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## Monetary Policy – Behind the Curve

Central banks are under pressure to tighten monetary policy as inflation hovers above 8%. The Bank of Canada (BoC) has recently raised short term interest rates by .50% and the U.S. Federal Reserve is expected to do the same shortly. Many analysts believe a jump of .75% in the Fed Funds rate is necessary, with more to come. The financial markets are said to be “pricing in” or expecting, a total of seven rate increases this year.

With a mandate of controlling inflation many believe it is critical for the U.S. Federal Reserve to “shock” the economy before inflation becomes entrenched. An independent Fed needs to ignore the demands of politicians and the wishes of financial markets. Both are typically highly critical of rising interest rates. Yet this is exactly what is required in order to combat inflation.

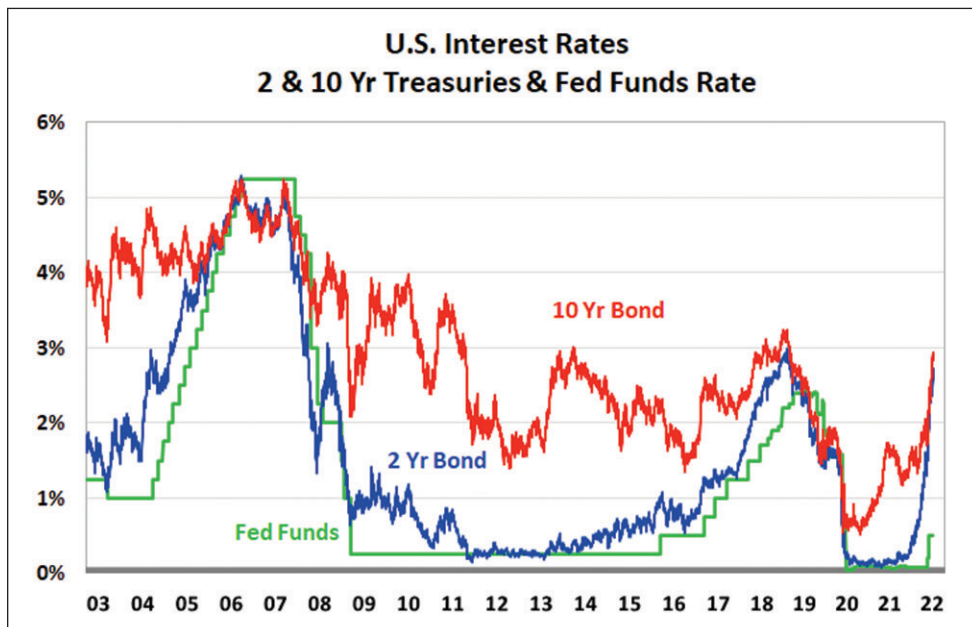
Given the extreme pressures emanating from both Washington and Wall Street, many pundits take the view inflation will not be tamed. According to Blackrock, the largest asset manager in the world, “If central banks do go ahead and hit the brakes, they will likely learn that the damage to growth to get inflation down is too great”. The idea of a benign and “transitory” inflation is fading as economists suggest inflation could remain high for a long period of time.

Inflation is usually the result of too much money and credit being created. Both monetary and fiscal policy can be blamed for the excessive stimulus, ostensibly a necessary strategy to deal with the pandemic. Covid related lockdowns and now sanctions against Russia are causing shortages and bottlenecks. Supply chains have been disrupted. The rising prices in food and energy are reducing consumer disposable income. Rising interest rates will only aggravate economic conditions as the Fed attempts to engineer a deflation.



The last time inflation was a major concern was back before the Great Financial Crisis (GFC) of 2008/9. For several months leading up to the GFC inflation had jumped to an annualized level of 6%. Then in 2009 in the midst of the recession, inflation plummeted below zero to minus 2%. It took a major economic downturn and a 50% collapse in the stock market to break inflation. Clearly, policy makers understand the risks and are likely to take a gradual approach to avoid a repeat performance.

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Importantly, however, the Federal Reserve is significantly behind the curve in fighting inflation. This can be seen in the adjacent chart comparing the 2 and 10-year bond yields with the Fed Funds rate. The Fed Funds rate (green line on the chart) is lagging considerably behind. As can be observed, this is typical.

In 2005/06 the Fed Funds rate was increased to 5.25%. In 2018 Fed Funds climbed to 2.5% before the Fed reversed course. As Mark Twain allegedly said, "history doesn't repeat itself, but it often rhymes."

Only this time around the Fed is extremely behind and has some catching up to do. By raising interest rates central banks hope to cool the economy and inflationary expectations. Higher interest costs to service debts should eventually dampen consumer demand. Some monetary analysts suggest a more gradual tightening policy can be justified because of the Russian invasion of Ukraine. The global economy is challenged, with higher food and energy prices already having a dampening effect on consumer spending. In time inflation will prove transitory. Just the same, the Fed is currently under pressure to act as bond yields are rising. This is a classic

## War, Shortages & Recession

The global economy was already dealing with bottlenecks and shortages due to the pandemic. Prices were rising for many goods and commodities well before Russia invaded Ukraine. With the price of oil spiking upwards along with nickel, aluminum, and wheat, the global economic environment is challenging to say the least.

According to J.P. Morgan and other reliable sources, Russia and the Ukraine are key producers and exporters of many vital commodities. A prolonged war, which appears more and more likely, will exacerbate shortages and prices for many goods and services will continue to rise. The following are some key statistics;

- Russia is the third-largest producer of petroleum and exports almost 5 million barrels a day of crude oil.
- Russia produces about 17 percent of the world's natural gas.
- Russia produces about 12% of platinum and 40% of palladium and is a major producer of aluminum.
- Russia and Ukraine together account for about 10% of global steel exports.
- Russia and Ukraine account for about one third of global wheat exports.

- Russia is one of the largest suppliers of titanium.
- Russia accounts for about 20% of the world's high-grade nickel production.

With Central Banks raising interest rates and the Russian/Ukrainian war continuing to escalate, a slowdown and possible recession could be right around the corner. Mainstream economists are still predicting growth, albeit a growth rate that is forecasted to decline. We are amused by a recent comment from David Rosenberg, former chief economist with Merrill Lynch, now heading up his own economics research firm Rosenberg Research. Rosenberg pointing to the poor forecasting ability of most economists noting they consistently get it wrong, stated, "Over the past thirty years, economists have forecasted only two of the 60 recessions that occurred around the world a year in advance".

Most economists agree a slowdown is unavoidable. Recent economic statistics including durable goods, housing, and retail sales, are confirming as much. As for a recession, only a minority of economists are leaning this way suggesting it is distinctly possible. In the minority camp, William Dudley, former President of the Federal Reserve Bank of New York stated recently that a recession was "virtually inevitable". We will have more clarity over the coming months.

# Globalization – A New Order

For the past two to three decades since the breakup of the former Soviet Union and as China entered the World Trade Organization (WTO), globalization was the dominant economic driver. Trade with China was especially transformative for both the Chinese and Western economies. Trade with Russia also expanded primarily in the energy and commodity sectors. Globalization contributed to a period of growth, prosperity, and disinflation.

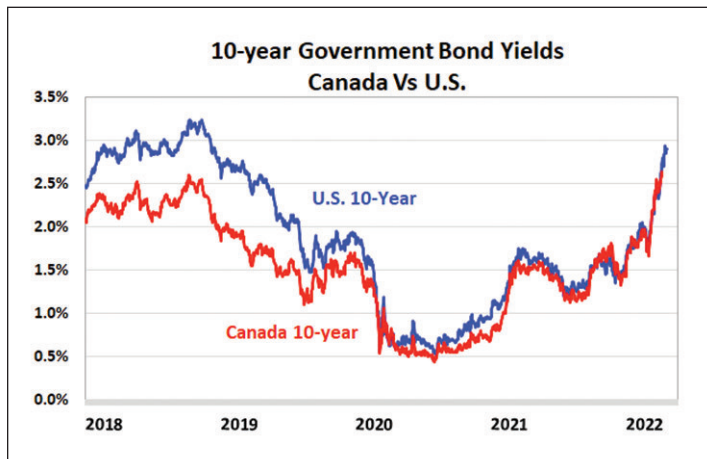
The Russia/Ukraine conflict could be the trigger point setting the stage for a shift in the global economic order. Geopolitical analysts are warning economic relations may have been permanently altered. There may be no going back. Relations with China, which had already been strained since the Trump administration may have taken a turn for the worse. With China unwilling to be critical of the

Russian invasion and reluctant to go along with international sanctions, they risk becoming a pariah.

Multinational corporations will be looking at diversifying production and changing supply management arrangements. An increased cost structure is inevitable during this transition stage. Over the longer-term the drive for clean energy and a carbon neutral environment will be constructive for economic growth. The changing global order means capital investment will be redirected to safer and more politically acceptable jurisdictions. This should benefit the Western world. The challenge will be in securing raw materials as we transition to a green economy. By some estimates, a tripling in the production of basic commodities like lithium, nickel, and copper will be required as we restructure and build out a green economy.

## Bond Market Outlook

The rise in bond yields this year is one of the steepest in decades. As per the chart below, 10-year government bonds are fast approaching 3%, having doubled in just a few short months. Short-term bond yields are also rising sharply with 2-year bond maturities closing in on the 10-year yield. A yield curve “inversion” appears likely, meaning short-term bond yields will rise above longer-term bond yields.



In a recently published article by the Fed entitled (Don't Fear) The Yield Curve, the authors contend that an inversion of the curve on its own is not very informative. Their conclusion states “it is not valid to interpret inverted term spreads as independent measures of impending recession”. Conceivably they may be correct. If history is any guide however, they are unlikely to be, as the previous 10 out of 11 times the yield curve inverted a recession was right around the corner.

It is also possible that a negative yield curve is very short-lived this cycle. There are hedging programs in place today whereby large institutions are incentivized to maintain a positive yield spread. These are leveraged investment bets which can distort the bond markets. It only adds to the confusion and makes forecasting much more problematic.

Credit spreads on the other hand are confirming a higher risk environment. Corporate bond yields are widening, and “junk” or high yield bonds have risen to over 6%. The loss of investor capital in the average bond ETF is around 15% year-to-date.

The Fed is expected to raise the Fed Funds rate by 50 basis points, and possibly even .75% over the next two meetings of the Federal Open Market Committee (FOMC). The Bank of Canada's Tiff Macklem has also suggested a .75% rate hike is possible. Perhaps interest rates will need to rise much higher this time around to tame inflation. Then again, many pundits are of the opinion that a more modest rise of 1 or 1.5% may be enough to dampen consumer spending and produce a “soft” economic landing; citing the high level of debt in the economy compared to previous cycles.

The combination of tightening monetary policy and higher inflation will eventually lead to slower growth and decelerating inflation. The cycle always repeats. Interest rates will then decline. At some point it will be beneficial to extend term and buy longer dated bonds. We will be monitoring economic and financial market conditions for a good entry point.

# Bitcoin

The Biden administration recently issued an Executive Order (EO), effectively to investigate the crypto industry and recommend some form of regulation. Importantly, there were no disparaging comments in the EO regarding this new industry. The EO did acknowledge that digital assets have a place in the future and as per the official press release, "this industry requires a thoughtful approach to regulation." U.S. regulation will have a major impact on the global crypto industry with many advocates insisting on and welcoming regulation.

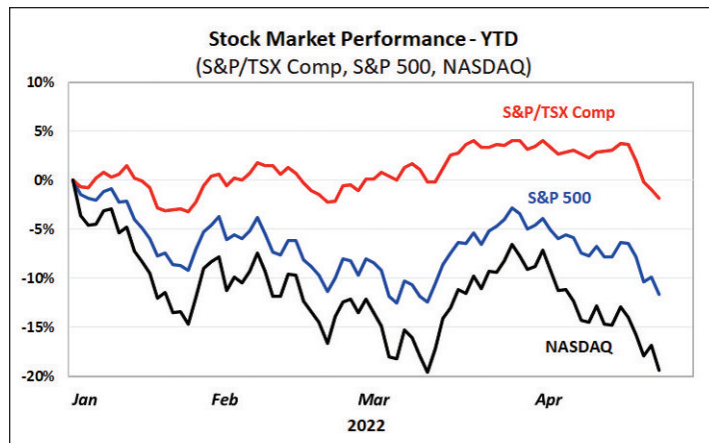
Due to the crackdown on the industry by China, the U.S. has become a leading center for crypto. According to Price Waterhouse Coopers, 43% of the world's crypto hedge fund managers are now based in the U.S. and the U.S. is now a

major center for Bitcoin mining. The annual conference, "Bitcoin Miami 2022" was recently held with a record attendance. Over 25,000 Bitcoin enthusiasts, mainly those working in the industry, arrived from all over the world. This is an impressive example of the maturity and growth of this sector in just a few short years.

For the converts and believers, crypto and blockchain technology is the next industrial revolution. The next phase of the internet, WEB3 as it is being called, is the money movement phase of the internet. The promise of WEB3 is to build a decentralized system where the users are at the core making peer to peer transactions without the control of a centralized institution.

## Equity Market Outlook

Stock markets are having a difficult start to the year. In the U.S., the S&P 500 sold off with a 12% plunge in the first quarter to mid-March. It has recovered part of the decline. As per the adjacent chart, it is the NASDAQ which has suffered the most with a 20% decline. This index is the bellwether for the popular and expensive technology stocks. The S&P/TSX Composite here in Canada has fared much better, declining only marginally. The Energy sector has held up the index with a strong performance from oil and gas stocks.



There is a good deal of uncertainty over the direction of monetary policy and the need to combat inflation. The conflict in Ukraine is escalating and a near term resolution appears unlikely. Markets dislike uncertainty and investors are no longer as excited to buy.

Liquidity is trending lower as is speculative activity. The

boom in new stock issues (IPO's), and the boom in special purpose companies (SPAC's), has withered. The flagship ARK Innovation ETF, an exchange traded fund focused on investing in growth and technology has collapsed, down by almost 50% in 2022. A purging of companies with excessive stock valuations is well underway.

There could be a long period ahead of higher-than-expected inflation with central banks unwilling to react fearing a negative outcome for financial markets. This may be an opportunity to invest in gold and precious metals.

Typically, gold is negatively correlated to the U.S. dollar. When the U.S. dollar is strong and rising, gold tends to be weak. In the past three months the gold price has been firm while at the same time the U.S. dollar has been strong. The correlation is changing, perhaps due to concerns over inflation. Precious metals are typically a desirable investment during inflationary periods as investors seek to protect their capital from the loss of purchasing power. Gold has been regarded as a "safe haven" for centuries preserving purchasing power over time when paper currencies have not.

Stock prices still remain expensive overall when looked at historically. Assuming a slowdown in corporate earnings in the months ahead there is further risk of a correction in prices. A mild recession later this year is a distinct possibility. Accordingly, we continue to recommend less than fully invested positions in the equity markets. Higher cash levels are desirable for the time being and will be deployed in the months ahead as opportunities arise.