BMO Nesbitt Burns

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# The Fundamental Investor

A QUARTELY INVESTMENT NEWSLETTER

## GROWTH GOOD: RECESSION BAD

For nearly the entirety of my life this has been the mantra espoused by politicians and central bankers. This notion has broadly permeated our society and is now generally accepted as some kind of noble objective. Indeed, so much so, that we have charged politicians and central bankers to do *'whatever it takes'* to avoid recession and extend the business cycle for as long as possible. On the surface this would seem like a logical goal, after all nobody likes recession. But the reality is, recessions are both an integral and necessary part of capitalism. Without them, there are simply periods of calm punctuated by periods of crisis. A recession is not a crisis, nor should it be. But of course such truth has been and will remain politically unpalatable. Thus the 40+ year trend has been for ever increasing, heavy handed, government interference in free markets, especially via central banks.

**Pressure Relief Valves Are a Must**

Recessions are the relief valve by which economic excesses are purged; excessive risk takers are punished with losses; assets are liquidated at lower prices; stronger players with the financial means acquire these assets on the cheap, turning them back into productive assets once again. It also means more reasonable stock prices for those trying to save for retirement and affordable home prices for the next generation of first time home buyers.

This self regulating aspect of capitalism used to occur roughly every five to seven years and thus excesses were never really allowed to build up to the point where they might threaten the entire financial system and/or the fortunes of the next generation.

We let this happen in the roaring 20s and paid dearly with the depression of the 1930s. Maybe we can chalk-up The Great Depression to naivety and inexperience with respect to political economy and monetary policy: but certainly we should have been wiser heading into a different kind of prolonged malaise induced by the high inflation rates of the 1970s and early 80s.

**Apparently Not…**

Amazingly any re-examination of Nixon's decision to close the gold window and the abandonment of the Bretton Wood's Accord was never an option. This 1944 accord would see 44 countries peg their currencies to the US dollar, which in turn was pegged to gold. Nixon's unilateral action to renege on the convertibility of the dollar into gold at a fixed price, essentially took the entire world off the gold standard in one fell swoop. This ushered in a new era of fiat money, freeing-up governments around the globe to print as much money as needed to pay for their war machines while appeasing/distracting the masses with social goodies. This type of irresponsible behaviour is hardly new, it is now colloquially referred to by historians as *bread & circuses* for the masses, referring to similar government behavior during Roman

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times. Ultimately the world's largest empire could ill afford to engage in either of these activities in perpetuity, and hence Rome began to dilute the most trusted currency of its time, the Denarius.

Ever increasing quantities of copper and lead were added to the once pure silver coins, previously held in such high regard throughout the empire, slowly rendering them worthless. As went the currency, so too went the empire.

### Outta Bullets

As evidence mounts that the global economy is slowing, it appears that both Europe and Japan may enter their next recession with interest rates at zero, while North America may enter recession with key rates having peaked at 2.25%. Suffices to say that from this level, even if The Fed were to aggressively cut rates, this is a small cushion to work with heading into the next down turn. Previous down turns required the Fed to cut rates by roughly five full percentage points to generate a positive impact on the economy.

| | Pre-Rec Rate | Rec Low | Delta |
|---|---|---|---|
| 1990 | 8.5% | 3.0% | -5.5% |
| 2001 | 6.0% | 1.0% | -5.0% |
| 2008 | 5.25% | 0.25% | -5.0% |

Source: St-Louis Federal Reserve

With a starting points near zero, where will central bankers take rates this time? Unable to shrink their balance sheets this cycle, will we simply attempt to drink ourselves sober once again with even larger doses of quantitative easing—aka money printing? Or will we take a shot at negative rates? If your bank starts charging you 3% to keep your money in a checking or savings account, will you leave your money in the bank? I would expect sales of home safes to rise dramatically.

Let us not forget former Federal Reserve Chairman, Ben Bernanke's congressional testimony in 2012:

> *'Our zero rate policy and Quantitative Easing program are temporary emergency measures. Once the economy has stabilized we will seek to normalize interest rates and shrink our balance sheet'*

Apparently the emergency went on a little longer than expected, because we kept rates at 0.25% for almost seven years. Furthermore, the current rising rate cycle, one of the most gradual on record, has stalled out at 2.25%. In addition, the market chatter is now about a potential rate cut later in the year, while any hope of shrinking central bank balance sheets is fading fast. The Fed recently announced that its Quantitative Tightening program will end in September, at which point the balance sheet will have shrunk from 4.5T to 3.8T: recall the Fed's pre-2008 balance sheet was 0.8T.

### The Tail Now Wags the Dog

It used to be that a rising stock market was a reflection of a robust economy. But the financialization of our economy has lead to a situation whereby the economy cannot seem to do well unless the markets are rising. Furthermore, the tax code has been adjusted over the years such that US Government revenues have become increasingly dependent on capital gains tax. How did this happen? This is not a stable source of income on which to build a budget. So, more than ever, both the economy and government revenues are dependent on a rising stock market!

### Symmetric Inflation Targeting—Are They Whacked?

This is the latest lunacy proffered by Fed officials and it goes something like this. The Fed targets inflation of 2%, but if inflation comes in at 1% for the current year, then they would strive to let inflation run hot, targeting 3% the following year, to 'make up' for the inflationary shortfall from the previous year! Let's be clear, the congressional mandate for the Fed is *price stability and full employment*, in that order. Over 30 years 2% inflation leads to roughly a 50% decrease in the purchasing power of a dollar. Does that sound like price stability to you? Take a survey of a 100 people and asked them if they would like to pay more for food and energy over the coming year, how many do you think would say yes? From my perspective price stability means 0% inflation. Furthermore, I am sure that if prices fell by 1 or 2% a year for a few years, most people would not object. The idea that we should somehow try to make up for inflation that did not happen in previous years has to be one of the most asinine things I've ever heard.

### Unicorns and Rainbows

If you need another example of the unintended consequences of radical monetary policy and how too much cheap money leads to the misallocation of capital, consider that there are now more than 100 American unicorns and more than 300 unicorns

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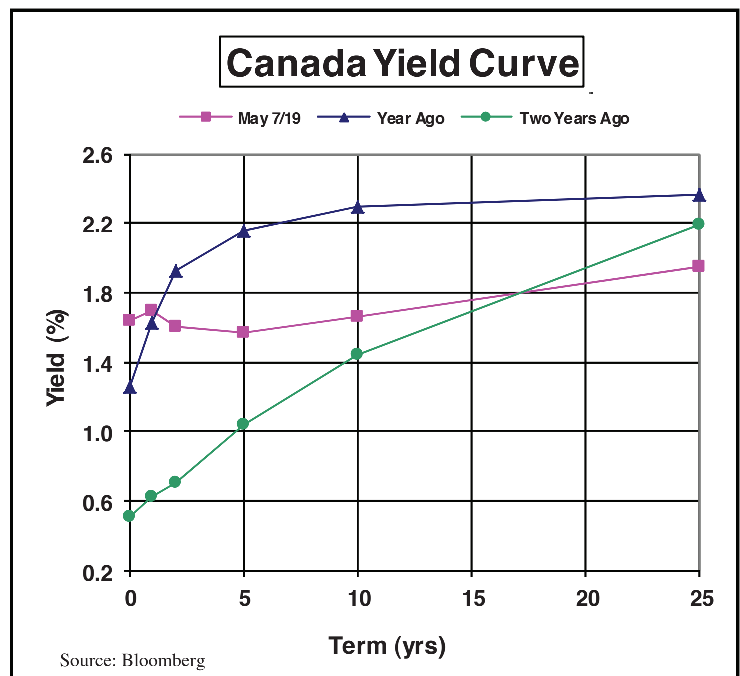


Source: Bloomberg

# STOCK TALK: Pharmacy Woes

So far in 2019 U.S. healthcare stocks have lagged the broader market. Pharmacy chains Walgreens and CVS have not been spared. Uncertainty caused by the threat of greater regulation and the constant talk out of Washington of reducing drug prices has pressured shares. In addition, healthcare reform, has been a recurring theme in the U.S. political debate and this is likely to continue into the 2020 elections. Furthermore, the threat of Amazon entering the space, pressuring margins, has been another concern. Management from both companies have said publicly that the current environment is the most challenging they have seen in years. The question is: Will they recover?

**Background**

Walgreens has been a leader in retail since 1901. It processes approximately 20% of all U.S. prescriptions. CVS (Consumer Value Sores), was established as a health and beauty chain in the early 1960s and became a pharmacy in 1967. Today they are the two leading retail pharmacies in America.

Traditionally, the pharmacy business has been a relatively defensive sector. As one can imagine, the fortunes of retail pharmacies for example are not highly related to the economic cycle or central bank policy. They tend to have stable business models, relatively reliable and consistent earnings and have historically been dividend growers. Many of these characteristics are typical of the kinds of businesses I like to invest in.

The operating environment for retail pharmacies has been getting tougher. On one side pricing pressure from major customers (government entities, Pharmacy Benefit Managers (PBMs) and consumers) who are demanding lower drug prices, and on the other side, competition from mass grocers and general retailers for their non-pharmaceutical products.

**Times are a Changin'**

Both chains are making changes in order to adapt to this new reality. They have remodelled their stores in order to become medical services centers. With their huge retail footprint across America, both chains believe they can be part of the solution. CVS calls them "health hubs" while Walgreens refers to them as "neighbourhood health destinations".

Consumers use to dropping by their local pharmacy to pick up Tylenol, diapers and a two liter bottle of Coke may find it odd that other clients are there getting blood tests. This is one of the challenges for management during this transformation. In order to enhance their new image as health centers both chains have now stopped selling tobacco products.

In recent years, Walgreens has purchased Alliance Boots a major European pharmacy retailer as well as partnering with Amerisource Bergen, a large U.S. drug distributor. Walgreens also bought roughly half of Rite Aide's pharmacy locations. These moves are intended to enhance efficiency and increase bargaining leverage.

CVS on the other hand has chosen to go vertical. That is, what started out as a retail pharmacy is transforming itself into a health care services giant. It has purchased Caremark (a PBM) as well as Omnicare (long term care) and most recently Aetna (health insurance). Of course these moves have not been without incident, while the Caremark acquisition has done well, so far Omnicare has been more challenged. The recent Aetna purchase required CVS to take on a substantial amount of debt and integration risk remains a concern.

As an investor, the question to buy/sell or hold is not an easy one. While it is clear both companies have huge challenges, I believe that the price quoted today already reflects this situation. In other words, I believe the market is well aware of the situation and has perhaps (only time will tell) taken too pessimistic a view of the future.

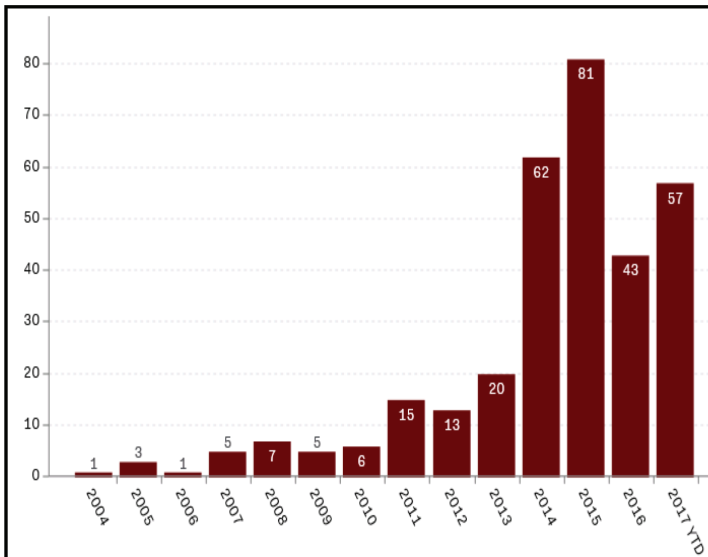
From a valuation perspective the shares of both companies appear extremely cheap. If we look at any valuation metric in finance, they appear undervalued. Of course if the fundamentals deteriorate further and earnings decline more in the years to come, then perhaps current prices may be justified. However this is not my base case.

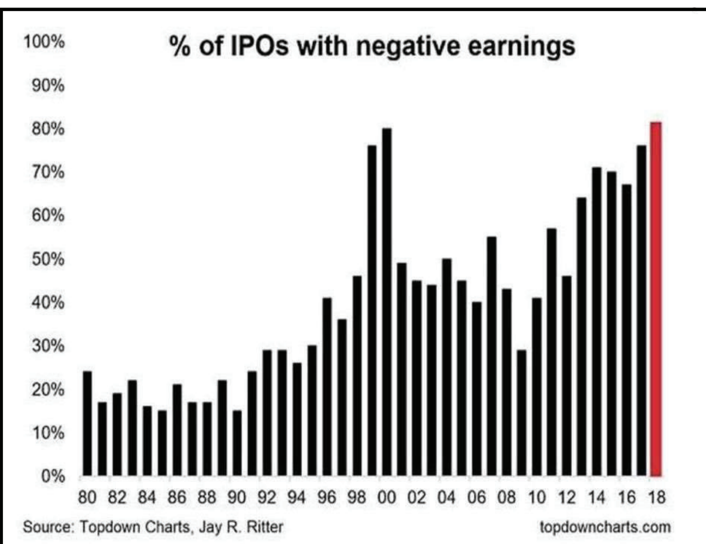
I believe these are two survivors in the new (post Amazon) retail and healthcare reality. They are experienced players, have healthy balance sheets, good cash flows and the pay sustainable dividends of approximately 3.5%.

I believe investors will need to be patient however. The temptation to dump these shares is understandable, but I think it would be selling at a bad price. In reality I suspect we will look back at the share prices today as a great buying opportunity.

*I never said managing money is easy….Al*

**Annual Crop of New Unicorns (source: Pitchbook.com)**




worldwide. So just what is a unicorn? It is an industry euphemism used to describe private company start-ups, funded by venture capital, that as of their last round of funding are currently being valued in excess of one billion dollars. Of course the VC guys hope to cash-out by pawning their holdings off to an unsuspecting public via an initial public offering. Lyft recently went public obtaining a market valuation in excess of 20 billion dollars, not bad for a company that's only been around seven years, has never made a profit and lost roughly one billion dollars in 2018 on 2.2 billion of revenues.

I think the two adjacent charts epitomize the mania that is going on in the venture capital markets today. Investors of all stripes, including some of the most sophisticated and risk tolerant investors, continue to move out on the risk curve, seeking higher returns in this continuing era of financial repression—rock bottom interest rates: just one more example of the unintended consequences of cheap money. Of course this is not likely to end well for venture capitalists and certainly not for buyers of these names as they are taken to the public markets: caveat emptor.

**After Thoughts**
It used to be that the central bankers, supposedly the wise adults in the room, we responsible for taking away the punch bowl before the economic party got too heated, before too much mal-investment could be made. Now it seems as if they are ready to spike the punch bowl at each intermission.

Meanwhile America is failing to re-invest for the future. Corporate capital stock (the nation's aggregate plant, machinery and equipment) is the oldest its been since 1958! With free money still aplenty, debt accumulation for stock buybacks remains the order of the day.

If that wasn't bad enough, cheap money has driven global housing prices well past pre-2007 highs in many places, completely pricing Millennials out-of-the-market. Some are fortunate (or maybe unfortunate) enough to be able to tap the bank of Mom & Dad for the 20% down payment, an amount many would be unable to accumulate, only to saddle themselves with a massive mortgage. There may be surprises to come for a cohort that thinks of 3-4% mortgage rates as 'normal'!

My biggest fear is that the absolute confidence that market participants currently have in central banks will at some point be shattered. For now, having fully drunk the Cool-Aid, they continue to believe that central bankers have their back, but the first moment that central bankers are either unwilling or more likely, unable to come to their rescue, the party will be over.

*Central bankers are not your friend, prepare accordingly. Sincerely, Mark.*

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