STONEBROOKE
ASSET MANAGEMENT

The Commentary

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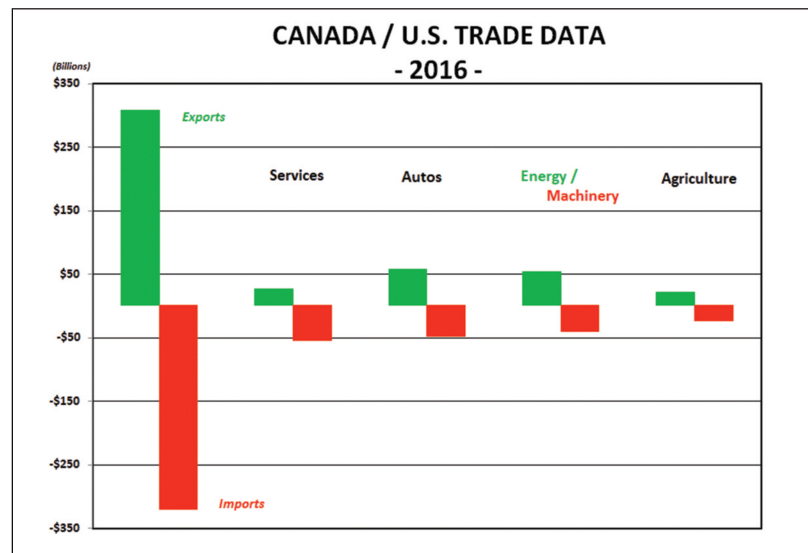
NAFTA - Round 4 Hits a Wall

The North American Free Trade Agreement (NAFTA) is in peril. Negotiations had been going rather smoothly until this latest round. Relations between Canada and the U.S. are reported to be tense. Some observers are questioning U.S. tactics suggesting they are not negotiating in good faith and have no desire to compromise. Tough U.S. demands include dropping the dispute resolution clause, stricter rules on auto-parts, and putting an end to Canada's supply management system. Originally, these NAFTA talks were expected to conclude by the end of the year. They have now been extended to the end of March.

The chart below shows the two-way trade between Canada and the U.S., expressed in U.S. dollars. Total exports of goods and services are roughly equal to total imports. In 2016 the U.S. had a slight trade surplus of $US12.5 billion. The prime areas of trade are in Energy and Autos at approximately US$50 billion. The trade flows in agricultural products is roughly even at about US$22 billion. Canada enjoys a US$10 billion trade advantage in Autos while the U.S. has a trade surplus in services of about US$25 billion. Overall, neither country enjoys a significant advantage over the other. Negotiations are usually adversarial as each party aims to attain an advantage. Free and fair trading should be encouraged as it is to the benefit of all parties.



Importantly, the US has more serious trading imbalances with the rest of the world. Trade deficits with China exceed US$300 billion and are also sizable with both Japan and Germany. We remain confident that a restructuring of NAFTA will be acceptable for all parties and the phase in periods will be long enough for industry to adjust.

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S&P/TSX : 15,635
S&P 500 : 2,519

90 Day T-Bills : .99%
10 Yr Cda Bond : 2.10%

Oil : $51.60 US
Gold : 1,280 US

Cdn $: .80 US
Euro : 1.47 Cdn

Canadian Outlook

Economic growth in Canada has picked up some speed with growth now forecast for 3% in 2017. The latest forecast by the International Monetary Fund (IMF), puts the growth rate up to 2.1% for 2018. Unemployment is now down to 6.2% and unfilled job vacancies are rising. Real estate and construction are contributing to this growth in the major cities and the demand for new condominiums remains strong while the market for detached houses has cooled off as prices have softened.

Jobs in the retail sector have been weak due to the Amazon effect, i.e. the increase in online shopping, and also cross border shopping generally. The bankruptcy of Sears Canada will shed about 12,000 jobs. The indirect effects are a concern as manufacturers and other creditors will see a decline in business. The retail sector is still considered overbuilt for the population demographic it serves.

A very unwelcome initiative by the Liberal Federal government to change the taxation of small businesses and private companies has created much anxiety among entrepreneurs and others contemplating self-employment. More than 70% of new jobs are created by companies having fewer than 100 employees. This is not in the economic interest of the country and has nothing to do with "fairness". It is a tax grab pure and simple on small businesses and the middle class. The consultation period has now ended, and the backlash has been deafening. The Liberal caucus has been quietly hostile towards this initiative as it is politically toxic. The expectations for less onerous taxation will await Mr. Morneau's decisions.

After spending close to $1 Billion in feasibility and environmental studies, the Energy East pipeline has been abandoned by TransCanada. Unfortunately, the anticipated narrowing of the discount pricing gap of Canadian produced oil has now disappeared. Oil will continue to be shipped to U.S. refineries and sold at a discount.

The Housing Quandary

In the Greater Toronto Area (GTA), housing prices are becoming "more affordable". As intended, government legislation to tighten lending requirements and to curb foreign speculation, has taken its toll and stopped the rise in home prices. Many in the industry are concerned that stricter mortgage rules will harm the residential real estate market. While prices have certainly declined from their peaks in April, there is no panic. A healthy price decline has resulted in a more stable market with home buyers having more time to make informed decisions.

Still, it should be remembered that the root cause of the financial crisis in 2008/09 was an overvalued U.S. housing market. When mortgage-backed hedge funds began to drop in value, anxious investors pulled their money out. In Canada we have confidence in our institutions and generally believe our lenders are more conservative. Yet the Home Capital affair earlier this year was a wake-up call. Nervous investors pulled out about $2 Billion. It took Warren Buffett to keep the company afloat and at a time when house prices were still rising.

There are many alternative mortgage lenders and mortgage investment funds operating in Canada. Many funds have been offering returns of 8, 9 or even 10%. On the other side of that investment is a home owner paying a much higher rate of interest. Who needs to pay over 10% for a mortgage? The answer to "who" is less important than "how"? "How" is only able to pay and stay solvent because home prices were rising 10-15% per year. A rising asset can easily be financed with a high-priced loan. Not so when prices stop rising. The math simply doesn't work.

Importantly, the fear of losing money often triggers a rush for the exits. Mortgage funds are by their very nature illiquid investments, and therefore vulnerable. The residential real estate market is showing signs of stability, yet the alternative mortgage space could witness some turbulence as it counts on higher prices. Hence the quandary.

The Fed: Fighting Inflation?

There are many reasons for inflation and ample theories on the subject. Typically, prices increase because of excess demand, and/or restricted supply causing shortages. The root cause is often attributed to the quantity of money and credit. Many believed quantitative easing (QE), would unleash a rapid bout of inflation. It has not. Raising interest rates therefore when inflation is benign seems rather strange. However, Fed Chair, Janet Yellen is expected to raise interest rates again in December stating it needs to do so to prepare for the next downturn.

The inflation data does not support a rate hike. The latest core Personal Consumption Expenditures (PCE) index, which is apparently the Fed's favorite inflation gauge, came in at 1.3%, and has seen a steady decline for five straight months. The PCE registered a peak of 1.9% earlier this year and at the time the consensus opinion was for the Fed to raise interest rates at least three times in 2017. It will be difficult to justify a rate hike in December.

Janet Yellen's term at the Fed comes to an end in February next year. The Trump administration is not likely to reappoint her. Former Fed governor Kevin Warsh is said to be in the running. He left the Fed in dispute in 2011 having misgivings with quantitative easing (QE), the policy of buying bonds and keeping interest rates low. He was for normalizing interest rates at that time. He continues to be a vocal critic and believes keeping interest rates low is deeply flawed. A change at the Fed is certain. A change in monetary policy is almost as certain.

The majority of pundits advocate gradualism, fearing that a quick and sharp increase in interest rates may bring on a recession. Gradualism however is not a magic solution. Still, low and gradually rising interest rates should continue to be supportive to the equity markets. Until of course they are not. The business cycle cannot be managed to circumvent an economic downturn. This has never happened before in history. The human emotions of fear and greed are alive and well. For evidence we need only to look at the Bitcoin phenomenon.

U.S. Outlook

U.S. consumer sentiment has surged to a 13-year high, the highest reading since January of 2004. This is surprising given the divisive political climate, a stressed economy, and the recent hurricanes. Normally sentiment indicators are reasonably good contrary indicators. Indeed, Richard Curtin, director of the University of Michigan consumer survey, said in a statement. "nothing in the latest survey indicates that consumers anticipate an economic downturn anytime soon -- which contrarians may consider a clear warning sign of trouble ahead."

Another component of the survey measures the confidence in the stock market and tracks consumers expectations to see how bullish/positive they are. The latest readings are high and at similar levels in the past when stocks have experienced significant corrections. Contrary indicators are not flawless and are always challenging from a timing point of view. Still, the basic tenet holds for the reason that "when everyone is positive there is no one else left to buy".

Tax cuts in the U.S may already be "discounted" by investors. In principle tax cuts should stimulate the economy. Getting tax cuts approved by a Republican controlled Congress is proving more difficult as special interests rely on tax favours. One of the main proposals is to reduce the number of tax brackets from the current seven down to three. Republicans are mindful of mid-term elections next year. It would not be a surprise to see a heavily compromised tax reform bill which on a net basis delivers only modest cuts. Such is politics.

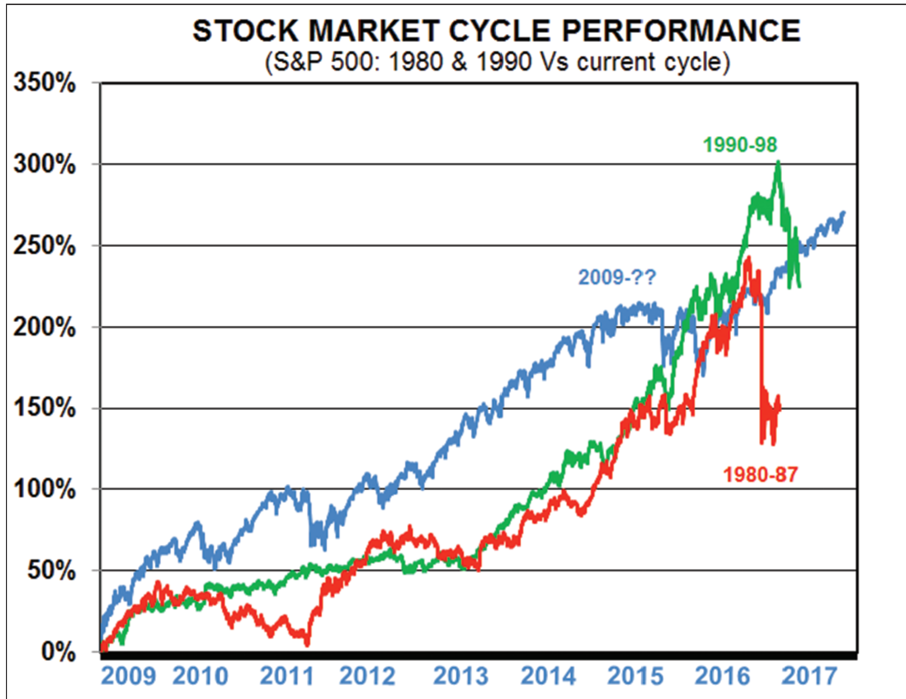
The geo-political climate is uncertain with North Korea at the top of the list. The saber-rattling is heating up and while it certainly could disturb the financial markets, looking back over history, significant market corrections occur because of fundamental economic events, not geo-politics. They tend to be short and shallow affairs.

Equity Outlook

While the S&P 500 in the U.S. is making new highs, there are only about 50 stocks showing positive uptrends. The clear majority of stocks are either going down or sideways. This narrow and concentrated stock market advance is not a healthy sign. Yet remarkably, the index has risen steadily without a decline of at least 3% since November of last year, the longest such stretch in over 20 years. The year-to-date gains for the S&P 500 in U.S. dollars is about 15%. With a rising Loonie this year, the return in Canadian dollars is only about 6%. This is comparative to the return in the S&P/TSX Comp which is running at about 4% year-to-date.

The sentiment in the Energy sector among analysts is more positive as oil price forecasts are rising. This despite recent International Energy Agency (IEA) data which was less than robust. Inventories however are declining at a faster rate which suggests demand must be higher than the official statistics. Some are suggesting demand for oil may be understated by .5 million barrels a day. While the fundamentals appear to be improving, investor pessimism is still very high for the companies in this sector. The Energy sector is an important component in the Toronto stock exchange with a weighting of about 20%. A rising oil price will help lift stock prices and improve the performance in the overall market index.

The chart below shows the performance of the S&P 500 since the trough of the current cycle in 2009, comparing it to the 1980-87 and the 1990-98 stock market cycles. The 1980 and 1990 cycles were two of the longest economic cycles post World War 2.



The infamous crash of 1987 is shown on this chart, an event which observes its 30th anniversary. Looking back, it was an opportunity for investors to buy into the stock market - although at the time it was not a very easy decision to make. The Asian crisis of 1998 also stunned investors and it was also another time when buying stocks would have been rewarding. In both periods the stock market recovered fairly quickly and the business cycle continued to advance for two more years.

Many highly regarded institutional fund managers have voiced concern that the stock market is expensive and priced well beyond reasonable fundamental valuations. At the same time there does not appear to be any looming economic issue around the corner that would cause a slowdown/recession. We have observed an increasing desire by managers to hedge or "protect" investment portfolios by betting on "volatility". There are a growing number of new investment products designed to perform based on the level of volatility in the market. This makes sense as a hedge since volatility tends to move in the opposite direction of the stock market. We are reminded however of something called "portfolio insurance", designed by Wall Street in the 80's to protect large investment funds. The design was flawed as it assumed perfect market liquidity.

Of course we can never know the precise timing of the next correction in stock prices. We do however expect it would again provide an opportunity for investors. Investors should never expect smooth sailing. To navigate well requires a prudent approach that recognises the elevated risks in the marketplace. That means a balanced approach with acceptable risk which allows for opportunistic shifts in asset mix to take advantage of volatile markets.

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