



PREDICTIONS 2015

ANIMAL SPIRITS AND CRISIS GHOSTS

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INTRODUCTION

Welcome to Reuters Breakingviews' annual attempt to set the financial scene for the year ahead. While we like nothing better than to be right, our goal is – as always – to provide insightful, entertaining and provocative ideas in the pithy style to which our readers are accustomed.

The subtitle of Predictions 2015, “Animal Spirits and Crisis Ghosts,” reflects what our writers see as a new level of tension between two conflicting sentiments.

On the one hand, stocks and other asset prices have in some cases several years of solid, but not yet outlandish, increases under their belts. On the other, regulations and policies inspired by the global financial crisis in 2008 continue to hold back certain industries, in particular banking where watchdogs are focused on maintaining bigger, and therefore more expensive, capital cushions.

Meanwhile, the end – most notably at the U.S. Federal Reserve – of a long period of very loose monetary policy represents one kind of crisis ghost that many in financial markets may not want to see disappear into the ether.

The past year has also brought new concerns, including a dangerous political and military standoff between Russia and the West over Ukraine. We predict that this and other shifts involving China and the United States will erase any vestiges of a post-Cold War peace dividend, with defense spending likely to ratchet higher and some risk of an arms-race spiral.

The oil price will stay well below \$100 despite the geopolitical tensions in oil-producing parts of the world, but that may itself provoke other kinds of trouble. The U.S. economy will lead growth in the developed world, supporting a strong dollar which could cause pain elsewhere.

The UK's intriguing general election, in which, unusually, five political parties could all matter, could go to a Labour-led coalition. Meanwhile, Japan is the monetary policy exception, and we predict Tokyo's may be the first regime truly to test the efficacy of almost literally dropping banknotes from the skies. China faces the twin challenges of slowing economic growth and a still festering bad-debt problem.

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Germany's players lift the World Cup trophy as they celebrate their 2014 World Cup final win against Argentina at the Maracana stadium in Rio de Janeiro July 13, 2014. REUTERS/Darren Staples

We predict more telecoms consolidation in Europe, probably led by BT, and that the biggest globally active private equity firms, flush with cash but struggling to compete with corporate buyers in 2014, will have to compromise on returns if they want to use up their dry powder.

Dealing with activist investors has become routine for corporate chiefs in recent years. Coca-Cola, PepsiCo and IBM could see more of it. Cagerattling may at last reach the U.S. banking sector in 2015, perhaps even Citigroup or JPMorgan, testing Janet Yellen's Fed in its capacity as the industry's top overseer. Globally, we suspect one or more of the lenders now in the too-big-to-fail category will try to become smaller.

A big cybersecurity breach is something else at the top of executives' minds in the financial sector and elsewhere after hacks at JPMorgan and Sony raised the profile of this risk. We argue that cyber-insurance is one related industry that will come of age as a result.

We also offer predictions referencing Carlos Slim's America Movil, Morgan Stanley, Bank of America, Alibaba, General Motors and others. We trust some of our ideas prove prescient, as we were for example in our data-driven prediction that Germany would win the soccer World Cup last year. But above all, we wish all our readers a happy and prosperous 2015, aided – we hope – by Breakingviews.

Richard Beales

*Deputy editor, Reuters Breakingviews
Jan. 2, 2015*

OLD WOUNDS

THE TOO-BIG-TO-FAIL CLUB WILL SHRINK IN 2015

BY PETER THAL LARSEN WITH ADDITIONAL RESEARCH BY ROBYN MAK

The too-big-to-fail club will lose some members in 2015. The list of global banks deemed vital to the financial system has barely changed since regulators first published it in 2011. But the costs of inclusion are rising. This year, some lenders will try to find a way to leave.

Being labeled a global systemically important bank or G-SIB was never supposed to be an aspiration. In the past three years, however, the epithet has perversely conferred a certain kudos: these were the institutions no government could ever allow to fold. Since 2011, Standard Chartered, BBVA of Spain and two of China's four largest state-owned lenders have joined the lineup. The only banks to drop off the list were European groups like Commerzbank, forced to shrink their balance sheets after receiving state bailouts.

Yet the costs of membership are beginning to outweigh the benefits, according to calculations by Breakingviews. The median G-SIB balance sheet shrank by 2 percent in the year to December 2013. Over the same period, smaller American and Asian lenders expanded their assets by 4 percent and 12 percent, respectively.

From 2016, G-SIBs will be required to keep an extra capital buffer worth between 1 percent and 3.5 percent of their risk-weighted assets. They will also be first in line to adopt proposed new regulations that require them to hold a minimum amount of equity and debt that can be written down in a crisis. Faced with these burdens, G-SIBs – and their shareholders – will begin to rethink the benefits of the designation.

Regulators are pointing the way to the door. In November, they spelled out the 12 criteria – ranging from size to cross-border scale – used to identify G-SIBs. That gives banks a clear incentive to rejig their operations in order to shrink the amount of extra capital they are required to hold.

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Not all institutions will be able to escape. Big banks based in small countries, like UBS and Credit Suisse, will face hefty demands at home regardless of their global status. For others, though, 2015 will be the year when too big to fail becomes too much of a bother.

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EURO ZONE WILL FLIT BETWEEN CRISIS AND CATHARSIS BY NEIL UNMACK

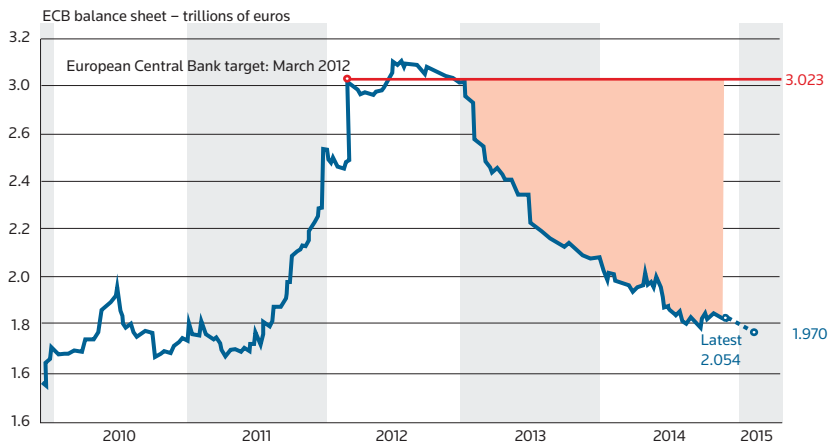
The euro zone will flit between crisis and catharsis in 2015. Populist parties are on the rise, the economy is stalling and governments are paralyzed by their divisions. On the other hand the euro zone has stronger banks, and an activist European Central Bank. There is cause for hope, but it is tiny.

The euro area may boast a fiscal deficit of only 2.3 percent of its gross domestic product, but that goes together with – and partly explains –

ECB balance sheet

Adjusted for net contraction of €59.6bln by February 2015.

****Click on the graphic to view online version.****



Source: Thomson Reuters Datastream, data to Nov. 28, 2014. V Flasseur

lackluster growth. The IMF expects the euro zone to grow 1.3 percent next year while the world economy will grow three times as fast. Two of the largest economies, France and Italy, are stuck.

At least there are two tailwinds. Banks have been recapitalized, and should be able to lend. And the ECB has become more active, after being prodded into credit easing by the threat of deflation.

Combined with lower oil prices, these should keep growth strong enough to prevent massive economic shocks. The ECB's policy should keep asset prices buoyant, and weaken the euro. Yet the euro zone will remain overly indebted, trapped in a fiscal straightjacket due to political paralysis, with the unemployment rate forecast by Citigroup at 11.2 percent. That will provide fodder for rising populism.

The threat may boil over in several places. Greece may see early elections with left-wing Syriza, which wants to renegotiate the country's debt, standing reasonable chances to be part of a government. Italian premier Matteo Renzi may also be forced to call early elections if his reform agenda stalls. That could hand greater power to the Northern League, which advocates leaving the euro. Spanish elections could see Podemos, whose radical policies might lead to a euro break-up, influence policies in Madrid.

Europe has the wherewithal to counter the populist threat. Healthy banks and proper monetary policy are a good start. But governments need to push ahead with growth-friendly reforms. These take time, so looser fiscal policy is needed in the shorter term. And governments need to listen to the populists: debt restructuring shouldn't be a taboo.

It's probably too much to expect tough action, barring economic disaster, as long as the ECB keeps loosening its policy. Central bank head Mario Draghi is determined, but as long as he doesn't get any help from the monetary union's governments, his fight to boost growth in the long term will be a losing one.

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STRONG DOLLAR IS \$10 TRILLION HEADACHE FOR DEBTORS

BY ANDY MUKHERJEE

The prospect of a stronger greenback is now a \$10 trillion headache for the global economy. Borrowers who have loaded up on cheap dollar debt since the financial crisis could get into serious difficulty – especially if they don't have enough U.S. currency revenue to repay creditors. The threat to financial stability is high.

The numbers are startling. Global banks' international claims on the non-bank private sector – the sum of cross-border lending and foreign-currency loans extended by their local affiliates – has topped \$9.5 trillion, according to the latest quarterly report from the Bank for International Settlements. In addition, non-bank private corporations in emerging markets have borrowed more than \$500 billion on the international bond markets between 2009 and 2013.



A man wears U.S. dollar sign rings in a jewellery shop in Manhattan in New York City Nov. 6, 2014. REUTERS/Mike Segar

The actual currency breakdown of these liabilities is unknown. But it's safe to assume that a big chunk of the borrowings will need to be repaid in dollars. That could prove challenging. The greenback has surged 12 percent against a basket of major trading partners' currencies since the end of June. An improving U.S. job market could see the dollar extend its climb in 2015.

Borrowers could find their debt burden rise in tandem with a strengthening dollar. In many emerging markets, domestic demand is weakening. At the same time, global growth remains anaemic, and prices of commodities – the staple exports of many developing nations – are in free fall. The sharper the rise in the dollar, the bigger the squeeze on borrowers in relatively poorer nations.

The risk of a debt accident is probably highest in China. At the end of 2008, global banks' cross-border loans to the mainland accounted for just 6 percent of their total such exposure to emerging markets. That ratio has now soared to 28 percent. If faltering growth leads to capital outflows from the People's Republic, causing the yuan to weaken significantly against the dollar, the repayment of the \$1.1 trillion that Chinese borrowers owe to the rest of the world could come under a question mark. While policymakers in Beijing may have the tools to deal with local-currency defaults, a foreign-currency debt debacle in China could do serious damage to the global financial system. The \$10 trillion headache would become a splitting migraine.

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CHINA NEEDS HISTORY'S BIGGEST SPRING CLEAN

BY JOHN FOLEY

China is in need of history's biggest spring clean. Two years of reforms have probably stopped the flow of undesirable conduct from increasing. To make behaviour really change, it's just as important to deal with the stock too: specifically a huge backlog of bad debts, empty houses and dirty secrets.

Start with debt. Lenders are in denial about loans to companies that are unlikely to pay back. According to figures from the Chinese bank regulator, just 1.1 percent of their lending had gone bad by the end of September.

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Yet that low number doesn't gel with the two-year low in industrial profit growth, or GDP for 2015 growing perhaps at its slowest rate since 1990.

Understandably, no bank wants to go first. If bad debts were revealed to be 5 percent, lenders would need around \$500 billion to restore their balance sheets to their current state of apparent health. The government, as major shareholder, would need to supply much of that. Yet it would be worth it. The mass of covered-over bad debt takes up precious lending capacity – and freed from it, banks would have less reason to fear transparent accounting.

Cleaning up the housing market must come next. China has 49 million units of empty dwellings, according to the wide-ranging but unofficial China Household Finance Survey. Yet home ownership passed 90 percent at the end of September. Most terrifyingly, almost 12 percent of household assets are tied up in empty homes. Prices are sliding, but not enough to attract new buyers. The market is stuck, and huge amounts of wealth are trapped.



A visitor takes pictures of a model of Beijing's downtowns at the Beijing Planning Exhibition Hall, a museum showcasing the achievement of Beijing urban planning construction. Nov. 5, 2013. REUTERS/Kim Kyung-Hoon

To get things moving again, China could do worse than set up a fund to buy back properties that are no longer wanted or can't be sold otherwise. Those 49 million houses, at roughly 60 square metres each, might be valued today at \$1,700 per square metre based on the national average price. Say, the new fund buys at 80 percent of that valuation and resells at 50 percent, primarily to lower-income families living in sub-standard accommodation. It would add \$1.5 trillion, or 15 percentage points of GDP, to the government's debt. No Western country would meddle so openly, but a supposedly socialist country could do so with ideological impunity.

Finally, there's corruption. The arrest of Zhou Yongkang, former security czar, showed that the ruling Communist Party is getting tough on high-level graft. Chinese citizens are hearing with increasing regularity about egregious cases like that of General Gu Junshan, who gave out Mercedes cars loaded with gold bars, according to a recent Hong Kong magazine report.

Yet not much has changed in everyday life. People are reluctant to call corruption when they see it, partly because low-level bad behaviour is engrained for them too. Advertisements tout fake documents that allow citizens to buy houses they shouldn't. Flouting the complex sales tax system is commonplace. Many officials are just lying low until the storm passes, confident that the government can't get rid of them all.

There's one way around that stalemate: declare an amnesty for financial misdeeds. China could demand that ill-gotten gains above, say, 1 million yuan (\$161,000) be returned over time, with stiff penalties for those who fail to declare and are found out later. It would be deeply controversial, and would have to apply to petty officials as well as powerful honchos.

China tried such an amnesty briefly in the late 1980s with little lasting success. But the climate is different now. Collecting a few top-level scalps as a warning could convince people to buy in. A little creative thinking might go a long way. Perhaps corrupt officials could be made to swap their hauls for zero-coupon bonds issued by the bad-homes bank, redeemable in thirty years or so. Their funds could even be used to recapitalise the banks.

Imagine China goes through with its enormous clean-up. What then? There would be big challenges ahead, not just eradicating bad behaviour

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but incentivising good. That will only happen when finance, politics and markets are seen widely to be fair and efficient. It's a task of decades, not just a year. But that ultimate goal can't even be considered until the slate has been wiped clean – and there's no time like the present.

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MORGAN STANLEY CEO CAN OUTDO BANK OF AMERICA BOSS **BY ANTONY CURRIE**

James Gorman will leave Brian Moynihan in the slow lane in 2015. It's the year the chairmen and chief executives of Morgan Stanley and Bank of America, respectively, mark five years in charge of the two global banking powerhouses. Neither has had an easy time of his first half-decade. Gorman, though, looks on track to lead his firm's return on equity back above 10 percent.

It's an important goal, representing the point at which large banks comfortably cover their weighted average cost of capital. Some six years after the worst of the financial crisis, though, it's also a pretty humdrum one. Moynihan has, of course, had to shell out more than \$60 billion to cover legal fees and to buy back dud mortgages. Gorman, meanwhile, has had to overhaul both trading and wealth management. And both, along with the rest of the industry, are adapting to new regulations.

Of the two, BofA's underlying business actually looks more robust. Its consumer and wealth management arms both cranked out returns on average allocated capital of around 25 percent in the first nine months of 2014. Global banking hit a decent 17 percent. Even trading managed 10 percent. Common equity returns at Morgan Stanley's individual divisions don't get out of the teens.

The problem Moynihan has is that the bank's expenses are still too high, even after recent cost cutting and allowing for legacy legal and mortgage charges. The bank's efficiency ratio hovers up near 70 percent, while rivals like JPMorgan and Wells Fargo are below 60 percent. To reach a firm-wide 10 percent return, BofA needs to find an extra \$6 billion or more



Left: Morgan Stanley Chairman and Chief Executive James Gorman. Right: Bank of America Chairman and Chief Executive Brian Moynihan. Both men spoke during the Institute of International Finance Annual Meeting in Washington Oct. 10, 2014. REUTERS/Joshua Roberts

of net income a year, whether from additional revenue, cost cutting or both, Breakingviews calculations show. That equates to around a third of adjusted earnings.

The only obvious help on the horizon would be a rise in interest rates. The bank reckons a 1 percentage point jump would add \$3 billion to the top line.

Morgan Stanley, though, has some levers to pull. Its growing deposit base allows the firm to reduce funding costs and also boost income from lending to its wealth-management clients. And a recent tweak to how bonuses are paid could add 0.6 percentage points to annual equity returns. That should just be enough to sneak Gorman a few steps ahead of Moynihan in the race for acceptable returns.

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BANKS WILL MAKE ASSET MANAGERS PAY FOR REGULATION

BY DOMINIC ELLIOTT

Asset managers are about to find life more expensive. After years of mounting regulatory costs and low interest rates, investment banks are attempting to charge clients more. The trend looks likely to accelerate over the coming 12 months.

Only three of the world's 10 biggest investment banks are expected to make a return on equity in excess of 10 percent next year, Eikon SmartEstimates show. A steady stream of fines has wiped out the efficiency gains from cutting operating expenses. Banks will struggle to make their cost of capital, estimated by McKinsey to be around 11 percent to 12 percent.

That leaves pricing as the next source of added return. The areas where profitability has been hit hardest are fixed-income trading and prime broking, the business of servicing hedge funds – this is where new regulation on liquidity and leverage really bites.

Rules forcing banks to hold enough high-quality assets to get through a 30-day market crisis restrict lending. These constraints are already widening bid-offer spreads on longer-dated derivatives, and raising rates on loans. Leverage requirements for banks make it costlier to provide finance to equity hedge funds seeking to gear up their portfolios. The same dynamic is at work for fixed-income repurchase agreements, or repo, a type of collateralised lending that enables hedge funds to bet on falling bond prices.

Banks may offer some of these services as loss leaders. Barclays, for example, is taking a holistic three-year view of client relationships in some cases, says one person familiar with its working. This approach will work only where clients are big enough to offer multiple revenue opportunities. Many banks are aiming for fewer overall relationships with more relevant clients. That may spur consolidation, particularly among hedge funds.

The simpler alternative is to raise prices where products are becoming uneconomic. Credit Suisse is talking to clients about raising prime-broking

charges, says a person familiar with its activities. JPMorgan Chief Executive Jamie Dimon has said that revolving loans and repos need re-pricing. The persistence of low returns will spur others to follow.

Published December 2014

DEUTSCHE STRATEGY REJIG MAY PRESAGE CEO SUCCESSION **BY DOMINIC ELLIOTT**

Deutsche Bank's board faces a stability test. The German lender says it will review its direction and targets in 2015. Its bet on capital markets remains unproven and likely regulatory settlements in the coming months could raise further doubts. Recent executive moves suggest Deutsche is keeping options open for strategy and leadership change.

Co-Chief Executives Anshu Jain and Juergen Fitschen are committed to a full-service investment banking model. But the credibility of this took a knock in May when the bank pushed back a 12 percent return on equity target by one year to 2016. Deutsche is now forecast to make a RoE of just 6 percent in 2015, Eikon SmartEstimates show, less than any of its nine largest peers.

It's not clear precisely what Deutsche has in mind. The introspection could lead to a sale of retail unit Postbank, sources have told Reuters. The business also accounts for a chunky 11 percent of Deutsche's non-core assets. Selling it would improve the firm's skinny 3.2 percent Basel III leverage ratio. A sale would also leave Deutsche even more reliant on investment banking, which would jump to half of group revenue, up from 45 percent currently.

There may be further pressure on the co-CEOs if Deutsche announces UK and U.S. settlements following industry probes into failings around Libor. These are likely to happen in the coming months, says a person familiar with the situation. Unlike other banks, Deutsche has not yet been involved in settlements for foreign exchange benchmark-rigging. The UK's Financial Conduct Authority told the bank in November it would not be taking action against it in relation to a settlement with five other banks. Deutsche has 3 billion euros in legal reserves.

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Anshu Jain (left) and Juergen Fitschen (right), co-CEOs of Deutsche Bank, and Paul Achleitner, head of the supervisory board, pose for the media prior to a shareholders meeting in Frankfurt May 22, 2014. REUTERS/Ralph Orlowski

Ongoing internal investigations into the Libor and FX debacles have found nothing that implicates Jain or Fitschen, says a person familiar with the reviews. But any settlements will offer a pretext to rethink governance.

Recent executive moves suggest Deutsche is already thinking about succession. In October, Chairman Paul Achleitner hired Marcus Schenck from Goldman Sachs to take over from Stefan Krause as chief financial officer. Krause, in turn, has been tasked with shaping Deutsche's strategy beyond its so-called "2015+" plan. Both look like possible CEOs in waiting, alongside Stephan Leithner, head of regulatory affairs, and retail bank head Rainer Neske.

Deutsche's performance in 2015 will be critical. If it slips, it will be hard to separate the strategic review from who should preside over Deutsche's next phase of evolution.

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U.S. HOUSING DEMAND IS BUILDING

BY DANIEL INDIVIGLIO

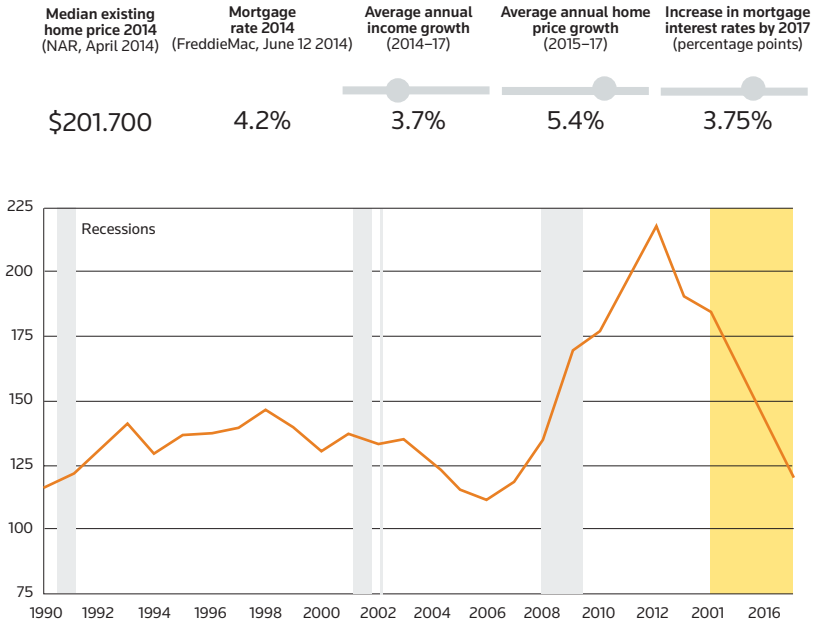
The U.S. housing market is set for another leg up. Increasing household formation, job creation and easing credit look set to give the market a boost, despite rising interest rates and the headwind of sliding affordability.

Prices rebounded surprisingly quickly after the 2008 financial crisis. Since the early 2012 trough, the S&P/Case-Shiller national index has jumped 25 percent, regaining mid-2005 levels. Median American home prices are back above \$200,000.

Breakingviews Housing Affordability Index

As housing prices in America rise and the Fed lifts interest rates, affordability will plunge by 2017.

****Click on the graphic to view online, interactive version.****



Source: Modeled on the National Association of Realtors' Housing Affordability Index using official statistics. June 18, 2014. Daniel Indiviglio/Richard Beales/Matthew Weber.

That owed more to shrinking supply than rising demand, however. The still-falling home ownership rate is at 64 percent, near the level seen in the mid-1990s before it took off. Meanwhile, new home sales at about 450,000 a year are running at only half the pace at the peak of the pre-crisis boom.

There's pent-up demand for homes from new families. Since 2007, household formation has averaged just 600,000 annually, half the 1.2 million that would be consistent with population growth. It's on pace to hit 850,000 this year, the highest since 2006, but there's scope for more.

That's especially true if more Americans aged 18 to 34 find jobs. Their employment-to-population ratio fell to a low 65 percent in mid-2011. But it's back up to 69 percent, with room to climb before matching the 2007 high of 73 percent. Per-capita incomes are also ticking higher in real terms, albeit still modestly.

Home loan availability has increased gradually since 2012 as well, according to the Mortgage Bankers Association. And housing regulators recently announced looser standards for some government-guaranteed loans.

The dangers include the higher interest rates expected from the Federal Reserve sometime in 2015. The Breakingviews Housing Affordability Index showed in June that higher rates could easily outweigh only slowly rising incomes and push affordability down to 2008 levels within a couple of years, and the situation hasn't changed much since then.

The economy and jobs market look strong enough to win out. A repeat of the housing boom looks thankfully unlikely, but 2015 could still offer the strongest housing market Americans have seen in a while.

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FUTURE FINANCIERS CONDEMNED TO REPEAT SINS OF PAST

BY JEFFREY GOLDFARB

Future financiers are condemned to repeat the mistakes of the past. Nearly 150,000 wannabe investment advisers, bankers, risk managers and analysts around the world will sit for the CFA exam on June 7. Success hinges on their understanding of the capital asset pricing model and return on equity. Knowledge of disasters like the South Sea Bubble and the Great Crash, though, are not required. Widespread ignorance of financial history is an overlooked systemic risk.

Some degree of comfort can be taken from the fact that most of today's finance professionals actually lived through a crisis memorable enough to be included in the economic canon. Even so, many of them still lack the context to realize the latest mortgage-induced meltdown wasn't unique. The best chance to break, or at least subdue, the pattern of greed-induced exuberance followed by fear-fueled crash is with a certain degree of appreciation of the phenomenon.

There's no evidence yet, however, of a scholarly renaissance. The latest candidates for the chartered financial analyst credential, much like the first class of just a few hundred in 1963, will have crammed for months to grasp the intricacies of currency exchange rates, credit risk, ethical practices and portfolio management. The ones who pass – only a small fraction do on the first attempt – will theoretically be in position to better serve customers and employers. But they will have a gaping hole in their education.

The CFA Institute is trying to adapt, albeit slowly and only up to a point. It wants to impress upon aspiring charter holders the significance of yesteryear without necessarily forcing it on them. The group eventually aims to teach students how to incorporate market history into investment-making decisions. Because the governing body creates its own materials to standardize them for a global audience, however, the likes of John Galbraith, Charles Kindleberger and Milton Friedman will not be the required reading they should be.

It's much the same for MBAs. At New York University's Stern School of Business, for example, Richard Sylla's 24-year-old course on the history of financial institutions, markets and economics is an elective. That may

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prevent students from resenting the subject matter, but also means most of them will devote their time at school to learning about the latest derivative rather than the evolution of central banking systems. That's why teaching the profession's past should be mandatory.

A simpler place to start, though, would be with the philosopher George Santayana, and his warning about what happens to those who can't remember history.

Published June 2014

CHANGING TIMES

SUB-\$100 OIL WILL INFLAME GEOPOLITICAL TEMPERS

BY KEVIN ALLISON

Sub-\$100 per barrel crude may inflame geopolitical tempers in 2015. The sharp slide in the oil price since June from triple digits into the \$80-\$90 range is turning up the heat on oil producers. But two of the world's most flexible suppliers – Saudi Arabia and U.S. shale drillers – can stand the pain for some time.

OPEC lynchpin Saudi Arabia needs an average oil price of around \$92 per barrel to cover public spending, according to analysts surveyed by Thomson Reuters. Even with the recent price slide, Brent crude oil has still averaged well over \$100 per barrel over the past six months. The price would have to stay below Saudi's breakeven level well into 2015 before OPEC's swing producer starts to feel the pinch. Even then, the kingdom has roughly \$770 billion of foreign reserves, enough to cover shortfalls for years.

Analysts say U.S. shale drillers, the newest arrivals among big global producers, mostly need an average oil price of \$60-\$80 per barrel to break even. But the precise number varies widely, and drilling costs have been falling as engineers become more experienced. The companies involved may just step up cost-cutting efforts or divert investment to cheaper oil fields rather than cutting supply if prices stay low.

Some petro-states won't have it so easy. Venezuelan President Nicolas Maduro, for instance, needs a crude price of about \$117 per barrel to pay his government's bills – second only to Iran's \$136. The Latin American nation's financial difficulties could morph into a political crisis. OPEC members in need of such high prices may not take kindly to Saudi Arabia's stance.

Vladimir Putin's Russia, meanwhile, relies on oil and gas to fund more than half government spending. And at just \$92 billion as of September, its rainy-day reserve offers only a limited buffer. A fall in oil revenue combined with the impact of sanctions over Ukraine could choke off growth in 2015.

BREAKINGVIEWS

OPEC breakeven oil prices

Oil price per barrel needed to meet OPEC countries budget

****Click on the graphic to view online version.****



— Brent crude oil price – US\$/bbl — Breakeven oil price* – US\$/bbl — Average price YTD – US\$/bbl

* Oil prices needed to meet expenditure based on Reuters survey of nine oil consultancies, banks and independent analysts. Source: Thomson Reuters Datastream, Reuters survey, data to Dec. 4, 2014.

The Saudi-U.S. shale dynamic suggests that without a big shock to supply elsewhere, prices in the \$80 a barrel range could hold in the coming year. For oil users, whether industrial importers or car-loving consumers, lower prices will provide a boost. But within the OPEC group and beyond, reduced oil revenue could make political tensions worse.

Published October 2014

JAPAN'S CASH HELICOPTER MAY BE FIRST TO TAKE OFF

BY ANDY MUKHERJEE

Japan could become the first rich nation to launch helicopter money. Dissatisfaction with deflation and growing disillusionment with quantitative easing might prompt the country to reach for the final trick in the monetarist playbook.

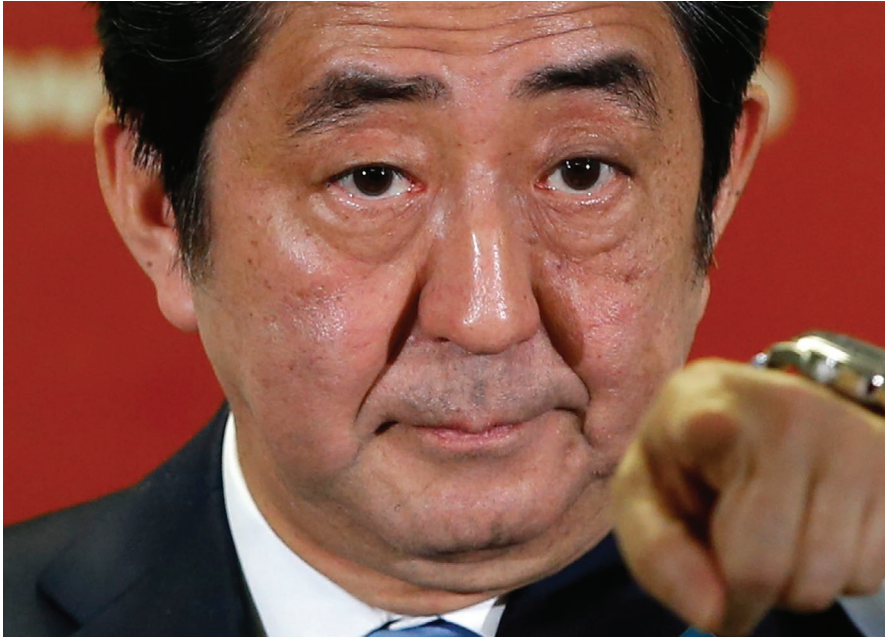
Economist Milton Friedman first conjured up the enticing image of bank notes dropping from the skies in 1969. Thirty years later, Ben Bernanke proposed a helicopter drop of cash as an antidote for Japan's anaemic demand and falling prices.

The future Fed chairman's suggestion was too outlandish for what was then still a conservative Bank of Japan. The central bank had already cut interest rates to zero, and subsequently embarked on quantitative easing. But that's about as far as it has been prepared to go.

Yet QE is failing to live up to its billing. The monetary authority is buying staggeringly large quantities of financial assets from banks in return for newly-printed yen. Government bonds worth about \$1.7 trillion – a quarter of the outstanding amount – have already vanished into the BOJ's vaults.

This bond-buying spree has yet to launch a self-sustaining cycle of private demand, or lift inflation to the central bank's 2 percent target. A panicky BOJ policy board decided in October to expand its asset purchases by as much as 60 percent.

BREAKINGVIEWS



Japan's Prime Minister and the leader of the ruling Liberal Democratic Party (LDP), Shinzo Abe, points to a reporter during a news conference following a victory in the lower house elections by his ruling coalition, at the LDP headquarters in Tokyo Dec. 15, 2014. REUTERS/Toru Hanai

QE makes cheap cash available to banks to lend, but they can't do so unless there are willing borrowers with profitable investment opportunities – a problem in ageing Japan. This is where Friedman's helicopter comes in by giving cash directly to households.

The mechanics would be relatively straightforward. Assume each of Japan's 52 million households received a debit card with, say, 200,000 yen (\$1,700) loaded onto it by the central bank. Any remaining balance on the cards would disappear after a year, ensuring that recipients spent the windfall. The move would inject an extra 10 trillion yen, or 2 percent of GDP, of private purchasing power into the economy. This in turn would encourage companies to invest and pay higher wages. The net effect would resemble a tax cut, but one financed by newly printed money rather than government debt.

For Japan, whose government debt already equals 245 percent of GDP, being able to stimulate the economy without having to sell more bonds would be a major advantage. Consumers could spend freely in the knowledge that they would not have to repay the windfall in future in the form of higher taxes.

But if Friedman's helicopter is such a doughty anti-deflation tool, why has no central bank used it yet? The usual answer is that tax cuts are fiscal decisions that only elected governments can make. Monetising the government's debt is a recipe for a debased currency and hyperinflation.

Japan has given cash to its citizens in the past and may do so again. But the cheques have always come from the government, not the central bank. Upsetting this status quo will mean the finance ministry loses control of fiscal policy. Politicians won't let such a thing happen. The BOJ might also balk at such a radical move: its policy board only narrowly approved the recent expansion of QE.

Yet Japan could introduce a money-financed tax cut by stealth. Suppose that QE ends in late 2016. By then, the BOJ will own almost two-fifths of Japan's government debt. Any attempt to sell those bonds back to the private sector could undermine the country's economic and financial stability.

Adair Turner, former chairman of Britain's Financial Services Authority, has suggested converting the central bank's government bonds into perpetual, zero-coupon securities. With one stroke of its pen, the government would be free of its obligation to repay the debt. The pressing need for Japan to raise taxes would vanish. The fragile consumer economy, which buckled under the burden of a modest increase in the sales tax last April, would breathe a sigh of relief. This too will be a money-financed tax cut by the back door, without the need for helicopters or debit cards.

Such an experiment in monetary manipulation would attract a worldwide audience. Many rich nations have depleted their rate-cutting arsenal. If the fight against long-term deflationary stagnation becomes a losing battle, Friedman's helicopters might not just be flying over Japan.

Published January 2015

BREAKINGVIEWS

UKRAINE CRISIS FORCED INTO SUSPENDED ANIMATION

BY PIERRE BRIANÇON

Western economic sanctions against Russia were expected to have no effect. Yet they have caused pain. They were also meant to have a clear goal. So far, they don't.

“The war that dare not speak its name,” to quote New York University professor Mark Galeotti, is a problem both for Russian President Vladimir Putin and for European leaders who have struggled to keep a united front since Russia moved to annex Crimea in March.

Defining a strategy beyond sanctions is all the more important for Europe now that Russia is sending all the signals that it has no intention of retreating from its power-flexing policy, from the Baltic to the Balkans. Moscow is hinting that it can take the pain from prolonged economic



A masked pro-Russian protester sits on a chair as he poses for a picture inside a regional government building in Donetsk, eastern Ukraine April 25, 2014. REUTERS/Marko Djurica

isolation – at least for the next couple of years. That is a highly optimistic view of the situation, but the implication is clear: don't expect any short-term change.

The harm done to a Russian economy already immersed in deep problems before anything happened in Ukraine has been substantial. The rouble fell more than 35 percent against the U.S. dollar in the first 11 months of 2014. Capital flight will amount to nearly \$130 billion this year, according to official estimates. The Central Bank of Russia is trying – without success – to keep inflation under control, putting a brake on growth. Meanwhile sinking oil prices are pushing Russia's resource-dependent economy ever deeper in the hole. Gross domestic product will barely increase in 2014 and probably shrink in 2015.

The European economy is hurt in return. Some countries are hit by Putin-ordered embargoes on food or clothing imports. Others are worried about their energy dependence on Russia. Western diplomats and businessmen think there's little chance Moscow will ever cut off gas to Europe. But no one has ever accused Putin of being predictable.

This state of affairs will continue as long as Europeans don't agree on what they want to achieve. Is Putin open to a deal that would ease tensions in eastern Ukraine? Or has he embarked on a long game of brinkmanship from which he will not retreat?

The answers to these questions lie with the Kremlin. But as long as Europe lacks a clear objective, the Russian president will be left to misinterpret mixed messages – and Ukraine will remain a crisis in suspended animation.

Published December 2014

WHERE TO HIDE IN AN EMERGING MARKET ROUT

BY ANDY MUKHERJEE

Emerging markets follow the biblical rule of seven lean years followed by seven rich ones, according to Harvard University economist Jeffrey Frankel. Every fifteen years, a crisis erupts.

By that measure, a rout is almost due. Developing economies have seen six years of brisk credit growth, fuelled by cheap global money. Private and public debt has ballooned. Since the end of 2007, the surge has been 90 percent of GDP in China, 30 percent in Brazil, and 40 percent in the Czech Republic.

These types of excesses typically stop abruptly. Seven years of frenzied petrodollar recycling in Latin America ended with a debt debacle in 1982. A seven-year boom preceded the 1997 Asian crisis. The trigger for the next rout could be an uncontrolled rise in U.S. bond yields, leading to an exodus of capital from developing nations.

Where can investors hide if emerging markets get into trouble? There are three possible sanctuaries. In Eastern Europe, growth has plunged in sanctions-hit Russia, and slowed in Poland. But Hungary under Prime Minister Viktor Orban is growing faster than before the 2008 crisis, and the forint has regained some of its lost competitiveness. Hungary's trade is in surplus, and its credit overhang is unwinding.

In Latin America, slowing Chinese demand is ending a decade-long boom in commodity exports. Trade deficits are widening in Peru; surpluses are dwindling in Brazil and Chile. GDP growth has stalled in Venezuela and Argentina. Mexico, led by President Enrique Peña Nieto, stands out. Its trade is balanced, growth is reasonably strong, and credit expansion is muted.

In Asia, the country that comes closest to a sanctuary is the Philippines. Growth is rapid, and government finances are in much better shape than before. In a 2015 beauty pageant, the Philippines might lose out to some larger economies which could reap a reform-led bounty. Still, India and Indonesia are risky bets, while South Korea is flirting with deflation.

Since the brief selloff of mid-2013, many emerging markets have sacrificed domestic demand to reduce their reliance on hot money. For them, the lean years may have begun without a meltdown. Even then, few developing nations appear ready for long-term U.S. bond yields of, say, 4 percent. If the skies darken, Hungary, Mexico and the Philippines are the most attractive shelters.

Published December 2014

DRY POWDER MAY EXPLODE IN BUYOUT BARONS' FACES

BY JEFFREY GOLDFARB

In the private equity world, almost everything is going up. That's just not as good as it sounds for buyout barons.

The return of heaps of capital to investors in their funds is one reason for them to celebrate. More troubling, though, are the record high multiples being paid for acquisitions, new highs in the amount of debt being larded onto portfolio companies relative to their operating cash flow, and intense competition from corporate buyers. For mega-fund managers including Apollo and Blackstone, their massive purchasing power heading into 2015 may be tough to deploy without pushing returns lower.

According to Preqin, buyout funds have some \$460 billion of so-called dry powder. Add leverage and the growing amount of capital from pension funds that want to co-invest alongside them, and the figure probably tops \$1.5 trillion.

One figure notably on the decline, however, is deal volume. Through early December, the value of leveraged buyouts around the world tumbled by 12 percent from a year earlier and accounted for less than 5 percent of total mergers and acquisitions, according to Thomson Reuters data. That's the lowest proportion since 2009. In the United States, the drop in volume was almost 30 percent. The biggest LBO of 2014 to date, the \$8.7 billion purchase of pet-store chain PetSmart by BC Partners announced on Dec. 14, is just a consolation prize for private equity as a whole.

BREAKINGVIEWS

Leveraged buyout merchants are being squeezed out. U.S. companies started 2014 with an unprecedented \$1.6 trillion of cash on their balance sheets and the S&P 500 Index has kept setting new record highs. As a result, private equity firms can't make the math work on most acquisitions. Often, they simply can't compete with the value that newly confident corporate buyers reckon they can find by wringing out costs.

There is evidence of the pressure. Buyouts announced in the fourth quarter on average cost 11.2 times EBITDA, according to S&P Capital IQ Leveraged Commentary & Data. That's a big leap from the 9.7 times in the first nine months of 2014 and it's higher than pre-crisis boom levels. What's more, the amount of equity required is increasing again, to about 40 percent, as borrowing levels are also rising. The average debt-to-EBITDA multiple on LBOs reached 6.3 times from October to early December, surpassing even the spike in 2007.

High prices mean private equity returns are apt to suffer. Meanwhile, firms that resort to buying companies from each other could struggle to top the returns available in public markets. It's hard not to think it's the wrong numbers that will be coming down.

Published December 2014

CHINA-U.S. SHIFT WILL END COLD WAR PEACE DIVIDEND BY DANIEL INDIVIGLIO

China's defense outlays may match those of the United States in 15 years. Meanwhile, America's relative austerity paired with Russian aggression could force European military spending higher. Western makers of aircraft and other weaponry will face new global competition from Chinese companies, though revenue prospects may improve. Governments, meanwhile, may have to choose between just rearming and an all-out arms race.

Accurate data on Chinese military spending is tough to find, but the Stockholm International Peace Research Institute keeps an approximate tally by country. Adjusted for inflation, the PRC's outlay was still dwarfed



U.S. Navy test Pilot Tony Wilson makes the first ever landing of the F-35C Joint Strike Fighter on an aircraft carrier using its tailhook system, off the coast of California Nov. 3, 2014. REUTERS/Mike Blake

by the United States in 2013, accounting for less than one-third of the American total of \$640 billion.

But the trends are moving in opposite directions. Over the past three years, spending cuts have been the norm in Washington, with the inflation-adjusted defense budget averaging a 5 percent annual decline. Over the same period, China has upped its investment by 8 percent annually. Assuming the United States follows the trajectory mapped out by the Congressional Budget Office through 2023 and keeps up with inflation thereafter while Beijing keeps boosting its spending at 8 percent a year, China will have the biggest military purse on the planet by 2029.

It's unlikely to pan out quite like that. China's economic growth could slow enough to hold back its military ambitions. And Uncle Sam isn't likely to stand by if a new Asian superpower does vie for armed supremacy. But adjusting for such possibilities changes the timing, not the likely end result.

BREAKINGVIEWS

And whatever the timing, Europe is likely to be forced into a buildup of resources. The American reluctance to spend, together with a less engaged foreign policy than in recent decades, makes it less likely the region will be able to rely as much as it has on U.S. might. The aggressive Russian stance in Ukraine sends a more direct message about the need for heightened self-defense.

Add the effect China's own military buildup has had on U.S. allies in Asia, and big Western defense contractors could be in clover. South Korea ordered 40 of Lockheed Martin's F-35 fighter jets last fall. In recent years, Thailand, Vietnam, Cambodia and Indonesia have beefed up their military technology.

That said, Indonesia's approach hints at the downside for Lockheed, United Technologies and their peers. The Jakarta government was one of the first in the region to begin buying gear from Chinese defense firms. The PRC's state-owned aviation industry giant showcased its J-31 fighter at a November air show, coinciding with a trip by President Barack Obama to the country. The Chinese jet is intended to compete with Lockheed's F-35.

It's probably not up to that task quite yet. But as Chinese defense firms, just like those in other industries, learn to produce better products, they will compete against Western firms for at least some customers. That could make growth a tougher challenge for Lockheed, which sees 20 percent of its sales coming from outside the United States within a few years, and United Technologies, which collected over 60 percent of its net sales from non-U.S. customers last year.

Looking ahead, there may be plenty of business to go around for contractors, even if China becomes a major supplier of aeronautical and other military technology. What's lost to competitive pressures in markets where governments are willing to buy Chinese hardware could be regained through increased defense spending in Europe and parts of Asia. The biggest challenge may be for those very governments as they try to balance their real and perceived security needs against prudence. One consequence seems clear: the shifting global landscape will put an end to any remaining post-Cold War peace dividend.

Published December 2014

UNCLE SAM STOKED TO HASH OUT MARIJUANA IN 2015

BY DANIEL INDIVIGLIO

It's high time for Uncle Sam to hash out America's marijuana situation. Now that four states and the District of Columbia have legalized recreational cannabis better regulation is warranted for commerce and safety reasons alone. Without the federal government tweaking laws to consent to the will of the states, the fledgling industry will remain in the shadows of professionalization.

When just Colorado and Washington began to experiment with legalized pot, the White House could merely look the other way. But in November's election, Oregon, Alaska and Washington, D.C. also approved recreational weed. With four states plus the nation's capital on board, nearly half of states approving weed for medical purposes, and others likely to follow, national lawmakers can't ignore the movement's smoke signals.



Marijuana-based products are displayed at the "Oregon's Finest" medical marijuana dispensary in Portland, Oregon April 8, 2014. REUTERS/Steve Dipaola

BREAKINGVIEWS

Without federal attention, the market for marijuana may be dangerous and dysfunctional. Colorado's struggles with the market for comestible products made with the drug's active ingredient, THC, demonstrate the problem. Edibles can contain concentrated doses or very little of the drug, leaving consumers dazed and confused on how much to eat safely.

The Food and Drug Administration, usually responsible for labeling and standards, is a federal agency and therefore takes a pass on weed. Universities in states that have legalized the drug could be in a position to research the effects of cannabis use to help local regulators. But they're forced to abstain for fear of seeing their federal funding revoked.

Commerce remains impaired too, as lenders aren't keen to back loans tied to the industry, fearing government retaliation. The federal Farm Credit System also refuses to back marijuana growers. Such problems prompt Congress to either prohibit these states' pot experimentation or to permit, and regulate, at the federal level, but let states determine whether or not to partake.

While a heavy lift, Washington lawmakers now have an excuse to weigh in sooner rather than later: weed was just legalized in their backyard, and they ended federal enforcement for medical marijuana in the year-end spending bill. There are good reasons for Republicans, who will soon control Congress, to embrace pot. For one, it would showcase their proclivity toward states' rights. And their libertarian-leaning members may support legalization outright: Kentucky Senator Rand Paul, a likely presidential contender, urged his colleagues to assent to the District's legalization.

The GOP's desire to appeal in the 2016 presidential election to younger voters and groups who may applaud decriminalization also favors relaxing federal opposition. It's probably not their first order of business, but stoners may be surprised to see their pastime liberated in the coming year.

Published December 2014

FRESH CHALLENGES

CHINA'S SUPERLATIVE GROWTH LOOKS HARD TO SUSTAIN BY PETER THAL LARSEN AND ROBYN MAK

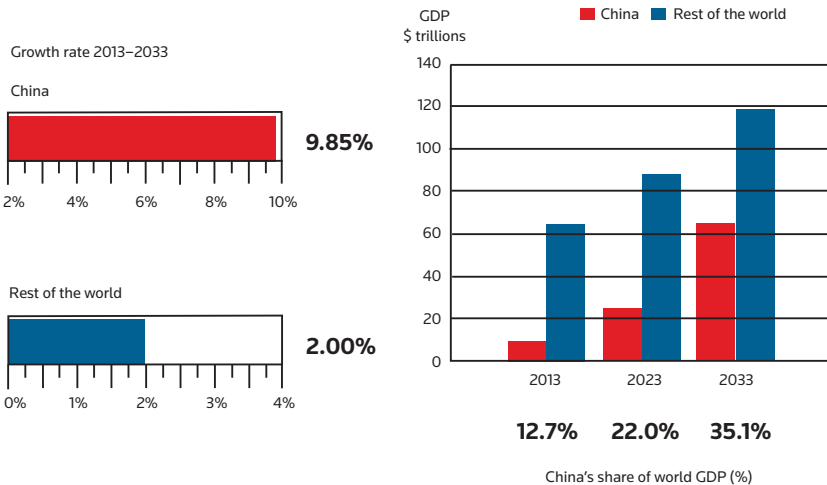
How fast will China's economy grow over the next two decades? Most economists predict that the People's Republic will expand at a rate not much lower than it has achieved in the past. Viewed in global terms, that assumption looks a stretch. A new Breakingviews calculator shows why.

China's GDP per head grew by an astonishing 9.85 percent a year in the first decade of the millennium. If expansion continued at the same rate, Chinese output would reach \$65 trillion by 2033 – almost seven times the 2013 total. Assume GDP per capita in the rest of the world goes on expanding by 2 percent. China's economy would account for more than

Just how big can China get?

How changes in per-capita GDP affect its share of the world economy

****Click on the graphic to view online, interactive version.****



Source: IMG WEO October 2014. Penn World Table 8.0; UN population estimates. Peter Thal Larsen, Robyn Mak Dec. 11, 2014

35 percent of the world in two decades. That would be an even bigger proportion than it achieved in 1820, before the country slipped into a century of stagnation relative to the West.

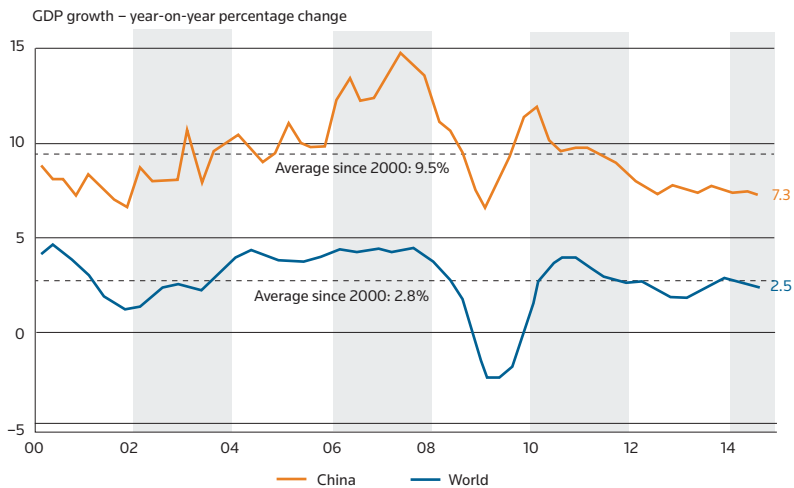
Most economists accept that double-digit growth is in China's past. However, many think the economy is still capable of expanding at a rate only slightly slower than the 7.5 percent it hopes to achieve in 2014. Even that seems ambitious over the long term, however. If China's GDP per capita grows by 6.45 percent a year for the next 20 years – similar to the rate Japan achieved between 1963 and 1983 – China's share of world output would almost double to just over 22 percent.

Past growth owed much to a relatively young population moving from the countryside to work in urban factories. In the future, China's population will age and its workforce will barely expand. Garnering more than a third of global output would require Chinese workers to deliver heroic improvements in productivity. Technological advances may help – though it seems unlikely that China will be able to avoid sharing these with the rest of the world.

China GDP growth vs the world

GDP growth – year-on-year percentage change

****Click on the graphic to view online version.****



Source: Thomson Reuters Datastream, data to Q3 14. V Flasseur Dec. 5, 2014

An alternative possibility is that China's growth slows to an annual rate of about 2 percent. That is what Harvard economists Lawrence Summers and Lant Pritchett argue tends to happen after countries exhaust their growth spurt. China's four-decade expansion is unprecedented in modern history. But its sheer size today makes sustained superlative growth even more improbable.

Published December 2014

ACQUIRERS CAN EXPECT MORE M&A INVESTOR SKEPTICS

BY ROB COX

Success begets imitation, especially in Wall Street's M&A factories. More than \$3.2 trillion of deals were proposed around the world in 2014. More will be encouraged by the uproarious response given by investors to shares of acquiring companies. As the easy pickings evaporate, though, the laws of corporate finance will prevail. Buyers can expect greater skepticism.

There's no obvious reason for the pace of mergers to slow. Companies are flush with cash and stock prices are robust. The total value of deals still lags its historical correlation to global market value.

Most importantly, companies are being generously rewarded by their owners for shopping. Of the 136 acquisitions over \$1 billion unveiled by U.S. companies through Dec. 2, 2014, two-thirds of buyers experienced a rise in their shares upon announcement, according to Thomson Reuters data. That defies the 50 percent average over the past seven years.

Such incentives will motivate boards, not to mention chief executives larded with stock options, to sanction more deals. Indeed, it's what happened in the second quarter, as the number of big acquisitions nearly doubled after four out of five U.S. buyers got stock-market bumps for ones unveiled in the first three months of the year.

With each successive quarter, however, investor ardor waned. After the roaring start, 70 percent of buyers secured a deal-related stock lift in the second quarter; 63 percent in the third; and 56 percent in the fourth.

BREAKINGVIEWS

A return to the long-term average is only natural. Investors are bound to cool on M&A as the more obvious transactions, where overlapping businesses slash costs, get done.

Pairings like Signet Jewelers and Zale, or cement-makers Holcim and Lafarge, were prime examples, where the net present value of synergies met or exceeded any premium paid. There is a limited supply of such deals, however. Similarly, inversions, where switching tax domiciles promised an instant increase on the bottom line, provided a sugar rush that has since crashed.

Following a post-crisis dearth of deals, the M&A business is rapidly fulfilling pent-up demand. Animal spirits are still high in corner suites, but less so among investors. In 2015, one will catch up with the other.

Published December 2014

HIGH-YIELD BOOM ENTERS HOLD-YOUR-NOSE TERRITORY BY NEIL UNMACK

The high-yield boom is heading for hold-your-nose territory. Egged on by central banks, bond investors will keep chasing yield, despite a market sell-off, a few blow-ups and rising corporate indebtedness.

By early December, 2014's high-yield issuance exceeded \$400 billion, with Europe breaking records at \$165 billion, according to Thomson Reuters data. At the end of the third quarter, default rates stood at just 2.1 percent.

Those volumes hide the fact 2014 was a turbulent year. From a trough at 359 basis points in June, credit spreads on junk bonds rose above 570 basis points by mid-December, as investors fretted first over the end of U.S. money-printing, then about the collapsing oil price and its effect on emerging markets. A few deals, like Phones4U in Britain, have gone awry.

The market turmoil means junk bonds are no longer screamingly expensive: on Lehmann Livian Fridson Advisors calculations, U.S. junk debt is cheap by roughly 30 basis points. Yet 2015 may bring yet more challenges, including

the first U.S. rate rise. A supply shock could knock prices, as a deluge of Italian and Russian bonds risk falling from investment-grade.

Default rates will probably start rising too. For a start, oil's plunge threatens to hurt many smaller energy firms, who make up 17 percent of the U.S. high-yield index. Looking further out, it's worrisome that junk bond issuers are increasingly shaky. Issuers with super-low CCC ratings account for 17 percent of deals, more than in 2007. Historically an average of 41 percent of these companies default within three years, Standard & Poor's data shows.

On the plus side, Europe's pivot away from bank financing will continue. And with the global economy still fragile, the U.S. Federal Reserve is unlikely to lift rates much. Meanwhile, other monetary authorities will keep policy loose: the European Central Bank plans to buy 1 trillion euros of assets, possibly including corporate bonds. Once again, investors will be forced into riskier credit to get returns.

When central banks eventually get tougher, money will flow elsewhere and increased borrowing costs will test the resilience of the weakest. But don't count high-yield out just yet.

Published December 2014

ACCOUNTING FRAUD IS RIPE FOR FRESH SCRUTINY

BY REYNOLDS HOLDING

Dodgy numbers will replace insider trading as Wall Street watchdogs' preferred prey in 2015. New auditing and analytics have already given the U.S. Securities and Exchange Commission a head start, even if the 2002 Sarbanes-Oxley reforms make cases of accounting fraud harder to track down.

American enforcers have racked up hefty settlements and priceless publicity pursuing the likes of SAC Capital for trading illegally on secrets. The SEC alone filed 52 such cases in fiscal 2014, near the 2006 high of 61.

BREAKINGVIEWS

Meanwhile, the number of accounting fraud actions has fallen about 60 percent since peaking at 219 in 2007. SarbOx's strict rules on internal company controls and officer responsibility deserve some credit: Far fewer listed firms restate their financials now than a decade ago, the SEC says.

Yet the watchdog may also have missed some serious misconduct. None of the five enforcement units it created in 2010 focused on accounting. And big cases like intentional financial statement errors at American Realty Capital Properties emerged only after being reported by the companies themselves.

The SEC seems determined to do better. It says a new audit task force is using software to analyze annual reports for accounting red flags. The "management's discussion and analysis" section, for example, can signal trouble with certain words or too much talk about minor matters. The task force's "accounting quality model" also sifts company filings for unusual numbers, auditor changes and off-balance sheet transactions – which Enron, Lehman Brothers and other failed firms used to conceal debt and inflate profits.

The efforts are already bearing fruit. The watchdog touts 2014 accounting fraud actions against Bank of America, Diamond Foods and CVS Caremark as well as smaller companies like Arizona-based JDA Software.

None of these cases match Enron, of course, but that's not necessarily bad. Enforcers overreached in some ways in that famous situation, putting the company's auditor, Arthur Andersen, out of business and costing thousands of employees their jobs.

The trick will be balancing tough enforcement against companies' good-faith attempts to comply with the law. That's no easy task when so much accounting is based on judgment calls. With the likes of SAC chastened, though, it makes sense to refocus on the next possible Enron.

Published December 2014

BANK CYBER-INSURANCE IS OVERDUE TO COME OF AGE

BY RICHARD BEALES

A high-profile hack at JPMorgan – to say nothing of monstrous breaches at Sony and Home Depot – has made cybersecurity a daily concern for executives at big banks and corporations. One partial protection is to take out insurance. It's a confusing market, but growing fast. With a U.S. government campaign on top of all the publicity, coverage may become standard.

The recent break into the internal email servers of Sony Pictures and the subsequent WikiLeaks-like data dump, stated by the FBI to be the work of North Korean hackers seemingly opposed to a comedy depicting the assassination of Kim Jong Un, may prove costly as well as embarrassing. But the Japanese conglomerate already knows that the failure to secure personal data can be expensive: it shelled out \$171 million to cover a 2011 breach of its PlayStation Network.



The word 'password' is pictured on a computer screen in this picture illustration taken in Berlin May 21, 2013. REUTERS/Pawel Kopczynski

BREAKINGVIEWS

Yet that pales beside the possible fallout for a big bank like JPMorgan, which suffered a hack potentially exposing certain data for up to 83 million accounts. That's where the government is focusing its efforts, with a Treasury official in December publicly urging banks to get insurance.

There are dozens of underwriters offering cyber-related cover. It's a market on track to double in 2014 to \$2 billion of gross premiums in the United States, according to Marsh & McLennan. The frequency of relevant events ticked up sharply last year to about 10 times the rate a decade ago, according to Advisen, a provider of data and analytics to insurers. Yet there are also dozens of different structures and definitions of insurance on offer.

That's where efforts by the banks and Washington may combine to create a bigger, more standardized market for cyber-insurance. That would provide financial cover for at least some of the liabilities arising from hacks. And if the criteria for getting insurance include demonstrating a base level of what Treasury Deputy Secretary Sarah Bloom Raskin called "cyber-hygiene" then it may also improve security, to a point.

But the bad guys are always going to be a step ahead. While governments no doubt want banks to have insurance, part of the motivation may also be to avoid ending up on the hook – just as the Feds have become for terror risks under the Terrorism Risk Insurance Act, which Congress failed to extend before the end of its last session of 2014.

The message to banks and insurers may be to get together and figure out coverage. But the companies involved still need to invest in cyber-protection and detection. Whether from North Korea or elsewhere, the threat will only increase in the coming year.

Published December 2014

ALIBABA IN 2016: AN IMAGINED LETTER TO INVESTORS

BY JOHN FOLEY

Breakingviews imagines the letter Jack Ma, founder of Alibaba Group, might pen to investors in the Chinese e-commerce empire a year from now.

Dear shareholder,

Our first full year as a U.S.-listed company brought growth and change for Alibaba Group. As I prepare to step down as executive chairman, I want to warmly thank you for making our success possible.

We continued to invest in our core e-commerce marketplaces throughout 2015, true to our customers-first strategy. Our new “Little Emperors’ Month” shopping festival broke records after we waived all commissions for sellers. We seized opportunities in commercial property to launch our new Alimall concept, matching customers with suppliers in a convenient offline-to-offline environment.



Alibaba Group Holding Ltd founder Jack Ma (2nd L) poses as he arrives at the New York Stock Exchange for his company's initial public offering under the ticker "BABA" in New York Sept. 19, 2014. REUTERS/Brendan McDermid

Elsewhere in the ecosystem, our unlisted financial affiliate is thriving. In less than a year, Alibank has grown into China's eighth biggest lender, after acquiring several troubled regional banks for an undisclosed sum. By December it had helped provide over 30 million crowd-funded residential mortgages.

The endurance of a horse is tested on a long journey. Profitability may decline further as we invest in lower-margin businesses. But our customers are delighted with our progress. The first season of "Jack Ma's The Apprentice" drew weekly audiences of 150 million. While we have written down the value of our stake in social network Weibo, I look forward to our new partnership with Facebook, which recently opened its flagship China office here in Hangzhou. Our sponsorship of the FIFA World Cup will ensure Alibaba continues to win fans around the world.

As you know, from today I take a step back to focus on philanthropic activities, starting by giving away my remaining 8 percent stake in Alibaba. Rest assured that I will resolutely continue to protect our cultural integrity as head of the group's controlling partnership. I welcome Facebook founder Mark Zuckerberg as our newest member, and look forward to him participating in our meetings in fluent Chinese.

Challenges remain. The regulators' investigation into tax havens used by Alibaba and its peers continues. Global tech valuations are sliding. As a shareholder, I am naturally disappointed that the stock market fails to appreciate the wisdom of our decision to build the business for the long term. Nevertheless, I have faith in your patience. In our planned lifespan of 102 years, there is still plenty of time to achieve our dream!

Jack Ma
Paramount leader
Alibaba Group

Published December 2014

UK FACES RISK OF COLD-WEATHER BLACKOUTS

BY OLAF STORBECK

Britain is dicing with darkness. The electricity system is ageing and the mix of generating technology – including renewable sources like wind power – is changing. Both factors increase the danger of power cuts at peak times. New capacity can't come soon enough.

This winter, the UK's available electricity supply is only 6 percent higher than expected peak demand, according to the National Grid. This already includes contingency plans like agreements to pay big users to shut down.

Reserve ratios of less than 10 percent are considered risky by industry experts. The pressure could increase by next winter as more generation goes offline, including some coal-fired plants whose emissions interfere with the achievement of environmental targets.



An off-shore wind farm is seen in the English Channel near Clacton-on-Sea in south east England Aug. 29, 2014. REUTERS/Toby Melville

BREAKINGVIEWS

Electricity shortages would still require an accumulation of nasty surprises. Demand could be greater than forecast if the economy grows faster than anticipated. On the supply side, power stations might suffer unexpected trouble. This year, three coal plants were ravaged by fires and two nuclear reactors had to be taken off the grid for safety reasons. These are temporary problems, but at peak times the system can only absorb a few breakdowns.

The British obsession with the weather may for once prove justified, too. An unusually cold spell could create a spike in demand. And with wind turbines now accounting for 10.5 percent of generating capacity, a windless period would crimp supply. In January 2009, Britain's wind farms stood idle for 10 days.

National Grid has ways to mitigate the risks. The operator can call on generators to run plants at full throttle, nudging available capacity higher by 1.3 percent. It can also stretch supply by temporarily reducing the grid voltage, something most users would barely notice.

All this means that even partial blackouts – “controlled disconnections” in the sector’s jargon – require worse scenarios than even pessimists are putting forward. Nonetheless, years of underinvestment have contributed to very tight supply.

New gas-fired plants are due online after the 2015-16 winter. And starting in 2018, utilities will be paid not just for generating electricity but also for keeping extra capacity at hand. Until then, the Brits’ safest bet may be to talk up the prospect of mild winters.

Published December 2014

WATER WOES COULD OPEN TAPS ON CORPORATE RISK

BY ANTONY CURRIE

Water is set to become a more serious risk for companies and investors. It's already recognized. World Economic Forum attendees named H₂O a top-three risk two years running. And two-thirds of the world's largest companies worry about how constraints may affect their business, according to environmental research firm CDP. Few, though, are well prepared for problems. That is set to change.

A few high-profile droughts have helped shake off some complacency. Taps in Brazil's Sao Paulo may run dry as early as March. California's supply is low after three years of scarce precipitation. The likes of Illinois and Indiana are starting to use their relative abundance of water to lure companies to their states.



An aerial view of the Atibainha dam, part of the Cantareira reservoir, during a drought in Nazare Paulista, Sao Paulo state Nov. 18, 2014. REUTERS/Nacho Doce

BREAKINGVIEWS

Some firms have taken action. SAB Miller has a goal of reducing water used in its breweries by a quarter by 2015. Coca-Cola used 2.08 liters of water for every liter of its own drinks in 2013, down 23 percent since 2004, and wants to be water neutral by 2020. Lockheed Martin, Kimberly-Clarke, AstraZeneca, AT&T and others have implemented water-saving strategies.

That's not always enough. Often, a company's idea of water risk is very narrow, CDP points out in a 2014 survey of big companies. Only two-fifths include other local users in their assessments. There's a similar myopia among those investigating what hazards companies in their supply chain might face – whether shortages, floods, pollution or what have you. Only a quarter consider their water needs in the context of other claims on the same river, for example.

This can leave them exposed, often expensively. Barrick Gold invested \$5 billion in its Pascua-Lama mine before putting the development on hold in 2013 after problems with pollution. BHP Billiton had to spend almost \$2 billion to build a desalination plant to ensure enough water for a Chilean operation.

Joint action can yield better results. A recent report by the Nature Conservancy outlines how restoring forests and reducing pollution along watersheds can quickly increase the supply of usable water for everyone.

Shareholders are cottoning on. Almost 600 investors representing \$60 trillion of assets under management now want CDP's data on corporate water use, for example – a more than threefold increase since 2010. The internet gives both companies and anyone monitoring them more information than ever, too. The financial hit from actual shortages may be what makes companies change. And if they don't, increasingly well informed activist investors may force the issue.

Published January 2015

EUROPE COULD EDGE PAST U.S. IN RACE TO COURTHOUSE

BY REYNOLDS HOLDING

Europe's companies could edge past Uncle Sam's in the race to the courthouse. New rules and bank scandals are boosting fraud and class-action filings in Britain. Patent combatants are flocking to German judges. And spats over failed investments are clogging courts across the EU.

The United States won't easily relinquish its title as the world's litigation capital. Brits, for instance, file about a third fewer complaints per person than Americans, a 2010 Harvard Law School study found. And most big U.S. businesses spend more than ever on lawsuits.

But European companies are quickly closing the gap. They reported a 41 percent rise in commercial disputes during the year ending June 2014, according to a survey by restructuring advisory firm Alix Partners. Their American counterparts reported only a 28 percent increase. U.S. firms also lagged far behind in so-called bet-the-company cases like antitrust actions.

One reason may be that the U.S. Supreme Court has curbed suits against foreigners, pushing many spats abroad. The justices have also made it much harder to sue en masse in class actions.

The main culprit, though, seems to be Europe's embrace of litigation. Since allowing class actions in 2000 and bigger lawyer paydays last year, Britain has seen several massive settlements. Calunius, Burford and other litigation-finance firms help fuel multibillion-pound securities-fraud claims against the likes of Royal Bank of Scotland and, potentially, Tesco.

Banks have also made themselves enticing targets with Libor manipulation – Barclays just settled a case for \$116 million – and dodgy mortgage securities. And the typically six-year filing deadline is about up for most complaints involving financial crisis matters, further boosting lawsuit numbers.

Those complaints are scattered around the EU. Cross-border litigation increased at 35 percent of European companies, according to the survey, with much of it focused on failed M&A deals and troubled business partnerships.

BREAKINGVIEWS

Meanwhile, judges in Mannheim and other German cities have become global favorites for patent litigation. They're quicker than their U.S. counterparts, take a more pro-patent approach, and allow companies to block rivals' intellectual property without proving monetary losses.

Many European firms are trying mightily to avoid lawsuits, settling more disputes or pushing them into private arbitration. Resistance may be futile, though: Britain and the EU are considering proposals to expand class actions even further. It seems the United States' days atop the litigation heap are numbered.

Published December 2014

ACTIVISTS MAY TAKE THE PEPSI, AND COKE, CHALLENGE BY KEVIN ALLISON

PepsiCo used to run advertisements in which it asked consumers to take a blind taste test comparing its cola to Coca-Cola's. It was called the Pepsi Challenge. The world's biggest soda-makers find themselves similarly challenged as stagnant sales have made them ripe, \$300-billion plus, targets for agitators. Pepsi risks a proxy fight in 2015 over billionaire Nelson Peltz's plan to break up the company. Coke, too, may face a radical shakeup.

It has been over 18 months since Peltz's Trian Fund Management disclosed a big stake in Pepsi, and 10 since Chief Executive Indra Nooyi rejected the activist's proposal to split the Doritos-to-Mountain Dew maker's snack and beverage divisions. Sweeter payouts and a better stock performance since then are unlikely to have mollified Trian, which has successfully pushed for splits at consumer food rivals including Cadbury and Kraft.

Coca-Cola, meanwhile, has yet to shake value investor David Winters, jazzed over the soda giant's too-generous equity compensation plan and overall lackluster financial performance. Unsatisfied by Coke's tepid response, Winters has since broadened his critique to include the company's management under Chairman and Chief Executive Muhtar Kent.

The issues that agitated shareholders show few signs of easing in 2015. North American soda sales are in decline, and forays into trendier energy beverages and teas have underwhelmed. Coke's newest project, a milk drink set to hit shelves next year, suggests the bigger company is convinced it can grow its way out of its current slump. Investors could argue for Coke to fess up to low growth, cut costs, and crank up cash rewards to shareholders.

Separating Pepsi's stronger snacks from weaker beverages would cut bureaucracy and force the latter division to chart a more profitable course. A Coke breakup, perhaps along geographic lines, may seem a stretch while it has the support of its top shareholder, Warren Buffett. But it wouldn't be unprecedented.

A troubled domestic market led tobacco giant Altria to spin off its faster-growing Philip Morris International division in 2008. The Marlboro parent company's shareholders have tripled their money, while PMI has made a total return of 126 percent since the split – double what Coke and Pepsi chalked up. Shaking up the kings of carbonation could lead to some explosive returns in the year ahead.

Published December 2014

NEW BEGINNINGS

CENTRE-LEFT MAY HAVE UK ELECTION EDGE

BY ROBERT COLE

Britain's three main political parties are weak. Its two nationalist groups are stronger. The probable five-way fight in the 2015 general election, due in May, will be unusual. It is also likely to produce an inconclusive result. A new Breakingviews calculator suggests, however, that a Labour-led coalition could take power.

The post-crisis Conservative-led coalition government under Prime Minister David Cameron has overseen an economic recovery, with official estimates showing solid 3 percent GDP growth in 2014. But history shows that doesn't necessarily translate into re-election. Voters may also shrink from the Conservative message – underlined in the budget update on Dec. 3 – that the UK's public finances must be further strengthened by cuts in public services.

Heated debate about immigration and the UK's membership in the EU will help the upstart UK Independence Party. Recent mid-term results suggest UKIP will take votes from both major parties. But many of the party's politicians, including its two current members of parliament, are Conservative defectors, suggesting Cameron's party has most to lose.

Labour is vulnerable to another grouping – people who support Scottish and Welsh devolution and even secession. Ed Miliband's party could lose seats to the Scottish nationalists. But the two groups are natural allies against the Conservatives. Pro-European Liberal Democrats, whose MPs often attract strong local support, are also unlikely to back a Tory party with a hardening anti-EU stance despite their current role in the governing coalition.

The Breakingviews interactive UK Election Calculator suggests that Labour will win an outright majority if public spending is the only driver of the vote. If business and the economy dominate and the Conservatives get the credit, they may scrape back into power.



By [Robert Cole](#) | Updated Dec. 16, 2014, 1 p.m. GMT

This interactive graphic models results for the general election expected to take place on May 7, 2015. The calculations draw on data from the nine national polls held in Britain since 1974.

Averages of past results give a neutral, base case outcome for each party. These have been adjusted to take account of the emergence of the UK Independence Party (UKIP) and the Scottish National Party.

Voters in most of 650 constituencies habitually return a candidate from the same political party. The overall outcome tends to be decided in the relatively small number of places where results can swing from one party to another. The average swing in elections since 1979 between the two big parties, the Conservatives and Labour, has been 61 seats. Users can select which key election issue will be most important to voters in the UK.

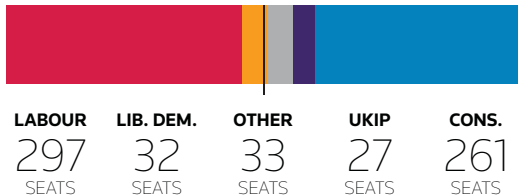
This alters the destiny of swing constituencies in our calculator to show the possible distribution of seats in parliament – and which party, or coalition, could form a government.

The Breakingviews base scenario reflects a weighted mix of the issues.

[READ THE FULL STORY HERE](#)

See how each issue—if most important to voters—would affect the outcome:

- BV BASE SCENARIO**
- PUBLIC SPENDING
- ECONOMY AND BUSINESS
- IMMIGRATION AND THE EU
- DEVOLUTION
- LOCAL POPULARITY OF CANDIDATES



Reuters Breakingviews' calculations produce a "neutral" general election result based on the distribution of seats since 1974. This is then adjusted to boost the number of seats for UKIP and the SNP in light of recent political shifts. This split of seats is then adjusted to reflect the possible results in swing seats, which are allocated to different parties depending on their association with different election issues.

Robert Cole/Richard Beales/Matthew Weber Dec. 19, 2014

The base case used by Breakingviews reflects a blend of voter concerns, with public spending as the hot issue working in Labour's favour but economic factors offsetting this and helping the Tories. Other issues will count, too, but with a more muted national impact. With these assumptions overlaid on voting patterns since 1974, no single party emerges as an outright winner, but Labour takes the largest number of seats.

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A five-way contest could bring a result that is unstable enough to force a second election in 2015. Together, however, the left-of-centre parties could win a majority of the seats in the Westminster parliament. If they can bury their differences, they have the best chance of forming a government.

Published January 2015

YELLEN SHOULD GIRD FOR ACTIVIST BANK INVESTORS

BY ROB COX

Janet Yellen faces a long list of challenges for 2015. The Federal Reserve chair must keep her fellow governors aligned on the timing of interest rate increases while battling a Congress hell-bent on circumscribing the U.S. central bank's powers. A less obvious trouble spot for Yellen's year two in the job may be restive shareholders of systemically important financial institutions.

Regulatory pressure, middling performance and a dearth of large-cap alternatives are making mega-banks like Citigroup and JPMorgan increasingly attractive for shakeup artists, which would add to the Fed's workload. Sweeping reforms after the 2008 crisis handed the central bank greater authority over the nation's biggest lenders. That means any moves they make, voluntary or otherwise, to break up or, heaven forbid, acquire rivals will require a green light from Yellen and her lieutenants.

Adjudicating corporate finance won't be the Fed's first order of business. Corraling some sort of consensus from the 12 members of the Federal Open Market Committee on when, and by how much, to raise the cost of borrowing will be her prime objective. During the first year of her term, the Fed had a relatively straightforward timeline to follow, by progressively cutting back each month on purchases of securities as part of its quantitative easing policy.

Opposition to the strategy was for the most part subdued. Two hawks, Richard Fisher and Charles Plosser, raised objections in September. A month later, the more dovish Narayana Kocherlakota dissented from the rest of the committee. Without a precise schedule to guide the Fed from here, its actions will be more clearly influenced by data, which leaves open



REUTERS

greater possibilities for interpretation, and therefore disagreement. Within the ranks of the Republican Party, which takes a majority of the Senate in January to give it control of both legislative chambers, the accommodative policy of recent years has decidedly more detractors. There is a strong possibility the new Congress will pass a bill calling for regular audits of the Fed by the Government Accountability Office. Even on the left side of the U.S. political spectrum there is sympathy for reining in the central bank. One Democratic senator proposed requiring the Federal Reserve Bank of New York's boss to be nominated by the president and confirmed by the Senate.

So Yellen has a lot to think about before considering the increasingly uppity owners of big banks. Though their shares enjoyed a strong run from the depths of the financial crisis, they have languished of late. Both Citi and JPMorgan have underperformed the S&P 500 Index this year. After finally creeping up to trade at book value, there is a concern that banks have



U.S. Federal Reserve Chair Janet Yellen testifies on the economy before the Joint Economic Committee on Capitol Hill in Washington May 7, 2014. REUTERS/Jonathan Ernst

nowhere to go, especially as they squeeze out returns on equity of, at best, 12 percent. And their ability to return capital is constrained by regulators. The Fed took the unusual step of thwarting Citi's efforts to raise its dividend earlier this year, citing concerns over its internal controls.

This has some stockholders running the numbers on breaking up the banks into more easily valued, less complex beasts. Prospector Partners, an investment manager, recently argued in a letter to investors that the above-market returns generated by activist funds like Elliott Management, Pershing Square and Starboard over the past year could lead to activism among the big banks.

Indeed, by Prospector's reckoning, JPMorgan could create four distinct companies focused on consumer finance, investment banking, asset management and commercial banking, with a valuation that is as much as 50 percent greater than its \$230 billion market capitalization. Citi could be worth at least a quarter more than its current value, according to Breakingviews calculations.

A litany of successes over the past year has enabled activist funds to gather greater war chests. Many of the biggest targets, including Apple, Procter & Gamble and Microsoft, already have been harassed. Banks, therefore, make a logical next choice. Over the past decade, only a handful, including UBS and HSBC, have proven somewhat vulnerable. Agitators otherwise have largely steered clear because their fortunes are so tied to regulators. It's hard to see, however, why any move to simplify them would be unwelcome.

Less obvious would be deals urging the already big to bulk up. For instance, a move by Goldman Sachs to get into the custody business and expand in asset management by, say, acquiring \$46 billion Bank of New York Mellon makes strategic sense. It would diversify Goldman away from its reliance on fixed-income trading. It also might appease the 230-year-old BNY Mellon's newest board member and activist shareholder, Nelson Peltz's Trian Fund Management.

While such a combination might actually make Goldman a more stable institution, it would also make it an even more systemically important one. That would be a trickier decision for regulators than approving a Citi

sale of its U.S. retail branches to, say, U.S. Bancorp, or deciding whether JPMorgan could spin off its asset management business. Activists already have stormed their way into the biggest U.S. boardrooms. Yellen may want to gird for them to show up at hers.

Published December 2014

INDIA'S GROWTH SPURT COULD BE FOR REAL THIS TIME

BY ANDY MUKHERJEE

India's decade-long obsession with GDP expansion has proved a costly misadventure. In recent years, inflation has surged even as growth has slowed, damaging the balance sheets of corporate borrowers as well as state-run lenders.

Prime Minister Narendra Modi is right, therefore, to emphasize reforms that bolster the supply side of the economy. The policies he has introduced since taking office in May 2014 aren't revolutionary. But taken together, they promise a slow buildup of India's growth potential.

Modi is trying to ease shortages of coal and gas and simplify rigid labour laws. He has courted Japanese and Chinese investment to augment infrastructure and has resolved to unify a plethora of local taxes.

The reforms are small, but connected. Modi's "Make in India" campaign needs power, but electricity producers are sitting idle without coal or gas. Similarly, a new goods and services tax that will replace local levies means manufacturers only get taxed on the value they add to final consumption. Given sufficient competition, the tax could actually make everything cheaper.

Add some tweaks to India's inefficiency-ridden food supply chain, and five years of double-digit inflation may have come to an end. The recent drop in oil prices is also helping. Already, Modi has decontrolled diesel prices. Once the state stops subsidising energy consumption entirely, future fluctuations in the price of crude won't burden public finances.

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Indian Prime Minister Narendra Modi addresses the nation from the historic Red Fort during Independence Day celebrations in Delhi Aug. 15, 2014. REUTERS/Ahmad Masood

Investors will need to be patient, however. With investment picking up, the economy will soon leave behind two years of sub-5 percent expansion. But the 9 percent-plus rates of growth India witnessed between 2005 and 2007 won't return in a hurry. Global demand is anaemic, and domestic balance sheets are far from healthy. Indian lenders need to raise \$200 billion in fresh capital by 2019, Fitch Ratings estimates. A big privatization push remains elusive.

Even so, small reforms will add up. Modi has persuaded banks to open millions of new accounts, which will pave the way for the state to replace market-distorting subsidies with direct cash payments to the poor.

All these improvements will boost productivity. India's growth spurt this time around may not be spectacular. But it will very likely be real.

Published December 2014

EUROPEAN TELECOMS WILL DIAL UP MORE DEALS

BY QUENTIN WEBB

European telecoms will dial up more deals in 2015. With M&A sweeping the sector, BT's mobile ambitions mean Britain is up next, and tie-ups could follow elsewhere.

Newly sympathetic regulators have allowed in-market mobile mergers in Germany, Austria, and Ireland and have a Danish tie-up to review. A second big trend is "convergence"-led transactions uniting cable and mobile outfits, as in Germany, Spain and France. Private equity also yearns for deals.

There's plenty left to do. Further mobile consolidation could take place in France (Numericable buying Bouygues Telecom), Italy (Hutchison Whampoa buying Vimpelcom's Wind), the Netherlands (a sale of Tele2 or Deutsche Telekom's local units), and potentially Spain (where Vodafone could perhaps buy TeliaSonera's Yoigo, the weak fourth player).

And Britain may not see the only fixed-mobile deal. In Belgium, Amsterdam-listed Altice could buy the local mobile unit of KPN or Orange, for example. In Italy, Vodafone is circling Swisscom-owned Fastweb.

The real surprise would be the return of the big cross-border deal. It's possible to sketch out scenarios. Suppose BT's purchase of a big UK mobile operator spurs Vodafone into bidding for Liberty Global. U.S. giants AT&T and Comcast, seeing their last chance to buy scale in European mobile and cable vanish, bid for Vodafone and Liberty respectively. Orange and DT, suddenly dwarfed, join forces. And so on.

But the acquirers' investors, at least, would need convincing. Some deals – like Vodafone-Liberty – would stack up at the right price. But in general the financial benefits are elusive. In January, Credit Suisse estimated European telecoms' overseas adventures had destroyed 169 billion euros of value between 2000 and 2012. And while Brussels would like European champions, politicians might be irked if U.S. predators get involved, or former national monopolies come under threat.

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Shareholders need to be alert. Consolidation benefits already look priced in. European telecoms trade at 7.4 times EBITDA, up 50 percent in two years, Nomura says. That looks rich, when EBITDA should grow just 0.7 percent annually over the next three years, and the promise of quad-play and mobile data is not fully proven. The investment story doesn't live up to the merger euphoria.

Published December 2014

IRAN'S REINTEGRATION IS A PRIZE WORTH WORKING FOR BY UNA GALANI

Iran is worth the effort. Negotiations involving six world powers to keep Tehran's nuclear programme peaceful remain contentious, having been extended another seven months after the participants failed to reach a deal by a Nov. 24 deadline. But bringing the resource-rich, highly educated nation of nearly 80 million people back into the international fold is a prize that would repay the work involved.

Just talking reduces geopolitical risk. It delays efforts Iran might otherwise make to build a nuclear bomb – the ambition underlying Western suspicions that triggered the now 12 year-old economic standoff. It makes use of force by the West less likely, not to mention the possibility of unilateral action by Israel. Keeping diplomatic channels open with President Hassan Rouhani's administration in Iran is all the more crucial with Islamic State militants creating havoc in neighboring Iraq and nearby Syria.

An international accord that saw sanctions lifted would achieve more. With GDP approaching \$400 billion in 2013 according to the World Bank, economically Iran is more substantial than, say, Singapore or Greece despite years of isolation. Unfettered, output could grow at between 6 and 8 percent annually over the medium term, reckons consultancy IHS. That's a big jump from the 1.5 percent growth in 2014 forecast by the IMF following two years of contraction amid sanctions that have also hammered the currency.





Iran's national flags are seen on a square in Tehran Feb. 10, 2012, a day before the anniversary of the Islamic Revolution. REUTERS/Morteza Nikoubazi

Restored investment and trade ties would fuel growth. Exports from the EU to Iran halved to 5.5 billion euros last year from 11.3 billion euros in 2010. There is huge pent-up demand, for example for spare parts from Western manufacturers in sanctions-starved sectors including cars and aviation. Even debt-laden Dubai would gain from the resurgence of business with one of its top trading partners.

A reopening of the energy sector to foreign investment would benefit both Iran and foreign companies. The latter's expertise and cash are needed to develop the nation's oil and gas fields, which contain the fourth-largest stock of proven reserves in the world. Even without new production, the return of 1.5 million barrels per day of Iranian crude to the world oil market could counterbalance to some extent the regional dominance of Saudi Arabia.

With global growth anemic, Iran's economy is big enough to move the needle if sanctions can be significantly loosened. Add the

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political incentives, and reaching a lasting agreement with Iran is a priority for 2015.

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MORE THAN SLIM ODDS AMERICA MOVIL BUYS T-MOBILE US BY ROBERT CYRAN

Carlos Slim may try to buy the \$21 billion T-Mobile US in the coming year. The Mexican billionaire needs to reduce his telephone company's dependence on its home country. The fourth-largest U.S. wireless operator is cheap, its parent doesn't want it, and there's strategic logic to a deal. Increasingly frightful competition in U.S. telecoms may be a sticking point.

Under a recent Mexican law, America Movil's profit will be sapped by penalties if it holds more than half of the country's telecommunications market. It now has about 70 percent of the wireless business. So it's studying divestitures – these could bring in over \$15 billion in cash, according to UBS. And credit markets are open and investors are willing to lend cheap money for acquisitions.

Slim has bought bargain American telecom assets before. America Movil has snatched up virtual wireless carriers that sell pre-paid service using other companies' networks. These now account for about \$7 billion, or about 10 percent, of America Movil's annual revenue. But EBITDA margins are slight, at about 11 percent. Running traffic over its own network would raise those margins.

Moreover, Deutsche Telekom Chief Executive Tim Hoettges put a neon "for sale" sign on its U.S. subsidiary in November, saying T-Mobile US was an attractive acquisition candidate for Dish Network, Comcast and America Movil. The price looks right. T-Mobile US is valued at about 5.8 times estimated forward EBITDA, Starmine shows. That's roughly a 13 percent discount to the average of AT&T, Verizon and Sprint.

The position of T-Mobile US as a smallish company in a market experiencing ferocious price wars may give pause to Slim, who is accustomed to running a

near-monopoly. The company should generate just over \$1 billion of free cash flow next year, MoffettNathanson estimates, but will have to spend more than that on an upcoming spectrum auction. Slim's experience in Mexico means he appreciates the handsome margins that exist in a market with limited competition.

The administration of President Barack Obama is set against consolidation among the big four U.S. cellphone providers. The next occupant of the White House may feel differently. Buying T-Mobile US cheaply now could give Slim an option on fat returns north of the border.

Published December 2014

WEARABLE TECH WILL GO FROM NOVELTY TO NECESSITY BY KATRINA HAMLIN

Wearable technology is a novelty. Soon it will become a necessity.

Consumers are embracing activity-tracking wristbands, which tell wearers how many steps they took or hours they slept. More than 3 million were sold in the United States alone in the year to last March. Developers like Jawbone and Fitbit collect the information and use it to offer motivational tips and advice on better lifestyle choices.

But in the not-too-distant future, the ability to gather personal data in real time will be vital for critical health services and products.

Health insurers may be early adopters. Discovery, a South African financial services company whose partners include insurers AIA and Prudential, already offers pioneering policies that mine data from wearable technology. Sporty customers can earn discounts of as much as 15 percent on their health insurance premiums. It's an appealing strategy: 70 percent of consumers surveyed by PricewaterhouseCoopers said they would wear a device to reduce payments.

This is just the beginning. Applications will become more practical as both hardware and software develop. Devices that measure temperature and

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An Apple Watch is shown on screen during an Apple event at the Flint Center in Cupertino, California, Sept. 9, 2014. REUTERS/Stephen Lam

blood chemistry could allow doctors to monitor patients from afar. For victims of chronic illness, that could be life-saving, or at least life-changing. Think of diabetics, who could ditch daily blood tests for smart contact lenses that constantly monitor their glucose levels. Google is currently developing prototypes.

Admittedly, there could be some side effects. As soon as technology is capable of gathering truly intimate biometric data, that information becomes vulnerable to theft or misuse. Will the insurance industry refuse coverage to potentially unhealthy clients? Technology developers can only use personal data with express permission from the consumer. But if most healthy people are happy to share their data, those who opt out may be conspicuous.

These are big questions, but not big enough to stall the technology's rise. Research group International Data Corporation says sales of wearable tech trebled in 2014 from a year earlier – and the market could increase more than five-fold to over 100 million units by 2018. These gadgets are fast becoming too useful to ignore.

Published December 2014

IBM TURNAROUND REQUIRES ATYPICAL ACTIVIST FIX

BY ROBERT CYRAN

IBM requires an atypical activist fix. Big Blue's strategy of cost cuts and debt-fueled buybacks is no longer working – even though the company keeps trying. A tarnished balance sheet, lean staffing and a history of disposals rule out typical activist wheezes. Encouraging Chair and Chief Executive Ginni Rometty to invest in IBM's core businesses could pay off.

For two decades IBM has run the same playbook. It sells low-margin businesses, slashes expenses, buys some profitable software companies, and returns a lot of cash to investors. Over the past four quarters, the \$152 billion company has spent more than \$23 billion on dividends and buybacks.



IBM Chairwoman and CEO Virginia "Ginni" Rometty speaks at an IBM Watson event in lower Manhattan, New York Jan. 9, 2014. REUTERS/Brendan McDermid

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The snag is that IBM is investing too little. Big Blue has only spent about \$11 billion over the past four quarters in total on R&D, capital expenditure and acquisitions. That's a problem in tech, where old products soon become obsolete. While Google spends about 16 percent of its sales on R&D, IBM spends 6 percent.

The effect is becoming clear on the top line. Revenue has shrunk for ten quarters in a row. Costs have been cut to the bone, sending customers fleeing to better service providers. In a good year for stocks, IBM shares have fallen more than 15 percent. That means IBM has overpaid on its last three years of buybacks.

That has spurred talk of activists. But what could rabble-rousing shareholders demand? Unlike Yahoo there's no obvious gem to dispose of or cash-laden balance sheet to raid. IBM has been selling off hardware, like last quarter's disposal of the chip division, lessening the appeal of an HP-style breakup. IBM hasn't done any big acquisitions recently, so an activist can't argue it is wasting capital like HP, which wrote off three-quarters of the \$12 billion it paid for Autonomy. And year after year of punishing cost cuts leave no obvious fat to cut.

A better idea is to invest more in the business. Assume IBM repurchases \$10 billion of stock next year. Bought back at current rates, that would result in a 7 percent increase in earnings per share. Meanwhile, IBM's pre-tax return on its business assets is 22 percent. Diverting that \$10 billion into the business could result in more than \$2 billion of pre-tax profit. Put this on IBM's low 20 percent tax rate and the result is more than a 12 percent increase in earnings per share.

IBM's focus on financial, rather than product, engineering has caused low employee morale, falling sales and shareholder dissatisfaction. It's time to invest.

Published December 2014

MARY BARRA GETS A SECOND FIRST YEAR AT GM'S WHEEL

BY KEVIN ALLISON

Mary Barra will have a second chance to make a first impression at the wheel of General Motors in 2015. The carmaker's ignition-switch fiasco crashed her first year as chief executive. The crisis may, though, have speeded up much-needed changes.

The tale of millions of faulty ignition switches, which broke just two weeks after Barra took the driver's seat, revealed just how sclerotic the Motown manufacturer had become, with corner-cutting and buck-passing rife.

So far, 42 deaths over more than a decade have been attributed to the problem. The company has set aside some \$3.1 billion to cover the costs. GM's total recall count for the year has surpassed 30 million vehicles. And Barra and other executives have been hauled before Congress.

She has, though, started laying the groundwork to improve the company's culture. Asking two well-respected outsiders to take on crucial tasks helped. Barra appointed external counsel Anton Valukas, who investigated Lehman Brothers' collapse, to dig into GM's failings and make them public. She also brought in Ken Feinberg to adjudicate and distribute all ignition switch-related compensation claims.

Barra has also changed reporting lines and enacted better procedures. These include simple but often effective measures like having, say, engineers spend a week at a dealership and insisting that senior executives handle several customer complaints a month.

So Barra can now look at 2015 as a do-over of sorts. Even GM's stock is giving her that opportunity: after falling around 20 percent through mid-December, it stands below the symbolic \$33-a-share 2010 IPO price.

The first trick will be to ensure that 2014's changes stick. Next comes building on recent financial momentum. GM's U.S. unit managed a third-quarter operating margin of 9.5 percent, its best in years. An ambitious line-up of new models should help, but signs of price wars are also picking up.

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General Motors CEO Mary Barra purses her lips before beginning her testimony before a House Energy and Commerce Oversight and Investigations, June 18, 2014. REUTERS/Jonathan Ernst

The key, though, is to prove that GM is prepared for the how technology is set to reshape the industry. Everything from electric cars to ride-sharing to autonomous driving is up for grabs, with the likes of Google emerging as new rivals.

Having spent the bulk of her first year fixing the past, Barra now has the chance to set her own course.

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M&A SPIN DOCTORS COULD GET SWEEPED UP IN THE ACTION BY QUENTIN WEBB

M&A spin doctors may get swept up in the action. If anyone knows how to assess the climate for takeovers, it should be financial public relations advisers.

A \$3 trillion-plus merger bonanza with plenty of hostile bids and activist investors creates a timely backdrop for sellers of all sorts. Three of the busiest deal whisperers – Alan Parker’s Brunswick Group, Joele Frank Wilkinson Brimmer Katcher, and Sard Verbinnen – remain tantalizingly independent. In London, Andrew Grant’s Tulchan and Rory Godson’s Powerscourt are, too.

Previous booms led advertising conglomerates WPP, Havas and Publicis to the doors of such financial communications firms as Finsbury and Abernathy MacGregor. Their experiences in the field have been patchy, though. Rival ad groups without a top-tier firm in the niche also are admittedly busy. Omnicom is rebounding from a failed merger with Publicis while an activist is hounding Interpublic.

Buyout firms also have taken a shine to PR. Advent, for one, invested in London-based Financial Dynamics before its \$260 million sale in 2006 to FTI Consulting. Teneo, a corporate adviser co-founded by two FTI alumni and a former consigliere to Bill Clinton, has just secured backing from BC Partners.

Such acquisitions can be as treacherous as buying an investment bank. After all, they’re about people, who easily can walk out the door – along with their clients. London’s M:Communications, for example, imploded after a 2008 sale to private equity-backed Sage Holdings, which later became King Worldwide. The target firm closed its doors last year and the Ms in the old company name, Nick Miles and Hugh Morrison, recently resurfaced with a new shop, Montfort Communications.

Publicis bought Kekst & Co. in 2008 and founder Gershon Kekst stepped down two years later. The 44-year-old firm has since slipped in the league tables. Britain’s Incepta, which later united with Huntsworth, perhaps tells the most cautionary tale. After a takeover in 2000 of Sard Verbinnen went sour, the founders bought the outfit back at a fraction of the original purchase price.

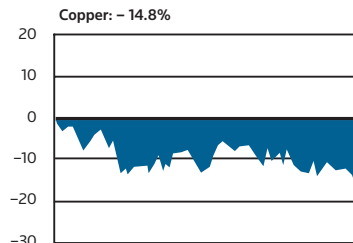
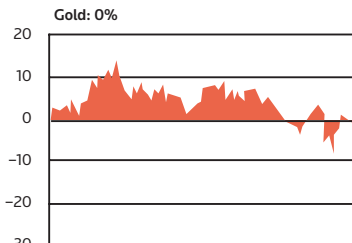
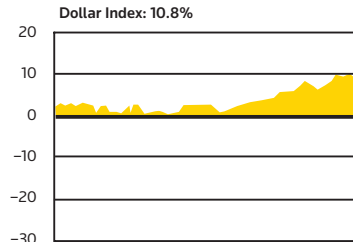
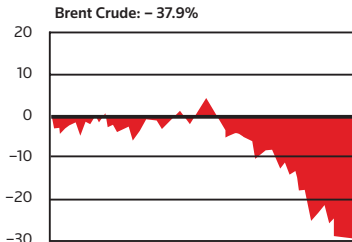
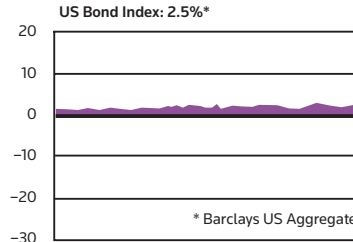
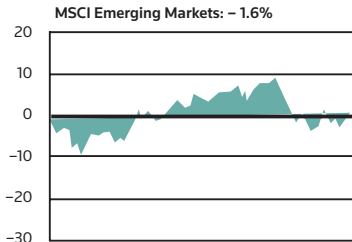
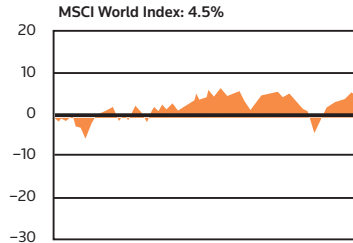
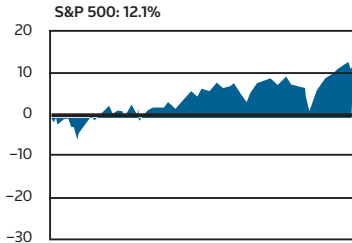
The message should be pretty clear for prospective buyers – and agencies tempted to sell. As with any M&A transaction, it’s vital to look past the spin. Drafting the celebratory press release is the easy part.

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BREAKINGVIEWS

Year-to-date asset performance percentage change

****Click on the graphic to view online version.****



Source: Thomson Reuters Datastream, Reuters graphic/Stephen Culp Dec. 5, 2014

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FRONT COVER

Left to right:

Lion named Carborra roars in his enclosure at the Hagenbeck Zoo in Hamburg March 4, 2011. REUTERS/Christian Charisius

A Libyan reveller wearing a ghost mask gestures as thousands take to the streets to mark two years since the start of the country's revolution, in Benghazi Feb. 15, 2013. REUTERS/Esam Al-Fetori

BACK COVER

Clockwise from top left:

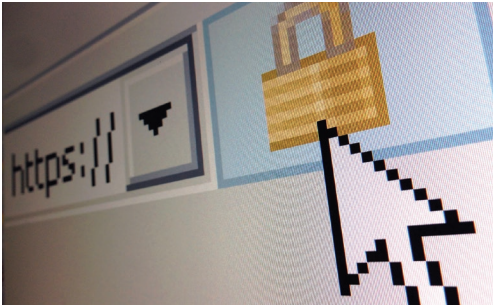
A lock icon, signifying an encrypted Internet connection, is seen on an Internet Explorer browser in a photo illustration in Paris April 15, 2014. REUTERS/Mal Langsdon

A man rides an escalator near Shanghai Tower (right, under construction), Jin Mao Tower (centre) and the Shanghai World Financial Center (left) at the Pudong financial district in Shanghai July 4, 2013. REUTERS/Carlos Barria

Smoke is released into the sky at a refinery in Wilmington, California March 24, 2012. REUTERS/Bret Hartman

United States one dollar bills are inspected under a magnifying glass during production at the Bureau of Engraving and Printing in Washington Nov. 14, 2014. REUTERS/Gary Cameron

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