THORNMARK ASSET MANAGEMENT INC.

PERSPECTIVE

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The "Powell Put" - Central Banks to The Rescue

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Despite no fundamental improvement, equity markets have been on a tear in 2019. For the first time since 2016, S&P 500 average earnings declined, year-over-year. As geopolitical risks remain elevated, economic and earnings forecasts lost momentum, but should gradually improve as central banks around the world provide more liquidity, creating a positive setup for equity markets in the second half of 2019.

DOVISH CENTRAL BANKS

Despite the fundamental equity challenges, the dovish shift of central banks was the antidote required for robust performance in the first half of the year. Investors now feel assured of a "Powell Put", when the U.S. Federal Reserve lowers interest rates to offset economic data or equity markets weakness. Like the "Greenspan Put", the central bank is protecting equity investors. The consensus, at the end of June, is a 100% probability of a U.S. rate cut before the end of the year. Naturally, we must ask if the conviction is justified, if Fed puts work and if we should be concerned about negative feedback loops? We evaluate each of these questions below.

OUTCOMES MIXED

U.S. rate cuts have generally delivered positive equity market performance. However, the timing of a Fed-induced rebound is a function of many factors, including the directional trend of underlying economic and business fundamentals. Fed cuts in 1995 and 1998 resulted in market relief rallies. However, in 2001 and 2007, the immediate outcome was less favourable. In the latter examples, the ensuing market recovery took 1 to 3 years to materialize and only after subsequent and significant rate cuts. In both '01 and '07, the initial Fed funds cut was followed by a dramatic equity market selloff. In 2001 the S&P 500 declined 25% (in US dollars) before recovering after the last rate cut of the cycle.

Similarly, during the financial crisis, the S&P 500 plummeted 37%. The difference between the 1990's rate cuts and the 2000's rate cuts was the underlying economic trend. The worsening economic fundamentals that preceded the Tech Wreck and Credit Crisis meant more stimulus and time was required to create an economic U-turn.

On the surface, recent historical data seems inconclusive about the short-term market response to Fed rate cuts. However, digging deeper reveals that market reaction is dependent on underlying economic trends. "One-and-done" rate cuts consistent with policy tweaks to maintain economic momentum are more likely to provide an equity market boost. However, if the economy is headed towards a recession, more dramatic intervention is required to reinvigorate the economy, as was the case in 2001 and 2007. Therefore, the market's reaction to rate cuts is dependent on the expected central bank behaviour beyond the initial cut. In either case, one-and-done or successive cuts, central bank intervention (actual or moral suasion) will increase market volatility, particularly if the bank is perceived to be behind the curve and will be forced to react instead of leading the economic outcome.

FUNDAMENTALS POSITIVE

At the Fed's July meeting, it is expected to cut rates between 25 and 50 basis points. At Thornmark, we believe 25 basis points is more likely. While monetary policy can be constrained by inflation, this cycle's cost pressures remain low. Therefore, central banks, and the U.S. Fed in particular, have policy flexibility. Naysayers worry that historically low unemployment at 3.8% will lead to upward wage pressure and broadly higher inflation. That would undermine ongoing accommodative monetary policy and, in turn, destabilize the economic expansion, leading to rerating of risk assets and, in turn, lower stock prices.

The probability of rate cut induced negative feedback loop happening now is relatively low. This is because several economic indicators show that structural changes are underway to limit inflation over the long term. First, for demographic reasons, the labour force participation rate remains historically low, around 62%, which means there is a demographic cohort with less spending power. Second, the prevalence of short-term, low value-added and low-paying jobs is changing the structure of the labour market. Third, after the '08 Credit Crisis, U.S. households significantly reduced leverage. Less borrowing means lower spending growth and inflation pressures, a trend we expect to remain intact for our investment horizon. Since inflation is expected to remain low in the face of some moderate stimulus, the risk of a negative feedback loop seems small. Thus, it does make sense to embrace the "Powell put".

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FISCAL STIMULUS IMPROVES OUTLOOK

Regardless of trade jitters and political haggling, world economic momentum is expected to broaden out in the second half of this year. Central bank stimulus around the world will help to extend the economic cycle. As always, rising and increasingly unpredictable tail risks are the wildcards in our assessment that we will continue to navigate if they materialize.

SECURITY NOTES

Home Capital (HCG), via its Oaken Financial and Home Trust subsidiaries, is one of Canada's largest independent banks. During the 2017 housing market decline, short-sellers triggered concerns of a bankruptcy causing a run on the bank as people withdrew savings. Investors pushed the stock price down 75%, creating a strategic investment opportunity for Warren Buffett that restored liquidity. While HCG loan losses were only 0.3% of total loans, HCG used the Buffet opportunity to strengthen its balance sheet with more extended duration borrowings, lower leverage and high loan credit scores to lower default risk. These changes set up HCG for a healthy recovery, and we now expect loan growth to exceed consensus estimate of 8% this year. Ontario accounts for 80% of HCG revenues, which benefits from low unemployment and robust labour growth, low interest rates, positive migration and real estate trends. GTA housing activity continues to rebound from the tighter B20 mortgage regulations and foreign buyer tax, with 15% sales growth in 2Q19 alone. EPS should continue outpacing peers at 15% vs large bank peers at 7%, leading to the discount in P/E to converge from 8x to peers at 10x. Share repurchases eliminating 20% of shares over the next three years and reinstituting its dividend, also help restore confidence. Our $25 target is based on 9x P/E for a total return of 14%.

Empire Co. (EMP) is the second-largest grocery chain in Canada with brands Sobeys, IGA, Safeway Canada, FreshCo and Farm Boy. Typically, in late parts of the economic cycle, food prices inflate from increased consumer spending, which leverages high fixed costs for grocers. Food consumption predictability also drives stock outperformance in a downturn. EMP should outgrow its peers from remodelling its Safeway stores into the higher growth FreshCo discount brand. FreshCo is driving an early uplift to margins. Farm Boy, its acquisition in 2018, will help its lagging GTA presence with its smaller stores, higher quality food and private label prices. It only has 26 stores but has the fastest growth and highest margins of any chain. Risks from Amazon grocery are low given the limited assortment of fresh food, Whole Foods' low market share and lack of a Canadian offering of its two-hour Prime Now delivery, which was piloted last year. Consensus estimates are too conservative with EBITDA growth of 3% next year driven by 1-2% in price inflation, 1-2% in volume growth and no margin gains compared to food inflation alone currently trending above 3%. We expect growth of 7%. Our $40 target is based on an 8.5x EV/EBITDA multiple in line with Loblaws, for a potential return of 19%. Should EMP raise op margins from 4.8% to rivals at 6% from increased scale, it could see long-term upside in excess $50.

Cargojet (CJT) controls 90% of the overnight air courier market in Canada. Late cycle economic conditions position it well as wage gains boost consumer spending and long-term contracts protect it from a potential recession. A 6-year deal with Canada Post and multiyear agreements with Amazon, UPS and DHL also protect it from new competition that requires scale to fill expensive aircraft. Profits are highly correlated with e-commerce sales in Canada and also benefit from growing consumer preference for faster shipping times. Recent announcements by Amazon to offer one-day delivery and Purolator as well as UPS to offer 7-day overnight deliveries should help accelerate demand. Planes currently sit idle on the weekend and daytime, but it seems inevitable CJT expands their Sunday night test flights to Saturdays to meet this demand. The consensus is only factoring in 8% revenue growth despite 7-14% growth over the past three years and small margin improvements despite larger 767 planes and increased utilization driving cost efficiencies. EBITDA should grow at over 15-20% over the next few years compared to street expectations of only 10-15%, likely driving valuation higher from 11x to 12x. Our target is $110 for a total return of 20%.

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