STONEBROOKE
ASSET MANAGEMENT

The Commentary

CommonSense Investing

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Canadian Outlook

Canada's economic growth rate is expected to improve, strengthening modestly in the months and quarters ahead. The energy sector has turned the corner, housing starts are rising, consumer spending and employment are firming. Interest rates remain very low encouraging the credit growth which underpins the demand for the housing and auto sectors.

The Alberta economy, for many years Canada's leader in growth and job creation is forecast to grow at 2.5% in 2017, bouncing back after the collapse in the oil price and the production shut downs due to the forest fires last spring. There is now more optimism in the energy sector with two major pipeline approvals and a rebound in the price of oil back over U.S. $50.00 a barrel.

The recent agreement by provincial leaders to reduce or eliminate trade barriers between provinces will over time be a boost to the national economy. The irony is it took a trade agreement with Europe to do so, as changes in domestic trade were a necessary pre-condition.

Fiscal policy remains stimulative. The Federal government along with most provinces are running deficits. The recent Federal budget forecast a deficit of $27 Billion for this fiscal year, 2017/18. Additional fiscal stimulus in the form of infrastructure spending will also help the economy in the next year or two. Although wages are growing at just under 2%, inflation is also subdued at around 2%.

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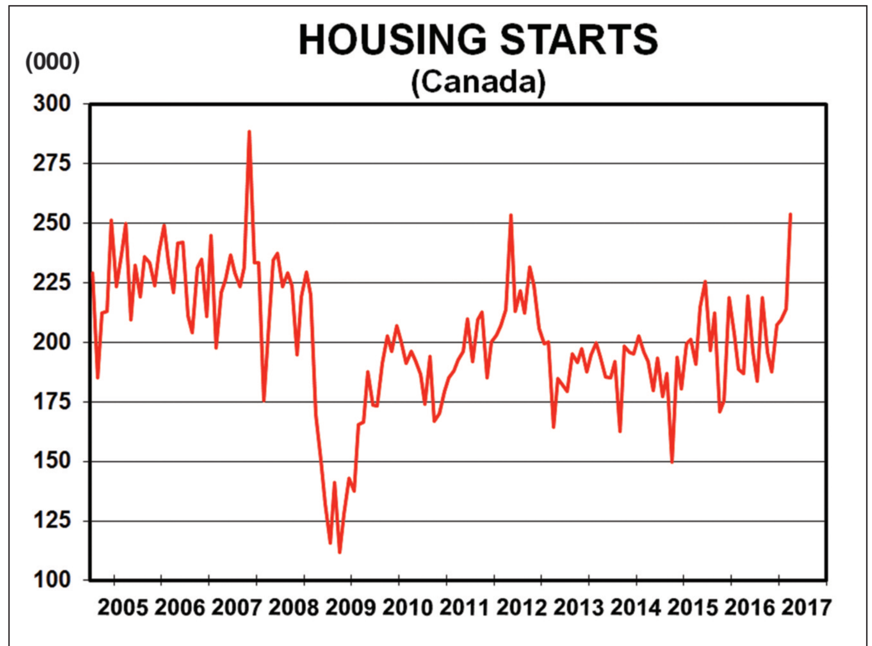
S&P/TSX : 15,548 | 90 Day T-Bills : .54% | Oil : $51.60 US | Cdn $: .75 US
S&P 500 : 2,363 | 10 Yr Cda Bond : 1.63% | Gold : 1,248 US | Euro : 1.44 Cdn

Real Estate Bubble

In the latest data release for March from the Toronto Real Estate Board, the average year over year selling price was up 33.2%. A stunning increase defying common sense. The rise has caught the attention of all levels of government with the stated concern being about housing affordability. Not wanting to be blamed for a correction in home prices, they have chosen to tread carefully. As Canada's largest urban center, any significant setback in real estate would be harmful to the national economy. A foreign tax on speculators is the least harmful course of action and politically palatable - foreigners don't vote and there is no admiration for speculators.



The main underlying reason for the developing bubble in real estate is low interest rates. Interest rates should have been allowed to normalize years ago. Instead cheap financing and leverage allowed the momentum in real estate to build. Restrictions on land use and increased development charges and regulations at the local level have all added to the costs of building new homes. It is doubtful our political leaders at either the Federal, provincial or municipal levels will volunteer to roll back costs. Their solution to affordability is to tax even more.

The more practical and obvious solution is to make it easier and more affordable for developers to build. More homes should have been built to meet demand. The solution is one of supply. As per the adjacent chart, housing starts have started to climb, finally recovering to pre-financial crash levels. As of March data from the Canada Mortgage & Housing Corp (CMHC), the total number of starts is up over 250,000 on an annualized basis. Increasing the supply side is part of the solution in stabilizing house prices. We suspect the next several years will not provide the same upside experience in house prices as achieved over the last several years.

Some have argued there would be more homes built (supply) if we had fewer rules and regulations. Governments, especially at the local levels, are blamed for red tape, restrictive land use and increased charges. The counter argument is the U.S. experience. Their housing bubble, which finally burst in 2007, was supported by government programs encouraging home ownership, and easing regulations. In the final analysis, there are quite a few reasons for the bubble developing in Vancouver and Toronto, and there is not one simple fix. Still, a rise in interest rates should do the trick to deflate this bubble. It's a question of time.

Brexit Has Begun

Article 50 was triggered by British Prime Minister Theresa May. In her letter to the EU she has proposed "a bold and ambitious Free Trade Agreement between the United Kingdom and the European Union." The UK and Europe are linked economically and the stage is set to negotiate over the next two years a trade agreement suitable for all. It will not be without its challenges but both parties already have similar regulatory institutions and the same standards. As we have mentioned, both sides stand to lose if mishandled. It will take cool heads and concessions from both sides to negotiate a fair new arrangement.

U.S. Federal Reserve May Pause

During a recent Federal Reserve meeting, Chair Janet Yellen was surprisingly very dovish in her remarks. There was no justification this time around for raising interest rates - no discussion of a growing and improving economy. Several times during the meeting she hedged herself, "our policy is not set in stone, it is data-dependent…" While Yellen may have confirmed the Fed hasn't altered their view of the economy and is on a path of further rate increases this year, her tone is much more cautious.

Importantly, the Fed will be very gradual increasing interest rates. With each move higher they are likely to pause and see how the economy is reacting. The objective is to normalize interest rates. It may still be three rate increases this year of a quarter-point each, however only if the economy can withstand it. Already the markets are doubtful there will be an increase in June, giving it a 50/50 probability. The main reason being a fairly soft series of economic statistics released in the first quarter. The latest U.S. employment report was disappointing, adding only 98,000 new jobs.

Still, the consensus appears to expect a better growth environment in the second half of the year. Few question the Fed's wisdom in increasing interest rates. This is quite a wholesale change. However it must be remembered the Fed is not infallible and it has a spotty track record at times. In 2007 and again in 2008, Chairman of the Fed Ben Bernanke, reassured congress and the investing public that the economy was on a sound footing and there would be no recession.

At the time the Federal Reserve was raising rates, which makes it more expensive to borrow money and that tends to slow down economic activity. Lowering interest rates makes it less expensive to borrow money and that tends to stimulate more economic activity. So with recent forecasts of a slower first quarter perhaps more analysts should be questioning the Fed's tightening policy going forward.

Should the data confirm a weak first quarter, it will be highly unlikely the Fed will raise interest rates before the summer. Already financial institutions have raised borrowing costs for adjustable and fixed rate mortgages and for auto loans. A decline in credit growth would not be a positive development. Since the financial crisis the Fed has done the heavy lifting, printing money and supporting asset prices. It needs to tread very carefully.

Great Expectations

The Trump presidency has had some recent setbacks with the noted recent failure to repeal and replace ObamaCare. The consensus opinion may be on the verge of changing its views about Trump's ability to get things done. His agenda for tax cuts and deregulation is now in jeopardy and the promised economic growth rates of 3 to 4% that went with it. Now that he is in office the reality and pitfalls of governing means that Trump has had to reverse many of his favoured positions during the campaign.

Our concern is that should the economy stumble, the blame will be placed on a pro-business government. Every new president promises change and yet finds it difficult to deliver. The electorate has finally had enough. If business is blamed for a poor economy rather than a dysfunctional political system, it may perhaps usher in a more extreme ideologue than Trump.

On the plan to lower taxes, a multi-trillion-dollar tax cut, without any new revenue or spending cuts is a dangerous proposition. Ronald Reagan encountered the same obstacles when he proposed massive tax cuts. He never got his spending cuts and the deficit ballooned during his first term, even taking into consideration the

(cont'd on page 4)

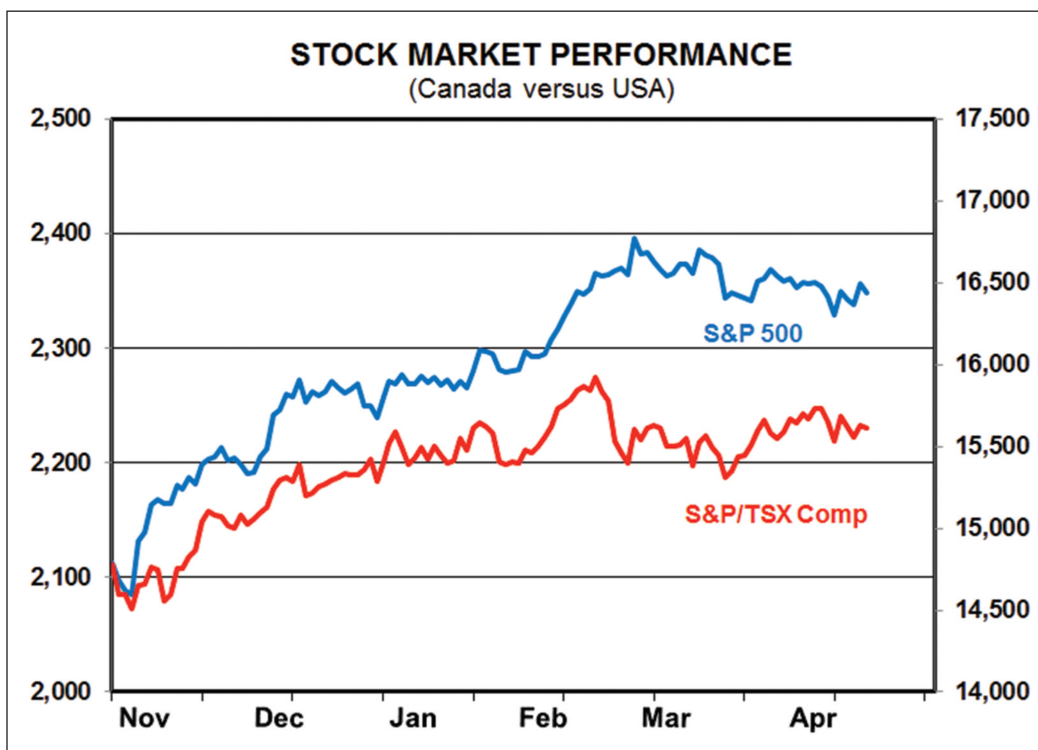
Great Expectations *(cont'd from page 3)*
recession at the time. Today, the U.S. has racked up a total accumulated debt of $20 trillion. As untenable as it seems it could be headed to $30 trillion.

One new revenue source being contemplated is a "border adjustment tax". Another hot and controversial topic, especially for Canada and Canadian businesses. David Stockman, former budget director under Reagan, advised "If you want to cut the corporate tax rate to 20%...you've got to raise $2 trillion over the next ten years to pay for it." He and others have also pointed out the current Republican controlled Congress are against deficit spending. They are proponents of tax cuts as long as the cuts are revenue neutral. Good luck. If the border adjustment tax fails, as it should, reducing the corporate tax rate down to 20% may be an impossible task. Those great expectations are looking a lot less great.

Portfolio Strategy

Despite the extreme valuation levels we have today, the stock market should be able to keep rising on the back of moderate earnings gains. As we have reiterated many times, stocks can remain expensive for an extended period of time. As long as interest rates do not rise too quickly the path forwards is likely higher. Investors could very well react negatively initially as interest rates move higher. This is quite understandable as they have become accustomed to seeing jittery stock markets with even a whisper of higher interest rates to come.

Since the election of Donald Trump the stock markets have rallied in what has been referred to as the "Trump Bump". As per the adjacent chart, the S&P 500 in the U.S. is up about 12% since the election last November. Even the Canadian market has had a positive runup in prices, advancing by about 8%. Year to date, both markets have stalled and are up just modestly. Some pundits are suggesting the jig is up and the inflated Trump Bump will soon turn into a Trump Slump. A correction in stock prices would not be a surprise. We would be inclined to view this as an opportunity and consider increasing portfolio positions. In the meantime, we continue recommending a balanced approach with a focus on Canadian markets.



In the bond market, prices have risen slightly as yields have declined. Shorter term government bonds and high quality corporate bonds are still recommended. They provide a safe haven in the event interest rates firm as expected. Interest rates have been kept artificially low for quite some time. When this changes and interest rates normalize, it will be a mistake to invest in longer term bonds and higher yielding bond type instruments. At this point in the business cycle it is best to stay safe and preserve capital. We will therefore continue to recommend shorter term maturities.

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