

In This Issue:

- Stock Markets Rebound
- Federal Budget in the Red
- A Problem with China's Banks
- Asset Mix
- Fixed Income Strategy
- Equity Strategy
- General Outlook is Mixed

Contact Us:

Stonebrooke Asset Management Ltd.
Waterpark Place
20 Bay Street, 11th Floor
Toronto, Ontario
M5J 2N8

344 Lakeshore Rd. East
Suite B
Oakville, Ontario
L6J 1J6

Tel: 416-850-2172
Email: info@stonebrooke.ca
www.stonebrooke.ca

Stock Markets Rebound

After a very weak start to the year, equity markets in Canada and the U.S have powered ahead during the past several weeks erasing all the losses year-to-date. Asian and European markets were still mostly down for the first quarter while emerging markets were mixed. In North America, markets are climbing a "wall of worry" reflecting apprehension about global economic weakness despite strengthening indicators in the U.S.

Mixed messages from the U.S. Federal Reserve suggest that interest rates will continue to rise during the year, albeit remain at very low levels. Canadian interest rates also appear likely to remain low as the economy grows at below 2% with unemployment above 7%.

The price of oil has recovered to about U.S. \$40.00 per barrel, lifting up the energy sector. Most other commodity prices however



remain depressed. Natural gas is suffering from over-supplied markets and a mild winter. The industrial and tourism sectors are benefitting from the 16% decline in the Canadian dollar last year. Automobile sales and production continue to set records in both Canada and the U.S. with strong growth in luxury and sport utility vehicles thanks in part to cheaper gasoline prices. All in all, the economic and investment climate appears back on the mend.

Federal Budget in the Red



The Liberal government's first Federal budget has been hailed as a welcomed boost for the economy and for the middle class. A projected \$29 billion deficit for 2016/17 has been defended as a confidence builder. The plan is for Federal spending on social programs, infrastructure and tax cuts for the "middle class" to provide a cushion until

private sector investment regains traction i.e. energy investment such as pipelines and infrastructure.

Neither Ottawa nor Alberta have chosen to assist the oil industry directly. Rather, employment insurance benefits have been improved to alleviate hardship and help keep the skilled workforce around for an eventual recovery. In the meantime, 50,000 jobs have been lost in Alberta alone in the oil industry.

While Alberta is currently in a tough financial bind, (a deficit of \$10 Billion is projected), it has a strong credit rating to tide it over. In the table below we highlight the debt and deficits of the four largest provinces
(cont'd on page 2)

Federal Budget in the Red

(cont'd from page 1)

as well as the Federal debt, (Canada). Ontario and Quebec have been chronic over-spenders having accumulated total debts of \$297 and \$181 Billion respectively (data sourced from debtclock.ca). As a proportion to GDP, Alberta is in relatively good shape. Still, the accumulated debt in Canada at all levels of government is worrisome.

Current Debt & 2016 Estimates				
	Annual Deficit (in Billions)	Total Debt (in Billions)	GDP (in Billions)	Debt/GDP (%age ratio)
Alberta:	10	20	325	6
B.C.:	0	65	250	26
Ontario:	7	297	750	40
Quebec:	0	181	380	49
Canada:	29	621	1990	32

A Problem with China's Banks

Many banking experts have been increasingly worried about China's high corporate debt levels now that the country's economy is slowing. In recent years, banks and other financial companies in China issued an enormous amount of new loans, many of which are now defaulting. While the Chinese financial industry is not known for its transparency, unofficial estimates of bad loans are thought to be as high as US\$5 trillion. Other estimates derived from corporate interest payments suggest that as much as 8% of corporate loans may be in distress.



consumption. China's economy is slowing from double digit growth levels to, officially, about 6% per annum. With an abundance of cheap labour as well as an educated middle class, China aims to balance production with rising domestic consumption and more value-added goods and services.

The stock market in China has been very volatile and may be signaling a weakening economy. As the second largest producer of goods in the world next to the U.S., the spill-over effects of slower growth in China and in emerging markets was a heightened

concern just a few short months ago. We doubt these concerns have receded permanently. It will be important to keep monitoring developments.

China is an important player in the global economy. It has been a driving force in commodity markets for many years, accounting for up to 50% of the growth in energy and metal

Asset Mix

The economic outlook is of course critical, affecting financial market performance and therefore the asset allocation decision. The current business cycle could evolve in a number of different ways. We outline three of the most likely scenarios we could see in the immediate period ahead.

Scenario #1 – Continued Slow Growth and Low Inflation

Consumers retrench slightly as sentiment is mixed, but not enough to precipitate an outright recession. Lower interest rates continue to support the housing and auto market. The price of oil stays in a narrow range of \$35 to \$45 U.S. per barrel.

Inflation remains subdued as the economic cycle extends at a relatively modest pace of growth – 1 to 2%. Financial markets remain tentative with mixed economic signals. Stock prices are directionless at first and then resume an upward bias in the confidence there is no pending recession. Bond prices begin to weaken as interest rates firm. However, they remain at very low levels.

Scenario #2 – Soft Recession Before End of 2016

The consumer balance sheet is stretched (high debt, low savings), confidence erodes as residential real estate prices soften. Spending declines and weakness spreads to autos and other durable goods. At the business level, the declining sales result in higher inventories (sales fall more quickly than production). Cut backs in production ensue and layoffs begin.

Short term and long term interest rates continue to fall. Concern over inflation evaporates with deflation becoming the dominant concern as prices fall in response to the lower demand. Stock market declines as corporate profits decline and investors scramble for liquidity. Bond markets do well as interest rates fall further. Traditionally, recessions bring lower interest rates as demand for financing falls due to lower levels of business activity and declining consumer spending.

(cont'd on page 3)

Asset Mix

(cont'd from page 2)

Scenario #3 – Stronger Growth & Rising Inflation

The many years of low interest rates and excessive money printing finally produces solid growth, lifting consumer confidence. Spending and borrowing expand. Unemployment rates decline and wages begin to increase. As demand increases, inventories are pared down and production bottlenecks begin to appear. Commodity prices rise.

Interest rates begin to rise again as competition for financing increases. The U.S. Federal Reserve attempts to hold down rates not wanting to influence the upcoming Presidential election. The U.S. dollar weakens and precious metals, commodities, and other hard asset prices begin to spiral upwards. Inflation advances higher than expected.

The stock market rises supported by an increase in corporate profits. Bond markets decline as interest rates rise and investors react by rotating out of bonds and into stocks.

Balanced Portfolio Structure

	Scenario #1	Scenario #2	Scenario #3
Cash:	5%	5%	10%
Bonds:	45%	55%	30%
Stocks:	50%	40%	60%

The table above illustrates the shifts in asset mix for the typical balanced portfolio mandate under the three scenarios. The asset mix decision adopted for a “soft” recession, scenario #2, is much more conservative than for a more robust economic expansion forecast under scenario #3. Since the evidence for either of these scenarios is inconclusive at the present time the prudent strategy is to take a relatively neutral approach, not betting exclusively on any single outcome. At this stage therefore we believe the focus should be to stay the middle course. For balanced accounts we would lean towards an outcome as described in scenario #1 with about a 50% exposure to the stock market.

Fixed Income Strategy

We believe a significant pick-up in economic growth is unlikely for the balance of 2016. Still, even modest growth at this stage in the business cycle should be accompanied by higher interest rates. We are therefore maintaining our strategy of investing only in short term fixed income instruments not exceeding 5 years.

With interest rates already at historical lows, Canadian 10 year bond yields have dropped to 1.23%, it is difficult to see a further move lower. Still, for some investors these lower interest rates foreshadow the onset of a recession. For others the slow down represents only a pause in the growth trend which is expected to resume.

Similar U.S. bond yields have dropped to 1.75%. The spread between U.S. and Canadian government debt has narrowed however interest rates remain higher in the U.S. by about

.5%. Although official U.S. Fed forecasts call for another two or three rate increase this year, the market is telling us there is a less than 50/50 chance of even one interest rate hike for the rest of the year. The U.S. Fed seems to be much more concerned with the soft international landscape. The result may be a reluctance toward increasing shorter term interest rates.



The Liberal government’s first Federal budget, which implies four straight years of deficit spending, was largely shrugged off by bond investors. Long-term Government of Canada bond yields actually declined in the days following the budget announcement. With a budget deficit of less than 2% of GDP, and with interest rates at such low levels, the risk that this triggers an uncontrollable rise in borrowing costs is unlikely. Bond yields will rise in conjunction with a strengthening economy.

Equity Strategy

Stock market volatility has picked up in the past several months. We are still of the opinion that an extension of the business cycle is likely. Normally, this would favour the more economically sensitive and cyclical groups such as resources. The interest sensitive groups, i.e. financials, utilities, usually lag in performance as interest rates climb higher. Both groups however have underperformed in the past year and therefore looking back at historical patterns may not help much going forward.

The consumer sector should continue to benefit from lower gasoline prices. However due to high debt, low savings, and slow income growth, lackluster consumer spending can be expected. Strong consumption trends are not likely to form a large part of the growth equation in Canada. Instead we believe growth will be driven by exports and eventually business investment as U.S. growth strengthens.

(cont'd on page 3)

Equity Strategy

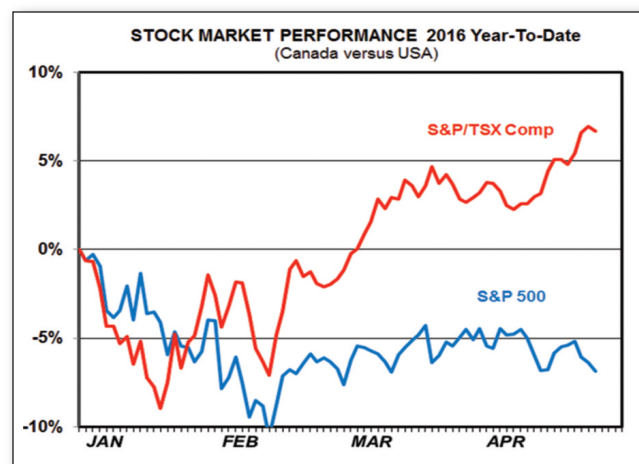
(cont'd from page 2)

In the U.S. market a change in leadership has taken place. The once invincible bio-technology sector has come tumbling down and the defensive sectors, namely Utilities, have surged higher. The U.S. financial sector has disappointed and year to date is one of the worst performing groups.

From the low of about \$27 in the first week of February the price of oil has seen a decent recovery. The more positive sentiment is based primarily on a better supply environment, with temporary disruptions in the Middle East, and the Saudis and Russians rumoured to be close to a deal to freeze output. Also the huge capital spending cutbacks by the industry will likely rebalance the market more quickly than earlier expected.

Still, the picture on the demand side has been less than encouraging. Economic activity is weak and low oil prices have not encouraged consumption as anticipated. The fundamental underpinnings for the oil market may still be several months out and will only be supported by a material decline in inventories, which we have yet to witness.

The rising oil price has certainly helped build confidence in the general equity market. As per the adjacent chart the Canadian stock market year-to-date has outperformed the U.S., when factoring in a rising Loonie. A further modest recovery in oil and a strengthening currency could finally break the long underperformance of the Canadian stock market vis-a-vis the U.S. Portfolio equity holdings should not have an overweighting in the U.S.



General Outlook is Mixed

Canada has been teetering on the edge of recession and the outlook for the balance of 2016 is mixed. Statistics released over recent months are inconclusive and it is therefore difficult to determine the future direction of economic activity with a high level of conviction. The volatility in the price of oil adds greatly to the uncertainty.

While the government may be burdened with a high debt level, fiscal policy is now aimed at expanding annual deficits, stimulating the economy until the private sector can take over.

A greater number of economic pundits have recently suggested that a recession is already underway. The majority still believe however that the current slow down is but a pause in the slow growth, low inflation environment that has persisted for the past several years. In the U.S. the index of new manufacturing orders is still above 50, indicating expansion, new building permits are strong and initial unemployment claims reflect a healthy job market. As the U.S. economy expands, Canadian business and consumer confidence should improve, leading to a renewed recovery and a longer more broadly based cycle of expansion.

Presidential politics in the U.S. primaries and caucuses have provided much entertainment for T.V. viewers which will climax this summer at the Democratic and Republican conventions. The polarizing platforms of Donald Trump and Bernie Sanders have shaken up the establishment of both parties and could provide surprise outcomes in the November election. The establishment candidates have discovered that elections can no longer be bought by Wall Street financiers and other special interests. Just the same, the status quo is likely to prevail ushering in another Clinton administration into the White House.

In summary, Canada continues to experience a growth recession with high unemployment. While the direction of interest rates is likely up, we will not experience tight monetary conditions in Canada or the U.S. during 2016. With government bond yields below 2%, equity valuations appear reasonable. Apart from the energy sector, corporate profits remain stable with an upward bias. Dividends are rising for non-resource companies making stocks, despite their higher volatility, a relatively attractive alternative to bonds.

Contact Us:

Stonebrooke Asset Management Ltd.

Waterpark Place 20 Bay Street, 11th Floor
Toronto, Ontario M5J 2N8

Tel: 416-850-2172 Email: info@stonebrooke.ca www.stonebrooke.ca

344 Lakeshore Rd. East, Suite B
Oakville, Ontario L6J 1J6

