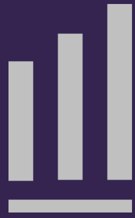

THORNMARK ASSET MANAGEMENT INC.

Perspective

December 31, 2018

Governments are the Problem, and the Solution...

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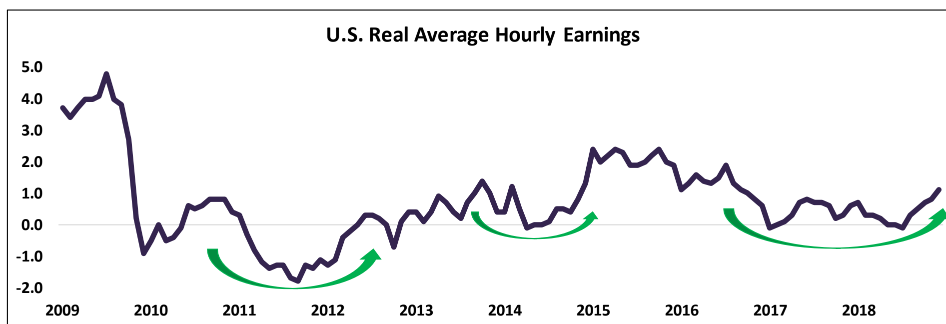
Last year started strongly, but volatility quickly increased with two significant pullbacks, the latter leading to the worst annual return since 2008. While a 2018 Christmas rally did materialize, eventually, it was not enough to recoup the Q4 losses. The economic benefit of U.S. tax reform was unhinged by European and emerging market slowdowns and concerns of higher interest rates. However, geopolitical conflicts were the straw that broke the camel's back and weighed heavily on global equity markets in the fourth quarter. The government, and more specifically but not exclusively, the Trump administration, was the root of the fourth quarter equity demise. Government indecision and conflict yielded an extraordinary period of policy uncertainty. Then, in November, U.S. Federal Reserve chairman, Jerome Powell, bobbled his November 28 speech, leaving investors worried about him auto-piloting future interest rate hikes. The same government forces that created the market overhang are likely also going to be the solution!



Source: Bloomberg Financial, Bureau of Labor Statistics

While Elizabeth May's government hung on by a thread, Brexit remained uncertain with risks of a hard exit mounting. Worries continued to mount that North Korea was fanning its nuclear ambitions, in apparent contradiction to the summit "agreement." The US/China trade war was heating up with threats of more tariffs on the horizon. China's Huawei CFO was arrested in Canada, sparking a conflict between the otherwise friendly nations. The Democrats took the house in the U.S. mid-term elections. Meanwhile, Trump shut down the U.S. government, thereby breaking a funding agreement with his own Republican party after Fox News host, Lauren Ingraham, accused him of not living up to his border wall promise (regardless of promises Mexico would pay for it). And that's just to name a few geopolitical conflicts outstanding the end of the year.

Adding fuel to the U.S. correction fire, FAANG stocks (Facebook, Amazon, Apple, Netflix and Google) lost their bloom. Facebook (investment position sold in March at an average price of $176), besmirched by data and integrity breaches, declined 43% from its intra-year high. Apple, facing growth concerns and consumer backlash to U.S. tariffs, declined almost 39%. Indeed, all market leading FAANG stocks were in bear territory of more than 20% declines by year-end.

Despite the gloomy fourth quarter, opportunities are emerging. The fundamental outlook for North American equity markets improved after the Q4 bear market. Falling oil prices and U.S. dollar strength enables the U.S. Federal Reserve to pause rate hikes. Powell's comments after his November speech catastrophe have been much more amenable to investment markets and sentiment. The Fed appears to have more "feel" for the financial markets as recommended by Trump and financial experts alike, debunked the autopilot concern and is likely to pause rates hikes this year. A more measured Fed approach allows the disinflation boom to help drive equity prices higher. The U.S. bond market, sometimes a leading equity market indicator, came to the same conclusion ahead of equity markets – that the Fed will pause soon. Therefore, interest rates declined and spreads widened marginally, a key signal that recessionary fears were overdone.

As a result, North American equities offer attractive value compared to bonds and cash. Stocks have high enough net cash to put a floor on share price declines. Stocks derated in the fourth quarter while margins were, and remain, close to a record high and, as a result, PEG ratios, an important valuation metric, collapsed.

The oil price collapse helps to keep a lid on inflation fears and enables the Fed to be more accommodative. Recession fears are also <u>not</u> supported by firm wage growth. Typically, wage growth starts to decline well in advance of a recession. Wage growth is just starting to gain momentum while credit markets continue to operate efficiently. U.S. corporate earnings will face strong dollar and increasing costs, however, valuation at the end of the year more than fully discounts these headwinds. In Canada,

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lower oil prices have weighed on our petrol-currency and TSX earnings, but we expect both to improve in 2019 as more signs emerge of policy stabilization and economic sustainability.

Paradoxically, the geopolitical uncertainty and resulting market woes are pressuring politicians to find a solution. For instance, the prospect of a no deal-Brexit is a firm rebuke of the political mechanism and a personal embarrassment to parliamentarians. Therefore, as the deadline tightens, there is more incentive for a negotiated solution.

Meanwhile, the toll of the U.S./China trade war is revealing itself, as is the need for a resolution. Unpredictable and inconsistent as he may be, Trump's measure of success is the U.S. stock market, which has been dismal through the end of his second year in office. Pressure is therefore on him to get a deal with China, which will remove one of the biggest economic headwinds he created. At the same time China, by many measures, is feeling the brunt of the trade war. Weakening economic data incentivizes China to stimulate growth while also initiating legitimate efforts to cool trade tensions and reach an agreement with Trump. As a result, the probability of a deal ending the trade war in the first half of 2019 or at least no further tariffs has improved. A deal, should it materialize as we expect, will be welcomed with a significant market rally.

We're optimistic geopolitical turmoil will abate as the growth deceleration bottoms out in the first half of the year. Therefore, equity markets should rebound from the December lows as the economic expansion extends into the 2020s. However, while Trump remains in the White House and nationalism gains momentum, forecast risks are higher than a year ago. A barbell approach is thus used for portfolio positioning whereby alpha strategies remain fully invested while more defensive strategies are underweight equities with a more defensive sector allocation.

COMPANY COMMENTARY

With revenues of $3.5bn and 30% market share, Maple Leaf Foods (MFI) is the largest Canadian supplier of pork (70% of sales) and poultry products (20% of sales). Added to portfolios in 4Q, MFI reduces its sensitivity to volatile commodity prices through its integrated operations (owns livestock, packaging and distribution), its brand loyalty, and under penetration of beef which is impacted most in recessions. Pork prices dropped following the Chinese embargo on US farmers, causing them to flood the Canadian market with excess supply and MFI's margins to fall from 11% to 9%. The share price sold off and remained at its lows despite a rebound on African Swine Fever curtailing Asian supply which seems to be ignored by investors. Combined with easier comparisons and a consolidation of its poultry facilities, there is a credible path to 14-16% by 2022. By then, free cash flow (FCF) should improve to $450mn, implying a 13% FCF yield on the current share price. Our target is $38, using 10x EV/EBITDA multiple on 2020 estimates and 9% FCF yield discounted to today. A relatively safe and stable 2% dividend yield imputes roughly 30% 1-year total return with meaningful upside should African Swine Fever spread across China or the end of the trade war.

Volatility in diversified healthcare company Johnson & Johnson provided an opportunity to add to our holdings. Despite being well positioned for slowing economic growth, its shares sold off in December by $60bn or 15% on concerns about contaminated baby powder litigation. These concerns have been a persistent overhang since 1972. However, in December an article was published suggesting that company executives were aware that the company's baby powder tested positive for asbestos decades ago. The potential liability, even admitted by litigating lawyers, is nowhere close to the amount discounted by the J&J price decline. Indeed, the potential liability was already factored into analyst expectations. Based on historical precedent, liability, if found guilty, would not likely be more than $7bn. We don't have any reason to expect criminal liability on the part of the current management team. More likely, the liability will not be material. J&J has been testing samples every hour for asbestos since the 1970s. The FDA also regularly tests J&J baby powder samples. Since 2013, J&J has won 35 out of 40 lawsuits with 5 others awaiting appeal. Despite the December article's claim that J&J management knew about asbestos contamination, the company has won the past five trials. There is no history of talc miners having contracted mesothelioma, a type of lung cancer caused from inhaling asbestos. Therefore, we believe this asbestos issue will be resolved on terms favourable to the company. J&J was trading at a significant discount to its 5-yr average forward P/E of 17. As visibility of a resolution materializes, we expect the multiple to trade up from 15 times forward earnings to the historical average of 17 for a target price of $156. Adding a generous 2.8% dividend yield provides a 1-year total return of 24%. Further upside to our target price is available if sentiment pops on a favourable and/or early settlement.

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