

As I was watching the first round of the NBA playoffs, it dawned on me that the *art* of anticipation has to be one of the most valued crafts that humans possess. Humans can either **react** to events happening around them, or **anticipate** those events and prepare accordingly. When James Harden has the ball at half court, he isn't going where the defender wants him – he is going to force the defender to go where he wants. He anticipates the defender's move based on what he does; therefore, he has the control. That's what makes Harden one of the best. Anticipation isn't just a sports thing - it's the most powerful tool humans have used for centuries. A good king anticipated the position of a rival army, just as a good merchant anticipated his buyers' needs. A good lawyer anticipates counterparty arguments, just as a good politician anticipates their rivals' motives. A good doctor anticipates his patients' reactions, just as a good team anticipates their opponents' next moves. **The world lives in the future.**

I use the phrase “art of anticipation” very carefully because “skill” implies a consistent and repeatable ability. Anticipating the actions of others will not be consistent. It is an art to be crafted, not a skill to be developed. This is exactly why anticipation is so valued in society – it is **hard**. Humans innately prefer easy & simple, and reacting fits the bill. Think of all the ‘reaction rules’ you know: “when *X* happens, do *Y*.” This is especially true in financial markets and is why algorithmic trading is a force. When spreads are too big, rulesets close them. When headlines drop, rulesets trade them. If there is a quantitative rule that can be written (which = a lot), a computer is learning it. Then algorithms execute (react) against these variables at speeds much faster than humans. So should humans be investing based on their reaction function to daily news flow and PE ratios¹? That is easiest, for sure, but in today's markets reacting will either be late or be wrong. Simply reacting won't work. We must anticipate.

Mid-year Outlook

No changes from our 2019 Outlook, i.e. expect another muted year filled with volatility. Focus on fundamental discipline within a valuation range. Don't chase price.

- Our focus has (rightly) been on labor costs and profit margins across the broader markets, as all sectors (ex-utilities & R.E.) saw margins contract in Q1. While consensus estimates have come down, we see further downside risk in the second half of the year.
- Labor, high inventories, & more tariffs will continue to weigh on margins.
- We don't see a clear path to robust sales growth, as global PMI indices, semiconductors, capital spending reductions, and late cycle dynamics slow the demand environment globally.
- *Our view **versus** consensus: S&P 500 earnings lower, cost inflation higher, GDP in-line.*

¹ PE Ratio identifies a multiple equaling price/earnings. A common “rule” is lower multiple = better value.

Today there are 164 member states of the WTO, 7.5 billion people, 60 major stock markets, and roughly \$80 trillion USD worth of global GDP – in other words, that’s a lot to react to and anticipate. Think of it as a 100-player chess match, it’d be a fool’s errand trying to anticipate every action across the board, therefore, we play to our strengths. This is how we approach markets, by staying in a framework we believe is best suited for our success.

1) **Nothing is simple.** Everything is complex with many variables and outcomes. In a 2010 speechⁱ, former Fed Chair Ben Bernanke said future actions are subject to an equation of benefits/costs/risks. This is how we frame all of our decisions: what is the benefit – for what cost – and at what risk?

2) **Ownership is better than rentorship.** Buying something just because the price is rising doesn’t make you an investor, it makes you a speculator. The average hold period of a security is just 7 monthsⁱⁱ. Very few people can sustain success on a six month time frame without superior speed or superior information.

3) **Maintain a ‘North Star’ to stay on course.** We have identified “DEED” as our macro theme going forward, all of them [here](#). This is incredibly important as our ‘North Star’ keeps focus on the highest conviction themes, not the day’s news flow. “Why did the market go up today?” or “Why did stock X go down yesterday?” are most often questions that involve many variables (see: point 1) and have answers that are often unknown.

Example: *The chart below by GSIMⁱⁱⁱ shows total net equity demand by buyer of the past 5 years. Pension funds & life insurance companies have to sell assets to meet liabilities. Corporations have buyback plans that are subject to blackout windows. Households & foreign investors may lever or delever at any time for any reason. **The point here is that money flows move prices, but the timing and motive of flows is often unknown.** “Watching price is simply seeing liquidity move around.”²*

Category	Net US equity demand (\$ billions)				
	2014	2015	2016	2017	2018
Corporations	\$ 442	\$ 508	\$ 697	\$ 296	\$ 509
Foreign Investors	114	(191)	(188)	125	(94)
Pension Funds	(272)	(7)	(217)	(162)	(243)
Mutual Funds	95	58	(112)	(134)	(124)
Households	95	(138)	(151)	226	191
Life Insurance	(5)	31	98	(45)	(18)
Other	12	(7)	(12)	(17)	9
<i>less</i>					
Foreign equities bought by US	432	197	22	167	128
Credit ETFs	50	57	96	123	100
Included among holders above are:					
Equity ETF purchases	\$ 191	\$ 174	\$ 188	\$ 347	\$ 210

Source: Federal Reserve and Goldman Sachs Global Investment Research

² Quote from hedge fund titan John Burbank III

Where We Stand.

Of course we are constantly evaluating our themes against important indicators, and YTD the fundamentals are playing out as we outlined in December, [here](#). Global growth is slowing down – and YTD data points have confirmed that narrative. Leading indicators in Asia, Europe, and the US have shown a substantial soft spot.³ However, markets have recovered since the big drawdown last quarter – mostly on a dovish turn by global central banks and a strong belief that growth will resume in the second half of the year. We are skeptical about this strong second half recovery and don't believe the risk/reward set up offers much of an opportunity at the broader level. **To put this in portfolio terms – we began the year with a defensive stance, and we hold that same stance today.** We favor US treasuries, defensive stocks, and assets of a better value like international markets & our DEED themes.

Our [2019 Outlook](#) continues to be the playbook going forward as late cycle factors are progressing as we expected. However, there is one big point worth revisiting on page 10:

*“.....we are very far into uncharted territory of central bank balance sheets. In short, the Federal Reserve, ECB, BoJ, & others wanted to provide additional liquidity to boost global growth, i.e. supply the world with money. 2018 marked the first year that this money tree stopped growing globally. Clearly volatility rose and asset prices fell, but how much does this reduction of liquidity matter? **It is really hard to tell. This is a prime unknown risk to markets – in both directions** (they could get the tree growing again).”*

Update: It is still really hard to tell. Central banks have completely pivoted to an accommodative stance, particularly China on the fiscal level. Has this influenced market prices? Has this changed global liquidity? Has this changed market psychology? We know the answer is yes, albeit the magnitude is debatable. This is a variable we constantly contemplate. Second, remember *point 1* on the previous page. This subject fits very well in the complex category.⁴

D in DEED: Demographics.

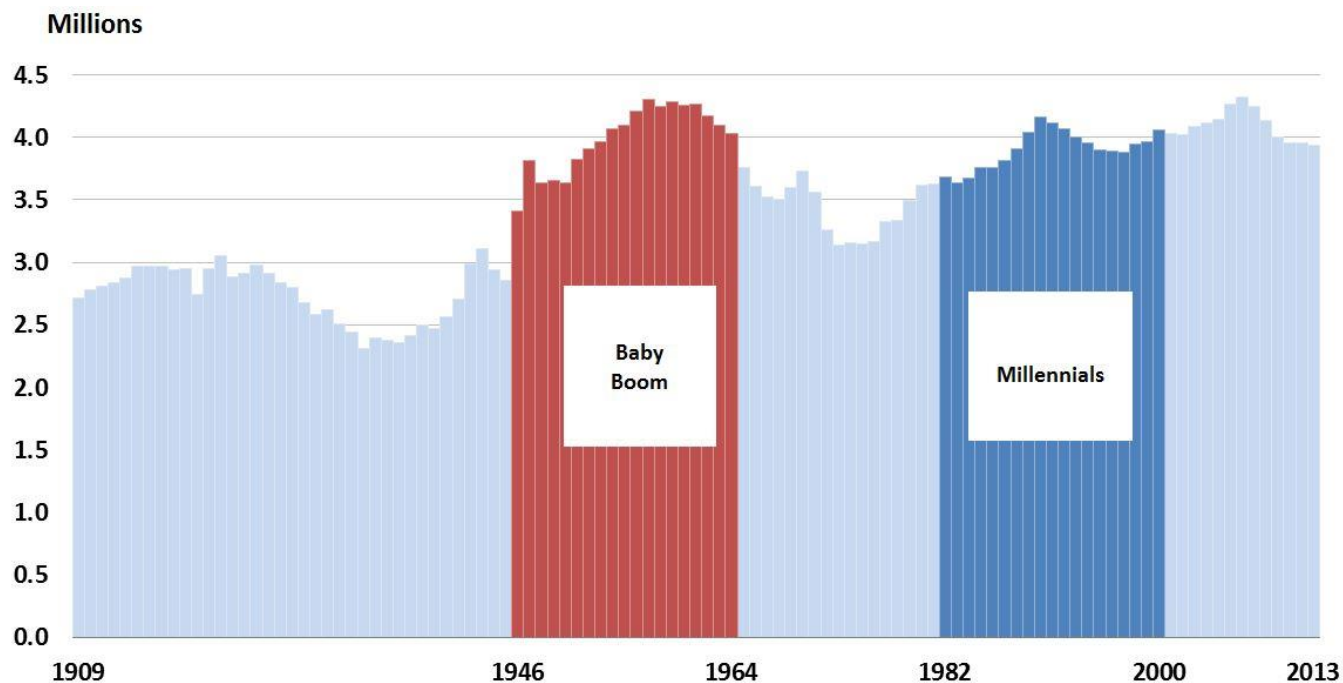
In the summer of 2015, we [wrote about demographics](#) and the importance of the millennial generation. Four years later, it is the first and arguably most important letter in our theme 'DEED'. Of course everyone knows malls are dead, all millennials live either in their parent's basement or a 300 SqFt. Brooklyn apartment (w/ roommates), aging boomers need retirement homes in Florida, and generation X...(wait, what is generation x?). Yes, these are all known trends, citing those is equal to **reacting**. Let's really unpack US demographics so we are better able to **anticipate**. First, some data^{iv}:

- Baby boomers were born in years 1946-1964, millennials between 1982-2000. (P.S. If you meet an 18 year old, they aren't a millennial – that's generation Z.)⁵
- Boomers are 55-73 years old, millennials are 19-37 years old.
- There are roughly 78 million millennials and 75 million baby boomers.
- A “prime” boomer is 55-64 years old, a “prime” millennial is 24-33.
- Millennials are now the largest cohort in the workforce. Millennials are also the largest spending group as well, making up 28% of retail sales ex-autos. Boomers are 26%.^v

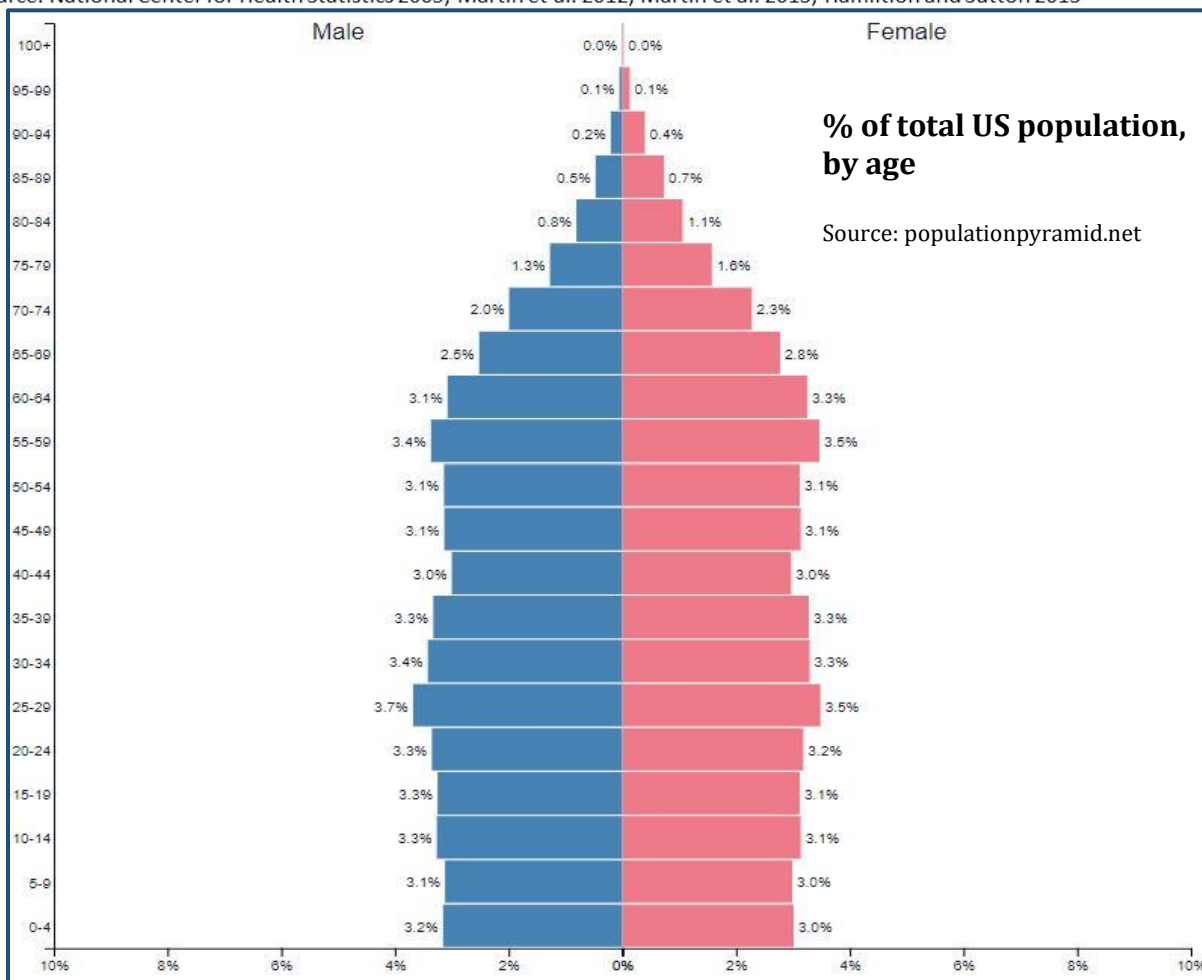
³ We use ECRI, PMI, & ISM data as good leading indicators. Retail sales, new orders, inventories are also used.

⁴ If you're interested in Federal Reserve effects, a good starting point is [here](#) from Mark Dow.

⁵ Note that these years are estimations – different sources will cite different years +/- a few. Think of generations from the median instead of at the fringes.

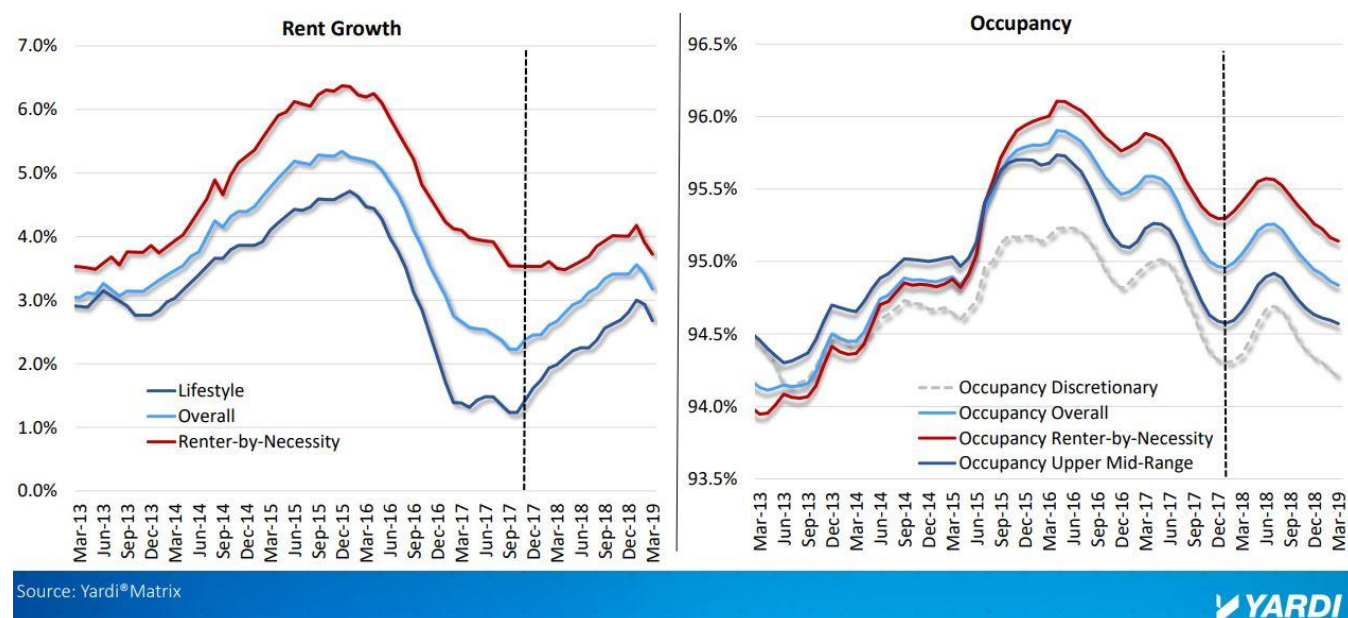


Source: National Center for Health Statistics 2005; Martin et al. 2012; Martin et al. 2013; Hamilton and Sutton 2013



- Millennial spending is growing too, with the # of monthly transactions up 16% since 2012, versus 5% for boomers.⁶

Yes, the last decade of millennials is incredibly well-documented – urban apartments, walkable districts, food blogging, selfies, avocado toast, and so on. Everyone reading this can stereotype the average 20 something. The catch here is, the midpoint of the millennial generation *isn't* 25 anymore – they are 28, 29, 30, & 31 – that makes a *very big* difference. You don't think so? Just look toward those urban core apartments:



Peak multifamily rent growth and occupancy coincided with prime millennials being 25/26 – out of college with a first job making real money in an urban core. Hardly a coincidence, no?

Our 'demographic' theme is one that focuses on millennials embarking on their 30's and boomers entering their retirement years. The transition between the two generations has begun and will define the next decade. Will 'big spending' boomers change reduce their spending in retirement? We know what 20-something millennials have been – but what will the millennial family be like?

First, it is important to note that millennials are different from their parents (boomers) in the same way boomers were different from theirs – *i.e. just at the margin*. So no, it's not really different this time. It *may seem* different because millennials do things in a different way and on a different time frame, but that is par for the course. Every generation forges their own path. Early boomers enjoyed Woodstock in 1969, just as millennials do the same at Coachella⁷ today. In the 1970's high school boomers changed American culture and society, followed by the 1980's where young worker/family boomers shifted businesses and spending. Today, think of all the subscription business models, "cut the cord"⁸ movements, strip mall turned restaurant patio

⁶ According to internal Bank of America card data.

⁷ Large music festival

⁸ Referring to cancelling cable subscriptions in lieu of internet & streaming only.

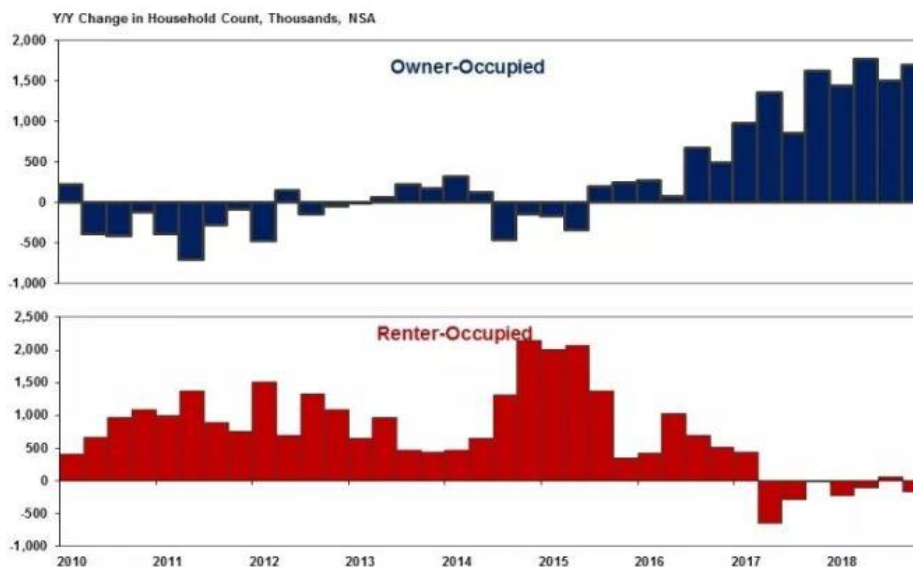
spaces, and so on. Businesses change with preferences. Boomers impress friends with a new suit, a new car, a bigger house, or an exclusive country club. Millennials aren't different! (why do you think Instagram was made?) Millennials impress their friends with Patagonia gear & Yeti coolers, a Thailand vacation, fancy small plates, or an exclusive pool party. *It's really the same, just different ways of expressing it.*

Housing

Coinciding at these demographic crossroads is single family housing. One of our largest themes in its simplest form: 1) millennials are still starting families and buying houses, 2) the average first time home buyer is 31 & the median millennial is 29, and 3) there is a shortage of houses.

- 1) Millennials are still starting families, buying houses, & doing things young people do. The average age of getting married, buying a house, and having a baby is between 29-34. That prime cohort of millennials is now hitting those ages; thus doing all the big life things every generation before them did as well.

Household Formation Changes



Household formation has picked up and home ownership has also turned the corner.^{vi} Share of grocery (eat-at-home) versus restaurants continues to gain steam among millennials as they age out of their prime eating out years.⁹ We fully expect to see 'baby mania' pick up in the next five years as well.

⁹ Per Morgan Stanley 2018 Survey

Power & Policy

The second largest ad company in the world is run by a millennial (Facebook/Instagram/Whatsapp).

Kimco Realty? Millennial. Airbnb, Lyft, Groupon, Spotify, Dropbox, Stripe, Blue Apron – all millennials.

One look at the composition of VC & PE firms and you can see investable capital is increasingly young as well.

Put simply, a regime shift is happening and it shouldn't catch you by surprise, everyone gets older.

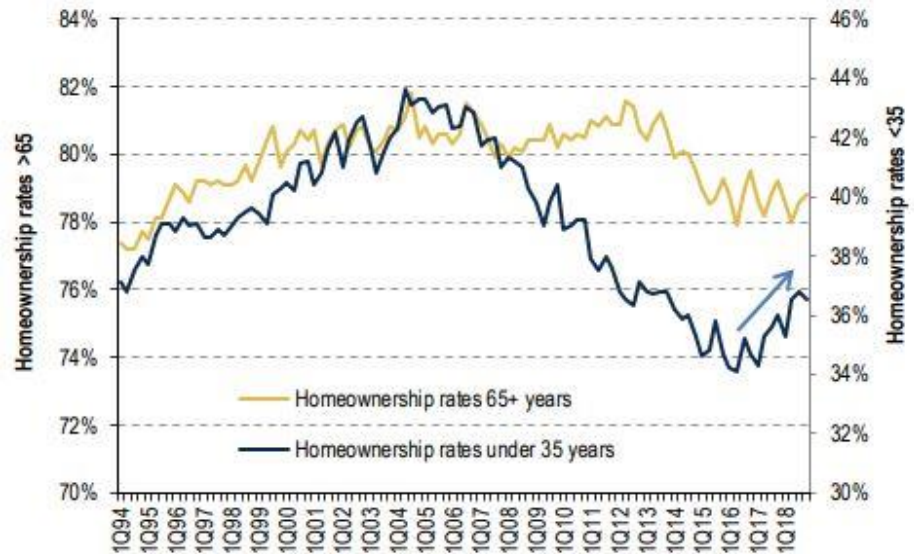
CEO turnover is the highest it's been in a decade as C-level executives retire. Pre-2018 midterms there were 6 millennials in congress, now there are 26 (5x). Remember the stat from above – "Millennials are now the largest cohort in the workforce. Millennials are also the largest spending group as well, making up 28% of retail sales..."

The point here is that consumer preferences, policy, and corporate behavior is shifting from one generation to another, just like it has in the past. This shift will define the next decade, will be long, and will be turbulent at times. To anticipate, you must have ample context of the moving variables – and this is likely one of the biggest there is.

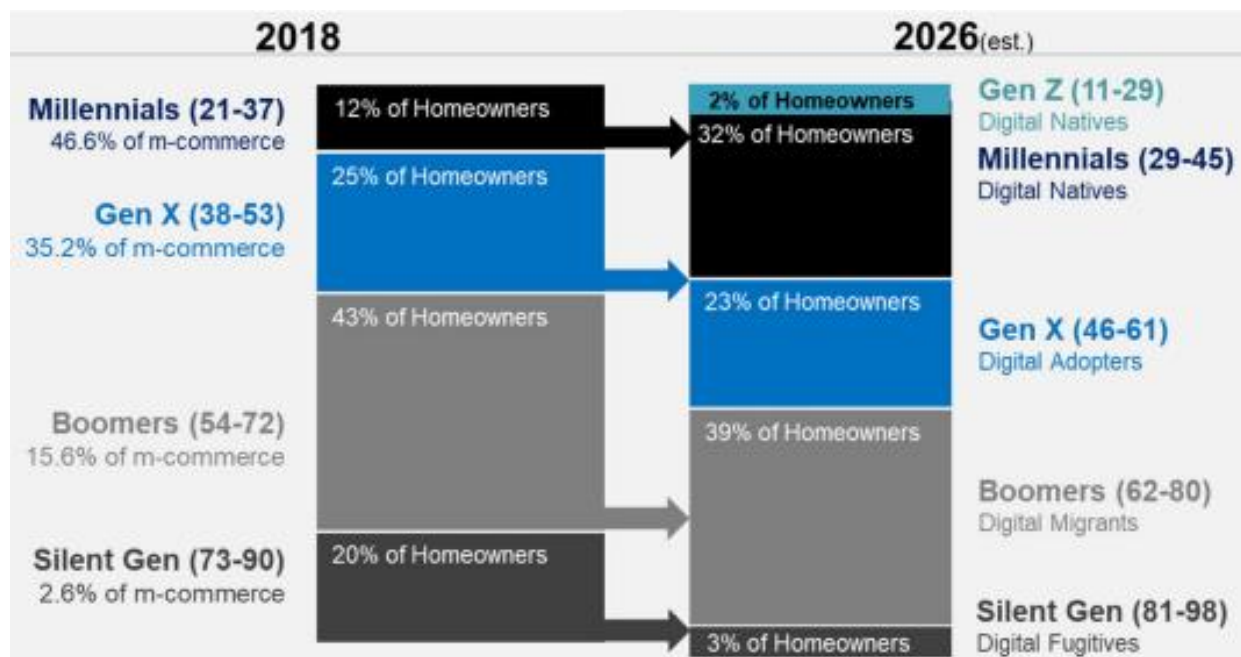
Don't discount it.

2) The average first time home buyer is about 31 years old, corresponding with the under 35 homeownership rate turning the corner. Context here is important – the median millennial is 29, so we have a long tailwind here.

As millennials move up the corporate ladder, form families, and have kids, naturally the 500 SqFt. downtown studio is left behind in favor of a school district and more square footage.



Source: US Census Bureau

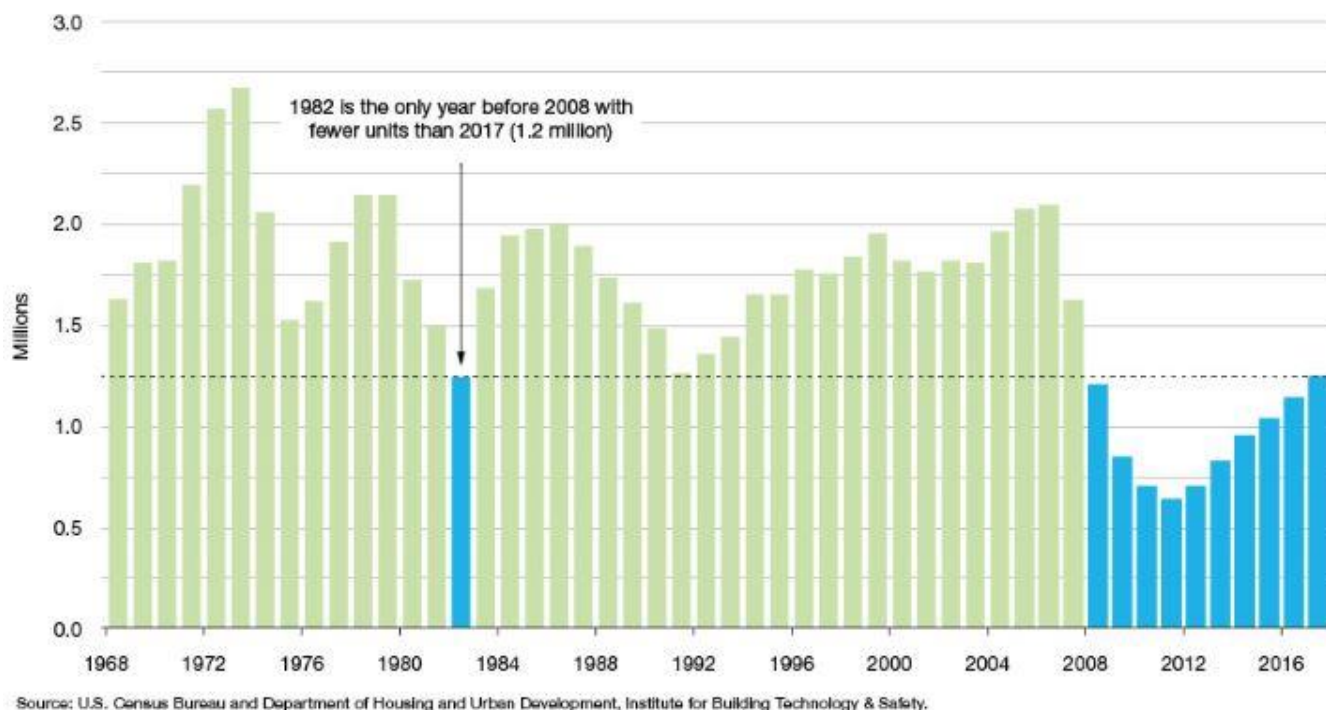


3) There is a shortage of single family homes. **Ok, this is where things get complicated.** First, as seen on the next page on the chart from Freddie Mac^{vii}, the US has underbuilt single family homes since 2008, leaving us very short homes. Our calculations show that the US was oversupplied by roughly 4 million homes in 2006 and is now undersupplied by about 2.3 million homes, assuming a constant homeownership rate.¹⁰ We've worked off all that excess inventory in 2006 and now found ourselves in a deficit. **So, build more homes! Possibly, but of course it isn't that easy.**

¹⁰ We held constant a 62.5% homeownership rate, where the peak in 2006 was 66%, the low in 2009 was 59%.

Supply of new U.S. housing (1968–2017)

The supply of new housing is low by historical levels



The **anticipation** here comes from behavioral economics of millennial home purchases. By and large, generations consistently do the same things (desire a home), **but in different ways**. Step into the psychology of a millennial here:

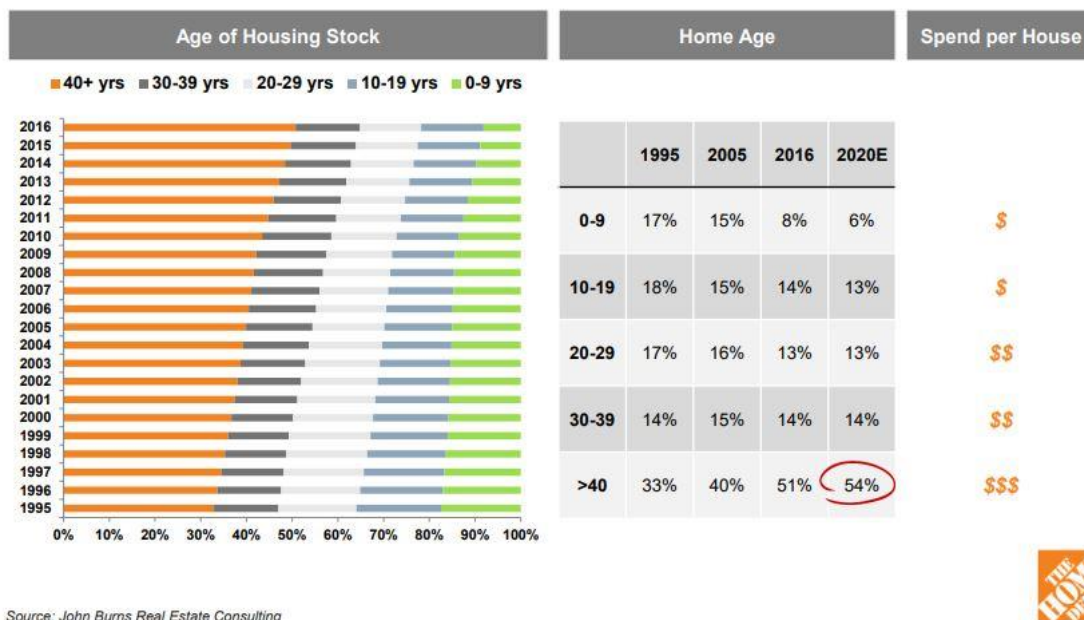
The average millennial's first adverse "real-world" event was the 2008 housing crisis. They possibly saw parents and friends go underwater and heard countless tales of "Don't ever..." Aging into a severe recession formed a lot of preferences & delays: sharing economy, adversity to credit, renting, and movability. Put simply, millennials don't want a big house or a big mortgage. They don't (truly) believe a house is an ironclad investment and won't overpay. They favor central location over size (& everything else).^{viii}

Enter baby boomers on the verge of retirement, looking to downsize from their 4,000 sq. ft. home in a suburb golf community an hour from downtown. Fannie Mae estimates that roughly 14 million boomers will no longer be homeowners by 2035.^{ix} Yes, we have ourselves a mismatch that will be interesting to watch.

Staying on the millennial side however, let's look at our prime buyer over the next decade:

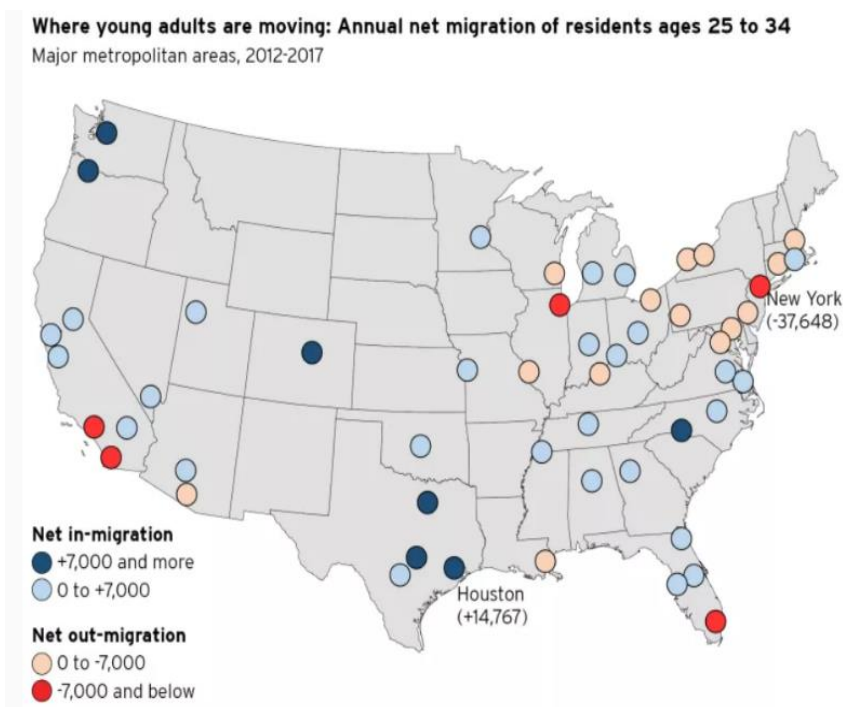
- Doesn't want "too much house" with a huge mortgage.
- Wants space but with the urban feel (urban suburban).
- Desires an eclectic, unique, or modern feel (anti-cookie-cutter).
- Is acutely aware that a home can lose or gain value.

What doesn't meet that demand? 1990's style Ryland 5br homes with a \$500 HOA and 75 minute commute. What does? The pre-1990's 1,800 SqFt. ranch style home on the street with 100 year old trees, 25 minutes from downtown and 5 minutes from a grocery store, rooftop bar, & dog park brewery. Does America have a lot of those? You bet.



The slide above from the recent HD investor day presentation what we are trying to say – next year roughly 54% of the US housing stock will be over 40 years old. These older houses are closer to metros (urban suburban), are cheaper and smaller, and have a uniqueness to them as renovations are rarely uniform.

Before you start flipping a bunch of 1920's homes, it's worth taking it one step further to recognize that **housing is very idiosyncratic by locale**. Outside of normal geographic variables, the migration of millennials also plays an important role. Millennials moved to the US mega cities out of college and like the urban environment. But even that 1920's house we mention inside the beltway of DC is out of most price ranges.¹¹ So do these millennials save harder and wait another 5 years? No, they just leave.^x



¹¹ Look for yourself: <https://www.redfin.com/zipcode/22003/filter/property-type=house>

The chart by Brookings captures this really well. A millennial apartment was great in New York or Chicago, but their house is great in Austin or Portland. Locale matters!

Key Takeaways:

- 1) Single family homes are and will continue to be in high demand as millennials enter their prime home buying years.
- 2) Both new build and repair & remodel (R&R) segments should be strong; however, we tilt slightly to R&R.
- 3) Geography is of the utmost importance. Migration trends are increasingly favoring the second-tier cities over the mega ones.
- 4) Millennial housing demand is fairly price elastic. Huge price spikes over a short period shouldn't have too much runway. This will differ a lot by region.
- 5) Large higher end homes may not have a buyer. *This will be interesting to watch.*

This is one of four themes in our macro framework as we direct our focus to assets with both exceptional valuations and secular tailwinds; navigating our way through this late-cycle environment.

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ⁱ Bernanke, Ben, https://www.federalreserve.gov/newsevents/other/o_bernanke20101105a.htm

ⁱⁱ Yusko, Mark, Morgan Creek Capital Spring 2019 Investor Presentation

ⁱⁱⁱ Goldman Sachs Investment Management Investor Presentation

^{iv} Pew Research Center, <https://www.pewresearch.org/topics/demography/> & Federal Reserve Economic Data, <https://fred.stlouisfed.org/>

^v Bank of America Merrill Lynch, April Investment Note.

^{vi} https://www.jchs.harvard.edu/sites/default/files/Harvard_ICHS_McCue_Household_Projections_Rev010319.pdf

^{vii} http://www.freddiemac.com/research/insight/20181205_major_challenge_to_u.s._housing_supply.page

^{viii} <https://www2.deloitte.com/insights/us/en/economy/issues-by-the-numbers/understanding-millennials-generational-differences.html>

^{ix} <https://latest.13d.com/baby-boomers-millennials-real-estate-housing-downsize-97186b0e0ed2>

^x <https://www.brookings.edu/blog/the-avenue/2018/03/06/millennial-growth-and-footprints-are-greatest-in-the-south-and-west/>

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