HARPER CAPITAL
Invest Wise

Global Markets July 2022 Outlook

Tighter monetary policy needed for long term economic stability

In April of this year, we wrote the following

We expect company earnings expectations to be revised downwards into the second half of 2022. The key for investors is what is already factored into the markets. While short-term yields will rise as the Federal Reserve continues to tighten monetary policy, bond yields at longer durations have adjusted to the new regime. The tech-led Nasdaq is down 24% from its peak in November 2021, but this masks the damage to a large section of index components. Only about 14% of index components are above the 200-day average.

While the market as a whole is more reasonably priced, we also think pockets of irrationality remain. Tesla for example has an Enterprise Value of $870 billion with 2022 year-end sales estimate of $87 billion. In comparison, Toyota Motors has an Enterprise Value of $427 billion with sales estimate of $275 billion. We would expect that Tesla remains an important player in the auto industry but would not expect the size of the market itself to grow any faster than historical trends.

There are many imponderables in the global political economy- inflation expectations, geopolitical risks, tightening monetary environment and potential slowdown in the economy. However, company valuations in aggregate are more attractive than at the start of the year. We expect the second half of the year to be more constructive for both equities and bonds.

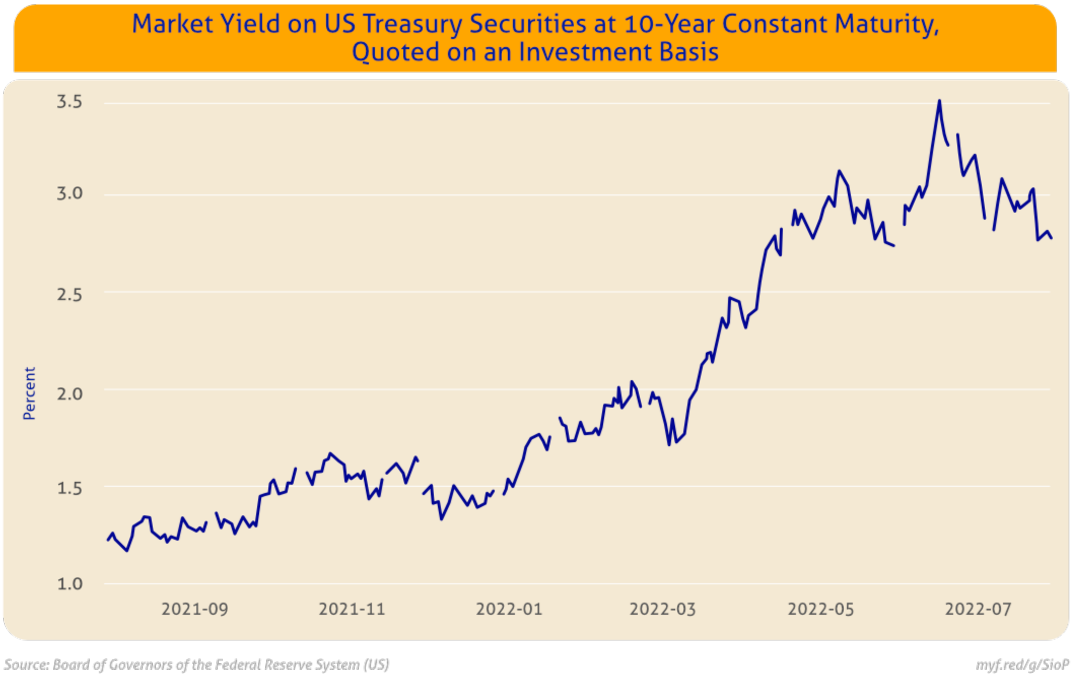
Through July end 2022, MSCI ACWI Index was -14.61%, EAFE Index -15.66% and the MSCI EM Index lagged at -17.83%. Markets that have outperformed through July are mostly commodity driven ones like Chile (+22.4%), Brazil (+8.43%), Saudi Arabia (+8.72%), Norway (-0.45%) and India (-3.69%). Underperformers are mostly European markets, with Germany, Austria, Sweden, the Netherlands, Hungary, and Poland all down over 25% in US dollar terms through July end. The bond ETF TLT which has an effective duration of 18.14 years is down 19.82% as of July 28th, 2022[1].

US 10-year Treasuries yielded 2.97% when we wrote our April commentary. Subsequently yields rose to about 3.48% on June 14th which coincided with the market low this year when the ACWI was -20.66% YTD and MSCI US -22.39% YTD.

1. https://www.ishares.com/us/products/239454/ishares-20-year-treasury-bond-etf

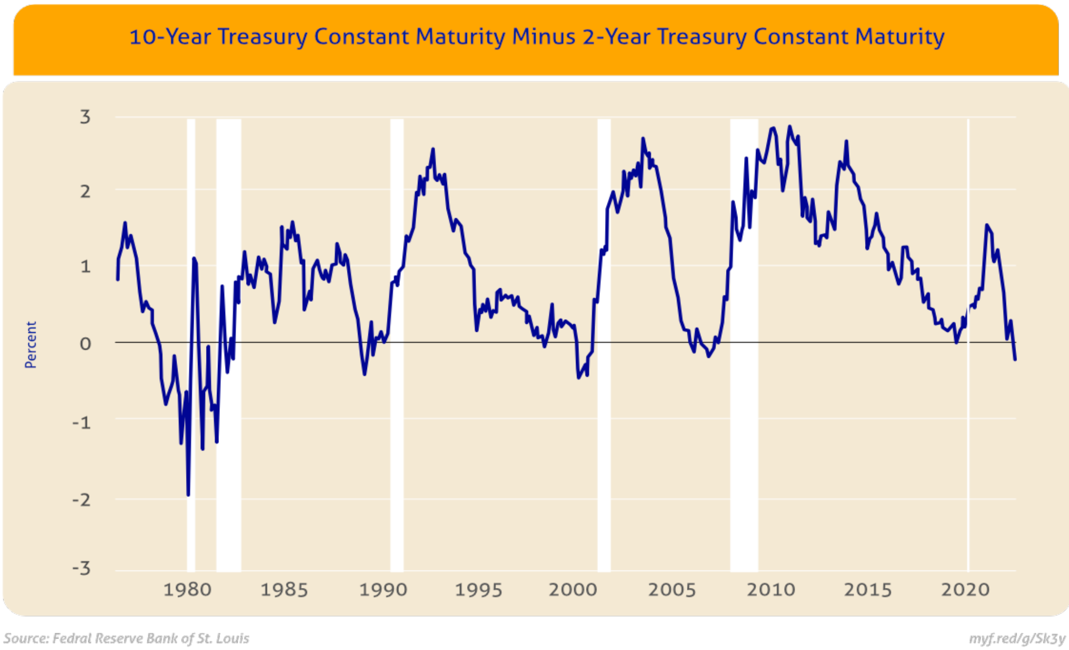
10-year yield at the end of July is at 2.66% a significant retreat over the last six weeks.

US Treasury 10-year yield

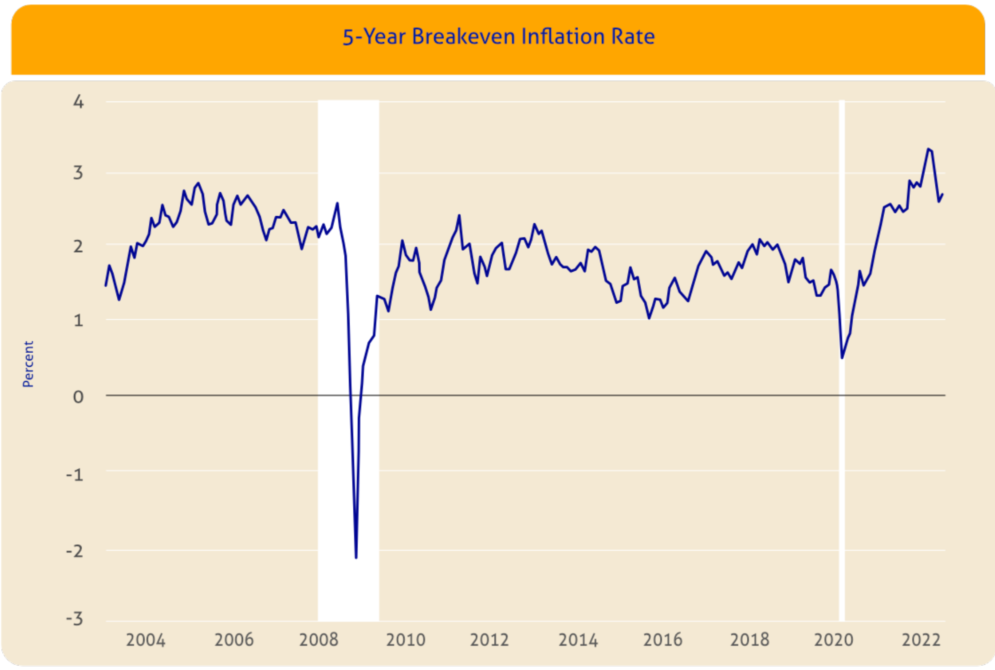


The 10-year-2-year spread has been inverted for several weeks now and the 5 year forward and the 5 year- 5 year forward inflation expectations remain reasonably anchored, though both are higher than a week ago. These measures are suggestive of the risks the Federal Reserve faces in its battle to keep inflation transitory without triggering a deep recession.

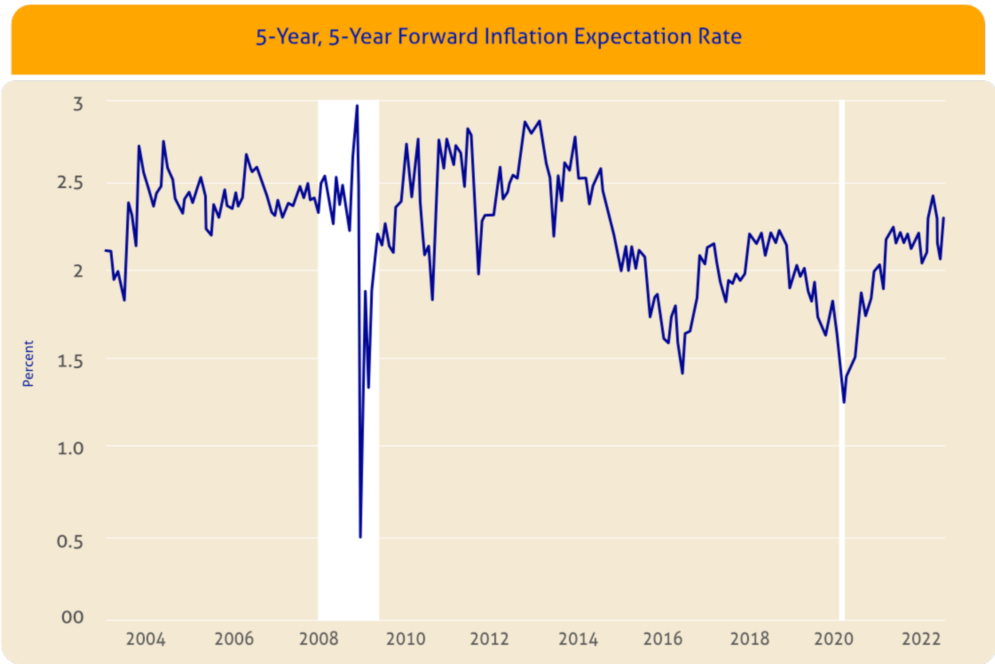
10-year-2-year yield spread



1. https://www.ishares.com/us/products/239454/ishares-20-year-treasury-bond-etf



Source: Fedral Reserve Bank of St. Louis *myf.red/g/SkKK*



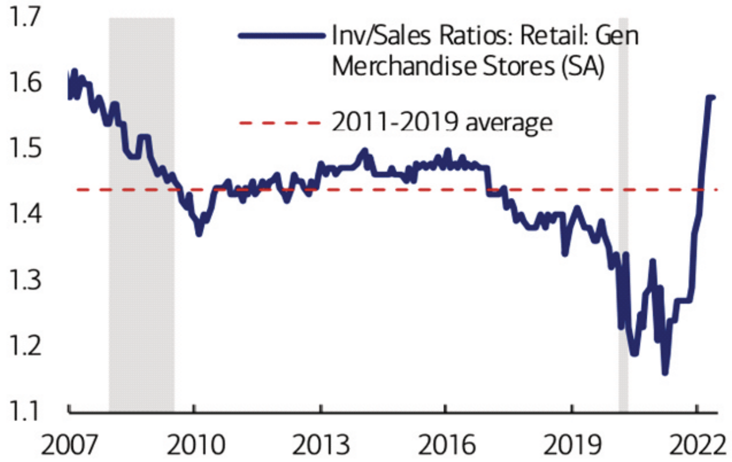
Source: Fedral Reserve Bank of St. Louis *myf.red/g/SkKO*

While commodity prices are up since the start of the year, they have pulled back substantially since mid-June as concerns about global growth have increased.

Other metrics also suggest that inflationary pressures have possibly peaked. Higher levels of inventory reported by retailers like Walmart and Target will lead to price reductions.

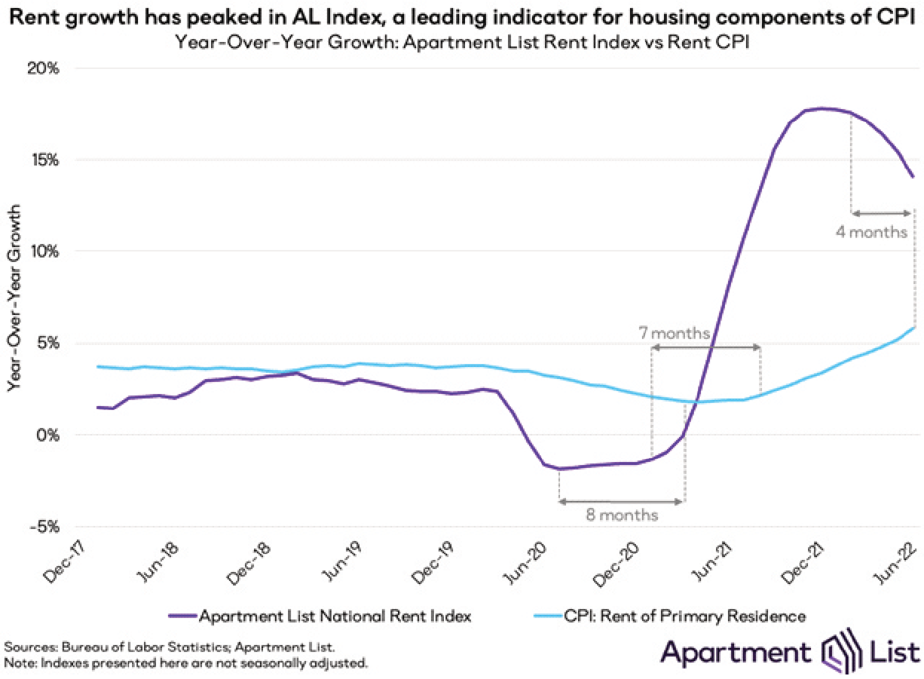
Exhibit 3: Inventory to sales ratio: general merchandise (monthly, %, SA)

Inventory to sales ratio for general merchandise surged to 1.58 in April and May, notably higher than the 2011-2019 average of 1.44

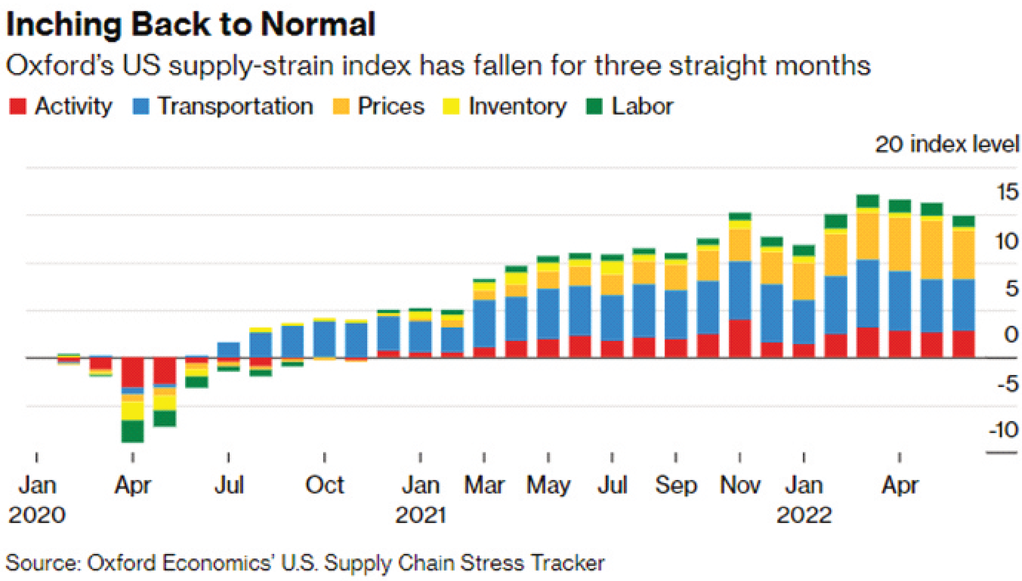


Source: Census Bureau. Shading means recessions

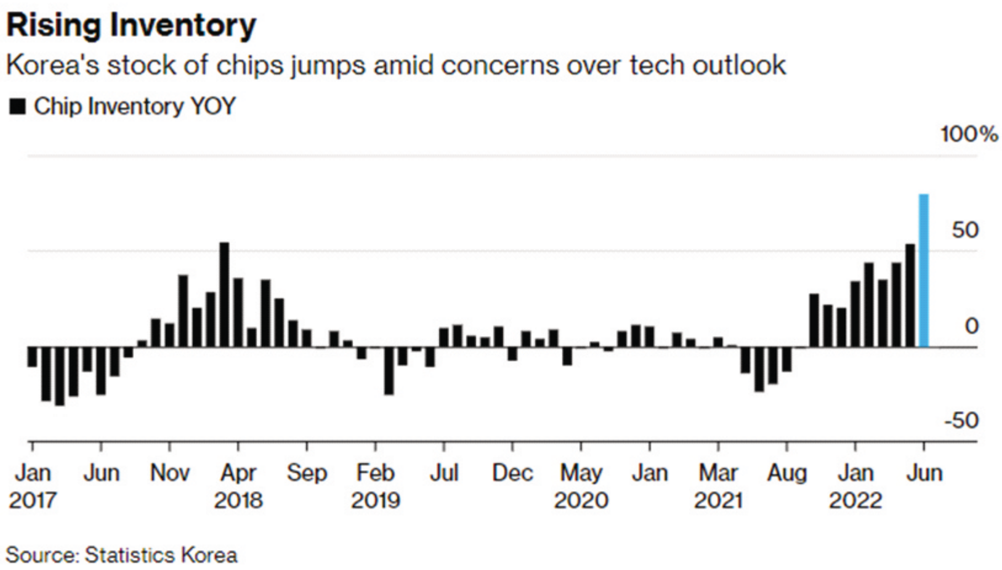
Rent growth has peaked, and imputed rent in CPI calculations will peak with a lag.



Supply chain pressures are easing, though they remain challenging and would be a risk to our view that inflationary pressures have peaked.



The semiconductor chip shortage is also easing as seen from inventory build in South Korea.



The US dollar has been strong since mid-2021 as the markets anticipated the Federal Reserve tightening monetary policy. Expectations that weakening economic activity may bring the rates to a neutral level by the end of the year have resulted in a pull back in the greenback.

Q2 GDP growth in the United States was -0.9% (quarterly #, annualized) which follows Q1 reported GDP growth of -1.6%. This would fit the often-used definition of an economic recession, though the high inflation metrics would mitigate the impact on the real economy, since the nominal growth remains positive.

Government spending and home construction were drags during the second quarter- a result of the ongoing fiscal and monetary tightening.

Ukraine-Russia war

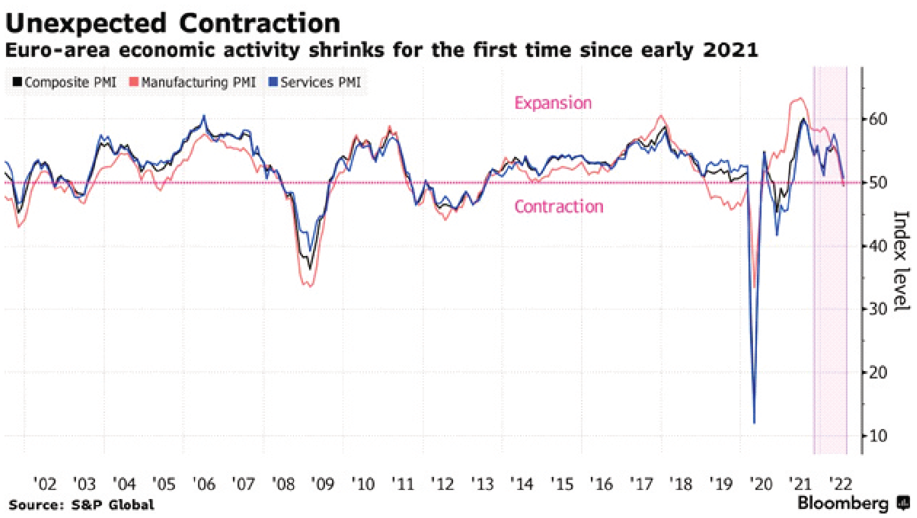
After four months of conflict, it appears that Russia has made minimal progress in achieving any of its initial objectives. The grandiose strategy of capturing Kyiv and splitting Ukraine at the Dnieper River failed almost immediately. In our January Letter, we advocated for the West being sympathetic to Russia's security concerns, given that the economic limitations of the country would limit its ability to challenge the global order in any significant manner. We also did not expect the precipitous action from Russian leader Putin since the following were quite clear:

- Ukraine's interest in being part of NATO was not making progress
- War would only push Ukraine closer to Europe and NATO and away from its neighbor that shared ties of family, history and culture. One third of Ukrainians (including President Zelensky) speak Russian as their first language and a majority speak it fluently.
- Ukraine's efforts to join the European Union had stalled since an association agreement was signed in 2014 after the Maidan protests and President Yanukovych's exit
- War would be damaging to the Russian military since the best it could do was the destruction of Ukraine, with little capacity to hold any captured territory besides the Eastern and Southern parts that adjoined Russia, where Russian supported militia already exercised control.
- War would be catastrophic to the long-term economic prospects of Russia

The War has brought death and destruction to Ukraine, and it has significantly damaged Russia's economic and strategic interests. A recent study from Yale School of Management[2] suggests that there has been a mass exodus of capital and technology from Russia that is creating significant long-term damage to the economy. Its strategic interests have been damaged with a generational alienation of Ukrainians, the European Union granting candidate status to both Ukraine and Moldova, and the likely NATO membership of Sweden and Finland. The War is a battle of attrition now, with fighting focused on control of small bridges, villages, and towns across Eastern and Southern Ukraine, and the occasional missile attacks into Central and Western Ukraine. It is tough to predict when and what can end the War, other than sheer exhaustion from the damage both sides are enduring.

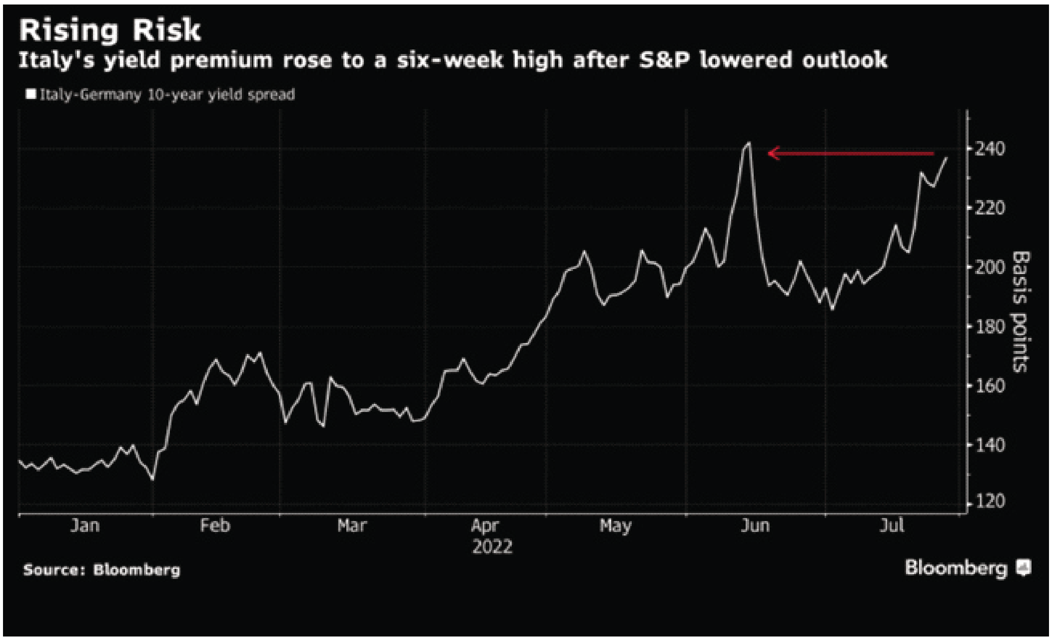
Europe

European economic growth surprised positively in the second quarter at +0.7% despite the periodic disruption of Russian gas flow. This follows Q1 2022 economic growth of +0.5%. However, the monthly PMIs suggest weakening ahead.



2. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4167193

Inflation remains high with the July reading +8.9% YOY, an increase from the +8.6% recorded in June. Energy supply is a significant risk to both inflation and economic growth, due to the unsettled geo-political situation vis-à-vis the Ukraine-Russia war and relationship with Europe's major energy supplier, Russia. The European Central Bank (ECB) raised interest rates by 50bps (vs 25bps expected) and also unveiled a new tool called Transmission Protection Instrument (TPI) which is aimed at supporting bonds of countries with surging interest costs. For now, this appears to be aimed at supporting Italian bonds where political uncertainty (resignation of Prime Minister Mario Draghi) and lack of fiscal discipline have resulted in widening spreads relative to German yields.



Japan

The Japanese Yen has depreciated significantly since March of this year. The impact of the weak currency and higher commodity prices has increased inflation to about 2.4% above the 2% level which has been the Bank of Japan's long-term goal. However, it seems unlikely that the long-term deflationary pressures due to a rapidly ageing population and a high level of risk aversion in the economy, have abated in any significant manner.

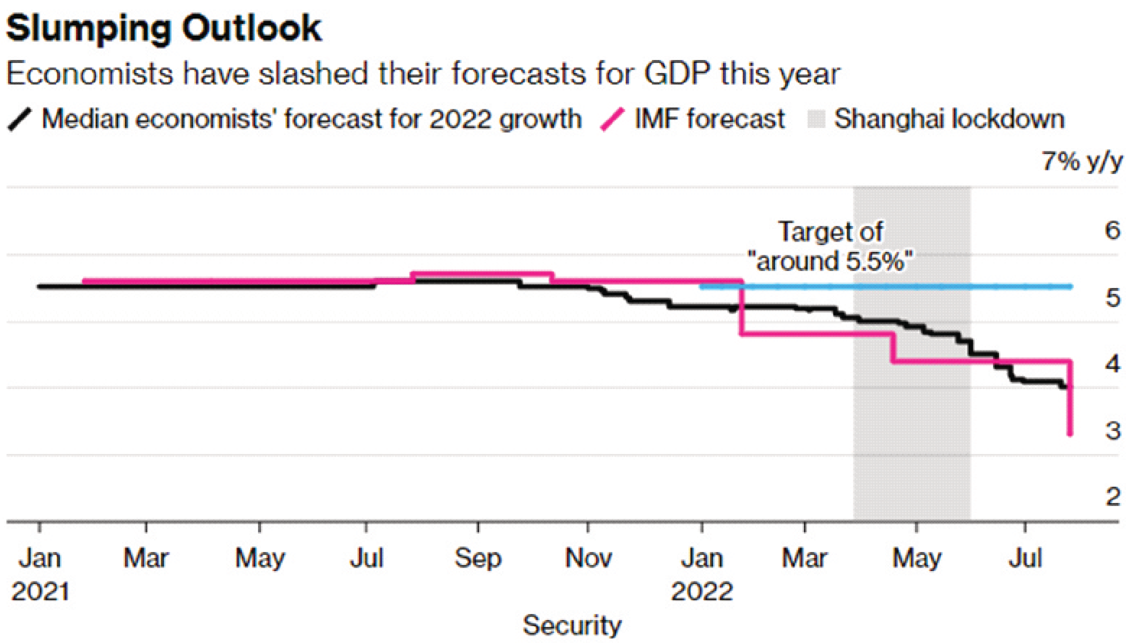
Shinzo Abe

The assassination of Shinzo Abe, Japan's longest serving Prime Minister is a tremendous loss to the world. Abe was the visionary behind the creation of the QUAD, which brings together democracies across the Pacific and Indian Oceans. This grouping of the United States, India, Japan, and Australia has emerged as a potential bulwark to counter the emerging military power of China, which under the Chinese Communist party (CCP), does not support the global rules-based order and seeks to turn every economic or strategic engagement to its advantage. Abe was only partially successful in his efforts to change the constitutional restrictions on military engagement, but it is likely that his leadership in creating the Indo-Pacific QUAD is a legacy to maintain regional peace.

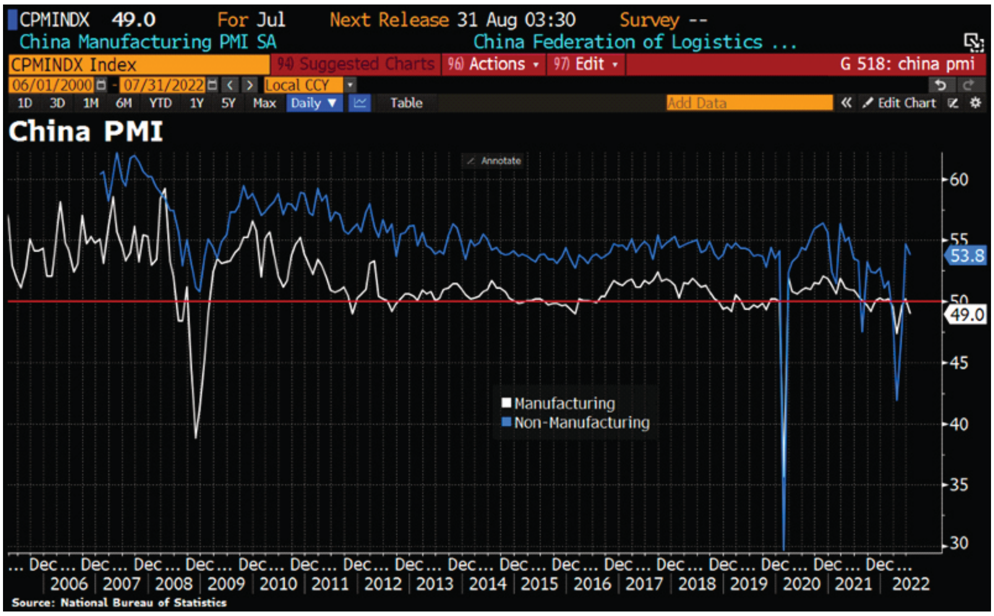
China

At a conference I attended earlier this year, an Emerging Markets Manager, while discussing their firm's approach to investing in China, said that they try to figure out areas that the government views as strategic and invests mostly in those industries or sectors. The view was that the sort of issues we have seen with the Internet Services companies, where the companies and their executives have been targeted by the government for various reasons, would not be seen in the "strategic industries". The Manager mentioned the semiconductor industry as one that they thought was relatively safe from intervention. The fallacy in this logic is of course, that when you are dealing with a capricious entity (CCP), in a country without the rule of law, things can change and quite suddenly at that. Last week it was reported that a Tsinghua Semiconductor executive was arrested on corruption charges. We have viewed Chinese companies as essentially un-investible for a while and such incidents reinforce our position.

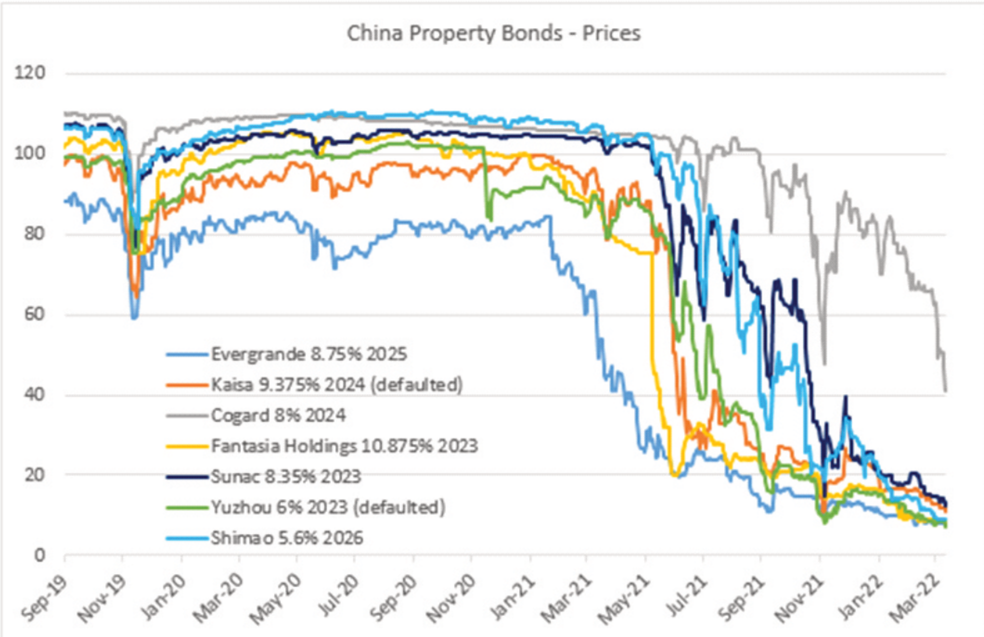
Economic growth expectations for China have been revised down since the start of the year, and the recently reported July PMI shows manufacturing contracted in July.



Source: Bloomberg surveys, International Monetary Fund



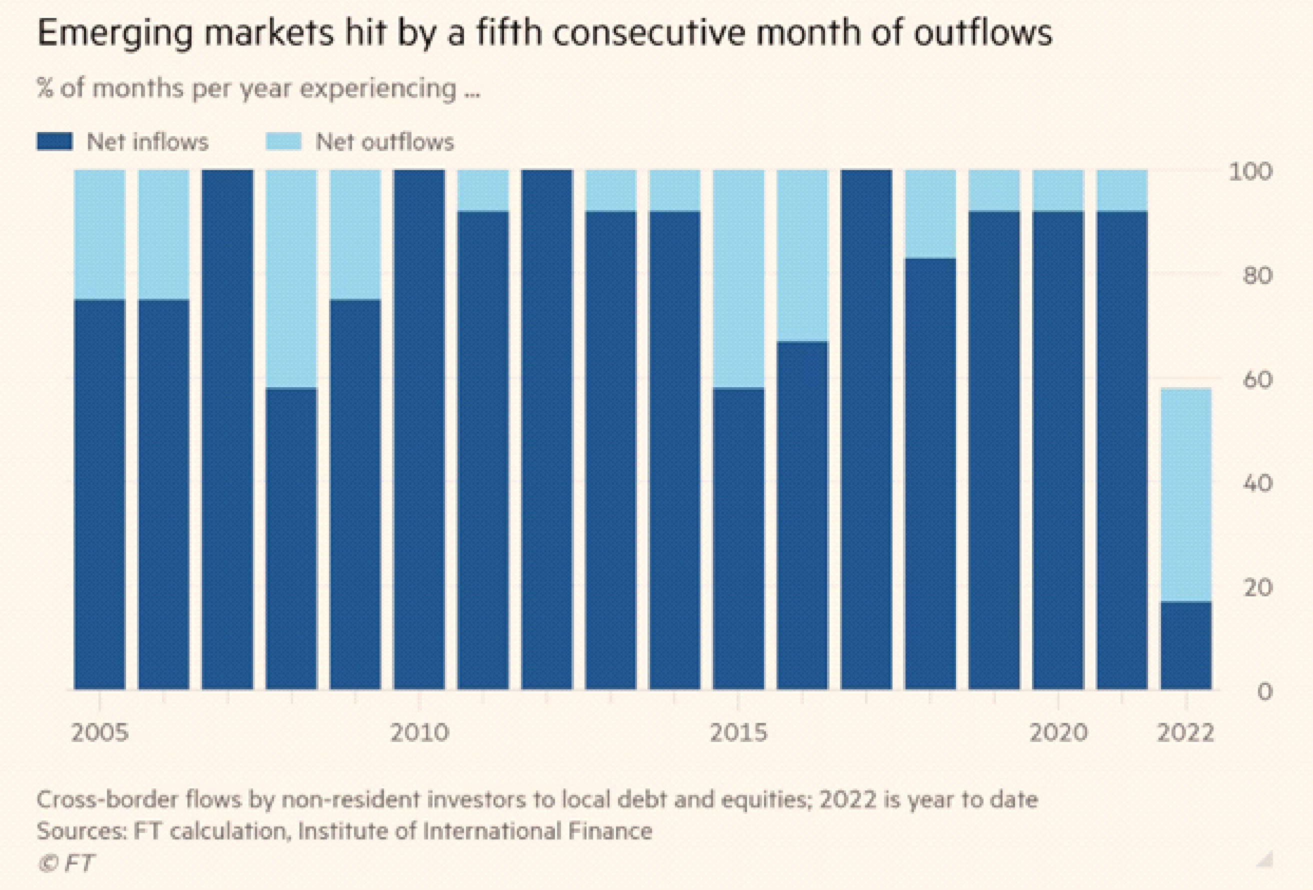
The short-term factors behind the weak economic growth are the zero covid policy which has resulted in rolling lockdowns across the country, and the significant problems in the debt-laden real estate sector. The recent consumer mortgage payment boycotts exacerbate the liquidity and solvency problems faced by real estate developers.



In the long-term, China would benefit if it moved from the current government-driven capital investment approach to generating economic growth to one that is market-driven. Large investments in low productivity assets that produce poor return on capital and increase financial strains in the economy result in an illusion of value creation. We are not optimistic on a change in the system under the current regime.

India

IMF projects India to be the fastest growing major economy in both 2022 and 2023 (current estimates are +7.4% in 2022 and +6.1% in 2023[3]). The current government deserves much praise for handling the COVID downturn with stimulus that was directed mostly at the most vulnerable segments of the population and protecting the fiscal outlook. Emerging Markets, including India have seen significant outflows from foreign investors this year, but an emerging domestic equity culture has supported the Indian stock markets. It is estimated that Indian households have only about 4.8%[4] of their savings invested in the equity market. A stable economic and investment environment with lower than historical inflation and growing corporate earnings should result in an increase in equity market investments.



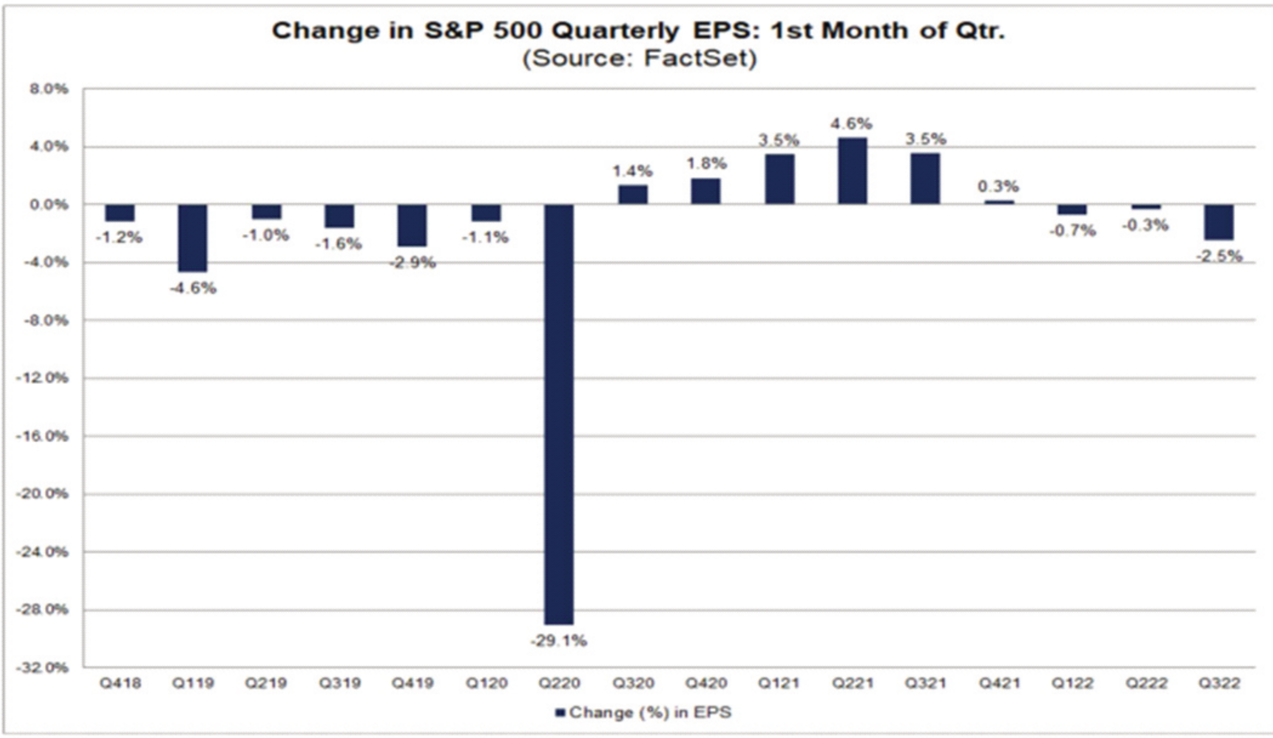
3. *https://www.imf.org/en/Publications/WEO/Issues/2022/04/19/world-economic-outlook-april-2022*
4. *https://grizzle.com/why-india-is-the-best-growth-story-in-asia/?ck_subscriber_id=860811662*

Outlook

If we use round numbers, the first half of 2022, saw both the Global MSCI ACWI Index and the MSCI US Index down about 20%. July has seen a strong bounce back in equity markets, and we remain relatively more constructive of equity markets in the second half. That of course is no high bar- it is a low probability that you see a much greater decline over the remaining five months of the year than we did in the first half. It is well possible that we are not out of the woods as yet, and that the lows in the current bear market have not been reached. We would remain somewhat cautious with the view that you add risk exposure during drawdowns rather than chase rallies. There are several risks that remain:

Inflation is not vanquished as yet, and it is preferable that the Federal Reserve err on the side of tighter monetary policy rather than pivot too early. Risk assets do far better when the economic and political environments are stable. We believe inflationary pressures have peaked for now, but it is important that inflation expectations remain well anchored. If the Federal Reserve, the ECB, and other Central Banks stay the course to bring inflation and inflationary expectations to levels seen during the benign environment since the 1990s through 2020, we would be back to a stable economic environment supportive of long-term returns for risk assets.

Higher interest rates, quantitative tightening and lower government spending are strong headwinds for the global economy. The IMF recently lowered global growth for 2022 by 0.8% to 3.6%. We think they may be optimistic. Corporate earnings are likely to see more downward revisions.



While risk aversion has returned to many asset classes, we think pockets of irrational behavior remain. We had highlighted the valuation of Tesla in our April letter. Meme stocks like GameStop and AMC still trade at valuations that do not make sense (to us). The whole crypto currency area is another pocket of irrational behavior. The believers (of crypto) have offered changing reasons for investing in the area, but none have stood up to scrutiny so far. While there are many honest participants who (wrongly) believe in the potential of cryptos, it appears to us that there are far more malicious players intent on proving the statement often (probably incorrectly) attributed to P.T. Barnum.

Geo-political risk remains in many parts of the world- Russia and China appear to be determined to change the global rules-based order that has prevented large-scale conflicts of the sort seen in the twentieth century. The differing interpretations on how Taiwan should be treated, is a potential flash point in the Indo-Pacific region. It is possible that ten years ago many would have thought that a re-emergent China would over time become more democratic, with a respect for the rule of law. We would have also thought that China would continue to support political autonomy for Hong Kong and offer it as a model for reunification with Taiwan. However, the CCP under Xi Jinping has reversed course- China is a far more repressive society today than a decade ago, minority cultures in Tibet and Xinjiang face eradication and Hong Kong no longer has any political autonomy. Taiwan has been effectively an independent country for decades, and there is no local desire to be part of China. The semiconductor industry in Taiwan is an important part of the global economy and the loss of independence would be a tremendous setback to the global economy. The QUAD (USA, India, Japan, and Australia) should look to ally with countries like Indonesia and Vietnam which also have concerns about China's aggressive behavior in the region. Explicit support for Taiwan's independence may be the best way to avoid unintentional conflict.

Updates on Portfolios (detailed performances since inception can be seen in Appendix I)

2022 YTD PERFORMANCE	Portfolio	Benchmark	Morningstar Category Median
INTERNATIONAL VALUE	6.75%	10.29%	(11.10%)
GLOBAL	(12.71%)	(14.61%)	(13.70%)
EMERGING MARKETS	(10.34%)	(17.83%)	(19.42%)

Performance on a YTD and long-term basis has been very strong compared to the respective benchmarks and the peer universes.

Portfolio changes (4/1/2022 through 7/31/2022)

International Value: We exited positions in Woodside (spin-off from BHP), WPP and BNP Paribas. We added to positions in Glaxo Smith-Kline (management focused on unlocking value through spin-off of branded consumer business, Haleon PLC), ABB and BASF.

Global Equity: No trades

Emerging Markets: No trades

Thoughts on Investing

We have over six years of GIPS Compliant track records on our International Value and Emerging Markets strategies and just over two years on the Global Equity strategy. From the outset, we took Jeff Bezos advice (paraphrased) to heart- that if you compete on a longer-term horizon than most of your competition, you have a strong edge. Financial markets can be efficient in pricing information flow, and too often money managers operate with a focus on the short-term. We consider two inefficiencies in the equity markets:

- Durable businesses with short-term negative news flow, which results in mispricing
- Durable businesses where the market underestimates the runway for growth

The key ingredient that we always look for is a high degree of conviction that the businesses we invest in will survive in the long-term (over 10 years). When you combine this, with the ability of businesses to earn adequate return on capital, generate strong cash flow, excellent governance in terms of capital allocation and return of capital to shareholders, and valuations that provide a margin of safety, we think the ability to outperform is substantially enhanced. The initial due diligence to understand the business, industry, financial metrics, and valuation is very important, but so is the patience to stay with conviction. Most investors err by doing too much rather than too little. Patience and the ability to deal with information flow in the context of the original investment thesis is something we value. An example to put this in context- we own two retailers in our Global Portfolio, and in the 2nd quarter when both Walmart and Target warned about excess inventory and reduced their expectations for the year, both of our holdings sold off significantly. The companies that we own operate their business as a "treasure hunt" experience rather than the "cover every category" model that Walmart and Target operate under. We were convinced that both our companies were great merchandisers that were unlikely to face the same issue of excess and wrong inventory. Business at both companies remain unaffected so far.

Our portfolio turnover ranges between 10% to about 22% annualized for the three strategies. This metric includes all trades, including additions or reductions in position sizes. We have seen some competitors use a different metric "core turnover", which only includes trades where a position is almost entirely eliminated.

Equity Markets can offer a range of opportunities, but our focus is

- Areas that we know well and constructing portfolios that have a limited number of holdings
- Companies that are less prone to disruption, i.e., greater probability of survival
- Avoiding areas where there is significant regulatory or business, or risk that we cannot assess (we discussed China being un-investible earlier in this letter)
- Avoiding governance or accounting issues

APPENDIX I

INTERNATIONAL VALUE	Portfolio	MSCI EAFE Value	Morningstar FV Category	Comment
2016	(3.20%)	6.90%	n/a	*Start date 8/1/2016*
2017	24.27%	21.43%	22.08%	
2018	(14.28%)	(14.78%)	(15.50%)	
2019	22.84%	16.09%	17.83%	
2020	7.62%	(2.63%)	0.93%	
2021	14.45%	10.89%	11.40%	
2022	(6.75%)	(10.29%)	(11.10%)	*YTD 07/31/2022*
ITD	45.40%	24.38%	n/a	*Cumulative (8/1/2016 to 07/31/2022)*
ITD	6.44%	3.70%	n/a	*Annualized (8/1/2016 to 07/31/2022)*
1-year	(5.07%)	(9.89%)	(10.54%)	*Annualized*
3-year	6.61%	1.64%	3.21%	*Annualized*
5-year	4.95%	0.27%	1.33%	*Annualized*
5- year Analytics (as of 06/30/2022)				
Annualized Alpha	4.21			
Sharpe Ratio	0.25			
Sortino Ratio	0.38			
Upside Capture	85.04%			
Downside Capture	74.24%			
Portfolio Turnover	10.00%			*Annualized*

GLOBAL	Portfolio	MSCI ACWI	Morningstar WLS Blend Category	Comment
2020	31.80%	23.10%	n/a	*Start date 7/1/2020*
2021	24.03%	18.54%	18.04%	
2022	(12.71%)	(14.61%)	(13.70%)	*YTD 07/31/2022*
ITD	42.70%	24.60%	n/a	*Cumulative (7/1/2020 to 07/31/2022)*
ITD	18.61%	11.14%	n/a	*Annualized (7/1/2020 to 07/31/2022)*
1-year	(9.13%)	(10.48%)	(9.81%)	*Annualized*
ITD Analytics (as of 06/30/2022)				
Annualized Alpha	6.02			
Sharpe Ratio	0.83			
Sortino Ratio	1.51			
Upside Capture	104.25%			
Downside Capture	81.34%			
Portfolio Turnover	22.56%			*Annualized*

EMERGING MARKETS	Portfolio	MSCI EM	Morningstar EM Category	Comment
2016	2.71%	8.67%	5.42%	*Start date 6/1/2016*
2017	41.92%	37.06%	34.17%	
2018	(11.93%)	(14.58%)	(16.07%)	
2019	19.63%	18.42%	19.26%	
2020	6.70%	18.31%	17.91%	
2021	4.94%	(2.54%)	0.08%	
2022	(10.34%)	(17.83%)	(19.42%)	*YTD 07/31/2022*
ITD	54.30%	42.97%	34.62%	*Cumulative (6/1/2016 to 07/31/2022)*
ITD	7.29%	5.97%	4.94%	*Annualized (6/1/2016 to 07/31/2022)*
1-year	(10.93%)	(20.09%)	(21.43%)	*Annualized*
3-year	2.00%	0.90%	0.96%	*Annualized*
5-year	2.64%	0.95%	0.79%	*Annualized*
5- year Analytics (as of 06/30/2022)				
Annualized Alpha	3.40			
Sharpe Ratio	0.28			
Sortino Ratio	0.41			
Upside Capture	105.26%			
Downside Capture	93.20%			
Portfolio Turnover	16.31%			*Annualized*