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Brexit: The Shock That Wasn't

It was a surprise victory for the "Leave" campaign. The reaction from the financial markets was swift as stock prices fell hard. The British Pound plunged more than 10% falling to levels not seen since 1985. Markets around the world were on edge driven by the uncertainty of events.

Three days later the panic was over. Markets have almost completely rebounded as if investors had made a terrible mistake thinking Brexit was somehow negative news. Perhaps a short and shallow correction is appropriate under the circumstances. Conceivably, Britain leaving the European Union may not be such an economic shock.

The referendum vote has exposed the general resentment with the EU. Many other countries in the union including France, Italy and Spain have large segments of their population that are anti EU. It is a tenuous union and the Brexit result likely means that any further integration politically and fiscally is likely off the agenda for now. With a sluggish economy and a brewing banking crisis, the EU project is looking very uncertain to say the least.

The decision by Britain to leave affects Europe equally therefore both parties will need to renegotiate sensibly. A disorderly separation will leave both of them worse off. For the EU the criticism has always been that it is a flawed creation. One of the consequences of Brexit could be its unwinding as tensions rise among member nations. Brussels will be anxious to deter other members from leaving. It may become vindictive and restrict access to Europe's single market, its main position of strength. It is doubtful that a smooth transition is possible to such a complex and emotional decision.

For now, investors will perhaps "keep calm and carry on". The popular catchphrase adopted by the British during World War II may be sobering advice. For many investors however the vote to leave the European Union is a scary proposition. In the weeks and months ahead many may decide not to keep calm and carry their money out! Financial markets are likely to remain unstable.

The “Experts” Are Turning Bearish

Many high profile and well-respected fund managers/investors have come out in recent months warning that stock prices are too high. They cite valuations are excessive compared to historical norms, especially given the weakness in the global economy. According to George Soros, chairman of Soros Fund Management, stocks should be sold. Soros is known for his bold views and he has made many accurate forecasts including the 2008/09 financial crisis.

Kyle Bass, head of Hayman Capital and a well-respected money manager, is recommending to “sell short” China. Short sellers are among the most bearish market participants as they need to borrow, or “sell” securities today in the hope of buying them back at a reduced price in the future. This is a highly risky strategy but it is highly rewarding when markets go down.

He has argued “China’s banking system has grown from under \$3 Trillion to over \$34.5 trillion in assets over the last ten years alone. No credit system in history has ever attempted this rate of growth. There is no precedent”.

China has been a concern for quite some time. Its phenomenal growth rate has indeed stalled and many pundits see trouble ahead. Even so, most of the “experts” recently turning negative are not forecasting a serious and deep recession. They are concerned about excessive valuations and would probably change their views after a shallow market correction and/or an improvement in the global economy.

Catastrophe in Alberta

The forest fires in Fort McMurray were truly terrifying. High winds quickly enveloped the city forcing evacuation of close to 90,000 people. Quick action by local authorities, firefighters and volunteers saved most of the city but the devastation of the area is shocking. The province and federal governments provided emergency funding while charities such as the Red Cross provided on the ground assistance. Months later the area is slowly returning to normal but many residents were sufficiently traumatized to leave permanently.

There was a financial cost to the oil industry already struggling with low prices. Many oil projects were shut down and evacuated while others accommodated workers and their families fleeing from the fires. The Insurance Bureau of Canada estimates claims are as high as \$3.6 Billion. Ironically these funds will show up on the growth side of the economy as homeowners and businesses spend to repair their property and replace lost contents. The insurance industry ranks this disaster as the costliest claim in Canada. The financial impact of these claims is not expected to be significant on Canadian insurance companies. The larger global reinsurance companies will absorb most of the burden.

If there is anything positive to come out of Alberta it is that an entire city was evacuated without loss of life, looting or serious damage to infrastructure. Also worth mentioning is the extent of cooperation and coordination among private and public agencies to mitigate the distress of those who lost everything. Economists estimate the impact on Canada’s economy will be at least ½ of 1% in reduced annual growth for 2016. Unemployment in Alberta is approaching 8% with continued downsizing in the energy sector, weaker retail sales and rising office vacancies.

In Canada unemployment remains high at 6.8%, as just reported by statistics Canada for the latest month of June. While U.S. unemployment at 4.9% is the lowest in a decade. Much of our unemployment is energy related with up to 100,000 jobs lost in Alberta, Saskatchewan and Newfoundland. Manufacturing jobs continue to shrink, 30,000 lost over the past year, as more auto production moves to Mexico and Asia. Confirming the negative trend, the Bank of Canada’s business outlook survey published recently was showing a weak outlook for employment.

Helicopter Money to the Rescue

Ever since a speech made back in 2002, Ben Bernanke, former head of the US Federal Reserve, has been nicknamed Helicopter Ben. His speech was on combating deflation and he stated the government has a printing press that “allows it to produce as many U.S. dollars as it wishes at essentially no cost”. The implication is that Central banks can create money out of thin air thereby preventing deflation and stimulating the economy.

There has been a renewed reference to Helicopter money. With a weak global economy and new challenges in the European Union, Central banks are looking to stimulate. Ben Bernanke recently paid a visit to Japan and met with the Chairman of the Bank of Japan (BOJ). Immediately after the visit the BOJ announced a major new stimulus package. It is no wonder the stock market has regained its positive momentum shaking off the Brexit uncertainty. Yields in the bond market have been driven to new lows. Our central bankers, dismayed that low interest rates have not provided enough economic stimulus, are

now determined to unleash negative interest rates. The theory underlying this policy action remains the same - entice consumers and businesses to borrow and spend in order to lift economic growth. Central Bankers are myopic and continue to do the only thing they understand – lower interest and stimulate.

There is now over \$13 trillion of government debt outstanding trading at negative yields (mainly in Japan and Europe). Germany recently issued a 0% 10-year bond priced under par. The decline to negative yields certainly does not reflect a strong and growing global economy.

Negative interest rates are a challenging environment for savers and could be having an opposite economic effect. Concerned about saving for retirement, consumers may be spending less. At least the wealth effect from higher stock prices and higher real estate prices is helping matters. Still, negative interest rates cannot create a stable and healthy environment. We are in uncharted waters.

General Outlook

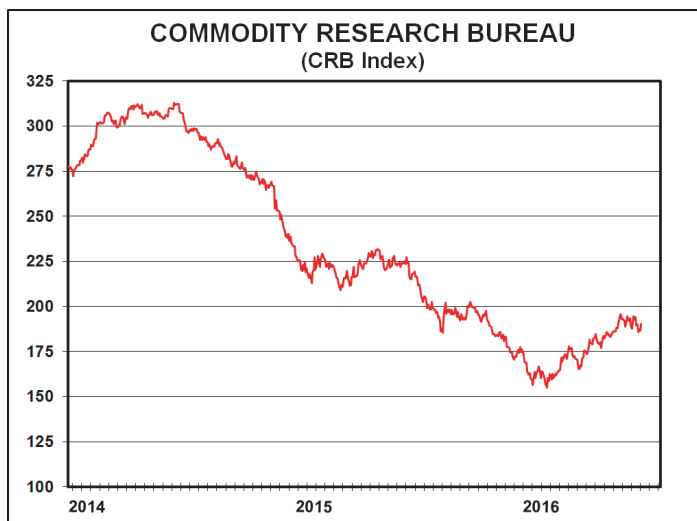
At the beginning of the year the markets were in panic mode. There was a fear of a hard landing in China as it's stock market was tumbling. The price of oil dipped below \$30 and many believed it was heading to \$20. Earlier rumblings out of the Federal Reserve suggested they were prepared to make two or three rate hikes this year.

We now have perhaps the best of all worlds, a moderate growth environment and no rise in interest rates any time soon. Still, the stock markets have become more volatile in the past two years as investors agonize over Central Bank monetary policy decisions. At times central banks are thought to be “out of ammunition”, meaning they cannot reduce interest rates any lower. Money printing is sometimes seen as positive and at other times investors are uncertain. After-all, if the economy is improving interest rates should be going up.

It is our concern that negotiations between Britain and the European Union may become disruptive.

While no one can really begin to accurately forecast the economic outcome of the Brexit vote, we do believe there is likely to be political instability. Both France and Germany have elections in 2017 and there is disenchantment with the current leadership.

Commodity prices have recovered some ground over the last several months. This has led to an improved level of investor confidence. The chart below of the Commodity Research Bureau (CRB), is an index of 19 commodities with the largest component being oil weighted at 23%. The two-year decline ended in February and since then the index has improved mainly due to the strength in oil and industrial metals. The CRB is widely followed as an economic indicator. A continued upturn in the CRB should be a positive signal for global equity markets.

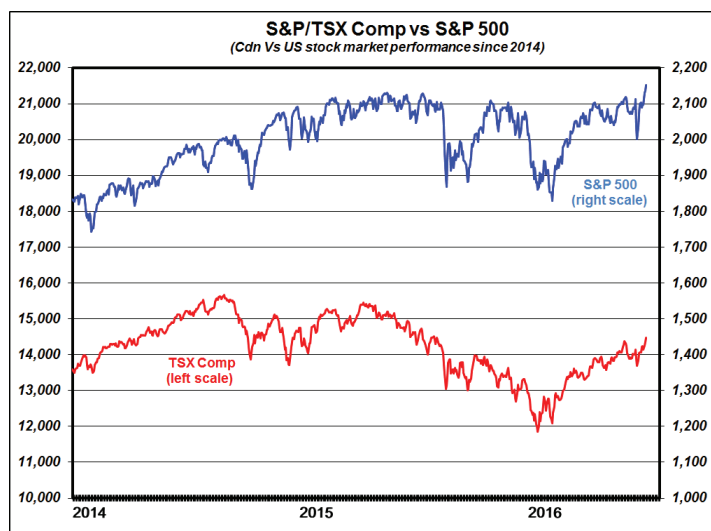


While commodity prices are a good indicator of the health of the global economy, inexplicably, interest rates have continued to head down. Normally, interest rates are sensitive to commodity prices and move in the same direction. This is because the rise in commodity prices is synonymous with rising inflation and therefore leads to rising interest rates. Perhaps a longer lag is at play this time around.

Importantly, for the Canadian stock market and also our Loonie, a rising CRB is a good omen. Our equity markets are resource dependent and a firming in commodity prices is welcome news.

Portfolio Strategy

Brexit has illustrated the risks to the macro economic environment. For now, investors stand ready to buy any short term correction in stock prices. We expect there will be many more corrections ahead of us. The chart below shows the performance of the Canadian and U.S. stock prices since 2014. While currently at the highs, the markets have essentially gone sideways over the past two years.



The periodic flight from risk can be alarming. However, negative interest rates will compel investors to allocate more of their savings into the stock market. There is no alternative. It is entirely

possible that stock prices keep climbing higher. Our strategy is to maintain a balanced approach. We continue to emphasize the purchase of companies and exchange traded funds with higher dividend yields.

Despite the prospects for a slower global economy, growth in the U.S. economy over the next year is more encouraging, forecast at around 2%. We could see oil prices climb to the \$50 to \$60 per barrel range. If so, there should not be a material difference in performance going forward between Canadian and U.S. stocks. Canada's outperformance has been significant this year, mostly due to the rising oil price and a rising currency. We do not recommend a significant exposure to the U.S. market at this time.

In the fixed income markets, Government of Canada 5 year bonds have hovered in a 0.60-0.80% yield range for the past 12 to 18 months. As oil prices continue to rise yields should now climb back up closer to 1%. We are maintaining our strategy of staying in shorter term maturities and are positioned in bonds and exchange traded funds with terms to maturity under five years.