US Stocks for a Baby Boom

November 21, 2013

by Bill Smead

of Smead Capital Management

As contrarians, we at Smead Capital Management frequently get questions about stocks like Gannett (GCI), Bank of America (BAC) and eBay (EBAY). To understand how excited we are to own these common stocks you need to understand how a long-duration common stock portfolio would benefit from the coming baby boom in the developed world. Thanks to wonderful research from The Bank Credit Analyst (BCA), we can understand the demographics of developed nations like the US. BCA concluded that a "baby boom" is coming in the US and in other developed nations. This research analyzed data from the Max Planck Institute of Demographics and makes five key statements:

II. The Coming Baby Boom In Developed Economies

> - Developed economies are about to experience a baby boom that will be bigger and longer-lasting than even the one that followed the Second World War.
> - The entry of the Millennial generation into their prime childbearing years, along with the recouping of births that were postponed both due to the recession and by the decision of many women to delay having children until their thirties, will drive the first leg of this new baby boom.
> - Continued progress in creating more family-friendly labor market institutions in developed economies, increased gender equality, rising incomes, as well as cultural and possibly genetically-driven shifts in the composition of populations towards more fecund individuals will all power the second leg of the baby boom.
> - Faster population growth implies stronger aggregate demand in the near term and more rapid supply growth over the long haul. Equities, housing, and commodities should benefit.
> - Properly measured, U.S. fertility rates are already well above the baseline used by the government in projecting future fiscal trends. Our estimates imply a fiscal surplus of 4% of GDP by the end of the century, even if current entitlement programs are not scaled back.

For regular readers of Smead Capital Management, you are aware that our bias is an echo-boomer led economic resurgence in the US. These 86 million Americans between 18 and 37 will marry, have kids, and buy houses and vehicles to house and transport those families. Therefore, we believe, you need an equity portfolio designed to thrive in the developed world and particularly inside the borders of the US. What are the characteristics of the US economy today and how ready is it for a population-growth driven period of above average economic growth? Which stock market sectors of the S & P 500 Index meet the needs of an economic growth period spurred by these young families?

The US economy has a very strong foundation laid by the cleansing of the last six years:

> 1. The household debt ratio is the best in almost 34 years of Federal Reserve data. This means folks are living the farthest inside their means in decades.
> 2. Banks are over-capitalized and stand ready to make loans on houses and cars.
> 3. Companies have learned to operate lean and mean, are gushing cash flow and are extremely well capitalized. They can hire and expand as soon as this baby-boom shows up for a few years.
> 4. Houses are incredibly affordable and interest rates are very low in relation to the last fifty years.
> 5. The dollar appears massively under-valued after our last two trips to Europe. Coffee and Hamburgers are twice as expensive in the major cities of Europe than in the US.
> 6. Unemployment is high currently, which means there is plenty of blue collar labor on the sidelines waiting to come into the game.

In this elongated economic cycle we foresee, your common stock portfolio needs to be valuation sensitive. From our vantage point, the best way to get access to this coming baby boom is through domestically-oriented equities in the consumer discretionary and financial sectors of the S&P 500 Index. You need to be picky, because you are primarily looking for domestically-oriented companies and/or brands which function in the rest of the developed world which BCA thinks will enjoy a similar baby boom.

Of particular interest to us is Gannett (GCI) which will soon own 43 network-affiliated TV stations and reach 21 of the 25 largest metropolitan media markets in the US. They own 82 daily newspapers in the US. Between the TV stations and newspapers they provide auto dealers, retailers and residential real estate marketers the advertising outlets they will need. At a P/E ratio on 2014 First Call estimates of 9.5 and offering a generous dividend of 3.0%, GCI looks like a multiple-year opportunity to us.

Bank of America (BAC) is almost ideally positioned to meet the financing needs of a faster-growing "echo-boomer" led US economy. They have a huge deposit base and are the dominant bank among average American households. A faster-growing economy would drive interest rates up and the spread the bank earns should get wider and more profitable over the next ten years. At a current price around 70% of book value, it still looks like a steal based on normalized earnings a few years away.

Lastly, EBay's (EBAY) original business of auctioning pre-owned items could see a huge rebirth as baby-boomers downsize while echo-boomers upsize. These tech-savvy 18-37 year old Americans could drive online retail to as high as 15% of total transactions from the current 5.8% as they replace their parents as the economically dominant demographic group. With $14.4 billion in cash, most recent quarterly free cash flow of $1 billion and a reasonable 16.2 P/E ratio based on First Call operating profit estimates, EBAY looks, to us at least, like a neat “toll bridge” for playing long-term economic growth in developed markets like the United States.

William Smead

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