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Thursday, 28th October 2021

B Capital Commentary and Outlook Update 4Q2021

The third quarter of 2021 was broadly flat for major equity markets after July and August gains were erased by a turbulent September. In the final month, the S&P500 dropped -5.0% while the European Stoxx600 Index shed -3.4% and overall the broadest measure, the MSCI World Total Return Index fell by -4.16%. This made for September being the worst month for equity investors since the nadir of the current crisis back in March 2020.

With the COVID-19 virus seemingly less worrisome and restrictions being lifted through the summer months one could be forgiven for wondering what shook markets recently. It has been a good year for growth and a generic economic recovery after the trauma of 2020 but doubts have started to surface. As is often the case, investors become shaky when there are too many worries at the same time and this might just be one of those periods.

What are the components that make the "wall of worry" and will markets be able to climb over it? Often since the GFC we have looked to the darling of global growth that is China for reasons to be optimistic. That growth may be slowing. When an economy hits a slow patch there are some sectors that can give an early signal of trouble ahead. Property developers are one such group, operating with high levels of credit and tight margins, they can hit the wall early in a cyclical downturn. Fears have mounted that Evergrande, a huge and indebted Chinese developer that has missed an interest payment, could be firing the starting gun for a wave of sectoral defaults that then might lead to contagion through the domestic banking sector. This could in turn result in a sudden tightening of corporate credit conditions that slows the growth of many companies across China.

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This news along with the summer clampdown on the largest tech companies by the Politburo to increase regulation (particularly on the use of consumer data) has sent China stocks into strongly negative territory for the year. Alibaba is a good example. The company is both a poster child of China's success in e-commerce but at the same time its founder became too famous for the authorities' liking and the result is a reminder of the balancing act between state control and free market growth. Just as the company has seen some loss of market share to competitive rivals (a healthy thing in our view), it then took a $2.8Bn fine for abuse of its dominant market position and also had its financial division's IPO cancelled at the last minute. Even though the Chinese e-commerce sector is still growing annually in the high teens, the value of Alibaba is down by over a third year to date. That is too much. Overall, stocks on CSI300 Index look cheap at 14X forecast EPS and may be due some respite in the quarters ahead.

In the US, Federal Reserve chairman Jay Powell added to valuation worries with a more hawkish speech that signalled reductions of the central bank's $120Bn a month bond purchasing programme. The US 10-Year yield has ticked higher to around 1.60% and asset managers have been reported to be the most short the '10 year' since 2016. The spectre of a taper tantrum is a Halloween possibility at this seasonally volatile moment of the year.

Higher interest rates can affect the more leveraged and more lofty-valued companies first. With the S&P500 Index dominated by tech, which has had a strong run since the pandemic began, these components have started to be a drag on performance. The question is whether their typically higher growth rates and innovative products will help their share prices power through a short-term pullback or if a longer-term downtrend persists if yields head higher. We think that tech stocks still offer value as a hedge in case of more COVID restrictions and because we think that the inflation and interest rate worries are overdone.

The worry over higher interest rates comes at the very moment that there are fears of an economic slowdown. The combination of the two can give rise to a particularly scary scenario - stagflation. This last happened in the 1970's at a moment when an oil crisis was combined with already-rising inflation backdrop and the economy stalled. Today, central bankers are united in calling the inflation spike 'transitory'. They believe that prices have jumped because the return to consumption has been way stronger than expected but will moderate quite quickly. We are inclined to agree and think that inflation will cool in 2022, helped by a fall in key input factors such as oil prices, which we expect to drop by -20% or more from the current $83 level, combined with manufacturing output increases and supply-chain improvements that should come to bear in the short-term.

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A strong return to consumption sounds good at first but it has resulted in a supply-side shock that is drawing attention today. The supply chain has been unable to meet demand and bottlenecks have

appeared everywhere. One of the most important of these is the supply of semi-conductors that today feature in everything from kettles to cars and whose scarcity mean suppliers in every sector have to stop production. Shipping lanes are clogged and the price of containers has multiplied by a factor of ten (see Fig 1 - The Baltic Dry Index of shipping rates), adding to the inflation pickup.

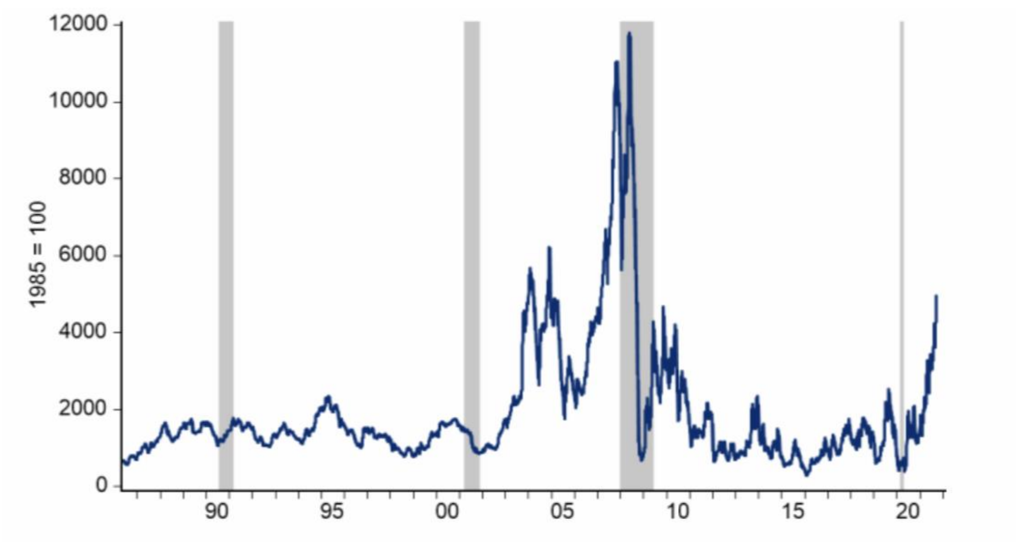

Fig 1 - The Baltic Dry Index

A shortage of natural gas at the start of the cooler period for the West has jumped in to add a little fuel to the inflationary fire and which has helped to cause CPI in the Eurozone to its highest level in 13 years. Russia is a key supplier of gas across Europe and is no doubt enjoying the squeeze on its westerly neighbours who are both critical and dependant at the same time.

Are they right? There remains a question over the central bankers' insistence that inflation will be transitory. Last year we forecast that inflation would be higher than usual in the summer of 2021 and it has reached the levels we anticipated. But we thought at the start of the year that inflation might settle down over the last quarter and into early 2022. This might now need some extension. Consumers don't seem to want to stop demanding more goods and suppliers probably won't be able to meet these needs for a short while. That means the inflation spike may not dissipate meaningfully until maybe a quarter or two later and the likely policy response from the central bankers around the world could be to move forward the timing of rises in interest rates.

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That is fine if gradual and in the face of a steadily growing economic picture. The million dollar question is whether the global economy will keep growing at sufficient pace to create a happy balance for equity markets. If not, then there may be a correction to reflect a higher discount factor and lower earnings growth.

Tech will be a casualty in such a scenario. On the other hand if the pandemic takes hold again over the winter season tech will again make strides ahead as online continues to replace bricks and mortar businesses. Commodity and energy sectors may do well if the situation is short-lived but in the end all corporates will suffer if stagflation takes hold properly.

Fig 2 - Global Growth Projections
***Source - IMF October 2021**

We think that in fact the global economy will keep growing at a reasonable clip and certainly above trend next year. The US may continue to expand at around 5% in 2022. China will slow to around 5% growth as well, which is a new dynamic for investors to contemplate but slowing growth is not unexpected. With these two powerhouses leading their respective regions, and Europe muddling along at around 4% it seems right to remain invested in global equities albeit with caution as the economic picture has become more unclear recently.

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With the view that interest rates will rise but gradually, we keep to a short duration theme for fixed income and maintain our view for credit. The transitory or persistent inflation question is the one to watch here and we are alive to the risks even though we think in the end growth will continue and the wall of worry will be climbed.

Best wishes,

Lorne Baring
Managing Director