

The Miatello Quarterly

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Let's connect

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You Are Being Watched

When historians write the story of 2021, the focus will not be on the pandemic and its aftermath. Nor will it be about economic conditions, work from home, indigenous issues, or electric cars. No, the most significant event of 2021 will be the July 1st celebration of the 100th anniversary of the Chinese Communist Party (CCP). It is the conviction of Premier Xi Jinping that the CCP is China and China is the CCP. Since Xi's ascension in 2012, he has eliminated the collaborative ruling council and has installed himself as the supreme leader with the right to rule until his own death.

Over the last four decades, the CCP has enabled a 53 times increase in per capita GDP, moved 770 million people out of poverty, and created a high-tech powerhouse. China's economy is on track to surpass the US economy within ten years. Understandably the CCP has high support amongst the citizens. I would note that there is dissatisfaction amongst Gen Z who are resentful of their own sub-status versus the owners of capital, the CCP and the 996-employment requirement. 996 means you work 9 to 9 six days a week.

Under Xi the CCP has returned to its authoritarian roots reminiscent of Maoist China. Mao was a historic disaster where at the end of his tenure in 1976 the country was in the same economic state as it was in the 1930s. It is an irony that the rise of the country since Mao borrowed heavily from the capitalist model and benefited immensely from its admittance to the World Trade Organization in 2001. With economic success, and some notable US failures including the Great Financial Crisis, Trump, and the pandemic response, the CCP believe they can chart their own superior path forward. Internationally it has been clumsy and geopolitically obtuse. Seeking to avert policy failure, especially of the 70-country global infrastructure development strategy known as the *Belt & Road* initiative, Xi Jinping has recently called on diplomats to face the world with a friendly face. Good luck.

The new global strategy of the CCP has caused the G8 to debate and decide its response. Prior to technological advances, it was widely thought in the west that the CCP control of the population would falter with increased prosperity. Artificial intelligence together with facial recognition software will allow complete physical monitoring of China's 1.4 billion people. It is no surprise that Beijing is pressing forward with an electronic renminbi which will enable the state to record every monetary interaction among the people. China will likely ban Bitcoin and other crypto currencies so that it retains the data and thus control of its citizens.

You are being Watched! The Chinese seem to be okay with that so far.

In the Spotlight: Defence Companies

The speech that Premier Xi Jinping delivered to the nation on July 1st was important. It confirmed the country was on a path to greatness and would not be impeded by any other nation. His meaning could not be clearer. Immense military capability is an essential feature of Xi's determination to make the world recognize China as a serious power. For example, China now has the largest navy in the world. Chinese war ships are increasing their patrols and incursions in the South China Sea. China has started building islands in the South China Sea in order to expand their claims to territorial control over key shipping lanes.

Russia is another malevolent presence. Putin's objectives seem to be to disrupt and discredit western democracies in an optimal matter. He has been successful in recent years. The fact is Russia is a failed state slowly declining economically. The West's response will be to manage the death thrashing as the kleptocracy slowly collapses. It is an ugly world out there and Western nation states need a 21st century defensive response.

We recently introduced positions in two defence-oriented firms.

Booz Allen Hamilton (BAH) provides management and technology consultant services to the U.S. government in the defence, intelligence, and civil markets. BAH is the brains behind the intelligence community. This behavior is like major corporations' outsourcing their deep thinking and justifications for initiatives. Head office is 22 kms from the Pentagon. BAH is a \$12 billion market cap company with 27,000 employees. 2022 revenue is expected to be \$8.5 billion with consensus earnings per share of \$4.18. We were able to buy in March at an 18.9 multiple. The stock had fallen 19% from an early year high due to concerns that the Biden administration would be making cuts to defence spending. These fears are misplaced. It is precisely the skills at BAH that the US needs to address the 21st century threats posed by China and Russia.

BAE Systems plc is a UK based defence, aerospace and security company. BAE has a broad portfolio across every domain. It is the company's goal to help nations to develop next generation military assets and securely integrate them.

90,000 skilled employees work in 40 different countries in several defence businesses including the Air Sector, Maritime, Cyber and Intelligence, Electronic Systems, and Platform and Services. BAE heads Team Tempest in the development of a 6th generation fighter jet scheduled for delivery in 2035. The F35 now being delivered worldwide was developed by Lockheed Martin is 5th generation. 6th generation fighter jets will incorporate swarming drones, directed energy weapons and hypersonic weapons. It will be able to fly unmanned, incorporating artificial intelligence and deep learning.

BAE developed and built the UK's new QE class carrier, the center of the new Carrier Strike Group comprised of Type 45 Destroyers, BAE built hunter-killer Astute class submarine, F-35 Lightnings, and Type 23 frigates. BAE is the sole integrator of the Combat Management System for UK's Royal Navy surface and submarine force.

BAE has a market cap of £17 billion. It trades at an 11.3 multiple to expected 2022 earnings per share of 50.7p. The yield is an attractive 4.45%. BAE's stock seems to be afflicted with a Brexit discount in comparison to American defence peers that trade on average at 14.5 multiple to 2022 earnings. This is quite an anomaly as 82% of 2020 BAE sales was to the US government.

Ask Brian

Hi Brian:

How would you describe your overall approach to the markets?

Best
Chris

Hi Chris:

Certainly, my asset class preference is overwhelmingly biased to stock/company ownership. As discussed in previous MQs, fixed income is played out and in fact, it is a dangerous asset class. I note there are many offerings of contorted fixed income products. I have never liked complications as they typically include risks for which you are not compensated or there are higher fees that steal any alpha generated. Beware of Black Boxes where your money goes into some complex process and a return is promised. Many now advocate alternative investments of various types. I was deeply involved with those at a previous employer and the same general comments apply. Usually there are performance fees justified as aligning the firm with the client. I would call these claims disingenuous.

Buying companies is straightforward. You get a sense of the business, prospects and challenges. Then you look at how market stockholders assess the business and try to judge how it could change in the future. The ideal is to identify a mismatch between where you think the business could be in a few years and what the market thinks.

There are many ways to fail. If you think the same as the market, then where is the advantage and by that question I mean where are you going to get an excess return? You will just get the normal median market return and I do not mean the index return. Many large asset managers do the latter and charge for the former.

Buying pieces of companies, that is stocks, is what businesspeople understand and a process with which they are comfortable.

Sources: Financial Times, New York Times, Washington Post, BMO Capital Markets, RBC Capital Markets, J.P. Morgan, Barron's, Wall Street Journal, The Globe & Mail, National Post, Bloomberg, Booz Allen Hamilton, BAE Systems plc



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