The Market in Review

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This week's articles and insights

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"The reason why it is so difficult for existing firms to capitalize on disruptive innovations is that their processes and their business model that make them good at the existing business, actually make them bad at competing for the disruption."

- ***Clayton M. Christensen***

Your Index Report

	Current	Last Week	Year-to-Date
Dow Jones Ind. Avg.	25,721	+ 2.19%	+ 10.26%
S&P 500	2,843	+ 1.96%	+ 13.43% (+11.08% in $CDN)
TSX	16,228	+ 0.86%	+ 13.30%

The Kings of Steam

The North American railway system grew rapidly after the U.S. civil war and reached a peak during the “Gilded Age” of railways in 1905, which was the peak year for domestic steam engine production. Railway barons like Jay Gould and Cornelius Vanderbilt grew rich as they bought up and built more and more track. Vanderbilt died with a net worth equivalent to almost $140 billion in today’s dollars. Their railways were the internet networks of the day, and they had similar monopolistic powers.

The titan of that era was Baldwin Locomotive Works. They were the kings of steam, producing over 3,000 steam engines per year, and at one point, outproducing its competitors by 2 ½ to 1. Every year, they worked diligently to manufacture the strongest, most efficient steam engines. They were so reliable, their designs were frozen during World War II when they built thousands for the US army and its allies.

In the world of locomotives, they were the IBM (**NYSE IBM**) of the day.

Upstart technologies appeared. Electric locomotives were one, which Baldwin also made. But they never really competed with coal-fired steam engines outside of the big cities. Diesel engines were another. Diesels were heavy and worked best when stationary, or on big stable platforms like ships. Trains were too shaky and required lighter engines. Baldwin poured its money back into steam.

Complacency is a funny thing. It keeps you from seeing what is about to hit you on the side of the head. In 1930, the chairman of Baldwin stated that advances in steam technology would ensure the dominance of the steam engine until at least 1980.

But as Donald Rumsfeld reminded us 70 years later:

“There are known knowns; there are things we know we know. We also know there are known unknowns; that is to say we know there are some things we do not know.”

“But there are also unknown unknowns—the ones we don't know we don't know. And if one looks throughout the history of our country and other free countries, it is the latter category that tend to be the difficult ones.”

Led by engineers at Electro-Motive, a division of General Motors (**NYSE GM**), diesel quietly continued to advance during the 1920s and 1930s. Fuel costs came down as more and more oil was discovered, and engine modifications led to higher and higher power with less and less weight. Baldwin struggled to catch up with its own diesel designs in the late 1930s, but by then, they were too far behind. Between 1940 and 1949, steam engines went from 30% of US locomotive sales to 0%.

This was a stark example of a disruptive technology. Back then, change could take decades to play out. Senior executives were not used to rapid change, so often ignored what was often right in front of their noses.

The Kings of Tech

Today's technology sector is an interesting parallel.

Interestingly, one of the first pins to pop the railway bubble happened in 1906, when the US government regulated activities and freight rates. Stock prices came tumbling down as investors realized the days of open-ended profits were behind them. The average railway company stock fell 47% over 18 months from 1906 to 1907 (source: Journal of Political Economy) as regulators tightened their grip.

This wasn't the end of the railways. It wasn't even the *beginning* of the end. Rather, it was the end of the beginning – the end of monopolies and charge-whatever-you-want pricing.

In fact, by 1909, railways stocks doubled and rose to new highs. Even with government regulations around their necks, they were still powerful and profitable. Their plateau came years later.

This week, the Department of Justice and the Federal Trade Commission began investigations into Alphabet (**NASDAQ GOOG**), Apple (**NASDAQ AAPL**), Facebook (**NASDAQ FB**), and Amazon (**NASDAQ AMZN**). These companies have gained unprecedented access to our personal data and have made billions from it. Along the way, they have reduced a jungle of hundreds of competitors into just a handful of stable monopolies. Facebook in social media, Google in search, Amazon in on-line shopping, and Apple in smartphones.

Stocks of all of them tumbled between -6% to -8%. This is just the beginning of the investigations, so more losses may follow. They are being reined in and it will be expensive. Expect fines, new disclosures, and limits on what information these companies can collect.

However, even with losses of -6% to -8%, most of these stocks have simply given up a few months' worth of growth in their share prices. They are profitable enough to pay the fines, and their markets are still growing, just as the railways continued expanding for years after the regulators stepped in. It will be slower growth, but it will still be growth.

While no one likes the disruption (and losses) that come with the surprise of a government investigation, the true test of all of these companies will come in the decades ahead. It will be when they are even fatter and more complacent. When some upstart company invents a new way to search or communicate, and these guys are caught flat-footed. When diesel upends steam, in a digital way.

It happens faster and faster these days. Another thing to keep us up at night.

Worries of the World

After a rollicking first four months, markets came to a screeching halt in May. Worries that had been pushed to the back of the stove were suddenly thrust to the front burner, causing stocks around the world to swoon.

As we all know, stocks do this from time to time. Especially after sharp rises. The 3rd year of a Presidential Cycle (where we are now) has returned +14.4% on average since 1900. We touched +14.5% in early May.

Recall what we said in our last letter about the S&P 500 return:

We may have already seen most of the year's gains.

The S&P 500 is now +12.5% for the year, so has given back about 2% of its gains through April. A 2% correction is not much in the great scheme of things, but worries have increased.

1. **US-China Tariffs**. As a trade deal was about to be signed, one of the parties suddenly refused and stated "you have pushed us too far!" The question is, was it China or the US? The US argues that China refuses to do anything about the ongoing theft of US intellectual property. China says

the US is using its financial might to crush China's state champions, like Huawei. The US raised tariffs on $200 billion of Chinese goods from 10% to 25% to pressure China. China is considering bans on rare earth minerals as a counterpunch.

In reality, these tariffs are small change to the US economy. These tariffs amount to $30 billion in additional taxes to American consumers in an economy worth $20.5 trillion. This would push the US tax bill from 26.9% to 27.5% of GDP. A "rounding error", as Marketwatch puts it. U.S. stocks fell $700 billion after the announcement – 23 times what the tariffs would be. An overreaction compared to the actual costs.

The biggest fear is fear itself. Shipping companies are seeing fewer shipments, banks are seeing less lending, and manufacturers are deferring orders, all because of the uncertainty.

2. **Mexico Tariffs**. Wait…isn't Mexico one of our allies? The US has a legitimate border refugee problem. Over 133,000 people crossed into the US illegally in May. These tariffs are meant to force action from the Mexican government to stop the flow at their own southern border. Will it work? There are rumours Mexico could bend. However, confusing trade issues with immigration is a dangerous recipe. Especially now that Mexico has replaced China as America's top trading partner. The US president also increased tariffs on India, another western ally.

3. **Brexit**. Theresa May resigned as UK prime minister this month. This is either a good thing (she could not pass a deal that satisfied all parties) or a bad thing (maybe no one can).

Any US recession is likely 18-24 months away. A list of 12 recession indicators we follow shows 6 or more turning down a year in advance of a recession. Today? This indicator has just one – the yield curve – flashing red. However, the three global issues above raise the possibility that a North American recession could happen sooner.

On the positive side, the US Federal Reserve is likely to cut rates by July, which is the exact opposite of what was expected just six months ago when all we saw was rate hikes coming. This should take some of the pressure off recession fears.

Our current thinking is nicely summarized by a money manager quoted in the National Post recently:

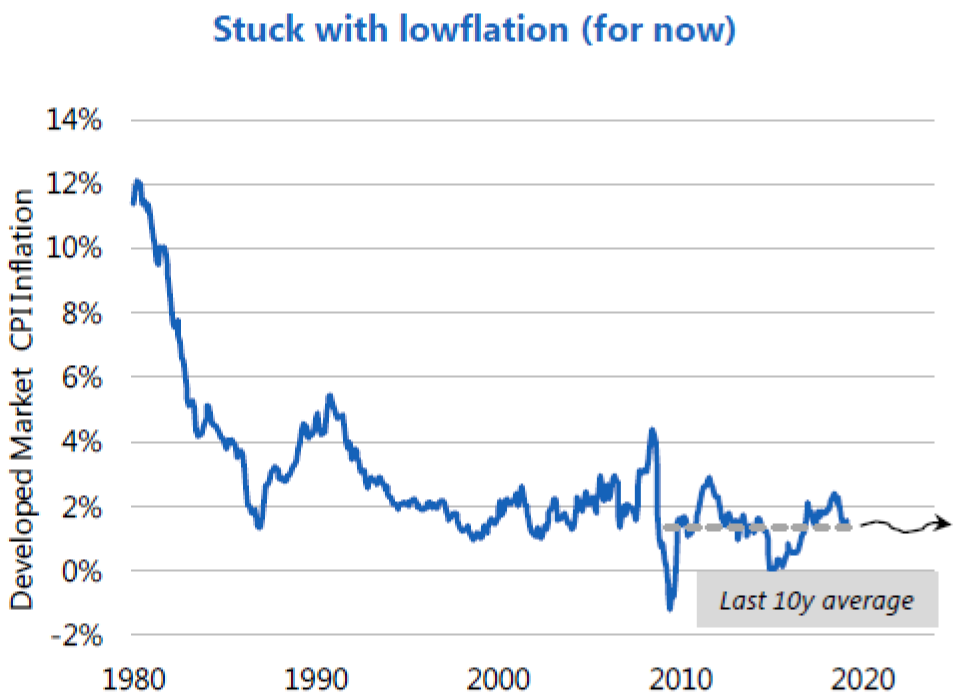
"*We don't expect there to be a recession, but we think there is a slowdown ahead*," says Seema Shah of Principal Global Investors, which runs $442 billion of investor money. "*Be more defensively positioned for (a) slowdown*."

Noflation

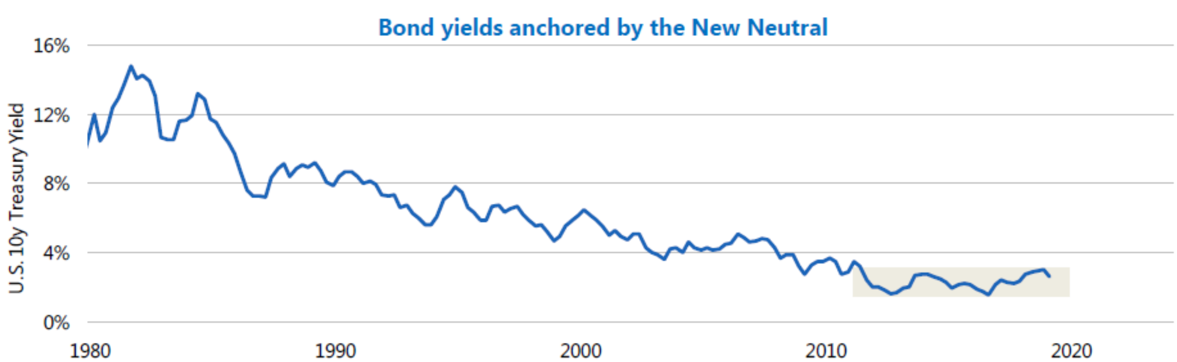
Inflation has been a central bank preoccupation for decades. Back in 1974, it was high inflation that was seen as a serious problem. President Gerald Ford asked citizens to limit their use of oil and gas to slow inflation, but it wasn't stopped until 1979-1980 when Federal Reserve chief Paul Volcker raised interest rates to nosebleed levels.

Ford even had WIN buttons printed for people to wear.

Today, low inflation is the problem. We may not like rising prices as consumers, but government officials would like inflation higher than it is. Try as they might through money printing and all sorts of easing, inflation has been stuck below 2% for the last decade. It is close to 0% in Japan and Europe.



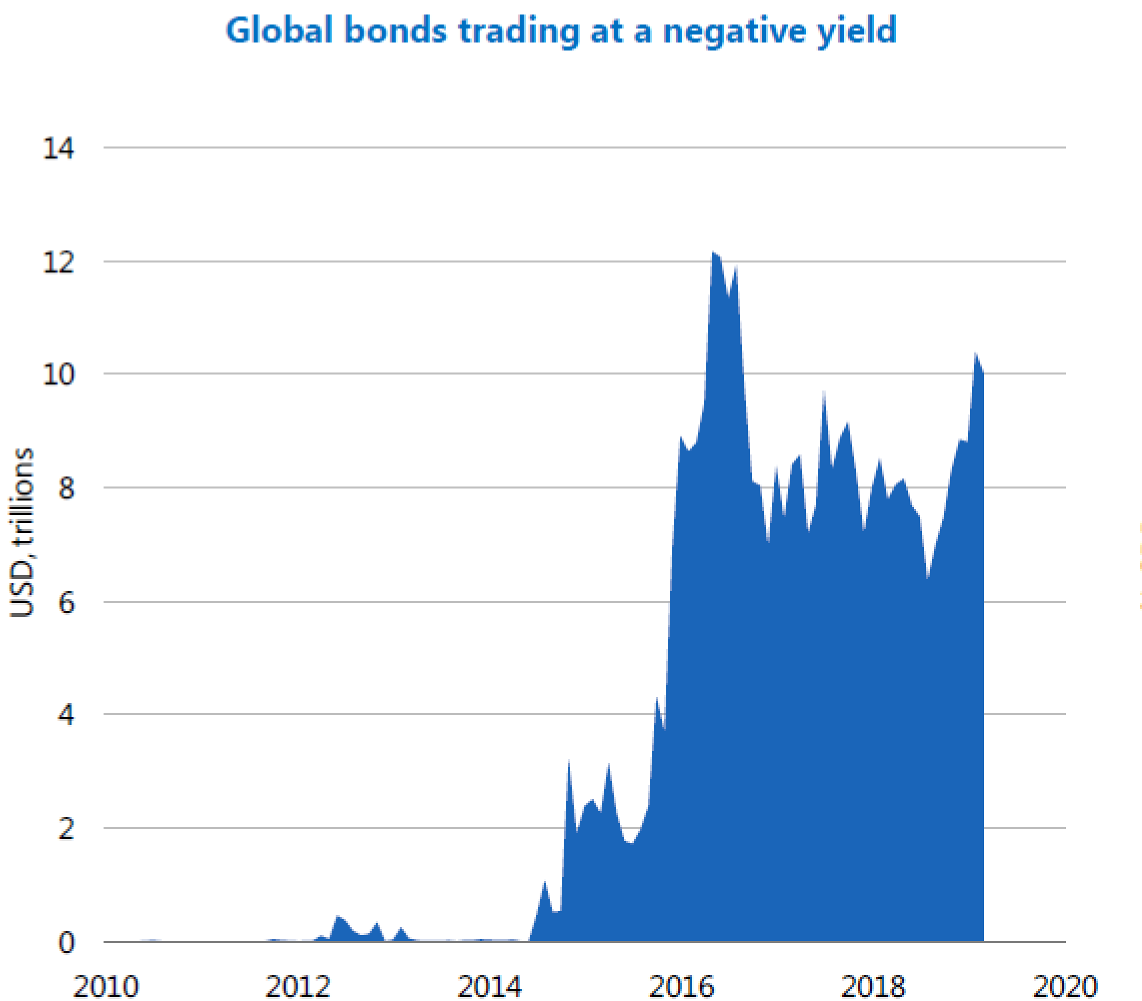
Low inflation also occurs hand-in-hand with low interest rates. Long-term bond yields have fallen below 4% for a decade now, and recently dropped below 3% in May. US 30 year bonds yield 2.66%, with Canada at 1.74%.



As of 31 March 2019 Source: Haver, Bloomberg, PIMCO. Developed market = Australia, Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Spain, Sweden, Switzerland, UK, US.

The problem is the direction. World economies should be growing faster than they are, and interest rates should be *rising*. Instead, they are *falling*. Over $10 trillion worth of bonds globally yield less than 0%.

Are US and Canada yields far behind?



As of May 2019. Source: BIS, Bloomberg, PIMCO calculations. Includes all securities in the Bloomberg Barclays Global Aggregate Index.

A Meat-Free World

Shares in A&W (**S&P/TSX AW.UN**) soared recently after they introduced their vegetarian Beyond Meat (**NASDAQ BYND**) hamburger. A&W has prospered in recent years at the expense of other burger chains through its focus on hormonefree beef and free-range eggs. Beyond Meat is the first of the “tastes like meat but isn’t” products to be served across Canada.

Now, this could be just another overhyped fad, or it could be the start of a real trend. There are many examples of fads that capture the investment public’s attention, only to fade away like last year’s soap opera star.

For example, 3-dimensional printing was a hot new invention several years ago. Every car company was going to print its car parts with these new industrial printers, and you could even print your own shoes at home someday.

Shares in the industry leader, 3D Systems, hit $96 in December of 2013.

The bloom soon came off the rose, however. 3-D printing works best with plastic (i.e. not so good for metal cars) and they are slow. Total sales have grown, but never at the pace that was once predicted.

The shares now trade below $10 per share.

I decided, purely for research, to try a Beyond Meat burger. Just to see what all the fuss was about. To convince this beef eater, these new burgers had to taste good.

Beyond Meat burgers cost about twice what a lean beef burger costs - $4 per patty versus $2 for beef. They hope to get the costs down to below beef, but even at $4 per patty, the company is still losing money. So, this may take time.

I barbequed the burgers the way they said I should, but they never really came out looking done. Why? Because the red colour comes from beets, and no matter how long you cook a beet, it never browns like beef (believe me, I tried). However, despite the odd appearance, they tasted remarkably like normal beef hamburgers. So much so, in fact, that many vegetarians are “grossed out” because they are so close.

Meat substitution is a huge market, especially with the green movement taking hold amongst younger consumers.

The investment firm Barclays predicts this new alternative meat industry could be worth $140 billion over the next decade. Beyond Meat, though, is not the only contender for the meat-free crown. The Impossible Burger is close behind, followed by such brands as Lightlife Burger, Green Cuisine, and the Awesome Burger from Nestle.

Back to the taste test. I like veggie burgers precisely because they <u>don’t</u> taste like meat. The Beyond Meat burger was so close, it made me wonder what exactly what I was eating. It turns out that the Beyond Meat burger is made primarily from pea protein while the Impossible Burger is soy-based. Both are plant-based proteins. Both have higher levels of saturated fats, due to the oils, and both are high in sodium (salt). They are healthy, but not as healthy as you first think.

This led me to a key realization: plant-based meat-substitute burgers are not really aimed at the same person as a veggie burger. These taste like real beef and so are aimed at people who might like to eat less meat for ethical or environmental reasons. Veggie burgers have been around forever and have a small market niche. Veggie burgers and meat-substitute burgers are likely to be completely separate categories going forward.

While my family eats far less beef than we used to, we decided that we would stick to the real thing after this test. When we want a beef burger, we are going to eat beef. These were just kind of weird. Lisa Hill did the same taste experiment and concluded exactly the same thing.

However, we are not the target market, as I mentioned. Younger diners wanting to improve the planet are. I may be missing a great investment opportunity because of this.

So, let's look at Beyond Meat as an investment. It is expected to lose money this year as it ramps up, and trades at 29x sales. Not 29x earnings (it still loses money, remember), but 29x annual *sales*. Amazon (**NASDAQ AMZN**) – another high growth company - trades at 4.5x sales as a comparison.

Beyond Meat is expected to grow about 24% this quarter, which is very strong. But, is it strong enough to support a share price that has risen from $25 on its opening day, closed at $46, and is now over $100?

The annual crop of peas in America and Europe is worth approximately $5 billion, according to Barron's. This means, at $6 billion in market capitalization, Beyond Meat – which uses peas as its protein - is now *worth more* than the entire pea crop. There won't be a shortage, because farmers will switch crops, but it does give us an idea of how hyped the product is right now. One company using peas is worth more than all the peas grown in the developed world.

With another fast-food chain about to adopt the Beyond Meat burger, the shares of Beyond Meat could continue to climb from its already-elevated levels. It is way too expensive for us to consider buying shares, though hot-stock momentum investors might like it up here.

Remember what happened to 3D Systems, however. And to Bitcoin and the marijuana stocks. All fads come to an end, and sooner than you think.

One area that could have promise is the pea crop itself. Peas like colder climates, and Canada could account for almost 30% of total output in 2020, according to Cargill. Global pea protein sales could quadruple by 2025 based on rising demand.

Canadian farmers affected by the Chinese canola ban should switch to peas.

Telus Update

Telus is widely held by clients. A recent update from our analysts:

Telus (**TSX – T**) reported Q1 results that were in line with expectations and announced an increase to the dividend. Revenue of $3.5 billion and EPS OF $0.76 both increased 4.1%, which matched consensus.

The biggest news in the release centred on the dividend. The company made a semiannual increase of 3.2% and announced an extension of the company's 7-10% annual dividend growth rate forecast through 2022. The average dividend increase over the past three years is 7.6%, which compares to 5.1% for BCE (**TSX - BCE**) and 0.4% for Rogers (**TSX-RCI.B**).

Conclusion: T remains our top pick amongst the Big 3 Canadian telco's as it continues to demonstrate superior revenue, EPS and dividend growth.

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

http://www.dividendvaluepartners.com

We thank you for your business and your referrals and we hope you find our site user friendly and informative. We welcome your comments.

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A&W Royalty Revenues Income Fund - Raymond James Ltd. has managed or co-managed a public offering of securities within the last 12 months with respect to the subject company. Raymond James Ltd. has provided investment banking services within the last 12 months withrespect to the subject company.

Prices shown are as of close June 6th, 2019.
