JCP Investment Partners – Investing in Practice

Impressions of the USA – September 2016

This report covers impressions, facts, reflection and analysis from travels through the USA in September 2016.

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Key areas of focus

- **An assessment of the US Economy**
- **The emergence of Donald Trump**
- **Areas of innovation**

Introduction

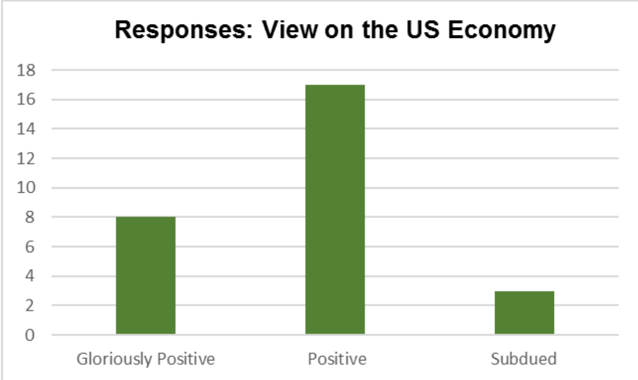
Having met with our contacts from the world of business, policy and politics during September, we learnt that context counts. Each faced with the same economic data that we observe from afar, had their own take. Partisan politics and naked self-interest skewed the interpretation of current conditions; the right talked the economy down, while the left lamented that the pace of the recovery was not achieving stronger income growth. We were surprised as to the degree to which the recent fall in unemployment was discounted by the lower participation.

But few argued that the economy wasn't operating smoothly, less still that it wasn't creating jobs, and almost no-one suggested that in aggregate the income and expenditure side of the consumer economy wasn't positive. The differences were whether this set of outcomes met their expectations.

Almost all wanted more. There was a general nostalgia for higher growth and a sense that something is missing. For JCP, a small number hit the nail on the head as to what is missing – the alluring growth of a debt fueled boom. Emphasised with equal consistency was the dynamic of inequality, and the continued growth of that inequality, with certain cohorts and regions that have been left behind. Brexit and the rise of Trump has firmly placed inequality at the heart of discussion around the economy.

The US Economy – doing remarkably well

Domestic demand is strong, despite the barren and acrimonious political landscape that has dominated life in the US for the entire recovery. In a landscape where the decisions required of government and the investment sector for growth have stalled for a variety of reasons, the US economy is doing remarkably well. The closer we got to people running real businesses, the more conviction we had in the strength of the economy, as demonstrated in the chart below. But this is always with a twist.



- **Fast moving consumer goods can be patchy, but areas where innovation is high are doing better than others.** Brambles reported they are experiencing growth in the protein, beverage and pharmaceutical sectors. We visited leaders in new supermarket formats, including HEB Central Market and Sprouts Farmers Markets. These companies have responded to the success of the higher income earners, as well as other growth areas by re-establishing the role of the supermarket in people's lives through higher quality food products. We look forward to Australian companies like Woolworths learning from companies that have moved beyond deflation and deranging. If they don't, it won't be long before someone does it for them. Similarly, big format department stores continue to struggle as the hollowing out of the middle class and internet shopping attack their business models.

- **Housing remains solid, building on recent progress and seeing further upside in housing formation.** Travelling through some of middle America, it is hard not to be impressed by the integration of multi-family into new activity centres and rejuvenated downtowns. With higher house prices, and a consistent supply of new housing, a company like Home Depot is optimistic about households trading up to higher quality products and are seeing the induced benefits of price appreciation (wealth effect). DR Horton are experiencing strong growth, with sales staff reporting their strongest annual sales growth in Dallas. This is resulting in double digit wage growth in the sector.

- **The wages story was as nuanced as the data suggests**. Our preferred analysis, presented by the Atlanta Fed Wage Tracker, was corroborated. The US in a classically semi-regulated structure approaching full employment, but produces a variety of wage outcomes. Companies that can are raising wages – those in growth industries, and those growing market share are paying to attract new workers (switching +3.7%) and to retain key staff. However, those on the edge of the labour market are faring much worse. This is likely exacerbated by regulatory uncertainty, as well as increased total compensation costs around

Obamacare. The pressure on wages in some sectors continues to grow in this environment.

- **A lack of productivity.** Many worried about productivity, and others just simply wanted the GDP number itself to be higher, as if it was the only proxy for success. Much of the productivity challenge will be addressed via innovation, particularly robotics, which is discussed below.

- **Advertising is resilient, but changing preferences for media delivery dominated discussion.** Fundamental restructuring of media rights is occurring in the US – the rise of Netflix, and what it pays for its access, compared to others that provide similar services is yet to be resolved. In the short terms, advertising revenue from the election is expected to be significant, with 21st Century Fox suggesting $80-100m in the next two months.

- **The Fed in this environment.** The rise of the theory of secular stagnation had cut deep amongst those we spoke with. But underneath the rhetoric and the "meddling desires of macro-economists", as referred by one contact, the profits continue to rise. This begs the question as to whether Fed inaction is about the numbers or something else – a so-called third mandate. While we can only speculate, we consider that maintaining financial stability in a globalized world is a key consideration for the Fed, otherwise the US economy has been performing too strongly for too long to sustain near zero rates. We consider that the risks to yields are on the upside, given the stronger fundamentals; however, the geo-political risk that would arise if Trump wins the election could keep the Fed on hold.

What drove the emergence of Trump?

A lot we knew from the media. A consistent story around inequality, as well as about Clinton, and the weakness of the other Republican candidates. But two other key stories emerged: i) the rejection of crony-capitalism; and ii) the hijacking of political correctness to hide a system that the US public increasingly see as rigged. Clinton is often viewed as both a symbol of crony-capitalism, expressed as a lack of trust (74% amongst white men), and as part of the system, unlike the "outsider" Trump.

The hijacking of political correctness is fascinating, and relevant for Australia. Discussions around immigration is important for two reasons: i) it uncovers a potent level of support for Trump and ii) it brings into the open a conversation that much of the US population has been having. When Trump speaks on this issue, he is seen to have a willingness to have the discussions that no one is apparently willing to have in Washington. In doing, so he highlights a "rigged system" that is seen by many to cover up issues. "Disenfranchised" (mentioned by almost all) is both about gridlock in Washington as well as not talking about the things that everyday Americans are discussing.

If these themes hold in key states, Trump can win. The probability of him winning rose with each day and with almost every meeting. The negative payoff is immense and the market isn't fully pricing this – all the elite and insiders [the political contacts we met in Washington DC] are simply "hoping" he won't win, and are largely relying on "electoral math". If Trump does win, the risks will be priced very quickly and markets will fall.

So why are people downplaying the risks? Two key reasons are relevant for Australia: i) Trump will be much more destabilising for the rest of the world than for the internal US in the short-medium term; and ii) the "checks and balances" placed upon a President provide a narrative that mean even if Trump wins, he won't get anything done with either a hostile or at least sceptical Congress.

Both reasons provide the rest of the world with little optimism. Without any prompting, three contacts referred to 1914; the fear of external conflict is palpable. In an environment where Trump may find it difficult to get things done internally, he may act out of frustration externally. This presents for an increasingly risky and volatile geo-political environment in 2017. In addition, executive orders (which have been increasingly used by Obama) could impact health funding and trade policy, potentially placing Australia into conflict or tension with major trading partners.

Innovation is alive and well

We saw that there is so much innovation to come. This could drive higher profits in general, and may result in higher wages in successful companies and sectors.

A dominant feature of innovation is labour-replacement. We are inspired by the amount of upside left in business transformation, supply chain investment, housing recovery and the deployment of robotics. Why? Not because we didn't know these forces are at play, but because the barriers to their implementation are so low.

Examples of innovation:

- **Automation and robotics**
  - Fast food chains are exploring robots to take orders and prepare food.
  - Home Depot is exploring robotics for their distribution centres.
  - UPS is investing $1bn over 5 years to automate their main hubs to reduce labour costs. UPS is also looking to integrate autonomous vehicles in to their network fleet, while testing drones to deliver goods

in remote places, such as Africa. With 60% of operating costs from labour, these advancements stand to improve profitability significantly.

- **Customised media content and data mining**
  - 21st Century Fox and NewsCorp are using big data to help them negotiate better with advertisers.
- **Predictive analytics**
  - Pioneer Natural Resources spoke of the advancements in predictive analytics. For example, when a drill gets stuck, steps are automatically taken in advance to fix it, reducing downtime.
- **Biometrics**
  - MasterCard is currently testing additional methodologies to reduce fraud.
- **Aging at home technology**
  - Futurists that we met spoke of sensors that will detect foot movement to better understand consumer responses, while screens will be everywhere (cheap and affordable) and bandwidth will be freely available.

There is a distinct possibility that investment is not being accurately measured in critical sectors (such as IT), which points to an array of expenditure that is "future enhancing" but never identified as investment. If this is correct, it could result in higher profits, with the investment already having been undertaken at low rates.

There are vast anti-competitive forces at play in finance and banking, and natural monopoly in new technologies are unchallenged. Some firms are simply the beneficiaries of QE and its inherent inequality. As an unnamed source said "most profitable business in America is in very 'competitive' activities - but they don't compete on price".

Conclusion

While neither innovation nor the sparks mentioned above are sufficient conditions for enhanced growth, this is a good starting point.

Of interest will be how the rise of Trump will affect the distribution of benefits flowing from structural profit enhancement. Will the US respond to create more "better" jobs and re-distribute more?

JCP believes this context creates a fertile breaking ground for stronger future growth, especially given a spark of change such as:

- **Infrastructure investment**. Both Clinton and Trump are proposing large infrastructure funding programs. Although not large by Australian scale ($250-$400bn over ten years for an economy 10 times as large as ours), this would be a significant political success given the current budgetary constraints.
- **Import replacing investment**. In an environment of nationalism, and the possibility of increased geo-political tensions, there is upside in such sectors.
- **Tax cuts** (short-term sugar hit).
- **Tax reform**.
- **An unlikely but important reduction in political tension** and an ease in the malaise that envelops politics, executive government and the media.

In summary, the fundamentals of the US economy appear relatively strong. The hollowing out of the middle class may well continue given the push towards automation and robotics by corporates, which will lead to increased profitability but not increased disbursement of that wealth. The immense inequality, dominated by the uneducated white male, is a key factor that has given rise to Trump. The probability of a Trump win is high (40%+) and, while his impact internally will be moderated by Congress, he could have broad impact externally given the commander and chief status that applies to the President. This only heightens the geo-political risk ahead, which is likely to result in increased volatility for markets, and which appear not yet to be fully priced by the market. In this type of environment, exposure to companies with US derived revenue, such as Brambles and Ardent Leisure (through their US based Main Event business), remains appealing given the greater risks are external.

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