March 23, 2020

RockCreek

WE ARE IN A RECESSION AND MARKETS HATE IT.

In case anyone doubted it at the beginning of last week, by the end of the week it was clear: the United States plunged into recession in March, as Alan Greenspan discussed in our interview with him. Unemployment insurance claims reported March 19 showed a more rapid rise than at any time since the 2008 crisis – and faster than in any week during that crisis. Markets had their steepest weekly decline since 2008. Circuit breakers were triggered, stopping trading in U.S. markets, a record four times.

This week, we expect markets may experience even greater stress as more layoffs are announced, panic spreads about increased death and sickness in our communities and dire shortages continue -- including in the US -- of essential medical supplies, masks and testing equipment. Also key this week: will the latest US economic package -- now climbing towards an unprecedented $2 trillion but stalled Sunday in the Senate -- pass remaining congressional hurdles quickly enough for markets and the economy. And how will this interact with the approximate $150 billion month end rebalancing by institutional investors.

Finance Ministers of the G20 major countries meeting virtually this week want to show that they can bury differences and work together to combat the health and economic crises sweeping the globe. To succeed, these countries -- which include the US and China, as well as other advanced countries and major emerging markets -- must do better. We know how important it is to mobilize together, not least to encourage scientific cooperation. Stories of hoarding by individuals and countries of supplies that our front-line health workers desperately need are just one sign of major shortcomings in global governance -- just when the world needs it the most.

If this crisis is not to be wasted -- in the famous phrase -- new measures from the government, companies and individuals should be aimed at bringing society together, building on America's strengths in technology and science, and providing for a better future for all its citizens.

WE PLUNGED INTO WAR-LIKE CONDITIONS – AT ASTONISHING SPEED.

We have never experienced a shutdown of economic activity like this. It is a "sudden stop" like no other. Comparisons to earlier financial crises began to give way to comparisons to war. Last week, across the United States and Europe – accounting together for almost half of the global economy – and now in some emerging markets, businesses were ordered to shutter and consumers, to stay home. In the United States, a cascade of lay-offs has followed.

Central banks raced to get liquidity to corners of the market that showed sudden and unexpected strains. Reports surfaced of some European banks refusing to deal with each other, nervous of counterparty risks. Companies raced to be declared essential, and thus deserving of extraordinary loans and government support, as they faced bankruptcy and ordered layoffs. And governments, including in the U.S., are moving to implement dramatic new budget measures to shore up the economy. Even so, it is clear that the U.S. economy will suffer an enormous shock. The only questions are how big the contraction will be – estimates of the decline ranged this week from a decline in output of five percent to a drop as much as five times steeper – and how long will it last. Some expect a V-shaped recovery that could begin in the third quarter if the lockdown eases. There are reasons to be more pessimistic, even if countries act more quickly than before to address financial and economic problems.

Three differences from the crisis in 2008 and 2009 make the point. First, the health crisis needs to be contained before markets and the economy can recover. Today's shock is closer to a natural disaster – or indeed a war – than a typical finance-induced recession. The response to the health crisis is still woefully inadequate and uncertain. Without testing, we cannot know who is at risk and how the virus is transmitted. Second, much financial ammunition was expended last time, leaving central banks with less room to maneuver and more pressure on governments, which are typically slower to act, especially in the United States. Third, although governments across the world are reacting, they are not working together. This contrasts sharply to the globally-coordinated reaction to the 2008-2009 crisis. The growing number of countries resorting to export restrictions on key medical items is just one illustration of how nationalist actions can undermine the effective response to what is a global crisis: more tests, masks, and ventilators could be produced for the world if supply chains were allowed to function and trade to continue.

GOVERNMENTS AND CENTRAL BANKS ARE REACTING, BUT TIME IS NOT ON THEIR SIDE

In the United States, the Fed unleashed more buying power, moving swiftly to extend support to markets for mortgages and corporate loans and opening dollar swap lines to relieve funding stress in key overseas markets. But this was not enough to calm markets. More action will be needed, and more time. As in 2008, there is strong upward pressure on the dollar as a safe haven. The Fed’s actions will slow the rise, but not stop it.

The then-extraordinary measures undertaken in the wake of the 2008 crises took time to feed through. It was many months before financial stability and confidence were restored – years in the case of Europe. Now, as then, the Fed seems willing to throw whatever it can at markets to keep them functioning and able to provide credit to the real economy. Europe also stepped up last week. The European Central Bank (ECB) announced a new €750 billion funding mechanism, with fewer strings, that reined in Italy’s spreads after a blowout the previous week. Governments in Germany and other conservative nations, irritated by ECB activism, reacted by slowing their own behind-the-scenes efforts to galvanize government to government funding. But the European Stability Mechanism (ESM), set up during the euro crisis to provide loans for governments under stress, may yet be activated.

German Finance Minister Olaf Scholz delivered a welcome upside surprise this weekend, showing that he understands crisis economics better than his predecessor, Wolfgang Schäuble. News leaked Saturday that Scholz was pushing a break in Germany's tough debt rules, to allow for borrowing of up to 10 percent of GDP. This would fund a big stimulus package and still more emergency lending to cash-strapped companies. In the United Kingdom, where the government has acted dramatically to shore up demand, including a promise to make up to companies that hold on to workers up to 80 percent of the cost for at least three months, some joked dourly that there was nothing left for the Treasury to do or buy.

As the Western world reels in shock, some key observations for the future, including on portfolios and investments.

1. Change is hard to manage; rapid change is even harder

Crises always demand quick and flexible responses. Most of us are not good at adjusting expectations and responding to sudden change. Financial market participants are among the best. But the pace of change last week, coupled with enormous uncertainty about the likely course of the virus and the policy response to it, was unprecedented. Across the world, markets – as well as medical experts, central banks, governments, and the rest of us – were unable to keep pace with the spread of the virus.

The reaction of many was to panic, hence distress sales of assets across the board. At times like this, concerted and steady government action is of paramount importance, both to reassure citizens and to respond effectively to the problem. In the United States, we saw a particularly dramatic switch last week from inaction – especially at the federal level – to daily announcements of new actions and reactions. Governors and mayors around the country, leading the charge in the initial absence of federal guidance and support, are also scrambling to keep up with the disease.

Now that nearly one in three Americans is in lock-down, the task for most is to adapt to this new reality. Companies are already doing that where they can, with many setting up arrangements for working from home. Restaurants are offering take-out services. Individuals will learn to cope as best they can.

The coming days should see a slower shift in the pattern of our daily lives. At the same time, we need even swifter action from government, on health and on the economy, to answer key questions about what comes next.

2. Governments must step up

As we said four weeks ago, governments need to act decisively on two fronts: to promote public health and support the economy. COVID-19 has put these goals in conflict. The now-drastic actions to curb the spread of disease are causing dramatic economic and financial stress.

On public health, there are still huge failings in the United States: testing continues to be excruciatingly slow; the provision of emergency medical supplies is haphazard, our front-line health workers are increasingly at risk. Medical experts have stressed the importance of testing in order to understand the disease and combat its spread. In the United States, as of mid-week, we had tested only 74 people per million inhabitants. Compare that to South Korea, where 5,200 per million have been tested.

As testing and other issues are gradually addressed, we will learn of more cases and more deaths. This will add to public concern. But it will also help the current fog around the future to clear. The indicator to look for is a switch from today's convex curve of reported infections – with bigger and bigger increases every day – to a flattening and eventual peaking of that curve.

Until that happens, expect the lockdown to stay in place, perhaps expanding across the United States to cover more than the 100 million Americans already being told to stay home. In the meantime, governments are the only ones that can keep the economy afloat and limit the human and business costs of stopping the economy in its tracks.

The Trump administration and Congress have been working to put together a massive stimulus package, the third one for coronavirus, that is approaching $2 trillion and getting bigger by the day. We saw the legislation get bogged down in political arguments this weekend over the type of support: should funding be channeled primarily to businesses or individuals, with strings or without. Governments around the world are choosing different ways to support their economies, whether through loan forgiveness or tax relief, direct payments or support in kind. Congress should not delay: more is better and sooner is most important.

One bright spot was the widespread support, following the lead from Treasury Secretary Steven Mnuchin, that any package should include putting money into the hands of individuals and families across America. The fiscal response to the 2008-09 crisis relied too much on slow-to-execute public investment and too little on support to households. That dented consumer confidence for years and slowed the pace of recovery. Shoring up the finances of state and local governments is also crucial.

Without more federal help, many states and local governments will be forced by balanced budget provisions to cut back just when needs are expanding.

3. In time, countries and citizens will face the trade-off: fight COVID-19 with "whatever it takes" or fight economic hardship

Fear of spreading illness and mounting deaths is making the trade-off between public health and economic health seem simple. No one wants to see a breakdown of the health system, with horror stories – and pictures – of piled up bodies and medical workers succumbing to the virus.

A U.S. governor declared last week that if it saves one life, the lockdown of his state will be worth it. But as the disease ebbs, as it will at some point, that position will look less tenable. The economic and social costs of lost jobs, bankrupt businesses, grounded planes, shuttered restaurants, and even hungry children without school lunches, as well as regular lessons, will start to weigh more heavily. We accept deaths from car accidents, from murders, even from childbirth and despair, that could be reduced with government actions and prohibitions. Maybe COVID-19 deaths will begin to look comparable if we see some success in fighting the virus, changing the trajectory of its spread.

A sharp reduction in new cases seems to be happening already in China, Korea, and elsewhere in Asia where the virus hit first. There, governments reacted with ordered isolation and mass testing. The critical question is whether a gradual re-opening and return to work leads to a resumption of infections. Reports from Korea of 129 cases apparently linked to one call-center suggest that this is a real danger.

So far, we know that slowing the spread of infection will allow breathing space for health systems to prepare. The race is now on for scientists to find effective treatments and eventually a vaccine. The latter will take 12 to 18 months at least to be tested and manufactured at sufficient scale. It is likely that governments will loosen restrictions before then. We may need to prepare for waves of economic disruption, in case a gradual return to work sets off a new wave of disease, calling for a new wave of social isolation and economic shutdown. Being prepared for this will be smart.

Looking further ahead, there will be changes to the economy that are not yet imagined, but in time will become the new normal. Just as 9/11 led to changes in security procedures, COVID-19 will lead to changes in health care, biotech, and pharmaceuticals, as well as cleaning and sanitizing products and protocols. Human resilience and ingenuity will be key as always.

One thing is clear: we are entering a period where a return of big government will be welcomed by many around the world, whatever their political leanings, with important consequences for companies, markets, and societies.

4. Portfolios, Positioning and Opportunities

The last week has clearly been all consuming for the endowments, foundations, pensions, and other institutional investors we serve. We continue to keep liquidity and be poised to take advantage of dislocations in the markets. It was a week where getting a bite to eat meant missing potential 3% up or 12% down moves in equities or spreads widening to over 60 bps between future and cash positions in fixed income (where 2-4 bps is usually the norm!).

At RockCreek we are focused on mispricings in the equity, credit, and fixed income markets and where we can adjust exposures to add long-term value.

Within fixed income markets we came into this market environment already positioned in higher quality fixed income instruments. We have been saying, albeit too early, for the last few years now that high yield was increasingly risky and we have had no exposure to high yield and very little to corporate credit, which have seen massive spread widening and losses over the last week. We continue to maintain a quality bias in fixed income which has rewarded portfolios thus far.

Looking ahead over the next six months, we are looking opportunistically to add inflation protection. Given our experience at the World Bank and IMF with dramatic, short-term volatility, we believe that automatic rebalancing rules need to be reset to larger bands and done in a more thoughtful way, spread over a longer period. Companies and funds with leverage and inadequate cash are getting crushed. Credit markets have deteriorated rapidly after lagging broader equity markets.

What initially appeared to be more specific selling related to industries directly affected by COVID-19 and the oil trade war spread more broadly into all industries and credit sectors. Beginning this week, cash bid lists and offers have been pouring in rapidly. While the selling started the week in an orderly fashion, it deteriorated quickly and became dysfunctional. By mid-week bid lists were no longer trading and moved to mostly DNT (Did Not Trade) and most transactions were happening away from the screens.

The selling pressure was the result of mutual funds and ETF redemptions. As the market downturn magnified, these investors turned into indiscriminate sellers and were joined by large levered investors who were forced to sell when their financing lines began to get pulled. Even investment grade credit faced dramatic selling pressures this week with over $35 billion of outflows, the largest ever on record.

We are looking cautiously at rescue credit and more broadly within credit for areas where we can deploy capital across higher quality investments. For example, there may be opportunities in senior secured debt issued by high quality companies or debt of companies in which a takeover has been announced and approved but the deal has not yet closed.

Equity markets were incredibly volatile last week. Although we believe we are not at the bottom, we are opportunistically identifying longer term themes. This includes most importantly a bias toward high quality, dividend yielding companies that have sold off during the periods of indiscriminate selling we have seen in these volatile markets. To understand the magnitude of the opportunity one just has to look at large, stable pharmaceutical companies trading at 6.5x earnings today versus 13.5x + earnings a month ago – there have been no changes to the company fundamentals or business model. If anything, there's considerable upside in terms of opportunity given the pandemic.

In the private markets, our portfolios have benefitted and will continue to profit from themes we introduced over the last several years in health care – including telemedicine and education – distance learning, and renewable energy.

In particular, we would highlight investments in: a clinical stage biotechnology company developing vaccines; a portfolio company that has developed a technology to expedite the archaic vaccine dosing process; a telemedicine platform geared towards students accessing healthcare while at college; and a company providing communication infrastructure through an app between school districts, teachers, and parents. Over the coming months we will continue to look for companies and sectors we think will be in line with our new norm as people's habits and ways of interacting with each other and in business experience change. We believe rebalancing needs to be implemented in a more thoughtful way and over more days.

We hope that you, your families and teams continue to be healthy and safe in these uncertain times. Our RockCreek team remains actively in communication with each other and our partners. We have been in touch with many of you over the weeks and hope that you will reach out if we can be of any help to you and your teams.

We have virtual town halls and investment committee meetings and maintain open lines of communication with all our teams and frequently disseminating internal communications. Our COVID-19 steering group, comprised of IT, security, engineering, and operations meet virtually daily and review preparedness and plans for new steps. The RockCreek management team meets regularly and is especially vigilant and mindful as the crisis continues.

Team RockCreek