Newscape
CAPITAL GROUP

Market Commentary: 10 Predictions for 2018

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Having just enjoyed a calm year in financial markets, when expectations were dire a year ago, the outlook for most markets and asset classes is for more of the same. Unfortunately, good years can follow good years, just as they can follow bad. That things are calm tells us little about the future and in the longer term, we know there are excesses in markets. These are most visible in bonds and growth stocks. Much of that has been caused by a prolonged period of macro-economic stability, which can't last forever. Normally a burst of inflation does the trick.

Stability boosts confidence, which is a good thing, as it leads to an increase in investment. Yet at some point, complacency sets in and bad decisions often follow. When that happens, the seeds for the next downturn are sown. It's never easy knowing whether that's just around the corner or many years away, but once valuations are elevated, we can be sure the pain will likely be worse when the cycle eventually turns down.

In this piece, I am making ten predictions for what's in store in 2018. Some of them are relevant, others flippant and a few possibly absurd. I can only do my best and it's for you to decide. My ten predictions for 2018 are:

1. OLD FINANCIALS BEAT THE NEW
2. BITCOIN STUMBLES
3. THERESA MAY SURVIVES
4. GOLD MAKES A FIVE-YEAR HIGH
5. THE USA PRODUCES 10 MBPD AND THE WORLD CONSUMES 100 MBPD
6. FTSE 100 BREAKOUT
7. RETAILERS ADAPT
8. CHINA DEBT CRISIS
9. PETROFAC GETS BOUGHT FOR £6 PER SHARE
10. BUFFETT AND MUNGER LIVE FOR ANOTHER YEAR

Old financials beat the new

Might we tire of financial technology (fintech)? The promise of apps and youthful disrupters to shuffle our money around has been relentless. However, I question how much difference this has made. A typical high street bank now offers a comprehensive online service at a low cost to the masses. You can send money around the world at the touch of a button and generally quite cheaply. It's at times like this that we should recall that not everything needs to be disrupted.

The banks have had a bad rap over the past decade because they were complacent in their dominant market position. They are able to create money and therefore sit at the top of the capitalist food chain. A decade ago they decided they wanted even more than just to enjoy that "license to print money" and serve society with a straight face. This past decade has seen that idea beaten out of them and thank goodness for that. Now almost all of the banks are stronger and have simpler balance sheets.

The attempts to challenge them have made them sharper and the interest rate cycle is likely to be on their side. The worst of the fines are behind them and once again, they are supporting the economy by supplying credit – the "oxygen" for the financial system. If 2018 turns out to be the year of economic strength and rising bond yields, then the banks that remain fairly valued will likely be at the front of the charge and leave their digital challengers behind.

Retailers adapt

In 2015, Kingfisher (KGF), owner of B&Q, came up with a new strategy called ONE Kingfisher. The focus over the next five years was based on three ideas. First to create a unified, unique and leading home improvement offer, second to improve the digital capability and third to optimise the operational efficiency. I agree that's its largely management guff from a Frenchman, but it demonstrates that the major retailers have been considering the threat from the Internet for some time. And they are fighting back.

More guff came from Halfords (HFD), a retailer that has "supported travel for 150 years". They want to support their "customers on the move" by "making their journeys better". Their strategy named "moving up a gear", aims to put their customers "into the driving seat..." and so on. I'll spare you the rest of the corporate nonsense, but they seek uniqueness, a blend between store and online and partnerships with the Olympics, the Tour de France and Sir Bradley Wiggins. It seems to make sense and improve the customer experience.

More generally for retailers, the race is on to save the high street and the shopping centre. Deals are being done, shops are becoming experiences and showrooms, rents are being realigned and retailers are improving their online presence. The result should see significant change and I believe that (slimmed-down) retailers will come back stronger and with a new purpose. After all, the most efficient model will win in the end. A white van shouldn't be delivering low value items during the rush hour and for that reason, online has its limits and Amazon will fall short of taking over the world.

Perhaps the councils that banned parking near close to city centres might even apologise to the retailers they have destroyed. Unlikely.

Bitcoin stumbles

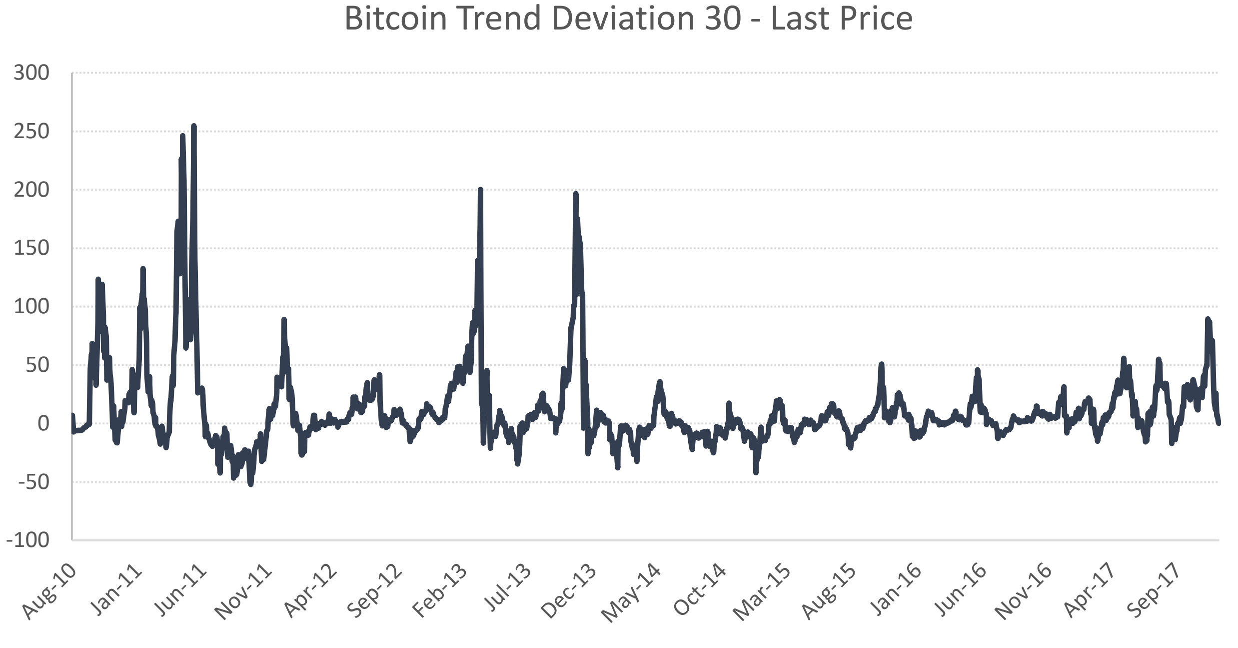
The annual league table for bitcoin returns since 2011:

2011	1,316%
2012	218%
2013	5,428%
2014	-57%
2015	36%
2016	120%
2017	1,403%

Source Bloomberg: Bitcoin ($), 2018.

My argument here is very simple, what goes up, must come down. I understand that Bitcoins might one day be worth a million dollars each. But equally, I also appreciate they may end up worthless. Who knows, but I can be sure that extreme hysteria generally marks a peak; even if it's only temporary.

A hundred billion too far



Source Bloomberg: Bitcoin ($) deviation from 30 day moving average since 2011

Consider that the bitcoin price is 57% ahead of its 30-day moving average. I stress that's not its 200 day, but its 30 day moving average. As the chart shows, you would normally expect a price to revert back to its trend – as has happened many times before. With a total value of $300 billion for all of the bitcoins, by implication, the market is $100 billion ahead of itself. That's quite a statement and the equivalent value of Diageo (DGE) or Rio Tinto (RIO) could be wiped out just as Bitcoin eases back to trend. Sentiment in this area has gone mad, the tabloids are covering it and it is very rare that there are crumbs left on the table when everyone knows there's a free buffet.

I suspect that digital assets, and the ability to exchange value over the Internet are still in their infancy. But the longer-term trade may or may not involve Bitcoin. One reason I have my doubts is the clunkiness of the network. The total cost of each transaction is $138 which is absurd. At that price, a deal needs to be huge before it is cost effective. Madness. Newscape Funds end the year with no exposure to digital assets.

Theresa May survives

I recently saw an old friend who was a firm "remainer" during the Brexit vote. Like many, and having believed the establishment view, she was "coming around to Brexit". The Independent has managed to conjure up a poll, by a German company, whereby the majority now wish to remain. Given that I haven't met a Brexit voter that has changed their mind, and have met remainers that have come around, I simply don't believe this poll. And as we know, polls are just polls.

Corbyn was relatively unpopular until the general election, and especially within his own party. One reason for calling the election was that it was seen as an easy win. He then took over the youth vote with his own version political promises that he couldn't deliver. Even more remarkably, he managed to bat off his Marxist past. Previous affiliations with the IRA, Hugo Chavez and CND seemed to make him even more popular. Remarkably, these views were his own and had nothing to do with the democratic process that defines the Labour Party. His resilience and refusal to budge served him well and his popularity grew. The lesson is to sit it out.

The energy behind his campaign seems to have peaked and now it's the Prime Minister's turn to shine. Despite the extraordinary and continuous barrage from the press, the conservatives are still ahead in the polls and like Corbyn, May has defied her critics. A successful outcome, or at least an outcome, to the Brexit negotiations seems ever more likely and when that comes, the people will respect her for it.

Britons are not stupid and will reject socialism because they know it has never worked in the past and will never work in the future. An electable Labour Party is a moderate one that holds the centre ground. The current representation of the left is dangerous and the people know it. As May's popularity rises and the UK's future emerges from the haze, the pound should make its way back towards $1.50. It's already half way there and it's time for the rest.

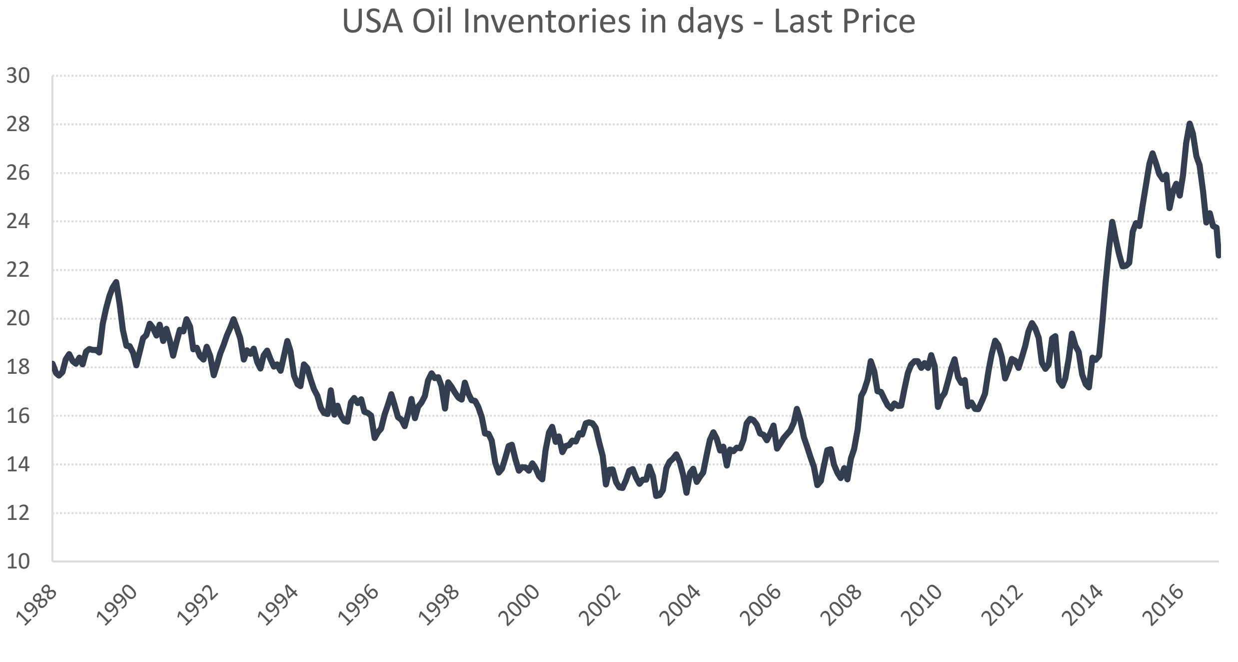
The USA produces 10 MBPD and the world consumes 100 MBPD*

Late in the cycle, it is the norm to expect higher inflation. Typically, this either comes from higher wages or higher commodity prices. In today's world, industrial metal prices are driven by Chinese demand, whereas oil and food are driven by global demand. A key reason for that is that oil and food must be consumed relatively quickly as there is no way to store them in bulk. For that reason, oil and food prices are more volatile and respond more vigorously to minor shifts in supply and demand.

*Million barrels per day

Since 2006, the USA was encouraged by its Presidents to produce more oil. Whatever your green credentials might be, this has saved the global economy. For without this extra 5 MBPD, oil would be in short supply. In 2008, the new supply came out of the ground and low oil prices post-2008 can largely be attributed to that crucial decision.

Tightening again



Source Bloomberg: Oil inventories expressed in days demand since 1998

While we should thank President W. Bush for his efforts, the sad facts are that the world demand will exceed 100 MBPD next year. That will coincide with a modest increase in US production which will not be enough to grow inventories. Once they fall below 20 days, the oil market will tighten and the price will likely rise.

The world economy has too much debt to withstand high oil prices and in my opinion, a slowdown would kick in with oil trading much above $80. The current environment is still within the sweet spot. At close to $50, energy is cheap enough so as not to tax the planet and harm consumer spending. But at $80, the pressures will be felt. Inventories are now falling quite quickly. Normally at this time of year, inventories are supposed to be rising. That they are still falling at the fastest rate for many years, can only mean that an oil spike is on the way.

Gold makes a five-year high

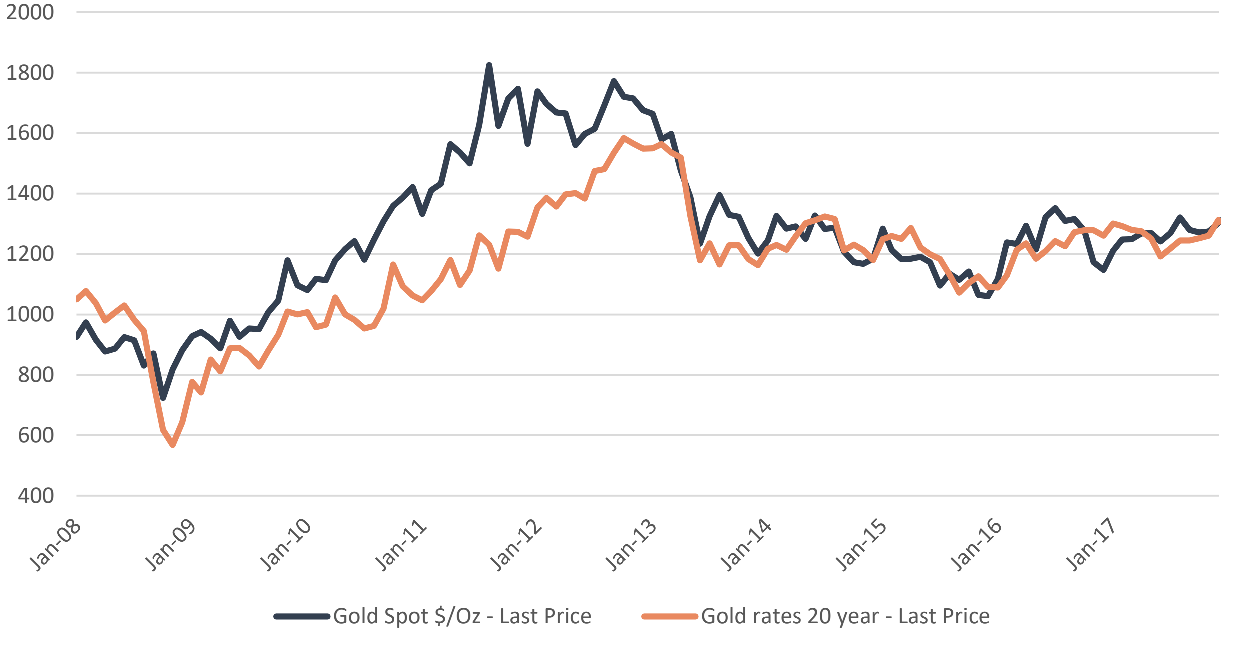
The old gold bull market peaked over six years ago and its digital incumbent has stolen the limelight. A year ago, it made sense to be a Bitcoin bull and be a bit more pragmatic on gold. But surely, and for whatever happens next, the time has come to reverse that view.

Gold behaves like an inflation-linked bond (linker) that pays no dividend, but with an advantage. In exchange for paying no dividend, which would currently be negligible anyway, gold has no sovereign risk and the ability to shoot to the moon.

That means it can be priced at a premium to linkers which can be beneficial when inflation fears rise. In addition, it can benefit when economic confidence collapses, because that tends to coincide with a loss of confidence in the currency (inflation) and an inability to repay (insolvency). For that reason, it's never a bad idea to hold some gold, whatever the outlook.

There's no suggestion that the UK will default in 2018, but global inflation may surprise while rates remain subdued. That would mean continued easy monetary policy that is good for gold. In addition, the speculators recently turned negative on the gold price, which means the sellers have left the building. When that happens, it doesn't take much to see the gold price rise.

A steady ship



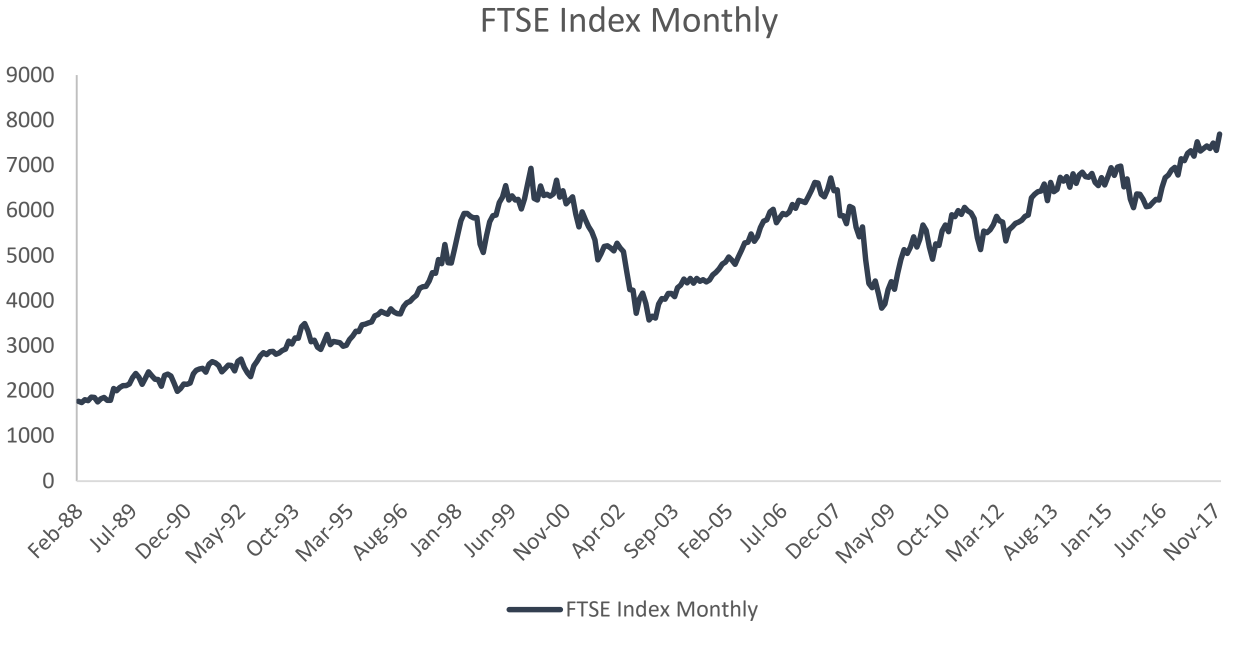
Source Bloomberg: Gold price (USD) and the Atlas Pulse fair value model (black) since 2008

The gold price has been trading close to fair value since its collapse in 2013. Since then, it has traded calmly and in line with its perceived fundamental fair value; at least by me. What might change this situation for the better would be a speculative premium driven by fear, or a downward turn in real interest rates. We can be fairly confident that the level of rates set by the central banks will remain accommodative, and so the game changer will be inflation; something that may be driven by oil.

FTSE breakout

The FTSE 100 decisively broke through the 7,000 mark in late 2016 on its fourth attempt. That's not entirely surprising as these things often need several prods; a good example being the Dow Jones between 1966 and 1982 (16 years) which had six attempts. This latest period of consolidation for the FTSE is 17 years old and its resilience shouldn't be underestimated.

7,000 may never be seen again



Source Bloomberg: FTSE 100 Index since 1988

The combined dividend yield is close to 4% and given the improved quality of the earnings from the recovery in banks and commodities, that level appears to be underpinned. One challenge for the FTSE will be a rising pound, but that won't matter too much if it happens slowly. Moreover, it will ensure that UK assets outperform global assets which will boost demand. It's high time that happened and a constructive Brexit deal will help. Finally, large caps tend to do better later in the cycle when liquidity concerns grow. The FTSE could be well placed to attract capital looking for a home.

China debt crisis

Chinese debt has been growing at an unsustainable rate since 2008 and has now surpassed 300% of GDP. In nominal terms that has seen a rise from $6 trillion in 2007 to $29 trillion today. Rising debt is a guaranteed way to grow an economy as you can spend the proceeds on whatever you like. The question thereafter is whether that spending turns out to be productive.

The funny thing about China is that after years of doubt, the commonly held view is now to accept that central planning seems to work. The stories of China' imminent demise have kept on coming and investors have become immune to them. In order to truly understand the situation, you need to have a comprehensive knowledge of macroeconomics. And even if you did, the Chinese don't disclose much useful information. Given these challenges, my preferred method is to observe free market prices.

Since many prices in China are controlled, that leaves us with general prices such as copper, the Renminbi and the stockmarket. The price of copper has risen over the past two years and is now overloaded with speculative money. Not much room for growth there.

The currency is richly priced having risen a great deal over recent years. Previous fears were that capital flight would see this collapse, but they didn't come to fruition principally because the authorities clamped down on capital movements. (That was inevitably linked to the restrictions on Bitcoin). A weak currency would be an early warning signal.

Finally, the stockmarket is lagging the world and if this trend persists, it will be the weakest major market in the world. Given that China is supposed to be the global engine of growth, this is an uncomfortable thought. Furthermore, Chinese equity breadth is weak, and this normally warns of trouble ahead. In short, China is a key concern that could derail the bull market next year.

Malaysian spice

The Malaysian stockmarket has lagged emerging markets since 2013 principally due to political instability. That it lagged over the past two years comes as little surprise but the lag prior to that challenges the idea that Malaysia as a defensive market. That defensive reputation comes from its low volatility compared to other countries. The country has relatively low inflation, is growing at 5% and debt to GDP is a manageable 52%. The stockmarket is attractively valued compared to its peers. In addition, the currency appears to be attractive relative to the Singapore dollar which is supportive.

Stronger economic growth and a rebound in oil prices is helping to boost government revenues, which should allow an increase in fiscal spending ahead of elections in 2018.

Buffett and Munger live for another year

The mighty duo will likely enjoy another bumper year. Charlie Munger (93) and Warren Buffett (87), the deputy chairman and chairman of Berkshire Hathaway (BRK), will do a monster deal. The company generated nearly $33 billion in free cash flow this year, taking his cash pile close to $100 billion.

They don’t want it, and would prefer another productive asset to add to their impressive collection.

At current prices, they could buy General Electric (GE) for $120 billion and enjoy a 5% yield. GE might be too complex a business for BRK, but the balance sheet is strong, the valuation is low and it has a strong market position. Another value situation might be Costco, for $85 billion. One advantage is the company is well known to BRK as Munger sits on its board. The company might be well positioned in the new era of retail as they sell in bulk which doesn’t necessarily lend itself to the Internet distribution model. Finally, a telecom such as Verizon (VZ) or adding to his utility book are options. A bit on the dull side, but better that having all that cash burning a hole in your pocket.

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