

A Recovery Investment Strategy for COVID19

Recovery Investment Strategy

This recovery investment strategy should not be one's entire investment strategy. A diversified asset allocation driven strategy should remain the core of the whole strategy. However, a dedicated strategy to address the current dislocations and distress can not only be profitable but provide capital where it is needed. This investment strategy seeks to maximize returns relative to risks in the specific context of recession and eventual recovery.

Contagion

The stages of the viral contagion are introduction in the human population, transmission, pandemic, containment, remission and extinction. Society's response will cycle through ignorance, discovery, panic and understanding. What is highly uncertain is the timing and duration of these various phases. Against this uncertainty, one has to construct a robust investment plan.

Social, Political and Economic Phases

Society will cycle through denial, panic, action, normalization towards a new equilibrium.

Government will progress through inaction, panic, containment, normalization and amortization. The economy will evolve from an old equilibrium to panic, recession, recovery and a new equilibrium. Again, the timing and duration of these various stages is highly uncertain.

- Government debt levels are already too high. And are rising fast.
- Real value of stock of debt needs to be eroded by inflation or devaluation.
- Steeper term structures will result.
- More FX volatility. USD initially strong, then to weaken.

Economic policy is already engaged. The lessons of 1929 and 2008 have been well learnt. Monetary policy has been engaged aggressively and may be amplified. That rates are at zero and central bank open market accounts are heavily loaded with securities may mute the efficacy of monetary policy. Nevertheless, no effort will be spared.

Fiscal policy has been engaged to address unemployment and wages. It is likely that fiscal policy will move beyond these initial emergency measures and expand significantly to a higher level. Expect larger deficits across the board. Tax rates will have to eventually rise, and tax codes be more progressive. Sovereign credit risk will be ever present, and accidents could happen, especially in emerging markets. On a relative basis, differential credit strength will likely manifest in exchange rates. Hopefully, countries will coordinate fiscal support with an eye on exchange rates, otherwise FX markets could become volatile. Basically, society has to view countries as roughly equally weak, or equally strong. Any breaking of ranks could result in FX volatility that could require a Bretton Woods redux. Monetary and fiscal policy will be coordinated to encourage inflation which would help to manage the real value of national debts, which will already be surging.

- Corporate debt levels are too high.
- Debt levels need to be reduced. This can only happen through default, repayment or restructuring.
- De-globalization and increasing robustness of supply chains through greater redundancy will increase inflationary pressures.
- Greater credit dispersion and lower credit correlation.

- Good supply of distressed debt. Multi-year opportunity.

The economy is already in recession. The severity is expected to be acute given the sudden and widespread nature of the suspension in activity. A -4% GDP growth number for FY2020 is reasonable to expect. The trajectory of the economy is likely to be U shaped, if this type of characterization is useful. Consensus has postulated L, U, V, W shaped trajectories from recession to recovery. Given human ability, recovery is inevitable, but time frames are uncertain. The duration of recession is one of the most important variables. Investors appear to expect a trough sometime from Q3 2020 to Q1 2021. It is prudent and reasonable to expect the trough to be at the later end of estimates and perhaps even beyond by a quarter or two. The new equilibrium is difficult to picture at this point and will be the subject of another discussion.

- Taxes to rise and be more progressive.
- Household debt levels are relatively conservative.
- Latitude for increasing leverage.
- Consumer debt funding costs must be suppressed. More tranching with senior to outperform.

Households will begin the crisis with balance sheets in better shape than corporates or government, however, the impact of the pandemic on employment and wages will be severe. Direct unemployment benefits, temporary universal basic income and indirect support via wage cost subsidies to employers will be provided by government, further stressing the sovereign balance sheet. This will of course require funding in the form of inflation and higher taxes. The tax code this time can be expected to be more progressive, not by reason of equity but of necessity. Expect also wealth taxes to tax the equity on consumer balance sheets.

Markets

Equities tend to lag in the recovery. The first loss nature of

equity, the need to discount cash flows further into a more uncertain future, and the highly liquid and high retail participation nature of equity markets will make them volatile and less attractive under such high levels of uncertainty.

Credit tends to lead in a recovery. The seniority of claim, the finite maturities, and the less liquid and less retail driven nature of credit makes it less volatile and more attractive under uncertainty.

Duration is a risky bet. Given higher expected inflation (from more robust but less efficient supply chains, and the incentive for government to encourage inflation when debt to GDP levels inflate acutely,) term structures are at risk of steepening significantly.

FX risk will be high. Every country will attempt to inflate and devalue, but not too much. This balance is fine and risky, and a failure of confidence can become an overriding dynamic which could drive rates and FX volatility beyond acceptable bounds. Generally, and on current data (Q1 2020) one expects the USD to strengthen, perhaps for the next 2 to 3 years, and then to subsequently weaken. If sufficient investors hold the same view, take 1 year away from those time frames.

Investment Plan:

Credit dislocation: Q2/Q3 2020

These are opportunities arising from de-leveraging in certain asset markets which were initially over-leveraged. The result of excessive leverage and unstable liquidity has led to price falls to such an extent that current pricing excessively discounts even highly draconian commercial assumptions.

- Investment grade CLO bonds.
- Syndicated loans

- MBS, including reperforming loans, agency RMBS, CRT RMBS, CMBS and non-agency MBS.
- TALF 2.0. The US government, specifically the Fed, is providing cheap financing to investors who are willing to bear some risk in financing US ABS. Basically, the Fed is holding itself out as a cheap and cheerful prime broker for the above assets.

Distressed Debt: Q3/Q4 2020

The speed of the COVID19 pandemic and the collapse in economic activity has yet to fully percolate through asset markets. Some markets are even rebounding strongly on the news of government support. However, the reality of economic recession will come to bear. It just hasn't yet. Distressed investing involves identifying the junior-most security that does not face a full write down in a winding up or restructuring scenario. This is rarely in the equity and mostly in the senior or the secured debt. The writing down of the junior most capital provides a degree of safety to new investors.

- Traditional distress debt investing, including performing and non-performing debt where one lends for control.
- CLO equity and mezzanine. While the investment grade tranches are attractive, once defaults actually occur and impact CLO collateral tests, the junior tranches will likely sell off even more than they have.
- Private credit has been in vogue in the last 5 years to the extent that too much money has been channeled into a crowded market. The funds will need to maintain the leveraged financing, and some existing LPs may need liquidity. This presents an opportunity to provide refinancing or to purchase secondary LP units in private credit.
- Real estate opportunities will also present as real estate is naturally leveraged and may require refinancing or rescue financing. Another adjacent strategy is to provide corporate

capital relief through sale and leasebacks.

Equity Deep Value and Recovery: Q3/Q4 2020, Q1/Q2 2021

Depending on where public equity markets have traded, a case may be made for buying public equities. At current valuations (circa 20X earnings) equities are acutely expensive both in absolute terms and more so in the current context of recession.

- If equity markets sell off more acutely, good value might present.
- Private equity also suffers from over-exuberant pricing and terms. If private equity valuations revert and overshoot, there may be a case for buying. There may be attractive opportunities in PE secondaries.
- In recovery, consolidation, rationalization, and buy outs will be attractive once again as a new expansion cycle begins.

New Equilibrium: Q2/Q3 2021

It is unlikely and not entirely desirable that the world should revert to the condition it was in before the COVID19 pandemic. The human race should be, and is prone to, advancing and improving itself. For investors, the difficulty will be predicting not only the pace of the recovery, which is hard enough but its shape. New industries will replace old. There will be new regulations, new structures, new institutions, possibly a whole new way of living lives. Public equity markets will lag in capturing these thematic developments.

- Generally, the New Equilibrium opportunities will be more easily found in Venture Capital and Early Stage growth private equity.
- Technology and biotech will be areas of development. As

society prioritize employment, a healthy and educated labour force will become more important. Education and Healthcare will be areas of focus and opportunity.

- Real estate will also be changed by the pandemic. As significant portions of society work remotely, commercial office real estate demand will be changed. The physical structure and scale of offices will be changed. Technology particularly in AI and robotics will change the nature of industrial real estate from manufacturing to storage to distribution. Even residential real estate will change around our response to climate change, to health risks, to evolving distribution chains and to the nature of work.

Risks and Contingencies

The Pandemic resolves quickly:

One clear risk to a recovery investment strategy spanning multiple quarters if not years is that the COVID19 Pandemic resolves quickly. A cure or vaccine may be invented. The pandemic may burn itself out, organically, or it may meet an unforeseen natural mitigant, the weather, a competing pathogen with more benign mortality, some physical factor. Or a cheap and quick test is found allowing life to return to some normalcy with minimal interruption.

A contingency plan would involve having pre-arranged credit lines against the illiquid assets in the portfolio allowing one to quickly reposition into a long equity beta posture. A ready shopping list is of course useful, populated by risk-on assets such as equity index or high yield ETFs.

Monetary policy exhaustion:

Given the scale of monetary stimulus, even before central banks have had the opportunity to roll back the policy responses to the 2008 crisis, the risk of monetary policy exhaustion is significant. Hyperinflation, rising interest rates, steepening yield curves could result. Inflation linked bonds, floating rate debt, interest rates swaps and swaptions, are tools needed in the kit before the event.

Fiscal policy exhaustion:

The debt mountain in the economy was clear before the pandemic. The massive amounts being spent on emergency support for the economy are substantial, by Q1 2020, the US has budgeted 11% of GDP in stimulus, Japan some 20%. These initial fiscal support programs will not be the end of it. Further deficit spending should be expected. The funding of these deficits once the pandemic is contained and once the economy has stabilized will be questioned. Hyperinflation and FX volatility are real risks. One should consider FX hedging options and where one can avoid such currency and country risks altogether.

Inflation:

Heavily indebted governments will seek to inflate their way out of debt. Deglobalized supply chains, more robust supply chains with more built-in redundancy will encourage cost push inflation. Hedges such as inflation linked bonds, gold, interest rate swaps and floating rate debt instruments should be included in the toolkit.

Taxes:

As national debt levels surge so too will taxes. Investors need to do periodic and continuous tax planning, reviewing their

investment holding structures so that they pay fair levels of tax but are not paying more than they expect or should.

Expropriations, Prohibitions and other Weird and Wonderful Beasts:

These are extraordinary conditions and extraordinary things can happen. It was in 1933 that President Roosevelt passed executive order 6102 prohibiting the hoarding of gold. The Bretton Woods currency system (1944-1971) was enacted in wartime. The recession triggered by COVID19 is still in its early stages and its evolution is highly unpredictable. One can only guess at the strange innovations that could beset us; fixed maturity currencies, a new system of fixed exchange rates anchored by the RMB, the mutualization of Eurozone sovereign debt via covered bonds, the establishment of a Federal Corporate Finance Agency to guarantee loans, tax receivables securitizations, the abolition of freehold property, and other seemingly outlandish ideas.

Growth is much worse than expected:

The central scenario behind this recovery investment plan is already gloomy. Even so, the risk remains that reality is worse. The economy could take 3 to 4 years to bottom. The recovery, when it happens, could be very slow with global growth below 2% per annum. The stressed conditions could exacerbate the US China rivalry, perhaps precipitate proxy wars, or war could arise elsewhere where we don't expect it. The EU could fragment as adversity tests the integrity of the union. China could be widely blamed for the COVID19 pandemic leading to economic sanctions with global consequences. The economic stress could amplify feelings of inequality and injustice fueling localized civil unrest. Nationalism, trade war and protectionism could rise.

Many of the assets in the recovery strategy are illiquid and of long gestation. These will need to be hedged. Liquid investments

can be sold, at a cost. Where investments are maintained they should be senior in claim, higher in credit quality and lower in equity beta. Gold will be a sought-after asset.

Long Term Possibilities:

Human response to adversity is to either cooperate or compete. The actual response will be difficult to predict and will be different in each context. The COVID19 pandemic presents us with acute adversity which will test the direction we take. Already, in the last 10 years, globalization had been in decline as nations sought to be less interdependent and more self-sufficient.

The supremacy of the US dollar may face a challenge from the Renminbi. China faces the trade-off between internationalizing CNY but relinquishing some control or maintaining control but sustaining the dominance of the USD. The challenge may not come from CNY but from some hitherto non-existent digital currency, sponsored by America's rivals, or disenchanting friends.

Supply Chains: Efficiency X Robustness = a Constant. Supply chains to be restructured for more robustness. This implies diversification of supply chains, and to some extent, self-sufficiency. The robustness of supply chains need not imply self-sufficiency but can be achieved by diversification, not just geographically but between labour intensive and automated. Costs likely to rise but there will be increased capex as well.

Automation and Labour: Automation has already been increasing and the pandemic and lockdowns will only accelerate the adoption. There will be immediate adverse impact on labour potentially to the extent that the right to own automata is questioned. Artificial intelligence can both extend or replace human ability. General AI's ability to do both will be extended with consequences on how we live and work.

Centralized versus Decentralized Planning. Conventional economics

contends that decentralized decision-making results in the best outcomes. With higher quality and quantity of data and the tools available to big data, the constraints upon central planning are significantly mitigated. As information tends asymptotically towards perfection, central planning may yield superior outcomes to the second-best solutions of decentralized planning.