# 2021 Theme Analysis:

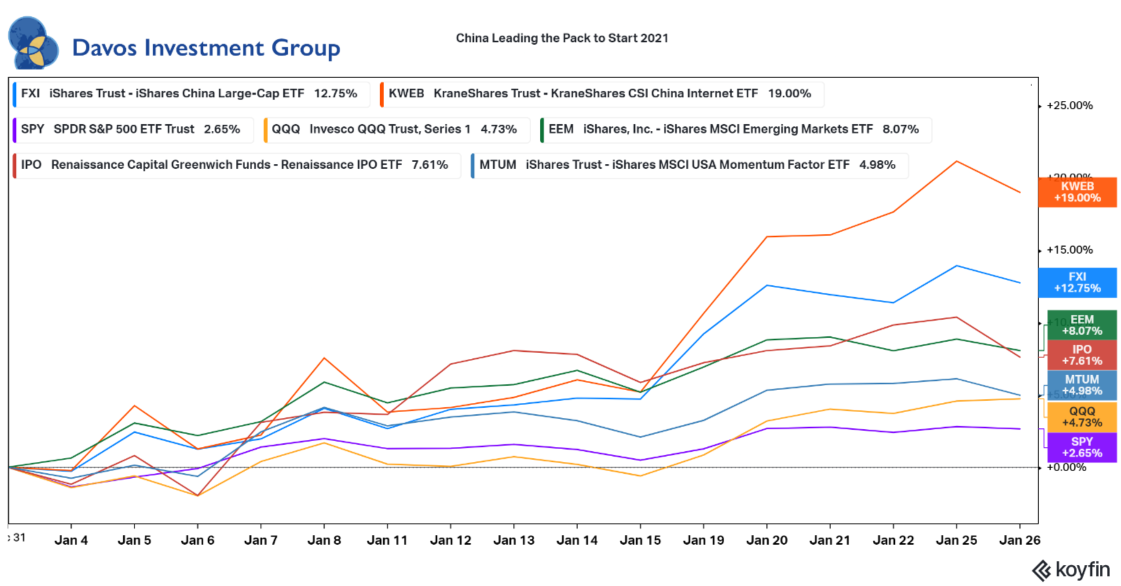
In this report, I am going to deep dive into what I believe what will be defining market narrative themes and how to trade them whether you agree or disagree.

### Theme One: China's Ascension to Dominance

The first major theme is that the 2020's will be the point where China replaces the US as the predominant military and economic world power. Biden's victory in the 2020 election was effectively thew US waving the white flag on the trade war, and the normalization of trade agreements means the return rising market share of China's global exports. They have also been helped as the rest of the world has faced more severe manufacturing capacity bottlenecks due to pandemic lockdowns (China got it out of system first and the quickest).  They also accomplished this recovery with the least amount of central bank easing/fiscal stimulus among any major power.

The combination of the dysfunction of American politics and the perceived superior ability of an authoritarian system like China on handling more global and dire crises has made many investors and world governments question the US's leadership. Democracy seems old fashioned in a world of information overflow and fake news. This sentiment is confirmed by polls showing the majority of millennials and Gen Z [globally having high degrees of disillusion with democracy]. Prominent business leaders such as Ray Dalio and Elon Musk have taken the side of Chinese ascendency not out of love for Xi, but a cynical hedge against the prospects of the West.

It is not just rhetoric and emotional sentiment. China has been asserting itself geopolitically by starting skirmishes across all the disputed regions in its borders, building a base in the South China Sea unimpeded, and aggressively cracking down on dissidents in Hong Kong to the point of arresting American huma rights lawyers. European "allies" of the US such as Germany and Italy are strengthening trade ties with China despite growing tension with their post WW2 guarantor of defense, the USA. China believes its own hype and will continue to directly undercut the US both diplomatically and via force and the China bull case is that they will continue to get away with it.



The markets so far believe in Chinese supremacy. Chinese equities have outperformed the rest of the world overall since Biden's election and the trend has accelerated since the start of the year. The Chinese tech sector has been red hot despite structural macro risks mounting against it. KWEB has outperformed by the NASDAQ by 15% YTD.

**To Bet with the Theme:**

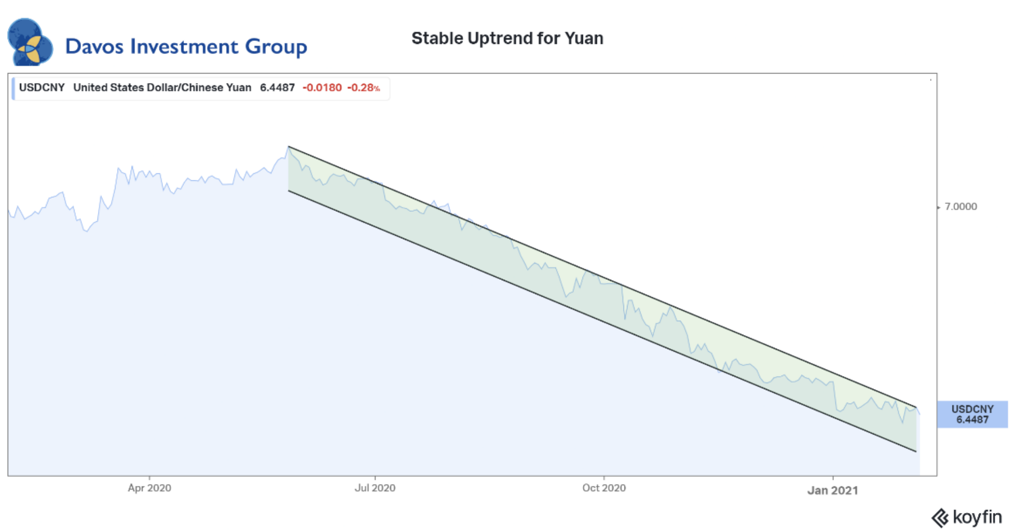
For traders who want to bet with the theme, the trade is to go long China and emerging market countries (particularly Chinese allies such as South African and Pakistan) and short the US against it. Going long the renminbi with the dollar also would be another way to play this trade. I recommend going long "old economy" stocks in China (banks, industrials, real estate) over tech as Chinese tech is in the crosshairs of the CCP's politburo. Commodity markets such as grains, copper, and natural gas also benefit from increasing Chinese living standards through higher energy consumption and more meat-based diets.

**To Bet Against the Theme:**

If you are skeptical of this theme, the trade is to short Chinese tech stocks (KWEB & CQQQ). Chinese tech momentum will fade with overall macro sentiment towards China, and the combination of valuation concerns, breakup of supply chains, and political risks on both sides of the Pacific means that this trade can work even if the macro conditions in China remain strong otherwise.

**Catalysts to Watch:**

The main fundamental catalysts to watch include further international geopolitical aggression from China (sign of optimism), how Chinese economic data performs with new COVID outbreaks, and signs of developed/US aligned nations decoupling or deepening dependency on Chinese trade (which way they go reflects which way wind is blowing). The main technical catalyst is the stable downtrend of the US dollar vs. the yuan since March 2020. The US dollar is ticking up versus the rest of the world's currencies, and if that trend extends to a breakout outside of the current channel, that would be the bear signal to reverse positioning on China.

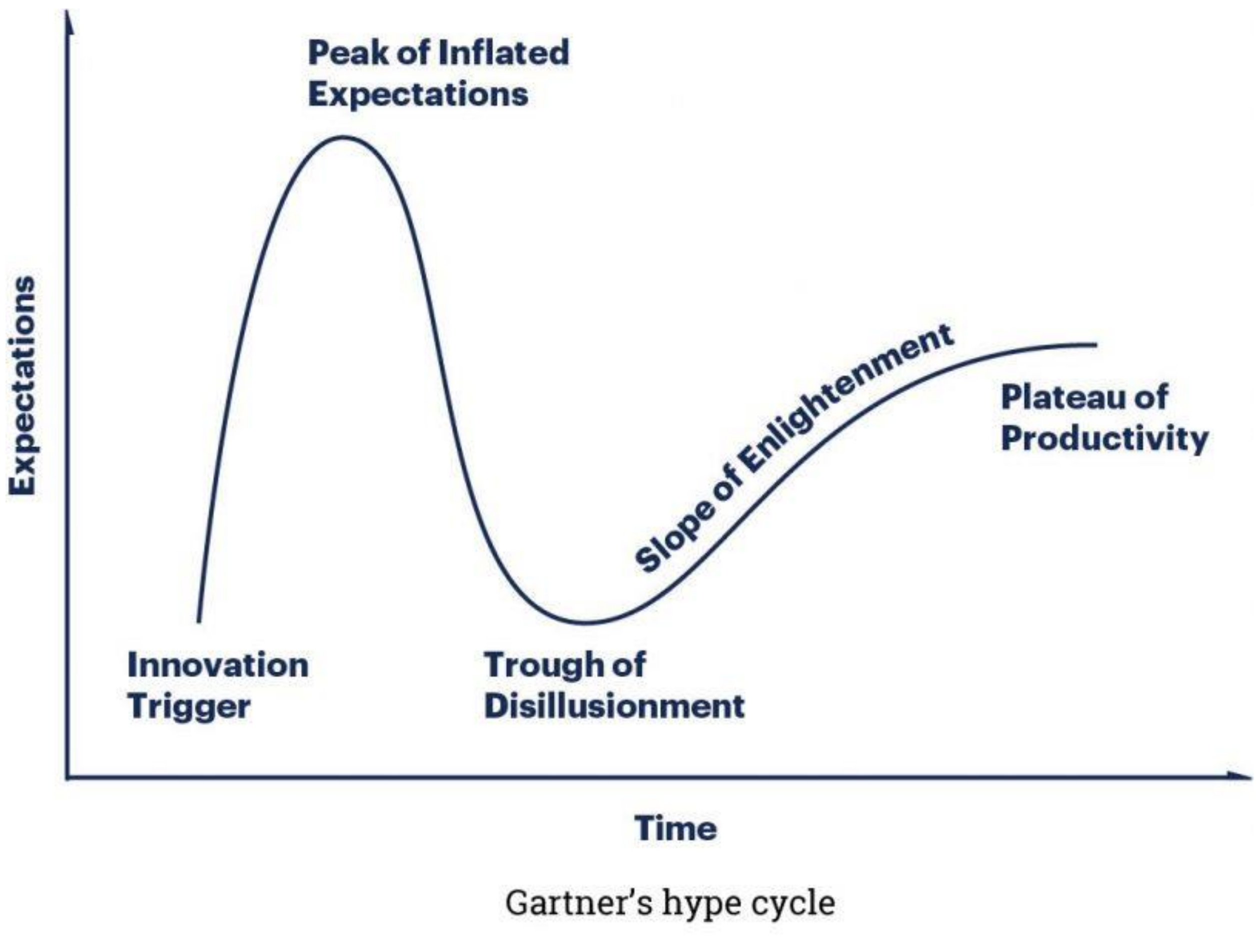



**RMB is up 8% year/year. This move is staggering given how low vol is in this FX pair historically. Source: Koyfin**

## Theme Two: Unwind of the "Innovation Premium"

The idea of perpetual accelerating innovation has become so ubiquitous [that the Economist magazine cover story was based on the idea of a roaring 20's in technological accelerationism]. Every new IPO is a disruptor now and we will all be living like the Jetsons by 2030 is the new dominant narrative. The result is the highest spread between growth stocks and value stocks, the strongest performance of IPOs since the tech bubble, and the strongest performance of money losing companies ever.

I'm sure a lot the current excitement will result in many fantastic technologies. However, many tech investors are discounting the concept of the Gartner cycle (chart below). For every technology there is initial irrelevance followed by a delusion of enthusiasm after early signs of the innovation gaining traction. When several innovations cycles line up together and money is cheap, the stock market syncs with the Gartner cycle. The last time this happened was in the late 1990's with the internet, and now it's happening with a portfolio of tech (EVs, cloud, clean energy, SaaS, automation, etc.) instead of one grand theme of dotcom. Nevertheless, the emotion around it is the same and I expect markets to repeat what NASDAQ did that cycle and follow the curve of the Gartner hype cycle. We are somewhere in the "peak of inflated expectations" curve, but I'm not sure if we are at the end of the upside of parabola or beginning or rolling over to downside.




**Gartner Hype Cycle: source Gartner**

**To Bet with the Theme:**

The way to profit from a "trough of disillusionment" is to go short the most overhyped tech stocks when their charts "break". Tesla on Friday January 29th seems to be the first to fall below critical support and the rest of the growth bonanza will likely join them. Many of these themes can be trade directly through an ETF basket such as IPO's (IPO), money losing ecommerce (IBUY), cloud computing (CLOU), and solar energy (TAN).

**To Bet Against the Theme:**

For those who remain bullish on the innovation theme there two trades are finding under the radar tech small caps who have potential to fill innovator as the next disruptor (easier said than done), or just buy Bitcoin. Anything in an Ark Investments mutual fund should also continue to outperform on the coattails of this narrative as their inflows has surpassed Blackrock's because of it. The crowd of investors who are riding the innovation wave via trading these stocks or as founders of these companies disproportionately has a pro-crypto outlook, and the gains from this space will leak into Bitcoin. Bitcoin also is perceived as the ultimate disruptor as it is discrediting the entire monetary system as the "true store of value". Bitcoin also does not have pesky fundamentals to get in the way of traders' collective enthusiasm.

**Catalysts to Watch:**

The catalysts to watch are tech companies reporting earnings beats, but still selling off anyway. I think we started to see that with Facebook, Microsoft and Apple, but it is to be determined if this ripples down to small cap growth. Updates on FAANG anti-trust case or seeing a major IPO flop on its first day of trading would be another fundamental cue.

## Theme Three: Inflation

Ever since the pandemic fiscal stimulus was first passed last spring, the inflation narrative fundamentally shifted from structural deflation to inevitable currency collapse. The truth is somewhere in between. The combination of near unlimited monetary easing and fiscal policy now willing to enact aggressive direct transfer payments provides the mechanism for a higher inflationary environment to last.

This has been reflected in the markets with commodity prices such as gold, oil, silver, agricultural goods, and copper all surpassing five-year highs. The TIPS breakeven spreads are also surpassing 2018 levels which was the previous five year high. Speculation in cryptocurrency stormed back into vogue on fear od "fiat collapse". National housing prices indices and rents outside a few core urban areas, are up double digits year over year. Deflation is only true now for retirees with mortgages paid off and healthcare covered Medicare. Unfortunately, America is a gerontocracy and this same demographic run economic orthodoxy and control government, so they do not see the problem under their noses.

**To Bet with the Theme:**

The bet with the theme is to buy commodities and stocks focusing on these sectors. Agriculture, industrial metals, precious metals, and energy all benefit from inflationary updraft. Technically the trends shifted bullish on these asset classes after vaccine news in 2020 and the combination of labor shortages, CAPEX fatigue, and environmental restrictions set up for supply not catching up quick enough with money printing and post-pandemic demand.  I prefer commodities over shorting the US dollar outright as I do not see the rest of the world deviating and having a relatively tighter policy than the US. Also, upside squeeze risk is high as USD [short positioning in the dollar remains near record extremes].

**To Bet Against the Theme:**

If you think deflation is here to stay, the bet is buying the long bond, utilities, and consumer staples equities and/or shorting precious metals, bitcoin, and agriculture. The long bond offers the best risk-reward here as the nominal value will likely be held up by a monetary policy through de-facto yield curve control, and the upside is the 30-year falling below 1% (the 30 year German bund is at -0.008% as I am writing this). Utilities also are cheap versus historical yield spread to treasuries and are unlikely to see demand loss as electric power is a necessity good. Regulatory risk for utilities is also lower in a deflationary market than an inflationary as the main political actions involve capping or blocking price increases.

**Catalysts to Watch:**

There are two catalysts to watch for inflation theme. The first one is the March/April 2021 inflation prints and how fast the data picks post the rollover of base effects from last year's sell off. The second and more important catalyst is the Fed's reaction function to when inflation averages exceed their targets. Central banks faced a "hard choice" between preserving purchasing power (and social stability via asset price inequality) and political capital to protect sovereign bond market. They chose the latter one not only for cynical reasons, but also some legitimate hope that direct transfer payment stimulus and allowing loose public sector can prevent sustained unemployment crisis. The market is taking the hint, but the Fed still has enough residual credibility that market participants do not believe central banks will let things run out of control. That changes this spring when residual deflationary effects of the March sell off in oil and agriculture markets, and the peak of pandemic driven discounting across the economy wears off. CPI and Core CPI numbers that look deflationary will all the sudden run hot. The Fed Funds market is not pricing in any chance of a rate hike for at least years, but at the pace inflation seems to be accelerating, the Fed's inflation targets of a five-year average of 2.5% will be hit well before then. The first Fed meeting after that target is surpassed could be the one that breaks credibility to contain inflation if they choose to move the goalpost rather than tighten. It is a lose/lose position scenario that is an unenviable position for policymakers.

## Theme Four: Regulatory Clean Up

The Trump presidency economically was known for its lax regulatory environment and using a permissive tax and oversight climate to gain capital flows at the expense of international rivals. The Democratic Party on the other hand governs on a platform of normalizing international relations and forcing the US to comply with global standards. This also includes increasing the size of the social safety net (and taxes eventually) to be more in line with European allies.

The lax regulation environment (especially in financial markets) has led to many abuses at the expense of investors and stakeholders of these companies. Momentum of a bull market has had these largely ignored, but in the event the tide comes up there is a potential for a wave of fraud exposures that match or exceed that of 2000-2003 that motivated the passage of Sarbanes-Oxley. The Robinhood/GME debacle is likely the start of a wave of scrutiny against what is taken to be standard business procedure on the street.

**To Bet with the Theme:**

To bet with this is trade is to short sell the companies who have considerable ethical, corporate governance, or geopolitical concerns and buy their competitors as a hedge (if there are any public ones). The most notable examples of these include certain EV companies, Chinese tech broadly, for profit colleges, private equity firms, SPACs broadly, non-bank lenders with loose credit standards and aggressive collection practices, cryptocurrency dealers, and tech companies that use creative share structure to restrict voting rights. They will all face scrutiny under an SEC and CFPB who will be led by more aggressive prosecutors in a Biden administration and have the green light from higher ups to be pursue investigations. Many would put FAANG anti-trust in this bucket as well, but he Biden administration's financial support from FAANG, and the result of appointing ex-big tech executives to the cabinet means that there is a strong chance that anti-trust suits result in little more than a slap on the wrist.

**To Bet Against the Theme:**

If you think the chances that the lax regulatory climate goes on indefinitely, there are two trades. The first is the reverse of my comments in the previous paragraph and the second one is to buy bitcoin and cryptocurrencies. The more that capital markets are perceived to be a farce, the more popular the belief that crypto will be the only safe place to put money (or as the greatest Ponzi the place to get the most beta "juice" on the bubble going higher

**Catalysts to Watch:**

The catalyst to watch is whether the SEC and CFPB increase prosecutions or investigations on the more suspect operators in the capital markets. The other catalyst is a general downdraft in markets which historically is when dodgy investment schemes or capital offerings go sour.

## Theme Five: Reopening

The fifth theme is re-opening of the economy and the pace it takes place. Shortly after the news of Pfizer's vaccine effectiveness was published in November, the timeline I expect re-opening to be realized was in late March/early April 2021 as the most vulnerable 10% of the population gets vaccinated. There are some signs of this timing with restrictions dropping in CA, NY, and IL, but fears of the spread of the new South African variant can erase that progress quickly. Most of the global re-opening has been domestic based and there has been little traction in normalizing international travel.

**To Bet with the Theme:**

The way to bet with this theme is to buy companies that benefit from domestic travel resuming that have not already priced in a perfectly normalized recovery. This includes theme park operators such as Cedar Fair and Six Flags, Hawaiian Airlines, apartment REITs, and hotel REITs/operators who are trading at favorable valuations. On the short side, Zoom, Peloton, and Wayfair have the most to lose from re-opening and have plenty of downside with frothy valuations.

The problem with betting on re-opening is that the easy money has been made and general optimism has already bid up the stock prices before the re-opening has fully taken place. To bet on the resumption of international travel, the trade is to go long Spanish equities (EWP), the Mexican peso, and Greek equities (GREK) as flows into these assets and economic performance reliant on tourists from larger neighboring countries.

**To Bet Against the Theme:**

The best way to bet against re-opening (or simply a slower re-opening than expected) is to short companies that have priced the best-case scenario before it happens but have material risk of loss upon a delay. The most obvious one of these is concert ticket operator Live Nation (LYV) whose stock is trading at pre-COVID levels despite no signs of concerts returning (and likely last thing to return). Bright Family Horizons (BFAM) also remains an attractive short as even without COVID, the mass acceptance of working at home makes parents less willing to fork out $2K a month to send their child to daycare.

Outside of LYV and BFAM, other short candidates include timeshare operators, airlines, Disney (sports and theme parks), rideshare companies, and the energy sector. Oil stands our particularly due to one of the key assumptions build into an energy consumption recovery is the resumption of air travel. On the FX front, the best trade is going long USD/MXN as requirements for a COVID test to return to US after a visit will be disincentive for future visits in favor of domestic alternatives such as Florida or Hawaii.

**Catalysts to Watch:**

The catalysts to watch are spread of mutated virus variants, updates on vaccination rates, and the reopening plans of major American cities and foreign countries.

## Theme Six: Universal Basic Income

The last theme on here is also the final bullet of fiscal and monetary policy: Universal Basic Income. This the limit because it is hard to exponentially grow easing from the point of regularly sending cash to citizens. In order to magnify this stimulus at the same rate, the annual "pay raise" for the citizens would have to increase at faster rates every year (2% growth one year; 3% next and so on). At a certain point either inflation or the complete lack of incentive for lower classes to work or produce will break the system. Those who do work will need much higher compensation to make up for the freedom of unlimited leisure and the likely higher tax structure needed to pay for a more generous safety net. With a higher effective minimum wage, productivity declines. This along with demand increases from increased income likely means structural inflation.

Universal basic income fundamentally changes the relationship between citizens, the private sector, and the state within a country. Geopolitically, the change transitions from countries that are the consuming class (US, Japan, and Europe) whose role is to buy the products and services that are made in countries cannot afford to pay off citizens and thus still must work (Emerging markets). Automation in this timeline would also accelerate by necessity due the need for domestic manufacturing of geopolitically sensitive goods (food, weapons, medical supplies, etc.). On a more micro level, there are a variety of socio-economic consequences to UBI that can result in actionable trades.

**To Bet with the Theme:**

The trade with this theme is to go long digital entertainment (especially videogames), alcohol, marijuana, ecommerce, restaurant delivery and utilities. Think of the entire working class adopting the lifestyle of the pejorative NEET living in his mom's basement. Automation manufacturing equipment producers (BRKS, ROK), SaaS, and warehouse REITs are also winner. Emerging market countries benefit from UBI due to higher employment (remote work to replace "retiring" developed market service workers), and more favorable trade balances from increased exports of manufactured goods.

**To Bet Against the Theme:**

Apart from taking the other side of the pro-UBI trades (which have other variables driving them for it is not clean enough of a trade), I do not have sure fire UBI fade trade idea at the point. Shorting EM would be one idea as a more economically protectionist world without UBI likely means that these countries will be getting cut out of narrowing industrial supply chains. Another indirect way to bet against UBI is to go long worker uniform manufacturer Cintas (CTAS) as lower wage workers are the most likely to drop into UBI dependency are more likely to be uniformed.

**Catalysts to Watch:**

The catalysts to watch are how well the economy recovers in response to Biden's current stimulus package. If this round of stimulus fails and the pandemic economic damage becomes perceived as permanent, then UBI is the next logical step. It's not that far out there as Vice President Harris herself proposed monthly guaranteed $2000 per month payments last September as a senator.