STONEBROOKE
ASSET MANAGEMENT

Investment Commentary

Summer 2015

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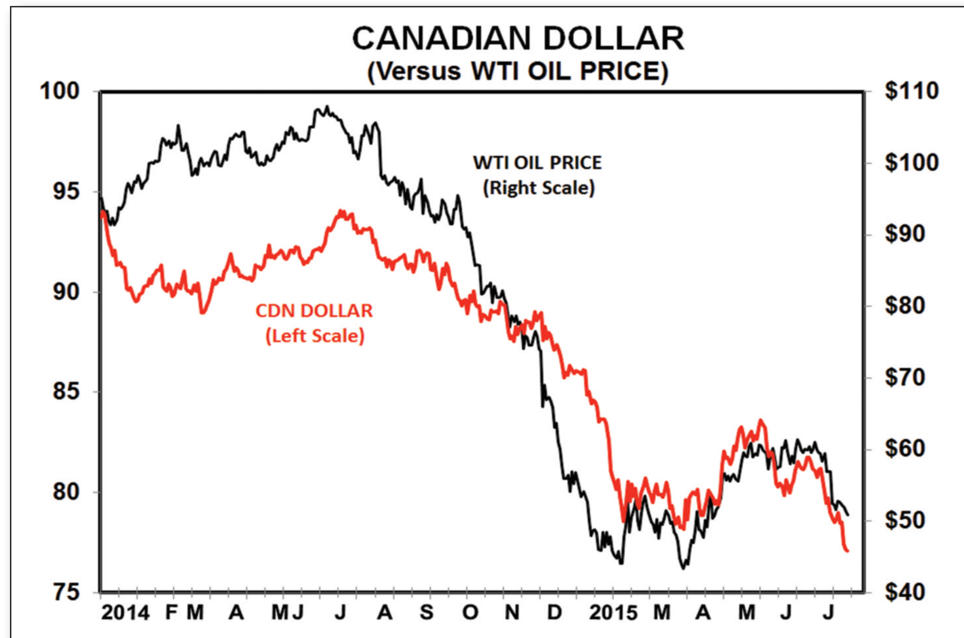
Early Signs of Stagflation

The word stagflation was coined in the 1970's when the growth rate of the economy "stagnated" during a highly inflationary period. Today stagflation refers to a period of low but *rising* inflation, combined with an anaemic economic growth rate. Canada has experienced negative GDP for the first four months of 2015 with very few pockets of growth across the country. Adding insult to injury, the decline in our currency means consumers are facing rising prices for imported goods. Inflation is creeping up. The official posted core rate in May was 2.2%, higher than the growth rate of the economy. A recently released report from the International Monetary Fund (IMF) forecasts a growth rate for Canada of only 1.5% for 2015.

In an attempt to avert a recession this year the Bank of Canada in January cut the official bank rate by .25%. It recently cut again by an additional .25%. This has put additional pressure on the Loonie, already reeling over the past year from a collapse in oil prices. The chart below plots the price of West Texas Intermediate (WTI) compared to the Canadian dollar over the past year and a half. Clearly the price of oil is a major factor in the decline of our Loonie. Slower economic growth and lower interest rates are all related symptoms.



The value of our exports have been declining since the big collapse in energy prices last fall. Imports such as agricultural products from the U.S. and consumer goods from Asia are becoming more expensive in devalued Canadian dollars. Government funded infrastructure projects and the auto sector are the exceptions to a rather weak national economy. Employment gains have been very choppy with the year to date figures lower than expectations. A lower Canadian dollar should help manufacturers and commodity producers. It is not likely however to increase business investment or consumer spending. Stagflation may become a more common word in our vocabulary in the period ahead.

S&P/TSX : 14,553	*90 Day T-Bills : .58%*	*Oil : $59.50 US*	*Cdn $: .809 US*
S&P 500 : 2,063	*10 Yr Cda Bond : 1.68%*	*Gold : 1,171 US*	*Euro : 1.37 Cdn*

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Alberta Politics Makes History

After 43 years in power the Conservative dynasty in Alberta was soundly defeated in the May election. Demographic changes, environmental issues and government scandals resulted in the election of a majority NDP government headed by Rachel Notley. Preliminary indications suggest that oil sands expansion, already uneconomic due to lower oil prices, will be curtailed by more stringent regulations and carbon taxes. The Keystone pipeline is likely to be postponed indefinitely while other projects will await the results of a new royalty review. Lower commodity prices had already dampened the business outlook. The new government finds itself in a conundrum as unemployment in Alberta's oil patch is rising rapidly. Capital investment in energy exploration and development continues to be deferred or cancelled and/or directed to other jurisdictions.

Companies whose operations are located in the U.S. and elsewhere may be favoured. Lower regulations, better logistics and infrastructure often provide easier access to markets and hence higher profits. Oil services such as drilling rigs and fracturing equipment can be relocated globally. High paying jobs are in jeopardy in an industry whose labour force is seen to be fairly transient. All in all the near term outlook is not encouraging for Alberta and for the country as a whole.

Federal Election In October

Polls currently indicate a tight three way race leading up to the October election. While Prime Minister Harper is the least popular leader, the other two main competitors are not exactly inspiring the electorate. Combined with a grim economic outlook, we may well see a minority government in the next parliament. As the election draws near investors and consumers alike are likely to become more defensive, deferring any commitment to major

purchases. Any change in government is initially seen as disorderly. The uncertainty usually fades quickly with the realization that the economy is fairly resilient to government meddling. When the dust settles, the consequences of a slight move to either the right or the left of center are often exaggerated. Improving trade relations and supporting a healthy business climate should be, and generally are, the end goals of all governments.

Bankrupt Greece Stays in the Euro

With a solid referendum victory behind him, Alexis Tsipras, the Greek Prime Minister failed to gain any negotiating leverage from his counterparts in the EU. No debt relief was offered until Greece first takes action to reign in its budget deficit. As of writing a bailout agreement has been approved in the Greek parliament. While hurdles still remain, it does appear however that for now Greece will stay in the Euro. Whether this is just another temporary lifeline or a final permanent fix is unknown. With the democratic will of the people ignored, it may just be a long hot summer on the streets of Athens.

The Greek debt situation has revealed fundamental flaws that exist with the European common currency regime. A rigid and centralized monetary structure is clashing with the independent fiscal policies of

sovereign countries. Without an independent monetary policy Greece cannot devalue its currency, an adjustment mechanism which sovereign nations often used in order to improve terms of trade and eventually rebalance their finances.

The irony is that Greece is not the only country with a large outstanding debt burden. It's unfortunately the first

(cont'd on page 3)

Bankrupt Greece *(cont'd from page 2)*
country caught in such a dire predicament. The rest of Europe is not far down the bankruptcy list, albeit it can be argued that the larger nations in the group have the advantage of more profound and diversified economies. The bottom line is that Greece is proving that a common currency union between unequal economic entities faces serious challenges. A lesson can perhaps be learned from Canada where we have long established equalization payments for have-not regions of the country. Perhaps Europe needs to remodel itself into a Federal system which provides subsidies to the less prosperous countries in the union.

The extreme austerity imposed on Greece is not a solution. Greece cannot repay its debts, estimated at well over €300 Billion Euros. Even if it's GDP were to grow at double digit rates for the next ten years it would still fall short. Tragically, austerity imposes wage cuts, pension reforms and tax increases. This is certain to contract the economy even further.

The weakness in the euro system remains. The Greek debt problem has only been kicked down the road. The main concern for the EU is that most of the Greek debt is held by European financial institutions that still have inadequate capital reserves. While Greece is not large relative to global financial markets, it is large enough to create disruptions and capital inadequacy at major banks across Europe. With a structural deficiency still in place it is unlikely investors will be attracted to the currency any time soon.

Chinese Stock Market Plunges

The Chinese stock market has come under pressure recently. After more than doubling in price in the past 18 months it was inevitable that there would be an eventual bust. There are many reasons why the market had been so strong. Chief among them was a desire by investors to diversify away from a languishing real estate market. Prices there had been sinking for two years the result of an overbuilt market. A shift of investor preferences into the stock market seemed to be a rational decision. The stock market was ripe for the next area of speculation.

Unlike more developed financial markets in the West, the Chinese markets lack depth and maturity. It is predominantly still a retail market for individual investors. Institutions play a much smaller role. The last time Chinese investors got excited buying stocks was before the financial crisis. As with all stock markets around the world, China peaked back in 2007/08. Since that time the market has not been a major focus of investor attention, certainly not compared to many Western markets which have fully recovered and are making new highs. The adjacent chart of the Shanghai stock exchange index shows a very long period of subdued performance in the years following the 2008/09 financial crisis. The doubling in stock prices is a very recent phenomenon and can be argued is merely catching up after years of underperformance.

Just the same, a rapid advance in such a short period of time usually leads to instability. The reversal we are witnessing today cannot be good for investor confidence which is so important to the economic climate. Importantly, the Chinese government is also partly to blame. It has promoted the stock market and encouraged investors to open trading accounts. The policy was to increase the public's ownership of financial assets and create an old fashioned wealth effect. Its self-interest was quite obvious as it sold shares in many state owned enterprises.

Beijing can also be criticized for allowing a surge in borrowing. Many investors took out loans and collateralized their poor performing real estate investments. Clearly this was a risky undertaking and ill-advised. The government is now in crisis mode imposing restrictions on insider selling and even resorting to threats. They are desperately trying to stop the stock market from collapsing. Investor's nerves are clearly fraying. While a protracted decline may ensue, we would not rule out the government's determination and resolve to prevent a panic from getting out of hand.

Equity Strategy

Central banks are still in the business of lowering interest rates to help lift up moribund economies. The Bank of Canada has cut twice this year. While the recession word is being whispered about, it appears we are only going through a soft period with very little growth. A protracted decline in economic activity is very unlikely at this point. *Until interest rates rise significantly the stock market should be able to offer investors further gains.*

Nevertheless, Central Bank stimulus policies are not a guarantee the stock market will perform well. Maintaining investor confidence is extremely important, especially when valuation levels are high. The market has and can stay expensive as long as investors are willing to funnel their savings into stocks and accept the risk. Albeit the choppy markets of late, there does not seem to be major apprehension. Surveys and investor sentiment readings have not deteriorated significantly and are still mainly positive.

China's growth is slowing. This is a significant development and is considerably more important than the Greek debt fiasco. China is the world's second-largest economy. Last year it accounted for almost 40% of global growth, up from about 25% as recently as 2010. It is the world's largest importer of many commodities and an important global trading partner. While a direct investment in China is too perilous at the current time, an investment in the region still makes sense longer term. Growth rates in Asia are expected to remain higher over the next decade.

In the oil markets production levels are still high relative to demand forecasts. Russia, Saudi Arabia, and shale producers in the U.S. are determined to maintain production. Price discipline is lacking in the industry. We are maintaining our positions in the energy sector for now. Many of the leading companies share prices have declined to very attractive valuation levels. Barring a global recession, which is very unlikely, we do not believe there is significant downside.

We have increased slightly our investment in the U.S. markets. We will continue to look for opportunities there in order to diversify. The U.S. economy is firming and shows greater potential going forward. While stock prices are generally expensive, the financial, technology and healthcare sectors are areas we would consider.

Our main focus continues to favour investments in higher dividend paying securities. Although many companies share prices have declined due to concerns of a slower economy, we believe much of the decline is also related to the predictions for higher interest rates later this year. Additional volatility can be expected however it is unlikely interest rates will rise meaningfully in the foreseeable future. Quality companies with dividend yields in excess of 4% should continue to be accumulated for income. These yields are, and will remain attractive relative to fixed income securities for at least the next twelve month period.

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