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2019 Investment Themes

Eight views from our investment teams

January 2019

Contents

Our Thinking:
Thought Leadership

Our thought leadership papers deliver thought-provoking analysis of key investment themes. Through focused and unique insights into topical issues, we aim to provide investors with a deeper understanding of the challenges and opportunities within global investment markets.

Foreword

By Andrew Milligan,
Head of Global Strategy

I am delighted to introduce the 2019 edition of ASI's annual investment outlook. This is an opportunity for a broad array of our investment managers and analysts to introduce you to some of the key themes and issues which they consider will affect the state of financial markets in the coming year.

Some of these themes will not be new to you: issues such as Trump and Brexit, US-China relations, or the regulation of major companies such as Facebook, are dominating media headlines. However, successful portfolio construction and accurate risk assessment will increasingly depend on detailed knowledge of a dynamically changing environment. **Stephanie Kelly**, **Brett Diment** and **Karolina Noculak** display these characteristics in their respective articles on populism, politics and geopolitics, and the future of the FAANGS sector.

Paying too much attention to day to day news flow can mask the importance of changes over time in various structural trends. Here careful sector analysis and stock picking can lead to beneficial returns. Examples in this edition would include **Milan Khatri** on housing trends in some of Asia's major cities or **Hugh Young** on changes in Asian consumption of food.

In some areas, change would be beneficial for society, economies and shareholders. However, as **Vicki Cobain** discusses, a variety of obstacles are likely to prevent the necessary merger activity in an over-crowded sector such as European banking. In other areas, the jury is still out on how successful a country will tackle the problems it faces; as an example **David Smith** examines the risks and opportunities for companies as the Chinese government invests heavily to meet a series of major pollution and environmental challenges.

Lastly, the financial sector itself is changing in response to new regulation and higher standards of governance. **Rod Paris** explains how changes in the LIBOR ecosystem of interest rates, a mainstay of the financial industry since the 1960s, will have considerable implications.

2018 was a complex year for financial markets, including divergent performance across the major economies, a new array of political pressures, and re-assessments of key sectors such as technology or oil. A rolling series of market corrections left few places to hide. We remain confident that riskier assets can provide positive returns.

Looking into 2019, the big picture questions facing investors focus on whether a recession will soon appear (we think not) and the state of US-China relations, where we consider tensions will be limited rather than becoming extreme. At a time when valuations have improved and investor sentiment is poor, we expect capital sitting on the sidelines will snap back into over-sold assets on even a modicum of better news. However, successful investment decisions need to be made at country, sector, style and company level. At Aberdeen Standard Investments our focus on fundamental research and close collaboration across 21 global offices of investment experts helps us achieve those aims.

Asia's winning cities: outlook for 2019

By Milan Khatri,
Head of Property Research,
Asia Pacific

Cooling house prices after a clampdown by authorities on runaway buying will create a rare window for investors in residential real estate. They will actively be seeking to find value in some of Asia's leading cities next year.

Demographic trends such as population growth and rural migration have driven demand for residential property in the region's most prosperous urban centres over the past decade.

High quality living standards have attracted skilled and unskilled labour both domestically and internationally to globally connected cities such as Hong Kong, Singapore, Tokyo and Sydney. We collectively refer to these as **"Asia's winning cities".**

House prices in these markets have surged 25% on average over the past five years to Q2 2018, having soared more than 200% in Hong Kong and 90% in Sydney since 2008. Low interest rates have acted as a catalyst, along with rising affluence as wealthy Asians – particularly mainland Chinese – have sought to capitalise on their newfound prosperity.

Governments and regulators have responded. They have imposed measures to stem rising prices, fearful that high levels of household debt pose a systemic economic risk in the event that rate hikes spark loan defaults and undermine consumer spending. They are mindful, too, of exacerbating societal divisions as homes have become unaffordable for even median income households.

To restrict demand and dampen prices, authorities have tightened rules for developers, companies and individuals, including raising transaction taxes for non-residents and the buyers of second homes.

This July, the government in Singapore raised stamp duty on property purchases and lowered loan-to-valuation (LTV) levels, thereby increasing the amount required for deposits. This is in addition to an escalation in stamp duty rates on both buying and selling properties.

Similarly, the Hong Kong government has announced a series of cooling measures this year. These have included a vacancy tax on new homes left empty for six of the preceding 12 months and a requirement for developers to offload at least 20% of their units during pre-sales. Both are designed to limit commercial profiteering and expose house builders to market forces.

In September, the city's commercial banks also raised mortgage lending rates for the first time in more than a decade after the Hong Kong Monetary Authority hiked interest rates. With the Hong Kong dollar pegged to the US dollar, more rate hikes are forecast if the US Federal Reserve continues to normalise its monetary policy.

In Australia, fears of a housing bubble have led the Australian Prudential Regulation Authority to tighten lending standards for banks in recent years, capping investor loans and limiting interest-only lending. Outright declines in house prices have been recorded nationwide since late last year.

Only Japan among the region's most developed urban centres has not attempted to regulate housing demand, with prices having only risen a fairly modest 15% since 2008. But this is a unique market in which the government promotes housing densification – turning low-rise homes into high-density towers – to increase the supply of housing units.

Regulatory restrictions have started to take effect, and together with forecast rate hikes they point to more subdued property prices next year. We think this will present opportunities for investors to capitalise on a slowdown in prices in Asia's winning cities.

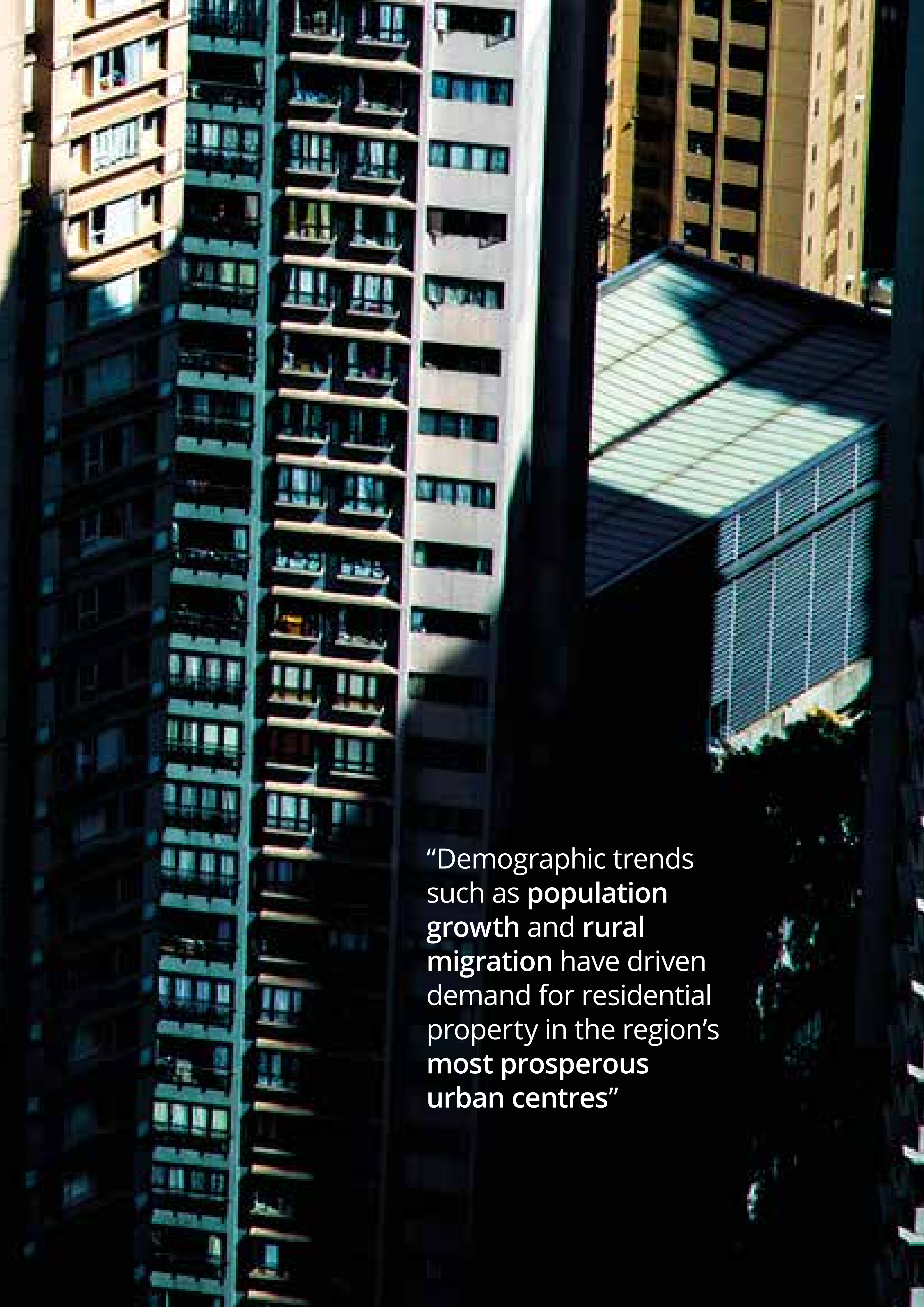
We don't anticipate a prolonged slowdown in housing demand, nor do we see modest price declines as a harbinger of a more serious downturn. Cramped living conditions and overcrowding remain a reality in these cities. Demand for housing has built up over many years. High prices have compelled many grown-up children to continue living with their parents, while population growth will only add to housing pressures.

Property prices in Hong Kong started to decline in the fourth quarter this year, and also look set to tread water in Singapore in 2019. Dips in valuation could arise quickly in these fast-moving markets and present potential entry points.

In Australia, an increasing shortage of capital for developers is creating opportunities to finance the development of well-located but affordable mid-market accommodation.

As for Japan, low yields make investment in core property unattractive. We see value in developing or refurbishing quality homes in leading cities to meet demand from rising foreign and domestic migration.

As such we anticipate continued housing demand in Asia's winning cities over the medium term. Investors might want to seize on this window while they have the chance.



"Demographic trends such as **population growth** and **rural migration** have driven demand for residential property in the region's **most prosperous urban centres**"

“In a **competitive market environment** super-normal profits would **attract the attention of rival companies.** In the absence of strong competitors, these profits are **instead attracting the attention of regulators and governments**”

Is the US technology industry being defanged?

By **Karolina Noculak,**
Investment Strategist,
Multi-Asset

Paypal founder Peter Thiel predicted in his 2014 Wall Street Journal essay, 'Competition is for losers', that Silicon Valley would become the centre of the global economy. He claimed that by operating under a set of rules that involve little competition or regulation, his own company, along with the likes of Facebook, Amazon and Google (some of the so-called 'FAANGS') would take control of the technology industry. This would enable them to enjoy abnormally high profits.

Specifically, Thiel thought the key to success involved companies minimising how much tax they spend (a key to Amazon's success); allowing the sharing of content without concerning yourself with copyright (as YouTube did); outpacing or buying the competition (Facebook's two billion members removes the need for many more social networks); and growing so fast that regulation has, so far, been unable to keep up.

His prediction has proved prophetic. At the start of this decade the biggest companies in the world were oil companies, such as ExxonMobil and PetroChina. Currently the biggest companies in the world by market capitalisation are Apple, Alphabet and Microsoft.

However, there are signs that these technology giants are becoming victims of their own success. In a competitive market environment the super-normal profits they enjoy would attract the attention of rival companies. In the absence of strong competitors, these profits are instead attracting the attention of regulators and governments.

Fears that the authorities are catching up with FAANGS lay partly behind the puncturing of their share price bubble in the latter half of 2018. We think there could be worse to come and that as Thiel's four laws continue to be rescinded, 2019 will be another uncomfortable year for investors in these companies.

So what are governments and regulators likely to do?

Their actions will be shaped by public opinion. Consumers are not yet sufficiently outraged to stop buying Amazon's cheap and convenient products, but disquiet is growing over the way these companies avoid tax. There are also growing concerns over the part tech companies play in facilitating political interference, including the mishandling of user information by Facebook, and the leaking of private data from the likes of Yahoo. In these increasingly febrile times, public outrage has a greater capacity to drive regulatory action.

The shape of anti-trust regulation could take the form of anti-tax avoidance measures, privacy and anti-surveillance laws, or possibly self regulation by the industry. As recently as November, President Trump said his administration is looking at anti-trust issues with regard to Google, Facebook and Amazon.

Some company bosses are trying to get out ahead of any regulation. Apple boss Tim Cook has made a point of saying that regulation of the technology industry is inevitable. We should expect this rhetoric to continue and a line to be drawn between companies almost encouraging regulation and seeking to influence what it may look like.

US politicians have been discussing how to regulate tech companies for the last two years. That will likely translate into legislation targeting privacy, political advertising and competition concerns over the coming year.

In Europe, the latest GDPR rules are having a major effect on how companies handle and protect personal information, with other countries watching with interest.Elsewhere, the UK is trying to increase the tax burden for technology companies with a new 'digital tax'. If this proves effective, cash-strapped governments across the world are likely to introduce similar taxes as early as next year.

The days of tax-free profits for technology companies might be coming to an end, but a collapse in profits is not imminent. The risk is not that today's tech companies will turn into dotcom fads. They will continue to generate strong real cash flows for years to come. Indeed, earnings in this sector are likely to continue rising next year.

However, the FAANGs have been priced for perfection at a time when their outlook is as challenging as it has ever been. Their successful track record has resulted in overly exuberant investor sentiment, crowded positioning and extended valuations. That should put pay to any recovery in the shares during 2019.

Mr Thiel himself appears to have grown weary of Silicon Valley, having moved to Los Angeles. It is perhaps too early to call time on the valley's pre-eminence in the technology world. But if Mr Thiel's predictive powers are anything to go by, we should start looking beyond Californa for the next wave of technology leaders.

Food for Thought

By Hugh Young,
Managing Director,
Asia

We are all aware, to some extent, of the importance of food in Asian cultures. In fact, many westerners' first contact with the Chinese, Indian, Thai, Vietnamese and Korean cultures will likely be via the cuisines of those countries.

Food is important to many Asians. It is a successful cultural export and source of pride for the diaspora – probably the most potent expression of Asian **'soft power'**. It is also a measure of how life has improved over the past three decades for those remaining in the region.

Recent developments in the food and agriculture sectors are prime examples of the effect of wealth creation and other dynamics, such as urbanisation. These lead to greater domestic demand for everything from automobiles to washing machines. In addition, as people get richer, they also become more discerning.

A generation ago, many people living in Asia would have been happy with three meals a day. Tragically, there are still plenty of people who go hungry amid income inequality that can be more extreme than that found in the developed world.However, there are also countless people in Asia who now buy their groceries from a supermarket (online as well as in a shop) rather than a street market; who consume more protein and fat in their diet; and more recently, have been asking questions about the food they eat and how it is produced.

Perhaps surprisingly, China is the world's fourth-largest market for organic food. The Chinese packaged organic food and beverage market is now worth some US$2.8 billion and is forecast to grow at a compounded annual rate of 14% until 2022.

Food safety is a particularly sensitive issue for China. A history of food production scandals means the country's growing middle class is often willing to pay more for brands, both foreign and domestic, that they trust. When trust commands a premium, companies with good environmental, social and governance regimes have a clear head start.

Consumer tastes elsewhere in Asia are also changing. Factors such as better access to knowledge, sedentary lifestyles and a rise in childhood obesity cases have forced people to think more carefully about what they eat. As Asian consumers become more sophisticated, many are demanding healthier alternatives. This is driving the growth in the market for healthier snacks containing less sugar and fat.

Legislation is also playing a part. Some Asian countries such as Thailand, India and Sri Lanka have introduced taxes to reduce the sugar content in food and beverages. This is in the wake of similar moves in Europe and the US, while the Philippines and Vietnam have tabled proposals to do so. Being 'unhealthy' now comes with an immediate financial cost.

The implication for companies is that tried-and-tested products that used to sell, may no longer be as popular. Food and drinks manufacturers will have to innovate in order to stay relevant in a changing marketplace.

This is evidenced by the conversations we have with management teams as part of our regular schedule of company visits. Aberdeen Standard Investments managers made 1,600 trips to almost 900companies across the Asia Pacific region in 2017 and a similar number in 2018.

For example, Hindustan Unilever in India produces a **'naturals'** range of food and personal care products that use all-natural ingredients and are free from chemicals and preservatives. This portfolio is growing two-and-a-half times faster than the company average.

In Vietnam a company called Dairy Products, better known as Vinamilk, is developing dairy farms that produce organic milk in response to the growth in domestic demand for this premium product.

Interest is also rising in living more healthily. In 2017 the Asia Pacific region accounted for some 30 per cent of the **'health and wellness'** market,encompassing superfoods, supplements and serums. This is up from only 19 per cent in 2007, according to Oliver Wyman. The global market generates sales of more than US$700 billion.

Health and wellness, natural products and food safety are industry trends that have become as important in the emerging markets of Asia as they are in the west. Food stopped being just about keeping hunger at bay some time ago. For more and more consumers here, what goes into the shopping basket reflects the greater expectations that come with enhanced wealth and knowledge.

> "In 2017 the Asia Pacific region accounted for some 30 per cent of the **'health and wellness'** market"

“For more and more consumers here, **what goes into the shopping basket reflects** the **greater expectations** that come with **enhanced wealth** and **knowledge**”

"The country is simultaneously the **world's worst emitter of carbon dioxide** and a **leading champion for environmental change**"

China's long green march

By David A. Smith,
Head of Corporate
Governance, Asia

Policymakers in Beijing can not afford to allow pollution to undermine economic and social welfare. It offers a structural driver that smart investors can take advantage of.

Next year will mark the latest milestone in China's drive to reduce its carbon footprint if it can consolidate its position as the world's top importer of natural gas, having just overtaken Japan.

The country is simultaneously the world's worst emitter of carbon dioxide and a leading champion for environmental change. This paradox encapsulates both its breakneck economic development and its urgent need for modernisation.

A major plank of China's reforms is the switch from coal to natural gas to power its energy needs, both industrial and household. While still a fossil fuel, natural gas emits 50% less CO2 than coal.

China imports the majority of gas from Australia and the US Gulf coast, although it is increasingly seeking to secure supply from central Asia and is busily upgrading its infrastructure and pipeline network.

The growth of the natural gas sector and associated industries that this switch is creating is an opportunity for investors, provided they are willing to search for the firms that would benefit.

China is similarly committed to renewable energy, having invested $126 billion last year alone, accounting for 45% of the global total according to recent UN figures. It installed 53GW of solar power last year alone, more than the entire world market as recently as 2014.

Falling costs and record low borrowing rates for project finance have facilitated this. Solar power generation costs fell 90% in the decade to 2017, reports Reuters, with panels springing up in industrial parks and on domestic rooftops across China.

However, the rising cost of such investment, sometimes for poor returns, means that Beijing is moving to withdraw subsidies for manufacturers and developers, reducing the burden on the state. It means the industry will need to adopt technological innovation and economies of scale to improve efficiencies, while also looking to the private sector for support.

Opportunities also lie in the companies that stand to benefit from the government's focus on renewable energy.

Electrification is another segment which, while nascent, is rich in potential. China accounted for half of electric car sales of 1.1 million units worldwide last year. While miniscule compared with the conventional light-duty car industry, the compound annual growth rate for electric vehicle sales was 66% from 2012 to 2017. Similarly sales of electric buses grew 30% last year – and China accounted for 99% of the market worldwide.

Again the financials have driven growth. The cost of lithium-ion batteries that power electric vehicles has fallen each year since 2010 amid improving technologies and economies of scale among manufacturers. However, much depends on the cost of source metals such as lithium and cobalt.

At current rates Bloomberg New Energy Finance forecasts that lifetime ownership of an electric vehicle could start to undercut that of an internal combustion engine in most markets by the mid-2020s. By the late 2020s upfront electric vehicle prices could even be cheaper. That would see electric vehicles account for more than half of worldwide light-duty vehicle sales by 2040.

It's certain to be a topic of discussion for policy makers over the next year. Policies aimed at promoting the widespread installation of electric charging infrastructure will potentially provide further pointers to investors.

Ultimately China's need to resolve its acute pollution problems falls into line with a global narrative. The Intergovernmental Panel on Climate Change warned in October that, at current rates, global warming would decimate coral reefs and crop yields. It would further drive some animal and plant species into extinction and see rising sea levels displace coastal populations by the second half of this century.

Governments are being compelled to take action, and China finds itself at the vanguard of this movement. As with any structural trend, informer investors should be seeking to take advantage.

"China is similarly committed to renewable energy, having invested **$126 billion last year** alone, accounting for **45% of the global total** according to recent UN figures."

The changing world of emerging markets investing

By Brett Diment,
Head of Global
Emerging Market Debt

At a basic level, accounting for the external factors influencing emerging market (EM) economies used to be a relatively straightforward task. Keeping an eye on US Federal Reserve policy, US dollar trends and the IMF, went quite a long way to understanding the most important external variables for these economies. That is no longer the case.

For a long time EM investors have been only too aware that higher US interest rates and a stronger US dollar are typically bad news for EM debt investors. This has been because they imply tightening global liquidity and increased external debt servicing burdens in local currency terms.

Of the external factors impacting EM economies, geopolitics has been relatively calm for the last couple of decades and less important. That is changing and it requires a different skill set from investors.

The pre-eminence of the US as a global hegemon is under threat from the rise of China. The US in turn is seeing its international role in the world in narrower terms. President Trump is using more sanctions than his predecessors and opting for bilateralism over multilateralism.

This poses challenges for investors. Conceptually, often the way investors think about global markets is premised on the pre-eminence of the US. If that changes over time then investors' assumptions about the role of the US will have to change too.

It will impact on the way we think about the institutions that control global governance too. The IMF and World Bank still play a pivotal role in emerging markets and it is hard to see that changing any time soon.

But the Trump presidency has undermined the World Trade Organisation, which was essentially the poster child for US trade policy for decades. The IMF could also yet find itself caught up in the crossfire between Trump and China.

Sanctions are familiar to EM investors, but what we have seen in the last two years is not.

In the past, sanctions generally came courtesy of the UN. They were reasonably predictable and focussed in nature. By contrast, many of the US sanctions over the last two years have been hard to predict and have had apparently unintended consequences.

When sanctions were imposed on Russian aluminium maker Rusal and its owner Oleg Deripaska in April, it had a significant impact well beyond the company and its owner. The entire global aluminium market and a vast swathe of Rusal's suppliers in and outside Russia were severely affected and almost no one saw them coming.

This pattern of sanctions will continue next year. Predicting them will be hard given so much seems to hinge on President Trump's whims. But investors will need to try to understand their impact. That means a more detailed analysis of transmission mechanisms of sanctions, through mechanisms such as supply chains.

However, sanctions are not the only new external factor. The US-China trade war is having anunequivocal and clear impact on the open economies of most EMs that are premised on open global trade.

Properly understanding the implications of this trade war will require more analysis than just looking at the brinkmanship alone. Anything beyond the first order implications will take until well into next year to fully understand regardless of whether the trade war ratchets up or down in the short term.

The new era of geopolitics will also force investors to revisit past assumptions. The close correlation of the Russian ruble and oil has been disrupted this year by sanctions. Rusal sanctions in April sent the ruble down as oil held steady and then rallied as oil fell at the end of the year. This was because anticipated new sanctions failed to materialise.

Yet more external factors could become relevant next year. President Trump's threats to cut aid to some countries could yet turn into more than words. The impact for some countries would be marginal. It would amount to around 0.4% of GDP in the case of El Salvador and Honduras and 0.2% of Guatemala's GDP.

Such aid cuts are manageable, but those proposed for Venezuela are not. Likewise, it is possible Trump pushes back on IMF support for countries that have borrowed significant sums from China, as Secretary of State Pompeo has done with Pakistan. That will not bode well for a broad swathe of countries in Sub-Saharan Africa.

External risk factors are nothing new for EM investors. But what is different from the past is that the key driver of risk is the US, where the policy environment has become less predictable.

The impact from changing US policies could be far reaching, weakening the influence of multilateral institutions and the countries that are dependent on their support. The world is changing. EM investors need to also.

“Sanctions are familiar to EM investors, but what we have seen in the last two years is not”

"We will be **developing our capabilities** to adapt to the new RFR environment so that we can continue to meet our clients' requirements **without disruption**"

Life after LIBOR

By Rod Paris,
Chief Investment Officer

What happens when the **"the world's most important number"** disappears? That is the scenario that the financial industry faces in the coming years as the London Interbank Offered Rate (LIBOR) is phased out.

The LIBOR ecosystem of interest rates has been a mainstay of the financial industry since the 1960s. Essentially, LIBOR is what some of the world's biggest banks estimate they would charge to lend money to their peers. At present, these interbank rates provide the benchmarks for global transactions running into the hundreds of trillions of dollars.

But there are problems with LIBOR. Since the global financial crisis, there is not nearly so much interbank lending as there was before. So the banks' LIBOR estimates are based more on judgement than actual transactions. As a result, and as successive scandals have shown, interbank offered rates have been open to manipulation by unscrupulous traders. Several have been jailed, and various banks have been heavily fined. LIBOR, then, has been deemed no longer fit for purpose.

Banks have been increasingly reluctant to publish their LIBOR submissions because of the conduct risks involved. The UK's Financial Conduct Authority has announced that they won't be required to do this from the end of 2021. So we will find ourselves in a completely different environment where some LIBOR rates will not be sufficiently supported.

The LIBOR benchmarks will be replaced by a host of new risk-free rates (RFRs). In the UK, the new benchmark will be SONIA, the Sterling Overnight Index Average. This RFR has been around for 20 years, but it has been administered by the Bank of England (BoE) since April 2016. The BoE implemented a reformed version in April 2018. As SONIA is based on actual transactions rather than estimates, it's much more robust. In the US, the Federal Reserve now publishes the Secured Overnight Financing Rate (SOFR) so it can be considered robust and a sound reference point. In the Eurozone, the picture is less clear; one possibility is that ESTER, the Euro Short-Term Rate, will replace interbank rates. Meanwhile, other regional RFRs will thicken the acronym soup.

So far, so simple. But the actual process of switching from the LIBOR ecosystem to the new RFRs entails considerable challenges. It is not simply a matter of using RFRs for new contracts. While there has been significant growth in the number of transactions benchmarked to SONIA and SOFR, existing contracts still pose problems. Given the myriads of contracts that depend on LIBOR, with more created every day, there is much work to be done by just about every financial institution on the planet.

Fallback clauses are crucial here. Many contracts contain provisions for the event of LIBOR becoming unavailable. But this was generally envisaged as a temporary disruption, not a permanent retirement. Therefore, the consequences of relying on those clauses could be undesirable, with the possibility of unintended transfers of value between the parties involved. There's a risk of instability in the financial system if a vast number of contracts are suddenly benchmarked at a different rate. Accordingly, the International Swaps and Derivatives Association is reviewing choices for more appropriate fallback clauses.

With all this in play, 2019 will be an important year. All financial institutions must ensure that their preparations for the end of LIBOR are well on track. This is not a task that anyone should underestimate. We are well advanced in our planning of this process.

So what will we be doing in 2019?

Aberdeen Standard Investments are already actively participating in the official consultations on this subject. And we have representatives in working groups at all levels of the industry, engaging with the Bank of England, the Investment Association and other industry bodies. In the year ahead, we will be monitoring and leading market developments to ensure that both our teams and our clients are fully prepared.

As part of this, we are already undertaking a thorough assessment of the impact on the industry. This will be a key focus in 2019. In the case of contracts that mature beyond 2021, we will be making provisions for transitions that entail only minimal disturbance of the assets under management.

Meanwhile, we will be developing our capabilities to adapt to the new RFR environment so that we can continue to meet our clients' requirements without disruption.

There is little doubt that the switch to RFRs is needed for the long-term health of the financial industry. The RFRs should prove more robust and reliable, and threaten the LIBOR ecosystem. Nevertheless, their adoption is one of the biggest shakeups that markets have faced in a lifetime. We will therefore be using 2019 to ensure that our clients experience a seamless transition to life after LIBOR. It is certain that all of us involved in the financial industry will be forced to adapt to this new environment over the coming years.

The four stages of populism

By Stephanie Kelly,
Political Economist

Relationships can be divided into four stages. First, there's euphoria. This is when all a partner's faults are forgiven, with the positives entirely outweighing the negatives. The second stage is early attachment. The euphoria has subsided, to be replaced with a state of contentment. Then, inevitably, comes crisis. Something changes drastically, creating a 'make or break' point. If, and only if, the crisis is successfully navigated, we get the deep attachment phase. That is when the relationship settles down for the long term.

As we enter 2019, the public's relationship with **'populist'** politicians will shape the political backdrop for markets. We expect this relationship to follow the four-stage pattern. The euphoric stage played out from 2016 to 2018 as voters flocked to populist candidates and causes. This was partly a response to the economic pain that followed the global financial crisis. It also reflected long-simmering resentment of **'elites'** and the effects of globalisation on living standards in the developed world. These problems are complex, but populist politicians put forward enticingly simple solutions. And a large part of the electorate supported them.

This euphoric catharsis manifested as a series of ballot-box shocks. We have also seen victories for Victor Orban in Hungary, Rodrigo Duterte in the Philippines, the Law & Justice Party in Poland and Jair Bolsonaro in Brazil. In the UK, the Leave campaign –the flagship policy of populist party UKIP – prevailed in the Brexit referendum. In the US, Donald Trump was elected president on a platform of trade protectionism and migration controls. And in Italy, the League and the Five Star Movement were able to form a coalition government this year..

Following these breakthroughs, the relationship between public and populists has entered various stages of the rose-tinted early-attachment phase. So far, the electorate has been getting what it voted for. In the US, President Trump has made good on his offers of t¬ax cuts and trade protectionism. In the UK, the Brexit process is underway, with departure from the European Union scheduled for March 2019. And the Italian government has embarked on both an expansionary fiscal policy and a programme of tax cuts.

But in 2019, we are likely to enter the crisis stage as the reality of those policies begin to bite. Elected populists will have to contend with the practicalities of government, potentially against a weaker economic backdrop. In the US, Democrat control of the House of Representatives threatens constant investigation of the president's affairs and complete stasis in domestic policy. To wrest back control of the news cycle, President Trump will have to up the ante with eye-catching measures, such as even more aggressive trade policies. These are likely to hurt his most loyal supporters where it hurts: their wallets

In Italy, the new government will have to face the reality of governing in a coalition of two very different parties. It must also attempt to make its fiscal plan function without destroying Italy's ability to service its debt. Clashes with the EU and the impact on Italian yields are likely to challenge this coalition. Another election or full blown Eurozone crisis is always just around the corner.

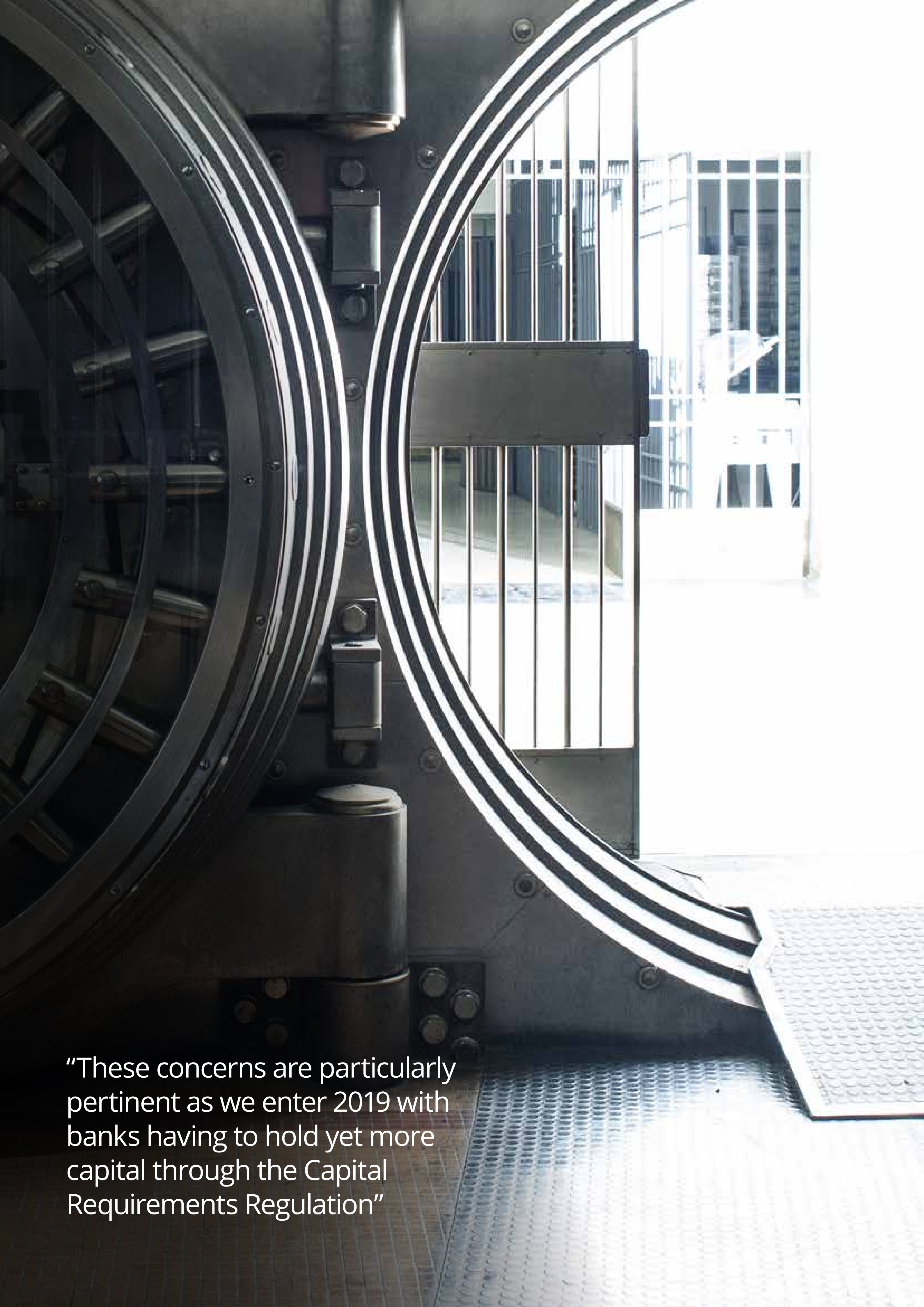
Meanwhile the UK will reach the crisis point as the post-Article 50 stages of Brexit begin to bite and the country has to contend with whatever deal is, or is not, reached. That will expose the impracticality of some Brexiteers who have simultaneously argued for independence from the EU and frictionless trade with it.

In short, populist politicians will be put to the test in 2019. This is likely to test voters in turn as populists attempt to build that deep attachment with unorthodox policy and strong language. Some populists may find that a challenging economic or political environment works to their advantage.. The key question is whether the challenges of 2019 cause voters to change course or deepen their attachment to these parties.

One thing to watch is how other politicians respond. Moderates in countries like Germany, the Netherlands and Sweden have already tilted towards populism to try to nip the appeal of the actual populists. Most would understandably prefer that populists fail under the weight of their own policies.

The underlying problem for all policymakers is that there are no simple solutions to deep-seated problems in the modern, globalised economy. In 2019, that reality is likely to become starker; the question is whether voters will stick by populist parties through the strife. In the meantime, markets are likely to continue to struggle to price in populism no matter what stage it is in.

“**Populist politicians will be put to the test in 2019.** This is likely to **test voters in turn** as populists attempt to build that deep attachment with unorthodox policy and strong language”



"These concerns are particularly pertinent as we enter 2019 with banks having to hold yet more capital through the Capital Requirements Regulation"

Consolidation constrained

By Vicki Cobain,
Investment Director,
F.I: Credit

On the face of it, European banks look ripe for mergers and acquisitions (M&A). According to the European Banking Federation, there are some 4,769 credit institutions in the Eurozone. And with so much competition in such a fragmented market, it is very difficult to be profitable. The average return on equity for Eurozone banks is just 5.6%, compared with a cost of equity estimated at above 10%.

So consolidation looks inevitable. It would cut costs, create economies of scale and provide opportunities for diversification, bringing higher profits in the process.

Regulators have been talking up the prospects for mergers for a long time and consolidation is all but inevitable at some point. But anyone hoping for a surge in activity any time soon will likely be disappointed.

One reason for the lack of action is that Europe's banks are still rebuilding from the global financial crisis. Progress at a region-wide level is happening – the European Banking Authority's latest stress test results showed this. But it is slow and banks will seek to avoid big M&A transactions before they've achieved significant improvements in profits and dividends.

Big mergers would however make that more difficult. When a bank becomes systemically important – as the product of any major cross-border merger would – it has to hold more capital and will attract greater regulatory scrutiny. This makes it harder for acquisitions to deliver uplifts in shareholder returns.

These concerns are particularly pertinent as we enter 2019 with banks having to hold yet more capital through the Capital Requirements Regulation. This will be fully phased in from 1 January 2019, and all banks in the European Union will need to comply.

Another reason is that banking mergers are just very hard to get right. The RBS/ABN AMRO debacle of a decade ago is a cursory example and will no doubt encourange caution among ambitious CEOs.

Given today's lighter-touch, data-driven relationships between banks and their clients, consolidation is arguably a higher-risk process than it used to be. The execution risks are substantial, with the integration of IT systems a crucial part of any banking merger. As we saw with Sabadell's acquisition of TSB, it is all too easy to get this wrong. These risks are particularly acute with cross-border mergers, creating a further major impediment to M&A.

Then there are the specifics of each country to consider. Italy continues to struggle with non-performing loans, and recovery progress has been slow here compared with other countries. Italy's largest bank, UniCredit, which has historically been active in cross-border consolidation, is still working through its recovery and accelerating the run-down of its 'bad bank' to 2021. It has other things than M&A on its mind.

In Germany, the banking market is crowded, with its 1,632 credit institutions making up around a third of the Eurozone total (Germany accounts for less than 25% of the Eurozone population). The industry's three-pillar ownership structure is itself an obstacle to intra-country M&A. There is a lack of pricing discipline and plenty of room for rationalisation of the branch network, but state ownership at both a federal and regional level limits political motivation to address these issues.

State support for banks is not limited to Germany with Italy, Netherlands, Belgium and the UK governments all bank equity owners. They have a vested interest to both protect the taxpayer's investment and the independence of the local banking industry.

These competing interests require potential suitors to have almost unending patience and diplomacy to try to make their interests align with those of their target, the government and even the public at large. When this state support is removed – as it has been to a limited extent in Spain and Germany – there will be some consolidation. But what's happened is minuscule in scale and more will not occur until state support is more comprehensively rolled back.

The great unfinished edifice of the EU Banking Union project is another impediment. There has been some harmonisation of rules but there are still big differences between countries in important areas such as tax and bankruptcy law. This makes any major cross-border M&A much more difficult to achieve.

The fact that it is not obvious when the banking union project might actually be completed does not help. Italy's new government and the start of Germany's quest to replace Mrs Merkel both make rapid progress unlikely.

Set against all these obstacles is the fact that shareholders need to see returns improve. That should happen as balance sheets continue to be repaired and banks have to deal with less new regulation.

Getting banks in better shape should grease the wheels of consolidation. But the journey has been long and there remains a good way to go. Consolidation will happen and should happen. Just not next year.


440.0
770.0
1,055.0
1,340.0

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*as at 30 Jun 2018

Important information