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CONTACT US:

Stonebrooke Asset
Management Ltd.

Waterpark Place
20 Bay Street, 11th Floor
Toronto, Ontario, M5J 2N8

344 Lakeshore Rd. E., Suite B
Oakville, Ontario, L6J 1J6

Tel: 416-850-2172
Email: info@stonebrooke.ca
www.stonebrooke.ca

Inflation Rages On

The latest U.S. measure of Consumer Price Inflation (CPI), for the month of June, registered a staggering annualized rate of 9.1%. This follows several months of inflation figures north of 7%. Inflation levels are similarly high in Canada and other parts of the world. Inflation has become a global phenomenon.

Allowing inflation to get out of control will be very problematic for the long-term health of the economy. It is imperative for policy makers to show leadership and to act quickly and rationally to bring inflation down. Unfortunately, the inflation rate is destined to stay high, as the CPI is a lagging indicator and adjusts very slowly. Many components of the CPI, especially rents and housing prices, are entrenched and will remain “sticky” in the reported numbers for the next several months. This is why the majority of forecasts are for inflation to remain elevated for much of the year.

The good news is a vast number of important commodities have seen sharp declines in prices this year. Prices in the entire metals complex have declined with copper down over 25%. Lumber prices have dropped by 50% this year. Oil, the most important commodity, has recently weakened with the price of West Texas Intermediate (WTI), now under \$100 USD per barrel.

The consensus opinion is the rate of inflation will return to pre-pandemic levels by the end of 2023. Whether a 2% or even a 3% inflation scenario is possible is hotly debated. For now, inflation rages on



The Fed – No Pivot in Sight

Jerome Powell, Chairman of the U.S. Federal Reserve appears determined to battle inflation by raising interest rates. Another .75% is scheduled soon, followed by another later this summer. Canada has already raised rates by one full percentage point, the first G7 country to do so. The U.S. may eventually follow suit.

Inflation is the elephant in the room and threatens to be elevated for quite some time. Increasing interest rates should theoretically bring inflation down over time, however this deliberate policy choice will slow economic activity and

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The Fed - No Pivot in Sight (cont'd from page 1)

raises the risk of recession. It has been alleged Powell is knowingly targeting the stock market which he sees as an area of speculative excess. The Fed also recognizes it is partly responsible for the buildup of excesses having printed the money which allowed financial and other asset markets to reach bubbly levels. Unfortunately for the Fed they are in the business of cleaning up the fiscal mess driven by government spending. This time, the pandemic devastated the economy resulting in huge fiscal spending on a scale not seen since World War 2. The Fed accommodated this by growing their balance sheet and buying almost \$5 Trillion in bonds. Without a friendly central banker to shoulder the burden a truly nightmarish scenario could have played out.

Still, interest rates were held down artificially for much too long. If Powell is indeed apathetic towards supporting the stock market, then a little more deflation in stock prices is likely on the agenda. This may just suit him fine as he attempts to fine tune the economy with a "soft landing". Creating a "negative wealth effect", to drive inflation lower may be part of the plan. With the S&P 500 down by 20% year-to-date, representing about \$10 Trillion in market value, the negative wealth effect, by some estimates, will reduce consumer spending and bring about a 2% drop in GDP.

Changes in the housing market is estimated to have a greater wealth effect than the stock market. Investments in stocks represent longer-term savings and there is an expectation of volatility. Housing is a different asset class and has a more immediate impact on how individuals feel about their financial health. A decline in house prices therefore has a much higher

impact on consumer spending than a similar decline in stock prices. Raising interest rates is a powerful policy tool, if somewhat of a blunt instrument on both the housing and stock markets. With CPI running north of 8% the Fed has very little options. Powell is not inclined to pivot just yet.

Of course, a Fed pivot will eventually come. As the economy deteriorates and labour market conditions worsen, there will be an outcry for the Fed to stop raising interest rates. The challenge will be to raise interest rates high enough to tame inflation in the short-term and cause a necessary change in *inflationary expectations over the longer term.* A pivot too early with a concomitant return to stimulus could sow the seeds for a secular advance in inflation. The Fed is still in the early stages in its battle against inflation. In addition to raising interest rates, it has only just begun to reduce its balance sheet. They have announced the intention to sell just over \$1 Trillion in bonds over the next year. It will be interesting to see if investors have the appetite to absorb these bonds.

Larry Summers, Harvard economist and former Treasury Secretary said it best when he voiced the following remarks *not too long ago; "So, the large spending package has contributed to inflation, this is now obvious. It is but one contributor as it is never just one thing. The Fed allowing to finance the deficits caused by the spending was also wrong. Keeping interest rates down to near zero was wrong with all the money sloshing around. It just encouraged speculation in the financial markets and the run up in real estate. The Fed must now pull the plug. Central planning is the root cause of misallocation of capital."*

Recession – Technically Speaking

For all intents and purposes, a "technical recession" in the U.S. is already in the cards. The strict definition of a recession is two consecutive negative quarters of GDP. The 1st quarter GDP came in at a negative -1.6%. The majority of recent forecasts for the 2nd quarter are also negative with the Federal Reserve Bank of Atlanta predicting a decline of -2.1% for the quarter.

The National Bureau of Economic Research (NBER) is the official arbiter of recessions. While the strict definition is usually applied when confirming a recession there are a number of economic statistics which are gathered in determining if the economy is truly in a recession. The problem is by the time the NBER gets around to confirming the current recession we could be well into 2023. They are very often six months behind.

Ironically, the current anxieties with inflation will eventually give rise to concerns about economic growth and recession. In fact, "google searches" reveal a growing curiosity with

recession. The word recession now exceeds the word inflation for most google searches.

Cyclical sectors of the economy will be vulnerable. Commodity prices are already reflecting a weakening demand environment. Without war in the Ukraine, the price of oil would be much lower. There are some industry experts that estimate the war premium for oil is about \$40. Any hint of a ceasefire and an end to hostilities would send the price plunging.

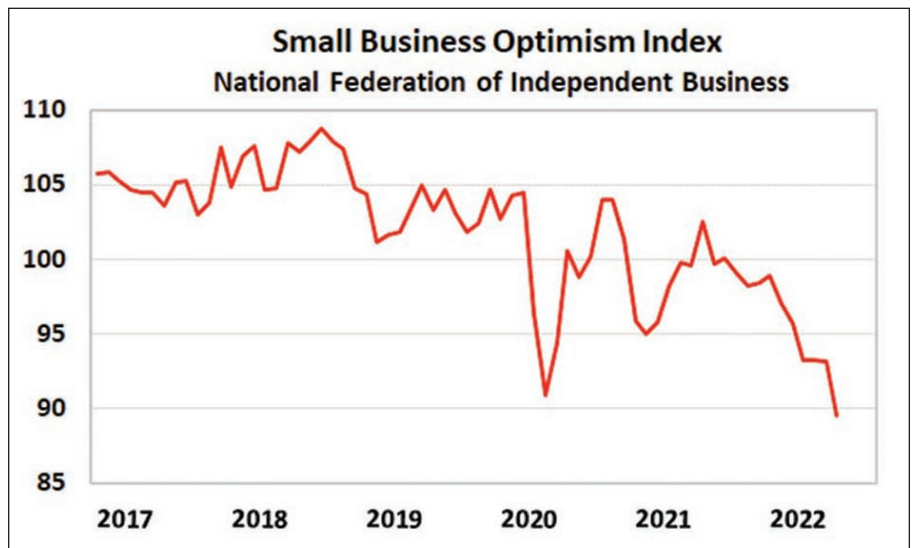
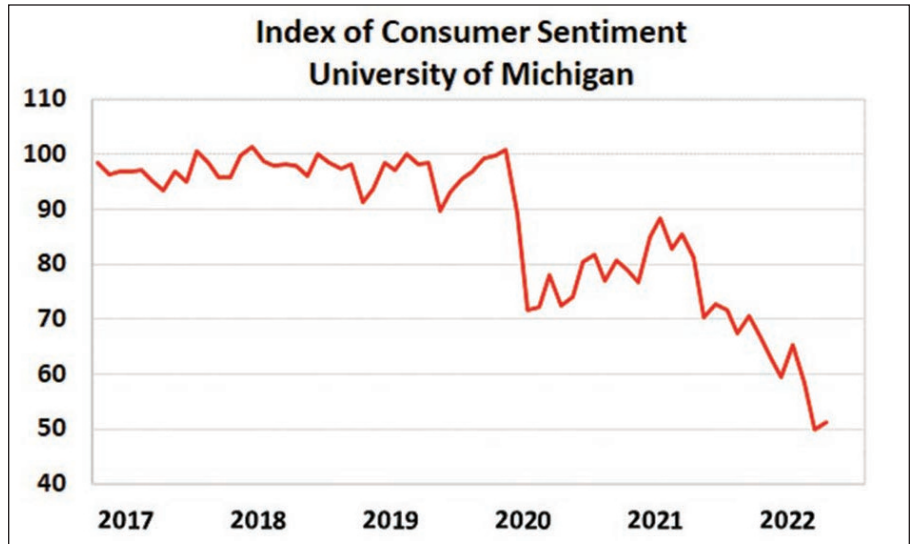
China is a large consumer of commodities and is often mentioned, on the other hand, as one of the principle causes of lower commodity prices. The Covid outbreaks had shut down many cities, including Beijing and Shanghai, resulting in a significant decline in economic activity. The Chinese economy is just now slowly beginning to reopen. Traffic in the port of Shanghai is showing an improvement. China could lead global markets out of any slowdown/recession much more quickly than generally anticipated.

Confidence Falling

The two adjacent charts show a dramatic decline in both U.S. consumer and small business confidence. The Michigan Consumer Sentiment Index (MCSI) has dropped to 50.2, the lowest reading in more than 40 years of data. This is far worse than during the Great Financial Crisis (GFC) back in 2008/9. In the U.S., the survey results from the National Federation of Independent Businesses substantiate the difficulties businesses are coping with as inflation drives up costs and order backlogs grow due to shortages and bottlenecks.

Still, it's a mixed picture for small business owners. Restaurant sales continue to trend higher, and the services sector is recovering well. Business owners however cannot find enough workers. Job openings and hiring plans are at record levels. Owners are raising compensation levels as well as raising selling prices. This is not a characteristic of a pending economic slowdown, at least from an employment point of view.

European confidence levels are also at very low levels. Lower than during the past two economic downturns. Canadian confidence numbers have similarly dropped. When mood shifts and consumers become more pessimistic it can build momentum. Changes in behaviour are difficult to forecast. As evidence accumulates that the economy is getting weaker consumers spend less and that has ripple effects all through the economy.



Bond Market

2022 is turning out to be the biggest bond market rout in history. Year-to-date the government of Canada benchmark 10-year yield has climbed to 3.25% from 1.4% at the start of the year. This represents a capital loss of almost 15%. In the U.S. the loss in capital is similar.

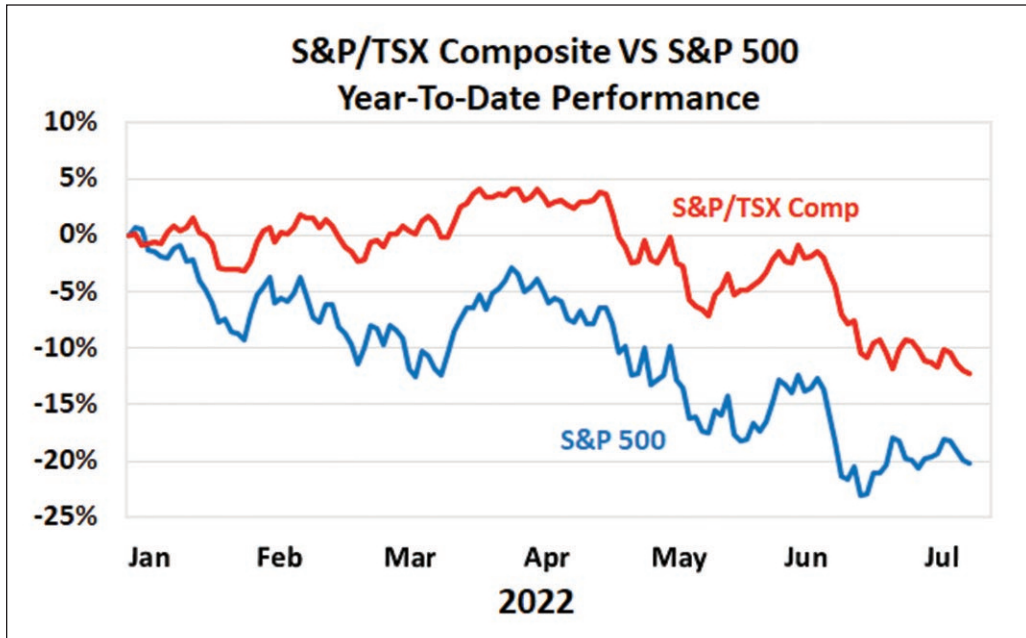
Even with the carnage in the bond market, analysts are claiming investors have still not adjusted for "term" or duration premium. This is a premium for the risk in holding longer term bonds and the associated risk of higher inflation in the future. The consensus expects inflation to decline back to the 2% level. Should investors eventually sense inflation will become problematic for a longer period of time then they will demand a large term premium, sending yields higher. It takes time to adjust attitudes after a decade or more of non-existent inflation and abnormally low bond yields.

The Fed has also distorted the bond market by financing government deficits. It has not been a free private market for quite some time. Furthermore, it also purchased high yield corporate bonds and by some estimates it has bought one third of all the mortgage-backed securities outstanding. Bond yields would be much higher without this major non private buyer in the marketplace. With the Fed now planning on paring down its balance sheet and selling bonds, the outlook for bond prices is not very favourable over the *intermediate term*.

Still, with the yield curve having inverted in the U.S. (short-term bond yields higher than longer-term bonds) the market is signaling a softer economic period straight ahead. The very short-term outlook for the bond market is likely more sanguine. Interest rates may take a breather.

Equity Market

This has been a turbulent first half for the stock market. The S&P/TSX Composite is down about 15% and in the U.S. the S&P 500 is down 20%. For the S&P 500 this is the worst first half of the year since 1970. For the NASDAQ index, the performance is even more dismal as this group of growth and technology stocks has shed almost 30%.



Rising interest rates and concerns over inflation are certainly responsible. The important question is if the stock market has fully priced in the coming decline in corporate earnings. Wall Street consensus estimates are still high and were recently forecasting for 10% year-over-year earnings growth. This is quite aggressive given the latest news from some of the largest U.S. companies including Walmart and AT&T.

Resource stocks have historically provided excellent returns during inflationary times. In the 1970's inflation roared to double digit levels. It was a period of phenomenal growth for energy producers and mining companies as commodity prices rose throughout the decade.

If the next ten years brings just a fraction of the inflation of the 1970's, then an allocation to resources will be important for performance as well as a portfolio diversifier. Energy has been the best performing sector in the past year and yet continues to be ignored by investors. The market capitalization of the entire resource sector has declined steadily over the past five years. It's weighting in the S&P/TSX Composite index is just 10%. There is significant upside if weightings revert back to where they were five years ago. The powerful

Environment, Social & Governance, or ESG movement, however, precludes investor savings will be flowing into the resource sector in a substantial way.

Still, the valuations are compelling and perhaps the tide is slowly turning. We were surprised to learn Exxon Mobil is an approved investment in several well-known ESG funds, including the Sustainable Advantage Large Cap Core Fund offered by Blackrock. This popular ESG fund holds a 1.23% position. Also, famed investor Warren Buffett earlier this year purchased a sizable stake in Chevron, making it one of Berkshire Hathaway's largest holdings. His justification for the purchase of a major oil company is based on valuation. Importantly the big oil companies are not standing still and are investing their capital and diversifying into green energy.

Compelling sectors over the next cycle are likely to be in technology and also infrastructure related to building out the new green economy. The COP26 conference last year and the Davos Economic Forum earlier this year are promoting a "Build Back Better" program. The sum of \$150 trillion has apparently been pledged in the next decade to fighting climate change and making the globe greener.

The stock market will continue to be driven by Fed policy as they attempt to deal with inflation, which is the immediate concern. A Fed pivot or a pause in raising interest rates is perhaps on the horizon later this summer. As more economic data is reported confirming the reality of a slowdown the Fed may give financial markets a temporary reprieve. It will be a challenging environment for corporate earnings for at least the next two quarters as margin pressures remain due to increased costs. Importantly, the stock market always leads the recovery. While it is difficult to know precisely where and when the market will "bottom", stock market valuations are improving, and we will be monitoring conditions and looking for opportunities to invest. In the meantime, we continue to recommend a cautious approach and a larger position in cash to take advantage of market volatility.