

Economic & Market Outlook

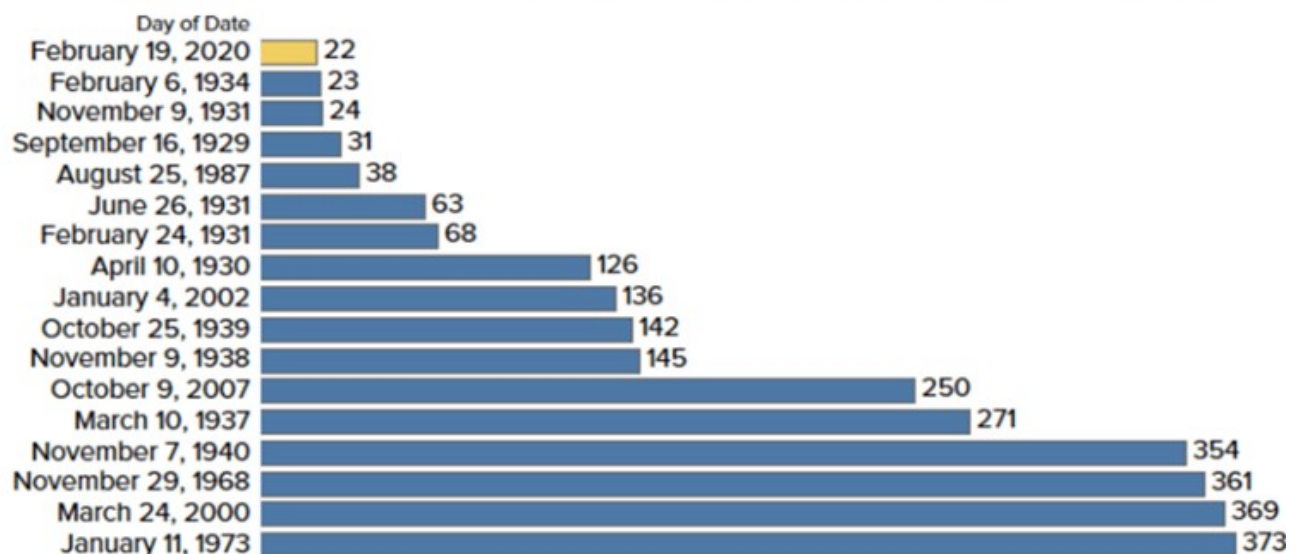
Executive Summary

- ~ The sell-off that ensued in March, across both equities and credit, was one of the sharpest on record.
- ~ Coronavirus has altered daily life around the world. Roughly 95% of the US population is under shelter-in-place orders, and over a third of the global population is practicing some form of social isolation.
- ~ Efforts to restrict the spread of Coronavirus have brought global commerce to a standstill. Initial jobless claims within the United States suggest unemployment sits around 18%, a level that is likely understated.
- ~ Prior to the March sell-off, global equity and credit valuations were historically elevated. Furthermore, excesses within the credit markets undermined the quality of credit issuance.
- ~ The actions taken by Congress and the Federal Reserve to protect our economy and financial institutions are unprecedented.
- ~ Opportunities within the global equity and credit markets are beginning to emerge. Today, we see actionable investment opportunities in the market for troubled credit, particularly within the energy sector.

Introduction

The start of 2020 was marked by one of the sharpest market corrections in history. From the peak (2/19/20), global equity markets fell 33.9% in a matter of only 23 trading days. Investment grade and high-yield corporate bonds witnessed corrections similar in speed. LQD, an ETF tracking the investment grade corporate bond market fell 21.7% in only 9 trading days. The high-yield market saw bond spreads (their incremental yield above Treasuries) climb from 3.4% to 11.0% in only 24 trading days. Within the levered loan market, the four worst trading days on record all occurred within a two week span this March. Although the magnitude of each of these movements is notable, the speed at which they occurred is what sets 2020 apart. The cause of these knee-jerk movements is obvious, Novel Coronavirus or COVID-19.

Number of Days it Took to Drop 30%



Source: CNBC, BofA Global Research

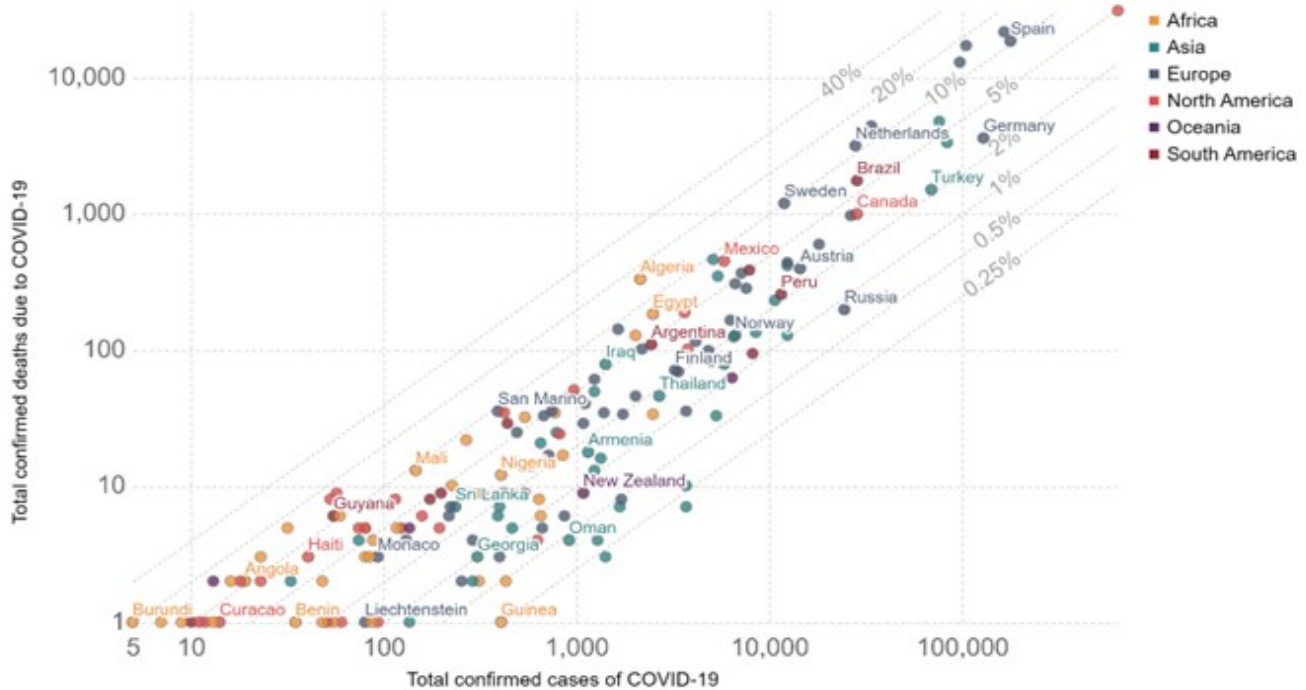
Coronavirus of COVID-19

We won't spend much time on the actual disease, because we are not epidemiologists, and we have all been inundated with information by the press. Here is what we do know.

As of 4/17/2020, there have been 2,206,676 cases and 148,663 deaths reported. If you naively divide the reported deaths by reported cases, you will incorrectly conclude 6.7% of individuals die from COVID-19. Or worse, if you look at the reported statistics where the healthcare system is overwhelmed and the population skews elderly (for instance Italy) you would draw even more dire conclusions (a 12.5% reported case fatality rate). Without good data, it is impossible to estimate the true fatality rate of this disease, and unfortunately, the lack of data exacerbates the level of fear already present in society.

Total Confirmed Cases vs. Deaths, Grey Lines Represent Case Fatality Rates, April 16th, 2020

Note: confirmed case counts are lower than actual case counts leading to overstated case fatality rates



Source: Our World in Data, European CDC—Situation Update

What we do know is the severity of the disease varies greatly from nation to nation. Each country has its own unique situation due to factors like demographics, preparedness, and the steps each nation has taken to combat COVID-19. We also know that the reported case count is understated, which inflates fatality rate statistics. The outbreaks that have occurred on cruise ships, like the Diamond Princess, provide interesting case studies, because their populations were tested and subsequently monitored. Think of cruise ships as less than ideal lab settings. As of March 26th, nine of the 712 infected Diamond Princess passengers had died, representing a 1.3% fatality rate, but it should also be noted some passengers remained in critical care. What we would stress to you is the actual severity of this disease is unknown, and it is best to think of the severity within bands. Right now, these bands are wide, with academic studies ranging from 0.4% to 3.8%, but over time we will gain additional clarity.

It also goes without saying that this disease is highly contagious. In a recent interview, Bill Gates noted “this is a nightmare scenario because human-to-human transmittal respiratory viruses can grow exponentially,” which is exactly what we have experienced. On March 7th, the confirmed case count was 106,099 and a month later it stood at 1,414,228. As we have learned, epidemiologists refer to the initial reproductive rate of a disease as R_0 or R . As was the case with severity rates, we do not know the exact reproductive rate of COVID-19, and it is best to discuss matters in terms of ranges. Initial estimates from the World Health Organization put R_0 at 2.0 to 2.5, implying that one infected individual is likely to infect 2 to 2.5 other individuals. However, a more recent study from the Los Alamos National Laboratory found R_0 to be closer to 5.7.

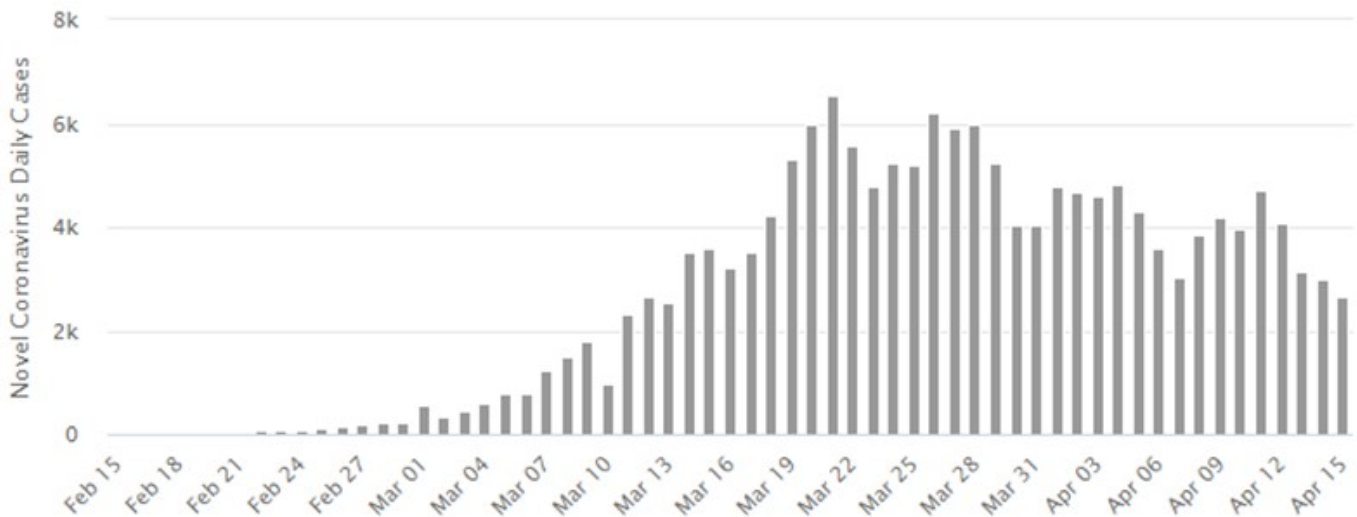
To sum things up, we can't say anything with precision, but we can surmise that we are dealing with a disease that if left unbridled is both deadlier and more contagious than the seasonal flu.

Curves

Governments around the world have taken action to control COVID-19's outbreak with varying degrees of success. The global mantra is to flatten the curve (i.e. the rate at which the disease spreads) via sanitary habits, testing, and most importantly, through various forms of social isolation. By taking these actions, we and other countries around the world hope to reduce the strain placed on our healthcare systems, and in turn, reduce the overall fatality rate of the disease. As of this writing, over a third of the global population is practicing some form of social isolation and 95% of the US population is under shelter-in-place orders.

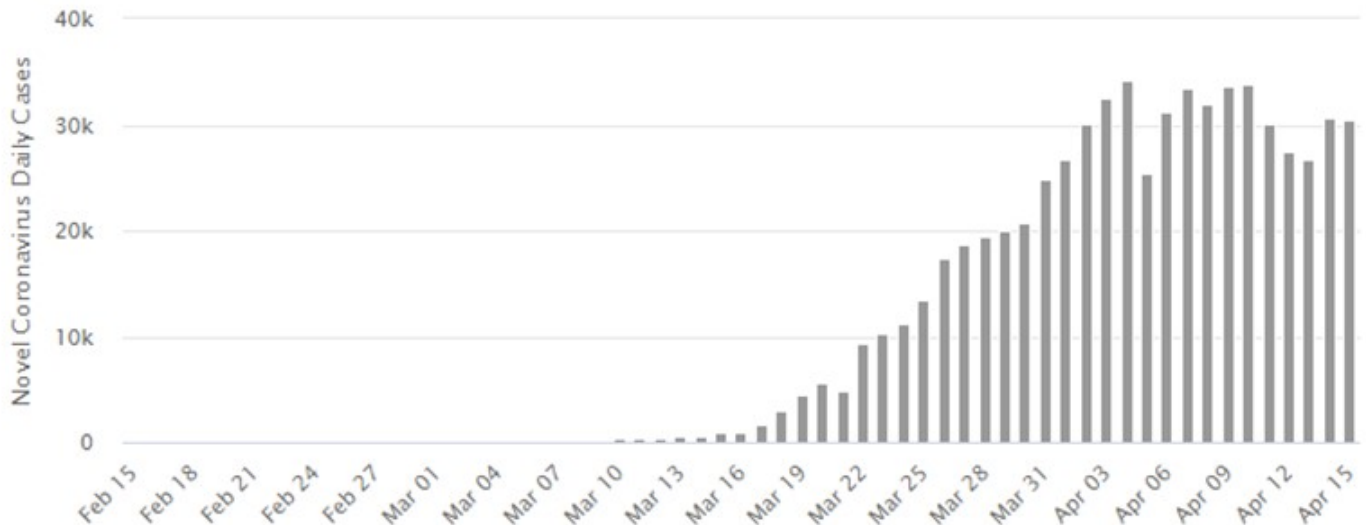
The good news is there are signs that many countries around the world have successfully flattened the curve, and even hope for some that the worst of the disease has passed. Consider Italy, by far the hardest hit nation. New cases in Italy peaked on March 21st, and the average number of new cases has steadily fallen along with deaths. This can be said of most European and central Asian countries. Even data coming out of the United States supports that we may be about to turn a corner for the better.

Italy: Daily New Cases



Source: WorldOMeter

United States: Daily New Cases



Source: WorldOMeter

With that being said, no one knows what will happen once we ease social isolation measures. Somewhat comforting is the fact that the previously discussed reproductive rate is not static. As a larger percentage of the population becomes infected with a disease, it becomes harder for that disease to propagate in society. This is often referred to as herd immunity. Previously infected individuals develop antibodies “theoretically” protecting them from future infections, and in turn, reduce the number of contagious hosts by which the disease can travel. If social isolation measures are lifted, we should expect a resurgence in cases, but the spread of the disease may not be as rapid as it was the first go-around.

The Economy

The economic costs of social isolation are high, if not devastating. It equates to a nearly complete standstill in commerce. There are the obvious first order effects, which we can see playing out in real time.

- ~ Domestic and global travel have come to a halt. By March 15th travelers passing through a TSA check point had fallen 40% year-over-year, and by month-end passenger throughput had fallen 93%.
- ~ Chip Rogers, a lobbyist for the hotel industry, claims that as many as half of the United States 56,000 hotels could close temporarily, and between 10-15% may file for bankruptcy in the very immediate future.
- ~ Retailers (within the US) have been forced to shutter stores and furlough over one million workers. TJX Companies the owner of TJ Maxx, Marshalls, Homegoods, and HomeSense, has not only closed all physical locations, but also its online presence.
- ~ The global restaurant industry has been hit to a similar degree. Open Table reports reservation data for its network of partners. By March 15th they had witnessed reservation seatings fall 48% globally. By month end, that decline rounded out to 100%. Side-note: if you are still looking to dine in the company of other people, it appears there are some establishments generating traffic in Kentucky and the Mexican state of Jalisco.

Almost every business model that requires foot traffic and/or face-to-face interaction to generate revenues is broken until social isolation measures end. To put matters into perspective, the industries directly affected (hotels & tourism, retail, restaurants, entertainment, and transportation) account for roughly 20% of US payrolls with a workforce of over 30,000,000 people. Likewise, these same industries account for almost 19% of US GDP according to JP Morgan. And to be clear, the economic fallout won't stop there. Here are a few follow-on effects:

- ~ Suppliers to industries directly affected will see revenues contract and be forced to take precautionary actions. We have already witnessed several suppliers to the airline and automobile sectors shutter plants and furlough workers.
- ~ Consumer spending will fall as individuals who have lost their income and/or anticipate future declines ratchet back spending. This in turn will negatively affect the broader economy.
- ~ The real estate markets will come under pressure as corporations and individuals miss lease payments. Hotel and retail centers will be hit hardest, but even “safer” real estate sectors such as apartment complexes will be hit. In fact, the National Multifamily Housing Council said only “69% of renting households were able to pay the April rent, down from 81% the prior month.”
- ~ Delinquencies and defaults will increase for various forms of consumer and corporate debt obligations. As we write this commentary, news is coming across the transit that both Wells Fargo and JP Morgan have set aside \$4 billion and \$7 billion, respectively, for future loan losses.
- ~ Banks and non-bank lenders will tighten lending standards making it harder for companies and individuals to obtain credit. Just recently JP Morgan, the country's largest lender, announced it is increasing minimum lending standards to require all home buyers to post at least 20% down and have a FICO credit score of 700 or better.

Like we said earlier, social isolation equates to an almost complete standstill in commerce. It is crippling. Nowhere is this more apparent than in leading indicators of unemployment. Over the last four weeks, roughly 22.0 million individuals have filed for unemployment benefits. This compares to a US labor force of 163 million individuals. This implies that since March 12, the US unemployment rate has grown from 4.4% to 17.9%, its highest recorded level since the Great Depression.



Source: Bloomberg

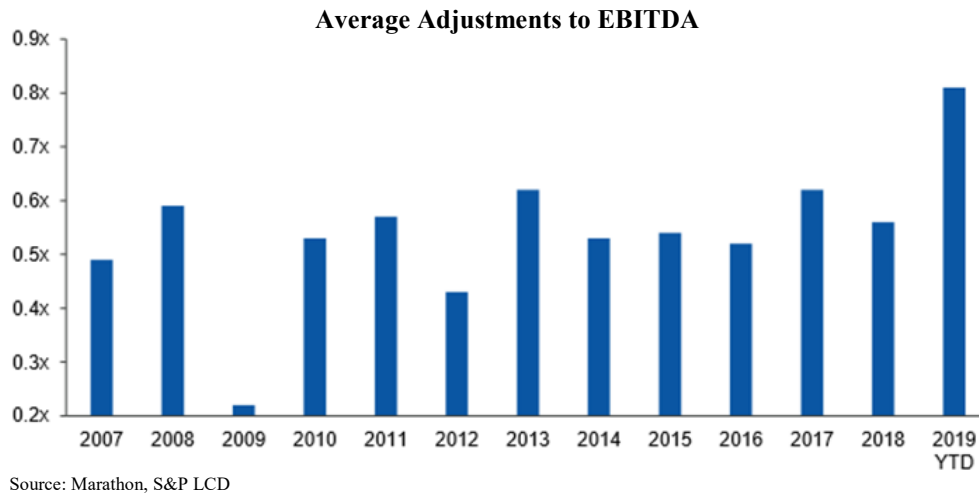
Context Matters

Before we can proceed further, we need to discuss the state of financial markets before the arrival of COVID-19. The business climate had been tranquil for over a decade. The United States was amidst the longest expansion on record, thanks in part to an era of abnormally low interest rates. Stocks traded near record valuations and so did bonds. Alternative forms of capital, provided by private equity and venture capital, flourished. Everything seemed rosy from the standpoint of Wall Street, which in our experience is almost always an omen for bad things to come.

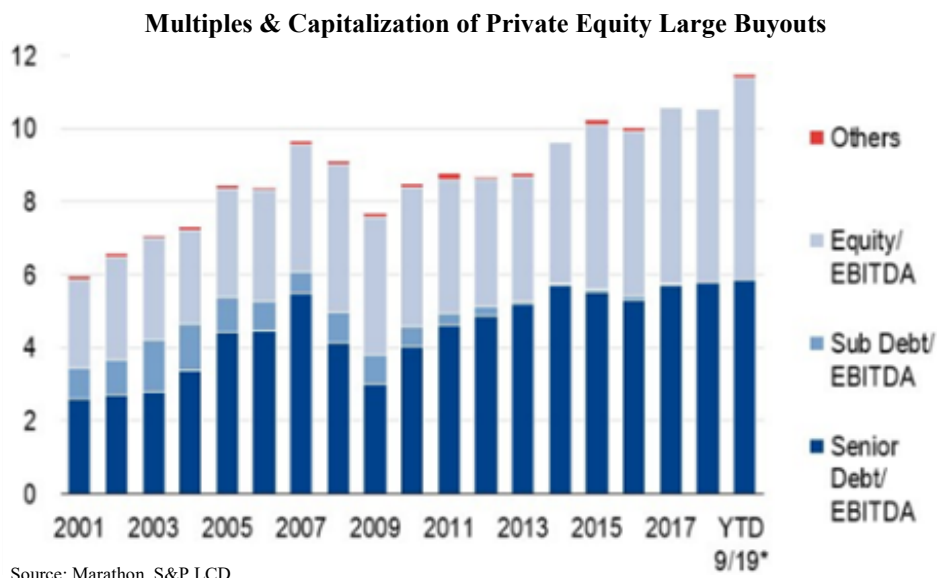
Broadly speaking, our financial system was encouraging what economist F.A. Hayek called malinvestment (i.e. investments that don't make sense unless the cost of credit is artificially suppressed). Think negative yielding bonds, the rise of WeWork, many venture capital funded startups, zombie companies, etc. Over time malinvestment weakens the financial system, but the extent of its damage isn't exposed until a negative shock occurs. The concern most relevant to today's discussion is the malinvestment that has taken place in the non-investment grade corporate credit markets, where years of cheap and abundant credit have encouraged excessive forms of risk-taking. What follows is the brief synopsis:

First, the composition of the corporate credit market has changed. Before the financial crisis, banks dominated the corporate lending markets. Not only were these banks regulated, but they often warehoused or carried the risk of the loans they originated. Today roughly 91% of levered loans are originated by alternative capital providers that don't face the same regulatory scrutiny as banks. Think business development companies and private credit funds (the lending side of private equity).

Second, the marketplace for loans (and bonds) has grown highly competitive. A near decade of economic peace has led to historically low default rates. As a result, income starved investors have perceived these higher yielding credit investments to be less risky. Since 2007, assets under management in the credit sphere have grown four-fold, while the amount of non-investment grade debt outstanding has doubled. Excessive competition has left lenders with little to no bargaining power. Last year, 87% of all levered loans issued were covenant-lite, meaning they lacked basic lender protections. And when bond covenants do exist, they have absurd provisions, such as letting a company inflate its cash flows (EBITDA) by future anticipated synergies.



Third, abnormally low interest rates have, understandably, encouraged borrowing. The total debt of US nonfinancial businesses has grown by about \$6 trillion since 2007, mostly to fund stock buybacks and M&A activity. Total corporate debt as a percentage of GDP stands around 75%, just past its financial crisis peak. With GDP levels set to fall, we should easily set a new leverage record. The use of debt has been most pronounced within the private equity arena. According to S&P Global, in 2019, the average private equity buyout utilized almost six turns of debt financing, a level only matched in 2007. And keep in mind those leverage levels are understated due to ridiculous EBITDA addbacks.



Before COVID-19, the aforementioned warning signs were just that, warning signs. Interest coverage ratios (i.e. cash flow over interest expense) were near all-time highs at 5.2x, and the credit markets were open, making it easy for corporations to make payments and refinance maturities as they came due. Exposing the levels and extent of malinvestment that has occurred required an economic shock - an interruption in cash flows, which COVID-19 supplied.

To help put matters into perspective, consider the following. At year-end 2019, there were 105 distressed issuers with bonds actively trading in the marketplace. Issuers whose bonds are priced at a 1,000-basis point spread to Treasuries, a sign that the marketplace is pricing in some form of default. By March 23rd, the number of distressed issuers had grown to 892 corporations, an 8.5-fold increase, surpassing records set during the Great Financial Crisis. At current levels, it is implied that over 10% of the non-investment grade bond market will default on its obligations.

Number of Issuers with Distressed Bonds



Source: Bloomberg

Enter the Federal Reserve and Congress

Policymakers were quick to recognize that financial markets, corporations, and individuals were ill-equipped to weather the ensuing recession (if not ensuing depression) caused by COVID-19.

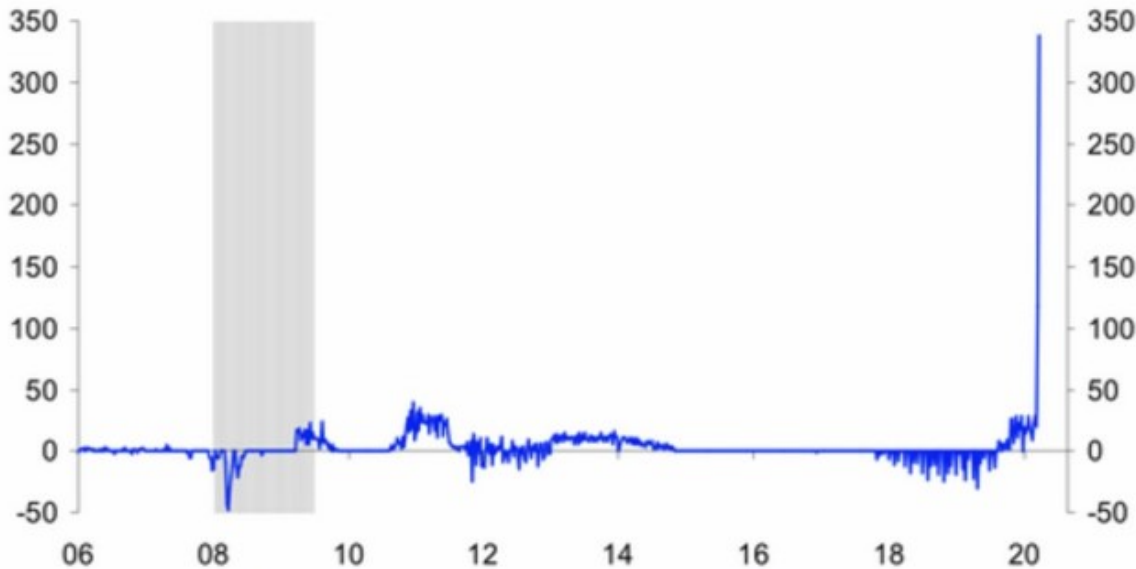
The Federal Reserve was the first to act. On March 3rd, the target Federal Funds rate was cut 0.50%. On March 15th, the Fed called an emergency meeting where they cut the target rate an additional 1.0%. At that meeting, they also announced \$700 billion in quantitative easing (split across Treasuries and mortgage bonds) and established various facilities to ensure the proper function of financial markets. As the month progressed, so did the alphabet soup of programs.

On March 23rd, the Fed fired its biggest weapon yet, unlimited quantitative easing, and a backstop for the ailing credit market. The corporate credit market backstops consisted of the Primary Market Corporate Credit Facility (PMCCF) and the Secondary Market Corporate Credit Facility (SMCCF), which allowed the New York Fed, in conjunction with the US Treasury, to lend and/or purchase up to \$750 billion in corporate credit. These facilities were a direct acknowledgement that the corporate credit markets were broken and without ample liquidity would witness a wave of corporate defaults. Similarly, they established a “Main Street” lending program that would help provide up to \$600 billion in direct loans to small and medium sized businesses. As veteran Wall Street Journal reporter Nick Timiaros said, it was “Powell’s whatever-it-takes moment.”

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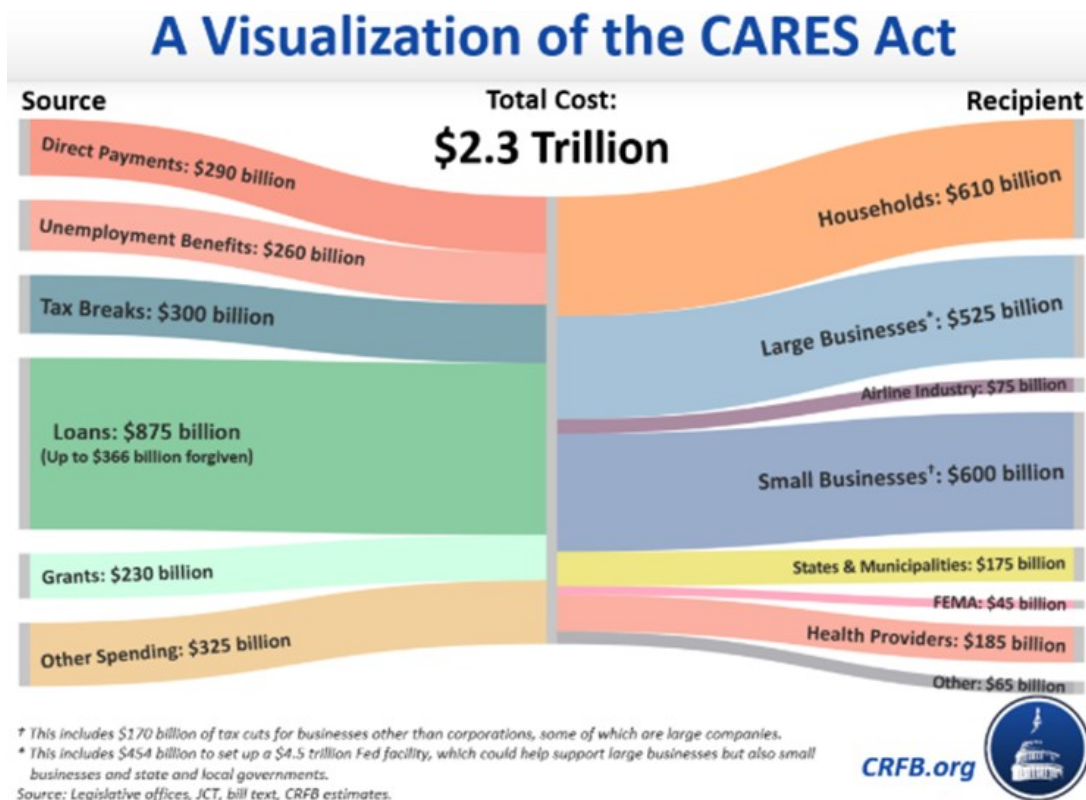
Weekly Change (\$ billions) in Treasury Securities Held Outright by the Federal Reserve

Today the Federal Reserve is buying roughly \$70 billion in Treasury securities per day. This compares to a peak of only \$120 billion per month following the financial crisis.



Source: Wall Street Journal, Deutsche Bank

Not to be outdone, on March 27th the Trump administration signed into law Congress's \$2 trillion economic stimulus package coined the CARES Act. Some of the Act's key components include: (1) Direct cash payments to select US households; (2) Expanded unemployment insurance; (3) \$350 billion in forgivable loans guaranteed by the Small Business Administration for the purpose of funding payroll, rent, and other expenses; (4) Tax credits and deferrals for individuals and corporations; and (5) ~\$450 billion in funding for special purpose vehicles that the Federal Reserve can leverage (10x) and use to backstop credit markets (see the PMCCF, SMCCF, and many other facilities). For perspective, this level of fiscal stimulus is more than threefold what we witnessed during the global financial crisis.



What we are observing is simply unprecedented. There is no historical road map or analog that investors can reference. We are encouraged by how quickly policymakers have rallied to the occasion, but we must also acknowledge the uncertainties that lie ahead.

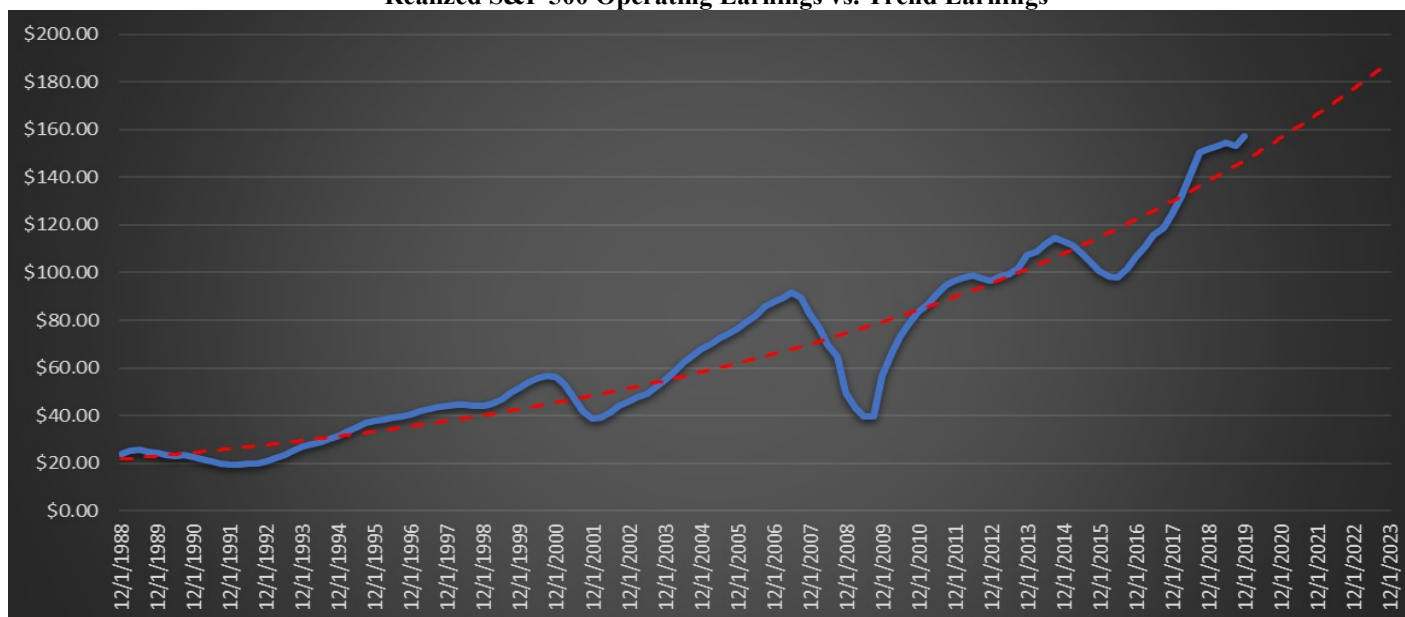
Getting Comfortable with Equities and Credit

We do not know how long social isolation measures will last. We cannot foretell the duration or depth of this recession. We cannot predict the long-term efficacy of the steps taken by the Federal Reserve or the CARES Act. No one can answer these questions with any hope of precision. The only thing we can say is that opportunities to buy assets on an attractive risk-adjusted basis are emerging. We don't know whether the opportunity set will get better or worse from here, but we do know the investment climate is more attractive today than it was when the year began.

To most that will sound counterintuitive, if not crazy, but we would argue the relative attractiveness of equity markets has grown even though we are staring down a recession (possibly a depression) of unknown magnitude. Our rationale ultimately comes down to cash flows and the appropriate way to value them. Last year, the S&P 500 generated \$157 in operating earnings. At the market's peak, on February 19th, the S&P 500 traded at 21.6x trailing earnings. By quarter-end, the market had fallen 23.6%, putting the S&P 500 at only 16.5x trailing earnings. Now here is the question we would pose to you. Would you rather pay 21.6x for a stable cash flow stream or 16.5x for one that is about to experience a major albeit temporary speed bump?

We fall into the second camp and here is an example to illustrate why. Suppose you are given the opportunity to buy an annuity that pays \$1 per annum into eternity. If we pay 21.6x for this annuity we will generate a 4.6% annual rate-of-return. Now let's make that same example relevant to today's situation. Suppose we can buy the same annuity for only 16.5x, but in the annuity's initial years the payment will be lower. If you do the math you will find that even if the first year's payment is zero, you come out ahead. In fact, if you only pay 16.5x you can afford to miss the first five years of annuity payments and still come out ahead of the individual who paid a premium for the stable cash flow stream.

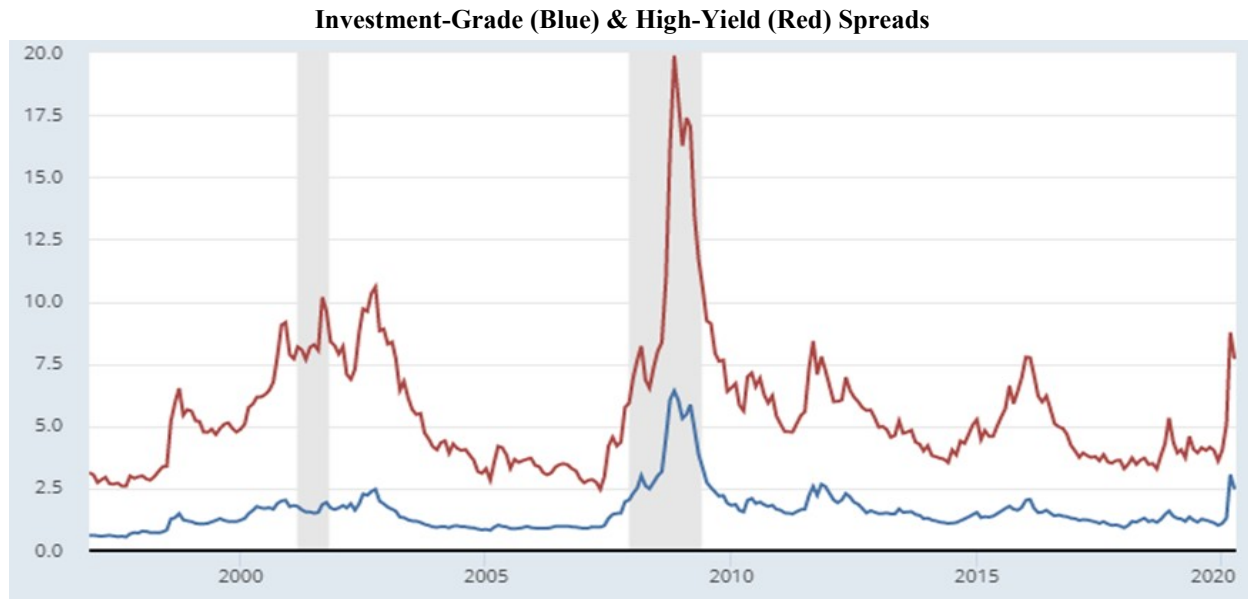
Realized S&P 500 Operating Earnings vs. Trend Earnings



Source: Annandale, S&P

Investors should not forget that in the long-run, markets are valued off of their normalized earnings power. Rational business owners care about how much in earnings their business can generate over its lifetime. By all accounts, COVID-19 will pose a major speed bump for these earnings, but the bump should prove ephemeral. It won't be in 2020 and it might not be in 2021 or even 2022, but eventually corporate earnings will return and surpass last year's levels.

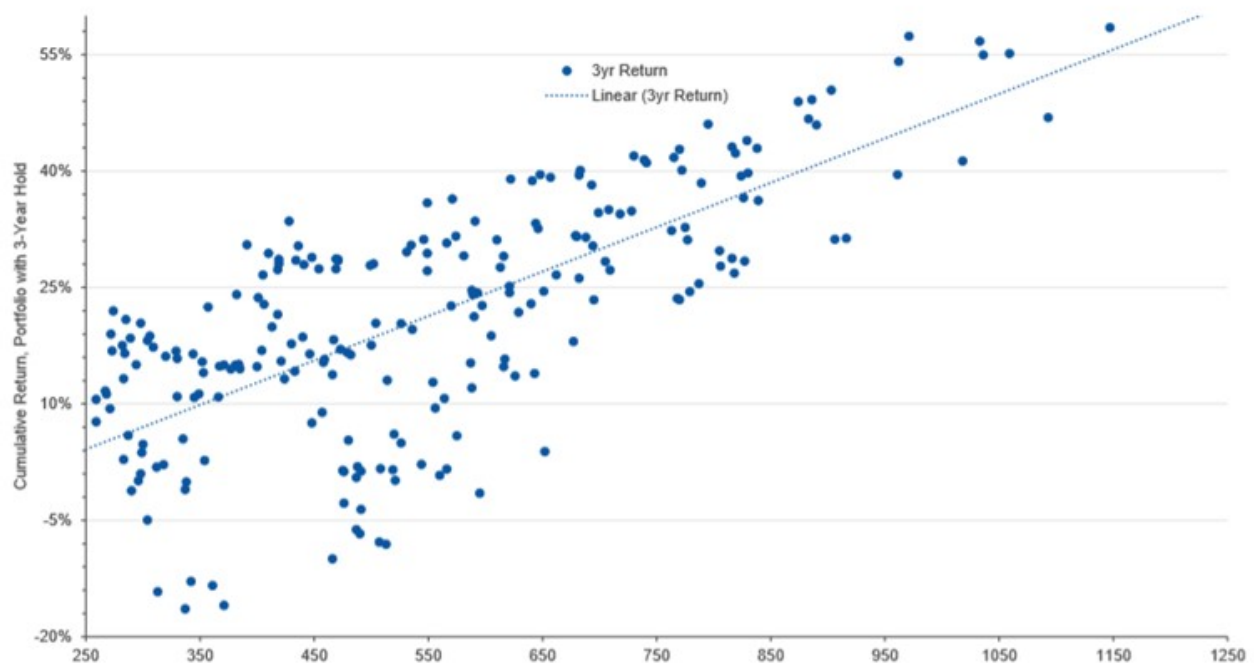
The same case can be made for the credit markets, namely investment-grade and high-yield corporate bonds, an area of the bond market we have avoided for almost two years. We won't rehash all the reasons why, because we outlined many of them in our earlier discussion of non-investment grade credit. Instead we will let the chart below do the talking for us. Before COVID-19 hit, investment grade corporate bonds paid a 1.0% premium to equivalent Treasuries and non-investment grade bonds 3.6%. At these levels, investors could afford only minimal corporate defaults, yet leverage multiples and lending standards were at some of the worst levels in history.



Source: Federal Reserve

By the end of the March sell-off, many of our concerns had been priced into the market. At quarter-end, investment grade corporate bonds paid an additional 3.1% over equivalent Treasuries and riskier high yield bonds 8.8%. In other words, market participants had quickly priced in a wave of defaults and credit downgrades making this asset class less risky than it previously was. In fact, from current levels high-yield credit, the riskiest segment of the market, has never generated a negative 3-year return.

Future High-Yield Returns (3-Year Cumulative) Given Starting Spread Level (Today = 764 bps)



Source: Marathon

We are careful to note that equities and credit markets increased in “relative” value. In other words, the long-term return prospects today are better than they were a month ago or even a year ago. Additionally, their return prospects relative to safer asset classes, like US Treasuries, have increased. Our language would be even more constructive about each of these opportunity sets, but the Federal Reserve’s announced quantitative easing program and corporate credit facilities (PMCCF & SMCCF) quickly put a bid under these assets. For the time being, the Federal Reserve’s interventions seem to have restored liquidity and brought order in the marketplaces. As a result, we plan to patiently take advantage of opportunities where we see a fit in both the equity and broader corporate credit markets, as opposed to jumping all in.

The one opportunity that seems obvious to us is in the market for distressed debt. Earlier in our conversation we noted the number of distressed issuers (i.e. corporations with distressed bonds) had increased 8.5-fold from the end of 2019 to the market nadir on March 23rd. This figure has fallen since the announcement of the CARES Act and the Federal Reserve’s intervention, but not by much. The principal reason why is the Federal Reserve’s corporate backstop programs were limited to companies that held investment grade credit ratings as of 3/22/2020. As a result, a large swath of the corporate bond market is ineligible for the Fed’s programs. By our calculations, the target opportunity set, within the US, amounts to roughly \$1.3 trillion in high-yield bonds, \$1.4 trillion in levered loans, and an unknown amount of privately originated middle-market loans whose fate will be left to the markets. Roughly one-third of those bonds and loans trade at highly distressed prices (less than 80 cents on the dollar). To that end, we are busy identifying individuals with both credit and restructuring expertise who can use the current market dislocation to either buy deeply discounted bonds that will recover and/or use the bankruptcy process to recreate quality assets at extremely compelling valuations. We have already zeroed in on a private opportunity within the energy sector and are examining three additional private investments that have broader mandates to take advantage of this dislocation in the credit markets.

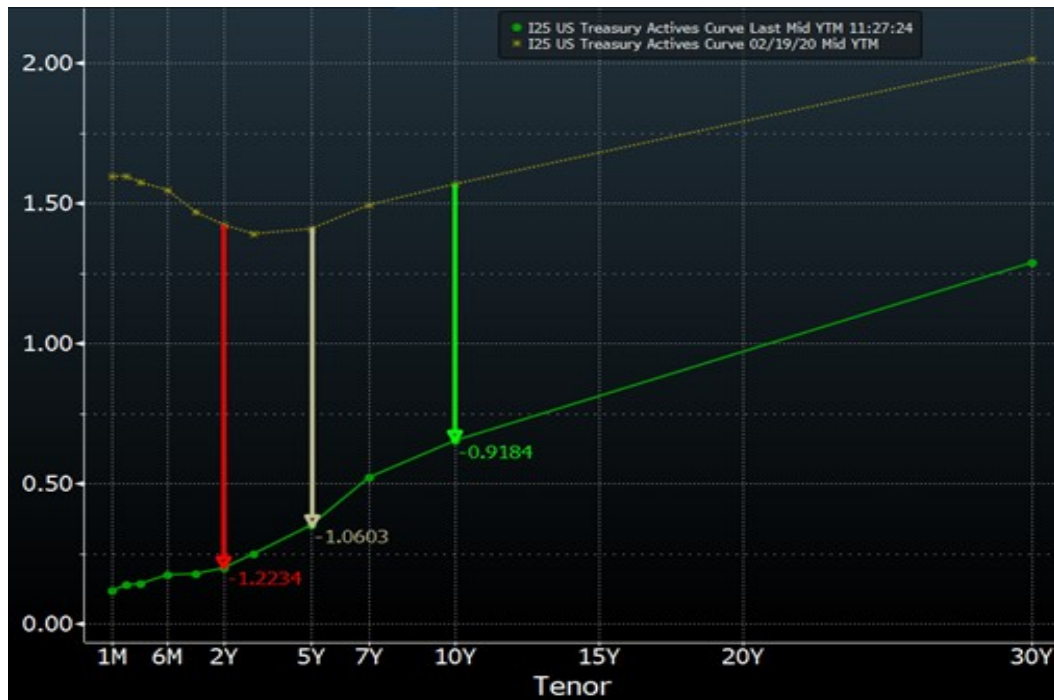


Source: Marathon

Our New Source of Concern

When 2020 began, our single biggest fixed income holding was US Treasuries. To us, it made little sense to reach out on the risk spectrum when other fixed income sectors offered little in the way of incremental return. Our view towards Treasuries today could not be more different. As you can see in the chart below, from the market’s pre-COVID peak on (2/19/20), Treasury yields have fallen precipitously. Two-year Treasuries are priced to yield 0.2% and 10-year Treasuries a paltry 0.6%. For these bonds to generate an acceptable rate-of-return requires a bet on negative interest rates, which we do not feel comfortable making.

Change in Treasury Yield Curve

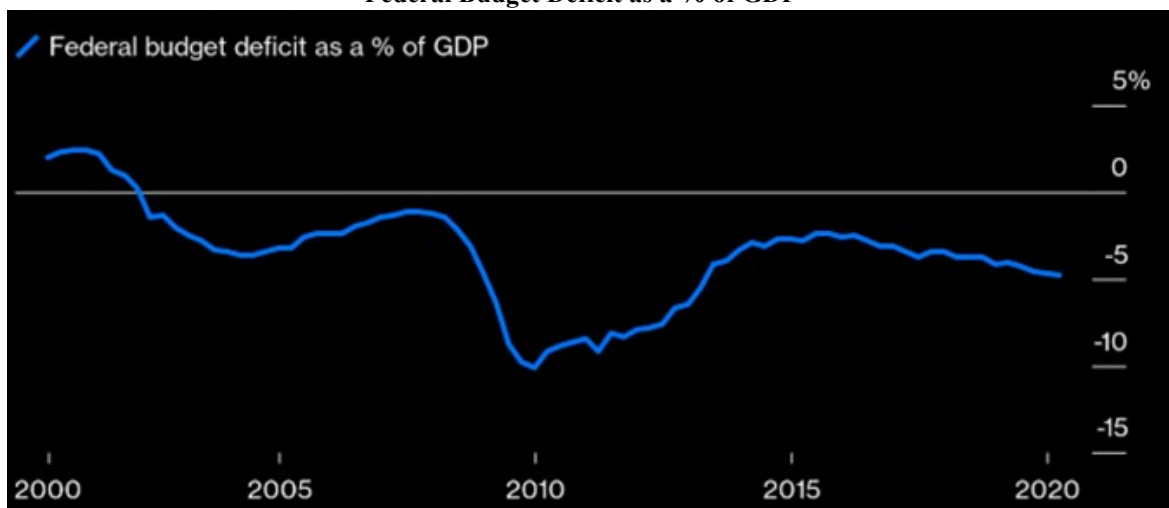


Source: Bloomberg

In the meantime, we cannot help but wonder at what point the combination of money printing and deficit spending will matter? The United States sits in the envious position of holding the world's reserve currency. Said another way, countries around the world perceive our economy to be the safest and strongest, and for those reasons, foreign governments hold reserves of our currency. The US dollar is to the world what gold and silver were in the times of mercantilism. What gives our currency value is nothing tangible, but rather the faith others have in our government and economy.

Before the advent of COVID-19, deficit spending was rampant in our country. Furthermore, ideas like Modern Monetary Theory (MMT) had been gaining acceptance. MMT espouses that the government can deficit spend and use its own printing press to finance that spending. The recently passed CARES Act and actions undertaken by the Federal Reserve have turned these theories into a reality. While we understand desperate times call for desperate measures, we do worry about the long-term effects of unbridled money printing and deficit spending. Given these concerns we plan to gradually unwind our Treasury holdings and redeploy the proceeds into other areas of the fixed income markets, offering more attractive risk-adjusted yields.

Federal Budget Deficit as a % of GDP



Source: Bloomberg

Conclusion

Before we part ways, we wanted to take a moment and say thank you. As a client base, you have handled the volatility of the last month with poise. We would even venture to guess that more clients have called in asking about prospective opportunities than have looking for assurance. Investing during times of uncertainty is difficult, and it requires objective unemotional decision-making. Assets are typically at their most attractive levels when it is hardest to buy. Navigating these markets and populating a portfolio poised to generate attractive returns on the other side is exactly why you have hired us. We look forward to fulfilling our mission and know it will be easier to accomplish given your fortitude.

Thanks for the trust you place in us to steward and grow your capital. We look forward to reporting back to you next quarter.

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