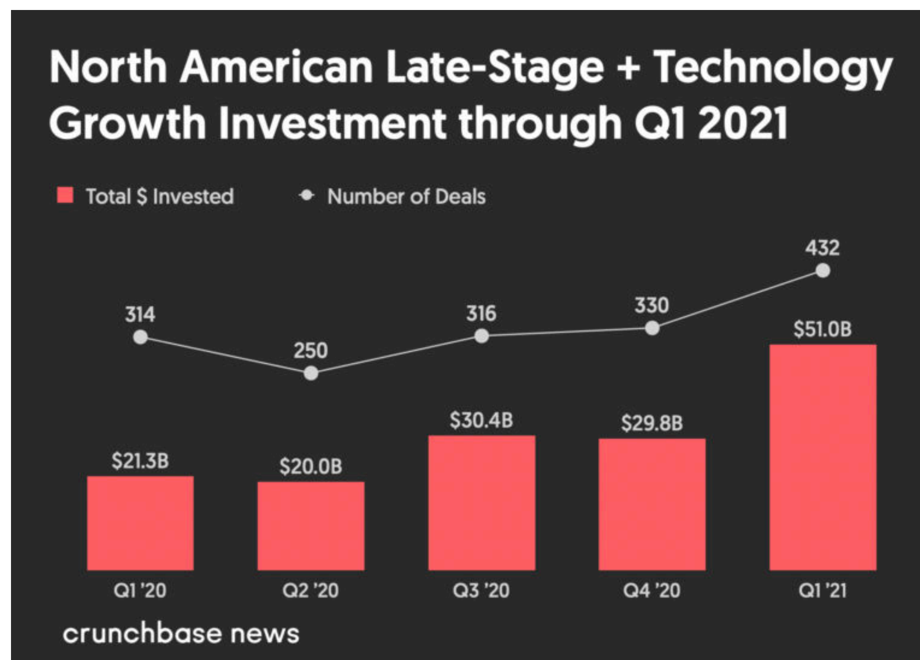
As The Tri Polar World Turns: Springing Forward
April 2021

I don't know if it's the Spring weather (72 degrees & sunny as I write) or the feeling that the dread & angst of Covid's long winter is finally starting to lift here in NYC but I sense excitement & forward movement in the air.

That's a welcome feeling to go along with the good job markets have done in pricking bubbles throughout the past few months: starting with the FANG stocks last Fall, the Robinhood Bros & ARK names earlier this year together with the whole SPAC craze. One can't forget Crypto with BTC suffering two 20% + declines ytd & Coinbase down 30% from its opening day high. These rolling corrections culminated in the Archegos affair & the repricing of the UST market with the 10 yr. UST yield backing up from .95% to 1.78% in a few months.

Notwithstanding this bubble pricking, there are two terms I continue to hear a lot and don't understand: the first is all the bubble talk – where is the bubble – I don't see any bubbles. Perhaps the bubble is in the private markets? See Chart 1. I see elevated sentiment, I see stocks at close to ATHs and credit spreads at near record tights but I don't see any bubbles. The second is this idea of zombie companies – maybe it's the FI version of bubbles. Supposedly there are all these zombie companies in the US and Europe that once the various fiscal supports end and the economies reopen these zombie companies will stagger into view and collapse, creating investment havoc. Really? When April US HY issuance is a record and Fitch cuts its 2021 default rate in half to 2%. Sure, some companies will go under but that happens all the time - a rash of zombie companies coming at you like the Walking Dead – don't think so.

CHART 1 – Is The Bubble in Private Markets?



Many of the regime changes first noted here five – six months ago are now unfolding: Vaccinations are working & Covid follow the leader is evident with the UK and US leading, the Global Economic BOOM is unfolding, transformational US Politics are manifesting under Pres. Joe, Go Big, Go Fast, Biden, Fiscal Policy is active across the DM & the Golden Age of Asset Allocation coupled with the rise of thematic investing drives activity across the investment spectrum.

As Covid is brought under control the developed economies are likely to experience a pretty full re opening process with the growth pick up expected to peak in Q2-3 in the US and Q3-4 in Europe. The real question is what lies beyond the growth surge, an elevated growth path for the global economy or a return to the subpar growth of the 2010-2020 period? Its way to soon to tell but this year and next should be very strong, aided by the gradual re opening effect. Early 2022 EPS estimates for the S&P reflect this with some forecasting roughly $200 for 2021 and $250 for 2022 which puts the S&P at 17x next year - not overly demanding. Even in recession, European earnings are running 40% ahead of year ago levels, reminding us once again that its earnings growth, not GDP growth, that drive stocks.

As we puzzle that out, my advice remains: ignore the inflation debate, don't worry about the Fed, keep calm & carry on. Remain overweight equity, especially non US DM equity, underweight bonds, especially Sovereign & overweight Commodities. Look to re opening laggards for opportunity. TPW Advisory's global, multi asset ETF based model portfolio with its thematic sleeve of nine separate themes, pairing both old (financials, energy) and new (fintech, clean energy) has allowed for both thematic & Value participation in line with the twin engine equity market – supported by Value in the early months, more recently growth, resulting in excellent breadth across both stocks and markets. I remain constructive on risk assets and expect the testing times to arrive in mid-late summer when the inflation debate really takes shape.

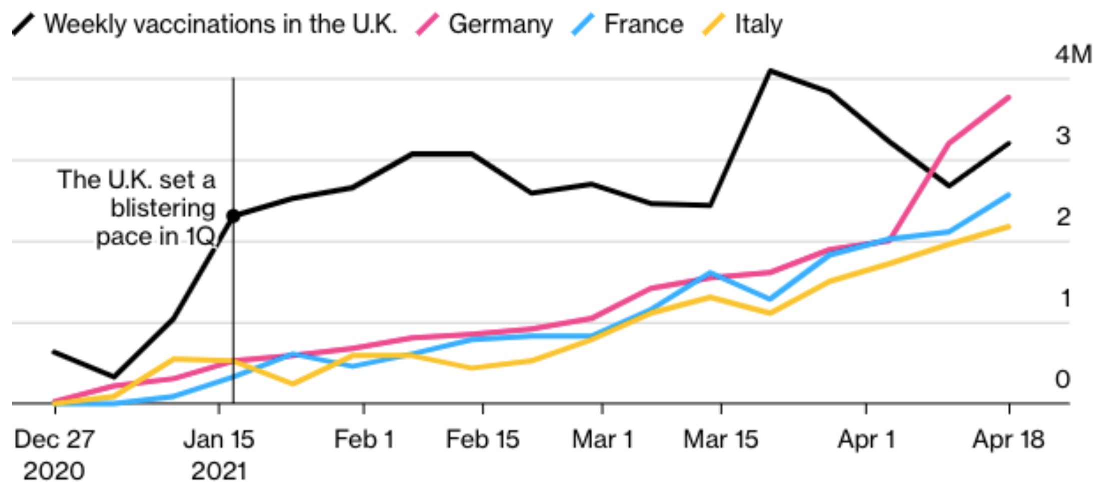
Let's use the Global Risk Nexus (GRN) – step two in our three step investment process - to guide us forward.

HEALTH

Follow the leader remains the Covid mantra and the UK now leads with its vaccination process advanced to the point where most restrictions have been lifted. The US comes next, with 42% of its population vaccinated; it too is easing restrictions, to the point where catchy headlines like "vaxxed & waxed" hint at a wild summer ahead. NYC is to be fully reopened on July 1st. The return of the J&J vaccine is welcome news as is the effort to encourage all adults to get vaccinated.

Europe continues to lag behind but as Chart 2 suggests, its vaccination process has finally picked up speed; hospitalizations/deaths look to be rolling over suggesting the all-important summer can be saved. Japan has been a DM vaccination laggard while EM has been disappointing, whether discussing India or Brazil or points in between, perhaps reflected in subpar ytd. Japan/EM equity performance.

CHART 2 - Europe Catching Up



A couple of things strike me – first, I may be able to retire the GRN's Health component in the coming months. I introduced it last Spring when it became clear that Health would drive everything else. Now that is becoming less and less the case. This is true even with the second point – that the concept of herd immunity and getting back to pre-Covid normal is unlikely given the varying degrees of vaccination both within & between countries. The trick is going to be ensuring that the slow vaccination rollout globally does not allow variants to accelerate faster than improved booster shots developed by that same global scientific effort that gave us the Covid speed of science model.

ECONOMICS

The BOOM I first highlighted back in November has become common wisdom – a good 15% later in ACWI. BofA expects close to 6% Global GDP growth this year and over 4% next vs the 20 yr. average of 3.5%. Markets, whose forward discounting mechanism I believe has sped up (Running Fast) have apparently already discounted this judging from the response to China's Q1 GDP growth of 18%, Manuf PMIs that are off the charts and 4% PPIs in China and US. The reaction to all of the above has been a collective yawn. Ok, we did get the back up in UST rates I have been expecting but that came before most of those numbers were released, suggesting that indeed growth numbers the likes of which have rarely been seen are being viewed correctly by the market as (to use an already overused word) transitory.

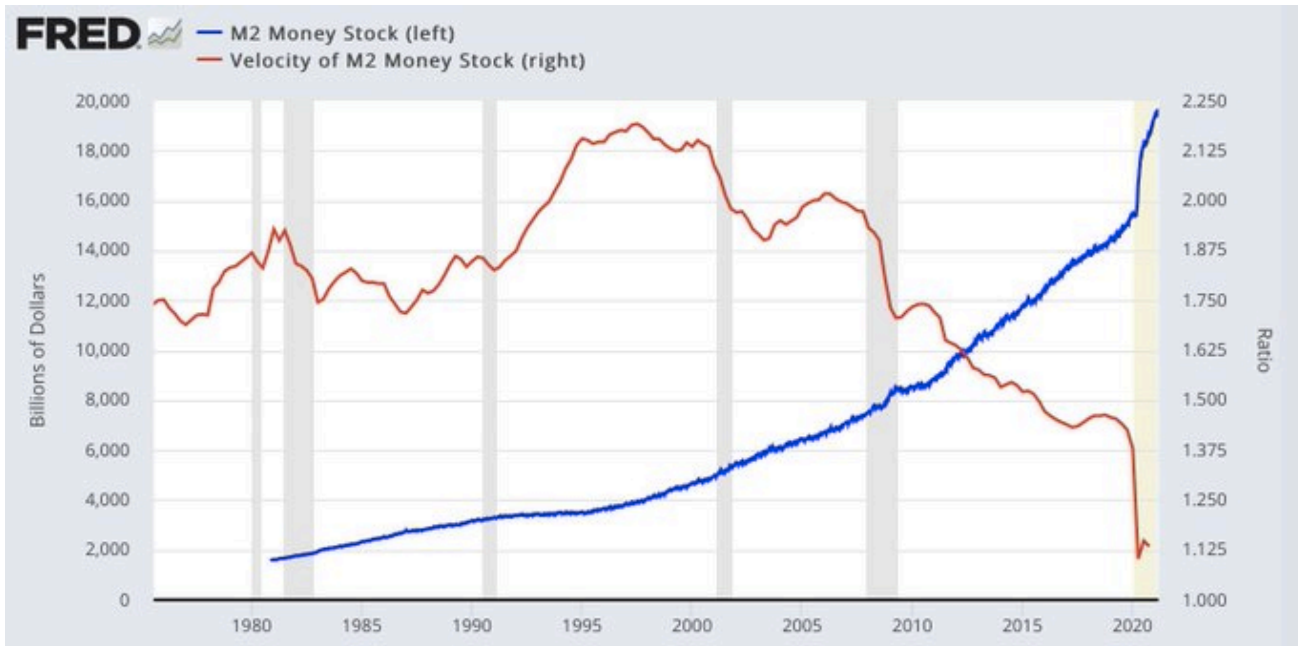
The key question is whether that other overused word: inflation, will also prove to be transitory. Here the doubt is pretty thick with many pointing to booming commodity prices (Dr. Copper anyone), surging PPIs, falling jobless claims and more to suggest that beyond the mechanical inflation pickup in March – May resulting from last year's collapse, inflation will prove sticky and possibly even ready to rise more in the 2nd half of the year.

This is where the rubber will meet the road – I expect the markets to watch the June – July inflation reports very carefully – if one can make the case that core CPI or core PCE inflation will get above 3% then rates head to 2% on the 10 yr. and perhaps beyond with attendant effects on other financial assets. Keep in

mind that core PCE has not been above 2.75% in roughly 20 years and that the Fed has said it wants to see inflation above trend for a period of time – most likely around a year. Fed 2021 core PCE forecast at year end is 2.2% vs Pimco for example at 1.7%. Bloomberg consensus is for the Fed to start talking taper this summer, maybe at the June meeting when it updates its forecasts or perhaps at Jackson Hole in August before starting to taper in Q4.

The bull case for inflation is both supply shortage (commodities, semiconductors & much in between) and demand surge related of course. But I struggle to sync this up with the idea of service sector dominated economies where the "digitalization of everything" is the rally cry. Those expecting inflation to surge need to also note that it is not just rapid Money Supply (MS) expansion that leads to inflation but also its velocity in coursing through the economy. As Chart 3 shows, while MS is on a tear the velocity of money is stuck in the mud with no sign that it's about to surge, likewise bank credit has been very weak, esp. in the US. Of course, there is a risk that companies recognize that the best time to raise prices is right now when folks are flush and desperate to get out.

CHART 3 - Hard to Get Inflation Without Velocity



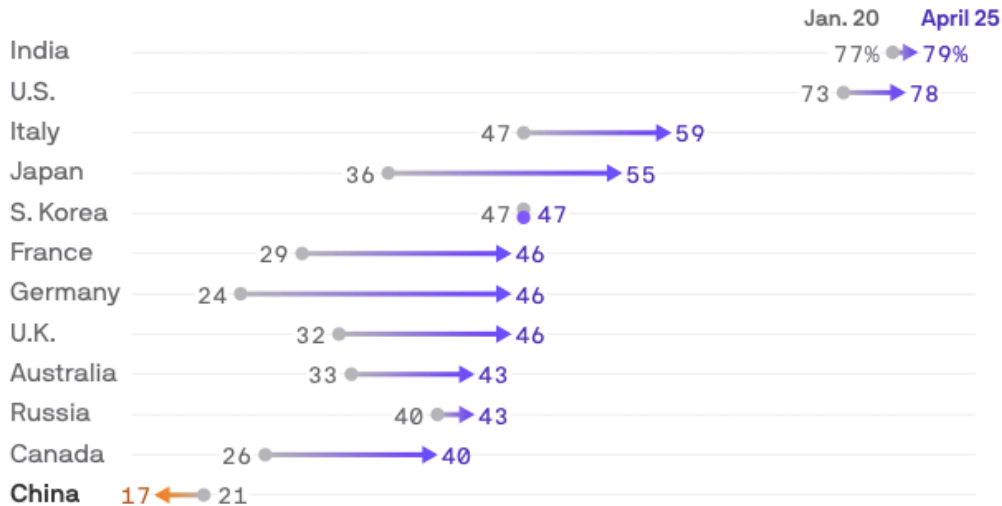
POLITICS

The Biden Admin's Go Big, Go Fast activist approach to governance certainly seems to be good politics given the high approval ratings his Rescue Plan, Jobs Plan and the just unveiled Family Plan have garnered. Stock market approval is the best since FDR as Biden seeks to become a transformational president. Interestingly enough the Plans are more popular than the President; according to first 100 days polling Biden's approval rate is roughly 52%, better than Trump's but worse than either Obama or Bush. The Biden approach continues to be solve Covid, jumpstart the economy and run on the results of both in 2022 and 2024. Makes sense to me.

I wrote last week (US Political Brand) about how decisions that might be good for the US political brand value (Climate, raising taxes on the wealthy to reduce inequality etc.) might have the opposite effect on the relative valuation of US financial assets. US exceptionalism has played out with US equity outperforming the rest of the world over the past decade & ytd; going forward massive twin deficits &

efforts to reduce them via sharply higher corporate and (wealthy) individual taxes could lead to a decline in relative valuations, particularly around the USD.

CHART 4 - US Political Brand Value Rises - What About Financial Assets?



Source: Morning Consult, Axios

The US is shifting from a 40 year regime (Reaganism) where the wealthy and corporates received the lion's share of rising wealth to a more equitable approach. The political class, at least its Democratic version, has now decided (and the country would seem to agree given those polling #s) that the prior era was a mistake and it's time to go in a new direction of climate and equality focused political decisions. To use the state to improve people's lives across the full spectrum of life – it is a pretty breathtaking change and it is moving quickly. Big problems are being met with big proposed Government led solutions.This is true in the case of the Americas as well with cross border railroad M&A bidding wars, US offering shots to Mexico and Canada, a proposed Marshall Plan for Central America and more - finally some action in the Americas pole of the Tri Polar world!

The US is not the only political game in the global square. Germany's upcoming election looks like it might bring in some fresh (Green) air. As Angela Merkel prepares to step down there is a real chance she is succeeded as Chancellor by another woman, Green leader Annalena Baerbock. The leader of the Greens is a young, 40 yr. old, charismatic leader of a Party whose raison d'etre is the issue of the decade, namely the climate. In Italy, Mario Draghi already resides in office but he too is moving fast to remake Italy, leveraging the Joint Recovery Funds (JRF) to be dispersed in coming quarters and years to remake the Italian economy. Success in both countries would reinvigorate both the North and South of Europe, improving the chances for more European dynamism and integration.

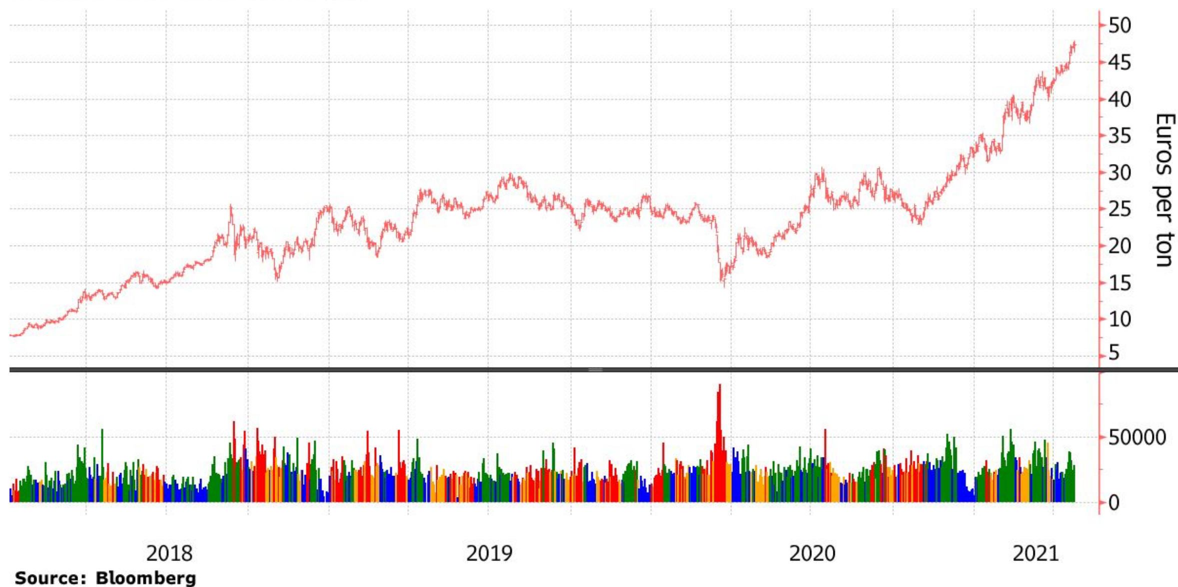
POLICY

The unprecedented first 100 days of the Biden Administration really sets the global policy pace. The approved $1.9T Rescue Plan, the proposed $2.3T Jobs Plan and the just announced $1.8T Family Plan together have the potential to reshape the American economy & society in the coming years and decades. The decision to use corporate tax hikes to pay for much of the Jobs Plan and higher taxes on the wealthy to

pay for much of the Family Plan is both politically astute and a recognition of the failure of the prior US policy mix, at least insofar as providing for an equitable society and clean environment.

The Biden Climate Summit while not filled with policy goals did include many countries, led by the US, who promised much more aggressive carbon emission reduction targets for 2030. These 2030 commitments ensure that the Covid Speed paradigm shift I have written about for some time now: global intellectual & financial capital focused on a singular goal (in this case climate) can lead to unprecedented results, is now firmly in place. This has significant implications for markets as well, primarily around the growing importance of investing thematically.

CHART 5 - Carbon Pricing is Key to Climate Change



While the Climate Summit failed to include a cross regional or global Carbon Border Adjustment Mechanism (CBAM) as I thought it might, it did drive home the point that setting realistic prices on carbon is key to driving down emissions - see Chart 5. I continue to expect this to occur as companies are pressed by their consumers, shareholders and employees to set out their emissions and how they're reducing them. As an example, look at the recent pressure Georgia based corporates faced following the passage of a Georgia voting law that many saw as restricting rather than expanding access to the ballot box.

Corporate policy is in flux & companies are under pressure – on the Climate front, on issues like voting rights, Uighur cotton and business in China, taxes and antitrust to the point that nominally Communist China appears tougher on its Big Tech companies than capitalist America. Germany and France just decided to support the US global minimum tax proposal, Europe leads on the antitrust front, China is pushing companies to decide whether it wants to do business in China and thus use Uighur cotton. Governments need revenue and the wealthy and corporates have it - interesting times indeed.

Europe has had a bad run of late – a disaster of a vaccination process rollout, questions around the disbursement of JRF monies, political rows across the Continent & what appears to be a recession. Markets have seen through it all however reminding us that its earnings not growth that counts. Expect a much smoother vaccination process from here; the EU is likely to be proven right when it says it is on track to vaccinate 70% of adults by summer's end. Its decisions to allow vaccinated Americans to come visit for the summer is a smart move and will help put many back to work, especially in the tourist heavy South of Italy, Spain Portugal, Greece etc.

The JRF is finally moving ahead and should be ratified by all 27 countries in the coming weeks as German courts, Polish politics and much else fails to stop the process. Monies should begin being disbursed in the coming months and will carry over in to 2022 such that Europe's 2022 growth could outpace the US. Note that Germany just raised its growth targets for both years – it's the first time in a while that a European country raised rather than lowered its growth targets - a truly welcome sign.

There is much worry about China and the potential for it to overly tighten monetary policy and withdraw liquidity thus threatening markets around the globe. This worry seems overdone to me and I note that China plans to increase credit by 11% in 2021 y/y which doesn't seem like tightening. Japan has also been very slow in its vaccination process even as the Olympics approach resulting in tough lockdowns across many of its leading cities. Nonetheless its Composite PMI just broke above 50 while its most recent retail sales # was well above forecast. India remains caught in the grip of a Covid surge – one that hopefully will give way soon.

MARKETS

Over the past several weeks there are several market issues I have been thinking about. The first is the idea that the market discounting mechanism is speeding up as a result of Covid speed, the ubiquity of data, the rise of machine learning & the digitalization of everything. I referenced the piece on Tiger Global and its disruption of the VC industry as it creates a new flywheel to do things better, faster, cheaper. Exhibit A lies in the recent UST rally from 1.78% to 1.55% when 90% of investors polled had expected the next 25 bps to be higher not lower. Yet, in the face of 4% PPI and 10% March Retail Sales #s, Treasuries rallied. Exhibit B is this week's great Big Tech results and the Nasdaq reaction which was a big yawn.

For investors this presents a real challenge because one has to be early to catch moves otherwise one is chasing and playing catch up which could mean getting chopped up. It reinforces the benefit of setting Asset Allocation and having a solid process to keep one grounded.

The second issue is the impact of the Biden Climate Summit on thematics in terms of laying out the total addressable market (TAM) for climate action over the coming decades. I saw one estimate that suggested the TAM for climate adjustment between 2020-2050, so granted, 30 years, is an astounding $115T. The new, sharply lower 2030 carbon emission targets suggest that the Covid speed paradigm shift as it pertains to climate will be huge and move much more quickly than most investor think. From linear to exponential.

The potential for much higher capital gains taxes also impacts the ETF based, thematic investing approach in several ways: First, it reinforces the tax efficient nature of ETFs vs mutual funds – V few ETFs pay out capital gains and secondly thematic investing implies investing for the long term, in line with the theme and thus not trading a lot, thereby reducing the likelihood of capital gains.

This raises in turn a third issue, namely the allocation process in regards to the reopening/rate rise/value play versus the thematic allocation. The backdrop is my belief that to sell in May and go away – very tempting this year given ACWI up close to 10% and Commodities up roughly 20% - would be the wrong thing to do. I expect the broadening of the re-opening process – from the UK and US to Europe, Japan and parts of EM - to sustain the dynamic currently in place of gradually higher DM rates (UST, BUNDS, JGBs) at the long end, supporting another leg of the Value rotation - see Chart 6. I expect 10 yr. German BUNDS for example to trade close to zero or even positive this year.

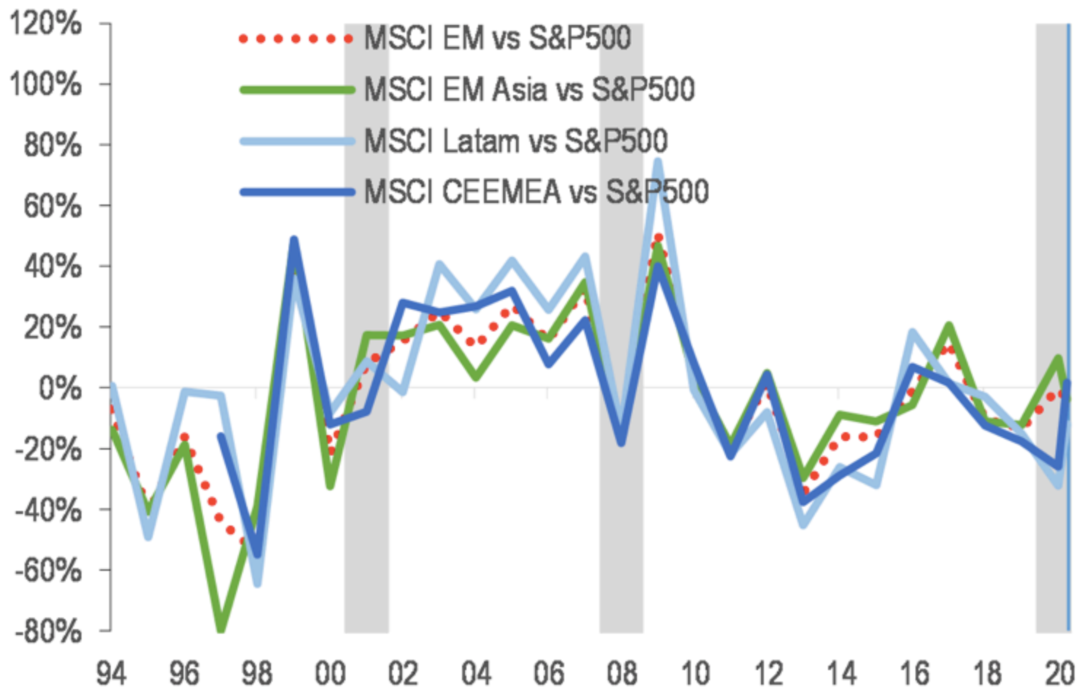
CHART 6 - 2nd Leg of the Value Opportunity Ahead?

I think the testing time for markets is more likely to be in the June – August period when investors get their first sense of inflation post the mechanical pick up addressed above. At the same time the Fed will have a few more months of big job gains hopefully and will be updating its forecasts in June and providing the backdrop for Jackson Hole in August. How does this foot with the advanced discounting noted above? I think because no one is really sure about the inflation numbers that folks will want to see the actual numbers. Summer seasonality tends to be poor for equities and trading desk may well be more understaffed than usual. All this suggests the tricky time for markets is likely to be in a couple of months rather than a couple of weeks.

So with a decent runway in the near term supported by great earnings across the DM, continued vaccination success in Europe and hopefully Japan and EM, a Fed clearly on hold thru late summer in terms of taper talk the question becomes what to do with the portfolio. Here I have been exploring the issue of having the broad AA and portfolio strategy well settled as laid out above. Given the early stage nature of the Economic Boom and Rotation away from US, Growth, LC to Non US, Value and SC the opportunity exists to devote much of one thinking time to the issue of investing thematically. As Europe's

vaccination process picks up together with those in Japan and EM this should spur the 2nd leg of the rotation which may well be led by the laggards – Japan in DM and old style EM in Latin America. JPM notes that Japan and Brazil are among the world's cheapest equity markets - see Chart 7.

CHART 7 - EM Laggards = Next Opportunity?



So it's back to the question posed above – re opening laggards vs thematic plays. I have been running the twin engine version as noted and expect to continue that but wondering if one should maybe tilt a bit to the re-opening trade and allocate to some of the laggards. We already have good exposure to Europe and Japan so it's really thinking more about EM and perhaps the old style EM rather than EM tech which has been hit by China's ongoing cutting down to size of its Internet elephants. Lat Am has started to look up in terms of relative equity performance and its major currencies, Brazil's BRL and Mexico's MXN, have both been strong recently which together with broad commodities having broken out suggests the re-opening is just ahead and these markets may be an opportunity.

Writing the Monthly is step one in TPW Advisory's three step model portfolio delivery process: step two comes next week with the portfolio review followed by step three – the model portfolio delivery to clients. So there will be time for more thinking about this question in the days ahead. For those signed up for model delivery get ready, for those who are not – reach out so we can fix that.