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As The Tri Polar World Turns: Investing Thematically in the Tri Polar World

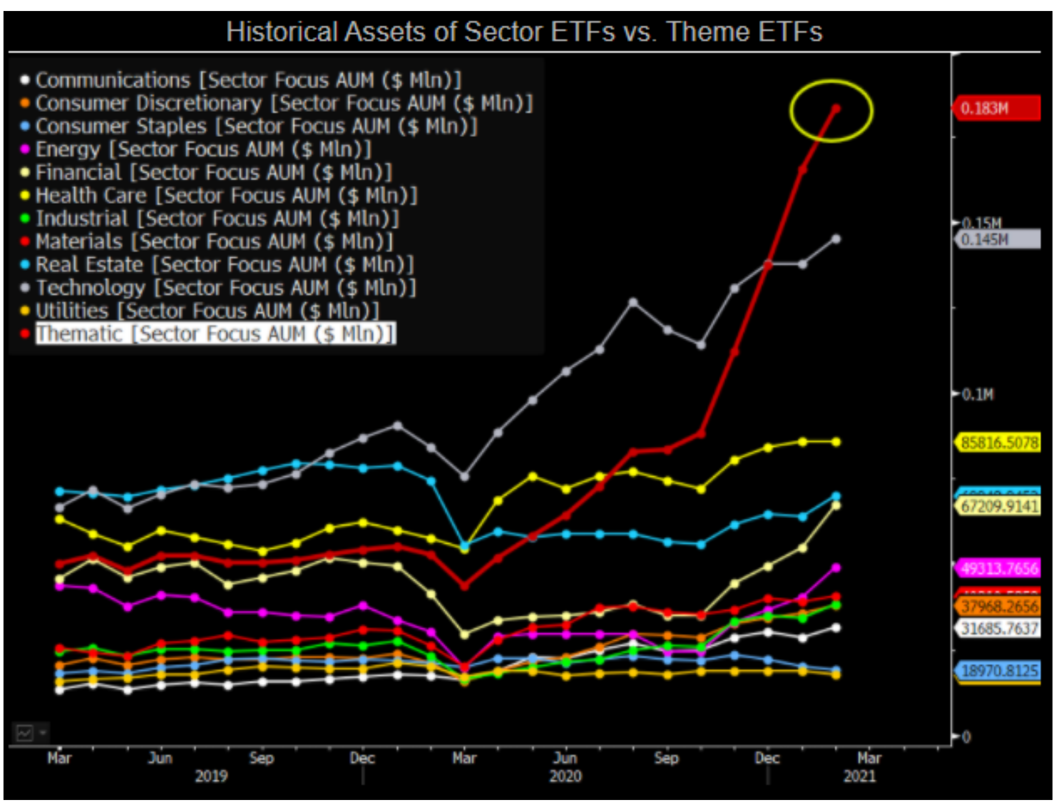
March 26, 2021

MACRO THEMES

Markets continue to do an admirable job in pricking whatever little bubble manifests itself, most recently the bubble in poor sell side forecasting with its December consensus call for the 10 yr. UST to end 2021 yielding 1.2%. That consensus has now moved closer to 2% (where I have been since the Fall) while the actual 10 yr. yield fluctuates around 1.7%. This repricing has been achieved alongside a healthy correction in Big Tech (vaccinations & rising rates = Tech Kryptonite) while barely affecting the broad market (S&P close to All Time Highs). The thematic universe, from clean energy to Crypto & in between, so bubbly a few months ago, has retraced back to the levels of last Nov.

I want to build on last month's piece "Investing Thematically" which generated some good feedback. It's clear that thematic investing is a hot topic, with Bloomberg noting thematic ETFs have tripled assets over the past three years to $180B and are now bigger than any sector ETF. Bloomberg forecasts that thematic ETFs could double assets again in the coming years and reach $500B by 2025, becoming bigger than all US sector funds combined & highlighting the limits of legacy sectors and styles. (Bloomberg: Themes could outgrow sectors as ETFs show sea change in effect)

Chart 1- Bloomberg Thematic Category breakdown



Clearly we all need to pay attention, especially global macro investors given the obvious tie ins between thematic & macro. But I have been thinking about a whole series of questions, to wit: how does investing thematically with the Tri Polar World? Can one leverage the Global Risk Nexus (GRN) to capture the inherent advantages of global macro in the thematic space? Given the high beta nature of thematics what processes can one use to ensure proper sizing and positioning? How can one integrate these themes into a global, multi asset ETF based portfolio? Finally, I want to share what lessons I have learned over the past few months of trying to achieve exactly this, investing thematically in a global multi asset portfolio.

I hope to bring a global macro practioner's perspective to answering these questions. I do so in part because I believe the appetite for guidance, for thought leadership and portfolio insights in the thematic space is expanding rapidly drive by performance, volatility, news flow and the eternal search for alpha. So this month I propose to do things a bit differently – rather than walk through the GRN components as usual we will break it down as follows: a walk-through of the Tri Polar World (TPW) framework & Global Risk Nexus (GRN) process, the linkages between the two and investing thematically and then my attempt to answer the questions above. Let's go!

THE TRI POLAR WORLD

The Tri Polar World (TPW) is a proprietary thesis I have been developing for over a decade, indeed since the aftermath of the GFC. Today, it serves as TPW Advisory's framework for thinking about the globalization process and as the starting point for my investment process. My thesis argues that globalization as we knew it back in the early 2000s is dead, a point of view reinforced by the GFC, Brexit, Trump's America First rhetoric etc. What replaces globalization is not nationalism but rather regional deepening or integration in each of the three main poles of Asia, Europe and the Americas.

There are three original drivers to integration: each region's growing ability to self-finance, self-produce and self-consume, coupled with two new drivers added roughly a year ago (TPW), each region's growing ability to self-innovate (tech) and self-protect (climate). One can see the linkages between the original drivers and ecommerce, fintech, robotics etc. – the stuff of thematic investing today. The new drivers of Tech and Climate dovetail with the thematic evolution both in terms of theme and region. Today, everything I see suggests that regional integration is evolving at a rapid pace and in symbiotic fashion with many of the thematics. Whether it's the geographic response to Covid (Asia 1st in, 1st out), Splinternet & China's drive for tech self-sufficiency, Europe's Green Deal and its quest for strategic autonomy in batteries & semiconductor chips or the Biden Climate & Infrastructure Plan, its regional and its thematic. Thus, the TPW framework provides clients with a differentiated perspective on the interplay between regional deepening and investing thematically.

THE GLOBAL RISK NEXUS

I developed the GRN process over the past five years or so to be the next stage in my investing process after the TPW. It also serves as way to maintain proper balance and equilibrium when thinking about the world. As a global macro strategist & investor, one is required to cover a lot of ground. The rise of thematics only expands this challenge. The GRN process is a risk mitigator – it reduces the risk of missing key issues or linkages between issues and regions. Pitched forward roughly six months or so, in an effort to sync my clock with that of forward looking markets, it originally looked at: Economics, Politics, Policy and Markets across each region and globally. I have found it to be a great macro process, never more so than over the past year.

That's mainly because a year ago I added a Health component; with the advent of Covid, it became clear that everything stems from Health. With Health now a regular part of the GRN process, I developed an understanding of Covid speed, an actionable investment insight that continues to provide dividends.

Covid speed refers to the speed of the spread, speed of policy response, speed of market reaction to that policy response, speed of science with the vaccine creation, speed of delivery with the vaccination process (the only example of subpar speed) and most recently speed of the Fall, to note the collapse in hospitalizations in the UK and US. Speed has arguably been THE key component to being on the right side of the markets this past year.

The Covid speed concept is a great illustration of the benefit of a process, one tried and true, if one is to focus on global macro investing. It doesn't mean one is always right (far from it) or that one won't look up and say how did I miss that, on the odd occasion. But it does mean that that one has structure, order, a process by which to think about the macro inputs of health, economics, politics & policy and how they impact markets either separately or together. It's also a great set up to think thematically.

INVESTING THEMATICALLY IN THE TRI POLAR WORLD

The GRN and Covid speed was the key that unlocked the thematic door for me. It became clear last Fall that the Covid speed of science would be successful and that multiple, effective vaccines from all over the globe would soon be available. It manifested the profound implications of what global intellectual and financial capital applied to a single problem could lead to – unprecedented results – in this case, vaccines in 1/10th of the normal time to create such. Over the past six months or so I have been able to extend this Covid speed analogy beyond health to other global challenges such as climate – the obvious one, but I believe Cyber, Genomics, and the emerging nexus between traditional banking, fintech and Crypto are also global issues with attendant global focus both intellectual and financial.

I believe these global challenges coupled with abundant, cheap money and the replicable success of the Covid speed model represents a paradigm shift that will drive an unprecedented period of innovation. In this vein the flood of capital we have seen enter the public markets through the Robinhood bros or the IPO boom or the SPAC craze may be a bit much but may also serve to bring that future forward and into the public market realm, disrupting to some extent the VC funds who have been the financiers of the early adoption cycle. Now it's the public market investors who have a chance to access that Innovation Curve at an earlier stage of the cycle. This of course means more risk but also more reward and supports the thematic investing process as a way of spreading one's bets, much as a VC investor does.

Alongside this paradigm shift and back in the Tri Polar World, we have regime shifts simultaneously unfolding across multiple spaces: Government, Economics, Policy and Markets. In the US in particular the shift in Governance has the potential to be profound as a Biden Govt that believes in going both Big and Fast replaces a 40 year old orthodoxy about how Govt is bad. In Economics we will have a Global Growth BOOM the likes of which have not been seen in 50 years. In Policy we have abandoned the slavish dependence on monetary policy to embrace fiscal policy in an effort to go beyond the status quo ante. In Markets we have entered a bear market for UST – the first in 40 years.

When one thinks of all these changes, many never before seen by the vast majority of today's investors, it reinforces the need for process, for structure as well as the need for suppleness of thinking and being open to new opportunities. Investing thematically is one such opportunity, especially for the macro investor. One can even hope that thematic investing might revitalize global macro investing whose returns have been so subpar that even Soros Fund Management, home to one of the greatest macro investors of all time, recently disclosed that global macro represented less than 10% of its assets. Pay attention people – there is an opportunity here.

Investing thematically should be a natural for global macro investors: after all, themes are top down & often reflect changes in macroeconomics, geopolitics & policy – exactly the building blocks of macro (and the GRN). MSCI, which has developed a whole suite of thematic indices based on four megatrends, notes how thematic investing cuts across traditional country, sector, industry & style classifications (GICS) which is where the alpha opportunity comes in. Bloomberg notes how many of the companies developing these themes are too small to be in the major indices – another benchmark beating opportunity. Thematic investing also leverages a long time frame which helps both the asset owner and pension fund segments of the investor community as well as the hedge fund space which can go long and short within a shorter time horizon, benefitting from the volatility the asset owners can ride through. Long only global macro strategy – where I spend my time - is perhaps the most challenging of all.

Chart 2 – MSCI Megatrends

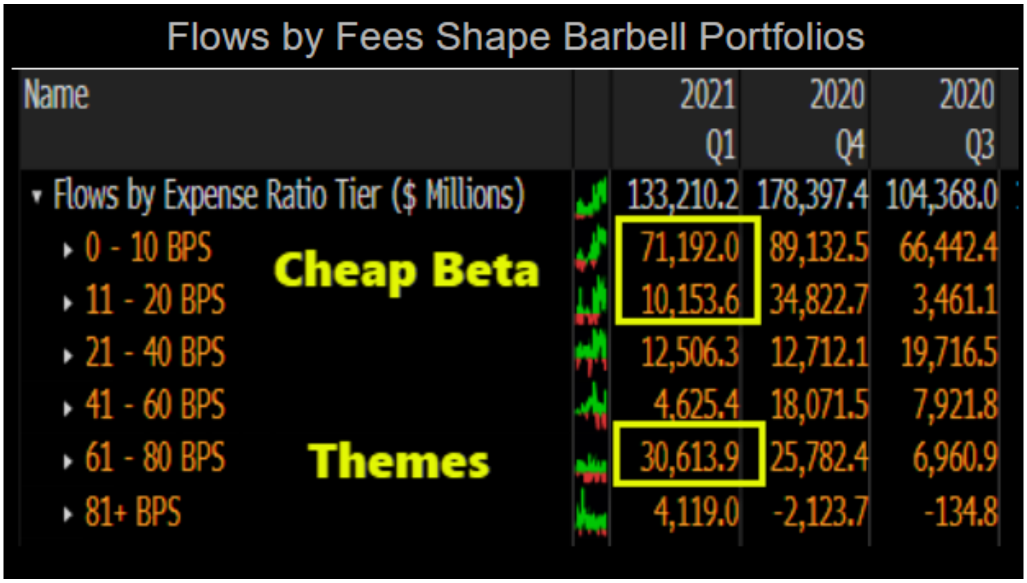
MSCI Mega Trends
Environment & Resources
Efficient Energy
Health & Healthcare
Digital Health
Genomic Innovation
Society & Lifestyle
Ageing Society Opportunities
Food Revolution
Future Education
Millennials
Smart Cities
Transformative Technologies
Autonomous Technology & Industrial Innovation
Cybersecurity
Digital Economy
Disruptive Technology
Fintech Innovation
Future Mobility
Next Generation Internet Innovation
Robotics

Clearly a major challenge then is the need to get up to speed on all these themes, many of which are specialized, think climate science, cybersecurity, life sciences, contactless payment, Crypto etc. etc. How is one meant to become expert in all that while keeping up with all the traditional macro factors? What about new business development or client servicing or any of the myriad other things one has going on? This is where one has to fall back on one's process as well as look for new guides for these new paths.

One of the benefits of having done global multi asset investing for some time is one has a go to list of folks one respects & listens to. Trusted former colleagues, strangers one has read for years & across cycles, friends in the business to whom one can relay concerns, uncertainties and with whom one can have an open dialogue. For me, one such group is a bunch of former Morgan Stanley buddies, mainly on the buy side, here and abroad, who get together monthly to talk markets – one of my best hours of the month; highly experienced practioners, open and willing to probe and be questioned. There are the top sell side firms with their unmatched resources (JPM in global macro) & independent providers like Alpine Macro who bring a unique voice to the markets.

But investing thematically requires new guides for these new spaces: the Cathie Woods and Elon Musks' of the world – folks who saw the opportunity set early, have the scars to prove it and are now looked to and listened to as true experts in the space. In fact, MSCI collaborated with ARK Inv Mgmt to develop its Innovation indices. These folks are today's version of Peter Lynch or Bill Miller or even Warren Buffett. ARK is particularly interesting – it is an active manager and so investing in ARK ETFs provides intellectual leverage across the thematic space which is very useful. Active management is still a small minority; 85% of thematic ETFs are passive but the 15% which are active have 32% of the assets and have a higher fee structure as well. This suggests that we can expect more thematic ETFs which makes sense – ETFs are a great instrument for investing thematically and thematic ETFs are premium priced products.

Chart 3- Bloomberg Fee Barbell



Flows by Fees Shape Barbell Portfolios

Name	2021 Q1	2020 Q4	2020 Q3
Flows by Expense Ratio Tier ($ Millions)	133,210.2	178,397.4	104,368.0
0 - 10 BPS	71,192.0	89,132.5	66,442.4
11 - 20 BPS	10,153.6	34,822.7	3,461.1
21 - 40 BPS	12,506.3	12,712.1	19,716.5
41 - 60 BPS	4,625.4	18,071.5	7,921.8
61 - 80 BPS	30,613.9	25,782.4	6,960.9
81+ BPS	4,119.0	-2,123.7	-134.8

[Source: Bloomberg Intelligence]

Other firms are getting in the thematic business as well – a hot idea never lacks for friends on Wall St. Morgan Stanley has a podcast called Thematic Alpha where it explores thematic investing. Private Equity behemoth Blackstone have become increasingly focused on high conviction themes in "fast growing parts of the economy with strong tailwinds", noting the opportunity for thematic investing to generate alpha. Blackstone highlights three specific themes: Life Sciences, Growth Equity and Digital Transformation.

Expanding the toolbox can also be helpful when exploring new & volatile territory. I have found technical analysis to be helpful while discussing ways to bring machine learning (ML) and AI into play. The quantamental approach may well have a role to play in the future of global macro. Of course, when these various resources line up together it's a signal to focus closely & often invest heavily. I first learned this when I was head of global asset allocation at Morgan Stanley responsible for a product called Macroscope which incorporated fundamental, technical and quantitively analysis into one product offering. Today that signal is in the Value space as I wrote last week.

The fundamental case for Value is strong as vaccinations and rising rates serve to curb the upside for long duration growth stocks while boosting Value sectors like financials & energy. Top technicians like Marty Pring are noting that long term equity leadership is moving away from tech towards energy and other value sectors. Finally, the JPM Quant team is noting how momentum is moving towards Value and away from Growth which has been the leadership for a decade or more. All three disciplines lining up together is rare and suggests investing in size on the thesis of equity leadership shifting away from the US and Growth/Tech to non US markets like Europe and Japan which offer more Value and Cyclical exposure.

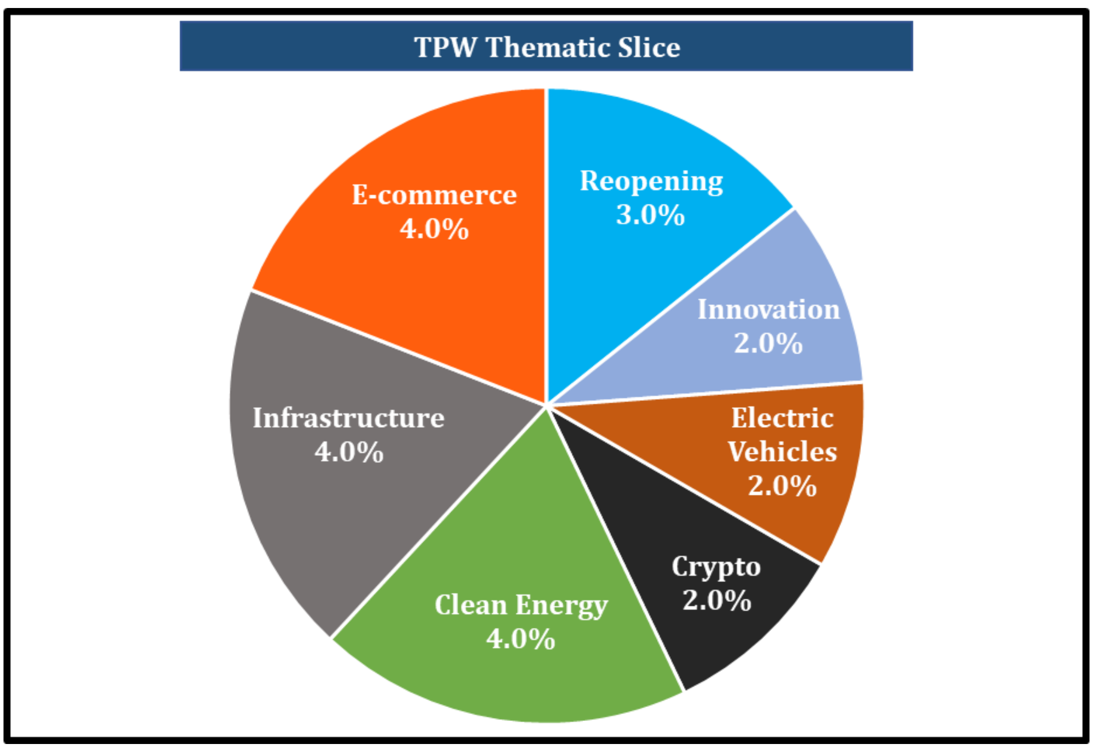
See that, we got off track. It happens. Back to investing thematically – with the focus now on the portfolio process. Unless one is starting with a pile of cash, investing thematically involves integrating thematic into existing portfolios already allocated to stocks or bonds, think 60-40, Risk Parity etc. or true multi asset with some Commodity and Alt exposure thrown in. How does one allocate to clean energy, to cyber, to fintech? How much should one allocate to each theme and to the thematic space overall? Crypto offers an interesting example. Given how much more volatile it is vs equities – roughly 4-5x more volatile according to JPM, that bank recommends a 1% allocation. Morgan Stanley just announced it thought a 2.5% allocation for its wealthy clients could be appropriate.

Even away from Crypto the recent volatility in the clean energy, battery, innovation space has been significant. Most themes have retraced their run up since last Fall and are now back to Nov – Dec levels. ARK's main ETF for example is off roughly 30% from its recent high. It suffered a similar decline year ago with Covid but recovered to new highs in under three months. As I write many segments have retraced even their little bounce of the past few weeks and are back to the lows of early March. Given that these are themes that have been developing for years and are in some cases still years from fruition the broad thematic space appears to be trading as a high beta, long duration growth stock. I understand this on one level but also feel that the paradigm shift I referenced at the top is yet to be fully understood & embraced. Thus the trick is to stay involved during sharp pullbacks like we have just seen. That's not easy to do and leads back to portfolio construction.

The lack of thematic research also manifests itself during volatile markets – since much of this works cuts across the traditional Wall St research sectors and styles, thematic research itself is quite limited. This of course can be an area of opportunity for alpha generation if one can finds the right guides & structure a long only portfolio so as to stay invested. I have found that pairing old and new has been effective over the past few months – old energy with clean energy, traditional banks with fintech etc. Given these comments above regarding how the various disciplines are lining up in favor of Value this pairing also offers a way to participate in both the value opportunity while investing thematically, reducing risk and staying invested thematically. Another approach would be a barbell approach with cheap beta on one end and more expensive thematic ETFs on the other.

There is also the opportunity to shift around within themes, reducing perhaps the more aggressive positions in favor of themes that can be either more traditional, for example Infrastructure, or even more cutting edge, such as Carbon. Pressure is growing to have companies and governments display their carbon emission footprints which will accelerate the carbon offset market across the Tri Polar World. Europe is likely to take the lead this summer with its Carbon Border Adjustment Mechanism (CBAM). Over the past few months I have migrated away from the more volatile segments to infrastructure and Carbon as a way to maintain roughly 20% thematic exposure while dialing down the volatility. I include a pie chart of my thematic exposure as a way to visualize this process.

Chart 4 – TPW Advisory Thematic Pie Chart



Thematic ETFs are driving the innovation process within the ETF space, stealing market share from MFs and ETFs tied to broad benchmark styles. One wonders if this might even happen in the ESG space. What about a Bitcoin ETF? It's only a matter of time. Existing vehicles are already belong affected with Grayscale's GBTC shifting from a steady 20-30% premium vs BTC to a 15% discount in a matter of weeks. Canada just listed the first Bitcoin ETF in North America; the good folks at HANetf have brought Crypto ETFs to Europe. With articles extolling the rise of Bitcoin now in Pensions & Investments one wonders if Crypto adoption by the PF community will be far off? As these long term pools of money deepen their thematic exposure they may also bring a welcome measure of stability to the heavily concentrated thematic space, which would then reinforce the thesis of investing in it for all investors. I discussed the impact on the 60-40 space stemming from a less generous beta world and how thematic investing can help in that regard last month.

The question today is the following: given that one expects strong growth, another 30-40 bp rise in the 10 yr. UST over the course of the year and thus continued relative underperformance of Big Tech and the broad US market relative to ROW how should one invest thematically? If many themes are going to continue to be treated as levered plays on Nasdaq then one would want to be less aggressive. If one thinks the paradigm shift will drive greater investment in thematics, particularly by LT capital in the public markets, then one would want to stay heavily invested. Current oversold conditions may offer a good entry point for some. I don't have the answer but it is the key question for me. I do believe investing thematically is here to stay and has alpha generating power; it might even be the salvation of global macro! Feel free to ponder and please share any thoughts.

I hope this has been helpful – keep calm and carry on!