FISHER INVESTMENTS EUROPE™

# MARKET PERSPECTIVES
## REVIEW & OUTLOOK

THIRD QUARTER
**2022**

THIRD QUARTER 2022 REVIEW & OUTLOOK

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# THIRD QUARTER 2022 REVIEW & OUTLOOK
# EXECUTIVE SUMMARY

12 October 2022

## PORTFOLIO THEMES

- We believe a new bull market appears close and the equities hit hardest during the downturn are likely to benefit most in the initial recovery.
- This bear market likely ends without broad capitulation and we expect solid returns moving into 2023 with existing fears already largely priced in.
- Inflation will remain elevated relative to recent history but should moderate going forward, easing pressures on central bankers to tighten excessively. Equities better suited to a slow growth, moderating inflation environment should benefit.

## MARKET OUTLOOK

- **Global Markets Look Primed to Recover:** Global markets reflect well-known fears and the likelihood of severe economic problems above and beyond what is already priced in seems low. Meanwhile, positive economic factors continue to be largely ignored.
- **Dour Investor Sentiment Supports an Unexpected Recovery:** Depressed sentiment, driven by concerns on inflation, global monetary policy, China's lockdowns and a variety of other factors has significantly lowered investor expectations, allowing room for reality to exceed expectations, spurring a new bull market.
- **Global Markets Typically Reward US Political Gridlock:** The incumbent party routinely loses power during midterm years, reducing political uncertainty and the likelihood of extreme legislation. Increased gridlock is largely underappreciated by investors and likely acts as a tailwind for global markets going forward.

Q3 again tested investors' patience globally as a midyear rally gave way to new bear market lows late in September, leaving the MSCI ACWI Index down -25.6% year to date[i]. Emerging markets (EM) paralleled developed markets ending the quarter at new bear market lows. While we are disappointed we didn't forecast this period correctly and reposition portfolios for a down market, there are lessons to be learned from 2022 on inflation and more. However, looking forward is crucial now. Hard as it may be to fathom when equities are falling, bull markets always follow bear markets. We see many reasons to believe one is close and will bring a far brighter 2023.

While we do think fears over rising rates have hampered equities this year, the theory of a fundamental connection presumes equity returns and bond yield moves are meaningfully negatively correlated, which isn't accurate. Equities often move upward alongside high and rising rates. Take the 1970s, for instance—the last time inflation fears erupted. In the seven years 10-year Treasury yields' annual change was positive during this period, the S&P 500 fell in just one: 1976.[ii]

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i Source: FactSet, as of 03/10/2022. MSCI ACWI Index return with net dividends, 31/12/2021 – 30/09/2022.

ii Source: Global Financial Data, Inc. and FactSet, as of 03/10/2022. 10-year Treasury yield and S&P 500 total return, 1970 – 1979.

Weak sentiment tied to ongoing fear of contraction in Europe due to energy shortages likely weighed on markets, too. We don't dismiss the possibility of continued shortages leading to severe energy rationing this winter, especially as Russia has been intermittently shutting off gas supply as likely retaliation for economic sanctions. However, shortage fears should alleviate as the EU continues curbing gas consumption, relies on higher-than-average inventory levels (presently over 80% of storage capacity), continues completing new European LNG infrastructure and gas pipeline projects (e.g. Baltic Pipe) faster than expected and increases LNG imports from big LNG-producing countries (e.g. Qatar, US). Overall, given the extremely dour expectations on this topic, combined with steps to mitigate and potentially add new supply faster, the risks skew towards upside surprise. Additionally, while EU energy prices have spiked, it does not mean it will have the same spillover effects globally.

In EM, large Asian constituents China, Taiwan and South Korea were hit particularly hard during the quarter on concerns over persistent COVID restrictions, geopolitical concerns and the strong US dollar. However, we believe sentiment particularly toward China is generally too negative and this EM bear market has already been uncommonly long. Economic fundamentals, while not stellar, do not indicate a hard landing is unfolding. Retail sales' sharp acceleration to 5.4% y/y in August may have stemmed primarily from the base effect, but the primary headwind remains the zero-COVID policy, which continues hampering activity.[iii] Meanwhile, growth in fixed asset investment has returned to its pre-COVID trend. Long-term corporate lending recently increased, likely tied to the government's steps to loosen credit to support infrastructure investment and small and mid-sized enterprises—a positive change from July. By now, President Xi Jinping's "common prosperity" and anti-corruption drives, which heightened investors' awareness of regulatory risk, are very well known and should fade into the long-term backdrop.

Latin America was relatively strong in Q3 on mixed economic drivers and hopes for less political uncertainty as we move toward 2023. Brazil's first round of their election was closer than many expected, but the late-October runoff will result in a winner mitigating political uncertainty, especially with Former President Lula expected to moderate further after failing to win an outright majority in October 2's first round.

We believe there are many underappreciated drivers that underpin the coming recovery. The US Midterm Miracle is one. From the beginning of reliable data in 1925, the three calendar quarters commencing with midterm years' fourth quarters are the most positive of any three sequential quarters in history tied to increased gridlock. S&P 500 returns in that nine-month span average 19.6% and are up 91.7% of the time since 1925.[iv] While this isn't perfect, it also isn't coincidence. Globally, markets are highly correlated to this. Better still, most people today can't fathom this potential—just as they couldn't heading into the third year of former President Donald Trump's term. Then, it seemed the Midterm Miracle wouldn't come, as investors reeled from a rough end to 2018, when equities flirted with a bear market at year's end. But markets soared in 2019, starting in the first half. Furthermore, when markets are down in the midterm year, a big third year is increasingly likely.

The Midterm Miracle isn't the only positive hiding in plain sight—falling political uncertainty globally, easing supply chain pressures, healthy bank lending and increasingly strong corporate profit margins despite elevated inflation are but a few notable positives. We aren't dismissive of existing negatives, but we believe markets are effectively discounting known concerns and largely ignoring positive drivers.

iii Source: FactSet, as of 30/09/2022.

iv Source: Global Financial Data, Inc., as of 28/09/2022. Average S&P 500 total return and frequency of gains from 30 September of midterm years through 30 June of the following, 1926 – 2021.

Whenever times are bad, investors seemingly forget how quickly—and how high—equities can rebound. It happened in 2020, when the MSCI ACWI Index jumped 70.5% between late March's pandemic low and that yearend.[v] We believe many investors are forgetting the strength of market recoveries now, manifesting in a sentiment phenomenon called the "pessimism of disbelief." Headlines emphasise bad news and either ignore positives or position them as problems-in-waiting, mostly centreing on inflation, the Fed and recession risk. When inflation began slowing, headlines warned the real problem wasn't consumer prices, but that inflation wasn't slowing enough to prevent draconian rate hikes that would sink the world's economy. In the UK today, pundits warn the problem isn't high energy prices, but that the government's response will crash the pound and import runaway inflation. Much of this is circular, but when markets are reeling and emotions are elevated, illogic can be hard for many to spot. The full Review will elaborate on these and many other issues we think the world sees wrong now.

By almost any measure, sentiment is depressed, which lowers expectations and is foundational to new bull markets. Some point to the broad lack of capitulation—violent selling amid strong outflows from equities and low overall liquidity—and claim this indicates much more downside ahead. But capitulation doesn't always define bear market lows, as 1966 and 1982's lows demonstrate. Today, we think that hunt for capitulation is a sign of investors' deep pessimism—one that doesn't acknowledge today's specifics. Selling out of equities is only one side of a trade. Broadly speaking, there is nowhere valid for pessimistic folks to go. Typically capitulation is cascading panic selling that shifts money from equities to perceived "safe havens." None of the standard safe havens look viable now. Not with bonds and gold down too, crypto crashing, inflation eroding cash, the dollar at generational highs and high mortgage rates shaking real estate. That is the bad news. The good news: When investors are this dour, reality needn't be anywhere near perfect to deliver positive surprise.

While the global economy isn't problem-free, it is holding up better than most coverage implies. We realise that the strength of the economy has become a political talking point, and our aim in pointing out the global economy's resilience isn't at all political: Rather, equities move on the gap between expectations and reality. That gap is big now. Existing fears aren't anything equities haven't already confronted—and priced in to a large degree. Meanwhile, positive developments go unheralded. While we don't know exactly when, we believe markets will shift positively as we move through Q4 and into 2023. We are looking to that period now and putting every effort into positioning portfolios for it.

v Source: FactSet, as of 30/09/2022. MSCI ACWI Index return with net dividends, 23/03/2020 – 31/12/2020.

# GLOBAL UPDATE AND MARKET OUTLOOK

31 October 2022

## MARKET RECAP

## LOOK TO THE RECOVERY

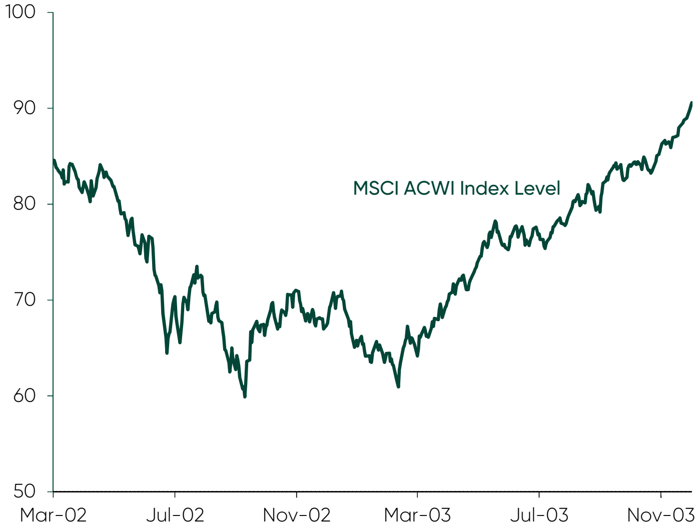
This Review will examine the issues plaguing global markets this year, but first, we think it is wisest to look forward. As we do, conditions appear ripe for a big rebound. US midterm elections are one factor. Rampant pessimism is another. We don't dismiss today's economic challenges, and the Review will discuss some, however bull markets follow bear markets. Their early bounce is often faster and higher than most fathom, beginning well before headlines and data reflect improvement.

### THE FOUNDATION OF A NEW BULL MARKET

After a rally in July, global equities' decline to new bear market lows has many thinking worse lies ahead. While that is possible, the market could also be forming a W-shaped bottom. Equities' retesting earlier lows, then surging, isn't unprecedented.

Consider 2002 – 2003. After global equities bottomed on 9 October 2002, they jumped 16.5% through November.[vi] But they moved sideways through early January, then sank through mid-March as the second Iraq war ramped up. The -14.2% decline from November's end through 12 March brought equities near October's bear market low.[vii] However, equities surged 48.6% through 2003's close, launching a five-year long bull market.[viii] This example illustrates that equities retesting June's low this year tells you little about the future.

**EXHIBIT 1: GLOBAL EQUITIES' W-SHAPED RECOVERY, 2002 – 2003**




Source: FactSet, as of 06/10/2022. MSCI ACWI Index returns with net dividends, 31/03/2002 – 31/12/2003.

Even if further downside is ahead, it doesn't mean poor returns will last. Since 1925 and prior to the current bear, 9 S&P 500 bear markets have breached -25%.[ix] A year later, equities were up in six of them—volatility after reaching -25% notwithstanding. The three in which equities were lower were 1929, 1937 and 2008, which we think bear little resemblance to today. Furthermore, capturing a bull market's early gains is crucial, as they compound throughout the ensuing bull market.

Investing is about probabilities, not possibilities or certainties. We think a bounce is the most likely scenario. We can't pinpoint the exact timing, but the conditions are in place. Sentiment is dismal—the pessimism of disbelief is rampant—as we will show. That is a new bull market's foundation. As legendary investor Sir John Templeton said, "Bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria." Few fathom a bull market soon; the counterintuitive reason for optimism.

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vi Source: FactSet, as of 06/10/2022. MSCI ACWI Index returns with net dividends, 09/10/2002 – 29/11/2002.

vii Ibid. MSCI ACWI Index returns with net dividends, 29/11/2002 – 12/03/2003.

viii Ibid. MSCI ACWI Index returns with net dividends, 12/03/2003 – 31/12/2003.

ix Source: Global Financial Data, Inc. and FactSet, as of 06/10/2022. S&P 500 total return, daily data interpolated from monthly.

Additionally, US midterms are poised to increase gridlock, setting up equities' strongest stretch of the political calendar. Meanwhile, while many fear deep recession, economic data are faring ok. Investment has continued despite rising rates as banks keep lending. Supply chain pressures and commodity prices are easing. Sanctions haven't proven as disruptive as feared, with Russian oil finding its way to global markets and Europe filling gas reserves ahead of schedule. The global economy isn't in perfect shape, but these conditions are inconsistent with the severe recession many claim is underway. They seem likely to deliver a better reality than most fear.

## HISTORY AS A GUIDE

Bull markets start fast, whether the recovery is V-shaped or W-shaped. The final decline is quick, but the recovery mirrors it—and runs on, as postwar returns in new bull markets attest to.

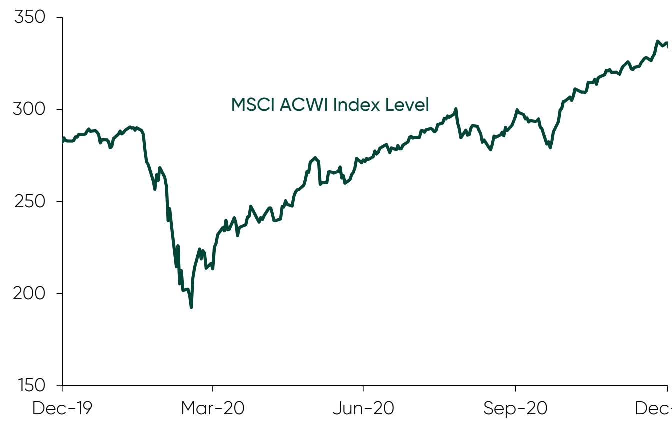
**EXHIBIT 2: NEW BULL MARKETS RAPID BOUNCE**

| Bull Market Start Date | 1-Month Return | 3-Month Return | 6-Month Return |
|---|---|---|---|
| 06/13/1949 | 9.0% | 16.2% | 22.8% |
| 10/22/1957 | 4.8% | 5.7% | 9.8% |
| 06/26/1962 | 8.5% | 7.3% | 20.5% |
| 10/07/1966 | 10.3% | 12.3% | 22.1% |
| 05/26/1970 | 6.0% | 17.2% | 22.8% |
| 10/03/1974 | 18.6% | 13.5% | 30.9% |
| 08/12/1982 | 18.1% | 36.2% | 44.1% |
| 12/04/1987 | 14.3% | 19.4% | 19.0% |
| 10/11/1990 | 6.2% | 6.7% | 27.8% |
| 10/09/2002 | 15.2% | 19.4% | 11.5% |
| 03/09/2009 | 26.6% | 39.3% | 52.7% |
| 03/23/2020 | 25.0% | 40.0% | 44.7% |
| Average | 13.6% | 19.4% | 27.4% |

Source: Global Financial Data, Inc., as of 20/07/2022. S&P 500 price returns, 13/06/1949 – 31/12/2020.

2020's bear market is a helpful case study. Equities fell -34.0% in less than five weeks.[x] The day equities bottomed, Britain became the last major nation to enter lockdown. Nine US states had issued shelter-in-place orders, and that rose to 21 by 26 March.[xi] The Fed unveiled a plethora of actions to help limit the economic damage, stoking panic amid terrifying forecasts of COVID-19's potential toll. Despite the pandemic, new lockdowns and no data confirming the extent of the economic impact, global equities soared. The MSCI ACWI jumped 70.5% from 23 March through yearend.[xii]

**EXHIBIT 3: GLOBAL EQUITIES' BOUNCE IN 2020**




Source: FactSet, as of 06/10/2022. MSCI ACWI Index returns with net dividends, 31/12/2019 – 31/12/2020.

Conditions looked similarly bad when equities bottomed on 9 March 2009. Chrysler and General Motors were nearing (and soon declared) bankruptcy. Troubled Asset Relief Program (TARP) confusion ran rampant as many banks sought to return the money. The Fed was dealing with the fallout of FAS 157, the mark-to-market accounting rule, which then-Chair Ben Bernanke suggested revisiting on 11 March. Corporate earnings were tanking—Q1 2009 S&P 500 earnings fell -35.6% y/y—and recession would last until June 2009.[xiii] Fear of a "second shoe to drop" in commercial mortgages, Alt-A loans and municipal debt ran wild.[xiv] From the low through yearend, global equities jumped 76.8%.[xv]

x Ibid. MSCI World Index returns with net dividends, 19/02/2020 – 23/03/2020.

xi "See Which States and Cities Have Told Residents to Stay at Home," Sarah Mervosh, Denise Lu and Vanessa Swales, *The New York Times*, 20/04/2020.

xii Ibid. MSCI ACWI Index returns with net dividends, 23/03/2020 – 31/12/2020.

xiii Source: FactSet and National Bureau of Economic Research, as of 10/10/2022. Statement based on S&P 500 earnings scorecard for Q1 2009 and National Business of Economic Research's business cycle dating.

xiv Source: FactSet, as of 06/10/2022.

xv Ibid. MSCI ACWI Index returns with net dividends, 09/03/2009 – 31/12/2009.

Bull markets typically begin when least expected. Recoveries to prior highs usually come faster than expected, too—a median 9.8 months since 1925.[xvi] Now, that figure contains significant variance, but we think it highlights equities' ability to recover faster than most presume.

## ON PORTFOLIO POSITIONING

This bounce is what we are positioning for. Even though we can't know *when* it will arrive, the strong likelihood it *will* arrive makes it vital to be positioned in advance. However, we aren't attempting to maximise the *magnitude* of the bounce. That would likely involve dialing up risk via too-high sector and industry concentration. Rather, we want to maximise the likelihood of benefiting from the rebound we expect. Accordingly, this means increasing exposure to equities we believe were punished excessively in the downturn and have a high probability of performing well in the upcoming recovery. We expect these changes to benefit portfolios when the rebound arrives.

## THE PREVALENT PESSIMISM OF DISBELIEF

If the above sounds overly optimistic, it may be because a phenomenon Ken Fisher calls "the pessimism of disbelief" runs rampant. It causes investors to view all news as negative. Bad news is a gloomy harbinger—e.g., a quarterly GDP contraction due to less meaningful factors like inventories and rising imports allegedly presages a nasty recession where consumption and investment plummet. Similarly, positive developments are supposedly negatives that just look positive—e.g., strong jobs data mean more Fed rate hikes, hurting equities and the economy.

Other manifestations of the pessimism of disbelief: Analysts argue better-than-expected retail sales stem from back-to-school discounts, with contraction to return shortly. Falling oil and gasoline prices signal weak demand and impending recession, not resilient supply. Focus on well-known supply chain headwinds (e.g., China's zero-COVID policy) overshadows evidence of *easing* pressures. The list goes on.

## WAITING FOR UNLIKELY CAPITULATION

One of the biggest examples of the pessimism of disbelief: Headlines griping about the apparent lack of capitulation—heavy panic selling as investors dump equities *en masse*. Since bear markets usually end in this manner, many say its absence means equities must fall further. We disagree. Capitulation happens *often* but not *always*. We see reason to believe capitulation from equities is unlikely in this environment.

People portray capitulation as if investors ditch equities and that is it. They forget exiting one asset necessitates entering another. But the typical "safe havens" don't look so safe.

### BONDS

Bonds are the logical destination when equities suffer. However, they have also tumbled this year. The Bloomberg Global Aggregate Bond Index, a gauge of corporate and government debt from 24 nations, is down -23.8% from its January 2021 high.[xvii] US bonds are also down from their highs: The ICE BofA US Treasury Index has fallen -17.3%, long-term Treasurys are down -37.9% and intermediate-term Treasury Inflation-Protected Securities have slipped -16.4%.[xviii]

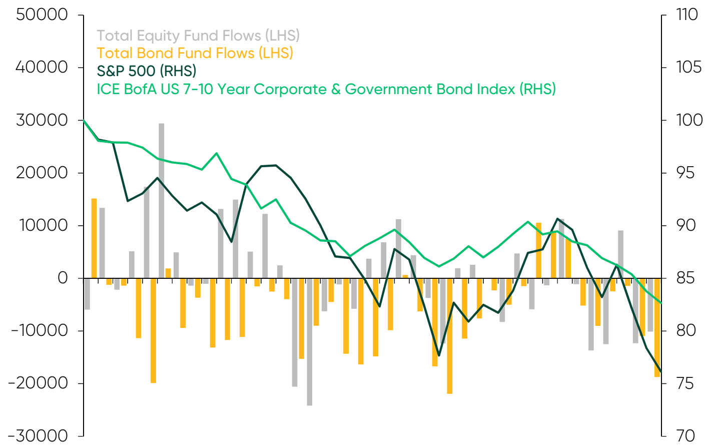
xvi Source: Global Financial Data, Inc. and FactSet, as of 06/10/2022. S&P 500 total return, median months from bear market trough to regain prior high.

xvii Source: FactSet, as of 07/10/2022. Bloomberg Global Aggregate Bond Index, total return, 04/01/2021 – 30/09/2022.

xviii Ibid. ICE BofA US Treasury Index, total return, 04/08/2020 – 30/09/2022, Bloomberg US Aggregate Government Long Treasury Index, total return, 09/03/2020 – 30/09/2022 and Bloomberg US Government Inflation-Linked 7-10 Year Index, total return, 08/03/2022 – 30/09/2022.

Many warn rates will keep rising, prompting an exodus. As Exhibit 4 shows, investors have pulled more money from bonds than equities this year. When equities charted new bear market lows at September's end, bond outflows again exceeded equity outflows as spiking yields triggered selling. If anything, investors are seemingly capitulating in bonds.

**EXHIBIT 4: WEEKLY FUND FLOWS YTD THROUGH SEPTEMBER'S END**




Source: FactSet, as of 07/10/2022. Weekly estimated total bond and total equity mutual fund and ETF net flows, 07/01/2022 – 30/09/2022, and S&P 500 and ICE BofA US Corporate & Government Index (7 – 10 year) weekly total return index levels, 31/12/2021 – 30/09/2022.

## GOLD

Gold, another popular safe haven, acted the part early this year, rallying 12.9% through early March. Yet it has plunged -18.0% since 8 March—trailing global equities' -10.4%.[xix] Its powers to hedge against fast inflation, geopolitical turmoil and equity volatility are myths.[xx]

## CASH

Inflation ensures a negative return on cash. The average deposit rate in the US is just 0.17%, while many high-yield savings accounts offer a little over 2.0%.[xxi] Some deem buying and holding short-term Treasury bills at around 3% attractive, but these rates are all negative after accounting for inflation. We doubt many flee equities (which could be negative, or not) for a surefire loss of purchasing power.

## CRYPTOCURRENCIES

Cryptocurrencies have fared worse than equities. Year-to-date, bitcoin—the most popular crypto—is down -58.0%.[xxii] From its 8 November 2021 record high, bitcoin has plunged -71.2%. Others are down similarly (or worse), undercutting the purported 21st century inflation hedge.

## REAL ESTATE

The S&P/Case Shiller Home Price National Index (up 15.8% y/y in July) is 66.5% higher than its prior peak in July 2006.[xxiii] Meanwhile, mortgage rates are denting demand, as the 30-year fixed rate hit 6.75% in the week ending 30 September its highest since 2006.[xxiv] This is hurting affordability and demand, with anecdotes of canceled purchases and homes languishing on the market—despite price cuts. That highlights another real estate risk: low liquidity. Once you are in, getting out isn't quick—and you aren't assured a "safe haven" price.

xix Ibid. Gold price return, 31/12/2021 – 08/03/2022.

xx Ibid. Gold price return and MSCI World Index returns with net dividend, 08/03/2022 – 30/09/2022.

xxi Source: FDIC and NerdWallet, as of 10/10/2022. Statement based on national deposit rates for savings accounts as of 19 September 2022 and "6 Best High-Yield Online Savings Accounts of October 2022," Margarette Burnette, *NerdWallet*, 03/10/2022.

xxii Source: CoinMarketCap.com, as of 06/10/2022. Bitcoin price, 31/12/2021 – 30/09/2022 and 08/11/2021 – 30/09/2022.

xxiii Source: FactSet, as of 07/10/2022. Home prices, Standard & Poor's Case Shiller US Composite National Index, 31/12/2005 – 31/07/2022.

xxiv "Mortgage Applications Decrease in Latest MBA Weekly Survey," Mortgage Bankers Association, 05/10/2022.

## THE CURRENCY EFFECT

Currency differentials have buffered many global investors from the bear market's brunt. When the dollar rises, investors outside of the US receive US equities' return plus the dollar's rise relative to their home currency. The MSCI World has a year-to-date return of -25.4% in USD, much worse than its return in euros (-13.4%), pounds (-9.5%) and yen (-6.3%).[xxv] Local returns tell a similar story. Eurozone equities are in a bear market in both euros and USD—yet the decline in euros is shallower (-22.3% to -33.1%).[xxvi] Several national indexes are merely in single-digit pullbacks or corrections in their home currency, including Britain, Australia, Japan and Canada. Investors in those nations may not even experience a bear market. Why would they panic sell?

**EXHIBIT 5: THE STRONG DOLLAR IS MAGNIFYING SOME COUNTRIES' DECLINES**

| | YTD Equity Returns (in Local Currency) | YTD Equity Returns (in USD) |
|---|---|---|
| UK | -6.6% | -23.0% |
| Australia | -7.4% | -18.1% |
| Japan | -7.5% | -26.4% |
| Canada | -11.8% | -18.9% |
| US | -23.9% | -23.9% |

Source: FactSet, as of 10/01/2022. S&P 500 total return and MSCI UK IMI, Australia, Japan and Canada index returns with net dividends in local currencies and USD, 12/31/2021 – 09/30/2022.

Some may argue that means there is far further to fall, but we think that is unlikely. Rather, it seems more like a symptom of this sentiment-driven, correction-like bear market fueled by an abundance of fears, including the strong dollar.

No historical parallel is perfect, but we find they are an excellent starting point for determining probabilities, and they demonstrate the possible. It is very possible this bear market ends like those in 1966 and 1982, which lacked broad capitulation. Today's political controversies and economic worries echo 1966's upheaval. High inflation, sky-high interest rates and ongoing recession talk dominated in 1982, which was also a midterm year. Yet those conditions didn't prevent a new bull market: Equities rose 319% through August 1987's peak.[xxvii] Some may argue that was because inflation—and rates—were heading lower. But that wasn't clear at the time—just as it isn't today.

# POWERFUL POSITIVES READY TO TAKE HOLD

Equities generally don't *need* major positive catalysts. Their long-run tendency is to grow alongside corporate earnings, with cycles turning when sentiment overshoots reality—either too positive at peaks or too negative at lows. That is *why* the pessimism of disbelief underpins new bull markets. It helps reality top expectations even if conditions aren't good. Yet, with that said, plenty of broadly unseen positives exist today, which should help support a rebound sooner than most anticipate.

## UNAPPRECIATED RESILIENCE IN MARGINS

Resilient profit margins are a prime example of underappreciated positives. Analysts acknowledge them but say inflation and the strong dollar will soon bite as businesses are exhausting ways to prevent the inevitable earnings crunch. However, they miss a simple point: Inflation and currency moves affect *revenues* and *costs*.

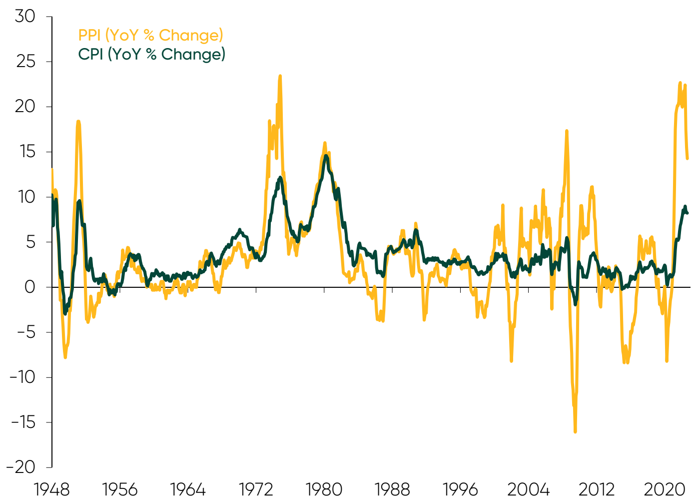
xxv Source: FactSet, as of 10/10/2022. MSCI World Index returns with net dividends in USD, euros, GBP and Japanese yen, 31/12/2021 – 30/09/2022.

xxvi Ibid. MSCI European Monetary Union Index returns with net dividends in euros and USD, 31/12/2021–30/09/2022.

xxvii Ibid. MSCI World Index price return, 12/08/1982 – 25/08/1987.

In inflationary periods, businesses raise prices as their costs rise. You can see this with the Bureau of Labor Statistics' producer price index (PPI), measuring input costs, and the consumer price index (CPI), representing the price of goods sold. They generally move concurrently, with PPI more extreme due to its heavier commodities exposure. That helps stabilise margins during inflationary periods, and it is one reason equities often overcome inflation. Consumer price hikes may not completely offset cost pressures, but they support profitability.

### EXHIBIT 6: CPI MOVES WITH PPI, HELPING PRESERVE PROFIT MARGINS

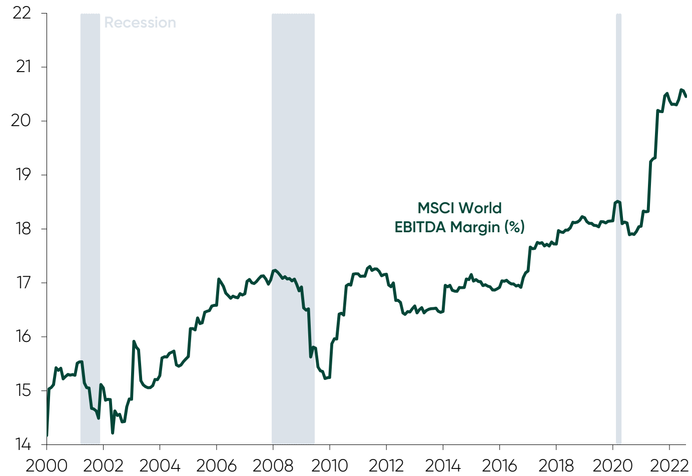



Source: Federal Reserve Bank of St. Louis, as of 13/10/2022. Consumer Price Index and Producer Price Index, January 1948 – September 2022.

As for currency, while the strong dollar reduces US firms' overseas revenues if they don't raise prices to compensate—which may hit sales volumes—it also reduces the costs of labour and components sourced abroad. That often cancels much of the effect on profits. Additionally, much of this is an accounting entry, as firms often don't repatriate profits. Rather, Generally Accepted Accounting Principles (GAAP) require businesses to convert all overseas profits at the going exchange rate, which can skew reported results, even if they don't convert those funds in reality. Thus many businesses report constant-currency earnings in addition to GAAP. These apply fixed exchange rates—removing currency fluctuations' impact—to better show whether actual activity has increased.

Even including currency effects, profit margins are fat—showing how well companies have been able to navigate this difficult stretch. Meanwhile, sales have risen to new highs.

### EXHIBIT 7: GLOBAL EQUITIES' PROFIT MARGINS NEAR RECORD HIGH




Source: FactSet, as of 04/10/2022. MSCI World trailing 12-month earnings before interest, taxes, depreciation and amortisation (EBITDA) as a percent of revenues, January 2000 – August 2022.

In the last three years, corporations have faced lockdowns, supply chain issues, inflation and currency swings. Yet their profit margins are close to record highs. If anyone can navigate challenging economic times, it is evidently global businesses. Owning equities means owning that adaptability.

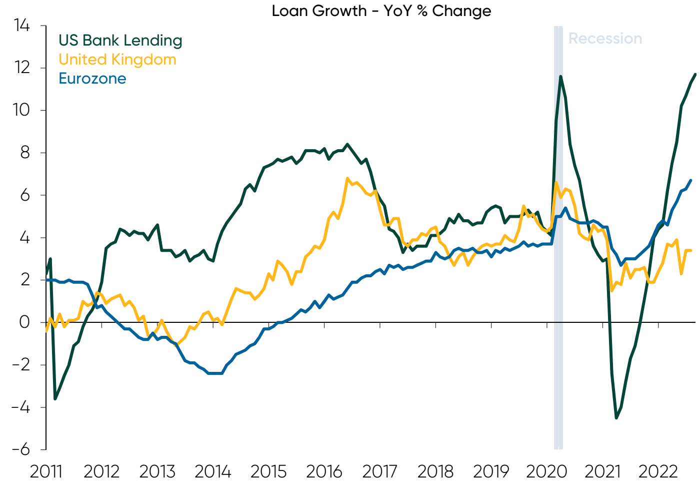
## ACCELERATING LOAN GROWTH GOES UNNOTICED

Another unappreciated positive: Rate hikes haven't crimped lending. While this doesn't predict equities' movement, it is exceptionally inconsistent with a deep recession, arguing against significant downside from here—and suggesting a fast rebound as investors realise the economy is holding up better than feared.

Lending underpins investment. While corporate bond issuance is down from 2021, US banks have added over $250 billion in new commercial and industrial loans, offsetting most of the bond shortfall.[xxviii] On top of nearly $4 trillion in cash reserves, companies have ample bandwidth to launch new projects—which they are.[xxix] S&P 500 capital expenditures are on pace to rise 20% y/y.[xxx] Total business investment jumped 7.9% annualised in Q1 and held steady in Q2.[xxxi] Core capital goods orders—a proxy for business investment in equipment—aren't inflation-adjusted, but they jumped throughout Q3.[xxxii]

The definition of recession has become increasingly politicised, and we aren't trying to make a political point. However, in a traditional recession, businesses must get lean to survive a credit drought, meaning they typically cut investment. We have the opposite today. Loan growth worldwide is abundant despite Fed and other major central bank rate hikes.

### EXHIBIT 8: US, UK AND EUROZONE LOAN GROWTH ACCELERATING




Source: Federal Reserve Bank of St. Louis, Bank of England and ECB, as of 04/10/2022. US loans and leases in bank credit, January 2011 – September 2022, UK sterling-denominated loans to non-financial private-sector borrowers and eurozone private sector loans adjusted for loan sales and securitisation, January 2011 – August 2022.

xxviii Source: Federal Reserve Bank of St. Louis, as of 04/10/2022. Commercial and Industrial Loans, 22/09/2021 – 21/09/2022.

xxix "Merger Announcements Slow as Corporate Cash Builds," Christine Short, FactSet, 09/08/2022.

xxx "Several S&P 500 Companies Step up Capital Spending Faster Than Share Buybacks," Vandana Singh, *Benzinga*, 04/08/2022.

xxxi Source: Bureau of Economic Analysis, as of 04/10/2022. Nonresidential fixed investment, Q2 2022.

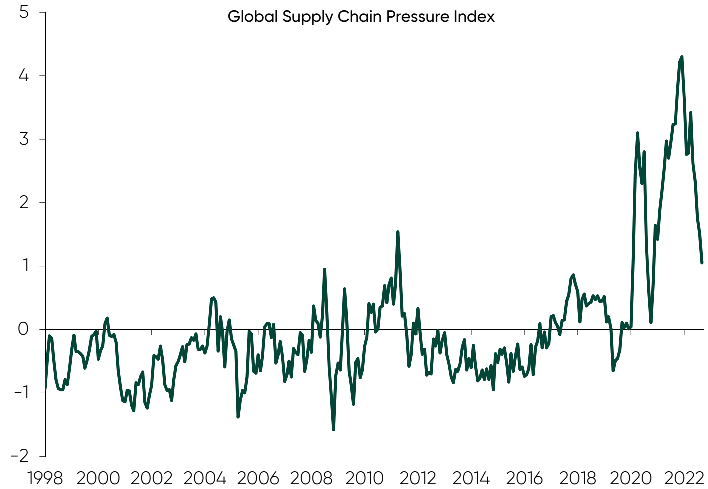
xxxii Source: Federal Reserve Bank of St. Louis, as of 04/10/2022.

Rate hikes don't seem likely to change this trend, although this could prolong inflation. When Milton Friedman wrote inflation stemmed from "too much money chasing the available supply of goods and services" in his October 1977 Newsweek column, 35% of M2 money supply (currency, bank reserves, checkable deposits, small time deposits, savings accounts and retail money market funds) was time deposits (e.g., CDs).[xxxiii] That rose to 48% in 1982. The yield curve spread was more important then, as it tied more of banks' funding costs to the fed-funds rate. Now 0.76% of M2 is in time deposits, 15.3% is in bank reserves (on which banks receive interest) and most of the rest is nearly interest-free.[xxxiv] Meanwhile, banks have more deposits than they know what to do with. Deposits exceeded loans by $6.2 trillion at September's end (up from around $250 billion in 2008).[xxxv] Bank rates on 2-year CDs and deposit accounts are far below 2-year Treasury and overnight rates, respectively—a good indication banks aren't trying to lure more deposits. So as long rates rise, banks lend even more profitably, with their cost of money still near zero.

## KEY GLOBAL SUPPLY BOTTLENECKS LOOSEN—TO LITTLE FANFARE

Meanwhile, supply chain pressures have eased considerably. Consider the New York Fed's Global Supply Chain Pressure Index (GSCPI), which compiles a range of shipping-related measures. While it remains above historical norms, it has significantly fallen this year. (Exhibit 9)

**EXHIBIT 9: GLOBAL SUPPLY CHAIN PRESSURES EASING**




Source: Federal Reserve Bank of New York, as of 10/04/2022. Global Supply Chain Pressure Index, January 1998 – August 2022.

The Baltic Dry Index, which measures shipping costs for bulk goods like coal and steel, is down by half since May and one-third below its October 2021 peak.[xxxvi] Ports are less congested, and booking most ships is easier (perhaps excluding liquefied natural gas tankers). Last year, it cost around $20,000 to ship a container from China to the US. Today, it is less than $4,000.[xxxvii]

Purchasing managers' indexes (PMIs)—which survey firms about business conditions, including supply chains—also show this. The Institute for Supply Management's (ISM) US manufacturing PMI subindex for supplier delivery times is at pre-2020 levels, down from multi-decade highs last year.[xxxviii] (Exhibit 10, next page) This has helped firms cut order backlogs from 2021's record highs.

xxxiii Source: Federal Reserve Bank of St. Louis, as of 04/10/2022. Small time deposits percent of M2, October 1977 – July 1982. "What Would Milton Friedman Say about the Recent Surge in Money Growth?" Peter N. Ireland, Mercatus Center, 02/05/2022.

xxxiv Source: Federal Reserve, as of 11/10/2022. Time deposits and bank reserves as percent of M2, August 2022.

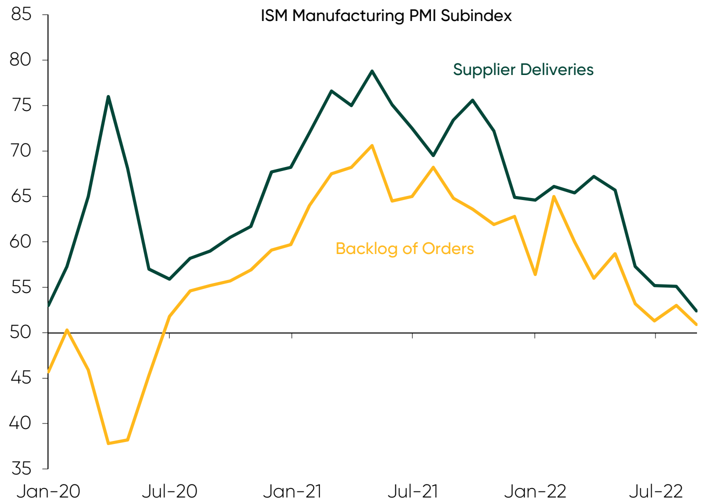
xxxv Source: Federal Reserve Bank of St. Louis, as of 04/10/2022. Deposits minus loans and leases in bank credit for all commercial banks, 31/12/2007 – 28/09/2022.

xxxvi Source: FactSet, as of 04/10/2022. Baltic Dry Index, 07/10/2021 – 30/09/2022.

xxxvii "How's the Container Ship Backlog at Southern California's Ports?" Kai Ryssdal and Maria Hollenhorst, *Marketplace*, 29/09/2022.

xxxviii Source: ISM, as of 04/10/2022.

**EXHIBIT 10: US SUPPLIER DELIVERY TIMES AND ORDER BACKLOGS FALLING**




Source: FactSet, as of 04/10/2022.

Much of the supply chain focus centres on the inflationary aspect, yet its decongestion is arguably even more positive from a business standpoint. Astronomical supplier delivery times prevent companies from completing orders, creating big backlogs. That stalls activity up and down the supply chain, which shows up in myriad economic statistics. Supply chain concerns also led businesses to amass inventories late in 2021, creating a big overhang they are now working off. That was the primary driver of Q2 GDP's contraction. As supply chain pressures ease, so should businesses' inventory management, resulting in less GDP skew.

# ASSESSING HEADLINE RISKS

As past Reviews discussed, we think sentiment is the dominant force hurting equities this year. On their own, we see no fundamental reason why inflation, rate hikes, the war in Ukraine and others would drive a full-fledged, big bear market. But together they sparked massive fear and took turns stoking uncertainty. As they fade, relief should help fuel the recovery we anticipate.

## WHAT WE MISSED IN PRICE PRESSURES AND HOW TO SEE THEM TODAY

First off, it is clear that we didn't anticipate the degree to which the interplay between a spike in money supply and lockdown-driven supply chain issues would exacerbate and prolong inflationary pressure. In early 2021, we acknowledged money supply's spike yet wrongly expected a muted inflationary impact as it mostly replaced lost income and spending. We also, in retrospect, overestimated the degree to which slowing money velocity (how often the money supply changes hands) would offset the rising quantity of money. We suspect common velocity measures, such as global M2 growth, failed to capture transactions in all instruments that could serve as money. We have further work to do on this and are reviewing it and other aspects of our decision making to improve our forecasts and positioning in the future.

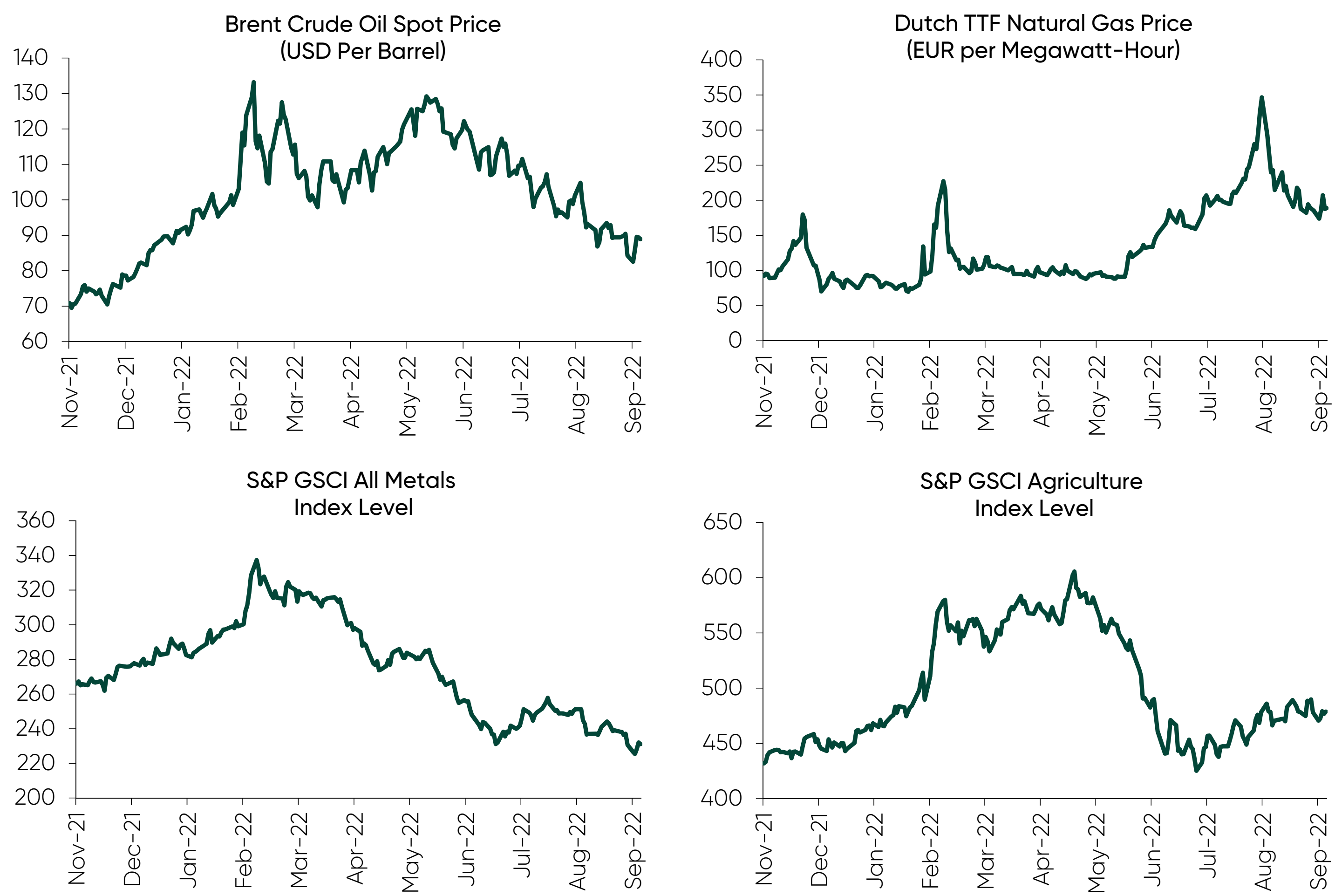
However, importantly: Even if we had seen inflation correctly, it is unlikely this alone would have led us to reposition portfolios for a down market. This was based largely on the fact that there is little evidence historically that inflation is problematic for equities. Companies can adapt to price pressures, passing on costs if needed. Actually, long-run inflation is one key reason investors likely need to get at least some equity-like growth. At the company level this year, our thesis has held. In our view, sentiment toward inflation, not inflation itself, contributed to equities' bear market.

While inflation is painful, equities don't represent households or economies at large. They are a share in publicly traded companies' earnings, and profit margins are resilient. The very inflation people dread, points to resilient margins as it means businesses can offset their rising costs. This is the little-understood reason why equities have historically hedged against inflation over long periods.

More immediately, whatever you think drove fast-rising prices, there are increasing signs of improvement. Supply chain pressures are easing. Commodity prices, which spiked as Russia invaded Ukraine, are settling and are generally down—likely a leading indicator of inflation, as they are an input cost to finished goods. Early 2022's supply fears stretched from oil and natural gas to cooking oil, grain, metals, fertiliser and anything using oil or natural gas as feedstock. (Exhibit 11) Russia is a large oil and gas producer, and the region has a heavy presence in grains, oilseeds, potash, iron ore, nickel, palladium and other industrial metals. Fears of the war interrupting production and shipping caused prices to skyrocket. But as we wrote in Q1, sanctions and fighting haven't disrupted global supply anywhere near as much as feared. Hence, prices have eased. The effect will eventually feed through to food and energy prices and every product using commodities as building blocks.

In effect, the dislocations from COVID-19 and the war in Ukraine, whether supply chain disruptions or central banks letting loose, have taken more time than we anticipated. However, before too long signs of improving prices suggest the pressure is beginning to ease.

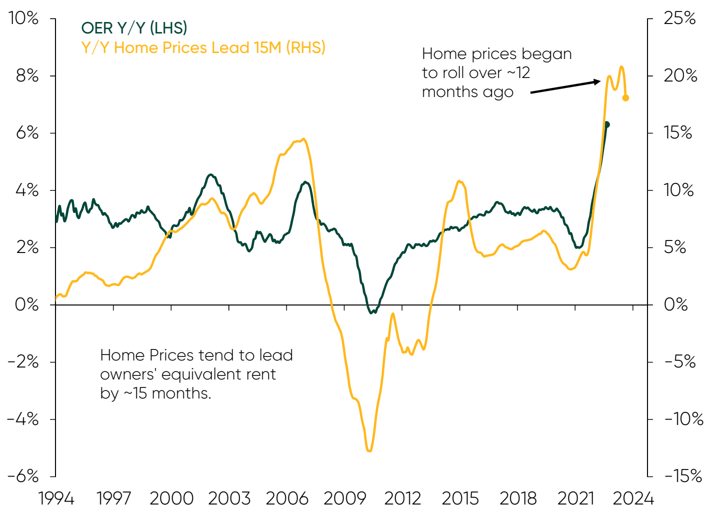
**EXHIBIT 11: COMMODITY PRICES ARE EASING**




Source: FactSet, as of 12/10/2022. Brent crude oil spot price, Dutch TTF natural gas futures price, S&P GSCI Index – All Metals and S&P GSCI Index – Agriculture, 30/11/2021 – 30/09/2022.

CPI's other big driver is rent—rent of primary residences and owners' equivalent rent (OER), a hypothetical measure of what someone would pay to rent their own home. It isn't a cost anyone pays, but rather a way to bring real estate values into CPI. Setting aside questions over the wisdom of including OER, given most US homeowners' ownership costs don't rise in sync with it, OER represents nearly 25% of CPI. It and primary rent combine for nearly one-third of the index, giving them outsized influence. Encouragingly, there are indications rents should ease. As Exhibit 12 shows, OER tends to lag home prices by about 15 months, and US home prices began levelling off about a year ago. That points to OER easing over the period ahead.

**EXHIBIT 12: FALLING HOME PRICES POINT TO SLOWER RENT INCREASES**



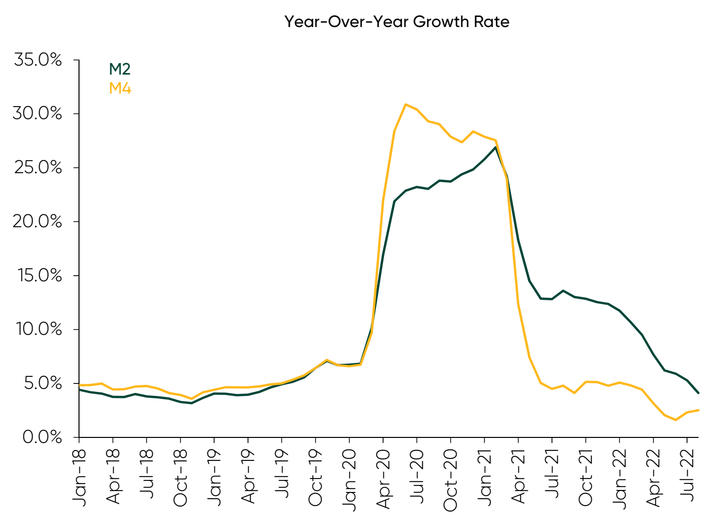

Source: FactSet, as of 30/09/2022. S&P/Case-Shiller US National Home Price Index and CPI-U Owners' Equivalent Rent of Primary Residence, year-over-year percent change, September 1992 – July 2022. Home price series is pulled 15 months ahead for illustrative purposes.

## MONEY SUPPLY

Traditional money supply measures also point to slowing inflation. Whether you prefer M2 (which includes currency, reserve balances, bank deposits and money market funds outside of qualified retirement accounts) or the broader M4, which adds liquid short-term securities that could function as money, supply growth has stalled. (Exhibit 13)

This is hard to square with robust loan growth. In the fractional reserve banking system, banks create most new money through lending, leading loan and money supply growth to move in tandem usually. For the past year, though, lending has accelerated while money supply growth fell. This stems largely from the monetary base's double-digit fall over the past year, leading us to wonder: Is money supply's disinflationary fall a more powerful force than inflationary loan growth? That is a factor to watch and one the Fed would also do well to consider.

**EXHIBIT 13: MONEY SUPPLY GROWTH HAS STALLED**

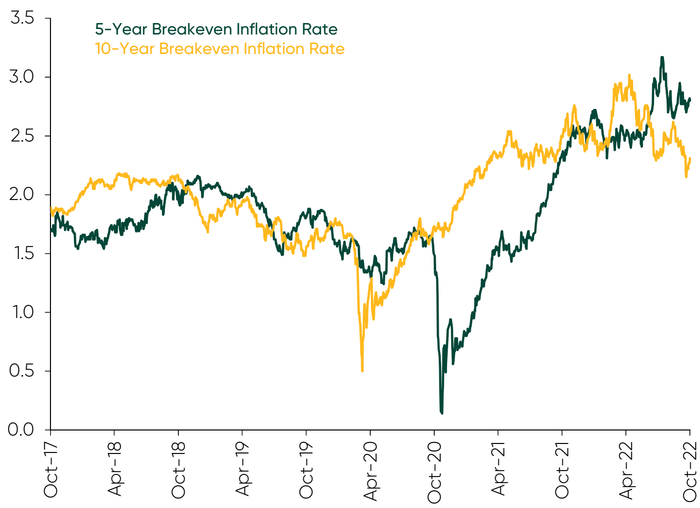



Source: FactSet, as of 30/09/2022. S&P/Case-Shiller US National Home Price Index and CPI-U Owners' Equivalent Rent of Primary Residence, year-over-year percent change, September 1992 – July 2022. Home price series is pulled 15 months ahead for illustrative purposes.

## INFLATION EXPECTATIONS

Market-based indicators also point to slower inflation from here. The 10-year breakeven inflation rate—calculated from 10-year Treasury and Treasury Inflation-Protected Securities (TIPS) yields—is now about 2%, down from about 3% in the spring and in line with historical norms. This implies investors expect inflation to average about 2% over the next decade. That isn't solely because they expect far-future improvement: The 5-year breakeven rate has moved similarly, pulling back from its recent high. (Exhibit 14) The market seems to be saying that, despite long-term stagflation forecasts, normalisation is more likely.

**EXHIBIT 14: 5- AND 10-YEAR BREAKEVEN INFLATION RATES**




Source: FactSet, 12/10/2022. 5-Year and 10-Year Breakeven Inflation Rates, 11/10/2017 – 11/10/2022.

## BUT WHAT ABOUT THE FED?

Many argue inflation isn't the real problem, but that it will trigger continued rate hikes, bringing doom. The US Fed has raised its fed-funds target range by 3 percentage points between March and September, from 0.0 – 0.25% to 3.0 – 3.25%. Now, market-based indicators and the Fed's forecasts see the fed-funds rate topping 4.5% next year. Some argue rates will go even higher, spurring a US recession.

Much of this stems from the Fed's "dot plot" forecasts, which show where each member projects the fed-funds target range's midpoint in each of the next three years. 2023's median forecast is 4.6%, implying a 1.5 percentage point rise in the target range (to 4.5 – 4.75%). We wouldn't read into it. Just last December, the Fed wasn't forecasting anywhere near 3 percentage points of hikes this year. Fed officials always react to incoming data and reports and many of these inputs are opaque. How Fed people react to them, informed by their biases, is even more so. The Fed rarely knows in advance what it will do while assuring everyone it does. Yet everyone seems to consider many more hikes inevitable. That is bullish, creating ample room for positive surprise.

We think the notion of Fed rate hikes causing a huge recession is a stretch. There is no evidence a particular fed-funds rate level has a particular impact on lending, economic growth or inflation. Almost 25 years ago, Milton Friedman observed: "After the US experience during the Great Depression, and after inflation and rising interest rates in the 1970s and disinflation and falling interest rates in the 1980s, I thought the fallacy of identifying tight money with high interest rates and easy money with low interest rates was dead. Apparently, old fallacies never die."[xxxix] Rates drop when money has been tight, as Japan has long showed, and rise when money has been too easy, as the US demonstrated in the 1970s. Simply, as Friedman also explained, when money supply growth accelerates, it initially reduces short-term rates—higher supply of any good, including money, lowers the price. But then rates rise as economic revival drives demand for even more money.

xxxix "Reviving Japan," Milton Friedman, Hoover Institution, 30/04/1998.

As they do, the effect is minimal—as economist Deirdre McCloskey once pointed out, "a little person in a large market cannot move the price very much."[xl] As McCloskey went on to show, the Fed controls the US monetary base only, which presently is just under \$5.6 trillion.[xli] According to the Fed, total US wealth is about \$130.8 trillion.[xlii] Credit Suisse's *Global Wealth Report* estimates the world's total at \$463.6 trillion at last year's end.[xliii] The notion that the Fed, controlling just over 1% of global wealth directly, dictates global liquidity is nonsensical.

Also, money crosses most borders cheaply and easily. Any big bank can borrow in one country, hedge for currency risk and lend overseas near-instantly. Businesses can act similarly, getting financing in Country X for projects in Country Y. The strong US dollar indicates this is happening now, keeping the liquidity spigots flowing regardless of Fed "tightening." When the Fed raises rates, money pours in from overseas, boosting liquidity here and countering the Fed's aims.

The Fed simply can't crush lending with its current tool kit. The fed-funds rate influences only the rate banks pay to borrow from one another. With reserve balances so high, the only reason it even "works" in that regard is that the Fed also pays interest on bank reserves, establishing a floor under interbank lending rates. Even then, interbank lending is just one funding source and not a big one these days, thanks to sky-high deposits. That limits the yield curve's influence on bank lending, especially since the Fed scrapped reserve requirements in 2020.

Meanwhile, rising long rates make lending more profitable, encouraging more of it. Absent reserve requirements, there is little to slow or stop lending, so long as demand exists.

Don't underestimate demand, even at higher rates. The Fed's projected 4.6% fed-funds rate isn't anywhere near former Fed Chair Paul Volcker era's double-digits. It doesn't translate to a sky-high prime lending rate. Consider the business perspective: If the difference between today's 3.25% and 4.6% is going to stop a long-term project, then the project probably shouldn't go forward at all. It has no safety margin.

If the Fed can't stop loan growth, it can't stop economic growth. But that also means it can't stop inflation, which is where we see some potential eventual risks. While we think inflation is likely to ease, if loan growth proves more powerful than the shrinking monetary base, it will be inflationary. That could make inflation stickier than we and markets anticipate. If this trend continues and the Fed realises its approach isn't working, it could make a radical move like increasing reserve requirements and freezing credit. However, this isn't an immediate or likely risk. But we are watching for the potential that failure to control inflation through interest rates leads the Fed to more extreme measures.

xl "Other Things Equal: Alan Greenspan Doesn't Influence Interest Rates," Deirdre McCloskey, *Eastern Economic Journal*, 2000, Vol. 26, Issue 1, 99 – 101.

xli Source: Federal Reserve Bank of St. Louis, as of 05/10/2022.

xlii "Financial Accounts of the United States," Federal Reserve, 09/09/2022.

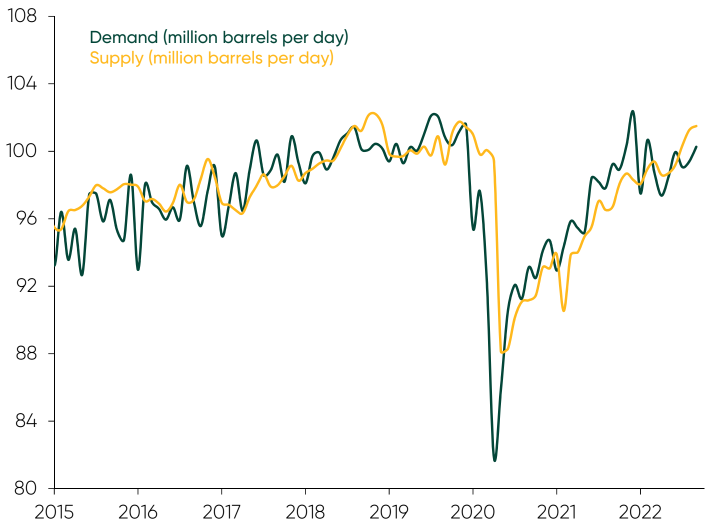
xliii Source: "Global Wealth Report 2022," Credit Suisse, as of 04/10/022.

## FEAR OF SANCTIONS-DRIVEN SHORTAGES IS FADING

Outside European energy, fear of the war's economic dislocations seems to be easing. People are gradually fathoming what we shared in our Q1 Review: Sanctions have little effect.

Sanctions' failure is disappointing from a geopolitical standpoint, but it is an economic benefit—preventing the widely feared supply shortages and helping commodity prices ease. It also shouldn't surprise. Commodity markets are global and not all nations participate in sanctions. Many big players, including India and China, opted out. As a result, supply lines changed, but overall supply didn't fall much. Russia sold more oil to China and India, which refined and re-exported it. Europe bought more from the Middle East, Northern Africa and the US—which shipped less to Asia as Russia ramped up supply to the region. Therefore, even with OPEC blustering about production cuts, global oil supply is up and exceeds consumption.

**EXHIBIT 15: GLOBAL OIL SUPPLY EXCEEDS DEMAND**




Source: FactSet, as of 03/10/2022. Monthly global oil supply and demand, January 2015 – September 2022.

# UNITED STATES **COMMENTARY**

## FATHOMING THE UNFATHOMABLE 'MIDTERM MIRACLE'

*Our political commentary is intentionally non-partisan. We favour no politician nor any party, assessing developments solely for potential market impact.*

8 November brings a remarkably bullish event poised to propel equities through at least 2023's first half: US midterm elections. Today they are a contentious debate. But soon they will likely deliver a divided government incapable of passing divisive legislation—a backdrop equities love. This normally propels big returns through the following year's first half. This year's election should follow the trend, with the Republicans poised to take the House of Representatives—*possibly* the Senate, too.

### THE BACKDROP

Tension is running high, as Democrat-leaning investors fear losing Congress but hope to keep majorities through voter mobilisation and leveraging contentious Supreme Court decisions, like overturning *Roe v. Wade*. Republican-leaning investors—in our experience, around two-thirds of US high-net-worth investors—hope the trend of presidents' parties losing seats in mid-terms holds, dividing government and delivering gridlock. But they fear the rare upset where the Democrats keep Congress, a worry enhanced by Department of Justice investigations of former President Donald Trump. This backdrop, plus hot campaign rhetoric—enhanced by redistricting that pushed many centrist seats toward extremes—has, in our view, contributed a bit to this year's negativity.

While midterm-year bear markets aren't normal, weak returns in the run-up to midterms are. The tense political environment roils sentiment. Since 1925, equities averaged 1.0%, -0.3% and 0.6%, respectively, in the three quarters before the midterm election. They rose just 48%, 56% and 60% of the time. (Exhibit 16)

However, in the 4th quarter that story flips. Midterm Q4s average 6.3%, rising 83.3% of the time. The positivity extends into the following Q1 and Q2, which average 6.6% and 5.5%, respectively, while equities have risen in 87.5% of each. Altogether, the nine-month period starting in midterm years' fourth quarters through the following June—the Midterm Miracle Window—is history's *best-returning*, averaging 19.6% gains, and *most-persistently* positive, up 91.7% of the time.[xliv]

In our view, this isn't coincidental. Equities prefer neither party. They like gridlock, which blocks extreme legislation that potentially complicates business planning and investment. Big legislation regularly create winners and losers, and behavioral finance teaches that losers hate the pain of loss over twice as much as winners appreciate equivalent gains. Gridlock, especially along party lines, blocks such legislation.

## WHAT ABOUT THIS YEAR?

Some question whether US midterms will really increase gridlock. Many argue the GOP is fading due to weak candidates while Supreme Court decisions and recently enacted legislation boost Democrats. Perhaps, and political risk would rise if it held true.

**EXHIBIT 16: MIDTERM MAGIC BY QUARTER**

| Midterm Year | Midterm Q1 | Midterm Q2 | Midterm Q3 | Midterm Q4 | Subsequent Q1 | Subsequent Q2 | Subsequent Q3 | Subsequent Q4 |
|---|---|---|---|---|---|---|---|---|
| 1926 | -9.1% | 8.9% | 10.1% | 2.0% | 4.6% | 7.3% | 16.1% | 5.2% |
| 1930 | 18.4% | -17.8% | -8.2% | -16.4% | 10.2% | -9.9% | -33.6% | -14.8% |
| 1934 | 7.4% | -8.0% | -6.2% | 5.4% | -9.9% | 22.1% | 14.4% | 17.0% |
| 1938 | -17.8% | 38.5% | 7.3% | 9.0% | -16.0% | 0.0% | 21.4% | -2.9% |
| 1942 | -5.9% | 5.8% | 8.5% | 12.1% | 20.1% | 8.0% | -0.9% | -2.1% |
| 1946 | 5.1% | 2.9% | -18.0% | 3.5% | 0.3% | 1.5% | 0.5% | 2.7% |
| 1950 | 4.9% | 4.0% | 11.9% | 6.9% | 6.7% | -0.3% | 12.8% | 3.8% |
| 1954 | 10.1% | 9.8% | 11.9% | 12.6% | 2.8% | 13.3% | 7.5% | 5.1% |
| 1958 | 6.4% | 8.5% | 11.6% | 11.2% | 1.2% | 6.3% | -2.0% | 6.1% |
| 1962 | -2.1% | -20.6% | 3.7% | 13.1% | 6.4% | 5.0% | 4.2% | 5.4% |
| 1966 | -2.7% | -4.3% | -8.8% | 5.9% | 13.2% | 1.3% | 7.5% | 0.5% |
| 1970 | -1.8% | -18.0% | 17.1% | 10.3% | 9.7% | 0.2% | -0.6% | 4.6% |
| 1974 | -2.8% | -7.6% | -25.2% | 9.3% | 23.0% | 15.4% | -10.9% | 8.6% |
| 1978 | -4.9% | 8.5% | 8.7% | -5.0% | 7.1% | 2.6% | 7.6% | 0.1% |
| 1982 | -7.3% | -0.6% | 11.5% | 18.3% | 10.0% | 11.1% | -0.2% | 0.4% |
| 1986 | 14.1% | 5.9% | -7.0% | 5.6% | 21.3% | 5.0% | 6.6% | -22.5% |
| 1990 | -3.0% | 6.3% | -13.7% | 9.0% | 14.5% | -0.2% | 5.3% | 8.4% |
| 1994 | -3.8% | 0.4% | 4.9% | 0.0% | 9.7% | 9.5% | 7.9% | 6.0% |
| 1998 | 13.9% | 3.3% | -9.9% | 21.3% | 5.0% | 7.0% | -6.2% | 14.9% |
| 2002 | 0.3% | -13.4% | -17.3% | 8.4% | -3.1% | 15.4% | 2.6% | 12.2% |
| 2006 | 4.2% | -1.4% | 5.7% | 6.7% | 0.6% | 6.3% | 2.0% | -3.3% |
| 2010 | 5.4% | -11.4% | 11.3% | 10.8% | 5.9% | 0.1% | -13.9% | 11.8% |
| 2014 | 1.8% | 5.2% | 1.1% | 4.9% | 1.0% | 0.3% | -6.4% | 7.0% |
| 2018 | -0.8% | 3.4% | 7.7% | -13.5% | 13.6% | 4.3% | 1.7% | 9.1% |
| 2022 | -4.6% | -16.1% | -4.9% | | | | | |
| Average Return | **1.0%** | **-0.3%** | **0.6%** | **6.3%** | **6.6%** | **5.5%** | **1.8%** | **3.5%** |
| Average Positive | **7.7%** | **8.0%** | **8.9%** | **9.3%** | **8.9%** | **6.8%** | **7.9%** | **6.8%** |
| Average Negative | **-5.1%** | **-10.8%** | **-11.9%** | **-8.7%** | **-9.7%** | **-3.5%** | **-8.3%** | **-9.1%** |
| % Positive | **48.0%** | **56.0%** | **60.0%** | **83.3%** | **87.5%** | **87.5%** | **62.5%** | **79.2%** |

Source: Global Financial Data, Inc., and FactSet, as of 07/10/2022. S&P 500 total return, Q1 1926 – Q3 2022.

xliv Source: Global Financial Data, Inc., as of 07/10/2022.

However, *possible* doesn't mean *likely*. House redistricting still favours the GOP, as does incumbency. Incumbents usually have an advantage in the House. But, in races considered competitive, 19 currently Democratic seats have no incumbent seeking re-election versus 7 for the GOP.[xlv] There is also a robust history of the president's party losing seats at midterms. It is critical to remember how slim the Democratic Party's House majority is. This Congress began with the Democrats nursing a historically small 10-seat edge.[xlvi] September resignations reduced that to eight. On average, the president's party loses 27 seats at midterms. Presidents with below-average approval—like President Biden today—average 38 seats lost in postwar midterms.[xlvii]

Republicans likely won't achieve that, much less 1994 and 2010-level landslides, but not because voters soured on them. Republicans picked the low-hanging fruit in 2020 and at special elections, hence Democrats' tiny majority. We still think they will take enough seats to flip control, though. This alone would deliver traditional gridlock.

## THE SENATE COULD FLIP, BUT IT IS LESS LIKELY

To flip the Senate, Republicans must gain just one net seat. Perhaps this seems easier than the House, but structure and incumbency favour the Democrats retaining control.

Of this year's 35 Senate races, only at most 10 seem to be realistic targets to flip (Arizona, Colorado, Florida, Georgia, Nevada, New Hampshire, North Carolina, Ohio, Pennsylvania and Wisconsin).[xlviii] Three of the GOP's five are open—no incumbent is seeking re-election. Meanwhile, all five Democratic seats have incumbents seeking re-election. That is a Democratic edge, considering Republicans must play near-perfect defence to have a realistic pathway to Senate control.

As of this writing, polls slightly favour the Democrats retaining the Senate, too, but with an asterisk. Republicans have outperformed final polls repeatedly in recent cycles, by an average of over four percentage points or more. There is a well-known trend of Republican voters either refusing to talk to pollsters or saying they are undecided, only to vote GOP in November.

Current polling renders this feasible. Exhibit 17 shows the latest poll averages from *RealClearPolitics* in the 10 close races, broken down by which party currently holds the seat. They show zero net seats changing, with Pennsylvania and Nevada swapping parties. However, factoring in Republicans' outperformance of final polls in recent years, and Pennsylvania seems less likely to flip while Georgia and Arizona seem more winnable. If the Republicans can win the five seats polls show them leading in Exhibit 17, pulling out any of those three implies Senate control shifting.

**EXHIBIT 17: THE 10 SENATE SEATS TO WATCH**

| Current Republican Seats | Poll Leader (Party) | Poll Margin |
|---|---|---|
| Florida | Rubio (Rep.) | 4.7 |
| North Carolina (Open) | Budd (Rep.) | 2.5 |
| Ohio (Open) | Vance (Rep.) | 2.0 |
| Pennsylvania (Open) | Fetterman (Dem.) | 3.4 |
| Wisconsin | Johnson (Rep.) | 2.8 |

| Current Democratic Seats | Poll Leader (Party) | Poll Margin |
|---|---|---|
| Arizona | Kelly (Dem.) | 4.5 |
| Colorado | Bennet (Dem.) | 7.7 |
| Georgia | Warnock (Dem.) | 3.0 |
| Nevada | Laxalt (Rep.) | 1.7 |
| New Hampshire | Hassan (Dem.) | 5.8 |

Source: The Cook Political Report and Real Clear Politics, as of 10/10/2022.

xlv Source: Cook Political Report, as of 14/10/2022.

xlvi Source: US House of Representatives History, Art & Archives, as of 07/10/2022.

xlvii Source: Gallup and US House of Representatives History, Art & Archives, as of 07/10/2022. Approval ratings as of September in midterm years.

xlviii Statement based on data from The Cook Political Report. Total seats rated either "Lean" or "Toss Up."

## GRIDLOCK'S IMPACT

If the House trend holds as we think likely, Senate results are less important—but either would bring traditional gridlock. We think its bullish impact could be impactful this year.

After November 2020's election, we argued the narrowly divided House and Senate would water down legislation and complicate President Biden's agenda. While that happened, some large contentious bills still passed, weighing on sentiment.

Hardcore gridlock doesn't mean nothing passes. Rather, it means what does pass is generally not very controversial, since bipartisan agreement must be strong. Such legislation is less likely to create winners and losers sufficient to have the losers hating it more than the winners like it. Hence, political risk aversion plummets—the midterm miracle.

## THE 1966 PARALLEL

Many claim we are in a new and unprecedented period more frightful and polarised than the past. But consider 1966. Not only did that bear market end without capitulation, the US political environment was also highly polarised. The Civil Rights Movement is one obvious example, with the issue still hotly debated following landmark 1964 legislation and 1965's Watts riots. The Vietnam War—and protests against it—was also ramping up. The House Un-American Activities Committee investigated US citizens' political leanings and speech, helping foster the Free Speech and Civil Liberties movements. The Women's Rights movement also pressed inclusion in employment law protecting equal access to education and jobs.

This tumult hurt President Lyndon Johnson's popularity. President Johnson was extremely popular upon taking office—a surge of affection following JFK's assassination. But by late-September 1966, President Johnson's approval rating was well below average.[xlix] His Democratic Party lost 47 seats at that year's midterms.[l] While their edge remained significant at 248 – 187, many were conservative "Dixiecrats" from southern states that often voted with Republicans. Seventeen months later, President Johnson chose not seek re-election after nearly losing the New Hampshire primary.

Meanwhile, a shallow, recession-less bear market ran on and ended without capitulation. While identifying capitulation is more art than science, the 9 February – 7 October bear market lacked many of the common signals. Capitulation generally manifests in sharply declining headline indexes, a high percentage of equities at 52-week lows and big equity outflows. Furthermore, liquidity issues are common, as seen by large intraday swings and a sudden spike in volume after a relatively low-volume stretch. The eight-month 1966 downturn featured none of these, and it was very shallow (-22.2%).[li]

xlix Source: Gallup, as of 07/10/2022.

l Source: US House of Representatives History, Art & Archives, as of 07/10/2022.

li Source: FactSet, as of 12/10/2022. S&P 500 Price Index, 09/02/1966 – 07/10/1966.

Then like now, inflation was a key concern for many, including the Fed, which used an array of tools to tighten policy sharply. It hiked the fed-funds rate by half, from 4% in November 1965 to 6% by October 1966.[lii] To cool loan and money supply growth, it increased reserve requirements by the same margin—a powerful move the current Fed has done nothing like, considering it abandoned reserve requirements in 2020 and hasn't reinstated them.[liii] On 4 October 1966—three days before a new bull market began—the Fed met and reaffirmed that it would maintain tight policy "with a view to maintaining firm but orderly conditions in the money market."[liv] You read that right—a new bull market began *before* the Fed stopped tightening and reversed course, a point those seeing easing as prerequisite to a market recovery today should consider.

Economically, US GDP slowed from Q1 1966's 10.1% annualised to 1.4% in Q2, 3.4% in Q3 and 3.3% in Q4.[lv] Recession fears abounded, with Republican frontrunner Richard Nixon touting the threat, telling reporters in May 1966, "I believe we are headed for a recession with inflationary trends to continue after the recession begins."[lvi] The 10-year minus 3-month Treasury yield curve inverted twice—first in January, but only by a few basis points for about a week.[lvii] Then, more significantly, in November—again *after* the bear market concluded. Additionally, the Conference Board's Leading Economic Index entered a multi-month downtrend in May 1966. Indexes measuring construction activity fell as mortgage rates rose.[lviii] By September, over a third of economists said recession was likely but argued inflation was a more pressing concern.[lix] Outside of the US, the Organization of Economic Cooperation and Development said there was a recession in West Germany, France and the UK. Meanwhile, Johnson administration officials said inflation would ease in 1967 with recession averted. The issue of recession was seemingly politicised, with data supporting some worries and refuting others.

Today's environment shares many similarities with this time period. Many forces on one side want to see recession and inflation because it would likely help Republicans in midterms. The Democrats argue just the opposite. You get one sense of reality from MSNBC, another from Fox and the two can't be reconciled. Mixed economic data feeds both narratives, but this rhetoric should calm somewhat after the election.

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lii Source: Global Financial Data, Inc., as of 19/10/2022.

liii "Federal Reserve Annual Report—Digest of Principal Federal Reserve Policy Actions in 1966," Board of Governors, *US Federal Reserve*, 19/04/1967.

liv "Meeting Minutes," Staff, *US Federal Reserve*, 04/10/1966.

lv Source: US Bureau of Economic Analysis, as of 10/10/2022.

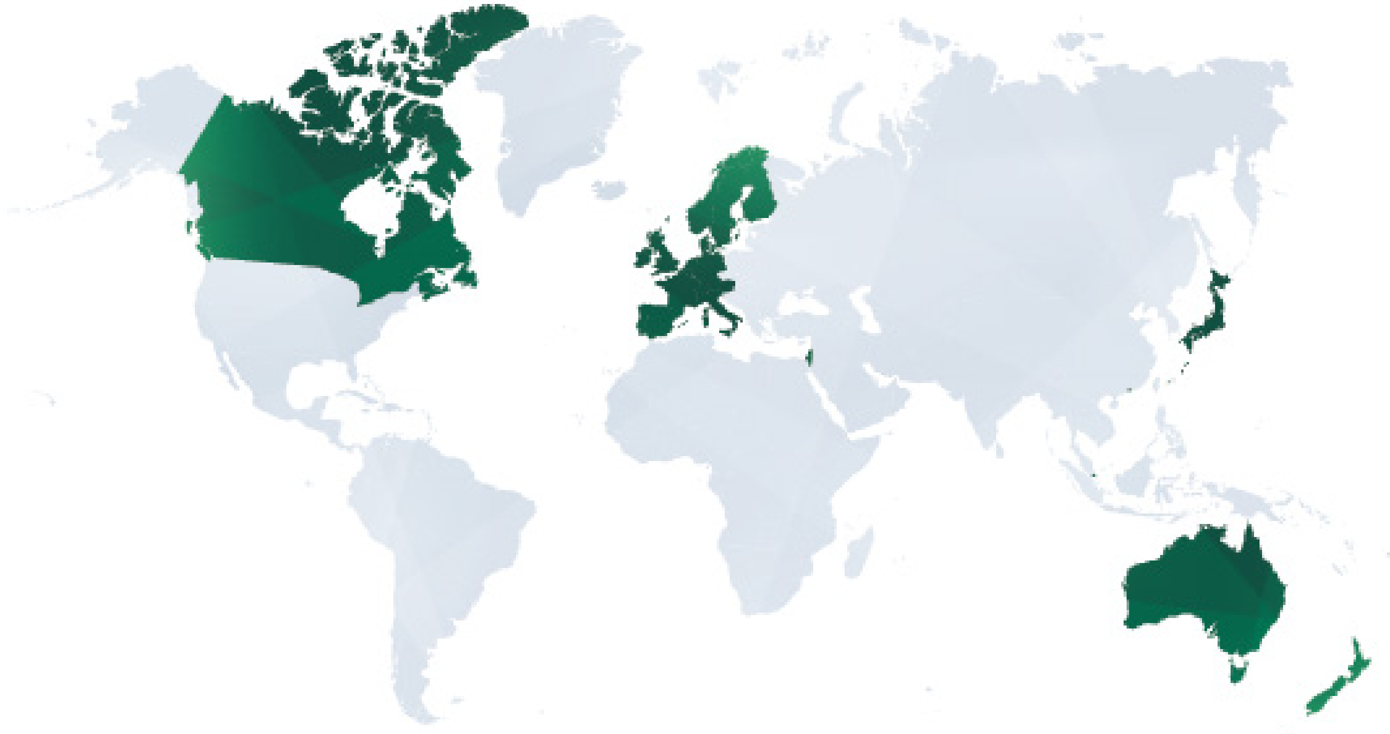
lvi "A Recession in '67 Foreseen by Nixon," Staff, *The Associated Press*, 15/05/1966. Accessed via *The New York Times* archive.

lvii Source: FactSet, as of 11/01/2022. 10-year minus 3-month Treasury constant maturity yields, 31/12/1964 – 31/12/1966.

lviii "Index at '66 Low in Construction," William Robbins, *The New York Times*, 29/09/1966.

lix "Third of Business Economists in Poll Sight Recession in 1967," Eileen Shanahan, *The New York Times*, 29/09/1966.

# GLOBAL DEVELOPED EX-US COMMENTARY



## GLOBAL POLITICS

Globally, politics should also contribute to falling uncertainty, with several widely watched developments concluding in Q3, bringing greater clarity in Q4.

## THE UK

Political turnover loomed over UK markets throughout Q3 and October, at times triggering sharp volatility in equity and bond markets. Volatility has seemingly settled for now, following the appointment of the third prime minister in less than two months, but pundits warn that it is a short reprieve as concerns about public debt—and the potential for sharp austerity—mount. In our view, this stance reads too much into the recent market movement and ignores the simple reality that UK politics is likely settling into gridlock for the foreseeable future, helping uncertainty continue to fall.

After a series of scandals brought down Prime Minister Boris Johnson, the Conservative Party's first leadership contest came down to a summertime race between former Chancellor of the Exchequer Rishi Sunak and former Foreign Secretary Liz Truss. Sunak was Tory Members of Parliaments' (MPs') preferred candidate, but grassroots party members overwhelmingly favoured Truss. She won the top spot in early September, becoming party leader and prime minister.

PM Truss largely campaigned on tax cuts and deregulation, channelling the late Margaret Thatcher in an effort to outflank Sunak on the right. When she won, pundits' general reaction was fear of wild measures putting Britain on an unsustainable path—fears based more on political biases than an objective policy analysis, in our view. This came to a head in late September and early October, when the blowback to PM Truss and then-Chancellor of the Exchequer Kwasi Kwarteng's "Growth Plan," popularly known as their "mini-budget," sparked big financial and political blowback.

The fiscal package, which aimed at helping households and businesses through what the press had long called a "cost of living crisis," consisted of household and business energy cost relief spending, plus small tax changes and some deregulation. Tax moves included:

- **The reversal of a 1.25 percentage point increase to tax that funds the National Health Service**
- **An increase in the home purchase price at which stamp duty will apply**
- **A 1 percentage point cut to the basic rate of income tax**
- **The abolition of the 45% income tax rate for incomes over £150,000 (leaving the top rate at 40% for incomes of £100,000 and higher)**
- **The cancelation of a planned dividend tax increase**
- **Reforms to the tax system for self-employed people**
- **The cancelation of the rise in corporation tax (from 19% to 25%) scheduled to take effect next April**

Headlines globally derided these as "unfunded tax cuts," warning they would spike the deficit and drive government debt far higher just when the BoE is reducing its Gilt portfolio. The implication: Only the BoE is financing government debt right now, and if borrowing soars while the BoE isn't buying, debt will become unsustainable.

We found that argument overwrought. The tax changes amounted to a partial offset of the stealth tax hike that has hit UK households since Sunak froze tax rate thresholds through 2026 while serving as Chancellor under Johnson. Typically, the thresholds rise with inflation, preventing households from having more income exposed to the higher rate simply because inflation raised their pay. Now they are stuck at 2021 levels even as inflation has lifted wages higher, subjecting more pay to higher rates—at a time when real incomes have fallen (since average pay hasn't kept pace with consumer price inflation). Lowering the basic rate by one percentage point would have been a partial compensation for these burdened households, while cancelling the corporation tax rise could have given businesses somewhat more flexibility to raise wages and salaries without hurting after-tax profit margins or forcing them to pass costs on to customers.

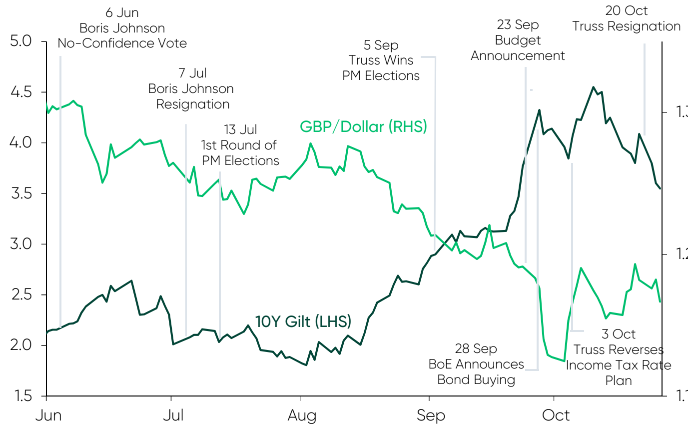
In our view, these measures amounted to small moves that likely wouldn't have spurred much growth or inflation. In other words, we think both the government and headlines overplayed their potential impact for good or ill. We think they amounted to partial relief. But pundits hyped fears over total levels of debt or the debt-to-GDP ratio rather than the simple question of whether the Treasury can easily service a modestly higher debt load. The reality is that, with nominal GDP growing rapidly thanks to this year's inflation, Britain's tax take is up while debt-to-GDP is falling, and interest payments were just 12.1% of total revenue in the most recent fiscal year.[lx] The estimated £72 billion in new borrowing to fund the plan was super unlikely to break the Treasury's back.

However, the narrative of imprudence stuck, and markets reacted sharply. 10-year UK Gilt yields jumped from 3.13% on 19 September to 4.32% on 27 September (Exhibit 18, next page), with the volatility exacerbated by forced selling from pension funds, which faced sudden collateral calls as prices fell due to a relatively common tactic involving leverage.[lxi] The volatility spilled globally, with US Treasurys also getting a jolt as trading demand overwhelmed dealers.

lx Source: Office for National Statistics, as of 18/10/2022.

lxi Source: FactSet, as of 26/10/2022.

**EXHIBIT 18: GILT YIELDS RISE AS UNCERTAINTY GROWS**




Source: FactSet as of 27/10/2022. Gilt 10Y Yield and GBP/USD from 01/06/2022 – 26/10/2022.

In response, the BoE announced it would buy Gilts directly from pension funds in order to ease the pressure on markets, with purchase allotments set at £5 billion per day and a maximum of £65 billion total through the program's expiration on 14 October. Initially the move seemed to calm Gilt yields, which drifted down a bit, but the relief didn't last as the expiration date loomed, fueling fears that the bond market's reckoning was merely delayed. In our view, the BoE's subsequent actions on 10 October should have put this fear to bed: They announced that while they had offered to purchase £40 billion worth of Gilts from pensions thus far, pensions had sold only £5 billion, and that they would therefore increase their daily purchase maximum to £10 billion for the program's duration.

We interpreted this as a signal that pension funds were overall in better shape than feared and the acute need to raise collateral had passed, but that point was lost in most coverage. Instead, attention focused on the new temporary lending facilities the BoE unveiled to complement their bond purchases and assist pensions through mid-November. These programs enabled banks to serve as middlemen for pensions to access the discount window and use Gilts as collateral, enabling them to get cash needed to meet immediate margin calls and then take extra time to be more selective about which assets to sell to repay the loans. Yet as often happens when central banks throw a range of new programs at an acute problem, it seemed to foment fear, implying that pensions' and bond markets' problems were deep-seated. Analysts also focused on the lending facility's architecture and concluded that banks would likely be unwilling to serve as pension funds' proxies, rendering the program feckless. Gilt yields spiked again, hitting 4.48% on 12 October, and two days later Prime Minister Truss fired Kwarteng and installed Jeremy Hunt as Chancellor.[lxii] He swiftly U-turned on the vast majority of the mini-budget, and when yields fell, pundits interpreted it as a vote of confidence in fiscal moderation.

On the political front, Chancellor Hunt's shredding of the mini-budget created the impression that PM Truss was no longer running the show and had ceded power to the proverbial "men in grey suits." She initially tried to battle through this, but one of the most chaotic days in Parliament in recent memory sealed her fate. On the day in question, 19 October, Home Secretary Suella Braverman resigned after discovering she had technically breached the rules on the use of personal devices when accidentally sending a policy brief to a colleague from the wrong email account. Many interpreted her resignation letter as a call for PM Truss to own up to her own mistakes and step down. Meanwhile, confusion reigned as Conservative Party whips implied a vote on whether to ban fracking would be a confidence vote in Truss's leadership, and there were reports of physical violence and intimidation during the vote. The next day, PM Truss resigned, kicking off a fresh leadership contest.

lxii Ibid

This contest was initially scheduled to last a week and appeared set to pit Rishi Sunak against Boris Johnson and Commons Leader Penny Mordaunt. However, Johnson and Mordaunt pulled out before the nomination window closed, leaving Sunak as the de-facto winner. He is now Prime Minister and has appointed a cabinet that seeks to unify the various party factions. Meanwhile, 10-year Gilt yields are now down to pre-mini-budget levels, fuelling the widespread narrative that PM Sunak has restored market confidence—in our view, a stance that reads too much into the volatility both up and down and focuses too much on politicians' personalities. Typically, when markets panic as they did over the mini-budget, they eventually settle down as it gradually becomes apparent that reality is much more benign than feared. We think that would have happened in this case, but Liz Truss's U-turn and resignation forestalled it, creating the impression that markets' reaction was justified and Rishi Sunak's appointment the best-case scenario.

We think this misunderstands how markets work. Markets care about policies, not personalities, and the swing factor is generally whether a government—regardless of leader or creed—can pass radical legislation creating winners and losers and discouraging risk taking. Looking forward, we see little likelihood of this, as the Conservative Party likely remains too divided to pass anything major. More likely, PM Sunak focuses on healing the party's wounds and not rocking the boat in order to rebuild support ahead of the next general election, which is due in 2024. Accordingly, UK politics likely settles into gridlock, helping uncertainty to continue falling.

## ITALY'S ELECTION REKINDLES FALSE FEARS OF EUROSKEPTICISM, DEBT DEFAULT

In July, Italy's technocratic Prime Minister Mario Draghi resigned after the Five Star Movement, which was part of his broad coalition government, refused to back a controversial bill to aid households burdened by rising prices, prompting a general election. After weeks of polling well, a right-of-centre bloc led by the nationalist Brothers of Italy's Giorgia Meloni won September 25's vote, once again triggering fears of populists squabbling with Brussels—potentially jeopardising the country's EU energy funding share—and spurring a debt crisis. Italian 10-year yields rose from 3.0% at Q3's start to 4.6% at its end, leading some to suspect a connection.[lxiii] However, as in the several prior episodes since 2010, we think fears over Italian politics and debt are overrated and likely to prove false.

Many commentators have long considered Italy "ungovernable," noting the fractured political scene prevents legislation and reforms from passing. There are a multitude of parties that seem to rise and fall in popularity swiftly, making it difficult to garner a majority and complicating forming workable coalitions, which have frequently collapsed—like PM Draghi's did in Q3. Hence, in 2020, the country held a referendum to change the Constitution—aimed at reducing the number of parliamentary seats in both chambers to ease coalition-building at the next election—which passed. September's vote was the first under these new rules. With euroskeptic parties leading, including the Brothers of Italy—which many note loosely descended from Benito Mussolini's Fascist party—some feared them taking a decisive majority. Others went further, arguing a Brothers of Italy-led supermajority would allow them to easily rewrite the constitution.

lxiii Source: FactSet, as of 19/10/2022.

The election results show the Brothers of Italy and their right-leaning allies the League and Forza Italia combined to take 237 seats in the Chamber of Deputies and 115 in Senate. That is sufficient to give this coalition majority control, but not enough for a supermajority. So a constitutional rewrite looks difficult, undercutting at least one fear. After government formation talks, reports indicated Meloni kept coalition partner leaders Matteo Salvini and Silvio Berlusconi from installing their preferred picks in key cabinet positions, also hinting at early friction. Italian President Sergio Mattarella swore her in as prime minister on 22 October, then she secured her government when it won confidence votes in both chambers 25 and 26 October.

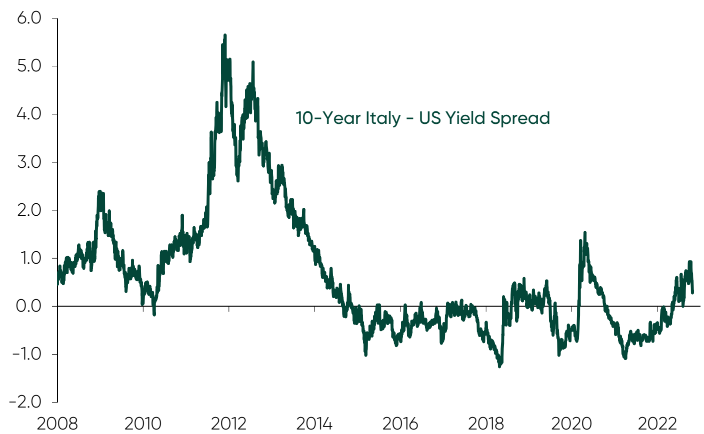
What they will do is anyone's guess. We would note, though, the parties' rhetoric appears far more moderate than feared. Meloni, for one, tacked to the centre when campaigning, fashioning herself—and her party—as pragmatists with no intention of leaving the euro or EU, aligning her views with the bulk of Italians'. She has said she wants to work with Brussels—not against it—to make European institutions more effective. She also plans to abide by EU budget rules and reforms to unlock NextGenerationEU funds agreed to under PM Draghi. She has repeatedly stated her support for Brussels' position in backing Ukraine, too—a key point. Of course, talk is cheap, but until Meloni takes actions otherwise, it doesn't look as if the new government is about to clash with Brussels, threaten EU cohesion and risk Italy's finances.

Meanwhile, Meloni's acting in sync with her coalition partners isn't assured—gridlock looks likely to us, just as with Italy's previous (unstable) multi-party coalition governments that rarely saw eye-to-eye. Already, Berlusconi's Forza Italia is at odds with Meloni after he questioned whether Italy should support Ukraine. Meloni threatened to go as far as booting the party from the coalition in response, complicating government formation. How smoothly their coalition will now run remains to be seen, but early sparring suggests big, divisive legislation isn't likely. It essentially means the constitutional amendment cutting parliamentary seats—the fix to "ungovernable" Italy—may have failed. While some would see that as disappointing, it means gridlock continues to rule Italy, preventing extreme legislation or policy that roils Brussels, creates winners and losers or complicates business planning.

While Italy's political circumstances have grabbed headlines, the question underlying the attention is longstanding: Is Italy at risk of defaulting on its debt? Rising Italian yields have many fearing the incoming government's potential to veer from reforms or fiscal rectitude, which could jeopardise EU funding and wreck public finances. Never mind there is little indication Italy will go those routes—or that rising yields are fully global, not unique to Italy. If Italy-specific credit risks were escalating, Italian yields' climb would probably be outsized.

Credit spreads against European and developed world benchmarks suggest a more benign story. Italy's 10-year yield spread over Germany's has barely budged since PM Draghi resigned. Italian credit risk hasn't suddenly exploded. The spread versus the US has widened some, but as Exhibit 19 shows, it isn't unusually high and remains far below 2011's peak. Italy didn't default then. We don't think it is any closer today.

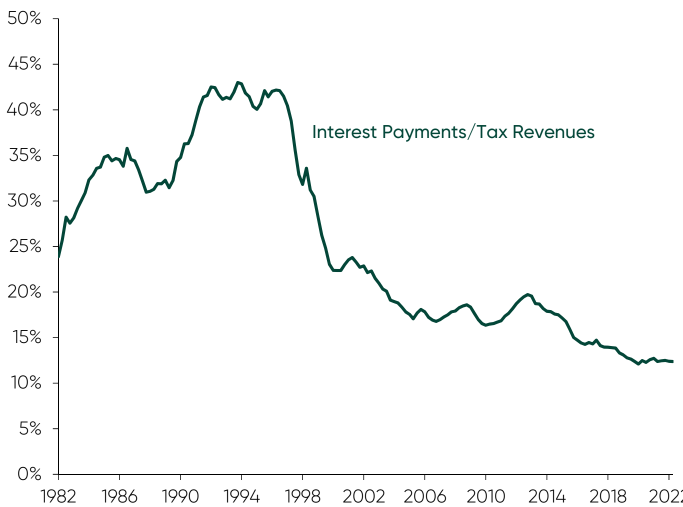
**EXHIBIT 19: ITALIAN-US CREDIT SPREAD WIDENED SOME**




Source: FactSet, as of 27/10/2022. 10-year Italian BTP yield minus 10-year US Treasury yield, 01/01/2008 – 26/10/2022.

The main reason why a debt crisis is unlikely: The Italian Treasury's finances are fundamentally strong—receipts cover debt service by a wide margin. Interest payments are only 12% of tax revenue, near the lowest percentage in decades. (Exhibit 20) If Italy didn't default in the 1990s when debt costs were nearly four times higher, then we doubt it will when they are far less. Rising rates could change that, but any shift would be slow. Italian bonds' weighted-average maturity is over seven years, so yields would have to soar and stay elevated for years for debt payments to balloon unsustainably.[lxiv] Moreover, the Treasury is still refinancing a lot of its maturing debt at a discount. 10-year Italian bonds coming due now carry coupons of about 5.5%.[lxv] Current 10-year yields remain below that.

**EXHIBIT 20: ITALY'S DEBT IS AFFORDABLE**




Source: FactSet, as of 14/10/2022. Italian interest payments as a percent of tax revenues, Q1 1982 – Q2 2022.

On the political front, populists in power draw scrutiny and concern, but Italy is no stranger to such situations. While worth monitoring, if they didn't materially alter Italy's finances before, it seems unlikely they unravel now.

## SWEDEN

Extremism fears raged similarly in Sweden after the far-right Sweden Democrats and three potential coalition partners took a two-seat majority in 11 September's vote. But vast divides between the Sweden Democrats and would-be partners the Moderates, Liberals and Christian Democrats proved insurmountable. Moderate leader Ulf Kristersson sealed a coalition agreement to form a minority government that doesn't technically include the Sweden Democrats but relies on them to pass legislation. This should defang extremism fears, as it reinforces gridlock.

## ON EUROPE'S ENERGY PINCH

European energy is one place war fears haven't eased. The EU's sanctions exempted natural gas, which several EU nations rely on, in order to give the Continent time to secure new suppliers and improve infrastructure to import more seaborne liquefied natural gas (LNG). But supply has fallen anyway, due primarily to throttled flows from Russia, including outages on the Nord Stream 1 pipeline. As a result, many fear a severe energy crunch looms for much of Central Europe, bringing rationing, blackouts and surefire recession. Germany, which has relied on Russian gas since it began phasing out nuclear power a decade ago, is central to these fears due to its large chemical industry—which needs natural gas for energy and feedstock. Some facilities have made severe production cuts, and many fear more could go offline.

Some economic fallout seems likely. Many eurozone nations have endured bear markets in euros, which is consistent with markets pre-pricing a recession. But this raises a key point: The likelihood of material negative developments above and beyond what markets have already priced in seems remote. If equities have spent this year digesting talk of blackouts and factory closures, anything milder than that disaster scenario would qualify as a positive surprise.

lxiv Source: Italian Department of the Treasury, as of 19/10/2022. Weighted average life of government bonds, September 2022.

lxv Source: Italian Department of the Treasury, as of 19/10/2022. 10-year BTP auction results, 31/10/2012.

We see a high likelihood that while all doesn't go perfectly, fears prove overstated. For one, most EU nations are filling winter gas reserves ahead of schedule. Germany's reserves are 93% full. So are the Netherlands, whose shipments from Russia ceased over the summer. France, facing maintenance-related shutdowns at some nuclear plants, has filled 97% of its storage capacity. Spain and Portugal, which don't rely on Russia, are 91% and 100% full, respectively. Overall, EU storage is 89.9% full as of early October, giving the Continent a good head start.[lxvi] While prices remain high, gas seems likely to be available. That is a key distinction. Companies can adjust to higher costs. A pure lack of energy is more challenging.

Additionally, EU leadership and several member states are taking additional steps to add energy supply. Germany has elected to keep three nuclear power plants online beyond this year's scheduled closures. Many countries have restarted mothballed coal plants. Floating LNG terminals are scheduled to open in January 2023, increasing capacity to import gas from the US and Asia. A new pipeline bringing gas from Norway to the EU has just come online. This follows the new supply relationships forged this year, which helped Russia fall from 40% of EU natural gas imports in 2021 to just 10% this year.[lxvii] By throttling flows and allegedly sabotaging the Nord Stream 1 pipeline now, Russia moved too late—they gave Europe time to plan and offset some of the worst effects. President Putin's energy leverage is largely gone.

Yet gas prices remain high. European leaders are attempting to address this, but their proposals are mixed. Positively, they are helping energy providers hamstrung by high collateral calls in energy trading markets, which should help prevent suppliers from failing simply because they lack liquidity—an important backstop. However, Germany and the UK have announced big spending packages to assist households and businesses with high prices, and EU leaders are negotiating something similar. The UK and Germany's plans have faced criticism for their perceived inflationary effect, with analysts presuming assistance will increase consumer spending, lifting CPI. We very much doubt this, considering there are myriad other cost-of-living pressures in both countries. But we do think there is a risk, in Germany and the UK as well as the EU, that capping prices will discourage conservation, offsetting progress on shoring up supply. Perversely, that would raise the risk of rationing and blackouts. For now this doesn't appear likely but it, too, is something we are watching.

lxvi Source: "89.8% of EU Gas Storage Is Filled," *Reuters*, 03/10/2022.

lxvii "Russia's Gas Exports to Europe Drop by 82% in a Year," Charles Kennedy, *Oil Price*, 23/09/2022.

# EMERGING MARKETS **COMMENTARY**

## CHINA UPDATE

China held its National Party Congress (NPC) in October, and President Xi Jinping was appointed to an unprecedented third term. While his appointment was unsurprising, the rests of the leadership saw material changes—some of which surprised observers. In the 205-person Central Committee, which sets policy for the next 5 years, 135 members were replaced. Moreover, the seven-person Politburo Standing Committee, the Communist Party's senior decision-making group, will have four new members. With many of these leadership roles going instead to Xi's allies, the stage is seemingly set for him to be leader for life—especially since no one appears to be a viable successor. Moreover, the replacement of Premier Li Keqiang, the party's second highest-ranking official and a widely reputed market-oriented reformer, with Li Qiang, Xi's former chief of staff, has stoked worries of a looming radical policy shift.

Furthermore, former President Hu Jintao's exit during the congress's final session—ostensibly due to a health issue—stoked some Western concerns of a major shakeup. However, this concern seems based more on speculative analysis of the officials' personalities—not necessarily a sign of a definitive policy change to come.

Against this political backdrop, in which President Xi seems to be prioritising consolidating political power than supporting growth goals, many fret over the economy's prospects. Though challenges remain, including ongoing regulatory uncertainty, many economic headwinds lack surprise power at this point. Moreover, while Chinese growth is slowing, a hard landing doesn't appear to be in the offing—queuing up some positive surprise upside if reality turns out better than expected.

## MIDYEAR HEADWINDS

Several well-known issues grabbed headlines this summer. For example, China's property sector issues remain a top concern. Last year, property developers' defaults—highlighted by behemoth Evergrande—drove fears of a real estate market collapse. Chinese developers' first-half 2022 profits fell -87% y/y, leading to worries more defaults remained possible.[lxviii] Commercial property sales fell -26.3% y/y in September, while residential sales dropped -28.6%.[lxix] Fears have morphed after a mortgage boycott knocked sentiment over the summer. Thousands of homebuyers refused to make payments on pre-bought, unfinished apartments, spurring further worries about renewed real estate weakness—and prompting regulators to step in and instruct banks to help property developers with financing as needed.

China also endured its hottest August on record, which wreaked havoc on number of industries, from energy generation to agriculture. The heatwave led to speculation about possible knock-on effects—*e.g.*, a severe heatwave would cause power shortages, driving a manufacturing slowdown, which would knock goods production. But the biggest economic concern has been the government's ongoing zero-COVID strategy. Frequent restrictions have weighed on economic activity and spurred uncertainty for domestic and foreign businesses alike.

We don't dismiss these developments' adverse economic impact—nor the uncertainty surrounding them. For example, policymakers' implementation of new COVID-19 restrictions isn't predictable. Neither are regulatory issues—another source of uncertainty. For instance, China and the US have had a years-long impasse over US access to US-listed Chinese companies' audit records—an issue that many worry would lead to Chinese firms having to delist from US stock exchanges because of a lack of compliance. Both sides made progress on this front, as China agreed to let US regulators inspect records in Hong Kong. However, several caveats remain, and it isn't clear whether US auditors will have access to all the information they require. Furthermore, many see Xi's appointment of loyalists as a sign that his government will persist in its regulatory crackdown on Tech firms and their leaders, as the Standing Committee now excludes the party's Youth League faction, which is historically where the impetus for market-oriented reforms has come from. Yet these headwinds aren't hugely surprising at this point—nor do they appear large enough to derail the Chinese economy, let alone the global economy.

## THE LATEST ON THE ECONOMIC FRONT

China delayed a spate of economic data set to be released in October, including Q3 GDP. While no official reason was given for the delay, many analysts suspected the government waited to deliver worse-than-anticipated news to avoid bad press during the NPC. The National Bureau of Statistics reported data on 24 October, after the NPC's conclusion, and some figures were better than anticipated. For instance, Q3 GDP rose 3.9% y/y (Exhibit 21), beating expectations of 3.5%, though still lower than the government's growth target of around 5.5%.

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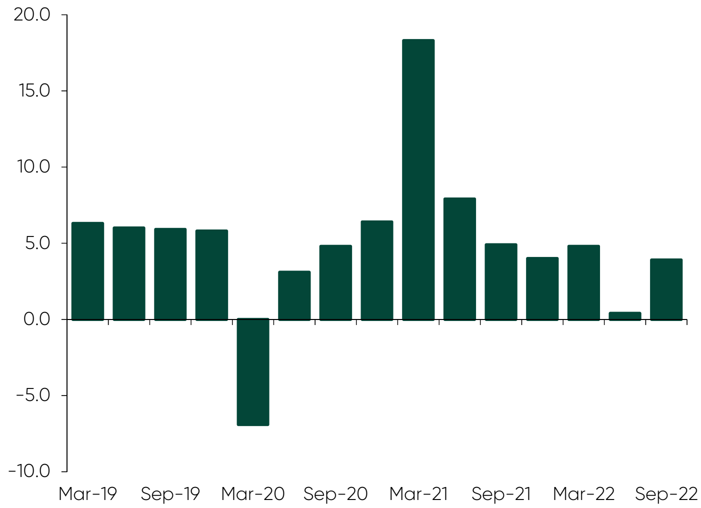
lxviii "Chinese Property Developers Slump 87% in the First Half of 2022—and It's Possible the Housing Market Still Hasn't 'Bottomed Out'," Grady McGregor, *Fortune*, 02/09/2022.

lxix Source: FactSet, as of 26/10/2022.

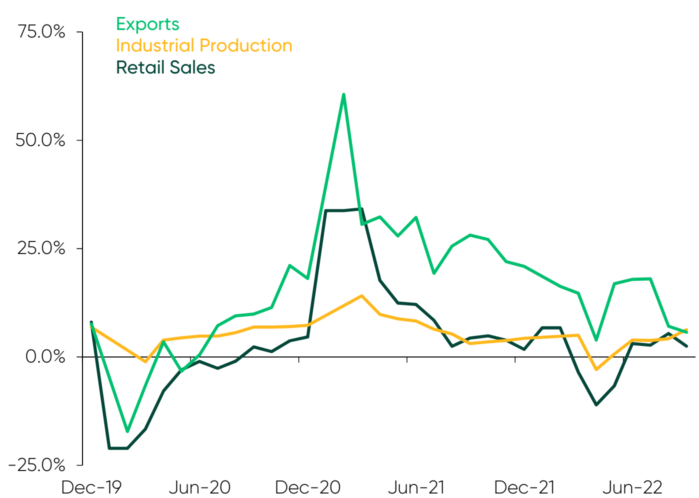
**EXHIBIT 21: CHINESE GDP GROWTH (YOY % CHANGE), Q1 2019 – Q3 2022**




Source: FactSet, as of 24/10/2022.

The latest monthly data were mixed. While September industrial production and exports both exceeded experts' estimates, retail sales fell short. All, however, grew on a year-over-year basis. (Exhibit 22)

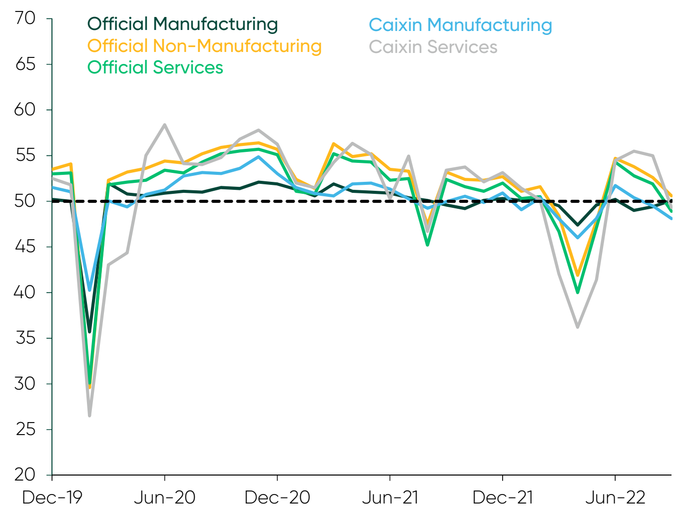
**EXHIBIT 22: CHINESE RETAIL SALES, INDUSTRIAL PRODUCTION AND EXPORTS**




Source: FactSet and National Bureau of Statistics, as of 24/10/2022. Year-over-year % change. Note: January – February figures for industrial production and January export figures aren't included due to data availability tied to Lunar New Year.

September purchasing managers' indexes (PMIs) were similar. The government's PMIs for the manufacturing and non-manufacturing sectors were slightly above 50, as was the services PMI from Caixin, which reflects smaller, private firms (Exhibit 23). However, the official services PMI and Caixin's manufacturing PMI dipped below 50. Now, PMIs indicate only the breadth, not the magnitude, of growth or contraction, so sub-50 PMIs don't necessarily imply contracting GDP, just as slight expansionary PMIs don't reveal much about robustness of expansion. In our view, these readings are consistent with slowing growth.

**EXHIBIT 23: OFFICIAL AND CAIXIN PMIS**




Source: FactSet, as of 24/10/2022. Readings above 50 imply expansion; below 50, contraction.

More broadly, the latest Chinese data haven't deviated from their longer-term trends. They are also in line with recent slower-growth trends in other major economies, as China's economic headwinds aren't wholly unique. For example, higher energy costs have also weighed heavily in Europe while supply chain bottlenecks have affected business in the US and other developed nations. Most importantly, slowing growth is still growth—and given China's economic heft, the country is still contributing meaningfully to global GDP.

Political developments have understandably driven the most coverage, as President Xi consolidates his power over the Chinese Communist Party. But while many fret over his policy priorities, the overarching one remains maintaining social stability, in our view. It is possible policy shifts stir uncertainty, as many worry how the government will address the flagging property sector or Internet industry. While worth monitoring, the new Chinese leadership slate still features Xi at the top, so we see little reason to think major policy shifts are afoot. Despite the abundance of concern, a Chinese economic hard landing still doesn't appear likely for the foreseeable future—which is likely better than what many anticipate today.

### SOUTH KOREA'S TOUGH QUARTER

South Korea suffered particularly badly during Q3, as the country underperformed, falling -16.4%. Currency factors likely bear much of the blame on two fronts.[lxx] One, in terms of pure currency translation, the US dollar's sharp rise in September detracted from returns throughout Asia: China fell -12.1% in yuan, Taiwan dropped -12.2% in Taiwan dollars, and South Korea fell -12.6% in won.[lxxi] Two, the sliding yuan, Taiwan dollar and won hit sentiment hard amid rumors of official intervention to stanch the bleeding. Additionally, Korea as a Tech-heavy country underperformed with other growth-like categories over fears around rate hikes, inflation and recessionary fears. Similar to our views on China, sentiment is overly negative on Korea and Tech making this a prime region to sharply recover in the early phase of the eventual new bull market.

## CURRENCY VOLATILITY AND INTERVENTIONS IMPACT EM AND DEVELOPED NATIONS

### CHINA

As the yuan slipped toward its lowest exchange rate since 2008 in September, officials stepped up their defence. Since 2015, when the People's Bank of China's (PBOC's) deployment of forex reserves to shore up the weakening yuan spooked markets globally, officials have sought more stealthy means of supporting the currency.

While the yuan isn't pegged outright, it has a managed float. The PBOC sets a daily reference rate, and the yuan is allowed to trade within 2 percent above or below it. Throughout the summer, the PBOC routinely set the reference higher than markets anticipated—an apparent effort to support the yuan. This proved ineffective and the yuan kept slipping. Efforts to reduce banks' purchases of dollars by reducing foreign currency reserve requirements also had little effect.

Toward the end of September, officials stepped up their defence. Initially, it was verbal, with regulators and state-run media warning against speculating on further declines and claiming the yuan's value would be stable looking forward. They backed this talk up days later by imposing a risk reserve requirement of 20% on banks' currency forward sales, making it more difficult and costly to speculate on further yuan declines. Toward September's end, *Reuters* reported the PBOC directed state-run banks to prepare their offshore branches to sell dollars, setting expectations for a major intervention. This initially helped sentiment toward the yuan, which jumped 2.2% between 28 September and 30 September, the last day before the week-long market closure for China's National Day holiday.

lxx Source: FactSet, as of 03/10/2022. MSCI China, Taiwan and South Korea Index returns with net dividends in USD, 31/08/2022 – 30/09/2022.

lxxi Ibid. MSCI China, Taiwan and South Korea Index returns with net dividends in CNY, TWD and KRW, respectively, 31/08/2022 – 30/09/2022.

Once markets reopened, however, the slide resumed—and continued as the National Party Congress got underway. On 17 October, *Financial Times* reported that state-run banks were increasing their dollar sales, but the decline continued.[lxxii]

For now, there is no talk of official forex reserve deployment. Most analysts think policymakers' goal is to slow the pace of the yuan's decline rather than foment a rebound, and keeping its reserves intact is consistent with this. At the same time, the debate is largely academic, as a weak currency isn't inherently negative or positive for equities or the economy—in any country, China included. More important, in our view, is that officials have learned from the world's reaction to 2015's yuan defence and subsequent mini-devaluation and haven't made any similarly panic-inducing moves this time.

As for the other major risk that usually affects Emerging Markets when their currencies weaken—dollar-denominated debt becoming more difficult to service—we don't think the calculus has much changed. Chinese property developers' debt problems were well-known before the yuan slid this year, and defaults on dollar-denominated bonds began in late-2021. Perhaps the yuan's weakness accelerates defaults that would have happened anyway, but—counterintuitively—that the government continues allowing defaults to happen should help long-running concerns about moral hazard fade, enabling markets to better price risk. It is also in keeping the government's aims to rein in excess in the property market.

## INDIA

India's rupee also weakened this year, crossing below 80 rupees to the US dollar in October. The Reserve Bank of India (RBI) has been intervening to stanch the bleeding, but it is questionable how much influence their chosen methods will have.

Throughout the year, the RBI appears to have waffled between traditional intervention—using forex reserves to sell dollars and buy rupees on the spot market—and a more unconventional approach. Its reserves are down by $114 billion (-17.8%) since reaching a post-2020 high on 3 September 2021.[lxxiii] Perhaps that has helped slow the rupee's decline, but this approach also appears to have drained liquidity from the banking system. Thus, the RBI has occasionally switched gears and used derivatives instead, an effort it has reportedly stepped up recently. With this approach, it still sells dollars and buys rupees on the spot market, but it then uses currency forwards to sterilise these transactions: On the settlement date it sells rupees and buys dollars to replenish interbank liquidity, then sells dollars forward to maintain the intervention. This has the added benefit of slowing the forex reserve drawdown, theoretically helping ease fears that India will follow its less-stable neighbours Pakistan and Sri Lanka into severe currency crisis.

However, there is an unintended side effect: Using currency forwards in this manner has reduced the rupee's implied yield, creating an incentive for investors to flee to higher-yielding dollar-denominated assets, which risks counterbalancing the RBI's efforts.[lxxiv] Plus, with liquidity in the banking system still severely depressed, some analysts predict it will have to resume its quantitative easing bond purchases to replenish bank reserves, which would further weigh on long-term interest rates—adding to investors' incentives to chase higher-yielding assets abroad, putting yet more pressure on the rupee.

In our view, this speaks to the overall fecklessness of currency intervention. For one, we don't think it is necessary from an economic standpoint, given our long-held view that currency swings' plusses and minuses largely offset each other. Two, it can easily create new problems and raise the risk of unforced errors.

lxxii "China State Banks Step Up Dollar Sales to Support Renminbi," Hudson Lockett, *Financial Times*, 26/10/2022.

lxxiii Source: FactSet, as of 26/10/2022.

lxxiv "RBI's Currency Intervention Ends Up Hurting Rupee Carry Trade," Subhadip Sircar, *Bloomberg*, 18/10/2022.

## JAPAN

Currency intervention isn't unique to emerging markets as Japan also illustrates the follies of currency intervention, in our view. While the BoJ and Finance Ministry are being coy about their actions, many analysts believe they have been conducting interventions to prevent the yen from slipping below 150 to the dollar for a sustained period. Japan has a mountain of forex reserves and isn't at risk of running dry despite this year's drawdown, but the effort is curious when you consider that the BoJ's own monetary policy caused the yen to weaken in the first place. While the Fed and other major central banks have hiked short-term interest rates and ended quantitative easing bond purchases (and in some cases begun letting their balance sheets unwind), Japan has done neither. Its policy rate remains negative, and it continues targeting a 10-year Japanese Government Bond (JGB) yield ceiling of 0.25%.

Keeping 10-year yields below that ceiling has at times caused the BoJ to conduct unlimited 10-year JGB purchases—the market is seemingly trying to pull yields higher, which would reduce the differential with US yields and probably help reduce capital flight. In our view, simply ending the long, unproductive experiment with asset purchases and negative rates would probably ease much of the extraordinary pressure on the yen and negate the supposed need for intervention. Some argue Japan must maintain its "ultra-loose" monetary policy to stoke growth and inflation, but the policy hasn't demonstrably boosted growth, and faster inflation has come only when the weak yen boosted energy prices, as it is now—the very problem the BoJ is trying to address.

In the meantime, absent a course correction, we think Japanese multinationals, which tend to reap large profits from currency translation when the yen is weak, probably outperform more domestically focused companies that lack export revenues to offset the higher import costs and rely on domestic demand, which likely remains weak.

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