

Winter 2017

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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

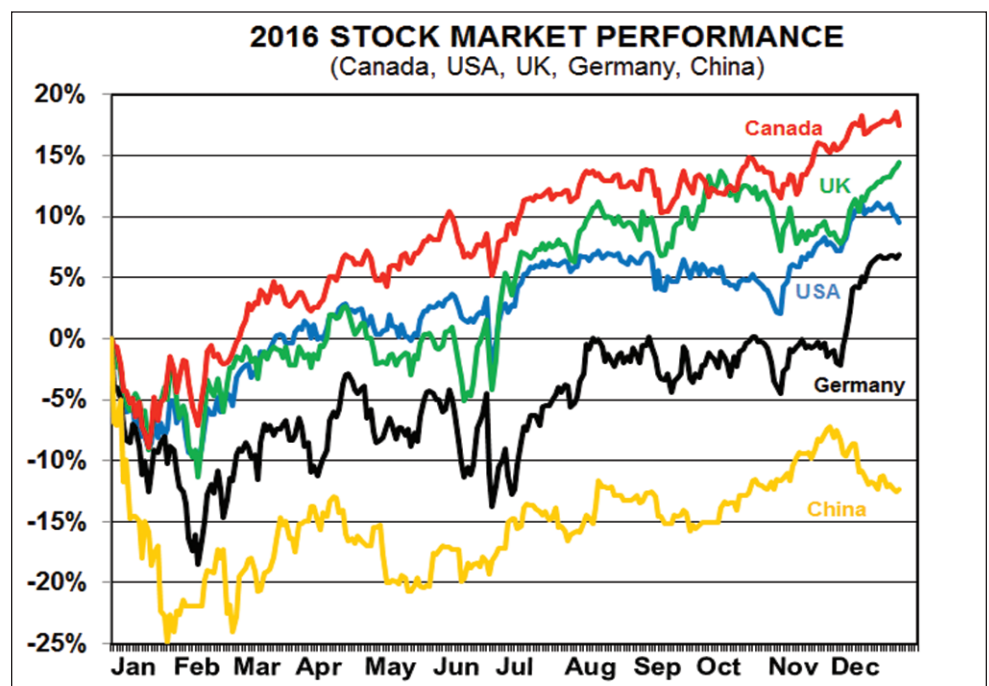
Tel: 416-850-2172
Email: info@stonebrooke.ca
www.stonebrooke.ca

Summary 2016

2016 got off to a tumultuous start. Investors panicked as the price of oil plunged and on concerns of a Chinese economic slowdown. After the frightful start, stock markets around the world quickly rebounded and put in decent gains. In Canada, the S&P/TSX Composite was one of the best performing markets with the price index up 17.5%. In the U.S. the S&P 500 price index rose 9.5%. The bond market had been performing well until the last two months of the year. The FTSE Universe Bond index still managed to finish the year up by 1.7%. It was a peculiar and volatile year.

The resource sectors were the best performing areas with basic materials and energy leading the markets higher. Quite the contrast from the previous year. Oil, which had tumbled to \$28 USD, closed the year at over \$53. The price of Gold bullion moved higher to close at \$1,146 USD. Commodity prices recovered briskly in 2016.

The chart below shows the performance of the S&P/TSX Composite compared to the major stock market indices in the U.S. the UK, Germany and China. Performance is shown in local currency. As indicated, Canada performed best and with a moderately recovering currency the gains translated into Canadian dollars were slightly better.



Triumphant Trump

Since the election of Donald Trump, stock prices have been on the rise. Bond prices on the other hand have been declining as yields have risen. It is understandable that financial markets have reacted this way, though it certainly was not predictable. There is optimism that taxes will be lowered, regulations rolled back and a good measure of spending on infrastructure. In the short-term investors may have inflated expectations. There is no guarantee a majority Republican Congress will push through all of Trump's agenda. It is a fractured party and the political process is anything but cohesive. The majority of conservatives, including the Speaker of the House, Paul Ryan, will be reluctant to approve a fiscal agenda that raises deficits.

Then there is the unpredictability factor. Trump is assumed to be good for business and supports *fair trade*, as opposed to *free trade*. His tweets however often send mixed messages. He can single out a company or an entire country and the financial markets can react assuming something far worse. Is he negative on a



sector? Will he usher in a protectionist trade policy? To say he is controversial is an understatement.

While many of Trump's appointments are seasoned businessmen and qualified government officials, there are many contentious appointments, including Peter Navarro, a professor at the University of California, and a staunch China critic. He is on record accusing China of waging an economic war against the U.S. A trade war with China or a confrontation with Iran or North Korea does appear possible. He risks aggravating relations with a host of other countries. Still, to assume he and those that advise him will be reckless is a bit extreme.

Trump will bring a business agenda to Washington and his unorthodox style will ruffle feathers on both the domestic and international fronts. He likes to play from a position of strength. His ability to then successfully compromise and make a "deal" requires a thoughtful and balanced approach. Just the same, investors should be braced to expect a volatile administration, one where the message is often incongruent.

America First

On the campaign trail, Trump was unabashed in his criticism of U.S. companies outsourcing jobs and manufacturing. Apple was criticized for making iPhones in China, Ford for making cars in Mexico. His "Make America Great Again" slogan bordered on protectionism. Fearing consequences, several American companies have announced plans to either move back or keep production in the U.S.

A "Made in America" policy however is not such an easy thing to accomplish. America has a skills gap or what is commonly referred to as structural unemployment. The new jobs are predominantly technology based. The old labour intensive industries are disappearing and factory work is now done with robotics and processes that require fewer people and with higher skills. Ironically, the "rust belt" that helped to elect Trump will not likely benefit from his campaign promises.

A majority of economists have warned that trade restrictions/tariffs with China would damage the

American economy. For starters, it would result in higher consumer prices for a vast number of manufactured goods. It is also doubtful that the U.S. can attract back manufacturing in a significant way - a strong and rising U.S. dollar is a major challenge for the made in America agenda. It helps imports and hurts exports. U.S. corporations with a significant domestic base of operations are competitively disadvantaged.



The political world is changing rapidly as the electorate has tired of the status quo. First it was Brexit, unseating the UK's David Cameron. A change in the U.S. with the election of President Trump. In France, Prime Minister Hollande will be stepping

down and in Germany the latest polls have Angela Merkel facing defeat. While political winds do blow back and forth there appears to be a shift underway *away from globalization*. The period of relative open trade and stability we have enjoyed may be a thing of the past. Protectionism and isolationism is on the rise. This is something we will be closely monitoring.

The Fed: No Longer on Hold

The U.S. Federal Reserve raised short term interest rates by .25% at the end of last year. It was widely expected and fortunately this time around it did not cause a negative reaction in the stock market. Furthermore, Fed Chair Janet Yellen telegraphed the probability of three more rate hikes in 2017, which if implemented, would bring short-term interest rates up to 1.25%. They had been sitting pretty much at zero for the past six or seven years.

The Trump administration's fiscal policy is aggressive and expansionary. The combination of personal and business tax cuts and spending on infrastructure is a recipe for budget deficits. With a pro-growth policy in place, inflationary expectations will rise. We may already be witnessing this with the rise in interest rates.

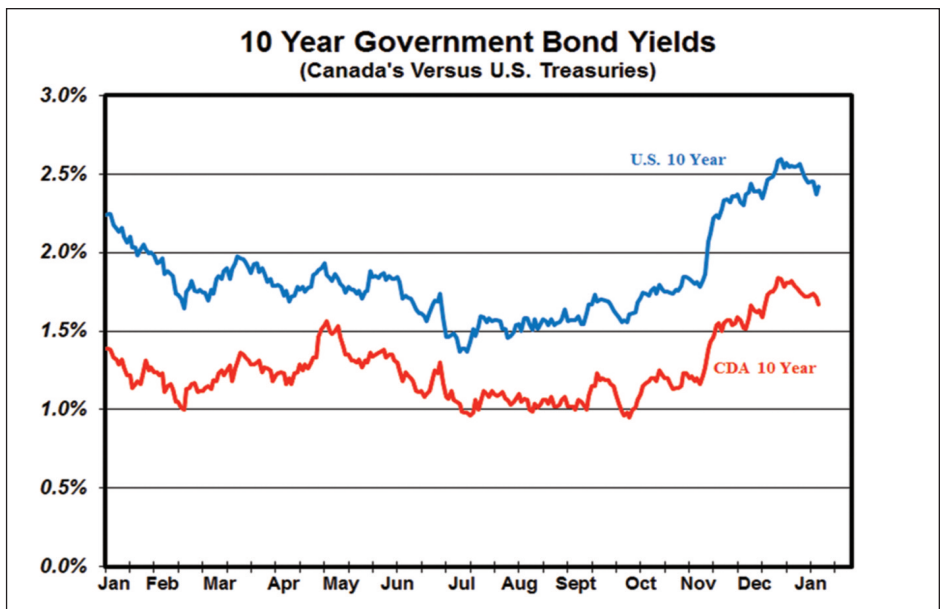
Recent reports have shown consumer sentiment has risen significantly since the election. Economic growth may pick up however a major shift in inflation is not likely. This is an issue for the longer term. In the immediate two to three years ahead our sense is that in a very highly indebted economy any significant rise in interest rates will quickly cause a slowdown/recession. Interest rates will then decline again and one more cycle of quantitative easing (QE), i.e. money printing, will be needed to jump start the economy. The bottom line is we believe it is still too early for inflation to return in any permanent or lasting way. Interest rates therefore are likely to stay comparatively low for a while yet.

Canadian Dollar Outlook

The fortunes of the Canadian dollar have been closely tied to the price of oil. We would expect this relationship to continue. The election in the U.S. of a pro oil government will be positive for the industry; encouraging exploration and development activity. The prospect of increased supply therefore, in a world already burdened with too much oil, will potentially put a cap on the price. For this key reason the Loonie is likely to remain range bound with limited upside.

When it comes to interest rates, Canadian bond yields are already lower than those in the U.S. and have been so for many years now. The adjacent chart also shows that the move to higher rates since the Trump election victory has been a parallel move higher. There is a limit to the independence of Canadian bond yields. Presumably, a U.S. economy with higher growth and higher interest rates will continue to pressure Canadian rates upwards. If not a widening differential in interest rates between our two countries will bring renewed currency concerns.

Of course, one of the other big risk factors is NAFTA. The message one hears loud and clear from the new U.S. administration is that the trade deal has been a bad deal for the U.S. Bluster aside, it appears the real target of concern is Mexico. The bilateral trade flows between Canada and the U.S. are fairly balanced at about \$300 million per year each way. Still, we should not assume Canada will be spared should the U.S. push for renegotiating NAFTA. Many of our industries are currently excluded; banking, dairy, softwood lumber, to name a few. While in theory greater and freer trade should be beneficial for all parties, a new deal may be a disadvantage to our economy and therefore poses a risk to the Loonie.



(cont'd on page 4)

Canadian Dollar Outlook (cont'd from page 3)

Adding to the confusion, the governor of the Bank of Canada, Stephen Poloz, is on record suggesting the need for lower interest rates for a prolonged period. It is a challenging state of affairs for the Loonie, which at this cheap and historically low level, should be enjoying a

competitive advantage in cross border trade. The bottom line; slower growth and lower interest rates in Canada, with limited upside in the price of oil means our currency is likely stuck in its current range with limited upside for 2017.

Portfolio Strategy

With the U.S. Federal Reserve no longer on hold and with a pro-growth fiscal agenda a rise in interest rates is now expected. At this stage in the business cycle, seven years into the recovery, it is remarkable that interest rates have remained so low. A return to a more normal environment, and consequently higher interest rates, is long overdue.

As a result, fixed income securities, including exchange traded funds, should be invested in shorter-term maturities not exceeding five years. Most investors are not prepared for a rate rise of 1 or 2%. Should this occur the losses in many high-income funds could be substantial over the next year or two. From a risk reward point of view, it is better to be invested in short-term maturities where volatility is low and maturing bonds can be reinvested at increasingly higher rates. Longer-term maturities offer very little extra yield to begin with, and their price volatility is much greater when interest rates rise. Of course, higher yields are eventually a good thing for investors. We must get there first however, while withstanding the turbulence in financial markets.

The rise in interest rates, at least initially, should not be detrimental to the stock market. In fact there is a consensus forming that bonds are the more risky asset class. Indeed, over the past few months stocks have performed well as bond prices have fallen. Investors' appetite for bonds is likely to wane as interest rates continue to rise. Stocks, and even interest sensitive stocks with higher dividend yields, could very well be the favoured asset class for at least the next year. Having said that we will remain vigilant should interest rates spike dramatically.

Despite lackluster economic growth, Canadian equity markets witnessed the best performance among the major developed countries in 2016. Our dollar also contributed to the gains being one of the strongest currencies finishing up by 3% on the U.S. dollar. We continue to recommend a strong allocation to Canadian securities.

The recovery in the price of oil was instrumental, assisted as it was by OPEC which finally reached an agreement to pare back output. The most positive news for the Canadian

energy sector was the approval of two pipeline projects, as well as the likelihood of the Keystone line being approved in the U.S. Completion of these pipelines will enable Canadian producers to access wider markets and obtain better prices.

Canadian economic growth depends largely on the global demand for energy and commodities, and its cross-border trade with the U.S. The American market accounts for 80% of our exports. The Trump administration may take a hard line to countries with trade imbalances. While Canada is vulnerable, we believe pragmatism will prevail in the end and any disruptions will be minor and/or longer term allowing for industry to adjust.



Since the election of Donald Trump the stock market has risen based purely on expectations his administration will be good for the economy. A stock market rally fueled by investor confidence can feed on itself and rise well ahead of rational valuation levels. There are studies that suggest the average investor is still underweight in the stock market, not having been too enamored with taking risk after the volatility of the past decade or so. This could all change with an improving investor confidence.

Importantly, the market *never* goes up in a straight line. It is bound to correct several times and raise doubts along the way. It is obviously impossible to forecast every twist and turn however we have confidence that as long as *interest rates rise gradually*, the conditions are in place for the positive trend in stocks to continue. Until there is a substantial change, we remain constructive and stocks appear positioned to move higher.