CIO BLOG

Fahad Kamal | Chief Investment Officer
Investment Strategy | January 2022

TAILS OF THE UNEXPECTED IX

Markets are exquisitely unpredictable, and each year, events – financial, economic, geopolitical, or otherwise – occur which few see coming, but cause powerful ripples to the prices of securities. Instead of consensus-tinged forecasting, we continue an annual tradition of exploring what unlikely but feasible events are not priced by markets in the year ahead. These Tails of the Unexpected, pushed to the overlooked "tails" of probability distributions, have the potential for outsized impact. If they occur, how would our portfolios perform? Do we have plans in place to protect against adverse market events? Are we positioned to prosper?

Let's dive right in!!

THE FUTURE IS YOU KLEINWORT HAMBROS

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1 Ceiling Falls

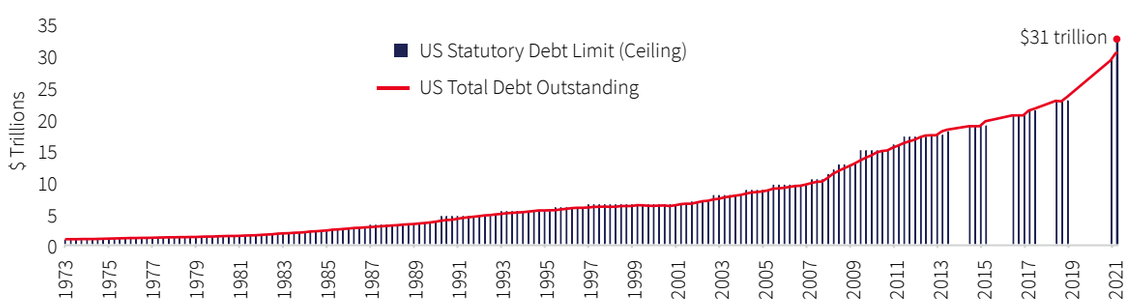
- **Consensus view:** The United States' borrowing power has been regulated closely since the first annual report of federal debt in 1791. Back then it was quoted as $75 million, or $2.4 billion in 2022 dollars - talk about inflationary pressures. Since a formal debt ceiling was instituted in 1917, it has been raised on an estimated 90 occasions over the past century, amidst enormous collective angst given the catastrophic implications of a US default. An annual "can kicking" bill being passed just in the nick of time has been taken for granted and was last seen in December, when the ceiling was raised by $2.5 trillion to a whopping $31.4 trillion in total.

- **What the consensus view is not pricing in:** Since the rise of Donald Trump in 2016 and the advent of populist narrative in mainstream federal politics, the partisan acrimony in the US has taken on horrific proportions – it's worse than anyone can remember, with both parties being pushed away from the political centre. In this toxic political environment, the Republicans decide "no more can kicking to pay for shameless Democratic excesses". No one blinks and, for the first time in its history, the US defaults on its debt.

- **Potential Market Reaction:** In a break from what was accepted as a cornerstone of capital market theory for the past century, United States debt stops being a risk-free asset, causing ructions throughout markets. Yields surge, the US dollar drops against all major currencies, and volatility spikes dramatically amidst spreading panic in equity and bond markets. Dollar-denominated Credit defaults mount as liquidity dries up and companies struggle to service existing floating-rate debt. Safe haven currencies like the Swiss franc and the Japanese yen rally, as does gold.

- **Our positioning:** Positioning for an event that threatens the very idea of the capital market theory is admittedly no easy feat. However, we continue to hold plenty of diverse safe havens in portfolios: Notably these include hedged gold positions (i.e. guarded against a catastrophic plunge in US dollar) and our Tail Risk Protection Note (TRPN), which is designed to capture upside if volatility surges. We may aggressively add to the latter should this kind of serious political gridlock begin to emerge ahead of debt ceiling debates.

Legislated US Debt ceiling levels over the ages
1973 - January 2022



Source: Bloomberg, Congressional Research Service, Office of Management and Budget, and Treasury Department

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2 A Force to be Reckoned With

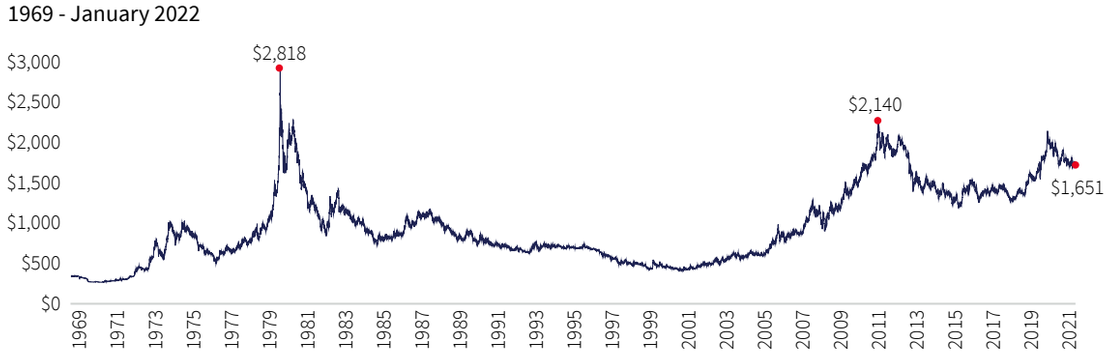
- **Consensus view:** The People's Republic of China have spent the past three decades resolutely building an empire of international relevance, largely by economic means - binding the Western world by dependence on its exports and much of the emerging world by infrastructure investments as part of its Belt and Road Initiative. The world acknowledges and partly condemns the autocratic nature of the Communist Party's (CCP) rule on the mainland and in Hong Kong, however few expect outright military action to finally annex Taiwan.

- **What the consensus view is not pricing in:** In 2022, Xi Jinping will receive his third term as head of the CCP; and subsequently in September he will begin his third term as President. Once these two are in the bag, imagine he goes rogue, cementing his legacy by achieving the long-sought reunification of the People's Republic of China and Taiwan (the Republic of China) by any means necessary. The US remains committed to "helping Taiwan develop and maintain the capability to defend itself" and aims to "dial down the temperature whenever possible" but is unlikely to respond with military force in case of an annexation. Much more likely it will introduce a set of strict punitive economic embargoes, encouraging its allies to follow suit.

- **Potential market reaction:** Despite significant efforts to onshore parts of their supply chain in the wake of the pandemic, developed equities could decline sharply on the prospect of additional supply chain issues and general economic disruption. Emerging Market equities – notably Asian markets, given their reliance on China as an economic powerhouse in the region – are hit especially hard, declining by -50%. As uncertainty takes hold of global financial markets, safe-haven currencies such as the USD and JPY surge and gold hits $2,800 – difficult to imagine in times of peace, though comparable to the metal's record price in real terms when the Soviets invaded Afghanistan in 1979.

- **Our positioning:** Relative to a standard basket of Global equities we maintain a neutral positioning on Emerging Markets, given their attractive valuations and long-term growth prospects. However, we hold significant exposures in safe haven assets to offset potential disruption to risk assets. In addition, we continue to hold dry-powder to deploy to distressed but attractive assets, which will surely present themselves in such a scenario – this includes active managers in the EM space with a proven record of identifying quality amidst the rough and tumble of Emerging Market equities.

Real Daily Price of Gold (2022 prices, USD)
1969 - January 2022



Source: Bloomberg, Factset

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3 Fed and Watered

- **Consensus view:** Inflation has gripped the public conscience globally and most central banks are expected to begin reversing ultra-loose post-Pandemic monetary policies. The US has the most acute price pressures in the G8 (CPI at 7%+), and thus the Federal Reserve, the vanguard of central banks, is expected to hike rates four times this year and begin Quantitative Tightening (QT, the opposite of Quantitative Easing).

  There is a wide consensus that bond yields can only rise, and equities – especially growth equities – will face pressure and volatility.

- **What the consensus view is not pricing in:** Current inflation is made up of two main components. First is the base effect from substantially lower energy prices a year ago. This effect will dissipate over time even at current prices. Moreover, shale production could finally ramp up production in response to higher prices as it breaks out of its current cost discipline and the Biden administration eases regulation in response to inflationary pressures.

  Second is ongoing supply chain bottlenecks. In the US, these could ease faster than expected on a combination of 1) a significant rebound in longshore workers and port employees, 2) economic incentives for clearing the deck of sitting containers, and 3) a lower volume of throughput in the post-Christmas period. Shipping costs have already fallen markedly from their peak (see chart below).

  This may well lead the Fed to raise rates at a slower pace than currently expected, perhaps only one or two times this year.

- **Potential Market Reaction:** Similar to previous years where policy proves more dovish than expected, bonds will rally as yields fall, and risk assets will rally, particularly those with cash flows that are less variable to economic cyclicality such as the growth equities. Moreover, the euro and yen – two currencies which have been hammered in 2021 – end up rallying as the expected yield differential between the ECB and the BOJ narrows relative to the Fed and the Bank of England.

- **Our positioning:** Such a scenario would be welcome. We are risk on, and risk assets would rally. Moreover, there would likely be outperformance from Growth equities in relation to Value, which few expect for 2022 – our positions are well balanced across the two factors. We would make gains on our bond positions, but as we are underweight, those would admittedly be limited. Our European and Japanese equity positions would have a favourable currency tailwind, all else equal.

Baltic Dry index
1985 - January 2022

Source: Bloomberg

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4 The Sun Rises in the East

- **Consensus view:** A bid to fix China's structural problems, like excess debt and social inequality, has morphed into something sinister. First is the ruling Communist Party's bid to take control of the Country's technology industry. Many fear this is killing the chutzpah and spirit that made China a tech power to rival the US, lacerating a critical pillar of the Chinese miracle. Second, policies designed to reduce leverage of the country's biggest real estate developers hit the sector hard and might well have triggered a real estate debacle on par with Japan's in the early 1990s, where property prices fell 80% (and the equity market more than halved). This cortex of negativity swirling around China has been widely publicised. Chinese growth estimates have been slashed for this year, with ramifications the world over.

- **What the consensus view is not pricing in:** Wave after wave of bad news from China has been priced into risk assets connected to the country. The country's equity market was down over 5% in a year where virtually every other major equity market was up handsomely. Once feared technology giants were lacerated in 2021: Alibaba returned -44%; Baidu returned -29%; Tencent returned -19%. Evergrande debt – the company has liabilities of about $300bn – are trading for pennies on the dollar.

  As of yet, the Chinese government has opted for the entire real estate situation to be dealt with "in a market-oriented way" as a full bailout may well give tacit approval of the reckless borrowing that led to this mess in the first place. On the other hand, the sheer size of Evergrande liabilities means a full-on collapse not only hitting creditors and customers, but also leaving tens of millions of ordinary Chinese people worse off – thus achieving the opposite of the "common prosperity" aim.

  The Chinese government may well accept that lessons have been widely learned and those most deserving of censure have been punished, therefore making it the right time to *step in and absorb some of the real estate losses, stabilising the market faster than expected*. Moreover, the crackdown on technology firms, at root, was about power and limiting the authority of tech executives who may have "overstepped". Those scales have also been rebalanced.

- **Potential Market Reaction:** There is big upturn in Chinese risk assets. Chinese equities rally by 50% this year, Chinese real estate bonds increase three-fold. A proxy to this is what happened to distressed Eurozone assets in 2011: Greek bonds went from yielding 27% in January 2012 to 10% by year end – they continued falling to 0.55% last year! China could indeed have its own "Whatever it takes" moment.

- **Our positioning:** We hold a substantial allocation to emerging markets, and our active managers will likely tilt further towards Chinese risk assets as conditions evolve for the better.

Greek Government 10 Year Yield (%)
2008 - January 2022

Source: Bloomberg

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5 Going Bananas

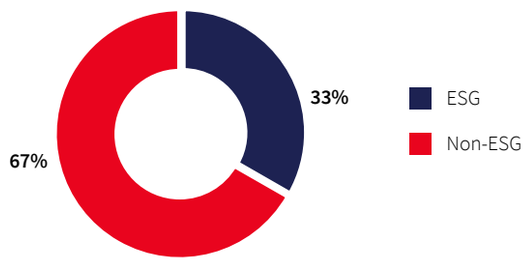
- **Consensus view:** COP26 – the 26th U.N. Climate Change Conference held in Glasgow last year – was yet another attempt to tackle the impact of climate change. However, even her majesty the Queen was noted to remark, "It's really irritating when they talk, but they don't do," and little of much significance came of the gathering of world leaders. The problem we face is that despite the rise in ESG (Environmental-Social-Governance) investing, of which climate change is only one facet, governments & financial markets are still struggling to coalesce on how to define ESG & responsible investing. Many firms and even governments are accused of greenwashing, as they spend more on marketing themselves as environmentally friendly than actually being environmentally friendly. Targets are either set with too low or too distant a bar to have a significant near-term impact, and no wonder - to say the connected costs are massive is an understatement of epic proportions. So for now, there is improvement enough for optics, if not enough effect.

- **What the consensus view is not pricing in:** We've seen Covid spread rapidly across the planet triggering massive lockdowns and an outpouring of financial aid to do everything possible to get the world back on track as quickly as possible, even if we are not yet fully there. Imagine that a new virus or possibly a fungus emerges, one more devastating than the presently feared Fusarium Tropical Race 4, that spreads like Covid. Few may realise that bananas – the world's most popular fruit and the most important traded fruit by value – are almost entirely of one genetic variety, the Cavendish. This became predominant when the Gros Michel banana was wiped out - luckily, we had the Cavendish. Imagine now that it is wiped out too.

- **Potential market reaction:** Aside from the devastating financial impact it would have on many smaller economies – bananas make up 9% of Costa Rican exports, while 70 million jobs in Africa depend on banana farming – the loss of the banana might also finally trigger a significant awakening in the belief that more needs to be done to protect the planet. Imagine, around the world, governments react to tighten and standardise ESG reporting standards. Initiatives, like the restrictions on thermal coal financing that are already in place, become more stringent. At first, markets would shudder under the regulations. Investment houses would race to comply quickly with tighter ESG standards while investors holding out-of-favour assets lose out. The proportion of ESG investments would soar at a pace that would dwarf the strong trend we have already seen.

- **Our positioning:** The effect of any tightening of ESG standards and comprehensive regulation of reporting requirements would cause a significant market sector rotation – where in-favour assets rise and out-of-favour assets drop – as investors move to comply. At present, we offer Responsible Investing (RI) portfolios with robust controls, and would look to ensure they remain fully compliant. Within our non-RI portfolios, where we are still actively looking to steer away from exposure to weak ESG names, we would look to shift exposure to meet any new regulations while also aiming to minimise any potential damaging effects.

Global value of ESG funds versus Global value of Investment funds
2020



Source: US SIF Foundation, Report of US Sustainable and Impact Investing Trends (13th Edition)

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