Global Market Strategy – August 2021

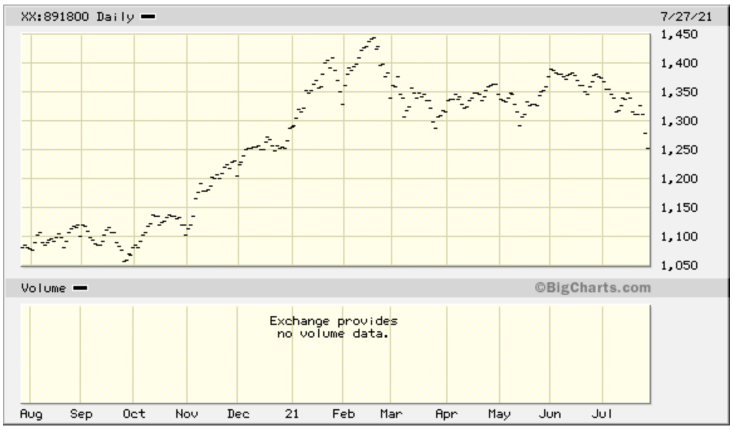
- **China stocks sell off big time**
- **Oil backwardation presages lower prices**

Does China really want to go to war with the West? Right now, it feels like it, not in the military sense but from an economic point of view.

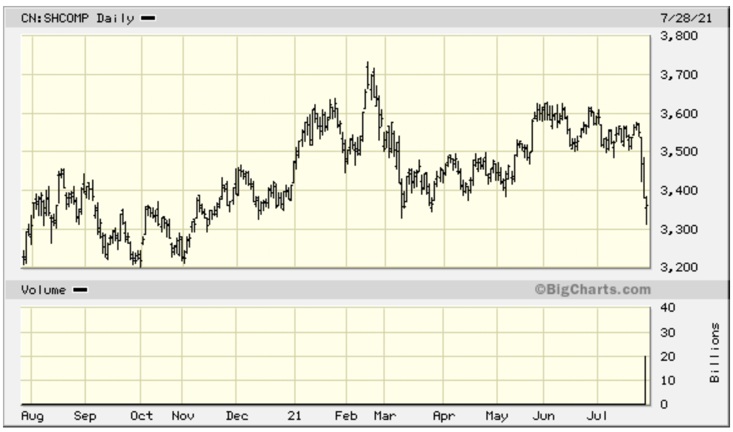
China does not want the West muscling in on its ambitions to take over democratic Taiwan, nor does it want to be told how to treat the people of Hong Kong. It doesn't want to be told how to run its economy and it recognises that the world sees China playing catch-up at a fast pace.

China is by far the biggest constituent of any emerging markets fund because fund managers see China as future growth, and they want to be a part of it.

The trouble is that being part of the fastest growing emerging market comes at the price of having to cope with non-transparency and unpredictability. Emerging market investors have seen their holdings going backwards since mid-February when the dollar began to show signs of strength in anticipation of sooner rather than later Fed tapering. Throw in the Delta variant and President Xi Jinping asserting his authority over the tech and education sectors, and markets have reacted (overreacted) by clobbering EM shares. Hong Kong's Hang Seng index fell 4% on July 27th, putting it on the verge of a bear market 20% downdraft from the highs.



MSCI Emerging Market Index XX891800, 1 year to July 30th (Source: bigcharts.com)



Shanghai Composite Index, 1 year to July 30th (Source: bigcharts.com)

Like all investments, it's the long game that counts. Those invested consistently in the SP500 over the last 10 years would have earned an annual compound growth rate of 16% (469% overall return). Those out of the market on the 50 best days over the period would be flat.

So-called 'family offices' which manage large amounts of money spread across typically a small number of family estates, choose to invest around 45% of available capital in "alternatives", ie private equity, real estate, farmland (including timber farms), shipping containers, biomass projects etc, where liquidity is not of immediate importance. The return on private equity over the last 10 years, according to Goldman Sachs, has been approximately 7.5% pa among the best fund managers and approximately 2.5% among the median fourth quartile managers. Similar to emerging market investing, private equity can produce oversized gains but can lead to extreme losses.

Aside from equities, **US Treasuries** were in demand during July. It's incredible to think someone wants to buy an investment that provides them with 1.3% each year for 10 years but that is indeed what has been happening. Treasuries and the US dollar are seen as a safe haven; pension funds need to invest in stable assets to satisfy the long term demographic shift to longer lives; and from a European and Japanese standpoint, 1.3% from a bond investment is more than they can obtain from a similar investment at home.

At the other extreme, **Bitcoin** has rallied from falls down to $30,000 early in July to $40,000 at the end of the month. UK investors struggle to invest in digital currency because its promotion is forbidden by the Financial Conduct Authority. Certainly, it has an aspect of 'greater fool' to it but the more corporates of the ilk of Square (SQ:US) and Tesla (TSLA:US) adopt it as transactional currency, the greater will be likelihood digital currency is here to stay. The really scary part is how much energy is used to 'mine' and circulate it. With the momentum behind adoption only of environmentally friendly investments, hyperbole in favour of digital currency is suppressed.

Despite **oil futures** being in backwardation (the front month price being unusually higher than months into the future), there was a feeling early in July that oil would break $80 per barrel. If it did so, technical analysis suggested $105 would be an achievable target. As it happened, although West Texas Intermediate (WTI) touched $77, it never threatened to break $80 and has since dropped back to the mid 70s, impeded by the threat of Delta shutdowns, slowing economic numbers, and the likelihood that $80 oil would bring increased production on stream, which would lower the price anyway. Peak oil demand is typically seen in July, indeed for each of the past 15 years, oil has retreated once the calendar has passed mid-month. Carley Garner, technical analyst at DeCarleyGarner.com, told Jim Cramer on CNBC last month that if $80 failed to hold, which it now appress to have done, the likelihood is we shall see a pullback to $60, and possibly even to $40 per barrel. Given the real threat of the Delta variant, and the fact that many in the developed world are still refusing to be vaccinated, and that the numbers of those vaccinated in the emerging world are still woefully short of where they need to be, it seems highly possible the world will face another series of economic shutdowns in the northern hemisphere this Winter which would see the chart analysis come to pass.

Crude oil futures, one year to July 30th (Source: uk.investing.com)

Given all the above, it may come as some surprise that Jeremy Siegel, Professor of Finance at the Wharton School of the University of Pennsylvania and author of the highly rated book "Stocks for the Long Run", sees **another 10-15% upside this year for share prices** belonging to companies which can maintain pricing power, most notably technology but in all areas of discretionary spending. Agreed, there is a threat of further economic shutdown, but any further lockdowns will only serve to increase the savings people are making. If we cannot travel, we will spend on something else. "Today is different from the oil squeeze of the 1970s", Professor Siegel told CNBC in mid-July. "Then, people had no liquidity. [Company] earnings estimates are too low for 2021", he said.

Because of freezes to UK tax thresholds and record share price levels of US equities, it is estimated that one third more households in the UK will be hit by **inheritance tax**, resulting in £6 billion revenue to the Treasury this tax year, more than a third more than in 2020/21.

IHT, as it is commonly referred to, is often termed the 'voluntary tax' because there are so many ways to mitigate or eliminate it. Ownership of the principal private residence (PPR) by a couple as tenants in common allows a half share to be left in a Will (although this needs extremely careful consideration before doing so). Trusts (Loan) allow capital value to be frozen inside the estate, with future growth accumulating outside the estate; Discounted Gift Trusts take capital out of the estate after 7 years but allow access to a steady tax-deferred income; and Revertor to Settlor trusts take capital out of the estate also out of the estate but allow either regular taxable income, partial postponement of income or indefinite postponement of income. Business Relief schemes also offer respite from IHT, as do the various allowances, including the standard nil rate band, the residential nil rate band, the 'normal expenditure out of income' exemption, and the standard annual exemption. There is also the 'small gifts exemption' and the 'gift in consideration of marriage'. Sizeable gifting of capital to charity also helps to mitigate IHT.

IHT is a complex area and needs to be examined carefully on a case by case and regular basis.

Last month Prudential gave the results of their investigation into **Individual Savings Account** holdings. Apparently, 40% of the UK population hold an ISA in one form or another. The total amount invested in the tax exempt environment of an ISA as at the end of the 2020/21 tax year was £620 billion, with more than half that, £316 bn, in cash. The typical ISA cash rate obtained was just 1.0%, in other words a negative real return. Perhaps unsurprisingly, most ISA subscribers are basic rate taxpayers. Unhappily, many higher and additional rate taxpayers, until the tapered annual allowance came into effect for pensions, believed the ISA allowance (£20,000 for an adult ISA for 2021/21) to be too small to be worthy of consideration for investment, thus missing out on what some couples now find themselves with: million pound ISA pots.

ISA portfolios form part of the individual's estate for inheritance tax purposes, however the beauty of the ISA tax exemption is that the account can be surrendered for cash without any capital gains consequence, and gifted into trust or used for some other IHT mitigation exercise very straightforwardly.

Favoured investment plays:
Nil risk:
Cautious risk: Cash
Balanced risk: **Managed / Multi-asset funds**
Market risk: **Multi-asset funds,** UK equity
Adventurous risk: **Asia, Europe, Japan, US equity**
Speculative risk: **Technology, Energy, Platinum, Emerging Markets**

Disclosure:
Nicholas Chappell has the following personal investment exposure: Technology (all US, including fintech) 20%, Energy 17%, China 10%, Asia 8%, Global Equity 7%, UK Equity 10%, European equity 7%, US Equity 3%, US smaller companies 1%, Emerging Market equity 8%, Platinum 4%, Cash 5%

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