STONEBROOKE
ASSET MANAGEMENT

The Commentary

CommonSense Investing

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Summary 2019

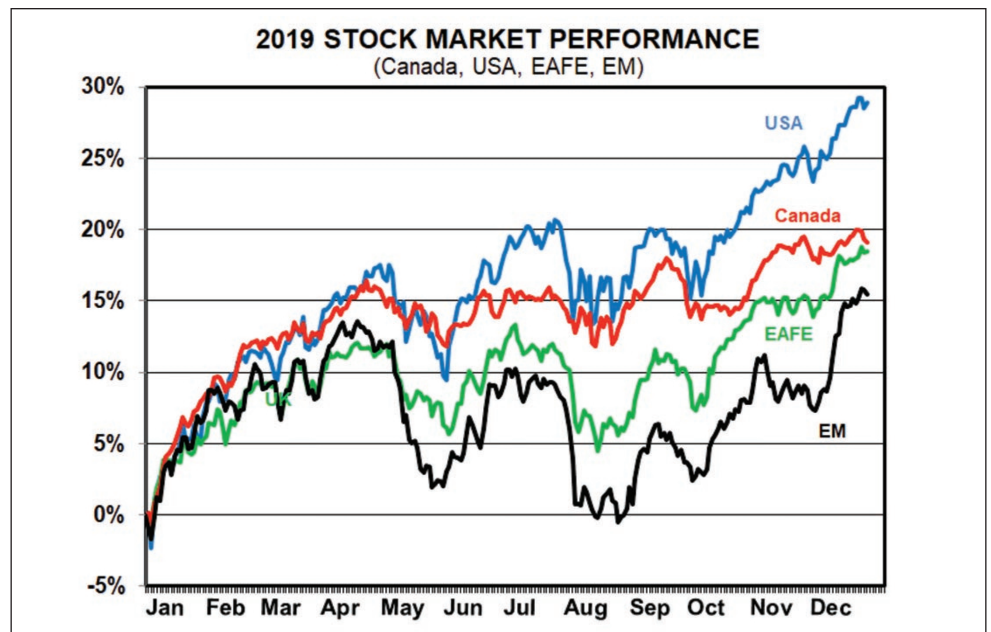
What a difference a year makes. 2019 was a terrific year for all major stock markets as well as most other markets including bonds, commodities and real estate. The year has been characterized as a "bull market in everything".

In Canada the S&P/TSX Composite stock price index was up 19% while in the U.S. the S&P 500 was up 29%, in local currency. With our Loonie appreciating by almost 5% last year, the difference in stock market performance was modest. The major European markets had strong results with Germany and France up by 25%. Asian markets were up with the major averages in China advancing by 23%, and Japan by 18%.

Commodities recovered nicely from a dismal performance in 2018. The price of Oil (WTI), closed the year at $61 USD, up 34%. Gold was up almost 20% to $1,517. The one major outlier was Natural Gas, which saw its price collapse by 25%, down to $2.19 per Mcf.

2019 was a superb year for the bond market with the broad decline in interest rates. The FTSE Overall Universe bond index was up 8%. The 10-year benchmark Canada bond yield finished the year at 1.7%, down 26 basis points. Preferred shares had a disappointing year as yields in this sector rose.

Charted below is the performance of the major Canadian and U.S. stock market indices; the S&P/TSX Comp and the S&P 500. The global indices for Europe, Asia & and Far East (EAFE) and Emerging Markets (EM) are also shown. The U.S. market outperformed again in 2019.



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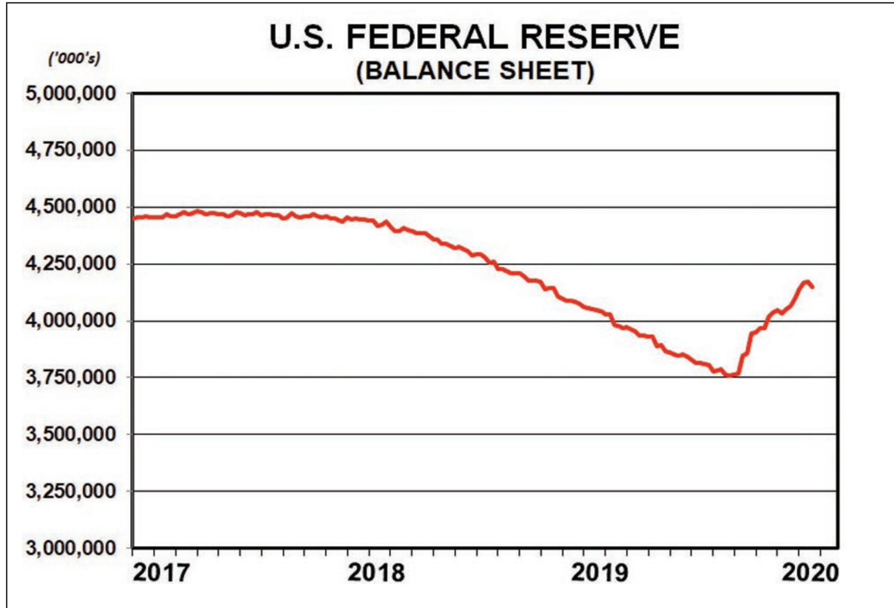
S&P/TSX : 17,063	90 Day T-Bills : 1.66%	Oil : $61.14 US	Cdn $: .77 US
S&P 500 : 3,231	10 Yr Cda Bond : 1.70%	Gold : 1,517 US	Euro : 1.46 Cdn

Fed Signals the All Clear

Stock prices quickly recovered at the beginning of 2019 when the U.S. Federal Reserve reversed its policy on interest rates. The Fed added fuel to the fire in the final three months of the year by providing liquidity which Chairman Powell emphatically insisted is "Not QE" - in reference to past quantitative easing policy initiatives. He also encouraged the financial markets by saying *"we would need to see a really significant move up in inflation that's persistent, before we would consider raising rates to address inflation concerns."*



The expansion of the Fed's balance sheet is clearly visible in the adjacent chart - a monetary all clear signal for investors.

Over $500 Billion of stimulus has been added to the balance sheet, reversing the declining trend which had been central bank policy for almost two years. Many analysts are questioning why. What does the Fed know that concerns them to inject billions into the financial system? Back in September, there was a mini panic in the "repo" market (repurchase agreements), with a sudden jump in overnight interest rates. At the time the rise in interest rates was dismissed as an anomaly. It may be something much more serious if the Fed needs to provide all this liquidity.

For better or worse, all of the world's major central banks stand ready to provide stimulus. In Europe, bond yields have been driven to negative yields. The European Central Bank (ECB), is estimated to have purchased over $2.5 Trillion in bonds over the last five years. Where would bond yields be without the generous support of central banks around the globe. Importantly, can the general economy and the stock market perform well without the generous support of central banks? This relationship will surely be tested one day.

Recession Risks Have Receded

The global economy is still soft with the major headwind still being blamed on the U.S./China trade dispute. The recent Phase-one agreement should improve the outlook although many issues remain unresolved, i.e. - U.S. intellectual-property rights and access to China's financial-services sector. The lack of an enforcement mechanism is also a concern. Phase-one was politically motivated, as China did not agree to buy any specific amount of goods from the U.S. In fact, the actual text of the trade agreement will not be made public. This chapter is not over.

Corporate earnings growth has been lackluster and while the consensus of analysts' forecasts are for positive earnings growth of 6-8% this year, they are traditionally always bullish at the start of the year.

A recent survey of CFO's in North America conducted by Deloitte, a major accounting and consulting firm, cited "82% of the 147 chief financial officers surveyed anticipate a slowing environment for 2020 and plan on taking defensive actions, including reducing discretionary spending and headcount, as a way to stave off the looming headwinds." Importantly, only 3% of the CFO's surveyed are forecasting a recession. This is down from 15% one year ago.

While recession risks have receded, a prolonged period of slower growth is a concern. It does not take a recession, only the fear of one, to drive stock prices lower. It was just over one year ago that the stock market fell by 20%. Investors sold quickly, repositioning portfolios for what they believed was going to be a higher risk environment. Whether or not we get a recession is academic. Volatility can appear at any time when investor mood changes, especially if the expected stronger economic activity fails to arrive.

Canadian Outlook

The Canadian political landscape changed considerably in 2019. The Federal Liberal government was reduced to a minority last October. In Alberta, Conservative Jason Kenny soundly defeated the NDP government of Rachel Notley. Political leadership in Canada has become more polarized. The Trudeau administration is rapidly trying to placate the Western provinces, while still fundamentally opposed to resource development and infrastructure. Still, prospects for the energy sector have improved – they really couldn't get much worse. The Federal government is going ahead with the expansion of the Trans Mountain Pipeline, which will triple oil deliveries to the West Coast. It could be the last inter-provincial pipeline to be built given the political impasse.

The Federal government continues to budget red ink. Instead of a balanced budget as was forecast four years ago, the Federal shortfall this coming year will exceed $28 billion. Two new spending programs, pharma-care and dental care were mentioned in the Throne Speech but without cost estimates. Since 2015, each annual federal budget has imposed new taxes, higher taxes, more complex taxes and more complex regulations. The recent budget offered a small reprieve and has lowered tax rates.

The Bank of Canada has left short-term interest rates unchanged at 1.75% and has signaled it is monitoring carefully the "growth slowdown" as it put it, to see if it is persistent. By all indications the next move by the Bank is likely to be a cut in interest rates.

Labour markets are firm with the unemployment rate dropping recently to 5.6%. Residential real estate prices are recovering. The feared recession associated with a backdrop of higher interest rates has been averted. Interest rates remain low, consumer spending and stable prices support growth and confidence.

Bond Market Outlook

The bond market performed well last year as interest rates dropped sharply. The U.S. treasury 10-year bond yield was at 2.7% in January and ended the year at 1.9%. In Canada the 10-year fell 26 basis points to end the year at 1.7%. The drop in bond yields was unexpected. The bond market may have been a temporary beneficiary of capital flows from anxious investors.

Bond markets are a good barometer of economic activity. When yields rise and bond prices fall, the economy is usually on sound footing and growing. When yields decline economic activity is usually more circumspect. For this reason, bond returns are often negatively corelated with returns in the stock market. Not so in 2019. Given the excellent performance in the bond market, (declining yields) a softer economy and a struggling stock market could reasonably have been expected. The stock market, however performed very well indeed. There are many pundits claiming that both markets (bonds and stocks) cannot be right. They cannot be forecasting the same economic conditions straight ahead. Presumably the bond market is telegraphing a poor economic outlook. Stocks in that case are giving the wrong signal.

We will consider extending term in the fixed income component of client portfolios. Long term interest rates could again hit a ceiling and decline materially at some point this year. As per the above chart on U.S. interest rates, the U.S. 10-year treasury yield broke quite sharply in 2019 – though they have rebounded somewhat in the past three months. A renewed slowdown could reverse the trend again and provide good capital appreciation in longer dated securities both in the U.S. and in Canada.

Balance & Timing Revisited

Investing retirement funds should always be about balance but also about tactical decisions or timing. One often hears that "you can't time the market". While this is generally true over shorter term periods, it is a dangerous statement to make because it ignores the obvious risk associated with expensive and overvalued markets. These come around every cycle. To suggest they should be ignored, or that expensive markets cannot be identified, is disingenuous. Yes, markets can stay overvalued for a long time and perform reasonably well. A balanced investment portfolio will be suboptimal in those periods. Eventually however, the mistake many investors make is having a high concentration in stocks, especially growth-oriented stocks. Taking on more risk when valuations are excessive is foolhardy. This is when timing matters most.

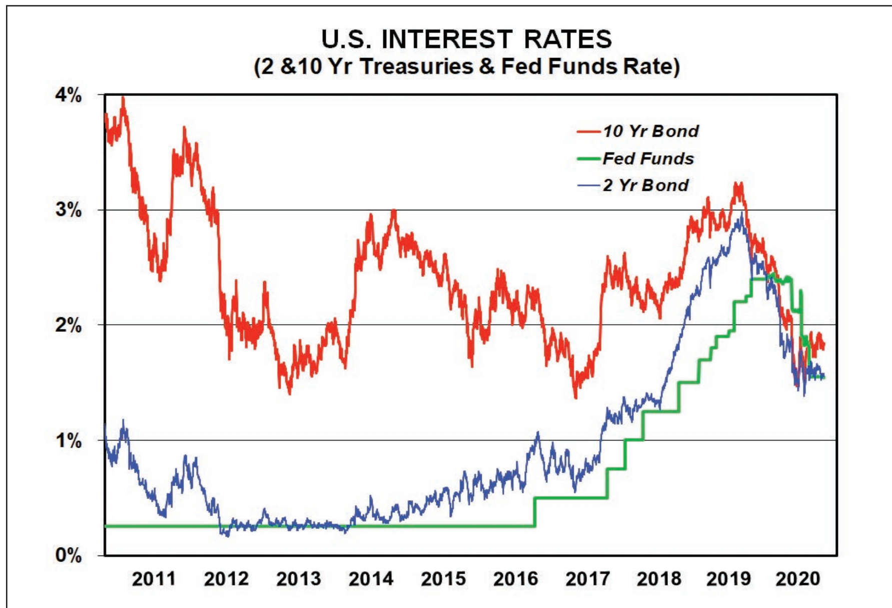
(continued on page 4)

Balance & Timing Revisited *(cont'd from page 3)*
There have been many studies done on investor psychology. Investors often behave according to perceptions rather than on economic fundamentals. This explains the outperformance of the technology sector, with just a handful of the same companies leading the advance – Microsoft, Apple, Google and Facebook, etc. It is impossible for these stocks to continue to provide annual growth rates of 50%. Moreover, there is significantly more price risk with higher valued stocks when their fundamentals (cash flow, earnings or sales growth), do not live up to expectations. Investors overreact in both directions.

So reducing risk is paramount when markets are expensive. This business cycle is now the longest in history. At this stage investors should not be 70 - 80% invested in stocks, a more balanced approach makes sense.

It was Hyman Minsky, one of the great economists of our time, who coined the phrase "stability leads to instability". In other words, the longer a trend is stable the more comfortable investors get, the longer it then persists. The trend eventually exhausts itself and fails, leading to an even greater decline.

There are many reasons why the "trend' of rising stock prices can head much higher over the course of the next one or two years. Many forecasters are encouraged by the eventual end in global trade frictions. Importantly, if interest rates can be managed and held down, there are plenty of stocks attractively priced with good dividend yields which can be purchased. Stocks are longer dated assets. Dividend yields are relatively attractive in this environment of low inflation and low interest rates.



Portfolio Strategy

Stock prices are expensive. As we have said numerous times, stock prices can stay expensive for a long period of time. It is not only the so-called "value" investors that insist stock prices are too high. The chorus is growing and now includes many prominent hedge fund managers. As per a news report from Bloomberg News, Seth Klarman, President of Baupost Group out of Boston, has stated recently, "the rocket fuel that has propelled markets in 2019 will run out".

Of course, he and others are referring to the Fed expanding its balance sheet at a record annualized pace of $1.2 Trillion. Additionally, on the fiscal side of the equation the U.S. Federal government is expanding its deficit at the pace of $1 Trillion. Over $2 Trillion of stimulus should keep the equity markets buoyant, at least for the balance of 2020.

Concerns of another bubble forming in the U.S. stock market are growing. The huge advance in technology stocks in 2019 reminds us of the "dot com" era of twenty years ago when valuations skyrocketed upwards and newly listed companies produced billionaires overnight. The concentration is also perturbing as just a handful of stocks have been responsible for the performance of almost the entire market. Take for example just two companies, the two largest valued stocks, Apple and Microsoft. Together these two companies command a market capitalization of $2.5 Trillion, which is greater than the entire capitalization of the German stock market (the DAX is valued at about $2.1 Trillion). And greater than the total value of all listed companies in Canada, about $2.4 Trillion.

The Energy sector remains depressed, mainly the oil and gas producers. The price of oil recovered sharply in 2019 with the WTI price rising about 35% to close at $61 US. The stocks showed modest declines. Rising commodity prices and earnings does not always translate into rising stock prices. For the pipeline companies however, the outcome was positive as these companies performed very well in 2019. Investors were attracted to their stability in earnings and higher dividend yields.

We should continue to expect volatility in 2020. Volatility will likely be an opportunity to take advantage of lower stock prices. Still, we are at a late stage in the business cycle. It is prudent for investment portfolios to be balanced and therefore at moderate risk levels.