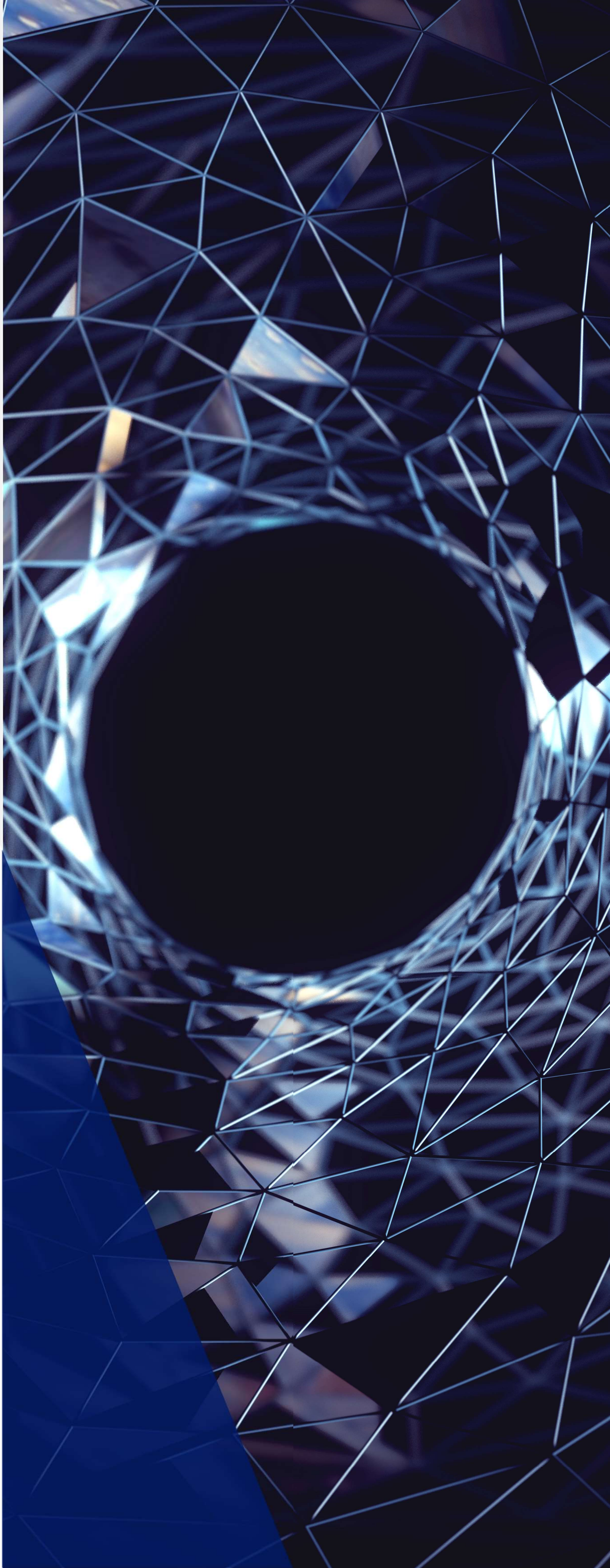
# VINDICATED… SO FAR… AND A PEAK DOWN THE 'RABID' HOLE

## Market update

September 2022

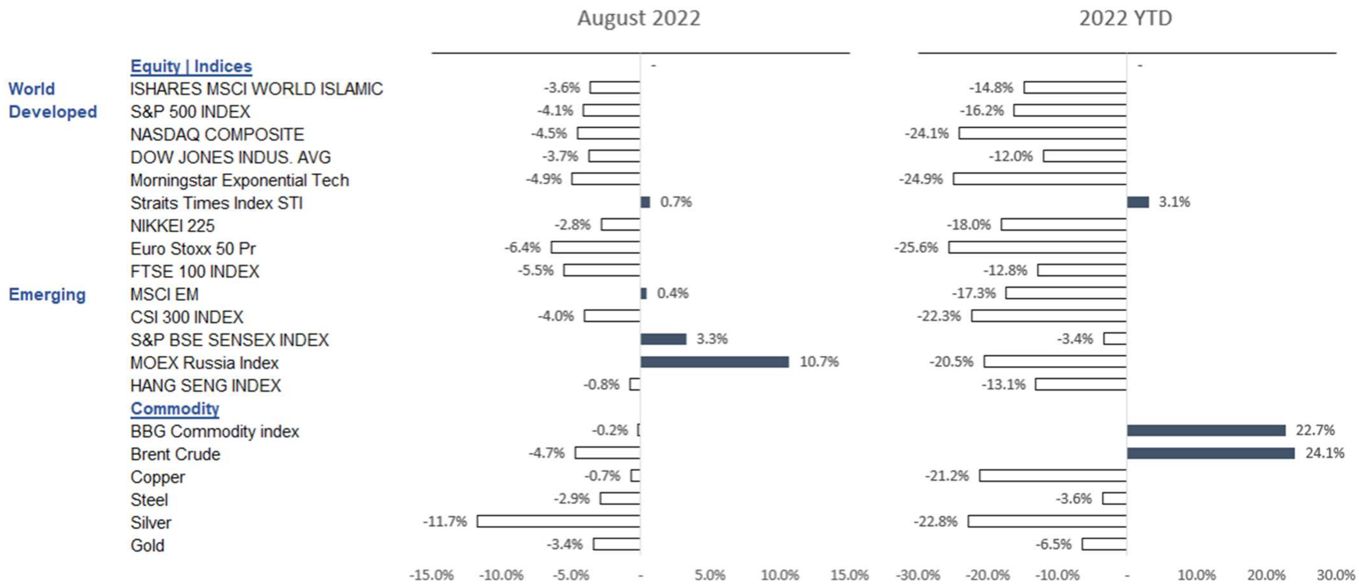


RASAMEEL

## VINDICATED … SO FAR… AND A PEAK DOWN THE 'RABID' HOLE

After July's sharp rebound, global equity markets saw a month of volatility as monetary tightening and hawkish messaging at the Jackson hole meeting weighed down investor sentiment. Consensus expectation heading into Jackson hole was for central banks to be less hawkish on the back of weakening macroeconomic indicators globally. The messaging from central banks, particularly the Fed was anything but that. The markets reacted to this with the S&P 500 ending the August month lower by 4.1% while the MSCI World Islamic index fell 3.6%. European indices fared worse while emerging markets outperformed developed markets posting a positive return of 0.4%. The US dollar further strengthened over the month, a headwind to commodities and gold.

For us, August was a good month, as all our global strategies outperformed their respective benchmarks. The Multi-Asset Fund delivered a positive return of 0.3% while its benchmark fell 3.8%. Global Equities Strategy fell 0.8% (gross) while its benchmark, the MSCI World Islamic index fell 3.6%. The Disruptive Technologies Strategy fell 1.9% (gross) while its benchmark, the Morningstar Exponential Technologies index fell 4.9%. We feel, to some extent, vindicated on our call that July was a bear market rally, with markets once again turning south.




Being bearish, is not an easy call to make, as 75% of the time markets are in an upward trend. But its critical to try and protect capital when we do have market events and periods of weakness, such as in August and also more recently (13th September '22) with the markets selling off dramatically following the inflation print which was higher than expected.

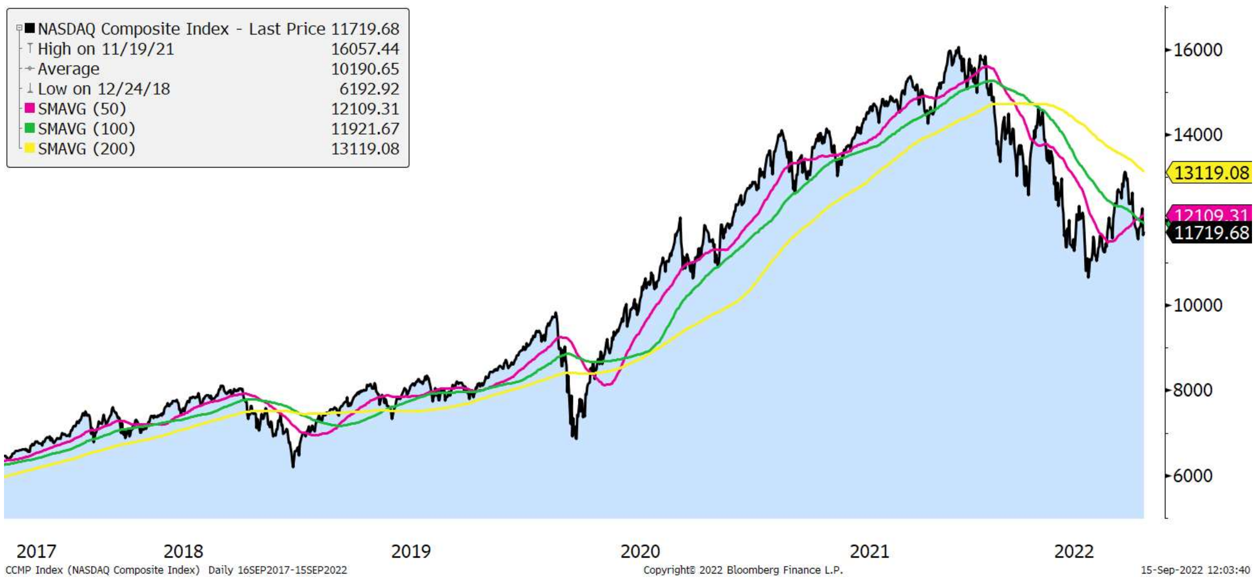
In this month's outlook, we go down the 'rabid' hole to get a sense of how bad things could get and what could be driving them. My reference to rabies is intentional as we find, as should any reader that questions their motives and actions, much of the current policy, towards C-19 and Russia, seems extreme and irrational.

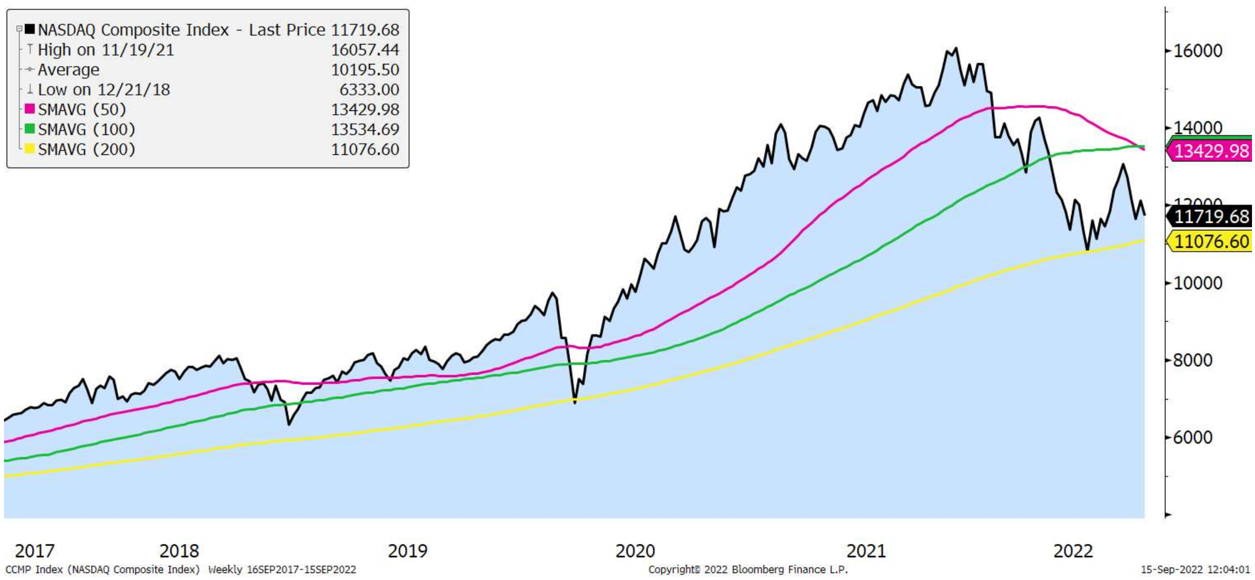
Areas of particular focus this month are:

- market review, inflation data and central bank response
- how the weaponization of gas to Europe will impact that market
- the inflation tsunami and its impact
- an assessment of China's policy around covid and the possible rationale behind imposing lockdowns.

The equity market is yet to fall below the June low, but as it stands, the charts, and the fundamentals would indicate to us that the market will trend lower in coming months. Of note, is that many of the indices, such as the Nasdaq, failed to break through the 200day moving average – which is now the level of resistance. We are watching to see if the indices break through the support line, which has been shown to be the 200wma in the prior few selloffs. We are also tracking the 50wma and 100wma, as a cross here would raise concern. In recent history, the 50wma has only crossed the 100wma on two prior occasions, namely 2000 and 2008.

### Charts – Nasdaq – Daily and weekly averages



And on the fundamentals – the inflation data continues to come in elevated and the central banks are powerless at this stage to not sound hawkish, having earlier proclaimed that they will do what it takes to reduce inflation. The timing of Powell's Jackson Hole Symposium speech was 'perfect', just as the various indices were reaching resistance.

Also, as we have been predicting, economic data continues to weaken.

FT Financial Times

Jay Powell says Fed will 'keep at it' in hawkish inflation speech

Jay Powell declared the Federal Reserve "must keep at it until the job is done" as he used a speech at Jackson Hole to deliver his most...

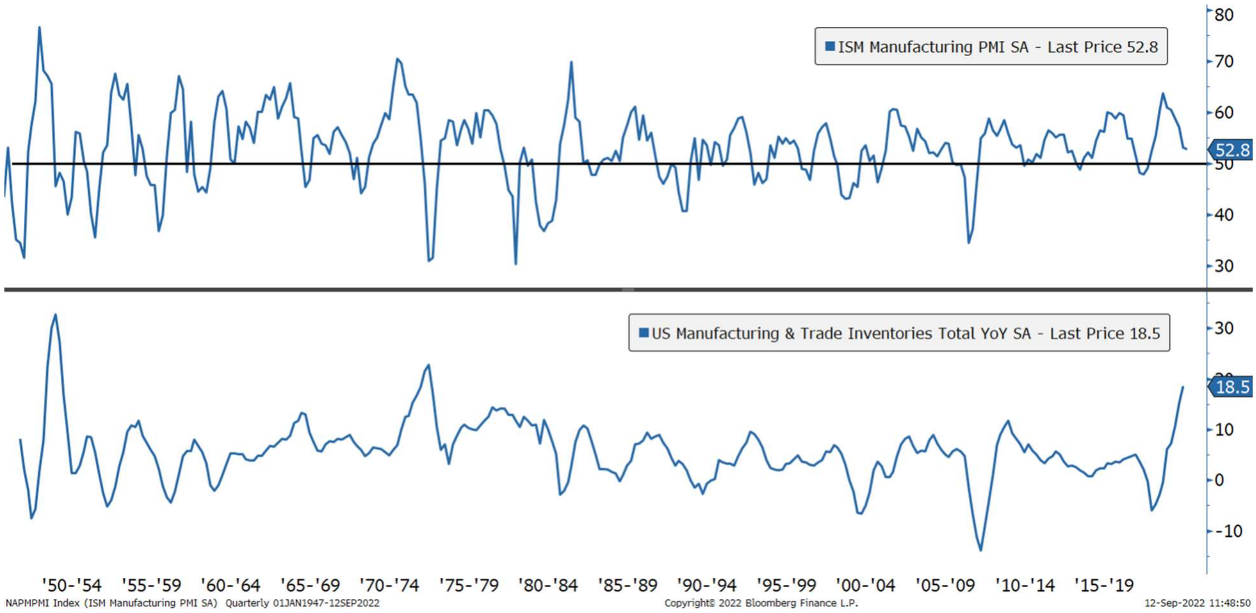
2 weeks ago

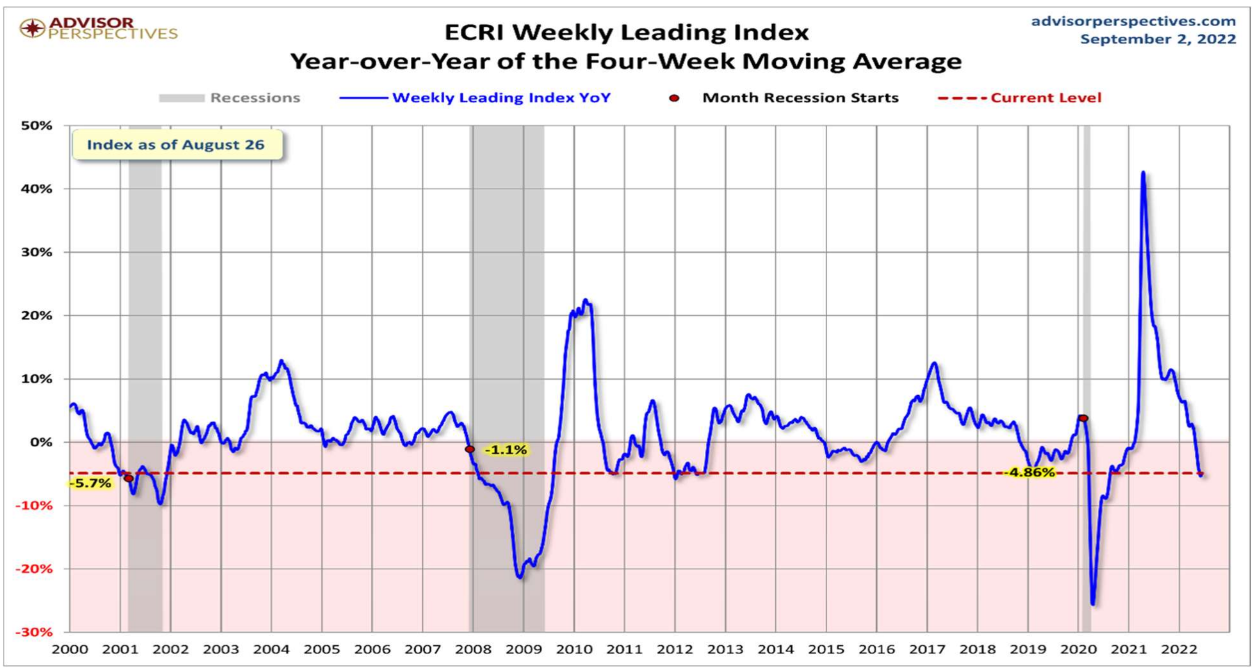
B Bloomberg.com

Top Central Bankers Deliver Hawkish Message at Jackson Hole

Error: Could not download required scripts. Please update your browser or turn off ad blocker to continue to watch. Powell's Jackson Hole...

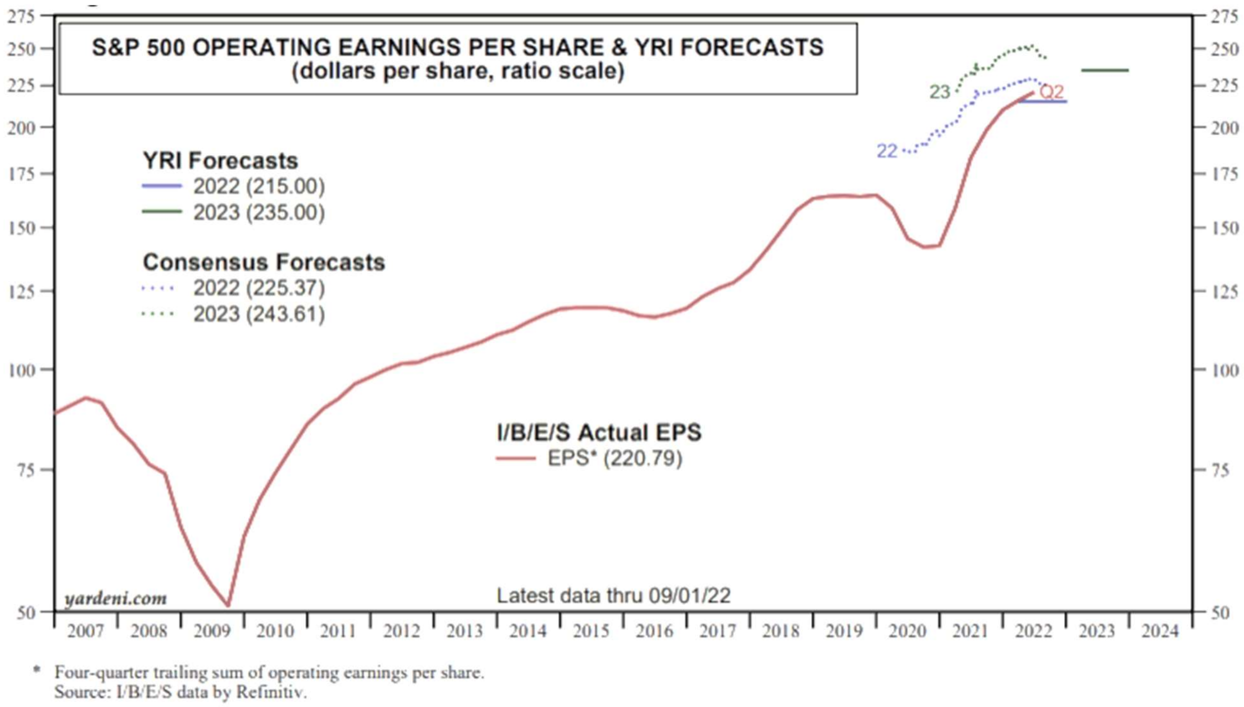
**Charts – ISM, ISM Manufacturing & Trade inventories and ECRI**



Not only is the economic data weakening, but markets remain on the pricier side. They are not yet cheap enough to simply throw caution to the wind and add risk. As we highlighted in prior reports, we also need to start seeing earnings expectations for 2023 come off significantly and to be reflected in forward valuations before we can gain comfort on the valuation front.

**Chart – S&P 500 EPS expectations**



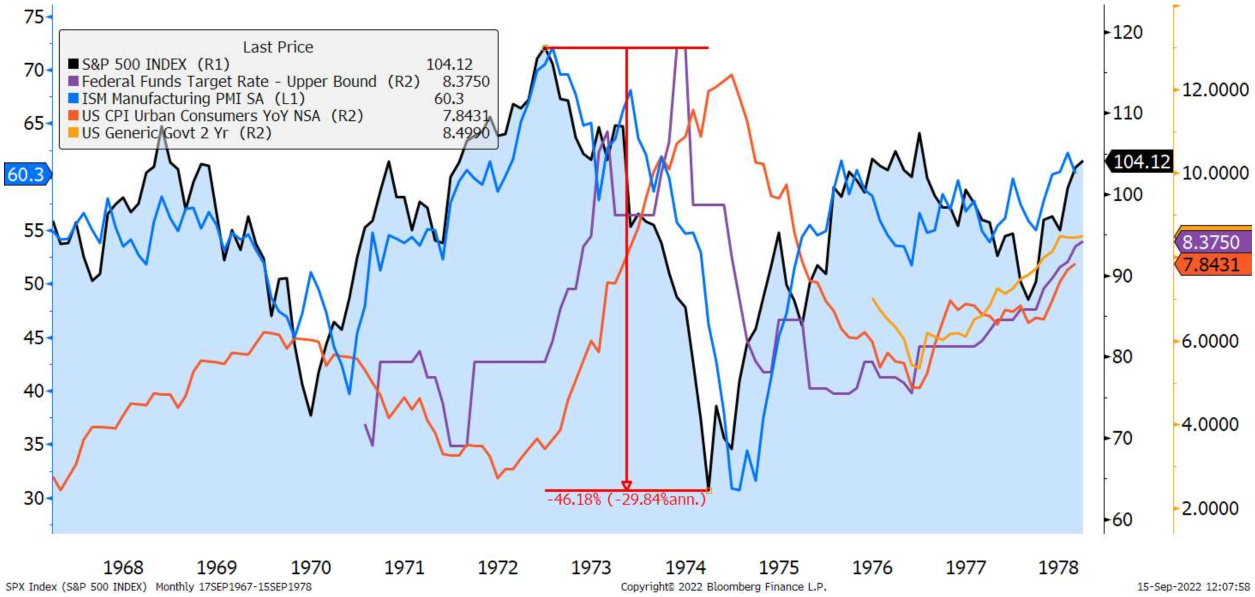

So, in summary, we have an expensive market, weakening economic data, weakening fundamentals, and rising rates. And a lot of geopolitical uncertainty around China/Taiwan and Russia/Ukraine

**How bad can it get?**

As we highlighted in our prior report, the Fed is between a rock and a hard place. Tighten aggressively to cut the inflation risk, and the economy will weaken precipitously. Tighten too little and inflation will rear its ugly head again. 1970s style.

In terms of historical comparison, the 1970s is perhaps the closest. Inflation in the US ramped all the way up to around 12% in 1974, and the Fed raised to 13% and the economy fell off a cliff. It was way worse back then in terms of inflation levels. Saying that though, the debt levels today are far higher so the economy can't manage higher rates as easily. In the 70s inflation bust, the S&P fell around 47% peak to trough. We don't expect this market to be as bad. But certainly, there will be a similar trend.

**Chart - 1970-1980 inflation**




There is that risk that, if they don't tighten sufficiently now, inflation may raise its ugly head further out. We highlighted in our last note, that we don't expect the Fed will tighten aggressively to the necessary 5% and above but will rather get up to 3-3.5% and then raise gradually from there if need be. They will be cautious not to engender a hard landing. Our optimistic view was that the Fed will sound more dovish as we move closer to year end, given the weaker economic data that is likely to come through. It may though be further out, given the Fed's increasingly tough stance on inflation and the level of core CPI in the last announcement. Should inflation prove to be sticky, it will be that much harder for the Fed to get it under control.

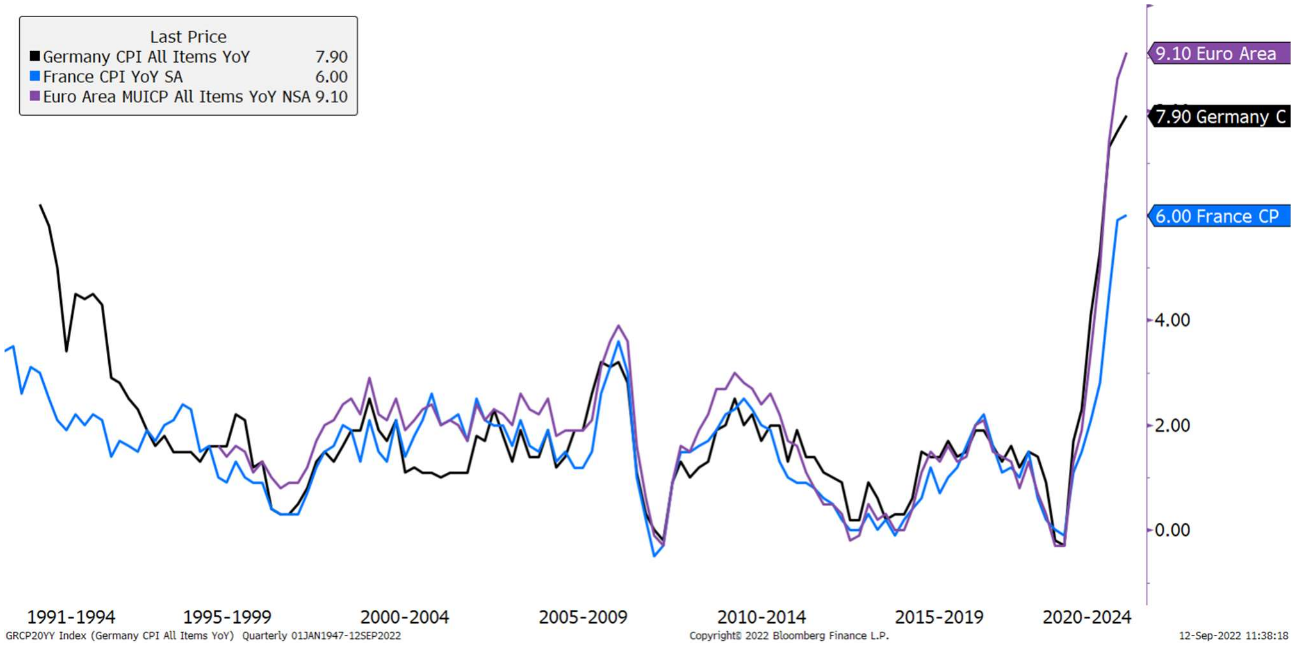
**In our view, it will though take lower asset prices to see them reverse policy.**

Should the Fed tighten aggressively (5%), it would push the economy into recession. With the US govt. debt to GDP being 120% and total debt to GDP around 350%, it could be very damaging.

Regardless of the Fed's action, we do expect that both the economy and inflation will weaken materially into 2023. Could inflation fall below current targets of 2%? Quite possibly. There is a significant amount of inventory piling up and a devaluation of the RMB would also be deflationary. This would feed into an even more aggressive round of QE and expansive monetary policy – so a further boom bust cycle.

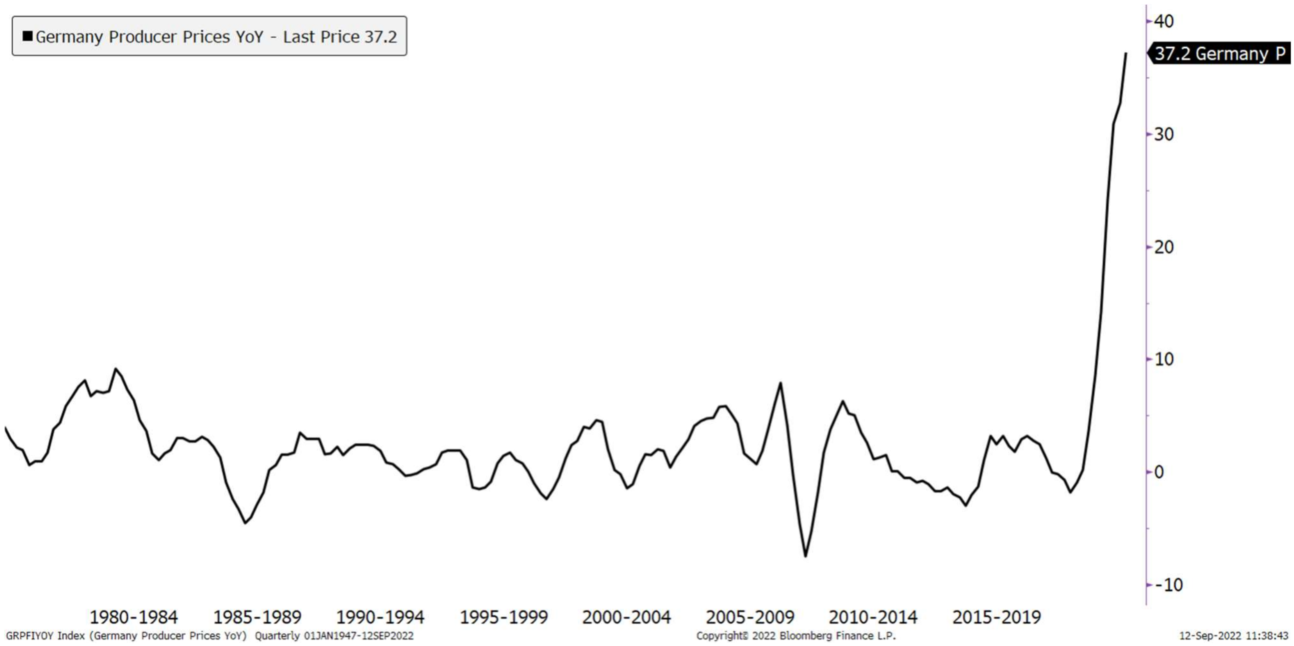
While the US is dealing with its own issues, Europe is in a far more dire position. Inflation is off the charts.

### Chart – Inflation in Europe




German CPI may actually be under reflecting the real damage. Inflation in the cost of production – PPI – has run all the way to 37% in Germany.

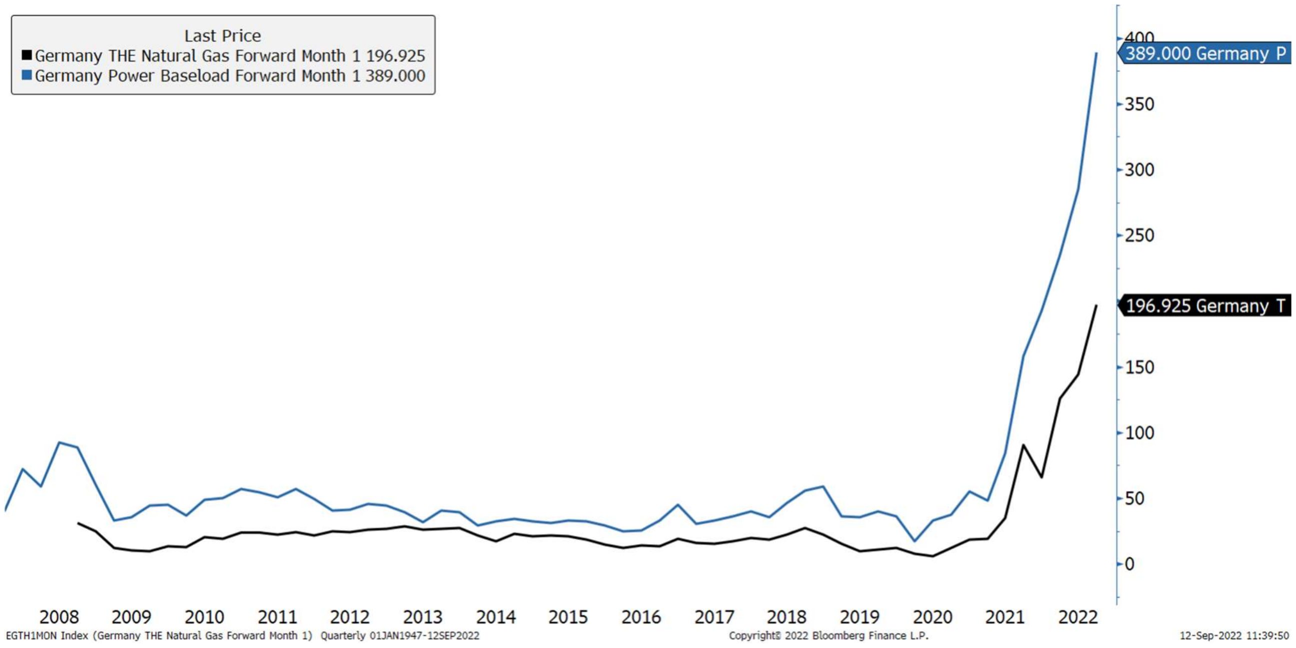
### Chart – German PPI




**And it's going to get worse……**

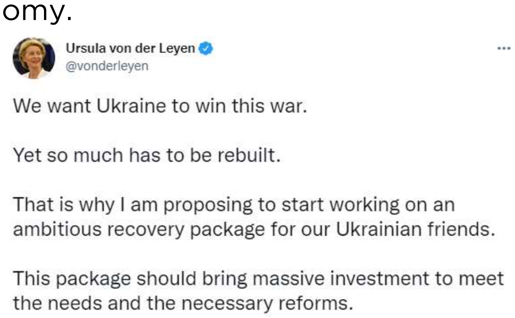
In retaliation against EU sanctions and the supply of weaponry to the Ukraine, Russia has weaponized its gas deliveries to Europe, by cutting supplies. Europe, and especially Germany, as President Trump warned a few years back are extremely exposed to Russian gas and recent 'green' initiatives of switching off nuclear power stations has clearly not helped.

Chart – German gas and electricity prices




So, unless it can get supplies back up and running, Europe faces a bleak winter of power cuts, restrictions, and production stoppages. And this is why I talk of 'rabid' policies.

Rather than stepping from the brink, the EU Commission and various politicians have taken the route of driving a further wedge between themselves and Russia by providing further funding and weapons to Ukraine. To date, I can't recall any politician taking the stance that peace must be found. Rather, it seems that most politicians are banging on the drums of war. This is hardly to the benefit of their local citizenry or economy.




The response from Ursula von der Leyen, the unelected head of the EU commission and a Trustee of the WEF, is to support the Ukraine further and drive for further sanctions. The German chancellor in a speech at Davos just said 'Putin must not win this war'. Well, perhaps he already has.

And, lest we forget, it was the West that was strongly 'rumored' to have been behind the coup that took place in Ukraine in 2014, with President Yanukovych being removed from office under very questionable circumstances. He was against the NATO expansion and resisted NATO's expansion into Ukraine. This was a breach of the 1990 accord between the US and Russia, that NATO would not expand Eastwards.

So, prod the bear too far and here we are.

**The reason we question German policy towards Russia, is because Russian gas accounts for 40% (down from 55% the prior year) of Germany's gas imports in 2022.**

Should the gas from Russia to Europe be shut down altogether, estimates are that it could cut GDP by as much as 12% (FT). Other studies show 2%. Anything within this range is very feasible depending on whether the gas is fully turned off, or if there is still a trickle through.

A new analysis by the Federation of German Industries (BDI) stated that the energy crisis "is a major challenge" for 58 percent of companies, and 34 percent believe the current crisis represents a matter of survival'. Germany is no exception either, with warning from the United Kingdom showing that six in ten manufacturing companies face the risk of closure due to the energy crisis.


Already, Germany has gone from a large trade surplus to close to being in deficit. All in a very short time period.

Given the background of the conflict, I find the proclamations of Ursula and Western politicians disingenuous and very much at the detriment of their citizens.

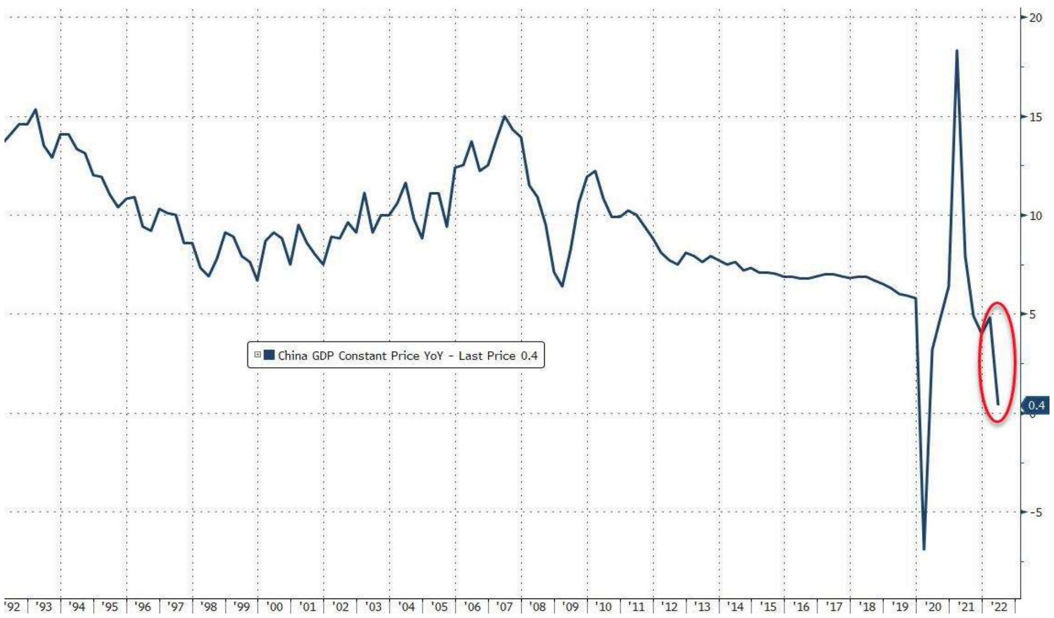
**Winter is coming to Europe.**

It's not much better when we look east.

China is already in the midst of its economic winter.

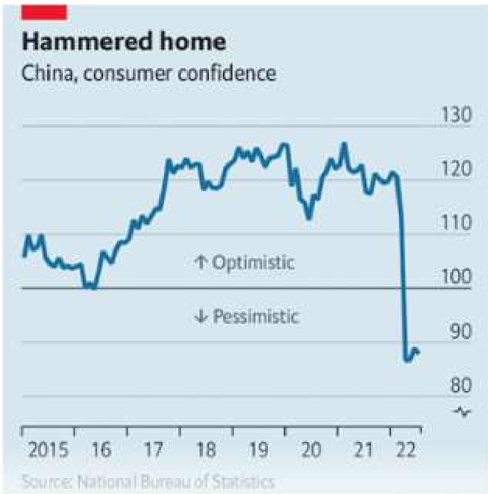
China's economy has collapsed badly. The last quarterly reading for GDP was 0.4%, missing market consensus of 1.0% and slowing sharply from a 4.8% growth in Q1. The latest figure was the softest pace of expansion since a contraction in Q1 2020, when the initial coronavirus outbreak emerged in Wuhan. China's statistics agency described the result for Q1 as "hard-earned achievements" and warned about the lingering impact of outbreaks and "shrinking demand" at home.

Chart – China GDP growth YoY

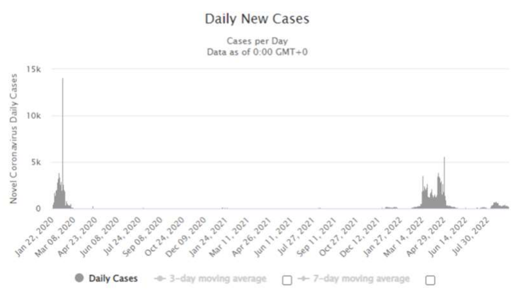


Two key factors are driving the slowdown. A weaker housing market and the impact of lockdowns and supply chain disruption, driven by their covid zero policy.

Chart – China property market


Daily New Cases in China

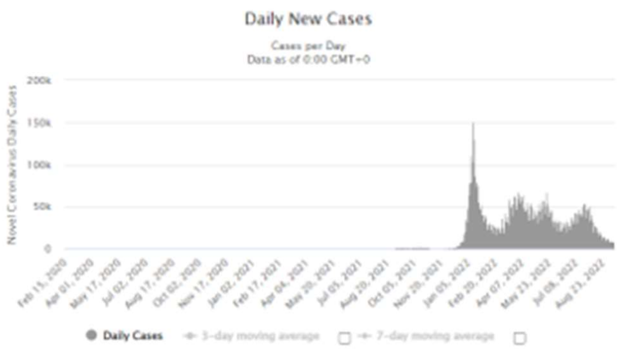



In terms of lockdowns, already we have seen massive cities like Shanghai (population of over 26m) in lockdown and now we have Chengdu a city of 20m in lockdown with drones blaring out ‘Stay at home or else…..’. The same strategy as was used in Guangzhou at the start of the pandemic.

And they locked down Chengdu because they had around 120 daily new cases of covid. This based on tests that will have false positives. Think on that for a minute. The covid data out of China also looks absolutely fabricated.

Also, lockdowns have been shown not to prevent spread, they just defer it for a bit. Take a look at Australia and New Zealand, which basically shut themselves down completely to outside tourism for two years.

Daily New Cases in Australia




Daily New Cases in New Zealand

**So why, over two years since the start of the pandemic, are they imposing these draconian policies. Simple stupidity? We doubt it. We posture that there may be a few reasons for it. But this is really going down the 'rabid hole'.**

Firstly, the government could be preparing for food shortages. In lockdowns, food supply is centralized and rationed. Is China preparing the ground on how to deal with food shortages?

Food shortages are a very real issue.

*Maximo Torero, chief economist from the Food & Agriculture Organization (FAO) of the United Nations (UN), who told Bloomberg TV that elevated fertilizer prices could decrease global grain production by upwards of 40% in the next planting season.*

*Combine food supply chain disruptions due to the war in Ukraine and crop failures worldwide due to extreme weather -- ramping up food production with reduced fertilizer next planting season via key exporting countries could be challenging.*

Secondly, could they not also be preparing for war? A major military conflict would also create economic blowback and shortages of food and other commodities. Locking the populace down would prevent riots on the street and looting. So, this could be preparation for something further out. We should also consider that it's also a practice exercise for economic warfare, testing the impact of supply chain disruptions on the wider global economy. This, under the disguise of managing the pandemic spread.

The third option we have and perhaps the most benign, is to control the populus and to limit any social unrest. By creating fear, you can control.

"No passion so effectually robs the mind of all its powers of acting and reasoning as fear", wrote the 18th century philosopher Edmund Burke.

*"The whole aim of practical politics", wrote HL Mencken, "is to keep the populace alarmed (and hence clamorous to be led to safety) by menacing it with an endless series of hobgoblins, most of them imaginary."*

In this case, the fear of Covid is being used by the government to wield enormous power. The power to crush any dissent. The populous, on average will go along with it. If it's done in the name of 'safety'.

None of our options are particularly encouraging.

The latter option may be related to China's rollout of social scoring and Central Bank Digital currency (CBDC). To some readers this may sound like conspiracy theory. Unfortunately, not. Already in China a negative social score could result in one's inability to travel. To open a bank account etc.

And China is already well down the road to developing their CBDC. The eCNY has been under development since 2014 and unlike crypto in general where the aim is to be decentralized, the purpose of the eCNY is to have centralized control. The control of money gives absolute control of the populous. Dissidents can find their accounts put on hold. Funds redirected.

So, China concerns us. It is too large a nation to sanction. Sanction China and you sanction yourself. The asinine policies of most Western policy makers, other than President Trump, who looked to apply tariffs of China imports into the USA, have facilitated a significant trade deficit which financed the growth of China that is the powerhouse today.

The relevance of this is significant. China and especially Taiwan are very significant players in the semiconductor space. Cut off supplies from Taiwan, as we recently saw in the auto space, can have major ramifications on global production.

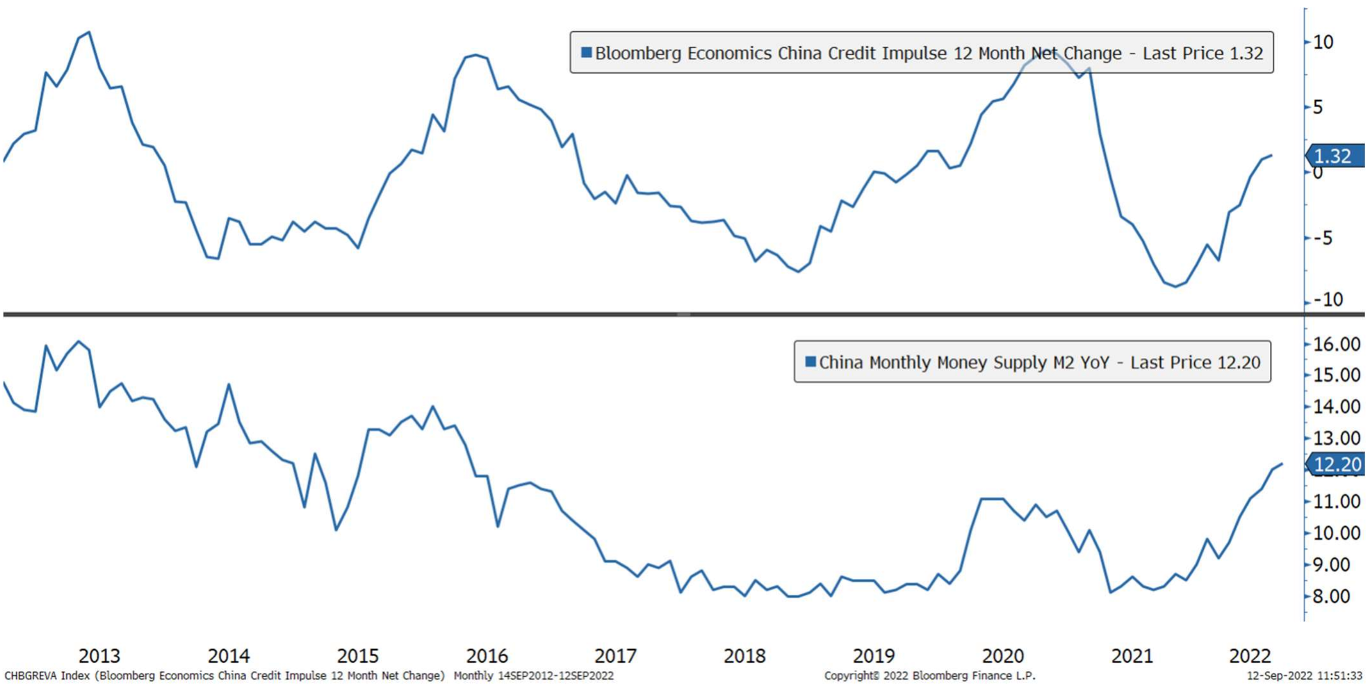
## Conclusion

**Equity Markets:** At this stage, we feel it is unwise to bet against the Fed and other central banks. When central banks are tightening, it is wiser to reduce risk exposure. So, we continue to expect the markets to be volatile and downward, at least until we see the Fed take a more dovish view. Given they have painted themselves in a corner, we see the odds of this being less than just a few months ago.

**Preferred sectors:** No change of view here. We like defensive sectors such as Healthcare and are underweight areas such as IT, economically sensitive Industrials, Materials and traditional forms of Consumer Discretionary. We like Energy, especially, its free cash yield, and are overweight in most strategies except for global where we are marginally less than benchmark (Energy is some 17% of the MSCI World Islamic).

**Country allocation:** we have an overweight to China (eCommerce names only) and are underweight the US and especially Europe. Why do we still overweight China? The Central bank there needs to support their local market and we expect this will flow into the financial markets. M2 has already moved higher. It reminds us of 2009, when China was the first major nation to undertake significant QE coming out of the GFC.

**Chart – China Credit impulse YoY and China M2 Money Supply**




**USD:** The USD and the US economy are the cleanest shirt out there. The Fed is already at over 2% rates, while the ECB has only just raised to 75bps. We expect the USD to continue to strengthen, and significantly so if we see a flight from risk assets. We are not there yet. But soon.

Crypto: Longer term we believe crypto assets will make new highs. With fiat currency moving towards the blockchain, it is only natural that crypto will also become mainstream. While it is correct to fear that governments will want to ban crypto in favor of CBDC, we would argue that CBDC will only encourage consumers to increase their holdings of alternative assets such as crypto. In terms of timing, we would expect the asset class to remain under pressure, at least until we see a reversal of tight monetary policies. So, this could be potentially as early as the first half of ‘23, should the economy weaken as we predict.

**While we paint a fairly bleak picture for the next few months – with inflation, rising rates, potential EU gas shortages and uncertainty around China policy – we are optimistic as investors and are positioned to take advantage of any significant sell off in the markets.**

**‘In the midst of every crisis, stands great opportunity”. One just needs to be prepared for it.**

Asset Management Department

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