

In This Issue:

- Canada: Steady as She Goes
- China adjusts to Slower Growth
- The Fed: On and Off Again
- Inflation and Interest Rates Revisited
- Commodity Prices Keep Tumbling
- Equity Strategy

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

Canada: Steady as She Goes

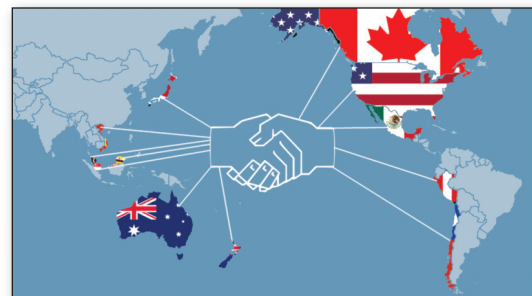
Canadian economic growth stalled a year ago shortly after the Organization of Petroleum Exporting Countries (OPEC) decided to flood the oil market with excess supply. Alberta, Saskatchewan and Newfoundland are expected to show negative growth for the full year while the entire country experienced a recession during the first half of this year. For 2016, as per a recent International Monetary Fund (IMF) report, growth in Canada has been revised down to just 1.1%.

Labour markets are mixed. Unemployment is now at 7.1% and the quality of jobs is declining with more part time work and self employment. The manufacturing sector, primarily located in Ontario and Quebec, is beginning to reap the benefits of the lower Canadian dollar. Auto sales and the construction sectors continue to show solid strength. Lower financing costs and incentives are certainly helping.

The Bank of Canada has been proactive on the economic front with two interest rate deductions this year. With interest rates already at such low levels, it is uncertain whether additional monetary stimulus can make a meaningful difference. Perhaps now that the price of oil appears to have stabilized, the energy sector will show signs of recovery. Profits in the industry have been battered however and layoffs continue in the short term.

On the political front the Liberals have won a majority and will likely be anxious to start delivering on their campaign promises. Market reaction, especially from foreign investors, may be reflected in the currency markets in the very short term. Investors hate uncertainty and so to some extent, a change after almost ten years of a Conservative government, may bring a negative knee jerk reaction. When viewed from a historical perspective, there is very little difference in whether it is the Conservatives or Liberals in power in Ottawa. Debts and deficits

keep expanding. We have never seen the size of government shrink nor has any government ever managed to pay back any debt after a full term in office.



One of the main issues going forward for the Canadian economy is the new Trans Pacific Partnership (TPP). Spearheaded by the U.S. this new agreement to reduce trade barriers was recently approved in principle by twelve nations in Asia and the Americas. The full terms of this deal have yet to be disclosed but already there is opposition brewing by dairy farmers and the auto industry who have been singled out for increased competition. In our view this is one of the more important economic issues straight ahead. While subsidies in the billions of dollars have been promised, unions in the auto sector for instance who are dead set against this deal have predicted 20,000 job losses as a result of an acceleration in off-shoring of auto parts and assembly work.

The economic malaise this past year is a reminder that Canada remains overly dependent on energy and commodities. In the short term the new Liberal government will be hard pressed to reverse this tide. Global growth needs to expand and Canada will need to diversify its economy and aggressively compete on the world stage. The TPP, as we have seen with trade deals in the past, will hopefully open markets and propel Canadian businesses forward.

China Adjusts to Slower Growth

The Chinese economy remains front and center in the debates about global economic growth. China's spectacular rise over the past two decades has been truly transformational. Its development triggered a voracious consumption of the world's raw materials. A decade ago an annual growth rate of 10-12% was the norm as the country was in the early stages of development. More recently, growth has settled in at 7-8%. The world now panics at the thought of growth falling below this level. In all likelihood China's growth rate is now descending to a 4-5% rate which would still be a very respectable growth rate considering China's size. It is now officially the second largest economy in the world and by some measures will very quickly become the largest.



Most of the slowdown in China has occurred in real estate investment, both commercial and residential. It has been well documented that their housing market is oversupplied. Home prices have been falling for well over a year resulting in a slowdown of construction activity. Investment in new manufacturing is also trending downward as many industries are consolidating underutilized factories.

Imports into China, in U.S. dollars, declined by 20.4% in September to \$145 Billion from one year ago. While this is a sharp decline it mostly reflects the drop in

commodity prices especially in oil. Actual volumes are still growing for the majority of commodities including oil, copper, iron ore, and coal; far from the pending disaster one often reads about in the media. *Demand is still healthy and growing, only prices have fallen.* Meanwhile, China's exports were down only 3.7% during September resulting in a trade surplus for the month of over \$60 Billion, much higher than forecasted.

Companies exporting to China in the commodity sectors are facing a classic inventory correction. Coal, iron ore and many other commodity producers in the world are cutting back. They geared up and expected continued high growth rates in China. A painful adjustment is now in progress and it will take a year or two to get

production levels in line to meet the lower demand from China. While this means a slower growth in global GDP the financial markets could very well have already discounted the worst.

China is adjusting to a slower growth rate as the country rebalances towards consumption. Chinese consumers have been notorious savers and are now enjoying rising purchasing power. Domestic investment in the service sector including tourism is diversifying their economy and will spawn new growth. China is adjusting to slower growth and over time so will the investment community.

The Fed: On and Off Again

The Chair of the U.S. Federal Reserve, Janet Yellen, has been discussing the need of raising interest rates for quite some time. After numerous delays the very first increase of .25% was finally scheduled for September. She blinked. For a brief period of time, the markets were up, choosing to believe the Fed's decision was the right one. Upon more reflection however, the markets started to tumble deciding that the failure to raise rates shows the US economy is weaker than the authorities are letting on.

While the Fed has for the time being decided to postpone raising interest rates, it is only a matter of time before they finally do so. The slowing global economy amid concerns that higher interest rates would further strengthen the dollar played a significant role in the

Fed's decision. A more cynical interpretation would be the Fed panicked when the stock market plunged suddenly in late August by more than 10%. For



Yellen, and the majority of central bankers, the default decision is a zero interest rate policy. Investors are becoming more conditioned of a Fed "bail out" every time the stock market declines. Unfortunately the danger is that it encourages more risk taking.

Inflation and Interest Rates Revisited

We have noticed a shift in opinion following the U.S. Federal Reserve's decision to again defer raising interest rates. While not a consensus, many market pundits are forecasting a long period ahead of ultra-low interest rates. They do not see any inflation on the horizon.

There are two or three powerful forces at work that will keep inflation at bay for many years to come. The first is the price of oil. It has fallen in price by about 50% in the past year. It certainly appears there is enough supply in the world to prevent the price from escalating any time soon.

Many experts have capped the upside potential for oil to the \$75-80 range for the foreseeable future.

Secondly, the pace of innovation in technology has a deflationary aspect on wages and salaries. We have all

witnessed how an innovative car sharing software app is disrupting the taxi industry. Uber is just one example of disruptive technology which threatens to shake up the labour markets. Intelligent software systems are driving out inefficiencies and lowering costs in all kinds of industries.



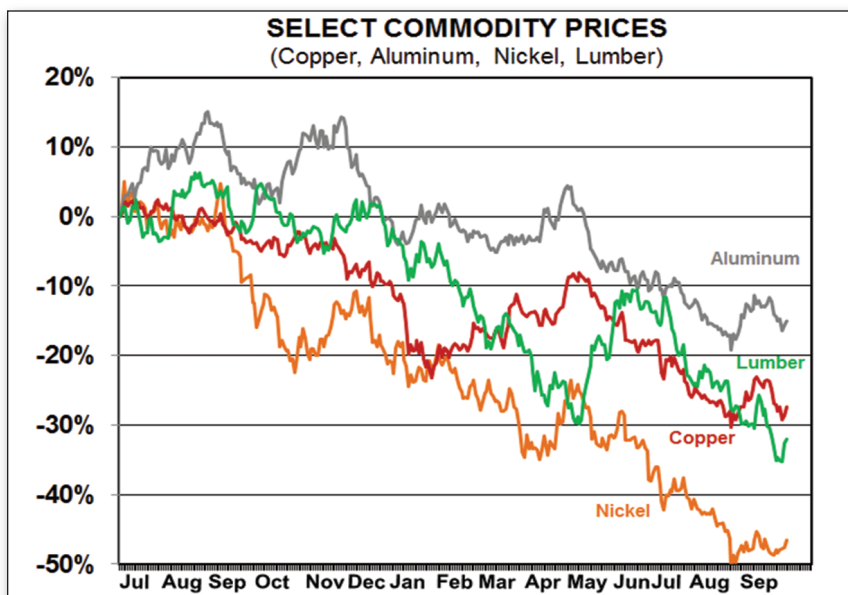
Inflation has often been considered a monetary phenomenon. As money and credit expands it drives up the price of goods and services. For several years now, central banks all over the world have been printing money. To date we have not witnessed a material rise in inflation. Money has

instead flowed into financial assets, stocks and bonds, and also real estate. Until money and credit create the conditions for much higher economic growth, financial assets are likely to continue to rise despite their higher valuation risk.

Commodity Prices Keep Tumbling

The majority of commodities have declined in price since last summer. The chart below plots the declining prices of four major commodities produced in the world; Copper, Nickel, Aluminum and Lumber. The decline in many of the metals since July 2014 parallels the drop in the price of oil. For Canada, and many other resource based countries the correction in prices has been especially disconcerting.

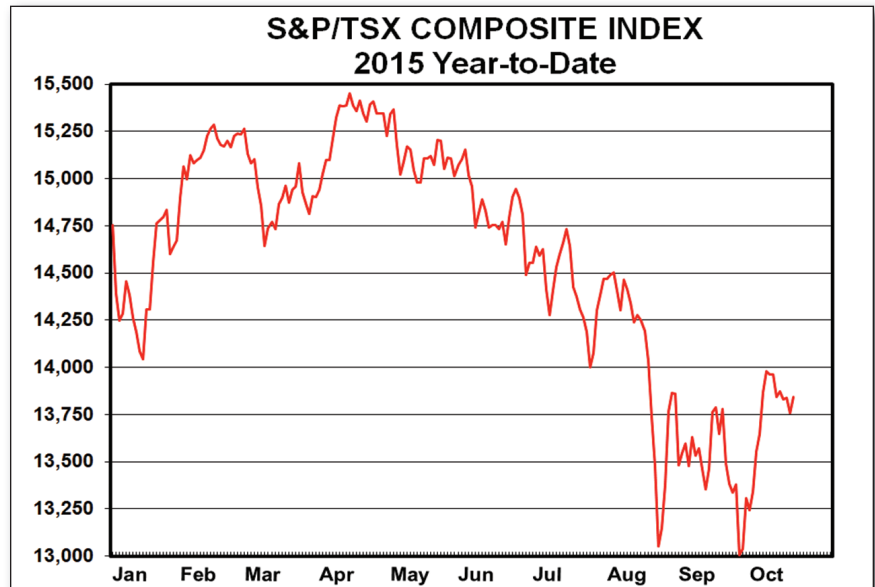
Some economists are suggesting the drop in commodity prices could be sending an ominous message. However, when looking back at previous business cycles, commodity prices often tended to peak coincidentally or shortly after the cycle peak. Considering the magnitude of price declines over the past year, the world economy should already be deep in recession. It is not.



Commodity price declines are also usually associated with weakness in demand. The demand for commodities remains buoyant. We continue to see growth in China, India, Brazil and other large developing countries where industrialization and population growth is expanding. There is likely some other explanation for the severe decline and we suspect the answer lies with central bank money printing. It is causing all kinds of mispricing in the capital and financial markets. The volatility is not good for investors and business owners alike.

Equity Strategy

Volatility returned to the stock markets with a vengeance this summer, as can be seen in the adjacent chart of the S&P/TSX Composite Index. According to many experienced “technical traders”, the sharp and sudden declines have eroded confidence and may bring more volatility in the months to come. Still, the mindset of many investors is to take advantage of what appears to be a buying opportunity. The main rationale is not based on value per se, but on a belief system that the Fed stands ready to bail out the stock market.



While caution is advised, we do not see an end to the business cycle or any financial crisis lurking around the corner. The global economy, especially in the developed world, has been growing at a lackluster pace since the last financial crisis in 2008/9. It is therefore not showing the typical excesses that normally propels an economy over the edge into recession. As Nobel Economist Paul Samuelson famously said, “*The stock market has predicted nine out of the last five recessions.*”

Businesses are however slowing their capital spending plans. By some estimates global spending will be down about 1% in 2015. A good part of this can be explained by the energy sector which continues to see layoffs and shutdowns. The strong U.S. dollar has been a challenge for U.S. multinational corporations. They are witnessing weaker profit margins thanks to currency exchange issues as well as weaker overall demand for American exports. With our own currency down in the .75 to .77 range we do not intend to make any significant investments in the U.S. markets. We would only contemplate a slight increase to current positions already held.

We continue to recommend holding positions in the banking and insurance sectors. They should eventually benefit from a rising interest rate environment. Banks are usually quick to raise lending rates and slow to raise rates on deposit therefore benefitting from widening spreads. Having said that, the economy is much more interest rate sensitive this time around. Households are carrying heavy mortgage debt loads, encouraged by many years of low interest rates. A rise in interest rates is likely to be problematic for the housing sector and in turn problematic for the banks. We will be monitoring this closely in the coming year and may need to adjust positions accordingly.

In our judgement the overall decline in stock prices is temporary. A 15-20% correction was long overdue and we do not believe the business cycle is about to descend into another recession. The global economy has challenges however there is still ample monetary and fiscal policy measures that can and will be applied to promote non-inflationary growth. We also expect to see a moderation in volatility as we close out the year.

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

STONEBROOKE
ASSET MANAGEMENT