

The Miatello Quarterly

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Let's connect

Miatello Investment Management
BMO Nesbitt Burns

Brian Miatello, CFA
Portfolio Manager

1 First Canadian Place,
39th Floor
Toronto, Ontario
M5X 1H3

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

www.miatello.ca

Markets Power Up

One of the most notable features of the last quarter was the continuing decline in the US 10 year Treasury bond yield. In the second quarter it moved from 2.4% to 2.0%. This was predicated by the Federal Reserve's comments in early June regarding the future effects of the US-China trade dispute and how that would negatively affect global growth. The Fed reacted to a sharp decline in business confidence and retrenchments in future expected capital spend. While consumer sentiment remains in good shape, it can be argued that consumers can't see the large train approaching them.

The Fed comments of June also caused an equity rally based on the high probability of a Fed discount rate cut. Stocks become more valuable in lower interest rate environments based on a dividend discount model. However, in the real world, the Fed's cuts would only increase real GDP by 0.1% to 0.2%. This is hardly anything to get excited about.

Recently the British ambassador to the US resigned as a result of critical comments including the adjective "inept" concerning the White House. This is not entirely factual. Trump has engineered a bipartisan shift among politicians that also extends to an attitudinal transformation amongst the diplomatic and corporate elites. "China Bad" is the rallying cry. Despite the headlines, this imbroglio is not about trade. It is about the US attempting to slow down a future hegemonic power. There will be long term capital market consequences from this cataclysmic change in world affairs.

In June it was reported that there is over \$12 Trillion of negative yielding debt worldwide. Think about that! Investors buying at current levels are guaranteed a loss. This is one of the interesting and quickly observed side effects of the easy money policy pursued by central banks worldwide. Others effects are less easily seen. The mass of excess money keeps alive companies that otherwise would die. Tangentially, we see this in record low corporate bond spreads over risk free treasuries. This is misallocation of capital on a grand scale and, if sustained, will have unintended consequences.

In the Spotlight: Kubota Corporation

The company brand statement is “For Earth, For Life.”

When you have that clarity of purpose, all other corporate objectives are natural extensions. Central to the objectives is the desire to listen to customers’ challenges, to analyse and solve their problems by developing superior Kubota products, technologies, and services, then to produce and sell them to grateful customers.

This approach has allowed Kubota to become the world’s top supplier of farming equipment and water infrastructure. In addition, it is a leading producer of small construction equipment and engines. The problems that have faced Japanese agriculture; an aging and declining farmer group, land scarcity, discerning consumers; in combination with a technology driven native mindset, have provided a bedrock for the company. Solutions to these domestic problems enabled Kubota to enter foreign markets that have their own unique and similar problems and develop and offer viable product solutions. Since 2016 Kubota has decided to become a global major brand and is orienting all company objectives toward that goal. This isn’t just a financial objective. Kubota strives to be “a company that can make the greatest social contribution as a result of being trusted by the largest number of customers.”

Revenue, actual and expected from 2017 to 2020 is ¥1.75mm, ¥1.85mm, ¥ 1.95mm, ¥1.99mm. Note that ¥1.0mm is ¥ 1 million million which at current FX is US 9.217 billion. JP Morgan estimated Earnings per Share from 2018 to 2020 are ¥112.4, ¥138.2, ¥145.6. Valuation remains reasonable.

We own the stock.

Ask Brian

Hello Brian:

There has been a lot of news about the China US trade war. Is it wise to be invested in the US market when there could be negative effects from the conflict?

Best,
Ron

Dear Ron:

Thanks for this timely question. It is notable that US business confidence has swiftly turned negative with the imposition of the initial tariffs. The effects of the sentiment change are a reduction in capital spending and future investment intention postponement. A benchmark stat is the Institute of Supply Management manufacturing index that, at 51.7, is at its lowest since fall 2016. While it is above 50, indicating expansion, the second derivative is negative, a worrying sign.

At the G20 meeting in late June, the trade discussion result was better than negative. The US agreed to no new tariffs, a resumption of trade talks, more imports of US agricultural products, and the US relented somewhat on Huawei. We note that Huawei's CFO remains under arrest in Vancouver. Nonetheless the news was sufficient to give a boost to equities in early July. What happens from here is unknowable, but the usual Trump pattern is deal talk volatility and the markets will price off those vacillations.

The companies we own are managed by smart people. Whatever the external environment throws at them, they adapt. There is no reason to believe that the same pattern will not ensue whatever happens on the China front.

In summary, I will repeat what I have said in previous comments. History reveals that the market advances significantly after the Federal Reserve begins an interest rate cutting cycle which is indicated to start very soon. Trade induced volatility may provide entry points for sidelined cash.

Regards,
Brian

Sources: Financial Times, BMO Capital Markets, RBC Capital Markets, J.P. Morgan, Barron's, Wall Street Journal, Kubota Corporation



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