12th October 2021

Emerging Headlines

Consumer Staples

The relative valuations for U.S food, beverage, tobacco, and household-product makers, presently indicate that these companies are not favored by investors. Valuations for these counters, are at the same levels as the end of the dot-com era. Their weight in the S&P 500 Index indicates as much: Consumer staples amounted to 5.74% of the U.S. equity benchmark in the last three trading days of August. The only lower readings in the industry gauge's three-decade history, occurred in March 2000. Its share of the S&P 500 fell as low as 5.35%. (As an aside, Bloomberg also highlights that the ratio of growth to value stocks is at its highest since November 2020).

We have taken a cautious approach to high equity valuations, inflationary pressures (refer below) and rising treasury yields.

Rockman Capital has started to sector rotate and reduce weightings in the ICT sector and allocate into defensive sectors, such as staples, pharmaceuticals, and food retail.

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What is the Evergrande Saga?

Evergrande Real Estate is a Chinese property development company that owns over 565 million square meters of development land and 1,300 projects in more than 280 cities across China. However, the Evergrande Group has grown to comprise far more than just real estate developments: Its businesses range from wealth management, shares in a bank, electric vehicles, and food & drink manufacturing. It even owns one of the country's biggest football teams – Guangzhou FC!

Presently, the company owes bondholders over $305 billion (€262.7 billion) in the next two years. Last week, the group missed a $83.5 million coupon payment on an offshore $2 billion note. This week, it was due to pay a further $47.5 million, which also appears to be in doubt.

So how did Evergrande find itself in this this position? Evergrande's core business, is to purchase, redevelop and sell residential units. This capital intensive and cash hungry businesses model, takes much time. To grow aggressively, the company used significant amounts of debt, to finance most of its projects. However, it also used debt, to fund forays into the electric vehicle production, media productions and other sectors.

Last year, the Beijing authorities introduced new rules to reign in real estate borrowings. Due to these new regulations, Evergrande was forced to offer its properties at major discounts, to ensure it was able to generate positive cash flow and keep its business afloat. However, it has run into significant difficulties, to meet the interest payments on its debts. The financial fallout that could occur, may be far reaching. In the event of default, banks and other lenders/investors may be forced curtail their advances. This could lead a credit crunch, whereby companies struggle to borrow money at affordable rates.

The latest news is that Evergrande is set to raise more than $5 billion by selling a majority stake in its property management arm, which will be its largest asset sale in its history. This will assist the company in the short-term, to settle its international bond payments and cover a bond maturity set to end in March 2022.

With liabilities equal to 2% of Chinas gross domestic product (GDP), Evergrande has sparked concerns its trouble could spread through the global financial system. Nervousness has eased recently as China's central banks vowed to protect homebuyer's interests. But investors remain nervous, owing to uncertainty around the wider impact on China's residential and capital markets.

Whilst this is not expected to be systematic to Chinese and international capital markets, lenders, and investors alike, will likely experience losses owing to Evergrande's over-indebtedness.

Inflation continues...

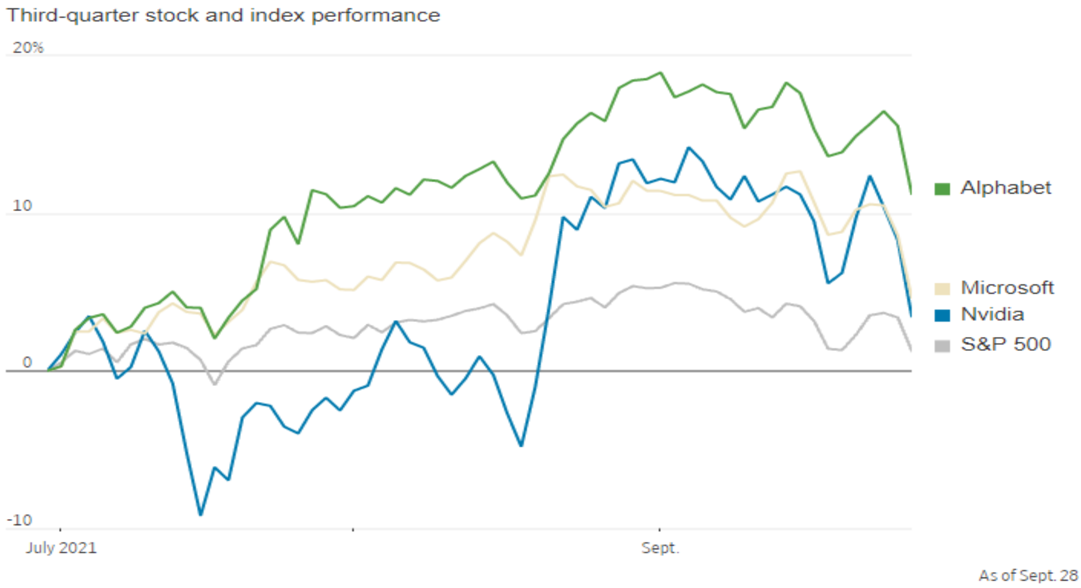
Inflation continues to be a significant worry to international capital markets. To understand the significance of inflation and its present rise, it must be understood in its historical context.

US inflation first commenced rising in the 1960's. It topped out in 1982, at 13.55%. It was tamed by the late Federal Chair, Paul Volcker. Volcker raised the federal funds rate from 11.2% in 1979 to 20% in June of 1981. This increased real interest rates and US unemployment, which rose to higher than 10%. Volcker's tough medicine led to not one, but two recessions, before prices finally stabilized.

By taming inflation, Volcker set the table for the long economic expansions of the 1980s and 1990s. With this expansion, long-term interest rates have declined until present day. This has boosted access to cheap credit, fueling economic activity and significantly increasing asset valuations.

Presently, we continue to witness inflationary pressures in the market. The current inflation rate is 5,3% in the US, 3,3% in Euro Area, and 3,2% in the UK. However, central banks are insistent, that the recent price pressures are temporary. Further, there have been continued disruptions to supply chain, soaring energy prices and a rebound in consumer demand, all causing prices to rally.

Valuations on major ICT stocks including, Microsoft, Facebook, Apple etc... have all declined over 5% over the past few weeks. To put this into context on the 28th of September 2021, the major seven tech companies lost $315 Billion in market value: the largest slide since October 2020.



As highlighted in our newsletter entitled, *Global Reforms - (Stag)flation – The significance and likelihood*, the danger of stagflation seems to be making its way onto the collective radar of investors.

As a house, we are not in agreement with central banks' view on the transitory nature of inflation and remain cautious.

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