March 15, 2020

RockCreek

ROCKCREEK UPDATE

Dear Investors and Friends of RockCreek,

First and foremost, we hope that you, your families and teams are well and safe. Some of us have had our daily lives disrupted and many more in our communities will experience the effects of the coronavirus in the days and weeks to come. In the meantime, we are preparing to respond to the possible scenarios ahead including health and safety concerns, market uncertainty, and social turbulence.

As we navigate the black swan event of 2020, our recent Finance Forward Podcast is focused on the impact of the coronavirus. Caroline Atkinson, RockCreek Senior Advisor and ex-senior official at Google, the National Security Council, the White House and the IMF, and RockCreek Founder Afsaneh Beschloss offer their expert insights on investments and the economy in the face of COVID-19.

We have also released an interview discussing the recent market events among Ms. Beschloss, Alan Greenspan, former Fed Chairman; and Liaquat Ahamed, author of “Lords of Finance” and ex-CEO of Fischer Francis. Together, they consider the ramifications of the recent actions of the Federal Reserve and the economy entering a global recession.

RockCreek's latest weekly update provides insights on uncertain market conditions and the rapidly changing impact on investing, observations on COVID-19 to guide expectations, and a summary of our preparedness guidelines.

IT’S OFFICIAL: A GLOBAL PANDEMIC AND A SHOCKING END TO THE 11-YEAR BULL MARKET – AND THE BREAKDOWN OF OPEC+ !

The black swan of 2020 is the stunning confluence of this week's triple threat of a global recession, the halt to OPEC+ power, and a fast growing pandemic. Each would be disruptive, but their combination, exacerbated by delayed global leadership in declaring the outbreak a pandemic, has resulted in a war-like climate.

At RockCreek, as indicated in our interview with Alan Greenspan, although we can't map the trajectory of the virus, we have entered into a recession and expect U.S. growth for 2020 to be close to zero percent. Further, we expect global growth to fall sharply below the January IMF projections of 3.3 percent. Financial markets crashed into bear territory and saw the worst one-day fall in equities since 1987. While corrections are normal and expected given the overvaluation of U.S. equities, the speed of the decline and the disruptions caused by the circuit breakers triggering spooked investors, led to a series of extraordinary actions by the Federal Reserve on Friday and Sunday to reduce rates and push liquidity into wherever they saw strains in financial markets. As shown by an almost immediate plunge in stock futures Sunday night, we need to buckle up and be prepared for continued wild market swings.

Week three of the market meltdown saw an explosion of bad news: for public health and for the markets and the economy. Before the world’s largest economy effectively shut down on Friday, the week began with Saudi Arabia putting fuel on financial market fires, massively increasing oil supply that drove a 30 percent overnight drop in the price of oil. Already fragile stock markets, concerned about the hit to the global economy from COVID-19, were rocked by the prospect of cascading bankruptcies in the heavily leveraged U.S. shale industry, on top of the economic disruptions from emergency public health measures.

Markets got another set of shocks mid-week. Italy, an advanced nation of 60 million people, announced an unprecedented nationwide lockdown to curb the public health threat, as hospitals were overwhelmed with sick patients and had to make difficult life and death decisions.

The WHO declared the outbreak of the coronavirus to be a global pandemic. And the United States upset allies and markets with a surprise 30-day ban on travel and possible ban on domestic travel as the main federal response to the disease, at a time when experts tell us that we need mass testing, clear public health guidelines, and emergency hospital and medical supplies for infection control and treatment. Hospitals canceled elective surgery to free up respirators and capacity, and medical students were sent home because of a shortage of masks and protective gear.

Finally, on Friday and Saturday, President Trump and his administration did an about-face. The President, flanked by health experts and business leaders, announced a strong and coordinated public health response, including welcoming foreign and private sector help in testing that he had previously rejected and supporting actions already taken by worried state.and local leaders. The White House later signaled its support for an emergency package put together by the House, to be voted on this coming week by the Senate, that will target the most vulnerable.

Much of normal American life is under siege. Major sports events have been cancelled and leagues are suspended, school closures spread, Broadway theaters went dark, museums shut down, workers were asked to stay home, members of Congress "self-isolated." In the absence of guidance from the federal government, businesses, individuals, and state and local governments have jumped into action to limit risk.

The recent fight for oil market share and the joint Saudi and Russian strategy to kill the U.S. shale industry seems to have gone wrong as it may have caused a falling out between Russia and Saudi. Unlike the usual plot, when OPEC+ arrives at an agreement within a day or two, the dynamic seems different this time. Neither side is blinking! In the longer run, we expect oil prices to remain lower than historical levels due to a confluence of increased renewable's and as U.S. policymakers may decide enough is enough with unreliable partners in the Middle East and protect the U.S. shale industry as a strategic market. In the meantime, there is increased pressure on lenders to the oil shale companies, and distressed buyers may be more likely consolidators than the large oil companies who are re-branding themselves to be "energy companies".

As this wild card is dealt at the worst time for the financial markets, oil importers, including emerging markets, are beneficiaries of lower prices. Also, as the share of oil sector in the United States has decreased from a peak of 15 percent to 3.5 percent of S&P 500, this energy shock will be more important for financial markets, since energy is the largest weight in the high yield bond index, than it is for the GDP. While this will provide opportunities, we believe the bigger opportunities looking ahead will be in renewables.

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OUR LATEST PORTFOLIO THINKING

Markets are in turmoil and we are preparing for more chaotic moves in the near term. The VIX and 10-day realized volatility have both gone up substantially this week and are now close to 2008 levels. Most unusually, realized volatility is even higher than implied volatility today. With a price war over oil and an equity market selloff not seen since 2008, we are closely monitoring your portfolio and assessing where future opportunities are best taken. Significant disruptions in a global and interconnected world underscore the need for long-term planning and consideration of what investment trends will be best to generate return in the future.

Going into this extreme period of market volatility, we are pleased to see that we are conservatively positioned and that our focus on diversification, asset allocation, liquidity, and active management is adding value to portfolios. Our extreme risk and cluster analysis have also been important portfolio tools. We have sufficient flexibility to look for pockets of opportunity that may exist across public and private markets and are actively engaging with our underlying investors to stay abreast of future positions we may want to prepare for.

Volatility provides an opportunity to enter markets that are high conviction as they become more attractive in valuation. These are sectors that would grow regardless of where we are in the economic cycle. We believe certain areas, some of which we are already invested in, will continue to benefit as we emerge from the crisis: the intersection of the health and technology sectors, such as tele-medicine; digital transformation; long-distance learning; and sustainability, such as renewable energy and water. Supply chain disruptions are sure to create new opportunities. We also believe that the Chinese health sector potentially will be an important area to add to as China uses the same approach to the health sector as it did to infrastructure. We expect the panic and disruptions in the next few weeks to provide entry points.

This volatility and drawdown may be here to stay for the near term and a slowdown in economic growth globally is a significant factor in positioning the portfolio for the longer term. Our cautious positioning allows us to be thoughtful in this environment and not feel the need to make forced or drastic decisions as we see how the virus and markets play out in the short term.

We are monitoring equity market valuations closely and seeing the alpha of our active managers outperforming in this sell-off. In equity markets, indiscriminate selling should set us up for buying opportunities as the impact from this period self-selects winners and losers.

There has been a decline in the open equity futures positions by investors. For 2020, given lower earnings, valuations may still be too high, though markets will be valued based on an after-virus run rate later this year and for 2021, unless the virus stays for longer than our current assumptions.

In emerging markets, we are defensively positioned and outperforming versus broader indices given a focus on domestic technology companies in the e-commerce, healthcare, and education spaces. Our portfolios have had relatively little exposure to export and commodity-related names. Somewhat surprisingly, China and Taiwan have shown resilience and are some of the best performing equity markets year to date, with the Chinese equity market outperforming the S&P 500 by approximately 11 percent in USD terms. Looking forward, as life returns to some semblance of normalcy in Asia, we expect to take advantage of specific opportunities in the consumer retail and leisure spaces, and to add to our existing health-tech and ed-tech companies.

Fixed income markets, generally a safe haven, have also been volatile this week as correlations with equity markets turn positive. This is in large part due to impairment in liquidity in the fixed income markets including in the U.S. Treasury market. In fact, off-the-run Treasuries had significant bid-ask spreads and government-backed agency mortgages widened out to about 160 bps. As a result of the increased illiquidity in the cash markets, the cash-futures basis also widened significantly. This spread started narrowing towards the end of the day on March 12 as a result of the $1.5 trillion repo facility offered by the Federal Reserve. It has remained fairly stable at the time of writing of this note. One reason for the cash-futures basis dislocation was the difficulty of financing in the repo market. This widening move put a lot of pressure on fixed income relative value funds that generally take advantage of spread convergence through a long cash and short futures trade.

Some of these funds have liquidated their positions including their Treasury cash positions resulting in downward selling pressure on Treasuries. However, funds have continued to hold their positions and their MTM losses should collapse at time of delivery of the cash instrument into the future.

Hedge funds have also been a bright spot in portfolios as many strategies have performed in line with expectations. Equity long short funds have seen meaningful contributions from their short positions and, absent a short squeeze, will continue to look attractive relative to global equity markets. Relative value strategies including those trading equity volatility have been positive in portfolios and continue to be a source of alpha. Underweight positions in hedge funds are looking to be attractive areas to add exposure in this environment.

High yield bonds and loans have also been under heavy pressure amid the broader risk-off sentiment, compounded by heavy outflows from mutual funds and ETFs. These bonds traded at their highest levels since summer 2016. Interestingly, selling is not panicked and markets are functioning in a more orderly fashion than they did in other recent selloffs (e.g., Q4 2018, 2015-16, and 2008-2009). While high yield spreads have doubled, they remain a long way from 2008 levels, and, unsurprisingly, most spread widening is related to the energy sector. We are, however, far from corporate distress levels witnessed in 2008, though are watching closely for signs.

We are focused on identifying opportunities in high-quality, larger companies that fundamentally are well positioned to withstand a period of prolonged economic weakness and whose spreads have fluctuated between 300 and 600 bps. For “eye of the storm” sectors such as leisure and energy, investors continue to be on the sidelines. Lower demand for air travel and hotels severely impacted the leisure industry during previous selloffs, but the industry eventually recovered. Nevertheless, permanent changes to consumer behavior could be impacted and it remains unclear the magnitude of this longer-term impact. An area within credit we are monitoring closely is aviation finance. With significant distress in airlines stocks, we are looking at developments in the aircraft leasing sector. Historically, when exogenous shocks have temporarily reduced air traffic demand, declines have been moderate, and growth has quickly resumed. While we expect COVID-19 to challenge carriers in the short term, questions remain around the timing of a recovery in the intermediate term. We are observing a slight rebound in Chinese air traffic as the spread of the virus decelerates there.

Private equity and venture funds have asked companies to ensure they have maximum financing to weather this crisis. The most adaptable companies who adjust to changing situations will survive and exceed.

WHAT'S NEXT? THREE KEY OBSERVATIONS TO GUIDE EXPECTATIONS

1. Understanding the likely path of the disease is what matters most now for markets and society.

Financial markets are pricing in worst-case scenarios: a further exponential spread of the COVID-19, broad-based economic disruptions and business failures, and a continued delayed response exacerbating already slow government action. But other scenarios are possible. Markets remained relatively calm as long as it seemed possible to contain the health threat. They welcomed reports in late February that the rate of increase in new cases in China was slowing. At the same time, Singapore was succeeding in limiting the virus's spread, and South Korea's robust response – with mass testing, swift information and early action – also appeared to be effective. When the outbreak spread to Europe and America and – even worse – the number of cases exploded day by day and jumped from place to place, that fear took hold.

Markets need information to function smoothly. In a crisis of fear, uncertainty is the worst enemy, and was a major factor in this week's wild market swings. The inexplicable lack of testing in the United States – fewer than 10,000 tests across the nation as of mid-week, compared to South Korea's 10,000 daily capacity – means that what we know is that we just don't know. Without proper data, we cannot measure whether the disease is spreading or being contained, nor which measures work and which do not. Markets will only be able to stabilize when there is reassurance that new cases are no longer rising exponentially and there is an end in sight to the collapse in economic activity.

The delayed and confused federal response to COVID-19 terrified investors, businesses, and individuals. We were reliant for now on drastic but uncoordinated actions by state and local authorities, individuals and families, health care providers, educational institutions, and the private sector to curb the spread of disease. By Friday, it seemed that the White House was getting ready to take more serious action. If we are lucky, the curve will begin to flatten sooner rather than later, and markets will be able to price in a path to recovery.

2. Getting economic policies right will also be crucial: the United States may yet show its strength.

Amid this market and economic turmoil, some analysts have begun to debate the likely timing and shape of a recovery. In addition to containment of the disease, bold action to support the economy will be needed for any recovery to take hold. Early commentary that demand-side policies were pointless in the face of this supply shock was simply wrong. Shocks of this magnitude ripple quickly and in unexpected ways through the complex global economy. Doing too little too late could mean a cascading of risks through markets and the real economy, as the global financial crisis showed in 2008-09, and the euro crisis two years later.

As before, monetary policy makers at the Fed have acted swiftly and creatively – while those in continental Europe are lagging. After an emergency rate cut last week, the Fed moved this week to offer $1.5 trillion to stabilize markets after strains were observed in key markets. Canada's central bank and the Bank of England – governed by Mark Carney this week – have also cut rates and boosted liquidity. As this proved insufficient, and worsening market dislocations threatened, the Fed – working with other major central banks – announced a further massive package on Sunday. The playbook borrowed from that following the global financial crisis. Too soon to tell if it will work in today's crisis, but clearly the right direction.

In contrast, the European Central Bank, now under the leadership of Christine Lagarde, disappointed with no rate cut at its regular meeting, although it did promise further bond purchases. Lagarde then made a widely criticized stumble in her press conference that sent European markets into another spin. Her suggestion that the ECB would not try to keep euro area bond spreads close together tanked Italian government debt. The ECB is likely hamstrung by the familiar resistance of Germany and the Netherlands to expansionary policies, whether monetary and financial actions by the central bank or fiscal measures such as government spending or tax cuts. If French President Macron is unable to persuade his colleagues to loosen up, the economic outlook in Europe is grim. Germany's sudden announcement Friday of a boost in public funding for German industry is a good step by Olaf Scholz – a Social Democrat in Chancellor Merkel's coalition government. He may find it hard to take more direct and sizeable action.

In the United States, while Republicans and Democrats in Washington may fight over where to target government help, it appears likely that some fiscal aid will be forthcoming.

As the health crisis unfolds, such support will be needed urgently by many Americans, including families without adequate health care, workers facing layoffs but unable to claim unemployment insurance, and children left hungry without free school meals and access to computers and internet as they are sent home. Support much bigger than announced for students with loans and for small businesses that cannot weather closures or the hit to cash flows from the sudden shut down in activity, as well as for some major companies hit by the shock to supply and demand (e.g., travel firms) is also needed.

3. Absence of global leadership at a time of global crisis is worsening the outlook.

Haphazard and uncoordinated measures across the world have demonstrated an absence of global leadership at a time of global crisis. Senior health officials called the crisis a pandemic privately in January in Davos, but only officially announced a pandemic on March 11. Much time was lost.

In 2008, President Bush called world leaders together in the G20 to address collapsing financial markets. After working together, China, the United States, the leading European economies, and major emerging nations all agreed to dramatic, coordinated action to boost the global economy and provide emergency financing through the International Monetary Fund and the World Bank.

Contrast that with today. China's initial secrecy, denial, and refusal to accept U.S. or other scientific help, allowed the new virus to escape into the global population. Since then, the current chair of the G20, Saudi Arabia, has thrown a hand grenade into already fragile global markets and then doubled down, without apparent regard for the economic and financial consequences of upending oil markets. And the other leading economic forum, the G7 group of leading industrial nations, is led this year by President Trump, who implemented drastic restrictions on Europe without consultation and has labelled COVID-19 as a "foreign virus". This will not help cooperation.

The one ray of light is that scientists and medical experts are now working in concert across the globe to develop testing, share knowledge about the characteristics of the disease and best practices for treatment and control, and work toward a vaccine and treatments. This may take time, but it is the only way out of this crisis.

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ROCKCREEK PREPAREDNESS

RockCreek has closely monitored COVID-19's spread and its impact globally and we are taking very seriously its risks. We continue to take steps necessary to safeguard the health of our team and partners. We have a lot of experience with business continuity during crises. Some team members have worked on financial and health crises in fragile states during their tenures at the World Bank, while our advisers have experience in the United States and Europe dealing with different levels of disease spread. Already, we have moved the majority of our team to remote working. For those remaining in the office, guidelines are in place to minimize any chance of contagion through social distancing, disinfectants, and other best practices. Our inclusive culture and technology investment have allowed us to gain experience with remote working. Our teams are actively working remotely and communicating through calls, Zoom video meetings, and other teleconference technology. Travel restrictions are in place, and all RockCreek travel is being cleared in advance. Given our team approach, we expect disruptions would be minimal in the event team members are quarantined. In January, we instituted limitations on visitors and staff who had traveled to affected countries.

The safety of our team members and their families, and of our clients and partners is our top priority. We have consulted with expert health officials and instituted a variety of precautions based on guidance from local and global public health organizations. We continue to take a dynamic approach to this complex, evolving situation to ensure we are implementing sustainable safeguards for our team members and partners.

Our long-standing business continuity plans and disaster preparedness plans are tested regularly. Our IT infrastructure has back-ups and is prepared to accommodate our team members as they work remotely.

We value our partnership with you and will stay in touch. Should you have any questions or if we can be of any help to you and your teams, please let us know.

All of us at RockCreek hope you, your families and your companies are healthy and we all help our communities to emerge from this crisis stronger and ready to benefit from new opportunities, technology, and markets.

The RockCreek Team