STONEBROOKE
ASSET MANAGEMENT

Investment Commentary

Winter 2016

In This Issue:

- Summary 2015
- Canada's Economy Uninspiring
- China Rattles Markets
- The Almighty U.S. Dollar
- Equity Strategy
- Asset Allocation

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

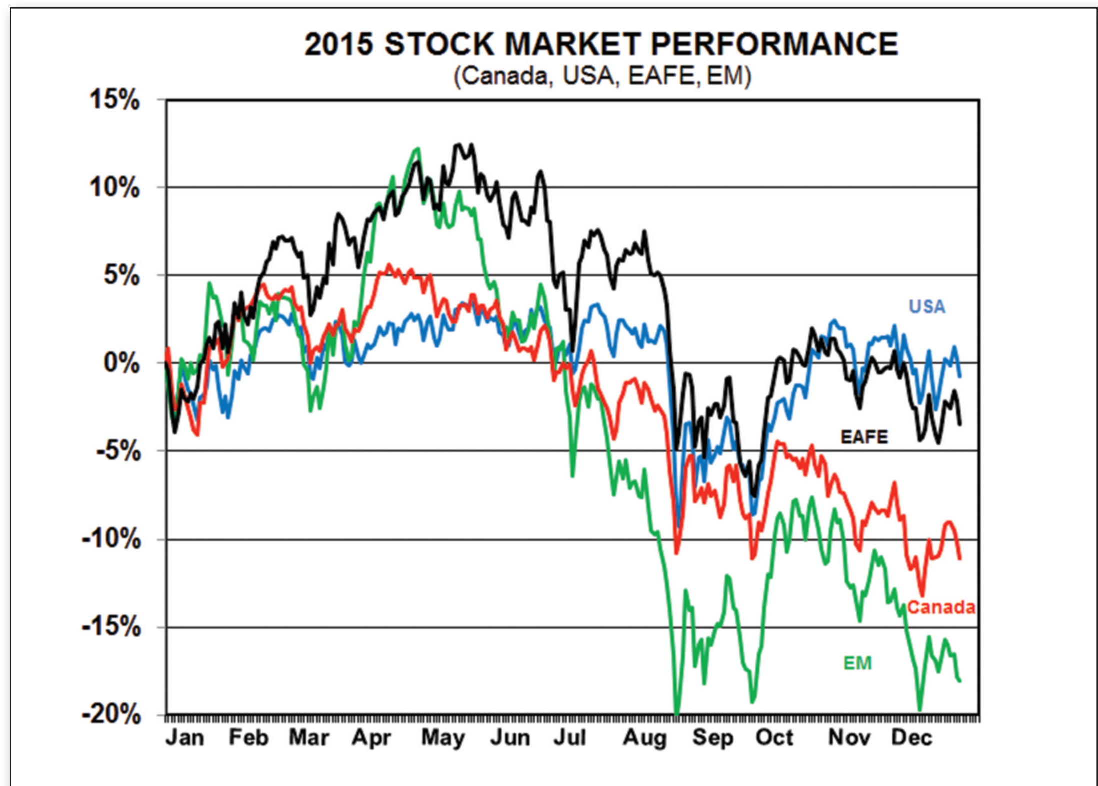
Tel: 416-850-2172
Email: info@stonebrooke.ca
www.stonebrooke.ca

Summary 2015

2015 was a disappointing year in the stock markets. In Canada the S&P/TSX Composite price index was down 11% while in the U.S. the S&P 500 was essentially flat with a slight loss of .7%. Bonds managed to post positive numbers with the FTSE Universe Bond index gaining 3.5%. The Government of Canada 10 year benchmark bond finished the year at a yield of just 1.4%.

For the third year in a row the Canadian Loonie fell vis-a-vis the U.S. dollar closing at $.72, losing an astonishing 16%. The price of Oil finished the year at US$37, for a decline of 30%. Understandably energy stocks tumbled recording one of the worst performances in decades.

The majority of commodity prices suffered declines in 2015 with zinc, copper, nickel, all declining. The price of Gold bullion dropped again albeit modestly by about US$150 to settle at US$1060. Indeed 2015 was an abysmal year for the resource sector.



The chart above plots the performance of the Canadian stock market (S&P/TSX Composite), the U.S. (S&P 500), the developed markets of Europe, Asia and the Far East (EAFE), and the developing markets in the Emerging world (EM). The performances are shown in local currency terms. The year started well for overseas markets but by year end the U.S. again prevailed, albeit by just breaking even.

S&P/TSX : 13,010 | *90 Day T-Bills : .51%* | *Oil : $37.20 US* | *Cdn $: .721 US*
S&P 500 : 2,044 | *10 Yr Cda Bond : 1.39%* | *Gold : 1,062 US* | *Euro : 1.51 Cdn*

Canada's Economy Uninspiring

There were few bright lights on the Canadian economic landscape in 2015. The Energy sector simply collapsed taking the country to the brink of recession. Our plunging currency and financial markets made Canada one of the worst places to invest of the major world economies. With low energy prices and generally weak commodity prices, the outlook remains challenging. The latest readings in GDP and consumer spending are uninspiring and employment gains disappointing. Adding to the pessimism Bank of Canada governor Stephen Poloz characterized the first quarter outlook as "atrocious".

The outlook for 2016 depends to a large degree on the direction of energy prices. Higher prices would help stimulate a recovery in western Canada where job losses have been significant. We believe a rebound in oil prices is likely by the second half of the year. The plunge in the Canadian dollar has also probably run its course and it too should start to recover. Any meaningful appreciation will likely be tempered by the negative differential in interest rates with the U.S. The U.S. is also better positioned economically and will be raising interest rates much quicker. Still, a rise back up to the $.75 area is very conceivable.

The Bank of Canada continues to voice concern about inflated residential house prices in the major urban markets. Low mortgage rates have boosted demand to the point that many homeowners are vulnerable to rising interest rates. For the moment however, house prices keep advancing by double digits while average incomes barely keep up with inflation.

The new Federal government is on record of supporting the economy by running larger budget deficits primarily for infrastructure. They can be expected to encourage the Energy East pipeline to the Atlantic region as well as LNG projects in BC. Growth in renewable energy initiatives will also help to keep Canada competitive in this advancing field now that global attention is focused on climate change.

While stagnant and uninspiring, the Canadian economy is not heading into a deep recession. The latest readings for retail sales were acceptable given the difficulties in Western Canada. Unemployment remains steady at 7.1% and appears stable for the country as a whole. As the year unfolds a moderate improvement in the price of oil and the Loonie should calm concerns in financial markets.

China Rattles Markets

The Chinese stock market continues to plunge rattling financial markets around the world. The currency is also under pressure although this is a deliberate move from the Bank of China signaling the desire to depreciate the Yuan relative to its trading partners in the region. Still, it adds to the uncertainty with many pundits claiming China is heading for a hard landing.

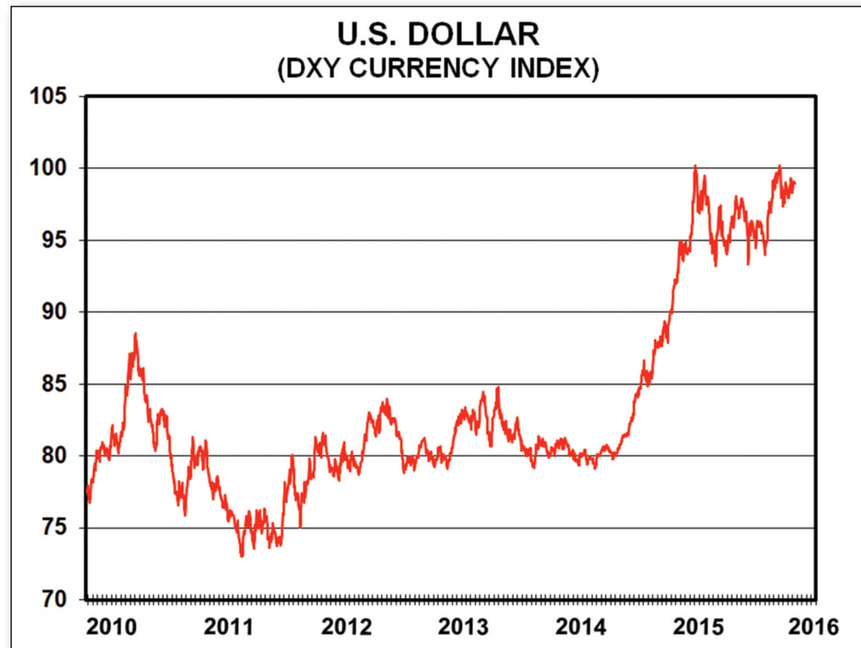
In contrast to the naysayers, China's transition to a consumer-based economy is slowly, but surely, occurring. Retail sales growth is strong and on track to grow by over 10% year over year. Automobile sales are picking up and expected to rise 5% to 7% in 2016. Consumer spending's contribution to GDP is already up close to 60%, from a level of 50% just two years earlier.

According to Zhou Jingtong, an analyst at Bank of China in Beijing; "There are no signs that the economy is getting worse, as the official Purchasing Managers Index (PMI), improved in December. The consumer prices remained high while the factory-gate prices did not drop further."

China is in transition which by definition is always a disruptive process. Policymakers are determined to reform domestic financial markets which includes loosening capital controls to internationalize the Yuan. With currency reserves of $US 3.4 Trillion, amounting to a third of the entire worlds reserves, China has ample room to manage this delicate process. Maintaining stability in the short term is always a challenge. In time markets should settle down as valuations become more attractive, to both domestic and foreign investors.

The Almighty U.S. Dollar

The relentless slide in the Canadian dollar masks the underlining strength in the U.S. dollar on the world stage. The U.S. dollar has been climbing against most currencies, as shown in the adjacent chart.



The DXY index tracks the U.S. dollar primarily against the Euro, the Pound, Yen, Canadian dollar and others. The impressive strength in the U.S. dollar is a function of many factors – a more resilient and relatively stronger economy, higher interest rates, positive capital flows seeking a safer haven.

Importantly, according to a report from Morgan Stanley, the strength in the US dollar is having the opposite negative effect on the price of oil. They point out a high correlation between the two. They also point out that oil inventory levels globally are not as high as generally believed. Inventories while stubbornly high in the U.S. have been declining in Asian markets. Within a year Morgan Stanley believes the high cost producers in the U.S. will eventually show a large decline in production and inventories which could be sudden and unexpected.

A recovery in the price of oil will then likely weaken the almighty dollar. In the meantime we are optimistic that most of the decline in the Loonie is probably over.

Equity Strategy

It was a dismal year for Canadian stocks in 2015. The Energy sector was the main contributor to the S&P/TSX Composite finishing down about 10%, along with the Materials sector and just about any company involved with commodities.

In the U.S., stocks were fairly flat with the S&P 500 barely above breakeven. However this masks the fact that most stocks were down for the year with about 40% of the stocks in the index falling by more than 20%. Supporting the index were a small number of high growth momentum stocks including Facebook, Netflix, Goggle and Amazon.

The early start to 2016 has not been encouraging. The stock market is being highly influenced by the decline in the price of oil and the ongoing volatility in China. The first stage decline in oil from $US100 to $US40 had an immediate and direct effect on the energy sector. This latest stage decline down below $US30 is driving everything down as investors link the oil collapse with the possibility of an economic collapse. While the economy has slowed there are no definitive signs we are tipping into a global recession.

In terms of volume the demand for metals such as copper, nickel, zinc, etc. is still positive. Prices will eventually improve as supply stagnates. With global economic growth expected above 3%, higher metal prices may surprise markets in 2016 and signal a badly needed recovery in overall confidence.

The Canadian financial sector declined slightly in 2015 despite all the major banks showing strong profits and increasing their dividends. Going forward the banks face headwinds from several directions. Energy loan losses, competition from new technologies, and low returns from investment holdings chief among them bonds. Several banks have announced staff reductions

(cont'd on page 4)

Equity Strategy *(cont'd from page 3)*

to control overhead costs and respond to slower growth prospects. Banks with major operations in the U.S. should benefit as economic growth there will be healthier. We may trim our positions in this sector before the year is out.

The U.S. stock market has once again clearly outperformed the Canadian market. In fact it has outperformed in each of the past five years. In addition to the currency gains Canadian investors would have realized by holding U.S. assets, the outperformance in the U.S. has been staggering. This is not likely to persist as the two markets have had a fairly close correlation over the longer term. Should the Loonie and the price of oil start to recover then the Canadian market may just finally outperform the US in 2016. We will be limiting our exposure to U.S. markets as a result.

2015 was not a favorable year for value investors. Less expensive stocks have generally not performed well, especially any companies remotely involved in the energy sector. A correction in the leading momentum stocks with a rotation from growth/momentum to value may be in store in 2016. If so then the defensive positions we hold in Financial Services, Telecoms, Utilities and Pipelines should do reasonably well as the market volatility is confined to a narrower group of expensive stocks in Technology, Bio-Technology and Consumer discretionary sectors. Our positions are very modest in these higher priced sectors.

Asset Allocation

The asset allocation decision is the most important decision influencing both the volatility and long term performance of an investment portfolio. The percentage allocation an investor makes to various asset categories, typically stocks, bonds and cash, and perhaps also commodities, real estate and precious metals, will influence performance to a much greater degree than the performance of any single investment or group of investments.

It is virtually impossible to *consistently and accurately* forecast the changes in economic or geo-political influences that would have a significant impact on stocks, bonds, currency and commodity prices. Interest rates may change and may significantly cause stock and currency valuations to change. On the other hand they may not, at least not right away as may be expected. Higher interest rates should have already materialised and at the very least would have negatively impacted bond prices. They have not.

Economic cycles are a permanent feature of our economic history. The average length of a cycle from top to bottom is about five years. Some cycles are shorter while others are longer. The two longest cycles were back in the 80's and 90's with each of those running about 8 years. Cycle dynamics are never the same. Usually however you can count on the peak of an economic cycle to be robust, driving labour markets to low unemployment levels and creating inflation such that Central Bank policy must tighten monetary conditions. In our judgement we are still a few years away from an economic peak especially now that oil prices have plummeted eliminating any inflationary concerns at present.

Many factors influence consumer spending and the demand for various goods and services. This in turn will have a significant effect on corporate profits and therefore on stock prices. Our best estimates for the duration of this economic cycle, already at seven years and one of the longest cycles on record, is that we have further to go. For a balanced portfolio, a 50% position in stocks can still be recommended in this environment. We do not see a disaster ahead reminiscent of the financial crises of 2008/9. The market is already down by 20% for most stocks. A further decline will likely clobber the more expensive momentum stocks which will bring down the index and scare many investors; however this is long overdue and would be healthy for a continuation of the cycle. The last thing we want to see is a fast and relentless move up into "bubble" territory which ends in a terrible crash. Our inclination is to use the opportunity to add to positions over the next several weeks and months.

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

STONEBROOKE
ASSET MANAGEMENT