The Miatello Quarterly

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BMO Nesbitt Burns

Let's connect

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Artificial Intelligence Hallucinations

The breakout story for 2023 has been the rapid adoption of the company OpenAI's software ChatGPT. In January, Microsoft announced a $10B funding package valuing the company at $29B and giving it a 49% ownership interest. Microsoft also announced that it would integrate the platform into many of its products including search engine BING, browser EDGE and Microsoft 365. Alphabet's GOOGLE, fearing for its life, announced its own AI application, BARD.

Not a week goes by without somber warnings of the emergence of an artificial superintelligence that will dominate humankind. Think of AI character and antagonist HAL in the film 2001: A Space Odyssey or Schwarzenegger's film Terminator 2: Judgment Day where Skynet is about to achieve sentience. Luminaries have signed a petition asking for a six month pause in development so that we can erect guardrails where needed. News flash: that is not happening.

Equity market effects have been profound. There has been a massive performance disconnect between the Big Tech 7, the expected beneficiaries of the perceived coming AI dominance, and the rest of the market. Tech dominated Nasdaq moved up CAD28.8% and the top-heavy S&P 500 up CAD14.3%, all accounted for by the increases in the top seven tech companies. Folks, that distortion portrays a sick market.

I am labelling this as hype. Within the last ten years the market cognoscenti have become enthusiastic about 3-D printing (obliteration of manufacturing as we have known it), self-driving cars (cities transformed and declining need for insurance), blockchain (elimination of back offices), and the metaverse (destroying the entertainment industry and eliminating business travel). All shiny toys that now have a rusty patina.

One of the noted features of ChatGPT is that it often constructs fabricated narratives presented as fact. Some journalists call these lying presentations hallucinations. Perhaps we should apply that description to investors in the Big 7.

Nonetheless, generative artificial intelligence will have long term effects. Historically, significant technological changes have taken ten years to have an impact at the corporate level. The reason is that it takes time for change which involves new processes and software, regulations, and reconfiguring organizations to optimize use of the new tool. This tool may reverse the anemic productivity problem that has dogged western economies for decades. The long-term future for economic growth and equity returns is very bright.

The problem is that we must get through the short-term to mid-term.

Broad equity market returns will be more challenged for the balance of the year. Air will come out of the Big 7 and there will be softening consumer trends resulting and eroding corporate pricing power. Recession is probable in late 2023 to early 2024.

I reiterate my message from previous MQs. Inflation has slid, which we expected based on the economic and return patterns, but global core inflation will remain well above 3% through 2024. The inflation persistence will mean central banks will tighten monetary policy further. This will cause more weakness leading to a hopefully soft recession. Expect that by mid-2024 the US Fed will see some inflation abatement and start to gradually ease rates.

In the Spotlight: Ross Stores

Ross Stores inhabits the sweet spot of American retailers. Ross's strategy is complementary to department stores, and it is insulated from Amazon's reach. Ross depends on full priced apparel and houseware chains to provide access to excess products that need clearing due to seasonal changes, mutable tastes, alternative distribution channels, and demand variability due to a myriad of external factors. Most importantly, Ross can take massive orders from the full-price merchants and discreetly manage them. The monster retailer Amazon is incapable of matching Ross's value proposition.

At Ross Dress for Less shops, their 70% women shoppers seek a bargain by treasure hunting rather than needing a value price. Price points for well-known brands are 20% to 70% less than original full prices at regular retail. At Ross's second chain, dd's DISCOUNTS, the targeted demographic is younger, ethnically diverse, and lower to moderate income. dd's offers more moderate brands at lower price points than Dress for Less. Ross Stores has 2,034 shops, located in over 40 U.S. states.

Ross had 2022 revenue of $18.7 Billion. Consensus 2024 revenue is $19.6 billion. Gross margins are stable at 26%, much higher than the single digits at Macys, Nordstrom, and Target. Ross management believes that they can continue to expand store count over 5% per year for over ten years. Free cash flow yield is 5.6% in 2023 and expected to be 6.3% in 2024. Earnings per share is expected to be $4.42 this year rising to consensus $4.91 in 2024. Dividend yield is 1.2% with expected buybacks of ~$950mm or 2.6% of market cap. In aggregate, it has an effective yield of 3.8%.

We purchased the stock in February 2022 at ~$95 and still hold as it trades at ~$110.

Ask Brian about RRIFs

Dear Brian:

I have heard talk about changes to Registered Retirement Income Funds. What is up?

Regards,
Brad

Dear Brad:

As most people know, the RRIF structure is the decumulation phase of retirement assets. During your 71st year you must roll your RRSPs into RRIFs or annuities. Most choose the former. Minimum payment from the RRIF starts in your 72nd year on a schedule issued by the government. You have the option of using your spouse's age to apply the schedule that in most cases will reduce the required minimum payment.

The RRIF structure dates from the 1978 federal budget. The minimum withdrawal schedule implemented was reflective of the then current investment returns and longevity of Canadians. Those rules exhausted RRIF accounts by age 90. It took the government 15 years to realize that too many seniors were at risk of outliving their RRIFs. In 1992 the rules changed to extend the progressive withdrawal schedule to age 95 and then require 20% annual withdrawals. The schedules as amended were designed under the following assumptions: a nominal 5% rate of return including a 2% inflation rate, that over a 35-year career with maximum RSP savings one could replace 70% of pre-retirement income, and that the initial payment received at age 72 would be maintained in real terms over the life of the RRIF annuitant.

In the last 30 years, longevity has increased dramatically and the return on the safe portion of investments, which is fixed income, declined significantly. Thus, the assumed 5% nominal return was not achieved. The proportion of seniors at risk of outliving their funds has increased substantially.

In June 2022, the House of Commons adopted a private member's bill asking the Finance Department to study the RRIF rules. Finance requested submissions from interested parties by last March 23rd. Many organizations made submissions including the Conference for Advance Life Underwriting, the C.D. Howe Institute, CanAge, Investment Industry Association, Canadian Life and Health Insurance Association, Expert Panel on Income Security, and various academic experts. Finance reported to the House on June 22. Its report did not make recommendations but enumerated core principals of RRIFs and listed a variety of recommendations from stakeholder submissions. These were to increase the maximum age for contributions together with the conversion age for rollovers to RRIFs, reduce or eliminate the minimum payouts, and exclude payouts for smaller RRIFs. Most submissions suggested, implicitly or explicitly, a change in the conversion age from age 71 to age 75.

I would expect that within a year the federal government will propose legislation that includes several of the recommended changes. It would be wise to be careful in retirement planning now.

Regards,
Brian

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, Ross Stores Inc