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Is 21% Sustainable?

Why the Low U.S. Corporate Tax Rate is Vulnerable

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U.S. equity markets have defied escalating tensions around global trade which have crimped returns in most of the rest of the world. Investors have shrugged off the news about tariffs and instead, focused on this year's solid corporate profit growth, extending the U.S. bull market run to over nine years. The two principal factors driving earnings have been: 1) a robust U.S. economy and 2) the lowest corporate tax rates since 1939. In this issue of *Global Foresight*, we take a close look at just how sustainable the current 21% U.S. corporate tax rate is. The first clues on its vulnerability may be drawn from the results of the contentious midterm U.S. elections, which could be viewed as a referendum on the current administration's economic policies and portend a big shift in ideology in next year's Congress.

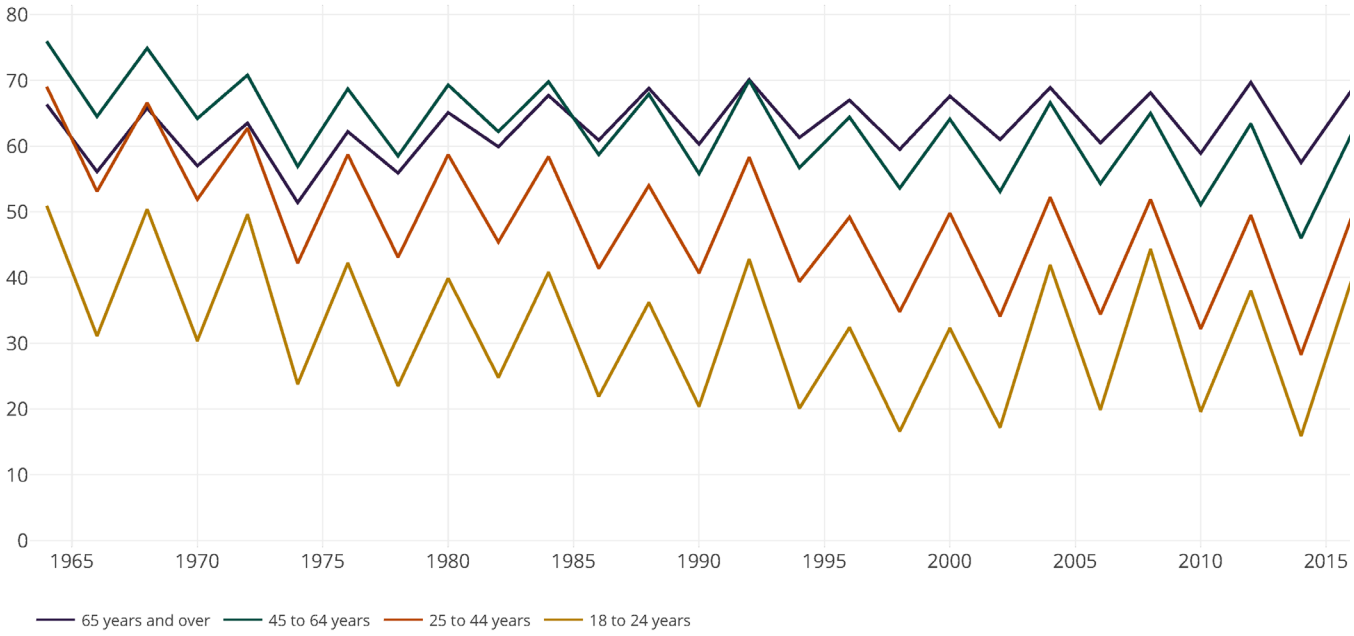
Fractured citizenry also seems to be the norm outside the U.S., with politicians from the right and the left gaining traction across Europe and Latin America. While the world becomes ever more divided, U.S. consumers keep on spending, with a strong jobs market supporting record high levels of confidence. In this issue of *Global Foresight*, Jimmy Chang reviews the rise of populism around the globe, Brian McNamara examines the resurgent U.S. consumer, while Mariela Vargova discusses some of the key issues in the U.S. midterm elections.

Introduction

In 1789, Congress debated an Amendment to the U.S. Constitution, limiting its authority to grant itself pay raises. It took an astounding 203 years before the 27th Amendment was finally ratified, the last change to the U.S. Constitution. With a shrinking political center in the U.S., perhaps it should be comforting that changes to the Constitution are so difficult to enact. In terms of lasting impact, the 26th Amendment was far more notable and may play a key role in the upcoming U.S. elections. This Amendment was ratified in 1971 and lowered the U.S. voting age to 18 years.

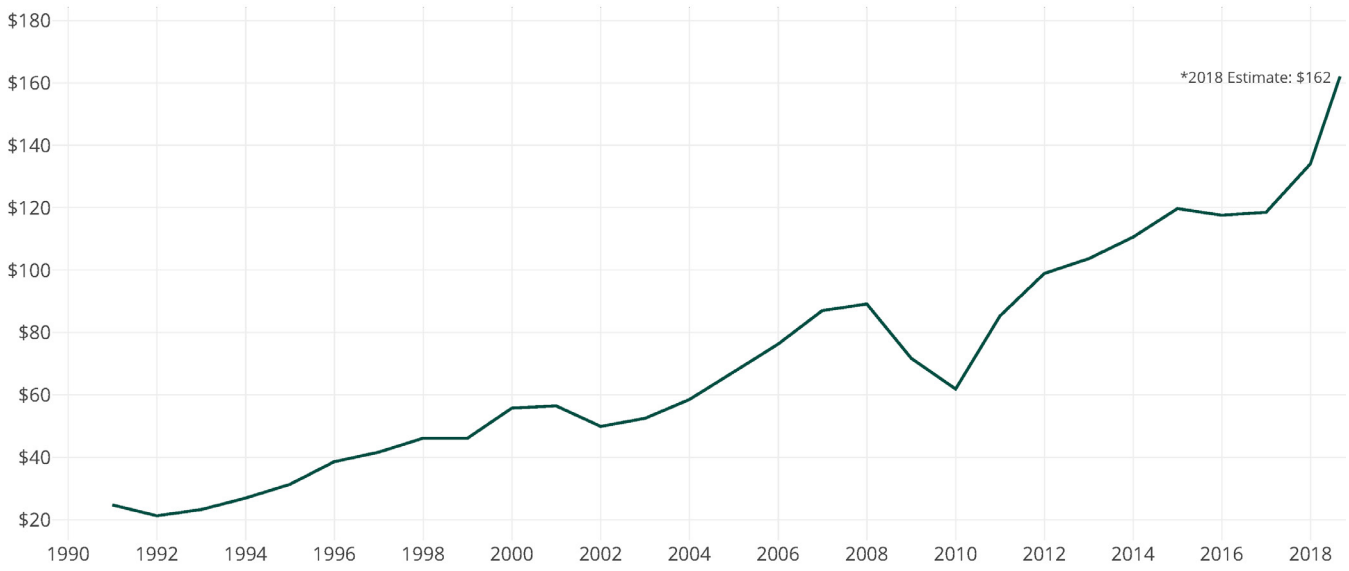
The irony of granting voting rights to 18 year olds is that they are part of the least likely age demographic to vote. However, these young voters may hold the key to the 2018 congressional elections as control of the House and Senate is still quite uncertain based on current projections. It seems every election cycle we hear about younger people becoming more engaged, but **CHART 1** suggests no trend in their voting turnout. While a drop-off in participation in midterms occurs

CHART 1: **REPORTED VOTING RATES BY AGE**



Source: The United States Census Bureau

CHART 2: **S&P 500 INDEX AGGREGATE EARNINGS PER SHARE**



Source: Bloomberg

in every age group, it is most pronounced in the youngest bracket, with roughly 20% of 18- to 24-year olds voting, compared to about 40% turnout in presidential elections. With control of the Senate and House projected to be tight, turnout amongst young people, who tend to vote more with the Democratic Party, will be a key factor in this election.

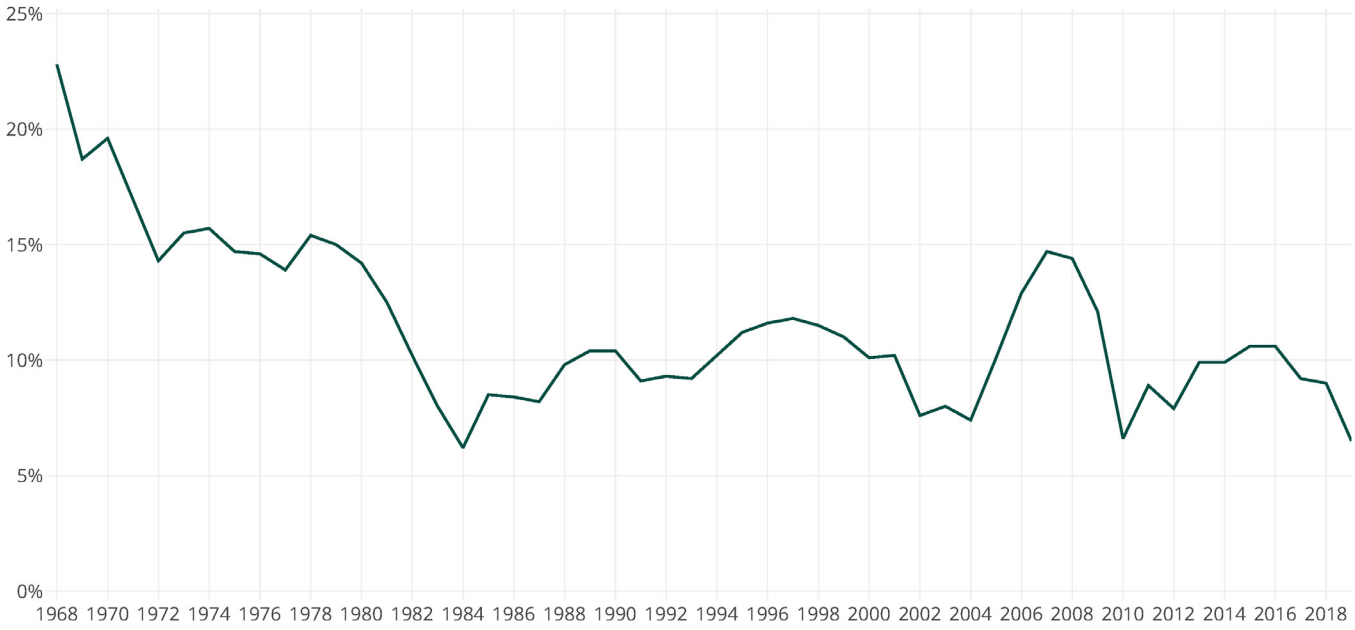
With the 21% corporate tax rate proving so vital for earnings growth and sustaining the bull market, we believe the U.S. midterm elections results will be particularly important for investors. While we do not expect the tax rate will be changed in 2019-2020, depending on the results from November's election, we may see higher corporate tax rates floated by the Democrats should they win control of the House.

Equally impactful, a strong Republican showing should embolden investors that the corporate tax cut is not in jeopardy.

To analyze just how meaningful the tax cut has been, **CHART 2** shows the aggregate earnings per share of the S&P 500 Index as if it were one large company. The tax cut has helped lift profits of the constituent companies of the S&P 500 Index from $134 in 2017 to an expected $162 for 2018, a potential 21% gain that has typically happened only when emerging from cyclically-depressed periods like recessions. By comparison, the percentage gain in S&P 500 Index earnings will likely be as great in 2018 alone as it was for the entire period from 2011 to 2016.

Photo source:Shutterstock

CHART 3: **PERCENTAGE OF U.S. TREASURY TAX RECEIPTS FROM CORPORATE TAX**



Source: Bloomberg, Percentage of Total Receipts

While many companies, especially those with substantial business overseas, were never paying an effective 35% tax rate, the tax cut was a big help to the bottom line of U.S.-centric industries like retailing, transports and financial services. Any threat of the 21% tax cut being repealed and replaced with a higher rate would have implications at the sector level, stock level and would have a material change in overall price-earnings (P/E) ratios for the S&P 500 Index.

Our belief that the 21% rate will not be sustainable over the long term is based on current budget deficit projections, which show a notably small contribution to the U.S. Treasury from corporations. Corporations are estimated to contribute only about 6.5% of total tax receipts to the U.S. Treasury in 2018, a decline from 9.0% in 2017. The only year when this contribution was lower was 1983 when corporate tax receipts were 6.2%. However, in 1983, the U.S. economy was just recovering from a recession and corporate profits were depressed. Nine years into an economic expansion, 6.5% is an exceptionally low figure and would almost certainly go even lower during the next downturn. As shown in **CHART 3**, during periods of good economic growth, corporate tax payments as a share of Treasury receipts have tended to be far higher — around 10% to 11% for most non-recessionary periods and spiking to over 14% during 2006 and 2007.

Low corporate tax receipts might be deemed acceptable if the federal budget deficit were in better shape. However, the U.S. budget deficit is high, especially during a period of economic growth when federal tax receipts from all sources should be robust. The U.S. will run estimated budget deficits (as a percentage of GDP) of 4.0% in 2018 and 4.7% in 2019.

Peacetime deficits this large have only occurred during recessions when tax receipts were depressed, and fiscal spending was used as a tool to simulate growth. These deficits are even more staggering when considering how low interest expense is, with the U.S. Treasury averaging just a little above 2.0% that it is paying on its outstanding bonds as shown in **CHART 4**.

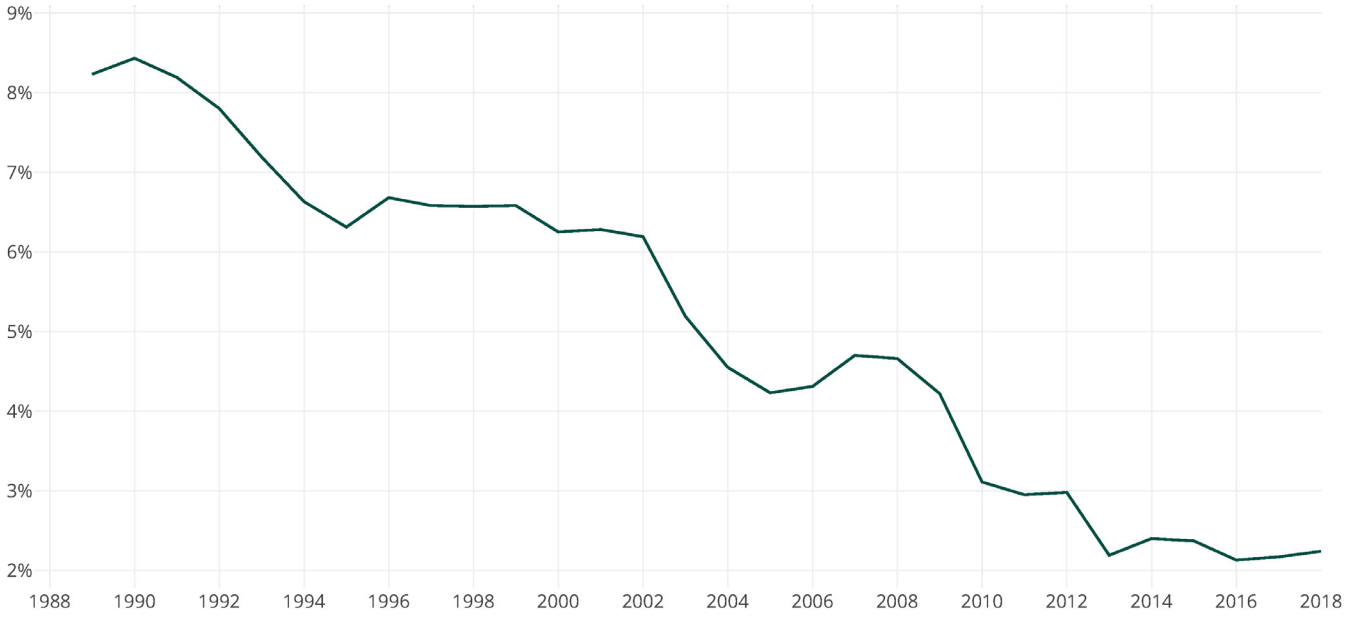
We have written recently about the U.S. budget deficit not being sustainable, and the current strong economy simply has not generated enough incremental tax revenue to change our minds. The recent rise in interest rates could add to this imbalance, but even if rates were held constant, we expect the budget deficit will have to be addressed. Depending on which political party is in control, we would expect by 2021 to see some combination of higher personal taxes, higher corporate taxes or a national sales tax [**CHART 5**].

Well before 2021, a strong showing by the Democrats in November could embolden them to call for "repeal and replace" on the corporate tax side when the new Congress takes office in 2019. Even though they would be unlikely to have the votes to overcome a sure veto from the White House, the issue may suddenly appear on investors' radar screens sooner than they expect.

Handicapping 2018 Midterms

While we believe it is too soon to change portfolio positioning ahead of the November elections, we will be closely focused on the results as it could alter our preferences should an unexpected scenario materialize. Below are three potential

CHART 4: **U.S. INTEREST EXPENSE RATE**



Source: Bloomberg and U.S. Treasury *U.S. Interest on Treasury debt securities gross as reported by Treasury/U.S. Treasury Total Public Debt Outstanding

outcomes for November along with potential market implications:

The Blue Scenario

The current consensus has the Democrats winning the House and the Republicans keeping control of the Senate. With 26 Democratic Senators up for re-election, they have a very narrow path to gain control. The Democrats appear to have command of 44 seats where there is either no election or they are polling solidly ahead, while the Republicans have 47. The battleground is the nine seats that poll very closely today and are too difficult to project a winner. The Democrats would have to win seven of those nine toss-up states to gain 51-49 control. Such an outcome would take a massive turnout of young voters in 2018, which would also augur well for the Democrats' chances in 2020. If the Democrats are able to win back control of the Senate, they will be overwhelmingly likely to win the House too. If this improbable scenario prevails, we believe the U.S. equity market would begin to discount a change in the White House in 2021 as the results would be viewed as a referendum against the current administration. So-called Trump stocks, beneficiaries of lower taxes and less regulation, would likely be less favored by investors.

The Red Scenario

If President Trump's base proves to be the more energized one, and the Republicans keep the House and Senate, we would expect to see continued gains in companies and sectors benefiting from lower taxes and less regulation. It is too soon to rule out the "red-state" scenario as historically most people will vote their wallet. In a period of low unemployment and early signs of wage growth, the Republicans may end up keeping both the House and Senate.

The Purple Scenario

The most likely outcome for this midterm election is that the Republicans keep the Senate but lose the House. However, the margins of victory in the House and Senate may provide either a sense of confidence or concern as it relates to the 21% tax cut. We will be closely watching elections for Republican-held seats in Tennessee, Nevada, Arizona and Texas to get a sense of potential shifts in voter preference that would tilt the balance for one party or another in 2020.

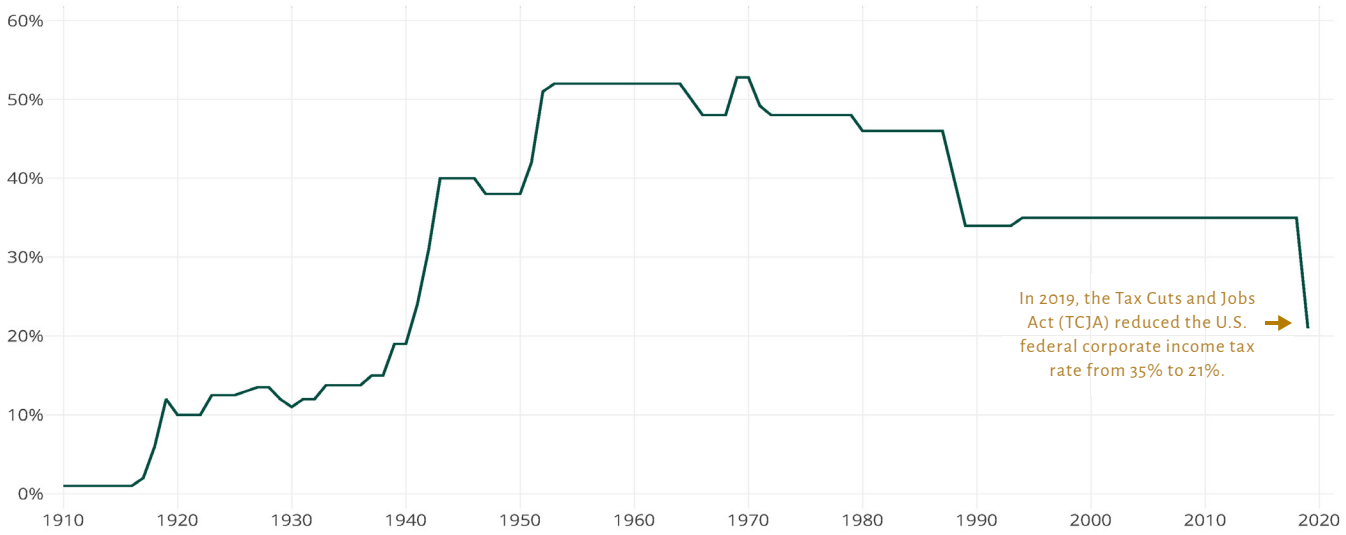
Sector Positioning

As we became more convinced in late 2017 of the likelihood of a U.S. corporate tax cut, we added stocks that we believed were positioned to get a meaningful boost in earnings. We added U.S. domestically-focused stocks like retailers, media, banks and to holdings in transports. Unlike multinational companies, those businesses that primarily operate on U.S. soil tend to be the biggest beneficiary of lower taxes. Should the midterms signal a shift to the left, we would likely be favoring stocks of companies that typically benefit from a weaker dollar and have tax rates shielded by earnings overseas. Most typically these companies would be in the industrial, healthcare and technology sectors.

Geographic Positioning

We believe the recent underperformance of non-U.S. markets is set to reverse, especially if the 21% tax rate is viewed to be vulnerable. While the markets may not like the outcome of the U.S. midterms, we believe the political news is set to improve overseas. We would expect to see significant relief rallies in the pound, euro as well as European markets should the Brexit deal be reached between the U.K. and the European Union (EU). This bears close scrutiny as a deal must be agreed upon

CHART 5: **HISTORICAL U.S. STATUTORY CORPORATE TAX RATE**



Source: Tax Policy Center (TPC), Urban Institute & Brookings Institution

well before the March 29, 2019 exit date to allow EU member nations time to ratify.

Emerging markets have come off a period of substantial underperformance that we believe is overdone. Most emerging markets are in far better fiscal condition than they were 20 years ago, when there was widespread contagion that started in Asia. Concerns of tariffs have hurt the Chinese market, but there are some businesses without export exposure that look attractive to us.

Summary & Conclusion

The 21% U.S. corporate tax rate has helped accelerate profit growth, giving fresh legs to a nine-year-old bull market for U.S. equities. Although a strongly-performing economy usually bodes well for the incumbent party, we believe control over the House and Senate is still too close to call, with a base case that the Democratic Party will win back control of the House but not the Senate. We are concerned that the market is taking the 21% tax rate for granted, a rate we regard as vulnerable should the White House change parties in 2021. Although we do not see the tax rate changing before then, investors will likely become more concerned should the Democratic Party surprise the consensus and win control of the Senate and House. Such a shift could signal that we are at "peak capitalism" in the U.S. in terms of low taxes and deregulation.

"Although a strongly-performing economy usually bodes well for the incumbent party, we believe control over the House and Senate is still too close to call, with a base case that the Democratic Party will win back control of the House but not the Senate."

By contrast, non-U.S. markets have been riddled with concerns about Brexit, Italy, Turkey, Brazil and tariffs. We believe the incremental news is likely to improve outside the U.S., while concerns here could mount after the November election. Depending on the results we see in November, we can see making some substantial shifts in sector and geographic exposures. Like with casino games, 21 has been a lucky number for equity investors, but as any gambler can attest, a good streak never lasts as long as one would like. ●

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The New Face of Populism

The Rise of Nativism and Strongman Politics

An Ancient Migrant Crisis

In year 376 AD, a large number of Goths, an East Germanic people, were fleeing from the marauding Huns. They arrived at the northern bank of the Danube River in today's Romania and sought asylum from the Roman Empire to the south of the river. In spite of earlier conflicts with the Goths, Eastern Roman Emperor Valens granted asylum to some on the expectation that they would join his planned military expedition against the Persians.

Under the Roman army's supervision, Fritigern led several hundred thousand Thervingian Goths to cross the fast-flowing river that was still cresting from the spring rains. Many perished as overcrowded rafts capsized, but that was just the beginning of the difficult settlement. The logistical challenges of accommodating the large influx of migrants soon overwhelmed the Romans. Although Valens had appropriated resources to the refugee camps, some supplies were diverted to the black market by local commanders. Famine and disease soon ravaged the Goths, forcing them into open rebellion and turning the Thrace region (parts of today's Greece, Bulgaria and Turkey) into chaos.

Photo source: Getty Images

Emperor Valens, upset at the ungrateful migrants, personally led an army to quell the unrest. On August 9, 378 AD, after seven hours of marching over difficult terrain, the mighty but tired Roman legions clashed with Fritigern's force at Adrianpole (now Edirne, Turkey). A series of miscalculations resulted in one of the Romans' worst defeats in history — Valens and two-thirds of his troops perished in the battle, and the killing lasted until nightfall.

Some historians believed that Valens' fateful defeat at the hands of the Gothic migrants marked a turning point in Roman history — Rome was no longer militarily superior to the so-called barbarians. In year 410 AD, Rome was ransacked by Alaric I, the first King of the Visigoths. Exactly 100 years after the Goths' crossing of the Danube River, Romulus, the last of the Roman emperors in the West, was overthrown by Odoacer, who became the first "barbarian" King of what is now Italy.

The 2015 Migrant Crisis

Sixteen centuries later, Europe was once again confronting a migrant crisis, this time with asylum seekers from Muslim-majority countries in the Greater Middle East and Africa. Years of wars in Afghanistan, Iraq, Syria and Libya have displaced millions of people. As of mid-2015, it was estimated that more than two million refugees from Syria and Iraq had trudged into Turkey, and many sought to reach Europe as their final destination. The flow of migrants into Europe accelerated in the summer of 2015, with tens of thousands of refugees each month crossing the Mediterranean Sea on rickety boats or trekking the Balkan routes across Turkey's border with Greece and Bulgaria. By late August 2015, as the refugee situation turned into a humanitarian crisis, German Chancellor Merkel made the momentous decision of accepting all Syrian asylum seekers.

It did not take long for Chancellor Merkel to realize that her well-intentioned decision was flawed. It made Germany a magnet to migrants and more refugees flocked into Europe. All told, more than 1.3 million migrants applied for asylum in the European Union (EU) in 2015, nearly doubling the previous record of 700,000 in 1992 after the collapse of the Soviet Union. Germany alone took in 890,000 migrants in 2015, which created stress on multiple fronts — housing, social services, security, integration, etc. In the autumn of 2015, the EU started in earnest a negotiation with Turkey in an attempt to stem the flow of migrants. In March 2016, a deal was finally struck to have the EU pay Turkey six billion euros of aid in exchange for tighter border security and settlement of remaining refugees in Turkey. Although the EU-Turkey deal was effective in materially reducing the flow of migrants, the impact of the 2015 migrant crisis has made indelible changes on Europe's politics.

Photo source: Wikimedia Commons

Photo source: Wikimedia Commons

The Rise of European Populism

In December 2017, the Tony Blair Institute for Global Change issued a report examining the rise of populism in Europe. Since 2000, the number of populist parties in Europe has grown from 33 to 63, and populist parties' share of votes has increased from an average of 8.5% in 2000 to 24.1% in 2017. The institute's definition of populism included only parties that "claim to represent the true will of a unified people against domestic elites, foreign migrants or ethnic, religious or sexual minorities." Although most populist parties tended to be right wing, left-wing populist parties have also gained acceptance in Southern Europe as a backlash against the sovereign debt crisis induced austerity — e.g., Greece's ruling left-wing SYRIZA party. The common thread among these populist parties is the embrace of protectionist and redistributive economic policies, restrictive immigration schemes and inflammatory rhetoric against independent institutions such as the media and/or the judiciary.

The conventional wisdom often attributed the rise of populism to income inequality and economic malaise. However, that failed to explain why populism was also rising in some of the countries with solid economic growth — Germany, Sweden, Austria, to name a few. The uncomfortable truth is that the rise of populism in many parts of Europe may reflect the fear of losing cultural identity and the rejection of multiculturalism, which the migrant crises has brought to the fore.

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Assimilation is Hard to Do

Western European countries began to recruit Muslim labor migrants from Turkey, the Middle East and North Africa in the mid-1950s to help with the post-WWII reconstruction. This trend lasted into the mid-1970s, when a recession prompted European countries to tighten labor immigration policies. However, the earlier migrants had settled down by then and were sponsoring their extended families to move to Europe. These new arrivals under the family reunification policies far exceeded earlier estimates, and Muslims became the fastest-growing population group in Western Europe.

Many of these first and second generation Muslims in Europe wound up living in segregated enclaves for a variety of reasons — cultural affinity, lack of social mobility and racism, amongst others. Unfortunately, the social and economic alienation created a vicious cycle of prejudice and stigmatization. In recent years, some alienated second-generation Muslims have become targets for recruiting by Islamic extremists. The flock of migrants into the EU also coincided with an increase in religiously-inspired terrorist attacks. According to the European Parliament, these terrorist attacks in the EU spiked up from two in 2014 to an average of 21 in 2015 through 2017. Some were high-profile incidents such as the shooting at the Charlie Hebdo magazine in Paris and the 2016 Bastille Day truck attack in Nice. The number of deaths from these attacks have increased from four in 2014 to an average of 116 over the last three years.

Photo source: Time Magazine

The right-wing populist parties have been quick to seize onto these issues to stoke the fear of Islamization and the loss of national identity. However, other than offering righteous indignation and denunciation, European liberals have yet to come up with effective policies to ease the assimilation of immigrants and to allay the fears of nativists. The reality is that there are no easy solutions. Historically, assimilation could take generations — it took several centuries for Goths in the Roman territory and other locales to be assimilated and converted to Christianity, and provincialism and rivalry have remained entrenched even among European natives to this day.

Realigning the European Political Map

Since the end of World War II, the center-left and center-right duopoly has dominated Western European politics. However, the rise of populism has recently upended that cozy arrangement across several European countries. The end result has been the collapse of many center-left parties while the center-right became more populist on immigration and social policies.

One can argue that Brexit, which was voted on in June 2016, was the first manifestation of right-wing populists' growing influence. It was followed by Donald Trump's surprise victory in November 2016 on our side of the Atlantic Ocean. Some had hoped that Emmanuel Macron's May 2017 victory over the right-wing National Front in France would stem the rising tide of populism. However, it turned out to be just wishful thinking. In October 2017, the then four-year-old right-wing nationalist Alternative for Germany (AfD) party became the third-largest party in Germany. During that same month, Austria's Freedom Party, originally founded by former Nazi official and SS officer Anton Reinthaller in 1956, won 26% of the popular vote and joined the coalition government. In March 2018, Europe's populist movement captured its biggest prize — the Five Star Movement became the largest party in Italy by winning 33% of the popular vote and went on to form a coalition government with the anti-immigrant League Party, which had 17% of the vote. The Five Star Movement and the League Party together captured 50% of Italy's popular vote.

Right-wing populist parties have also made significant strides in the supposedly enlightened and liberal Scandinavian countries. Sweden's anti-immigration Sweden Democrats Party argued that the country's general welfare system will collapse under the burden of supporting migrants. While its detractors were quick to point out that Sweden Democrats' third-place finish in the September 2018 general election was worse than expected, their 17.6% share of the popular vote was still an improvement from the prior election's 12.9%, and the ruling Social Democrats suffered its worst-ever electoral result. In Denmark, right-wing populist Danish People's Party has become a kingmaker and was successful in passing legislation to toughen its immigration policies. For instance, in an attempt to discourage asylum seeking, Danish authorities have been empowered to seize from asylum seekers' assets exceeding 10,000 kroners (about $1,560) to help pay for the cost of accommodating them. Sensing the growing public embrace of tougher immigration policies, Denmark's center-left Social Democrats have broken off its 25-year alliance with the Social Liberal Party and openly courted the Danish People's Party's support in preparation for the 2019 general election.

The former communist countries across Central and Eastern Europe have been the most fertile ground for populism. Of 15 countries in the region, populist parties currently hold power in seven and belong to the ruling coalition in two others. Of note, Hungary, Poland, the Czech Republic and several other countries have refused to accept the EU-wide refugee settlement quota. Hungarian Prime Minister Victor Orban defended their position by telling the German media that "you wanted the migrants, and we didn't." Indeed, Orban's supporters would argue that Chancellor Merkel never sought their approval when she opened the border to migrants in 2015. There was so much bad blood that the EU has initiated proceedings to censure both Poland and Hungary, which could ultimately strip them of their EU voting rights.

These shifting political alignments could someday threaten the European integration project. The champions of traditional European values and tighter union may not be around after the next electoral cycle — German Chancellor Merkel has been weakened politically and is likely serving her final term; French President Macron's popularity has plunged to new lows in September. Meanwhile, Matteo Salvini, Italy's anti-migrant, Euroskeptic Interior Minister and the head of the League Party, has his headshot prominently featured on the cover of Time Magazine under the banner "The New Face of Europe". Recent polls have shown the League Party surpassing the Five Star Movement as Italy's most popular political party. It is a clear manifestation of the ascension of Europe's right-wing populist parties. They have even attracted Steve Bannon, former White House Chief Strategist for President Trump, to set up a group called "The Movement" to support and coordinate various nativist and anti-establishment parties across the Old Continent.

Populism in the Rest of the World

In the non-Western world, populists have mostly stuck to the traditional playbook of blaming social, economic and political ills on the elites, corruption, crime and foreign interference, etc. In some instances, populist leaders such as Rodrigo Duterte in the Philippines and Turkey's Recep Tayyip Erdoğan have become strongmen who eroded civil liberty and compromised rule-based institutions. South African President Cyril Ramaphosa has proposed a constitutional amendment that would allow the government to expropriate private farmland without compensation. It's a crowd-pleasing policy as more than two-thirds of farmland owned by individuals in South Africa was still controlled by whites who represent 9% of the population. In the United States' backyard, Mexican voters gave left-wing populist Andrés Manuel López Obrador a resounding presidential mandate to reduce inequality, attack corruption and stand up to Donald Trump's brand of populism.

In the upcoming Brazilian presidential election on October 7th, candidates with extreme populist platforms have been gaining while centrist candidates were left behind in recent polls. Right-wing populist Jair Bolsonaro, dubbed "Brazil's Donald Trump" for his law-and-order stance and inflammatory rhetoric, is currently the front-runner. He is likely to face Fernando Haddad, the candidate from the left-wing Workers' Party in the October 28th run-off.

Another country to keep an eye on is Indonesia, the world's most populous Muslim country. Former general Prabowo Subianto, who unabashedly styled himself as a populist strongman but lost the presidential election in 2014, has made gains of late by allying with conservative Islamists to challenge President Joko Widodo in the April 2019 presidential election. Widodo has sought to boost his Islamic credentials by naming a controversial 75-year-old cleric as his running mate. It seems that the casualty will be religious tolerance and pluralism as political Islam broadens its influence, which could also result in a less market-friendly environment down the road.

Investment Implications

With populists' rise being fueled by backlash against the so-called establishment, their policy prescription and behavior would often cross the boundary of what's considered normal and acceptable. The case in point has been the Trump Presidency, which has at times made a mockery of traditional protocols and decorum and whose policies have often left both friends and foes befuddled. To investors, controversial policies could lead to market anxiety and higher volatility. However, they could also create investment opportunities if the controversies turned out to be not as bad as feared.

So far in 2018, Italian politics have created much anxiety and weakened the euro. At the start of the year, investors were expecting the European Central Bank (ECB) to start the long-awaited monetary policy normalization process. The euro climbed to a three-year high of 1.25 euro per U.S. dollar in early February. However, since the Italian general election in March, the euro has given up nearly 7% from the February peak. It appeared that Italy's political as well as policy uncertainty has kept ECB President Draghi on the dovish side, as he signaled in June that the negative 40 basis-point benchmark rate will persist through at least the summer of 2019. Italy's populist coalition government may have taken on too much at once — cutting taxes, offering universal basic income, lowering pension age and threatening to pull EU funding over migrant issues. EU officials have complained that the populist government's proposed 2.4% budget deficit was a breach of Italy's obligation to reduce structural debt. Investors have also shown their concern by materially driving up Italy's government bond yields. From a contrarian vantage point, we suspect the euro and European equities, especially financial stocks, could mount a relief rally in the coming months as it is in the best interest of the EU and Italy to eventually make a compromise.

In emerging markets, the rise of populists with economic nationalism is a disconcerting trend, as it could scare away sorely-needed foreign capital. Venezuela's failed-state status, with inflation projected at 1,000,000% in 2018, should serve as a warning to other aspiring populists with extreme agendas. Turkey's currency crisis was another example of markets disciplining government overreach. That said, with emerging markets having already suffered sizeable pullbacks in 2018, there may be undervalued investment opportunities. For example, Brazil could surprise on the upside as Bolsonaro seems to favor more privatization while Haddad positions himself as an heir to former President Lula, a leftist who turned out to be market-friendly.

"Some may also view the U.S. as a safe haven. However, the full impact of Donald Trump's economic populism has yet to be felt — the trade war remains a real and present concern."

Interestingly, among major economies, Japan stands out as an island of stability, in our opinion. Shinzo Abe is on course to become the country's longest serving prime minister, and the Bank of Japan has remained highly accommodative. While there are long-term demographic challenges, we believe Japan has many world class companies trading at reasonable valuations.

Some may also view the U.S. as a safe haven. However, the full impact of Donald Trump's economic populism has yet to be felt — the trade war remains a real and present concern. The Trump tax cuts, while a short-term boost to U.S. economic and business profit growth, have created unprecedented boom-time budget deficits with negative long-term ramifications. Furthermore, as David Harris observes in his lead article, there is a good chance that Democrats will replace and repeal some of the tax cuts should they return to the seats of power in Washington. In short, rising populism is a global trend, yet investors may be too sanguine about the outlook of the U.S. equity market and overly pessimistic about non-U.S. equities. ●

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From Straws & Sticks to Bricks (& Mortar)

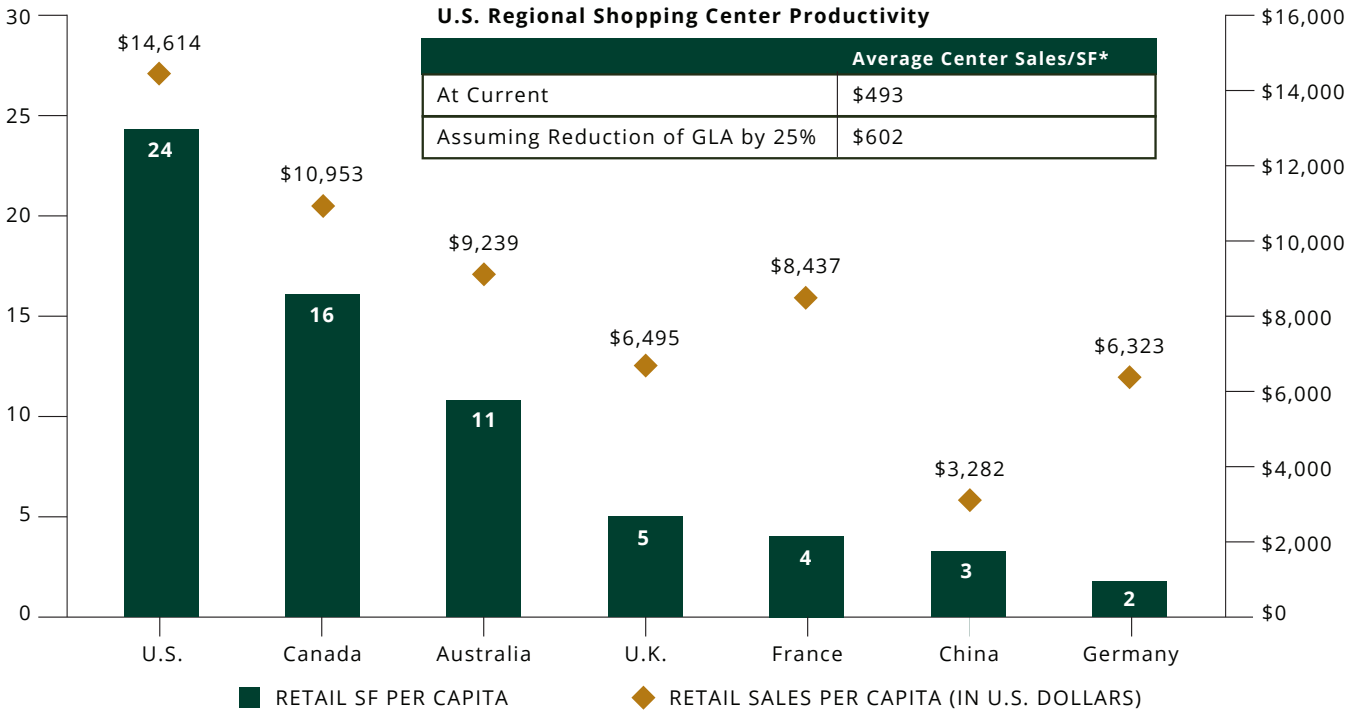
Retail Resurgence Aided by Store Rationalization and a Healthy U.S. Consumer

"We're currently benefiting from a very strong consumer environment, perhaps the strongest I've seen in my career," exclaimed Brian Cornell, CEO of Target, on a late summer earnings call with analysts. His claim may be up for debate, but his experience in retail and consumer packaged goods is not. The former PepsiCo executive has 34 years of industry experience to draw upon, and Target — much like its competitor, Walmart — had just reported its best quarterly same-store-sales (SSS) growth in 13 years. After years of decelerating (or even negative) sales growth and dwindling margins, brick and mortar (B&M) retailers are now enjoying a long-awaited revival. Unemployment is low, labor markets are tight, and wages — which had been stubbornly stagnant — are growing meaningfully. Although Amazon.com is responsible for nearly a third of the growth in the $3.5 trillion U.S. retail sales industry (excluding autos, auto parts and gasoline stations), a healthy U.S. consumer, coupled with a rationalized store base, has resuscitated B&M retailers. The trend is particularly noticeable among those retailers with strong balance sheets and cash generation necessary to make sustained investments in the customer experience.

Online shopping has changed the way most of us live with this relatively new retail medium redefining convenience. Though Amazon is almost assured to get the convenience shopper nine out of 10 times, B&M retail can offer a consumer base, increasingly composed of millennials, something that digital shopping simply cannot — an experience; hence why historical e-tailers, such as Warby Parker, have transitioned towards developing physical locations. Notably, with a target of 100

Photo source: Getty Images

CHART 1: **RETAIL REAL ESTATE GLA AND SALES PER CAPITA**



Source:ICSC Country Fact Sheets
*At Current is the average center sales per square foot data from Green Street Advisors, while "Assuming Reduction of GLA by 25%" removes 25% of lowest quality centers by productivity and redistributes sales to remaining centers.

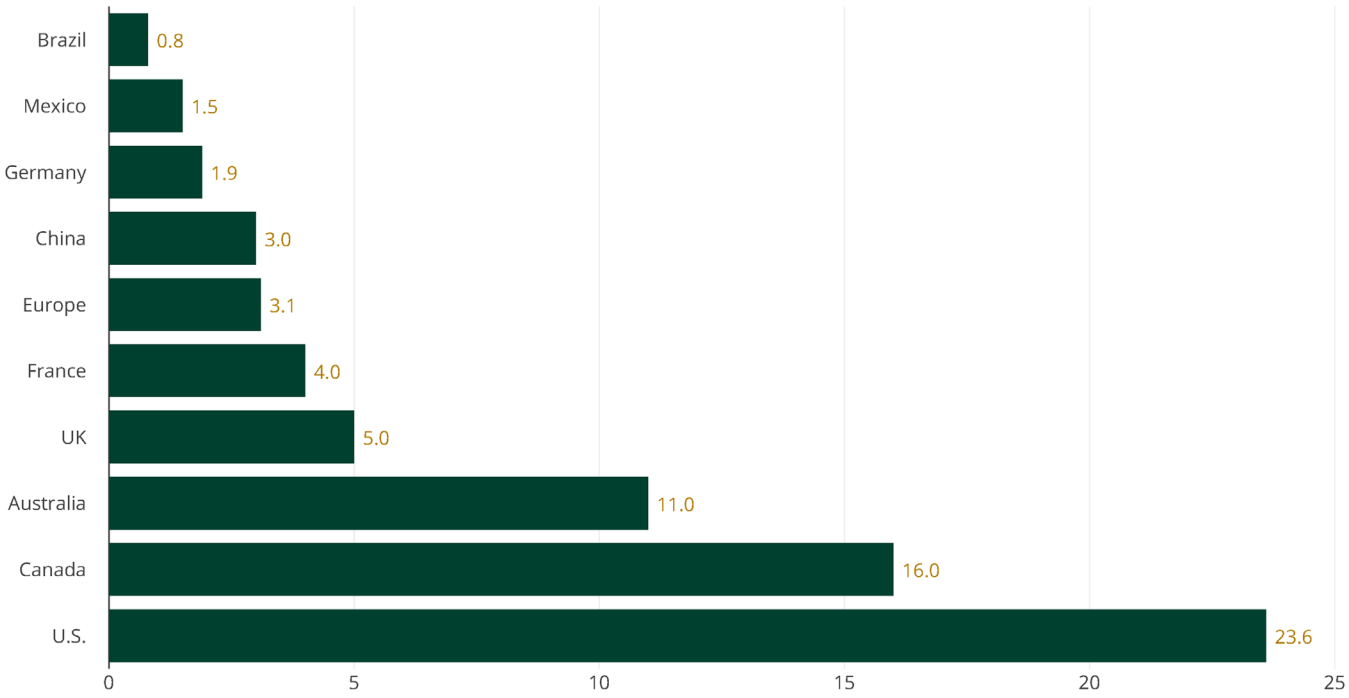
stores by year end, the majority of Warby Parker's revenues actually come from its physical stores and recent revenue growth has been aligned with store openings. Moreover, this cross-pollination between landed and online offerings is not unique to boutique retailers. CVS Health and Walmart, for example, have introduced same-day delivery services to effectively compete with Amazon. Since buying Whole Foods, recent reports suggest that Amazon is considering adding up to 3,000 cashier-less Amazon convenience stores over the next few years.

After years of losing ground to more forward-looking online merchants, retailers appear to have awoken in a major way. For years, industry participants had followed a similar playbook to achieve strong revenue growth: open new stores, grow SSS aided early by the novelty effect of a new concept and later on by the store maturation process, then rinse and repeat. It was commonplace to grow square footage at a double-digit percentage clip per annum, especially when a new concept was in its infancy. As a rule of thumb, first-year sales in a new store are approximately 60%-65% that of a mature store. Assume a five-year maturation process, and this provides a four-year double-digit percentage like-for-like sales lift, which disproportionately benefits younger store fleets yet still helps mature concepts eke out growth.

> "Given the fierce competitive retail environment and looming trade war updates constantly refreshing at the top of everyone's news feeds, retailer profits may continue to struggle to find growth, and thus stock selection remains as critical as ever."

This recipe for success generally continued on unabated for years, until the big bad wolf — Amazon — started reaching critical mass, particularly over the last 10 years. For perspective, in 2018, Amazon is expected to add more revenue ($37 billion) to its North American retail business alone (excluding the impressively-growing Amazon Web Services and international businesses) than it achieved companywide in 2007 and 2008 combined ($34 billion). Moreover, this impressive revenue growth understates Amazon's true impact on B&M retail as third-party revenues — where Amazon takes a 10% to 15% cut — would need to be grossed up to reflect true industry share shifts. With this in mind, according to the International Council of Shopping Centers (ICSC), since 1970, retail gross leasable area (GLA) in the U.S. has increased over 400%, while the U.S. population has increased 50%, leading to an oversupply of retail properties and a migration to higher-quality locations by businesses and consumers. Despite the space being 30% more productive than our neighbors to the north, the U.S. has 50% more retail space per person than Canada, eight times that of China and around five times that of Europe. Remarkably, according to Abrasce — the Brazilian Shopping Centers Association — the U.S. has 30 times the per-capita mall square footage compared to our Latin American friends!

CHART 2: **RETAIL GLA PER CAPITA (SQUARE FEET)**



Source: ICSC, Cushman & Wakefield, Abrasce, *gross leasable area (GLA)

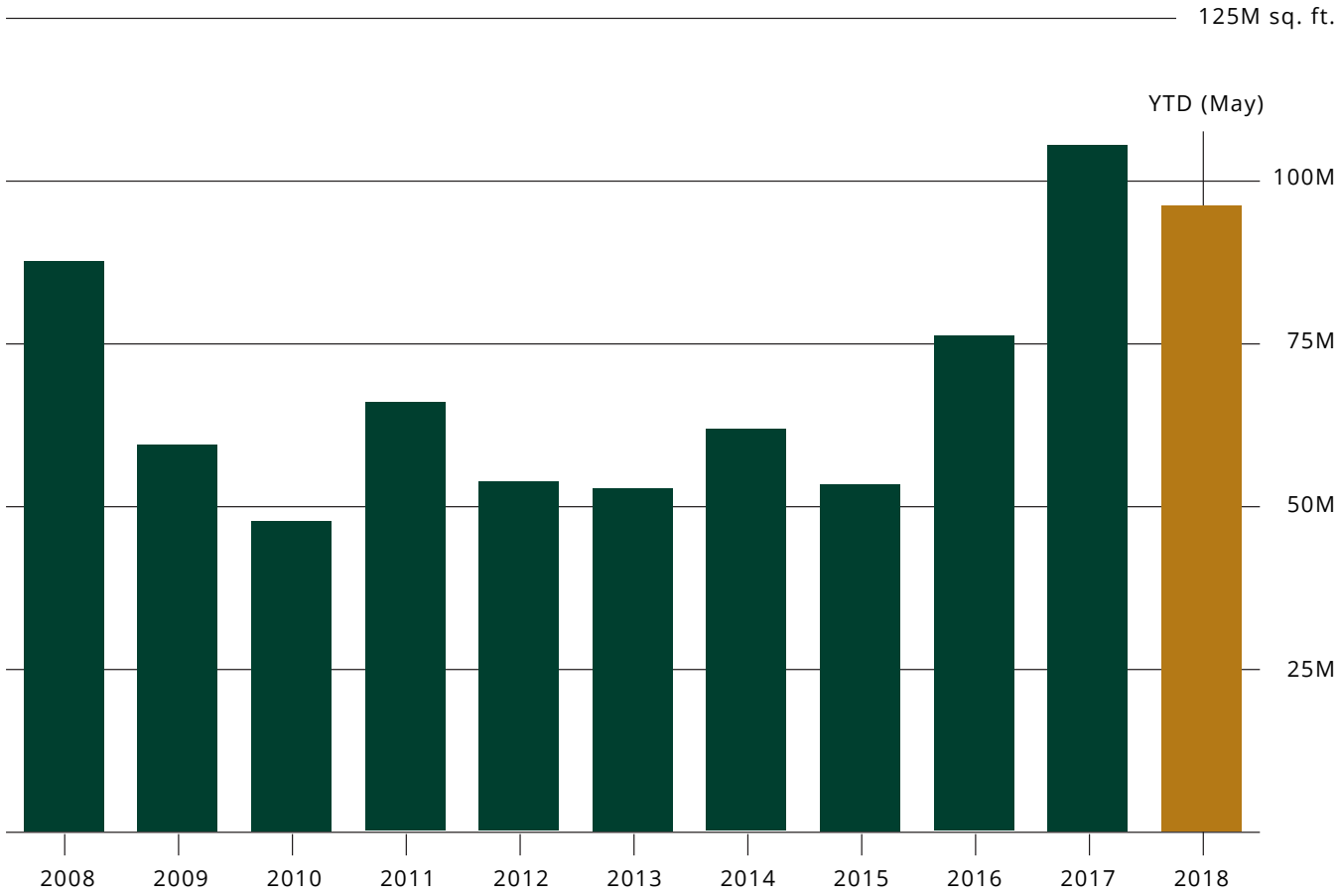
Inevitably, retailers have needed to take painful but important steps to rationalize unproductive square footage over the last three years. Through May, store closures announced this year reached 95 million square feet, according to data compiled by CoStar Group. This suggests that 2017's peak of 105 million square feet might not be in the record books for long. From 2008 to 2015, store closures averaged roughly 60 million square feet annually. But given recent high-profile bankruptcies, that average should approach 100 million square feet since 2015. While 2018 could prove the peak year for closures, as many companies are in the process of restructuring, the reality is store rationalization will continue. Amazon-able categories such as mid-price apparel, bookstores, consumer electronics, department stores, office supplies and a number of specialty stores could continue to consolidate.

This excess retail square footage is particularly pronounced among malls. Macy's, down to 690 stores (after peaking at over 850 in 2007) and more on tap to close, should give us a good indication of what malls could look like when the retail rationalization is complete. In our view, it's reasonable to assume that each mall that survives will likely house a Macy's. With roughly 1,100 malls in the U.S., nearly all of the 350 C- and D-rated malls will likely close over time — and the 100 malls rated 'B-' are likely at risk as well. Even though C- and D-rated malls represent roughly a third of the mall fleet, they account for just 4% of value. Lower-quality malls in rural areas with thin populations and lower incomes will likely continue to close at a fairly steady pace. Conversely, 'A' malls may continue to thrive. Taubman Centers reported record sales per square foot in the second quarter and its high-quality mall real estate investment trust (REIT) peers are at or near all-time highs in this metric as well.

Nevertheless, while new construction is well below the post-recession average, not all concepts are reducing space. According to Cushman & Wakefield, "white hot" off-price concepts along with discounters and dollar store chains continue to aggressively grow square footage. Ross, having recently upped its long-term projected store potential from 2,500 to 3,000 stores (compared to a current fleet of 1,680), plans to open 100 stores this year. Similarly, competitors T.J. Maxx, Marshalls, Nordstrom Rack and Burlington are all adding between 35 and 50 new locations. In addition, after 1,700 openings last year, new dollar stores will slow their pace of growth but still open roughly one every 10 hours in 2018.

Amazon has arguably impacted the market values of other companies — in even seemingly unrelated industries — more than any other company in history. When Amazon announced its intention to acquire Whole Foods for $13.7 billion in June 2017, it impacted B&M retailers (which traded -3% to -4% on the day), food manufacturers (-2% to -4%), retail REITs (-5%), retail pharmacies and pharmacy benefit managers (-4% to -5%), in addition to courier services, trucking companies, warehouses and even robot manufacturers/automation companies. Through a single acquisition within food retail, Amazon effectively disrupted dozens of industries. Amazon's stock responded in turn, adding about $11.3 billion in market capitalization on the day (or the equivalent of one Macy's). Shares of retailers continued to struggle throughout the

CHART 3: **U.S. STORE CLOSURES (SQUARE FEET)**



Source: CoStar

summer and into late autumn before bottoming in early November 2017. Since then, shares of the median B&M retailer are up nearly 30%, handily outperforming the S&P 500 Index (+13%) in that timeframe. Why? Likely on inflecting sales, tighter inventories, low valuations and corporate tax reform — where the median retailer would see mid-teens earnings growth — in addition to the revelation that, just perhaps, B&M retailers can coexist with the Amazons of the world.

As long-term investors, we strive to understand how the world will look in three, five and 10 years with the information at hand. During the height of the retail apocalypse (as it was infamously dubbed), I joked with colleagues that eventually — since everyone will be capable of shopping, communicating and working remotely from home through offerings from Netflix, Amazon and the next generation of disruptors — shopping in stores may become fashionable again.

Stronger sales are encouraging, and the painful adjustments to strategy and footprint undergone by many retailers have begun to pay dividends, but we need to be diligent and mindful of the risks that are ever-present. Given the fierce competitive retail environment and looming trade war updates constantly refreshing at the top of everyone's news feeds, retailer profits may continue to struggle to find growth, and thus stock selection remains as critical as ever. Between rising interest rates, tariffs and Amazon's near-$1 trillion market cap, the 2019 debate is just starting for retail stocks with a wide variety of potential narratives. Consensus' 8% earnings growth in 2019 could turn negative for several retailers just on tariffs alone, and retailers are also disproportionately at risk should the 21% corporate tax rate get raised in 2021, as David Harris discusses in his article. Regardless, we believe success will continue to follow differentiation and value: retailers that provide an experience and/or exclusive product should continue to rule the day, and those that do not will be melting ice cubes. ●

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Will Corporate Sustainability Endure Environmental Regulation Rollbacks?

Since the beginning of 2017, we have seen a series of policy rollbacks, 47 of which were aimed at easing the standards of environmental protection and ultimately weakening the U.S. government's commitment to climate change policy. For investors, one of the most pressing questions today is whether public companies will continue the path of sustainability and climate-friendly investments or if they will retreat under the pressure of deregulatory policies and legal uncertainty. Will the upcoming midterm elections elevate the issues of environmental protection and will the American voters show support for the climate change agenda?

The U.S. withdrawal from the Paris Agreement in 2017 signaled not only a loss of global leadership on climate change but steered the country away from a group of 194 nations who have jointly committed to curb global greenhouse gas emissions.[1] Earlier this year, the government continued its policy agenda by dismantling U.S. clean power programs designed to study and mitigate the effects of climate change and cut the funding for renewable energy. In August, the administration took aim at the fuel economy rules that would have increased vehicle mileage standards for cars made over the next decade. It also dismantled the air pollution rules on coal-fired power plants that were designed to curtail carbon dioxide and methane emissions. Most recently in September, the government eased requirements for oil and gas companies that were designed to limit leaks of methane.[2] While the government's public rationale behind these policies was economic and cost-cutting in nature, for many environmental experts and stakeholders, this was a "U-turn in the fight against climate change."[3]

The concern is important as what is at stake is the progress made by many U.S. companies over the past 20 years in investing in sustainability programs and a low-carbon economy. The issues of climate mitigation and energy use, carbon, waste and clean-air production have all been at the core of understanding corporate sustainability and are considered by many corporations and stakeholders as material to business and shareholder value creation. The current environmental policies undoubtedly pose risks to corporate behavior, testing companies' long-term commitments to a low-carbon economy and sustainable growth. Will U.S. companies turn this into an opportunity and a catalyst for greater investments in sustainable clean energy? Will the American public keep its support for addressing climate change? The answer to these questions is, most likely, yes.

> "The issues of climate mitigation and energy use, carbon, waste and clean-air production have all been at the core of understanding corporate sustainability and are considered by many corporations and stakeholders as material to business and shareholder value creation."

The Business Case for Sustainability

Right after the pullout from the Paris Agreement, major U.S. corporations spoke out publicly about their commitment to combat climate change. Big companies ranging from ExxonMobil and ConocoPhillips to JPMorgan Chase and Goldman Sachs, as well as Apple and Google, along with hundreds of others, spoke in support of climate regulation and the need of U.S. leadership to develop the low-carbon economy. The companies unequivocally made the business case that expanding markets for clean technologies is not only beneficial for the environment but leads to long-term economic growth. Climate change, they state, presents both risks and opportunities, and staying committed to the global agreement

1 http://environment.law.harvard.edu/policy-initiative/regulatory-rollback-tracker/

2 https://www.wsj.com/articles/epa-to-roll-back-obama-era-methane-rules-1536628368

3 https://www.nrdc.org/experts/luke-tonachel/pruitt-moves-weaken-clean-car-standards

Photo source: Shutterstock

will strengthen competitiveness, create jobs and reduce business risks.[4]

The fuel-economy rollback was another attempt this year to challenge prior achievements by the government and businesses in improving sustainability in the United States. The 2012 Corporate Average Fuel Economy (CAFE) program required light cars made after 2012 to become almost twice as efficient by 2025, averaging nearly 54 miles per gallon. The program was broadly accepted as it provided regulatory certainty for automakers, reduced gas costs for consumers, and improved the carbon footprint of the transportation sector.[5] In contrast, the rollback aims to freeze the CAFE standards at 2020 levels of 36.9 miles per gallon. The proposal offers as justification that this will: 1) reduce social costs, including savings in increased vehicle prices and 2) from reduced fatalities and crashes as consumers will supposedly be able to afford newer, safer and less expensive cars to replace their current older models.

According to experts, however, the rollback is expected to increase the consumption of gasoline thus making the cost of having a car much more expensive. According to estimates, consumers could lose over $130 billion on fuel savings. On the environmental side, the rollback would cause an unprecedented increase in climate emissions by 870 million tons of carbon dioxide.[6] Reducing standards will also likely make U.S. car manufacturers much less competitive and cutting-edge in comparison to vehicles and markets like Europe and China where government policy encourages the adoption of electric vehicles (EVs). Some of the biggest automakers have publicly spoken against the fuel economy rollback and for the need of national standards. General Motors Chairman and CEO Mary Barra publicly reaffirmed the company's "absolute and unwavering" commitment to improve fuel economy, reducing emissions and investing in electric vehicles. Ford Motors Chairman Bill Ford publicly supported "increasing clean car standards through 2025" and delivering on carbon emission reductions consistent with the Paris Agreement.[7] Ford's current sustainability strategy includes investing $11 billion to deliver 40 hybrid and fully electric vehicle models on the road by 2022.

Companies are also firmly betting on the future of renewables. Across different sectors, businesses are committing to using renewable sources of energy in procurement practices and operations. Facebook is the latest tech company to announce it will power its operations with 100% clean and renewable energy by 2020. Walmart, the largest retailer in the world, has announced the goal to be powered by 50% renewable sources by 2025 and was one of the first companies to place orders for Tesla's all-electric trucks for its fleet. As of today, about 63% of Fortune 100 companies have concrete renewable energy benchmarks in place and these numbers are expected to grow.[8] This shows how companies are moving to align more closely with the global growth outlook of renewable energy.

4 https://money.cnn.com/2017/06/01/news/ceos-respond-trump-paris-agreement/index.html

5 https://www.forbes.com/sites/danielsperling/2018/08/02/trying-to-make-sense-of-trumps-rollback-of-vehicle-standards/#66a2ff21e71a

6 https://www.forbes.com/sites/danielsperling/2018/08/02/trying-to-make-sense-of-trumps-rollback-of-vehicle-standards/#66a2ff21e71a

7 https://www.freep.com/story/opinion/contributors/2018/03/31/ford-fuel-economy-rules/473612002/

8 http://thehill.com/opinion/energy-environment/383241-trumps-white-house-will-not-define-sustainability-standards-tech

Photo source: Shutterstock

According to Bloomberg New Energy Finance, wind and solar are set to surge by almost 50% of the world's electricity generation capacity by 2050 with hydro, nuclear and other renewables taking total zero-carbon electricity up to 71%. Coal, on the other hand, is expected to shrink to just 11% of global electricity generation by 2050.[9] This forecast is starkly contrary to the premise of the rollback on the Clean Power Plan that dismantles U.S. federal rules over coal plants and gives regulatory authority to each state. While the Clean Power Plan had intended to cut U.S. emissions 32% below 2005 levels by 2030, the rollback plan is expected to cut emissions by only 1.5%. This is a scenario that could prove catastrophic to the environment.

The New Stewards of Sustainability

Climate change is expected to be a "hot edge" issue in the upcoming midterm elections this year.[10] According to a 2018 Gallup poll, 62% of Americans state that protection of the environment should be a priority and believe that the U.S. government is not doing enough to protect it. This is the highest level of support in 12 years. About 70% of Americans on average back government proposals to reduce emissions, enforce environmental regulations, spend government money on alternative energy sources and pass a carbon tax.[11] For example, the millennial generation alone is considerably more likely to support climate action this election year, according to studies.[12] It is apparent that the rollback policies are contrary to the general trends in U.S. public opinion.

Today, we also observe a new phenomenon of corporate consumer engagement. Consumers have unusually higher expectations for corporate behavior and leadership. According to a 2018 Global Strategy Group study, about 81% of Americans believe that corporations should take actions to address important societal issues today, and 77% believe corporations have a responsibility to do so.[13] Consumers are much more proactive in seeking information about companies and their values, with more than three-quarters (76%) of Americans saying that CEOs have a responsibility to bring about social change on issues facing society today. Corporate leaders have recognized the new voice and power of consumers. In the words of Mark Benioff, CEO of Salesforce, they should be ready to stand up "not just for their shareholders, but their employees, their customers, their partners, the community, the environment, schools, everybody."[14]

With all this in mind, we are unlikely to see a reversal in the long-term corporate behavior of U.S. companies regarding sustainability investments. The environmental rollbacks are unlikely to stop corporations from further investing in low-carbon solutions and climate change. What is likely, however, is for us to see the formation of a much broader and energized base of stakeholders, the new stewards of sustainability, casting their vote for the environment and its protection. ●

9 https://bnef.turtl.co/story/neo2018

10 https://www.sightline.org/2018/08/06/climate-change-hot-voter-issue-2018-midterms/

11 https://news.gallup.com/poll/232007/americans-want-government-more-environment.aspx

12 https://www.sightline.org/2018/08/06/climate-change-hot-voter-issue-2018-midterms/

13 http://www.globalstrategygroup.com/thoughtleadershiptype/business-and-politics/

14 http://time.com/4276603/marc-benioff-salesforce-lgbt-rfra/

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