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WHY BE BEARISH?

1,333 words, a 4 minute read.

Another week of one step forward, two steps back with ample opportunity to get chopped up. No surprise given the history of post options expiry week (weak). It's a great time to let the market tell one what is happening rather than try to impose one's POV.

Having said that I do wonder why be bearish – everyone else is, starting with the major banks. I know well that being bearish makes one sound smart & I get that there are all sorts of reasons to trot out: Delta, political risk, stock valuation, TINA, seasonality, Fed taper, fiscal cliff, and of course the big kahuna: Evergrande – world's biggest property debtor about to go under, dragging down pretty much everything with it.

But isn't all that already known and thus in the price? Shouldn't the real question be not when will we have a correction but rather how much longer will the correction last? While plenty talk about how long it has been since SPY had a 10% pullback Schwab makes the very useful point that 86% of SPY constituents have ALREADY had a 10% pullback.

To declare an interest, TPW Advisory is bullish not bearish. This week's action increases our conviction in our previously expressed view that we are setting up for a performance chase into YE, led by underperforming hedge funds and focused on Cyclical/Value, Small Caps in the US and our OW non US DM, especially Japan, our recent adds to Asian/European EMs and Commodities, esp. energy and metals.

There is a ton to cover; as this is a Musings we will simply scratch the surface but fear not, the Monthly comes next week. As an aside, over the past week we have been very fortunate to be able to lean on a number of folks inside China and out who are the true China experts – a big shout to all – you know who you are! It's been a real time demonstration of the TPWA network, built over the past 30+ years.

For now we can look at a few things that suggest the Evergrande story is, as former MS colleague Jordi Visser has noted, a misdirection – in that its reinforcing the growth slowdown, China implosion, story at a time when the opposite is unfolding around the globe.

To start, the Asian reopening is fully under way with Goldman's Lockdown Index showing the most open since Covid began. Japan is likely to end its lockdowns in coming weeks and its August Service PMI at 47 is up sharply from prior 42 level, Malaysia has vaccinated 80% of its people and is ending its lockdown, Thailand has cut its tourist quarantines in half, India is resuming its vaccine exports as its cases stabilize & China has vaccinated 78% of its population. Its Mid Autumn festival provides some recent color – hotel bookings up 20% vs 2019, car rentals up 77% (more stay cation yes but still not an implosion).

If Evergrande was really going to bring China down then Chinese stocks would be cratering right? Actually the CSI 300 is up, yes, up over the past month – outperforming the US. More to the point, China equity is outperforming ACWI and the US over the past week.

If Evergrande was going to slow the Chinese economy and cause growth to weaken sharply then Commodities would be under lots of pressure right? Actually, the CRB index is likely to end the week up – for the 5th week in a row. Crude oil is breaking out and even AMLP is catching a bid.

Evergrande fears would lead to UST rallying sharply in a safe haven bid right? Actually, UST have sold off for the last 5 weeks and looking V much like they want to break key levels and kick off the Value – Cyclical trade for real (oh please, pretty please). EM credit would be a disaster right? Actually its fine – in EM and globally – why? Because going into this week Evergrande debt was already trading at 30 cents on the dollar and Asian HY property debt was yielding 14%.

Evergrande is in the price.

Sure Evergrande is a mess that will be with us for at least a month or so and sure it is worth thinking through but when you do that you note that the whole thing is Govt inspired and led – its not a surprise at all which is why markets have been so calm absent Monday's freak out. Keep in mind China has tons of arrows in its policy quiver (see recent liquidity adds) and a possible silver lining – if money does flow out of property it may well flow into Chinese equity.

Monday's selloff was a big deal –JPM reports it was the biggest one day equity outflow on a down day in a year, BofA reports the biggest US equity outflow week in over 3 years, the TICK ratio hit capitulation levels & SPY put volume was the 9th highest on record, levels which historically mark a bottom.

But when looking at various positions one notes that the broad China exposed ETFs didn't break their lows from a month or so ago – other ETFs held their Delta discount lows of mid July and some, like JETS that herald the reopening, are breaking out.

If one has held China exposure as we do, then there have been three chances to sell in the past 2 months; the Delta scare of 7/19, the China edict scare of 8/20 and this week's Evergrande freak-out. JPM notes that for EM investors China onshore property developer exposure = 1% of their onshore equity exposure. Its not a new story; everyone who wants out is out and now China offers great value relative to other markets, especially the US.

Here's the thing: Evergrande is actually the storm that clears the deck – what follows a storm? A period of calm right… the set up from now into YE looks very appealing. JC at All Start Charts points out that high beta stocks are hitting multi month highs & are back to outperforming low volatility stocks, the opposite of what one would expect if markets expected a big downdraft.

Seasonality is coming our way (Ned Davis Research points out that Q4 has been the best Q over the past decade with ACWI averaging a 5% gain), Delta is fading, Asia is reopening, China is not imploding, the Fed has made taper a non event (well done Jay – you should get re upped for sure), the growth scare has ended (data flow is improving, MS says US growth bottomed in August & Citi's US ESI is starting to turn up just as investors get fully convinced growth is slowing further), we have had capitulation action in equity markets, earnings are coming and should be VG across the globe.

The synchronized global expansion we expect in 2022 looks to be on track with Germany's IFO raising its 2022 GDP forecast to 5.1% from 4.3% and the Asia Development Bank (ADB) raising its growth forecast for the region to 5.4% from 5.3%. Asian reopening should help ease supply chain worries and inventory rebuild across the globe should provide further growth support.

There are a few things still out there – mostly in the political realm: German elections next week, Japan's LDP party leadership contest, the fate of the Biden infra plan in the US together with the tin pot debt ceiling issue. BofA reports Infrastructure fears have already led to the biggest infrastructure equity fund outflows ever!

Maybe the debt ceiling will actually lead to a shutdown and further weakness, maybe the Democrats will engage in a circular firing squad and not get the Biden plan across the goal line. Maybe these would be sufficient to cause further significant stock market weakness. But most likely none of that will happen and the Evergrande capitulation will mark the last best chance to get on the reopening train.

TGIF!

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BACK TO THE 1990S