The Miatello Quarterly

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Let's connect

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The Next Recession

We are currently in the ninth year of economic expansion. Most expansions do not last this long, but this one may be starting to kick into high gear. Exclusive of policy mistakes, there are historic economic metrics that presage the cycle end. The pattern is usually a tightening labour market (new lows in the unemployment rate and an economy approaching maximum capacity), causing wage inflation. This possibility causes central bank anxiety and, in an attempt to moderate the flow-through of the inflation ripple, central bankers raise short term lending rates. Generally, longer term rates do not rise as much as short term, thus causing a yield curve flattening and sometimes an inversion. Demand for goods and services slacken, net job creation decreases and both business and consumers reduce spending. Sensing slowdown, domestic banks tighten credit and assets values drop. Equilibrium breaks, and down everything goes.

There are six key economic series that paint a fairly good picture of this phenomenon. The indicators are based on changes in the employment situation (two indicators), changes in real retail sales, changes in the yield curve shape, the real Fed funds rate, and finally, changes in the Leading Economic Indicator series.

Added to these raw indicators is a more predictive analysis that develops probabilities of the timing of the next recession.

According to Guggenheim Investments the US recession probability within two years is 22 percent. That being the most likely case, our position is that the bull market remains intact for 2018.

In The Spotlight

Kraft Heinz Company (KHC-US)

If you shop for groceries, then you are familiar with the products produced by Kraft Heinz. Their products comprise between 4% and 6% of grocery store sales. You may not know that the overall brands are owned by one company or who the notable investors are who control the company. They are Warren Buffet-controlled Berkshire Hathaway, at 26.7% and 3G Capital from Brazil, at 23.9%. Buffet likes 3G because they are very efficient operators. Some may say ruthless.

You may remember that 3G was behind the takeover of Tim Horton's by Burger King. The new company, Restaurant Brands International, is 51% owned by 3G Capital. You may have read about how Tim Horton franchisees are reacting to the ownership change. They are not happy, to say the least.

3G performed a similar operation at KHC. Since the Kraft Heinz merger in 2015, 3G has reduced the workforce from 55,000 to 42,000 employees. Operating margins have expanded significantly to the high 20% range, as compared to peers in the consumer staples space who make due with mid teen margins.

In February 2017, KHC was interested in acquiring Unilever NV for US$143 billion; deep pockets indeed. KHC was rebuffed by the company and withdrew from further discussions.

The consumer staples space is ripe for M&A activity. The conditions that cause this are many; less brand loyalty, lower/stagnant growth, increasing consumer preference for organic products, relative power shifts in the end vendor market, and the possible disruptive presence of Amazon. These headwinds apply to every company including KHC.

There are operating risks for KHC in the business. However, peers are likely to blink first, and KHC is waiting to pounce.

We hold a position in Kraft Heinz Company.

Profit as AMAZON Creates Havoc

Amazon started life as an online bookseller. Business expanded quickly and soon it expanded into CDs and DVDs. Next up was toys and electronics. Another year, and it started Marketplace, in which Amazon acted as a platform for third party sellers. In each of these cases, Amazon's success sowed the seeds of destruction for the existing players.

Recently Amazon purchased Whole Foods as an entry to the grocery business. This has yet to play out as they develop their approach. Amazon is currently evaluating entry to the ethical drug distribution industry. Pharmacy stocks took an immediate hit on the announcement.

According to the *Yale Law Journal,* Amazon is a “marketing platform, a delivery and logistics network, a payment service, a credit lender, an auction house, a major book publisher, a producer of television and films, a fashion designer, a hardware manufacturer, and a leading provider of cloud service space and computing power.”

Continuous success has created a market consensus that whatever industry Amazon touches will be destroyed. Is that a reasonable approach? Of course not. This is irrationality that we can exploit.

As an example, the auto parts replacement sector in the US was affected in this manner in 2016-2017. We focused in on AutoZone, which is a magnificent operating company. Over the period from 2000 to a 2016 peak, AutoZone rose in value by 30 times. Then, AutoZone was identified by Wall Street as a target of Amazon. This fear drove the price down 38 percent to mid-2017, where we bought the stock in the Quality Growth portfolio. The auto parts replacement industry exploits the need for urgent repair and technical assistance. Amazon cannot compete here, which the street in the last few months has realized. As a result, we are up over 50 percent.

Let us hope Amazon sends us more expedited gift parcels like that.

Amazon, the “Barbarian at the Gate”

Amazon, as best I can tell, is a charitable organization being run by elements of the investment community for the benefit of consumers.

Matthew Yglesias

. . . and astute investors.

Brian Miatello

What Would Brian Do?

Dear Brian:

I am currently dealing with a large money manager who, I am told, is registered with the Ontario Securities Commission. I always receive calls for my business from all the well-known firms on the street, many of whom are associated with the banks. I may be looking for a change in approach, but I find the investment industry all a bit confusing.

Best Regards,
James

Dear James:

It can be hard to understand the investment industry and all the ways you can hire people to help you. Part of the reason for your confusion is that the structure and capability of the various participants is always changing. Let me give you a quick tour.

The broad categories of channels can be thought of as Do it yourself, Do it with me or Do it for me. Today, you can also say I'd rather deal with a robot. The banks are involved in every distribution channel possible. If there is a current or possible future demand, the banks are there. There are also many single purpose firms in niches that serve particular markets.

The firm you are dealing with sounds like a non-bank investment counsel, part of the Do it for me channel. Their principal clients are institutional, but they have found that private investors are a profitable market to serve. There are some investment counsels who are a bit more tilted to private investors, but these are relatively rare. This channel solely focuses on managing the money without any other wealth considerations. A very different approach is offered by banks in this area through their private banking units.

The banks, through their investment dealers, dominate the whole private investment universe. Bank investment advisors deal in the channels Do it with me and/or Do it for me. The banks have made substantial investments to equip their investment advisors with capabilities that enable them to effectively compete along the whole spectrum. Each advisor can arrange their business so that they can do what best suits their skills and the type of clients they attract. That ranges from funds, new issues, trading on hot ideas, all the way to doing the function of an investment counsellor in the same fashion as your current arrangement. In addition, advisors can draw on all the capabilities in the Wealth area that banks offer including financial planning, insurance, and estates and trusts. There are pluses and minuses to each arrangement that you would have to match against what you are really looking for. If you want to know more, please contact me.

Sources: Financial Times, Morningstar, J.P. Morgan, Guggenheim Partners

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