The Cut

Bringing the latest views from a selection of Independent Research Providers working with IRF

Edition 2 - 27th January 2017

***Editor's Note** - Welcome to the next edition of The Cut from Independent Research Forum (IRF) in which we bring the latest views from a selection of Independent Research Providers working with IRF*

We highlight outside-the-box thinking, contrarian viewpoints and specific investment recommendations across macro, sector and single stock research

IRF works with 80 Research Providers covering all geographies, asset classes, industry sectors and methodologies

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Events associated with IRF

- **Co-sponsors of Global Independent Research Conference, 9 March, 1 Wimpole Street**
- **CAGE (Consumer Analysis Group Europe) Conference, 20-22 March, Hilton London Metropole**

Researchers visiting London in the coming month

- **Siebels Asset Management Research** - Jane Siebels, Founder, **27 January - 9 February**
- **Schulte-Research** - Paul Schulte, Founder & Editor, **30 January**
- **Bespoke Charts** - Aiden O'Donell & Brian Gray, Senior Analysts, **2-3 February**

- **Hedgeye** - Lt Gen USMC (Rey) Emo Gardner, Defence Policy, **20-21 February**
- **Hedgeye** - Jay Van Sciver, Sector Head - Industrials, **22-24 February**
- **Summit Redstone** - Srini Nandury & Jagadish Iyer, Senior Analysts, **23-24 February**

Macro Research

1. **Asbury Research** - Conditions are bullish for gold as they expect rising treasury prices and declining long term rates
2. **J Capital Research** - Anne Stevenson-Yang believes this is the year that China's financial system finally faces a crisis
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- Positive news for **Tesla** (TSLA US). **JL Warren Capital** – showing very strong sales for Tesla vehicles in China and **Roskill** – highlights Tesla's Gigafactory build up, seen as boosting lithium hydroxide and nickel sulphate demand
- **Stockcube Research** - **Long Altice S.A**. (ATC NA) as it makes new short term highs and closes long in Phillips Electronics (PHIA NA) as it encounters resistance

Macro Research

1. Asbury Research - Conditions are bullish for gold as they expect rising treasury prices and declining long term rates

IRF Note *– Taken from a section of their 'Monthly Investment Compass', Asbury, through the use of several key charts (see attachment), explain how the positive correlation between the yield of the 10y Treasury Note and S&P 500 indirectly suggests an upcoming shift out of stocks and into Treasuries. And given the inverse correlation between 10y Treasury yields and gold, they suggest that gold prices are headed higher during Q1. Some of the key points are outlined below:*

- Commercial hedgers are at a multi-year net long extreme in the T-Bond contract. Asbury says that represents an aggressive bet by the smart money on declining interest rates.
- Meanwhile, the yield of the benchmark 10y Note is declining from 2.63%, and according to Asbury appears poised to test at least 2.36% to 2.30%, and potentially 2.00%.
- They believe it would take a sustained positive shift in the T-Bond's 1-month rate of change to confirm that the commercial hedgers' bullish bet is working.
- Asbury go on to show that gold and platinum prices have maintained a tight and stable positive correlation to one another since 2000. Smart money commercial hedgers are also very bullish on platinum, which indirectly corroborates both Asbury's positive call on gold and negative call on rates.
- With gold prices having been inversely correlated to the USD since 2011, they argue rising gold prices should coincide with a declining USD.

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2. J Capital Research - China's financial system to finally face a crisis in 2017

IRF Note *– According to Anne Stevenson-Yang, co-founder of J Capital, when it comes to China, raw money flows have been better predictors of listed equity valuations than* *fundamental assessments. China benefitted from as much as US$2trn in incoming hot flows in 2012/13, lifting all floated boats together. However, now the market has grown sceptical of these and other Chinese listed Companies, but the scepticism (and reduced valuations) correlate with net outflows since mid-14 more than with any change in the way companies report. Some of the key points are outlined below:*

- In the coming year capital will be tighter – Anne points to the fact that it is already draining (US$41bn in Dec which they think is certainly a low-ball number) and companies reliant on raising new capital such as Alibaba, VIPShop, will be challenged to match their earlier growth.
- Companies with operating leverage and disciplined management should do well.
- Anne thinks China will not allow any disaster to occur before their Oct Party Congress and thinks they may try to pull off another round of housing appreciation or seek to foster another bubble in a different asset class (gold/Wealth Management Products are examples offered).
- But Anne believes these self-imposed hurdles can only be met so many times and 2017 could well be the year China sees a financial crisis.
- Arbitrage plays – Anne describes how the new fluidity of the global market will not change. Government structures will, but much more slowly. Innovative new companies will be those that offer arbitrage strategies to take advantage of the gaps between regulatory regimes. The hottest plays now according to Anne are the payments, stored-value cards and online trading companies.

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3. Longview Economics - Remain Underweight EM assets as multi-year bear market set to continue

IRF Note - *The EM equity bear market is now almost 6 years old. Key EM indices are down by ~30% from their 2011 highs (US$ terms). Relative to DM equities, they have roughly halved. With that, the case for owning them has grown. But Harry Colvin, Director & Senior Market Strategist at Longview, is not convinced. For EM equities to outperform DM equities, they need to i) deliver faster earnings growth; ii) re-rate higher; and/or iii) outperform due to currency strength. Harry argues that none of those are likely. Indeed, the reverse is a key risk, with EM equities remaining in an ongoing bear market. Some of the key points are outlined below:*

- Underlying EM growth dynamics are poor. Rapid growth seen over the last 15 years is largely complete. China is the prime example, where the investment share rose from 34% in 2000 to 48% in 2011.
- But there others such as Indonesia, and the problem is that currently investment shares are trending down in 8 of the 10 key EM/proxy EM economies Longview track.
- Productivity has also deteriorated significantly in recent years (*see attachment for chart*).
- The direction of capital flow has been the key driver of emerging market equity performance and so tighter Fed policy, and continued capital flight from EM economies, should result in relative underperformance of EM assets.
- The relative PER of EM to DM equities is tightly correlated with EM bond spreads. EM credit spreads have narrowed considerably in recent months. But given the points

above, it’s unlikely that the risk premium on either equities or credit will fall meaningfully from current levels (indeed the reverse is a key risk).

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4. Palissy Advisors - Oil price to hit $85 before year end as US shale faces major bottlenecks in ramping up activity

IRF Note *– Matthieu Raimbault, founder of Palissy Advisors, isn’t afraid to go against the consensus with his forecasts for 2017. Having recently provided clients with his Macro and Commodity views for 2017, these are the cornerstone from which Palissy Advisors generate detailed bottom up equity investment ideas. Some of the key points from his 2017 Oil Report regarding why ‘the lazy $50/$55 consensus oil price equilibrium is wrong, detailing true US Shale corporate breakevens at $85 are outlined below:*

- Matthieu was bullish on oil from Q1 16 having anticipated a supply response to low prices. Before the recent OPEC deal he argues we were exiting a downturn with no spare capacity for the first time in oil markets history.
- According to Matthieu, the ability of US onshore shale oil to ramp up activity is vastly over estimated. Reasons include: Frac sand availability, Frac crew labour force and Pressure pumping equipment.
- He argues that existing oil services capacities already can’t satisfy demand and pressure pumping equipment attrition is evident; Matthieu thinks the effective utilisation rate is already close to 80%!
- Matthieu expects E&P’s to release strong production guidance at FY in the coming weeks. So the market will be concerned by production guidance and this will happen before real checks on OPEC deal (Q2). But very quickly we will see multiple production warnings/guidance cuts due to the bottlenecks mentioned above and 2017 will show how costs are cyclical in this industry rather than structural.
- He thinks investments themes to play are early cyclical oil services, North American exposed oil services names, high yielding big oil companies and high netback International E&P’s with higher exposure to fixed costs.

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5. Topdown Charts - Callum Thomas explains why there is a high chance of more carnage in bonds in 2017

IRF Note *– Callum Thomas, founder of Topdown Charts, in one of his recent ‘Weekly Macro Themes’ shows how global growth indicators are improving around the world. He believes the historical experience of PMI expansions along with the proximity of the major bond markets to key trend lines means 2017 could be extremely chaotic in the bond market. Some of his key points are outlined below (see attachment for chart & table):*

- He explains how the average expansion of the US manufacturing PMI since the mid-80's was 11.1pts (excluding 2008) and took an average 14 months.
- Callum says if you add this to the trough of 48 in Dec 15 the implied peak would be c.59.1 in Feb this year. The current move has so far been 6.7pts across 12 months (implying 4.4pts upside).
- Alternatively, the chart also shows what it would look like if you just took the 2012-13 expansion in the DM composite PMI and projected it on the current experience. On the basis of history repeating itself, Callum believes it is not that hard to paint a scenario where you get the US 10y yield sailing above 3.5%!
- Callum also points to the fact that the US 10y is sitting at it's trend line of the past 10 years and that of Germany/Japan/UK are all getting closer to testing their own trend lines and thinks there will be a domino effect where yields break out across the world's major bond markets.

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6. WaveTrack International - Euro Stoxx 50 to significantly outperform this year

IRF Note *– Taken from their 'Elliott Wave Navigator', WaveTrack's monthly flagship report and utilising the Elliott Wave Principle as well as their own proprietary indicators. WaveTrack are targeting gains of 36% (at time of writing) from the EuroStoxx 50. The key points are outlined below to supplement the chart which can be found in the attachment:*

- The post-financial-crisis recovery has begun by unfolding into a zig zag pattern ending into the Apr. '15 high at 3836.28. According to WaveTrack, both pattern structure of the zig zag, subdividing 5-3-5 and fib-price-ratios confirm this diagnosis.
- The following decline completed a corrective pattern into the Feb. '16 low at 2672.73. They believe that this indicates the post-financial-crisis recovery is set to extend into a double zig zag pattern. Extending the first sequence by a fib. 61.8% ratio projects a terminal high for the secondary sequence towards 6197.32+/-, scheduled for a conclusion in year-2020+/-.
- This results in prices breaking into new record high territory but only as super-cycle wave 'B' within a multi-decennial expanding flat pattern. Extending super-cycle wave 'A's decline above the Feb. '00 high by a subliminal fib. 9.01% ratio projects the terminal high for super-cycle wave 'B' towards 6119.32+/-.
- WaveTrack argue that once again, a close-convergence like this forms a fib-price-ratio matrix which pulls prices towards this area, but once the energy is discharged by the Fibonacci barrier, the pattern ends resulting in a reversal signature.
- They say that closer inspection of the cycle degree double zig zag advance from the Mar. '09 low of 1765.49 is shown here (*see chart!*), cutting the secondary zig zag to ultimate upside targets of 6197.32+/- by a fib. 61.8% ratio projects cycle wave A's high towards 4450.00+/-, hence, outperformance this year with gains of 36%.

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7. Macro Research Snippets -

Hedgeye - Their 'Hedgeye Canada Tracker' research product, aimed at helping investors spot changes in the Canadian Housing Market showed home sales fell -5.3% recently, which is the largest M/M drop since Aug 12. The Y/Y rate of change deteriorated for all four major regions (Vancouver deteriorated further to a -39.4% Y/Y contraction in Dec). Separately, small business lending came in at its lowest level since Jan 13. **Click here** for a short overview of this researcher

Messels - Taken from a recent Macro Chart Report, they display how the VIX trades at the bottom of it's multi-year range (*see attachment for chart. There is also a sample video from one of their recent chart movies*). Messels have proved that the key to success is in the analysts themselves, and their ability to cut through the noise by interpreting the correct meaning of market activity. The evidence is in the fact that they have consistently generated alpha over the long term. **Click here** for a short overview of this researcher

Trimtabs Investment Research - The TrimTabs Demand Index (TTDI), which uses regression analysis of fund flow and sentiment variables for market timing, dived deeper into bearish territory. It fell to 14.9 on Jan 12, its lowest level since Jan 23, 2009 (*see attachment for chart*). Since the TTDI is between 0 and 25, the TTDI Model Portfolio is 100% short the S&P 500 (1-2 month view). **Click here** for a short overview of this researcher

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Company Research

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1. Blueshift Research - Examines how major technological shifts in networking and storage affect IT and data centre host spending in 2017 and beyond

IRF Note *– Extensive analysis by Blueshift, sees IT costs continuing to drop, as technology advances allow data centre-based private network owners/operators to shut down more IT space than ever before. Small data "pods" powered by companies like Intel Corp. (INTC US) that can be located anywhere are coming to the market in 2017. However, not all Companies are set to benefit, as one CEO of a data services and integration firm had this to say about* ***IBM Corp.*** *(IBM US) "[they are] always going to be around, but they will never dominate again. The cloud is killing them." Some of the key points are outlined below:*

- Blueshift sources forecast a major shift in the target markets for public data centre operators like Equinix Inc. (EQIX US), CyrusOne Inc. (CONE US), DuPont Fabros Technology (DFT US) & Digital Realty Trust Inc. (DLR US).
- IBM also finds itself in the crosshairs, Blueshift believe they will have to consolidate a customer base that is not consolidating on the public superclouds. Their SoftLayer does not appear to be ready to deliver large-scale services across an integrated global platform, pushing it further behind AWS and Azure.
- If IBM does not begin to develop a broad data hosting platform for its clients, it will become an adjunct feeder company to AWS, which offers certain analytical services but not complete solutions for critical data hosting and high-end storage.

- While the IoT may become a searing negative for large facility owners, Blueshift highlights **Zayo Group Holdings Inc**. (ZAYO US) as one of the small carriers that are filling gaps overlooked by the larger data centres.

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2. Libra Investment Services - **BUY Infineon Technologies** (IFX GY) as a value gap has appeared between intrinsic and fair value

IRF Note *– According to Libra, Infineon is now back as a 5-star green (their highest rating!). They have spotted an opportunity as it is trading at both a discount to Fair Value (FV) and Intrinsic Value (IV). Their research is supplemented by a number of key charts and graphics (an example can be seen in the attachment). Key points include:*

- The FV and IV trend are rising once again. As FV rises, so does the FV range and the shares have found support at the lower boundary of that range and a value gap has appeared.
- Libra believes that gap provides an opportunity to buy into the story once again after it has underperformed the sector.
- Evidence is also provided that the shares highlight a better investment profile relative to its peers, for example IFX has a stronger 3m IV growth performance.
- Finally, Libra points to the fact that the timing is also good, as the Tech sector is once again in the top 4 on their beta heat map.

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3. SmartInsider - **Adds Uniper** (UNO1 GY) to their high conviction list after COO purchase, whilst additional Senior Director **selling** at **Acacia Communications** (ACIA US) gives cause for concern

IRF Note *- Here are two recent examples of the type of analysis SmartInsider offer their clients. Key points include:*

- Uniper – Rummler (COO) purchased 11,000 shares (early Jan) at an average price of EUR 13.10.
- He last purchased stock (Sept) at EUR 10.20, soon after the stock began trading and after being spun-out from E.ON SE. In addition to Rummler, Schafer (CEO) and Delbruck (Finance Director) each purchased shares at EUR 10.50 in Sept.
- SmartInsider see this purchase 3 ½ months after the spin-out, and at a higher price, as significant and they conclude by assigning a +1 rank (positive insider pattern).
- Acacia - Murphy (Corp. Controller) sold 6,752 shares (early Jan) at $62.15, half of it was option related.
- SmartInsider says this follows sales in Dec at $67 and Nov at $69, and while these sales don't appear aggressive, they are concerned that he continues to sell as the stock moves lower *(see attachment for chart)*.

- They also point out that while the stock is well up from its recent IPO at $23, the stock has recently fallen from $120 just 3 months ago.
- As a result SmartInsider are ranking the stock -1 (negative insider pattern).

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4. Storm Research - has initiated with a **Positive** rating on undervalued **eRex** (9517 JP) in report entitled 'Unfettered Access'

IRF Note *– Storm describes eRex as a Power Producer & Supplier (PPS) which retails electricity to businesses & households, undercutting regional utility rates by 3-8%. It recently added eRex to its select list of companies rated Positive, highlighting that the stock trades on just 12x 3/19 earnings for a projected 3 year OP CAGR of +58.8%. Key points include:*

- eRex now has unfettered access to the entire electricity supply market after Apr 2016 reform in Japan legalised PPS sales to low voltage customers, thus enabling competition with utilities. Storm emphasises that total PPS penetration remains low at just 6.3%, indicating significant expansion potential.
- Margins are improving on fixed rate high voltage contracts as a result of declining electricity consumption. Storm believes eRex is set to further capitalise by targeting profitable low usage customers via a network of affiliated agents.
- The steady acquisition of low voltage customers post reform is also resulting in margin improvement, enabling eRex to reduce the amount of surplus energy sold at low prices back to Japan Electric Power Exchange.
- Storm also notes eRex's plans to increase in-house capacity. Given energy derived from the company's own biomass plants is cheaper than that of third party suppliers, the development should prove a further boost to earnings.
- Storm expects profitability on high voltage contracts to remain above plan in H2, with positive implications for FY earnings.

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5. Tematica Research - **BUY Nuance Communications** (NUAN US) as Voice goes big

IRF Note *– Coming out of CES 2017 earlier this month were a number of speeches that focused on voice recognition technology, which is one area Tematica has been focusing on in their 'Disruptive Technology theme'. Although they are bullish on some of the so called big-hitters in the industry (Amazon and Alphabet), their respective VDA businesses, at least in the medium term, will have at best modest influence on their overall financial picture. So, in their own words, Tematica would rather 'buy the bullets not the guns', and instead prefer Nuance Communications* (NUAN US). Some of the key points include:

- Overall market growth for voice recognition technologies expected to grow from $90.3bn in 2015 to $184.9bn by 2021. As a result, Tematica see ample room for Nuance to expand beyond the $1.9bn in revenue it generated in 2016.
- Recurring revenue means greater visibility - Nuance have been shifting from a contract business model to a Cloud based one that offers integrated solutions. In 2016, c.70% of the company's revenue stream was recurring in nature, up from c.65% in 2015, and they expect further improvements this year.
- Opportunity in the Automotive sector - Tematica believe we are nearing the tipping point for the Connected Car, which should bode well for their Mobile segment (19% of revenue)
- Tematica highlight the fact that Alphabet recently acquired Limes Audio to improve its voice recognition capabilities and think that Nuance could be an attractive target for a larger player.
- With Nuance shares trading at under 10x expected 2017 earnings of $1.59 per share, Tematica set a price target of $21.

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6. The Retail Tracker - How trend changes are impacting the retail sector, benefitting companies such as **L Brands** (LB US) and **TJX** (US) but causing problems for **Burberry** (BRBY LN)

IRF Note *– Technology impacts many areas of our lives and retail is no exception. Retail Tracker believes the profound changes are creating space for winners to gain momentum and losers to suffer more pain. Some of the key trends are outlined below, as are some of their winners and losers:*

- Branding is the focal point - shoppers are browsing online before they arrive in the store creating an intent to purchase. Retail Tracker argues retailers must invest in online marketing to win shopper's attention digitally to increase the likelihood of store traffic.
- Buzzfeedification - Buzzfeed and its lists, quizzes and general exclamatory tone have fed a generation. Millennials respond to this type of marketing and messaging and retailers must respond by incorporating this approach into their strategy.
- Snapchat Retail - Retail Tracker's view that retailers provide apparel (tops) that are inexpensive to be seen in a few snaps and then discarded. The documentation of one's life means consumers are constantly updating parts of their wardrobe.
- Bricks & Clicks will remain a powerful combination. While e-tail will continue to grow Tracker believes smaller stores that serve as points of brand distribution and returns will be critical in the future.
- While retail has turned upside down, it is the product and brand that will still drive the thought and motivation to buy with the promotion cinching the deal.
- Retail Tracker believes L Brands (LB US) has begun to recover with changes to Victoria's Secret offering creating big H2 upside. TJX (TJX US) remains a favourite as they appeal to the Snapchat and branded consumer while they continue to expand in the US and Europe.
- Burberry (BRBY LN) has priced in a recovery that may be limited given their challenges in outerwear.

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7. Company & Sector Research Snippets -

Things looking good for **Tesla Motors** (TSLA US)

JL Warren Capital - Strong sales for **Tesla** in China as 2,322 units of Tesla cars were imported in Nov 16, compared to only 226 units in Nov 15. From Jan to Nov 16, Tesla exported 9,159 units of cars to China, 3.5x more than the same period in 2015. JL Warren's research also suggests that the order book for the Model 3 is strong. Complementing Tesla's improved affordability, the build-out of charging stations in key markets (primarily T1 and 2 cities) has greatly reduced consumers' mileage anxiety. **Click here** for a short overview of this researcher

Roskill - Tesla starts Gigafactory lithium-ion battery production in early Jan for cells that will be used in Tesla's Powerwall 2 and Powerpack 2 energy products. Model 3 cell production will follow in Q2 2017. Tesla intends to use the cells to build 500,000 electric vehicles, with the Model 3 starting production for 2018 delivery. Gigafactory ramp-up seen to boost lithium hydroxide and nickel sulphate demand from 2017. **Click here** for a short overview of this researcher

Stockcube Research - Combining major technical indicators, price, volume, momentum and relative with other proprietary tools, their analysis produces alpha-generating ideas. They recently opened a long position in **Altice S.A.** (ATC NA) as it makes new short term highs on bullish VAD (Volume Accumulation Distribution). With an Abs. Target of 22.50 and a trend score (proprietary indicator) of 88 (out of 100) emphasising the strength of the trend. Stockcube also believe clients should watch to close longs in Phillips Electronics (PHIA NA) as it encounters resistance at 29, forming a short term relative top and trend score 79 (See attachment for charts). **Click here** for a short overview of this researcher

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