

# FISHER INVESTMENTS AUSTRALASIA™



## MARKET PERSPECTIVES REVIEW & OUTLOOK

THIRD  
QUARTER  
**2021**

# THIRD QUARTER 2021 REVIEW & OUTLOOK

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# THIRD QUARTER 2021 REVIEW & OUTLOOK

## EXECUTIVE SUMMARY

12 October 2021

### PORTFOLIO THEMES

- We continue to favour larger, high-quality companies given our assessment that we remain in a late bull market cycle despite the technical bear in 2020.
- While value's relative strength occasionally interrupted growth's leadership in Q3, sustainable value leadership is unlikely until the early stages of the next bull market.
- Economic growth and inflation expectations likely continue to moderate as global economies reopen supporting our preference for growth equities.

### MARKET OUTLOOK

- **Global Equities are Solidly Positive:** Despite a relatively flat third quarter, global markets are on track for a good year tied to equities' resilience, political clarity and continued vaccine development and distribution.
- **We Believe We are Late in the Market Cycle:** The 2020 downturn behaved more like an outsized correction than a traditional bear so the market cycle did not reset. The vast majority of our sentiment and market indicators point to this being a late cycle bull market, yet many forecasters expect early-cycle leadership.
- **Investor Sentiment Moderated in Q3:** Increased pessimism—partly tied to the Delta variant impacts—likely proves temporary, while reducing the likelihood that equities reach a euphoric peak anytime soon.

Global markets started Q3 strong, rising in July and August. But volatility returned in September, driving equities slightly lower during the quarter.<sup>i</sup> Growth beat value again—albeit narrowly—and Tech led most other sectors while value had a short burst of outperformance toward September's end. Yet some back-and-forth is normal. Broad markets don't move in a straight line, and neither do subcategories like country, sector or style. Reacting to countertrends, in our view, raises the likelihood of errors.

Three quarters in, 2021 is shaping up much as we expected. Even with September's downdraft, global markets are up 11.1% year to date.<sup>ii</sup> Tech and the Tech-like Communication Services sectors are outperforming global markets. Growth is modestly trailing value year to date but remains ahead significantly since mid-May. While still positive for the year, the Consumer Discretionary sector weighed on global markets this quarter tied to impacts of the Delta variant and fears of increasing Chinese regulation.

<sup>i</sup> Source: FactSet, as of 01/10/2021. MSCI ACWI Index return with net dividends, 30/06/2021 – 30/09/2021.

<sup>ii</sup> MSCI ACWI Index return with net dividends, 31/12/2020 – 30/09/2021.

Emerging Markets (EM) suffered in Q3, driving the index to a slight negative year to date. EM growth lagged value primarily driven by Chinese internet and growth companies amid weak sentiment tied to fears of a regulatory crackdown in China. Further, Brazil weighed on EM performance as the country entered a technical bear market in August, tied to fears surrounding economic recovery and political uncertainty. The prolonged negativity in EM equities is one of this year's biggest surprises, yet it is also worth noting the negativity isn't universal. Several EM nations have delivered positive year to date returns. Regardless, we think it is crucial to look for fundamental negatives that could worsen in the struggling nations from here. In our view, however, the positives outweigh the negatives—which at this point are widely known and likely already reflected in prices.

The fundamental backdrop continues to support prospects for growth equities. Major economies' GDPs are near or above pre-pandemic levels—and naturally slowing after the reopening rush. Inflation is elevated but gradually trending down. Economic headwinds, including labor shortages, factory constraints and shipping issues, are contributing to slowing growth, but we believe slow-and-steady pre-pandemic growth rates were always likely to return. Crucially, this environment should favour companies with big, durable margins and the scale to navigate increasingly complex logistics and spread higher costs over more products. It should also benefit companies that ride long-term technological trends, not the economic cycle. The high-quality Tech and Tech-like names we favour are at the nexus of this universe. Digital services are relatively insulated from today's headline headwinds, and demand for them transcends the economy's near-term fluctuations.

Sentiment deteriorated markedly during the quarter. This is bullish. While optimism was pervasive early this year—with some froth in speculative assets like cryptocurrencies—it has faded lately under the glare of false fears. One such fear is hot inflation, which we will revisit in the full Review. Slowing economic growth rates also hurt sentiment as pundits warned of a rapidly weakening world. Central banks set expectations for “tapering” their quantitative easing (QE) bond buying programs, which also sparked fear. As we have written before, many investors don't see this correctly, not realizing QE was more sedative than stimulus, in our view.

A busy September in global politics mostly resulted in uncertainty and gridlock. In Japan, markets rallied on excitement for a new prime minister and potential reform. In our view, that optimism seemed misplaced from the start as reform has been historically difficult to implement. Germany's federal election gave the center-left SPD a small plurality, but the most clear result was that the country's next government will be a coalition which will likely struggle to pass sweeping legislation. That gridlocked outcome is likely fine for equities. Canada's snap general election also extended gridlock, as Prime Minister Justin Trudeau's Liberal Party failed to achieve a majority. In our view, the result extends Canada's political status quo—a gridlocked government unlikely to implement major legislative changes. In Norway, a potential minority government between the Labour and Centre Party should also decrease political risk.

US politics remained polarized in Q3 as legislators bickered over infrastructure spending and the debt ceiling. We are monitoring the former's progress and will discuss any late-breaking news in the full Review. But our basic forecast—that because of the slim margins in US Congress, less will happen than some hope for or fear—seems prescient. Almost nothing that was scheduled to get through Congress in the third quarter did—due to gridlock. The closer we get to 2022, the greater the likelihood that anything that does get through Congress will be watered down.

As for the US debt ceiling, pundits routinely depict the lack of a prompt debt ceiling increase as risking default. This is misinformation. Defaulting means failing to pay interest and principal on maturing debt—not missing other scheduled spending. If Congress doesn't lift or suspend the debt ceiling for the 112th time, default won't happen. According to the Supreme Court's ruling on the 14th Amendment's public debt clause, the Treasury must prioritize debt payments before all others. The debt ceiling doesn't threaten principal repayment, as the Treasury can issue new debt to refinance maturing bonds. Tax revenues more than cover interest, with plenty left over. Paying some bills and not others after paying interest creates winners and losers, but that resembles a government shutdown, not a default. No shutdown has ever caused a bear market or recession.

All these fears collided with real estate worries in China and rising energy prices in September, triggering a pullback. Some argue equities are "due" for a correction because we have gone so long without one, but this is a fallacy. Corrections don't become more likely with time. They are random.

Bull markets always climb a wall of worry as they mature, and many of the aforementioned factors have contributed to that wall being high today. That being said, temporary negativity like September's volatility helps reset and frame sentiment, building positive surprise power that should continue to support global markets through this late stage cycle.

# GLOBAL UPDATE AND MARKET OUTLOOK

08 November, 2021

## Q3 MARKET RECAP

### A BUMPY CLOSE TO Q3 EXTENDS THE WALL OF WORRY

Through August, world markets had enjoyed a serene ride to above average returns—no pullbacks larger than -5% and few large daily swings. At August's close, the MSCI All Country World Index (ACWI) was up 15.9% on the year.<sup>iii</sup>

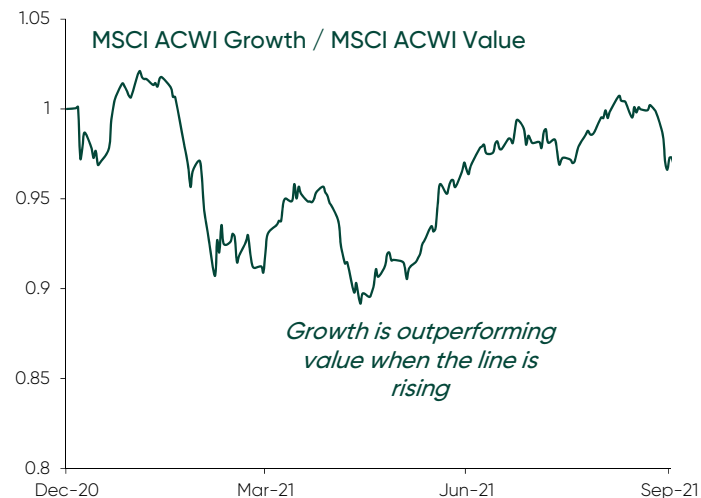
Then came September. Inflation, chatter about central bank "tightening", concerns surrounding China's property market and other fears hit sentiment. Global equities' -4.9% fall from their record high on 3 September through quarter end set many on edge.<sup>iv</sup>

Despite September's pullback, global markets were flat in Q3 and up 11.1% on the year.<sup>v</sup> Tech was Q3's third-best performing sector.<sup>vi</sup> Tech and Communication Services, which includes several Tech-like giants, are outperforming global markets year to date.<sup>vii</sup> We expect that leadership to persist as the bull market continues.

## GROWTH REMAINS IN FAVOUR

Growth extended its leadership over value in Q3, outperforming value by 0.7%.<sup>viii</sup> While growth is trailing value on the year—9.5% to 12.6%, most of value's outperformance came early.<sup>ix</sup> Growth has beat it since mid-May, up 8.4% to value's -0.7%.<sup>x</sup>

### EXHIBIT 1: GROWTH VERSUS VALUE IN 2021



Source: FactSet, as of 30/09/2021. MSCI All Country World Growth Index and MSCI All Country World Value Index returns with net dividends, 31/12/2020 – 30/09/2021. Indexed to 1 at 31/12/2020.

iii Source: FactSet, as of 11/10/2021. MSCI All Country World Index return with net dividends, 31/12/2020 – 31/08/2021.

iv Source: FactSet, as of 07/10/2021. MSCI All Country World Index return with net dividends, 03/09/2021 – 30/09/2021.

v Source: FactSet, as of 07/10/2021. MSCI All Country World Index return with net dividends, 30/06/2021 – 30/09/2021 and 31/12/2020 – 30/09/2021.

vi Source: FactSet, as of 07/10/2021. Statement based on MSCI All Country World Index sector returns with net dividends, 30/06/2021 – 30/09/2021.

vii Source: FactSet, as of 07/10/2021. MSCI All Country World Information Technology Index and MSCI All Country World Communication Services Index returns with net dividends, 31/12/2020 – 30/09/2021.

viii Source: FactSet, as of 07/10/2021. MSCI All Country World Growth Index and MSCI All Country World Value Index returns with net dividends, 30/06/2021 – 30/09/2021.

ix Source: FactSet, as of 07/10/2021. MSCI All Country World Growth Index and MSCI All Country World Value Index returns with net dividends, 31/12/2020 – 30/09/2021.

x Source: FactSet, as of 07/10/2021. MSCI All Country World Growth Index and MSCI All Country World Value Index returns with net dividends, 13/05/2021 – 30/09/2021.

But some late-September outperformance reenergised value bulls. Many see rising long-term interest rates favouring value from here. The 10-year Treasury yield's increase from 1.19% on 4 August to a still-low 1.55% at quarter end isn't huge.<sup>xi</sup> But pundits connected rising rates to the Fed's talk of slowing or "tapering" quantitative easing (QE) bond purchases, arguing yields' recent upturn was only the beginning—spelling trouble for Tech and supporting value-oriented equities.

## RISING RATES ARE NOT DETRIMENTAL TO TECH

The theory suggests rising rates weigh on growth firms, which depend on expected future cash flows to justify premium valuations. Higher rates increase the time value of cash invested, which lowers the value of far-future revenue and profits. By contrast, value-oriented companies benefit from stronger near-term economic activity. Rising long rates also steepen the yield curve, typically bullish for value equities, especially banks.

This argument has some flaws. One, as last decade's bull market shows, rising rates don't automatically hurt Tech. From 24 July, 2012 to 3 January, 2014, 10-year Treasury yields rose from 1.39% to 3.00%.<sup>xii</sup> Tech rose 34.1% over that stretch, trailing the MSCI World's 40.9%, but still up nicely.<sup>xiii</sup> Treasury yields climbed from 1.37% on 8 July, 2016 to 3.23% on 8 November, 2018.<sup>xiv</sup> Meanwhile, Tech jumped 69.7%—more than doubling global equities' 30.8%.<sup>xv</sup> We doubt long rates keep rising, but even if we are wrong, that doesn't mean Tech will falter.

Few appreciate this, but Tech and Tech-like companies are positioned well for the supply shortages and slow growth so many now fear. Big digital services companies don't depend on massive labour forces or face big shipping costs, while the largest online retailers have invested heavily in their own logistics infrastructure, mitigating headwinds.

Also helping growth equities: their large gross operating profit margins (GOPMs)—a simple gauge of future growth. GOPMs (sales minus costs, divided by sales) demonstrate a company's ability to self-finance growth—crucial, given slow overall loan growth. As Ken wrote in RealClearMarkets on 11 August: "Fatter gross margins enable more capacity for sales, marketing and R&D expenses to fuel growth". They allow easier financing of capital expenditures, mergers and acquisitions or anything else driving future expansion." We continue to favour large-margin businesses, which can also weather rising costs better than competitors, in our view.

xi Source: FactSet, as of 07/10/2021. 10-Year US Treasury Yield, 04/08/2021 – 10/11/2021.

xii Source: FactSet, as 12/10/2021. 10-Year US Treasury Yield, 24/07/2012 – 03/01/2014

xiii Source: FactSet, as of 12/10/2021. MSCI World Information Technology Index and MSCI World Index returns with net dividends, 24/07/2012 – 03/01/2014.

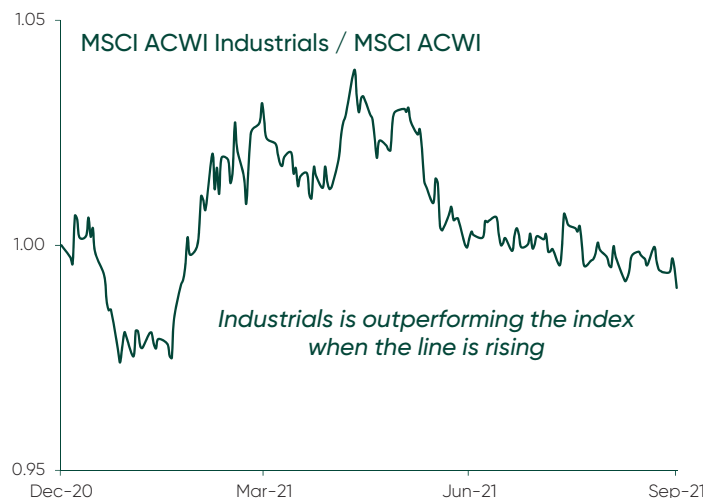
xiv Source: FactSet, as 12/10/2021. 10-Year US Treasury Yield, 08/07/2016 – 08/11/2018.

xv Source: FactSet, as of 12/10/2012. MSCI World Index and MSCI World Information Technology Index returns with net dividends, 08/07/2016 – 08/11/2018.

## COUNTERTRENDS ARE COMMON

Sector leadership countertrends are common during periods of volatility and rarely translate into sustained changes. Take Industrials, which outperformed in Q1 and drew many investors' attention for its economic sensitivity. (Exhibit 2) Maintaining an underweight to the sector ultimately contributed positively to performance in global portfolio's year-to-date.

### EXHIBIT 2: THE INDUSTRIALS COUNTERTREND

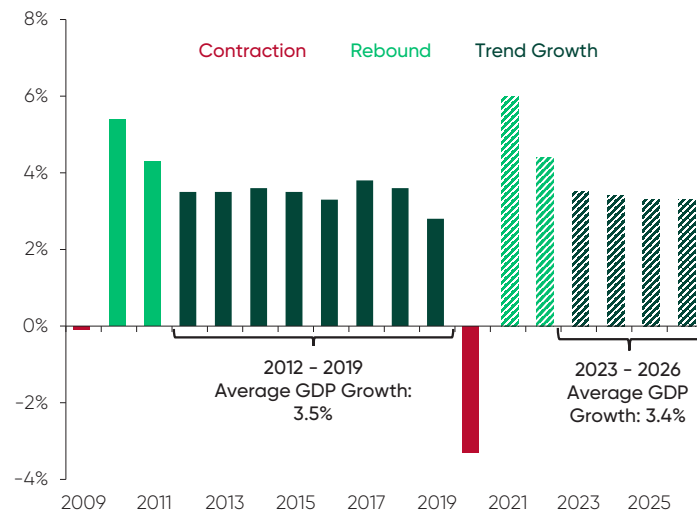


Source: FactSet, as of 06/10/2021. MSCI All Country World Industrials Index divided by MSCI All Country World Index, both with net dividends, 31/12/2020 – 30/09/2021. Indexed to 1 at 30/12/2020.

## THE EVOLVING POST-PANDEMIC ECONOMIC ENVIRONMENT

Economies globally are reverting to pre-COVID trends. GDP is notching new highs in the US and China. Major European economies are nearing prior peaks. Americans have exhausted most of their pent-up demand, returning retail sales and consumer spending to pre-pandemic trends. Now the UK and Europe are following suit. In short, post-pandemic growth looks a lot like pre-pandemic growth, further indicating the effects of fiscal and monetary “stimulus” are fleeting at best and won’t set the economy on a lasting, faster-growth trajectory. (Exhibit 3) This is an environment we think favours growth equities now.

### EXHIBIT 3: POST-COVID GDP GROWTH SIMILAR TO PRE-COVID



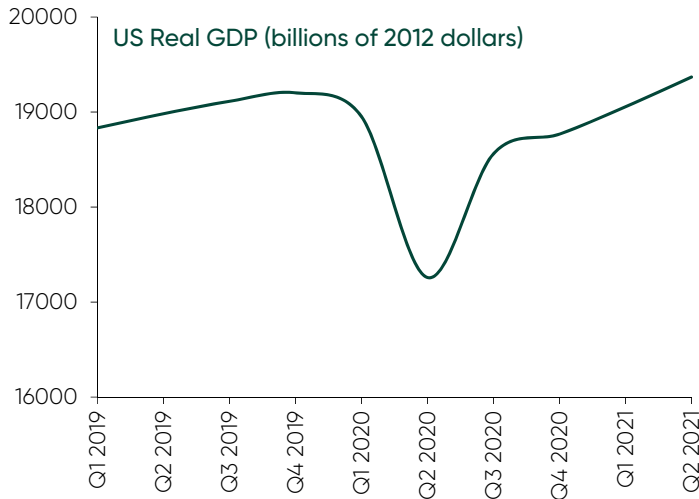
Source: International Monetary Fund, April 2021 World Economic Outlook. Real actual and forecasted global GDP growth, annually, 2009 – 2026. Forecasted data starts in 2021.

## SLOW GROWTH IS A RETURN TO NORMAL, NOT A WARNING SIGN

Early in the year, as vaccines fanned out and economies reopened, pundits anticipated a new “Roaring Twenties” of strong consumer spending. Yet after the initial burst, people mostly returned to normal habits, and growth rates moderated. Pundits mistook this for the Delta variant upending the recovery. Slow-growth fears set in as forecasters slashed GDP projections. Pundits warned markets had come too far, too fast—and would soon sag in disappointment.

What everyone missed is that the post-lockdown trend largely looks like the pre-pandemic trend—a fine environment for equities. US GDP jumped off the bottom, then slowed after the initial bounce. Q2 GDP’s 6.7% annualised growth propelled GDP above its Q4 2019 high, completing the recovery. Growth probably slows naturally from here in the US and globally.



**EXHIBIT 4: US GDP TOPS PRE-PANDEMIC HIGHS**

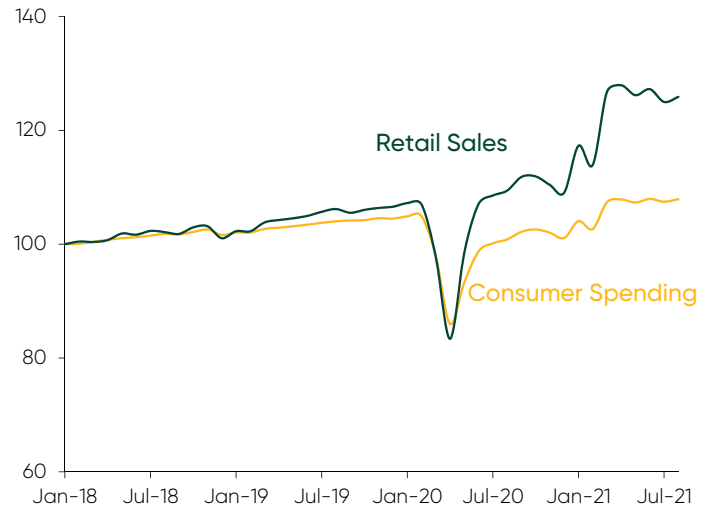
Source: FactSet, as of 07/10/2021. GDP based on seasonally adjusted annual rate.

Retail sales and consumer spending illustrate the return to normal. US Retail sales grew 7.2% in the two years preceding their early-2020 peaks, while consumer spending grew 4.9%.<sup>xvi</sup> Behind the divide: Most consumer spending is on services, most of which are essential—things people don't skimp on during tough times, including utilities and medical spending. Retail sales skew more discretionary and tend to be more sensitive to changes in demand, while consumer spending normally doesn't fluctuate much, even during recessions.

Except for last year. Forced business closures prevented people from accessing personal and medical services, so consumer spending plunged -18.0% from February's peak through April's low.<sup>xvii</sup> Retail sales fell even more, -22.2%, from their January peak through April.<sup>xviii</sup> Yet they recovered quickly, passing their prior peak last July.

Meanwhile, consumer spending took over a year to break even, largely because shops reopened before services. Plus, locked-down consumers shopped online when brick-and-mortar stores were shuttered. That option wasn't available for many services. When gyms, hair salons, spas and entertainment took longer to reopen, it dragged out consumer spending's recovery. Still, both enjoyed swift recoveries off their depressed levels, slowing as delayed spending waned.

Both enjoyed another short boom around March as the United States reopened from COVID's second wave earlier in the year. But as Exhibit 5 shows, that burst faded long before the Delta variant spread. Society followed 2020's pattern—shopping and dining with glee initially, then adopting more sustainable habits. Today's choppy, mild growth rates resemble the years before the pandemic.

**EXHIBIT 5: THE US REOPENING BOOM, ILLUSTRATED**

Source: FactSet, as of 01/10/2021. US Consumer Spending and Retail Sales, January 2018 – August 2021. Indexed to 100 at January 2018.

xvi Source: FactSet, as of 01/10/2021 Cumulative growth in US retail sales, January 2018 – January 2020, and cumulative growth in US consumer spending, February 2018 – February 2020.

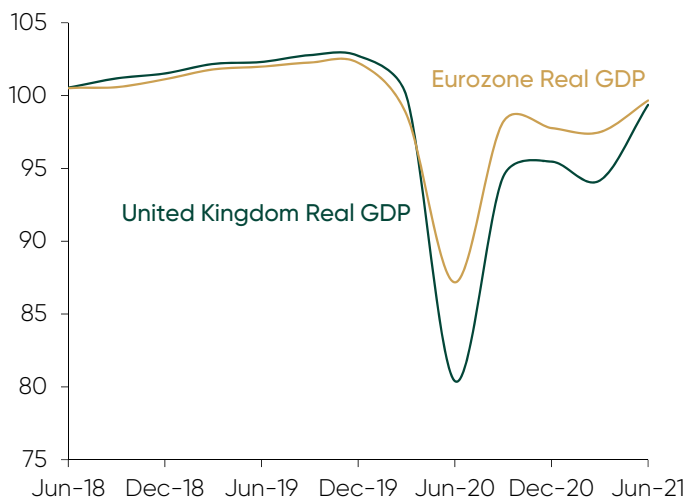
xvii Ibid. Percent change in US consumer spending, February 2020 – April 2020.

xviii Ibid. Percent change in US retail sales, January 2020 – April 2020.

## THE UK AND EUROPE ARE CLOSE BEHIND

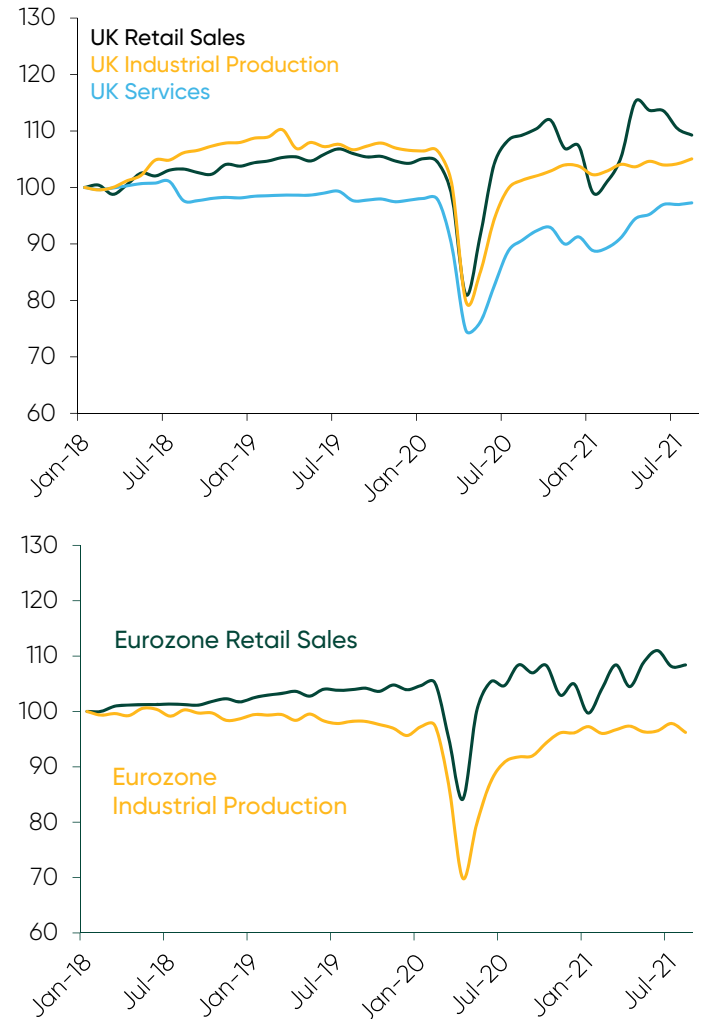
The UK and Europe had tougher second-wave lockdowns and eased restrictions later, reopening around mid-year. As a result, UK and eurozone GDP contracted late last year and remain just off pre-pandemic highs. (Exhibit 6) There, too, monthly data are leveling off some after swift recoveries. (Exhibit 7) Slow-growth fears reign—particularly with an energy shortage threatening manufacturers. We think pundits have overlooked the parallels with the US and China and gotten excessively dour, creating plenty of room for even slow growth to positively surprise and propel equities up the wall of worry.

### EXHIBIT 6: UK AND EUROZONE GDP ARE NEARING PRIOR HIGHS



Source: FactSet, as of 01/10/2021. UK and Eurozone Real GDP, Q2 2018 – Q2 2021. Indexed to 100 at Q1 2018.

### EXHIBIT 7: MONTHLY DATA ARE STARTING TO LEVEL OFF



Source: FactSet, as of 04/10/2021. UK Retail Sales, UK Index of Services, UK Industrial Production, Eurozone Retail Sales and Eurozone Industrial Production, January 2018 – August 2021. Indexed to 100 at January 2018.

## INFLATION FEARS SHOULD DIMINISH

Inflation dominated headlines in Q3 and October as the US Consumer Price Index (CPI) inflation rate surged to 5.4%.<sup>xix</sup> When assessing inflation as a market risk, however, it is crucial to focus on inflation's drivers and the likelihood they worsen. In doing so, we conclude that elevated inflation isn't likely to persist. Monthly inflation rates are already moderating, though supply shortages may distort prices a while longer.

High year-over-year inflation will likely last for a few months due to a math quirk we have discussed in past quarters—the base effect. Last year's lockdowns depressed prices all year. Now those low prices are the denominator in the year-over-year growth rate calculation, adding backward-looking skew. Once depressed prices fall out of the denominator, this should even out.

With year-over-year data skewed, we think month-over-month price changes better demonstrate current trends. Last quarter, we showed how hotels, airfares and used cars were the largest contributors to accelerating inflation. All had clear ties to reopening and all moderated as Q3 progressed. Used car prices, up 10.5% m/m in June, slowed to 0.2% m/m in July and fell -1.5% and -0.7% in August and September, respectively.<sup>xx</sup> Hotel costs dipped -3.3% in August and -0.6% in September. Car rental prices, up big earlier in the year, fell -15.3% from June through September. All helped month-over-month inflation slow from 0.9% in June to 0.5% in July and 0.3% in August. That last figure matches CPI's average month-over-month increase since data begin in 1947—a striking sign of normalcy returning. September's uptick to 0.4% m/m stemmed from volatile food and energy prices—most other prices moderated.

Big one-time price increases hurt, but they aren't equivalent to lasting, elevated inflation rates. They can elevate the headline rate for a while because they stay in the year-over-year calculation's numerator for a year, all else equal. But that, too, is just math. The next year, they enter the denominator, bringing slower inflation off a higher base. So just because inflation topped 5% recently doesn't mean it will stay there indefinitely.

// **BIG ONE-TIME PRICE INCREASES  
HURT, BUT THEY AREN'T  
EQUIVALENT TO LASTING,  
ELEVATED INFLATION RATES.** //

## CPI ISN'T A COST OF LIVING MEASURE

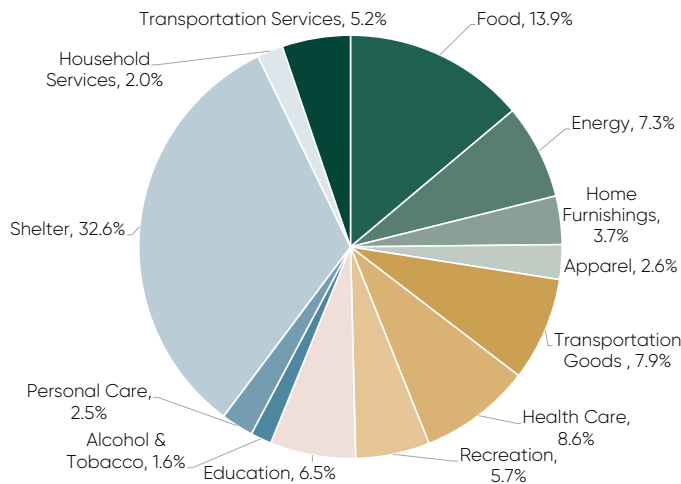
As many families' costs rise, people question whether CPI is accurately recording inflation. Questioning data is valid, but it is important to consider: CPI likely won't approximate any one household's costs. It isn't designed to. Rather, it tracks prices of goods and services across the entire economy. Big increases in some categories often offset decreases elsewhere.

Exhibit 8 shows US CPI basket weights. While food looms large in many folks' minds, it is only 13.9% of the CPI basket. Food at home—groceries—is just 7.7% and meat, which has drawn a lot of attention lately, is only 1%. Meanwhile, nearly 25% of the basket consisted of owners' equivalent rent, a subset of shelter. This is the theoretical amount homeowners would pay to rent their own houses—something no one actually pays. Education is 6.5% of the CPI basket, yet your personal education costs may be much higher if you are paying college tuition—or zero if you aren't and have no school-age dependents. CPI serves to inform policymakers and observers about the state of prices economy-wide. It says little about any individual's changing cost of living.

xix Source: US Bureau of Labour Statistics, as of 14/10/2021

xx Source: FactSet, as of 14/10/2021.

## EXHIBIT 8: US CPI BASKET WEIGHTS



Source: Bureau of Labour Statistics, as of 04/10/2021. CPI basket weights in July 2021.

## SUPPLY BOTTLENECKS, ELECTRICITY SHORTAGES AND PRICE SPIKES ARE LIKELY TEMPORARY

Headlines now dwell on labour shortages, supply shortages, shipping delays and spiking electricity costs—allegedly a perfect storm that will spike inflation and derail global growth.

No doubt, these issues are headwinds. The semiconductor shortage, for instance, affects many products using computer chips, from smartphones to autos. It has caused car manufacturers globally to idle plants or cut shifts despite high demand. Plastics and raw materials including plywood, industrial metals and rare earths are also scarce, hampering building construction and production of batteries and other intermediate goods. Meanwhile, ports throughout Asia have faced closures due to COVID lockdowns, and ships attempting to dock at US ports must idle for weeks before securing a berth, slowing the supply of empty containers flowing back to Asia.

Fuel and electricity shortages also have multiple causes. China, which relies heavily on coal-fired plants, has implicitly banned Australian coal imports over a geopolitical spat. Utilities had to rely on natural gas, which is spiking and in short supply globally. China's government also sets the retail price of electricity, inflating demand and forcing utilities to operate at steep losses when natural gas prices are high. This brings blackouts as utilities cut back.

As for natural gas, Europe's shortage stems partly from the shift to solar and wind power and partly from Russia cutting gas flows for much of the last several months, ostensibly to goad the EU into approving the new Nord Stream 2 pipeline swiftly. When wind calmed throughout Europe and the North Sea, utilities turned to gas. With inventories low, Russia's political maneuvering and global shipping bottlenecks affecting seaborne tankers, prices quickly spiked.

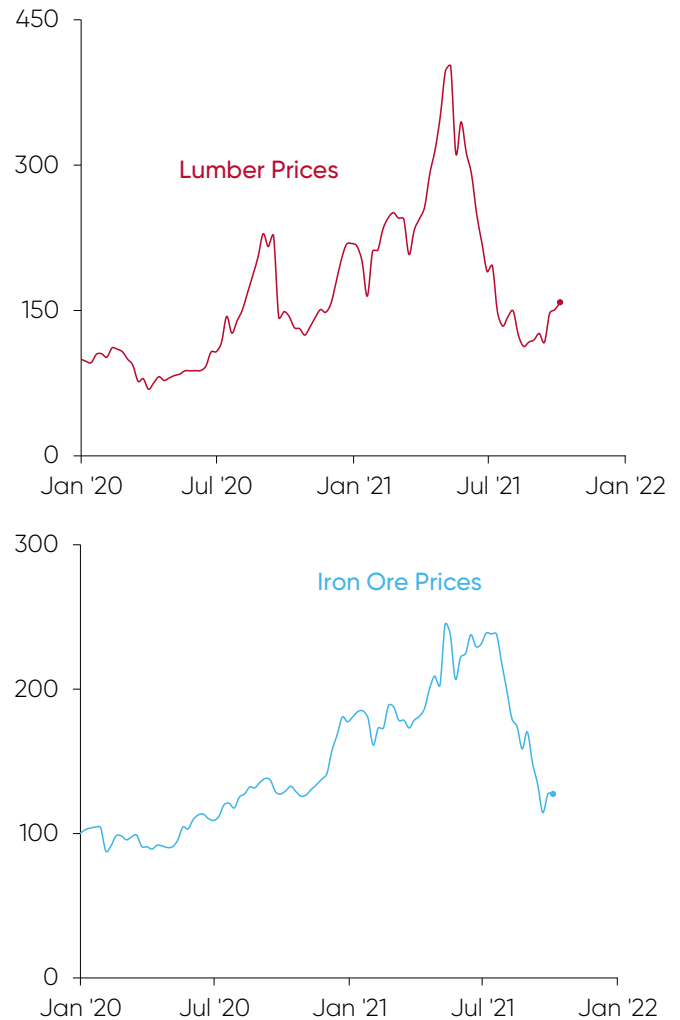
The UK took an outsized hit after an undersea cable bringing electricity from France caught fire. The country has price controls for household energy but not businesses, forcing fertilizer and steel plants to idle production as their costs jumped. But factories in eurozone nations, which regulate electricity to varying degrees, are also under pressure. Meanwhile, to offset the natural gas shortage, utilities are now ramping up coal- and oil-fired power plants, driving crude prices to seven-year highs. This coincided with a dearth of truck drivers in the UK, bringing gasoline shortages that recalled the 1970s, sparking the dreaded "stagflation" comparisons.

In that way, the energy price jump resembles stories that commonly accompany volatility or corrections. It starts with a grain of truth—that supply issues, particularly in energy, present a headwind. But it carries it too far, failing to scale and assess the impact of duration, invoking dire historical examples instead.

The situation is worth monitoring as energy price spikes accompanied some historical market peaks. That said, while there will probably be some short-term impact, the reaction seems overdone. Supply chain problems likely won't last long. Semiconductor producers are investing in increased production capacity. Rare earths mining projects are launching in the US. Eventually, factories and ports in China, Vietnam and Southeast Asia will move on from closures. France and the UK are planning investments in nuclear power, while Japan is talking of reopening idled plants. Winds normalising in Europe will solve a significant portion of the power price problems. Natural gas producers in the Middle East and North Africa are stepping up output to meet the current demand spike, and US shale producers are also ramping up. On the oil front, OPEC is gradually raising production, and US active rig count has almost doubled over the past year.<sup>xxi</sup>

While lead times vary, high prices are signals to increase production. The allure of higher profits initiates investment. We have already seen this with lumber earlier this year, when spiking prices prompted idled sawmills to restart. New supply quickly brought down prices, as discussed in last quarter's Review. (Exhibit 9) Soon enough, supply of semiconductors, energy and other resources should similarly rise to meet demand.

#### EXHIBIT 9: SOME BOTTLENECKS ARE EASING

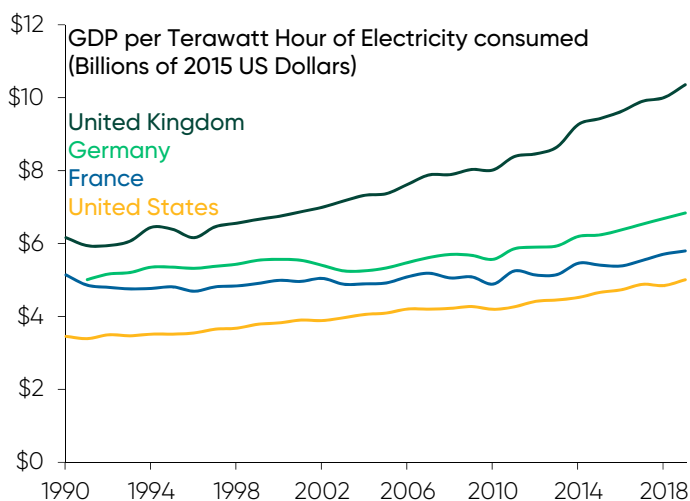


Source: Chicago Mercantile Exchange (CME), Lumber pricing random length, 1st position conditional futures, weekly data as of 13/10/2021. Bottom Left Source: Steel Iron Ore Australia Cost per metric ton including insurance & freight to China, weekly data as of 13/10/2021.

xxi Source: FactSet, as of 10/14/2021. Baker Hughes US active rig count, 02/10/2020 – 01/10/2021.

In the meantime, shortages may keep inflation elevated a while longer, but we don't think this is recessionary. For one, developed-world economies have become more energy-efficient, producing more GDP with less electricity. (Exhibit 10) Two, above-average inflation isn't inherently an economic headwind, as demand adjusts and businesses adapt. Inflation has often accompanied fine equity returns. (Exhibit 11) While high inflation has sometimes preceded bear markets, in our view, that was less about prices and more about the Fed overshooting and inverting the yield curve when trying to contain them.

### EXHIBIT 10: THE DEVELOPED WORLD IS MAKING MORE WITH LESS ELECTRICITY



Source: US Energy Information Administration and United States Statistics Division, as of 19/10/2021.

### EXHIBIT 11: EQUITIES OFTEN DO FINE ALONGSIDE RISING INFLATION

US CPI Inflation vs. S&P 500 Total Return				
Rising Inflation Period	Months	Rate Trough	Rate Peak	S&P 500 Return
February 1965 – December 1969	59	1.0%	6.2%	22.7%
June 1972 – December 1974	31	2.7%	12.3%	-30.1%
December 1976 – March 1980	40	4.9%	14.8%	11.8%
December 1986 – October 1990	47	1.1%	6.3%	43.0%
March 1998 – March 2000	25	1.4%	3.8%	39.7%
June 2002 – September 2005	40	1.1%	4.7%	31.5%
October 2006 – July 2008	22	1.3%	5.6%	-4.8%
July 2009 – September 2011	27	-2.1%	3.9%	19.8%
April 2015 – July 2018	40	-0.2%	2.9%	39.3%

Source: FactSet and Global Financial Data, Inc., as of 17/03/2021. S&P 500 Total Return Index and US Consumer Price Index, February 1965 – July 2018.

## INTEREST RATES SHOULD STAY MODERATE

With inflationary pressures likely to ease, interest rates are unlikely to shoot much higher and stay there indefinitely—even with the Fed poised to “taper” QE.

Yes, long rates ticked higher as the Fed escalated its taper talk in August and September. Many called this a headwind, ignoring the fact that rising long rates incrementally steepened the yield curve.

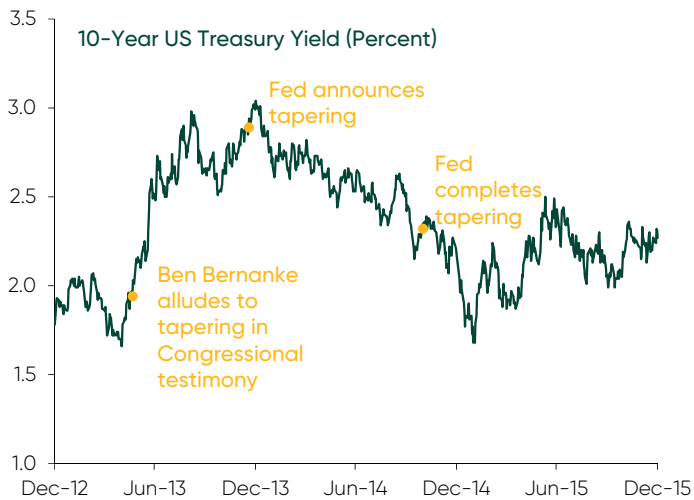
We have long disagreed with the thesis that QE is stimulus. We think it is the opposite. When central banks buy long-term bonds while pinning short-term interest rates near zero, it reduces long-term rates, flattening the yield curve. Over a century of economic theory and data show steep yield curves aid economic growth, flatter curves are sedatives and inverted curves are contractionary.

Banks pay short-term rates for funding (via deposits or commercial paper) and lend at long-term rates. US Treasury rates influence most loan rates, so the yield curve spread—the gap between short and long-term interest rates—is a proxy for banks’ potential profit margin on new loans. When the yield curve flattens, it shrinks margins, discouraging lending to all but the most creditworthy borrowers. We think this largely explains this year’s weakening loan growth in the US and much of Europe. The yield curve’s mid-year steepening, if it were to last, would likely help modestly.

Yet we don’t think long rates are likely to keep rising. Bond markets, like equities, discount all widely known information. As the Fed telegraphed its next move, markets pre-priced it, likely sapping an official tapering announcement’s surprise power.

There is precedent for this. In the last cycle, the Fed started setting expectations about tapering QE in mid-May 2013. From then through yearend 2013, 10-year Treasury yields rose from 1.94% to 3.04% as markets priced the approaching taper.<sup>xxii</sup> The Fed announced its tapering plans in its December 2013 meeting and reduced bond purchases at each meeting in 2014. By October, bond purchases were at zero, and the 10-year yield was down to 2.35%.<sup>xxiii</sup> By 12 January, 2015, yields were at pre-taper talk levels.

#### EXHIBIT 12: TAPERING AND LONG RATES IN 2013 – 2015

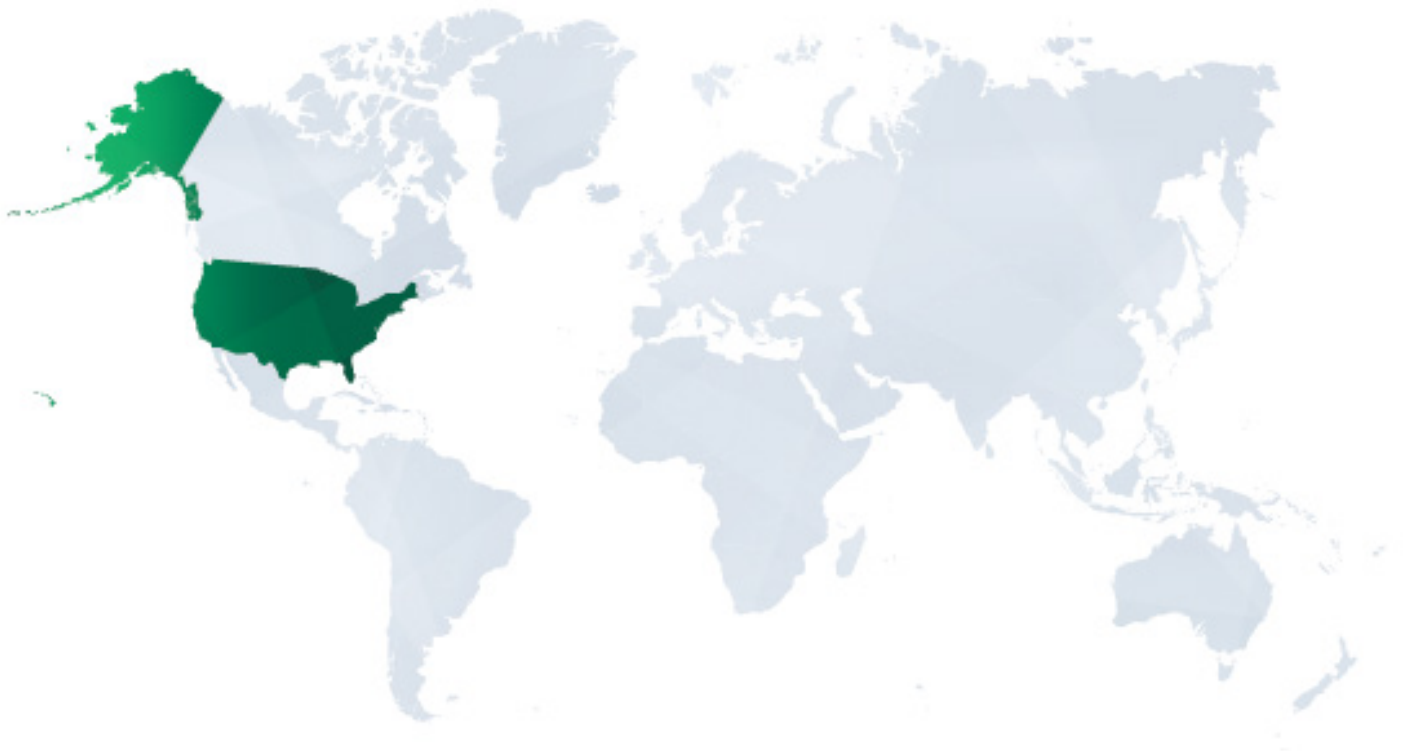


Source: FactSet, as of 08/07/2021. 10-Year US Treasury Yield (Constant Maturity), 31/12/2012 – 31/12/2015.

xxii Source: FactSet, as of 12/07/2021.

xxiii Ibid.

# UNITED STATES COMMENTARY



## US POLITICS REMAINS EXTREMELY DIVIDED

*As always, we are politically agnostic. We prefer no party nor any politician and assess developments for their potential economic and market impact only.*

Q3 encapsulated our political expectations: Much sound and fury with little substance. Democratic leaders, using fiscal year-end and the need for a new budget as leverage, set 30 September deadlines for the bipartisan infrastructure bill and the Democrats' \$3.5 trillion spending bill, which they aimed to pass via reconciliation. Moderate and progressive Democrats failed to find a compromise in recent months. As it became clear she didn't have enough votes, House Speaker Nancy Pelosi moved the deadline to 31 October, when highway funding expires.

Legislators then passed a continuing resolution to avoid a partial government shutdown, followed by a bill to push the debt ceiling to early December—likely teeing up a late November standoff.

This is deep gridlock at work. Congress can't pass as much as some hope and others fear. That doesn't mean nothing passes. But the negotiating takes time. The longer a big bill takes to pass, the likelier it is watered down. That reduces the likelihood of major changes creating winners and losers, which should reduce markets' legislative risk aversion and aid returns—particularly with next year's midterms amplifying the appeal of inaction. Rhetoric will get louder, but potential legislation will get less and less extreme, widening the gap between fear and reality. As it gradually becomes clear there is no way a \$3.5 trillion spending bill or a big tax hike passes, fear should fade, boosting returns.



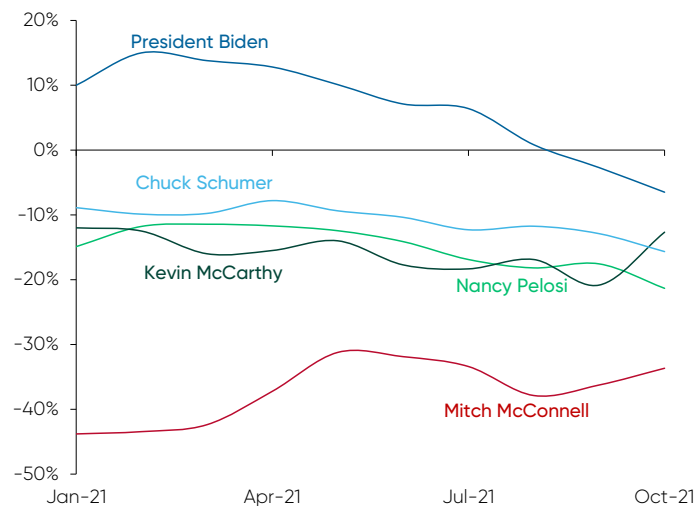
## TIME IS THE GREAT MODERATOR

Just like 30 September, the 31 October “deadline” isn’t real. Democrats detached the infrastructure and reconciliation bills from the continuing resolution at the last minute then, and they can untangle both from highway funding now. As September showed, if Speaker Pelosi and Senate Majority Leader Chuck Schumer don’t think they have the votes, they will delay and draw a new line in the sand. Then another. And another.

Time kills or impairs all deals. We already know Senators Schumer and Pelosi lack the votes for a \$3.5 trillion bill. Senator Schumer needs all 50 Democratic Senators—Joe Manchin (WV) and Kyrsten Sinema (AZ) have publicly stated their opposition. Both want the cost materially lower. House moderates are quieter, but many in red or purple states are equally hesitant.

Speaker Pelosi and Senator Schumer know what won’t be accepted. Now they are thinking through what will—what number will Senators Manchin, Sinema and moderate House Democrats get behind? The longer this drags out, the smaller that number will likely get. Senator Manchin already said his maximum is \$1.5 trillion. Additionally, approval ratings for Republican and Democratic leadership adds to the challenge in passing contentious legislation. (Exhibit 13)

### EXHIBIT 13: APPROVAL RATINGS FOR US POLITICAL LEADERS



Source: RealClearPolitics, as of 12/10/2021. Political approval minus disapproval ratings of political leaders in the US throughout 2021.

Tax increases will be milder, too. In general, the closer you get to an election, the smaller tax hikes get relative to spending increases. This is myopic loss aversion in action: People hate losses over twice as much as they enjoy equivalent gains. Yes, spending generally polls well. But if plans impact voters’ taxes—or even threaten to—then they don’t like the spending so much. The pain of the loss outweighs the potential gain. Hence people seeking re-election want to campaign as spenders, not tax-and-spenders. That means passing whatever spending they can while shrinking the tax hikes in order to get swing voters.

Republican leadership’s strategy appears to hinge on this. When Senate Minority Leader McConnell agreed not to filibuster a short-term debt ceiling increase, he stated it was to give Democrats sufficient time to pass a larger increase using reconciliation. Reading between the lines, the strategy appears to be, give them more latitude to their detriment. Knowing the Democrats—like all politicians—will wait until the last minute to act, if he can keep dangling short-term extensions, it delays closer and closer to the election, raising the likelihood nothing passes. It also gives him a midterm fundraising issue. Of course, Senator McConnell risks the Democrats using that latitude to pass something. They seem keen for a win to tout on the campaign trail. Regardless, the longer this runs, the more benign legislation should be.

## PREPARE NOW FOR THE MIDTERM ANTAGONISM

Heightened rhetoric might make it hard to fathom legislation getting smaller—prepare now for a lot of rhetoric.

Politicians in both parties have become more shrill in recent decades, for a simple reason: Redistricting has created more safe seats. The more safe an incumbent’s seat is, the more they can say extreme things without fear of voter blowback. Actually, the wider their margin is, the more incentive they have to be outrageous, as appearing moderate invites a primary challenge. Witness Senator Schumer’s rhetorical transformation from bipartisan to progressive amid rumors of a primary challenge from Democratic Rep. Alexandria Ocasio-Cortez next year.

The Cook Political Report's Partisan Voter Index demonstrates this using presidential election results. Since 1997, it has tracked how many House districts averaged within 5 points of the national result. Today, 78 fall in this range—down from 167 in 1997.<sup>xxiv</sup> Now, district maps will be redrawn before next year's vote, so that will sway this number somewhat. But it is instructive, in our view, showing most congress people aren't campaigning to voters in the middle. They have every incentive to be extreme, lest primary challengers strike.

So talk will get louder while action gets increasingly benign. Those 78 incumbents won't want to vote in a way the opposition can seize on. This is a classic wall of worry for equities to climb.

## THE DEBT CEILING IS DEAD. LONG LIVE THE DEBT CEILING.

The Treasury estimates October's short-term debt ceiling increase extends its headroom to 4 December. A stalemate is possible, though Democrats can easily kick the can on party lines. Most coverage got this wrong, claiming using reconciliation for a standalone debt ceiling bill would kill the spending package. However, Senate rules allow reconciliation once per fiscal year for each of the following areas: taxes, spending and the debt ceiling.

Yet Democrats seemingly have little appetite for this, as they don't want Republicans to campaign as the party of fiscal probity next year—they want the opposition tainted. That is a strong incentive to run out the clock again. If that happens, expect more warnings about the US "defaulting on its obligations"—a tired, inaccurate statement. Missing payments to vendors, contractors and the like isn't default. Default is one thing only: failing to pay interest and principal on maturing debt. The likelihood this happens is tiny—and catastrophe is even more remote.

When debt is at the limit, the Treasury can still replace maturing bonds—the retiring and new issues offset. As for interest payments, the Treasury can easily make them without borrowing, as monthly tax revenue dwarfs interest payments. In fiscal 2021, there was usually enough to fund Social Security and Medicare, too.

Beyond this, the Treasury would have to make hard choices, picking winners and losers. That isn't great, but it isn't default. It resembles a partial government shutdown, and no shutdown has ever caused a recession or bear market.



... NO SHUTDOWN HAS  
EVER CAUSED A RECESSION  
OR BEAR MARKET.



Many argue the Treasury can't prioritise interest payments, which is not the case. The 14th Amendment says "the validity of the public debt of the United States ... shall not be questioned." In 1935's *Perry v. United States*, the Supreme Court ruled this requires the Treasury to place debt service above all other priorities. In a 1985 memo, the Government Accountability Office confirmed prioritising interest payments is legal and doable—a fact former Treasury Secretary Jack Lew confirmed in 2014. These facts render default extremely unlikely.

And if we are wrong? If the Treasury is a bit late with an interest payment? History suggests this isn't catastrophic. In 1979, the Treasury missed interest payments on three Treasury bill issues due to a computer glitch. It eventually made them, but a delayed payment is still technically default—a failure to pay bond interest and principal exactly as stipulated in the covenant. It didn't prevent the US from continuing to issue debt. Nor did it wreck demand for Treasury.

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xxiv "Introducing the 2021 Cook Political Report Partisan Voter Index," David Wasserman and Ally Flinn, The Cook Political Report, 15/04/2021.

Endless missed payments would be bad. But both parties have huge incentive to prevent it. Most likely, in the bizarre event that Congress fails to kick the can, the Treasury would pay interest, then rank everything else and pay what it can. But if it failed to do so, it would be akin to that 1979 glitch—and widely anticipated. Not a market catastrophe, although volatility is always possible.

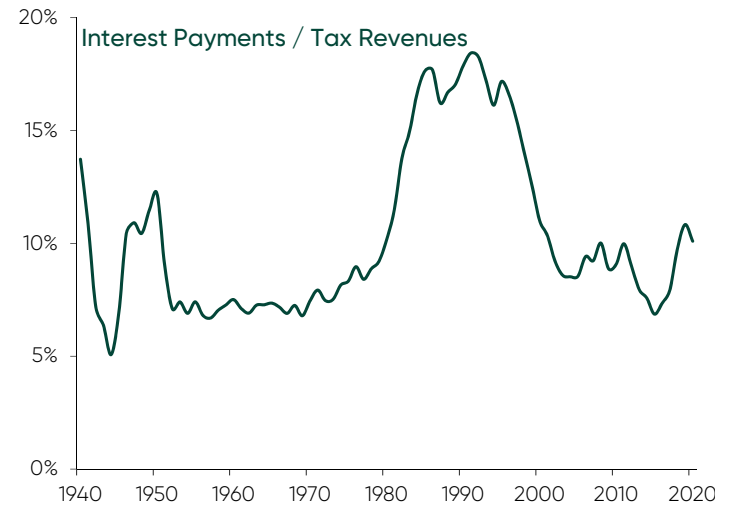
## US DEBT STILL ISN'T A TICKING TIME BOMB

People see trillions in projected new spending and debt and worry it will end poorly. We don't think it would be beneficial for politicians to amass debt endlessly, and it could become problematic in the very long run if they do. But equities don't price long-term risks today. They look about 3 – 30 months ahead. Within that window, the likelihood of a debt crisis rounds to zero, in our view. If debt does start looking troublesome, we should have ample warning.

We have covered debt many times in past publications, but to sum it up, the amount of debt isn't telling—big numbers are meaningless without context. Many pundits acknowledge this, scaling debt against GDP. We understand why: The economy generates the revenue the government uses to pay debt, so in theory, a large debt-to-GDP ratio might imply debt isn't sustainable.

But debt-to-GDP is apples and oranges. GDP is an annual flow of economic activity. Debt is accumulated over time—an amount outstanding. That amount matters much less than what the Treasury spends to service the debt each year. The Treasury pays interest with tax revenues, not GDP. Therefore, a good way to assess debt's viability is to calculate affordability—interest payments' share of tax revenues—and compare today to history. (Exhibit 14)

### EXHIBIT 14: US DEBT SERVICE REMAINS AFFORDABLE



Source: St. Louis Federal Reserve, as of 05/10/2021. Federal Interest Payments and Tax Revenues, 1940 – 2020. Data are based on the US Treasury's fiscal year, not calendar years.

Even with debt's recent big jump, interest payments are plenty affordable. Granted, official data aren't yet available for fiscal year 2021, which ended in September. But interest payments fell in fiscal 2020, even as debt jumped, thanks to interest rates' pandemic plunge. While rates have risen a bit this year, they remain near generational lows, making it cheap for the Treasury to issue and refinance debt.

For debt to become problematic, one of two things would have to happen: Debt would have to quickly rise exponentially, adding to the immediate interest burden, or interest rates would have to skyrocket and stay there for several years. At 2020's end, the weighted-average maturity of net public debt was 64.6 months.<sup>xxv</sup> It would take years of high interest rates to render debt service prohibitively expensive. Sky-high interest rates in the 1970s and early 1980s didn't do it, as Exhibit 14 shows. If the US could afford its debt when interest rates gobbled a much larger share of revenues throughout the 1980s and 1990s, then it probably won't be a problem in the timeframe equities weigh.

xxv Source: US Treasury, as of 06/10/2021.

## **DON'T OVERRATE THE FED'S IMPORTANCE**

Chatter about the Federal Open Markets Committee (FOMC), which sets monetary policy, reached a fever pitch in September. There has long been one vacant seat. Soon there will be another as Richard Clarida's term expires. Following outrage over the revelation they were actively trading investments, two regional Fed presidents resigned in late September, one of whose seats is slotted for next year's FOMC. Above all, Fed head Jerome Powell's term ends in January. Will President Joe Biden reappoint him? If not, will Powell serve out his term on the Fed's Board of Governors? His predecessor didn't. Many fret this shifting makeup could sway policy.

We suggest tuning down the speculation. For one, Fed officials frequently think one way before joining the Fed, then defy expectations once in office. Former Fed head William McChesney Martin once joked that when you become Fed head, they make you take a little pill that makes you forget everything you once knew—then, once you are no longer at the Fed, your memory returns. When pressed about his own unexpected decisions, his successor, Arthur Burns, quipped that he took "Martin's little pill." Ben Bernanke and Janet Yellen both defied expectations plenty while in office.

Hence, forecasting policy moves based on the various personalities staffing the FOMC is impossible, in our view. We think it is also unnecessary, as Fed policy just isn't that powerful. Monetary policy is just one variable affecting economic conditions.

# GLOBAL DEVELOPED EX-US COMMENTARY



## A DEEPER LOOK AT EUROPE'S ENERGY CRUNCH

Europe's escalating energy prices have largely displaced COVID as the most-discussed risk to the global economy and equities. Pundits see crisis and extended supply-chain dysfunction ahead as shortages and price spikes leave households in the cold this winter and cut companies' production and profits. While we don't dismiss the hardship some are facing, we don't think the outlook is as bleak as pundits portray.

The crunch has myriad causes. Flagging September winds sapped European wind-power generation, while low reservoir levels hit Nordic hydroelectric power output. These factors drove electricity outages, which in turn sparked demand for gas-fired production. The problem: Russian gas export curbs depleted European inventories to decade-low levels. Some in the EU claim Russia is exerting leverage to expedite Germany's regulatory approval of the recently completed Russian-German Nord Stream 2 pipeline running under the Baltic Sea, which could double gas exports to Europe. Russia says it just needs to top off its own inventories and will increase exports to Europe soon.

Whatever the case, surging demand alongside low supply sent benchmark European natural gas prices up more than seven fold since March, with knock-on effects that continue to reverberate.<sup>xxvi</sup> European utilities are switching to dirtier sources of power—and competing with other large fuel-importing countries like China, which face similar situations. From a \$65 per barrel August low, oil prices shot to \$85 in October.<sup>xxvii</sup> Coal has climbed over 200% year to date.<sup>xxviii</sup>



IN OUR VIEW, THOUGH, THERE IS LITTLE TO INDICATE A LONG-LASTING CRUNCH IS LIKELY.



Headlines liken this so-called “perfect storm” to the 1970s’ energy shocks, summoning the specter of rationing, gas station queues and possible three-day workweeks. Economists suggest it could destroy demand and cause factory closures far above and beyond the isolated stoppages at UK steel mills and fertilizer plants. Meanwhile, pundits warn price spikes of this magnitude have often historically resulted in recessions and bear markets.

In our view, though, there is little to indicate a long-lasting crunch is likely. While the stalemate over Nord Stream continues, there are other avenues to alleviate energy shortages. Algeria is currently ramping up gas supplies to Europe, while Qatar has stated it has capacity to divert some of its liquid natural gas (LNG) volumes to Continental terminals—for a price. Similarly, while most American LNG exports—at record highs and rising this year—are going to Asia, more could be headed Europe’s way if worthwhile. Elsewhere, Norway and Britain just opened a new undersea electricity cable—the North Sea Link—which should go a long way to smooth power supply and demand between them. Norway—Europe’s second-largest gas supplier after Russia—is also increasing pipeline shipments to the UK and EU.

High gas prices encourage substitution into more affordable alternatives, too, allowing countries more flexibility. China competes with Europe for LNG, but it is now ramping up coal production and securing oil supplies. While this runs counter to China’s long-term emissions goals, it should help ease shortages in the here and now, which we think is likely more important to markets—and China’s commitment to social stability. Looking a bit longer term, European governments are making plans to add more low-emissions options to their energy mix. The UK is poised to confirm funding for carbon-free, mini-nuclear reactors.<sup>xxix</sup> France just announced a €30 billion push for hydrogen and mini-nuclear reactors as well.<sup>xxx</sup> Many are now urging Germany to delay its plans to decommission its nuclear plants.<sup>xxxi</sup>

xxvi Source: FactSet, as of 20/10/2021. Dutch TTF Gas continuous futures, 03/03/2021 – 05/10/2021.

xxvii Ibid. Brent crude oil price per barrel, 20/08/2021 – 19/10/2021.

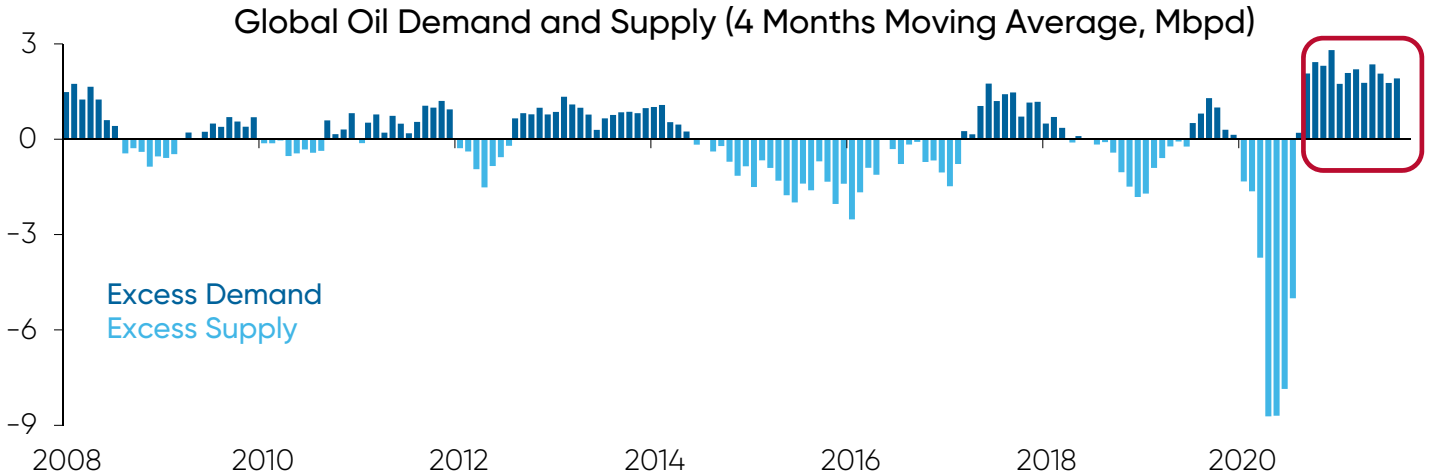
xxviii “European Gas Price Surge Prompts Switch to Coal,” Forrest Crellin, Reuters, 12/10/2021.

xxix “UK Poised to Confirm Funding for Mini Nuclear Reactors for Carbon-Free Energy,” Rob Davies, The Guardian, 15/10/2021.

xxx “Macron Pushes Nuclear, Hydrogen Power in €30 Billion Plan to Reverse Industrial Decline,” Staff, France 24, 12/10/2021.

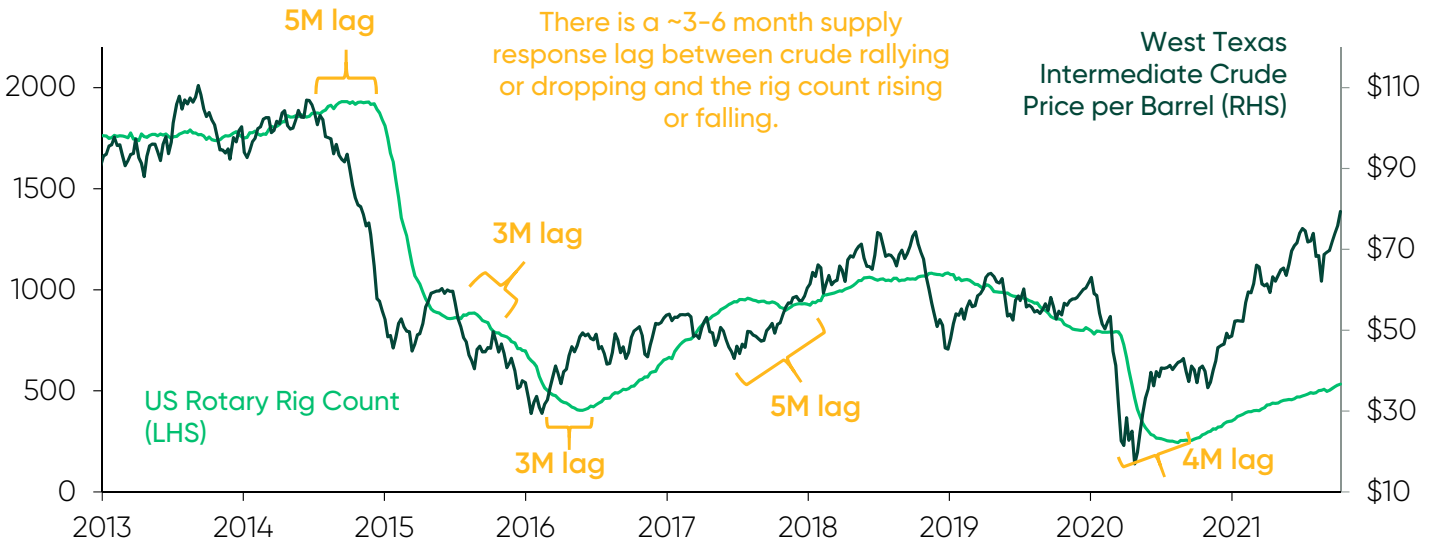
xxxi “Re-Balancing of Europe’s Gas, Power Markets Seen Unlikely in Q4,” Stuart Elliott, Andreas Franke and Frank Watson, S&P Global Platts, 30/09/2021.

**EXHIBIT 15: GLOBAL OIL DEMAND & SUPPLY**



Source: FactSet, daily, EIA, International Crude Oil and Liquid Fuels Consumption, Total World Consumption, Forecast and International Oil Supply, 01/01/2008 – 01/09/2021.

**EXHIBIT 16: US OIL PRICES & PRODUCTION**



Source: Baker Hughes & FactSet, weekly, Total US Rig Count by Basin and West Texas Intermediate Crude Oil Price Per Barrel, 01/01/2013 – 08/10/2021.

But even in the shorter term, OPEC+ and US shale can help meet world energy demand. (exhibit 15) Stung by the last decade’s oversupply-driven oil price collapse, they appear to be exerting greater discipline this cycle, but both have the ability (spare capacity) and incentive (attractive profits) to raise supply. (exhibit 16) OPEC+ is on track to increase oil production by 400,000 barrels per day (bpd) in November.<sup>xxxii</sup> The Energy Information Administration’s Short-Term Energy Outlook projects US crude production, currently averaging 11.0 million bpd this year to hit 11.7 million bpd next.<sup>xxxiii</sup>

xxxii “21st OPEC and Non-OPEC Ministerial Meeting Concludes,” Staff, OPEC, 04/10/2021.

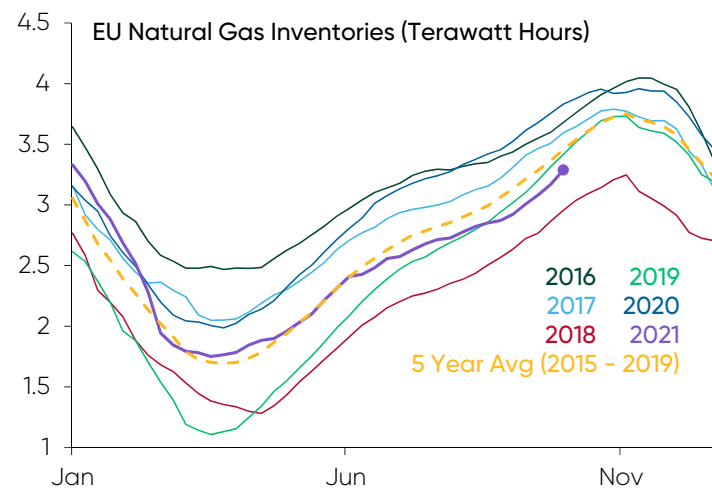
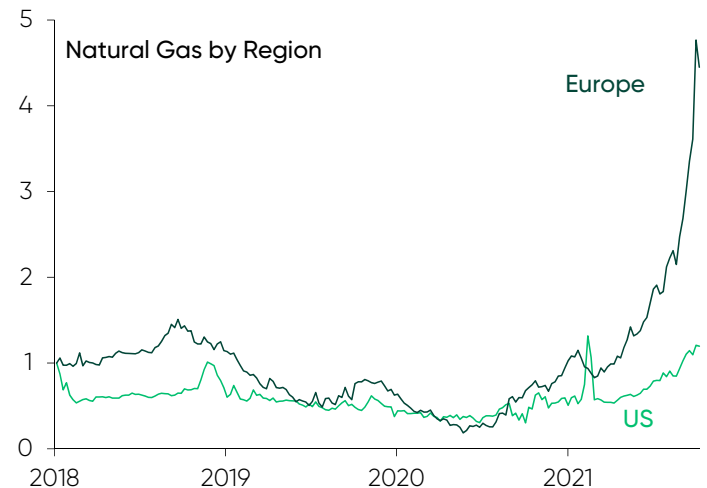
xxxiii “Short-Term Energy Outlook,” Staff, EIA, October 2021.

Relief won't be immediate, but when allowed to work, we think markets are the most effective coordination mechanism to resolve supply-demand squeezes with the least amount of economic pain. In our view, after weeks of tumult, forward-looking markets largely reflect the extent of the situation already. The MSCI ACWI Energy sector rose 9% in September, while all other sectors fell.<sup>xxxiv</sup> Among the worst: Utilities, caught between regulated retail rates and rising wholesale prices.

More adjustment may be in store, particularly if there are new developments stymying production and delivery beyond what markets have already priced. A bigger than expected wallop could precipitate a protracted downturn. We are monitoring conditions closely for those circumstances. But with the abundance of caution we see today, we don't think this winter's looming energy crunch looks close to surprising markets. To us, this should set up falling uncertainty. As producers and consumers respond and adapt to price signals, likely blunting the damage most seem to anticipate, there is a greater likelihood reality exceeds expectations.

The energy crunch could last a while longer, and it is unlikely to abate in a straight line. However, some signs of improvement are already evident. Wind power generation, while intermittent and subject to weather shifts, is up markedly in October versus Q3's average and September's lows.<sup>xxxv</sup> European gas prices also appear to be leveling off, with the benchmark futures contract -22.1% below its 5 October peak.<sup>xxxvi</sup>

#### EXHIBIT 17: EU NATURAL GAS CRISIS UNLIKELY TO SPREAD INTO US



Source: FactSet, daily, indexed to 1 on 05/01/2018. Europe data based on Dutch TTF Gas Futures. US data based on Natural Gas Henry Hub Spot. FactSet, weekly, US data based on Lower 48 States Natural Gas Working Underground Storage, 01/01/2016 – 01/10/2021.

xxxiv Source: FactSet, as of 20/10/2021. MSCI ACWI Energy return with net dividends, 31/08/2021 – 30/09/2021.

xxxv Source: WindEurope, as of 20/10/2021.

xxxvi Source: FactSet, as of 20/10/2021. Dutch TTF Gas continuous futures, 05/10/2021 – 19/10/2021.



## GRIDLOCK IS GLOBAL

Gridlock reigns throughout the developed world, keeping political uncertainty low—a plus, in our view. Canada's September election delivered another minority government for Prime Minister Justin Trudeau, keeping extreme bills unlikely. Most European nations have coalitions that do not have the political capital necessary to accomplish major change. The UK has a single-party government with a strong advantage in Parliament, yet several of its proposals—including unpopular tax hikes—face intraparty opposition. The Netherlands held elections in mid-March and still doesn't have a new government. In France, focus is shifting to next year's presidential contest, diminishing the incentive to pass legislation. Norway voted in September, and a left-leaning minority government is set to replace the outgoing right-leaning minority government—a recipe for continued legislative morass.

When governments can't pass major legislation creating winners and losers, equities face one less source of uncertainty. Businesses gain the clarity needed to plan and invest, which encourages risk-taking. Gridlock annoys voters, but it is great for equities in developed nations. Q3's biggest political developments illustrate we have this in droves.

## GERMANS VOTE FOR CHANGE, SORT OF

Germany held federal elections in late-September, a contest that will eventually determine who will replace Chancellor Angela Merkel. She may remain in office for several months as caretaker leader, however, as no party came close to a majority and German coalition talks can drag.

The centre-left Social Democratic Party (SPD)—Merkel's coalition partner in her past two governments—placed first with 206 of the Bundestag's 755 seats. Meanwhile, Merkel's centre-right Christian Democratic Union (CDU) and its sister party, the Christian Social Union, won just 196 seats and suffered its worst post-war losses.

Forming a majority government requires 368 seats, teeing up tough coalition talks. Neither main party has an appetite for renewing their coalition, positioning the Free Democratic (FDP) and Green Parties as kingmakers. The SPD and CDU would need both parties to form a majority coalition. That is easier said than done, as they have next to no ideological overlap. The Greens lean left and favour high state spending on environmental matters, while the FDP has a strong libertarian and small government bent. As we write, the FDP and Greens have begun talks with the SPD. Perhaps they succeed, although Merkel's attempt to form a coalition with them imploded in 2017, requiring her to re-up her coalition with the SPD.

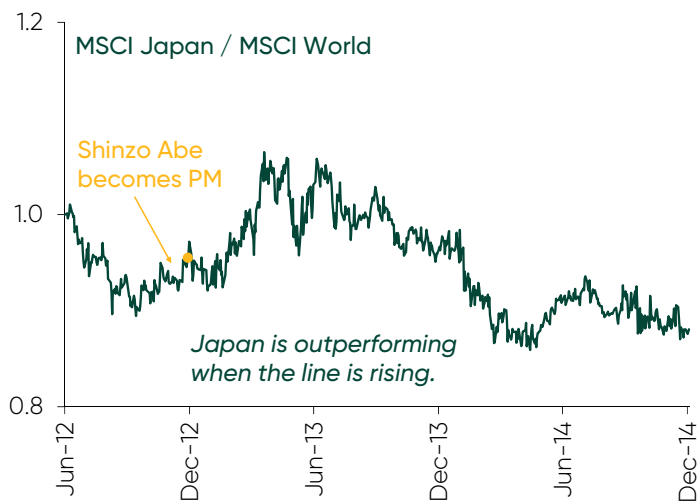
However this shakes out, gridlock likely dilutes any major policy initiatives. Taxes and spending might change somewhat, but there doesn't seem to be enough votes for the major changes featuring in some parties' platforms, including the repeal of Germany's constitutional debt brake.

## REFORM HOPES DASHED IN JAPAN

Japan's revolving door of prime ministers took another turn last month. On 3 September, Prime Minister Yoshihide Suga announced he wouldn't run in his Liberal Democratic Party's (LDP's) leadership election, opening the door for a new PM. The immediate front-runner was Taro Kono, the cabinet minister in charge of reforms. That raised markets' hopes that Japan's deep structural issues would finally get some attention, and Japanese equities jumped. But they returned to earth when LDP insider Fumio Kishida pulled off a surprising victory. Mr. Kishida, the status-quo candidate, isn't from the LDP's reformist faction, dashing equities' high hopes for changes to labour laws, the mega-conglomerates' (known as keiretsu) entrenched dominance and other factors that have often stifled Japan's competitiveness.

Japan is an exception to gridlock’s bullishness—a place where well-crafted reforms would likely be a net benefit. But even if Mr. Kono had won, major change seemed unlikely. Japan’s two prior long-serving, reformist PMs, Junichiro Koizumi and Shinzo Abe, had noteworthy policy successes but couldn’t overcome entrenched opposition to labour reforms or changes that would expose the keiretsu to meaningful competition. The likelihood that Mr. Kono would achieve what they couldn’t—especially in the COVID age—seemed low. Had he won, we think there was a risk Japan would outperform for a while longer, but disappointment would likely have set in after the honeymoon, following the general trajectory when Prime Minister Abe took office. (Exhibit 18) Absent reforms to improve domestic competitiveness, Japan’s largest multinationals probably outperform their domestic-focused counterparts.

**EXHIBIT 18: REFORMIST PMS’ HONEYMOONS ARE SHORT-LIVED**



Source: FactSet, as of 29/09/2021. MSCI Japan and MSCI World Index returns with net dividends, 30/06/2012 – 31/12/2014. Indexed to 1 at 30/06/2012.

# EMERGING MARKETS COMMENTARY



## CHINA'S HECTIC THIRD QUARTER

From President Xi Jinping's "common prosperity" push to Evergrande's potential default, the government's cryptocurrency ban and a continued economic slowdown, China stole headlines throughout Q3. These factors, to varying degrees, likely contributed to the country's equities entering a bear market and had pundits fearing global fallout in September. While developments in China bear watching, we think those thus far are localised and more limited than many fear.

## A WORD ON CHINA EXPOSURE

Despite recent regulatory fears, we continue to favour the consumer and service portions of the Chinese market relative to the state-owned heavy industry and financial sectors. Reform progress also provides the potential for positive surprise, although the reality has been slow and uneven to date. While regulatory concerns have weighed heavily on Chinese technology shares in Q3, pullbacks tied to regulation are not uncommon and though we expect new regulation will disrupt some industries, most fears seem overblown. We remain broadly constructive on Chinese internet names as regulatory developments are leading to depressed investor sentiment, overlooking strong fundamentals.

While not our sole China holdings within Global and EM portfolio's, our commentary in this Review centres around technology platforms Tencent and Alibaba who jointly make up approximately 25% of the MSCI China.

While these firms' performance has disappointed, we think it is a sentiment overreaction to relatively small regulatory changes impacting the two firms directly—and a sharp reaction to much more meaningful changes that don't hit them at all.

## CHINA'S REGULATORY SHIFTS

For eight months after 2020's bear market low, Alibaba and Tencent mostly tracked global markets' climb. But over the last year, their performance has diverged from world equities. Alibaba began declining first, last October.

At the time, Alibaba's financial services technology ("fintech") subsidiary, Ant Group, was slated to go public in Shanghai and Hong Kong. But it fell through. The government said it delayed the debut tied to new leverage limits and capital requirements for fintech firms. But it happened just after Alibaba founder Jack Ma made comments perceived as criticising China's financial regulators, sparking fears of longer-lasting retaliation. In January, China's antitrust regulators opened an investigation into alleged anti-competitive practices at Alibaba. While this settled in April with a small fine, several other investigations into it and Tencent followed. They mostly involved user data protections, but investors feared worse to come.

That crackdown hasn't arrived. In July, further regulatory measures emerged, but these small rulings and fines weren't significant to the businesses. We think the companies' mid-year swoon stemmed mostly from a factor that didn't hit them directly: China's decision to require private-tutoring companies to re-register as not-for-profits and restrict their ability to raise foreign capital via listings outside mainland China.

Obviously, these measures are far more significant than antitrust regulations, fines and a cancelled IPO. Alibaba and Tencent have next to no exposure to this industry, but sold off in sympathy.

August saw more small measures, including a data-protection law and rules requiring online gaming companies to restrict minors' screen time. Tencent has a gaming arm, so many feared this would hit hard. Yet the company had already reduced its exposure. In Q2 2021, just 0.3% of gross gaming revenue came from users under age 12.<sup>xxxvii</sup> Still, continued pronouncements rattled investors. Each announced measure, big or small, brought volatility. In our view, while the MSCI China is technically in a bear market by magnitude (it finished Q3 down -30.3% from 17 February's high), sentiment is the chief driving factor—a correction-like feature.<sup>xxxviii</sup>

Alibaba and Tencent boast the growth characteristics we think are in favour globally. Both Tech-like firms feature strong brands with almost ubiquitous reach in China, fast revenue growth and fat gross margins. They are also central to China's consumers, which government policy has long emphasised. With markets having priced extreme concern over further regulations, expectations and sentiment are extremely low. We are watching developments closely. But if regulatory moves slow or aren't as dire as feared, it should generate a sizable positive surprise and bullishly help Alibaba, Tencent and other Chinese tech and tech-like equities resume acting like their global peers.

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xxxvii Source: Company filings, as of 12/10/2021. 2021 Interim Annual Report.

xxxviii Source: FactSet, as of 06/10/2021. MSCI China Index return with net dividends, 17/02/2021 – 30/09/2021.

## PUTTING CHINA EVERGRANDE IN PERSPECTIVE

In September, pundits hyped another worry: Concerns over China Evergrande—a large, heavily indebted property developer—defaulting on its \$300 billion debt load. Some say its default could be a Chinese “Lehman moment,” triggering a financial crisis and global economic downturn. While default looks likely, as the company has missed multiple bond interest payments, we see many reasons to think the outcome wouldn’t be so awful: Markets are well aware of the situation; China has the means, motive and opportunity to prevent big fallout; and there is little sign Evergrande presents a material global risk.

Evergrande is big. It claims to have nearly 2,800 projects in 310 Chinese cities (mostly apartment buildings).<sup>xxxix</sup> According to The Wall Street Journal, it has 1.4 – 1.6 million pre-sold, unfinished apartments worth roughly \$200 billion, and employs over 200,000 people.<sup>xi</sup>



HOWEVER CHINA HANDLES  
EVERGRANDE, WE SEE LIMITED  
INTERNATIONAL IMPACT.



Regulators’ efforts to cool the housing market seem to be driving Evergrande’s debt-servicing troubles. In recent years, China has tightened regulation and credit for the property market—an effort to tame fast-rising prices. Officials have capped banks’ real estate lending—to both developers and mortgage borrowers—overhauled property auctions and adopted price controls on home sales in select cities.

Last year, Chinese regulators launched their “three red lines” policy restricting real estate developers’ leverage. This hampered Evergrande’s ability to pre-sell apartments, hit property prices and slashed the firm’s credit access.

But this isn’t new, limiting surprise power. Evergrande first encountered issues servicing its debt in September 2020. It compromised with creditors, converting debt to equity. It has since tried to raise cash by selling assets, but the bond market doesn’t seem to think it will suffice—Evergrande’s bonds have traded far below par value for most of 2021. Even before it started missing payments on offshore bonds last month, Evergrande’s debt traded at roughly 20 cents on the dollar.<sup>xii</sup> Equities didn’t ignore this, either. Before the missed payment, Evergrande shares were down more than -80% this year.<sup>xiii</sup> That suggests markets have pre-priced default.

China’s government could easily stem the fallout. While they don’t seem inclined to rescue Evergrande, officials could let the company fail and make customers, suppliers and workers whole (or somewhere near whole) thereafter. They have done it before, and we think they have many reasons to do it again. Chiefly: China’s single-party government relies on social stability to help it retain power. Having 200,000 workers and a vast array of citizens who purchased apartments lose out seems to risk that. They are already reportedly starting to mitigate the effects by having local governments place cash in escrow accounts where Evergrande can use it only to complete construction, not pay offshore investors.

xxxix Source: Evergrande Group company website, as of 20/09/2021.

xi “How Beijing’s Debt Clampdown Shook the Foundation of a Real-Estate Colossus,” Xie Yu and Elaine Yu, The Wall Street Journal, 18/09/2021 and “China and Evergrande Ascended Together. Now One Is About to Fall,” Alexandra Stevenson, Michael Forsythe and Cao Li, The New York Times, 28/09/2021.

xii “Evergrande Moment of Truth Arrives With Bond Payment Deadlines,” Rebecca Choong Wilkins, Bloomberg, 18/09/2021.

xiii Source: FactSet, as of 20/09/2021.

However China handles Evergrande, we see limited international impact. Despite incremental reforms, China's markets remain largely firewalled. US and global banks don't have material exposure to Evergrande. According to research from UBS, even Chinese banks have limited exposure. Higher-risk property developers account for 4.5% of large banks' outstanding loans and 6.3% of regional banks'.<sup>xliii</sup> Chinese investors have more exposure via debt securities dubbed wealth management products, but those aren't broadly owned outside the country.

The primary way China's economy impacts the world is through its contribution to global demand. If China endured a recession, that could be a headwind for world growth. But real estate development alone doesn't seem large enough to drive this. Construction, real estate, renting and leasing activities accounted for just over 10% of Chinese GDP in 2019 (used to avoid lockdown skew).<sup>xliv</sup> When China's property market floundered in 2015, GDP still grew nicely and generated a chunk of global demand. Furthermore, Bloomberg reported the government is taking measures to ensure healthy developers stay afloat and have access to credit.<sup>xlv</sup>

## CHINA'S SLOWING GROWTH

Most Chinese indicators show cooling growth rates. Regulatory shifts and crackdowns on real estate may contribute to that. However, we think the bigger picture is simpler: China is reverting to pre-pandemic trends—like the US.

Before 2020, Chinese growth had slowed across the board. Retail sales, which grew more than 14% ytd y/y in each month in 2012, eased to the low 8% range by 2019.<sup>xlvi</sup> Industrial production charted a similar course. By 2019, it was growing below 6% ytd y/y. GDP shows the same. (Exhibit 19) Outside the post-lockdown surge, double-digit GDP growth is a relic in China.

<sup>xliii</sup> "How Serious Could the Evergrande Spillover Effect Be?" Tao Wang, May Yan, John Lam, CFA, Alex Ye and Ning Zhang, UBS, 20/09/2021.

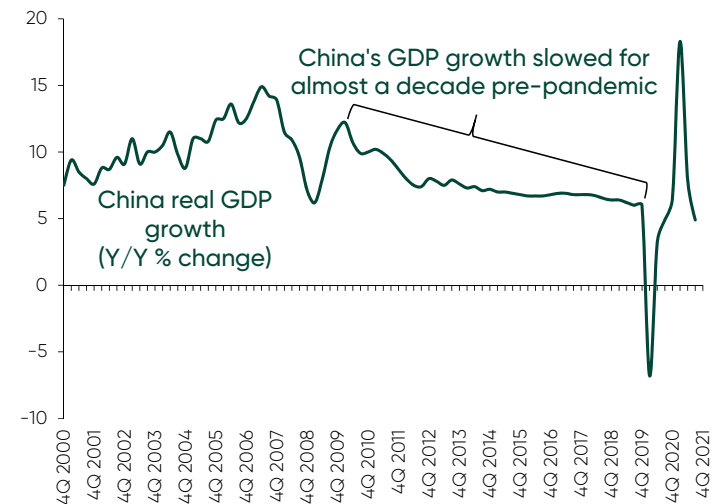
<sup>xliv</sup> Source: National Bureau of Statistics of China, as of 20/09/2021. Construction, real estate, renting and leasing activities' share of Chinese GDP.

<sup>xlv</sup> "China Steps Up Efforts to Ring-Fence Evergrande, Not Save It," Staff, Bloomberg, 04/10/2021.

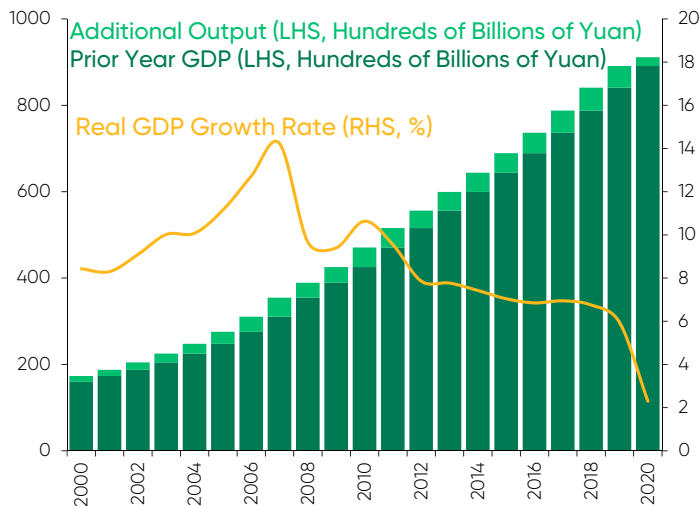
<sup>xlvi</sup> Source: National Bureau of Statistics of China, as of 07/10/2021. February 2012 – August 2021. Data are presented in year-to-date year-over-year format to avoid skew from the Lunar New Year holiday.

This is natural. As economies mature, they tend to exhaust rapid gains from industrialisation and infrastructure buildouts, slowing growth. Furthermore, China is gradually shifting its economic focus from heavy industry and exports to domestic consumption and services, which likely drives slower growth. Finally, even if China grows more slowly, it is building off a larger base. The annual addition to GDP is still very large, often larger than years with fast growth rates. Exhibit 20 shows this, plotting China's annual growth rate and the addition to output in yuan.

**EXHIBIT 19: CHINA'S PRE-PANDEMIC SLOWDOWN**



Source: FactSet, as of 18/10/2021. Year-over-year China real GDP growth rate Q4 2000 – Q3 2021.

**EXHIBIT 20: SLOWER GROWTH, MORE OUTPUT**

Source: FactSet, as of 01/10/2021.

**CHINA'S CRYPTO-BAN**

Lastly, China generated headlines by banning cryptocurrencies in late September. This isn't surprising. They have been signaling this for years. For one, China employs strict capital controls restricting the withdrawal of traditional currency from the country. We have long found it hard to believe they would accommodate cryptocurrencies, which can move cross-border in a flash with some degree of anonymity. Furthermore, regulators banned Chinese banks from dealing in cryptocurrencies in 2013, with further scrutiny ratcheting up over time.

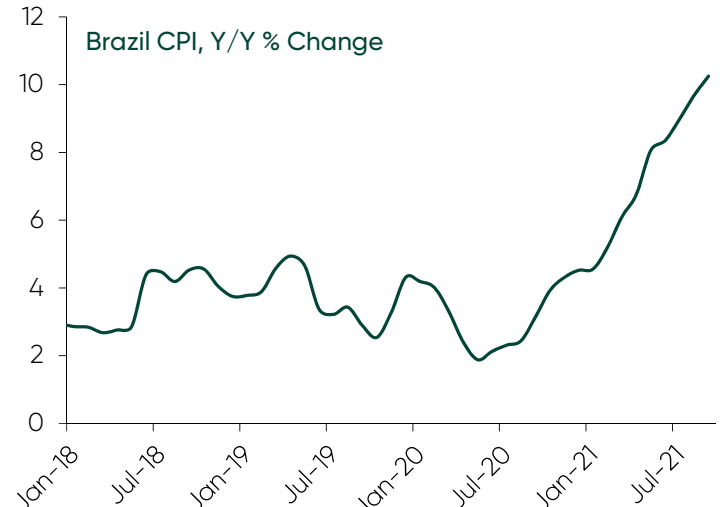
Also worth mentioning, China is developing its own digital currency. No government likes to have its currency monopoly challenged. Tiny El Salvador, which made Bitcoin legal tender earlier this year, is an outlier—and an experiment likely to fail. Bitcoin is too volatile to be a medium of exchange.

**BRAZIL: A CONFLUENCE OF HEADWINDS IN Q3**

Brazilian equities fell -20.2% in Q3, entering bear market territory—and finished as the worst performing country within EM in Q3.<sup>xlvii</sup> Brazil's heavy tilt toward value equities in Energy, Financials and Materials likely explains some of this weakness, which continued into October. While we don't expect these areas to outperform, we included some exposure to help diversify our overall growth emphasis. However, country-specific factors, including slowing Chinese growth, high inflation and political uncertainty, exacerbated Brazil's struggles, causing the country to trail EM Value last quarter.<sup>xlviii</sup> While the country's Q3 performance was disappointing, we still think equities from this region are a valuable addition to portfolios.

**INFLATION AND RATE HIKES**

Brazilian inflation has risen faster than consensus expectations this year, accelerating through Q3 and hitting 10.3% y/y in September.<sup>xlix</sup> (Exhibit 21)

**EXHIBIT 21: BRAZILIAN INFLATION'S RECENT SURGE**

Source: FactSet, as of 10/22/2021. Extended National CPI (IPCA), year-over-year percent change, January 2018 – September 2021.

xlvii Source: FactSet, as of 12/10/2021. MSCI Brazil Index returns with net dividends, USD, 30/06/2021 – 30/09/2021.

xlviii Source: FactSet, as of 25/10/2021. MSCI Emerging Markets Value Index returns with net dividends, 30/06/2021 – 30/09/2021.

xlix Source: FactSet, as of 21/10/2021.

The Central Bank of Brazil responded to rising prices with a series of interest rate hikes. The bank has raised rates by 425 basis points since March, with a 100-basis point hike in September bringing the Selic rate to 6.25%. Many experts expect Selic to reach 7.25% by year-end, with some worrying the combination of rising prices and rate hikes could crimp Brazil's economic recovery.

But we don't think inflation will continue rising and stay high indefinitely. Brazil's high inflation is related partially to the country's easing COVID restrictions, which released some pent-up demand. Brazil has also endured a severe drought, which put upward pressure on food and energy prices.

As for rate hikes, any time a central bank hikes rates this swiftly, it raises the chances of a monetary error. Hence, we are monitoring developments closely. That said, we don't think the hikes to date are problematic. Long-term interest rates have mostly tracked short-term rates' climb, keeping the yield curve steep. We would be much more concerned if the hikes had inverted the curve, putting short rates above long. Because banks borrow short term to fund long-term loans, inverted curves hurt lending's profitability and very often lead to frozen credit markets. With Brazilian 10-year government bonds currently yielding 12.2%, that isn't close at hand now.<sup>i</sup>

## WHAT'S BEHIND BRAZIL'S Q3 STRUGGLES?

The commodity-driven Energy and Materials sectors comprise large shares of the MSCI Brazil: 14.9% and 23.7%, respectively, both exceeding the sectors' weights in the MSCI EM.<sup>ii</sup> However, both Brazilian Energy and Materials equities diverged significantly from their broader EM counterparts in Q3. Brazilian Energy was down -10.5% to EM Energy's 9.1% climb while Brazilian Materials equities badly trailed EM Materials, -28.5% to -4.8%.<sup>iii</sup>

<sup>i</sup> Source: FactSet, as of 26/10/2021. 10-Year Brazil Benchmark Bond Yield on 25/10/2021.

<sup>ii</sup> Ibid. Statement based on sector weightings of MSCI Emerging Markets and MSCI Brazil, as of 12/10/2021.

<sup>iii</sup> Source: FactSet, as of 22/10/2021. MSCI Brazil – Energy Index, MSCI Emerging Markets– Energy Index, MSCI Brazil – Materials Index and MSCI Emerging Markets – Materials Index returns with net dividends, USD, 30/06/2021 – 30/09/2021.

<sup>liii</sup> Source: FactSet, as of 25/10/2021. Percent change in Brazilian Real per US Dollar, 24/06/2021 – 30/09/2021.

<sup>liv</sup> Ibid. MSCI Brazil Index returns with net dividends, in USD and BRL, 30/06/2021 – 30/09/2021.

“  
...A LULA VICTORY COULD  
CREATE A HIGH WALL OF  
WORRY A COUNTERINTUITIVELY  
BULLISH DEVELOPMENT.  
”

Currency contributed to that lag, as the Brazilian real depreciated -8.6% relative to the US dollar in Q3 (and -10.6% since 24 June).<sup>liii</sup> In local currency, Brazilian equities fell -13.3% in Q3 vs. -20.2% in US dollar terms.<sup>liv</sup> Political uncertainty tied to the prospect of profligate government spending may have played a role in the real's tumble. Additionally, President Jair Bolsonaro's disapproval rating is high, and leftist candidate and former President Luiz Inácio Lula da Silva has emerged as the primary opponent in 2022's general election. Current polls suggest Lula would win, stirring chatter of a far-left government that would spend irresponsibly and set back Brazil's economic reform progress, weighing on the real.

While political uncertainty may have weighed on the real, we think fears of something worse to come are overwrought. Some fear Bolsonaro resorting to big spending plans that breach the country's constitutional spending cap, but Finance Minister Paulo Guedes reaffirmed the government's commitment to fiscal responsibility, and Bolsonaro's latest spending proposal would breach the constitutional spending cap by about 0.3% of Brazilian GDP—not a material move, in our view. As for a potential Lula presidency, the general election is still a year away, and a lot can change. Early polls tend to reflect name recognition and sentiment, not much more.



Moreover, a Lula presidency isn't necessarily an automatic negative for markets. During President Lula's two terms in office from 2003 – 2010, Brazilian equities were negative only one year—2008, tied to the global financial crisis.<sup>lv</sup> Fears today of a far-left Lula regime seemingly parallel fears from early in his presidency, and a Lula victory could create a high wall of worry—a counterintuitively bullish development.

## MATERIALS: THE IRON ORE FACTOR

Beyond currency, the Materials sector, and specifically the Metals industry, faced global headwinds in Q3. Iron ore prices plunged -28% in the quarter over fears of weakening Chinese demand related to government curbs on steel output and a slowdown in the real estate market.<sup>lvii</sup> The fall in iron ore prices had an outsized impact on Brazil, as Vale—one of the world's largest iron ore producers—comprises 16.6% of the MSCI Brazil and 70.1% of the country's Materials sector.<sup>lviii</sup> In our view, though, sentiment seems to have overshot to the negative. Headlines focused on the struggles of a handful of Chinese property developers and whether they would drive broader economic weakness. But the Chinese government has taken steps to navigate the local property market's soft patch, from injecting liquidity into the financial system to local governments' offering support. While commodity prices are volatile, demand likely isn't as weak as feared. With today's low expectations, it won't take much for reality to positively surprise—which could reduce the gap between Brazil and EM Value.

## ENERGY: POLITICAL UNCERTAINTY

Though oil prices slid from mid-July to mid-August, they ended Q3 higher.<sup>lviii</sup> Typically, higher oil prices would benefit an oil-heavy economy like Brazil's. But public anger over rising fuel prices drove price-cap speculation, which hurt sentiment toward Brazilian Energy companies. Brazil's truckers threatened to strike and staged demonstrations and blockades throughout the country in September in protest of high diesel prices. Those political pressures stirred concerns the government may influence the large state-owned oil producer Petrobras—which comprises 13.0% of MSCI Brazil—to artificially manage energy prices.<sup>lix</sup>

While implementation of price caps would be a negative, chatter isn't action. Moreover, political uncertainty could hurt sentiment in the short term, but it is only one factor influencing equities. Earlier this year, Brazilian Energy fell -31.5% from 17 February – 3 March after President Bolsonaro ousted Petrobras' CEO over the latter's decision to hike fuel prices.<sup>lx</sup> Yet from 3 March – 24 June, Brazilian Energy rose 64.8%.<sup>lxi</sup> Some of that reflected easing political uncertainty, as Petrobras' new CEO didn't usher in radical change. However, other factors, including reopening progress and rising oil prices played a role, too. Though some uncertainty may linger, markets likely reflect the widely discussed concerns, in our view. Looking forward, we see opportunity for reality to beat today's exceedingly dour expectations.

lv Source: FactSet, as of 11/03/2021. MSCI Brazil price returns, USD, 2003 – 2010.

lvi Source: FactSet, as of 30/09/2021.

lvii Source: FactSet, as of 25/10/2021. Statement based on constituents in MSCI Brazil and MSCI Brazil – Materials, as of 22/10/2021.

lviii Source: FactSet, as of 26/10/2021. Statement based on Brent Crude Oil Global Spot ICE Price, 30/06/2021 – 30/09/2021.

lix Ibid. Statement based on constituents in MSCI Brazil, as of 22/10/2021.

lx Ibid. MSCI Brazil – Energy Index returns with net dividends, in USD, 17/02/2021 – 03/03/2021.

lxi Ibid. MSCI Brazil – Energy Index returns with net dividends, in USD, 03/03/2021 – 24/06/2021.

## RUSSIA'S "ELECTION" AND RELATIVE STRENGTH

Russia was one of the MSCI EM Index's top performers in Q3—and led all other EM nations in September—delivering nicely positive returns as the benchmark fell. While Russia is only a small slice of the MSCI EM Index's market cap, we think a quick look at events in the quarter teaches a valuable lesson about how markets evaluate political developments in less democratic nations.

September's election for the State Duma, like all recent Russian elections, delivered a victory for President Vladimir Putin's United Russia Party and spawned allegations of ballot-stuffing and other forms of fraud. The controversy began a few days before the contest, when major US Tech companies complied with the Russian government's request to remove from their app stores a programme designed by allies of longtime dissident Alexei Navalny, which provided guidance on opposition candidates likeliest to beat United Russia in individual districts. This "smart-voting" tactic aimed to consolidate fractured opposition support and cut into United Russia's supermajority. The Tech companies' decision to delete the app sparked outcry among Russians and anti-censorship watchdogs globally. In other words, it was a classic rigged Russian "election." United Russia emerged with over two-thirds of the Duma's seats despite its share of the vote falling to about 50% from 54% in 2016, extending the status quo.<sup>lxii</sup>

In developed nations with robust democracies, elections that most of the world views as a sham would likely be a significant political risk for equities due to sheer surprise. But in many EM nations, equities have long since learned to live with undemocratic political systems. Other examples where equities have largely shrugged include Turkey and Thailand. We think there is a simple reason for this: Markets care about legislative risk, not personalities. Elections that people perhaps view as negative at the societal level often extend a status quo that equities have become used to, which—perhaps counterintuitively—can reduce uncertainty and create a fine backdrop for markets.

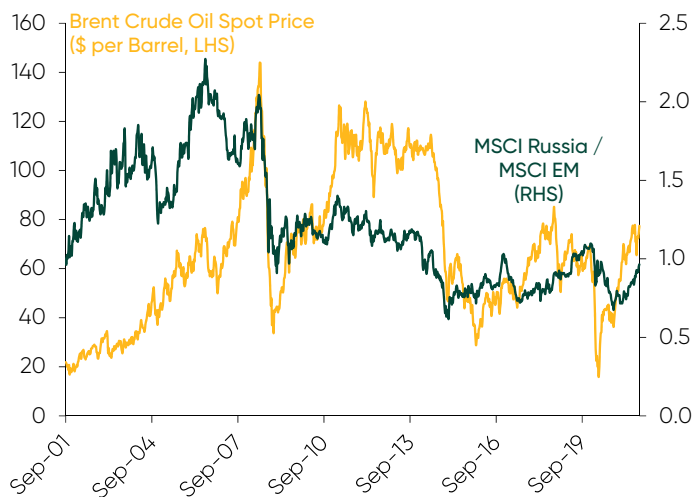
In Russia's case, that backdrop let sector trends shine through as natural gas prices jumped, benefiting the country's large Energy companies. Most eurozone nations haven't significantly developed their own shale-based natural gas reserves, so as they move away from dirty fuels like coal to cleaner-burning ones, they have become reliant on natural gas from Russian pipelines and suppliers. That gives these companies (and President Putin) an outsized influence over supply and prices in the region. For much of July and August, Russia reduced gas exports to Europe, a key contributor to the acute shortage that is now spiking prices across the Continent. Since Energy firms' earnings are sensitive to prices, not volumes, this was a boon to Russian producers. A twin benefit arrived in the form of crude oil's jump from \$65.51 in mid-August to \$77.81 at September's end, driven by a surge in demand as electricity companies ramped up oil-fired power plants to fill the natural gas shortfall.<sup>lxiii</sup>

lxii Source: Russian Central Election Commission, as of 07/10/2021.

lxiii Source: FactSet, as of 07/10/2021. Brent crude spot price, 20/08/2021 – 30/09/2021.

Not only are oil and gas companies a large component of Russia's equity markets, they also play an outsized role in the country's economy as oil rents contribute a significant share of government revenues. Accordingly, oil prices can have a large influence on Russia's relative returns at times, as Exhibit 22 shows. The correlation between Russia's returns relative to the MSCI EM Index and Brent crude oil prices is 0.30 over the past 20 years, implying they move together more often than not. While other variables matter too, of course, oil's pull has been particularly evident over the past year.

#### EXHIBIT 22: RUSSIA'S FORTUNES OFTEN RISE AND FALL WITH OIL PRICES



Source: FactSet, as of 07/10/2021. MSCI Russia and MSCI EM Index price returns and Brent crude oil spot price, weekly, 30/09/2001 – 30/09/2021. Russia returns indexed to 1 at 30/09/2021.

While we don't think oil prices are likely to soar from here and stay there, we do think firm oil prices should remain a tailwind for Russian shares over the foreseeable future. While US producers have added rigs and are ramping up output, Russia and OPEC nations are thus far increasing supply only marginally, proceeding with a planned 400,000 barrel-per-day supply boost. On the demand side, while power producers' strong demand for crude is likely temporary, the return of air travel and other heavy sources of oil consumption as the pandemic wanes globally should counterbalance that. As supply and demand likely balance out, oil likely stays range-bound.

As for natural gas, prices likely don't remain at recent highs indefinitely. One purported reason for Russia's curbing European gas flows was to goad European governments into approving the opening of the recently completed Nord Stream 2 pipeline, which will ship gas from Russia to Germany under the Baltic Sea. The gambit, apparently, is that high prices and the prospect of shortages will goad regulators into accelerating the green light. Whenever that pipeline comes on, it likely improves European supply, bringing prices down to more normal levels. At the same time, Nord Stream 2 stands to be a more economical means of transportation for Russian producers, which should support profits even as natural gas prices slip.

#### SOUTH KOREA

South Korea lagged the broader EM benchmarks over the quarter, as Korean equities suffered in September, primarily driven by growth companies in Health Care and internet categories. Notably, Korean internet firms were impacted by fears over potential regulatory pressures affecting companies with Fintech exposure. In August, Korean equities paralleled volatility in China, tumbling -10.8% between 4 August and 20 August, before a late rally cut the monthly decline to -1.6%.<sup>lxiv</sup>

The Bank of Korea stole headlines globally when it became the first major central bank to hike rates after the pandemic. Observers largely interpreted this as a shift in focus from supporting the economy to staving off a debt bubble. In our view, the latter doesn't appear anywhere near as acute as commentary suggested, considering loan growth is overall modest. We believe there isn't much indication the economy needs central bank support, even as COVID continues circulating in the country. Officials have continued resisting the temptation to implement a full lockdown, and the economic recovery from last year's recession remains on course.

Looking forward, as the world economy recovers from the COVID outbreak, renewed growth in developed-market demand should support export-oriented countries like South Korea.

lxiv Source: FactSet. MSCI Korea return with net dividends in USD, 04/08/2021 – 20/08/2021 and 31/07/2021 – 31/08/2021.

The country's market structure is favourably weighted towards higher margin sectors expected to outperform. Political stability following a string of scandals should also provide a boost to sentiment, though President Moon's policy agenda is geared more toward welfare spending than reform.

## INDIA'S SURPRISING STRENGTH

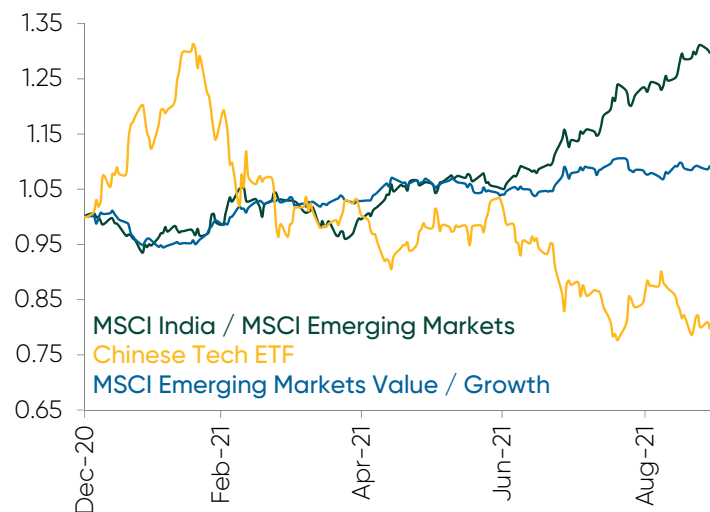
India outperformed in Q3, enjoying increased investor flows in September as investors rotated away from China amid regulatory concerns and fears over China Evergrande's potential default (exhibit 23). India is outperforming the broader EM benchmark year-to-date, with most of the outperformance starting in July as a beneficiary of China's regulatory issues. Further, the country skews towards categories that have done well within EM, such as small cap, value and defensive equities.

Given our global forecast for a continued bull market led by large, high quality, growth leadership we expect much of what has helped India outperform this year to reverse course in the next 12 months. Further, China's downturn should soon reach the average duration seen in past downturns, while India's re-opening optimism should moderate along with economic growth as we move further from COVID.

## EM SUMMARY

The prolonged negativity in EM equities is one of this year's biggest surprises, yet it is also worth noting the negativity isn't universal. Several EM nations have delivered positive year-to-date returns. Regardless, we think it is crucial to look for fundamental negatives that could worsen returns in the struggling nations from here. In our view, however, the positives outweigh the negatives—which at this point are widely known and likely already reflected in prices. While COVID continues flaring up in some EM hotspots, triggering localised lockdowns, most of the world is open and demand for goods from EM is increasingly strong. Supply and electricity shortages, which receive lots of attention, likely prove temporary. So far, data indicate companies have been able to adapt and keep raising output. While returns likely continue varying among EM constituent countries, we think there is ample room for reality to exceed expectations across the broader category over the foreseeable future, which should help the bull market resume.

**EXHIBIT 23: INDIA BENEFITTED FROM CHINA'S ISSUES**



Source: FactSet, daily returns indexed to 1 at 31/12/2020. Chinese Tech ETF used: Invesco China Technology ETF.

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