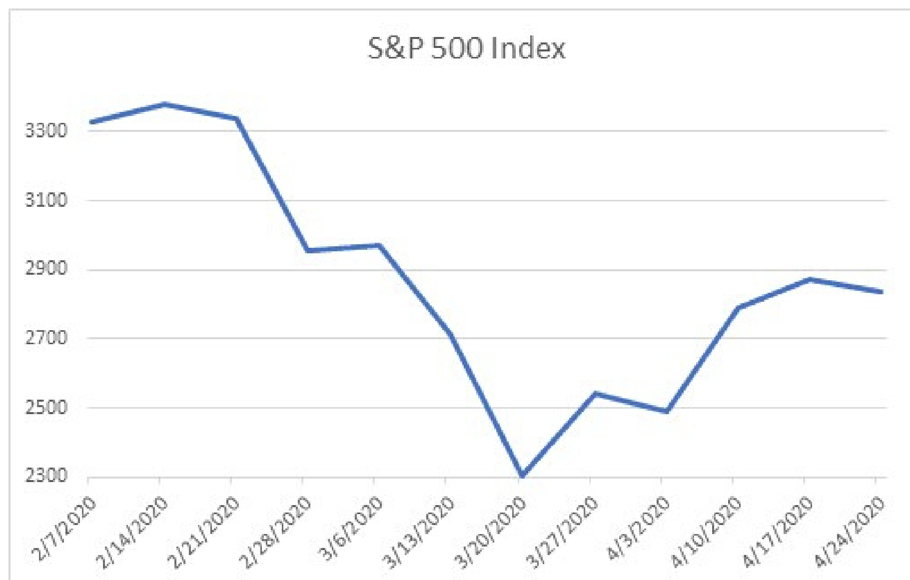
MONDAY, APRIL 27TH 2020

THE LONG HAUL

Just as states and countries are moving to reopen, the reality is sinking in: we have a long haul ahead. Oil markets have been particularly mind-boggling, with negative prices last week for May US futures contracts. Demand has disappeared on top of supply shocks. More broadly, markets that shot up from the March 23rd low took a pause. The reason: it is becoming clear that life is not going back to "normal" anytime soon. Some businesses will survive, others will prosper. But few, if any, will reopen unchanged. Meanwhile, unemployment claims in the US have now topped 26 million. There are bound to be more strange twists in our pandemic economy.

Businesses need to rethink how to function in a world where Covid-19 lurks, unvanquished. As politicians toggle between the considerations of health experts and businesses – watching infections and deaths on the one hand and soaring unemployment on the other – many are likely to lift lock-down orders, long before we have a vaccine or effective treatment. Few countries are able or willing to follow Australia and New Zealand on the ambitious path of eliminating Covid-19 internally and then closing the borders. True, it may be possible to contain, rather than crush, the disease, if health systems can cope with the sick, and society with the deaths, as the disease recedes. But even that will be risky. Social distancing has curbed infections and deaths dramatically. But for as long as testing is in short supply, the virus may be able to spread again unseen and unchecked. It is hard to see a full-throated economic rebound in that world, however much liquidity the Fed pumps into markets.



Looking ahead, five observations for investors to consider:

1. This crisis is unlike any other, and as time goes on, uncertainties have only grown

The more we learn about the disease, the less we seem to know. Estimates vary wildly about how contagious Covid-19 is, how deadly it is, and why or how it kills. At first, medical concerns focused on the lungs and breathing difficulties. Now, some studies show that Covid-19 can trigger kidney failure, heart attacks, and even strokes.

One of the few certainties: life and work will be different, in many ways that matter, until scientists and medical experts have reduced concerns about the disease to no more than background noise. And the magnitude of these effects will differ across industries. Manufacturers are already formulating plans to keep workers safer. On the factory floor, social distancing and worker protections are feasible, if expensive. The measures will take getting used to. They will also add to business costs, and to pressures to automate further. At the same time, "just-in-time" models relying on global supply chains to minimize costs will be challenged. Those issues seem simple compared to the ones facing companies in service industries, where most Americans are employed. Despite all the publicity around Georgia's newly opened tattoo parlors and nail salons, we are seeing that many consumers in China are slow to take up leisure activities that now come with a risk of a deadly illness. How will restaurants, bars, sports arenas, hair salons manage social distancing without killing the fun? Not to mention airplanes, hotels and other huge parts of advanced economies.

It is natural to look back to try to understand the present. But this time it is hard to find the right analogy. Governments in the US and Europe have learned from 2008, and acted swiftly, with some success to shore up markets. A month ago, it was common to wonder how this recession would compare to the global financial crisis. In one sense, the damage has been less: financial markets have not broken down and Fed actions have held financial market conditions in check.

But with unemployment now expected to soar above its post-war peak in a matter of weeks, analysts are looking back at the Great Depression for comparison. Important lessons for fiscal policy and government spending can be found there. Some have compared battling Covid-19 to fighting a war. But this is no war economy, when production runs full tilt and everyone is needed to work. Instead of Rosie the Riveter, we have legions of unemployed. The government can, and should, try to minimize their pain and – perhaps – put them to work helping to build our post-Covid-19 economy. We need the equivalent of a small army of workers to carry out health tasks – testing, temperature checks, and contact tracing – as well as the additional cleaning and other services that will be necessary in businesses and public spaces. And, if politicians can agree, there will be jobs improving and future-proofing infrastructure, including providing adequate internet access across the country.

The St. Louis Fed Financial Stress Index provides a weekly measure of the degree of financial stress in the markets, constructed from 18 daily data series: seven interest rates, six yield spreads, and five other indicators.

2. Partisan politics is back in Congress again; that will hurt the economy

Congressional action since Covid-19 hit us has been impressive. Last week, President Trump signed into law the fourth bill designed to shield the economy from the worst impact of the pandemic. Although not as large as the third coronavirus bill, which allotted $2.2 trillion to recovery efforts, the latest was by most measures a substantial boost. It mainly benefited small businesses – with $310 billion to replenish the Paycheck Protection Program loan, $60 billion reserved for lending by community banks, and a special $75 billion for hospitals. But a gaping hole remains. As we have been saying for almost two months: state and local governments need large-scale support from the federal government. The crash in economic activity is cutting their tax revenues at the same time as rising unemployment and demand for social programs is pushing up costs.

Unless the federal government moves to fill the budget gap, states and local governments will be forced to reduce spending and/or raise tax rates – slamming on their fiscal brakes just as the federal government is trying to press on the accelerator. The result will be a weaker economy across the board, hurting both red and blue states. Senate Majority Leader Mitch McConnell threw down the gauntlet last week, saying that states in fiscal trouble should consider filing for bankruptcy rather than looking for federal aid. Others have pointed out that Covid-19 is like a natural disaster: disaster relief is a federal responsibility as well as a local one. It is worth remembering that teachers, police, firefighters and other essential workers are among the millions employed and paid for by local and state governments.

3. Two camps of investors: we can hope the optimists are correct, but should prepare for the pessimists' view to come true

After weeks in lockdown, investors are starting to focus on the economic and societal tradeoffs associated with opening the country back up – and what that means for their portfolios in the long run. The more optimistic ones are looking at a potential economic recovery beginning mid-year and maybe a return to "normal" in 2021. On this view, perhaps the markets have had it right after all? Others, including RockCreek, see a longer time horizon before a sense of normalcy returns across sectors of the economy, and are preparing for another leg down in markets.

One gauge of uncertainty comes from universities, many of which have endowments to safeguard. Listening to universities highlights the uncertainty most of us face, one way or another. University leaders are finding it hard to plan a fall semester and they worry about the financial burden continued shutdowns will place on their future sustainability. They are not alone. We are looking through our portfolios to see which businesses, regardless of sector, have strong balance sheets and the ability both to weather this storm and come out in a more competitive position. It still makes sense to move portfolios toward higher quality companies that are building up their franchises and can handle this disruption given their business model.

We have written previously about our enthusiasm when looking at our current portfolio, which has included sustainable investments in health, education and distance learning, as well as new investments targeted at the intersection of education, technology, and healthcare. The broader investment community seems to be catching on: telemedicine and distance learning are the new buzzwords. Wouldn't it be rewarding for investors if out of this crisis comes a host of innovation in these areas that generates strong returns and maybe even helps address the growing inequality across different communities?

4. What about credit? Watch for where government intervention may overwhelm apparent opportunities

Credit is hot: it seems as if every other day another firm has closed on a $1 billion fund targeted at the disruption in credit markets brought on by the pandemic. Will the opportunities credit investors are rapidly gearing up for really materialize? Or will the returns be muted, tie up capital for longer than needed, and disappear faster than they come?

We have been analyzing the different areas of credit looking, for each, at the expected returns, duration, leverage and risk in anticipation of selectively investing in the appropriate areas for our portfolios. The most immediate headlines have been around the TALF funds that are designed to be "low risk" and promote buying of AAA tranches. These funds are attractive but may have too little return for some investors given the three to four-year term. With such dynamic markets the spread at which funds will be able to purchase ABS/CMBS/CLOs is ultimately an important consideration for whether it is a worthwhile place to focus.

Dislocation funds have also received increasing attention as credit investors look to focus on higher quality, performing credits of businesses still trading at discounted prices. Solid businesses that have faced liquidity issues may be ripe for financing, and the potential need could be great if we are right that the economy will take time to recover from the virus. With these types of investments, credit selection, limited leverage and identifying opportunities that are mispriced but offer little chance of impairment could be a solid risk/return proposition.

The wait-and-see approach may lead investors to be ready for distressed opportunities as they materialize in the medium to longer term, but again, this is dependent on the timing of a recovery. True distressed investors who take total control will be looking for companies where the likelihood of restructuring is high, and the post reorganization prospects are attractive. Return expectations should be well north of the low to mid-teens returns from TALF funds, but the timeline is also extended. Although there is a higher likelihood of capital impairment, with the right credit selection and restructuring expertise, this area could be the most interesting in the aftermath of the dislocation.

As we look across the landscape of where to take risks, we are cautiously optimistic. Depending on return expectations and liquidity tolerance, there will be much to do in the coming months. Keeping dry powder on hand is essential to take the appropriate risks at the right time.

5. Weirdness in the oil markets: and likely more to come.

On Monday April 20th, the front WTI crude contract settled at a mind-boggling negative $37.63 per barrel; an event so strange that the CME group sent an email to its members clarifying that WTI futures contracts "have no low limit and may trade negative." Though prices have stabilized in recent days, questions remain on many investors' minds: how did this happen, and will it happen again?

Some investors learned the hard way that futures contracts require physical delivery at settlement. For weeks, RockCreek has been highlighting that with the collapse of energy demand from Covid-19, output cuts agreed by OPEC+ would not be enough to stabilize markets. At the same time, dwindling storage capacity drove investors who were long futures and facing the end to get out of their positions at any cost. In some instances, that resulted in paying the buyer a premium of more than $37 a barrel to take the oil off their hands. Violent price swings were exacerbated by the relative illiquidity in the contract, as most market participants had already rolled to the next contract.

Who then was left long? Many retail investors – or energy "tourists" – jumped into both futures and the USO oil ETF believing that oil prices had hit bottom and would rally. What less sophisticated, USO investors may not have known is that with the purchase of this ETF, they were buying futures that depend on both the current and future price of oil and the costs of storage.

What is a less risky way to express a view on the oil market? Most experts are bearish on prices, until there is a significant uptick in demand across the global economy and a drawdown in inventories. Investing in large and stable energy companies, that are shifting into renewables and away from oil, has more upside opportunity, less climate risk and we believe is the better path.

RockCreek Update

The RockCreek team has completed our sixth week of working remotely, and our remote set ups have served us well. Like many others, we are drawing up careful plans for the eventual return to offices while continuing with remote work as usual. We have been talking to medical and other experts and reviewing the evolving guidelines provided by federal and state authorities. We are developing a plan that includes a phased approach centered around screening and configuring workspaces to implement social distancing measures. In parallel to these practical measures, we are also reflecting on our experiences and those of our partners and communities. Our entire team is especially grateful to have strong, trusted relationships with our clients and partners. We continue to work with our communities and support local businesses. We look forward to hearing about any ideas you might have to make a positive impact during these difficult times.

Team RockCreek