2018 Edition

PERSPECTIVES

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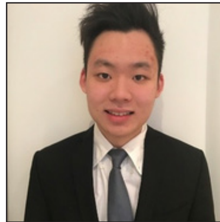
Editorial



The IRG was truly a memorable and unforgettable experience for me, and I would like to thank Jack, Ellen, Gabriel, Marie, Prithvi, Mati and the team for making it so. I would like to share the story of the IRG here before we dig into the analyst reports, to provide more than a name to the writers of the story. It was a fun ride for me, and I hope it is for you, the readers too.

We set up the IRG with a simple vision at the start of the year, we wanted a platform to educate and inform students on investment research. It wasn't easy to achieve that with a big team of 60 people, but I was fortunate enough to recruit the most enthusiastic people on campus to work with, to growth with. We needed a plan to guide the team on how to put the vision into play, and so we focused on internal growth to start with. We received over 120 applications from students across different years and diciples, but we wanted the IRG to have students from different backgrounds to provide different Perspectives on the markets, so the managers and I came up from scratch a concise 10-week eductation programme to equip the students with the basic tools so that they can get started with their own research, from basic technicals such as pricing bonds with spreads to operating the Bloomberg terminal. Our team consisted of first year social anthropology to master of finance students, so although we lacked in resources compared to investment banking and asset management firms, we were unique in the sense that having these students work together, we came up with a truly unique perspectives on the markets, with some students even pitching about FI equities. We also met up weekly to discuss about current affairs, we learnt more not only about the markets, but about each other as well. Some of these meetings would be more formal and we collected data on students responses on questions such as their thoughts on whether interest rates will go up, but often we would also have socials.

We focused more on external outreach in the second term. The magazine and reports are a collection of casual discussions in a local pub near campus, with the idea backed by research and technicals learnt through more formal lessons held on campus by our finance and more experienced students, adding to ocassional visits to the Bloomberg terminal in the library, even the Beast from the East could not stop blow us away from the continuous search for alpha. I hope you find the articles interesting, or even helpful. And if you do, please visit the website lseinvestmentresearchgroup.com that we have set up, where we have more articles published at least once a month!

Best,

Wei Jen
Head of IRG

Email: W.J.Lew@lse.ac.uk

A Message from the LSESU Investment Society President

Dear reader,

The LSE SU Investment Society's mandate is to 'invest in our members'. The Executive Committee and I defined the society as a place for all of you to gain advice on finance and banking. We would offer educational and networking opportunities to help you dive into investment and commence your finance careers. Our guiding principle would be simple: as newly elected president last March, I promised to "maximise the real benefits of your membership". We delivered on our promise.

The society's research arm, the Research Group, has been re-named and is on its way to complete its transition from last year. I must congratulate Lew Wei Jen, the head of the Research Group, for having successfully implemented the venture's strategy to provide real educational and practical experience to student analysts. Everyone at the Research Group was taught to write industry-standard research reports within various asset classes. Their excellent work is being published in Perspectives, the LSE Investment Society's flagship publication. It offers you niche insights into the frontier changes in the markets. It is on track to become a leader in the country this year.

This year's other educational initiatives by the LSE Investment Society have also been outstanding. The Investment Fund, our virtual investment venture, was entirely re-done to teach you proper valuation techniques, discover business strategies within markets, and connect you with like-minded peers. At the centre of our educational initiatives, the newly established Mentorship Programme has been a stellar success. The venture offers real-world career advice from final-year students and alumni. The unique opportunity for students to learn tips and guidance about finance directly from experienced mentors was extremely popular.

The Investment Society's other ventures have also performed very highly. The Investment Banking Conference, the year's first major conference, has been the largest in its eight-year history. Newer and smaller ventures have shown their potential to directly benefit you. Overall, the LSE Investment Society and its 10 ventures have successfully been re-defined. We hope you made the most of your year at the leading finance and banking student society in the UK. I hope our next year will be even better. Enjoy the read!

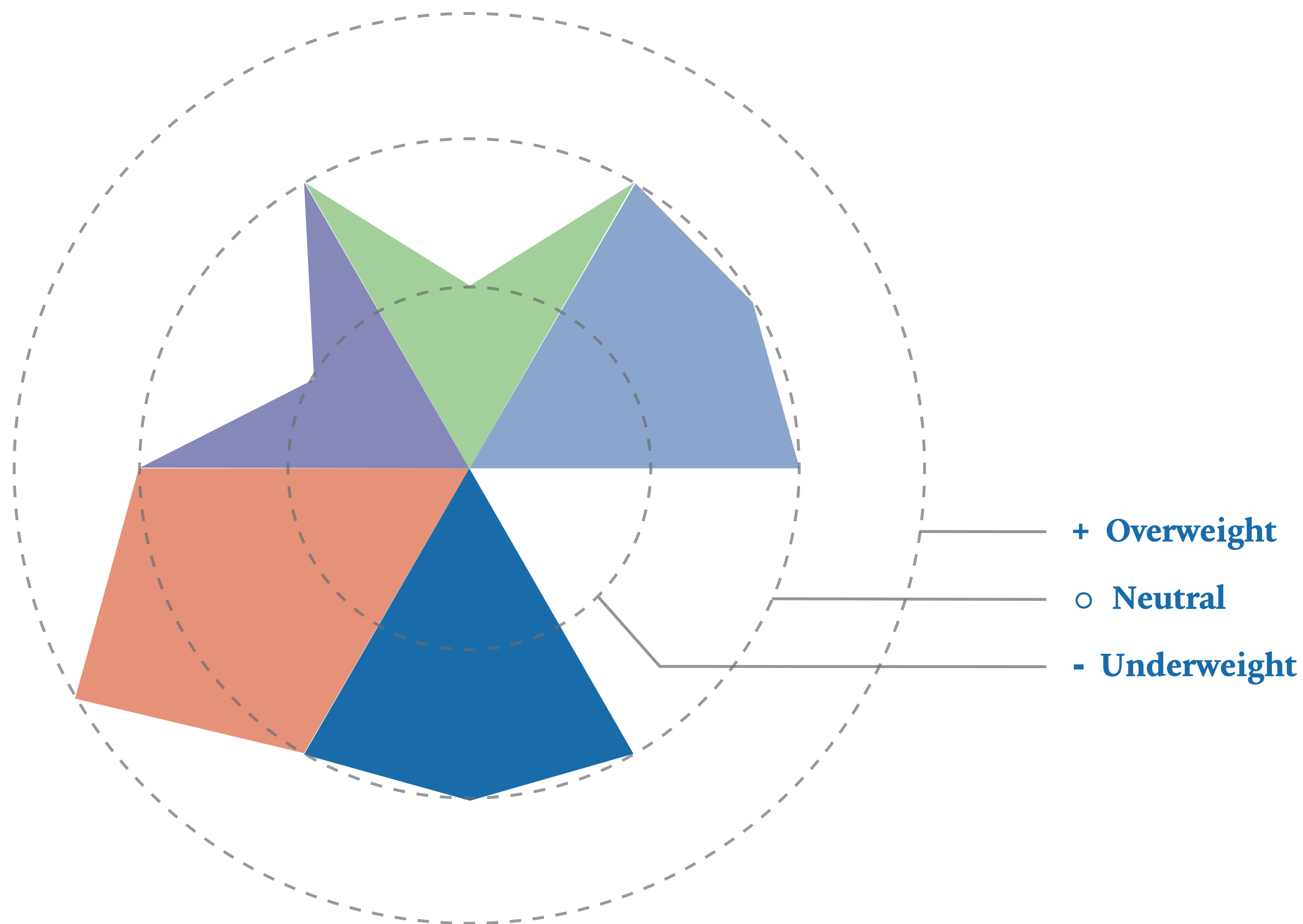
Your President,

Egor Nevsky

Email: g.nevsky@lse.ac.uk

About the Society

The IRG is the research arm of the Investment Society that publishes the Society's flagship magazine, Perspectives. The Magazine's name reflects the IRG's goal to provide a unique view on the different asset classes and the markets, as it is written entirely by students, differentiating itself from typical analyst reports sourced from an investment banking firm or a research house. Perspectives is formed to help the reader (investor) understand the IRG's House View on the markets that is generated every month, through top-down research articles covering industries and macro-trends, to bottom-up articles covering individual societies. Perspectives is also aimed at being at the forefront of the industry, adopting new research methods in its analysis and also informing readers of the latest developments in the industry. Ultimately, the IRG is a part of the Investment Society's family and shares the common goal of helping and encouraging interaction within students interested in the industry at the LSE, and hence Perspectives aims to promote, collaborate and complement the other Ventures within the society.

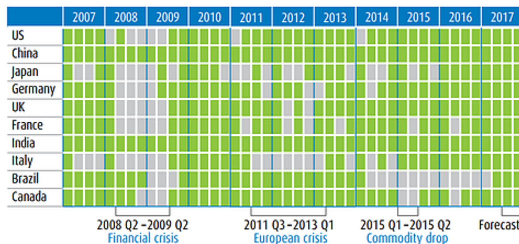


	EQUITIES Emerging Markets	EQUITIES Developed Markets	FIXED INCOME	CURRENCIES	COMMODITIES	ALTERNATIVES
+ Overweight	**IND** (Financials), **IDN** (Consumer Discretionary, Telecommunications), **CHN** (Financials, Consumer Discretionary, Information Technology), **KOR** (Consumer Discretionary, Information Technology, Energy), **Central/Eastern Europe** (Consumer Discretionary, Information Technology, Energy) **RUS** (Financials, Energy), **BRA** (Energy, Materials),	**USA** (Financials), **GBR** (Financials), **DEU** (Automotive), **JPN** (Pharmaceutical, Renewable Energy)	Emerging Markets (debt) Developed HY	AUD RUB CNY	Crude Oil Palladium Copper	Private Equity, Cryptocurrencies, Real Estate, Alternatives
O Neutral	**CHN** (Materials), **ZAF** (Materials)	**USA** (Tech)	US Treasuries European Bonds	MXN EUR NOK	Steel Gold Aluminium	Venture Capital
- Underweight	**MEX** (Energy, Industrials)	**USA** (Consumer Staples), **GBR** (Consumer Discretionary)	Developed IG	USD GBP JPY	Natural Gas Iron Ore Ethanol	Hedge Funds, Luxury items

H1 2018: Macro House View

Marie Chen
Head of Macro Team

Despite political kerfuffles in the developed world and tightening global monetary policy, The state of the world economy can be summarised in one chart, left.



2017 was the first year where all of world's largest economies are expected to grow in sync for the first time since global financial crisis Green indicates positive quarter-over-quarter growth

Stock markets, whose returns are correlated with economic growth, also saw a fantastic year, with the S&P 500 & MSCI Developed World indices both rising nearly 20%, while emerging markets (in USD terms) returned a remarkable 34.3% over the 2017 calendar year. For now, the growth has ignored any murmurs of irrational exuberance and continued to outperform in the first month of 2018. At the time of this writing, the S&P 500 has returned 5.5% year-to-date, the Euro Stoxx 50 returned 6.0%, the Nikkei 6.4%, and the MSCI Emerging Markets Index by 6.5%. To see how unsustainable this is, consider that a 5.5% return over 20 days equates to 166% return over one year. Which one is more likely - that the S&P 500 exceeds its highest annual historical return (45% in the year 1945) by over 3x, or that stock markets may not grow as fast as expected for the rest of the year?

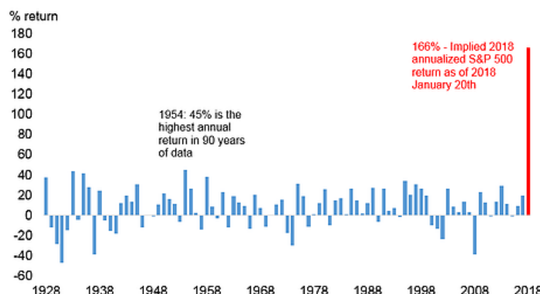


Chart 2: S&P 500 is unlikely to grow at the rate we've seen far this year S&P historical annual return in blue, annualised growth for YTD 2018 in red

Warren Buffett once said: "We simply attempt to be fearful when others are greedy and greedy only when others are fearful." 2017 was a year where it was difficult to lose, where those who made 20% from holding a stock market ETF - a fantastic return compared to almost any year in history - complained about others who made 200%, 500%, or 1000% from Bitcoin. In this environment, it is easy to let greed take over; in this environment, we choose to tread cautiously.

What is there to be fear? Several things come to mind.

#1 Fear: Central bank tightening

How much of our current economy is fuelled by normal growth and how much is fuelled by the massive balance sheets of central banks? Just because we don't see the physical money doesn't mean it isn't floating in cyberspace, flooded in the wires between the central banks and the financial institutions that then disseminate it into our world. In our view, this is a major headwind for both economic and capital markets growth in the coming year, as Fed, ECB, and BoJ looks to discontinue, decrease, or ease on their respective quantitative easing programs. Central bank tightening will have all types of follow-on effects for the economy, and informs our views on fixed-income (underweight), equities (underweight), and commodities (overweight) & FX (overweight EUR).

#2 Fear: Geopolitics

Wall street currently has its ears closed to the noises in Washington DC. Perhaps they are correct to do that - economic fundamentals are strong, as we've already stated before. In particular for the US, unemployment rate - currently at 4.1% - continues to break cyclical lows and is now lower than the period right before the global financial crisis. Wage growth has trended up towards 4% year-over-year in the latest data point (November 2017), and small business optimism is also hovering near 15-year highs. If anything, we concede that perhaps it is the politicians that are overly-dramatic this time.

However, policy changes, like recently approved tax cut (our analyst Bryan Si wrote an article on the website in more detail about this), renegotiation of NAFTA, and Brexit negotiations in Europe all have long-term implications that are not quite clear at the moment. In this respect, markets seems to have taken a "no news is good news" approach, which we caution could lead to an eventual rude awakening. In particular, decreased fiscal responsibility from the US and increased isolationist sentiment both have negative long-term implications for global trade and growth. Buyer beware.

Finally, we believe that recovering commodities prices give the Middle East more fiscal leeway, and may hinder its ambitious 2030 plans to become less dependent on oil (see analyst Sainka Shah's article on our website). However, if the OPEC countries - particularly Saudi Arabia - continue to shift their concentration away from energy production and into other industries, commodity prices is well on its way to continue its recent recovery. We believe that this offers a bright spot in our largely cautious view. Backed by a fast-improving world economy, demand for energy and base metals are likely to increase, while the supply side may choose to tread cautiously, not wanting to risk flooding the market and repeating the 2014-15 crash.

Currencies & Commodities Outlook

Jack W Brady

Head of Currencies & Commodities

Figure 1: 5 Year chart illustrates the USD's lacklustre performance in 2017 follows a multi-year rally USD (Source: Bloomberg)

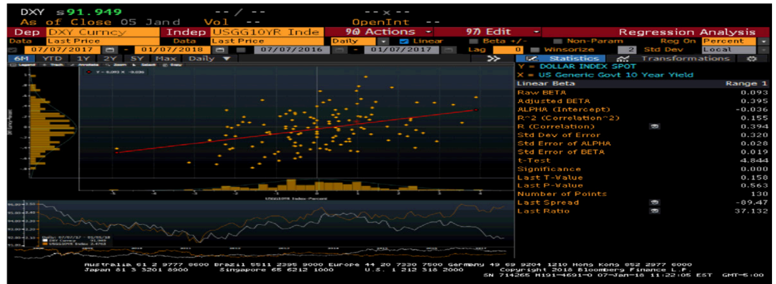


Figure 2: In recent years, the yield on the U.S. 10-year has become increasingly correlated to the USD (Source: Bloomberg)

In many respects, 2017 was a fantastical year for financial markets. Almost every single major consensus prediction that was made at the outset of the year proved to be incorrect. Equities consistently rallied to new highs, volatility plunged ceaselessly, the yield curve flattened, and reflation never quite took hold. It is against this backdrop that I will make my predictions about the performance of the U.S. Dollar and of commodities in the upcoming calendar year.

If you had asked me three weeks ago, I might have had reservations about predicting a continuation of 2017's bear market for the USD, based on the unpredictable impact that U.S. tax reform may have had on dollar strength. However, as you can see in the TTM USD price chart, even as tax reform was passed in the early weeks of December the US Dollar fell in value – reflecting the fact that favorable corporate tax policy was more than priced into the USD.

It therefore seems appropriate to discount any impact that U.S. tax policy will have on the value of the U.S. Dollar, and instead to look at the other main factors that have been driving USD performance of late: U.S. interest rates, U.S. economic growth, and U.S. inflation.

Beginning with interest rates, it is interesting to note that the tried-and-true correlation between the USD and short term rates in the U.S. has broken down over the last several years, as the rates being paid on longer-dated maturities have become a more important factor (Figure 2). This makes intuitive sense, as yield-starved investors outside the U.S. are increasingly demanding dollars to purchase longer-dated U.S. treasuries that yield more. In fact, 10-year rates in the U.S. explain over 10% of movements in the USD over the past two years. And long-dated yields seem likely to remain depressed in 2018, despite the recent uptick in rates, due primarily to the 60 billion dollars per month continuing to pour out of the ECB and BOJ in the form of quantitative easing. Global QE has eased financial conditions globally for years (see figure 3) – and look poised to continue to do so in 2018. For evidence of this, look no further than the Goldman Sachs U.S. Financial Conditions Index, which shows that despite 5 Fed rate hikes since December of 2015, U.S. financial conditions have eased substantially over that time period.

Real GDP growth is poised to accelerate in the U.S. in 2018, from a growth rate of 2.3% in 2017 to 2.6% in 2018, according to a Bloomberg Composite of over 50 forecasters. That acceleration should be a positive catalyst for the USD, especially because the global economy is forecasted to maintain its 2.1% growth rate from 2017. Relative to the rest of the world, the U.S.' economic prospects look quite cheery. This growth is going to be driven not only by fiscal stimulus coming out of Trump's White House, but also by a tight labour market that is currently operating at the full-employment rate of 4.1%.

The final major catalyst for the USD in the first half of 2018 will be whether or not inflation materializes. Inflation has remained stubbornly low throughout the economic recovery that is now stretching into its 9th year, which has capped interest rates

Figure 3: Even as the Fed has raised short term rates, financial conditions in the U.S. have become considerably more accommodative in recent years. USD (Source: Bloomberg)

Figure 4: Fed tightening and depressed inflation have caused the spread on 10- and 2- year bonds to flatten to its lowest levels since 2008. USD (Source: Bloomberg)

on longer dated bonds. Further, now that the Fed is tightening in a meaningful way, the lack of inflation is causing the U.S. yield-curve to flatten to its lowest levels since 2008. (Figure 4) Over the past 5 years, U.S. inflation has struggled to reach the Fed's 2% target, and in my opinion there is no reason that will change any time soon. The disinflation we've witnessed in the U.S. is, by all indications, a structural feature of the post-crisis economy. A combination of stagnating productivity in the U.S., a surplus of labour in the developing world, and the disinflationary effects of technology have been substantial headwinds for higher inflation over the past decade, and there is little evidence that strong growth alone will be enough to push inflation up in a meaningful way this year.

Despite economists' projections of accelerating real GDP growth in the U.S. relative to the rest of the world, my outlook for the U.S. Dollar remains bearish headed into the first half of 2018. Continued quantitative easing being conducted by the ECB and BOJ, combined with a weak inflationary outlook in the U.S., look poised to keep interest rates capped in their current trading range and exert downward pressure on the dollar. Furthermore, even stellar GDP growth won't be enough to catalyze a serious move upward in the USD unless it ignites the fires of inflation. I expect the USD to continue to underperform a broader basket of developed-market currencies for the first half of 2018.

1H18 Commodities Outlook: Overweight

In the commodities space, 2017 marked the asset class' second consecutive year of price consolidation, after a significant selloff in energy commodities such as oil and coal put significant pressure on the sector beginning in 2014.

Coming into 2018, prospects for commodities as a group look good, as evidenced by the fact that the Bloomberg Commodities Index notched its longest streak of consecutive up-days in more than a decade heading into the New Year, driven by strong performance in oil and iron ore. Throughout the second half of 2017, a boom in oil and gas prices, as well as a bull market in copper and iron ore prices, lifted the index significantly as they posted double digit gains over that period. Additionally, commodities related to electric vehicle manufacturing, such as Nickel, performed well throughout 2017 on prospects of accelerating demand and limited supply in the short term. A falling USD, which we expect to continue, also drove up prices of dollar-denominated commodities in 2017.

Looking forward, the next six months should see commodities prices finally break out of their two year trading range to the upside. Specifically, the acceleration of synchronized global economic growth to an estimated 3.8% (Figure 6) should provide continued support for global commodities demand, especially for energy and industrial metals. For example, the IEA is currently projecting that continued economic expansion globally will increase demand for crude oil by 1.4 million barrels per day in 2018. Additionally, an expected acceleration in Chinese GDP growth from its current rate of 6.8% would provide support for commodities, as China's is the world's largest importer of commodities ranging from oil to copper. As 2018 is looking to be the first year in several that Chinese GDP growth accelerates, the demand prospects for the space in general look especially promising. Furthermore, any further depreciation in the value of the US Dollar would provide an additional boost to the prices of dollar-denominated commodities.

Supply-side dynamics are also looking encouraging for several key commodities, most notably for oil and for industrial metals. As long as OPEC and Russia continue to fulfill their promises on production cuts and U.S. shale oil production continues to stabilize, supply growth for oil should remain limited, allowing prices to rally on the back of a sustained uptick in global demand. Further, China's increasing focus on environmental issues will likely hold back supply growth over the next 6 months for many key industrial metals, including copper and iron ore. For example, China, which is the world's largest producer of aluminum ore, saw production fall from 2.9 million metric tons in June to 2.57 million metric tons per month at the end of the year after China began introducing environmental regulations on domestic mining companies this summer. Additionally, geopolitical unrest in commodity-producing nations around the globe, from Iran to Venezuela, is likely to further restrict supplies of key commodities such as oil over the next several months.

Overall, the commodities outlook for the next 6 months looks bright. Amid favorable supply-side dynamics for many key commodities and expectations of robust global demand growth in 2018, commodities look set to break out of their 2 year trading range over the next 6 months. Furthermore, any depreciation in the value of the US Dollar will provide a boost to the value of the dollar-denominated commodities that comprise the Bloomberg Commodities Index. Therefore, unless there are substantial changes to either our supply or demand outlook, we recommend being long-commodities over the next 6 months, and we view any weakness in the sector as a buying opportunity.

96) Chart | 97) Set as Default View | Economic Forecasts

Country/Region/World: World | Contributor: Contributor Composite | Yearly / Quarterly | Browse | Private / Official

Actual / Forecasts

Indicator	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Economic Activity										
Real GDP (YoY%)	5.4	4.3	3.5	3.5	3.6	3.4	3.2	3.6	3.7	3.6
CPI (YoY%)	3.7	5.0	4.1	3.7	3.2	2.8	2.8	3.1	3.1	3.0

Figure 6: Consensus economic forecasts call for global GDP to accelerate to 3.7% in 2018 (Source: Bloomberg)

Emerging Market Equities Outlook

Ellen To
Head of Equities (Emerging Markets)

The Backdrop

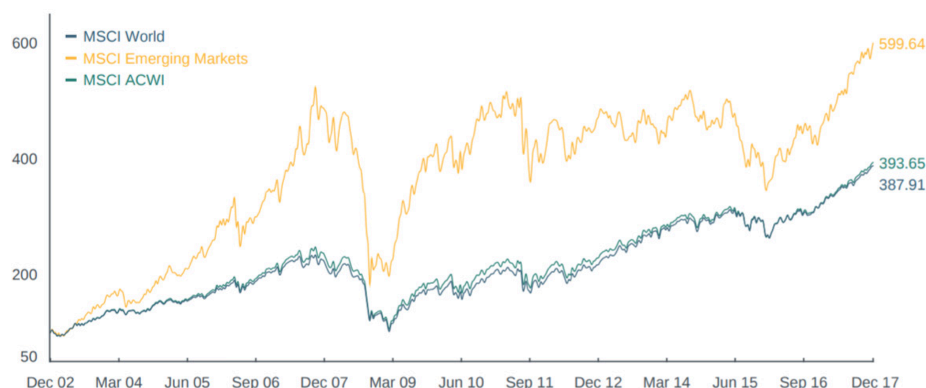
With strong outperformance in 2017, Emerging Market (EM) equities are set for a continued rally with the broad MSCI Emerging index already climbing 1.2 per cent at the start of the year. The advance comes after significant gains driven by global growth improvements, structural reforms in developing countries resulting in higher profitability and a weaker USD creating a tailwind for domestic economic momentum.

After years of underperformance versus its developed peers, investment has poured into EM stocks with inflows into EM mutual and exchange-traded funds amounting to $72bn last year. This represents 6.5 per cent of total assets under management whilst developed market funds experienced much smaller inflows accounting for 2.6 per cent of total AUM.

The asset class is predicted to achieve its highest absolute and relative returns since 2009. Last year, over a third of the performance of the MSCI EM Index of 839 stocks was merely driven by the five largest stocks representing 20% of the benchmark's weight. Looking at specific countries, China and South Korea (the two largest markets) have outperformed and sector-wise, technology accounted for only 23.3% of index weight at the start of 2017 yet has been responsible for almost 42% of index performance. Valuations remain attractive; EM stocks trade at 12.5 times estimated earnings for the next 12 months which is at 27% discount to DM stocks.

Particularly in Asia and Eastern and Central Europe, EM equities' strong performance over 2017 can largely be attributed to improving business confidence, margins and profitability. Under a global "synchronisation" of growth, business conditions are expected to improve further and the Fed's slow tightening of monetary policy (expect another trio of quarterly increases in 2018) is further good news for the EM bull market since rapid rate increases often lead to asset flows back to the US. It is also worth noting that free-cash-flow yield for EM non-financials has exceeded that of developed markets for the first time since 2007, a sign that companies have reduced wasteful investments. Earnings have already grown faster than stock prices, particularly in EM tech and financial stocks, signalling significant potential upside in the next 12 months and beyond.

CUMULATIVE INDEX PERFORMANCE - GROSS RETURNS (USD) (DEC 2002 – DEC 2017)



Source: MSCI

Significant investment opportunities

Asia

Strong growth is expected in most countries, leading us to overweight the region as a whole. One of our favoured markets is India, which arguably has seen some of the most substantial reforms among EMs since Modi's 2014 election. As a result, company margins have been challenged but are slowly showing signs of improvement amid lower expenses and inflation. Due to India's growing middle class and trend towards increased borrowing, we are overweight on financials which are poised to capitalise on fast-growing disposable income streams such as HDFC Bank, the largest private bank in India, whose earnings have compounded 20% a year over the past decade in U.S. dollar terms.

In Indonesia, there has also been significant reform progress which paves way for a buoyant equity market in 2018. Company fundamentals are generally strong and there is huge potential for catch-up especially since Indonesian equities have lagged both EM broadly and EM Asia. Despite rising commodity prices (most notably crude oil prices), continued developments in infrastructure and a stable rupiah exchange rate given broader economic recovery means that cyclical sectors look promising, especially consumer discretionary and telecommunications.

China plays a significant role in supporting the rest of the EMs, especially the Asian economies closely linked to the Chinese supply chain. In 2018, China may see a moderate slowdown in growth due to its reforms on state-owned enterprises, addressing overcapacity in some industries, focusing on improving quality of life and trying to restrict its build-up of debt. However, previous concerns about Chinese financial sector instability due to the country's growing debt levels have eased and the economy continues to move towards

services and the consumer, enabling a positive outlook on financials and consumer discretionary stocks in the region.

Chinese tech stocks have seen remarkable outperformance for four consecutive years, notably top performers such as Alibaba, Tencent and Baidu. However, significant headwinds include the potential for increased government regulation or a shift in market sentiment given high valuations. Going forward, we take a modest overweight position as the sector continues to benefit from the rapid adoption of mobile technology and the growth of the 'New Economy', but will progressively reduce our overweight stance over several months due to increasingly extended valuation levels.

We remain neutral on materials; Chinese demand for processed commodities is projected to decrease due to technological advances, larger inventories and increasing labour costs. However, the previous sharp commodity price decline seems to have ended, as shown by the rise in the GSCI Commodity Index, but we need more evidence in the sustainability of this gain and the strengthening US dollar remains a significant risk for the sector.

South Korea looks attractive in 2018 yet many small-cap listings aiming to capitalise on a rising middle-class and cater to the vast consumer market in China are often overlooked by investors. Again, we are overweight in consumer discretionary and tech stocks in the region such as Samsung Electronics and beauty-products maker Hugel. Generally, we expect companies to reap benefits from the global upswing and the recovery in consumer as well as corporate capital goods expenditures. We can also expect increasing appetite for IPOs, especially for refineries given rising oil prices, high valuations and increasing liquidity.

EMEA

The Eurozone expansion serves to benefit smaller economies such as Poland, the Czech Republic and Hungary which remain favourable outsourcing destinations for Western European companies. Inflation looks on the rise as spare capacity is reduced and this, combined with monetary tightening, supports banks' profitability and our overweight stance on financials in the region.

In Russia, there was strong domestic demand-led growth in 2017 with the central bank being expected to continue interest rate cuts in the face of moderate inflation, supporting further growth and an equity bull market. Despite the run-up in crude prices, Russian equities still lag behind the broader MSCI EM index over the long term with the biggest gainer being Sberbank, Russia's largest bank. The rouble has strengthened, inflation has dropped and interest rate spreads widened so we remain bullish on financials in 2018. Energy stocks look attractive as oil priced in roubles has rebounded to the pre-crash levels and Russian oil companies have ample cash flow to pay higher dividends. Overall, Russian equities remain cheap, trading at half the price-to-earnings ratio of emerging markets but investors should watch out for potentially more economic sanctions.

The outlook for South Africa is bleak, with deteriorating domestic growth prospects and increasing discontent with Zuma's government leading us to underweight the region. Underlying demand in South Africa's economy is relatively weak yet there is absence of structural initiatives that would boost confidence. Although the recovery of commodity prices is expected to boost mining stocks, moderating growth in China remains a large risk. There is still significant policy uncertainty in the mining sector which continues to constrain FDI. Overall, the market trades at expensive valuations and is characterised by low earnings growth; MSCI South Africa is above 20 times 12-month-trailing P/E, well above its 10-year average.

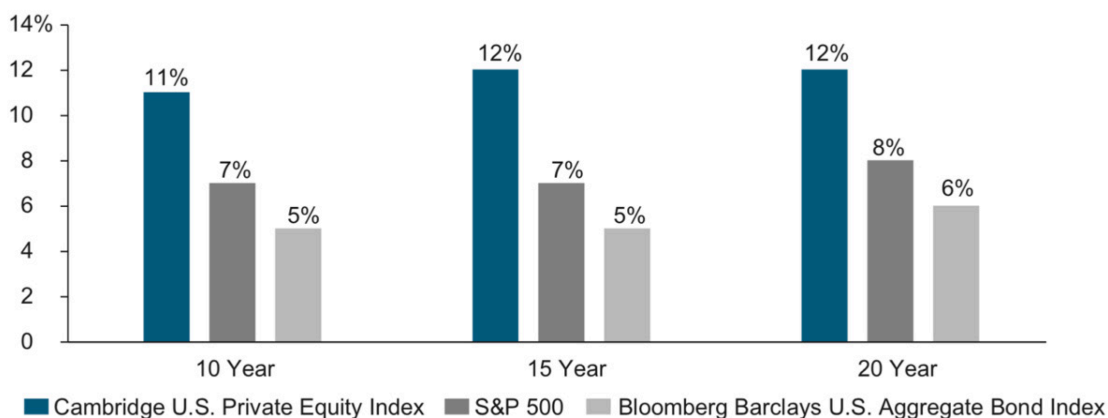
Latin America

After a three-year recession, Brazil is positioned for strong economic growth in the year ahead, boosted by easing monetary policy, stronger US and global growth and successful reforms such as the spending cap and labour market laws. We take a modest overweight position due to high chances of a new reformist president but remain cautiously optimistic as markets face increasing volatility from the predicted binary outcome of October elections, with the potential for substantial downside. Consumer sentiment is estimated to grow 3.1%, up from 0.7% in 2017, and the rebound in oil and commodity prices have further helped stabilise business confidence. Therefore, we anticipate strong gains in energy and materials, with expected outperformers including Petrobras, the state-owned oil company and mining giant Vale, which have already climbed 12.6 per cent and 27.6 per cent respectively on the Bovespa over the past three months.

Similarly, political uncertainty is a prominent factor in Mexico with presidential elections scheduled for July 2018 and local polls favouring a leftist market-unfriendly candidate. Under Obrador, who currently leads the polls, the outlook for crucial domestic economic reforms is uncertain and exacerbated by upcoming NAFTA renegotiations. In particular, we are underweight on industrials due to peaking US auto demand and energy stocks which face significant risk from Obrador's attacks on reforms in the sector. Mexican oil and gas reserves remain largely untapped as state-owned Pemex lacks specialist technology and funds. Generally, crude oil output is on a steady decline, now below 1.9 million bpd after peaking at around 3.4 million bpd in 2004 and companies are ill-positioned to take advantage of the rising oil prices. Around four-fifths of Mexico's exports go to the US so it remains particularly vulnerable to increased US protectionism.

Alternative Investments Outlooks

Prithvi Boggavaram
Head of Alternatives



Introduction

With low volatility and high valuations characterising equity and bond markets over the past few years, alternative investments are increasingly becoming an integral part of an investor's portfolio. The unprecedented low interest rate environment has led to investors purchasing alternative assets not only to diversify their portfolio, as they have typically, but also in a bid to benefit from their higher returns. As such, this search for yield has led to strong performance for alternative investments and we expect this to continue in a 12-month horizon. Hence, we are OW on alternative investments as a whole in the coming year.

Private equity

Investments into private equity funds has recorded stellar growth this year, with $453 billion of new capital being pumped in by investors. Private equity strategies have always been popular owing to their ability to provide investors with access to unique investment opportunities and increase portfolio diversification. Despite certain strategies having lower volatility than equities, as the graph below shows, long-term performance of private equity investments have outperformed equity and bond markets.

Bill Roosman's article dives into how European technology companies, in particular, can expect to see strong private equity interest as they are presently undervalued. Given the aforementioned factors, we are OW on the private equity industry as a whole.

Venture Capital

While venture capitalists have been extremely active this year, a trend of investing more money into fewer startups has plagued the start-up ecosystem. Spearheaded by Softbank's $100 billion Vision Fund, investors have started to raise the stakes on their investments and commit more capital to each investment. While the outcome of this trend remains to be seen, it should certainly make investors more cautious of venture capital funds as their risks increase with this style of investing. In this edition of Perspectives, Hayley Looh has chosen to explore the largest recipient of venture capital investments last year - Artificial Intelligence. While we believe that more capital will flood into venture capital funds over the coming year, we remain Neutral on their performance prospects after taking these trends into account.

Cryptocurrencies

The alternative investment that has had markets buzzing throughout 2017 was the meteoric rise of cryptocurrencies. Bitcoin, the first cryptocurrency, has seen its value skyrocket by more than 1000% in the past year.

Furthermore, with the introduction of futures by various stock exchanges, cryptocurrencies are being increasingly legitimised as viable alternative investments. However, the nascent market is still extremely volatile and susceptible to regulations, as recent events in South Korea and China have shown. Nikunj Paliwal's fascinating article on initial coin offerings offers an insight into the risky nature of cryptocurrency markets. We are OW on the cryptocurrency market as a whole as we believe that, in a society where technology is so widely integrated, cryptocurrencies can potentially have an instrumental role in the future. However, being the hardest market to predict, we will refrain from making predictions for any particular cryptocurrency.

Real Estate

Without delving into particular regions, real estate as a whole tends to be positively correlated with the stock market as both are indicators of an economy's wealth and confidence. Hence, with stock markets spiralling to new highs, the real estate market has followed suit, with the MSCI World Real Estate Index returning 15.6%. However, some real estate markets, such as Canada, have also showed signs of heating up as real estate prices have declined for the first month in several years. Therefore, while we are still bullish on real estate as a whole, we would recommend investors to look at more niche markets. Phoebe Chan has written an excellent piece on one such market, self-storage real estate, that offers an attractive value proposition for investors.

Hedge Funds

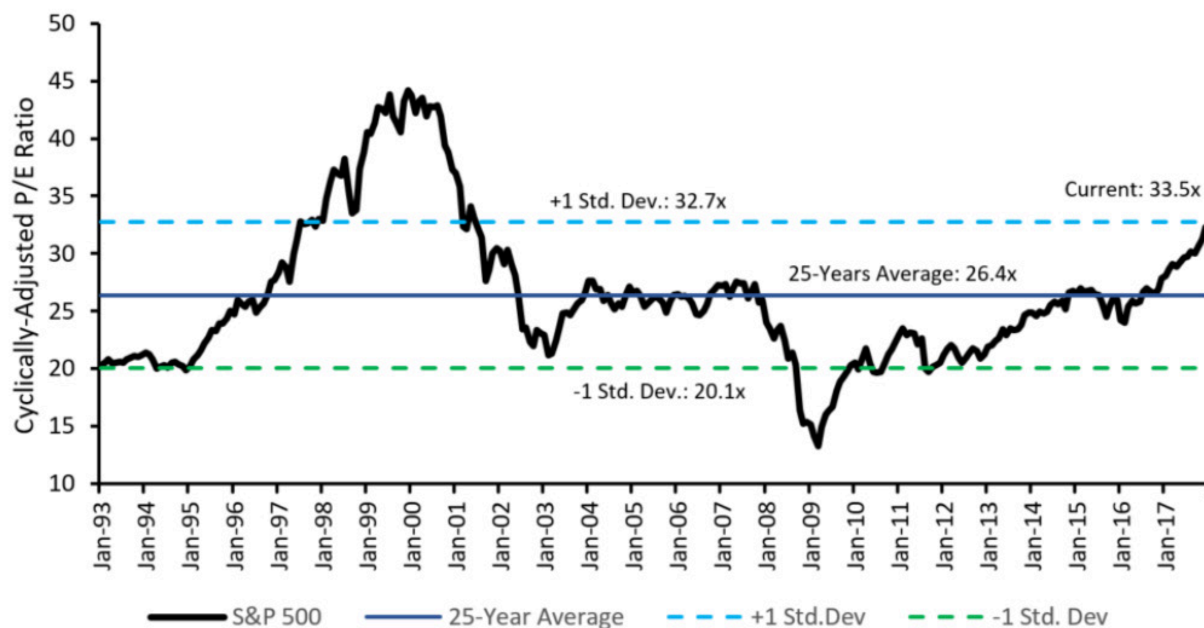
Hedge funds is the only alternative asset class that has suffered despite the strong performance of the overall market. While the overall performance of hedge funds has improved, it still underperformed the S&P 500 by 9% in 2017. A primary reason for this underperformance is that short selling has been ineffective in the prolonged bull run that the market is experiencing. Furthermore, the rising capital flows into index funds acts as a self-reinforcing cycle and leads to markets neglecting stocks that are not included in these indexes. With the bull market set to continue, we are UW Hedge Funds for the next 12 months as we continue to expect them to underperform the market.

Luxury items

Apart from the aforementioned alternative asset classes, luxury items are also being increasingly viewed as investments that have attractive risk-reward characteristics. Investment vehicles such as watch funds and car funds act as ETFs for investors to gain exposure to these asset classes. While most of these luxury items underperform the market in a 12-month horizon, they possess a unique ability to act as an effective store of value over a long period of time. Hence, their performance over a 12-month horizon is not an accurate representation of their performance. Isaac Hesketh's article will provide readers with an insight into navigating the world of luxury watch investments. We are UW on luxury items in a 12-month horizon but OW on the asset class as an investment for wealth preservation.

Developed Market Equities Outlook

Gabriel Qing Kai Kwok
Head of Equities (Developed Markets)



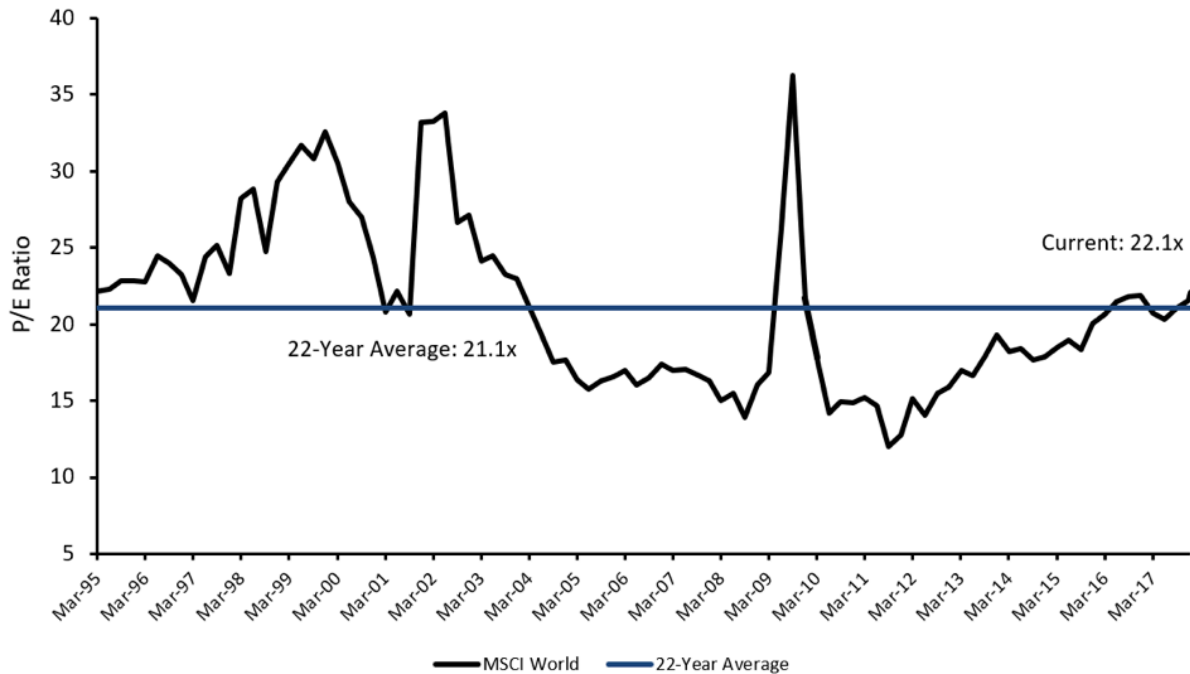
Looking back at 2017

Many investors are likely to remember 2017 as a year of exceptionally good investment returns. 2017 has seen some of the most extraordinary gains in the stock market after the '08 financial crisis due to strong global economic recovery and stellar earnings that has consistently beaten analysts' expectations. Political risks this year have been rather lenient on the equities market as major downside political risks failed to materialise, while the one of the major upside political risks – US tax cuts – was realised. Global equities capped off a strong year with strong gains in the fourth quarter and are still rallying to record highs as we move into 2018. Major indices showed tremendous gains in the year 2017, with the S&P 500 Index racking in 21.8% return; Dow Jones Industrial Average Index with 25.08% return; MSCI World Index with 22.4% return and most noticeably, the MSCI Emerging Market Index with a whopping 31.0% return.

Is the market overvalued?

Richly priced stocks are one of the biggest concern for investors. Shiller's P/E ratio is a better metric than the P/E ratio when comparing current P/E to historical P/E because it eliminates fluctuation of the ratio caused by profit margin variation during business cycle. Looking at the S&P 500 Shiller's P/E ratio, we can see that current P/E holds at 33.5x, shy of 1 deviation away from the 25-years average P/E. It is starting to seem quite overvalued. Stocks are highly valued by historical standards, but we think that valuation is justified given low global interest rates, steady GDP and stable inflation. These factors should translate into higher equity valuation. Because of this macroeconomic backdrop, investors are advised to be extremely cautious investing in U.S. equities and pay close attention to the valuations.

The MSCI World Index however, is valued at a P/E ratio of 22.1x, indicating that the developed market as a whole seems to be fairly valued according to historical standards.



Is the bull market going to continue in 2018?

We believe that global growth momentum is likely to persist into 2018, with emerging markets outperforming the developed markets. Steady growth, coupled with low interest rates and subdued inflation will be the main drivers for equities returns in 2018. Global equity returns are likely to be positive in 2018 but much more moderate compared to 2017, due to counter-cyclical measures by governments, for instance, the slow and moderate tightening in monetary policy from central banks and unwinding of quantitative easing. While there are causes for optimism, we should not overlook the possibility of the current economic expansion coming to an end due to the removal of central bank stimulus and the risk of an inflation overshoot, coupled by geopolitical risks. In this time of global economic expansion, we should exercise caution by keeping an eye on the signals of an economic downturn when the bull market comes to an end.

Regional Outlook

United States

Strong global equities performance in 2018 is unlikely to be led by the U.S., albeit the potential boost in near-term growth with the introduction of tax cuts. We expect rates to move higher and a tightening Fed in the 2018 as there are signs of the economy overheating. Stocks could appear to be more expensive due to potential decrease in earnings caused by higher cost of borrowing. Currently, the S&P 500's forward P/E ratio is 18x, the highest since 2002 and the Shiller's P/E ratio is 32.2x, its highest level ever outside of 1929 and the late 1990s. Both metrics show signs of overvaluation of U.S stocks. However, we remain neutral on the U.S. equities market as we believe that the strong global economic expansion will continue to push U.S. equities to new highs in 2018 for the first two quarters of the year and may start to slow down towards the end of 2018.

In retrospect, the technology sector achieved a return of 34.28% in 2017, becoming the best performing sector in the U.S. Tech gains were mainly driven by profit growth that repeatedly beat analysts' expectations and we predict that profit growth will continue to push prices up. Strong momentum in tech stocks is likely continue in 2018, however we feel that tech stocks will not be the best performing sector in 2018. One of the main reasons is that the tax reform will not benefit the technology sector as much as other sectors given that the tech sector is already paying lower effective tax rate. We decide to downgrade the tech sector

from overweight to neutral. Financials on the other hand is well-positioned to outperform other sectors due to rising rates, deregulation and tax cuts. These 3 factors will help to boost profitability, which will translate to higher stock prices. Given the strong tailwinds, we decide to overweight financials.

We decide to underweight consumer staples as they are extremely vulnerable to major online retailers, for example Amazon, who are becoming bigger players in the sector, hence pressuring traditional leaders in the sector. The convenience of online shopping has broken down traditional barriers to entry for consumer staples companies. Big data has come into huge play in this sector as online retailers have the ability to find out consumer's preferences using advanced analytics, hence providing consumers a better shopping experience and also boost sales for themselves. In the short term, we expect major consumer staples companies to see huge disruption in their businesses.

EMEA

United Kingdom

2017 was a particularly strong year for the FTSE 100. It gained almost 7% and in doing so reached record highs. With its dividend yield of almost 4% added to its capital growth figure, the total return provided by the index was around 11%. UK growth in 2018 is expected to slow down to 1.5% as higher inflation and sluggish wage growth will continue to squeeze household spending power. Uncertainty surrounding Brexit is holding back business investments and causing UK to underperform in 2017. Although a divorce bill was struck with the EU last December, negotiations are set to become more complicated this year. A successful trade agreement between the UK and the EU will be crucial to alleviate investors' confidence. Stocks in the UK remain fairly valued, with slightly above average P/E ratio, counterbalancing slightly below average profit margins. Although consumer confidence remains weak in the UK, we expect company earnings to continue to advance in 2018, which will be the main driver of stock prices in 2018. We continue to overweight on financials given their improving profit margins and gradual tightening of monetary policy, and underweight on consumer discretionary as real wage is expected to stagnate until the end of 2018, according to the Trades Union Congress (TUS). However, we continue to underweight UK as a region.

Germany

The German economy grew sharply in the third and fourth quarters of 2017, and it is likely to continue in the first and second quarters of 2018. The German economy is expected to grow at a rate of 2.5%, primarily driven by growth from exports due to improving global economic condition. Private consumption is also projected to increase in light of the reduction in unemployment and optimistic consumer sentiment. We decided to overweight on the automotive sector due to increasing demand from the international market and higher than expected growth in the aviation industry. Germany is the world's top automotive exporter and is expected to retain that position in the upcoming years.

Japan

After 2 decades of deflation, it seems like Japan is slowly coming out of the deflationary trap that has cost the country dearly. According to the quarterly Tankan survey, there is a gradual improvement of confidence in the Japanese market and many agree that economic conditions 'have never been so good.' Moreover, Mr Shinzo Abe's recent landslide victory in the snap election eased political uncertainty and investors can safely assume the continuation of both monetary and fiscal policies. We are positive on Japanese equities due to several reasons. Firstly, great macroeconomic backdrop in the region. Secondly, good sales momentum, weakening of yen and share buybacks will drive earnings which will in turn drive prices. Thirdly, forward P/E ratio of 15x is very attractive as compared to the P/E of the global market, which is 10% higher. We decided to overweight renewable energy in Japan due to strong efforts by the government to accelerate this sector. Since the introduction of the feed-in tariff (FIT) scheme, the installed capacity of renewable energy has grown by 2.5 times, with solar energy in particular taking center stage. Prices were lowered for solar power, which had experienced the biggest growth, while prices for geothermal, hydropower, biomass, and other energy sources remained the same to promote their further growth. We are also positive on the pharmaceuticals industry in Japan due to steady growth and rising demand for biopharmaceuticals in Japan. While biopharmaceuticals account for around 30% of overall global drug sales, the products only make up 10% of sales in Japan. As such, rapid growth is projected for the Japanese biopharmaceutical market.

Fixed Income Outlook

Matilde Durazzano
Head of Fixed Income

As interest rates rise and central banks adjust their quantitative easing policies, 2018 prospects to be a tricky year in the Fixed Income universe. However, one can still find interesting opportunities within Fixed Income, as highlighted by the articles that follow. This house view will briefly outline our thoughts on individual asset classes, stating whether we are underweight, overweight or neutral.

Starting from US treasuries, we decide to take a neutral position. The possibility of inflation rising further could lead to the US Federal Reserve increasing interest rates more than expected, something which has investors worried. These signs of higher inflation have prompted US investors to engage in a fierce sell-off, causing a decrease in prices and increase in yields on the 10-year Treasuries to a nine-month high. Nevertheless, other factors, which will be further explored in one of our articles, such as, for example, demographic trends, have led to a constant downwards trend of bond yields in the past years and, despite recent volatility, we believe that it is too soon to assert whether the trend will end now. We take a neutral position also on European bonds, with the ECB repeatedly announcing a gradual approach to rising interest rates and tapering, in an environment of more subdued inflation compared to the US.

Source: Financial Times – Available at: https://www.ft.com/content/05e487ce-1228-11e8-8cb6-b9ccc4c4dbbb

Moving on to emerging markets, we overweight EM debt as it presents more attractive yields and better spreads, with strong growth and macro fundamentals. There have also been structural reforms and a more promising political and regulatory environment that have made investments in emerging markets more attractive. Our articles will highlight some interesting opportunities which can be found in the EM investment grade sector, but will also shed a light on some riskier investments, for example in countries that are overly reliant on raw materials, highlighting the importance of selecting bonds carefully in the EM universe.

We also overweight both EU and US high yield bonds. Default rates are likely to be at all time lows in 2018, at around 1.7-2.0% as predicted by Moody's. With higher yields and more attractive spreads, HY bonds offer a great form of carry trade. Corporates have been maintaining healthy levels of indebtedness and many "junk" bonds actually present strong technicals and fundamentals, making them a worthwhile investment. However, it is again necessary to pick promising issuers attentively, since, as one of our articles will indicate, in some cases the risk one bears when investing in certain HY bond is not worth the return. Instead, we underweight investment grade bonds in the EU and US market as spreads are too tight and yields unattractive, not providing enough protection should Treasury yields increase further.

EU Breakup

Anthony Zhang

Since the financial crisis of '08 and the subsequent Eurozone debt crisis, Euroscepticism has gained significant ground across the continent. Italy's 'Five Star Movement', France's 'Front National', and more recently Germany's rise of the far right nationalist party, AfD, are just some examples of the growing populist movement. Whilst there may be many other catalysts to a Euro break-up, we see political fragmentation and populism as the most likely culprits to such an event. The aim of this article is not to address the causes or the probability of this however, but to give readers a flavour its potential consequences. In particular, we tackle this issue from a macroeconomic perspective.

There are many permutations of a Eurozone break-up, from just a Greek exit to the dissolution of the entire monetary union. Whilst the magnitude of immediate economic destruction of these scenarios may differ, the implications we outline will serve as a reasonable indicator for the sorts of impacts any break-up may produce.

On the outset, the problem seems relatively simple. Without a currency or free trade union, countries lose a significant export market. A study by the REC shows that for an average country within the EU, average incomes would be 12% lower than if they had not joined. There is also wide literature that shows the productivity benefits within the free trade zone, attributed to financial integration. Stepping out of the EU is still an unknown, though the collapse of trade and decreased output is inevitable. ING for instance, predicts a cumulative output loss of 12% in Europe for the first 2 years after the break-up. This is substantially greater than the losses that followed the Lehman Brothers in 2008.

Bank Run and Capital Controls

Even before the demise of the Euro, a bank run is likely to take place. People fear, and rightly so, the safety of their savings. Potential economic collapse, corporate insolvency (discussed later) and currency devaluation will drive depositors' money (in Euros) out of the country, either by electronic or physical means, in search for the preservation of capital. The only real way to avoid such a run is to make Euro dissolution completely unexpected- this seems implausible. Thus, for a peripheral country such as Spain or Portugal, capital controls will probably implemented to prevent large scale capital flight. For a stronger country such as Germany or France, we may even witness controls on capital inflows to remain competitive in export markets.

Currency Trouble

The level of currency depreciation matters for trade, the value of sovereign and corporate debt, and also for inflation. Deutsche Bank predicts a 25-30% depreciation of the Euro with the break-up announcement, followed by a further 40% decrease in legacy currencies afterwards. This sort of drop has profound implications. It is worth noting the causes of such a currency depreciation.

Firstly, the fair value of the Euro is less than what it currently trades at. Why? The Euro is a reserve currency, and thus carries a currency premium. Despite the rise of the Chinese RMB as a reserve currency, the Euro has managed to increase it reserve share by approximately 5% since its creation. A break-up of the EMU, with countries having to adopt new currencies,

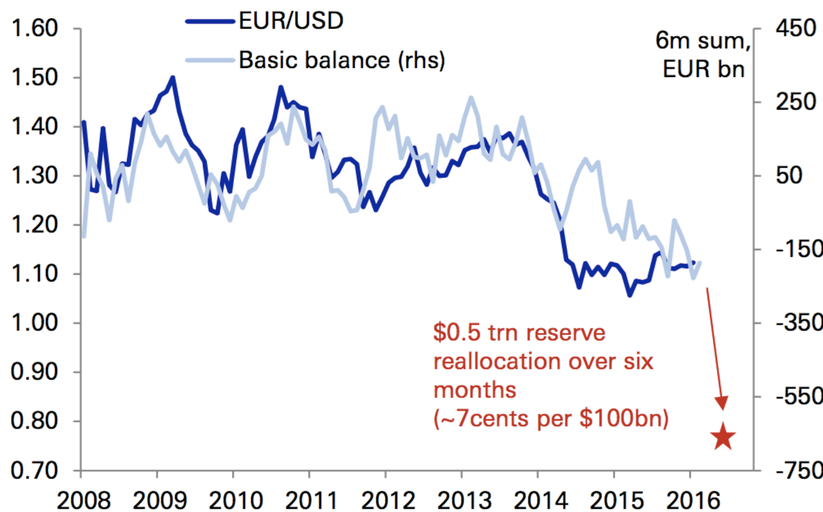
means the credibility of the ECB and EU is lost, along with the Euro's reserve status. Withdrawals of this reserve could cause the Euro to Dollar to plummet by 30%. This is even before the decline of the local currencies of exit countries.

The second cause is a large negative productivity shock- a reason for currency collapse as well as a direct consequence of a Euro break-up. Trade, financial disintegration, and economic slack are the main drivers for such productivity declines.

Inflation and Monetary Policy

For both the peripheral and core of Europe, there is a sizeable possibility that the central banks will be unable to pursue inflation targeting (in the short term). Sure, without the ECB, countries now gain interest rate sovereignty, but the debt crisis may be so bad that the priority of central banks turn to reducing the real value of debt- i.e. maintaining a lower interest rate. With such monetary expansions and potentially more quantitative easing to ease the economic collapse, central banks cannot simultaneously contain inflation.

In the periphery, a large depreciation of legacy currencies will create large upward price pressures in the economy. In the case that capital controls are implemented (or just that trade deteriorates), a decreased supply of imported goods not only puts great pressure on domestic suppliers, but also causes significant inflation. Hypothetically, even if trade flows were to be unaffected, the weak currencies of peripheral countries



(SOURCE: DEUTSCHE BANK)

will still create short term imported inflation. Indeed, historically, the most common cause of hyperinflation is the collapse of a multinational currency union with competitive currency issue and large uncleared payments balances. The collapse of the Soviet Union, Yogoslavia, and Austria-Hungary is a fine illustration of this.

High inflation in stronger countries should not be ruled out either. Whilst hyperinflation is unlikely, investors may seek to hold assets in a more stable country in the hope that these assets are converted to a more stable legacy currency- that of Germany or France for example. It is also worth noting that though these currencies may end up appreciating after the break-up, for instance the Deutschemark, the negative economic implications of the free trade area dissolution will by far overshadow this.

SOVEREIGN AND CORPORATE DEBT

The depreciation of a peripheral country's exchange rate will also carry another implication, namely the rise in the repayment of sovereign debt. This is because this debt is denominated in Euros. Thus, particularly for weaker countries, sovereign defaults are highly likely. This carries negative implications for the creditors.

For a stronger European country, sovereign default is more unlikely (due to relatively more stable exchange rates) but also not entirely impossible. The earlier mentioned impacts on domestic growth will lower tax revenues and increase debt, thus raising the default risk. Whilst this is more of a pessimistic view, it is hard to argue against at least a credit rating downgrade.

The same analysis continues to corporate debt. In peripheral countries, widespread default is highly likely, whilst in countries with a more stable exchange rate, it very much again depends on the company's asset base and business areas.

Now though, one can see the full scale of disaster. Equity markets will plunge, and sovereign debt yields will sour. Further to this, because of stringent capital controls, appropriation of assets and potential hyperinflation, people may seek solace in gold or even cryptocurrencies. Venezuela is a prime example of this- since June this year and within a three-month period, the trading volume of local bitcoins in the country has quadrupled, from around 9 billion to 40 billion Venezuelan bolivars.

Looking Ahead

One could say that with central banks' newly found monetary sovereignty, countries such as Germany, Austria, Belgium, Netherlands, and Finland will be able to pursue 2% inflation targets with better outcomes than the ECB could.

However, this is not to say that countries will overall be better economically without the Euro. Whilst it is highly likely that trade deals may be struck in the event of Euro dissemination, the ease of the flow of goods and services will be less than what was possible inside the union. Greater focus on domestic markets will have 2 consequences. One, a disincentive to innovate on a level that was done within the EU, and two, a growth in industries that were previously futile under European competition. The extent of these factors obviously depends on capital mobility and trade barriers after the break-up. Nevertheless, both will have negative implications for productivity in the long run.

Moreover, with the need for structural changes, the slow transition to a new labour market equilibrium will affect growth. The question is for how long- depending on the level of labour market regulation, companies in different countries will exhibit varied costs of firing employees. Regardless, such transitions and frictions in regard to capital movement can only increase unemployment.

A Global Shock

A Eurozone break-up will not only be detrimental within Europe, but a severe global recession is entirely possible. With financial services and global trade so interconnected, it is difficult to argue how markets outside the current EU will be unaffected. Whilst China is less reliant on European exports than it was 5 years ago, economic woes in Europe is still detrimental to Chinese output. Adding to misery, the global impact is likely to be much worse than that of 2008.

Some may argue that a recession here is rather far fetched. However, even with what the Chinese would call a growth recession (i.e. growth in the very low figures), global markets will still take a huge dive. Consider how GDP growth in China hovered around the 8% mark between 2012 and 2014. The announcement of the 2015 growth target cut, to 7%, triggered sizeable market uncertainty, particularly in emerging market equities. Now, imagine the effect of their performance if Chinese GDP were to experience a 2% annual growth rate instead.

In the US, other than a probable reduction in equity performance, the shock of the initial EUR to USD depreciation could also serve as a deflationary shock to the economy. To counter this, the Fed will probably cut rates and restart QE to maintain price stability and trade.

So, the initial consequences of a Eurozone break-up are catastrophic. And yet, there are still parts of the story we are missing. For one, the uncertainty caused by huge market volatility and the legal qualms that follow currency redenomination will no doubt have a dramatic bearing on what consequences we will see. However small the probability of a Eurozone break-up may be, companies will need to start thinking about bracing themselves.

Investment Recommendations:

Bitcoin: a doomsday asset, immune to currency manipulation and inflation. With capital controls, appropriation, and huge uncertainty from a Euro break-up, bitcoin may turn out to be a viable long term investment.

ECB's path to normalisation

Tiancheng Wu

To combat the crisis, the European Central Bank (ECB) employed a series of unconventional monetary policy tools (refinancing operations, asset purchases and negative rates) which has left it with an enormous (€4.4T) balance sheet. As growth returns in the Eurozone, the ECB is starting to unwind the excessive liquidity which, although served well in emergency, have distorted asset prices and are barely able to transmit credit into the real economy. Former Fed staff Stephen Roach argued that it is essential for central banks to normalise decisively in order to avoid nurturing bubbles and running out of tools for next downturn. This article will explore potential paths of normalisation and potential investment opportunities in Europe.

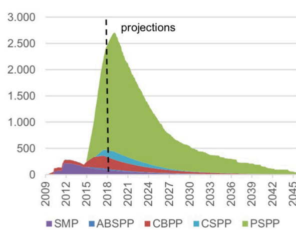
The key variables to the unwinding are time, stock and flow.

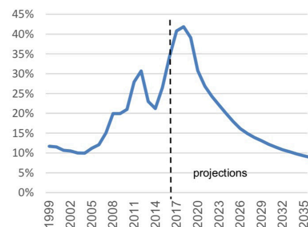
Time: Although ECB only contends it will provide support until inflation stabilise around 2%, we may still track the indicators that ECB uses to evaluate macroeconomic environment. In the October press conference, Draghi based his decisions mainly on economic and monetary conditions. Economy wise: Eurozone enjoyed solid GDP growth of 0.7% in Q2, deleveraging, business financing and domestic demand are supported by ECB's policy, increased private consumption coupled with lower unemployment figures showing healthy sign, and global recovery boosted Euro area export. Eurozone HICP stood at 1.5% but no sustained upward trend given subdued oil price and limited wage growth. Monetary side: M1/M3 growth have been robust (9.7%/5.11%), loan to non-financial corporation and households have increased, and credit standards for new loans have been consistently easing. Thus, reduced but continued support is needed based on core economic and monetary considerations. Since official end of QE programme is set at September 2018, it is likely that ECB will stop purchasing new assets in March 2019.

Stock: Currently, Asset Purchase Programme amounts to €2.3T and the matured security will be reinvested indefinitely producing lasting stimulation to bond market. If current benign environment continues, based on the forecast by Bruegel, it will take ECB 14 years just to restore the balance sheet back to pre-crisis level with respect to euro area GDP and it will take another 16 years to fully offload the assets purchased. Nevertheless, given the decreased efficacy of lower interest rates, APP might be the main stimulating method for ECB and hence it will keep its asset stock in order to offer liquidity support in case of a recession.

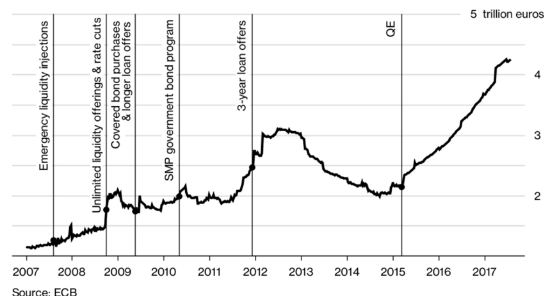
Flow: The ECB has reduced new asset purchases from €80 to €60B/month in March and the October meeting announced further reduction in January 2018 to €30B/month until September. Even the Fed have only talked about the possibility of actual sale of assets hold, thus it is too early to gauge the magnitude of the tightening.

Being aware of the taper tantrum in 2013, ECB would take a gradual and transparent approach which likely follow the path of first guiding policy rates higher, followed by downsizing balance sheet and hiking of rates. However, this approach is by no means a panacea. Gradual could mean falling behind whereas transparency would induce excessive leverage taking for investors. ECB would have to communicate effectively and act prudently so that it can get market feedback without losing initiative. Thus, it is too early to forecast the actual path of normalisation. Given current Europe recovery and continued support from ECB, investors should favour European stocks over bonds, investment grade bonds over junk bonds and gradually reduce government/company debt (that are backed by ECB purchase) exposure before September 2018 official programme end. The risk lies with chasing the yield and bearing excessive risk in corporate bonds and high-yield domain. Apart from equities, investors who are looking for low correlation alternative strategies should consider solutions in hedge funds and real estates.





Source: Bloomberg, ECB, Ameco, Bruegel calculations.



US Trade

Jeffrey Yu

A year into Trump's presidency, his economic nationalism "America First" is in full swing. Prioritising reducing the US's trade deficit and bringing back American jobs, he has chosen to renegotiate and even pull out of multiple trade deals. The deals, including the Trans-Pacific Partnership and the North American Free Trade Agreement, have taken decades of negotiation and Trump's actions no doubt will bring uncertainty into the US's trade regime and industries which are dependent on it. The automotive and agricultural industries will be affected the most, and this will likely be negatively reflected in their stocks.

First, the Asia focused TPP is a trade agreement involving 12 countries, including the US, together they make up about 40% of the global gross domestic product. Trump's on his third day in office, has withdrawn the US from the agreement. At the Asia-Pacific Economic Cooperation in late 2017, Trump attempts to create new bilateral trade with individual countries, in hope for better deals for the US. However, the chances of any significant deal are slim. Due to the size of the US market and economy, bilateral deals heavily favour US, imposing difficult terms of trade and high costs on the other party, for example regulations on cross-border data flows and state-owned enterprises. Countries are hence reluctant to strike the deal. With this uncertainty, US exporters will face higher tariffs that damage export performance. In the meantime, the rest of the 11 countries have forged ahead and agreed to a new Comprehensive and Progressive TPP without the US, undermining the importance of the US in such trade deals. This should come as a warning to the US, which will likely see diminished influence in Asia and in international trade.

Second, and arguably more important is the NAFTA. NAFTA is a free trade agreement between the US, Canada and Mexico. To put the size of the deal into perspective, the US's total value of trade with Canada and Mexico in the year of 2016 was $985bn, whilst US's largest trading partner China was $598bn. Additionally, Canada and Mexico are America's first and second largest export destinations respectively.[1] Over the decades, deeply integrated supply chains have formed between the countries, allowing companies to take advantage of lower costs. Renegotiation of the agreement will be an economically and politically risky decision, pulling out would cause significant damage to the economies. A rule change proposed by the US is that at least 50 per cent of the car parts made in North America must come from the US for them to qualify for NAFTA's tariff-free benefits. The automotive industry is likely to be disrupted the most, since around 25% of all imports from Mexico and Canada belongs to transportation, meaning cars and parts for the industry.[2] These are vital for the industry's international competitiveness. Politically, Trump's stance on the NAFTA dismays many farmers in states which have always been Republican supporters. Take Kansas as an example, it exports more than a third of the $10.2bn in beef, grains and other goods to Canada or Mexico.[3] The stability of the Trump administration becomes increasingly precarious. Upcoming political agenda including the presidential election in Mexico July 2018 also puts pressure on the available time to complete the negotiations considering little progress has been made and plenty conflicts remain.

Perhaps the worst-case scenario of a real GDP decline of 0.225 per cent in the NAFTA region as a whole will be averted, it is still difficult to be optimistic. Amongst them Mexico would suffer a 1.2 per cent decline, the largest of all, whilst Canada and the US would face a 0.54 per cent and 0.1 per cent fall respectively.[4] This leads to a heightened risk of the Mexican peso and the Canadian dollar depreciating.

Developments in US trade agreements should be carefully monitored throughout Trump's presidency, whether he is able to budge other countries to his will, or will he fail and isolate US's firms from a globally integrated market.

Will Africa's chaos be a ladder to economic prosperity?

Max Marian

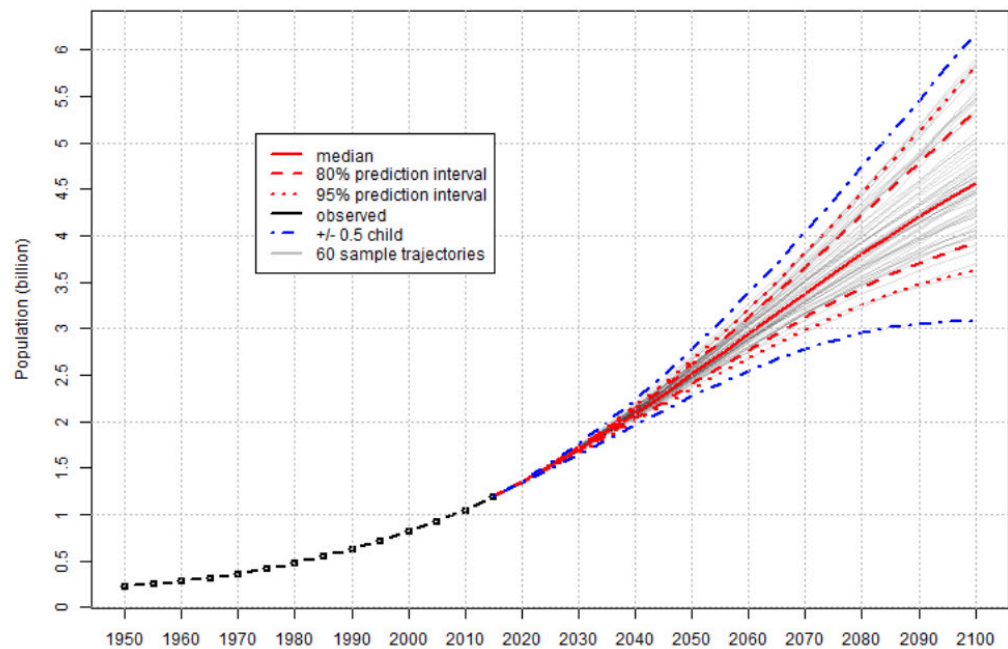
The African continent is undergoing an extreme population boom as its current total population is forecasted to double by 2050 due to a delay between the drop in child mortality and household mentality. With already 3 in 5 current Africans are younger than 24 years old, the population growth will specifically yield a big increase in the amount of young people which leads to potentially much higher labour force. However, high youth unemployment could lead to social unrest as we have seen in the Arab spring. It is hard to predict whether the population boom is a bliss or a curse for Africa, but it is not hard to see that substantial change is on the way for the continent.

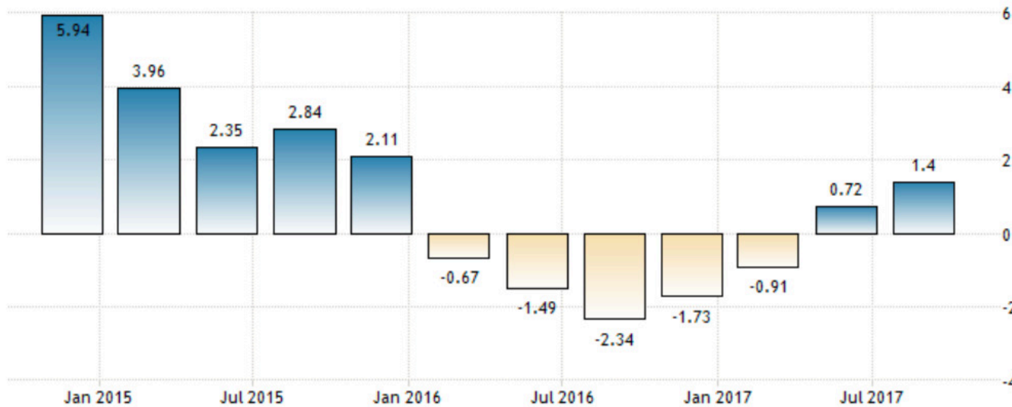
From 2000 to 2016, the African continent has experienced an average yearly GDP growth of 4,6%, driven by growth in sectors of telecommunication, water and electricity, agriculture, services and resources. Overall the growth in the resources sector accounts for approximately one third of the GDP growth. The African resource reserves are considered to be rich and are far from being fully discovered yet, meaning there is still a potential for further increase of resource mining and exporting. However, the lack of economic diversification of major resource exporting countries in Africa leads a strong reliance on the price of and international demand for these resources (the 2014 drop in the oil price was, leading to high volatility of growth.

According to an article published by the McKinsey Global Institute, African countries can be categorized into four types of economies: oil exporters such as Libya, Nigeria and Algeria which have a high exports per capita ratio but a low economic diversification, diversified countries such as Egypt, South Africa and Morocco which have a high exports per capita ratio and a high economic diversification, a large group of transition countries with a relatively high economic diversity but a low export per capita ratio, and finally the pretransition countries such as Ethiopia which rank low in both respects.

In order to push deeply needed infrastructure construction, as well as to support further economic diversification, Africa relies on foreign investments and good state governance; thus, one of the most important challenge of development to Africa will be political instability as it represents a risk for investors. Furthermore, an instable government usually correlates with bad governance. Substantial political change is hard to predict but has some common triggers such as regime change due to a coup d'état, an election or a health emergency of a leader. According to a report by the CSIS Africa program common pressures on stability in the continent are population growth, rapid urbanization, youth unemployment and climate change; the likelihood that these factors will increase in the future indicates a hike in political risk for the future. Generalised corruption is also a major hinderance to economic growth because it distorts allocation of resources, undermines competition in the market and thus creates an unhealthy environment for investments.

The flow of foreign investments into Africa went from US$20 billion in 1990 to above US$120 billion in 2012,





which is a big change but far from enough to finance the African development. China's slowing GDP growth has caused it to drop its African investments by 40%, but other factors indicate that African government bonds could become increasingly attractive. Research institutions such as the Centre for the Study of African Economies are in the process of building a "coherent body of accepted ideas" (Prof. Paul Collier) which the aim of providing a framework for investment in Africa, giving more confidence to investors and institutions such as the Multilateral Investment Guarantee Agency which provides political risk insurance to establish a good sovereign debt rating.

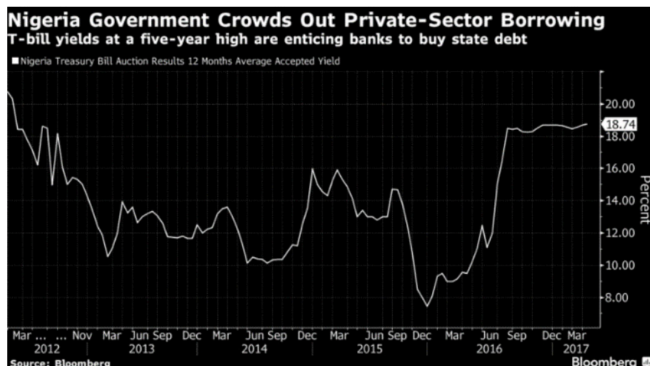
I believe buying African government bonds can be a good strategy to attain high returns; even if African bonds have high default risks, they also have yields going up to 20%. Investors have to take in account that every African country has its own specific economic situation; in the framework of increasing pressure on political instability it seems likely that economic development will not uniformly take place in the continent. Thus, choosing a country from which to buy a government bond is comparable to betting on horses. Nevertheless, a relatively high and steady state income has historically been a strong support for a governments stability and subsistence. Using state income as a criterion, economically diversified countries as well as countries whose oil exports have remained stable even after the 2014 fall in oil prices become attractive.

A visit to Nigeria

Nigeria is the most populated country and biggest economy in Africa. The relatively peaceful last two power transitions and the representation of multiple parties at elections make it one of the more stable democracies in the continent. While there is strong social unrest in the North-East of the country due to the presence of the Islamist military organization Boko Haram, the militia is still far away from the economic epicentre of the country in the south and a report by the university of John Hopkins showed that Boko Haram has weakened and split in the last years. Nigeria's relative political stability combined with its low current debt to GDP ratio of about 20% suggest that the default risk of Nigerian government bonds is low beacause the government still has a big margin for future indebtment if needed.

Nigeria's steady and strong GDP growth over the last two decades was recently interrupted by the 2014 fall in the oil price, ultimately leading Nigeria's economy to go into a slight recession in 2016. The country is now slowly recovering from it as its oil production slowly picks up again.

Government spending in Nigeria relies heavily on oil exports which lead the current government to issue bonds to cover the fall in oil revenue. Whether Nigerian government bonds whose yields are currently around 15%-16% are worth it or not will depend on the inflation of the Nigerian naira (currency) which is currently at 16%. The inflation has slightly recovered already and I believe the prospects for the inflation going back to a level of 7% over the next five years are good for the following reasons: there is a growing substitution of domestically produced goods for imported goods pushed by a rigorous growth of the agricultural and mining sectors, this will ease on the trade balance and foreign currency reserves of Nigeria resulting in a stronger naira; the economic rebound along with economic stimulations announced by the government (mainly investment in infrastructure) will bring the GDP growth back to decent level, thus reflecting well on inflation which was caused by the 2016 recession in the first place. Even if the inflation does not fall, it is very unlikely it will further increase, and thus very unlikely that investors would make losses. Based on this analysis, I would recommend buying 15-year government bonds as there is reason to believe they will give high returns on investment on the medium-long term once inflation falls back to a normal level.



Chinese Economy restructuring

Rolandas Adomaitis

With the 19th National Congress of the Communist Party of China over, newly re-affirmed President Xi Jinping has laid out an ambitious strategy to change China's economic growth dynamics. Proposed structural reforms include deleveraging and containing financial risk, achieving higher quality growth (via consumption) and improving environmental protection regulation, as well as continuing the highly publicised Belt and Road international infrastructure development project.

Following the introduction of capital market principles in 1978 by Deng Xiaoping, the Communist Party leader at the time, China has experienced rapid GDP growth since the early 1990s, averaging approximately 10% every year. However, there is no doubt that China's economic growth miracle is fading away, with GDP growth having been consistently under 7% in recent years. With a previous promise to double GDP from 2010 to 2020 by predecessor Hu Jintao, which should be comfortably achieved if China can maintain at least 6.3% GDP growth for the remaining 3 years, President Jinping has indicated (and a senior economic advisor has confirmed) that China will not announce a new GDP growth target post-2020, instead stressing the need for high-quality rather than high-speed growth. For China, this involves weaning the economy off from heavy infrastructure investment fuelled by open-handed credit generation, and increasing consumption levels (currently one of the lowest in the world as a percentage of GDP).

Growing debt problem

This change in policy has been a direct result of China's exploding debt problem. Over the past 10 years, China's total non-financial sector credit has risen from 147.5% to 256% of GDP as of June 2017, resulting in an average annual gain of 5.66% - second highest only to Hong Kong. To make matters worse, this measure is on top of China's relatively high GDP growth, which somewhat masks the elevated leverage growth problem. Additionally, over the past 5 years, China has experienced persistently higher credit growth relative to nominal GDP growth (roughly double – figure 1), indicating diminishing credit returns to growth. This raises the issue of what the true sustainable economic growth rate of China is, i.e. whether credit contributes a large proportion to GDP growth. Comparing total debt to other countries, however, shows that this level is nowhere near Japan's 373% or Luxembourg's 433.4% of GDP.

Despite this apparent respite, what has Chinese policymakers concerned most is the credit to non-financial corporations (this includes the liabilities of local government financing vehicles, as well as the state-owned-enterprises that borrowed heavily from government-backed banks), which stood at 163.4% of GDP in June 2017, the highest among major economies (figure 2). A lot of these loans have gone increasingly into unprofitable ventures ('zombie' companies), resulting in excess capacity in industries such as coal, steel and shipbuilding. However, it is fair to say that some of the excess capacity has been alleviated by expanding Belt and Road infrastructure projects in neighbouring countries. Worryingly though, pressure to maintain the country's rapid growth has bred an unwillingness to allow struggling firms within these industries to fail, which has increased financial instability within the economy.

China bulls argue that the economy is somewhat shielded from any debt crisis arising from a lack of global confidence because of its closed capital account, powerful state control of the economy and external debt only amounting to 13% of GDP. Highly indebted state-owned enterprises (SOEs) are funded by China's large infrastructure banks (having a strong buffer on defaults), which are in turn completely backed by the government. However, it was precisely this 'too big to fail' mentality and shored-up complacency in the financial system that caused the financial crisis in the western world a decade ago. A simple historical international comparison of 43 large credit booms by the IMF has found that "almost every single one resulted in a sharp slowdown or a financial crisis". In China's case, any problems arising within the SOEs,

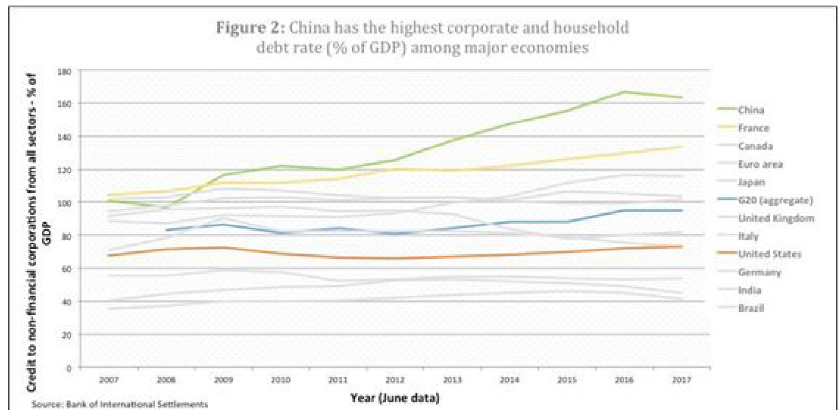
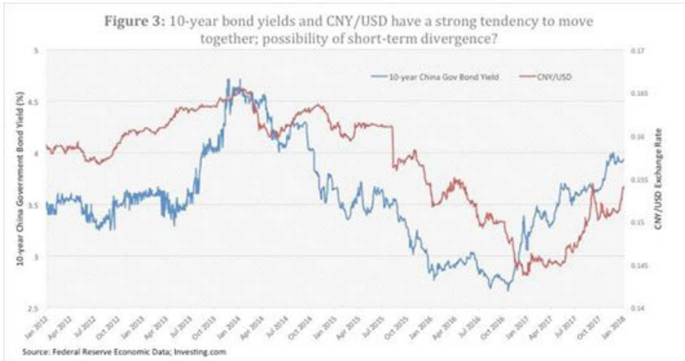


Figure 2: China has the highest corporate and household debt rate (% of GDP) among major economies



which have been increasingly funded by off-balance sheet loans and opaque refinancing agreements (another reason that caused the financial crisis), will lead to systemic risks and directly affect the government's finances. Hopefully, President Jinping's reforms will set the Chinese economy on the right track, a difficult feat considering China's centralised hybrid economy, complex financial system and obscure reporting figures. So far, optimism is prevailing; Chinese big bank equities have rallied this year.

10-year sovereign bond yields

Chinese government 10-year bond yields have increased from roughly 3% to 4% in 2017, due to deleveraging efforts initiated by the Chinese government, consisting of shadow-banking regulation, a tightening monetary policy and capacity reduction efforts in loss-making industries. If China continues this restructuring, then the sell-off of sovereign bonds will continue and yields will rise further, following deleveraging and a more positive outlook on stocks. However, some analysts argue that the government is unlikely to allow rates to climb rapidly as this will increase corporate funding costs and put pressure on the economy. To control the yield, the central bank will have to buy up any surplus bonds to alleviate upward pressure and maintain a steady yield rate, which it already did at the end of October 2017 by injecting $45 billion, to little effect.

It is realistic to assume that there is still upward pressure on the 10-year bond yield. Firstly, this is because regulatory financial reforms should continue to take effect following repeated announcements by government officials to follow through on Xi Jinping's vision of higher quality growth. Secondly, inflation pressures should begin to pick up following the increase in global oil prices (China is a big importer and is significantly affected by its volatility), resulting in an outflow from bonds (as these are not protected from inflation) and hence a rise in their yields. Thirdly, US tax cuts and repatriation flows by American multinational corporations (e.g. Apple recently announcing that it will move $252.3 billion back to the US due to lower repatriation tax rates) should spur the US economy to higher inflation expectations, leading to a more hawkish Fed; meaning more interest rate rises in the US in the future. This should stimulate a short-term US dollar rebound against the renminbi within the next few months (unless Chinese bond yields rise in response), following a persistent decline throughout 2017 against all major currency pairs.

Bottom Line

1st and 2nd Investment: In response to the upward pressure on the Chinese 10-year government bond yield, the Chinese government will either allow the yield to continue to rise at a more gradual pace, or will attempt to stop the ascent by easing monetary policy, which will force the yuan to depreciate against major currencies.

To take into account both scenarios, and exploit the potentially diverging positive relationship between the 10-year bond yield and CNY/USD (figure 3) due to the above arguments, consider a short position on Chinese 10-year government bonds with a target of 4.2% and a long position on USD/CNY with a target of 6.6 (currently at 6.3) with an investment horizon of 4 months.

10-year bond:

Investment Horizon: 4 months

Current Yield: 3.93%

Target Yield: 4.2%

USD/CNY:

Investment Horizon: 4 months

Current Price: 6.3

Target Price: 6.6

Risks: European recovery may impact the USD/EUR trade heavily, adversely spilling into the USD/CNY relationship. Fears over tax cuts contributing to a rising US government debt during the wrong part of the cycle, US government shutdowns becoming more hostile or a more dollar-depreciation-accommodative US government (to boost exports) will all decrease the likelihood of a dollar rebound.

3rd Investment: For a longer-term position, consider a long position in EUR/CNY, which has steadily been increasing from a low of 6.56 in March 2015 to the current price of 7.84, following the Eurozone's gradual recovery. The most recent substantial pick-up in growth in Europe and Japan has generated speculation over the European Central Bank and Bank of Japan to begin to significantly tighten monetary policy early next year, following recent hints of reduced quantitative easing. Investors are closely following central bankers for any such announcements, which will send the euro and yen rallying.

Investment Horizon: 12 months

Current Price: 7.84

Target Price: 8.25

Risks: The Eurozone recovery may fail to take hold, meaning a continuation of monetary easing. Central banks may significantly increase their foreign exchange reserves of the yuan leading to higher demand for the currency. The yuan may successfully achieve "true" reserve status sooner than expected due to its growing international initiatives (e.g. BRI, renminbi-denominated debt, etc.).

Vale SA: Mining for Value

Shuvod Rai

Key Information

(BVMF: VALE3)

Investment recommendation: Buy

Price (1-Jan-18, R$): 40.6

Target price (R$): 54.8

Potential upside (%): 35.0

52-week price range (R$): 23.99 – 40.26

Market cap (R$ B): 212.6

Shares outstanding (B): 5.22

Investment Summary

The last few years have not been kind to Brazil. The country has been plagued with widespread corruption scandals, a presidential impeachment that has thrown the political establishment into chaos and an economy in free fall. However, 2017 seems to have marked a turning point. Looking ahead, there are signs of improving macro fundamentals and to some extent, political stability. The government has projected GDP growth to come in at 1.1% for 2017 and improve to 3.0% in 2018.

Similarly, Vale SA has had quite the year with its share price rising 68% from R$23.99 to R$40.26 in 2017. With the appointment of a new CEO in May, Vale has moved quickly to limit the state's interference in the company, strengthening governance and transparency through a share restructuring exercise which was completed ahead of schedule in December 2017. This change will open the company to new investors globally and boost liquidity. Furthermore, with the massive S11D project coming on board and the premium for higher quality iron ore widening, Vale SA is poised to benefit from these growth catalysts and is set for another exciting year ahead.

Company Background

Vale SA is one of the biggest mining companies in the world and one of the largest logistics operators in Brazil. The company is the leader in global production of iron ore, pellets and nickel. Vale also produces other metals such as manganese, copper and cobalt and is involved in the production of fertilizers. In addition, it operates nine hydroelectric plants and a large network of railroads, ships and ports that it uses to move its products. Its biggest source of revenue comes from iron ore production as ferrous minerals made up 75% of Vale's revenue in 3Q17.

Vale shares are traded on the NYSE (VALE and VALE.P), the BM&FBOVESPA (Vale3 and Vale5), the Euronext Paris (Vale3 and Vale5) and the LATIBEX: Bolsa de Madrid (XVALO and XVALP). The company underwent a major corporate restructuring in 2017 which aimed to limit the influence of the Brazilian government on the company and boost transparency. The Brazilian government still owns 12 golden shares that allows it to direct major strategic decisions.

Industry Outlook

The outlook for iron ore is still positive (especially for higher grade iron) as China continues to curb air pollution through stricter quality controls. China's infrastructure and housing projects have been pushing up the demand for steel over the past two years and this trend is set to continue into 2018. With higher demand for steel, iron ore consumption should be well supported over the next two years. In addition, the outlook for copper (which accounted for 7.4% of Vale's operating revenue in 2016) is also very optimistic heading into the new year. The company is expected to cut down nickel production for the next five years to focus on iron ore. However, Vale is still maintaining its nickel optionality given the expected growth of electric vehicles for which nickel is a key component of the battery. Nickel made up 14.6% of Vale's operating revenue in 2016.

Investment Thesis & Growth Catalysts

1. Onboard the S11D Train: The S11D project is arguably the most important project carried out by Vale in its history. It is the world's largest iron ore mine producing some of the highest quality iron. Production began during the tail end of 2016 and has been ramping up through 2017, well on schedule. The US$14.3B investment is central to the company's future and is expected to reduce costs, increase productivity and help secure Vale's position as one of the biggest mining companies in the world. The project has incorporated a high degree of automation in its operations and when fully ramped up by 2020, S11D's C1 cash cost is expected to be lower than Vale's current (3Q17) C1 cash cost by 47%. Gradual onboarding of the capital-intensive S11D project should boost FCF going forward due to higher output, lower costs and tighter capex.

2. Flight to Quality: Vale SA stands to gain immensely from China's recent push towards higher quality iron ore in the production of steel as the country fights environmental pollution. The effect of this policy shift is visible through the increasing premium spread between high and low-quality iron ore in 2017. Vale's high-quality iron puts it in prime position to take full advantage of this shift; the company has the highest-concentration iron ore in the world with the lowest levels of impurities (in particular, the iron ore from the Carajás region where S11D is located).

3. Improving Operating Environment: The global economic recovery is well on track and expected to continue into 2018. Most importantly, China is expected to maintain a steady growth rate this year and this is a market where Vale made 42% of its revenue in 3Q17. Brazil finally managed to drag itself out of its worst recession in history in 2017 and capital is returning to its shores. With its recent share restructuring which limits the government's influence on the company, Vale can finally pursue its key strategies: divestment of non-core assets and cost reduction. The company is planning to sell non-core assets worth US$1.5B over the next three years which will strengthen the balance sheet and allow Vale to focus on its core iron ore mining business.

Investment Risks

As is the norm in the commodities industry, Vale is exposed to the cyclical nature of the business and macro-economic conditions. Although unlikely, the company would especially be susceptible to the economic condition in China worsening and the demand for steel collapsing. A more pertinent and urgent risk is the Brazilian general election due in October 2018. After the political upheaval unleashed by Lava Jato, the outcome of this election will have far reaching consequences for the country's future and, by extension, for Vale where the government is still a key decision maker. With battle lines being drawn and uncertainty in the air, a protracted dirty campaign or the appointment of a non-market friendly leader might spook investors, prompting capital flight and a decrease in liquidity.

Baidu, Inc.

Jack O'Brien

Key Information

(BIDU: NSQ)

Investment recommendation: Buy

Current price (US$): 234.96

Target price (US$): 261.06

52-week price range (US$): 166.00 - 274.97

Market cap (US$ B): 85.1

Earnings history	30/12/2016	30/03/2017	29/06/2017	29/09/2017
Est. EPS	0.94	0.91	1.54	2.04
Actual EPS	1.99	1.03	2.41	3.9
Difference	1.05	0.12	0.87	1.86
Surprise %	111.70%	13.20%	56.50%	91.20%

Table source: https://finance.yahoo.com/quote/BIDU?p=BIDU

Industry & Company Overview

The Chinese technology sector has seen significant growth throughout 2017. The Guggenheim China Technology ETF (CQQQ), which can be used as a proxy for the Chinese tech sector as a whole, has grown by 166.9% since its inception in 2010 and grown by 74.32% in the last year alone. Compare this to the GDP of the whole of China which has grown by 47.9% since 2010 and it is clear why investors are so drawn to this sector. This trend is expected to continue in 2018 with the global tech market due to grow by a further 4% in the coming year, reaching a milestone of $3 trillion.

Baidu is a promising player within both the CQQQ and the MSCI EM Index. One of the top holdings of the CQQQ, Baidu is a leading Chinese web company which offers a multitude of web services including IQiyi (one of the largest video streaming websites in China) as well as news, global mapping and transaction services. However, most prominent is its search engine, giving Baidu a 76.05% (as of April 2017) share of the Chinese search engine market and gaining it the nickname 'The Google of China'.

Baidu's strong outperformance has largely been enabled by China's ruling Communist Party which has essentially sheltered home-grown industries, making it difficult for rival Western companies to break into the Chinese market. However, it is the party's relationship with Google which has really proven fortunate for Baidu. Google, the largest outside threat to Baidu, decided to end its self-censorship as of January 2010 in reaction to a state sponsored cyber-attack which targeted them as well as other US tech firms. Google search was subsequently banned in 2010 in mainland China, leaving its 36% search engine market share up for grabs and eliminating Baidu's biggest outside competitor from the market.

Investment Thesis & Growth Catalysts

1. Since 2010 Baidu, Inc. has skyrocketed in stock value growing by 476.6% (as of Nov 2017), outperforming the CQQQ by 309.7%. We see strong earnings growth since 2010 with 3Q17 earnings 91.2% higher than expected (as shown in the table) and this large earnings surprise is indicative of what to expect in the future. Baidu's earnings have exceeded forecasts for the last four quarters giving an average earnings growth rate of 25.61%, performing better in comparison to peers such as Alibaba which saw an average earnings growth of 17.37% over the same period.
2. 3Q17 net profits rose by $1.2 billion which represents a rise of 156% YoY, reinforced by the sale of Baidu's delivery service for approximately $636 million. This is vital in freeing up funds which will allow the company to further invest in its Artificial Intelligence (AI) program. With revenues rising the company's top line was reported as being its fastest growing since 3Q16. With mobile usage on the increase in China, mobile advertising revenue is expected to contribute 82% of online advertising in the country by 2021. Baidu is well positioned to take advantage of this due to its focus on online mobile advertising.
3. Baidu has increasingly been spending more on R&D, particularly in its development of AI. In October 2017, the company announced the opening of a new Research and Development facility in Silicon Valley, with a focus on AI and autonomous driving. In an attempt to rival US firms, Baidu has announced it will invest $1.5 billion into its Apollo project, with the aim of perfecting autonomous driving, potentially creating a brand-new revenue source when self-driving cars hit the market in the foreseeable future. This push into AI development is reinforced by the Chinese Government's aims; on July 20th, they announced a development strategy aimed at making China the AI world superpower by 2030.

Investment Risks

As indicated by its strong performance over the last year, Baidu's diversified range of services means it is somewhat sheltered from significant risk. However, with its major investments into automated driving it is very possible that it will be beaten to market by one of the many other big players in the automated car industry such as Google, Tesla or Toyota. It is true however that they are somewhat protected by the state in their home market of China.

As Baidu is headquartered in China, it is also vulnerable to political risks. In the last few months, the capital city of Beijing has seen the uprooting and eviction of thousands of migrant workers with official aims to cut down population size by 15% (approximately two million people). The problem that this poses to many companies based in Beijing (including Baidu) is that these migrants are cheap labour and so their removal may considerably drive up employment costs. In regards to the migrant evictions, a spokesperson for Baidu stated "we have already actively liaised with hotels and moving companies to provide a special discount for Baidu employees and made space for leaving luggage in our offices". This indicates that the company is feeling the impact of the state's actions and so could potentially be adversely affected by them along with other competitors such as Alibaba and JD.com which rely on cheap labour for couriers.

Conclusion

While the potential for China to dominate the AI market could prove worrying for western powers, it presents a real opportunity for investors which should be seized upon while it is in its early stages. With clear intentions to push forward in AI, continued government support and an unrivalled dominance of the Chinese search engine market it looks clear that Baidu, Inc. is on the road to becoming a superpower of its own.

JD.com, Inc.

Cameron Sit

Key Information

(NASDAQ: JD)

Investment recommendation: Buy

Rating: Outperform

Share price (US$): 45.64

Target price (US$): 51.5

52-week price range (US$): 25.92 - 48.99

Market cap (US$ B): 64.99

Graph 1: https://finance.yahoo.com/quote/JD/

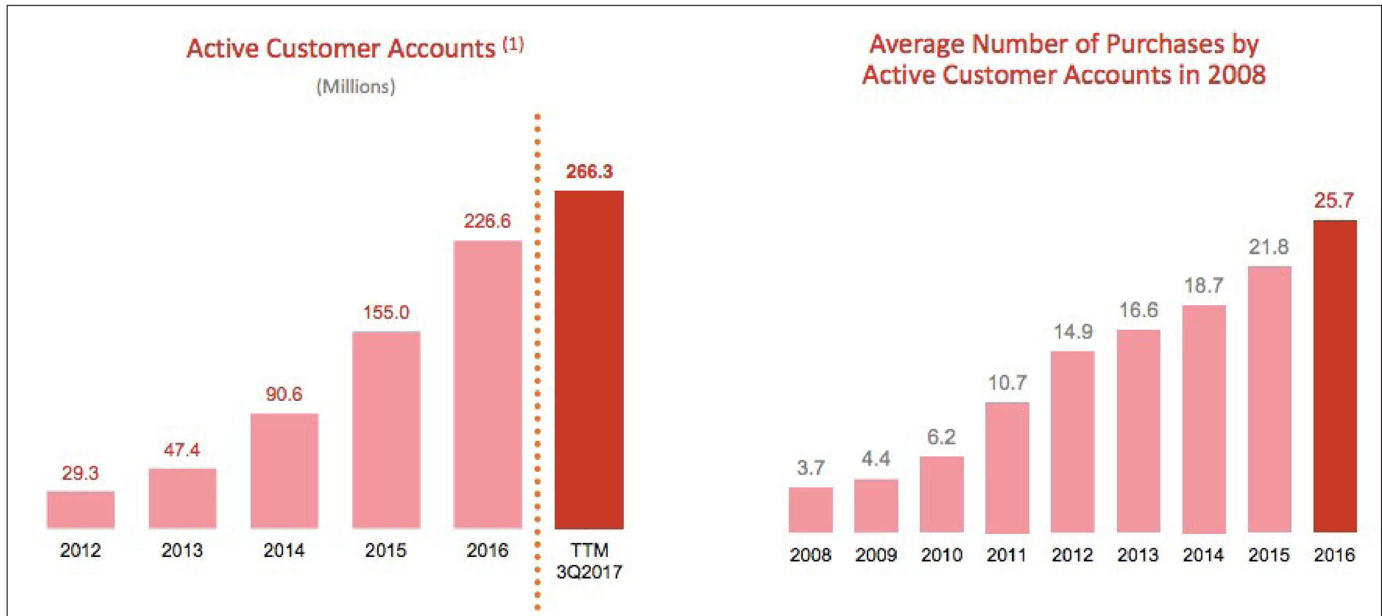
Company Overview

JD.com, Inc. is an online direct sales company headquartered in Beijing, China. Through its website and mobile applications, JD.com sells digital products, communication products, garments, books, and household items to consumers and vendors. Despite bullish expectations, competition with Alibaba's Tmall (NYSE: BABA) and most recently an eviction of migrant workers provide the main downside risks towards our outperform rating and target price.

Investment Thesis

1. JD.com is the second largest B2C (business to consumer) e-commerce platform in China with a market share of 32.9% in the Chinese e-commerce retail market and 266.5 million annual active customer accounts from 3Q16 to 3Q17. Holding a significant share of the Beijing electronics market, JD.com is poised to challenge the supremacy of Alibaba's Tmall in terms of active customers and spending per customer. JD.com's partnership with Tencent (HKG: 0700) gives JD.com access to Weixin and Mobile QQ whose sticky user base of 963 million and 850 million active monthly users respectively are a key driver of JD's annual active customers and revenues which surged 41.2% YoY to reach Rmb76.2 billion in 1Q17. The online direct sales company also boasts the largest e-commerce fulfilment (product delivery to customers) network in China. With 200 million new online shoppers set to be connected by 2020, 71% of whom are forecasted to be based in lower tier cities, JD.com is expanding its logistical advantage into lower-tier cities to capture the next wave of China's consumer base.
2. JD.com are also addressing consumers from China's mid-tier cities who have felt neglected by premium brands. In 2Q17, the Chinese e-commerce behemoth invested $397m in a partnership with UK luxury retailer Farfetch, allowing the Chinese e-commerce platform to profit off the sales of luxury brands which might otherwise be hesitant about entering a country where fakes proliferate. JD.com also announced "Toplife" in 4Q17 which will feature "dust-free" warehouses and white-glove wearing couriers in Shanghai that deliver brands like Louis Vuitton and B&O Play.
3. To catch up with Alibaba's Tmall, JD.com have also broadened its portfolio beyond the traditional consumer electronics in pursuit of an asset-heavy vision. A new partnership with Wal-Mart subsidiary and British supermarket retailer ASDA to bring UK products to Chinese consumers in 3Q17 exemplifies JD.com leveraging others' advantage in procurement scale and product variety. Despite having no sales campaigns and a pull back on marketing in 3Q17, JD.com's Q317 net income of Rmb1.01bn exceeded the Rmb114.1 million loss expected by analysts.

The e-commerce giant is currently trading at US$45.64 with non-GAAP net income increasing 252% YoY from FY16 to FY17. Diluted EPS in Q317 was Rmb0.69 compared to a negative diluted EPS of Rmb0.32 in Q316. A P/E ratio and PEG is unavailable because diluted EPS for the trailing twelve months is -0.11; however, key operating metrics show signs of strength.



Graph 2: http://ir.jd.com/

Growth Catalysts

1. During 3Q17, JD Logistics test-launched the first unmanned sortation center in the logistics industry. JD.com have also sealed agreements to rollout out China's largest and most advanced drone network that will reach mountainous regions. The firm's investment into technology could be a potential catalyst for future growth whilst addressing rising labour costs and high turnover among blue-collar jobs.
2. In October 2017, JD.com and Tencent collectively launched JD-Tencent Retail Marketing Solutions. The initiative integrates consumer behavior from Tencent's social media platforms with online and offline shopping data from JD.com and its brand partners. Already established in the West, the strategy will enable more precise target marketing and understanding of consumer behavior. Similar initiatives can be expected as JD.com look to form strategic partnerships with Baidu and NetEase to leverage their powerful big data resources.

Investment Risks

In November 2017, a fatal fire in Beijing started a government "clean out" of migrant workers, threatening the business model of the country's booming e-commerce industry. Low-wage migrant labour are employed by companies like JD.com to transport items across the "last mile" of China's logistics network. According to Huang Gang, a logistics expert at the China E-commerce Association, hiring will get more difficult and wages will increase if delivery men get evicted.

Secondly, JD.com will continue facing fierce competition from Alibaba. Backed by an in-house logistics network like Amazon's (NASDAQ: AMZN), JD.com's formula of faster delivery times compared to its competition excels in developed urban markets like Beijing and Shanghai. However, any edge appears to be lost in smaller Chinese cities, where JD.com is seen as a costlier option to Taobao, Alibaba's scrappier offering. Consumers in these markets have lower incomes than those in first-tier cities and data suggest price rather than speed remains their primary consideration. On the 11th of November every year, JD.com and Alibaba battle it out on Single's day where consumers spent $18bn in 2017. This is triple the $5.9bn spent on Black Friday, Cyber Monday and Thanksgiving combined in the US. According to Bernstein Research, the fierce competition could lead to Alibaba introducing discounts, intensifying the face-off with JD.com.

Gilead Sciences

Karon Pangestu

Key information

(GILD: NSQ)

Investment recommendation: Buy

Current Price (US$): 78.71

Target price (US$): 85.63

Market cap (US$ B): 102.82

Float (B): 1.30

Major Shareholders: Blackrock Inc.

Company Overview

Gilead Sciences is a research-based biopharmaceutical company that discovers, develops and commercialises innovative drugs. Gilead's portfolio of products and pipeline of investigational drugs includes treatments for HIV/AIDS, liver diseases, cancer, inflammatory and respiratory diseases, and cardiovascular conditions.

Investment Thesis & Growth Catalysts

1. The stock is undervalued at its current trading price. Based on relative valuation compared to its main competitors (such as AbbVie Inc. and Pfizer), GILD is trading at a P/E ratio of 8.96 whereas Pfizer has a P/E ratio of around 22.53, which is almost 4 times as higher. Furthermore, Gilead's EV/EBITDA multiple of 6.08, which is almost 3 times lower than the biopharmaceutical industry average of 14.17, elucidates how the company is relatively undervalued amongst its peers.
2. US FDA has granted approval to the first chimeric antigen receptor T cell (CAR-T) therapy for the treatment of adult patients with relapsed B-cell lymphoma after two or more years of systemic therapy. CAR-T is likely to be the next growth catalyst to fuel Gilead Sciences; it is forecasted that CAR-T could add $1-2B in revenue between 2018 and 2021. Gilead's success in CAR-T therapy development is mainly due to its subsidiary Kite Pharma, whom Gilead acquired in August in a deal valued at $11.9B. This major acquisition was long awaited by investors, especially as sales of Gilead's Hepatitis C Virus (HCV) franchise (its main revenue-generating product) has suffered due to the drug being a one-off cure and therefore having non-cyclical demand.
3. The general slowdown and negative sentiment brought upon the biotech sector had pushed 2017 stock prices low across the industry; these include pricing controversies, industry uncertainties and a slowdown in FDA drug approvals in 2016 in the U.S. Issues in accessing capital for biotech firms create a difficult equity financing environment. However, Gilead's acquisition of Kite Pharma could benefit the industry as a whole, potentially acting as a catalyst in jumpstarting biotech M&A activity to revive the sector in 2018. The general slowdown in M&A activity, due to a recent uncertainty regarding tax reforms in the US and the failed merger between Pfizer and Allergan in 2016, has led to stalled inorganic growth in the sector. However, with share price on a general downtrend, there is an opportunity to rally and significant purchases have been made by value investors which is a vote of confidence that could potentially tip the scales for the biotech industry.
4. Gilead's sound business management and corporate governance also leads to a competitive advantage against rival firms. When Gilead's HCV revenue started receding, management decided to cut back domestic supply and expand across China (where Hepatitis C is most prevalent). According to Gilead's 3Q17 filing, China's FDA has approved Sovaldi for the treatment of HCV. This upcoming launch in China is likely to significantly boost revenues due to the country's huge population and HCV pandemic (fourth most reported infectious disease in China). Research estimates that around 840,000 Chinese (0.06% of China's population) have HCV. Globally, with Sovaldi procuring $25B peak sales from 150 million HCV cases in 2015, it is estimated that $1.5B could be generated as revenue from the Chinese market.

Investment Risks

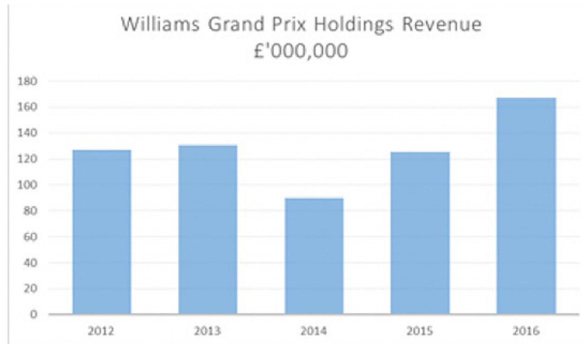
Although Gilead's expansion into the Chinese market is expected to have a positive impact for the company (in terms of revenue), the extent of this cannot be determined as there is significant downside risk in terms of net sales if the Chinese market is not as receptive to Sovaldi in comparison to other countries consuming the drug. Sales of Sovaldi in China depend on its efficacy and people's perception of the drug.

The main downside risk for Gilead is the performance of its revolutionary CAR-T franchise. The efficacy and safety of CAR-T treatments should be taken into account, and also how the FDA will react to further approvals. Other risks involve the individualised treatment of CAR-T patients (therefore slower sales), but this could be countered by charging compensation and a more substantial premium if demand is high.

Conclusion

Despite the risks, current market expansion into China and ground-breaking FDA approval of the CAR-T therapy highlights Gilead Sciences as a stellar growth company with significant potential in the long term. Therefore, I would recommend a 'buy' on Gilead Sciences.

Williams Grand Prix Holdings - Formula One



Williams Grand Prix Holdings PLC is a British racing team and engineering firm based in Oxfordshire comprised of two main divisions. Williams Advanced Engineering (WAE) is one arm of the Williams group whose main aim is to provide industry-leading innovation and manufacturing to key sectors including defence, motorsport, healthcare and automotive. The other arm of Williams is the Formula One racing team. Since its establishment in 1977, Williams Formula One has had great success, achieving 16 FIA (Federation Internationale de l'Automobile) Formula One World Championship titles and currently being the third most successful team on the grid. It must be noted that Williams is unique in Formula One as it is the only publicly traded team. The reason being that F1 teams rarely generate sufficient revenues to cover their costs and have a surplus large enough to justify paying out dividends, as any surplus is usually plowed back into the team in the form of research and development.

Following an IPO in March 2011, Williams' revenue has averaged £128 million across all divisions in the 5 following fiscal years. Operating a Formula One team has allowed and continues to allow Williams to increase its brand awareness, whilst also generating significant revenue for the firm. Overall in 2013, F1 generated around £1.2 billion in commercial revenues, of which £520 million was distributed to the teams. Roughly half of this cash fund is shared equally, while the other half is allocated according to where the team finished in the championship. On top of these commercial revenues, individual teams can bring in their own sponsorship, merchandising, and corporate revenues. One significant sponsor for Williams, is Martini - whose contribution to the team is estimated at £11 million annually.

In 2014 there was a 35% drop in revenue to £90 million. This was mainly due to a deterioration in performance by the Formula One team throughout 2013, which resulted in 9th place in the Constructors Championship. The Constructors Championship is where the points from each driver are added together to give a season-long running total, and is the best indicator of a team's racing success for that season. Following Williams' 9th place in 2013, 2014's revenue declined due to lower commercial rights and partnership income. Williams, however, bounced back in the following two years, with two consecutive 3rd place-rankings followed by three 5th place-rankings in 2015, 2016, and 2017 as well.

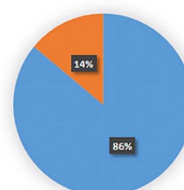
Williams Advanced Engineering

Williams Advanced Engineering division, (WAE), is becoming an increasingly important contributor to Williams revenue. In 2016, WAE saw a 74% growth in divisional revenue. Williams' key infrastructure investments in 2014 have been the main driver of this change. The investments included relocating to a new facility, as well as moving into new industries such as defense, aerospace and energy. WAE's value looks set to further increase given Williams' key engineering expertise lies in energy and lightweight composite materials. The IEA (International Energy Agency) estimates that there will be 140m electric cars by 2030 globally, given current trends. Notably, Williams has recently been awarded a £100m [1] contract by the Advanced Propulsion Centre to build a factory in the UK and create a battery production system for electric vehicles. This places WAE in a highly advantageous position to become a key player of the electrification of the automobile market, seeing as they can distribute their intellectual property and seize new opportunities.

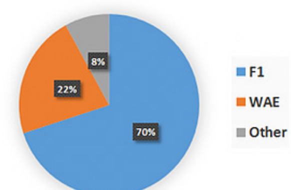
One more example of WAE's recent innovations comes from a business partnership with Sainsbury's, the second largest supermarket chain in the UK. Sainsbury's have incorporated the Aerofoil system, inspired by the aerodynamically efficient rear wing on their racecar. This is soon to be integrated in refrigerators across all of the 1400 Sainsbury stores in the UK. This will save 44 million kWh per annum.

Williams has gained valuable knowledge and data from ventures in Formula 1 and Formula E, which it is now employing to solve challenges in racing

2013 Revenue by Division



2016 Revenue by Division



and the development of road-car electric vehicle technology. Although WAE's involvement in the car arena is confidential, evidence of their impressive progress, however, can be found in pre-production vehicles such as the Aston Martin RapidE[2] fully-electric concept car (set to enter production in 2019) and the Dendrobium hypercar[3]. Both projects represent the strides Williams is making in road cars, thanks to their involvement in Formula E. Furthermore, independent of major automotive partnerships, WAE has introduced a lightweight EV platform concept, named the FW-EVX. This maximizes efficiency by 40% in comparison to conventional bodies and has the potential to be employed in various cars. This major move towards supplying EV technologies for major manufacturers, such as Jaguar and Nissan, has driven the share price up by 1-2 % after press releases.[4]

Risks

There are many market risks which Williams is prone to, including exchange risk, liquidity risk, interest rate risk and credit risk. In terms of firm-specific risk, the key driver in the Williams share price is sensitivity to earnings announcements. When expectations either fall short of or exceed realized earnings, this causes higher trade volumes than normal in response.

Williams has not paid dividends to date. This indicates the future stock price will be determined by Williams' capacity to start paying dividends. Currently Williams is heavily reinvesting their earnings into research and development. This decision shows Williams is taking the necessary steps to increase shareholder returns in the near future, as WAE streams of revenue continue to increase. Williams may find themselves in a position to offer dividends from profits earned not only in F1, but from WAE as well.

Williams generates relatively consistent revenues from their involvement in F1, totaling approximately £100m [5]each year. However, F1's ability to continue this should be questioned given its decrease in viewing figures. F1 viewing figures have decreased by 17% between 2011 and 2015. This poses significant risk to Williams as sponsorship revenue would decrease if this trend continues.[6] However, Williams is heavily engaged in the new Formula E racing series. Williams has been manufacturing the 28kw lithium ion batteries that power all 40 Formula E cars. Following technical involvement there have been rumors Williams will enter their own racing team into the series. This could be a vital opportunity as Formula E provides new opportunities for both the Williams brand and as a test platform for WAE. Furthermore, Formula E has capped teams' operating budgets at £2.6m[7]. Compare that to Williams' spend of £108 million to compete in Formula One in 2016. This indicates a favorable low-cost entrance for Williams into the series. Overall, an entry to Formula E could serve as a hedge against the unpredictability of F1.

Future Outlook

The FIA's proposed regulation changes for F1's power units, due to be implemented in 2021, present significant challenges for Williams. Mechanically, these will include the removal of the outdated turbo-based energy recovery system and in turn will place more emphasis on the kinetic energy recovery system. This is a profound change as the kinetic energy recovery system is similar to what is found in hybrid vehicles. Hybrid power systems are a key area of innovation for Williams and have been for over 2 years. This could be fundamental in improving Williams' current performance in F1 and also provide notable revenues for Williams Advanced Engineering.

Furthermore, the FIA has further plans to cut costs to benefit smaller teams including Williams. They are hoping to achieve this by standardizing components across all aspects of the car, such as engine specifications, energy storage systems and electronic controls. Customer-teams, who are teams that purchase and use engines from other manufacturers, are always marred by the additional expense of having to redesign the engine bay to accommodate the new manufacturers' engine. This, coupled with the standardization of external car measurements, could have a positive impact on Williams Formula One. The Formula One team should benefit from reduced costs. However, the new regulations could stand to reduce the scope of technical solutions that WAE could be providing to the market of F1. The management could potentially misinterpret regulations and put Williams behind their competitors. Although WAE might stands to lose revenue from reduced innovation in F1, WAE's divisional revenue is not solely reliant on F1. We believe the benefits from the standardization of components should outweigh any loss of revenue incurred by WAE and provide Williams overall with significant advantages.

Conclusion

As WAE continues to grow, this places Williams overall in a strong position going forward. This is supported by industry trends such as the increasing adoption of electric transportation. Williams also looks set to become more competitive in Formula One, given the reduction in costs that now allow mid-tier teams a fighting chance against the likes of Mercedes and Ferrari. Furthermore, Williams have a partial hedge against F1 in Formula E, which will provide a platform for innovation in WAE. We believe Formula E is primed for Williams to enter in an advantageous position. Given current projections, the Williams Group can be expected to derive sufficient revenue levels from all divisions to start paying dividends by 2021-2022. This would likely have a large positive impact on share prices. This puts investors in a favorable position in the midterm to BUY.

Aurora Cannabis – Proceed with Caution

Sean Lim

Rating: Neutral (as of 20th January 2018)
Current Price: CAD $13.48
Target Price: Unknown

Revenue	17.81M
Revenue Growth	414.85%
Net Income	-2.64M
Revenue Per Share	0.04
Gross Profit	7.85M
Trading Data	
52 Week Range	0.00 - 11.83
52 Week Performance	455.15
Market Cap	4.87B
Enterprise Value	767.41M
P/S	224.60
P/B	21.29
P/Tangible Book	31.92
EBITDA	-14.70M
Operating Income	-15.97M
Net Income Avail. to Comm.	-2.64M
EPS	-0.00
Earnings Growth	88.75%
Gross Profit Margin	44.09
Operating Margin	-89.64

Summary

- The market for Cannabis stocks seems to be based more on speculative activity and hype rather than current fundamentals and prudent forecasting of the sector's potential.
- Cannabis stocks are on the soar currently due to impending legalisation acts in the US and Canada, with California having just legalised sales and Canada set to do so in June this year.
- Aurora Cannabis is set to be the largest producer by the time Canada legalises, giving it a tremendous cost advantage over competitors.

Key Factors in the Industry

- The Cannabis Industry is a highly price sensitive industry. As such, the long term sustainable trend for producers is to compete on scale, as consumers search for the cheapest brands available (even if this means buying illegally i.e. from shadow producers).
- Quality matters. Recreational users search for the highest-quality pot available i.e. the pot that gives the highest highs. This is determined by the level of THC (the chemical responsible for producing highs) within the weed. However, there remains the possibility that regulators might step in to limit THC levels in new markets, following studies that show severe health effects. Currently, there remains no legal limit on the amount of THC weed companies can apply, although industry averages converge to around 30%.
- Taxation is going to severely limit the potential market for legal cannabis. In California, prices of legal pot are at least 15% more expensive than they should be, inviting further opportunity for sellers in the black market to compete away licensed retailers' profits.

Industry Overview

Are Cannabis stocks the latest growth stocks? Is this an upcoming trend people have yet to look into? Are they worth investing in now? My answer to these questions are: I honestly don't know, and neither do I think analysts out there have a clearer vision without enhanced skepticism in their findings. What I do think, is that the market for Cannabis stocks is very sentiment-based and is likely to rally further given the global community's slow acceptance of cannabis as a socially beneficial drug, rather than a social stigma.

This follows from California's legalisation of recreational pot, although sales of legal cannabis in the state is likely to be weak, following producer taxationary woes - $9.25 per ounce of cannabis flowers, a 15% excise tax on the final product, leading to a 7.5% base sales tax rate,

on top of other local business tax rates which affect the profitability of weed companies. My conclusion is that the California legal market is set to lose sales towards its cheaper black-market alternative, given that pot is a regularly consumed, youth-targeting, thus highly price-sensitive product, making California-based pot companies weakly positioned to grow and highly risky to invest in.

Aurora Cannabis – Canada-based

Aurora stands out as the company with the highest sales potential to capture the Cannabis pot market, with its Aurora Sky project that is to finalise in July, at around the same time Canada is expected to legalise recreational pot. There are a number of reasons to be optimistic about Canada as a big potential market for Aurora:

1. A low effective tax rate: Canadian Prime Minister Justin Trudeau has openly mentioned not to tax legal marijuana exorbitantly, thus enabling Aurora and others to compete with the black market on more equal footing.
2. Aurora's scale: Aurora's Sky project will build an 800,000 square-feet facility to produce an estimated 100 tonnes of dried cannabis annually, making it the largest-capacity cultivator of cannabis, outsizing the current market leader Canopy Growth. This will allow it to compete heavily on price with Canopy and smaller producers.
3. Canadian demand for pot is expected to grow, with already 12% of the population using cannabis in 2015, consuming an estimated 697.5 tonnes of cannabis at $7.14 - $8.84 per gram. This adds up to a black-market estimate of $6.2 billion already in 2015 just within Canada. Even a relatively modest CAGR of 10% implies an $9 billion valuation for the Canadian cannabis sector in 4 years' time.

Aurora Investment Thesis

On a fundamental level, there is little basis to invest in Aurora because it's potential has been hardly realized. Earnings are currently based on sales of medical marijuana and given the small size of this industry (due to stringent laws defining a tiny proportion of medical users), all cannabis companies including Aurora have been reporting operating income losses, such as seen above.

A potential earnings figure can be estimated for Aurora, but that is based on an estimated recreational market and an estimated potential market share for the company, which in my opinion will be too figurative and highly inaccurate even with the most professional analysis.

Instead, I want to base my investment thesis on growth factors and potential catalysts that will uplift Aurora over its competitors.

Growth Factors and Potential Catalysts

1. ***Deals, mergers and acquisitions:*** One of the most promising factors for Aurora is its fast pace of growth, enabled by its $130 million pile of cash sitting currently in the company. It has acquired both Larssen Ltd and H2 Biopharma which can add synergies to its cannabis production unit. Larssen's high-tech, fully automated greenhouse technology is most-likely to lower further its cost of production and H2 Biopharma's state-of-the-art 48,000 sq foot cannabis production facility, which upon completion in 2018 will boost Aurora's scale beyond measure. Aurora's enormous scale gives it market bargaining power to set the retail price flexibly, as well as absorb any unprecedented taxation measures levied on its products.
2. ***Current scale:*** The Company operates a 55k square foot production facility in Alberta known as "Aurora Mountain" and a second 40k square foot high-tech production facility known as "Aurora Vie" in Quebec and is currently constructing another 800k square foot production facility, known as "Aurora Sky" at the Edmonton International Airport, as well as a fourth facility in Lachute, Quebec through its wholly owned subsidiary Aurora Larssen Projects Ltd.
3. ***Diversification:*** Aside from production, Aurora invests in R&D, owning a 20% stake in Cann Group Ltd, an Australian licensed company which conducts research on potential uses for medical cannabis. Aurora also owns Pedanios, a leading wholesale importer, exporter, and distributor of medical cannabis in the European Union, based in Germany.

Unlike its competitors, Aurora actively seeks to enter the European medical cannabis market, which currently has high demand for cannabis oils which Aurora can take advantage of.

4. ***Global Expansion:*** Linked to the topic of Diversification, but well-defined enough to deserve an analysis of its own, is Aurora's goal to achieve an international market, through a joint venture with Danish company Alfred Pedersen & Son, branching out Aurora's operations into Aurora Nordic, which will build a 1,000,000 square foot automated facility that will produce about 120,000 kg annually. The facility will be built in stages, with the first 200,000 square feet scheduled to be completed in the third quarter of 2018.

Risks

Of course, with any investment comes its risks. Similarly, with Aurora, there are big potential setbacks to consider, such as the convergence of the recreational cannabis market to a perfectly competitive market, especially given the competition over cost and scale with Canopy Growth and Aphria pursuing aggressive cost-cutting and growth policies to out-price and out-scale Aurora.

Secondly, and quite importantly, diversification and global expansion may be one step too soon. Given that the global cannabis market has only room for medical uses aside from a few states and countries, investing in cannabis is not a get-rich-fast strategy, rather a patient buy-and-hold struggle to see how the market will play out in the medium to long term. In the short-term, globally there is no attractive playout for cannabis companies, with marijuana still deemed illegal at the US federal level.

To many, past performance is no guarantee of future performance, but is certainly a good indicator of it, setting a yardstick for comparison. For companies like Aurora however, its past performance reports an operating loss of 16M for the year 2017 making it almost impossible to value the company, and is overvalued by a long-shot using current metrics, with a P/S of 200+ and a P/Tangible Book ratio of 30+, meaning you are paying $1 for every $0.005 of sales made if you buy the stock today.

Furthermore, when breaking down production costs across companies in the latest quarter, Aphria's reported oil processing costs is $0.05 per gram, while Aurora's oil cost per gram was a whopping $1.42 per gram. Aurora did not disclose any more details around the extremely high oil conversion costs, so this is one of the red flags that we will continue to monitor and hopefully get an answer soon.

Conclusion

My opinion holds that Aurora is still in its inception stage and has yet to prove itself as a valuable investment, other than a hype-fuelled, speculative investment. I am slightly bearish over the stock and would recommend to HOLD if you already have the stock, or buy only a small percentage of your portfolio <2%. Any money that you invest in Aurora can multiply or disappear, so invest only what you are willing to lose.

A safer way to play the cannabis market is to invest in Cannabis ETFs, such as the Horizons ETF (HMMJ) which invests in a diversified range of companies, from Aurora and Canopy to pesticides for cannabis, to pharmaceutical companies that use cannabis in various medicines.

Another way is to invest in Scotts Miracle-Gro, a leading lawn care company in the US with products ranging from pesticides to weedkillers, which will benefit from the boom in marijuana plantations sprawling across the US with 28 states already legalising the cultivation of cannabis. Given that the company is not directly exposed towards the marijuana picture, it may be a better investment for now when the future outlook for the industry is uncertain.

Notes: The terms cannabis, pot and marijuana refer to the same thing.

Disclaimer: The author is not advocating the use of cannabis, pot or marijuana in any way. The views reflected in this article is the author's own and the author has no stakes in any of the stocks mentioned.

Fullers (FSTA:LN)

Sam Woolston

Outperform

Current price: 952.00

Target: 1,100

Key statistics

P/E Ratio: 15.29

EPS: 0.62

52 week range: 896.00-1,124.00

Market capitalisation: 529.927M

Shares outstanding: 32.1M

1 year return: -3.91

Dividend: 2.01%

If a trip to the pub is the nations favourite pastime, you would not guess it from the standoffish attitude of investors. As asset prices boom, the price of shares in Britains largest pubs are crawling along at historic lows. Three reasons explain the markets sobering view.

The biggest factor is the prospect of stagnant consumer income, the key driver of pub revenue. Squeezed consumers as of late have caused an unrelenting hangover for the pub trade as many drinkers have proved all too happy to switch to cheaper fizz provided by supermarkets. Second, Brits as a whole are (unfortunately) becoming healthier. Volumes of alcohol consumed fell by 2% per year, largely driven by sharp upticks in the number of millennials opting to reduce their drinking or to quit the bottle altogether; teetotallers now make up 27% of the population aged 16-24 years, up from 19% in 2005. Finally, longer-term demographic trends are at play. Pubs in rural communities typically face falling demand as local populations age. Whilst demand for beer still booms in the cities, the Pubs here face the threat of soaring rents which rapidly erode margins. All in all, since 2001, 20% of pubs have called time. Given these reasons, it's no surprise that stocks in Britains publicly listed public houses look so woozy. Could it be time for investors to reconsider their positions?

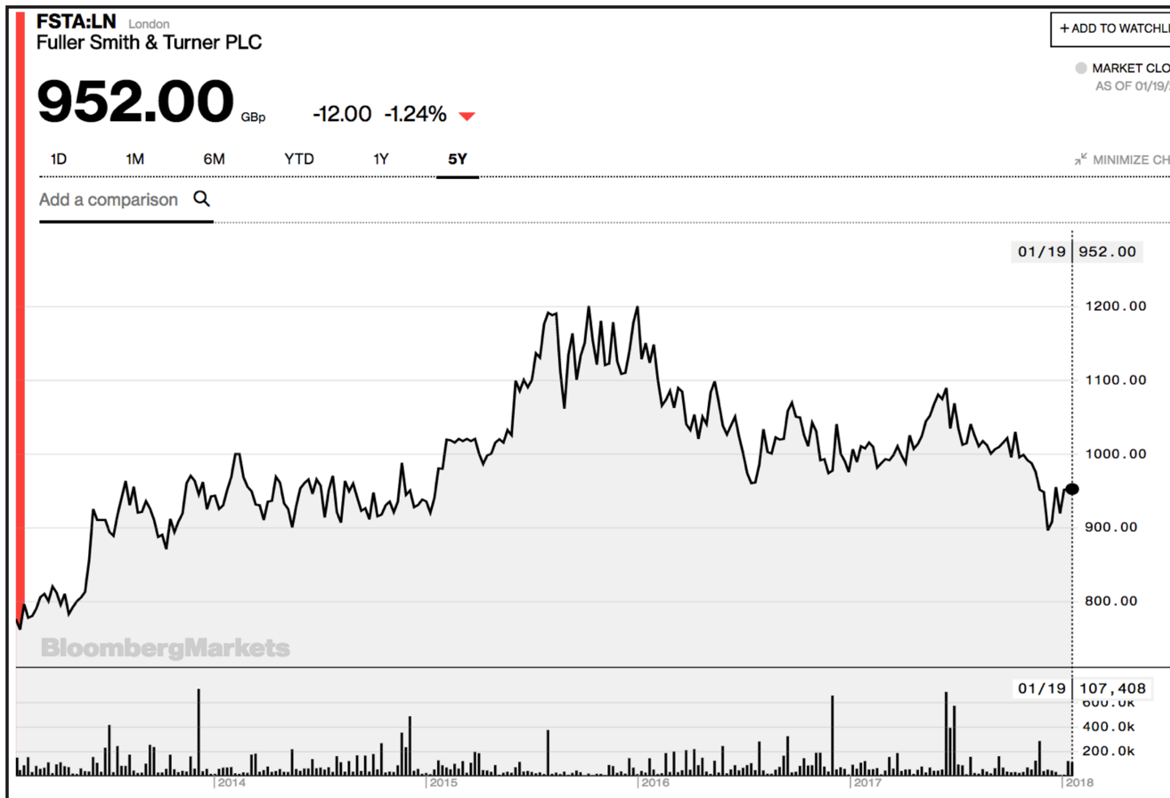
The recent earnings reports of a few pub chains suggest; yes. Despite the sobering trends taking place in the industry overall, a few pub firms look set to clear sustained growth in face of the industry's headwinds. One firm, Fullers, stands out in this regard. Its business model shields the firm from the sectoral decline, its fundamentals are strong, and its revenue growth would be envied by firms in any industry. Yet its share price is close to a five year low. Why? Its been severely undervalued.

Less beer, higher margins

The first interesting thing about Fullers is that, whilst beer volumes have declined in line with the 2% those experienced on an industry level, beer revenues increased by 5%. This is the result of a rampant premiumisation trend which continues shake up a portion of the British beer market, the most visible aspect of this is the reemergence of so-called "craft" beverages. Fullers have embraced these changes quicker than most in the managed pub sector and its consumers have proved all too willing to shell out for new and funky brews. Fullers has devoted more of their beer taps to featuring innovative new local beers than their competitors Weatherspoons and Greene King, which typically prefer to use their taps to favour cheaper beverages which they brew themselves. More quietly, Fullers have picked up the sole UK distributor rights for the products of Sierra Nevada, the world favourite craft brewery. With estimates for growth in the sales of Craft Beer are close to 8%, exposure to this market is a considerable opportunity for Fullers. Investors looking to gain exposure to this bubbly slice of the industry should buy the stock.

Property Locations and Favourable Property Ownership Structure

Another thing to note is that Fullers well-placed property portfolio which looks set to insulate it from the risk of the grizzly demand declines which have blighted the nations more rural taverns. Most of the firms 390 pubs fall in highly urbanised areas in England's South, characterised by relative affluence and a consequential healthy thirst. Income growth here has outpaced the rest of the UK contributing to a strengthening financial position. Fuller's revenue growth was 12% last year and its profit margin of 11% is high compared the performance of its competition. Fullers high degree of property ownership is also helping it fair better than its peers. Unlike most pubs which rent their premises, 88% of Fuller's pubs are owned by the company. This rate is the highest of any pub chain in the UK and will prove a boon as Fullers will avoid the devastating effects of rising rents on profit margins.



Risks

Before reaching for your beer goggles, it is worth highlighting a couple of the main risks Fullers may face. First is that whilst Fullers certainly seems to be ahead of its competitors in terms of following the Craft beer bandwagon, this section of the market is lucrative but capricious. Threats might not appear from Fullers presumed rivals but from the rapid growth of previously unknown upstarts. Another risk is related to Brexit. Depending on the evolution of the "Brexit deal", the concentration of Fullers' pubs in the South could turn into a disadvantage. Studies from the LSE suggest that this region trades most with Europe, and would therefore disproportionally hit in the event Britain's leaves the single market. Whilst the findings of this report are contentious, its worth close attention.

Risks aside, given Fullers' success in harnessing a share of the craft beer market, its overexposure to affluent and fast growing UK regions and its relative invulnerability to the vicissitudes of the rental market, Fullers deserves a solid "outperform" rating.

	Price (GBp)	Revenue	Revenue Growth	EPS	P/E	EBITDA	Profit	Profit Margin
Fullers	952.00	£392m	12%	0.62	15.29	£70.5	£42.9m	11%
JDWWeatherspoons	1,279.00	1.595bn	4.3%	0.5	24.84	£202m	£135.7m	3.4%

Equity Research Report – Southern Copper Corporation

Jason Ng Cheuk Hei

Company Background / Business Model

Southern Copper Corporation (SCCO: NYQ) is a mining company that focuses on copper production, alongside with other by-products such as silver, zinc and molybdenum. It has one of the largest copper reserves in the world, with its operations mainly in southern Peru and northern Mexico. Its operations include both open-pit operations and underground mining operations. Open-pit operations create terraces that extract mineral resources in the near surface, while underground mining involves digging vertical shafts and horizontal tunnels to extract minerals deep under the surface.

Investment Thesis

As of 10 January 2018, Southern Copper Corporation is trading for $49.46 per share (Figure 1). The price has increased for more than 12 percent in December 2017, with a total increase of over 44 percent in the last year. Profit of copper production companies depends highly on copper price. By the end of December 2017, price of copper has reached over $7300 a ton, a sharp increase when compared to just $4000 a ton in early 2016, and is currently in its highest level in four years. The insufficient copper supply has been a major factor driving the copper price up. The yield of copper from each unit of ore mined has decreased gradually. In 2010, the average rate of yield of reserve of the 15 largest copper producers are around the 1.2 percent. The figure has dropped to around 0.7 in recent years. This make the supply become more and more insufficient when facing the demand. Although there exists a deficit in supply in copper, Southern Copper Corporation is one of the few major copper suppliers that are able to maintain, and even increase, their average rate of yield. Southern Copper is therefore able to benefit amid the rise in price with its relatively high rate of yield of copper. In 3Q17, the operating cash cost of Southern Copper decreased to $0.90 per pound, which is lower than $0.92 per pound in 3Q16. As of 10 January 2018, Southern Copper Corporation achieved a 6.62 percent year-over-year increase in revenue.

Figure 1

Catalysts

1. ***Electric cars***
   When comparing to most cars which use internal combustion engines, electric vehicles require much more copper in their manufacture. The lithium-ion batteries, motors, inverters, and charging points of electric cars all need copper. It has been estimated that a total of 83 kg of copper is required for every electric car, four times the amount of a conventional internal combustion engine car. Currently there are over 1 million electric vehicles globally, and the figure is predicted to increase to 140 million by 2035. An addition of 390 000 tons of copper will be needed by 2020 to meet the increase in demand for electric cars. The existing mines are not able to meet the large increase in demand for electric cars, and therefore new mines need to be explored to increase the copper supply, which a higher price in copper will be required to cover the exploration costs.
2. ***Ban of Scrap Metal by China***
   China is the largest consumer of copper in the world, taking up half of the global supply. China imported over 1.2 million tons of scrap metal in 2017, and now the government has decided to ban the majority of imports of scrap metal by the end of this year. This implies there will be a large increase in the demand for refined copper in China, and will benefits copper miners like Southern Copper Corporation.
3. ***Contract Negotiations***
   The supply of copper affects significantly its price, and the stability of supply depends a lot on the labor market of copper

Company	Beta	P/E ratio (TTM)	PEG ratio	P/B ratio (MRQ)	P/CF ratio (TTM)	P/S ratio (TTM)
Alcoa Corp	--	38.35	0.11	1.77	8.53	0.94
China Nonferrous Mining Corp Ltd	0.63	13.80	--	1.38	3.99	0.63
Arconic Inc	0.94	--	--	2.43	--	1.68
Anglo American plc	1.63	7.87	0.17	1.54	4.88	1.37
Freeport-McMoRan Inc	2.57	26.99	0.07	4.05	9.81	1.79
MMG Ltd	1.44	--	--	4.42	4.60	1.22
Jiangxi Copper Co Ltd	1.18	32.81	0.17	0.82	19.15	0.28
Rio Tinto plc	1.20	16.14	0.24	2.35	9.12	2.65
BHP Billiton plc	1.22	19.62	4.09	2.01	8.73	3.23
Average	1.35	22.23	0.81	2.31	8.60	1.53
Southern Copper Corp	0.63	32.19	0.38	5.80	20.83	6.18

Figure 2

production. In 2018 there is an estimate of 30 sets of labor contract negotiation, which accounts for a quarter of the world's copper supply. It is not uncommon to see mining strikes when copper producers negotiate labor contracts with workers. The large number of negotiations that take place in the coming year will potentially disrupt copper mining, causing an increase in the price.

Risks

Reduce in demand from China:

The demand for copper has increased a lot in China since 2011 as the Chinese government implemented stimulus packages to deal with the financial crisis. Yet, the property market of China has become overheated in recent years that the government is finding ways to cool down the market. It is expected that there will be less investment in infrastructure in China, which will affect the demand for copper.

Valuation

Nine comparable firms are used to evaluate the performance of Southern Copper Corporation. The price-earnings ratio, price-to-book ratio, price-to-cash-flow ratio and price-to-sales ratio of Southern Copper are 32.19, 5.8, 20.83, 6.18 respectively, which are much higher than the peer group average of 22.23, 2.31, 8.60 and 1.53 respectively (Figure 2). The relatively high P/E ratio, P/B ratio, P/CF ratio, P/S ratio suggest Southern Copper may be overvalued. Return on investment (return on asset) of Southern Copper is 9.33, which is substantially larger than the peer average of 4.44. This suggests the company's management is very efficient in using its asset to generate earnings. Gross margin (five-year average) and net profit margin of Southern Copper are 49.91 and 18.88 respectively, which are higher than the peer group average of 35.38 and 7.15 respectively. This suggest both the relatively high profitability in its manufacturing activities as well as the overall profitability. The interest coverage ratio and total debt-to-capital ratio of Southern Copper are 7.51 and 0.47 respectively, which are similar to the peer group average of 8.16 and 0.42 respectively. This suggest the firm's fair financial health when compared to its peers. (Figure 3)

Recommendation

The overall recommendation on Southern Copper Corporation would be a buy. Although the relatively high P/E ratio, P/B ratio, P/CF ratio, P/S ratio suggest Southern Copper may be overvalued, the price/earnings to growth ratio is only 0.38, which is below 1. Although the PEG ratio is still higher than most of its peers, its beta is only 0.63, which is the lowest among its peers with the peer average being 1.35. The higher PEG ratio may just be a result of investors being risk averse and therefore reward the lower risk of Southern Copper Corporation with a higher price. The high return on investment, gross margin (five-year average) and net profit margin suggest the high management efficiency of Southern Copper Corporation in generating profit relative to its peers. Together with the strong outlook of the copper market as a result of the catalysts mentioned before, it is recommended to buy Southern Copper Corporation stocks.

Company	Return on investment (TTM)	Gross margin (5 yrs avg)	Net profit margin (TTM)	Interest coverage (TTM)	Total debt to capital (MRQ)
Alcoa Corp	3.75	--	4.29	6.24	0.15
China Nonferrous Mining Corp Ltd	7.56	15.35	8.83	14.61	0.56
Arconic Inc	-3.81	16.81	-10.36	2.45	0.54
Anglo American plc	11.03	25.85	18.60	--	0.33
Freeport-McMoRan Inc	3.41	22.50	6.54	3.68	0.59
MMG Ltd	0.91	--	2.81	1.62	0.78
Jiangxi Copper Co Ltd	2.55	3.27	0.58	4.15	0.30
Rio Tinto plc	8.37	76.78	16.81	13.86	0.25
BHP Billiton plc	6.19	87.07	16.25	18.69	0.33
Average	4.44	35.38	7.15	8.16	0.42
Southern Copper Corp	9.33	49.91	18.88	7.51	0.47

Figure 3

Marks & Spencer

Jackson Yip

Overweight

MKS.L, MKS LN

Price: £304.00 (Date of price: 19/1/2018)

Price Target: £384.00

P/E Ratio: 9.9

EPS: 30.36

52-week Range: £398 - £296

Market Cap: £4.93 billion

Shares Outstanding: 1,636 million

Company Overview

Product mix: The company believes c.60% of its products are differentiated, with the remainder comparable with competitors' offerings.

Revenue mix: The UK accounts for 89% of M&S revenue. International makes up the balance. Food contributes 60% to total UK sales and Clothing & Home 40%. It is expected the proportion of food could grow to 75% within five years.

Margin mix: The UK operations account for 85% of the company's adjusted EBIT. Overseas represents 15%. In the home market, food produces 46% of gross profit, with Clothing & Home at 54%.

Investment thesis

A five-year turnaround plan that focuses on efficiency savings is in place. We believe the plan, which brings an estimated annual cost savings of £340 million, is strategically coherent and well-thought-out. While we acknowledge that this could adversely affect revenue in the short-term, we expect margins to rise over time.

The new management focuses on improving customer loyalty in both price and non-price aspects. With lower prices but fewer promotions becoming the norm, we expect a positive effect on sales that will translate into higher margins. Shoppers looking for niche offerings will contribute to further sales growth.

M&S's online shopping penetration rate shows considerable room for growth. We expect improvements in its online platform and delivery efficiency to result in stronger online earnings.

Catalysts

The first four catalysts are related to the five-year turnaround plan.

1. ***A more streamlined UK distribution network improves efficiency and customer service, which boosts gross margins*** by increasing sales and lowering costs. The closing of its Neasden site and the opening of a new distribution centre in Welham Green, Hertfordshire, provide a more agile network, hence better availability for customers. By making use of this "single-tier" logistics system (where clothing is directly sent to warehouses, then straight to stores instead of having to go through multiple warehouses), we believe a wider range of products will be available in each store. Besides, the better transportation links of the new site also make it more likely for online customers to receive their order within a day. We expect these to generate revenue increases both online and in-store, at 5% and 2% respectively.
2. ***Operation in fewer wholly-owned markets drives down costs.*** While local and international shop closures, as well as sales of retail businesses abroad will adversely affect short-term revenue, we expect margins to rise over time. Taking the online retail market in mainland China as an example, boosting sales means slashing margins due to the cutthroat competition. Therefore, it is unsustainable to continue operations there. We believe M&S has made the right decision to quit, and expect savings of £20 million along with other closures.
3. ***Technology partnerships with Tata Consultancy Services enable M&S to achieve efficiency savings and acquire better analytics capabilities,*** thereby improving its competitiveness against tech-savvy rivals including the brick-and-mortar giants Zara and Primark, as well as online fast fashion sites. This involves a revamp in its computer systems, which allows M&S to adapt more quickly to fashion trends by, for example, replenishing stocks faster for products in high demand. We expect M&S's transformation into a digital-first business to result in savings of £30 million by the early 2020s.
4. ***Scaling down the opening of new Simply Food stores lowers cost - and is unlikely to obstruct revenue growth if executed carefully.*** While the opening of new Simply Food stores has been the key revenue driver of the firm for the last decade, we believe the momentum is fading, due to the increasingly intense competition in the food retail industry. Despite the premium positioning of M&S food products, the brand has yet to distance itself from the competition of supermarkets, which are making strides in improving the quality of their premium offerings. Consumers, on the other hand, tightened their budget in response to stagnant wage growth against a backdrop of rising inflation and Brexit uncertainty. These all led to the stall in Food sales growth. Therefore - contrary

to general consensus - we believe putting the brakes on the Simply Food expansion is the right strategy, especially when the standalone stores, unlike larger ones, fail to contribute to the C&H business. We think the scale-down also puts a smaller strain on supply chain operations, which guarantees the availability of products better and generates less wastage. Besides, it is worth noting that the smaller franchised units, which are mainly located in transportation hubs, have much higher sales densities than the main food halls. While the revised expansion plan creates fewer units, it could still preserve much of that margin growth if the new stores find themselves in the right places.

5. ***Improved pricing consistency restores consumer confidence in prices. M&S's new strategy of lowering prices instead of carrying out excessive promotions boosts sales without compromising much in margins.*** Customer loyalty was marred by the many confusing promotions across the business, which created unreasonably wide price gaps between upmarket offerings and basic items, leaving customers confused about the quality of the lower-priced items and the value of the remainder. We believe M&S's improvement in pricing strategies could reconstruct brand loyalty. Besides, M&S is reducing prices to attract younger shoppers in C&H, while avoiding short-term promotions like the Black Friday. While the strategy has resulted in a one-time price drop on 2,700 lines, products like ribbed jumpers have recorded significant sales growth of more than 60% YoY. Therefore, we believe this strategy could increase margins despite lower prices.
6. ***Product differentiation builds up brand loyalty.*** M&S stands out from high-street peers with new developments like the launch of CURVE collection for its plus-size customers, which opens doors to a lucrative industry with an estimated worth of £5.4 billion. This demonstrates its willingness to expand its customer base. We expect significant sales growth to follow initiatives like this, due to the presence of relatively few competitors in the niche market.
7. ***The firm has high potential for online growth,*** as it generates only 18% of its non-food sales online, but has a target to drive that up to a third in the medium term. We believe its relatively lacklustre performance in online sales could be attributed to the inefficiency in the logistics network. The firm's plan to streamline distribution makes one-day delivery more likely, which increases customers' willingness to use the online platform. Besides, its technology partnership means the online platform could be refined to attract more new users, particularly the young. We see promising sales growth opportunities in this segment.

Valuation

We set our price target at £384, which is based on c.8x multiple - 35% lower than long run average to reflect intense competition and structural changes in the industry. While EV/S multiples at the moment may suggest this target is a stretch, we believe the pickup in sales starting from 2Q 2018 to bring the multiples closer in line with our forecast. Indeed, the retailer's Trailing Twelve Months EV/EBITDA at 5.3x is a discount to the industry average of 6.3x. As business prospects are expected to improve, we believe the stock is undervalued.

Investment Risks

1. ***Economic environment:*** The retailer's margins are susceptible to changes in macroeconomic conditions. A "Hard Brexit" or a no-deal scenario could lead to a much weaker pound, hence exorbitant rises in input costs. On the other hand, Brexit uncertainty also leads to a prolonged period of stagnant wage growth and weak consumer sentiment. However, with the recent "Soft Brexit" developments, we believe this downside risk is limited.
2. ***Structural change:*** consumers' shift to online shopping. While competitors like Amazon are grabbing more and more market share, M&S is also stepping up its efforts in online sales. Even if M&S's transformation doesn't result in an immense success, we don't see online shopping as a perfect substitute for the traditional shopping experience. It is because some customers may enjoy the interaction with staff in brick-and-mortar stores (particularly in clothing), and it is much more difficult to return goods online than in-store.
3. ***C&H business may not be robust enough to make up for the Food weakness.*** Its 3Q 2017 C&H revenue dropped by 2.8%, but it could be attributed to the warm October weather, which reduced the sales of high-priced coats and put more stock into the December sale. We believe if product differentiation takes place successfully with careful inventory management, C&H could still see substantial growth.

Conclusion

We believe the market is overly pessimistic about the country's retail sector, and in particular, M&S. We have faith in the brand, which has a 130-year heritage, as it goes through a turnaround plan to cut costs, and takes a new path in technology, pricing and differentiation to generate growth in a challenging market. While it remains to be seen whether the turnaround will be a success, we believe the plan is a feasible one. Investors should act quickly to avoid regrets when the retailer's transformation efforts begin to bear fruit, which could happen in as soon as a year.

Adobe Systems Inc. (ADBE)

Niclas Hallberg

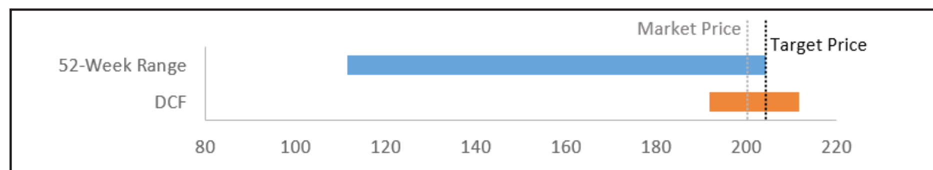
Recommendation: HOLD

Rating: Equal Weight

Market Price (23/01/2018): $200.09

Target Price: $204.60

52-week range: $110.30- $204.45



Investment Thesis

Decent but Very Uncertain Growth Potential - Adobe has a strong, recognisable brand centered around its famous Photoshop image editing software, and a marketing platform business making inroads into AI. However, the firm faces there are currently free alternatives to many of Adobe's offerings, and market competition is toughening. Lastly, most of the firm's competitors are utilising AI technology, making it unclear whether Adobe's move into the AI space will give it any comparative advantage in the future.

Secure, Long-Term, Stable Revenue - Adobe's push towards adoption of its cloud-based subscription model, combined with its brand name and diversified product catalog, will likely secure long-term revenue streams for the company.

Strong, Emerging Competition - The company is up against tech giants such as Google, Microsoft, and Facebook, while also being chased by increasing competition from younger firms such as Salesforce. All of these are developing and integrating AI into their products.

Watch Closely - While the market may be overvaluing Adobe right now we strongly advise to watch the company carefully. Its secured revenue streams should give the firm a good plateau to potentially grow from. Right now this potential is too uncertain in the long-term, but the less risk-averse investor may want to bet on this uncertainty even now.

Company Background

Since its founding in 1982 Adobe has been one of the largest and most diversified software companies in the world. It's first product, Adobe Postscript, which translated documents into a printing format, became the first international standard for computer printing.

The firm's history in print and publishing, as well as web application development, remains with the company as a host of legacy services running for Adobe's mature products. However, its current focus lies primarily in digital media, with Adobe Photoshop, its most famous piece of software. Around 2010 the company also diversified into digital marketing, which has since become its second largest business segment. Currently the firm is in the midst of developing and integrating its flagship AI, Adobe Sensei, into its various services.

Adobe's management views the brand as being "uniquely positioned to be a leader in both the Digital Media and Digital Marketing categories".

Business Model

Adobes main business model centers around its varied portfolio of software distributed through a Software-as-a-Service (SaaS) cloud-based model, allowing customers to access several of their products categorised under a single subscription. This is opposed to their previous straightforward product-sales model, which they are still partly in the process of transitioning away from. Their main two business segments focus on media and marketing, with a the tiny remaining minority of their business being a collection of legacy services and mature products.

Most significant among Adobe's continued transition towards a consolidated SaaS approach is the contractual changes to their software license agreements. For the past several years Adobe has been using End Term License Agreements (ETLAs) instead of their previous ELAs, the difference being that once an end-user terminates their subscriptions they cannot continue using Adobe's software.

Business Segments

Digital Media

Adobe's currently largest business segment, responsible for 69% of Adobe's total revenue in Q3. Main component is Adobe's Creative Cloud, which includes Adobe Photoshop, Premiere Pro, and InDesign created for image, video, and publishing layout editing respectively. The targets end-users ranging from large publishers, media companies, and global enterprises to design agencies, SMEs, and individual freelancers.

This segment also includes Adobe's Document Cloud used for viewing, editing, and signing PDF documents. Adobe has seen solid adaptation of this technology in government, legal, and financial industries.

The firm's stated approach for this segment is to continue migrating users from their old products to the new subscription model utilising the ETLAs.

Digital Marketing

This segment addition to Adobe's business accounts for 29% of the total revenue as in Q3. Similarly to their Digital Media segment the Digital Marketing Segment primarily consists of Adobe's Marketing Cloud containing a range of different software. Also of note is that this business segment utilises Adobe's AI, Sensei, more heavily than the Digital Media Segment.

Long-Term Performance

Adobe's currently largest business segment, responsible for 69% of Adobe's total revenue in Q3. Main component is Adobe's Creative Cloud, which includes Adobe Photoshop, Premiere Pro, and InDesign created for image, video, and publishing layout editing respectively. The targets end-users ranging from large publishers, media companies, and global enterprises to design agencies, SMEs, and individual freelancers.

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The firm's stated approach for this segment is to continue migrating users from their old products to the new subscription model utilising the ETLAs.

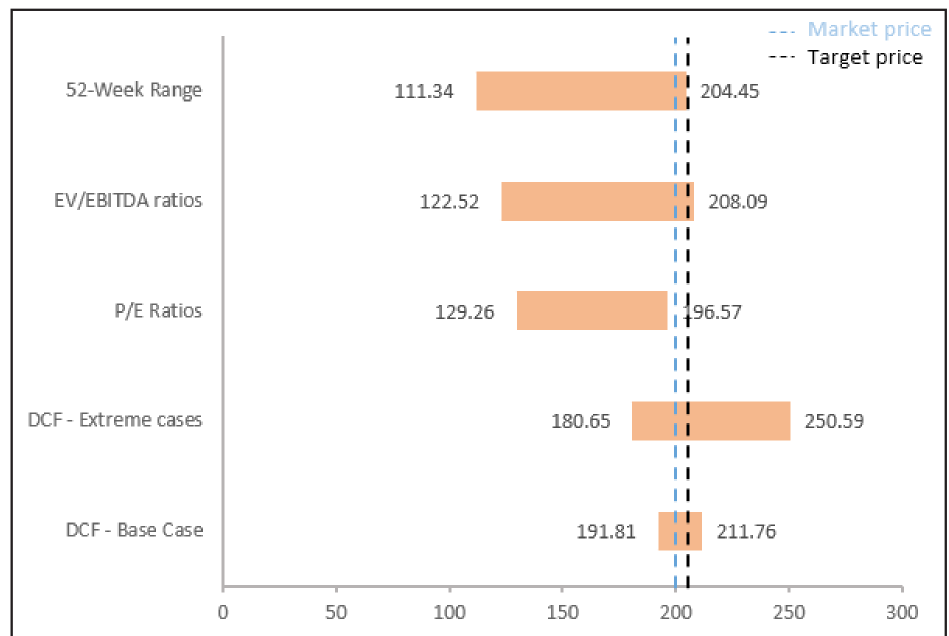
Risks

The greatest risk to Adobe, besides the risk inherent to the technology markets rapid pace, lies in its competitors. Adobe is far from the only company offering cloud services, and not unique in its thrust to utilise AIs.

When it comes to the Digital Marketing segment Adobe has to contend not only with giants such as Facebook and Google, both with their own AIs, but also younger firms such as Salesforce and Oracle, also utilising their own AIs. So the space where Adobe looks to have the most room to expand is becoming increasingly more competitive. For Adobe's Document Cloud there is competition from Google, Microsoft, as well as a host of free online alternatives that can provide functions similar to, but less comprehensive than, Adobe's software.

Despite to potentially great upside in growth potential that AI can bring, the current market situation makes it unclear whether this investment will lead to any great comparative advantage for Adobe. The first obstacle lies in Adobe's competition with far larger, leading technology firms such as Google and Facebook who arguable should have greater economies of scale to support their AI development. Furthermore, both of these are already huge in the marketing space and so offer significant competition to Adobe. In addition to this, in its Digital Media segment, it is unclear how Adobe's AI is going to greatly increase its product quality and thus lead to revenue growth.

Adobe has not indicating any great potential for innovation outside of AI, so this leads us to highlight the stability of the company rather than its growth prospects.



Football Field Analysis

Notes on graph: Here the Relative Valuation leads to a very wide range in the price indicated. On the upside the prices are pushed by strong projected financials for Adobe. These highly positive projections, and the corresponding imprecision of the Relative Valuation is mitigated and explained, respectively, by the inherent uncertainty to the venture of integrating AI and machine learning technology into a current product catalogue. The comparables have from firms with a similar SaaS business model, offering either products fully intersecting with Adobe's offering, such as marketing or digital media creation software, or a varied collection of software resembling Adobe's.

Here the Discounted Cash Flow valuation has been prioritized as more indicative of Adobe's inherent value, and the current base case range has been generated with a conservative to optimistic set of assumptions regarding the company's growth factors.

First steps to reconstruction? Iraqi International Bonds

Alex Graham and Jeremy Wong

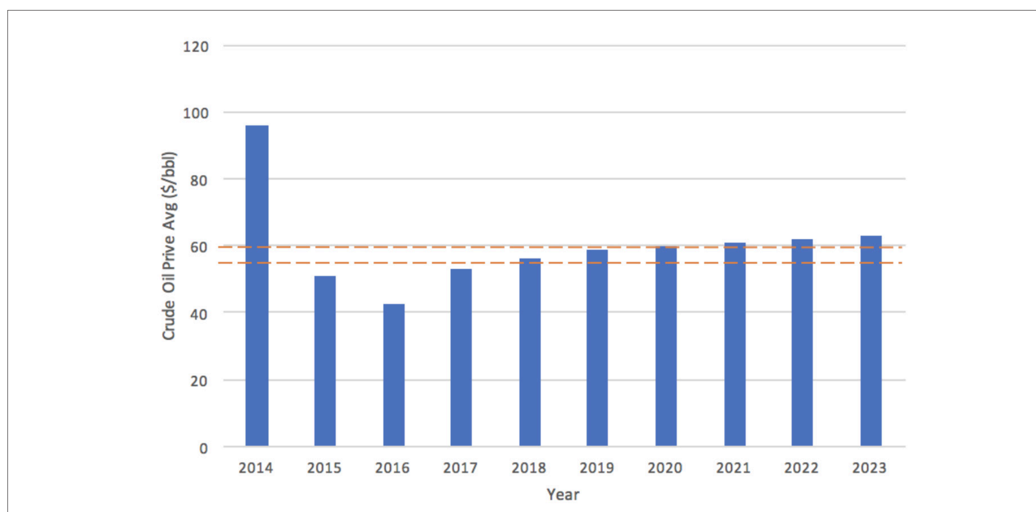


Figure 1: Projected Crude Oil Price by the IMF. The orange line denotes Iraq's price range estimate to remain economically healthy. [Source: IMF]

Overview

Following Iraq's second ever successful bond sale in early 2017, Iraq went back to the international capital markets to secure $1 billion USD worth of funding. The 6-year bond, rated B- by S&P Ratings matures on 09/03/2023 has an annual coupon rate of 6.752% to be paid semi-annually. Unlike the predecessor, this bond is not insured by the US government. The capital raised will go towards the reconstruction of infrastructure which has been decimated from years of conflict with ISIS as well as to help finance budget deficits.

Recently, these bonds have been popular with many investors amidst higher appetite for risk as low interest rates have forced these investors to seek higher returns. Rating agencies including Fitch have also raised Iraq's economic outlook from NEGATIVE to STABLE as a sign of the improving economic situation. However, are these bonds really a worthy investment despite the risks?

Oil prices (Marco-economic analysis)

Iraq is an incredibly oil rich country with the 5th largest oil reserve in the world providing the government with over 90% of its revenues. Although these vast quantities of oil can provide wealth for the nation, the oil price crash alongside the political turmoil in 2014 depleted much of the countries' foreign reserves and deep budget deficits which led to an emergency loan from the IMF of $5.4 billion. A recent statement from the Iraqi finance minister highlighted that balancing the fiscal budget will require the price of oil to be between $55 and $61. In order for oil prices to stay above this level, cooperation between OPEC countries remains vital. Currently, the OPEC oil production cuts have proven to be successful as oil prices have rebounded, but cooperation rates will be tested in 2018 as members including Iraq approach the limit as to what they can produce. As this limit is reached, Iraq will either have to invest in oil production facilities to boost productivity which is hard to finance given the current low oil prices or risk being unable to finance infrastructure projects to rebuild the country. Furthermore, other oil price risk factors including the oversupply of US shale oil as well as demand side factors such as lower than expected world economic growth and the rapid growth of alternative renewable energy sources would prove detrimental to Iraqi bonds. While there has been calls by the IMF to diversify the Iraqi economy from oil, efforts to do so by the government has been very slow or non-existent.

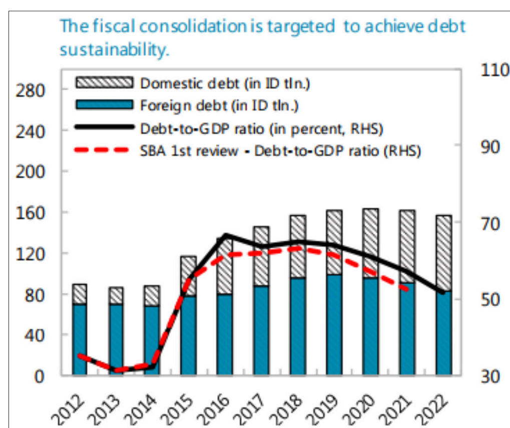


Figure 2 Iraq's domestic and foreign debt levels. SBA denotes the Stand-By Agreement between Iraq and the IMF. [Source: IMF]

Microeconomic analysis

The stand-by agreement between the IMF and Iraq and it represents a 3-year project committing to rebuilding the Iraqi financial sector and stimulating growth through restructuring state-owned banks. The agreement is subject to annual reviews to ensure that the Iraqi government is meeting expectations. The annual reviews in 2016 and 2017 showed that Iraq failed to meet expected benchmarks set by the IMF - which were subsequently waived, but there is a risk that future funding will not be received. Unlike other similar emerging market countries such as Saudi Arabia, Iraq is starting with a higher risk of insolvency as the government's total debt is 67% of its GDP compared to Saudi Arabia's 13.1% in 2016.

In terms of monetary policy, the performance of the Iraqi central bank has been mixed in recent years. Inflation has been controlled well between 0 and 2%. The pegging of the Iraqi dinar to the US dollar has helped to stabilise inflation but a fall in foreign reserves of about 50% and lack of transparency of remaining foreign reserves could lead to a surprise devaluation in the dinar which would lead to large levels of inflation and little monetary or fiscal tools to combat it.

Besides high reliance of oil, Iraq has also been plagued by security threats from ISIS and other regional terror groups. Although the prime minister of Iraq declared the end of the ISIS war in December 2017, political tensions in the region are still a cause for concern. The resurgence of ISIS militants in Northern Iraq has occurred where the national government has been unable to fill in the political vacuum. Frequent attacks to sabotage and plunder oil from pipelines towards Turkey, Jordan and Syria have resulted in investments in drones to be able defend large stretches of pipeline from insurgents and will start in operation in 2018. Further, sectarian divisions between religious groups has reduced the power of the government to implement growth enhancing policies and parliamentary elections in May 2018 adds to the political instability. These factors requiring the Iraqi government to invest more in defence and security may further impede the government from implementing the necessary reforms to ensure financial sustainability in its economy.

Security & Competitive Analysis

When compared against the average of similar peers in terms of oil reliance like Nigeria, the bonds have little difference in terms of yields and spreads as they differ by at most 14 basis points each. Despite the risks, there are some plus points in investing in these bonds which have a spread of around 350 bps above US Treasuries which is very appealing given the low yields in investment grade bonds. Although the risk of default is much higher compared to similar emerging market bonds; in practice, sovereign governments are unlikely to default as governments or international bodies will usually step in to prevent such a default from occurring. This was true for Venezuelan bonds last year when Russia stepped in with an emergency loan to prevent outright default. In Iraq's case, it is likely that the US Government or the IMF will step in again should default seem imminent.

Conclusion and Recommendation

We recommend a hold on these bonds in the short-term and a sell for the long-term outlook due to the country's heavy reliance on oil for government revenue. While the price of oil has rebounded in recent years, there are a variety of significant risk factors highlighted above that may cause another crash in the market whilst the US shale oil producers will cap anymore significant increase in oil prices. In addition, we also expect global interest rates to rise again in the near future which would likely shift investors back away from high yield emerging market bonds and towards investment grade.

Tencent's Bonds

Simran Kangle and Akanksha Singh

2017 saw booming stock markets and the best global economic growth in seven years. At the start of this year's World Economic Forum annual gathering, officials from the International Monetary Fund upgraded their forecast for global expansion in 2018 and 2019 to 3.9%, the highest level since 2011. Despite a rocky start in 2017, mostly due to a fear of rising US interest rates and a stronger dollar, the Emerging Market debt sector continued to show resilience, driven by EM economic recovery, strong fundamentals and broadly attractive valuations.

During this period, with the exception of Venezuela and Turkish local bonds, it would be a struggle to find an EM asset which produced negative returns. In both the hard and soft currency space, major indices for EM government and corporate bonds showed returns anywhere between 7.5% to 13%. Asian markets are taking centre stage at the most ideal time, with their bond and equity markets growing rapidly. China has undoubtedly been the driving force for the region as it continues to open its huge domestic market to global investors, presenting incredible long-term opportunities for both alpha and beta seekers.

However, a mixture of optimistic and cautionary market sentiments sets the tone for 2018, with IMF officials already stressing that investors and policymakers should not become too complacent about continued growth. Due to the existence of downside risks such as potential irrational exuberance in financial markets, surging global debt and growth in geopolitical tensions, it becomes more crucial for investors to be selective.

As such, we bring into focus a company that may continue to see strong demand into 2018, despite the risk concerns outlined above. On the 12th of January, orders of Tencent's largest bond sale skyrocketed to $40bn, showing global investor's strong appetite for Chinese corporate debt despite a prior sell-off in sovereign bond markets. The Shenzhen-based tech group raised $5bn in a fixed- and floating rate bond sale, which spanned five- to 20-year maturities. Rated A-plus by S&P Global and A2 by Moody's, this bond issuance comes as no surprise; Asian groups – with the exception of Japan – have in total raised a record $340bn in the dollar bond market in 2017. This includes Tencent's close competitor, Alibaba, which raised $7bn last November, attracting similar demand.

With gaming contributing more than half its revenues in 2017, the internet giant Tencent dominates China – the world's largest video games market – as consumers shift away from PC to mobile gaming. It also has a strong foothold in the social media space, with over 980m users on its multi-purpose WeChat social media platform. Last November, the company's market capitalisation surpassed that of Facebook, becoming the first Chinese company to surpass the $500bn mark. Currently, with holdings in Snap, Tesla and Spotify, Tencent aims to use this cash raised to make further acquisitions and expand its business overseas and into other sectors.

If you're perhaps looking at the more conventional US tech market, there is evidence to suggest that Chinese technology empires such as Tencent are as good - if not better - options to invest in. A phenomenon that is driving the growth of Tencent and other Chinese firms is the 'reverse brain drain,' wherein which Chinese citizens that have gained the skills in Silicon Valley are choosing to return home. The big players in the technology industry are beginning to see that China is no longer merely a supplier of components but also a hub for innovation, with Google recently opening up an office in Beijing. The Chinese government is also placing emphasis on fostering innovation. They have adopted the Made in China 2025 strategy, which aims to use Chinese patents and

inventions in manufacturing. Tencent has just recently signed a deal with Google to cross-licence patents. This will allow the two companies to access each other's patent portfolios without being able to sue for copyright infringement. In short, Tencent stands to benefit greatly from the Chinese government's strategy.

Tencent had previously struggled to bring WeChat to foreign markets. A major reason for this is the fact that the firm's offerings are tailored towards the Chinese consumer, and they don't benefit from the censorship rules that the China has. However, the deal with Google and investments into US firms shows that Tencent remains highly ambitious to become a global empire.

In terms of competition within China, despite worse underlying fundamentals than Alibaba, according to debt investors Tencent seems the better - and safer - bet. With the two bond issuances happening so close to one another it is inevitable that these two companies will be in direct rivalry with one another. Tencent bonds are rated A2 according to Moody's Investor Services, a level below that of Alibaba's. Despite this, Alibaba has a higher spread than Tencent. One major reason for this is that Tencent has historically had less corporate governance concerns. Analysts also point to a WeChat premium factored into the bond prices. These companies do not directly rival one another in the fields they operate in, but increasingly Tencent is looking to move into the Chinese retail space, which Alibaba has a monopoly over.

Despite high valuations, we believe that Tencent is a good investment. It has shown strong growth over the past few years, and there are many strong growth opportunities in the future. Investors need only to look at the Chinese tech sector to see that there has been stable and persistent growth. Given the growth strategies of Tencent outlined above, we also recommend that investors should be mindful of certain domestic and global risks, which include fluctuations in the US dollar and the growing government debt in China.

US Treasury bonds: Has the bull run finally reached a turning point?

Ler Rui Lin

Since the early 1980s, the 10 year US Treasury bond yields have been steadily decreasing in a long bull run from a yield of around 16% in 1981 to current yields hovering between 2% and 3%. This is primarily because of low inflation levels in the US when the Federal Reserve under Paul Volcker decided to tackle the 14% inflation levels in 1981. WIth an inflation target of 2% in present times, it makes sense for bond yields to drop, as fixed income and principle from the bond investment will not erode much over time, making investors more willing to accept a lower yield.

Other reasons have kept bond yields low. Demographics of the population has also had a downwards pressure on bond yields. With a higher ageing population as the post war baby boom generation reaches retirement, the proportion of the population in the workforce has declined, dampening growth and thus interest rates. In addition, retired pensioners tend to buy more bonds, usually through an annuity that pays out a guaranteed income. An increased life span has also put pension funds under a greater stress, and many regulators require pension managers to buy more bonds to match the liabilities that have to be paid out as income to pensioners. With a higher demand in bonds, yields fall further. Another theory for the decreasing yields in the past decade would be the quantitative easing by central banks around the world to stimulate the economy post financial crisis. The Bank of Japan, China and the European Central Bank have been aggressively buying bonds, thus resulting in lower US yields.

Yet, recent developments in the market have shown US 10-year treasury bond yields rising to 2.642% this week, from 2.40% at the beginning of the year. Bill Gross, the so called bond king" and founder of Pimco, has even gone as far as to declare the US bond market to have entered a bear market. Jeffrey Gundlach from DoubleLine Capital echoes similar sentiments, albeit disagreeing about the timing of a bear market, believing that certain upwards pressures may drive yields up.

What has led to a turning point on a downward trend for the past 30 years? Central banks have been embarking on quantitative tightening with a stricter monetary policy. The Bank of Japan has announced that it would reduce purchases of long-term Japanese government bonds, concerning investors that central banks are moving away from post crisis policies which have kept yields low. The European Central Bank has also halved its monthly buying of bonds to €30bn from €60bn this year. While seemingly insignificant, these decisions was far from minor as foreign investors hold 44% of outstanding Treasuries, and mainly because analysts view bond purchases by the European Central Bank and the Bank of Japan as key factors behind overseas demand for Treasury debt. With a stricter monetary policy, bond yields are expected to rise.

In addition, the US economy has enjoyed an increase in growth this year, further aided by a large tax cut under the Trump administration. Unemployment levels are already low and wage growth may finally be triggered with the growth in economy. The Federal Reserve also intends to raise interest rates 3 times this year, which should leave to a drop in bond prices and an increase in yields. With a rise in inflation and higher interest rates, there is much cause for bond yields to break the long standing bull run.

Of course, no story in finance remains this clean cut. There are reasons to doubt the sudden reversal of the bull run. Firstly, the tax cut will be going mostly to big corporations and businesses, rather than the lower tier of the economy with a higher propensity to spend the extra money they get due to tax cuts. This means that there may be a limited growth in the economy even with the tax cut. Wage inflation may also never take off. If there is an unrealised workforce in the economy, meaning workers who have previously been unable to be employed, extra demand for workers need not be inflationary. It is also important to note that ageing demographics are a consistent force in driving yields down, and it will take time for demographic patterns to shift.

It seems reasonable to predict that change, if any at all, to US Treasury bond yields, will not occur overnight and probably not in 2018. It is however, important to keep an eye on US Treasury bond yields, as the historically downward trend has become a backbone for much of the finance world, with yields used as the widely accepted "risk free rate". Investors have taken on additional credit risks on the notion that rates will stay low as low yields lead to cheaper lending and borrowing rates. The Congressional Budget Office calculated that costs on US federal debt will rise from $270bn to $712bn over the next decade if 10-year yields rise from 1.8 per cent to 3.6 per cent (excluding the Trump tax cuts). A sudden increase in yields could renew a financial crises and raise the risk of bankruptcies as debts become much more expensive. A reversal of one of the most fundamental trends in the financial world if the bull run for bond yields end could change the terms of trade and present a great risk. It is better to hold the bond for now until it becomes clearer the trend that the yields will follow. It is still unclear whether the bull run is indeed over, or if the downwards trend will persist.

Alibaba Issues 2nd Multi-Billion Dollar Bond

Kevin Chee and Seah Wen Xin

Executive summary

Last November, Chinese e-commerce giant Alibaba Group Holding Ltd sold a five-tranche dollar bond with maturities up to 40 years. This includes 5.5-year, 10-year, 20-year, 30-year and 40-year maturities. It is the company's second visit to the bond market in 3 years after it sold US$8 billion of debt in 2014 just a couple of months after its initial public offering. The bond issue was on the back of its fastest pace of sales since its IPO, with record retail sales of US$ 25.4 billion for the recent Singles Day Festival, an annual cyber shopping event. The forward momentum of the company's performance has attracted a blow-out response to the US $7 billion bond issue, the biggest sale in Asia from a non-bank issuer. With investor orders on the deal reaching $46 billion, over six times its size, the deal went against the trend of corporate bond offerings being bought largely by investors in the region as it was oversubscribed globally. As such, a buy on Alibaba's bonds is recommended.

Market Context

Nevertheless, this multi-billion dollar bond issue out of China is amidst market jitters in China over Beijing's drive to decrease debt in the corporate sector. Aside from the steady Yuan, Beijing's attempts to decrease unregulated lending by raising borrowing costs in the interbank market has driven many other companies, including Alibaba, to seek funds outside of mainland China. Apart from gauging investors' confidence in the company, the proceeds of the bond issue will be used for general corporate purposes which includes investing in long-term cash flow growth, repayment of offshore debt and potential acquisitions of complementary businesses. Alibaba is certainly a high-quality issuer as it has a dominant market position in the e-commerce industry and has solid positive cash flows. In the same month, Alibaba also announced its revenue for the quarter that ended on September 30 increased 61% from a year earlier, while net income also more than doubled to 17.7 billion Yuan. Its performance in the Singles Day Festival in which sales was up 39% a year ago has also reassured investors that the company remains to be in a strong position which has led to Morgan Stanley, Citigroup, Credit Suisse, Goldman Sachs and JP Morgan becoming joint bookrunners for the proposed offering of the bonds.

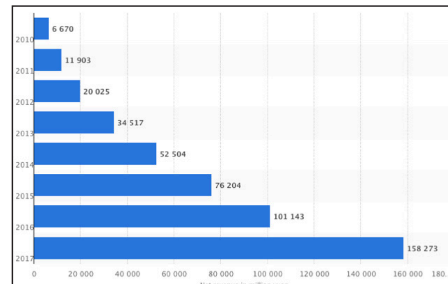


Fig 1: Growth in Alibaba's revenue from 2010-2017

Presently, China is the world's largest and fastest growing e-commerce market. This is driven by the expansion of dot-com companies in China driven by economic growth, a strong supply of highly trained labour and significant government support in the tech sector. With its middle-class population projected to exceed 600 million by 2022, nearly twice the entire U.S. population, and with retail spending stagnating in much of the developed world, China represents a unique opportunity for sales growth. Claiming two out of 10 spots in the global top 10 companies by market capitalisation, China's BAT trinity of internet giants—Baidu, Alibaba and Tencent, is also becoming increasingly prominent.

Risks & Catalysts

The rising competition with rival firms could pose as a threat to Alibaba's profit margin. Tencent, mainly known for its gaming products for many years, has been steadily rising as a formidable competitor to Alibaba, with an increasing overlap in their areas of operation, such as in social networking, online streaming and search engine services. Last year, Tencent, JD.com and U.S. retail giant Wal-Mart formed a coalition in a direct challenge to alibaba. This resulted in JD.com taking in 20% of Singles Day sales. On the other hand, as part of a wider push into offline retail, Alibaba is looking to invest $2.9 billion for a major stake in China's top hypermart operator, Sun Art Retain Group, in a bid to take on Wal-Mart. Nevertheless, with higher credit ratings, lower leverage and a stronger balance sheet, Alibaba remains a safe bet. Furthermore, with its banking assets, payments in Alipay and rapid expansion into fund management, there is still massive scope for Alibaba to grow. In comparison to American F.A.N.G companies—Facebook, Apple, Netflix and Google, which BAT has been routinely been compared to, the diversification of the Chinese companies also make them less vulnerable to a pull-back and more capable of monetising their platforms.

Fig 2: Converging E-commerce Values

Alibaba also seems to be taking advantage of the current market conditions as the low inflation continues to suppress long-term rates and flatten the yield curve on the back of speculation of three interest rate rises by the US Federal Reserve in 2018. The tranches for the 5.5, 10, 20, 30 and 40-year maturities were priced at 73, 108, 118, 138 and 158 BPs over US Treasuries. A comparison with other bond issues of the same rating such as BP Plc and Qualcomm Inc whose financials are far worse than Alibaba's makes Alibaba's debt even more attractive to the extent that it seems debt investors are pricing in a China discount for the bonds.

Conclusion

After assessing Alibaba's accounts, CreditSights has an outperform recommendation on Alibaba's outstanding 10-year notes and a market perform rating on the rest of its bonds. With its ability to achieve fast growth while demonstrating prudent financial management and maintaining a stable credit profile, a buy on Alibaba's proposed bond is recommended and can be viewed as a good way to be exposed to one of the most stable names in the Asian investment-grade realm. The 20-year bonds also serve as a very attractive entry point as the pickup in the spreads and comfort in its fundamentals makes it rather attractive for risk-averse investors looking to diversify investments by purchasing equities or bonds of multi-national Chinese companies.

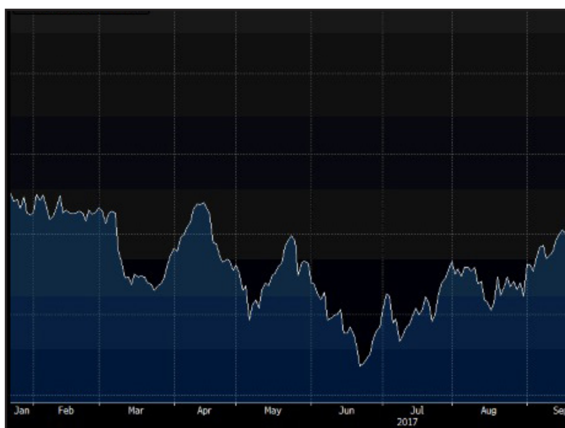
Betting On Valeant's Path To Recovery: Is It Worth The Risk?

Sang Hyun Kim

- VRX offered $1.5 billion of 9.000% non-investment grade bond that is set to mature in 2025
- The current management has successfully reduced debt down to around $25.7 B from $32 B
- Debt reduction will decelerate as the company shift focus from divestitures to free cash flows
- Debt/EBITDA ratio has not fallen significantly since 1Q 2016
- Rising generic competitions make future cash flow uncertain
- Postponing debt obligation will cost the company in the long run due to rising interest rates

Company Overview and Bond Detail

Valeant Pharmaceuticals International, Inc. (NYSE: VRX) is a Canadian specialty pharmaceutical and medical device company that develops and produces generic, branded, over-the-counter products, and medical devices. After series of scandals and disappointing acquisitions under the previous management led by former-CEO Michael Pearson, the company has been struggling to reduce its enormous debt, which was over $31 billion in 1Q 2016.



As part of the new management's overarching effort to control debt by postponing its obligations, the company recently released $1.5 billion of 9.000% senior unsecured notes due in 2025, priced at $98.61, on 4 December 2017. The proceeds will allow the company to repurchase three different bonds maturing in 2020 and, ultimately, cushion its debt obligation in two years from $4.3 billion to under $3 billion. This will be Valeant's fourth bond offering of the year, bringing up its total bond sales to $6.7 billion in 2017. Due to the company's high credit risk, the new 8-year bond has garnered 'junk' bond ratings of Caa1 from Moody's and B- from Standard and Poor's.

Competitive Analysis

The 9.000% coupon on the newly issued bond is the highest amongst Valeant's outstanding debt obligations, reflecting the company's worsened financial condition compared to pre-2015 when most of its other bonds were issued. However, since its offering, the bond's price has risen steadily, chipping away its attractiveness by making its yield comparable to, or even below, that of investment grade pharmaceutical bonds.

Future Outlook

CEO Joseph Papa, who succeeded Pearson in April 2016, has prioritized the reduction of Valeant's debt by tying executive cash bonuses to EBITDA rather than earning per share (emphasizing debt holders over shareholders) and divesting non-core businesses to generate more cash. So far, he has been able to exceed the market expectation through shrinking the company's debt by almost $6.5 billion since 1Q 2016. However, there are reasons to believe that the current debt reduction rate will be unsustainable and the company's bond will continue to be a risky investment with above average probability of defaulting.

Micro Trends

While Valeant's $6.5 billion debt reduction sounds promising, it is important to note that the company will change its debt repayment strategy starting in 2018 that may hinder its ability to repay debt. Since the beginning of 2016, Valeant has generated around $3.8 billion from divesting its non-core businesses like its skin care brands (CeraVe®, AcneFreeTM, AMBI®). This action has allowed the company to streamline its operation and

raise funds to pay off its debt. However, with Papa's decision at the end of 2017 to cease asset divestment and place more focus on strengthening its core businesses, the company will have to rely mostly on its free cash flow to pay back the remaining debt of $25.7 billion. The result of this decision will likely leave less cash available to reduce debt, and its success will depend on the company's ability to increase its profit, which has been mostly falling for the last two years.

Moreover, even though the company has steadily paid off its debt, its leverage, measured by debt/EBITDA ratio, has mostly remained the same, quarter over quarter, since 1Q 2016 due to its declining EBITDA. This problem poses a significant challenge for the current management because it will not only affect the company's ability to pay future obligations through free cash flow but also demonstrate an inability to sustain its core businesses, which thrived from price gouging practices under the previous management.

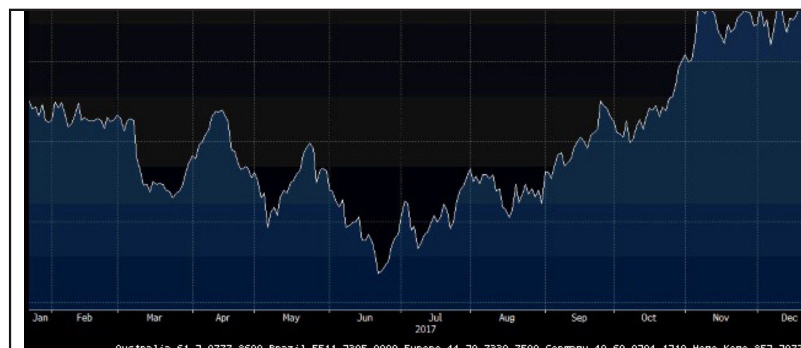
Lastly, Valeant's future cash flow growth is uncertain as rising competitions from generic brands are threatening the entire pharmaceutical industry. In the last few years, the US Congress has introduced new legislations like the CREATES Act that allow faster FDA approval process for generic drugs to prevent drug manufacturers from price gouging practices by increasing their competitions. Although Valeant's patent-protected drugs in its core brands like Bausch + Lomb, Salix, and Ortho Dermatologic (~70% of total revenue) will remain safe from these competitions, the market shares on its remaining brands will be significantly reduced. All in all, the company's cash flow will depend on its ability to successfully release newer drugs as patent protections on its existing drugs will eventually expire.

Macro Trends

One of Valeant's strategy with its massive debt is to postpone debt obligations to provide capital flexibility in the short term. However, with multiple interest rate hikes planned for 2018 and probably more afterwards, the cost of borrowing for Valeant to refinance its current debt will increase. Furthermore, with around 15% of the bonds being floating rate, the company's interest expense will rise along with the interest rates. If the company cannot accumulate enough cash to bring down the majority of its deficit before its current bonds mature, it will be paying much higher interest expenses in the future, putting the company in a worsened financial condition.

Conclusion

Given the company's uncertainty in future cash flow and enormous debt level, the current yield on the 8-year note is far too low for a risky high-yield bond. While the company is confident in a revenue boost from its upcoming "Significant Seven" drugs that will hit the market in 2018, the future cash flow remains uncertain with changing competitive landscape in the industry. Moreover, though Valeant's earnings from 3Q 2017 has shown some signs of sales increase in the company's core brands, its performance should be monitored for a longer time to justify that the growth will be sustained. Finally, with rising interest rates, investors seeking to buy one of Valeant's bonds will likely find better opportunities in the company's future offerings that will likely have higher coupon rates. Therefore, I recommend a strong sell on Valeant's 8-year bond for investors who cannot diversify away significant risk. For investors who can diversify the bond's risk, I would still be cautious and recommend a short-term hold and a long-term sell.



Brent In 2018: Don't Bet On The Party Ending Any Time Soon

Jake Kang Jin-An

> ***Key information***
> **Position:** Long Brent
> **Entry price:** $65.5
> **Stop Loss:** $56
> **Exit Price:** $100
> **Expected Return:** 53%
> ***Reward / Risk:*** **3.6x**

Demand and supply factors play a dominant role in price determination of oil prices in the global market. At the end of 2017, Brent crude LCOc1, the international benchmark for oil prices, had risen by about 18% year on year and U.S. crude CLc1 had risen by about 10% year on year. This was mainly due to robust demand growth and several supply shocks. China's oil demand rose by 690,000 barrels per day in July, marking a 6% year over year increase, with its total oil demand reaching 11.67 million bpd in July. In November, OPEC and non-OPEC producers led by Russia agreed to extend oil output cuts until the end of 2018, which saw Brent crude LCOc1 rise by 0.5% to trade above $63 per barrel. More recently, armed men blew up a pipeline pumping crude oil to Es Sider port on Tuesday, cutting Libya's output by up to 100,000 bpd. Brent crude LCOc1 rose $1.51, or 2.31 percent, to $66.76 a barrel and hit a session high of $66.83 a barrel, the highest since late May 2015. U.S. crude CLc1 climbed $1.29, or 2.21 percent, to $59.76 a barrel after touching a session high of $59.86, the highest since late June 2015.

Moving into 2018, the main determinants of global oil prices are going to be persistent demand growth, OPEC's robust commitment to rebalancing the oil market as well as increased US production and geopolitical risks. Firstly, the International Energy Agency's estimate for global demand growth in 2018 is 1.4 million bpd, and OPEC's estimate is 1.53 million bpd. The continued demand growth, especially in emerging economies like China and India, comes on the back of the recent global economic strength, which has exceeded many analyst's expectations. As a result, strong demand growth should continue to drive oil prices up in 2018.

Secondly, the decision made by OPEC and non-OPEC producers, led by Russia, to extend the supply cut agreement to cover all of 2018 will see a tightening of the oil market in early 2018 as they look to get rid of a supply glut, which may result in global supply and demand for crude oil to be largely balanced by late 2018. However, rising world oil prices has simultaneously raised concerns about the US shale industry filling the void left by OPEC's supply cuts, potentially derailing the cartel's efforts to rebalance the oil market. The OPEC as well as the IEA have recently raised their forecasts of Non-OPEC production growth to 1 million bpd and 1.5 million bpd, respectively. In recent months, U.S. shale producers have surprised market participants with how quickly they have ramped up production in the wake of rising oil prices, which capped Brent Crude prices at about $63 a barrel despite OPEC's extension of their supply cut. This response of shale oil and other producers to higher prices is going to further incentivise OPEC and Russia to reduce their now greater capacity, thus leaving risks to prices skewed towards the downside over the long term. Furthermore, with the Saudi Aramco IPO listing to come in the latter half of 2018, OPEC kingpin Saudi Arabia would have greater incentive to increase compliance among the OPEC producers, which is now at 86%, as well as its commitment to rebalancing the market as the higher the price of oil, in order to boost the price it will fetch in its upcoming IPO. Hence a stronger than anticipated OPEC-led commitment to extend production cuts would likely support oil prices through the end of 2018.

Lastly, another key price driver of oil in early 2018 would be geopolitical developments, specifically in the Middle East. Yemen is currently experiencing a conflict in which more than 60,000 people have been killed or wounded, and which has triggered a cholera epidemic and famine. Meanwhile, Qatar is suffering from a blockade enforced in June by Saudi Arabia, the United Arab Emirates, Bahrain

and Egypt. Heightened tensions in the region would likely drive up global oil prices as production would be disrupted. In addition, Venezuela's worsening debt crisis has hampered the OPEC member's oil production. Amid intensifying economic pressure, its productions levels have decreased to levels not seen in more than 30 years. Hence overall, the factors that could lead to a decrease in supply, as well as robust demand growth for oil, outweigh the increase in production of US shale, and thus a possible trading strategy would be to go long on Brent crude LCOc1.

Figure 1

From Figure 1, the CCI and RSI indicators reflect that Brent Crude is currently overbought, which indicates that a mild, short-lived pullback should occur soon. In addition, a 'head and shoulders' pattern (refer to Figure 1) can be spotted in the MACD indicator, which indicates that the MACD may be peaking for now and momentum may , but we expect a pullback as soon as the 15-day moving average crosses and falls below the 30-day moving average. This would constitute a loss of momentum resulting in a price fall. Hence, a suitable entry point would be at $65.5 which is approximately how far prices would need to fall for Brent to close in on its 50-day SMA. A suitable stop loss in this case would be when WTI is around $50.0, for US Shale production to be a viable option, which would imply a Brent price of around $56.0. Based on the last time where the oil market was at its tightest, during Q12014 (refer to Fig. 2), Brent Crude prices were fluctuating around $105.0. Hence a suitable limit would be at $100.0. This would give us a risk/reward ratio of 1: 3.6. However, as the Saudi Aramco listing is one of the main drivers of oil prices, it is recommended to sell the position before the IPO as Saudi Arabia's incentive to increase compliance among OPEC producers and limit production will fall dramatically after the listing.

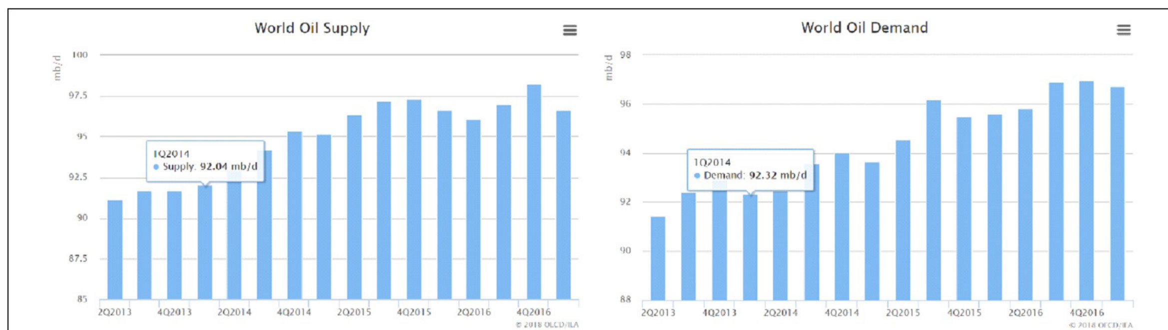


Figure 2

Gold: A Tale of Opposing Forces

Odin Mamo Haraldson

Key information

Recommendation: Short Strangle

Current Price: $1,275/lb

Legs: $1,300/$1,220

Expiry: December 2018

Premia Collected: $83

Break-Even Levels: $1,383/$1,137

2017 was a good year for gold, with the precious metal registering a gain of 13%. However, this appreciation was mainly due to a weakening U.S. dollar, with the DXY down nearly 10% for the year. Hence, measured against a wider basket of currencies, gold prices remained largely unchanged throughout 2017. My view is that this situation resulted from the cancelling out of 2 forces: global uncertainty (bullish) and an increasingly hawkish Federal Reserve (bearish). This article will analyse the current fundamental, demand-side scenario for gold and its implications for the market in 2018.

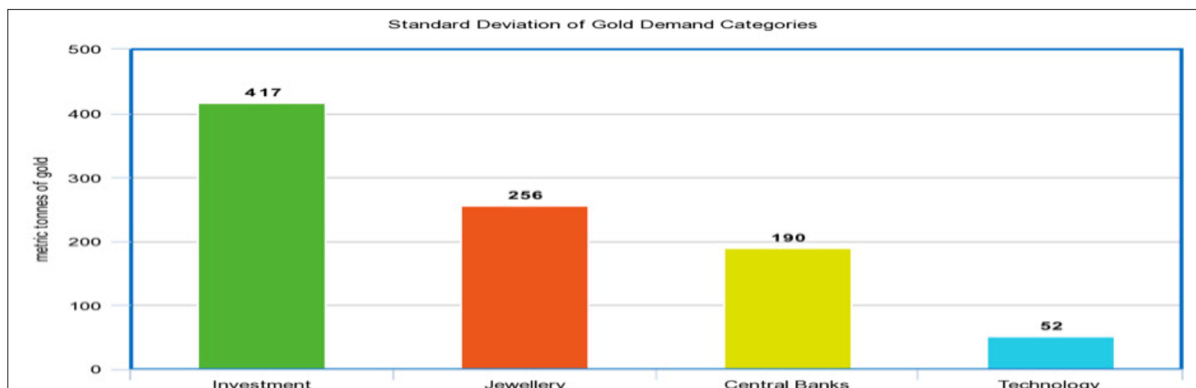
Demand-Side Analysis

Demand for gold can be categorised depending on the purpose of the buyer. The 4 categories are: investment demand, jewellery demand, central bank demand and tech demand. Every year, each category accounts for some quantity of demand for gold. The degree to which each category's respective demand level varies from one year to another determines the extent to which that particular category influences the total demand for gold. The bar graph below illustrates the standard deviation of each category's quantity of demand based on data from 2010 to 2016 (below).

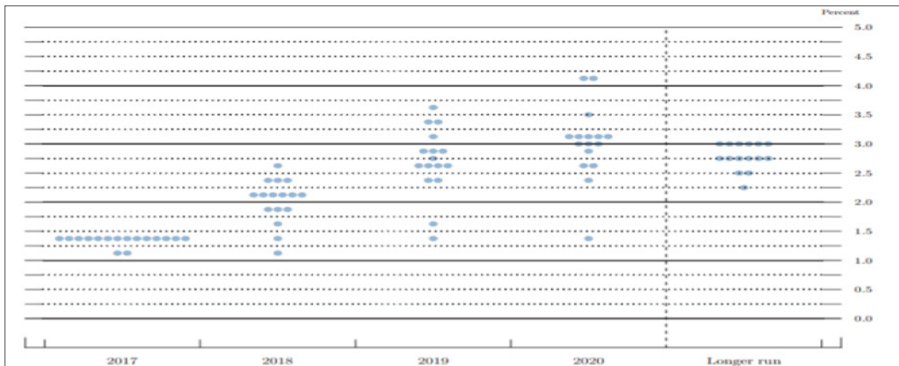
During the same period, the average total demand for gold was 4,432 metric tonnes. Hence, the standard deviation of investment demand was equivalent to 9.4% of the average overall demand for gold, implying that investment demand is by far the most important factor to consider in this demand-side analysis.

As an investment, gold serves as a hedge against inflation and as a safe-haven asset. However, holders of the precious metal forgo the possibility of earning interest on cash holdings. This means that generally, instability is bullish for gold prices whereas higher interest rates are bearish.

Currently, the federal funds rate range is 1.25% to 1.5%. 10 out of the 16 FOMC members expect the range to be 2% to 2.25% by the end of 2018, as



Bar graph showing the standard deviation of gold demand categories



FOMC members' assessments of appropriate monetary policy

illustrated by the December 2017 dot plot (above).

However, federal funds futures for January 2019 delivery imply that the market expects the benchmark rate to be just 1.885% by then. This indicates that the market has not yet priced in the rate hikes anticipated by the FOMC, and that gold prices are poised to weaken if the Federal Reserve delivers these 3 rate hikes in 2018.

At present, many analysts believe that Trump's tax reform plan will reinforce investors' risk-on mentality, causing equities to advance further and gold to retreat. However, I believe much of the reflation narrative has by now been priced into equities and gold following Trump's election, and that the tax reform will not be much of a threat to gold prices going forward. To the contrary, Trump's style of presidency (coupled with issues such as Brexit and North Korean hostility) is likely to reinforce the atmosphere of uncertainty felt throughout 2017 and prevent gold prices from falling significantly.

Unlike the case with many other commodities, supply-side factors do not contribute significantly to gold price changes. This is because 51% of gold demand belongs to the jewellery category, which is sensitive to prices. Hence, overall gold demand is relatively price elastic, meaning that changes in the supply of gold do not impact its price meaningfully compared to shifts in demand. Hence, no supply-side analysis is necessary in this article.

Outlook for 2018

The demand-side analysis does not provide a clear direction for the price of gold in 2018: higher interest rates point to a decrease in gold prices, while global uncertainty indicates that lower prices are unlikely. Consequently, my prediction is that these 2 opposing forces will cancel each other out, and by the end of 2018 gold prices will not be significantly different from current levels. From a technical standpoint, gold has been trendless for the most part of 2017, reinforcing my belief that prices will be range-bound in 2018.

Recommended Trade

My recommendation for options traders is to sell a strangle. I suggest selling equal amounts of American December 2018 $1,300 calls and $1,220 puts on the December 2018 gold futures.

I believe $1,300 and $1,220 are appropriate leg levels since they have both acted as support and resistance levels multiple times throughout the past year. Currently, these options can be sold on CME Globex for a combined premium of $83 per strangle. This implies a profit of $83 per strangle if gold prices remain within the $1,300 and $1,220 range. The trade incurs a loss if prices exceed $1,383 (i.e. rally by more than 8.5%) or fall below $1,137 (i.e. drop by more than 10.8%).

If the investor has a particular view on the future of the U.S. dollar in 2018, I would suggest shifting the trade legs up or down depending on the view. For instance, if an investor expects the DXY to rally by 10%, I suggest shorting the $1,170/$1,098 strangle instead (i.e. shifting the legs down by 10% each). This will ensure that the trade is hedged against expected changes in the dollar.

Daily bar chart displaying spot gold prices throughout 2017

Superpower Showdown

Nick Chan

Key information

Rating: Short USD/CNY

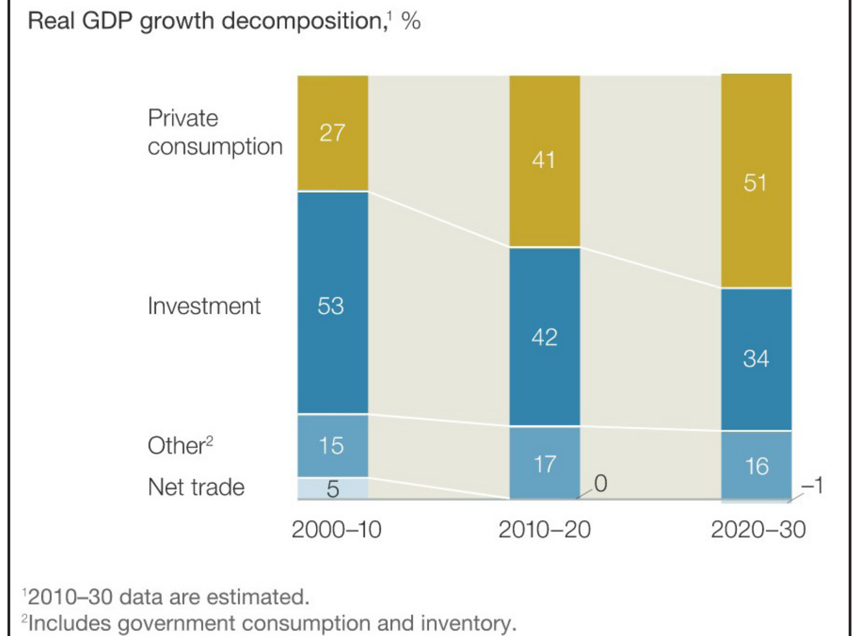
Entry Price: 6.40167

Target Price: 6.27351

Stop Loss: 6.45899

Expected Return: 20.01% (10x Leverage)

***Reward / Risk:* 2.24x**



Source: Global insights; McKinsey analysis. Figure 1

2018 looks to be the year China takes centre-stage, with the U.S attempting economic reflation through an "America First" foreign policy, and China picking up the slack as the leader of the developing world.

An Economy Divided

The Greenback weakened throughout 2017, with the U.S Dollar Index (DXY) down 10.2%, but can this weakening continue into 2018? While we expect the Fed to hike rates 2 more times in the coming year, we don't see these as giving strength to the Dollar and are instead strategic moves by the Fed to create room for monetary policy in the coming economic downturn. Currency appreciation as a result of increasing interest rates is front-end heavy, meaning most of the appreciation has already occurred over the past 2 years, and raising rates further will merely have a diminished effect. Another driver of the Greenback in 2018, the passing of Trump's flagship tax reform, has done little to help, having seen a sell-off after being priced in throughout November last year. We instead see these tax reforms doing more harm than good to the Dollar due to its steep cost, resulting in an even larger U.S national deficit, all this at a time when U.S treasuries are at their most unattractive. With a myriad of upward and downward drivers working on the Dollar, we in expect comparative weakening as the world looks to emerging markets in the coming year, mainly China.

China regaining momentum

While China as a manufacturing/exporting economy has grown at an average of 10% per annum, much of this has come with the constant risk of asset bubbles, debt-fueled expansion, and a foreign policy with little regard for its trade partners. No longer a developing economy, China now seeks to transition into a more stable, consumption/innovation led model of economic growth. A massive structural change like this comes at the expense of slower growth, from the highs of 12% post-crisis to a modest 6.7% in 2016. However, 2017 saw a change of wind, with growth picking up to 6.8%, breaking the declining growth trajectory. Is China nearing the end of its transition? Let's look at the stats:

- Consumption from 2015-2017 grew at 10% annually, and forecasted to add another 1.8 trillion (the size of the entire German consumer market) in the next 3 years, seen in Figure 1
- Investment as a percentage of GDP from 53% in 2010 to 44% in 2017
- Consumption as a percentage of GDP from 27% in 2010 to 38% in 2017

All signs point north, but we don't expect 2018 growth to outdo 2017's as China does have problems, it's lurking debt-crisis, a reliance on shadow banking, widening income gap and an uncertain housing market.

We do however, see a transition of power happening in 2018, and amongst the long agenda list of China, is the internationalisation of the Yuan.

The Yuan

Picture this, China currently has the 3rd largest trading economy in the world, but the Yuan only accounts for 1.7% of Foreign exchange reserves as of end-2017, absurd? Well, A reserve currency must have two features, stability, and a large portion of global trade must be conducted with it, both features long upheld by the U.S Dollar. Notorious for currency manipulation and capital controls, the Yuan remains only partially convertible, far from ideal. But more and more countries are adopting Yuan for use as reserves, and for bilateral trade, and each instance comes at the expense of the Greenback, the current global reserve.

- European central banks are replacing Dollar reserves with Yuan reserves, with Germany leading the charge.
- The Yuan was included into the IMF's Special Drawing Rights basket as of 1st Oct 2016.
- Yuan-backed oil futures contracts gained a foothold in 2017 against 4 decades of Petrodollar dominance.

Key catalysts for the Yuan

One of the key drivers for the Yuan in 2018 will be a growing number of countries adopting it's use for bilateral trade, the current total stands at 57 countries with Pakistan the as the most recent addition. That being said, we see the Yuan getting a boost as Xi Jinping's flagship One Belt One Road initiative continues to take shape, with OBOR-China trade already in upwards of USD240 Billion and OBOR countries excluding China making up 14.85% of Global output. As many of these OBOR countries have little to no relationships to the U.S Dollar or the Euro, we expect an increasing number of countries along OBOR routes to adopt the Yuan for bilateral trade in 2018.

A major catalyst for Yuan appreciation is in the works, as a decades-long mechanism of China accumulating USD reserves (3.1 trillion as of 2017) and using these reserves to purchase US treasuries (and in the process strengthening the USD and keeping Chinese exports attractive) comes to a slowdown. With China's economic growth decreasingly reliant on exports, the long-term end of the treasuries yield curve looking unattractive, and rising trade tensions, China will begin to seek lucrative investments elsewhere as it seeks to diversify and become less dependent on the U.S as a market.

Lastly, China has constantly kept the Yuan undervalued, either by devaluation or purchasing U.S treasuries. The red trend channel in Figure 2 shows the run up of the U.S Dollar due to a mix of Chinese devaluation and capital controls, bringing the U.S Dollar to artificial highs against the Yuan. In addition to a potential slowdown of U.S treasuries purchases, one driver of the Yuan's correction will be the normalisation of China's monetary policy, shifting towards a more interest rate/liquidity based, market-friendly approach. Look for the Yuan to continue gaining strength, a key support level at 6.44443 has just been breached and we expect the Dollar to fall back down to more natural levels given by the green trend channel in Figure 2.

Source: Bloomberg, USD/CNY chart, Figure 2

NOK/JPY: An Exotic Currency Pair Presenting Substantial Opportunity

Harvey George

Key information

Position: Long NOKJPY

Entry Price: 14.0500

Target Price: 14.5000

Stop Loss: 13.8000

Expected return (10x Leverage Assumed): 31%

***Reward / Risk:* 1.8x**

This report will take a bullish stance for the 6-8 month outlook for the exotic currency pair Norwegian Krone/ Japanese Yen (NOKJPY). Japanese 2018 monetary policy, G10 interest rates, Brent crude prices and geopolitical tensions will be evaluated, and risks will be discussed. Aggregated analysis will then guide outlook on price movement and a suitable trading strategy will be examined.

Fundamental Analysis

In the first half of 2018 global growth looks poised to continue its upward trend. As per Jan Hatzius and Jari Stehn, Goldman Sachs' chief research economists, 2018 should see 4% GDP growth. As G10 central banks execute their planned rate rises in 2018, the Yen should trend weaker because the Bank of Japan (BoJ) remains committed to their stimulus package imposed by Abenomics. This means that the interest differential between the Yen and other major currencies will increase through 2018, providing further downward pressure on the Yen as carry trade volume increases.

Belief in the continued BoJ monetary easing is reinforced by 2 events in late 2017. Firstly, Shinzo Abe's re-election in October, which quelled fear that Abenomics could be discontinued. Further, in a September press conference BoJ Governor, Haruhiko Kuroda, gave little indication of any motivation to divert from the current monetary easing package. Although there is slight concern about 'stealth tapering' by the BoJ, which could strengthen the Yen.

Figure 1

The recent rally in Brent crude prices, if it continues, presents another reason to be concerned about the strength of the Yen in early 2018. Japan's two largest imports by value are crude petroleum and petroleum gas which account for 14.6% of total import value. Rising prices will increase outflows of the Yen onto global markets and provide downward price pressure.

The Norwegian Krone is also an oil dependent currency – illustrated by figure 1 with an overlay of Brent crude prices and the USDNOK pair. Norway's 2016 crude petroleum and petroleum gas export value accounted for 49% of total export value, showing huge dependence on oil for export revenues. With this considered, we are not surprised that YOY the Krone has strengthened 8% against the dollar as Brent crude has increased 20.5%. With the outlook for crude in 2018 positive, as detailed by MRG analyst Jin-An Kang

in this issue of Perspectives, we see large potential upside for the Krone as oil looks to continue its uptrend from the last few months of 2017. Despite the fact that Norwegian inflation has been on a firm downtrend since a mid-2016 peak of almost 4.5%, the Norwegian central bank has indicated it is planning to raise rates from their current level of 0.5%. Further, economic growth has been positive YOY for the last 4 quarters with the most recent data showing 3.2% GDP growth and rebounding business confidence. An increase in economic activity could spur a quicker rate rise schedule by the Norges Bank.

Before I conclude it is necessary to mention that there is a further source of upside risk for the Yen, and it is geopolitical in nature. The Yen is considered a safe haven currency, thus when political uncertainty arises, typically in the US and Europe, the Yen strengthens. Significant risk is therefore posed to this trade if political unease arises from the US due to further policy mishaps or progression by Robert Mueller in his investigation into the Trump administration. Moreover, the Italian General election, held in March, poses risk as the populist 'Five Star Movement' lead according to some polls. These examples show a small insight into the events that could destabilise Western politics, which would manifest themselves in a stronger Yen.

Trading Strategy

Having concluded that the Yen has moderate downside potential and the Norwegian Krone to have upside potential, we will buy the NOKJPY pair (Per 1 Krone the amount of Yen it can buy will increase). Do note that many exchanges will not offer the NOKJPY pair directly. Exposure can be achieved by buying the USD/JPY pair and selling the USD/NOK pair, in equal quantities. We should keep in mind with this trade that the spread on the pair is quite large, thus we should aim to capture significant price movement to offset this notable cost of taking a position.

As figure 2 shows, NOKJPY has tested support 3 times against the 50-day moving average since August and then broke this support in late October and proceeded on a substantial and sustained decline below this previous support. As the second red circle shows, the price broke the 50-day moving average in early January and thus we may expect a substantial and sustained increase as per the previous occurrence. The price target should be established at 14.5000 as at this level we encounter previous trend reversal resistance and thus further price movement beyond this would be uncertain. If a position is entered at the current price of 14.0500 then a stop loss should be established at 13.8000 to allow for potential pullbacks because of the recent, almost uninterrupted, bull run of the pair. This gives us 1:1.8 reward/risk ratio and an expected return of 31% (10x leverage assumed).

To provide a summation, given the continued support for monetary easing in Japan, an uptrend in Norwegian interest rates, and the projected rise in Brent crude prices, the NOKJPY pair looks to rise in value. Despite minor concerns about stealth tapering by the BoJ and uncertainty around the continued bull run of crude oil, the largest source of risk is assuredly geopolitical.

Figure 2

USD/RUB: An Attractive Carry Trade

Myooran Vasieharan

> ***Key information***
>
> **Position:** Short USD/RUB
>
> **Current USD/RUB price:** 56.49
>
> **Target Price:** 53.50
>
> **Stop Loss:** 60.23
>
> **Expected return (Assuming 5x Leverage):** 51.5%
>
> ***Reward / Risk (After Adjusting for 5% Positive Carry):* 6.35x**

Since 2016, the Russian Ruble has strengthened against the US Dollar, with USD/RUB decreasing from 72.99 to its current level of 56.49. This is largely due to the Russian economy recovering from the Russian financial crisis that began in 2014, in which a fall in the price of oil and economic sanctions placed on Russia as a result of its military intervention in Ukraine led to the Ruble reaching record lows against the dollar. Currently, USD/RUB is being impacted by three factors in particular: the price of oil, international economic sanctions and monetary policy. Our position on the Ruble is that it will strengthen against the US Dollar in 2018, and we have targeted a price of 53.50 by the end of the year, which would make a return of 5.29%, as well as positive carry.

Crude oil accounts for 26% of Russia's exports and Russia is the second largest exporter of oil in the world. The rise in oil prices since record lows in 2016 have helped to boost the Russian economy. We anticipate that the bullish trend for oil prices will continue due to strong economic growth globally leading to more demand for the commodity and OPEC being likely to continue to keep production low, which will help Russia continue its steady GDP growth since the first quarter of 2017 (For our full analysis of opportunities in the oil market, see Kang Jin-An's article on Brent Crude in this issue of Perspectives). Although oil prices will also increase demand for USD through the so-called Petrodollar market in which oil is bought and sold in USD, we feel that, because of oil being such an important sector of the Russian economy, it will have a bigger impact on the Ruble than the USD. A possible risk to this trade is the possibility that OPEC fails to agree to cut production later this year, which could reduce oil prices and lead to the Ruble weakening. However, the UAE's energy minister has recently said that he does not anticipate any change in OPEC's current policy of reducing production, so the likelihood of OPEC raising production levels is low.

Russia's economy has been hit hard by economic sanctions imposed because of its interference in Ukraine and its annexation of Crimea in 2014, as well as due to recent allegations of interference in American elections. In August 2017, President Trump signed into law further sanctions against Russia after pressure from the US Congress. However, we feel that the likelihood of there being further damage to Russia's economy due to sanctions is low because any further sanctions will likely be aimed at individuals suspected of election interference rather than on the entire Russian economy. In addition to this, the US President has hinted that he will work towards better relations with Russia, which could increase investment into Russia and thus stimulate demand for the Ruble. However, the risk of further sanctions and the uncertainty surrounding the nature of these sanctions is perhaps the biggest risk affecting this trade.

The Central Bank of Russia has indicated that it will continue with its dovish monetary policy. Currently, the interest rate is 7.75% and the bank is expected to cut rates further to 6.8% (source: Bloomberg average) during 2018. However, we feel that

the market has already priced in this dovish outlook from the central bank, since it has been constant since 2015 and does not appear to be accelerating any time soon given Russia's strong economic performance of late. We believe that the differential in rates between the US and Russia is another reason to sell USD/RUB, due to the positive carry (which we expect to be 5% if the Federal Reserve raises rates to 2% and the Russian central bank reduces rates to 7%, as we expect them to do) that can be accumulated by borrowing a currency with a lower interest rate and using it to buy a currency with a higher interest rate. Overall, our outlook for the Russian economy is positive. GDP growth has been positive for the past four quarters (0.3%, 0.5%, 2.5% and 1.8%) and it is forecasted to grow by 1.9% in 2018 (source: Bloomberg). Inflation, a key determinant of monetary policy, is forecasted to grow to 4.0% by Q4 2018 (compared to 2.6% in Q4 2017). Russia's debt to GDP ratio, at 10%, is low compared to other emerging market currencies and its dependence on USD-denominated debt is low, making Russia's fiscal position strong relative to other oil-dependent nations. We expect the economy to grow and inflation to pick up, and we believe that this could cause the Russian central bank to cut rates at a less aggressive pace than the market now anticipates, meaning that the Ruble is likely to be undervalued at current market prices.

Our target price of 53.50 has been determined after considering the 5.76% fall in USD/RUB over the last year (61.26 to 57.73), and 2.14% fall over the last six months (58.99 to 57.73) which we expect to continue Through technical analysis, we have identified a resistance level of 60.23 and we recommend that, if the USD/RUB rate reaches this level, it may be worth ending the trade to prevent further losses. The main risks to this trade are the possibility of high-impact economic sanctions, a shock move by OPEC to raise production, and large reductions in interest rates by the Russian central bank to less than 5%. We believe that the attractiveness of this trade is boosted by the positive carry that can be gained along with the strengthening of the Ruble.

Private Equity: The bet on European Technology

Bill Kevin Roosman

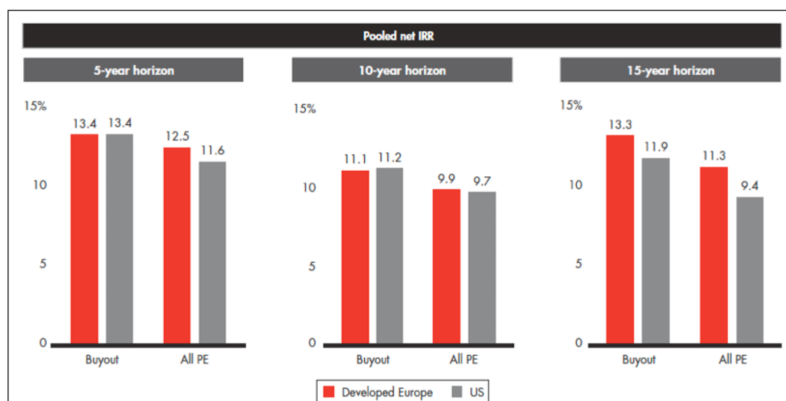
Private equity funds have experienced a record inflow of capital in 2017, surpassing the previous record set before the onset of the 2008 financial crisis. A total of 921 funds have secured $453 billion in investor commitment last year, with undeployed committed capital snowballing to over $1 trillion for the first time in December. Mega buyout funds of $4.5 billion or more are key drivers for the growth in fundraising, accounting for close to 40% of investor commitment last year. Apollo Global Management's 9th private equity fund – Apollo Investment Fund IX – raised $24.7 million alone, becoming the largest buyout fund ever. In fact, mega funds are likely to dominate the trend in the coming year, with SoftBank's technology-focused Vision Fund yet to reach its final close. This positive trend points to the strength of the fundraising market and highlights the potential pressure on fund managers to deploy capital in the coming quarters.

It seems that the laggard and fractured continent of Europe, coupled with an incessant barrage of headlines portraying a perpetually troubled region, would not merit the time and money from deep-pocketed investors. Rising sovereign debt, severe unemployment in parts of the continent and uncertainty of Brexit's exact path are adding heights to the scepticism about the durability of the EU. Yet, as the graph below displays, PE investments in developed Europe have performed better, or at least as well, as the US on a returns basis.

Some explanations lie in the ample supply of companies available for sale. The UK, Germany, France and Italy, for instance, have relatively more large-scale companies per unit GDP than many other parts of the world. Moreover, the lower level of deal value as a percentage of GDP in Western Europe countries also signifies the potential for growth, while the diversity of languages and culture poses a natural barrier to entry by outside firms that do not have a local presence. Furthermore, the shorter duration to use buyout "dry powder" in Europe, averaging at 3.3 years compared to 4.3 years in North America, has also put Europe at a more favourable starting point. Such trend is likely to continue into the near future, especially with the new tax code in the US – lower taxes will be seen to bite out the bottom line of heavily leveraged Main Street companies owned by private equity firms and will further reduce the incentives to overload their portfolio companies with debt.

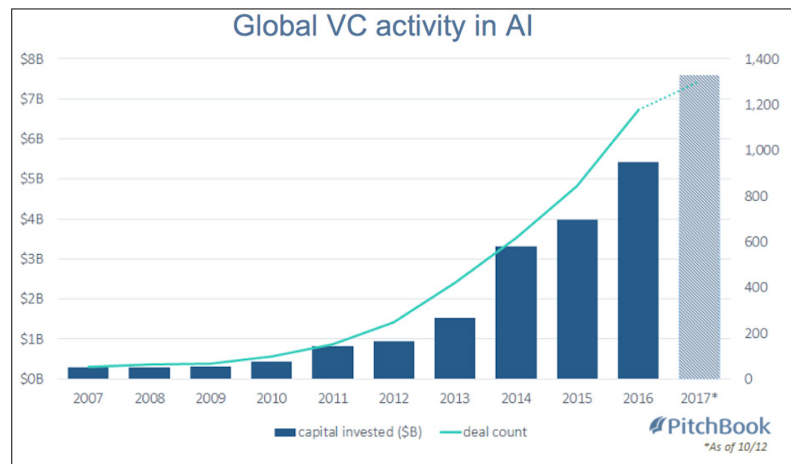
To succeed in Europe in the face of macro uncertainty, investors could subscribe to subsectors that have proven to be resilient through and post recessions - some of which includes medical technology, cards and payments, software and healthcare providers. In fact, PE investors have been ploughing capital into the technology sectors in the recent years, with 4 of the 10 largest leveraged buyouts involving tech companies: Dell, BMC Software, Veritas Technologies and Solera Holdings. Recession resistant features of these subsectors stem from stable and recurring revenue streams, and consumer loyalty due to high switching costs. Indeed, recession resistance feature of technology companies have been priced into valuation multiples, as seen in the price-to-EBITDA multiple for software deals averaging at 18.1 vs 10.2 for non-tech deals. However, returns multiple for software buyouts in recent years have been higher than non-software deals (1.9 vs 1.6), and fewer deals have suffered from capital impairment (3.9% vs 14.7%).

In a financial landscape where debt is cheap and cash is in abundance, it is imperative to note that multiples paid for LBOs have surpassed those seen before the crash in 2007, signifying the potential of a bubble formation. Leverage multiples in both US and Europe have also been inching closer towards those seen before the crash. Despite such alarming signs, the benign outlook remains that returns from investments in private equity will still be higher than other asset classes. Thus, taking a cautious stance in light of recent developments and historical trends, I believe that private equity firms whose bet is on European technology will realize a safer and higher return.



The Rise of Artificial Intelligence

Hayley Looh



From smartphones and houses to banking and healthcare, artificial intelligence is becoming increasingly omnipresent in our modern society. Its prevalence in our society will only increase as it continues to open our abilities to solve a new scale of problems and provide solutions for the betterment of humanity. As AI has made a visible impact in most industries, venture capital firms have paid strong attention to funding AI-enabled startups for new innovation. According to Pitchbook, venture capital investors have poured more than $10.8 million into AI and machine learning companies in 2017. This is a huge increase in global venture capital financing since the beginning of the decade. Venture investment in this industry was just $500 million in 2010 compared to a staggering $5.7 billion last year.

In 2007, when the iPhone launched, the use of artificial intelligence in Siri has impacted millions with the huge breakthrough of technology. At that time, the capital invested was just $285 million. The capital invested has increased exponentially to $7.6 billion as of 2017. One of the biggest deals of last year involves Rokid, which develops smart home devices that utilise artificial intelligence and deep learning to recognise users and adapt to specific personalities and needs. Rokid raised $50 million last October in its latest round of funding at a reported valuation of $450 million. Anki, another company in the AI industry, creates a variety of objects that could engage in intelligent interaction with the physical world. It raised $77.5 million in Series D funding last year at a $600 million valuation.

The strong demand for AI stems partly from the increasing interest in analysing the massive amount of data that the world's 2 billion smartphone users generate. The insights that can be obtained from this information would be a massive advantage in understanding how consumers think and behave. However, analysing the massive quantity of information available from electronic devices requires processing power that far exceeds what humans are capable of. It would take human many lifetimes to even organise the data from billions of people, let alone drawing useful conclusions from it. Artificial intelligence has the potential to revolutionise this. With deep learning, machines can teach themselves to learn over time and improve their effectiveness.

In conclusion, investors are highly interested in this industry because it has the potential for significant productivity gains and ability to positively impact the way humans interact with their environment. Goldman Sachs stated that artificial intelligence is the "apex technology of the information age" with "significant implications for every industry." The company also estimates a 1.5% reduction in labour hours, which is about 5 billion hours per year, by 2025 as a result of efficiency improvements that arise from utilising AI and machine learning. Therefore, artificial intelligence will continue to attract an increasing amount of investments from venture capitalists as it is a very attractive industry that is growing tremendously.

However, investments would taper down after an initial increase in the next few years because investments in AI are already at an all-time high and excessive venture capital investment can be counter-productive. If several venture capital firms invest in an artificial intelligence company, the company can no longer entertain a reasonably priced M&A offer and must therefore scale its team and products to be able to reach a higher valuation in the future; otherwise investors cannot get the return they require. These high valuations push the AI industry into a bubble and hence, I believe that VC firms should reduce the inflow of capital to AI firms and look elsewhere for a better chance of sustainable returns.

Time to invest?

Isaac Hesketh

Although watches have been produced and sold in the millions since the sixteenth century, the idea of investing in the individual timepieces, as opposed to their manufacturers, is far less prevalent than other forms of alternative investments. Many investors consider watches to be a perishable good, as its value tends to decrease with usage. However, watches are a surprisingly good alternative investment that allows investors to diversify their portfolio. Furthermore, the market for watches is also much simpler for beginners to understand, because the selection of items suitable for investment is smaller than other luxury alternatives. Investors can follow established general rules such as the better the appearance of a watch or the more exclusive it is, the higher its potential resale value will be. Much like fine wines and other luxury goods, there are two main ways to invest in watches. An investor can either buy shares in watch funds to earn dividends or go the traditional route of buying luxury timepieces and storing them until their value increases significantly.

There is a plethora of reasons why one should invest in watches. Firstly, the price of a watch changes quite predictably depending on its brand and therefore, there is far less volatility when compared to traditional investments. Once the price of a model has started to rise, it is highly unlikely that this trend will reverse. Watch Fund, managed by Dominic Khoo, says its investors expect 20-30% returns after a period of two to three years, and that it has averaged a return of 10-15% annually. Watchfinder, a marketplace for luxury timepieces, has an inventory that has grown in value by 6.6% a year on average.

The constant increase in watch prices can be attributed to a number of factors. The economic expansion after the financial crisis has increased the ability of individuals to purchase these luxury goods which has contributed to growing demand. On the other side of the market, supply is also limited for luxury watches. This supply and demand dynamic constantly increases prices. Timepieces are also less affected by volatility in the economy as investors will hold onto their investments during a downturn of the economy. As you can see from the graph below, according to Knight Frank research, investments in luxury watches have outperformed most other alternative asset classes in the last 12 months. In addition, watches have experienced similar growth to the KFLII, a luxury investment index run by Knight Frank including typical alternative investments like wine, cars and artwork.

However, like many other alternative investment products, watches are an illiquid investment and the process of selling a watch through exchange markets or auctions is time consuming. Despite the price stability and positive returns obtained from investing in luxury timepieces, there are still many inherent risks. These include the storing of your investment, purchasing fake models and the unregulated nature of the market. Furthermore, while the process of selecting the correct watch model to purchase is similar to how investors decide which stock to invest in, it varies significantly after a suitable investment is chosen. In the case of public equities, investors can immediately place an order to purchase them. But when buying a watch, investors have to make sure the item is genuine, in good condition, fairly priced, and has all of its certification.

Many investors choose Rolex or Patek Philippe watches due to the fact that their watches almost always hold their value or generate positive returns. However, investors should be aware that these items are among the most expensive and need regular maintenance to ensure profitability. In addition, the demand for each brand will change over time and hence, their price may change accordingly. For investors that prefer to diversify without the burden of storage and maintenance, watch funds are an alternative. However, it is important to compare the credibility and expense ratios of each fund. An example of a good fund would be Dominic Khoo's Watch Fund stated earlier, which purchases luxury timepieces that are not accessible to regular collectors such as one-offs, prototypes, limited editions and other models that don't make it to stores. Fund management fees vary, but are generally quite high. For example, Precious Time charges a management fee of 2.5% and takes a cut of 20% if profits exceed 5%. If investors leave the fund, they pay 10% of their profit or 5% of the total sale price, whichever is higher. It is also important to be cautious when dealing with funds as they are often unregulated.

Overall, watches are an attractive long-term investment that can effectively diversify an investor's portfolio. It is also becoming increasingly accessible with more online platforms, such as Watchfinder, serving as marketplaces and information providers that evaluate various models. With due diligence and meticulous research, investors can mitigate the risks of unregulated markets, fraudulent sellers and storage associated with investing in timepieces.

For newcomers, the best strategy is to purchase from established brands like Rolex and start with investing in a particular model that has a proven history of profitability, like Rolex's Daytona line. Investors should also never purchase a watch they would not wear themselves, buy quartz watches instead of mechanical ones and invest in watches with the expectation of short-term gains.

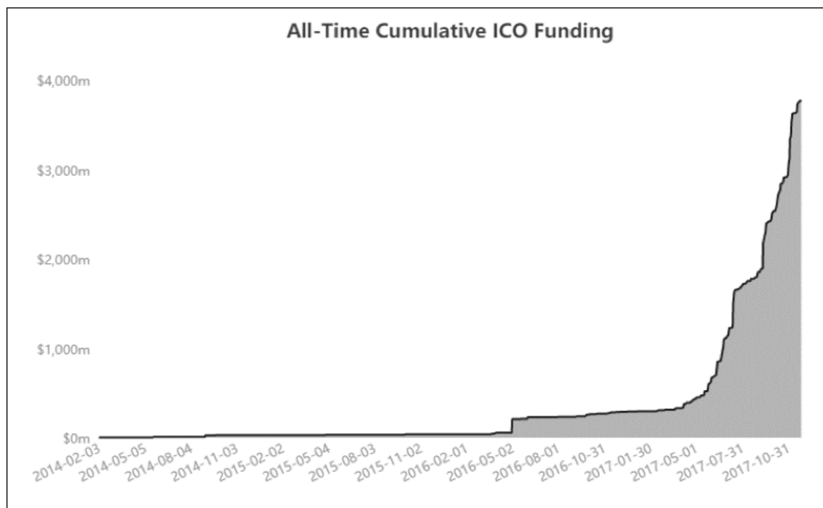
The Dangerous World of ICOs

Nikunj Paliwal

The dizzying growth of initial coin offerings, or ICOs, in the last year is reminiscent of the internet bubble that took hold at the start of the decade: nascent companies travelling the capital-raising world, branding their companies as internet companies and searching for any investment from all too willing investors. But as ICOs move into the mainstream, investors must tread lightly to avoid the pitfalls that come with this new form of early-stage investment.

ICO growth over the last year has been staggering. Total funding from ICOs has risen almost 1500%, from $250 million in 2016 to $3.7 billion in 2017. As seen from the graph above, interest in ICOs only began in mid-2016 and it was not until 2017 that it gained any popularity. ICOs allow firms to raise significant amounts of capital in a very short span of time under loose regulations. In May 2017, internet browser Brave's ICO raised $35 million in 30 seconds. The largest ICO to date, Filecoin, raised a total of $257 million in January 2018, with $200 million being raised in the first hour alone. Notable upcoming ICOs include established messaging app Telegram which is looking to raise $2 billion in their token sale.

ICOs offer an alternative to the traditional capital-raising process of using venture capital firms and angel investors. In a typical coin offering, aspiring entrepreneurs crowdsource capital by issuing digital tokens to investors in exchange for other cryptocurrencies or fiat currencies. Details about the tokens, as well as what the startup is looking to do and how much capital it is looking to raise, are published before the ICO in a 'white paper'.



The primary issue with ICOs arises from the characteristics of the tokens they sell. While often compared to shares, these tokens grant no ownership rights. Instead, they only represent the belief that the price of the tokens will rise due to increased demand in the future, which essentially paves the way for speculation by investors. If ownership of tokens offers claims to dividends, these are often paid out in the very same tokens. In rare cases, holding tokens will grant something within the project that is raising capital – for example, in a file storage ICO, tokens may grant a certain volume of storage. Of course, whether this claim means anything still depends on the success of the ICO, which in turn depends on how many tokens are bought. Overall, it is evident that most of these tokens have no intrinsic value and are not backed by any party other than the issuer itself. Tokens represent bubbles of the purest form, even more so than markets for major cryptocurrencies like Bitcoin, which are already criticised for over-speculation.

Whilst championed as a rescue from the corrupt financial intermediaries of old, proponents of ICOs fail to understand the importance of these intermediaries. The lack of any screening or auditing for 'white papers' results in them often being filled with unverified or misleading claims that go unnoticed by investors. White papers that appear professional and make exciting claims attract investors that are eager to make extravagant returns, with no way to make sure that what is promised will be provided.

Like the internet bubble in the 1990s, ICOs are still developing and they may reach a point in the future where they become a valuable and viable capital-raising method. Certainly, their principles are appealing – internationally accessible investment opportunities with few restrictions. However, at present, investing in ICOs seems needlessly risky. Lack of transparency and weak regulation means many offerings are outright scams, with the most promising ones being almost impossible to find without insider information or extensive technical understanding.

The Appeal of Self-Storage REITs

Phoebe Chan

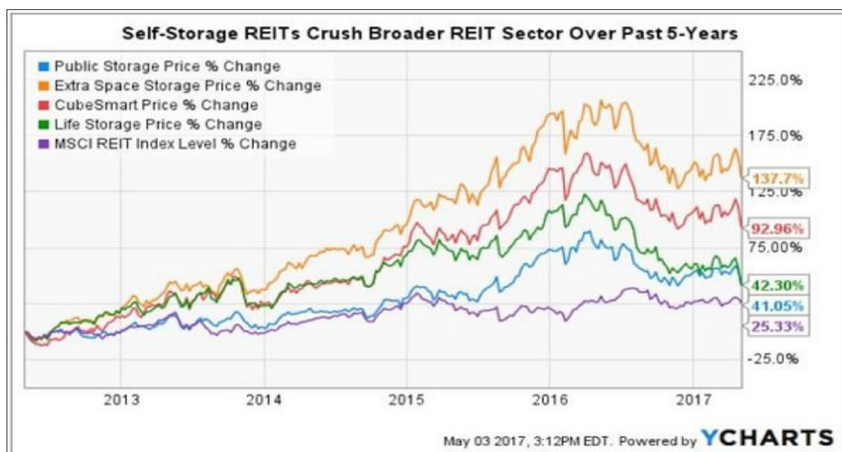
With global equity markets at their historical peaks, investors have started looking elsewhere for secure and steady returns. Many of them have turned to Real Estate Investment Trust (REITs) as a means to reduce risk and increase returns in portfolios. REITs have been a popular avenue for real estate investment since 1960s and, in the past five years, they have generated over 7% returns annually for residential and commercial real estate investors.

One specific sector of REITs that investors should look to gain exposure to in the coming year would be industrial REITs, which has posted strong returns of 20.8% annually. The driving factor for these strong returns is the expanding e-commerce sector and significant growth in the number of warehouse users. This trend is expected to continue, with industrial REITs extending into urban areas.

In particular, REITs in the self-storage sector which accommodate archives, inventories and furniture that are not currently in use, has experienced robust growth recently. This is due to demographic changes, increase in rental rates and decrease in property ownership. The sector itself is growing at 6%, outpacing other REIT indexes despite being the worst performing sector in 2016.

The graph below shows the fluctuations of price changes in the five major self-storage REITs over the past 5 years. The primary reason for their underperformance in 2016 was due to excess supply being present as the previous boom had led to new competitors entering the market. However, since then the sector has started to pick up as the vacant spaces have been absorbed by higher occupancy rates. The UK self-storage sector is the strongest in the European markets and, like the US, it is also supported by customers who tend to use the same self-storage facilities for repeated usage.

A blue chip industrial REIT investors could consider would be Public Storage (PSA). It is one of the largest storage company in the US with over 2000 storage facilities in 38 states and it has significant presence in the European markets as well. Specialising in self-storage, PSA actively pursue growth opportunities through expanding their business landscape and storage units over time. It has a relatively strong balance sheet to meet their liquidity needs as Public Storage has refrained from financing their businesses with debt under the direction of their CEO Ronald Have. It has also recorded strong revenue growth of 3.3% and generated an average return of 15.2% over the past 30 years.



I believe that investors should take advantage of the dip in 2016 and take a long position in Public Storage based on the progress of recovery of the self-storage sector and expectations of promising long-term performance of the firm. Public storage's core funds from operations (FFO) recorded $2.61 per share in Q3 2017, which has increased by 3.2% year-on-year. It has a P/E ratio of 28.30x, which is much lower than the industry average of 32.98x. Their profitability ratios are also above industry and sector average.

Long-term catalysts for Public Storage include their strong balance sheets, sound reputation in the industry and strong business model. Their financial strength can be shown by their low debt to equity ratio of 15.86x and low break-even occupancy rate. The company also expands constantly through M&A operations, for instance acquiring storage facilities worth $11.6 million in Q2 2017, increasing their footprint in both U.S. and European markets. These acquisitions are expected to sustain Public Storage's long-term growth.

Interest rate hikes in history have been associated with negative performances in REITs as it shifts investors to investing in fixed income as well as incurring higher borrowing costs for PSA. However, this should not be a concern for investors as the Fed signalled that rate hikes will be done gradually and they reduced their forecast of rate hikes to twice in 2018. Furthermore, REITs distributes substantial dividends to investors as it comes as a requirement that they should distribute at least 90 percent of their taxable income and dividends stream from rental income. Therefore, REITs will remain an opportunity to investors looking to diversify their portfolios in the coming year.

Taking everything into consideration, investors should grasp opportunities in industrial and self-storage REITs as they are expected to remain competitive in the long term with limited supply of rental spaces and increasing demand. In particular, for Public Storage, it has a strong position financially and is expected to generate strong returns for investors. A rise in interest rates will not be a threat to the company as they are not dependent on debt financing.

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