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Trade Wars: The Saga Continues

The U.S. imposition of tariffs on Steel and Aluminum has resulted in the increase in tension in the ongoing NAFTA negotiations. Canada decided to retaliate and to hit the U.S. with an equal and measured dollar for dollar response. While this first skirmish is unlikely to cause significant economic damage to either country, the latest round of threats by the U.S. is another matter altogether. The U.S. is looking to impose a 25% tariff on the auto sector. By some estimates this could result in the loss of 100,000 jobs, both direct and indirect. This next round of tariffs, if imposed, would be very troubling indeed.

Fortunately, a strong anti-tariff message has been delivered to the White House by the world's automotive industry. Prominent Republicans also fiercely oppose any tariffs and scoff at the Administration's assertion that imported cars are a national security threat. It is unlikely such tariffs will ever be approved. Still, an escalation in the rhetoric can lead to a real escalation in protectionism. No one wins at this game.



Meanwhile, China has repeatedly blamed Washington for the trade conflict, with Chinese foreign ministry spokeswoman Hua Chunying calling it the biggest "confidence killer" for the global economy. China appears determined to fight back if the United States continues to up the ante.

Judging from the markets reaction, it appears the ongoing trade tensions are immaterial. Until of course they are. Investors have likely so far concluded that the economic impact of already-imposed tariffs is small and that there is likely a longer time to reach a compromise before a much larger wave of duties ever gets approved and implemented. Also, though China has reacted with alarm, they have not taken any aggressive actions. It just might be they understand Trump's tactics as he does have a history of changing his mind and reversing course. Still, a possible trade war may yet become the dominant concern for investors. The uncertainty is already having an impact as some surveys have reported businesses are delaying investment decisions, troubled about the disruptive effect on supply chains.

Importantly, investors will maintain their confidence so long as expectations are met. They dislike and will react to surprises. Very often negative events take longer to unfold, and then they happen much faster than imagined. The financial markets currently believe the Trump trade war will not be a material negative for the U.S. and consensus appears to be that China will not retaliate and will eventually give in. An unquantifiable risk in the market is that expectations suddenly change.

Bank of Canada; Follow the Leader

The Bank of Canada recently raised its key policy rate by .25% to 1.50%. While the rate increase was widely expected, the Governor of the Bank, Stephen Poloz, issued a warning on trade tensions saying, *"the possibility of more trade protectionism is the most important threat to global prospects."* Fortunately, he expects the economic effects of current tariffs enacted by the U.S. and Canada to be very modest.

The Bank updated its forecasts for GDP growth and now expects the economy to grow 2% this year, 2.2% in 2019 and 1.9% in 2020. Inflation forecasts have risen slightly with the Bank projecting 2.4% this year, 2.2% in 2019 and 2.1% in 2020. According to Governor Poloz, economic conditions in Canada have essentially normalized. The Bank will therefore look to raise interest rates to a "neutral level", estimated to be between 2.5% and 3.5%.

Just over a month ago in mid-June, the U.S. Federal Reserve increased its key policy rate by .25%, up to 2%. Chairman Jerome Powell offered a positive assessment of the economy, describing growth as solid and labour markets as robust. With respect to the trade tensions he said, "concerns about changes in trade policy are rising". However, he also stressed that currently they are not seeing it "in the numbers". Chairman Powell also forecast that inflation would remain close to the Fed's 2% target.

Although trade tensions remain a downside risk, stronger economic activity and rising inflation will likely prompt the

Fed to raise interest rates in September and December this year and twice more in early 2019, before an economic slowdown eventually persuades them to reverse course.

We think the Bank of Canada's outlook for the Canadian economy may be too optimistic especially on the prospects for business investment. While growth was fairly strong at the beginning of the year, the latest business outlook

suggests that capital investment growth will slow. The housing market is tenuous at best, even though sales seem to have rebounded recently in the Toronto GTA. Regardless, the Bank of Canada will have to play follow the leader as the U.S. is determined to raise interest rates. A balancing act will be necessary as the Bank must monitor the state of the economy and contend with any pressures on the Canadian dollar exchange rate.



The financial markets appear to be adjusting to a further rise in interest rates over the next 12 months. They are also likely pricing in stronger economic growth with no substantial impact from any trade disputes. It is possible the pace of tightening may have to slow in the event leading economic indicators point to a slowdown. In the past several years the economic data has been irregular, with many unsuccessful efforts at achieving a strong sustainable growth rate. Central banks will need to fine-tune their policies accordingly.

Bond Market

The bond markets have experienced a reprieve in the past several weeks as yields have drifted down. The benchmark 10-year U.S. Treasury bond is now yielding 2.85%, down from the recent peak of 3.1%. Many "experts" were calling for yields to rise to 3.5%, with a few extreme forecasts speculating interest rates could rise swiftly to 4%. It seemed probable. The consensus economic view for the U.S. is very positive with GDP growth rates estimated above 3.5%. This, along with the concern over fiscal deficits due to tax reform, rising bond yields seemed a certainty. As well, the U.S. Federal Reserve is, after all, adamant about raising short-term interest rates.

So what happened? There are a number of possible reasons bond yields declined. Perhaps it is a result of a flight to safety over concerns of a trade war causing a global recession, or the temporary influx of foreign money. Or maybe there were a number of institutions and hedge funds that purchased bonds believing a yield level over 3% was

attractive. After all, it wasn't long ago that 10-year bonds were yielding a miserly 2%.

Importantly, interest rates are likely to resume their upward path. A gradual rise is generally expected, and this appears to make common sense. The dynamics can change quickly however nudging interest rates up far higher than anticipated. For many years investors have piled into bond funds seeking safety and yield. For instance, high yield bond funds in the U.S. have amassed around \$2 Trillion of investor savings. The majority of these funds will hold lower quality corporate bonds. There is the possibility that at some higher level of interest rates, maybe 3.25%, or maybe 3.5%, investors, seeing the decline in prices, will panic and head for the exits. The market for bonds has doubled in size over the past several years. If investors are fearful and want to sell, it could trigger a flood of redemptions. We are in a brave new world.

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Bond Market (cont'd from page 2)

Concerns over China's investment intentions have resurfaced. China holds over \$1 Trillion in U.S. treasury bonds. Over the past several years analysts have expressed reservations about this huge foreign position in bonds, seeing it as a major risk. There was always a genuine fear of China dumping bonds and driving interest rates up. Ironically, it could be domestic investors who disrupt the markets and send yields higher.

Bond yields in Canada are highly influenced by the level of bond yields in the U.S., as well as globally. Interest rates have

been much lower than they should have been in recent years primarily because of the global support from central banks. That support is now changing as central banks reduce their bond purchases. Political risk is also increasing in Europe. In Italy, support is growing for anti Euro populous parties. In recent elections the "Five Star Movement" gained the most seats in the Italian Parliament. Nervousness in the Italian bond market caused a spike in interest rates with the 2-year Italian bond jumping over 2% in a matter of days. Bond markets globally have become less stable and changes to the status quo have the potential of driving interest rates up much higher than generally expected.

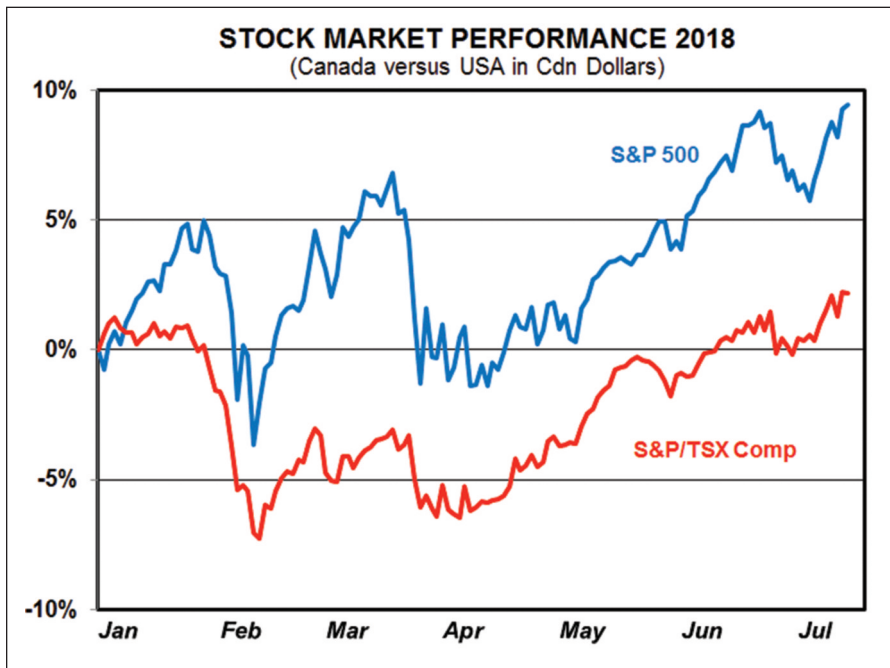
Equity Market

Despite some pretty severe headwinds - rising interest rates and trade tensions, the stock market has been very resilient over the past few months. From being down about 6% at the end of March the S&P/TSX Composite is now up about 2% for the year. In the U.S., the S&P 500 stock index is up about 4%. With the recent weakening of our Loonie, in Canadian dollar terms the performance is almost 5% higher. See adjacent chart.

With interest rates generally edging up, the economic sensitive sectors of the stock market are outperforming. For instance, the Consumer Discretionary sector is outperforming the more defensive Consumer Staples sector. Technology is also outperforming although this is partly a momentum play led by just a few of the larger well-known companies – Amazon, Goggle, etc. The Financial sector and Utilities, a more defensive sector, are both in negative

territory year-to-date. Investors are currently preferring the riskier sectors of the market and have confidence in the narrative that economic growth will accelerate.

Since year end the energy sector has enjoyed a 23% recovery in the price of oil (WTI), the North American benchmark for crude oil. Also, the large discount for heavy Canadian oil has contracted during the past few months. Canadian energy companies are experiencing some of the best profit growth in a long time. While the sector is up modestly year to date, stock prices have lagged behind the improvement in earnings and the more positive outlook. Should the price of oil continue higher as some industry watchers are predicting, this will be a boost for the performance of the Canadian stock market as the oil sector component still represents about 20% of the S&P/TSX Composite.



Earlier this year the stock markets in Canada and the U.S. ran into some turbulence as the 10-year U.S. government bond yield rose over 3%. While the actual level may be just a psychological number, the stock markets were uneasy as interest rates marched higher. As yields have declined slightly over the past two months the stock market has recovered and regained lost ground. The tight inverse correlation with the 10-year bond yield bears watching. As rates climb back up over 3% again, the stock market may encounter some resistance.

The Federal government's purchase of the Trans Mountain Pipeline from Kinder-Morgan may have marked the low in confidence for the Canadian oil patch. Finance Minister Morneau has assured Canadians that government ownership would guarantee the timely construction of a parallel line to facilitate exports of Western Canadian oil to Asian markets. U.S. demand for our oil and gas is expected to decline in the coming decades. It is important to build the

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Bond Market (cont'd from page 2)

necessary infrastructure and diversify for the benefit of the national economy.

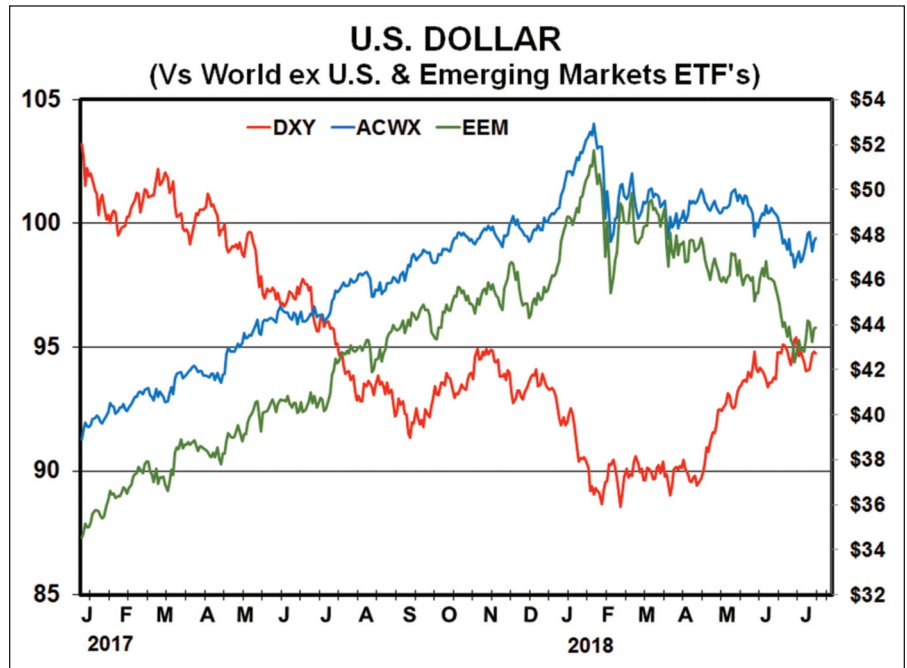
The oil sector has had a history of exaggerated forecasts on the outlook for demand, supply, and ultimately on prices. The current rebound in oil prices is no exception. Some geologists are again warning that world oil production will soon peak and then begin a steady decline.

Their analysis is based on the decline in spending on exploration and development and on faster depletion rates for new oil supply, largely from fracking. This serves as the basis for some forecasts of \$100 oil in 2019.

The U.S. dollar has strengthened in 2018. This is in sharp contrast to 2017 when the dollar plunged against most major currencies. As the chart below illustrates, a rising U.S. dollar this year has not been good news for global stock markets. The chart plots two popular global exchange traded funds. The EEM is the emerging markets ETF and the ACWX is an ETF representing the developed global market, excluding U.S. stocks.

Trade tensions may have an influence on the U.S. dollar and may be affecting the relative attractiveness of global stock markets. The

Chinese stock market is down almost 20%, taking the brunt of the developing uncertainties. For now, investors have determined the U.S. is the safer bet. For the U.S. economy, trade is a less important matter as exports comprise only about 12% of GDP. In China and elsewhere, the trade sector is much more vital with a higher concentration on manufacturing which is also a large employer.



Portfolio Strategy

In the fixed income component of investment portfolios, we continue to recommend short to medium term bonds. While interest rates are slightly higher for longer-term bonds, the tradeoff is not worth the extra risk. There is greater capital safety in short term bonds. In an environment of rising interest rates, the prices of longer-term bonds would fall by a much greater amount.

The U.S. Federal Reserve is determined to raise interest rates and reverse the decade long policy of monetary easing. Quantitative tapering (QT), is now the stated Fed policy. The Bank of Canada will likely follow along. The traditionally safer securities in the stock market, Utilities, Telecom, and other higher yielding companies, have all corrected in price, some by as much as 15%. The rise in interest rates is primarily to blame. These defensive areas are now more attractive, and we plan on increasing positions over time. In many respects some of these companies can be viewed as substitutes for fixed income securities provided a 3 to 4 year

time frame is being considered. The volatility over that period should be an acceptable risk for the opportunity of earning annual dividend yields in the neighbourhood of 4 to 5%. This is very competitive with the interest earned from short term bonds.

We continue to recommend a balanced portfolio structure. The risk of a *significant loss* is therefore greatly reduced. The current market is best characterized as expensive, and especially so for the technology sector in the U.S. which is almost single handedly responsible for the gains in the overall stock market. Stocks in general have not exhibited any signs of *major* structural weakness. They can advance further on positive momentum and investor confidence. Maintaining a balanced portfolio position with investments predominantly in Canada is in our judgement a safer and more prudent strategy for now. Exchange rate movements and/or a setback in U.S. stock prices will encourage us to shift more investments into the U.S. market over time.