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As The Tri Polar World Turns: Climate, Crypto or Both?
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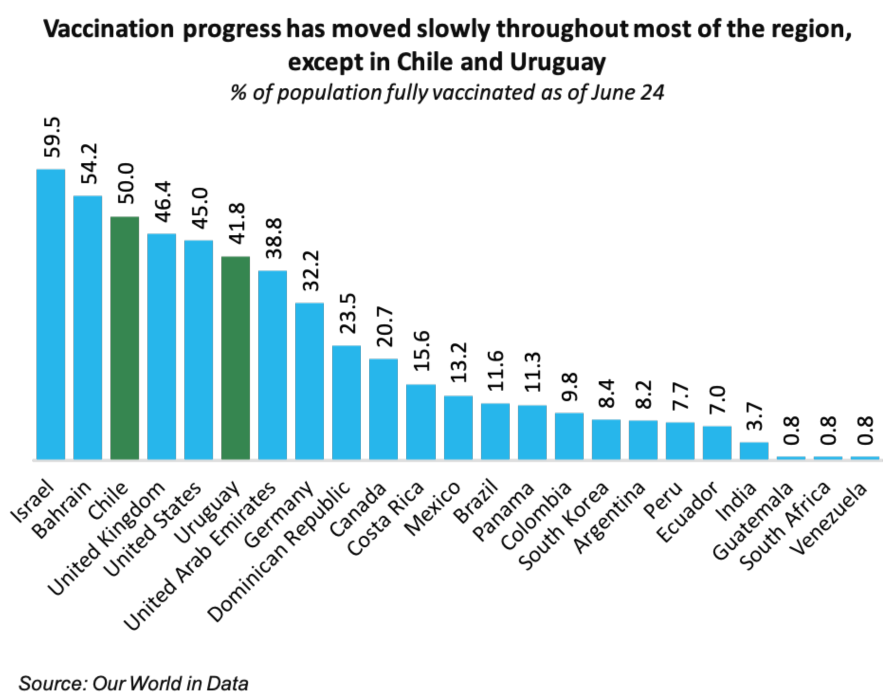
As we head into the heat of a NYC summer, investors seem to be trying to make up their minds, engaging in a rotational, cross asset two step. The Fed inspired "pothole" a few weeks back crystallized questions around not just transitory inflation but also the risk of a Fed policy mistake. The seemingly relentless rise of the Delta variant has caused animal spirits to ebb. Within equities June was a nice comeback month for growth while a cross asset check shows that both the long end of the UST curve as represented by TLT and the Commodity sector as repped by GSG both rose roughly 3% which strikes one as a somewhat odd pairing.

"Often wrong but rarely in doubt" is an apt characterization for many a market pundit including yours truly. As I look out over the 2H horizon I continue to expect a transition from staggered reopenings to synchronized global expansion. Notwithstanding the Delta variant risk the untold story seems to be the rise of vaccine production: Europe is now giving 2x as many shots pd as the US while Japan ramps up its vaccinations to 1Mpd as the Olympics draw near.

Over the next six months, I expect a similar outcome in the EMs as 2H US – EU vaccine production ramps close to 6B shots, the vast bulk of which will be for export to the EM. Vaccine procurement has been the main reason why Asian vaccination rates are under 25% and roughly 10-12% in Lat Am. The surprise is likely to be that by YE the bulk of the world will have vaccination rates approaching 40-50% with all that implies for activity levels, rates, earnings etc.

Chart 1 – Vaccine Production Surge to Lead to EM Vaccinations



This synchronized global expansion should bode well for non US equity, Value–Cyclicals, Commodities and thematics while leading to higher rates and a weaker USD as capital flows to those just enjoying the fruits of reopening. This set up suggests that the recent healthy pause, pullback in the above assets should be bought. All this seems pretty straightforward – of course there are always questions and doubts but the main asset allocation tenets seem to be in place. Skepticism regarding this outlook is good & healthy – a stair step higher process is much more sustainable than rocket shots. Note that downside protection in both US equity and credit has rarely been more expensive.

With the main asset allocation tenets in place one now has the scope to think more broadly; in my case about the question mooted in the title: Climate, Crypto or Both? What do I even mean by that? Well, it seems that we are in an age of rapid change with those much more knowledgeable than me expecting more change in the coming decade than in the last 100 years. As a macro thinker, investor and advisor the real opportunity to make money would seem to lie in figuring out which of these big changes are most fruitful and invest accordingly.

Of course, this is also a natural outgrowth of the thematic investing approach I have discussed & embraced for much of the past year. (Invest Thematically) Climate is certainly an area one needs to try to understand and invest in. It is arguably this decade's single biggest macro trend. It's global – every country on earth is active, it has a timeframe – the decade of the 2020s - to move to peak carbon; it is investable & incorporates vast amounts of public – private capital to support that effort. It is a huge undertaking – one that arguably puts Pres. Kennedy's moon shot claim to shame.

Crypto's adherents say it too is not only changing finance but the world at large. When Marc Andreessen, the guy who said that software is eating the world a decade ago, announces that his company is launching a $2B Crypto Fund, he is someone with a track record worthy of respect and thus worth paying attention to. Many of the top hedge funds are now tackling digital – both coin and chain. Crypto is almost the anti-Climate in that climate is visible- especially on a 97 degree day in NYC, while crypto is invisible.

They share similarities as well: both are somewhat open ended, have been around for many years & both have burst onto the investing scene in the past 1-2 years. Crypto and carbon share a scarcity value (coins and allowances) as well. Crypto also has Govt influence but not necessarily the same (mainly) positive kind that Climate has – at least not yet. Govts are more likely to be hostile to Crypto though one can argue that a more regulated environment with cleaner bitcoin mining etc. could be a place where the price of coins could enjoy appreciation. There is also the pick & shovel nature of DEFI or decentralized finance and the blockchain potential within the melding of traditional finance, fintech and crypto. Coins have been the appreciating asset but the volatility limits sizing whereas the blockchain buildup could provide better risk adjusted returns.

So, as an investor should one focus on Climate, on Crypto, or both? I come down on both but with a much greater focus on Climate than Crypto. Of course, it's hard to imagine becoming expert in one of these areas let alone both. I have discussed the need and utility of expert guides in these new realms while also building up one's own knowledge base. Building the right team – internal & external will be key as will a fast flywheel. Climate and Crypto are likely to be the biggest of the thematics in the decade ahead – Cybersecurity will be very big as we digitize everything, Robotics too as reshoring and near shoring drive adoption but Climate is likely to dwarf the rest with Crypto having significant global potential.

This is obviously a discussion that can, should & will take place over time but it is uppermost in my mind as I write and so in keeping with the effort to speed up the TPWA flywheel and build better, faster, cheaper I wanted to put it out there. Those clients participating in our Model Portfolio Delivery Service (MPDS) are already reaping the rewards of this focus.

Ok, let's return to our trusty GRN process to review Climate, Economics, Politics, Policy and finish up with Markets.

CLIMATE

As I develop my thinking on this huge topic it seems logical to break it done into two emission focused categories, namely transportation which is the DM's main emissions creator & power generation, the EM emission leader. Carbon pricing links the two as a key factor in determining how fast we as a global community decarbonize and so it is a critical component to stay abreast of.

We should get some important updates on the carbon emissions front in the coming weeks as Europe prepares to update its emissions trading system (ETS) which is the largest in the world and which forms the basis for the Carbon ETF (KRBN). Currently only 16% of global greenhouse gases are covered by an ETS – this will clearly change significantly in the years ahead. For example, China, the world's largest carbon emitter, is ramping up its regional ETSs as it seeks to move away from coal fired power generation. Currently, carbon is priced at roughly $3-5pton in China vs $20 in California's ETS and roughly $40 in Europe. Most observers believe a price well in excess of $100pton is necessary to meet the Paris Accord targets.

Chart 2 – Carbon Pricing Key to Global Decarbonization Effort

Source: International Carbon Action Partnership (ICAP), 2021

In addition to a carbon focus the other area of great interest is the "dual track" investment thesis on the energy side, namely the ability to invest in both clean energy and fossil fuels. This is a point I made last Fall and have executed in the model portfolios. During the transition away from fossil fuel and amidst the ESG focus it is likely that we will have a period of years where there is a supply – demand imbalance due to lack of investment in the fossil fuel or material space while demand grows as a result of the green energy push. With supply & demand out of whack price has to step in to clear the market. I expect this price clearing process to occur across both the fossil fuel & clean energy space in the coming years. It is a prime reason why I am a firm believer in the Commodity Super Cycle.

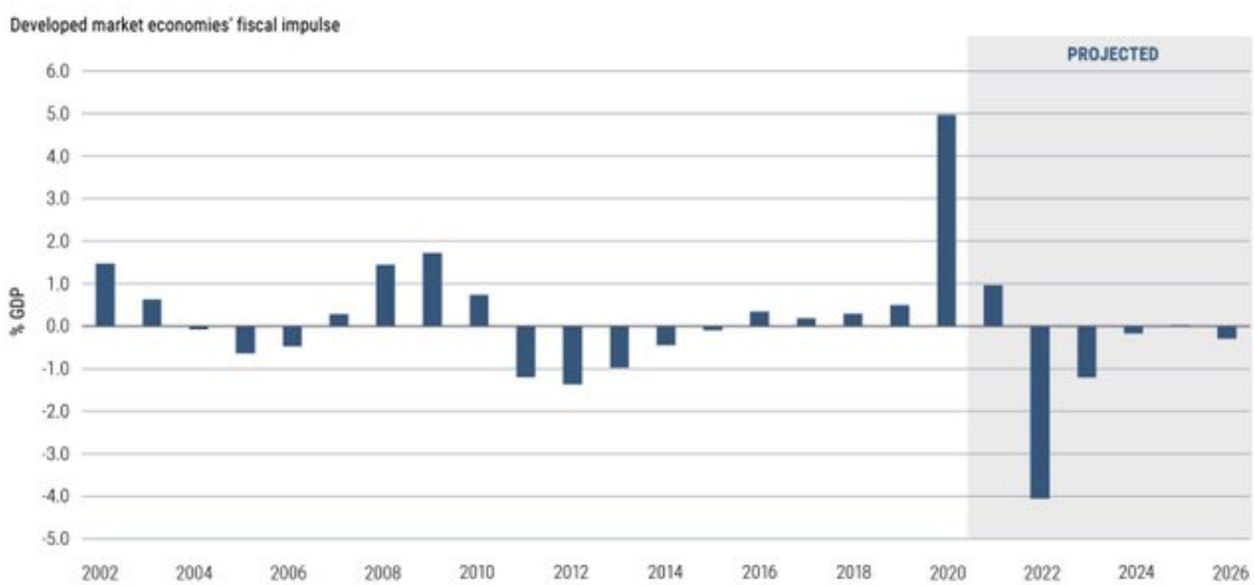
As an active global macro investor with an ETF focus this seems to be the direction of travel for investing in Climate, rather than simply buying an ESG fund. Investing is all about where one spends one's thinking time - Climate is a must think, learn, invest arena that is likely to be an area of great profit potential in the decade ahead. Simply buying an ESG fund is highly unlikely to cut it. It should come as no surprise then that Climate is the top category in our TPW 20, 100% thematic, global model portfolio.

ECONOMICS

While the inflation debate continues to generate the most heat I am not sure how much light has been generated. I expect more insight as we exit summer and enter Fall when clean post Covid bottom data is available and we get a sense of what US legislation has been passed. I remain of the view that the inflation spike will be transitory & that a year or so of 3% PCE inflation is far more preferable than my Bear Case of a sudden sharp US growth slowdown.

Given the sharp US fiscal contraction coming down the pike, the ebbing of US liquidity as M2 growth rolls over and the widespread US reopening, a US growth rate slowdown would seem to be a given. In fact, the well-respected economic forecaster ECRI has recently noted a Growth Rate Cycle slowdown ahead. The question we need to be asking is from 7% growth this year to what in 2022/23? If it's to 3-4% as forecast then that's a slowdown I would be happy to have. If it's to 1-2% then I suggest we will be in some trouble. I expect the former.

Chart 3 – The Coming Fiscal Contraction Will Be Sharp



Source: PIMCO

Notwithstanding China's growth rate having already peaked, the transition from global recovery to global expansion is upon us with IHS Markit noting Q2 2021 will mark the surpassing of Q4 2019 global GDP; hence the 2H of the year will be a global synchronized expansion led by reopenings in Europe, Japan and EM. As a result, Q/Q global growth is expected to expand from 2% in Q1 2021 to 6-7% in 2H 2021. Europe is furthest along here – consumer confidence just hit a 20 year high while flights have picked up roughly 60% in the past few months.

This is the story that has not yet been embraced, certainly not by pundits nor by the cross asset markets if one looks at Growth/Value, bond yields, Commodity futures etc. It's the story that is likely to manifest, supported by the expected vaccination surge noted above. Today, the market talk & action is all about rampaging Delta –look for that to change in the coming Qs.

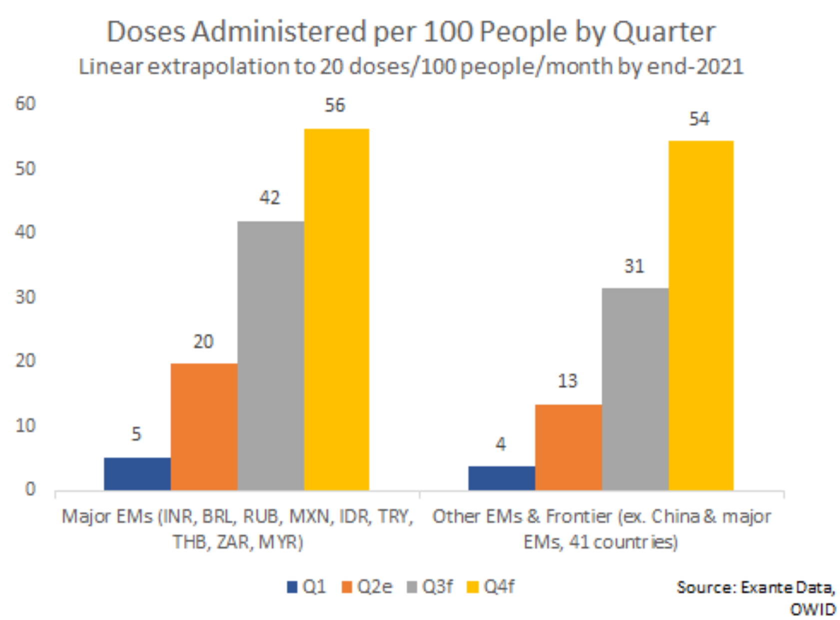
POLITICS

I wrote in my last Musings that Joe Biden's potential to be a transformational Pres. depends a lot on his ability to bend Congress to his will. Given his 40 years of governing experience he is as well placed as those two prior legislative masters FDR and LBJ though both had much better #s on their Congressional side. The Biden plan remains to remind Americans that Govt can work, that it can work for them and help them in their daily lives. Thus the vaccination campaign, the push for bipartisanship on infrastructure and the focus on human or social capital in the next phase of action.

Given the paltry number of days the House and Senate are in session over the summer months (9 and 16 respectively) there is much to be done. I continue to expect the Infrastructure bill to pass along those bi-partisan lines and the much larger human capital bill to pass via reconciliation - the so called dual track approach.

Outside the US, as we move thru summer elections will heat up in both Europe and Japan. A new German coalition between the CDU and the Greens looks likely while in France the outcome is less certain given a noticeable lack of enthusiasm in recent regional elections. PM Suga in Japan has cast his lot with a successful Olympic Games, a bet I expect him to win. In EM, vaccination politics are manifesting; Brazil, where former Pres and convict Lula is running far ahead of current Pres. Bolsanaro is one such example.

Chart 4 – An EM Vaccination Surge is Key to A Synchronized Global Expansion

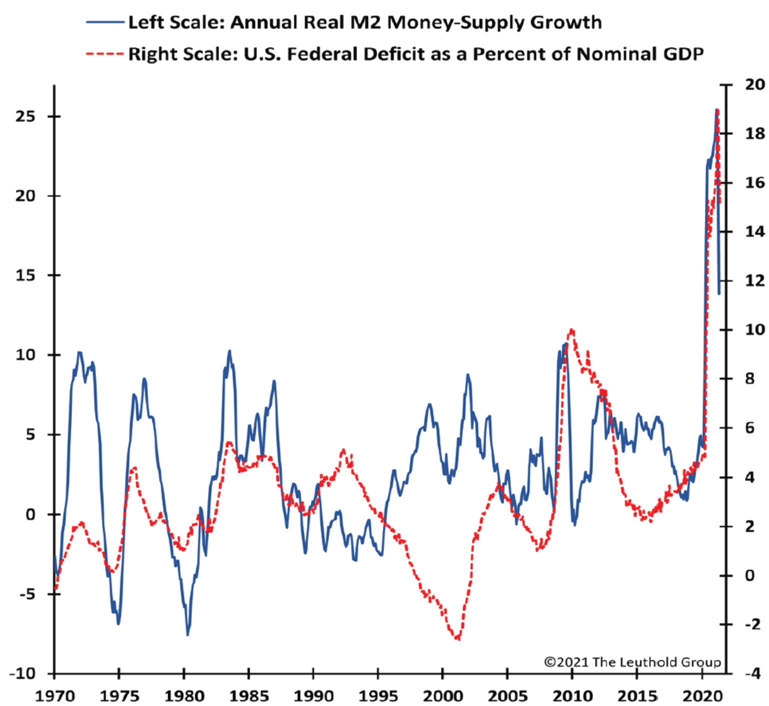


POLICY

The absence of any bond vigilantism allows the Fed to move slowly along an extended timeline with a tapering announcement likely at the Fed's September meeting followed by a Q1 2022 tapering start. Expect tapering to run through most of the year ($120B pm running off at $10-15B pm should take 8-12 months) followed by an assessment of current conditions and the potential for rates hikes in 2H 2023. I expect the Fed to remain data dependent & true to its FAIT.

A pretty straightforward Fed path leaves the US policy focus on the fiscal side and the expected sharp contraction from double digit deficits the past 2 years to a much smaller 2% or so deficit in 2022. Of course much depends on potential legislation as the Biden team pushes for dual track negotiations. While Pres. Biden tries to preserve some ambiguity around whether these are in fact tied at the hip one would think they almost have to be to keep his own side in line. Given that the main risk factor is a sharp US growth slowdown that impacts earnings and thus risk assets, one hopes there is further progress on this front as such would alleviate that principal risk factor.

Chart 5 – US Fiscal & Monetary Pullback Will be Tricky



On the plus side there is the potential for above trend US growth with stable inflation via this procyclical spending approach coupled with a long overdue public – private cap ex boom. Such a combo could set the stage for a productivity surge that leverages the tech advances of the past decade & the full employment imperative for companies to invest in productivity enhancing processes. The potential here is real as we leverage the technology advancements of the past decade and set the stage for even more in the years ahead. Investors should keep an open mind to this prospect and position accordingly.

In Asia, China celebrates the CCP's 100th anniversary and as such one can assume that China's growth slowdown will not turn into anything sinister or worrisome from a global perspective. June PMI data support the slowdown with Composite PMI at 52.9 down from 55.1 in Dec 2020. Slowing growth ensures China's monetary tightening will be unlikely to get out of hand.

Europe is finally rolling out its Joint Recovery Fund (JRF) with various national Govts. plans being approved by the EC and regional borrowing kicking off as Europe looks to link its Green Deal with the JRF to jumpstart its own integration prospects. The warm welcome to the EU bonds has been impressive (latest offering 8x oversubscribed) and suggests the long awaited European safe asset curve may be forthcoming after years of reliance on the tiny, illiquid German BUND market. As previously noted, the JRF disbursements over the coming 2-3 years set Europe up very nicely during this period, arguably more so than either Asia or the Americas.

MARKETS

As noted at the top it has been a month of rotation within equities with the US benefitting most from its twin engine capacity as the non US equity markets, more Cyclical and Value based, saw some healthy profitmaking fueled largely by the uncertainty regarding the Delta variant and its impact on reopenings, summer travel etc. US equity Growth – Value correlations are at record lows while positioning is now much cleaner with MS reporting very low levels of hedge fund net exposure to US Cyclicals. Across the pond, Europe went from its longest winning streak in almost 35 years to near oversold in roughly 2 weeks. Thematics performed well in line with growth stocks – to wit, 16 of the 20 positions in our TPW 20 100% thematic model were up for the month.

Earnings are up next & will be great; more important will be the 2H outlook and early 2022 read. The VIX remains calm and is supported by seasonality yet we are in a "pothole" period with the number of 5% VIX daily moves surging from 9 between 1994-2007 to over 60 in the post GFC period as liquidity ebbs and machines trade. Such data reinforces my view that only the most adept traders should try and compete here – the rest of us are much better off riding through the roughs.

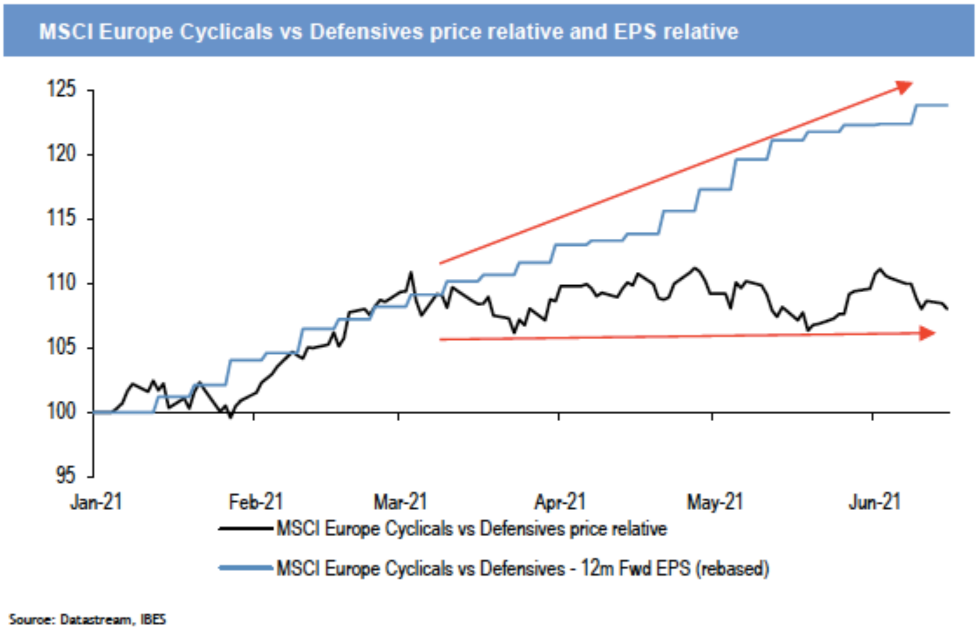
As we exit the 1st H, the 10 yr. UST wavers around the 1.5% level, failing to confirm either strong growth and some inflation or subpar growth and no inflation. Much of the commodity space had a healthy pull-back; oil enjoyed its best 1st H since 2009 while Gold suffered its worst month in roughly 5 years. The USD has likewise oscillated around without breaking one way of the other. These are tricky trading markets which provides lots of opportunity to misjudge, mistime, misallocate and thus generate lots of agita.

Crypto had a tough Quarter with big drawdowns, lots of volatility, anti-Crypto Govt and semi Govt action coupled with the odd pro Crypto push from the likes of El Salvador. Noticeable here was the less volatile and far better risk adjusted performance of the pick & shovel component of the space. The lack of a widely applicable use case and valuation parameter for Bitcoin, the push for CBDCs, the melding of fintech, traditional banking and Crypto suggest the pick & shovel, blockchain opportunity might be more tangible and more accessible to investors as some form of digital currency is gradually adopted on national, regional if not global basis.

Tactically the Delta variant spread vs the vaccine production run would seem to be the relationship worth watching. JPM just came out arguing that the death toll from the Delta variant, even in countries like the UK and Russia where it has exploded, is much less than prior surges and thus arguing that it should not impede the global reopening, cyclical recovery and JPM's preferred Value & non US equity recommendation.

This is the TPW camp as well – a camp fortified by the vaccine surge which JPM does not note. The recent pullback in Europe for example has opened a big gap between Cyclical earnings growth and performance, suggesting the pullback as a good entry or add point. Laggards are likely to become leaders. I made the Japan equity bull case in last week's Musings: cheap, cyclical, under owned, improving vaccination pace, only DM with sub 50 Composite PMI, better news flow on successful Olympics etc. Latin America remains the preferred EM region.

Chart 6 – European Cyclical Opportunity

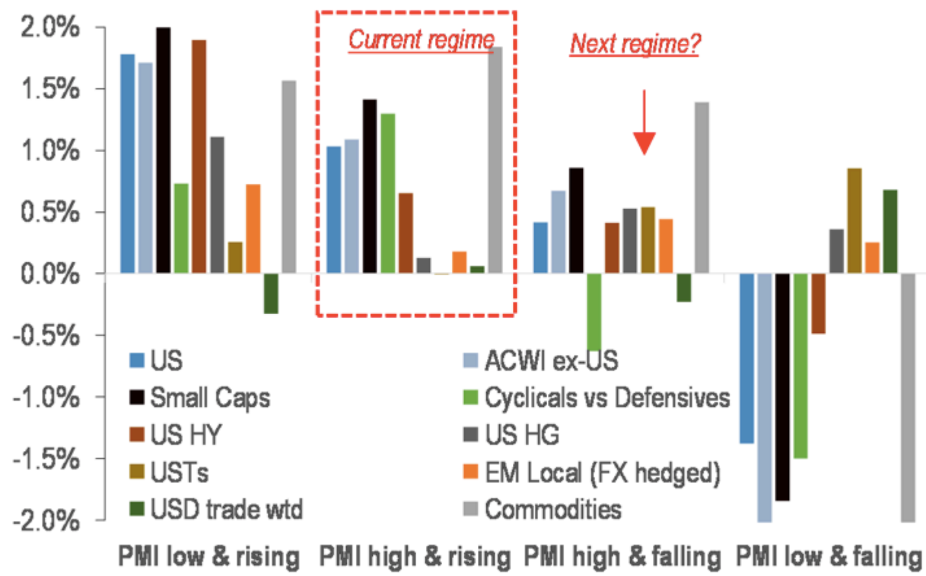


Strategically and as noted at the top the focus here has been on thematics and especially on Climate. The upcoming EU update to its ETS, the prep and run up to the Fall meeting of the UN COP26 in Glasgow, the visible outcomes of climate change in heat waves and wildfires at the onset of summer all reinforce the need to invest time and effort in getting up to speed here. The juxtaposition between climate change on the ground and ESG in the boardroom will have big price implications across both stocks and sectors.

In digging more deeply into the Carbon market for example it is fascinating to note that the ETS market is structurally designed to gradually rise in price as the number of allowances are gradually cut back. The risk reward here for LT investors seems very good – an expanding market as China and other countries come on board, the potential for carbon border adjustment mechanisms (CBAM) to drive further price appreciation, the lack of downside risk and limited ways to participate make it an appealing vehicle.

On the fixed Income side JPM had done some interesting work on where FV resides for the 10 yr. UST and while perhaps not surprising the gap between current levels at 1.5% and its estimates for YE 2022 and YE 2023 are large. To wit, JPM forecasts a 10 yr. UST yield of 1.95% at YE while its FV model suggests 2.2% followed by a nominal yield of 2.8% at YE 2023. Now there are many assumptions built in but the direction of travel is the main point. I continue to expect the 10 yr. German BUND yield to drift higher as well and approach if not breach the zero bound (from -.2% currently) by YE. Europe's inflation is running behind the US and is likely to peak at lower levels. As noted previously some inflation will be good for Europe not bad. Higher LT rates, in the US and Europe, will be good not bad for risk assets.

Chart 7 – A Golden Age for Asset Allocation & Thematic Selection



Source: J.P. Morgan.

The USD continues to chop around – at some point it will break its range – the question, as always, is in what direction? I posit lower as US exceptionalism ebbs, ROW reopens, twin deficits come home to roost, political risk rises into mid-terms and overweight foreign investors take money back home. EMFX is likely to do better than the majors in this environment, with the likes of Brazil and Mexico already inoculating themselves against Fed hikes by hiking themselves.

Commodities remain a favored asset class for both return enhancement and diversification, ranging from fossil fuels to clean energy, copper to carbon, uranium, precious metals etc. Grains are worth a look after their healthy pullback. One of the tricks to be successful in the coming years will be to not get shaken out of winning LT positions too early. The required duality of keeping both short term technicals in mind while holding firmly to LT secular change in leadership will help define the investment winners and losers of the coming decade. I see Commodities & thematics as ways for global, multi asset, macro investors to add value to clients who have not previously invested in either space.