PREDICTIONS 2013

EXPLORING THE YEAR AHEAD

BREAKINGVIEWS
The economic challenge for China’s new leaders

Xi Jinping and China’s other new leaders take charge of a slowing economy and an increasingly vocal populace demanding cleaner government, better welfare and more affordable housing. Only modest progress has been made at shifting the economy from an investment-led, industrial model to one driven more by consumers and the services sector.

Louis Kuijs, Chief China Economist at RBS, says investors expecting the incoming administration to respond with rapid reforms or a major fiscal stimulus are likely to be disappointed.

Find out what we think. Read the full article at rbs.com/insight
PREDICTIONS 2013
PREFACE
EXPLORING THE YEAR AHEAD

Stop reading now if you expect Predictions 2013 to be a list of trading instructions. This book – in the best Breakingviews tradition – treats its readers with more intelligence than that sort of sentiment implies.

Don’t misunderstand: Breakingviews writers and editors want to be right. And if the record in the coming year is as good as what was achieved in 2012, a fair slug of the insights will hit the mark. But our primary role is to stimulate thinking and help readers to make useful, smart and perhaps even lucrative decisions. Readers, ultimately, will judge whether to take the Breakingviews predictions at face value – or use them as an analysis-rich platform from which to draw their own conclusions.

How did we do last year? We asserted that investment banking dreams would die in 2012 and that the euro would stick together but live dangerously. We said grey market trading would suck life from IPOs, particularly that of Facebook – bingo called on that one. Corporate carve-ups, we argued, would help sustain M&A bankers. We even cited News Corp as a candidate to perform the splits. Both predictions came to pass. We said that China’s growth would dip below 8 percent. That was a decent call. We said: “Sustained low stock prices make it another classic year to accumulate stocks.” The world’s leading equity markets are up, by 10 percent or more in some cases, and they are still cheap by historic standards. We also suggested that France was heading for a major spring crisis and that new currency unions might see the light of day. So the year has been less than kind on some of the forecasts. But they still provoked, and may yet be fulfilled – in which case we simply would have been too prescient by a few months, or a few years...

If the Breakingviews’ Predictions 2013 materialise, the world will avoid economic calamity. The troubled Hewlett-Packard could break itself up and central bankers will find their independence threatened. Latin America will draw economic strength from its consumers; shadow banking could lead
China towards a darker place and Angela Merkel will win an uncomfortable victory in this year’s German elections. If the Predictions 2013 are good, the end for 2-and-20 fee structures will hove into view and Japan’s new leaders will preside over a three-digit yen. The year may see Bob Diamond – the former CEO of Barclays – bounce back but there could be career changes for some of the investment banking industry’s financial crisis survivors.

Enjoy Predictions 2013, and read them in the spirit they are written. Breakingviews will work hard to explore the entire year ahead with a blend of insight, analysis, speed, and common sense. With these predictions, and all the Breakingviews we will publish in the next 12 months, we hope our subscribers will profit financially and intellectually from the year ahead.

Robert Cole
Assistant Editor, Reuters Breakingviews
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OLD SCHOOL MARKETS COULD RETURN IN 2013

BY ROB COX

After five years of macroeconomic mayhem, 2013 may at last mark a return to the ordinary. Market signals already suggest the focus has shifted away from central bank interventions and systemic worries like the dissolution of the euro or a financial collapse towards companies, deals and fundamentals. That would be refreshing.

Ever since the financial crisis started in earnest in the United States in 2008, fear has reigned. After Lehman Brothers’ collapse, the slightest hint of a bank run would strike anxiety. Then it was sovereign governments, with rollercoaster reactions to the latest deal in Athens, Madrid or Frankfurt.

During these tumultuous periods, it usually didn’t matter what stock, or indeed what asset class, investors held. With a few exceptions, such as gold or U.S. government debt, everything moved in tandem. Fundamental analysis regularly proved superfluous.

That’s changing. The 252-day average internal correlation between stocks on the S&P 500 index currently sits at around 40 percent. True, by historical standards, that’s above the average since 1990 of 30 percent, as calculated by Boston fund manager GMO. But it’s down from 60 percent before markets rallied in July and has not dipped below 35 percent since the crisis hit in 2008.

What does this mean? For savvy investors, particularly those who placed their bets when markets traded in monolithic fashion, it may be time to shine. Company executives, meanwhile, may now be able to strike deals and invest with more confidence that such decisions will be rewarded on their merits, rather than lost in the latest headlines emanating from...
far-flung capitals. At Reuters Breakingviews, our work may shift to covering more corporate finance.

Risks remain. The economic peace brokered by European Central Bank boss Mario Draghi and German Chancellor Angela Merkel could be undone by any number of unforeseen events. Governments like Italy might break promises of fiscal probity. A slowdown in China’s growth could herald a collapse of social order. And the biggest kahuna of all, the United States, seems ever in danger of dysfunctional breakdown.

As prognosticators, markets may be flawed. Still, after a half-decade of fear from above, a return to something more old school might be the most welcome prediction of all.

First published 2 January 2013
MERKEL SET FOR UNCOMFORTABLE ELECTORAL VICTORY

BY OLAF STORBECK

The parliamentary elections Germany will hold next year will be both boring and exciting. Chances are high that Angela Merkel will win a third term. But voters won’t give her conservative CDU party a clear majority, and they still haven’t made up their mind about her coalition partner. The results’ implications for Germany’s stance in the euro crisis will be limited, no matter which party is in government.

Germany’s Chancellor Merkel arrives at the EU council headquarters for an EU leaders summit discussing the EU’s long-term budget in Brussels. REUTERS/Francois Lenoir
Merkel’s first choice is continuity. However, the free-market FDP, her partner in the current “black-yellow” coalition, is at risk of finishing below the 5 percent threshold necessary for parliamentary representation. It has been trailing at 4 percent for months. But its electoral base may be larger than that. Early next year, the party could replace its unlucky leader, economy minister Philipp Rösler. A fresh face – and the prospect of looking into the abyss – might energize its supporters. So the jury is still out on the FDP’s fate. Even if it survives, the outgoing coalition could still lose its Bundestag majority. Merkel then has two options.

The most likely is another “black-red” alliance with the Social Democrats (SPD). Both parties see such a “grand coalition” only as a last resort. Both stand to lose, because the lack of a vocal opposition nurtures voter’s disaffection. After the last experiment, which ended in 2009, the SPD sunk to its lowest level since 1930.

Finally, Merkel could think of replacing yellow with green. This would have been inconceivable a few years ago, but the cultural divide between the Conservatives and the Greens has narrowed of late. Both parties collaborated constructively in a number of cities and – at least for a time – in the state of Hamburg.

By deciding to phase out nuclear power after the Yukushima disaster, Merkel moved the biggest obstacle to “black-green” out of the way last year. On the Green side, the party base surprisingly nominated Katrin Göring-Eckardt, a moderate East German, as one of their top candidates. Nevertheless, “black-green” is still a long shot. Staunch supporters of both parties would find it hard to swallow. It might result in a less stable government.

Both the SPD and Greens are less prone on austerity than the FDP is, and both center-left parties are staunchly pro-European. Hence the stricken periphery would either prefer “black-red” or “black-green” to “black-yellow”. But black there will be.

First published 18 December 2012
Mario Draghi’s words were enough to keep the euro zone together in 2012. In 2013, his actions will have to speak louder to consolidate the fragile state of the monetary union. The president of the European Central Bank will have to make good on his bond-buying pledges, guide the new common banking regulator’s tentative first steps, and show what he can do to foster growth in the region.

Draghi’s mere promise of “outright monetary transactions” (OMT) – unlimited buying of the bonds of indebted countries struggling with high yields – were enough to calm markets. But it raises a problem: a country such as Spain is now under less pressure to request that new type of bailout. Yet Spanish borrowing costs haven’t come down enough and still hurt the economy. Draghi’s task is to convince Madrid to accept the ECB’s intervention. Even then, he won’t be in a risk-free zone. He must make sure that Madrid won’t slow down on reforms. Then there’s the question of how northern European countries will react if bond-buying becomes massive.

The second of Draghi’s challenges is the creation of the euro zone’s single banking supervisor, which should be up and running in 2014 and will operate under the ECB’s general authority. The supervisor will have to overcome domestic vested interests, and spot troubles before they happen. Draghi will have to engineer the necessary strict separation between the new institution and the ECB’s governing bodies, and make sure that concerns about the banking system will not influence the determination of interest rates. And he will have to ensure the credibility and authority of the new supervisor over the 17 different national banking regulators. No easy task.

Last, Draghi needs to show he can do more to boost growth than repeating that austerity and “structural reforms” are enough. The EU’s economy is still flat, all of its members are facing high unemployment and a credit crunch. Draghi could come under pressure to take more drastic action, for example by providing banks in peripheral Europe with ultra long-term, cheap loans, or targeting its action so that credit flows to small and
mid-size companies. Once interest rates have been lowered further, which looks unavoidable, pressure may build for more controversial action, such as money printing or cutting deposit rates below zero. This could divide the governing council. Draghi may first want to see how the OMT will work; which brings him back to problem number one.

First published 28 December 2012

UNCERTAIN SEC LEADERSHIP HERALDS DYSFUNCTION

BY ROB COX AND DANIEL INDIVIGLIO

Gridlock isn’t just a problem in the U.S. Congress. It may also freeze up the Securities and Exchange Commission. By elevating one of five commissioners to replace departing Chairman Mary Schapiro, without naming a replacement, President Barack Obama has put the Wall Street watchdog in a bind. Political expediency may present substantial risks for investor protection.

The problem is simple math. Schapiro’s departure leaves the SEC’s ruling body with two commissioners from each party. To effectively govern, a fifth vote is necessary. It’s precisely why the SEC, like the Commodity Futures Trading Commission and Federal Trade Commission, was established along these lines.

That affects investors for two basic reasons. First, without a deciding fifth vote it will be virtually impossible to pass new rules overseeing financial services, such as whether additional investor safeguards should be imposed on the $2.6 trillion money market fund industry. Democrat Luis Aguilar opposed reforms supported by Schapiro until a proper study could show whether post-crisis modifications had been effective.

The report was issued last week. For the most part, it suggests that while changes made in 2010 were helpful, they alone wouldn’t have prevented the Reserve Primary Fund from “breaking the buck” in 2008. The results might convince Aguilar to support some of the proposals embraced by Schapiro, Reuters reported in December. Absent a fifth vote, however, the objections of the two Republican commissioners would still sink the initiative.
Finally, there’s the recruitment problem. Though Elisse Walter was given the chairman title, news reports suggest she’s a short-term fix with her term ending in a year. That gives cold comfort to securities lawyers who might otherwise be willing to work for the SEC. In just one week in December, the regulator lost its general counsel, its trading and markets director and the head of the corporate finance division. Who would take a senior position at an agency whose boss is leaving soon?

The president may have avoided a confirmation battle over leadership at the SEC. But he has done no favors for investors by leaving the watchdog rudderless and, ultimately, toothless.

First published 7 December 2012

UK’S CHOPPING CHANCELLOR MAY FACE THE CHOP

BY IAN CAMPBELL

As the UK economy wobbles, George Osborne’s austerity policies are under fire. It’s all rather unfair. His essential surgery won’t cripple, it will revitalise. But as 2013 progresses the Chancellor of the Exchequer may become more of an electoral liability. Chopper George may find himself axed.

His blood-letting has been savage. Public jobs have fallen by a mammoth 578,000 since 2009, reversing much of the 856,000 rise between 1999 and 2009. This brutality in a weak world would lead to soaring unemployment, his critics said. Instead the unemployment rate has fallen as private employment has soared by 1.3 million since 2009. And total employment in the UK has risen to a new record high of 29.6 million.

Osborne’s critics ought to ask themselves whether that job creation would have occurred had the chopping Chancellor held back. But instead they are more likely to complain about weak growth and to point out that many workers are accepting part-time employment and taking jobs whose pay is low and rising at only half the inflation rate.
Well, yes, but this toughness has its positive side. Osborne’s austerity has prompted workers to become more flexible and cheaper to employ. It is hard, but that's the nature of economic restructuring. The benefit is likely to come in UK competitiveness and exports - and in future pay rises.

It’s jam tomorrow, of course. At present, exports, like growth, are disappointing despite the fact that a recession-afflicted Europe, to which exports are falling, is largely to blame. Yet in trade just as in the jobs market, some restructuring is taking place. UK exports outside the EU are rising by 9 percent. For the first time since the 1970s the UK is exporting more to countries outside the EU and linking itself to emerging economies. These are gains in which Osborne’s successors may rejoice.

Osborne’s decision to repeal the 50 percent top rate tax embeds his unfortunate public image. Welfare recipients are “still asleep,” he said unkindly. A sharp rise in growth might save Osborne’s skin, but that won’t come easily while Europe ails. And if Conservative politicians see austerity and weakness stretching on, it may be Osborne himself that they axe.

*First published 31 December 2012*
DIAMOND BOB WILL BOUNCE BACK

BY GEORGE HAY

Few executives had a worse 2012 than Bob Diamond. The ex-Barclays chief executive started the year running one of the few UK banks without a big government stake, and spearheading a drive to make banks better citizens. He ends it having been forced out following a perfect storm of shareholder revolts, regulatory ire and, most notoriously, Libor.

Diamond can’t escape the huge dent Libor has left in his reputation. Suggestions that Barclays might have submitted artificially low rates in the now-discredited daily process to set inter-bank borrowing rates may have been rendered less toxic by financial stability considerations. But Barclays Capital traders also tried to fix Libor during the boom to line their own pockets. Although Diamond denies any knowledge of the wrongdoing, he was running the investment bank at the time. He had to go.

Yet perversely Libor may enable Diamond to regain some of his sparkle. It’s become increasingly clear that other banks also tried to fix Libor, and that other banks’ settlements could match or exceed Barclays’ $450 million regulatory fine. UBS has already exceeded it by a wide margin. If full details of their misdeeds are published it would be surprising if it didn’t affect how people think about Diamond.

Any Diamond rehabilitation would probably happen outside the United Kingdom. Investors will probably still be narked about Barclays’ decision to award him 80 percent of his possible bonus for 2011, when Barclays flunked its stated returns targets. And UK regulatory disclosures in the wake of Libor make it clear supervisors didn’t approve of the hard-driving culture Diamond set at Barclays.

Yet Diamond could pop back up in his native U.S. Providing Barclays is shown to be in the pack on Libor-fixing, he could secure a non-executive position on a financial board. Alternatively, his experience setting up a global-sized investment bank could come in handy as universal banks start shedding non-core investment bank assets.
The main threat to rehabilitation is further dirt from Barclays. The UK bank is the subject of an independent review into its culture by lawyer Anthony Salz, and a Serious Fraud Office probe into its Middle Eastern capital-raising in 2008. Yet unless these heap further ordure, 2013 should be a better year for Bob Diamond.

First published 21 December 2012

**BANK CEO SURVIVORS’ CLUB MAY SHRINK AGAIN**

**BY DOMINIC ELLIOTT AND ANTONY CURRIE**

At least one of the three big bank chief executives to survive the financial crisis could be without a job by the end of 2013. Goldman Sachs’s Lloyd Blankfein, JPMorgan’s Jamie Dimon and Brady Dougan at Credit Suisse have each suffered setbacks in the past year or more. The two U.S.-based bosses have done a better job of shrugging those off. But Dougan looks vulnerable.

Holding onto the top role at a bank during the financial crisis has required guts and skill. The survivors’ club halved in size in 2012: Deutsche Bank’s Joseph Ackermann, Citigroup’s Vikram Pandit and Bob Diamond at Barclays all left their banks – though for very different reasons.

Blankfein has weathered almost three years as the lightning rod for criticism of Wall Street’s role in the crisis and of its excessive pay. He’s not out of the woods: Goldman’s return on equity for the first nine months of the year was a disappointing 8.8 percent. But for now, calls for his head have all but ceased.

Dimon, meanwhile, was knocked in 2012 by some disastrous trades that stripped shareholders of $6 billion of revenue. This blow to his reputation as a prudent risk manager forced him to reshuffle his executive team, putting two of them in the race to succeed him. But for now he has a good hold on the reins of a firm that still cranked out an 11 percent ROE in the first three quarters.
Across the Atlantic, Dougan’s summer flip-flop over whether to raise the capital deemed necessary by the Swiss central bank made him look weak and may have strained relations with the regulator. And UBS’s October decision to quit most fixed-income trading called Dougan’s strategy of sticking with the business into question. His rival’s shares soared by a fifth.

Some major shareholders still support Dougan. And he has no obvious successor. But investor support can be fickle. And unlike his two American counterparts, Dougan does not hold the chairmanship. Citi showed in October how effective that role could be when Chairman Mike O’Neill ousted CEO Vikram Pandit. None of the three crisis survivors should feel too secure in the corner office. But Dougan has the most to worry about.

First published 27 December 2012
IF APPLE BECOMES MICROSOFT, INVESTORS SHOULD CHEER

BY ROBERT CYRAN AND RICHARD BEALES

If Apple becomes Microsoft, investors should cheer. At least, that is, for their wallets. Middle age for technology stocks can hurt as shareholders looking for rapid growth lose interest and value-oriented owners await stability. But Apple has already made the transition - before its growth has slowed much. Even if its next decade echoes Microsoft’s last, the company is worth over $1 trillion.
First, consider Microsoft, worth $220 billion as of Friday’s market close. The software behemoth churns out more than twice as much profit as it did a decade ago. The company traded at 30 times estimated earnings in 2002. As investors realized its future was more Clark Kent than Superman, they paid less and less for the prospect of future expansion. Annual percentage revenue increases of late have at best been in single digits. Strip out its $67 billion of cash, and the business trades at about 6.5 times estimated earnings, according to Thomson Reuters.

Now look at Apple. In the fiscal year to September, its top line surged 45 percent. That was less than the year before, and there are reasons to expect a more pedestrian future: the company lost part of its creative soul when Steve Jobs died in October 2011; it’s a big ask for Apple to come up with another product like the iPod, iPhone or iPad; and competition in mobile devices is becoming tough. But analysts still expect revenue to increase 24 percent this year. And after taking out Apple’s whopping $121 billion cash pile, the underlying business in November traded at a price-to-expected earnings ratio of some 7.9 times, scarcely richer than Microsoft’s.

Suppose Apple Chief Executive Tim Cook turns out to match his Microsoft counterpart Steve Ballmer, and that Apple’s earnings increase at an 8 percent annual rate for the next 10 years, roughly what Ballmer has coaxed out of Microsoft since 2002. Apple’s profit would then be about $90 billion in 2022. On the software company’s multiple, that would make Apple’s business, excluding cash, worth $585 billion. Start with last fiscal year’s cash accumulation of about $40 billion and assume the same rate of growth, and in a decade the company will have added another $625 billion to its cash pile or to dividends. Add back all the cash, and the iPhone maker would be worth $1.3 trillion – approaching three times more than now, or a 10 percent annual gain.

Of course, the technology industry is littered with fallen tech giants. Competition, for instance, could depress Apple’s margins, though in fact they have widened in recent years – and Microsoft’s have held up. But if Apple turning into a sluggish Microsoft lookalike is all that it takes to more than double investors’ money, that seems a safe bet.

First published 19 November 2012
Lehman Brothers could be the Humpty Dumpty of 2013. It’s not quite as crazy an idea as it sounds. The defunct firm’s two biggest operating businesses – both snapped up by rivals in 2008 – could be up for grabs in the next 12 months. Stitching the old firm back together could be an enticing project.

Nomura has struggled since taking on Lehman’s European and Asian operations - although cost-cutting helped the investment bank return to profitability in the three months to September. If the outlook doesn’t improve, pressure will mount on the Japanese bank to call it quits. Meanwhile, Barclays may offload the U.S. business, which it scooped from Lehman’s rubble, as part of scaling back its trading and corporate finance unit.

There are no obvious buyers. European firms are shrinking. Wells Fargo, America’s fourth-largest bank by assets, might see Barclays’ retreat as a way to establish itself on Wall Street. But investment banking is not its core strength, and would probably prompt regulators to designate Wells as systemically important, which would require it to hold more capital.

So why not put the two homeless divisions back together? The challenge would appeal to sidelined investment banking executives like Jes Staley, who was recently booted upstairs at JPMorgan’s investment bank, or his predecessor, Bill Winters. Even Goldman Sachs’s second-in-command Gary Cohn might fancy a crack.

The overwhelming obstacle would be funding the new beast. Bondholders would probably want a new Lehman to maintain a much higher common equity ratio than the 8 percent or so held by Goldman and Morgan Stanley. And those two are already failing to generate decent returns for shareholders.

That would probably scupper any attempts to put all the pieces back together again as a public firm. A smaller boutique focused just on advisory might have more luck. Recreating a private partnership, where senior executives have real skin in the game, might make investors and counterparties more supportive.

**BREAKINGVIEWS**
The quandary highlights investment banking’s problem in a nutshell: if you’re not already a dominant player, why bother? UBS has already quit much of its fixed-income trading. The struggle of tackling Lehman’s possible Humpty-Dumpty status suggests others may soon have to follow.

First published 2 January 2013

GAZPROM’S TRAVALS ENCAPSULATE RUSSIA’S PROBLEMS

BY KEVIN ALLISON

When Rosneft formally completes its acquisition of TNK-BP to become the world’s biggest listed crude producer next year, it will cement a major shift in Russian energy realpolitik. For decades, Gazprom, the gas producer and export monopoly, was a key lever of post-Soviet Kremlin power. But years of mismanagement have taken their toll. And gas isn’t what it used to be. Rosneft is emerging as the new official energy torch bearer. But Russia remains at the core a badly-managed resource economy.

Rosneft is in the ascendant. Backtracking on his government’s promise to privatize the Russian oil sector, President Vladimir Putin has instead set the state-owned group up as the gatekeeper of his country’s energy might – a privileged position in a country where oil and gas account for about a fifth of GDP. The company will account for close to half of Russian oil production after it swallows TNK-BP. Its boss, Igor Sechin, is a Putin ally and old colleague from their KGB days.

Global oil majors have lined up to partner with the state behemoth on projects in the offshore Arctic and other places where Russia needs foreign expertise to get at new finds. Those projects, rather than Russia’s declining Soviet-era oil and gas fields, are where the future lies.

If Rosneft’s story has been one of steadily creeping control, Gazprom’s recent experience has been the opposite. The Kremlin has expressed frustration at Gazprom’s slow reaction to the US shale boom and the globalization of the natural gas market. The vice-like grip that Gazprom’s piped gas once held on
European supply is now looser. Belated efforts to strike pipeline deals with China and invest in liquefied natural gas have yet to pick up the slack. Gazprom has struggled to deliver big projects, such as the recently deferred Shtokman offshore field. Granting price concessions to several big European customers in 2012 was a definite sign of a hegemony in retreat.

Rosneft may not be subject to the same disruptive forces as Gazprom; U.S. shale hasn’t had a big effect on oil, and Rosneft never had a monopoly to lose. But in the end, it will just be another petroleum producer selling into global markets. After years of mismanagement, marked by cronyism and the wholesale looting of its natural resources, Russia’s days of projecting energy power are in their twilight.

First published 28 December 2012
HP BREAKUP IS ON TECH WORLD’S AGENDA

BY ROB COX AND ROBERT CYRAN

David Packard and William Hewlett may be Silicon Valley’s answer to Romulus and Remus in Rome’s founding story, but the era of their brainchild, Hewlett-Packard, as an everything-to-everyone conglomerate is coming to an end. Chief Executive Meg Whitman and HP’s board, not to mention investors, won’t stick around for an arduous and risky five-year turnaround project. Breaking the company into good bits and selling bad ones must be on the agenda for 2013.

The company famously founded in a Palo Alto garage in 1939 is in a barely controlled descent. Its PC division is shrinking at a double-digit annual rate, and sales from its supposedly steady IT services, enterprise hardware, and printing operations are also in decline. Turning around one failing division would be hard enough – just look at Michael Dell’s struggle at his eponymous PC firm. HP’s management has the unenviable task of fighting several multi-alarm fires simultaneously.

Accomplishing such a feat is rare in the tech world. IBM did it under Lou Gerstner in less trying times by jettisoning hardware lines and bulking up in the more easily defended and higher-margin software business. There’s little reason to believe investors have the patience and trust in HP’s management team to allow a similar attempt, especially after the latest debacle, an $8.8 billion writedown of the Autonomy software business the company acquired for $11.1 billion just a year ago.

Having lost her run to become California’s governor, Whitman took one for the Valley by volunteering to lead HP after the board forced out her predecessor, Leo Apotheker. But the scale of the company’s problems and the work required to fix them weren’t fully apparent at the time. Board member and activist investor Ralph Whitworth, who successfully pushed for breakups at ITT and L-3 Communications, is prohibited by a standstill agreement from launching a proxy fight to splinter HP. But nothing precludes him from trying to persuade the board to take that step.
Naturally enough, the company says splitting itself into pieces would be a mistake. HP argues that it is cheaper to buy parts in bulk, that customers often prefer to deal with one supplier, and that its tarnished brand still has value. But with the stock valued at less than four times estimated earnings for 2013, any benefit from these largely theoretical synergies has been fully eclipsed in the eyes of investors by the cons of a bloated bureaucracy, managerial confusion and research-and-development inefficiency.

So much so, that breaking up the firm looks like a financial no-brainer. HP’s market capitalization is about $27 billion. That’s scarcely more than half the price its parts would fetch as standalone entities. At least that is the conclusion from a new Breakingviews calculator that compares revenue multiples at each of HP’s divisions to similar publicly traded companies. This isn’t a precise valuation method, but it’s a way to assess the worth of troubled businesses since profitability can be swamped by inefficiencies or flattered by aggressive accounting.

**Printing a breakup ticket for HP**

How much is the Silicon Valley old-timer worth in pieces?

<table>
<thead>
<tr>
<th>Divisions to sales multiple</th>
<th>Divisions implied EV</th>
<th>Potential gain from Dec 6 2012 value</th>
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<tr>
<td>PCs</td>
<td>0.24</td>
<td>$8.6</td>
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<td>IT services</td>
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<td>Software</td>
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<tr>
<td><strong>Total equity value</strong></td>
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Source: Reuters Breakingviews. V. Flasseur, R. Cox, R. Cyran, 06/12/2012
Start with the company’s personal computing division, which had about $36 billion of revenue in the most recently reported 12 months. Rival Dell is valued at 24 percent of sales on the same basis. By that measure, the PC unit would be worth about $9 billion. The cash-generative printing division had about $25 billion of sales. At the same multiple of that as competitor Lexmark that business could also be worth about $9 billion. HP’s enterprise servers and storage business would fetch about $22 billion based on the value of peer NetApp.

The company’s services arm, including the Electronic Data Systems unit HP bought for $14 billion in 2008 before writing off most of its worth, may bring in some $17 billion if valued similarly to Computer Sciences. Finally, the software division, with a top line of about $4 billion, would be worth roughly $11 billion using the average multiple attached to similar enterprise software groups analyzed by JPMorgan. Add up all the pieces and net out HP’s $16.4 billion of net debt, and shareholders would potentially be left with assets worth over $50 billion, or just under $26 a share – 85 percent more than HP’s current share price.

This is a back-of-the-envelope calculation. The rapid deterioration in HP’s operations, structural shifts in technology and the possibility of further accounting gaffes could mean some of the company’s assets are worth a lot less. Equally, there could be buyers for pieces of the business, including competitors like Oracle or private equity firms, which might pay premiums for some units. Either way, it’s hard to avoid the conclusion that HP would be worth more dismembered than whole. The company’s board surely knows that too.

*First published 6 December 2012*
PREDICTIONS 2013

SULZBERGERS WILL MAKE HEADLINES IN NEW YORK TIMES

BY AGNES T. CRANE

Expect the Ochs-Sulzbergers to make headlines in their own New York Times in 2013. The family that controls the U.S. paper of record has loyally seen it through some dark days. With the Gray Lady now on sturdier financial ground, they have a better chance to find a safe custodian at a decent price – maybe someone like billionaire New York Mayor Michael Bloomberg. The window of opportunity could close quickly.

After unloading peripheral businesses like About.com, the Times has about $1 billion of cash. Debt and pension obligations also amount to around $1 billion, but the overall operations are profitable and should generate about $175 million of EBIT next year. Owners long starved of dividends, led by the Ochs-Sulzbergers, will want them restored.

The dozens of family members, who own about 15 percent of the $1.2 billion company but control it with super-voting shares, should consider going a step further. In five years, they’ve collectively lost on paper half their Times-based fortune. Those eager to remain custodians of the heirloom could see their numbers dwindle as relatives cash out.

Beyond some sense of responsibility to their ancestors, it’s hard to see why they wouldn’t all opt to sell. Despite a more stable balance sheet and nearly 600,000 digital subscribers, the outlook isn’t necessarily bright. The industry’s advertising revenue has tumbled by half in just seven years and is still shrinking. The digital side can’t help fast enough. The ratio of print losses to online ad gains clock in at a dismal 19-to-one.

Shutting down the Times’ costly print operations now would damage newsroom morale and the newspaper’s clout, but the step is inevitable. The right owner could see it through that difficult period, as well as preserve both the family’s and the newspaper’s legacy.

BREAKINGVIEWS
Bloomberg is one candidate, Warren Buffett is another. Waiting too long could eventually leave the company as a more distressed seller. Instead, by negotiating from a relative position of strength, the Ochs-Sulzbergers stand a better chance of securing not only their own fates, but that of the New York Times.

First published 18 December 2012

WEIBO SHOULD TAP THE FINANCIAL NETWORK

BY JOHN FOLEY

Weibo is changing Chinese society, but can it change investors’ minds? The rambunctious social media site, where over 400 million of the country’s web users post, follow, share and criticize, could be worth multiples of what the market currently suggests. A partial spin off in 2013 could be a good way to unlock Weibo’s charms.

Part social network and part blog, valuing Weibo requires some lateral thinking. The closest U.S. rival, Twitter, is still unlisted. And Weibo’s stature outweighs its finances. It has broken news of national disasters and outed corrupt officials, yet only started contributing revenue in the second quarter of 2012.

Say Weibo can produce $1 of income per registered user by 2015, giving total revenue of around $400 million – and that this year’s $160 million of costs grow 25 percent by then. On the 15 percent tax rate China offers high-tech firms, that leaves $170 million of earnings. Apply U.S. listed Facebook’s 2015 price-to-earnings multiple, and Weibo is worth $4.3 billion.

Two things suggest that’s achievable. While ad revenues in China are slowing, Weibo’s network of well heeled urban users is an asset advertisers should covet. Yet Sina has only just started asking companies to pay for accessing its “social graph”, plans to let advertisers appear in users’ news feeds have yet to launch.
Then there’s its political usefulness. Weibo has outlived several rivals by unapologetically censoring when told to. Meeting onerous government controls is now a sizeable barrier to entry for new rivals. Meanwhile, Weibo is becoming increasingly useful to the authorities as a way of letting the public blow the whistle over low-level corruption.

Investors haven’t yet twigged. Sina’s market capitalization is $3.3 billion, based on its share price on December 19. Strip out its main portal and wireless business, worth around $1.7 billion according to JPMorgan estimates, and around $900 million of cash and investments, and Weibo’s implied worth is just over $700 million.

Sina could do worse than spin off a minority stake through a separate listing if markets permit. True, Weibo’s owner is unlikely to want to let go altogether – and given the political significance, China’s authorities may not let it. But with such a big valuation gap, tapping the financial network seems a logical move.

First published 27 December 2012

CORPORATE CARBON BUBBLE MAY START TO DEFLATE

BY KEVIN ALLISON

Markets could start to wake up to a proper carbon bubble in 2013: the inflated value of hydrocarbon-heavy corporates.

Fossil fuel companies may already have found more coal, oil and gas than can safely be burnt without prompting damaging climate shocks. A 2011 report by Carbon Tracker, an environmental think-tank, found 745 gigatonnes of carbon embedded in the proved reserves of the world’s biggest listed coal and petroleum companies.
Sun seen rising behind chimneys of brown coal Hazelwood Power Station in Latrobe Valley, Victoria, Australia. REUTERS/Mick Tsikas
That was almost a third more than the 565 giga-tonnes that some of the best available science suggests can be burned before 2050 without running significant climate risks. Add in reserves held by unlisted companies and governments and the embedded carbon figure hits 2,800 giga-tonnes. And that’s just known, recoverable deposits. Prospectors make new finds all the time.

It presents a conundrum for investors, who tend to value energy companies based on the expected cash flows from their reserves. If the fossil fuel has to stay in the ground to save the planet, so does the cash.

So far there’s been little reason to worry about the disconnect. But three things may prompt a rethink.

First, it’s no longer just environmental campaigners sounding the alarm. In its November world outlook, the International Energy Agency threw its weight behind the carbon bubble math. That can only embolden activists pushing for more aggressive accounting for carbon risks in company reports.

Second, high food prices from the summer’s severe drought and the after-effects of Hurricane Sandy are likely to persist well into the New Year, offering a reminder about the kinds of disruption scientists expect to become more common on warming planet.

Finally political attitudes in the United States, a long time climate-change laggard, are shifting. Nearly two-thirds of U.S. voters in a November poll said the government should address the issue. Three years ago, only a small minority were concerned. It’s not inconceivable that President Barack Obama might embrace carbon pricing, as a tool to combat emissions, in his second term.

A final decision on TransCanada’s Keystone-XL pipeline, expected in early 2013, will test the new mood. If the Obama administration kills the controversial oil sands conduit, investors should start applying a steeper discount to expected cash flows from carbon-intensive fossil fuel deposits.

First published 12 December 2012
ANIMAL SPIRITS WILL STIR BUYOUT BARONS BEFORE CEOS

BY JEFFREY GOLDFARB

The megadeal is a rare bird these days. Chief executives and buyout barons alike have shied away from them since 2008. Corporate bosses keep getting rewarded for more modest acquisitions while the likes of Glencore and Hewlett-Packard serve up fresh reminders of the hazards of going big. Private equity firms, however, may need to be bolder in 2013.

A baboon yawns in his enclosure while sitting in the sun at the Hellabrunn zoo in Munich.
REUTERS/Michael Dolder
Despite their stockpiles of cash, companies have been reticent to splash out. From 2005 to 2008, there were 127 corporate acquisitions of at least $10 billion, according to Thomson Reuters data. In the four years since the crisis, the figure has tumbled to 74. The comparable decline for private equity – using $5 billion-plus deals instead to account for the relative scale – is even starker, with the four-year total falling from 62 to 11.

Bank deleveraging, investor skittishness, global unrest and political dysfunction all have played their parts. Fortune 500 CEOs and boards, in particular, also have found that curbing their enthusiasm for so-called transformational deals has its benefits. Shareholders have typically been more receptive to spin-offs than big efforts to bulk up. Perhaps with post-crisis caution in mind, they also have welcomed bread-and-butter-type M&A with simple strategic logic and obvious cost savings.

Those carrots are accompanied by countervailing sticks. Glencore got hammered by investors for months before it could close its $90 billion acquisition of Xstrata. AT&T squandered $4 billion in the form a break fee when it failed to persuade trustbusters to allow its $39 billion purchase of T-Mobile USA. HP’s aggressive push into software led it to buy Autonomy for $11 billion, most of which it recently wrote down to metaphorical market jeers.

Private equity bosses lost some swagger, too, after high-profile humiliations like the record $44 billion buyout of TXU in 2007. Yet their business model may impede continued discipline. The biggest funds are sitting on about $230 billion of investor commitments they haven’t yet deployed, according to research firm Preqin. That’s probably some $750 billion of purchasing power once leveraged, enough for many years of supercharged buyouts.

The life cycle of funds is such that firms may soon lose capital and the associated fees if they don’t use it. And interest rates on debt can only go up, something that could start happening by the end of 2013. Those should be the catalysts to make private equity’s animal spirits stir.

First published 18 December 2012
COMPANIES

BANKS WILL STOP GIVING STUFF AWAY THIS YEAR

BY PETER THAL LARSEN

Banks will stop giving stuff away in 2013. For years, financial institutions have underpriced everything from corporate loans to current accounts in an effort to suck in business. But tougher regulators and shrinking revenue streams make such cross-subsidies increasingly hard to justify. An overhaul of the industry’s approach to pricing is overdue.

Measuring profitability in banks is hard. Income comes not just from interest, but also from fees and hard-to-measure margins on derivatives and other products. Costs, meanwhile, depend as much on interest rates as on overheads. And future bad debts can make a business that seemed highly profitable look disastrous in hindsight.

During the boom, complexity and banks’ desire for expansion combined to encourage behaviour that now looks irrational. For example, banks underpriced loans to large corporations in an effort to win more business arranging corporate bond issues or managing currency risks. Meanwhile, banks in some countries effectively gave away core services – like checking accounts and use of cash machines – in order to attract customers who could then be persuaded to buy other products.

The crisis has challenged such thinking. Higher capital charges and elevated funding costs have increased the cost of lending to big companies, while the shrinking pool of investment banking fees means there is less revenue to go round.

To get back to pre-crisis levels of profitability on corporate loan books, banks must increase prices by 35 basis points of assets or cut costs by an equivalent amount, according to Oliver Wyman. Given that many large companies can now borrow cheaply in the bond market, higher prices look unlikely.

Retail bankers will have to make a similar calculation. Low interest rates have undermined the benefits of capturing customers’ deposits. Meanwhile, new regulations are eating into profitability: European rules could knock 4
percent off already-slim return on equity for banks in Germany, France, Italy and the United Kingdom, according to McKinsey. And the cost of compensating customers for mis-sold products like payment protection insurance will make consumers and regulators wary of new offers.

These pressures will force banks to become more efficient, and to shrink. But they will also put an end to the great bank giveaway.

First published 2 January 2013

WALL STREET SHOULD LEARN FROM DETROIT

BY ANTONY CURRIE

Wall Street could learn a thing or two from Detroit about getting the business back on the road. Both needed government aid in 2008. But it is the automakers that have restructured and become decently profitable in more straightened times. Motown’s chiefs can more easily justify big pay days too.

Uncle Sam attached more strings to bailing out General Motors and Chrysler than it did to Bank of America and Citigroup. The two Motown manufacturers had to slash dealerships and brands and cut factory worker pay to the same levels as foreign rivals. Ford took similar measures, too.

Banks also restructured by shedding assets and businesses, but not as much. And as the fifth anniversary of the bailouts approaches, most of the bulge bracket U.S. investment banks are only eking out single-digit returns on equity. That’s well below the rule-of-thumb cost of capital of 10 percent.

Detroit, meanwhile, is cranking out cash. General Motors’ pre-tax margin in North America is a healthy 8 percent or more while Ford routinely bests 10 percent – a level once reserved for the best luxury Carmakers.
So what can the Motor City teach Wall Street? First, that it pays to make swift strategic decisions on product lines. Only Swiss bank UBS has taken the real bold step of shutting down whole swathes of fixed-income trading. And that was hardly a decision taken quickly.

Second, banks have to learn that compensation needs to fit the environment. Investment bank bonuses are lower than pre-crisis on an absolute basis, but still hover around 40 percent of revenue. Reducing that would give an immediate boost to ROE. Goldman Sachs’s would jump from 8.8 percent to 12.3 percent for the first nine months of the year if pay fell by a quarter to one-third of revenue.

Putting shareholders first has its own rewards, too. Ford Chief Executive Alan Mulally and Executive Chairman Bill Ford took home $43.5 million between them last year, or 0.55 percent of net income. Applying the same metric would double pay to $24 million for Goldman’s Lloyd Blankfein. JPMorgan’s Jamie Dimon, meanwhile, would net around $100 million, almost five times his 2011 reward.

It’s unlikely a bank would ever be able to hand over that much again. But it illustrates that despite the challenges they still face, especially on Europe, Detroit’s Big Three have responded to the challenge much better than Wall Street.

First published 3 January 2013
Autocrats and strongmen have long held the whip hand in global energy. Now democracies are starting to outclass countries like Iran, Venezuela and Russia in oil and gas production. That should reduce the economic and political influence of authoritarian states. And the West's booming output ought to steady fuel prices, a rare boon for the global economy.

Until recently rich nations looked likely to become more reliant on repressive regimes for their energy needs. The democratically deficient Organization of the Petroleum Exporting Countries – whose members include Saudi Arabia and Kuwait – controls about 80 percent of the world's crude reserves. Add in Russia, which has been veering back towards one-party rule under President Vladimir Putin, and this share rises to 85 percent. With demand for hydrocarbons surging in China, this seemed like a recipe for higher prices and even greater clout for oil potentates.

But the balance of power is shifting in the direction of mature democracies. They are likely to enjoy the biggest increases in oil and gas output in 2013. Revolutionary drilling techniques have enabled the United States to boost oil output by a third since 2008. It is now on track to surpass both Saudi Arabia and Russia and become the world's top producer by 2017, according to the International Energy Agency. Canada is not far behind. Meanwhile Australia looks set to overtake Qatar as the leading global provider of liquefied natural gas by 2020. And within the Middle East the best hope for rising output is Iraq – though its status as a representative democracy is far from secure.

This trend should curtail the ability of energy bullies to throw their weight around. Russia, for example, which has often used its vast reserves to influence neighbors, was recently forced to cut prices for gas sold to Poland.
Authoritarian regimes like Iran will also have less potential to cause disruptive spasms in oil trading.

Objectionable governments will continue to loom large in energy markets. And even if the United States becomes self-sufficient, China won’t. Still, climbing hydrocarbon output around the globe is at least providing a welcome check on the power of energy strongmen.

*First published 24 December 2012*

**GROWTH OUTLOOK GIVES U.S. STOCKS EDGE OVER EUROPE**

BY ROBERT COLE

Earnings strength gives U.S. stocks the edge over European counterparts. On common valuation measures, euro shares look attractive – at least compared to the other big, mature market across the Atlantic. But that ignores superior growth potential in the United States. A new Breakingviews calculator shows why better value lies to the west.

Emerging markets could provide the juiciest long-term equity returns. But risk-averse investors need the developed markets of Europe and America. Europe’s Stoxx 600 Index is offering a dividend yield of 3.6 percent, noticeably richer than the 2.2 percent that investors can expect to earn from holding shares in the S&P 500 Index stateside.

A comparison of price-to-earnings ratios for the two markets paints a similar picture. Investors can buy European blue-chips for just over 10 times estimated earnings, while U.S. stocks trade at just over 12 times forward earnings – a 20 percent valuation premium.

Other things being equal, Europe looks like the better deal of the two big, developed regional markets. But their different outlooks for earnings change the balance. When it comes to profit growth, the United States has a better track record and – with Europe’s rumbling debt troubles far from over – better prospects, according to numbers crunched by Thomson.
What price earnings?
How much would $1,000 be worth given these variable assumptions?

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<tr>
<th>World</th>
<th>Total real return</th>
<th>Annualised real return</th>
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<td>Assumed annual growth in earnings</td>
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<td>Investment period (yrs)</td>
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<td>Exit p/e ratio</td>
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Note: Real returns assume 2.6% dividend income per year and annual inflation of 2.5%
Source: Reuters Breakingviews. V Flasseur, R Cole, 19/12/2012

Reuters Starmine and Datastream. It is also the norm for European shares to trade on slightly lower multiples than their U.S. counterparts, so that’s not the value advantage it might seem.

The Breakingviews calculator combines the valuation and earnings outlook of different markets and a selection of individual stocks to generate estimates of long-term returns. Feed in consensus figures and, over a 10-year horizon, U.S. stocks pip Europe’s with an annualized return north of 12 percent.

Returns on stocks in emerging markets could top 15 percent, and some individual companies – Apple or Samsung, say – might do better still. And with valuation metrics at historically modest levels, shares on both sides of the Atlantic and indeed all over the world look a solid long-term bet. But with earnings growth a key differentiator, equity investors choosing between Europe and the United States may well prefer to shop in New York rather than Frankfurt, Paris or London.

First published 19 December 2012
INDIA BRACES FOR LAST YEAR OF POLITICAL STABILITY

BY ANDY MUKHERJEE

After the 2014 general elections, neither of the two mainstream national parties will have the numbers to form a government, paving the way for a wholly opportunistic “third front” to take over and pursue populist policies that will wreck an already fragile exchequer. And since containing the budget deficit holds the key to reviving investments in India, the business cycle recovery that will start in 2013 won’t endure.

This is not a risk investors have faced in the last 13 years. Since 1999, one of the two main national parties – the centre-right Bharatiya Janata Party or the centre-left Congress – has been at the helm in New Delhi. The policies and performance of BJP- and Congress-led coalition governments may have been less than stellar, but the politics has been stable: All governments since 1999 have completed their full terms. Manmohan Singh, the current prime minister, is already the third-longest-serving Indian leader after Jawaharlal Nehru and Indira Gandhi. But this era of stability will now end.

The rise of smaller parties in national politics is a two-decade-old trend, as the slide in the combined number of parliamentary seats won by the Congress and the BJP demonstrates. The 2009 polls were an exception. In the next elections, fragmentation will resume as the Congress loses seats, and the BJP fails to capture them.

The Congress is beset by a string of corruption scandals. On its watch, GDP growth has slowed and inflation has been high. Rahul Gandhi, the party's likely prime ministerial candidate, has no track record in government. Meanwhile, the BJP is facing its own midlife crisis. The party’s president is being investigated for shady business dealings, senior leaders are fighting openly, and there is no agreement on who should be prime minister. The strongest candidate the BJP has for the job is Narendra Modi. The business-friendly chief minister of the western state of Gujarat is an effective administrator. But his alleged involvement in anti-Muslim pogroms 10 years ago makes him controversial and divisive. Besides, Modi’s authoritarian streak may render him unacceptable to the BJP’s existing allies.
The disarray in the two national parties presents an opportunity for a motley crew of regional parties. At some time before or after the polls, they will probably forge an alliance of convenience with the communists, who are willing to back a non-Congress, non-BJP formation, provided the parties can agree on a left-wing agenda. Then there is the more vexing question of leadership. There are several contenders, but the third front will most likely be led by Mulayam Singh Yadav, whose son rules as chief minister of Uttar Pradesh, India’s most populous state.

Yadav currently plays a key role in keeping the Congress-led minority government in power in New Delhi. Political analysts are assuming that he will be a kingmaker if the next election returns a hung parliament, as all national polls since 1991 have. But if both the Congress and the BJP flounder, Yadav may as well be king himself. In that event, the Congress will have no choice except to tolerate a third-front government in order to block the BJP from returning to power. That is what happened in 1996. A fractured mandate led to two unremarkable non-Congress, non-BJP governments, which together lasted for 22 months.

There is little incentive for such unsteady governments to push for economic reforms. Regional politicians who have made their careers promising free power to farmers and subsidized rice to the poor will have no commitment to reducing subsidies. Once they are in charge, they may even use a new system of direct cash transfers to recklessly expand the welfare state.

Economists are predicting that 2013 will see a revival in India’s GDP growth, which slumped to a three-year low of 5.3 percent in the third quarter of this year. Investors are optimistic about policy changes, especially a long-pending overhaul of direct and indirect taxes. But the window for economic reforms is closing fast. By the end of 2013, the risk of unstable politics will come to the fore.

First published 2 January 2013
An advertising boom could play out on every smartphone screen in 2013. Internet firms moaned for years that users spent lots of time surfing the Web on their desktops, but marketing dollars weren’t following from print and TV. Time and the growth of broadband have mostly closed the gap. The surge in smartphone and tablet use is now providing similar fuel for mobile advertising.

There’s no iron rule, but what advertisers spend and how people consume media seem related over the longer run. Five years ago, 29 percent of users’ media time involved the Internet but their screens attracted only 8 percent of ad spending, according to Forrester Research. Now, 26 percent of time is devoted to internet browsing, and that brings a much closer 22 percent of ad dollars, as Mary Meeker of Kleiner Perkins noted recently. U.S. internet ad spending has ballooned to $30 billion, the Interactive Advertising Bureau reckons, up 76 percent since 2006.

Web advertising really took off after 2007, when for the first time half of U.S. homes had broadband access, according to the Department of Commerce. Ads loaded faster, companies became more comfortable promoting themselves on the Web, and the development of better analytics meant improved customer targeting.

A new mismatch has emerged. Some 10 percent of media time was spent on mobile devices in 2011, yet they only attracted 1 percent of ad spending. Closing that gap would result in nearly $15 billion in mobile ad revenue in the United States alone. That’s a conservative estimate, as mobile gadgets continue to proliferate and draw more of users’ attention.

This gap, too, should close. Half of U.S. cellphone customers now have smartphones, and the number is growing rapidly. That means faster downloads and larger screens to view promotions — echoes of the shifts in desktop Web use five years ago. Analytics have improved for mobile ads, too.
Facebook only started gunning for smartphone and tablet ads earlier in 2012. By the end of the third quarter that business was running at $1 billion a year, with sales still increasing. Google expects to reap $8 billion this year worldwide from mobile ads, three times as much as last year. Smaller concerns like Pandora and Yelp are reporting similar trends. Expect much more of the same, coming to a smallish screen near you.

First published 18 December 2012

GRAINS ARE THE COMMODITIES TO WATCH

BY KEVIN ALLISON

Iffy Chinese demand makes it hard to gauge the outlook for bulk metals such as copper and iron ore. But grains look different. Global stocks of agricultural commodities are low and the drought that hit harvests in the fall of 2012 has continued, jeopardizing the new wheat crop. With low rainfall also hitting river-borne U.S. trade routes, grain prices may well stay elevated.

Prices of corn and soybeans have retreated somewhat from the record highs they reached when the severity of last summer’s dry spell became clear. But the lull may be deceptive. Several factors point to high prices.

Dry weather has persisted, with some 63 percent of the continental United States facing at least “moderate drought conditions” in early December, according to the U.S. Drought Monitor.

Snarled logistics could exacerbate cost pressures. Water levels on the Mississippi River, a critical grain transit corridor, are near record lows, causing headaches for barge operators. Supply risks also extend beyond the United States. Unsettled weather has delayed recent plantings in Argentina, another big grain exporter.

Stockpiles offer scant comfort. The U.S. agriculture department recently estimated U.S. corn reserves at 647 million bushels for 2012-13, the lowest level in 17 years and a thin-looking 5.8 percent of total demand. Soybean
inventories are headed for a nine-year low. On exception is wheat, where
the U.S.D.A. recently bumped up its stockpile forecast. But the U.N. Food
and Agriculture Organization expects tighter stocks for a variety of
important foodstuffs next year.

That should support prices even before taking ultra-low interest rates and
central bank money printing — which can boost demand for inflation
hedges like agricultural commodities — into account. Demand for corn in
U.S. ethanol production is another potent factor.

It all fits a broader theme: since the financial crisis, unusually low stockpiles
have left agricultural markets on a razor’s edge. Prices may only fall
significantly in 2013 if near-ideal weather delivers the bumper harvests
needed to supply the world’s growing hunger for grains.

First published 18 December 2012
BANKING UNION WILL REVIVE PAN-EU BANK M&A

BY GEORGE HAY

Europe’s banking union could reignite cross-border bank mergers. Spooked by financial and euro zone crises, national regulators have pressed their charges to retrench to domestic markets. But the arrival of a single supervisor and central bailout fund could revive the M&A frenzy seen earlier in the decade.

From 2000 to 2007, Europe’s big banks pulled off deal after deal across the single currency area. UniCredit bought German bank HVB, BNP Paribas splashed out on Italian lender BNL, and Credit Agricole acquired Greece’s Emporiki. The logic was that, as the single market evolved, economies of scale would give bigger players a crucial advantage.

Right now, that logic looks pretty flawed. The financial crisis showed that national taxpayers were on the hook for their banks’ expansionist ambitions. And fears of a euro zone break-up have prompted regulators to fortify their domestic banking systems. Most big European lenders have shrunk their foreign loan books, while Germany’s BaFin has made UniCredit hold high levels of capital in its HVB subsidiary, reducing the capital flexibility that should be one of the benefits of scale.

Banking union could reverse this fragmentation. The creation of a permanent bailout fund, as well as common resolution and deposit guarantee schemes, should break the link between banks and their home countries. That will reassure banks with operations in multiple countries, and encourage lenders mulling cross-border expansion.

The M&A revival could take different forms. Non-European investors could swoop while valuations are still cheap. Alternatively, national regulators wanting to maintain domestic influence could push for defensive mergers. The shotgun marriage between National Bank of Greece and rival Eurobank may be a precursor of similar deals elsewhere.

Regulators and investors will remain wary. The 2007 carve-up of Dutch lender ABN AMRO - by far Europe’s biggest bank deal to date - is a salient reminder of how badly M&A can go wrong. Political squabbling over
banking union, and the euro zone’s ongoing travails, may also mean this trend takes time to develop. But as long as genuine banking union is on the cards, bank boards will be dusting down their merger plans in 2013.

First published 7 December 2012

WASHINGTON MAY FINALLY TAKE UP MORTGAGE REFORM

BY DANIEL INDIVIGLIO

America’s lawmakers may finally be set to take reform of housing finance seriously. Assuming Congress settles the deficit debate, sorting out the government’s role in funding home loans should be its next stop. And a number of obstacles are dissolving.

U.S. taxpayers are on the hook for at least 90 percent of the nation’s mortgages through Fannie Mae, Freddie Mac and the Federal Housing Authority – a dramatic increase since 2007. But Frannie’s guarantee fees are now so low that private lenders cannot compete to wrest back market share.

Increasing the fee is the simplest policy fix. But that doesn’t wholly address the future role for Fannie and Freddie, which between them needed $188 billion of taxpayer aid to stay afloat. The general consensus is that they should be wound down – even some Democrats and the Treasury are on board.

But there’s no plan of action because the environment seemed too tricky. That’s now changing. The housing market is recovering. Home prices and existing home sales have risen steadily this year while inventory fell to a 10-year low.

Some regulatory certainty is coming as well. The Consumer Financial Protection Agency should finalize what constitutes a qualified mortgage in January. This will exempt lenders from certain lawsuits. That will then enable the Federal Reserve and five other watchdogs to define the meaning of a "qualified residential mortgage" that will set standards – such as how much equity a borrower has in a property – for prime loans that lenders won’t need to retain a chunk of. New documentation standards will also improve transparency.
PREDICTIONS 2013

So banks and investors should feel comfortable taking on more mortgage risk. Meanwhile, Congress now has an advocate who wants mortgage reform front and center: incoming House Financial Services Chairman Jeb Hensarling.

Some hurdles remain. Industry lobbyists will make a stink about reform. Lawmakers can still make dumb decisions. And any new financing framework is likely to be implemented over several years to avoid a crash. But if lawmakers don’t realize that 2013 is a prime time to take up housing reform, it’s hard to imagine when they ever will.

First published 21 December 2012

WHOLE OF SUB-SAHARAN AFRICA IS THE REAL QUASI-BRIC

BY MARTIN HUTCHINSON

The whole of sub-Saharan Africa is the real quasi-BRIC. South Africa alone can’t match the others in the emerging club. But add non-Arab continental neighbors, and the combined GDP is $1.3 trillion by the World Bank’s tally, and growing fast. Single countries are too small for most investors. But if the region can combine markets and trade, it could take off.

That kind of output brings Sub-Saharan Africa within striking distance of Brazil, Russia, India and China. Russia and India, for instance, each have GDP of some $1.8 trillion, according to the International Monetary Fund. With expected growth of around 5 percent in 2012 and 5.7 percent in 2013, the region would attract investor interest – that beats, for example, the anemic expansion expected in Brazil. Inflation, meanwhile, is running below 10 percent in Sub-Saharan Africa and even the collective current account deficit, some 3 percent of GDP, is only a mild worry.

That’s all the more impressive considering that Africa has at least its share of basket-cases. The Democratic Republic of Congo is riven by civil war, Zimbabwe is recovering from hyperinflation, Somalia is close to a failed

BREAKINGVIEWS
OPPORTUNITIES

state and South Sudan is struggling with birth pangs following Sudan’s split. Even the continent’s richest large country, South Africa, is facing labor unrest and expected 2012 growth of only 2.6 percent.

Yet the 50-plus countries in Sub-Saharan Africa are hopelessly fragmented and private foreign investment is meager at only 1.8 percent of GDP in 2012, according to the IMF. Official capital inflows are about the same size. For that to change, concerted action is needed.

Political union seems a distant prospect. As Europe’s difficulties have shown, a single sub-Saharan currency is also an unlikely idea for such disparate economies. A central stock exchange, however, is a possibility, perhaps located in a small, wealthy and stable country such as Botswana, Gabon or Ghana. Such a center could provide an entrepot for Africa similar
to the function performed for Asia by Singapore and Hong Kong. In addition, free-trade agreements could lower the generally high intra-African tariffs, thereby increasing the markets available to producers in the region and allowing them to achieve economic scale.

Africa is emerging, fitfully. Its mutually suspicious governments aren’t likely to find much common ground. But if only they could, they might have a serious rival to the BRICs on their hands.

*First published 14 December 2012*

**MEXICO MAY TEACH U.S. A LESSON ON GOOD GOVERNMENT**

**BY RAUL GALLEGOS**

Mexico may teach the United States a lesson on good government in 2013. Latin America’s second-largest economy needs to enact key fiscal and energy sector reform. That might sound hard since its political parties have little history of working together. But they look set to reach a compromise with far less rancor than their counterparts north of the border.

In some respects Mexican politics ought to be more polarized than America’s. After all, Uncle Sam’s representatives of the people are used to power switching between the two parties. But in Mexico the Institutional Revolutionary Party (PRI) ran the government for 71 years until 2000. With Enrique Peña Nieto as president, it has just returned to office after 12 years in opposition.

Rather than go back to the old ways, though, Peña Nieto is already building bridges with opposing parties. Of course, the PRI holds less than half of the seats in either chamber of Mexico’s bicameral Congress, so he lacks absolute control. But the three big political parties agree on the major reforms needed to help Mexico’s long-term growth: while it was a decent 3.4 percent in 2012, it is slipping. They signed a reform pact the day after the president’s December inauguration. In fact, the outgoing National Action Party (PAN) passed some labor reforms with the PRI’s help even before Peña Nieto took office.
That doesn’t mean politics has been suspended. They may agree on the need to increase Mexico’s oil output beyond 2.6 million barrels a day and to strengthen state oil company Pemex, for example. But changing the constitution to open the door to private capital may be harder to do. Peña Nieto’s party is cozy with labor unions while the ousted PAN is wrought by internal divisions. These may cause ructions that could delay progress.

But Mexico’s administration is off to a good start. Peña Nieto’s willingness to compromise demonstrates that democracy is taking a stronger hold in the country and should help boost economic growth. America’s lawmakers could do far worse than emulating Mexico’s newfound political pragmatism.

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**SHAREHOLDER VOTES WILL BE A FEAST FOR LEGAL EAGLES**

**BY REYNOLDS HOLDING**

Shareholder votes could offer up a feast for legal eagles in 2013. Restrained from suing over securities fraud, lawyers are starting to prey on dodgy disclosure in corporate elections. Say-on-pay votes are popular, but anything needing investor approval is fair game. Starved of other business, attorneys’ hunger for these suits can only grow.

The plaintiffs’ bar’s resilience should surprise no one. Its bread and butter was federal class-actions blaming stock losses on fraud until Congress began limiting the suits in 1995. Challenges to M&A deals that allegedly cheat investors then became the flavor of the day, though companies’ rising determination to fight – and win – the cases may bode ill for their survival.

The latest litigation recipe derives from a requirement in the Dodd-Frank Act that shareholders vote on executive pay. Lawsuits against companies that failed to get enough investor support generally went nowhere, because the results weren’t binding. So investors are suing over pre-vote disclosure that omits supposedly crucial information like the data reviewed in calculating compensation.
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The suits, which seek a court order to delay balloting, are pouring in. Microsoft, Clorox and some 18 other listed companies have been hit in the past year, according to Reuters. At least six companies settled, agreeing to provide beefed-up disclosure and shelling out legal fees of up to $625,000. One lawsuit persuaded a judge to block temporarily a shareholder vote. It was eventually settled, too.

The tide may be turning, though. Five courts have ruled against shareholders and other suits have been dropped, according to law firm Pillsbury Winthrop. But the tactic might have a future in other contexts.

A scheduled board election, for instance, could draw a lawsuit claiming a proxy statement excluded important information about proposed directors. A planned change in auditors could also attract a challenge if shareholders weren't told about, say, the new auditor’s past run-ins with regulators.

The defense bar, however, is already cooking up its own creative arguments. One asserts that shareholders shouldn't win a say-on-pay case because Dodd-Frank doesn't give them the right to sue. No court has bought the argument yet, but the lawyers can afford to be patient. Litigation, after all, can be good business for both sides.

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LATAM CAN RELY ON MASSES FOR NEXT PHASE OF GROWTH

BY RAUL GALLEGOS

Latin America can count on the masses for the next phase of growth. Though epitomized by a handful of people like the world’s richest man, Carlos Slim, and showy political leaders spearheading the region’s commodity-led export economies, a burgeoning middle class will make its mark in 2013 powering Latin America’s future.

Consumers are wielding newfound clout from Mexico City to Tierra del Fuego. The World Bank reckons some 50 million people have been lifted
out of poverty in the region over the last decade, swelling the middle class ranks. That, in turn, has created millions of new borrowers. Unemployment is very low in some places while wages are rising in others.

Take Brazil's $2.5 trillion economy. Despite modest GDP growth, consumers have been resilient. Sales at shopping centers may top $58 billion in 2012, the seventh consecutive annual increase, according to trade group Abrasce. A record 48 malls are expected to open in 2013. A $12 billion e-commerce business lured Amazon and Google.

Meanwhile, Mexicans are emulating their northern neighbors. The region's second largest economy, at $1.2 trillion, is now the world's biggest soft-drink consumer. Wal-Mart is growing twice as fast there as in the United States. The country’s new “Buen Fin” shopping campaign, modeled after America's Black Friday, saw November sales jump 30 percent from a year ago.

That lays the groundwork for a surge. As Chile keeps inflation at bay and Colombia pursues potentially landmark peace talks with rebels, Brazil, in particular, should lead the way. It’s gearing up to host soccer’s World Cup in 2014 and the summer Olympics in 2016. The associated infrastructure spending will create jobs and enhance spending power. Combined with benchmark interest rates that recently hit an all-time low of 7.25 percent, the pieces are in place for a consumer-led boom.

The fiesta will need to be monitored. Left unchecked, households could borrow too much. Inflation is always a bubbling worry in Latin America. And the region isn’t immune from slower growth in other parts of the world. But the underlying trends suggest a coming spark for foreign investment and local markets.

First published 31 December 2012
ANXIETIES

EUROPE’S TWO BIG CHALLENGES: ECONOMY AND UNITY

BY PIERRE BRIANÇON

The euro crisis will morph into a European crisis in 2013. The survival of the common currency is not in question any longer, but European economies, after two years of crippling and contra-cyclical austerity, are stuck on flat. Furthermore, the question is not so much whether any country will exit the euro but whether the further integration of the zone will lead to the exit or de facto ouster of a non-euro member from the European Union. In 2013, Europe will be weakened by its economy and threatened in its unity.

The Academy of Arts in Berlin. REUTERS/Thomas Peter

BREAKING VIEWS
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Even if euro zone leaders decide that the folly must stop, they will pay the price of two years of cult-like devotion to austerity: in the arsenal of measures deployed to save the euro, it’s the one thing that has failed to work. European governments have created two bailout funds, rescued three euro members and recapitalised the banks of a fourth. They have restructured Greek debt twice. The ECB has poured cheap funds on the banking system, and it has promised to do “whatever it takes” to keep the common currency together.

Yet governments have undermined these efforts by obsessing about fiscal discipline – and it shows. After declining 0.4 percent in 2012, the euro zone’s economy as a whole will stagnate next year. Official forecasts vary – but few lie outside the spectrum that stretches from mild shrinkage to paltry growth.

In a rosy scenario, where reason would prevail, euro zone leaders in 2013 would stop reacting and start acting. They would design joint policies aimed at stimulating growth and reducing unemployment from levels that have become unbearable. It will simply not do to wait for the future benefits of the structural reforms most of them have begun to implement.

Meanwhile, powerful centrifugal forces are pulling non-euro members away from the European Union. Some of them, such as the UK, never saw it as any more than a one-dimensional “single market” in the first place. But if it ever comes to a choice between a smaller EU and a stronger monetary union, it’s easy to see what euro zone governments will choose. 2013 could be the year when that choice becomes clearer.

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CALAMITY LIKELY TO BE POSTPONED AGAIN

BY EDWARD HADAS

The gloom-and-doom brigade has had a second-class crisis. For four years, prognosticators of calamity have eagerly awaited the end. They expected the financial mess and draining recession to become a disaster which would
shake the modern global economy to its foundations. It hasn’t turned out that way.

Early in 2009, it looked like the nightmare scenario might come true, at least in part. With investment markets in meltdown, international trade in fast retreat, and politicians stumbling, something truly awful looked plausible. We might have been in for massive inflation, debilitating deflation, a new great depression, even war. But governments and central banks regrouped. They remembered that money could be conjured from thin air and given away in unlimited quantities. The fiscal and monetary machines are still on overdrive. Disasters have been avoided.

The doomsday crowd does have some things going for it. There’s a steady stream of drab news from rich countries, which still account for a little more than half of global GDP, according to IMF data. GDP growth has slowed elsewhere and unemployment remains uncomfortably high in most countries.
The problems of the developed world have impeded growth in many developing economies and may continue to do so. But pessimists are generally on the defensive. Most notably, despite many dire predictions, China refuses to collapse.

Calamity is unlikely in 2013. If anything, the miasma could lift a little. The growth rate is again increasing in China and the drag from the U.S. fiscal cliff shenanigans is unlikely to last long. Euro-sceptics may shake their fists, but the euro zone seems to have found the desire to resolve its long-running crisis. Even Japan may become more aggressive in the fight against deflation.
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It would be a mistake to get carried away, as the optimists did in the heat of the crisis. In 2009 many so-called experts predicted a rapid snap-back. The distortions of the credit boom years have proven hard to repair. Debt and doubt have slowed restructuring.

Perhaps 2013 will turn out to be the breakthrough year hoped for by optimists. But that looks less likely than the disaster forecast by gloomsters. Expect low-to-no growth in most leading economies.

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SHADOW BANKS LEAD CHINA TOWARDS A DARK PLACE

BY JOHN FOLEY

China avoided an economic hard landing in 2012 by shovelling credit into the economy. In doing so, it may have laid the groundwork for a financial crisis. An unfolding mess involving risky, short-term investment products threatens to strain China’s credit-driven model.

Growth of above 7.5 percent in 2012 hasn’t come cheap. For the year to November, China was producing just $1 of new nominal GDP for each $2.80 of new so-called “social financing” - mainly loans. Corporate borrowing may reach 128 percent of GDP by the end of the year, according to Standard Chartered, compared with around 100 percent at the beginning of 2009.

The secret sauce is no longer just bank lending, but an explosion in off-balance sheet credit. One avenue is wealth management products: short-term investments offering attractive returns above the mandated one-year interest rate of 3 percent on deposits.

Some 12 trillion yuan of wealth management products are outstanding, according to Fitch. Around a fifth of this sum is explicitly channelled into loans or bonds. But with only partial disclosure, some analysts suggest the real sum could be as much as half.

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Investors in wealth products can find themselves exposed if loans don’t repay. Hua Xia bank in Shanghai gave a preview of what can happen in early December. Customers took to the streets after a particularly risky product, which had ultimately funded the operations of a pawn shop and car dealership in Henan province, was reported to have failed to pay back.

Wealth management products depend on confidence. Because investments are short-term but the loans they provide may not be, many products depend on existing customers rolling over their investments - or new ones signing up.

Were a wealth management product to fail outright, three things could happen. The benign case is that buyers, who include retail investors and companies, would demand higher yields, pushing borderline borrowers that depend on financing from wealth management products into distress.
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A more worrying outcome would be if depositors are turned off wealth management products in a big way. Issuers would then be forced to quickly call in loans or dump assets on the market in order to repay investors. That might trigger a credit crunch which would feed through into the rest of the banking system, and further knock confidence.

Alternatively, authorities might force banks to pay back investors out of their own funds – even though in most cases they’re technically not obliged to do so. Doing so would calm investors, but strain the banking system. Hua Xia, which blamed a rogue employee for its failed product, will be a test of policy.

The authorities are clearly concerned: China’s bank regulator has established a committee to monitor the situation. But wealth products are really a manifestation of deeper financial repression. With returns on their deposits of only 3 percent a year, inflation of 2 percent and an economy growing at 8 percent, depositors are desperate for higher-yielding investments.

Finally, there’s a pricing problem: buyers don’t believe products will default, because they never do. It’s not just wealth products - China hasn’t had a domestic bond default in fifteen years. That skews risk premiums. Sometimes the effect is absurd: for a while, yields on experimental bonds issued by Shanghai and Guangdong governments at the end of 2011 were lower than Chinese treasury bonds.

Taming wealth management products probably means creating new problems. Raising deposit rates would encourage depositors to leave their money in the bank, but also choke off borrowers who depended on off-balance sheet channels for credit. Overstretched banks can’t take up the slack - lenders actually cut their medium and long term loans to companies by 3.1 billion yuan in November.

As for those products already outstanding, the logical thing would be to move credit-backed products explicitly onto banks’ balance sheets, where at least they can be made visible. Banks would need extra capital - some smaller lenders might need to be taken over by bigger rivals. In an extreme case, it’s not unthinkable that the government would simply buy the assets and liabilities of products outright and create a “bad bank”. It wouldn’t be the first
time - that's how the central bank sucked out bad loans from the banking system a decade ago.

China’s economy will eventually have to become less reliant on credit and pay depositors properly - or face a crisis. Wealth management products alone may not be enough to push China’s economy off course, but in tackling them the authorities have a chance to head off the kind of catastrophe that does.

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U.S. DOLLAR MAY SMILE AT END OF 2013 UGLY CONTEST

BY IAN CAMPBELL

The world’s leading currencies are in an ugly contest. Central banks are bent on debasing them with active printing presses and ultra low rates. Small wonder gold is over the moon and the Australian dollar, paying a mighty 3 percent interest rate, is considered a beauty. The yen is determined to come last. The euro’s nerves have improved but it is still fragile. The dollar and the pound are most likely to show strength, especially later in 2013.

While other majors have suffered in the last five years the yen, despite some recent slippage, has been running at its highest against the dollar since the mid-1990s. But the backdrop is shifting. Exports are struggling, the current account surplus is dwindling and Shinzo Abe, elected prime minister on December 16, wants more money printing and a weaker currency.

The European Central Bank may seem a comparative model of prudence. But its bond buying and liquidity provision means its balance sheet, just like the Fed’s, has roughly trebled since 2007. The euro contestant’s nerves have improved markedly since Mario Draghi, the ECB president, made his summer “whatever it takes” promise. The euro has risen from $1.21 to over $1.30 in the second half of 2012. It might go higher still early in 2013, to say $1.35, if markets remain optimistic on Europe. But as recession bites it in the periphery the euro’s ability to avoid nervous breakdown will remain in serious doubt.
The pound is hardly sound. Yet the UK is expected by the IMF to grow faster than Germany in 2013. If recovery proceeds, London’s printing presses may stay quiet. The pound’s chances of rising to 75 pence per euro from the current 81 pence are good.

But all major currency movements depend ultimately on the U.S. dollar. Here, massive monetary debasement contrasts with slow fundamental economic improvement. House prices are rising, unemployment is falling, and U.S. growth in 2013 is predicted at 2.1 percent by the IMF—ten times better than the 0.2 percent forecast for the euro zone.

It is faster growth that gives the dollar upside attractions against the euro. But failure to skirt the fiscal cliff would be a definite negative. The Fed’s response would be to print still more money. Now that would be ugly.

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Currency performance in 2012
% change in dollar spot rate since end of 2011

Source: Thomson Reuters Datastream. Reuters graphic/Scott Barber 14/12/2012
PENGUIN IN BONDAGE HIDES REAL RISKS IN MEDIA M&A

BY QUENTIN WEBB

Three deals from 2012 will reshape the book, music and film industries in 2013: Penguin’s merger with Random House, Universal’s $1.9 billion purchase of EMI’s recorded music business, and Walt Disney’s $4.1 billion takeover of Lucasfilm. There are sound business reasons for all three. There are also reasons for artists and consumers to fret.

Both Penguin-Random House and Universal-EMI are in industries being upended by the digital revolution. The record labels have had it much worse so far. But both should enjoy economies of scale and improved bargaining power with suppliers and retailers, including digital’s big beasts, Amazon and Apple.

So far so good. Artists can’t thrive in a dying industry. But there are risks too. OK, so Random House’s credentials are solid enough and Universal should fit with EMI far better than previous owners Citigroup or Guy Hands. But clashing cultures can undermine a deal. That danger, omnipresent in M&A, looms particularly large in creative industries. Cartoons that depict a kinky “50 Shades of Grey” Penguin reflect this.

Secondly, creative types may lose influence and cachet. Regaining power through scale cuts both ways – with both retailers and suppliers, which includes artists. Concentration may curtail bidding wars for talent. And the cultural landscape could suffer. True, electronic self-publishing offers authors and bands an unprecedented, direct route to audiences. But the mainstream matters. With less competition, big houses have less incentive to take risks by signing mavericks.

At worst, freedom of expression could be tested. Rupert Murdoch famously stopped HarperCollins printing a memoir China disliked. A smaller circle of book giants, several inside wider business empires, might hesitate to speak truth to power. (A big news-media deal, like the sale of the Financial Times, could face tough scrutiny for similar reasons).
The third tie-up, Disney’s purchase of George Lucas’s studio, has also inspired caricaturists: Mickey Mouse as Darth Vader, for instance. Disney can use the Star Wars characters to power a string of blockbusters and adorn everything from bedspreads to fizzy drinks. However, this does tip Hollywood
even further towards heavily merchandised, teen-targeted film “franchises”. Real cinephiles might prefer to see the sun set on this kind of empire.

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CENTRAL BANKERS MAY EMBRACE OLD ENEMY: INFLATION

BY AGNES T. CRANE

The Bank of Japan has been trying to juice its economy for more than a decade. The U.S. Federal Reserve, the European Central Bank and Bank of England have been at it for more than four years. The efforts – near-zero policy interest rates and bond-buying with newly created money – have not produced much. In 2013, the siren call of inflation will become more alluring.

For today’s central bankers, inflation used to be enemy number one. Most of them came of age during last century’s clashes with consumer prices. In Japan and Germany, the collective memory of hyperinflation still haunts interest-rate gate keepers. It is hard to abandon the battle, even if it been won definitively and is no longer relevant.

Ben Bernanke and Mario Draghi work with targets that look right – for a pre-recession world. The Fed and the EBC aim at just 2 percent in any year – a rate established through faith more than science in the 1990s. The Bank of Japan has painted its bull’s eye at just 1 percent.

Times have changed. After the credit bubble, the world is left with a mountain of debt and no easy way to erode it. A higher rate of inflation would not make the mountain shrink, but it would make it less dangerous, since there would be more GDP available for debt service.

Many economists have been dropping hints that a new, higher inflation target rate would not be a bad idea. The thought, common in the 1970s, that a 5 percent rate was acceptable, is still too radical, but Olivier Blanchard of the International Monetary Fund did suggest 4 percent in a 2010 paper. And the Fed changed its policy in December to say it would be
comfortable with 2.5 percent inflation when the unemployment rate is high. It may take some work to make investors comfortable with higher targets, and a different sort of work actually to push up prices. And the traditional objection to inflation – that it unjustly punishes the prudent and the weak while rewarding the reckless – still holds. But there may be no better alternative.

First published 13 December 2012

CENTRAL BANK INDEPENDENCE IS AT RISK

BY RICHARD BEALES

The Federal Reserve will celebrate its centennial in 2013. Though independence for the U.S. lender of last resort and its peers elsewhere has historically come and gone, in recent decades it has become an article of faith. But these days, faith in central banking is far from rock solid.

Independence for the management of monetary affairs is supposed to allow prudent policymaking that is insulated from short-term political pressures. That should provide, for instance, the freedom to quash voter-pleasing bubbles. The problem is that Western central banks are looking more like volatile players than stable referees. To start, the sheer size of their balance sheets has expanded dramatically. Since 2007, the eve of the financial crisis, British and Swiss central bank assets have surged roughly five-fold, while the U.S. and European equivalent holdings have both approximately tripled. In the UK and the euro zone, central bank balance sheets have already swollen to around 30 percent of GDP.

And central banks are taking the sort of risks that normally merit political scrutiny. Ben Bernanke, the Fed chairman, portrays unprecedented post-crisis activities like quantitative easing – large-scale bond-buying programs undertaken by the Fed, the Bank of England, the European Central Bank and others – as technical variations of traditional monetary policy. But critics see QE as straying into the government’s fiscal realm, distorting financial markets, fueling future inflation, or all of the above.

BREAKING VIEWS
Central banks also have responsibilities which are undeniably political. The Fed is America’s most powerful bank regulator, the lender of last resort and, especially now, a major influence on interest rates and financial asset prices. The Bank of England, which gained monetary policy independence only in 1997, is about to take on a bigger watchdog role. Even in Japan, where the central bank has maintained a near-zero interest rate policy for well over a decade and is supposed to operate in harmony with government policy, newly elected Prime Minister Shinzo Abe wants more influence.

Up to now, central banks have been able to defend their autonomy, which anyway isn’t complete. But anti-Fed political rhetoric and demands for greater accountability resonate with some American voters and many economists struggle to defend institutions which failed to predict or prevent the worst financial crisis in decades. Another big error or an unpopular move – perhaps a return to more typical interest rates – could mean the beginning of the Fed’s second century is marked by an assault on central bank independence.

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NEW U.S. STRESS TEST NEEDED: HIGHER INTEREST RATES

BY AGNES T. CRANE AND RICHARD BEALES

“Don’t fight the Fed,” the saying goes. The U.S. Federal Reserve is promising ultra-low interest rates into 2015. Yet the buildup of low-yielding debt on financial firms’ balance sheets means they may suffer badly if rates jump. The central bank aside, prudent bosses – and their watchdogs – need to ensure they are avoiding fights with history, too.

It has been nearly two decades since financial markets had to deal with a serious interest rate shock. Old-timers may still remember 1994, when the Fed jacked up rates by 2.5 percentage points, destabilizing investments that rested on risky foundations. Orange County crumbled under derivative bets, hedge funds imploded and Mexico’s currency collapsed. To younger finance types, that probably seems almost quaint after the carnage seen in 2008.

Yet rising interest rates can be highly toxic to bonds – especially the kinds that investors like insurance companies, banks, pension funds and the Fed itself have been buying by the bucketload. These include U.S. Treasuries, mortgage-backed securities and investment grade corporate debt. Smaller community banks could be particularly vulnerable, since many of them have tried to maximize their income by investing in longer-dated bonds that yield a bit more. The longer the maturity of a fixed income instrument, the more its value will fall as interest rates rise.

The Federal Financial Institutions Examination Council (FFIEC), an umbrella group for U.S. financial watchdogs, put out an all-points bulletin early in 2010 warning regulated firms to be alert to interest rate risk, and followed up early this year with more detailed guidance. The Fed, which is represented at the FFIEC, is party to this appropriate regulatory concern. But the message is undermined by its monetary policy stance, which implies that interest rate risk is a non-issue for at least a couple more years.

But the Fed has only limited power to control interest rates. And sharply higher yields would be far from unusual. For instance, 30-year Treasury bond yields are currently under 3 percent. As recently as last year, they
topped 4.5 percent, and in early 2000 they briefly exceeded 6.5 percent. Because of the long maturity, a single percentage point rise in rates would translate into roughly a 20 percent decline in the value of long bonds.

AAA-rated mortgage-backed securities backed by Uncle Sam are also vulnerable. For example, when 10-year Treasury yields rose 1.3 percentage points over four months beginning in October 2010, it shaved about 9 percent off the value of Fannie Mae mortgage bonds, according to a report from Fitch Ratings earlier this year. By way of comparison, that's nearly double the expected credit losses on prime mortgages originated during the frothy years of 2005 to 2008.

Corporate bonds are also at risk. And in the quest to maximize yield, investors have pushed the duration of outstanding investment grade corporate bonds in a Bank of America Merrill Lynch index – fixed income-speak for the instruments' sensitivity to changes in interest rates – to record levels. Based on a back-of-the-envelope calculation, every percentage point increase in rates would lead such debt to sink in value by nearly 7 percent on average.

The FFIEC has suggested banks individually test their holdings' sensitivity to a 4 percentage point interest rate shock. A new study by Welton Investment, a hedge fund, finds that a portfolio of the highest-rated corporate debt would decline by 35 percent if rates surged higher by that amount over the course of a year. That's not the extreme scenario it might seem. Bonds have been on a 30-year bull run, but interest rate rises of three percentage points or more inside a calendar year used not to be so rare. They happened three times in the 1970s and 1980s. Inflation was the culprit then; simply freeing rates from their zero-bound cage could be the driver next time around. The Welton study also notes that even more modest rate increases can cause significant losses.
Even the Fed itself has loaded up on seemingly safe fixed-income securities, having expanded its balance sheet to a whopping $2.8 trillion thanks to its various bond-buying programs. If rates rise, Chairman Ben Bernanke’s team will find it difficult to reduce its holdings of Treasuries and mortgage bonds without spilling red ink – and losses surely wouldn’t play well in Washington. That’s aside from the problems the U.S. government would face with suddenly higher borrowing costs.

There’s a final wrinkle. The U.S. bank stress tests conducted after the 2008 crisis, which brought higher levels of capital and credibility to the sector, didn’t consider a spike in interest rates. Instead, regulators were focused on how the system would deal with a severe recession, which tends to lead to Treasury yields falling, not rising.

Bernanke is confident that he and his colleagues can manage the retreat from the extraordinary policies the Fed has followed in recent years. He may hold most of the cards for now, but long before 2015 that could change. Any unexpected upward shift in rates will be painful. Maybe before it happens, U.S. watchdogs should ensure higher interest rates are part of their stress tests.

First published 4 October 2012
The most surprising thing about the demise of two-and-20 hedge fund fees is how long it took. Neither losses in the 2008 credit crunch nor the feeble returns during the ensuing seven-year euro zone crisis did much to bring down the archetypal fee structure: 2 percent management fee and 20 percent of gains. Now, though, it can finally be said: two-and-20 is dead.

Back in September 2012, the average hedge fund still charged 1.6 percent annually in management fees and collected 18.7 percent of any gains, according to data provider Preqin. Through November that year, the average global hedge fund investor earned just 2.6 percent, according to the HFRX global index maintained by Hedge Fund Research. In 2011...
investors lost nearly 9 percent. The average annual return from 2009 to 2012, supposedly recovery years following the losses of more than 20 percent in 2008, was a measly 3 percent.

A few investors – including huge institutions like California’s giant pension fund, Calpers – managed to negotiate better deals. More often, funds that did badly simply shut down, while investors often signed up for new funds at the usual fees in the hope that the high-return strategy so elegantly set out for them by the latest persuasive trading titan turned out to work.

And a few duff years did little to dent demand. Hedge fund assets reached $2.2 trillion by the third quarter of 2012, some 17 percent above the 2007 pre-crisis peak. By 2015 they were still rising.

Yet it now looks as if those traumatic years marked the beginning of the end for the image of hedgies as superhuman traders. Faced with unpredictable markets, heavy central bank intervention and increasing red tape, some managers simply gave up. Pioneer Stanley Druckenmiller closed his fund in 2010, noting tellingly that managing more than $10 billion didn’t allow him to make the kind of returns he wanted. Some others did the same or returned money to outside investors. A wave of insider-trading scandals further tarnished the sector’s image, casting doubt along the way about the legitimacy of some top managers’ returns.

It didn’t help that hedge funds were becoming an industry. After the 2008 collapse, regulators and investors alike watched funds more closely. Managers needed to have large businesses to justify the required information and compliance systems, and diverse ones to avoid concentrated risks that might scare cautious institutional investors like pension funds. As Druckenmiller had foreseen, big firms ended up making lower returns, on average. And for the fund firm bosses, management fees approaching 2 percent made a large-scale business a ticket to riches even without stellar returns.

Investors initially settled for modest returns during good years and capital protection in bad times. But then many realized that the two-and-20 fee structure was out of kilter. Pension fund managers’ own rising liabilities made them tougher in claiming a higher proportion of the investment returns on their money. The most sophisticated ones set up their own
in-house managers, staffed with refugees from shrunken investment banks and unlucky hedge funds.

Now in 2020, there’s still a lot of money run by hedge funds. But there’s a clear bifurcation. It’s hard to distinguish parts of the industry from traditional asset managers like Blackrock and Fidelity – and those behemoths have snapped up some funds. In this branch, firms can still charge a management fee of 1 percent. But performance fees have shrunk to 5 percent or less, often after a minimum risk-free return is reached, in recognition of the more earthbound expectations investors now have of performance.

The other wing of the industry consists of hedge funds that have essentially gone back in time to something closer to the original concept – impressive returns in all market conditions, with fees to match as long as the returns are forthcoming. In the 1960s, Warren Buffett ran a fund charging no management fee but taking 25 percent of investment gains above a 6 percent threshold return.

In 2012 Guy Spier, whose $100 million-plus Aquamarine Capital Management has a class of shares that follows Buffett’s old structure, referred to the “microscopically small proportion of investment managers who decline to charge a management fee”. Eight years on, there are more of them, though it’s the harder and lonelier – if arguably the most investor-friendly – of the two hedge fund roads. Neither would look familiar to a manager who retired hugely wealthy in the early part of the past decade. But as places to invest, at least both now have fees that are a better fit.

First published 28 December 2012

ABE ERA WILL HERALD A THREE-DIGIT YEN

BY ANDY MUKHERJEE

The Shinzo Abe era will herald a spectacular decline in the yen. The promise by Japan’s newly elected prime minister to end the country’s chronic deflation spells curtains for the half-hearted quantitative easing that has
been the Bank of Japan’s hallmark for more than a decade. At some point in 2013, one U.S. dollar will buy 100 yen or more.

Since 1997, the BOJ has expanded Japan’s monetary base from 10 percent to 27 percent of GDP. Yet it has failed to convince markets that it would tolerate a sustained rise in prices. The election changes that. Investors will soon realize that the BOJ has become as reckless a money-printer as the U.S. Federal Reserve has been under Chairman Ben Bernanke.

The yen had already started its slide during the campaign, as opinion polls predicted a resounding Abe victory. Nevertheless, a three-digit yen still represents a near-20 percent swing from pre-election levels. The last time the currency’s value changed so dramatically was in the 15 months following the collapse of Lehman Brothers. Back then, the yen strengthened as the financial crisis and Europe’s sovereign-debt woes boosted Japan’s status as a safe haven.
Abe’s strategy will be to ratchet up deficit-financed construction spending, with the central bank buying a big chunk of government-issued debt from the market. He has also talked about lifting the BOJ’s inflation target from 1 percent to 3 percent – though his Liberal Democratic Party’s manifesto promised a 2 percent goal.

Confirmation of the shift will come in April, when Abe replaces outgoing Bank of Japan Governor Masaaki Shirakawa with someone more comfortable with at least five years of 3 percent inflation, required to return prices to their 1998 levels. Then, after the summer of 2013, when the LDP gains control of the upper chamber of parliament, Abe will introduce a bill that will allow the BOJ to buy foreign securities – a job currently reserved for the finance ministry. That will make Japan’s currency intervention more powerful.

Timing is on Abe’s side. Unless the U.S. economy jumps off the fiscal cliff, the Federal Reserve is unlikely to unveil any new easing measures in 2013. One strong push from Abe, and the yen will tumble.

*First published 17 December 2012*
WHIMSIES

A TALE OF TWO HALF-CENTURIES

BY EDWARD HADAS

The future rarely turns out as expected. Imagine, for example, two sets of economic predictions for the half-century that began in 1962. The first, the Blind Guide, is written with only the knowledge available then. The second, the Retrospective Guide, is based on what actually happened.

The biggest economic issue a half-century ago was the battle of economic systems: communism versus capitalism. The Blind Guide would have predicted a lively rivalry in 2012. True, communist countries were already falling behind economically in Europe, but political oppression would keep the system well entrenched. Besides, 50 years ago many Western experts still believed that communism’s social levelling and central planning offered poor countries the best hope of rapid economic growth.

In the retrospective volume, the future abject failure of communism has a prominent place. The decline would be slow, but the people would inevitably become increasingly disenchanted with the system’s incompetence, hypocrisy and cruelty. The will of the people ultimately prevailed.

Next comes the plight of the wretched of the earth, to use the English title of Frantz Fanon’s 1961 book on post-colonial society. Although the nascent Green Revolution in agriculture was encouraging, the blind prediction would be for another half-century of wretchedness. While the policies and practices which could eliminate abject poverty were fairly well understood, many generations would be needed to overcome the effects of colonial oppression and to spread industrial culture. In the interim, there would be social disorder, numerous wars and firmly entrenched repressive regimes.
It has not turned out that way. While the retrospective forecast calls for much shocking poverty in 2012 and some dreadful wars – Vietnam, Iran-Iraq, Congo – along the way, it also predicts tremendous improvements in living standards in most poor countries. For example, the share of global oil consumption accounted for by poor countries moved from a quarter to a half, while the proportion of young people in secondary education has more than doubled. Dictatorships have become scarcer and less secure.

The Blind Guide would also have given prominent place to the disasters expected from what Paul Ehrlich was soon going to call the “Population Bomb”. According to the Retrospective Guide, however, there was no problem. The world was about to enjoy an unprecedented combination of increased prosperity and decreasing family size. By 2012, the major demographic concern was not too many people but rapidly ageing populations – and absolute declines in such economic leaders as Japan and Germany.

Finally, in 1962 the blind view was clear: Europe was a problem. The United States and Soviet Union might avoid all-out conflict there, but the likely French rejection of the British application to join the European Economic Community (that happened in 1963) was a sign of bad things to come. Retrospectively, however, Europe was looking forward to what were definitely the most prosperous and probably the most tranquil five decades in its history.

The conventional economic wisdom of 1962 was mostly wrong. Fortunately, the errors were largely of excessive pessimism. What about the next half-century?

It would be nice to predict that more mostly good news, but such optimism might tempt fate. I would hate to predict prosperity and find calamity. Still, journalists and economists should not be afraid of looking foolish, especially posthumously, so I will hazard one bold prediction: by 2062, finance as we know it will have disappeared almost entirely.
It may take a few decades and a few more crises, but I believe that politicians and economists will eventually realise that to welcome greed throughout the financial system is akin to welcoming foxes into chicken coops. Financial greed – seen in the desire for unwarranted high returns from investments in stocks, bonds or real estate – will be seen for what it really is: an impediment to economic progress. That thought is at least as revolutionary as the idea that Europe should be peaceful. It will lead decision-makers to decide the current system is unfit for purpose. A critical look at every aspect of finance, from debts with maturities and fixed interest rates to supposedly independent central banks, will show that many instruments promise more certainty than is possible in an uncertain world. Others are too generous to financial intermediaries or are simply not suited for modern economies.

Once the old system appears to be obviously outdated, new ways will be found. Perhaps debt and its alluring promises will simply disappear, and be replaced by financial instruments which are like shares, basically permanent and always subject to losses in value. Maybe governments will stop borrowing from financial markets; they could simply print money directly to pay for deficit spending. And economic authorities in search of stability might find more potent tools than policy interest rates and crude bank regulation.

Improbable? Yes, but no more so than what actually happened in the last 50 years.

First published 12 December 2012
A MERGER ARB WRITES TO SANTA

BY DONDER UND BLITZEN

After another thin and bumpy year for betting on M&A, one desperate European merger arbitrageur wrote to Santa decided to write to Santa, with a 2013 wishlist. Breakingviews obtained a copy from a source close to the North Pole.

Dear Santa,

I usually only write to fund investors. But after a testing year for merger arbitrage, I thought it was time to broaden my letter-writing strategy.

As is the custom, I should start by stressing how good we’ve been this year. We’ve been nice to our new hire, the astrophysics nerd. We’ve sworn off trading based on market-report chatter. We hired more compliance guys. We’re even thinking of tweaking fees.

A clown looks on during a news conference in Mexico City. REUTERS/Eliana Aponte

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With all that in mind, here’s what I’d like for Christmas: More deals. More big, public deals. Ones that don’t fall over, either. I’m not asking you to magic deals from nowhere. But as a “thought leader”, could you nudge company directors to, you know, seize the day a bit? Their wariness feels like one of the biggest obstacles. I’m sure you have ways to influence the debate. Maybe include notes with the presents you deliver - or a few well-chosen words at Davos, which I gather you attend as a top-level delegate, could also help.

It wasn’t pretty, but Glencore basically saved European M&A this year. An encore with Anglo American would be great. How about a big consumer goods deal too, then? Could AB InBev be ready to swallow SABMiller? How about a Reckitt-Colgate merger? Some chunky buyouts would be nice as well. Bond markets would be more than happy to help. And it’s encouraging to see timeless classics like Marks and Spencer, ITV and United Utilities being talked about again.

A second thing. Politicians and regulators have been more than a bit awkward. Did Brussels really need to frighten Mayfair so much by almost killing UPS-TNT, just to keep Europe’s “international express small package market” tickety-boo? I know international delivery is one of your things, could you have a word? And more generally, could you get the guys to lighten up a bit? You’re a monopoly operator: living proof that it ain’t all bad. Just get them to show a bit more belief.

If there’s any way you can help, all of us here at Herald Angel Capital would be most grateful.

*First published 24 December 2012*
IT’S 20.12.2012; AND IT’S THE END OF A MAGICAL ERA

BY HUGO DIXON

One doesn’t have to be a Mayan to believe that we are at the numerological end of an era. Apocalyptic visions stemmed from reading the Mesoamerican Long Count Calendar. But even using the widely used Gregorian Calendar, there’s something special about 20.12.2012.

It’s one of those dates where digits create interesting patterns. It also comes at the end of 13 years which have been astonishingly fertile for such numerologically “magic” dates. The rest of the century is going to be a desert by comparison.

Dates can be aesthetically attractive because they repeat a number several times (eg 12.12.12) or contain a string of successive numbers (eg 10.11.12) or because they are palindromes (eg 01.1.01), where you get the same date if you run the numbers backwards.

The beauty of these numbers is in the eye of the beholder. There can be no consensus over what constitutes a date that has numerological significance. But one way of shedding light on the situation is to look at different formats.

First up is the series that runs from 1.1.1 to 2.2.2 and all the way up to 12.12.12. There are only 12 members of this series because there are only 12 months in the year. It is this feature of the Gregorian Calendar, indeed, which is the main reason why the magic number boom is about to end. The last member of this series was in December 2012. We will have to wait 88 years until 1 January 2101 before we get the next one.

With three members of this series, it is also possible to add a time of day to make the date even more magical: 10.10.10 10.10am (or pm); 11.11.11 at 11.11am; and 12.12.12 at 12.12am. The middle one – containing ten “1”s in a row – is exceptional.

Next, comes the series that starts with 1.1.11 and ends with 9.9.99. There are nine members in this series, one every decade. The next one is just over nine years away.
Then we have 11.1.11 and 22.2.22. There are just two members of this series because of another feature of the Gregorian Calendar: no month has more than 31 days, so you can’t get 33.3.33. The next member of this series is nine years away – and then emptiness.

Where you put the dots also matters. 1.11.1, 11.11.1, 1.11.11 are all beauties. But there are, sadly, no more of this type until the next century.

There are 12 dates in the series of which 20.12.2012 is the last – using the European convention which puts the day before the month rather than the American convention which reverses the order. Others include 20.01.2001, 20.02.2002, and 20.09.2009. We have to wait 88 years until 21.01.2101 for the next one.

And then there are the palindromes: 01.1.10, 02.2.20 and the rest up to 09.9.90 are really beautiful. The second member of the series can also be written as 02.02.2020 – another great palindrome. Given this double dose of magic, it is worth putting a reminder in the diary for 2 February 2020.

22.02.2022 is another good palindrome, the only member of its series – unless you want to go back over 900 years to when Henry I was King of England. It too is magical twice over - as February 22 2022 can also be written as 22.2.22.

Then there are dates that contain a string of successive numbers. These include the series: 1.2.3, 2.3.4, and 5.6.7….. The best three, which I count as magical, are: 1.2.3, 10.11.12 and 11.12.13. Set your watch to a quarter past two on December 11 2013: 11.12.13 14.15pm. It’s the last really magical number of this decade.

In the appendix which lists all the numbers I think make the grade. I reckon there are a total of 68 magical dates in the 21st Century, using the convention that the century began on 1 January 2000 rather than 1 January 2001. 43 of these have already passed – an average of just over three a year. There are only 25 left in the next 87 years.

What this means is that the incidence of magic number dates so far this century has been 12 times greater than it will be in the remainder of the
century. Unless one is superstitious or mystical, there is nothing much one can do with a magic number date apart from admire its beauty. But that’s not to sniffed at. Let’s cherish the date. It’s almost the end of an era.

**Appendix – full list of magic dates in chronological order, grouped decade by decade**

1.1.00, 2.1.0, 1.1.1, 10.1.01, 11.1.0, 20.01.2001, 3.2.1, 1.11.1, 11.11.1, 2.2.2, 20.02.2002, 20.2.02*, 22.2.2, 1.2.3, 3.3.3, 20.03.2003, 30.3.03, 4.4.4, 20.04.2004, 5.5.5, 20.05.2005, 6.6.6, 20.06.2006, 7.7.7, 20.07.2007, 8.8.8, 20.08.2008, 9.9.9, 20.09.2009.

01.1.10, 01.2.10, 3.2.10, 10.10.10, 20.10.2010, 01.11.10, 1.11.11, 11.11.1, 20.11.2011, 1.2.12, 10.11.12, 12.12.12, 20.12.2012, 11.12.13 at 14.15pm.

02.2.20, 02.02.2020*, 02.22.20, 4.3.21, 12.3.21, 1.1.22, 2.2.22, 22.2.22, 22.02.22*.

03.3.30, 3.3.33, 1.2.34.

04.4.40, 6.5.43 at 2.10am, 4.4.44.

05.5.50, 7.6.54 at 3.21am, 5.5.55.

06.6.60, 6.6.66.

07.7.70, 7.7.77.

08.8.80, 8.8.88.

09.9.90, 9.9.99.

* Same date but different format as previous entry.

*First published 20 December 2012*
PREDICTIONS ARE RUBBISH

BY OLAF STORBECK

Horoscopes are incredibly popular, quite literally unbelievable. Financial and political predictions should be treated the same. Forecasts are usually either wild guesses or extrapolations of past trends into the future.

In a series of experiments, behavioural economists have collected convincing evidence pointing to the human tendency to believe that patterns of the past will prevail in future. We think we are looking ahead, but in fact we are staring into history. The same fallacy is hard-wired into state-of-the-art models used to forecast economic growth. Moreover, they assume that any genuine, exogenous shock — be it a drop in oil prices or the bursting of a property bubble — will only have a short-term impact. It is assumed that economies will digest disruptions quickly and revert to long term trends.

This would be fine if we lived in a mechanistic, predetermined world where the relevant probability distributions were known beforehand. But unexpected events – occurrences that Nassim Nicholas Taleb famously dubbed “black swans” – are neither predetermined nor predictable.

Just think of the three most important events of the past 25 years: the fall of the Berlin Wall, 9/11 and the financial meltdown. They were huge surprises which have had fundamental and long lasting impact on political, social and financial affairs. If they had been anticipated, meanwhile, they might not have happened because economic and political agents would have adjusted their behaviour in advance.

Even trends that are visible well in advance present headaches. The mobile internet is a case in point. At the turn of the century, experts more or less accurately predicted a rapid rise in wireless communications. Yet still telecoms companies spent too much on 3G licences and the technology took much longer to take off than was expected. And it is outfits such as Apple, Google and Facebook – companies one step removed from the golden ether – that have drawn the largest tranches of benefit.
There is nothing wrong with making predictions. Indeed, anyone who refuses to look to the future will almost certainly be less well able to cope with present dangers. Like horoscopes, predictions are also entertaining. Ultimately, however, they are akin to a chocolate fireguard. Enticing but, well, a bit rubbish.

First published 31 December 2012

PREPARE FOR A MOODY, GRUNGY AND DEFIANT YEAR

BY ROBERT COLE

The twenty-first century becomes a teenager in 2013. As with so many young adolescents, you may find that the year manages only grunting communication. It will keep odd hours. It will want to laze around in bed until early afternoon and then become hyper and stay up late, annoying those around it. It will make unsuitable new friends. It may begin an infatuation with ponies or seek furtive fumbles with the fleshpots of finance – or both. It will experiment with mind-altering monetary stimuli. There will be highs of excitement and lows of tearful regret.

2013 will find ever more ingenious ways to inflict sartorial dismay. The hemlines will rise, the pants will slide. Hair will start growing and be cut, dyed and crimped, often until unrecognisable.

It will say you don’t understand. And it might be right: it is very hard for grown-up adults to make any sense of unreasoned rage – especially when it is followed, minutes later, with pleas for hard cash handouts.

The year will complain, endlessly. Its obsession with handheld electronics will continue. But be fair: remember that the year must cope with seemingly endless treadmill of examinations: high-pressure tests at various junctures of all its organs and limbs that will determine its prosperity, and satisfaction, in years to come. Remember also that as you get older, it will be the younger generations taking the wheel of the economy. Today’s
PREDICTIONS 2013

Teenagers will have to deal with tomorrow’s frailties, impoverishment - and incontinence.

Guardians of 2013 must comfort themselves with the thought that it must surely be only a phase. It is an inevitable, albeit intensely annoying, period of strain that marks the coming of age. As any parent knows, or will find out at substantial cost, the only way to deal with stroppy teenagers is with patience. Through the pain of adolescence comes the maturity of adulthood. Is that wishful thinking? It certainly turned out to be the case for the parents of 1913. But it is your only hope. Hang on to it for dear life.

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ON THE COVER

A woman leaves her house through a decorated doorway during Corpus Christi day in Zahara de la Sierra, southern Spain. The village of Zahara de la Sierra celebrated the feast of Corpus Christi (or Body of Christ in Latin) by covering the streets and facades of houses with the branches of trees and grass. REUTERS/Jon Nazca

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