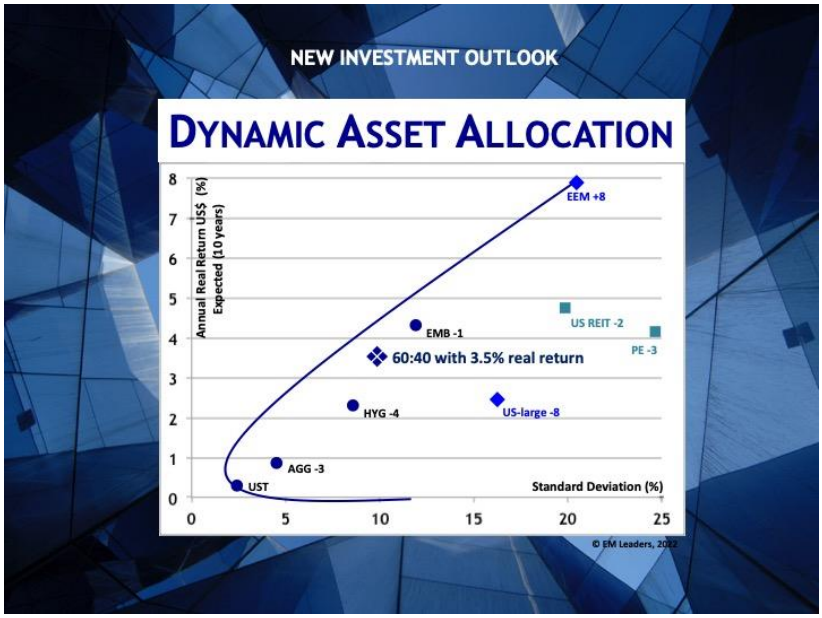


BEWARE OF ZERO PRICING

Repricing of Money, Carbon, and Political Risk

"There Is No Such Thing as a Free Lunch" Milton Friedman, 1975

Milton Friedman emphasized in his 1975 book that nothing is free, somehow someone is paying, at least an opportunity cost, just as historically a greedy consumer got a "free" salty lunch in a saloon but paid dearly for drinks. So why do we get addicted to free money and QE∞? Why do we refuse to put a price on carbon? And why do we build supply chains assuming a zero price for political risk? The day of reckoning is coming.

FREE MONEY CREATED COSTLY LEVERAGE

Inflation and real interest rates have been remarkably low during the past two decades across most developed markets. Globalization, efficient supply chains, innovation, and political stability were major contributors. Governments also used central banks for political purposes, such as bailing out important US industries or closing sovereign spreads in southern Europe. Central banks also employed massive quantitative easing, expanding their balance sheets either to enhance financial stability or to reduce financing costs and support employment in vulnerable firms.

Modern monetary theory (MMT) postulates that monetary expansion and the rising national debt can finance social objectives without traditional economic restrictions. During the pandemic, many developed economies de-facto implemented that theory with massive monetary and fiscal stimulus leading to inflation that was deemed to be moderate and temporary, reflecting global supply disruptions. Free money had saved employment at zombie companies, encouraged leveraging across alternative assets, and inflated equity valuations in the belief that discount rates would remain very low.

What happens when the price of US money is now rising by 4% within 12 months? And what happens when war in Ukraine and sanctions are pushing inflation up further? Higher discount rates crush multiples and valuations of public equities, leverage in alternative assets multiplies the pain, and a stronger dollar is challenging stability of the Euro and the Yen. The BOJ may finally capitulate over its failed MMT experiment and the ECB rate hikes may be limited to contain widening spreads in Southern Europe unless Europe creates a fiscal and transfer union in response to the current crisis.

Our forward-looking asset allocation (chart 1) looks bleak for US markets: only in three years over the past century (2022, 1969, 1931) have bond markets (AGG -16%) and equity markets (SPX -20%) declined simultaneously, with alternative assets falling further (US real estate -30%, US listed PE -40%). CAPE ratios may need to correct lower from today's multiple of 26, which leads to projected annual real returns of large US equities over the next decade in the range of below 3%. On the other hand, EM equities are priced at historical lows and now offer 8% projected real returns.

IGNORING CARBONIZATION CREATED HUGE CONTINGENT LIABILITIES

California has been at the forefront to realize what free carbon emissions and free water imply for the environment. Today, carbon credit markets are priced at $28 per ton in California as compared to $37 in Canada, $74 in Europe, and only $8 in China. Water prices have soared over 50% this year in California, while they remain near zero in many parts of the world. The IMF states that climate change is one of the most critical global challenges and that emissions globally are still too cheap, advocating a carbon price floor of $25 ($50, $75) for low (middle, high) income countries.

Europe is leading material disclosure efforts under the corporate sustainability reporting directive (CSRD) and is imposing carbon border adjustment taxes (CBAM) that will be phased in next year. Although China has engaged in the world's largest renewable energy push, it still is the largest coal producer, and its emissions exceed those of the US & EU & India combined. Many exports from China and India would not be viable under the IMF carbon price floor or under the EU carbon border taxes.

Contingent liabilities from mis-pricing carbon and other natural resources are huge: many companies in materials and industrial sectors must re-price their liabilities which will imply higher financing costs and likely losses among banks and investors. Rising carbon prices will inevitably contribute to higher energy prices as long as the transition to renewables remains supply constrained. Trade flows and competitiveness of industries may be transformed by carbon border taxes. And energy policy has major geopolitical implications, as China is seeking a new strategic collaboration with Saudi Arabia, and may wish to denominate oil in RMB rather than USD, which would signal China's rising global influence and broader acceptance of its currency.

NEGLECTING POLITICAL RISK CREATED UNSUSTAINABLE SUPPLY CHAINS

Last year, 55% of German gas consumption came from Russian imports. Malaysia produced more than 60% of global personal protective equipment. Taiwan's advanced micro-chips represent 92% of global consumption. And China controls over 80% of rare earth materials. This was possible because political risk has been gravely neglected.

Credit default swaps are pricing default risk for the next five years and have blown out significantly this year. Russia's CDS was priced at 120 bps in January, similar to those of BBB rated Mexico and Hungary. Russia's default was unexpected, reinsurance losses from mispriced political risk insurance exceeded $2bn, aircraft leasing lost $4bn and French banks lost $5bn. By comparison, Citibank's exposure to China is estimated at $27bn, and China's CDS spreads tripled this year to about 120 bps currently. Markets have long underpriced political risk, in part driven by subsidized rates of public and multilateral agencies (OPIC/DFC, MIGA) which facilitated trade growth.

Russia and China have become major factors for political risk, and many companies have started to re-shore critical industries, such as metals, batteries, technology, medical, and transportation. The CHIPS Act also allocates $53bn into US-based chip manufacturing, similar to $46bn dedicated to European-based technology production. While globalization had increased trade and growth with disinflation, we now observe the opposite trend from re-shoring and diversifying supply chains, which will have a significant inflationary impact and could reduce US and EU imports by about 10%. In addition, new US export restrictions to China risk to accelerate this de-coupling. China now is focusing on its own industrial policy to strengthen technology and fintech development and is trying to collaborate with the EU to undermine US sanctions.

EM Leaders has generated 4% of alpha having exited Russia last year and having cut China/Taiwan weights by one-half. Chinese valuations are at historic lows (CAPE bands, chart 2) and may slowly recover, whereas Indian valuations are very rich in anticipation of supply-chain relocations from China. Opportunities may arise in Poland, Turkey, Brazil, Korea, Malaysia and Vietnam with very attractive valuations.

Implications for Asset Allocation – Reprice Money & Carbon & Political Risk

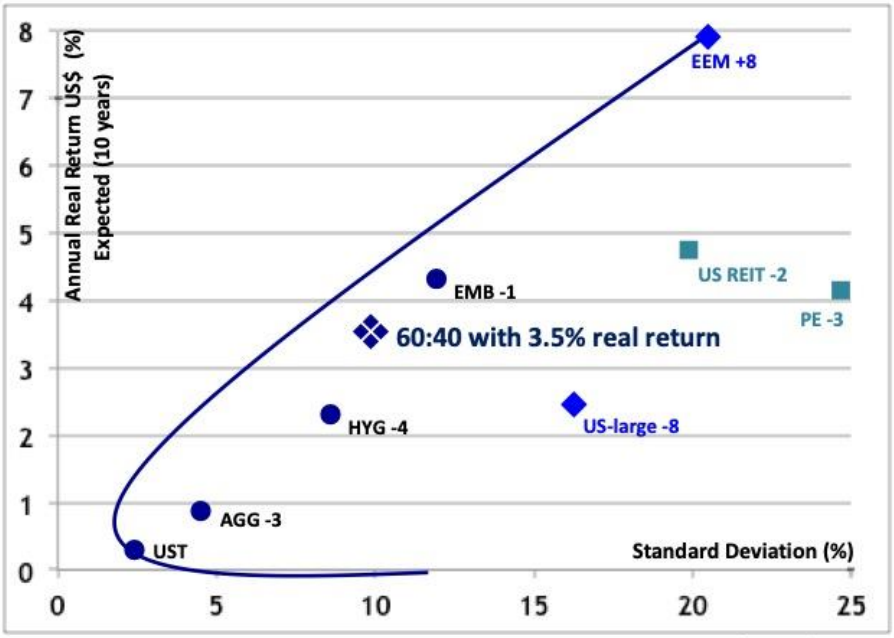
First, **higher interest rates** and higher structural inflation imply more attractive fixed-income returns, lower equity multiples and expensive leverage for alternatives. The quality factor may further outperform. Central banks that suppress interest rates may require capital controls or face rapidly depreciating currencies. Overall financial conditions may further tighten as the cost of debt servicing is rising substantially.

Second, continuing supply shortages may propel a **new commodity price cycle**, which will likely be dollar bearish. Decarbonization targets will require much higher carbon prices globally. Enhanced carbon disclosure will reveal substantive hidden liabilities, esp. in industrials and materials sectors, which may impact corporate debt valuations. Trade conflicts may arise as border adjustment taxes are phased in. Ongoing supply shortages for renewable energy components will likely keep energy inflation elevated.

Third, gains from globalization are reversed as **political risk** is rising and Chinese markets continue their de-coupling. Re-shoring pressure will impact semiconductor and biotech/pharma sectors and will contribute to rising prices and tighter supplies. Indian and Asean markets, as well as Poland and Brazil, stand to benefit most from more diversified supply chains, as Chinese growth will be structurally impeded. However, Chinese fintech and digital currency ambitions may gain traction in a polarized world, where massive structural changes will require active management. http://www.emleaders.com/pdf/eml-zero-2022.pdf

Long-Term Asset Allocation — Chart 1

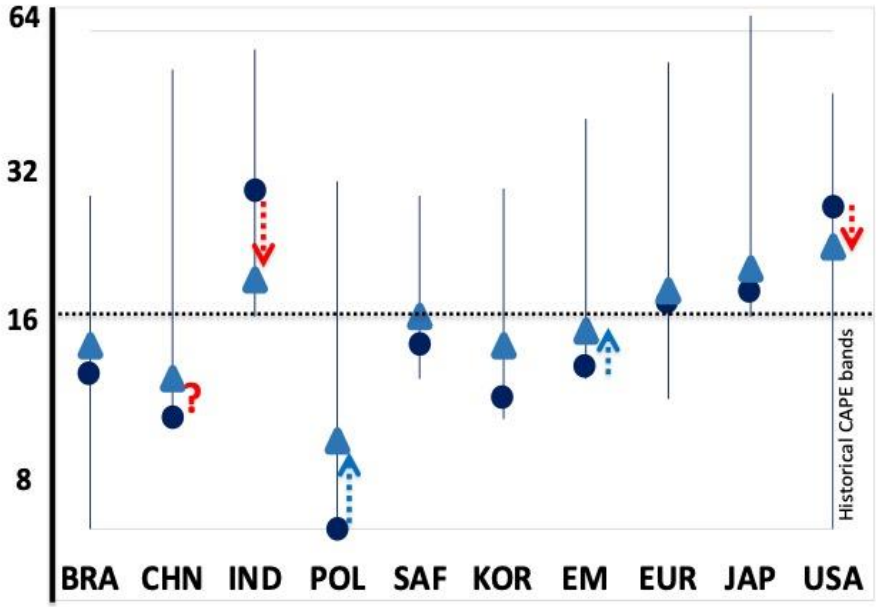
2022 Long-Term Return Projections: barely 3% real returns



Sources: Bloomberg, Research Associates, GMO, Barclays, EM Leaders 2022

Equity Valuation Benchmarks — Chart 2

2022 Equity Market CAPE ratios ● versus long-term expectations ▲



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