STONEBROOKE
ASSET MANAGEMENT

# The Commentary

*CommonSense Investing*

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## The Return of Volatility

Stock markets have tumbled sharply in recent weeks - an occurrence which is often thought synonymous with the month of October. There is no single reason for the correction and it may be over just as quickly as it started. Stock markets are volatile and cannot be expected to rise forever at a steady pace. It does appear that rising bond yields, having eased for a few months, are a contributing factor. The U.S. 10-year treasury bond yield hit 3.23%, the highest level in more than 7 years. The previous volatility shock came in February when the 10-year yield approached 3.0%.

It is not just rising bond yields that are scaring the markets. Recent news reports have likely elevated the perceived risk level. The International Monetary Fund (IMF) issued a statement that growth would be lower next year. This is the first indication that the U.S. China trade dispute will be negative for global growth. IMF chief Christine Lagarde said risks to the global economy had begun to materialise and were a concern. In a recent speech she said the rise in trade barriers "is hurting not only trade itself, but also investment and manufacturing as uncertainty continues to rise." She further urged governments to de-escalate disputes and cautioned that they fail to do so at their peril.

Furthermore, a flurry of cautionary articles have appeared in the business media. The latest cover of the Economist magazine warns of "The next recession" and asks

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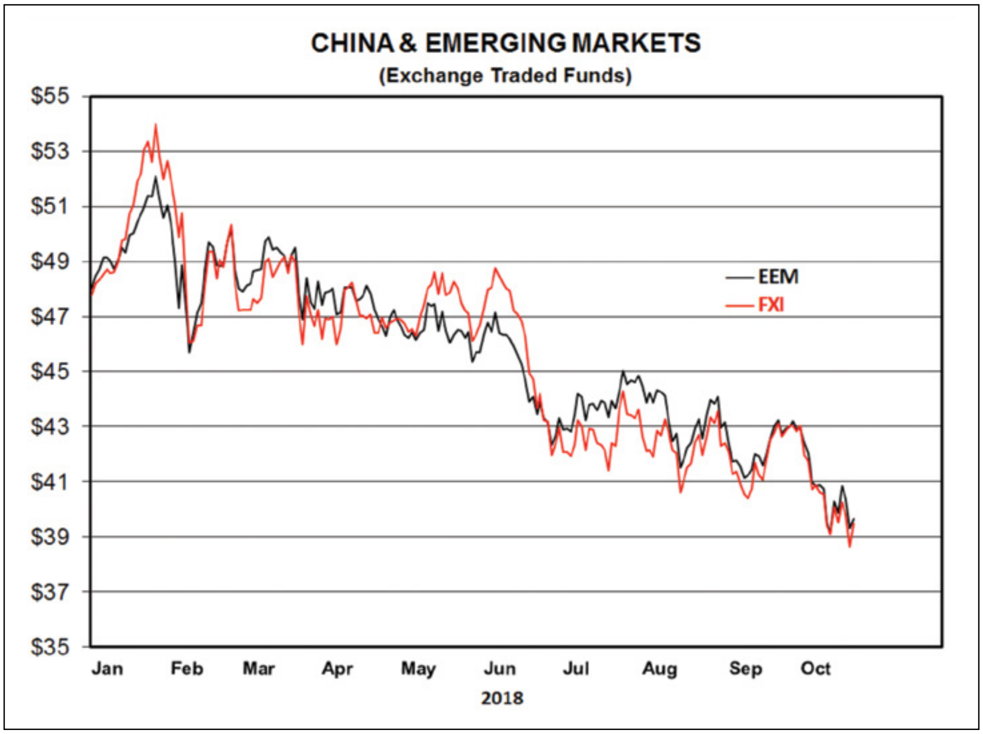



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S&P/TSX : 16,073
S&P 500 : 2,914

90 Day T-Bills : 1.59%
10 Yr Cda Bond : 2.42%

Oil : $73.20 US
Gold : 1,187 US

Cdn $ : .775 US
Euro : 1.49 Cdn

**The Return of Volatility** *(cont'd from page 1)*

the question - how bad will it be? Another business publication warned of the "Coming global downturn". As far as we can ascertain, this is being fuelled by the rise in interest rates, a strong U.S. dollar and the trade friction between the U.S. and China. The fact that stock markets in China and emerging markets are down about 20% year to date is also worrying. Many are questioning if the U.S. market is the next to fall. The chart on page 1 plots the year-to-date performance of two popular exchange traded funds. The FXI, a broad basket of larger Chinese stocks, and the EEM, which tracks the performance of the emerging market benchmark stock index. Both have moved down considerably this year.

While the mid-term elections in the U.S. are not usually a significant political event for the financial markets to worry about, it may be influential this year. To the extent the current rally in the stock market is based on the Trump administration's economic policies, namely tax reform and deregulation, a Democratic majority in the house and senate could be important this time around. Democratic control of key committees may alarm markets especially if rolling back the tax cuts is on the agenda.

# **USMCA** – Son of NAFTA

An agreement on trade between Canada and the U.S. was finally reached just hours before the September 30th deadline. The North America Free Trade Agreement, or NAFTA will be replaced by the new United States Mexico Canada, USMCA trade pact, subject to the formal approval by the U.S. Congress and the Parliament of Canada. The U.S. and Mexico had already reached agreement.

Foreign Affairs Minister Chrystia Freeland did an exceptional job defending Canadian interests. Positive changes for Canada include duty-free auto exports at a higher level of volume, a sixteen year sunset clause or expiry date, and maintaining the dispute resolution mechanism.

Softwood lumber exports remain subject to tariffs based on price and volume. Steel and aluminum exports are still subject to tariffs imposed earlier this year. This has increased costs for many companies. Ford Motor Co. estimated their costs of steel and aluminum amounted to an extra $1 Billion. It is hoped that there will be some relief on these outstanding trade issues after the U.S. mid-term elections.

Canada made concessions on dairy products which was instrumental in reaching a final agreement. President Trump had continually complained about the restrictions imposed on U.S. milk and by-products. Over time Canadian consumers will see lower prices for these items while dairy farmers in Canada will face stiffer competition. All in all, the new USMCA trade agreement appears acceptable to the majority, and importantly, it ends the uncertainly for Canadian businesses.

# Monetary Tightening

The U.S. Federal Reserve is continuing to tighten monetary policy by raising interest rates. Chairman Jerome Powell has stated interest rates are too low and need to be "normalized". In a recent television interview, he stated, "interest rates are still accommodative, but we're gradually moving to a place where they will be neutral". He added that interest rates are *still a long way from neutra*l, implying that rates have much further to rise.

The Federal Funds rate is the rate banks pay to obtain funds. As the rate rises, banks will in turn raise the cost of borrowing. The demand for bank loans will decline over time as interest rates rise. A slowdown in the growth of bank credit will be felt in the economy with a slowdown in the growth of consumer spending. At this juncture the growth in bank lending has not been negatively affected by monetary tightening.

However, the annualized forecast for economic growth in the U.S. in 2019 has dropped to just 2.5%, as per a recent International Monetary Fund (IMF) report. Just a few short months ago there were many forecasts of 3 to 3.5% growth from some prominent financial institutions. The consensus view was buoyant, driven by the success of tax reform and strong corporate profit growth. Suddenly there is concern of a slowdown. An additional .25% rise in the Federal Funds rate is no longer guaranteed. Some pundits have suggested that raising rates in December and again in the first quarter in 2019 will tip the economy into a recession. While the economy is very interest rate sensitive, the evidence for a significant slowdown in growth, let alone a recession, is lacking. The majority of economists and market strategists are still forecasting solid growth ahead.

Rising interest rates in the U.S. continues to attract foreign capital. The U.S. dollar is a prime beneficiary as it continues to strengthen. From a relative perspective the U.S. economy is seen as an attractive place to invest. Monetary tightening by the U.S. Federal Reserve may in time become problematic. At its current gradual pace, it should still be fairly benign.

# The Fed Under Criticism

President Trump, who has been critical of the Fed Chairman for raising interest rates, has been criticized for interfering with an "independent" Federal Reserve. The Fed has always been subject to political pressure, sometimes in the most unprofessional of ways. An infuriated Lyndon Johnson once pinned then Federal Reserve Chairman William McChesney Martin against the wall after he increased interest rates against his wishes. Trump may be many things, but he is not a complete fool. He does not want to be blamed for the next downturn. He knows there is a bubble growing in financial assets. He said so back in 2016 during the election campaign. He knows rising interest rates has always been problematic for the stock market and the economy. By criticizing Powell, he is setting up a potential scapegoat.


The financial markets have become more complex in recent years. Some have long argued the Central banks have manipulated the markets. Their "zero interest rate" policies have certainly distorted markets leading investors, both institutional and retail, to seek higher yielding alternatives. Investments have been made in all sorts of higher risk securities which would not pass muster in a normalized interest rate environment. As interest rates now rise the stress level will also rise.

There are some analysts who claim that monetary policy has distorted the yield curve. The majority of U.S. debt is short term, maturing in under three years. Perhaps a negative yield curve (short term interest rates higher than longer term rates), will not occur this cycle, or will be delayed. Central bank interventions may be timed appropriately and successful in keeping the economy and financial markets orderly.

There are many dauting issues for investors to be concerned about. Europe is in political turmoil with a Brexit agreement still up in the air. The European Union recently rejected Italy's new budget stirring up anti-Euro sentiment. Escalating trade tariffs between the U.S. and China is a threat to global growth. Criticizing the Federal Reserve at this juncture is purely political. There are greater and more important issues out there.

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# Buy At Any Price

The so-called FAANG stocks, an acronym for Facebook, Apple, Amazon, Netflix, and Google continued to attract investor capital through to the end of the September quarter. As of mid-October, these high-growth momentum favourites are under pressure.  Facebook has been faltering since earlier this summer when it warned of slowing revenue. Its stock price is down about 25%. The other momentum favourites may be following its lead.

There are many examples throughout history when investors overpaid for stocks. It never ends well when a mania takes hold and common sense goes right out the window. Stocks, or at least certain groups of stocks, become a "buy at any price". Investors just can't get enough, and at every opportunity when the market corrects they plunge back in sending prices higher and higher. The pattern repeats itself until valuations become so stretched that any disappointing news will send them reeling.

Regrettably, the various stock indices and many of the exchange traded funds (ETF's) that track the stock market are themselves full of FAANG stocks. NASDAQ was up 17% this year as of the end of the third quarter, led by just four stocks; Apple, Amazon, Microsoft and Goggle. The market capitalization of these four giants is about $4 Trillion. They also represent the bulk of the performance this year for the S&P 500 index as well. (Apple alone represents over 4% of the S&P 500 stock index, and a whopping 9% of the NASDAQ).

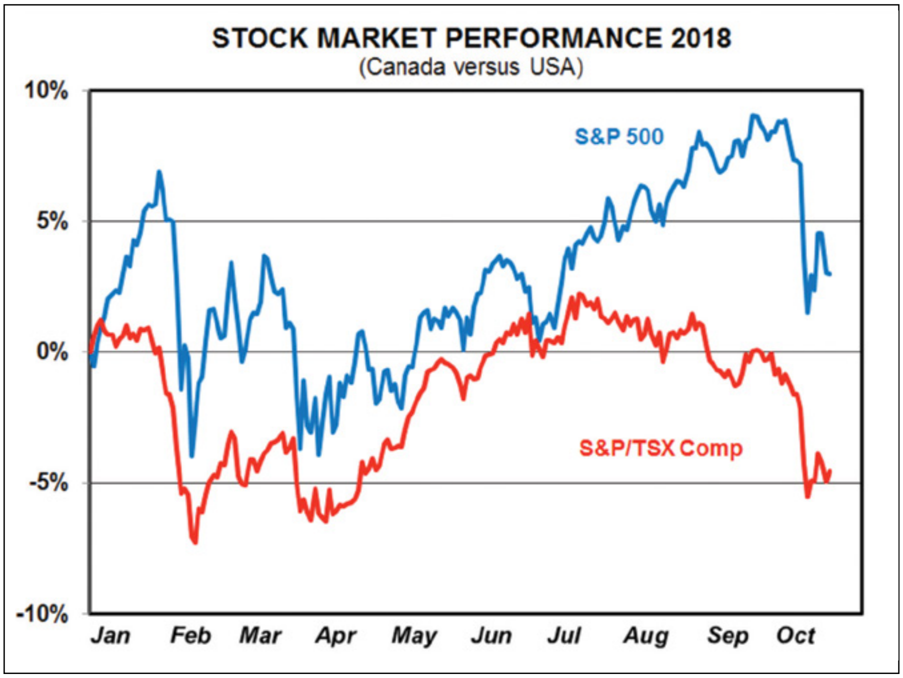
NASDAQ has peaked for the second time this year, having recently fallen by about 7% in mid-October. The January peak was more inclusive representing more stocks making new highs. This time the market has made a second peak with only a very concentrated number of companies. We will see if investors are quick to keep purchasing these expensive stocks. The "buy at any price" mantra will be tested again.

# Portfolio Strategy

We remain defensive and balanced which means roughly an equal weighting between stocks and fixed income securities. Our focus remains in Canada due largely to the heavy discount in our currency and the simple recognition the U.S. markets have expanded well beyond reasonable value. The U.S. market can continue to do well and outperform the Canadian market. It would do so on extreme optimism and euphoria, not on a foundation of fundamental strength.

Emerging markets (EM) his year have so far suffered losses close to 20%, and 25% from the January peak. Chinese equities have the largest weighting in the EM index. The U.S China trade war has added to the tensions. The value proposition for emerging markets is looking very compelling on both a relative and absolute basis. The average price earnings multiple for EM stocks is about half that compared to the U.S. market.

The Canadian stock market is down about 6% year-to-date. In the U.S. the broader market is just barely positive. Our currency has slipped about three cents this year vis-a-vis the U.S. dollar. For the Canadian market the energy sector and commodity prices remain influential. Oil prices ranged from U.S. $65.00 to U.S. $75.00 during the third quarter, up from U.S. $60.40 at the end of 2017. U.S. sanctions on Iran and growth in global consumption appear to have placed a floor on the price of oil.




Unfortunately, Canadian oil producers continue to endure discounts of up to 40%, partly due to the lack of pipeline capacity. The Federal government purchased the existing Trans Mountain Pipeline earlier this year on the premise that being publicly owned would facilitate expansion. A Federal Appeals Court ruled that there had been insufficient consultation with B.C. native groups, among other issues, and construction was immediately stopped. Just when there was hope of some improvement, the Canadian oil sector has again been discouraged.

Natural gas producers received some good news. A consortium of companies led by Shell announced an investment in a long-term project for the export of liquid natural gas, or LNG. A new pipeline would move natural gas from wells in Northern Alberta and B.C. to a terminal at Kitimat B.C. where the gas would be liquified, cooled and shipped to Asian customers. Total cost for completion of the pipeline and other infrastructure is estimated at $40 billion. Many new jobs would be created during the construction phase and unlike the Trans Mountain expansion, the Province of B.C. is fully supportive of this project, providing grants and other incentives.

With the legalization of cannabis coming into effect stock valuations in this new sector have become completely irrational. The total market value of the public companies in this nascent industry is devoid of any reality. Stock prices are massively ahead of any reasonable calculation of future earnings. When companies trade in excess of 100 times earnings and 20 times book value, they quickly attract others to the industry. Bay & Wall Streets are only too happy to issue new securities to a ravenous pubic. In the case of cannabis there are now more than 200 companies either public or getting ready to go public. This will perhaps become a large and viable industry however not all will survive and profit. The sheer number of competitors will ultimately reduce returns and lower market valuations going forward. Investing at this stage is speculative and amounts to betting on the greater fool theory. When the "dust" settles, many of these companies will disappear in a puff of smoke.

Since the major indices in the U.S. are dominated by a few of the big and expensive tech companies, we are looking to invest in a broader and more diversified group of blue-chip stocks. The S&P 500 is a good alternative should it correct further. While it also has a significant position in tech stocks at least they do not dominate the index. A position in emerging markets is also being considered due to the compelling valuation metrics. We will be monitoring markets carefully for an entry point when volatility subsides.