2020: SECOND QUARTER MARKET UPDATE

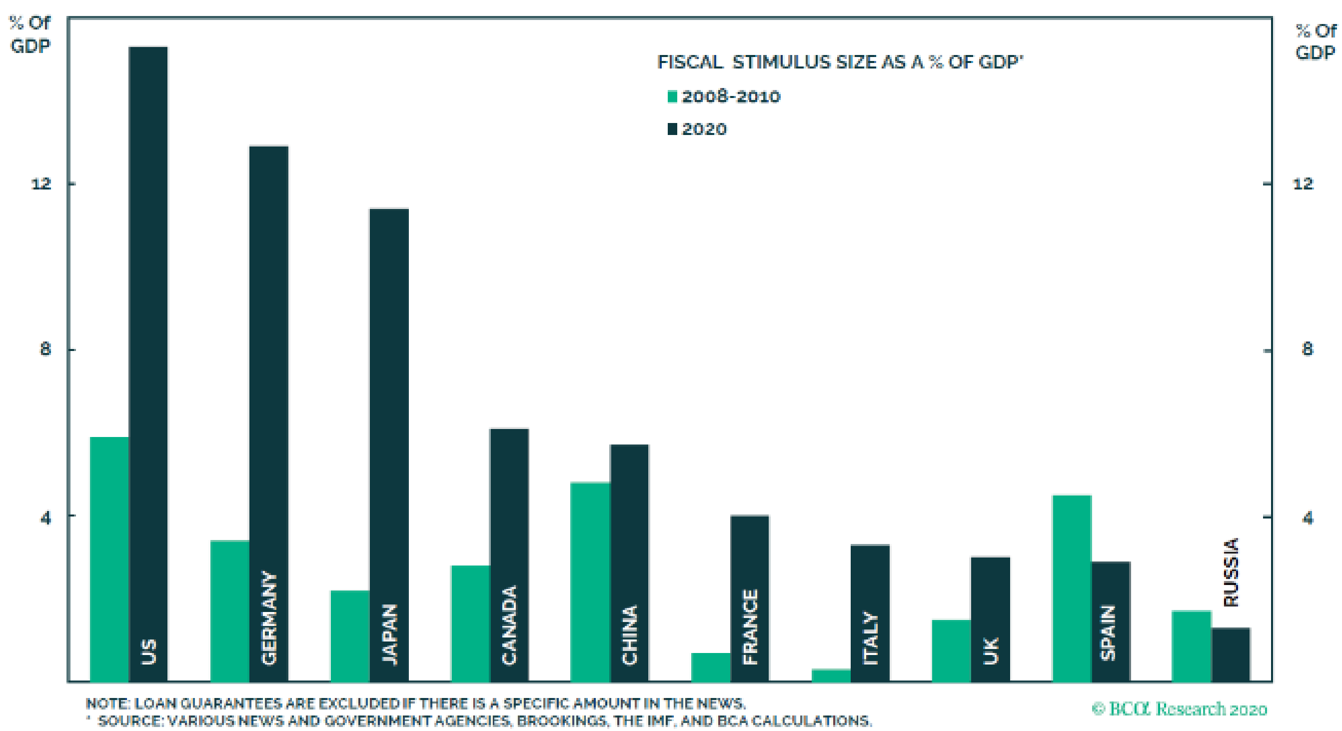
RECOVERY

Unprecedented is the word that best captures the events that have unfolded so far in 2020. After the novel covid-19 infection became a global pandemic and induced one of the fastest and most severe recessions on record in the first quarter, world governments unleashed historical levels of monetary and fiscal stimulus (figure 1) and engineered the sharpest recovery since the Great Financial Crisis of 2008. Risk assets received a further boost as the number of new cases in Italy, Spain, New York City and other hotspots began to decline rapidly in April. The S&P500 index recovered by 20.5% in the second quarter, erasing most of the losses of the first quarter and ending at -4.0% year-to-date (figure 2).

Among novel measures implemented by the Federal Reserve, the decision to use the Fed's balance sheet to purchase credit assets in the corporate debt markets represented a new escalation in the level of support afforded to an over-levered economy. Setting aside long term issues of moral hazard created by recurrent support, the immediate effect was to restore order to credit markets and ward off a wave of bankruptcies. The Barclays High Yield Corporate index recovered by 10.2% during the quarter, ending at -3.8% year-to-date.

In Europe, France and Germany spearheaded a new recovery fund. Eventually approved in July by all European countries, this was a watershed event marking the first planned issuance of loans at the European Union level. In effect the beginning of a fiscal union finally addressing the shortcomings of the monetary union, it lowered the risk of further political disintegration of the Euro zone. The new fund also heralds infrastructure investments in renewable energy as 30% of proceeds are earmarked to address climate change. Emerging markets (MSCI Emerging Markets) and Foreign Developed Markets (MSCI EAFE) recovered by 18.1% and 14.9%, respectively, ending at -3.4% and -5.1% year-to-date, respectively.

Fiscal Stimulus Is Greater Today Than It Was During the Great Recession of 2008



Source: BCA Research

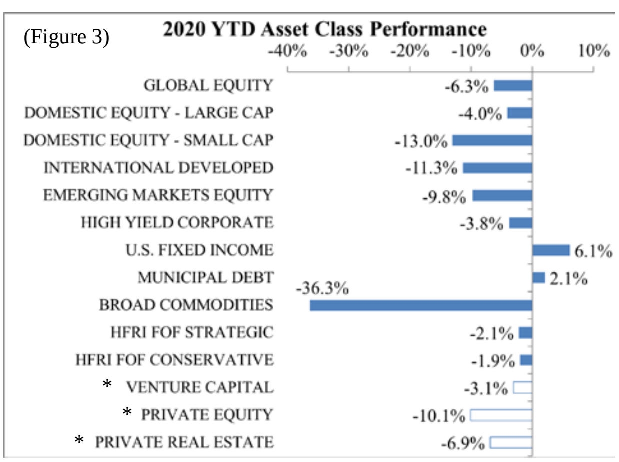
(Figure 2)

Source: Light Sky Macro

Reflecting the market recovery, equity volatility (VIX index) declined from a peak of 82.7 on March 16 to 30.5 by quarter end. The yield on the benchmark 10-year U.S. Treasury note remained relatively stable near a historical low, ending the quarter at 0.64%. Low interest rates ushered a weakening in the U.S. currency and contributed to a rally in gold, with spot prices up 30% year-to-date.

Year-to-date, fixed income is the only broad asset class to deliver positive returns (figure 3).

(Figure 3)



Source: Bloomberg

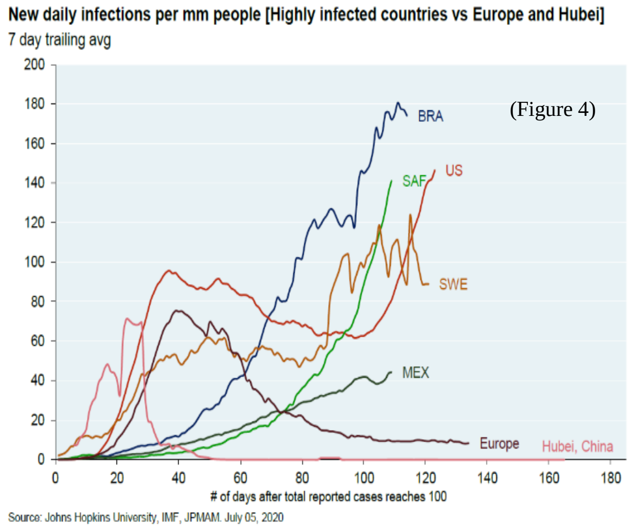
*(*Venture Capital, Private Equity and Private Real Estate report with a lag. We show the performance of the most recent reported quarter through March 2020).*

KNOWN UNKNOWNS

As the third quarter unfolds, the question on everyone's mind is whether a secondary wave of infections will lead to renewed lockdown measures.

Widespread use of masks and stricter limits on mobility in Europe and Asia helped control the infection in these regions, setting the stage for a gradual recovery. By contrast, the U.S. experienced a spike in cases in Western and Southern states, areas that were previously relatively spared. Some emerging economies with less developed health care infrastructures (e.g. Brazil, South Africa) are also showing rising levels of infection (figure 4).

While great strides are being made in vaccine research, world economies will continue to deal with containment measures until a treatment becomes widely available.



Source: JP Morgan

The health care crisis and ensuing recession have affected the odds of the upcoming presidential election, with a democratic sweep of the White House and Congress now seen as likely (figure 5).

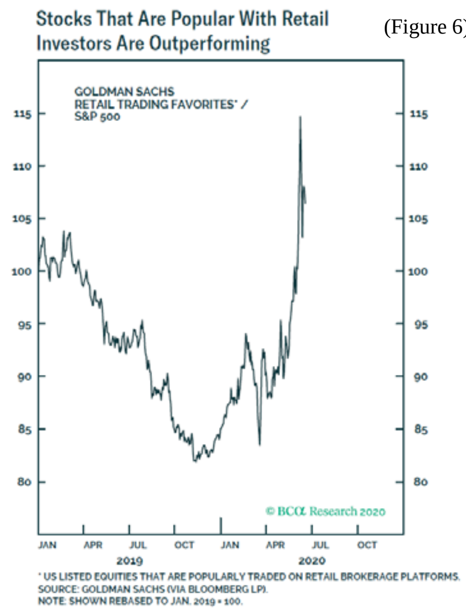
Source: Goldman Sachs

In this context, we think that there is a strong incentive for the current administration to promote additional stimulus measures and to ramp up its trade war rhetoric with China leading up to the election.

A STRETCHED RUBBER BAND

The extent of the rally defied expectations, given a sharp decline in GDP, increase in unemployment and lowered forecasted earnings in an environment of high uncertainty and expensive stocks. Indeed, the most common comment we hear from clients is "I don't understand this market."

While many professional investors concerned with fundamentals missed out on the rally, retail investors flush with stimulus money became the marginal buyers of stocks and bought the dip, generally favoring secular growth names at high valuations and "story stocks" (e.g. Hertz Global) with non-existing or vanishing earnings (figure 6).



Source: BCA Research

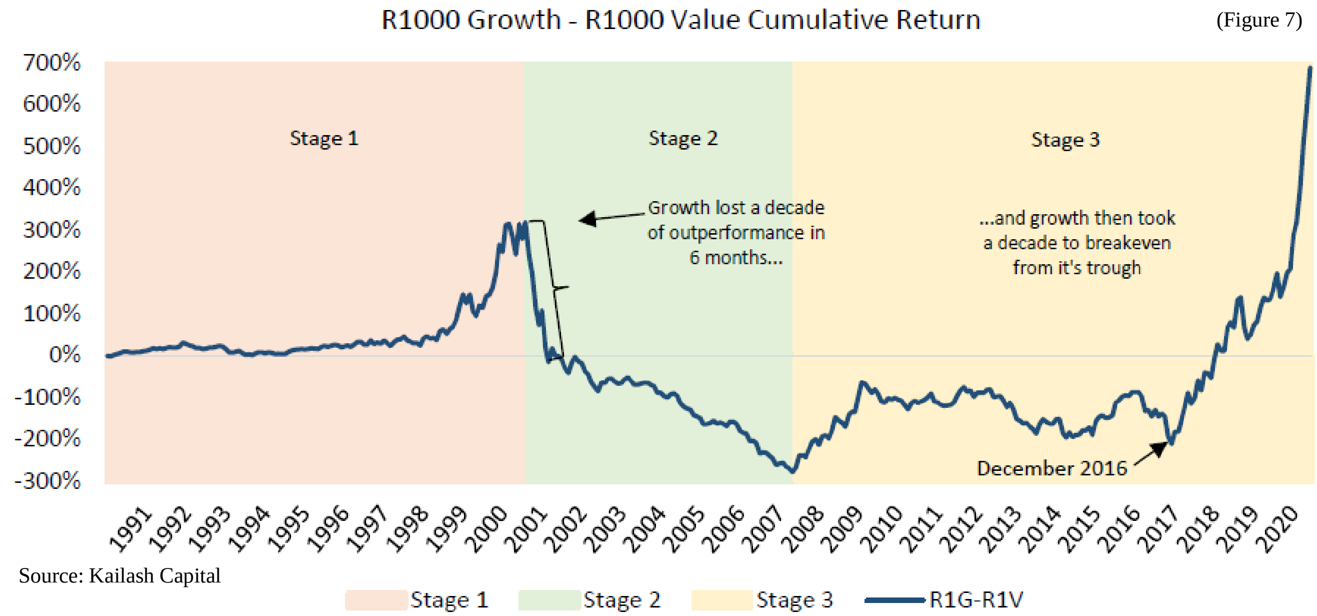
This environment of continued outperformance for expensive stocks has now taken the markets to extremes. In the U.S., Large Value stocks are now trading in the first valuation percentile relative to history (going back to 1996) while Large Growth and Quality stocks trade near the 100th percentile. The same pattern is found across geographies.

The last time this pattern materialized was in 1999 at the peak of the Tech bubble (figure 7). Similar to the late 1990's, any portfolio with a value orientation would be bound to underperform a market cap-weighted benchmark such as the S&P500, which is becoming increasingly dominated by large growth and momentum stocks.

During the second quarter, five stocks in the S&P500 index (Apple, Microsoft, Amazon, Facebook and Paypal), representing almost 18% of the index weight, contributed 31% of its return.

We urge investors tempted by the siren songs of passive investment in such indices to consider the risks of such market concentration.

(Figure 7)



Source: Kailash Capital

For example, in an August 5th strategy note, Goldman Sachs cautioned that an earlier than expected positive vaccine outcome could defy assumptions about eternally negative real rates, supporting steeper yield curves and cyclical stocks, and challenging tech leadership. Similarly, a potential change in the U.S. administration could reduce trade policy risk for non-U.S. equities while increasing taxation risk for domestic stocks.

At Windrose, we think that timing these market turns is impossible. Therefore, the best approach in these challenging markets is to maintain equity portfolios balanced across styles (value and growth) as well as geographies.

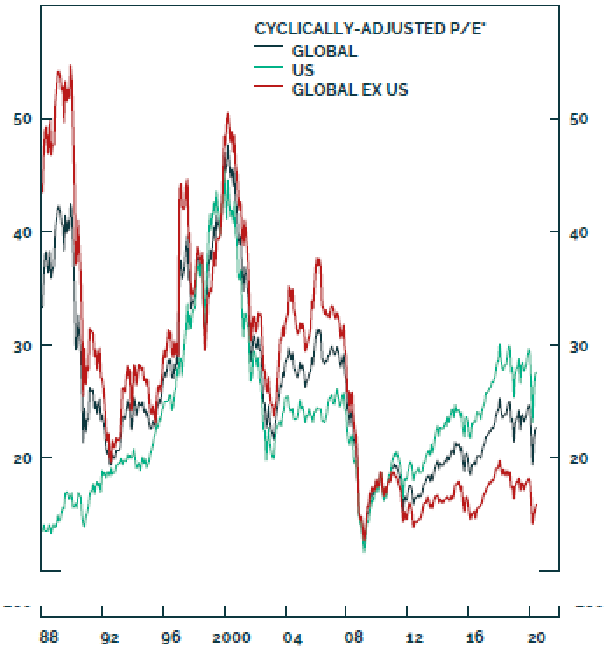
THE END OF U.S. EXCEPTIONALISM

Until now, U.S. financial markets have benefitted from higher interest rates among developed countries, a growth differential thanks to tech leadership, and political stability (compared to Brexit in Europe for example). All of these contributed to attracting assets to the U.S. and strengthening its currency. However, all these advantages may dissolve in the wake of the pandemic. Consider the dynamics taking place between the U.S. and Europe:

- Income inequality and a recession are fueling social unrest and desire for political change in the U.S. while Europe is taking steps toward more unity.
- Both sides of the political spectrum are wary of the influence of big technology companies, and more regulation is likely going forward. By contrast, Europe is dedicating a significant proportion of its new recovery fund to investment in renewable energy, which could support a new economy.
- Finally, interest rates have collapsed in the U.S. The real yields (i.e. after adjusting for inflation) on U.S. 2-year notes were 2.21% above comparable Euro area rates at the beginning of 2019 but 0.35% below at the end of July 2020. This has triggered a weakening of the U.S. currency relative to the Euro.

The diminishing allure of the U.S. market and currency going forward weaken the argument for an overweight to U.S. assets especially in light of a wide valuation differential (figure 9).

(Figure 9)

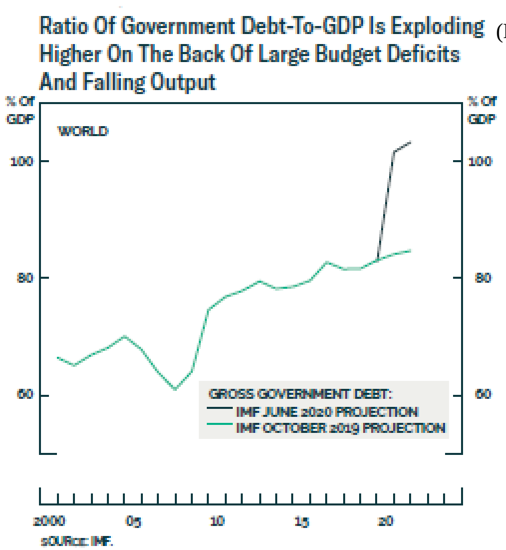


Source: BCA Research

THE INFLATION SOLUTION

The deflationary shock caused by the pandemic has led to a vast expansion of government debt across the world (figure 10).

(Figure 10)

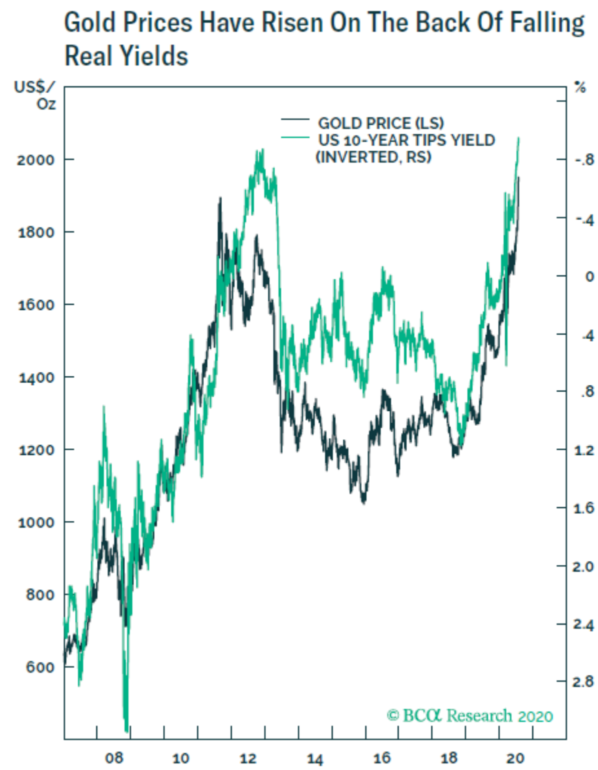


Source: BCA Research

This is spurring fears that at some point in the future, once economies normalize, central banks and governments will be tempted to allow inflation to drift higher in order to reduce their debt burden. The alternatives of course, would be to increase taxation to repay the debt, which is politically unpalatable, or hope for a high level of growth to allow the debt to GDP ratio to shrink over time.

Thus, despite the recession, future inflation expectations have increased with fears of currency debasement, driving down real yields and the U.S. Dollar. Gold, as the ultimate hedge to fiat currency, has appreciated in response, entering a new bull market (figure 11).

(Figure 11)



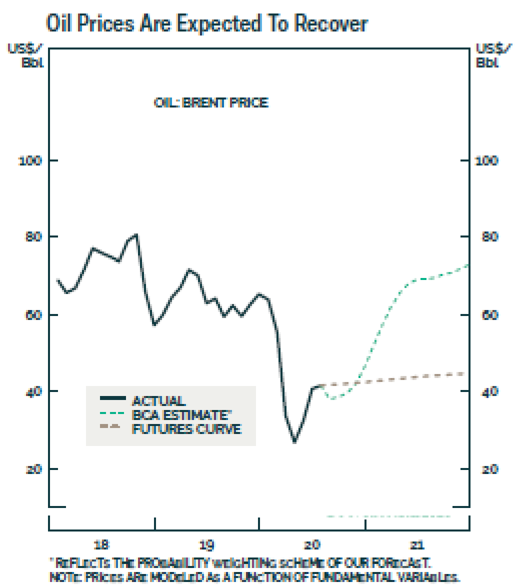
Source: BCA Research

Going forward, gold would do best in an environment of low growth and rising inflation expectations, or stagflation. The probability for such an outcome has increased and therefore an allocation to gold is warranted at this point, and we recommend adding on weakness. Other precious metals (e.g. silver or platinum) may offer a similar hedge but these metals have more industrial uses and tend to be more correlated to global growth.

While gold is the best hedge against the risk of currency debasement, it does not really feature in the commonly used economic measures of inflation. Oil and other commodities eventually drive the CPI, or Consumer Price Index, measures. Therefore, oil and commodities tend to hedge the risk of unexpected inflation.

The world has been generally oversupplied with various commodities, particularly given the sudden drop in demand. However, the supply response has been intense. The energy and materials sectors have now been deprived of new capital, which will curtail supply in the future as resource depletion sets in. As the world economy normalizes, demand could rebound to pre-covid levels, leading to higher prices (figure 12).

(Figure 12)



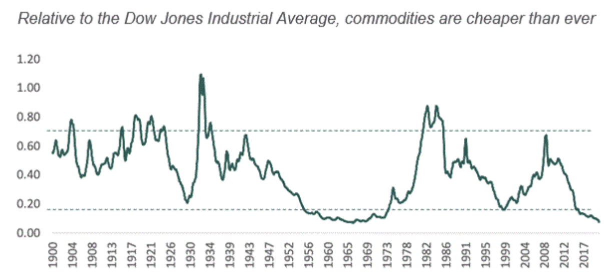
Source: BCA Research

Consider that commodity-intensive, large scale infrastructure projects are a common way for governments to spur economic activity in the wake of a recession. In addition, commodities are denominated in U.S. Dollars and benefit from a weakening U.S. currency.

While waves of stimulus have propped up financial assets in recent years, commodities have languished on fears of a global slowdown and oversupplied markets. As the cycle turns, commodities now look cheap relative to financial assets (figure 13).

As a final thought, real estate is an asset commonly acquired with leverage. Given low interest rates and rising inflation potentially eroding the cost of leverage even further, this asset class is likely to attract significant capital in coming years.

(Figure 13)



Source: Goehring & Rozencwajg, Bloomberg

There are obvious caveats on office, hospitality and retail properties resulting from the pandemic such as the decline in travel, shift to remote work and the further erosion of brick and mortar retail relative to the rise of e-commerce. However, suburban residential housing, industrial warehouses or data centers offer opportunities in a post-covid world.

Despite performance challenges in recent years, a diversified portfolio of real assets including exposure to commodities and select real estate is now well positioned to benefit client portfolios.

PARTING THOUGHTS

Uncertainty linked to the evolution of the virus and the upcoming election imply a volatile environment and bumpy recovery in the near term.

Looking into next year, we would suggest considering the aftermath of the 2000 tech bubble as a potential blueprint. In the period from 2000 to 2008, small caps and value stocks outperformed large caps and growth stocks; foreign equity and commodities appreciated in the wake of a weakening U.S. Dollar; and low interest rates fueled a housing bubble (which benefited financials and commodities).

"History doesn't repeat itself, but it often rhymes," as Mark Twain is often reputed to have said. As markets move through this economic cycle, we will continue to inform our portfolio management process with past experience.

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