STONEBROOKE
ASSET MANAGEMENT

The Commentary

CommonSense Investing

Spring 2023

IN THIS ISSUE:

Outlook Remains Ambiguous

U.S. Banking Crisis, Deja Vu

ChatGPT

M2 Money Supply

Growing U.S./China Tensions

Equity Strategy

Outlook Remains Ambiguous

Many key economic statistics for the U.S. and Canada are continuing to slow, pointing to a recession or "soft landing". That being said, the labour market is bucking the trend as the unemployment rate remains low and stable. This despite many high-profile job cuts announced from companies such as Amazon, Meta (formerly Facebook), and Disney. Since the unemployment rate is considered a lagging indicator, the deterioration is likely to show in the months ahead. For all the gloomy headline news in the economy and labour market, financial markets are performing relatively well year-to-date.

Consensus opinion is more hopeful now than at the beginning of the year. Still, the outlook for the year is ambiguous, complicated by a host of different opinions on inflation, interest rates, politics, and war. A major deviation in any of the above could reap havoc for the economy and short circuit the financial markets. For now, inflation is perceived to be under control and financial markets appear resilient to any bad news.

Over the next year or two we are more encouraged that financial markets, both domestic and global, will be able to provide investors with decent performance – no matter how volatile the conditions. Consider the experience of the recent past. If in early 2020 you knew with certainty the next three years would witness a global pandemic, with China locking down for two years, soaring inflation and interest rates and a war in the Ukraine, a rationale investment strategy would have considered putting your money in a mattress.

The longer-term outlook does pose some challenges. Macro headwinds include higher average inflation and interest rates, and geopolitical confrontation as the world splits into two main power blocks competing for dominance. Business cycles are not new and will continue to be the norm. A more profound change may be unfolding globally. Risks will always emerge and need to be managed and opportunities taken.

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

S&P/TSX : 20,100	90 Day T-Bills : 4.30%	Oil : $75.80 US	Cdn $: .74 US
S&P 500 : 4,125	10 Yr Cda Bond : 2.93%	Gold : 1,969 US	Euro : 1.47 Cdn

U.S. Banking Crisis, Deja Vu

The recent failure of three U.S. banks, notably the Silicon Valley Bank (SVB) in California, the 16th largest bank with over $200 Billion in deposits, was a classic old fashioned bank run. Concerned about the financial stability of the bank, depositors pulled their money out. Unlike the banking crisis during the Great Financial Crisis (GFC), there was no fraud this time, just a mismatch in assets versus liabilities. SVB had purchased longer-term fixed-rate mortgages and treasury bonds when yields were low. When interest rates rose sharply last year, these investments declined in price. Rising interest rates meant having to pay more for money on deposit. The negative interest rate spread made for an untenable situation and nervous depositors fled.

In order to calm markets and avoid panic, in a recent speech to the American Bankers Association, Treasury Secretary Janet Yellen stated, "*the U.S. banking system remains sound*". She affirmed liquidity was being provided to the banking sector and that depositor outflows from regional banks had stabilized. This happens to be the same Janet Yellen who said back on June 27th. 2017, when she was then Chair of the Federal Reserve, that another financial crisis was unlikely. Her exact words were, "*Would I say there will never, ever be another financial crisis? You know probably that would be going too far but I do think we're much safer and I hope that it will not be in our lifetimes, and I don't believe it will be.*"

The Federal Reserve has learned a few things since the last banking crisis. Importantly, the debt, or assets on the balance sheets this time around are not fraudulent securities. We expect the Federal Reserve will shore up the banking sector and provide the necessary liquidity. Stricter regulations can be expected for the mid-sized regional banks, along with enhanced supervision. Regional banks will become more cautious and therefore a decline in lending should be expected. This is unfortunate for small and medium sized businesses who depend on the regional banks for credit.

In the past decade investors had become used to earning very little in interest by maintaining their cash on deposit. Money market funds declined in popularity as they also yielded very little. This is now changing due to the high-profile banking collapse of SVB. Millions of bank customers now rely on banking apps to transact and pay bills. The ease of transferring money to earn a higher rate of interest is accelerating the deposit outflow.

The Federal Reserve has been quite adamant, insisting they intend to keep interest rates "higher for longer". Notwithstanding the unfolding disorder in the regional banking sector, they will likely go ahead as planned and raise the Federal Funds rate again. Reversing policy and dropping interest rates is not on the agenda as the Fed is determined to bring down inflation first. Its credibility is on the line.

ChatGPT

OpenAI's release of ChatGPT, just a few months ago, has been met with an astonishing rate of adoption. The sudden interest in Artificial Intelligence (AI) is exciting and is likely to grow exponentially. AI promises to enhance productivity in novel ways. Many companies are experimenting and finding it easy to use and a time saver.

The potential economic impacts are unclear with many pundits believing this software tool is revolutionary and will bring a huge decline in the work force. Many others disagree and believe AI will enhance productivity and lead to more economic growth.

The following paragraph has been written using ChatGPT. We copied material on monetary policy from our previous 8 newsletters and instructed ChatGPT to provide an executive brief not exceeding 200 words. This is the result;

"This executive brief discusses several topics, including the current situation facing Jerome Powell, Chairman of the U.S. Federal Reserve, who must balance raising interest rates to curtail inflation while avoiding mishaps in financial assets. Powell has a history of hawkishness and will be closely watched by market

(continued on page3)

ChatGPT *(cont'd from page 2)*

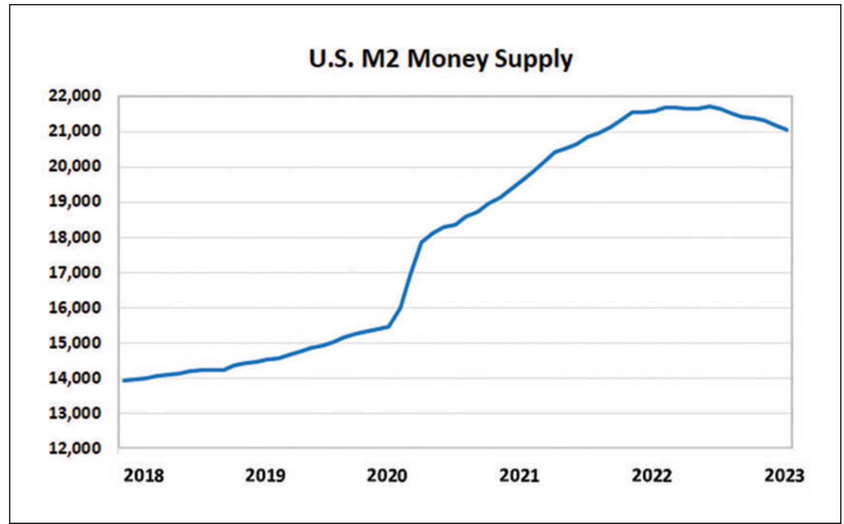
participants. Additionally, the excessive government spending, financed by central banks buying bonds, has led to inflation, and cryptocurrencies like Bitcoin are seen as alternative stores of value. Inflation is currently high, and many analysts believe that the Federal Reserve needs to 'shock" the economy before it becomes entrenched. However, rising interest rates could exacerbate economic conditions.

Lastly, the Federal Reserve is currently behind the curve in fighting inflation, as seen in a chart comparing the 2 and 10-year treasury yields."

Impressive, and no "major" editing is required. ChatGPT is already showing great promise and is just in its infancy. Our next newsletter may be written with the assistance of this technology providing it is able to deliver accurate content.

M2 Money Supply

M2 measures the overall amount of cash, bank deposits and money market funds, and is basically the broadest measure of cash and liquid assets. The U.S. money supply is contracting for the first time in post-World War II history, with total M2 at just over $21 trillion, down from $21.7 trillion. The adjacent chart shows the staggering rise in M2 over the last five years, up from $14 trillion in 2018.



The contraction of the money supply follows the huge spike in M2, the result of massive post-pandemic fiscal and monetary stimulus. Money supply is a driver of economic growth. The current contraction is therefore concerning and could lead to both a weaker economy and financial asset prices.

Confirming the slowing M2, the recent Senior Loan Officer Survey released from the Federal Reserve revealed that 43% of bank loan officers are currently tightening standards, a level not seen since the Great Financial Crisis (GFC). Additionally, following the Silicon Valley Bank failure, small and mid-sized banks are concerned about deposit withdrawals and are therefore reluctant to make new loans. Regional banks are a significant lender to commercial real estate, a sector which is facing economic challenges. Overall, the uncertainty in the banking industry is making banks more cautious, signaling a slowdown is inevitable.

Growing U.S./China Tensions

As per the Commerce Department, U.S. imports of goods from China increased by 6.3% in 2022 to $536.8 billion. (U.S. exports to China grew only 1.6% to $153.8 billion). With tensions escalating between Beijing and Washington, the growth in trade is likely coming to an end.

The Biden administration has implemented several programs to shore up domestic manufacturing with hefty subsidies and "Buy America" requirements. The Chips Act is targeting $53 billion for domestic semiconductor manufacturing, research, and development. The Inflation Reduction Act will allocate $369 billion for energy-security and climate-change programs, including electric vehicles and solar panels. Along with U.S. tariffs, the objective is to reduce the dependency on China as it is a dominant supplier of many products such as cell phones, personal computers and solar panels.

China's share of U.S. imported goods has been declining

(continued on page 4)

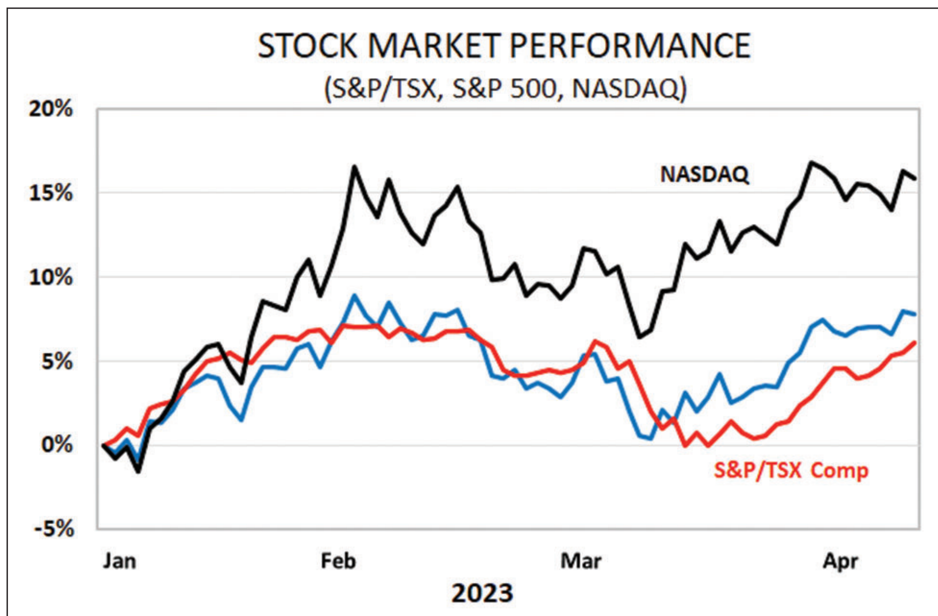
Growing U.S./China Tensions *(cont'd from page 3)*

over the past five years, down to 16.5% in 2022, from 21.6% in 2017. This is due to the higher growth in trade with the rest of Asia which has jumped to 24.8% from 20.9%. China's economy rebounded by 4.5% in the first quarter. Still, Chinese growth is no longer expected to buoy the global economy as it once did. The relations with the West have soured and do not appear to be reversing any time soon.

The production of goods and the changes in trade flows take time. Reshoring, near-shoring, and "friend-shoring" will spur capital spending and stimulate economic growth. India, Japan, Mexico, and Latin America may be beneficiaries of the changing global dynamics.

Equity Strategy

As per the adjacent chart, stock market indices have managed to make gains so far this year. The major Canadian and U.S. stock markets are up by 6 to 7%. It is the NASDAQ which has made impressive gains, up about 16%. Incredibly, half of the gains are the result of two stocks - Microsoft and Apple.



Incredibly, a total of just seven companies accounted for almost 90% of the entire advance. A truly phenomenal concentration of investor capital. Gaining more than $2.1 trillion in market capitalization year-to-date, these seven favourites are; Alphabet (Google), Apple, Microsoft, Meta (Facebook), Nvidia, Amazon and Tesla.

Concentration is never a good sign. The fact performance is not more equally dispersed shows the lack of commitment by investors to the broader economy. They feel safer in the larger and proven companies.

Overall valuation levels are still high for stocks. The P/E multiple (stock price divided by earnings) is at its high range on an historical basis. Cash and cash equivalents yielding 5%, are becoming a competitive challenge for stocks. Investors' sentiment towards taking risks may be changing.

The layoffs at Amazon showcase the challenges in the consumer sector. Consumer spending represents about 70% of the U.S. economy and Amazon is an important barometer. Importantly, Amazon has some of the best data in the industry and therefore is very aware of consumer spending trends. This is a company that typically invests in its business through good times and bad. While they did expand aggressively during this pandemic, the current cutbacks are alarming and perhaps a sign of things to come.

For the large technology companies, there are concerns from some quarters that the pandemic, and the shift to working remotely, pulled demand forward for tech products and services. This is what occurred during the Y2K upgrade cycle back in the 2000 Dot-Com era. There was a huge demand for technology products at the time. Revenues then plunged over the subsequent year. While the scenarios are not likely to be the same, recent comments from Taiwan Semiconductor, the world's largest semiconductor manufacturer and a major supplier to both Apple and Nvidia, suggest that business conditions are soft. A good reason to be careful and to not overpay for growth stocks.

We are maintaining a cautious approach with portfolio weightings in stocks at the lower range of investment mandates. Current conditions do not favour an aggressive posture. Our emphasis is on defensive sectors in Consumer Staples and Utilities, and companies with higher dividend yields that should do relatively well in this challenging environment.