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Let's connect

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The Times They Are A-Changin'

In the MQ of April 2020, I wrote that the world would see substantial changes in its approach to matters because of the pandemic. The underlying massive change is a consensus that demands governments and related institutions change their focus. In brief, it means more government involvement in the economy. It means more socialist/collectivist approaches to society and economic management and less profit- seeking capitalist approaches.

There are direct and indirect implications for the capital markets.

The first pandemic economic problem was to avoid a global depression. Central Banks used their tools of lowering interest rates and employing “quantitative easing” (central bank massive bond buying) that flooded the world with money. These actions saved the world at the cost of blowing up asset prices that subsequently made transparent massive inequalities among social classes. Governments distributed cash to all manner of people affected by the lockdowns. This money flow was essential. Sectors of the economy shut completely reducing government tax revenues. The result has been massive government fiscal deficits and ballooning overall debt. At low interest rates this would not be overly concerning for most developed economies, but it is not true for some emerging market countries.

The pandemic is a profound shock to global economies equivalent to the Great Depression of the last century. 2020 to 2021 will be the inflection point between the economic regime in place from 1984 to 2020 and the period from 2022 onward. We can characterize the period we are leaving as economic liberalism on a free run, a period enabled by secularly declining interest rates. During this time policymakers continually fine-tuned their tools to deal with a variety of challenges that beset the system. In the previous period, the optimization objective was maximization of economic growth and suppression of economic volatility. For most groups in society the policies enacted were a success.

Today, people are much richer and there are fewer poor people despite what the CBC may continually portray. The same applies in most emerging economies except those governed by incompetent and/or corrupt governments. However, notwithstanding the adaptive policy responses, towards the end of the period, developed economies produced weak growth, social inequality, and an un-investable fixed income sector. The regime caused near worldwide depressions in 2008 and 2020. These are gross failures that cannot be repeated. Within its accomplishments were the seeds of its eventual destruction.

We could name the new period we are entering, ***Common Prosperity (“CD”)***. China at this moment is making a dramatic secular shift in this direction. In the West, we have the trenchant analysis of economist Mariana Mazzucato who provided the theoretical basis for the newly born Cornwall Consensus. At the spring G7 meeting, the leaders tasked an international panel, the G7 Panel on Economic Resilience, to make policy recommendations on the structure of the proposed new paradigm. The final report was just released and may be accessed here.
https://www.g7uk.org/wp-content/uploads/2021/10/G7-Economic-Resilience-Panel-Report.pdf

The new paradigm is the antithesis of the Washington Consensus that provided the intellectual basis for the last paradigm of 1984 to 2020. This document will provide the underlying policy justification for decades of G7+ government legislation. If you want to understand what is going to happen in western economies for a long time to come, read this. If you are a business leader, adapt, adjust and prosper. Those who fight it will lose.

In the West, the central feature of CD is government debt. Notwithstanding Central Bankers statements that current inflation is transitory, we disagree. Governments will run continuing deficits and will need buyers of their bonds. Current bondholders have enough and will require higher interest rates to induce buy orders. The alternative would be for the Banks to continue to buy the bonds but that would be problematic since that would exacerbate existing inequality conditions outlined above. So, it will stop as communicated by Central Banks.

Business cycle duration will compress. The new economic scenario will be a world with higher nominal growth, inflation volatility, and higher secular inflation. Central Bankers will not be able to suppress the economic volatility. Does anyone remember the Greenspan market put of the nineties? More volatility requires a higher risk premium. Add it all together and what we are considering is an imbedded secular inflation rate of 4%.

This means capital market changes. Earnings will increase but the market will not reward the higher earnings. In other words, PE multiples will decline. The changes will not be coincident, so it is likely that the market would fall in anticipation of inflation and the higher earnings would kick in later, after the increased inflation filters through the markets. This could happen 3 to 5 years out.

The fixed income market will deliver negative returns while it adjusts to higher secular inflation. The same outcome would apply to any security with bond-like characteristics. Types that come to mind are fixed rate preferred shares, no-growth REITs, and high dividend/no-growth equities favored by retirees.

I should note that this forecast is long-term in nature and extends beyond the current post-pandemic economic circumstance. Today we read about how today's inflation is less transitory than originally thought. If that is true, then the transition to the longer-term outlook of 4% inflation will accelerate.

Come gather 'round people
Wherever you roam
And admit that the waters
Around you have grown
And accept it that soon
You'll be drenched to the bone
If your time to you is worth savin'
And you better start swimmin'
Or you'll sink like a stone
For the times they are a-changin'

Bob Dylan

In the Spotlight: Makita Corporation

For a man, walking through the power tool section of a Home Depot has similarities to a candy store of boyhood. So many great gadgets. Varied brands differentiated by their corporate colors. You just want to pick up and feel each one. Which one feels best in your hands? Will the one in your hand do the job required?

For all the brands available there are only three overall corporate entities. Stanley Black & Decker with brands, DeWalt, Stanley, Black & Decker, Porter Cable, and Bostitch. The company has other brands in the hand non-power tool area. Techtronic Industries from Hong Kong with brands Milwaukee, AEG, Ryobi, and other non-power tool brands. Makita, from Japan, whose only brand is Makita.

Makita has existed since 1915. It operates globally in fifty countries with over 18,000 employees. Sales and service offices exist in 170 countries. Ninety percent of its products are manufactured outside of Japan in China, Romania, Thailand, Brazil, Germany, the U.K., and the U.S. All plants have received ISO9001 and ISO14001 certification. 2022 expected revenues are Yen 636 billion (~US$ 5.6 billion) with earnings per share of Yen 270. 2023 earnings are expected to be Yen 280. The stock trades on the Tokyo exchange at about Yen 5610 with a current market cap of US$13.8 billion.

Makita has a 20% global market share in the power tool industry. It is a wonderful place to be competitively. With its singular focus on producing excellent quality power tools and maintaining them through their life cycle, Makita seeks to provide holistic sales and service dominated by diligence and customer satisfaction. How Japanese.

In 2005 Makita was the first to introduce battery powered power tools. They foresaw the future demands of the work setting and the current ESG phenomena. Since 2005 they have continuously improved their battery powered tool offering. The most innovative technology is a Lithium-Ion 40-volt max series of battery. This battery is far in advance of competitors products and is useable with all Makita products in its range. Makita products are the products of choice in Outdoor Power equipment and disaster scenarios which as we know are increasingly common.

An interesting feature of Japanese institutional equity investors is that they are very theme-driven with a brief time horizon. This can present opportunities for Western investors with appropriate medium to longer term investment horizons.

We own the stock.

Ask Brian

Dear Brian:

I am concerned about what will happen in the next year, not so much in 5-10 years.

Vince

Hi Vince:

The U.S. is currently running monthly inflation of 0.3% to 0.4%. There is less confidence today that there is a high transitory element to the numbers.

In the capital markets the current price is really a discounted value of future cash flows. In the equity market one of the determinants of the price, in addition to the attributes of the business generating the cash, is the interest rate applicable to the future cash flows. It has a huge effect on price. A low interest rate means higher current price and vice versa.

If there is no dividend or if the dividend yield is very low, then the current price is wholly or highly dependent on the terminal value of the security. Stocks with no dividends are known as “long duration” assets, a borrowed phrase from the fixed income market. In fact, these no dividend stocks are longer duration that almost any bond.

The long duration means that the value of these assets would be negatively affected by a rise to 4% inflation as the discount rate would increase quite substantially. The category of stocks in this category are commonly known as growth/story stocks. These stocks are usually a favorite of speculative investors.

It’s quite a situation. Increasing inflation is a negative for bonds, high yield/no growth equities and zero yield/high growth equities. It means a change in market leadership after over a decade of enthusiasm for high growth tech stocks. The trend would shift to reflation/value/cyclical areas of the market. Readers will be happy to know that our portfolios are already there.

Best Regards,

Brian

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, Makita Corp., Lawrence Summers, Ray Dalio, Jan Loeys