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Powell's Puzzle

Like many celebrators, stock markets rang in the new year with a wobble. The quarterly total return for the S&P 500 of -13.5% was worse than all but 5% of quarterly periods in the index's history. Average share price volatility, as measured by the CBOE Volatility Index (VIX), was the highest since 2011. But the yearly decline in US stocks was more tame, with the S&P 500 posting a total return of -4.4%. Share price declines were not evenly distributed; international stocks generally fared worse, with a total return of -14.1% for the year for the MSCI World ex-US Index.

The newfound fragility in the markets is due in part to the poor hand dealt to Federal Reserve Chairman Jerome Powell. Following ten years of low interest rates and quantitative easing that contributed to corporate earnings growth and asset price inflation, the Fed is attempting to raise rates and reverse the swelling in its $4 trillion balance sheet in order to stockpile needed stimulus for future economic cycles. The market's mounting concern that this may nudge the US into recession has induced the recent view that the Fed may stop tightening or even cut rates, but other factors may cause future interest rate changes. Tax cuts that were enacted a year ago contributed to an increase in US Treasury debt issuance from $546 billion in 2017 to $1.34 trillion in 2018, and the Office of Management and Budget expects trillion-dollar deficits to continue for the next four years. The last time Treasury issuance was over $1 trillion annually – from 2008 to 2012 as the Great Recession was taking its toll – the Federal Reserve was a voracious buyer of Treasury debt, sopping up $2 trillion in order to keep interest rates low and inject liquidity into the sputtering economy. This go-round, the market will have to absorb the extra supply of Treasuries without the Fed as a buyer. If that supply/demand imbalance pushes rates higher, debt service payments will be pressured at a time of record leverage. The Federal Reserve Bank of St. Louis reports that US federal and corporate debt have grown 128% and 84%, respectively, since the beginning of the last recession, compared to 41% growth in GDP.

We don't spend our time trying to predict Chairman Powell's next move or when the next recession will arrive, but we do think about the longer-term impact of economic policy when constructing our portfolios. Our strategy provides ballast against the risks discussed above in three ways. First, our portfolios are conservatively positioned with higher than normal balances of cash equivalents that now have palatable yields above the rate of inflation. Second, our bottom-up fundamental analysis of companies is oriented around strong balance sheets that can withstand economic cycles, and businesses with enduring competitive advantages that increase normalized earning power over time. Third, rather than piling into the broader markets simply to satisfy an arbitrary allocation, we scour the globe and target areas that we believe offer the best values. We are finding attractive investments internationally, in markets where average stock valuations are roughly half of those

in the US market. Within the US, we remain focused on sectors where absolute valuations are compelling, including bank, energy, and healthcare stocks.

While the long-term trend for stock market prices is upward, they have oscillated liberally around fair value throughout history. We view stock market corrections as opportunities to buy more normalized earning power per dollar invested. In other words, lower prices are the ultimate fuel for higher returns.

New Investments

China is of great interest to us because of its long-term growth prospects, highlighted by the tenfold increase since 1999 in per-capita gross national income (GNI) to $8,700, according to the World Bank. McKinsey notes similarities to China's progression with that of Japan in the 1950s and 1960s, and South Korea and Taiwan in the '80s, all of which experienced rising incomes, urbanization, and better education. China's evolution is on a much larger scale, with 800 million people having emerged from poverty in the last two decades. The still-wide gap with US per-capita GNI of $58,000 suggests a long runway of growth for the Chinese middle class.

That secular growth story has recently been overshadowed by a cyclical slowdown in China's third quarter 2018 GDP to 6.5% – the lowest growth rate since the first quarter of 2009 – and the festering trade war with the US. In reaction, stock exchanges in Hong Kong and Shanghai have plunged into bear market territory. That presents opportunities, especially in technology. China has the world's largest and rapidly growing e-commerce market, higher penetration rates of e-commerce and mobile payments than the US, and a small handful of entrenched franchises that are capitalizing on those trends. At the top of that list are Alibaba and Tencent, whose shares we purchased in the second half of 2018 at 30-40% discounts from their January 2018 highs.

Alibaba

Alibaba (BABA), founded in 1999 by Jack Ma, is China's largest e-commerce company with 58% market share, according to eMarketer, and a revenue growth rate of over 50%. It executes more transactions than Amazon and eBay combined. The company's 601 million annual active consumers are growing at an annual rate of 23%, and engagement among those consumers increases over time. In fiscal 2018, consumers who had used the platform for five years spent four times as much money across four times as many product categories compared to consumers who had used the platform for one year. We believe sticky customers are Alibaba's core competitive advantage. This phenomenon is similar to that of banks that layer services on to their customers, beginning with checking accounts that lead to direct deposits, credit cards, mortgages, and automated bill payments. Each additional service acts to lock in the customer because the inconvenience of switching increases. Similarly, a new Apple customer might start with an iPhone, and then purchase apps, subscribe to iCloud storage and Apple Music, use Apple Pay, and eventually buy more hardware. Alibaba's core retail service becomes part of its customers' routines, and provides the company with a pool of good prospects for its other services, some of which are described below.

Jack Ma has consistently reinvested the company's cash flow to strengthen its core franchise. Nowhere is his investment mindset more exemplified than with Ant Financial, Alibaba's 33%-owned financial services affiliate that was last valued at $150 billion in a private transaction. Ant Financial's Alipay has the #1 market share of Chinese mobile payments with 54%, compared to 40% share for Tencent's WeChat Pay, according to iResearch Consulting Group. Alipay has about 700 million active users, nearly three times as many as PayPal, which has a market cap of $100 billion. According to iResearch, mobile payment transactions in China have experienced explosive growth from $200 billion in 2013 to $15.4 trillion in 2017. That compares to $12.5 trillion of transactions processed by Visa and Mastercard globally last year. US mobile payment transactions in 2017, including for PayPal and Apple Pay, were only $377 billion, estimates Javelin Strategy & Research. Alibaba (and Tencent) have created pervasive payments networks, but have barely scratched the surface of monetization from transaction fees and other products such as money market funds. China has shown the world what disintermediating the payments industry looks like, and Alibaba and Tencent offer reasonably priced opportunities to own the new model.

Another area where Alibaba has invested is cloud computing, where it is the top player in China with about 33% market share, compared to Tencent's 15%, reports The Economist. Its cloud revenue grew 90% in the September quarter, and is about one-tenth the size of Amazon Web Services, suggesting a tremendous growth opportunity. Its service offering has further been enhanced by acquiring Cainiao, a leading logistics company, and Ele.me, a leading online food delivery business, and it's leveraging its active user base to grow Youku, China's third largest online video platform. Youku's daily average subscribers grew over 100% in the September quarter, and five of its original shows ranked in the top 10 last year by Douban, a top commentary community in China. Alibaba now has the fragmented offline retail market in its sights. According to The Economist, China's five largest supermarket companies have 27% combined market share, compared to 78% in Britain. China's six million independent shops are disadvantaged against Alibaba's ubiquitous brand name, technology and distribution infrastructure, and trove of consumer data. Outside of China, the company has expanded through the acquisition of Lazada, the largest e-commerce operator in Malaysia, Vietnam, Thailand, and the Philippines.

Last fall, Ma announced that he will retire as executive chairman in September 2019, and will step down from the board in 2020. As the company's founder, with ownership of $28 billion of stock, Ma has every incentive to orchestrate a careful and orderly succession plan. He relinquished the role of CEO in 2013, and the board removed his first successor in 2015. Over the last four years, Ma has grown comfortable with current CEO Daniel Zhang, who has been with the company since 2007, and will succeed Ma as chairman.

Alibaba has generated positive free cash flow for the last eight years, has $8 billion of net cash, a $50 billion stake in Ant Financial, and $30 billion of value marked on the balance sheet from equity investments in various companies including Lyft, Didi Chuxing (China's leading ride-sharing business), and Paytm (India's leading payments company). At our purchase price, the $350 billion market cap was 22x consensus earnings estimates for next year, or 17x excluding net cash and equity investments. In our view, the multiple is a bargain considering its entrenched and high growth businesses, strong balance sheet, and the potential value of its private investments.

Tencent

Tencent (TCEHY) is China's largest internet services company, with leading franchises in social media, messaging, gaming, payments, and music streaming. Its multipurpose WeChat app, with over 1 billion users, is the heart of its ecosystem and driver of about half of revenues, primarily from social networks, advertising, and payments. Gaming, the company's other primary business, accounts for about 40% of revenues. Tencent has the #1 Chinese market position in publishing both PC games, with 66% share, and smartphone games, with 38% share. Aside from the broader reasons for the pullback in Chinese stocks discussed above, Tencent's shares have also been punished because of a government directive issued last summer to limit the number of online games and restrict playing time as part of an effort to prevent myopia in children and teenagers. This is one of many challenges Tencent has faced in its evolution, and we view the reaction in the shares as shortsighted. Limiting games may actually strengthen Tencent's market position because of its unparalleled development and distribution resources, as well as its recently announced player ID verification system.

The genius of WeChat is its universal functionality including social networks, messaging, and mobile payments, the latter of which has 800 million monthly active users and 40% market share, up from 10% in 2014. The WeChat ecosystem is further buttressed by the availability of 1 million "mini programs", or quick-loading, slimmed-down apps. Users can perform a range of functions including shop, search, watch videos, read news, order food, hail cars, book restaurants and doctors, present government-issued digital identification, and transfer money, all without leaving the WeChat app. Just two years since its introduction, this app store is already half the size of Apple's, thanks to app developers' attraction to WeChat's broad reach. It all adds up to high user engagement; the average WeChat user spends more time on the app than the average user of Facebook and Instagram combined. Yet, WeChat has tremendous untapped earnings potential because it hasn't pushed advertising nearly to the extent of Facebook. Morgan Stanley estimated in 2017 that WeChat earned $2.10 per daily active user compared to $30.10 for Facebook. Another growth avenue is geographic expansion, especially in Southeast Asia. WeChat has 20 million users in Malaysia, or nearly two-thirds of the population.

WeChat's development exemplifies the long-term mentality of Tencent founder and CEO Pony Ma, who in 2010 embraced the market shift to mobile even if it meant the ultimate destruction of QQ, the company's dominant desktop-based messaging system. This is reminiscent of Apple's 2007 launch of the iPhone, which essentially destroyed the company's then flagship iPod product line. For WeChat, Ma fostered internal competition to spur innovation by tasking three disparate teams to develop the new mobile messaging platform. This strategy proved effective as it was not the legacy QQ team – who were anchored to their existing product – that won the competition and commercialized what became WeChat.

Tencent and Alibaba have become China's leading private financiers. The Economist estimates that the two tech behemoths, along with search company Baidu, have collectively invested in half of the 124 Chinese unicorns (privately held startups valued at more than $1 billion), and 80% of private Chinese companies valued at more than $5 billion. Among Tencent's holdings are JD.com, Flipkart (India's largest online retailer), Didi Chuxing (China's largest ride-sharing company), Tencent Music (China's largest music streaming company), Tesla, and Meituan Dianping (ticket

booking and reviews business similar to Groupon and Yelp, as well as food delivery). Tencent is beginning to spin off certain businesses, such as its music streaming business, and could follow a similar path to that blazed by TCI's John Malone. An investor in TCI in the '80s would have eventually owned about 15 different stocks through spin-offs.

Tencent has generated increasing free cash flow for the last six consecutive years, and is growing revenues at 30%. Cash plus the balance sheet value of investments in affiliates and available-for-sale securities, net of debt, was $35b at the end of 2017. Excluding net cash and investments, our shares were purchased at 21x 2019 consensus earnings estimates for the core business. We view that as an attractive entry point for an entrenched, high-growth business.

As always, please reach out to us with any questions or comments.

Sweetbay Capital Management

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Different types of investments involve varying degrees of risk, and there can be no assurance that any specific investment will be profitable. The New Investments section describes each new security in which we initiated a position during the referenced six-month period. Every security may not have been purchased for each client based on the timing of a particular account opening, or based on assessed needs of a particular account.

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