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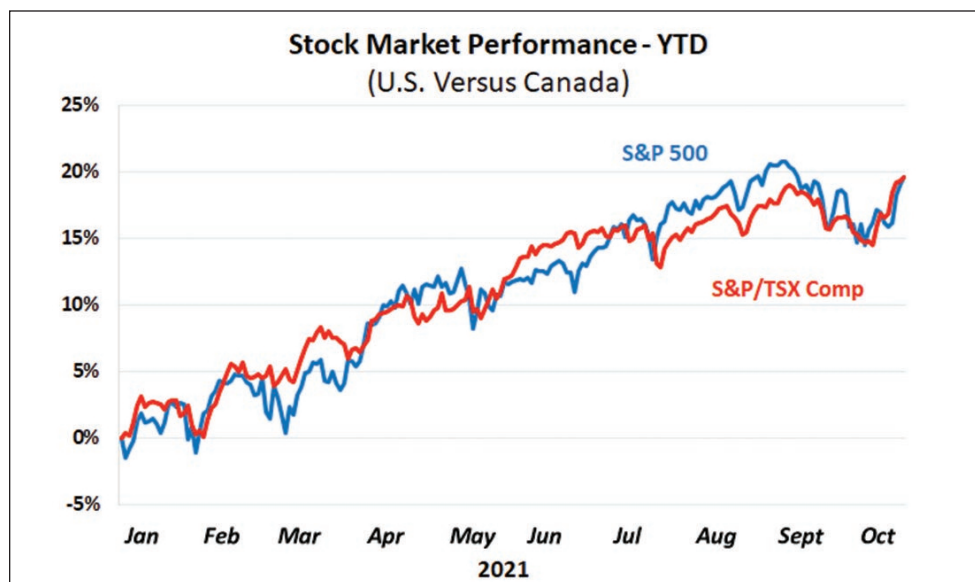
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## Equity Markets

Both the S&P/TSX Composite in Canada and the S&P 500 in the U.S. are performing well. As per the chart below both major indices are up approximately 20% year-to-date. With our Loonie up almost 3 cents on the year, the Canadian stock market is outpacing its U.S. counterpart in Canadian dollar terms



The Energy, Financials, and Technology sectors have led the way this year. The defensive sectors, namely Consumer Staples, Utilities and Health Care have lagged. The momentum in the stock market slowed over the summer months. It has recently picked up. Financial markets have stayed resilient despite political grandstanding in the U.S., whether over the infrastructure bill or the bill to raise the debt ceiling.

Bloomberg Economics estimates that US consumers are sitting on \$2.3 trillion of excess savings. They estimate that figure to be about \$400 billion for Eurozone consumers. These figures do seem to suggest consumers have adequate finances to spend and invest and keep the economy growing.

The banking sector, the largest component of the Canadian stock market, has reported sturdy earnings for the third quarter, even though growth in lending was rather tepid. Balance sheet growth was strong. The banking sector should continue to do well, benefiting from a rising interest rate environment. Lending rates rise more quickly than rates on deposit therefore the banks benefit from widening interest rate spreads. The drawback is that the economy is much more interest rate sensitive. Households are carrying heavy debt loads. As long as interest rates rise gradually, the outlook should not be problematic for the sector.

# Another Taper Tantrum

A potentially nerve-wracking issue ahead for the financial markets is the Federal Reserve's plan to "taper" or exit from the bond market. They are currently purchasing \$120 billion per month in bonds and this figure is soon to be reduced monthly by \$15 billion per month. The Federal Reserve has attempted to withdraw from the bond market before. It was called quantitative easing, or QE back then. In 2013 Chairman Ben Bernanke surprised investors by announcing he would begin "tapering asset purchases", shifting to a less stimulus monetary policy. The 10-year bond yield rose quickly that year to 3%, from around 2%, as investors sold bonds.

Three years ago, in 2018 it was Jerome Powell's turn to try and put an end to stimulus. Another taper tantrum caused bond yields to again climb to the 3% level. Stock prices in

both periods corrected about 20%. With lessons learned, the narrative from the Fed will certainly have to change to avoid volatility in the financial markets. They are already telegraphing the economy has sufficiently recovered and no longer needs assistance from a stimulative monetary policy.

In addition, Powell has emphatically said tapering did not mean he would raise interest rates. Well, the market may just decide to do it for him. The next 6 months should be interesting as bond investors react to the Fed's exit. Finesse will be required to placate the bond market. Should bond yields rise quickly, Powell will need to backtrack, as he has done so before. Another blunder would be unwelcomed and may also erode confidence in the Fed.

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# The China Syndrome

No, not the fictional movie about a nuclear reactor meltdown. China has been one of the lead financial news stories of late due to several recent troubling events. On the economic front the country recently released a slower than expected quarterly growth rate of 4.9%, down from 7.9%. Evergrande, China's largest property developer, announced it may not meet interest payments that are due to bondholders. It is teetering on the edge of bankruptcy with wider implications for the entire housing sector. Finally, the government is cracking down on some of China's largest domestic technology companies. New regulations in place are meant to impose more control and reallocate "excessive profits" for the sake of social equality - so-called "common prosperity". According to George Magnus of the China Centre at Oxford University, "It is part of the leftward lurch and part of the lurch towards ever more control that has been indicative of Xi Jinping's tenure".

Evergrande may be the proverbial "canary in the coal mine". With an estimated \$300 Billion in outstanding liabilities, it may be the tipping point for the residential property market and the economy at large. The debt buildup at Evergrande is common to most builders and has been a concern of the central government for several years. Housing development has been an engine of economic growth. By some estimates it has accounted for 30% of economic activity over the past 20 years. This has

produced a vast number of empty apartment buildings. According to a Wall Street Journal report, about 21% of homes, or 65 million units, are vacant. Could this be a property bubble in the making?

China is the number 2 economy in the world. A protracted slowdown in China will be felt around the world. While consensus growth estimates are still in the 5 to 6% range for next year, a drop in the 2 to 3% range, similar to

growth rates in the western world, would be disconcerting. Chinese consumer spending, especially on luxury brands, and the country's ravenous appetite for commodities are just two of the more obvious sectors affected by a slowdown.

For quite some time many economic observers have suggested that China's economic model must change and become less reliant on

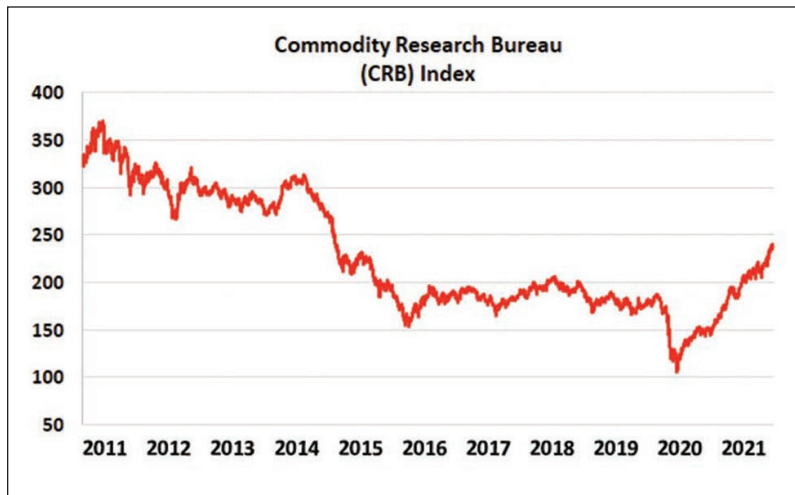
infrastructure/residential development. In developed economies consumer spending typically represents 60% or more of the national economy. In China it is still less than 40%. The shift to rebalance is necessary and will take time.

In any event China will want to contain any short-term fallout. With the Beijing Olympics scheduled in February 2022, the last thing China needs to showcase to the world is a property bust. The betting is that China kicks the can down the road.



# Commodity Markets - Inflation Rising

The chart below shows the CRB index plotted over the last ten years. This index from the Commodity Research Bureau, is a good indicator of commodity markets, measuring the price direction of a basket of 19 commodities. A weight of almost 40% is allocated to the energy complex, (Crude oil, heating oil, and gasoline at 33%, and Natural Gas at 6%), 40% to agricultural commodities of which corn and soybeans are at 6% each. Finally, 20% to the metals, with copper and aluminum each at 6% weights. The CRB index is highly correlated to the price of oil, which is to be expected as this component carries the highest weight in the index.



Since the low point in March of 2020, the index has had a powerful move up as commodity prices have soared. Oil (WTI) is now over \$80 USD, and the price of natural gas is the highest in almost ten years. The majority of commodity prices are rising with copper, zinc, aluminum, wheat and corn, all up significantly this year.

The rise in commodity prices certainly confirms that global economic growth is improving. This would naturally include China as there cannot be a commodity bull market without Chinese demand. The rise in the CRB may also confirm that inflation is more than just transitory.

At the 250 level on the index, it has already broken above a ten-year declining trend. Further upside will have the deflationists in the transitory camp worried.

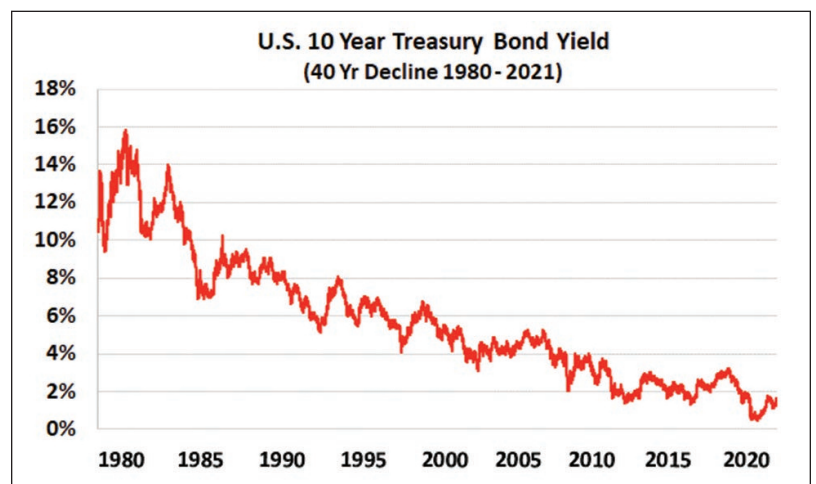
Importantly, the current headline CPI inflation rate of 5.4% comes at the start of this new business cycle. Coming out of the past two recessions in 2003 and again in 2009, inflation was nonexistent. This allowed the Federal Reserve and all Central Banks to pursue stimulus policies for longer. If inflation remains stubbornly high, the Fed may have to battle with rising interest rates and therefore will be constrained with monetary policy going forward. The jury may be still out on inflation, however it is now very likely running at a higher rate than the Fed's long term target of 2%.

# Bond Markets - Yields Rising

The adjacent chart shows the decline in bond yields over the past 40 years. U.S. government 10-year bond yields peaked back in 1981 at just over 15%. It has been a long downward trend since. At numerous times, especially in the past decade, many bond market strategists were of the opinion interest rates would rise and break the downward trend. Strategists are again starting to forecast that higher yields are pending. They are predominantly in the inflation camp and argue that inflation will be trending higher in the years ahead. A breakout above the recent high of 1.75% in the U.S. 10-year bond yield may finally signal an end to the long-term downward trend.

It is quite remarkable bond yields have not already risen much higher. The bond market is normally inversely correlated with the stock and commodity markets. Conditions are quite robust in both these markets. As well, the Fed intends on tapering its bond

purchases very soon, which should be a concern for bond investors.



(cont'd on page 4)

**Bond Markets – Yields Rising** (cont'd from page 3)  
*Interest rates will definitely rise if and when inflation rises and becomes entrenched.* Inflation is mostly the result of fiscal and monetary excesses. Government spending programs were necessary to combat the pandemic led recession. Companies and individuals benefited through a vast number of funding programs. This is still driving the excess demand over supply in the manufacturing sector of the economy. Supply chain bottlenecks are making things worse resulting in shortages, delays, and ultimately higher prices. In the auto sector, new car inventory is alarmingly low. For the first time ever, prices of new cars are above the MSRP (Manufacturers Suggested Retail Price).

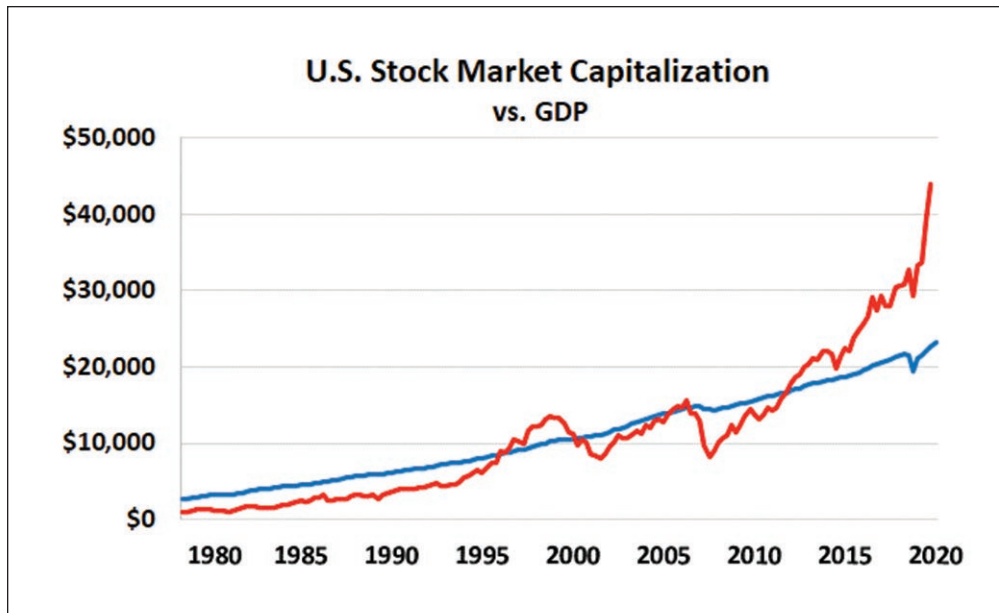
The price of oil could rise much further than expected and worsen the inflation outlook. The demand is still high and

rising for fossil fuels, yet the oil industry has been reluctant to invest in capital spending to find more oil. The economics of an oil project is calculated over decades. With the global movement to carbon neutrality, it is not practical for the industry to invest in long-term projects. Oil prices appear destined to move higher.

There is a great divide over the causes of inflation let alone whether it will be transitory or not. Even members of the Federal Reserve are uncertain. James Bullard, of the St Louis Fed was recently quoted saying “he gives a 50% chance that inflation will not be transitory”. The arguments supportive of a higher and longer bout of inflation are growing. Once the bottlenecks clear and the container ships are no longer sitting idle out at sea, perhaps inflation will subside. The debates are unlikely to subside.

## Uncharted Waters

When it comes to the overall valuation of the U.S. stock market, we are in uncharted territory. Stock prices in aggregate have never been this richly priced. The chart below shows the market capitalization of the Wilshire 5000, compared to the annual U.S. Gross Domestic Product (GDP), over the past 40 years. The Wilshire 5000 represents all publicly traded U.S. stocks. The total current market value is approximately \$47 Trillion. This compares to an annual U.S GDP which is currently close to \$23 Trillion.



This method of measuring valuation is known informally as the Buffett valuation model, after the esteemed investor Warren Buffett. At just over 200% the ratio has never been higher. While this measure of valuation is an important gauge, it is not a very good timing indicator. It

is perhaps best described as a “warning” indicator that investors are paying up more for stocks today when compared to previous periods in financial history.

The stock market is often described as a discounting machine, in that the market looks forward. Maybe the market has already priced in every imaginable amount of good news in the near future - improved economic outlook and strong corporate profits. As well, investors

regularly get carried away bidding up prices driven by optimistic narratives. Stock market valuations are indeed stretched.

Stretched valuations are also notable in the private equity markets and in residential real estate. Institutional investors are frantically putting cash to work in a multiple of asset markets, including crypto currencies. Bitcoin and Ether have recently made new all-time highs. Money is pouring in and bidding up the price of everything – an “Everything Bubble” as many are now describing the current environment.

It would not surprise us to see some turbulence in the stock market

before year-end, or early in 2022. Taking significant risk at this stage is not recommended, especially for growth investment mandates. A balanced approach is still recommended with a larger than normal allocation to shorter-term bonds.