PWM Weekly Observations

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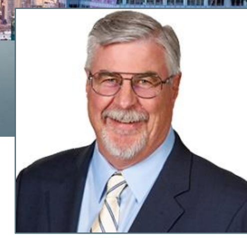

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When Will They Ever Learn?

The title is a line from Pete Seeger's old folk song "Where have all The Flowers Gone?", which has been recorded by many artists over the years. Whether we speak of war and peace, as the song does, or economies, it is a cyclical world. The past is typically prologue. So, when the Ever Given got stuck in the Suez Canal earlier this year, further compounding supply chains, and now Evergrande is in the midst of a slow-motion train wreck, we need to ask: When will they EVER learn?

- Evergrande is the largest property development company in China. Like many similar companies in China, they have been at the forefront of the shadow banking market as they raised money not only from the West, but also from Chinese citizens in the form of Wealth Management Products that promised very attractive returns.
- As the CCP has attempted to reduce leverage in the sector, Evergrande and others have been caught in a pincher; needing additional capital to keep the promises made to date, but unable to add more leverage. Thus, it is facing insolvency/bankruptcy.
- The CCP has acted to protect the Chinese citizens caught up in this mess by forcing Evergrande to make Yuan bond payments and continuing to spend money to build. However, the CCP appears to have little regard for the rights of those outside China that invested in Evergrande dollar bonds. An interest payment due Thursday was not made and no indication was given that it would ever be made.
- The CCP is caught in a vise of its own. It needs to protect Chinese investors because of the risk of massive social unrest if the Chinese public is not protected. Social unrest is something the CCP will bend over backward to control as it is the one thing that could bring down the current leadership. However, if the CCP ignores the dollar bonds, it is ignoring the rights of foreign securities holders, essentially saying that China does not want to play in the same capitalist sandbox as the rest of the capitalist world. If investors conclude that Chinese securities carry

unreasonable political risks, that could limit the availability of outside capital to Chinese companies in the future and placing downward pressure on growth.

- Projected growth rates for the Chinese economy are already coming down and that trend is likely to continue as the need to repair the massive property development sector sucks capital away from productive growth. If foreign capital is less available, that would only exacerbate the situation.
- One potential silver lining for the U.S. is that a slowing Chinese economy implies reduced demand for various commodities, which could be helpful in keeping inflation more manageable than it would otherwise have been.

Evergrande dominated the headlines early in the week, and deservedly so. Evergrande is the poster child of the over-levered Chinese property sector. It is important to understand that the Evergrande problem is not limited to one company. Evergrande is simply the largest and most visible of the property development companies in China, most of which are also in over-levered positions.

Evergrande may be the tip, albeit a very large tip, of the iceberg. The initial fear that roiled markets was the concern of a financial contagion, much like 2008 in the U.S. That concern faded quickly on the realization that the odds of the Chinese government doing nothing to stem the tide was unlikely.

The CCP has been actively working to reduce the leverage of this sector, which puts pressure on all of the property development companies. What complicates this is that fact that these companies have raised money in the West through traditional channels, but they have also raised money from the Chinese public via 'Wealth Management Programs'. Many average Chinese have a significant portion of their wealth tied up in these products, from Evergrande and other similar companies. The CCP can ill-afford a chaotic demise of Evergrande, which could produce a 'run on the bank' at other property management companies as well.

We suspect there are ultimately two important aspects to the Evergrande situation: 1) The realization that the risk in Chinese securities is probably much greater than the West had previously estimated, and 2) There is a price to be paid for excess leverage. The Chinese appear very likely to follow in our foot steps and kick the can down the road in hopes that a solution can be found along the way. We wish the U.S. and the Chinese good luck with that effort.

Another China Crypto Crackdown

The People's Bank of China (PBC) has announced that all crypto-currency transactions are illegal, although it apparently does not specify exactly how a transaction is defined. This is just the latest in a crackdown on crypto assets, but don't for a minute think that it is not related to the Evergrande situation. One of the thing's that the PBC fears most is an exodus of capital from China. (This fear is one of the reasons we do not foresee the Chinese Yuan replacing the U.S. dollar as the world's reserve currency. A reserve currency must be open to capital inflows and outflows. China maintains strict capital controls to prevent capital from fleeing the country.)

A failure, or even a hint of a failure of Evergrande, and/or some contagion with other property developer is China, is more than enough to incentivize wealthy Chinese to move capital out of the country, and crypto assets are the ideal way to circumvent capital controls. In our view, it is just another piece of evidence that the situation with Evergrande and other property managers is probably more serios than we perceive.

Caution - Time for Earnings Pre-Announcements

Part of our thesis for the stock market to continue to rise was the strength of corporate profits. The third quarter may be presenting some challenges to that earnings growth trend. We already know that GDP growth cooled off substantially in the third quarter and we know that inflationary pressures are common and are not going away easily. The natural expectation is for margins to be somewhat compressed by that combination, opening the door for earnings disappointments. As the quarter draws to a close, the next 2 weeks are prime time for those that are not making the grade to make that fact known. We have no crystal ball, but we have already seen some poor earnings this week (FedEx, Nike, and KB Home, as examples). As we have said before, bull markets don't end purely because of over-valuation; the market needs a catalyst. We view upcoming earnings as having the potential to provide that catalyst.

What We're Reading

- *UPS CEO: Supply chain issues are going to last for a while*
- *Americans Have No Idea What the Supply Chain Really Is*
- *Record backlog of cargo ships at California ports*
- *U.S. single-family housing starts decline further in August*
- *PBC says all cryptocurrency-related activities are illegal*
- *Without Merkel, many German voters don't know who to vote for*
- *America Risks an 'Evergrande Moment'* ***(2.5 min. audio, or subs. required to read)***
- *Inflation to remain higher for two years, warns OECD*
- *Dr. Scott Gottlieb breaks down the Covid vaccine booster confusion*
- *COVID-19 may impair men's sexual performance*
- *Big Tech CEO Insider Trading During the First Half of 2021*

Markets This Week

We week started on a difficult note as the Evergrande issue made headlines and put a scare into equities. That didn't last very long and the market proceeded to creep back into positive territory for the week. For the week, the broad indexes were generally higher with the exception of those indexes dominated by growth. The Fed continues its march toward tapering, which sent bond yields a bit higher, and prices lower. The sector winners included financials as a steeper yield curve implies greater opportunity for profitability. Energy was also a winner as commodities continued to generally rally. REITs and Utilities were the weak sector links and like bonds, the action was driven by higher interest rates.

US Equities	1 week	YTD	Fixed Income	1 week	YTD	Sector Breakdown	1 week	YTD
S&P 500 (SPY)	0.57%	19.12%	20+ Yr. Treasuries (TLT)	-1.52%	-5.88%	Consumer Disc. (XLY)	0.58%	15.35%
Dow (DIA)	0.65%	14.53%	Barclays US Aggregate (AGG)	-0.40%	-1.17%	Info. Technology (XLK)	0.97%	21.09%
NASDAQ (QQQ)	-0.02%	19.28%	Intermediate Municipal (MUB)	-0.15%	0.79%	Financials (XLF)	2.14%	30.76%
Russell 1000 Growth (IWF)	0.22%	19.36%	US Corporate Bonds (LQD)	-0.33%	-0.82%	Health Care (XLV)	-0.77%	17.20%
Russell 1000 Value (IWD)	0.20%	17.84%	Barclays US High Yield (HYG)	-0.10%	2.79%	Utilities (XLU)	-1.90%	5.47%
Vanguard Mid-Cap (VO)	0.47%	19.09%				Industrials (XLI)	0.84%	14.60%
Vanguard Small-Cap (VB)	0.57%	15.85%				Energy (XLE)	4.45%	37.12%
						Materials (XLB)	0.11%	12.96%
International Equities	1 week	YTD	Commodities	1 week	YTD	Consumer Staples (XLP)	-0.42%	5.96%
MSCI EAFE (EFA)	-0.25%	11.56%	Commodities (PDBC)	2.06%	36.37%	Comm. Services (XLC)	-0.66%	22.62%
MSCI Emerging (EEM)	-1.15%	-1.28%	Gold (GLD)	-0.29%	-8.44%	REITS (VNQ)	-1.48%	25.04%
						Homebuilders (XHB)	-1.08%	30.58%

The table above is an analysis of the weekly and year to date returns of various markets/sectors that we follow (More RED = worse performing markets/sectors; More GREEN = best performing markets/sectors). Source: IEX Trading & PWM Research.

Retirement Planning:

Tactical Asset Allocation: Don't Try This at Home

Making rapid-fire shifts to take advantage of market trends is easier said than done.

Estate Planning:

How Exactly Do You Stress-Test Your Financial Plan?

Some tasks are not good for DIYers, and stress-testing your portfolio is probably one of them.

Tax Planning:

Will proposed IRA tax changes targeting the rich hurt smaller nest eggs?

The Ways and Means Committee's proposed tax law changes zero in on how the super-rich use self-directed individual retirement accounts (IRAs).

Health:

One Major Side Effect of Caffeine on Your Vitamin D Levels.

Medical researchers have found a possible downside to your beloved beverage.

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