

February 2013

EXECUTIVE SUMMARY

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Market Update in The Age of Capital Allocation

Including dividends, the S&P 500 rallied 5.2 percent last month for its best January return since 1997. Given that the market has returned roughly 6% annually over the last century, that makes January a good *year*, let alone a good month. Key events included record corporate earnings and U.S. lawmakers forging a deal to avert the so-called fiscal cliff of automatic spending cuts and tax increases. (Ed: We recall one of Garrett Hardin's "Filters Against Folly" – "What are the words?" Hardin's warning was that words are as often used to obfuscate as to illuminate. The words "American Taxpayer Relief Act of 2012" suggest taxes were cut. Instead they were raised in multiple ways. We suppose the "Taxpayer Relief" was that we didn't go over the fiscal cliff.) The S&P 500 is now about 3 percent below its record of 1,565.15 set in October 2007, while the Dow is about 1 percent from its all-time high of 14,164.53.

Risks remain. Huge sovereign debt burdens still have no clear resolution in sight. We are still waiting for real work on the U.S. budget deficits. Many investors are steering clear of equities in a world of slow growth and deleveraging government balance sheets. Clearly there is substantial risk of some messy periods during the great debt unwinding in the years to come. Currency debasement is ongoing. Significant inflation could arise.

Meanwhile, the stock market has roughly doubled from its 2009 lows. A portion of this increase is due to massive economic stimulation from the world's Central Bankers. This "sugar high" is not sustainable. At the same time, however, the U.S. economy is improving in the areas of housing, autos, banking, energy, and manufacturing. Corporate balance sheets are loaded with cash from record profits, the banking industry is the best capitalized it's been in 50 years, and global companies continue to extend their brands. A recent World Bank report projects GDP growth for 2013 of 1.2% in developed countries and 5.5% in emerging markets. Just because growth is slow in our neighborhood does not mean that's the way it is

everywhere else. In addition, the return of an individual stock can be driven by many things other than the economy. Buybacks, spin-offs, mergers, special dividends and more can create value for shareholders regardless of the general market trend. The real key for investors in our minds is **capital allocation**. In a world flush with liquidity, how excess capital gets allocated will be a major determinant in investor returns. Though stocks are less cheap with the recent rally, for the patient and value-oriented, there remains plenty of opportunity.

The U.S. Manufacturing Rebound

One way for corporations to allocate excess cash is to reinvest in the business. For some U.S. manufacturers, that is becoming a more compelling option. In our last issue, we mentioned how lower energy costs were driving a major pick up in industrial America and how surprised we were more had not been reported on it. Shocked, actually, considering that this is a major, game-changing event and, at the same time, with all the hand-wringing going on by politicians over the economy, one would think they'd be quick to grasp at any positives. How could they not know? At the end of January, *Barron's* came out with a cover story on this event entitled "*Made in America...The Next Boom*". The business press is finally beginning to notice.

The article had a number of juicy stats:

- The United States once made nearly 40% of the planet's goods. These days, that number has shrunk to 18%.
- That trend is reversing thanks to cheap energy. Natural gas in the U.S. costs \$3.55 per BTU (British Thermal Unit) versus \$12 in Europe and \$16 in Japan.
- North America now produces far more natural gas than any other continent.
- Over the past six years, U.S. production of petroleum and natural gas has jumped from 15 million barrels of oil-equivalent a day to 20.1 million, a 20-year high. Over the same period, imports have fallen from 14 million barrels a day to below eight million, a 25-year low.
- Graduates from the South Dakota School of Mines & Technology now command a starting

salary 16% higher than that of Yalies. (ed: This data does not apply to Harvard grads.)

- China's wage advantage is diminishing with wages and benefits rising 15% to 20% a year, while they're stagnant here.
- Industrial land is increasingly expensive in China, averaging \$21 a square foot in Shenzhen compared to \$1.30 to \$4.65 in Tennessee and North Carolina.
- U.S. ports are ready for increased exports, operating at just 54% of capacity.
- Dow Chemical is investing \$4 billion to boost production and build an ethylene plant in Texas that could hire 2000 workers.
- Foreign companies are investing here. Samsung plans a \$4 billion semiconductor plant in Texas. Airbus SAS is building a factory in Alabama.
- BCG conservatively estimates that 2.5 million to 5 million manufacturing positions will be added in the U.S. by 2020.

Again, we have been surprised not more has been made of these very positive developments. Apparently even economists were not aware of these tailwinds. Here are three recent economic reports that reflect these positive shifts. We've italicized the parts that show economists were not expecting improvements of this degree.

*Bloomberg 2.1.13 - Manufacturing in the U.S. expanded *more than forecast* in January, reaching a nine-month high and showing the industry is starting to improve.

*The Institute for Supply Management's manufacturing index climbed to 53.1 last month from December's 50.2, the Tempe, Arizona-based group's report showed today. Readings above 50 signal expansion. *The figure exceeded the highest estimate in a Bloomberg survey of 86 economists.* The median forecast was 50.7.

*Bloomberg just reported that the U.S. trade deficit narrowed more than forecast in December, led by record exports of petroleum that gave the world's largest economy a boost at the end of 2012. The gap shrank 20.7 percent to \$38.5 billion, *lower than any estimate in a Bloomberg survey of 73 economists* and the least since January 2010, Commerce Department figures showed.

This is not a flash in the pan. Cheap energy, competitive wages, and low land costs have combined to create a long term "on-shoring" trend for America, reversing years of "off-shoring". And that is good news for the U.S. economy.

Mutual Fund Allocations

One of the areas we have tracked for many years is mutual fund flows. In general, when fund investors are piling into a particular industry, then it may be about time to get out. This was overwhelmingly the case during the Internet Bubble with tech stocks. Likewise, when fund

investors are exiting a certain industry in droves, that may be a fruitful place to search for bargains. Since 2008, fund investors have been shunning *the entire U.S. stock market.*

To update briefly, from January 2008 to year-end 2012, about one trillion dollars went into bonds funds while nearly half a trillion dollars came out of U.S. equity funds, an amazing migration both for its scale and duration. Remarkably, despite this massive selling, the U.S. stock market has doubled since the 2009 lows. All else being equal, in this one respect, all that would be required to accelerate this market rally would be for *mutual fund investors to stop selling equity funds.* Interesting thought, yes?

Lipper reported that for the month of January equity mutual funds had *net inflows of \$20.7 billion*, the most since in any month April of 2000. That still trailed taxable bond funds which took in \$31 billion. It's way too early to say that this marks a reversal in the five-year migration by mutual investors from equities to bonds. However, if fund investors actually began investing into equity funds in earnest, that could have a remarkable impact on stock market returns.

Shortage of Shares

John Templeton introduced us to the idea of a "shortage of shares" as a bullish market indicator more than two decades ago. He predicted in 1990 that the early 1990's would feature a strong market rally as a result of shrinking share counts and a return of discouraged investors to the stock market. Was he ever right. Last January, we saw the makings of another shortage of shares scenario lining up. The IPO market was weak, limiting the issuance of new shares. Corporate buybacks were up, increasing the elimination of shares. By September we had confirmation that net share counts were indeed declining to the tune of \$275 billion.

What's next? If anything, the shrinkage of shares may be *accelerating*. Large buybacks appear to be continuing apace. (e.g. UPS just raised its share repurchase authorization from \$1.5 billion to \$4 billion). And we may have an additional accelerant if buy-out activity picks up. Indeed, it is entirely possible that a mergers and acquisition boom could be in the offing.

M&A Boom?

Mergers and acquisitions (M&A) are another area of asset allocation. While we most prefer companies that can grow organically, many companies will seek to grow by buying other companies and assets as well. The danger here is that animal spirits can run away with common sense, especially as the merger game heats up. For now, with ultra-low interest rates and corporate coffers flush with cash, the potential for a bull market in deals appears

substantial. And there are signs that such a surge may be underway.

For example, on Feb. 14 (Valentine's Day – how sweet), Berkshire Hathaway and 3G Capital Management, a Brazilian private equity firm, offered to pay \$23.3 billion to acquire Heinz. Buffett noted that “This is my kind of deal and my kind of partner. Heinz is our kind of company with fantastic brands. I have a file on Heinz that goes back to 1980.” With the successful completion of the Berkshire/3G Capital acquisition, Heinz's 323 million shares with a market value of \$23.3 billion will soon disappear from trading.

We see many more deals coming. In a slow growth world where most American corporations have worked hard to refine their operations - cutting costs, paying down or refinancing debt, getting more efficient – the improvement in margins has largely run its course. For many companies, to get additional earnings growth is going to require going down the acquisitions trail.

Russell Glass of RDG Capital Management, in an interview in the *Graham & Doddsville* investment newsletter from the Columbia Business School, also sees a M&A boom in the offing. He notes that some \$150 billion of private equity investment was raised in '07-'08. That money must be returned to investors if it hasn't been invested within five years. The clock is ticking and the time is nearly up. All totaled he estimates there is \$300 billion to be invested by private equity that could handle another \$750 billion of debt at today's low rates, summing to about \$1 trillion of buying power. Add in the \$1.7 trillion in cash sitting on non-financial corporate balance sheets and you have close to \$3 trillion of buying power. He cites an Ernst & Young survey that notes 36% of U.S. corporations intend to engage in M&A within the next year or so. With companies in the 7th or 8th inning of cost cutting efforts, the shift to acquiring growth by buying businesses may soon be underway.

The Age of Capital (Mis)Allocation

“Don't confuse trying to do well with doing well.”
– anonymous

This was one of Dick Pecaut's favorite aphorisms and Corey quotes it often as well. Despite good intentions, many allocations turn out poorly or even counter-productively. Corey and I agree that some of the most egregious areas of poor allocation occur under the banner of “economic development” by cities, states, and federal authorities. Sometimes it's so bad it's hard to believe.

For example, a recent *Wall Street Journal* article reported that Oklahoma's Small Business Capital Formation incentive Act provides a 20% tax credit for investments in Oklahoma small businesses. In 2009, the Oklahoma Tax Commission reported that **the program cost the state**

\$17 million but generated only 21 new jobs. That's \$809,000 per job. Yikes. One might prefer a bridge to nowhere for that kind of money.

Another article reported that the University of Minnesota has hired a third more staff over the last decade while the student population increased just 10%. It amounted to 1 staff for every 3.5 additional students. Most of the hires were administrators. One of them is a “parking director” earning \$170,000 a year for a building complex that will not be completed for another 10 years.

We have seen dozens and dozens of such boondoggles over the years. The waste is jaw-dropping. Our guess is that we can do MUCH better in the allocation of capital at the government level. And we'll have to as budgets fall under evermore pressure.

Just One More....

We don't know if this will make you feel any better, but even these disasters pale in comparison to the travails of football quarterback Vince Young. He received \$26 million in guaranteed money when he signed with the Tennessee Titans in 2006. Now he's out of money.

This might set a new mark for poor allocation. Young even borrowed \$1.9 million at 20 percent interest in May 2011 to cover expenses during a lock-out. Part of the loan went for a \$300,000 birthday party he held for himself. Hope he really enjoyed the party.....

North Dakota – The New Alaska

Just wanted you to know: since 2007, North Dakota's oil production has *nearly quintupled from 150,000 to 728,000 barrels per day*. That is absolutely astounding to us. North Dakota has now passed both California and Alaska to become the second-leading oil producer in the U.S., trailing only Texas. Hydraulic fracturing and horizontal drilling techniques have allowed energy companies to tap into shale formations and release pockets of oil and natural gas that had been considered unreachable. Entrepreneurs have wasted no time in acting on the opportunity in the Bakken Shale play in North Dakota.

Ethanol – Dumber Than Ever

At a time of economic slowdown and world unrest, one might think keeping food prices low and food abundant would be of the highest priority. Not for America. Corn prices have doubled over the last couple years, partly due to a drought in the U.S. that produced the smallest corn crop in six years. A bigger part is that 42% of the 2012 crop, 4.5 billion bushels, went to make ethanol.

Under the 2007 energy law that established national renewable-fuels requirements, the EPA can suspend the program if it would severely harm the economy of a state,

Pecaut and Company

region or the U.S. That has not happened as yet. The legislation calls for the U.S. to use 15 billion gallons of biofuels, such as ethanol, annually by 2015 and 36 billion gallons by 2022. Half of that amount will have to come from “next generation” or cellulosic sources such as grasses and wood waste, and not from corn.

In a *Barron's*, Dec. 3 article, Ross Margolies of Stelliam Investment Management notes that Celanese has developed a process that can make ethanol from natural gas and coal. The cost is substantially below the cost of making ethanol from corn. Its first commercial plant will open *in China* in the third quarter of next year. Given the huge requirements of ethanol in the U.S., it's ironic that a U.S. company is opening its first ethanol plant in China. Why? U.S. policy mandates that ethanol be made from corn.

Needed – New Policy Structure

This, in a nutshell, is the beauty and burden of progress in the New Global Economy. In North Dakota, entrepreneurs using responsible drilling techniques quintupled production in just five years. This is the tremendous upside of economies where citizens are free

to do what makes sense. The system can adapt to change rapidly. This is particularly accelerated in the world of the Internet, creating worldwide disruption and new possibilities daily.

Meanwhile, command and control policies, however well intended, simply cannot take in all the variables of a dynamic world nor manage the unintended consequences of each decree. Once issued, there is then the problem of review and mid-course corrections. In ethanol we've had all of this. A well-intended though nonsensical policy for renewable fuels has contributed to a worldwide food crisis. Meanwhile a U.S. company with proven R&D for cheaper ethanol is opening its first plant in China (when many other companies are opening plants *in the U.S.* with our low gas prices.). You can't make this stuff up.

Our general sense is that the old political, regulatory, and policy structures evolved for a bygone age. They have been bypassed by technology and globalization and are 20 years behind the curve. And the curve is accelerating.

Dan Pecaut Corey Wrenn