BMO Nesbitt Burns

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The Fundamental Investor

A QUARTELY INVESTMENT NEWSLETTER

JAPANIFICATION

In the mid 2000s, with our bond bull celebrating its 25th anniversary, a handful of financial people began to question whether we were all destined to follow Japan into a permanent economic funk, characterized by chronically low inflation, low interest rates and anemic growth. After all, it had been more than 15 years since the twin bubbles of Japanese real estate and stocks had collapsed simultaneously (circa 1990) and neither had seen much of a recovery over the decade and half that followed, nor had the economy been able to generate much in the way of growth, with real GDP hovering between –1% and +1%.

It wasn't an unreasonable concern for investors to harbour. After all Japan was the world's second largest economy and its strong growth had helped propel the global economy for years. Furthermore, our economies (North America and Europe) seemed to need more and more fiscal (bigger government deficits) and monetary stimuli (ever lower interest rates) to 'right the ship' following our own economic downturns. All the while, interest rates would start and end each cycle lower than the one preceding it. By the time the Great Financial Crisis (GFC) of 2008-09 rolled around, it was clear that this cyclical trend was real, as were some of the Japanification fears expressed more that a decade earlier. The downturns whether measured in the markets or the real economy were getting worse and getting ourselves 'off the mat' was taking longer each time. The rebound in unemployment, wage growth, etc., were much more gradual then expected, while GDP growth during the recovery years could only be described as tepid at best.

Many of the arguments made for Japanification of the global economy were dismissed by the other side, but today, nearly 15 years forward from when those arguments were first made, we see Japan's lost decade has turned into three lost decades and now Europe has followed suit with a lost decade of its own, firmly working a second. Are America and China destined to follow suit?

Let's look at some of the arguments made back then, actions subsequently taken by policy makers and the results.

Bad Demographics

When it comes to long-term secular trends, there is none more immutable than demographics. Following its twin bubble collapse Japan's own 'boomer' cohort was getting set to retire in the mid 1990s. Those that dismissed this issue as a uniquely Japanese one, were simply ignoring the data. The same demographic trends (would) are playing out around the globe's major economies with a time shift of about 10 years for Europe and 20 years for America. Which co-insides perfectly with Europe's lost decade following the GFC.

Immigration and Productivity

Many pointed to Japan's xenophobic society and lack of immigration as the 'real' reason for their economic malaise. And while there is some truth in that statement, more liberal immigration policies in Europe and the United States are far from reversing these powerful demographic trends. At best, they are slowing the negative effects at the margin. Canada and Australia are two examples of countries with very aggressive immigration policies, that at least in the short term (3-5 years), have failed to deliver the economic medicine their political proponents had hoped. True, nominal GDP has grown in Canada over the last few years, but if you consider per-capita figures rather than the

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PORTFOLIO MANAGER: Rewind & Review

Over the last ten years, I have written about various stocks in this publication. For the most part, I have been recommending various companies, which I had already purchased or was about to do so. I thought it would be interesting to do a follow up of my original recommendations. I have included all recommendations in chronological order.

Originally, *The Fundamental Investor* was Mark's publication. When we teamed up ten years ago my first article in the **Fall of 2010** was called *"Tech Rewind".* In it, I discussed how valuations on large technology companies had swung from ridiculously overvalued in the late 1990s to very reasonable with good dividends to boot. I specifically highlighted shares of Microsoft which was trading at $26 with a 3% dividend. Many investors viewed the company as a has-been, tied in to the dying personal computer business and very few analysts were recommending the stock. Mark and I saw a great business, pumping out consistent profits, with a pristine balance sheet.

Original recommendation:	Fall 2010
Price purchased:	$26
Action/Position:	continue to hold
Current price:	$150
Gain to date:	600%*

My next recommendation was in our **Spring 2011** issue. I talked about how Coca Cola had come off in price over the last decade and while it was not cheap on an absolute basis, it was at a good entry point.

Original recommendation:	Spring 2011
Purchase price:	$33 (2:1 split 2012)
Action/Position:	continue to hold
Current price:	$53
Gain to date:	115%*

In the **Fall of 2011**, I spoke about General Mills: *"Say hello to the general".* We purchased the shares and held them for a few several years, however I was not a fan of some acquisitions the firm made (in particular the price paid) and for this reason, I sold them in February 2018.

Original recommendation:	Fall 2011
Price purchased:	$37
Action/Position:	Sold @ $55 (Feb 2018)
Current price:	$52
Gain to disposition:	54%*
Change since disposition:	-5%

My **Spring 2012** article was titled *"Nothing runs like a Deere".* As a fan of John Deere and its big green machines, I also saw the investment merits of this great American icon. I understand the cyclical nature of the business and therefore, I sold it a little quicker than I should have. In fact, I traded in and out twice. The shares continue to be on my radar and would like to own it again at the right price.

Original recommendation:	Spring 2012
Price purchased:	$79
Action/Position:	Sold @ $95 (Oct 2012)
Realized gain on trade #1:	20%
Repurchase date:	May 2018
Purchase price:	$135
Action/Position:	Sold @ $158 (Oct 2018)
Realized gain on trade #2:	17%
Current Price:	$175
Change since disposition:	11%

The **Fall 2012** issue contained my first recommendation of Target Corp. I had been impressed with the company's history and track record. It was around that time that Target entered the Canadian market. The Canadian adventure did not work out very well, the company lost money, and subsequently closed their Canadian operations, to focus solely on their U.S. business. I wrote again about the company in the Spring of 2017 issue as I felt the fear of Amazon taking over the world was overblown and companies like Target were mispriced.

Original recommendation:	Fall 2012
Price purchased:	$50
Action/Position:	continue to hold
Current price:	$125
Gain to date:	236%*

I recommended shares of CSX, the Jacksonville, Florida based American railroad in our **Spring 2013** issue. At the time, the shares seemed to trade at a discount to their intrinsic value. I got a bit lucky as the late, great Hunter Harrison left his position as Canadian Pacific to bring his "precision railroading" methods to CSX. This caused the shares to surge, giving me and my clients a big winner.

Original recommendation:	Spring 2013
Purchase price:	$23
Action/Position:	Sold at $75 (Oct 2018)
Current price:	$69
Return:	250%*
Change since disposition:	-9%

In the **Fall of 2013,** I talked about Intact Financial. I'm a fan of the casualty and property business. They way I see the business is 'head we win, tales you lose'. That is; if you don't make a claim in a given year, premiums increase due to 'inflation', if on the other hand you do make a claim, then your premiums increase even more. The Canadian market was (is) quite fragmented and Intact has been an important consolidator of smaller players.

Original recommendation:	Fall 2013
Purchase price:	$60
Action/Position:	continue to hold
Current price:	$135
Gain to date:	125%

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In the **Spring 2014** issue, my article *"Where I want to be"*, discussed Visa. I wrote that if the shares were to come off a little, giving me a better entry point, I would be a buyer. Unfortunately, the shares never dropped enough for me to pull the trigger. I have always been fearful of overpaying for a stock. Visa has consistently been expensive in my opinion. The shares have done very well since I wrote about them.

In our **Fall 2015** issue, my article *"Long and winding road"*, discussed two names: Walmart and IBM.

Walmart stock had fallen 30% that year, as it had been making investments in its online strategy and raising wages for employees. The market decided to take a short term view of its declining profitability. I felt paying workers a decent living wage made good business sense and beefing up their on-line presence to better compete with Amazon was a must. Since then Walmart has demonstrated to the market that it is truly a force to be reckoned with in retail. Its JetBlue acquisition and on-line strategy have propelled annual on-line sales growth in the 40% range. At the same, time physical stores have been reorganized and same store sales are up nicely. The shares are no longer cheap, however the retail landscape is transforming in America and Walmart is emerging as one of the clear winners.

Recommendation:	Fall 2015
Purchase price:	$50
Action/ position:	continue to hold
Current price:	$120
Gain to date:	200%*

IBM had been in a transformational process for a few years when I wrote the article. It was transitioning from older businesses to newer (more profitable) ones. During the second quarter of 2018, after looking at their latest earnings report, I recognized that the shares were rallying on an unsustainable spike in mainframe sales. I used this rally as an opportunity to sell. I had been quite patient with the company for some time, however I began to believe that the turn around was going to take longer and was more uncertain than I initially thought. I was no longer confident that management was on the right track or was doing a good enough job.

Recommendation:	Fall 2015
Purchase price:	$130
Action/ position:	sold @ $149 Apr 2018
Current price:	$134
Realized gain:	10%*
Change since disposition:	-10%

In the **Spring 2015** issue, I recommended Schlumberger. It is a great oil field services company but my timing was bad. It was a mistake at that price. I believe oil services will come back and SLB will participate.

Original recommendation:	Spring 2015
Purchase price:	$102
Action/ position:	tax loss driven sale, otherwise still holding
Current price:	$35
Loss to date :	-65%*

During 2016, I did not recommend any individual stocks as I decided to write about other issues. However, in the **Spring 2017** issue, I revisited the Target and Walmart recommendations.

My next recommendation was United Technologies in the **Summer 2018** issue. I wrote that some investors, including activists, believed that breaking up the company would unlock value in the conglomerate. At that time, there was no indication that CEO Greg Hayes had any intention of following through with the break up, however things have changed since then. The company has announced its intention to break up into four. I had purchased the shares believing that they were high quality and reasonably priced. At the same time, fully aware that this was the kind of business that can be sensitive to movements in the overall economy, I decided to sell the shares in October 2018, as I felt there were risks to the global economy. Once the share price had fallen enough to discount the uncertainty and give a greater margin of safety, I repurchased them.

Original recommendation:	Summer 2018
Purchase price:	$95
Action/position:	sold @ $137 (Oct 2018)
Realized gain on trade #1:	44%*
Repurchase date:	Jan 2019
Repurchase price:	$109
Action/ position:	$147
Gain to date:	35%*

My most recent recommendation was in the **Summer 2019** issue, in the article *"Pharmacy Woes"*. I wrote about how the current political environment (pressure to reduce the cost of healthcare in America), combined with (once again) fear of Amazon, had put pressure on shares of CVS and Walgreens. I felt like the market was taking too pessimistic a view of the future and that patient investors would likely be rewarded. Although not all the clouds have cleared, since that time the shares have rallied as market participants now realize that the possibility of a truly radical over hall of the healthcare system proposed by some candidates in the 2020 election is unlikely. Despite the recent rally, I still believe these are early days and the shares can still move substantially higher.

Golden Rule #1: Always be super careful when managing other people's money…… Al

*Return expressed in CAD which includes gains or losses on currency.

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frequently proffered aggregate figures, you get a much different picture. Population growth due to immigration has been about 1.0-1.1% while natural population growth remains about 0.4%. Together this represents about 1.5% total population growth, roughly in-line with real GDP growth over the last few years. So while politicians may trumpet that national GDP has seen growth, as would be expected with a growing population, the average worker has seen no real growth in their income. This tactic is also producing similar statistics in Australia. Proponents often argue that things would have been far worse in many countries without these more liberal immigration policies: however, such counter-factuals are impossible to prove. I'll stick with real data, which we have, and thus to argue that Japan could have avoided all of its woes with an open borders immigration policy does not seem to be supported by the data in other countries.

Those who believe that technology will solve all that ails us, via productivity enhancements, should reconsider that notion. No country has invested more in automation, over the last few decades, than Japan, yet this too seems to have had a marginal impact at best. Productivity gains in both Europe and America this cycle have been low to non-existent. Thus neither of the arguments for more liberal immigration policies and/or productivity enhancing technology investment seem to be strong arguments against Japanification.

Fiscal Stimulus
Currently there are many arguing for more fiscal stimulus from policy makers, via infrastructure spending, student debt forgiveness, free health care for all, or if need be, dropping money on the masses from helicopters. But a thirty year review of Japan's extreme attempts at both monetary and fiscal stimulus should convince everyone that these policies have failed to stoke growth.

Abenomics, named after Prime Minister Shinzo Abe, was launched in 2013 and remains the most aggressive effort by any government to revive the moribund Japanese economy. The two pronged attack, fiscal and monetary, resulted in four consecutive years of record federal deficits aimed at infrastructure spending, while monetary policy pushed rates below zero on the 10 year Japanese Government Bond (JGB). Furthermore, following massive quantitative easing efforts, the BoJ found itself owning roughly 50% of all outstanding JGBs. That's saying a lot, given the country's debt to GDP ratio of 250%, an elevated ratio possibly only rivaled by that of Greece!!

Negative Rates = Broken Banking Systems
Another argument against global Japanification, is that Japan failed to write down (take losses) on all of its bad real estate and other mal-investments related to the 1980s and thus forcing a re-capitalization of its banking system. Throw-in a flat yield curve with miniscule interest rates making it almost impossible for banks to make money from traditional lending, and you end up with an insolvent, zombified financial system that is a drag on economic growth. Europe seems to have learned nothing from the Japanese experience and has followed suit, failing to recapitalize its banks and punishing this critically important sector with negative interest rates. Credit to America, which successfully recapitalized its banks and has managed to keep rates in positive territory, at least for now. So this argument doesn't hold true for Europe and the verdict may still be out with respect to negative interest rates in America.

Debt & Deflation
In 2018, Japan had a Net Foreign Assets (NFA) balance of 700 billion USD, about 14% of its GDP, leaving it in a much better position than the US, which now has a negative NFA balance of 50 billion. Clearly, under duress Japan could liquidate its foreign assets, repatriate the funds and pay off, in whole, all of its foreign creditors, not so for the USA. Many have argued that mounting global debt represents a deflationary force. This is probably true, consider that even under a benign status-quo regime, eventually rising interest expense draws money from the consumption side of the economy unless debtors can continue to issue (take-on) ever increasing amounts of debt in order to cover both interest expense and maintain consumption. As economist Herbert Stein said in 1985, *'if something can't go on forever, it will stop'.* If Dr. Stein is right and the debt bubble pops, I agree that the initial impact will be highly deflationary, however, policy makers will not stand idly by as the public at large clamours for action. The cure will be more of the same actions we have seen over the past decade but turbo-charged. Governments will not tolerate defaults (think autos, banks, grossly underfunded state pensions, etc.), and will do the only thing they know how to do, throw vast amounts of money at each problem, relying on central bankers to facilitate their actions by monetizing the treasury's debt issuance. Thus, the short and painful initial deflationary forces of a economic downturn will be turned into an even longer and more painful type of inflationary stagnation via policy responses.

Conclusion
Draw your own conclusion, but from what I've seen over the past decade in Europe and indeed around the globe, those nascent arguments from fifteen years ago about global Japanification don't seem so crazy to me now. While there are certainly differences between Europe, America and Japan. It seems that erroneous policies in these three important economic regions are being repeated in one way or an other, with some new twists here and there, but that the three immutable forces of demographics, debt and deflation may eventually push us all into a very difficult to get out of, Japanese style economic funk.

Policy is leading us towards a rewind of That 70s Show, stay vigilante. Sincerely, Mark.