BMO Nesbitt Burns

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ENERGY CRISIS 101

The energy crisis I wrote about in the Winter issue of The Fundamental Investor, entitled '*The Coming Energy Crisis*', seems to have arrived a little sooner than I had originally expected: I hadn't expected the energy crisis to bite quite so hard until the first half of 2022. Of course making predictions about the timing of such events is always difficult, but here we are.

Coming Home

The problems seem to have started in Asia and Europe and because energy markets are global in nature, rising prices overseas are dragging up energy costs in North America. Prices are increasing in North America in sympathy to rising global energy constraints, rather than as a result any true domestic shortages. But rest assured, a true energy crisis will likely come home soon enough.

Parts of the globe outside North America have seen skyrocketing prices for many different kinds of fuels. For example, thermal coal in Southeast Asia is up almost 100%, while dwindling gas stocks in Europe have resulted in 300-400% increases for LNG (liquified natural gas). UK wholesale electricity prices doubled in the month of September alone.

Cart Before the Horse

It seems that replacing our fossil fuel and nuclear base load capacity with intermittent renewable sources such as wind and solar wasn't a great idea. Power output falling well short of demand when the wind doesn't blow and the sun doesn't shine: surprise, surprise.

The mad dash to de-carbonize our energy system, coupled with the emotionally driven fear of nuclear, has resulted in a dismantling of much needed steady baseload capacity in favor of less reliable renewable sources. Germany's vow to go nuclear-free post the 2013 Fukushima disaster, with an emphasis on solar, has resulted in a doubling of electricity prices in Germany over the last decade. That's a 7% compounded growth rate in electricity prices, well above average wage growth over the same decade.

While England's pledge to go nuke-free has been weaker, it has pushed all-in with offshore wind farms in recent years. Unfortunately, 2021 wind volumes in the North Sea have been running at less than 50% of their historical average. Thus, standby gas fired power plants needed to be run more regularly to make up for the missing wind power. This resulted in a depletion of gas stocks just ahead of the critical winter heating season in Europe, a period when gas held in storage across the continent should be rising (not hitting five year lows) to provide a supply cushion for the very high demand winter heating months.

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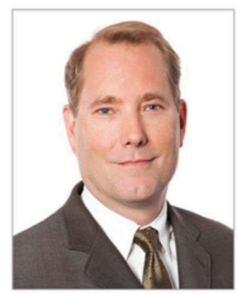

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FIXED INCOME: A Balancing Act

Since the start of the pandemic, central bankers have been uber friendly to markets by slashing interest rates and buying bonds. The bond buying, known as quantitative easing, helped push down bond yields and hence borrowing costs for consumers and businesses alike. No doubt these actions helped to avert economic disaster, especially during those dark early days.

Recently, supply disruptions and surging commodity prices have pushed inflation above the stated 2% target. Montreal born Bank of Canada Governor, Tiff Macklem, and his colleagues on the global stage must walk a fine line between letting inflation get out of control and being too aggressive with an economy still finding its footing as it emerges from the pandemic.

While the Bank of Canada (BoC) and the U.S. Federal Reserve have not yet begun to raise rates, it won't be long. In fact, markets are already pricing-in 4 to 6 hikes by Dr. Macklem in 2022: we should see the first by April at the latest. The Americans will not be far behind, mid-2022 is the current thinking. The Loonie has benefited from Canada's more hawkish position vis-a-vis the Americans'. It has also benefited from surging energy prices.

The BoC is currently not planning on actually selling any of the $350 billion worth of Government of Canada bonds it has purchased since the beginning of COVID. It intends to simply replace maturing securities, while not being a net buyer.

Massive Shift

For market participants there is no mistaking that a massive shift is taking place. The trend has turned and interest rates are going up. The implications are far reaching. Home buyers who locked in mortgage rates at bargain basement levels will face higher payments at renewal time. Equity investors in high growth and speculative areas have benefited from discounted cash flow assumptions at near zero rates. The math doesn't look so good when you plug in higher numbers. Yields on bonds have begun to rise. Bond market participants have already seen negative returns so far in 2021. Despite having received the interest on the instrument, the price of the security has fallen. This is likely to continue into 2022.

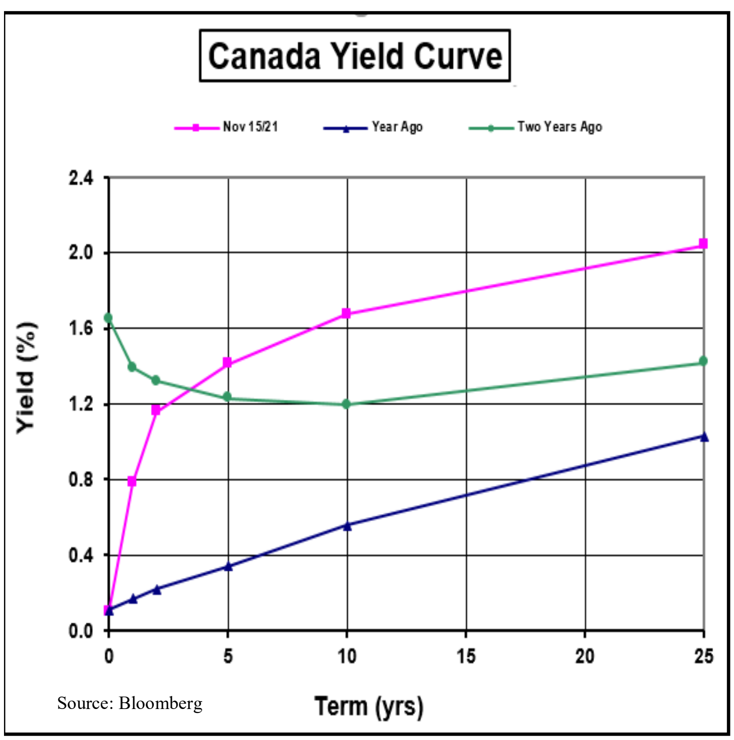
So far, most central bankers have been sticking to the story that inflation is transitory. That is, much of what is causing inflation to rise are things that should pass. For example, the supply chain bottle necks and surging commodity prices should ease as we get into the latter part of 2022 and into 2023.

This remains to be seen of course, but it makes the task at hand that much more difficult. Currently the BoC's estimates for the Canadian Consumer Price Index (CPI) are for 3.5% this year and next. Clearly something must be done to bring that number down.

Unfortunately, economics is not a pure science. Central bankers do not have a playbook for "inflationary pressures coming out of pandemics". To complicate matters, there is a chance that higher rates on their own will not necessarily bring down inflation. For example, will higher rates make it rain more, hence easing some of the food price inflation resulting from recent droughts? Or will higher rates help bring about a solution to the looming energy crisis (energy prices are an important component of the CPI) brought about by underinvestment in traditional energy sources at a time when the world appears willing but not quite ready for an energy transition?

Given current conditions, central bankers have no choice. They must roll back the emergency policies enacted during the pandemic. Dr. Macklem and other central bankers must balance various forces working in opposite directions, find the right formula to keep the economy expanding without overheating, while also keeping inflation and deflation at bay. Good luck to them, they will need it !

Sincerely....Al



STOCK TALK: Linda, Nancy & Margaret

A Canadian Success Story
Founded in 1966 in a basement by a Hungarian immigrant named Frenec Hasenfratz, Linamar has grown to become the second largest auto parts manufacturer in Canada. Mr. Hasenfratz called his company Linamar derived from the names of his two daughters Linda and Nancy as well as his wife Margaret. Linda Hasenfratz is currently the CEO while Frenec is on the board and still owns a quarter of the business.

The company has two main divisions, Mobility and Industrial. Mobility is responsible for precision machinery and assembly in addition to transmission systems for both combustion engines and electric propulsion vehicles. The industrial component is made up of Skyjack and Macdon. Skyjack builds aerial platform equipment while Macdon is in agricultural harvesting machinery. Linamar has operations in 61 countries and employs over 26,000 people.

Light Vehicles....Mostly
Approximately 80% of the company's earnings are derived from the mobility division, hence profits and share price performance are highly corelated to the automotive industry. In 2018 and 2019, slowing economic activity reduced demand for automobiles. In the early part of the pandemic demand plunged, as did the quoted share price. Automotive demand has recovered faster than expected. Among other factors, consumers have shown a preference for personal mobility vs. public transport.

Over the last several months automotive manufacturers around the world have been suffering from a shortage of semiconductors. This forced Linamar and others to reduce output and idle assembly lines. Analysts estimate that production for the most recent quarter will be down 25%. The shortage and related production cuts will adversely impact earnings for the sector and share prices have come off substantially. Despite the challenges related to labour costs and commodity inflation, the industrial division has cushioned the blow to earnings and margins. One can make the case that Linamar is more diversified than a pure auto parts maker and should be rewarded with a higher multiple.

Timely
Historically, Linamar's stock has traded between 3 and 7 times EV/EBITDA. The recent quoted price is close to 3, so in my opinion this is an opportunity for investors to step in and buy as I have recently done in the mid $60s. The shares have paid a dividend, albeit a modest one, for over 15 years and management has lately raised the payout by 25%.

The balance sheet is in excellent shape with zero net debt. In addition, strong free cash flow generation has given management the confidence to announce a share buyback of up to 10% in the open market.

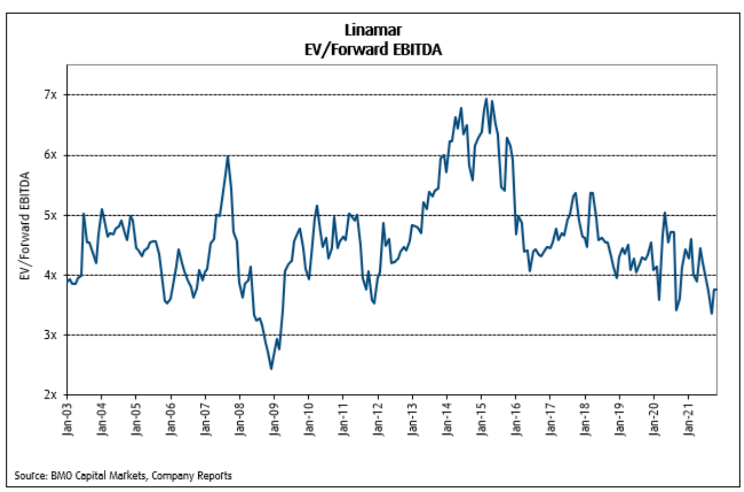
The component shortages will eventually be resolved. Currently, BMO is forecasting a substantial improvement by the second half of 2022. If we assume normalized production and earnings, the shares appear inexpensive and offer substantial upside from my perspective.

Bright Future
Linamar is well positioned for the transition to hybrid and electric propulsion vehicles. The company's programable and flexible production line can be adjusted relatively easily to various types of vehicles without excessive cost and disruption.

There is little doubt that these are highly cyclical shares. Both the mobility and industrial divisions' fortunes are reliant on economic conditions, therefore this may not be a buy and hold type name. However, it would appear that with demand currently strong and inventories low, the cycle has not yet even begun. Additionally, during the pandemic, Linamar, like many companies, cut costs and derived efficiencies. Hence, profitability can surprise to the upside when production and demand meet at the top of the cycle.

Of course, as always, there are risks. For example, if ongoing parts shortages were to persist longer than expected or if inflationary pressures related to input commodities and wages were to remain elevated, these costs might prove difficult to pass on to consumers. Also, if interest rates climb substantially creating an environment where consumer financing rates for light vehicles became prohibitive, this would also pose a risk.

Always be super careful out there...Al



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The Transition Will Not be a Smooth One

There's no quick fix to the rash and ill thought-out decisions made years ago by EU policy makers, looking to score green points with voters. Adding further pressure, at the margin, to the electrical grid is the mandated push for electric vehicles all across Europe. Indeed, an EU regulatory threat to prohibit the registration of new gas and diesel cars is pushing manufactures to commit to time lines that seem unrealistic to me. On the fossil fuel front, integrated multi-nationals such as BP and Royal Dutch are being nudged, regulated and beaten into submission: both have now made 'voluntary' pledges to a carbon neutral time line that also seems unrealistic.

Given the current overwhelming desire by both policy makers and the public to do whatever it takes to de-carbonize, regardless of the consequences, we should all expect to see recurring intermittent energy crises over the course of the coming decades. If ideas, actions, legislation and popular opinion remain unrealistic about how much can be achieved over any given time period, than the norm will be big recurring energy price spikes and shortages.

As an aside, a half dozen smaller electric power producers in the UK have recently filed for bankruptcy, leaving 1.5 million customers without power. Squeezed by higher electricity production costs due to skyrocketing wholesale natural gas prices and unable to pass on rate increases due to government price controls on retail electricity, these power producers have had no choice but to file for bankruptcy.

My personal belief is that rising energy prices, which disproportionately hit the middle and lower classes much harder, will cause a shift in popular support for the green mad-dash. Hopefully this will result in a more thoughtful policy decision making process and regulatory implementation. In the meantime, I plan to take advantage any such policy-induced chaos to make money for clients in the energy space as best I can.

Typical Commodity Cycle Extended

Europe is clearly leading the de-carbonization charge (electrification revolution) and if the rest of the world follows suit thereafter, expect the prices of essential metals for this transition to stay sky-high. Metals such as copper, nickel and molybdenum could easily double and triple in price in the near future, making it virtually impossible for manufacturers to bring down the price of EVs, which are currently 20-30% more expensive than comparable ICE (internal combustion engine) cars.

Further adding pressure on the metals complex will be the need to upgrade and build-out the required charging station network, grid distribution capacity and many new power stations. This could result in persistent and chronic shortages of electricity as the EV fleet builds: shortages can only be compensated for using standby fossil fuel power stations, which are becoming more costly to run due to de-carbonization efforts. As moral suasion and regulatory pressures build, expect the economic advantage of burning clean cheap electricity in your EV to vanish.

Fortunately, the greens are slowly moving to support nuclear. Furthermore, high prices for metals and energy should temper our desire to put the cart before the horse. If we unilaterally dismantle the carbon economy without having built something green and reliable in its place, we should all expect adverse consequences to follow.

Indeed, the movement to permit and construct many more nuclear power plants should have been undertaken more than a decade ago; as should have the permitting of many new uranium and other mines for the vital metals we will need to electrify our transportation systems. This lack of long-term strategic planning, coupled with our short-term rush to de-carbonize, surely means persistently strong prices for metals and energy for years to come. While the metals and energy sectors will remain cyclical, we are likely to experience higher lows and higher highs as the business cycle ebbs and flows.

Rising Dollar Tempers Commodity Price Increases

The US dollar has remained remarkably stable, if not strong, versus other world currencies, despite huge budget deficits and aggressive money printing by the Federal Reserve. This is not hugely surprising given that many other governments around the globe have engaged in similar currency debasing behaviour during COVID. While investors have enjoyed good performance from commodities over the past year despite a strong*ish* dollar, should the dollar begin to decline, this could add an additional tailwind generating further upside to the price of both raw commodities and the share price of producers.

Investors are currently riding unicorns over the ESG rainbow, hoping for the best, which is not the same as planning wisely to invest in the resources we will need for success in the coming energy transition. Sincerely, Mark.