The Miatello Quarterly

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Let's connect

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A Quarter to Forget

In the Miatello Quarterly of October 2018, I warned that market volatility could continue for several months. Well, it could continue for longer yet. The catalyst for October's woes was a spike in US 10 year Treasury yields. Bond yields abated when Fed chairman Powell made some dovish statements in early November that caused the market to question the continued strength of the US economic expansion. The logic was that he must know something that is not apparent to everyone else. What to do? Sell equity and buy bonds!

In the 4th quarter, the tech industry started to implode. Among bellwethers, Amazon started a steady decline and Apple had a few announcements that lead to a 35 percent drop. As tech had lead the market for years, this rout was foreboding for everyone. Fixed income credit spreads widened from 1.84 to 2.48 during the quarter, meaning that the market wants a higher return for corporates versus treasuries, an indicator of economic angst. Industrial metals fell 5% and crude oil plunged 16%. Finally, in one small part of the US yield curve, a minor inversion became apparent, which, if it had sustained and expanded along the curve, would be a negative indicator for expansion longevity. Reacting to the negative news, equities turned in the biggest December loss in 72 years. A Santa Claus rally did not appear.

What was striking during the quarter was the intra and inter-day volatility. These massive sudden sentiment shifts appeared inhuman. In fact, they likely were driven by hedge firms with quantitative mandates, meaning software is deciding to trade without human intervention. Some may employ artificial intelligence. The firms have algorithms running the show that for the most part are momentum driven. Basically, if the market starts moving in one direction, the algorithms triple down on the trend and accelerate the move. Naturally, the chief architect of one of the major quant firms denies any responsibility.

At some point, regulators may question what value these participants bring to the capital markets. From our perspective however, their trading induces much anxiety, driving security prices lower into our willing hands.

Forecast 2019

2019 will be dominated by the US China trade conflict. The US has decided to confront its emergent global rival on its trade practices including the forced transfer or theft of US intellectual property. For the world, this is an epic confrontation that will not easily be resolved. The current dispute interregnum lasting until March 1 will not be renewed.
Our challenge will be to find investments that will succeed in spite of the impasse. We will hold and buy companies with good managements that generate free cash flow and have good balance sheets. We will embrace volatility and buy these companies on downturns when their valuations are compelling.

In the Spotlight: Aramark

Have you ever bought a beer or a hot dog at a Blue Jays game? That was an Aramark employee serving you. Aramark is the exclusive food and beverage provider at Rogers Centre. Though some people may have issues with selection and quality, the package chosen from Aramark is an MLSE decision. Aramark delivers what the customer (MLSE) wants.

The company's core business is outsourced concessions, cafeterias and facilities, such as plant maintenance and custodial. About 80 per cent of revenue is generated in North America. Aramark is a US$7.7 billion dollar company generating $15 billion in sales and about $2.11 earnings per share in 2018. Education and health care account for over 50% of revenue.

There is a world-wide trend to outsourcing food preparation for contract catering. The market is under penetrated and grows faster than national GDP. That is a key attribute. Client retention is very high at 95% over five years. In recessions, Aramark picks up more business as companies attempt to reduce costs. The company is one of the three largest food purchasers in the world and, as such, receives the best prices. Aramark expects to deliver 2-4% organic revenue growth and double digit EPS growth. We own the stock.

Ask Brian

Hi Brian,

This market seems crazy to me. Are we going to have another 2008 situation?

Best,
Mary

Dear Mary:

The quick answer is "No."

The year 2008 super recession was caused by a deep structural flaw in the capital markets that gave rise to a liquidity crisis, and a great fall in equity prices. That precise confluence of events will most probably not be repeated due to remedial regulations put in place since then.

The business cycle has not been repealed. In due course a recession may ensue, and typically, equity prices will decline over 20 percent from a previous high point. The equity decline will forecast the recession since the equity market is a leading economic indicator. You won't see it coming.

What is in store for 2019? The three indicators of a deep bear market are negative GDP growth, declining earnings, and inflated valuations. These signals are not present. In the US, consumer spending was up 2.9% in October year over year, and labour productivity in Q2 and Q3 was the best in ten years. Bear markets don't ensue from the old age of an expansion, so there will not probably be a bear market in 2019. For context, consider that Australia has not had a recession in 25 years.

To be an equity investor you need to have a multi-year time horizon. If you don't, then don't own equities, or have a hard cap on the percentage of your total investments that will be invested in equities. One of the most successful investors of the last 60 years has been Warren Buffet. He has suffered through many severe declines in the process of creating enormous wealth over the years. Be like Warren if you want success.

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Dear Brian

One of my cannabis stocks has recently come under attack by short- sellers. I don't understand why the authorities allow this to happen to great companies. By the way, what do you think of cannabis companies?

Ron

Dear Ron:

The function of the equity market is to allow companies to raise capital for economic expansion. The market is a fabulous method for an economy to efficiently allocate capital to it best possible use. Inherent in this system is the requirement that security prices accurately reflect true economic value.

In effect, the market is a price discovery mechanism. There is a strong case to be made that short sellers play an important function in price discovery. There are circumstances, such as the nascent cannabis industry, where the action is fast and furious, and there are pockets of possible weak due diligence by investment banks or analysts. The short sellers make a case against the prevailing wisdom and, if they are correct in their analysis, the new security price will reflect the new reality, meaning the security will be properly priced. The capital markets benefit by this new correct pricing for the security. The only losers are those investors who are owners of the previously over-priced security but, as they say in war, they are just collateral damage.

The cannabis industry may be a large industry in the future. The current pricing of the securities anticipate a straight line to a very rosy future with no industry-wide or company specific problems. That idyllic future almost never happens in rapidly growing industries. There is a subset of investors who are comfortable operating in an environment where you can lose all your money, but I am not one of them.

Good Luck,

Brian

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

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