A rising tide lifts all boats

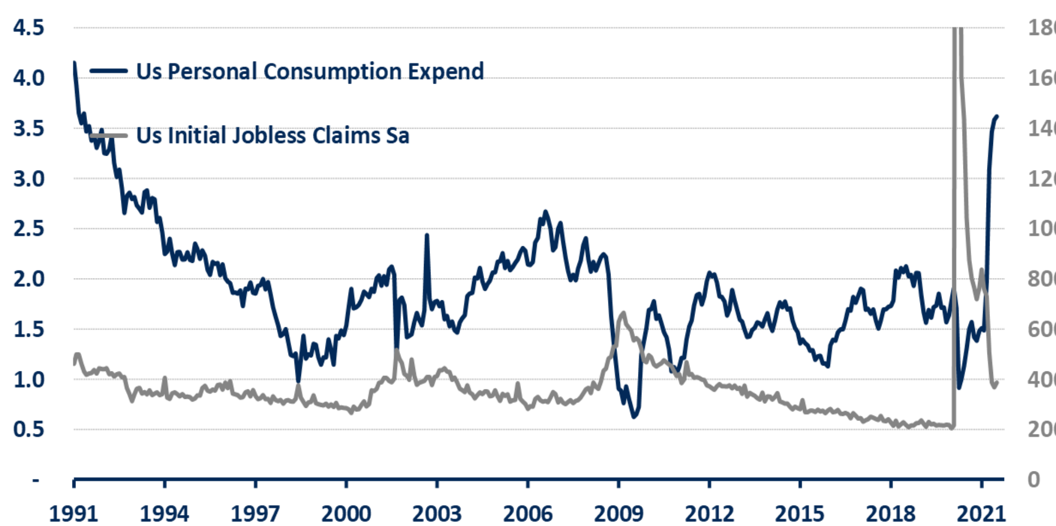
In an interview with the Financial Times on August 27th 2021, Gita Gopinath, the Chief Economist at the International Monetary Fund (IMF), warned that *"emerging markets cannot afford a repeat of the 2013 taper tantrum"*, highlighting that a surge in interest rates would be an extra burden on low and middle-income countries, most of whom suffered disproportionately from the coronavirus crisis. In our opinion, she is incontestably right. Bonds and equities, which are expensive by historical standards, would be in a tough position once interest rates start rising. This is especially true for emerging markets bonds and equities, as emerging markets are inherently volatile and most foreign investors would prefer holding emerging market assets only during "risk-on" periods. For that reason, we remain distant from the multiple "recommendations" we have received over the past few weeks suggesting that "Emerging Markets" or "EM" is the next big investment theme. According to the Institute of International Finance (IIF), more than US$360bn flowed into EM stocks and bonds between March and December 2020, such inflows could rapidly turn into outflows when interest rates start rising and pose an adverse effect on EM assets. The case could be different for Chinese equities however, while we keep in mind that volatility is likely to remain elevated as further regulation announcements might be made by Chinese authorities. Thanks to a 50% correction from its February 2021 peak the Nasdaq Golden Dragon China Index, primarily composed of Chinese Tech champions like Baidu, Alibaba, TDH Holdings, etc., is now trading at an average 2.5x price-to-sales ratio (as seen in Graph 1) compared to the Nasdaq 100 Index which is trading at an average 5.5x making it look reasonably attractive for investors with a long-term view.

Graph 1: EV/EBITDA ratio comparison between Nasdaq Golden Dragon China Index & Nasdaq 100 Index (US)

Source: Bloomberg, Lighthouse Canton, August 2021

The sad news for emerging economies is that the US may not take potential turbulences overseas into account before pulling up interest rates. As US Treasury John Connally famously reminded European finance ministers back in 1971, “The US dollar is our currency, but your problem”, the same rule is likely to be applied to emerging countries in the coming quarters. The truth is that the Fed is probably late in its tightening cycle and any further procrastination may be more harmful than helpful as far as the US economy is concerned. Indeed, as illustrated in Graph 2, the US Personal Consumption Expend (Fed’s inflation preferred gauge) has spiked above 3.5%, a level last seen in 1991. Weekly US initial Jobless Claims have also receded to 350,000, another illustration of the US economic strength. Unemployment is expected to further decline in the coming weeks as US states start ending their participation in federal unemployment programs.

Graph 2: US Personal Consumption Expend Index (%) and US Initial Jobless Claims (k) since 1991

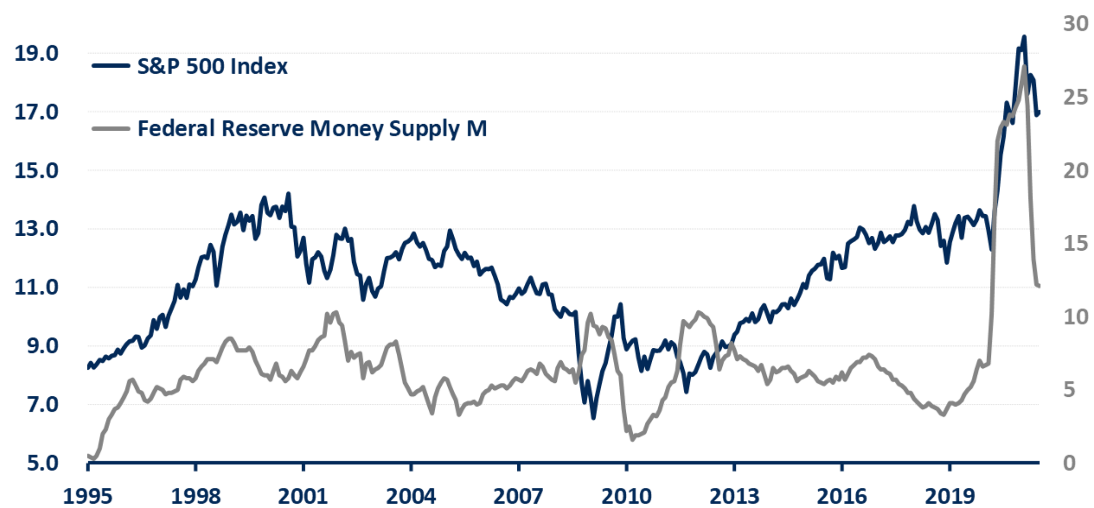


Source: Bloomberg, Lighthouse-Canton, August 2021

Equity markets have, in our view, dislocated from fundamentals in March 2020 as a result of Central Banks’ substantial intervention through their accommodative central bank policies. Abundant liquidity and bond purchasing programs, across Central Banks globally, have propelled equity prices to much higher levels, creating a huge disconnect in asset prices. As an example, the S&P 500 index reached 4,500 points on August 27th, 2021, almost double its March 23rd, 2020 (2237 points) level.

As illustrated in Graph 3, the S&P 500 EV/EBITDA ratio, now at 17x, trades 3 points higher than during the dot.com bubble in the year 2000. Such a jump in equity valuations unsurprisingly coincide with M2, which is a measure of the money supply that includes cash, checking deposits, and easily convertible near money, in the US being amplified by 25% in March 2020. We believe both are related and it does not bode well for financial markets when liquidity starts drying up. Another alarming factor observed, according to the Financial Industry Regulatory Authority (FINRA) is the amount of leverage (i.e. borrowed money) used by retail investors. In July 2021, the brokerage accounts of retails investors had reached US$880bn, which is 50% higher than during pre-covid levels. It implies that higher valuations have been fueled by Central Banks complacency as well as retail speculation, which could potentially be a red flag.

Graph 3: S&P 500 EV/EBITDA multiple and US M2 YOY growth (%) since 1995



Source: Bloomberg, Lighthouse Canton, August 2021

Investors took assurance from Jerome Powell's message at Jackson Hole that while tapering of bond purchases may begin this year, the pace will be gradual. Fed’s chairman also refrained from giving any specific timing regarding scaling back on bond purchases or rates hike, reiterating that the surge in inflation would be a short-lived phenomenon as it was primarily caused by supply chain bottlenecks.

Market consensus suggests that US interest rates should not be raised before 2023 whereas the tapering (slowdown in bonds purchase) should be announced during the FOMC (Federal Open Market Committee) to be hosted on the 2nd - 3rd November, 2021 and implemented as soon as December 2021. Our view is that we anticipate the Fed to keep its dovish tilt, to avoid markets from correcting too sharply. As money supply reduces over time, we believe investors will have to shift their focus back to company fundamentals from Central Bankers subsidies when making investment decisions and not to rely solely on liquidity-driven opportunities regardless of fundamentals.