MONDAY, MAY 4TH 2020

FINGERS CROSSED...

Equities had their best month in April in over two decades. Federal guidelines on social distancing lapsed last week. And close to two-thirds of Governors in the US have outlined plans to begin lifting restrictions, with some gone already. So, is it over? Not so fast. May is beginning with a dose of caution in markets. Quite right. Health experts still warn of a second wave of infection in the US, before effective treatments and a vaccine are up and running. Controlling the spread – without a return to mass lockdown – will be hard without the mass testing and contact tracing that is not yet in place. The Administration acknowledged this weekend that thousands more deaths are still to come – maybe even twice as many as the 68,000 recorded as of May 4th. Investors need to keep their eyes on that infection curve.

Listen to the latest episode of Finance Forward with Laurence Boone, Chief Economist of the OECD. She warned early on of the dangers to the global economy from a spread of Covid19 into Europe and America.

Markets crept into May after whiplash in March and April. Since Covid-19, changes in markets and the real economy have occurred at dizzying speed. The S&P dropped 34% in just 28 days through March 23rd, before the nearly 13% jump in April. During the great financial crisis, it took 300 days for a similar decline to occur. Rapid layoffs as the US locked down have now pushed unemployment to more than 30 million in less than two months. In 2008-09, the jobless rate never got that high and climbed slowly over 15 months to its peak. Expect things to slow down now. The latest rise in unemployment claims – while worse than expectations – was smaller than those of the two previous weeks. As businesses gradually reopen, the dramatic collapse in economic activity will slow and reverse. The question for investors is whether markets have moved too quickly to anticipate recovery – or whether they are right to expect that the Federal Reserve's extraordinary moves to support the American economy will suffice to keep equities afloat. One big question is how consumers behave in a post-Covid-19 world. Even the Fed cannot make people go out to work, shop or eat.

Fighting words between China and the US don't help, especially with US business and consumers surprisingly reliant on China for key products. Presidents Trump and Xi Jingping are keen to push the blame for today's crisis on to each other. Without entering into that debate, one thing is clear: China seems to be doing better right now at making and selling what we need – or want –- in this crisis. As businesses scramble to reopen safely, with little guidance from government on how best to do so, they are discovering that a simple search on Alibaba is the best way to find not only essential health supplies, but also the humble toilet roll. In an interesting twist, internet giant Alibaba is going beyond the (slowly recovering) Chinese consumer to build market share. Taking advantage of

the dire shortage in personal protective equipment (PPE) and the inexplicable shortage of toilet paper, Alibaba has aggressively targeted parts of Europe and the US, leveraging its supplier network in China to meet demand. In the process, Alibaba is hoping to establish itself as a credible alternative to US e-commerce companies. Pre Covid-19, Alibaba was a domestic and regional company, but now it has become a global brand: the ex-ceo is traveling the world bringing gifts of masks and PPEs in a sign of goodwill from the company and China.

Four observations and a coda on emerging markets

1. Cognitive dissonance between health experts and politicians – and markets and the real world?

As we all look with relief – and some nervousness – towards resuming old habits such as entering an office, traveling to see family, and sitting down at a coffee shop, are we factoring in how different life has to be? There may be a double disconnect.

On conquering or simply containing the health crisis, Sanjay Gupta, neurosurgeon and CNN medical correspondent, noted a cognitive dissonance among experts and politicians last week. Everyone expects lockdowns to be lifted in coming weeks or even, in some cases, days. But no one believes that we were safe from a resurgence in the virus. Indeed, even Anthony Fauci has said that he thinks it is virtually certain that there will be another wave of infections in the US. There have been renewed spikes of Covid-19 in Singapore and other countries that seemed to have contained the virus successfully. They have systems in place to stamp out new infections before a dangerous spread. We do not. As Microsoft founder and philanthropist Bill Gates has commented, the world needs to innovate not only in treatments and vaccines – where scientists are working together at impressive speeds – but also on testing and contact tracing. With many more, and better targeted, tests, and swift and efficient contact tracing, the US and Europe could cope much better with the next wave of Covid-19 than the last. Will we get that?

Financial markets and the real economy also moved in counterpoint. As markets rebounded in April, output and employment showed a dramatic decline and hopes faded for a swift V-shaped recovery. It is easy to say that markets, faced with an unprecedented crisis of health rather than finance, have not properly priced risks of an inadequate health response and the coming economic pain.

As always, it is important not to underestimate the market's rationality. There are three main ways to make sense of April's bounce. The first is just the enormity of the monetary and fiscal response to the crisis. Analysts estimate that the Fed and ECB together pumped well over $3 trillion into financial markets between end-February and end-April, rapidly swelling their balance sheets and providing enough liquidity to let the private sector get comfortable taking risk. Just as important, both central banks signaled that there is plenty more where that came from. Central bankers have no intention of allowing a health crisis to lead to a financial market crisis that could hinder recovery. The fiscal response – while not yet enough given the depth of the economic slump – was also unexpectedly swift and surprised on the upside. Fiscal deficits in the major five global economies, including China, rose to 6.5% of GDP in 2009, but we expect – as do a number of banks – that they will top 10% this year, with the fiscal boost in the US expected to be twice as high in 2020/21 as in

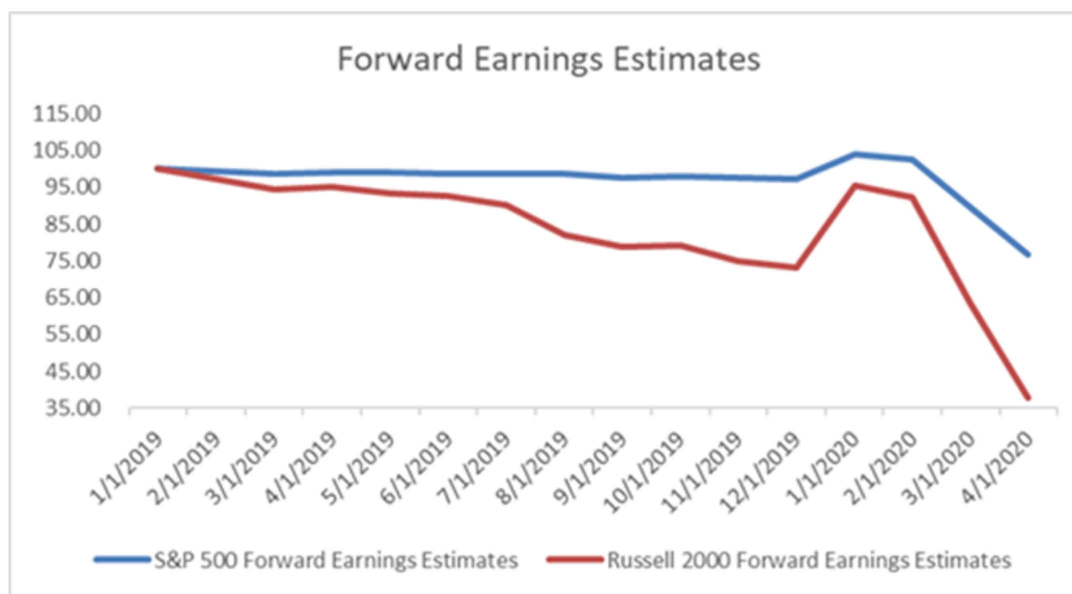
2009. A chunk of today's government support is in the form of loan guarantees, rather than outright spending or tax cuts, so comparisons with actions after the global financial crisis should be treated with caution. Loans are supposed to be repaid, after all. But even so, the magnitude of government action is impressive.

The second reason for April's market rally is technical: the sudden and dramatic market decline through March 23rd left an oversold position with large short interest in many securities. When sentiment shifted on Fed and Congressional action, a wave of short-covering, estimated by some as the largest in four years, helped to push equities up. And, thirdly, the rally in stocks was big, but mainly concentrated on companies that look better placed to survive, or thrive, in a post-Covid-19 world.

2. The post-Covid-19 economy will be kinder to some companies than others

Analysis of market behavior and earnings since the lockdown shows that while some companies and sectors may weather the coming economic storm, another leg down is likely for many. Looking at sector contribution for the S&P 500 since March 23rd – when the market bottomed – through April 30th, a pattern of sorts becomes apparent. The rally was focused on companies that stand to benefit from the changing economic landscape, such as tech and health, as well as those that were among the worst hit in the March drawdown, such as poorly rated travel companies, cruise liners and hospitality. Short-covering helped these latter companies' stocks to rise, not their future prospects, which remain grim. Indeed, there has been a huge market bifurcation since Covid-19 began between the best performing sectors and the rest.

Given how drastically the outlook has changed this year, the P/E of 19 for the S&P 500 as of close May 1st may still look high, compared to the pre-Covid-19 21 at the end of 2019, But, remember, interest rates have plunged. Taking that into account, it would appear the market is now pricing in a roughly 25% drop in corporate earnings for the S&P as a whole. This is broadly consistent with analysts' expectations of forward earnings, which have been revised 21% lower since the end of 2019.



In a post-Covid world, of course, it is possible that many companies, particularly those exposed to the real economy, will suffer earnings declines that top 20%. An example of what may happen to their earnings and prices comes from the pattern for the five diversified banks in the S&P 500. Going into the earnings season, consensus analyst estimates pointed to an average drop in earnings of 27% for Bank of America, Citi, US Bancorp, JPMorgan, and Wells Fargo. These banks' stocks kept pace with the broader April rally – until earnings were released that showed a much sharper decline than expected, of 56% on average. The market reacted. The five have subsequently lagged.

3. What about Govtech? We certainly need it, with websites crashing and crucial payments delayed

In Europe, before Covid-19, governments and others were talking up the possibility of a new field for tech start-ups: "govtech". In countries with an extensive public sector and large transfer payments for social security and income support, the value of innovative technology for government operations is perhaps obvious. It could be useful elsewhere. In the US, technology companies have focused on consumer and business products more than government systems, except of course for defense. The decentralized and now disrupted health care system is clearly ripe for innovation. But two other examples of poor digital infrastructure have also come into view in recent weeks– federal payments, and state and local government systems, notably for unemployment benefits.

The chaos around the Small Business Administration (SBA) special lending programs for small and medium-sized business is partly due to the unprecedented nature and size of the program. Similarly, with the individual payments from the Treasury to all Americans earning below $75,000. But the inability to scale up quickly and send payments efficiently to where they are most needed suggested deeper operational problems: remember healthcare.gov, anyone?

Many newly laid-off Americans can testify that states and local governments are in even worse shape. Filing a claim for unemployment has proved difficult, time-consuming or even impossible in some areas, with crashing websites and unanswered telephones. The additional $600 flat weekly payments from the federal government, that have pushed some workers' unemployment benefits above their regular pay, were a workaround. Computer systems in local unemployment offices could not easily adjust the replacement ratio to increase payouts relative to previous earnings, so Congress and the Administration found a second-best solution. Let's hope the private sector and government in a post-Covid-19 world can work together for first best, bringing innovation.

4. Now we don't have enough food in America?

The pandemic has highlighted terrible inequities across the US, in the health sector for sure, but also in the rest of the economy. Perhaps the food industry demonstrated that most clearly last week. Lines for food banks stretched for miles in states across the country, from Texas to Florida to Virginia, as parents queued to make sure that they had enough to feed their families. Many had never needed help to afford food before. At the same time, farmers unable to get their produce to market ploughed it back into fields and slaughtered animals that could no longer be processed in the giant meatpacking plants that closed due to outbreaks of Covid-19.

Poor diets contribute to bad health among many Americans, particularly those of color and at the lower end of the income scale. Diabetes, obesity and other ailments have made these communities particularly susceptible to illness and death from Covid-19. We now see that harsh working and living conditions have also endangered many of those working in the huge US food industry that keeps grocery stores supplied. Severe outbreaks of disease have led big meatpacking plants to close. The $200 billion plus beef industry saw sales plummet by 25% in the last week of April. Ordering people back to work without improving safety conditions may be ineffective, as well as wrong.

Finally, some thoughts on emerging markets

Being selective matters, now more than ever. The Covid-19 crisis is hitting emerging markets and developing countries hard, as witnessed by massive capital outflows and a line-up of close to 100 countries for IMF help. But unlike other times, health as well as economic and financial preparedness can make a huge difference. And here North Asia and countries with stronger governments are the best placed, whether investors are looking at equities or credit.

Emerging markets are no strangers to global financial shocks, global health crises and oil price shocks. But this is the first time they have faced all three together. They face the same global pandemic and health crisis that has led large portions of the global developed economy to cease operations, but with fewer supportive resources. At the same time, oil prices have plummeted disproportionately. While a boon for oil importers, such as India, the collapse in oil hurts a number of emerging markets that rely heavily on oil proceeds to finance government spending as well as imports, including Russia and Venezuela as well as the Middle East.

Emerging markets have varied drastically in their health policy response to Covid-19, some opting for strict lockdown measures to contain and control the virus (e.g., China and South Korea), and others taking a much more laissez-faire approach (e.g., Brazil). Emerging markets also differ significantly by country in their healthcare infrastructure with Singapore, Taiwan, South Korea standing out for a swift response to the new coronavirus and better mobilization of testing, contact tracing and targeted – rather than mass – quarantine than in Europe and the US. And, of course, vulnerability to financial market pressures amid a global outturn also differs across regions and countries.

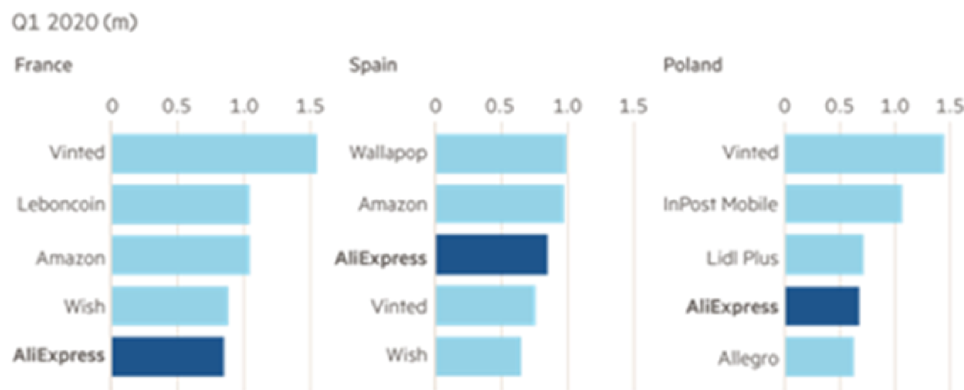
These disparities argue for caution and selectivity, RockCreek also sees opportunity and embedded alpha. While global growth will be impaired for quarters to come, most economists expect emerging markets to continue to drive global GDP, suggesting opportunity for investments in local companies at the intersection of technology, delivery, health, education and long distance training.

Emerging market equities first. Small caps led the way up in April, for the first time in many months, with the consumer and healthcare sectors particularly strong. This partly reflected a bounce-back after underperformance in March, relative to large caps, local buyers went bargain shopping for high quality small cap names.

Energy and basic materials also staged a comeback in April, led by oil names in the Middle East and Russia as well as mining names in South Africa and Chile. However, in this case we consider the move a technical bounce rather than a supply/demand dynamic which in our estimation points to further weakness in the coming months. Forecasts for the Baltic Exchange Dry Index for example, call for a continued albeit modest decline in activity for the next twelve months.

In EM, as everywhere, much will depend on progress made towards therapies that can blunt the impact of the Covid-19 virus. But overweight allocations to North Asia continue to look right, given the region's attractive valuations, higher visibility of both top and bottom line performance for corporates and unquestionably stronger macro balance sheet fundamentals. And the "first in, first out" experience with Covid-19, as well as remarkable success in containing the virus early on, was reflected in April manufacturing PMI figures. These show further normalization in manufacturing activity across the region. For China, the normalization of domestic consumption demand and service sectors will be a key driver of the economy's recovery in the second half of 2020. Internet platforms such as Alibaba, Tencent, and Baidu are expected to benefit from renewed consumption, not just in China, but worldwide. In Europe, the AliExpress app was one of the top downloaded shopping apps in the first quarter, and traffic to the AliExpress website also increased markedly in Russia, the US, and Brazil.

Top Shopping Apps Downloaded in Select European Countries



Source: RockCreek, Sensor Tower Data, SimilarWeb

We expect to see other Asian tech giants leverage their supply chain advantage and not just in e-commerce space, but in services and tech hardware as well. European and US companies are studying options to diversify supply chains away from Asia. However, shifting supply chains is a costly, time consuming and largely irreversible endeavor. As such, any calculus tied to abandoning several decades of multi-billion-dollar investments in China is being carefully studied by companies and governments. A recent survey conducted by PwC China of 25 large US corporations with sizeable presence in China found that over 70% reported that they have no plans to leave the country any time soon. Twice as many companies plan to shift sourcing within the chain rather than shifting their own production to new geographies.

Now for EM debt. Here too, we believe active management is needed to capitalize on relative value opportunities. Despite the overall difficulties faced by emerging markets, RockCreek believes EM debt continues to offer attractive relative value provided due attention is paid to local circumstances, including debt characteristics and governance as well as the response to Covid-19. By actively avoiding lower-quality issuers and focusing on countries that are best positioned from a financial and governance perspective, investors can capture the benefit of an undervalued asset class.

In terms of overall valuations, emerging market debt has corrected along with other financial markets since March, and now offers attractive return potential. The combined impact of yield and spread tightening (currently 500+ bps over US Treasuries) means that hard currency emerging market sovereign debt can deliver total returns in excess of 20%. Some believe that local currency sovereign debt might experience an even sharper recovery. Emerging market currencies are currently 20% cheap to the USD and have historically strengthened relative to the USD coming out of prior market corrections. Of course, a long down-turn may lead to a more general hesitancy to relinquish safer dollar assets.

For poorer countries, social distancing is particularly hard, although India has just renewed its lockdown. On average, EM per capita incomes are just one-sixth those of developed markets and much of the labor force depends on daily wages. Financial independence also varies from country to country. Some emerging market economies with larger domestic bond markets (e.g., China, South Africa, Brazil, Mexico, etc.) can fund most of their liabilities in local currency. Others more dependent on foreign currency and external debt (e.g., Argentina, Angola, etc.) are more vulnerable to any downturn or shift in sentiment. Countries with large debt burdens and pending debt maturities are particularly at risk.

On top of this, emerging market debt investors face the challenge of assessing not only an issuer's ability to pay, but also its willingness. In addition to understanding a country's resilience based on metrics such as reserve balances, pending debt maturities, current liabilities, and access to support (e.g, International Monetary Fund packages), investors must also understand a country's governance. Some large issuers in emerging market debt indices should be avoided on this basis. Analysis by JP Morgan found that 15% of the JPM EMBI Index is trading at distressed levels (i.e., spreads >1,000 bps), implying significant default risk. Countries accounting for roughly 10% of emerging market sovereign debt have already initiated some form of restructuring process, including Argentina and Ecuador. Moreover, JP Morgan expects default rates to be as high as 44% over the next two years, representing the largest wave of emerging market sovereign defaults since the Asian debt crisis of the late 1990s spread first to Russia and then Brazil and Argentina.

RockCreek Update

While the RockCreek team continues to operate remotely, we are working on appropriate re-entry plans. There will not be a one-size fits all re-entry roadmap, so we will put in place what works best based upon the advice of medical experts and the best practices that are developing. RockCreek is committed to a re-entry plan that provides for the health and safety of our team and our community.

Team RockCreek