RockCreek

MONDAY, APRIL 13TH 2020

THE POWELL PUT?

Can the Fed save the economy from Coronavirus? Markets last week couldn't decide. As Federal Reserve Chair Jay Powell unleashed yet another $2.3 trillion on April 9, equities had their best week in 45 years. Stocks priced in a quick return to business as usual. But corporate credit markets stayed cautious, while downright gloom continued to surround structured credits. Meantime, the real economy continues to crater. And the US death toll from coronavirus is now the highest in the world.

Listen to our latest episode of Finance Forward to hear Caroline Atkinson and Afsaneh Beschloss discuss the government response to the pandemic with Dr. Peggy Hamburg, former FDA Commissioner and Chair of the American Association for the Advancement of Science.

The world is in the grip of the worst slump since the Great Depression; but for how long? As data mounts up about the economic costs of the shutdown, economists agree that the real economy is in deep trouble right now. What is harder to judge is how long the pain will last and therefore how bad the scars from the recession will be. Unemployment has climbed as much in three weeks as it did over two years during the 2008 financial crisis. The 17 million Americans who have been thrown out of work since early March are hurting badly. State unemployment offices are overwhelmed, an estimated one third of rent payments were not made when due last week. Food banks are struggling to meet demand. Other indicators, such as electricity demand, show the enormous hit to the economy just in March. April – with a full month of lockdown under the most hopeful scenarios – will be worse. New economic forecasts this week from the International Monetary Fund (IMF) will make depressing reading. It still depends mostly on the virus.

The evidence is building: the all-important flattening of the curve has begun. Drastic economic shut-down seems to be working, perhaps better than expected, to curb the spread of the coronavirus. Governments in Europe as well as in the US are beginning to work on how and when they can ease restrictions and allow a return to work. If the US and Europe can reopen successfully over the summer and fall, this recession could be one of the shortest as well as one of the steepest. But health experts are still warning that a premature return to work will risk a resurgence of disease. They point to the need – still – for much more testing capacity in the US to judge who can safely mingle with others. And while infections level off in New York, they are still rising in other parts of the country. The terrible death toll in the US – which now has the highest number of fatalities from Covid-19 of any country in the world – should give this pause. As Dr. Anthony Fauci said this weekend, there would have been fewer deaths with a swifter lockdown. Businesses eager to reopen might turn their eyes to Sweden, where a laissez-fare approach is being put to the test. But the jury is still out on how Sweden will fare: infections are rising and GDP is expected to decline sharply there as well.

Investors are watching the Fed, as well as Covid-19. The Fed last week pushed its support into corners of the market where central bankers normally fear to tread. In addition to a ground-breaking "Main Street" facility, and support for munis, the Fed expanded lending programs even to parts of the junk market – so-called fallen angels. Investors may be perplexed by the market reaction: equities pricing in a three-month shut down, corporate credit is pricing in a three-quarter shut down and structured credit is pricing a three-year shut down.

Regardless of which market is right on timing, taking a long view is wise. We continue to look to deploy capital into assets where we believe extreme downside has been priced in and there is long-term upside.

What to watch for: a few key observations

1. Central bankers proved skeptics wrong: they still have enormous power to support the economy

Before coronavirus, many worried that the Fed and other central banks had used up all their ammunition, leaving nothing to fight the next – inevitable – recession. We were all wrong. The extraordinary actions taken by the Federal Reserve in the last month have convinced markets that they need not panic, kept financial institutions from buckling under the strain of a collapsing economy, and are providing support – through the banks – aimed at keeping Main Street alive. Given the shock of the crisis, there has been little push back so far. Economists, including Jay Powell's predecessors Janet Yellen and Alan Greenspan, have been generous and vocal in support of the Fed going "all in." However, difficult judgements are yet to come – which companies and sectors to prop up, and when is liquidity support keeping "zombies" alive inappropriately. This will likely complicate things for the Fed down the road, especially if oversight from Treasury is lax, and the money goes mostly to bigger companies, better able than small ones to get access to banks. Even worse, politically, if the "small companies" are ultimately owned by private equity firms.

2. Congress is fighting over next steps: will we get Coronavirus bill #4 in time?

The Fed may be "all in" but, as Chairman Jay Powell made clear last week, we urgently need the government to step up as well, with more fiscal support to counter the yawning hole in private activity. It is for Congress and the Administration – not the Fed – to take on the political tasks of sharing out the burden of economic losses from the shut-down and providing sustainable support to those in need. Republicans are right that small businesses urgently need more funding: the Peterson Institute for International Economics noted in its semi-annual Economic Prospects presentation that, before the crisis, the median small business has just a couple of weeks of cash on hand. But Democrats are also right that the federal government must ease the funding squeeze on states and local governments, individuals and the health system. What the economy cannot afford is political infighting and delay.

3. The virus knows no national boundaries; neither does recession

IMF managing director Kristalina Georgieva warned this week that growth is turning sharply negative across the world. She predicted that in more than 170 countries real incomes per head will fall in 2020. So far, policymakers' attention has been focused internally as economic measures have been crafted, just as with health responses. But as we are seeing already in China, the world's second largest economy, the outlook for

each nation can be made better or worse because of the global multiplier. China is back to operating at an estimated 80 percent of capacity; the drag on its economy now comes mainly from weak global demand rather than supply constraints. The US and Europe – and China – can borrow to finance extraordinary relief packages. Most emerging markets and low-income countries are less fortunate. As the scale of capital outflows from these nations becomes clearer, the center of gravity in policy circles is moving towards favoring a widespread debt standstill. Even the International Institute for Finance (IIF) is calling for this.

4. The Fed gave something to everyone last week.

The Fed's liquidity programs (Term Asset-Backed Securities Loan Facility (TALF) and Primary and Secondary Market Corporate Credit Facilities) contributed to a cyclical and junk rally within equities, and fixed income markets responded to the additional flood of promised liquidity. Banks geared up for more activity as the Fed added a financing facility for the Paycheck Protection Program (PPP) – aimed at supporting small business through the Small Business Administration (SBA). Smaller community banks in particular that have stronger relationships with small and mid-size business should be able to take advantage of these programs, making this segment of financials a potentially interesting area in which to invest. Although many complained about difficulty in accessing the program, the numbers tell a different story. The SBA usually lends $25-30 billion a year and now in a matter of weeks has put out some $150 billion of the $350 billion Congress approved. A question remains, however, whether the many smaller firms without relationships with major banks will manage to access these loans. Some fear that instead, money may go to wealthy individuals who also own small businesses.

The Fed's expansion of its primary and secondary corporate bond purchasing programs and TALF aimed to boost liquidity in strained markets for AAA, CMBS and CLOs. The illiquidity which hurt some institutional investors also led to a dislocation opportunity. Many credit funds have raised capital to invest opportunistically in areas of the market that do not see relief from the Fed. Also of note to investors with investment grade credit exposure was the Fed support of the BBB-rated and lower investment grade credit securities – the "fallen angels." The Fed actions should prevent further concerns around an active downgrade cycle. But the question for investors: there may be a political, if not technical, limit to Fed support. And at some point, no matter what the central bank does, the equity market will start to price in deteriorating company fundamentals, as credit markets have been quicker to do.

5. Don't be passive.

We remain cautious on entering markets indiscriminately or through passive indices. Current policy support from the Fed and the government provides critical short-term relief. But it may not be sufficient to overcome the negative news ahead of Q1 (and later on, expected Q2) corporate earnings. Q1 announcements coming next week will begin with the large banks (JPM and others). Last week's junk rally owed much to short covering of all the most beaten down stocks – leisure, airlines, REITs. It was painful for those investors still unwilling to underwrite increased cyclical risk in their equity portfolios. Again, a case for active management and a potential shorter-term buying opportunity in those defensive, stable high-quality stocks left behind.

In emerging markets, discrimination also remains key, with North Asia still doing better than other areas. We saw continued signs of virus containment in China, along with Korea and Taiwan, marked notably by the suspension of the 76-day lock-down of Wuhan. Some 55,000 people left by train immediately. It remains to be seen what the long-term structural changes to China's economy will be. In the short term, tourism and travel

related companies will see a rebound although a second wave of infections – not yet ruled out despite China's aggressive moves to curb any new infections running out of control – would obviously deal another blow. Investment opportunities in Chinese companies that have mainly domestic driven businesses are interesting in the short term as they benefit from China's earlier recovery from this crisis. Global companies with considerable China exposure are also increasingly attractive as they have existing franchise businesses, and solid balance sheets.

Emerging market central banks have largely continued to ease monetary policy in response to a bleak growth outlook and rising financial stability risks. But these actions have tended to weaken currencies and fuel capital outflows. In addition, erratic approaches to the COVID-19 crisis by countries like Brazil and Mexico have negative implications for the timing and magnitude of their eventual recoveries.

Energy markets remain unsettled – unsurprising as the oil market collapse now in full swing has no historical precedent. Economics, and politics, finally drove Russia and Saudi Arabia to agree in principle to production cuts of some 10 mbd. Pushed by the US, they recognized that plunging oil prices was not helpful to any of the three countries and even got G-20 energy ministers – chaired this year of course by Saudi Arabia – to formalize support for market stability. OPEC reached a broad deal Sunday. But with demand at rock bottom, prices are not going anywhere fast. While this hurts middle east producers, shale oil and some important sovereign wealth funds, cheaper oil will be helpful to the large commodity importers in North Asia, India and the rest of the world.

RockCreek Update

We hope that you, your families and teams continue to be healthy and safe in these uncertain times. The RockCreek team continues to work remote as our investments in technology have made the transition easier and we are looking at the applicability of some of this adaptation to the post virus period.

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 all appreciate the brave work of our first responders, doctors, nurses, and all health professionals as well as others in the agriculture, food and delivery services putting their lives at risk for all of us. They are the heroes in this crisis. At RockCreek we continue to work with our communities – to find sources of masks and PPEs, assist local food banks and small businesses – and research groups. We continue to reach out to our partners and other investment firms to join us to leverage our resources. Please let us know if you have any ideas.

Team RockCreek