Global Markets October 2022 Outlook

Economic effects of tighter monetary policy are seen with a lag

In July of this year, we wrote the following

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:

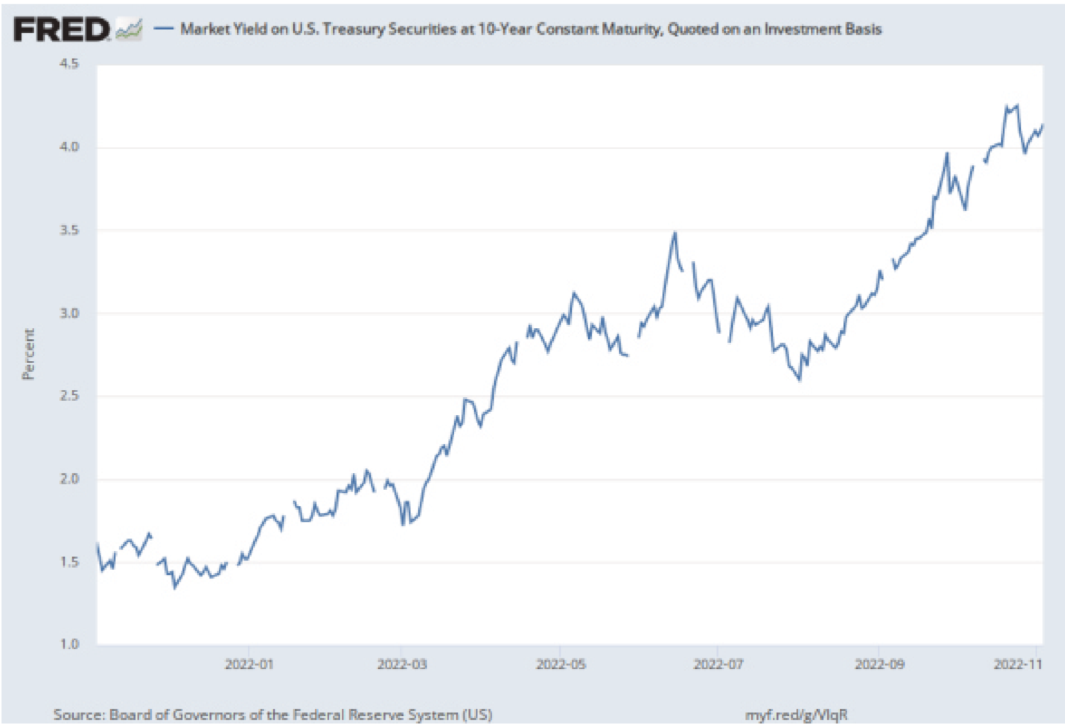
- *Inflation is not vanquished as yet, and it is preferable that the Federal Reserve err on the side of tighter monetary policy rather than pivot too early. Risk assets do far better when the economic and political environments are stable. We believe inflationary pressures have peaked for now, but it 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.*

Markets have been volatile over the last three months, but broadly in a trading range. We did see new cycle lows for the stock market in October, but despite interest rates being significantly higher, equity markets declined less than what one might have expected. Inflation being higher than in other recent economic downturns has limited the damage to company earnings. Companies without earnings and cash flow have remained under pressure. The crypto area is coming unglued with multiple firms forced into liquidation- rate increases result in higher hurdle rates and the lack of viable business models is being exposed. The possible liquidation of FTX and Alameda are the latest examples of the hollowness of investing based on FOMO (fear of missing out). The Series C Venture Fund raising for FTX valued the firm at $32 billion, and investors included Lightspeed Ventures, Temasek, Ontario Teacher's Pension Plan and Tiger Global. We are a start-up asset manager with somewhat compelling track records and recognize the difficulty of getting institutional capital, so it is always interesting to see so many venerable allocators invest in unproven businesses with the risk of permanent loss of capital.

Through October end 2022, MSCI ACWI Index was -21.14%, EAFE Index -23.17% and the MSCI EM Index lagged at -29.42%. Markets that have outperformed through October are mostly commodity driven ones like Brazil (+21.15%), Chile (+15.36%) and Saudi Arabia (+5.78%). Underperformers include China (-42.79%), Poland (-42.87%), Hungary (-41.93%) and several developed European markets which are all down over 30% on a YTD basis. The bond ETF TLT which has an effective duration of 17.19 years is down 34.16% as of November 4th, 2022[1].

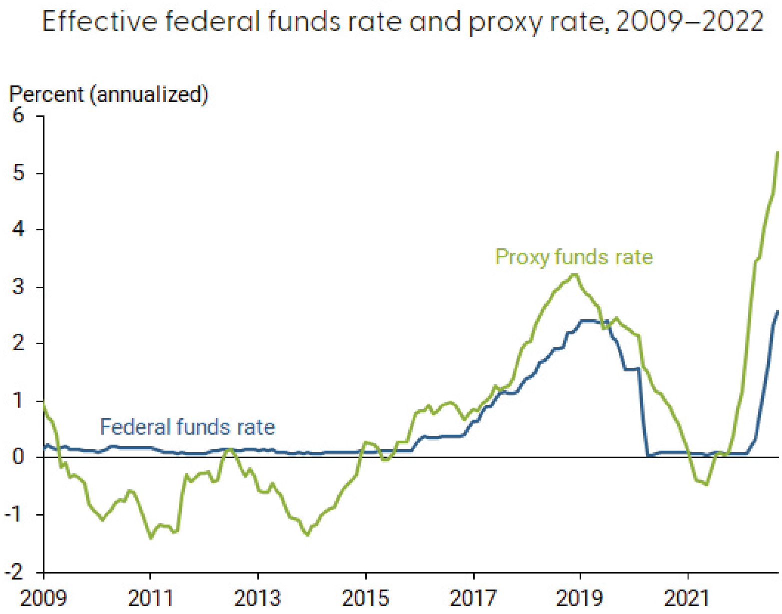
US 10-year Treasuries yielded 2.66% when we wrote our July commentary but have risen substantially across all durations with the 10-year Treasury now yielding 3.81%[2].

US Treasury 10-year yield



1. *https://www.ishares.com/us/products/239454/ishares-20-year-treasury-bond-etf*
2. *https://www.cnbc.com/quotes/US10Y*

A measure of effective federal funds rate which includes rate set by the Federal Reserve plus impact of balance sheet tightening and forward guidance suggests that monetary conditions currently are quite restrictive.

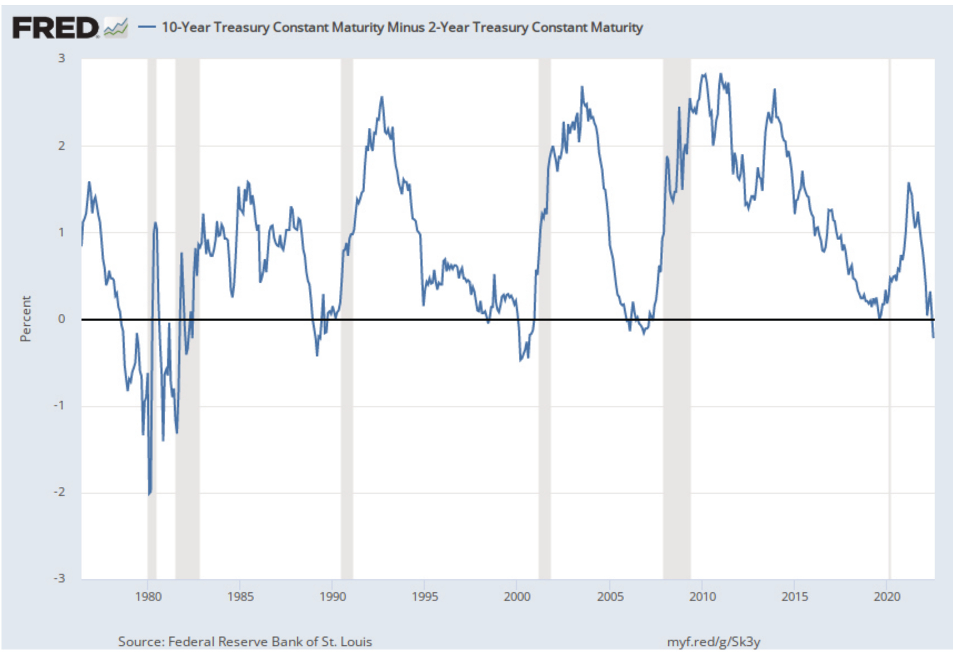


Source: Federal Reserve Board of Governors, Freddie Mac, The Bond Buyer, Moody's, and authors' calculations.

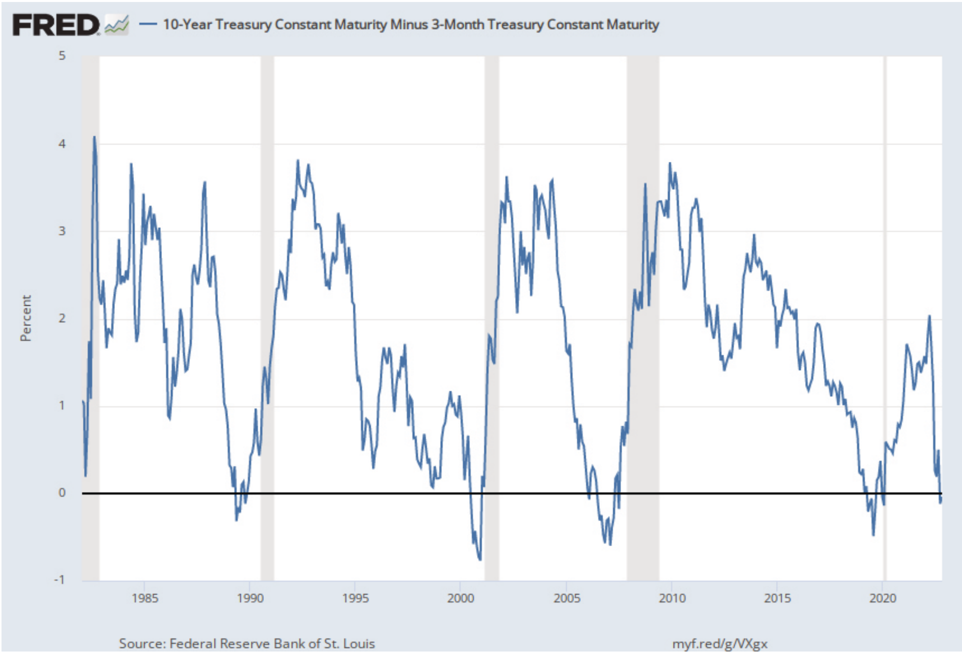
The 10-year-2-year spread has been inverted since June and is now at the maximum negative it has been since the early 1980s. The 10-year-3-month yield spread has also inverted since October. The combination of these two yield inversions is suggestive of:

- Lower forward inflation expectations
- Potential recession ahead

10-year-2-year yield spread

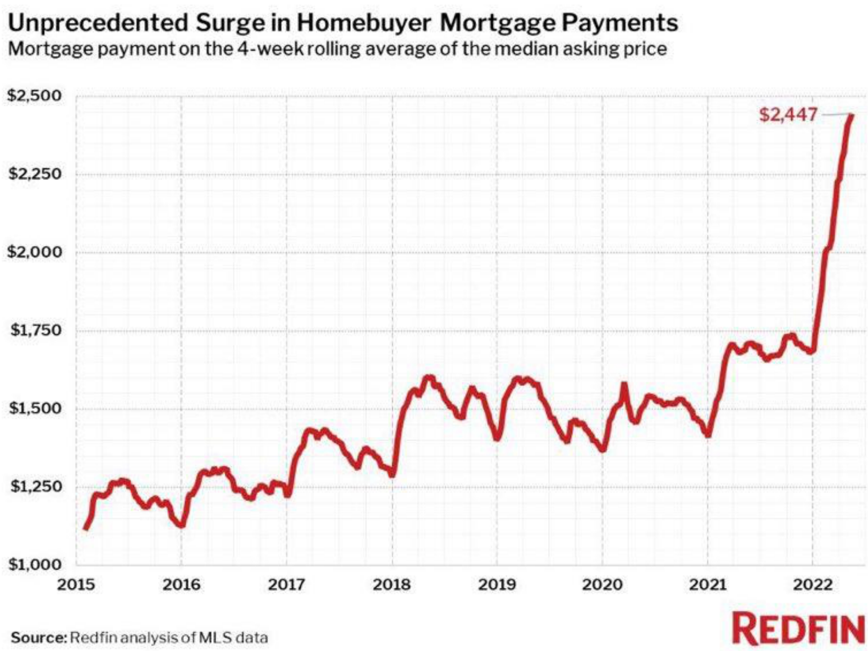


10-year- 3-month yield spread



The recent rise in yields has resulted in real yields being positive across every period greater than one year looking forward- for example 1-year treasury yield is at 4.61%[3] Vs 1-year forward inflation expectation of 2.89%[4].

The increase in bond yields is starting to impact the housing sector, since mortgage rates are substantially higher than at the start of the year and affordability has been impacted.

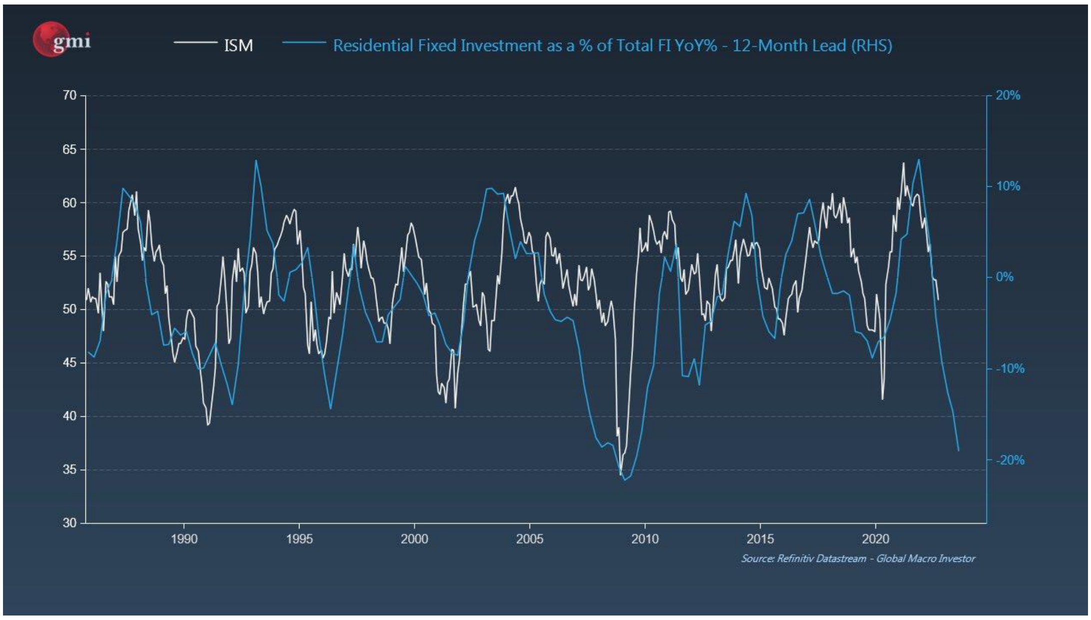


Housing starts have decreased, and this is often a leading indicator for a broader economic slowdown.

3 https://www.cnbc.com/quotes/US1Y

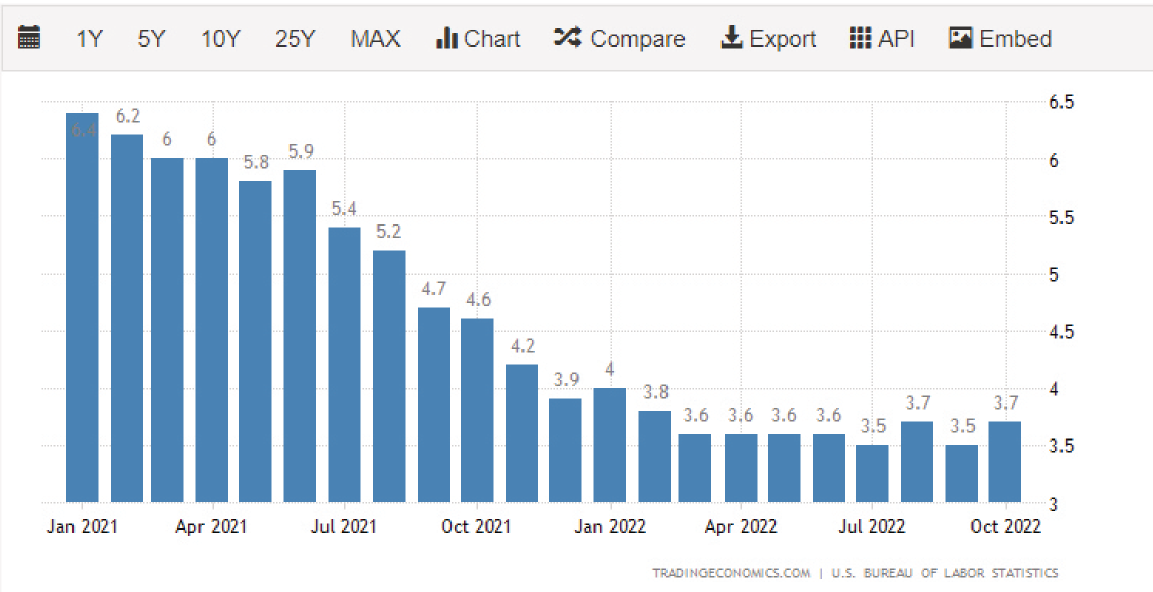
4 https://fred.stlouisfed.org/series/EXPINF1YR

Drop in Residential Fixed Investment

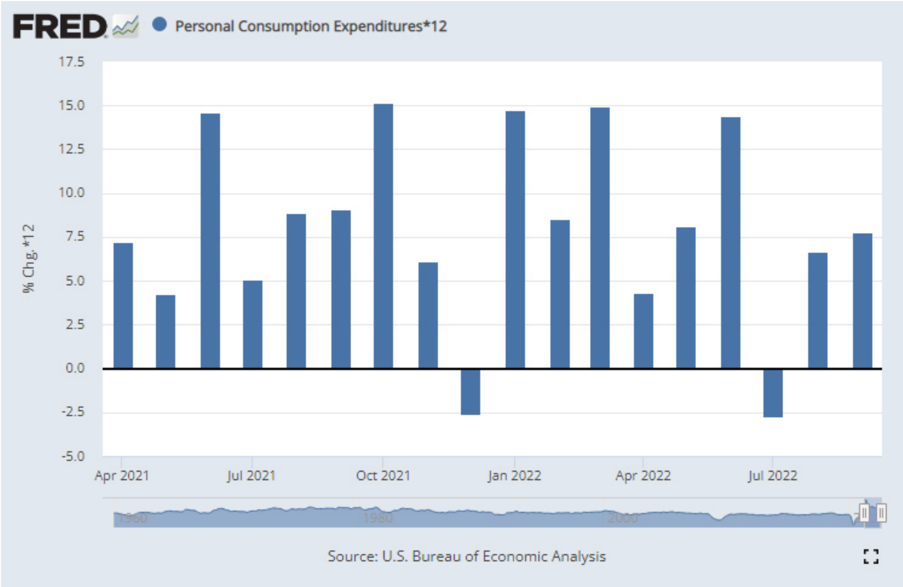


The unemployment rate remains low, though recent layoffs in the Technology sector could be an early sign of economic weakness ahead.

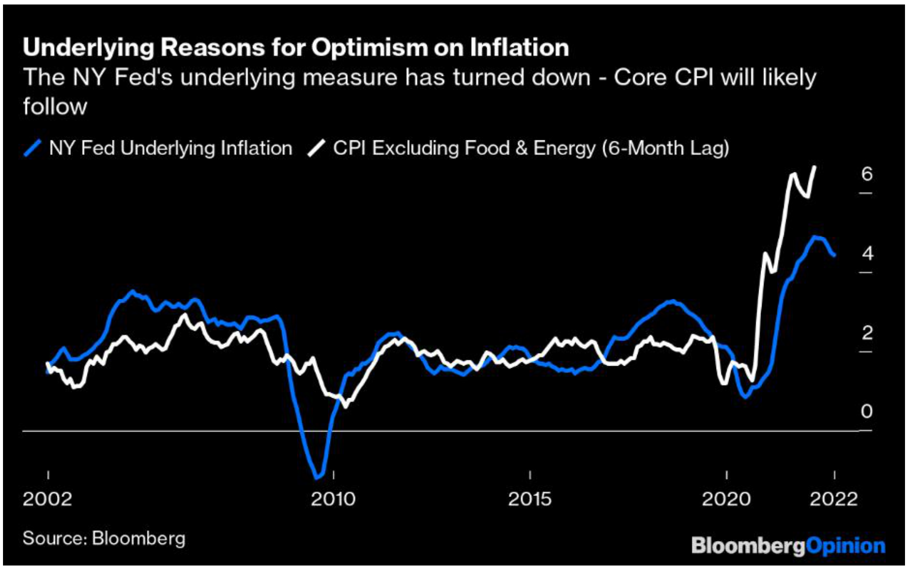
Low Unemployment rate

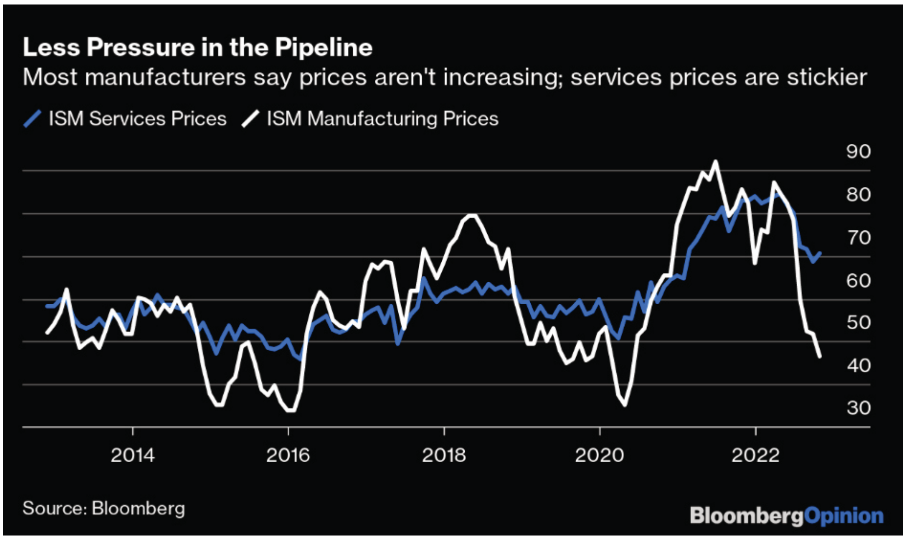


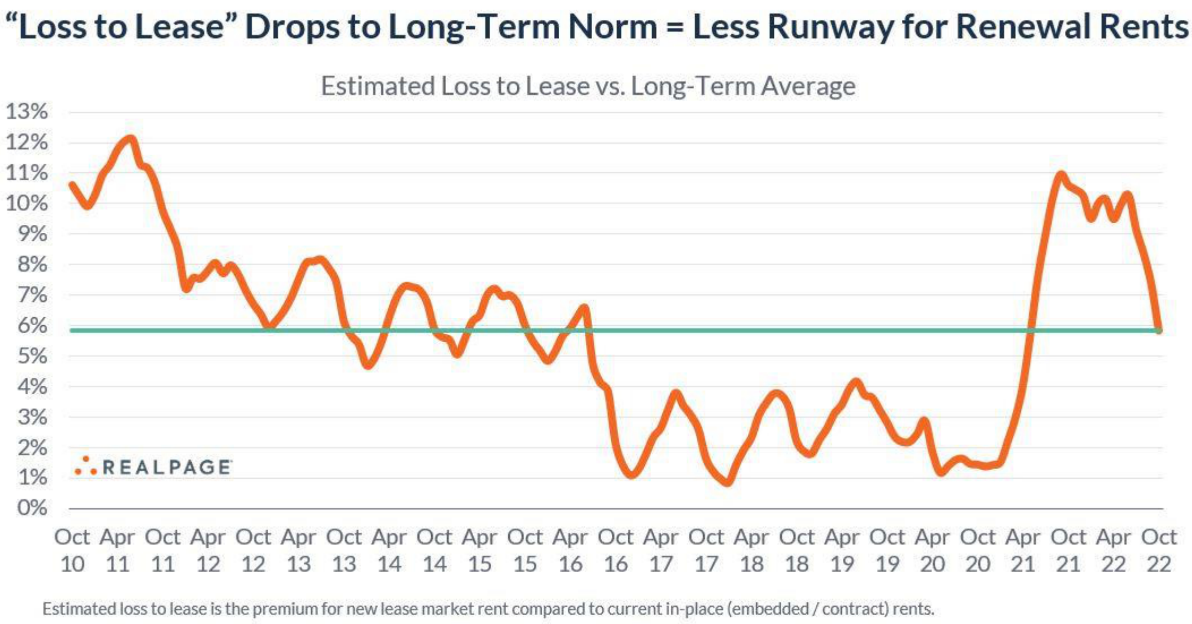
Looking at the annualized month over month changes in the Fed's preferred inflation gauge the Personal Consumption Expenditures Index, we can see that inflation remains elevated by historical norms (excludes last week's report).



However, some of the leading indicators of future inflation do indicate that the monetary tightening measures are having an impact.







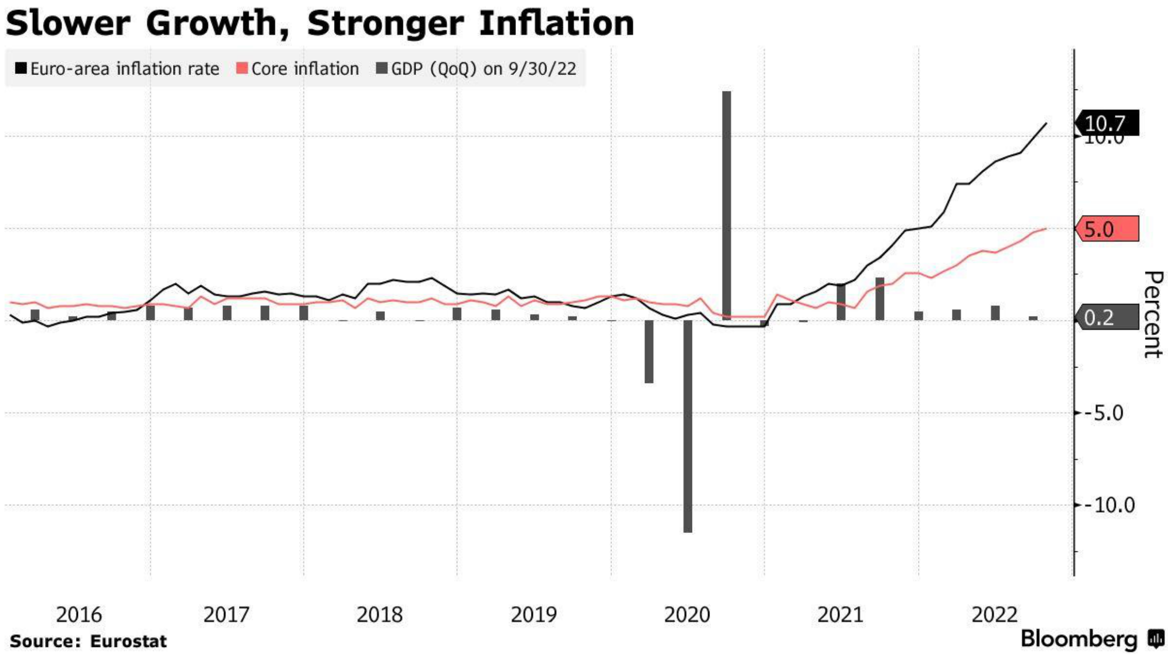
Above chart looks at difference between new leasing rates for residential multi-family apartments relative to existing leasing rates. A leading indicator for the largest component in CPI and PCE calculations.

Ukraine-Russia/Europe

There is not much to add to what we have published in the three Investment Letters from earlier this year. We have a war of attrition with substantial damage to life and property for both countries. The War has been a historic blunder by Putin, and it has weakened Russia economically, militarily, and strategically. Russian military has come up short not only in the early efforts to capture Kyiv, but also across Eastern and Southern Ukraine where Russian-allied militia had a strong presence before the War. As President Biden remarked "Putin expected the War to result in the Finlandization of NATO, but he is getting the NATOization of Finland and Sweden"[5]. However, Russia remains a threat to the global political economy based on its importance as a supplier of oil, gas and other commodities and its threat of using its large nuclear arsenal. There are efforts to re-start talks aimed at ending the War, and we hope these are successful.

Europe's dependence on Russia for its energy supplies has resulted in higher inflation and lower growth than the United States.

5. https://www.foreignaffairs.com/ukraine/russia-dangerous-decline



Lower income families are impacted to a greater extent by the inflationary pressures.

Inflation difference between the lowest and highest income quintile households in the euro area

Sources: Eurostat Household Budget Survey, ISTAT and ECB calculations.
Notes: Chart B shows the difference between the effective inflation rates for low-income households (first quintile) and high-income households (fifth quintile). Quintile-specific inflation rates are calculated based on quintile-specific consumption baskets (Chart A) excluding spending on "rents and owner-occupied housing costs". Weights based on the HBS are updated annually in line with updates to the official HICP weights.

The United Kingdom has seen three Prime Ministers over a few months- Boris Johnson, Liz Truss, and Rishi Sunak. Concern about the conflicting goals of the Bank of England, which is tightening monetary policy to bring down inflation, and the Liz Truss government which sought to ease fiscal policy to stimulate economic growth, resulted in a period of sharply rising bond yields and potential instability in defined benefit pension funds.

UK Gilt rates

The more conservative fiscal policies of the new Rishi Sunak government has stabilized the Gilt market, though inflationary pressures mean yields are significantly higher than during the pre-Covid years.

China

We have been cautious on China since the start of the Xi Jinping era- concern that the expected trajectory of the country both politically and economically had changed for the worse. The consensus-driven approach and collective leadership instituted by Deng Xiaoping set up the country on a path away from the capricious leadership of Mao Zedong and on a path of rapid economic growth. Xi has dismantled this system and is potentially a ruler for life in the manner of other dictators we have seen in history. The zero Covid policy, the aggressive confrontations with many of its neighbors (Taiwan, parts of SE Asia and India), and the move away from seeking incremental changes to the Global Order since World War II, are all suggestive of the risks that arise without balance in political leadership.

Rapid Increase in lending by Chinese Banks

India

India has been one of the best performing major stock markets in 2022. Down 7.4% through October end in a year where oil prices are up significantly is a positive sign for a country that is a major importer of the commodity. The robust economic performance (2022 GDP growth expectation of 6.8%) is a result of economic reforms carried out by the government over the last seven years and the return to health of the banking system after years overcoming non-performing assets accumulated during the 2008-2013 period.

India The Only Country To Improve Debt Ratio

kotak Mutual Fund

Debt levels and change since 2008 (as percentage of GDP)

	Core debt of non-financial sector (Q1 2022, % OF GDP)				Change since Q1 2008			
	Household	Corporate	Government	Total	Household	Corporate	Government	Total
Debt/GDP (Avg %)	61	84	104	249	4	10	48	62
Australia	118	64	57	239	11	-13	49	47
Brazil	38	54	88	180	20	23	26	69
Mainland China	62	157	70	289	43	62	41	147
France	65	166	129	360	19	61	61	141
Germany	56	73	74	203	-4	5	9	10
India	37	51	85	173	-6	-12	11	-6
Italy	43	70	154	267	5	-8	58	55
Japan	60	119	249	428	2	20	82	104
South Korea	104	117	45	266	34	29	23	86
Mexico	16	24	40	80	2	10	20	32
South Africa	34	34	69	137	-10	-1	44	33
Spain	57	98	154	309	-25	-28	114	61
UK	84	70	119	273	-10	-15	79	54
US	76	82	124	282	-23	11	61	49

Source: IF, BIS, IMF, National Sources, Note data taken from end- Q1 2018 and end-Q1 2022

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Barring political mishaps, we expect India to remain the fastest growing major economy over the next decade. Increase in the working age population and the improvement in the physical and digital infrastructure, combined with better governance and improving social welfare benefits are the key drivers of faster economic growth.

Outlook

The US mid-term election results from last week highlight a point we made in our Investment Letter in early 2021- American democracy has strengths and weaknesses, but in the end the positives outweigh the negatives. The GOP performed far worse than would be expected given the background of high inflation and a weakening economy that would normally hurt the incumbent party in power. However, the incessant genuflection of many of its (GOP) candidates to the whims of Donald Trump appears to have turned away enough independent voters and perhaps increased turnout among Democrats who normally do not vote during mid-term elections. Markets normally cheer divided government since they are more likely to be periods of fiscal rectitude, and it appears that the GOP will control the House. We think, the failure of candidates that have promoted conspiracy theories about the 2020 election results and promised to work on overturning future election results using state legislature powers, is a long-term positive for American Democracy and its Economy. For those with an interest in politics and constitutional law, there is a case before the SCOTUS (US Supreme Court) Moore v. Harper that could clarify the power of partisan state legislatures to override the state constitution and the results of federal elections.

The October consumer price inflation report suggested that core inflation may be weakening. However, while we think inflationary pressures have probably peaked, we may continue to see volatility in the monthly reports and many sub-categories of the CPI index continue to see sticky inflation.

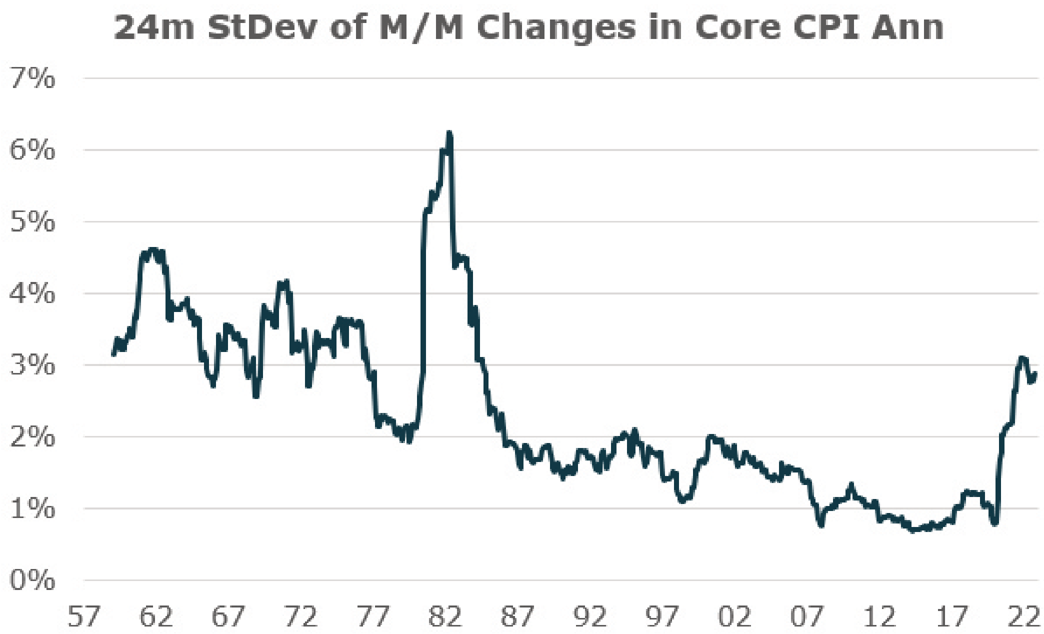
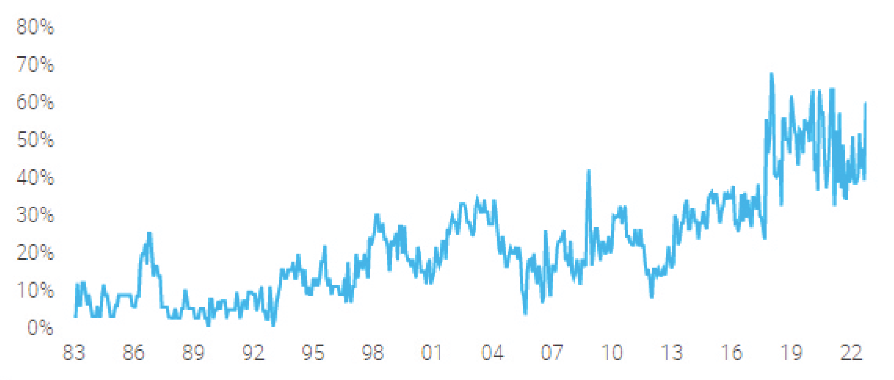
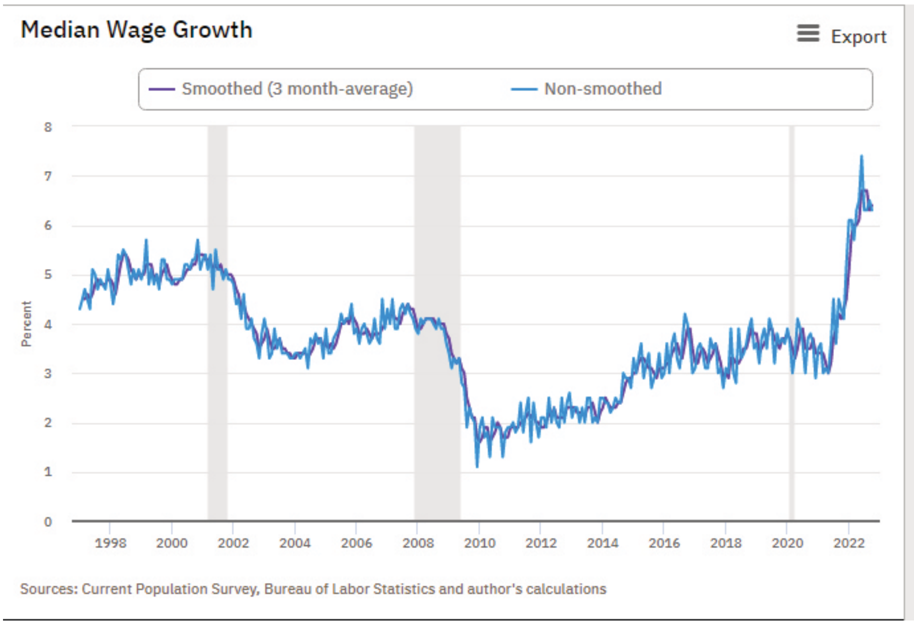


Chart 6 Percentage of CPI sub-categories where 3M %Ch > 12M %Ch

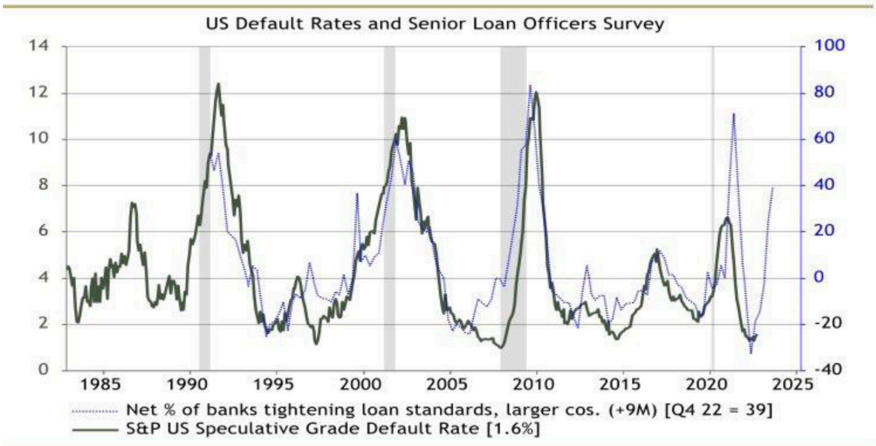


Source: BLS, TS Lombard

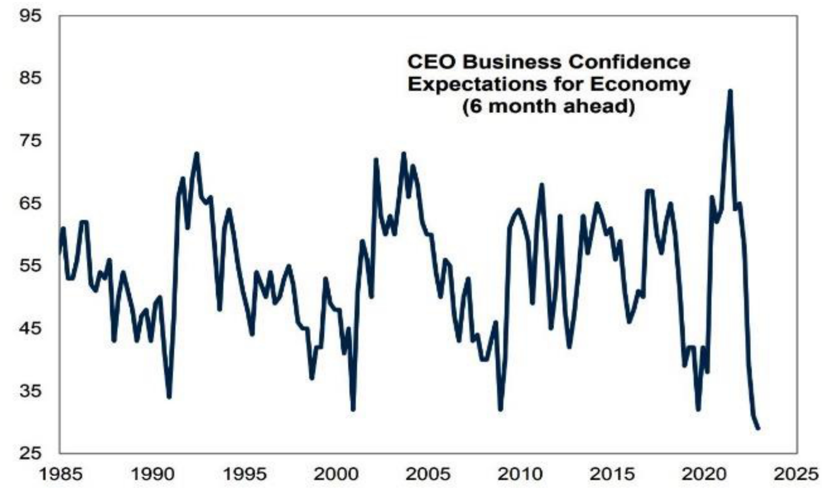


The volatility in the month-over-month changes are now much higher than what was seen during the 1980s to pre-COVID period. We expect two more increases in the Federal Funds rate which will take them to 4.75 to 5%. It would be prudent for the Federal Reserve to maintain a restrictive monetary policy for longer (end to rate increases is not followed by immediate rate cuts and the run-off of the Fed balance sheet continues) to ensure that inflation expectations are reduced and then remain well anchored. The economic effects of tighter monetary policy are seen with a lag.

Chart 3: The SLO Survey Leads the US Credit Default Cycle by 9 Months



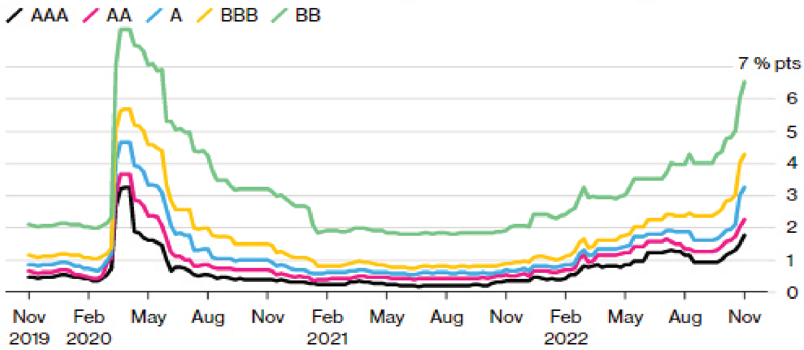
Source: ASR Ltd. / US FRB / S&P Global / Refinitiv Datastream



Source: The Conference Board, Goldman Sachs Global Investment Research

Subprime Widening

Spreads on lower-rated tranches of subprime ABS are widening fastest



Source: JP Morgan
Note: Shows percentage points of yield above Treasuries for three-year subprime auto ABS

If the Federal Reserve follows a prudent path of restrictive monetary policy till inflation expectations return to the benign levels pre-Covid, it is likely that we will see earnings expectation weaken in the months ahead. By many measures, the economy remains strong- low unemployment levels, no sign of slowdown in consumer spending and company earnings reports generally stronger than expected. However, as the charts above and the Treasury yield curve inversion suggest, it is likely that we are ntering a period of slower economic growth and weaker earnings expectation. Potential counters to this scenario would include:

- End to the Ukraine-Russia war
- End or mitigation of China's zero Covid policy
- Premature Fed pivot

A premature Fed pivot could result in a rally in risk assets in the short-term but would be a long-term negative with the likelihood that inflation expectations remain elevated for longer. There is also the risk that investor behavior in the form of bidding up prices of negative cash flow companies, meme-stocks popular on social media, shiny objects like cryptos and NFTs, will return and create new asset bubbles. Data from recent years suggest asset bubbles can alter consumer behavior in ways that can create cost of living pressures. This could be as direct as home or rental prices, or indirect through the incentives to seek employment. Our outlook remains unchanged from three months ago-we remain cautious, but more constructive in terms of valuation than at the start of the year. We do not think last week's strong rebound is the start of a new bull market though seasonality could drive the equity markets higher through year-end. We would suggest that long-term investors use drawdowns like the ones in June and September to add to risk assets rather than chase short-term rallies. Disciplined investing is the best way to compound returns in the long-term.

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

2022 YTD PERFORMANCE (10/31/2022)	Portfolio	Benchmark	Morningstar Category Median
INTERNATIONAL VALUE	(8.81%)	(15.99%)	(18.62%)
GLOBAL	(16.33%)	(21.14%)	(19.88%)
EMERGING MARKETS	(12.86%)	(29.42%)	(28.91%)

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

Portfolio changes (8/1/2022 through 10/31/2022)

International Value: We reduced our position in ICICI Bank which has been one of the best performers since inception and has held up well in the market drawdown. The company is no longer as deeply undervalued as when we initiated the position over six years ago.

Global Equity

Exited SEI Investments company and reduced our position in Wells Fargo as we evaluate better investment opportunities in the market drawdown. SEI was a small position, a company that has managed its cash flow well. However, the company is facing headwinds in terms its longer-term growth. Wells Fargo performed well in 2021 and we have reduced its position size to free up cash for new opportunities.

Emerging Markets

Exited position in Femsa, where do not see a clear strategy to enhance shareholder returns. Reduced position in Embraer ahead of elections in Brazil. We initiated a new position in Reckitt Benckiser, a UK based company that has 40% revenue exposure to Emerging Markets. We have a full note on the company for anyone interested- the short summary is the potential to improve profitability, return on invested capital and return to shareholders. The CEO driving the changes left the company (after we initiated a position) with plans to takeover as the CEO of Starbucks. We did not expect this but remain confident that the changes underway will continue.

Thoughts on Investing

We have written about the key tenets of our investment philosphy and process in previous letters. The link below is a more detailed look at this and was published in the Wall Street Transcipt. Appendix I shows that we have added substantial value over the respective benchmarks and our peer groups. It is well possible that our style has been in favor over the last one year, given the market conditions that have punished companies not focused on cash flow generation and return on capital. However, the longer-term performance for the International Value and Emerging Markets strategies, and the outperformance of the Global Strategy in both up and down markets is a measure of success. We have had periods of underperformance- the first six months for both International and Emerging Markets (low quality outperformed), the calendar year 2020 for Emerging Markets (China and Internet/high P/E did well) and first half of 2022 for Global (we had drawdowns not related to newsflow from our own holdings, but impacted them nevertheless). We have maintained our discipline and investment rigor through the few rough patches-questioning if we have made any mistakes, but not making any unwarranted changes. An institutional allocator asked for analysis of how different things might be if we managed a hypothetical $5 billion in the International Value strategy- based on trading no more than 1/3rd of daily volume in each holding, we would hold no more than three days of trading in most positions and just one position was greater than five days of trading.

https://harpercapital.net/assets/blog/WallStreetTransciptInterview.pdf

APPENDIX I

INTERNATIONAL VALUE	Portfolio	MSCI EAFE Va	Morningstar F	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	(8.81%)	(15.99%)	(18.62%)	***YTD 10/31/2022***
ITD	42.19%	16.48%	n/a	***Cumulative (8/1/2016 to 10/31/2022)***
ITD	5.79%	2.47%	n/a	***Annualized (8/1/2016 to 10/31/2022)***
1-year	(5.16%)	(16.35%)	(18.50%)	***Annualized***
3-year	5.60%	(1.91%)	(1.27%)	***Annualized***
5-year	3.75%	(1.67%)	(1.09%)	***Annualized***

5- year Analytics (as of 09/30/2022)		
Annualized Alpha	4.52	
Information Ratio	0.70	
Upside Capture	87.93%	
Downside Capture	75.68%	
Portfolio Turnover	10.00%	***Annualized***

GLOBAL	Portfolio	MSCI ACWI	Morningstar \	Comment
2020	31.80%	23.10%	n/a	***Start date 7/1/2020***
2021	24.03%	18.54%	18.04%	
2022	(16.33%)	(21.14%)	(19.88%)	***YTD 10/31/2022***
ITD	36.77%	15.07%	n/a	***Cumulative (7/1/2020 to 10/31/2022)***
ITD	14.36%	6.20%	n/a	***Annualized (7/1/2020 to 10/31/2022)***
1-year	(12.90%)	(19.96%)	(18.30%)	***Annualized***

ITD Analytics (as of 09/30/2022)		
Annualized Alpha	6.99	
Information Ratio	1.03	
Upside Capture	108.75%	
Downside Capture	84.19%	
Portfolio Turnover	22.68%	***Annualized***

EMERGING MARKETS	Portfolio	MSCI EM	Morningstar E	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	(12.86%)	(29.42%)	(28.91%)	***YTD 10/31/2022***
ITD	49.98%	22.80%	18.77%	***Cumulative (6/1/2016 to 10/31/2022)***
ITD	6.52%	3.25%	2.72%	***Annualized (6/1/2016 to 10/31/2022)***
1-year	(13.73%)	(31.03%)	(30.42%)	***Annualized***
3-year	1.20%	(4.42%)	(3.63%)	***Annualized***
5-year	1.27%	(3.09%)	(2.62%)	***Annualized***

5- year Analytics (as of 09/30/2022)		
Annualized Alpha	2.46	
Information Ratio	0.23	
Upside Capture	96.66%	
Downside Capture	90.81%	
Portfolio Turnover	16.45%	***Annualized***