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The Fed Blinks

U.S. monetary policy has once again been influenced by fears of a falling stock market. The U.S. Federal Reserve reversed course in early January by deciding to ease monetary policy rather than continue tightening - interest rate hikes are on hold. Stock markets have since rebounded nicely. The Fed "Put" is alive and well. A "Put" is in reference to the central bank coming to the rescue every time the stock market falters. Following the plunge at the end of the year which saw the S&P 500 stock index drop 20% in just under three months, Chairman Jerome Powell took to a podium in early January and declared an end to rate hikes - interest rate normalization would have to wait. The 180-degree turnaround in Fed policy is striking considering in early October three rate hikes were expected for 2019 with Powell articulating at the time "we are a long way from neutral".

Now that the Federal Reserve has reversed course the pundits are coming forth saying "I told you so". The rationale being that raising rates would be a precursor to a stock market rout and that any attempt to normalize interest rates would be self-defeating. The massive accumulation of debt since the Financial Crisis of 2008/9, has made for a very interest rate sensitive economy. It would not take many rate hikes by the central banks to slow things down. This camp is now growing in influence with the opinion being we may never get back to "normalization".



The Fed likely made the right move. It may very well turn out to be perfect timing. A rise in interest rates has a lagged effect on the economy, by up to two years. Interest rates have been on the rise for three years already, albeit very slowly compared to the two most recent cycles.

While the current economic slowdown is largely depicted in the news as temporary, caused mainly by the U.S./China trade dispute, it is likely due more to rising rates. If so, the Fed may just get this one right and be ahead of the curve. A pause here could stabilize the financial markets and extend the business cycle.

Modern Monetary Theory (MMT)

Alternative, and unconventional monetary stimulus tools are being debated. A concept called MMT or modern monetary theory is making the rounds among mainstream economists. The premise is that fiscal policy, or direct government spending, may be more beneficial for economic growth. Current monetary policy relies on private credit creation. The argument is over its ineffectiveness to generate real sustained growth for the majority. Critics, mostly on the left of the political divide, claim that deficits really don't matter, and that conventional monetary stimulus has inflated asset prices benefiting only a few.

MMT is an old concept which has never worked before. It produces inflation as more money ends up directly in the economy. However, this is precisely the point. Ten years of quantitative easing (QE) did not create any significant inflation. Policy makers should therefore consider using a new stimulus tool.

Also, while the Fed has its eye on the stock market, it has never purchased stocks. In fact, it is legally not allowed to do so. This is not the case for other central banks. The Bank of Japan has been a buyer of stocks in the past decade and by some estimates owns about 5% of the Japanese stock market. Most recently the Bank of Switzerland has reported it owns many positions in some of the largest U.S. companies, including over 16 million shares of Apple. The Swiss bank is said to hold about \$90 Billion in foreign stocks, representing about 20% of reserves. So, while it is currently illegal for the Fed to purchase stocks, it would not be unthinkable for legislation to be changed in order to do so. Even former Fed Chair Janet Yellen has supported the idea of purchasing corporate stocks and bonds. It may one day become another policy tool available to stabilize financial markets.

Central banks are likely to go "above and beyond" to support the stock market and promote a stable growth environment. As investors, we hope they are successful. The record is a contentious one.

Global Economy Slowing

The IMF has again lowered their forecast for global growth for 2019, reducing it to 3.3% from 3.5%. This marks the third downgrade in the past several months. The U.S./China trade dispute, along with Brexit are cited as the main reasons for the downgrade.

The latest German manufacturing PMI (Purchasing Managers Index) came in at 44.5, well under the 50 which is a sign of continuing contraction. The automotive industry is the heart and center of the German economy. Likewise, all is not well in Italy, which by some measures is already in a recession. Both are important members of the European Union.

In the U.S., while economic growth leads the developed world, signs of slowing are becoming evident. In the auto sector, sales are stagnant and the big three, GM, Ford, and Fiat Chrysler, are building inventories. If this continues the auto industry will need to slow production. Auto analysts remain optimistic sighting the new lineup of cars and the upcoming transition to electric vehicles (EV's). Still, the excess inventory is a concern and any further drop in sales activity will be cause for alarm. So far it is the U.S. economy that is leading the developed world. The U.S. economy will not remain insulated if the rest of the world does not soon pick up.

In China, the official GDP growth numbers are slowing, to 6%. Unofficially some estimates have growth down to only 4%. Fewer construction cranes provide anecdotal evidence. Importantly, China is now the largest auto market in the world with annual sales of 28 million cars. For the first time in almost 20 years sales of cars dropped in 2018 by some 3%.

This is highly inconsistent with an economy growing at the official rate of 6%.

Fortunately, Chinese data is improving with exports in March rising by 14.2%. Still, many important economic data points have slowed over the last several months. As a result, China has recently boosted lending to try and improve consumer confidence. In addition, the government has

announced further fiscal expansion with increased spending on infrastructure and tax cuts for businesses.

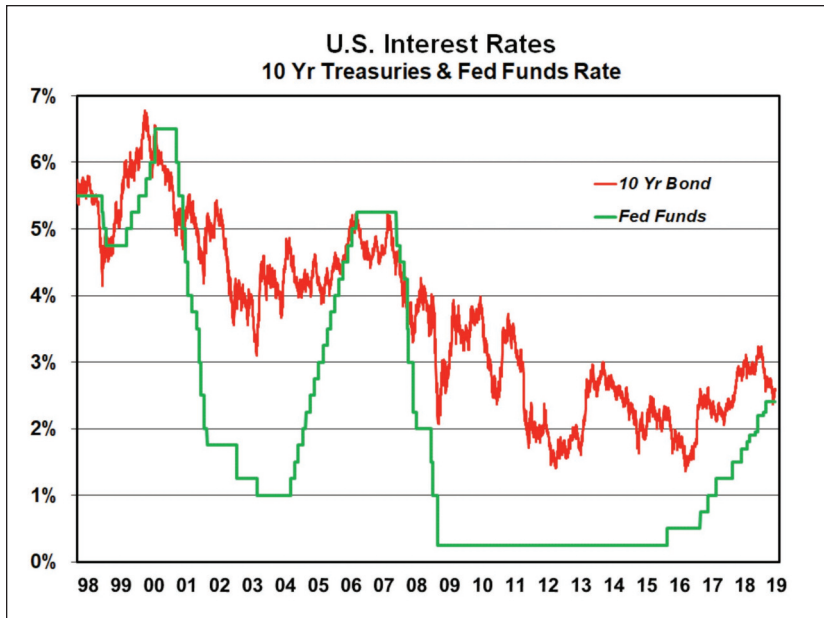
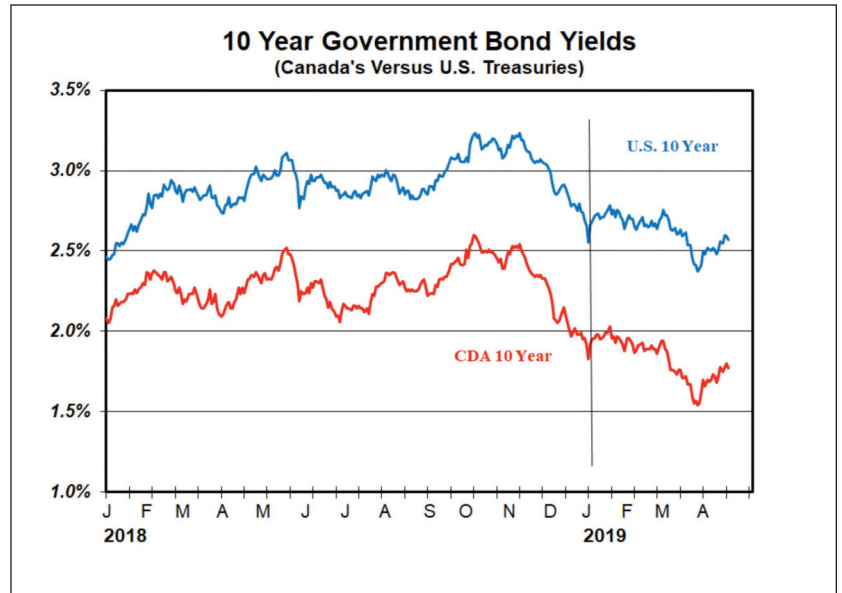
The signing of a U.S./China trade deal would certainly be welcomed. An additional risk however is that Trump is now gearing his sights on Europe, particularly Germany. A trade dispute with Germany, the third largest exporter in the world, could again unsettle financial markets.



Bond Market Confirming a Slowdown

Bond yields have been declining this past quarter with the widely followed U.S. 10 Year Treasury yield down to 2.65%. At its lowest point in March it touched down to 2.4%. Canadian 10 Year government bond yields are down to 1.7%. The adjacent chart shows the trend in bond yields over the past year.

Investors have mixed opinions. Many are still in the camp that believe interest rates will rise again, either later this year or early next. While on the other hand, many now believe interest rates are heading much lower and we have likely seen the peak in rates this cycle. The next couple of years will bring us back to the "zero-bound", or close to zero short-term interest rates. If correct, then this cycle would have experienced a fairly short period of monetary tightness. Usually, the Federal Reserve tightens for a considerably longer period of time and with a much higher level of interest rates. As shown in the chart below dating back to 1999, the



previous two business cycles witnessed a much more aggressive Fed monetary policy. In 2000, interest rates rose to 6.5% over a two-year period. In 2008 before the Financial Crisis, interest rates rose to 5.25% over a two-year period. This time around, the Fed started raising interest rates in December of 2015. Three years later short-term rates are only 2.4%.

The Powell reversal has caused a rally in the bond market as interest rates have dropped. The first chart shows the rise in the U.S. 10-year Treasury bonds which twice in the last 18 months were flirting with the 3.25% level threatening to break out from there alongside an expected booming and reflating economy. Yields have tumbled to 2.55% and could go even lower. "Normalization" may possibly be deferred for another two years as the economy underperforms.

Of Brexit & Yellow Vests

Brexit has been delayed. A request by the UK to extend Article 50 has been given until October 31st. Meanwhile, European Parliamentary elections are scheduled for the end of May. Ironically the UK, not yet formally out of the EU, will be participating in the elections. In a farce right out of Monty Python, a new political party, the Brexit Party, led by Nigel Farage, is leading in the polls - a party formed without any intention of staying in Europe.

The EU and the UK have had over two years to negotiate a

satisfactory arrangement. Some blame the EU for refusing to yield. Some put the blame directly on Prime Minister Teresa May, the Tory party or Parliament itself. As it stands the current deal is seen by many as a victory for the EU. The customs union has been one of the main stumbling blocks. Under a customs union, Brussels would continue to make the decisions on tariffs, quotas and trade agreements with all non-EU block countries. The UK would not be allowed to make their own trade deals. This is an important economic

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Of Brexit & Yellow Vests (cont'd from page 3)

policy tool that the hard line Brexiteers do not want to accept. If the goal is independence, then it makes little sense to be bound by rules which limit that independence. In France, protests continue with the Yellow Vest movement refusing to accept compromise. They seem intent on forcing President Macron to resign. Populist anti-establishment movements are spreading everywhere. There is a disenfranchisement with politics as usual. This is perhaps a risk to economic growth and stability that financial markets are not appreciating.



Portfolio Strategy

The stock markets in both Canada and the U.S. have recovered in dramatic fashion. The “V” shaped recovery can be observed on the chart below. Both markets have been highly correlated over the past eighteen months and have witnessed higher than average volatility. For the third time they are at their highs with the S&P/TSX Composite back at the 16,500 level and the S&P 500 again at the 2,900 level.



This market pattern is rare for corrections that exceed 15%. While markets often drop this quickly, they do not often recover so quickly. There was a similar pattern in the summer of 1998, the year of the Asian crisis. The devaluation of Thailand's currency, and a Russian default, sent Long Term Capital Management, a hedge fund managed by Nobel economists, into bankruptcy. The S&P 500 in the U.S. dropped 20% in about three months and then quickly recovered within a month. The next eighteen months witnessed an explosive growth in the stock market and led to the infamous Dot Com crash of 2000/02. That was a lesson learned by the

Federal Reserve which was faulted for expanding monetary policy. Should the stock market get carried away once again fueled by easy monetary policy, it will be important not to get too carried away in the excitement.

We continue to have concerns with valuation levels and are surprised stock prices recovered so rapidly. Importantly, while the Federal Reserve has had a positive impact, healthy and suitably priced capital markets should not need the support of any central bank or government agency.

Despite a level of volatility not seen in many years, investor enthusiasm has returned. This being the third year of a U.S. presidential election cycle, the stock market has usually performed well historically. It has started out with a strong headwind. A more active portfolio strategy may be appropriate this year, both in an attempt to augment portfolio returns and for risk management purposes. Volatility may be the norm.

In fixed income markets, bond yields are not likely to decline much further than current levels. They appear to be range bound for the time being as inflationary expectations are subdued. The bond

market may also have already priced in a weaker economy. If the economy strengthens more than expected, bond prices are likely to decline. We do not recommend extending duration in fixed income investments and are therefore maintaining positions in short-term bonds not exceeding more than five years to maturity.

A balanced approach is still the most sensible strategy overall. In the meantime, we will continue to monitor events closely and make adjustments to portfolio weightings as necessary to moderate risk.