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Weekly Market Flash

First of All, Do No Harm

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The pandemic may have imparted two important lessons for the pundits and prognosticators who populate the world's financial markets. First, you cannot predict the timing and magnitude of something like a debilitating virus that sweeps across the planet. Second, even if you could predict the event, you couldn't predict what the market reaction would be. Think about it. Armed ahead of time with the information that the SARS-COV2-19 virus would shut down the global economy in March 2020, would you have predicted that the S&P 500 would end the year up nearly 20 percent? Or that China's gross domestic product growth in 2020 would be positive, as if the pandemic had never happened?

Don't Do Stupid Stuff

With year-end just several months away, money managers great and small are focused laser-like on year-end returns. For many of them it is a comfortable place to be. For much of the year it has been easy to coast along on the gentle jet stream provided by generous central banks, rebounding corporate earnings and a bevy of retail investors adding their collective weight to the rivers of capital flowing into all manner of assets, from the solid to the silly. Clients are generally happier when their hard-earned wealth is showing healthy returns.

But, as we noted in our commentary a couple weeks ago, the environment is looking a little twitchier as the fourth quarter approaches. Peak growth, sticky inflation, ongoing supply chain problems, high valuations and potentially disruptive events in China are all clear and present themes. The delta variant, despite a slower growth rate in daily new cases, shows no signs of going away any time soon. The depressingly familiar 2020 refrain of "with an abundance of caution" is making an unwanted reappearance as even some outdoor events slated for the coming weeks pull the plug.

With that same abundance of caution, many investors are deciding to sit tight on their year-to-date gains and not extend themselves further into exposures that could snap back and bite them --- but at the same time not do too much de-risking. This perhaps explains why, while equity markets have been registering a higher than usual number of down days recently, the magnitude of the losses has been relatively contained. Right now the S&P 500 is around two percent off the most recent record high reached on September 2. Fear is not the mood of the moment, it's caution. An abundance of caution.

More Trouble in China

What about those China exposures? It seems that every week we potentially have a new "China risk" story to share, from the clampdown on overseas ADRs to geopolitical risk, the disappearing of China-based financial bloggers and much else besides. In the news this week have been the travails of Evergrande, a large real estate developer and wealth management firm with by some estimates as much as $300 billion in total liabilities amid collapsing sales, on the brink of default. The "great fall of China," as some wags have named it, could potentially reverberate outside the domestic investors, suppliers and homebuyers who stand to lose a great deal. Among those billions of dollars of Evergrande obligations are the interests of some of the world's largest institutional investors.

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It’s an uncertain situation, to be sure. But again we go back to that lesson learned from 2020: you can’t predict what is going to happen and you couldn’t predict the response even if you had a crystal ball. In this case the first node of the decision tree might be easier to assign a probability to: there is a very high chance that, left to fend for itself, Evergrande goes under and takes all those creditors and vendors along for the fall. But there is also probably a better than average chance that the Beijing financial authorities step in and bail the company out (though on preferential terms that probably will not be to the benefit of those foreign creditors).

Maybe the bail-out comes along with a more general economic stimulus package that puts a new luster on those underperforming China shares weighing down diversified portfolios. In which case, the “first do no harm” approach would be to not sell out low today. For many, exposure to China is a strategic play – a toe in the water or maybe even a whole foot in the expectation that what may be the world’s largest economy by the middle of the decade is simply too important to completely pass up.

Lots of unknowns, in other words. Too many to keep one from doubling down – and too many to keep one from running for the hills. First, do no harm.

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