

Fall 2023

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An Uncertain Outlook

The on-again, off-again recession narrative has pretty well defined the year. In January, a looming recession was the consensus opinion. Defying consensus, the recession has still to arrive. Recent comments from the U.S. Federal Reserve suggest they are pausing interest rate hikes. The Bank of Canada (BOC) has also messaged a softer tone and are holding steady for now.



Typically, Central Banks pause once they see evidence of falling inflation and weakness in the economy. The easing part of the cycle, actually lowering interest rates, only starts when recessionary pressures are already present. A recession typically comes fairly quickly after the peak in interest rates. There is no hard evidence yet of a recession, therefore interest rates are likely to remain high for the time being.

Still, the lagging effects from the sharp and aggressive rise in interest rates are starting to take hold. It has been a long slow process. The U.S. Conference Board's index of leading economic indicators fell again in September, down -0.7%. The index has now declined for eighteen straight months, the worst and most sustained decline since the Great Financial Crisis. The weakest areas were consumer expectations, housing permits and 'new orders' in the manufacturing sector. Europe is now in a de facto recession. The latest Purchasing Managers Index (PMI) is under 50 showing a contraction in both the manufacturing and services sectors. German manufacturing PMI is at 40.7. France has plunged to 42.6.

Paradoxically, September was a good month for U.S. consumer spending. Up .7% month over month. Retail sales surprised most forecasts and reversed the soft data of the past several months. Despite the economic obstacles, consumers threw caution to the wind in September, going further into debt.

Government spending has played a big part in helping to keep the economy afloat. The Biden administration ran a \$1.7 trillion budget deficit in fiscal 2023, ending September 30th. Federal receipts fell by 9.3% to \$4.44 trillion, and spending soared to \$6.13 trillion. Interest expenses rose 23% to \$879 billion. This is a doubling of the deficit in one year at a time when economic conditions are stable and near full employment. This is a contributing factor to why the GDP has held steady and not declined meaningfully, as many expected.

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An Uncertain Outlook *(cont'd from page 1)*

Labour markets continue to show resilience, holding up rather well. Although conditions are not as robust as they seem. There have been seven months in a row of downward revisions to the employment data. The dubious monthly jobs report is the fault of the Bureau of Labor Statistics (BLS). It uses models to estimate the number of jobs created and lost.

These models are not as accurate at major turning points in the economy.

The financial and economic landscape is complex. Central Banks typically overreact to the inflation threat and implement a restrictive monetary policy that exacerbates the economic downturn. The outlook remains uncertain.

A Secular Change

The economic and investment environment may be at the beginning of a long secular change. We have just witnessed over a decade of low interest rates which fueled the rise in all major asset groups - stocks, bonds, and real estate. Borrowing ballooned. The majority of investors still expect a return to the good old days and for Central Banks to eventually lower interest rates. This may be wishful thinking.

Since 2020, the year of the pandemic, money supply in the U.S. has risen by 40%. Monetary easing has its consequences and is fundamentally inflationary. The Federal Reserve understands it made a policy error by expanding the money supply and keeping interest rates so low for so long. Zero Interest Rate Policy, or ZIRP, will not be repeated. Central banks have learned their lesson and are now dealing with the consequences of printing too much money.

The next decade will likely be a period of higher-than-average inflation and interest rates. A wage price spiral is beginning with labour unions making demands for increased compensation. The United Auto Workers, (UAW), under a tentative agreement, have settled for a more than 30% pay rise over the next four years. The average compensation,

including benefits, is now well over \$150,000 a year. Many other sectors, such as Healthcare and Hospitality are making similar demands on their employers. After a decade of practically zero wage price growth, the tide has changed. Behavioral economics suggests once behaviour and attitudes change, they become entrenched. Strikes and protests demanding higher wages, and the shortage of unskilled workers, will put pressure on inflation.

The outbreak of hostilities in the Middle East is troubling. A larger regional conflict threatens. War is always inflationary as it uses resources and drives up spending. Global tensions have risen since the onset of the war in Ukraine. Sanctions and protectionist trade policies have disrupted international commerce. As businesses adjust to a multipolar world, costs will inevitably rise.

A secular change will require a change in investment strategy. Commodities and cyclical sectors should be major beneficiaries. For large institutions and pension funds, capital reallocation will be a multi-year process. Investors will need to be diligent as a secular change of higher inflation and higher interest rates has a high probability of occurrence.

Households are Stretched

There are many financial challenges facing households on both sides of the border as inflation continues to erode purchasing power. Despite the claims of "high cash balances", households are depleting their savings. The increase in expenses, primarily for food and energy, and a lack of income growth has depressed the savings rate. According to the website Trading Economics, the U.S. savings rate has decreased to 3.4%, from 5.3% in May.

To cope with rising costs, credit card usage is up as well as "Buy & Pay Later" credit programs. Overall, consumer sentiment is deteriorating, evidenced by consumer surveys that cite rising food and fuel prices. Bank of America stated that their credit card delinquencies

have increased 50%, year-over-year, rising to 2.1% from 1.4%. The CEO of the bank, Brian Moynihan commented that, "U.S. consumer spending continues to slow."



The resumption of student debt payments is also adding to financial burdens. A moratorium on student payments has been in place for over three years, since 2020, at the start of Covid. The outstanding debt is estimated at \$1.63 trillion.

Monthly payments have now resumed and will certainly be a headwind for consumer spending.

The Fed is advocating a higher-for-longer interest rate policy,
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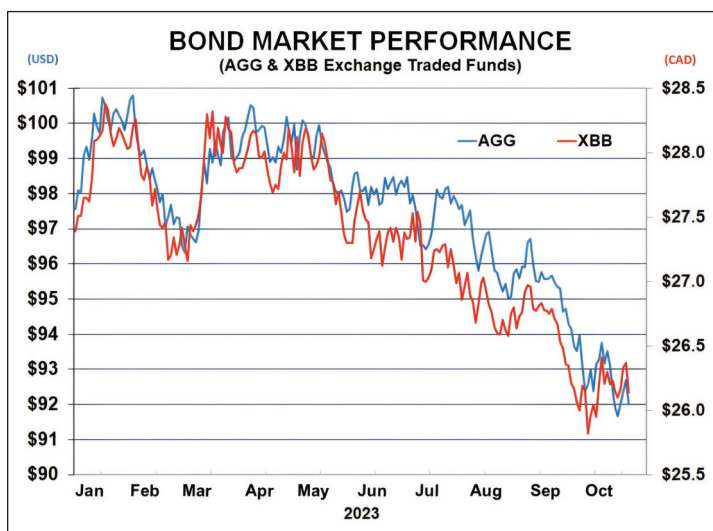
Households are Stretched (cont'd from page 2)

meaning unless there is a financial accident requiring a change in policy, the Fed will keep interest rates high for longer than expected. The consensus opinion appears to be shifting with many financial commentators suggesting the

Fed has finished raising interest rates. Importantly, The Fed's balance sheet is expected to decline as bonds are sold, at a rate of \$98 billion per month. This will put upward pressure on interest rates especially as fiscal deficits are also adding to the supply of bonds.

Bond Market Rout

The bond market has suffered its worst performance in more than 30 years. The chart below plots two popular fixed income Exchange Traded Funds (ETF). 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 8% so far this year. Investors have again lost money in what is normally regarded as a safe and conservative investment.



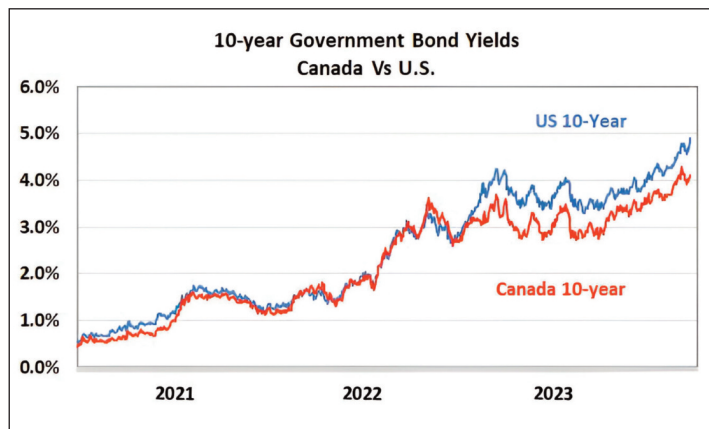
Bond yields keep rising, as shown in the adjacent chart of U.S. and Canadian 10 Year government bonds. At close to 5%, U.S. bond yields are now back up to where they were almost 20 years ago. In 2006, the yield on 10-year bonds peaked at 5.24%.

Perhaps bond yields have now adjusted for the higher risk environment of potentially surging oil prices and massive fiscal deficits. Still, some fixed income analysts suggest

longer term bond yields are not offering enough return given these longer-term risks. With the economy operating at close to full employment, deficits during a recession would swell making the current red ink look frugal in comparison. This may be the most significant and alarming concern for bond investors.

As well, Jamie Dimon, CEO of JP Morgan, has recently weighed in commenting the Federal Reserve could raise interest rates an additional 75 basis points due to "stickier" inflation going forward. Jerome Powell, Chairman of the Fed, is unequivocal, in a recent speech saying, "additional evidence of persistently above-trend growth, or that tightness in the labor market is no longer easing, could put further progress on inflation at risk and could warrant further tightening of monetary policy."

At the very least, it appears that "sticky" inflation means interest rates will also be sticky. Bond investors may need to wait a bit longer before the water is safe again to swim in.

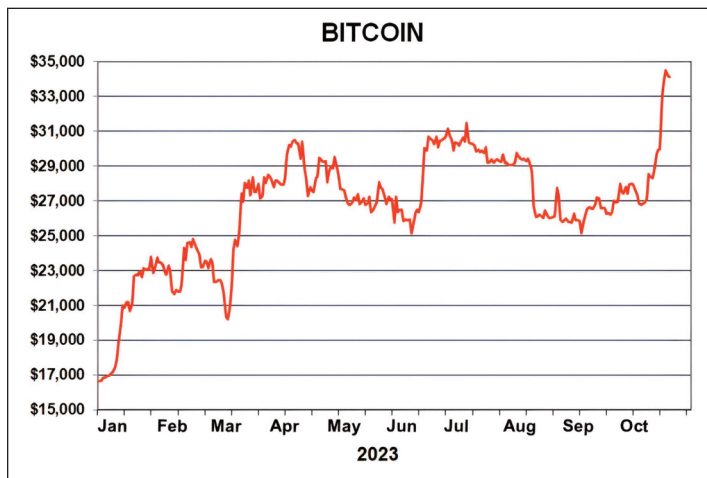


Bitcoin Returns

Bitcoin is staging another rally. The price has doubled in the past year from a low of around 16,000. In the past month it is up almost 30%, in hopes that the Securities and Exchange Commission (SEC) in the U.S. will soon approve the first physical Bitcoin exchange traded fund (ETF). This past summer, Grayscale, a crypto asset manager, won an important legal battle over the SEC. Very recently, the SEC

declined to appeal the ruling, setting the stage for the current speculation in Bitcoin. Major asset managers Blackrock and Fidelity, along with ten other institutions, have filed for their own Bitcoin ETF's. These developments will make it easier to purchase Bitcoin.

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Some are suggesting that Bitcoin is becoming a safe haven asset, as the predicaments in the bond market and the banking sector have reduced confidence in the financial markets generally. Fiscal mismanagement is also a concern

as the current administration in the White House spends with abandon. Increasing debt and increasing interest rates have investors looking at other options to invest their capital.

Bitcoin has been characterized as “digital gold”, and so a flight to safety trade makes some sense. Gold has long played that role. The geopolitical backdrop has changed for the worse with the outbreak of war in the Middle East between Israel and Hamas. A wider regional conflict could escalate which could certainly drive the prices of both gold and Bitcoin higher, and lest we forget, including of course the price of oil.

As well, the next Bitcoin “halving” is expected in April of 2024. This event occurs every four years and reduces by half the number of Bitcoin earned by Bitcoin miners as rewards for validating transactions. In previous such periods, the halving event has always sent the price of Bitcoin higher by reducing the number of coins created. Reduced supply brings scarcity, and this typically increases demand. The prospects for Bitcoin in the next several months are potentially explosive.

Equity Market

The “Magnificent Seven”, as they are known, (Amazon, Apple, Tesla, Microsoft, Nvidia, Google and Meta) have led the way year-to-date and contributed to virtually the entire performance in the U.S. stock market, as measured by the S&P 500 index. These seven stocks now represent 29% of the S&P 500. By contrast, the equal-weight S&P 500, which measures performance equally for all stocks regardless of size, is flat for the year, as is the S&P/TSX Composite. The Russell 2,000 index of smaller companies is down by approx. 3%. It is a tale of contrasts with the large “mega” growth companies, the obvious fan favourites.

There are more companies reporting weaker sales numbers in this third quarter. Forward guidance is also decidedly weaker. The Conference Board’s CEO confidence index slipped from 48 to 46 for the next quarter. Economic expectations (for the next six months), fell to 43 from 45. The outlook for payrolls has declined as job cuts in the next year rose from 60% to 62%. At the margin, companies are preparing to manage their budgets more prudently.

The Price to Earnings, or PE multiple for the S&P 500 index is a lofty 20 times. This means that the rise in interest rates has not materially changed the fundamental valuation of companies. Despite rising interest rates and economic headwinds, Wall Street analysts are forecasting more than 10% growth in earnings for 2024.

Investors are realizing cash instruments and short-term

bonds are finally providing decent returns, at roughly 5%. A more modest PE multiple of 16 or 17 times on 2024 earnings may be more appropriate. This means stocks are at risk of a moderate correction from current levels.

“I have spent most of my life worrying about things that have never happened.” – Mark Twain

Maybe we worry too much about a potential recession and the prospects for volatile financial markets. Still, worrying is a good trait. A healthy amount keeps you focussed and alert. We believe opportunities will surface in the months ahead. In the meantime, reducing portfolio risk and having cash on hand remains a sound strategy.

