ENVESTNET PMC

What We Are Hearing And Seeing

Envestnet offers one of the largest asset manager networks in the industry. Given the current environment, we want to share what we are seeing and hearing – perspectives from our trading & operations and Envestnet | PMC teams.

Ed Zablan AVP, Senior Investment Analyst

The Rise and Fall of Evergrande Group

Evergrande Group's woes have reverberated across the $5 trillion Chinese property sector, with a string of default announcements, ratings downgrades, and slumping corporate bonds. Global financial markets are watching the company's debt crisis to see whether it will develop into a broader contagion, prompting comparison to the 2008 collapse of the US investment bank Lehman Brothers. Yet many investors believe the risk of a system-wide event is minor, and any potential systemic fallout from Evergrande has been well flagged. Since 2018, Chinese regulators have instructed financial institutions to stress-test their exposures to a specified list of large, privately-owned firms that include Evergrande.

It is worth noting that although Evergrande is one of China's top-three developers, the residential property market is highly fragmented. Evergrande's share of the Chinese real estate market in 2020 was only around 4%. Therefore, the risk of significant pressure on housing prices in the event of a default would be low, unless the restructuring or liquidation of its assets becomes disorderly. In addition, high levels of mortgage down payments, typically a minimum of 30%-40%, used by Chinese borrowers are in sharp contrast to the popular use of zero down payment loans and negative amortization loans during the US housing bubble.

Most managers with whom PMC has spoken do not expect the current situation to trigger a broader contagion across either the Asian high yield bond market or in wide-ranging emerging markets corporate debt. Although undoubtedly the current events are causing market volatility in China's property sector, many managers take comfort in the strategic importance of the Real Estate sector to the Chinese economy and the urbanization that creates long-term fundamental demand for housing. Thus, the Chinese government is strongly motivated to ensure orderly default and resolution of Evergrande's debts and to avoid their Lehman Brothers moment.

David Chandler, CFA, VP, Senior Investment Analyst

Inflation Views in the Large Value Space

Inflation has been one of the hot topics since elevated CPI numbers were reported earlier this year. The Federal Reserve's official position, with which the market appears to agree, has been that inflation is largely transitory and stems from the one-time effect of the reopening of the global economy. Yet many large value managers, contrarian as they often are, disagree, and think elevated inflation will persist well beyond the short term. The following is a synthesis of some of these recent views on the global supply chain, basic materials costs, and wage pressures.

Higher inflation caused by supply chain disruptions eventually will be solved, but managers report that some companies are indicating these disruptions will not be settled until the end of 2022, and certainly not by this year's Christmas season. COVID-19 continues to be a problem for areas with lower vaccination rates than the US. An outbreak in Malaysia, for example, has seriously affected the semiconductor supply chain, and, in turn, has caused delays and higher prices for industries ranging from automobiles to consumer goods. China also continues to suffer disruptions because of its ongoing virus containment measures. Closer to home, the ports in southern California are a major ongoing bottleneck for goods coming into the country. Interestingly, some retailers are even moving to charter smaller ships so smaller port facilities elsewhere can be used. Such logistics changes will take time to put in place.

Many managers also think commodities inflation will persist. The most obvious one is oil, but other key materials such as copper, aluminum, and nickel are included. In the case of oil, production was already being cut prior to 2020 due to a couple of factors. First was the ongoing price war by OPEC to disadvantage high-cost production—mainly fracking. Second was the industry's move toward renewables, stemming from climate change and related ESG concerns. These renewable projects should pay off in the long run, but their opportunity cost has resulted in reduced production today. Furthermore, quarantine measures during 2020 further accelerated the industry's production cuts. Oil giants are trying to play catch up, but with production running on low gear, it is hard for managers to see oil supplies meeting prior levels of demand, let alone increasing levels of demand any time soon. Higher oil prices will likely lead to higher costs in transportation, agriculture, packaging, and chemicals, for example.

Finally, wages are increasing as restaurants, retailers, transportation, and many other businesses struggle to find workers. Labor unions are demanding pay increases for the first time in years. Health care workers are also apparently suffering from COVID-19 burnout, and compensation is rising in an attempt to retain them. Compounding all of this is a lower labor participation rate, as people are leaving the workforce at elevated levels. Some of our value managers believe the Fed and the market are overestimating the amount of slack in the labor force, and will ultimately wait too long before tightening monetary policy. To some degree, though, they think the Fed is privately willing to accept short-term elevated wage inflation, so long as the economy gets back to full employment.

All that said, inflation has been low for years. Higher levels are, for the moment, merely bringing us back to the long-term baseline trend. When asked, one manager quipped that depending on your view, the 1970s were a "transitory" period of inflation. Consequently, the Fed's wordsmithing has the benefit of never being wrong if an investor's perspective is long enough. Thus, many of our large value managers think market reaction will be negative if these elevated inflation levels persist into next year and the Fed ultimately tightens monetary policy more aggressively than expected.

Mike Wedekind, AVP, Senior Investment Analyst

After a Tough September, REITs Bounce Back in October

After posting positive total returns every month from February through August, in September the FTSE Nareit All Equity REITs Index took its biggest hit (-5.92%) since March 2020. Every subsector of the REITs universe, with the lone exception of hotels, dropped into the red, as negative price action dragged down overall Q3 returns to a mere 0.23%—behind the S&P 500 Index's similarly modest 0.58% return.

Heightened rate volatility, a correction in heavyweight cell tower names, seasonality effects, and ultimately unwarranted fears of contagion from China's wobbly property sector likely all had a hand in September's weakness. As Strategas noted in its September REIT Focus piece, more than 50% of the S&P Real Estate sector's stocks reached a 20-day low during the month, but did so against the backdrop of a broader uptrend, setting the stage for a rebound.

Indeed, this is exactly what happened in October: The FTSE Nareit All Equity REITs Index returned 7.08% for the period, and slightly outperformed the S&P 500 Index's 7.01%. Notably, every subsector posted positive results for the month, with industrials (14.77%) and self-storage (14.26%) at the high end, and hotels (0.94%) and health care (1.69%) at the low. The sector continues to exhibit wide breadth, and appears likely to sidestep any corporate tax increases as a result of the Biden Administration's currently mooted Build Back Better agenda.

Suresh Ramasamy, Investment Analyst

Alternatives to the 60/40 portfolio

Advisors have long used the 60/40 portfolio as the classic asset allocation mix. However, post-Covid-19 market movements have changed the investment landscape, and many managers have begun to question whether the traditional 60/40 portfolio can achieve desired outcomes for investors. Part of the reason for this thinking is that equity valuations have climbed to new highs, and the yield on bonds has dropped to historical lows. However, rising inflation is now the biggest concern for managers. If inflation stays at these elevated levels for a prolonged period, then it will be challenging to protect the real, after-inflation value of investments.

The strong bull rally witnessed in the US equity market over the last decade helped managers to outpace inflation even when yields were low. However, current high asset valuations and a persistent increase in inflation have forced managers to consider different options to improve future portfolio returns. As a result, many managers are considering an increase in their allocation toward alternative assets. Over the last ten years, the traditional 60/40 portfolio has benefited largely from the strong equity market rally. However, if we look back at the prior ten-year period from 2001 to 2011, when the equity market was less rosy, the return for the corresponding 60/40 portfolio against the 50/30/20 (equities/bonds/alternatives) portfolio stands at 3.95% vs 4.38% for the latter. The improved returns also came with lower volatility: 10.96% for the 60/40 portfolio compared with 10.31% for the 50/30/20 portfolio. This could indicate that if equity returns remain muted, alternatives could add extra value while reducing the overall portfolio volatility.

In addition to their diversification benefits, alternatives also may be attractive now due to their potential for higher income and returns compared with traditional stocks and bonds. As yields have dropped on traditional bonds, investors may need to look to higher-yielding alternatives such as MLPs and Global Infrastructure to achieve their desired income. Similarly, commodities have had a strong rally in 2021, mainly on the back of sharp increases in oil prices. As of September 2021, one-year returns for the Bloomberg Commodity Index were 29.13% vs. -1.55% for the Bloomberg US Aggregate Index and 15.92% for the S&P 500 Index. The potential for higher income and returns has led to a renewed interest in alternative assets as evidenced by strong flows within the asset category, year to date.

With inflation looking more persistent than transitory, many strategist managers believe it will hurt traditional asset classes, especially fixed income assets, as elevated inflation numbers can shorten the horizon for rate rises. This has led to a greater allocation toward alternative assets in recent times by many strategist managers. Although alternative investments appear to be attractive, investors must remember that most alternative instruments are relatively illiquid. So these are best suited for investors who are seeking, and are comfortable with, long-term investments.

* Model portfolios returns are calculated using a representative index: S&P 500 Index for equity, Bloomberg US Aggregate for Fixed Income, and HFRI Fund Weighted Composite for Alternatives.

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