The Market in Review

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This week's articles and insights

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"We were just here - what was the point of that? That was the longest possible route we could take to just stay here!"

- ***"Do the horses know they're racing?" sketch by Jerry Seinfeld***

Your Index Report

	Current	Last Week	Year-to-Date
Dow Jones Ind. Avg.	26,143	- 0.92%	+ 12.07%
S&P 500	2,888	+ 0.31%	+ 15.22% (+12.91% in $CDN)
TSX	16,399	+ 0.54%	+ 14.50%

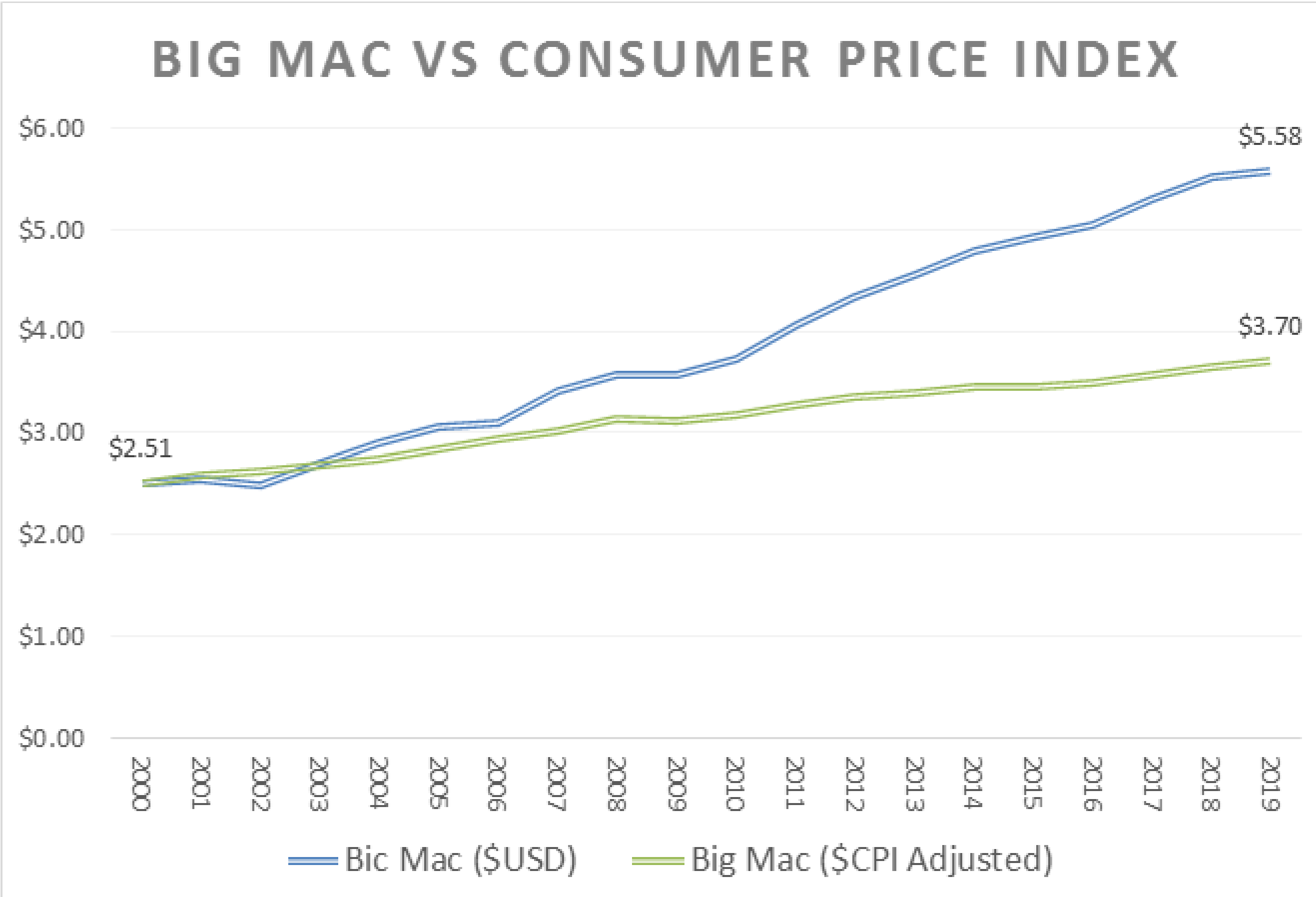
McFlation

Noticed the price of food lately?

Government statistics on inflation paint a picture of very modest price increases in the things we need to live on and in. However, there is a lot of computational mumbo-jumbo in those calculations to keep official inflation low. Faster computers, for example, lower inflation because you are getting a better product this year for the same price as last year - even if the price of the computer is exactly the same year over year.

Our office is across the street from a McDonald's and, admittedly, we have been known to visit in a weak moment. Fast food is a reliable gauge of average food prices, because it incorporates not only food costs, as well as municipal taxes on the building the food is made in, and the rising wages of the workers.

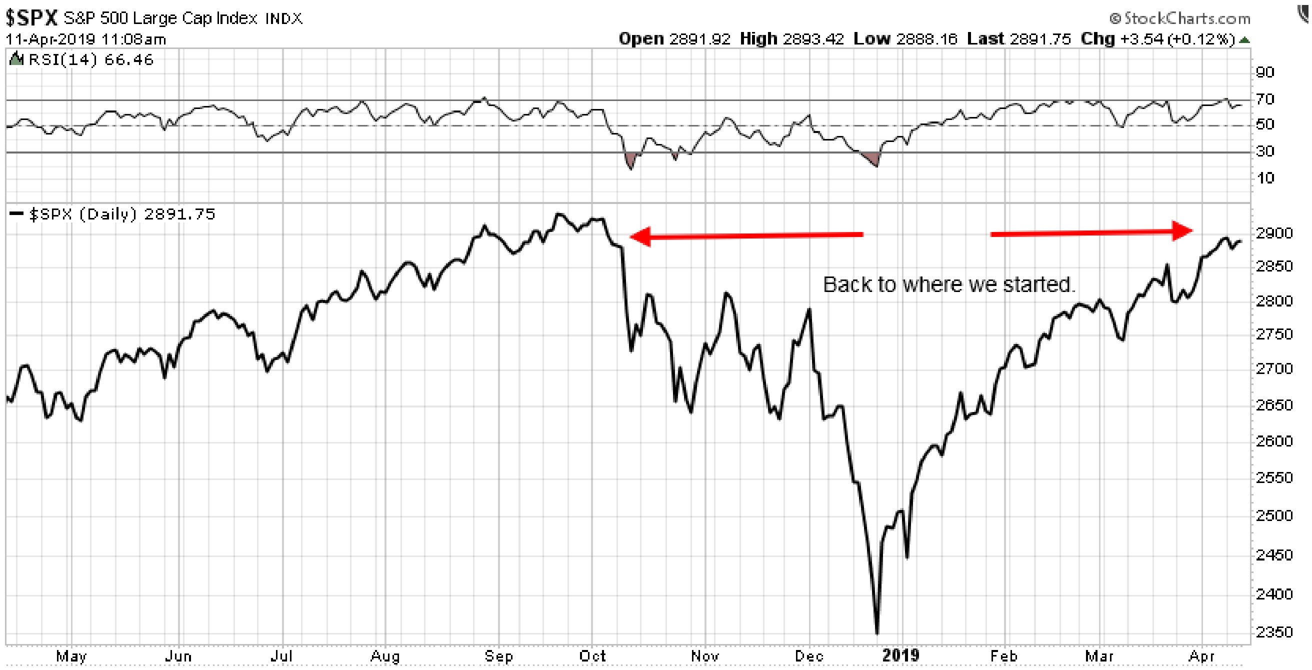
The Big Mac was introduced in 1968 at a price of US $0.49. Today, the same burger is US $5.58. The following graph compares the annual Big Mac price (source: The Economist) to reported Consumer Price Inflation starting in the year 2000. The story it tells is that inflation has been almost twice as high as reported – especially since Quantitative Easing began in 2009. The burger that 'should' cost $3.70 is actually $5.58 today.



Inflation is alive and well in food prices.

Full Circle

Like Jerry Seinfeld's horses, we have come full circle since last fall. Both Canadian and US markets are back to where they were in September, erasing the sharp October-to-December decline that ruined 2018 year-end returns.



Does this mean nothing has changed? Or has everything changed?

In hindsight, what happened in December was the result of panic. A series of market-unfriendly events that happened all at once sent markets falling 20% in just two months.

As we were thinking about what exactly happened in December, we realized that it was not so much <u>what</u> lit the match, but <u>why</u> the house burned in the first place. Today's market structure has changed dramatically since we began in the business 30 years ago, in ways both good and bad.

For example, approximately 45% of the US market is now controlled by passive investing (source: CNBC), which is up from 25% just a decade ago. Index funds, ETFs that pay no attention to valuation, robo-investors, and algorithms are built to own fixed baskets of the largest stocks. This means millions of investors own the same amounts of the same stocks.

- The positive side of this is that fees for these kinds of investments are lower than when an active manager is paid to run your money.
- The negative side is that investors in passive investments tend to buy more at the top, when news is good, than at the bottom when stocks are cheap.
- Because of the nature of index investing, these baskets have more money invested in the largest and most overpriced stocks.

Who did the passive investors replace? Active, value-seeking investors, for the most part. As a group, these now control less of the market than they have in over three decades.

- Active investing involves humans, and so is more expensive (and sometimes more flawed).
- Active managers often buy less common, non-index stocks. This can hurt, when the indexers ignore them. They are starved of buyers, in other words.
- Value investors also tend to buy more at the bottom of cycles, when values appear, than at the tops. When they are gone, who is left to buy low?

This has led to a much shallower market than it appears. In a large pool of water, like a lake, it is hard for swimmers to make waves. In large, "liquid" markets, it is easy to buy and sell shares without moving prices much. In a small pool, like a bathtub, one person can really make waves. It's why kids love baths more than the pool – more splashing!

Passive investing withdraws a great deal of liquidity from the market pool because investment dollars get "parked" in these passive baskets of stocks that rarely change. The only time things really move is when passive investors panic, as we saw last October through December. News of interest rate hikes and tensions in China-US trade shook markets much more sharply than normal.

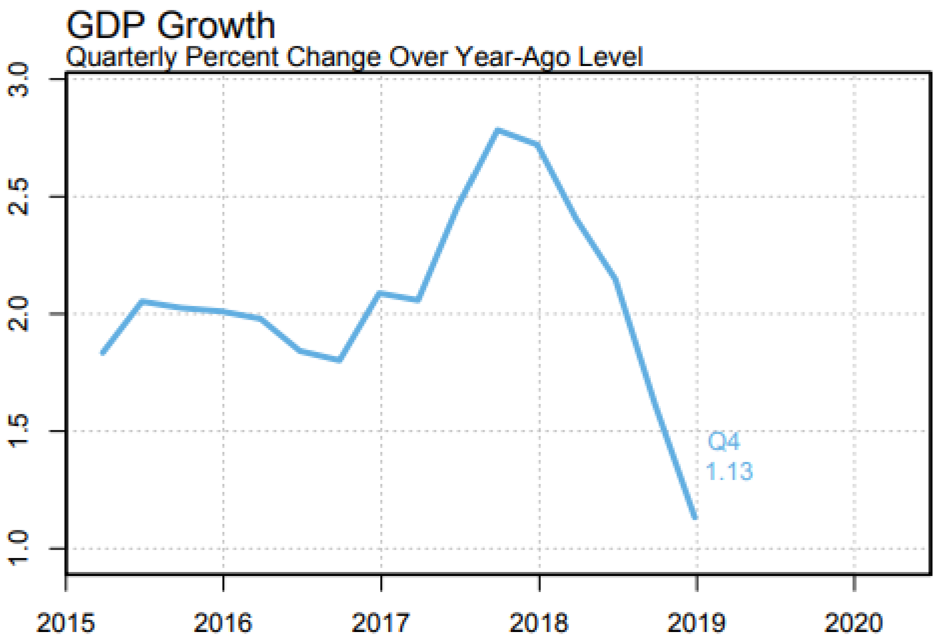
And when stocks go down, there are no longer thousands of eager value investors waiting to buy at the bottom. Going forward, we can expect more sudden spikes like that of December because of this.

What Has Changed?

With markets at the same level as six months ago, has anything changed?

Clearly, the global economy has slowed. Activity everywhere - sales of semiconductor chips in South Korea, autos in Germany, homes in the US - has declined. As a result, central banks are on hold. The US Federal Reserve stated this week that it now has no plans for any hikes in 2019 – this after threatening as many as three hikes late last year. How things change.

The Euro area has shown the most weakness:



Source: Federal Reserve Bank of New York, Haver

North America is not in recession, but the sharp decline in interest rates suggests our economies are slowing, rather than speeding up.

Canada’s 10-year bond yield has slid from 2.60% in October to 1.71% today, a 35% decline in just a few months:

Time will tell if our economies slow further.

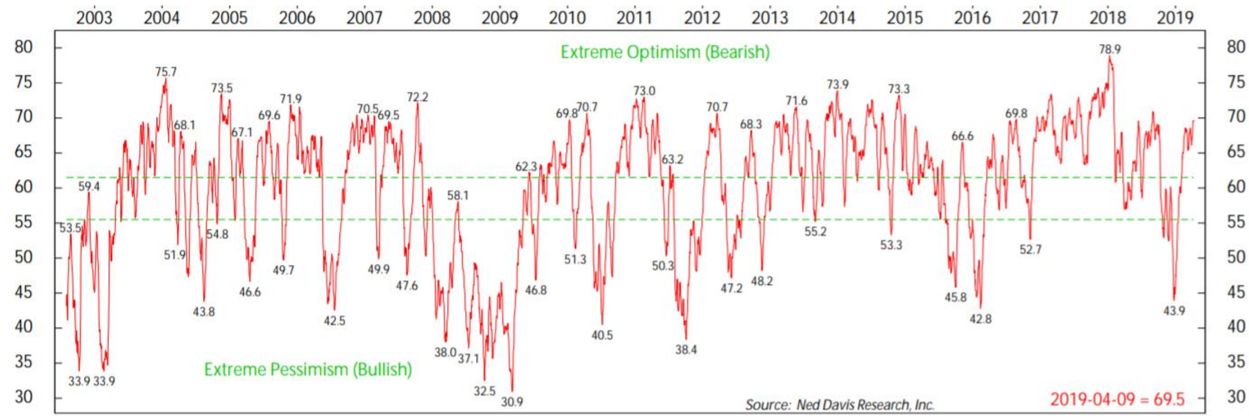
How about the trade picture? Has that changed?

Despite progress in US-China negotiations, so far it is just words and posturing. No deal has been formalized or even drafted yet. And Brexit? Despite our hopes that something would happen, Britain is still a seething mess of indecision. This week, the country asked to delay until October 31st, and the European Union agreed. At least it will dial the bickering down until another referendum can be called, or a more concrete separation plan proposed.

And earnings?

Earnings are likely to stall this quarter, which could cause some volatility. We don't think there will be a sharp decline in profits, but the slowdown we see around the world will likely impact earnings.

This comes at a time when stock investors are overly bullish. It is time to be a more cautious buyer of stocks.



NDR Crowd Sentiment Poll

Therefore, we expect April to be a flat month, at best. It is also the month we all have to pay our taxes, which serves to pull money from the markets.

Hard Landing for Boeing

"There are only two kinds of companies: those in trouble now, and those who will be in trouble tomorrow."

There is always a story about a company on the ropes. Falling sales, poor earnings, corporate scandal, product recalls…a stock's rise that takes years can be unwound in moments when disaster strikes.

In 1982, someone tampered with bottles of Tylenol and poisoned seven people to death. Johnson & Johnson (**NYSE JNJ**) shares plummeted 20% in days.

In 1978, Ford (**NYSE F**) had to recall every Pinto automobile made from 1971 through 1976 because of gas tanks that exploded on impact. Reports stated as many as 180 people had died in crash-caused fires. It didn't help that Ford knew about the defects and decided it would be cheaper to sell faulty cars and pay restitution than fix the problem. Ford shares fell 40% that year.

Closer to home, when grocery company Empire Group (**TSX EMP.A**), owner of Sobey's and Thrifty's, bought Safeway's Canadian operations in 2015, the integration of the two became a complete mess. Employee morale, food shipments, and quality all suffered, sending the shares down over 50% by 2016.

Today, the company in the doghouse is Boeing (**NYSE BA**). The company has had two 737 Max jets crash due to faulty auto-pilot software, resulting in 346 deaths. The shares have declined 19% as sales of the 737 Max – one of the world's most popular planes – declined to zero in the aftermath. The company is feverishly working on new software, new training protocols, and probably a new name for the plane to get this debacle behind them. Lawsuits and fines will likely cost billions.

Companies survive, though.

Including dividends, JNJ is up 100 times since 1982, even as it survived other product recalls and lawsuits. Empire Group has doubled in price and risen to new highs, and while Ford has only risen modestly since the late 1970s, it is a survivor in a very challenging market.

Boeing has a tough road ahead, but its military and space operations – as well as its Dreamliner jet – will carry it over until the 737 issue is fixed. We may not have seen the low in the share price yet, but we are likely close.

Value investors love bad news, for this is what creates bargains. What other companies are in the doghouse today?

Here's a few, all of which we have evaluated, or are in the process of doing so:

Kraft Heinz (**NYSE KHC**) – down 63% in two years.
CVS (**NYSE CVS**) – down 32% in 6 months.
Walgreens (**NYSE WBA**) – down 35% in 5 months.
Canadian oil sector (**TSX XEG**) – down 45% over the last 5 years.
Twitter (**NASDAQ TWTR**) – down 50% since its initial public offering 5 years ago.

Thank you for your referrals this month! They are always handled with great care and discretion.

http://www.dividendvaluepartners.com

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Prices shown are as of close April 11th, 2019.

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