Front Line Thinking

INDEPENDENT AND OBJECTIVE OBSERVATIONS FROM FRONTWATER CAPITAL | January 2, 2019

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FRONTWATER CAPITAL

Jerome Powell:
The New Sheriff In Town

Early October was shaping up to be a festive time to celebrate Canadian Thanksgiving. US markets were trading at record levels and volatility was at an all-time low. On October 4th, everything abruptly changed for the worst. Fed Chairman Jerome Powell decided to shock the markets, nearly undoing all the good work that Ben Bernanke and Janet Yellen had accomplished over the last ten years.

From 2008 to 2014, the stock market relied heavily on Ben Bernanke, an expert on the 1930s Great Depression, to breathe life back into the US economy after it was put on life support in 2008. Bernanke did not disappoint. Bernanke knew deflation was a much tougher enemy to defeat than inflation - better to keep interest rates low, increase the money supply and err on the side of quantitative easing. Sure enough, the US economy found its footing; deflation was avoided and inflation remained mild.

In 2014, Janet Yellen took over the reins and proved to be just as competent as her predecessor. Recognizing that the US economy was no longer sputtering but also not clicking on all cylinders, Yellen acted prudently relying on 'data dependent' information to drive her decision-making. Investors enjoyed one of the least volatile periods in history combined with steady economic growth. By 2017, Yellen began raising interest rates as the health of the US economy had been nursed back to form.

Then in early 2018, Jerome Powell took over the Chairman role. At first, Powell stuck to the program and raised interest rates three times in 2018. Few investors took issue with the higher interest rates. Inflation was tame, the US economy was growing but not humming, and stock market valuations were within an adequate trading range.

For some reason, on October 3rd 2018, Powell changed the playbook. Completely unscripted, Powell shocked the market by hinting that the Feds were about to

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accelerate the pace of interest rate hikes in 2019. That set off a chain of catastrophic events over the next three months.

Many investors were aghast at the Feds 180 degree turn. The mantra went from 'slow and steady' to 'there's a new sheriff in town'! In an over-heated economy, the strategy of raising interest rates makes sense but the numbers hardly pointed to that fact:

- US inflation at 2.0%
- US wage inflation 3.0%
- US housing slowing down
- Worldwide commodity prices plummeting

Only US unemployment had a very strong showing (a potentially flawed number since it discounts the unemployed people who have given up looking for a job). But with wage inflation low, raising rates in dramatic fashion seemed like an overreaction to one positive piece of data.

Powell was now putting in place all the necessary pieces for a do-it-yourself recession. A significant dose of higher interest rates is very bad for the economy because the cost to service debt increases for both corporations and consumers. Corporations have to eventually pay higher interest costs as their bonds renew which means less profit for corporations. Consumers have to eventually pay higher mortgage costs which means less disposable income resulting in less dollars spent on furniture, cars, travel, leisure, etc. In essence, both corporations and people become poorer, setting off a domino effect of cascading negative events.

Then November came and that left even more investors trying to make sense of the Feds stance. Many indicators showed that worldwide growth was decelerating. Oil prices had plummeted more than 30% over a two month period on very weak global demand. The two biggest economies, US and China,

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were fully engaged in a trade war. In addition, large global companies like Fedex and Accenture began reporting weak earnings and lowering their guidance for 2019.

Next, the short term bond market dried up. Why invest in a 2 or 3 year bond today when an investor could wait but a few months and get an even higher rate. As a result of a lack of liquidity, the yields on short term bonds rose even higher than longer term bonds. This caused the bond market to slightly invert in November.

Unfortunately, yield inversion is often cited as a precursor for a recession which on its own creates even investor angst. In tandem with program trading, many computer traders have algorithms that are specifically designed to start selling stocks when the yield curve inverts. These algorithms trigger more selling and even more downward pressure creating a one-two punch -- nervous investors selling based on the Feds rate hikes and program traders selling in response to the inverted yield curve.

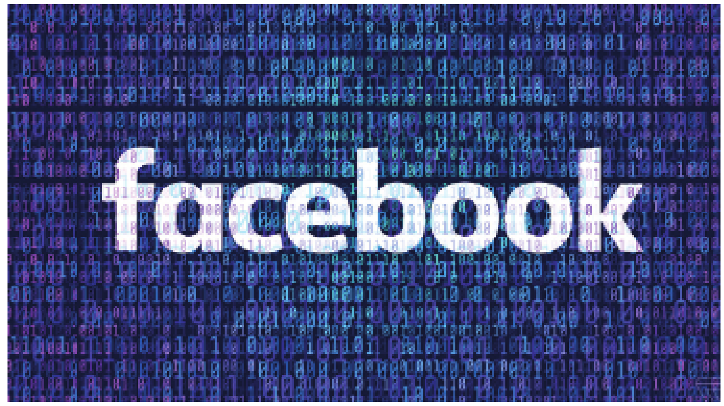
On December 19th, Powell delivered the last Feds meeting minutes. Not in the last 10 years, had there been so much anticipation and tension around a Fed announcement. Markets were down more than 15% but hope had not completely faded. There was still talk of a "Santa Claus rally". So would Powell admit that he goofed as Trump and Jim Cramer had tweeted so many times *or* would Powell stand firm?

Turns out, Powell took the middle ground. He admitted the Feds were overly aggressive in calling for rate hikes but he still called for two more in 2019. The market was not pleased and the S&P 500 fell another 500 points eventually making December the worst performing one in history.

While this past quarter's volatility could have been avoided, Powell did us long term investors a huge favour -- he cooled the market and created some very favourable opportunities. Just as it is unrealistic to expect the market to always move upwards, the corollary is also true. Markets eventually bottom out and the trend reverses. While talk of a recession is plausible, today's economic data still points to worldwide growth. At Frontwater, we know picking market tops and bottoms is a fruitless exercise. As we saw in 2010, 2013, and 2015 market corrections are healthy. Think of them as a body detox that flushes out the bad in order to position the market for the next leg up.

FACEBOOK: BUY ON THE DIP?!

Since hitting a high of $218 in July, Facebook has tanked more than 35% to $130. That would normally put a lot of investors on edge, but we see this as a great dollar cost average opportunity in the 5th largest company in the world. Even the best hitters strike out and Facebook is still very much in the batters box. Investors are used to seeing Facebook smack out of the park home runs and this past quarter's earnings were more on par with a single or a double. Good luck finding another company with operating margins of 40% at an attractive forward P/E ratio of 19 times earnings.



Launched in February 2004, Facebook initially targeted college students. It quickly expanded via email and word of mouth. Today, Facebook is the largest social network in the world, with more than 2 billion monthly active users.

And much like Apple, Facebook has developed an ecosystem of loyal, dedicated users. Once people are part of the ecosystem, few exit. Facebook is not just a way for people to keep in touch with colleagues, friends, and family -- it's a religion. Some people pray three times a day. Facebook users post pictures, videos, commentary three, four, five times a day. Users are spending approximately 50 minutes per day posting photos, exchanging messages, making comments, uploading content, liking or disliking other content, and more.

The growth in users along with the valuable data that they generate, makes Facebook extremely attractive to online advertisers. A major benefit of Facebook advertising is its ability to target an exact audience. You can advertise to people by age, interests, behavior, and location. Another major benefit is that it is one of the cheapest forms of advertising. You can literally spend $5 and reach 1,000 people. No longer do businesses need to allocate large budgets to radio ads, television commercials, billboards, and other traditional media to reach the same audience.

Indeed, one of the key financial metrics for gauging FB's profitability is its average ad revenue per user, or ARPU. In Q4 2017, the average revenue per user was $6.18 -- nearly double the ARPU at the end of 2014 when it was $2.81 - an incredible feat.

Facebook's ability to monetize its network of users is an unprecedented achievement in the modern industrial age. Over the last twelve months the company has achieved profit margins near 39%, return on equity over 26% and quarterly earnings growth of over 31%. Yet, the company trades at only 19 times forward price earnings ratio. By comparison, Johnson and Johnson - also a high quality company but with much less growth potential - trades at 16 times forward price earnings ratio -- not that much less than Facebook, yet Facebook has so much more upside.

Admittedly, the hyper-growth days at Facebook are officially over. In its July earnings report, the company announced user growth was flat in the U.S. and Canada. In Europe, the news was even worse with declining subscriptions due to new Internet laws and privacy legislation in the Euro zone (see European Union's General Data Protection Regulation).

On the cost side, one might say it looks ugly. Costs are on the rise as US regulators pressure Facebook to tackle fake news and phony accounts like we saw in the 2016 US election. This past summer, Facebook announced that 50 million user accounts had been hacked. Plans to hire an additional 20,000 people to handle safety and security on its platform will certainly erode profitability.

That said, while the subscriber base for the Facebook app may have hit a saturation point, the company has been active in strengthening and expanding its product offerings with shrewd acquisitions such as Instagram and Whatsapp. These new applications continue to make Facebook, the company, relevant to users even though Facebook, the application, becomes less relevant.

In 2012, Facebook purchased photo sharing app, Instagram, for $1 billion dollars. At the time, it looked like a crazy acquisition. Instagram was founded only two years earlier in 2010. It had only 13 employees, and

TICKER: FB   PRICE AS OF DEC 31, 2018: $130.12

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- Trusts
- Endowments

FACEBOOK

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it made absolutely no money. Its main asset base was 30 million users but that hardly seemed to justify a billion dollar price tag.

Today, the Instagram acquisition looks like a bargain. This past June, Facebook announced Instagram had achieved over 1 billion active users. Moreover, Instagram is ready to compete head-on with YouTube. The company recently announced it will begin allowing users to upload videos up to one hour in length, up from the previous one-minute limit. Facebook does not break out Instagram's revenue and does not provide guidance about it. But if one digs into the numbers, it is not difficult to deduce that Instagram is becoming a major revenue driver that is approaching 15%-20% of Facebook's overall project revenue.

In 2014, Facebook purchased WhatsApp for $22 billion and it was making even less money at the time than Instagram by comparison. But the combination of WhatsaApp, Instagram, and Facebook serves to strengthen the 'social-network' effect in which all these 'connected' apps become the 'go-to' ecosystem for people to join. Moreover, users who have spent hours, weeks, years, setting up profiles are unlikely to leave behind friends, contacts, pictures, memories by departing to alternative platforms like SnapChat or Twitter.

We believe Facebook has a wide moat now that it has emerged as the clear-cut social media leader. Given its successful track record of monetizing its vast user network via advertising, we believe Instagram and WhatsApp present fantastic growth opportunities. Facebook is also slowly becoming an entertainment hub which will only further increase engagement and user time spent on Facebook. The combination of a sticky user base with continual expected growth in online advertising bodes well for Facebook. To conclude, we believe that Facebook's current overhangs are unwarranted. We believe that the business model is largely intact and the stock price will correct itself in due time.

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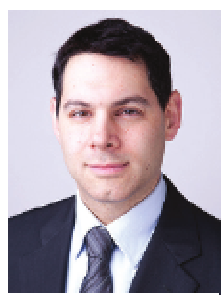
	ANNUAL PAY	RRSP	RRIF	TFSA
1yr GIC	3.00%	2.75%	2.75%	2.75%
2yr GIC	3.15%	2.95%	2.95%	2.95%
3yr GIC	3.27%	3.25%	3.25%	3.25%
4yr GIC	3.40%	3.15%	3.15%	3.15%
5yr GIC	3.60%	3.25%	3.25%	3.25%

* Rates subject to change

[1] Frontwater does not issue GICs. GICs are issued through independent, third-party financial institutions.

[2] Based on comparable posted rates as of June 30, 2018 at Canada's five largest financial institutions.

JEFF KAMINKER, MBA, CFA founded Frontwater Capital in 2009 and is a licensed Portfolio Manager. He is a member of the CFA Institute and holds an MBA and Engineering Degree (with Honours). He has more than 15 years capital markets experience.



Frontwater Capital offers an array of private wealth management services including investment management, insurance, financial planning, tax and retirement planning.

Frontwater Capital is licensed as Portfolio Manager, Commodity Trading Adviser, and Exempt Market Dealer.

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