Seymour Investment Management

July 17, 2019

The markets continued to build upon the strong growth felt during the first quarter

Equities around the world performed well in the second quarter as investor concerns over rising interest rates and trade disruptions eased. Continuing to build on the strong growth felt during the first quarter, the Canadian benchmark S&P/TSX Composite Total Return Index ('TSX') reported a return of 2.6% during the second quarter and 16.2% since the start of the year. Global equities experienced similar gains, with the U.S. benchmark S&P 500 Index rising 3.6%, MSCI World Index up 3.0%, and the United Kingdom's FTSE 100 up 2.0% during the quarter.

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The long-term, worldwide trend of declining interest rates has continued in 2019 after a brief reversal in 2018. Previously accepted limits for how low interest rates can decline have been dashed with the fairly recent emergence of negative interest rates. The seemingly perverse phenomenon of negative interest rates (where lenders pay borrowers to hold their money) seems to us to be unlikely to persist over the long term, but currently accounts for more than $10 trillion in bonds.

Consensus expectations suggest that additional Fed rate increases are unlikely and in fact we may see rate cuts. However, as a reminder, at Seymour our primary focus is not on short term interest rates or other macro-economic factors. Instead, we think about investing over the long term. Undoubtedly, the companies in which we invest will have to navigate periods of economic growth and recession (and therefore periods of both rising and declining interest rates).

As always, there are reasons for optimism and concern. Most notably, the current economic expansion already has a longer duration than most. The inverted yield curve (see our last letter) and recurring international trade disputes are also cautionary. However, these concerns are well recognized and publicized, seemingly limiting the probability of negative surprises in these areas (or discounting in security prices). At Seymour, we endeavor to identify risk factors that may not be discounted in equity markets. One such risk factor is the extremely tight labor markets in North America and its longer term implications for inflation.

Employment Rates and Inflation

The U.S. unemployment rate currently stands at a 50 year low of 3.7%, nearly 100 basis points, or 0.1%, below estimates of full employment. Moreover, labor market participation has also increased suggesting long-term unemployed people are returning to the labor force.

The tightening labor market has (finally) accelerated wage growth which is now tracking at 3.3%, the fastest rate of growth since 2007, as depicted in the graph below. These employment and wage gains are

generally very positive and are also very indicative of the trends in Canada and many other developed markets. However, this very positive trend poses some threats to investors.

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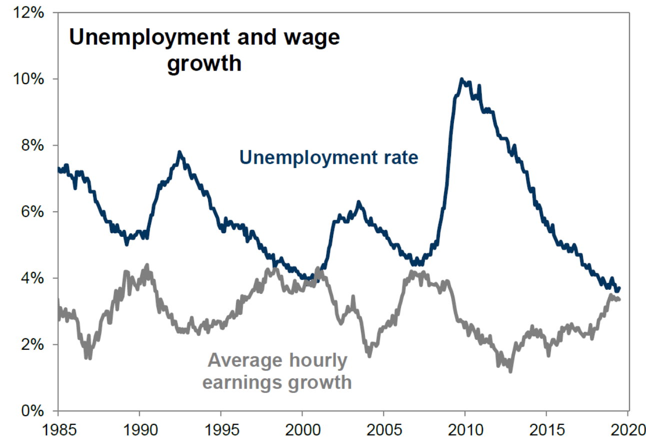
Exhibit 1: Tight Labour Market Lifts Wages



Source: BLS, Goldman Sachs Global Investment Research

Persistent wage growth is likely to be reflected in rising prices (inflation) and/or lower profit margins

Persistent wage growth can become embedded in expectations for workers and companies. In the absence of consistent improvements in productivity, these gains are likely to be reflected in rising prices (inflation) and/or lower profit margins for corporations, both of which are negative for most asset classes.

Navigating a trend of extremely low unemployment and higher wage gains is an area of focus in our investment process. With many businesses facing difficulties in hiring and retaining employees, we believe that companies that have adapted through increased automation or exceptional employee hiring and retention practices may have a widening competitive advantage going forward.

We have been writing about the possibility of this trend emerging for several years but it seems as if the process is starting to gain some traction. If inflation does trend upwards, equities will not be immune to a valuation correction but they are likely to outperform most other financial assets such as fixed income.

Four non-resource based, domestic sectors with oligopolistic market structures now comprise over 35% of the Canadian index compared to only 18% thirty years ago

The Canadian Market

A common criticism of the Canadian equity market is that it is a resource-dominated market with few high-quality, investible companies. At Seymour, we have a different view. Our investible universe in Canada is more extensive than that of our peers given our small size and ability to invest in small- and mid-cap companies. Moreover, we believe Canada is home to a number of world-class, large-cap companies that increasingly comprise a larger proportion of the Canadian benchmark S&P/TSX Composite Index.

A recent publication by CIBC portfolio strategist Ian de Verteuil supports our differentiated perspective on the Canadian market. The Canadian equity market has long been viewed as a resource dominated index. However, de Verteuil points out that four non-resource based, domestic industry groups with oligopolistic market structures now comprise over 35% of the Canadian index compared to only 18% thirty years ago. These four industry groups are the Canadian Banks, Railroads, Grocers and Telecom companies.

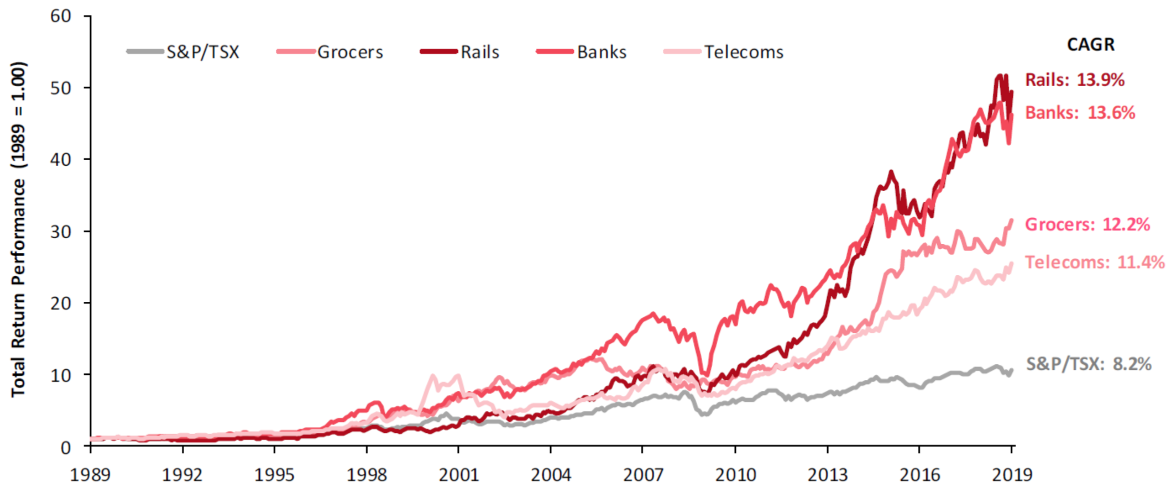
In an oligopolistic market structure, relatively few participants dominate the market due in large part to high barriers to entry that help to limit the number of competitors. Oligopolies typically demonstrate relatively stable and above average levels of profitability.

Less than 50% of the revenue of companies comprising the Canadian index originates domestically

De Verteuil's publication also points out that the revenue mix of companies in the Canadian index are increasingly North American and international with less than 50% of the revenue of companies comprising the Canadian index originating domestically.

We believe both of these trends are positive for Canadian equity investors. At Seymour, we have consistently "under-invested" in resource industries with the view that commodity prices are volatile and many resource industry participants generate sub-par long-term returns for shareholders. Focusing on industries with a sustainable competitive advantage and somewhat limited competition is likely to enhance investor returns. The work by de Verteuil supports this thesis as shown in the chart below.

Exhibit 2: Total Return Performance of Canadian Oligopolies Relative to the S&P/TSX Composite Index



Source: Compustat and CIBC World Markets Inc.

Companies with solid balance sheets and enduring competitive advantages typically are well situated to weather a wide range of market environments

The macro-economic outlook is always somewhat unpredictable, particularly in the near term. History tells us that there will be an economic recession at some point which will reduce corporate profitability. With equity valuations near their long term average levels, a recession would likely result in pressure on valuations. Companies with solid balance sheets and enduring competitive advantages typically are well situated to weather such downturns and are often able to utilize periods of weak economic growth to enhance their long term growth prospects.

A correction in equity prices, as we have spoken about in previous letters, should be viewed as a "normal" part of successful, long-term equity investing. As always, we continue to focus on well managed companies with strong cash flow and growth characteristics which can prosper in a wide range of market environments.

We look forward to hearing from you and thank you for your continued support.

Warm regards,
The Seymour Team