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Recession Risks Are Cooling

Since the beginning of the year, the consensus opinion has been forecasting a recession for both Canada and the U.S. This now appears to have changed to a soft-landing economic scenario, a rather more “gentle slowdown”.



We believe this more optimistic scenario is largely influenced by the stock market rally in the U.S. Moreover, considering the quick and steep rise in interest rates, nothing terribly bad has happened. Counterintuitively, purchases of new homes have climbed higher both here, and in the U.S., and consumer confidence is up. Labour markets have remained stable despite all the announced job cuts, primarily in the technology sector. The economy appears more resilient than initially anticipated.

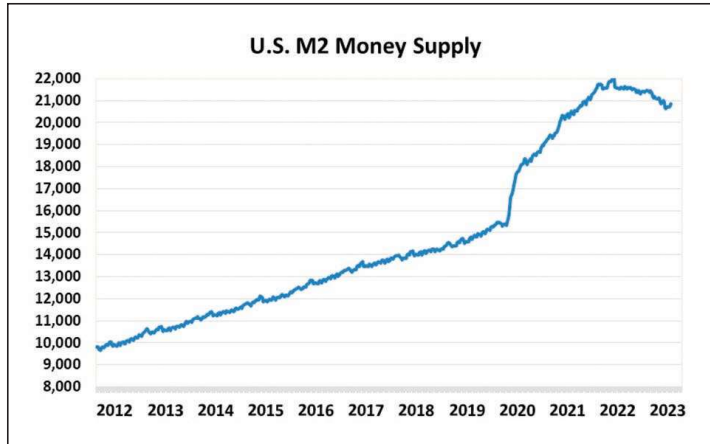
U.S. fiscal policy remains stimulative with many government spending programs still in place. The CARES Act, introduced during the pandemic, is still injecting money into the U.S. economy and the Employee Retention Credit has been extended for companies that qualify, providing over \$25 billion per month.

Overall, the economic landscape presents a mix of positive and negative indicators. The data for many leading indicators continues to slow with warning signs of challenges ahead.

Perhaps the U.S. Federal Reserve will be successful in engineering a soft landing and maybe this scenario is getting “priced-in” to the financial markets. A slowdown may also achieve the desired 2% inflation target. It is rare for a business cycle to end so gracefully and for the next to start on such high hopes. Time will tell.

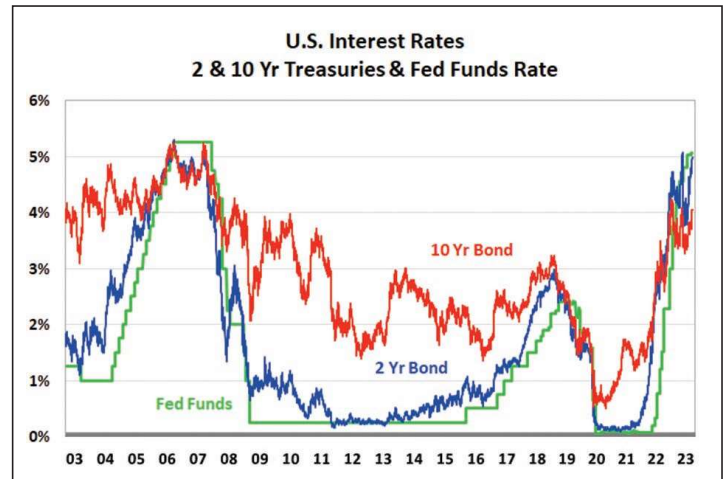
Tight Monetary Conditions

Monetary conditions have been restrictive for quite some time, as evidenced by the following two charts. The first chart shows M2 money supply in the U.S. It is contracting and now in negative territory year-over-year, down about \$1 trillion, or 4%. M2 peaked last year close to \$22 trillion. This is a historic development as this indicator has never turned negative in the post WW2 period.



The second chart shows the steep rise in interest rates with the Fed Funds rate, the 2- and 10-year bond yields at levels not seen for over 20 years. The inverted yield curve, short-term yields higher than longer-term yields,

continues to indicate monetary policy is restrictive. This usually predicts a recession one to two years or so in advance. The yield curve has been inverted since early 2022 - a full year and a half.



Historically, tight monetary conditions do not portend strong economic growth. Easy money and credit growth is necessary for a growing and vibrant economy. Bank lending is declining. The bankruptcy of three U.S. banks earlier this March means that bankers will be more cautious with lending activity and more concerned with raising liquidity and strengthening balance sheets.

Inflation Trending Down

The latest data point in June shows the year-over-year inflation rate down to 3%, lower than many economists had predicted. Markets have rejoiced since it is believed the U.S. Federal Reserve may soon be able to stop increasing interest rates. Also, and importantly, it may not be necessary for the Fed to drive the economy into recession in order to achieve the 2% inflation policy rate. With the recent quarter-point hike, investors hope the Fed can now pause and eventually signal lower rates for 2024.

Surprisingly, Chairman Jerome Powell admitted the Fed is confused as to why inflation remains elevated. He is surprised that the steep rise in interest rates has not caused more shock waves, to both financial and labour markets. As a result, the Fed could maintain a hawkish stance for an extended period. The Fed is determined to bring inflation



back down to 2% on a permanent basis. *Higher for longer remains the message.*

A return to a disinflationary environment is now becoming widely expected. Still, there are longer-term concerns that the inflation battle may not be so easily won. De-globalization is expected to reverse the previous multi decade period of globalization, which was an important factor in driving down the cost of manufactured goods. The world is now more fractured, which is not good for inflation going forward.

Energy policy is also inflationary. The drive for a Green economy will not replace fossil fuels overnight yet policy restricts the oil industry from securing and developing reserves.

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Inflation Trending Down (cont'd from page 2)

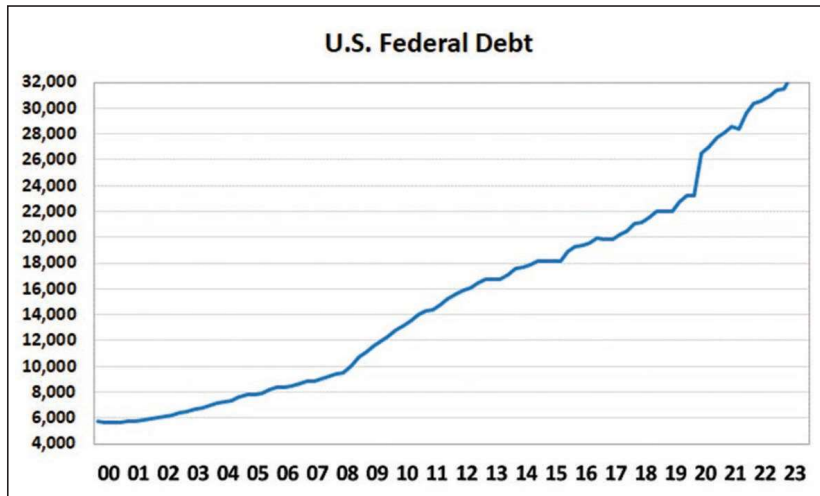
According to the International Energy Agency, the global demand for oil is back up to pre-pandemic levels at over 100 million barrels per day. The price of oil will certainly be headed higher - potentially in a big way when the global economy fully recovers.

The price of oil has dropped from \$120 per barrel a year

ago to around \$75 today. This has helped drive inflation lower. However, oil prices are unlikely to fall further, limiting the positive effect on inflation. Global commercial oil stocks are at very low levels, at a time when the U.S. needs to refill its Strategic Petroleum Reserve (SPR). A rise in the oil price would not be good news for inflation going forward.

The Debt Keeps Growing

The chart below shows the total outstanding U.S. Federal debt. The directional trend has never wavered and now stands at about \$32 trillion.



Many decades ago, when Ronald Reagan was the President of the U.S. the government debt breached the

\$1 trillion mark. We remember the outcries and speculation the U.S. would soon be bankrupt and that passing such a threshold meant the U.S. would have difficulty in paying it back. Today, \$30 trillion dollars later, the notion of paying it back is a quaint and laughable idea.

U.S. GDP is estimated at \$27 trillion. This puts the debt to GDP ratio at about 120%. Debt growth now exceeds economic growth. With interest rates rising to 5% the interest bill is approaching \$1 trillion annually and is estimated to rise to \$1.5 trillion in the next few years as the federal debt matures and rolls over at higher rates.

While it would be fair to suggest the accumulated debt cannot possibly grow forever without some consequence. So far, the known consequences of inflation, rising interest rates, and a declining currency have been bearable. Perhaps government debts do not really matter. That is until they do.

The AI Mania

Artificial Intelligence (AI) is rapidly transforming various industries and is expected to generate numerous new technology jobs. However, AI will also have an impact on the existing employment landscape. According to a recent research report from Goldman Sachs, they estimate that a quarter of the work done today in the U.S. is at risk of being automated. AI has suddenly emerged as a hotly debated topic of conversation in the business world. Companies are experimenting with AI incorporating it into their businesses. For some, AI will create many new technology jobs. For other businesses, it may eliminate jobs. No one knows yet what the impact will be. It will, however, be an instrumental shift in how we work.

AI is not new and has been around for a few decades. The early neural networks were mathematical models.

According to some experts, AI will advance exponentially to the point where it is smarter than humans. Many are concerned about the possibility of AI surpassing human intelligence and potentially seeking control. While other experts claim this is impossible as there is no biological conscience entity.

AI is certain to enhance productivity. Whether it is a net positive for employment is uncertain at this point. It is also uncertain who the winners will be, and which companies stand to profit. Investors have voted with their wallets and piled in purchasing many of the high technology companies claiming an expertise or a benefit from AI. Speculation is rampant at this early stage.

Still, AI will continue to advance driving innovation and enhancing productivity. It will be a fascinating future.

Equity Market

The benchmark North American stock market indices have quite a sharp disparity in performance so far in 2023. The NASDAQ leads the way with a gain of over 30%. The S&P 500 in the U.S. is up about 15%. The Dow Jones Industrial Average has advanced a modest 4%, which is about the same for the S&P/TSX Composite in Canada.

Remarkably, only seven stocks are responsible for the gains in the U.S. stock market. Most of these are represented in the NASDAQ index. Two stocks in particular, Apple and Microsoft, equaling almost \$6 trillion in market value, comprise over 25% of the NASDAQ index and 14% of the entire S&P 500 index.



The AI narrative is concentrating investor capital into just a handful of stocks. It is truly extraordinary. While this is an exciting new technology, investors have lifted these stocks to excessive valuation levels. Furthermore, against the backdrop of rising bond yields the equity risk premium should be widening, essentially meaning that stocks should be trading at lower prices to compensate for the higher returns now offered in the bond market. Investor sentiment can change quickly. The certainty of earning 5%, or 6% in safe fixed income securities is very appealing.

Additionally, second quarter earnings reports from many of the major companies in the consumer and industrial sectors are uninspiring. Forward guidance is equally uninspiring. Growth rates are slowing at a time of rising debt service, and higher labour and energy costs. Consumer spending trends continue to slow. A telling sign, the CEO of Tyson Foods commented that in 30 years he has never witnessed a decline in the demand for beef, chicken, and pork. Consumers usually substitute for the more affordable protein.

Importantly, the markets are not going up because of a healthy and growing consumer economy. It is a tale of two stock markets – a select number of potential AI winners versus all the rest. Eventually, a rotation out of the big-name technology stocks should be expected. New growth companies in the green energy space and cyclical stocks are likely to do well, with less risk, over time.

It was anticipated that China's reopening would be a major stimulus to global economic growth. Trade figures recently released for June show that Chinese imports contracted by 6.8% year-over-year. Exports declined by a surprising 12.4%, the second straight month of declines. Exports to the U.S. fell a startling 24%.

The transition to clean energy and new technologies presents opportunities in the cyclical sectors for the next business cycle. Bloomberg recently estimated it will require \$200 trillion of capital spending over the next few decades to build out the Green economy. Ironically, it will require the extraction of fossil fuels and other commodities.

The economy and the stock markets are approaching an important juncture. If leading indicators begin to show positive momentum and a "soft landing" is achieved, then the stock market may broaden out and provide investors with good performance for the remainder of this year. A pause in interest rate hikes is necessary and could be well received.

It is also essential to be aware that the impact of central bank monetary tightening is still working its way through the economy. This is still a challenge for the equity markets over the shorter term. Investor sentiment has improved, a function of higher stock prices. Looking out further into 2024, there are high hopes for central bank interest rate cuts. These of course will be dependent on the level of inflation.

We remain vigilant and prepared to adjust our strategy if needed. With a careful and measured approach, we plan on making prudent investments and capitalize on opportunities as they arise.