Edison Insight

Strategic perspective | Sector focus

January 2018

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EDISON

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Prices at 5 January 2018

Published 10 January 2018

US$/£ exchange rate: 0.7445
€/£ exchange rate: 0.8848
C$/£ exchange rate: 0.5862
A$/£ exchange rate: 0.5742
NZ$/£ exchange rate: 0.5233
TRY/£ exchange rate: 0.1952
MYR/£ exchange rate: 0.1831
RUB/£ exchange rate: 0.0128
NIS/£ exchange rate: 0.2132
NOK/£ exchange rate: 0.0910
HKD/£ exchange rate: 0.0953
CHF/£ exchange rate: 0.7562
SGD/£ exchange rate: 0.5548
EGP/£ exchange rate: 0.0417

Welcome to the January edition of the Edison Insight. This special edition strays from our usual format as it does not include any company profiles. Instead, we look at the outlook for 2018 and include a focus piece on each of the major sectors that we cover. Healthcare companies are now covered separately in Edison Healthcare Insight. Click here to view the latest edition.

The book opens with a strategy piece from Alastair George, who believes that 2018 is likely to be a year of two halves for global equity markets. Initially, strong economic momentum and investor sentiment is likely to prevail over the negatives of high valuations and continued monetary tightening. However, the delayed impact of tighter policy in 2017 and further tightening in 2018 appears to be a strong headwind to further equity performance from mid-year. He notes that output gaps in developed markets have now closed, in aggregate, for the first time since 2009. This is a structural change from the slack environment which persisted following the financial crisis of 2008-09 and investors should therefore consider sector allocations carefully. In his view, equity portfolios should now be tilted towards sectors which have offered a degree of resilience and a better risk/reward in the past. Specific growth or event-driven situations should also be favoured over broad market exposure, as developed market price/book valuations as a whole remain unappealing.

Readers wishing more detail should visit our website, where reports are freely available for download (www.edisongroup.com). All profit and earnings figures shown are normalised, excluding amortisation of acquired intangibles, exceptional items and share-based payments.

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We welcome any comments/suggestions our readers may have.

Neil Shah
Director of research

Global perspectives: Top-of-cycle investing

Analyst

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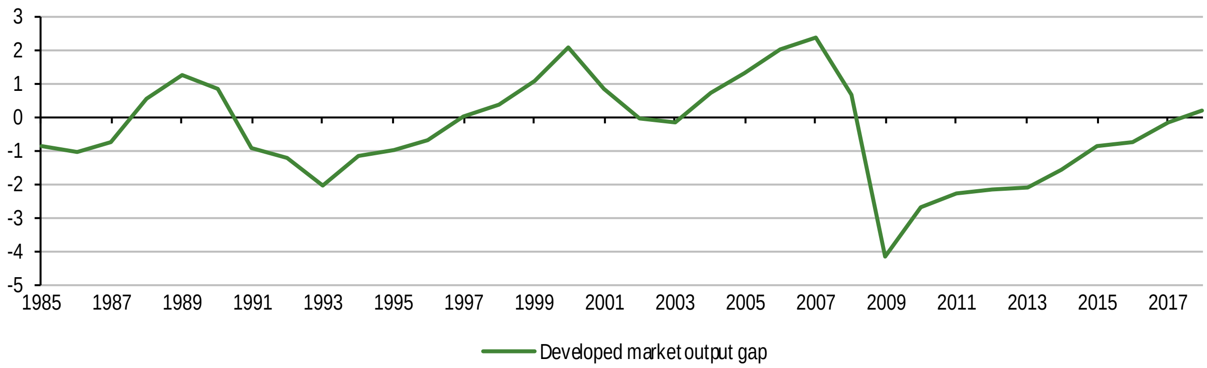
- **2018 is likely to be a year of two halves for global equity markets.** Initially, strong economic momentum and investor sentiment is likely to prevail over the negatives of high valuations and continued monetary tightening. However, the delayed impact of tighter policy in 2017 and further tightening in 2018 appears in our view to be a strong headwind to further equity performance from mid-year.
- **Output gaps in developed markets have now closed, in aggregate, for the first time since 2009**. This is a structural change from the slack environment which persisted following the financial crisis of 2008-09. Investors should therefore consider sector allocations carefully. Our analysis of sector performance over the previous three cycles indicates that lower-risk and less cyclical sectors may offer the better risk/reward even if cyclicals for now have the whip hand.
- **The closing of global output gaps has eliminated much of the room for manoeuvre in terms of monetary policy**. We view developed market monetary policy as being in a steady transition from accommodative to restrictive, a process which started in H216. In our view, investors should be cognisant of the long 18- to 24-month lag of the effect of monetary policy on economic variables such as inflation and growth. The current record strength of the eurozone economy for example is likely to prove the exception rather than the rule.
- **Ultra-low long-term government bond yields remain at odds with our base case of continued growth.** Price insensitive buyers – the world's major central banks – are either actively winding down balance sheets (US Fed), tapering QE (ECB), or becoming more sensitive to economic distortions (Bank of Japan). Though the level of debt in major economies means that future long-term rates are likely to be lower than historical averages, we see little diversification benefit in owning bonds at current yields. Investors should remain underweight duration risk in our view.
- **Equity valuations remain unappealing in general.** Price/book multiples for developed markets are now well above historical averages, except for the bubble period of the late 1990s. However, in an environment of such positive economic surprise, valuation data are unlikely to represent an impediment to further market progress but remain a real risk factor when the cycle turns.
- **Top-of-cycle investing is an uncomfortable proposition.** What performs most strongly up to the peak in activity often performs the worst immediately after. We believe the time for maximum equity market exposure was much earlier in this cycle when valuations discounted all but the worst economic outcomes. At present, equity portfolios should be tilted towards sectors which have offered a degree of resilience and a better risk/reward in the past. Specific growth or event-driven situations should also be favoured over broad market exposure, in our view.

Top-of-cycle investing

Strong near-term economic momentum supportive of markets

Finally, the developed market output gap between trend and actual output has closed, a decade after the financial crisis of 2008. The recovery has been slow but of a long duration. The nature of the economic cycle, such as it has existed in the past, is that long periods of expansion are followed by short, but sharp, contractions. Therefore, while the output gap may have closed only recently, it is likely that developed market economies are closer to the top of the cycle.

Exhibit 1: Developed market output gap closes



Source: IMF, Edison weights and calculations

Investing at the top of the cycle requires a different approach, in our view. There is something of an analogy with musical chairs as no one wants to be caught out when the music stops – or the cycle turns. Just as in the game, hovering near a safe chair may be the best strategy. With developed market equity valuations as high as they are now, in our view there is relatively little balance sheet or asset value support, in the event of a hiccup in growth momentum.

Although we continue to have concerns over the medium term (and we will outline how best to navigate the conflict between our short and medium-term views) in the short-run there has been remarkably positive economic momentum across all regions in the latter part of 2017. We fully expect this to follow through into the first half of 2018 and a round of profits upgrades is increasingly likely as analysts return from the seasonal vacation, given the continued economic surprise.

Commodity markets highlight the positive momentum in the global economy. Oil prices are now well above the marginal cost of shale, only recently regarded as a ceiling for prices, indicating the demand-led nature of the current market. Industrial commodities such as iron ore and copper are also trading close to new highs in recent weeks. The crash in the commodity sector in early 2016 is now a long-distant memory as the forecast collapse in demand from China failed to materialise.

Many of the risks associated with the excesses of the past will naturally diminish in the event of a period of above-trend growth. These include the productivity puzzle, as increased investment by the corporate sector should in theory improve the labour output per hour by increasing capital intensity. The corporate sector now has an increased incentive to improve labour productivity as labour becomes increasingly scarce.

Furthermore, improved levels of GDP add scope to either reduce deficits or increase government spending in otherwise fiscally constrained nations. A recovery which eases the fiscal pressure in the periphery of Europe would be welcomed by the ECB as it comes closer to the scenario of escape velocity, which the central bank has been trying hard to achieve.

The extended period of strong profitability in the corporate sector also goes some way to accommodating the rather large levels of non-financial corporate debt by enabling corporations to deleverage and improve credit metrics through operating cash generation. Benign deratings of currently high price/book valuations can also be realised by a continued strong return on equity, which allows for more rapid growth in book values.

However, it is important to recognise that despite the comforting psychological narratives that an economic expansion provides, investing has over the last 30 years been much riskier at the top of the cycle compared to during periods with a negative output gap or recessionary conditions.

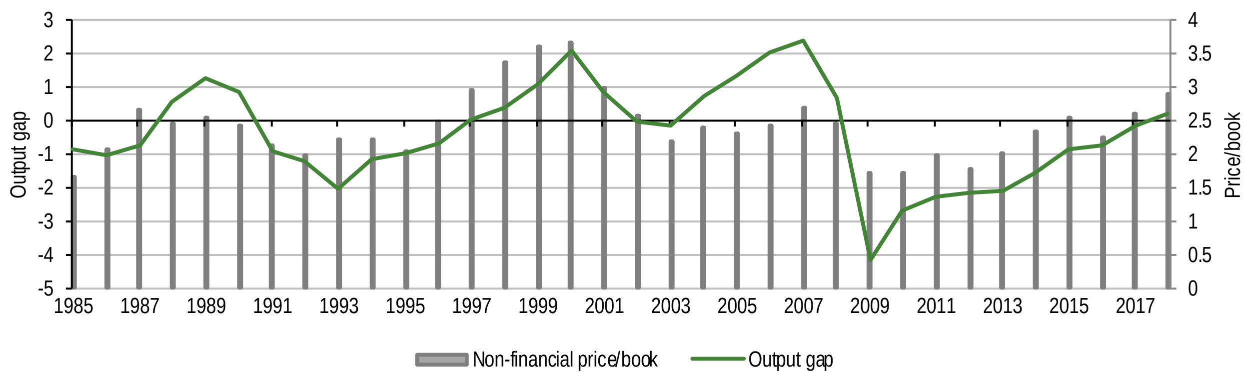
The reason for this is not that markets do not perform less strongly when the output gap has been closed – in fact the average annualised return until the peak in economic activity is modestly higher at 14%, compared to 12% during periods when the output gap is negative.

Rather, as Exhibit 1 shows the data highlights that the period of above-trend output prior to the next recession tends to be rather short. Furthermore, the actual turn of the cycle has recently been associated with substantial equity losses (2000-02 and 2008-09) and modestly negative equity returns over the 1988-1991 period.

Multi-year losses such as these will be a long way from investors' minds in the current environment. Yet this is precisely the pattern which has repeated over the previous three cycles. We believe investors should at least be aware of Exhibit 2, which shows that benign economic conditions can ultimately lead to difficult markets.

Periods of above-trend output are marked by the tendency for valuations to run ahead of long-term averages in such an environment, setting the stage for disappointing performance when the economic cycle turns. It may be different this time – but the historical data suggest it may be prudent to invest with a view to a swift exit, should the need arise.

Exhibit 2: Output gap and non-financial price/book



Source: IMF, Edison weights and calculations, Thomson Reuters Datastream

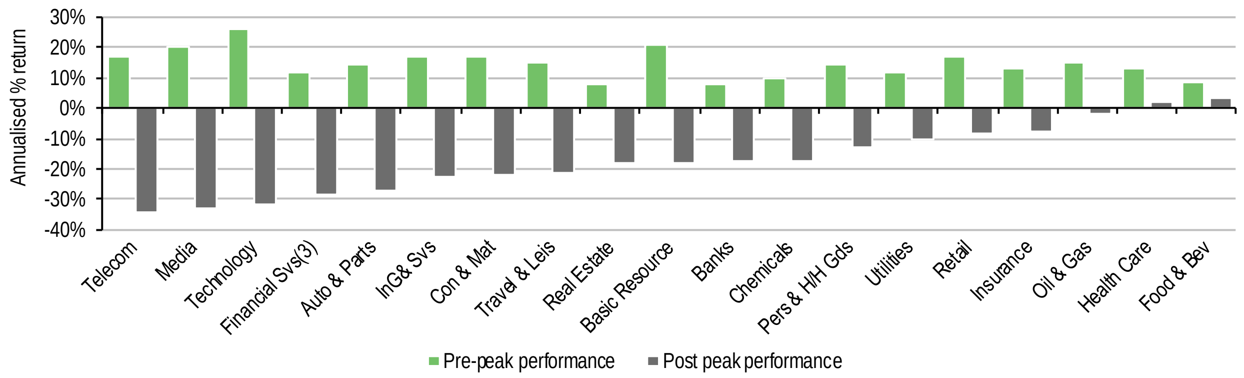
Look for value in defensive rather than cyclicals

Late cycle returns relatively uncorrelated to magnitude of post-peak losses

We have examined the sector performance of developed markets during periods when economic output is above trend since 1980. We have split these periods into an early phase (such as now) and a post-peak phase when the economy is slowing but still above its long-term trend and taken the average annualised return over the prior three cycles.

Exhibit 3 shows that average returns in the early phase of above-trend growth (such as now) are strong at 14% and modestly higher in traditionally cyclical and higher beta sectors such as basic resources, construction and autos. Telecoms, media and technology have also generated similarly strong returns although this is in part due to the influence of the dot-com bubble of the 1998-2002 period which may be an outlier.

Exhibit 3: Sector returns pre- and post- economic peak



Source: IMF, Edison weights and calculations, Thomson Reuters Datastream

What Exhibit 3 also confirms is that stock market returns in the period after the cycle has peaked have on average been very disappointing. Over the last three cycles the average sector has lost 15% in capital value following the peak in activity.

It is unfortunately not, in our view, easy to pinpoint a peak in economic activity in real time. Economic data are reported with significant lags and can be revised years later. Therefore, we believe from a strategic perspective it is better to be prepared ahead of time and be at least in part guided by the typical length of the period of above-trend output and the lags inherent in monetary policy. The average duration of the pre-peak period has ranged between 18 and 48 months over the last three cycles. For the present cycle, we may have been operating in an above-trend environment since the beginning of 2017. On past data the peak in activity could be as close as six months or as far as three years away.

Fortunately what the data also suggest to us is that a precautionary approach only sacrifices a modest degree of performance. Defensive sectors such as food, personal goods, insurance, large-cap oil & gas and pharma have delivered double-digit annualised returns at the top of the cycle but also offered substantially better capital preservation after the peak in activity, thus offering a better risk/reward and long-term return.

It is clearly tempting to keep running profits when commodity prices continue to climb and profits momentum is strong. But this is precisely the time to take profits in cyclical sectors and rotate into more defensive and less cyclical investments. There is also something intrinsically more exciting about trying to pick the top of the market rather than aim for a steadier but ultimately better long-term performance and it requires a degree of humility to accept that the end of this period of expansion is likely to be difficult to predict.

Over-confidence comes in many forms; one is a subconscious belief that it will be possible to time the market in this way. This bias runs the risk of dashing for cash too early or exiting the market too late. The data show that a pre-emptive move closer to the exit by rotating into more defensive investments may be a more rational step, foregoing relatively little return while at the same time substantially reducing risk to capital.

Closing of output gaps points to tighter monetary policy

Central banks have much less room for manoeuvre in 2018

Positive economic momentum and the elimination of slack in developed markets clearly support the policy stance of the US Federal Reserve of gradually removing monetary accommodation. Money markets originally tried to call policymakers' bluff but short-term interest rate markets have now shifted to discount Fed guidance for three rate increases in 2018. This would take market US interest rates close to 2% - a level unseen for well over a decade.

In the eurozone, the ECB is also well past peak monetary accommodation and is in the process of winding down QE. Should the record strong momentum evident in PMI data continue over the coming quarter, we believe the ECB may even have to guide to a more hawkish stance, couched in the terms of the unanticipated success of their prior policy initiatives. Such a development is already being priced into the euro which has continued to strengthen against the US dollar over the last few weeks.

While gradualism in returning monetary policy to more normal levels has been clearly emphasised by policymakers, the closure of global output gaps and the remarkable decline of unemployment in the US, UK and Germany highlights the challenge of attempting to run supportive monetary policy at the same time as factoring in the traditional lags between policy changes, inflation and growth. The current debate in the US about the advisability of raising rates while inflation is below target and falling is an example of the communication challenge – the Fed is not targeting current inflation but inflation in 12 to 24 months' time.

There is also policy uncertainty driven by questions over the lack of wage growth in developed markets to date, despite declining unemployment. The value of even implicit use of the Phillips curve model, which links labour market slack to forecast wage growth and inflation is even being called into question by the US Fed's own policymakers. We believe this is a difficult question and the data required to resolve this academic debate will not be available until after policy for the next 12 months at least will have been set. Minutes for the Federal Open Market Committee (FOMC) December 2017 meeting show there is an active debate on whether the currently low levels of US official unemployment will in fact lead to an acceleration in wage growth in future.

In terms of the Fed's current thinking, also taken from the December 2017 meeting minutes, there is certainly a range of views. While the consensus was still in favour of gradual rate increases over the next 12 months, a few participants were not comfortable with the current median projection for the Fed Funds interest rate at the end of 2018 of 2.1%, as they believed this may prevent inflation rising sustainably to 2%. On the other hand, a few other participants highlighted the lack of tightening of financial conditions even as interest rates have increased and the diminishing slack in the labour market.

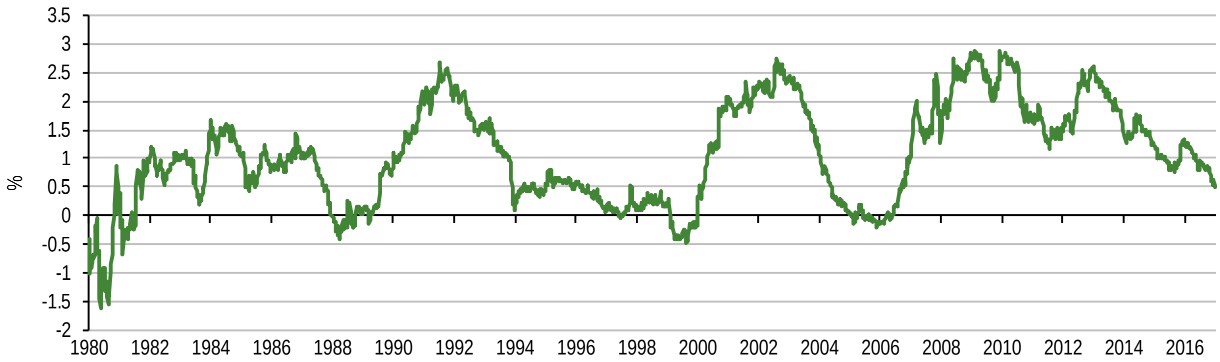
In the absence of definitive data to the contrary, we believe the bias for the FOMC will be to stick with traditional relationships between economic variables. This means that unless there is a significant market hiccup, the Fed will continue with its policy for increasing rates gradually over the course of 2018.

While the US interest rate increases of 2017 have been easily absorbed by the equity market, which at the fringes is showing signs of speculative behaviour, at least in the realm of blockchain-related technologies, there is in our view no guarantee that 2018's rate increases will be so easily absorbed.

We can see a risk scenario where the first round of monetary tightening (2017) starts to impact the economy by mid-year, slowing the current growth momentum while the limited slack in the economy and rising inflation pressure validates a monetary policy stance which may be inconsistent with currently rich equity and bond market pricing.

For bond markets, the flattening of the US yield curve, Exhibit 4, has already caught the attention of Fed policymakers. A reduction in the term premium was attributed to the large holdings of bonds by central banks combined with substantial global private demand for long duration assets. In some respects policymakers may believe this is a desirable crowding-out of the private sector, forcing investors to look elsewhere for returns and lowering financing costs in the process. To date, the flat yield curve was not regarded by Fed policymakers as unusual by historical standards with a divergence of opinion on whether it may foreshadow a recession or is a natural consequence of rising short-term interest rates – in which case inversion was said to carry no signal in respect of the outlook.

Exhibit 4: Flattening US yield curve – too early to claim a harbinger of recession



Source: Thomson Reuters Datastream

Based on the current trajectory of economic momentum and central bank policy, our base case is that global bond yields will gradually move higher as investors realise US interest rates are likely to stick at higher levels for a period of time and the ECB and Bank of England are likely to follow from 2019. In a benign economic scenario, which is the most likely outcome in our view at present, it is no longer unthinkable to consider US 10-year rates of over 3% by the end of 2018 in such circumstances.

We would also suggest that German bunds continue to appear exposed at ECB-depressed yields of just 0.44% when German unemployment is close to 15-year lows and inflation is running close to the ECB's target of below but close to 2%. To win the mandate to resolve the problems of the periphery of Europe, policymakers within the ECB had to overcome stubborn German resistance. Nevertheless, Germany remains the dominant economic and political force within the eurozone and tolerance of above-target inflation at the Bundesbank is limited. We believe bund yields are likely to move higher during 2018.

Equity valuations remain unappealing

Strong performance during 2017 has increased price/book premiums

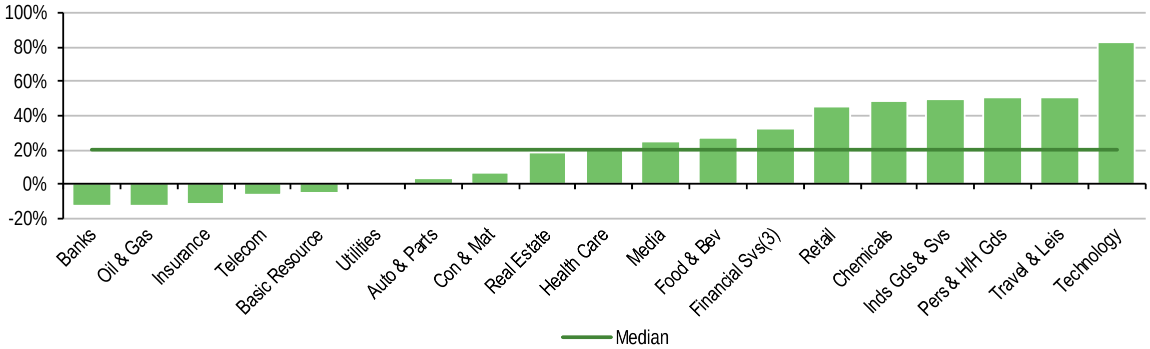
The corporate sector has been the standout beneficiary of the low interest rate and low wage growth rates during this cycle. Low interest rates have substantially lowered financing costs while low wage growth and the ability to source the lowest cost production on a global basis has enabled record-high profit margins to be maintained. This has confounded those who viewed low equity returns as a corollary of slow economic growth.

The doubts over the sustainability of the economic recovery also diverted the corporate sector's strong cash flows into share buybacks and dividends rather than riskier capital investment. In hindsight, it is perhaps clearer that such conditions were going to lead to a substantial re-rating of equities from the depressed levels of 2010-12.

As we have outlined previously, in the short term we do not see any slowdown in corporate profits performance which is currently receiving an additional benefit from rising commodity prices. However, we do have concerns over developed market valuations, which historically have been a reasonable guide to medium-term returns.

Based on currently high developed market valuations, Exhibit 5, we believe markets are fully discounting a continuation of the currently benign economic scenario. This benign scenario may also be our base case for the short term, but not into perpetuity. This is why we believe it is important to be prepared for the possible end of the current expansion. Fortunately, based on our earlier analysis rotating into sectors which have historically offered a degree of capital preservation in a downturn should not sacrifice too much portfolio performance over the near term.

Exhibit 5: Developed market sector price/book multiples remain at a premium to long-run averages



Source: Thomson Reuters Datastream, Edison calculations. Chart shows price/last reported book value for each sector.

It is also the case that following a long market rally the need for active management is increasingly questioned. In our view, with market valuations at current extended levels it is in fact a better time to question the merits of passive management which in traditional form can only offer broad market exposure.

Instead of the broad market exposure which has worked so well in the past, we believe investors should now focus on a limited list of carefully researched ideas, preferably where the outturn depends less on macroeconomic variables but instead on company or situation-specific factors.

Conclusion

For 2018, we continue to believe that as we may be late in the cycle investors should combine a relatively modest level of market exposure with carefully selected exposure to specific company- or event-driven situations.

Our analysis of sector performance leading up to the peak in economic output and immediately afterwards suggests that while it may be tempting to ride cyclical exposure further the risk/reward is becoming unattractive. Defensive sectors have historically offered only modestly less return during above-trend periods of expansion and markedly greater capital preservation if or when a downturn comes.

For equities in 2018, we believe strong economic momentum and investor sentiment is likely to prevail over the negatives of high valuations and continued monetary tightening at least until mid-year. However, the lagged impact of tighter policy in 2017 and a further tightening in 2018 seems to us to be a strong headwind to further equity performance in the second half of the year. However, we have discussed the difficulties in timing the cycle to perfection and would suggest investors should at least stand close to the exits.

We believe the time for broad equity market exposure was much earlier in this cycle when valuations discounted all but the worst economic outcomes. At present we would prefer focused portfolios based on specific growth or event-driven situations.

Focus on:

Consumer

Industrials

Media

Mining

Oil & gas

Technology

Sector focus: Consumer

Analyst

Paul Hickman

Managing cyclical and structural change

UK consumer confidence extended its declines in 2017, finishing -13 points in December against -7 points a year before and +2 points in December 2015 (GfK). With 2018 CPI inflation forecast at 2.4%, real household income growth at 1% (BOE), and personal borrowing set for some degree of correction, consumer demand faces increasing challenges.

Any investment in UK **General Retailers** must be on the right side of the structural change that is outstripping expectations. UK online sales for three months to November 2017 grew an average 11.6% against all retail 4.0% (ONS). High Street majors M&S, Next and Debenhams showed weak UK sales, driving 11% sector underperformance in 2017, while failures included Jaeger, Multiyork and Palmer and Harvey. Shop numbers are forecast to shrink 22% in 2018 (Centre for Retail Research). By contrast, Boohoo and ASOS grew UK sales by 100% and 16% respectively for the year to August 2017, and Gear4music by 25% for the four months to December. Their current P/Es of c 70x factor in continued growth and picking the next online play is difficult, although discounters should also do relatively well.

UK leisure investments may face sudden crystallisation of cyclical risk. Oversupply in UK bars and restaurants is endemic, as it has been in the pub industry for over 50 years. Stock successes in 2017 included travel companies TUI (+32%) and Thomas Cook (+43%), with Just Eat (+34%) continuing to disrupt leisure retailing. Traditional hospitality operators like Greene King (-19%) and Restaurant Group (-11%) struggled however. Despite weakening property prices, undifferentiated competition will challenge profitability, we believe, particularly with wage costs increasing through regulation and repatriation of foreign workers (irrespective of Brexit). Again, exposure to growth economies, technological disruption and consumer value are desirable features where available.

Consumer staples had a mixed 2017, outperforming in H1 and slightly underperforming in H2, but positive overall. Muted global FMCG demand will likely remain tough in 2018. M&A featured with a range of deals, from RB/Mead Johnson early in the year to the putative Kraft Heinz/Unilever bid and Unilever's subsequent sale of its Spreads business. Global consumer staples companies continue to suffer from the trend of health- and ethically-conscious millennials preferring niche brands that feel authentic. Still, with its less discretionary and less volatile characteristics, this sector should outperform. Bolt-on acquisitions may continue, as leaders strive to sustain growth, underpinning the sector. Potential catalysts include Nelson Peltz's success in driving change at P&G, activist investor intervention and renewed M&A by Kraft Heinz (either Unilever or another target).

In conclusion: macro factors are negative to cyclical retail and leisure, both on the grounds of their current above-trend ratings, and of their volatility to the economic cycle. As developed economies fade and particularly in the UK, these sectors are likely to worsen, and an agile stock-picking strategy has never been more necessary. Food and beverage, however, is one of the few sectors to provide positive returns post economic peaks in the past. Consumer staples, therefore, is where we would look for relative exposure.

Sector focus: Industrials

International exposure favoured

Analyst

Toby Thorrington

November OECD estimates point to **broadly stable annual global GDP growth expectations** of around 3.6-3.7% for 2017-19 inclusive. Consequently, cyclical growth in overall terms still appears to be a positive investment story for the time being. Among western economies, the US (small 2018 growth uptick, followed by a slower 2019 at 2.1%) and euro areas (gradual slowing from 2.4% in 2017 to 1.9% in 2019) appear to be relatively well placed. (We might also expect a boost to US corporate earnings from recently approved tax regime changes.) Over the same time period, China is expected to sustain annual growth above 6% while India is seen as accelerating to above 7% by 2019.

Given **UK economic challenges** with Brexit negotiations and weak consumer confidence data, industrial stocks with international exposure might reasonably expect to see profit progress ahead of that for more domestically-oriented ones, in local currency terms. With a global interest cycle trend now rising from historic lows, this might amplify returns to sterling-based investors if UK rate increases are more influenced – and therefore constrained – by personal/household sector sensitivities. We note that the OECD does reference a “risk of financial turbulence” generally which we interpret as the yet-to-be-seen lag effects of interest rate rises thus far. In our view, while this may affect actual growth rates it does not change our relative comments above.

Of course, the broadly-based **Industrials sector offers good exposure to ex-UK economies** especially among larger caps (noting indeed that Halma and DS Smith both became members of the FTSE 100 in December) but also down to small caps. Some subsectors such as Chemicals, Aerospace & Defence and Industrial Engineering have constituent companies that naturally operate in international markets. In contrast, Construction & Materials has more of a bias towards UK earnings, though not exclusively so, while the Industrial Support Services grouping contains a wide spectrum of profit splits generated domestically and overseas. Both multinational companies with overseas operations and UK-based export operations – especially in the absence of sterling strengthening – can provide good access to faster-growing economies.

Within this over-arching driver, we suggest a number of sub themes for investors in cyclical stocks to consider given the backdrop of an expected slowdown in growth rates in western economies over the next two years. First, **longer visibility** plays that provide some indicators of future activity levels beyond the current financial year. For example, this might include companies exposed to aerospace/defence (eg civil order books, defence budget frameworks) and expansionary government fiscal policy measures (such as infrastructure and housebuilding). Second, we favour **low financial risk** (eg low gearing, good cash generation, facility headroom) which also provides scope to raise growth rates via organic/inorganic investment. Lastly, with energy and oil prices rising currently, stocks with scope to improve **productivity** either directly or as a service provider (eg industrial support or oil/energy services) might be relatively advantaged.

Sector focus: Media

Analyst

Fiona Orford-Williams

Shifting sands

There seem to be plenty of reasons for caution stepping into 2018, not least of which are the geopolitical uncertainties that will undoubtedly be wheeled out as an explanation of underperformance for some over the next few months. Some of the key questions revolve around how far CMOs are prepared to look out to support their brands, as opposed to bridging with short-term campaigns, more easily curtailed or cancelled.

Transparency is likely to stay front of mind. Growing online reach and traffic have not been driving digital advertising revenues as was once hoped. Revenues per impression, or per click, have been falling while the market complexity has meant more intermediaries taking a cut from the process and serving more ads has just encouraged the use of adblockers. The breakdown in trust over this lack of transparency, exacerbated by brand safety concerns, has changed the balance of power in the relationships along the marketing chain. 2018 forecasts for digital advertising growth remain strong – GroupM's figure is for 11.3% growth vs 4.3% for the overall advertising market in 2018e. But, tellingly, the combined Facebook and Google 2017 gain was 186% of digital growth, so taking considerable share and 84% of all digital growth in the year (ex China). This dominance of the so-called FANG stocks (Facebook, Amazon, Netflix, Google) shows no signs of abating. The introduction of the GDPR (General Directive on Privacy Regulation) in May 2018 could even drive more business their way, adding complexity and costs. One of the consequences is to drive the incentive for publishers and other providers to generate income from online content in other ways than advertising, with a resurgence of interest in subscription-based models and better monetisation of e-commerce.

The willingness to subscribe for content is partly a response to the proliferation of content, some of which is of dubious origin, and a shift in the balance in the value of consumers' available time, along with more flexible pricing models. Deloitte's latest outlook survey reckons that by the end of 2018, 50% of adults in developed economies will have at least two online-only subscriptions, rising to over four by end 2020. With the growing penetration of higher broadband speeds and 4G with larger mobile screens, reach is even greater. Traditional cable and satellite subscriptions, though, have been losing out to digital alternatives that are cheaper and allow for more flexible bundling, including traditional broadcasters.

The power imbalance with the FANGs is also likely to be a continuing driver of consolidation amongst content providers. The Disney-21st Century Fox and AT&T-Time Warner tie-ups are unlikely to be the last of the major deals.

Sector focus: Mining

Analyst

Charles Gibson

Cleaning up

If metals markets could be described in 2017, they might be encapsulated by the phrase, 'the great divergence'. Throughout 2015 and the first nine months of 2016 the degree of divergence in the prices of the 17 metals and minerals regularly tracked by Edison was minimal. Afterwards, it exploded. While it might be tempting to attribute this to the election of Donald Trump as president of the US, this may not be entirely fair. Initially, China's initiatives to clean up its back yard, with a suite of measures aimed at curbing dirty coal production, provided the impetus for a tripling of the coking coal price and associated strength in the iron ore price, which once again largely confounded analysts' expectations.

However, what can probably be said with reasonable certainty is that 2017 was the year that metals contributing to the 'clean' economy distinguished themselves from the rest of the pack. Four out of the five top performing metals in the 15 months to January 2018 were drawn from this constituency, namely cobalt (+174%), vanadium (+140%), copper (+49% despite being written off in mid-2016 as destined to wilt under a wall of newly mined supply), and palladium (+46% in sharp contrast to its dirtier sister metal, platinum, which was one of the worst performers). The price of palladium has reversed its traditional discount to the price of platinum and is widely tipped to overtake the price of gold. Such has been its rise that cobalt (usually priced in US$/lb) could now be priced in US$/oz – at c US$2.25/oz, it is not far from the price of silver as recently as 1992. There was even a late bounce in the price of nickel as the renewables/energy storage/battery/ electric vehicle story broadened its appeal. As a result, the average return over the period for all 17 metals and minerals was 37%. Even gold, which was towards the bottom end of the spectrum, returned a creditable 17% to investors over 2017 in US dollars (metal price data from Thomson Reuters).

Gold, equity indices and mining indices moved more or less in tandem until the middle of the year when mining indices suddenly took off, and until Q4, when general indices also took off. Over the 12 months, general mining indices outperformed general price indices (in the form of the Dow Jones and the FTSE 100 index), which outperformed gold, which in turn outperformed gold mining indices. For once, small cap shares tended to outperform large cap ones. In a reversal of recent form, London mining indices outperformed Australian ones, which outperformed Canadian ones. One other feature of the market was the skew in returns recorded by individual companies, eg while the average total return of the top 10 risers in the Bloomberg World Mining index was 160%, the average of the bottom 10 fallers was only -15% (the index rose 32%).

In 2018 we anticipate that the trend will continue to be investors' proverbial friend as long as China continues to grow, the US shows no sign of tripping itself up and no geopolitical upset appears to spoil the party. We expect base metals to continue to outperform precious metals (which should nevertheless continue to be held as an insurance policy), with a special focus on battery metals, and explorers to continue to outperform majors. However, as always, as and when the macro environment changes, investors should be poised to reverse course rapidly.

Sector focus: Oil & gas

Analyst

Sanjeev Bahl

2018 – an optimistic start

2017 inventory rebalance: 2017 was a year of transition for oil markets. OPEC acted cohesively, with Russia and 10 non-member producers reducing supply and drawing down inflated crude inventories. By the end of 2017 excess oil in OECD industry stocks had fallen from 300mmbo to c 110mmbo relative to the five-year average, driving a 22% increase in Brent (dollar terms). The MSCI World Energy Index delivered a 6% total return versus 23.1% for the MSCI World Index in 2017, a material underperformance after a strong recovery in 2016.

Testing US shale elasticity: Oil prices are likely to remain a key driver of sector performance in 2018. With Brent trading above $67/bbl, it is likely that the financially and operationally leveraged small/mid-cap E&P sector will see the lion's share of gains in Q118. However, the sustainability of the recent rally in crude is likely to come into question as prompt price strength, and a shift in term structure from contango to backwardation tests US shale oil price elasticity. The IEA currently estimates US shale growth of 870kbod in 2018, which would lead supply growth to exceed demand growth in H118 based on the agency's forecasts.

Debt, distributions and developments: It is uncertain whether higher oil prices and resultant cash generation would lead to an increase in organic investment across the E&P sector as financially leveraged stocks are put under pressure to reduce their debt burden and shareholders demand capital constraint and greater distributions. Nevertheless, we expect to see an increase in capital available for organic growth opportunities that can take advantage of a lag in oilfield service pricing and which offer a high risked return on a $50-60/bbl oil long-term planning assumption.

Cautious optimism: Our outlook for 2018 is of cautious optimism. OPEC has acted successfully to reduce the inventory overhang and demand growth remains robust in the short term, notwithstanding welcome advancements in fuel efficiency and vehicle electrification. A stable oil price above $60/bbl is likely to be viewed as 'light at the end of the tunnel' by many E&P management teams, shifting the focus from debt obligations and covenants to distributions and growth. There is potential for oil prices to move higher as inventories normalise, with the market reverting to pricing in a supply risk premium to reflect the probability of disruption – this was apparent in early 2018 with disruptions to the North Sea Forties pipeline and unrest in Iran. Nevertheless, in light of our global macro view, whereby restrictive monetary policy curbs global output and oil demand growth, investors will have to remain selective, stress testing investment opportunities in the event of an oil price correction.

Sector focus: Technology

Analyst

Dan Ridsdale

Technology outgrows the sector

Belief returns in spades: It was difficult to lose money investing in technology stocks in 2017 – such was the universal outperformance of technology indices against a very positive equity markets backdrop. Within this, companies exposed to strong structural growth trends – particularly cloud computing, cyber security, internet of things (IoT, certain segments), digital payments and gaming substantially outperformed those who lacked it – regardless of the substantially higher valuation ratings of these growth stocks entering the year. This outperformance was driven by a combination of superior earnings growth and a significant valuation re-rating as belief in technology disruption surged across the investment community.

Technology is perhaps the key driver of value creation in listed markets: The re-rating of the structural growth stocks has been such that many valuations now look compelling and some look extended. We concede that, at any point in time the sector invariably plays host to a number of overhyped themes and it is doubtful that the sector as a whole will repeat its outperformance in 2018. However, we believe commentary drawing parallels with the dot-com bubble are off the mark. The extent to which technology innovation has become a driver of economic growth cannot be ignored. For example, Polar Capital estimates that if the technology sector was excluded from the S&P index, blended earnings growth would fall from 6.2% to 2.8% and this does not include the role technology is playing in driving earnings outside the sector. Technology companies make up seven of the top 10 largest companies globally by market capitalisation and all of the largest four.

Looking beyond the technology sector for plays on tech disruption: The confluence of multiple technology trends such as cloud, IoT, social media, automation, AI and, in due course, distributed ledger (blockchain, tangle) is creating unprecedented opportunities to transform nearly every industry. In many cases the best ways to play this will not necessarily be in the technology sectors, but in the most capable, committed innovators within “traditional” industry verticals. Reflecting this, over the past year or so we have seen a number of technology fund managers establish funds with remits which span beyond the technology sectors and seek to play disruptive themes across a broad range of industries. For more generalist investors, gaining a firm understanding of a corporate’s technology strategy is becoming imperative.

We highlight our view on some key themes overleaf.

Sector focus: Technology (continued)

Artificial Intelligence: AI remains one of the most prominent themes and there is no question that this is a major technology trend. However, we remain cautious about investing strongly into this theme in isolation, particularly in small/mid-cap technology equities. The term AI is being overused as a valuation multiplier and, in the technology sector, the big ecosystem players appear to hold most of the cards, particularly the search engines – Google/Alphabet and Baidu. We believe that Google has extended this lead over the past 12 months. Beyond this, we believe the most investable listed AI market plays may lie outside the technology sector, where companies can combine AI with large data sets and domain expertise to automate consumer interaction or dramatically accelerate research tasks.

Automation: AI is just one part of a very significant trend towards automation, along with robotics (hardware and software), digitisation and not to neglect good old software, analytics and faster processing power. These technologies will progressively enable the automation – or partial automation – of more and more skilled or complex tasks. Corporate investment in automation is accelerating and companies that ignore this trend may find themselves underperforming competitively or financially sooner rather than later. The scope for value creation and destruction spreads across nearly all sectors. The risk that pervasive automation drives a further polarisation in wealth is real, and policy will also come under increasing pressure to address this.

Cloud computing – irresistible momentum: This remains the strongest structural technology growth trend and we expect this to continue for some time. The rate at which data and computing are moving to cloud platforms continues to gather pace. It is also the technology cycle on which the development of many others, such as big data analytics and AI, depend, which strengthens the case for enterprises to move data to the cloud. Following mostly difficult transitions, companies that invested in transitioning their business models early are now outperforming, while growth is slowing and margins are contracting for those that did not. Newer businesses are now able to potentially gain a cost and flexibility advantage over older peers by leveraging cloud infrastructures (PaaS, third-party SaaS solutions etc) while focusing on their core differentiators.

Distributed ledger (blockchain, tangle etc): Like AI in 2016, blockchain and cryptocurrencies surged into public consciousness in 2017. We believe that in due course the disruptive potential of both distributed ledger technologies (embracing blockchain and tangle plus others) and cryptocurrencies is high. However, cryptocurrencies aside, we are yet to see many instances of where distributed ledger technology has actually been successfully deployed, and there are few investable opportunities on the public markets. While there have been numerous IPOs (and rebranding) of 'blockchain companies', most of these are very much in the development phase, and many are little more than fledgling ideas. From our initial research into the technology, we also believe that the tangle may have more potential than blockchain due to its superior scalability.

Sector focus: Technology (continued)

Cyber: The incidence and scale of cyberattacks continued to increase in 2017 with high-profile breaches such as Equifax, ransomware (WannaCry, NotPetya) and the Russia-backed manipulation of social media the tip of the iceberg. We see no reason for this to abate and expect attacks to become more sophisticated, and the industries targeted more widespread as machine learning becomes increasingly powerful. IT departments, already under strain, will need to incorporate more dynamic security tools that incorporate a higher level of automation in their threat detection and are more likely to turn to companies that can offer a networked or holistic view of the threat landscape. Ahead of the May implementation of General Data Protection Regulation (GDPR), we also expect a last-minute surge of activity for the consulting industry as companies scramble to get their compliance in order. Furthermore, with identity fraud increasingly commonplace and almost everyone's personally identifiable information (PII) available for purchase on the dark web, consumers increasingly accept the need for multi-factor authentication for most online transactions. As such, we expect companies offering these solutions, as well as next-generation IAM solutions, to have another good year.

Edison dividend list

Company name	FY0 period end	Currency	DPSFY0	DPSFY1	DPSFY2
4imprint Group PLC	2016/12	USD	52.5	57.5	62.5
Acacia Mining PLC	2016/12	USD	10.4	1.3	1.3
APQ Global LTD	2016/12	GBP	0.5	6.0	N/A
Augean PLC	2016/12	GBP	1.0	1.2	1.4
Avon Rubber PLC	2017/09	GBP	12.3	16.0	20.8
Bezant Resources PLC	2016/06	GBP	1.0		
Borussia Dortmund PLC	2017/06	EUR	6.0	6.0	7.0
Brady PLC	2016/12	GBP	0.0	0.0	0.5
Braemar Shipping Services PLC	2017/02	GBP	14.0	15.0	15.8
Caledonia Mining Corp	2016/12	USD	28.4	27.5	27.5
Carclo PLC	2017/03	GBP	0.0	0.0	3.9
Carr's Group PLC	2017/08	GBP	4.0	4.2	4.4
Cenkos Securities PLC	2016/12	GBP	6.0	11.0	
Centrale del Latte d'Italia S.p.A.	2016/12	EUR	6.0	6.0	6.0
China Aviation Oil (Singapore) LTD	2016/12	USD	3.3	3.3	3.8
China Water Affairs Group LTD	2017/03	HKD	20.0	12.5	15.0
Circle Property PLC	2017/03	GBP	5.0	5.2	5.2
Coats Group PLC	2016/12	USD	0.8	1.5	1.7
Cohort PLC	2017/04	GBP	7.1	8.2	9.0
CREALOGIX Group AG	2017/06	CHF	50.0	100.0	150.0
Custodian REIT PLC	2017/03	GBP	6.4	6.5	6.6
DeA Capital S.p.A.	2016/12	EUR	0.1	0.1	0.1
Ebiquity PLC	2016/12	GBP	0.7	0.7	0.8
Eddie Stobart Logistics PLC	2016/11	GBP	0.0	5.4	6.3
EMIS Group PLC	2016/12	GBP	23.4	25.8	26.8
Entertainment One PLC	2017/03	GBP	1.3	1.4	1.5
Epwin Group PLC	2016/12	GBP	6.6	6.7	6.7
EQS Group AG	2016/12	EUR	75.0	0.0	15.0
Esker PLC	2016/12	EUR	30.0	33.0	36.0
Euromoney Institutional Investor PLC	2017/09	GBP	30.6	31.0	34.0
Focusrite PLC	2017/08	GBP	2.7	3.0	3.3
Game Digital PLC	2017/07	GBP	1.0	0.0	0.0
GB Group PLC	2017/03	GBP	2.4	2.5	2.8
Greggs PLC	2016/12	GBP	31.0	32.8	34.8
Jersey Electricity PLC	2016/09	GBP	13.5	14.2	14.9
John Laing Group PLC	2016/12	GBP	8.2	11.0	10.0
La Doria PLC	2016/12	EUR	18.0	17.0	20.0
Learning Technologies Group PLC	2016/12	GBP	0.2	0.3	0.4
London Stock Exchange Group PLC	2016/12	GBP	43.2		
Lookers PLC	2016/12	GBP	3.6	4.0	4.2
Low & Bonar PLC	2016/11	GBP	3.0	3.2	3.3
Marshall Motor Holding PLC	2016/12	GBP	5.5	6.5	6.9
Medserv PLC	2016/12	EUR	0.0	0.0	3.8
Mondo TV S.p.A.	2016/12	EUR	2.0	0.0	0.0
Norcros PLC	2017/03	GBP	7.2	7.8	8.4
Numis Corporation PLC	2017/09	GBP	12.0	12.0	12.0
Ocean Wilsons Holdings PLC	2016/12	USD	63.0	64.0	67.0
OTC Markets Group INC	2016/12	USD	116.0	116.0	119.0

Palace Capital PLC	2017/03	GBP	18.5	19.0	19.5
Pan African Resources PLC	2017/06	GBP	0.5	0.9	0.9
Picton Property Income LTD	2017/03	GBP	3.3	3.4	3.5
Piteco S.p.A.	2016/12	EUR	15.0	17.5	20.0
Polypipe PLC	2016/12	GBP	10.1	11.7	12.9
PPHE Hotel Group LTD	2016/12	GBP	21.0	22.0	23.0
Primary Health Properties PLC	2016/12	GBP	5.1	5.3	5.4
QinetiQ Group PLC	2017/03	GBP	6.0	6.4	6.8
Rank Group PLC	2017/06	GBP	7.3	8.1	8.8
Raven Russia Ltd LTD	2016/12	USD	2.5	2.0	2.0
Record PLC	2017/03	GBP	2.0	2.3	2.4
Regional REIT LTD	2016/12	GBP	7.7		
Renewi PLC	2017/03	GBP	3.1	3.1	3.1
SCISYS PLC	2016/12	GBP	2.0	2.2	2.4
Secure Trust Bank PLC	2016/12	GBP	75.0	79.0	83.0
Severfield PLC	2017/03	GBP	2.3	2.7	2.8
Share plc PLC	2016/12	GBP	0.3	0.3	0.5
Shore Capital Group LTD	2016/12	GBP	5.0	10.0	
SNP Schneider-Neureither & Partner AG	2016/12	EUR	39.0	45.0	52.0
StatPro Group PLC	2016/12	GBP	2.9	2.9	2.9
Stobart Group LTD	2017/02	GBP	13.5	18.0	18.0
Stride Gaming PLC	2017/08	GBP	2.7	3.0	4.0
Target Healthcare REIT LTD	2017/06	GBP	6.3	6.5	6.6
Treatt PLC	2017/09	GBP	4.8	4.6	4.9
Trifast PLC	2017/03	GBP	3.5	3.7	3.8
TXT e-solutions S.p.A.	2016/12	EUR	30.0	15.0	16.0
Tyman PLC	2016/12	GBP	10.5	12.3	13.8
Ultra Electronics Holdings PLC	2016/12	GBP	47.8	49.6	52.0
Walker Greenbank PLC	2017/01	GBP	3.6	4.5	5.6
Wheaton Precious Metals PLC	2016/12	USD	21.0	33.0	42.0
WYG PLC	2017/03	GBP	1.8	1.8	1.9
XP Power LTD	2016/12	GBP	71.0	76.0	79.0
YouGov PLC	2017/07	GBP	2.0	2.3	2.5

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32Red	Travel & leisure	Update	13/03/17
7digital Group	Media	Flash	07/12/17
4imprint Group	Media	Update	01/08/17
Aberdeen New Dawn Investment Trust	Investment trusts	Investment company review	23/07/15
Aberdeen New Thai Investment Trust	Investment companies	Investment company review	13/11/17
Aberdeen Private Equity Fund	Investment companies	Investment company review	16/11/15
Aberdeen UK Tracker Trust	Investment companies	Investment company review	31/07/15
Acorn Income Fund	Investment companies	Investment company review	03/10/17
AFH Financial Group	Financials	Update	26/01/16
African Petroleum Corporation	Oil & gas	Update	18/03/16
Alabama Graphite	Metals & mining	Update	01/11/17
Alkane Resources	Metals & mining	Update	23/11/17
Amur Minerals	Metals & mining	Update	07/03/16
appScatter	Software & comp services	Initiation	28/11/17
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Ariana Resources	Metals & mining	Update	02/03/16
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Augean	Industrial support services	Update	30/10/17
Avanti Communications Group	Fixed satellite services	Update	15/12/17
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BlackRock Greater Europe Inv. Trust	Investment companies	Investment company review	11/08/17
BlackRock Latin American Inv. Trust	Investment companies	Investment company review	31/07/17
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Braemar Shipping Services	Industrial support services	Outlook	10/05/17
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Dunedin Enterprise Investment Trust	Investment companies	Investment company review	05/10/15
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Edinburgh Worldwide Investment Trust	Investment companies	Initiation	13/10/14
Egdon Resources	Oil & gas	Flash	05/01/18
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EMIS Group	Software & comp services	Update	05/09/17
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EQS Group	Media	Update	16/11/17
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Jersey Electricity	Industrials	Outlook	03/03/17
John Laing Group	Investment companies	Update	13/12/17
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JPMorgan Global Convertibles Inc Fund	Investment companies	Investment company review	28/07/17
JPMorgan Global Growth & Income	Investment companies	Investment company review	21/06/17
JPMorgan Private Equity	Investment companies	Investment company review	28/04/15
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paragon	General industrials	Update	24/11/17
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Picton Property Income	Property	Update	30/11/17
Piteco	Software & comp services	Update	10/10/17
Pointer Telocation	Tech hardware & equipment	Update	27/11/17
Polypipe	Construction & materials	Update	22/11/17
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PPHE Hotel Group	Travel & leisure	Flash	06/11/17
Primary Health Properties	Property	Update	18/12/17
Prodware	Technology	Update	26/05/16
PSI	Technology	Update	10/11/16
Qatar Investment Fund	Investment companies	Investment company review	23/02/17
QinetiQ Group	Aerospace & defence	Update	30/11/17
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The Scottish Investment trust	Investment trusts	Investment company review	26/07/17

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Touchstone Exploration	Oil & gas	Update	23/01/15
Tourism Holdings	Travel & leisure	Update	05/09/16
TR European Growth Trust	Investment trusts	Investment company review	28/11/17
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Yowie Group	Food & beverages	Update	22/09/17
YPB Group	Industrial support services	Update	10/06/16

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