March 2022

Three from the front pages of the WSJ, beginning with two from Friday:

Stocks Suffer Worst Quarter In 2 Years Amid War, Inflation

BY GUNJAN BANERJI

A head-spinning quarter came to a disappointing end, with major stock indexes suffering their worst performance in two years and other markets recording some of the most extreme moves on record.

The action reflects a sense of dislocation shared by many traders and portfolio managers who are confronting challenges not seen in years. Yet their unease has been offset in part by a determination among many investors to take advantage of any price declines to add to positions in stocks, bonds and commodities.

Inflation has surged to its highest level in four decades, Russia's invasion of Ukraine has rattled already stretched supply chains and the Federal Reserve has embarked on a rate-increase plan whose pace investors struggle to handicap.

All three major U.S. indexes declined more than 1.5% on Thursday, with losses accelerating in the final hour of the session as traders dumped stocks to end the quarter. The declines have dragged the S& P 500 down 4.9% over the past three months, snapping a seven-quarter streak of wins. The Dow Jones Industrial Average and Nasdaq Composite have lost 4.6% and 9.1%, respectively, this year.

U.S. oil futures cleared $130 a barrel in early March, a level that flashed a warning for many economists. They have since declined to around $100, a price that likely limits immediate economic damage but still marks the biggest quarterly gain since 2008.

Underpinning the uncertainty that permeated the first quarter was the Fed's plan to raise rates. In doing so, the central bank removed a wave of stimulus that had driven stocks to dozens of records over the past two years and fueled a rush into some of the most speculative investments in the market.

That made the recent market downturn markedly different from the crash in 2020, which was abnormally short and severe. ...

Few assets were left untouched by the volatility. Investors have dumped bonds, sending yields on corporate and municipal bonds as well as Treasurys sharply higher. The Bloomberg U.S. Aggregate bond index—largely U.S. Treasurys, highly rated corporate bonds and mortgage-backed securities— returned minus 6% in 2022 through Wednesday, headed toward the biggest quarterly loss since 1980.

Wheat prices have climbed 31%, logging the best quarterly performance since 2010. The swings in nickel prices during the Ukraine crisis were so large that the London Metal Exchange closed trading in the commodity after a huge run-up in prices inflicted severe financial pressure on producers that sold nickel as a hedge. ...

Adding to the pain for many investors was the decline among shares of big technology companies, the biggest market leaders of the past decade.

Facebook's parent company, Meta Platforms, lost about $232 billion in market value in a single session after posting disappointing earnings, the biggest loss in market value for a U.S. company in history. The next day, Amazon.com recorded the biggest-ever one-day gain in market value.

Meta had its worst quarter since its shares started trading publicly in 2012 and has been one of the biggest losers within the S& P 500. Other former market leaders also struggled. Netflix has lost 38% this quarter, its worst period since 2012. ...

The S& P 500 outperformed the tech-heavy Nasdaq Composite by about 4.2 percentage points, the greatest margin since 2006, according to Dow Jones Market Data.

Other corners of the market have fared better. The S& P 500's energy sector has soared 38% and notched its best quarter in history. ...

Some optimism crept back into the market recently. After the Fed raised rates in March for the first time since 2018, a familiar pattern emerged. Investors piled back into stocks and stepped in to buy the dips in shares of tech and growth companies as well as more speculative bets that had suffered to start the year.

Bitcoin prices rebounded in March. Meme stocks like GameStop and AMC Entertainment have soared, gaining more than 30% for the month.

Some analysts said individual investors appeared to be piling back into the market, driving some of the gains, a move reminiscent of last year. ... Some institutional investors might have had to cover their bearish positions, accentuating the recent rally in tech, traders said.

The wild moves for big tech stocks continued in the last week of the quarter. Tesla shares jumped 8% in a single session after it said it would seek approval for a stock split, a move reminiscent of the frenetic 2020 rally in its shares ahead of a previous split.

While a sharp decline early in 2022 put the Nasdaq Composite Index in a bear market, more than 20% below its recent high, the rebound of the past weeks has cut its losses roughly in half. The Dow Jones Industrial Average and S& P 500 are just around 6% below their highs.

Some investors remain puzzled by the recent surge and have focused on the apparent disconnect between equities and other parts of the market. A widely watched signal in the bond market (the 2/10 yield curve inverted, as covered below in Global Investment Strategy's 2Q Outlook), for example, has been flashing a warning sign that a recession might be ahead.

Mortgage Rates Leap To Highest Since 2018

BY ORLA MCCAFFREY

The average rate for a 30-year fixed-rate loan jumped to 4.67%, mortgage-finance giant Freddie Mac said Thursday, marking the weekly figure's highest reading since December 2018.

The increase extends the 2022 surge in mortgage rates. The rise was hardly unforeseen, given the record low rates reached in the pandemic period and concerns about high U.S. inflation readings. But it has been faster than

many analysts expected. At the beginning of the year, the average rate on the U.S.'s most popular home loan was 3.22%.

Over time, higher mortgage rates typically slow home-buying activity. But for now, there are ample signs that the U.S. home boom, featuring surging prices, ultralow inventories and persistent demand around the country, is far from over. ...

So far, higher rates haven't dented consumer interest. The number of applications submitted by hopeful home buyers has risen for three of the past four weeks, according to the Mortgage Bankers Association trade group. Mortgage credit availability, a measure of lenders' willingness to issue home loans, rose in February to its highest level since last May, the bankers association said ....

Expectations that the Federal Reserve will raise interest rates several more times this year to control inflation are driving up mortgage rates.

Before the central bank in March raised rates for the first time since 2018, the Fed's decision to unwind its purchases of mortgage-backed securities had started forcing rates upward. ...

Still, people who want to buy a home this spring face plenty of challenges.

At the current sales pace, the supply of homes on the market would last 1.6 months, a record low, according to the National Association of Realtors.

The median American household would need to devote 34% of its income to cover monthly payments on a median-price home in January, according to the Federal Reserve Bank of Atlanta. That is the highest since November 2008. ...

and one from this weekend's:

Moscow Regroups, Signaling It's Ready for a Prolonged War

BY YAROSLAV TROFIMOV

Russia's war on Ukraine shifted gears this past week, as Moscow, lacking the strength to pursue rapid offensives on multiple fronts, began pulling back from Kyiv and other cities in the north, and refocused for now on seizing parts of the country's east.

The pivot, after five weeks of intense fighting, was a gauge of the intensity and effectiveness of Ukrainian resistance and signaled a decision by the Kremlin to pursue what is likely to become a prolonged war of attrition.

Ukraine's counterattacks— including a helicopter strike inside Russian territory—and Moscow's redeployment toward Donbas in Ukraine's east suggest that ... peace talks won't result in a deal anytime soon. ...

That could be a recipe for a prolonged conflict, increasing the stakes for both sides' ability to raise troops and money and access weapons, ammunition and supplies.

For Ukraine, with its smaller military resources, such a shift to a lengthy conventional war heightens the need for shipments of heavy weapons such as tanks and artillery, Ukrainian officials said.

Russia's declared shift toward trying to seize Donbas could allow it to concentrate firepower on a smaller front, shorten supply lines and make air support easier, giving Moscow a better chance at military success. It would also position Russia to try to encircle some of Ukraine's best units, which are stationed there.

The Russian pullbacks from Kyiv, however, also allow Ukraine to redeploy additional resources to the eastern Donbas front—and to do it much faster because of shorter routes.

Initial skepticism

Ukrainian officials were initially skeptical of Russian announcements that Moscow would limit military operations near Kyiv and Chernihiv, but lengthy convoys of Russian armor began leaving these areas Thursday, and scores of villages in northern Ukraine have been retaken by Ukrainian troops.

Russia initially appeared determined to retain a smaller, blocking force around Kyiv to threaten the Ukrainian capital and prevent a large Ukrainian redeployment to Donbas, Ukrainian officials say. But a threat of encirclement of these Russian forces, northwest or northeast of Kyiv, Friday precipitated a rapid withdrawal toward the Belarus border, often under fire. ...

Russia sent some of its best units to Kyiv and northern Ukraine. Many of them have been battered by fierce fighting and would need considerable time to be reconstituted and prepared for redeployment, military analysts say.

U.S. officials estimate that some 10,000 soldiers out of Russia's 190,000-strong force in Ukraine have been killed, with tens of thousands of others injured or taken prisoner. ...

Seeking to replenish its forces, Russia has been calling up reserves, sending to Ukraine troops deployed in Nagorno-Karabakh and South Ossetia as well as conscripts. Some of these troops, particularly from the Russian National Guard, which usually performs mostly internal-security duties, have refused orders to deploy to Ukraine.

British Air Marshal Edward Stringer, who headed operations for the British Defense Ministry and also helped create Britain's military training program in Ukraine, said Russia no longer has many additional reserves to throw into new offensives.

"Most of the effective combat power is already assigned to the war," he said. So Russian President Vladimir Putin " has to build some more, which is tricky without mobilizing and under sanctions, or concentrate the combat power that he has." ...

In northeastern Ukraine, Russian forces have tried for weeks to fight their way south, past the city of Izyum in the Kharkiv region. That maneuver, if successful, could allow them to link up with troops pushing from the southeast and encircle Donbas. Much of that southeastern force is still engaged in urban battles in the besieged city of Mariupol—and could renew its push north should Mariupol fall.

Ukraine has deployed some of its best units in Donbas, which is composed of the Donetsk and Luhansk regions. While Mariupol, a part of the Donetsk region, has been encircled, Ukraine has largely held the line to the north, including the key cities of Kramatorsk and Slovyansk. ...

Talks continue

Many Ukrainian officials and military analysts think the conflict is likely to drag on for months, or longer, even as Kyiv and Moscow continue peace negotiations. While these negotiators have made some progress on Ukraine abandoning its aspiration to join the North Atlantic Treaty Organization in exchange for binding security guarantees from the West ~~and Russia~~, Kyiv and Moscow still remain far apart on the status of Donbas and Crimea, among other issues.

Even though Russia has a much larger population—145 million to pre-war Ukraine's 37 million—and significantly more military equipment, time isn't necessarily on Moscow's side in a lengthy war of attrition. ...

Until recently, U.S. and allied weapon supplies to Ukraine were premised on estimates that Kyiv would collapse quickly, and that the war would largely be fought as an insurgency.

These weapons, such as Stinger antiaircraft missiles and Javelin and NLAW antitank missiles, can be carried by one person and have been heavily used by Ukrainian troops operating as small nimble units.

Instead, Ukraine has been engaged in fighting a large-scale conventional war, using long-range artillery, tanks, air defenses and its own warplanes and combat helicopters— military assets that, while being lost daily, haven't been replenished by the West.

West's aid

That is slowly beginning to change. On Thursday, U.K. Defense Secretary Ben Wallace said a donor conference of 35 nations agreed to provide Ukraine with long-range artillery, armored vehicles, counter- battery systems and antiaircraft and coastal-defense weapons. While falling short of the tanks and combat aircraft requested by Mr. Zelensky, these supplies, if delivered quickly, would significantly improve Ukraine's chances.

"The next three weeks will determine whether Russia's war of attrition can succeed. If we, the West, have the sense of urgency and can provide Ukraine with what it's been begging for, then they can break the back of the Russians while the Russians are down, and can win," said retired Lt. Gen. Ben Hodges, a former commander of the U.S. Army in Europe.

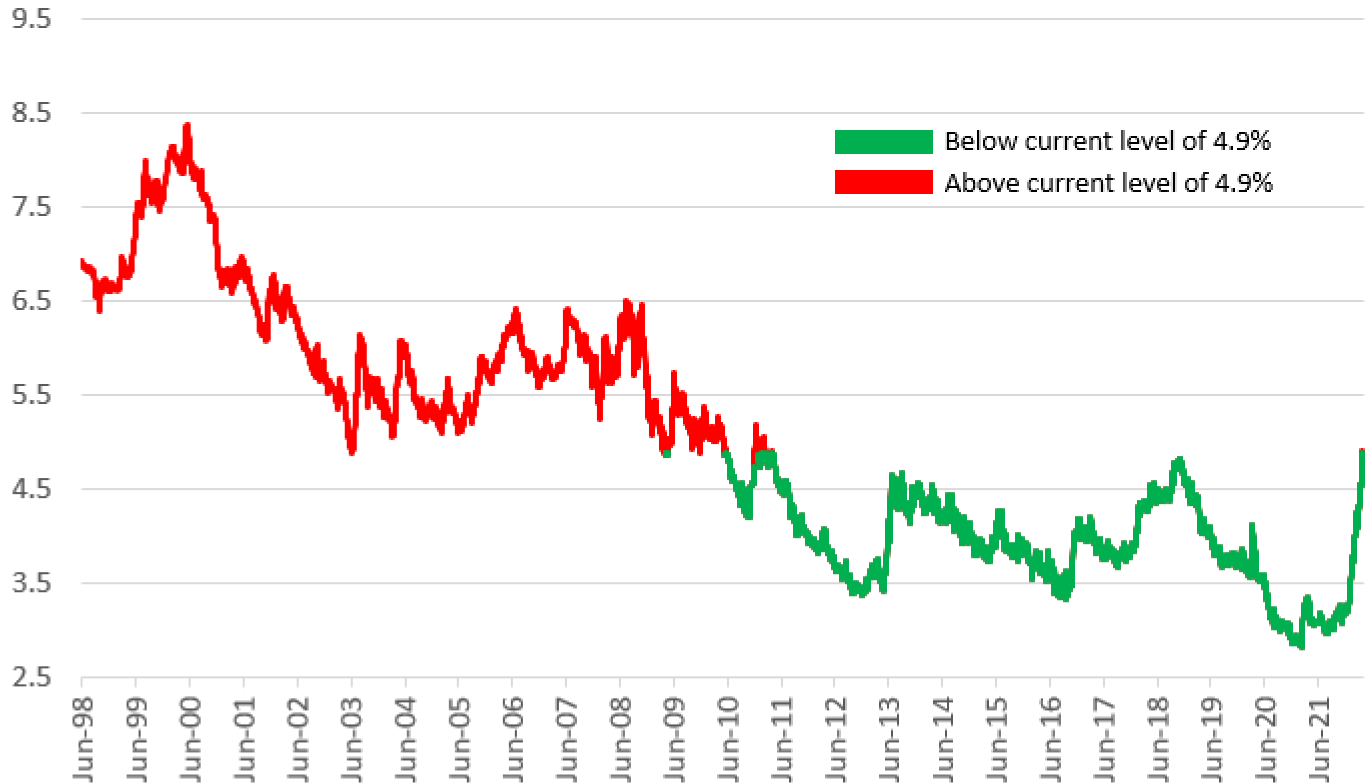
"But if we don't have that sense of urgency, the Russians will have the time to regroup, to reestablish logistics, and to continue grinding down Ukrainian cities and Ukrainian armed forces."

Three from Bespoke:

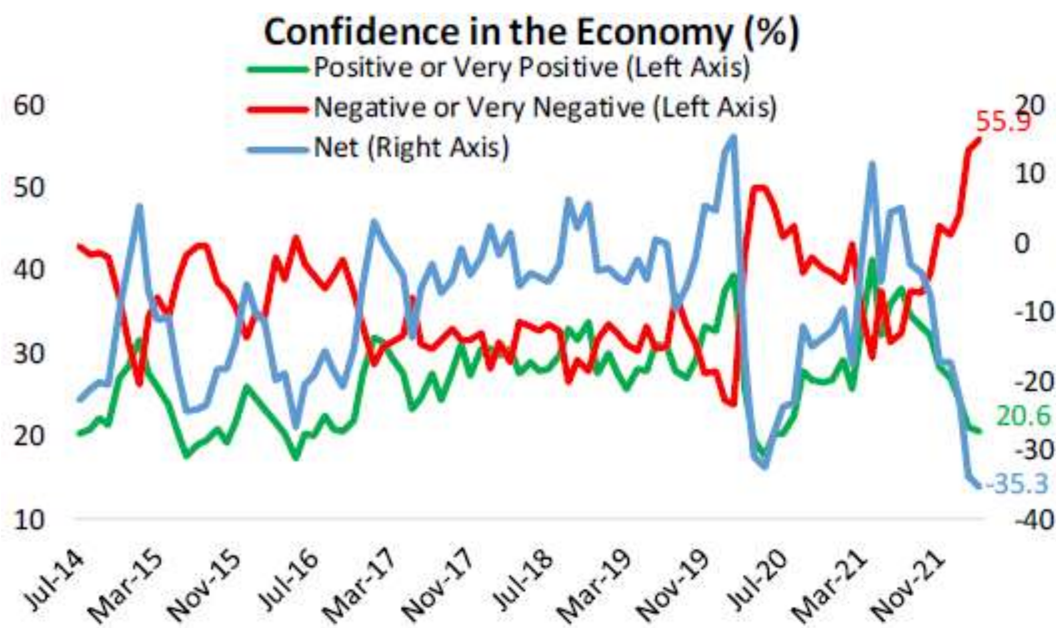
It's April Fool's Day, but the charts and data points below are no joke.

Apr 1, 2022

First off, mortgage rates were sitting at all-time lows in the 2s less than a year ago, but now they're closing in on 5% at levels not seen in at least a decade. Spikes like this cause a massive increase in monthly payments that prospective homebuyers were not factoring in until recently.



Interest rates are spiking due to massive inflation, which is causing consumer sentiment to completely tank to levels usually seen at the depths of recessions. We run a monthly survey of 1,500 US consumers balanced to census numbers, and in this month's survey, our "negative confidence" gauge continued to skyrocket to new all-time highs. Yes, the job market is great, but in terms of how consumers are feeling about things, it's BAD out there.



All the negativity was felt in the stock market in Q1, with the S&P 500 falling more than 13% from its high

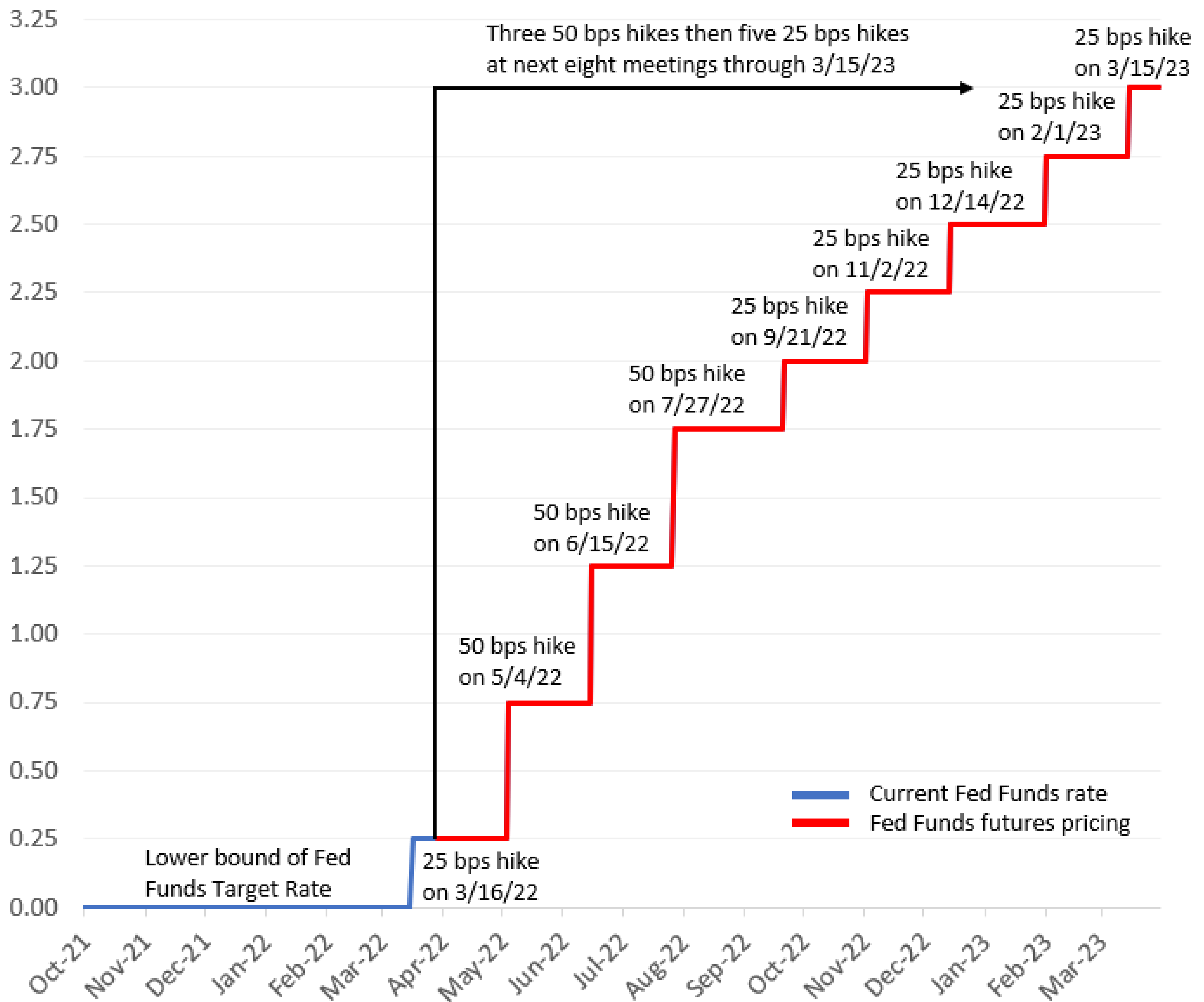
through early March. But investors went on a buying spree in the second half of March right after the Fed hiked rates for the first time in two years. The resulting 11% rally off the lows made Q1 2022 just the 12th quarter since WW2 that saw the S&P 500 fall 10%+ and then bounce back 10%+ as well.

Visualizing Rate Hike Expectations

Mar 28, 2022

Earlier this month, Fed Chair Jerome Powell raised the lower bound of the Federal Funds rate from 0% to 0.25%. It was the first time the Fed tightened monetary policy by hiking interest rates since the pandemic began in 2020.

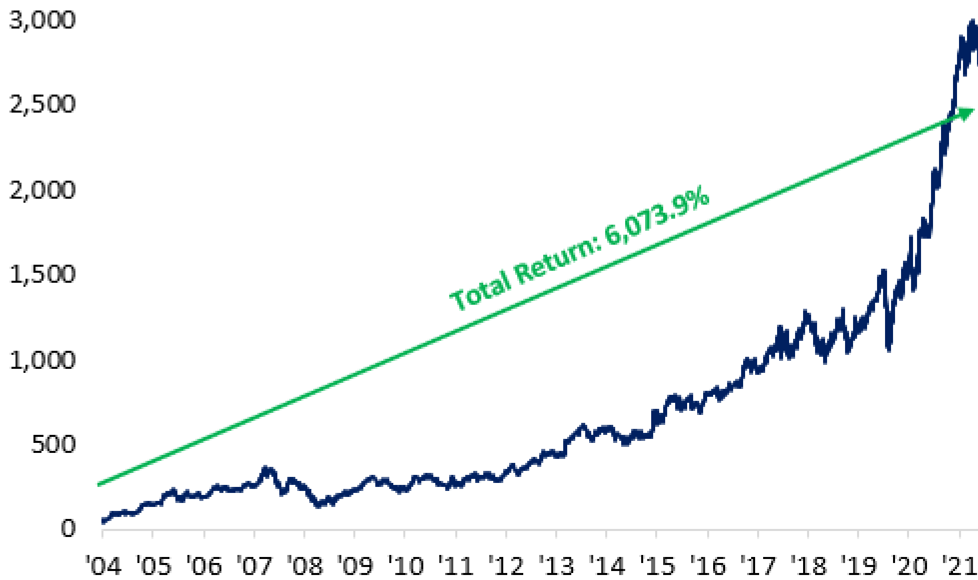
With inflation running extremely hot for months now and the Fed signaling that it plans on raising rates as much as it needs to in order to tame inflation, futures markets are pricing in a huge amount of further tightening over the next 12 months. Based on Fed Funds futures pricing, the chart below takes a look at the path that "the market" expects the Fed Funds rate to take from here through next March. As shown, the market currently expects Powell to hike rates by **50 basis points** in **each of the next three meetings** through July followed by **five consecutive 25 basis point hikes** beginning in September 2022.



"Verb" Stocks Hit the Curb

Fri, Mar 11, 2022

In the business world, there's an axiom that says: when your company name becomes a verb, you've arrived. Take the example of Google in the late 1990s. When people started replacing the phrase 'online search' with 'Google it', you just knew that Google was going to be a big company. Since its IPO in 2004, Google - now called Alphabet (GOOGL) - has been an absolute behemoth, posting a total return of 6,073.9% and an annualized gain of 26%. GOOGL has taken over the internet search business over the years, making it one of the world's most influential companies and the ultimate verb stock.



While GOOGL is an example of a verb stock that has seen stellar returns, a group of more recent verb stocks hasn't fared nearly as well. Over the past few years, certain companies have introduced products and services that have become so integral to their daily lives that their names have become verbs. Owe someone money for lunch? Just *venmo* them. Not feeling well? Might be a good idea to schedule a *teladoc* appointment with your doctor before going out. Need to sign a document? No need to print it out and fax it back. Just *docusign* it. Have a client meeting but traffic is a nightmare? Why don't you just hop on a *zoom*.

The services these companies offered became necessities of daily life during the pandemic, and because of that their stocks surged. We created an equally-weighted basket tracking the performance of PayPal (PYPL), Teladoc (TDOC), DocuSign (DOCU), and Zoom (ZM). From the start of 2020 (right before the pandemic) through the basket's peak in early 2021, these stocks tripled. Around that point, investors began to question what the outlook for these stocks would be when the economy re-opened, but proponents argued that the services these companies offered provided such a convenience that they wouldn't miss a beat.

While consumers around the world are still venmo-ing, teledoc-ing, docusign-ing, and zoom-ing, the stocks of all these companies have been imploding. The basket of four stocks has now erased all of its COVID gains and is now in the red relative to where it traded at the start of 2020.

Although there is a little bit of variation in the performance of these four stocks, the overall trend is largely similar. Of the four, ZM is the only one that is still positive relative to where it started in 2020. PYPL, TDOC, and DOCU, on the other hand, have declined 11.4%, 33.6%, and 4.1%, respectively. As you can see from the graph below, these stocks have round-tripped, erasing all of the gains provided by the pandemic. While valuations were certainly stretched for a while, the fact that these stocks are lower now than they were before COVID, even after proving their worth during the pandemic, shows how much sentiment has shifted in the last several months. One trend not working in favor of these verb companies is competition. As the pandemic proved the viability of their business models, competitors have been quick to step in. These days, someone may 'venmo' you using the CashApp, do a 'teladoc' appointment through CVS, 'docusign' an application using Adobe E-signature, or do a 'zoom' over Teams or Google Meets.

As clearly detailed on our Website, and regularly reinforced in our Worth Sharings over the years, Bonds should generally be avoided. From Morningstar:

Bond Investors Facing Worst Losses in Years

With inflation still running hot, bond prices are sliding as the market looks for faster Fed rate hikes.

Sandy Ward
Mar 23, 2022

Investors may be in for a rude surprise when they look at their bond investments come quarter-end.

The normally sleepy bond market is seeing some of its worst losses in years as the markets once again reset expectations for how quickly the Federal Reserve will be raising interest rates.

The latest back-and-forth around how much the Fed will raise rates has the bond market shifting into a "higher, faster" mode for interest rates thanks to inflation remaining elevated longer than most investors expected, a dynamic worsened by the spike in oil prices after Russia's invasion of Ukraine.

The result is that yields--which move in the opposite direction of bond prices--have been rising at their fastest pace in years. In just the past week, the yield on the U.S. Treasury 10-year note has jumped to 2.32% from 2.19%, and is up from 1.63% at the start of January. At the same time, the yield on the U.S. Treasury 2-year note has risen to 2.11% from 1.97% a week earlier, and 0.79% on Jan. 3.

This is translating into pain for bond investors in their portfolios.

The $16.5 billion iShares U.S. Treasury Bond ETF (GOVT) is down 5.90% for the year to date, falling more than 3% in the past month and more than 1% in the past week. A broader tracker of the bond market, the $305 billion Vanguard Total Bond (VBMFX), is down 6.4% this year, with a 2.7% decline in the past month. For comparison, the worst year in history for VBMFX was a 2.66% decline in 1994. ...

These declines are some of the worst that the bond market has seen in many years. For example, the Morningstar US 5-10 Year Treasury Bond Index is down 5.7% so far in 2022 and has lost some 9.6% since its last peak in August 2020, the largest drawdown in its history.

The rout in Treasuries that began Monday followed more hawkish inflation-fighting remarks by Federal Reserve Chairman Jerome Powell, less than a week after the central bank raised the federal-funds rate by 0.25 percentage points. That was the first rate increase since December 2018.

In a speech to the National Association for Business Economics, Powell said inflation "is much too high," and that the Fed would move "more aggressively by raising the federal-funds rate by more than 25 basis points at a meeting or meetings" if the central bank deemed it appropriate.

Powell also signaled there would be a series of similar-sized hikes coming through the duration of the year as it seeks to bring down inflation without tipping the economy into recession. ...

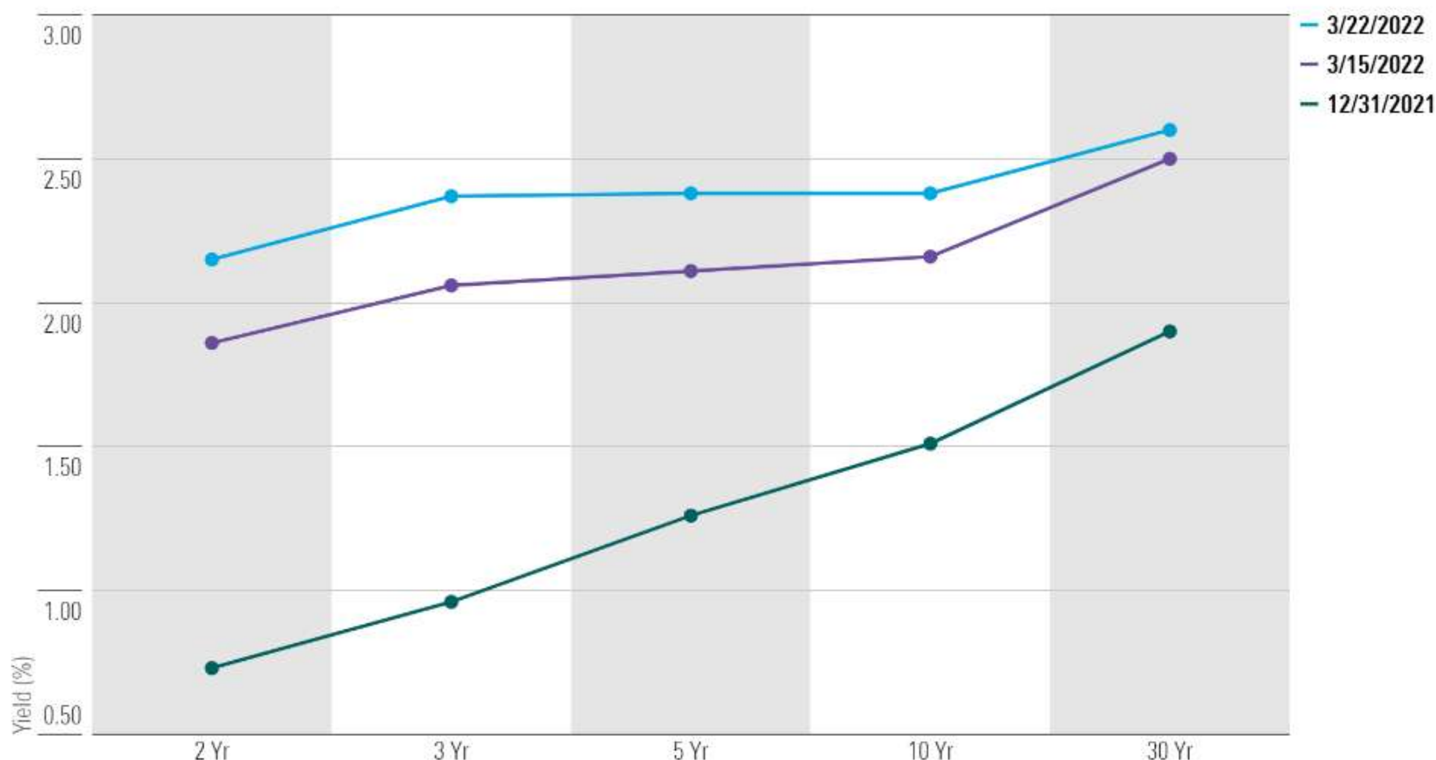
In response to Powell's comments, the market began pricing in a more aggressive pace of interest-rate increases. Expectations shifted from a consistent series of 25-basis-point rate hikes over the course of the year to 50-basis-point increases in May and June, along with continued hikes over the course of 2020. Wall Street firms, such as Goldman Sachs, are now calling for 50-basis-point increases in the funds rate at the next two meetings.

"The market is implying the Fed will move faster and at a higher rate of 50 basis points potentially at the next couple of FOMC meetings," says David Sekera, Morningstar's chief U.S. market strategist.

Powell also reiterated that the Fed would begin to shrink its $9 trillion balance sheet this year, which would result in a further tightening of monetary policy. This so-called "quantitative tightening" would reverse the impact of the Fed's bond-buying program--"quantitative easing"--employed to push bond market yields down during the pandemic recession and help stimulate the economy.

With its buying program, the Fed was essentially the largest purchaser of bonds in the market. It was only two weeks ago that the Fed stopped buying Treasury bonds. ...

Powell indicated that more details on the Fed's thinking around cutting its bond holdings will be available when minutes are released from the most recent meeting of the policy-making Federal Open Market Committee. That



is scheduled for release on April 6.

"Based on how much and how fast the Fed decides to unwind the balance sheet could have a significant impact on the supply-demand characteristics of the bond markets," says Sekera.

Complicating the Fed's policy decision making is the war in Ukraine, which has accelerated inflationary pressures by disrupting the energy, metals, and agricultural markets. ...

There is also widespread agreement that the Federal Reserve waited too long to address inflation threats. ...

One of the fundamental issues dogging the bond market is uncertainty about how high rates will actually need to be raised.

Fed policy has been exceptionally accommodative, keeping rates very low as a way to boost the economy during the pandemic. The Fed has set a 2% target rate for inflation and to meet its goal of achieving full employment and price stability. With inflation running at about 8% that is seen as too low and off target.

As a judge of where the Fed needs to get to, investors try to assess what the bank's "neutral rate" should be, which the central bank defines as an interest rate level that doesn't accelerate growth and doesn't crimp demand. ...

Another from Morningstar, this time a better late than never?

Autocracy Is a Bad Investment

Russia, China highlight the need to consider 'regime risk.'

Tom Lauricella
Mar 8, 2022

Investors in Russian stocks and bonds played with fire and have gotten burned.

In the wake of Russia's horrific invasion of Ukraine, stocks and bonds from Russia are being written off as essentially worthless, inflicting losses on investors.

But there is a broader lesson for investors to consider: when it comes to investing in autocratic countries such as Russia, the normal rules of picking stocks and bonds, such as valuations or the fundamental outlook of a company or country, can be rendered irrelevant overnight.

Sure, investors might make money for a while, but in the end, all that matters are the rules set by the person running the country. And often that means they are setting the rules to maintain power, enrich themselves and their cronies, or both.

It was one thing to miss the risks of investing in Russia. It's a country where most diversified investors have only a small percentage of their portfolio. It's a different story for a country like China. Many mutual funds and stocks have hefty direct or indirect exposure to the country, and observers who had warned about Russia are encouraging investors to ask similar questions about China.

"China has been this incredibly lucrative emerging market to invest in, but there's been so little discussion of the regime," says Jon Hale, director of sustainability research for the Americas at Morningstar.

The question directly confronting investors is whether "it is really sustainable long term to be investing in these kinds of countries," Hale says. It's "a systemic risk that we are all contributing to and that we should be paying more attention to."

And the reality has been that for more than the past decade, investors would have been better off keeping their money in the United States rather than sending it to Russia or China.

Geopolitical Risk and Rule of Law

One way to look at these questions is to consider the two risks of investing in autocracies: geopolitical risks and rule of law.

Russia's attack on Ukraine is an extreme example of the geopolitical risks that come with investing in autocratic countries. The risk that investors are more likely to bump up against is rule of law.

Rule of law should be a primary consideration for investors, says Bill Browder, the famed hedge fund manager who made his fortune in Russia, only to be deported after run-ins with oligarchs and whose Russian lawyer was arrested in Moscow, mistreated by authorities, and died in a prison.

"You can do all the analysis you want on an industry, on the economics, on the management team, and then all of a sudden somebody comes along and rips you off, and you don't have any recourse in the courts, you don't have recourse in the media … and generally if they're not rule-of-law countries, you have no recourse with the regulators," he says. "It's flying by the seat of your pants, hoping you're in the good graces of whoever is in charge."

Browder says he's heard various rationales and strategies for investing in countries like Russia. For example, investors should avoid strategic industries such as oil and gas that are likely to be closely aligned with the power structure and corrupt officials. "Yes, you can invest in nonstrategic industries, but usually the only things aren't strategic are money-losing," he says.

Who's Lying?

There's also the lack of transparency in autocratic or authoritarian regimes.

Many mutual fund companies and professional investors like to talk about their "boots on the ground" research when it comes to stock or bond research. But consider the example of BlackRock's emerging-markets team. As Morningstar analyst Samuel Lo noted, "The team running Silver-rated BlackRock Emerging Markets (MADCX) thought the odds of warfare were unlikely after some team members visited Russia in late January as the country mustered more than 150,000 troops on its neighbor's border. The fact that the population did not seem primed for a full-scale invasion and other factors, including cheap valuations, argued in favor of maintaining the strategy's long-term positions in Russia, the team said on Feb. 16."

Of course, there were many observers who did not believe Russia would invade Ukraine. And it's not as if a mutual fund manager could ask someone in power if Russia was going to invade Ukraine and get an answer. But Browder says this reflects a broader point.

"In America when officials or company managers tell you something, they tell you the truth," Browder says. "They may not be telling you everything, and they might hold back information, but they will tell you the truth. In Russia and in places like Russia, [company managers and officials] lie and there is no shame in lying. They'll say, 'We have no intention of defaulting' and then default the next morning."

Tie it all together, Browder says, and investors wrongly think they can approach these markets the same way

they do a market that operates on investor-friendly principles. "You have somebody who says, 'OK, I've done my research, I've read *Barron's* and Gazprom is trading at 2 or 3 times earnings."

Parallels are being drawn between Vladimir Putin's designs on Ukraine and China's long-running claims on Taiwan. China has also been cracking down on freedoms in Hong Kong and has been persecuting its Uyghur population. But China doesn't have to go as far as invading Taiwan to show investors the risks that come with investing in the country.

Last summer the Chinese government imposed a regulatory crackdown on internet companies that included some of the biggest names in the market, ones owned by most emerging-markets and China stock funds, such as Alibaba (BABA) and Tencent (TCEHY) . Over the past year, Alibaba has lost nearly 60% of its value and Tencent more than 40%. Chinese regulators also took aim at private education companies. TAL Education (TAL) was one of the names in the crosshairs of the Chinese government, and its shares have lost roughly 97% of their value over the past year.

These moves, along with heightened tensions between the U.S. and China over issues such as corporate disclosure policies for publicly traded stocks, hammered U.S. investors in Chinese equities.

As Perth Tolle, manager of Freedom 100 Emerging Markets ETF (FRDM), recently said in an interview with Morningstar's Leslie Norton, "From an investment standpoint, the biggest concern is not Russia, which is 3% of most benchmarks, but China, which is more than 30% of most emerging-markets indices. That's a huge concentration risk."

Says Browder: "Just because it's a big economy that's grown doesn't mean they're going to treat foreign investors fairly as they get more nationalistic."

Hidden Risks

Even if investors don't have direct exposure to autocratic countries, they may have hidden risks from companies based elsewhere in the world that do business in nations lacking in rule of law. A frequent example, says Shin Furuya, impact investment strategist at Domini Impact Investments, are energy and other natural-resources firms. "A European or Asian energy company might well be on the ground in Sudan, or the same thing with Myanmar," he says.

Energy and natural-resources companies often have to partner with state-owned enterprises, which makes it very difficult to disentangle from the risks posed by a government that might be involved in war, human rights abuses, or have a considerable degree of corruption.

Risk vs. Reward

For all these risks, there has not been much in the way of returns from Russia and China over the past decade. Prior to the closing of Russia's financial markets, the RTS Index had returned an average of 4.2% a year for the past 10 years, the S&P/BNY Mellon China Select Index 1.9% a year, and the Hang Seng Index negative 0.24% a year. Meanwhile, the Morningstar US Market Index averaged 14.9% returns for the past decade.

Long-Term Performance

Source: Morningstar Direct. Data as of March 7, 2022.
All indexes shown in Total Returns USD except Hang Seng China Enterprises, which is shown in HKD.

Browder notes that markets like China, while they have periods of outperformance, are afflicted by [big drawdowns caused by political decisions] . "If you're a trader, you can find moments when the markets are really bombed out, and then you trade out of it. But long term … there's just as much chance that you will lose money as make money."

Morningstar's Hale thinks that with investors being burned in Russia and China, perhaps awareness of regime risk will grow among investors. That could extend to countries such as Turkey and Hungary. "I think it will be considered more prominently than it has been in the past couple of decades," he says.

Turkey, mentioned above, is another EM that we have specifically warned about. From Verdad on Mar. 7th:

The Crisis in Turkey

By: Johann Colloredo-Mansfeld, Greg Obenshain, Dan Rasmussen, and Igor Vasilachi

Only a few weeks ago, the economic crisis in Turkey dominated headlines. Even as the US market soared to new highs, Turkey's stock market experienced a brutal >50% sell-off. But the market barely noticed this week as Turkey posted a 54% year over year rise in consumer prices in February. Below we show the performance of the S&P 500 and MSCI Turkey indexes in both local and dollar-denominated currencies since the beginning of 2020. (As shown below, it is critical, especially with EMs, that when we compare stock Indexes that they be in USD.)

Figure 1: MSCI Turkey and S&P 500 Index Performance (1/2020-12/2021)

Source: Capital IQ

Turkey is experiencing a crisis that follows what Paul Krugman described as a familiar script for emerging economies: foreign capital pours into a hot emerging market, the debt is denominated in dollars, a small shock hits that causes a "sudden stop" in foreign lending, the loss of confidence causes a drop in the currency, this makes it harder to repay USD-denominated debt, and this hurts the real economy, which further hits confidence in the currency, and so on.

Leaders in this situation face a terrible choice. Either raise interest rates to nosebleed levels to prevent capital flight and depress the economy or allow the currency to depreciate, create runaway inflation, and hope that the eventual export boom saves the economy from climbing debt-to-GDP ratios.

Figure 2: Turkish Lira vs. US Dollar Exchange Rate (2/2021-1/2022)

Recep Tayyip Erdoğan, Turkey's leader, has taken the latter path. He has replaced central bank leaders with political allies, repressed critics, and vowed to battle "the scourge" of high interest rates by lowering them in the face of high inflation. ...

From Saturday's Global Investment Strategy:

2022 Second Quarter Strategy Outlook – The New Neutral

I. Overview

We continue to recommend overweighting global equities over a 12-month horizon. However, we see downside risks to stocks both in the near term (next 3 months) and long term (2-to-5 years).

In the near term, stocks will weaken anew if Russia's stated intentions to scale back operations in Ukraine turn out to be a ruse. (As detailed in today's WSJ shared above, Russia is not scaling "back operations", but is in the process of repositioning its forces to concentrate on taking the entire Donbas region, and securing a defensible land bridge from there to Crimea.) There is also a risk that China will need to temporarily shutter large parts of its economy to combat the spread of the highly contagious BA.2 Omicron variant.

While stocks could suffer a period of indigestion in response to monetary tightening by the Fed and a number of other central banks, we doubt that rates will rise enough over the next 12 months to undermine the global economy. This reflects our view that the neutral rate of interest in the US and most other countries is higher than widely believed.

If the neutral rate ends up being between 3.5% and 4% in the US, as we expect, the odds are low that the Fed will induce a recession by raising rates to 2.75%, as the latest dot plot implies.

The downside of a higher neutral rate is that eventually, investors will need to value stocks using a higher real discount rate.

How fast markets mark up their estimate of neutral depends on the trajectory of inflation. We (as was HCM) were warning about inflation before it was cool to warn about inflation ....

Our view has been that inflation will follow a "two steps up, one step down" pattern. We are currently near the top of those two steps: US inflation will temporarily decline in the second half of this year, as goods inflation drops but service inflation is slow to rise.

The decline in inflation will provide some breathing room for the Fed, allowing it to raise rates by no more than what markets are already discounting over the next 12 months.

Unfortunately, the respite in inflation will not last long. By the end of 2023, inflation will start to pick up again, forcing the Fed to resume hiking rates in 2024. This second round of Fed tightening is not priced by the markets, and so when it happens, it could be quite disruptive for stocks and other risk assets.

Investors should overweight equities on a 12-month horizon but look to turn more defensive in the second half of 2023.

II. The Global Economy

War and Pestilence Are Near-Term Risks

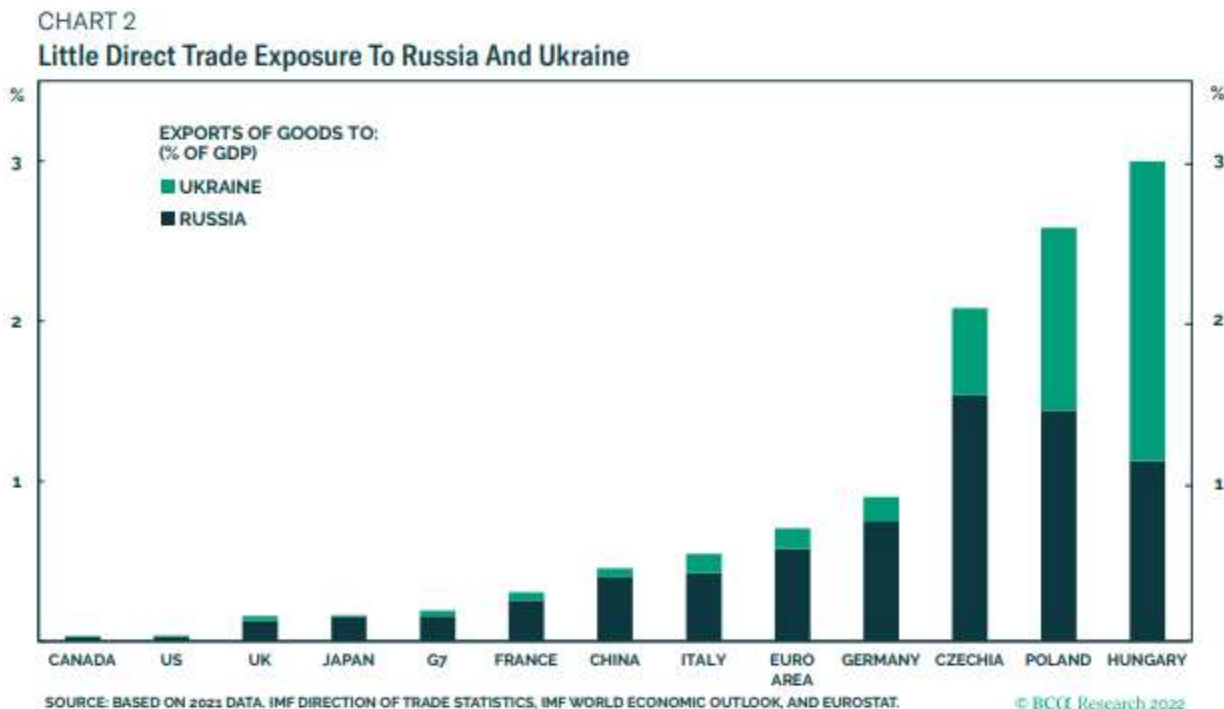
BCA's geopolitical team, led by Matt Gertken, was ringing the alarm bell about Ukraine well before Russia's invasion. ...

The West is not keen to give Putin an easy off-ramp, and even if it were, it is doubtful he would take it. The only way that Putin can salvage his legacy among his fan base in Russia is to decisively win the war in order to ensure Ukraine's military neutrality.

For his part, Zelensky cannot simply agree to Russia's pre-war demands that Ukraine demilitarize and swear off joining NATO unless Russian forces first withdraw. To give in to such demands without any concrete security guarantees would raise the question of why Ukraine fought the war to begin with.

The Impact of the Ukraine War on the Global Economy

The direct effect of the war on the global economy is likely to be small. Together, Russia and Ukraine account for 3.5% of global GDP in PPP terms and 1.9% in dollar terms. Exports to Russia and Ukraine amount to only 0.2% of G7 GDP (**Chart 2**). Most corporations have little direct exposure to Russia, although there are a few notable exceptions (none of those listed are held directly by HCM clients).

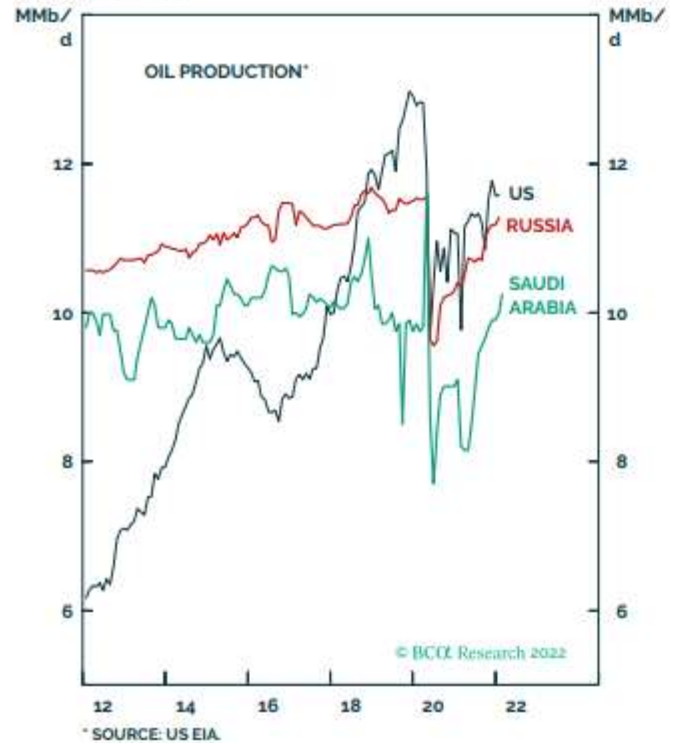


In contrast to the direct effects, the indirect effects have the potential to be sizable. Russia is the world's second largest oil producer, accounting for 12% of annual global output (**Chart 4**). It is the world's top exporter of natural gas. About half of European natural gas imports come from Russia. Russia is also a significant producer of nickel, copper, aluminum, steel, and palladium.

Russia and Ukraine are major agricultural producers. Together, they account for a quarter of global wheat exports, with much of it going to the Middle East and North Africa. They are also significant producers of potatoes, corn, sugar beets, and seed oils. In addition, Russia produces two-thirds of all ammonium nitrate, the main source of nitrogen-based fertilizers.

Largely as a result of higher commodity prices and other supply disruptions, the OECD estimates that the war could shave about 1% off of global growth this year, with Europe taking the brunt of the hit.

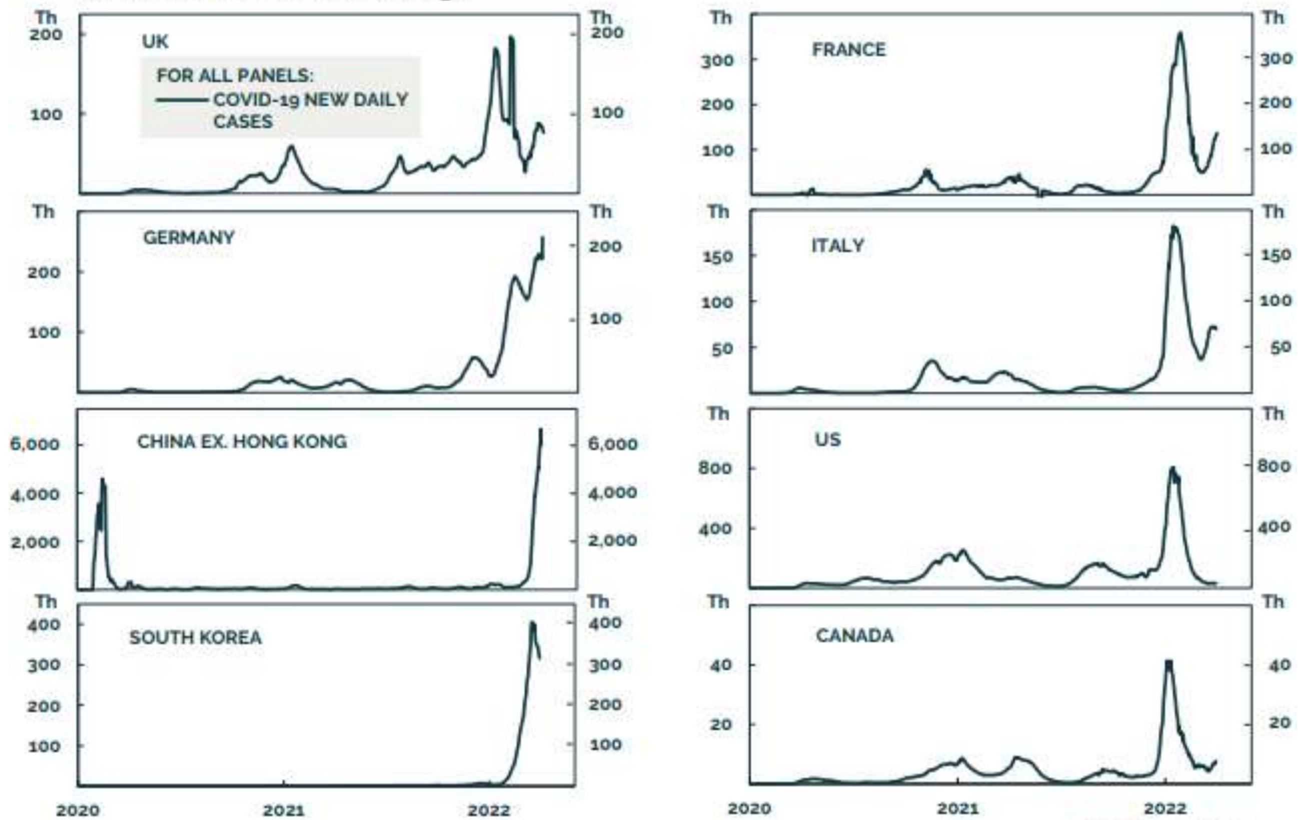
At present, the futures curves for most commodities are highly backwardated. While one cannot look to the futures as unbiased predictors of where spot prices are heading, it is fair to say that commodity markets are discounting some easing in prices over the next two years. If that does not occur, global growth could weaken more than the OECD expects.



Another Covid Wave

... In the pre-Omicron days, keeping the infection rate below one was difficult, but not impossible for countries with the means and motivation to do so. As the virus has become more contagious, however, keeping it at bay has grown more difficult. The latest strain of Omicron, BA.2, appears to be 40% more contagious than the original Omicron strain, which itself was about 4-times more contagious than Delta.

BA.2 is quickly spreading around the world. The number of cases has spiked across much of Europe, parts of



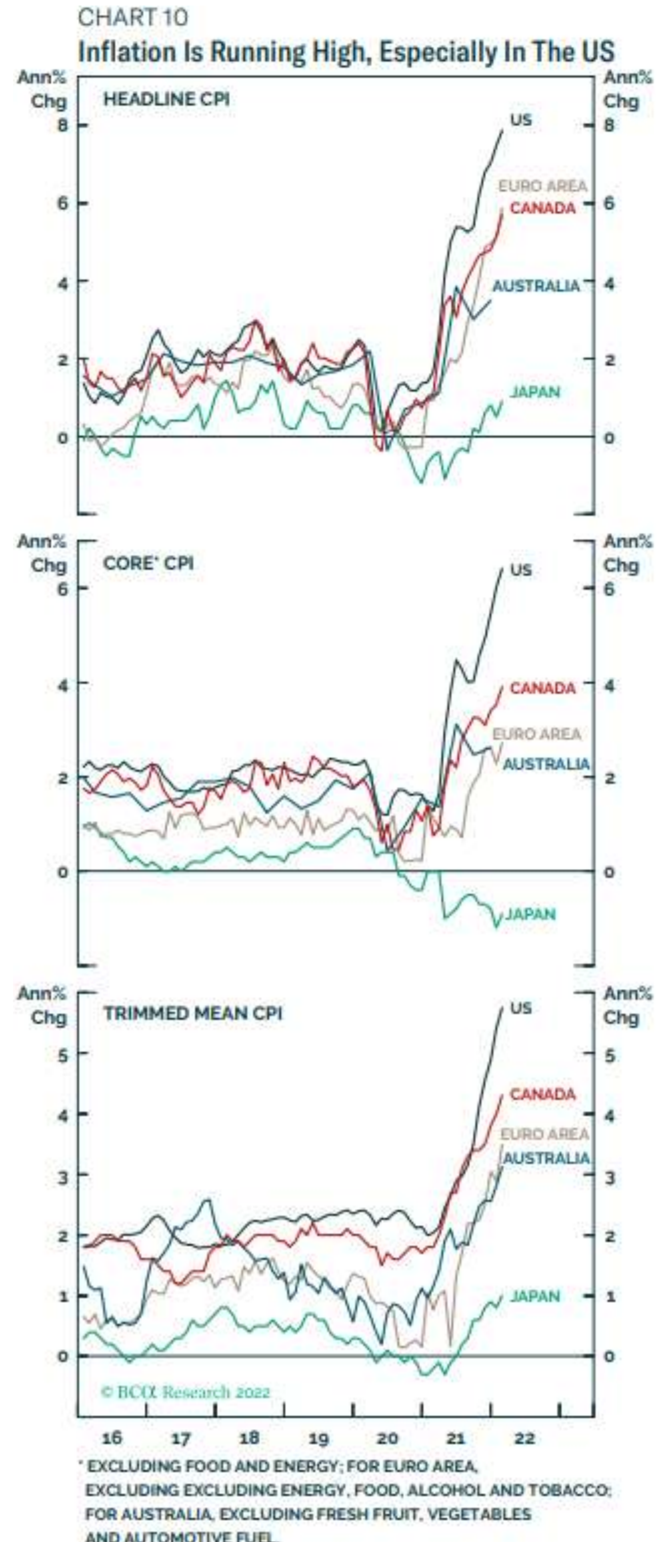
Asia, and has begun to rise in North America **(Chart 8)**. In China, the authorities have locked down Shanghai, home to 25 million people.

The success that China has had in suppressing the virus has left its population with little natural immunity; and given the questionable efficacy of its vaccines, with little artificial immunity as well. Moreover, as is the case in Hong Kong, a large share of mainland China's elderly population remains completely unvaccinated.

This presents the Chinese authorities with a difficult dilemma: Impose severe lockdowns over much of the population, or let the virus run rampant. ...

Our guess is that the Chinese government will choose the former option. China has already signed a deal to commercialize Pfizer's Paxlovid. The drug is highly effective at preventing hospitalization if taken within five days from the onset of symptoms.

Fortunately, Paxlovid production is starting to ramp up (Chart 9). China will probably wait until it has sufficient supply of the drug before relaxing its zero-Covid policy. While beneficial to growth later this year, this strategy could have a negative near term impact on activity, as the authorities continue to play whack-a-mole with Covid.



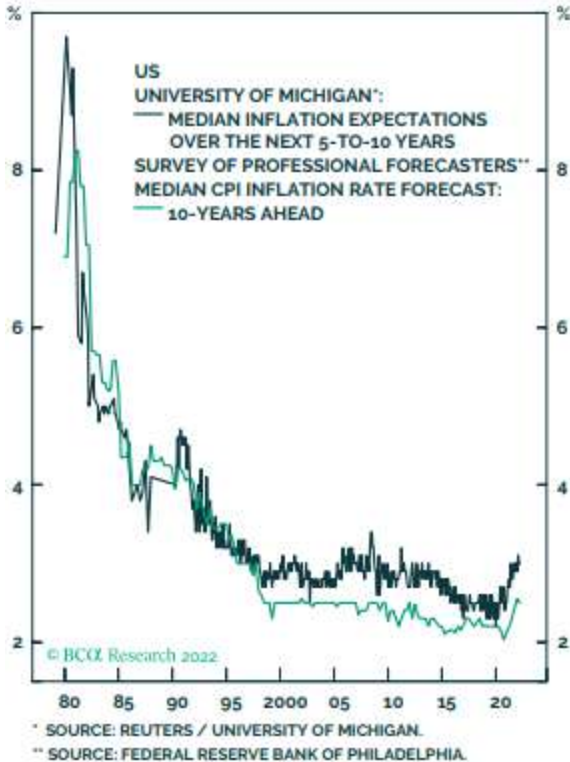
Central Banks in a Bind

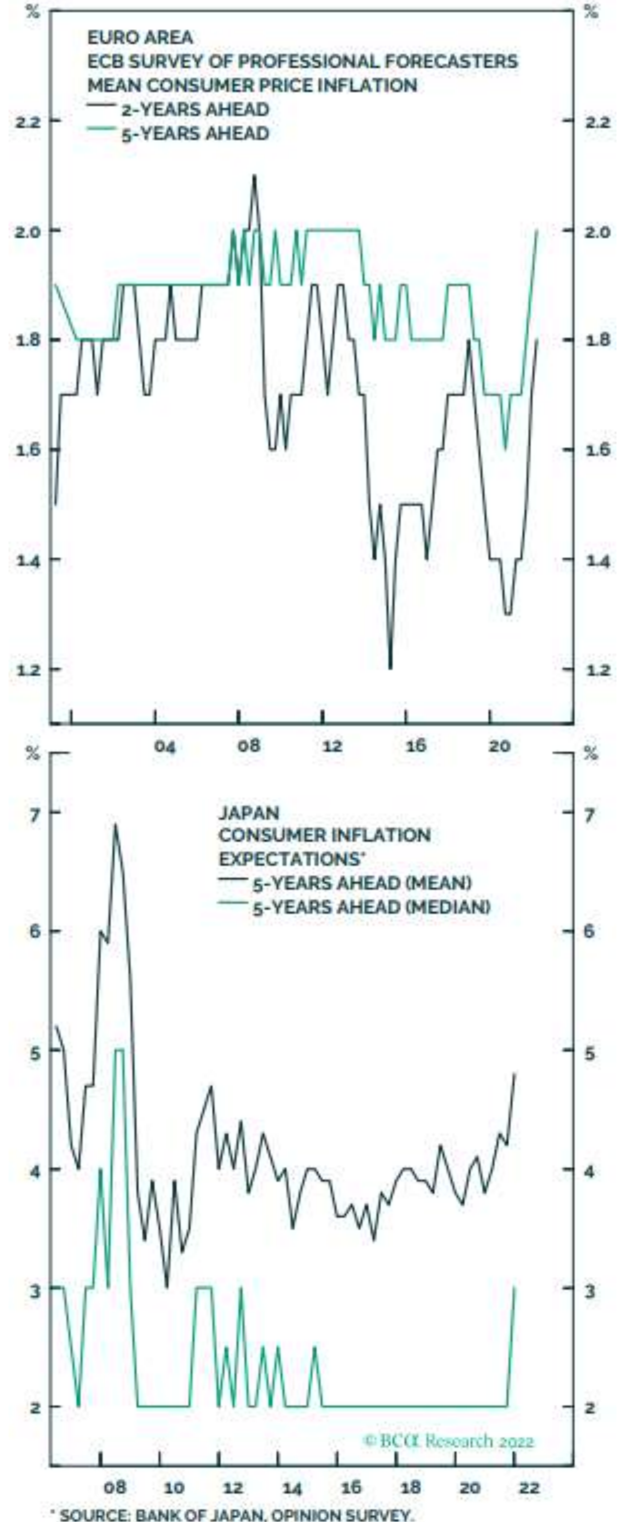
Standard economic theory says that central banks should adjust interest rates in response to permanent shocks, while ignoring transitory ones. This is especially true if the shock in question emanates from the supply side of the economy. After all, higher rates cool aggregate demand; they do not raise aggregate supply

The lone exception to this rule is when a supply shock threatens to dislodge long-term inflation expectations. If long-term inflation expectations become unanchored, what began as a transitory shock could morph into a semi-permanent one.

The problem for central banks is that the dislocations caused by the Ukraine war are coming at a time when inflation is already running high. Headline CPI inflation reached 7.9% in the US in February, while core CPI inflation clocked in at 6.4%. Trimmed-mean inflation has increased in most economies (**Chart 10**).

Fortunately, while short-term inflation expectations have moved up, long-term expectations have been more stable. Expected US inflation 5-to-10 years out in the University





of Michigan survey stood at 3.0% in March, down a notch from 3.1% in January, and broadly in line with the average reading between 2010 and 2015 (**Chart 11**). Survey-based measures of long-term inflation expectations are even more subdued in the euro area and Japan (**Chart 12**).

Market-based inflation expectations have risen, although this partly reflects higher oil prices. Even then, the widely-watched 5-year, 5-year forward TIPS inflation breakeven rate remains near the bottom of the Fed's comfort range of 2.3%-to-2.5% (**Chart 13**).

Goods versus Services Inflation

Most of the increase in consumer prices has been concentrated in goods rather than services. This is rather unusual in that goods prices usually fall over time; but in the context of the pandemic, it is entirely understandable.

The pandemic caused spending to shift from services to goods. This occurred at the same time as the supply of goods was being adversely affected by various pandemic-disruptions, most notably the semiconductor shortage that is still curtailing automobile production.

Looking out, the composition of consumer spending will shift back towards services. Supply chain bottlenecks should also abate, especially if the situation in Ukraine stabilizes (which we doubt).

It is worth noting that the number of ships on anchor off the coast of Los Angeles and Long Beach has already fallen by half. The supplier delivery components of both the manufacturing and nonmanufacturing ISM indices have also come off their highs. Even used car prices appear to have finally peaked (**Chart 18**).

On the Lookout for a Wage-Price Spiral

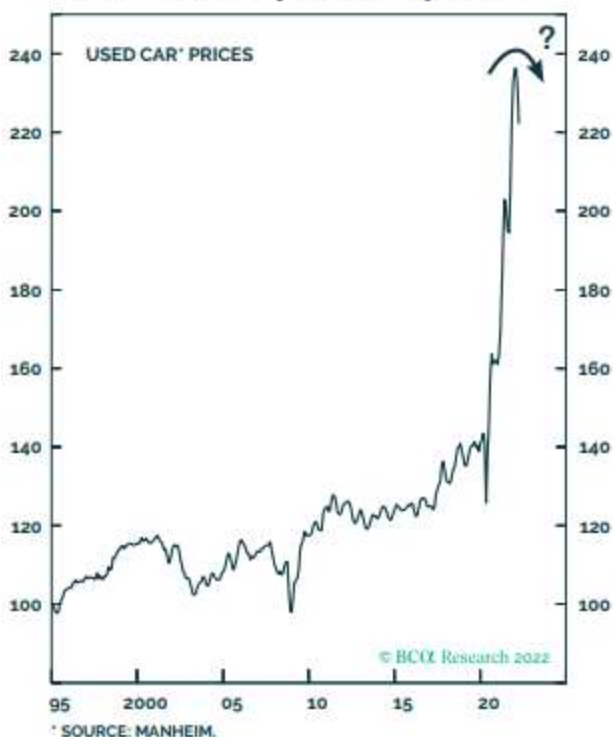
Could rising services inflation offset any decline in goods inflation this year? It is possible, but for that to happen, wage growth would have to accelerate further. For now, much of the acceleration in US wage growth has occurred at the bottom end of the income distribution (**Chart 19**).

It is easy to see why ... low-paid workers have not returned to the labor market to the same degree as higher-paid workers. However, now that extended unemployment benefits have lapsed and savings deposits are being drawn down, the incentive to resume work will strengthen.

The end of the pandemic should allow more workers to remain at their jobs. In January, during the height of the Omicron wave, 8.75 million US workers (5% of the total workforce) were absent from work due to the virus.

How High Will Interest Rates Eventually Rise?

If goods inflation comes down swiftly later this year, and



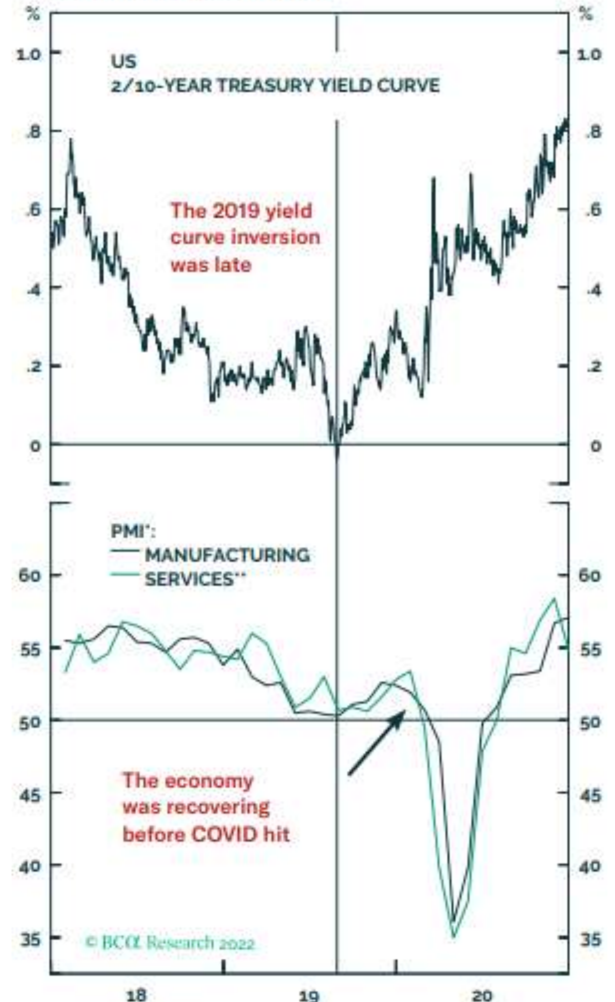
services inflation is slow to rise, then overall inflation will decline. This should allow the Fed to pause tightening in early 2023.

Whether the Fed will remain on hold beyond then depends on where the neutral rate of interest resides.

The neutral rate, or equilibrium rate as it is sometimes called, is the interest rate consistent with full employment and stable inflation. If the Fed pauses hiking before interest rates have reached neutral, the economy will eventually overheat, forcing the Fed to resume hiking. In contrast, if the Fed inadvertently raises rates above neutral, unemployment will start rising, requiring the Fed to cut rates.

Markets are clearly worried about the latter scenario. The 2/10 yield curve inverted earlier this week.

With the term premium much lower than in the past, an inversion in the yield curve is not the powerful harbinger of recession that it once was. After all, the 2/10 curve inverted in August 2019 and the economy actually strengthened over the subsequent six months before the pandemic came along (**Chart 22**).



Nevertheless, an inverted yield curve is consistent with markets expectations that the Fed will raise rates above neutral. That is always a dangerous undertaking. Raising rates above neutral would likely push up the unemployment rate. There has never been a case in the post-war era where the 3-month moving average of the unemployment rate has risen by more than 30 basis points without a recession occurring (**Chart 23**).

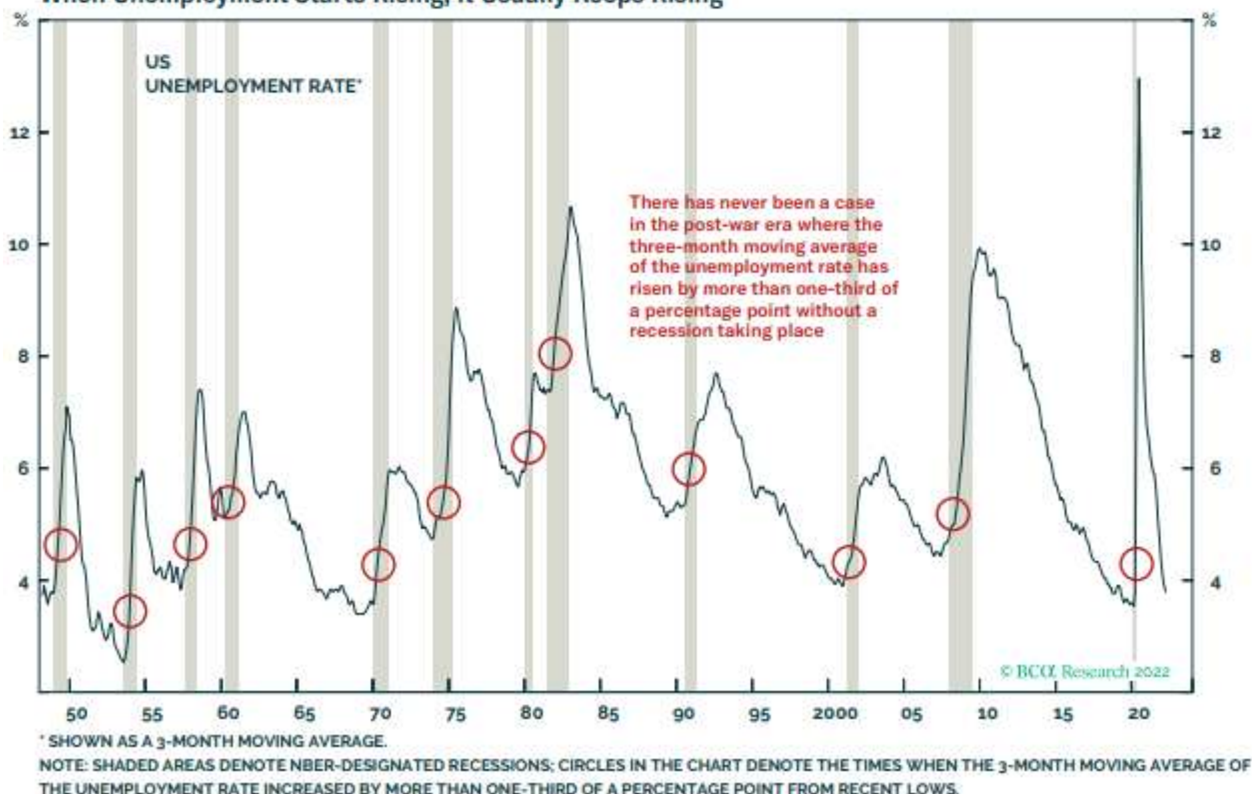
... the neutral rate of interest is probably between 3.5% and 4% in the US. This is good news in the short term because it lowers the odds that the Fed will raise rates above neutral during the next 12 months. It is bad news in the long run because it means that the Fed will find itself even more behind the curve than it is now, making a recession almost inevitable. ...

IV. Financial Markets

A. Portfolio Strategy

As noted in the overview, if the neutral rate turns out to be higher than currently perceived, the Fed is unlikely to induce a recession by raising rates over the next 12 months. That is good news for equities.

A look back at the past four Fed tightening cycles shows that stocks often wobble when the Fed starts hiking rates, but then usually rise as long as rates do not move into restrictive territory (**Chart 40**).



Unfortunately, a higher neutral rate also means that investors will eventually need to value stocks using a higher discount rate. It also means that any decline in inflation this year will not last. The US economy will probably start to overheat again in the second half of 2023. This will set the stage for a second, and more painful, tightening cycle in 2024.

Admittedly, there is a lot of uncertainty over our "two steps up, one step down" forecast for inflation. It is certainly possible that the "one step down" phase does not last long and that the resurgence in inflation we are expecting in the second half of next year occurs earlier. It is also possible that investors will react negatively to rising rates, even if the economy is ultimately able to withstand them.

As such, only a modest overweight to equities is justified over the next 12 months, with risks tilted to the downside in the near term. More conservative asset allocators should consider moving to a neutral stance on equities ....

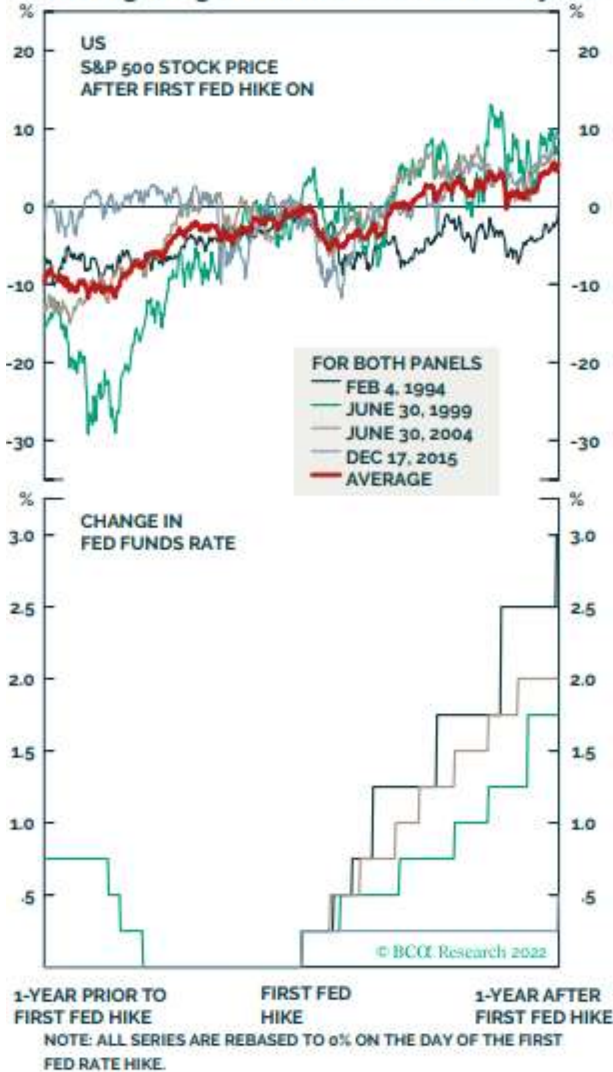
E. Equities

Equities Are Still Attractively Priced Relative to Bonds

Corporate earnings are highly correlated with the state of the business cycle (**Chart 61**). A recovery in global growth later this year will bolster revenue, while easing supply-chain pressures should help contain costs in the face of rising wages.

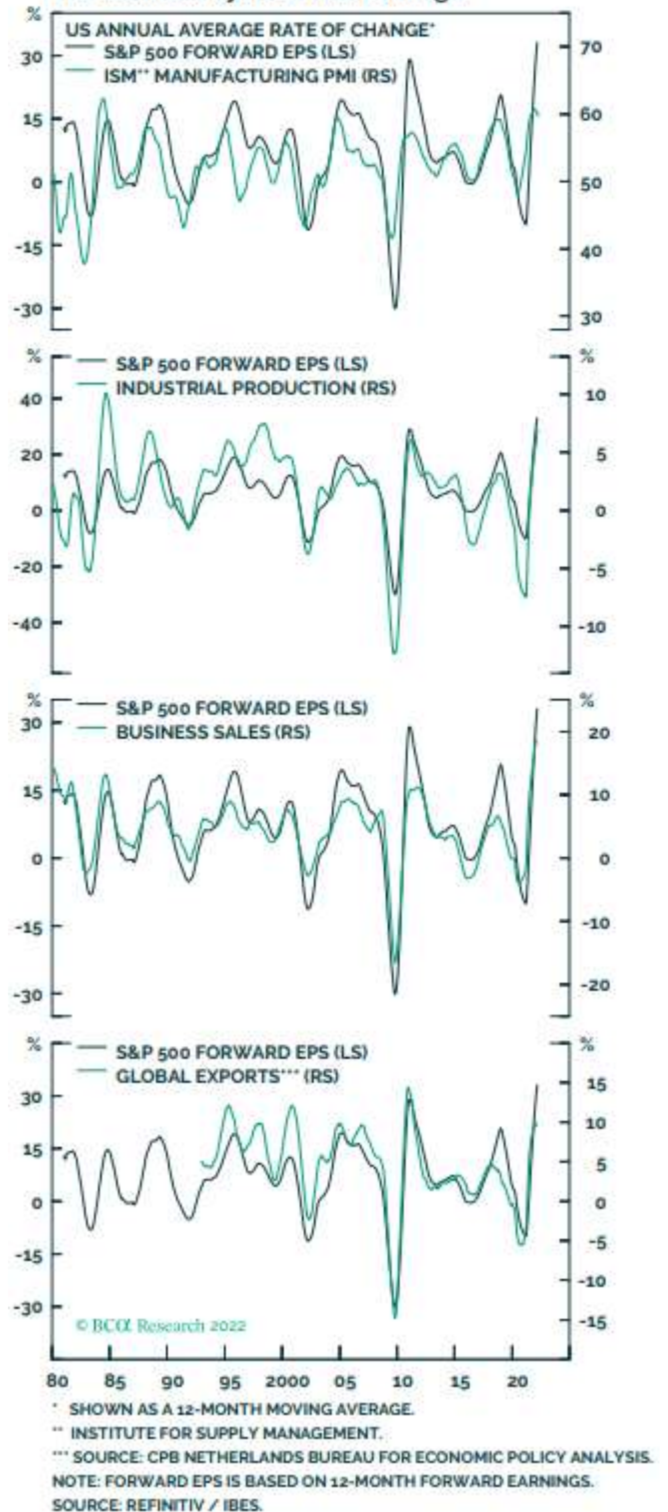
It is worth noting that despite all the shocks to the global economy, EPS estimates in the US and abroad have actually risen this year.

As Doug Peta, BCA's Chief US Strategist has pointed out, the bar for positive earnings surprises for Q1 is quite low: According to Refinitiv/IBES, S&P 500 earnings are expected to fall by 4.5% in Q1 over Q4 levels.



Global equities currently trade at 18-times forward earnings. Relative to real bond yields, stocks continue to look reasonably cheap (**Chart 63**).

Even in the US, where valuations are more stretched, the earnings yield on stocks exceeds the real bond yield by 570 basis points. At the peak of the market in 2000, the gap between earnings yields and real bond yields was close to zero.



Favor Non-US Markets, Small Caps, and Value

Valuations are especially attractive outside the US. Non-US equities trade at 13.7-times forward earnings. Emerging markets trade at a forward P/E of only 12.1. Correspondingly, the gap between earnings yields and real bond yields is about 200 basis points higher outside the US.

In general, non-US markets fare best in a setting of accelerating growth and a weakening dollar – precisely the sort of environment we expect to prevail in the second half of the year.

CHART 63
Equities Are Still Attractive Versus Bonds

* 12-MONTH FORWARD EARNINGS YIELD MINUS REAL 10-YEAR GOVERNMENT BOND YIELD. BOND YIELD DEFLATED USING HEADLINE CONSUMER PRICES AND 10-YEAR CPI SWAPS.
SOURCE: REFINITIV / IBES, AND MSCI INC. (SEE COPYRIGHT DECLARATION).
NOTE: GLOBAL IS THE MARKET CAPITALIZATION-WEIGHTED AVERAGE OF THE US, EURO AREA, JAPAN, UK, CANADA, AUSTRALIA, SWITZERLAND, SWEDEN, AND EMERGING MARKETS.

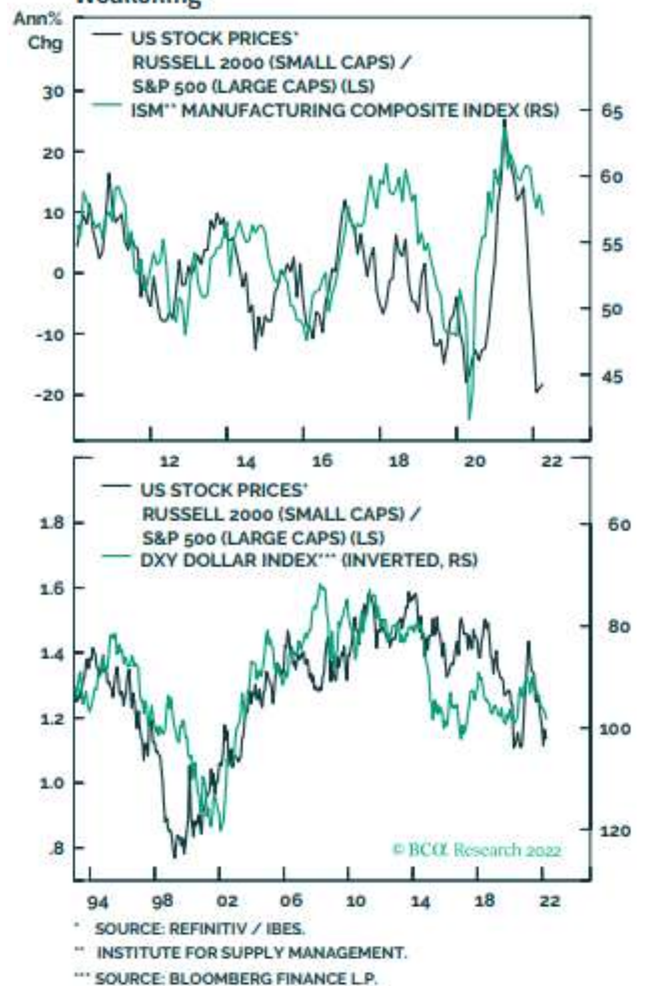


CHART 65
US Small Caps Usually Fare Well When The Economy Is Strengthening And The Dollar Is Weakening

* SOURCE: REFINITIV / IBES.
** INSTITUTE FOR SUPPLY MANAGEMENT.
*** SOURCE: BLOOMBERG FINANCE L.P.

US small caps also perform best when growth is strengthening and the dollar is weakening (**Chart 65**). In contrast to the period between 2003 and 2020, small caps now trade at a discount to their large cap brethren.

The S&P 600 currently trades at 14.4-times forward earnings compared to 19.7-times for the S&P 500, despite the fact that small cap earnings are projected to grow more quickly both over the next 12-months and over the long haul (**Chart 66**).

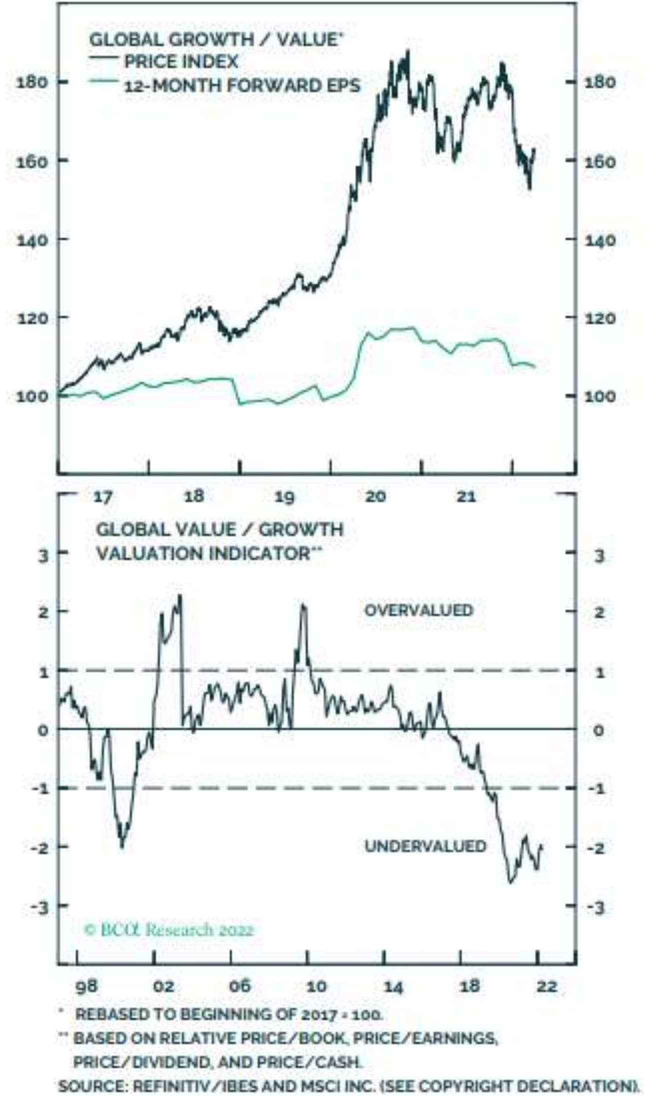
Globally, growth stocks have outperformed value stocks by 60% since 2017. However, only one-tenth of that outperformance has come from faster earnings growth (**Chart 67**). This has left value trading nearly two standard deviations cheap relative to growth. ...

On the flipside, structurally higher bond yields will weigh on tech shares (as shown below). Moreover, as we discussed in our recent report entitled The Disruptor Delusion, a cooling in pandemic-related tech spending, increasing market saturation, and concerns about Big Tech's excessive power will all hurt tech returns.

CHART 66
Small Caps Look Attractive Relative To Large Caps

* PRICE / EARNINGS-TO-GROWTH RATIO.
SOURCE: IBES / REFINITIV.

CHART 67
Value Remains Cheap



* REBASED TO BEGINNING OF 2017 = 100.
** BASED ON RELATIVE PRICE/BOOK, PRICE/EARNINGS, PRICE/DIVIDEND, AND PRICE/CASH.
SOURCE: REFINITIV/IBES AND MSCI INC. (SEE COPYRIGHT DECLARATION).

* REBASED TO JANUARY 2015 = 0%.
** REBASED TO JANUARY 2018 = 0%.

Follow-ups

Another case of better late than never? From the front page of Thursday's WSJ:

SEC Proposes Stricter Regulations for SPACs

BY PAUL KIERNAN

WASHINGTON— Federal regulators proposed new requirements for special-purpose acquisition companies, or SPACs, and their takeover targets amid widespread concern that the vehicles skirt important investor protections.

The Securities and Exchange Commission advanced a set of rules Wednesday that, if implemented, would make it harder for SPACs to raise money from investors and execute mergers. Its goal is to force the vehicles to meet similar regulatory standards as initial public offerings, though critics accused the agency of aiming to end their use altogether.

Also known as blank-check companies, SPACs became wildly popular on Wall Street in 2020 and 2021, when they accounted for the majority of U.S. initial public offerings. Like cryptocurrencies and meme stocks, critics saw them a symbol of the excesses that bubbled up in financial markets as governments and central banks pumped trillions of dollars of stimulus money into the economy to battle the pandemic.

SPACs function as pools of cash listed on a stock exchange that can be used by a sponsor to buy a private company. If acquired by a SPAC, the private company effectively gets access to everyday investors without providing the timely disclosures that a traditional IPO would involve. Existing rules also enable target companies to make lofty forecasts about their business prospects, something they wouldn't be able to do in an IPO.

Wednesday's proposal is part of SEC Chairman Gary Gensler's push to rein in Wall Street through tougher regulation. ...

The enthusiasm around SPACs has cooled this year amid regulatory scrutiny, declining share prices and missed projections. Dozens of companies that went public by employing that method—from a designer of all-electric school buses to a startup developing indoor farms in Appalachia— have missed their forecasts, often by substantial margins just months after they made them.

"They have on average been pretty costly and not performed up to the marketing," Mr. Gensler, who was appointed by President Biden, said Wednesday. "There's an awful lot of fees in here for the sponsors. There's an awful lot of fees for bankers and lawyers as well."

He said the proposal would reduce the information advantages that SPAC insiders have over ordinary investors as well as conflicts of interest, by demanding more disclosure and tightening rules on marketing practices and underwriters. ...

Under the proposal the SEC is considering, blank-check companies would have to disclose information about their sponsors' compensation as well as the dilution that shareholders might suffer if an acquisition is completed. Current rules often allow SPAC insiders to multiply their initial investment even if the companies they take over struggle and ordinary shareholders lose money.

Companies acquired by SPACs, as well as their officers and directors, would become liable for misrepresentations or omissions in the merger documents that SPACs file with the SEC. That is because the proposal would make target companies “co-registrants” with the blank-check companies.

SPACs and their buyout targets would be required to disseminate the required information disclosures to investors at least 20 days before any vote by shareholders on whether to approve an acquisition.

The proposal would also tighten rules around the forward- looking projections that SPACs are allowed to tout without running afoul of the SEC, to address concern that the entities often woo investors with unrealistic growth forecasts.

“The idea is that parties to the transaction shouldn’t use overly optimistic language or overpromise future results in an effort to sell investors on the deal,” Mr. Gensler said.

While advocates of tougher Wall Street oversight are likely to welcome the SEC’s proposal, it may be coming too late to help the investors who already suffered losses after the peak of the SPAC frenzy.

SPACs have been around for decades.

Their predecessors were known as “blind pools” and associated with penny-stock fraud in the 1980s. Last year, those blank-check companies raised more than $160 billion, topping the total from all previous years combined, according to SPAC Research. Investor enthusiasm for fast-growing startups and their rosy projections in areas such as electric vehicles attracted piles of capital.

Many companies then hit business snags or technological delays, sending share prices tumbling. The SEC has investigated several SPAC deals, including those that took electric-vehicle makers Nikola and Lordstown Motors public. Nikola late last year agreed to pay $125 million to settle a regulatory investigation into allegedly misleading statements by its founder and onetime executive chairman, Trevor Milton.

An exchange-traded fund tracking companies that went public this way has fallen about 30% in the past year. Several companies such as savings and investing app Acorns Grow that previously announced SPAC mergers eventually called them off as sentiment shifted. The prospect of tighter regulation has also cooled deal making in the sector.

So far this year, blank-check companies have raised just $9.8 billion.

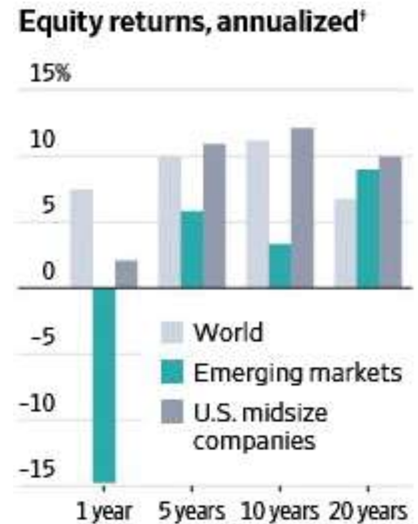
There are still more than 600 SPACs seeking deals. Those that can’t find mergers within a deadline, typically two years, will have to return money to investors.

From March 22nd's WSJ:

Conflict Tests Faith in Emerging Markets

BY HEATHER GILLERS AND MATT WIRZ

After rushing to unload Russia investments, some big asset managers are taking a hard look at their exposure to other emerging markets.



Large investors and their advisers in recent years searched developing countries for higher returns and growth, particularly with U.S. stocks at elevated prices and U.S. bonds at historic low yields. Instead, losses last year from Chinese home builders and technology companies are being exacerbated by the Russia-Ukraine war. Now, after years of underperformance relative to some U.S. equivalents, some investors are questioning the role of emerging markets in their portfolios. ...

Emerging-markets stocks returned an annualized 3.3% over the past 10 years as of March 17, compared with 11.1% for global equities and 12.1% for U.S. midsize companies, according to indexes from MSCI and S&P Global. ...

Emerging-markets stock funds continue to attract interest, taking in a record $120.5 billion last year and $25 billion in 2022. ...

Pension funds around the world moved to divest themselves from Russian stocks and bonds over the past several weeks, both to protect against losses and because they didn't want a stake in a country attacking its neighbor. By the time they did so, the value of the investments had plummeted, trading was near-frozen and Russia's assault on Ukraine was under way.

The selloff soon spread to other countries. Emerging-markets bonds have lost about 10% in 2022, according to JP-Morgan, while the total return on the MSCI Emerging Markets Index, which tracks stocks in emerging economies, is minus 8.7%. ...

Three from Morningstar:

Chinese Stocks: The Road to Nowhere

Where are the shareholders' yachts?

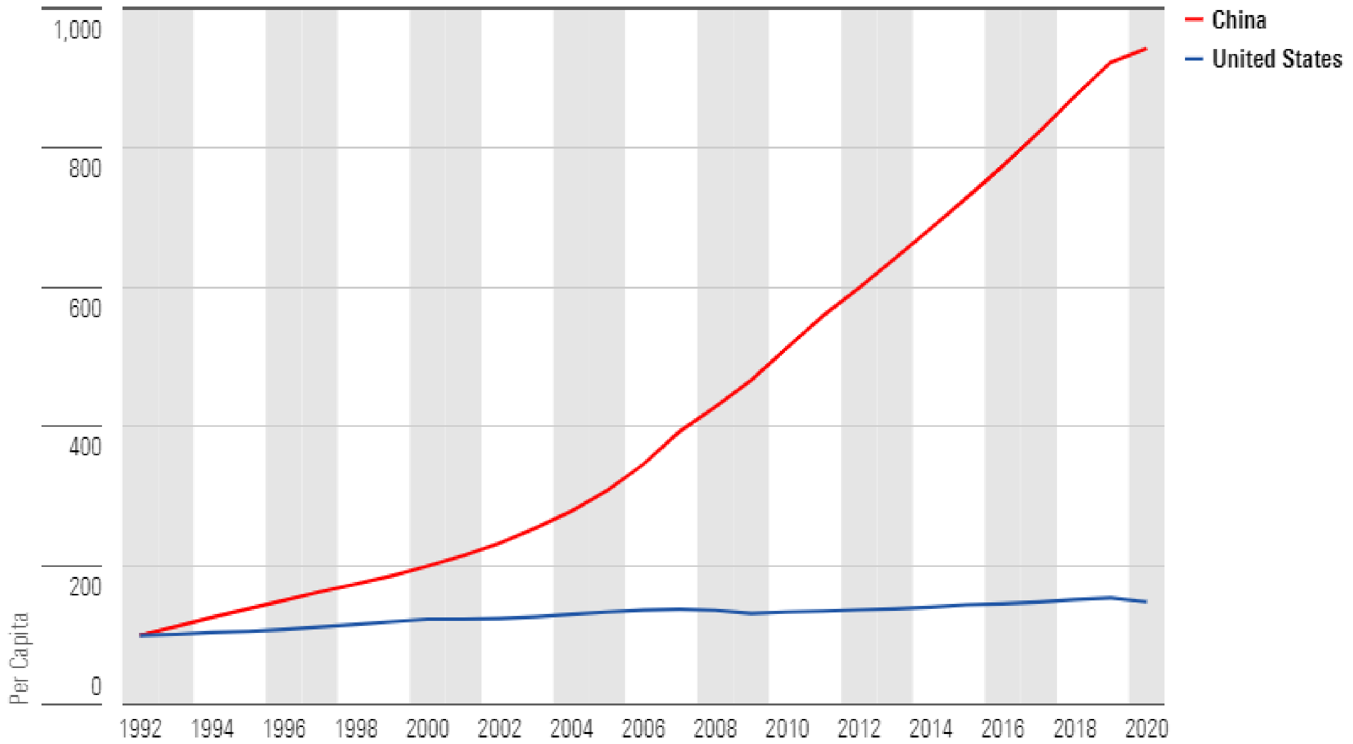
John Rekenthaler
Mar 21, 2022

The All-Time Champion

Over the past 30 years, China has recorded the greatest economic advance in world history. Although South Korea recorded a similar growth rate during the previous three decades, that country possessed a much smaller population. South Korea got there first, but China did so with the most.

Exhibit 1 depicts how China's per capita gross domestic product growth has dwarfed that of the world's biggest economy, the United States. The period begins in 1993, when the MSCI China Index commences, and concludes in 2020, the most recent year for which World Bank supplies the GDP data.

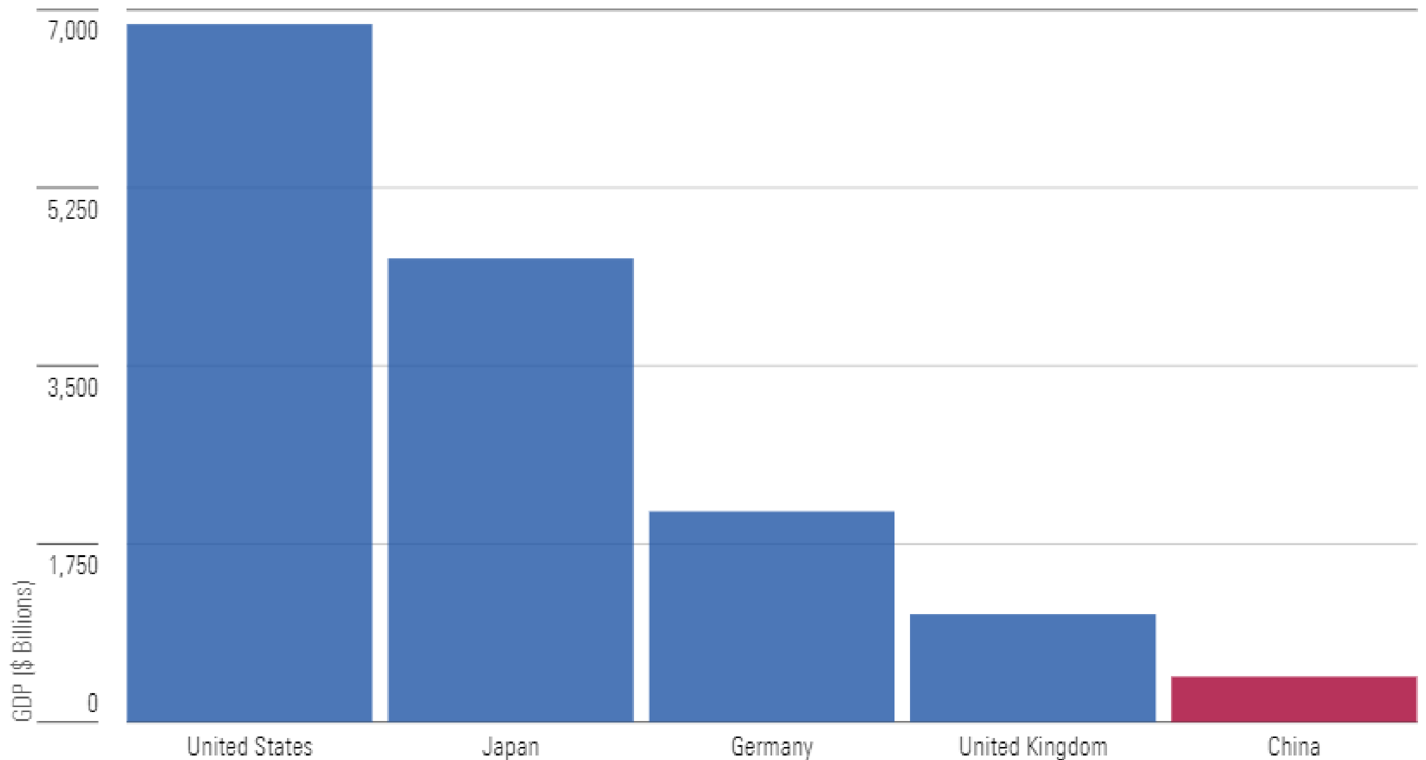
Exhibit 1 Real GDP, Per Capita (China Vs. United States, 1992 = 100, constant 2015 USD)



Source: World Bank.

It's not that the U.S. fared badly. Its economy grew faster than did those of the other leading markets. Nor was the U.S. especially sluggish by its own standards. At no time in American history--not in Colonial times, nor the railroad era, nor its postwar glory days-- has the U.S. economy ever advanced at anything resembling China's

Exhibit 2 Real GDP, 1993 (Constant 2015 USD $ Billions)



Source: World Bank.

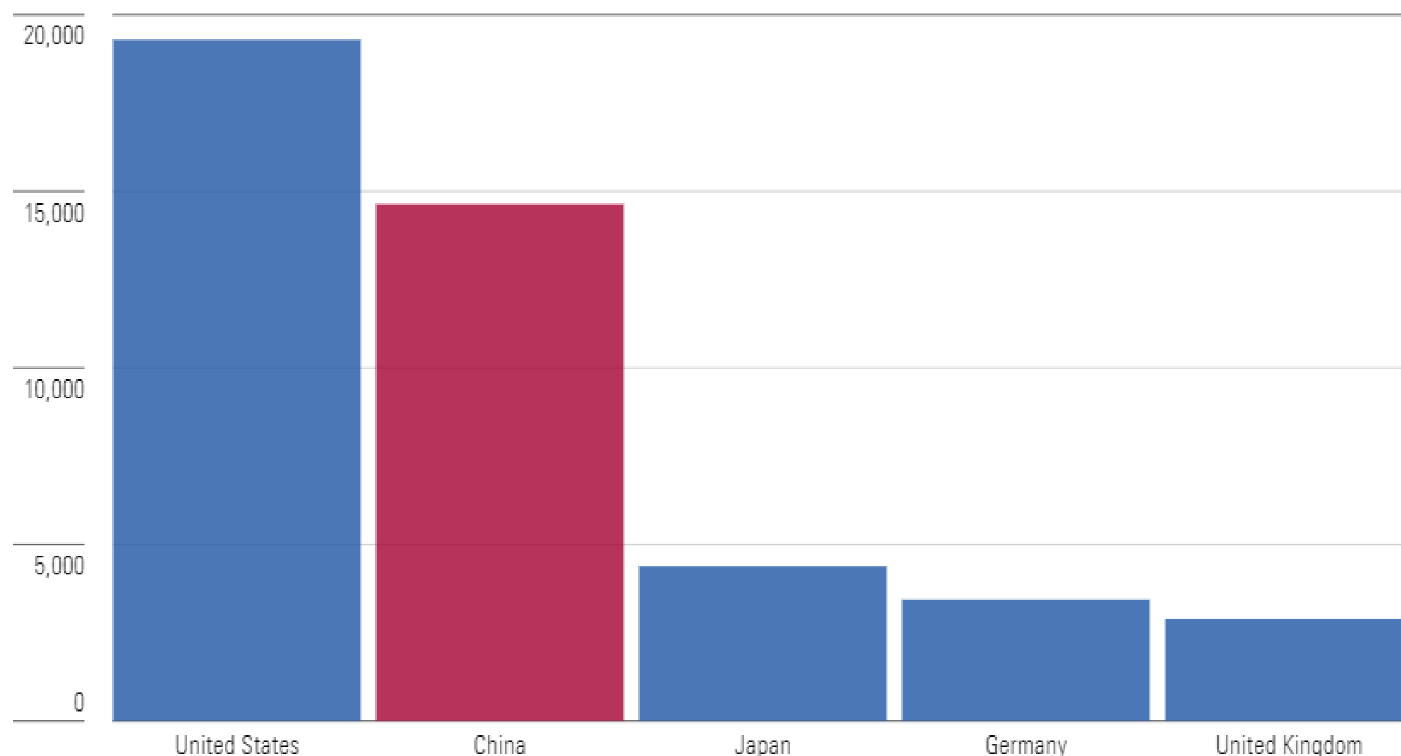
recent rate. The relevant story is not America's decline, but China's spectacular rise.

A Humble Beginning

Setting each country's 1992 production at 100 is useful for comparing subsequent movements. However, indexing the results obscures China's initial poverty. It's easy to forget how destitute China was just one generation ago. Expressed in [2015 U.S. dollars](), China's per-capita GDP in 1993 was $1,100--one sixth of Chile's output. Because of its size, China was not an economic backwater, but neither was it a major player.

It's no secret that things are very different today. Whereas China in 1993 stood behind several other countries in challenging U.S. dominance, today it rates as America's only serious challenger. What's more, given the two countries' growth rates, China will overtake the U.S. sometime around 2030, thereby becoming the world's largest economy.

Exhibit 3 Real GDP, 2020 (Constant U.S. 2015 $ Billions)



Source: World Bank.

China's economic development has surpassed almost all forecasts. One would think therefore that the country's stock market, reopened after a 41-year hiatus in 1990 and tracked by an MSCI stock index since 1993, would have soared. After all, a tenfold expansion in national wealth should represent a huge opportunity.

Profiting From Growth?

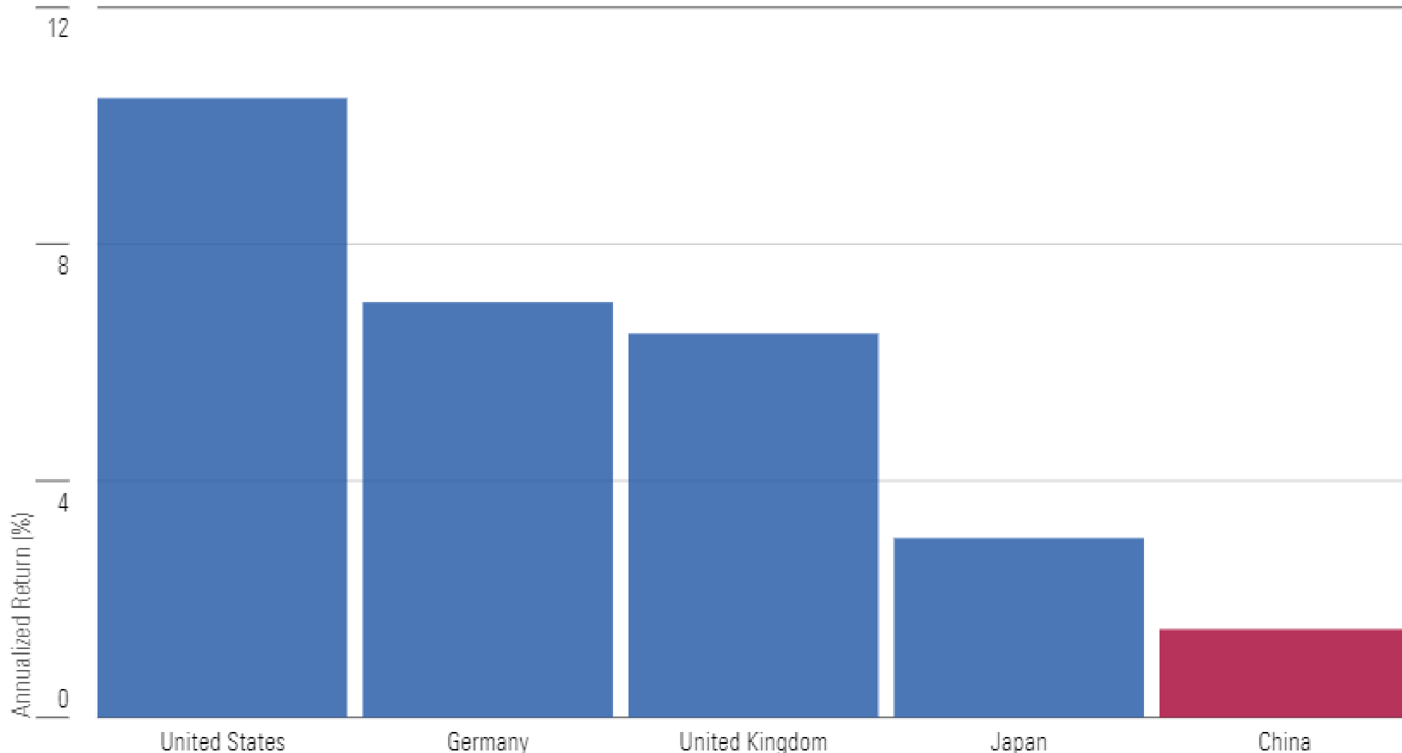
Consider, for example, business fortunes in the U.S. From 1993 through 2020, U.S. GDP increased by 85%. During that time, the nation's [pretax corporate profits]() grew to $8.7 trillion from $2 trillion. Stripping out the effect of inflation shrinks the former figure to $4.9 trillion, but that still amounts to a 145% boost in company earnings, well above the economy's growth rate. For every dollar of GDP expansion, American businesses accrued $1.70 of pretax profits.

The U.S. stock market, of course, performed much better than that. For one, publicly traded equities pay dividends, so even if their shares had traded at the same price/earnings ratios in 2020 as in 1993, stock returns would have exceeded those companies' income growth. For another, the stock market's price/earnings ratio did not remain flat, but instead increased. For a third reason, some companies hiked their reported earnings by repurchasing their equity shares.

Given how American businesses leveraged their country's modest economic growth by fattening their profits, and thus their stocks' prices, the sky would have seemed to be the limit for Chinese equities. By the late 1990s, Wall Street strategists were pitching that idea. I vividly recall a 1998 speech at a financial advisors' conference, counseling that they look to China. Their clients could begin by buying the shares of multinationals that operated in China, and later, they could invest directly in Chinese companies. He received a standing ovation.

Bad advice. Since Jan. 1, 1993, as measured by MSCI's index, Chinese stocks have trailed those of the other major economies.

Exhibit 4 Stock-Market Total Returns (Annualized, Jan 1993-Feb 2022)



Source: Source: Morgan Stanley Capital International, Morningstar Direct.

The outcome is even worse than first appears. After inflation, that nominal 1.5% annualized gain disappears entirely. Which means that this column's headline is overly generous. In real terms, Chinese equities have not taken the road to nowhere: They have headed somewhere distinctly warmer, dropping 1.8 percentage points per year.

Two Caveats

To be sure, measuring the results of Chinese stocks is tricky. As an emerging exchange, with various rules restricting the activities of foreign investors, China's stock market poses challenges for indexers. One provider's attempt at capturing the overall Chinese marketplace can differ substantially from another's. For example, over

that very same period, S&P/IFCI's Chinese equity index gained 4.73% per year, a full 3 percentage points better than what MSCI reported.

While disturbing for those who expect uniformity from research organizations, that discrepancy is immaterial for this column. Whether Chinese equities have lost money in real terms, as MSCI's numbers indicate, or have eked out a modest profit, as reported by S&P/IFCI, matters not. The key point is that, despite the country's unprecedented economic boom, its stocks have flopped. Investors were better off owning U.S. Treasury notes.

It should also be noted that, after an abysmal first decade, marred initially by the 1997 Asian financial crisis and then by the global 2000-02 stock-market downturn, Chinese equities performed well for almost 20 years. But more recently, they have stumbled badly again, spooked by President Xi Jinping's crackdown on entrepreneurs and by problems with China's enormous--and crucially important--real estate market. This time, S&P's figures agree with those of MSCI: Chinese stocks have shed 30% of their value over the past 12 months.

Looking Forward

In short, Chinese equities have confounded reasonable expectations. Even those who dispute that general economic improvement leads to stock-market success might have granted an exception for China, given the extent of the country's boom and its political stability. If so, they would have been mistaken. The critical question, of course, is *why*. Friday's column will address that topic.

John Rekenthaler (john.rekenthaler@morningstar.com) has been researching the fund industry since 1988. He is now a columnist for Morningstar.com and a member of Morningstar's investment research department. John is quick to point out that while Morningstar typically agrees with the views of the Rekenthaler Report, his views are his own.

Chinese Stocks: What Went Wrong

A bad start, then a missed opportunity.

John Rekenthaler
Mar 24, 2022

Stumbling Out of the Gate

Tuesday's column raised a question. Although China's economy has soared, its stock market has not. Since January 1993, when Morgan Stanley Capital International first began to track the nation's equity performance, Chinese stocks have trailed every one of the 10 biggest stock markets from that date. Why?

To begin, the launch of the Chinese stock market was something of a debacle. After a four-decade break, the Shanghai Stock Exchange reopened in December 1990, a scant two years before the MSCI China Index commenced. During those early years, market makers, regulators, and investors were each learning their roles in a country unaccustomed to modern capitalism. It is therefore unremarkable that, after the initial euphoria, Chinese stocks took a drubbing.

The timing was also unfortunate. As China's marketplace attempted to work out its kinks, the country got sucked into the maelstrom of the 1997 Asian financial crisis. Technically, the crisis bypassed China, as it infected the currencies of neighboring nations. However, given both China's proximity and strong trade relations, its equities were unavoidably affected. The five-month loss for Chinese stocks was a breathtaking (or, perhaps more accurately, heartbreaking) 60%.

Then came another event that was not China's doing: the global technology-stock meltdown. Even the Pacific Ocean could not prevent it from reaching China's shores. From spring 2000 through autumn 2002, Chinese stocks traded roughly in line with their American counterparts. That performance not only hurt total returns, but it also disappointed investors who had sought geographic diversification. After all, while the United States entered a recession during that period, the Chinese economy boomed. Surely its stocks would escape the damage. But they did not.

Better Days

After their rough debut, Chinese stocks have righted the ship. Over the past 20 years, Chinese equities have roughly matched the after inflation return posted by the stronger developed markets, and they have exceeded those of stock market weaklings such as Japan, Spain, and Italy. However, given the high volatility of Chinese stocks, their risk/reward profile has been less attractive. That much smoke should have produced more fire.

That adage applies even more strongly to China's economic success. Over the past 20 years, the United States has increased its per capita gross domestic product by 20%, while China has done so by 400%. Yet the two countries have posted similar stock-market gains (with, of course, the U.S. holding the risk/reward edge). That Chinese stocks did not lead from the onset is understandable. That they have not since taken full advantage of their country's economic achievement is not.

Top and Bottom Lines

Unsurprisingly, Chinese businesses have been very successful at increasing their sales. Each year, *Fortune* ranks the world's 500 largest companies, as measured by revenue. China possessed 10 such

publicly traded businesses in 2002. It now hosts 124, three more than does the U.S. Those 124 Chinese companies generate more revenue than do all the organizations on *Fortune's* chart from Japan, Germany, France, and the United Kingdom combined.

The challenge has been profitability. With Chinese companies, there's many a slip 'twixt the cup and the lip. When reviewing *Fortune's* 2020 list, the Center for Strategic and International Studies compiled the average return on assets for, among others, the organizations based in the U.S. and China. The American companies recorded an average profit margin of 9.1% and a return on assets of 4.9%. For the Chinese businesses, those figures were 4.5% and 1.9%, respectively.

Are Chinese companies less profitable because of their home market? Although Chinese consumers are rapidly growing their income, their wages remain far below developed-markets levels. Chinese corporations therefore face pricing constraints that do not trouble businesses that operate in wealthier countries. Perhaps Chinese firms are quite efficient, considering their handicap.

It's a reasonable supposition, but incorrect. In a 2021 survey of members of the U.S.-China Business Council, 95% of the respondents asserted that their Chinese operations were in the black. What's more, 43% replied that their Chinese branches enjoyed higher profit margins than did their overall business, as opposed to 22% who stated the opposite. Thus, while Chinese companies struggle to convert sales to the bottom line, American firms do not.

(A 2019 publication by the Chinese Ministry of Commerce found similarly, reporting that "most multinationals have a return on investment in China higher than their global average.")

Powerful Voices

The problem comes from the companies' leading stakeholders: their major investors and their government. As Fuxiu Jiang and Kenneth Kim explain, in "Corporate Governance in China: A Survey," publicly traded Chinese companies routinely have very large owners. In 2018, more than 80% of listed Chinese firms possessed a shareholder that held at least 20% of the company's equity. These investors, write the authors, often use their powers to "expropriate wealth from minority shareholders." For example, they may engage in *related-party transactions* that advance their other businesses at the expense of the company.

A related obstacle is the close connection between the Chinese government and ostensibly private enterprises. For example, Jiang and Kim report that in a 2007 study, 27% of Chinese businesses classified as nongovernment operations were nevertheless headed by former bureaucrats. Maintaining close ties with the government is essential for conducting business in China, but the relationship can also harm profits. For example, to ensure high employment, officials may pressure companies to hire more employees than they need.

Finally, Chinese legal protections have historically been poor. Happily, the authors write, the regulatory climate has improved dramatically over the past 25 years. The risk that a company's assets will be commandeered by the government, or its intellectual property stolen by its rivals, has sharply declined. (Or at least it had, before President Xi Jinping began, as one writer put it, "kneecapping Chinese companies.") Still, such concerns sometimes cause managements to forgo profit-maximizing strategies in an attempt to forgo legal problems.

Summary

The bad news for Chinese-stock enthusiasts is that the marketplace has dogpaddled over the past three decades. Early adopters would have been better off investing almost anywhere else. The good news is that conditions

have since improved, permitting Chinese stocks to at least partially benefit from their country's extraordinary economic growth. Whether progress will continue, or be halted by Xi's "reforms," remains to be seen.

When the Stock Market Is Openly Inefficient

The curious case of Digital World Acquisition Corporation's warrants.

John Rekenthaler
Mar 7, 2022

Separate Ways (Worlds Apart)

On Jan 20, 2022, I published "How to Lose Money: Buy Digital World Acquisition Corp." That column was misnamed. It should have been entitled, "How Not to Make Money: Listen to Rekenthaler." When the stock markets closed on Jan. 19, Digital World Acquisition Corporation's (hereafter just (DWAC)) stock cost $77.45. It closed this past Friday at $97.54.

Guilty as charged. But here's the thing. Although my forecast was wrong about DWAC's stock, it has been *correct* about the company's warrants. That should not have occurred. Either my prediction should have been wrong about both DWAC's common stock and its warrants, or it should have been right about both. There is no defense for a split decision.

Basic Math

To explain: When DWAC issued its equity, it distributed one warrant for every two stock shares to its IPO buyers (which consisted of various hedge funds). Each warrant permits its owner to buy a share of the company's stock at a price of $11.50. The warrants may be exercised starting on Sept. 3 of this year, or 30 days after the company's scheduled merger with Trump Media & Technology Group, whichever date comes first. The warrants will expire in 2028.

As with other forms of options, warrants carry two sources of value: 1) intrinsic value, being the difference between a warrant's exercise price and the cost of the company's stock; and 2) time value, which recognizes that, unlike owners of common stock, warrant investors have a choice to either convert their warrants or abstain. Having that choice is a benefit, which is why time values are almost always positive. (This, allegedly, is a rare counterexample.)

Determining the intrinsic value of DWAC's warrants is straightforward. That amount is $86.04, obtained by subtracting the $11.50 exercise price from the stock price of $97.54. Typically, calculating the time value of the warrant is tricky, as it involves estimating the stock's future volatility. In this case, though, the computation is simple. Because the stock's price is so far above the warrant's exercise price, the time value is negligible. Possessing the right to abstain means little when one will almost certainly not abstain.

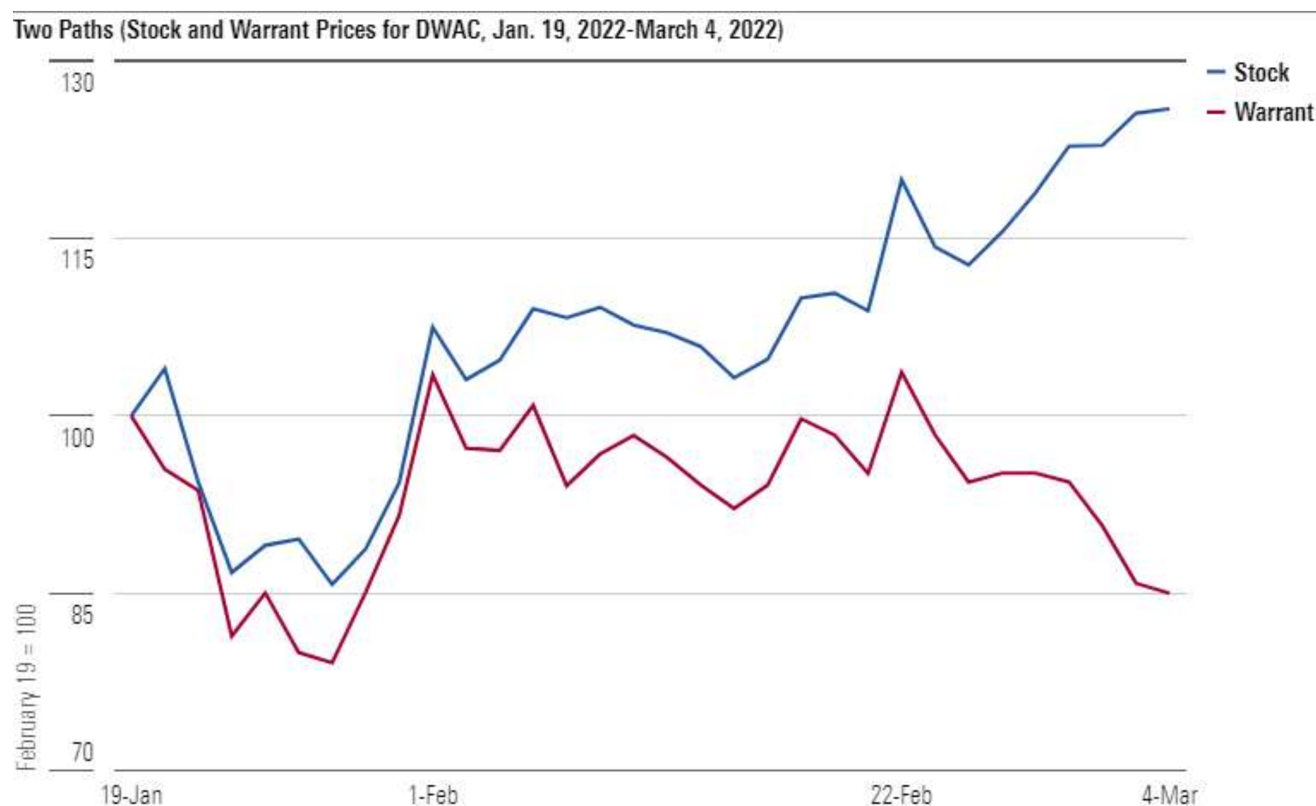
Thus, DWAC's warrants should be worth about $87. Their actual value: $23.76. That was the cost to purchase a warrant on Friday afternoon.

Left Arm, Right Arm

Well, you might say, Rekenthaler botched that evaluation, too. Fair enough. One should distrust arguments by researchers who claim to have spotted what the marketplace missed. Usually, the opposite is true. But in this case, I *am* the consensus. Last month, *The Wall Street Journal* talked to several investment professionals, each of whom also believed that DWAC's warrants should trade at roughly their intrinsic value. (It would be difficult to conclude otherwise.)

The clinching argument, however, derives not from the disparity itself, but instead from its *inconsistency*. Maybe the investment professionals who were contacted for the article overlooked a critical reason why DWAC's warrants should trade at a large discount to the company's stock. But even if that criticism is true, it does not explain why the two securities don't trade in tandem. After all, each was issued by the same company. Whatever price difference exists between the two should therefore be relatively constant.

And yet it has not been constant. The following chart shows the relative performance for each investment since Jan. 19.



The relationship between DWAC's stock and warrant prices is battier than Bruce Wayne's lair. Consequently, when investigating that issue, we needn't worry about finding evidence that squares the circle. The task cannot be accomplished. Either: 1) DWAC's stock price is wrong, 2) DWAC's warrant price is wrong, or 3) both prices are wrong. The one interpretation that cannot hold is that both prices are correct.

Assessing the Possibilities

My analysis can go no further. None of the three narratives above adequately explains the behavior of DWAC's equity investments.

If the company's stock price is accurate, why haven't its investors--who were by that account highly astute in recognizing the opportunity--seized the lowest-hanging fruit that ever hung on an investment tree? Sell 1,000 shares of DWAC stock, buy 2,500 shares of DWAC warrants, pay the $11.50 conversion fee for each warrant when September arrives, and DWAC supporters will own 2.5 times as many equity shares as they own today, with $9,390 in cash left over.

If, on the other hand, the company's warrant price is accurate--meaning that DWAC's common-stock holders are deceived rather than astute--why has this error persisted? Is the equity marketplace so inefficient that a relatively large stock can trade for months at several multiples of its openly signaled true worth without any correction occurring? Perhaps … but if so, business schools ought to revise how they teach investment theory.

The final explanation--that both the stock and warrant prices are wrong--strikes me as the likeliest of the three possibilities. Assessing DWAC's prospects is difficult, as its fortunes depend entirely upon that of Trump Media & Technology Group, which has barely begun operations. One should therefore expect confusion in determining the company's value. What's more, special-purpose acquisition companies often perform erratically before (and shortly after) their mergers, because they have a bifurcated shareholder base: Their institutional owners are seeking to exit, or at the least to hedge their exposures, while their retail investors are bullish.

Final Note

In hindsight, I erred when I said DWAC was a sure loser. The company's investment terms are deeply unfriendly to the stock's retail shareholders; should Trump Media & Technology Group disappoint, they will be left holding the bag while the institutions reap profits. That is a fact that no DWAC supporter can successfully deny. I, personally, would not be interested in buying into a startup media business that is valued at more than $15 billion while possessing $1.25 billion in capital.

But, as this column has demonstrated, there is nothing "sure" about DWAC. The performance of its securities has defied analysis. I was mistaken to believe I could solve that mystery. Back to the Batcave.

Note: So much for planning ahead! I wrote the bulk of this column over the weekend. On Monday, after I'd finished, DWAC's stock dropped 14.6% because ... well, who am I kidding? I have no idea why. At any rate, the key points of this article still stand: DWAC's stock remains above its Jan. 19 level; its warrants have declined even further; and the performance of both investments continues to baffle.

Positions

COMM - This Communication Equipment IVA System Pick was purchased on 3/21 for 5 clients @ 8.62:

Insider Buying:

Trade Date↑	No. Part	Participants	Net Sell (Shares)	Net Buy (Shares)
03/11/2022	2	Treadway Charles, Drend...		117,965
03/10/2022	1	Watts Claudius		6,000
03/08/2022	1	Watts Claudius		4,000
03/04/2022	1	Watts Claudius		6,000
03/03/2022	1	Choi Justin		8,000
02/25/2022	1	Roman Derrick		7,500
02/24/2022	1	Yates Timothy		5,000
02/23/2022	1	Yates Timothy		5,000