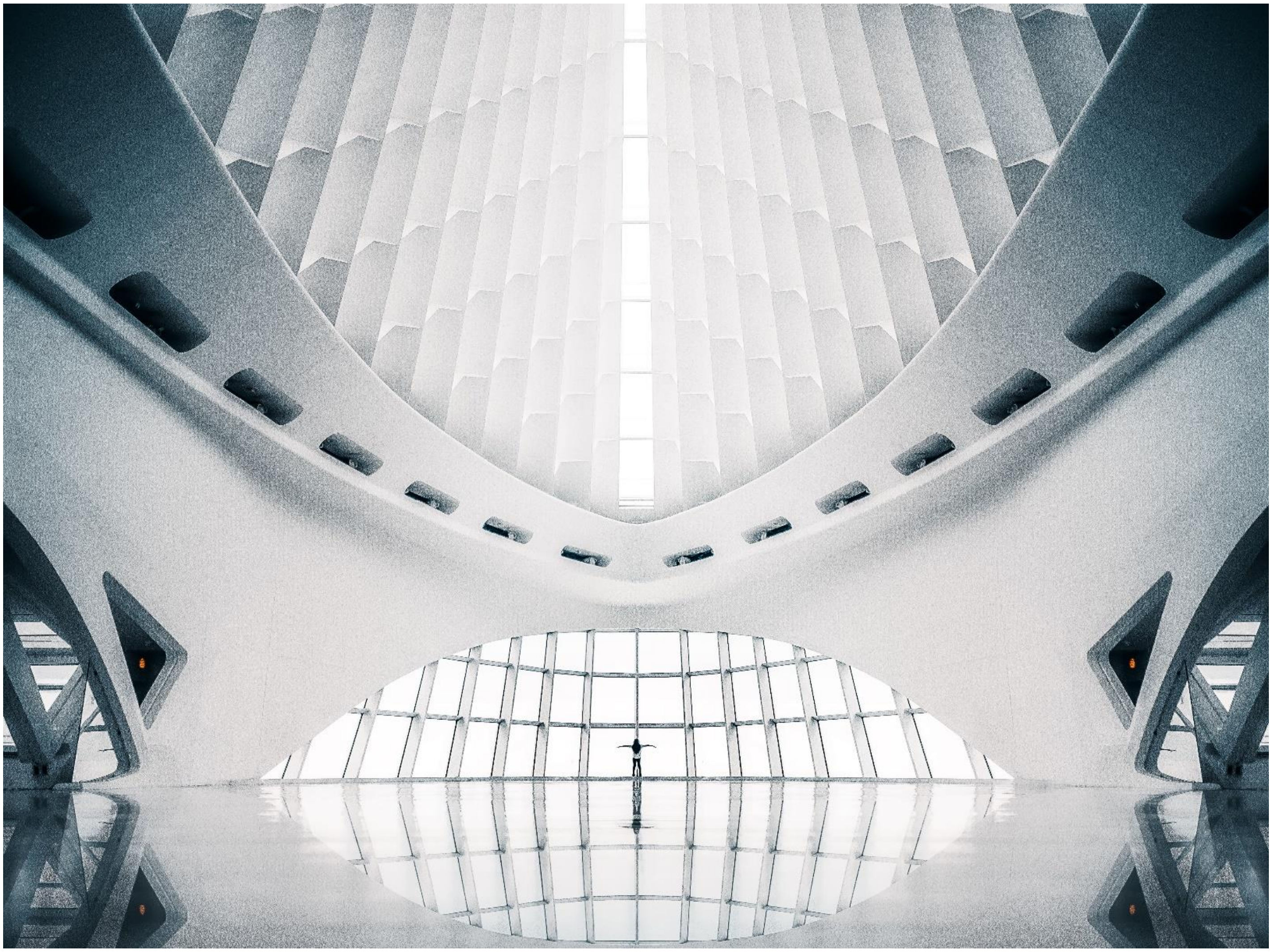
Rockefeller Insights

Around the Markets

Uncertainty Creates Opportunities

June 22, 2020



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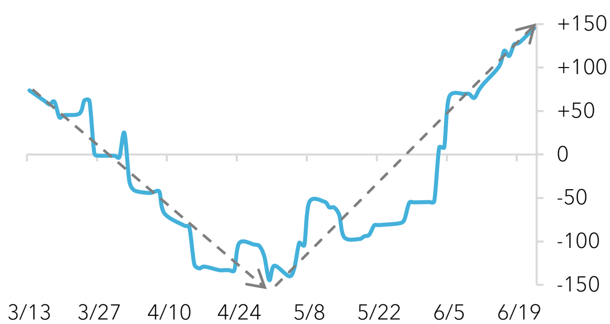
Uncertainty Abounds

Much has happened to the Citi US Economic Surprise Index over the past three months. The index, which measures the magnitude of data surprises relative to market expectations, fell over 200 points from +74 on March 13th to -133 on April 20th. Since then, it has fully recovered, climbed higher, and reached a historical high of +145 on Monday,[1] as record upside surprises in economic data have been pouring in over the recent weeks. The positive momentum is further confirmed by high-frequency indicators that provide more real-time measures of economic activity.[2]

Citi US Economic Surprise Index



The US economy and – to a certain extent – the global economy are improving at a faster pace than many economists have predicted.

Yet, most investors remain skeptical of the sustainability of the current recovery. The June Global Fund Manager Survey by Bank of America found that only 18% of institutional investors expect a V-shaped recovery (up from 10% in May). 64% expect a U-shaped or W-shaped recovery (down from 75% in May).[3]

Although there is a broad consensus that the US economy will bounce back fully from the current crisis, uncertainty remains around the path to recovery. We discuss in the following section three major variables critical to future economic growth. The uncertainty factor is evident in that each of them can be argued by the bulls as a case for more optimism, and – just as effectively – by the bears as a case for more pessimism.

A Glass Half Full Is A Glass Half Empty

Variable 1: A Second Wave

With major global economies now entering a new phase of eased restrictions, a second wave of infections is perceived by many investors as the greatest tail risk to a sustained recovery.

On one hand, we have evidence of successful reopenings in many countries that experienced outbreaks in March and April. For example, across most of Europe, cases have yet to spike since lockdowns were lifted weeks ago. In fact, reported daily infections have continued to plummet.[4]

On the other hand, infections and hospitalizations in the US have climbed sharply in recent days. This is primarily driven by rising new cases in Southern and Western states, where restrictions began to ease in early May.[5] In our view, a continued rise in infections is unlikely to pressure state governments to reinstate lockdown measures. Besides the associated obvious economic pain, the US health care system is expected to have grown more resilient against COVID-19. Hospitals are better prepared in terms of staff training and medical equipment. Scientists and doctors have learned more about the virus in the last three months, which suggests a higher survival rate for the infected. Nonetheless, the accelerating spread of the virus within the US will – at a minimum – weigh on economic activity as a result of heightened voluntary social distancing practices.

[1] Bloomberg, 6/22/2020
[2] Apple Mobility Trends Reports, 6/22/2020
[3] BofA Research, 6/16/2020
[4] Johns Hopkins Coronavirus Resource Center, 6/21/2020
[5] The New York Times, 6/21/2020

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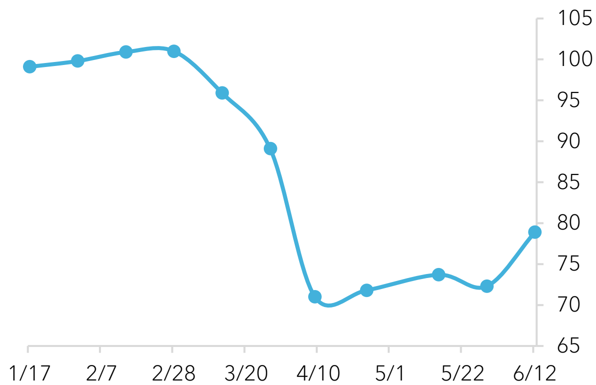
Variable 2: Job Growth

Consumer activity has clearly started to pick up. US retail sales in May jumped nearly 18% (annualized) versus April – the largest monthly increase on record – recovering to above the March level.[6] The latest University of Michigan Consumer Sentiment Index also rose sharply compared to two weeks prior. Within the index, the component that measures consumer's perception of current and future economic conditions saw an even greater increase.[7]

University of Michigan Consumer Sentiment Index



We believe that improvement in the willingness and ability of consumers to spend is strongly related to the positive news on the labor market. Specifically, the US unemployment rate surprisingly fell to 13% in May (from 15% in April), well below consensus expectations of around 20%, as economists predicted eight million further job losses for the month.[8] The Bureau of Labor Statistics noted that the unemployment rate is underreported due to technical issues and should have been around 16%; the adjusted figure is still well below consensus, nonetheless.[9] Furthermore, other measures confirm that the labor market has indeed begun to recover, albeit slowly. The weekly US continuing jobless claims data reported a steady decline since early-May, suggesting that new layoffs are being more than offset by new hires.[10]

From a more skeptical perspective, we may argue that such positive data on the labor market are simply direct results of more states and businesses reopening. Naturally, employers are recalling furloughed workers. And as one would expect, the largest job gains in May were from Leisure and Hospitality and Retail Trade sectors that contracted the most in March and April. With regions such as New York City partially reopening restaurants and stores this week, hiring activities should continue to accelerate in June and July. Much of the momentum, however, depends on continued fiscal support, notably the Paycheck Protection Program (PPP), which offers business loans that can be forgiven if 60% of the capital is used towards payroll[11] – a critical support to the US labor market as social distancing requirements have rendered many small businesses unprofitable. Until an effective vaccine becomes widely available, a depletion of PPP funding will likely trigger another round of layoffs.

The US labor market is a long way from recovery. As of June 5th, 20.5 million Americans are receiving unemployment benefits, more than triple the peak figure during the Global Financial Crisis.[12] The consensus economist forecast of unemployment rate for Q4 2021 – despite recent upbeat revisions – is still at an elevated level of 7%.[13] As there are sure to be bumps along the way, surprises to the current job growth trajectory will likely remain skewed to the downside.

Variable 3: Fiscal Policies

The US economy has proven to be significantly more resilient than many feared in March, when it felt almost impossible to overstate the potential economic destruction caused by the COVID-19

[6] Bloomberg, 6/16/2020
[7] Bloomberg, 6/12/2020
[8] Bureau of Labor Statistics, 6/5/2020
[9] Bureau of Labor Statistics, 6/5/2020
[10] Depart of Labor, 6/18/2020
[11] US Treasury, 6/16/2020
[12] Department of Labor, 6/22/2020
[13] Bloomberg, 6/21/2020

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crisis. Much of this is attributed to the unprecedented series of fiscal stimulus packages. Lawmakers in Washington acted quickly and aggressively to prevent disruptions to critical economic relationships, e.g., widespread bankruptcies by businesses and households with otherwise strong balance sheets heading into the crisis, thus reducing the uncertainty factor in the path to economic recovery.

There is general consensus that fiscal policies will remain accommodative for the foreseeable future. In his testimony before the Senate last Tuesday, Fed Chairman Jerome Powell reiterated the limitations on what the Central Bank can achieve, and the potency of fiscal support, such as the direct flow of credit to households and businesses, in the current circumstances.[14] As the enhanced weekly unemployment insurance benefit is slated to expire at the end of the July, it is widely expected that Washington will release a new fiscal package.[15] Failure to do so would most likely strike a severe blow to the US economy (including consumer and business confidence), which – as policymakers on both sides of the aisles recognize – is still in a frail state despite the recent modest recovery.

The counterargument here is that the recent better-than-expected economic data may make it tougher for Congress to pass more fiscal stimulus, especially given the backdrop of the surging federal deficit. In addition, a recent report by the Congressional Budget Office (CBO) finds that the incremental positive impact of the enhanced weekly unemployment benefits diminishes as time goes on.[16] As the US economy continues to reopen, fiscal stimulus may become more muted and reactive in the second half of 2020.

Furthermore, the unprecedented fiscal support in response to the COVID-19 crisis has resulted in a current federal budget deficit of approximately $1.9 trillion.[17] The approaching US election and correspondingly the uncertain future of tax policies pose a critical risk to corporate profitability. As the COVID-19 crisis has had markedly different social and economic effects on Americans by income and wealth groups, it is plausible that the burden of paying for the rapidly increasing federal deficit may fall upon the wealthy via higher corporate and income taxes.

Welcome to The Jungle

As the US economy enters the recovery phase, significant uncertainty remains around the timing and strength of the future path to recovery. Investors face the additional challenge of limited visibility into what is really happening with the economy based on available short-term macroeconomic data.

The record upside surprises in US economic data in recent weeks are a case in point. While such surprises are clearly a reflection of the stronger-than-expected resilience of the US economy, it also highlights the increasing difficulty that economists struggle with in coming up with accurate forecasts.

This is primarily attributed to the rapid speed at which events have been unfolding as more and more regions in the US begin to reopen. One direct consequence of such fast developments (e.g., hundreds of thousands of restaurants and stores opening for business, millions of people returning to work) is the likely poorer quality of short-term data. By the time information has been collected, organized, and disseminated, it is likely no longer representative of the actual economic condition. While macroeconomic data has always been subject to recognition lag, the impact of such time lags has been substantially magnified in the current environment.

Additionally, in normal times, investors are used to analyzing the subtle changes in short-term data, hoping to extrapolate probable future trends in the

[14] The Federal Reserve, 6/16/2020
[15] www.Congress.gov, S.3458
[16] Congressional Budget Office, 6/4/2020
[17] Congressional Budget Office, 6/8/2020

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economy and the financial markets. Such practice is a lot less meaningful at the moment, as the direction of a change in short-term data likely provides more reliable information than the magnitude of the change. As investors resort to a blunter approach to interpreting macroeconomic data, their visibility into the pulse of changes in economic growth is much more limited versus normal market environments.

There has been a lot of skepticism about the US equity market rally from March lows, especially the swiftness of the ascent. We believe that the consideration of limited near-term visibility is important in this context, as it helps us formulate a more complete understanding of the drivers behind the recent market behavior. Specifically, the equity market is anticipatory of the future. While other factors (discussed in the following section) have had important effects on stock prices, we suspect the historic speed of the equity market recovery may also reflect investors' looking past the next few months and thinking longer term.

Walking on Sunshine

With the S&P 500 Index down around 7% from its February peak, just how bullish is investor sentiment?

As one would expect, unprecedented fiscal and monetary policies explain a lot of the asset price recovery over the past three months. The fiscal stimulus packages, notably the CARES Act, have played a fundamental role in transforming investors' attitude towards the equity market recovery – specifically from a binary event of "will it happen" to a matter of "when and how". The Fed's firmly dovish stance, on the other hand, has had a more measurable impact on valuation. The dot plot released in June strongly indicates no rate hikes until after 2022.[18] All else being equal, there is a transparent relationship between lower discount rates and higher asset prices. In addition, the Fed's asset purchasing program has directly driven up bond prices and indirectly equity prices – as investors look outside the fixed income world for financial assets with higher future return potential.

We believe that the recent retail trading frenzy has contributed to frothy valuations in some pockets of the market. In general, retail traders are well known for their tendency to sell low and buy high, chasing momentum and giving little regard to fundamentals. In March, the combination of zero-fee, fractional-share trading, enhanced government benefits payments, increased volatility, and the rapid runup of the equity market from its trough sparked a surge of retail trading. If we categorize stocks within the S&P 500 Index based on two characteristics: quality and cyclicality, we find that, based on the list of most popular stocks on Robinhood, retail traders have been drawn most to the biggest winners of the current crisis (i.e., high quality, low cyclicality) and the biggest losers (i.e., low quality, high cyclicality).[19] The attraction to the former may stem from the fear of missing out as the likelihood of a melt-up increased. The fascination with the latter is more puzzling in our view. The risk-and-return profiles of some of the most popular names on Robinhood do resemble that of Russian roulette. Meanwhile, the middle group (i.e., the high-quality, high-cyclical stocks) has been mostly unloved by retail traders.

We found that little of the equity rally can be attributed to institutional investors, whose sentiment has only recently shifted from bearish to cautiously optimistic. The June BofA Global Fund Manager Survey found that net 33% of institutional investors are overweight cash, nearly one standard deviation above the long-term average. Most of the overweight to cash is a result of investors moving out of bonds as yields continue to compress. On a net basis, 26% of investors are underweight bonds. Only 6% are overweight equities.[20]

[18] Federal Reserve, 6/10/2020
[19] Robinhood, 6/22/2020
[20] BofA Research, 6/16/2020

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Embrace the Middle Child

As the US economy gradually re-opens and business conditions improve, investors are likely to focus more on cyclical investments – those that are generally correlated with economic data. This makes sense to us particularly as cyclical stocks, typically many constituents of the Materials, Industrials, Energy and Financials sectors, have dramatically underperformed growth stocks and now trade at what appear to be attractive valuations.

MSCI US Growth & Cyclical Total Return Indices[21]

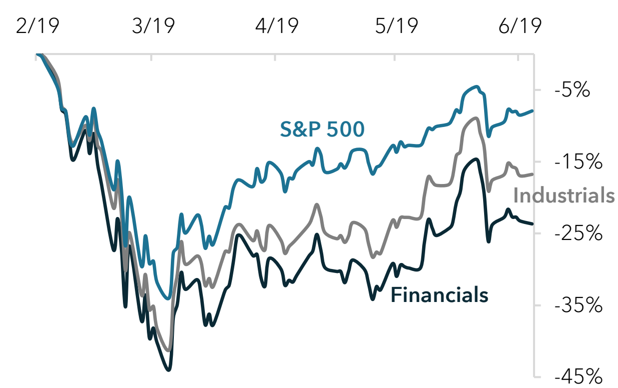
Scaled Value = 100 on January 1st, 2020

In the US, Industrials and Financials are two cyclical market sectors that we view as high in both quality and uncertainty. Both are characterized by many well capitalized companies that have undergone structural balance sheet repair. In the past decade, Industrials de-levered and restructured debt, and spun-off weaker divisions, to compete in a world of cheaper labor and weaker currencies. Financials were forced to undergo significant balance sheet repair after the Global Financial Crisis and fortunately entered the COVID-19 crisis in relatively good shape. Nonetheless, both sectors are mired in uncertainty as they are dependent on a relatively smooth and timely path toward economic recovery.

Expectations are low for Industrials and Financials; both sector indices are down around 20% from peak levels vs. the S&P 500 Index down around 7%.[22] We have a higher degree of confidence that Industrials are on the path to recovery but think that both sectors offer opportunities for investors.

MSCI US Industrials & Financials Indices vs. The S&P 500 Index[23]

% Price Return Since Feberuary 19th, 2020



A Manufacturing Renaissance?

Global economic shutdowns are not favorable for industrial-related stocks, nor is a strong US dollar. Both of these appear to be reversing; the ISM Purchasing Managers' Index (PMI) for manufacturing in May showed modest improvement (to 39.8 vs. 36.1 in April),[24] and sustained low interest rates and inflation in the US should keep the dollar in check. The worst may be over for the goods-producing segment of the economy yet expectations for Industrials are low; global investment bank UBS notes that analyst earnings estimate revisions and return projections are at multi-year lows.[25] The bank also suggests that

[21] Bloomberg, 6/22/2020
[22] Bloomberg, 6/22/2020
[23] Bloomberg, 6/22/2020
[24] IHS Markit
[25] UBS, 5/26/2020

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because 70% of Industrials is comprised of the more cyclical capital goods stocks, the best opportunity for the sector should arise during an economic recovery accompanied by monetary stimulus.

In our view, there is another allure to Industrials in the pandemic-induced acceleration of the need for more localized supply chains, both for accessibility of critical products and for national security reasons. The non-woven fabric industry produces materials for critical supplies such as N95 respirators. It requires specialized manufacturing processes and is dominated by China.[26] Eighty percent of US active drug ingredients are imported from China,[27] arguing for enhanced pharmaceutical manufacturing capacity. In fact, a bill has been introduced into both the US House of Representatives and the US Senate requiring the Defense Department to ascertain the risk of reliance on non-US manufacture of pharmaceutical products. The "Strengthening America's Supply Chain and National Security Act" aims to identify gaps in US manufacturing capacity and would encourage diversification of source dependencies for pharmaceutical products.[28]

Re-shoring of supply chains will drive demand for equipment and automation. Bank of America estimates that for every $10 billion in manufacturing revenue moved back to the US, there is an approximate $3.8 billion capital spending (capex) need, primarily on buildings and equipment.[29] Capex is currently challenged because of the slowdown in oil & gas production, but we expect improvement in 2021.

We see additional pandemic-related opportunities for Industrials in logistics and enhanced worker safety. Increases in e-commerce argue for improved automation in areas like warehouse inventory, bar code scanning and distribution center optimization. Transportation company UPS is reportedly adding 5 million sq. ft. of automated capacity this year and hopes to process 100% of its volume in automated facilities by 2022.[30] New worker safety requirements like temperature scanners, disinfecting/air circulation equipment, and social distancing monitoring all require additional investment in automation.

Patience Required but Should Be Rewarded

Financials, particularly the banks, entered the pandemic in good fundamental shape, with decreased leverage and increased liquidity. Bank capital levels remain well above required levels, but we see heightened risks around regulatory pressure to reduce shareholder distributions, and we expect asset (loans) quality to deteriorate along with the lingering drag on the economy.

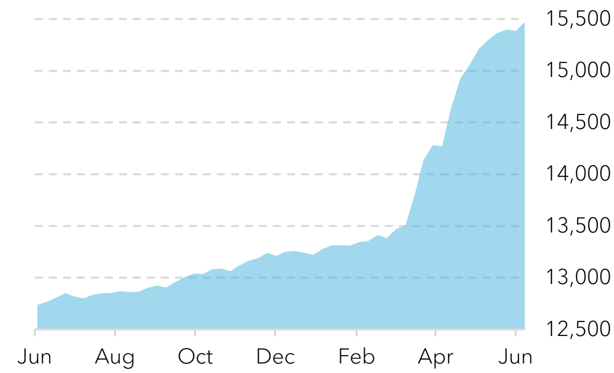
An improving employment picture could signal a trough in bank earnings expectations. While we would like to see a steepening yield curve that should boost bank valuations, the reality of low interest rates has forced banks to adjust to a sustained period of lower net interest margins. Banks with diversification in revenue streams, particularly those with capital markets businesses– trading, underwriting, market making – are likely better positioned than those that rely heavily on lending.

The banks have been viewed as partners with the Federal Reserve and the US government in helping facilitate pandemic relief. Along with the surge in liquidity provided by the Fed and Congress, banks have been granted adjustments to capital requirements and asset categorizations that support their ability to lend. Banks have experienced loan growth, as construction-based loans have risen, and many commercial clients have tapped credit markets to shore up balance sheet liquidity, given the unpredictability of economic

[26] Bank of America Research, 5/11/2020
[27] US Dept of Commerce, May 2020
[28] www.Congress.gov, S.3538
[29] Bank of America Research, 5/11/2020
[30] Bank of America Research, 5/11/2020

decline. Deposits have also grown significantly and, while favorable for liquidity, create further pressure on margins. Fortunately, banks have been able to lower deposit costs, of which savers are well-aware.

US Commercial Bank Deposits[31]
(unit in $Billions)



Banks are faced with the challenge of managing existing borrowers who have been granted payment deferrals (mostly personal loans and govt. agency mortgages) or forbearance as part of pandemic relief. As banks ascertain the risks to these loans, it will undoubtedly affect their willingness to make new loans. So far, the major banks are reporting lower-than-expected loan deferral requests and cite high numbers of loan deferral customers that are paying on time.[32] Nonetheless according to credit reporting firm TransUnion, 106 million personal loan accounts were enrolled in some form of payment relief as of May month-end.[33] As deferral programs run off and delinquencies work through the system, losses may not peak for several more quarters. Bank asset quality could deteriorate if this occurs prior to the economy getting back on track.

Another challenge for banks lies in the upcoming annual stress tests required by the Federal Reserve, with results due to be reported the last week of June. Stress tests ensure that banks have adequate capital to absorb losses so that lending could occur even under dire conditions. We expect most banks to fare well in this year's tests. But this time around the Fed is also focused on banks' capital distributions. While most banks have suspended share buybacks, many have robust dividend payouts. The Fed has hinted that maximum dividend payout ratio requirements may be imposed, that would result in forced dividend cuts among some key bank stocks. While this concern may be unwarranted, it is a risk worth mentioning as many investors purchase bank stocks for their above average income distributions.

Despite these near-term hurdles, bank stocks are inexpensive; many of the large cap banks trade just over book value.[34] If employment gradually improves as we expect, the yield curve should steepen which would likely mean that bank earnings can improve. For patient investors, this could be an area of opportunity.

Resource Markets Can Add Luster to a Portfolio

Australia and Canada, although not large in terms of global market capitalization, fit nicely into our search for investment opportunities where quality and uncertainty are both high. Both markets are dominated by high quality financials and both have high exposure to stocks with cyclical characteristics. Together the Financials, Industrials, Materials and Energy sectors comprise 65% of the Australian market and 74% of the market in Canada.[35] Both markets have witnessed sharp upward moves in their currencies since March; these "commodity currencies" have significant exposure to metals and agriculture, and can be viewed as proxies for economic growth. In fact, both economies show signs of having bottomed, yet their market indices are well off their 2020 high levels. MSCI Australia

[31] Federal Reserve, 6/10/2020
[32] CreditSights, 6/9/2020
[33] The Wall Street Journal, 6/18/2020
[34] Bank of America Research, 6/8/2020
[35] MSCI Australia IMI Index, MSCI Canada IMI Index, 6/16/2020

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Index is 18% below its January peak while the MSCI Canada Index remains 15% below its peak in February.[36]

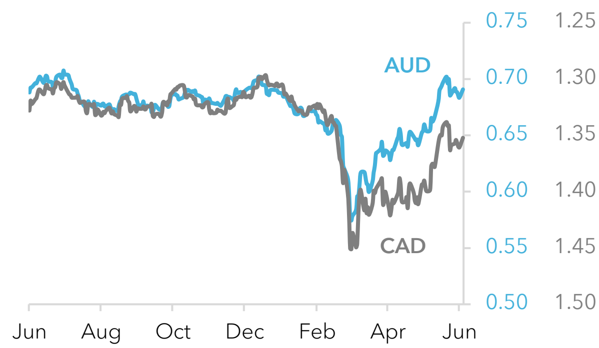
Australia has made significant progress in containing the spread of the COVID-19 virus. Daily new cases have been near zero since mid-May and the mortality rate of 1.4% of those infected remains among the lowest of all measured countries.[37] Mobility has improved but increased activity does not seem to be resulting in new cases of the virus; it seems likely that Australia will retain travel bans at least through the remainder of 2020.

Australia's economy is showing clear signs of rebounding. Housing is improving, with home prices only down marginally from pre-crisis levels and sales estimates have been climbing.[38] This bodes well for the banks, as residential mortgage lending is the largest component of bank loans. Like in the US, Australia's central bank has pumped significant liquidity into the banking sector. The government has offered support for the critical construction sector, that employs 10% of the labor force according to Bank of America.

Although unemployment levels were 7.1% in May, this is below original forecasts of 10% by June.[39] Job losses have been concentrated in the very young and very old segments of the population that do not hold much mortgage debt—another good sign for the banks. As government subsidies taper off, industries are likely to undergo structural change and unemployment could rise from current levels. Like other markets, a higher degree of uncertainty surrounds service sector jobs, as they are more dependent on consumers' willingness to spend.

UBS analysts write that the Australian dollar should be supported by an improvement in the country's balance of payments.[40] Iron ore is a key export; prices and production are both up sharply because of strong demand from China. This view is also shared by BCA Research; the firm writes that Australian bond yields have likely bottomed, as inflows to bonds have improved amidst rising business confidence.[41]

Australian Dollar & Canadian Dollar Spot Prices[42]



Canada shares many parallels with Australia as noted above, although we view the market recovery as slightly more uncertain. For one thing, Canada appears to be further behind in virus containment. Although the trend in new cases of the virus is clearly improving, the mortality rate of 8.3% is bothersome. (For comparison purposes, the mortality rate in the US is 5.4%.)[43] And while we believe that Canada's cyclical market should benefit from an improving global economy, its high exposure to the volatile Energy sector (14.5% Index market capitalization) adds another layer of uncertainty.

As in the US, the Bank of Canada has taken many steps to support economic recovery through lower interest rates and multiple bond and money market purchase programs. Businesses are re-opening, with housing, spending and employment data all improving in May. One-half of all small businesses are fully open but sales are slow, according to the Canadian Federation of Independent Business (CFIB).[44] Job increases in May were split almost

[36] Bloomberg,6/22/2020
[37] JP Morgan, 6/12/2020
[38] Bank of America Research, 6/16/2020
[39] Bank of America Research , 6/16/2020
[40] UBS, 6/3/2020
[41] BCA Research, 6/9/2020
[42] Bloomberg, 6/22/2020
[43] Wikipedia
[44] CFIB, 6/16/2020

equally between goods-producing industries and service industries[45] – a good sign for continued recovery in spending. A deeper challenge, according to BMO analysts, will be recovery in energy-related segments of the economy; they do not expect the economy to fully return to pre-COVID levels until the end of 2021.[46]

Canadian banks are by far the largest industry component of the market; Financials overall comprise one-third of the MSCI Canada Index. Banks appear to be in good shape and able to absorb losses, with capital ratios well above regulatory requirements. Throughout the pandemic, mortgage loan growth has remained elevated, and the large Canadian banks have, on average, just 2% loan exposure to the Energy sector.[47]

Recommend Adding Cyclical Exposure to Portfolios

Major US stock market indices appear to shrug off bad news and climb higher despite expectations for a long and slow economic and earnings recovery. It has become increasingly challenging to find opportunities that are not either: (1) already reflecting full-on optimism because they are pandemic-insulated, or (2) mired in deep-rooted pessimism because they are in the eye of the pandemic storm.

We believe that many securities in the Industrials and Financials sectors, and in the Australian and Canadian markets, may be in that in-between segment: adversely affected by the pandemic but able to recover to normalized levels in the foreseeable future. Because they are cyclical in nature, their asset prices are dependent on gradual economic improvement. We see signs of early economic recovery; patient investors should benefit from portfolio additions in these areas.

[45] Bank of America Research, 6/5/2020
[46] BMO, 6/11/2020
[47] Bank of America Research, 6/1/2020

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