OWNERSHIPCAPITAL
Long-Horizon Investing

The Ownership Capital Q3 2019 Letter

After a remarkably quiet and sanguine second quarter, the third quarter certainly opened with a thud. The markets were awash with fear again, this time wondering just how much further interest rates in the US were going to collapse in a signal of impending doom. A September rebound was swiftly followed by an October that opened with, yet again, more fearmongering, increasingly backed up with real data.

Our early and regular readers might recall that over the past six years, we've at times provoked scorn by appearing to be overly optimistic in the face of the many temporal crises that we experienced, whether it was Brexit, China or Trump's election in 2016. We speak of "scorn" because any commentator knows that it sounds psychologically more intelligent to prophesy doom, backed up by arcane statistics, than to speak plainly and suggest that things are better than feared. And indeed, over the past five years, our working global economic model premised that global economic growth would be generally fine; a strong US being sufficient to offset a stagnant Europe. With all global economic regions benefitting from relentless technological progress, low interest rates to accommodate investment, and - sadly still the keystone of our economy – low energy costs. When we penned our investor letter in January of this year, we noted how the massive rates and oil price "reset" of Q4 2018 might help reload the gun of economic momentum, and so it appeared for most of 2019, as the global economy continued to defy the doom and grow (even if not at impressive rates).

Alas, the artificial stimulus of low interest rates and oil prices can only go so far. We call them artificial because rates and oil are not productivity-enhancing drivers of growth like technology, they merely lower the cost of capital and production. Lower interest rates accommodate greater capital and housing investment, while low oil prices are a lubricant of economic activity. However, at current levels, oil is no cheaper than a few years ago, thus limiting its stimulative value. And while interest rates have hit new record lows, this too may have only a temporal boosting effect on growth given the overall low rate environment we've already experienced in recent years. This means that the baton of growth passes almost entirely into the hands of technology and trade, as drivers of true organic productivity-driven economic growth. Yet it is exactly in the areas of technology and trade where the greatest stagnation and risk is occurring.

Scaremongering politicians wielding blunt trade tools incentivize executives to invest in their own stock and cost-cutting, rather than in long-term technology R&D and the efficiencies of global supply chains. Indeed, with a seemingly unending list of countries that could get thrown outside the US trade net, why would western multinationals dare invest anything outside of the Developed Markets at the moment? While global investors pour more and more capital into what increasingly appears to the only remaining bastion of safety, the US dollar and its capital markets, there is little corollary investment outflow by US corporations and lenders back into the Emerging Markets, thus limiting access to capital for emerging economies. The dramatic stock market meltdown in Argentina during August is just one symptom of the chokehold that US capital-markets-centricity has placed on the Emerging Markets, particularly those without large domestic savings pools. Europe, with larger

pools of its own domestic savings, has been hurt less by this effect, but its anti-startup bureaucracy shackles young talent to a career in the elite hegemonistic industrial champions of the past, rather than releasing them to build a technologically-oriented modern economy.

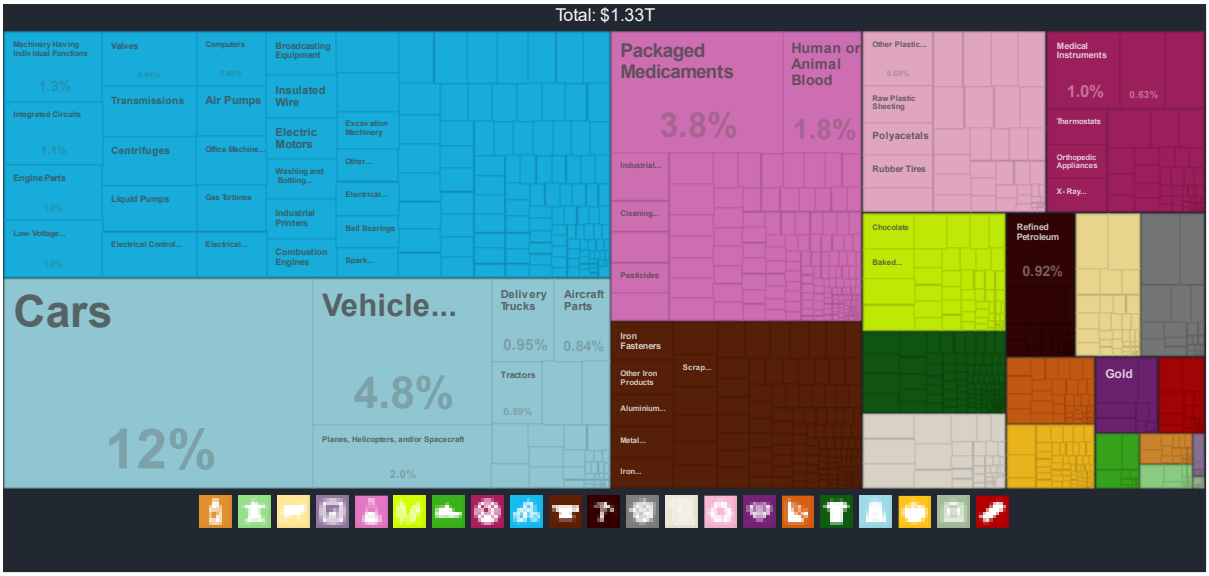
To step back from all the detail, we need to look at some of these symptomatic events in the larger context of the Wealth of Nations, if you will, and this investor letter will explore the theme of true value creation in an economic context, and how we see this impacting the wider investable world, our investment strategy and the long-term investment opportunities for our Ownership Capital portfolio.

The state of Europe: structural decline accelerates

Let us start with Europe and its laudable focus on sustainability. When European politicians lay down vital climate-change fighting edicts - without considering the painful reality that only a handful of European companies have the capability to supply the world with sustainable technology - they are not only choking off their domestic fossil fuel-dependent automotive and power industries, they are locking Europe into a massive capital transfer to those countries outside of the EU (notably China and the US) whose companies are actually capable of providing the technologies required to achieve Europe's sustainability goals. This might be a win for sustainability, but it puts a chokehold on some of Europe's biggest legacy industries. And for all the fanfare around EVs, Europe's automakers are not in a great position. Mercedes' recently launched "flagship" EV, the EQC, has a battery pack of only 80KW, when more than five years ago, Tesla's model S already had an 80KW battery. Audi's e-tron SUV debuted early this year with a 95KW battery– yet even this is below the 100KW battery that Tesla launched… in 2016! Keeping in mind that batteries should not be charged above 80% on a regular basis, and ideally should not go below 20% if you want a quick recharging speed and residual driving range in case of emergency, then the actual workable range of a 100KW battery is really only about 60KW – good for maybe 250-275KM of autobahn driving, but not exactly workable for the average Northern European whose holiday consists of a 1000+KM drive down to the Alps in winter or Southern Europe in the summer. Given the technological inferiority of Europe's EVs so far, it's awfully hard to see how the European auto sector can make the massive leap required from where they are today to catch up with Tesla's technology lead.

But let us, as in a fairytale, imagine that European auto manufacturers - with their theoretically better economies of scale and build quality - will finally have affordable, genuinely long-range 150KW batteries available in four or five years (don't underestimate the time it takes to scale these things): what happens in the meantime? Well, in Europe – where a steady drumbeat of anti-fossil fuel sentiment seems to lead to new driving restrictions and edicts by the day (Amsterdam just announced a blanket 2030 ban on fossil fuel powered cars) – it means people are increasingly delaying their car purchases and driving their old cars longer. This is leading to a huge air pocket in current demand that could well extend for several years, thus exacerbating the current broader European structural stagnation by pushing current auto demand into the future. When combined with the implosion of Chinese automotive demand, this is particularly painful for Europe, keeping in mind that Germany - the engine of Europe - is only the fourth largest economy in the world, but it is the second largest exporter. You read that correctly: Germany, whose GDP is less than 20% the size of the United States', nonetheless exports more to the rest of the world ($1.33 trillion) than the US does ($1.25 trillion). The only potential bright spot in this delay of automotive consumption is that part of Germany's (and thus Europe's) malaise is potentially temporal and that money not spent on new-model autos could, in the meantime, flow elsewhere within the European economy.

Taking apart Europe's pain further, the below image of Germany's exports from the Observatory of Economic Complexity illustrates just how dependent Europe is on global cyclical growth and trade, with fully half of Germany's exports dependent on discretionary, capital equipment expenditures in the form of automobiles and industrial equipment and machinery – below shown in blue. In a fearful world, where these are exactly the sorts of discretionary expenditures that people and firms can delay, it is no wonder that Europe is getting hit just as hard as China, the intended victim of Trump's trade tariffs.



Source: Observatory of Economic Complexity

EVs are but a single component of one large European industry where Europe faces unprecedented challenges to its historical leadership. On a broader scale, the commoditization of manufacturing is impacting most European manufactured goods, while the global technology winners that are seeing increased pricing power and developing oligopoly or even monopoly positions are not European. All this points to European economies caught in a deep structural funk, lacking the future technology leadership required to re-ascend the economic value-creation pyramid, while its existing industries become increasingly commoditized. While, in theory, a new generation of European millennials plot their own takeover of the world with a plethora of technology start-ups, in practice it's hard to see many of them winning in head-to-head matchups with technology companies in US and Asia that possess deeper pools of startup capital and knowledge, market homogeneity, and greater risk appetites.

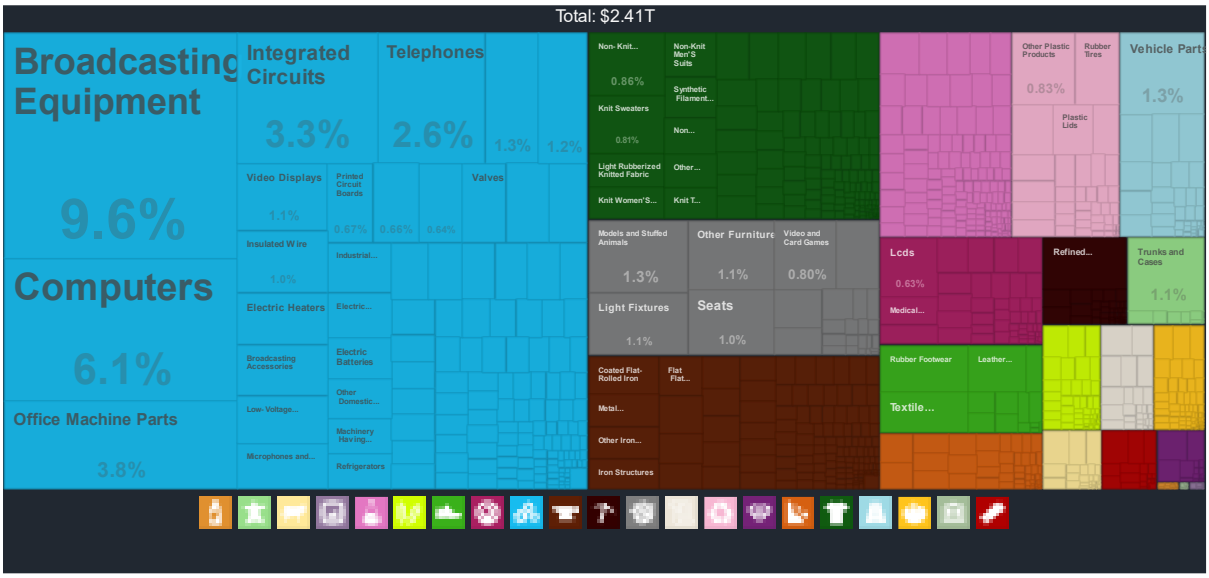
As European residents and inherent optimists, we naturally hope that the picture is not so bleak. Yet, objectively, we cannot underestimate the magnitude of the challenge ahead for Europe. The biggest barrier to change is that much of Europe's populace believes it has become morally entitled to earlier levels of prosperity. A Europe in thrall to populists peddling a theory of justice and economic fairness based on yesterday's world of manufacturing prosperity cannot hope to succeed. Not when they are competing against a Chinese populace that outworks them in hours and is willing to work for much less. This is true for American companies too, of course; however, manufacturing is a smaller part of US economic activity and thus the impact is lessened. The brilliant new Netflix documentary, American Factory, is a must-see in this regard, illustrating the yawning gap between mesmerized Chinese workers who live to work, and American workers, who appear to do so more reluctantly. Unless we see a great cultural awakening to the reality that prosperity and progress

must be earned through hard work and risk-taking innovation, we fear that what awaits Europe is decades of Japanese-style stagnation and reduced relevance on the global stage.

Why the China trade war is just beginning

While Europe is in a struggle for survival (masked in severity due to the unprecedented monetary stimulus of recent years), markets have been far more focused on China and the hope that a trade deal can be struck with the US. However, this hope clearly shows that markets continue to not only underestimate but fundamentally misunderstand the true purpose of the US trade war: to shackle and permanently blunt China's threat to the US. China understands this reality full well, which is why they've been unwilling to play ball and bow to the US. However, many people still wonder how a manufacturer of cheap plastic toys and trainers can possibly represent a threat to the US.

In fact, China's rise has been so rapid that Western perceptions of it have badly lagged the reality on the ground. Today, China is much more than a cheap manufacturer and workhouse. When taking apart trade statistics, it becomes clearer why Donald Trump chose to take aim at China, rather than, say, Germany. Firstly, China is the world's biggest exporter, exporting a stunning $2.4 trillion a year, almost as much as the US and Germany combined. Secondly, as already mentioned, where fully half of Germany's exports are automotive and industrial equipment and machinery, half of China's exports are, in fact, technology products, as illustrated by the blue shaded area in the pictorial below.

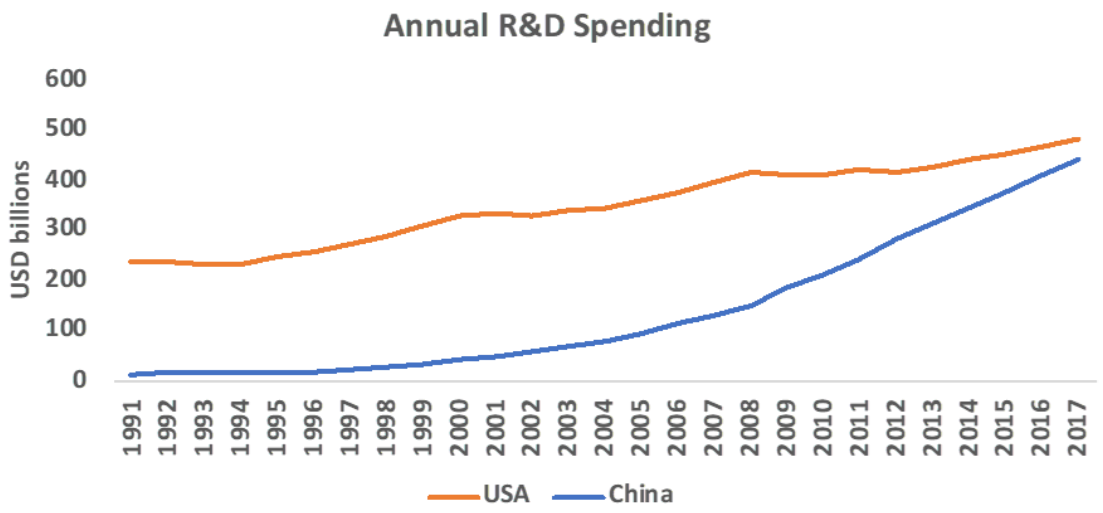


Source: Observatory of Economic Complexity

This is an important distinction, because technology today represents the very top of the economic value creation pyramid. Where once it was engineered manufactured products that stood at the peak of the economic value chain – hence the US economic battles over cars with Japan and Europe in the 1980s - today it is technology products that have the highest economic value multiplier effect. A single piece of control software can run thousands or even millions of machines that in prior decades would have still been manually controlled. And thus, in the same way Japan became a manufacturing powerhouse by starting with low-level assembly and then went on to dominate the very technologies of the industries they were serving, so too the US worries that China will climb up the value chain to dominate the technologies of the future, and thus reverse the technology-driven vassal-state relationship the US has had with the rest of the world in recent decades. Simplistically put, a Superpower cannot stay "Super" for very long, if the very chips it puts into its missiles, the

networks across which it communicates, and the software that power its drone armies, are built by its adversaries.

The demotion of manufacturing to second place within the economic value pyramid, below that of technology, goes a long way to illustrating America's unlikely rise over the past two decades, versus the stagnation of Japan and Europe. We say "unlikely", because as recently as the 1980s, Japan and Europe were in the ascendancy and America's story was one of woe and decline as it was pushed out of the manufacturing prowess it once enjoyed. Yet in pivoting to technology – and outsourcing decreasing value-added manufacturing to the rest of the world - America has outrun its former rivals by a tremendous distance, as witnessed by its continued outsized economic growth. Yet, in outsourcing the manufacturing of technology products to China, America inadvertently established a rival of greater proportion, and greater historical motivation, than any the US has faced off with before. The simple fact that China will likely become the world leader in R&D within just a few years indicates that, from a technological point of view, China is here to stay. Indeed, given that a dollar spent in China goes a lot further than one spent in the US, China is arguably already spending more on R&D than the US or any other country in the world.



Source: OECD

This is not merely a theoretical threat. The rise of Huawei, which has (by some estimates) a technology lead of more than two years over its most advanced Western rivals, is the very illustration of the clear and present danger that China already presents to US (and by extension, European) dominance. The ability for Chinese hackers to enter Western networks seemingly at will, provides further evidence that China is not merely in the ascendancy – it has already ascended - and wants to keep on rising. This reality makes blatantly clear that the trade war with China is not a passing ship in the night. And while Trump repeatedly dangles theoretical deals to calm markets (and may choose to acquiesce soon, in advance of the 2020 election), he equally knows that he's on to a winning issue, as China's rise has engendered deep fear within America's populace. While some may hope that a Trump defeat in 2020 will return the world to the peace of yesteryear, the likelihood is greater that if Democrats win, they too will try to keep the squeeze on China. This means that, in all likelihood, the trade war and populism are here to stay, with all of the investment-depressing impacts thereof.

Oil and interest rates to the rescue?

If the technology supercycle that has powered so much US economic growth this decade risks slowing down or stopping altogether, due to global trade uncertainty, then the question remains whether the other major pillars of the prosperity of the last decade – low interest rates and low energy prices – will be sufficient to maintain global growth, albeit at a lower, mediocre rate.

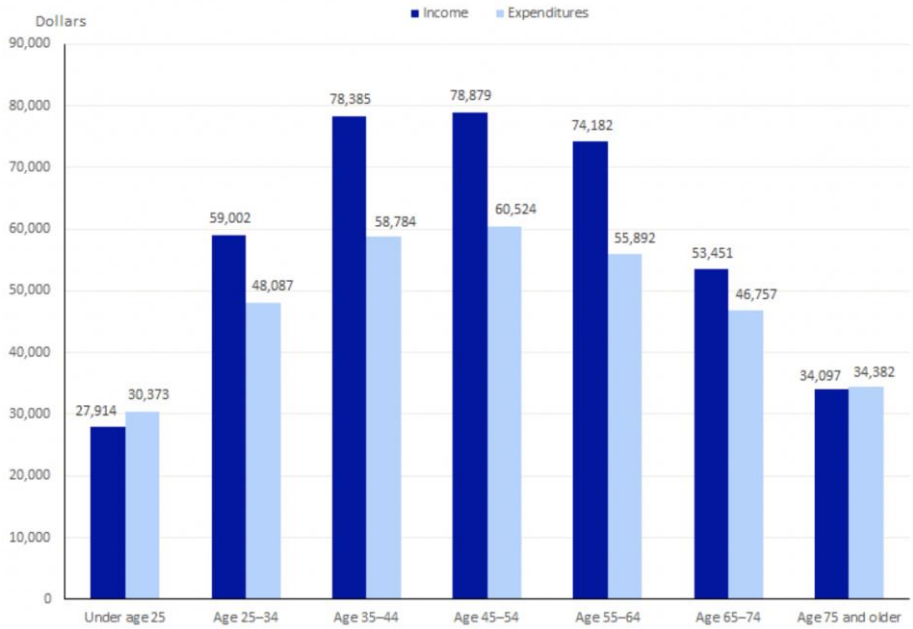
With regards to energy, as we mentioned earlier, a large part of the consumption dividend of permanently-lowered oil prices has already filtered into global economic activity. We have in prior letters discussed in some detail our theory that energy prices are effectively capped, due to the vast reserves of shale oil within the US. For example, even at today's subdued prices, shale production in the US is forecast to grow by well over 1 million barrels per day, or 16%, in 2019. With oil demand in 2019 expected to increase by only 1.1 million barrels per day according to the IEA, that means all other oil producers would have to keep 2019 output stagnant to prevent a surplus. In other words, the US is now single-handedly able to accommodate incremental energy demand globally. Of course, other producers might want some of the action too, thus setting up a multi-year struggle for supremacy, which should continue to contain prices, or push them lower if producer discipline slips, as it often does.

While a substantial drop in oil prices is not without question given excess supplies and the current global economic uncertainty (and could serve to soften the blow of faltering economic activity), it's hard to see - given breakeven prices of incremental oil sources - how oil could permanently remain at the sort of sub-$40 level required to really have a meaningful and continuous stimulative impact on disposable income and corporate profit margins. It appears, therefore, that barring temporal energy price pullbacks, and thus temporal stimulative effects, energy prices will play a decreasing accommodative and stimulative role in promoting economic growth compared to the last five years. In essence: don't count on cheaper energy to bail out the global economic growth challenges this time around.

Which brings us to our final pillar of growth: interest rates. It is the current state of interest rates that causes us the most concern. In a world dependent on capital, there is no single greater stimulant or dampener of consumption and investment than interest rates. We have often spoken about the benefits of low interest rates (which enables cheap capital that encourages investment and consumption), but our current (unproven) working theory suggests that we may be reaching the end of the line in terms of genuine, real-economy impacts of such cuts.

Firstly, the Developed World which still controls the majority of economic activity and investment capital, is in the grip of a major aging wave. Fully one-third of people aged 65 or over live in the Developed World.[1] While older people are able to make their accumulated savings available to society in exchange for a return, their active working economic contribution has largely ended by the time they reach 65. Furthermore, with the age of child-rearing and home buying behind them, their participation within the economy is one of decreasing expenditure and increasing accumulation of assets, rather than recycling the majority of their available income into the economy through consumption.

[1] Source: US Census Bureau



Source: US Bureau of Labor Statistics

This aging trend has been a large driver, beyond the impact of QE, for the vast accumulation of excess investment capital that has enabled the depression of interest rates.

Economists work with historical models of behavior, thus when modelling the assumed economic impact of future interest rate cuts, they look to past cycles of activity to assist them in making their predictions. Unfortunately, given a fundamentally different demographic backdrop, economies and its denizens are likely to respond differently to rate cuts today than in the past. In fact, while rate cuts will still stimulate house buying within the younger generation, and create a wealth effect due to the psychological impact of subsequent rising asset prices, the older person - having already lived their midlife crisis - is unlikely to run out and buy a fancy new car when interest rates are cut; and certainly not one that will be obsolete soon, as per our earlier narrative on EVs. Nor will they buy the big McMansion – they are probably already living in one, and, if anything, they will be inclined to downscale to a condo without all the maintenance hassles and accompanying tax bills.

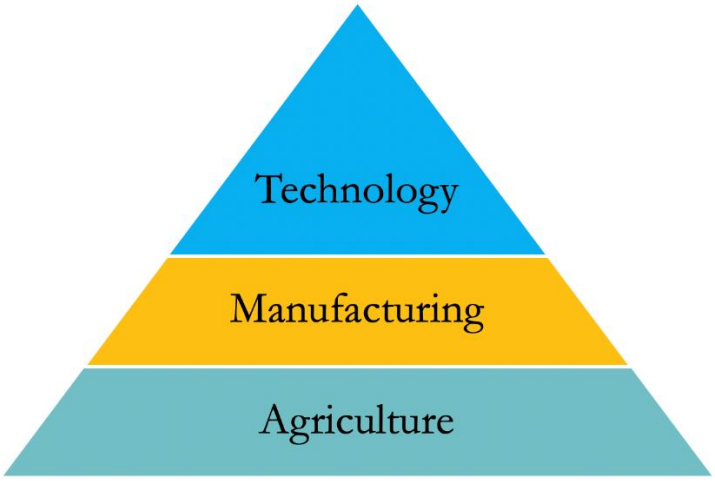
Indeed, the older person today faces a far more anxious retirement than his or her counterpart of yesteryear. Once upon a time, retirees would duly shift their assets from equities to bonds upon retirement and live their golden years in some relative certainty about the scale of their annual income. Alas, that golden time is gone and instead, negative interest rates make holding capital deposits of any kind a guaranteed money-losing exercise in many countries. As such, the retiree today often must maintain elevated allocations to the stock market, and thus face the fears of its daily volatility. Little wonder perhaps that even the smallest, short-term movements in stock markets have become fodder for mainstream media – whereas not so long ago, such market updates were the purview of specialist newspapers and obscure financial TV shows.

The corollary of lower interest rates, therefore, is a wrenching lack of income for those many millions of older folks depending on investment income to fund their retirement and consumption. While the wealth effect of rising asset prices has moderated the pain of reduced income-production from invested assets in recent years, there is nonetheless a frightening psychology at play for millions of retirees - that they can only live on their assets if they remain invested in high-risk categories such as equities and real estate. The effect of this added stress, is that these high net-worth (in asset-value relative to the rest of society), but income-poor retirees, thus start to spend

less in the real economy, piling up hordes of further financial assets in the capital markets where they float on top of already over-valued "safer" areas of the large cap fund universe. In sum, interest rate cuts – with yet still some runway to go lower and thus (with some lag) boost asset prices further – might be coming close to reaching the end of the line in terms of being able to encourage more consumption and sustainably boost the real economy. In fact, the psychologically damaging effect on confidence of lower rates, could have the opposite effect. In essence, don't count on the stimulative effect of interest rates to keep the world economy growing.

The consequences of global stagnation

If this working theory is correct, then we stand at the threshold of a dangerous potential "pause" or "decline" in economic progress within the world at large. While we do not put much stock in predictions, or timing thereof, we would be remiss in not pointing out to our investors the possibility that the current economic and political backdrop could have a multi-year depressing impact on economic growth. If there is good news, it is that investors do not need to be sitting ducks in this potential "new normal" of stagnation. This is because even when "total" economic growth stagnates, such growth statistics can misleadingly suggest that all sectors are in a funk, but in actual fact there has always been a continuous battle over the centuries between the different layers of the value creation pyramid, with shifts therein not reflected in the aggregate total picture. So, if we simplistically look at the value creation pyramid below, the upper tiers are constantly climbing up the value chain, but in a static total pie, they "take" that value from the more commoditized lower tiers:



For a good example of what that shift might mean, let's look back in history to the 1800s. Before the Industrial Revolution, the primary mode of value creation was through agriculture, and it was only through substantial innovation in cultivation practices that the masses were freed from the land to begin work in the factories. Thus, an agricultural revolution essentially pre-dated the advent of the manufacturing revolution. This led to a wholesale reshuffling of the developed economies, with millions moving off the land and into cities and factories.

If we think the Global Financial Crisis of 2008/9 was hard, or if we look back and consider the "Great" Depression of 1930-1939 as being lengthy, these pale in comparison to an even longer economic downturn, known as the "Long Depression", which lasted from the Panic of 1873 to 1896. Little solid data exists from this time period, but some interesting datapoints from Eric Hobsbawm and Eric Foner indicate that despite this prolonged downturn and period of unemployment, certain sectors continued to grow. For example, while the price of grain in 1894 was astonishingly only one-third of

the level of 1867 a full 27 years earlier, and the price of Cotton dropped 50% between 1872 and 1877, manufactured goods such as steel for railroads saw a 20-fold increase in production between 1870 and 1890. In other words, in a time when farmers were fighting for their lives and needing to invest heavily in technology to stay ahead of the drastic decline in the price of their products, much of that money went into infrastructure and implements, and the makers thereof generated excellent returns at a time that the total pie wasn't doing very well. This historical data vividly illustrates the potential for pyramid-topping sectors and companies to grow at the expense of commoditized sectors, even against a backdrop of overall stagnation or even decline. This illustrates why at Ownership Capital, we focus on those top of the pyramid companies, that can increase their economic relevance over time, rather than being dependent on economic cyclicality for growth.

Translating our worries about the state of the world ahead, how might this affect different regions of the world? The US, as the unchallenged economic and technological power of the world, appears likely to want to continue to choke off Chinese attempts to achieve its own economic and technological independence. This means trade barriers – with their dampening effect on investment and R&D spending – are here to stay (notwithstanding temporal truces along the way). This will also slow America's own technological advancement and economic growth - dependent as they already are on external partners for key components of their technological fabric. Yet the hegemony of the US dollar, combined with world-leading technological development, increasing self-sufficiency in base minerals and energy, and a large homogenous market, means the US and its homegrown companies actually appear to be best positioned and insulated from these negative potential global trade and demographic forces.

Europe and Japan, meanwhile, enthralled as they appear to be to the increasingly commoditized manufacturing world of yesteryear, appear doomed to remain in glacial but unstoppable decline until their politicians wake up to reality. Meanwhile, China - though facing its own demographic challenges - has a call with destiny to reclaim its role as one of the leading nations of this world, and we would not bet against their eventual success. If anything, this trade battle sharpens their resolve and almost assures that China emerges in five or ten years with such great technological progress and independence that the US may be forced to the bargaining table. China, Trump forgets, is already too technologically advanced, and with too big a pool of captive domestic capital, to be brought to its knees like a recalcitrant banana republic. China can outlast trade pressure, and its resolve has only been doubled by this confrontation. However, until the US is forced to strike a bargain, China, and Asia by extension, will likely struggle during the transition of coming years. Given these struggles ahead, we will be watching China very closely for any signs to greater openness and democracy which would be the necessary prequel for inclusion in our long-term sustainable global equity portfolio. We are not there today, but we would not bet against them, over the longer term.

Looking ahead

Where does this leave the long-term investor? What does it mean for the Ownership Capital portfolio? A decade of lost growth and global stagnation? Thankfully, we have a healthy degree of skepticism about predictions, including our own, and while it seems incontrovertible that the risks of global stagnation and even the decline of entire Developed regions have grown, we don't believe in pivoting portfolios to any set of "expected" macro circumstances, knowing full well how unpredictable the world is. Even if the world stagnates, liquidity flows into equity markets could support market valuations for many more years, as investors flock to the only game in town with potential for investment yield. Thus, beware the prognosticator with well-founded arguments for a future that can never be predicted with precision.