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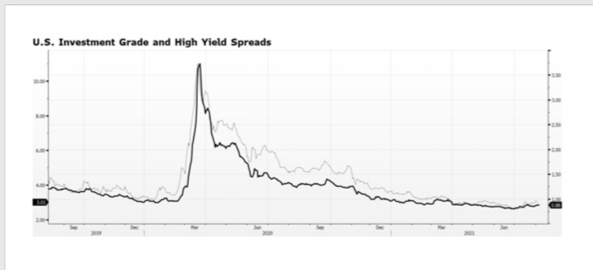
Newsletter and Capital Markets Review

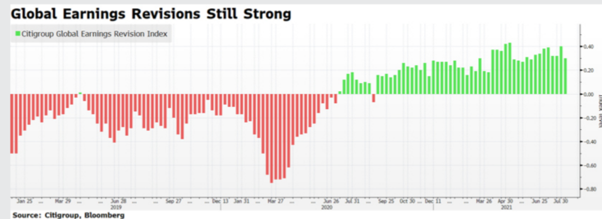
SUMMER 2021

So far this is a Summer of contrasts, with COVID on the march and climate-related crises advancing, including the hottest July globally since records have been kept, while at the same time markets have been reasonably quiet and the news of economic recovery encouraging. We have discussed at length our views on hotspots teasing but not proving inflation in areas such as used automotive, housing, and wages for low-skilled jobs, and this Summer our focus shifts to other recovering economies, pandemic notwithstanding.

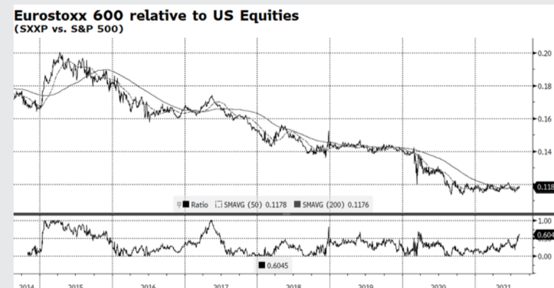


Investment Grade and High Yield bond spreads have been edging higher since reaching their tightest levels ever at the end of last quarter. Admittedly, the spread widening may have more to do with the decline in Treasury yields since June 30th than an indication of any deterioration in the credit markets. What is interesting to us is that this has been occurring while broad stock market indices in the US and also Europe are hitting all-time highs. Equity market valuations are full, particularly in the US, but according to Bloomberg consensus earnings are expected to grow by 11.8% over the next 12 months, putting the forward PE ratio of the S&P 500 at 20.3x. Lofty, yet not extreme. Our sense is that, barring a major surprise or a misstep by the US Fed, the positive tone in equities in the Western world will continue. The outcome of the Fed's September meeting will be highly scrutinized but the likelihood that they will surprise markets is low.

Another encouraging trend in equity markets globally is positive earnings revisions. According to Citigroup, analysts have been increasing their earnings forecasts for nearly the entire year with the exception of early September 2020, and Continental Europe measures among the world leaders in this metric.



The consensus earnings-per-share growth in Europe is also expected to expand over 40% in 2021 after contracting over 25% in 2020 based on MSCI indices. European shares have been performing well so far this year with the MSCI Europe index up 18% through the end of July, on par with the S&P 500. Valuations in Europe are favorable with the 12-month forward PE ratio currently standing at 15.7x versus the previously mentioned rather full 20.3x for the S&P 500. The performance of Europe in the global equity rally so far this year is an encouraging sign that further gains may become a reality as market participation expands.



European stocks have underperformed US stocks for over five years. The Eurostoxx 600 has climbed 69% over the five year period ending July 31st which is a respectable advance but trails the S&P 500 by more than 53%. Over the past several months, European shares have been keeping pace with their US counterparts, which may suggest that there is a rotational opportunity on the Continent taking into account the valuation advantage.

Portfolio Positioning

Stability seems to be the current state of affairs after a chaotic 2020, with an expectation that resurgent developed economies tempered by ongoing challenges in the developing world will be generally good for equities. Central bank policy and the whiff of inflation pose challenges but not a crisis for fixed income. We continue to hold an overweight allocation to equities overall as well as a modest underweight in fixed income, also leaving cash meaningfully underweight. Within global equities, we are overweight with respect to the US, modestly overweight to Asia x-Japan and slightly underweight in Emerging Markets. We are neutral with respect to Eurozone stocks and underweight Japan. Within fixed income, we are overweight in the US with a preference for mortgages and investment grade corporate credit. We have little to no exposure to non-US fixed income except through Green Bonds in our ESG series portfolios. All portfolios holding fixed income maintain lower duration than the benchmark.

Risk Outlook

- Concerns about inflation have loomed over the market in recent months, although not so much so that asset prices have been adversely affected or that central banks have taken action. There have been flashes of what would, under ordinary circumstances, signal inflation. We have seen spikes in prices of building materials and scarcity of new cars for purchase as examples. But, while we cannot discount those observations entirely, we principally see them as graphic examples of how interdependent world economies and supply chains are and how fragile they were with just-in-time inventory management. While investors have extolled just-in-time since Toyota popularized it, it introduced an inelasticity into global supply chains that was not capable of absorbing the blow of COVID. This was further exacerbated by climate-related issues with beetle infestation and fire affecting Western timber stocks and storms knocking petro-chemical production capacity off line among several other challenges. The results were issues such as a microchip shortage affecting the ability of factories to finish automobiles for delivery. We believe as major parts of the global economy get back on pace that the current situations will self-correct, but as investors and market watchers we are looking longer term at the confluence of business practices that are not sustainable, resilient or adaptive and externalities like global health and climate change which can and will disrupt businesses and markets again.

- Benign conditions do not always result in benign outcomes. As discussed elsewhere, even a slight normalization of the rate environment, which would reflect stabilizing economic conditions, could have profound effects in fixed income markets, severely dragging down assets like 30-year Treasury Bonds which are normally seen as safe harbors from risk. Wall Street has been cautioning about the risk of rising rates since the end of the Financial Crisis in 2009, but we have yet to actually have to live with those risks because a slow grind recovery followed by a series of crises including COVID have conspired to hold central bank policy where it has been – accommodative. A mild turn of phrase by the Fed Chair has resulted in temporary shocks in the bond and even equity markets, so we can anticipate that rising rates are not welcome in markets that have enjoyed easy money for more than a decade now. This compels us to think about risk in globally diversified portfolios differently, where the traditionally more conservative parts of asset allocations may actually represent more material risk in the nearer term.

- Big questions about the social contract will continue to play out in the months ahead. The ratio of constructive to destructive discourse and activism will weigh heavily on the impact to investors and the economy. Advancements in diversity, equity and inclusion, civil debate about justice reform, building back better and stronger as part of the COVID recovery, and improving participation in the US (and global) economy will be positive drivers. Putting that at risk, and with it capital formation and job creation, would be more violent and destructive actions that focus attention and resources away from serving and supporting the individuals and communities and their families, businesses and livelihoods who are struggling everywhere from the urban Northeast to the rural Southwest.

Risk Outlook [cont'd]

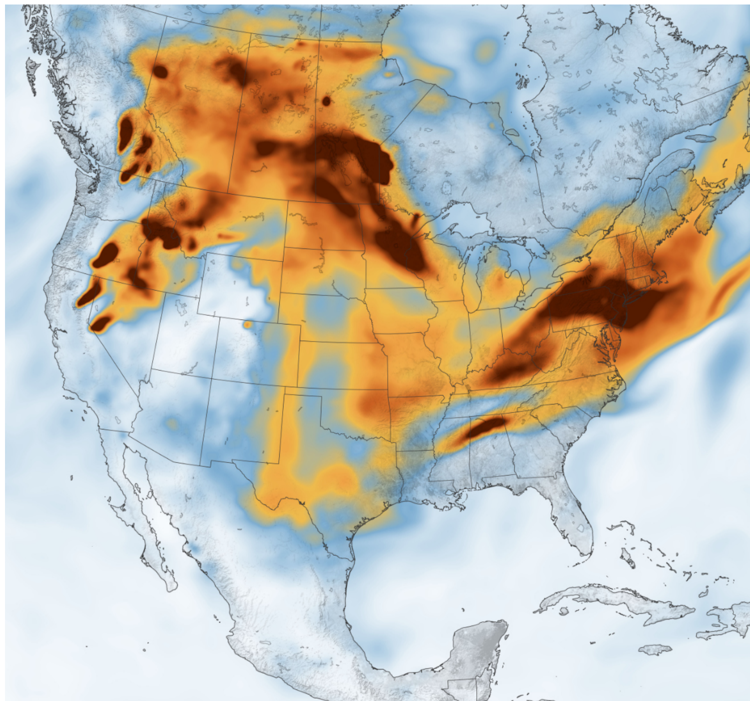
- It may not be a risk per se, but we are mindful of the legislative efforts around major spending initiatives coming out of Washington DC, starting with infrastructure. Discussions around infrastructure have been increasingly bipartisan and bicameral, suggesting there is a political and practical will to see it done. The additional and larger spending programs that are being discussed are not directly related to the $1 trillion infrastructure play, but Beltway politics being what they are, the dependencies can be manufactured, with the party in power (Democrats) holding up a popular bill both parties like to try to drive progress on other parts of the legislative agenda. Meanwhile the party in the minority (Republicans) could threaten to drop support for infrastructure if the majority pushes too hard on the rest of their wish list. As we have been saying since the election, an evenly split government means a lot of triangulation and not a lot of surprises, so we do not think the market will either jump or drop materially on the outcome.

- On a planetary level, we have only made a dent in the pandemic, and in the developed world new and more efficient COVID-19 variants are propagating, driving infection rates back near peak levels. The most significant key learning for us is that the vaccinated can still asymptomatically spread the new variants. Even so, we are beginning to see a separation between countries enjoying a post-peak social and economic resurgence and those that are still in the grasp of the pandemic. We say "post peak" and not "post COVID" because we see a lack of certainty about the global community's ability to put the coronavirus completely behind us as new variants circulate that are more transmissible and more infectious. Curiously, our expectation was that the division between vaccinated/open-for-business and not would be almost entirely across socio-economic lines, with developing nations lagging behind developed. In a broad sense this is true, but in the wealthy developed world we still find a spread from Israel at better than 59% completely vaccinated to Japan at barely above 21%. There are also indeed dozens of nations that have not even cracked 1% (Johns Hopkins University COVID-19 Tracker). Pledges are coming in that will help the WHO COVAX program to begin to address the divide in access to healthcare resources, but there is still a daunting gap between the 4.7 billion doses already administered (Bloomberg August 15, 2021) and the number needed to end the pandemic and allow the global community to fully return.

- One of our long-term risk themes continues to be our focus on Chinese Communist Party actions which have not materially shifted for the better in the COVID era. From aggression in the Asia-Pacific region to military tension along the border with India to suppression of Hong Kong citizens' rights and the interests of the Uighur population and the lack of contrition for their early role in failing to stop COVID-19 in its tracks, all may contribute to China-directed backlash or retaliation. There does seem to be regional coherency in the response as nearly all Pacific nations have aligned with the US against Chinese aggression. From lack of respect for intellectual property rights to involvement in global criminal drug trafficking to financial crimes and human rights abuses bordering on genocide, the country is finding it harder to get the global community to look the other way. We view this as a risk to investment in China and investment in companies reliant on a Chinese supply chain, but likely bullish for other parts of the Asia Pacific interested in usurping China's role as the manufacturing floor for the world.

ESG Considerations

Working Group I has released their contribution to the UN Intergovernmental Panel on Climate Change Sixth Assessment Report. That is a mouthful, and is just the first installment of the 6th Assessment which is due for completion next year. There is no good news to be found in the report. In short, the accepted climate science holds that an increase of 1.5 degrees Celsius over preindustrial levels brings us to a tipping point where climate change becomes irreversible on a human time scale and 2 degrees may be a level where systemic change feeds back on itself and creates a runaway climate volatility scenario. The report, which is cross-sectional and includes the work of thousands of scientists across numerous studies and data sets, shows we have used 1.1 degrees of that climate cushion, and are on track to exceed 1.5 within two decades.



From an investment point of view this is material because companies and markets can no longer discount climate and the environment as externalities. The consequences of human activity have a price tag attached, not just for the planet, but the people who live on it. Fire has become a season in the Northern hemisphere, with runaway blazes making the nightly news from the American West to Greece.

Warming in the Arctic region is causing the permafrost to, well, defrost, which in addition to releasing additional carbon into the atmosphere and further amplifying the greenhouse effect, creates unstable ground across which major oil pipelines transit. The Alaska Department of Natural Resources has for the first time developed a plan to use thermosyphons defensively to maintain the temperature integrity of the permafrost on a critical stretch of ground on which the Trans-Alaska Pipeline sits.

Massive cyclones require companies and nations to re-rate the infrastructure and other risks from wind, rain and inundation. Drought threatens harvests and food and water insecurity has been shown historically and at present to contribute to the political destabilization of countries and put their populations into diaspora or direct conflict with more resource-rich neighbors.

It is not possible to be a long-term investor and not consider in addition to the explicit human cost what the direct and implied cost to capital is, from banks and insurance companies losing property to fire, wind and flood to major multi-national manufacturers experiencing permanent disruptions to their supply chains. A long-term investor also should intelligently assess not just the total cost of an asset including the environmental and climate cost, but also assess the stranded-asset risk, that on a fully allocated basis it may no longer be financially lucrative to pull that barrel of oil, cubic meter of gas, or lump of coal out of the ground. There is also an investment opportunity in allocating capital to the processes and technologies that can reduce carbon emissions, remediate what is already in the atmosphere, make communities and companies more resilient in the face of the damage already done, and make them more adaptable to the damage yet to come.

Image courtesy NASA Earth Observatory, NOAA-20 – VIIRS Black Carbon Column Mass Density, July 21, 2021

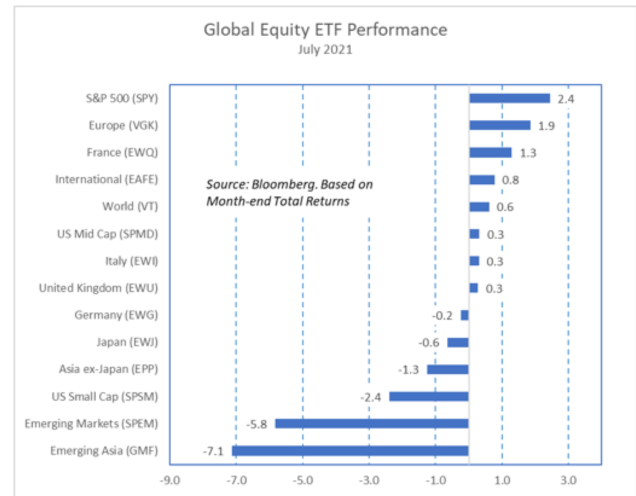
Summer 2021 Capital Market Review

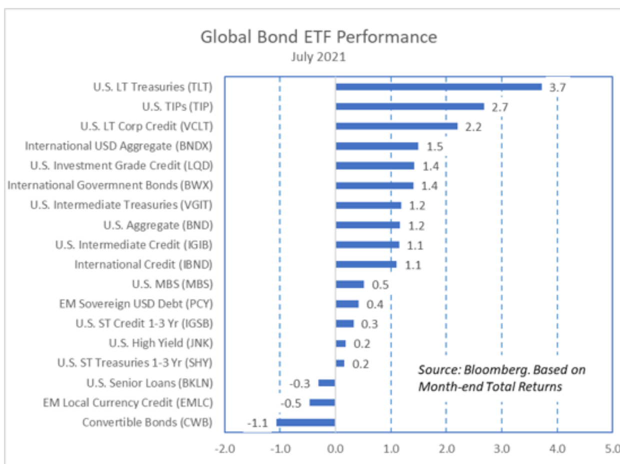
With the exception of Emerging Markets and China in particular, capital markets have been reasonably quiet through much of the Summer, with developed equity markets flat to positive and bonds appreciating as rates settled lower again.

Equity Markets

In July, US Large Caps led global equities (+2.4% vs. 0.6% overall). Emerging Asia and Emerging Markets more broadly (-7.1% and -5.8% respectively) were the dampeners on the global story while Developed Markets generally held their own, including Europe (+1.9%). That said, France had to do the heavy lifting (1.3%) as several other major Euro economies including Germany and Italy did not contribute meaningfully.

In addition to the regional divergence between the US and Asia, of note within the US was the dispersion of returns according to company size. Returns for small cap US companies were down as much as large





Bond Markets

After some market stress earlier in the year from rising yields, US Treasury rates fell in July, driving price appreciation meaningfully at the long end of the curve (long-dated Treasuries as represented by TLT rose 3.7%). With bonds, a receding tide (counterintuitively) floats all boats, and declining rates carried nearly everything but equity-like and EM (local currency) debt higher. Even developed-market international bonds, which have been perennial drags on globally allocated portfolios, posted modestly positive results for US-based investors.

The returns cited reflect total return performance of exchange traded funds listed in the corresponding bar charts

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Diversification and strategic asset allocation do not guarantee a profit nor protect against a loss in declining markets. All investments are subject to risk, including the loss of principal.

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