The Miatello Quarterly

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Let's connect

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Global Trade War?

The second quarter saw the continuation of disturbing developments worldwide.

In Italy, a coalition government took control that was the conjoining of far left and far right parties. Both are adherents of nativist sentiment. Their stated intention is to withdraw from the European community. The appointed president rejected the nomination of a few extreme anti-European Union ministers, blunting for the time being any radical action on secession. The scare has enabled Germany's Merkel to finally generate the political capital to offer some policy positions that may help defuse the Italian situation.

In Poland, the Law and Justice "LJ", party led by Jaroslaw Kaczynski seeks to restructure the nation's Supreme Court which has previously denied LJ its policy goals of nativist governance. Despite threats from the European Union to sanction and suspend Poland, the government is undeterred.

In Hungary, Viktor Orbon continues to push a nativist line also. In Turkey, Erdogan does much the same.

Finally in the United States, President Trump has continued his internal attacks on the press, the justice system, and the political process. Externally, and most importantly from a Canadian perspective, he has mounted incipient trade wars world-wide.

All of these actors are the symptom of systemic global changes rather than the cause of current disruptions. The underlying causes are the rise of China as a global power and the information technology revolution. Both of these cataclysmic unfolding events have caused massive economic ripples.

Specifically they have led to the redundancy of localized labour pools and the relocation of production facilities worldwide. The changes have been facilitated by the current world trade order, which is under attack by president Trump. Trump believes he can make a series of bilateral trade deals where he can strike more favourable terms for the U.S. as the more powerful partner.

The larger problem is the apparent isolationist cynicism with the US administration that does not bode well for optimal world GDP growth at the least, and perhaps foretells more dire geopolitical implications.

According to JP Morgan the markets at this point are pricing in a 0.5% reduction in global GDP growth. If all countries in the world impose 10% trade tariffs then the growth hit would be 1.4%. The scenarios only cover first order effects not venturing into derivative consequences that could be significant.

In The Spotlight

Middleby Corporation

Odds are you have no idea what this firm does. Middleby manufactures and services a very wide range of food service equipment, food preparation and packaging, and premium kitchen equipment. In the Commercial Foodservice segment its brands include Beech Ovens, Holman, Toastmaster, and CookTek among 30 key brands. There are over 250,000 units installed at top chains, including KFC, McDonalds, Burger King and Wendy's. It is the #1 supplier in all of the following: pizza chains, convenience stores, fast casual, deli sandwich, steakhouses and seafood, chicken outlets, Pan-Asian, casual dining and in Quick Service Restaurants. Middleby equipment is used in one out of three restaurants worldwide. In the residential market, that is Middleby's smallest component; the two largest brands are the premium AGA Rangemaster and Viking.

The company has existed and been rapidly expanding for 20 years. At a market capitalization of US$5.8 billion it is the primary consolidator in a fragmented industry. In the past 12 years, sales have increased 15.7% per year and profits 16% per year. It generates free cash flow of about US$260 million a year that helps to fuel acquisitions. In May this year Middleby purchased for US$1 billion cash, Taylor Corporation, a leading provider of soft serve ice cream freezers, frozen drink machines and commercial grills. Middleby's finances are prudent and disciplined.

The restaurant industry, customers of Middleby, is at an inflection point. Restaurants are under pressure from higher costs and oversaturation. Food deflation and food store incursion into the restaurant space has also reduced restaurant sales. These factors have caused capital outlays to slow, directly affecting Middleby, which has recently reported declining organic growth. In addition, the rapid growth of Middleby has introduced sufficient complexity to its operations that a period of rationalization and streamlining is upon them. The response of the restaurants to these pressures is to create a better value proposition for customers and to drive down operating costs. It is here that Middleby provides solutions that inevitably the restaurants must buy.

These short term problems have provided an entry point for us to buy the stock. Analyst consensus earnings for 2018 through 2020 are $5.99, $6.66 and $7.41.

Ask Brian

Dear Brian,

I've heard some talk about a bear market coming soon. Should I be worried?

Regards,
Peter

Dear Peter:

First of all, let's define what we mean by bear market. It is a decline in an equity major market index of at least 20 percent from the most recent highest point on a closing price basis that occurs over two months. The stock market is a leading economic indicator, meaning that it signals in advance what the economic conditions will be from six months to a year in future; a crystal ball you might say. The advent of a bear means that economic conditions are in for a slump, perhaps a recession, which is technically defined as two consecutive quarters of negative GDP growth, or shrinkage, in other words.

Recessions are a normal feature of economic cycles. Historically they were caused by excessive factory inventory building in anticipation of demand that is not currently there. This mostly doesn't occur today due to information systems and just in time manufacturing. It still occurs with large commodity producers who cannot shut down production in the short term. Today, as explained in the Miatello Quarterly of January 2018, recessions are caused by rising inflationary pressures and central banks raising interest rates to moderate but eventually choking off the expansion by limiting system liquidity.

Nonetheless, bear markets can be painful to live through. What one should do depends on the time horizon for your funds in equities. You should not be invested in equities if you need funds within four years, so at this point you should revisit your personal situation. If you have high flying stocks (anything trendy or highly levered), it might be time to substitute stocks that are perhaps more boring. As we move through 2018 and into 2019, you may want to hold more cash than usual.

Once we are into the bear there are a few typical responses. Some will sell out completely. This one action you should avoid is selling all stocks as this sets up a psychological approach to the markets that leads to very high opportunity costs. That is, people sell too early then refuse to get back in at higher prices. Don't do that!

Others may freeze, as a deer in the headlights, and do nothing. Doing nothing may or may not be appropriate. It all depends on what you own.

There is no doubt that the various media outlets will be of no help whatsoever. The media will just increase your stress. The anxiety level can deprive one of sleep and thus prevent you functioning in the face of important day to day responsibilities.

If you'd like to explore your options, please contact me today to discuss. Backed by industry-leading research as well as my years of experience navigating stormy weather, I would be happy to provide some solutions suited to your unique needs.

Regards,

Brian

Sources: Financial Times, BMO Capital Markets, New York Times, J.P. Morgan, Barron's, Wall Street Journal, Middleby Corp.

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