Harper Capital Management:

Global Markets- July 2021 Outlook:

In Physics, Dark Matter and Dark Energy are unknown and hitherto undetectable forms of matter/energy used to theoretically explain the behavior of the observable universe. Financial markets, which trade based on economic expectations, financial metrics, and investor behavior, often need similar plugs to explain behavior in the short-to-medium term. In the long-term, with the benefit of hindsight, explanations are easier. At the start of the year, we had said the following:

"*Where does this leave us in terms of an outlook? There are many elements of a bubble in the Equity Markets. Real interest rates are negative in most of the developed world. Government bonds in the developed world are likely to offer low returns given current yields. Investors searching for returns are forced to move further along the risk curve. Monetary policies and fiscal policies will remain supportive of risk assets in 2021. The economic recovery and the strong earnings growth will also be supportive of risk assets. Inflation is likely to trend higher through the year, but it will probably take longer for any impact on longer dated bonds. The Federal Reserve has indicated they would like to see inflation north of 2% with the goal of supporting full employment. Increasing inflation is supportive of hard assets and precious metals. We may see occasional market sell offs, but the odds are that continuing strong policy responses and the recovering global economy should result in a good year for equity and other risk asset performance*."

Mid-way through the year, MSCI ACWI Index is +12.30%, EAFE Index +8.83% and the MSCI EM Index +7.45%. The United States continues to lead performance among the major markets (Chart 1) with the MSCI US Index +14.63%. Japan was a laggard among developed markets with the MSCI Japan Index +1.28%. China has been a laggard among Emerging Markets, with the MSCI China Index +1.82%.

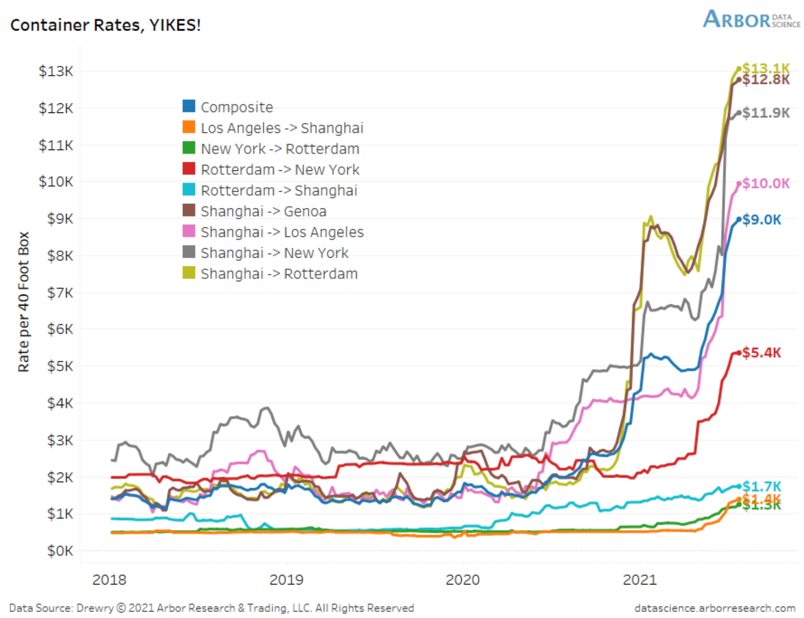
Chart 1:

While the Equity Markets have been volatile at times this year, the real story has been the US Bond Market- 10-year yields were at 0.94% at the start of the year, steadily increased to 1.74% in March before dropping to 1.19% mid-July. Part of the sell-off relates to investor positioning. As Chart 2 suggests, after the bond sell-off earlier this year, investors were bearishly positioned. This positioning, combined with new variants of COVID-19 and concern that the strong economic rebound underway may be a touch weaker, have contributed to strength in the US bond market.

Chart 2

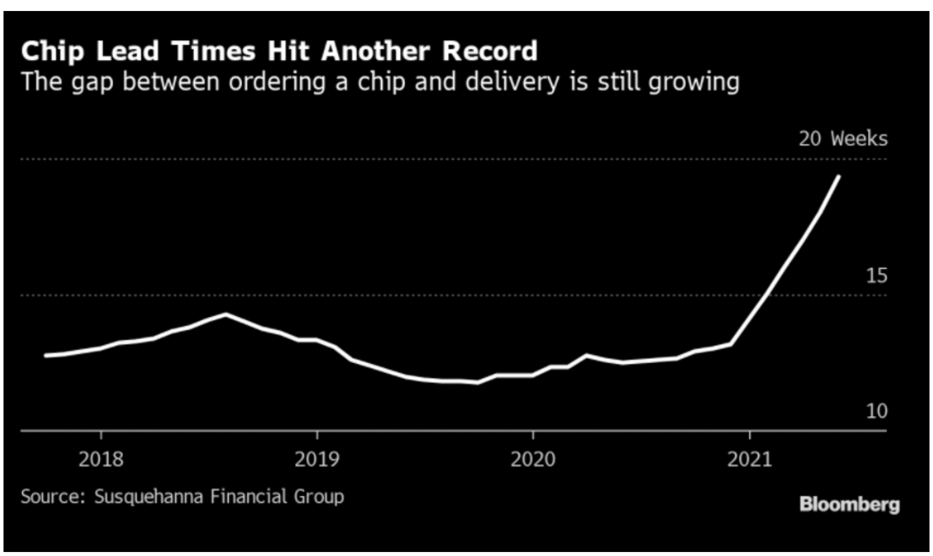
The sell-off in bonds early in the year reflected concern that inflationary pressure may not be transitory, and that the Federal Reserve may be forced to taper Quantitative Easing ahead of their original plans. Unlike the period following the Great Recession of 2008, there are some warning signs that inflation could be sticky. Supply shortages following industrial and transportation shutdowns have resulted in higher prices.

Chart 3



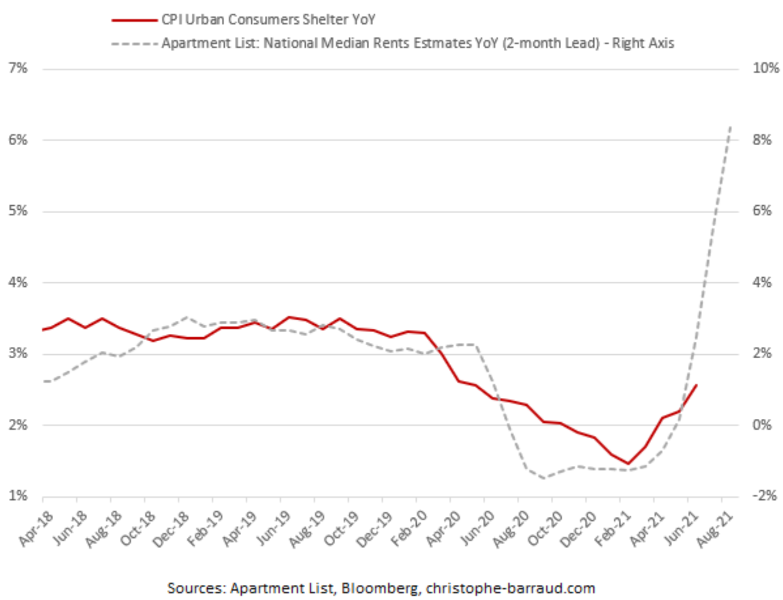
Semiconductor shortage (chart 4) has contributed to rising prices in many different sectors, including the auto industry, where demand from a recovering economy far exceeds current supply. This has affected both new car and used car prices.

Chart 4



The concern would be "how are inflation expectations" modified by the current spike in prices. The areas to monitor would be wage pressures into 2022 and 2023, and signs that the appreciation in real estate prices translates into sustained increase in the measure the Fed uses in estimating shelter costs. Chart 5 suggests this measure will rise in the months ahead.

Chart 5



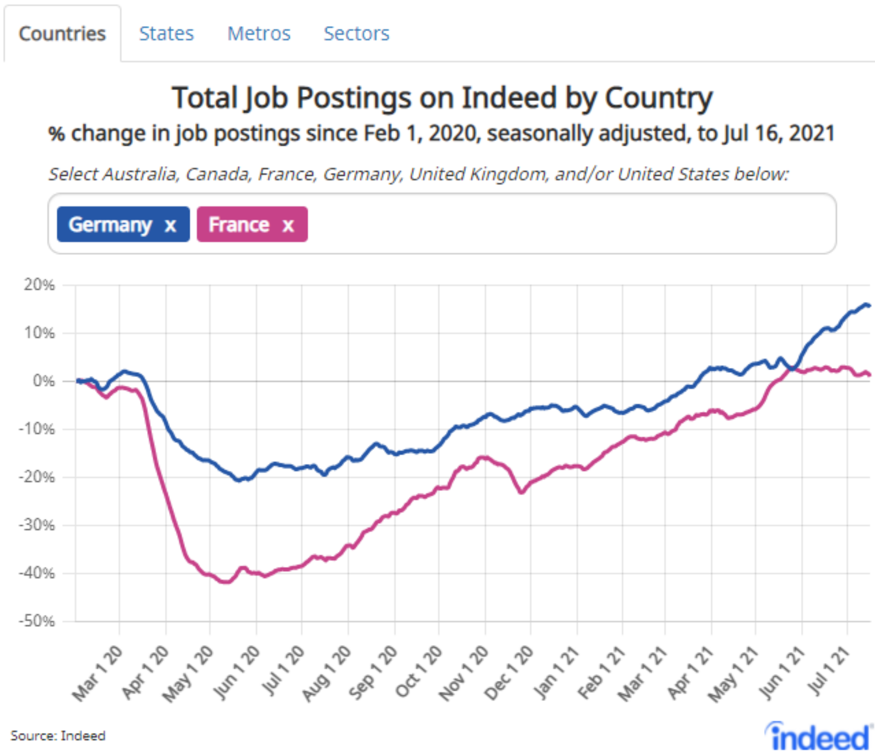
A closer look at the recent headline CPI print of +5.4% suggests that the Federal Reserve may be right at assessing these as transitory. 10% of the basket increased 20% YOY- these being autos (new, used and rental), hotels and airline and movie tickets. The remaining 90% increased 2% YOY. Wage pressures have been due to minimum wage increases across many states and the temporary shortage of labor due to higher/longer unemployment benefits and fear of COVID-19. Outside of leisure/hospitality and transportation, hourly earnings were +0.1% YOY[1]. Overall, while there are concerns about the spike in inflationary pressures, we think the bond market is probably correct that these are transitory, and we will revert to the long-term trend when the supply chain issues are sorted out.

Economic recovery in Europe has lagged the United States (almost always does, it seems), with lower vaccination rates and a surge in COVID-19 delta variant cases.

[1]David Rosenberg https://twitter.com/EconguyRosie

Composite PMIs have been in expansion territory for several months (chart 6) and employment levels are increasing again (chart 7).

Chart 7



The European Central Bank (ECB) expects monetary policies to remain extremely accommodative for the foreseeable future with its benchmark interest rate at -0.5% and with planned bond purchases.

Emerging Markets have lagged Developed Markets this year. China, which is the largest component of the MSCI EM Index, has been a drag on performance. We have written before about the long-term risks of investing in China, with a focus on the increasing debt intensity needed to maintain economic growth and the dependence of capital investment in the country on local government land sales. The rising debt levels and the risk from any measures to cap rapid property price pose threats to long-term economic stability. This year has highlighted some of the other risks to investing in China- the lack of balancing factors with a single person/single political party controlling all aspects of the economy and the lack of "rule of law." These have come to the fore in recent months, starting with the targeting of Alibaba Group and its founder Jack Ma, and progressing to other large "private companies." We use the quotes because it always been our belief that no company with most of its operations in China could operate successfully without the blessings of the Communist Party (CCP). In the past, the consensus was that, pragmatic elements of the CCP would adhere to Deng's dictum that businesses should be free to pursue growth and profit. However, under Xi, China has become far more restrictive in both the economic and political spheres. The issue for us as investors is "what risk can you assign to China investments," when the rules of the game can change overnight. Last week, China announced that companies offering tutoring in school curriculum subjects had to be "non-profit" enterprises, essentially destroying the value proposition for many of these companies. We think indices like the MSCI Emerging Markets should consider such factors like the how strong is the "rule of law", how independent are commercial entities from government influence, do the corporate structures such as VIE (used by all ADRs from China) create risks, when they consider weight of index constituents. Just like a discount is attached when there are ownership limits in shareholding, such limits should be considered and enforced when factors that we mention above affect investors.

Aside from the "rule of law" issue, China faces economic, social, and political issues that could prove challenging in the years ahead, as it tries to maintain economic growth with a political system that is an anachronism. Total debt in China has increased rapidly over the last decade, driven by large increases in corporate and state-owned enterprise (SOE debt)- charts 8 & 9

Chart 8

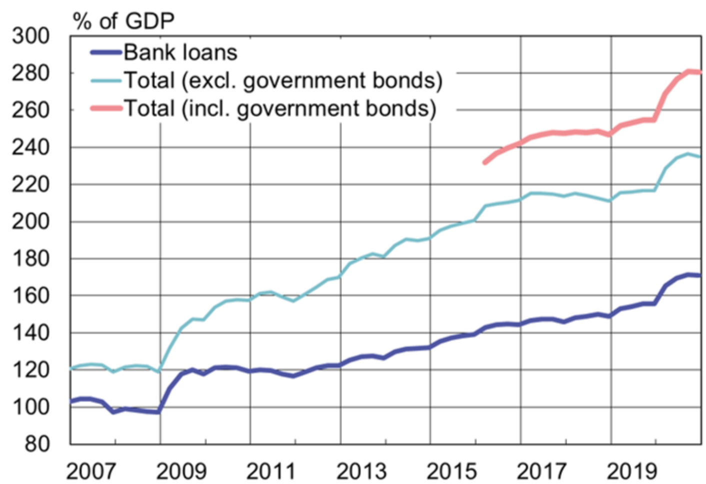
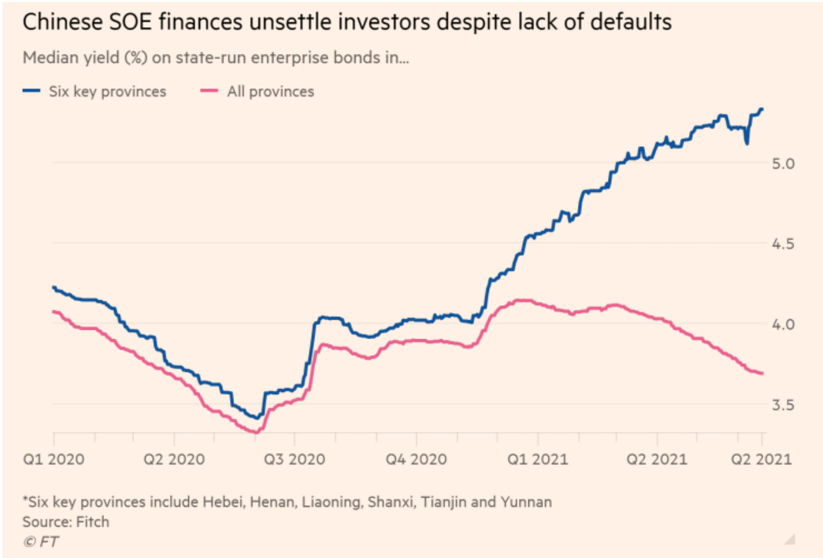


Chart 9



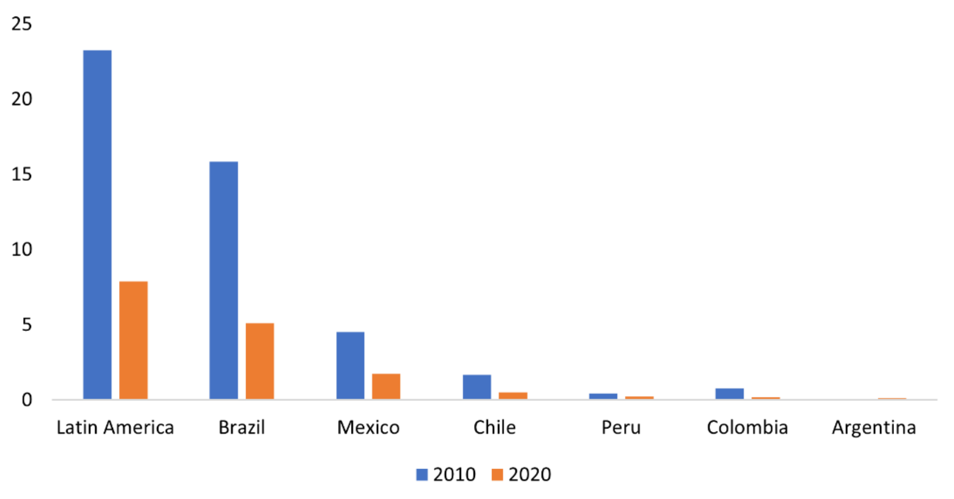
Despite easier monetary conditions, stressed SOEs and corporations are facing higher yields.

In the social context, China has seen very low population growth in recent years, and it is likely to face a declining working age population of about 25% by 2050[2]. This will pressure economic growth, and the options are ones that the CCP has been trying to avoid- accept lower economic growth and dent the party's image of having engendered development or continue the build-up of debt to finance growth that is not productive.

The political issues may be the most significant for not just China, but the entire world. The United States has facilitated the rise of China as a leading economic and military power by co-opting the country into the global economic system, and not creating burdens on its growth. The thought process was an economically strong China would seek to be part of the Global Order and not upend it. However, one-party rule has created a situation where the country's interests are diverging from the CCP's interests. We have seen this in the ruthless suppression in the previously libertarian city-state of Hong Kong. We see this in the bullying of smaller ASEAN countries in the South China Sea. We see this in the invasion of Taiwan's airspace, the provocative actions near islands controlled by Japan and in border skirmishes with India. Without a coordinated attempt by the Quad and other like-minded countries to counter the CCP's many transgressions, we think the risk of conflict rises significantly.

[2]https://www.weforum.org/agenda/2016/07/china-working-ageing-population/

Latin America has become a much smaller part of Emerging Market and Global indices over the last ten years- Chart 9



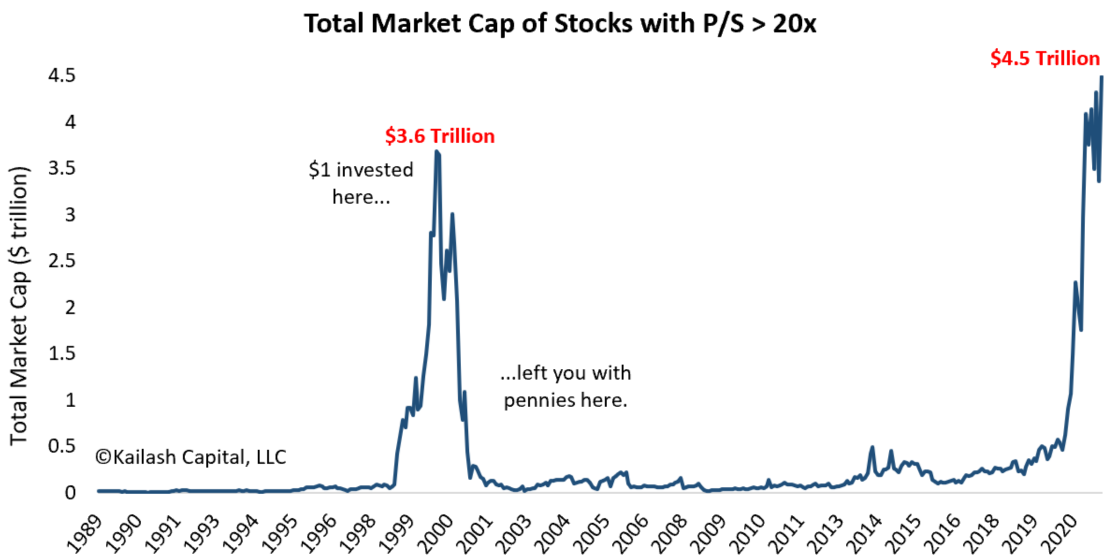
We think the fear of populism driving poor economic policies may be overstated. The election of Castillo in Peru and the potential return of Lula in Brazil may result in more pragmatic governments than the market currently expects- we have seen this in the case Mexico with Lopez Obrador. There have also been a large number of technology start-ups in Latin America, especially Brazil, and this has the potential to improve productivity and economic inclusiveness as has happened in Asia.

We remain positive on the Indian economy in the long-term- despite the disruption from COVID-19, the structural reforms of the last few years should sustain economic growth. Technology has also been an enabler of economic participation. We can share a recent detailed report on India published by a firm we work with closely, Sameeksha Capital.

As we stated at the start of the year, we remain constructive on Equity Markets for the year. We expect US Treasury 10-year bond yields to remain below 2%, despite higher (but transitory in our view) inflation prints this year. Earnings and cash flow are supportive of US Equity Markets- share buy backs and cash dividends are expected to total $1.45 Trillion[3] which translates to a shareholder yield of 3.9% vs current 10-year yield of 1.2%. Earnings expectation for 2021 and 2022 are higher now than at the start of the year, and both over 85% of companies have beat both revenue and earnings expectation. While, the United States economy and its corporates continue to outperform its developed market peers, there is an element of risk with the entrenched political divide and the attempt by certain state politicians to create scenarios where the legislatures could override election results. We believe, these efforts would be thwarted by the Judiciary. Supreme Court Chief

[3]JP Morgan/Barron's July 26, 2021

Justice Roberts may well turn out to be the most important figure of this fraught period in our history. Europe presents a lot of value opportunities and could perform well as they catch up on vaccinations. We like select opportunities in Emerging Markets where there are higher long-term growth opportunities. As we wrote in the last letter, there are elements of speculation in some risk assets (chart 10), particularly ones that are not anchored by cash flow. These include stocks trading on expectations of extremely high future growth, certain SPACs, "meme-stocks" like GameStop and AMC, and crypto assets.



Source: Kailash Capital; Data from 4/30/1989-6/30/2021

The broader market has seen rolling corrections across sectors that have been supportive of the continuing bull market. New variants of COVID, especially if they are vaccine-resistant could be a risk to the Markets if they result in a return to economic shutdowns.