Jefferies Prime Services Monthly

OUTLOOK 2019

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*****The Jefferies fiscal year runs through November 30th, so December 1st is our 'new year.' We hope this piece – while a bit early – prompts some reflection on the year to date and stimulates conversation as to what may lie ahead. Thank you to all of our clients and partners for a productive and successful 2018, and…'Happy New Year.'*****

Jefferies

Going Out with a FAANG…

In the month leading up to this publication, the FAANG stocks saw $1 trillion of value wiped out, leaving the S&P relatively flat for the year.

Some of what's been on our mind as we reflect on 2018 and prepare for what's next…

1. **When the Music Stops.** For much of 2018, despite small periods of volatility, equity markets marched up. Oil – marched up. U.S. rates – up. Many asset classes seemed impervious to the animal spirits and shocks of other years. Then, October happened – and with it came an apparent trap door for many asset prices.
2. **Is *Old* Data the Best Data?** Big data. Alt data. "Old" data is finally having its day, as managers become increasingly able to efficiently clean and digest traditional forms of data like governmental, regulatory or permitting data. "Old" data has a longer horizon, which can create more holistic data sets.
3. **The Era of *Hypercustomization*.** Given the industry's maturity – allocators increasingly go to managers *first* when seeking new solutions. Despite the enormous size of the long only market, more than half of managers have been approached by an allocator to create a long only, or strongly long biased product in the last 18 months.
4. **When – not if – we'll see data regulation in the U.S.** The pendulum has swung, and it's only a matter of time.
5. **On the Cusp.** Rather than being deep into the Technological Age, many believe were are transitioning into the *true* Tech Age – one built on and enabled by today's nascent innovations.

Biggest cliffhangers heading into 2019:

- Which blue chip stock will follow GE into the doldrums?
- Will Brexit be London falling or much ado about nothing?
- Can market optimism re-emerge after a tough end to 2018?

Our inaugural Prime monthly quoted Jimmy Iovine: **Everything we know could be wrong already**. It's no less true now than in 2017. The key is to stay focused on spotting what could be **right**.

TOP PREDICTIONS FOR 2019

Last year, we challenged ourselves to make a few predictions for the coming year. Twelve months later, we were close to spot-on. In the hopes of replicating that success, here are our bets for 2019.

Acceleration of specialization. The years of being everything to everyone are over. Healthcare/Tech specialists & Quant Directional are the only Equity substrategies to regularly welcome inflows. Managers go back to basics and focus on more specific themes or strategies.

Regulatory divergence. Brexit. Trump. Europe. For the first time in a decade, we have regulatory divergence across jurisdictions. As Europe ramps up its focus on data and privacy, these regimes continue to diverge.

New launches continue to gain steam – especially in Europe. The 2018 new launch landscape was fertile on both sides of the pond, with London start ups nearly twice that of 2016.

Aspiring neurosurgeons don't get their hands tested. Two decades ago, hiring engineers and quants was seen as going far afield from the "typical" Wall Street hire. Today, the quest for talent focuses on non-traditional candidates who may not be options & futures experts when they walk in the door

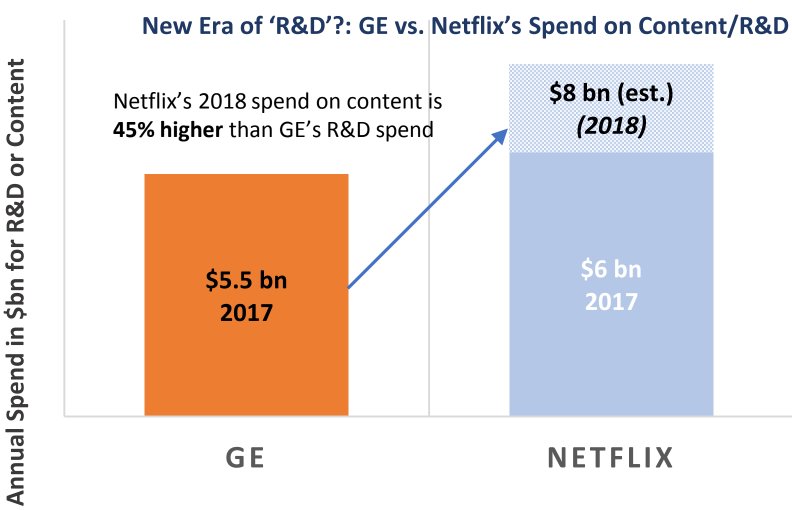
Oil, Light, Water. Energy investors continue to increase the scope of their portfolios – looking across multiple resources for asset allocation.

Next generation tech & data leaders will be on the enterprise side (B2B), after a decade of B2C dominance. Old economy drives next generation of data creation as IoT takes hold.

More Family Affairs. In 2019, we expect to witness more established managers moving to the Family Office model, a trend that has already picked up steam heading into 2018 year end.

INVEST TO GROW: CONTENT & THE FUTURE OF 'R&D'

Last year we noted that Netflix's anticipated 2018 content spend was **~45% higher than GE's entire R&D spend.** There has been pullback on NFLX, but we continue to believe that in this era – content is just as critical as R&D. To some, it **IS** R&D. Otherwise, what else could explain Amazon and Apple diving into the content ring? Because *content drives customer and client engagement*. Engagement creates data – which, as everyone knows, is the "new oil."



Source: GE Annual Report 2016; Netflix 3Q 2017 Earnings Call; Chart as of 11.21.2018

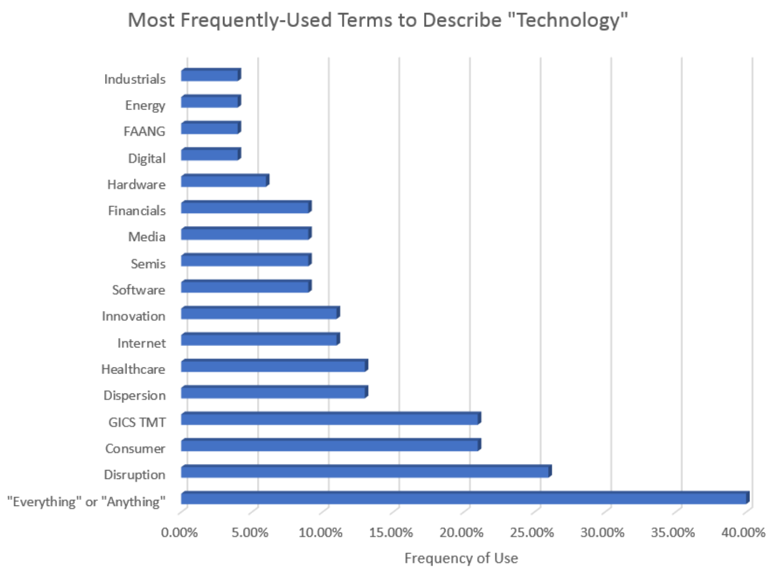
TECH-TONIC SHIFTS: A DEEP DIVE ON ALLOCATING TO "TECHNOLOGY" SECTOR FUNDS

In November, the Jefferies Capital Intelligence Team published its second sector-specific deep dive: Tech-tonic Shifts: A Deep-Dive on "Technology" Sector Funds.

At a time when everyone from the GICS classification to CIOs at the world's biggest pensions are trying to more precisely and accurately define "technology," the **Jefferies Capital Intelligence team conducted a deep dive with 50 leading alternatives** investors to precisely understand *why and how they have allocated to the space in the last few years*.

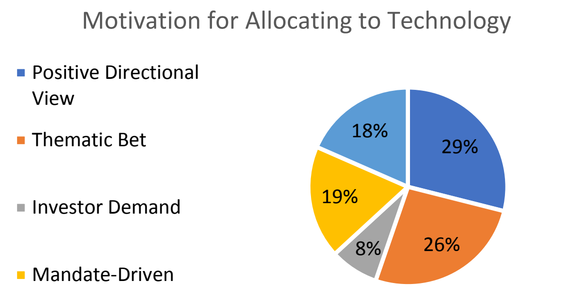
We drilled into **what technology means to investors *right now*, and what it means for portfolios in the years ahead, as they look to make allocations in the next 24 to 36 months.** The very definition of "technology" is shifting and expanding to include any company that is **data-driven and technology-enabled**.

One point of consensus amongst allocators is that **the definition of Technology from a sector perspective should be broad—broader than any other sector, as allocators look to identify and capture a paradigm shift not seen since the Industrial Revolution.** As such, **there is much less concern about mission creep from an investible universe perspective.**



Source: Jefferies Prime Services

While an overwhelming majority of allocators' initial motivation to invest in Technology was either a positive directional view on the sector or a thematic bet, almost 20% of allocators cite dispersion as their primary motivation for seeking exposure to the space. For many, **Technology is not purely a growth strategy.**

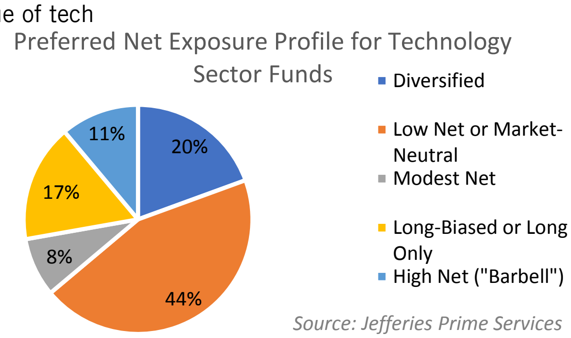


Source: Jefferies Prime Services

Though buy-and-hold strategies in technology have certainly seen success, allocators are increasingly focused on the ability of sectors specialists to unlock returns in the public market *across cycles*, and they speak highly of tech specialist managers who have also identified pockets of dislocation that sector generalist managers might miss.

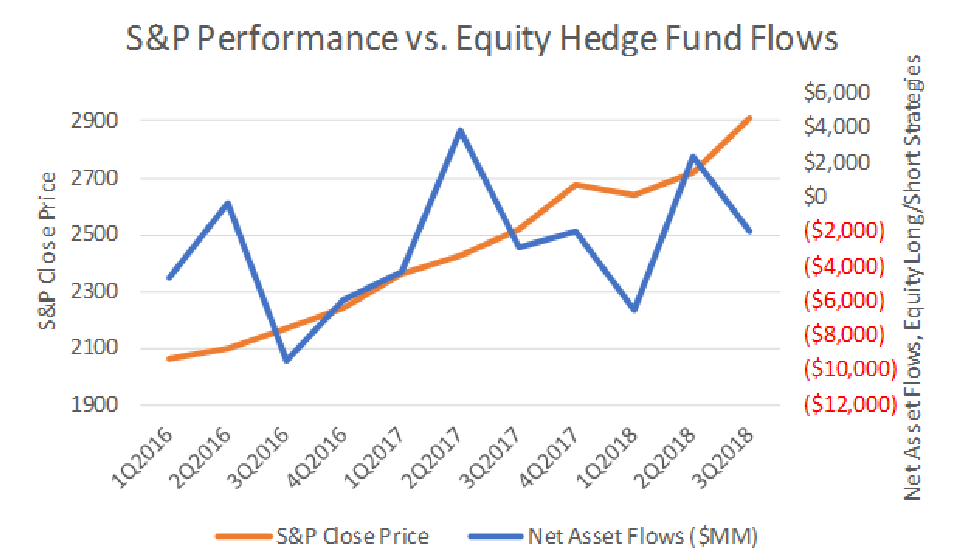
Allocators are on the lookout for managers who:

- Play in small- and mid-cap Technology names
- Maintain low net or market neutral exposure,
- Run capacity-constrained strategies, or
- Pursue a variety of idiosyncratic avenues for unlocking the value of tech



Source: Jefferies Prime Services

The Equity - Redemption Bloodbath That (Usually) Isn't



Sources: HFR, Bloomberg

We got a lot of questions as to whether the November 15th date for hedge funds requiring 45-day redemption notice ahead of year end would presage additional sell offs.

History does not bear this thesis out – at least at the broadest level. Perhaps at a security level, but not in aggregate.

Equity Long/Short hedge funds witnessed net outflows in **nine of the last 12 quarters**. The largest of which came in 3Q2016, when more than $9 billion left the strategy.

But these numbers represent just **.03%** of the U.S. Equity market. And redemptions don't typically trigger across the board selling of a manager's positions. Rather, strategic unwinds or targeted tailoring of specific holdings are the norm.

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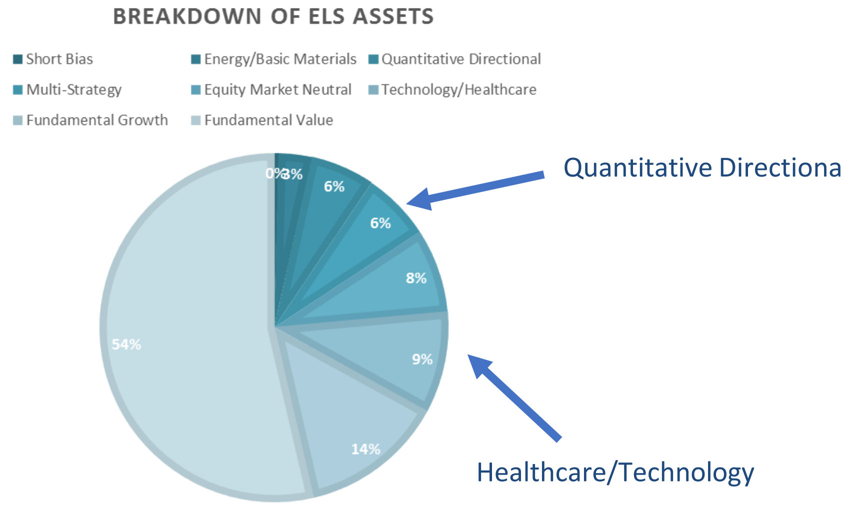
2019: THE YEAR AHEAD FOR SPECIALISTS' CAPITAL - HEALTHCARE

The **Jefferies Capital Consulting team spent time focused on specialist funds** in 2018, soliciting feedback from allocators across: hospital systems, insurance companies, family offices, endowments, foundations, consultants, Fund-of-Funds, and pensions, among others.

The resounding message: we are looking for "different" – and different often takes the form of specialist funds. Quantitative Directional and Tech/Healthcare specialist funds are the only two substrategies that have witnessed 6 straight quarters of net inflows. Both are a material and growing percentage of Equity Long/Short assets.



Quarterly Net Asset Flows for Equity Hedge Strategies

	Strategy	Q2 2017	Q3 2017	Q4 2017	Q1 2018	Q2 2018	Q3 2018
Equity Hedge	Energy/Basic Materials	$144	$151	$59	($285)	$156	($614)
	Equity Market Neutral	$105	$478	$1,221	$1,999	$1,101	($62)
	Fundamental Growth	($813)	$185	($4,886)	$457	($136)	($1,826)
	Fundamental Value	($2,824)	($6,592)	($1,472)	($9,751)	$1,558	($586)
	Multi-Strategy	$4,962	$476	$1,378	($335)	($1,701)	($435)
	Quantitative Directional	**$2,145**	**$1,903**	**$1,347**	**$1,275**	**$858**	**$1,169**
	Short Bias	($68)	$78	($13)	($47)	$1	($142)
	Technology/Healthcare	**$131**	**$434**	**$325**	**$115**	**$529**	**$510**
	Equity Hedge	*$3,782*	*($2,889)*	*($2,041)*	*($6,572)*	*$2,367*	*($1,986)*

Source: HFR

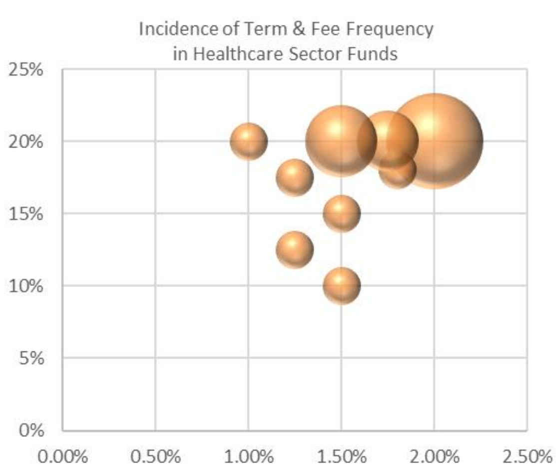
Spotlight on Healthcare Specialists

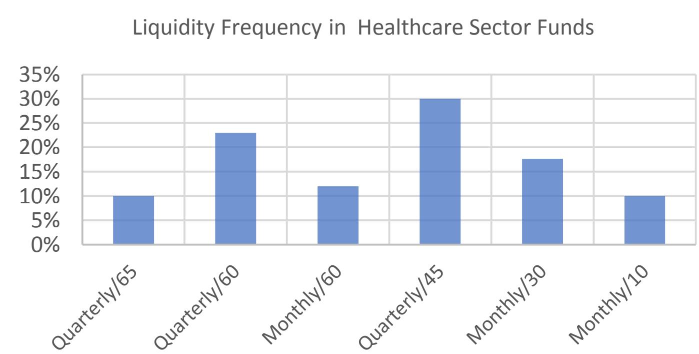
We conducted a deep dive on appetite for healthcare specialist funds – specifically what moved the needle from interest to allocation. *Checking the Pulse: A Deep Dive on Healthcare Funds* explored how allocators have responded to portfolio shifts by increasingly incorporating healthcare exposure.

While there was considerable diversity across type of fund, substrategy, overall capacity and ultimate reason for trigger pulling, there *was* consensus around terms and fees.

Healthcare is seen as a more expensive product – with average management and incentive fees lingering closer to traditional 2/20 model than other funds.

Liquidity is more in line – with the majority of funds falling into a Quarterly-60 or Quarterly-45 frame.





Source: Jefferies Prime Services

Another Day, Another Use Case for ESG

Sustainable investing may have once seemed like a fad, but with McKinsey estimating **nearly $23 *trillion* invested according to some form of ESG principles**, our clients and partners are now devoting time and serious thought to understanding the topic

In 2018, the Jefferies Capital Intelligence Team fielded questions about Environmental, Social, and Governance (ESG) driven investing that were increasingly frequent and sophisticated. Notable takeaways from these conversations include:

ESG uses cases are multiplying and evolving. Allocators no longer question why they should understand ESG investing—more than half of the 10 largest 1-day downward moves in single equity names have been ESG-related. **ESG has been empirically tied to improved profitability, lower tail risk, and lower systematic risk.** Now, we speak to allocators who utilize ESG in a variety of ways. **Last year, Japan's largest pension invested almost $9 billion in ESG indices.**

As they become more knowledgeable about ESG investing, **allocators are sharpening their view on its role in their portfolios, which varies widely**. While some leverage ESG data as a faith- or values-based screening tool, many others utilize climate change stress tests to perform scenario analysis and risk management.

Investors' questions are beginning to shift in scope. Data providers report that allocators are shifting their focus away from backward-looking questions (e.g. "How have stocks in my portfolio contributed to global emissions?") to forward-looking ones (e.g. "How do I build a portfolio for a certain global temperature contingency plan?")

The ESG data offering is expanding and improving. Investors want information that is **increasingly detailed, granular, standardized and actionable**, and data providers are producing models, stress tests, and screening mechanisms that meet this demand. Increasingly, allocators seek ESG data on the asset class level in addition to on individual equity names.

U.S. based allocators are increasingly having discussions around ESG investing and strategies – especially as the next generation rises at family offices and various institutions. ESG is more familiar with European and some Asian investors, but it is increasingly in focus as a way to more precisely reflect an organization's values.

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FIGURE A
Sustainable and Responsible Investing in the United States 1995–2018

SOURCE: US SIF Foundation.

2019: THE YEAR AHEAD IN CONTENT

State of the Union 2019

The Capital Intelligence team will publish our updated outlook on the unique role in the hedge fund industry in January

- Last year, we focused on the rising importance of *intelligence* in an era of data ubiquity. Clients, experts and providers alike are grappling with how to more effectively and efficiently navigate the enormous deluge of information.
- Looking forward to 2019, we believe that "Intelligence" will continue to act as a key differentiator of the next generation's success stories, but what this means is already – and constantly – evolving.
- Now, our clients will require Capital Intelligence, Organizational Intelligence, and Resource Intelligence to truly boast a competitive advantage—and we look forward to publishing content in the coming year on all of these matters.

Flagship Capital Introductions Conference

Our annual Flagship will be held on April 18th in New York City.

- In 2019, the Capital Introductions team will feature more than 30 hedge funds at its annual Flagship Conference in New York.
- If you are interested in receiving information about how to request a meeting with a featured manager, please reach out to your Jefferies Capital Introduction coverage contact.

Jefdata Advisory Services

The Jefferies Data Science Working Group offers ongoing advisory services to Jefferies clients and partners on the role of data in their firms.

- In this era of data ubiquity, the Jefferies Data Science working group sits as the nexus of funds leveraging data, data providers, and the experts and specialists focused on this rapidly evolving landscape.
- With representatives across our Equity Sales, Equity Research, and Prime Services franchises, the working group is uniquely positioned to provide guidance and advisory services to clients on any and all data-related inquiries.
- To subscribe to the Data Working Group's weekly newsletter, please contact Rich Carbone (Rcarbone1@Jefferies.com)

Ahead of Brexit: Notes from Europe – France

France's 3Q18 GDP growth came in at 1.5% y-y and was the third successive decline. More worryingly, industrial production slipped in September -1.1% y-y while export orders grew by a meagre 0.4% y-y in the same month. Just as concerningly new orders overall dropped 12.1 points in November following a similar double digit drop in October. Business confidence recovered from a two year low in November. Suddenly, a slowdown seems to be appearing everywhere. Similar to other EU markets we cover, pricing power has held up well.

'While there has been some loss of momentum in some of the macro indicators, the core driver of the economy – services is still running hot. The same is true for manufacturing. Meanwhile the labor reforms have entered a virtuous circle - falling unemployment alongside rising job openings. The consumer discretionary sector is on fire', France: Leaving the Past Behind (II), 20th August, 2018

'Once you break a habit into its components, you can fiddle with the gears', Charles Duhigg

Services up, manufacturing down. The latest Flash composite PMI (54) for November was little changed but manufacturing production contracted for the second month running while services continued to expand. The France Business Outlook showed expectations for new business and activity the lowest in two years. Paradoxically, the services business activity (54.8) accelerated last month and was the joint record fastest new expansion since April which came alongside the third consecutive month of job creation. Even so, French services businesses were unable to reduce their amounts of outstanding business - the volume of unfinished work has risen in every month since March 2016.

While the technical picture remains poor, the earnings story is more mixed. Although only 12% of companies had earnings upgrades of more than 5% over the past quarter, the percentage of downgrades was 37% (out of a universe of 407). The forward ERP is still cheap and the FCF yield spread versus bonds is wide at 5%. Real interest rates are deeply negative. Net margins have shown a steady improvement. 48% of companies (out of a total 388) had FCF yields over 5%.

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The Jefferies Global Strategy Team recently released notes on:

- France: *Changing Gears*
- Germany: *Passing the Baton*
- Switzerland: *Imperfect Perfect*
- Netherlands: *From Disinflation to Inflation*
- Ireland: *Difficult Questions, No Easy Answers*
- Norway: *From Disinflation to Inflation*
- Sweden: *Patently Obvious*
- Italy: *Tempering Expectations*

Ahead of Brexit: Notes from Europe - Netherlands

The Jefferies Internet team hosted multiple company and expert meetings across Seattle in November, which reinforced their view Amazon AWS is running away with a major lead in cloud and can help support a $750bn-$1trillion market cap by '22. While AWS is ~8x larger than Google Cloud, we continue to find encouraging partner/customer data points supporting our view that Google is no doubt the up and comer to watch. Both Amazon and Google remain top large cap picks.

Netherlands: From Disinflation to Inflation. The country could be described as being in somewhat of a goldilocks with the unemployment rate the lowest level since 2001 but wages starting to grow close to the German average of 4%. Furthermore, a virtuous circle has developed with budgetary surpluses forecast despite additional spending', Netherlands: A Global Reflationary Beneficiary (III), 22nd August, 2018

However there are some clouds on the horizon. While the September CPB produced its 'Macro outlook 2019' with the conclusion 'in the Netherlands, favorable economic developments are continuing', the October PMI reported their slowest new order growth in over two years . Importantly, the CPB highlighted that employment is set to increase at the same time as unemployment will decrease to the second lowest level of the last four decades. Meanwhile higher wage costs and the increase in the low VAT tariff will cause inflation to rise. In a perfect 'disinflation to inflation boom', the CPB reported that capacity utilization is approaching its highest level since the turn of the century - the positive outlook, low capital costs and large profits are encouraging business investments. Just under 40% of construction companies report that the labor market is a hindrance to production (see RHS chart). Interestingly, industrial confidence has waned, suggesting that business investment might be lower in 2019. The PMI fell to a 21-month low (57.1) in October - weakest increase in new export orders in two years and ongoing strong inflationary pressures.

Monetary conditions are loose. The Netherlands has negative real rates while the currency REER is trading in its historic mid-range since 2008. The Dutch yield curve is negative up to six years.

The equity market has fallen into the modestly cheap territory while earnings momentum is lackluster. On conventional measures (PB, PE), the market has de-rated to its lower part of the band, while the ERP is slightly inexpensive and the FCF yield versus government bond yields suggest the market is cheap. Market breadth is poor but a lot better than many of its peer groups. Based on Du Pont ratios, net profit margins have risen while leverage has fallen and, consequently, ROE has improved over the past three years. Over 15% of companies have FCF yield around 15%, 40% have an Altman Z score 3 (high solvency). Dutch companies continue to exhibit better earnings revisions than its peers while nearly 70% of companies have a FCF yield of 5% (out of a population of 46).

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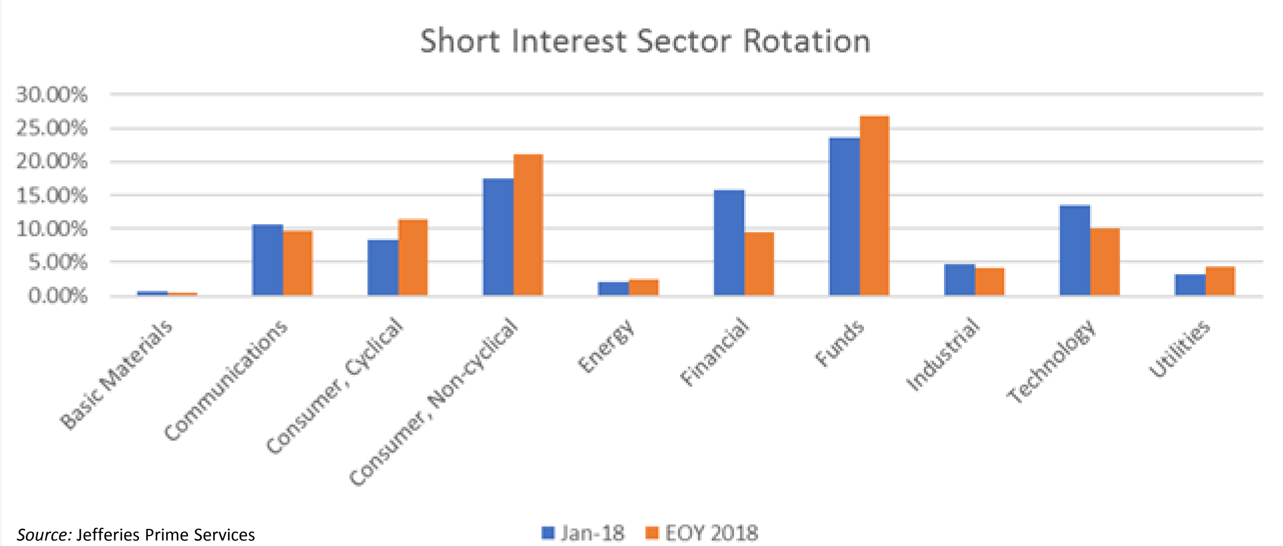
JEFFERIES SECURITIES FINANCE: 2018 – A SHORT LOOK BACK



Source: Jefferies Prime Services

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OBSERVATIONS & LOOKING AHEAD

2018 Observations

Long/shorts increased their exposure to both Consumer sectors over 2018.

- Other than the obvious add of Tesla during the year in the Auto Manufactures sector we have seen increases in short exposure to companies in the Pharmaceutical, Healthcare Services and Commercial Services sectors. In the second half of the year, we started to see additions to the short book in the Retail sector.
- Cannabis related stocks took the main stage from digital currency ones - especially in the hard to borrow space, which has seen an overall decrease in stocks trading non GC levels. Companies like Tilray, Canopy Growth, Cronos Group and Aurora Cannabis have all faced minimal supply with high demand over the past year.

The end of the year rotation into ETFs has been less about the traditional hedging strategies, that we typically see at the turn, and more of views around volatility, credit and commodities.

2019 Looking Ahead

From conversation with our clients, below are the important central themes going into 2019:

- Hedge Funds will continue to increase their need for term borrow for longer term financing and stability.
- Hedge funds becoming a bigger participant in the end of year as well as during the year funding activity as a direct counterparty with their Primes.
- Creating alpha from lending of longs.
- Emerging market shorts will continue to increase as a share of their portfolios as funds seek returns.
- Data and Prime activity will continue to play a large role in the added services that Primes are supplying or in some cases selling.

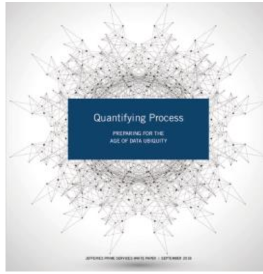
Suggested Reading & Listening

We continue to receive positive feedback on our humble reading and listening suggestions.
Here are a few more to help you close 2018 in the most interesting, informative or humorously way possible….

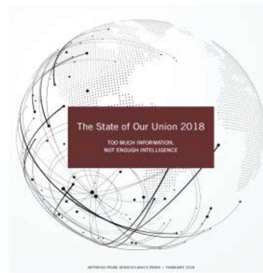
- **On Being with Anand Giridharadas** – *When the Market is Our Only Language* (podcast)
- **New York** – *Edward Rutherfurd*
- **Sapiens** – Yuval Noah Harari
- **Our Hat in the Podcasting Ring** – AQR Insights (article)
- **Lululemon's Founder is an Unlikely Guru. That Might Be Why He's a Billionaire** – *New York Magazine* (article)
- **The Borough Market Cookbook** – part recipes, part stories from the storied Borough Market in London.
- **The Friday Five by Jefdata** – Jefferies Data Science Working Group's weekly newsletter. To subscribe, please reach out to Rich Carbone (Rcarbone1@Jefferies.com)

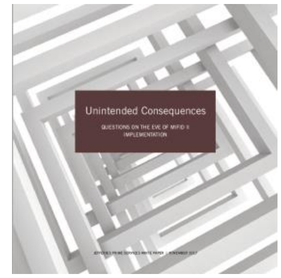
2018: JEFFERIES CAPITAL INTELLIGENCE YEAR IN CONTENT

The *Quantifying* Series: The Future of Data

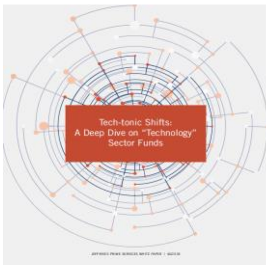


Thematic White Papers: The State of Our Union, Momentum Economies for the Tech Age – The Case of Israel, Unintended Consequences: MiFID





Specialist Fund Deep Dives: Healthcare and Technology



Consulting & Communication Series: Rise of Voice, The New ODD, BattleFin London