Memorandum

To: BCA Clients and Friends
From: Sid Nadkarni, BCA CIO
Date: September 24, 2021
Subject: Potential for Increased Equity Market Volatility Over the Next 12 months

UPDATE OF MARKET DEVELOPMENTS AND OUR VIEWS

Dear BCA Clients and Friends,

We hope everyone enjoyed the summer and are staying safe and healthy. We recently published our comprehensive quarterly piece in August and wanted to follow up with a brief note to address recent and potential future US stock market volatility (the US has the highest weighting in the MSCI ACWI Index and among client portfolios) and offer some thoughts on Emerging Markets as well.

US Equities

In Equity markets globally, Emerging Markets have rallied 72% and the S&P500 by 98% since the March 2020 lows. During 2021, US markets have continued their dominance with the S&P up 16.8%, Developed International markets (MSCI EAFE) up 10.3% and Emerging Markets down 0.7%. The US has exhibited very strong absolute and relative performance for the following reasons:

- Highest level of fiscal stimulus deployed relative to other regions
- Less stringent application of widescale COVID-based lockdowns leading to faster economic recovery
- Faster initial rollout of vaccines
- Continued loose monetary policy with record low interest rates
- Highly impressive corporate earnings performance through Q2 2021 with S&P 500 earnings far outpacing analyst expectations. Analysts have been consistently revising forecasts upwards with 2021 S&P earnings now forecast at $207 vs. $165 one-year ago and 2022 earnings forecast at $225 vs. $195 one year ago

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However, volatility has picked up in US markets recently. From early September through Sept 20 (intraday) – the S&P 500 had declined by almost 5.7% before rallying over the last week. We foresee a period of heightened volatility with higher potential for a 10%+ correction over the next several months driven by the following:

- Increasing difficulty for corporate earnings to keep surprising to the upside. Corporate earnings may in fact disappoint due to a combination of a) lagged supply-chain inflation, b) increased transport and logistics cost, c) slowing economy due to Delta Variant effects and d) missed sales due to difficulties in obtaining materials to produce finished goods. Fedex and Nike are prominent S&P 500 corporations that recently cut their full-year earnings forecast due to a) higher than anticipated cost inflation or b) lack of product availability due to factory shutdowns in Southeast Asia.
    - While Q3 2021 through H1 2022 US corporate earnings may be lower than forecast, we do view this situation as somewhat transitory as end consumer demand remains robust and the supply chain logjams should begin to alleviate by the second half of 2022.
- Increased political noise with regards to passage of the US Debt ceiling and potential US government shutdowns. We expect headline noise as Congress likely wrangles till the last minute before the deadline, before ultimately passing a resolution. Additionally, the White House's ambitious $3.5 trillion spending package faces significant opposition and is likely to face substantial reductions before ultimate passage.
- Likely increases in corporate taxes beginning in 2022. While the ultimate amount of increase remains unclear, analysts are forecasting a 3%-5% decline in S&P earnings due to potential corporate tax hikes (if passed through legislation).
- Potential further slowdown in China's economy due to governmental regulations and possible spillover from the Evergrande situation (overall reduction in property and real estate demand if the government adopts further stringent measures on leverage). China is an important source of overseas earnings for many S&P 500 companies.
- Potential for inflation readings to remain high which could result in consumers viewing inflation as non-transitory. There remains a considerable gap between producer and consumer inflation currently.
- Elevated valuations colliding with potential changes in investor sentiment. The S&P 500 is trading at 20x forward earnings, well higher than historical averages of 16x. Typically, when valuations are elevated and earnings begin to disappoint, markets are more prone to pullbacks.

Importantly, we are highlighting the potential for a well-overdue correction, not a market meltdown or implosion. Since the March 2020 lows, the S&P 500 rallied over 100% (at its

peak) without a single 10% correction and hardly any 5% pullbacks (extremely rare by historical standards). As such, a 10%+ correction should not come as a surprise and would be healthy for US equity markets.

Over the mid-term, we continue to expect US equity markets to grind modestly higher and deliver mid-single digit annual pre-tax nominal returns (well below the 16.4% S&P 500 annual return over the past decade due to current elevated valuations). US consumer balance sheets remain very healthy, and consumers have significant pent-up demand, especially for services. Furthermore, the Federal Reserve is likely to maintain accommodative monetary policy for the next few years. Inflation should moderate and supply chain logjams should clear by H2 2022 enabling a resumption in healthy corporate earnings growth in 2023 / 2024 (essentially reaching mid-cycle conditions). Finally, we see greater potential for a near-term resumption of value / cyclical stocks geared towards re-opening trades outperforming large-cap technology stocks (similar to the period Nov 2020 – March 2021) as Delta case counts appear to have peaked.

Emerging Markets:

The MSCI Emerging Markets Index is down modestly YTD (-0.6%). Most of the declines have occurred from May onwards (-7.4%). China has been the major driver of poor performance this year with the MSCI China Index down 16.8%. While many anticipated a slowdown in Chinese equities performance in 2021 (following +29% 2020 performance), the main driver behind poor performance in 2021 has been highly increased governmental regulation across several sectors including ecommerce, gaming, for-profit education and property and development. Clearly, the Chinese government is increasingly utilizing its influence to blend capitalist ambitions while addressing social equality challenges. The ultimate implication on corporate profits for many business models remains to be seen.

A recent worry for China includes the China Evergrande situation. Evergrande, the largest real estate developer in China, is facing a liquidity crisis from over expansion. The company has warned bondholders that it may default on obligations if they are not able to secure liquidity. Evergrande has important implications in China as the property sector accounts for roughly 25% of GDP (hence a broad spillover to the broader economy would have severe negative consequences). The base case remains that the Chinese government will engineer a "soft landing" and will step in to manage an orderly process. As such, the likelihood of Evergrande creating a wide-scale China economic collapse is unlikely.

Importantly, the MSCI Emerging Markets Index is a compilation of several different regions (each with their own drivers). The following table depicts some of the larger countries' index weighting and equity performance over 2020 and 2021 YTD.

MSCI EM Index				
		Performance		
Country	Current Weight	2020	YTD 2021	Last 10 Years
China	34.0%	29.5%	-16.9%	8.6%
Taiwan	14.8%	41.0%	17.3%	14.6%
Korea	13.0%	44.6%	-4.4%	8.6%
India	11.7%	15.6%	27.5%	9.5%
Brazil	5.0%	-19.2%	-7.8%	-1.5%
Russia	3.6%	-12.5%	28.2%	6.6%
South Africa	3.0%	-4.0%	4.2%	6.3%
MSCI EM Index		18.3%	-0.6%	6.4%

Interestingly, many asset allocation strategists have consistently recommended large overweight allocations to Emerging Markets over the past several years. Rationales have included: a) wide valuation gaps vs. the S&P 500, b) better micro-level EM corporate balance sheets and governance relative to history, c) better fiscal positions of many countries relative to prior history and d) change in index composition with greater weighting to China and also reduced weighting of highly volatile energy and metals sectors.

- While many of the factors cited above are true, the MSCI EM index has still consistently underperformed the S&P 500 over the past 15 years. Furthermore, Emerging Markets have demonstrated far greater volatility vs. the S&P 500 as well.

We believe that EM stocks certainly merit allocations in a well-diversified global equity portfolio. However, we believe that EM will always exhibit greater sensitivity to macro conditions (Brazil, Russia, Mexico with their exposure to commodities) and to political / governance considerations (China governmental regulations). As such, we generally have lower conviction in EM being able to sustain robust earnings growth and close the valuation gap vs. developed markets. We believe that the only conditions in which EM outperforms US stocks over a multi-year period is during a period of large-scale above-trend synchronized global growth (as seen from 2003-2007). While such a scenario may occur in individual years, we do not wish to underwrite that scenario as a base case going forward. Hence, we do not advocate clients having significant overweight allocations to Emerging Markets.

Finally, in emerging markets, we believe nimbleness is critical when it comes to investing. We favor managers who can quickly pivot from investing in thematic secular-growth ecommerce stocks such as Alibaba and Tencent to resource intensive Russian stocks like Gazprom or Lukoil. Some have also demonstrated a keen awareness of macro and political developments among EM regions and pivot their exposures to or away from certain countries accordingly.

We continue to recommend that clients maintain relatively neutral allocations to Emerging Markets and we believe some well-chosen managers can continue to deliver superior relative performance vs. passive ETFs through nimble stock selection.

Concluding Thoughts

Despite the strong performance of equities over the last decade and elevated valuations relative to history, we believe our clients will need to maintain high equity allocations to drive investment returns over the next decade (given paltry fixed income yields).

Having said that, clients whose equity allocations are towards the high end of planned ranges may wish to take some chips off the table or re-allocate towards alternatives or private investment strategies (while also taking into account liquidity and tax considerations).

As always, we welcome the opportunity to speak further. Please let us know if there are any topics you wish to discuss further.

Regards,

The BCA Team