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DM PORTFOLIO COMMENTARY
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Financial stress in China adds to inflation worries

As the third quarter was drawing to a close, equity investors were served a jolt of long-forgotten volatility when the Dow dropped by more than 600 points in a single day. The catalyst for the plunge was the revelation – *or at least the acknowledgement* – that one of China's major property developers was buckling under the strain of a mountainous debt load and would struggle to complete its vast array of projects. In a country where households are uncommonly levered to real estate and construction accounts for an outsized portion of GDP, this was understandably worrisome. Of particular concern in the west was the possibility that cascading property and debt markets in China would reach into our financial systems, much like the sub-prime crisis had imperilled major banks and lenders well beyond US borders just over a decade ago.

Within China, the implications of this dam burst have momentous potential and could impact everything from where households direct their savings, to the composition of the economy, to the political and social trajectory of the nation itself. To be sure, there is little that displeases (or even frightens) an authoritarian government more than internal instability and so the fallout from recent and expected events should be fascinating to watch.

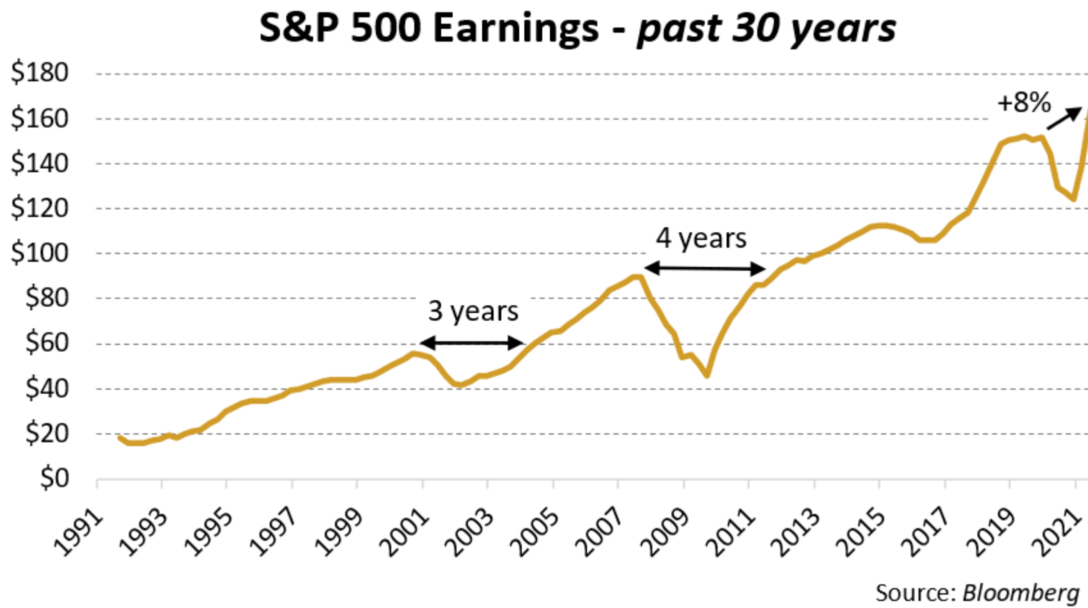
Outside of the Middle Kingdom, however, effects are likely to be more varied and, in some cases, may not be noticeable at all. One of the areas that did take an immediate hit was the mining sector, especially international producers of industrial metals. With China's voracious demand for steel, copper, and other building materials expected to slam to a halt, shares of mining heavyweights like Rio Tinto, BHP, and Freeport-McMoran fell sharply and have yet to recover. Elsewhere, though, weakness was short-lived as investors undoubtedly calculated that the news probably wouldn't have an excessive impact on global growth. Though the Chinese consumer will surely retreat in response to financial stress, this cohort is not a significant contributor to the worldwide economy, as it's still the case that we buy lots of stuff from them and they buy comparatively little from us. That said, Chinese leaders have long coveted a more balanced economy and a rightsizing of the property sector could be a major contributor to the eventual emergence of a Sino consumer class. If that were to occur, this jarring episode could mark the birth of a vast new marketplace for many of the companies held in DM portfolios.

Whereas the financial systems of developed economies are closely intertwined, China's is largely closed. So, while a property market collapse in the US ripped through the balance sheets of German, British, and even Japanese banks, it seems unlikely that a comparable episode in China would have the same knock-on effect. As well, the government there has the tools and reserves necessary to prevent an internal financial contagion and presumably will not want to let local challenges escalate enough to undermine its international reputation.

Back on our shores, the primary concern underlying stocks continues to be inflation's persistence and what it means for earnings, interest rates, and the potential next steps of central bankers. With logjams plaguing major ports, labour markets

experiencing uncommon tightness, and executives increasingly lamenting cost pressures during earnings calls, relief doesn't seem like it will be forthcoming, at least not in the very near term. Much like China's recent travails, rising economy-wide prices won't affect all businesses equally, though, and some could actually experience a net benefit under such a backdrop. In simplest terms, companies charge prices for goods or services and pay wages and incur expenses to purchase the means of production: those which can maintain (or even expand) the spread between these inflows and outflows will fare best in an inflationary environment. Who has pricing power and who will have difficulty keeping up with rising costs is a topic that has occupied a substantial portion of our recent investment committee meetings and something that we'll monitor closely in the weeks to come, most immediately via third quarter earnings reports that will begin in mid-October.

To date, the market's rise off its spring 2020 bottom has been supported by outstanding fundamentals. As the chart below illustrates, it took three years for earnings to fully recover following the dot-com crash of 2000 and four years to undo the damage of the sub-prime crisis. As of this summer, however, S&P income is already 8% higher than it was pre-covid, a remarkable result over a comparatively short period of time. This is the underlying strength that investors have paid for over the past several months and which we'll be looking for as we evaluate existing and potential holdings in our equity mandates.



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