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CIO Strategy Bulletin

Around the World in 7 Days

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Summary:

- **This week, a review of major events in major regions. Though they are unrelated, they each will impact future global economic growth and growth expectations.**
- **In the US, we do not expect that growth shares will predominantly be viewed in light of interest rates once market equilibrium is reached. When the US economy normalizes and supply-chain shortages abate, investors are likely to differentiate between technologies that people and businesses cannot live without and those that will see more typical growth rates reflecting the regular economy.**
- **China's GDP growth is likely to fall well below 6% in 3Q and the risk of sub-4% growth for 4Q is rising rapidly. Growth is slowing more than policymakers desire. We believe that China will accelerate easing into 2022. Looking at relative valuations, the ratio of mainland stock prices to those in Hong Kong (for companies in both markets) is 1.45 reflecting a high level of pessimism among foreign buyers. We see this as a likely counter-cyclical positive for Chinese equities after a prolonged period of underperformance.**
- **While high gas prices and shortages in the UK and Europe will have unintended consequences, looking toward Spring, we see these abating. The impact on consumers is mitigated by the structure of energy markets and delivery systems across Europe. Services are delivered by regulated utilities and the consumer's cost is constrained. We believe that the energy shortage in Europe is temporary and will have a smaller impact on economic performance and inflation than expected.**

Washington Watch

Talk about kicking the can (not far) down the road. Policymakers raised the US debt ceiling by $480 billion and agreed to fund the government until December 3rd. In the meantime, President Biden met with Democratic lawmakers and suggested a compromise $2.1 trillion target for the second infrastructure bill. This is an effort to bring House progressives and moderates in the Democratic party together to pass a reconciliation bill without any Republican support.

The implications of these actions are that the probability there will be a second bill is going up and the cost of that bill, in the form of incremental taxation, both individual and corporate, is going down. The PredictIt site that tracks the odds of the bill's passage currently assigns a greater than 80% probability for a $1.5 to $2.5 trillion bill. If that's true, a corporate tax rate of approximately 25% is likely.

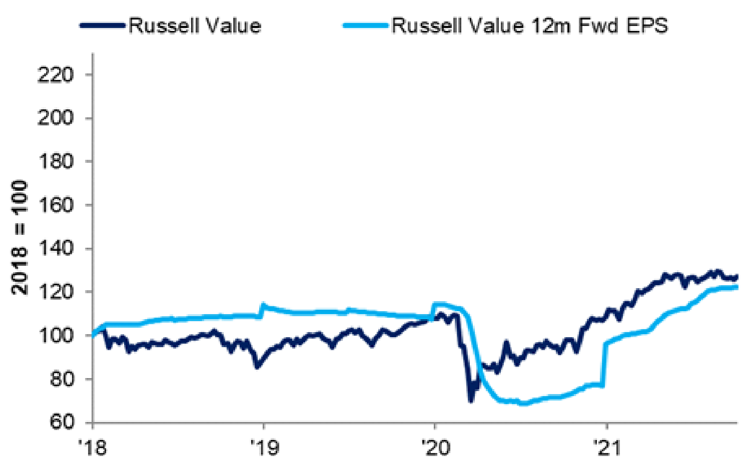
Finally, the Democrats have given themselves time to cobble together a winning coalition. House Speaker Nancy Pelosi has moved the non-binding voting date to October 31 as she attempts to gather sufficient support to ensure the passage of both infrastructure bills. Once a reconciliation bill is reached in Congress, the odds look good for its passage. History shows that 21 of 25 past budget reconciliation bills (or 85%) have subsequently been signed by the President.

Inside the Mind of the US Market

Stock market watchers are monitoring the Fed and interest rates closely as they anticipate how the rate environment will affect shares in various sectors. Joe Fiorica, a senior member of our OCIO team, put together four charts that tell a simple story as to where we are just now, though the end of the story is yet to be written. With growth slowing as expected in the US and also in China, which is experiencing stronger economic headwinds than we anticipated 6 months ago, rate pressures should be manageable, with a 1.8% to 2.0% 10-year range in sight.

As we have written before, earnings matter and drive share prices. Investors will in fact turn their focus towards the latest earnings data starting this week when US banks unofficially kick off Q3 earnings season, (see our full preview here). Value shares have recovered well after the pandemic-induced global shutdown and recovery. As illustrated in **Figure 1**, their earnings are "catching up" to that strong recovery in share prices. Note that the light blue lines are Forward EPS, already estimating future earnings 12 months out.

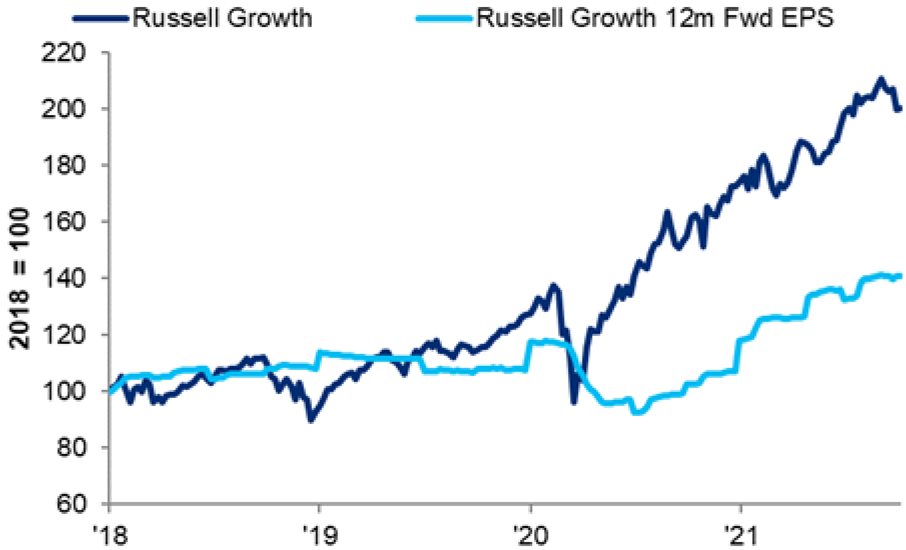
Figure 1: Russell 1000 Value Index vs Value Share EPS



Source: Bloomberg as of October 8, 2021. Note: Russell 1000 Value Index measures the performance of Russell 1000 constituents with the lowest price-to-book. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. Past performance is not indicative of future returns. For illustrative purposes only.

Growth shares have been on a tear since the pandemic began as the substitution value of technology for human interactions became crystal clear. Many have hypothesized that the acceleration of the adoption of technology due to the Covid-crisis brought forward higher utilization rates for everything from food delivery to digital communications. When one looks at the performance of growth shares relative to earnings (**Figure 2**), one can see that the stock market assigned a much higher value to growth shares anticipating that earnings will follow greater adoption. However, the delivery of those earnings necessary to justify those higher values will take time. Forward earnings for growth shares are now above 130% of the pre-pandemic level, but share prices are more than 200% higher.

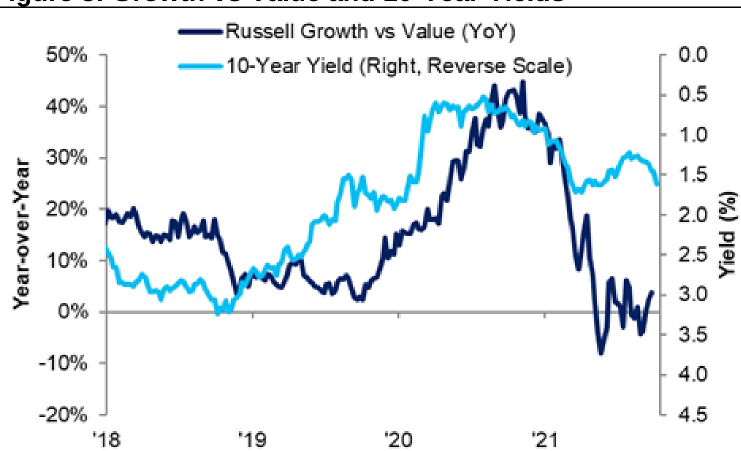
Figure 2: Russell 1000 Growth Index vs Growth Share EPS



Source: Bloomberg as of October 8, 2021. Note: Russell 1000 Growth Index measures performance of Russell 1000 constituents with the highest forecasted growth rates. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. Past performance is not indicative of future returns. For illustrative purposes only.

Lots of time has been spent by analysts looking at the impact of interest rates on growth share valuations. Given that the stock market is a discounting mechanism for future growth and earnings, it is highly sensitive to the discount rate as reflected in the 10-year note. Most recently, growth shares have been crushed relative to value, see **figure 3** (note that the yield is inverted in the chart.) The market's hypersensitivity to small rate increases suggests that there are doubts about the ability of growth shares to sustain their EPS growth rates. This is where discernment is required on the part of share analysts. In order to meet expectations, leaders in tech will require accelerating "demographic" growth in the form of demand for services (think cloud and cybersecurity), a sustainable value proposition relative to competitors (high substitution costs and greater value to clients over time) and increasing margins in their core businesses relative to the acquisition cost of clients. Many tech businesses are reinvesting cash into research and client acquisition at increasing rates, but ultimately free cash flow and earnings will dominate their valuations. Thus, it is not just sensitivity to the "discount rate" at play in growth share valuations. It is the sustainability of their growth in terms of market size, market share and margins that will matter most.

Figure 3: Growth vs Value and 10-Year Yields



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You can see all this interacting in **figure 4**. When 10-year rates rise (note inverted scale), assets like gold that have no "dividend" attached to them, perform in line. Growth shares are also impacted negatively due to their higher discount rate applied to their future cash flows. But we do not expect that growth shares will only be viewed in light of interest rates once market equilibrium is reached. When the economy normalizes and supply-chain shortages abate, investors are likely to differentiate between technologies that people and businesses cannot live without and those that will see more typical growth rates reflecting the regular economy.

Figure 4: Long Duration Asset Performance (Treasuries, Gold and Growth Stocks)

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China Under Pressure

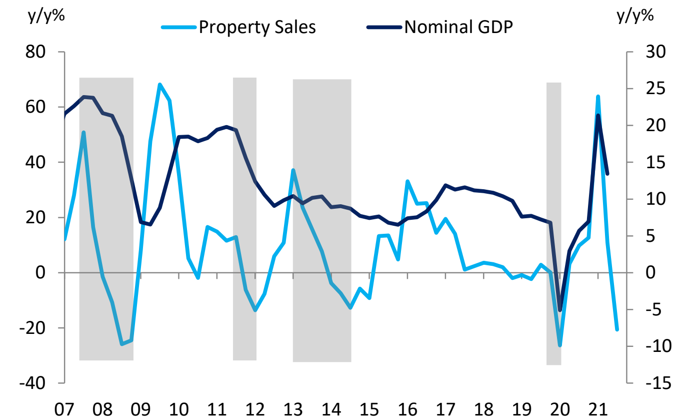
The retail data printed after China's week-long National Day holiday was disappointing. Golden Week tourism revenues were -5% year-over-year, while stay-at-home consumption was up. Movie ticket sales (+10%), home food delivery (+30%) were winners, while spending for clothing declined. As we recently reported, retail sales growth had fallen to just 1% annualized in August compared to 2019.

As for real estate, property sales at China's 100 largest developers plunged 36% year-over-year in September. Confidence among potential homebuyers is falling as some buyers wonder if their "pre-sale" purchases will be delivered. Pre-sale financing, where buyers pay for all or some of their home purchases in advance, is utilized in more than half of new home sales in China (Natixis data). The declining pace of property sales is pointing to a growth slowdown, akin to the pandemic period (1H 2020) and 2008-09 (**Figure 5**).

The acute weakness in residential real estate has knock-on impacts. Chinese government revenues from land sales were 8.3% of GDP in 2020 and are likely to decline in 2021 and 2022. A slowdown in real estate sales elevates credit risk among otherwise viable developers, even as The People's Bank of China (PBOC) has pledged to safeguard the orderly operation of the property market and to protect homebuyers. Note that real estate is the largest asset of most Chinese families and mortgage debt is their greatest liability.

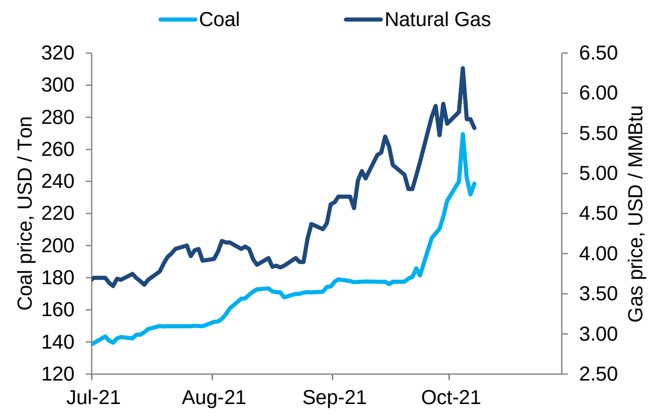
In recent weeks, 19 provinces in China have suffered power shortages. The high cost of coal is one factor, but the desire to meet strict environmental limits on energy consumption is another. Though energy prices have fallen 20% from peak, they are still materially elevated (see **Figure 6**.) All of this suggests that industrial production will remain under some pressure until a new supply/demand equilibrium is reached.

Figure 5: Property sales plunge pointing to further slowing in China's GDP growth



Source: Haver Analytics, Bloomberg, as of 8 Oct 2021. Note: Shaded areas are recessions.

Figure 6: Coal and natural gas prices have come down from October peaks



Source: Bloomberg, as of 8 Oct 2021

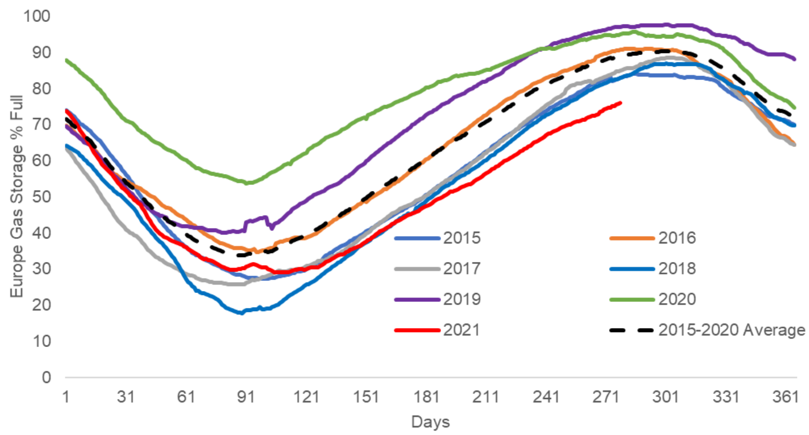
All of this suggests that China's GDP growth is likely to fall well below 6% in 3Q and the risk of sub-4% growth for 4Q is rising rapidly. Growth is slowing more than policy makers desire and central bank policies are rapidly moving from structural tightening to cyclical easing. We believe that China will accelerate easing into 2022, just as the Fed and several other central banks will be withdrawing liquidity. Looking at relative valuations, the ratio of mainland stock prices to those in Hong Kong (for companies in both markets) is 1.45 reflecting a high level of pessimism among foreign buyers. We see all of this as negative for the Chinese currency, but a likely counter-cyclical positive for Chinese equities after a prolonged period of underperformance.

Near Term Pressures in Europe Before a Likely Spring Thaw

Winter promises to be a challenging period for Europe and the UK. The region is seeing energy supply and price shocks given its high dependency on energy imports. Across the region, a robust recovery continues, but there are rising impediments for follow-through. A lack of finished goods due to supply chain issues continues even as demand for goods is beginning to slow. Within the UK, all of this is exacerbated by adjustments to how the UK economy is operating post-Brexit. For example, the UK has less immigration adding to the typical post-pandemic labor shortages seen globally.

UK and European natural gas spot prices have surged to record levels even as economic activity rebounds. European natural gas prices are up 650% year-on-year, oil prices are 100% higher and carbon prices on the EU's emissions trading system have risen 170%. The causes are numerous and include supply issues in Russia and Norway, untimely demand for LNG by China and an absence of traditional energy alternatives as coal-fired power plants now are paying up for coal. Over the past 6 months LNG imports into Europe were 15% below 2020's volume and natural gas inventories are well below their long-term average (**Figure 7**.) Ironically, looking backwards, Europe is emerging from a period of unusually low gas prices. In real terms, gas prices now are unchanged since the 2008-09 recession.

Figure 7: Europe Gas Storage % Full



Source: Bloomberg as of October 5, 2021.

Adding to Europe's energy woes are its relations with Russia. Russia has been slow to refill Europe's gas storage since last winter. While state-controlled Gazprom has been fulfilling long-term contracts, it has not increased short-term supplies.

Impacts of High Energy Prices and Shortages

Two major UK fertilizer plants were forced to shut down as natural gas is the feedstock for ammonia. As CO2 is a by-product of ammonia production, the reduced supply of CO2 has led to less dry ice that supermarkets need to keep food cool in their delivery vans. This means less ice cream in stores. And that's not all. Less CO2 has impacts on other significant users of industrial gas including hospitals, nuclear power plants (they use gas for cooling) and the cattle industry.

The bigger economic impacts will be on consumers and energy producers. Ten small UK energy providers have ceased operating in the past two months, forcing some 1.7 million homes to switch energy providers. European household savings rates (see **Figure 8**), bolstered by pandemic stimulus, will now fall faster as higher energy prices and inflation caused by supply shortages hit pocketbooks. While the European Central Bank expects consumer price inflation to decline to an average of 1.7% in 2022 after peaking at 3.1% in 4Q21. However, this expectation will be tested as sustained higher energy costs rumble through the economy (see **Figure 9**).

Figure 8: EU and UK Savings Rates, %

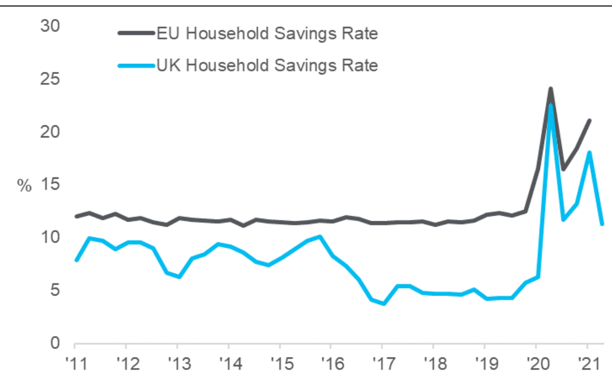
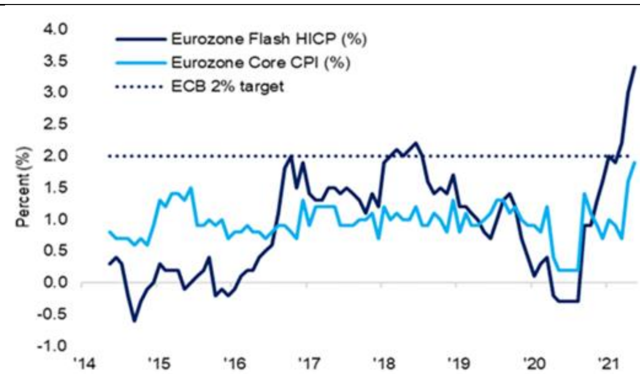


Figure 9: Eurozone Inflation Rate vs ECB Target



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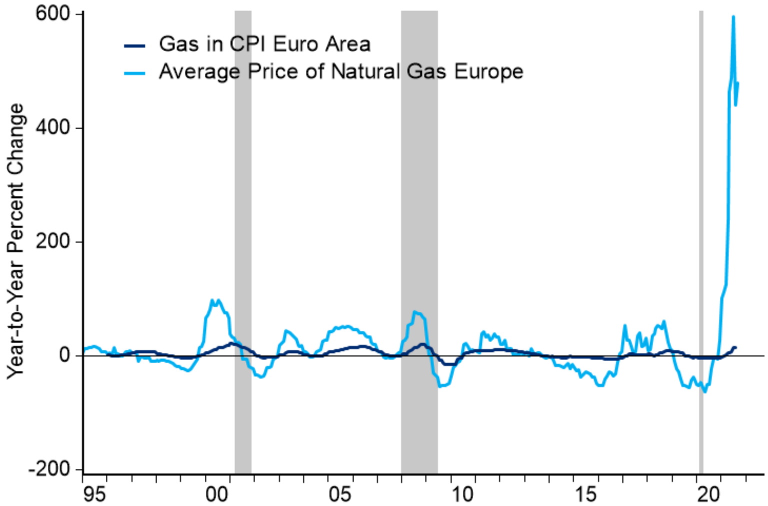
A Temporary Headwind

While high gas prices and shortages will have unintended consequences, looking toward Spring, we see these abating. First, the impact on consumers is mitigated by the structure of energy markets and delivery systems across Europe. Services are delivered by regulated utilities and the consumer's cost is lower and very different than industrial users (see **Figure 10**). Third, we believe that the gas shortage in Europe is temporary and will have a smaller impact on economic performance and inflation than expected.

Governments are starting to step in to support households and businesses. The support varies by country. France is taking steps to shield voters ahead of next year's general election by blocking any new increases in regulated gas tariffs and cutting taxes on electricity. Spain wants to impose a windfall tax on utilities and proposed a central platform for natural gas purchases. Poland wants debate on the crisis at this week's ministerial meeting, as the price rise threatens a backlash over the EU's clean energy reforms (Fit for 55). So, we expect that the EU collectively and countries individually will act to mitigate the impacts of energy shortages and higher marginal prices. See our previous EMEA Bulletin on the topic – A Greener Europe Offers Compelling Investment Opportunities.

Figure 10: European Natural Gas Prices and Consumer Prices of Natural Gas



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Likely Market Impacts and Views

Equities

We maintain our overweight to UK equities in the Global Investment Committee tactical asset allocation versus our strategic benchmark, taking a 12-18 month view. Over that time horizon, we remain confident of European and especially the UK's potential for renewed economic strength and EPS growth. The relative valuation of EU and UK shares remain at a significant discount to the US and the global average, while the available dividend yields are the highest in the world. For the remainder of 2021, we expect a continuing mid-cycle consolidation in these indices, with worries over how 2022 earnings could be impacted by input costs and supply chain issues dominating the more likely story of improved earnings. That said, we see private equity and M&A activity continuing without diminishment, led by foreign buyers.

Currencies

The Euro faces downside pressure with the next support levels at 1.151 and then 1.145 versus the USD. The pressures are coming from three directions: Firstly, the ECB will follow other developed market central banks in tightening its monetary policy, so with European inflation picking up significantly the relative real interest rate is not supportive. Second, on the political front, the Euro was helped by the German Left party doing less well than expected in the recent election, however next year's French election is now coming into focus and with it the potential for extremist parties to poll well. Third, the energy storm is at least temporarily limiting foreign investor interest.

In the UK

The BOE has indicated that they may raise rates prior to the end of their bond buying program, in contrast to the Fed and the ECB. With the recent Sterling weakness, near term inflation forecasts moving above 4%, and ongoing property market strength, the prospect of higher rates is, in our view, rising. We expect two rate rises totaling 40 bp by May 2022. At the current ruling Conservative party conference, the Chancellor has said that his long-term aim is to lower UK taxes (despite the recent slight fiscal tightening) and PM Johnson is also taking a long-term approach in tackling the supply shortages through wage rises. These actions could put pressure on the BOE to raise rates further in late 2022 and 2023.

Sterling has retraced all of its year-to-date gains versus the US dollar. Our trading desks are seeing more accumulation at these levels than sellers. The valuation of the currency appears inexpensive.

Implications for Equities

There are four areas in the UK and Europe that we favor:

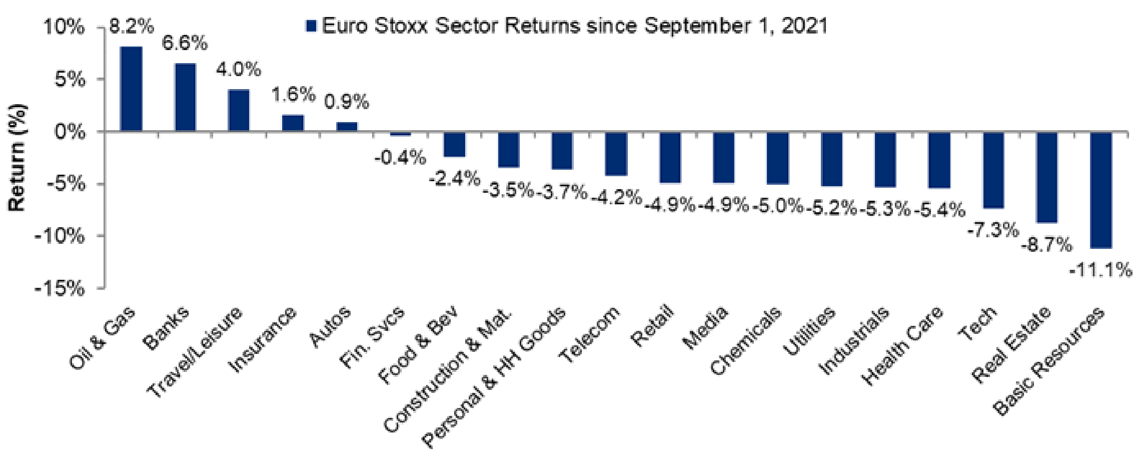
Defensives – Healthcare is well represented in regional markets. The sector has steady top and bottom-line growth and has underperformed during the pandemic.

Quality – the region has many companies with long histories, strong management, strong balance sheets and cashflows, which raises the dividend potential.

Brands – as price pressures rise, companies that are able to pass on cost increases should do well. Europe and the UK have many companies with strong well-established brands which give them pricing power, for example luxury goods companies.

Value – Financials have doubled in share price in under a year, yet are still inexpensive with an average P/B of 0.7X. The sector benefits as yield curves steepen, loan growth is rising from depressed levels, and provision writebacks are likely. This is a shorter-term view than the prior three areas noted above.

Figure 11: Sector Returns



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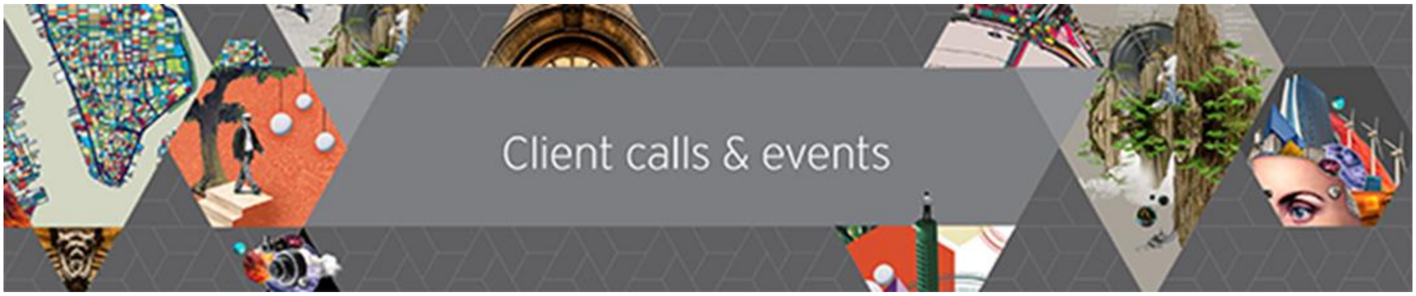

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