STONEBROOKE
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Summary 2018

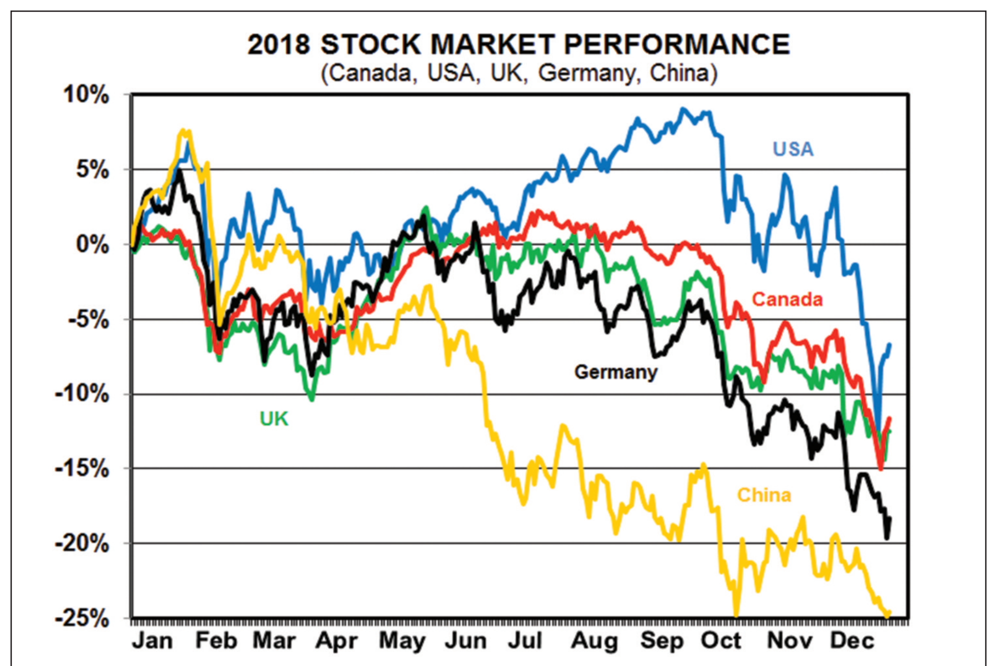
2018 was a discouraging year as stock markets plummeted around the world. The S&P/TSX Composite price index was down 11.6% for the year, while the S&P 500 in the U.S. fell by 6.2%. The final three months were particularly punishing as stocks in Canada and the U.S. fell by 11% and 14% respectively.

European stock markets were under pressure most of the year. The German Dax index finished lower by 18%, while the London FTSE was down by 12.5%. Asian markets faired poorly led by a 25% decline in China's Shanghai index (SSEC). Emerging markets were also under stress with the main benchmark EM index registering a decline of over 12%.

Commodity prices plunged in the final quarter as well. The price of Oil (WTI) began the year around $60 US climbing to over $75 before dropping to end the year at $45.40 US. Volatility was also witnessed in other markets such as Natural Gas and Copper. The price of Copper was down over 15% to finish the year at around $2.60 per pound.

In fixed income markets the preferred share sector was under pressure in the final months of the year. Panic selling amidst thin trading volumes sent yields higher. The preferred index dropped 12% in 2018. Bonds on the other hand were an area of relative strength. The FTSE Overall Universe bond index finished the year up 1.4% as the yield on 10-year Canada bonds finished at 1.96%.

The chart below shows the performance of five of the world's major stock markets in 2018, in local currency. The U.S was the best performing market while China was the worst. All significant markets were down for the year



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
www.stonebrooke.ca

S&P/TSX : 14,323
S&P 500 : 2,507

90 Day T-Bills : 1.64%
10 Yr Cda Bond : 1.96%

Oil : $45.40 US
Gold : 1,282 US

Cdn $: .733 US
Euro : 1.56 Cdn

What Went Wrong

2018 was expected to be a year of positive financial market returns. Initial forecasts were optimistic signaling strong economic and corporate earnings growth, yet the stock market struggled and then finally plunged in the last three months of the year. Trade tensions with China and a more hawkish U.S. Federal Reserve were mainly to blame.

To a large degree we believe the financial markets have gone through a process of *changing expectations*. That change began in October from what was then the assumption global growth was vigorous and sustainable, to be replaced by a sense of concern and caution. Investors expected strong corporate earnings growth, led by tax reform, and the U.S. Federal Reserve was expected to raise interest rates several times confirming the robust conditions. At first the markets appeared to buy the narrative. Then opinions started to change with the growing realization the economy may be slowing. To continue raising interest rates in the face of a weakening global economy would be a classic policy mistake. The uncertain policy response by the Fed made investors nervous.

Investor sentiment is no longer positive. This is to be expected when the stock market plunges quickly by 20%. When this change occurs even good news becomes suspect and no longer commands investor excitement. In addition, recession forecasts start multiplying.

While the stock market can be a good leading indicator, it can just as often be wrong. A common saying among industry professionals is that the stock market has forecast *nine of the past five recessions*. While there is now a widely expected slowdown around the corner - *a growth slowdown is not a recession*. The main headwinds; trade friction with China, U.S. Federal Reserve policy, and the U.S. government shutdown, are all temporary and resolvable. A change of expectations always brings volatility to the financial markets. A cycle ending stock market collapse with an accompanying recession does not appear likely for 2019.

Rethinking The U.S. China Relationship

In a speech last October at the Hudson Institute, Vice President Mike Pence gave an unusually somber view of U.S.-Chinese relations. The Vice President accused China of everything from stealing U.S. technology to interfering in U.S. elections, to violating human rights. While claiming the Trump administration is seeking a good working relationship with China, Vice President Pence warned that the U.S. will not tolerate Chinese threats either regarding trade, or on broader geopolitical issues which threaten U.S. interests. As China asserts its economic influence around the globe, the struggle for global dominance is perhaps just beginning.

Importantly, the hardline tactics by the Trump administration risks pushing China, and the global economy, into a growth slowdown. The president himself has boasted he will succeed, and he points out a trade deal is in China's interest, citing its falling stock market. Perhaps he believes his threats will make President Xi Jinping back down. This is unlikely. The U.S. is pursuing a high-risk policy that will have massively negative consequences if it fails. The geopolitical environment appears more important than ever for financial markets. The year ahead could mean more volatility in currency and bond markets as institutional investors consider risk hedging strategies to protect capital.

A slowdown in China would be problematic. China has been the primary driver of growth for the global economy. While it represents about 15% of the world's GDP, China accounts for 25%-30% of global annual growth. Importantly, China's Caixin PMI manufacturing index has slipped recently to 49.7, a sign manufacturing is contracting.

The world has never experienced a Chinese recession since China entered the WTO in 2001. For almost 20 years the growth rate of their economy has been exceptional. During the 2008/9 financial crisis China expanded debt massively in order to maintain high growth rates. A slowdown in China today, now the second largest economy in the world, will have global repercussions.

Additionally, China is increasingly being vilified, accused of having a closed and unfair market. Its global export growth model is challenged. The poisoned environment has put direct investment decisions by major international companies on hold. This turn in U.S.- Chinese relations is much more than just a simple trade skirmish.

Canada – The Unfolding Energy Disaster

Canada's energy industry has an Achilles heal – pipelines. To move oil to offshore markets or even to Eastern Canadian refineries, land-locked Alberta is dependent on pipelines, of which construction is currently stalled by an insensible political and judicial process. Indigenous and environmental concerns, while important, have never stopped previous development of the large and more controversial oil sands projects. It makes no sense to have given these huge projects the green light and then delay or deny the flow of oil.

There is now a glut of oil in storage. The cost to the economy has been estimated at $80 million per day. As a temporary remedy, the Alberta government has requested the industry to "shut in" about 9% of oil production until new railroad tank cars can be put into service. This has helped to lift prices however production levels are lower.

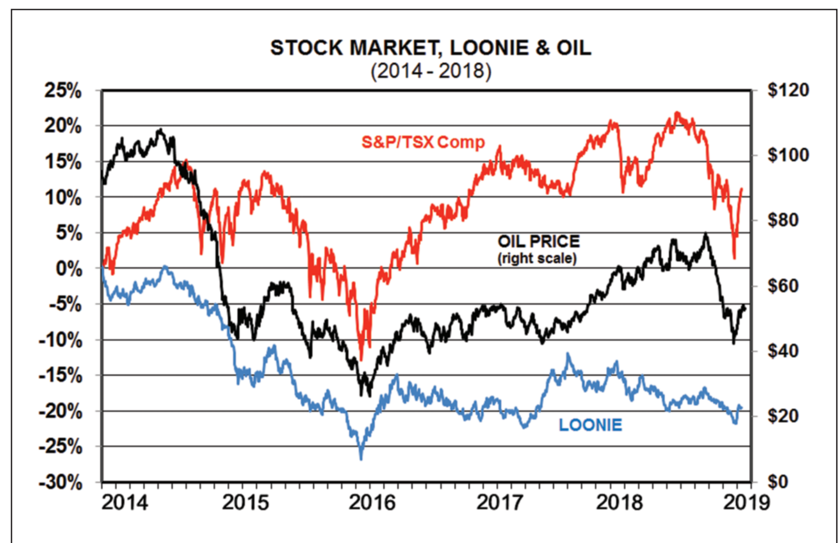
In addition, Bill C-69, and the controversial Carbon Tax is expected to discourage new investment in oil and gas production and infrastructure.

The Federal government's treatment of the oil sector is leading to a steady decline in foreign investment and to the outright sale of Canadian assets. The government's forced $4.5 billion purchase of Trans Mountain Pipeline was a sign of desperation. Even our own energy companies are looking outside Canada for investment opportunities. Trans Canada Pipelines already obtains over 50% of its revenue from investments in the U.S. and Mexico.

The Canadian industry has no incentive to increase production or develop new reserves. Along with delays in approving pipelines, this has resulted in massive job losses in Alberta and Saskatchewan as oil rigs and service companies move to the more hospitable U.S.

Fortunately for the oil sector, the Organization of Petroleum Exporting Countries (OPEC), agreed to reduce oil production by over 1 million barrels per day. The objective is to better match supply with global demand and to offset rising U.S. production which is estimated to reach 11 million barrels per day in 2019. The U.S. has become the largest oil producer in the world. The action by OPEC has stopped the freefall in the price of oil which dropped from over US $75 at mid-year to about US $45 in late December.

The swings in the price of oil have had a pronounced influence on the performance of our currency and stock market. Our Loonie has often been referred to as a Petro-currency. The S&P/TSX Composite stock index has an exposure to the oil and gas sector which is still about 20%. The chart below illustrates how the gyrations in the price of oil over the past five years affects our currency and stock market.



In the previous year, from March 2017 to Sept 2018, when oil rose from US$40 to $75, the Loonie conspicuously drifted lower, ending the correlation. The dynamics of a stronger U.S. economy with an improved investment climate was a contributing factor. Should the price of oil begin to recover once again, there is no guarantee our Loonie, nor even perhaps our stock market, will rise in tandem.

Faith In Central Planners

One of our fundamental beliefs is that Central banks still have the ability to influence markets in a positive way. This will not always be the case, however at this stage in the business cycle, with what has been a low growth and low inflation environment, the Central Banks still have the latitude to ease monetary policy. This would not be the case if inflation had taken hold of the economy and was rising rapidly.

The change in the yield curve is also confirming inflation is not an issue. At its foundation, the yield curve is a real measure of monetary policy. A steep upwards curve, with long-term interest rates higher than short-term interest rates, represents a normal curve. The opposite, higher short-term interest rates, or an inverted curve, indicates a tightness in monetary policy. Central banks deliberately

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Faith in Central Planners *(cont'd from page 3)*
tighten policy to fight inflation leading to an inverted yield curve. This will usually create a slowdown/recession. The reason is essentially due to the supply and demand for credit. Credit growth is an important factor for economic growth. As interest rates rise the desire for borrowing declines. As bank lending slows down, the economy slows down.

With the economy currently forecasted to slow and with moderating consumer inflation, the U.S. Fed will now be on hold. The next 25 basis points rise in the federal funds rate will likely come much later in 2019, if at all.

Portfolio Strategy

Many are now convinced we are in a bear market. The positive trend has been broken with the 200-day moving average having been crossed and now sloping down – see chart below of the S&P 500 index in the U.S. This is never a good signal, although it does not imply with certainty that further losses are in store. In 2015 the market also incurred some turbulence having dropped about 10%, after which the uptrend resumed.

Still, in the event the trend has indeed changed, trimming back positions into strength as the market tries to recover may be a good strategy. We will be monitoring conditions carefully for adverse economic news ahead. A few large and influential companies have recently announced disappointing results. Apple, Federal Express and Macy's have given lower guidance for 2019. As a result, the market mood is much more somber. The upcoming quarterly earnings results along with management forecasts for 2019 will take on heightened importance.

The infamous FANG stocks, those high-technology darlings, have been de-fanged. It certainly appears the peak in FANG stocks has been witnessed. Facebook, Apple and Nvidia, have declined well over 25%. Similar to earlier excesses in the Bio-technology sector, or the Bitcoin craze, these overpriced momentum favourites are likely finished for this cycle. This does not mean the stock market in aggregate will necessarily perform poorly. A rotation into other less expensive and less risky sectors is possible, as is a rotation into other sectors with promising growth attributes.

When the market declines it is important to reassess matters, especially when it declines as quickly as it did in the final quarter of 2018. Collectively, a number of other indicators of economic activity are weakening and confirm that a slowdown is around the corner. While the magnitude of the slowdown is uncertain, the market selloff has already discounted part of it. If it is entirely trade related, then a resolution will eventually lift anxiety and business confidence.

Also, while corporate earnings are softening, the comparisons are from a very high level. 2018 was a great year, stimulated by tax reform and low interest rates. It was unlikely the high level of earnings growth could continue into 2019.

Asset allocation is always the most important portfolio strategy decision. A balanced mix of stocks and bonds continues to be appropriate for the longer term. The duration of this economic cycle is already one of the lengthiest on record. With interest rates and inflation still relatively low, the cycle can extend another two or more years.

We could be entering a period of prolonged volatility. The stock market could easily decline further should the more expensive high-technology/momentum stocks come under renewed pressure. Our predisposition is to take advantage of the opportunity of purchasing stocks at lower prices, while of course maintaining a more cautious and balanced asset mix.

Stonebrooke Asset Management Ltd.
Waterpark Place 20 Bay St., 11th Floor, Toronto, ON M5J 2N8
344 Lakeshore Rd. E., Suite B, Oakville, ON L6J 1J6
Tel: 416.850.2172 Email: info@stonebrooke.ca www.stonebrooke.ca