STONEBROOKE
ASSET MANAGEMENT

The Commentary

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The Times Are Changing

It wasn't long ago economists were forecasting global economic growth with little to no inflation. Interest rates would remain low due also in part to productivity gains driven by advances in technology. Rising financial markets fuelled investor confidence.

Covid of course put an abrupt halt to the economy as lockdowns closed businesses and borders. The global economic contraction was significant. Unemployment spiraled and consumer spending plummeted. Governments stepped in to provide massive relief to businesses and individuals with a fiscal spending boom never before witnessed.

The cost to the national economy was substantial, taking the federal debt in Canada to almost $1.9 trillion. According to the Fraser Institute this amounts to approximately $48,000 for every citizen, an increase of 30% since early 2020.

In the U.S. the stimulus programs reached into the many trillions. To accommodate the spending the U.S. Federal Reserve added almost $5 trillion to its balance sheet since the start of the pandemic.

The consequences of this enormous spending started to manifest itself early in 2022 - inflation has returned with a vengeance. Food, energy and consumer durable prices from appliances to autos are all up significantly. By mid-year the Consumer Price Index was over 6% on its way to over 8% by September.

Inflation was initially thought to be "transitory", largely an issue of transportation bottlenecks and shortages (supply chains). Expectations were that prices would eventually come back down.

The Russian invasion of Ukraine effectively ended the transitory narrative. Energy and food prices climbed higher and central banks finally began to raise short-term interest rates. Bond yields have soared. From practically zero, in 6 short months the interest rate on 2-year U.S. Government bonds has climbed to 4.5%.

The times have indeed changed. The previous dozen years characterized by low inflation and near zero interest rates are unlikely to return.

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S&P/TSX : 18,444	90 Day T-Bills : 3.55%	Oil : $79.50 US	Cdn $: .73 US
S&P 500 : 3,585	10 Yr Cda Bond : 3.16%	Gold : 1,662 US	Euro : 1.34 Cdn

Geopolitical Tensions

The war in Ukraine is in its eighth month with no end in sight. The rhetoric on both sides has escalated with accusations of war crimes. The use of tactical nuclear weapons is being openly discussed. There will be no winners in this war if it goes nuclear. While it is unfathomable to think the world could be headed for such a devastating outcome, the longer-term implications when hostilities do finally end are not encouraging. The bombing of the Russian Nord Stream gas pipelines was a watershed event. The cold war is guaranteed to return when the war in Ukraine ends.

Tensions have escalated with China over Taiwan. It would not be an understatement to suggest the U.S. and China are officially in an economic war. The U.S. Senate recently passed the CHIPS Act and the Biden administration imposed export controls and restrictions on the sale of advanced semiconductors to China. It also placed restrictions on foreign multinationals, banning them from dealing with China if they use U.S. technology to make their own advanced chips.

Advanced graphics processing chips are vital for advanced weapons systems and for artificial intelligence. The deteriorating relations with both China and Russia will certainly reverse the trend of globalization and impede world trade.

As a result of sanctions imposed on Russia, European countries are experiencing the worst fuel shortages since the 1970's Arab oil embargo. While Germany likely has enough storage of natural gas to last through a normal winter, deliveries of gas in 2023 to Europe will be problematic creating hardships for industries and households alike. Protests are rising throughout Europe as food and energy prices climb. Tensions will reach a boiling point and may trigger a geopolitical event with unforeseen risks to the financial markets.

Data Confirms A Slowdown

Many recent economic statistics along with consumer and business surveys continue to confirm a slowdown. The September data from the Institute of Supply Management (ISM), dropped below 50. A reading below 50 denotes a contraction. The important leading indicators of the ISM data dropped well below 50. New Orders, slowed to 47.1 from 51.3 and Employment slowed to 48.7 from 54.2.

Personal consumption expenditures are slowing. The savings rate has dropped to 3.4% and credit card balances are rising. The outlook for consumer spending is not encouraging.

Despite all the data confirming a slowdown, it appears many investors are still indifferent and expect economic conditions to recover and normalize. Flows into equity funds have remained relatively strong. Even the ARK Innovation ETF, the popular ETF with investments in "best in class" technology companies, has not suffered net redemptions, even though it has fallen by over 70% in price.

For now, the "buy the dip" mentality is still alive and well. Investors appear to be looking for opportunities to buy as opposed to sitting on the sidelines.

Wall Street is Always Bullish

The industry is perpetually bullish, mainly because a positive story sells. The industry needs investors to transact and to buy "product". If Wall Street encouraged caution and suggested markets were risky, investors would put away their wallets and save for the rainy day. The financial media also perpetuates the positive for the same reason.

Understanding this bias from both Wall Street and the financial media is essential. The large investment banking and brokerage firms will rarely write an unfavorable research report on a company. They usually have, or seek, a banking relationship and therefore their research can be somewhat compromised. Investors must seek out balanced reporting and challenge every narrative from the mainstream financial services firms and media outlets.

A recent example was the cheerleading that promptly followed the release of the Consumer Price Index (CPI) for the month of July. The CPI dropped to 8.5% from 9.1% in the previous month. The market swiftly rose that day by 3%. The storyline was that inflation had peaked and the Fed no longer needed to tighten. Ironically, it was the inflation sectors that rose the most that day. Natural Gas was up 6.1%,

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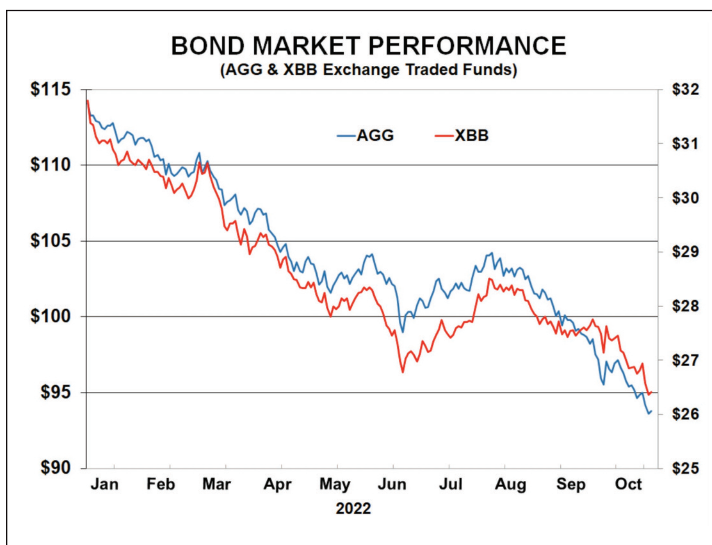
Wall Street is Always Bullish *(cont'd from page 2)*
the Gas Producers up 4.8%, Oil Exploration & Production sector was up 4.7%, and Small Cap Energy was up 4.6%. The reality was completely different. Inflation was still a concern and the market bid up those sectors which stood to benefit.

Importantly, the perennially "bullish" forecasters calling for inflation to decline are the same pundits who did not see it coming earlier this year. They were wrong then on inflation and wrong on the direction of the economy, yet they continue to get media attention.

Bond Market

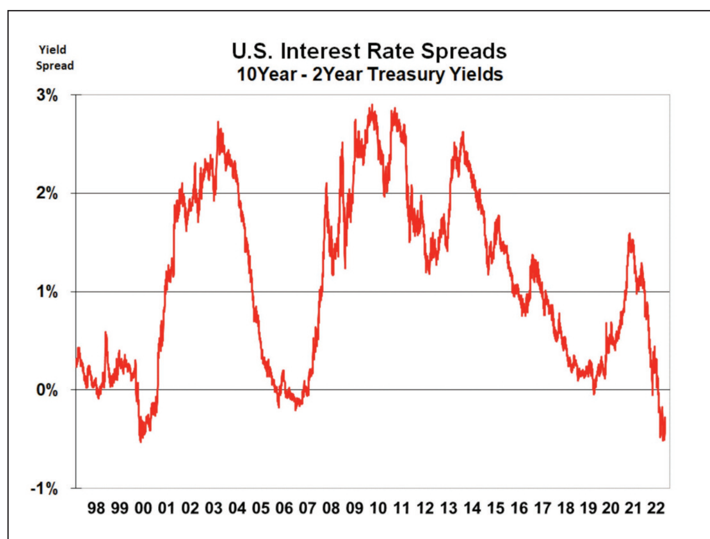
The bond market has suffered its worst performance in more than 30 years. The chart below plots two popular bond exchange traded funds. The XBB is the Canadian Universe Bond Index ETF and the AGG is the U.S. Core Aggregate Bond ETF. These popular bond ETF's have declined approximately 16% so far this year. Investors have lost money in what they normally regard as a safe and conservative investment.



Shorter-term bond funds have performed relatively better. The XSB, a Canadian ETF of shorter-term bonds has declined about 6%. *Short-term interest rates* have now climbed well above *longer-term interest rates*, producing a "negative spread". Normally interest rates are higher the longer the maturity. The chart below shows the yield difference between 2-year and 10-year U.S. treasury bonds. Negative spreads are rare. Since 2000, a negative spread has occurred three times. Recessions usually follow. In 2000 the negative spread reached .50% and stayed negative for the entire year. Two-year bonds rose to a peak of 6.93% in May and 10-year bond yields reached a peak of 6.56%. In 2006 the negative spread reached .20% and two-year bond yields peaked at 5.29% while 10-year bonds peaked at 5.24%. The recession followed about one year later.

Currently, spreads are a negative .50% as 2-year bonds have quickly climbed to 4.5%. Relying solely on this indicator, the probability of a recession in 2023 is fairly high.

Furthermore, the long-term, 40+ year trend of *declining interest rates* with falling inflation could be at an end. We



may be seeing the beginning of a new secular trend of *rising interest rates* with stubborn and rising inflation. In such an environment, bond yields may not keep pace with inflation. This was the situation that prevailed in the 1970's. Interest rates rose while still remaining below the rate of inflation for almost the entire decade. Investors in fixed income instruments experienced negative real returns and lost the purchasing power on their savings.

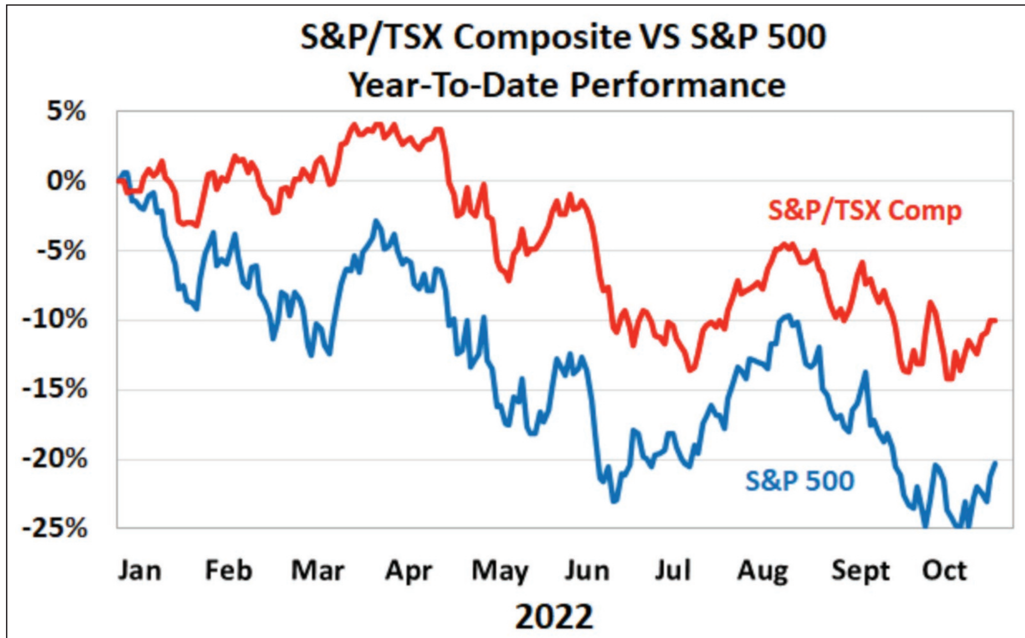
There are good arguments being made inflation will be contained and that a return to a 1970's period of stagflation is very unlikely. At the time, the debt to GDP ratio was about 30%. In comparison, today the ratio is at 130%. There is a limit to where interest rates can climb as the cost of servicing the accumulated debt will become unmanageable.

We are likely closer to a peak in interest rates. Central bankers are committed to fighting inflation, and they risk breaking the economy by doing so. The comments made a month ago by Chairman Jerome Powell should resonate with investors; *"we have got to get inflation behind us. I wish there were a painless way to do that. There isn't."*

The Fed will continue to raise interest rates and likely keep them elevated until the economy slows sufficiently and unemployment begins to rise. We believe the peak in interest rates may only be a few months away. Extending term and buying longer dated bonds may be an appropriate strategy in the first quarter of 2023.

Equity Market

Stock markets recovered somewhat during the summer months only to see prices reverse again to the downside. The chart below shows the year-to-date performance of the major U.S. and Canadian stock market indices. The U.S. has fared worse this year with a decline in the S&P 500 of about 22%.



Volatility continues to be the main feature with daily market swings of 2% becoming the norm. We expect stock markets to continue to struggle until there are clear signs inflation will be tamed and bond yields are no longer rising. A soft-landing economic scenario is possible. Unfortunately, soft landings are rare, and inflation appears unlikely to improve materially until the economy is well into a recession. At that point reversing policy and driving interest rates down is not immediately effective. It takes time to recover from a recession. Financial markets however always look forward. They will climb again when least expected, when conditions are still far from ideal, in anticipation that economic growth will return along with growth in corporate profits.

The slowdown is now quite evident in the technology sector. The major companies, Amazon, Google, Facebook and Microsoft, have all guided for lower growth over the next quarter. According to Canalys, a market research firm, shipments of smartphones fell by 9% globally in the three months ended September. Apple, which has gained market share, has nevertheless announced it will not increase production of its new iPhone 14. The outlook for Cloud services and computing generally has fallen with growth rates well below expectations.

The energy sector has performed well this year. The price of oil has now retreated from its high of about $120 USD earlier this year. The global slowdown is certainly the main cause for the decline along with the decision by President Biden to tap the Strategic Petroleum Reserve (SPR). The SPR will need to be replenished. The Saudis have also made it perfectly clear they intend to manage the oil price to stabilize prices. Oil and gas companies have been discouraged and disincentivized to explore and invest their capital. With diminished strategic resources in the U.S. and an OPEC+ cartel cutting production, the price of oil is guaranteed to move higher over time.

While the energy complex is not a sector we find attractive over the longer term, the companies stand to do very well in the current environment, as well as other resource and cyclical sectors. Our preference is to look for opportunities in the new emerging technologies that promise a greener environment.

Perhaps most of the decline in stock prices is behind us. If inflation were to soon fall to about 5%, investors may rejoice concluding the Fed will stop raising rates. Still, stock market valuations are based on earnings estimates that remain too high. Analysts remain too optimistic and are at odds with an economy trending downwards. There are plenty of profitless companies promising unreasonable growth rates that are still too expensively priced.

The best opportunities to invest in the stock market are when prices have fallen, and the majority of investors are no longer in the mood to buy. It requires patience and discipline to buy during a downturn. It is an exercise in judgement that is not often rewarded in the very short term. We believe while stock valuations are now more compelling, there is still the potential for a further decline in prices. We will look for opportunities on a selective basis over the months ahead and into the first quarter of 2023.