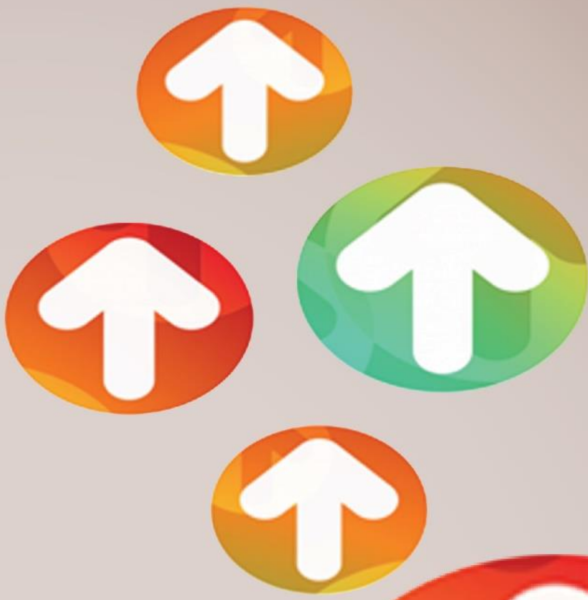
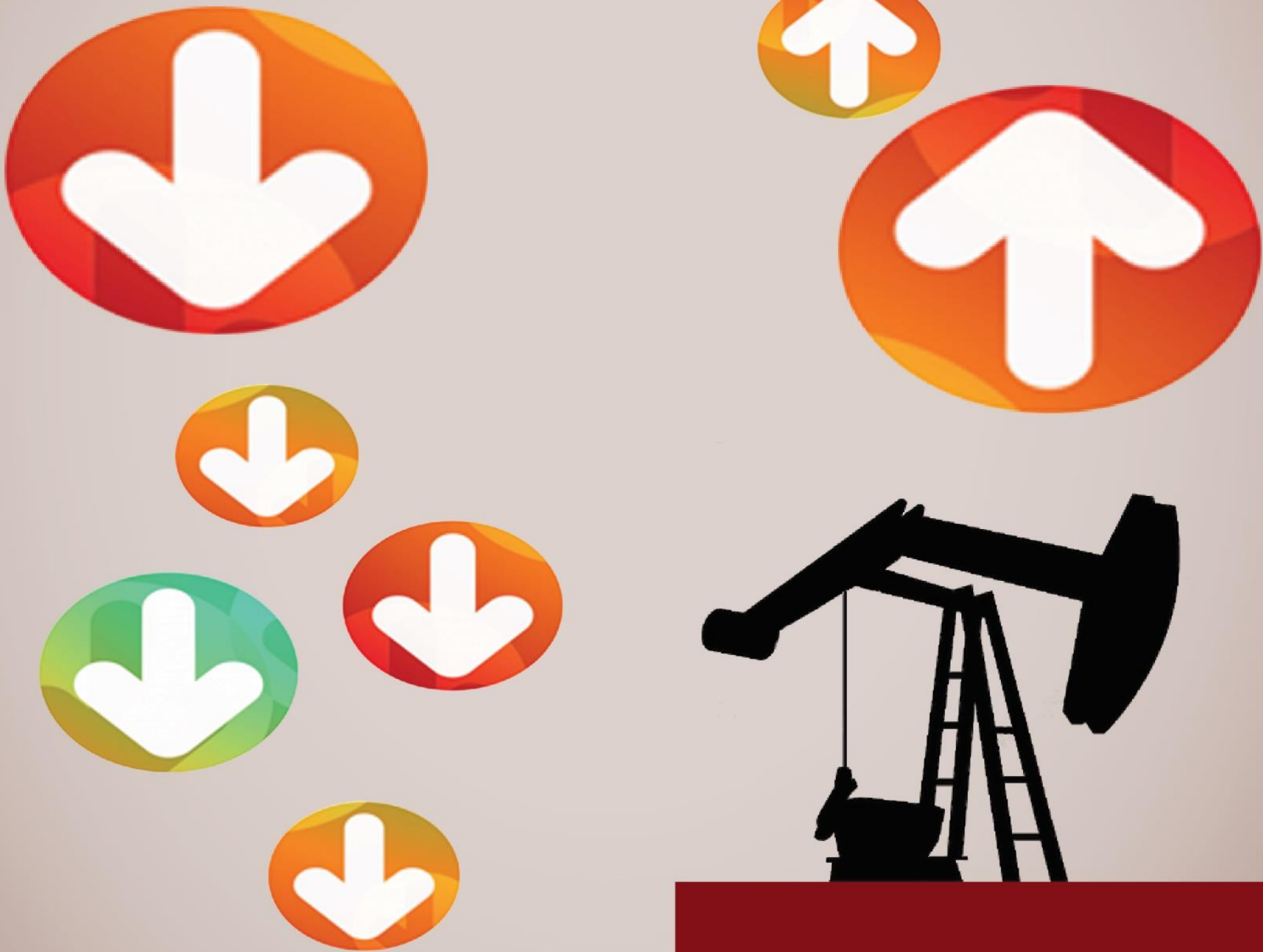
The Good, The Bad And The Oily

2018: what is in store





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Avalon Perspectives 2018

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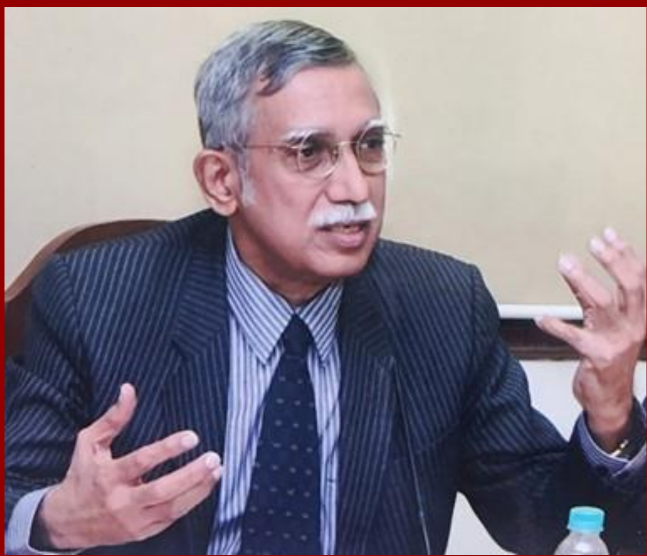

ABOUT THE AUTHOR

As a strategy consultant, Raj has helped companies across diverse industries in India, USA, Europe, and the Middle East to develop strategies, align strategy to vision, grow in competitive markets, restructure to make companies more customer focused etc.

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The Good, The Bad and The Oily

By Mr. Raj Nair, Chairman, Avalon Consulting

We live in a world that is expecting widespread economic growth in 2018, the likes of which, it has not seen after the great collapse of 2008 and rightly so. Real estate prices are creeping to record levels, as also commodity prices and stock market indices. Have we forgotten the several casualties in the corporate world, real estate, banking, and a wide swathe of other sectors, shattered dreams and broken lives of ordinary people in the aftermath of crisis of ten years ago? Have we learnt our lessons? No. The pattern of mass memory lapse for which documented history exists is mankind's curse.

A hundred years ago in 1918, World War I ended without the world getting wiser despite the 16 million lives being lost. What else can explain the mindless rush to the Second World War two decades later? One possible explanation is that the Spanish flu or the Influenza pandemic that soon followed World War I completely overshadowed the War by claiming 50 million lives. Since great strides have been made in medicine following that, we need to worry less about viruses today than human stupidity that can wreck our lives.

Today, risks are more measurable, productivity is way higher, and data is plentiful, so much so that minds are numbed. Oil prices have touched new highs. Speculative exuberance is evident except in commercial banking according the statistics provided by the Bank for International Settlements, partly because banks have been chastised after the Lehman collapse and have been over-regulated to the point that making extra-ordinary profit is difficult. However, the world is over-borrowed. The stock market and commodities are on fire, as are feeble minds. Money pouring into stock and commodities is driving up prices, and rising prices have been attracting more money. This may end up in grief because markets are over-valued, be it in the US, EU or in India.

2018 opened with the CAPE ratio in the US at 31 (ratio of the S&P to the average annual inflation-adjusted earnings over the previous 10 years) created by Robert Schiller, the Nobel Prize winning economist from Yale. This is 25% above the 15-year CAPE the average ratio over the past 15 years. Does the fact that the CAPE went above 30 in 1929, before the Great Depression, and just before and during the dot-com bubble suggest anything about the future that awaits us? There are good reasons why the stock market may not remain at the highs that it has touched in the US driven by very low interest rates and Quantitative Easing. Interest rates have risen thrice in 2017 and more hikes are on the cards in 2018. QE is being unwound. The heated real estate sector and corporate profits will get impacted as will stock valuations. No prizes for guessing why celebrity value-investors like Berkshire Hathaway (Warren Buffett) and Canada's Fairfax (run by Prem Watsa whom, I personally respect) have nearly 33% and 43% respectively, of their investible funds retained in cash. Rational investors who track them should also be waiting for the market to correct in 2018. The situation in the EU is not very different. In India, corporate earnings have not risen in the past couple of years, but P/E ratios have steadily risen, driven by sentiment and by the fact that when demonetisation happened in India, banks got flooded with money, and they consequently dropped interest rates on deposits.

The money naturally chased equities and mutual funds for better returns. MFs, actually, mis-sold balanced funds as better yielding, safe 'fixed deposits' to mop up a huge amount of money, which then entered the stock market even as FIIs slowly reduced their commitment to the Indian stock market. Robert Schiller's thesis is that big falls in the stock market have been preceded by a fall in prices for a few days, which was triggered by a narrative that causes fear that stock markets will fall. Right now, both in the US and in India, serious investors are wary of the very high market valuation, but no one can say what the narrative will be and when a correction will get triggered. Could the Indian Budget on February 1 be the narrative to cause fear about the stock market or will it be that so many sops are given now that the general elections are just a year away? 2018 will be a testing time for the intelligent investor.

1918 was also the year in which the USSR was formed on a wintry day in January. Over the next hundred years, Communism went on to scale many heights but then collapsed under its own weight whereas Capitalism mellowed and evolved in to something less unstable. So much so that China, a leading light of oppressive communism, adopted capitalism on its own terms and is poised to overtake the USA in nominal GDP before 2028, having already surpassed it in PPP terms. It was unthinkable as recently as 10 years ago when China's GDP was only a third that of the US. This will have serious implications for the World in 2018. It is in China's interests to keep the North Korea issue on the boil while appearing to broker peace. That will keep President Trump preoccupied with his favourite whipping boy, Kim Jong-un, and will also prevent him from going to the extreme in creating a strong USA-Japan-Australia-India Axis to counter China or keep him from reviving the Trans Pacific Partnership that he killed in 2017 just to spite Obama. President Xi has, through his diplomacy, made USA need China more than ever before. Tackling the adverse trade balance of $350 billion in favour of China will probably get less attention from Trump than it deserves. Russia's dependency on China to buy energy from them and Russia's alleged covert control over Trump due to the well-known controversies, will also help China maintain the power balance with the US. Trump the President, may be advantageous for China in 2018.

That brings me to Trump's presidency and its influence in the ME. I had, in my last year's note, explained that Trump will get close to Saudi Arabia despite the Jewish lobby in the US not wanting him to get too close to the Arabs. Knowingly or otherwise, Trump has emboldened King Salman of Saudi Arabia to place his son, Mohammed Bin Salman, as his successor, ending the long line of sons of the Kingdom's founder, King Abdul Aziz, taking turns to rule the Kingdom. The purge of many wealthy princes and businessmen, will have some implications on overseas investments of the Arab oil barons. The financial sector and the real estate sector will feel the pinch. The Saudi need for security against internal and external threats, which Israel can provide in large dollops, could see covert collaboration between Saudi Arabia and Israel which could lead to thawing of the adverse relationship between the two countries. Egypt is in a good position to broker such deals. The fact that the Sunni Arabs, USA and Israel will get closer in 2018, would point to a further alienation of Iran. The real danger is strife between these two sides in other theatres like Palestine, Bahrain, Yemen and even Iraq, and less so, a conflict between

North Korea and the US. The final beneficiary of the Saudi-Iran tension would be the US and Russia who will step up arms sales to the respective combatants.

Amidst all this, the global economy will, for the first time since 2008 heave a sigh of relief when real growth will be felt across large parts of the world. Even Philippines, once labelled the sick man of Asia may clock over 6.5% GDP growth. Growth will be more palpable in SE Asia, China, India and many other Emerging Markets. The beauty would be that the Developed World will see significant growth, thus setting in motion a virtuous cycle due to the inter dependency of the two Worlds. The global GDP growth is likely to be in the region of 3.7 ± 0.2%.

How will this happen when oil prices are at a 3-year peak in end 2017 and some experts are expecting a further rise? It is true that high oil prices will take some shine off the GDP growth rates of oil importing countries, but it will not be fatal. For instance, India may lose about 0.4% from its potential GDP growth rate. The reason for optimism is that oil price is expected to settle down by April - May to end the year with an average of close to US $ 60 ± 2 with a bias towards the lower end (though no one can accurately predict the events that trigger oil price changes).

OPEC and Russia have joined hands to ensure an oil production cut, but it will likely be offset by higher supply from non-OPEC countries, including shale oil producers. At $60 per barrel, OPEC and Russia would earn enough to balance their own economies, yet not kill global economic growth. At $70 or more per barrel, the global oil demand could dip below 93 million b/d, resulting in oversupply. The bad news for OPEC however is that a price of $60 /b is adequate to keep shale oil producers in business. This kind of balancing of demand and supply could see oil prices going south of the current highs.

In the longer term, the threat from Electric Vehicles combined with cheaper power from non-conventional energy sources looms large on the oil producers. Solar cell prices were dropping rapidly despite the limitation that common solar cells rarely exceed 22% energy efficiency. Higher efficiency could be obtained with other materials but at an uneconomical price. The big news is that the limits of silicon cell (Shockley-Queisser limit) have been overcome in 2017 by Step cells technology using Gallium Arsenide Phosphide on conventional Silicon cells. Step cells can go up to nearly 40% conversion efficiency without proportionate increase in costs. This coupled with rapidly dropping battery costs (see link to my talk https://www.youtube.com/watch?v=mDss2DR5_BE&feature=youtu.be) will eat into the demand for oil as fuel in the future.

The impact of high oil price will be cushioned because the US $ will probably weaken at some time, during 2018. This is not because the US economy will weaken but because of widening deficit and other policies. The EU will also be cushioned because the Euro is expected to strengthen. However, the declining pound sterling could add to the UK's oil price woes. That situation could drastically change if there is another Brexit referendum, which cannot be ruled out.

The good news for India is that her economy will surpass those of the UK and France in dollar GDP terms in 2018 though the per capita income will lag significantly. In India, due to elections in important states like Karnataka, Madhya Pradesh and Rajasthan, we will see economic policies through 2018, not just in the annual Budget that will favour rural employment, crop price protection, risk covers for farmers, etc. which will eat into funds available for development. This means that there may be very few business friendly policy announcements on Feb 1, 2018. Fortunately, there is a possibility to create quick rural employment through infrastructure projects in rural areas, like roads that benefit the whole economy. The ENSO (EL Nino Southern Oscillation) forecast favours normal monsoon. That in addition to the likely policy push to placate the rural areas could offset some of the negative effect of the oil price. The Indian economy could grow at 7.1 $\pm$ 0.2% in FY 2018-19, which is a significant jump over that in FY 2017-18. Forecasting stock market indices is perilous in the best of times; fortunately for experts, public memory is poor. Bank of America ML expects the Sensex to drop to 32000 by end of 2018 but back in 2015, their report had predicted a level of 58000 by end 2018. That was rendered meaningless by so much that happened later. I would argue that the Indian market is poised for a serious correction in 2018 in line with global cues, given that P/E multiple is nearly 24! Small and mid-caps will lead the slide.

Some commentators would like to believe that 2018 will be the year of the BitCoin, when it will become unstoppable and will earn the respect of mainstream users. At the risk of being proven wrong, I would say that it might earn more notoriety than applause, not because the underlying Blockchain technology is suspect but because the unregulated manner, in which cryptocurrencies are being developed. Breaches will lead to loss of trust. A currency that cannot be trusted is an oxymoron. Crypto currency's time under the sun will come, but before that, a lot has to happen. Several non-currency applications using Blockchain will succeed in 2018.

Many believe that 2018 is the year in which Amazon will deal a big blow to the advertising fortunes of Google and Facebook. It is getting there, having overtaken them for internet searches for products and services in 2017. Since the 'search' world deals with more than products and services, Google and Facebook will get some more time to develop new strategies to deal with Amazon's relentless march so that the real battle will spill over into the next year. Yet 2018 will be interesting for those who care about this phenomenon.

There are techies who believe that 2018 will be the year in which robotic assistants for consumers, virtual and augmented reality headsets, smart speakers and smart gadgets will go mainstream. Sorry, if going mainstream is like the way smartphones caught on, they will need to wait a wee bit longer; but it will get there in time. What will go mainstream in 2018, with assistance from technology, is women's right to self-respect.

Some expect 2018 to be the year in which professional tablets will kill laptops. That is not likely to be. Instead, laptops will fight back, with most manufacturers offering laptop-tablets with touch screens and a folding hinge, a trend pioneered by Lenovo's Yoga series. Look out for laptops with long life batteries of 15 to 20 hours life and a few that will perform like proper gaming devices with powerful chips - the type that strange bed-fellows, Intel & AMD have combined to develop. TVs did not die when television broadcasters started losing share to the likes of Netflix, Amazon Prime, etc. which could be viewed on phone screens. Instead, TVs became smarter devices to view the new type of content.

It is the year in which Islamic terrorists will be wiped out say some who are encouraged by the small and big victories in 2017, a rather unrealistic expectation given that fighters are driven by passion and covert support from some Governments across the belt from the ME to South East Asia. More bitter skirmishes may be expected. It will help the OPEC to prevent oil prices from crashing.

Elon Musk's much feared prediction of massive job losses will not all happen in 2018. There will be some job losses in 2018 and more in the next 10 years but much of it will get replaced by new kinds of jobs over the years.

So in 2018, there will be no nuclear war, AI will not put half the world out of jobs, Google and Facebook's advertising revenues will not be had by Amazon for breakfast, crypto-currencies will not go mainstream, Laptops will not get wiped out, etc. What then, is likely to happen in 2018 from the business point of view?

Just as Amazon acquired the brick & mortar Whole Foods chain, look out for big ticket acquisitions of e-commerce companies by retail majors because the world is heading towards the omni-channel model. This may be a good time for investors to buy stakes in e-commerce companies with good consumer reach, which can complement the brick & mortar buyers.

If you are a businessman of some standing and have sufficient financial backing, 2018 will be like no time ever in the past in India. There will many industrial assets that can be picked up cheap. Never before, have Banks shown the resolve to oust borrowers who have defaulted on loans and never before have the laws of the land been able to empower such moves. Healthy Banks (and there are quite a few) are willing to lend to quality buyers to fund asset purchase at reasonable rates because safe lending avenues for Banks have decreased over the past decade when the politician-lender-borrower nexus destroyed many a bank's balance sheet. This is a never-before opportunity for potential buyers, to acquire manufacturing businesses just as the Indian economy enters a growth phase post the GST implementation. International investors would do well to quickly assess the opportunity in India, monitor it closely over the year end and act decisively.

In India, sectors that may do well are infrastructure, commercial vehicles, inputs, equipment and services for agriculture, cotton textiles, textile chemicals, insurance, NBFCs, FMCG, food processing, construction materials, etc. due to rural centric policies that may be expected in the pre-election year in the aftermath of the Gujarat election results. Industries that are dependent on oil as an input will face challenges except in industries like paint, luxury goods, etc. which may be able to pass on the increased input costs.

I ended last year's note saying that Paytm's wallet model has no future in the light of various developments. Paytm needs to be complimented for smartly moving way beyond the wallet during 2017 and so does PayUMoney India which decided to shut down its standalone wallet at the start of 2018. Others are trying to reinvent themselves. I will end this year's note saying that Uber and Ola will do well to alter the revenue model before the dawn of 2019. More on that next year.

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