The Miatello Quarterly

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BMO Nesbitt Burns

Let's connect

Miatello Investment Management
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US Federal Reserve Stiffens Spine

It is amazing to me that amongst industry insiders the innate market bullishness persisted through mid-August. Given that central banks have supported asset price inflation for 40 years, exceeding the life span and or trading experience of most market participants, I suppose this is understandable. Until mid-August the equity markets were convinced that the US Federal Reserve Bank would relent in their path to higher rates because it would cause short-term economic harm. The Jackson Hole confab of late August blew that hope apart. Chairman Powell forcefully stated that reducing inflation was the utmost priority and they would continue raising rates until there was evidence of future victory. The equity market was aghast and dove south accordingly. The bond market prices (yields rising) started sinking again so that today 10-year US bonds, the benchmark, were flirting with 4% yields.

By the end of the third quarter the stats looked grim. Year to date: Canadian bonds -11.8%, US Bonds -13.1%, TSX index -11.1%, USD S&P 500 -23.9%, USD NASDAQ (home of the tech stocks) -32.4%, CAD MSCI World Index -20.8%, CAD Euro Stoxx -26.6%. There was considerable damage. How much more was there to endure?

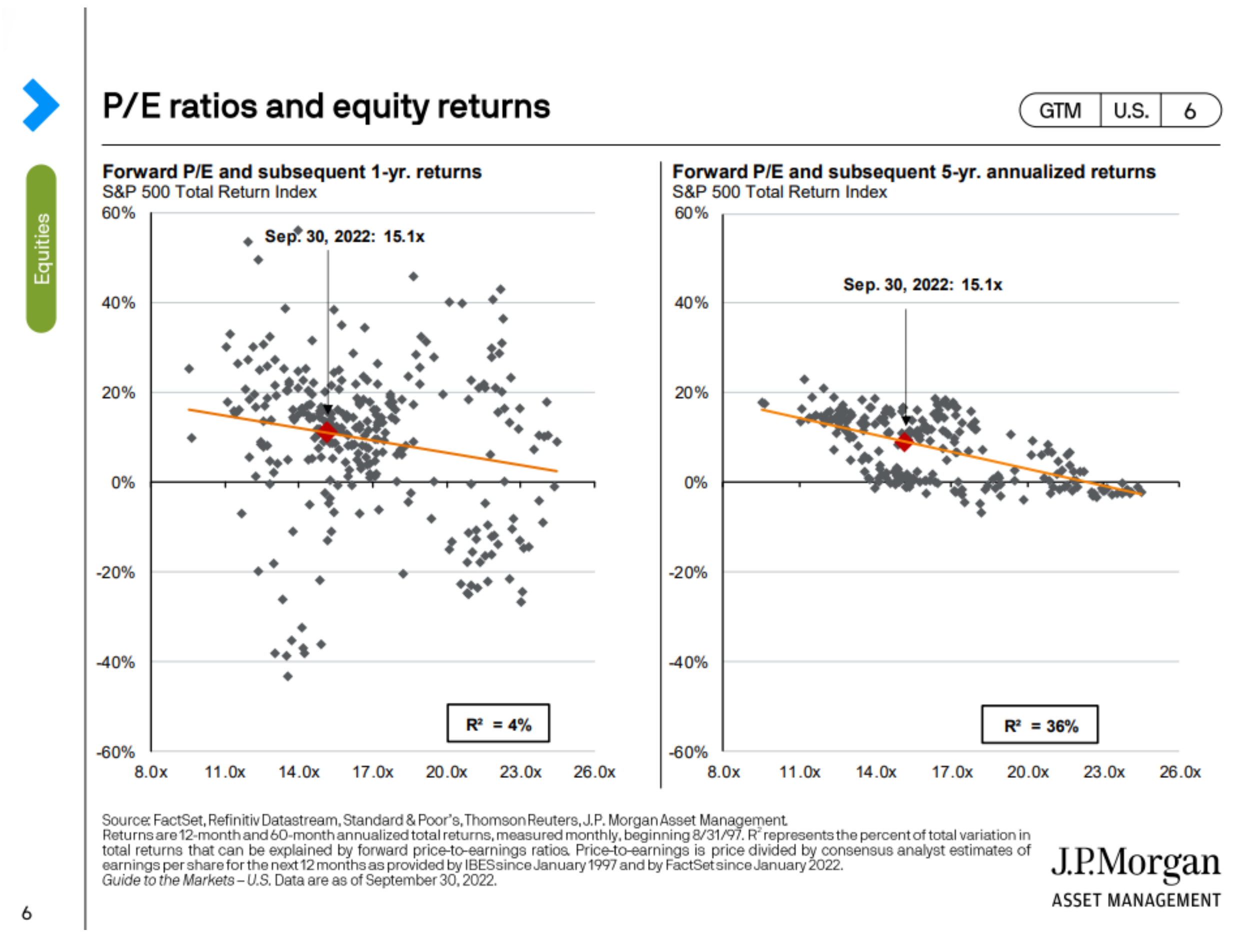
Traders concluded that there was not much more and seized on a marginal decrease in the US ISM manufacturing index to propel the index 5.9% higher in the first two days of October. Traders thought this was evidence of a slowdown and that the Fed would reverse course. Extreme movements are more pronounced now for a few reasons, but lack of institutional trading liquidity and general anxiety about getting the market direction wrong are prominent. Getting it wrong can cost your job.

A rising stock market is not what the Fed wants as it indicates their failure. It is not that they explicitly want this to happen, but the markets' movements are a judgement on their policy direction. After the two-day jump, a parade of Fed governors preached the gospel to the press, and the markets once again started declining.

What the Fed wants, in fact what all central banks want, is to reduce aggregate demand for goods and services to reduce inflation. Inflation is the biggest long term economic threat, not whether there is short to medium term economic pain. The Fed well remembers the failure of the late 70s US Fed when they gave up the inflation fight too early, and inflation exploded. The new Chairman Paul Volcker had to raise rates to 20% in June 1981 to finally have an effect.

For all of us this means more pain ahead. There is no hiding as even the real value of cash declines at the rate of inflation. The same dour outlook applies to real estate.

The chart on the right below shows the good probability of excellent five-year returns in the equity markets from these valuation levels.



The chart on the right also suggests that if the S&P500 sinks much further than the September 30th level of 3586, the 5-year returns would be higher still with greater probability of success.

Through the third quarter we sold fully valued companies and opportunistically bought into the decline those companies that offer under valued growth in the years ahead.

In the Spotlight: Schneider Electric

Schneider Electric is a France-based company whose mission is the enhanced and most efficient electrification of societies. The company is a global leader in electrical distribution, automation, and energy management products. Amongst its peers, Schneider is the best positioned globally for secular growth in data centers, building automation, smart grid, and electrification of fossil processes. It is the only firm with an integrated approach, offering all critical aspects of the value chain with superior market access combined with the largest exposure to the main profit pool in low-voltage products.

Over 128 thousand employees globally drove 2021 revenues of € 29 billion generating EBITA of ~ € 5 billion and earnings per share of € 6.23. 2023 estimates are for revenues of € 35 billion, EBITA of € 6.4 billion and earnings per share of € 8.61. Schneider trades on the Paris exchange at a current market cap of € 67 billion. The company has a record of consistently outperforming peers across electrical and automation end markets outgrowing them by 2% organically per year since 2018. When you are this dominant, you are wildly profitable and generate high cash flow. Free cash flow is now about € 2.6 billion rising to an estimated € 4.5 billion in 2024 which is a 4.5% yield.

In the current bear market, the stock has declined over 35% from its 52-week high. Today it trades at 13.5 x its estimated adjusted diluted 2023 € 8.61 eps.

We recently bought the company's stock.

Ask Brian about Journalists

Dear Brian:
How would you assess the guidance provided by financial journalists from the major newspapers? In other words, should I sit down and read the business section or take the dog for a walk?
Best regards,
Jason

Dear Jason:

That is an easy question to answer. Take the dog for a walk.

There are a couple of exceptions to that broad advice. One that comes to mind is Tom Bradley who writes infrequently for the National Post. His advice is based on a lifetime of experience as a buy side investment counsellor. Another in that category from the fixed income area is Tom Czitron, a new writer for the Globe. Other investment counsellors in the papers merely talk their book. Journalists who write frequently usually provide just daily information and spin familiar useless investment tropes. Some current general topics are "where to hide in a bear market" or "the merits of dividend growth stocks." You know there is a dearth of talent when one publication drags out an 86-year-old to write columns.

A major issue with journalists' Canadian investment recommendations is that they are Canadian investment recommendations. A client once said to me that if he were a resident of Rochester NY, he is sure that his equity portfolio that other advisors did for him would not have many Canadian equities. Outside of Canada there is little discussion about energy or bank stocks. The fact is Canada represents 2% of the world equity market yet Canadian stocks are the only securities in the press.
In summary, enjoy your walk and let me read the international press, research reports, and buy global companies.

Sources: Financial Times, New York Times, Washington Post, BMO Capital Markets, RBC Capital Markets, Scotia Capital Inc., J.P. Morgan, Barron's, Wall Street Journal, The Globe & Mail, National Post, Morningstar, Bloomberg, Schneider Electric