



STONEBROOKE  
ASSET MANAGEMENT

# The Commentary

CommonSense Investing

Fall 2016

## IN THIS ISSUE:

Canadian Outlook

**US Election:** For Adults Only

**Interest Rates:** Lower for Longer

Bonds Should Be Avoided

General Outlook

Portfolio Strategy

## CONTACT US:

Stonebrooke Asset  
Management Ltd.

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

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

Tel: 416-850-2172  
Email: [info@stonebrooke.ca](mailto:info@stonebrooke.ca)  
[www.stonebrooke.ca](http://www.stonebrooke.ca)

## Canadian Outlook

Since the mild recession of early 2015, Canada's growth has been very modest. While unemployment hovers around 7% nationally, in Alberta, which remains in a recession, the unemployment is around 8%. Office vacancies in Calgary are estimated to be as high as 23% as the petroleum industry slashes spending and the demand for related services contracts. The petroleum industry estimates about 100,000 jobs have been lost since the oil price collapse. While the energy based provinces will continue to be a drag on the overall economy, the worst is probably over.

Encouragingly, natural gas demand has been stronger and the current approval of a liquefied natural gas project near Price Rupert B.C. and associated pipelines could create thousands of jobs in the years ahead. The recently negotiated labour contract with General Motors (GM) in Ontario will extend auto production at the Oshawa plant for at least 4 years with GM actually undertaking to bring some production from Mexico back to Canada. The drop in the value of our Loonie to around .75 over the past two years has been a factor in making Canadian manufacturing more competitive.

Residential real estate has been an engine of growth, especially in the greater Toronto and Vancouver areas. Measures to stem the sharp rise in house prices have been introduced by both Federal and Provincial governments. B.C. announced a 15% tax on foreign purchases of Vancouver homes plus various other penalties to discourage speculation. The Federal government has imposed stress tests on new mortgage applications. Some experts in the mortgage lending industry have reacted with alarm and claim the new rules will mean a sharp decline in what the new home buyer can afford. The next few months will provide evidence and at the very least we should expect a decline in sales activity. In the past two months since the 15% foreign tax was imposed in Vancouver, housing sales have seen more than a 20% drop. While prices have remained stable, such a large drop was not anticipated. Prospective buyers are holding back and taking a wait and see approach.

Importantly, a decline in housing sales will have repercussions across the entire residential housing sector. Mortgage brokers, bankers, real estate brokers, lawyers and appraisers will be affected, as will the furnishings and appliance retailers which benefit when new homes are purchased. A slowdown in housing while the Canadian economy is stumbling along is not reassuring. Nonetheless, many in the industry are now forecasting an end to the insane double digit annual rise in home prices in Canada's two hot markets. A cooling off period is healthy in the long run and will allow a balance to return to these markets.

S&P/TSX : 14,726  
S&P 500 : 2,168

90 Day T-Bills : .53%  
10 Yr Cda Bond : 1.00%

Oil : \$47.72 US  
Gold : 1,323 US

Cdn \$ : .761 US  
Euro : 1.47 Cdn

# US Election: For Adults Only

A mudslinging, short on substance, and shall we say highly “entertaining” presidential election was always to be expected. However, it has degenerated into the gutter normally reserved for the worst of reality TV. The media coverage has disgracefully encouraged it all. Rather than debate the issues this election will come down to a battle of personalities. At no other time have the stakes been so high. The policy differences between Donald Trump and Hillary Clinton are extensive. There is a strong and determined movement to prevent Trump from being the next President. It certainly appears the victory should go to Clinton however both candidates have intense unfavorable ratings. What is truly surprising is that the election is still close.



Jack Welch, former CEO of General Electric, and several prominent business leaders have come out in support of Trump’s domestic economic policies. Business leaders do not make headlines and probably carry little sway among voters. Still, with Trump a “grenade ready to explode”,

influential individuals generally will distance themselves from his campaign. What is unknown is the level of dissatisfaction among the electorate with “politics as usual”. Surprisingly, Trump’s self-destruction is not shifting voter preferences over to Clinton in a significant way. By all accounts she should have a huge majority. Her

own drawbacks and negative perceptions are limiting her chances of winning a huge victory. Importantly, only a swing of 1 or 2% of voters is needed in what ostensibly is a two-horse race. It is quite inconceivable that Trump can appeal to more than 50% of voters.

---

## Interest Rates: Lower for Longer

Stephen Poloz, Governor of the Bank of Canada, recently commented that interest rates will stay low for a longer period of time. In contrast, the US is intent on increasing rates. Everyone is fixated on the U.S. Federal Reserve’s next move and the general assumption is that the Fed will raise short term interest rates this December. Ironically, investor perception is of an authoritative Fed with the power to set interest rates at will. In reality the Fed usually follows along. This is why it has long had the reputation of being “behind the curve”. The Fed typically adjusts to market conditions. European Central Bank President Mario Draghi perhaps summed it up best recently; **“Low rates are a symptom of the underlying economic situation. They reflect weak long-term growth trends and the protracted macroeconomic slump that has resulted from the crisis.”**



Perhaps this time around the Fed is determined to raise interest rates in advance. The reason may be due to the unprecedented amount of money printing since the 2008/9 recession. Additionally, the Fed has been routinely

criticized that the protracted low interest rate environment carries the risk of overvaluation in all asset markets as a direct result of investors searching for yield. We would not be surprised to see financial markets influence events again. In the past three years every attempt to raise interest rates resulted in a stock market tantrum. The Fed was quick to reverse course. If the same

pattern repeats itself then overall market risk is probably limited. At some point the market will come to accept that a rise in interest rates means the economy is strong enough to bear it.

While the Fed may have good intentions it has a dubious history. The pattern of providing too much stimulus and then too much tightening is a recurring theme. In

our opinion they should have raised interest rates long ago. In the fullness of time the policy of central banks will be recognized as a problem and confidence will again be shaken in the financial markets. For now, and likely through 2017, investors are still inclined to invest and the risk to the markets appears acceptable.

# Bonds Should Be Avoided



Bond yields have continued to move down over the past year. This is understandable given the general economic malaise and the decline in commodity prices, especially oil. The yield-to-maturity on 10-year Government of Canada bonds dropped under 1% recently to reach a low of

.95%. Investors buying and holding these bonds for ten years are virtually guaranteed to earn a negative return after inflation. Moreover, an increase in interest rates to just 2% in the next year would generate almost a 10% *capital loss*. It must be remembered that it only takes a minor change in interest rates to suffer a loss of capital.

The bond market is a ticking time bomb. It offers very poor returns at these low interest rates especially when factoring in what is likely to be a rising inflationary trend, however moderate. The multi-year decline in interest rates is probably over and should make investors in *long-term* bonds very nervous. How can investors justify an investment in 30-year government bonds yielding under 2%?

Going forward we will be taking our cues from the housing market. Debt financing is always advanced to an asset class that is rising in price. It is very likely that a curtailment in mortgage lending will slow down activity in the housing market. This should be an impediment to any disaster scenario featuring a spike in interest rates. Regardless, we plan on maintaining our bond purchases in shorter term securities and exchange traded funds with bond maturities under five years.

---

## General Outlook

Having experienced a prolonged period of easy money and low interest rates which have boosted financial markets, there is a danger investors have become too complacent. With the passage of time investors may have forgotten that stocks can decline sharply – having twice declined by 50% since 2000. The argument that stocks cannot decline because interest rates are so low, an argument heard often, ignores the Japanese experience. Over the past twenty years, interest rates in Japan have stayed well below 1%. That did not prevent their stock market from also plunging by 50% or more.

Despite the heavy amount of borrowing during this business cycle, real GDP growth has averaged about 2% since the recession ended, producing the weakest economic recovery since World War 2. It is striking that with all the debt and with interest rates so low for so long that we have produced so little growth. In the U.S. the total government debt is now just shy of \$20 Trillion. Eight years ago when President Obama was elected the debt stood at \$10.5 trillion.

There is a growing realization that money printing has not been effective in stimulating the global economy. Instead it has encouraged stock market speculation, corporate mergers and acquisitions and stock buybacks.

These activities have been less helpful for economic growth and jobs creation. In fact, some would argue the reverse - corporations have become larger and as a result have cut costs. The Trudeau Liberals are winning praise from the IMF and other governments around the world for their increase in public spending. Fiscal expansion through infrastructure investment is now gaining popularity. Significantly for the economy, government policies are on an expansionary course on both the fiscal and monetary fronts.

Deutsche Bank was recently fined \$14 Billion by the U.S. Department of Justice, for their role in the 2008 mortgage-backed bond scandal. Immediately after the announcement the stock price plunged and markets globally came under pressure. Fears of another global crisis have since lifted as rumours circulate the fine will be substantially reduced. The bank will need to sell assets and to raise equity to settle the lawsuit. It is inconceivable the German government or the European Central Bank will allow Deutsche Bank to go bankrupt. Still, it is a reminder that a bank's financial strength is a confidence game. Bank balance sheets are highly leveraged and a run on the bank can escalate and quickly get out of control.

(cont'd on page 4)

## General Outlook (cont'd from page 3)

The Prime Minister of the United Kingdom, Theresa May, has announced Article 50 will be triggered in March. She is under pressure to disclose how "Brexit" will be negotiated. One of the greatest concerns is that both British and non-British firms have integrated their operations in the production and distribution of manufactured goods throughout Britain and Europe. Supply chains were designed in a borderless era. Will they now need to be dismantled? Brexit will not be an easy process and the reality is Britain and Europe



are close neighbours geographically with ties that run deep. It makes no sense to limit access. Lost trade will be difficult to replace by finding new markets, all of which are much further away. This was always one of the central issues of the Brexit referendum and unfortunately was overshadowed by the migrant story. We would hope and expect the uncertainty to be resolved with some strong and positive announcements from the political class. Otherwise 2017 will surely test the markets.

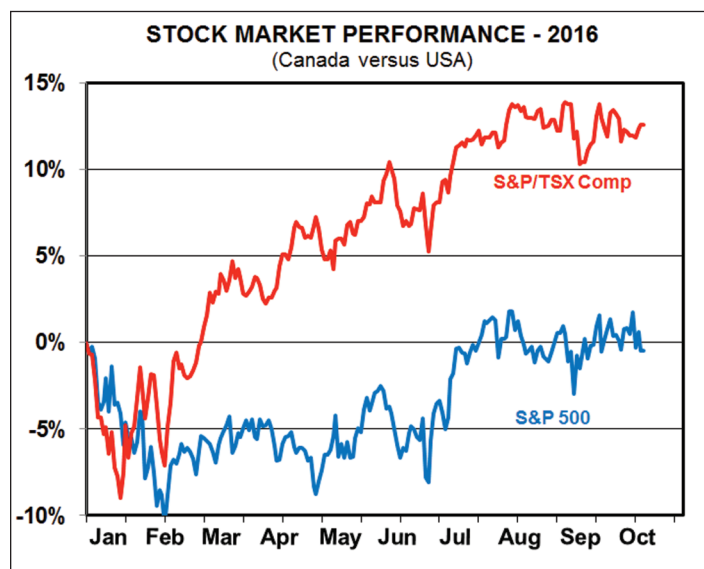
## Portfolio Strategy

The bounce in oil prices is a welcome relief for the oil sector and Canada's economy. Over the longer term however the outlook remains challenging. The supply and demand dynamics have changed significantly. On the supply front there is much more oil available than previously thought and the economic price point for fracking has come down considerably. Many U.S. producers stand ready to drill at a price north of \$50. The forecasts for demand have slipped, partly the result of a lower global growth outlook and of the advances expected in electric automobiles. Already we are seeing progress in countries like Norway where 1 in 4 vehicles on the road are now electric. Norway intends to ban the sale of fossil fuel powered cars by 2025. This is a trend which will erode the demand for oil. As such we are less favourable on the sector and will be reducing positions over time.

The period ahead could be problematic for the banking sector. Mortgage loan growth is likely to slow down due to the latest government initiatives. On the other hand, the Canadian banks are well diversified and should interest rates rise as expected the banking sector will benefit from rising margins. We continue to hold positions in the financial sector either directly or through exchange traded funds. U.S. financials are also attractive, nonetheless with the Loonie at the .76 cent level we do not generally recommend large equity positions in the US market.

The adjacent chart compares the performance of the Canadian and U.S. stock markets, in Canadian dollars. The rise in the Loonie this year and the recovery in the oil and

basic materials sectors has Canada outperforming the U.S. by a significant margin. While we can expect some catch up, the trends are still favourable and we expect the Canadian market to continue doing relatively well.



We are in a challenging environment as there remains a great deal of geopolitical uncertainty. We should continue to expect volatility in the financial markets. Still, the attractiveness of stocks, which are paying much higher yields than what can be earned in the bond market, means that investors should expect positive portfolio returns over the next year. Periodic price corrections should be taken in stride and still viewed as an opportunity. We have room to increase equity weightings to take advantage of these events.