# Fourth Quarter 2019

## Government Stimulus to the Rescue!

Economic Activity Rebounds, Slightly, After Governments Around the World Embrace Unprecedented “Recession Insurance”

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## Quarterly Summary and How We're Positioning for Q1

The vast majority of stocks markets around the world posted positive single digit returns in Q4 and double digit returns for all of 2019. The return picture is a little more mixed over the past two years after a decidedly bad 2018. US stock markets extended their gains over other markets over the past two years and are outperforming most other markets over 1, 3, 5 and 10 year time periods.

The global economic boom that started in 2009, the longest in US history, appears it is nearing its end. The US yield curve inverted in March 2019 and recessions typically occur six to eighteen months following yield curve inversion. That said, we are living in unprecedented times. Governments are spending like never before and central banks are coddling the economy like never before.

***Governments Gone Wild!***

Fiscal responsibility is no longer in vogue as governments run significant budget deficits, ten years into the economic expansion with no specified catalyst (e.g. war, natural disaster, recession, etc) for doing so. The US federal government is expected to run a ~$1 trillion budget deficit in 2019, or roughly 4.6% of GDP, by far the greatest budget deficit outside of wartime or recession. To put this in perspective, total nominal US GDP growth in 2019 was 4.6% and the 2019 increase in the US federal budget deficit accounted for over a fifth of 2019 US nominal GDP growth. It is easy to see that economic growth would likely be somewhat lower if the US federal government wasn't running a historic budget deficit.

This ongoing fiscal stimulus certainly could prolong the current economic expansion, but it will also likely increase the severity of the eventual downturn as unsustainable debt accumulates in the government, corporate and household sectors. Even a lack of increases in the US federal budget deficit could be enough to bring GDP growth rates close to zero and begin to make some outstanding debt unsustainable.

The US is not alone when it comes to governments buying GDP growth. Canadian governments, both federal and provincial, are also running historically high budget deficits for being this late in the economic expansion. The majority of other G20 nations have been running meaningful budget deficits as well. On top of growing budget deficits around the globe throughout 2019, China and Japan announced in December 2019, one-time stimulus measures amounting to ~US$350 billion.

In addition to all of this fiscal stimulus, central banks around the world have been busy cutting interest rates to boost growth throughout 2019. Over sixty central banks around the world cut interest rates by a cumulative 30% with the US Federal Reserve accounting for 0.75% of that.

We now enter a brave new world where unsustainable debts are temporarily sustained by pre-emptive stimulus. Typically, we see a natural cyclical culling of weak and overlevered businesses followed by a stimulus induced "rebirth" of new businesses and economic activity. Only time will tell what happens when weak and overlevered businesses operate far longer than they otherwise should have, as per the old playbook. Our best guess is a more rapid and severe downturn than average when it inevitably arrives.

We believe that maintaining equity exposure is prudent until there is a clear signal that the current economic cycle has ended. This is especially important in this economic cycle given the uncertainty

around timing and amount of pre-emptive government stimulus and just how long the cycle can be extended by pre-emptive actions. Our favoured indicator remains the US Senior Loan Officer Opinion Survey (SLOOS) on Bank Lending Practices. We believe this indicator may be even more prophetic than in the past given the unnatural extension of the current economic cycle and excessive accumulation of debt relative to past cycles. This indicator has yet to indicate any significant stress in US financial markets, and as a result we remain confident in maintaining equity exposure.

***Economic Rebound Starting and Stocks Assuming a Full Rebound Lies Ahead***

Global economic activity has begun to pick up in late 2019 with the JP Morgan Global Composite Index PMI hitting its highest level in eight months, though activity remains near levels seen shortly after the 2012 eurozone sovereign debt crisis and 2016 energy market downturn so we are not out of the woods just yet. It is good to see stabilization of economic growth following a two-year downtrend in global economic activity but it is clear we're on borrowed time, literally, because of all the government borrowing.

Global stocks broke out to all-time highs once it was clear that the two-year decline in economic activity was subsiding. Time will tell whether stocks are right or not. Economic growth has a long way to go to justify current market valuations.

***UK Tories Take Control and Look to Brexit Come Hell or High Water***

In the UK, a snap election was called in late October and voting took place in mid-December. The Tory government led by Boris Johnson was able to attain a significant majority eliminating the need to pander to other parties during the Brexit process. UK parliament has already passed a revised version of a Brexit withdrawal deal and EU parliament is set to vote on the deal in late January. If the EU approves of the deal, the UK will officially leave the EU and trade negotiations will begin with a trade negotiation end date of January 2021. A majority Tory government adds some certainty to the equation but it is still unclear whether a new trade deal can be reached in that short time frame. Ongoing trade negotiations could continue to hinder capital investment in both the UK and EU throughout 2020.

***US-China Trade Relations Improving but Plenty of Work to Be Done***

The US-China trade war tensions cooled throughout the fourth quarter. A "phase one" trade deal, reached in principle in December and subsequently signed in mid-January, outlines the US would remove some tariffs, avoid initiating new tariffs and redact a US stance that China is a currency manipulator. In return, China will buy US agricultural goods, pledge to better protect US intellectual property and further open its financial sector to foreign companies. The phase one deal is a good sign of progress and goodwill, but with many of the tariffs still in place, it is hardly a solution to the US-China trade conundrum. As a result, the phase one deal may provide a short-term boost to investor sentiment, its impact on economic growth will likely be minimal.

***US-Iran Tensions Push Oil Higher***

Quarter-over-quarter the price of oil was higher, finishing at ~US$61 (WTI) versus ~US$54 (WTI) at the end Q3. Oil prices steadily edged higher throughout the quarter but the bulk of the gain was toward the end of the quarter as the US-Iran conflict ramped up. American and Iran-linked attacks on military installations, an attack on the US embassy in Baghdad and the elimination of Iran's top general Soleimani was a tit-for-tat conflict that ended only with Iran accidentally downing a Ukrainian airliner carrying mostly Iranian and Canadian nationals.

***Positioning Heading into Q1***

Given we are likely very late in the equity market cycle, we believe it is prudent to maintain diversified equity market exposure but with a strong tilt toward value, quality and low volatility stocks. We believe maintaining a meaningful weight of high quality fixed income exposure makes sense here as a risk offset. High quality fixed income securities (e.g. government bonds, investment grade corporate bonds) have declined from their August 2019 highs and interest rates are now a bit higher and slightly more attractive. In Q3 we stated "*we believe it is more likely that a recession and market downturn occurs after a short-term, stimulus-induced burst in investor sentiment rather than following a long period of gloomy investor sentiment*" and we have now seen this stimulus-induced burst in investor sentiment. Time will tell how long this burst lasts. You can expect us to be diligent about detecting any recessionary market downturn and taking advantage of this on your behalf.

Sincerely,

Steele Wealth Management

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