The Miatello Quarterly

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BMO Nesbitt Burns

Let's connect

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Jack be Nimble

2022 was an unmitigated disaster for investors. There was no asset class that produced positive returns except for cash, commodities, and the US dollar. Harmful to overall returns were the large losses in the bond markets that have traditionally offset negative equity markets. In fact, the traditional USD balanced portfolio delivered the worst performance in over 80 years. The disaster description doesn't even start to address the wipe outs in the speculative areas of the market including pandemic stocks (Zoom, Peloton, Teladoc Health, Shopify); SPACs, meme stocks (AMC, GameStop, Bed Bath & Beyond), unprofitable tech stocks including the infamous disruptor type ARK Innovation ETF, profitable tech (Amazon, META, Nvidia, Apple), the crypto debacle and, of course, the deflated Tesla. Readers of this letter were not surprised as some of this was predicted in the MQ of January 2022, headlined Ride 'em Cowboy, https://nesbittburns.bmo.com/Brian.Miatello/blog.

Consider the returns. CAD S&P500, -12.2%; CAD NASDAQ -28.3%; S&P Euro 350, -11.6%, CAD TSX300, -5.8%; MSCI World CAD -12.2%; MSCI Europe CAD -10.7%; Canadian Fixed Income, -11.4%.

Our portfolios, whether balanced or all equity, delivered -4% to -6%.

What is next? While the-set up for 2022 offered ways to outperform due to the absurd valuations, 2023 is not the same. There are guideposts. The era of low interest rates and long term 2% inflation has passed. There are too many secular forces against this target. First, aging populations are causing worker shortages, meaning higher wage inflation. Second, geopolitical tensions are subduing globalization and shortening supply chains via friend and near-shoring, meaning higher costs of production. Third, the suppression of carbon emissions is causing havoc in the energy markets, meaning supply shortages increasing prices. The last point is further explained in the Ask Brian section.

This means no sustained large bounce back in the previous high growth tech stocks and other sector high growth stocks. Private equity, discussed in the MQ of July 2022, which is still not reflecting public market pricing, is due for a correction. A major red flag is the industry salivating over access to large flows of retail money.

It is difficult to see how inflation normalization can occur without a recession, a conclusion reached by most economists. In the last 70 years, no major reduction in inflation has been accomplished without inducing a recession. On December 14th, the Fed Chair Powell stated that "there is no basis for confident economic prediction." A recession in 2023 is a slam dunk.

The market response will be negative as earnings are reported in the January/February, April/May, and July/August periods. As companies report disappointing earnings, stocks will decline. Finally, analysts will revise earnings projections and target prices downwards. Analysts always follow the stocks.

So far in January markets are reacting as if the Fed will soon stop raising rates and then perhaps decrease. The S&P500 is up 3.7% and the US 10-year bond has declined to 3.44%. A more reasonable explanation is that they will pause and assess whether they have done enough. However, after that they may start to raise rates again. What investors still do not seem to understand is that the Fed's goal is to crush inflation, not promoting asset prices as they have done for decades.

Will all individual stocks and sectors decline to the same degree? No. Today the S&P500 is down ~17% from its peak. Our equity portfolios are now above year end 2021 levels. The evidence from 2022 is that there is a change in market structure occurring. Expensive growth stocks are out of favour and have more to decline. In a typical bear market, the major index drops 30% to 35%. Thus, there is 10% to 15% further decline in the still "growth" heavy S&P500. Much less so for our portfolios.

It will be a year to be sharp and agile. I turn to an old nursery rhyme that seems quite appropriate.

Jack be nimble, Jack be quick,

Jack jump over the candlestick.

Jack be nimble, Jack be spry,

Jack jump over the apple pie.

Jack be nimble, Jack jump high!

Jack fly up into the sky.

The sky is where we want to end up over time.

In the Spotlight: Dollar Tree Inc.

Dollar Tree has over sixteen thousand stores and twenty-five distribution centres. The store count is split evenly between the two operating subsidiaries, Dollar Tree, and Family Dollar. Locations are across the lower forty-eight states and five Canadian provinces. Dollar Tree is a discount variety store operator with ever changing merchandise offered at a fixed price point. Family Dollar stores offer consumable merchandise, hardware and automotive supplies, diapers, batteries, pet food and supplies, electronics, apparel, and accessories.

Before December 2021, the company had underperformed its peers. Our holding of the stock follows on the news in December 2021 that activist investor Mantle Ridge (MR) was now a holder of a 5% interest. We have had a previous pleasant experience following MR with a pass at Aramark Inc, a position we have last year re-entered as MR is still involved and Covid presented an opportunity to do it again. Another big winner for us following MR was with railroad CSX and the late Hunter Harrison as CEO.

MR had recently started discussions with Rick Dreiling, former CEO of Dollar General and architect of its transformation starting in 2008. In December 2021, MR proposed a new slate of directors, and the game was on.

Dreiling is now Executive Chair with the former CEO reporting to him. MR replaced five board members so that Dreiling now effectively controls the board and the organization. In 2022 he cleared the decks and started implementing his multi-pronged multi-year turnaround strategy. He is a four-star general in this area who has experience and will not fail. Of course, there will be bumps on the road. But that will be an opportunity to add to positions.

Dollar Tree has a USD market cap of ~$33 billion. Consensus earnings per share forecast for the next three years starting 2023 are $7.33, $8.27, and $9.61. There is no dividend as cash flow is being reinvested in the business.

We purchased the stock in 2022 at 16 times projected 2023 earnings.

Ask Brian about Oil & Gas

Hi Brian:

Canadians have been going gaga for oil and gas. Should I step in?

Regards,

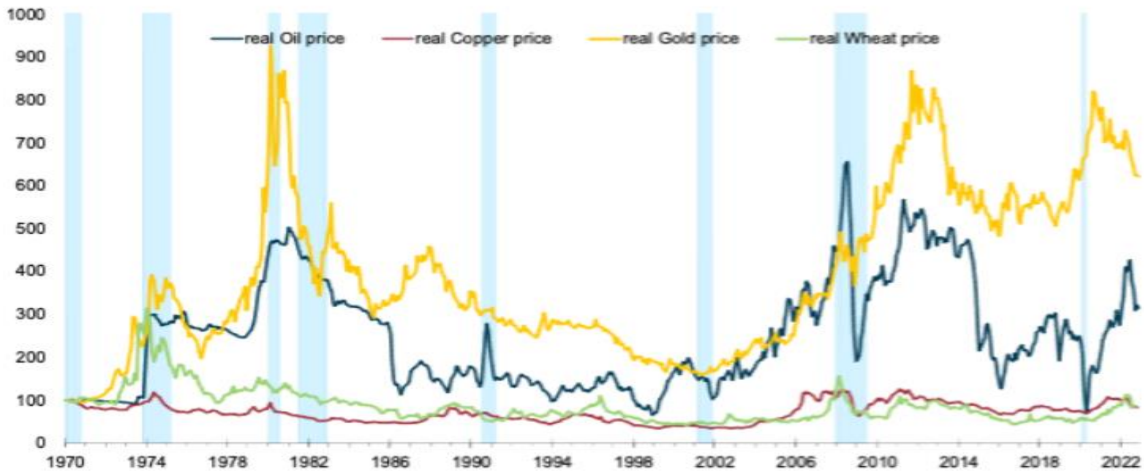
Chris

Dear Chris:

The Canadian energy sector index returned 48.9% in 2021 and 30.3% in 2022. It was a large contributor to the broad index TSX300 performance in each year. Naturally, there is a buzz in the air.

The fact is that the index topped out on June 8, 2022, declined 29% by July 14th and has been treading water with volatility since then. The volatility provided opportunities for expert traders and speculators, but long-only investors saw nothing. The energy stocks peaked at about the same time the light crude priced topped out at $122 a barrel.

Historically, commodity price cycles are always overwhelmed by the business cycle. Think about the usual pattern: energy and commodity price surges, CPI overshoot, restrictive monetary policy leading to recession and thus demand destruction of commodities. In terms of historic duration of the commodity cycles most have lasted two to three years. This last one has been noticeably short lasting from mid-2020 to June 2022. This duration corresponds to the five-year average length of the US business cycle. Commodities provide alpha in the expansion phase then provide significant losses as the economy slows. The below graph illustrates the clear pattern. See the blue line.



Source: EIA, IMF

It is important to appreciate the difference between cyclical and secular patterns. The near term expected correction in energy stocks is cyclical. Not discussed thus far are the longer-term secular drivers. There are longer term risks to supply including possible Russian production disruption because of regime collapse, the current disinclination of companies to spend capex even with firmer energy prices, and fossil fuel funding challenges due to energy transition decarbonization efforts. With these factors the fossil energy market is attractive on a secular basis. Watch for the correction.

Sources: Financial Times, Washington Post, BMO Capital Markets, RBC Capital Markets, Scotia Capital Inc., J.P. Morgan, Barron's, Wall Street Journal, The Globe & Mail, National Post, Morningstar, Bloomberg, Dollar Tree Inc., John Norman

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