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## The Global Slowdown Continues

The International Monetary Fund (IMF), has again cut its global growth forecast for 2019, now down to 3%, citing the same reasons – namely the U.S./China trade dispute and its effects on world trade.

In Canada, the consensus outlook is for slow to moderate growth. Recent data on retail sales activity shows a generally stable consumer spending environment. The residential real estate market has firmed, with low interest rates forecasted well into 2020. With the Federal election now behind us the Liberal party has been returned to Ottawa with a minority government. While too early to pass judgement on the agenda going forward, if history is any guide the electorate will likely be back in the voting booths within two years' time, at least that seems to be the experience with minority governments.

Canadian oil output and exports will likely rise towards year end with some additional rail capacity and pipeline re-routing. Any significant growth in exports will be years away due to the lack of pipelines. Any rise in the world oil price will therefore not fully accrue to our domestic energy sector. Tellingly, however, the recent attack on Saudi Arabia's oil processing facilities, cutting output by a highly significant amount - 3 million barrels per day, had no lasting impact on oil prices. The global slowdown is a contributing factor.

In the U.S. the economic statistics show a slowing economy. Non-farm payrolls in the U.S. have been slipping all year with last month reporting a total gain of 114,000 jobs. Monthly gains were well over 200,000 jobs in 2018. Still, the unemployment rate is at 3.7%, near a 50 year low.

Germany is likely already in a recession or very near. Their GDP contracted in the 2nd quarter of this year and it appears a decline is likely again in the current quarter. New German machinery orders are weak. The purchasing managers index (PMI) remains under 50, indicating a contraction in manufacturing.



# Monetary System Liquidity

The recent disturbance in the “repo” market (repurchase agreements between financial institutions), has many analysts on edge worried about monetary system liquidity. The “repo” market is an important lending market providing financial liquidity for short term borrowing needs, usually overnight. A lack of liquidity caused overnight interest rates to suddenly spike to 10%. The U.S. Federal Reserve was forced to inject \$75 Billion to calm markets and has announced it will provide ongoing reserves to the banking sector. This may be a serious and destabilizing issue eventually requiring another round of quantitative easing (QE).

Chairman Jerome Powell however has insisted, “In no sense is this QE”. The intended aim is to provide the banking system with overnight liquidity, not to flood the banks with excess funds as was the case with previous episodes of QE. Importantly, if this does turn out to be another round of QE, or even a QE “lite”, then the stimulus could very well propel financial markets higher in the period ahead.

There have been previous warnings about the repo market not functioning effectively. Over the years the global banking sector has reduced the size and scope of trading

desks. Regulatory changes and lower profit margins are cited as the main reasons. While the experts who follow this arcane world of finance are at a loss to explain what is happening, some believe that U.S. dollar liquidity is the issue. U.S. dollar denominated debts outside the U.S., have grown steadily and now exceed \$15 trillion. More debt requires more liquidity.

Perhaps monetary largess will extend the business cycle for another year or two and pre-empt the coming recession, which so many pundits have been forecasting lately. By lowering interest rates and providing liquidity central banks are encouraging the accumulation of more debt. If interest rates head to zero, then presumably this will encourage more borrowing for asset purchases, whether houses or stocks. The additional debt financing will help to inflate the price of assets.

This could also be why the stock market, notwithstanding the occasional hiccups, has been surprisingly firm. Investors have been conditioned by years of accommodative central bank policy. Any decline in stock prices will be met by a shot of monetary adrenaline. We could see much lower interest rates for many years to come.

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## Rising Geo-Political Risks

In our opinion, investors should be more focused on the rising geopolitical risks. While these risk levels are subjective and difficult to measure, they are important and must be monitored closely. There are at least four principle risks which the markets face:

- 1) The protests in Hong Kong;
- 2) U.S. China trade dispute;
- 3) Brexit; and
- 4) The Middle East and Iran.

While the U.S./China trade dispute has been the primary concern for financial markets, the continuing standoff in Hong Kong could take center stage should China intervene militarily. The situation in Hong Kong has escalated with the imposition of a colonial-era emergency law. The protestors have been emboldened and are also ignoring a ban on face masks. A political solution is needed quickly with the local HK government. A military intervention by China would be a huge mistake demanding a response from the West. At the very least economic sanctions would be imposed on China which would be highly disruptive for the financial markets. The trend to de-globalize would be given a strong push.



Brexit is an ongoing issue which is taking an eternity to resolve. Still, a no-deal Brexit is a possibility however remote. It would bring economic uncertainty. The Middle East is a perennial flashpoint. Tensions are heating up between Saudi Arabia and Iran. The rhetoric is alarming, and a conflict could erupt at any time. The last thing a slowing global economy needs is a spike in oil prices. It would send the global economy over the edge into a full-blown recession.

Another risk is impeachment, although at this point the risk appears low with Republicans having control of the U.S. Senate. In any event it is unclear whether either an impeachment or the defeat of Trump in the upcoming 2020 election, is a favorable outcome for financial markets. It depends who the Democratic nominee is for President. Two of the leading candidates, Bernie Sanders and Elizabeth Warren are viewed as too extreme. Markets are fickle and dislike uncertainty - they would prefer a status quo candidate like Joe Biden.

To some degree these risks may already be partially discounted by investors. Any positive announcement which eliminates any or all of these risks could shift investor confidence overnight and send financial markets higher.

# Negative Interest Rates - A Banking Conundrum

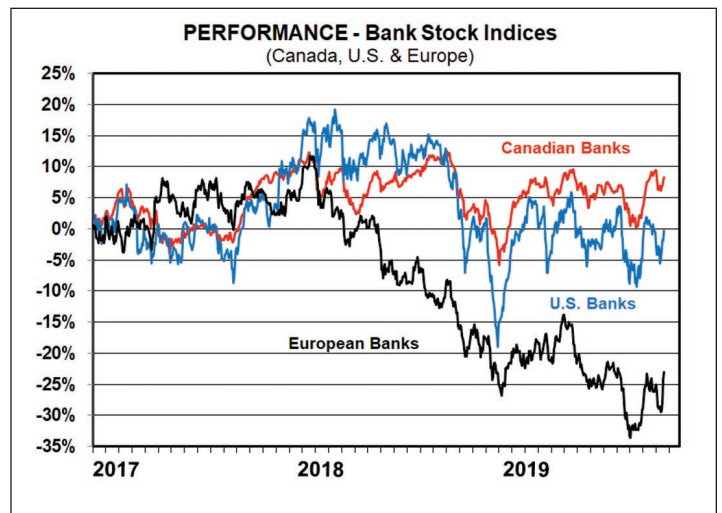
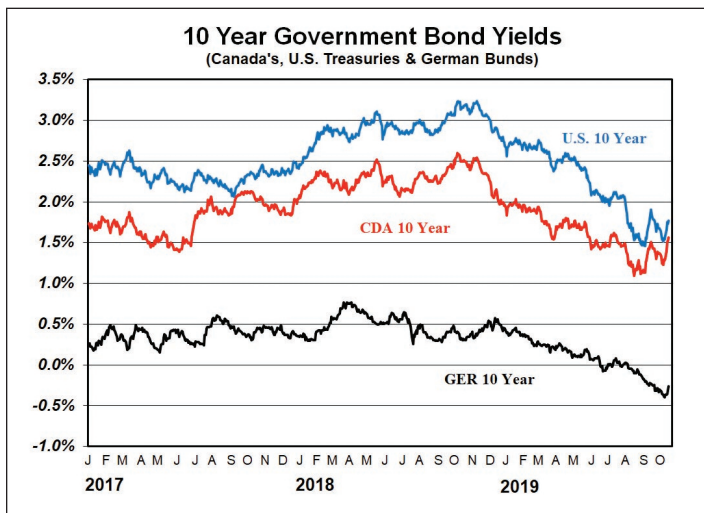
A good portion of banking industry profits come from the traditional spread in interest rates, the difference between short-term and long-term rates. Banks typically borrow, or take in deposits short term, and they lend money for a longer time period earning the "spread" or difference between short and longer dated investments.

With the yield curve virtually flat, i.e. short-term interest rates at the same level as long term interest rates, the banking sector is struggling to make money on this vital part of their business. Additionally, it is estimated there is a total of \$17 Trillion in government and corporate debt, mainly in Europe, with interest rate yields below 0%.

Accordingly, the shares of European banks have fallen with the move to negative interest rates and the tighter interest rate spreads. Both short, and long-term interest rates have

plunged below zero resulting in an insignificant profit spread. Historically, spreads were around 1.5 to 2%. Incidentally, Japan has had zero to negative interest rates for the better part of two decades and their banking institutions have struggled to generate decent earnings.

The two charts below plot the decline in 10-year government bond yields for Canada, the U.S. and Germany, and the Canadian, U.S. and European bank stock indices, in local currencies. The dismal performance of the European banking sector is striking. It was about 5 years ago when the first zero interest rate bond was issued in Europe. If North American interest rates are eventually heading towards zero, as some economists and strategists have recently proclaimed, our banking sector is likely to face the same challenges as their European counterparts.



## U.S. Dollar – Reserve Currency?

In a recent article, Michael Cembalest, Chairman of Market and Investment Strategy for J.P. Morgan Asset Management, suggested that the U.S. dollar could lose its reserve currency status. He posed the question whether the dollar's "exorbitant privilege" is coming to an end?

JP Morgan is influential and an esteemed institution. For the investment bank to be questioning the U.S. dollar's status as the world's reserve currency is very telling. The U.S. government has doubled its outstanding debt over the past ten years from \$10 Trillion in 2009 to the current \$22 Trillion. The annual budget deficit is growing, estimated at \$1 Trillion in this fiscal year. There are very few



budget "hawks" left in Washington. The big political battles and debates are rarely about balancing the budget.

Also concerning is that there is a growing attraction to Modern Monetary Theory (MMT). Politicians are seeing MMT as a way to expand spending on all kinds of social programs. If adopted, it is questionable whether an increase in U.S. dollar debt would be welcomed

globally. International coordination would be necessary to avoid a run on the dollar. Reserve currency status has indeed been a privilege for the U.S. Any change in that status will be a major financial event.

*(cont'd on page 4)*

Coincidentally, there has been a considerable amount of discourse over the past few months on Gold. Many articles have been published from respected sources arguing the time may be right for investing in Gold. The price trend has been favourable, recently rising as high as \$1,550 US. The potential for an expansionary monetary environment, bringing U.S. dollar uncertainty, is seen to be the root cause.

Governments are eager to spend to support continued economic growth and to even produce a little inflation. Central banks will look to extend the business cycle. There are monetary policy analysts that believe the U.S. Federal Reserve should cut interest rates more aggressively to avoid a downturn. An aggressive pre-emptive policy with a quick decline in interest rates may be the ideal policy choice to avoid a more desperate and alarming expansion of QE later on. Currency markets may be in for some interesting times.

## Portfolio Strategy

Corporate profits in the first half of the year were down in aggregate and continue to slide. Many of the larger multinational companies are forecasting a challenging environment ahead faulting the U.S./China trade conflict for creating uncertainty. Third quarter estimates have been revised lower and are expected to be down 4% from a year ago. This is a far cry from 2018 when tax reform and a much healthier economy contributed to a 20% growth in profits. Adjusting for the lower tax rates, earnings growth was still up a respectable 6%.

Initial Public Offerings (IPO) are struggling as investors appear less willing to speculate. The recent Peleton IPO, a company in the fitness equipment business was priced at \$29 per share, valuing the entire company at around \$8 Billion. In its most recent financials, the company reported losses of almost \$200 Million. The stock price has fallen to \$23. WeWork, another highly anticipated IPO was recently shelved. In the private market WeWork once commanded a valuation as high as \$47 billion. The sudden lack of investor interest could not even get the IPO done at a vastly reduced valuation of \$15 billion.

IPO's such as Uber and Lyft, which raised capital earlier this year have seen their stock prices decline. Lyft came public at \$72 and now trades under \$40. These are all money losing companies that should not have priced their stocks at such excessive valuation levels. Reality is finally setting in and investors are less willing to gamble in this highly volatile market segment.

Furthermore, these companies promoted themselves as technology companies when in reality they are only leveraging technology in their various businesses. Peleton sells stationary exercise bikes and WeWork sells office space – not exactly cutting-edge technology. Investors often get carried away seeking new investment opportunities in the

IPO market. The weakness in this market given the absurd valuations should not be a surprise.

The Utilities and Consumer Staples sectors are outperforming this year. These are defensive sectors and generally offer higher dividend yields. Certain growth and technology companies are still attracting investors, although the gains have moderated. The emphasis on defensive sectors, higher yields, and the letdown in the IPO market are clear indications of **the beginning of a shift to de-risk portfolios.**



Rudiger Dornbusch, the late MIT economist and author of several economic books including *Macroeconomics*, correctly observed that, "In economics, things take longer to happen than you think they will, and then they happen faster than you thought they could."

Financial markets act in a similar fashion. At times certain sectors of the market defy logic, being either vastly overpriced, or underpriced. Adjustments can be quick. One of the darling groups in Canada has been the cannabis sector. These

stocks defied gravity with economic fundamentals that made no common sense. In just the past six months the sector is down 50%, with many once high-flying stocks like Tilray, collapsing by 80%. It is a classic example of Dornbusch's observations. The valuations for these companies were extreme to say the least. It was just a matter of time before investors came to their senses.

For the majority of portfolios, we continue to recommend a balanced mix of fixed income and equity securities. Our bond holdings emphasize shorter duration maturities, with little portfolio risk. We would not be surprised at the return of more volatile conditions for the major stock market indices. These volatile periods have been short lived, and we would likely view it as another opportunity.