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BMO Nesbitt Burns

Miatello Investment Management
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Crawling to Recession

As expected, Capital Markets in the first quarter were quite volatile but range bound. Markets hyper- reacted to perceived changes in Fed policy as recession sentiment changed from soft landing to hard landing to no landing. When central banks raise rates quickly, as they have this past year, things break. The first to go splat were four banks. In the US one was mismanaged while in another case regulators capriciously closed a bank to set an example to other institutions involved in crypto. Another California bank, First Republic Bank, experienced a run and so far, has needed $30 billion in support by a consortium of large US banks. Panicked large depositors in the troubled Credit Suisse started a run on the bank and the Swiss regulators forced it out of business. As one observer opined, there is never only one cockroach. The problems in the US seem to originate in the loosening of oversight of mid-sized regional banks under the Trump administration.

You might be wondering where is the recession? There are reasons for the delay. First, in the US, trillions of dollars were injected into the economy from '20 to '22. The cash is still sloshing around causing robust demand for goods and services even in the face of rising prices. This has caused corporations to remain optimistic and to keep hiring, thus the low unemployment rate. Second, interest rates were ultra low for a decade allowing individuals and corporation to repair balance sheets. The higher rates have not had an effect yet. Third, there has been a manufacturing renaissance because of higher offshore costs, Covid, and reshoring due to the China conflict.

What about the market? History provides a view. The Fed has said no rate cuts this year, but the market does not believe it. The Fed just raised rates by 0.25% and did not state they were finished hiking. History says there has never been a sustained equity rally before the Fed has stopped hiking.

The Fed is determined to crush inflation. It is impossible to achieve this objective when nominal incomes are increasing at 7% and Fed funds are at 4.5%. It is likely that Fed funds will increase to at least 6% and beyond. Failure to defeat inflation would mean

a 1970s scenario with high inflation and no growth, derisively labelled as stagflation. That outcome would be misery.

The most important question is at what rate inflation will become stable. This will play out over 2023. In past MQs I gave three reasons the 2% inflation target is unrealistic based on new global secular forces. By Q4 this year it should become apparent to all that inflation is stuck at the 3% to 4% level. To be sure, central banks can cause a deep recession to push on and attain 2%, but it is unlikely that they will. Instead, expect a new narrative to be floated that stability of inflation is more important than the abstract number of 2%. At a 4% inflation rate, a normalized interest rate yield curve is much higher than where it now sits. Try to envisage 5-year risk free rates at 5-6 percent and 10-year rates 6-7 percent. That is not going to be favourable for capital markets.

The high-priced growth stocks which this year have seen a resurgence are not ready for this scenario.

In the Spotlight: Mattel Inc.

One of the fascinating features of getting older is watching grandchildren. Do you realize that they play constantly? When one activity tires them, the question is, what are we going to play next. Play is essential to children's development.

Mattel is deep into a corporate turnaround. The problems seem to have started ten years ago when Mattel, who held Disney's license for princess dolls, launched a competitive line called Ever After High. Soon after, in 2016, Disney dropped Mattel and licensed Hasbro for the princess line. Upon losing a 70-year relationship with Disney, Mattel went into a cultural funk where it became a firm driven by accountants with little understanding of what children wanted in toys. How could they have been so dense? In the next two years Mattel cycled through three failed CEOs. The stock took a beating.

Finally in April 2018, Mattel hired the right guy as CEO, Ynon Kreiz. The company at that point was a hot mess. Kreiz realized that Mattel owns, next to Disney, the strongest catalog for children and family entertainment franchises in the world. The Intellectual Property catalogue is very deep. He had an immense task. First was to make it an exceptionally good toy company and he started by deindustrializing. Kreiz closed factories and cut staff by five thousand to end up with 8,500 employees. Kreiz decided they did not need to manufacture the toys as the value add was in creativity and design. Kreiz has restructured the company by de-siloing the brand employees so they can feed off each other's creativity. One of the interesting children's focus group findings was that children wanted dolls not to appear too life like. Designers developed new knitted fibers for hair allowing more diverse hair types. Symbolic of Kreiz's efforts in 2022, Mattel regained the Disney princess doll line including Cinderella, Moana, and Anne and Elsa of "Frozen."

The iconic Barbie doll is not the Barbie of your memory. The mission of Barbie today is to empower girls and show them that they can be as successful and accomplished as boys. Barbie today has more than two hundred careers, thirty-five skin tones and one hundred hairstyles. The doll is a world leader amongst dolls in Diversity and Inclusion. The evolution and transformation of the Barbie brand is typical of the relaunch and reimagining older IP including Masters of the Universe, Monster High, and Matchbox.

Simultaneously, Kreiz's task was to position Mattel to make movies and TV based on Mattel toys. The objective is to produce media experiences that are excellent and compelling and not simply to sell more toys. This is a much bigger market than the toy industry.

Early on Kreiz hired Robbie Brenner the producer behind Oscar nominated film "Dallas Buyers Club" to head the new unit, Mattel Films. Mattel Films will produce films tied to its toy brands. There are fifteen feature films in development with the first release this summer of "Barbie" directed by Oscar nominated Greta Gerwing and starring Margot Robbie, Will Ferrell, and Ryan Gosling. Barbie (2023) - IMDb. The Barbie film is co-produced with Warner Brothers Studios. Another film in production is "Rock'em Sock'em" starring Vin Diesel. The film will be co-produced with Universal Studios and Diesel. Incredibly there are 20 TV shows and other media works based on Mattel toys. Mattel is a co-producer with different studios on all these productions.

In 2017 Mattel lost $343 million. In 2022 the company had a profit of $443 million. We first purchased Mattel in our growth portfolio in September 2018 and experienced a 100% return over 3.5 years. We trimmed the position near the high. As is typical the market usually gets ahead of fundamentals and there was a correction in late '22 and early '23. We used the slack to reup the position and to introduce the position in our more conservative portfolio given that the turnaround is well established.

Mattel has a market cap of $6.3 billion and 2023 expected revenue of $5.45B. Consensus earnings per share are $1.18 in '23 and $1.48 in '24. Consensus free cash flow is $1.71 and $2.10. At current prices, P/Es are 15.1 in '23 and 12 in '24. There is no dividend, but it may be reestablished in 2025.

Mattel is one of our larger positions.

Ask Brian about Tech Stocks

Hi Brian:

Tech stocks are back in favour. I sold them last year so I was wondering if I should buy the sector.

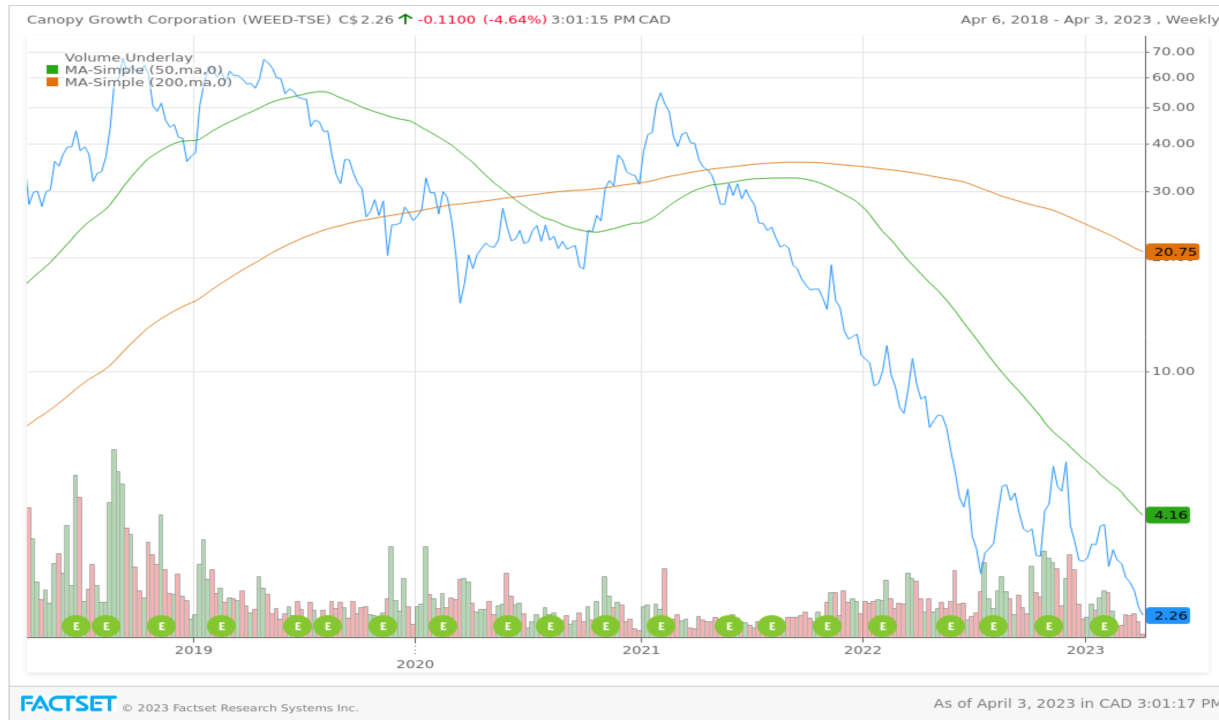
Regards,
Caleb

Dear Caleb:

Have you heard the term "Dead Cat Bounce?" It is based on the unsavoury spectacle of a cat falling from a great height, expiring on impact, yet still bouncing up off the pavement. From a distance you may believe the cat survived. But it is indeed quite dead.

The historical record of past manias provides lessons for the current tech situation. There have been many past market bubbles. We had big US companies in the sixties, commodities in the seventies, Japanese stocks in the eighties, US tech in the nineties, Chinese shares in the last ten years, and in Canada the now crashed cannabis industry. In each case the

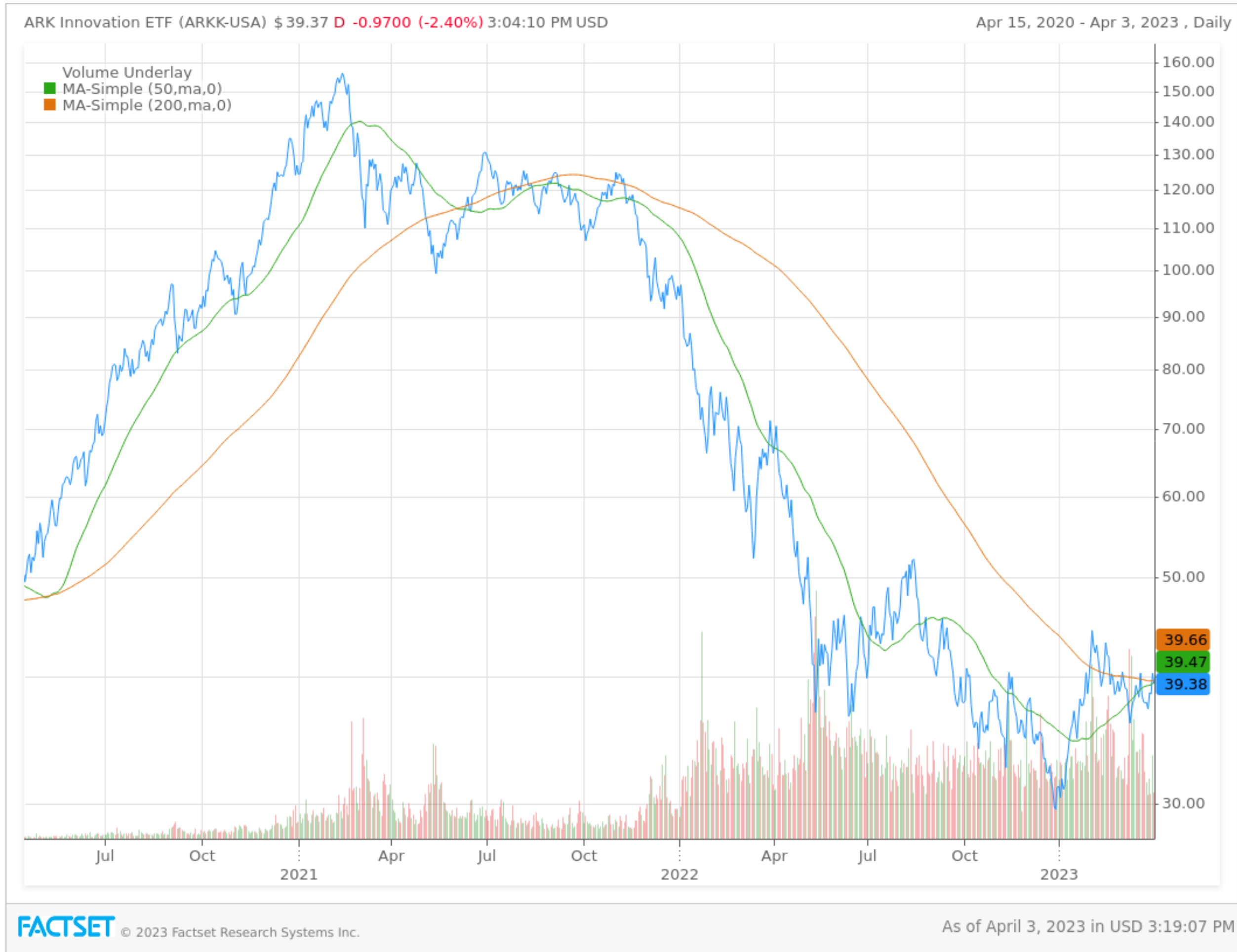
consensus was that it was an obvious way to profit which meant no price was too great to pay for a share of certain utopia. This "buy at any price" mentality leads to crazy valuations and wild volatility. An example of how this happens is Canopy Growth, once Canada's premiere cannabis stock.



The first substantive bounce started in October 2020 where it tripled in price to February 2021. Since then, it has declined 96%.

Each bounce back raises hopes, which are soon dashed.

The recent classic tech bubble is encapsulated in the ARK innovation ETF shown in the below three-year chart. In the past year there was still money flowing into the ETF to the tune of $156 million. People want to believe!



Of the last ten historic bubbles, four have yet to fully recover including Japanese stocks which peaked in 1989. Of the other six, the average time to recovery was 15 years.

Forewarned is forearmed.

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, Mattel Inc.., Kara Swisher podcast, Ruchir Sharma, Mohamed El-Erian, Nancy Lazar, Lawrence Summers, Gillian Tett

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