MWC MANENTIA WEALTH CONSULTING GROUP

Quarterly Market Overview 2Q 2020

July 2020

MWC Group

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When an irresistible force meets an immovable object

> ***"We've seen two years' worth of digital transformation in two months…"***
> **Microsoft CEO Satya Nadella, quarterly earning presentation, April 2020**

Regular readers of our missives may have realised that we have a penchant for using laws and theories from the world of physics to try and put into perspective that which takes place in the world of the financial markets and the consequent impact our investments.

The corona crisis including the consequent government response has been a disaster for modern civilisation, causing an exogenous shock to the global economy the likes of which we have never experienced. If someone had told you six months ago that we would have a global pandemic and a global economic shutdown in response to that pandemic that resulted in the biggest surge in unemployment in the modern era and the most negative quarter for GDP on record, that the stock market would only fall 30-something percent and then be back near all-time highs* in three months, you would most likely have laughed them out of the building.
*admittedly, only as measured by the S&P 500 or the Nasdaq 100, but both are driven by a handful of FAANG stocks which is hardly reflective of the wider economy or other markets.

In the world of finance, we're witnessing an irresistible (unstoppable) force beginning to collide with an immovable object, and the impact between such large (read: theoretically, of infinite size) elements is creating all sorts of fascinating outcomes in the markets:

- on one hand, we have the biggest global economic contraction of the modern era, the highest unemployment level in post-WW2 history, and a virus that continues to affect consumer, business, and government behavior. The world went into this crisis with record debt-to-GDP levels, which made what could have been a manageable situation into a more extreme one. The fiscal stimulus that government has been obliged to provide to cushion the blow to incomes and economic activity resulting from the lockdowns is on a scale equivalent to being in on a war footing and is otherwise unprecedented in times of peace. Private debt is also set to increase as companies seek to bolster or repair their balance sheets to counter their diminished cashflows and excessive risk taking.

	Government Debt (%GDP)	Private Debt (%GDP)	Combined Debt (%GDP)
United States	100%	150%	**250%**
Japan	204%	163%	**367%**
Euro Area	84%	164%	**248%**
China	54%	204%	**258%**

Source: IMF Global Debt Database, 2018 Data

This is the immovable object: an incredibly heavy economic anchor that has grown over decades and whose acceleration in growth has been triggered by a random event.

- on the other hand, we have the largest-ever collective fiscal injection by countries around the world, and rapid debt monetization and asset purchases by central banks to facilitate those sovereign deficits and smooth out volatile markets. For example, the US Federal Reserve has crossed the Rubicon into buying individual bonds including some junk bonds, as well as municipal bonds, in addition to the Treasuries and mortgage-backed securities they already have a long history of buying.

  This is the unstoppable force: the ability of Central Banks to use an infinite balance sheet to print money and buy assets.

The result is that we have very large dislocations, like the stock market soaring on heightened liquidity, and junk bond spreads lower than they would be in a natural market, while the economic situation remains stressed. As this chart below shows, employment levels in the United States have crashed to levels not seen since previous recessions in 2003 and 2009, and yet the stock market itself has reflated nearly back to all-time highs.

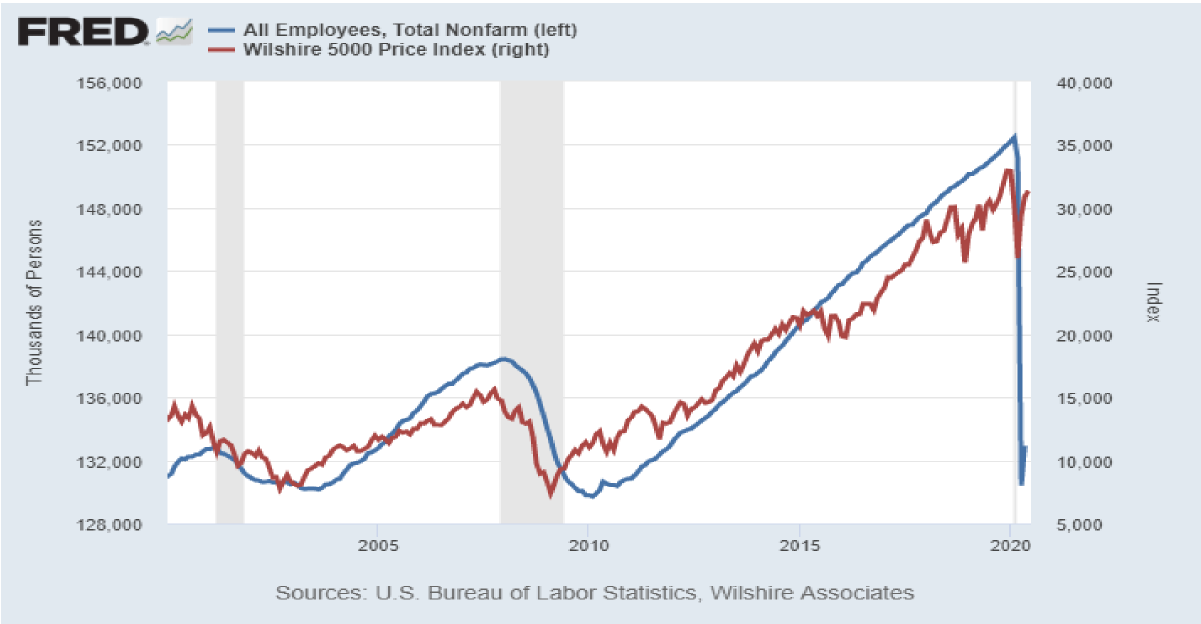


Chart Source: St. Louis Fed

A record amount of stimulus has supported equity markets, while the economy continues to face serious issues. If, as the saying goes that ‘a picture paints a thousand words’, then the image above neatly encapsulates the concerns at the forefront of investors’ minds: how to reconcile what is taking place in the financial markets with what is happening in the real world, to you and me, to our jobs, our mobility and our health?

Policy revolution

There has been a much-needed policy revolution to cushion the coronavirus shock. Policymakers are relying less on financial sector transmission (monetary) to stimulate activity and more on direct support (fiscal) to the real economy, with a melding of fiscal and monetary policies as well as government intervention in the economy and financial markets.

We alluded last year to the necessity for more coordinated monetary and fiscal response to a major shock because it would help reduce lost output and could lessen risks such as rising inequality. Without proper guardrails and a clear exit strategy, however, this would create medium-term risk of uncontrolled deficits with commensurate monetary expansion and, ultimately, rising inflation.

The initial Covid-19 contraction is larger than the global financial crisis, but we believe its cumulative impact on the economy will likely be less as long as the policy response remains strong enough to cushion the blow. The global policy response to the pandemic has been unprecedented in speed and size with the combined sum of fiscal and monetary actions so far covering the virus-related hit to the economy in both the U.S. and euro area. We now see a risk of policy fatigue in the U.S. as policymakers face a series of “fiscal cliffs” and may cut fiscal relief prematurely. By contrast, Europe has been slower with the policy response and is only now ramping up stimulus efforts.

Where are we now? Debt has ballooned – so far without a rise in rates. If coordination made that possible, it could be tempting to continue even in normal times – as postulated by Modern Monetary Theory (MMT). But there is no free lunch. Debt rollover will become harder if and when rates rise. It may eventually have to be dealt with through austerity, default or inflation. Inflation could be seen as the most politically palatable solution. And even a well-designed monetary policy strategy may not prevent inflation over time due to the effects of de-globalization and re-regulation.

We believe that the policy revolution was essential as it was needed to cushion the devastating and deflationary impact of the virus shock. It is a near-term positive for risk assets – but is unlikely to be the prelude to the type of policy-driven, decade-long bull market that followed the GFC. In the medium term, however, the blurring of monetary and fiscal policy could bring about upside inflation risks.

The Economy

The virus-shock was like a natural disaster – and very visible – and is entirely different from the normal business cycle. Global economic activity was deliberately frozen to stem the pandemic. The initial shock was sudden and very deep. Yet what matters for asset pricing is the cumulative

impact of the growth shortfall over time. Markets priced in the impact before the horrendous job losses materialized. The unprecedented policy response initially helped turn risk assets around in late March. Once the extent of the damage started to become clear in April, markets looked forward to the reopening of economies and eventual recovery. Although the policy actions to cushion the impact of the virus shock were nothing short of a revolution, execution remains a risk. If successful, we see the cumulative economic damage even under the currently most bearish forecasts as below that in the wake of the 2008 global financial crisis. As such, there doesn't appear to be a major disconnect between market pricing and the real economy.

History offers little insight on the path of economic reopening – or on how asset prices should react. Ahead of us is a "restart" of economic activity, with many uncertainties around how quickly people and companies will feel comfortable to resume their pre-pandemic activities. The longer it takes for activity to restart, the more cracks might appear in the financial system and productive capacity. That leaves us with key risks of renewed infection waves, policy exhaustion and any permanent damage to the economy. Therefore, setbacks from any of these key risks could hit asset prices.

The shock will have long-term consequences that are starting to play out. The pandemic is reinforcing structural trends such as ecommerce and the digital economy, and amplifying de-globalization and geopolitical fragmentation. It has also highlighted the weaknesses in many countries' healthcare systems, which were often structural and driven by capitalist considerations of efficiency and cost-effectiveness. We expect a major revolution in the healthcare sector in particular as measures are implemented to address these weaknesses.

Now that many governments are working on reopening their economies, we need to assess what the 'new normal' may look like. Transitions do not happen overnight, but we expect this crisis to act as an accelerator for some macro-related trends, including the emergence of a bipolar world (increasing confrontation between China and the US), reshoring (value chains shifting from global to local) and the need to implement more unorthodox macro policies. This all has consequences for governments, companies and investors alike.

We observe a widening divergence in recoveries among regions, countries and sectors, which has implications for the respective credit qualities, growth potentials and also for the respective currencies. The crisis has revealed some of the conceptual shortcomings in politics and economics and shown our vulnerability to such shocks. For investors, it is important to learn from what we have seen and prepare for the future.

Geopolitics

The pandemic has added fuel to geopolitical dynamics already underway. The post-coronavirus world is likely to be characterized by several key themes:

- The world will increasingly become bifurcated, with the U.S. and China at opposite poles. Intense rivalry looks set to affect nearly every dimension of the U.S. – China relationship, regardless of the U.S. election outcome. Other countries may increasingly be pushed to choose sides.

- The pandemic is poised to accelerate de-globalization as it magnifies nationalist and protectionist trends. The crisis adds to existing pressures such as global trade tensions and populism. This threatens to disrupt the web of global supply chains at the expense of efficiency. It may lead to onshoring the production of strategic goods.

- Government intervention in economies is likely to become more entrenched. Unprecedented policy support comes with strings attached including curbs on share buybacks and dividend payouts and companies increasingly will need a social license to operate.

- Lastly, the pandemic exacerbates inequalities within and across countries. It has hit emerging economies with more limited policy capacity harder.

Domestic polarization is on the rise too, with the U.S. presidential election set to take place against the most tumultuous domestic backdrop since 1968. The two parties are as far apart on policy as they have ever been, making the result consequential for markets with a Trump victory possibly marking an escalation on the trade issue with China and a Democratic victory potentially threatening to reverse the 'business-friendly' Trump policies.

The US and China continued to exchange blows as President Trump condemned Beijing's new security laws on Hong Kong which would erode the autonomy of the former British colony under the 'one country, two systems' model. The move was met by the revoking of special trade privileges Hong Kong had enjoyed which had enabled it to become one of the world's financial hubs. Tensions were further escalated when TSMC, the Taiwanese and world's largest contract semiconductor manufacturing company, announced plans to build a $12bn plant in the US, succumbing to President Trumps' calls to boost domestic production and shift reliance away from Asia.

Brexit still hangs in the balance. The self-imposed end-2020 deadline by the UK government for an agreement with the EU to allow for an orderly exit looks increasingly unlikely to be met. We cannot rule out another 11th – hour solution, but the longer this saga continues, the greater the likelihood of a disorderly exit. One way or another, an exit will be long-term positive for the UK economy.

Peering into the future

Stocks rallied so sharply in Q2 for a number of reasons – chiefly stimulus, both fiscal and monetary, as well as the reopening of economies and reduced virus infection rates in most countries, though this trend has somewhat come undone in the US and other countries in the last couple of weeks. So far, the resurgence in infections appears to be localised and localised measures are being implemented. Policy-makers appear to be trying to avoid countrywide lockdowns, but we cannot yet rule out a secondary wave wide-scale restrictions.

The aggressive pullback in February and March also left stocks rather oversold on a short-term basis, when considering the stimulus and relative yields to government bonds. Monetary and fiscal stimulus, and more recently news on virus treatments or vaccines, have fueled a huge rally from March lows, though ultimately there is a risk that the stock market is not accurately reflecting second-order and longer-term economic impacts of the virus and attendant economic shutdown (including bankruptcies and temporary layoffs becoming permanent job losses). There is also a risk that the stock market is not accurately reflecting the weakness yet to be fully felt in corporate earnings.

Meanwhile hopes of a vaccine are central if we are to see 2021 look more like 2019 than this year. For gains to be sustained in Q3, stocks require the continued support of stimulus, which remains on tap, as well as a better outlook on the virus spread and for the hard-economic data to show a strong bounce from Q2, both of which could be quite variable. In today’s environment, the stock market seems to be high on “hopium’’ with regard to the expected success of a reopened economy and also with regard to finding therapeutics or a vaccine for the virus itself.

For additional views, we provide a link to an interview with Mohamed El-Erian, Chief Economic Advisor at Allianz and former CEO of PIMCO: The New Normal: Mohamed El-Erian’s Predictions for the Global Economy

Final Thoughts

In our 1Q20 commentary, we thought that there would not be permanent damage to the global economy resulting from the lockdowns. We were quick to come to this assessment, even having lacked the visibility on what the lockdowns had meant for China, its economy, its people and the effect on their mobility as well as the changes in their behaviours. Having come through an equivalent experience ourselves, we are reassured that our instinctive reaction was not entirely misplaced. Some may argue, but in our opinion, it would be on semantics and while there will be some damage in some parts economy, there will also be many gains made through the elimination of inefficient practices and their replacement with more productive ones.

What is now abundantly clear is that many adaptions to work and life under the lockdowns will be far-reaching and long-lasting. Many will result in permanent changes to societal interactions and working practices, and there will be winners and losers in the economy. This is fundamentally reshaping the investment landscape and how we, as investors respond to those changes will be key to investment outcomes.

We began with a quote from Microsoft's CEO. We end with yet another company executive pointing to an acceleration in digitalisation. **Applied Materials'** CEO said in its earnings call:

"...the global pandemic is acting as an accelerator for key technology inflections that were already underway. Working from home, learning from home and e-commerce are driving investments in cloud data-centres and communications infrastructure.

We expect companies to build stronger business continuity plans which will include geographic redundancy and increased use of automation and IoT technologies, and the adoption of AI and Big Data remains non-discretionary for many companies. As I have said before, these game-changing technologies will transform entire industries and there will be big winners and losers through the transition. My personal view is that we will see significant and permanent changes in the way companies operate and prioritize their investments."

Data Table

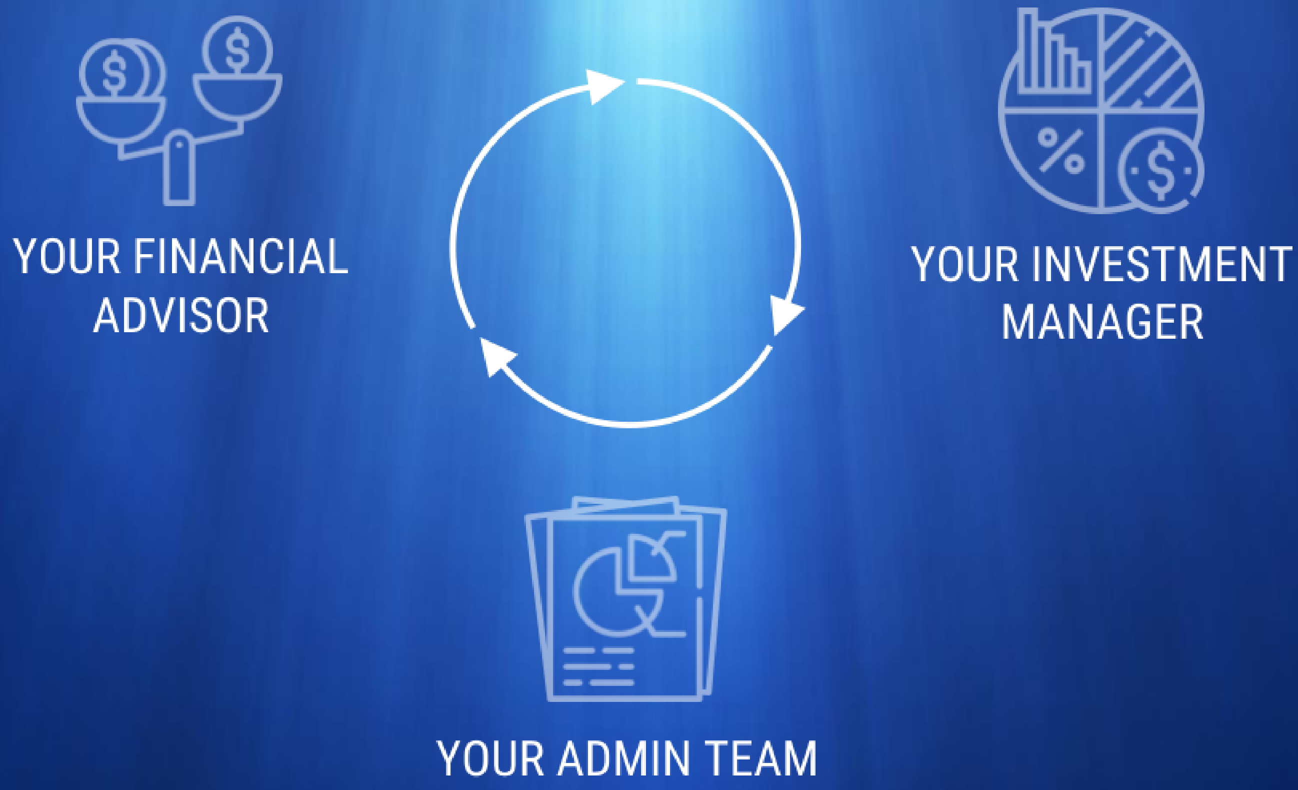
July 2020

Stock Markets	Month	Q2 20	YTD	GDP YoY	Interest Rates	Inflation Rate
United States	1.84%	19.95%	-4.04%	0.30%	0.25%	0.10%
Euro Area	6.03%	15.98%	-13.65%	-3.10%	0.00%	0.30%
Germany	5.47%	21.29%	-9.35%	-2.30%	0.00%	0.90%
France	5.12%	12.28%	-17.43%	-5.00%	0.00%	0.10%
Italy	6.47%	13.63%	-17.57%	-5.40%	0.00%	-0.20%
Spain	1.90%	6.57%	-24.27%	-4.10%	0.00%	-0.30%
Greece	-2.10%	14.44%	-30.30%	-0.90%	0.00%	-1.10%
Switzerland	2.17%	7.76%	-5.38%	-1.30%	-0.75%	-1.30%
United Kingdom	1.53%	8.78%	-18.20%	-1.70%	0.10%	0.50%
Brazil	8.76%	30.18%	-17.80%	-0.30%	2.25%	1.88%
Russia	0.31%	9.34%	-9.94%	1.60%	4.50%	3.00%
India	7.68%	18.49%	-15.36%	3.10%	4.00%	5.84%
China	7.68%	12.96%	1.64%	-6.80%	3.85%	2.40%
Japan	1.88%	17.82%	-5.78%	-1.70%	-0.10%	0.10%
MSCI World Equity Index	3.03%	18.66%	-7.14%			

Bond Indices	Monthly	Q2 20	YTD
Barclays Capital U.S. Aggregate Bond Index	0.48%	3.50%	5.34%
Barclays Global Aggregate ex-USD Float-Adjusted Index (Hedged)	0.45%	2.61%	2.03%
J.P. Morgan Government Bond Index Emerging Markets Global Core Index (Local Currency)	-0.29%	7.97%	-9.61%
Barclays Global Aggregate ex USD 10% Issuer Capped (Hedged) Index	0.27%	1.81%	1.62%

Currencies	Monthly	Q2 20	YTD	Price
EUR/USD	0.88%	1.83%	0.19%	1.12
GBP/USD	0.45%	-0.15%	-6.49%	1.24
EUR/GBP	0.76%	1.98%	7.20%	0.91
USD/CHF	-1.47%	-1.43%	-2.14%	0.95
EUR/CHF	-0.28%	0.37%	-1.96%	1.06
USD/JPY	0.13%	0.36%	-0.64%	107.93
GBP/CHF	-1.03%	-1.58%	-8.55%	1.17

Commodities	Monthly	Q2 20	YTD	Price
Gold	3.09%	13.39%	17.42%	1781.67
Oil (WTI Crude, NYMEX)	31.01%	-16.56%	-72.60%	16.73



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