The Miatello Quarterly

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Let's connect

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The Charging Bull

The contrast between fourth quarter 2018 and first quarter 2019 could not be greater. Quarter 4 was the worst quarter since 1932. Quarter 1 was the best first quarter since 1998. What happened? The end of 2018 generally saw worsening economic news which fed into the bears' negative world view that the economic cycle, in play since 2009, was ending. However, the economic cycle wasn't ending. How it evolves is in large measure dependent on the US Federal Reserve. The US Federal Reserve slammed on the breaks when it stated, that given some incipient signs of economic weakness, it was lowering its projections of interest rate increases. Other world central banks, based on the same trends in their countries, came to the same policy decisions.

A quick summary would be as follows. The pace of US economic activity has slowed. This caused investors to aggressively buy the fixed income markets, because that's when you make real money in fixed income, raising prices and lowering yields. Lower long term bond yields make equites more attractive given the standard way of valuing equites using discounted cash flow analysis. The lower the discount rate, the higher the net present value. So stocks rally despite economic weakness because their value is greater in a lower interest rate environment.
Interestingly, this turn of events helps the re-election prospects for Mr. Trump. The US administration is now attempting to browbeat and stack the Federal Reserve with sympathetic members who can bend policy to political considerations. This is not a good outcome for long term economic health and hopefully there is enough resistance in Senate and the Congress to thwart Trump's current favourites.

In the Spotlight: Borg Warner Inc.

BorgWarner Inc. provides technology solutions across auto propulsion systems including combustion, hybrid and electric vehicles. Organically and through acquisitions, the company has positioned itself to profit from global trends such as clean air legislation, demand for fuel economy, and demand for SUVs and crossover vehicles. The company continuously innovates and produces highly engineered products that command high gross margins. It manufactures and sells globally to original equipment manufacturers on long term contracts.

The company is well positioned for an electric propulsion future currently providing many products including electric drive modules, power electronics, electric drive motors, and EV transmission eGearDrives. Together these components provide an integrated electric drive module. By 2023, the company expects hybrid and electric products will provide 32% of much higher company revenue versus 18% today. Overall company revenue is expected to be 43% higher in five years.

Revenue in the combustion vehicle segment is still increasing although at moderate rates. Products are centred on transmission technologies, boosting technologies and exhaust gas management. In these product areas, the company's market penetration is expected to significantly increase over the next ten years.

2018 revenue was $10.5 billion with earnings per share of $4.38. Analyst consensus earnings for the next two years are $4.64 and $5.18. The valuation metrics are very reasonable, and with expected company growth, may be rerated higher.

We own the stock.

Ask Brian

Hey Brian

Not that I look at the business pages that much but there seems to be a lot of articles written about the yield curve. What is the yield curve and why are journalists writing about it? Should I bother to read the articles?

Bob

Dear Bob:

Your questions pierce my bubble. That bubble would be the insular investment world bubble in which I live. The quick answer and one designed to simplify your life would be, don't read it. Ignore it all. But I will answer your questions.

You may have noticed that mortgage rates move up the longer the term of your loan. Those rates are based off the yield curve for federal government bonds. There is a vast bond market in the world with value of hundreds of trillions of dollars. In general, and under normal economic conditions, the bond buyers want more return for holding the bonds for longer durations. If you were to draw a line joining all the individual points of specific return and maturity, you would produce what is called a yield curve. The short end of the yield curve with maturities under two years is greatly influenced and almost determined by the central bank in each country. The interest rates for maturities from two to thirty years are determined by market participants. The market bases the return it desires on expected general economic conditions over the term to maturity of the bond in question.

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In general, if the yield curve is upward sloping, everyone is happy. If the yield curve starts to flatten or turn negative, with shorter rates higher than longer term rates, then the market becomes alarmed. There is a lot of angst and journalists produce a lot of copy inches. The reason is that the curve inversion indicates that the collective wisdom of people running trillions of dollars of capital is that the economy will be in trouble in the next year or two and that the central bank will have to lower short rates to stimulate the economy. The effect of lower short rates pulls down longer term rates meaning bond prices must go up. So they rush to buy now to beat others in the market.

Yield curve inversion must be sustained to have any economic predicative power. We continue to have a positive slope so it is full speed ahead.

Sources: Financial Times, BMO Capital Markets, RBC Capital Markets, J.P. Morgan, Barron's, Wall Street Journal, Borg Warner

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