STONEBROOKE
ASSET MANAGEMENT

Investment Commentary

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Canada Underperforming

The slump in oil prices is certainly not good news for the Canadian economy. Alberta is likely near recession and can no longer be relied upon to provide economic leadership and employment growth to the rest of the country. According to a recent research report from Goldman Sachs, every job lost in the oil and gas sector may result in another three to four jobs lost outside the industry. An overdependence on energy exports has exposed the Western provinces vulnerability to commodity prices. The Prentice government has reacted by raising personal taxes and slashing government spending. Alberta, and also Saskatchewan, will be laggards in economic growth for at least the next year.

Although central Canada should benefit from cheaper energy costs, (along with another 8% currency devaluation since year end) these favourable stimulants may not show up immediately in business investment and job growth. Retail store outlets are contracting with the closure of Target and several other chains resulting in unexpected job losses and store vacancies. Consumer confidence is not robust and to make matters worse imported goods, especially food costs, are rising.

Apart from the wealth effect of strong house prices, salaries and wages have not kept pace with the cost of living. Outside of the larger urban areas in Ontario and BC, housing demand appears to be softening. Consumer debt per capita continues to rise. The banks and other lenders are quietly anticipating rising arrears and defaults.

This year the Federal government is pre-occupied with electioneering. While it desperately wants to deliver a balanced budget it will also be keen to make spending promises, as most governments do during an election year. Fiscal prudence may have to wait until after the election. This could be positive in the short term however is unlikely to lift growth much beyond the consensus estimates of about 2%.

Compared to the U.S. our economy is underperforming. As a result the pressure will remain on our currency. The fact the U.S. is likely to raise interest rates sooner is also an important consideration which should continue to underpin a strong U.S. dollar. Nonetheless, Canada's finances are in relatively good shape. Failing an unforeseen disaster, a drift to $.75 cents is probably a worst case scenario for the Loonie. Industry would be handed a strong competitive advantage and with improved cost structures the pendulum would eventually swing back in our favour. We are not yet there however.

S&P/TSX : 14,868	***90 Day T-Bills : .55%***	***Oil : $47.70 US***	***Cdn $: .791 US***
S&P 500 : 2,084	***10 Yr Cda Bond : 1.36%***	***Gold : 1,187 US***	***Euro : 1.37 Cdn***

Macro-Economic Risk

In our judgment the macro or "bigger picture" risk has increased over the past several months. Europe and Japan remain sluggish. China is slowing and according to some pundits may be heading for a hard landing. The economic engine of the world, the U.S., is finding that a strong dollar is beginning to affect the competitiveness of its big multinationals. Also, the sharp decline in the price of oil is having a destabilizing effect. Oil producing nations growth rates are declining. The offsetting lower price "dividend", a boost in global consumer spending, is failing to materialize.

The Greek debt impasse is looking very critical with both sides taking a hardline approach. Negotiations with the International Monetary Fund (IMF) and the European Central Bank (ECB) are reportedly not going well. Without an agreement on some major economic reforms, the Greek government may be forced to default on its upcoming debt obligations. This could lead to Greece being ejected from the EU. The repercussions for global financial markets are unlikely to be positive.

The good news is that Central banks in Europe and Japan are pushing ahead with monetary stimulus. The U.S. in the meantime is on hold. Another quantitative easing (QE) program seems unlikely to be initiated in the U.S. until either the stock market falters and/or signs of an economic slowdown appear. The latest jobs number in the U.S. was a major disappointment with only 126,000 jobs created in March. One slow month however is not necessarily the beginning of a trend.

Risk is also higher due to the divergence in the bond and stock markets. Stocks are rising with the full expectation that economic growth will continue at a healthy rate. Bond yields on the other hand are telegraphing a slower period ahead. Many governments continue to cut short-term interest rates in order to stimulate growth – a very abnormal situation six years into a recovery. We would be more encouraged by a modest rise in interest rates.

Safety in Cash

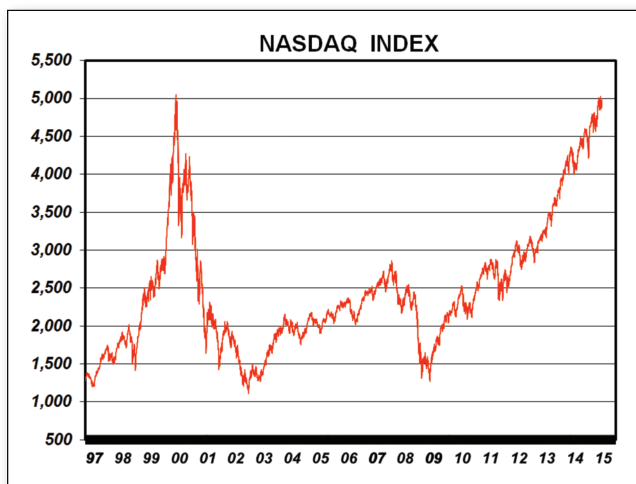
Mohamed El-Erian, Chief Economic Adviser at Allianz, and a highly influential strategist, was recently asked where he holds his personal investments. "It is mostly concentrated in cash. That's not great, given that it gets eaten up by inflation. But I think most asset prices have been pushed by central banks to very elevated levels."

Many value investors hold the same opinions and have been reluctant to be fully invested for quite some time. As far as we are concerned the value proposition in common stocks is severely lacking. Regardless, the market continues to rise offering decent gains despite the occasional volatility. It is a perplexing dilemma which will likely resolve itself as it always does – in a meaningful correction in stock prices.

Holding larger cash positions in an environment of expensive stocks and a potentially dangerous bond market (rising interest rates), is a safe and defensible strategy. For the time being however we believe the risk in holding stocks is still manageable - until interest rates begin to rise. We would then anticipate a correction in stock prices to likely present a good buying opportunity. In the meantime some cash or cash equivalents, i.e. short term bonds, along with more conservative stock investments in higher yielding securities should protect balanced portfolios reasonably well.

NASDAQ: Back to the Past

After 15 long years the NASDAQ index is back up at the 5,000 level. It was last at this level very briefly in March of 2000, before its fateful plunge. The excesses of that dotcom era are now largely forgotten. The NASDAQ looks quite a bit different today although it is still primarily a technology and growth index. The largest names in the index feature companies like Google, Facebook and Amazon. These companies, along with many others at the top of the list barely existed 15 years ago. Three familiar names do remain from the 2000 list of top ten companies – Microsoft, Intel and Cisco. Collectively, these three stocks are still down about 50% from their peaks.



The total market valuation of the NASDAQ stands today at roughly $8 Trillion dollars. This compares to about $6.5 Trillion back in 2000. However the profitability today of the largest firms that make up the index is much improved. Today the price to earnings ratio (P/E) for the largest stocks on the index averages about 30 times, versus about 60. As an example, Apple, the largest company representing 10% of the index, has a P/E ratio of 18 times. Back in 2000 the top stock was Microsoft, trading at 60 times earnings. Also, compared to the broader S&P 500 index, the premium today on the NASDAQ is only about 20%.

However there are also some glaring similarities to the dotcom era. Speculation is fuelling a rise in many small and mid-sized companies. A total of 71 companies came to market in 2014, more than at the 2000 peak. These initial public offerings (IPO's), are again funding promising companies with little to no revenues, especially those in the biotech sector. Investors are excited at the prospect that new drug discoveries, currently in clinical trials, will be approved by the FDA. Yet statistically, the FDA approval process is such that *over 90% of new drugs never come to market!* The absurdity of investors willing to play against these odds is mindboggling.

Venture capital activity is also strong, with $52 Billion invested into U.S. companies in 2014. Again, this is the highest dollar amount invested since just before the 2000 peak. Speculative activity is again heating up. It certainly appears another frothy bubble is in the making.

Portfolio Strategy

With interest rates so low the nominal returns from bonds or other secure fixed income vehicles is downright miserable. In a rush for yield even junk bonds (companies with poor ratings), are being purchased by conservative investors despite their associated risks. While bonds have been viewed for decades as a less risky asset class, at these low yields this is no longer the case. A small rise in interest rates will send prices lower and can easily result in a significant capital loss.

In parts of Europe interest rates are below zero. German bonds were recently issued for a seven year term at a slightly negative interest rate. Imagine, investors are now willing to pay in order to simply hold onto their savings. In Switzerland the demand for ten year bonds were oversubscribed, also priced at a negative interest rate. Taking advantage of low interest rates and strong demand in Europe, Mexico launched an extraordinary bond issue borrowing in Euros for a term of 100 years - at a yield of 4.2%. It is all quite remarkable. With interest rates at generational lows, it makes no sense to us in purchasing long term bonds. We continue to recommend shorter term securities maturing under five years.

(cont'd on page 4)

Investment Commentary

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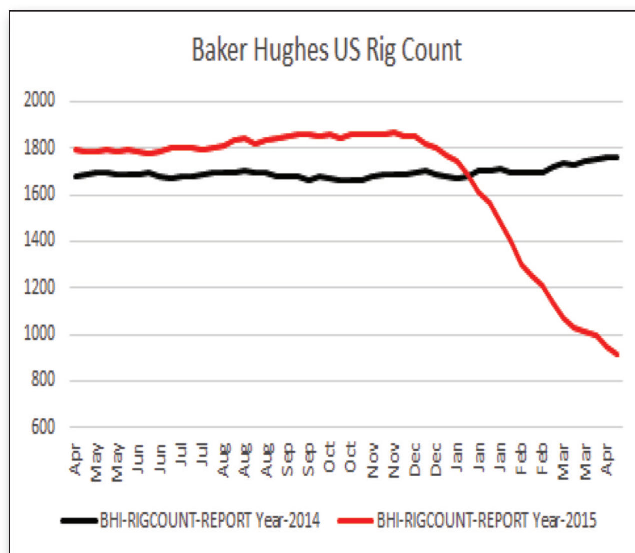
Portfolio Srategy *(cont'd from page 3)*

In the equity markets there is opportunity in the energy sector. The price of oil has stabilized somewhat and is back up over $50 U.S. For a while it was feared the price may drop below $40. Recent statistics are showing the growth in North American oil production is starting to slow. With rig counts down almost 50% since last October (adjacent chart shows the Baker Hughes rig count down under 1000, from a high of 1900), it was just a matter of time before the supply of oil would be affected. The mid-term outlook however may be more problematic for the oil industry. The nuclear agreement with Iran is set to be finalized and signed on June 30th. The lifting of all sanctions will allow Iran to once again export oil. With some analysts proclaiming the price of oil could see $20 next year, the window for owning oil stocks may be shorter than expected. In the meantime the trend appears to be favourable. We expect prices to firm as the supply and demand fundamentals for oil improve. Many of the higher quality oil stocks are well off their January lows. We believe there is the potential for further gains through the summer months.



There is also opportunity in the midstream and services sectors of the energy sector. While stock prices have weakened in sympathy with the price of oil, these companies are only indirectly affected. Expansion in pipelines and storage facilities will continue and there is longer term potential in the market for LNG - liquefied natural gas.

Corporate earnings growth has slowed dramatically for the large U.S. multinationals. From an expected growth rate of 12% earlier this year, to slightly in negative territory. The rising U.S. dollar is to blame. In contrast European companies stand to benefit competitively from a lower Euro. Stock markets there have shown good returns so far this year. We are looking to invest in the European markets through an ETF, or exchange traded fund. Our preference would be to do so with an ETF which is currency hedged.

There are several research papers recently proclaiming investors should have a higher weighting in common stocks then has traditionally been the case. They cite the appeal of higher dividend yields in relation to bonds. They believe investors will also rotate out of bonds as interest rates rise and shift their investments into stocks. After several years of rising stock prices it is not surprising that arguments for yet higher stock prices are surfacing. This is typical and reminds us of the exuberance exhibited in past cycles. Not so long ago it was the consensus opinion that stocks had entered a new paradigm of permanently high valuations.

It is more important to begin developing an exit strategy, particularly for the higher priced growth stocks in portfolios. In 2007, a year or so before the financial crisis of 2008/9, which saw a 50% plunge in stock prices, we began to purchase "bear funds" (securities which appreciate in a declining market). At the time we were convinced stock prices were overheated and the economy was due for a cyclical decline. Today, while the stock market is pricey and has already exceeded many previous cyclical peak valuation levels, we cannot say with any certainty that we have arrived at another major peak. Under normalized interest rates that would be a different matter altogether. Until such time, there appears to be more upside to the economy and likely to stock prices.

We are proceeding with caution. A more conservative strategy with an emphasis on high dividend yielding securities is recommended both for income and moderate growth.

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