

# PREDICTIONS 2014



## REVERSALS AND REVIVALS



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# PREDICTIONS 2014

REVERSALS AND REVIVALS



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# INTRODUCTION

When people ask Breakingviews editors how our past predictions panned out, we have a simple response: “We nailed a few, missed a couple – but they were all interesting.” Consider that the guiding philosophy for our annual attempt at agenda-setting financial foresight.

We do expect to get a few key prognostications right. A year ago we argued that U.S. stocks would best the rest of the world. Bingo. We said central banks would need to fight to retain their independence from politicians. Look no further than the summer’s public tussle over who should lead the U.S. Federal Reserve. We also predicted the Japanese yen would crest above the three-digit mark against the dollar: *domo arigato* Kuroda-san.

Not all of our views hit the mark. Goldman Sachs, JPMorgan and Credit Suisse are still led by chief executives whose tenures we thought might come to an end in 2013. George Osborne still reigns as the UK’s chancellor of the Exchequer despite our scepticism a year ago. And while we predicted a great American newspaper would change hands in 2013, we should have opted for the Washington Post, which was sold to Amazon founder Jeff Bezos, over the New York Times.

This year our views have been divvied up into six sections: people and power, money and markets, buys and sells, fees and fortunes, mergers and manias, and odds and ends. In the first category, look for India’s next prime minister to channel Japanese leader Shinzo Abe in reviving his economy. For Latin America, commodity price deflation will make governance matter for a change, giving Mexico a chance to shine.

The highly anticipated tapering of bond buying by the Federal Reserve will be the story of the financial markets. Optimists say it’s all priced in, but they may not be prepared for 10-year Treasury bond yields of 4 percent. Ditto the great American oil boom: abundant supply should keep energy inflation at bay for another year.

## BREAKINGVIEWS

In the corporate world, activism will keep more companies on their toes, including General Electric, which has thus far managed to keep uppity investors calm. Among other predictions: America's gun bubble is poised to burst, the booming solar business will hit electric utilities, Siemens' new chief faces rising pressure for a turnaround, and some Chinese corporations will warrant newfound attention from investors.

On Wall Street, look for Wells Fargo to snatch more market share from established titans, while prosecutors hunt new targets after shaking down JPMorgan and hedge-fund manager Steve Cohen. Mergers and acquisitions activity will continue, but not meet the ardent expectations of its Hermès-tied practitioners. And don't be surprised if Chinese antitrust watchdogs flex their muscles.

There are other odds and ends to consider in the coming year, such as which buzzwords will proliferate following a 2013 rich in "visionary" and "disruptive" behaviour. And investors may get glimpses of hot new firms like Square, Pinterest and the "shared economy" favourite Airbnb. There will be sport, as the World Cup puts the spotlight on Brazil. And in case you're wondering, Germany will walk away with the trophy.

Read Predictions 2014 in the spirit in which it has been written. And whether we are spot-on or just half-right, know that Breakingviews will work tirelessly to explore the coming year with the insight, analysis, speed and common sense you have come to expect.

*Rob Cox*  
*Global editor, Reuters Breakingviews*  
*Jan. 2, 2014*

# PEOPLE AND POWER

## **WHO PACKS THE BIGGEST POWER TO SURPRISE IN 2014?**

**BY BREAKINGVIEWS COLUMNISTS**

Difficult jobs abound in the global economy, finance and business in the coming year. But so do incredibly low expectations. That means getting it right could mint legacies, and surprise investors in a good way.

Think of politicians like Brazil's Dilma Rousseff, who is about to host the world's biggest sporting event of the year, the soccer World Cup; or John Boehner, the speaker of the U.S. House of Representatives, an institution with one of the worst public approval ratings in history. Equally, there are a few chief executives who could defy the current consensus, such as the bosses at Deutsche Bank, Barclays or Microsoft. Herewith, Breakingviews columnists compile a list of those who might surprise us.

### **DILMA ROUSSEFF, PRESIDENT OF BRAZIL**

Brazil has had six years to prepare for World Cup hosting duties, but what was supposed to be an opportunity to showcase the country's economic ascendance may now have global eyes peering in at just the wrong time. State meddling is undermining flagship energy giant Petrobras; Brazil's one-time richest man Eike Batista has become a poster-boy for excess; and the country is battling inflation using a swift progression of interest rate hikes. With expectations on the descent, there's an opportunity for President Dilma Rousseff to exceed them. If she can pull off a soccer extravaganza without any major disruptions and head off fiscal trouble, Rousseff could secure re-election in 2014 and stick around to host the 2016 Olympic Games in Rio.





*Brazil's President Dilma Rousseff speaks during a ceremony where she signs into law the bill that allocates the country's oil royalties to education and health care, at the Planalto Palace in Brasilia, Sept. 9, 2013. REUTERS/Celso Junior*

## **MICROSOFT'S NEW CHIEF EXECUTIVE**

Securing a leader to replace Steve Ballmer at the helm of the software-to-games console conglomerate proved tricky. And for good reasons: Microsoft missed the shift to mobile computing, and the PC market, its mainstay, is melting down. Bill Gates remains chairman and spiritual patriarch of the firm, and Ballmer will soon be the biggest shareholder. Yet there's a path to recovery for the newcomer – reverse the old guard's capital-wasting strategy of chasing markets outside enterprise software. Though Ballmer and Gates remain stifling presences on the board, there's a big opportunity for the new chief executive to create a more focused, secure and valuable Microsoft.

**KIM JONG UN, SUPREME LEADER OF NORTH KOREA**

The baby-faced dictator has been something of a comic figure since replacing his father as North Korea's supreme leader two years ago. The recent public purge and execution of his uncle suggests he should be taken seriously. The risk is that internal divisions force Kim – or whoever is actually in charge – to provoke a dangerous international confrontation. Another option is that the nuclear state finally decides to embrace some kind of reform. Expectations that Kim could opt for the latter could hardly be lower. But that makes any positive surprise all the more welcome.

**MAX BAUCUS, INCOMING U.S. AMBASSADOR TO CHINA**

The world's most important expat faces a tough year. Baucus, a retiring Montana senator, must calm nerves as territorial disputes with Japan and the Philippines intensify. China's cack-handed treatment of U.S. media organisations also threatens otherwise healthy trade ties. He could prove a lame duck. But Baucus has been outspoken on China's undervalued currency, and has less to lose than a younger nominee with big ambitions. If he talks tough on trade and human rights while balancing the China-Japan-U.S. military triangle, Uncle Sam's global policeman badge may recover some of its shine.

**JOHN BOEHNER, SPEAKER OF THE U.S. HOUSE OF REPRESENTATIVES**

After Republicans led a 16-day federal government shutdown and barely hiked the U.S. credit limit in time to avoid default, just 30 percent of Americans believed John Boehner should remain speaker, according to a CNN poll. But he has some positive momentum after rallying his party around a small budget compromise in December. And 2014's midterm election year may hold Boehner's greatest test yet: the debt ceiling must rise again this spring. Conservatives may brazenly resist the vital hike to impress voters. This could be Boehner's moment to shun party radicals in favour of U.S. economic stability.

**BREAKINGVIEWS**

**LEE RAYMOND, LEAD INDEPENDENT DIRECTOR AT JPMORGAN**

The former chief executive of Exxon Mobil has backed boss Jamie Dimon to the hilt despite the \$6 billion London Whale trading fiasco and \$15 billion, and rising, of legal payments. But Raymond could dispel his image as a classic board crony by preparing the bank for life after Dimon. At a minimum, that would require instituting a succession plan. A bolder move would see Raymond appointing a new chief executive, from a bench including young frontrunners like former chief financial officer Mike Cavanagh or chief operating officer Matt Zames, while keeping Dimon on as chairman.

**ANSHU JAIN, DEUTSCHE BANK CO-CHIEF EXECUTIVE**

Jain's wretched first full year in charge was summed up by Deutsche's 2.1 billion euro (\$2.9 billion) of fines in December. More litigation looks likely in 2014, with probes into possible cartels in currencies and credit derivatives. Germany's largest bank must still settle with national watchdogs over Libor, too. Yet Jain runs a top investment bank. And in the next 12 months the bulk of Deutsche's expensive cost cutting will be complete. Investors could even see Deutsche trade close to its book value, rather than at a 40 percent discount.

**NARENDRA MODI**

Narendra Modi could be India's prime minister of small things. Investors seem to believe the opposition politician, expected to win the 2014 general election, will usher in sweeping reforms to combat stagflation and despair. The surprise would be a focus on smaller but more meaningful issues. Easing bottlenecks – for instance, in the vegetable supply chain – that aggravate India's chronic shortages will also go well with Modi's carefully cultivated image as a useful handyman rather than an ineffectual visionary. Those who like headline-grabbing master plans may not like it – until they see the effect of better productivity on Indian corporate earnings.





*Hindu nationalist Narendra Modi, prime ministerial candidate for India's main opposition Bharatiya Janata Party and Gujarat's chief minister, addresses his party's supporters during a rally ahead of the state elections, in New Delhi, Nov. 30, 2013. REUTERS/Anindito Mukherjee*

#### **ANTONY JENKINS, BARCLAYS CHIEF EXECUTIVE**

The Barclays boss had a ropery 2013. Jenkins had barely set out his maiden restructuring when the UK regulator bounced him into a 6 billion pound (\$9.7 billion) rights issue to meet new leverage ratio requirements. Until recently it looked a stretch for "AJ" to hit return targets while hitting a 40 percent dividend payout ratio. But recent clarity on how the UK will implement "Basel III" rules means Barclays' capital position looks a bit better, and European Commission Libor fines were worse for other banks. The expectations aren't high, but if AJ can start to realize his vision of a safer, more solid Barclays, he will emerge as one of the few heroes of a tarnished global banking cohort.

*First published Jan. 2, 2014*

## **BREAKINGVIEWS**

## CARNEY WILL STRUGGLE TO SUSTAIN BOE GOVERNORSHIP

BY EDWARD HADAS

Mark Carney never said he would serve a full eight-year term as governor of the Bank of England. From the outset he said he'd go back to his native Canada after only five years. But the UK's central banker-in-chief has a tough agenda for 2014. If things don't go his way, he might decide to go home even earlier.

Carney's signature policy innovation is forward guidance – a promise of continued minimal policy interest rates until the economy recovers. The goal is to keep bond yields down and the currency relatively weak. To date, he has fallen short. The yield on the 10-year gilt has risen from 2.3 to 2.9 percent under Carney's watch. Sterling, on a trade-weighted basis, has risen 5 percent.



*Bank of England Governor Mark Carney listens during the bank's quarterly inflation report news conference at the Bank of England in London, Nov. 13, 2013. REUTERS/Toby Melville*

The Canadian will be fine if Britain enjoys a steady, non-inflationary economic recovery. But if the recovery moves faster, the BoE's Monetary Policy Committee might be forced to increase rates sometime in 2014. Carney can say, with technical accuracy, that the forward guidance he gave was always conditional. But his authority will be undermined. Besides, the governor is only one of nine members of the MPC. His position could be destabilised by doubts and disagreement within this somewhat fractious group.

Then there is housing. The most recent Halifax survey says UK residential property prices climbed 7.7 percent over the last year. The BoE's Financial Policy Committee, which Carney chairs, has expressed concern about this crucial and troubled market. The Bank of England is also withdrawing some cheap mortgage funding. But it all could easily go wrong. Investors will run scared if house prices keep rising, while politicians will be horrible to Carney if house prices start to fall.

Under-fire British civil servants can often look for support among well-connected old friends. Carney is an outsider. His appointment may have irritated many insiders who never saw any need to bring him in – with his high salary and generous housing allowance. If the Bank of England looks lost, he may find himself friendless. At that point, Carney may wonder if his heart is in his London job. His former home, Ottawa, could look like a much nicer place to raise a family.

*First published Dec. 23, 2013*

## **U.S. AND CHINA WILL SET GLOBAL GROWTH PACE IN 2014**

**BY PETER THAL LARSEN AND ROBYN MAK**

The United States and China will determine the pace of global growth in 2014. Though America accounts for a quarter of the world economy and China less than a tenth, the two countries will generate roughly half the expansion in overall gross domestic product in the coming year. With Europe in the doldrums, Japan still recovering and emerging markets subdued, the planet heavily depends on its twin engines.

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The global economy is expected to expand by about 3 percent next year, according to World Bank forecasts. But growth rates vary widely across the globe, and so do individual countries' contributions. North America's recovery means it will deliver almost 25 percent of the total growth in world GDP, according to a Breakingviews calculator. Though China's economy is much smaller, if it achieves a forecast growth rate of close to 8 percent it will make an almost equal contribution.

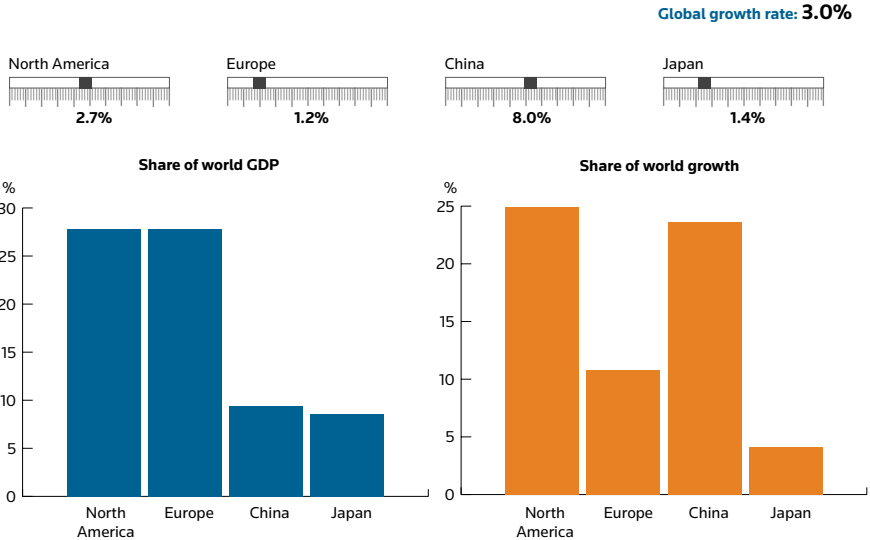
The world's dependence on these two dynamos is partly a reflection of subdued growth elsewhere. Europe's share of overall output is the same as North America's, but the continent is expected to expand by little more than 1 percent in 2014. Japan's economy, meanwhile, is only slightly smaller than China's. However, even with the help of an Abenomics revival it is expected to grow by just 1.4 percent, which means its share of overall growth will be just 4 percent.



*U.S. President Barack Obama meets with Chinese President Xi Jinping at The Annenberg Retreat at Sunnylands in Rancho Mirage, California, June 7, 2013. REUTERS/Kevin Lamarque*

## Who's driving global growth?

See how much each region contributes to world GDP growth in 2014



Source: World Bank Global Economic Prospects, June 2013, P Thal Larsen, R Mak, C Trevethan 05/12/13

The calculator also shows how sensitive forecasts are to changes in growth rates. Any acceleration or slowdown in the United States will be felt by the rest of the world – not just through trade and investment but through changes to the Federal Reserve’s money-printing policy. If China’s economy grew by a disappointing 6 percent, meanwhile, it would shave less than 20 basis points off world GDP growth. A relatively small acceleration in Europe’s rate of expansion, to 1.8 percent, would boost overall growth by the same amount.

The fortunes of emerging markets such as India and Brazil will doubtless attract a great deal of interest, especially if the Fed begins to turn off the tap of cheap dollars. But when it comes to setting the overall direction of the world economy, these countries hardly register. On current forecasts, global growth is very much a two-horse race.

*First published Dec. 16, 2013*

## BREAKINGVIEWS



## NARENDRA MODI COULD BE INDIA'S SHINZO ABE

BY ANDY MUKHERJEE

Narendra Modi could be India's Shinzo Abe. If recent state polls are any indicator of the electorate's mood, the opposition politician will be prime minister of the world's largest democracy by May 2014. Just like his Japanese counterpart, Modi would oversee higher asset prices and revive growth, but struggle with structural reforms.

Financial markets would cheer a Modi victory just as loudly as they hailed the Japanese prime minister's ride to power. Both Goldman Sachs and UBS expect India's benchmark stock index to rise by 10 percent by the end of 2014, a prediction that's bound to be raised if Modi manages to cobble together a majority. Add a recovery in the battered rupee, and the gains for foreign investors could be quite lucrative.

The economy will also revive, as it has in Japan. But when the euphoria subsides, questions will arise about Modi's resolve to usher in structural reforms. If the February 2015 budget disappoints, confidence will take a knock.

Modi will face a tougher job than Abe. The Japanese prime minister's Liberal Democratic Party won a decisive mandate in December 2012, and took control of the upper house of parliament the following July. Unlike the all-too-entrenched LDP, Modi's Bharatiya Janata Party will need the support of a number of coalition partners to wrest power from Sonia Gandhi's Congress Party. These smaller regional parties prefer populism to reforms, and will expect Modi to make costly concessions.

Moreover, the Indian leader doesn't have a well-articulated vision for the economy. That's quite unlike Abe, who has made slaying deflation his mission. Modi has attacked the Congress for inhibiting growth and stoking inflation, but hasn't spelt out just what he will fix and how. There is no "Modinomics".

Electoral tactics may be part of the reason. Tackling India's stagflation requires tighter government finances, but cutting spending will depress growth further. The obvious solution is to raise money by privatising state-owned businesses. But Modi can't talk about that now for fear of upsetting unionised state-sector employees. The closest Modi has come to supporting the idea is saying: "I



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believe government has no business to do business.” This suggests he would restart the process of selling controlling stakes in state-owned enterprises, the BJP’s strategy before it lost the 2004 elections.

It’s doubtful Modi will invest much of his political capital in labour reforms, which Abe has also avoided. Reviving the stalled credit cycle will also prove a challenge for both countries. Japanese banks aren’t boosting domestic lending because credit demand is still weak. India’s banking system is dominated by poorly run, government-owned lenders, saddled with bad loans. Privatizing them is a non-starter because these lenders keep uncompetitive businesses – and their politically connected owners – afloat.

Modi’s best hope is to revive credit demand. That won’t be an insurmountable problem given just how strongly big businesses are rooting for him. As chief



*A supporter of India’s main opposition Bharatiya Janata Party holds up a mask of Hindu nationalist Narendra Modi, prime ministerial candidate for BJP and Gujarat’s chief minister, during a rally ahead of the state elections in New Delhi, Nov. 30, 2013. REUTERS/Anindito Mukherjee*

minister of the Gujarat state, Modi has built a reputation for cutting red tape and making it easier to do business. Those skills could help him revive private investment nationally. As prime minister, however, he will also need to make states agree to taxation reforms. A nationwide value-added tax that subsumes many bad local levies remains an elusive goal.

Indeed, Modi and Abe could help to solve each other's problems. Japanese businesses, banks and pension funds want to invest, but Japanese society is too old to utilise many new investments. The solution might be to invest more in India, which has a young population and desperately needs infrastructure.

As in Japan, foreign affairs could upset the optimism. Investors will be spooked if they see any evidence that Modi is allowing nationalism to get the better of his reformist zeal. How Abe deals with China and South Korea will be crucial for stability in north Asia. Modi's approach to China and Pakistan will determine the security landscape of the south.

In 2013, Abe raised hopes that decisive leadership can help tackle Japan's deep-seated economic problems. In 2014, Modi could do the same for India.

*First published Nov. 10, 2013*

## **HOLLANDE COULD USE ELECTORAL DEFEAT TO CHANGE TACK** BY PIERRE BRIANÇON

France's most unpopular president in more than 50 years will be tested twice in the polls in 2014. There is a glimmer of hope that terrible results might prompt François Hollande to consider changes in both the substance and style of his presidency. The real trial isn't of his policies, but whether he understands the predicament of the French economy, and can muster the personal capacity to rule decisively.

In the last 25 years, France's economy has survived persistent attempts by the country's governments, right and left, to bring it to its knees. Hollande is no exception but he may be stretching the economy's patience to the limit.



*French President François Hollande reacts with recipients of the Family Medal award during a ceremony at the Elysée Palace in Paris, Nov. 30, 2013. REUTERS/Lionel Bonaventure/Pool*

Since his election in May 2012, he has been caught between his attempt to meet the European Union's fiscal targets and the crying need for growth-friendly reforms. He has missed the former and failed at the latter.

Austerity has played its part, with the structural fiscal deficit – the shortfall after stripping out cyclical factors – cut by 1 percent each year of his term. But Hollande's difficulties also come from his and the traditional French left's deep mistrust of businessmen, moneymen and money, and their default preference for plugging budget holes with higher taxes. France needs to rein in the state machine and stimulate competition, notably in the services sector. Hollande has given no sign he wants to do either.

In his electoral campaign, the French president said that "the world of finance" was his real enemy. Yet finance has been good to him: yields on 10-year French government bonds, hovering around 2.4 percent,

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are at historical lows – 50 basis points lower than the UK’s. The French government’s travails and blunders don’t seem to bother investors much.

French voters will choose their towns’ and cities’ mayors at the end of March. Two months later, they will elect their deputies to the European Parliament. Expectations are so low that anything short of a disaster will make the French president look like a comeback kid. Whatever the outcome, he may want to use the opportunity to show that he is not tone-deaf, starting by ousting hapless Prime Minister Jean-Marc Ayrault. That won’t solve Hollande’s problems, but would at least prove he sees them.

*First published Jan. 2, 2014*

## **GOVERNANCE WILL MATTER SOUTH OF THE U.S. BORDER** BY MARTIN HUTCHINSON

Good governance will begin to matter more in Latin America. For the last decade, easy money and a boom in natural resources allowed bad governments to do as well as good ones. Now with commodity prices flattening and rates rising, regimes that respect investor and property rights, while spending money and allocating capital wisely, should outperform their less-disciplined neighbours.

Latin America has had a good 21st century, primarily because of a prolonged rise in commodity prices in the decade to 2011. As a result, profligately run nations like Argentina and Venezuela, and spendthrifts like Brazil, were able to prosper almost as much as more conservatively managed Chile, Colombia and Peru. Only Mexico, where raw commodities represented less than 20 percent of exports in 2012 compared with around 60 percent in Brazil, failed to benefit much from the price surge.

That boom has come to an end, with the Thomson Reuters Equal Weight Continuous Commodity Index, measuring both metals and soft commodity prices, down 10 percent since December 2011. Consequently Venezuela, Argentina and Brazil face difficulties, which will intensify in 2014 absent a commodity price rebound.

Venezuela, in particular, is heavily dependent on \$100-a-barrel oil, with every dollar decline in average oil prices costing it roughly \$1 billion in annual hard currency revenue. Any decline would cut the funds flowing to the government and make its fiscal and payments position difficult.

Brazil's third-quarter GDP shrank 0.5 percent; interest rates have been raised six times since April; public spending continues to grow; consumer debt is high; and the twelve-month current account deficit is 3.7 percent of GDP. The state-funded model Brazil has followed this century is imperilled. The coming year could see an unpleasant confrontation between Brazil's policymakers and market realities. With the currency still overvalued on a purchasing power basis, further weakness in the real is likely.

Other resource-reliant countries should suffer less. Chile's principal export, copper, is showing relative price strength. Moreover, the country has little debt and a \$15 billion stabilisation fund to cushion against a downturn. This gives incoming President Michelle Bachelet some room to respond to demands for reform.

Colombia is heavily oil-dependent, but its balance of payments has improved in recent quarters and its government is small with a budget close to balance. Peru's balance of payments is in deficit, but its exports are more diversified than Colombia's and its budget was in surplus in 2012 and balanced in 2013.

The outlier may be Mexico, which will benefit disproportionately from U.S. growth, its market liberalisation, and foreign manufacturing investment. As the least commodity-dependent Latin economy, with improving governance under Enrique Peña Nieto and an oil sector finally opening to the world, Mexico may finally outshine its more southerly neighbours.

With the commodity surge out of the way, investors in the region will have to distinguish carefully. But the simplest pair trade may be the best: go long the Mexican peso and short the Brazilian real. With the U.S. economy reviving and Brazil suffering both economic sluggishness and political uncertainty, both sides of the bet look attractive.

*First published Jan. 2, 2014*

## SCOTLAND WILL REJECT INDEPENDENCE

BY GEORGE HAY

Scotland will say no to independence in 2014. Citizens of England's northern neighbour will decide in September whether to secede from the United Kingdom. Domestic rule from Edinburgh could reinvigorate the Scottish economy, bolster national pride, and address a long-held perception that Scots get a raw deal from London. Yet the secession plan is flawed, because it relies too heavily on generosity from the rest of the United Kingdom.

Alex Salmond, Scotland's pro-independence first minister, could have sold an attractive picture of a free Scotland with a separate currency. An independent Scottish central bank could then have taken command of



*A Scotland soccer fan waves a Scottish Saltire flag with Big Ben seen behind in Trafalgar Square in central London, Aug. 14, 2013.*

monetary policy and set interest rates at levels best suited to the needs of Scottish businesses. That would have complemented domestic politicians' greater ability to set their own taxes, rather than relying on Westminster handouts. At present only 14 percent of spending for which responsibility lies in Scotland gets financed by taxes set in Edinburgh.

But if Scotland were independent, its finances would look rosey. True, in 2011-12 Scotland's budget deficit – the gap between its spending and revenues – was 5 percent, compared to 7.9 percent for the UK as a whole. But that assumes Edinburgh can keep 94 percent of North Sea oil revenues, which are volatile and predicted to decline. Westminster also spends 10 percent more, per person, in Scotland than for the United Kingdom as a whole. To balance the budget, Salmond would have to cut public spending or jack taxes up.

Salmond says that an independent Scotland would retain use of the pound, join a sterling area, and potentially look to the Bank of England to regulate its commercial banks. It's not at all clear how this would work, but any system would need compromises. London might insist that Edinburgh share more oil revenue or take on a bigger chunk of the United Kingdom's national debt.

Independence, in theory, is a respectable idea. But given that the independence on offer is barely worthy of the term, Scots are likely to conclude they are better off remaining in a United Kingdom. They will vote no.

*First published Jan. 2, 2014*



## BUYS AND SELLS

### **THE “ABE PUT” WILL KEEP JAPANESE EQUITIES BUOYED** BY PETER THAL LARSEN

Say sayonara to the “Bernanke put” and hello to Shinzo Abe’s alternative. While the Federal Reserve chairman developed a reputation for supporting the price of bonds, the Japanese prime minister’s reforms are designed to push up stock prices.

Early enthusiasm for “Abenomics” prompted a hefty rally. Despite trading water in recent months, Japan’s main equity indices are up 55 percent since the prime minister’s electoral victory in December 2012. So far, most of



*Japan's Prime Minister Shinzo Abe attends a news conference in Tokyo Oct. 1, 2013.  
REUTERS/Toru Hanai*

the buying has come from abroad: foreign investors controlled close to 30 percent of the Japanese stock market by value at the end of 2012. But there are good reasons to believe that will change.

Start with retail investors. At the end of September, Japanese savers were given the opportunity to register for new tax-free investment accounts, which start in January. More than 3 million have already signed up for the scheme, which allows them to invest up to 1 million yen (about \$10,000) a year tax-free.

The numbers could be large: a survey by Nomura Research Institute suggested that as many as 10 percent of eligible investors – equivalent to 10 million people – would open accounts. Assume that all of them put in the maximum permitted, and allocate 23 percent of it to Japanese equities, in line with the current weighting in retail portfolios. In that case, small investors would inject an extra 11.5 trillion yen into the stock market over the next five years, according to Nomura. That's equivalent to almost 3 percent of the capitalisation of the entire Japanese stock market at the end of October.

The actual amounts may turn out to be smaller. Not all investors will use up their full allocation. And some of the money flowing into tax-free accounts will be siphoned from existing equity investments. Even so, the new accounts look set to rekindle interest in stocks among a population that has grown used to keeping its savings in cash or government bonds.

The same logic applies to Japan's sleepy pension funds. For years, their response to deflation has been to hoard Japanese government debt. But if inflation picks up, the value of those holdings will take a hit. That's why an Abe-appointed commission is expected to urge pension funds to increase their allocation to equities when it reports later this month.

Once again, the shift could be significant. The giant Government Pension Investment Fund of Japan, which has assets of 121 trillion yen, currently has just 15 percent of its portfolio in domestic equities. Lifting that to, say, 25 percent would mean another 12 trillion yen flowing into Japanese stocks. Smaller public funds would be likely to follow suit.

Sheer weight of money alone won't support stock prices if corporate earnings don't continue to improve. Though third-quarter earnings at most Japanese companies rose, recent warnings from Sony and Nissan are

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a reminder that some of Japan's high-profile corporate names still face strong headwinds.

Yet corporate performance could get an added boost from a new equity index that selects companies according to profitability. That index, due to be launched in January, will select 400 constituents according to criteria including return on equity. That's a big shift for Japan, where companies have historically prioritised size over the value they create for shareholders. Nomura's Japan strategist, Hiromichi Tamura, believes funds like the GPIF may decide to track the new index. That would put pressure on executives to use capital more efficiently.

Enthusiasm for the equity market depends on Abe's reforms. Any sign that Abenomics is faltering will send investors – both domestic and foreign – scurrying back to the safety of bonds. But if that happens, there is another source of support: the Bank of Japan. The central bank is already buying so many government bonds that any plan to boost its asset purchases would probably mean buying equity funds – or even individual stocks. This is not as unthinkable as it may sound: the BOJ is already pumping an extra 1 trillion yen a year into exchange-traded funds. All the signs suggest that the "Abe put" for Japanese shares will be in place for some time to come.

*First published Nov. 18, 2013*

## **CAN GENERAL ELECTRIC KEEP THE ACTIVISTS AT BAY?**

**ROB COX**

Can General Electric keep activist investors at bay? If the gates at Apple, Microsoft and Procter & Gamble can be rattled, complacency just isn't an option for any company, even and maybe especially a \$270 billion conglomerate. While GE's broad strategy looks more coherent than ever, the Connecticut giant still has two potential vulnerabilities: its finance arm and its long-time leader Jeffrey Immelt.



**REUTERS**



*The logo of the GE Money Bank is seen behind a traffic light in Prague, May 29, 2012.  
REUTERS/David W Cerny*

Corporate America has learned of late that size offers no immunity from the braying of ornery shareholders. A \$320 billion market value didn't shield Microsoft from the pressures of ValueAct Capital, which nabbed a board seat and accelerated the exit of Chief Executive Steve Ballmer. Even bigger Apple, and boss Tim Cook, have been targeted by both David Einhorn and Carl Icahn to return more cash to shareholders. A long-standing reputation as a consumer-products stalwart didn't protect \$220 billion P&G from the advances of Bill Ackman.

GE has so far kept clear. Its executives, however, seem to be cognizant of how quickly that could change. The engines-to-dishwashers manufacturer has been proactively restructuring in ways that could wisely head off rabble-rousers. GE is reducing its exposure to finance, and in recent years exited businesses like NBC Universal, deemed ancillary to a strategy focused on global infrastructure.

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As a result, the existing configuration of GE's industrial portfolio looks better positioned to take advantage of a middle-class future. That world, to put it simply, involves more people around the globe seeking better healthcare, travelling on jet planes and gaining access to clean water and abundant energy – from which they can run GE appliances.

So what would an activist investor go after at GE? The most obvious weak spot is GE Capital. During the financial crisis, the division's balance sheet of some \$550 billion overshadowed the world-class industrial businesses. The need to finance a large financial institution without a stable base of deposits stoked fears GE might even need to jettison valuable assets. GE Capital has since pared its balance sheet by almost a third.

There's also more to come. In November, GE said it would begin the process of spinning off its consumer finance business, which carries some \$59 billion of assets. Once the divestiture is completed, GE Capital will have a loan book of about \$350 billion. That's far below its peak. Yet it still puts GE Capital on a par with U.S. Bancorp and renders it among the country's biggest financial institutions.

Some of this is easy to justify. About a quarter of GE Capital's assets will be devoted to what it calls "GE Verticals" where it uses its balance sheet to help finance customer purchases of GE products. But it still envisions tying up more than half its assets in lending and leasing initiatives and some \$50 billion in commercial real estate. To investors wanting a more focused, industrial GE, this could provide a potential soft spot.

Outside of capital allocation and portfolio management, the other typical target for activists is management. Chairman and Chief Executive Immelt can't ignore the possibility of a broadside. Since taking over in 2001, GE's total shareholder return has been flat compared to a doubling of the S&P 500 Index.

Immelt was passed a tough hand. His ascent coincided with the attacks of Sept. 11, 2001, and the subsequent economic downturn. He also led GE through the outburst of financial services, which brought earnings to a record high of \$38 billion, or \$2.21 a share, in 2007. The crisis erased those gains. A dozen years on, GE is slated to record \$146 billion of revenue and earnings of \$1.64 a share – just around 28 cents more than in 2001.

Of course, with hindsight it's easy to argue that Immelt should have been more proactive at reducing the size of the financial business he inherited from his predecessor Jack Welch. What matters now is that Immelt has put the organisation on a better trajectory.

It's not impossible, though, to envision a new hard-nosed investor demanding a more aggressive reduction of GE's exposure to financial services, a conflict that could escalate into a referendum on management. That would put Immelt in an uncomfortable spot. He has at least groomed many able successors. Don't be surprised if one of them gets a shot at the job in the coming year.

*First published Dec. 18, 2013*

## **MEET CHINA'S PRIVATE CORPORATE GIANTS IN WAITING** BY JOHN FOLEY

Private companies in China have to work harder to survive. State-owned enterprises get the pick of capital, resources and investment opportunities; the rest get scraps. While that's wasteful, it has also fostered private enterprises that are gritty, ambitious and efficient. If recent government pledges to allow the market a more decisive role prove sincere, these wannabe giants could be worth watching in 2014.

### *Spring Airlines – the ascetic budget carrier*

The economics of airlines are brutal everywhere. In China, where state-owned carriers dominate the market, survival requires astonishing efficiency. Discount carrier Spring Airlines has managed just that. Its flights are around 95 percent full – better than Western low-cost carriers like Ryanair and EasyJet, and higher than the roughly 80 percent at state airlines. Its net profit margin of more than 5 percent is a rarity in the industry.

Part of the success comes from being part of one of China's biggest travel agencies, which means Spring can fill up its own planes before those of rivals. But a culture of austerity also helps: cash-conscious Spring

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*Spring Airlines founder and chairman Wang Zhenghua poses for a portrait during an interview with Reuters at the Spring Airlines training facilities in Shanghai, July 3, 2012. REUTERS/Carlos Barria*

executives who eat instant noodles on business trips are the antithesis of state-sector bureaucrats.

Small airlines in China have been held back by regulators, who are reluctant to let them buy new planes. Nevertheless, Spring has ordered 30 more jets from Airbus, and launched international flights to Tokyo, Taipei and Thailand. An initial public offering in 2014 is not out of the question. Plans to loosen the budget airline sector may allow it to grow much faster, and spread further outside of the mainland. But even within China, the 13 percent annual growth rate in passenger-kilometres means there is much to play for.

#### *Xiaomi – the smartphone usurper*

The formula for Xiaomi's smartphones is pretty simple – go for top-range crowd-pleasing technologies, on wafer-thin margins, and snatch market

share from everyone else in the process. In three years, the private company has overtaken Apple to take more than 5 percent of the Chinese market.

Founder Lei Jun styles Xiaomi as a software company, updating its operating system weekly based on user feedback. It poached Google executive Hugo Barra in 2013. But merely selling phones in China has supplied plentiful growth. In August, the company raised its 2013 sales target from 15 million to 20 million handsets.

Xiaomi's challenge will be to avoid falling into the mid-market trench – too small to compete with Apple and Samsung globally, but too big to charge luxury prices. While investors such as Singaporean sovereign fund Temasek remain happy to fund its expansion, that's less of a worry than the company falling victim to its own hype.

#### *Great Wall Motor – the Jeep of the east*

Chinese autos have yet to make a great leap into Western markets, but Great Wall may be the first. The former pick-up truck specialist is on track to sell over 400,000 sports utility vehicles in 2013, and its Haval 8 model is taking on the Toyota Highlander and Audi Q5 at half the price. Its target is to sell more SUVs than Jeep – which would mean doubling its current output.

As with other private companies, efficiency is Great Wall's great advantage. Its 17 percent operating margin is three times that of Volkswagen and the overall Chinese auto sector, according to Thomson Reuters data. While major markets like the United States are still untested, Great Wall already sells its SUVs in Australia, New Zealand, Russia and Iraq.

China's automotive companies need to soup up their exports, or slim down dramatically. The industry will have capacity for making over 30 million vehicles a year by 2015, but annual sales will be little more than half that. If Great Wall's 2013 forecast of 28 percent annual growth in revenue is a guide, and it can move beyond China's "cheap and clunky" image, it has a decent chance of leaving less efficient rivals standing.

*First published Dec. 18, 2013*



## FADING REFORM HOPES TAKE GUN SHARES WITH THEM

BY ROBERT CYRAN

Fading reform hopes should take the shares of gunmakers with them. Such a turn of events would reverse an extraordinary run for the industry. The U.S. government collected \$6 billion of excise taxes on gun and ammunition purchases in 2012, more than twice the typical amount in the years to 2007. The year 2013 is on pace to generate the biggest sum ever. The number of federal background checks, a good indicator of future gun purchases, also should easily exceed 20 million in 2013, a record.

The 2012 massacre at Sandy Hook Elementary School in Newtown, Connecticut, created a broad perception that tighter gun laws were coming. The week following the tragedy spurred close to 1 million background



*Hand guns that were turned in by their owners are seen in a trash bin at a gun buyback held by the Los Angeles Police Department following the mass shooting at Sandy Hook Elementary School in Connecticut, in Los Angeles, California, Dec. 26, 2012.*

checks. Other factors have been brewing for longer. Smith & Wesson's order backlog increased more than ten-fold in the six months following Barack Obama's 2008 election victory. Doomsayers also worried the financial crisis had set the stage for a societal collapse, sending sales of "tactical weapons" like the AR-15 used at Sandy Hook up even more sharply.

The percentage of households owning firearms has declined slowly over the past three decades. Current demand, therefore, looks borrowed from the future, especially considering the durability of guns, 300 million of which already exist in the United States. Moreover, institutional investors like public pension funds face increasing pressure to divest holdings in such manufacturers. The decision by private equity firm Cerberus Capital to let investors exit Freedom Group, the maker of Bushmaster rifles, is a case in point.

Over the past two years, Sturm, Ruger shares have more than doubled. Smith & Wesson's have more than tripled. If Sturm, Ruger's \$650 million in revenue reverted to its pre-Obama, pre-crisis 2006 level, about three-quarters of it, and a bigger proportion of net income, would be erased. The shares, in that scenario, would look absurdly overvalued at over 100 times earnings.

Some investors are already pretty worried. Nearly a third of the shares of Sturm, Ruger and Smith & Wesson have been sold short. Significant gun-law reforms don't look promising now, and neither do the financial prospects of gunsmiths.

*First published Dec. 11, 2013*

## **CHINA WEB GIANTS TAKE THE FIGHT OFFLINE IN 2014**

**BY ROBYN MAK**

Remember when every offline company was desperate to become an online one? In China, it's happening the other way round. The country's internet giants are making forays into traditional industries, from logistics to consumer electronics. The pace will increase, but what starts as disruption could turn into overreach.

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*Jack Ma, chairman of China's largest e-commerce firm Alibaba Group attends a corporate event at the company's headquarters on the outskirts of Hangzhou, Zhejiang province, April 23, 2013. REUTERS/Carlos Barria*

China's internet is young, but already concentrated. Although three contenders, Tencent, Alibaba and Baidu, dominate the market, keeping and adding users is a constant battle. Gaming group Tencent has a social network of 626 million users a month, but its video streaming site ranked just sixth in September in terms of monthly viewers, according to comScore. To boost traffic, the gaming firm outbid rivals for licensed content and produced its own shows. An acquisition in the film industry would not be a surprise – LeTV, China's number two video portal, bought a TV production studio in October.

The other two tech giants are also investing offline to get more face-time with potential web users. Alibaba, the e-commerce group, announced a HK\$2.8 billion (\$361 million) investment with an electronics and logistics group in December. Search engine operator Baidu has partnered with

manufacturers on smartphones and wearable devices to promote its cloud platform. An investment by a web group in one of the region's struggling handset makers – say, HTC – is not unthinkable.

One danger is that the companies overextend themselves. At heart Baidu is not a hardware manufacturer; supply chains and after-sales distribution networks require new skills. An investment in logistics similar to Alibaba's may present itself if Baidu is serious about selling gadgets. But these opportunities may prove to be distractions. China's tech firms will put their core businesses at risk simply by trying to do too much too soon.

Venturing offline will also dilute margins. Baidu, which now makes over 99 percent of its revenue from ads, has an enviable operating margin of 43 percent, versus Facebook's 32 percent. Compare those with the meagre 2.5 percent margins of a handset maker like Lenovo. Investors want revenue growth and market-share preservation – but their patience may be limited if it means an end to those generous profits.

*First published Dec. 17, 2013*

## **TIME FOR SIEMENS' TURNAROUND CEO TO DELIVER**

**BY OLAF STORBECK**

New Siemens boss Joe Kaeser must live up to expectations in 2014. The ouster of predecessor Peter Loescher was enough to make Siemens shares top performers in the second half of 2013: a gain of more than 20 percent by mid-December beat most peers and the wider market. Now Kaeser has to justify this optimism.

The new chief executive starts from a good position. Bar external shocks like a new European recession, Siemens should hit lowered 2013-14 operating profit targets relatively easily. A cost-cutting programme launched by Loescher will deliver more margin improvements.

Kaeser can also make more fundamental changes. He should dismantle the "megacities" unit – a mishmash of loosely related, low-margin operations

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stretching from fire detectors to traffic lights and high-speed trains. It keeps missing targets and had an operating margin of just 3.7 percent in the last financial year.

Most bits would sit more naturally in other Siemens units. That would allow for oversight by stronger divisional managers, and streamline the company. But Siemens should just get out of train manufacturing. This distraction, plagued by delays, write-offs and fierce competition, is unlikely to earn good returns any time soon. A full sale would be best but Siemens might have to compromise on a joint venture, perhaps with Swiss rival Stadler.

Kaeser should also break the habit of overpaying for takeovers. And he ought to improve project management by installing an early warning



*A worker removes lettering spelling Siemens from an information board at a Siemens AG office building in Berlin Sept. 30, 2013. REUTERS/Tobias Schwarz*

system, making it harder for less senior managers to conceal problems. During the last six years, botched large-scale projects generated 4.2 billion euros in write-offs.

In mid 2013, Siemens shares traded at a multiple of 11.4 times forward earnings, way below other industrial conglomerates. By December this ratio had risen to 13.7, almost closing the discount, Thomson Reuters data shows.

There's no reason why a well-run Siemens should not enjoy a high stock-market rating. It is big, diverse, makes excellent products, and is based in Europe's strongest economy. Yet saddled with poor management, corporate complexity, and internal bureaucracy, it has consistently disappointed investors. So any evidence Kaeser is finding the problems more intractable than expected could put the re-rating at risk.

*First published Jan. 2, 2014*

## **U.S. UTILITIES FACE GERMAN-STYLE SOLAR BURN**

**BY CHRISTOPHER SWANN AND ROBERT CYRAN**

America's utilities face a German-style solar burn. So far, solar power accounts for just 1 percent of U.S. electricity demand, against 10 percent in Germany. But generators stateside are already feeling the heat and pushing for levies on solar panels. They're keen to avoid the scorched profit seen at traditional Teutonic utilities like E.ON.

Germany's enthusiasm for solar energy has set it apart. After years of generous subsidies, by the end of 2012 it boasted around 30 gigawatts of photovoltaic generation capacity – a third of the total in the world, according to the Renewable Energy Policy Network for the 21st Century. That is about four times more than the United States – or 16 times as much per head of population.

That may have delighted environmentally conscious electricity users. But it has been painful for German utilities. Millions of customers who have installed rooftop solar panels now need to buy less electricity from E.ON or

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RWE. These former captive customers have also now become competitors of sorts, selling surplus power back to the grid.

Solar panels also act as a disproportionately powerful downward force on electricity costs, since they are most productive during the middle of the day when utilities traditionally enjoy peak prices. That helps explain why wholesale power prices in Germany have plummeted from a 2008 high of more than 80 euros per megawatt-hour to under 40 euros. Defenders of the utilities also argue that homes with panels are essentially free-riding on the grid, taking advantage of its flexibility to either draw or supply electricity while contributing nothing extra towards the high cost of maintaining it.

Whether that's entirely fair criticism or not, utility profits have been crushed. Net income at German electric utility E.ON is forecast to dive 43 percent in



*A factory site of German solar power equipment company Q-Cells is pictured near Bitterfeld, April 3, 2012. REUTERS/Tobias Schwarz*

2013 compared to the previous year, according to Thomson Reuters. Since January 2008, both E.ON and rival RWE have lost about 70 percent of their market value. Peter Terium, RWE's chief executive, said in November that his operating model was "collapsing" and announced that one in 10 jobs would be cut. German utilities have other challenges, including the government's retreat from nuclear energy after Japan's Fukushima accident in 2011. But solar panels have contributed to their distress.

American utilities have taken note. The cost of panel technology has been falling sharply and companies like Elon Musk's SolarCity help households install solar panels at little or no upfront cost. With panel prices still falling by about 5 percent a year, on SolarCity's estimates, within a few years the U.S. government's subsidies – modest compared with Germany's – won't be needed to make solar power competitive.

A home solar system is being installed in the United States once every four minutes, GTM Research calculates. At that rate 1 million houses will have panels by 2016, a tenfold increase on 2010. About \$170 billion of utility revenue across the country could be at risk from solar competition by 2017, according to the Edison Electric Institute, a lobby group – about a third of the industry's top line.

If the threat on a German scale still seems distant overall, it's more immediate for utilities in sunny states like Arizona and California, where solar panels are most financially appealing. Arizona's main electricity provider has already taken the issue on, pressing the state's regulators to impose a monthly fee on customers with panels. Utilities in northeastern states, where the price of electricity is high, may also suffer earlier than generators in other parts of the country because the economics of solar power will become attractive sooner.

Aside from price pressures and grid costs, utilities risk being left with underused coal, gas and nuclear generating plants. Exelon, a huge U.S. utility that has specialised in nuclear power, could be particularly hard hit from falling prices because of the high fixed costs of running such plants.

The heavy debt load that utilities typically carry also makes them vulnerable. The relatively small Hawaiian Electric Industries, for example, would need to devote five times its 2013 earnings before interest and tax

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if it had to pay off its \$1.5 billion of net debt. The giant Exelon's \$19 billion debt mountain would take about as long to whittle down. But if revenue fell by one third, as the EEI suggests is possible, and margins were cut in half – as has happened to E.ON in Germany – debt would then represent about 15 years' worth of EBIT at both firms.

There's time to prepare, and the damage won't be fatal. Regulators will find ways to help utilities keep functioning. For example, as in the first step taken by Arizona's watchdogs, panel users may be saddled with extra fees to defray the utilities' grid costs.

Still, Uncle Sam's electric utilities trade on an average enterprise value of more than eight times next year's forecast EBITDA while E.ON, for one, is now valued at just five times EBITDA. The U.S. and German sectors are of course different. All the same, investors in American utilities need to keep an eye on the sun.

*First published Jan. 2, 2014*

## MONEY AND MARKETS

### MARKETS FACE A YEAR AS TOUGH AS 1994

BY IAN CAMPBELL

It's all priced in, the optimists say, referring to the tapering of the U.S. Federal Reserve's money printing. But tapering is just the beginning of the end of ever looser monetary policy and the long road towards normalisation.

In 1994 it was an unexpected Fed move that triggered an infamous sell-off. This time, the shift in policy is widely anticipated. And since Ben Bernanke, the Fed chairman, first hinted at tapering in May the yield on 10-year U.S.



*A trader looks up at charts on his screen just before the end of trading for the day on the floor of the New York Stock Exchange, Nov. 18, 2013. REUTERS/Lucas Jackson*

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Treasuries has gained about a percentage point, to 2.9 percent. But they are still expensive. The three-decade bull market in bonds that culminated in depression fears and monetary extremism is over.

That is a good thing, mostly, but markets will take it hard. Yields on 10-year Treasury bonds could reach 4 percent, or more, by late 2014 as the Fed gradually winds down its quantitative easing, the U.S. recovery broadens and inflation picks up. Other global bond yields will follow and provoke further shifts in capital flows and currencies.

Emerging markets have suffered already. For some, that suggests fresh upside potential. But the MSCI Emerging Markets index almost doubled in 2009 and 2010 as investors fled from what they perceived as stricken developed markets and now emerging economies must absorb the real economic impact of reduced capital inflows. Brazil and India are among those pushing up interest rates to cope with currency weakness and inflation. Emerging market growth rates are falling. And those with currency difficulty will be selling Treasuries, not piling into them.

Investors face the problem of where to take refuge. In 2013 they found one answer. Developed country equities soared, with the U.S. S&P 500 Index up by a vertiginous 27 percent. Yet this may set up a repetition of recent history seen in other asset classes. Gold, commodities, bonds and emerging markets stocks have all bubbled – and burst. If monetary conditions tighten and bond yields push ahead of dividends, developed market equities may follow suit. U.S. shares, according to Reuters Starmine data, trade on a forward price earnings multiple of 16. That is not impossibly high, but it is high enough to worry.

*First published Jan. 2, 2014*

## **OIL'S NEW AGE OF PLENTY CHALLENGES OLD ASSUMPTIONS** BY KEVIN ALLISON

The energy business may enter a tumultuous period in 2014, even if sanctions on Iranian oil exports remain in place. The combination of increased shale drilling, cheaper solar power and higher investments in energy efficiency have the

potential to create a glut of oil from countries outside the OPEC producers' cartel at current prices. A sharp drop in the oil price is possible, and more volatility in oil prices, energy investments and geopolitics are almost inevitable.

### *Spreading the shale revolution*

Prolific American shale drilling is already changing the global petroleum map. The International Energy Agency, a rich-country oil club, expects the United States to overtake Saudi Arabia as the world's biggest crude producer by 2015. By 2035, the world's biggest economy may be self-sufficient in petroleum. The gains for the country are substantial, as domestic production with a cost of \$40-\$80 a barrel replaces imports at something like the global Brent benchmark of \$112 a barrel.

Analysts have consistently underestimated shale's U.S. potential and they're probably still underestimating the size of the global revolution. For example, the IEA's latest long-term forecast estimates that production from shale and other "light tight oil" will hit only about 6 million barrels per day by 2030. That is about 6 percent of global supplies, but the combined production from would-be shale powers Russia, China and Argentina would only be about a fifth of that of the United States.

The caution is based on a belief in American energy exceptionalism. Other countries with big unconventional deposits, it is believed, lack entrepreneurs, friendly regulators and so forth. And there's no guarantee that drilling techniques developed in North Dakota or Texas will work in other hotspots.

But shale wannabes have strong economic and political incentives to overcome such hurdles. U.S. factories today are paying about a quarter what European and Asian rivals pay for their energy. Consultant IHS estimates the shale boom could add \$3,500 to the average American's disposable income by 2025. There are also the geopolitical benefits of not relying on Middle Eastern oil.

Political resistance may slow down shale in Western Europe, but the governments of Russia and China are not likely to let the opportunity pass. It might take time, but a global shale boom could emerge just as U.S. production growth reaches a plateau, probably sometime in the mid-2020s.

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### *Solar flares, energy saves*

Shale is not the only technological revolution that could confound conservative forecasts. Installed solar capacity is growing rapidly. Admittedly, it's off a low base, and helped by generous government subsidies. But the unsubsidised cost of solar panels has plunged by more than three quarters since 2008. Utility-scale solar power is now economically efficient – without subsidies – in the sunnier parts of Europe. If costs stay on their downward trajectory, as seems likely, installations could continue to exceed forecasts.

Meanwhile, after a decade of high energy prices, interest in saving energy is heating up. European Union member states will begin to implement the bloc's latest efficiency directive in 2014. In the United States, the Obama administration has tightened auto efficiency rules and recently announced plans to curb pollution from power plants – developments that are bearish for greenhouse gas emissions and oil. For fast-growing, resource-constrained countries like India and China, it makes more economic sense to invest in energy efficiency than to import foreign fuel.

### *Aftershocks*

Investors understand each of these trends, but they probably underestimate the effect of their convergence. The consequences could be profound.

To start, crude could be in persistent oversupply. The excess would only increase if recent trouble spots like Iran, Libya and Iraq were able to push up production. OPEC's swing producer, Saudi Arabia, might have to cut production sharply to keep prices above \$100 a barrel.

Longer-term, if the Saudis are unwilling to keep bearing the brunt of foregone production, or if the shale revolution spreads, oil prices might become more vulnerable to a sudden collapse. That would be good for users, but potentially destabilising for producers that rely on pricey crude to make government budgets work.

Energy investments – particularly those like ultra-deepwater or Arctic oil, which require high oil prices to break even – would become riskier, and more complicated. Conversely, climate change could become less of

a political issue if cheap solar panels and unexpected strides in energy efficiency lead greenhouse gas emissions to peak sooner than expected, taking some of the urgency out of the hunt for cleaner-burning fuels.

Rapid technological change has a way of up-ending forecasts rooted in historical trends. In 2014 and beyond, energy market participants should expect the unexpected.

*First published Jan. 2, 2014*

## **U.S. EMPLOYERS WILL BRING MORE JOBS BACK HOME** BY ANTONY CURRIE

America's employers will bring more jobs back home in 2014. The nation's energy costs and wage growth are lower than in many other countries. Productivity's higher, too. That makes outsourcing less appealing and may herald a renaissance of sorts for American manufacturing.

Companies based in the United States are now benefitting from trends that only a few years ago worked against them. First, the country's average annual hourly manufacturing pay rose just over 4 percent between 2006 and 2011, according to T. Rowe Price. China's, by comparison, shot up 14 percent and Brazil's hit 18 percent.

Americans get a better deal on energy prices than their global counterparts, too, thanks to the growth in domestic fracking. T. Rowe Price states that their natural gas, for example, costs around \$3.50 per million British thermal units whereas in South Korea it's almost six times as much. The investment firm also points out that U.S. electricity at 7 cents per kilowatt-hour is less than half the price in Germany and Japan.

On top of that, American workers are more productive, with the average output per worker as measured in dollars rising almost 5 percent a year since 1990 compared with 3.5 percent globally, T. Rowe Price notes. Employers stateside probably cannot squeeze much more out of their current workforce, at least not without ramping up the overtime bill. The

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length of the week is, at 41.8 hours, just shy of its post-World War II high, according to Barclays. That suggests companies will need to hire to grow.

There's one more factor: China. Its workforce is expected to decline and its ageing population will increase in coming years just as its economy shifts more towards internal consumption from exports. That's likely to keep wages rising and strip the country of its low-cost appeal. Average urban wages have almost doubled in nominal terms since the end of 2007, according to official data.

Combined, these are arguments for doing less new manufacturing abroad. Auto companies are still booming after restructuring four years ago. Ford announced on Dec. 12 that it would hire 5,000 workers in the United States in 2014. Overall, U.S. manufacturing could add 20,000 jobs a month in 2014, according to Barclays – five times its showing in 2013. With some 8 million manufacturing jobs lost since 1980, according to the Bureau of Labor Statistics, it doesn't quite point to a new industrial heyday. But it's a welcome change of direction.

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## **COMMODITIES SET TO DISTINGUISH THEMSELVES**

**BY KEVIN ALLISON**

Commodity prices look set to distinguish themselves in 2014. From gold to grain, raw materials will trade less in line not only with equities, but with each other – and are likely to fall, to boot. Thank a calm euro zone and the prospect of the U.S. Federal Reserve cutting back its bond purchases.

Historically, commodities and equities have tended to move independently of one another. But for most of the period since the stock market's March 2009 trough, the performance of the Thomson Reuters/Jefferies CRB commodity index has closely tracked that of the MSCI World Index of stocks.

Distortive central bank policies and euro zone fears meant investors didn't really distinguish between the two asset classes. When stocks

moved, commodity prices tended to move in the same direction, and by a similar amount.

Asset-inflating central banks did not totally overwhelm real-world supply and demand. Expensive crude oil has led to a surge in U.S. shale drilling and a glut of non-OPEC crude. A decade of pricey copper and iron ore has induced miners to bring giant new pits online, even as growth in Chinese demand for raw materials wanes.

The unusual correlations finally started to change over the summer and by early December there was little relationship to discern at all. Correlations between different commodities have also fallen.

Many raw materials prices are still high by historical standards, though. That should change if the Fed cuts its extraordinary support for the economy, as expected. In addition, the more normal monetary policy becomes, the greater the likelihood that individual commodities start trading more on their own fundamentals than anything else.

Cheaper raw materials would be a boon to industry. Consumers would welcome less expensive oil and grain. Softer metal prices would ease the impact of slower growth in China – at least until demand catches up with supply again. And commodities that no longer trade in lock-step with each other may even provide a boost to Wall Street's struggling trading desks. Prices set by fundamentals, not fear, would be good news all round.

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## **U.S. HOUSING RECOVERY COULD RUN OUT OF STEAM**

**BY DANIEL INDIVIGLIO**

The U.S. housing recovery could run out of steam in 2014. Banks are likely to tighten lending standards once new rules come into place. Rising interest rates may drive down home loan volume, too. Cash purchases by investors could set a floor for house prices, but they may not be enough to prevent a major slowdown.

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*A U.S. flag decorates a for-sale sign at a home in the Capitol Hill neighbourhood of Washington, Aug. 21, 2012. REUTERS/Jonathan Ernst*

Of late, the market has been on a tear. American home prices in the third quarter of 2013 rose 11 percent compared with the same period a year earlier, the S&P/Case-Shiller index shows. That's the strongest jump since the bubble popped six years ago. Foreclosure activity, meanwhile, has fallen to 2005 levels, according to online marketplace RealtyTrac. And existing home sales have been the best since 2007 with over 5 million on an annualized basis since May, reports the National Association of Realtors.

But Washington appears poised to throw cold water on the fiery recovery. In January, the so-called Qualified Mortgage rule goes live. It piles strict new standards on lenders who want to avoid borrower lawsuits. That could shrink home loan credit from the current level that is already lower than before the boom.

Congress may even make some reforms to mortgage finance next year, possibly laying out the funeral plan for guarantors Fannie Mae and Freddie Mac. Both lawmaking chambers are pondering bills, and outgoing Senate Banking Committee Chairman Tim Johnson needs some legacy legislation.

Meanwhile, demand for mortgages is likely to shrink, too. That's because long-term interest rates are on the verge of rising after years of the U.S. Federal Reserve holding them artificially low. Not only will that lead to a slump in borrowers refinancing their existing home loans – a business that already dropped in 2013. It will also dissuade some from buying a new home.

It's not looking totally bleak. Since mid-2010 all-cash purchases, mostly by investors like Blackstone, have made up 30 percent of all existing home sales, according to the NAR. That's more than three times its historical norm. That may prevent house prices plummeting, but it's of little comfort to the average buyer.

*First published Jan. 2, 2014*

## **CHINA IS MOVING CLOSER TO ITS “DUBAI MOMENT”**

**BY PETER THAL LARSEN**

China's reform drive is getting closer to its “Dubai moment”. The emirate's 2009 refusal to bail out its flagship holding company shocked lenders who had assumed all debt carried an implicit state guarantee. As China introduces market forces to its financial system, it will also have to draw a clearer line between public and private lending.

Dubai's era of easy credit came to a halt in November 2009, when Dubai World asked lenders to forbear on its debts. Even though the company did not enjoy an official state guarantee, lenders mistakenly believed Dubai's ruling family – and neighbour Abu Dhabi – would never permit a high-profile entity to default.

China's binge is based on similar assumptions. Banks and investors have lent freely in the belief that financial institutions, state-owned enterprises and local governments will get official help if necessary. To date, that has proved correct: the country's domestic bond market has yet to suffer a single default. However, if Chinese leaders are serious about letting market forces set the price of money, it cannot last. The state will need to spell out the limits of its support.

## **BREAKINGVIEWS**

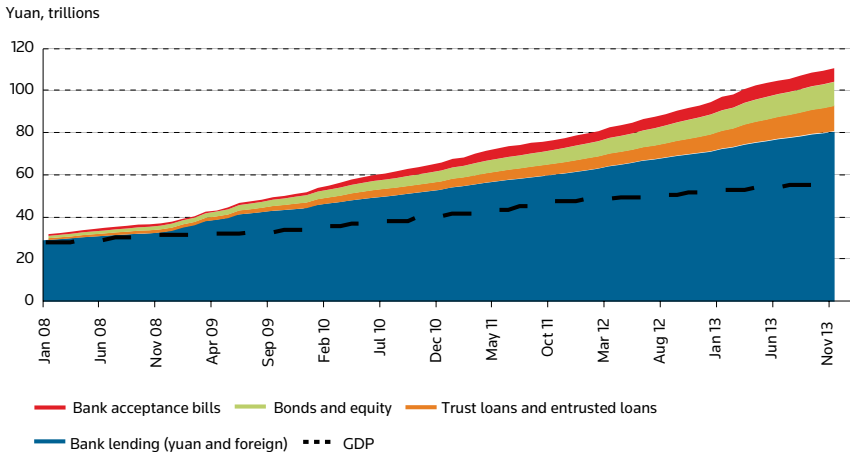
Of course, China's problem is much, much larger than Dubai's. At the time of its bombshell, the emirate and its associated companies had outstanding borrowings of about \$80 billion. China's total debt is around twice 2013's estimated \$9 trillion GDP. However, most of the lenders and borrowers are domestic and many are owned by the state. Unlike Dubai's rulers, China can dictate where the losses will fall.

Any attempt to enforce market discipline is bound to be messy and inconsistent. Even so, those borrowers who are cut loose will suffer a painful shock, while credit will be suddenly repriced across the economy. China's political calendar and the country's lack of an explicit system for protecting ordinary savers weighed against such a dramatic move until now. But regulators are preparing to introduce a deposit insurance scheme along with powers to wind down failing banks next year. With new leaders determined to give markets a greater role in the economy, China will soon be ready to replay Dubai's debt drama.

*First published Dec. 19, 2013*

## Who funds China?

Total social financing by type vs GDP



Source: Thomson Reuters  
John Foley, Robyn Mak 12/12/2013

## FEES AND FORTUNES

### WELLS WILL KNOCK LOUDER ON BULGE BRACKET'S DOOR

BY ANTONY CURRIE

Wells Fargo will start knocking more loudly on the bulge bracket's door. The California lender is already one of the top 10 global investment banks by fees, according to data from Thomson Reuters. Much of that comes courtesy of middle-market clients. But if the bank run by John Stumpf starts going after bigger fish, it could put Wall Street's bigwigs on the defensive.



*A man walks past a Wells Fargo Bank branch on a rainy morning in Washington, Jan. 17, 2012.  
REUTERS/Gary Cameron*

## BREAKINGVIEWS

Stumpf has been expanding Wells' investment banking business ever since picking up Wachovia, which had been making a move on Wall Street, in 2008. The bank is not much of a trading house. What little information it provides shows that a day where it makes more than \$15 million in revenue is a big one, compared with the \$100 million marker the likes of Goldman Sachs lay down. At \$2 billion, though, the underwriting and advisory fees earned in the first 11 months of 2013 are already double the bank's take for the whole of the first year after Wells purchased Wachovia.

America's fourth-largest bank by assets still has room to grow. Its equity capital markets division had just a 5 percent share of the U.S. market in the year to November. While that's an impressive jump from its 1.7 percent showing in 2009, it's less than half of what the top four players each command. The gap is even starker in advising on mergers. Wells' 2.5 percent share is five times its 2009 number. But it only advised on \$53 billion worth of deals – a tenth of market leaders Goldman Sachs and JPMorgan.

Yet Stumpf's firm has the balance sheet, and lending relationships, to do better. Its loan-to-deposit ratio is just 79 percent, meaning Wells has \$200 billion of lending firepower, should it choose to deploy it more aggressively. While explicitly tying loans to other business is verboten, it does provide a handy calling card – as JPMorgan and other mega-banks have shown in the past.

Taking on Wall Street's old guard won't be easy. Corporate executives and their boards don't like trying out newcomers for selling stock or inking transformational deals. That's why Wells' run in the debt business is more noticeable – it underwrote more high-yield bond deals this year than Morgan Stanley, for example. Advising on takeovers is a harder nut to crack and faces extra competition from boutiques. But the returns are hefty enough that Wells may find the lure of a more enduring Wall Street presence irresistible.

*First published Dec. 19, 2013*

## CHINA'S BANKS ARE COMING – THIS TIME FOR REAL

BY JOHN FOLEY

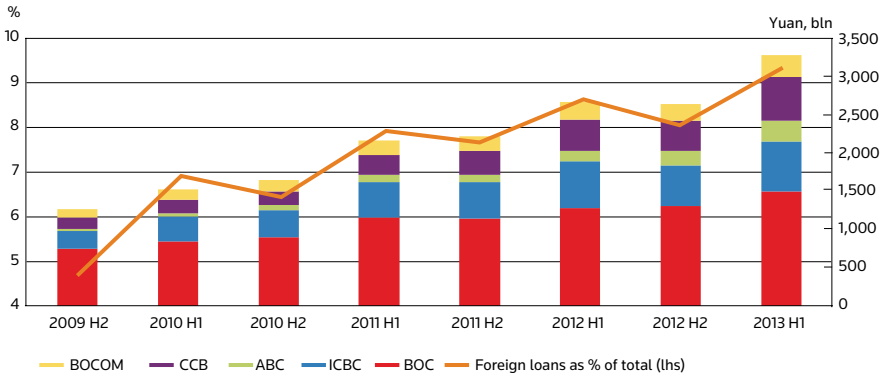
China's banks are racking up foreign assets, driven by trade flows, and the country's corporate diaspora. Even at the current slow pace, what today looks like "following the client" could soon become "following everyone's clients".

In 2013, China's lenders abroad mostly stuck with what they knew – servicing Chinese companies. But there were firsts. Agricultural Bank of China started clearing yuan trades in the United Kingdom, and Industrial and Commercial Bank of China issued a yuan-denominated UK bond. Those niche markets can still grow fast: the yuan is now the second most-used trade currency after the U.S. dollar.

Takeovers are the logical next step. A dream pairing of ICBC and UK-based emerging market lender Standard Chartered may be too complex, despite the latter's sliding valuation. But majority stakes in markets where Chinese companies trade and invest make more immediate sense. China Construction Bank set the tone by buying a stake in Brazil's BicBanco in

### Loan rangers: China's banks are coming

Overseas loans for the biggest five commercial banks



Note: \$1 = 6.09 yuan  
Source: Company Filings



*A man and his daughter ride a bicycle past a branch of the Industrial and Commercial Bank of China Ltd in Beijing, June 26, 2013. REUTERS/Jason Lee*

November. Africa and Eastern Europe may see similar deals. Even oil-rich Iran could be a target in a future sanctions-free world.

The challenge is not to make the same mistakes as Japan in the 1980s. Fuelled by an appreciating currency and a restrictive home regulator, Japanese banks started expanding abroad. By 1988, six of the world's 10 biggest banks were Japanese, according to *The Banker*. When bad debts rose at home the lenders retreated, leaving a credit crunch in their wake.

China's saving grace may be its banks' inexperience and government micromanagement. CCB's BicBanco deal was two years in the making; ICBC has been haggling over Standard Bank's UK commodities desk for over a year. That limits the scope for impulsive and foolish deals. Capital controls also mean China's banks can't easily switch their onshore yuan into dollars or euros, limiting their ability to lend abroad.

Still, China is a land of big numbers. The top five banks' overseas loans totalled \$538 billion by the end of June, double the level of 2010 and close to the size of Ireland's entire domestic loan book. Even if global banks aren't yet losing business to China's mega-lenders, 2014 should see them start to take the prospect seriously.

*First published Jan. 2, 2014*

## **QUALITY, NOT CAPACITY, IS KEY FOR EUROPEAN IPOs**

**BY QUENTIN WEBB**

For the first time in years, Europe's new issues market is in decent health. Fund managers have cash, the economic gloom is lifting, and most recent deals have traded up. That makes for a supportive environment for successful initial public offerings. But quality control is becoming paramount. A few shoddy or over-priced deals could badly set the market back.

The year to Dec. 5 saw \$32.1 billion of initial public offerings in Europe – more than double the previous year's total, but still lagging the \$49.5 billion raised stateside. A string of prospective issuers will hope the bandwagon keeps rolling. These include British mobile giant EE and Euronext, which runs the Paris and Amsterdam stock markets; plus former buyouts such as Saga, Pets at Home and Applus+, the Spanish industrial testing company.

Judged purely on financial capacity, they have nothing to fear. By September, inflows into European equity funds totalled 54.8 billion euros (\$75 billion), Lipper reckons. Moreover, North American fund managers have ended a long buyer's strike, and could stump up a lot more: in September Goldman Sachs estimated these houses might be \$150 billion behind their historic rate of investment into Europe. Mergers and acquisitions will help too. Vodafone's U.S. sell-off alone will hand managers \$24 billion in cash, and far more in shares.

Generally, investors' support has been rewarded. Only a few new shares, such as Moleskine, TCS and Partnership Assurance, are below their offer price. Most have performed well and some, such as Countrywide, Crest

## **BREAKINGVIEWS**





*Small foam bull figures are seen in front of the German share price index DAX board at the stock exchange in Frankfurt, Nov. 27, 2013. REUTERS/Kai Pfaffenbach*

Nicholson, and Royal Mail, have soared more than 50 percent. Sanitec, Sweden's biggest float since 2006, listed on Dec. 10 and made a solid debut. That is helpful.

Still, the longer an IPO window stays open, the more careful investors should be. Already a pessimist might detect a few cracks – a few tiddling deals have been pulled, although the level of cancellations is low by historical standards. And other floats such as Infinis or Tarkett met with an underwhelming reception.

One obvious worry is that stragglers are less appealing than their predecessors, who were able to float in tougher times. The lower quality can take many forms: governance, disclosure, financial controls, or earnings resilience might lag top public companies', for example. Or vendors may just be too aggressive on price for what is, to the buyer, still an unknown

quantity. For the current happy state to continue, owners and their financiers must stay disciplined.

*First published Dec. 10, 2013*

## **FIXED INCOME TRADING GOES FROM BAD TO WORSE**

**BY DOMINIC ELLIOTT AND ANTONY CURRIE**

Fixed income trading will go from bad to worse. Industry revenue was down 18 percent to \$120 billion over 2013, according to Deutsche Bank research. Although most bank analysts only expect a single-digit percentage drop in revenue in 2014, the effects of scandals, new rules and central bank policy could easily lop another fifth off again.

There's plenty to be bearish about for anyone involved with fixed income, currencies and commodities – known as FICC. Credit default swaps, foreign exchange and precious metals rate-setting are all under international investigation as potential cartels. Large fines would cut into both pay cheques and profit. Meanwhile, new regulations such as the U.S. swaps overhaul, leverage ratio limits, and the Volcker Rule will squeeze out any final flirtations.

On top of that, merely the prospect of the U.S. Federal Reserve reducing its bond-buying programme whacked trading volumes in 2013's third quarter. An increase in borrowing costs resulting from actual tapering could cut into income from credit and interest rates trading in a big way.

Recent changes in strategy mean some firms will suffer more than others. A drop in rates volume, for example, would hurt UBS – having slimmed down, it won't have as many other desks to pick up the slack. Securitisation yields a decent return on equity – 15 percent or more at Morgan Stanley.

Those with reduced balance sheets, like Morgan Stanley and Credit Suisse, could find it hard to win trading volumes. Goldman Sachs is more reliant on big institutional trades than most – which hurts when there's a mishap like when the firm was caught out holding wrong currency positions in the

## **BREAKINGVIEWS**

summer. The likes of JPMorgan and Deutsche Bank may be in a better position, as their commercial banking clients could generate FICC flows.

It's not all doom and gloom. A drop in income as some FICC products move onto exchanges might in years to come be offset by a jump in volume, as happened with equities over a decade ago. And volatility in commodities could boost one of the least profitable trading units. These are mostly trends for the longer term, though. FICC's immediate future looks pretty feeble.

*First published Dec. 19, 2013*

## **WALL STREET'S PITCHFORK MOB NEEDS NEW VILLAIN**

**BY RICHARD BEALES**

Wall Street critics need a new villain. Goldman Sachs has implemented a successful charm offensive since lawmakers hauled chief executive Lloyd Blankfein up to Capitol Hill and regulators extracted a \$550 million settlement from the bank a few years ago. The case against JPMorgan boss Jamie Dimon is struggling to take hold. Steve Cohen, the hedge fund Wizard of Oz, is nursing legal wounds. The culture of greed in finance won't disappoint for long, though.

Though Bernie Madoff, another big-time baddie, is behind bars, scarcely any other financier has come close to jail time for a role in the 2008 crisis. With the U.S. government still chasing wrongdoers, it could yet happen but looks increasingly unlikely.

Renewed pressure could dog Dimon and there's a chance a relatively minor scoundrel like Jon Corzine, the former Goldman boss and New Jersey governor who presided over the failure of brokerage MF Global, reappears on centre stage. Uncle Sam's enforcers may yet expose details shocking enough to reignite popular indignation over, say, Countrywide, the once-prolific mortgage lender headed by Angelo Mozilo that was sold to Bank of America.

Overall, though, it's as if the pitchfork-wielding anti-finance mob has no choice but to disperse for lack of targets. Yet even the first draft of crisis

history isn't fully written. It's possible there was egregious behaviour in money market mutual fund organisations as they struggled to stay in business or even in parts of national or state government as markets imploded and watchdogs scrambled.

Moreover, there's again a danger that investors and Wall Street eggheads will stretch both investing structures and credulity in a renewed quest to beat the near-zero returns currently available on short-term lending. With stocks on a roll this year, the next scandal – like options backdating and initial public offering favouritism – could already be unfolding in the corporate arena. That could provide new rogues in the vein of Enron's former bosses and the likes of Dennis Kozlowski, who went to prison in 2005 for looting Tyco International and may be released on parole in January.

The next villain of finance is as hard to predict as the next crisis. The only sure thing is that there will be one.

*First published Jan. 2, 2014*



*A Guy Fawkes mask lies on the ground after the Occupy LA encampment was dismantled outside City Hall in Los Angeles, Nov. 30, 2011. REUTERS/Lucy Nicholson*

# MERGERS AND MANIAS

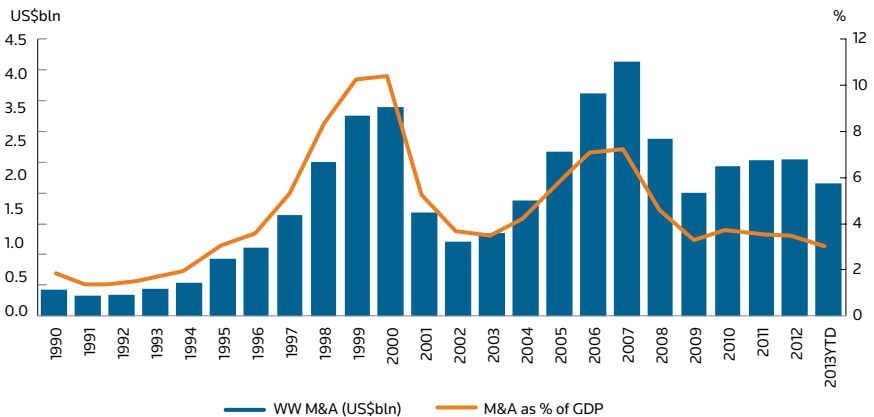
## M&A POTENTIAL WILL SUCCEMB TO LAWS OF PHYSICS

BY JEFFREY GOLDFARB

The laws of physics are apt to work against an upturn in mergers and acquisitions. The investor love being heaped on acquirers should be a catalyst for takeovers amid plentiful cash and credit. The pendulum could also swing to correct other market anomalies. Yet opposing pressures still exist and chief executives and boards have settled into a cautious mindset. Inertia is about as powerful a force there is.

For years now, investment bankers have been anticipating a surge in transactions because of the balance-sheet ammunition available to clients. Benign borrowing conditions and overflowing war chests haven't yet made much difference, however. As of mid-December, according to Thomson Reuters data, global merger volume was roughly on pace to match the \$2.5

## Worldwide mergers and acquisitions



Source: Thomson Reuters, IMF GDP Figures

trillion of deals unveiled in 2012. And the total wasn't much different in 2010 or 2011.

Executives in a position to make such decisions expect a sharp increase in global deal activity in 2014, according to a survey conducted by Thomson Reuters and Freeman Consulting, and they have their reasons. For starters, investors have rewarded acquisitions of \$1 billion or more at a higher rate this year than in the previous five, as buyers chose sensible targets that provided large synergies. Sysco, Salix Pharmaceuticals and Gannett are among the acquiring companies whose shares gained at least 10 percent upon announcement of a deal.

Mergers are also lagging broader indicators. According to Deutsche Bank, the number of deals tends to correlate closely with equity market valuations but has now fallen noticeably short in comparison to buoyant stock prices. And the dollar volume of acquisitions has tumbled below 3 percent of worldwide GDP for the first time since the mid-1990s. A return to historical averages would mean more deal-making.

Corporate chieftains, however, have grown more fearful of aggressive regulators and activist investors disrupting their plans. American Airlines parent AMR and McKesson are the latest to encounter such troubles and remind chief executives of such hazards. Lingering memories of the 2008 crisis coupled with expectations of continued sluggish economic growth will also help keep boardrooms conservative. As long as the rewards of deal-making don't glitter enough to obscure the risks, eager merger practitioners should prepare to endure more unrealised potential.

*First published Dec. 19, 2013*

## **BEIJING WILL BLOCK A BIG OVERSEAS DEAL IN 2014**

**BY ETHAN BILBY**

China will seek its own GE-Honeywell moment in 2014. European regulators asserted their growing power over global competition when they blocked the merger of the two U.S. industrial companies in 2001. Beijing's

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*A sign is seen in front of the giant portrait of Chinese late Chairman Mao Zedong, on Tiananmen Square in Beijing, Oct. 30, 2013. REUTERS/Kim Kyung-Hoon*

antitrust watchdog is already giving increasing scrutiny to tie-ups even when both companies are foreign. The desire to show its economic might could see it block a deal outright.

After studying the European Union's model, China revamped its own competition rules in 2008, giving the Ministry of Commerce the power to weigh in on domestic and foreign deals. The regulator can rule on any transaction where the parties each have more than 400 million yuan (\$66 million) of Chinese revenue and combined sales are greater than 2 billion yuan in China or 10 billion yuan worldwide.

Of the over 700 filings that MOFCOM received since 2008, just 21 were subject to an in-depth review. But those investigations are taking longer. Before 2012, the average period from submission to decision was 172 days. That has risen to 309 days for more recent deals. China studied the

\$35 billion merger between miners Glencore and Xstrata for over a year, forcing the deal to be repeatedly pushed back.

So far, MOFCOM has only rejected one deal outright: Coca-Cola's 2008 attempt to purchase Chinese juice-maker Huiyuan. But it has imposed far-reaching conditions. Glencore Xstrata was forced to sell its Peruvian copper project and guarantee future supply of various metals. MOFCOM's broad legal remit for "improving China's macro-economy" allows it to make decisions for more overt political reasoning than EU or U.S. regulators.

That could eventually prompt Beijing to deliver a big "no" against two non-Chinese firms. The rationale could be safeguarding industries China hopes to dominate, such as network equipment or mobile phones. Or it could focus on industries the country sees as important, such as commodities or pharmaceuticals.

Beijing may not even have to dig for an argument itself. Opposition to the GE-Honeywell deal was partly fuelled by lobbying from rival United Technologies. In 2014, opponents to a merger will increasingly take their grievances to Beijing.

*First published Jan. 2, 2014*

## **POST-TWITTER HYPE WILL FIND MANY HAPPY HOMES**

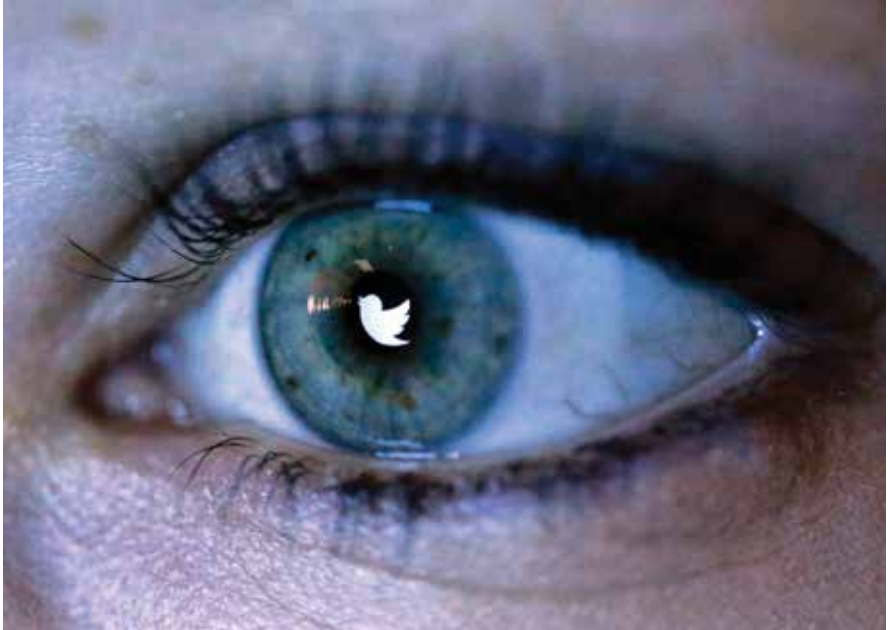
**BY ROB COX**

Twitter has barely fluttered its wings as a public company and, true to form, Wall Street bankers, investors and venture capitalists are perseverating over the next big thing. After years of anticipating Facebook's debut, and then Twitter's, there's no single tech blockbuster teed up. A bunch of fast-growing smaller ones, though, including Pinterest and Uber, should fill the enthusiasm gap.

Leading up to its initial public offering last year, Facebook was the Holy Grail for any underwriter wanting to lead the biggest internet launch in history. Yet even those investment banks that failed to handle the IPO could

## **BREAKINGVIEWS**





*An illustration picture shows the Twitter logo reflected in the eye of a woman in Berlin, Nov. 7, 2013.  
REUTERS/Fabrizio Bensch*

at least content themselves with a shot at Twitter's matriculation. Investors were in a similar boat.

Though there's no obvious Twitter-size transaction waiting in the wings, there's lucrative work for equity capital markets desks to chase. Moreover, while the deals may not be as captivating as Twitter's, the rewards could be, especially as future underwriting fees should exceed the 3.25 percent being paid by the microblogging company.

Consider the hottest Silicon Valley darlings on the docket. In the consumer internet arena, at least three relatively immature firms may come to market with a combined value of more than \$7 billion. Given their meteoric growth rates, it also wouldn't be inconceivable for them to double from their last fundraising rounds.

There's Pinterest, the electronic corkboard that is only now toying with generating revenue. It was most recently valued at \$3.8 billion. Airbnb, which allows homeowners and apartment dwellers to rent out rooms to travellers, saw its paper worth hit \$2.5 billion last year, making it the biggest of the so-called "sharing economy" start-ups. Connecting drivers and riders by app enabled Uber to raise \$361 million at a \$3.4 billion valuation in August.

Square is likely to hit the stock market next year, the Wall Street Journal reported in November. The mobile payments service founded by Twitter chairman Jack Dorsey last raised money in 2012, at a \$3.25 billion value. In the enterprise space, there is MongoDB, a database company whose last pass of the hat pegged it at some \$1.2 billion.

By their lonesome, none of these debutantes would rival one Twitter. Should they seek the adulation of public investors, however, the class of 2014 would provide investment hype many happy homes.

*First published Nov. 11 2013*

## **SMALL TECH BEST PLACED TO TAKE ON BIG BROTHER**

**BY KATRINA HAMLIN**

Feeling insecure? So are companies everywhere. The lesson of 2013 was that there are grievous flaws in security systems once thought virtually impenetrable. Business needs better protection. The most credible providers may be smaller tech players.

Governments from the United States to China have embraced online surveillance and regulation. That won't end in 2014: paranoia is rising, and besides, spying between countries isn't technically illegal. Corporate spying has increased too, particularly as cloud-based services introduce new vulnerabilities. Detected attacks were up 25 percent year on year in 2013, according to a PricewaterhouseCoopers corporate survey. Half of respondents say security spending over the next 12 months will increase.

## **BREAKINGVIEWS**

But whom to trust? Market leaders are suspect. The likes of IBM and Cisco Systems are seen as facilitating U.S. state surveillance, and have suffered a sharp drop-off in revenues, led by clients in overseas markets like China and Russia. Other deep-pocketed giants such as Deutsche Telekom and Huawei want to offer alternatives, but they may also appear compromised. Deutsche Telekom's SiMKo secure phone and tablet technologies are undermined by its state ownership. Privately owned Chinese group Huawei is at pains to deny it has connections to the military and can be pushed around by the state.

Where smaller specialists excel is in perceived neutrality. Privately owned Silent Circle – former provider of encryption services to former U.S. spy agency contractor Edward Snowden – has grown its subscriber base by around 400 percent since the second quarter of 2012: the company showed its anti-surveillance cred by closing its email unit to protect client data. It's hard to imagine Google or Yahoo taking such extreme measures to show their independence.

There are relatively few ways to invest in the sector, but scarcity only incites keener interest. Barracuda, which provides security and data storage products, debuted on the New York stock market in November with a 32 percent first-day share price pop. Shares in malware protection firm FireEye and cloud security company Qualys have both risen 90 percent since they floated in September.

This may not last forever. Cisco Chief Executive John Chambers thinks the giants will regain trust and market share – though it could take time. But for now, “small tech” will be best placed to take Big Brother down a peg.

*First published Jan. 2, 2014*

## **SELFISH BEHAVIOUR WILL PROPEL SHARING ECONOMY**

**BY JEFFREY GOLDFARB**

Selfish behaviour will propel America's sharing economy. New matchmaking business models are thriving in large part by forging into grey areas of tax and regulation. As a result, fast-growing start-ups like

Uber, Airbnb and Lending Club face growing scrutiny from authorities. Like Amazon before them, though, self-interest should inspire some canny manoeuvring from these socialism-peddling capitalists.

Financially hard times and mobile technology enabled peer-to-peer options to proliferate. Citywide bicycle-sharing schemes in New York, London and beyond, along with operations like communal Zipcar auto rentals helped shift attitudes about ownership. Consumers are turning their homes into hotels, swapping clothes and meals with strangers, kennelling dogs, making their cars available for hire, and exchanging power tools with neighbours. Often, there's even extra cash to earn.

Such businesses generally can't operate without breaking rules, however, even if some of the regulations are antiquated or simply designed to entrench incumbent operators. For example, Hailo, an app for hailing



*A trader works at his computer on the floor of the New York Stock Exchange at the market open in New York, Oct. 14, 2013. REUTERS/Carlo Allegri*

## BREAKINGVIEWS

London's black cabs, charges a minimum rate in defiance of transport guidelines. Food sharers like Mealku may run afoul of health standards. Many state regulators in the United States have yet to sign off fully on institutions that directly match borrowers and lenders. Insurance-related questions remain open for ride-sharing options like RelayRides.

As devout believers in the power of the network effect, founders and their financial backers know they can't sit around and wait for elected officials to respond. While many new sharing ventures are trying to negotiate new rules, lawmakers aren't sitting still. New York Attorney General Eric Schneiderman targeted Airbnb, a home-rental service privately valued at some \$2.5 billion, to see if users were skirting hotel taxes. Some cities worry such lodging arrangements fall foul of public safety and fire prevention rules.

In many ways, though, the backers of the sharing economy's emerging players can take comfort from Amazon's experience. The online retailer established a price advantage early on by carefully avoiding, and fighting, the collection of sales taxes. Only now, two decades after its founding is it relenting on the issue. And the business it created over that period is now worth some \$175 billion of market value.

Younger entrepreneurs are trying new crafty tactics, too. Airbnb touted a study that purported to show the firm generated over \$600 million in economic activity in the Big Apple. Meanwhile, a budding trade group called Peers bills itself as a "grassroots" organisation that supports the sharing "movement" by advocating for "smart regulation." As it happens, Peers was founded by an Airbnb executive and its board includes a founding partner of the Collaborative Fund, an early stage investment firm devoted to this burgeoning segment of the economy.

What's clear is that the technology whizzes behind many of these operations can probably outrun most politicians and watchdogs for a while. And despite the feel-good connotation of their sharing sobriquet, they are also sufficiently cutthroat.

Take Uber, a \$3.5 billion mobile-based taxi service, which suavely propagates a cuddly image with marketing events that allow customers to

summon ice cream trucks and kitten deliveries. The firm, however, also has been sued by multiple taxi and livery companies, encountered resistance by some city officials and even faced a strike in Boston. Yet earlier this year it was Uber founder Travis Kalanick who accused rival Lyft of “regulatory arbitrage.” In the end, these sharers will look out mainly for themselves.

*First published Jan. 2, 2014*

## **ASIA IS RIPE FOR A BREWERS M&A BRAWL**

**BY UNA GALANI**

It is a seller’s market in the last frontier for beer. Asia Pacific is the last region not dominated in profit terms by the world’s four biggest brewers – Anheuser-Busch InBev, SABMiller, Heineken and Carlsberg – according to Bernstein Research. Consumption of suds is growing fast, and for-sale assets are hard to find. The coming year may see new owners for Philippine brewer San Miguel and South Korea’s Oriental Brewery. The real prize may be in China, the world’s biggest beer market by far.

For San Miguel, the question is whether Japan’s Kirin, which already owns 49 percent of the beer-maker, makes a play for the rest. Parent group San Miguel Corp is mulling a listing of its beer subsidiary, but Kirin may be keen to increase its stake to diversify away from a flat home market with unattractive demographics. Taking full control could cost the Japanese brewer \$5.5 billion, on the same frothy valuation of 17 times EBITDA that Heineken paid in 2012 to buy out minority shareholders in Asia Pacific Breweries.

In South Korea, AB InBev could buy back Oriental Brewery, which it sold to KKR in 2009. The Belgian brewer can do so for a price of 11 times the previous year’s EBITDA from July 2014, a source told Reuters Breakingviews when the deal was first struck. That could be as much as \$4.1 billion, according to a Reuters Breakingviews calculation – more than twice what KKR paid.

## **BREAKINGVIEWS**



*A bartender serves a glass of Carlsberg beer at a bar in Kuala Lumpur, July 4, 2012. REUTERS/David Loh*

The biggest potential for deals is in China. Denmark's Carlsberg still lags rivals SABMiller and AB InBev, but if China's rulers stick to their recent pledge to let market forces flow more freely, there could be an opportunity to beef up. One attractive partner is state-backed brewer Beijing Yanjing, which currently lacks a Western partner or a premium brand. Joining forces, perhaps with a joint venture, would turn Beijing Yanjing from the fourth to the third-largest player by volume.

Consolidation would be good for China's low beer margins: the market accounts for a quarter of global beer production, but is only the world's eighth biggest beer market by operating profit. For brewers looking to grab a bigger share of Asia's growth, that is a glass half full.

*First published Jan. 2, 2014*

## ODDS AND ENDS

### GERMANY WILL LIFT THE SOCCER WORLD CUP

BY ROBERT COLE

Germany is going to win the soccer World Cup. The football-mad Brazilian hosts have won five times, more than any other country. But using a Breakingviews calculator based on the hard numbers – the players' transfer value, population, participation and public engagement – Teutonic power will squash the romantic dream of a sixth win for Brazil.

There are 32 national sides in the quadrennial tournament. Spain has the most valuable squad of players, worth \$720 million according to data collator transfermarkt.co.uk. The United States has the most people to



*German supporters wave flags during the 2014 World Cup qualifying soccer match between Germany and Ireland in Cologne, Oct. 11, 2013. REUTERS/Ralp Orłowski*

## BREAKINGVIEWS





2014 FIFA WORLD CUP

BREAKINGVIEWS SOCCERNOMICS

Predicting the winner of soccer's biggest prize using hard numbers – player values, countries' economic and social factors.



**How it works:** There are 32 sides set to compete for the soccer World Cup due to be held in Brazil in June and July 2014. They start in groups of four with the top two sides progressing to the knockout stages. Here, they are represented by their respective national flags. Breakingviews has scored the 32 countries by rank in each of five each criterion used. Interactive users can change predicted outcomes by adjusting the weight attached to each of the five inputs.

**Sources:** Squad values according to transfermarkt.co.uk. Population numbers taken from the World Bank, with the exception of England, which comes from its Office for National Statistics. Participation rates calculated using FIFA "All Players" data, adjusted for gender and expressed as a percentage of male population. Fan Base rankings based on FIFA figures for the number of times games in the 2010 tournament were watched for at least 20 minutes. Data loaded December 2013.

choose from, more than 300 million in total. Little Bosnia Herzegovina has the most avid supporters, if television viewership from the last tournament in 2010 is a guide.

Germany, however, has all-round strength. It is top of the heap when it comes to participation in soccer. Figures from FIFA, the sport's governing body, suggest 36 percent of German men play the game. It also has the sixth most valuable squad of players, worth a total of about \$550 million, the sixth most engaged supporters and the seventh-largest population among the nations travelling to Brazil, with 82 million people.

That means that across the four criteria, Germany tops the list with Brazil second. Italy and Spain, also previous winners, come in third and fourth. England and Argentina will make it to the quarter-finals if *Breakingviews'* soccernomics ranking holds up. Chile, France and Japan will punch above their weight, compared to FIFA's current assessment of form.

There is, of course, more to the so-called beautiful game than socio-economic underpinnings. The hosts could suffer from the tournament draw, held in early December. Although ranked second, they could meet Germany in the semi-finals with Italy surviving the other half of the draw to lose to *Die Mannschaft*, as the German national team is known, in the final.

On the field, meanwhile, home support and even familiarity with hot and humid conditions could boost Brazil. Luck will matter as players are injured and referees make controversial decisions. Soccernomically speaking, though, in-form Portugal, Colombia and Uruguay may be in for disappointment. For the German football machine and its fans, the numbers suggest the trophy is there for the taking.

*First published Dec. 20, 2013*

## **RECOVERY WILL ONLY INCREASE INEQUALITY**

BY CHRISTOPHER HUGHES AND EDWARD HADAS

A normalising world will not be a harmonious world. The massive fiscal and monetary stimulus that is helping revive GDP growth in developed

## **BREAKINGVIEWS**

economies favours the privileged directly, and trickles down only slowly to the middle classes, the poor and the unemployed. That tension will worsen.

The trend to increased income inequality began long before the 2008 financial crisis. Income distributions in 17 member states from the Organisation for Economic Co-operation and Development became more unequal between the mid-1980s and 2008, while there was no significant change in three. Inequality decreased in only two, Turkey and Greece.

What happened after the crisis isn't yet clear. But in the United States the very rich have done very well. The share of income taken by the top 1 percent of earners declined with the markets in 2008, according to Emmanuel Saez of the University of California at Berkeley, but has rebounded. The upward trend, from 9 percent of total U.S. incomes in the early 1970 to about 20 percent before the crisis, has resumed. The inflation-adjusted income of the bottom 99 percent rose by only 0.4 percent between 2009 and 2012.

Post-crisis low interest rates helped some poor borrowers, but penalised frugal small savers. In the United Kingdom, many workers who retired during the crisis were forced into taking abysmal annuity rates. At the bottom of the income ladder, unemployment has increased and welfare benefits have generally fallen.

At the top, though, quantitative easing has produced gains on financial and real estate assets, especially for people rich enough to take the risks of leverage. Executive pay has continued to rise, and in the still extravagantly rewarded financial sector, the best remunerated have gained from a misguided regulatory assault on variable pay.

Recovery is on the way, and some of the exceptional policies are set to be unwound in 2014. But the less well off face more time out of work, more years in the workforce, and less real income and lower pensions than they would have expected before the crisis. A recovery that doesn't feel like one will lead to an increasing sense of grievance.

*First published Jan. 2, 2014*



## THE CHILLING ECHOES OF 1914, A CENTURY ON

BY MARTIN HUTCHINSON

A rerun of 1914's descent into global war is really rather unlikely. But some of the danger of a hundred years ago is present today.

The years before 1914 saw the formation of trade blocs separated by high tariff barriers. Back then, the world was dominated by several roughly equivalent powers, albeit with different strengths and weaknesses. Today, the world is similarly multi-polar. The United States is in a position of clear leadership, but China is coming up fast. Europe is weaker than it was, but is still a force to be reckoned with. Japan, Russia, Brazil, India are also too powerful to ignore.

A hundred years ago, big international infrastructure projects such as the Berlin-Baghdad Railway, and before it the Suez Canal, were built to



*Andy, a World War One Historical Association "14-18 en Somme" member, stands at sunset after a ceremony at the military cemetery of Lamothe-Warfusee, Northern France, Nov. 10, 2013.*

*REUTERS/Charles Platiau*

protect favored trading. Today's equivalent may be the bilateral mining partnerships forged between, for instance, China and mineral-rich African states. Today, the World Trade Organization offers some defence against tariffs. But protectionism could become entrenched if prolonged economic stagnation leads countries to pursue their own narrow interests.

Germany, Austria, Russia and France lost between 20 and 35 percent of national output between 1913 and 1918, according to Angus Maddison's data used in Stephen Broadberry's *The Economics of World War 1: A Comparative Analysis*. British GDP declined in 1914 and 1915, but grew 15 percent over the four years, as did the U.S. economy. The 37 million military and civilian casualties may tell a more accurate story but if history were to repeat itself, the global conflict could be both more universal and more destructive. Nuclear weapons proliferate. Warped diplomatic anger could lead to the deployment of chemical and biological devices. Electromagnetic pulses could wipe out our fragile electronic networks.

Like the assassination of Archduke Ferdinand that sparked the First World War, the catalyst for cataclysm might be something quite surprising. A global run on bank and other investment assets or an outbreak of hyperinflation, maybe? These threats get more serious the more policymakers pump up equity, bond, property and banking bubbles. If global wealth evaporates, or is proven to be an illusion, today's largely cordial global entente could be smashed with precipitous speed.

*First published Jan. 2, 2014*

## **BUZZWORD VISIONARIES WILL RIGHTSIZE THE LEXICON** BY QUENTIN WEBB

Do executive thought leaders need best-in-class jargon? Can only visionary C-suiters move the needle at the investor day or the Davos interactive panel? It appears embedded in the corporate DNA, but is a laser-like focus on buzzwords mission critical? Join Breakingviews, your end-to-end provider of financial commentary solutions, on a deep dive.

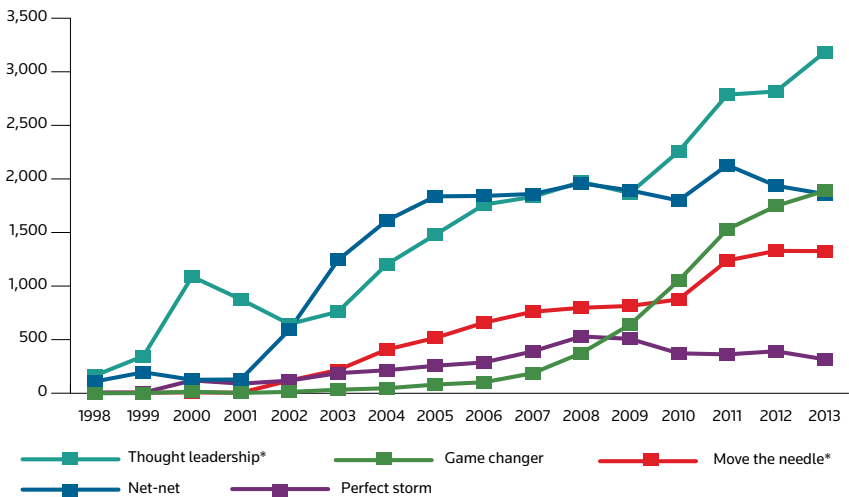
Analysis of 15 years of corporate press releases, and a decade or so of conference calls, shows some expressions are relentless in taking share. “Visionary” and “disruptive” have consistently surprised to the upside (See content-rich infographic with value-added functionality). However, counter-examples have experienced sustained sequential deceleration.

If you are looking to impress in terms of linguistics, there is a rich opportunity set to target. But be careful with what looks like low-hanging fruit. These phrases, net-net, may have transitioned past an inflection point.

Some have been sunset by comparables. Best-of-breed is no longer best-in-class. And the paradigm has shifted: in fact, yesterday’s paradigm shifts are today’s game changers. Other terms simply exhibit sustained downwards momentum. Win-win is on a losing streak. Perfect storm is a bit 2008. And only a mergers and acquisitions boom could increase the relevance of synergistic.

## Benchmarking buzzwords

Mentions in press releases and corporate conference calls of the following expressions



Note: \* Search includes similar terms

Source: Business Wire, Marketwired, PR Newswire and CQ FD Disclosure, via Factiva. 2013 figures to December 17 2013.

So we recommend drilling down for additional granularity. The bear-case scenario would be a sub-optimal impact on personal brand equity. Or here's an alternative. Rightsize the lexicon. That means abandoning the verbal benchmarking against the peer set altogether. If you really want to stand out, ditch the verbiage. Use fresh, clear language instead.

*First published Dec. 24, 2013*

## **TIME FOR LARRY AND SERGEY TO INVEST IN JOURNALISM?** BY ROB COX AND RICHARD BEALES

Is it time for Google billionaires Larry Page, Sergey Brin and Eric Schmidt to invest in journalism? In 2013, Amazon architect Jeff Bezos bought the Washington Post for \$250 million and eBay founder Pierre Omidyar announced a new investigative reporting venture. Yet strictly by the numbers, few have made their money at the expense of the old-school pillars of the fourth estate quite as obviously as the Google guys.

In 2000, the year Google introduced AdWords, still its main advertising program, U.S. daily and Sunday newspaper advertising peaked at \$48.7 billion, according to the Newspaper Association of America. It has since tumbled to less than half that level, some \$18.9 billion in 2012.

The decline is widely attributed to the rise of the internet. In fact, without Google and its online rivals, print ad spending might have continued rising. At the pace of growth achieved in the decade before 2000, it would now be running around \$80 billion a year.

It's uncanny, therefore, that of the \$60 billion plus of potential annual ad sales that print publications seem to have lost, Google had grabbed about \$44 billion by 2012, from virtually nothing in 2000. That two-thirds slice of the spoils is about equal to the company's market share of the online search business.

Maybe the mathematical symmetry is coincidental. But the larger point is not. Nobody has made as much money as Google disrupting the business



*Sergey Brin, chief executive and co-founder of Google, wears a Google Glass during a product demonstration at the Google I/O 2012 at Moscone Center in San Francisco, California June 27, 2012. REUTERS/Stephen Lam*

model that once supported the edifice of journalism – an endeavour which, as Bezos put it, “plays a critical role in a free society.”

Google has long maintained that it doesn’t want to get into the business of creating content. That’s fine. But Google’s leaders, who have become fabulously wealthy individually, could still invest for their personal accounts – just like Bezos and Omidyar. If any tech moguls have reason to feel they owe it to the now cash-strapped world of journalism to give something back, it’s Messrs Page, Brin and Schmidt.

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## ON THE COVER

*Front cover [from top right, in clockwise direction]:*

Janet Yellen, President Barack Obama's nominee to lead the U.S. Federal Reserve, is sworn in to testify at her U.S. Senate Banking Committee confirmation hearing in Washington, Nov. 14, 2013. REUTERS/Jason Reed

A soap bubble from a street artist floats in front the U.S. embassy in Berlin, Oct. 25, 2013. REUTERS/Tobias Schwarz

Sergey Brin, chief executive and co-founder of Google, wears a Google Glass during a product demonstration at Google I/O 2012 at Moscone Center in San Francisco, California, June 27, 2012. REUTERS/Stephen Lam

A man talks on an iPhone in Beijing, July 24, 2013. REUTERS/Kim Kyung-Hoon

A multiple exposure photo of an emergency exit sign and a detail of the current German share price index DAX curve at the stock exchange in Frankfurt, Oct. 17, 2013. REUTERS/Kai Pfaffenbach

French President François Hollande reacts with recipients of the Family Medal award during a ceremony at the Elysée Palace in Paris, Nov. 30, 2013. REUTERS/Lionel Bonaventure/Pool



REUTERS

*Back cover [from top right, in clockwise direction]:*

Lei Jun, founder and chief executive of China's mobile company Xiaomi, speaks next to his company's logo at a launch ceremony of Xiaomi Phone 2 in Beijing, Aug. 16, 2012. REUTERS/Jason Lee

Russia's President Vladimir Putin holds a news conference at the end of a G8 summit at the Lough Erne golf resort in Enniskillen, Northern Ireland, June 18, 2013. REUTERS/Yves Herman

The FIFA World Cup trophy is displayed after its arrival at Juan Santamria airport in Alajuela, Sep. 27, 2013. REUTERS/Juan Carlos Ulate

A supporter of India's main opposition Bharatiya Janata Party holds up a mask of Hindu nationalist Narendra Modi, prime ministerial candidate for BJP and Gujarat's chief minister, during a rally ahead of the state elections in New Delhi, Nov. 30, 2013. REUTERS/Anindito Mukherjee



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