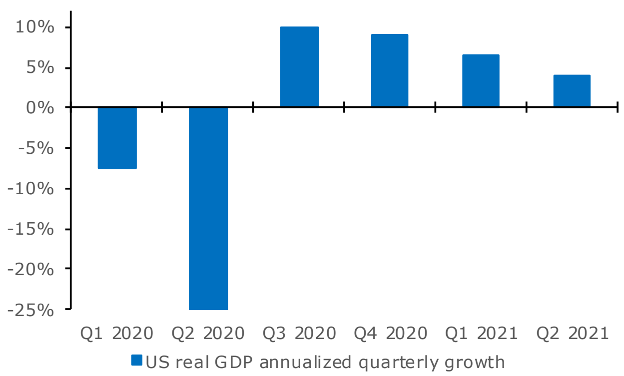
Quarterly Investment Letter – Q2 2020

Hope for the best, prepare for the worst

The **COVID-19** has just given the world economy an **external shock** and the crisis in 2008 seems almost like a walk in the park. The measures taken to contain the pandemic are leading to a massive contraction across sectors. Even if the pandemic can get under control, the damage has already been done. A **global recession has become a fact** as illustrated by the chart underneath, which is based on quarterly GDP estimates from Goldman Sachs.

Chart 1: US real GDP annualized quarter-over-quarter growth



Source: Goldman Sachs, Bloomberg, Alpinum Investment Management

Global GDP growth will be **highly negative in Q1 and Q2 2020**. For Q3 and Q4 2020 economists are positive but still undecided, whether we will see a **V-shaped, U-shaped or no recovery at all**. It remains open, whether output will **recover quickly** to pre-crisis levels because of massive pent-up demand (V-shaped), **slowly** because of the deep recession and lost income (U-shaped) or **remain depressed** and leading to a deepening contraction because of high unemployment and negative second round effects. Besides the economic downturn, the world is faced with a **liquidity crisis**, which is best illustrated by **price dislocations and dysfunctionalities** in fixed income markets because of forced liquidations. The **script to forced liquidations** starts with a spike in volatility, leading to increasing correlations and higher

Summary Points

- Central banks and governments around the world will do "whatever it takes" to bring the world economy back up and running. The chances that a deepening contraction can be avoided are intact.
- A recovery depends on progress in testing people and finding medication to reduce the mortality rate. A normalization is only likely if there is positive news changing investors' perception about future economic growth.
- Europe is around six weeks behind China and could see a peak of new infections in mid to end of April, while the US is around eight weeks behind China and could see a peak in early May only.
- Emerging markets with large external financing needs suffer from a sudden stop in capital flows. Consequently, the currency depreciates and increases the burden of foreign debts in real terms.
- **Conclusion**: With a global recession now a certainty, government bond yields remain very low and offer no long-term investment perspective, but help diversifying the portfolio as of now. Credit spreads in some market segments have reached extreme levels and led to price dysfunctionalities. In equities "there is blood in the streets" but one cannot call a bottom yet. Places to hide are the global health care and consumer staples sectors. The situation remains very fluid. We recommend a well-diversified portfolio across asset classes with relative high cash levels as investment opportunities will be plentiful once the Covid-19 crisis ebbs down.

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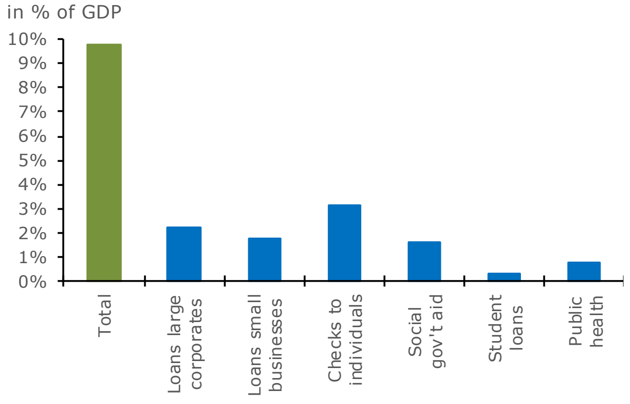
expected losses (so-called "value at risk"). As a consequence, financial institutions increase their margin requirements, which leads to margin calls and forces leveraged investors to sell. This process feeds on itself and can spin out of control, if there are no buyers on the other side. This Quarterly Letter is about many "ifs", as the situation is very fluid and information constantly changing.

United States

In the fight against COVID-19, the US is probably **eight weeks behind China**. This means that if China saw a peak in new infections on March 10, the **US could see such a peak beginning of May** only. In order not to risk a new wave of infections, measures could only slowly be rolled back and, hence, economic activity would only slowly recover. The entire process **could well last into August**, depending on progress in testing people and finding medication to reduce the mortality rate. Estimates for developing an effective **vaccine** range between **9 to 18 months**.

With the US in recession, the debate is now about **how deep** it will be and the **shape of the recovery**. Goldman Sachs, for example, expects a V-shaped recovery with quarter-on-quarter annualized GDP growth in Q1 2020 to drop by -6%, to collapse by -24% in Q2 and to recover by +12% and +10% in Q3 and Q4, respectively (chart 1). The full year **GDP growth for 2020 in the US is expected to drop by -3.8%**. The COVID-19 outbreak is not only **challenging** for large corporates, but **in particular for small- and mid-sized businesses**, which are the backbone of the economy. To cushion the economic crisis, the US has proposed various **fiscal relief packages totalling USD 2.2 tn or 10% of GDP** (chart 2).

Chart 2: Breakdown of US fiscal stimulus package of USD 2.2 tr



Source: Gavekal Research, Alpinum Investment Management

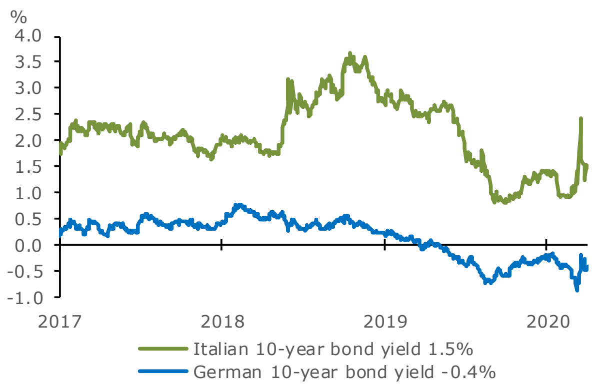
It is to ensure liquidity for big corporates, pay expenses for small businesses that retain workers and replace lost wages to individuals through expanded unemployment insurance. In the end, it is to make sure that previously **solvent companies do not become illiquid** and are driven into bankruptcy. The US Fed on its side has cut interest rates to zero and has launched **unlimited quantitative easing (QE)** to ensure liquidity in the commercial paper, municipal debt and investment grade corporate bond markets. **All told, the combined measures are unprecedented in American history**.

Europe

Europe is probably **six weeks behind China** in fighting COVID-19. Hence, **Europe could see a peak of new infections in mid to end of April**. In this crisis, Europe seems to have realised that this time it is **not about ideology or orthodoxy, but action.** As such, European leaders and finance ministers have swiftly responded with aid packages.

First and as a pre-requirement, the European Commission granted EU countries **"full flexibility" in their fiscal rules** to allow them to boost expenditure. Subsequently, European governments have reacted with individual measures such as credit guarantees, income subsidies, tax deferrals and others. In the short-term, markets will turn a blind eye on debt and fiscal budgets. However, in the **medium term, Italy** which already entered the crisis from a position of weakness, **will take centre stage again**.

Chart 3: Italian versus 10-year German bond spread



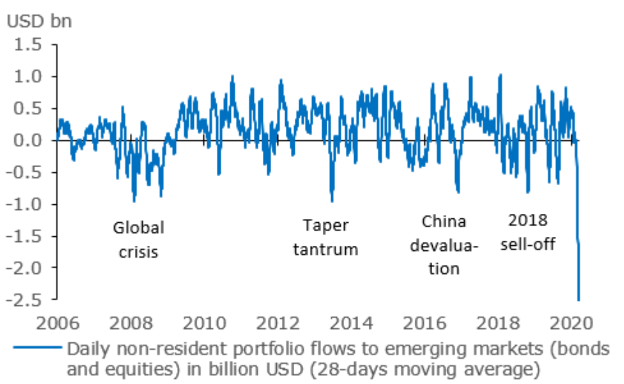
Source: Bloomberg Finance L.P., Alpinum Investment Management

The European Central Bank (ECB) has also responded by taking various measures. Its true weapon, however, **is its OMT program** (outright monetary transaction program), which has never been used so far. The OMT program allows the ECB to buy an unlimited amount of bonds of a Eurozone country, if financing cost are pushed to unsustainable levels, threatening a break-up of the Eurozone. Should Italy's 10-year bond yields (currently 1.5%) spike as they did back in 2011, the official use of OMT is just a question of time.

China and emerging markets

China was been successful in terms of containment of new infections and is in the process to put the economy back on track. Estimates are that **China is operating at 80-85% of its normal level again.** That said, official data on work resumption, electricity consumption and rail freight traffic has become more limited. The Ministry of Transport, for example, has stopped updating daily passenger transportation data. Looking at the most recent numbers in industrial output (-13% yoy), retail sales (-20% yoy) and investment (-24% yoy), **China GDP growth will be hit hard**. Reliable numbers are not available yet but first estimates are that **GDP growth in 2020 could be down to 1.4%** (5.9% in 2019), which is nothing less than a recession in Chinese terms. As China is ahead of the rest of the world for around eight weeks, China's incoming numbers will allow to estimate the extent of damage that large scale quarantines will have on other global economies.

Chart 4: Daily non-resident portfolio flows to emerging markets



Source: Haver, Inst. of Internat. Finance, Alpinum Investment Management

As mentioned at the beginning, second **round effects pose another macroeconomic risk**. Such a risk is liquidity and credit in emerging markets (EM). Over the last two weeks **capital flows in EM have suddenly stopped** (chart 4). There is policy space in EM to respond to the situation but the sudden stop in capital flows puts **EM with large external financing needs** at a particular risk. Such countries are Chile and Colombia, which are more dependent on commodity prices and Turkey and South Africa.

Indicators in focus:

- China monetary conditions index (availability of credit in the system)
- Li Keqiang index (measuring electricity consumption, rail freight and bank loans)
- Daily non-resident portfolio flows to emerging markets (external financing stress)

Investment conclusions

With all the stimulus measures from governments and central banks around the world, the chances are intact that a **deepening contraction can be avoided.** However, it remains a potential scenario. **A V-shaped or U-shaped recovery is possible** but depends on progress in testing people and finding medication to reduce the mortality rate. Right now it still feels like an open-ended problem. As a consequence, investors have sold no matter the fundamentals, which has led to price dislocations and **market dysfunctionalities. Mostly affected have been fixed income and bond markets.** Investment visibility is very low in the short-term. We, therefore, recommend a **well-diversified** portfolio across asset classes with relatively **high cash levels.** Once the COVID-19 crisis is ebbing down, investment opportunities will be plentiful. The sweet spot to play the recovery in equities and credit markets will be in cyclical sectors.

Fixed Income: The authorities will try to avoid a **freeze up of credit markets** under any circumstances. With a global recession now a certainty, corporate default rates could jump from current levels of 3% p.a. to 10-15% p.a. However, combined measures by central banks and governments around the world should put a ceiling on that number. **Government bond yields are anchored at historical low levels** and credit spreads are expected to remain wide in the short-term. Credit spreads in high yield and senior loans **have already reached extreme levels** and imply not only double digit default rates, but also a sizable liquidity premium on top of it. All fixed income markets, but US Treasuries, were dysfunctional in terms of pricing at some point in March and offer historic investment opportunities for long-term investors.

Equities: "There is blood in the streets" but one cannot be sure of a bottom yet. The global health care and consumer staples sectors are to be favored in this market environment.

Whether in fixed income or equities, the **situation remains very fluid** and investors need to be agile in their positioning. **If chaos can be averted, investment opportunities will be plentiful.**

Market Consensus Forecasts

Economists and strategists are still in the process to evaluate and update the macroeconomic impact on their 2020e and 2021e forecasts.

GDP growth (%)	2018	2019	2020e	2021e
World	3.6	2.9	2.5	3.3
United States	2.9	2.3	1.1	2.0
Eurozone	1.9	1.2	-1.0	1.5
Germany	1.5	0.6	-0.1	1.4
France	1.7	1.3	-1.5	1.6
Italy	0.8	0.3	-2.3	1.3
United Kingdom	1.3	1.4	-0.6	1.5
Switzerland	2.8	0.9	1.1	1.3
Japan	0.3	0.7	-0.8	1.1
Emerging economies	4.9	n.a.	3.2	4.8
Asia Ex-Japan	6.0	5.3	3.7	5.5
Latin America	1.6	1.1	0.3	2.6
EMEA region	3.1	2.5	1.7	2.7
China	6.7	6.1	3.9	6.2
India	7.0	6.1	4.9	[illegible]
Brazil	1.3	1.1	0.1	[illegible]
Russia	2.5	1.3	[illegible]	[illegible]

Inflation (%)	2018	2019	2020e	2021e
World	3.6	3.4	2.8	2.8
United States	2.5	1.8	1.7	2.1
Eurozone	1.8	1.2	1.0	1.4
Germany	1.9	1.4	1.3	1.5
France	2.1	1.3	1.2	1.4
Italy	1.3	[illegible]	0.4	1.0
United Kingdom	2.5	[illegible]	1.3	1.8
Switzerland	[illegible]	[illegible]	[illegible]	0.5
Japan	[illegible]	[illegible]	[illegible]	0.6
Emerging economies	[illegible]	[illegible]	[illegible]	3.4
Asia Ex-Japan	[illegible]	[illegible]	[illegible]	2.3
Latin Amer[illegible]	[illegible]	[illegible]	[illegible]	7.5
EME[illegible]	[illegible]	[illegible]	[illegible]	5.2
[illegible]	[illegible]	[illegible]	[illegible]	2.1
[illegible]	[illegible]	[illegible]	4.8	4.0
[illegible]	[illegible]	[illegible]	3.5	3.7
[illegible]	[illegible]	4.5	3.2	4.0

Central bank rates (%)	2018	2019	2020e	2021e
US Fed Funds	[illegible]	[illegible]	[illegible]	[illegible]
ECB Main Refinancing	[illegible]	[illegible]	[illegible]	[illegible]
China 1yr Best Lendi[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Bank of Japan [illegible]	[illegible]	[illegible]	[illegible]	[illegible]
UK Base [illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Swis[illegible]	[illegible]	[illegible]	[illegible]	-0.75

[illegible]	2018	2019	2020e	2021e
[illegible]/barrel	49	60	32	35
[illegible]USD/barrel	56	65	35	39
[illegible] USD/metric ton	71	91	78	67
[illegible]opper USD/metric ton	5965	6174	4985	4875
Gold USD/troy oz	1277	1518	1605	1597
Silver USD/troy oz	15.5	17.9	14.7	14.2

Major r[illegible]	2018	2019	2020e	2021e
USA 3mt[illegible]	[illegible]	1.9	0.7	1.1
USA 10yr[illegible]	2.7	1.9	1.1	1.6
Eurozone [illegible]	-0.3	-0.4	-0.5	-0.4
Eurozone 1[illegible]ond	0.2	-0.2	-0.4	-0.1
China 3mth [illegible]	3.3	3.0	2.0	2.2
China 10yr Gov't Bond	3.3	3.1	2.6	2.8
UK 3mth rate	0.9	0.8	0.3	0.5
UK 10y Gov't Bond	1.3	0.8	0.5	0.8
Swiss 3mth rate	-0.7	-0.7	-0.8	-0.8
Swiss 10y Gov't Bond	-0.3	-0.5	-0.7	-0.4

Exchange rates	2018	2019	2020e	2021e
EURUSD	1.15	1.12	1.13	1.16
EURCHF	1.13	1.09	1.08	1.10
USDCHF	0.98	0.97	0.96	0.96
EURJPY	125.81	122.20	120.00	124.00
EURGBP	0.90	0.85	0.87	0.85
USDJPY	109.70	108.72	107.00	108.00
GBPUSD	1.27	1.33	1.29	1.34
USDCNY	6.88	6.96	7.00	6.85
USDBRL	3.88	4.02	4.39	4.20
USDRUB	69.72	62.49	67.50	66.25

Performance table

		Performance		
Global equity markets	Price	2019	Ytd Q1	Div.yld
MSCI World (USD)	1853	25.2%	-21.4%	3.1
MSCI World (USD) hedged	902	28.4%	-19.8%	n.a.
HFRX Global Hedge Fund	1204	8.6%	-6.9%	n.a.
S&P 500	2585	28.9%	-20.0%	2.5
Russell 1000	1416	28.9%	-20.6%	2.4
Nasdaq 100	7813	38.0%	-10.5%	1.2
Stoxx Europe 600	320	23.2%	-23.0%	4.4
MSCI Emerging Markets	849	15.4%	-23.9%	3.5
Nikkei 225	18917	18.2%	-20.0%	2.6
China CSI 300	3686	36.1%	-10.0%	2.8

	Forward		EPS growth	
Equity market valuations	PE	PB	2020e	2021e
MSCI World (USD)	14.7	1.8	7%	14%
MSCI World (USD) hedged	n.a.	n.a.	n.a.	n.a.
HFRX Global Hedge Fund	n.a.	n.a.	n.a.	n.a.
S&P 500	15.9	2.6	3%	16%
Russell 1000	16.1	2.5	5%	17%
Nasdaq 100	20.8	5.1	10%	21%
Stoxx Europe 600	13.2	1.4	22%	14%
MSCI Emerging Markets	11.2	1.2	3%	18%
Nikkei 225	13.9	1.2	14%	13%
China CSI 300	11.1	1.5	19%	13%

		Performance		
Global gov't bonds	Yield	2019	Ytd Q1	YtW
10yr US Treasury	0.67	8.5%	10.3%	n.a.
10yr Euro gov't bond	-0.47	6.8%	0.4%	n.a.
10yr German gov't bond	-0.47	3.1%	2.1%	n.a.
10yr Italian gov't bond	1.52	14.5%	-0.9%	n.a.

		Performance		
Global bond indices	Price	2019	Ytd Q1	YtW
Barclays Global Corporate IG	263	11.5%	-5.4%	3.0
Barclays US Corporate IG	3123	14.5%	-3.6%	3.4
Barclays Euro Corporate IG	243	6.2%	-6.2%	1.8
Barclays Emerging Market USD	1095	13.1%	-9.5%	7.2
Barclays US Corporate HY	1906	14.3%	-12.7%	9.4
Barclays Pan-European HY	351	12.3%	-15.1%	9.6

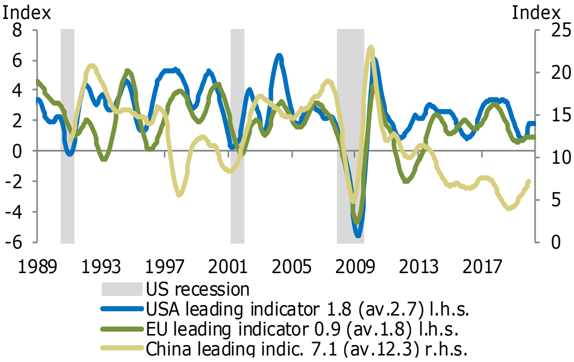
		Performance	
Commodities and currencies	Price	2019	Ytd Q1
Brent oil	23	22.7%	-65.5%
US Energy Services	25	-2.9%	-68.4%
Copper	4943	3.3%	-19.7%
Gold	1577	18.3%	3.9%
EURUSD	1.10	-2.2%	-1.6%
EURCHF	1.06	-3.7%	-2.3%

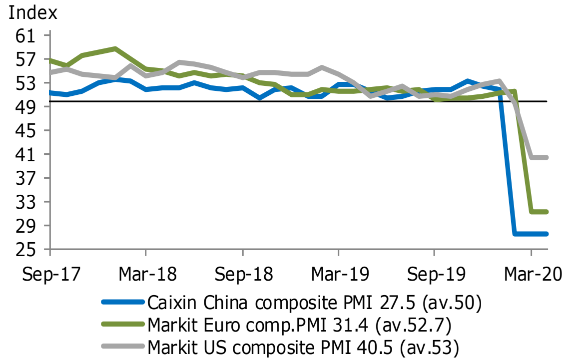
Source: Bloomberg Finance L.P., Alpinum Investment Management
Note: Q1 = data as of March 31, 2020 / PE=price-earnings / PB=price-book / EPS=earnings per share / YtW=yield-to-worst

Key Charts

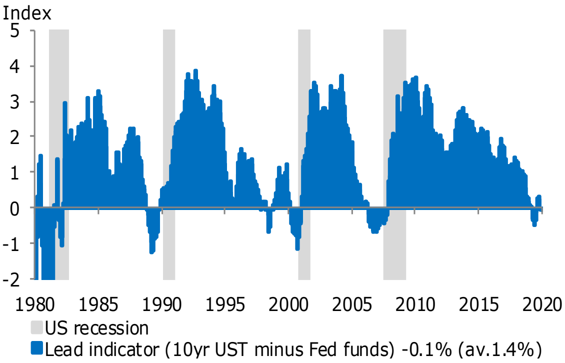
Leading indicators and manufacturing

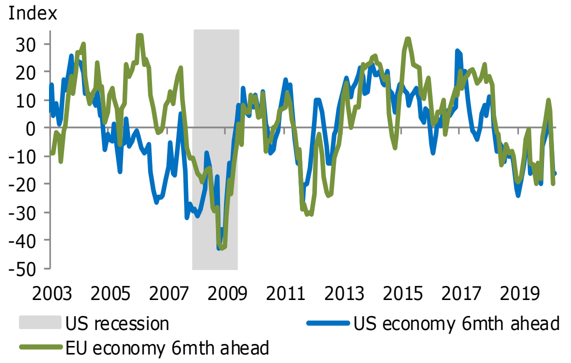
Source: Bloomberg Finance L.P., Alpinum Investment Management



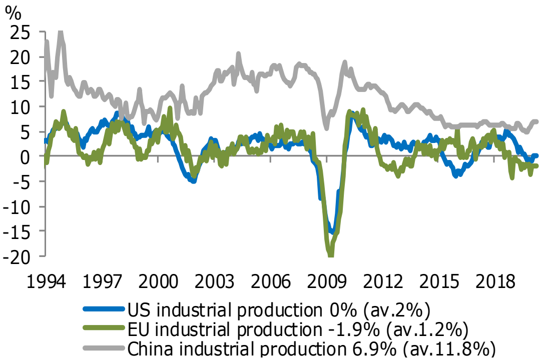


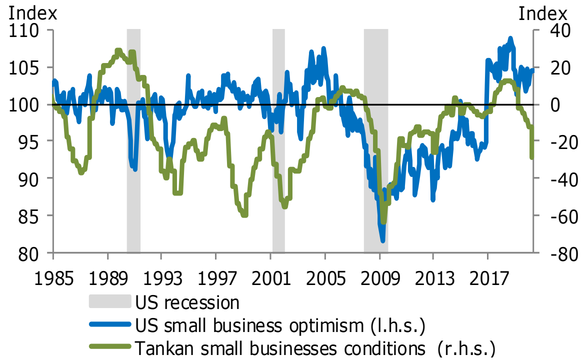
Recession indicator



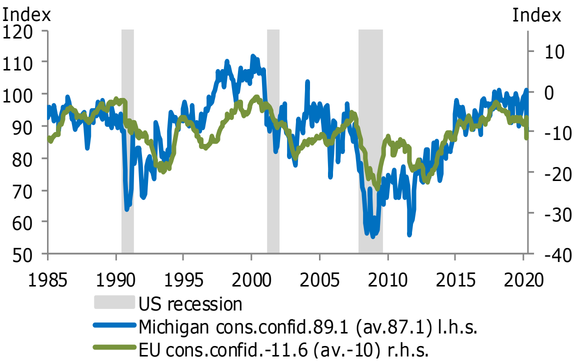


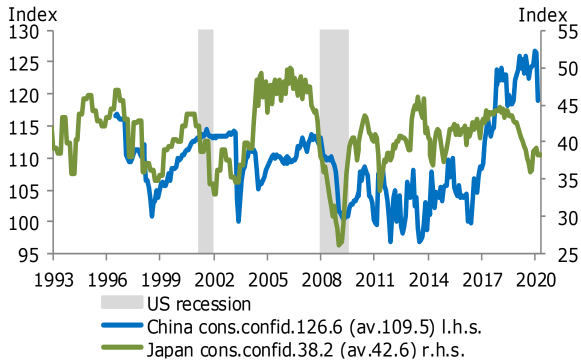
Industrial production and small businesses





Consumer confidence





Scenario Overview 6 months

Base case 70%

- **US:** U-shaped recovery. GDP growth collapses in H1 2020 and the U.S. enters into a rapid and severe recession of an unseen magnitude. Unprecedented government support softens the damage somewhat. H2 (Q4) will benefit from pent-up demand when lockdown is eased. Steep increase of corporate defaults (mainly energy/services sectors).
- **Eurozone** GDP growth collapses with immense financial damage to Southern Europe as tourism shutdown affects also summer months. More severe crisis as in 2011. Huge fiscal stimulus and unprecedented actions of the ECB can avoid a financial collapse for now, but Europe acts as the weakest global link to the Covid-19 crisis.
- **Chinese** GDP growth negative in H1; recouping all in H2 for a minimal positive number in 2020.
- **Oil:** Prices remain low and volatile. Exposed to conflicts among OPEC members, Russia and U.S.

Investment conclusions

- **Equities:** Equities have a wild ride. Soon the focus shifts to 2021 earnings. However, for now, uncertainty remains elevated and path of recovery remains uncertain and asks for a premium via lower PE multiple of <16x. Ultra-lose central banks provide equities an advantage vs. low (negative) interest bearing bonds. US and Asian equities are preferred.
- **Interest rates:** Neutral on rates, but yields are not attractive. (US) Duration exposure serves as a valuable diversifier and tail hedge.
- **Credit:** Credit spreads are wide and will somewhat tighten despite a spiking corporate default rate. Loans will recover from their lows. IG bonds are again attractive with higher spreads now. Distressed CLO valuations will normalize in H2.
- **Commodities/FX:** USD stops strengthening heading into Q3. Gold benefits.

Bull case 15%

- **US:** V-shaped recovery. After the collapse of the economic activity in H1, we experience a V-shape recovery in H2 as shutdown gets terminated more quickly. Pent-up demand feeds quickly into all parts of the economy and even the service sectors recovers to 70-80%. Total resumption rate >95%.
- **Europe:** Thanks to the V-shape recovery and the immense fiscal and monetary stimulus, peripheral countries avoid a collapse.
- **China/EM:** Normalization in Q2. H2 will be particularly strong as export markets recover (EU/USA) and interest rates remain low and help easing the pressure on local FX depreciation.

Investment conclusions

- **Equities:** Equities mirror the V-shape recovery of the economic activity and have the potential to reach pre-crisis levels as monetary and fiscal stimulus are ultra-expansive.
- **Interest rates:** Rates will normalize, curve steepens. Avoid duration as inflation revives.
- **Credit:** Corporate default rates surge, but will not top 2008-levels. Credit in general and loans in particular will benefit the most.
- **Commodities/FX:** Support for commodity bloc and precious metals, EUR accelerates, EMFX stabilizes.

Bear case 15%

- **US:** Lock down lasts longer than anticipated and recessionary environment will remain as the knock-on effects can't be avoided. Pent-up demand was not sufficient to recover enough and GDP resumption < 95% (L-shaped recovery).
- **Europe:** Peripheral countries are close to a collapse as tourism fallout is severe. Investors lose faith and Italian long-term yields rise. Germany is also unable to leave the recessionary territory. (EU confidence crisis 2.0).
- **China/EM:** China is able to recover domestic growth rates, but exports suffer from global recession. Rest of EM is doing poorly as global trade is on low level and currencies are depreciating.

Investment conclusions

- **Equities:** Equities fall to new lows with European equities performing the poorest. Use bear market rallies to reduce exposure.
- **Interest rates:** Rates will go lower, but not much room left. Support for high quality assets (US Treasuries, A and AA corporate bonds or agency bonds). Cash is king!
- **Credit:** Financial crisis 2.0 is emerging. Corporate default rates climb above 12% p.a., but thanks to unprecedented monetary and fiscal spending a collapse of the financial system is avoided. Favor short dated & high quality bonds.
- **Commodities/FX:** Negative for commodity bloc, USD & CHF (safe haven) remain robust.

Tail risks

- Asset price bubble bursting, liquidity shock.
- An Italian sovereign debt crisis, Euro break up.
- US/China military conflict in the South China Sea.
- Iran closing the Strait of Hormuz, leading to an extended oil price shock.
- Emerging market meltdown similar to 1998.

Asset Class Conviction Levels

Equities	Underweight		←		Conviction Level over 6 Months Neutral		→		Overweight
North America	☐		☐		☑		☐		☐
Europe	☐		☐		☑		☐		☐
China	☐		☐		☑		☐		☐
Japan	☐		☐		☑		☐		☐
Asia - Emerging Markets	☐		☐		☑	←	☐		☐
Others - Emerging Markets	☐		☐		☑		☐		☐

Fixed Income	Underweight		←		Conviction Level over 6 Months Neutral		→		Overweight
US - Treasury Bonds	☐		☐		☑		☐		☐
Euro - Government Bonds	☑		☐		☐		☐		☐
US - Investment Grade Bonds	☐		☐	→	☑		☐		☐
Europe - Investment Grade Bonds	☐	→	☐	→	☑		☐		☐
US High Yield	☐		☐		☑		☐		☐
US Short Term High Yield	☐		☐		☐		☑		☐
US Loans	☐		☐		☑		☐		☐
US Municipal Bonds	☐		☐		☐	→	☑		☐
European High Yield	☐		☐	→	☑		☐		☐
European Short Term High Yield	☐		☐		☑		☐		☐
European Loans	☐		☐		☐		☑		☐
US/EUR Preferred Securities	☐		☐		☐		☑		☐
US/EUR Asset Backed Securities	☐		☐		☑	←	☐	←	☐
Emerging Market Local Currency	☑	←	☐	←	☐		☐		☐
Emerging Market Hard Currency	☐		☐		☑	←	☐		☐
Emerging Market High Yield	☐		☐		☑	←	☐		☐

Commodities	Underweight		←		Conviction Level over 6 Months Neutral		→		Overweight
Gold	☐		☐		☐		☑		☐
Oil (Brent)	☐		☐		☑		☐		☐

Hedge Fund: Strategies	Underweight		←		Conviction Level over 6 Months Neutral		→		Overweight
Equity Long-Short	☐		☐		☐		☑		☐
Credit Long-Short	☐		☐		☐		☑		☐
Event-Driven - Corporate Actions	☐		☐		☐	→	☑		☐
Global Macro	☐		☐		☐		☑		☐

Hedge Fund: Regional Focus	Underweight		←		Conviction Level over 6 Months Neutral		→		Overweight
Hedge Fund: North America	☐		☐		☑	←	☐		☐
Hedge Fund: Europe	☐		☐		☑	←	☐		☐
Hedge Fund: China / Japan	☐		☐		☑	←	☐		☐
Hedge Fund: Emerging-Markets	☐		☐		☑		☐		☐

Note: The above conviction table reflects on the one hand our view of the relative expected return of an asset class versus well-recognized benchmarks such as BarCap Global aggregate (for bonds) and MSCI World (equities), but does on the other hand also partly incorporate our view of the absolute expected return versus "cash".

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