Investment Views

August 2021

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Regulatory Risks in Focus

In October last year, shortly before the proposed listing of Alibaba's fintech subsidiary Ant Group, Jack Ma, founder of Chinese e-commerce and cloud computing giant Alibaba, spoke at a finance conference in Shanghai. Ma was highly critical of what he thought was an outdated regulatory framework which resembled a "pawnshop mentality", stifling innovation in the finance sector and constraining credit creation. Leaders in China were said to be furious.

The Ant Group listing was expected to be the largest in history and value the company more highly than most of the world's biggest banks, while also cementing Ma's position as the nation's richest man. However, the week after Ma's Shanghai speech, the IPO was suspended and a series of regulations were introduced clamping down on Ant's lending business.

The new rules provided guidance on anti-competitive behaviours, including abuse of dominant market positions and using concentration and market power to restrict competition. Although this came as a big shock to investors, it seemed that this action was very much targeted at Alibaba and not a systemic risk to Chinese equities more broadly.

Fast forward to the end of June this year and China's largest ride-hailing platform Didi listed in the United States and raised US$4.4bn from US investors. However, just two days later the company was placed under investigation by the Cyberspace Administration of China and told to stop registering new users. The apparent concern being that Didi's data could be accessed by foreign interests and therefore endangered national security. According to accounts by Didi employees, the company was under pressure from the cybersecurity regulator to delay its IPO, but proceeded anyway. If this is the case, then the firm is likely to face more investigations and an uncertain future.

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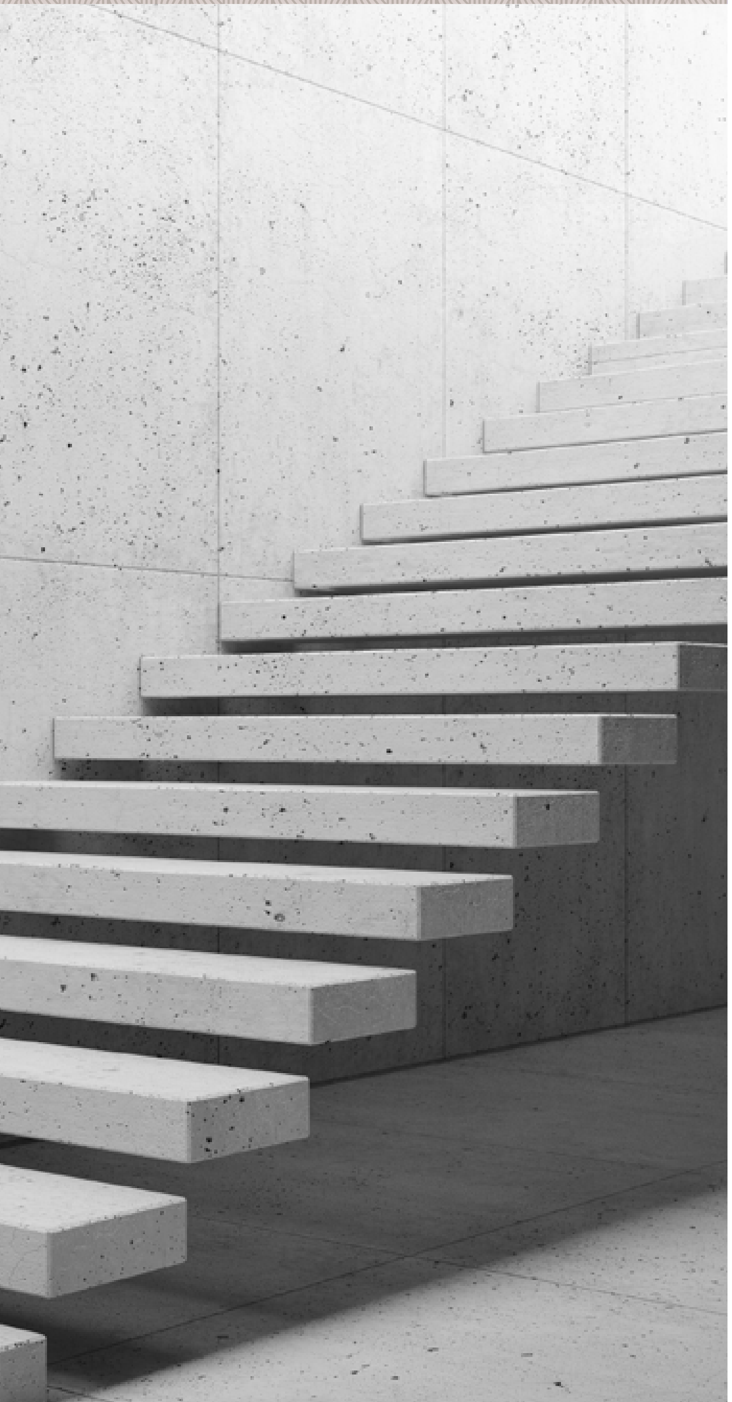

More recently, digital gaming stocks came under pressure when an editorial published in state media criticised the social consequences of video games. Next in the firing line were stocks of education companies, which have fallen significantly, as a leaked memo suggested that Beijing may require home-schooling education companies to register for non-profit status. The broader context here is that Chinese policymakers have been cracking down on sectors whose business practices they believe harm China's social fabric.

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The listing of Chinese companies in the US has attracted regulatory scrutiny over recent years due to concerns around corporate governance and these latest actions will only serve to strengthen the Security Exchange Committee's (SEC) resolve.

In December 2020, new legislation was passed which mandates the de-listing of firms that do not comply with the necessary auditing standards for three years running. In the absence of regulators in the US and China striking a deal, Chinese firms deemed non-compliant in their audits, face having to de-list in the US from 2024. The unique challenges of investing directly in Chinese equities are in the spotlight at a time when Chinese assets have been added to global bond and equity indices and international investors have increasing exposure. There are more questions than answers at this point regarding how this regulatory story will unfold, but this is certainly a risk that has become increasingly prominent.

Fixed Income

A Perfect Storm

With the S&P 500 hitting a new all-time high, copper and oil climbing higher and credit spreads subdued, the bond market continues to paint a gloomier picture with 10-year US Treasury yields ending the month at 1.22%. Yields declined by 25 basis points over the month and this took the total return on long dated bonds to almost flat year to date; a significant rally after rates topped out on the 31st March at 1.74%. So what is driving this disconnect?

Essentially it is a perfect storm of the reassertion of long bonds as a risk-off hedge, concerns over the Delta variant which is adding fuel to an already slowing economy, risks surrounding a potential Federal Reserve policy mistake and now the reduction of new US Treasury issuance supply due to the impact of the upcoming US debt ceiling.

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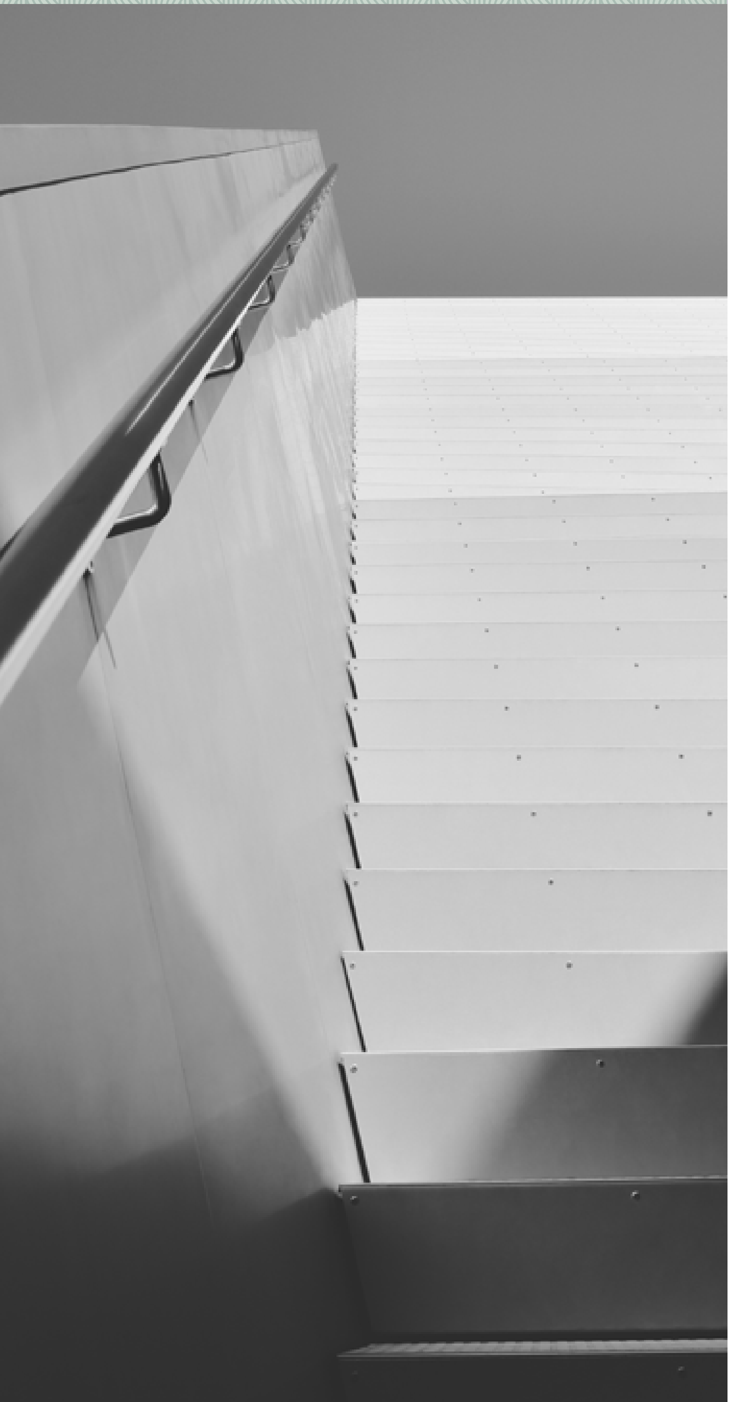
As we covered in last month's commentary, the COVID-19 Delta variant has been a key concern, but evidence from the UK showed that while vaccination does not prevent infection it largely prevents fatalities. This has continued to be the case over the past few weeks and UK case numbers have been falling more rapidly than expected, boosted by the school summer holidays, high vaccination and natural immunity rates.

Europe has for the most part performed better than expected as virus cases have not increased substantially since reopening. Over the Atlantic in the US, Delta has clearly become the dominate strain and is infecting the unvaccinated adults and children, primarily in states with low vaccination coverage (such as Alabama, Louisiana and Mississippi), but at this stage cases are manageable.

Not all vaccination programs are equal though and we are seeing massive rates of infection throughout the developing world, with Vietnam currently the worst globally. More worrying from a markets perspective is



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Australia, China and Japan, which together total 25% of global GDP. China looks to have a serious problem on par with the start of 2020, of which only severe lockdowns will be able to contain. In the near term this could be bad news for economic growth, company earnings and the reflation trade.

Although the economic and policy outlook has become more uncertain, over the past few weeks the bulk of the current global slowdown in activity remains centred on China and emerging markets. Europe is largely offsetting this weakness at the moment and the US, although displaying signs of slowing as elevated inflation across a multitude of items is starting to impact consumer sentiment and housing demand, managed to reopen fully this year providing a boost to global exports. This leaves us positive on global economic growth overall, as a less synchronised slowdown allows markets to ‘look through’ periods of weakness, as a major economic region will likely be growing every quarter.

We have many catalysts that could drive a renewed risk-off move, but the largest and most concerning is China. However, authorities have a lot of control over the economy, so can stimulate at will and COVID-19 will eventually pass, no matter how extreme the case growth becomes, as it moves in waves and become a non-story. In short, we have a volatile third quarter ahead of us, but at this current time we have faith that overall global growth will remain robust and we are a long way from a recession.

Portfolio positioning in our US dollar bond funds has been to overweight the 5-7 year part of the US Treasury curve in order to capture attractive carry and roll down returns,

with a large cash balance as a counterweight. This trade is still in place, but made a lot more sense with 5-year US Treasury yields at 0.90% versus 0.69% at the end of July. As a result we are looking for an opportunity to shorten duration and add exposure to the 3-year part of the curve. Although, falling US Treasury supply, solid buying momentum and continued Delta headlines, possibly leaves some more upside in this trade yet.

For multi-currency accounts, we start the month with overweights to the Japanese Yen and US dollar and an underweight to the Canadian dollar, which given its correlation to oil prices, is still vulnerable to any further global growth disappointments ahead. We remain neutral on the Euro and Pound Sterling, as Delta looks to have peaked in the region, and service-led sectors should perform well over the remainder of the year. Credit positioning remains overweight, as default rates are projected to stay very low with a recession very unlikely in the near term and monetary policy unlikely to be tightened quickly, but we prefer high yield exposure relative to investment grade on valuation differentials.

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Equities

Earnings Growth Well Ahead of Expectations

With two thirds of the S&P 500 companies having reported earnings for the second quarter of the year, earnings growth is tracking at a growth rate of +86% versus last year, against expectations of +61%. It sounds like hyperbole, but it is fair to say that company earnings in the US have been crushing expectations. There was some concern that wage inflation and higher input costs would compress margins, but profit margins set a new high of 12.1%. It is clear that the US has experienced a rigorous economic revival as a combination of loose fiscal and monetary policy, economic reopening and pent up demand underpin robust growth. Furthermore, analysts kept revising their forward earnings estimates higher, not lower, as the earnings season progressed; this is a very unusual phenomenon.

Consumer discretionary and the financials sectors are leading the positive earnings surprises with 31% and 25% growth respectively. 96% of the technology companies and 95% of the financial companies have beaten the analyst targets, suggesting that expectations were rather low despite the previous upgrades. The nature of the recovery from the pandemic, together with unprecedented levels of stimulus, has made for a challenging environment for analysts tasked with forecasting company earnings. In downturns, analysts tend to be too slow to downgrade earnings and in upswings too slow to upgrade them, so what we are seeing is the usual dynamic play out during a recovery, but the magnitude is much greater due to the nature of the pandemic shock.

Company earnings are by definition reporting events that have already happened and are now in the rear view mirror, while financial markets are by their nature forward looking. With a lot of good news already priced into equity markets, investors are largely disregarding this season's results and focusing on forward guidance instead.

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Investors have listened closely to commentary around the labor market and inflation outlook. There have been widespread reports of companies struggling to hire workers and this has put upward pressure on wages, especially at the low end of the wage distribution. Shortages have been caused by a combination of hesitancy to return to work due to the virus, extended unemployment benefits and challenges with finding affordable childcare. Furthermore, higher commodity costs and supply chain delays have also increased inflationary pressure. To date, companies suggest that they are managing rising input costs well and expanding margins by passing through prices or reducing costs.

With July dominated by Chinese regulatory action weakness in Chinese equities, there was a lot of focus on differences between the state-driven regulatory frameworks in China, compared to the US capitalist system of regulated free markets. While it is easy to criticise China’s regulatory clampdown, the truth is that the West is grappling with many similar questions. The large cap technology companies are the ones in the spotlight here: is Amazon too big and powerful? Is Apple’s App Store benefitting from monopoly pricing? Is Google Search really a utility? Is social media bad for democracy and social cohesion? How should companies use personal data? Given the scale of these businesses, antitrust action and higher taxes is one of the larger risks that global investors need to consider.

While there is a consensus across the Atlantic that regulation and antitrust action should be stepped up, there is less agreement on exactly what that should look like. Furthermore, the current US administration has a long list of priorities and again there is little agreement on exactly what action should be taken. We are following events closely, but where theory and practice can be easily aligned in China, in the US there is a big gap between what makes sense in theory and what can be legislated in practice.

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