STONEBROOKE
ASSET MANAGEMENT

The Commentary

CommonSense Investing

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Canadian Outlook

The Canadian economy started the year on a soft note. Statistics Canada reported GDP for the month of January was off by .1%. This while inflation year over year has advanced by 2.2%. Inflation has flared up with gasoline prices up double digits from a year ago. Restaurant meals are up 4% as many operators have had to cope with the increase in minimum wage in Ontario and Alberta. Travel, clothing and internet services also contributed to the rise in prices.

House prices in the major urban centers of Toronto and Vancouver have continued to soften with more stringent mortgage criteria taking effect this year. Buyers and sellers appear more cautious amid fewer transactions and as lenders require larger down payments. The softer residential housing market this year will also affect related ancillary spending that goes along with purchasing a home. Rising interest rates in an economy already saddled with high consumer debt levels will likely put added pressure on this sector.

Additionally, business confidence may have slipped as a result of escalating trade tensions. While the U.S. recently exempted Canada and Mexico from new tariffs on steel and aluminum imports, it applied new duties on Canadian newsprint. The Canadian and U.S. economies are largely integrated with companies operating on both sides of the border. Tariffs also hurt many American subsidiary companies. Importantly, capital spending projects are at risk as well as new equipment purchases as manufacturers await the outcome of NAFTA negotiations.

Domestic trade issues are also a concern with internal strife between provinces. The Alberta and B.C. governments continue to squabble over the Trans Mountain pipeline expansion, discouraging resource development in the region. Major energy corporations have been exiting Canada in favour of more pro-development jurisdictions. The Federal government has been inconsistent in providing clear signals to the energy industry. Lack of new pipeline capacity has placed a heavy penalty on the profitability of Western Canadian oil and gas operations.

The reality is Canada is an exporter of a resource which is locked-in and reliant on one customer. The changing dynamics has meant our oil is sold at a heavy discount and as a result the country is worse off. There is less economic activity, fewer jobs, and as a result lower tax revenue. Oil may become obsolete one day and solar panels will be powering our cars, but until then we are still reliant on oil.

Private capital will go where it is treated better and where the economics are more advantageous. Canada has an abundance of advantages that are self-evident and there is no reason to suggest our future is anything but bright. The immediate outlook however may have its challenges.

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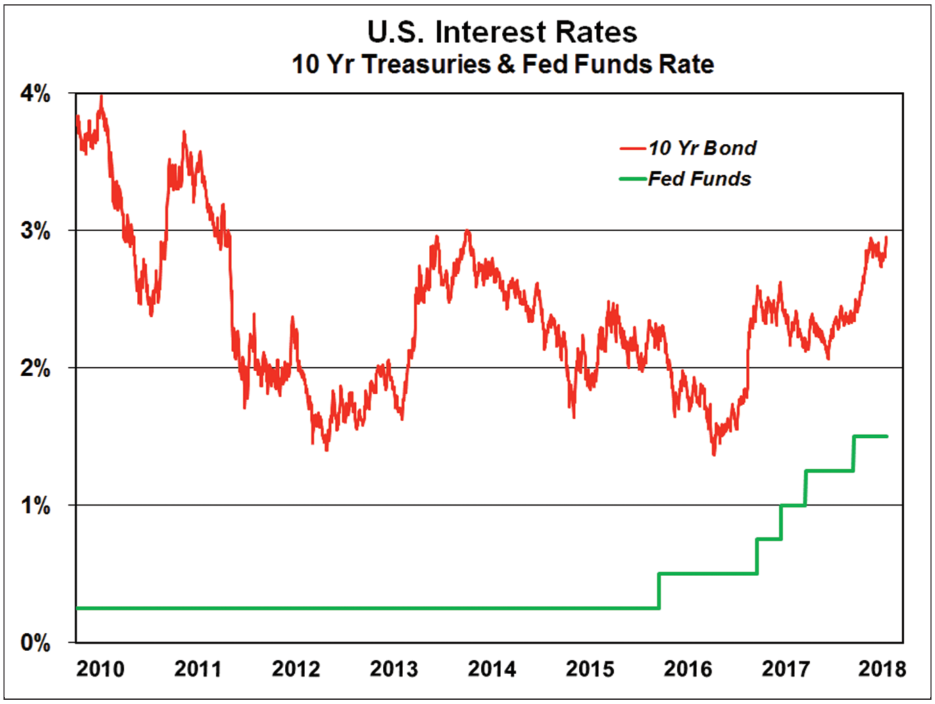
S&P/TSX : 15,367	90 Day T-Bills : 1.10%	Oil : $64.85 US	Cdn $: .776 US
S&P 500 : 2,641	10 Yr Cda Bond : 2.09%	Gold : 1,324 US	Euro : 1.59 Cdn

Bond Yields Heading Higher

In both the U.S. and Canada bond yields have been rising. The adjacent chart shows the yield on the 10 Year U.S. treasury bond. It is closing in on 3%, a level which is causing quite a bit of investor angst. The yield has doubled from about the 1.5% level back in the summer of 2016. The Federal Funds rate, an overnight interest rate administered by the Federal Reserve (lower line in green on the chart), is also rising as monetary policy is now clearly in a tightening mode.



The Federal Reserve was too aggressive in raising the Fed Funds Rate during the previous cycle from 2002 to 2008. They remember only too well how their actions popped the stock market bubble and ushered in the Financial Crisis. The Fed will likely be extra cautious this time around. Still, in the most recent Fed minutes, the median projections for the Fed Funds rate is 2.1% for the end of this year, 2.9% at the end of 2019, and a 3.4% rate at the end of 2020.

With interest rates rising investors are fixated on the shape of the yield curve, watching closely for an inversion. An inverted yield curve is when short-term interest rates are at a higher level than longer-term interest rates. This has been a fairly reliable leading indicator of economic activity - yield inversions typically signal oncoming recessions.

Some market strategists have concluded the stock market will continue to gain strength *precisely because interest rates are rising*, a sign of a strengthening economy. Many are also confident we are still a long way from an inverted yield curve. In contrast, others argue it will not require a large increase in rates to shift investor preference to bonds and away from stocks, which are considered expensive. A bond yield of 3.5% has been suggested to be a level where bonds offer a good risk/return profile. Of course, this could change over time depending on the global economic outlook.

A deflationary bias is still in place. While inflation concerns are rising it is still in the context of a longer term deflationary trend. Two important inflation barometers are disposable income and money/credit creation. Neither are likely to show strong growth anytime soon. U.S. M2 money growth is just 2.8% annualized over recent months. This is consistent with low inflation and low GDP growth of around 2%. The environment does not suggest interest rates will rise quickly, at least not due to any significant inflationary pressures.

An ongoing concern has always been centered around the supply of bonds. The level of debt just keeps growing. According to the Institute of International Finance (IIF), global debt has reached an all-time high of US $233 US Trillion, up from $140 Trillion at the time of the financial crisis in 2008, a rise of 65%. This is an extraordinary amount. It represents debt in all the sectors of the global economy - personal, corporate and especially government debt. Global debt is now growing faster than global GDP.

A supply and demand imbalance may be developing for U.S. bonds. The Federal Reserve is in the process of shrinking its balance sheet by selling the bonds it had accumulated during the quantitative easing (QE) phase. There are indications that foreign governments are selling U.S. treasury bonds. Japan and China are the suspects. In addition, deficits are rising, expected to climb to U.S. $1 Billion in the coming year due to tax reform and an increase in government spending.

The climate is too uncertain to be buying longer dated bonds. For now, we are still concentrating our investments in fixed income securities in shorter-term maturities.

Trade Wars and Geopolitics

The pursuit of globalization over the last three or four decades has resulted in trade becoming intertwined among nations. Companies have outsourced manufacturing primarily in China, but also to many other countries around the globe. The move towards protectionism presents a major uncertainty for businesses. The Trump administration's hard line approach towards China is disturbing. Importantly, the trade deficit between the U.S. and China, estimated at $350 Billion, is not a simple two-way trade of finished goods benefiting Chinese companies to the disadvantage of U.S. ones. Trade flows include component parts from Japan, Thailand and other Asian countries which end up being assembled in China for the U.S. market. According to a study by Oxford Economics, the value of imported components for final assembly represent about 50% of the trade deficit. Made in China is not often what it seems.

Still, trade flows between China and the U.S., as well as between the U.S. and Europe should be more balanced. While Europe also has a trade deficit with China, on a global basis they are in balance. The U.S. is looking to achieve the same goal and to encourage manufacturing in the U.S. According to some of Trump's closest advisors, his desire is for "fair trade" and is not interested to start a trade war. In reality, the real agenda may be to start turning back the tide of globalization and encourage U.S. companies to produce in their own domestic market.

The good news for Canada is the NAFTA trade talks appear to be progressing with the latest reports being positive. This is a relief since just a few short weeks ago there was the possibility the deal could be scrapped altogether. We are hopeful that as negotiations resume a deal can be reached which is agreeable to both sides.

Equity Strategy – Buy the Dip?

The stock markets in both Canada and the U.S. took a sharp plunge in February. Suddenly there is a huge increase in daily volatility. There have been eight days when stock prices in the U.S. moved by more than 2%. Seven of those times the market was down. This is not a positive signal as heightened volatility has often occurred at turning points in the market.

Many investors are convinced this period of volatility is just another opportunity to "buy the dip". Buying the dip and taking advantage of any set-back in the stock market has been a good strategy over the past eight years. Still, this dip may develop into a more serious correction and rather than rushing in on blind faith we advise taking some time to monitor events and see if a recovery is sustainable. There may be several false rallies first, especially in the U.S. high technology sector where valuation levels are rich.

In retrospect, it is no secret that the U.S. stock market has outperformed Canadian stocks for a number of years. The chart below plots the Dow Jones Industrial Average against the S&P/TSX Composite, the benchmark stock index for Canada. Both indices used to be valued at similar levels and the correlation had always been very high. This has changed dramatically in the past three years since the collapse in oil prices in 2015. In addition, our currency has depreciated by over 20% since 2013 when it was trading at par to the U.S. dollar.

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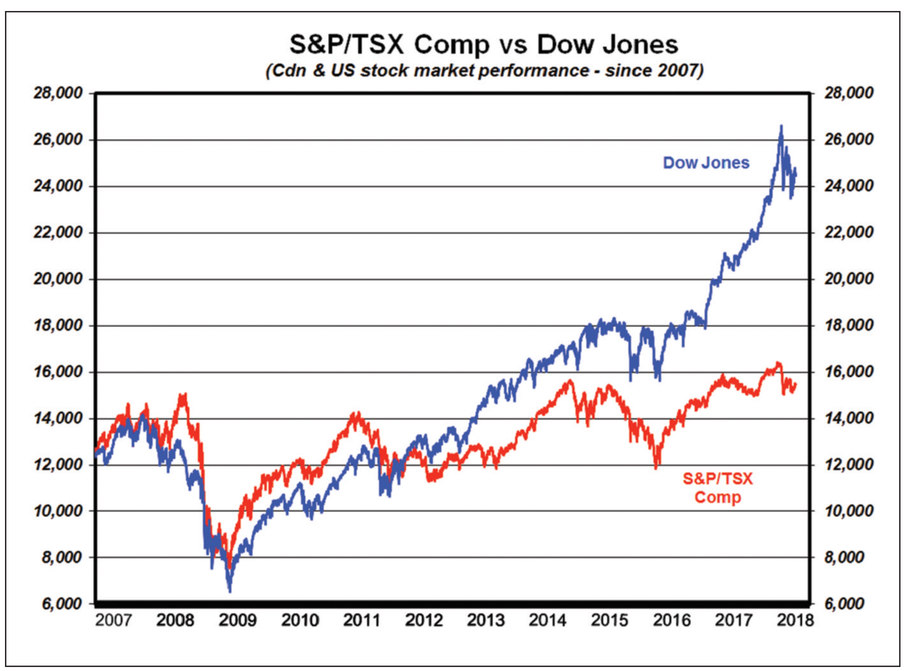
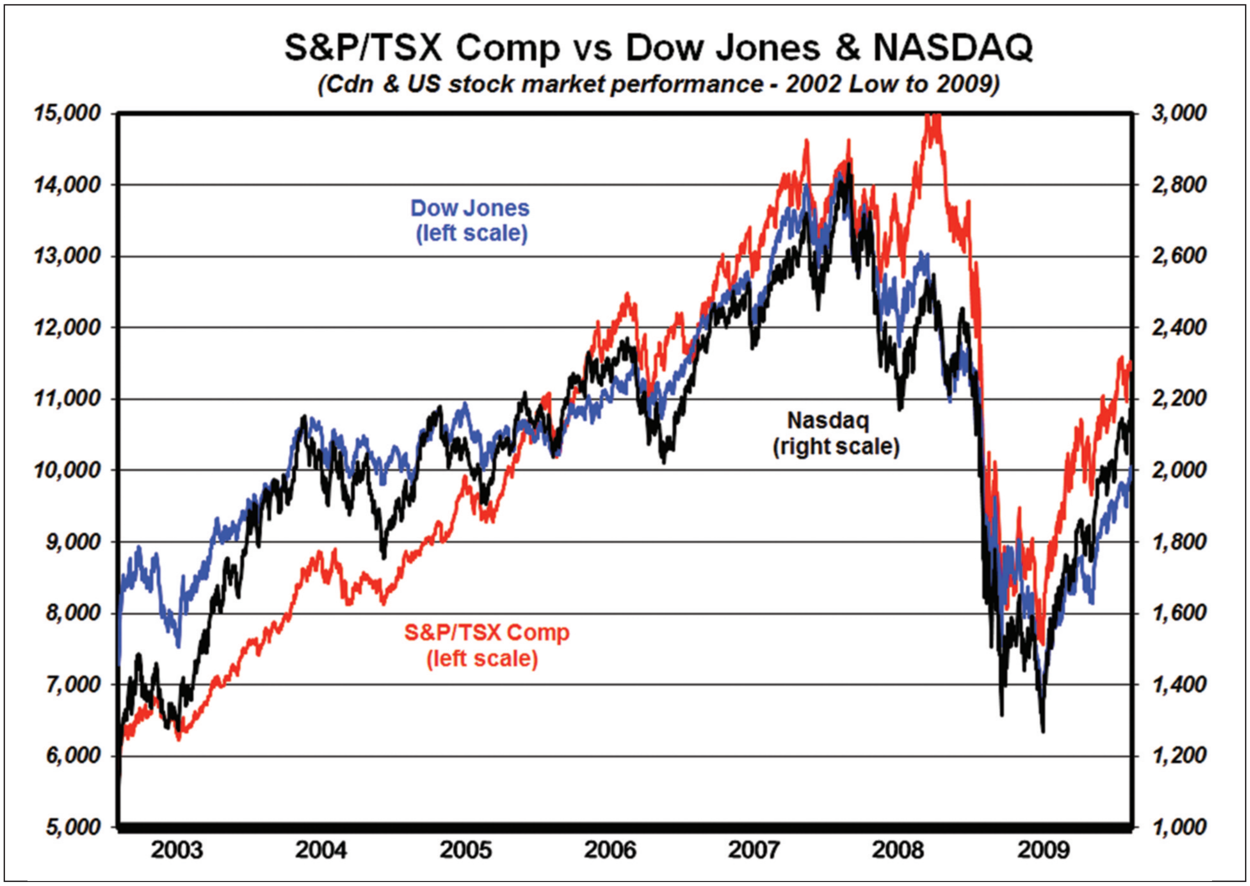


Equity Strategy *(cont'd from page 3)*
The wide differential in performance between Canada and the U.S. is abnormal. For perspective, the second chart below plots the same two stock indices and adds the performance of the NASDAQ, the growth/technology benchmark index in the U.S. The time period shown is the previous market cycle which began on exactly October 9th in 2002. All three indices registered their lowest price on the exact same day, following the now infamous "Dot Com" crash of 2000/02. Canada outperformed the U.S. over the entire cycle – almost six years. On top of this our currency was up by over 50% during the period as the Loonie rose from about .65 cents in 2002 to parity in 2008, (the charts show the price indices in local currency). For Canadian investors it was not a good time to be invested in the U.S. stock market.

For the optimists, the long-term trend is on their side and they believe the positive momentum will continue. They will "buy the dip" and support the upside. There may still be a pent-up desire to chase stock prices much higher. The U.S. stock market could still perform well for some time.

The critical difference this time is the Federal Reserve is determined to tighten policy. In past cycles, rising interest rates were initially seen as positive as it meant the economy was growing and demand for credit was rising. Consensus expects the U.S. economy can finally grow in excess of 3% in 2018. Any shortfall will be a disappointment. However, in modern times the markets have never previously experienced a zero-interest rate policy for such an extended time – a full nine years! Therefore, in our judgement it is not reliable to look back and conclude rising rates are positive for the markets. This will be proven in due course.



The Canadian stock market can recover. It certainly is not trading at a huge premium. We must also recognize that the U.S. market possesses more risk at these rarefied valuation levels. The popular FANG stocks, an acronym for the leading high technology companies in the U.S., are priced for perfection. Any disappointment in their status as super-growth stocks will certainly alarm investors with the potential for a large sell-off.

On balance, we expect more volatility in the period ahead. Rising interest rates, geopolitical events, higher oil prices, a weaker U.S. dollar, a softening real estate market are all near term concerns that can change investor sentiment. Financial markets may continue to disappoint before they recover again. Overall portfolio risk should therefore be maintained at moderate levels.