RockCreek

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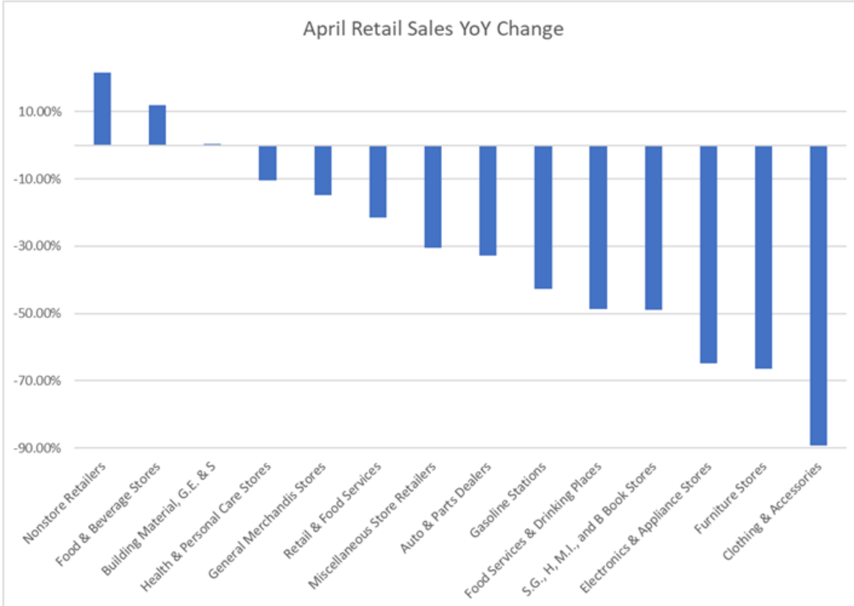
UNFREEZING

When the snow melts after a huge storm, who knows what may be uncovered? The US economy is now reopening – unevenly but unmistakably. April may have marked the low point for the economy. If Covid-19 reasserts itself in coming months, as health experts have warned, look for a stop and go recovery, with still elevated financial and economic risks. Markets remain apparently unworried despite warnings from the Fed and others. But don't rule out another leg down if earnings and the economy disappoint.

<u>Finance Forward:</u> RockCreek Senior Advisor and former Federal Reserve Chairman Alan Greenspan warns that with the virus still here, economic uncertainty abounds. Listen to his discussion with Afsaneh Beschloss and Caroline Atkinson in the latest episode of RockCreek's podcast.

More fiscal stimulus is unlikely to come for some weeks, despite the call from some unlikely quarters, like central banks. Federal Reserve Chairman Jerome Powell warned last week of a "highly uncertain" path ahead, commenting on the pain felt by the lower paid, with some 40 percent of those in households earning less than $40,000 a year now laid off. The House has passed another stimulus package. But it was declared dead on arrival by Senate majority leader Mitch McConnell and the Administration also criticized its $3 trillion price tag. Negotiations now begin.

Fed actions to support the economy continue to impress markets, which have largely held on to the gains reached in mid-April. Technical risk indicators give a mixed picture: way better than the extremes reached around the market trough of March 23, but still far from fully recovered. A Fed report released on May 15 was candid about the extraordinary strain on financial markets as Covid-19 gathered strength. Looking ahead, corporate leverage – at a 20-year high even before the pandemic – is a particular risk. Defaults are already climbing, industrial production numbers for April were dismal and retail sales even worse than expected. Sales plummeted almost across the board from a year earlier, with e-commerce being the unsurprising exception. JCPenney was the latest traditional retailer to throw in the towel last week and file for bankruptcy.



What to watch for

1. We tested the limits of economic pain; now we will test the virus.

As unemployment soared to Great Depression levels in March and April, the economic costs of lock-down became unacceptable across much of the US. An economy can only last so long in deep freeze before it withers. Liquidity problems become business insolvencies. Bankruptcies among companies in hard hit sectors – hospitality, travel, personal services – threaten to spill into other areas. Moreover, the health crisis seems better restrained as two months of extensive shut-down have "flattened the curve." The question going forward is whether this progress can be maintained as the economy is restarted.

Unsurprisingly, regions impacted the least by Covid-19 were the most impatient to reopen. Experts remain concerned that opening up too soon could risk the worst of both worlds: more deaths and a return to lockdown. But they are increasingly turning to the next question: how best to avoid that outcome. Many Americans are now back on the move, while the daily rate of new infections is hovering around 30,000 and over half of all states report more than 10,000 cases in total. Detailed official guidance to help businesses, schools, individuals and local governments open safely remains scarce.

Former Federal Reserve Chairman, and current Rock Creek Senior Advisor, Alan Greenspan and, coincidentally, famed investor Howard Marks agree that what we mostly know is that we don't know. Uncertainty about the course of the virus and the path for the global economy is indeed extremely high.

But there are some lessons from the past four months. One of them – that squeezing down infections to very low levels with mass testing, mass tracing of potentially infected contacts, and then strict quarantine – worked for many Asian countries, and for Germany. But for the US, and a number of other countries, that route proved too hard. Testing is now increasing in the US and the United Kingdom and can help to guide care for infected people. But it is unlikely to reach the mass levels needed for targeted isolation and shut-down any time soon. For poorer countries in the developing world, this route may never have been practical. The head of the WHO, Tedros Adhanom, commented in mid-May that the world may need to live with the disease – at least until effective treatments and a vaccine are widely available.

In the meantime, other non-pharmaceutical interventions (NPI) can be effective. Some – handwashing and maintaining social distance – can be a matter of individual choice, although not for all of us. Scientists now believe that avoiding closely packed indoor spaces and, where possible, staying outside, effectively curbs the spread of the virus. This is great news for those keen to get to the beach, but harder for workers in meatpacking plants or care homes, or for the 2.3 million Americans in prison. Other precautions, notably personal protective equipment (PPE) for those in most danger of infection, would help protect them and their families and contacts. More is still needed. Perhaps not as popular, another simple but effective intervention now advocated by health experts, including some previous skeptics such as Dr. Marty Makary from Johns Hopkins, is the widespread wearing of masks in public. Perhaps those countries now reopening in Europe will persuade their citizens to adopt the Asian way. Hard to see that in the US, where health precautions are increasingly seen as a political signal.

2. Who will survive in the post-Covid-19 economy? And will the winners take all?

Avoiding a shut-down does not necessarily avoid economic pain. Sweden's economy has contracted as sharply as Denmark's next door despite businesses, schools, and restaurants staying open. The difference shows up in the death toll: deaths in Sweden so far amount to 325 per million inhabitants, compared to 9 in Denmark.

The boost from reopening in the US – and much of Europe – will depend on how consumers and businesses react, as well as on the virus. In China, retail sales remained sluggish in April, although production was recovering. Some sectors are bound to shrink near-term as a result of social distancing rules or practices. Restaurants, hotels, airlines all need scale to stay in business. If restricted to fifty percent occupancy, many will be unable to break even, let alone turn a profit. Others look more doubtful longer-term: will business travel ever revive to previous levels? Will office space in dense cities like New York and London still command premium rents, or might commercial real estate flourish elsewhere? For companies and investors, it is likely that winners will take market share as a wave of consolidation pushes more vulnerable companies to the wall. Small businesses are particularly vulnerable. A new study of the impact of Covid-19 called the pandemic a "once-in-a-generation crisis for America's small businesses, especially those that specialize in face-to-face service."

Despite the focus by Congress and the Administration on helping these companies with special loan and grant programs, some 100,000 small and medium-sized firms have already gone out of business because of the pandemic. Many have found the new programs difficult to access and not suited for their needs -- very small companies spend as much or more on rent as on payroll, and are reluctant to use emergency loans that they will need to repay in a short period of time. The Small Business Administration (SBA) has put out 4.2 million emergency loans under the new legislation. But there are 30 million firms classified as small businesses. Expect more adjustments to the programs to come.

The longer the slowdown lasts, the worse the economic damage will be. But fewer than half of surveyed small firms expect to survive if the crisis lasts for four months. No wonder that many have urgently called for reopening, even as they worry about the dangers.

3. Finding the needle in a haystack...

Investment opportunities are materializing in countries, sectors, and markets not previously top of mind for investors. Mainly created or fast tracked by the impact of the Covid-19 crisis, there are pockets lurking across asset classes that we should be mindful of in the near term. Distinct opportunities where the risk/reward is in an investor's favor – amidst an environment where the balance between these two factors seem to be skewed to the downside – are worth highlighting.

Alignment of Interest – Stay Close to the Fed!

While the Fed's tone last week may have put a damper on markets, the unprecedented amount of stimulus thrown at the worst economic data globally may be a godsend for fixed income investors. With the Fed essentially joining the ranks of asset managers, buying high yield bonds, ETFs, and corporate debt directly from US companies, investors need to be deliberate in investing in fixed securities that are aligned with the Fed support and stay ahead of their purchases.

The Federal Reserve has been highly transparent in what securities they are buying, in which markets, when transactions will occur, and how much. This transparency coupled with an increase in volatility and a dramatic increase in supply and issuance is creating attractive arbitrage opportunities, duration bets, and directional trades.

Under the secondary market corporate credit facility for example, the Fed is buying $250 billion of US corporate bonds and corresponding ETFs. ETFs must have exposure to US high yield corporate bonds and trade at a premium to NAV for the Fed to step in. They will limit their ownership of the ETF to 20% of shares outstanding. This is only one part of the Fed's response. Eligible securities under the TALF include auto loans, auto leases, student loans, credit card receivables, etc. The list goes on and on in terms of securities that apply and are spots where there are returns to be generated by fixed income portfolios.

As long as the Fed is involved and policing the market – not buying so much that volatility is dead on arrival – this is an area where investors should pay attention. Winners and losers in the fixed income market will be dictated by an understanding of the Fed and an ability to position a fixed income portfolio to stay ahead of the Fed. An opportunity to generate returns in a tough market for the foreseeable future.

Global Underdog – Checking out India.

Will India become a game changer in the global economy, supply chain dynamics and trade talk for companies and become the new China? Investors may want to be cognizant of the growing implications of Covid-19 after-shocks on emerging market dynamics and sentiment. There's been increased attention towards India and Vietnam as markets that are becoming viable and more attractive to companies seeking to be nearer to the Asian consumer, but wary of the politics of China.

Just last week, Apple made headlines for their prospective plans to move the production of up to $40 billion worth of smartphones to India through manufacturers Wistron and Foxconn. Talks between India and Apple include the possibility of shifting nearly a fifth of its production capacity from China to India over the next five years. Apple currently sells $1.5 billion of phones in India but less than a third of those are locally manufactured. On top of this, Jio Platform – a next-gen tech company and the largest mobile operator in India – has raised nearly $10 billion from 4 partners in the last 4 weeks for a 15% stake to develop 5G technology. These partners include Facebook followed by General Atlantic, Vista and Silver Lake.

Despite its drive to increase manufacturing, India has barely seen any meaningful increase in manufactured exports over the last decade (India's share of global manufactured exports is <2% while China's share is approx. 20%). Low productivity, skill, scale, labor laws and other issues have prevented the Indian Government's growth objective, but the pandemic has strengthened Prime Minister Modi's ability to push through reforms. This may be an opportunity for India to lure companies like Apple to India in the hopes of reversing a decades long trend of companies considering China, not India, for manufacturing operations.

In fact, India is developing a land pool nearly double the size of Luxembourg to incentivize businesses to move out of China. The Indian Government is focused on ten sectors including electrical, pharmaceuticals, medical devices, food processing and so forth as focus areas for promoting manufacturing. It's been working with embassies globally to identify companies to promote this new initiative. So far it seems that Japan, the US, South Korea and, ironically, China have all expressed some interest in establishing operations in India.

Tensions between China and India also need to be monitored, though preventing Chinese companies from investing in India may be more posturing than reality. On April 17th, the Indian Government tightened its FDI policies requiring countries that share a land border with India to go through a pre-approval process. This was probably targeted towards China and a worry that China would attempt to take over Indian companies that may be experiencing economic stress during this period. The same fears incidentally being quietly warned about by some DFIs on what may happen in Africa across other sectors.

While North Asia continues to see the majority of emerging market investor interest, India is not to be ignored by the long-term investor. The pandemic has turned many historical trends and norms upside down and India may be a part of this transition.

The politics are clear: President Trump is casting China as the villain. Few in Washington (or Delaware, for that matter, where presumptive Democratic Presidential nominee Joe Biden is staying) want to risk being painted as pro-China. After last week's action against Huawei, American companies will look again at their dependency on China, whether for supply or as a market. Can India, the only other country of scale in the region, grasp the opportunity?

Opportunities ahead

We remain bullish when looking at our current portfolio and the growing investments targeted at the intersection of education, technology, and healthcare. Quizlet, an online flashcard company and RockCreek investment, just closed a Series C round at a $1 billion valuation. Investors are catching on to the new opportunities that lie ahead across sectors previously not considered. Other areas we continue to focus on such as renewable energy, affordable housing, logistics, and e-commerce, are all poised for growth in the years ahead. In the shorter term, we are investing in high quality companies with robust business models and strong balance sheets that can endure interim economic pain and in sectors ripe for a speedier recovery.

RockCreek Update

The RockCreek team continues to work remotely. We have a plan for those team members who have expressed a preference to be in the office after mid-June that will protect the health and safety of our team and community.

We continue to be active in providing support to those most affected by the Covid-19 crisis. RockCreek has ordered masks and other protective gear to donate to organizations supporting frontline workers. Our team has done studies to find effective and impactful ways to assist different communities. We are working with local organizations, non-profits, food banks and other groups that provide food from restaurants most affected by the pandemic in DC, VA, MD, NY, NJ, Conn, and other communities for frontline emergency workers, especially those working at hospitals serving low-income populations. We are working with World Central Kitchen, Martha's Table, and others that have been providing services and donating food to those in need for years.

We will continue to update you on the work we do across communities. If you have any questions or know of other ways we can partner with those organizations helping in the aftermath of this pandemic, please let us know.

Team RockCreek