The Miatello Quarterly

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BMO Nesbitt Burns

Let's connect

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Ein Zeitenwende

What a quarter. Two dominant events shocked the markets.

Most prominently, the Russian invasion of Ukraine. Second, and related, the western worlds' central banks declaring that they had let the inflationary genie escape the bottle and now they are anxious to get it under control. As the German chancellor Olaf Scholz stated, the world is experiencing a turning point (ein zeiterwende), where the world after is no longer the same as the world before.

The fact of the Russia/Ukraine war is of historical multi-generational proportions. A geopolitical realignment is underway. The countries of Europe will forswear Russia which will become a pariah state. Europe and the West will unite against a profound threat via more cooperation economically and greater military spending. It is most unfortunate that military spending increases will occur throughout the west in a secular 15-to-20-year cycle. Money spent on defence, which is essential, is not available for other social purposes.

Mostly because of the war, global food prices in February jumped 12.6 percent in one month. Russia and Ukraine account for 30% of global wheat trade. 50 countries depend on Russia and Ukraine for 30% of their wheat imports. Food price inflation is already causing riots in Sri Lanka.

I first started talking about the strong possibility that inflation would shoot higher and stabilize at higher levels, i.e., ~4% in the MQ of October 2021. At that time, global Team Transitory held that everyone should stay calm as inflation would recede as soon as global bottlenecks resolved, and everyone returned to work. That was so much dreaming. A completely wrong narrative.

Early in the first quarter, high monthly inflation numbers were posted worldwide. In

BMO Private Wealth

March, central banks abruptly concluded that they had massively erred and would quickly cease quantitative easing (buying government bonds in the market thus creating more money), and simultaneously start raising rates aggressively. The new bank narrative, led by the US Central Reserve Bank, is that it will work out fine. They believe that cleared supply chain bottlenecks and rising employment rates will reduce inflation to the old target of 2%. But nothing went according to plan in 2021, and now we have new war induced bottlenecks, Chinese Covid lockdowns, accelerated deglobalization, and a troubled labor market. Larry Summers, former US secretary of the Treasury and President of Harvard University, points out that over the last 75 years, every time inflation has exceeded 4 percent and unemployment was below 5 percent, the US economy went into a recession within two years. Inflation is north of 6 percent and unemployment is making historic lows far under 4 percent.

Summers says that real rates (nominal rates minus inflation rate) must be positive. In the US, real rates are massively negative. Without positive real rates, inflation rates will stay too high and could explode. It is possible that they are assuming that inflation will collapse which would move real rates into the positive column. But this is just a fanciful assumption. The weight of the evidence stands against this assumption.

There is real danger that the central banks are lost in the woods, and we will suffer for it.

In the Spotlight: PG&E Corporation (PCG)

There is no doubt that PG&E has been one of the most troubled corporations in America. First, let us review its background. Pacific Gas & Electric, the operating subsidiary of PG&E, is the largest California based utility. The company provides natural gas and electric service to approximately sixteen million people throughout a 70,000-square-mile service area in northern and central California. Their generating facilities capabilities include three forms. Hydroelectric: including 99 reservoirs, 56 diversions, 174 dams, 172 miles of canals, 43 miles of flumes, 130 miles of tunnels, 54 miles of pipe (penstocks, siphons, and low head pipes), and 5 miles of natural waterways. Nuclear: the 2256 Mwe Diablo Canyon nuclear power plant. Natural gas: the Humboldt Bay 164Mwe natural gas power plant.

In the last ten years, PG&E has been bankrupted twice, most recently emerging from bankruptcy in June 2020. Throughout its long history, PG&E has been the defendant in lawsuits alleging and proving criminal negligence for causing fires and other negligence issues. The list is too long to enumerate but as a point of interest, PG&E was the defendant portrayed in the film Erin Brockovich starring Julia Roberts.

The recent lawsuits resulted from extremely dry conditions being the catalyst causing wildfires that the company's infrastructure was not designed to manage. California has a strange "inverse condemnation" law that made utilities liable for damages, even if the equipment was according to specifications. The 2018-2019 fires caused massive damage for which the company was held liable in the amount of $30 billion. In this case the equipment was at fault. The victims of the fires ended up with an ~18 percent equity interest in the post-bankruptcy PG&E. The state is in the process of passing new wildfire legislation (AB 1024) that will limit catastrophic downside risk from "inverse condemnation."

There is a new board and new management, lead by CEO Patti Poppe, since the bankruptcy. These leaders are responsible for remaking the corporation to provide what their customers and the California state demand of a responsible corporate entity. From the state's perspective the reformation absolutely needs to work, and the state, through its regulators, has designed a system where PG&E can make all the infrastructure capital investments necessary, including undergrounding transmission lines of the 10,000 highest risk power lines at a cost of $20 billion, to mitigate fire hazard, and still earn a good return on equity for shareholders.

Obviously, given the history, and the possibility of another bankruptcy due to more fires, investors are extremely cautious. That means a current value priced stock and hence the opportunity.

PG&E is a $24 billion market cap company with 2022 revenue of $21.9 billion. 2023 consensus earnings per share are $1.21. The PE based on 2023 eps is 9.6. The company expects a compounded rate base growth of 9% per year until 2026. The dividend is expected to be reintroduced in 2024.

We own the stock.

Ask Brian about Robots

Brian

Thousands of people offer investment services including non-people, no cost robots. What is different about you and why do you deserve your fee?

Big John

Dear Big John:
Let us dispense with the robots first. If the robot errs you cannot yell at it. That would just be comedy. The robot program is a fixed algorithm that is set in stone, meaning no adaptability. Popular ETFs are just unthinking rules-based systems run by algorithms. Most algorithmic logic is simply based on momentum or doing what is most popular in the market. The underlying logic of momentum investing is that sectors of the market that have been generating higher returns will continue to generate higher returns, without end. Has running with the crowd proved effective over the long term? It is a comfortable strategy, but the answer is no.

Human advisors, in a sense, unknowingly try to mimic robots. Except, since they are human, they are undisciplined and subject to emotional decisions. The investments suggested are usually ultra-popular and lead to overly concentrated positions. This leads to higher volatility and bigger drawdowns. This approach is best for people seeking excitement in their investments.

To describe my practice, I am typically walking directly into a heavy wind. There may have been a thunderstorm with active lighting a bit earlier. It is still raining heavily. Nobody is walking in my direction or walking at all. I have a large umbrella. There is shelter close to me. That is what is like when I am choosing what to buy. The possibility of more storms discourages people from venturing. The umbrella and nearby shelter represent the margin of safety available in a washed out share price.

Over time, this method has delivered pleasing results for clients.

In a typical advisor relationship, there usually is a double fee structure. There is the fee directly paid to the advisor posted on a monthly statement. Second, there is the fee payable to the actual portfolio manager for the stock selection expertise. These fees are readily available for those who know where to look. My clients pay one fee only which is much lower than a double fee structure.

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, Morningstar, Bloomberg, PG&E Corp., Lawrence Summers