Quarterly Market Outlook: Exploring the broader context

Geopolitical background

◊ President Biden addressed the UN General Assembly on 21st September to lay out the administration's vision of US engagement with allies, emphasising the tools of 'relentless diplomacy' and development aid to renew and defend democracy as well as to confront common challenges such as the pandemic and climate change.

◊ In terms of the US determination to contain the Chinese military-techno-economic challenge to American hegemony, the Biden team is continuing the policies of the previous administration, not lifting earlier imposed tariffs of ~$350bn on Chinese goods, 'holding their feet to the fire' in respect of the phase one trade agreement signed 15th January 2020, while also re-energising diplomatic relationships with allies.

◊ Burgeoning defence alliances from AUKUS (sharing of military hardware within a subset of the Anglo-state five eyes alliance) and the QUAD (US, India, Japan and Australia) should be seen in the context of the 'third offset' and 'pivot to Asia', which have guided bipartisan US defence policy in the Indo-Pacific since 2014.

◊ Possibly the greatest single risk to the global economy is a Chinese assault on Taiwan, whose 70%+ market share in leading edge semiconductor foundry has made the island 'the pivot on which the world turns'. The PLA has expanded its naval capabilities including amphibious landing, and escalated incursions into Taiwanese airspace. The Taiwan air force has matched the PLA one-for-one with US supplied state-of-the-art fighter jets, and most defence analysts believe that China cannot capture the island.

◊ 'Made in China 2025' aims to indigenise higher value added production, including semiconductor localisation and next generation technologies from robotics and electric vehicles to quantum computing. China has import substituted some foundry at mature nodes (led by SMIC), as well as commodity memory (YMTC).

◊ But apart from certain areas such as machine learning in big data analytics, indigenous innovation remains unproven as the 'sea turtle' migration runs its course, and anti-takeover measures by CFIUS and equivalent agencies are ramped up. In April the US Commerce Department added seven more firms to the Entity List, citing civil-military fusion, tightening the de facto Chinese technology blockade.

◊ Meanwhile the ongoing Evergrande bond default saga has drawn market attention to structural weaknesses in the fabric of the Chinese Communist Party led model of state capitalism, with the real estate and construction sectors constituting over 25% of GDP, and total private sector credit exceeding 300% of GDP, which is greater than any Western economy in history. If something is unsustainable, it will stop.

FOMC and the macro outlook

◊ 'Taper' is the mot-du-jour, as US CPI measures accelerated over the summer, and wage-linked items such as rents surprised the market in the August print. In the FOMC meeting of 22nd September, the Fed brought forward tapering of net asset purchases to December 2021, with the termination of balance sheet expansion by mid-2022.

◊ Meanwhile, the median 'dot plot' of FOMC participant rates expectations indicated some tightening compared to June, with Fed Funds expected to reach 100 bps by 2023.

◊ This still means the Fed keeps the policy rate at 25 bps for now and continues to buy $120bn of UST and agency securities per month for at least the next 9 months.

◊ In his press briefing following the meeting, Fed Chair Powell stated that the Fed will support the recovery for as long as it takes to achieve full employment, while citing bottlenecks and supply shortages as the cause of higher goods prices (not wage costs).

◊ U.S. unemployment fell to 5.2% in August, well above the February 2020 level of 3.5%.

◊ The FOMC projected real GDP growth at 3.8% in 2022 and 2.5% in 2023.

◊ So the economy will 'run hot' until US labour supply tightens and participation re-normalises. Inflation is likely to overshoot before any surprise monetary tightening: the UST 10 year yield is likely to remain below 200 bps for the next 12 – 18 months.

Equity market outlook

◊ In such an environment, companies with strong barriers to entry in oligopolistic markets and pricing power are likely to fully pass through cost increases, maintain margins and enjoy accelerated nominal revenue and EPS growth.

◊ This includes enabling technologies in key sub-segments such as wafer fabrication equipment and electronic design automation that continue to be core holdings in the BlueBox Global Technology fund.

◊ Year-to-date, the S&P 500 has risen +16.90% YTD and Nasdaq-100 +17.44%; but LTM Q2 EPS growth for the two indices were 7.89% and 30.86% respectively. So despite the 2020 rally in technology stocks driven by work-from-home, ecommerce and other covid-beneficiary trends, YTD the Nasdaq-100 has lagged relative to earnings growth.

◊ The MSCI Global Technology Index has roughly tracked Nasdaq-100, up 16.56% YTD.

◊ Anti-trust measures against so called 'FAANG' stocks have so far been minimal and it remains to be seen how individual cases against the big tech four will evolve.

Outlook for technology stocks

◊ Semi cyclicality: there is no indication that the semi cycle is turning, as supply shortages persist and national industrial strategies drive expansion of foundry capacity.

◊ Chinese competition and IP theft remain threats to margin in commoditised and low end sections of the semi complex, but broader geopolitics is protecting the high end.

◊ Valuations are not as attractive as at market lows in March 2020 but remain within GARP bounds given expected earnings growth driven by secular technology trends.

Rupert de Borchgrave

24.09.2021