House View

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St. Gotthard
Fund Management

Turbulence underway

After a summer of calm, with global equity markets not dropping more than 3% from May until early September, global investors are confronted with the first significant drawdown since early March (-6%). Many underlying issues that have capped investor optimism of late, such as the default of Evergrande, a major company in China, an ongoing surge in energy prices, as well as more political drama in Washington, DC, regarding major stimulus programs.

MSCI ALL COUNTRY WORLD INDEX

Source: Bloomberg

Real estate market imbalances in China

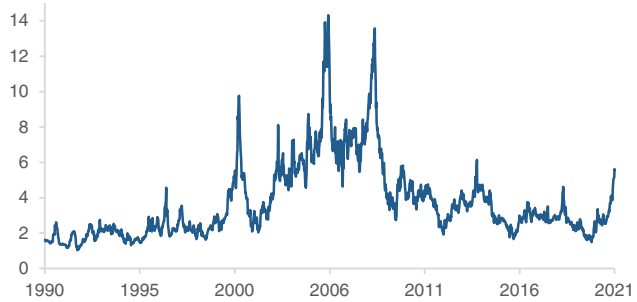
The demise of Evergrande, the second-largest Chinese real estate developer with outstanding debt in the order of USD 300bn, casts a shadow on the Chinese economic model. The company could be rescued by the government, but moral hazard issues have kept the authorities from stepping in, carrying the risk of a downward spiral in real estate prices. The financial system in China, without open borders to capital, suffers from the non-convertibility of the yuan into other currencies. As the banking system is dominated by state-owned enterprises (SOE), savers in China have no choice but to put their wealth into low-paying bank accounts, invest in the stock market or to buy real estate. Stories abound of Chinese citizens owning several apartments that are empty simply viewing them as a potential source of speculative gain. A downturn in real estate prices would lead to significant losses and weigh on consumption as well as on support for the one-party state, something which must be avoided at all cost from the perspective of the ruling communist party.

As the Beijing Olympics in February and the 20th Communist Party Congress in May 2022 will cast an increased global scrutiny on China, the government is likely to do whatever it takes to contain any potential threat to stability, in order to not derail the global economy in the coming quarters.

Energy crisis?

The recent rise in energy prices has led to a number of developments many had thought unthinkable only 12 months ago. Natural gas prices, which had undergone a severe bear market due to oversupply stemming from fracking, started to rise after new lows in March 2020, and have risen more than 130% in the past 6 months. Inventory drawdown fueled the rally, and news of European fertilizer producers cutting production due to the lack of natural gas is a clear display of these "sudden" supply difficulties.

NATURAL GAS PRICES



Source: Bloomberg

In energy production there is the potential of substitution between different types of fossil fuels. The rise in natural gas prices led to an increase in the use of coal, the price of which has also risen impressively in the past half year. Thermal or steaming coal futures in China for instance rose by 150% since March of this year, while met coal futures prices also rose by about the same amount. We saw similar movements in lumber prices earlier this year, only to witness a fall from the highs as steeply as the ascent. We view the situation in energy prices to be fundamentally different. As the demand for lumber fell significantly in the wake of the price rally since home builders had the option to put off the construction for an extended period, energy displays a materially higher price inelasticity, meaning the demand reacts only slowly to even starkly higher prices. Depending on the weather pattern for the coming winter, inventories could be drawn down even more, resulting in continued price strength for natural gas, but also in second round effects also for coal and even crude oil.

COKING AND THERMAL COAL FUTURES PRICES

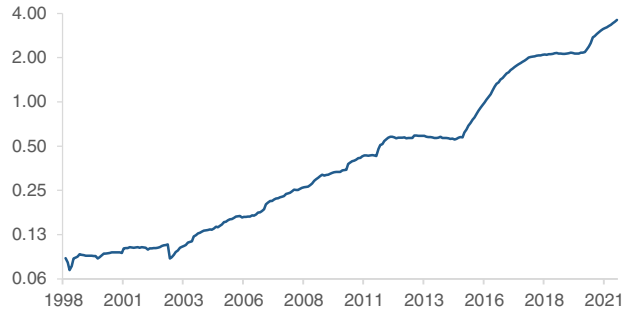
Source: Bloomberg

While the growing importance of ESG (ecological, social, governance-related) topics in today's investment world is to be welcome on a warming planet, the law of unintended consequences has created a number of difficulties, of which the current "energy crisis" is the most conspicuous. With a rising component of renewable energy, variations in electricity supply can be high, leading to strained electricity grids and at times a lack of supply that ultimately leads to power outages. With a wave of government initiatives that ultimately increase electricity consumption (electric vehicles, heating systems) over the coming years, demand is set to grow healthily. We can see the potential of some decisions of the past, namely the abandoning of nuclear energy which could provide an important baseload supply, to be overturned, or at least the closing of nuclear power plants to be protracted until a solution for sustainable grid stability is eventually found.

Political pressure

The nature of liberal democracy entails regular power changes in government between competing parties. The past decades' weakening "people parties" in Europe continued in the federal elections in Germany in late September. All major coalition options contain the Green party, barring an unlikely renewal of the unloved grand coalition of four years ago. It is difficult to imagine, but not entirely unthinkable, that a new government in Germany would delay the final shutdown of the last nuclear power plant in 2022. The presidential elections in France in May of next year also will have their impact on the future of the EU which currently is in the process of digesting the pandemic-related fiscal stimulus in the order of EUR 800bn.

ECB GOVERNMENT BOND HOLDINGS (LOG CHART IN TN EUR)



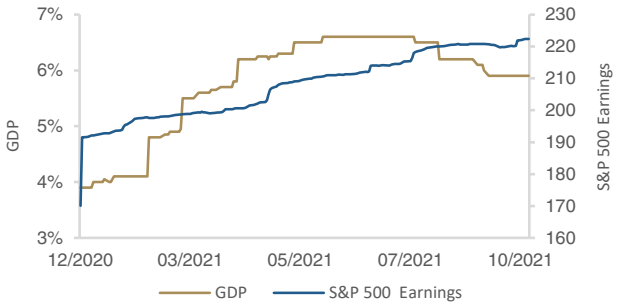
Source: Bloomberg

The fiscal package is another step towards an ever closer political (also: monetary) union, as the funding is undertaken by the EU commission by the creation of "EU-bonds". That adds to the non-explicit "euro-bonds", i.e. the government bonds of eurozone members that have been purchased by the ECB under different programs amounting to some EUR 4tn. With the German election results at hand, chances of further entanglement of national finances within the monetary union appear high. This might mean a tailwind for southern Eurozone countries, since austerity demands from German politicians would seem like a more distant threat. On balance that should be seen as a marginal positive for the euro.

Weaker economic growth going forward

With the strong price increases in energy products, but also in other goods due to still disrupted supply chains, the resulting inflation eats into consumers' budgets. Demand for other products, therefore, is reduced, leading to lower economic growth as a result.

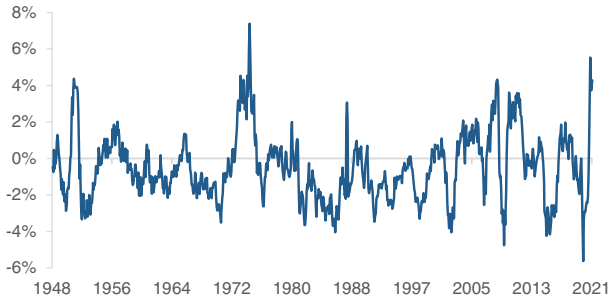
US GPD GROWTH AND S&P 500 EARNINGS ESTIMATES



Source: Bloomberg

US GDP growth estimates for 2021 have risen strongly in the first half, from a level of 4% to above 6.5%. In the past three months, however, optimism has fallen back, while earnings estimates continue to be raised. Considering the spike in the spread between producer price and consumer price indices' yearly changes, there will be margin pressure unless the higher input costs are passed on. Upward pressure on consumer prices on an extended basis therefore appear real and cannot be passed-off as merely 'transitory'.

PRODUCER - CONSUMER PRICE INDEX YOY CHANGE



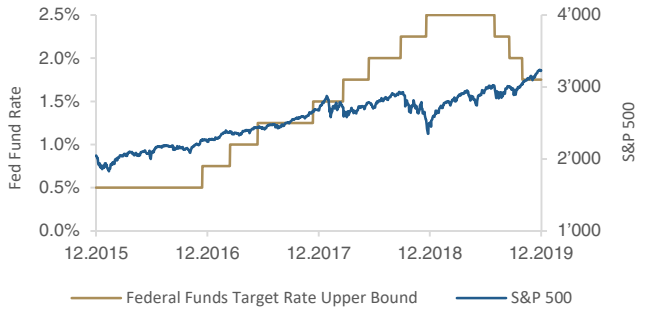
Source: Bloomberg

A dilemma for central banks

Bond yields started to move upward after the last FOMC meeting in September, as the Fed chairman announced his plan to dial back the monthly purchases of Treasury bonds and mortgage-backed securities (currently still at 120bn per month combined) by mid-2022. An important buyer leaving the stage means lower demand and hence lower prices. Should the market start to anticipate an active reduction of the Fed's Treasury bond holdings of USD 5.5tn, yields would rise even further, as supply would then be increased. An active balance sheet reduction to us appears a very distant prospect, however, as the near-term risks for the economy will keep the Fed from doing anything aggressive, with the latest weak September jobs report highlighting the challenges that remain.

The Biden fiscal package and its size remains to be seen, and with all the quarrels within the Democratic party between the centrist and progressive factions, there is a significant chance of a severely pruned total amount compared to the Biden administration's original USD 3.5tn size. By averting the government shutdown, if only until early December, members of Congress at least showed that they will not sacrifice everything in order to prevail over the other side of the aisle. Needless to say, there is considerable scope for further market turbulence as partisanship continues to provide uncertainty for the coming weeks at least.

FEDERAL FUNDS RATE and S&P 500 2016-2019



Source: Bloomberg

The "hawkish" stance of the Fed contains memories of late 2018, when equity markets plunged by 20% in the wake of rising bond yields triggering fears of economic slowdown. At the end of that year, Fed chairman Powell communicated a pivot in monetary policy that led to a strong year for equities, with US lead equity indices rising by some 30% by the end of 2019. We consider the chances of a similar sequence of events to be material. In today's environment, the political struggle in Congress regarding substantial further stimulus are a new driver of market volatility, with the current stock market weakness appearing set to continue until at least the month of November.

Real and digital assets

The prospect of stickier inflation rates above long-term projections leads to the question of how to evade this erosion of purchasing power. We remain positive for precious metals, because we are nowhere near any normalization in yield levels: there are still close to USD 13tn worth of outstanding bonds globally that trade at negative nominal yields. It remains to be seen how the markets cope with any meaningful rise in yields. Were we to see a yield of 2% for 10-year Treasury bonds within the coming months, that would mean an almost doubling of the yield seen in early August. This threat by itself could be the source of meaningful equity volatility, as market participants will start to ask themselves when monetary support will wane. The resulting change in valuations for the different sectors could lead to major trend changes, in our view. We expect the resources-extracting industries, despite strong headwinds from regulation and legitimate environmental protection issues, to profit from the high prices to expect in the coming years. On the flip side, some growth-oriented companies could see their market cap shares shrink, on both the prospect of tighter regulation reducing earnings expectations and the lower present value of future profits thanks to higher discount rates.

The strength of digital asset prices in the third quarter, after the steep correction in to early July, is a display of the strong interest by investors, with more institutional wealth entering the sector. Not even news of China banning cryptocurrency transactions could keep the market from trending up, which we consider extremely telling. Bitcoin dominance, i.e. the share of bitcoin's of total digital assets' market capitalization, currently is interesting as it appears to have bottomed in May and then again in September, opening the possibility of significant outperformance vis-à-vis altcoins in the coming weeks. Long-term, we consider bitcoin dominance to rejoin its down-trend, the inevitable consequence of many other digital asset projects gaining in importance, since progress is continuing at tremendous speed at various promising projects.

BITCOIN DOMINANCE

Source: Trading View

Crypto market participants often mention bitcoin's 4-year halving cycle to be an important driver of price direction. Four years ago, the crypto market burst up in a very steep upward slope, with bitcoin reaching almost 20K USD and ETH 1400 USD, up 20 and 100 times, respectively, over 2017. If we are to see anything distantly similar to the events of four years ago, already hot markets could become even more speculative. After all, one should remember the strong price corrections that followed almost vertical upswings in the young asset class of digital assets, with the top to bottom drop amounting to more than 80% in each instance. Crypto sentiment indices hint at already elevated levels of greed, but the extreme levels of late Q4 of last year, when they stayed there for two months, have not been reached. We therefore expect the positive environment for digital assets to continue for the time being.

CONCLUSION

- We expect the period of increased volatility to continue for a number of reasons. The threat of political gridlock to any meaningful fiscal stimulus in the US with an ensuing drop of demand could put a pressure on equity prices. Adding the prospect of the Fed stepping back from propping up Treasury bond markets, this makes for an uncomfortable outlook at least for the coming weeks.
- The stronger US dollar in the wake of a risk-off wave on financial markets poses a threat for a number of economies, especially in EMs. We would see the Fed aiming for a relief of the revaluation pressure by not maintaining its perceived hawkish stance.
- The upmove in yields, even in the wake of the latest job market data which was weak, could remain in place. The funding side of any meaningful fiscal stimulus legislation also needs to be kept in mind, as there will be significant shifts in both demand and supply of Treasury bonds in the coming 12 months, depending on the size and timing of the infrastructure and social stimulus packages.
- While other commodity groups have outshone precious metals year-to-date, we remain strong proponents of exposure towards them, as the general view of the current inflation only being of transitory nature will slowly change going forwards, as a multitude of factors speak for a prolonged period of elevated rates of inflation, starting from high commodity prices feeding through to consumer prices, over to surging rents as real estate markets, and the potential of strong wage growth due to record job openings and a shortage of labor in many industries.
- Digital assets are in a bull market, with the potential of bitcoin outperforming in the coming weeks. Should the SEC open the way for bitcoin ETFs to be investable for retail investors, the expected wave of demand could temporarily lift bitcoin dominance significantly. Altcoins, while potentially lagging bitcoin, could still thrive in such a scenario, we would add.

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CONTACT US

Gotthardstrasse 14
6300 Zug
Switzerland
+41 (0) 41 544 91 20
info@stgfm.com
www.stgfm.com

St. Gotthard
Fund Management