On the Mark – Multi Asset Strategy

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September 2021 – Double Trouble!

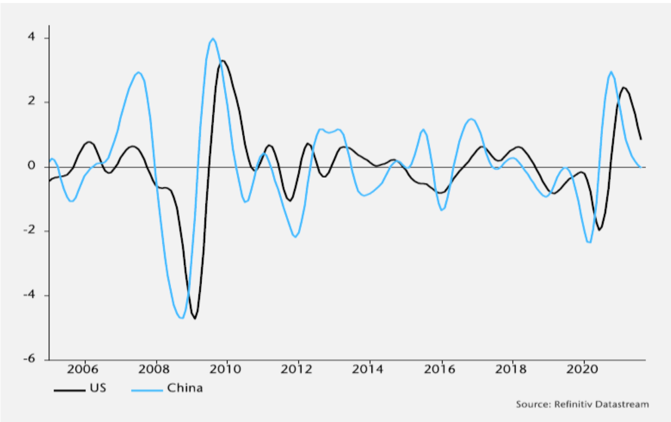
"Double, double, toil and trouble. Fire burn and cauldron bubble." *Macbeth, Shakespeare.*

We have been at pains to point out for some time that we believed that a slowdown in global economic activity would unfold in the second half of this year. We previously cited comments from Simon Ward of Money Moves Markets – "Cycle upswings usually last at least two years, with an initial upthrust giving way to an interim correction before a final push into the peak." This would equate to a slowdown (interim correction) around Q3 2021.

Composite leading indicators are designed to provide early signals of turning points in business cycles, showing fluctuation of the economic activity around its long-term potential level. The leading indicator components include consumer sentiment, along with the ISM PMI, housing starts, durable orders, the manufacturing work week, the yield curve, and stock prices.

The chart below (Figure 1) shows that the OECD's US composite leading indicator is mirroring China's with a lag i.e. the Chinese economy is leading the slowdown. Given it was the first to become affected by the pandemic, the first to show signs of recovery, and is now going through a tightening of policy, this should not come as a major surprise.

Figure 1: OECD Leading Indicator (% change 6m).

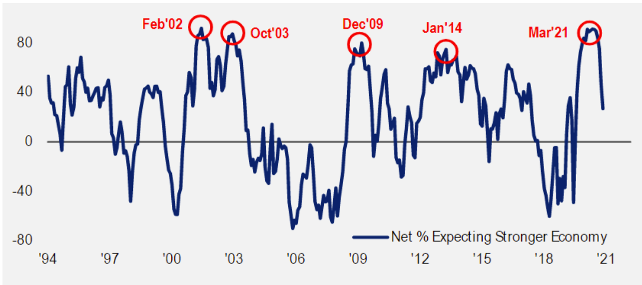


Source: Garraway, Simon Ward http://moneymovesmarkets.com.

Interestingly it appears that the wider fund management community as surveyed in Bank of America's (BofA) Global Fund Manager Survey (GFMS) for August is catching up with our views.

Figure 2 shows that that their growth expectations have fallen dramatically since March 2021. Highlighting this point, Goldman Sachs just slashed its Q3 GDP forecast for the US to just 5.5% from 8.5% as of late July (and 9.5% previously), Goldman's chief economist warning that "the impact of the Delta variant on growth and inflation is proving to be somewhat larger than we expected." Additionally, BofA Securities now finds that "the economy is running at a slower pace in 3Q," and currently tracking just 4.5% following the retail sales report, down from the bank's official forecast of 7% quarter on quarter.

Figure 2: BofA GFMS Net % Expecting Stronger Economy.



Source: Garraway, BofA GFMS.

If we are correct in our view this would indicate that we will see the US slowing further and with it hopefully see stabilsation of inflation numbers. This should allow the Fed to retain a slow and steady approach to monetary policy, with less pressure to raise interest rates.

As Guggenheim Macroeconomic and Investment Research Group state "evidence of a slowdown in third quarter economic activity will continue to mount in the coming weeks, putting the Fed's 7 percent real GDP growth projection for 2021 out of reach. This string of weaker data will likely prompt the Fed, led by Chair Powell and Governor Brainard, to take a more cautious approach to the timing and speed of tapering plans, in turn keeping Treasury yields low." Equally, this may mean that the People's Bank of China (PBoC) shift their emphasis towards easing policy. The latest PBoC's monetary policy report stating that the bank would maintain the stability of monetary policy to support the economy, would indeed support that thesis. Furthermore, the BofA GFMS report showed that there was "a surge in respondents expecting China to ease, up to net 78% from 44%."

This would normally be a positive for the prices of a range of connected assets. However, the recent sweeping overhaul of its $100 billion education tech sector, banning companies that teach the school curriculum outside of school from making profits, raising capital, or going public, has added another level of complexity. Whilst the government's intention of making social and economic development fairer may be considered laudable and viewed in a good light, it was done in a heavy-handed way, which caused investors to feel threatened and rerate many stocks precipitously downwards.

At a wider level many investors think that this signals the progression of further measures/restrictions that will target other key areas where the state feels too many inequities exist i.e. the property sector (unaffordable house prices) and pharmaceutical sector (drug pricing). However, Ray Dalio of Bridgewater states while it would be better if Chinese authorities explained their reasoning behind financial regulation moves, investors shouldn't "misinterpret these wiggles as changes in trends, and don't expect this Chinese state-run capitalism to be exactly like Western capitalism… "

Our conference call with Ping Zhou and Cicy Wu, managers of the Hereford Bin Yuan Greater China Fund – our preferred exposure to Chinese equities – reassured us and confirmed several points. Namely that the government is trying to resolve the conflict between people's increasing demand for a better life and unbalanced economic and social development given a rapidly changing emerging economy where regulation has fallen behind, especially in areas of explosive growth.

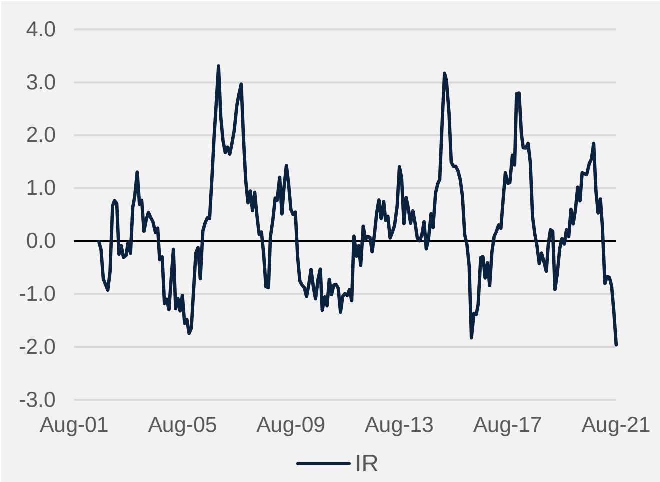
One of the most concise and stand out pieces of research we read on the topic was a well written note and constructive piece by Jerry Wu, manager of Polar Capital's China Stars Fund.

Inevitably some companies will fall on the wrong side of these policies and have their value impaired longer term (or close to zero in the case of the home-schooling sector). However, many stocks have been indiscriminately sold down and this provides opportunities. We can see in Figure 3 that the Information Ratio (IR) of the MSCI China index relative to the MSCI Emerging Markets (EM) Index has collapsed and now sits near significant lows, which presents good entry points to the wider market.

We also listened into a call by Kevin Carter, CIO and founder of the EMQQ Index, about the recent Chinese regulatory concerns and gained a great deal of comfort on the strategy longer term. If you listen to the call (linked below) you will hear Carter call this a buying opportunity of the ETF that tracks the index.

https://www.brighttalk.com/webcast/17122/502898.

Figure 3: MSCI China vs MSCI EM IR Net Total Return GBP.

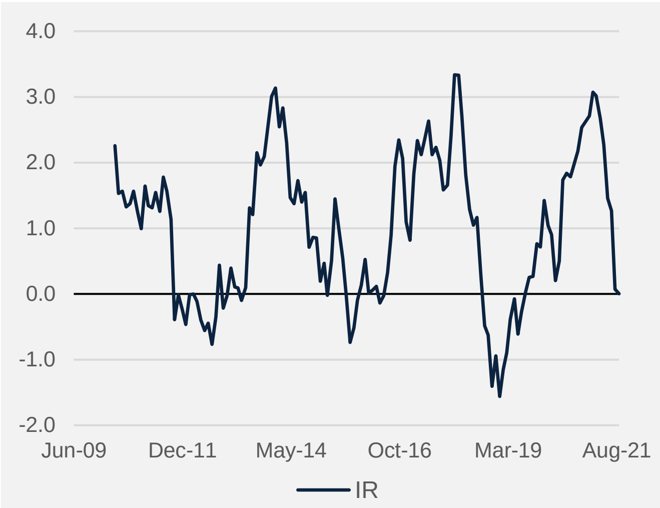


Source: Garraway.

Equally the information ratio for the EMQQ Index/ETF has collapsed and now sits close to historic lows (Figure 4).

Consequently, it may be that there is potential for the correction to extend, but should the fund's information ratio get close to the previous lows this will offer a major buying opportunity. It maybe that performance now stabilizes with the IR approaching zero and then turning, as our proprietary signals are indicating. Given the uncertainties, it is probably worth looking at this as a buying opportunity and averaging into a position depending on your own risk disposition. However, the point is simply that this should be considered as a buying opportunity, and generally one must be brave in such circumstances.

Figure 4: EMQQ vs Cash IR Net Total Return GBP.



Source: Garraway.

We are not alone in these views, as BlackRock's research unit has recommended investors boost their exposure to China by as much as three times. Their internal think-tank suggested the higher allocations to Chinese stocks and debt as the country's capital markets have boomed in size and sophistication.

"China is under-represented in global investors' portfolios but also, in our view, in global benchmarks," Wei Li, chief investment strategist at the BlackRock Investment Institute (BII), said in an interview. "It has the second-largest equity market, the second-largest bond market. It should be represented more in portfolios."

The interview is linked here:

https://www.ft.com/content/f876fb63-1823-4f4b-a28f-faa7797aa49c.

We are positioned accordingly.

The Multi Asset Team.

Important Information