The pot.com Rally

Equity Markets

Equity markets were fairly mixed during the third quarter, with the domestic S&P/TSX Composite index falling just 0.6% and the MSCI EAFE index falling just 0.3%, both in Canadian dollar terms. Emerging markets fared worse, with the MSCI Emerging Markets index falling 2.7%, continuing a slide that began at the start of the 2018 with troubles percolating in Turkey and Argentina. In comparison, the S&P 500 index remains notably strong, rising 5.9% over the quarter and continuing a lengthy multi-year rally. During the quarter, the Financials sector managed to reverse a trend of underperformance across developed markets, reflecting some relief that loan demand and credit conditions generally remain quite benign. Meanwhile, technology companies remain very popular, and in all cases, the Information Technology sector has handily outperformed the regional benchmark index over the past year. Finally, and specific to Canada, the Healthcare sector gained handsomely on rising anticipation about the impending Federal legalization of cannabis for recreational consumption.

The gains in the US market come despite rising trade war rhetoric between the Trump government and several nations across North America, Europe and Asia. At this juncture it remains to be seen what impact a rising level of tariffs across an increasing array of products will have on both demand and inflation. Closer to home, a long-awaited resolution to the negotiations of the trilateral trade agreement between the US, Mexico and Canada (just don't call it NAFTA) removed some of the biggest clouds obscuring the outlook for the North American economies and will likely result in restarting the flow of strategic investments that was previously being held back within the nations by the lingering uncertainty.

Fixed Income Markets

North American investment grade fixed income continued its weaker course in the third quarter, with both the US Federal Reserve (Fed) and the Bank of Canada continuing their policies of tighter money. The US treasury curve shifted higher through the quarter, though the premium offered for owning longer-dated bonds continued to be compressed. Canadian fixed income moved higher in yield, and lower in price, though the shift in Canada was more parallel and the yield curve was largely unchanged.

Canadian corporate credit returns were mixed, with AA and A rated bonds tightening in to the benchmark, while BBB rated debt yields rose in near-tandem with Canadian benchmark bonds. Corporate credits in Canada remain strong, with the big six banks in particular showing strength. American corporate credit benchmarks tightened in towards Treasury debt, reflecting the overall robustness of the US economy. High yield bonds showed continued strength in the quarter, holding at nearly the same spread premium to Treasury bonds to close the period.

The Bank of Canada seems set to slow their course of hiking the overnight policy rate, with action likely in the fourth quarter of 2018 followed by data or event-dependent moves in 2019. The Fed continues their course of tightening, though observers – and the Fed themselves – are mindful of how close to an inversion event the US yield curve is, as that has typically been a bellwether for a pending recession. The demand for corporate credit remains robust, as yields have moved substantially in favour of new money bond-buyers in a short period, issuance continues to be strong and well-received, corporate balance sheets remain very strong, though some sub-sovereigns – Provincial and State agencies – continue to labour with higher than desirable debt levels.

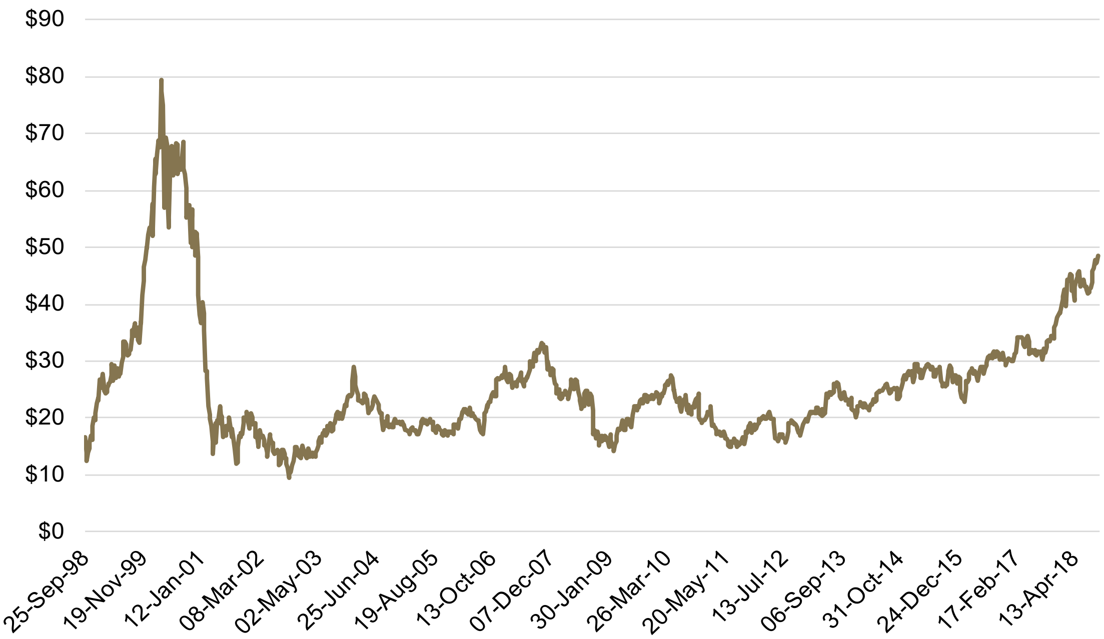
Commentary

By now every reader will likely be aware that Canada is about to legalize the recreational consumption of cannabis in October, becoming one of just a handful of nations to have done so. A level of buzz (pun intended) surrounds the industry, currently with 118 licensed medical cannabis producers, of which several dozen are publicly-traded in Canada. The largest of these have posted spectacular returns, rising between 200% and 500% over the past year alone. One, by virtue of uniquely gaining a NASDAQ listing south of the border during the quarter, rose more than tenfold in its initial two months of trading. At its heights, the company, yet to turn a profit, had a market valuation greater than household Canadian names such as Loblaw, Fortis, Husky Energy and Canadian Tire.

To a degree, the euphoria is understandable: it is uncommon to witness the birth of an entirely new industry. There are, however, periodic historical reference points, such as the rise of the automobile at the start of the 1900's and the dot.com euphoria near the end of that century, and like all other precedents, the legalization of recreational cannabis shows potential. It is also worth revisiting how these prior episodes all played out, with an initial period of excitement that results in sharply rising stock prices, and a growing list of participant companies able to fairly easily attract investors into newly listed shares. Almost invariably, a level of industry overbuilding results, with too much capacity added from this initial group. From there, an interval of re-sorting takes place, as stock prices subside, weaker competitors exit or merge, and a much smaller collection of survivors move forward. For example, in the early 1900's, during the initial days of transition from horse to car, there were an estimated 2,000 automobile manufacturers in America, but the list had been winnowed to essentially three over the next twenty years. Another example might be, the estimated 90 million miles of fiber-optic cable installed across America during 1999, in anticipation of a coming internet boom. The boom eventually did materialize, but for the first three years, 95% of this network lay "dark" and unused, and the major players backing its installation had ceased to exist.

At this point, valuing these recreational cannabis producers requires making some assumptions on end market demand, wholesale pricing, and production costs. Beyond this, factors such as consumption growth, regulatory regime and international factors – both in terms of possible demand, and new competition – must be weighed. Finally, once all of this is considered, a view on valuation is required. Given the list of risks at the current stage, an ample margin for error should be demanded before moving forward with an investment. Simply basing an investment on an optimistic industry view alone can backfire, even picking the eventual winners is no guarantee of short-term profits. Consider those who bought shares in technology hardware company Cisco, commonly considered a provider of the "plumbing of the internet", in the late 1990's. These investors were correct in their estimation that the company would go on to prosper from rapidly growing data consumption: company revenues, at just over $12 billion in fiscal 1999, had risen to over $49 billion in the most recent annual set of results. However, a lack of discretion on valuation means these buyers near the peak are still looking to recoup their initial investment, over fifteen years later.

Cisco: "Plumbing of the Internet", But Still Down The Drain From the Peak



Data for the period from September 25, 1998 to September 27, 2018
Source: FactSet

At Guardian, we look to invest in companies with sustainable competitive advantages, strong management teams, and a proven record of superior financial performance. These are necessary ingredients when attempting to value securities for consideration. By definition, this makes it difficult to commit to investments in brand new industries where there is an absence of reference points regarding pricing, costs, end market demand, to say nothing of regulatory constraints. Until these materialize, it is certainly possible that a chosen cohort of stocks continues to levitate, supported by faith and a lack of data to refute speculation. This therefore, is the essential difference: pot stocks – like cars and tech companies – represent a speculative bet rather than an investment. There will be winners and losers in this space; companies that learn how to operate publicly, stay onside with regulations, balance growth and stability, will be the winners. Which constituents of this new subset of healthcare companies will operate profitably and sustainably is unknown today. We want our clients investments to go up, just not "Up in Smoke".