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Federal Budget – More Red Ink

After a two year wait due to the pandemic, the Federal government finally released a budget. It is a budget that sets a record for spending and the deficit numbers are both surreal and numbing. The budget deficit in the fiscal year just ended (March 31st) came in at \$354 Billion. The deficit forecast for the current fiscal year 2021/22 is \$155 Billion, and the deficit in the 2022/23 fiscal year is projected at \$60 Billion. The current deficit is more than 6 times larger than the \$55 Billion deficit back in 2008/9 during the great financial crisis. The total accumulated debt has jumped to over \$1.1 Trillion and brings the Federal debt to GDP ratio to about 55%. The Federal debt outstanding has almost doubled over the past five years.

The Canada Emergency Wage Subsidy and the Canada Recovery Benefit have been extended. New programs to assist individuals and businesses have been created with an additional \$101 Billion in new spending including \$30 Billion for a national childcare program.

According to the Fraser Institute, the combined government debt, adding provincial debt to the mix, is approximately \$2 Trillion, equaling about 92% of annual GDP.



These are extraordinary times, and the buildup of debt is truly extraordinary. There are bound to be consequences of running these huge deficits and piling up an astronomical amount of debt. Economists are divided with the optimist camp asserting we will manage, likely with a little extra inflation. We would bet that some extra taxes are also likely.

An Improving U.S. Economy

In the U.S. economic growth is accelerating. The labour market is improving as the economy opens back up. Just under 1 million jobs were recently added in the latest payroll report. Still, there are over 8 million that remain unemployed since the pre-pandemic peak. The vaccination effort is a success with more than enough vaccines to go around. In the next two to three months, barring any surge in variant strains, economic activity will be returning to more normal levels. In contrast, Canada is a few steps behind. The economic recovery here therefore can expect to be more halting.

The next two quarters will show a strong rate of change in growth as the comparison is with last year's catastrophic drop in GDP, at the height of the

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An Improving U.S. Economy (cont'd from page 1)

pandemic. The projected 7 or 8% growth rate is therefore not sustainable and is expected to normalize at 2.5 to 3% in 2022. The new Biden administration has big spending plans. The passing of the American Rescue Plan, a \$1.9 trillion relief package is just the start. Plans are also in the works to spend upwards of \$2 Trillion on infrastructure. This second spending bill may need to be watered down in order to pass Congress. Just the same, the priority of this

new government is to provide fiscal stimulus and support economic growth.

Jamie Dimon, the influential CEO of JP Morgan, recently stated he expects a booming economy that could easily last into 2023. Should this prediction be accurate, it would likely mean the financial sector would be an active participant in providing the needed capital. The continuation of strong and rising equity markets with stable interest rates could certainly be part and parcel of this forecast.

Return of the Day Trader

Much has been written about the GameStop affair and how a network of individual investors succeeded in pushing up the share price and bludgeoning professional "short sellers". Melvin Capital, a well-known hedge fund, lost over 50% in one month, approximately \$6 Billion, mainly shorting GameStop. Flush with stimulus cheques and with nothing to do during this pandemic, a new generation of young adults have a newfound interest in the stock market. Too much euphoria however is encouraging speculation. Moreover, the retail frenzy to buy stocks is a phenomenon typically observed at market tops. By some accounts, professional investors such as hedge fund and pension managers, on the other hand have been net sellers. Still, \$1,400 stimulus cheques are on the way as part of the \$1.9 trillion American Rescue Plan. More than 150 million Americans qualify. With some of this money destined for the stock market, the bull market may continue to run.

Interestingly, according to a survey of retail stock investors by E*Trade, almost three-quarters of individual investors agreed

the stock market is either "fully in a bubble" or "somewhat in a bubble". Sentiment is also very positive towards the stock market and the majority does not want to miss profiting from the "bubble".

According to data from VandaTrack, over \$1 billion is being invested into stocks on a daily basis.

Equity markets in both Canada and the U.S keep moving higher. There appears to be no apprehension of rising global Covid-19 case counts, nor the spreading of new variants. The vaccines are winning the sentiment race as investors believe the reopening of the economy is a given and is right around the corner.



Bitcoin Going Mainstream



Encouraging news continues for Bitcoin, and cryptocurrencies more broadly, as adoption grows by both individual and institutional investors. Buying Bitcoin is

becoming easier as companies this year have launched new ETF's (exchange traded funds). With competition on the way, the Grayscale Bitcoin Trust, with over \$30 billion in assets under management, plans on converting to an ETF. Institutions such as Blackrock and Fidelity have also announced they will offer Bitcoin to their clients. Many corporations have purchased Bitcoin adding it as a store of value to their balance sheet, with Tesla being the most noteworthy. If corporations start to invest just a portion of their cash in Bitcoin, a continued rise in the price seems inevitable.

Coinbase, an exchange for all things crypto, recently went public by issuing shares via a direct listing. The company is valued at approximately \$80 Billion. Coinbase is to crypto what the TSX is for stock trading. Opening a Coinbase account allows investors to buy and sell cryptocurrencies, with Bitcoin and Ether (Ethereum), representing most of the trading volume. Coinbase has become extremely profitable collecting transaction fees. More exchanges and crypto services companies will become public, expanding this new financial industry.

Governments are finally realizing that crypto has become too large to ignore. It is a growing asset class which needs to be regulated - the total valuation of Bitcoin now exceeds \$1 Trillion. Just recently, China has given its tacit approval after many years of trying to thwart it. Li Bo, Deputy Governor of the Peoples Bank of China, recently said, "We regard Bitcoin and Stablecoin as crypto assets...these are investment alternatives". Bitcoin is going mainstream as the network grows and as it employs more people. For the optimists in this space, crypto is just getting started.

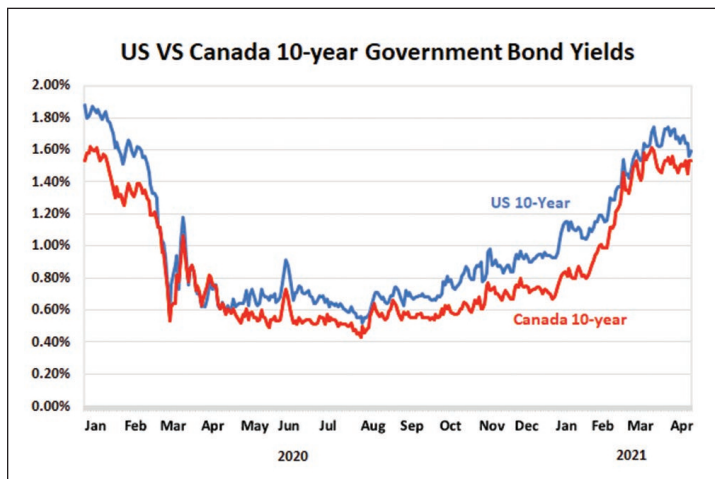
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Bitcoin Going Mainstream *(cont'd from page 2)*

Bitcoin is also gaining adherents from the inflationist crowd and from the fear that Modern Monetary Theory (MMT) will become a fiscal policy tool. While Gold has traditionally been a beneficiary of rising inflationary expectations, Bitcoin appears to be a competing asset this time around. Although

it cannot be determined if money previously invested in Gold has flowed directly into Bitcoin, there have been outflows of investment dollars from Gold ETF's. In any event, both assets are essentially perceived as a hedge against money printing and currency debasement. The implementation of (MMT) will only drive the price of both Bitcoin and Gold even higher.

Pondering Inflation



The U.S. Federal Reserve, while acknowledging inflation is on the rise, is insisting that any inflation will only be “transitory”. They are forecasting for inflation to remain low and consequently interest rates will also remain low through 2023. The bond market appears to have taken notice of the rise in inflation. As per the adjacent chart of U.S. and Canadian 10-year bond yields, interest rates are moving higher. Commodity prices have soared over the past year, lumber especially, up over 200%. Copper, and oil keep rising along with many agricultural commodities, Corn and soybeans are up double digits since the start of the year. The rise in commodity prices is refueling forecasts of a global commodity boom.

Inflation has a habit of sneaking up in stages. Rising raw material costs are passed along to manufacturers who are in turn forced to pass the rise along to finished goods, or else face lower profit margins. Leading consumer products companies like Coca-Cola and Procter & Gamble have

already announced they will raise prices to offset the rise in their input costs. Wage pressure are already building.

Whether inflation this cycle is “transitory” or becomes more problematic longer term is debatable. It takes time before consumers shift their behaviour. As prices continually rise, spending patterns will change. Fearing rising prices, consumers will be motivated to buy today what they were considering buying tomorrow. Shortages then develop which compounds the problem and an inflationary cycle is born. It will be a challenge for the Federal Reserve to convince consumers inflation is “transitory” when the headline consumer price index is pushing close to 3%. Inflation may become more persistent than the Fed currently anticipates.

Still, commodity price inflation is rarely in and of itself a permanent inflationary threat. There have been many periods of commodity price booms, which in the end were not sustainable. Prices eventually came back down as higher prices were always met with an increase in supply. Supply shortages are currently a factor in boosting headline inflation. Comparisons with the pandemic lows are also causing higher rates of change. While inflation will certainly rise in the coming year and give investors pause, it is too early to make any bold predictions and to position for a more permanent rise.

Bond yields have been rising and are likely to be under continued pressure going forward. As yields rise and prices of bonds decline, investors may initially respond positively towards stocks. At some point higher interest rates will become problematic and as we have witnessed many times, the stock market will experience volatility. This will again change the inflation narrative and will likely bring interest rates back down.

Fixed Income Strategy

A significant pick-up in economic growth is guaranteed for the balance of 2021. At this stage as the economy fully reopens it will be accompanied with higher interest rates. We are maintaining our strategy of investing primarily in short term fixed income instruments not exceeding 5 years. Although, longer dated bonds are likely to become a more attractive investment as the year progresses.

While interest rates have moved up they are still at a very low range historically. Canadian 10-year bond yields have risen to just 1.55%. With the economy saddled with an alarming debt load, interest rate sensitivity is high. The consensus opinion among economists is that bond yields cannot rise by a significant amount without jeopardizing economic growth. Higher interest rates will risk the onset of a recession.

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Fixed Income Strategy (cont'd from page 3)

The equivalent U.S. 10-year treasury bond yield has risen to 1.65%. The spread between U.S. and Canadian government debt has narrowed however interest rates remain higher in the U.S. by about .10%. Some forecasts are predicting a tightening of Federal Reserve policy later this year. It would more correctly be a "tapering" as the Fed continues to be highly stimulative buying \$120 Billion in bonds per month. There is a 50/50 chance that a tapering policy will be announced this year and will gradually remove the Fed from effectively supporting the bond market. While no longer reluctant to interfere, the Fed can be counted on to keep a close eye on the bond market. The theory that long-term bonds are still a free market has its challenges.

The Bank of Canada recently announced the policy rate for short-term interest rates would be held at .25%. It will also be trimming its asset purchases program, currently at \$4 Billion

per week, down to \$3 Billion. This partly reflects the Bank's improved outlook for GDP growth, now forecast at 6.5% for 2021. New Bank of Canada governor Tiff Macklem noted that there is still "considerable uncertainty" in the forecast. There is no uncertainty in the booming residential housing market. New housing starts climbed to a record high last month. The Canadian Mortgage & Housing Corporation reported a seasonally adjusted annualized rate of 335,200 housing starts in March, a 22% monthly increase. Housing prices also gained to all-time highs, increasing over 30% year over year, as per the Canadian Real Estate Association.

Stronger economic growth and inflationary pressures should eventually influence interest rate policy. The expectation is for the Bank of Canada to close out its asset purchase program by year-end. This should put some pressure on longer-term interest rates going forward and considering the requirement to finance massive budget deficits.

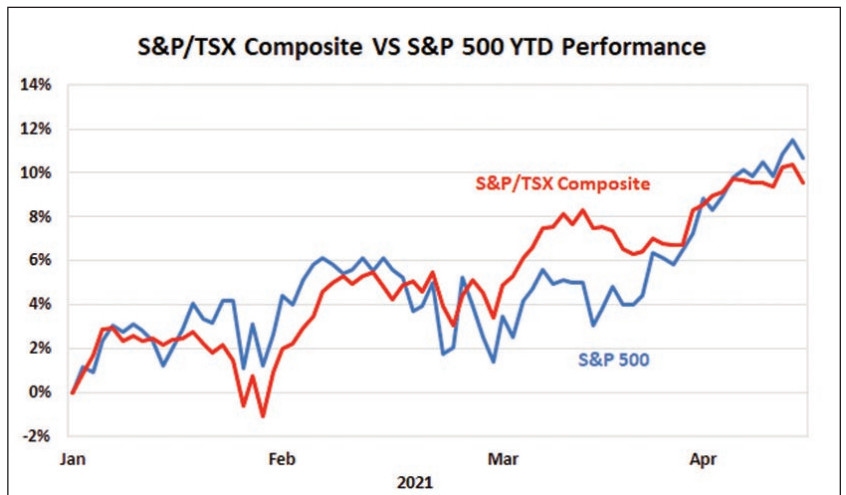
Equity Strategy

The aftermath of a pandemic led recession is unprecedented, and an outlier event. The ensuing economic recovery will be an unusual one. New business cycles usually begin in the depth of a recession. This time around a deep plunge in economic activity unleashed a quick financial response from governments. A prolonged recession has been avoided which should favour end of cycle and more economically sensitive and cyclical groups. Interest sensitive groups, i.e. financials, utilities, usually lag in performance as interest rates recover. This time, the historical patterns may not help much going forward.

The consumer sector will continue to benefit from the reopening of the economy. Savings rates have climbed to 25%, from around 7% pre-pandemic. Consumer spending will shift to larger ticket items and to sectors that have been put on hold over the past year, travel, entertainment, etc. Strong consumption trends along with export growth to the U.S. can be expected.

In the U.S. market a change in leadership appears to finally be taking place. The seemingly invincible technology sector is lagging as investors rotate into other sectors. The financial and energy sectors year to date are two of the best performing groups.

From an extreme low last year, the price of oil at over \$60 U.S. has seen a strong and surprising recovery. The supply side has been better managed with the Saudis and Russians limiting production. The massive capital spending cutbacks by industry are also a factor driving the more positive sentiment. Still, the longer-term demand for oil is set to decline. The fundamental underpinnings for the oil market are changing as the world repositions to reduce the use of fossil fuels.



As shown in the above chart the Canadian and U.S. stock markets year-to-date are performing well, up about 10%. The S&P/TSX Composite has actually outperformed when factoring in our rising Loonie. A further climb in the price of oil along with the entire commodity complex, together with a strengthening currency should result in better performance of Canadian stocks vis-a-vis the U.S.. Portfolio equity holdings should have an overweighting in the Canadian stock market.

Stock markets are certainly "priced for perfection", or at least from a fundamental perspective, priced based on 2023 profit estimates! Markets are expensive. We shall see if investors can remain patient waiting for earnings to catch up to current stock prices. Momentum-driven markets can perform well for an extended period of time. Central bank intervention and government fiscal stimulus measures are a strong incentive to stay fully invested. Stock markets will most likely be higher three years from now. We just need to navigate the choppy waters in the meantime.