> *Inflation is when you pay fifteen dollars for the ten-dollar haircut you used to get for five dollars when you had hair.*
>
> *-Sam Ewing*

Lorne Steinberg,
MBA CFA
PRESIDENT

The Manheim Index

Dear Investor,

Delta variant. Rising inflation. Fed tapering. Political dysfunction. Debt ceiling. Microchip shortage. Supply chain problems. China Evergrande.

There is no shortage of negative headlines, yet the stock market is at a record high.

Against this backdrop, one might expect investors would be pessimistic. However, such is not the case. The negative headlines tell part of the story, but they omit a few important things.

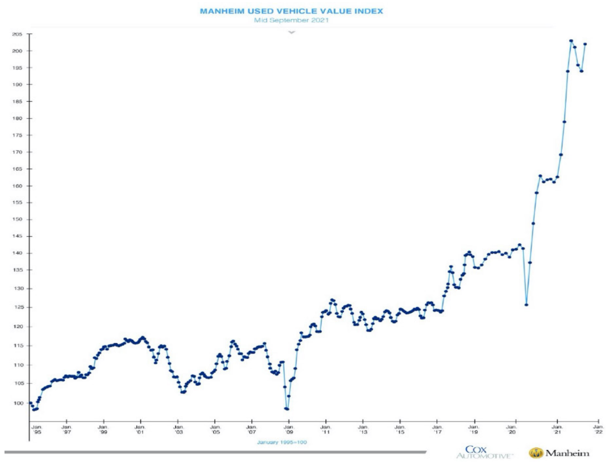
This bull market has been underpinned by historically low interest rates and the assumption that we have seen the worst of the pandemic. Regarding rates, the Fed has indicated that with the recovery well underway, as well as an uptick in inflation, investors should prepare for the “tapering” of asset purchases before the end of this year, and rate hikes by 2023. Bond yields have been rising as a result, with the U.S. 10-year Treasury yield now at 1.7%.

While it is true that inflation has picked up, the Fed believes this increase to be transitory, which is why they see no need to raise rates at present. COVID shutdowns had a significant impact on supply chains and labour availability, resulting in shortages of a number of critical items, such as microchips. The relatively quick economic rebound has exacerbated the problem, as demand has increased faster than supply.

The auto sector has been impacted more than most, as a new car can have up to 100 microchips on board. The automakers have been forced to cut production which has resulted in a steep increase in used car prices.

Until recently, few people had ever heard of the Manheim Index, much less paid attention to it. This index is a measure of the wholesale used car market in the U.S. Today, however, the Manheim Index is a closely watched proxy for inflation.

As can be seen in the Manheim Used Vehicle Value Index chart below, the index has risen over 40% since February 2020.



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However, price spikes such as this are usually temporary. General Motors indicated recently that it expects vehicle production to increase at least modestly in the 4th quarter of this year, and gradually improve over the next two years.

Despite the recent uptick in inflation and the Fed's comments regarding allowing yields to rise, interest rates remain at very low levels. The 10-year U.S. Treasury currently yields 1.5%. Even if this yield doubled, it would still be well below the long-term average (which is greater than 4%).

If yields rise faster than investors anticipate, markets will be in for a bumpy ride. Fortunately, however, we do not own the market; our portfolio is composed of quality companies trading at valuations that should continue to create excellent long-term returns for our clients.

China Evergrande Group

There have been concerns about China's debt-fueled real estate market for years, but the government always seemed to be able to manage the situation aided by strong economic growth as well as regulation and support. However, recent news that several property developers have missed interest payments suggests that the problems are more serious this time.

China Evergrande Group is the largest property developer in China, with various debts and other payables of $300 billion. The company recently decided not to make interest payments on some bonds. At the same time, two other developers, China Properties Group and Sinic Holdings, are also on the verge of defaulting on their obligations.

Real estate and related industries account for about 25% of China's GDP (Moody's), so problems in this sector have the potential to impact the economy as a whole. The government has indicated that it would protect consumers, and it is trying to reassure investors that the fallout can be contained, but at present the scope of these problems are unknown.

The underlying cause of this is related to the fact that, with its low birthrate, household formation rates have been falling, while the rate of new residential construction has been increasing (Rhodium Group, Foreign Policy September 2021).

The only way for China's housing market to stabilize will be for residential construction to moderate substantially, and this, in turn, would negatively impact economic growth. The best-case scenario is that the sector will be restructured to some degree, with investors bearing the brunt of the losses.

The Evergrande situation sparked contagion fears which rattled global markets and contributed to the volatility in September.

Volatility and the Sleep at Night Factor

The days when investors could hold a significant portion of their investments in government bonds and still earn a reasonable return are gone … at least for the foreseeable future.

Investors have responded by moving a greater percentage of their assets into equities, high yield bonds and other assets which offer higher yields and much greater upside, but which also come with increased volatility.

Over the years, a few clients have asked me how we sleep at night – given the size of the assets we manage and the responsibility that comes with it. My answer has always been a simple one, and it always relates to the quality of what we own. Investors who own high quality businesses trading at reasonable valuations should rest easy. While volatility may cause the share prices of these businesses to fluctuate, investors focused on quality understand this to be temporary, and that the share price at a moment in time does not always reflect the fair value of their investment. Fair value is the magnet which pulls undervalued securities higher, and overvalued securities lower. The key to navigating volatility is knowing what you own, why you own it, and what you believe it to be worth.

While some investors struggle greatly with market turbulence, volatility is simply the price that investors pay for higher returns over time.

RECENT ACTIVITY

While Ferrari is ostensibly a car manufacturing company, it has more in common with luxury goods businesses, than with Toyota or Volkswagen. Ferrari sells approximately 10,000 cars per year, albeit at a starting price of over USD$250,000. They also sell engines (mainly to Maserati and Formula 1 teams) while providing spare parts and offering repair and maintenance services. These businesses account for about 85% of sales, with the balance from their racing teams and licensing income.

Annual production volumes are anticipated to rise as much as 50% over the next 2-3 years, due mostly to the upcoming launch of their SUV, the Purosangue. As evidenced by the success that Porsche, Lamborghini and others have had in this market subsegment, Ferrari should see strongly rising sales accompanied by increased margins -- a powerful combination that should result in a substantial increase in profits over the next 5 years.

Scotts Miracle-Gro (SMG) is a leading manufacturer of consumer lawn and garden products, such as fertilizers, grass seed, soil, weed killers, pest, and disease control products, as well as spreaders and other durable products. In addition to their eponymous brands, they also own Turf Builder, Ortho, Roundup (licensed from Monsanto) and have a leading position in the nascent hydroponics market. The U.S. accounts for over 90% of sales.

While there are quite a few competitors, SMG is positioned as a premium brand, and it spends a considerable amount on R&D and marketing in order to grow its industry-leading 20%+ market share. The company benefited from the pandemic, as consumers increased spending on their homes, but longer-term they remain well positioned to serve a growing market.

Organic sales growth is likely to be complemented with strategic acquisitions and the group has an excellent track record of sustaining healthy operating margins. The share price has fallen by about one-third over the past few months, as the economy is opening up, presenting us with an opportunity to buy these shares at an attractive discount.

High Yield Bonds

A review of the high yield bond market and our high yield fund is available here: High Yield Quarterly.

Final Thoughts

Until recently, it looked like inflation in North America had been tamed forever. However, JIT (just-in-time inventory) has its limitations, and inflation is at its highest level in decades.

The quote at the top of this letter resonates with me, as I recently visited Willie, my barber, last week. Yes, he continues to refer to himself as a barber, not a hair stylist. I had scheduled my haircut to coincide with Willie's 90th birthday (no, that is not a typo), and as I was sitting in his chair we were reflecting on the price-inflation of haircuts since he came to Canada sixty-some years ago.

When input costs rose, be it rent, labour or utilities, Willie would raise his price accordingly, and ultimately his income would grow. His approach to managing inflation is no different from the companies in our portfolio. Great businesses are able to pass on higher costs to their customers, resulting in an increase in earnings, dividends, and ultimately share prices.

Sincerely,

Lorne Steinberg
President

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