Basis Points July 26, 2018

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Above the Fold

- A beneath-the-headlines casualty of the continuing tariff and trade war with China is the surging amount of oil exports from the U.S. to China. An escalating trade dispute with China would represent a lost opportunity for the U.S. to further break into a strategic market, if China resorts to slapping tariffs on U.S. energy imports. China relies on imports of oil for 70 percent of its energy needs, and that dependence is estimated to rise to 80 percent by 2040. The U.S. has ramped up its oil exports to China over the past two years, and China has been the biggest new buyer of U.S. shale oil. China is now the second largest consumer of U.S. oil exports after Canada, and China last year bought 20 percent of all U.S. oil exports. For now, oil is not one of the products that is involved in the trade and tariff war, but if the fight escalates, oil exports to China could be cut and U.S. domestic producers and workers could suffer as collateral damage in the U.S.-China trade war.

- Be careful what you wish for: Whirlpool stock fell 14.5 percent Tuesday, its worst day since Black Monday, October 19, 1987. Whirlpool, the U.S.-based washing machine giant who was once in favor of stricter trade controls for its own industry, blamed rising steel and aluminum costs for much lower quarterly earnings. Global steel costs have risen substantially and, in the U.S., have reached “unexplainable” levels, Whirlpool management told shareholders on the earnings call. Whirlpool was a major advocate for legislation to protect against what the CEO called a “long story of dumping” by foreign competitors LG and Samsung. Now the company cites U.S. tariffs on steel and aluminum as contributing to the increased cost in Whirlpool’s raw materials.

Three Things

- From the Historically Bad Mergers department: In July 1981, with the price of crude oil trading at $40 a barrel, DuPont, the nation’s largest chemical manufacturer, announced that it was purchasing Conoco for $7.5 billion in stock. When it closed two months later, it was the largest deal of all-time. DuPont’s largest business cost was energy products, as 80 percent of DuPont’s products were based on petrochemical feedstocks. When the energy crisis hit in the early 1970s, DuPont was exposed to serious losses, and its profits fell from $586 million in 1973 to $273 million later in the decade. DuPont management shuddered at the rising power of OPEC and feared it would lose control of its own destiny. Egged on by Wall Street dealmakers, they concluded that the best idea would be to buy an oil company. However, the energy crisis was temporary, and the price of oil soon crashed and hit $10 a barrel in 1986. In 1998, when oil again traded at $10 a barrel, DuPont exited the energy business by spinning out Conoco in an IPO. Conoco now trades as ConocoPhillips and sports an $81 billion market cap. DuPont bought Conoco in a seller’s market, when everyone wanted oil companies, and sold it in a market where no one wanted oil companies. The great Allen Sloan put it best: “In 1981, Wall Street loved DuPont buying Conoco. In 1998, Wall Street loved DuPont selling Conoco. The bottom line is that Wall Street has never seen a deal it doesn’t like.”
- At the end of 1999, Microsoft’s market cap was $586 billion, MSFT had revenue of $22 billion for the year, and net profits of $8.7 billion. Its cash balance amounted to $22 billion. Microsoft today has a market cap of $815 billion, but in the fiscal year 2018 just ended, it had revenue of $110 billion, net profits of $29 billion and has $150 billion in cash in the bank. Due to the crazy high stock prices during the dot-com bubble, MSFT revenue has increased by five times since then and its profits have tripled, while the stock price has only risen 40 percent over the past 18 years.

- By next year, the title of Youngest Self-made Billionaire in History could be held by a new name. It will not be Mark Zuckerberg, Bill Gates, Steve Jobs or Mark Cuban. That title could be held by 21-year-old Kylie Jenner, daughter of Kris and Bruce Jenner. Kylie Jenner, who has 110 million Instagram followers, runs one of the hottest makeup companies ever. Kylie Cosmetics launched two years ago with a $29 "lip kit" consisting of a matching set of lipstick and lip liner and has sold more than $630 million worth of makeup since, including an estimated $330 million in 2017. Even using a conservative multiple, and applying a standard 20 percent discount, *Forbes* values her company, which has since added other cosmetics such as eye shadow and concealer, at nearly $800 million. Kylie Jenner owns 100 percent of it. With continued growth over the next year, the company would be worth more than $1 billion. And it is a remarkably employee-light company as well. Jenner employs just seven full-time and five part-time employees, as she outsources all manufacturing, packaging, human resources, sales and fulfillment to local and overseas companies. Leveraging her massive and loyal base of social media followers is a powerful growth engine, as a new product can immediately be seen by 110 million people in her proven target market, without paying for a dollar of advertising.

<u>Did You Know</u>

There is tremendous information content in dividend yield levels. The S&P 500 Index yields 1.8 percent today, but within the 500 stocks of the index are many different dividend yields, and for many different reasons. Utility stocks have an average yield of 3.5 percent, much higher than the index average, because these companies generate steady profits that are paid out to shareholders. However, utility companies usually do not generate much earnings growth, so a high dividend yield is the main reason why an investor would hold the stock of such a low-growth company. On the other end of the spectrum, a small technology or biotech company may not generate much net profit and invests any profit and cash in the bank back into the business to grow its earnings over time. Investors in these companies are focused on the future growth of the company, and do not require or expect current dividend payments.

An interesting dividend yield story these days is AT&T. This 140-year-old company has steadily increased its dividend payout for more than 50 years in a row. The stock currently sports a dividend yield of 6.3 percent, which is very high compared to the S&P 500 Index, to its competitors (Verizon yields just 3.0 percent), and the yield is even more than twice as high as the 10-year T-Bond. So, what does this yield say about what investors think about the prospects of the company and the safety of the payout? With such a large yield, the yield implies that investors are worried about that payout continuing in the future. AT&T recently closed the acquisition of Time Warner, which further diversifies its base cellular phone business into the media space, after purchasing DirecTV a few years ago. AT&T continues to morph into being more of a media company than a cellphone service provider. While some investors worry about the high debt levels of the company impacting the chances for continuation of future payouts, AT&T management states that Time

Warner does not require much capital to run and is a strong cash flow generating business, so its addition to AT&T only enhances its ability to pay its dividend. AT&T should generate $23 billion in free cash flow in 2019, and the dividend payments take only $15 billion from that total, so for now the payout does seem safe. AT&T knows that its attraction as a reliable dividend-paying company is important to its investor base, so the very last thing it would do would be to cut its dividend. But the very high 6.3 percent yield tells us that there is still considerable doubt among investors about that high yield level continuing. The company has repeatedly claimed that the payout is safe, but investors are implying that it is not. Differing opinions are what makes a market, after all.