STONEBROOKE
ASSET MANAGEMENT

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Summary 2021

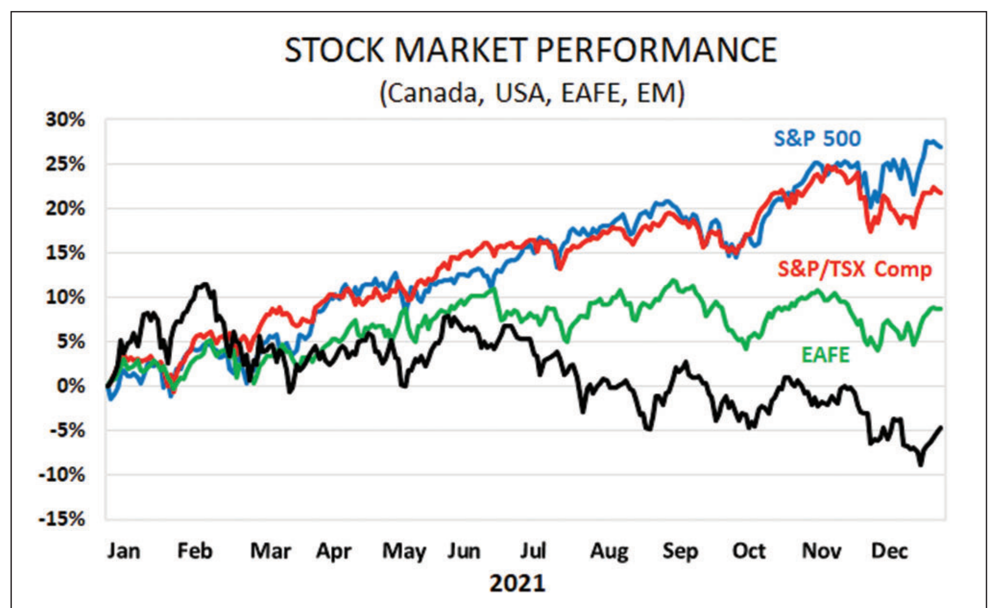
2021 was a phenomenal year for financial markets. Commodity and real estate markets also experienced an extraordinary year with record high prices. The post-pandemic recovery in most asset prices is historic.

The S&P/TSX Composite price index was up 21.7%, while the S&P 500 in the U.S. was up 26.9%. The major European markets performed well in local currency terms, however the US dollar gained almost 7% on the Euro. The Europe Australasia & Far East (EAFE) index was up by 8.8% in USD. The Emerging Market (EM) index however was down by 4.6% in USD.

Commodity prices rose sharply. The CRB commodity index was up by 38.5%. Oil (WTI), rose by 55% to close the year at $75.20 USD. Aluminum was up by 42%, and copper rose by 26%.

It was a challenging year for bond investors as interest rates rose. As a result, the Universe bond index was down 2.8%. The 10-year benchmark Canada bond yield rose to finish the year at 1.42%. The preferred share market had a good recovery, advancing by 19.4%, including dividends.

The chart below shows the performance of the major stock market indices; the S&P/TSX Composite (Cdn dollars), the S&P 500, EAFE and EM, in US dollar terms. The U.S. market outperformed again in 2021.



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S&P/TSX : 21,223	90 Day T-Bills : .16%	Oil : $75.20 US	Cdn $: .79 US
S&P 500 : 4,766	10 Yr Cda Bond : 1.42%	Gold : 1,822 US	Euro : 1.49 Cdn

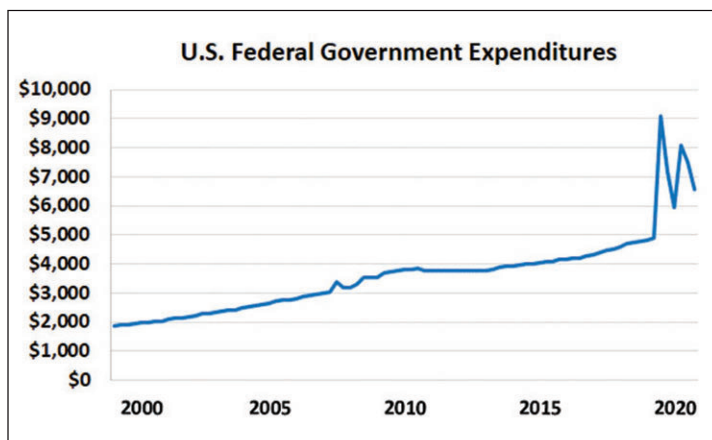
Growth Slowdown Expected

Although forecasts for global economic growth in 2022 are declining, they nonetheless remain positive. The growth slowdown is mainly due to a return to "normal" as previous quarters of strong economic growth were a catch-up from the pandemic. The IMF recently lowered the rate of global expansion by .5%, down to 4.4% for 2022. For the U.S., the Conference Board forecasts GDP growth of 3.5% in 2022 and falling to 2.9% in 2023. While in Canada, the growth rate for 2022 is also expected to be about 3.5%.

The growth slowdown is partly due to the Omicron variant as it's lingering effects derail travel plans and spending on various consumer services. While a soaring economic recovery may be behind us, inflation concerns are not. Bottlenecks and shortages still exist. The price of oil continues to climb. Still, with growth slowing down, it is expected that inflation will also begin to moderate.

Fiscal spending is contracting this year compared to the massive fiscal stimulus during 2020 and 2021. (See adjacent chart of U.S. government expenditures). Monetary policy is reversing course and has begun tightening. The U.S. Federal Reserve is tapering its bond purchases and has announced it will likely raise interest rates in March. The consensus forecast has the Fed raising interest rates a total of four times in 2022.

Banks have been encouraged to lend throughout this pandemic. Governments have provided incentives and guarantees, especially to the larger companies that are economically important. The Large Employer Emergency Financing Facility (LEEFF) provides bridge financing for large Canadian companies that are in need of liquidity. The airlines have borrowed at attractive rates and financial institutions have received partial guarantees as the Canadian government has stepped in as facilitator.



The government has been warning for many years that Canadians are overleveraged. Many independent research institutes have opined the economy is carrying too much debt. The irony is that on behalf of all Canadians, the government solution to recovering from this pandemic has been to add more debt. In light of the economic challenges, a somewhat necessary solution.

Still, debts have ballooned over the last two years. Interest rates are now finally rising. It is a combination which is guaranteed to raise service costs and over time will act to slow down the rate of economic growth.

The Fed at a Crossroad

Jerome Powell, Chairman of the U.S. Federal Reserve, is at a crossroad. Caught between a rock and a hard place is perhaps a more suitable metaphor. The Fed must do enough, in the way of raising interest rates to curtail inflation and yet not enough to be blamed for a possible mishap in financial assets. Another concern is that he does not go far enough and reverses course too soon. This could spark a higher round of inflation making it necessary to raise interest rates to a much greater level the next time.

Jerome Powell has a history of hawkishness. Before becoming Chairman of the Federal Reserve, he sat on the board of directors and was never a supporter of Quantitative Easing (QE). He was concerned it would create a bubble in the credit markets. He was one of the few members of the board that advocated for shrinking the Fed's balance sheet. He has always been in favour of normalizing monetary policy and raising interest rates. If he abandons his current hawkish tone his credibility will be questioned. In the coming weeks and months, he will be watched closely by all market participants.

Government spending has been excessive for decades. It is inherently inflationary to run deficits year after year. Governments rarely consider cutting spending as it is far easier to finance deficits by issuing bonds. Central banks have been willing to oblige by buying those bonds. The balance sheet of the U.S. Federal Reserve is up to almost $9 trillion, having purchased about $4 trillion over the past two years. The paradox is that Central Bankers have effectively financed inflation allowing governments to spend. They are now having to respond by fighting inflation.

The Yuan Goes Digital

The Chinese government has launched its own crypto currency - the digital Yuan. The Digital Currency Research Institute of the People's Bank of China (PBOC) has announced there has been a large increase in the number of newly opened personal "digital wallets". China has been working at developing its own digital currency for at least the past 5 years. They have successfully piloted several projects in smaller centers and appear finally ready to expand nationwide.

In the summer of 2021, the PBOC released a white paper outlining the country's transition toward a digital economy and the gradual removal of cash-based transactions. It was also at this time that China decided to ban the use of competing crypto currencies. Bitcoin mining companies have now moved out of China and established themselves in more friendly jurisdictions, primarily in the West.

For China, the adoption of a Central Bank Digital Currency (CBDC) promises to bring efficiencies to the domestic payments system. It will also allow the government to have greater visibility and control over all financial transactions. Importantly, it appears China's longer-term goal is to have a digital global currency which will ultimately reduce the reliance on "SWIFT", the global banking payments system which is dominated by the US dollar.

CBDC's are being researched by the Bank for International Settlements and the International Monetary Fund. Both institutions have called for global cooperation in the development of CBDC's and to protect against any potential macro-financial consequences.

Perhaps governments will one day replace the current physical currency system with a digital one. It will still be a centralized government monopoly with an unlimited supply. The ability to print money would not change.

Money, Bitcoin & Gold

Bitcoin is frequently compared to Gold – a new digital Gold. Gold is regarded as money. It has a long history as money and is tangible. The current reality however is that no one uses Gold as money to transact. The world is no longer on a gold standard. It has limited economic purpose and essentially sits in a vault with the status of a safe haven asset.

The private market is accepting Bitcoin as a store of value. If gold would be tokenized and warehoused on a computer, it would serve the same purpose. At the price of $1,800 per ounce, the total amount of above ground Gold is valued at approximately $10 trillion. This compares to less than $1 trillion for Bitcoin. Value is determined in the marketplace by buyers and sellers. Whether Bitcoin is accepted as money, a commodity, or as a transformational new technology with promising applications, its adoption curve is truly remarkable.

Bitcoin has a fixed supply of 21 million coins and unlike the mighty U.S. dollar, it cannot be printed. This is partly why Bitcoin has gained so many adherents. All cryptocurrencies have taken a tumble recently. Nevertheless, as the weeks and months pass, more high-profile individuals and institutions are jumping on the crypto bandwagon. The acceptability of cryptocurrencies and the dominance of Bitcoin is growing. While there are never any guarantees when it comes to investing, Bitcoin appears on its way to becoming a mainstream financial asset. Investors realize governments continue to actively debase their currencies with expansionist monetary policies. Bitcoin's ultimate valuation is of course unknown. We suspect as long as Central Banks and governments continue to expand the supply of money, both Bitcoin and Gold can only benefit over time.

The Shortcoming with Indices

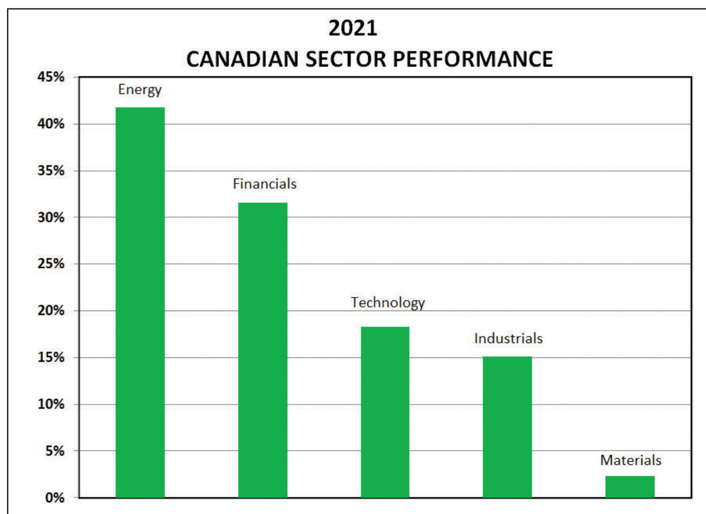
Many investors do not really understand how stock market indices are constructed, or at least pay little attention to their composition. Most indices, including the S&P 500 in the U.S. and the S&P/TSX Composite in Canada, are constructed based on market capitalization. Which means the largest valued companies have a greater weighting and influence in the index and subsequently on performance.

Currently, the top five companies in the S&P 500 by market capitalization, Apple, Microsoft, Google, Amazon, and Tesla, account for 24% of the entire index. (The top ten companies represent almost 32% of the index). The performance of these big 5 companies has been exceptional. By some estimates, in 2021 they contributed about half of the S&P 500's performance. To have performed well in 2021 required a heavy portfolio concentration in these leading technology companies.

The issue of concentration is not lost on Canadian investors. The S&P/TSX Composite is heavily concentrated in the Financial sector. This group, primarily the big five banks, commands a 32% weighting in the index. (The Energy sector was 20% of the index a few short years ago and is now 13%). It is not healthy to see such heavy concentration in just a few companies.

Equity Markets

The S&P/TSX Composite price index advanced by 21.7% in 2021. Energy was the best performing sector rising by 41.8%. The Financial sector had the second-best performance with a gain of 31.6%. The bar chart below shows the performance of the top five sectors in the index. Together these five sectors represent almost 80% of the index weight. The worst group last year was Health Care, which posted a decline of 20.1%.



The Energy sector appears poised to make further gains in 2022. JP Morgan is predicting an oil price of $125 for this year and higher again in 2023. Simply stated, the demand for oil is rising and supply is declining. New oil discoveries are down. According to Rystad Energy, a Norwegian energy intelligence firm, only 4.7 billion barrels are likely to have been discovered in 2021, the lowest in 75 years.

Notwithstanding the excellent year in the stock market last year, according to Bloomberg News there were 334 stocks in the S&P 500 that made new lows, while just over 100 stocks made new highs. This wide divergence confirms investors are chasing a select few number of companies. Apple of course, being one of those companies, is now the largest company in the world measured in market capitalization – valued at $3 Trillion. By comparison, the value of the entire S&P/TSX Composite is $3.4 Trillion.

Investors remain confident the financial markets can continue to move higher. According to Bloomberg News, "Investors poured almost $900 Billion into equity funds in 2021", a record high. Equity exchange traded funds received the bulk of investor savings. The amount of leverage used to buy stocks is also at a record high.

Importantly, inflation continues to be problematic. It is expected the U.S. Federal Reserve will raise short-term rates starting in March. According to Goldman Sachs, the Fed could raise rates four times in 2021, equal to a full one-percentage point increase. The Bank of Canada is likely to follow the same path.

Interest rates rising by just one percent does not seem extreme. The issue however being there is a heavy amount of leverage in the financial markets. Broker margin debt is at a record high. Large hedge funds and other investors routinely borrow money to buy both stocks and bonds. A small rise in interest rates changes the economics of leveraged positions. We will be monitoring markets closely.

It would not be unexpected for the market to correct after last year's stellar gains. In balanced portfolio mandates we have moved to a slightly more defensive posture. A mix of 50/50 invested in stocks and bonds is still advisable given the current environment. Any pullback in stocks should prove temporary and be an opportunity to add to portfolio holdings.