Market Overview

It is a sign of the difficulty disentangling vice from virtue that two of the shiniest examples of the clean new world, Apple and Tesla, were also two of the first victims of power cuts arising from China's struggle to source essential coal. Humour aside, this raises critical issues: the new era of great power rivalry, inflation, and market valuation.

When Russia committed suicide with *perestroika* in 1991, US GDP ($6.2tn) was 12x the size of Russia's and 7x China's. Now it is Pax Americana that is tottering, and China is in fine fettle. China represents 16% of World GDP, the US 24%. This makes the asset allocation decision with respect to China easier. Mr. Xi is unlikely to throw away the gains of the last few decades on hot wars with Taiwan and other neighbours, at least not until he has developed the technology and production capacity to replace western semiconductor manufacture. The US has a strong hand. It controls the international payments system, has a technology, military, food and energy resource lead and a huge import market. Together with allies, it commands 60% of World GDP. China has more up its sleeve. It has cornered the clean energy supply chain and is on the verge of creating a digital currency that will block US sanctions via Swift. Xi has centralised vertical power for a reason. He is remoulding Big Tech, boosting Party legitimacy by changing the way wealth is generated. The aim is to transform factor productivity, allowing smaller enterprises to prosper using the nation's deep technology stack. As China lets the steam out of its property sector, it is clear there is a shift to a new model led by hard tech. In many areas, the West is years behind and the US is right to fear loss of hegemony. An added attraction is that China is not reliant on the Magic Money Tree. Xi's 'Common Prosperity' strategy shows he takes the interests of China's equivalent of the 'median voter' as a serious constraint.

Worldwide, median voters have not been well served by lockdown as global supply chain issues force energy, food, and many other goods' prices

higher. While headline CPI rates are still in the 3-5% range, energy inflation is near 20% due to resource shortages everywhere you look. Even in the US there are winter blackout warnings. China's coal-fired power plants are caught between price regulation and soaring coal costs, as drought hits hydro power. Poor energy strategy decisions over many years in Germany and Britain are coming home to roost. As Buffet says, 'You see who is swimming naked when the tide goes out.'

The bottleneck crunch should work itself out, despite central bankers stretching the definition of 'transitory'. Every sector is different, some products spiking in both directions, with others on a slower burn. For example, UK house prices have risen 25% but rents have barely moved, a situation in danger of seeping into CPI given wage pressures. It is in lingering second-order effects that risks lie. The UK labour market has Brexit distortions and public sector political pressure, while the US has an 8 million job output gap. The IMF has called for central banks to get ahead of the curve if prices rise too fast or economies overheat, even without full employment.

Between bond yields peaking in 1982 and the 2008 GFC we lived in a deflationary regime. This changed with the GFC. Aversion to the deflationary impact of globalisation ushered in Brexit and Trump. China will not emerge again, and India has missed the boat. Baby boomers are leaving the workforce, female labour participation is flatlining and digital technology is diffusing at a sedate pace. Lockdown just pumped a triple monetary, supply, and demand shock into a system no longer proof against inflation.

How bad is inflation for investors? The record seems to show that inflation rates above 4% or 5% impact equity returns. This is attributed to companies not being able to fully pass on costs to customers, hurting profits and valuation multiples. But it is also likely the harm is caused by interest rates hikes to quell inflation hitting growth and discount rates, and scope for such rises is limited.

Which brings us to equity valuation. Where are we as we near the end of the monetary expansion that has fuelled the rally? Most ratios are bad guides to market direction. One or two measures, like *q*, (the ratio of the S&P's market cap to the replacement value of net assets) and CAPE (the Cyclically Adjusted P/E ratio) have a better record. Today, the Fed *q* stands at around 2x, which is high, while CAPE suggests 45% overvaluation. But this does not allow for the monetary background. Taking the broad US equity market against liquidity, the Willshire 5000 Index divided by M2 money supply, the measure is high, but not extreme. In the late 1990s, the ratio peaked around 3x, while today it sits at just over 2x. With inflation at 5%, interest rates at 0%, it is easy to see this as reasonable.

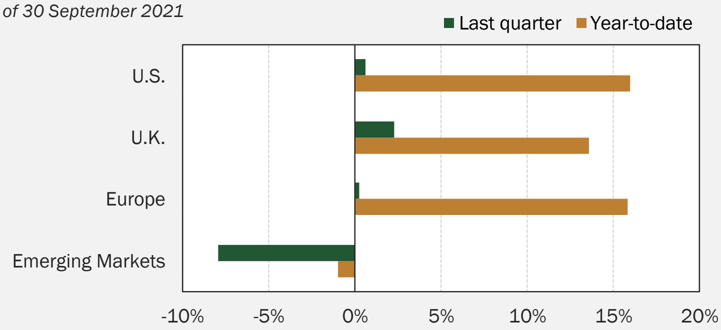
Looking at markets in more detail there are a surprising number of realistic value opportunities. With rising energy and material prices many miners look cheap, banks are a yield pick-up play and there are property REITs with low debt and index-linked rental income. Even the mature tech giants tick the right boxes: market dominance, cash rich, high margin, and pouring money into innovation. Google may spend more on quantum computing R&D than China. China itself, the Saudi of data, is bristling with well-capitalised advanced technology stocks. As to the seeds for the next generation of giants, one of the lessons of our oil and gas price spikes is that clean energy investment needs to intensify. Space, AI, energy storage, quantum computing are other areas sucking in speculative capital at scale.

Asset Classes

Equities

Figure 1 | Equity Market Performance

Returns as of 30 September 2021



Source: S&P 500 (USD), FTSE All-Share (GBP), EURO STOXX 50 (EUR), and MSCI EM (USD) via Bloomberg.

US equities racked up gains through August on strong earnings and favourable guidance from the Fed, before retreating late in the quarter on inflation worries and Fed talk of tapering, along with Biden's stalling fiscal stimulus plan, to end up 0.58% for the quarter (see Figure 1). UK stocks added 2.2% on the back of solid earnings, while European stocks were effectively unchanged in Q3, gaining just 0.22%, as lifting of COVID restrictions based on high vaccination numbers were offset by spiking energy prices, supply chain issues, and inflation fears. EM stocks were the outlier in Q3, declining –8.0% as a number of countries dealt with COVID outbreaks and supply chain headaches, China kicked off a wave of regulatory interventions while struggling under power shortages, and the collapse of major property developer Evergrande prompted fear that a slowing Chinese economy might ripple through other emerging markets.

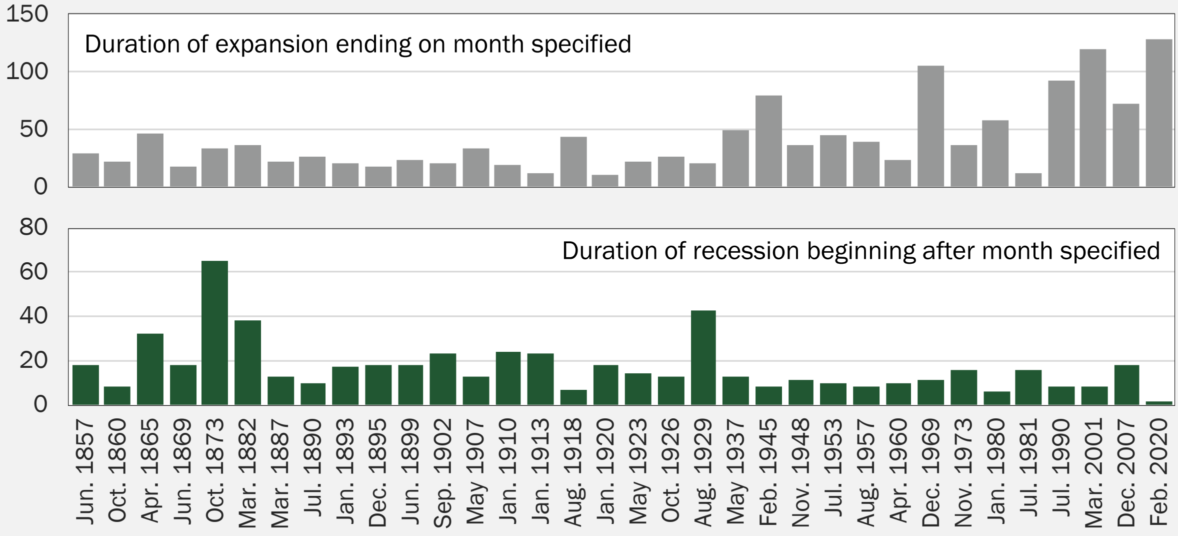
At the end of the third quarter, the rally taking place in global equities since the depths of March 2020 felt like it might finally be losing steam. Increasingly stretched valuations met with continued data of persistent inflation, bringing the expected timeline for rate hikes forward, while manufacturing and shipping disruptions—familiar to anyone buying a car, an appliance, or any random household item, for that matter, in the last year—threatened the post-vaccine resumption of global growth. On the other hand, bulls had plenty of reason to believe September was a mere speed bump, with economists concluding last year's recession, lasting just two months, was the shortest in US history (see Figure 2), while good corporate earnings news provided micro-level support for the "economic revival" narrative. Indeed, according to research platform Sentieo, in addition to frequent "congratulations" by sell-side analysts joining August earnings calls, the phrase "great quarter" tallied a record 327 appearances.

Even many equity bulls would likely acknowledge that outsized stock returns have created a number of pitfalls in today's market. At the sector level, a large part of stocks' gains—particularly since the onset of 'stay-at-home'—have accrued to technology firms, with major benchmarks becoming increasingly heavy in tech shares, exposing passive investors to concentration risk on par with that observed at the height of the 1990s Internet bubble (see Figure 3). Within sectors, a surge in trading activity among amateur retail gamblers (see Figure 4) has pushed companies with suspect fundamentals to valuations so high that their overvalued shares have become meaningful components of large-cap equity benchmarks. One implication of this heightened risk to passive portfolios is the increased usefulness of active strategies, engineered not only to deliver truly diversified exposure at the level of geographies and industries, but also to exploit mispricing at the level of individual stocks.

Figure 2 | Last Recession, Shortest on Record, Capped Longest Boom Ever

The National Bureau of Economic Research (NBER) maintains a Business Cycle Dating Committee, charged with determining exactly where the U.S. economy sits in its continuous wave of booms and busts. In July, its members ruled that the downturn sparked by COVID-19 reached its trough in April 2020, making it the shortest economic contraction since the mid-1850s, when the group's dating of business cycles begins. The recession, which commenced in February, closed out 128 consecutive months of expansion, officially the longest such period in U.S. history. Investors looking to justify lofty equity valuations might note that nearly 28 of the last 30 years qualified as boom times for U.S. companies.

Length in months of US economic expansions and contractions, 1854—2021

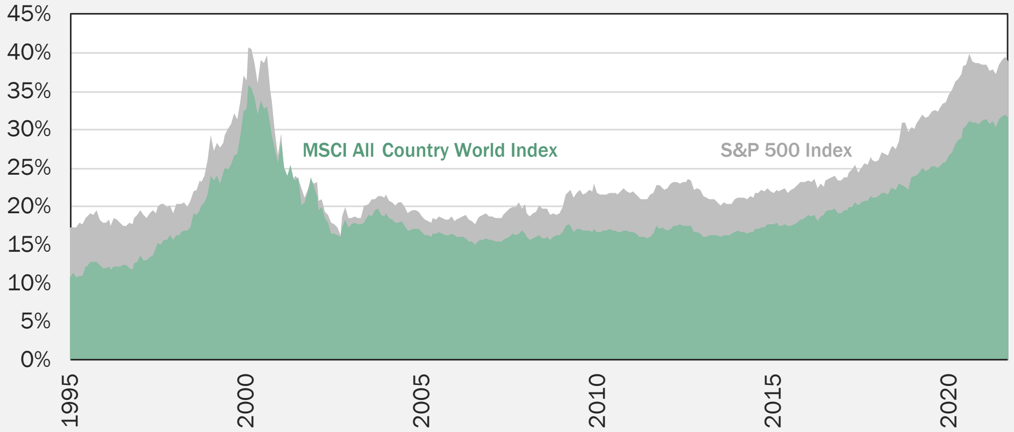


Source: National Bureau of Economic Research

Figure 3 | Passive Equity Benchmarks Increasingly Heavy on Tech

Equity investors hoping to get broad exposure to the global economy through ownership of passive index funds have seen big gains since the lows of early 2020, although most of that return has come from technology names, leaving so-called "broad market" benchmarks nearly as concentrated in the sector as they were at the peak of the late-90s Internet bubble. At the end of September, summing exposures to Information Technology and Communications Services stocks, tech made up 39% of weight in the S&P 500 and almost one-third of the global MSCI All Country World Index. Even those eye-popping numbers underestimate the level of concentration risk faced by passive investors, as they miss companies like Amazon, for example, which hides out in the Consumer Discretionary sector based on dated industry classification schemes.

Percentage weight in Info. Technology & Comm. Services stocks, Jan. 1995—Sep. 2021

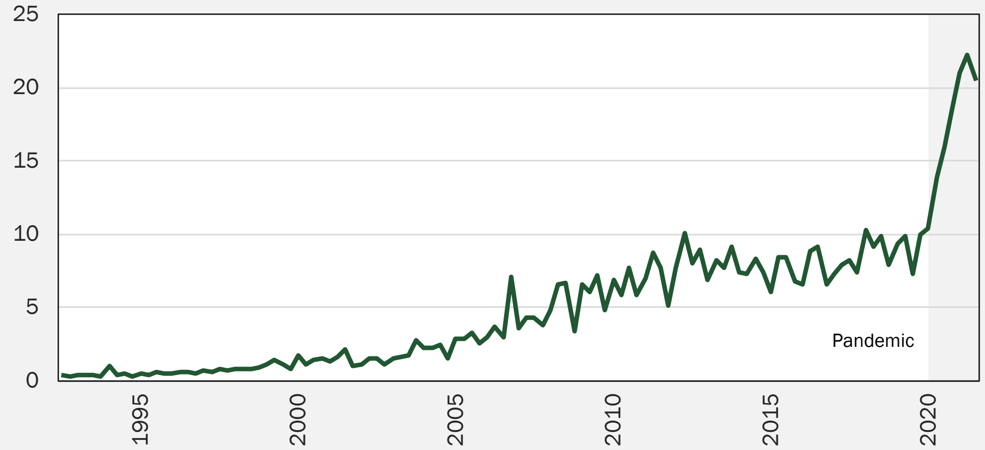


Source: Bloomberg

Figure 4 | Options Trading Spikes on Meme Stock Bets

In yet another sign of frothy equity markets, amateur stock traders, swapping ideas over online forums like Reddit and trading through Robinhood and other mobile apps went on a "meme stock" gambling spree in 2021, placing bets on struggling companies like GameStop, AMC Theatres, and BlackBerry. Of course, simple margin trading provides a fraction of the rush that retail punters achieve through highly levered and time-sensitive trades in options, which has resulted in a surge of buying that sent U.S. call option volume above 20 million contracts in each of the last three quarters. Much of the action was in "small call trades"—those for 10 or fewer contracts—on which retail investors plunked down over $30 billion in premiums for the month of January, alone. According to industry source App Annie Intelligence, hours spent on mobile trading apps jumped 135% for U.S. users in 2020, with those in the U.K. logging over 50% more time trading online.

Quarterly volume of call options traded in U.S., millions of contracts, Sep. 1992—Sep. 2021

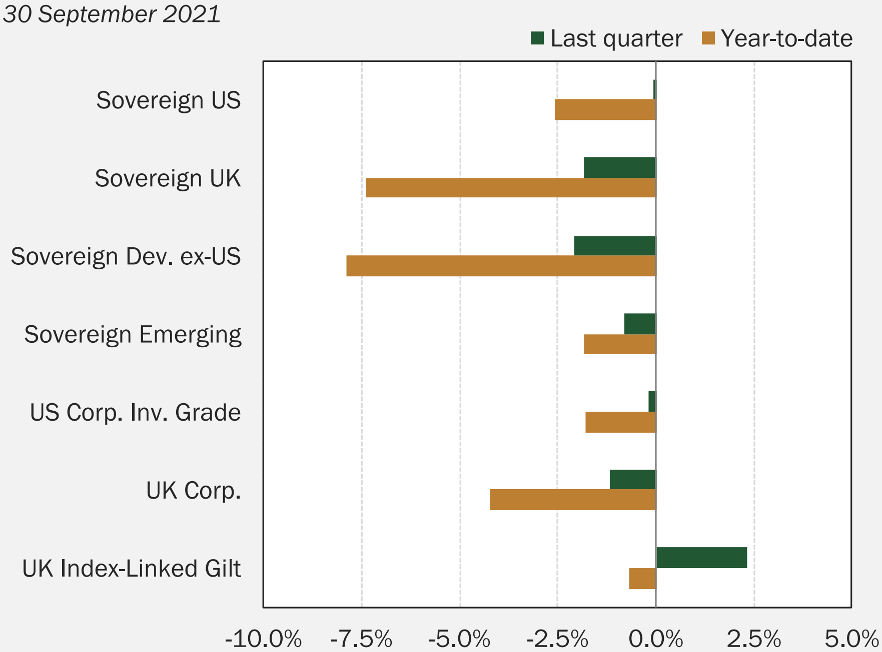


Source: Bloomberg, Sundial Capital Research

Fixed Income

Perhaps reflecting the uncertainty among bond market participants as to transient vs. persistent inflation and when rock-bottom rates might finally begin to rise, fixed income reversed course once again in Q3, with most bonds losing ground over the last three months (see Figure 5). Rates initially fell in the third quarter, as headwinds to economic growth gave investors hope of a reprieve from tightening. By quarter-end, central banks had generally shifted to a more hawkish footing, moved by data suggesting rising prices observed in 2021 might not soon abate (data not lost on investors in index-linked bonds, who bid prices higher in Q3, producing positive returns for debt with an embedded inflation hedge).

Figure 5 | Fixed Income Market Performance
Returns as of 30 September 2021



Source: Bloomberg, expressed in USD except for UK Gilts and UK Corporate in GBP.

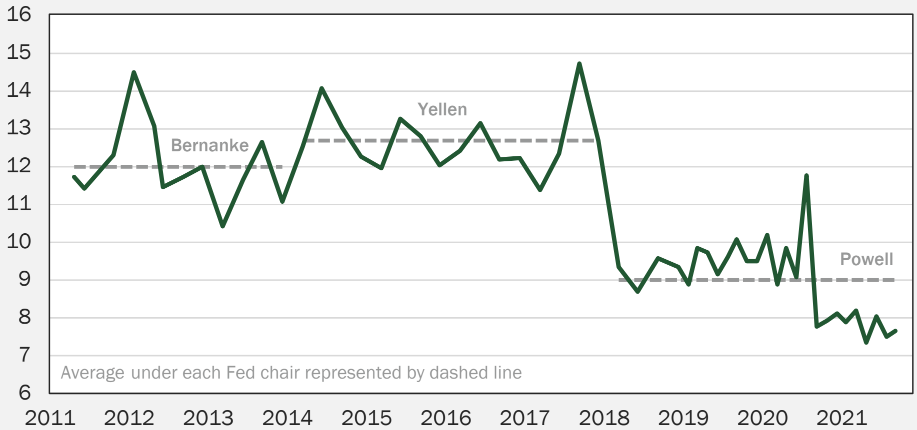
Investors seeking to time the inflection point for monetary policy have increasingly focused on the language of the Fed, parsing bankers' speech in an attempt to gauge a change in sentiment, to the point that FOMC press conferences move markets and produce troves of linguistic data for industry and academic researchers to dissect (see Figure 6). In the spirit of hanging on Fed officials' every word, it's interesting to note that the economic buzzword *du jour*, "transitory", an unusually popular term in Fed dispatches since the first quarter, suddenly fell out of use by the FOMC in September—though "inflation" has been rolling off the tongues of managers on corporate conference calls at an increasing clip throughout the year (see Figure 7).

Norway became the first G-10 nation to hike rates in September, raising its policy rate from zero to 0.25%. Even without explicitly raising rates, given the size of central banks' balance sheets in the wake of long-running quantitative easing programmes (see Figure 8), the spectre of an end to banks' bond buying represents a source of anxiety for fixed income investors. To that point, ECB President Christine Lagarde recently pledged to slow the pace of emergency bond purchases, with a call for similar scaling down of QE by officials at the Bank of England. By the end of September, even the US Fed had announced that tapering was on the table, triggering a selloff in Treasuries at quarter-end.

Figure 6 | Reading the Fed's Tea Leaves Easiest Under Powell

According to research by Michiel De Pooter of the U.S. Federal Reserve Board of Governors, who made a detailed study of text from every FOMC press release, prepared statement, and unscripted Q&A between the Fed Chair and reporters since 2011, the market reacts to what's said in FOMC press conferences. An interesting aspect of the investigation concerned the linguistic complexity of the Fed Chair's responses to journalists' questions which was highest under Bernanke and Yellen—roughly at the college level, classified as "fairly difficult" to comprehend—but has fallen significantly during current chair Powell's tenure, to a level categorized as "plain English". This is, no doubt, music to the ears of Fed-watchers seeking insights as to when rates will next rise.

Flesch-Kincaid grade level readability, Fed Chair Q&A with reporters, 2011—2021

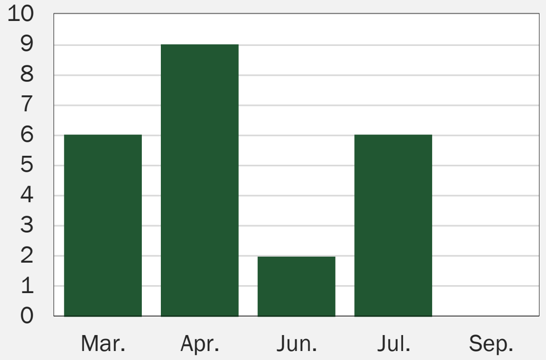


Source: Reproduced from research by Michiel De Pooter, Federal Reserve Board of Governors

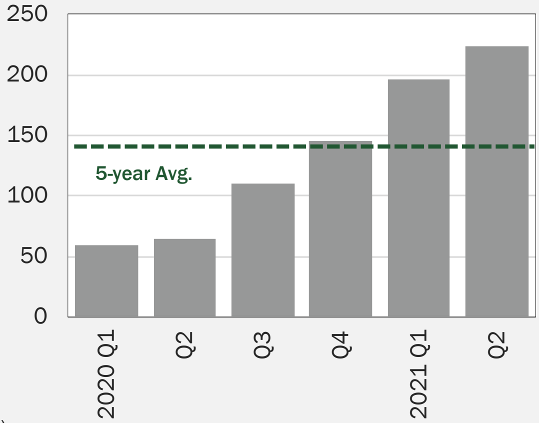
Figure 7 | "Transient" Falls Out of Fed's Lexicon, Firms Feeling Inflation

Since markets began flashing signs of inflation earlier this year, the great debate has been whether rising prices would be temporary, induced by transient features of the pandemic and set to work out in short order, or persistent—which would naturally be of much greater concern to investors measuring the real value of future cash flows to the stocks and bonds in their portfolios. Since Q1, the U.S. Fed has championed the "transitory" view of inflation, with that word showing up again and again in press releases and statements by central bankers. That was the case, at least, until September, when not one reference registered, suggesting the Fed might feel the recent run won't soon reverse. Meanwhile, firms' managers, keenly aware of the bite of surging prices, have been raising alarm bells in earnings calls since the beginning of the year.

FOMC press conference references to "transitory"
Number of mentions per month



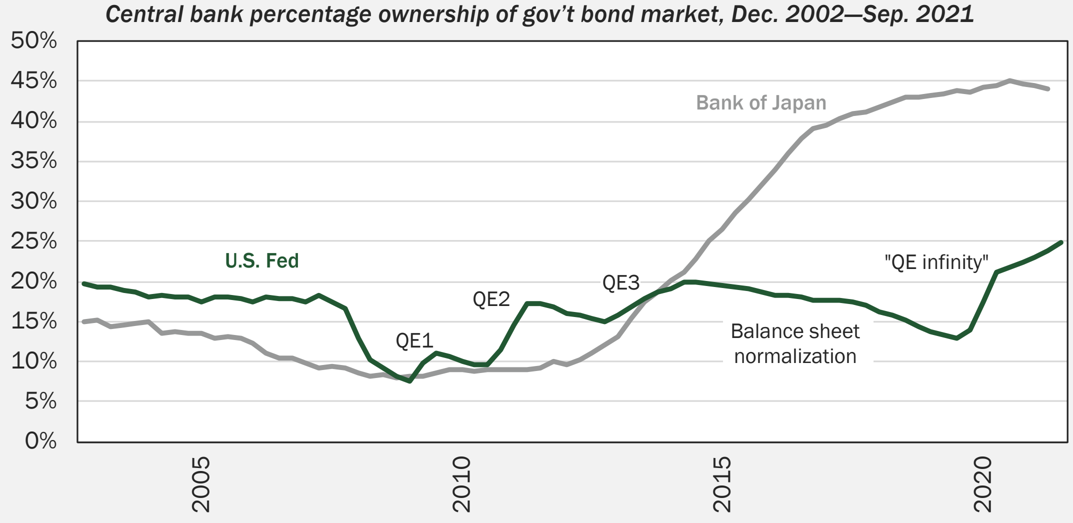
Quarterly earnings calls referencing "inflation"
S&P 500 firms with a mention, 2020 Q1—2021 Q2



Source: Aitken Advisors (left panel), FactSet (right panel)

Figure 8 | "QE Infinity" Pushes Fed Stake in Treasury Market to 25%

With nominal interest rates approaching zero in markets around the world, central banks have increasingly resorted to the practice of quantitative easing: direct purchase of bonds for the purpose of increasing the money supply and stimulating growth. While still a far cry from the Bank of Japan, which now holds around 45% of outstanding Japanese government bonds, three rounds of QE by the U.S. Federal Reserve, along with the latest program of "unlimited" bond purchases, have pushed its ownership of Treasury securities to almost one-fourth of U.S. debt. The size of the Fed's stake has led some to fear that when bond buying ends, rates might rise quickly, although experts have noted the bank is conscious of the role it plays in the system and is highly unlikely to begin unwinding its balance sheet anytime soon.



Source: U.S. Federal Reserve, Bank of Japan, Bloomberg

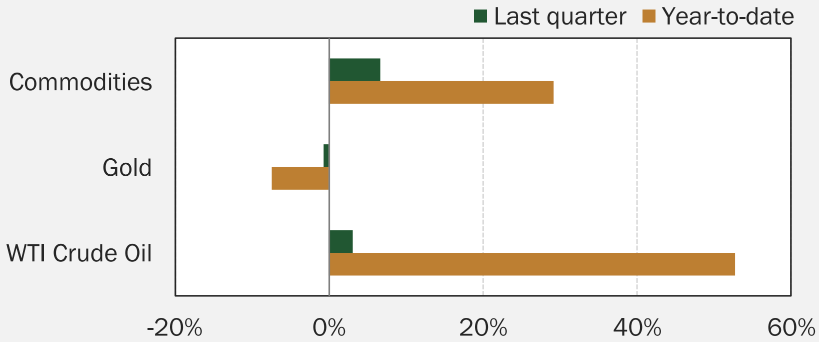
Commodities

Commodities continued a record run in Q3, with the Bloomberg Commodity Index rising 6.6% for the quarter, placing its year-to-date return at nearly 30% and marking an historic high for the broad basket of energy, agricultural, and metal commodities (see Figure 9). Energy led the way, as the global economic recovery boosted demand and a confluence of factors held down supply, while disruptions to global transportation and supply chains—including a dire shortage of shipping containers—prompted a rally in coffee prices (see Figure 10). Precious metals declined for the quarter, as the value of commodities like gold, silver, and platinum as inflation hedges lost out to the fear of rising bond yields, which increase the opportunity cost to holding metals.

Iron ore was the biggest loser among commodities tracked by the World Bank, as signs of slower growth in China and the woes of property developer China Evergrande sparked concern that the nation's steel industry would demand less of the industrial metal. European natural gas turned out to be the biggest winner by a wide margin, climbing nearly 480%, year-over-year (see Figure 11), benefiting from increased demand as countries with mostly vaccinated populations lifted COVID restrictions, EU carbon emission rules increased the commodity's value relative to other energy sources, and coal-starved Chinese firms dipped into European production. At the same time, a cold 2020 meant inventories were already low coming into this year's heating season, with Russia's likely political move to curb supply to Europe creating conditions perfect for a September rally in natural gas.

Figure 9 | Commodities Performance

Returns as of 30 September 2021

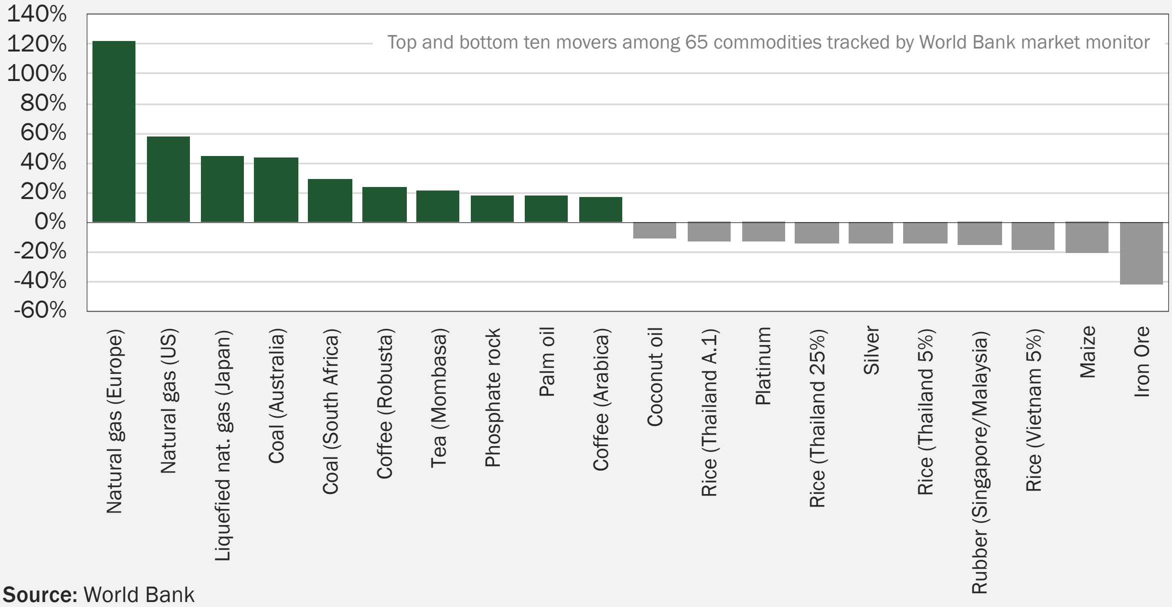


Source: Bloomberg Commodity Index (USD), WTI Crude (USD), Gold Spot (USD) via Bloomberg.

Figure 10 | Supply Chain Chaos, Macro Fears Move Commodities in Q3

From heavy rain over Thai rice paddies and a lack of shipping containers for Vietnamese coffee beans to fear of a reduction in steel manufacturers' demand for iron ore as China's property sector grappled with the possible default of its second-largest developer, the third quarter witnessed big swings in prices for a range of commodities. The greatest action was seen among energy contracts, as strong global demand for power combined with supply chains disruptions and plans for reducing carbon emissions, resulting in surging natural gas and coal prices, with European natural gas climbing over 120% for the quarter.

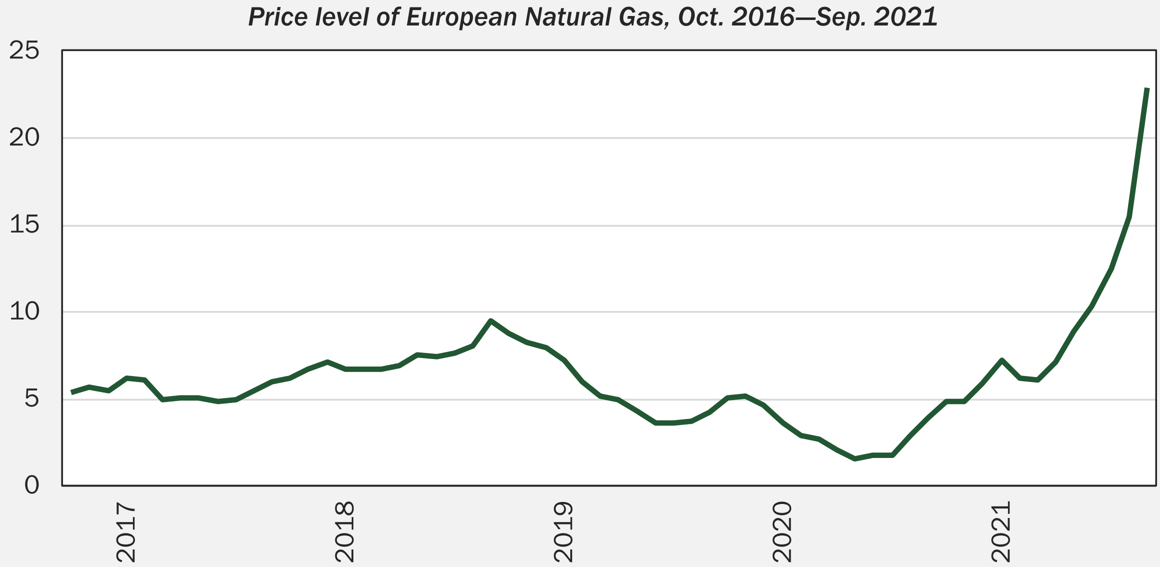
Percentage changes in price, from beginning to end of Q3



Source: World Bank

Figure 11 | Natural Gas Prices Reach Record High in Early October

Natural gas prices exemplified the energy sector's contribution to commodity indices reaching record highs in September, and nowhere was the situation more extreme than in Europe, where the commodity was up nearly 480%, year-over-year. On the demand side, rekindled economic activity saw Asian consumers competing for energy with European buyers, who were themselves moved to buy natural gas as a result of EU carbon emissions regulation. Supplies were already short going into the year after an unusually cold 2020 winter, and tightened further into the beginning of October, with European gas inventories falling to their lowest seasonal levels in over a decade, as Russia curbed output to Europe and weather forecasts indicated below-average temperatures to kick off the gas market heating season.



Source: World Bank, Bloomberg

Looking Ahead

The threat of high interest rates is not a done deal. Central banks are constrained by high levels of debt, sovereign and private. The US had been doing a good job of running down private sector debt from 2008, substituting state borrowings that, but for COVID, would now be reducing. Indeed, the US may be the only country able to sustain aggressive rate rises with impunity. This would support the Dollar, even with President Biden's ambitious spending plans.

How will the world deal with its 300% debt-to-GDP ratio? Inflation seems to be the preferred option for now, as politicians 'level up' to increase wages and create huge spending programmes labelled 'investment'. Rebuilding local production capacity is another opportunity for state spending largesse as is green investment. But there will be plenty of investment opportunities for those who can avoid capital misallocation. Ultimately the switch to green should feed across sectors, a recent Oxford study calculating the benefit at $26 trillion, over a quarter of world GDP, as energy costs halve from 4% to 2% of GDP. Developed world savings ratios are at record levels. If debt-constrained governments keep interest rates low, as inflation picks up it is this kind of story that could force cash to capitulate, pouring into equities and propelling them higher.

Key Economic Releases and Events for Q4 2021

UNITED KINGDOM

Bank of England Official Bank Rate Release: 4th November, 16th December

PMI Figures: 23rd November, 3rd December

EUROZONE

YoY GDP: 16th November, 10th December

PMI Eurozone: 3rd November, 3rd December

Unemployment Report: 3rd November, 2nd December

ECB Monetary Policy Meeting: 11th November, 30th December

UNITED STATES

FOMC Rate Decision: 3rd November, 15th December

GDP Figures: 24th November, 22nd December

PMI Figures: 23rd November

Closing Comments

US equities and fixed income are still hovering around all-time highs, but as usual it remains an even bet which way they go from here. All assets are expensive in an absolute sense, but risk asset prices are easier to justify relatively, because the risk-free portion of returns is historically low thanks to decades of low inflation. Evidence from lockdown's fiscal support programmes suggests that this has been a mistake—that the way to get economies moving is not manipulating asset prices with low interest rates, but putting money to work in ordinary peoples' pockets. While a decade of QE has kept the markets happy, it has escalated the West's inequality resulting from turning Emerging Markets in general, and China in particular, into the world's low-cost manufacturing base.

Because of this misunderstanding, there is a risk of underestimating the effects of stimulus. Further, inflation is often a political choice, and now that it is brewing, it is easy to see the attraction to governments of reducing debt-to-GDP without the pain of austerity. In *Revolution and Rebellion in the Early Modern World*, Jack Goldstone asserts that a classic mistake historically has been for states to see inflation as a chance to raise covert taxes and fund pet projects, only to find inflation increasing costs more than it reduces debt. The dangers are widely recognised, with the IMF and several central bankers calling for action in November. Interest rate rises may hit sovereign credit so governments may need to pull other levers if they decide to control the inflation they have unleashed. Stand by for a bull market in administrative measures! In which case, low rates may allow equities further room to run.

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