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Global Equity Strategy

September 16, 2019

No California Love for the Gig Economy

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- **What happened?** On September 11th, California lawmakers approved Assembly Bill 5 (AB 5), a piece of legislation which requires companies, including ride-hailing giants Uber and Lyft to reclassify certain contract workers as employees. If signed into law, AB 5 will go into effect on January 1, 2020 and could deal a heavy blow to companies which rely on contractors, adding to existing concerns over the path to profitability for many of these companies.
- **Who is affected?** Companies such as Uber, Lyft and Doordash are among the high profile companies affected. The legislation also covers many other groups such as truck drivers and newspaper carriers. It is estimated the legislation could change the employment status of over one million Californians.
- **Pro legislation:** Gig economy workers arguing that all workers should be entitled to a basic level of economic security such a paid vacation, sick days and health insurance benefits. They have support from lawmakers, including democratic Presidential hopefuls Bernie Sanders, Elizabeth Warren and Kamala Harris.
- **Against legislation:** Silicon Valley. Ride hailing and food delivery companies don't consider themselves to be in the transportation or delivery business. Rather, they view themselves as online market places connecting workers with opportunities.
- **Impact on gig economy companies:** Employees are estimated to cost 30% more than contractors. The additional expense from higher wages and contributions to healthcare plans, 401ks, Medicare, FICA and other payroll items would make the path to profitability for high profile ride hailing and food delivery companies incrementally less clear.
- **Impact on gig economy workers:** The legislation will likely curtail the flexibility contractors enjoy, while fares will rise to cover additional costs. Unintended consequences might be a limit on driver hours in an effort to avoid over-time payments or the requirement to cover health care costs. Full-time employees would also not be able to work for multiple companies, i.e. a driver won't be able to drive for both Uber and Lyft.
- **Why now?** Legislation always trails innovation as regulators struggle to keep up with the pace of technological advances. The ramping up of the US presidential election cycle is likely playing a role. Lawmakers need to tread a fine line; too much regulation too early hinders innovation, while reacting too slowly risks a regulation over-shoot.
- **Snowball effect?** The greatest risk for gig economy companies is the potential for AB 5 legislation to spread, as was the case with the California Consumer Privacy Act (CCPA). The law to enhance the privacy rights of Californian consumers was passed in 2018, and since then a further 19 states have introduced similar laws or amended existing laws. With New York Governor Andrew Cuomo signaling his support for AB 5 legislation, New York looks the likeliest to follow California's lead in some form or another.
- **It ain't over till it's over:** Although companies adversely affected by AB 5 are facing an uphill battle, the fight is far from over. A trinity of Uber, Lyft and Doordash have pledged a total of $90m to bring the issue to a ballot.
- **Conclusion:** It is significant that this legislation originates in California; the birthplace of app-based work and a harbinger of broader progressive views. Public perception is shifting – gone are the days when everything with a Silicon Valley stamp was universally applauded for its potential to change the world. Instead, the spotlight is being shone on the unfair treatment of workers and cultural problems inside organizations.
- **Tech sector impact:** The combination of turning public opinion, growing privacy concerns and rising political risk from the electoral cycle will likely limit the upside for the parts of the tech sector most dependent on contractors, advertising revenues and the use of customer data. Less impacted are likely to be tech giants with more diversified revenue streams and established, profitable business models.

No California Love for the Gig Economy

This decade's revolutionary technologies have been nothing short of extraordinary. The sharing economy, social media, cloud computing, mobile payments, and smartphones, to name a few, have dramatically changed our daily lives and the way we interact with each other. As a result, these technologies have more recently raised concerns from regulators as they try to grapple with these fast changing technologies. Issues of employee protection, anti-competitive behavior, and data privacy have taken center stage in an era where the divide between those that have benefitted from these technologies and those that have been displaced has diverged significantly and gripped public opinion.

From an investment perspective, the spectacular growth achieved by some companies operating in this technological realm has resulted in major investor interest. We believe a driver of this growth has been an uneven regulatory playing field. The lack of regulation has been a tailwind for some of these disruptive firms and a headwind for more established, traditional companies. However, taking the pulse of regulatory momentum, this dynamic appears to be changing.

Liberal states in the United States have been at the forefront of advancing the regulatory environment for select companies. Most recently, California state senators have advanced a bill, namely AB 5, in their state senate to change the definition of independent contractors to employees. AB 5 will likely disproportionately upend the business models of companies like Uber, Lyft, Postmates, and DoorDash who benefit from keeping employees off the books. The change of employee status would prompt companies to assign shifts and mandate hours, diluting the flexibility that these companies offer. Additionally, the cost of labor is expected to rise, as these companies will be forced to offer benefits and others protections due to the employment status change. Simply said, these increased costs will most likely be passed on to consumers.

European regulatory bodies have also weighed in on the debate over the lack of regulation. France's National Assembly approved a 3% tax on digital services. The revenue threshold starts at €750m of which €25m must be earned in France. As a result, companies like Alphabet and Amazon will be forced to pay taxes on sales generated on their platforms regardless of the profit the sales incur. This unilateral tax hike has drawn the ire of President Trump who has tweeted about the digital tax and threatened retaliation. Record fines have also been levied by the European Commission on Google and Facebook. In the midst of a tenuous trade war backdrop, the risk of tit-for-tat taxes and tariffs on consumers and business does not bode well for cross-border relations.

The anti-competitive behavior of some large technology platform companies has also been a hot button issue lately. In wake of the Russian election hacking scandal, questions directed at Facebook and Alphabet over a lack of competition among companies handling large swathes of customer data have raised concerns over individual firms holdings too much personal information on users. This is at odds with the very nature of their business models, which are predicated on their ability to build algorithms around the data they collect by offering free services. It also appears that the large fines levied on both companies by the Department of Justice and Federal Trade Commission fails to get to the root of the problem.

Amazon has also caught the eye of regulators with the FTC and DOJ investigating its platform for potential anti-competitive behavior. Third parties have long complained that Amazon's ability to collect sales data from them creates an uneven playing field as it grants Amazon the ability to undercut popular third-party products. The displacement that Amazon has single-handedly created in the retail industry also leaves it vulnerable to the populist backlash that politicians may seek to exploit.

Apple and its App Store have not escaped the scrutiny of regulators either. Developers have long complained that Apple unfairly elevates searches of its apps over third-party app developers. Furthermore, popular apps are recreated and rebranded under Apple to the detriment of developer apps. Finally, it is claimed that Apple's increasing power gouges developers by forcing a charge of a 30% commission on apps sold on the Apple App Store. Though still in the early innings of litigation for each of these platform companies, legal costs are likely due to rise in defense of these allegations.

Clearly, the regulatory landscape is in flux. We believe tools used to deal with the technological developments in the past are ill-suited to capably deal with the challenges of today. As a result, politicians will need to evolve the regulatory framework. The risk here remains the threat of over-regulation and the usage of blunt tools to deal with the intricacies of large platforms that have become necessary for the common good. Valuation of these technology platforms will remain the central question as investors try to weigh fast approaching risks with parabolic growth.

Conclusion

AB5 legislation is nothing new. Instead, it adds to a growing list of scrutiny tech companies are beginning to face as regulators struggle to keep up with innovation and politicians answer the populist call from voters. Central to this theme is rising income inequality in the US, something Citi Investment Management have written on extensively (see The Populist Revolt). As populism spreads and intensifies, a greater number of sectors in the economy are likely to be impacted. Health care and banks, two favorite political piñatas have now been joined by technology.

Headwinds to tech now range from stronger privacy protection to a lack of competition, share buybacks, tax avoidance and worker misclassification. While a number of well-known tech behemoths are well placed and funded to absorb fines or fight legislation in the courts, others in newer industries and with less established and as yet unprofitable business models are at greater risk.

Asset Allocation Definitions

Asset classes	Benchmarked against
Global equities	MSCI All Country World Index, which represents 48 developed and emerging equity markets. Index components are weighted by market capitalization.
Global bonds	Bloomberg Barclays Capital Multiverse (Hedged) Index, which contains the government -related portion of the Multiverse Index, and accounts for approximately 14% of the larger index.
Hedge funds	HFRX Global Hedge Fund Index, which is designed to be representative of the overall composition of the hedge fund universe. It comprises all eligible hedge fund strategies; including but not limited to convertible arbitrage, distressed securities, equity hedge, equity market neutral, event driven, macro, merger arbitrage and relative value arbitrage. The strategies are asset-weighted based on the distribution of assets in the hedge fund industry.
Commodities	Dow Jones-UBS Commodity Index, which is composed of futures contracts on physical commodities traded on US exchanges, with the exception of aluminum, nickel and zinc, which trade on the London Metal Exchange (LME). The major commodity sectors are represented including energy, petroleum, precious metals, industrial metals, grains, livestock, softs, agriculture and ex-energy. The Thomson Reuters / Core Commodity Index is designed to provide timely and accurate representation of a long-only, broadly diversified investment in commodities through a transparent and disciplined calculation methodology.
Cash	Three-month LIBOR, which is the interest rates that banks charge each other in the international inter-bank market for three-month loans (usually denominated in Eurodollars).

Equities	
Developed market large cap	MSCI World Large Cap Index, which is free-float adjusted and weighted by market capitalization. The index is designed to measure the equity market performance of the large cap stocks in 23 developed markets. Large cap is defined as stocks representing roughly 70% of each market's capitalization.
All Country Ex US	MSCI All Country ex US, which is free-float adjusted and weighted by market capitalization. The index is designed to measure the equity market performance of the large cap stocks in all countries excluding the US.
US	Standard & Poor's 500 Index, which is a capitalization-weighted index that includes a representative sample of 500 leading companies in leading industries of the US economy. Although the S&P 500 focuses on the large cap segment of the market, with over 80% coverage of US equities, it is also an ideal proxy for the total market.
Europe ex UK	MSCI Europe ex UK Large Cap Index, which is free-float adjusted and weighted by market capitalization. The index is designed to measure large cap stock performance in each of Europe's developed markets, except for the UK
Eurozone	Euro Stoxx 50 is a stock index of large cap Eurozone stocks. It's aim is to measure the performance of 50 of the largest Eurozone domiciled stocks.
Emerging Markets	MSCI Emerging Markets Index, which is free-float adjusted and weighted by market capitalization. The index is designed to measure stock performance 24 Emerging Market countries.
UK	MSCI UK Large Cap Index, which is free-float adjusted and weighted by market capitalization. The index is designed to measure large cap stock performance in the UK
Japan	MSCI Japan Large Cap Index, which is free-float adjusted and weighted by market capitalization. The index is designed to measure large cap stock performance in Japan.
Asia Pacific ex Japan	MSCI Asia Pacific ex Japan Large Cap Index, which is free-float adjusted and weighted by market capitalization. The index is designed to measure the performance of large cap stocks in Australia, Hong Kong, New Zealand and Singapore.
Developed market small and mid-cap (SMID)	MSCI World Small Cap Index, which is a capitalization-weighted index that measures small cap stock performance in 23 developed equity markets.

Bonds	
Developed sovereign	Citi World Government Bond Index (WGBI), which consists of the major global investment grade government bond markets and is composed of sovereign debt, denominated in the domestic currency. To join the WGBI, the market must satisfy size, credit and barriers-to-entry requirements. In order to ensure that the WGBI remains an investment grade benchmark, a minimum credit quality of BBB–/Baa3 by either S&P or Moody's is imposed. The index is rebalanced monthly.
Emerging sovereign	Citi Emerging Market Sovereign Bond Index (ESBI), which includes Brady bonds and US dollar -denominated emerging market sovereign debt issued in the global, Yankee and Eurodollar markets, excluding loans. It is composed of debt in Africa, Asia, Europe and Latin America. We classify an emerging market as a sovereign with a maximum foreign debt rating of BBB+/Baa1 by S&P or Moody's. Defaulted issues are excluded.
Supranationals	Citi World Broad Investment Grade Index (WBIG)—Government Related, which is a subsector of the WBIG. The index includes fixed rate investment grade agency, supranational and regional government debt, denominated in the domestic currency. The index is rebalanced monthly.
Corporate investment grade	Citi World Broad Investment Grade Index (WBIG)—Corporate, which is a subsector of the WBIG. The index includes fixed rate global investment grade corporate debt within the finance, industrial and utility sectors, denominated in the domestic currency. The index is rebalanced monthly.
Corporate high yield	Bloomberg Barclays Global High Yield Corporate Index. Provides a broad-based measure of the global high yield fixed income markets. It is also a component of the Multiverse Index and the Global Aggregate Index.
Securitized	Citi World Broad Investment Grade Index (WBIG)—Securitized, which is a subsector of the WBIG. The index includes global investment grade collateralized debt denominated in the domestic currency, including mortgage -backed securities, covered bonds (Pfandbriefe) and asset-backed securities. The index is rebalanced monthly.

Other miscellaneous definitions	
Asset Backed Securities (ABS)	A security whose income payments and hence value are derived from and collateralized (or "backed") by a specified pool of underlying assets such as consumer credit card debt or auto loans.
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High Yield Corporate Bonds (HY)	High yield corporate bonds are bonds with a credit rating less than BBB- (S&P) or Baa3 (Moody's), and are debt securities issued by a corporation and sold to investors. The backing for the bond is usually the payment ability of the company, which is typically money to be earned from future operations.
Investment Grade Corporate Bonds (IG)	Investment grade corporate bonds are bonds with a credit rating equal to or above BBB- (S&P) or Baa3 (Moody's), and are debt securities issued by a corporation and sold to investors. The backing for the bond is usually the payment ability of the company, which is typically money to be earned from future operations.
CAPE	Cyclically Adjusted Price to Earnings Ratio is an equity valuation measure calculated by taking the price divided by the average of ten years' earnings, adjusted for inflation. The ratio is designed to smooth variations in profit margins over the business cycle.

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Bond credit quality ratings	Rating agencies		
Credit risk	**Moody's[1]**	**Standard and Poor's[2]**	**Fitch Ratings[2]**
Investment Grade			
Highest quality	Aaa	AAA	AAA
High quality (very strong)	Aa	AA	AA
Upper medium grade (Strong)	A	A	A
Medium grade	Baa	BBB	BBB
Not Investment Grade			
Lower medium grade (somewhat speculative)	Ba	BB	BB
Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
In default	C	D	D

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