BMO Nesbitt Burns

The Miatello Quarterly

October 2018

Let's connect

Miatello Investment Management
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Bond and Equity Market Rampage

Since I started writing this October quarterly issue I have found myself in a state of ongoing revision as market events have provided new information to add to my original thoughts.

The most noteworthy event since our last newsletter occurred after the September 30 quarter end. That event was the decisive breakthrough to a new high of the US Treasury bond ten year yield. It happened on October 3, when institutional investors sold bonds aggressively, pushing through boundaries that had held since 2011. The frantic selling was caused by an advance report suggesting that the US was to post strong employment growth and wage growth near 3%. In fact, the advance wage news was correct, giving evidence that the US economy is smoking hot. A major technical bond market hurdle has been breached, and US rates are heading a lot higher. As the USMCA trade agreement has eliminated the possibility of Canadian economic Armageddon and because of domestic economic strength, the Bank of Canada will be free to raise rates to keep pace with the US Federal Reserve.

Equity markets reacted negatively to the bond market rout. Market technical dynamics beneath the major S&P 500 index had been deteriorating for a few weeks. Amongst other technical red flags, there was a negative divergence between different market size sectors which is usually a bad omen. There is some speculation that the probability of interest rate increases was finally being priced into smaller cap stocks (meaning they fell) because of greater debt levels among smaller companies compared to the larger companies of the S&P 500. At this point we could see a normal correction of some months duration, which may be startling, within the current secular bull market.

There is no shortage of some plausible and some esoteric theories to explain why and how this correction is unfolding. There are some talking heads that claim omniscience and give very assured answers. But it is basically impossible to be definitive when there are trillions of dollars sloshing about the world and we try to understand why they move in the directions that they do.

With that disclaimer this period may be where the growth style trade terminates that has dominated markets for years (i.e., the FAANG stocks), and more value oriented stocks start to outperform. That is our forte, and we have been waiting for this.

The equity markets should be able to absorb the higher bond yields. Historically, even in the case of a quick jump in the ten year bond yield, the equity markets have taken it well, after an initial shock. To repeat an earlier commentary, we would need a US bond yield curve inversion to occur for an equity bear market to be precipitated, and we are not anywhere near that. Even at the point of inversion, equity bull markets usually last another year.

Quarter end provided another opportunity to lament the poor performance of the Canadian equity market relative to world peers. Over the last five years if you had invested in a basket of world equities, instead of the Canadian market, you would have 41 percent more assets. Over ten years the number is 64 percent. Think about that! The long term relative positions are not going to change given the distorted composition of the Canadian market. In addition, the opportunity set for investment in developed markets is 33 times larger outside Canada.

In the Spotlight: Schneider Electric

Schneider Electric ("SE") is a world leading French company whose mission is the digital transformation of energy management and automation. SE offers integrated efficiency solutions tailored to its customers' needs, to provide decarbonized, digital, decentralized, and electric energy. In 2017 with 142,000 employees, revenues were €24.7 billion producing EBITA of €3.6 billion.

SE is at the forefront of several global secular evolutions including increased electrification, anticipated to be up 60% by 2040; digitization, including the Internet of Things (IOT); decarbonisation, through automation efficiency solutions, as a solution to climate change; distributed energy resources; and energy storage.

In the same vein, from a governance perspective, the company speaks to its responsibility to all stakeholders, in congruence with the likely future path for ethical corporate responsibility.

Operationally and financially, SE is firing on all cylinders. In Q2 2018, SE delivered 8% organic growth in sales after 6% in Q1. Despite this performance, the stock is down 22 percent from its 12 month high of €78. There may be a perception in the market that SE has too much exposure to late stage cyclical industries which will cause an earnings slowdown. Even if this is true, it would be a hiccup in a very long-term growth situation.
Analyst consensus earnings for 2018-2020 are €4.53, €5.00, and €5.37 per share.

We hold a position in Schneider Electric.

Ask Brian

Dear Brian,

I am thinking of buying Amazon and perhaps some other e-commerce stocks. Should I?

Chris

Dear Chris,

If you did buy Amazon, you would be jumping on what was a fast moving train. Amazon is what I would call a crowded trade. Everyone knows the great success of Amazon and how it dominates. Everyone thinks buying the stock is a no brainer. However, its status as an obvious buy may have changed (see the first article.) Well, let’s tear this buy idea apart a bit.

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Almost all securities analysts use outdated techniques to determine a security's value and then project that methodology to suggest a specific worth at a future point in time. Depending on the distance between the current price and their expected value, the stock would be labelled a buy, hold, or sell. For Amazon, among the many analysts following the stock, the consensus is quite near a "strong buy" rating.

Sophisticated statistical methods have been around for decades but for some reason have not entered the investment sphere. Security analysis is the very essence of multivariate uncertainty and statistics is the only method of dealing with it. The fact that present day securities analysts have not done so is disappointing. In the case of Amazon, there is much uncertainty among a few key input variables that are important to its valuation. Based on the work of Aswath Damodaran of the Stern Business School, the key variables for Amazon are revenue growth, operating margins, cost of capital, and the ratio of sales to invested capital. He built an algorithmic simulation using dynamic variable inputs with their own distributions that produced a distribution of future values. Using the October 12 closing price of $1,789, in 22% of cases, Amazon's current value would be less than the simulations estimates of value. The corollary is that the stock is more expensive in 78% of cases and the median future price is 31% below current level. Note that the stock is down ~13% from April's high of $2,050.

In my opinion, it is at least a sell candidate.

Sources: Financial Times, BMO Capital Markets, New York Times, J.P. Morgan, Barron's, Wall Street Journal, TD Securities, Aswath Damodaran, Schneider Electric

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