RockCreek

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WHEN THE TIDE GOES OUT

The global economy is going through an extraordinary period. No wonder investors are puzzled and policy makers around the globe are trying to better understand what is going on. Recession has been talked about for months, but it's still not here in the US, as shown again by this week's strong retail sales data, notwithstanding terrible Q3 results for Target. The market reaction was largely mixed, with the S&P 500 down roughly 70 basis points for the week, with the tech-heavy NASDAQ Composite down close to -1.6% over the same period. Performance in international markets was also muted, with emerging markets down -0.34% and non-US developed markets down close to 50 basis points.

The renewed strength in equities this quarter comes against an unpromising backdrop of continued tightening in financial conditions, worries from some retailers about holiday shopping and the spectacular crash of one of the darlings of the pandemic boom, crypto company FTX. Big tech companies are still up from pre-pandemic levels, even after the shift to tight money has brought valuations down sharply. The Fed is not yet finished raising rates. And when it does stop, we will be in a different world from the regime of easy money to which many grew accustomed. Are investors ready for that?

It is not just economists whose assumptions are being challenged. Political change is also in the air, whether in the US after the midterms, with Speaker Nancy Pelosi stepping down from her democratic leadership role after she hands the gavel to a Republican in January; in China; or in the UK, where the third Prime Minister in as many months announced a budget this week that reverses his predecessor's growth plans – although austerity policies do not kick in for a while. Presidents Biden and Xi have both been strengthened politically in the last month, easing the way for their face-to-face meeting this week, the first since Biden became President. But questions about whether President Biden will run again will likely grow after the generational change in the House. Reps. Steny Hoyer and James Clyburn are also relinquishing their roles as Democratic party leaders. The early frontrunner to replace Nancy Pelosi, Hakeem Jeffries of New York, is only 52, while the likely new Speaker, Republican Kevin McCarthy, is 57.x

Global trading patterns and policies are shifting dramatically as a consequence of politics. War in Europe disrupted not just energy but also critical food supplies. The pull-back from globalization triggered by the Covid pandemic may be cemented by the sharper tensions in recent years between the world's biggest importer, the US, and biggest exporter, China. At the same time, the US Administration – with strong bipartisan support – has shown greater readiness to intervene in economic decisions, with its push to bring manufacturing back home and readiness to direct US companies' investments overseas – see the CHIPS act.

A Changing World

These changes are clearly consequential. But it is unclear how deeply they will impact the economy in the near term.

The most obvious global shift underway now, although not the most important for the world long-term, is in monetary policy. The breakneck pace of interest rate hikes in the US since June is unprecedented. The Federal Reserve is not alone: central banks around the world have been tightening policy to squeeze out levels of inflation that we have not seen for decades.

As the tide of easy money retreats, it is inevitable that some risky bets go bad, frauds that could be concealed become visible, and some investors lose money. The critical issue is how widespread losses are – and whether they compromise the functioning of the financial system. So far, so good. Contagion seems limited, beyond the world of crypto – which, as its supporters intended, is not too tightly entwined with the traditional financial sector. As long as the core financial system stays resilient, the Fed can focus on fighting inflation. That means it will continue to hike rates, albeit likely at a slower pace.

While investors kept one eye on the fallout from crypto, the other eye was on retail earnings and what they might portend for a possible recession. Target's 52% profit drop in the third quarter and management's warning of a subpar holiday season ignited worries about the state of the middle-class consumer, but positive announcements from a bevy of other retailers, including Walmart, Bath & Body Works, Macy's, Ross Stores, and GAP indicated otherwise. In addition, healthy earnings for Home Depot and Lowe's signaled a more favorable outlook for housing demand and home improvement which have been under intense scrutiny given rising interest rates.

Meanwhile, planned job cuts have received much attention but they have been mostly contained within the technology sector thus far. Amazon announced plans to cut about 10,000 jobs, joining Meta and other large tech companies. Alphabet has been a remarkable anomaly by not having announced any major cost cuts, but that may change with activist investor Chris Hohn urging the company to take action to reverse its deteriorating profit margin by reducing employee headcount and compensation. Nevertheless, companies across many other industries remain in hiring mode.

Last week we raised concern about the market getting ahead of itself following a single data point showing that inflation had slowed and that the Fed will remain on its course of tightening. It is important to remain mindful we are in an environment where good news is bad and bad news is good. This week, data pointing to a healthy labor market and consumer willingness to spend poured cold water on unrealistic hopes the Fed will soon pivot.

Eventually, the Fed will indeed pause and then bring rates down. In the meantime, rising rates will cast a continued shadow over prospects for the real economy. So far, the US consumer is still going strong. This week's data showed retail sales up by 1.3% in October. The economy is set to slow down. But talk of recession is still premature. Some fear that Fed policy will be the trigger for a downturn next year, even if not now. It is true that Chair Powell and colleagues believe that rates have to go on rising until they see labor markets turning down and inflationary pressures are truly subdued. As St. Louis Fed President James Bullard warned on Thursday "We're going to have to see very tangible evidence that inflation's coming down meaningfully toward target, and I think we're going to want to err on the side of staying higher for longer in order to get that to happen." It is still not clear that tightening so far this year has done the trick.

What became clear this week is that the traditional pattern of collapse by the biggest risk takers as conditions tighten is still alive and well. The world of crypto, (of which more below) is evidence. Other assets more connected to the real world and more prevalent in portfolios that have boomed since 2020 are also turning down – think tech and housing. The most important for the real economy will be housing. This week's report of a further drop in October in existing home sales – now down more than 30 % from the peak in January – reflects the impact of sharply higher mortgage rates on affordability and demand. At the same time, prices continue to rise as sellers are reluctant to move when that would involve swapping a much cheaper mortgage for one at today's rates

Re-Education of the Retail Investor

As the FTX saga continued to unfold this week many have been on watch for signs of contagion. For the most part it has been limited to the crypto universe. Genesis, a crypto lender, announced that it was pausing new loan originations and redemptions, while Gemini, a crypto exchange, announced that it was suspending withdrawals from certain accounts. BlockFi, another crypto lender that was bailed out by FTX only a few short months ago, is also rumored to be headed into bankruptcy as part of the FTX fallout. For the moment, it appears the knock-on effects are constrained to a relatively niche corner of financial markets, but we are watching closely for unforeseen linkages that can quickly spiral.

On Thursday, John Ray III, the newly appointed CEO of FTX that will see the company through its bankruptcy, laid bare the issues that permeated FTX. In a filing in Delaware bankruptcy court, he stated bluntly, "never in my career have I seen such a complete failure of corporate controls and such a complete absence of trustworthy financial information as occurred here. From compromised systems integrity and faulty regulatory oversight abroad, to the concentration of control in the hands of a very small group of inexperienced, unsophisticated and potentially compromised individuals, this situation is unprecedented." The use of the word "unprecedented" is a strong statement given that Mr. Ray oversaw the bankruptcy of Enron. He went on to seek distance with Sam Bankman-Fried stating that FTX has "made clear to employees and the public that Mr. Bankman-Fried is not employed by [FTX] and does not speak for them" as he "continues to make erratic and misleading public statements."

Interestingly, in conversations we have had over the last week with institutional crypto market participants, some seem prepared to go on offense citing potential opportunities in trade claims, secondary LP stakes, and the numerous direct venture investments made from the FTX balance sheet. Another notable takeaway was that few were actively trading with FTX at any scale or using FTX as custodian, which leads to another mystery in this story – where was the purported massive trading volume coming from? Undoubtedly, there is much yet to be revealed.

Two Climate Summits?

At COP26 last year in Glasgow, we saw big pledges – Net-Zero pledges from countries and companies; $130 trillion of private capital represented in the GFANZ coalition pledged to accelerate the de-carbonization of the economy. But that world, one of easily available capital and peace in Europe, no longer exists, and we have seen a resetting of expectations from many of the major players, both on the public and private side.

We saw something of a phenomenon this week, where the world effectively had two major climate summits happening at the same time: COP27 in Egypt with a scientific angle and the G20 summit in Indonesia with an economics view. COP27 had the potential to be somewhat either hamstrung or accelerated by the events at the G20. But with President Biden and President Xi Jinping agreeing to resume cooperation on climate change, a much-needed boost to negotiations in Sharm El-Sheikh were tangible. The leaders of the world's two biggest carbon emitting countries indicated that they would "empower key senior officials" on areas of cooperation, including climate change.

One of the central issues of COP27 was negotiations over loss and damage – how much richer countries, which have been the source of most global warming emissions, owe to poorer countries, who bear much of the burden of climate change. Developed nations haven't kept their end of the 2009 deal to raise $100 billion annually to help developing nations transition to clean energy and adapt to climate impacts. That was supposed to have happened by 2020, but less than 20% of the funding has been accounted for.

Perhaps the most high-profile and – potentially impactful – proposal to come out of Egypt was US Climate Envoy John Kerry's plan to launch the Energy Transition Accelerator, which would design a new carbon credit that would help channel private sector investment to phase out fossil fuels and accelerate renewable energy. The goal is for corporate players – Bank of America, Microsoft, and PepsiCo have expressed interest – to fund clean energy transition projects in emerging markets, which need roughly $2.1 trillion in clean energy investment.

Just a few years ago, it was inconceivable to see the U.S. Government working alongside U.S. corporates and foundations to proactively roll out clean energy solutions in emerging markets. And while there is still a long way to go before this becomes put into practice, the fact that private industry is acknowledging the problem and willing to be a part of the solution speaks volumes to the endeavor's viability. Climate is dominating the conversations of world leaders, delegates and investors, and RockCreek sees tremendous opportunity for investors in the space – ranging from renewable energy to clean transportation to sustainable agriculture.

But perhaps the biggest climate news this week didn't come from COP, but from the G20 summit in Bali. A group of countries led by the US and Japan (along with Canada, Denmark, the EU, Germany, France, Norway, Italy, and the UK) organized a $20 billion package to help Indonesia sharply cut its fossil fuel use and speed up its transition to clean energy. Indonesia is the 4th most populous country in the world and one of the largest consumers and exporters of coal. This funding will help Indonesia source more than a third of its power from renewables by 2030, cutting emissions and helping reshape energy markets in the years ahead.

China, China, China

Dismal economic performance in the world's second largest economy has been a drag on global growth this year. The slowdown is due to two very different factors: Covid shutdowns and a property collapse. Although both were triggered by deliberate policy decisions, the government has much more control over the first than the second.

The strict Zero-Covid policies of President Xi stalled growth, kept millions of consumers at home, and closed cities and factories around the country. As many hoped, there are now signs of easing. President Xi, secure in his political position after the Party Congress last month, may now be willing to live with the inevitable rise in Covid cases that will come with opening up, given the largely unvaccinated population. Markets have reason to cheer, and the government's Covid policy will continue to dictate market movement in the short term.

On the back of China's potential exit from its Zero-Covid policy, China's GDP growth could accelerate meaningfully next year, benefiting from the very low base this year. Many expect that China's reopening could lead to higher equity prices, higher commodity demand, and a stronger renminbi vs. US dollar next year; however, on-the-ground conversations from our Asia trip this week reconfirm our belief that after the investors are done with the initial Covid relaxation excitement, they will start to focus on the implementation execution of the updated Covid policies, any tangible economic improvements can be observed as a result of these policies, how private Chinese companies are treated in relationship to their SOE competitors, will a property tax finally be imposed, and the next stage of the US and China relationship given the upcoming US election.

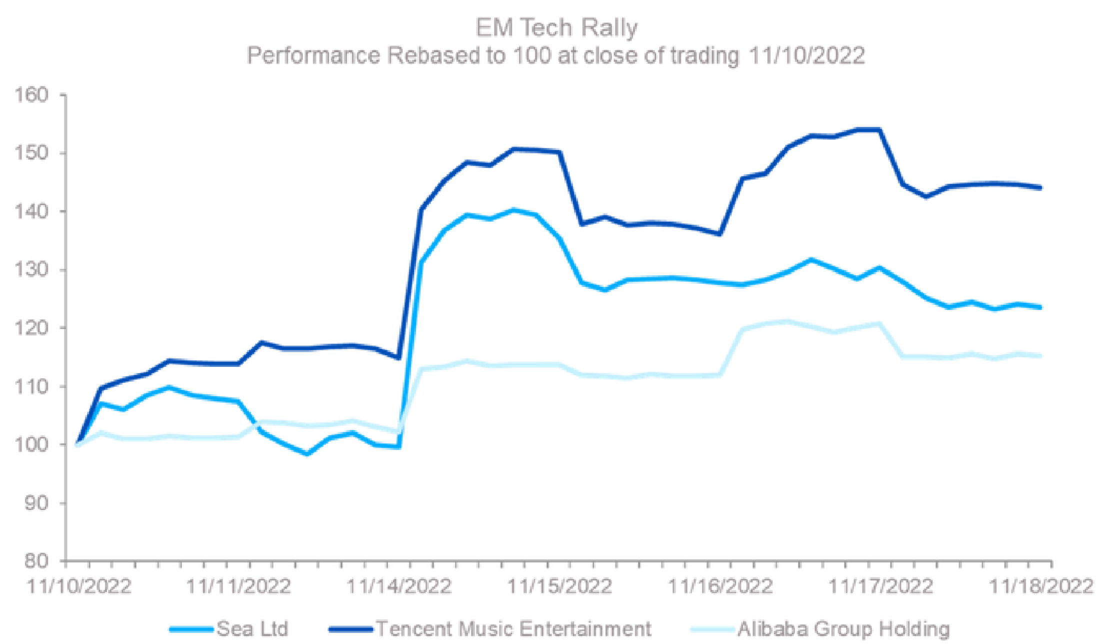
Many we have met in Asia this week say softening on China's Covid policy is inevitable but for us a lot more needs to be done by the government in order to turn this reopening trade into a more sustainable longer-term trend. This year, the job placement rate for fresh graduates from top Chinese universities, such as Fudan University, is only 30%. Local government is asking companies like Tencent to hire fresh graduates, however due to Tencent's own business struggle given the current economic condition, they had to let some current employees go in order to accommodate fresh graduate hiring requirements by the local government.

In our view the longer-term trajectory for China will depend more on the ability of the government and the central bank to manage the ramifications of the property collapse and re-prioritize economic growth as their top priority in the coming years in order to soften the impact of some of the country's longer term challenges such as a slowing GDP growth and a shrinking population of working-age adults coupled with an increasing retiree population.

Emerging Markets - It's not only about China

As the year comes to a close and we look to opportunities in 2023, there are two macro scenarios emerging markets investors are contending with. The first is China's reopening and the second is moderating inflation (and consequently a less hawkish stance by the Fed), in the US. China's re-opening should have positive implications for commodity related names, particularly in Latin America, South Africa, and parts of the ASEAN region. A slowdown or reversal in interest rate hikes in the US should have positive implications for technology related names, many of whom have suffered enormous price drawdowns on a year-to-date basis. This week, price action in EM seemed to echo these macro trends, particularly in tech names with some well-known companies like Tencent and SEA Limited rallying over 46% and 30% in five days.

EM Tech Rally



RockCreek Update

Berkeley Haas Sustainable Futures

Afsaneh spoke with Ann Harrison, Dean of the UC Berkeley Haas School of Business as part of the Dean's Speaker Series-Sustainable Futures event. They discussed Afsaneh's early career, pioneering investments in renewable energy, leading financial innovation at the World Bank, founding and growing RockCreek, and sustainable investing areas that can bring both strong returns and high impact.

Watch the discussion here.

Happy Thanksgiving!

The fourth Thursday in November in the US is generally categorized by three F's: football, family feuding, and feasting. While it's hard to put a price on the first two, the feast is not immune to the phenomenon of inflation. The annual American Farm Bureau Survey estimates the cost of a traditional Thanksgiving dinner is up 20% compared with last year. Turkeys are 21% more expensive, at $1.81 per pound, while a bag of stuffing is 69% more expensive. The lone drop – a 14% decline in the price of cranberries – hardly makes a dent in the overall meal.

American Farm Bureau Federation Chief Economist Roger Cryan cited general inflation slashing the purchasing power of consumers, but also supply chain disruptions and the war in Ukraine.

Despite a more expensive feast, we wish you all a wonderful Thanksgiving, from the entire RockCreek team. We will be off next week, and the Weekly Letter will return on December 2nd.

With more to come,

Team RockCreek

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