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Housing Outlook

The housing market in both Canada and the U.S. is mixed. Most major urban markets are firm, while housing inventory is up in many areas where speculation fueled large price increases during the pandemic, especially in Florida and Texas. In Austin, the number of homes for sale has climbed over the last two years and prices have decreased 20% from the 2022 peak. In certain parts of Florida, housing inventory this year has spiked. The U.S. Northeast, along with the GTA, appear fairly stable. There is still a shortage of homes for sale.

The shortage of resale homes in the U.S. is partly a function of higher mortgage rates. The 30-year mortgage rate is still about 7%, which makes it a challenge to transact. The majority of U.S. households refinanced when rates were low and are carrying mortgages under 4%. The institutional market in the U.S. is also a factor in the housing market. Publicly listed and private companies have been buying homes for the past fifteen years, since the Great Financial Crisis of 2008/9, and renting them out. The institutional market is estimated to own 27 million homes, or one quarter of all homes in the U.S. As an example, FirstKey Homes was bidding up and buying properties in Florida during the pandemic. They are now in the process of selling. In certain communities in the U.S., the housing market has quickly changed from a seller to a buyer's market.

Still, interest rates are likely heading lower over the next year. The demographics are positive with a huge cohort of millennials hoping to buy their first home. Housing inventory in most markets is still insufficient to meet the expected demand. Housing activity is expected to rise, and prices should stabilize in most markets.



Consumer Spending

During the pandemic, consumers heavily indulged in *goods* purchases while in lockdown and shifted their spending to services upon reopening, significantly contributing to the resilience of the U.S. economy. This trend of robust spending is now fading. The first half of 2024 has seen real consumption growth slow to an annualized rate of 1.4%, a drop from over 3% in the latter half of 2023. The slowdown in consumption is directly related to real disposable income growth, which has averaged just 1.3% so far in 2024, compared to an average annual increase of 4.1% in 2023.

Notably, spending on goods has been weak throughout the year, with a marked slowdown in auto sales indicating consumer reluctance to make major purchases. According to research firm NielsenIQ, consumers are still visiting stores regularly, but are buying fewer items during each trip. Regarding the services sector, according to the

National Restaurant Association, spending at restaurants in May fell to its lowest level in seven months.

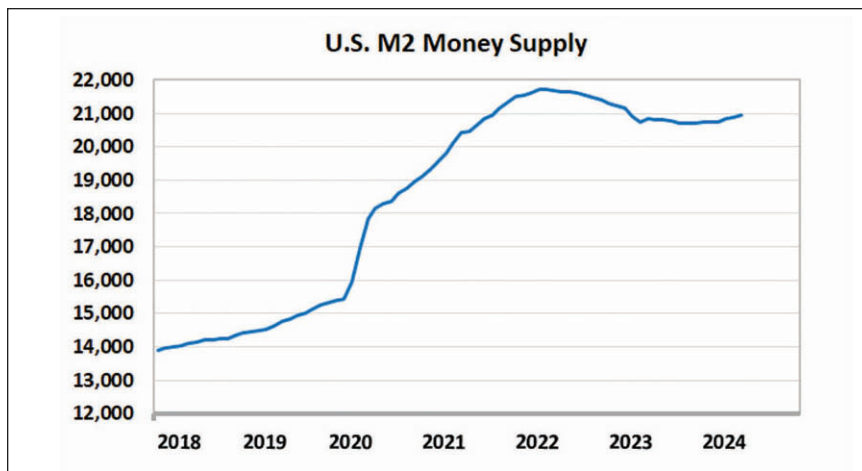
Consumer sentiment, as measured by the University of Michigan, has fallen to an eight-month low and remains well below pre-pandemic levels. More and more companies have indicated a softening in spending. The CEO of Best Buy stated recently consumers are making “tough choices with their budgets.” Shoppers are becoming more price sensitive and with sales stagnating, retailers are again returning to offering discounts.

Inflation and higher interest rates continue to squeeze household finances. As real incomes decline and savings are drawn down, more households have turned to debt to support lifestyles. Credit-card balances outstanding have risen to \$1.33 trillion, up from \$970 billion during the pandemic low back in April 2021. Delinquencies are also rising, highlighting growing financial strains.

M2 Money Supply

The chart below is an update of the M2 money supply in the U.S. The economic impact of changes in monetary policy are well documented, however the changes become evident only after a significant lag. The actions taken by the Federal Reserve during the pandemic were unprecedented. The huge increase in M2 was driven by massive deficit spending and temporary tax cuts, resulting in a surge in inflation during 2021-23. Many analysts overlooked the correlation between the increased money supply and rising inflation, attributing the inflationary pressures to other factors like supply chain disruptions and geopolitical events. The “transitory” nature of inflation did not materialize, with consumer prices continuing to rise significantly.

As the Federal Reserve continues to downplay the role of the money supply in its analysis, recent academic work and economic forecasts have begun to highlight the critical link between money supply and inflation. Notably, a paper by Greg Mankiw, professor of economics at Harvard University, pointed out the accuracy of inflation forecasts that considered the surge in M2. This recognition underscores the importance of the money supply in understanding inflationary trends. Currently, with M2 down from its peak and showing very modest growth, the economy has started to show signs of cooling. This is evidenced by the recent softness in economic growth indicators like retail sales, durable goods and the slight pick-up in unemployment.



Looking forward, the trajectory of M2 will play a crucial role in shaping the economic outlook. If M2 continues its modest growth, the economy might achieve a soft landing with inflation gradually moving towards the Federal Reserve's 2% target. However, a renewed decline in M2 could increase the risk of a recession. While M2 is a lagging economic indicator, investors should closely monitor its movements to better anticipate and respond to economic developments.

U.S. Elections

Recent developments suggest Trump could be in the White House again for a second term.

Under a Trump administration, the U.S. economic landscape could be poised for significant shifts. Still, we do not expect a change in monetary policy, and any significant change in fiscal spending is also unlikely given Trump's record. The federal debt increased by \$6.7 trillion, or 33%, during his first term in office. Additional tax cuts and potential trade wars could aggravate this, leading to unsustainable debt growth.

Tax reductions and deregulation are to be expected. Collectively, these policies should create a favourable environment for corporate profit growth and could lead to a broader economic expansion.

A critical concern would be the implementation of tariffs. The proposed tariffs include a significant 60% on Chinese imports and a universal 10% on goods from other trading partners. Tariffs pose a substantial risk of retaliatory measures. Analysis by Wells Fargo highlights the likely

economic repercussions of such tariffs, predicting a stagflationary shock where GDP would contract while core CPI inflation increases. This scenario could certainly undermine the America First program and could lead to prolonged economic instability.

Trump's desire for a weaker U.S. dollar saw the US dollar index fall by approximately 9% during his first term. Trade wars could further pressure the U.S. dollar, although its status as the global reserve currency remains strong despite challenges from the BRICs nations, i.e. Brazil, Russia, India and China. The U.S. dollar's decline might continue as global investors and central banks divest U.S. treasuries and securities.

Inflammatory rhetoric will not cure the many challenges the U.S. economy faces in the next four years. Balancing the growing budget deficit, currently approaching \$2 trillion, will be a major challenge. Whoever wins the White House will have some work to do. Unfortunately, debt and deficits are not a priority with either party.

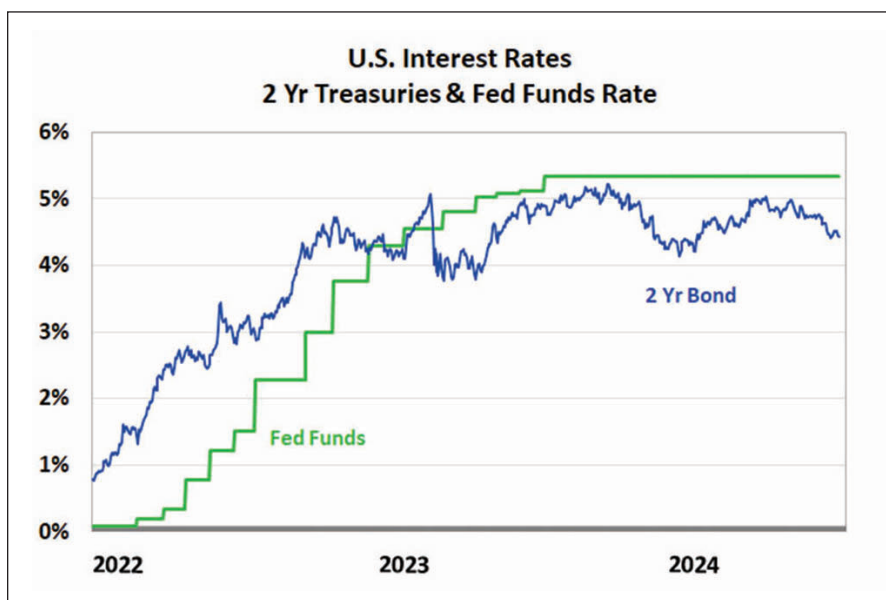
Bond Market

Following the most significant rate hike cycle since the 1980s, interest rates have reached their highest levels in over two decades, presenting an attractive opportunity for investors. These high rates allow for considerable returns on various fixed income securities with relatively low risk. With monetary policy highly restrictive, the likelihood of further rate increases is minimal, greatly reducing the risk for bonds. Moreover, as the economy

begins to adjust and inflation decreases, anticipated rate cuts could further enhance capital gains in the bond market.

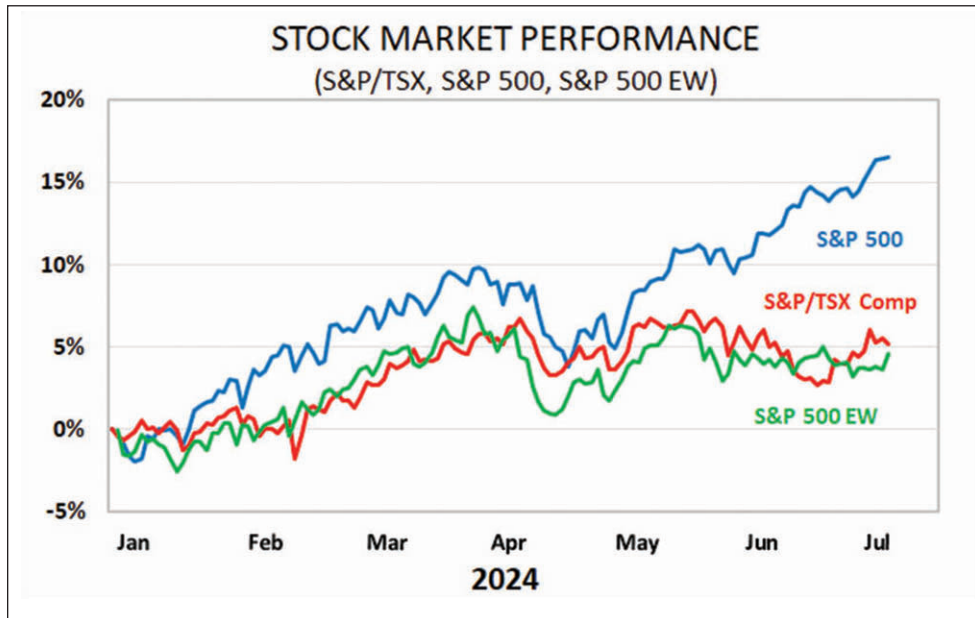
The chart above shows the U.S. Federal Funds rate compared to the two-year bond yield. The two-year yield is again declining. The Fed Funds rate typically follows the shorter end of the yield curve. It is expected that the Federal reserve will soon reduce interest rates, likely during their September meeting.

This situation sets up a favorable risk-reward scenario for fixed income investors, with bond yields at a two-decade high, minimal chances of additional rate hikes, and a strong likelihood of future rate reductions providing both attractive income and capital appreciation potential. Investors who have traditionally placed their money in high-interest savings accounts, money market funds, and GICs should now recognize the enhanced income and capital return possibilities offered by bonds, making this an opportune time to consider reallocating into longer term fixed income instruments.



Equity Market

The dominance of the large high-growth and technology stocks, the “Magnificent 7”, continues. The top six companies, Nvidia, Microsoft, Apple, Google, Amazon and Meta/Facebook, accounted for 65% of the gains in the S&P 500 so far this year. *Nvidia alone was responsible for 1/3rd of the advance of the entire index.* In sharp contrast, the remaining stocks in the S&P 500 index were down for the year.



The adjacent chart shows the year-to-date performance of the S&P/TSX Composite index, the S&P 500 index and the S&P 500 Equal Weight (EW) index. As the name implies, the EW index treats all stocks equally, as opposed to giving a higher weight to the largest companies. The EW index better reflects the aggregate performance of all stocks.

The Magnificent 7 group of companies is ripe for a correction simply based on their excessive valuations. To illustrate just how excessive, the top three companies, Nvidia, Microsoft and Apple, have a collective market capitalization just shy of \$10 trillion. This almost equals the value of the entire European stock market.

Nvidia is now the largest valued company with a market capitalization of \$3.2 trillion dollars. Trading at over 40 times its annual sales and is over 12% of U.S. GDP. This compares to Cisco which at its peak in 2000 during the DotCom craze, traded at about 5% of GDP. The investor appetite for large high tech growth stocks is truly mind boggling. The Price to Earnings (P/E) multiple for the S&P 500 index typically ranges from 16 to 20 times. P/E multiples of 40 times are considered high. A *Price to Sales* multiple of 40 times is extreme to say the least.

AI is already a powerful tool, and it has the potential to be a transformative technology. Still, it is not yet advanced enough, or profitable to the leading companies, to justify the huge valuations. Investors are caught up with the hype and believe growth rates are infinite.

The narrative in the energy sector is changing. The notion of “peak oil” being imminent and the sector facing

obsolescence due to stranded assets or rapid decarbonization is inaccurate. Recent analyses, including those from Goldman Sachs, suggest that peak oil demand is still at least a decade away, with a gradual decline expected only post-peak. This underscores a continued, and even increased need for Canadian oil and natural gas production.

The Canadian energy companies remain undervalued, trading at significant discounts compared to U.S. counterparts, and showcasing the strongest balance sheets in its history. Canadian energy companies are not only generating record amounts of free cash flow but are also actively returning this capital to shareholders

through dividends and share buybacks. This sector, although less significant, is still an important component of the S&P/TSX Composite index. A higher appreciation by investors for the value it represents will help in improving the performance of the Canadian stock exchange index.

“Animal spirits” in equities can continue to drive momentum in the near term, potentially leading to much higher stock prices. The anticipated interest rate cuts may initially be viewed enthusiastically. Still, volatility is pervasive for companies that miss their earnings and guide down expectations. Investors are reacting more sharply to negative news. This is a sign of a nervous, and uncertain market.

Considering the evolving macro landscape, including stubborn inflation, higher oil prices, a softening labor market, and increasingly frugal consumers, it is prudent to stay the course with a defensive investment strategy. It should also be remembered that the investing time frame is not a 100-yard dash. It is a marathon over an entire business cycle.