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December 31, 2019

The Monthly Letter covers three topics this month. First, we provide a brief look at both venture capital technology stocks and the rise of home rentals. Both these asset classes became the "Can't Lose" sectors of this recovery over the past few years. However, with fundamentals peaking and turning down for the first time in almost a decade, the future likely will look very different from the recent past. Second, we return to our Great Game of Power series. With the US and China declaring a short term truce in their economic hostilities, peace appears to be returning to the relationship between the two countries. However, with both countries moving to put their interests forward, only a short truce stands as the likely outcome with renewed hostilities in the not too distant future. And Third, as always, we close with brief comments of interest to our readers.

As The Cycle Turns: 2001, A Stock Market Odyssey & Everyone Into The Rental Pool

Every cycle possesses an asset whose ability to deliver returns no one can deny. It creates strong returns for early and mid-cycle investors, but then attracts gobs of capital late cycle that drive returns downward, just as the fundamentals turn against the asset. In the 1980s, leveraged buyouts and commercial real estate, principally office buildings, attracted significant capital. For those early on, this produced excellent returns. Companies like Drexel Burnham Lambert rose to prominence financing these deals. However, in the late '80s, deals got bigger and bigger, as did leverage, in order to make these deals work. And, as these investors found out, leverage cuts both ways. In the ensuing recession, investors lost 100% of their investments, numerous insurance companies became insolvent, and many banks disappeared into government receivership. In the 1990s, technology companies, internet companies, and new telecom companies flourished. These companies were value stocks early on and produced fundamentally sound returns. As with most things, Wall Street took a good idea to an extreme, driving valuations to record levels and bringing public companies with no revenue, but large valuations. Of course, they became the Tulip Bulbs of the modern era, with numerous technology companies shutting down and the survivors limping along with revenues often down 80% or more. In the early 2000s, Housing continued its recovery from the 1987 – 1993 downturn. However, instead of allowing the market to have a pullback in 2004, the Federal Reserve allowed lending institutions to loosen standards, creating what came to be known as "Liar Loans". This enabled homes to become the "Can't Lose" asset from 2004 – 2007, as traditional lending metrics were discarded. The spectacular rise in home prices, as a result, led to an equally spectacular collapse in values during the 2008 – 2009 recession, as traditional lending standards returned once more. This bankrupted the financial system and caused untold hardship to millions of people.

This cycle, another speculative cycle appears to have occurred in technology companies and venture capital backed companies, with companies such as WeWork trading at $50+ billion private valuations

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and with companies such as Uber, Beyond Meat, and Slack coming public and trading at nostalgic valuations last seen in the late 1990s and, before that, in the late 1960s, when the GoGo Era of conglomerates, such at ITT, ruled the day. However, as in all speculative cycles, eventually the tide turns. That appears to have occurred over the past year with the failed IPO of WeWork and the disappointing performances of Uber and Lyft since they came public. These companies sold themselves as capturing the markets of tomorrow and were "Willing to lose a little on each sale and make it up on volume." And with Venture Capital looking for a home for the hundreds of billions of dollars raised from investors, these companies and their founders found willing shareholders who would fund their dreams. These founders understood that when financials did not have to bear the scrutiny of the public markets, this worked, as profits were an afterthought. And while public biotech investors understand that research takes years and the companies might not be profitable until their products receive FDA approval, investors expect public real estate and transportation companies to show profits once they reach some minimal scale, let alone the level of a WeWork or Uber. With WeWork showing massive cash outflows, despite its scale, not only did the company not make it to the public markets but it needed an emergency infusion of cash to stay afloat. And, not surprisingly, Uber's and Lyft's stock performances since their IPOs produced negative returns for investors, as they continue to lose money overall. However, with the discipline of public investors, who, for some reason, expect a company to make profits, Uber and Lyft refocused on driving profitability for the first time in their existence. And with the public markets indicating to Venture Capital firms that revenue does not equal profits, a novel idea, and that dreams don't equate to business valuations, Venture Capital firms pivoted over the past few months. They now demand companies not only show a path to revenue growth but to profits. This change of heart or, more aptly, this change in the pocketbook became the beginning of the end as markets begin to shut to dreams and focus on reality, repeating the lessons from 2001 and sending these dream companies on a Stock Market Odyssey.

And while these Venture Capital companies attracted attention, making the front page of the newspaper, the real capital headed into commercial real estate, where the average investor moved into rental properties over the past few years just as the professional investors, who purchased properties from 2009 – 2011 during the depths of the real estate cycle, exited their properties. For example, Blackstone, entered the home rental business massively in the aftermath of the 2008 – 2009 Housing Collapse, buying tens of thousands of properties between 2009 and 2013 from banks, the government, and through bankruptcy auctions. It then filled them with renters to create a true cash flowing real estate company. In 2017, it took this company, Invitation Homes, Inc., public, as a means to create an independent valuation on the assets and provide for Blackstone's eventual exit. From March, 2019 through November, 2019, Blackstone sold 100% of its ownership through a series of offerings to the public. All in all it made $7 billion in profits on its investment plus collected dividends along the way.

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In addition to numerous professional investors exiting the market, the fundamentals that supported the massive upward move in rental valuations appear at a peak or to have rolled over. First, Gross Rent to Income ratios for the median renter have soared since 2011. In cities such as Boston and New York, this now exceeds 30% of the median income, up from the low 20's, matching peak rates seen in prior cycles. In some cities, such as Miami, this now exceeds 40%. With lessees complaining about the high cost of rentals, local governments have begun to respond, imposing Rent Controls in a number of cities and mandating legal representation for renters. While this may impact supply over the long term, it will limit the ability to raise rents and to evict residents over the intermediate term. Second, Home Price to Rent Ratios have soared, due to the collapse in interest rates driving home prices to levels well above those of 2007. As a result, Home Price to Rent Ratios stand at 28x in San Francisco, 24x in Fort Lauderdale, and 22x in Atlanta. With prices at these levels, the inverse ratio, Gross Rents to Home Prices sit below 3% in a city like New York (Home Price to Rent Ratio of 34x) and mostly sit between 3.5% and 5.0% for most major cities in the United States. Thus, finding bargain homes to rent at a reasonable return on investment has become much more difficult. Third, Millennials continue to move into their prime home buying years. Statistical data on Millennials demonstrates that they look similar to Baby Boomers, but moved 2 – 3 years later for marriage, kids, home buying, … The latest Household Formation data confirms these statistics, as Millennials continue to form new home owning households at a rapid rate:

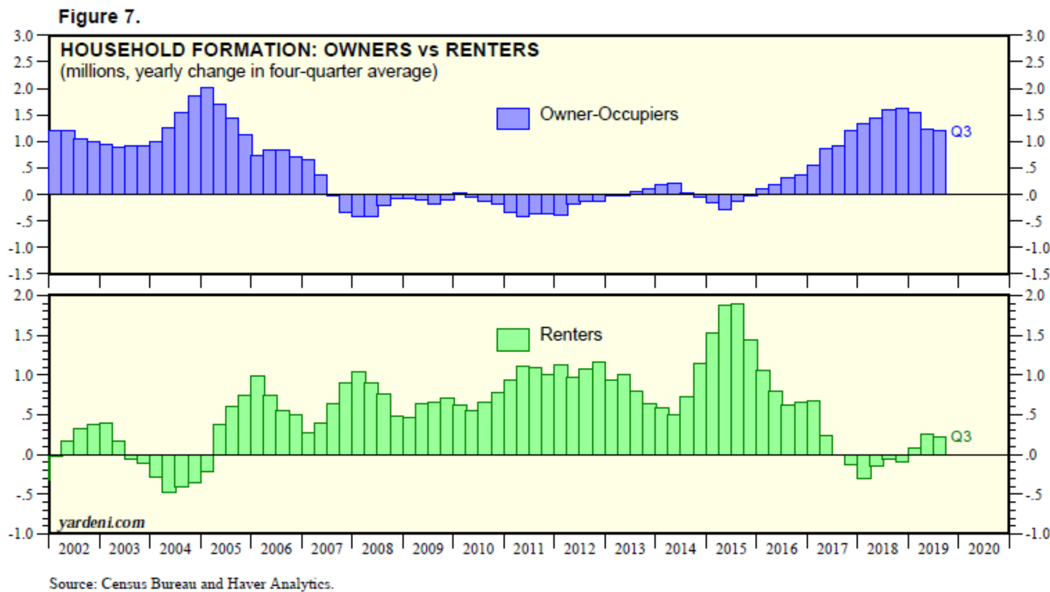

Chart courtesy of Yardeni & Company.

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As the chart demonstrates, growth in rental demand collapsed in 2018 and currently sits at very low levels. Fourth, over 19% of U.S. households with incomes over $100,000 rent today compared to 12% in 2006. This represents 3.4 million incremental renters compared to a decade ago. The following chart demonstrates the issue for these first time home buyers:

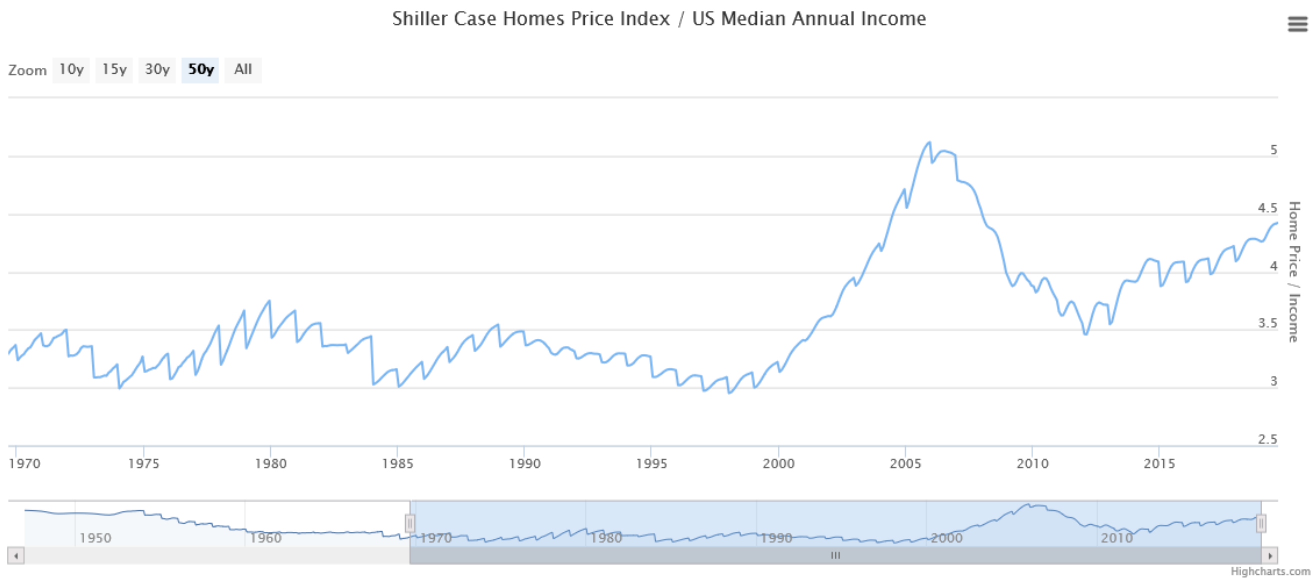

Chart courtesy of longtermtrends.net.

Despite the collapse after the Housing Bubble, home prices did not return to their historical relationship to incomes. This shut many first time homebuyers out of the market, as they had difficulty accumulating the necessary down payment. As the major public homebuilders refocused their product on entry level housing over the past two years to meet this demand, the supply for these first time home buyers will start to come to market in 2020 and accelerate thereafter. The new homebuilder focus will enable these renters to locate affordable first homes. Fifth, Multi-Family Housing Permits continue to soar. According to the U.S. Census Bureau, Not Seasonally Adjusted Housing Permits are up 10.2% through November and Starts continue to follow with a lag. And with Multi-Family Housing Starts already exceeding demand growth, the gap will only grow. And Sixth, banks began to tighten terms for commercial real estate loans, as the following chart demonstrates:

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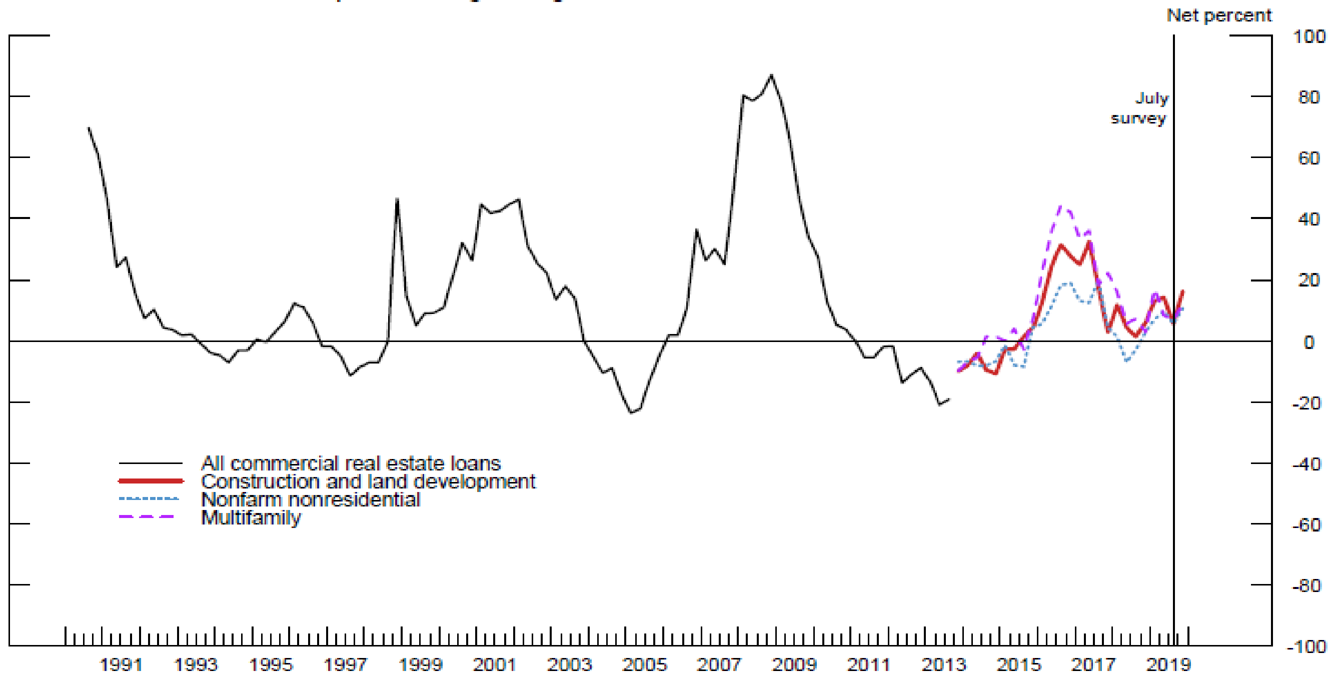

Chart Courtesy of Federal Reserve.

Typically, once this tightening begins, terms do not ease until after the next recession. And as credit tightens, the ability to leverage properties at high multiples of cash flow will become increasingly constrained, likely forcing multiples down.

Despite professional investors exiting and fundamentals turning negative, renting homes continues to attract attention as a “Can’t Lose” proposition. Numerous seminars continue to extol its virtues, given the profits of the past decade. And a whole ecosystem, built over the past decade to focus on this asset, continues to look for new entrants to this market to sustain itself. But with home prices already leveling out or pulling back in a number of major metro areas, home price appreciation may be coming to an end for this cycle. And should mortgage rates rise, with first time home buyers comprising over 50% of all home purchases, further pressure could come on home prices. However, as at the end of most major cycles, money continues to pour into the home rental sector, with the cry, “Everyone Into The Rental Pool”. (Data from US Census Bureau, Yardni & Company, governing.com, rentberry.com, and various publicly published home price data coupled with Green Drake Advisors analysis.)

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The Great Game of Power: Cold Wars, Proxy Wars, and The Path Well Trodden

> "*National security requires far more than military power. Economic and moral factors play indispensable roles. Any program that endangers our economy could defeat us. Any weakening of our national will and resolution, any diminution of the vigor and initiative of our individual citizens, would strike a blow at the heart of our defenses.*"

Annual State of the Union Message
President Dwight D. Eisenhower
January 10, 1957

> *"Igitur qui desiderat pacem, praeparet bellum."*
> *("Therefore he who desires peace, let him prepare war.")*

De Re Militari
Publius Flavius Vegetius Renatus
4th Century A.D.

Since the dissolution of the Soviet Union in 1991, which unofficially ended the Cold War, United States economic and foreign policy became based on the premise that global rivalries no longer existed. That the U.S. could and should help other countries to grow. And that the need to maintain an enormous military capability would no longer prove necessary. Thus, the US entered into NAFTA in 1993 with Mexico and Canada. And followed it with a conclusion to the long running global trade discussions between the Emerging Markets (EM) and Developed Economies (DM) that led to the creation of the World Trade Organization (WTO). Through the WTO, America and other Western countries provided unfettered access to their economies for foreign goods and provided a rules structure that favored EM economies. This led to 20 years of accelerated EM economic growth and enabled China to modernize its economy. For those who put these policies in place, they did their job producing the intended results.

Unfortunately, thirty years later these policies look out of place in a world in which both China and Russia resumed their traditional roles as Great Power rivals to the United States. And while numerous politicians continue to extol the virtues of these globally oriented policies, the dawning of a new view of China by the U.S. and European public over the past two years, as China militarized the South China Sea and demanded Western citizens and corporations apologize for exercising their democratic rights to free expression, brought to the fore a very different reality. This reality reflected the massive change in China's economy since 2000 and its Communist political orientation. And when coupled with Russia's invasion of Ukraine and Vladimir Putin's recent move to deploy hypersonic weapons, the past 30 years look more like an intermission between Act 1 and Act 2 of a continuing Cold War. And with the U.S.

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moving to counter China and Russia for the first time in over 25 years, events look set to accelerate over the next five years. Even Henry Kissinger, who engineered the opening of China through President Nixon's visit in 1972, recently stated that the US and China stand in the "foothills of a Cold War". (New Economic Forum speech, November 2019. Please see the following link to the speech on Bloomberg: https://www.bloomberg.com/news/articles/2019-11-21/kissinger-says-u-s-and-china-in-foothills-of-a-cold-war .)

To understand China's actions to elevate its global economic and strategic position at the expense of other countries and the growing global reactions by other nations over the past two years, a few concrete examples of China's strategy will illustrate clearly the issues at bay. First, China's BAIC Group, a Chinese State Owned Enterprise (SOE), announced it took a 5.23% position in Daimler A.G.'s voting stock. This stands in addition to Zhejiang Geely Holding Group, another Chinese company already owning a 9.7% stake in Daimler. Given Daimler's poison pill, China could not increase its position in Daimler through the same company, so it used a separate SOE in order to increase its stake. This gives China a 15% stake in Germany's leading automotive company and one of the largest commercial vehicle manufacturers in the world. Also, in order for Daimler to continue to grow its business in China, Daimler agreed to create a jointly owned electric battery research lab with BAIC in Beijing. After the Chinese takeover of Kuka, the premier robotics company in Germany and one of the leading global robotics companies, the German public reacted negatively to the government allowing this sale to occur. As a result, Germany passed laws to limit foreign companies' ability to take over German companies involved in key areas of the German economy. To what extent Germany will allow China to influence Daimler and exactly what technology Germany will allow the company to share, remains to be seen.

Second, over the past five years, China opened plant after plant to produce LCD TV panels, displacing foreign imports to the country, putting in place excess capacity for export, and creating massive oversupply in the global markets. This excess supply led to the expected results. Foreign plants saw capacity utilization come under pressure over the past year. Global Capacity Utilization dropped from 89% in early 2019 to 82% lately. With Capacity Utilization collapsing, TV Panel prices fell to less than the cash cost to produce them. With cash losses on every panel produced, this put massive financial pressure on foreign rivals to close capacity while the Chinese companies could depend on the Chinese government to infuse cash to fill the gap through this period, however long it needed to be. This strategy to put pressure on foreign rivals appears successful, as Korean manufacturers announced the closure of some capacity in an attempt to balance the market and stem the losses.

Third, China's push, via Made in China 2025, to create a global semiconductor industry to displace foreign chips continues apace. Memory chips will become the next area to come under pressure. With technology stolen from Micron Technology, as documented publicly, Yangtze Memory Technologies

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Co. expects to manufacture 5% of global output for NAND flash memory chips by the end of 2020 and ChangXin Memory Technologies expects to produce 3% of global DRAM memory chips by the same date. The Chinese national and local governments effectively paid for the $24 billion Yangtze plant and the $8 billion ChangXin plant. For the U.S., South Korea, and Japan, which developed the technology and currently dominate this market, such a state subsidy coupled with massive state industrial espionage to create global rivals and displace their companies cannot sit well. The likely reaction by these countries, to cut off these Chinese chips and any products containing those chips from Western markets and to push for an embargo from countries allied with them in Asia, Europe, Africa, and South America over the next year, should come as no surprise as these chips come to market. For those who think the economic strife and turmoil, exhibited over the past two years, entered a truce due to the "Phase 1" deal between the U.S. and China over trade, they likely will find themselves sorely disappointed.

And Fourth, China attempted to dictate to Vietnam where it could drill for oil offshore, claiming Vietnamese waters in the South China Sea for itself. In this instance, there exists no question about the block where the drilling occurred from June until October, utilizing a Russian vessel with the needed drilling capabilities from Rosneft. International law long recognized this portion of the sea as Vietnamese territorial waters. Chinese coast guard ships entered these Vietnamese waters in an attempt to stop the drilling. Vietnam responded with its own ships to protect the Russian drilling rig. The Chinese vessels fired water cannons at the Vietnamese vessels in an attempt to provoke a reaction. The U.S. sent a warning to China not to escalate. Ultimately, the Chinese did not fire live weapons at the Vietnamese ships. This is similar to Chinese actions against The Philippines which led the United States to remind China it possessed a mutual defense treaty with the country. However, with China claiming the whole South China Sea for its own despite internationally recognized boundaries for each country's exclusive economic zone, the probability that such a confrontation could escalate into a shooting match will rise over time.

In reaction to these moves, the U.S. began to revive and implement policies last seen during the 1980s, during the height of the Cold War. These policies cover a wide variety of areas, from economics to military preparedness to foreign policy. While no "Grand Strategy" yet exists to unify these actions, taken as a whole, they represent a visible symbol of the likely Grand Strategy the U.S. will formally adopt over the next few years. First, the U.S. directly targeted trade with China, which undermined U.S. manufacturing capabilities over the past 20 years. With the reality of China's State Owned Enterprises receiving massive government support and subsidies, allowing the status quo to continue would lead to further reductions in U.S. industrial base. From a global strategic and domestic security perspective, this stands as an unacceptable result. Second, the U.S. moved to protect its technology. This occurred in two ways. The legislation behind CFIUS (The Committee on Foreign Investment In the U.S.) was updated to address the current economy. This enabled the government to legally stop China's SOEs from buying U.S. technology to bring to China. And this enabled the government to stop China from

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investing in start-ups with potential leading edge technology products. Third, the U.S. moved to invest significant sums into critical technologies in order to keep up with China. This can be seen in the following initiatives:

National Electric Vehicle Supply Chain Initiative
National Quantum Computing Insitute
DOD R&D Funding for Hypersonic Vehicles
National Initiative on Advanced Manufacturing, AI, and Robotics

Fourth, the U.S. set in motion initiatives to reshore critical manufacturing. Over the past 20 years, significant advanced manufacturing moved offshore as large companies sought to save money and the U.S. government allowed this. With a new Cold War in place, security of supply will now trump other considerations. Integral to this effort stands the production of computer chips. The Pentagon and TSMC continue to negotiate the construction of a fab for advanced semiconductor manufacturing to be built within the U.S. borders. TSMC manufactures 90% of advanced semiconductor chips designed by U.S. and European companies. This includes key chips for the U.S. military that go into some of the most advanced weapons in the U.S. as well as jet fighters, radar systems, combat ships, and other key areas. DARPA, the Defense Advanced Research Projects Agency, allocated $1.5 billion in 2017 for chip R&D through the Electronics Resurgence Initiative. Fifth, the U.S. Congress performed numerous studies on China to provide the basis for future legislation and budget allocations. These include The US-China Annual Economic and Security Review, China Belt and Road Initiative Analysis, and Threats to U.S. Research Enterprise: China's Talent Recruitment Plans. The President, through his ability to direct the Executive branch and through Executive Orders, put in place the following: the American Technology Council, the Strengthening Cybersecurity Initiative, the Revival of the National Space Council, Strengthening the Manufacturing and Defense Industrial Base and Supply Chain Resiliency Initiative, a National Security Strategy, the Critical Minerals Initiative, the Strategy for American Leadership in Advanced Manufacturing, an Automated Vehicles and Preparing for the Future of Transportation Strategy, an Accelerating America's Lead in Artificial Intelligence Initiative, the National Space Weather Strategy, the National Resilience to EMP Strategy, and the National Strategic Computing Initiative, among other actions. Seventh, the US significantly increased its defense spending. With China's real defense budget now 75% or more of the U.S. budget, the U.S. needed to increase spending to maintain its global military capabilities. Eighth, the U.S. moved to paralyze the WTO (World Trade Organization) and reestablish the GATT (General Agreement on Tariffs and Trade). By refusing to approve any new appellate judges, the U.S. effectively prevented the WTO from ruling on any matters leaving all disputes to country to country negotiations as under the GATT. (For a more detailed discussion of this topic, please see *The Fight For Global Growth: Technology Leadership, Currency Wars, and The Death of the WTO* published on August 31, 2019.) Ninth, the U.S. moved to use economic sanctions against countries allied with China around the world. This action seeks to

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undermine the governments and economies that have put themselves under China's sphere of influence, thereby undermining China's global strategic position. And Tenth, as a logical extension to economic sanctions, the U.S. seeks to deny China critical items to meet its economic goals. For example, this might mean withholding computer chips from China. This strategy seeks to undermine the Chinese economy much as China sought to undermine the U.S. economy over the past 20 years. For historical reference, the U.S. successfully used this strategy against Japan. And those economic sanctions ultimately gave Japan no choice but to launch war against the U.S.

While Henry Kissinger speaks of the "foothills of a Cold War", the reality of the actions outlined above by both China and The United States speaks only of the early stages of a full blown Cold War. The closest historical analogy stems from the late 1940s when Russia and the U.S split Europe. There followed a global alignment of countries either with the Western democracies or with Russia and China. This effectively split the world into two for the next 50 years. Winston Churchill in his 1946 Sinews of Peace speech famously stated, "It is my duty, however, for I am sure you would wish me to state the facts as I see them to you, to place before you certain facts about the present position in Europe. From Stettin in the Baltic to Trieste in the Adriatic, an iron curtain has descended across the Continent." With the U.S. and China moving down The Path Well Trodden, the world will likely split into two once more over the next decade. And instead of an Iron Curtain, a Red Curtain will fall. As it does, the likelihood of a Proxy War somewhere in the world, with the U.S. and China backing different sides for their own strategic gain, becomes highly likely, with the most probable location Asia or the Middle East. For China, the issue will come down to how to manage a U.S. that now recognizes its strategy to become the dominant country in the world and who will act to oppose this outcome. For the U.S., not only will it need to address China's strategy across all spheres of action, but it will need to address the moral leadership of those opposed to the authoritarian system offered by China and enabled with today's technology. As President Dwight D. Eisenhower famously stated in his State of the Union Address in January 1957:

> "*Our pledged word, our enlightened self-interest, our character as a nation commit us to a high role in world affairs: a role of vigorous leadership, ready strength, sympathetic understanding. The State of the Union, at the opening of the 85th Congress continues to vindicate the wisdom of the principles on which this Republic is founded. Proclaimed in the Constitution of the Nation and in many of our historic documents, and rounded in devout religious convictions, these principles enunciate:*
>
> *A vigilant regard for human liberty*
> *A wise concern for human welfare*
> *A ceaseless effort for human progress*

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> *Fidelity to these principles, in our relations with other people, has won us new friendships and has increase our opportunity for service within the family of nations. The appeal of these principles is universal, lighting fires in the souls of men everywhere. We shall continue to uphold them, against those who deny them, and in counselling our friends.*"

With The Great Game of Power once more afoot, the world will become a more dangerous place. And simple differences easily can morph into major crises once national interests become involved. Unfortunately, with a new Cold War raging and The Path Well Trodden for the combatants, Proxy Wars stand ahead on The Path. Which fork the travelers take will become critical in determining whether these crises can be contained or will spill over, as before, into a larger conflagration. And should they spill over, the world will once more engage in the conflicts that tore it apart numerous times before, but on a greater scale. (Data from public sources coupled with Green Drake Advisors analysis.)

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A Brown New World, Its All Marginal, and The Blahs

Finally, we close with brief comments on A Brown New World, Its All Marginal, and The Blahs. First, China continues to add massive amounts of coal fired capacity for electric generation. This capacity will swamp more than 100% of all the coal capacity being closed elsewhere in the world. Despite the push for tighter environmental regulation and the actions around the world to limit CO2 emissions, it is A Brown New World. Second, US Shale Production growth appears to be slowing. After drilling the most prolific locations over the past decade, which drove US production to over 12 million barrels a day, the productivity of wells may have peaked in a number of geographic areas. This is leading to slower US production growth. For the oil and gas companies, Its All Marginal. And third, Bank loan growth for Commercial & Industrial Loans collapsed over the past year, dropping from 8% year over year growth in January to less than 1% in December. For the US Banks lending to corporations, we see them Feeling the Blahs.

In Closing

Should you have any questions on how the above issues or the items discussed in our accompanying cover letter impact your family's financial position or your business's future as well as the potential actions you could take in response, please do not hesitate to contact us. We welcome the opportunity to discuss this with you.

Yours Truly,

Paul L. Sloate Chief Executive Officer & Senior Advisor	Steve Rodia President & Senior Advisor

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