

# Predictions 2018

## Froth and Frustration



BREAKINGVIEWS



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# Introduction

## Breakingviews predicts a frothy, frustrated year

There is plenty of discord and uncertainty as U.S. President Donald Trump's second year starts. Yet money is cheap, the global economy is motoring, and markets are ebullient. That combustible mixture could be called "froth and frustration." How this ironic social contrast, worthy of Jane Austen, resolves itself will be key for 2018.

Ten years after Lehman Brothers imploded, the bulls are ascendant. A single Hong Kong skyscraper recently fetched \$5.2 billion and an imperfect Leonardo da Vinci sold for \$450 million. With huge run-ups at tech giants such as Apple and Tencent, global stocks added roughly \$13 trillion in value in the first 11 months of 2017. Bitcoin prices shot for the heavens. Yield-chasers gorged on debut bonds from Tajikistan and the Maldives, and 100-year debt from serial defaulter Argentina.

This is not all hot air. A world recovery is gathering steam: the World Bank reckons global growth will hit 2.9 percent in 2018. The last time expansion was faster, China was splurging on bridges, roads and airports, effectively underwriting a rebound from the financial crisis. Meanwhile, central banks have barely begun to lift interest rates or sell assets. And online behemoths such as Alibaba and Alphabet keep growing and churning out fat profits.

Investors appear to be taking the same mercenary view as one of Austen's characters: "A large income is the best recipe for happiness." Yet things look less reassuring close up.

The populist anger that enabled Trump and Brexit is still simmering, fuelled by inequality, disruption, immigration and the echo chambers of social media. An unpredictable America is no longer committed to advancing a rules-based, liberal world order. China is growing increasingly assertive under President Xi Jinping, while Saudi Crown Prince Mohammed bin Salman is flexing his muscles around the Gulf. The risk of a conflagration on the Korean peninsula is all too real. Business is grappling with self-inflicted scandals and activist attacks, and a backlash is building against Big Tech's overweening power.

That is the backdrop for Predictions 2018. We have collected more than 40 in a single volume, with dozens more available at [breakingviews.com/2018](https://breakingviews.com/2018). It is a truth universally acknowledged – to draw from Austen again – that forecasting is hard work. But it's nonetheless a useful exercise, at the very least giving readers a way to frame the big debates ahead intellectually, and perhaps profitably.

## Zombies and vigilantes

This year, we are positive on global growth – provided Trump and Xi don't somehow spoil the party. Midterm U.S. elections could have serious investment implications, with radical candidates edging out compromisers, as could a populist resurgence in Latin America.

The bull market need not end badly, although bitcoin could prove a total wipeout – and several other possible triggers for trouble, like blow-ups in exchange-traded funds or hedge funds, bear watching. Perhaps the biggest financial shift will be at central banks. Markets must adjust to increasingly tight policy at the U.S. Federal Reserve under new Chair Jerome Powell. And for the first time in years, rich-world bond issuance will outstrip buying by the Fed and friends. Much like the modern additions to the Austen canon in “Pride and Prejudice and Zombies,” bond vigilantes will rise from the dead.



Actors dressed as zombies arrive at the European premiere of “Pride and Prejudice and Zombies” in Leicester Square, London, Britain, Feb. 1, 2016. REUTERS/Stefan Wermut

The executive suite will see sustained pressure from many sides. Big miners will have to ape buyout shops. One of Wall Street's titans will bow out. Passive funds will, despite their name, dethrone a chief executive. Activists could make an ugly scene in luxury. In India, the long reign of "promoter" tycoons is, mercifully, nearing its twilight. And corporate America will need to rethink attitudes to diversity and sexual harassment in the wake of recent revelations. But that should catalyse positive change, just as a spate of quality-control crises ought to force Japanese bosses to become more competitive.

In tech, investors can consider a tasty new dish: SLAW, for Spotify, Lyft, Airbnb and WeWork, four prospective candidates for public life. Europe's electric cars will catch up with gas guzzlers in cost terms. And super-fast 5G mobile broadband, on show at the Winter Olympics and the World Cup, will demonstrate China's hunger for technological leadership.

Among tech's giants, Apple's position as a privacy-sensitive hardware specialist will give it some shelter from mounting anger at Silicon Valley's power and lack of accountability. Amazon could win friends by choosing a deserving location for its second headquarters. The sun will begin to set on U.S. tech's feudal approach to corporate governance. But Chinese startups could push Hong Kong the other way, while it also bends over backwards to accommodate Saudi Aramco.

Not all of these prognostications will materialise. Last year, among other things, we anticipated India's banking bailout, argued Beijing would offer Trump more carrot than stick, and correctly highlighted the difficulties Uber and Aramco faced in going public. Our biggest mistake was overestimating the pace of change in Trump's America, which meant we braced for a stronger dollar, a flood of repatriated cash and an infrastructure bonanza.

With those caveats, we hope this will be an enjoyable and thought-provoking read.

**Quentin Webb**

Asia Financial Editor, Reuters Breakingviews

Jan. 2, 2018

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# Peaks and pessimists

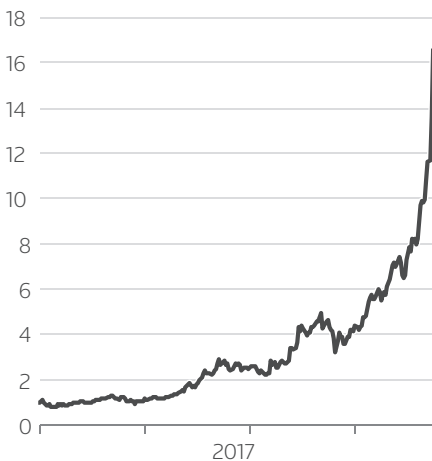
## Five possible triggers of the next market shock

By Richard Beales

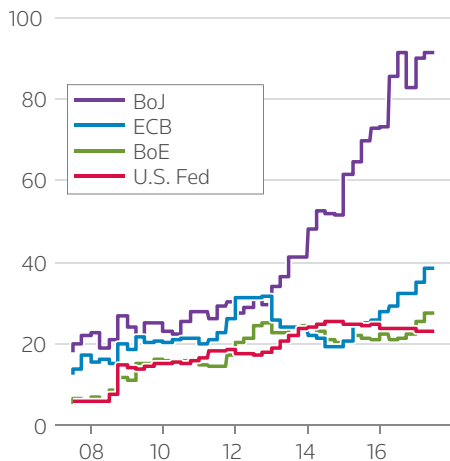
What will cause the next market downturn? It takes a catalyst to trigger one, and other reagents to sustain it. Breakingviews runs through a few more and less obvious elements to watch.

### Fuel for the next crisis?

Thousand U.S. \$ per bitcoin



Central bank assets as % of GDP



Source: Thomson Reuters Datastream, central banks, IMF, BitStamp data to Dec. 11, 2017

### Central bank surprises

Central bankers like Janet Yellen at the Federal Reserve and Mark Carney at the Bank of England try not to surprise investors. That's likely to be a tougher act to pull off in 2018.

Yellen, for one, will soon be replaced by President Donald Trump's nominee as Fed chair, Jerome Powell. In addition to being an untested hand, he along with his counterparts may end up changing policy faster than markets expect. Carney, for example, has to keep an eye on UK consumer prices, with inflation running at 3.1 percent in the 12 months to November. Any sign that prices are suddenly on the rise could explode

expectations of very gradual increases in interest rates.

Sharp market moves could be amplified by the Fed's pre-programmed shrinking of its gargantuan \$4.5 trillion balance sheet. After a decade of ultra-low rates, there could be huge amounts of exposure to rising interest rates, and in unexpected places.

## Exchange-traded funds

The rapid growth and evolution of easy-to-use ETFs is a boon for investors. The vehicles hold some \$4.4 trillion in global assets, according to a recent EY survey, a more than 10-fold increase since 2005. The consultancy predicts 15 percent annual growth in the coming years.

That's all well and good, but a few risks are creeping in. One is the widening range of what ETFs are trying to track. Bond funds, for example, are burgeoning. And increasingly providers are offering proxies for everything from certain hedge fund-like strategies – so-called smart beta – to the equivalent of leveraged bets against stock performance, like triple-short S&P 500 Index ETFs.

Some of these risk recreating a problem that bedeviled many banks and investment funds in the crisis of 2008-09: a liquidity mismatch between an ETF that can be traded during market hours and underlying assets that are, or become, illiquid, whether scarce bonds or volatile futures. Just as the failure of long-held beliefs about money-market funds exacerbated the crunch a decade ago, a loss of confidence in key characteristics of ETFs could worsen any future meltdown.

## Crisis alpha

Big pension funds and other institutions have been delighted by buoyant equity markets. The FTSE All-World index, for example, was up 20 percent through Dec. 14, and the U.S. S&P 500 had gained 18 percent. But investors are also worried about the next downturn.

One fashionable notion is to put some cash into strategies variously dubbed crisis alpha, crisis risk offset (shortened to CRO) and similar clever monikers. These are supposed to perform positively in any big downturn. One strand of many such models is a strategy known as managed futures, which essentially follow momentum in a raft of liquid markets. These funds delivered big positive returns during the global financial crisis.

The danger, though, is that managed futures, and even more so other approaches with less history, could turn out like modern-day versions of portfolio insurance, which was supposed to minimize investors' losses but ended up amplifying the market crash of October 1987. David Harding at Winton Capital cautions that the success of his own managed-futures sector in recent downturns is not guaranteed to repeat in the next,

and that superficially countercyclical strategies could end up going wrong, especially if too many investors have the same ideas.

## Hedge-fund trouble

To give these funds their due, they weren't the main fuel for the conflagration of 2008-09 – that dubious honor goes to banks. Yet leverage and potentially crowded trades can create systemic risks, as Long-Term Capital Management demonstrated in 1998.

The largest hedge fund, Bridgewater Associates with \$160 billion under management, has as its flagship a so-called risk-parity strategy. It's designed to spread risk more or less equally across a range of asset types and possible market behaviors, using an element of leverage to help. The fund's record and reputation are good, but it hasn't been tested by a sustained bear market in bonds and it's not immune to a set of circumstances that crater almost all its holdings at once, spreading fear among its legions of clients.

Alternatively, large numbers of smaller funds – whose collective assets have doubled since the crisis to top \$3 trillion, according to Hedge Fund Research – could end up being caught out by the same market moves, as computer-driven quant funds were in August 2007. Too many investors running for the exit at once is a recipe for market freefall.

## Crypto-currencies

It's hard for a long-term investor to take seriously a holding that plunges nearly 20 percent in a day and then surges 80 percent to a record high just a week later. That's what happened to bitcoin between late November and early December, though. For all the talk of its use as a currency along with the related blockchain technology, digital coinage is more than ever the domain of tech-savvy speculators. No wonder, with the value of bitcoin up around 17-fold in 2017 through Dec. 14.

The total value of outstanding bitcoin and rival ether reached over \$350 billion, according to Coindesk. Much of that is on (virtual) paper, but it's still symptomatic of booming financial markets combined with the growth of the digital economy. If hacks that exploit technological flaws or a sharp fall in demand crash the price, the fallout could prove contagious to the real world, too.

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## Best thing Trump and Xi can do in 2018 is nothing

By John Foley

The world is headed for a year of smooth economic sailing. How smooth depends on U.S. President Donald Trump and Chinese leader Xi Jinping. The best thing that a duo who steer one-third of the planet's GDP can do for growth is nothing.

Almost half of the 2.9 percent increase in global GDP forecast by the World Bank for 2018 comes from the United States and China. Investment and consumption are rising reasonably strongly in both, and central bank policy will remain generous. The United Kingdom, which is heading for a divorce from the European Union, has a more brittle economy but contributes just 2 percent of the world's growth. The damage it can inflict will be limited.

Trump could cause harm by dismantling the global trading system of which the United States is a linchpin. The U.S. congressional system contains checks and balances when it comes to war or bad policy but the president has considerable freedom on trade. He has already raised tariffs on some Chinese aluminum products. Talks over NAFTA, or the North American Free Trade Agreement, the U.S. trade pact with Mexico and Canada, are tense. Only Congress can annul NAFTA. But if Trump pulls the plug, it will be as good as dead, to the detriment of jobs and productivity.

China could crater too, if Xi wills it. Activity will slow sharply if he curbs abundant credit growth, which is boosting house prices, investment, and imports. China's home-made measure of broad credit, called "total social financing", is still growing far faster than nominal GDP. True, debt – forecast by the International Monetary Fund to reach 300 percent of GDP by 2022 – is the biggest risk for China and at some point the piper must be paid. But a bigger threat in the near term is a clumsy, too-rapid deleveraging.

Xi is less liable to use his powers rashly than the U.S. president. Moderates, such as economic adviser Gary Cohn, have so far tempered Trump's actions. They may not stick around. Were midterm elections in 2018 to hand the Republican-controlled Congress to the Democrats, support may grow for retaliation against perceived trade slights.

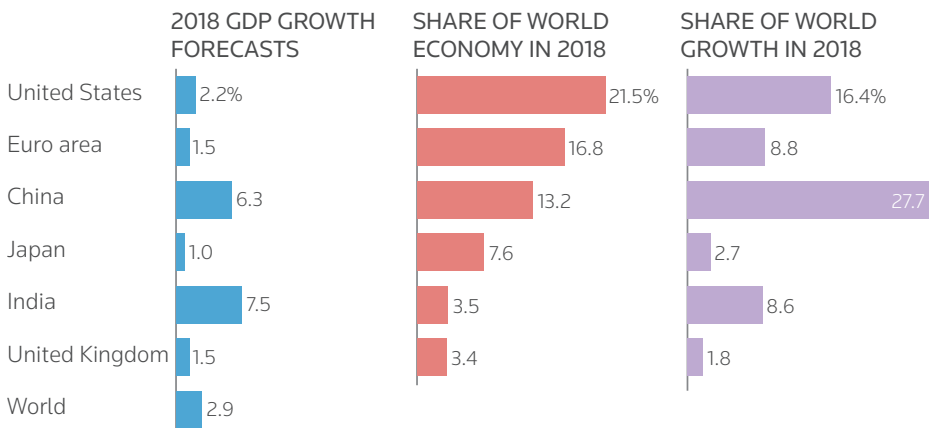
Both leaders have good cause to want the synchronized expansion to continue. Besides being responsible for economic smooth sailing, Xi and Trump are also the biggest beneficiaries. Inaction, or impotence, are therefore the best things they can give to the world.



U.S. President Donald Trump and China's President Xi Jinping make joint statements at the Great Hall of the People in Beijing, China, Nov. 9, 2017. REUTERS/Jonathan Ernst

## Who's driving global growth in 2018

Here's how GDP expansion breaks down for the coming year, based on World Bank estimates.



Source: World Bank Global Economic Prospects, June 2017; Datastream calculations

## Fed calls time on monetary and regulatory activism

By Gina Chon

The U.S. Federal Reserve is looking to put its tools away. After almost a decade of near-zero interest rates, massive asset purchases and tighter rules, the central bank is stepping back. Fed chief Janet Yellen started this transition as after-effects of the 2008-09 financial crisis faded, but her successor, Jerome Powell, promises a real laissez-faire shift in approach.

Powell will bring a background in law and a stint at the Carlyle Group to the central bank, which has been led for more than a decade by economists steeped in monetary and labor policy. He has voted with Yellen for the past five years, but his pedigree as an establishment Republican makes him less inclined to believe the Fed should try to address every economic problem. He also echoed President Donald Trump, who appointed him, when he told Reuters Breakingviews in October that his biggest worry was slow economic growth.

To promote expansion, Powell has already made moves to relax crisis-era regulations, which will accelerate under his new vice chair, Randal Quarles. The Fed is looking to



Federal Reserve Chair Janet Yellen testifies on the U.S. economic outlook before the Congressional Joint Economic Committee on Capitol Hill in Washington, D.C., United States, Nov. 29, 2017. REUTERS/Carlos Barria

ease major constraints on banks, including the annual stress tests, the living wills exercise and the Volcker Rule limiting proprietary trading.

Yellen has orchestrated five hikes since December 2015. The Fed projects three more increases in 2018, but with unemployment at a 17-year low of 4.1 percent, Powell may have to step up the pace.

Such tightening will coincide with a shrinking of the central bank's \$4.5 trillion balance sheet, which began in October. The Fed bought bonds in an effort to keep rates low and stimulate the economy. The purchases skewed markets just as Yellen and her predecessor, Ben Bernanke, intended. Fed economists estimated that yields on 10-year Treasuries would be about 85 basis points higher if the Fed hadn't done quantitative easing. By the end of 2018, the balance sheet reduction will be roughly equivalent to a 1 percentage point hike in the fed funds rate, according to research by Benn Steil at the Council on Foreign Relations.

It all adds up to a substantial tightening. The central bank will also face pressure to remove accommodation if Congress passes tax cuts, providing fresh stimulus and stoking the deficit. Markets may struggle to adapt to life without a Powell put.

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## **Bond vigilantes will grab power from central banks**

By Swaha Pattanaik

Bond vigilantes are poised to wrest back power in 2018. For the first time in four years, the U.S., Japanese, euro-zone and UK governments will together issue more net debt than their central banks will buy. That gives investors a welcome chance to hold profligates to account. But markets may be prone to over-reaction as money managers rediscover their rusty powers of discernment.

Combined net debt issuance by these so-called G4 economies will total \$1.3 trillion, up by a third from the projected issuance for 2017, according to Morgan Stanley. The increase in supply will coincide with a decline in demand from central banks, which are expected to reduce their combined bond purchases. That makes for a watershed year in which net issuance will exceed official purchases of debt.

Bond prices will respond. In the past couple of years, buying by central bankers dwarfed issuance, on a net basis, and drove down yields, sometimes into negative territory. About 43 percent of outstanding European government bonds and 60 percent of Japanese ones were yielding less than zero at the end of October, according to Tradeweb.

## Decline in bond volatility

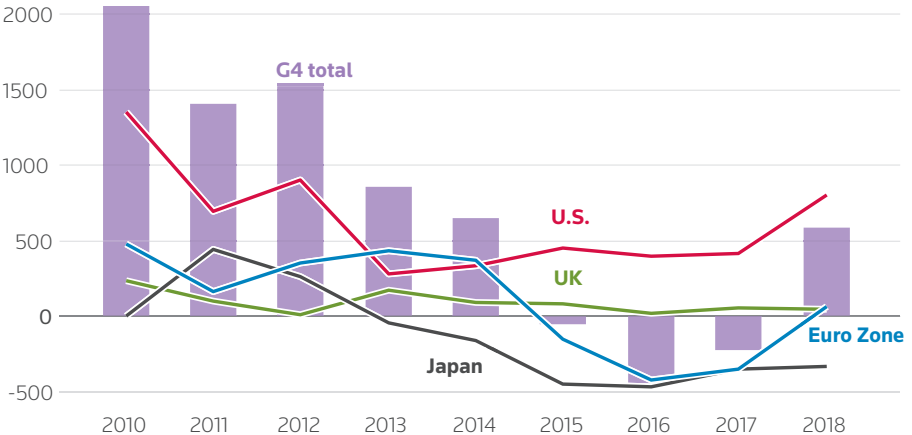
Merrill Lynch Option Volatility Estimate (MOVE) three-month index



Source: Thomson Reuters Datastream, data to 12/8/2017

## Watershed year for G4 bond markets

Net government debt issuances minus central bank purchases (\$ bln)



Local currency data converted at year-end exchange rates except 2017 & 2018 estimates (as of 28/11/17).

Source: Morgan Stanley



Investors who wanted better returns have been forced to buy longer-dated or riskier debt and venture into other markets. Liquid assets, such as equities, were bid up by what Citi analysts dubbed bond “refugees”. So were illiquid alternatives such as infrastructure and private equity funds. As the balance between the supply and official purchases of government debt flips, investors may return to their natural comfort zone.

If all goes well, that shift will be gradual and bond yields will rebound slowly. That’s not a given. Say corporate defaults were to rise markedly. Authorities have dampened market sensitivity to these risks for so long that investors may over-react when confronted with them. Price swings will be further amplified if asset managers find themselves stuck in illiquid markets during a broader selloff. Those who cannot bail out of their riskiest holdings may be forced to sell less risky but more liquid bonds.

Bond prices have been getting less volatile for several years. When valuations are less driven by central banks, that will no longer be the case. A necessary shift, to be sure, but one likely to create some unsettling market moves.

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## Verizon will be one of 2018’s few mega-dealmakers

By Jeffrey Goldfarb

Dealmakers are no longer living large. In 2015, there were more than 60 mergers and acquisitions announced globally worth at least \$10 billion. Combined, they accounted for over a third of total M&A volume, according to Thomson Reuters data. By 2017, the trend had reversed. Expect an even shorter list of mega-mergers in 2018, but look for U.S. telecoms titan Verizon’s name to be on it.

By the time CVS Health unveiled its \$77 billion plan to buy Aetna in December, the number of 11-digit takeovers in 2017 had halved from the record set two years ago. Their total value also had shrunk from nearly \$1.5 trillion to about \$700 billion. That’s despite the steady increase in market capitalizations and available cash that combine to make such transactions theoretically possible.

High valuations, erratic signals on U.S. tax and trade policy, and stronger pushback from trustbusters all conspired to restrain chief executives’ more animalistic spirits. Greater clarity on corporate tax rates could start to change some thinking, but with the S&P 500 index in early December trading at over 18 times earnings, more than 25 percent above its 10-year average, according to Datastream, it could still be hard to pull the trigger on a sizeable acquisition.

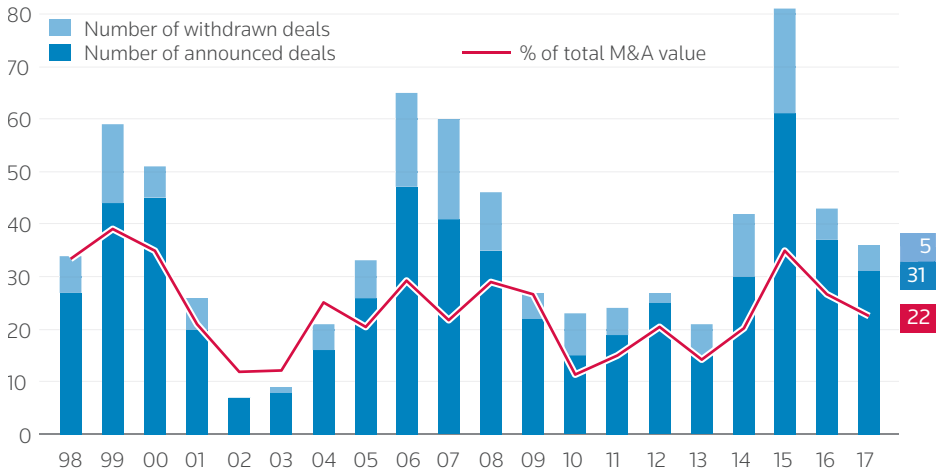
Verizon is one company that may not have the luxury of time, however. Growth has



A mobile cell tower is parked outside a Verizon store in Superior, Colorado, United States, July 27, 2017. REUTERS/Rick Wilking

## Mega deals

Mergers and acquisitions over \$10 billion in value



Source: Thomson Reuters data to Dec. 5, 2017

been tough to come by and consumers are shaking the ground more strongly under the media and telecom industries. Acquisitions of internet has-beens AOL and Yahoo hardly qualify as game-changers for a \$210 billion company.

It sniffed around Twenty-First Century Fox, but regulatory resistance to combining wireless and programming power seems to be rising. Regulators sued in November to block AT&T's acquisition of Time Warner, the owner of CNN and HBO. Instead, Verizon boss Lowell McAdam might be wiser to stick closer to home and consider buying satellite operator Dish Network. It would come with a \$45 billion price tag, after factoring in net debt and a 30 percent premium. Even though McAdam has rejected such a combination before, it would help resolve a serious spectrum shortfall at Verizon identified by New Street analysts.

Financially, it could be a stretch. For one thing, the Dish enterprise trades at twice the multiple of expected EBITDA for the next 12 months as Verizon. And even if it could wring out the equivalent of 9 percent of the target's operating costs, as AT&T said it would at Dish rival DirecTV, Verizon's implied return on investment would be just 4 percent, according to Breakingviews calculations. Nevertheless, McAdam could buck the M&A trend because the rapid upheaval in his industry is such a big deal.

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## Apple provides hedge against global tech backlash

By Robert Cyran

Authorities worldwide are growing worried about how Facebook, Google and Amazon are eroding privacy, using data to push rivals out of business and even affecting elections. This is one tech battle Apple can sit out. As a security-minded purveyor of hardware, it's likely to avoid the worst of the blowback.

Europe will be the eye of the tech storm in 2018. The European Commission has already fined Google \$2.8 billion for favoring its own services and burying rivals in search results. Regulators are now deciding whether the Alphabet unit's Android mobile operating system gives it another means of unfairly promoting its businesses. A bigger fine and reduced mobile revenue from Google search could result.

Fining Google for favoring its own products sets an unwelcome precedent for other tech firms. European Union authorities could proscribe Amazon's listing of own-label products ahead of competitors' offerings.

The biggest danger comes in May, when companies must comply with Europe's General Data Protection Regulation. It requires that they seek explicit consent before using



A customer is shown a new iPhone X at an Apple Store in Beijing, China, Nov. 3, 2017. REUTERS/Damir Sagolj

personal data. It's probable many customers won't agree, which means Google could find it harder to customize Gmail ads and Facebook might not be able to use WhatsApp information to sell ads on other sites and apps. Customers also have the right to delete their data or port it elsewhere – reducing the ability of Amazon and Google to lock in cloud customers.

Parts of Europe's agenda may be adopted elsewhere. And U.S. lawmakers are mulling putting big internet firms under the strict Federal Communications Commission, rather than the more lax Federal Trade Commission.

Apple is the biggest tech giant, worth nearly \$900 billion, yet it stands curiously apart. The company sells lots of expensive phones, but it's no monopolist. The iPhone's combined share of the five biggest European markets is under 20 percent, says Kantar Worldpanel. Tim Cook's company also uses privacy as a selling point. It doesn't gather personal information to sell to advertisers, places similar restrictions on app developers, and fights government attempts to unlock suspects' phones. Apple's inability to master social media means its business doesn't affect elections either.

Apple isn't carefree. The company's attempts to slither out of paying taxes make it a target in its own right. At worst, though, the result is probably a fine. Its rivals are looking at major, forced changes in their business models.

## Bitcoin speculators face total wipeout

By Edward Chancellor

Bubbles aren't just about the madness of crowds – nor are they simply manifestations of excess liquidity and leverage. But both of these factors are present in the extraordinary rise of bitcoin over recent months. Every spectacular bubble involves a premonition of the future. The trouble is that they turn out to be deeply flawed premonitions. In this respect, bitcoin has much in common with great historic speculative manias.

The acting head of New Zealand's central bank, Grant Spencer, is correct to say that bitcoin resembles a "classic" bubble. First, there's the telltale super-exponential price explosion. The South Sea Company stock soared 10-fold in 1720. Today's red-hot cryptocurrency is up more than twice that amount over the last 12 months. Bubble assets also exhibit tremendous volatility during their so-called "blow-off" stage. Bitcoin's recent price oscillations suggest as much.

Great bubbles attract speculators from far and wide. At the high point of France's Mississippi Bubble, also of 1720, up to half a million foreigners are said to have flocked to Paris. In the internet age, bitcoin leaves John Law's scheme far behind. Coinbase, which provides bitcoin wallets, now boasts some 12 million accounts – a threefold increase in a year. While the Mississippi fraud minted the first paper "millionaires", bitcoin appears to be producing digital billionaires – including the Winklevoss twins of Facebook notoriety, according to media reports.

Every great bubble produces great anecdotes. Charles Mackay's account of the early bubbles in "Extraordinary Popular Delusions and the Madness of Crowds" is stuffed with such urban myths. CNBC recently reported that a young Dutch family had sold its house, cars and other possessions, and moved to a campsite. The father intended to feed his children with the profits from trading crypto-currencies. The computer programmer who used bitcoins to buy pizzas back in May 2010 shelled out more than \$150 million at current prices for his lunch.

George Soros argues that a "superbubble" only forms after it has survived a severe test, imbuing speculators with a sense of invincibility. Bitcoin has weathered a number of such trials. After peaking at close to \$1,000 in late 2013, it shed more than 75 percent of its value over the following 18 months, before starting its more recent, epic ascent. Bitcoin has also survived a number of outright scandals, including grand larceny at the Mt. Gox exchange when billions of dollars worth of bitcoins (at current value, anyway) vanished into the ether.

All great bubbles occur during periods of easy money, when interest rates are low or falling and liquidity is super-abundant. The Dutch tulip mania, for instance, appeared

in the mid-1630s at a time of massive capital inflows, falling interest rates and massive money printing by Amsterdam's Wisselbank, Europe's first central bank. Sound familiar? At the beginning of 2017, the world's largest central banks were expanding their balance sheets like never before. Some \$11 trillion worth of bonds worldwide currently offer negative yields. The American stock market is more expensive than at any time save for the dot-com peak in early 2000. This leaves savers with an uncomfortable dilemma: speculate or starve.

The supreme object of speculation is one which generates no yield and is therefore impossible to value. Think of those tulip bulbs, or gold in late 1970s, or contemporary art in recent years. Bitcoin, which produces no income, has a restricted new supply, and whose ownership is concentrated in relatively few hands (some 95 percent of outstanding coins are held in just 4 percent of accounts), providing a very small free float, is the most perfect speculative asset ever devised. Throw in some leverage, open a futures market, and there's no limit to bitcoin's potential upside.

The word speculator derives from the Latin word for a "lookout". The financial variety looks out into the future, and backs this vision with money. Great bubbles are often uncannily accurate premonitions of the future. The 17th-century mania for tulips anticipated the development of the country's flower industry, now one of Holland's largest exports. Britain's railway mania of the 1840s reflected an enthusiasm for the commercial and cultural potential of this new transportation technology. Likewise, speculators in the dot-com bubble foresaw how the internet would profoundly change our lives.

Law's Mississippi Bubble appears most relevant to what is going on today in cryptocurrencies. Law believed that money needn't be backed by any commodity. He established a bank, the Banque Générale, which issued a paper currency and demonetized gold. Law used the newly issued bank notes to support the share price of his Mississippi Company and reduce the rate of interest – in other words, he provided the world's first quantitative-easing experiment.

Law's vision was prescient. We now live in his world of paper credit and central bank money. However, it was also deeply flawed. Law tried to achieve, in the space of a few years, what would eventually take two and a half centuries to accomplish. Only in 1971 was the link between currencies and gold finally severed with the collapse of the Bretton Woods currency accord. Confidence in what Law called his "system" soon collapsed and the Mississippi Co's share price fell by 90 percent. Law, who in his heyday boasted of being the world's richest man, died in penury in Venice. Speculators in tulip bulbs and in all the other great manias have learned the hard way that in investment to be early is to be wrong.



A man walks past a bitcoin mining show booth during a business technology and innovation fair in Riga, Latvia, Nov. 9, 2017. REUTERS/Ints Kalnins

This brings us back to crypto-currencies. They aim to cure today's monetary problems – a lack of confidence in paper credit and central bank money – with a new technology, the “distributed ledger” or blockchain. Bitcoin believers call this revolutionary – it will “change the world”. Perhaps they will be proved correct – in the very long run.

But if that time comes, bitcoin won't be a contender. Its technology is simply too inefficient. Transactions on the network are too expensive, massively energy intensive and can take days to settle. Amazon won't take payment in bitcoin. The U.S. government won't accept bitcoin for the payment of taxes. In short, bitcoin as money is going nowhere, except in the markets where it's been heading vertically upwards. It resembles the gold prospector's fabled sardine tin: good for trading but not for eating.

Super-parabolic price movements often contain their own premonition, namely that the end is nigh for the mania. When the tulip boom ended, the price of Gouda bulbs fell from 60 guilders to what would have been the equivalent of around 10 cents, a price decline of 99.8 percent. Given that bitcoin has soared higher than humble tulips and has even less intrinsic value, a decline of similar magnitude is not out of the question.

*First published Dec. 13, 2017*

## Passive funds will claim a CEO scalp in 2018

By Tom Buerkle and Neil Unmack

Index-tracking funds keep gaining market share but companies can't take their passivity for granted. Firms like State Street, Vanguard and BlackRock are holding management to task on issues like climate change and backing activists. Firing a poor manager is the logical next step.

Cost concerns and the failure of most active stock pickers to outperform indexes have turned the flow of funds to tracker products into a tsunami. In the United States, passive mutual and exchange-traded funds that invest in equities attracted \$525 billion of new money in the 12 months to October while active counterparts had outflows of \$225 billion, according to Morningstar. Moody's predicts index funds will account for more than half of the U.S. asset-management industry by 2024, nearly double the current share. That growth risks "devouring capitalism," hedge-fund manager Paul Singer has warned, because index funds have no incentive to push companies to raise performance.

Except they do. Outgoing Vanguard boss William McNabb argued in an August letter that the group has to become more active on issues like governance precisely because its funds must hold stocks almost indefinitely. And as the ownership of stocks becomes more concentrated among fewer passive providers, they will have greater clout in shareholder meetings.

These investors are backing words with action on issues from gender diversity to pay. State Street voted against directors at 394 U.S. companies in the first half of 2017 because they had no female board members. It joined BlackRock and Vanguard in forcing Exxon Mobil to report on the risks it could face from climate change. Britain's Legal & General, which manages \$377 billion of index funds, voted against 118 pay resolutions in 2016. In September it was part of a shareholder insurrection that nearly ejected the chairman of Sports Direct for weak oversight of the struggling retailer's founder and chief executive, Mike Ashley.

Notwithstanding Singer's warning, passive funds are helping activists. BlackRock voted against three candidates at aircraft parts maker Arconic, paving the way for Singer's Elliott Management to take board seats. It also backed Nelson Peltz's bid for representation at consumer-goods giant Procter & Gamble. There will inevitably be more proxy fights ahead, with passive funds playing a pivotal role. Expect them to cast the decisive vote in sacking a chief executive in 2018.





Larry Fink, chief executive officer of BlackRock, takes part in the Yahoo Finance All Markets Summit in New York, United States, Feb. 8, 2017. REUTERS/Lucas Jackson

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## Credit markets will enjoy one last hurrah

By Neil Unmack

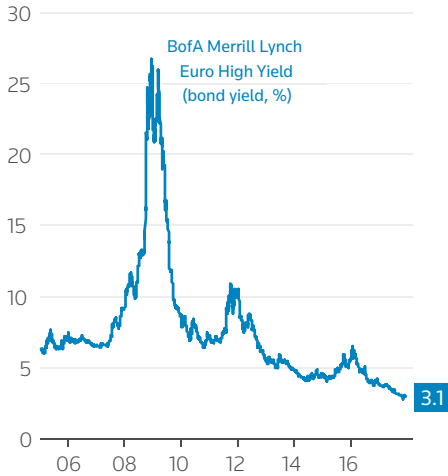
Riskier borrowers are going to enjoy one last hurrah in 2018. Chief executives and buyout firms will be more adventurous in a year of buoyant global growth. And they will be keen to lock in cheap borrowing costs before central bank policy becomes less generous. But the cheer may not last all year.

A pickup in economic activity has yet to translate into a frenzy of risky financing. The value of mergers and acquisitions worldwide fell 4 percent in the year to November, according to Thomson Reuters data. However, deals backed by private equity funds rose 32 percent, and the coming year should be friskier. Several large buyouts are already in the works in Europe, including the sale of Unilever's spreads business to KKR and a spinoff of Akzo Nobel's specialty chemicals unit.

Private equity firms have good reasons to invest. They have nearly \$1 trillion of unspent capital, according to Preqin, and will be happier cooking up bold business plans in 2018,

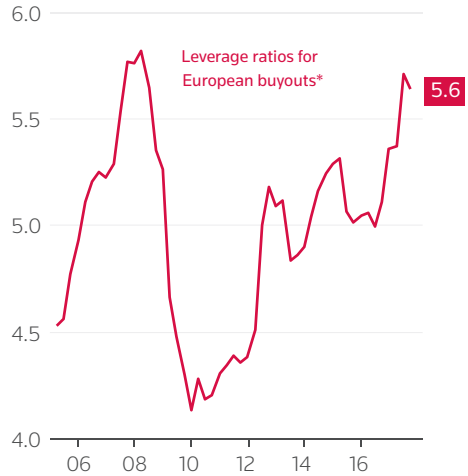
## Still dancing

Junk bond yields are low...



Source: Thomson Reuters Datastream, LPC

...and buyouts are piling on debt



\*Debt/EBITDA ratios, 4-quarter average

when the global economy will grow by 3.4 percent compared with 3.2 percent the year before, according to Citigroup.

And bond and loan investors will continue to provide funds cheaply. Policy rates are low, and the total amount of assets that central banks are purchasing will only be pared back slowly. The European Central Bank will grow its balance sheet until at least September. Its policy of buying an average of 7 billion euros of investment-grade company debt per month forces investors to pile into riskier junk bonds. There's nothing to dim the attraction of such debt for now since Fitch Ratings expects the default rate in the U.S. high-yield bond market to fall to 2 percent in 2018, below the 2.3 percent average outside of recessions.

But the risks are growing. The average debt-to-EBITDA multiple on senior-ranking leveraged buyout, loans in 2017 was 4.6 times, in line with the last peak in 2007, according to LCD, a unit of S&P Global Market Intelligence. And company executives are growing bolder: take Hochtief's bid for Abertis, which would push the construction firm's debt to over five times its EBITDA.

Faster economic growth could also prompt central banks to raise rates and shrink their balance sheets more quickly than anticipated. That could make 2018 a year of both partying and hangovers.

# Boards and belligerents

## Wall Street's next challenge: graceful retirement

By Antony Currie

Retirement beckons for at least one chief executive of a major U.S. investment bank in 2018. Most of those running the top Wall Street firms have been in the job for a long time. And while they might pledge total commitment, each now has a decent excuse to step back: all their companies are on the most solid footing in a decade.



JP Morgan CEO Jamie Dimon speaks at a Remain in the EU campaign event in Bournemouth, southern Britain, June 3, 2016. REUTERS/Dylan Martinez

Four of the big five institutions – Bank of America, Goldman Sachs, JPMorgan and Morgan Stanley – now have market capitalisations comfortably above book value for the first time since last decade's financial crisis. Citi's hovers just below the value of its net assets, but it was whacked hardest by the mortgage bust and its aftermath. Chief Executive Mike Corbat has had, at five years, less time in charge than his peers.

Each can claim credit for the recovery. JPMorgan's Jamie Dimon and Lloyd Blankfein at Goldman Sachs – the two longest-serving chief executives at just over and under 12

years, respectively, avoided major missteps during the financial crisis. Dimon has grown JPMorgan into a dominant investment and commercial bank. Morgan Stanley's James Gorman has expanded wealth management and trimmed fixed income, while Bank of America's Brian Moynihan and Citi's Corbat have both sold unwanted assets and cut costs.

But bank share prices have also benefited from rising rates and U.S. President Donald Trump's planned tax cuts and rules rollbacks. Between the 2016 U.S. presidential election and Dec. 11, 2017, this triple bonus added more than 40 percent to Goldman's market capitalisation, more than 50 percent to Citi, JPMorgan and Morgan Stanley and around 70 percent to Bank of America. That must increase the appeal of moving on to executives who have – excepting Corbat – been in charge for longer than the average CEO tenure of eight years, as measured by executive search firm Korn Ferry.

Letting go is tough, of course. Blankfein still has to deal with poor performance at Goldman's fixed-income trading group. Gorman and Moynihan may want to stay until they consistently hit the 10 percent return on equity at which they are creating value for shareholders. That leaves Dimon as the obvious choice to retire first. He has served the longest, and his is the only bank with returns that have beat the S&P 500 since 2010. The coming year is his chance to leave on a high.

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## Activists are at the back door of fortress luxury

By Carol Ryan

Activists could stir things up in the business of luxury. Family control allows high-end fashion brands to hoard cash and live with second-rate governance. But assertive investors are becoming more willing to take them on, while some companies, like Prada, are more vulnerable than they appear.

Investors pushing for change have already targeted jeweller Tiffany & Co and handbag purveyor Kate Spade in the United States. In Europe, Albert Frere's Groupe Bruxelles Lambert recently became Burberry's largest shareholder with a 6 percent stake. Burberry is one of the few European players without a dominant shareholder, making activism a more obvious option. Yet Harris Associates has bought 2 percent of the public shares at Richemont, which owns Cartier, and 3.5 percent at Swatch. Both companies are dominated by insider voting blocks.

As developments elsewhere show, like Elliott Management's agitation at Samsung Electronics, entrenched owners shouldn't be complacent. A Harvard Law School study of 120 shareholder campaigns at companies with a controlling shareholding above 50



A woman sits in front of a Burberry shop in Rome, Italy, March 24, 2016. REUTERS/Tony Gentile/File Photo

percent found that four in 10 succeeded in getting one or more of the activist's demands accepted.

The luxury sector could benefit from the scrutiny, too. Richemont, for instance, is sitting on almost 6 billion euros of cash. And dealmaking hasn't always been disciplined. The high price paid by LVMH for Bulgari, for example, means that returns on the investment still aren't reaching the group's cost of capital six years later, according to HSBC. Elsewhere, companies that could be leading the way on governance are not: the chairman and chief executive roles remain combined at LVMH, Kering and Hermès.

One tool for activists is an Italian law that gives minority shareholders the right to appoint directors. It could give them a way in at companies like Tod's, Salvatore Ferragamo, Brunello Cucinelli and Moncler. The \$8 billion Prada, too, is exposed despite its Hong Kong listing and an 80 percent family holding. And shareholders could easily find things to complain about. For one, the 12.4 million euros paid last year to each of the brand's co-CEOs, Miuccia Prada and her husband Patrizio Bertelli, amounted to 9 percent of net income.

Activists have fewer options at, for example, French giants LVMH and Kering, where outsized voting rights can shut out insurgents. Still, all luxury brands are touchy about their reputations. A high-profile activist assault could lead even powerful families to see the light.

## Mega-miners will find good things in small packages

By Clara Ferreira Marques

Being a global miner is no longer all about size. The industry still depends on moving tons cheaply. But big producers must increasingly think like small ones. For companies like Rio Tinto and BHP Billiton, that requires a change of mindset – and in some cases, leadership.

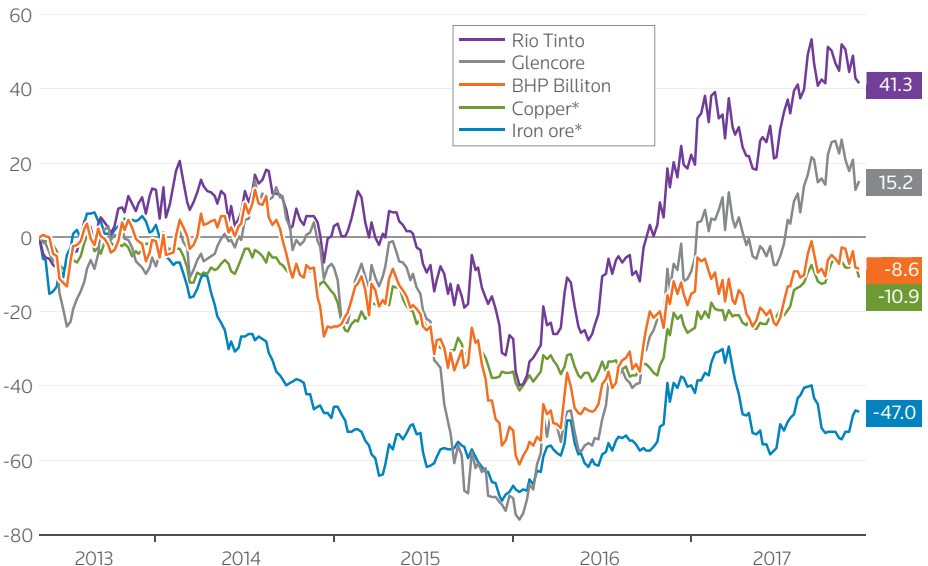
Commodity producers have for years chased bigger mines, larger diggers and longer ships. Valemax vessels, giant iron ore carriers, were so large they were unable to dock in China for more than three years after they launched. BHP's attempt to buy Anglo-Australian rival Rio in 2008 epitomised the quest for scale.

When the commodities cycle turned downwards, empire-building bosses like Vale's Roger Agnelli and BHP's Marius Kloppers made way for cooler heads. Divestments and writedowns followed. The need to cut debt curbed acquisitive tendencies.

That's changing. First, miners have less debt and more cash. BHP's free cash flow is close to where it was in 2011, before prices plunged. The big four miners – BHP, Rio,

### BHP versus metals and rivals

Total shareholder return (incl. reinvested dividends) since Mackenzie became CEO



Source: Thomson Reuters Datastream, data to 12/8/2017

\*price performance

Anglo American and Glencore, with a combined market value of almost \$300 billion – have more than halved their net debt since 2013, to just under \$44 billion.

Secondly, there's the impact of green energy. Rechargeable batteries have boosted demand for copper, lithium and cobalt – the price of which has roughly tripled since the start of 2016.

Sure, new trends are not going to upend sources of profit like BHP's Australian megamines. But miners now need to think like private-equity investors or tech companies, buying small stakes that provide growth or skills. Rio is considering a bid for a stake in Chile's SQM, the world's largest lithium miner, sources told Reuters. That would add expertise and some growth, though SQM's entire revenue only amounts to 6 percent of what Rio made in 2016.

Whether current bosses are up to the task is a different question. BHP's Andrew Mackenzie, for example, has been willing to sell assets, but it took a shove from activist Elliott before he started to actively tackle underperforming divisions like U.S. shale and Canadian potash. Being nimble is tough. A cyclical shift may need a governance shift to match.

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## Big Oil's discipline reinforces shale's swing role

By Lauren Silva Laughlin

Big Oil is going to be disciplined in 2018. That doesn't necessarily mean less production, but it does mean going for cheaper, faster projects first. That only helps U.S. shale – and means more frustration for oil-producing countries that would like to see a higher price.

ConocoPhillips is one U.S. producer that has explicitly discussed a measured approach to future spending. In November, Chief Executive Ryan Lance told Reuters the company would limit production spending to \$5.5 billion per year over the next three years, and it wouldn't invest in projects that required oil above \$50 a barrel to make a profit. It's a common theme. Exxon Mobil, Occidental Petroleum, Royal Dutch Shell and their peers are all under pressure from shareholders to prove they can make money throughout the cycle.

Expensive, longer-term projects will be constrained as a result, while U.S. shale, among the fastest and least costly sources of oil in the world, will fill in the gap. In 2017, U.S. tight oil, as shale is also known, solidified its place as the market's swing producer even as OPEC, the oil world's dominant cartel, cut production. The International Energy



An oil pump is seen operating in the Permian Basin near Midland, Texas, United States May 3, 2017. REUTERS/Ernest Scheyder

Agency says that though the number of active U.S. rigs fell in 2017, output will continue to rise in 2018.

In the nearer term, OPEC's decision to extend its curbs on production until the end of 2018 will help keep a floor under prices. But shale's contributions will keep a lid on them. The U.S. Energy Information Administration sees oil hovering at \$53 a barrel, with the International Monetary Fund's estimate slightly lower. Aiming for profit might keep some disciplined. But analysts expect returns on capital for the most focused tight oil drillers to shoot up as a result of the higher prices wrought by OPEC. And \$50 a barrel is plenty high enough for drillers in the Midland Basin in West Texas, who can cover their operating expenses at half that.

Unless new discoveries or technologies upend the energy sector, shale's influence will grow. The IEA says U.S. shale output in the 15 years to 2025 will match the highest sustained period of oil output growth by any single country in the history of the oil markets. By then the United States will be the largest liquefied natural gas exporter and, shortly after, a net exporter of oil. Shale has the power to keep oil prices subdued for a long time yet.



## Saudi Aramco's backup IPO plan runs through China

By Rob Cox and Pete Sweeney

Saudi Arabia's Mohammed bin Salman is a crown prince in a hurry. Besides detaining members of his family in a corruption sweep and painting a high-tech vision of the kingdom's future, the young ruler-in-waiting is also planning to sell a chunk of the national oil company, Saudi Aramco, to international investors. For that to proceed in 2018, he'll need to choose a venue besides Riyadh for the listing early in the year. China looks like the best option.

Setting aside questions about Aramco's value, which the crown prince himself has pegged at an ambitious \$2 trillion, there are hurdles to bringing what's likely to be the world's largest corporation to more traditional marketplaces.

Start with London. Britain is bending over backwards to bring Aramco to the London Stock Exchange. Prime Minister Theresa May and then-LSE chief Xavier Rolet traveled to Riyadh and lobbied Aramco's chairman for the business in April. Over the summer, the Financial Conduct Authority proposed to twist its rules to create a new listing category for companies controlled by sovereign states. Amid some resistance, the rules had yet to be finalized as of early December.



Amin Nasser, president and chief executive officer of Aramco, arrives at the Future Investment Initiative conference in Riyadh, Saudi Arabia, Oct. 24, 2017. REUTERS/Hamad I Mohammed

There's also an additional wrinkle. The LSE's biggest shareholder is the Qatar Investment Authority, the sovereign wealth fund of that country's al-Thani monarchy. Yet Saudi Arabia launched a trade and economic boycott of Qatar in early 2017, alongside other Gulf nations. The crown prince, in an interview with Reuters Breakingviews in October, called Qatar's investment a "very, very, very small issue." But that still signals it's an issue.

New York has a different problem. President Donald Trump took to Twitter in November to extol the benefits of a U.S. listing. But Saudi Arabia could fall foul of the U.S. Justice Against Sponsors of Terrorism Act, or JASTA. The law passed by Congress in 2016 would allow Americans to sue the Saudi government for damages, on the alleged grounds it helped to plan the 2001 attacks on the World Trade Center and the Pentagon. Aramco's New York presence would make it the biggest target for the plaintiffs' bar in American legal history.

## Chinese backup

All of which raises the possibility of Hong Kong's role in Aramco's future. The Chinese city is morphing from a mere back-up plan to a potential front-runner among the deal's backers.

One reason is flexibility. Though the Hong Kong exchange would need to bend some rules to allow Aramco to list, Chief Executive Charles Li is loudly signaling his eagerness. He's pushing a new program called "Primary Connect," which would allow mainland Chinese investors to buy into initial public offerings in the special administrative region's exchange. Li says that's "key" to closing the Saudi float.

Even without the Connect – which would require Beijing's approval, too – the exchange has other advantages. Hong Kong Exchanges and Clearing is a for-profit company trading publicly in Hong Kong, which regulates listings on the very board on which its own stock trades. It is in its business interest to grant the oil giant an exception to its requirement that companies list a minimum of 25 percent of their stock – something that would instantly render Aramco the largest member of the Hang Seng Index by a margin of around \$200 billion.

A 5 percent free float would be easier to swallow. At \$100 billion, it would leave the company adjacent to insurer AIA, politely leaving mainland tech champion Tencent in first place. Exchange executives would have to deem the Tadawul exchange in Riyadh to offer standards of shareholder protection "equivalent to those provided in Hong Kong," but that is unlikely to take long.

The other thing the city can offer is a roster of Chinese state-owned financial gorillas, potentially ready to invest on terms that will give the crown prince the valuation he wants – and not too fussed about transparency. Reuters reported in April that a consortium of

government oil giants like PetroChina and Sinopec, major banks, and the \$800 billion sovereign wealth fund could be rallied to serve as cornerstone investors.

If Aramco does choose Hong Kong, it could signal a political shift. China's interest in the relationship with Saudi Arabia is strategic, focused on offsetting American influence in the Middle East, and on achieving greater leverage over energy prices. It is therefore likely to ask for a quid pro quo, such as oil-price concessions, supply guarantees, or even denominating oil contracts in yuan instead of dollars. The latter could set off unpredictable changes in global energy and currency prices, and alienate the United States, Saudi Arabia's primary security guarantor.

The biggest risk might be embarrassment. Non-Chinese companies haven't done too well out of secondary listings in Hong Kong of late: Swiss miner Glencore and U.S. luxury brand Coach – now known as Tapestry – took down their tickers in late 2017, blaming tepid turnover. There have also been numerous scandals surrounding IPOs by mainland firms. If nobody trades the stock, share prices could struggle to stay in natural sync with the Tadawul, which is unlikely to see much volume.

No matter the reception in secondary markets, an Aramco listing in Hong Kong would be rich in irony: a marriage of convenience between an atheist communist bureaucracy and a monarch from the theological heart of Sunni Islam – united by a preference for opacity.

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## Regulators will drive next wave of EU bank mergers

By Peter Thal Larsen

The next wave of European bank mergers will please regulators more than shareholders. A decade after Royal Bank of Scotland completed its catastrophic 70 billion euro break-up bid for Dutch lender ABN Amro, European financial institutions are once again at the centre of speculation about cross-border deals. This time, however, watchdogs rather than executives are leading the charge.

For years after the 2008 financial crisis, the notion of European banks crossing borders to buy their rivals was taboo for bankers, politicians and regulators. The painful memory of ABN Amro was largely to blame. The Dutch lender and two members of the three-bank consortium that acquired it were nationalised within a year of the deal's completion in 2007. The British state is only now preparing to offload its 71 percent shareholding in RBS. Chastened regulators instead concentrated on making banks smaller and simpler.

Europe's banking union has changed the mood, however. The sovereign debt crisis in the single currency area exposed the dangers of intertwined banks and governments, as both Ireland and Spain were forced to seek financial assistance from other countries to rescue their own lenders. In an attempt to break the link, policymakers handed responsibility for regulating euro zone banks to a new supervisor, housed in the European Central Bank. That institution has become a cheerleader for consolidation. "The banking union has paved the way for cross-border mergers," Danièle Nouy, chair of the ECB's Supervisory Board, declared in September. "All that's missing is brave banks that will set sail to explore and conquer this new territory."

Advocates of dealmaking have roughly four arguments. First, mergers and acquisitions will help shrink what is still an oversized and fragmented industry: though the number of euro zone banks has fallen by roughly a fifth to 5,000 since the crisis, their assets are still a hefty 280 percent of the region's GDP. Banks in the United States are roughly a third of that size relative to economic output, although this is mainly due to a more vibrant capital market and government-backed mortgages. Second, cross-border deals will create more diversified lenders which are better able to weather local economic shocks. Third, consolidation will boost efficiency. Finally, bigger European banks will be in a better position to compete with American and Asian rivals.

Many bank executives remain sceptical. For one, Europe's banking union is still far from complete. Lenders with subsidiaries in multiple jurisdictions face restrictions on moving cash across borders. It is still not possible for a bank to use, say, German retail deposits to fund small business loans in France. Taxes, regulations and laws for protecting consumers differ from country to country. Politicians continue to bicker over the details of the euro zone's proposed deposit insurance fund – a scheme which executives see as vital to creating a level playing field for banks across Europe.

This regulatory patchwork limits the scope for banks to squeeze savings from cross-border mergers. Indeed, there's little evidence that big financial institutions are more efficient than smaller national lenders. A recent study by UBS analysts found that large retail banks had lower returns on tangible equity than local peers, accepted lower lending margins, and often struggled to sell a broader range of products. The extra capital buffers that regulators impose on banks deemed of global systemic importance are a further deterrent to bulking up.

Even so, speculation is heating up. UniCredit of Italy and BNP Paribas of France are both seen as potential suitors for Germany's Commerzbank. Executives including Deutsche Bank Chief Executive John Cryan and Urs Rohner, chairman of Credit Suisse, have talked publicly about the benefits of cross-border deals.



A pedestrian holding an umbrella and her wallet walks past the word "CASH", part of a sign on a street at a shopping district in Tokyo, Japan, March 7, 2016. REUTERS/Yuya Shino

A decade ago, the combination of gung-ho executives and short-term investors led to the ABN Amro catastrophe. This time round, regulators are the driving force. Any big cross-border union will have to determine which executive ends up in charge of the enlarged group, and which location gets to keep the headquarters. Politicians and unions will object to branch closures and job losses, while shareholders will be wary of anything that smacks of a cosy carve-up. Still, euro zone bank executives who are able to overcome these obstacles will at least be assured of a warm welcome from their supervisors in Frankfurt.

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## Bank compliance-cost explosion will abate in 2018

By Christopher Thompson

Banks will soon have scaled Peak Compliance. Post-crisis over-regulation, as he sees it, has rankled with JPMorgan boss Jamie Dimon lately, and he's not alone. Over the past decade European banks' operating margins have shrunk by more than a third, according to Deutsche Bank research. Ultra-low interest rates have a lot to do with that, but another factor is higher outlays on reporting, due diligence and the like – not to mention litigation. Next year could prove the turning point.

Two large outstanding pieces of the regulatory jigsaw should fall into place. These are the introduction of the updated EU Markets in Financial Instruments Directive and the finalisation of new Basel rules on bank capital.

Though bankers like to kvetch about compliance, they mostly have themselves to blame. Rule-breaking and reckless risk taking – albeit mostly before 2008 – have cost lenders some \$320 billion in bad-conduct fines since the financial crisis, according to the Bank of England. Governments and rulemakers have cracked the regulatory whip in response.

The number of rule changes resulting in regulatory alerts totalled a staggering 52,506 in 2016, according to Thomson Reuters data. However, that represents a mere 2 percent year-on-year rise, a dramatic slowdown from the average double-digit annual increases since 2008. The completion of the two big initiatives should further reduce regulatory churn, as should the deregulatory bent of U.S. President Donald Trump's administration. That's a relief for the likes of Credit Suisse, which says compliance costs have surged 84 percent in the past two years.

Meanwhile, most banks have put fines for earlier misdeeds behind them. Only around half of the biggest of them expect higher compliance budgets this year and next, down from more than two-thirds in 2016 according to a Thomson Reuters survey.

Universal banks will continue to shoulder a large burden, not least because of their exposure to money-laundering risks. In November, Standard Chartered said its deferred prosecution agreement with U.S. authorities would be extended. But HSBC said on Dec. 11 that its DPA was expiring. That suggests some kind of boundary even for the potentially limitless extent of so-called know-your-customer rules.

It all means the pressure of continually tougher – and costlier – standards will begin to ease. That in turn should be positive for profitability.



A sign for Bank Street and high rise offices are seen in the financial district in Canary Wharf in London, Britain, Oct. 21, 2010. REUTERS/Luke Macgregor/File Photo

## A deluge of scandals in Japan will drive change

By Quentin Webb

Investors will keep the pressure on corporate Japan to change. On top of governance trouble, like the strategic and accounting errors that nearly killed Toshiba, have come revelations of dodgy quality-control at firms such as Mitsubishi Materials and Toray. The scandals are likely to continue into 2018.

Recent episodes have turned out less serious than the lethal airbags which drove Takata into bankruptcy in June. Kobe Steel, for example, sold metals that were not up to specifications although as of Dec. 1 the company had verified with over 90 percent of customers that they were still safe. Meanwhile Nissan and Subaru had unqualified staff inspect cars. Exhaustive coverage of these gaffes also reflects Japan's national obsession with quality.

Still, it is hard not to worry about corner cutting when products go into trains, planes and nuclear plants, as Kobe Steel's do. The lapses undermine a hard-won reputation





Kobe Steel Managing Executive Officer Yoshihiko Katsukawa bows at the end of a news conference in Tokyo, Japan, Oct. 11, 2017. REUTERS/Toru Hanai

for manufacturing excellence. And they dovetail with anxiety, rekindled by the crisis at Toshiba, about poor corporate governance. That is despite years of pressure from reformers and activist shareholders to make firms better-run and more investor-friendly.

Likely factors include overworked staff, unrealistic promises to customers and, when it comes to whistleblowers, declining loyalty to employers as Japan's "job for life" culture fades. In the coming year, the flood of publicity could encourage more leaked revelations, while some companies might find fresh flaws themselves.

The silver lining is that this ought to catalyse better behaviour. Thanks to governance reforms, many boards now have at least two independent directors. They should be asking tough questions about culture and processes, whether compliance teams have enough clout, and whether executives oversee things effectively.

Given the potential for value destruction, shareholders should also keep pushing. Even after recovering somewhat, Toshiba's shares closed 36 percent lower on Dec. 7 than a year earlier. Takata's nightmare wiped out well over \$2 billion of shareholder value. Creditors, including carmakers, banks, and bondholders, are owed \$33 billion.



Companies could bring in global experts to help with quality control, too. More testing could be outsourced to specialists like Bureau Veritas. Firms will also need truly independent lawyers, accountants, investigators and the like to review systems and controls, says Tadashi Kageyama of Kroll. They should wherever possible eliminate easily manipulated manual data collection, he adds. Japan Inc has work to do to earn back trust.

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## India bids adieu to “promoter” capitalism in 2018

By Una Galani

India will make strides in kicking “promoter” capitalism to the curb in 2018. Errant tycoons have fewer places left to hide as Prime Minister Narendra Modi ushers in a new era of corporate governance, including a strict insolvency code. This will send serial defaulters packing and begin a shift toward more market, creditor, and shareholder-friendly forces.

The promoter is a concept unique to India. It describes businessmen who rose to prominence after independence in 1947, when the country needed locals to literally promote new industries. Those with access to capital and influence in New Delhi rose quickly. It typically refers to a large shareholder who has control over the affairs of a company.

Yet over the years, too many tycoons abused the system, borrowed to finance their equity, and siphoned off funds to enrich themselves. Alongside the withdrawal of government permits and legal obstacles, that’s partly responsible for \$150 billion of bad debt at banks now requiring recapitalization.

Modi’s new bankruptcy ordinance, modelled on Britain’s – along with recommendations to force companies to split the roles of chairman and chief executive – points to a clearer set of parameters for promoters. The insolvency regime cuts the “crony cord”, as one Mumbai-based bank CEO put it.

New Delhi leaves no room to doubt its determination to change corporate culture. India is going further than other countries by also stopping borrowers whose loan arrears have been outstanding for a year or more from bidding for assets out of bankruptcy. This is stymieing plans by the billionaire Ruias to buy back Essar Steel. India is also seeking the extradition of fugitive businessman and owner of the now-defunct Kingfisher Airlines, Vijay Mallya, who faces charges, including alleged fraud.



A stockbroker reacts as his family watches him trading during a special “muhurat” trading session for Diwali, the Hindu festival of lights, at the Bombay Stock Exchange in Mumbai, India, Oct. 19, 2017. REUTERS/Shailesh Andrade

Fast forward a few years and corporate India will look much cleaner, Zia Mody of AZB Partners said on a Breakingviews Predictions panel in Mumbai, noting large shareholders with skin in the game can still instill greater values in a firm than entirely professionalised companies.

Promoters face a more level playing field in other ways too. There is greater access to capital, and it’s no longer so easy to curry favour from politicians. Following demonetisation and a crackdown against illicit funds, a wall of domestic money is flowing into the local stock market, which is trading near a record high. India should get better governance to match in 2018.

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## **A Western money manager will turn Chinese in 2018**

By Alec Macfarlane

China could snare a Western asset manager in 2018. The industry is at a vulnerable point. Meanwhile, wealth in the People’s Republic is ballooning, and although overseas

investing is for now tightly restricted, firms will want to position themselves for any lifting of those curbs.

The rise of passive investing, and tougher regulations such as the revised version of Europe's Markets in Financial Instruments Directive, or MiFID II, has put pressure on traditional fund houses and helped spur consolidation.

That doesn't, however, make these outfits unattractive to potential Chinese suitors: they still offer expertise, big brand names, and lots of funds under management. Instead, if anything it makes them easier to pick off. As of late November, the Datastream index of European fund managers traded at roughly 15 times earnings, or nearly 16 percent below its 20-year average.

And this should all come with Beijing's signoff: China wants to develop its institutional-investment sector, and approves of strategic outbound deals in financial services. Deals like HNA's purchase of a stake in Old Mutual's U.S. unit are further evidence of the appetite.

This is a fragmented industry, with dozens of significant players, so identifying targets is difficult. But they could include both European institutions and U.S. stalwarts such as



Head of European fixed income at Franklin Templeton, David Zahn, speaks during a Reuters Global Investment Outlook Summit in London, Britain, Nov. 16, 2016. REUTERS/Luke MacGregor

Franklin Resources, the listed group behind Franklin Templeton. In some cases, bidders could swoop in on firms that are preparing to float, such as Axa's AllianceBernstein unit in the United States, or Deutsche Bank's asset management arm, which it is rebranding as DWS.

China's nascent industry also wants to spread its wings, so Western managers of credit, private equity and infrastructure funds could be alluring, too. And technology providers could be attractive, as the 2016 purchase of AssetMark by Huatai Securities shows.

The list of potential buyers is long as well. It spans insurers and brokerages; commercial banks; private conglomerates such as Fosun; and bad-debt managers like China Huarong and China Cinda, which are also increasingly ambitious. Western money managers are used to identifying investment opportunities; for China Inc, now they could become one.

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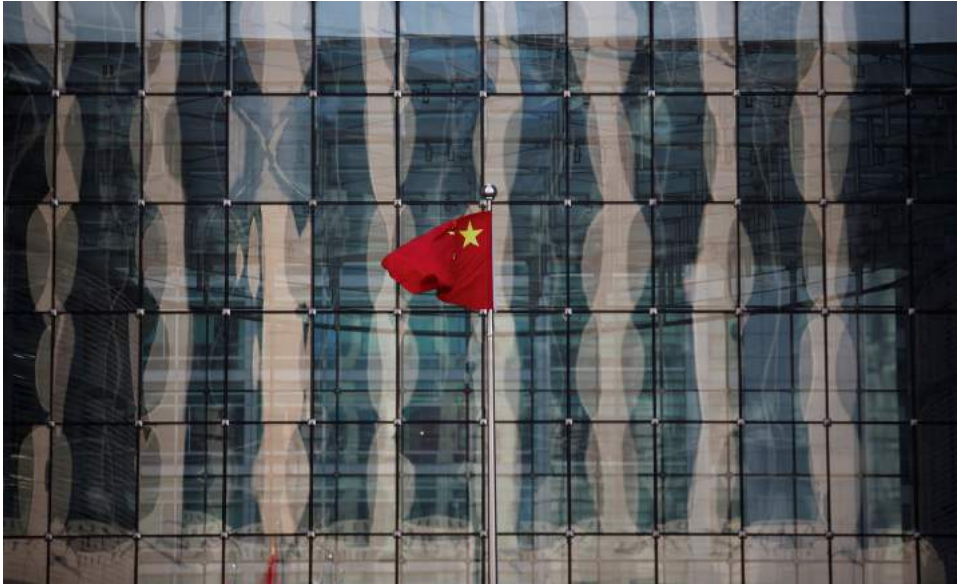
## China will pull private capital into state orbit

By Christopher Beddor

China's "mixed-ownership" policy push will put more private capital into lumbering state-owned enterprises in 2018. Beijing wants cash and expertise from the private sector to upgrade SOEs, many of them heavily in debt. The private companies concerned will take comfort that cooperation could reduce political risk. But for the broader reform agenda, half-measures will likely be worse than none at all.

This phase of ersatz liberalisation hit a new peak in 2017 with rickety telecoms giant China Unicom, which announced in August it would divest 35 percent of its Shanghai-listed unit to Alibaba, Tencent, Didi Chuxing and others for \$11.7 billion. The next round will likely include China Petroleum Electric Energy, a new unit of state oil champion China National Petroleum Corp. There are dozens more in official crosshairs, and signs of private interest. Private equity firm Hopu, for example, is raising a \$2.5 billion fund to invest in SOE reform.

Yet little real control will change hands. Unicom, for instance, will see its stake in the Shanghai subsidiary fall to 37 percent from 63 percent, but the government's net ownership will stay around 53 percent thanks to stakes held by other official entities. The presence of entrenched Communist Party committees, regulatory meddling, and divergent business interests among the private companies will further stifle any efficiency initiatives. From a certain angle, this programme looks more like a hidden tax on uppity private firms sitting on big cash piles.



A Chinese national flag flutters at the headquarters of a commercial bank on a financial street near the headquarters of the People's Bank of China, China's central bank, in central Beijing, Nov. 24, 2014. REUTERS/Kim Kyung-Hoon/File Photo

This initiative is running alongside others that will strengthen the party's influence within both state and private commercial enterprises – including reported plans to take equity positions and board seats in the country's biggest tech firms. That's hardly a shareholder value proposition, but there's a big upside for investors in these companies, particularly those who find themselves frequently on the receiving end of the regulatory stick – like Tencent. The targets are too important to fail, capping the downside. In addition, stakes may buy seats at the industrial policy insider's table, where executives can curry favour.

Unfortunately there's little else positive to say. Cross-shareholdings will make clubby industries even more incestuous. This could also align some powerful private companies alongside government monopolies. Beijing's tighter embrace might benefit private interests; the private sector, not so much.

## Sexual misconduct will haunt 2018 annual reports

By Jennifer Saba

This year's sexual-misconduct scandal will live on – in corporate America's 2018 annual reports. Revelations have sprung up in recent months that some companies used shareholder bounty to settle allegations male executives harassed and made unwanted advances on mostly female workers. In the coming proxy season, expect investors to put forward proposals pushing for more gender diversity and greater disclosure and action on the matter.



People gather for the Women's March in Washington, D.C., United States, Jan. 21, 2017. REUTERS/Shannon Stapleton

The sexual-harassment news gushing from Hollywood, New York, Washington and beyond is unprecedented. On Nov. 29 NBC fired popular talk-show host Matt Lauer. CBS's Charlie Rose, movie mogul Harvey Weinstein, actor Kevin Spacey and Democratic Senator Al Franken are just a few of the other high-profile men who have been called out for lecherous behavior.



Their abysmal conduct is reprehensible. It's also expensive. In recent years taxpayers footed around \$17 million in payments doled out to silence victims of ill conduct and discrimination on Capitol Hill. Rupert Murdoch's Twenty-First Century Fox forked over some \$200 million, according to a group of shareholders, to settle charges of misconduct leveled at executives and on-air talent at its cable news network.

The extent of the charges is still emerging, so it stands to reason that shareholders will take notice and make companies do more than simply apologize and settle. Larry Fink, the chief executive of BlackRock, which manages nearly \$6 trillion, bluntly summed up shareholder duty earlier this month: "You have to force behaviors."

Fox is already feeling the pressure. Investors rankled by scandals involving deceased former Fox News Chairman Roger Ailes and a star anchor, Bill O'Reilly, sued the board citing a systematic, decades-long culture that led to a hostile work environment. Fox agreed to settle for \$90 million and set up an independent "workplace professionalism and inclusion council."

Non-disclosures are insidious and flag real risks. Having more female directors may help keep bad behavior in check. Their ranks are growing, but slowly: in its sample of 500 of the largest U.S. companies by revenue this year, research outfit Equilar found women occupied around 21 percent of board seats, compared to 17 percent five years ago.

One activist who spoke to Breakingviews believes the sexual-harassment scandals will accelerate a push for more females in management and director roles. Added to that are possible shareholder proposals, similar to those delivered by environmental activists, seeking greater disclosure on how firms handle accusations of impropriety within their ranks. The proxies are coming.

*First published Nov. 29, 2017*

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# Code and consequences

## Tech salad will come with a side of SLAW in 2018

By Rob Cox

Much of 2017's American stock-market boom resided in an acronym: FAANG, for Facebook, Apple, Amazon, Netflix and Google, aka Alphabet. As important as they've become, investors tired of this trade can look forward to a new set of letters to jumble into a more exciting investment thesis. Call it SLAW.



People write messages next to a slogan at Facebook's offices in London, Britain, Dec. 4, 2017. REUTERS/Toby Melville

Four of the most highly valued private companies – Spotify, Lyft, Airbnb and WeWork – are in various stages of preparing to go public. Although none may ever match the scale of a FAANG or a BAT – as China's Baidu, Alibaba and Tencent are known – they're uniquely disruptive enterprises whose success, or failure, may determine the future of cities, mobility, work and fun.

The FAANG components altered the internet, retailing, communications and entertainment businesses. It's hard to imagine the next debutantes blossoming into \$900 billion Apples, but they operate in areas offering extraordinary potential to snatch market share from incumbents and stimulate new demand for their products.



Take Lyft. Though second in the United States to Uber in ride-hailing, an initial public offering would make it the first pure play for public investors on a future where transportation is sold as a service, not as an automobile. That potential has lured investors, including Google and General Motors, into giving it a valuation of \$11.5 billion.

Similarly, Airbnb has snagged a \$31 billion valuation as the leading home-rental app. Founder Brian Chesky says he's taking a "get rich slow" approach, but will be ready for an IPO in 2018. That would offer a way to bet on the emerging model for the lodging industry.

What Chesky is doing to hotels, Adam Neumann is doing to office space with WeWork. While it sounds grand to suggest Neumann's company is redefining the future of work, it was credible enough for SoftBank to shell out \$4.4 billion, valuing WeWork at some \$20 billion.

Then there's Spotify, which has upended the music industry with its streaming service. As if that's not unruly enough, founder Daniel Ek plans to list Spotify's shares without an IPO, potentially upsetting Wall Street's lucrative underwriting cartel.

These upstarts could choose to remain in private hands for another few years. But with investors hankering for ways to capitalize on changes to the way we work, play and travel, the ingredients to make a perfect SLAW will come together nicely in the new year.

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## Amazon to become biggest impact investor ever

By Rob Cox

Since June, when Amazon.com agreed to buy Whole Foods Market, Kroger, the largest publicly traded U.S. supermarket chain, has seen nearly \$8 billion of its market value disappear. That is a testament to the Shiva-like force the e-commerce pioneer led by Jeff Bezos can unleash, threatening to destroy swaths of the retail landscape and many of its jobs.

But here's another figure to consider. Over the past 10 calendar years, as Amazon grew from \$15 billion in revenue to almost \$100 billion, it paid just two-thirds of the taxes that Kroger did. The supermarket chain doled out \$7.2 billion to federal, state and local governments compared to Amazon's \$4.5 billion, according to annual reports.

That could be one foundation for public and government resentment against the \$550 billion e-commerce giant. But Bezos' search for a second headquarters for Amazon gives the company a chance to forestall that kind of backlash by setting up – and investing heavily – where it's needed most.

The company's request for proposals for a second North American head office, in which it expects to invest \$5 billion and to create as many as 50,000 high-paying jobs, is one route to some kind of redemption. Amazon received 238 proposals from 54 states, provinces, districts and territories by the Oct. 19 deadline. It says its final choice will come in 2018, kicking off with a \$600 million project to create 1 million square feet of office space.

No matter who wins, the competition has already had a beneficial impact. It has forced municipal and state leaders, local development agencies, businesses and nonprofits to work together, assess their strengths and weaknesses, take a fresh look at infrastructure and pool their resources. Even though only one city will win Amazon's office park, they should all now be better able entice other enterprises.

But Amazon has the chance to do more than just whip North American cities into a frenzy of tax rebates, sewer permits and land giveaways. Bezos' company could transform a place that might otherwise be struggling into an information-technology hub of the future – affecting millions of lives for the better, and creating new customers for its services, along the way.

“The big question for Amazon is whether they want to go to some place that is already an eight and help it get to 10,” John Strangfeld, the chairman and chief executive of Prudential Financial, told me recently. “Or they can choose a place that needs help, that may be a four today and could become an eight over time with Amazon's help. It's potentially a huge opportunity for Amazon.”

Strangfeld knows. Prudential is often lobbied to leave Newark, the city where the insurer and asset manager was founded in 1875 as The Widows and Orphans Friendly Society. Two years ago Prudential instead doubled to \$1 billion its commitment to impact investing, with a big slug of that devoted to its New Jersey hometown. Among projects Prudential helped support in Newark has been the redevelopment of the historic Hahne & Co department-store building – now home to one of Amazon's Whole Foods stores.

Newark isn't alone among municipalities that might be considered in need of a boost. Detroit has also made a pitch. “We are small-business savvy and billion-dollar business bold,” its promotional video to Amazon claims. Those hawking the Motor City's charms include Dan Gilbert, the Quicken Loans founder whose own investments helped revitalize a once-moribund downtown.

“By reinvigorating the American industrial heartland and going into Detroit, (Amazon) would add real social value,” says Scott Galloway, a marketing professor at New York University's Stern business school and author of “The Four: The Hidden DNA of



Jeff Bezos, president, chairman and chief executive of Amazon, speaks about the future plans of his spaceflight company Blue Origin in Washington, D.C., United States, March 7, 2017. REUTERS/Joshua Roberts

Amazon, Apple, Facebook, and Google.” He predicts a widespread political and social response to the rising power of the largest technology enterprises.

He may be right. While Amazon’s investors are patient, accepting Bezos’ strategy of diverting much of the money the group makes into other ventures, like web hosting and online entertainment, legislators and regular people, cognizant of the behemoth’s power to put people in traditional jobs out of work while contributing little to public coffers, needn’t share their tolerance. America’s biggest technology outfits are already facing scrutiny in Washington and other capitals over their market power and influence over society.

Though Galloway calls the Amazon headquarters competition “a giant head-fake and a ruse to occupy the front pages,” he believes Newark will win. In part that’s because, in conjunction with neighboring New York City, it will match many of the goodies other contenders offer. Plus, Galloway jokes, where else would a billionaire like Bezos want to spend his time besides Manhattan?

If making a socio-economic impact matters to Amazon executives deciding on “HQ2,” Newark and Detroit could be joined on a list of targets by Pittsburgh, Cleveland and

Baltimore. But none of these offers quite the symbolism that Hartford would, says the Connecticut state capital's mayor, Luke Bronin. The city Mark Twain called home once rivaled New York on the population and culture fronts. Today it is considering filing for protection from creditors.

"I gotta think someone like Bezos would understand that talk of bankruptcy to some extent reflects a willingness to do what's necessary to make a place strong," Bronin told me during a recent visit to his office overlooking the Wadsworth Atheneum, America's oldest continuously operating public art museum and the first to acquire works by Dali and Caravaggio.

Hartford's pitch includes its cultural attractions, as well as its location between Boston and New York, a nearby international airport and a skilled and educated workforce in a metro area that counts 1.2 million people. It's an opportunity to give new life to "a city that was at the forefront of the industrial revolution, that was at the forefront of insurance and financial services, and that still has that legacy visible," says Bronin.

Amazon's decision next year will shed some light on how much it considers itself "part of the fabric of the community," as Bronin puts it. By locating its second headquarters where it can make a real difference, Amazon could initiate one of the biggest impact investments ever.

*First published Nov. 16, 2017*

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## Sun will be setting on Silicon Valley imperialism

By Rob Cox

Around the time Snap's stock began slouching toward bedlam in March, something uncommon happened at a smaller outfit called MaxLinear. As the messaging-app owner was thumbing its nose at democratic capitalism by selling shares conferring no votes, the maker of specialized integrated circuits converted its super-charged shares to regular ones.

As of late November, Snap had made nearly half its market value disappear. Two other companies that followed its poor example by selling vote-challenged securities performed similarly. Cable operator Altice USA lost a third of its value and Blue Apron 70 percent.

MaxLinear did better than all of them, if only by treading water. The company – and a few others that went public more recently without Snap's fanfare – may prove lastingly



The Apple Campus 2 is seen under construction in Cupertino, California in this aerial photo taken Jan. 13, 2017. REUTERS/Noah Berger

influential for investors. Partly because of Snap's abysmal performance, rising pressure from fund managers and index creators will mark 2017 as a low for Silicon Valley governance.

Technology companies will keep going public with shareholder structures that treat outside investors like serfs. Expect more of them, however, to include so-called "sunset provisions" in their bylaws. These are expiration dates that draw limits around the despotism of founders and insiders.

They take various forms. MaxLinear's special powers endured for seven years from its initial public offering. MuleSoft, which went public days after Snap, has vowed to convert to one-share, one-vote status by 2022, or sooner if the super-class dips to 15 percent of outstanding shares. Other 2017 debutantes, including Stitch Fix, Alteryx and Okta, offered variations on the theme, albeit with terms twice as long as MuleSoft's.

For most investors, these clauses buried deep inside offering prospectuses matter less than growth prospects, valuations or burn rates. But who knows where these enterprises will be in five years? They may be so big they merit inclusion in the S&P 500 Index, which recently banned dual-class share structures for new entrants. Having the option to convert thus makes sense.

Alternatively, they could be failures – all the more reason for investors to know they will someday have an equal say. As the sun sets on 2017, at least some better governance is dawning.

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## India's e-commerce war to surface on U.S. shores

By Una Galani

A local war against Amazon will take on a global flavour when Flipkart, the arch-enemy to Jeff Bezos' American behemoth, files for a U.S. initial public offering as soon as 2018. The Indian online retailer, which sells everything from mobile phones to books, has good reason to snub Mumbai's markets, even though they are trading near record highs. For one, its biggest global peers are all listed stateside, where tech valuations are robust. But a New York debut for the \$12 billion Flipkart would also take the battle to Amazon's Wall Street home turf.



Binny Bansal, group chief executive of India's largest e-commerce firm, Flipkart, poses at the company's headquarters in Bengaluru, India, July 7, 2017. REUTERS/Abhishek N. Chinnappa

The firm founded by former Amazon employees Sachin Bansal and Binny Bansal (no relation) counts SoftBank's Vision Fund and U.S. fund Tiger Global amongst its largest investors. Smaller stakes are in the hands of U.S. marketplace eBay as well as two Chinese giants, Tencent and Alibaba, which itself is part-owned by SoftBank. That makes Flipkart something like a proxy for global investment into India's e-commerce market, which Morgan Stanley reckons will be worth around \$200 billion by 2027.

SoftBank's Masayoshi Son has clear ambitions to dominate the booming online consumer market, having earlier backed smaller rival Snapdeal. Jack Ma's Alibaba, which is already dominant in China, is also dabbling in India through its investment in Paytm Mall, which remains a relatively small player. It is all but inevitable that the pair, with Ma's assent, will consider combining resources to take on the mighty Amazon.

The \$550 billion Seattle giant already appears to have an edge in India, where it is investing heavily. An audience poll at a recent Breakingviews Predictions event in Mumbai concluded Amazon would win the e-commerce race in India and ranked Flipkart and Alibaba in distant third and fourth position. Mukesh Ambani's disruptive oil-to-telecoms conglomerate Reliance Industries, which isn't really a competitor yet, came in a surprising second.

A U.S. listing will provide access to capital as the industry increasingly devotes itself to expensive customer acquisition offers, like 100 percent cash back. It might also pave the way for a deal with Paytm Mall, and the start of a real challenge to Amazon's seemingly unstoppable dominance. Throw in a Flipkart listing and the online proxy war in India will start enlisting mercenaries on Wall Street, too.

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## Hong Kong will start atoning for missing Alibaba

By Alec Macfarlane

Losing Alibaba's 2014 listing to New York was embarrassing for a city that has thrived connecting China to world markets. Hong Kong could go some way to making up for this in 2018.

New York has been the go-to venue for initial public offerings of Chinese technology firms. It hosts more internet companies than Hong Kong and the market is simply much bigger. U.S. investors have traditionally been more open to backing loss-makers. And founders can retain outside control relative to their economic stakes, which is not possible in Hong Kong.





Hong Kong Exchanges and Clearing Chief Executive Charles Li attends an interview by Reuters in Hong Kong, China, Sept. 5, 2017. REUTERS/Bobby Yip

That is starting to change. The Frangrant Harbour hosted a string of well-received tech flotations in 2017, some of them unprofitable. The growing number of stocks means analysts and investors are increasingly well informed about the sector. And Hong Kong has an in-built cultural advantage: it is more welcoming of Chinese bosses who do not speak English, and of apps that would baffle an American audience.

So the stage is set for Hong Kong to win over China's up-and-coming tech players. The biggest include news aggregator Toutiao, food-delivery to hotel-bookings group Meituan-Dianping, and ride-hailing firm Didi Chuxing. Actual or potential fundraisings in 2017 valued the three at \$20 billion, \$30 billion and \$50 billion, respectively. All three could list in 2018. Assuming valuations rise by one-quarter by the time the trio list and they sell up to 25 percent stakes, the IPOs could raise over \$30 billion. Lufax, a peer-to-peer lender backed by Ping An Insurance, is another prospective candidate.

The potential clincher for these companies is due in 2018, when firms will probably be allowed to list with multiple classes of shares. This is not great news for investors: Hong Kong lost Alibaba's record-breaking IPO because of the regulator's principled objection to unorthodox voting rights. There are some signs of movement in the other direction stateside. And weakening the system does not bode well for governance in an already scandal-prone market. But it will undoubtedly increase the city's attraction for company founders. Expect Hong Kong's tech sector to expand in 2018.



## China will plant a tech leadership flag with 5G

By Robyn Mak

China will lead the global 5G race. The country will soon set many standards for ultra-fast mobile broadband, boosting domestic outfits at the expense of Nokia and other foreign companies. This is a foretaste of coming battles for technological superiority.

The two big sporting events of 2018, the Winter Olympics in South Korea and the soccer World Cup in Russia, will both be used to showcase 5G. Spectators in Pyeongchang will be able to stream 360 degree virtual-reality videos in real time, and catch self-driving buses, the South Korean telecoms operator KT boasted recently.

For China, launching the first commercial 5G network in 2020 is a key industrial priority. It reckons 5G, which can connect billions of devices and machines, will contribute 2.9 trillion yuan, or \$440 billion, of economic value and 8 million jobs by 2030.

Beijing also wants its technology to be included in worldwide standards. To date, new wireless technologies have been dominated by the likes of U.S.-based Qualcomm, Nokia in Finland, and Sweden's Ericsson. These companies own huge stashes of mobile patents that are used by everyone from Apple to Samsung.



People check their phones during the third annual World Internet Conference in Wuzhen, Zhejiang province, China Nov. 17, 2016. REUTERS/Aly Song

But Chinese outfits, in particular telecoms-equipment makers Huawei and ZTE, are pouring huge sums into researching and developing 5G breakthroughs. Local carriers are already experimenting with network upgrades in the world's largest mobile market.

So the first draft of global standards, due in 2018, is likely to show lots of Chinese influence. The ultimate specifications will not be finalised until 2020, but Edison Lee at Jefferies reckons Chinese groups, led by Huawei and ZTE, could capture up to 20 percent of essential 5G patents. That would make them the most important force in this generation of technology, after playing a negligible role in 4G. The financial benefits are hard to estimate, but this should help the duo win more business abroad.

Similar battles will follow. In electric vehicles, China is becoming a major player, aided by government-stoked demand. That benefits local suppliers, like car and battery maker BYD. Likewise, web titans Tencent, Alibaba and Baidu are chasing the likes of Alphabet in artificial intelligence and cloud computing, again with state backing. China's influence in global tech will keep rising.

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## Electric cars will catch up with gas guzzlers

By Katrina Hamlin

Electric cars will draw even with gas guzzlers in 2018. Plans to ban dirty vehicles have been stoking investment in clean transport, reducing costs. Consumers will soon find battery power as cheap as combustion engines – even without subsidies. But automakers will struggle as margins tighten.

Policymakers have gently encouraged electric vehicles for years. Now they are revving up more aggressive tactics. In recent months, China, India, Germany, France, and the United Kingdom announced policies to phase out the internal-combustion engine. Even venerable carmakers can no longer see electric vehicles as merely a nice-to-have: Daimler, Ford Motor, General Motors and Volkswagen are all hurrying to establish new technology and brands.

As demand speeds up, both the quantity and quality of battery production is improving. Manufacturers are doubling down on energy-dense battery chemistry, making cells more efficient and economical. China plans a rapid increase in capacity as local giants BYD and CATL expand, bolstering economies of scale. So do other major production hubs. Battery costs are falling as quickly as 10 percent a year, according to analysts.

In May, UBS suggested that 2018 could be the year consumers first find electric vehicles as affordable as fossil-fuelled alternatives, factoring in running costs – the bank reckons



Nissan Motor's new Leaf is seen during its world premiere in Chiba, Japan, Sept. 6, 2017. REUTERS/Kim Kyung-Hoon

Europe will come first, followed by China and other markets. The case has become more bullish since then. Enlarged manufacturing capacity and cheaper production for battery packs offset rising component costs, adding to downward pressure on prices. Since electric vehicles are cheaper to maintain, there is rising demand from commercial fleet buyers like cab and ride-sharing companies. For those buying in bulk, price parity could be even closer.

Unfortunately the traditional auto industry has less to look forward to. Mercedes Benz executive Frank Lindenberg said he expects electric models to earn half as much profit as traditional cars. The world's largest auto-parts maker, Bosch, reported 2016 profit fell 6.5 percent on investments into EV products. UBS forecasts manufacturers might achieve an EBITDA margin of 5 percent on their electric models – by 2023. Rising commodity prices and fierce competition could push that date further back, and PSA Group has cautioned that consumers may also need time to develop a taste for EVs.

The transition will be environmentally and economically positive. But the old auto brands will have to be dragged along for the ride.

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## Uber for everything will arrive in 2018

By Quentin Webb

The tech industry had an incredible 2017, awash with cash and eager to disrupt everything. Sure, there may have been the odd governance scandal, some unfortunate hacks, and a few loopy ideas. But technology is clearly eating the planet, and the exuberance of forward-thinking investors like Japan's SoftBank and Saudi Arabia won't last forever. So Breakingviews, through its new innovation lab BreakingVentures, presents some choice startup ideas.

**Superficial.ly:** Think "Theranos for mining". Instead of digging huge holes, our direct-to-consumer service uses top-secret technology to extract totally useful amounts of natural resources through a straw, then ships them via courier to the doorstep. Our highly decorated board, each a Nobel laureate, is a badge of quality. They all won the literature prize, but still: experts.

**Jailr:** "WeWork for prisons". You might think correctional facilities are a property and staff-intensive concept straight out of the boring "old economy". Jailr, inspired by the boom in shared workspaces, has other ideas. Our asset-lite prisons, curated by algorithmically vetted guards, will show that crime actually can pay. And what if we told you there was foosball and yoga?

**Inward.ly:** "SpaceX for Jules Verne fans". Footling about with 280-character messages is for kids. Instead, we're drilling to the centre of the earth. Let's go after the hard problems!

**Respectful.ly:** "HR for tech bros". Think of this application, which rewords abrasive or inappropriate email communications and overrides questionable recruitment decisions, as a diversity and compliance solution in a box. Tailored versions will be available for adjacent verticals like Hollywood, stand-up and politics.

**Tabbouly.ly:** "Juicero for hummus". Make way for the internet of chips-and-dips. In keeping with our relentless focus on solving humanity's most pressing challenges, we are excited to present this maker of \$800 high-protein spreads. You won't believe you ever settled for shop-bought chickpea paste or baba ghanoush.

**Viewscoin:** "Bitcoin for latecomers". Breakingviews predicted the collapse of bitcoin when one unit of the digital currency was worth \$87. At the time of writing, it's worth roughly \$20,000. Having missed a massive rally, we now want in with our own crypto-currency. White paper and initial coin offering coming soon.



A photo illustration shows the Uber app on a mobile telephone, as it is held up for a posed photograph, in London, Britain, Nov. 10, 2017. REUTERS/Simon Dawson

# Polls and populists

## U.S. political doomsday will hurt economic growth

By Gina Chon

A political doomsday is approaching in the United States. Republican and Democratic parties will splinter ahead of the 2018 midterm election, marginalizing moderates. More firebrand politicians increases the chances of government shutdowns, a U.S. debt default and trade wars. The economy would be collateral damage.



A statue of George Washington stands in U.S. Capitol Rotunda in Washington, D.C., United States, Sept. 12, 2017

Turmoil is growing inside both major U.S. political parties. On the Republican side, former White House chief strategist Stephen Bannon is backing congressional candidates who defy the establishment, like Roy Moore, the former Alabama judge accused of sexual harassment. Moore lost a special Senate election in mid-December, in a stunning upset for the GOP. Bannon has also called for the resignation of GOP Senate Majority Leader Mitch McConnell.

Democrats are not immune. Senator Elizabeth Warren recently said the 2016 presidential primary was rigged against socialist Bernie Sanders in favor of Hillary

Clinton. Senator Dianne Feinstein was booed at a San Francisco event for saying President Donald Trump could be a good leader if he changed. A few months later, she drew a primary challenge from a more liberal candidate.

In November and December, left-wing congressional Democrats were pushing for a government shutdown if Republicans failed to help young illegal immigrants who faced deportation under Trump. In 2013, the tables were turned when conservative Republicans forced a 16-day shutdown and put the country at risk of defaulting on its debt over the Obamacare repeal fight. Extremists on both sides also want to scrap trade deals like the North American Free Trade Agreement after successfully pushing for the U.S. pullout from the Trans-Pacific Partnership.

Moderates, meanwhile, are fleeing politics or are under threat of ejection. About two dozen House Republicans have announced they will not run for re-election. Many are centrists from districts that Trump narrowly won, like Dave Trott in suburban Michigan.

Six moderate Democratic senators face tough re-election bids in states that Trump won in 2016. Five of them, including Joe Donnelly of Indiana, co-sponsored a Republican-led bill to raise the threshold for a bank to be considered systemically important from \$50 billion to \$250 billion. It was a rare moment of bipartisanship.

Those kinds of moments could disappear altogether with many 2018 candidates running to blow up the system. Many are willing to risk government shutdowns, debt defaults and trade wars to prove their point. There will be few compromisers left to stop them.

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## U.S. will miss out on infrastructure again in 2018

By Richard Beales

Every week is infrastructure week, the wags in Washington say. But the effort promised by President Donald Trump to revitalize everything from airports to schools to toll roads keeps being pushed back. It will still be up in the air in 2018.

The president has talked about mobilizing \$1 trillion, though even that's modest compared with the more than \$2 trillion of infrastructure investment the American Society of Civil Engineers says is needed over the coming decade. There's plenty of private money eager to step in, not least the \$40 billion fund announced in May by Blackstone, with Saudi Arabian backing.

Some of the tax tweaks proposed by the House and Senate GOP could tilt the market in that direction. The lower chamber's ideas include ending tax exemptions on interest

## U.S. investment plans fall short

### Infrastructure needs, \$bln

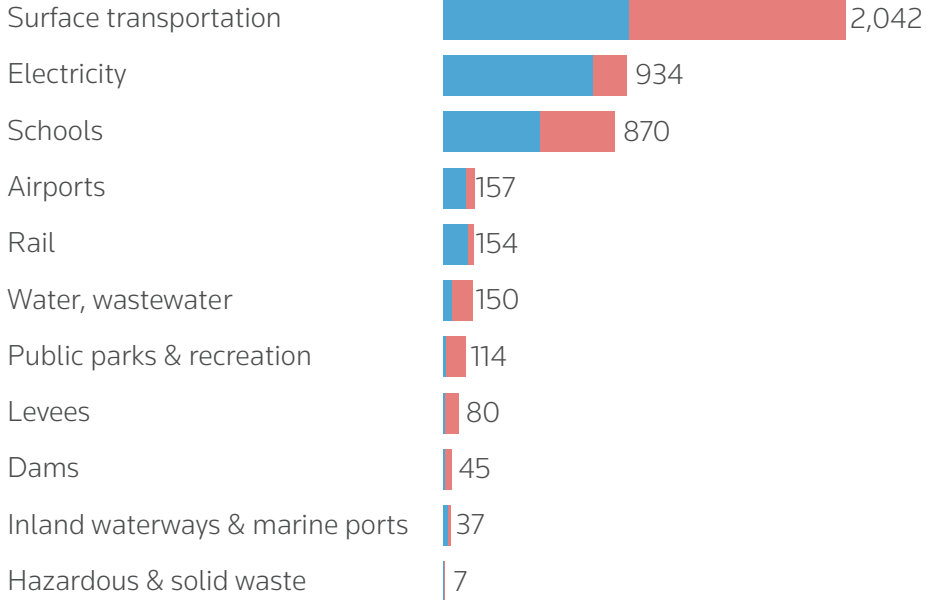
2016-2025

### Existing funding

Total: \$2,526 bln

### Funding gap

Total: \$2,064 bln



Source: American Society of Civil Engineers

income from so-called public-activity bonds, one source of funds for airport projects, for example.

Removing that subsidy, and others like it, could narrow the gap between the cost of private-sector capital and tax-exempt debt. That could allow privately funded projects to proliferate, bringing to bear cash and management expertise that's not bogged down in federal, state or local government bureaucracy. It's possible, though, that this type of change will be eliminated as lawmakers compromise on one bill.

Meanwhile, most U.S. states and cities haven't embraced public-private partnerships for infrastructure to the extent seen in Europe and Australia. That is partly because of the cost advantage of the \$4 trillion municipal-bond market. Yet most authorities are strapped for cash if not already dangerously indebted. So-called P3s can take big outlays off a local government's plate and manage assets efficiently. Even so, they are no panacea, especially for socially important projects that don't offer sufficient financial return.



That leaves the feds. Trump's infrastructure initiative, such as it is, was overtaken in 2017 by efforts to repeal his predecessor's healthcare law and cut taxes for companies. With the tax changes seemingly on track, Republicans are now looking to squeeze spending on welfare and healthcare rather than lay out more on transportation and the like.

Australia's federal government incentivizes states to "recycle" assets by selling concessions on existing infrastructure to private buyers and sinking the proceeds into new projects. The trouble is, that kind of program requires both time and money. At this rate whatever the White House says, Congress won't have much of either in 2018.

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## Latam's turn from populism will be put to the test

By Martin Langfield

Latin America's turn from populism faces a stress test in 2018. Demagogues of right and left will challenge the region's recent embrace of moderate, pro-business pragmatism. Presidential elections in Mexico and Brazil look set to feature verbal bomb-throwers keen to exploit voter anger at corrupt elites and lawlessness. The center, if it holds, will emerge stronger.

The blowhard policy stylings of U.S. President Donald Trump will have echoes in Latin America's two biggest economies.



Mexican presidential candidate Andres Manuel Lopez Obrador signs one more book before leaving a book signing session in Los Angeles, California, United States, Aug. 29, 2017. REUTERS/Kyle Grillot

In Brazil, lawmaker and ex-paratrooper Jair Bolsonaro has courted outrage with misogynist and pro-gun postures as well as support for the use of torture by former military dictatorships. He hopes to follow Trump's path to the top job by appealing directly to voters through social media, building on Brazilians' disgust at rising urban violence and corruption scandals tainting many established politicians. Bolsonaro confesses himself hazy on matters of economic policy. He and leftist former President Luiz Inacio Lula da Silva currently lead opinion polls for the October election, though Lula may not be able to run because of a graft conviction.

In Mexico, Trump's denigration of the United States' southern neighbor as a job-sucking, thug-exporting sump of criminality has wounded national pride and helped Andres Manuel Lopez Obrador rise to the top of polls ahead of the country's July 1 presidential election. A left-wing nationalist who lost two previous tilts at the presidency, AMLO, as he is widely known, has been skeptical of the country's ground-breaking liberalization of its oil and gas industry and plans to campaign for higher infrastructure and social spending without raising taxes. That has rattled the ruling Institutional Revolutionary Party, which has failed to rein in corruption and drug violence. The PRI, as it is known, likens him to the inept socialist leader of Venezuela, Nicolas Maduro.

In both countries, voters' intentions may shift as election day nears. Mexico's PRI will almost certainly run former Finance Minister Jose Antonio Meade, a widely respected technocrat and non-party member, against AMLO, while Brazil's main parties have yet to decide their candidates. If centrists prevail, pragmatism would get a fresh lease on life. Yet many voters up and down the region are disenchanted with traditional political elites and could favor outsiders. Presidential elections will also be held in 2018 in Costa Rica, Paraguay, Colombia and Venezuela, though Maduro looks unlikely to allow a free and fair vote there. Elsewhere, voters may spring surprises they come to regret.

*First published Dec. 15, 2017*

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## **Canada will be biggest loser in U.S. trade spats**

By Gina Chon

U.S. trade spats pose a big danger to its northern neighbor. President Donald Trump has threatened China and Mexico with tariffs, but the real levies have hit Canadian lumber and Bombardier jets. Although Ottawa is seeking other trade deals, America remains its biggest market, taking 25 percent of goods and services exports.

The tensions started in April when the Trump administration imposed preliminary anti-



U.S. President Donald Trump welcomes Canadian Prime Minister Justin Trudeau at the White House in Washington, D.C., United States, Oct. 11, 2017. REUTERS/Jonathan Ernst

subsidy duties averaging 20 percent on Canadian softwood lumber. Those levies were finalized in November.

In October, the Commerce Department said it would slap a 300 percent tariff on certain Bombardier jets as part of a dispute with Boeing. Prime Minister Justin Trudeau responded by vowing to block the Canadian military from buying Boeing fighter jets. He's starting from a vulnerable position, though, as Canada sends about half of its aerospace products to the United States.

A foul mood in the North American Free Trade Agreement negotiations is worsening trade relations. Along with Mexico, Canada rejects U.S. demands to require 50 percent American content for North American-built autos to get duty-free treatment. That's in addition to increasing the North American content requirement from 62.5 percent to 85 percent.

The United States has also asked Canada to eventually end its supply management system for dairy, poultry and other products, a major political hurdle in Ottawa. The setup controls domestic production and limits imports with high tariffs. Trump called the system a "disgrace" in April. Scrapping NAFTA could affect 500,000 Canadian jobs and decrease annual output by C\$20 billion, or about \$15.6 billion, according to the Royal Bank of Canada.

Other trade fights have popped up. In September, the U.S. International Trade Commission found that Canadian groundwood paper imports were harming U.S. producers, which could lead to tariffs. In an October complaint with the World Trade Organization, Washington accused Canada of giving exclusive retail access to wine producers in British Columbia.

If U.S. trade talks worsen, Mexico could pull back cooperation on security, immigration and the drug fight. China has North Korea as leverage to temper tariffs. Canada doesn't have as much to offer, making it the chief target.

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## Germany will follow money in EU top jobs carve-up

By Swaha Pattanaik

European leaders will begin a multi-dimensional game of horse-trading in 2018 as they prepare to carve up the region's most powerful jobs. Leading candidates to replace the likes of European Central Bank President Mario Draghi are likely to emerge during the year. Germany will probably care more about who controls purse strings than who sets interest rates.

The game will be a long one. Draghi's term lasts until October 2019, around the same time that Jean-Claude Juncker and Donald Tusk are due to vacate their offices. The former is the head of the European Commission, which proposes EU laws and enforces competition policy. The latter is president of the European Council, where countries fix the EU policy agenda. Who ends up filling these posts will be determined by a series of decisions, the first of which is picking a replacement for ECB Vice President Vitor Constancio when his mandate ends in May 2018.

Countries that have little chance of bagging the top jobs in Frankfurt or Brussels will vie to have one their nationals replace the Portuguese central banker. Bigger nations will back those candidates in return for support later on. The usual horse-trading will be even more complicated if French President Emmanuel Macron gets his way with the appointment of a new finance minister for the euro zone. Proposals to create a new European Monetary Fund (EMF), with the power to offer financial help when members of the single currency get into trouble, would create another important position.

Nationalities matter, particularly when it comes to the ECB. A German has never led the central bank, so it may seem time for one to take the helm. But Berlin may care less about the head of an institution that is fiercely protective of its independence – and whose governing council votes on all big decisions – than about who is in charge of



The euro sign in front of the former headquarters of the European Central Bank is photographed through a rain-covered shattered glass window in Frankfurt, Germany, Nov. 20, 2017. REUTERS/Kai Pfaffenbach

doling out money. A euro-zone finance minister or head of the EMF could end up with more direct control over policy. Berlin will want at least one of the two positions to be held either by a German national or by someone from a country with similar views on the need for budget restraint. In this carve-up, the ECB may not be the top prize.

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## Britain heads for Brexit in name only

By Peter Thal Larsen

Brexit is rapidly becoming a symbol without substance. Prime Minister Theresa May's last-minute deal with the European Union reduces the chances of a chaotic divorce but exposes the difficulty of preserving trade flows after the separation. A lengthy transition period will create further scope for May – or another prime minister – to make concessions.

The first phase of Brexit talks was supposed to be straightforward. In reality, the six-month negotiation was punctuated by British compromises. Despite initial protestations, the government will pay a divorce bill that UK officials estimate will be between 40 billion and 45 billion euros. It also conceded that the European Court of Justice can rule on disputes involving EU citizens for up to eight years after Britain leaves.

The biggest climbdown, however, was over the border with the Republic of Ireland. Ministers had insisted it was possible to leave the EU's single market and customs union



A woman attends an anti-Brexit demonstration in Trafalgar Square in London, Britain, Sept. 13, 2017.  
REUTERS/Hannah McKay

without reintroducing a hard border. That was exposed as naive. Decisions on a detailed plan are deferred to the next stage of the talks. In the absence of a solution, however, the UK has committed to maintaining “full alignment” with the EU rules required to keep the border open.

The tussle is a preview of the issue likely to dominate the next phase of the talks: Britain’s willingness to comply with EU regulations after quitting the bloc. May wants an ambitious pact, but also insists on her country’s right to determine its own future. Officials in Brussels say that means London may have to settle for an agreement like the one the EU has with Canada. Even that could prove tricky since all 27 remaining EU nations will have to approve it.

Fully resolving this question by March 2019, when Britain is due to leave, looks impossible. A transition period, initially of two years, will buy time to agree details. Once in place, that limbo could easily be extended. May might then make further concessions – or be replaced by a prime minister not bound by the same “red lines”. Reversing the referendum decision still looks unlikely. But the chances of Britain leaving the EU in name only will continue to grow.

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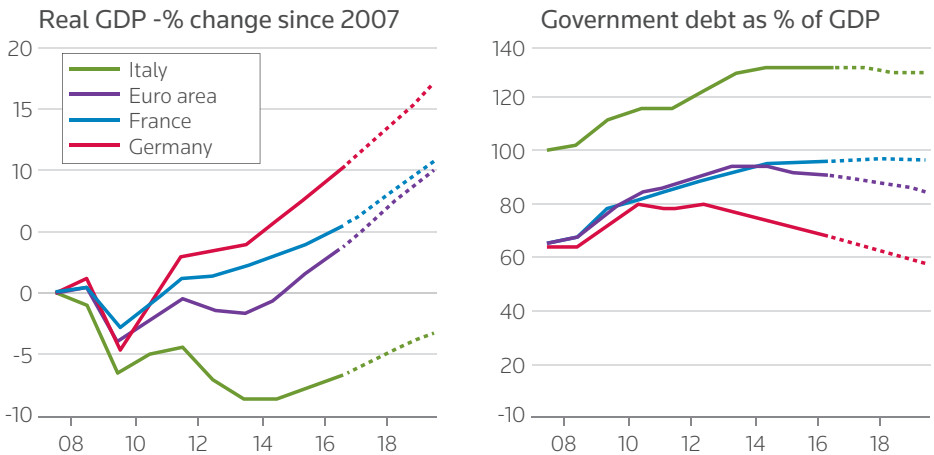
## Italy will go back to its old ways in 2018

By Lisa Jucca

It's a sunny spring day and Italians are waking up to a new legislature. None of the country's political parties has won enough seats in the previous day's election to safely control parliament, yet each claims victory. The anti-establishment 5-Star Movement earned the largest number of votes, Silvio Berlusconi's Forza Italia and its Northern League ally form the biggest political group, while the centre-left Democratic Party secured the most parliamentary seats. A flawed electoral law means a coalition – a regular feature of Italian politics – seems inevitable.

This is the imagined scenario the euro zone's third-largest economy could face in early 2018. As of late November, polls suggested each of the three main political groupings would attract roughly 30 percent of votes. The risk is that gridlock tips Italy back into its old bad habits.

### Italian economy and government debt



Source: Thomson Reuters Datastream, European Commission forecasts

The new government's economic inheritance is positive. Growth is at its highest rate since 2010, exports and manufacturing activity are rising and the number of Italians in work is back at pre-crisis levels. Italian banks appear to have escaped a financial meltdown, despite being saddled with around 175 billion euros of bad loans.

Previous prime ministers have pushed through some reforms. Mario Monti overhauled pensions in 2011 while Matteo Renzi overcame a long-held taboo by partly liberalising labour laws. The insolvency code has also been simplified. However, Italy is still grappling with hefty debt and a byzantine administrative system.

None of the key political parties is offering solutions to lower the country's public debt, which at 132 percent of GDP is the highest in the European Union after Greece. Pre-electoral promises could make the problem worse: 5-Star leader Luigi Di Maio wants to introduce a universal basic income, while Berlusconi is offering to raise the minimum pension to 1,000 euros a month. Renzi's Democratic Party and the Northern League are promising tax cuts.

The parties are also skirting Italy's dysfunctional bureaucracy and complex legal system – the biggest hurdle to attracting investment. While well-run cities like Milan are attracting investment and high-value employees, the south struggles with unacceptably high levels of unemployment, poverty and crime.

The worry is that Italians disillusioned by their current political class turn away from elections. Turnout for national polls is falling towards 70 percent, from close to 90 percent 25 years ago. In recent regional elections in Sicily, less than half of potential voters cast a ballot. If that trend is replicated on a national scale, apathy could be the election's unwelcome winner.

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# Sports and substances

## European soccer's spending splurge will intensify

By Liam Proud

Soccer fans have found a topic as contentious as refereeing decisions: eye-watering transfer fees. The 222 million euros that Paris St Germain paid Barcelona for Brazilian star Neymar in August – a sum described by Arsenal manager Arsène Wenger as “beyond rationality” – may not be surpassed in 2018. Nonetheless, clubs will have good reason to open their cheque books even wider.



Dominic Samuel scores Blackburn's first goal in a match between Blackburn Rovers and Crewe Alexandra at Ewood Park, Blackburn, Britain, Dec. 3, 2017. Action Images/Carl Recine

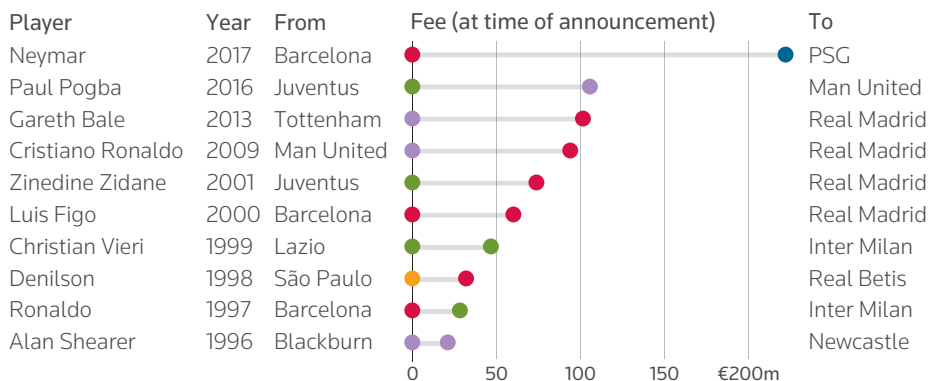
Talk of a bubble is understandable. The 20 clubs in England's Premier League splashed out 1.4 billion pounds on players in the summer of 2017, according to accountancy firm Deloitte, almost a quarter more than in the previous year. FIFA, the sport's governing body, reckons clubs worldwide spent \$4.7 billion between June and the end of August, almost equal to the whole of 2016.

Wasteful spending, meanwhile, seems to be rife across leagues in England, Spain, Germany, Italy and France. Consultants at 21st Club reckon just 56 percent of the players who became their club's most expensive signing went on to become a “core”

## Players who moved for world record transfer fees

With countries they moved between

● SPAIN ● FRANCE ● ITALY ● ENGLAND ● BRAZIL



member of the squad, which means starting more than half of matches in the subsequent season.

But the largesse is grounded in commercial logic. The Premier League's gross player spending in the summer was 31 percent of estimated full-year revenue. That's not much higher than the average of 27 percent since 2003 – including the more modest amounts clubs spend in January. Utilities and entertainment-software companies deploy similar proportions of their sales on capital expenditure, according to New York University data.

Income from broadcasting rights, meanwhile, keeps soaring. Media and telecoms groups have long been locked in a battle for exclusive TV content. Some combatants, like Britain's BT and Altice in France, are fighting with diminished resources. But tech giants, eager to attract eyeballs, may open a new digital front. Amazon recently beat Sky for the right to broadcast ATP World Tour tennis matches, while Facebook made an ultimately unsuccessful \$600 million bid for an Indian cricket tournament.

The prospect of deep-pocketed tech giants entering the battle for soccer rights is not lost on clubs: Manchester United executive Ed Woodward said on a recent call clubs would "welcome the interest". That gives them little reason to slow their spending splurge in 2018.



Headphones are seen in front of a logo of online music streaming service Spotify in this Feb. 18, 2014 illustration picture. REUTERS/Christian Hartmann/File Photo

## Musical debuts will produce financial syncopation

By Liam Proud

Musical market debuts are set to present a stark choice between content and distribution in 2018. Streaming service Spotify and label owner Universal Music both probably will fetch hefty valuations, but the Swedish startup is more vulnerable to falling flat.

Money-losing Spotify is likely to list its shares first, albeit directly without raising new capital. The boss of Universal owner Vivendi, meanwhile, sounds increasingly willing to spin out the business.

The industry's resurgence should keep investors upbeat about Universal's back catalogue and a stable of artists ranging from Katy Perry to Frank Sinatra, as well as the 60 million subscribers who pay to hear their songs on Spotify. In television, program producers like CBS typically trade on higher multiples than cable operators such as Comcast. The calculus will be flipped in music.

Spotify's private valuation in September was \$16 billion. Assume its top line rises 40 percent, and it would reach some 4.1 billion euros, or \$4.9 billion, in 2017. Netflix, a

similar sort of subscription business, is valued at more than seven times expected revenue including debt. Even discounting that to a still-generous five times would give Spotify a market value of \$25 billion, assuming its debt converts to equity as planned.

Vivendi, meanwhile, may be seeking a tech-like valuation of its own. Chief Executive Arnaud De Puyfontaine in November touted a potential \$40 billion figure for Universal Music. The company expects impressive 20 percent growth in earnings before interest, taxes and amortisation in 2017, which would amount to more than \$900 million. Even on a healthy multiple of 20 times, it would be worth \$18 billion including debt.

Exuberance is more likely to affect Spotify, and could come back to haunt it. The company is bound to suppliers like Universal, to whom it paid more than \$8 out of every \$10 it generated in 2016. Unless it can find a way to slash those royalties, along with operating expenses, it'll be hard to sustain the business model. As Snap, Twitter and others have found, unprofitable public companies get punished if user growth slows.

When Spotify shakes or rattles, Universal may be able to keep rolling. It has other buyers of its product and, while times can get rocky, music usually finds a place to be heard. Those dynamics will lead to some financial syncopation.

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## As Macau welcomes the humble gambler, bet on MGM

By Katrina Hamlin

Macau's humbler customers will outshine the high rollers in 2018. That puts MGM China in position to hit the jackpot.

It can be easier to find Louis Vuitton than McDonald's in the autonomous region that has become a playground for China's nouveau riche. But local authorities are keen to make Macau less flashy and more family-friendly. Upcoming licence negotiations will all but force casino operators to follow the official line.

Market forces are moving things in the same direction. VIP growth is starting to look unsustainable and the number of ordinary punters is on the rise. China's middle class are travelling more often and for longer stretches.

A slowdown in big spenders will leave plenty to play for. Pockets may be shallower but there will be many more of them. Visits from the mainland increased 7 percent in the first 10 months of 2017. A new ferry terminal and a bridge connecting to Hong Kong should keep them coming.



MGM Grand resort in Macau is seen in the evening of May 15, 2011. REUTERS/Bobby Yip

In the third quarter, Macau raked in 10,000 patacas, or about \$1,250, for every tourist. That's 17 percent more than a year earlier. Suppose the rate of increase halves as the market rebalances towards the lower end, but arrivals rise by a conservative 5 percent. Overall quarterly spending would increase by 14 percent, to nearly \$12 billion.

MGM China offers particularly good odds in a more modest Macau. Despite some delays, it's ready to open a new property on the Cotai Strip, aiming at the lower end of the market with cheap thrills such as a giant theatre and a hotpot restaurant. It is built on a similar scale to rival Wynn Palace, which pulled in more than HK\$6 billion (\$770 million) in casino revenue in the first half of 2017, within months of opening. If Hong Kong-listed MGM China's new property ramps up similarly, the operator could double its overall revenue.

These trends signal a reversal of fortunes in the world's largest gambling hub. Shares of popular VIP venues have been flying high, while investors have looked less favourably on less blingy outfits. MGM China, for one, has lagged the benchmark Hang Seng index in 2017. Soon its luck will change.

## China's shared bikes will merge into car lane

By Pete Sweeney

China's shared bikes are ready to merge into the car lane. A slew of two-wheeled ventures have exhausted investor cash and municipal patience. Left standing will be market leaders Mobike and Ofo, both valued at over \$1 billion. Instead of uniting in 2018, though, they will tie up with the likes of taxi app Didi Chuxing.

These custom-built rides solve a common urban problem: the trudge from a train or bus stop to a final destination. By building GPS transmitters into frames, entrepreneurs freed them from fixed docking stations. Instead, the apps locate a bike and unlock it with a mobile payment. It can be abandoned anywhere for the next user. They are now ubiquitous in Chinese cities.

A flood of cheap capital swamped the industry, however. At one point, there were around 40 companies competing to be this next big internet-of-things thing. Local officials, annoyed by bicycles clogging walkways, cracked down. The biggest companies started hogging funding rounds. A die-off duly began. Bluegogo, with over 15 million customers, shut down in late November, and others have folded since.



Bicycles of various bike-sharing services are seen in Shanghai, China, Nov. 3, 2017. REUTERS/Aly Song

Some earlier-stage investors in Mobike and Ofo have pushed for a merger to create a market giant. That would be diplomatically tricky. Mobike is backed by Tencent, while Alibaba, which is battling Tencent over mobile payments, is invested in Ofo by way of its Ant Financial affiliate. Operational integration also would require retrofitting millions of bikes.

Nor is it necessary. As competitors fall away, the pressure to eat into profitability with subsidies will ease. There are also untapped revenue sources to exploit, like in-app and on-bike advertising, plus reselling user travel information to retailers and the like. Both companies are already expanding into higher-margin markets overseas.

Integrating with complementary apps makes more sense. Doing so would help them find new users and retain existing ones, while deepening data collection on their behaviour. Look for Didi, which is also funded by Ant, to start by acquiring Ofo. Mobike is already exploring a ride-sharing partnership, as is Shanghai-listed Youon Technology. They might also link up with home-sharing apps like Tujia, the domestic version of Airbnb. China's sharing economy is better off shared.

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## Temperance is the new craft beer for drinks groups

By Carol Ryan

With a teetotaler in the White House and strong demand for low-alcohol tipples, moderation is having a moment. Greater health awareness and restrained consumption among young drinkers mean volumes of low- and no-alcohol beer will expand five times faster than traditional drinks in 2018. It's a new source of growth for global companies as the craft beer craze loses its froth.

Abstemiousness is on the rise in many markets. Among drinking-age Britons, 57 percent bent the elbow in the week before being interviewed by the Office for National Statistics about their drinking habits early in 2017. That's the lowest level since records began over a decade ago. In Spain, low-or-no-alcohol varieties make up 13 percent of the total beer market, according to Euromonitor data. Almost a third of Americans, including President Donald Trump, steer clear of alcohol altogether.

Growing health consciousness is a factor. The same trend that has prompted consumers to reject processed foods has also led them to imbibe less. Concern that drunken antics will go viral on social media may be another reason why so-called millennials are proving more disciplined drinkers than their parents. Drinks companies are tapping into that restraint. Global volumes of low-or-no-alcohol beers will grow by 4.9 percent in





A bartender holds a glass with a cocktail at a bar in Kiev, Ukraine, June 20, 2017. REUTERS/Valentyn Ogirenko

2018, compared with less than 1 percent for alcoholic drinks, Euromonitor forecasts.

Big companies are eager for a slice of the action, as well as the sheen of responsible drinking. While non-drinkers once had to content themselves with a rather sad selection, booze-free choices increasingly look and taste like the real thing. Diageo recently bought a stake in Seedlip, a maker of alcohol-free distilled spirit set up by a teetotaler fed up of boring drinks options. Budweiser-owner AB InBev wants a fifth of its global beer volumes to be low in alcohol by the end of 2025.

The development is welcome as craft beer increasingly becomes a victim of its success. Production volumes in the United States in the first half of 2017 were up 5 percent, just a third of the growth rate two years ago. That's bad news for the more than 5,200 U.S. microbreweries that have sprung up to cater to demand for authentic brews. Bigger companies will avoid the hangover by going after the sober.

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