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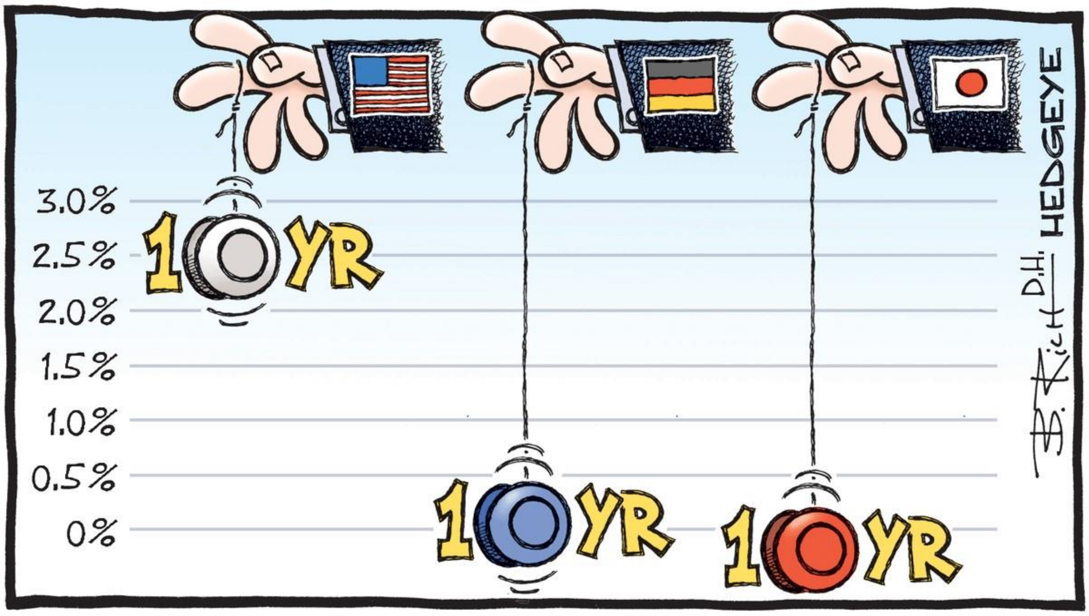


10yr government bond yield JoJo by Hedgeye, 24 April 2019

Waning market stimuli put stock markets on notice

A pleasant Easter break has been followed by new highs for US equity indices. And yet, it has been a less comfortable week for professional investors. The tailwinds blowing the 2019 stock market bounce-back are waning. Rebounding bond yields have made corporate borrowing a little less cheap than it was in Q1; oil prices – climbing on supply fears rather than demand pull – are creating a strain for economic activity; and an unexpected step up in the value of the US$ is equally concerning for emerging market $ borrowers, as it is for $ denominated global trade volumes. And the major central banks of China and Europe have been indicating no great inclination to loosen monetary conditions further.

To be sure, the recovery of risk assets from the lows of Christmas 2018 still looks rational. The backdrop is that the global economy is slow rather than recessionary. Valuations have risen but are still at levels which do not require anything more than muted economic growth. As long as bond returns remain low, even slow earnings growth will keep valuations in line with historical averages.

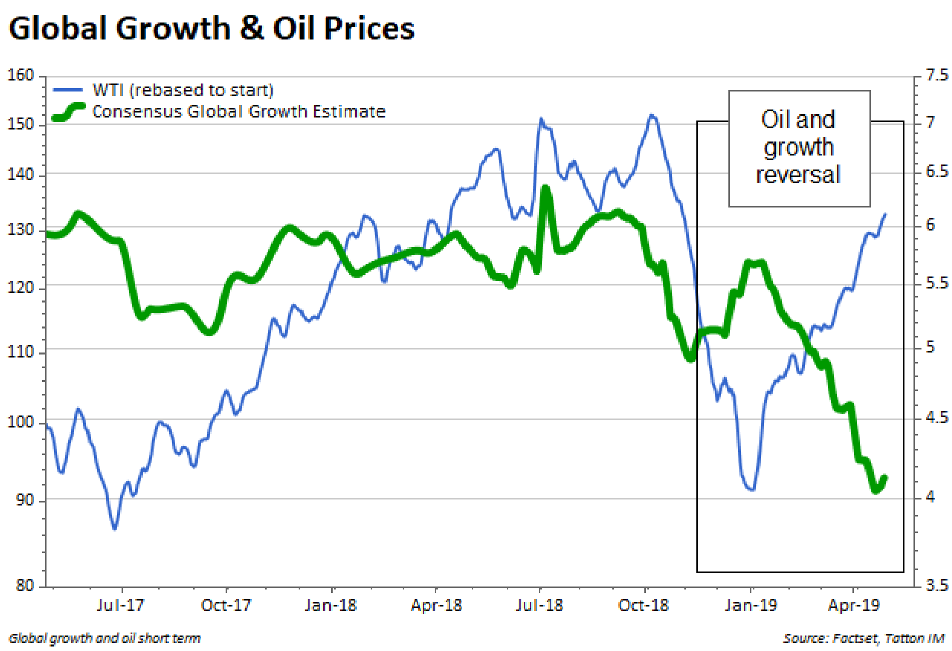
We have written before that investors can look beyond a not-so-great quarter for corporate earnings results, as long as the medium-term outlook (over the subsequent quarters) remains positive, or central banks deliver more liquidity. This week's economic data may be indicating limited headroom for growth optimism later this year. Unless the prospects for the second half of 2019 stop undermining the fundamental support of earnings growth expectations, further increases in stock market prices will depend yet again on the weary central banks.

At the moment, the warning signs are not flashing. But the more pronounced they become, the greater is their ability to sour investor sentiment and reverse the private sector risk-appetite that has propelled markets since the start of the year. For the moment, corporate earnings for Q1 2019 are better than anticipated and management outlook statements no worse than neutral. The positive news flow stimulant should continue for another couple of weeks and markets should remain stable. However, should the current deterioration of the medium-term outlook persist, then a bout of market volatility may well be on the cards.

Rising oil not a boon for global economy

When looking at the price of anything, it can be a problem working out whether a change is due to supply or demand. In the case of oil, this is especially so. Demand for oil is immense and highly linked to economic growth. When growth is strong, the price will go up even when the oil producers fully turn on the pumps. However, if growth is weak, the producers will try to manage the supply so that prices remain stronger than demand might indicate. Thus oil price rises can signal demand strength, or occasionally demand weakness.

The recent moves in oil seem to be in the latter camp. The chart below shows what appears to be the two phases. Strength in the global economy allowed prices to rise until the last quarter of 2018. The cooling which started in October coincided with a fall back in oil prices. However, a bounce in growth expectations (courtesy of China optimism) did not provide any solace for the oil producers.



After breaking through the $80pb mark at the end of the third quarter, the last three months of 2018 were unkind to oil traders. Fears over slowing global growth – which likewise sent wider asset markets into tailspin – sunk Brent to a low of $50pb at Christmas.

Oil price falls of over a third from the highs convinced the producers that action was needed. Since that point, prices have gained around 50%. Unfortunately, it looks like their success may be a factor in another swing down in growth projections.

Mid-week, we saw oil prices shoot to their highest levels in six months before cooling off a little on Thursday and Friday. Brent Crude, the international benchmark, topped $75 per barrel, while US West Texas Intermediate climbed to $66pb.

The price moves seem to be a function of supply-side stories. Poland and Germany have temporarily closed a key crude oil pipeline from Russia over contamination fears, shutting off a flow of around 700,000 barrels per day. Meanwhile, the US has cranked up the pressure on Iran, announcing that they will not renew sanction waivers for buyers of Iranian oil – contrary to market expectations. This, combined with ongoing Venezuelan sanctions, has left traders expecting tight supply in the near future.

However, prices backed off those highs later in the week. A larger than expected build in US inventories weighed down on WTI, sending the benchmark 1% down on Thursday, while expected production increases from Saudi Arabia and its allies knocked Brent of its perch too. According to consultancy firm Rystad Energy, "Saudi Arabia and several of its allies have more replacement barrels than what would be lost from Iranian exports,"

Price jumps like these have been the trend this year. Part of this has to do with the general recovery in risk sentiment this year, with market traders less in fear of the next global recession. But it's mostly supply. While the US has stated that OPEC and the other major oil producers have enough capacity to make up for the Iranian shortfall, Saudi Arabia – OPEC's de facto leader – has made far more measured remarks. Market analysts suspect that the world's largest oil exporter will not be in any rush to end production cuts, opting for discipline in the ranks.

Oil prices will probably continue to act as a dampener for global growth. The rise in oil prices will still feed through into higher inflation later this year, but the dampening effect on global growth means that we expect to see core inflation (ex-food and energy) move lower over the next 6-12 months.

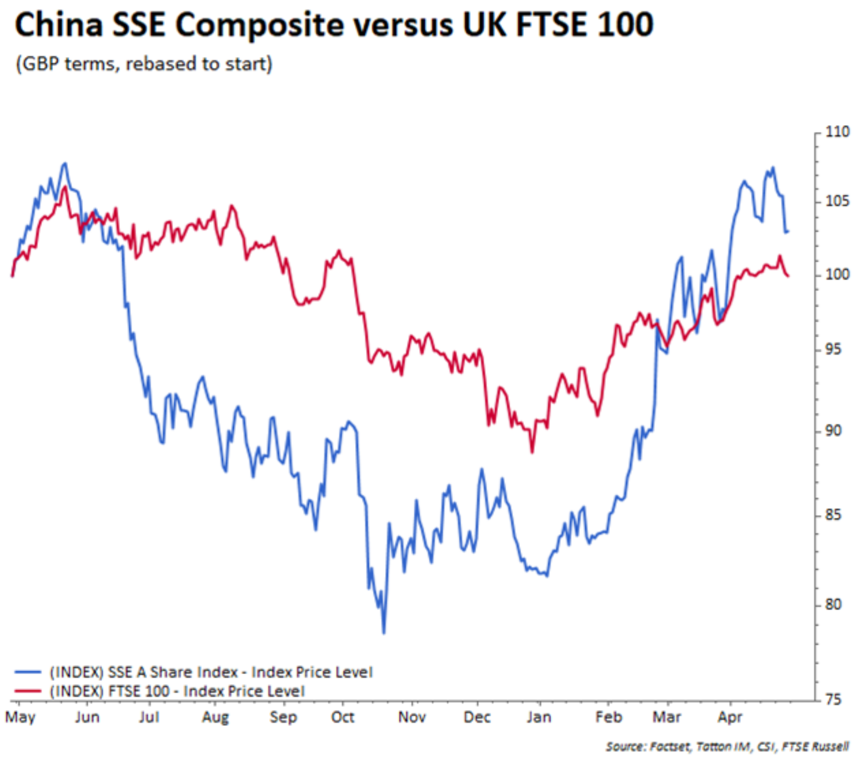
For us, this reinforces our view that both global growth, and ultimately inflation, could head downward in the second half of this year. We expect that oil prices will have to move lower, reflecting lower global demand, which in turn should help to stabilise the economy.

China moving away from stimulus

This past week has seen several high-profile pronouncements from the Chinese government. On Friday, a Politburo statement indicated that Beijing believes the economy has now rebounded enough to not need further stimulus. This sentiment was echoed on Monday, when Xinhua news cited a top-level meeting chaired by President Xi Jinping as arguing for a balanced monetary policy, "neither too tight, nor too loose".

Recently, the release of economic growth data from the first quarter of this year seemed to vindicate the government's stimulus measures. GDP expanded 6.4% year-on-year during Q1, according to official figures. While this is still low by China's high growth standards, it matches the figure posted during the last quarter of 2018, suggesting that the world's second largest economy may be on the way out of the economic slowdown it endured last year. Premier Li Keqiang called the economy stable after the better-than-expected results, but noted there remains "downward pressure" and that the government will continue to reduce taxes and fees on a large scale.

Through all this policy-speak, there does seem to be a clear shift of focus from the government. Now that short-term stimulus measures have stabilised the economy, Beijing wants to renew focus on its long-



term reform goals. This apparent change proved to be damaging for China's stock market. After a torrid 2018, investors have bet big on Chinese equities this year, leaving the CSI 300 index up around 40% since the beginning of January. But during the course of this week the CSI lost over 6%, and the Shenzhen and Shanghai composites came down by even more.

This year's China rally has been more about sentiment than economic performance – with markets buoyed by Beijing's stimulus promises – so signs that the government could be backing off were never going to be well received. But regular readers will know that this is largely in line with our expectations. China's current stimulus program was never going to be a repeat of 2016, when Beijing pumped vast amounts of credit into the economy to avert a slowdown. What seems clear now is that, while being anxious about putting too much pressure on the economy, the government wants to focus more on its long-term reform goals. It is notable, for example, that we have recently seen arrests for pollution violations, suggesting a reinvigoration of Beijing's anti-pollution campaign.

It has been interesting that the government's recent stimuli have been mainly fiscal rather than monetary. There is little evidence of policy easing by People's Bank of China (PBoC), and recently the central bank has withdrawn liquidity from money markets. This reaffirms what we have been saying for some time: Chinese stimulus is real but partial and targeted: it will not be as much help to global growth as some seem to anticipate.

Maybe capital markets have priced this already. The substantial rally in Chinese equities may have been over-extended this year, but wider global asset prices are not trading at levels which imply particularly strong global growth. Although those expecting a Chinese boost to global activity are most likely going to be disappointed, it should not be a big negative for risk assets generally.

The waning bite of the FAANGs?

The so-called FAANG stocks (Facebook, Apple, Amazon, Netflix and Google) have had enormous success in equity returns over the past decade. In the 10 years to tech's peak at the end of June 2018, Netflix and Amazon surged 652% and 402%, respectively. Over the same time-frame, Facebook (+218%), Apple (161%) and Google (100%) have also far exceeded the broader S&P 500 index. But this spectacular growth story has looked vulnerable in the last year or so. Are the heady days of uninterrupted FAANG growth coming to their natural end?

The growing influence of tech led to profound changes at an index level. Just six companies powered 37% of the S&P 500's 44% increase over the past five years: Amazon (10.1%), Apple (6.5%), Facebook (4.7%), Google (6.4%), Microsoft (7.8%), and Netflix (1.8%). While Netflix's contribution of 1.8% may look small, the increase in its market worth was the same as JP Morgan's $133 billion – not bad for a business that still relies on outside creditors. Without these six, the S&P would have only seen an annual rate of growth of 5%, instead of the actual 7.6%.

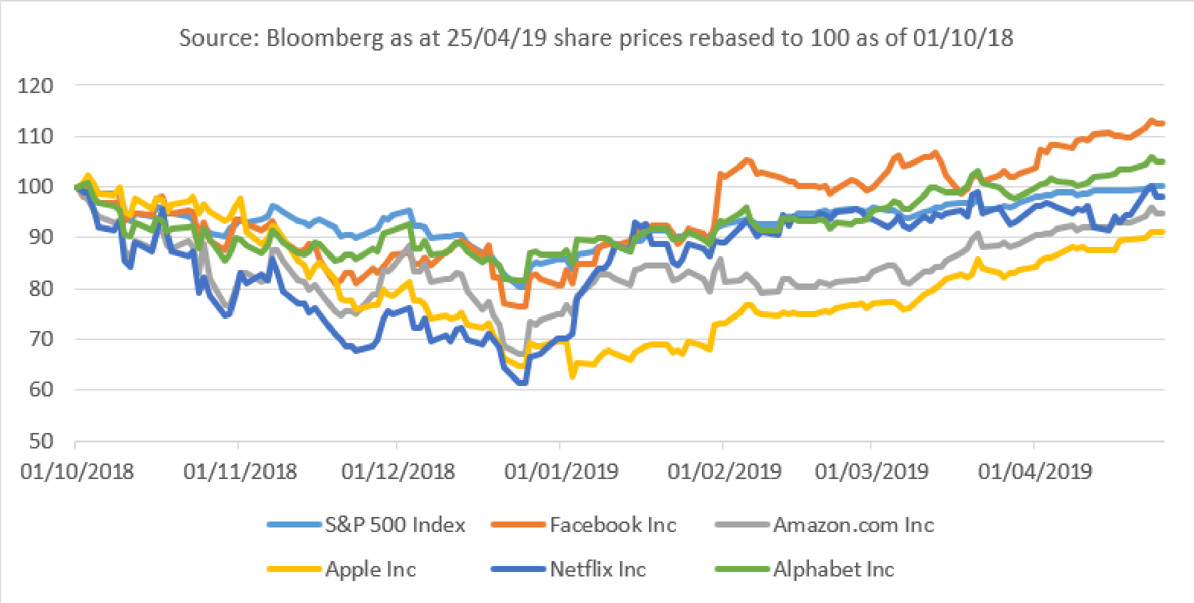
Stock market bulls might argue that US equity valuations today are simply a reflection of tech's disruptive power, and that this will not change anytime soon. Perhaps, one could conclude that tech's disruptive power, when scaled up to a global level can add just as much market worth as the older, more established, and more physical goods and services-focused sectors, especially if it is well-run from a governance perspective.

But lately, the old guard do not seem to want to play second fiddle and have begun to fight back, leading to a deeper evaluation of longer-term growth prospects in response to growing competitive and regulatory threats.

The FAANGs' aura of invincibility was pierced over the course of 2018 when markets began to question their ability for further spectacular growth. Those concerns led to larger share price falls for the FAANG stocks during the Q4 stock market sell-off than the broader S&P 500. Facebook (-25%), Google (-15%), Amazon (-25%), Netflix (-27%) and Apple (-30%) all fell faster than the S&P's 13% decline.

Since the start of 2019, Facebook (+36%), Google (+20%), Amazon (+24%), Netflix (+34%) and Apple (+29%) have all outpaced the 16% gain in the S&P 500. Much of this has to do with returning risk sentiment (thanks in part to a dovish shift from the Federal Reserve) easing valuation pressures. But those growth concerns have not gone away.

The most visible battle against the FAANG stocks is in TV streaming. Until recently, Netflix and Amazon (Prime Video – formerly UK's Lovefilm) basically had the streaming market to themselves and continued



to attract new subscribers by simply offering an efficient way to view a wide array of TV and movie content on demand. This strategy will not work forever.

Slowly, the battle between the two has been heating up, leading to huge investment in original content in order to keep users on their platform. Netflix plans to spend over $19 billion on new programming over the next five years, while Amazon is reported to be spending $6 billion in 2019 alone (acquiring popular Sci Fi show *The Expanse*, for example).

It is not difficult to see how Amazon can fund original programming content out of its large $10 billion annual free cash flow. The picture is less clear for Netflix, which as noted above, increasingly relies on debt financing to continue operations. Total debt at Netflix currently stands at $10 billion and the company has reported 21 consecutive quarters of negative free cash flow (i.e. needs external financing).

So, the news that the undisputed king of content, Disney (with its newly acquired Fox assets), as well as Apple (with balance sheet cash at $130 billion) and AT&T (via Warner Brothers) all plan on launching rival streaming services has likely sent a few shivers down Netflix's spine. Perhaps this explains why Netflix announced a further $2 billion bond sale this week (just six months after the last $2 billion sale) in order to raise funds against these vast competitive threats.

If content is king, then Netflix could be in trouble. Netflix viewers seem to prefer shows created by others and the above three new rivals represent an estimated 40% of all viewing minutes on the platform. Licensed content accounts for around 70% of all viewing minutes on Netflix's platform, according to WSJ and Nielsen.

Perhaps Netflix's new competitors have stumbled upon its greatest weakness – a heavy reliance on external content – and are now turning the competitive screws. This is the day Netflix always knew would arrive. Deals are being renegotiated (AT&T's WarnerMedia obtained $100 million from Netflix for the *Friends* back-catalogue) and content is being removed (Disney's Marvel films will be gone from Netflix).

Disney's streaming service (Disney+ at $7.99 a month) could represent the greatest threat to Netflix. Disney has 95 years' worth of content headed towards its service and is cheaper than Netflix, along with the exclusive *Marvel* (a Loki show) and its *Star Wars* programming (*The Mandalorian*). This is not to mention Fox assets like *The Simpsons*, *Family Guy* and *Futurama* (sometimes considered nerd-friendly but the types of show likely to attract tech-friendly users.).

Apple's TV+ service also contains a host of entertainment heavyweights, from *Oprah* to legendary director Steven Spielberg all bringing content. AT&Ts WarnerMedia service can call on 96 years of Warner Brothers content, iconic characters like Batman, Superman and Wonder Woman, and more recent hits like HBO's wildly popular *Game of Thrones* show.

These competitors have not even been launched, but Netflix seems to be feeling their effects. It's worth remembering that back in October, S&P upgraded the Netflix's credit rating to BB-, saying the streaming leader should see its revenues and profitability grow in 2018 and 2019. But neither has occurred and one wonders if S&P will re-evaluate its rating due to the addition of an extra $4 billion in debt in the past six months alone.

Netflix reported quarterly numbers last week and its own forecast of subscriber numbers was below analyst estimates, on the back of rising competition. The focus on profitability has led to the firm raising prices in its biggest territories. This could compound the problem when others are launching cheaper services with potentially far more content that people want to watch.

Even worse for Netflix, Disney announced it would happily lose $1 billion each year for the next five years in order to gain market share. Future bond offerings are likely to be closely watched to see if Netflix is losing its shine with investors.

The typical business model for a FAANG (excluding perhaps Apple) goes like this: They have an idea that can feed on networked effects, attract users with 'free' services or exclusive features, scale rapidly across the globe to achieve monopoly position, and then build a moat that will protect profits and allow them to rise over time.

The problem for the FAANGs is that the 'moats' they have built against the competition are not as uncrossable as they may believe. Each of the tech giants is facing its own individual issues that could reduce profitability or at least provide new entrants with an opportunity.

Netflix is facing competition from entrenched content owners. Facebook could see new regulatory changes that limit what it can do with user data (and other platforms like minds.com are growing). Google faces its Microsoft moment and is being forced to change the way it displays ads (and also browser unbundling on Android). Competition authorities could take a closer look at Amazon, and the smartphone era has likely peaked for Apple.

With the competitive pressures mounting against the FAANGs, will the disruptors themselves become disrupted as the old guard fights back by using the very same technologies that once threatened their business models? Maybe existing firms no longer fear the bark nor the bite of the FAANGs.

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29th April 2019

Global Equity Markets

MARKET	FRI, 16:30	% 1 WEEK*	1 W	TECHNICAL
FTSE 100	7437.1	-0.1	-9.8	→
FTSE 250	19711.7	0.9	173.4	→
FTSE AS	4069.9	0.1	2.5	→
FTSE Small	5568.0	0.8	46.5	→
CAC	5502.7	0.5	26.5	→
DAX	11999.9	-0.1	-9.8	→
Dow	26372.0	-0.2	-53.0	↗
S&P 500	2901.0	0.3	8.3	↗
Nasdaq	7616.0	0.5	37.2	↗
Nikkei	21870.6	0.3	63.1	→
MSCI World	2147.6	-0.1	-2.2	→
MSCI EM	1087.5	0.2	2.4	→

Global Equity Market - Valuations

MARKET	DIV YLD %	LTM** PE	NTM*** PE	10Y AVG
FTSE 100	4.8	17.5x	13.1x	13.3x
FTSE 250	3.2	24.9x	13.6x	14.1x
FTSE AS	4.5	18.5x	13.1x	13.4x
FTSE Small	3.9	83.1x	10.8x	14.0x
CAC	3.2	18.5x	14.2x	13.4x
DAX	3.1	15.1x	13.3x	12.6x
Dow	2.2	16.7x	16.2x	14.9x
S&P 500	1.9	19.1x	17.5x	15.9x
Nasdaq	1	24.1x	21.3x	17.8x
Nikkei	2.1	16.1x	15.1x	18.7x
MSCI World	2.5	17.8x	16.0x	15.2x
MSCI EM	2.6	13.3x	12.8x	12.1x

Top 5 Gainers / Top 5 Losers

COMPANY	%	COMPANY	%
EasyJet	8.7	Reckitt Benckiser	-7.5
GVC Holdings	7.0	Standard Life Aberd.	-5.1
Schroders	6.5	Whitbread	-3.8
TUI	4.9	Rolls-Royce Holdings	-3.8
Experian	4.8	Aviva	-2.9

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.31	0.35	OIL	71.5	1.6
USD/EUR	1.13	0.80	GOLD	1291.3	0.0
JPY/USD	112.02	-0.26	SILVER	15.0	-0.7
GBP/EUR	0.86	-0.43	COPPER	293.5	1.4
CNY/USD	6.70	0.20	ALUMIN	1860.0	-1.8

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W YIELD
UK 10-Yr	1.2	8.6	0.10
US 10-Yr	2.5	2.1	0.05
French 10-Yr	0.4	10.2	0.04
German 10-Yr	0.1	685.7	0.05
Japanese 10-Yr	-0.1	-93.1	-0.03

UK Mortgage Rates

MORTGAGE BENCHMARK RATES	RATE %
Base Rate Tracker	2.57
2-yr Fixed Rate	1.68
3-yr Fixed Rate	2.00
5-yr Fixed Rate	2.04
Standard Variable	4.27
10-yr Fixed Rate	2.58

* The *% 1 week* relates to the weekly index closing, rather than our Friday p.m. snapshot values
** LTM = last 12 months' (trailing) earnings;
***NTM = Next 12 months estimated (forward) earnings

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