CIO Strategy Bulletin

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Answering Your Questions on 3 October Market Surprises

Key Takeaways

This week, we cover three questions that represent challenges in the outlook for the economy and markets, albeit one that is a positive surprise for some investors.

1. The widening Middle East war: how will it impact the world?
2. Dockworkers on the US East Coast went on strike for the first time since 1977. Could labor actions derail the economy?
3. Does China's announced monetary and fiscal action change the return outlook for Chinese equities?

Potential Portfolio Implications

- The tragic conflict sparked on Oct. 7, 2023 has now widened markedly. Global investors have braced for a potential petroleum supply shock amid Israel/Iran confrontation. Prices often swiftly rise above sustainable levels on supply uncertainty, only to fall back. However, immediate risks to oil and gas supplies may still be underrated, arguing for hedges for appropriate investors, but not necessarily significant changes to long-term asset allocations.
- The first strike in the US by the International Longshoreman's Association since 1977 had many households rushing to stores in a fear of a return to the shortages of the pandemic. A tentative agreement now allows work to continue until January 15th. The strike weighed on market enthusiasm, which risks returning if the remaining issues are not resolved.
- After a long period of deflation worries, China announced decisive action plans on both the fiscal and monetary front in late September. If China can transform this liquidity-fueled optimism into more durable economic and corporate performance, we believe the rally could continue despite a 27% bounce since September 23rd. Our direct weighting in mainland China equities for globally diversified, all-asset, medium risk portfolios is less than 3%. For all of Asia equities, just under 13%. There are portfolios designed for more or less exposure, but we believe *no single country equity market makes a portfolio.*

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Answering Your Questions on 3 October Market Surprises

Presidential election years in the US have become known for "October" surprises – events that upend expectations for the race at nearly the last minute (for a history of these, please see Road to the Whitehouse: Part 8).

We have long argued that one data point does not make a trend, but amidst significant upward revisions, it is the soft July and August numbers that look like outliers. While many more pessimistic observers thought September employment could register as an October surprise, payrolls beating to the upside in September (adding 254K jobs) should put to bed the fear that the US economy is imminently or currently falling into recession. With the unemployment rate falling back to 4.1% on a robust gain in both jobs and the labor force, it looks like the Sahm rule will not have correctly timed a contraction this cycle. The strong September report should crystalize the view that the Fed will only cut rates by 25 bps in November and December.

The very start of October has brought new surprises to the fore in 2024. We look to provide some perspective on three of the most pressing new surprises in this week's CIO Bulletin:

1. The widening Middle East war: how will it impact the world?

The conflict sparked on October 7, 2023 has now widened on multiple fronts in the Middle East. A first direct exchange of fire between Iran and Israel took place in April, but the latest escalations appear significantly more dangerous for the region. We can't possibly describe the human toll here. As usual, global markets have reacted in a predictable way. With Iran being the 7th largest petroleum producer state in the world amid fraught politics in the region and beyond, the global benchmark for crude oil jumped as much as 8% on October 1st before settling just 2.5% higher (see **FIGURE 1-2).** As we have noted routinely over the years, regional conflicts can have severe local impact. It is historically *very rare*, however, for these conflicts to drive a new direction in the world economy (see **FIGURE 3**).

Threats to oil security can cause price spikes often far larger in magnitude than supply losses. An unusual situation at present in petroleum markets is also present. OPEC, led by its largest producer Saudi Arabia, has been purposely restraining output. Despite this, increases in output elsewhere have been sufficient to reduce the price of crude oil to roughly $75 per barrel from just below $90 in early 2022 (see **FIGURE 4**). This is the level that prevailed before Russia's invasion of Ukraine, an event that has dramatically redirected global energy trade.

Recent reports have suggested OPEC producers may not be satisfied with the ongoing loss of petroleum market share to others. In short, apart from the insecurity plaguing many national oil producers, there are downside risks to the price of oil. At the same time, near-term security risks in the region may have never been so acute. This may argue for hedging risks around petroleum market volatility over the near-term.

Despite the message that global diversification can help to shield investors somewhat from regional conflicts, we do take security quite seriously in managing portfolio risks. As multiple conflicts stretch the capacity of governments, we see greater incentives for bad actors to see this as opportunity. For investors, we believe allocating to less volatile assets like government bonds or more direct risk hedges alongside equities helps to balance the rewards with risk management.

FIGURE 1: Largest oil producers as % of world output

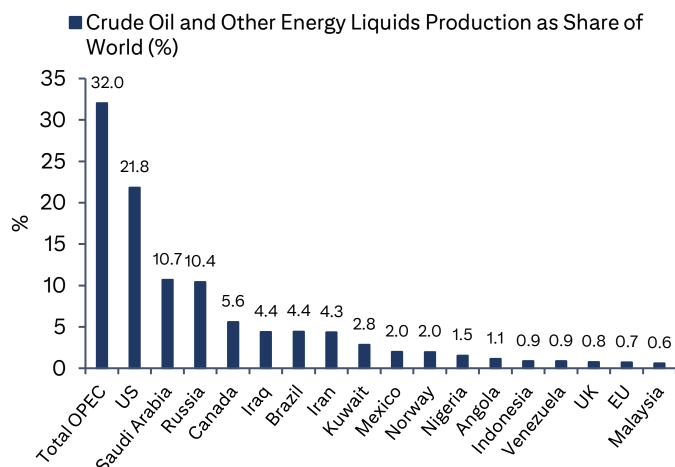
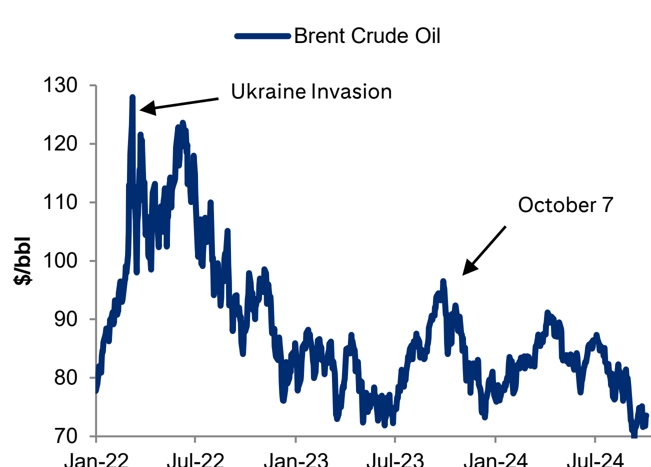


FIGURE 2: Brent crude oil price: $89 pre-Ukraine invasion, $75 now



Source: Haver Analytics as of October 2, 2024. Past performance is no guarantee of future results. Real results may vary.

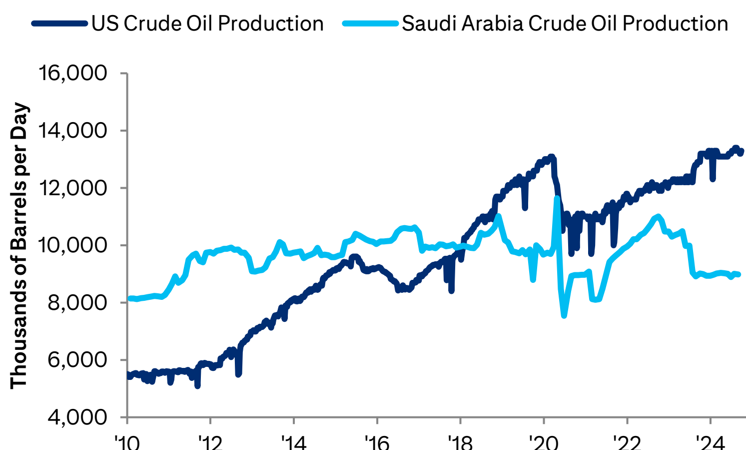
FIGURE 3: Geopolitical events since WWII and market outcomes

Geopolitical Event	Trading day before event	Trading day after initial reaction	S&P 500 (% since event date)			Crude Oil (% since event date)		
			Initial Reaction	30 days	90 days	Initial Reaction	30 days	90 days
Pearl Harbor	12/7/1941	12/10/1941	-6.87	-2.90	-12.02			
Cuban Missile Crisis	10/19/1962	10/23/1962	-3.78	7.61	17.16			
JFK Assassination	11/21/1963	11/22/1963	-2.81	3.06	8.28			
US Bombs Cambodia	4/29/1970	5/26/1970	-15.30	-6.43	-4.94			
Arab Oil Embargo	10/15/1973	12/5/1973	-16.26	-5.61	-15.11			287.04
USSR Invades Afghanistan	12/24/1979	1/3/1980	-2.27	5.37	-7.78			8.33
Iraqi invasion of Iran	9/9/1980	9/11/1980	1.28	5.62	5.17			6.66
US Bombs Libya	4/15/1986	4/21/1986	2.95	-1.39	0.16	-3.91	8.70	-15.65
US Invades Panama	12/15/1989	12/20/1989	-2.06	-3.73	-3.43	2.82	5.08	-6.21
Gulf War	12/24/1990	1/16/1991	-4.16	0.09	12.10	17.75	-20.67	-31.32
World Trade Center Bombing	2/26/1993	3/1/1993	-0.31	1.67	2.04	-0.18	-3.44	-5.81
911	9/11/2001	9/21/2001	-11.60	0.45	4.34	-4.09	-17.68	-31.98
US Invasion of Iraq	3/20/2003	3/21/2003	2.49	2.06	15.57	-8.16	-5.86	-6.54
Russian Annexation of Crimea	2/26/2014	3/21/2014	1.16	0.68	3.62	-3.77	-2.43	-0.92
Russian invasion of Ukraine	2/23/2022	3/8/2022	-3.11	5.54	-8.44	19.04	17.26	18.98
Hamas attack on Israel	10/6/2023	10/9/2023	0.63	1.33	9.02	2.77	-0.29	-8.60
North Korea Related								
Korean War	6/23/1950	7/13/1950	-12.80	-8.67	1.20			
Operation Paul Bunyan	8/18/1976	8/24/1976	-3.15	1.64	-4.32	0.00	0.00	0.00
2006 Nuclear test	10/9/2006	10/12/2006	0.90	2.60	4.60	-1.46	1.09	-7.43
2009 Nuclear test	4/25/2009	4/28/2009	-1.28	5.09	13.05	-3.73	19.56	36.56
2013 Nuclear test	2/12/2013	2/15/2013	0.02	2.88	7.53	-0.27	-8.18	-12.49
2016 Nuclear test	9/9/2016	9/14/2016	-2.55	-0.81	2.97	-3.38	14.12	16.54
2017 Escalation	8/7/2017	8/8/2017	-0.24	-0.64	4.44	2.19	7.00	21.65
Missile test over Japan	8/28/2017	8/29/2017	0.08	2.69	6.43	-0.83	10.37	23.06

S&P 500	Initial Impact %	30 days %	90 days %
Average all events	-3.3	0.8	2.6
Average ex WW2	-3.1	0.9	3.2
Average ex WW2 and Oil Embargo	-2.6	1.0	4.6

Source: Bloomberg as of October 2, 2024.Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

FIGURE 4: US vs Saudi Arabia crude oil production



Source: Haver Analytics as of October 1, 2024. Past performance is no guarantee of future results. Real results may vary.

2. Dockworkers on the US East Coast went on strike for the first time since 1977. Could labor actions derail the economy?

The pandemic shortages and associated price spikes were fully global in nature and the result of both production distortions and record demand stimulus. The port strike involving 45,000 dockworkers from the East Coast to the Gulf Coast fell far short of producing the same impact, but certainly stoked fears last week. Late Thursday evening, bargaining found a balance that would allow work to continue through January 15th, while several non-wage issues remain unsolved. The actual impact of the strike will likely be minimal, but the threat to the broader economy was real for dependent, regional small businesses and was an inconvenience to consumers. In a global economy that depends on properly functioning complex supply chains, any bottleneck – in this case, port transportation – will have far greater impact on economic output measures than the direct revenues of the ports and incomes of the striking workers.

During the last major port strike – lasting from October to mid-November 1977 – real GDP growth slowed to zero but then bounced back to a 16.4% annualized rate by the second quarter 1978. There was much else going on in the economy at the time. Domestic production and retail spending didn't slow, but international trade contracted around the event. Inventories were drawn down during the labor action but spiked up after the strike ended. Inflation was already quite high and only accelerated well after the strike for unrelated reasons. Despite 1977 being remembered as a notoriously bad year for the economy, US employment grew by no less than 200,000 per month during the year, including the months of the strike.

Today's economic context differs significantly. Goods imports have risen somewhat in importance (11.2% of US GDP today vs 7.2% of GDP in 4Q 1977). Inflation is much lower, but markets are in a sensitive period assessing any deviation from the progress the Fed sees in driving inflation down further. US employment growth is also slowing significantly. If the strike had persisted through mid-October, it could have threatened total non-farm employment gains falling below

100,000 on the strike impact. And this threat could return in January if no further resolution is reached, but given the rapid negotiation we have seen to date, that risk looks modest.

No labor action has driven the US into recession in post-WWII history. The number of lost hours worked from labor actions in the US is still running at a fraction of the 1970s average (see **FIGURE 5**). So, while we have resolution for now, markets can add a potential renewed strike in January to their list of worries over the path of growth and inflation. But as this week's experience illustrates, it is easy to exaggerate the long-term consequences of the strike (see **FIGURE 6**).

FIGURE 5: Lost US hours worked to labor actions as % of total

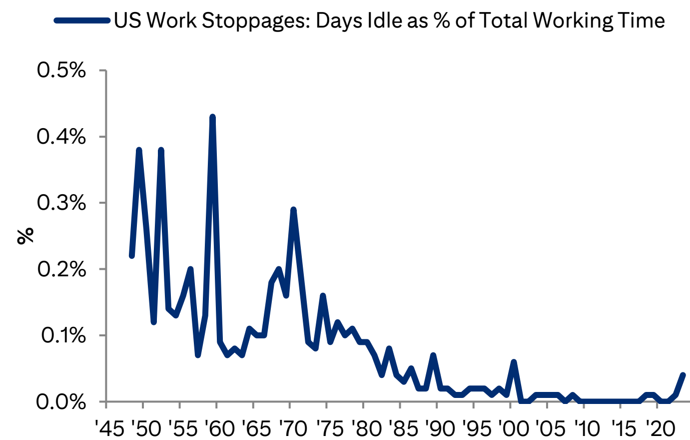
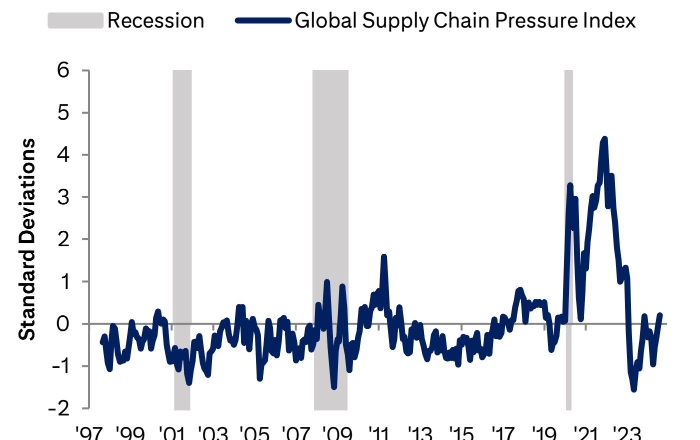


FIGURE 6: Monitoring shipping costs and global supply chain pressure index



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3. Does China's announced monetary and fiscal action change the return outlook for Chinese equities?

After a three-and-a-half-year bear market that lowered Chinese share prices to levels first reached in 2006, several announcements from China's Politburo, Ministry of Finance and Central Bank in late September sent share prices up at a record-breaking pace.

The Chinese equity rally continued 27% in two weeks since September 23rd, with record breaking trading volumes. As discussed in our last two Asia Strategy bulletins (Re-Levering China and China Finally Begins to Fight Deflation) and the September 14th CIO Bulletin, the monetary and fiscal policies announced over this period were unprecedented, representing a pivotal reversal in the direction of economic policy from the highest levels of China's leadership. Enabling this pivot was the start of the Fed's rate cut cycle, which gave more flexibility to policymakers in China and worldwide.

While there remains a lot of skepticism on the longevity of this rally, there's a chance we're less than halfway through this bull market for three key reasons:

1. So far, the rally has been funded by savings accumulated by firms and households over the past few years. Leverage has yet to be applied and it is likely a powerful source of funding for this rally, as it is funded cheaply by the central bank. The bull market likely won't end until financial policy turns to tightening again.
2. Earnings growth and cyclical economic recovery is under way and may have more forthcoming (see **FIGURE 7**). The amount of fiscal stimulus is substantial, and the equity rally itself is likely to lift the propensity to consume after two years of belt tightening. Upward earnings revisions have just begun and may extend further, with higher certainty for the financial and consumer related sectors.

3. IPOs and other public offerings are likely to return, after low valuations have paused this original function of the equity market. These include the hundreds of firms lined up for IPO, as well as banks and other state-owned enterprises looking to raise capital. Until substantial capital raising takes place, financial policy is unlikely to tighten again.

While we believe this strong rally still has legs, China's equity market has often performed like a "stampede of bulls" moving in and out. As noted, certain US policies could stand in the way of further gains. Our visibility and confidence level in China's economic performance is admittedly fairly low. In such a case, we don't think a cyclical bull or bear market should be the deciding factor in one's strategic exposure.

Our direct weighting in mainland China equities for globally diversified, all-asset, medium risk portfolios is less than 3%. For all of Asia equities, just under 13%. There are portfolios designed for more or less exposure, but we believe *no single country equity market makes a portfolio.*

FIGURE 7: China CSI 300 forward EPS and share prices

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Upper medium grade (Strong)	A	A	A
Medium grade	Baa	BBB	BBB
Not Investment Grade			
Lower medium grade (somewhat speculative)	Ba	BB	BB
Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
In default	C	D	D

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Mortgage-backed securities ("MBS"), which include collateralized mortgage obligations ("CMOs"), also referred to as real estate mortgage investment conduits ("REMICs"), may not be suitable for all investors. There is the possibility of early return of principal due to mortgage prepayments, which can reduce expected yield and result in reinvestment risk. Conversely, return of principal may be slower than initial prepayment speed assumptions, extending the average life of the security up to its listed maturity date (also referred to as extension risk).

Additionally, the underlying collateral supporting non-Agency MBS may default on principal and interest payments. In certain cases, this could cause the income stream of the security to decline and result in loss of principal. Further, an insufficient level of credit support may result in a downgrade of a mortgage bond's credit rating and lead to a higher probability of principal loss and increased price volatility. Investments in subordinated MBS involve greater credit risk of default than the senior classes of the same issue. Default risk may be pronounced in cases where the MBS security is secured by, or evidencing an interest in, a relatively small or less diverse pool of underlying mortgage loans.

MBS are also sensitive to interest rate changes which can negatively impact the market value of the security. During times of heightened volatility, MBS can experience greater levels of illiquidity and larger price movements. Price volatility may also occur from other factors including, but not limited to, prepayments, future prepayment expectations, credit concerns, underlying collateral performance and technical changes in the market.

An investment in alternative investments can be highly illiquid, is speculative and not suitable for all investors. Investing in alternative investments is for experienced and sophisticated investors who are willing to bear the high economic risks associated with such an investment. Investors should carefully review and consider potential risks before investing. Certain of these risks may include:

- loss of all or a substantial portion of the investment due to leveraging, short-selling, or other speculative practices;

- lack of liquidity in that there may be no secondary market for the fund and none is expected to develop;
- volatility of returns;
- restrictions on transferring interests in the Fund;
- potential lack of diversification and resulting higher risk due to concentration of trading authority when a single advisor is utilized;
- absence of information regarding valuations and pricing;
- complex tax structures and delays in tax reporting;
- less regulation and higher fees than mutual funds; and
- manager risk.

Individual funds will have specific risks related to their investment programs that will vary from fund to fund.

Asset allocation does not assure a profit or protect against a loss in declining financial markets.

Diversification does not guarantee a profit or protect against loss. Different asset classes present different risks.

The indexes are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance.

Past performance is no guarantee of future results.

International investing entails greater risk, as well as greater potential rewards compared to US investing. These risks include political and economic uncertainties of foreign countries as well as the risk of currency fluctuations. These risks are magnified in countries with emerging markets, since these countries may have relatively unstable governments and less established markets and economics.

Investing in smaller companies involves greater risks not associated with investing in more established companies, such as business risk, significant stock price fluctuations and illiquidity.

Factors affecting commodities generally, index components composed of futures contracts on nickel or copper, which are industrial metals, may be subject to a number of additional factors specific to industrial metals that might cause price volatility. These include changes in the level of industrial activity using industrial metals (including the availability of substitutes such as manmade or synthetic substitutes); disruptions in the supply chain, from mining to storage to smelting or refining; adjustments to inventory; variations in production costs, including storage, labor and energy costs; costs associated with regulatory compliance, including environmental regulations; and changes in industrial, government and consumer demand, both in individual consuming nations and internationally. Index components concentrated in futures contracts on agricultural products, including grains, may be subject to a number of additional factors specific to agricultural products that might cause price volatility. These include weather conditions, including floods, drought and freezing conditions; changes in government policies; planting decisions; and changes in demand for agricultural products, both with end users and as inputs into various industries.

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