity, employment and prosperity. However, there remains a lot of work to be done to make the world's economies healthier. Sovereign countries are fighting for their financial lives.
The Fed is no longer playing defense. It is on the offence, buying unheard of amounts of bonds in an attempt to make us 'feel' better about our situations, so that we'll buy another iPhone (and a house to put it in.)
All the while, there is a lot of debt that needs to be destroyed.

You can only spend money you don't have for so long before things go bad. That goes for anyone.

CHRIS GRANT, CFA
Senior Partner, Portfolio Manager
cgrant@celernus.com