**FOOD, HOUSE, CAR**

The parable of the blind men describing an elephant comes to mind. "Like a snake," says one, as he feels the trunk. "No," perhaps like a tree," declare another as he tries to encompass a leg. "Absolutely not" says a third," it's like a palm leaf", as he rubs the giant ear.

I suppose the men could, in short order, assemble a credible description of an elephant by linking their observations.

We observers and commentators on world economics try to do the same: try to assemble a credible description of any economy from disparate views. Worse, we then try to forecast from what we individually think we found. We study each economy, willing to allow some are "emerging," some are "developed" and some, even, are "mature."

In any case, the yardsticks we use – per capita GDP, inflation, industrial growth rate and the like, tend to be used as if each economy was at or near the same point of development. Even when it's acknowledged there might be different stages of development, we often fail to note the stages themselves lengthen or shorten as technology or even human life expectancy improves.

Consider, for one simple example, how Africa, lacking the copper wire-and-pole system for telephones can leap straight to wireless with no aged infrastructure to remove, much less find a use for, as we persist in doing.

In 1960, W. W. Rostow published a book titled *The Stages of Economic Growth: A non-Communist Manifesto*. In his view, there were 5 stages:

- Stage One: The traditional subsistence society of basic agriculture, some hunting and gathering. There was little if any economic mobility and change, Rostow felt, was viewed as threatening. One individual was pretty much like another. In brief, an unchanging food and shelter focus. Describing such an economy today is rather straightforward.

- Stage Two: With passing time and population growth, need arose for materials not locally available. Perhaps more timber or maybe animal pelts became an issue. The gradual introduction of efficiencies such as communal wells or sale of surplus crops also began. We think of it as early commercial agriculture with some changes to both the farming or growing environment and subtle changes to the social structure around it. This occurred particularly for individual mobility. Some "technology" appears: canals to route water, the harnessed animal, a rudimentary plow or a mill to grind crops. Some individuals began to specialize. Food and shelter are now joined by broader mobility, mobility beyond running for safety.

- Stage Three: In this stage, towns form, generally around either agriculture or the shipping of goods. Ports appear. New specialties such as coopers or blacksmiths rapidly expand.



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After food, Rostow notes, shelter and clothing take on even greater importance at this point, leading to early industrial-like plants for weaving or sewing. The order is important: Food, then shelter. Mobility allows bad things also---external conflict and internal social divisions sharpen and grow more numerous.

- Stage Four: a productive base for secondary or supporting goods exists. Now multiple industries grow: Blades for tools, machines to mine ore, newly created metals and large-scale production of industrial goods. The fast-growing segment of consumer goods, particularly around transportation and housing, appears. Parallel to this urbanization and shift off the farm to the city/consumer comes larger schools, hospitals, social controls like police, fire and regulatory agencies.

- Stage Five: Rostow postulates that the fifth stage is when creating the <u>means</u> of production, heretofore the dominant social objective, takes second place to <u>producing goods</u> for mass consumption. No longer is society defined as solely industrial or solely agricultural. No longer do primary industries like fishing or lumber dominate. Their output is either directed to consumer goods or replaced by imports from nations still a stage or two behind.

He contends countries go through these stages fairly linearly, but acknowledges that time, both between stages and stage length, varies greatly. Basic needs, food, shelter and mobility, always remain. The overlap of Stages and transitions Stage to Stage within a given nation are highly apparent i.e. China still reflects all 5 Stages.

Building the infrastructure – the ports, the roads, the canals, the cities is, as Rostow puts it, very much a governmental process, a top down development – a few powerful citizens hiring/ordering others to build a pyramid, a dam, a city in Mongolia; a top-down process.

Ultimately, this Stage grows smaller and economic growth primarily from building dams or mining ore or fabricating cities, peaks.

At some point, domestic food and raw materials sufficiency is found and export markets are opened to help maintain employment and subsequent further growth (and civil order). That, too, on a global scale, has a point of saturation as other economies now compete on all fronts with you and each other.

Demand now comes substantially internally, bottom up from the citizens, for goods and services. This cannot be top-down mandated. It is much affected by individual need for status or convenience or necessity. The industrial understructure continues but the immensely broad consumer goods society takes the key role. Basic needs remain the key drivers, though, remain: food, shelter, mobility.



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It isn't hard to go around the globe and roughly place nations along this 5-stage continuum. One quickly notices both the laggards and their reasons for being behind. Corrupt? North Korea. Social distortions? India. Continuing conflict? The Middle East. Be it China or Brazil, Greece or the United States, one can see the top-down forces once in dominance evolving away. China, trying to transition to a consumer/consumption economy, Russia trying to return to another time, a time of top-down authority . . .

In the U. S., we are at the highest level to date of consumerism. We, and all nations at this stage for that matter, must deal with those still seeking to centrally plan individual needs. Economists arrive with plans. Fiscal and monetary policies are created and tweaked to optimize the centralized search for individual economic wellbeing---as if it was known for each citizen. The struggle breeds "isms" of all types. E.O.Wilson summed it up when he said that even today "we are a Paleolithic (mind) people with medieval institutions and powerful technology". He saw that as the worst possible combination…and still the basic needs remain.

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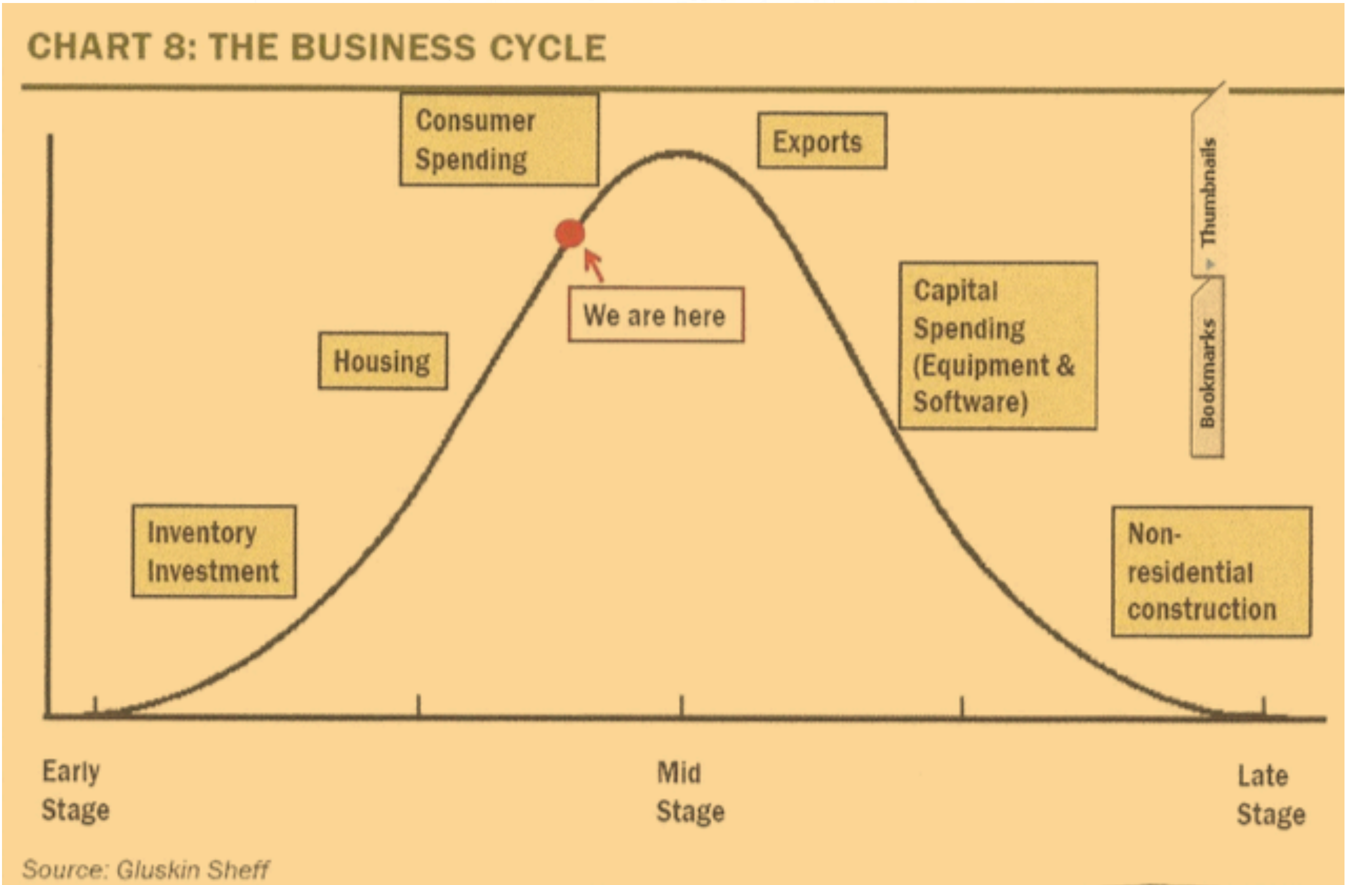
In this country the evolution to a near total consumer society grew in earnest after WWI ended – you all know the history. The businesses cycle, with its over invest –under invest, over optimistic, too pessimistic management of labor, of capital, and of goods production, arrives. Self-generated by consumers it can also be self-correcting, but a cycle nonetheless. Here is one view of the current cycle:




The two huge engines of our economic growth persist: cars and homes. Both are characterized by literally thousands of downstream suppliers, large numbers of employees and, most important, the ongoing human demand for shelter and transportation. We can, some other time, debate whether 16,000 square feet is shelter or a small hotel, whether a Prius even makes sense, but the commonality of shelter and mobility is deeply embedded. Some will propose that deep in any animal, we humans included, there exists at least three inviolate needs: Food, shelter and mobility. The fourth need, reproduction leading to a growing society, cannot exist without great stability in the first three.

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As investors our interest is in Economies worldwide and at various stages of both overall economic development and their individual citizens basic wellbeing. This wellbeing is frequently reflected to the extent there is need for shelter and mobility. As we select stocks, for instance, we may find ourselves selling or reducing exposure to an industry in one country while increasing it in another. Country Stage of development is very important to stock


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selection. Cosmetics, for example, may be of greater interest (as an early luxury) in a Stage Three country than in a Four or Five.

A word about mobility. In most Fifth Stage countries, it's for work and leisure; in perhaps a Third Stage nation, it's near always for work, be it to get there or to facilitate it. Governments, I suspect, will always toy with mass transportation system as a bridge solution (or the only solution if you believe California's politicians). The reality, I surmise, is that when means allow, the citizens of any nation will opt for personal transportation – and for reasons they only partially suspect. The same can be said for shelter: my own cave , not a shared one.

The point is that governments in Fourth and Fifth Stage nations were weaned, purposed, on top-down control. Very logical for dams and roads, not so much for consumer well being. The trend toward my own home, my own transport, will be and is already clashing with the will of those in various positions of control.

In the United States then, it behooves us to take a look at these important elements of shelter and mobility – they are both very much still in flux. Food is not the lead-off issue.

**HOUSING**

The last housing boom – the one that ended in 2005-2006, was a finance-driven boom not a demographic one.

To date, student loans, unemployment, low wage growth and tighter lending standards have created significant pent-up demand among the largest generation in history: The millennials. Housing is on pause, though, yet again for financial reasons.

The consensus is that housing starts will rise from their now deeply depressed rate of 1 million annually to a 1.2 million to 1.4 million rate over the next few years. That would be more in line with the 50-year average. What consensus does not fully weight is the sheer size of the millennials coupled with now near a decade of much reduced starts, much reduced consumption. There are about 73 million of them – a bit over 20% of the population. They are the largest demographic group this country has ever seen—far bigger than the boomers.

What captures my attention beyond that pent-up demand of millennials is the behaviors of the boomers. I've written before that they have had a severe shock over the last 10 years. Zero interest on savings, massive layoffs and a continuing decline in minimum-skill jobs, all leading to more controlled spending. I think "age in place" – staying in their current home – will be a new significant factor. Supporting it are things like advancement of mobile health services, disconnecting the doctors office from patient attention with practical nurses (and CVS Pharmacy in-store service), providing transport via services like Uber and, not least, a new effort to eat better, exercise more and generally try to stay healthier.

The net effect, it seems to me, could be a shrinking stock of used homes and a slowing in the building of ubiquitous "retirement communities." Fewer "McMansions" are already evident.


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Recall that the size of the GenX generation, born between 1966 and 1985, was small – very small. It is often described, in fact, as the "baby bust" time when their parents were busy on the career track. It follows that a slump in housing demand 25 or 30 years later was inevitable based solely on demographics. Of course loose credit and too much money falsely boosted the number of homes they did buy – until 2007 when it all fell apart, credit wise.

The housing bust that followed suffered not only from the credit disaster, but also from the much smaller number of potential buyers. Hence the trend to give a mortgage to anyone breathing---Washington knew, I suspect, the ramifications of weak home demand on the labor force. GenX, though, has rather fallen through the cracks as an economic force.

The millennials – born between 1986 and 2005 – combined with the boomers, are larger than the generations they replace. The millennials living at home are a larger-than-ever group restrained by financial issues, not a lack of desire for a home. The recession hurt them; the recovery has been far slower than normal, but the pent-up demand is, I believe, very much alive.

Marrying later, the millennials have further altered the trend of home buying with that delay. Once married, of course, renting looks less attractive and the desire for everything from more room to children begins to enter the equation.

The outlook for housing is far better than most investors think. The demographics don't lie and I think we are seeing the early, if halting, first steps this year. The largest generation in our history is on the move after 30 years in the making. A guess? Maybe 1.9 million starts annually.

Credit: Daniel Rohr (*Morningstar*)

**<u>AUTOS</u>**

To literally survive, you need the ability to move. You move to avoid sudden danger or to follow game or water or a milder climate, but moving is critical. Today it may be as basic as finding work if you do stoop labor in the Central Valley or construction jobs in housing, but move you must.

If we go looking for the bridge from the ox pulling a plow to the BMW , I suspect we'll find it in Dearborn, Michigan. It occurred elsewhere, I'm sure, but to my mind Henry Ford was wise selling his first cars with an accessory we seldom see today – a power take-off to run a thresher or a pump or any device requiring an engine to ease the human work load. Perhaps the last vestige of this evolutionary step is the Jeep with a front winch . . . seldom used, of course.

But Henry had the original goal of moving people and then goods over greater distances. What triggered cars is clear: Horses were polluting the streets in town, needed to be fed, had the risks of injury or disease while a farmer could keep a simple car running almost indefinitely.


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People trapped on farms (his demographic), he felt, needed to reliably travel to town, to church, to relatives. He saw the same need the first oxcart-maker saw and then some.

Anyone, anyplace, can launch a car company – and hundreds did in Michigan alone. Therein lies today's issues: The consumer has endless choices by cost, color and purpose. The issues compound with demands for durability.

Planned obsolescence today is built around styling and gadgets; this was not the case 20 or 30 years ago when poor quality and poor construction gave cars an average 6-year life. Today 10 or 12 is normal. Manufacturers now face the twin goals of selling more cars into a market where cars must be more durable and last longer. Cost and style become delineators over durability and purpose.

Car makers worldwide and especially here, have had a great run. Growth in unit sales, a byproduct in part of the temporary success cheap money brings, has seen a double in output here in the States over the last decade or so. September, in particular, was a great sales month reflecting higher consumer confidence, cheap gas prices and the Holiday weekend ( a big car shopping day) falling where it did.

The overall trend, therefore, is still weakly upward. Profitability is very good for the largest manufacturers. Globally, about 88 million cars will be sold this year, but that's up less than a percent from last year.

Falling sales have to be occurring in Russia, Brazil and, in fact, most of Latin America and, of course, China – home for about 30% of all car sales. The 17-18 million rate here, while significant and with longer term potential to settle in at this level, can't carry our domestic producers with heavy exposure to the countries noted. I suspect our domestic Big Two are at or very near their global peak for this cycle – that or we are looking at price wars overseas to maintain non-US sales rates. Some would add that in a deflationary environment they might even maintain margins if raw materials continue to fall…but labor won't stay cheap; the UAW is already rejecting preliminary wage offers.

Two positives could still add to domestic sales for the Big Two: Millennials finding work and low oil prices. In the very short run I'd bet on the latter, only. I am not ignoring the millennials, they are huge lessors of new cars but they are not in full recovery just yet.

Two negatives are also present: A very real chance of a rise in interest rates and, thus higher car loan costs and the one I think is a sleeper – an older population not as needful of 2 or even 3 cars. And Uber lurking in the shadows further nibbles at multi-car (and even elderly) owners' buying.

It should also be noted that at least in August, Ford, GM and Fiat-Chrysler generated 74% of their combined sales from trucks and SUVs and that, to me, seems an anomoly not a trend. Car sales, as such, are not that strong after all. Somewhere in this data are clues. Maybe Uber and an SUV? What is curious is the number of boomers buying trucks.



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Of course, as always, new capacity is coming on line from (what I could find) Ford, Toyota and Volvo – heavily in the southern U. S. Right as we appear to have returned to “peak” domestic consumption….they add to capacity. We Detroiters recognize the pattern. Exane BNP Paribas estimates 7 million units of new capacity by 2018 – up 20% over this year. According to Alix Partners, GM and VW relied on China for 44% and 41% of operating profit last year and now with VW under severe pressure, that profitability and fully utilized capacity may default to GM. The point is, all have depended on China, few will benefit, new capacity has to be paid for.

To this point, then, cheap loans and plenty of buyers got us here. The EU is still on an upswing as it slowly recovers from the last decade, but they’re small cars with small profits. As a whole, the EU expects 5% to 7% growth. In the U. S., we expect 3% to 5%, what with recent rate rise rumblings.

It’s the future of the auto industry that is of interest. The traditional car builders with their massive plant infrastructures, sales and delivery platforms and down-stream suppliers are facing Google, Apple, Tesla, Uber, et al, that have no old, semi-efficient assembly plants. And the new guys have plenty of cash, innovation and, yes, direct, personal appeal to the 73 million millennials who live in the Apple-- Google world.

This is a 100-year old industry facing terminal sclerosis. Forget the carbon footprint battle they must fight, or the world of hybrid/electric cars. The issues for them are whether they can develop the total technology platform plus an image that appeals to the millennials which is needed to compete with the Google-Apple world. Millennials may not do much more than help them maintain their new production levels in the meantime .The mobility trend, though, is alive and well. Model A to Uber, cave to McMansion.

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I have spent little time on food. The subject is well covered in the simple summaries of Rostow’s work at the beginning . Most experts in this space believe food and food alone allowed the luxury of permanent shelter and personal mobility. The nomadic life ended for the great majority of the globe at some form of late Stage Two or better. Violent wars and mass migrations continue but for the early Stage nations, aware of other places, the aspiration to home and mobility continue. We could have a grand time, though, exploring food sourcing: GMF, the organic back to nature movement, the end of the big food conglomerates—much to discuss there. Like autos, I suspect the largest food companies are struggling with old business models, big infrastructures and a reluctance to change. It’s now about the millennials.

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