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## Canadian Outlook

The Canadian economy is rebounding well so far in 2017. The growth rate in the first quarter was up 3.7%, the strongest rate of growth in Canada in several years largely driven by a surge in industrial production and business investment. Employment growth in the first six months of 2017 has been strong with 186,000 new jobs, albeit many of these jobs are part time. The national unemployment rate is now officially down to 6 ½%.

Yet not everyone is optimistic. In a recent report from the International Monetary Fund, Canada's economy is forecast to grow 2.5% in 2017, and will struggle to achieve 2% growth in 2018 and beyond. The IMF is concerned about our non-energy related exports, the housing market and labour productivity. According to the IMF, "they raise uncertainty about the durability of the Canadian recovery".

Mortgage debt keeps expanding as well as debt for car loans which are typically leased or financed for 4 years or more. Canadians now have the dubious record for one of the largest household debt to GDP ratios in the developed world. The high ratio makes the economy vulnerable to rising interest rates, which may no longer remain at these historically low levels.

Residential real estate has slowed recently in the Toronto and Vancouver greater metropolitan areas. Provincial government regulatory actions have been put in place in both Ontario and British Columbia as an attempt to slow down the boom like conditions. A healthier and more stable market is the objective.

With the U.S. triggering the process for renegotiating NAFTA, trade discussions are expected to be on the agenda this summer. Changing NAFTA will take time and we do not expect much progress on the trade file with the U.S. despite much lobbying and bravado coming from the Trump administration. New penalties have been imposed on softwood lumber exports but no more than our industry expected. Trade is not likely a major issue for 2017. Given the fact our two-way trade is already balanced means negotiations should not be too contentious.



# Central Banks to Tighten

The desire of central banks to tighten policy, in what has been an era of unprecedented monetary easing, is now quite clear. The U.S. Federal Reserve, now seems to be somewhat less data dependent, signaling they want tighter monetary policy because of concerns about **future inflation**. This is a significant shift. As well, the Bank of England, and the European Central Bank are all telegraphing they want to get on with raising interest rates and/or eliminating “quantitative easing”.

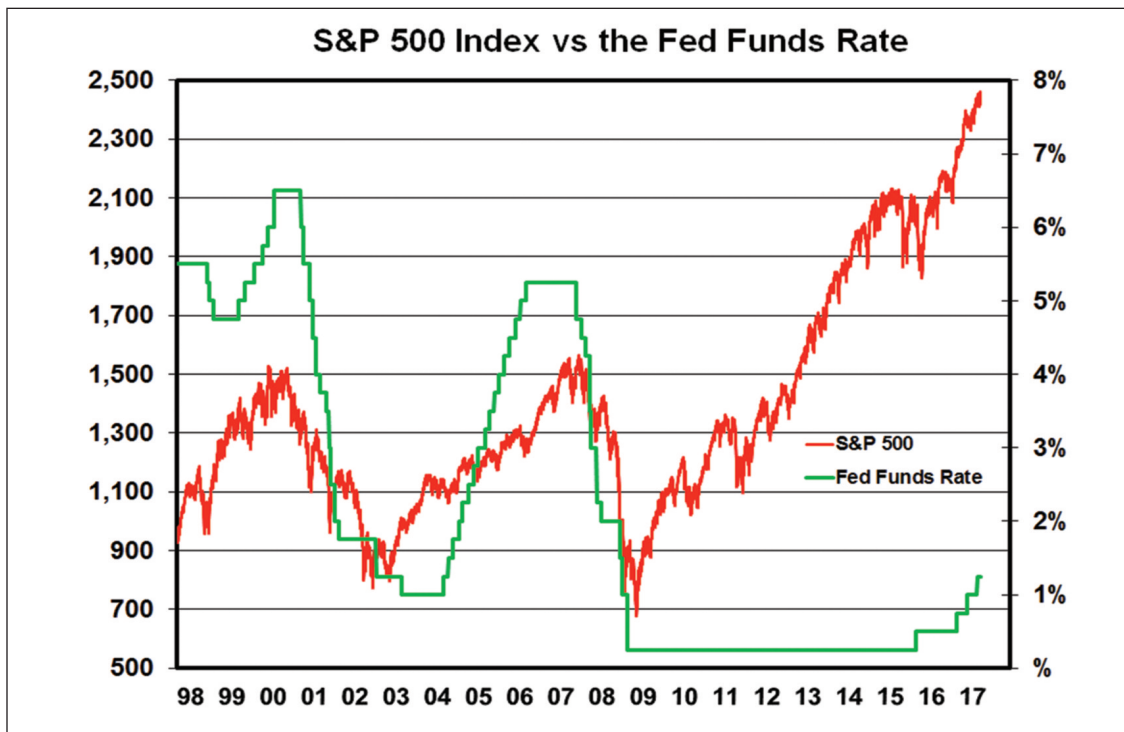
The Bank of Canada is also joining the chorus of central bankers in raising interest rates. Steven Poloz, governor of the Bank raised rates by  $\frac{1}{4}$  of 1% recently. In prepared comments he stated, “In the full course of time, I don’t doubt that interest rates will move higher, but there’s no predetermined path in mind at this stage..”

In our opinion, the central banks should have raised interest rates much earlier. The chart below plots the U.S. Fed Funds Rate over the past twenty years spanning two business/financial cycle peaks and troughs (as identified by the S&P 500 stock market index). In 2000 and 2007, it took a Fed funds rate of 6.5% and then 5.25% to bring the cycle to an end. Following the downturn in 2001/02, interest rates started to rise quite steadily. Since the financial crisis of 2008/09 however, rates were kept artificially low at .25% for seven straight years. It has long been argued the U.S. Federal Reserve has allowed a speculative financial market to develop. Both the stock and bond markets have risen to

extreme levels. The Fed will now be blamed should the financial markets decline, and also for fueling the rise in financial markets in the first place.

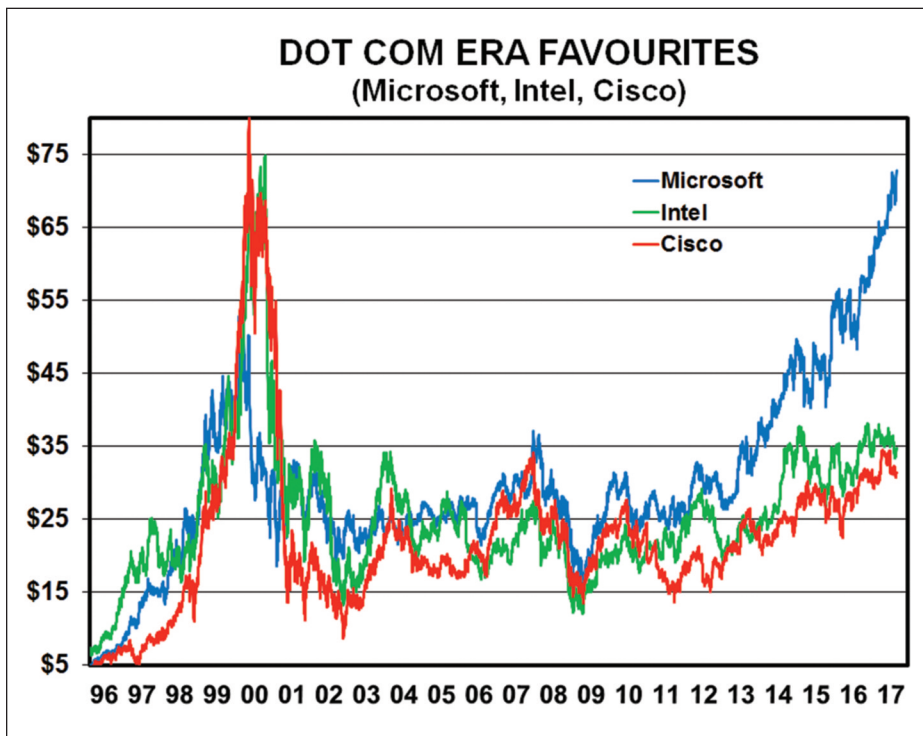
Realizing their predicament, we suspect the Fed is now more determined to act and cool off the rise in asset prices before valuations become even more extreme. Fed Chair Janet Yellen has made this clear enough by stating recently, “asset valuations are somewhat rich if you use some traditional metrics like price earnings ratios...” This is not the first time the Fed has weighed in with a concern about the level of stock prices. In a now infamous speech in December of 1996, then Chairman Alan Greenspan suggested there may be “irrational exuberance” behind the rise in stock prices. The market eventually corrected sharply in 1998 but went on to put in almost two more years of irrational gains before the dot com plunge in early 2000.

The long period of monetary stimulus is coming to a foreseeable end. Globally, the credit expansion has been incredulous this cycle. According to a McKinsey Global Institute (MGI) report, in 2007 total world debt stood at \$142 Trillion. It has since grown by over 50% and now stands at \$217 Trillion. In the first five months in 2017, Central banks for their part have purchased \$1.5 Trillion in assets. Were it not for central banks buying up bonds, interest rates would already be much higher. A shift to monetary tightening will likely have an economic impact.



# Dot Com Era Parallels

It is incredible how history often repeats. The NASDAQ composite index in the U.S., home to all those growth stocks in the technology sector, has again become a magnet for investor attention. The parallels to the “dot com” days of the early 2000’s are uncanny. Today, Apple, Amazon, Google, Netflix, and Tesla are among the “go to” names. Much like Microsoft, Intel and Cisco back in 2000, investors are excited to own what they believe are *permanent* growth investments. These big three NASDAQ companies that everyone had to own in 2000 have turned out to be very poor performers over the ensuing 17 years. The hazards of buying extremely overvalued stocks are illustrated in the chart below. They don’t go up forever.



At the height of the dot com era the top five largest companies were Microsoft, Cisco, Intel, Oracle and Sun Microsystems. Investors could not get enough of them and everyone speculated which company would be the first to be valued at \$1 Trillion. Microsoft and Cisco had broken through \$500 Billion at the time and Intel was not far behind. The dot com era reminds us of how investors can get carried away and act irrationally. After 20 long years Microsoft is again challenging the top rankings with a market cap valuation of \$560 Billion. Apple and Google have the first and second spot with valuations of \$770 and \$660 Billion respectively.

Have we come to a similar extreme crossroad today? In some cases, yes, but perhaps not yet overall. Companies today have much higher profit margins while interest rates are very low in comparison. By these metrics, valuation levels are less extreme today.

Various measurement ratios are at extremes and others are only moderately so. The larger stocks promising endless growth, Google and Facebook for example, trade at price earnings multiples that are not as high as their counterparts - Microsoft, Intel and Cisco, in the dot com days. This same ratio however is extremely high for Netflix or Amazon. Price to sales ratios are lower today and dividend levels are more generous.

Stock prices can always go much higher, and there is no reason to suggest investor appetite, particularly for growth stocks, will decline anytime soon. Still, investors are paying a high price for these stocks. Furthermore, the high price is based on a high profit margin which is not sustainable when the economy slows down.

There are also a number of technical similarities to the previous market peaks in 2000 and 2008. These include some indicators such as a very low VIX Index, which is a measure of volatility and therefore investor complacency. The low reading often precedes market turbulence. Another technical sign of weakness is that the stock market is being driven higher by fewer and fewer of the larger capitalized stocks. Ideally the markets will rise in a broad-based advance. It is not healthy when there are only a handful of winning stocks that investors care for – i.e. Tesla, Amazon, Apple, Facebook and Google.

However, to conclude from all this that the markets have peaked and are on the way down is not a forecast we are prepared to make. While valuations are rich and risk is higher than average, that does not mean investors will not chase these stocks even at these higher prices. There is nothing on the horizon which is alarming apart from the determination of central banks to finally raise interest rates. They are still however very low and it is unlikely an extra quarter or half point rise in the next year will trigger a serious slowdown or recession, no matter how interest rate sensitive the economy may be.

# Oil Falls, Loonie Rises

Technological advances have continued to drive down the break-even price of extracting shale oil in the U.S. A recent industry report estimated that up to 80 billion barrels of shale oil is economic at a WTI price of \$48 US. The current horizontal oil rig count is 650 and climbing, which potentially could yield 4.5 million barrels per day of gross new production. On the global demand side of the equation, growth estimates for 2017 have been about 1.7 million barrels per day, yet actual growth seems to be tracking closer to 1.5 million barrels.

The imbalance in supply and demand has caused the price of oil to slip over the past two months. The current view is less than enthusiastic with many analysts seeing pricing pressures continuing through to the end of the year.

For the Canadian dollar, the weakness in oil is no longer a negative. The Loonie is moving up as the price of oil heads down. From just under .73 cents in early May the Canadian dollar has managed to climb closer to .80 cents. The major influence is now the increase in interest rates by the Bank of Canada. Narrowing the spread in interest rates between Canada and the U.S. has given our dollar a lift. Whether this is just temporary remains to be seen. All things being equal, an additional rate rise along with a stable oil price should push the Loonie even higher.

As for the stock markets, the oil sector has hindered the performance of the S&P/TSX Composite this year. In the U.S. the S&P 500 stock index has been stronger and is near all-time record highs. However, in Canadian dollar terms the relative outperformance has narrowed quickly as the Canadian dollar has climbed by about .06 cents, or 8%. This is shown in the chart below.

In conclusion, central banks are in the process of raising interest rates. Inflation is not an immediate concern, nor are *inflationary expectations* a serious issue needing a firm and aggressive monetary stance. Interest rates are likely to rise very gradually. Any nervousness by investors in the months ahead due to the change in policy, or for any other reason, may cause volatility in financial markets. Portfolios should be positioned to take advantage of weaker markets should the opportunity present itself this summer. In the meantime, we continue to recommend higher dividend yields where possible and remain in shorter dated fixed income securities and exchange traded funds.

