What’s bond yields got to do with Die Hard, Trading Places ? read in. The disinflationary impact of the two secular forces – demographics and technology – will continue to prevail, as we progress through this decade.

Summary

If you were to watch the movie *Die Hard* this Christmas, just remember that the plot wouldn’t likely exist (or it would be vastly different) if bond yields in the 1980s were not very high. Hans Gruber, the legendary villain in *Die Hard*, dreams of earning a bond yield of +20%, as he and his accomplices attempt to steal $640 million in bearer bonds. Bond yields have been trending down over the last four decades. In Q1 2000, the US 10Y Treasury yield stood at +6%. That was then. The US 10Y yield currently stands at +1.4% despite the US Federal Reserve (Fed) starting to taper its asset purchases and inflation beginning to cause some consternation. Whilst many would like to blame central banks for the low yields – and Quantitative Easing (QE) has certainly been a contributing factor over the last decade, but the downtrend in bond yields predates QE. Often, a more powerful secular force, greater than the ebb and flow of financial cycles, underpins such long term multi-decade trends. I believe the disinflation trend is not over yet and will reassert itself soon enough. I ardently believe that the disinflationary impact of the two secular forces – demographics and technology – will continue to prevail, as we progress through this decade.

The equity markets are not concerned about the Fed reducing its asset purchases and the bond market is indicating that the Fed will not be raising interest rates anytime soon. It’s also worth noting, that during the most recent tightening period (November 2016 – July 2019), the US economy didn’t enter into

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recession and neither did equities sell-off. Although, the Fed Funds Rate over the period went from +0.5% to +2.5%, the S&P 500 rose by over +44%. For 2022, I therefore see equities continuing to inch higher in a very benign environment, as Covid finally takes a back seat (let's hope), and economic growth gets a leg up from a boom in the services sector.

What would Hans Gruber and Ophelia make of current bond yields?

It's December. Another year has gone by and very soon we will find ourselves sprawled on the couch after a big Christmas lunch (or dinner), working down the list of Christmas movies. For every person who believes Frank Capra's classic *It's a Wonderful Life* is the best Christmas film, there's another who ranks *Miracle on the 34th Street* as the true number one. Then there are other favourites such as *Home Alone, Bad Santa, Love Actually, Trading Places, Die Hard,* and the list goes on…

If you were to watch *Die Hard* this Christmas, just remember that the movie plot wouldn't likely exist (or it would be vastly different) if bond yields in the 1980s were not very high. In the movie *Die Hard*, Hans Gruber (played by Alan Rickman), the meticulous mastermind behind the Christmas Eve Nakatomi Tower heist, is nonchalantly dreaming of earning a bond yield of +20% as he and his accomplices attempt to steal $640 million in bearer bonds of the Japanese firm Nakatomi Corporation.

To quote Gruber – "by the time they figure out what went wrong, we'd be sitting on the beach earning 20%"

Alan Rickman as the villain Hans Gruber in the movie Die Hard (1988)

DT5GFP ALAN RICKMAN DIE HARD (1988)

Source: AF archive / Alamy Stock Photo

In *Trading Places*, Jamie Lee Curtis' character Ophelia reveals that she has $42,000 in the bank "in T-bills earning interest" and that she could retire in "two-three more years."

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Being invested in T-bills (a loan to the US government with a maturity of one year or less) and thinking of retiring in 2-3 years, will come as a shock to almost anyone, but particularly shocking to those under the age of 35, who have seen a near-zero yield throughout their adult life.

Yet in 1983, when *Trading Places* was released, the 3-month T-bill yield was around +9%. You would agree that this is somewhat higher than the measly +0.5% average of the past decade, or even today's rate of +0.06%? To put it in context, a sum invested in 1980's-era T-bills would double in eight years. At a yield of +0.5% and +0.06%, the same sum invested in 3-months T-bills, would double in over 130 years and over one thousand years respectively.

Bond yields have been trending down over the last four decades (as the chart below indicates). In Q1 2000, the US 10Y Treasury yield stood at +6%. A decade later, it had halved to +3% and a decade after that, it had halved again to +1.5% by Q1 2021. The yield currently stands at +1.4% despite the US Federal Reserve (Fed) starting to taper its asset purchases and inflation causing some consternation.

While many would like to blame central banks for low yields – and Quantitative Easing (QE) has certainly been a contributing factor over the last decade – the downtrend in bond yield predates QE.

Often a more powerful secular force, greater than the ebb and flow of financial cycles, underpins such long term multi-decade trends.. So, are we now at an inflexion point, as inflation chatter grows? Are bond yields going to reverse course and uptrend? These are trillion-dollar questions, with no quick and easy answers. I believe the disinflation trend is not over yet and it will reassert itself soon enough.

I am not convinced that inflation will be a problem in the medium and long term, as I ardently believe that the disinflationary impact of two secular forces – demographics and technology – will continue to prevail, as we progress through this decade. By demographics, I mean both a low birth rate and people living longer.

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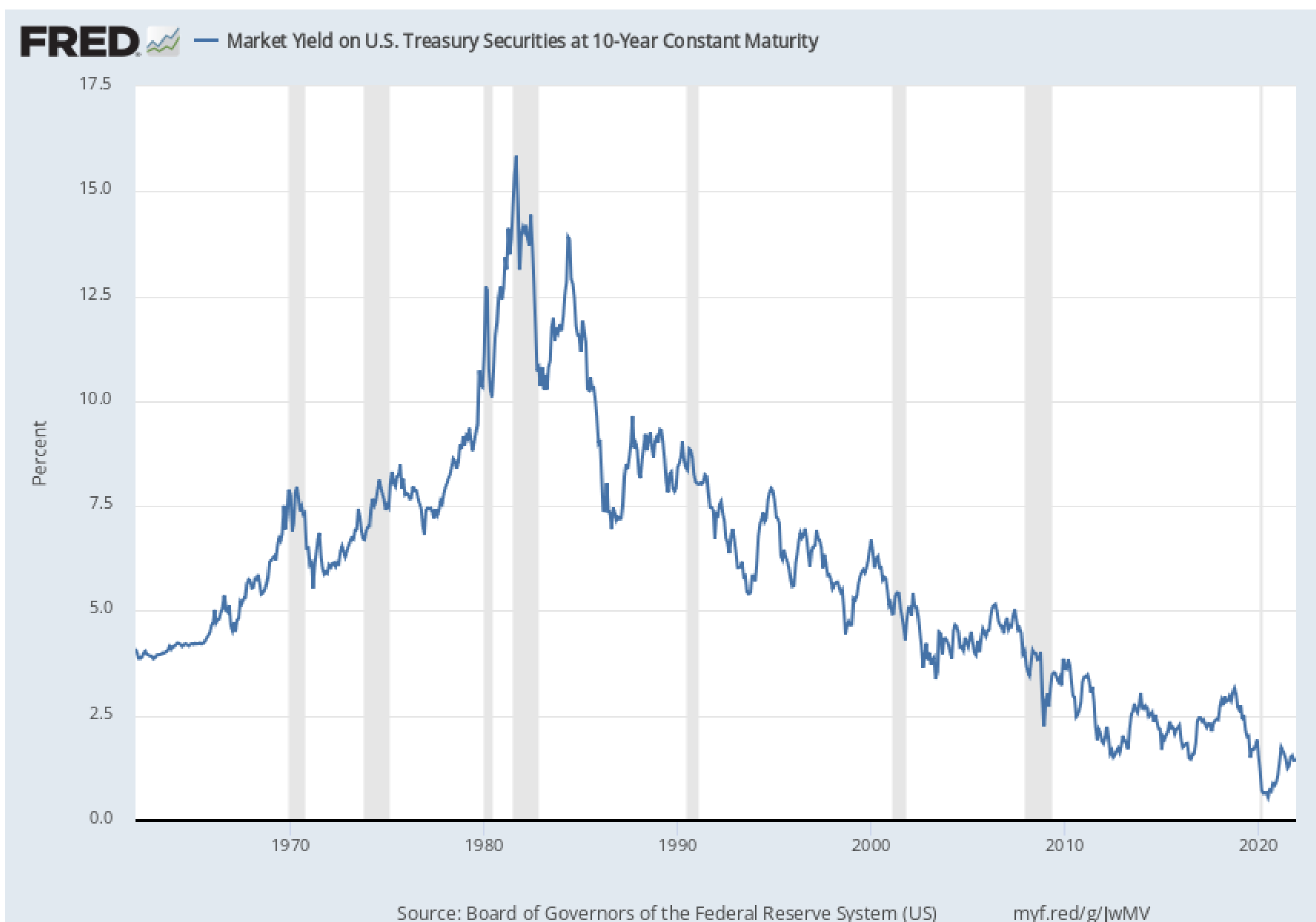

A very low birth rate puts downward pressure on demand and technological innovation puts downward pressure on prices. Better technology leads to better supply, as hindrances to increasing supply gets removed at a rapid pace. The post-Covid world is showing no signs of reversal in the falling birth rate and if anything, technological innovations have only accelerated in the wake of the pandemic.

Also, we have seen that people will save even at negative interest rates. Increasing life span probably necessitates it. A savings glut exerts downward pressure on interest rates, keeps the cost of capital down, fuelling further enterprise and technological innovations, which in turn exert further disinflationary pressure on the economy.

Economics is an art and not a science, and so far economists have been shockingly poor in studying the impact of technology on the economy. It's no wonder economists have got their inflation forecasts wrong consistently over the last decade or so. Disinflation due to technology trends goes unnoticed as the debate gets combined with – "but have you seen the cost of a college education?" or "the cost of healthcare" … et al. Such news items dominate reports, become political pinata to beat the government of the day and colour the newswires. It keeps us distracted and we fail miserably to see secular trends working behind the scenes.

2021 was the year when many expected bond yields to go higher, or to be precise, real bond yields (nominal rate minus inflation) to go higher, as central banks tapered their asset purchases. This didn't happen.

In 2013, when Fed Chairman Ben Bernanke hinted that the Fed would soon begin to taper its asset

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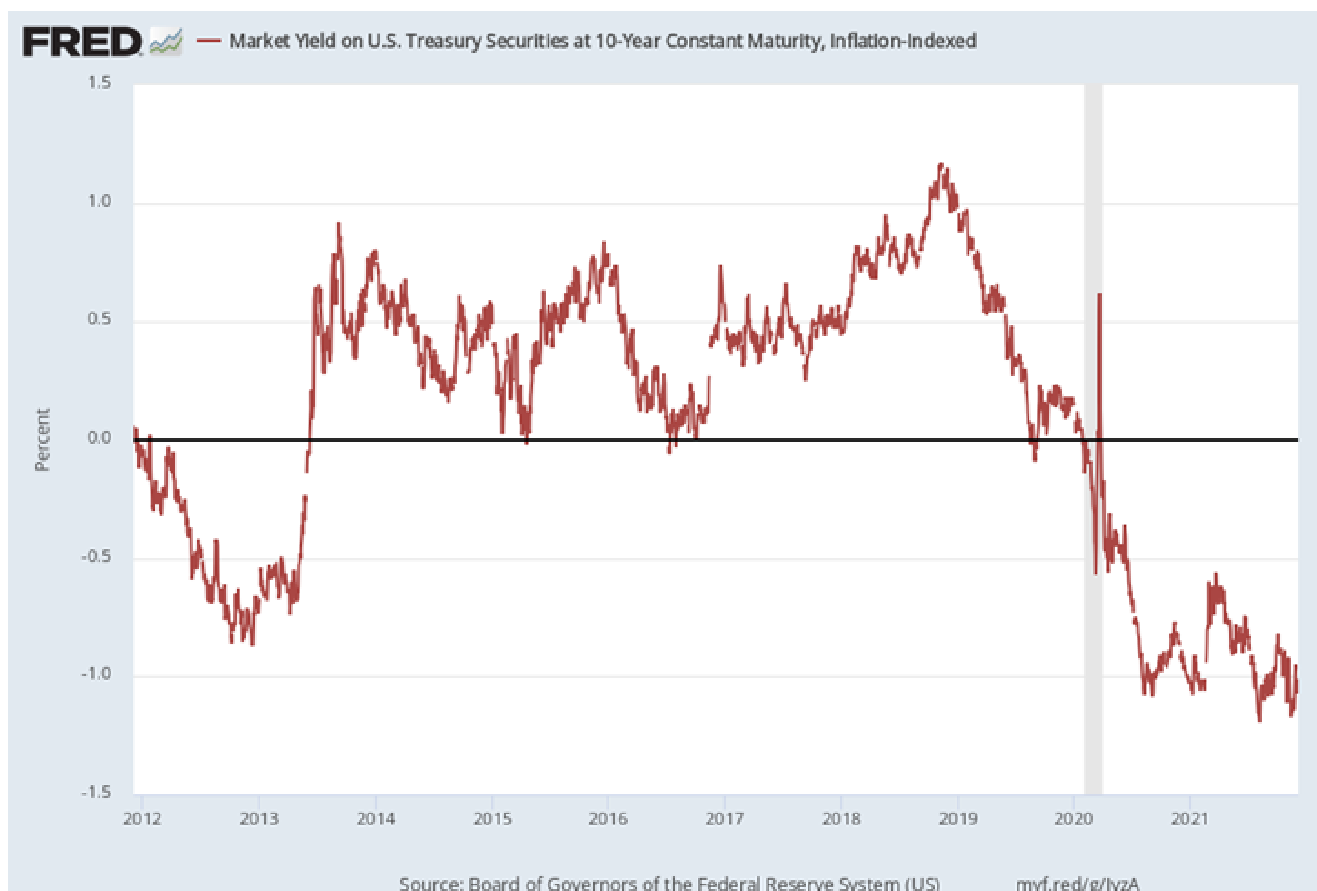
purchases, real yields on the 10-year US Treasurys promptly jumped, rising from around –1% back into positive territory. This time around, tapering has started, but the real yields continue to fall, as the chart below indicates.



The bond market is clearly indicating that it doesn't buy the – inflation is going to be a problem – story. It is perhaps more concerned that when the temporary bout in inflation subsides, growth will be a problem again and as the disinflation trend reasserts, financial repression will resume and US Treasurys will remain bid.

That's all good news for growth stocks, which have been battered over the last couple of months. As I wrote in the May Market Viewpoints – "Japanification" of the western world is in progress and nothing I have seen, or continue to see, tells me it's going to stop. Low bond yields are a reality that we will have to live with. The Fed may raise interest rates a couple of times over the next two years, but I suspect the European Central Bank (ECB) will not be so lucky, and it may stay on hold until 2025, if growth doesn't change dramatically in the Eurozone over the next 12-24 months.

What would Hans Gruber make of the low bond yields now? Would he risk his life over such a feeble yield, let alone get excited about negative real yield bonds? Maybe a discussion to be had over Christmas dinner. Perhaps a remake of *Die Hard* in a deflationary environment would lead to Hans Gruber fighting to return the stolen bonds to Nakatomi Corporation?

Markets and the Economy

In the markets, all the chatter is about the Omicron variant. So, let's deal with that right away.

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Earlier this week, the first study on vaccine effectiveness versus the Omicron variant was released in South Africa. The research head of a lab at South Africa's Health Research Institute, released results that showed the impact of antibodies in blood plasma from individuals vaccinated with Pfizer (PFE) – led to a 40 times reduction in the neutralization capacity against Omicron.

This does not mean that vaccines won't help protect against Omicron's hit to vaccinated immune systems, and it also does not rule out Omicron leading to fewer deaths or hospitalizations relative to other variants. What it does suggest is that Omicron is very easy to spread and will do so even amongst vaccinated people.

A report in *The New York Times* on Monday, indicated that researchers at a major hospital complex in Pretoria have reported that their patients with coronavirus were much less sick than those they have treated before, and that other hospitals are seeing the same trends. They said that most of their infected patients were admitted for other reasons and had no Covid symptoms.

So, the early signs seem to indicate that the Omicron variant may be "manageable" and thus – we saw the relief rally in the equity markets on Tuesday.

The S&P 500 (SPX) Index may be up over +20% for the year (see table below) but it hasn't been a smooth ride. We have seen four -4% to -5% dips during the year. The last one came only ten days ago and the most sustained one was in September, when it looked like we may see a bigger move down.

The Omicron variant was discovered only last month, and more study is clearly needed before one can judge, with any degree of confidence, its true impact.

As we know from the Delta variant, the effect of coronavirus is not always felt immediately, with hospitalizations and deaths often lagging considerably behind initial outbreaks.

Let's hope vaccines, masks and safety measures do their job and we can put Covid behind us once and for all. Make no mistake, there will be more variants. There are more viruses than stars in the universe. An estimated 10 nonillion (10 to the 31st power) individual viruses exist on our planet—enough to assign one to every star in the universe 100 million times over, but most are not poised to hop into humans, let alone infect us. Mammals and birds alone are thought to host about 1.7 million undiscovered types of viruses.

Benchmark Global Equity Index Performance (2020, 2021 YTD and QTD)

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Ticker	Name	Country	2020 Performance (Lcl Ccy)	2021 Year-to-Date Performance (Lcl Ccy)	2021 Quarter-To-Date (Lcl Ccy)
MXTR Index	MSCI TURKEY	Turkey	12.6%	32.5%	42.2%
CAC Index	CAC 40 INDEX	France	-7.1%	26.0%	7.3%
MXIN Index	MSCI INDIA	India	16.8%	27.5%	-0.1%
SPX Index	**S&P 500 INDEX**	**US**	**16.3%**	**25.2%**	**9.1%**
FTSEMIB Index	FTSE MIB INDEX	Italy	-5.4%	20.2%	4.1%
SX5E Index	**Euro Stoxx 50 Pr**	**Europe**	**-5.1%**	**18.4%**	**3.9%**
CCMP Index	NASDAQ COMPOSITE	US	43.6%	22.5%	9.3%
IMOEX Index	MOEX Russia Index	Russia	8.0%	16.1%	-7.0%
INDU Index	DOW JONES INDUS. AVG	US	7.2%	16.8%	5.6%
DAX Index	DAX INDEX	Germany	3.5%	13.9%	2.4%
UKX Index	**FTSE 100 INDEX**	**Great Britain**	**-14.3%**	**13.2%**	**3.2%**
IBEX Index	IBEX 35 INDEX	Spain	-15.5%	4.3%	-4.3%
NKY Index	**NIKKEI 225**	**Japan**	**16.0%**	**4.7%**	**-2.5%**
SHCOMP Index	**SHANGHAI SE COMPOSITE**	**China**	**13.9%**	**5.8%**	**2.9%**
MXEF Index	**MSCI EM**	**Emerging Markets**	**15.8%**	**-3.9%**	**-1.0%**
IBOV Index	BRAZIL IBOVESPA INDEX	Brazil	2.9%	-10.2%	-3.7%
HSI Index	HANG SENG INDEX	Hong Kong	-3.4%	-10.9%	-1.3%

Source: Bloomberg

Having discussed in the section above – why I don't believe inflation will be a problem in the medium term, I have just read a news article in *The Financial Times* entitled "Yellen Says Supply-Chain Shift May Need Protectionist-Like Steps."

In this article, US Treasury Secretary Janet Yellen says – "It's possible that policies that people will describe as protectionist are going to be necessary in order to create the appropriate incentives to produce things at home." Yellen adds – "I don't think this is just about the United States making everything at home, but in some cases that may be part of the answer."

Protectionist measures have a history of leading to higher prices and ending in tears for the consumers. So, this is one policy error I would be very wary of, if the US were to go down the path of protectionism and overdo it. This could change the inflation narrative very quickly and is one to keep a watchful eye on during 2022.

Fears of a Russian invasion of Ukraine grew last week, with US officials citing new intelligence reports about a troop build-up at the border. The expected 175,000 troops Russia is planning to assemble at the border, would be roughly twice the size of the build-up in the Spring. This is another development that could upend things in Q1.

Energy exports are the lifeblood of Russia and anything that threatens these will get a big response from them. Eastern Europe could become collateral damage (yet again). Politics will surely dominate economics again next year, as it has for quite some time now.

Last week US Fed Chair Jerome Powell announced the Fed will speed up its taper program and added "it's time to retire the word transitory regarding inflation."

Well played Sir! Powell stuck to "transitory" when inflation was rising through to +6%, and now decides to catapult "transitory" when it's very likely that inflation has peaked. We shall find out when we get the next monthly inflation print in January.

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The equity markets are not concerned about the Fed reducing its asset purchases and the bond market is indicating the Fed will not be raising interest rates anytime soon. I see equities continuing to inch higher in a very benign environment, as Covid finally takes a back seat (let's hope), and economic growth gets a leg up from a boom in the services sector.

It's also worth noting, that during the most recent tightening period (November 2016 – July 2019) the US economy didn't enter into recession and neither did equities sell-off. The Fed Funds Rate over the period went from +0.5% to +2.5%, and the SPX rose by over +44%.

The external shock of Covid did cause a recession and a market sell-off, but that had nothing to do with Fed policy. Therefore it's worth giving credit to the Fed for pulling off a tightening cycle without inducing a recession. Hopefully, the Federal Open Market Committee (FOMC) can do it again.

However, the unpredictability over how long the supply chain issues will last, the macro risk from a Russia-Ukraine escalation leading to higher energy price means policy error risks are more pronounced now than they were in the last cycle. Nevertheless, equities is the asset class I feel most comfortable holding.

With US inflation hitting +6.2%, a level not seen since 1990, many economists and market commentators seem baffled and some even angry, about how equities keep hitting new highs.
Well, the US 10y bond yield is remaining stable in a narrow range of +1.25% to +1.75%, despite the inflation scare. The bond market doesn't buy the inflation story and therefore equities are a good hold.

Chinese equities are particularly undervalued and they trade at an almost -40% discount to their US counterparts. China sentiment is overly bearish. As China's credit impulse picks up, Chinese equities will close the valuation gap to US equities. China's recent cut to its reserve-requirement ratio is another signal that policymakers will deal with a sharp slowdown in growth directly and firmly, no matter what is said or written about the rising debt in the Chinese economy.

Sector-wise, I prefer the Consumer Staples Select (XLP) Discretionary (XLY), Technology (XLK) and Communication (XLC) sectors.

For specific stock recommendations, please do not hesitate to get in touch.

Benchmark US equity sector performance (2020, 2021 YTD)

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Ticker	Name	2020 Performance	2021 Year-to-Date (YTD) Performance	2021 YTD Relative Performance
XLE US Equity	ENERGY SELECT SECTOR SPDR	-36.9%	51.1%	20.7%
XLRE US Equity	REAL ESTATE SELECT SECT SPDR	-5.5%	35.6%	8.3%
XLK US Equity	**TECHNOLOGY SELECT SECT SPDR**	**41.8%**	**33.3%**	**6.5%**
XLF US Equity	FINANCIAL SELECT SECTOR SPDR	-4.2%	32.6%	5.9%
XLY US Equity	**CONSUMER DISCRETIONARY SELT**	**28.2%**	**28.8%**	**2.9%**
XLB US Equity	MATERIALS SELECT SECTOR SPDR	17.9%	21.9%	-2.6%
XLI US Equity	INDUSTRIAL SELECT SECT SPDR	8.7%	18.9%	-5.0%
XLV US Equity	**HEALTH CARE SELECT SECTOR**	**11.4%**	**17.9%**	**-5.8%**
XLC US Equity	**COMM SERV SELECT SECTOR SPDR**	**25.8%**	**14.5%**	**-8.5%**
XLU US Equity	UTILITIES SELECT SECTOR SPDR	-3.0%	9.8%	-12.2%
XLP US Equity	CONSUMER STAPLES SPDR	7.1%	7.9%	-13.8%

Source: Bloomberg

Anyway, all that is left for me to say this year is thank you for your time and attention. I also wish you and your family all the best for this holiday season as well as a very Happy New Year. And if you celebrate Christmas – hope you have a great one – and watch *Die Hard*!

Best wishes,

Manish Singh, CFA

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It took two centuries before coal overtook wood as the world’s top energy resource and it took oil a century to replace coal. The global economy depends on fossil fuels for 84% of its energy. The pursuit of “net-zero” is both an opportunity and a risk.

Summary

On September 6, two coal-fired generators had to be fired up to meet the UK’s electricity demand, in a move that usually only happens during the winter months. For several hours that day, coal went from zero to more than 5% of the UK’s energy mix, as warm, still, autumnal weather, meant wind farms had not generated as much power as normal. Coal, the unloved power source, had come in from the cold to the rescue! Energy is the lifeblood of the modern economy. It is one of the most important inputs for economic development and is central to almost every economic activity and integral to any country’s development. Policymakers ought to be very careful in their pursuit of “green energy” at any cost.

History shows that energy transitions don’t happen quickly. It took two centuries before coal overtook wood and waste as the world’s No. 1 fuel and it took oil a century to replace coal as the world’s top energy resource. Of course, in those days, there was no government policy for energy transition or technical innovation and climate activism that are all pushing today’s energy, but nor was the demand for energy as high as it is now. The global economy stands at over $90 trillion and it depends on fossil fuels

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for 84% of its energy. The pursuit of “net-zero” is both an opportunity and a risk.

The S&P 500 Index had a bumpy month and a half over September and early October, but it has recovered since and is back in touching distance of all-time highs, last seen on September 2. The tech-heavy NASDAQ Index has fared similarly. Concerns had started to build up over inflation and slowing growth, but a strong start to the third-quarter earnings season has alleviated some of that uneasiness and bullish sentiments have returned. Demand is strong and it’s only the supply that is holding the economy back. Investors have started looking past the supply shortages and expect these to be worked through eventually.

Coal comfort

Last month, an interesting report in The Times of London caught my attention. It read like a script for a potential new movie, let’s call it, *“How coal came in from the cold:”*

“It was 3 a.m. on Monday, 6th September and staff at National Grid’s central control room had a problem. Arrayed before them were dozens of computers tracking the UK’s energy supply and demand. Overhead was a huge screen displaying, second by second, Britain’s whole electricity generating and supply network. The giant bear pit of a room is the nerve centre of Britain’s complex power grid…the 20 engineers on shift in the ESO (electricity system operator) control room realised there would be a shortfall of power before the morning rush. They sprang into action…The solution was to turn to a rather unloved power source – coal. The order to fire up the station, one of only two remaining coal plants in the UK, was sent electronically from Wokingham. Just in case the message didn’t get through, operators still have a green phone on their desks to send instructions the old fashioned way.”

On that Monday, the 6th of September, as temperatures surged giving Britons one last glimpse of summer, the wind turbines up and down the country had slowed to a crawl in the still air. Britain’s wind power dipped to just 2.5% (down from 21% at the same time the week before) and this is when coal came in from the cold to the rescue!

Two coal-fired generators had to be fired up to meet Britain’s electricity demands, in a move that usually happens only in the winter months. For several hours that day, coal went from zero to more than 5% of the UK’s energy mix.

The West Burton A coal plant, Lincolnshire, UK

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Source: EDF

Earlier this week, UK Prime Minister Boris Johnson said that Britain will become the *“Qatar of hydrogen”*, as he laid out his Government’s green agenda ahead of the Cop26 climate summit in Glasgow at the end of this month.

My knowledge of chemistry from school days tells me that hydrogen is not a primary fuel. It is an energy vector, i.e. a means of storing and transporting energy. You need electricity/energy to make hydrogen.. Also, for hydrogen fuel to have green credentials, the energy/electricity used to generate it, has to be from a renewable or a nuclear source. When we don’t have enough renewable sources of energy as is, so it is unclear to me where the renewable energy is going to come from in order to split water and generate hydrogen? One wonders…

In September, Johnson said he wants to turn Britain into the *“Saudi Arabia of wind”*.

I am fast losing track of “green energy” promises made by Johnson and other climate change champions.

The UK Labour party’s late Deputy Leader, Aneurin Bevan, told the party’s 1945 conference, *“This island is made mainly of coal and surrounded by fish. Only an organising genius could produce a shortage of coal and fish at the same time.”*

Over the last few weeks, Britain has faced a shortage of both fish and energy. Of course, energy shortages and empty shelves are not a uniquely British phenomenon and I am not accusing Johnson of lying or even of incompetence. The UK is still forging ahead with decommissioning its coal-burning power station West Burton A from September 2022, leaving just Uniper’s Ratcliffe-on-Soar burning coal beyond 2022.

Does this rush to meet its carbon goals, risk power blackouts in the UK? Only time and maybe a few days

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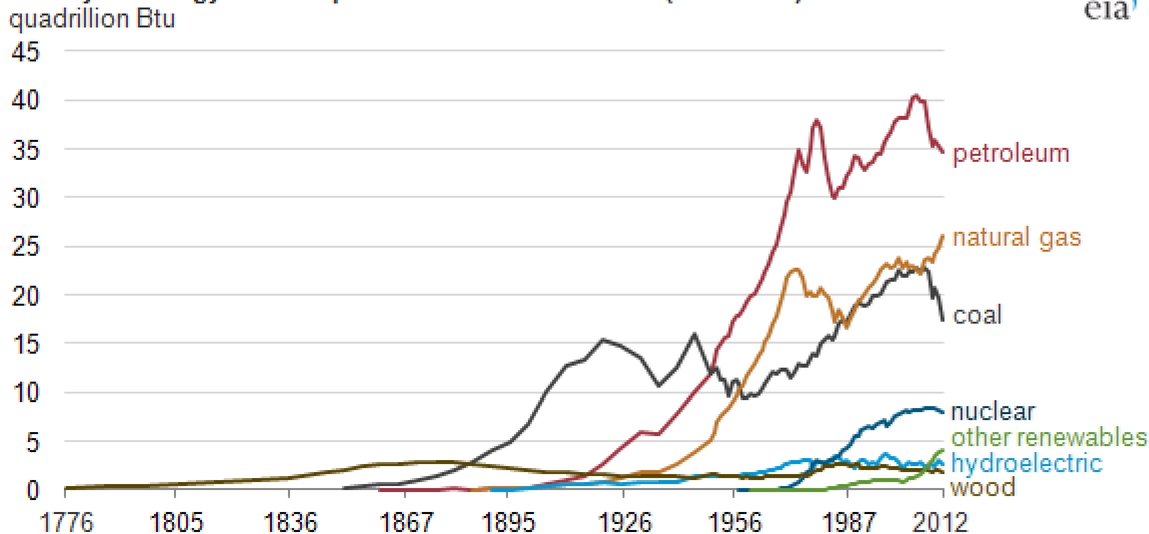
of dipped wind power will tell.

History shows that energy transitions don't happen quickly. The key moment in the first major transition—from wood to coal—was in January 1709, when an English metalworker named Abraham Darby used coal as a fuel for brass and cast iron manufacturing. But it took two centuries before coal overtook wood and waste as the world's No. 1 fuel. Oil was discovered in western Pennsylvania in 1859, but it was not until a century later, in the 1960s, that oil replaced coal as the world's top energy resource.

Of course, in those days, there was not the government policy, climate activism, or technical innovation that is pushing today's energy transition, but nor was the demand for energy as high as it is now. The world's urban population has increased four-fold from 1 billion in 1960 to 4.4 billion today.

The chart below from the US Energy Information Administration (EIA) shows how a typical American family's energy source has changed since the United States was founded in 1776. Wood was the primary energy source until the mid-to-late-1800s. Early industrial growth was powered by water mills. Coal became dominant in the late 19th century before being overtaken by petroleum products in the middle of the last century, a time when natural gas usage also rose quickly.



Source: US Energy Information Administration (EIA)

Energy is the lifeblood of the modern economy. It is one of the most important inputs for economic development and is central to almost every economic activity – manufacturing, transport, schooling, communication and so on, and is thus integral to any country's development. Policymakers ought to be very careful in their pursuit of "green energy" at any cost. The world economy is over $90 trillion and it depends on fossil fuels for 84% of its energy.

The world is setting ambitious "green energy" targets. The "net-zero" emissions pledges aim to bring global energy-related carbon dioxide emissions to "net-zero" (refers to a state in which the greenhouse gases going into the atmosphere are balanced by their removal out of the atmosphere) by 2050. The chart below from the International Energy Agency (IEA) highlights the adjustment to sources of energy supplies needed to achieve that goal.

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Clean energy’s contribution to total energy demand has to go up nearly nine-fold over the next 30years from its current level now. It’s an ambitious goal and a mammoth task. The pursuit of “net-zero” is both an opportunity and a risk.

Opportunity: To meet global energy demand, as well as climate aspirations, investments in clean energy would need to grow from around $1.1 trillion this year to $3.4 trillion a year until 2030, according to the IEA. The investment would advance technology, transmission and storage, among other things.

Risk: Cut fossil fuel supplies too soon and face future energy shortages threatening life and livelihoods and indeed ever higher energy prices. Once a deep coal mine is decommissioned, it quickly fills with gas and water and one cannot get coal from it again.

Projected market share of energy supply to reach zero emissions

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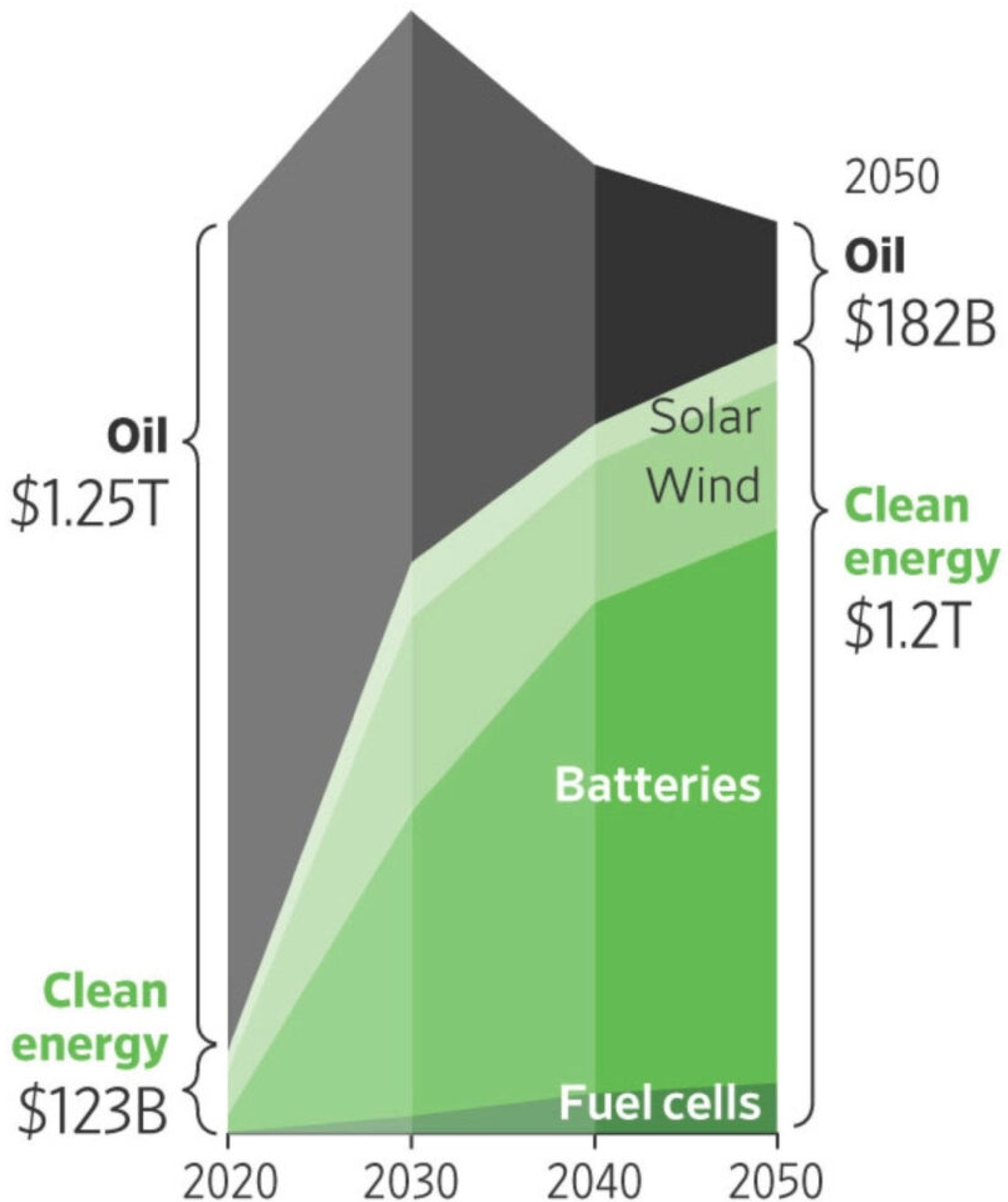

Source: IEA, WSJ

More green energy? Yes, but not at the cost of turning blue when sources of renewable energy fail in times of unprecedented weather conditions.

Climate is unpredictable no matter how much we try to model and predict the future of climate change. Energy supply and energy security are essential to our survival. The way to ensure progress for everyone, better living standards in all societies and protect the environment, which should be the job of the

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government, is to supply affordable, reliable, efficient energy for domestic consumption and industry. It's pragmatic to not decommission fossil fuel sources entirely in pursuit of green energy.

Let's hope the renewables will be able to fill the gap in time and if not we will have to take up knitting. Woolly knickers, vests, scarves and jumpers. Sustainable, renewable, a bit scratchy but they will keep us warm when energy supplies fail.

Markets and the Economy

Last week, the US Federal Reserve (Fed) released its September Federal Open Market Committee (FOMC) meeting minutes. The committee meets in two weeks' time for the November FOMC policy meeting.

The FOMC participants worried about disrupted supply chains and risks of more persistent inflation. The minutes indicate a stronger consensus over scaling back the $120 billion per month bond-buying program amid signs that higher inflation and strong demand could call for tighter monetary policy next year. When presented with a plan to reduce purchases of Treasuries at a pace of $10bn per month and mortgage-backed securities (MBS) at a pace of $5bn per month, *"participants generally commented that the illustrative path provided a straightforward and appropriate template that policymakers might follow"*, which suggests that $15bn reduction in bond buying per month should be the baseline assumption for tapering.

At this suggested "taper rate," July 2022 will likely be the first month of no asset purchases. The big question is will an interest rate hike follow?

A rate hike is not a done deal and "various" FOMC members believe the Fed Funds rate should be kept *"at or near its lower bound over the next couple of years"*.

During a moderated discussion on Sept. 29, Fed Chairman Jerome Powell conceded that the Fed was facing a situation it hadn't encountered in a very long time, in which there was tension between the central bank's two objectives of low, stable inflation together with high employment. Powell remarked – *"Managing through that process over the next couple of years is…going to be very challenging because we have this hypothesis that inflation is going to be transitory. We think that's right. But we are concerned about underlying inflation expectations remaining stable, as they have so far."*

Below is a chart from Gavekal Research, on US manufacturing production and US consumption. Those concerned about inflation may wish to take a closer look. The US manufacturing production data for September released this week was a double disappointment. The -0.7% month-on-month decline, down from a growth of +0.2% in August, not only fell short of consensus expectations for +0.1% growth, but also dampened hopes that manufacturing was set to emerge as a significant driver of US economic growth. This raises questions over the future strength of the US expansion.

The chart indicates that the early stages of the US rebound were powered almost entirely by personal consumption growth (the blue line). However, since March, consumption has plateaued, with September data for US retail sales published last Friday confirming the sideways trend.

US goods production has lagged the rebound in consumption

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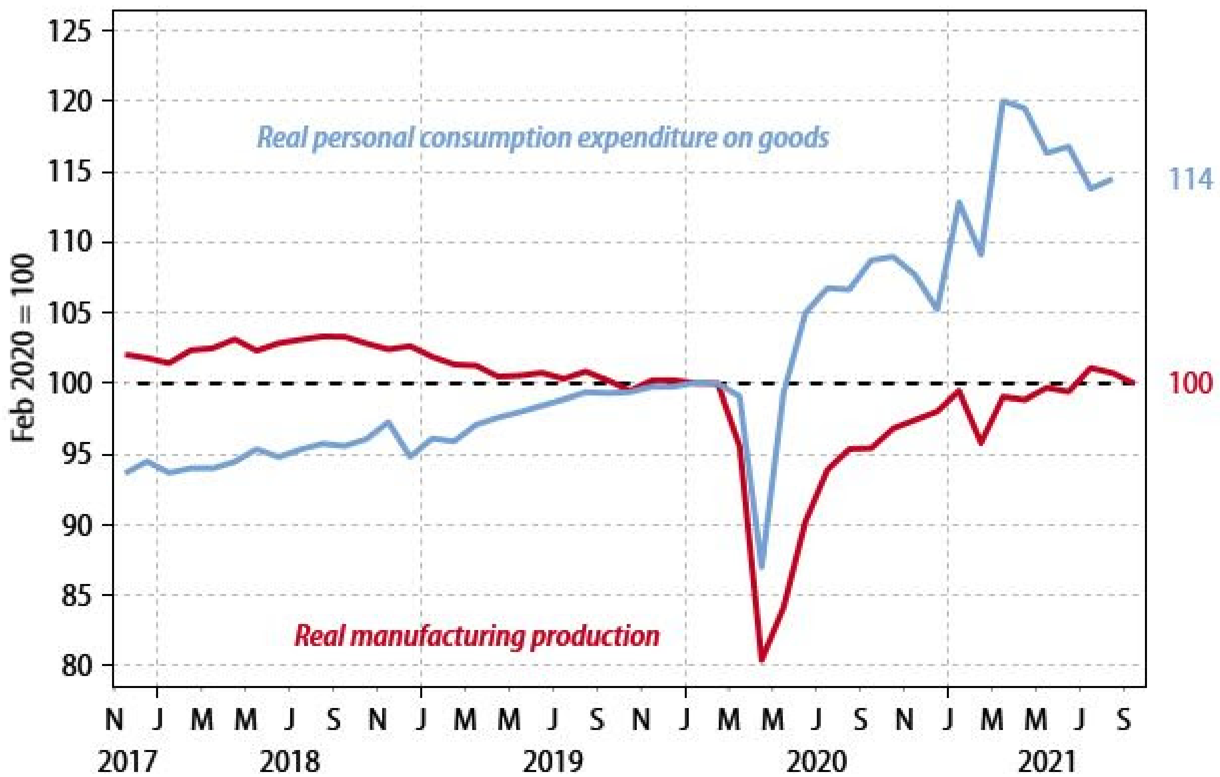

Source: Gavekal Research/Macrobond

With business confidence and capacity utilization both high, there were reasonable grounds for expecting the acceleration in capital expenditure over recent months to drive robust growth in US manufacturing output. Yet the recovery in US manufacturing production continues to lag far behind the recovery in consumer demand. Material shortages, hiring slowdown, and weak competitiveness – are the principal reasons behind lacklustre performance in US manufacturing.

Shortages of key components, such as microchips, are throwing whole production chains out of kilter.

Since July, most of the temporarily laid-off workers who wanted to return to work have been back in employment. To step up production further, manufacturers must hire new faces, which is a time-consuming process. With US manufacturing sector job openings at a record high, slower payrolls growth is likely to drag on the pace of manufacturing production recovery.

The US dollar has strengthened this year leaving it richly valued. The competitiveness of US producers is poor relative to their foreign counterparts, and US consumers will tend to prefer imported goods. As a result, even when the current supply constraints are resolved, there is little reason to believe the deterioration of the US trade deficit over the last 18 months will quickly reverse, and that the recovery in US manufacturing production will converge with the rebound in consumption.

There's plenty of food for thought for the FOMC participants to not rush with a rate hike. I would expect the US dollar to weaken from here as manufacturing continues to lag.

You may recall that during the 2009-11 recovery from the Great Financial Crisis (GFC), concerns over recovery-driven inflation during 2010-11 led to a reduction in stimulus, but those price pressures faded

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and eventually Quantitative Easing (QE) was restarted with rates at zero for almost another half a decade.

In April 2010, hawks such as Philadelphia Fed President Charles Plosser argued – *"The risk is really to the upside of inflation over the next two to three years."* Eleven years later, we are yet to see any inflation worries, let alone any meaningful and sticky inflation.

On the other hand, doves like Janet Yellen (then at the Fed) and now US Treasury Secretary, was very prescient in saying: *"When unemployment is so high, wages and incomes tend to rise slowly, and producers and retailers have a hard time raising prices. That's the situation we're in today, and, as a result, underlying inflation pressures are already very low and trending downward."*

I am very glad that Yellen is a powerful and key voice in current US economic policymaking, alongside FOMC voting members Powell, Governor Lael Brainard and Minneapolis Fed President Kashkari who all remember the 2010-11 episode – given their involvement then as Fed or Treasury officials. They learned the lesson and I expect the Fed to keep monetary policy easy during this post-recession period of temporarily higher inflation before letting the economy run hot as long as possible to expand the labour force. They will likely hold off the hawks.

Benchmark Global Equity Index Performance (2020, 2021 YTD and QTD)

Ticker	Name	Country	2020 Performance (Lcl Ccy)	2021 Year-to-Date Performance (Lcl Ccy)	2021 Quarter-To-Date (Lcl Ccy)
MXIN Index	MSCI INDIA	India	16.8%	30.7%	2.4%
IMOEX Index	MOEX Russia Index	Russia	8.0%	28.6%	3.1%
CAC Index	CAC 40 INDEX	France	-7.1%	21.1%	3.1%
SPX Index	**S&P 500 INDEX**	**US**	**16.3%**	**21.1%**	**5.6%**
FTSEMIB Index	FTSE MIB INDEX	Italy	-5.4%	19.7%	3.6%
SX5E Index	**Euro Stoxx 50 Pr**	**Europe**	**-5.1%**	**17.5%**	**3.2%**
CCMP Index	NASDAQ COMPOSITE	US	43.6%	18.1%	5.3%
INDU Index	DOW JONES INDUS. AVG	US	7.2%	16.3%	5.2%
DAX Index	DAX INDEX	Germany	3.5%	13.0%	1.6%
UKX Index	**FTSE 100 INDEX**	**Great Britain**	**-14.3%**	**11.4%**	**1.6%**
IBEX Index	IBEX 35 INDEX	Spain	-15.5%	10.5%	1.5%
NKY Index	**NIKKEI 225**	**Japan**	**16.0%**	**5.0%**	**-2.2%**
SHCOMP Index	**SHANGHAI SE COMPOSITE**	**China**	**13.9%**	**3.2%**	**0.4%**
MXEF Index	**MSCI EM**	**Emerging Markets**	**15.8%**	**0.1%**	**3.2%**
IBOV Index	BRAZIL IBOVESPA INDEX	Brazil	2.9%	-9.5%	-2.9%
MXTR Index	MSCI TURKEY	Turkey	12.6%	-3.2%	3.8%
HSI Index	HANG SENG INDEX	Hong Kong	-3.4%	-4.1%	6.3%

Source: Bloomberg

The S&P 500 Index had a bumpy month and a half over September and early October but it has recovered since and is back in touching distance of all-time highs last seen on September 2. The tech-heavy NASDAQ Index has fared similarly.

Concerns had started to build up over inflation and slowing growth, but a strong start to third-quarter earnings season has alleviated some of that uneasiness and bullish sentiments have returned. Demand is strong and it's only the supply that is holding the economy back. Investors have started looking past the supply shortages and expect these to be worked through eventually.

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China's economy grew +4.9% in the third quarter from a year prior, a sharp slowdown from the second quarter's +7.9%. The slowdown didn't come as a surprise to the market. Many market participants expect China's growth to lose its momentum over the coming years and it's not a bad thing. I would say it has all been "well planned," given the long-term thinking that Chinese policymakers deploy.

China was never looking to be a long term supplier of cheap labour to the rest of the planet. The plan all along was to use the cost advantage of cheap labour to manufacture a whole range of goods and achieve export leadership in numerous industries and use the valuable US dollar earned from rising exports, to develop the domestic economy by investing in technology, infrastructure, energy and innovation. The goal was to achieve global export leadership and end up developing a Chinese economy driven by domestic consumption. In that, they have used the playbook used by South Korea and Japan. Exports were simply used to jump-start the moribund Chinese economy, trying to break free of the consequences of the Cultural Revolution.

Now that the infrastructure is in place, domestic consumption will drive the Chinese economy. It's not all bad news. A growing Chinese consumption will drive growth in the west (particularly in the Eurozone), albeit on terms set by China.

In Europe, the European Central Bank (ECB) has indicated tolerance for a temporary period of higher inflation. ECB President Christine Lagarde has stuck to the ECB's official view that inflation will ease back below 2% next year but seemed to acknowledge growing that higher price growth might be here to stay. The Eurozone inflation for September came in at +3.4%, a pickup from the +3% recorded in August. It was the highest rate of price increases since September 2008, and well above the ECB's 2% target. Energy prices accounted for much of the pickup in inflation in September.

Speaking recently to lawmakers at the European Parliament, Lagarde said – *"While inflation could prove weaker than foreseen if economic activity were to be affected by a renewed tightening of restrictions, there are some factors that could lead to stronger price pressures than are currently expected."*

ECB policymakers were also open to expanding the ECB's regular Asset Purchase Programme (APP) for a limited time when emergency bond purchases stop in March of next year. The ECB has also signalled that it will keep interest rates in negative territory through 2023.

Therefore, the risk to equities, be it in the US, Europe or China remains to the upside. Tapering of asset purchase by the Fed will not impact the equity market a great deal, as the market fully expects the Fed to taper and eventually stop asset purchases. Even when asset purchases do end, the Fed is a long way off from raising interest rates.

As the table above indicates, Consumer stocks (particularly XLP) have still have quite a way to catch up and present a very good buying opportunity. Energy stocks are flying, and it may be a good idea to trim any holdings in your portfolio. There is no shortage of oil and gas in this world and supply shortage concerns are being addressed rapidly.

Tech and Communication Service sector stocks (XLK, XLC) are in for more upside, as we head into the festivals and holiday period of consumer spending.

In the bond markets, the yield on the 10-year Treasury bond ticked up to +1.64% and is still below the

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+1.75% reached in March this year. As the Fed tapers, expect yields to rise further.

Benchmark US equity sector performance (2020, 2021 YTD)

Ticker	Name	2020 Performance	2021 Year-to-Date (YTD) Performance	2021 YTD Relative Performance
XLE US Equity	ENERGY SELECT SECTOR SPDR	-36.9%	51.5%	25.1%
XLF US Equity	FINANCIAL SELECT SECTOR SPDR	-4.2%	35.9%	12.2%
XLRE US Equity	REAL ESTATE SELECT SECT SPDR	-5.5%	29.5%	6.9%
XLC US Equity	**COMM SERV SELECT SECTOR SPDR**	**25.8%**	**21.7%**	**0.5%**
XLK US Equity	**TECHNOLOGY SELECT SECT SPDR**	**41.8%**	**22.3%**	**0.9%**
XLY US Equity	**CONSUMER DISCRETIONARY SELT**	**28.2%**	**20.3%**	**-0.7%**
XLV US Equity	**HEALTH CARE SELECT SECTOR**	**11.4%**	**15.6%**	**-4.6%**
XLI US Equity	INDUSTRIAL SELECT SECT SPDR	8.7%	17.9%	-2.6%
XLB US Equity	MATERIALS SELECT SECTOR SPDR	17.9%	17.4%	-3.1%
XLP US Equity	CONSUMER STAPLES SPDR	7.1%	4.9%	-13.4%
XLU US Equity	UTILITIES SELECT SECTOR SPDR	-3.0%	6.7%	-11.9%

Source: Bloomberg

For specific stock recommendations, please do not hesitate to get in touch.

Best wishes,

Manish Singh, CFA

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The AUKUS defence is a disaster for France and it has reduced the EU to the status of a paper tiger now that the UK has left the EU. The geopolitics and economic centre of the world is fast shifting eastwards. US-China relation in the Indo-Pacific will be the defining issue of the 21st century.

Summary

America's withdrawal from Afghanistan, the Quad partnership (US, Japan, Australia, India), the Five Eyes Alliance (US, UK, Canada, Australia, New Zealand), and now the AUKUS pact (Australia, UK, US) all indicate that the defining issue of the 21st Century will be the strategic rivalry in the Indo-Pacific region – between the United States and China.

The AUKUS defence pact however, is not only a commercial disaster for France, it also deals a body blow to France's ambitions in the Indo-Pacific region. European leaders ought to be thinking if the US and the UK can do this to France, what chance does the rest of the EU stand against the ambitions and self-interest of the Anglo-Saxon alliance? It suddenly highlights to the EU how weak they are now that the UK has left the EU. You can't fault French President Emmanuel Macron for wanting an EU army. However, to have an EU army or not seems to be an intractable problem. Germany, the most important member of the EU, is largely a pacifist state and only too happy to piggyback off NATO for its security and, it would seem very few others in the EU, want to be led by the French. With so many differing views by the time the politicians of the 27 member states decided there was a viable military threat and mobilised an EU Army, Europe would have fallen.

No "tapering" was announced at the September meeting of the US Federal Reserve. However, I expect the Fed to announce a gradual taper in November, that wraps up by mid-June 2022. There's a lot of talk right now about the global supply chain crisis and I am afraid we will hear more of it over the next few months. Factory shutdowns (particularly in Asia as they manage and contain outbreaks of Covid-19), port closures in China, commercial flight reductions and container ships challenges globally – are hampering supplies. Lingering growth concerns mean that monetary policy is not going to tighten much anytime soon – even as bond yields and inflation rise temporarily. "Tapering" will not imperil the Bull run in equities as the market fully expects the Fed to taper and eventually stop asset purchases. Even if asset purchases end, the Fed is a long way off from raising interest rates. Equites are still a good place to be.

The AUKUS ruckus

France is livid at Australia's decision to cancel a $90 billion contract it signed with the French company Naval Group in 2016, for a fleet of 12 diesel-electric submarines and replace it with the AUKUS defence pact – a new three-way strategic defence alliance between Australia, the UK and US. This new alliance, will see the UK and the US jointly build eight nuclear-powered submarine for the Royal Australian Navy. Nuclear-propelled submarines are stealthier and faster than conventional diesel-powered boats, and can deploy for long periods, far from home. The US and UK will also provide Australia long-range cruise missiles and other defence technologies, including cybersecurity and artificial intelligence.

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The AUKUS deal is not only a commercial disaster for France, it also deals a body blow to France's ambitions in the Indo-Pacific region. France is a resident player in the region via its overseas territories and 93% of its Exclusive Economic Zone (EEZ) is located in the Indian and Pacific Oceans. The region is home to 1.5 million French people, as well as 8,000 French troops stationed in the region. France's Indo-Pacific strategy announced in 2019 was, based in part on its emerging partnership with Australia. That relationship now lies in tatters. A humiliated France called the AUKUS deal a "stab in the back."

The deal announced two weeks ago and signed in Washington last week with all three leaders – UK Prime Minister Boris Johnson, US President Joseph Biden and Australian Prime Minister Scott Morrison – present, has caused a major diplomatic ruckus and, at one point, threatened to plunge the western world into an unprecedented diplomatic crisis as France recalled its Ambassadors to the United States and to Australia. The French Ambassadors have since returned to their respective postings. It's the first time since the American Revolutionary War (1775-1783), that France has felt the need to recall its Ambassador to the US, such is the French anger at the "betrayal."

America's withdrawal from Afghanistan, the Quad partnership (US, Japan, Australia, India), the Five Eyes Alliance (US, UK, Canada, Australia, New Zealand), and now the AUKUS pact (Australian, UK, US) all indicate that the US is stitching together a robust coalition to contain China's rise and its influence in the Indo-Pacific region. The US security network also stretches into the Association of Southeast Asian Nations (ASEAN), where Singapore, Malaysia, Thailand and the Philippines, each host US troops from time to time.

It is now beyond doubt that the defining issue of the 21st Century will be the strategic rivalry in the Indo-Pacific region between the United States and China. In this respect, the US pivot to Asia-Pacific, risks deepening fractures in the North Atlantic Treaty Organization (NATO) – the bulwark of guaranteeing peace in Europe.

European Union (EU) leaders couldn't contain their excitement when Biden was elected President of the United States. *The Financial Times* declared – "The Grown Ups are Back in Charge in Washington." The AUKUS deal is an astonishing lesson in *realpolitik* for the French who like to describe themselves as America's oldest ally. The AUKUS nations didn't even see it fit to inform the French ahead of the announcement, let alone discuss it with them constructively and yet, for decades, France has been the only EU nation to provide direct military support to the US-led actions globally. The EU leaders ought to be thinking if the US and the UK can do this to France, what chance does the EU stand against the ambitions and self-interest of the Anglo-Saxon alliance? It suddenly highlights to the EU how weak they are now that the UK has left the EU.

A US Virginia-class (also known as the SSN-774 class), is a class of nuclear-powered cruise missile fast-attack submarine

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Source: General Dynamics/US Navy

An incandescent French President Emmanuel Macron is now doubly determined to build a 5,000-strong EU army, with France playing a leading role in it to restore some of the lost French pride.

Is it a good idea? Will there be an EU army?

You can't fault Macron for wanting an EU army. A nation or a bloc (as the EU is) can't have a foreign policy without an army, just as it can't have monetary union without political union. The EU is a half-way house and risks irrelevance if it can't make up its mind on what sort of entity it wants to be.

Having said that, to have an EU army or not seems to be an intractable problem. At least nine of the 27 EU countries have neutrality written into their constitutions. Germany the most important member of the EU is largely a pacifist state and only too happy to piggyback off NATO for its security.

Germany is not keen to maintain a standing army, let alone create and lead the EU army. One recent report indicated that the *Bundeswehr* (Military of Germany) was so under-resourced that one tank unit was forced to use a broomstick painted black to simulate a missing gun on a Boxer armoured fighting vehicle. The German Luftwaffe had only four combat-ready Eurofighter jets out of 128, because of missile shortages and a problem with coolants and all six German submarines had to be put out of service for repairs.

France on the other hand is militarily capable and wants to lead the EU army. However, it would seem very few in the EU want to be led by the French. Particularly, the Eastern European members like Poland and the Baltics nations have more trust in the NATO and the Anglo-Saxon nations than France or Germany. Who can blame them given their experience of two world wars?

Over the past 2 years, UK armed forces have been deployed in Estonia, Romania and Lithuania. It is the inescapable reality that the overwhelming majority of the power of NATO is delivered by the Anglo-Saxon nations.

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I am very sceptical of an EU army. The EU's handling of the vaccine procurement programme told you all you need to know about them working together over globally important matters. In my opinion, an EU army would be doomed to failure. In the EU, decisions are made by unanimity.

How you get 27 governments to agree to attack or even defend a target in the brief time available for such decisions, is highly questionable. With so many differing views by the time the politicians of 27 member states decided there was a viable military threat and mobilised the EU Army, Europe would have fallen. However, if the EU does set up an army of 5,000, it will be the only brigade in the world with 27 Generals – one for each member nation. Whoever supplies the gold braid for them (and inevitable layers of Colonels and Major Generals) is going to make a lot of money.

Markets and the Economy

Last week, the AAII US Investor Sentiment Survey, which had been as high as 43.4 at the beginning of September, plunged to a new 12-month low of 22.4, before bouncing back slightly to 29.9 this week. The survey is a weekly measure of American Association of Individual Investors (AAII) members, which asks them if they are "Bullish," "Bearish," or "Neutral" on the stock market over the next six months.

The overly bearish sentiment, was largely driven by the anticipation that the US Federal Reserve (the Fed) was set to announce "tapering" (reducing) its asset purchase program at the Federal Open Market Committee (FOMC) meeting held last week. The Fed is currently purchasing $80 billion in US Treasuries and $40 billion in mortgage backed securities (MBS) every month.

In the end, no tapering was announced at the September meeting, but it's very likely that the Fed will start to reduce, or taper, its $120 billion in monthly asset purchases as soon as its next scheduled meeting in November.

The US 10y Treasury yield has risen in anticipation rising from +1.3% to +1.5% (chart below), yet barring a couple of volatile sessions, the S&P 500 index has held up well and risen. This however, hasn't stopped the "permabears" from calling an end to the Bull-run in equities which started in March last year.

S&P 500 Index, 10 year US Treasury yield – 6 month price chart

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Source: Bloomberg

In my nearly 17 years in this profession, I have never seen a Bull market that has been viewed with such cynicism and scepticism. Every 1-2% correction is followed by a dire prognosis by the usual permabears. Red lights start flashing on CNBC and the parade of the bears ensues. Every short pull-back is met with more rash predictions of a disaster ahead.

In my opinion, Bull markets don’t end when there is still is so much scepticism. Bull markets end when there is all around euphoria and everyone is all-in at the top. The bearish sentiment remains high and it tells me that this Bull Run in equities has more room to run. Ignore the noise and instead focus on long term economic trends, secular policy or market structure changes.

As for short term pullbacks, these can happen even in healthy markets with strong economies. In fact, the S&P 500 has dealt with 32 pullbacks of -10% or more since 1950. Data crunched by Callie Cox of Ally Invest, shows that of those pullbacks, just 11 took place during economic recessions. The other 21 were quick storms, rebounding to new highs in an average of five months.

Here is another statistic tallied by investment blogger Brian Feroldi:

2011: Europe debt crisis
2012: Fiscal cliff
2013: US Government shutdown
2014: Ebola
2015: Brexit
2016: U.S. Election
2017: Harvey/Irma/Maria storms
2018: 2 US Government shutdowns
2019: US Impeachment inquiry
2020: COVID-19
2021: US Capitol Attack

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During the above period 2011-2021, what was the total return of the S&P 500? Well, a staggering +375%!

The message is simple – stay invested if you believe the growth outlook over the medium to long-term remains positive. The conditions that have boosted equities – accommodative fiscal and monetary policies, very low to zero yields on cash and the low yields on bonds, growth upturn, and no inflationary concerns over the medium term – all still prevail.

Long-time readers of this newsletter will know that I do not believe in timing the market. Timing the market and getting it right is a matter of luck. In my opinion, one has to be either conceited or not understand probability and chance, to think that one can time the market.

Yes, there will be market corrections but "Time in the market" holding assets you have researched well will always beat "Timing the market".

Benchmark Global Equity Index Performance (2020, 2021 YTD)

Ticker	Name	Country	2020 Performance (Lcl Ccy)	2021 Year-to-Date Performance (Lcl Ccy)	2021 Quarter-To-Date (Lcl Ccy)
MXIN Index	MSCI INDIA	India	16.8%	28.4%	12.8%
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MXEF Index	**MSCI EM**	**Emerging Markets**	**15.8%**	**-2.4%**	**-8.3%**
IBOV Index	BRAZIL IBOVESPA INDEX	Brazil	2.9%	-7.5%	-13.2%
MXTR Index	MSCI TURKEY	Turkey	12.6%	-8.8%	1.7%
HSI Index	HANG SENG INDEX	Hong Kong	-3.4%	-9.4%	-14.4%

Source: Bloomberg

One other issue that has consumed the markets of late is – Evergrande.

No, it's not the new size of pumpkin spice latte at Starbucks and nor is it a new lipstick line by Ariana Grande. Evergrande is the second-largest property developer in China by sales and it is in distress.

Is this China's "Lehman moment?"

No, it isn't.

"Lehman moments" are always a policy choice. The US Treasury made a conscious decision to let Lehman go bust. They regretted it later. Such monumental events don't happen by chance but by choice.

China will not make that choice. China doesn't want a systemic crisis. It doesn't want a "Lehman

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moment."

My understanding of China, its culture and psyche tells me Evergrande will "not get a bailout" but that retail investors who have bought the property from Evergrande will be protected and "made whole." Other Chinese developers will be asked to take over Evergrande's unfinished projects, complete them and deliver the properties to the rightful owners, who have already paid for them. China via its central bank People's Bank of China (PBoC) will always protect the Chinese consumers. It's a matter of existential importance for the Chinese Communist Party (CCP).

Also, bear in mind Lehman was an investment-grade credit, and the Lehman bonds were held by mom and pop investors via money market funds. Evergrande has been rated junk for a long time now. Therefore, expect an upturn in Chinese equities and Emerging Market equities as soon as the Evergrande issue is resolved or there is more clarity from the PBoC.

Over in Europe, the German elections are over. The Social Democrats (SPD) led by the current Finance Minister Olaf Scholz won 25.8% of the vote, while Chancellor Angela Merkel's Christian Democrats (CDU) and its Bavarian sister party, the Christian Social Union (CSU), received a combined 24.1%, down from 32.9% at the last general election in 2017. The Green party came third, on 14.6%, followed by the Free Democrats (FDP) with 11.5% and the right-wing populist Alternative for Germany (AfD) with 10.4%.

Germany's proportional electoral system makes it difficult for parties to have absolute control over parliament and hence the government. This time, with the largest party (SPD) only getting a quarter of the votes, the race is now on to form Germany's first three-party ruling coalition since the early 1950s. The SPD and the Greens governed Germany together from 1998 to 2005. The CDU-CSU and the FDP are old allies and last ran Germany in a coalition government under Merkel from 2009 to 2013.

The SPD and the Greens would like to raise income tax on higher earners and bring back Germany's wealth tax, which was abolished in 1997. The Greens would also like Germany to take on €500 billion of public debt for investment and give Berlin's blessing to a permanent mechanism for the EU to borrow money in its own right.

The FDP much like the CDU-CSU promises not to raise taxes. It also pledges to reduce the burden of tax and bureaucracy on businesses. The FDP also want to reduce the total burden of business tax from 31% to 25%, create tax breaks for private investment, and take Germany back to the "Black Zero", the stringently balanced budget it maintained before the pandemic.

I suspect we will see a Grand coalition of SPD-CDU/CSU and FDP with SPD's Scholz as the new Chancellor.

In 2017, it took six months to form a new government. I do not expect the new coalition government to be in place this side of Christmas. A Chancellor Scholz on the margins would be fiscally loose, but in no way a game-changer for EU politics, as some expect or make it out to be.

Benchmark US equity sector performance (2020, 2021 YTD)

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Ticker	Name	2020 Performance	2021 Year-to-Date (YTD) Performance	2021 YTD Relative Performance
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XLY US Equity	**CONSUMER DISCRETIONARY SELT**	**28.2%**	**13.4%**	**-2.2%**
XLV US Equity	**HEALTH CARE SELECT SECTOR**	**11.4%**	**12.7%**	**-2.7%**
XLI US Equity	INDUSTRIAL SELECT SECT SPDR	8.7%	12.7%	-2.8%
XLB US Equity	MATERIALS SELECT SECTOR SPDR	17.9%	11.5%	-3.8%
XLP US Equity	CONSUMER STAPLES SPDR	7.1%	3.0%	-11.1%
XLU US Equity	UTILITIES SELECT SECTOR SPDR	-3.0%	1.4%	-12.5%

Source: Bloomberg

There’s a lot of talks right now about the global supply chain crisis and I am afraid we will hear more of it over the next few months.

Product delays, product shortages and rampant freight costs, will all weigh on growth in Q4 and possibly Q1. The supply concerns are also magnified as demand is running very high. Consumers flush with cash from personal savings and payment support from the government are not afraid to spend.

However, factory shutdowns (particularly in Asia as they manage and contain outbreaks of Covid-19), port closures in China, commercial flight reductions and container ships challenges globally -are hampering supplies.

Did you know that approximately 50% of air cargo is transported on passenger flights?

It’s a great revenue stream for passenger airlines. With travel, particularly international travel still much reduced, there is a significant reduction in air cargo capacity causing further supply issues.

All this means, the monetary policy is not going to tighten anytime soon even as bond yields and inflation rise temporarily.

Equites are still a good place to be. I expect the Fed to announce a gradual taper in November that wraps by mid-June 2022. Tapering will not impact the equity market a great deal, as the market fully expects the Fed to taper and eventually stop asset purchases. Even if asset purchases end, the Fed is a long way off from raising interest rates.

As the table above indicates, Consumer stocks (XLY, XLP) have taken a beating and present a very good buying opportunity. Industrial (XLI) and Material (XLB) sector stocks should also benefit from the cyclical upturn when growth picks up again. Energy stocks are flying and it may be a good idea to trim them in your portfolio. There’s is no shortage of oil and gas in this world. It’s just a matter of supplying them adequately and in time to meet demand.

For specific stock recommendations, please do not hesitate to get in touch.

Best wishes,

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Manish Singh, CFA

The US has played the role of global cop, answering 911 calls. Captain America is homeward bound. Sometimes getting out of a needless war is the best thing to do. Focusing on home, spending money domestically will serve the US interest well.

Summary

Over the last 70 years, rightly or wrongly, US allies have counted on the US – “Captain America”- to come to the rescue when needed. The US has played the role of global cop, answering 911 calls from nations near and far, sometimes at great personal cost. The US has come to the rescue of foreign nations, foreign nationals and its own citizens stuck in foreign nations and warzones. Captain America is now calling time. Captain America is homeward bound. The political will and the political capital in the White House (be it a Republican or a Democrat White House) to fight a war in a foreign land is greatly reduced and continues to wear thin. In 1975, the loss in Vietnam was seen as the final humiliation of the “spent hegemon” – the US, yet its GDP is now 12 times bigger. Sometimes getting out of a needless war is the best thing to do. In the post-Saigon era, Japan was seen as the rising economic power, and for two decades (1975-95), it was. Japan’s GDP in 1995 reached $5 trillion. Japan’s GDP today still stands at $5 trillion. Japan atrophied and the US’ economic and technological power came through. US GDP, over the

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same time period, nearly tripled from $7.6 trillion in 1995 to $21 trillion today. Focusing on what needs to be done at home and spending money domestically, instead of waging wars abroad, will serve the US agenda and the US economy well.

US Real personal income received a big boost over the last 12 months. It increased due to transfer receipts – benefits received by people where no current services are performed i.e. Social Security, unemployment insurance, and Covid relief payments. If you strip out these transfer receipts, it becomes quite clear that US Real personal income has actually not improved much. Transfer receipts are set to end soon and I fail to see how the consumer will continue to feel cheerful and chase products, if prices were to increase. Besides, technology has ensured that the pricing power for average or easily produced goods has shifted and continues to shift in favour of consumers and not producers. Inflation will not be a problem for a long time yet and this is good news for equities. The US Federal Reserve's tapering of asset purchases is coming, but a rebound in bond yields will not kill the Bull Run in equities. Of course, there will be volatility, but the uptrend in equities isn't about to end.

"Captain America" – homeward bound

"A Fish Called Wanda" is one of the funniest movies I have ever seen. If you've seen the movie, you will recall the scene on the tarmac as the movie comes to an end. Archie Leach (played by John Cleese – who also wrote the screenplay) – taunts former CIA agent and Anglophobe Otto West (played by Kevin Kline) about Vietnam.

Otto: You know your problem? You don't like winners

Archie: Winners?

Otto: Yeah, winners.

Archie: Winners, like North Vietnam?

Otto: Shut up! We didn't lose Vietnam! It was a tie!

"It [Vietnam] was a tie" shows how difficult it is for those who are used to winning, to accept defeat.

Wars rarely have a good outcome. Whether the withdrawal from Afghanistan is the United States' Saigon or its Suez moment – will be debated for generations to come, and I will spare you my commentary in this newsletter.

Over the last 70 years, rightly or wrongly, US allies have counted on the US – "Captain America"- – to come to the rescue when needed. The US has played the role of global cop, answering 911 calls from nations near and far, sometimes at a great personal cost.

Very egregiously, some like the EU nations who now criticise the US, have for years benefited from US defence preparedness, without paying their stipulated budgetary contribution for membership of the North Atlantic Treaty Organization (NATO). Captain America has come to the rescue of foreign nations, foreign nationals and its own citizens stuck in foreign nations and warzones. Captain America is now calling time.

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Captain America is homeward bound.

The truth is that successive US Presidents starting with President Barrack Obama no longer saw the Middle East region as central to US national interests. What you see in Afghanistan, I suspect, will repeat throughout the Middle East, as the US continues to pull away and concentrate on matters at home.

Except for “Dunkirk”, I fail to think of any retreat that has not embarrassed the withdrawing forces. Therefore, yes, America will be embarrassed and it will lose significant “soft power” due to its chaotic Afghan withdrawal. The consequences of it will be felt for years to come. After Dunkirk, Britain stayed in the war to finish off (with the help of the allies) Nazi Germany – otherwise the Dunkirk retreat would have been the greatest embarrassment for Britain. I frankly don’t see the US returning to Afghanistan with a large army!

In fact, the US may not return to Asia for a military conflict in the foreseeable future, and that must worry US allies there, particularly Taiwan, Korea and Japan. The political will and the political capital in the White House (be it a Republican or a Democrat White House) to fight a war in a foreign land is greatly reduced and continues to wear thin. It would also seem, that Pax Americana (Latin for “American Peace”, the US playing the cop to maintain peace) is over. A world in which the global economic leader is not prepared to act as a cop, leaves the world open to many risks that will manifest over time. The UK responded to the US decision to withdraw from Afghanistan by cobbling together an alternative coalition, but it was impossible without the vital logistical support of the US. It is abundantly clear now, that without the US there is no hope of a coalition of the West in the future.

US Marine Corps infantry force in training in Afghanistan

Source: Pixabay

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Having said all that, the US withdrawal from Afghanistan is the right thing for the US to do, distasteful as it may be. As an investor in US equities and therefore someone with a vested interest in the US economy and the US dollar, the events of last week haven't made me overly gloomy about the US economy. The withdrawal is chaotic but not a disaster. I am more concerned about US President Joe Biden's policy with respect to the Ribbentrop-Molotov (German-Russia) Nordstream 2 pipeline treaty. I believe that will have calamitous ramifications in the future. The chaotic Afghanistan withdrawal will be quickly forgotten.

The US pulling out of expensive wars in faraway lands is good for the US economy and is US dollar positive. The UK suffered a bloody nose in the Suez crisis in 1956, yet it has prospered since. In 1975, the loss in Vietnam was seen as the final humiliation of the "spent hegemon" – the US, yet its GDP is now 12 times bigger. The US is more prosperous and much better off since the "Saigon" moment. Sometimes getting out of a needless war is the best thing to do, and it can stop the bleeding of the economy.

In the post-Saigon era, Japan was seen as the rising economic power, and for two decades (1975-95) it was. Japan's GDP in 1995 reached $5 trillion. Japan's GDP today still stands at $5 trillion. Japan atrophied and the US' economic and technological power came through. The US GDP over the same time period nearly tripled from $7.6 trillion in 1995 to $21 trillion today.

The United States is still a military superpower, the US dollar still is the world's currency and will be for the foreseeable future. Focusing on what needs to be done at home and spending domestically instead of waging wars abroad, will serve the US agenda and economy well. In 1975, the US had a major oil dependency, today the US is an energy exporter.

China is a clear beneficiary of the US' withdrawal, but Afghanistan will not be a cakewalk even for them, as they go about extracting minerals and trading with the tribal Taliban government.

In the movie, as Archie continues to taunt Otto, Ken (played by Michael Palin) arrives on the tarmac driving a steamroller, seeking vengeance for his pet fish that Otto had eaten. Otto too busy arguing with Archie finds he has stepped on wet concrete and cannot move. He is run over, but survives. Will the US, stuck in the Afghanistan quagmire have such a lucky escape? Or will it be more damaged than Otto coming out from under the steamroller? Not even John Cleese would like to write a screenplay for it. Only time will tell.

Markets and the Economy

The S&P 500 index (SPX) has made over 50 all-time highs this year and is up +19% year-to-date. It is up over +100% since the Covid-19 pandemic induced lows of March 2020. It took less than 17 months to double, the fastest Bull market to double since WWII.

As the table below indicates, while US and European equities have thrived, Emerging Market equities, particularly China, have not just lagged, but gone into reverse.. Policy uncertainty in China is a key reason for this..

At the current levels, Chinese equities are greatly undervalued. For example, the combined market capitalisation of the four Chinese tech giants – Alibaba, Tencent, Baidu, and JD.com – is a quarter less than the market capitalisation of Amazon (AMZN), yet their combined Free Cash Flow (FCF – refers to the amount by which a business's operating cash flow exceeds its working capital needs and expenditures

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on fixed assets) is nearly double that of Amazon.

"Whether a country is strong or not cannot be determined by the size of the economy alone, nor the size of the population or the size of the territory. In modern history, one of the roots of China's fall and defeat was our backwardness in science and technology." – wrote President Xi Jinping of China in this 2018 article. Please bear this in mind when analysing China technology and that would include internet, blockchain and digital currencies. China doesn't want to be backwards in technology ever again i.e. China technology stocks are unlikely to remain undervalued for too long..

Benchmark Equity Index Performance (2020, 2021 YTD)

Ticker	Name	Country	2020 Performance (Lcl Ccy)	2021 Year-to-Date Performance (Lcl Ccy)	2021 Quarter-To-Date (Lcl Ccy)
MXIN Index	MSCI INDIA	India	16.8%	20.5%	5.9%
CAC Index	CAC 40 INDEX	France	-7.1%	19.9%	2.3%
SPX Index	**S&P 500 INDEX**	**US**	**16.3%**	**19.7%**	**4.6%**
IMOEX Index	MOEX Russia Index	Russia	8.0%	17.6%	0.7%
SX5E Index	**Euro Stoxx 50 Pr**	**Europe**	**-5.1%**	**17.1%**	**2.4%**
FTSEMIB Index	FTSE MIB INDEX	Italy	-5.4%	16.8%	3.4%
CCMP Index	NASDAQ COMPOSITE	US	43.6%	16.7%	3.7%
INDU Index	DOW JONES INDUS. AVG	US	7.2%	15.7%	2.6%
DAX Index	DAX INDEX	Germany	3.5%	15.1%	1.7%
IBEX Index	IBEX 35 INDEX	Spain	-15.5%	10.5%	1.1%
UKX Index	**FTSE 100 INDEX**	**Great Britain**	**-14.3%**	**10.2%**	**1.1%**
IBOV Index	BRAZIL IBOVESPA INDEX	Brazil	2.9%	1.5%	-4.7%
NKY Index	**NIKKEI 225**	**Japan**	**16.0%**	**1.1%**	**-3.6%**
SHCOMP Index	**SHANGHAI SE COMPOSITE**	**China**	**13.9%**	**0.8%**	**-2.5%**
MXEF Index	**MSCI EM**	**Emerging Markets**	**15.8%**	**-1.2%**	**-7.2%**
MXTR Index	MSCI TURKEY	Turkey	12.6%	-1.4%	10.0%
HSI Index	HANG SENG INDEX	Hong Kong	-3.4%	-6.9%	-12.0%

Source: Bloomberg

The economists who wildly underestimated the strength of the post-COVID re-opening, only to be surprised by it, may now have gone in the opposite direction. The Citi Economic Surprise Index (graph below) which measures how economic indicators are coming in relative to expectations, has recently ticked into negative territory for the first time since the early days of the pandemic in 2020. There is no doubt that eventually, economists will overshoot to the downside just like they usually overshoot to the upside.

The focus however will squarely be on the inflation, "tapering" of asset purchase by the US Federal Reserve (Fed) and their upcoming annual economic symposium in Jackson Hole, Wyoming.

The US unemployment rate fell from +5.9% in June to +5.4% in July. The jobs lost in pandemic have been recovered in no time. To put it in perspective, following the 2008 recession it took 7 years for the jobless rate to fall back to +5.4%!

Citi Economic Surprise – United States (2018-2021)

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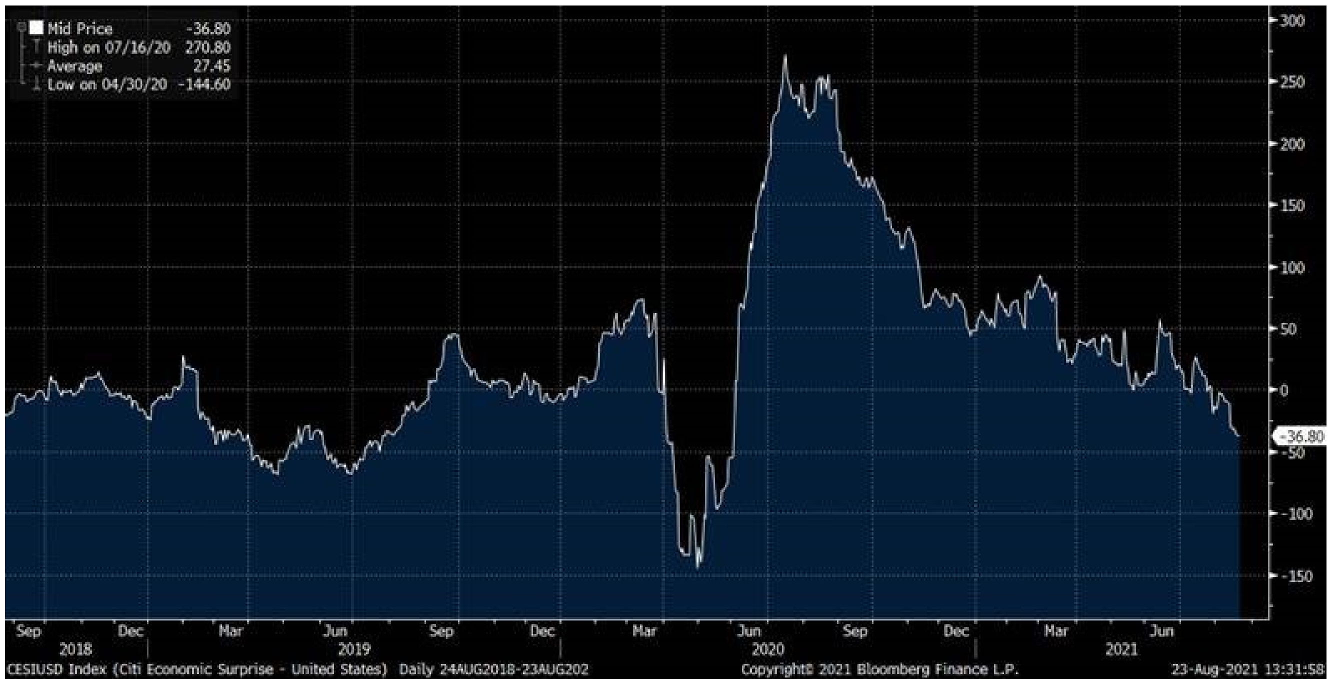

Source: Bloomberg

On inflation, as I have written in the last few newsletters, I continue to believe inflation will not be a problem in the medium term and inflationary bets will start coming off soon. With it, you are likely to see a new rally in Emerging Market equities and perhaps Chinese equities too.

Why do I think inflation is "transitory"? Please take a look at the chart below. US Real personal income (the red line) got a big boost over the last 12 months. It was boosted by transfer receipts – benefits received by people where no current services are performed i.e. Social Security, Unemployment insurance, and Covid relief payments.

If you strip out the transfer receipts, US Real personal income excluding transfer receipts, (the blue line), you will notice that US real personal income has not actually improved much. Transfer receipts are set to stop soon and I fail to see how the consumer will continue to feel cheerful and chase products if prices were to increase.

In my opinion, inflation will not be a problem for a long time and it's because neither President Obama nor President Donald Trump in the past or President Biden today have done or are doing anything to better the plight of the middle class American (let alone poor Americans). The real adjusted median US household income is flat over the last two decades. Over the last few decades, in the US, the giant portion of the economic benefits have continued to accrue to wealthy Americans, while 90% of Americans continue to suffer from pre-existing economic, wage and labour challenges. Record low unemployment since the 1960s make for a good statistics and political points, but on the ground, it has not done much to improve the balance sheet of the average American.

US Real personal consumer income and expenditure

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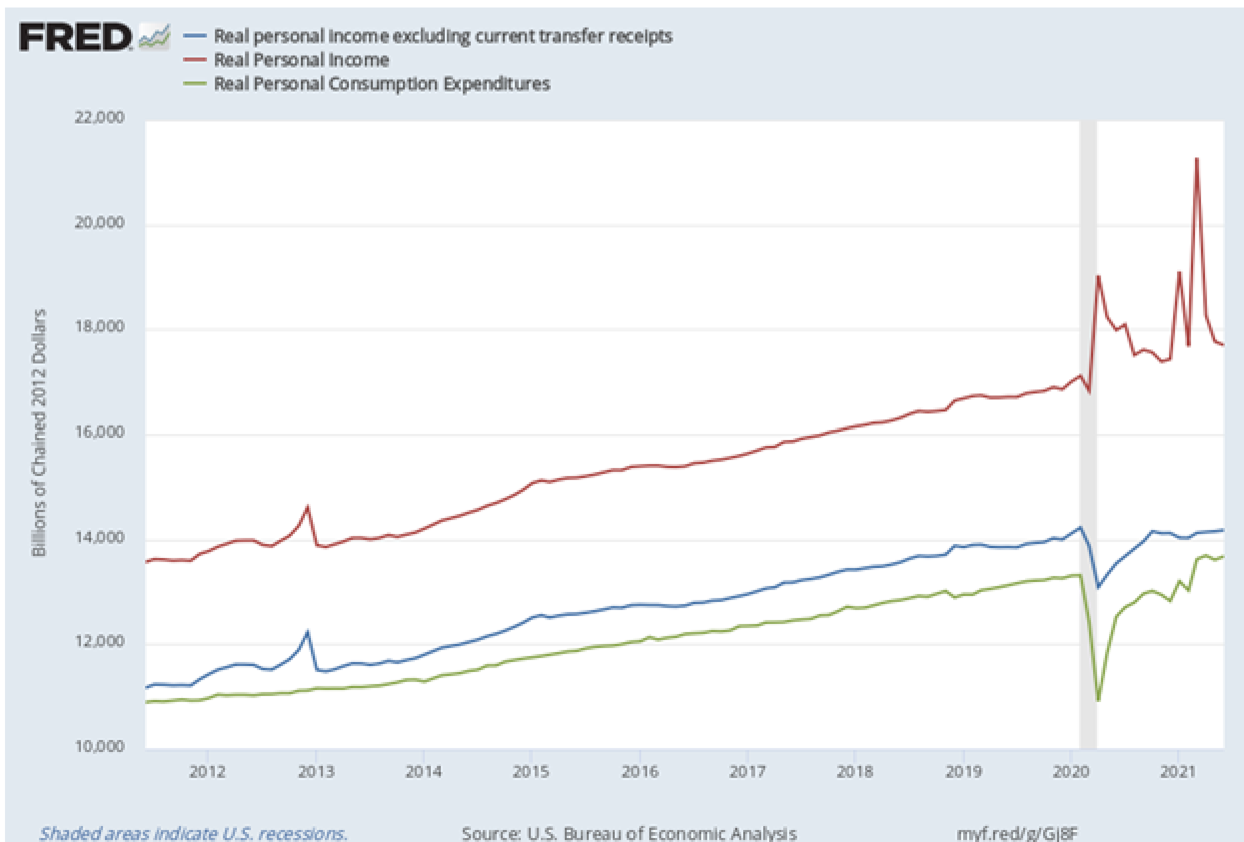

Remember, inflation will be driven by demand for average daily consumer goods by average American consumer and not by the wealthy re-stocking their freezer with delicacies – like House Speaker Nancy Pelosi and her $24,000 freezer full of $12-a-pint luxury ice cream. (If you think I made this part up about Nancy Pelosi, please see the video evidence here)

Besides, technology has ensured that the pricing power for average or easily produced goods has shifted and continues to shift in favour of consumers and not producers. Price discovery using the internet is a kid's job. Run a search for any item on Amazon and you have a plethora of suppliers. The producers are compelled to compete on price and this isn't going to change. Global trade and supply chains, with the help of technology are so well ironed out, that demand shocks will be dealt with promptly and easily and price increases will be arbitraged away in a short time.

In Germany where national elections are due in less than a month, over the last two weeks, the Social Democrats (SPD) have not only overtaken the Greens in the opinion polls but the SPD is also polling marginally ahead of the Christian Democratic Union (CDU) – Christian Social Union (CSU) faction. If this trend continues, an SPD-led government is more likely than another CDU-led coalition. That will mean more fiscal spending within Germany and greater economic cooperation at the level of the European Union (EU) and perhaps a more lax debt and deficit targets for the EU nations. This would be positive for European equities.

The Fed's tapering of asset purchase is coming but a rebound in bond yields will not kill the Bull Run in equities. Of course, there will be volatility, but I don't see the uptrend in equities breaking down.

The market is primed to see the Fed reduce and eventually pause bond buying. I say pause because I

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fervently believe that the "Japanification" of the western world bond market is in progress. When you know – if needed – the Fed will buy bonds again – it doesn't matter if the Fed stops now, buys later so long as the Fed indicates it is there to "help" which they always have and continue to. They have no other option.

Benchmark US equity sector performance (2020, 2021 YTD)

Ticker	Name	2020 Performance	2021 Year-to-Date (YTD) Performance	2021 YTD Relative Performance
XLK US Equity	**TECHNOLOGY SELECT SECT SPDR**	**41.8%**	**21.1%**	**1.2%**
XLV US Equity	**HEALTH CARE SELECT SECTOR**	**11.4%**	**19.3%**	**-0.4%**
XLY US Equity	**CONSUMER DISCRETIONARY SELT**	**28.2%**	**13.1%**	**-5.5%**
XLC US Equity	**COMM SERV SELECT SECTOR SPDR**	**25.8%**	**24.7%**	**4.2%**
XLF US Equity	FINANCIAL SELECT SECTOR SPDR	-4.2%	31.2%	9.6%
XLI US Equity	INDUSTRIAL SELECT SECT SPDR	8.7%	18.2%	-1.3%
XLP US Equity	CONSUMER STAPLES SPDR	7.1%	6.5%	-11.0%
XLU US Equity	UTILITIES SELECT SECTOR SPDR	-3.0%	9.6%	-8.5%
XLB US Equity	MATERIALS SELECT SECTOR SPDR	17.9%	18.0%	-1.4%
XLRE US Equity	REAL ESTATE SELECT SECT SPDR	-5.5%	27.0%	6.1%
XLE US Equity	ENERGY SELECT SECTOR SPDR	-36.9%	28.7%	7.5%

Source: Bloomberg

Post "taper" we will some rates rises in 2022/23 but the Fed and other central banks buying bonds will go on for a very long time (if not forever). I continue to be bullish on growth and equities and I do not see inflation as a major medium term concern as outlined above. I see central banks pulling away support in a very steady manner and interest rate rises, when they come, will be very gradual and hit a low plateau soon.

As the table above indicates, Consumer Discretionary (XLY) and Consumer Staples (XLP) sectors have taken a hit in last few weeks, as the Delta variant has spread and the re-opening trade has paused. Once those concerns settle, and they will, consumer stocks will bounce back. Those two sector present good opportunities to stock pick.

For specific stock recommendations, please do not hesitate to get in touch.

Best wishes,

Manish Singh, CFA

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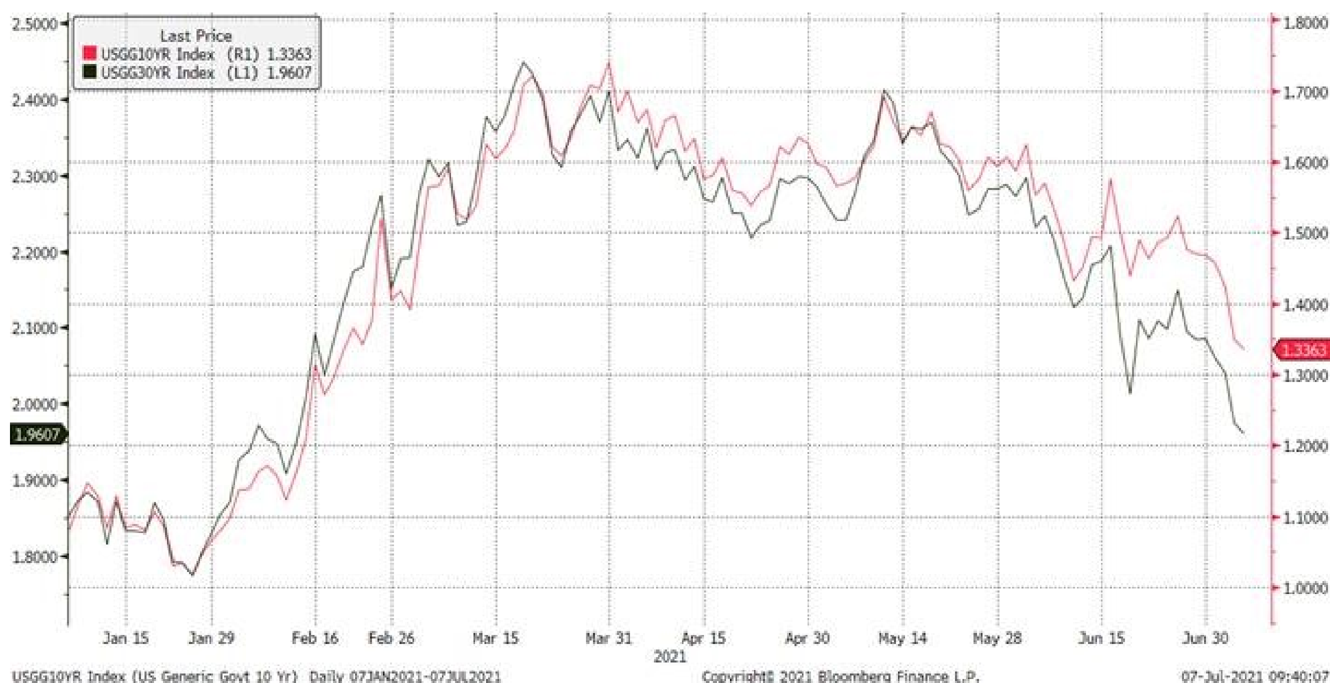

“The difficulty lies, not in the new ideas, but in escaping from the old ones.”

John Maynard Keynes

Summary

Despite slightly hawkish central banks of late, equity markets have continued their upward trajectory and bond yields have fallen. The yield on 10 and 30-year US Treasurys, is now back at the levels seen last February. Whilst inflation may not yet be showing up or may not show up for a while, it has however already achieved an important goal– raising inflation expectations and thus taking the risk of deflation off the table for few years. The US Federal Reserve has had its foot on the gas since the COVID pandemic started and it is getting ready to take it off ever so slightly. The Fed is however not ready to put the brakes on yet, and rightly so, as the “Delta variant” of Covid-19 rages on and the vaccination rate is still very low in many parts of the world, particularly in Asia and Emerging Markets.

As per a recent report in The Wall Street Journal, the greatest wealth transfer in history has begun. The “Baby boomer” generation has started parcelling out wealth to their heirs and others, unleashing a torrent of economic activity. Older generations will hand down some $70 trillion between 2018 and 2042. A good percentage of this will be “spent” to meet living, leisure, and luxury expenses and that means GDP expansion, job creation and business growth.

The S&P 500 index has steadily rallied in the last 15 months and each quarter has seen a rally of more than +5%. A gain of +5% in any quarter is impressive enough, but five quarters in a row is almost breath-taking. The only other period to match the current streak was in the five quarters ending in December 1954.

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Approximately $580bn has been added to global equities funds in the first half of 2021. This inflow surpasses the cumulative inflow to global equity fund during all the previous 20 years. Far too many people focus on levels of the markets and miss out reading the structural changes that are happening in the economy and the markets, that have long-lasting impact. Many fall into the trap of thinking an “all-time high “ means a correction is on the way. Whilst some fret over inflation, in my view, we may be in the early stages of another Bull Run in asset prices.

The case for Inflation has weakened but be happy the risk of deflation is off the table

The yield on the 10 year and 30-year US Treasurys (chart below) is now back to the levels seen last February i.e. the inflation narrative priced in over the last three months has been unwound, and then some.

Cynics may say –inflation, what inflation?

Whilst inflation may not be showing up yet or may not show up for a while, it has however already achieved an important goal– raising inflation expectations and thus taking the risk of deflation off the table for few years. This must be applauded. You will recall, not so long ago, central banks were more concerned about the potential “deflation” risk. Deflation is catastrophic for asset markets, as history and the more recent experience in Japan have demonstrated.

As I wrote in May Market Viewpoints I don’t discount the risk of inflation fully. In fact, we may yet see a short burst of high inflation driven by wages (though it’s not the 1970s when the impact of labour unions on wages was considerable), or indeed because of an increase in Oil prices , however, over the medium-term, inflation is not a big risk. As outlined in the April Market Viewpoints – the last 250 years of US inflation can be summarised as – a very long period of little or no inflation, a couple of decades of high inflation in the 1970s-80 and back to more than three decades of low inflation. Inflation will be tame because of structural reasons and technology’s disinflationary impact will bear on the world for many years to come.

6 months chart: US Treasury 10Y and 30Y yield

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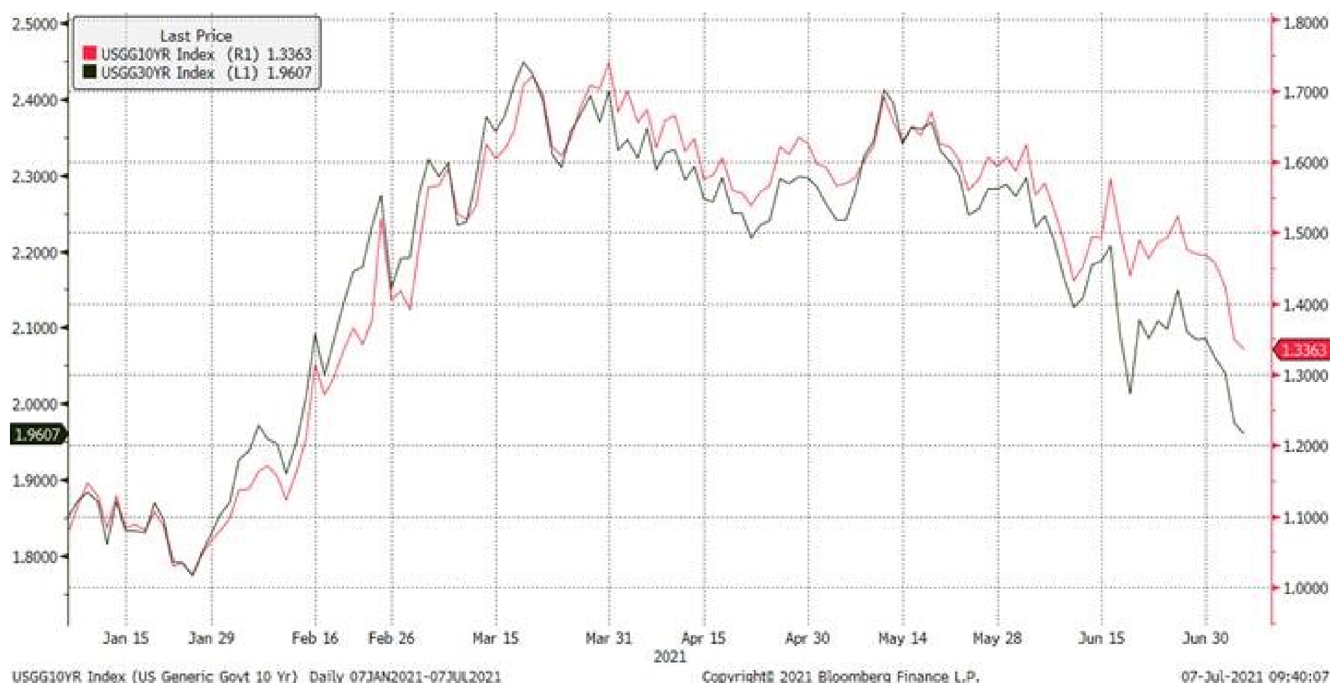

Source: Bloomberg

It seems that US economic growth may also be peaking.

The US economy has been on a tear. It expanded at an annualized rate of +6.4% in the first quarter of 2021 and the growth in the second quarter should be even higher, as the economic re-opening has accelerated. No doubt, the bipartisan Infrastructure Bill to spend $1.2 trillion on roads and bridges will be a further boost to growth. However, more recent US economic data indicates that we may have seen the top of the US growth cycle, as the re-opening exuberance fades.

According to the current estimate of the Federal Reserve Bank of Atlanta, GDP growth in the second quarter should be +7.8%. This reading is down from +8.6% on July 1, +10% in June and +12% in May.

The marginal gain from further re-opening is likely to moderate, as most US states are now largely open and data from the Transportation Security Administration (TSA) shows that the number of Americans passing through airports actually surpassed pre-pandemic levels at some points over the July 4 long weekend. Some 2.15 million people passed through security checkpoints on Thursday and 2.2 million on Friday last week, versus 2.09 million and 2.18 on the same days in 2019. The rebound of travel follows the plummeting of coronavirus-linked cases, hospitalizations and deaths in the United States. Nearly 60% of American adults are at least partially vaccinated.

If the growth in the US has peaked, then that is good news for the equity markets. The fear of a spike in inflation will recede and the US Federal Reserve (Fed) will be under less pressure to tighten monetary policy.

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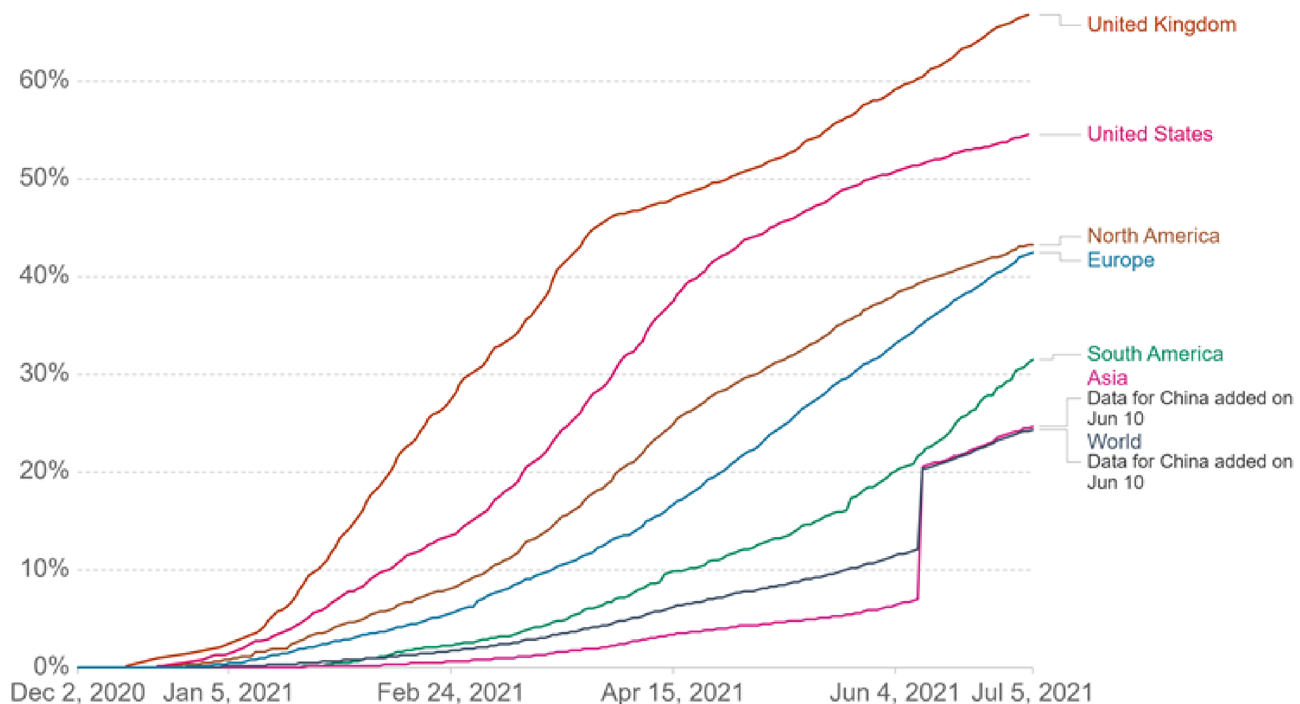

The UK has the highest vaccination rate among the G20 group of economies and yet the number of confirmed cases of Covid-19 is now back up to 25,000 per day, a rate last seen in February this year. Over 90% of these cases are that of the Delta variant. The Delta variant is far more contagious and is therefore spreading rapidly. However, very encouragingly, the number of deaths is down from 600 per day in February to less than 20 per day now i.e. a reduction of -96%.

The vaccine is working and, the higher the vaccination rate, the sooner things will get back to normal. Until then, central banks will be in no rush to taper their asset purchases with anything other than a token amount. As things stand, the Fed and the European Central Bank (ECB) are still buying assets at the rate of $120 billion and €100 billion per month respectively. So, while the guidance has been adjusted at the margins by the Fed, the printing presses in the US and Europe are still whirring and increasing fiat money supply at an annual rate of $2.8 trillion.

Markets and the Economy

It is no surprise therefore that equity markets have continued to increase. Inflation fears seem to have done little to dampen the spirit of equity investors.

Approximately $580bn has been added to global equities funds in the first half of 2021. This inflow surpasses the cumulative inflow to global equity fund during all the previous 20 years, according to data provider EPFR. The S&P 500 (SPX) is up more than +15% this year, while the FTSE All-World Index has gained slightly more than +12%.

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So we've had slightly hawkish central banks and still equity markets have been going up and bond yields have fallen. Far too many people have focused on levels of the markets and miss out on the changes going on around us. Many fall into the trap of thinking an all-time high (ATH) means a correction is ion the way.

Benchmark Equity Index Performance (2020, 2021 YTD)

Ticker	Name	Country	2020 Performance (Lcl Ccy)	2021 Year-to-Date Performance (Lcl Ccy)
IMOEX Index	MOEX Russia Index	Russia	8.0%	17.4%
SPX Index	**S&P 500 INDEX**	**US**	16.3%	16.0%
CAC Index	CAC 40 INDEX	France	-7.1%	16.0%
MXIN Index	MSCI INDIA	India	16.8%	14.6%
CCMP Index	NASDAQ COMPOSITE	US	43.6%	13.8%
SX5E Index	**Euro Stoxx 50 Pr**	**Europe**	-5.1%	13.4%
INDU Index	DOW JONES INDUS. AVG	US	7.2%	13.3%
DAX Index	DAX INDEX	Germany	3.5%	13.1%
FTSEMIB Index	FTSE MIB INDEX	Italy	-5.4%	12.1%
UKX Index	FTSE 100 INDEX	Great Britain	-14.3%	9.4%
IBEX Index	IBEX 35 INDEX	Spain	-15.5%	7.8%
IBOV Index	BRAZIL IBOVESPA INDEX	Brazil	2.9%	6.7%
MXEF Index	**MSCI EM**	**Emerging Markets**	15.8%	3.8%
NKY Index	**NIKKEI 225**	**Japan**	16.0%	2.5%
SHCOMP Index	SHANGHAI SE COMPOSITE	China	13.9%	1.5%
HSI Index	HANG SENG INDEX	Hong Kong	-3.4%	-0.4%
MXTR Index	MSCI TURKEY	Turkey	12.6%	-8.4%

Source: Bloomberg

After the worst quarter for US equities since the Financial Crisis of 2007/8, during the first quarter of 2020, the SPX has steadily rallied in the last 15 months and each quarter has seen a rally of more than +5%. A gain of +5% in any quarter is impressive enough, but five quarters in a row is almost breath-taking. The only other period to match the current streak was in the five quarters ending in December 1954. Besides this streak, there were three other periods when the SPX has rallied by more than +5% for four consecutive quarters (1958, Q3 1982- Q2 1983 and 1995).

So what happened to equity markets in 1955, in the quarter that followed that fifth straight quarter of gains, I hear you ask? Well, the SPX didn't rally more than +5%, but it was up a respectable +1.7%. For the entire year that followed the five-quarter streak, the SPX added another +26.4% (chart below)

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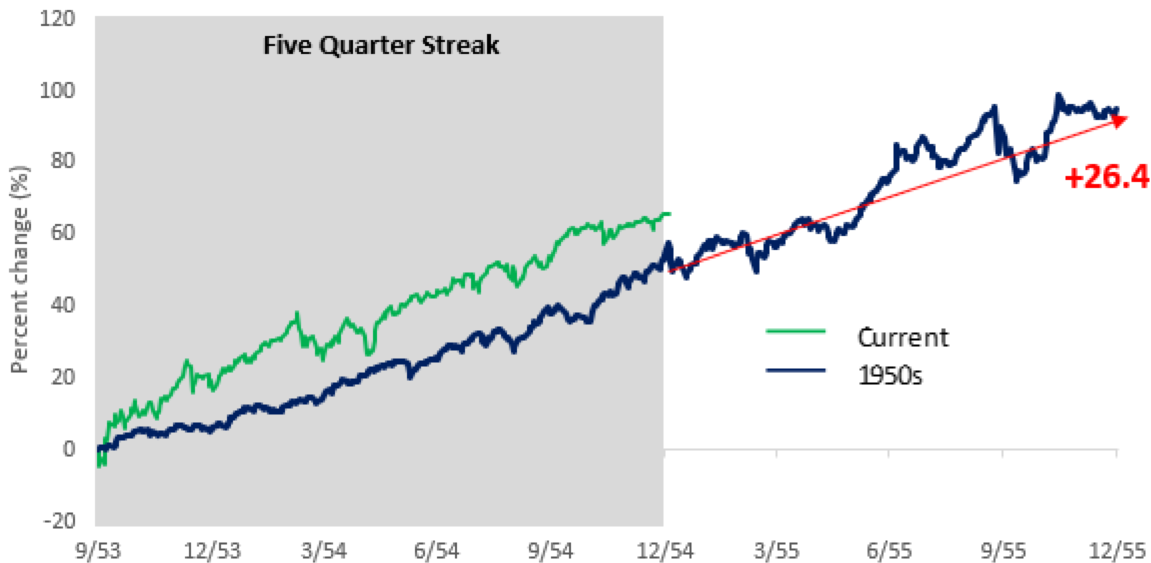

Source: Bespoke Invest

So what were the factors that contributed to the 1954-55 rally in equities? The events that led up to it have some similarities to the current period. Then, as the US struggled to finance World War II, the Fed kept interest rates low to reduce borrowing costs. The Fed did so through the purchase of Government securities, even as inflation levels surged. Naturally, when the war was over, President Harry Truman and his Treasury Secretary John Snyder argued for a continuation of the Fed's easy policy. What politicians wouldn't?

This time around, the pandemic has had a similar impact on Fed's monetary policy and Chairman Powell who has already faced pressure from then President Donald Trump to cut rates and keep interest rates low, may yet find it difficult to get out of the "low rate" policy as debt and deficits continue to mount to fund President Joseph Biden's spending plans.

The chart below compares the current bull run in US equities, that started in March 2020 to the last bull run (March 2009- March 2011) we witnessed. The current bull run looks even better and stronger and there is no sign of a dip.

S&P 500 performance: Comparing the 2020-21 US equity Bull Run with the last one (2009-11)

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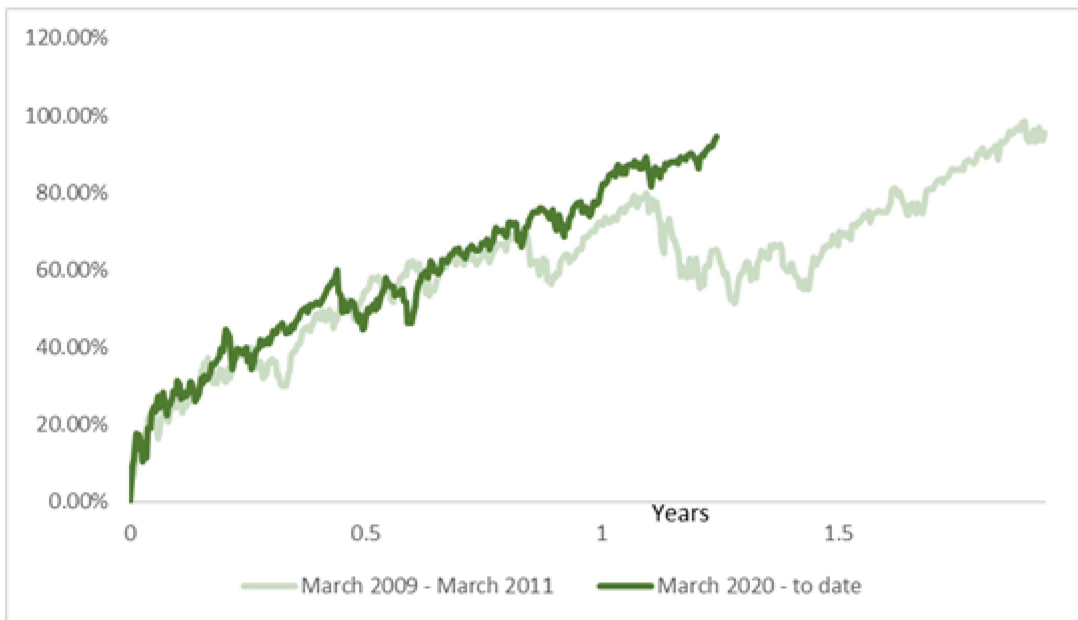

Source: Crossbridge Capital, Bloomberg

It took a once in half a century pandemic to bring the last Bull Run to an end. While some fret over inflation, in reality we may be at the early stages of another Bull Run in asset prices. Ongoing fiscal and monetary accommodation, a high rate of savings coming out of the pandemic, and a buoyant jobs market, all indicate higher consumer spending which will continue to fuel the rally in equities.

Add to that these startling statistics published in The Wall Street Journal (WSJ)

- Baby boomers and older Americans have spent decades accumulating an enormous stockpile of money. At the end of this year's first quarter, Americans age 70 and above had a net worth of nearly $35 trillion. That amounts to a whopping 27% of all US wealth, up from 20% three decades ago. Their wealth is equal to 157% of US GDP, more than double the proportion 30 years ago
- The greatest wealth transfer in history has begun as boomers started parcelling it out to their heirs and others, unleashing a torrent of economic activity including buying homes, starting businesses and giving to charity. Older generations will hand down some $70 trillion between 2018 and 2042, according to research and consulting firm Cerulli Associates

Of course, some of this wealth will be saved or invested, but a good percentage will be "spent" to meet living, leisure, and luxury expenses and that means GDP expansion, job creation and business growth.

It's too easy to be bearish. Some people even have it as their base case and relish reminding everyone "I told you so" at every piece of negative news. Sadly for them, however, their much-awaited -20% correction often comes after +100% rallies.

It's a fact that "most people would rather be in the majority, than be right" and when the media highlights doom and gloom it becomes that much easier to be a bear than a bull and find yourself in minority as I have found myself through the last bull run and this one. Yes, there will be market

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corrections but “Time in the market” holding assets you have researched, will always beat “Timing the market.”

Investing is as much about knowledge, forecasting as it is about psychology. If you are bearish and overindulge, you get anchored to bearish views and start seeking echo chambers full of other bears. It doesn’t take long thereafter to lose sight of reality and you completely miss the structural changes happening in the economy and the markets that has long-lasting effects. A John Maynard Keynes quote to bear in mind – “The difficulty lies, not in the new ideas, but in escaping from the old ones.”

Benchmark US equity sector performance (2020, 2021 YTD)

Ticker	Name	Country	2020 Performance	2021 Year-to-Date Performance
XLE US Equity	ENERGY SELECT SECTOR SPDR	US	-36.9%	37.3%
XLRE US Equity	REAL ESTATE SELECT SECTOR SPDR	US	-5.5%	24.0%
XLF US Equity	FINANCIAL SELECT SECTOR SPDR	US	-4.2%	23.5%
XLC US Equity	COMM SERV SELECT SECTOR SPDR	US	25.8%	21.3%
XLI US Equity	INDUSTRIAL SELECT SECTOR SPDR	US	8.7%	16.7%
XLK US Equity	TECHNOLOGY SELECT SECTOR SPDR	US	41.8%	16.3%
XLB US Equity	MATERIALS SELECT SECTOR SPDR	US	17.9%	14.0%
XLV US Equity	HEALTH CARE SELECT SECTOR SPDR	US	11.4%	13.7%
XLY US Equity	CONSUMER DISCRETIONARY SELECT SECTOR SPDR	US	28.2%	12.7%
XLP US Equity	CONSUMER STAPLES SELECT SECTOR SPDR	US	7.1%	3.8%
XLU US Equity	UTILITIES SELECT SECTOR SPDR	US	-3.0%	3.2%
Source: Bloomberg				

As you may have guessed by now, I continue to be bullish on growth and US equities and I do not see inflation as a major concern. I see central banks pulling away support in a very steady manner and interest rate rises, when they come, will be very gradual and hit a low plateau soon.

European equities still have a long way to catch up and I would caution against underestimating the changes going on in the Euro group. Italian Prime Minister Mario Draghi has established himself as the leading light, given his background and experience. As the only macroeconomic expert in the G7 leader group, he far outshone Chancellor Angela Merkel of Germany and President Emmanuel Macron of France at the recently concluded G7 meeting in Cornwall. Draghi is driving the European Union (EU) towards higher debt and higher deficit and this will be funded by more money printing by the ECB and borrowing using the EU Recovery Fund.

The first syndicated issuance by the EU recovery Fund saw a demand of €142 billion for the €20 billion inaugural issue EU’s 10-year bond offer. The EU Commission had to pay interest below 1%. By the end of 2026, the EU recovery Fund plans to raise around €800 billion. The money raised will back grants and loans to EU member states to help their economies recover from the Covid-19 crisis.

Austerity is well and truly over in the EU and spending will carry on. Of course, there will be a day of reckoning as both the EU and the Euro are structurally flawed. However, such flaws usually take a long time to unravel. The political will should never be underestimated and a flood of money can keep the market forces at bay for longer than one anticipates.

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For specific stock recommendations, please do not hesitate to get in touch.

Best wishes,

Manish Singh, CFA

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