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BMO Nesbitt Burns

Miatello Investment Management
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Brian Miatello, CFA
Senior Portfolio Manager

1 First Canadian Place
39th Floor
Toronto, Ontario
MSX 1H3

Tel: 416-359-5793
brian.miatello@nbpcd.ca

www.miatello.ca

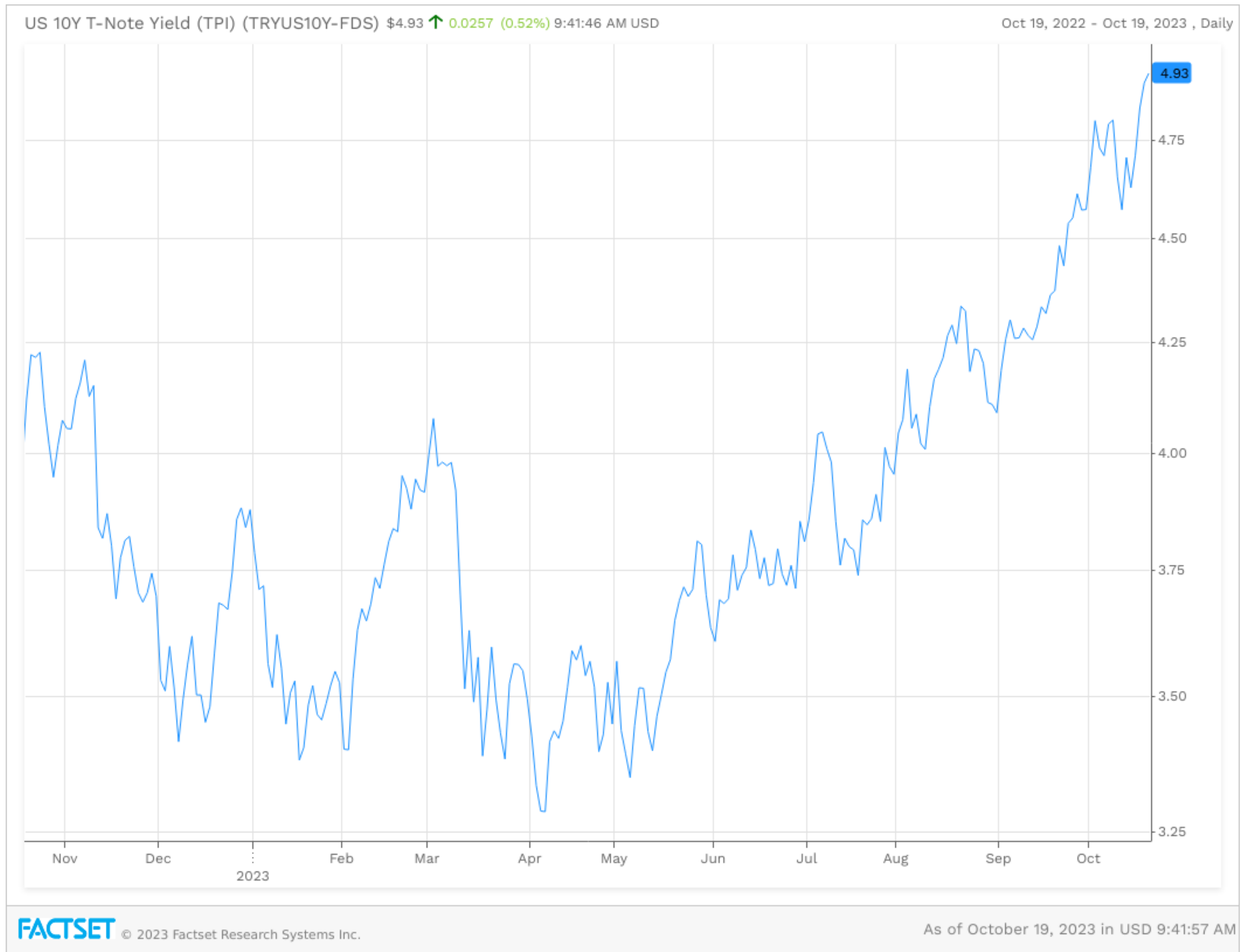
Return of the Bond Vigilantes

The US Bond Market is in a state of high anxiety. The benchmark Treasury 10 Year bond's yield has increased 1.5% since last spring and 0.75% in the last month. See the graph below. This is the highest yield seen since 2007. Over the last 16 years, the US Federal Reserve has been a bemouth that cowed the market. In times of crisis when long rates threatened to rise, the Fed would buy US treasury bonds and mortgage-backed securities, thus taking supply out of the market, increasing bond prices, and thus reducing yields.

The problem is that the US debt, because of running massive federal deficits, is 43% larger than four years ago. The misnamed Inflation Reduction Act, an unfunded multi trillion-dollar federal stimulus program, will be debt financed by bond issuance. As it is politically impossible to raise taxes to pay for the program, the bond buyers anticipate that the market will need much higher yields to attract bids. The Fed expects economic growth will raise general tax revenues. However, if a recession ensues, that will not happen, and the gap will have to be filled by bond issuance.

In times of uncertainty people sell their assets. In the Bond Market this action raises the yields.

What happens at these higher yield levels is that governments and central banks lose control of the economy, and the new ruler is the Bond Market. Are you doubtful? A recent UK example shows the Bond Market's power. In September 2022, PM Liz Truss' government said that it would slash taxes while ramping up borrowing in a bid to produce faster growth. Investors were concerned that the plan would push up inflation just as the Bank of England wanted to bring it down. Fears also crept in about the sustainability of government debt at a time of rapidly rising interest rates.



The pound crashed to a record low against the US dollar, while bond prices slumped, sending yields soaring. That pushed mortgage rates much higher and brought some pensions funds to the brink of default. Ms. Truss fired her Chancellor (Finance Minister) on October 14, and she resigned on October 20.

In the US market several risks exist. Ten-year rates have increased but short-term rates have not. This indicates structural changes to the Bond Market. In other words, there is a concern about demand and supply at the long (i.e., 10-year) end. The press acknowledges the markets starting to price in a "higher for longer" rate scenario, but the inflation expectations have not changed. So, what is the problem? Historically, both Japan and China have been huge, price insensitive, buyers of US Treasuries. If they reduced purchases by not rolling over maturities or executed outright sales, which seems probable, then higher rates would be required to induce other buyers.

Thus, the tables have turned. Bond Market Vigilantes now rule the US economy. The new regime will constrain the Fed and imperil the US Administration. The re-election possibility of President Biden is in doubt. We should consider the Bond Market a safety feature of modern economies that serves as a warning of economic risks ahead. Higher bond yields should shock decision makers into corrective action. Hopefully, they get the message.

In the Spotlight: RB Global Inc.

RB Global (RBA) is a new name in the portfolio with positions added in May and August 2023. The company recently changed its name from its historical name, Ritchie Brothers, which may be more familiar to some people.

RBA was founded in Kelowna BC in 1958 and conducted its first industrial auction in Radium Hot Springs in 1963. Growth was steady and it went public in New York in 1998 when revenues were US$1 billion.

Historically, RBA was an auctioneer of industrial equipment and, with this year's acquisition of IAA Inc. ("IAA"), also of salvage automobiles. The company is a global dominant player in the auction marketplace. RBA's early roots are in physical auctions, but the business shifted seamlessly to 100% online bidding at the onset of the pandemic.

The great liquidity of their auctions has a compounding or a "network" effect in that it attracts more sellers and buyers and raises transaction prices. RBA charges sellers a commission and charges fees to buyers as well. RBA has three broad revenue areas: automotive, commercial construction and transportation, and other categories including agricultural, oil and gas, government surplus verticals, and equipment attachments.

The acquisition of IAA for $7 billion this year was a controversial large transaction. The deal was opposed by the two main proxy advisory firms, but RBA won over key shareholders to close the transaction. The acquisition was driven by then CEO Ann Fandozzi. In an interesting move last August, the Board of Directors forced Ms. Fandozzi out over an apparent compensation dispute. Taking over was COO Jim Kessler who has background and connections in the insurance industry from his time in the auto collision space. This experience is important to the integration of IAA. The IAA acquisition should be transformative for RBA. Cost synergies of $100 million and revenue synergies of $350 - $900 million of EBITA are expected.

Over the last decade RBA has become a multi-channel, full-service marketplace for customers looking to buy, sell, and manage their used equipment. The evolution from auctioneer required investment in technology platforms and several small tech acquisitions. We assess RBA as a multi- year growth opportunity.

RBA has a market cap of US$11.9 billion. Focus for management over the next two years will be to reduce leverage from ~3.0 x to ~2.0x. After that they will refocus on specific complementary acquisitions. The one year forward price/earnings multiple is 27.

Ask Brian about 60/40

Hi Brian:

I have heard that the ideal portfolio allocation is 60% stocks and 40% bonds. Is that true?

Regards,
Bill

Dear Bill:

Thanks for this important and timely question.

The concept behind this idea is the normal negative correlation between the two asset classes. When stocks go down, bonds should go up, and vice versa. The stock market goes though a secular decline when the business cycle turns down and companies earnings decline. The central bank cuts short term rates to mitigate the negative economic effect. Investment managers sell stocks and buy bonds of all maturities with the proceeds. This action increases the returns to existing bond holders as the bond prices increase. This pattern did not work in 2022 and may not work this year. It would seem like an appropriate time to raise the question.

Western University's Ivey Business School professor Stephen Foerster recently wrote a piece in medium.com on this issue. Foerster spoke to Martin Leibowitz, Keith Ambachtsheer, Edward Bernstein, Edward McQuarrie, Marty Fridman, and finally Bill Sharpe (creator of the Sharpe Ratio). Most answers were hazy. There was no definitive piece of analytical work through the decades that accorded 60/40 as the magic numbers. Neither was their any law or regulation that ever even addressed the question let alone set it as a standard. The evidence points to a combination of circumstances, events, and market history that points to 60/40 becoming a "thing" in the early 1960s. Gradually insurance companies, historical all bond investors, and pension managers started increasing their equity weights, but over time, all seem to converge on 60/40. Dr. Leibowitz concludes that 60% equity assets seemed to be the optimal number that produced high enough returns yet did not endanger the managers' jobs by severe negative return periods. The same rationale applied to pension fund trustees who did not want to face excessive criticism for large losses. The risk profile (0.6 Beta) remains constant no matter what types of asset classes are included in the portfolio.

The same logic applies today for private investor clients of large asset managers. Everyone is on the same page; clients are happy, regulators and courts are satisfied with the structure, and asset managers maximize their revenues.

Now that you know the history you can make your own judgement. If you are comfortable with larger temporary fluctuations, then take higher equity weights and enjoy the higher returns.

Regards,
Brian

Sources: Financial 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, RB Global Inc.

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