Private Bank

CIO Strategy Bulletin

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A Rare and Remarkable Time

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Summary

- **Finding Opportunity:** Had this been a typical recession, bearish sentiment would have been preeminent. It would be a great time for bondholders to sell their safe-haven assets to buy cheap equities. But this COVID-recession is unconventional. Anticipating a shutdown in the economy, policymakers – led by the US – took action to create a financial bridge over a short-term chasm in economic activity. By doing so, they created broad market confidence, ensured the proper functioning of markets and altered the typical recessionary market dynamics. This held up equity markets overall (see May Quadrant: New Cycle Opportunities and Risks) and has created large pockets of opportunity for investors on our preferred 12-24 month timeframe. We also advise that holding too much cash decreases the value of portfolio strategies as we introduce our **New Cycle Investment Strategy.**

- **Real Risks Remain:** With the US Presidential race heating up and the heat of summer arriving in the Northern Hemisphere, we see tensions with China rising and the COVID virus hiding in plain sight. While Europe appears to be coming together, President Trump has taken aim, one again, at China for its initial handling of the virus and for its trade practices.

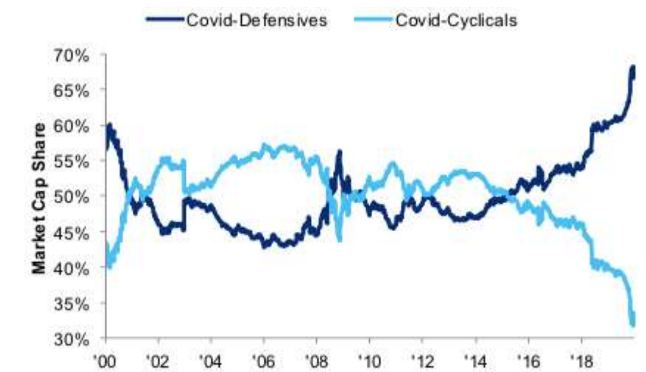
Finding Opportunity: Looking Backwards and Forwards at the Same Time

Markets have expressed the health, business, mobility, and work/life impacts of the pandemic with remarkable clarity. Even as economies "reopen" and people flock to beaches in the Northern Hemisphere, the likely impact of COVID-19 is still going to be strong for the next 18 to 24 months. Reflecting this, there is strong investor discrimination between winning and losing industries based, in part, on the projected length and depth of these impacts. Larger companies with better balance sheets are favored. Technology shares reflect the degree to which we have gone "on line" for everything retail, entertainment, business and communication. Leisure industry equity prices still reflect the numerous, significant hurdles faced by airlines and hotel companies in providing safe experiences to fearful customers. Home improvement businesses have seen the redirection of leisure spending into appliances, electronics, and even carpet. Competition for major category players, like Starbucks, will be diminished as local coffee houses close globally. And retail real estate equities reflect the impact of both the virus and e-commerce on their short and longer-term prospects. That's why following indices clouds the impact of this peculiar recession, an intentional shutdown with uneven and unintended consequences.

Our job, therefore, is to look to history as a reference for some aspects of "how to invest now" and to look forward thoughtfully for other guideposts. We cannot count on the "buy now while everything is cheap" 2008/09 mantra. Rather, we must use the current massive dispersion in valuations to guide us. When we choose to hold shares of companies whose stock prices have done well through this period, we must expect *average future returns* from them. On the other hand, we can identify investment opportunities for the coming years by assessing if markets have properly priced what is likely to happen. We know that the pandemic will end with a vaccine or broad immunity, having altered consumer and business behaviors, confidence, and preferences. So, we investigate how and when businesses will come back, conscious of how consumer behavior will evolve. There is a lot of value to be identified via this investigative process.

There are several major observations we have already made that deserve serious attention from investors. The first is the divergence of two groups of equities, the first of which we have labeled "COVID Defensives", including Information Technology, E-Commerce, Healthcare and Staples. These have outperformed the "COVID Cyclicals" that comprise Industrials, Energy, Real Estate and Financials. The relative valuations of these two groups reflect their current economic circumstances, but not the likely ones in two years or more **– Figure 1**. And one can see this in markets by looking at two tradable components of the MSCI All Country World Index **– Figure 2**.

Figure 1. Market Cap Share of COVID-Cyclicals vs COVID-Defensives



Source: Bloomberg as of May 22, 2020

Figure 2. MSCI ACWI Industrial and Technology Indices

Source: Bloomberg as of May 22, 2020

COVID-Cyclicals: Financials, Industrials, Energy, Materials, Real Estate, Consumer Discretionary ex-Amazon; COVID-Defensives: IT, Health Care, Communication Services, Consumer Staples, Utilities, Amazon. This should not be construed as an offer of, or recommendation of companies discussed. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. For illustrative purposes only. Past performance is no guarantee of future results. Real results may vary.

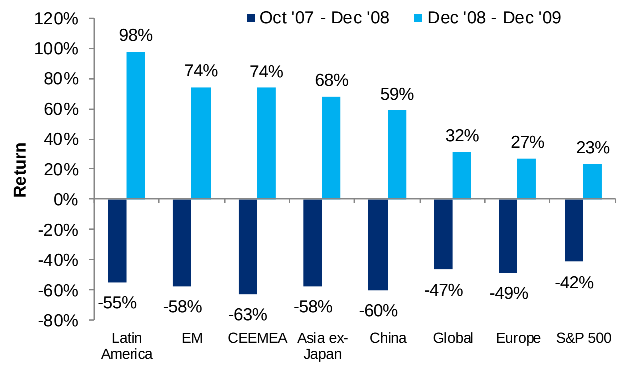
Global industrial businesses have been deeply impacted by the lockdowns and supply chain impacts. Industrial share prices generally reflect huge drops in Q2 EPS and a slow recovery thereafter. Technology shares have flown higher, but are not immune to a slowdown in business spending on digital advertising, cloud services, and software purchases. However, these share prices do not reflect a possible pause in their growth. In fact, we expect purchasing managers' indices to show a rebound in manufacturing with very little incremental improvement for tech services. If one has an investment horizon of a full year or more, an investor could explore opportunities in industrials or use a relative value strategy between the two sub-indices. Given the global nature of the pandemic, global industrial exposure looking across 23 developed and 26 emerging markets with a focus on large- and medium-cap stocks makes sense.

Our New Cycle Investment Strategy

Our second observation, one that we will emphasize in our Mid-year Outlook, is that the optimal portfolio management strategy given today's valuations is to seek strong income-generating investments and long-term growth opportunities, while adding exposure consistently to depressed assets that we think will recover faster than expected. We will also avoid taking excess risk by reducing exposures in regions and sectors that will likely lag in their recovery.

We have identified several of these undervalued opportunities in the US and overseas, focusing on historical relationships (such as how Emerging Markets can rebound from excessively depressed valuations) – **Figure 3** – and new relationships (i.e. how industry dynamics in the US homebuilding sector have changed) **– Figure 4**. We talked about homebuilders last week and noted four factors favoring them (see CIO Strategy Bulletin: The Inevitable Rise). This week the published data confirmed our initial findings.

Figure 3. Pre/Post Global Financial Crisis Returns



Source: Bloomberg as of May 22, 2020

Figure 4. Homebuilders still down significantly

Source: FactSet as of May 22, 2020

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The most recent data on inventories and sales of existing homes are enlightening. There has been a 19% decline in available for sale home inventories versus a year ago, as well as a 15% decline in existing home sales against the same period last year – **Figure 5**. However, when we look at the prices of homes for sale, we see no decline – **Figure 6**. With low existing home inventories, higher market prices in spite of the COVID recession and attractive mortgage rates, new homes are favored and so are the companies that build them.

Figure 5. US single family home sales and available for sale (YoY%)

Source: Haver Analytics as of May 22, 2020

Figure 6. US existing home prices (YoY%)

Source: Haver Analytics as of May 22, 2020

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Homebuilders, Mexico and Brazil are examples of our new cycle investment strategy, which adds exposure to assets and regions that we believe will recover more quickly than expected.

Fast Action in Fixed Income

Since the Federal Reserve reduced policy rates to the zero-bound in March, short US rates have plunged. Further exacerbated by the weakening macro outlook, 2-year US Treasury yields have reached historical low levels. Thanks to central banks and government intervention, market function have since calmed. However, it is likely short-term US rates will remain low for quite some time.

US LIBOR rates have historically maintained a tight relationship to the Fed Funds rate. Although this connection can break down during periods of market stress, the average spread between these two rates is roughly 25bp. Today, 3-month LIBOR is 35bp, after dropping 150bp over the last several months. For those with floating-rate liabilities, near-zero short-term yields create an opportunity to reduce and lock in future cash flows. Thanks to heightened technical demand on the short-end of the US swaps curve, it is actually cheaper to hedge longer than shorter. As such, we advise investors to hedge as long as needed, either to match the maturity of a bond in a portfolio or the term of the outstanding loan.

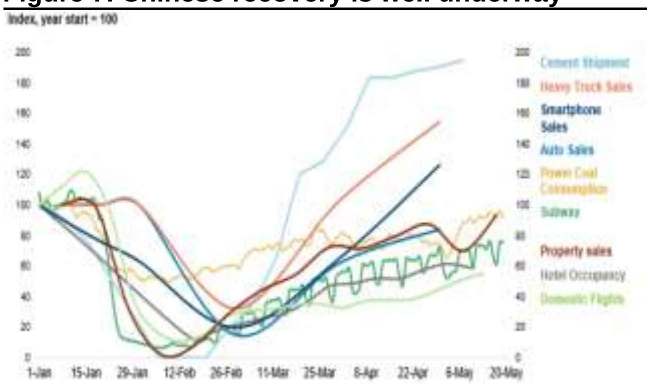
Conversely, investors sitting on too much cash in their investment portfolios are now earning next to nothing. As part of our New Cycle Investment Strategy, we do not want clients to remain paralyzed, waiting for “something good” to happen. Short-term rates are unlikely to rise soon and we see pressure on spreads for intermediate bonds and credit as the Fed begins to make purchases of ETFs and other instruments in the BBB space.

To offset the risk of declining cash returns (and we believe that holding excess cash decreases the value of portfolio strategies!), we are advising investors to consider short and intermediate opportunities in high quality corporates, municipal bonds (for US investors) and other instruments including preferred equities and certain mortgage REITs. Currently, taxable US investment-grade corporate bonds maturing between 1-3 years offer yields around 1.5%. Moving down in credit quality (BBB-rated) can raise the yield proposition. For US investors that benefit from municipal bond tax exemption, certain short-dated A-rated bonds can offer yields well above 2.0%,

The “Big Bounce”: A Fast, Uneven Recovery Begins (and The Law of Small Numbers)

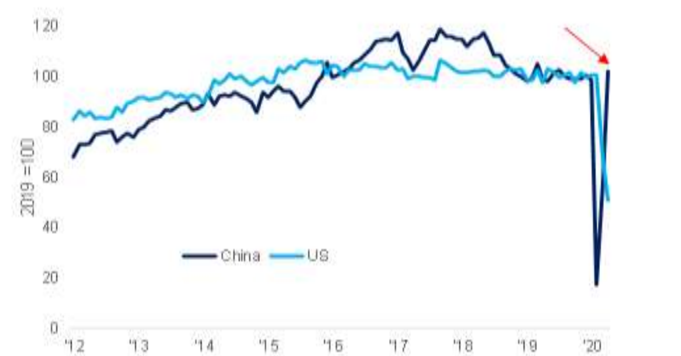
We see promising signs for the US economy based on anecdotal, economic activity data that parallels tangible signs of progress in China, where the COVID-19 shutdowns came two months earlier. The Chinese recovery is well underway. Industrial material sales are above normal as inventories build and supply chains fill up. Pent up demand for truck and phones is present. Broader retail sales in China have lagged, but have still turned up from the lows of 1Q – **Figure 7**. Auto sales in China last month were already higher than their pre-COVID level **– Figure 8**. We would expect a similar, uneven pattern of manufacturing and consumer behaviors in Europe and the US, as both re-open. Slower recoveries should be expected from leisure sectors and in industries where people need to congregate.

Figure 7. Chinese recovery is well underway



Source: Bloomberg as of May 22, 2020, including multiple scaled data sources

Figure 8. US and Chinese Auto Sales



Source: Haver Analytics as of May 22, 2020. Note: Red arrow shows China’s auto sales subsequently made a full recovery by April:

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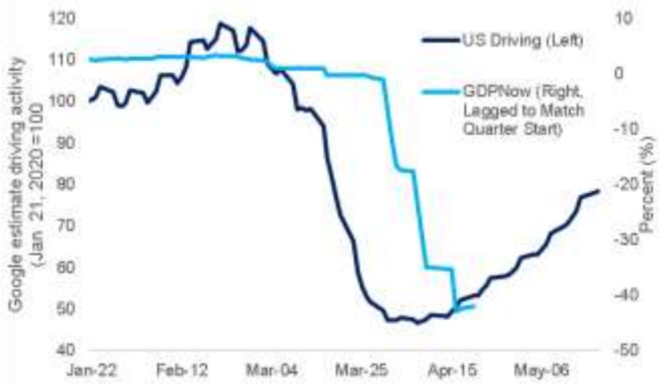
There is no doubt about the severity of the economic crash. In the US, the Federal Reserve Bank of Atlanta’s daily estimate of GDP for the current quarter lurched lower with the release of actual economic reports, and now shows a 42% annualized decline for 2Q. Yet, positive signs for the post-lockdown period represent more timely data than complex, lagged government economic reports. We believe that the data coming in now and over the next few months will challenge investor expectations of continuous declines and a long-lasting recession. We believe that the green shoots from the re-opening of the economy are already in evidence. And, just as we saw in April, markets seized on the “positive” news and moved higher.

Let’s be clear: ending the lockdowns **will not** result in a rebound in employment in May. Data instead suggest declines in employment that remain catastrophic this month. However, the rate of decline is ebbing, as job losses in May will be roughly half as large as the April drop. But a rise in driving – including to retail stores – suggests a May rebound in consumer demand.”. Even accounting for the usual seasonal rise in driving, US driving activity over the past four weeks has risen 50% (a 600% annualized rate that illustrates the law of small numbers!). Our point is that a sharp rebound in US GDP is highly likely and the data will appear strong, but represent a fractional recovery - **Figure 9**. It will take us a long time to return to 2019 economic output and profit levels. What markets are looking for – and are likely to see – is an initial “big bounce”.

Figure 9. Atlanta Fed "GDP Now" Tracking Estimate for 2Q US GDP vs Google Estimate of US Driving Activity



Source: Haver Analytics as of May 22, 2020. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be guarantees of future events.

Real Risks Remain: China Tensions and COVID Stay In Focus

China Syndrome?

This past week, the battle to assign blame for the health crisis rose to new levels. Citing COVID, President Trump said the US could "cut off the whole relationship" between the US and China. Showing continued remarkably bi-partisan support for any anti-China legislation, the US Senate passed a bill that may in time force Chinese companies to de-list equities from US exchanges and move their listings elsewhere. The US administration also announced new technology restrictions that could result in a permanent ban on US-derived technology sales to Huawei. It also announced sanctions on individuals in Hong Kong who it deems to be violating the autonomous territory's freedoms. China, in a major policy reaction, looked to enshrine new legislation to assert more direct control over Hong Kong.

As a result of these escalating statements and actions, the fate of the announced "Phase 1" trade deal that partially unwound US tariffs has been called into question. It would be hard to assess the Chinese purchase of goods looking over such a short period given COVID impacts, yet one could state that the Chinese had not made progress to score political points. The "allegations" seem likely in the US election season, as both parties will likely compete to "out hawk" each other on China.

The risks from rhetoric and action are real. The recovery of the world economy as a whole depends on the economic rebound of the world's two largest economies. This is a fragile time when expectations have risen for post-COVID economic growth. Financial conditions – which can support or restrain the rebound - cannot afford a severe blow from policymakers if they expect to traverse the dangerous chasm and move toward a full recovery.

Annual goods and services trade between the US and China is $600 billion. The gross portfolio holdings of both parties are about $2 trillion. Direct investment assets is roughly $200 billion based on historical cost data. As we have discussed before, China's currency (capital flight from it) has been a quick "lever" by which risk aversion has spread across world markets – **Figure 10**. In August 2015, for example, a mere 3% devaluation within a week for the Chinese Renminbi drove a 9% decline in global share prices – including US shares. In 2016, a similar move drove further turmoil in petroleum markets and drove widespread liquidations of assets.

At a time when financial markets are "giving growth a chance" and lagged economic reports show weakness and vulnerability, confidence in the present recovery is fragile and subject to policy fears. China/US friction seems the largest of the risks. A future "competition" between the US and China is now spelled out explicitly as US policy (please see "United States Strategic Approach to The People's Republic of China"). A scientific investigation into COVID's origins is certainly warranted. But it would be a sad turn of events if the world's desperately needed economic recovery faces added hurdles from disputes that offer little to aid it.

Figure 10. China's Currency vs US Dollar vs Global Share Prices Jan -September 2015

Source: Haver Analytics as of May 22, 2020.Note: RHS = Price of 1 USD in CNY
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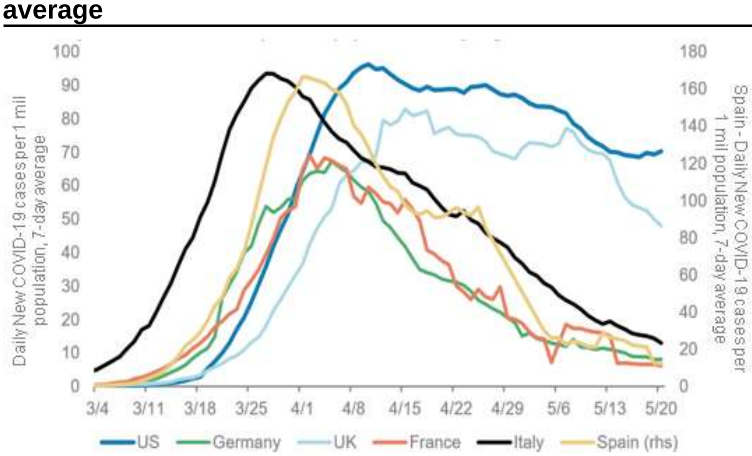
COVID: Hiding in Plain Sight

With the heat of summer arriving in the Northern Hemisphere, the COVID virus will be hiding in plain sight. Nonetheless, even if we see rates of infection and disease dropping due a summer lull, our view is that passive attitudes toward the pandemic may expose developed markets to unforeseen risks in the fall and winter.

We have written before about the trade-off between the economy and COVID-related health care policy. This past week, the director of the CDC, Robert Redfield, said that the US must be as "over-prepared as possible" for a second wave of both lockdowns and infections. Researchers issued results that suggested that had social distancing in the US started two weeks earlier, it could have saved at least 54,000 lives. Our concern for the future is the absence of a centralized response at the inception of the pandemic that will impact the US economy in the event of a major flair-up in one or more locations after the summer.

Looking at the rate of infection as expressed by "Daily New Case" data **– Figure 11**, the results of the newly ended lockdown periods in the US and the UK hardly look encouraging. To say that either of these countries flattened their infection curves would be an overstatement, in our view. The US now has one-third of all deaths and is, according to estimates, likely to see 25-30,000 additional deaths per month through August 2020. And with just 15% of the population exposed to the virus, there are risks to individuals and businesses that depend on maintaining control over its spread through social distancing, testing and other measures. We will present more data about this critical issue in the coming weeks.

Figure 11. Daily New COVID-19 cases per 1 mil population, 7-day average



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