

Winter 2018

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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

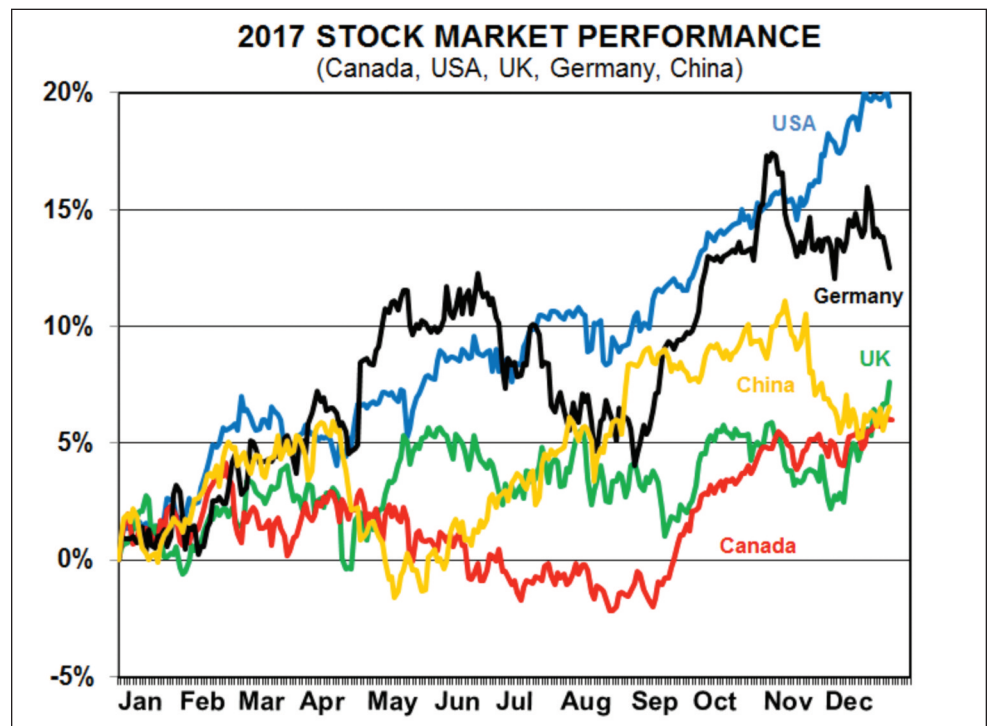
Tel: 416-850-2172
Email: info@stonebrooke.ca
www.stonebrooke.ca

Summary 2017

Financial markets performed respectably in 2017. The S&P/TSX Composite price index was up 6%, with all of the gain in the stock market coming in the final months of the year. In contrast, U.S. stocks climbed steadily higher with the S&P 500 index recording an incredible gain of 19.4%. However, in Canadian dollar terms, the price gain was reduced to just under 12% as our Loonie appreciated just over 7% for the year.

European indices performed well with the German Dax up 12.5% in local currency (Euro's). Asian, and emerging markets also put in good stock market returns with stable to rising currencies. In fixed income markets yields on longer dated bonds surprised most investors by declining as shorter-term bond yields rose. The FTSE TMX Canada Universe Bond Index showed a positive return of 2.5%.

The chart below plots the stock market returns from various major countries in local currency. The U.S. was the top performing market in local currency terms. The Canadian stock market had one of the poorer performances in 2017. This is quite a contrast from a year earlier when Canada outperformed all major international markets.



The Year Ahead

Looking to the year ahead, the majority of market prognosticators are forecasting an upturn in global economies accompanied by rising interest rates, especially in the U.S. While emerging markets in Asia and Latin America seem to generate enough inflation to justify higher rates, this is not the case in the developed world. Europe and Japan have inflation rates still well below 2%. Rising productivity and competition have served to keep a lid on prices that consumers pay for food, clothing and electronics. The rise in interest rates is expected to be gradual and not likely to be a significant impediment to global growth.

We expect 2018 to be a more volatile year for financial markets, if only because volatility has been extremely low over the preceding eighteen months. The main reasons for more volatility have not changed materially yet continue to be a source of concern for investors;

- 1) Rising short term interest rates, more quickly than expected.
- 2) China, a renewed concern over economic stability/growth.
- 3) North Korea and the potential for war.
- 4) Conflict in the Middle East causing oil prices to spike.

Any one of these outcomes could result in a correction in stock prices. China was a major concern two years ago that resulted in a 20% stock market correction. A sharp rise in interest rates may be the trigger this time around. Even then, if markets were to weaken significantly, a panicked Federal Reserve is likely to rush in with soothing words and an injection of money.

In Canada, the residential housing market has stabilized in the major city centers. Starting this year new Federal requirements for “stress testing” will apply to mortgage applicants to prevent home buyers from purchasing a home they may not be able to afford should mortgage rates rise by up to 2%.

The once generous lending practices by banks and other financial institutions continues to be more restrictive. Along with first mortgages, it is becoming more costly to borrow against home equity. The average Canadian household already carries a debt of 1.7 times annual disposable income, the highest of any major Western country. A slowdown in the level of borrowing could be around the corner. This would have implications for consumer spending and unless offset by a stronger business sector could have an adverse impact on the economy.

Importantly, we still expect Central banks will play an important role shaping the economic and investment landscape. Cheap money policies have been the driving influence for both stock and bond prices. Without the printing of money “out of thin air” to buy bonds, which has been instrumental in holding interest rates near zero, the financial markets would not be at the levels they are today. In the U.S. especially, stock prices are making new record highs and it appears that “animal spirits” are taking hold, with investors once again excited to chase stock prices higher. Valuation levels are already at rarefied levels, the second highest in history – a fact lost in the hubris of the moment. It will be an interesting year ahead.

U.S. Tax Reform

The tax reform bill in the U.S. has finally passed. The top corporate tax rate will fall from 35% to 21% and personal tax rates will also decline, although marginally. The overall effect on the U.S. economy is expected to be positive with a boost to corporate spending. U.S. multinationals are also expected to repatriate off-shore profits, stimulating the domestic economy.

The record on tax cuts is unclear. Previous tax cuts were introduced either at the wrong time in the economic cycle or were “diluted” with other spending measures, either increasing tax revenues from other sources or running up deficits.

A tax cut which increases the deficit on a permanent basis is not a practical solution. It results in a tax hike down the road to pay for the funding gap. A revenue neutral tax cut would merely shift the tax burden and/or broaden the base. The Trump tax reform bill is more than just a simple tax cut. While it may not be revenue neutral immediately, elements of the bill are designed to encourage corporate spending and hiring. An improved economic growth rate and more employment will lead to additional tax revenues.

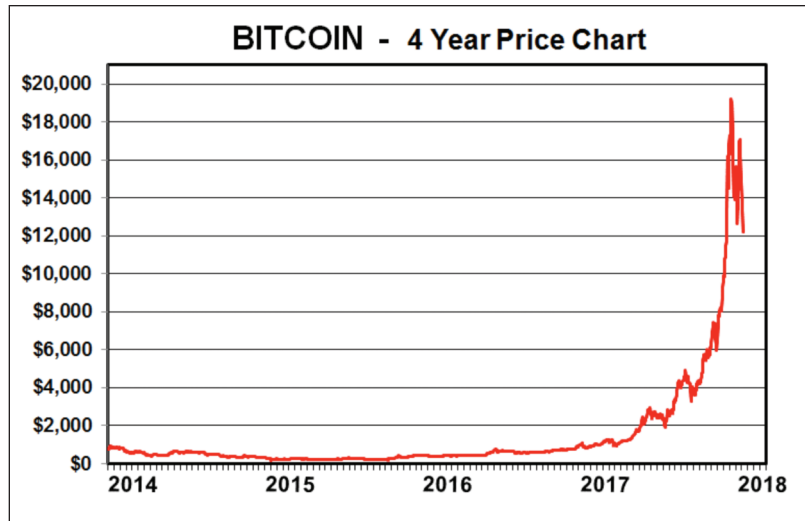
Some studies have estimated as much as U.S. \$2.5 Trillion in untaxed corporate cash is sitting in overseas financial centers. Tax reform will encourage a portion of these funds to be repatriated and used to invest in capital equipment, increased dividends to shareholders and share buy-backs. Apple Computer recently announced it will be repatriating funds held outside the U.S., estimated at \$250 Billion. They will be paying a whopping tax bill of \$38 Billion and plan to increase capital spending by \$30 Billion over five years.

Tax reform in the U.S. poses a challenge for Canada. It may be a far bigger issue than NAFTA. Canadian companies may be encouraged to shift business to the U.S. These shifts have already started to take place because of increased indirect taxes and increased costs in operating a business in Canada. In the U.S., small and medium sized businesses are the most optimistic in years. They are supportive of the tax reform bill and surveys reveal an increased intention to invest in plant and equipment and in hiring.

Bitcoin – Bites the Dust?

The extraordinary rise in the price of Bitcoin in 2017 has made it a household name. Less well known is the computer technology underpinning this investment phenomenon or crypto currency, known as “blockchain”.

To begin with, Bitcoin is *not* a currency. A currency must be stable in price for it to be used reliably in transactions. Nor is it a store of value since the price is much too volatile to be relied upon. Bitcoin, along with all the other cryptocurrencies recently issued are *speculative instruments with no tangible value*. While we have no idea how high the price of a Bitcoin will ultimately reach, one day it will decline and a panic will set in. Sellers will overwhelm the few buyers on the way down leading to a crash. It may have already started, although there have been many spikes down before and the price always recovered quickly. One day the price will not recover and like all speculations this will end badly.



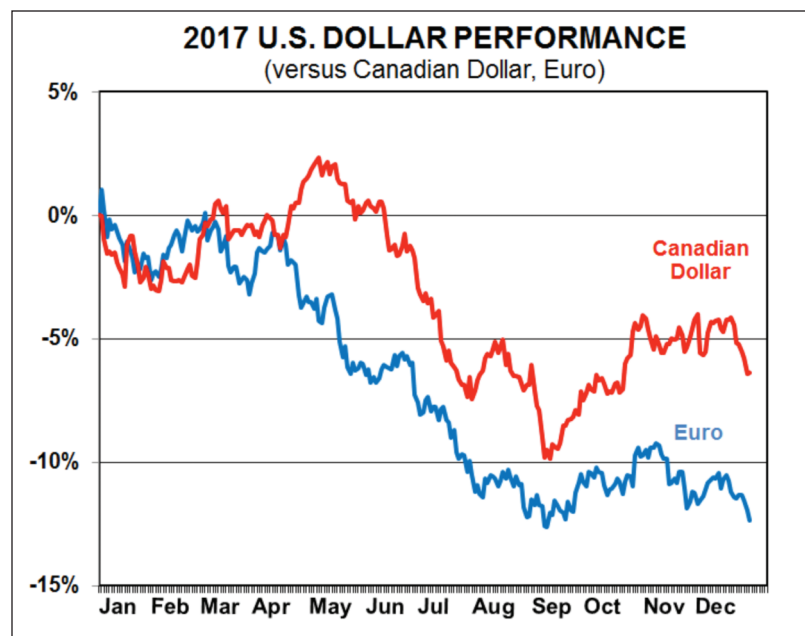
One of the early reasons given to purchase Bitcoin was the limited number of supply. There will never be more than 21 Million of these Bitcoins in circulation. While this may be true for Bitcoin, the market for other cryptos appears unlimited. Investors can now jump aboard and buy all kinds of new cryptos, Ethereum, Litecoin, etc., including even new versions of Bitcoin. The market for cryptocurrencies has exploded with well over 1,200 now available. The Bitcoin phenomenon is a sign of the times. Investors' appetite for taking risk is obviously high.

Lest we be labelled as “old school” investment managers who *just don't get it*, we find the technology itself mathematically innovative and very fascinating. Blockchain, and variations of it, will likely be adopted as a means of secure record keeping, as well as for many other trusted applications. However, as some new type of free and independent currency, well, let the buyer beware.

U.S. Dollar Stumbles

The U.S. dollar declined about 10% last year as measured against major G-7 countries. The Canadian dollar appreciated 7% versus the U.S. dollar to end the year just under .80 cents. The Euro appreciated by just over 14% and finished the year at 1.20 to the dollar. The adjacent chart plots the decline of the U.S. dollar in 2017 vis a vis both currencies.

The decline of the U.S. Dollar surprised the majority of pundits. At the start of the year the consensus expectation was for a stronger dollar with the main reasons being a more hawkish monetary policy from the Federal Reserve and a pro-growth Trump Administration fiscal agenda.



The prospects for 2018 are divided with tax reform, oddly enough, as the major reason given for the opposing views. Those predicting a weaker U.S. dollar view tax reform as a recipe for increased debt and debt servicing costs. Rising interest rates only add to their trepidation as they warn of a budget deficit once again out of control. Others argue tax reform will bring an increase in economic growth and will drive capital into the U.S., supporting the dollar. In hindsight, 2017 seemed like an easy forecast for the U.S. dollar, and the majority got it wrong. 2018 is anyone's guess.

(cont'd on page 4)

U.S. Dollar Stumbles (cont'd from page 3)

Still, the U.S. dollar should regain some stability and perhaps end the year in an uptrend. The initial burst of optimism in the Euro with the election of Emmanuel Macron in France will likely fade, as usually happens with politics. Brexit concerns are likely to be rekindled and a relatively slower growth environment in Europe remains evident by simply observing the still huge differentials in interest rates – even 10-year Italian government bonds at 1.95% are trading much lower than equivalent U.S. treasuries (2.65%).

The Canadian dollar has been helped by stronger global economic growth and the improved demand for commodities. After many years of slower global growth, the economic cycle is

finally set to favour cyclical industries, including the commodity producers. Energy, metals and lumber represent large exports for some of our major companies. Last year witnessed strong price increases (U.S. currency), for lumber, up 43%, copper, up 30%, zinc, up 28%. Nickel and aluminum prices were up about 20%. Even the price of crude oil was firm rising 12%. The upward momentum appears set to continue in 2018, although we would expect more moderate price increases.

The Bank of Canada is not expected to raise interest rates as fast as in the U.S. where the Federal Reserve has announced the likelihood of three more rate hikes in 2018. This in itself should keep the Canadian dollar from appreciating too much more.

Portfolio Strategy

For balanced portfolio mandates we recommend maintaining a 50% exposure to the equity market. Some of the higher dividend yielding sectors have recently become more attractive. A slight increase in portfolio equity weightings is therefore anticipated. This would be a shift out of short term bonds and into conservative equities and/or exchange traded funds.

The Canadian stock market finished the year with a reasonable gain, especially considering the market was in negative territory in the month of September. The bank stocks rallied in the final months lifting up the averages for a 6% price gain in the S&P/TSX Composite index. Many of the larger companies with higher dividend yields underperformed, including BCE, and pipeline companies, Enbridge and TransCanada. These companies offered yields well north of 4% and were over-weighted in many high-income exchange traded funds. Rising short-term interest rates were partly to blame for their underperformance.

Investors' appetite for risk is returning, as is the desire to invest in something new – cryptocurrencies and marijuana stocks are all the rage. While the later will become a legitimate industry when recreational use is legalized later this summer, Bitcoin is pure speculation of the highest order. The speculation is not with the underlying technology, it is with the idea that governments will allow a competing currency that they cannot control. Importantly, speculative fever is typically associated with aging bull markets. Investors tend to get carried away at the top when prices are expensive.

The U.S. stock market has risen steadily in the past eighteen months, setting new records. It has been one of the longest periods on record without more than a 3% decline. According to

the Financial Times, corporate share buybacks have equaled \$5 trillion U.S. dollars since the financial crisis of 2008/9. It represents the single largest source of demand for stocks. With the passage of tax reform and a one-time lower tax rate for companies repatriating funds from abroad, share buybacks are expected to continue, and perhaps at an accelerating pace.

Much of the gains in the U.S. stock market index continue to be attributable to a handful of Technology stocks. Facebook, Apple, Amazon, Netflix and Google continue to climb to expensive valuation levels. They are the momentum "darlings" that investors cannot get enough of. While some of these technology stocks could grow profits by 20-25% annually, their stock prices have gained over 50% in the past year. This divergence only confirms the mania environment developing in the U.S.

According to Jeremy Grantham, of GMO, a large and respected value-based pension fund manager in the U.S., "Expensive markets have historically provided very poor risk-reward trade-offs," he also said very recently, "...we are currently showing signs of entering the blow-off or melt-up phase of this very long bull market."

In fixed income markets investors in government and corporate bonds experienced moderate gains in both capital and interest income in 2017. The FTSE TMX Universe bond index was up by 2.5%. Long-term bond yields declined slightly as shorter-term bond yields rose (two-year Canada bond yields rose almost 1%). This resulted in a flatter yield curve, which was unexpected, and resulted in only a marginal overall return for shorter term bond indices. The FTSE TMX benchmark short term bond index was up just .1%. As interest rates rise to more normal levels bond holders risk losing capital. Remaining in shorter term instruments is still the better risk/reward strategy for now.

