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Random Interesting Thoughts for 2019

One of the recharging features of Christmas break is we catch up on some reading and podcasts that have gone into the "to-do" pile for some time. There are of course many things that are somewhat outdated at this point – but we still found some trends and thoughts that may be of interest to you as well. We have added links to PDFs provided by companies if you would like to read the entire document too.

- Byron Wien's top predictions for 2019 on the economy, trade, politics

- Byron Wien's research notes that the US has never had a recession when corporate profits are rising

- Starwood Property Trust's Investor Day presentation shows $3.3 trillion in annual infrastructure spending through 2030

- The housing ownership rate has returned to normal

- Stephen Moore's view that new trade deals effectively cut US export prices more than foreign import prices – which can be a new catalyst for the US economy

- Steve Schwarzman questions why 3.5% growth is bad after being told 1.8% was good

- Ares Capital Corp's Investor Day presentation showing just how much the banks have disappeared from the leveraged loan market – falling from 71% to 7%

- AT&T and 5G roll-out potentially driving a rebound in Apple and Samsung's new phones as the 5G speeds are game-changing

- Daimler still citing strength in China and confirming that it is set up to grow volumes faster than the market at a good profit level over time

- The new Prison Reform Act is releasing more inmates, shortening sentences and requiring inmates be held within 500 miles of home – does this make many prisons obsolete?

A good New Year's read is Byron Wien's top predictions for the next year

He has been doing this for years and here is the 2019 edition. We agree that the FED will not be raising rates very aggressively. However, we would also point out that the market is taking care of this regardless of FED activity. With large trading partners such as Germany having a 10-year bond at 20bp and Japan at 2bp – the US market is attracting buyers and holding our 10-year bond yield down. In 2013, there was the taper tantrum and US 10-year rose above 3% momentarily on fears that we would soon be at 5%-6%. That turned out to be completely false and here we sit in 2019 at 2.7% after numerous FED hikes. We also agree with Mr. Wien's prediction for heavy focus on infrastructure spending.

Another piece from Mr. Wien we found interesting was from October when he takes on recession fears. He does not believe there is one coming before 2020 at the earliest pointing toward solid growth figures:

> ***"the U.S. has never experienced a recession when corporate profits have been increasing,*** *and this is the current trend that is expected to continue in 2019. S&P 500 earnings are projected to be up 20% in 2018 and 7% in 2019. Also, there has never been a recession in the U.S. when the leading indicators have been rising, as they are now. Even when they turn down, there is usually a lead-time of a year or more before the economic decline starts."*

Starwood backs up the infrastructure theme

We have seen considerable investing in the pipeline sector, data centers, telecom, airports. Starwood Property Trust has started investing in some infrastructure – primarily power plants. The company had an investor day in December with a 129-page presentation. STWD likes to invest in real estate areas where there is growing demand such as medical-related buildings, affordable housing, and now power production. On pages 70-83, they discuss the increasing spending hitting infrastructure and the strong return potential.

Some key points listed are the world needs to invest $3.3 trillion per year in infrastructure through 2030 and low natural gas prices in the US continue to drive more power plant construction using gas. It also highlights the need for more logistics infrastructure.

We note an interesting housing graph in the Starwood presentation on page 86

Long-time readers know we focused considerably on some warning signs in housing during 2004-2008. One of the biggest signs of the mania was the US homeownership rate had been 64-65% for basically 50 years. Suddenly it was rising to 69% rapidly and then started to decline in 2006 before collapsing in 2008-09. The graph on page 86 shows the ownership rate bottomed in 2016 has now recovered to the long-term rate of 64%. The information is from the Federal Reserve Economic Data.

Stephen Moore says new trade deals can be a new catalyst for the US economy

Stephen Moore who is currently one of Trump's economic advisors and has been a member of the Wall Street Journal's editorial board and a leader of the Club for Growth, did an interview last fall talking about the economy, taxes, and the new trade deals. The standard points of lower taxes help the economy grow as do lower tariffs were discussed – that's not too earth-shaking. **However, he called out the new European trade agreement because part of that deal is a focus to continue working toward a 0% tariff rate for both the US and Europe. What he noted is the lower rates and a drive toward 0% is huge because the US export goods are starting from a much higher tariff rate than the European imports.** Thus, this could be another trigger for US economic growth because US exports should enjoy a larger price cut due to high tariff rates coming down and sell more volume than European imports where the price cut will not be as significant starting from a lower tariff rate.

An interview with Steve Schwarzman the CEO of Blackstone also puts the economy in perspective.

His view is we're growing at rates people said were impossible a year ago – why is that bad?

> *"In terms of 2019, we see a pretty good momentum with our companies. In real estate, we have and other exposures, it's slowing a bit, which should not be unnatural. I mean,* ***you were at 4.2% for economic growth two quarters ago. Gee whizz, so we were like a huge developed economy. That's pretty out there on the curve. And last quarter it was 3.5%,*** *and it'll be -- nobody ever knows what next year will be. But consumer confidence is really high and business confidence is high, markets are in high. But you'd expect to be somewhere around 3% next year.* ***And people forget that for eight years we averaged 1.8% and we kept being told that was good.*** *And so I don't see the feds, particularly trying to induce an economic slowdown that's certainly not what Jay was saying as I happened to be at the speech that he gave last week at the Economic Club here in New York. So we look forward to a reasonably good year. But a year whether it's sort of mid-to-upper single digits for growth, that kind of approach for companies."*

Ares Capital presentation showing banks have fallen from 71% to 7% of leveraged loan market

Ares Capital Corp. (ARCC) is another company that we follow. They also had a large investor day presentation in November. They outline their growth potential with the rising leverage factor now allowed for BDCs. **What is often touted by finance companies like ARCC and STWD is with all the new banking rules and Basil requirements – the banks have really left a vacuum behind as they exit many areas of the market.** On page 41, ARCC had the best stats we have ever seen on this subject. They show the leveraged loan market in the US broken down by banks and non-banks such as hedge funds, finance companies, REITs, BDCs. **In 1994, the banks had 71% of the leveraged loan market and that fell to 45% by 2000. In 2018, it was down to 7%!** That's a strong tailwind for these companies to pick up share of a growing market.

AT&T and the 5G rollout could potentially drive rebound in new Apple and Samsung phones

Like most people in the last few weeks, we have seen the weakness in sales of the new iPhone from Apple and some of the Samsung phones as well. Much of this seems to be customers extending the time before they upgrade as many of the new features are not compelling enough to cause people to spend $1,000. This is not a full review of Apple or Samsung by any means but reading some interviews from AT&T management talking about 5G – there may be a catalyst to drive phone sales in 2019-20. AT&T is selling 5G and is touting some speeds that may be game-changing to many people. However, to get those speeds, a customer needs a newer phone – an iPhone 8, Samsung 8 or higher. The speeds being discussed are 400mb/second to 1gb/second.

> Scott Mair of AT&T described the 5G Evolution in December:
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> "*The capability we're putting up on the tower is really one that leverages LTE advanced capabilities. And what that means is carrier aggregation, improved modulation techniques and 4x4 MIMO. All yield a much better experience for our customers. In fact,* ***those towers will support 400 megabit-per-second peak speeds. And I always like to say, kind of rule of thumb, 10% to 20% of that is what an average customer will see, so 40 to 80 megabits per second is the experience. And that -- right now, we'll have that complete in 400 markets by the end of this year, over 175 million people. And we'll be nationwide next year, by the middle of the year in 500-plus markets.***
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> *And so between end of June to what will now be end of this year, right, December this year (2018), we're finally going to see commercial.* ***We've said we'd be first in the market with a mobility 5G solution in small parts of 12 cities, going to 19 cities in the first half of '19.*** *That commercial interval of six months, to me, is absolutely amazing, from standards being built and finalized six months later. In an infrastructure business, having -- getting that out in six months is amazing. So our product that we're going to be using -- that device ecosystem is pretty important. So the product we're using is a MiFi product. It's the Netgear Nighthawk 5G mobile hotspot. That will be an entry device. And the device ecosystem is really what drives adoption, obviously. You got to have something to use it. And the way the time lines are shaping up, there's news this week, right, on what we'll see in the first half '19.* ***So we'll begin to see some 5G-capable devices in the first half of '19. And I think in the second half***

of '19 and early first half 2020, we start to see that ramp. *We start to see the scale devices come into play. We see scaling of networks in '19 and '20. And so what we're starting now is important. The ecosystem is developing very nicely, and it's coming together. And so you'll see '19 ramp into 2020 in terms of 5G rollout."*

CEO Randall Stephenson agreed in December:

"***I'm probably about as energized about 5G as any technology innovation that we've ever deployed. It's such a radical game changer to have the kind of capacity, performance of a network with – I'm going to exaggerate, but no latency. It's effectively a no-latency network. So, the always-on conductivity is really, really important.*** *Between here and there, you're going to see an evolution. I think you used that term. In fact, we have a technology term, we're calling it 5G Evolution. As we go through the last part of this year and 2019, we will be deploying 5GE, 5G Evolution, which means all this spectrum I told you about that we're hanging up, there's a technology called carrier aggregation that allows us to kind of make that spectrum – I'm going to oversimplify it, but like a single channel of spectrum. You get that kind of throughput. You get that kind of performance. We're deploying that technology and some other technology, MIMO and 256 QAM, the punchline of all that, all that means is,* ***if you have an iPhone 8 or an iPhone X or a Samsung 8 or later, as we deploy this, 400 markets by the time we exit this year will have 400 meg theoretical speeds on this network.***

Now, you load it up, you're not going to get 400 meg, but this is step change improvement in speeds. So, 400 markets, by end of this year, they will roll this out through 2019.

And so, you're going to see between now and just deployment of 5G in the millimeter wave spectrum some rather ***radical increases in the performance of these networks, of our network, and a huge amount of our customers that have, like I said, iPhone 8 or newer or Samsung 8 or newer handsets will experience these speeds.*** *And so, we're rolling that out right now as we're doing all this other work at the cell site and so forth."*

Daimler is still citing strength in China and confirms it is set to grow faster than the market

Daimler is a stock that has been slaughtered based on China, tariffs, and software concerning emissions. The company had 50,000 cars in inventory that should have been delivered in 4Q that would help rectify some of this. We saw their 3Q18 call where they still listed China as a strong market for them:

> "*Let's come to the outlook for the fourth quarter and full year 2018. At Mercedes-Benz Cars, we plan for unit sales in full year 2018 in the magnitude of last year.* ***While we are benefiting from a very attractive product portfolio and unchanged strong demand in China,*** *at the same time, our unit sales are, to a certain extent, influenced by delivery delays and drive cycle effects of certain model series, such as the new A-Class and the model upgrade of the C-Class."*

What really caught our eye though was they had a great Q&A about if you remove some of this short-term noise – is this company on path to consistently hit expected profitability figures and sales forecasts:

> Arndt Ellinghorst of Evercore:
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> *"One question on the more medium-term outlook, Bodo, really. Given where the stock is trading, I think we shouldn't spend too much time on the nitty-gritty quarterly stuff here. Can you ensure investors that there is growth in Mercedes cars that you can keep the level of profitability at 8% to 10% for the, say, coming two years to three years? Can the Group generate €4 billion to €5 billion of free cash flow ballpark? Could you, as much as you can, I don't – I know you don't want to give us a guidance for the next year, but can you give us a bit of a framework for the next two years to three years really because some of your long-term investors or the potential investors here? I think that's incredibly important at this point.*
>
> Bodo Uebber
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> *"Arndt, thank you for your very good question. And let me outline a little bit in this direction. I do think we have given you a frame for the strategic direction of Mercedes cars. When I go back to the last Capital Market day and the things we have shown at this day, and these are – I do think I can refer nicely to your question.* ***I do think in***

the long run, we do have possibility to grow the Mercedes car group volume because of strong product on the one hand of our core product, but also the upcoming electric product. *So there's a – as you know, our 10 models, of course, we are investing a lot in this direction.*

So I'm fine with the product portfolio to accelerate growth in the long run over and above the market volume. *You can see in passenger cars. On the one hand,* ***we have outlined our strategy to stick to the 8% to 10% bandwidth of profitability. That includes, of course, the higher investments, on the one hand, as we have mentioned, but also the Fit for Leadership program, which addresses the optimization of the total business model****, as it was also outlined. So we will accelerate in these directions also on the cost side, as I have mentioned, over the €4 billion program to make sure that we achieve the bandwidth. We have to consider some certain rules, of course, which I need to tell you.*

We had some discussions, as you know, about customs and other stuff, which might have some short-term impacts, which I can't exclude, but I do think we have, again, finally, also the answers on this kind of questions, finally. So nothing has changed in the direction. We need to accelerate. We need to be disciplined in terms of spending, and so on and so forth. But other than this, there is no change of the strategic directions. The market for premium is still better than for volume, from my point of view. We have always in-depth discussion about this development. ***When you look at China, for example, and other markets, I do think we are in the right segment for accelerating growth.*** *And I even do believe that, for electric products and for elements out of case, that the premium manufacturer is well positioned in this area of digitalization and electrification."*

Does the Prison Reform Act render many prisons obsolete?

A final area we would throw out is the prison reform bill signed into law in December. Not only will this shorten prison terms and release many people early, we noticed the new law requires prisoners be held closer to their families – no more than 500 miles - and gives judges more leeway in dealing with mandatory sentencing laws. We have not explored this much yet, but we did considerable work on the prison companies in the past – The Geo Group - GEO and CoreCivic -CXW. The private prison business was driven by two things – mandatory sentencing and outsourcing.

Many prisons were built in low population areas in smaller population states like Oklahoma, Arizona, Colorado, etc. Those states are not supplying all the inmates. States with large populations would contract to have their prisoners held in these facilities. Even a small state like Hawaii had a huge number of prisoners being held in Arizona in private facilities. When you consider that a state like Colorado is surrounded by Wyoming, Nebraska, Utah for example – how many prisoner families live within 500 miles? Oklahoma is more than 500 miles from big areas like Chicago, Minneapolis, and Illinois.

We would need to look at this more closely – but, this could make some existing prisons obsolete. **One of the risks we always pointed to for these companies is their real estate has very little terminal value.** People value them like other REITs owning apartments in Charlotte or office space in Boston where replacing tenants or remodeling are possible. In reality, prisons are not going to become multi-use and have half the property converted to a hotel. Moreover, they tend to be in the middle of nowhere – with directions that include steps such as, "turn off the paved road then go another 25 miles." **At this point, we are going to throw this out as a possible new risk factor for the prison companies and have not seen any other comments on it.**

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