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CONTACT US:

Stonebrooke Asset
Management Ltd.

Waterpark Place
20 Bay Street, 11th Floor
Toronto, Ontario, M5J 2N8

344 Lakeshore Rd. E., Suite B
Oakville, Ontario, L6J 1J6

Tel: 416-850-2172
Email: info@stonebrooke.ca
www.stonebrooke.ca

Canadian Outlook

The latest series of economic statistics point to a mixed picture. Consumer retail sales for the month of May were down .1% and year over year the growth rate is a meagre 1%. The housing sector seems stable with recent monthly residential home sales little changed. Still, sales activity is not as robust as in the peak years of 2016/17. Sales of autos and other durables have declined year-over-year resulting in layoffs at General Motors and Fiat Chrysler.

Inflation is moderating. The Consumer Price Index (June) rose 2% year over year, down from 2.4% in the previous month, higher food prices being the main reason. The Bank of Canada is unlikely to respond with rate increases given the economic headwinds.

Trade issues with the U.S. have been mostly resolved and the ratification of the USMCA trade agreement (formerly known as NAFTA) awaits U.S. Congressional approval. Temporary tariffs on steel and aluminum have been lifted. While China has banned the importation of certain agricultural products, a major escalation in trade tensions between our two countries is not expected.

Though the Canadian energy sector has its challenges, Western Canada is advancing some large energy projects such as a Liquid Natural Gas export terminal on the West Coast and chemical processing facilities in Alberta. The Trans Mountain pipeline expansion should begin this summer and eventually help to alleviate the critical pipeline shortage in this country, narrowing the discount on Canadian oil prices.

Importantly for the Canadian economy and the health of the financial sector, the residential real estate market is not distressed - a concern in the past year. The latest decline in interest rates should alleviate that fear as the cost to carry a mortgage will now decline. Housing has become out of reach for the average family already. Incomes have not been growing by the same rate as house price inflation. The 10% plus appreciation in house prices could not continue indefinitely. No other asset class was rising consistently at that pace. A stable real estate market is expected, and this is certainly more beneficial over the long term for the economy.



China, A Changed Relationship

The U.S./China trade dispute is a major and dominant theme. The importance of reaching a resolution is self-evident. The stock markets certainly expect there will be an agreement signed, with very little fallout for the global economy - stocks are trading at, or near, record highs. While the mood remains positive, we believe the risks may be underappreciated. Conceivably, the U.S./China relationship could deteriorate into a *permanent conflict bordering on economic war*.

From a corporate viewpoint political risk translates to business risk. Whether to have a significant dependency on China for your production and/or revenues, is now debated in the boardrooms of many multinational companies. Maintaining the status quo and hoping for a positive outcome is short sighted. Nationalistic sentiment is rising and could mean the beginning of a new Cold War and the subsequent decline of the globalized world trading system that has prevailed over the last two decades.

There is a very real risk that the proverbial "light bulb" goes on collectively and the markets realize the trade spat is not just a temporary phenomenon, but a more permanent and transformative change. If globalization was responsible for creating prosperity and achieving higher economic growth rates, then it follows that the reverse must be true. The economic impact should be harmful at least until global supply chains re-adjust. Higher consumer prices can be expected, along with higher inflation. With the stock

markets at or near their highs, this is certainly not the conventional thinking.

Many pundits believe China to be in the weaker position. Even Chinese economists are predicting that a trade war could cost about a 2% reduction to GDP. The possibility of increased domestic social and political tension must also be on President Xi Jinping's mind.

While a U.S./China split need not be acrimonious, there will be a permanent change when it comes to technology transfers, which has become a national security issue. Both Republicans and Democrats are now in agreement on this one vital non-partisan issue.

In just under one year, the prospects for trade and robust growth coming out of China will have changed considerably. Chinese growth forecasts may need to be revised downwards.

India, conversely, is set to expand with more economic reforms and a buildup

in infrastructure. Prime Minister Modi has won a new five-year term and the forecasts are for India to grow at one of the fastest paces, 6-7%.

Mexico is likely to be a beneficiary of the U.S. China split. Businesses are looking to divest out of China and are considering Mexico. The new USMCA trade deal puts Mexico in a good position to compete and it is right next door to the U.S. Still, China is a formidable competitor and for many basic simple goods it has the manufacturing infrastructure in place to produce very cheaply.



A Recession On The Horizon

We are now officially in the longest U.S. economic cycle in history – 10 years. According to the National Bureau of Economic Research (NBER), this cycle officially started in June of 2009. It has also produced one of the slowest growth rates with GDP over the period expanding by only 25%. The previous longest expansion was from March 1991 to March 2001. A total growth rate of 42.6% was produced during that ten-year expansion.

Economic cycles do not just end in exhaustion. Rising interest rates leading to a contraction in credit are usually the root cause. This is why the current environment of rising interest rates is being critically analyzed. There are a few celebrated economists that are now on record forecasting a recession is right around the corner.

According to David Rosenberg, of Gluskin Sheff, "the recession

has already started". David is one of our favorite economists, not so much because he is always accurate, no one is, but because he has a better sense than most of how the capital markets work. He expects we will see negative GDP numbers in the coming quarters led by a decline in capital spending. In his recent testimony to Congress, Fed Chairman Powell had expressed a concern in the outlook for business spending. Business fixed investment was soft in the previous quarter.

Nouriel Roubini is another well-known economist and professor at NYU's Stern School of Business. He drew fame by correctly forecasting the housing bubble which led to the 2008/9 financial crisis. According to Nouriel, "The consequences of this trade and tech war and cold war [are] the beginning of de-globalization ... and the decoupling of the global economy. We'll have to redo the global tech

(cont'd on page 3)

A Recession on the Horizon (cont'd from page 2)

supply chain. And eventually by next year, if this escalates, it will be a global recession." His base case is that the trade war with China escalates. He points out global manufacturing is already in recession. The services sector will follow.

The Bank of Canada has confirmed the concerns citing, "Evidence has been accumulating that ongoing trade tensions are having a material effect on the global economic outlook....

trade conflicts between the U.S. and China, in particular, are curbing manufacturing activity and business investment and pushing down commodity prices"

The business cycle came very close to ending in 2015. Monetary policy was



starting to tighten, however interest rates remained very low. The Federal Reserve is currently making a U-turn and can afford to be aggressive in lowering interest rates. Will this be necessary, and can it prevent a recession? At the moment the stock markets seem to think so. The bond market on the other hand is suggesting otherwise as yields slide lower. The bond market, supposedly, is believed to be the "smarter market", i.e. a better indicator. Maybe the bond market has figured out the global economy is in trouble.

It is also just as likely that in this era of extremely low interest rates the U.S. and Canadian economies can continue to produce a little more growth for at least another year or two.

Yield Curve Update

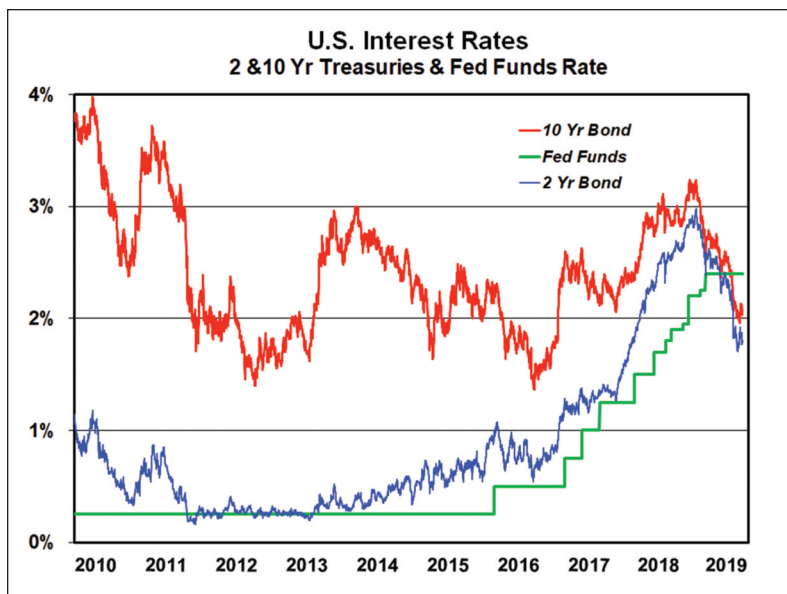
The yield curve has inverted. Short term interest rates are now above longer-term interest rates. The chart below shows the U.S. Fed Funds rate (2.4%) along with the two, and ten-year Treasury bond yields. At a 2.1% rate on the ten-year, longer-term yields are now below shorter-term yields (the Fed funds rate is an overnight rate set by the Federal Reserve). A Yield curve inversion has been a reliable indicator of a pending recession – however it is not 100% perfect. The majority of market analysts believe that Chairman Powell's monetary policy reversal is perfect timing and will prevent a recession from developing. Usually the Fed waits too long before dropping interest rates. Still, the Powell "pivot", signals just how dependent the U.S. and world economies have become on artificially low interest

rates. How will the world be able to normalize interest rates if they cannot do so after a ten-year economic expansion? Central banks are trapped, and it appears the monetary tightening cycle may now be delayed for quite some time.

Looking back over the post war period, an inverted yield curve has been a fairly accurate signal. Gary Shilling, another well respected and widely followed economist, is on record with a forecast of the 10-year bond yield declining to 1%. Shilling has held this view for a while believing the economy is headed into a deflationary cycle. He again said recently "I am more confident than ever in that forecast". In addition, he points out that "in 12 of the 13 attempts by the Fed in the post-World War II period to simply cool what it saw as an overheating economy, a recession followed. The only soft landing was in the mid-1990s".

Normally, the Fed is worried about cooling off an inflationary prone economy. This is not the case today. The fact that the 10-year bond yield has fallen so quickly is indicative of this. In the previous two cycles, the yield curve stayed negative for a much longer period of time. Inflation was a very real concern.

A .25% cut in the Fed funds rate is expected this summer and another .25% before the end of the year. It could be much more if Gary Shilling is correct with his economic assessment. Perhaps the U.S. and Canada are destined to join Japan and Europe and move to negative interest rates. It has been reported that over \$12 Trillion in bonds, primarily in Europe, are trading at **below zero** interest rates (The German 10-year Bund yield is at -.3%). As improbable as it may seem, we may be heading right off the charts – *in this case well below the charts.*



Portfolio Strategy

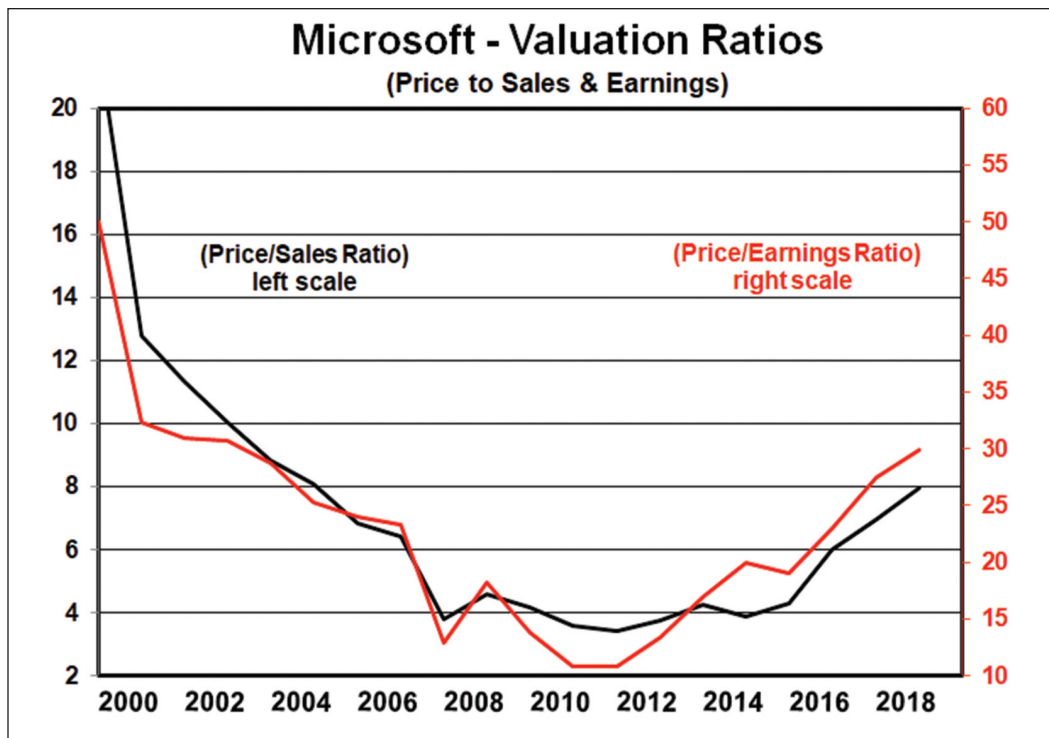
Not long ago the majority of investors assumed the economy would by now be firing on all cylinders. Rising interest rates was confirmation the economy was strong and the demand for credit robust. With the U.S. Fed now reversing course, the outlook has changed. The economic data is soft around the world.

Despite this sub-par economic outlook, the stock market has been resilient. It has made a strong recovery. The bond market on the other hand is nervous as interest rates have dropped considerably. Many market analysts have commented on this apparent contradiction, and there are no shortages of strong views proclaiming lower interest rates are exactly what is needed to keep the business cycle expanding. Investors, it seems, are willing to pay up for stocks. Until that changes, which it will, the stock market could head much higher. Microsoft is a case in point as it has become the world's most valuable company, trading at a market capitalization of over \$1 Trillion. The chart below shows the valuation level in terms of two ratios – Price divided by the company's sales and by earnings.

Price to sales and price to earnings ratios were well over 20X and 40X respectively. Today these valuation ratios for Microsoft are much lower and seem inexpensive in comparison. Investors may continue to throw caution into the wind and drive prices higher.

The global financial sector has been stunned with the recent news surrounding Deutsche Bank. The bank announced they will be laying off 18,000 employees, which represents a fifth of their global workforce. It is rumoured depositors are pulling out \$1 Billion Euros per day. Being one of the major international banks, Deutsche Bank is "too big to fail". It is too important in the interconnected global financial network. A failure would certainly cause a panic in the financial markets. Surprisingly, the markets have remained complacent.

While risk levels are elevated, liquidity can take financial markets to much higher levels. The markets may be counting on Central banks to yet again carry the day. We continue to recommend a balanced investment approach. Higher dividend yielding securities and



Twenty years ago, during the "dot com" craze, investors were eager and willing to pay up for technology stocks. Microsoft was one of the darlings. The company was reporting solid growth with about \$20 Billion in revenue and \$8 Billion in earnings. Valuation levels rose and became highly speculative - one for the history books.

exchange traded funds makes sense for the equity component. We are monitoring the fixed income markets and may consider slightly increasing the maturity term. In the period ahead we could certainly have an environment which continues to send interest rates lower.