September 2021 Monthly Commentary

The month of September is historically a volatile one for global stock markets, and this September was no different, as the TSX Composite fell 2.8% and the S&P500 (in CAD) fell 4.3%. The Canadian Bond Universe fell 1.7%, further increasing losses on traditional balanced portfolios, highlighting the current risk of bonds. Traditionally, bonds have hedged losses when stocks fall, providing a diversified portfolio. However, with rates so low, bonds are now more correlated to stocks, which is why Harbourfront has introduced private debt and private real estate as an alternative to bonds. These two asset classes continue to remain uncorrelated to stocks, resulting in a more diversified portfolio than those with bonds.

Markets

Markets drifted lower to start the month and then hit a small air pocket lower in the middle of the month (the S&P500 fell 3.3% over two days) after China's 2nd largest property company, Evergrande, could not make an interest payment on its debt. Evergrande's liabilities are approximately 2% of China's GDP, while the construction and property market make up around 16% of China's GDP. While 2% is not large, the market is worried about other companies in these industries and any spillover effects. Furthermore, with roughly 75% of Chinese wealth tied to the property market, and many loans tied to this wealth, a drop in the property market could pose a problem for China's economy.

Until recently, the Chinese government has always bailed out property companies in distress. So, it is significant that China could be allowing its second-largest property developer to go bankrupt. China is currently targeting capitalism within its country, increasing the regulatory burden on internet giants Tencent and Alibaba earlier this year and then doing the same to the for-profit education industry. After the massive growth the country has recently experienced, it appears that President Xi is trying to reign in wealth inequality; after all, they are still a communist/socialist state.

In addition, China's outstanding debt has skyrocketed since the financial crisis, with debt to GDP rising from around 170% in 2008 to 330% in 2020. This amount of debt could be a major problem during the next recession, so managing this now also seems like a good reason to reign in the property market. However, the likely result is lower economic growth coming out of China for the next couple of years also, thus lowering global GDP in real terms (if inflation persists, then global growth will continue to appear strong due to the underlying price increases caused by inflation).

At this point, we are not yet too concerned about what is happening in China and will keep an eye on events there. The actions of the US Central Bank, the Federal Reserve, are currently more paramount as the market is trying to determine when they will start their tightening cycle, for that historically leads to the end of the expansion as credit tightens. The market believes the FED will start reducing its bond purchases by the end of the year. Less liquidity will ultimately result in increased volatility as less money makes it into the equity markets. Furthermore, with inflation persisting, the market may push the FED into raising rates earlier than they'd like.

Considering the risks above, we added to the existing position of the Long/Short fund during the month. The fund invests in companies which they believe have strong future cash flows and then offsets those investments by selling companies with poor future outlooks (with the goal of buying the companies back at lower prices after they decline). The net result is a less volatile investment, with some downside protection. Combined with private debt and private real estate the portfolios should continue to provide strong risk/adjusted returns when compared to a traditional balanced portfolio made up of stocks and bonds, protecting better on the downside, while still participating in returns when equity markets rally.