Review of Q2 2020 and Current Capital Markets

August 17, 2020

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Executive Summary

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- Equity and credit markets appreciated sharply during Q2 2020 and have rallied further since.
  - Equities have appreciated 45%-50% since March lows despite dismal global economic data.
  - Massive fiscal and monetary stimulus cushioned economies during lockdowns and enabled significantly better-than-expected economic data upon re-opening.
  - Much faster progress towards COVID vaccines has further buoyed investor sentiment.
- However, corporate earnings' trajectories still remain highly uncertain.
  - Q2 corporate earnings surpassed analyst projections by a larger-than-normal magnitude. However, the pace of earnings recovery to pre-COVID trend levels is still highly uncertain and dependent upon the course of the pandemic and the development of successful vaccine and / or therapeutic treatments.
  - Presently, Wall Street consensus projects a substantial recovery in 2021 earnings (back to 2019 levels). Additionally, consensus currently projects 2022 earnings as surpassing pre-COVID 2020 "trend" levels.
    - We view these forecasts as potentially optimistic and expect the recovery to be more gradual.
- Equity valuations are increasingly elevated with risks mounting.
  - Equity market valuations are highly elevated based on NTM and 2021 earnings. Even when looking at pre-COVID trend earnings, markets are still trading well above historical averages.
    - We do acknowledge that relative to extremely low-yielding Treasury bonds, equity valuations based on "normalized" pre-COVID earnings appear quite attractive.
  - Near-term risks include a) potential for further widespread virus resurgence, b) setbacks or delays surrounding vaccine development, and c) volatility surrounding the November US elections.

How we are incorporating views into portfolio positioning:

- Given increasing risks across public equity and credit asset classes, we advocate increasing exposure to alternative investments with lower volatility and expected downside exposure.
  - long/short equity, long/short credit, merger-arbitrage strategies
- We see attractive opportunities in distressed debt strategies.

Strategic Allocation View

- Overall – <u>we still expect relatively modest nominal returns from traditional equity and fixed income asset classes</u> over the next seven years (relative to the prior period).
  - However, we forecast *lower* expected returns across certain risk assets (public equities and publicly traded corporate credit) relative to our last quarterly update in May 2020.
  - We expect continued bouts of volatility throughout the rest of 2020 (especially during Q3 and as the US election approaches).
    - We recommend investors maintain dry powder and opportunistically add to risk assets at lower price levels.
- <u>From a strategic allocation standpoint (7-year time frame)</u>, we now expect the following:

ASSET CLASS: STRATEGIC OUTLOOK (7-YEAR TIMEFRAME)	Negative — Neutral — Positive	Average Annual Return
EQUITIES		
US Large Cap (S&P 500)		Mid Single-Digit
US Small Cap (Russell 2000)		
Europe Stoxx 600		
Japan Topix		Mid Single-Digit
MSCI Emerging Markets		
FIXED INCOME		
US Treasury		Low Single-Digit
US Corp IG		
US Corp HY		Mid Single-Digit
US Corp Lev. Loans		
EM Sovereign USD		Mid Single-Digit
EM Sovereign LC		
ALTERNATIVES, PRIVATES & REAL ESTATE		
Real Estate (Private)		Mid/High Single-Digit
Hedge Funds		
Private Equity/Credit		

Tactical Allocation View

- <u>From a shorter-term tactical standpoint (next 6-12 months),</u> we believe that equity markets' direction will be primarily driven by a) progress towards a COVID vaccine with a slew of trial datapoints expected later this fall and b) the outcome of the US elections and perceived implications regarding policies that may ultimately impact corporate earnings and equity markets.
  - We expect relatively range-bound markets with bouts of volatility as these events play out through the fall.
- <u>Despite the 50+% rally from March lows, both bulls and bears can still offer credible arguments regarding anticipated equity market performance over the next 12-18 months.</u>
  - *On the one hand*, the ultra-low interest rate environment coupled with significant global stimulus and liquidity may provide a continued attractive backdrop for stocks. Equity market valuations could easily expand further if there is successful vaccine development coupled with continued economy recovery. Under this "melt-up" scenario, markets could rally 20% further from current levels.
  - *However, several risk factors could derail the market rally* including a) increasing waves of virus reoccurrence leading to slower than expected economic recovery, and b) the outcome of US elections and the potential for substantive policy changes vs. the status quo. A 20% correction is easily feasible under this scenario.
  - Within public equities, we are neutral geographically (vs. the MSCI ACWI benchmark).
- <u>Corporate credit spreads (both investment grade and high-yield) have materially compressed</u>
  - Spreads are now closer towards historical averages despite significantly weaker corporate fundamentals.
  - While near-term further spread compression may occur given Fed support and liquidity, risk / reward is increasingly asymmetric towards the downside.
- <u>However, we believe compelling opportunities exist in private distressed debt funds</u>
  - Liquidity needs are increasing across middle-market companies, with private-equity backed companies needing near-and-mid-term financing solutions.
  - Bankruptcies are steadily increasing across sectors with YTD bankruptcies at the highest levels since 2009.

Economic Activity

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- Q2 GDP data represent the worst recorded figures since the Great Depression, as Western economies were largely shut through April and portions of May.
  - US GDP declined at a 32.9% annualized rate Q/Q in Q1. Europe's decline was even steeper at an annualized rate of 48.0% (-12.0% Q/Q), with Canada's GDP also forecasted to decline at an annualized rate of 45% (-11.2% Q/Q). Only, China's GDP accelerated in Q2, up 3.2% YOY as the country re-opened earlier than Western economies.
    - The IMF is forecasting 2020 global GDP declines of -4.9%, followed by a 5.4% recovery in 2021. Even after this recovery in 2021, Global GDP is still projected to be 6.5% lower than pre-COVID levels.
  - Unemployment rates have also increased globally. However, unemployment rates vary widely regionally, dependent upon individual regions' labor laws and stimulus mechanisms.
    - US unemployment spiked swiftly to 14.7%% in April from 3.8% in February before declining to 10.2% at the end of July. The rise in unemployment has been more gradual in the Eurozone however, with unemployment increasing from 7.0% in Feb. 2020 to 7.8% at the end of July. This lower rise in the Eurozone unemployment rate is due to Europe's socialist policies and higher levels of labor protections.
- Economies progressively re-opened throughout May and June, with greenshoots emerging and economic data significantly exceeding dire investor expectations
  - Massive government stimulus programs (10%+ of countries' annual GDP) coupled with extremely accommodative monetary policies cushioned economies through the lockdown phase.
  - Upon re-opening, retail sales, housing, employment, and other US economic data widely exceeded investor expectations. The Citibank Economic Surprise Index registered the highest levels in recent history.
  - Eurozone manufacturing PMI's have inflected positively for the first time since early 2019.
  - China delivered +3.2% YOY GDP growth in Q2, well ahead of forecasts. China's manufacturing recovery is progressing swiftly despite a lack of large-scale infrastructure stimulus.
  - Continued economic recovery will be highly dependent upon controlling virus flare-ups, continued stimulus deployment, and progress towards COVID vaccines or COVID treatments.

Vaccines and Political Developments

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- <u>Swift progress towards development of COVID vaccines</u>
  - Progress towards successful vaccine development has occurred much faster than initially anticipated.
  - Several vaccine candidates are undergoing advanced Phase III trials including those developed by Moderna, AstraZeneca and Pfizer (with many others shortly behind), with trial data expected later this fall.
  - Backed by significant government funding, manufacturing has already commenced for many of these vaccine candidates (unusual given the risk of potential trial failure).
    - As such, it is quite likely that vaccine doses will be available for critical workers by year-end 2020 and more broadly available for public dissemination by Spring or Summer 2021.
  - Ultimately, an effective vaccine or successful mitigating treatment is necessary to enable "normal" lifestyle resumption and full economic recovery.
    - While equity markets are increasingly factoring in successful vaccine development, we believe that an actual successful vaccine announcement should serve as further positive catalyst for global equities near-term as it lends credence to scenarios forecasting rapid recoveries in corporate earnings against an ultra-low interest rate backdrop.
    - *We stress, however, that the ultimate effectiveness and consumer adoption of vaccines is still to be determined.* These factors are crucial in determining the ultimate trajectories of economic and corporate earnings recovery.
- <u>Volatility is likely to increase ahead of the US Presidential and Congressional Elections</u>
  - There are significant policy differences between the agendas proposed by Donald Trump and Joe Biden. Key areas of difference include corporate and individual tax rates, business regulatory policy, fiscal spending priorities, healthcare coverage and foreign policy.
  - The outcome of Senate races are as important as that of the Presidential election. Successful enactment of critical US legislation is dependent upon having a same-party President and Congressional majorities.
  - Three potential election outcomes are possible, each having different potential policy outcomes.
    - Scenario 1: Trump victory with split Congress (status quo) – likely viewed positively by markets with potential for increased China or Europe trade tensions as offsetting negatives.
    - Scenario 2: Biden victory with split Congress – likely viewed positively by markets as Biden's most progressive policies (unfriendly to markets) are less likely to pass.
    - Scenario 3: Biden victory with Democratic control of Congress ("Blue Wave") – likely viewed negatively by markets.

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Capital Markets Review

Equity Markets - Performance

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- Global equity markets appreciated sharply during Q2 2020, with the rally accelerating post quarter-end. Several factors contributed to this rally including:
  - Large-scale coordinated global fiscal and monetary stimulus, which cushioned economies and injected tremendous liquidity into the financial system.
  - Upon re-opening, economic data sharply and consistently exceeded dire expectations (especially in the US), lending credence to faster-than expected recovery scenarios.
  - Corporate earnings were more resilient than feared with higher-than-normal earnings beats during the Q1 and Q2 earnings seasons.
  - Progress towards vaccine development significantly outpaced expectations with investors now ascribing a base case view that an effective vaccine will be broadly available during the spring or summer of 2021.
- The Q2 corporate earnings season further highlighted the strength and resiliency of US large-cap technology / e-commerce companies.
  - S&P 500 index concentration has increased significantly with the top 5 companies representing 23% of index market capitalization (up from 16% five years ago).

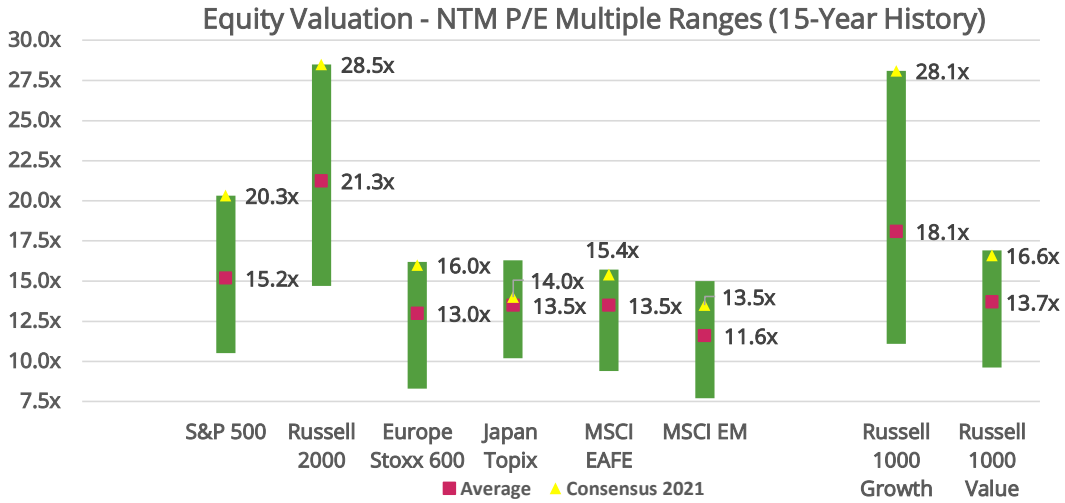
Equity Indices - (As of 08/07/2020)

	YTD Performance			Total Returns (%) - USD *				
	YTD	Feb 19-23-Mar	23-Mar - Present	June-Qtr	1Y	3Y	5Y	7Y
US Large Cap (S&P 500)	4.6%	-33.8%	50.5%	20.4%	17.8%	12.1%	11.6%	11.9%
US Small Cap (Russell 2000)	-5.2%	-40.7%	57.3%	25.4%	6.1%	5.0%	6.9%	7.5%
MSCI EAFE	-7.5%	-32.7%	38.5%	14.9%	4.0%	1.0%	2.6%	3.6%
MSCI Emerging Markets	-0.8%	-31.2%	45.5%	18.1%	14.7%	2.9%	6.7%	4.6%
MSCI ACWI	0.8%	-33.6%	47.8%	19.2%	13.6%	7.5%	8.0%	8.1%
Russell 1000 Growth	20.8%	-31.4%	61.3%	27.8%	36.6%	21.4%	17.6%	17.2%
Russell 1000 Value	-10.6%	-38.0%	42.9%	14.3%	0.2%	3.6%	6.2%	7.3%

**Returns are annualized except for June-Qtr and YTD returns which represent actual performance*

Equity Markets - Valuation

- Current equity valuations on a next-twelve-months (NTM) and 2021 forward earnings basis, are high, given severely depressed earnings due to COVID-related disruption.
  - However, investors are looking past 2020 and even 2021 results. Rather, they are focusing on 2022 earnings as the first "normal" year post COVID.
  - Valuation multiples are also higher than historical averages based on pre-COVID trend earnings.
    - Markets are generally trading at 20%-30% and 15%-20% premiums to historical average P/E valuations based on 2021 forecasted earnings and pre-COVID trend earnings, respectively.
  - Additionally, uncertainty regarding 2021 and 2022 earnings forecasts is much higher than normal.
- However, relative to ultra-low interest rates, equity valuation multiples might be justified.
  - S&P 500 presently trades at 18.6x pre-COVID trend earnings. If interest rates remain near present levels, valuation multiples of 20x-22x could be justified vs. the 16x historical average.
    - These multiples are based upon a 350bps spread (average over the last 20 years) between S&P 500 earnings yield vs. 10-Year Treasury yields.
- Nevertheless, on balance we think the reward/risk tradeoffs are increasingly skewed to the downside.



Fixed Income Markets - Performance

- Fixed income markets benefitted from risk-on sentiment during Q2, with rallies in credit extending after quarter-end.
  - US Treasuries were relatively flat as interest rates held steady over the quarter.
  - Credit assets (high yield bonds, leveraged loans, and EM Hard Currency sovereign bonds) rallied sharply as credit spreads narrowed significantly.
    - Initially, credit-related bonds rallied as implied Fed support restored confidence to the bond market.
    - In addition, the Fed bought individual investment grade and high-yield bonds as well as bond ETFs, providing additional liquidity to the market.
      - Interestingly, the Fed's actual level of investment-grade and high-yield bond purchases has been nominal.
      - However, the implicit signal sent to credit markets has sharply restored risk appetite.
  - EM hard currency (USD) bonds rallied strongly despite flattish US Treasury yields as spreads declined.
  - EM local currency bonds appreciated due to currency appreciation as well as falling local interest rates.

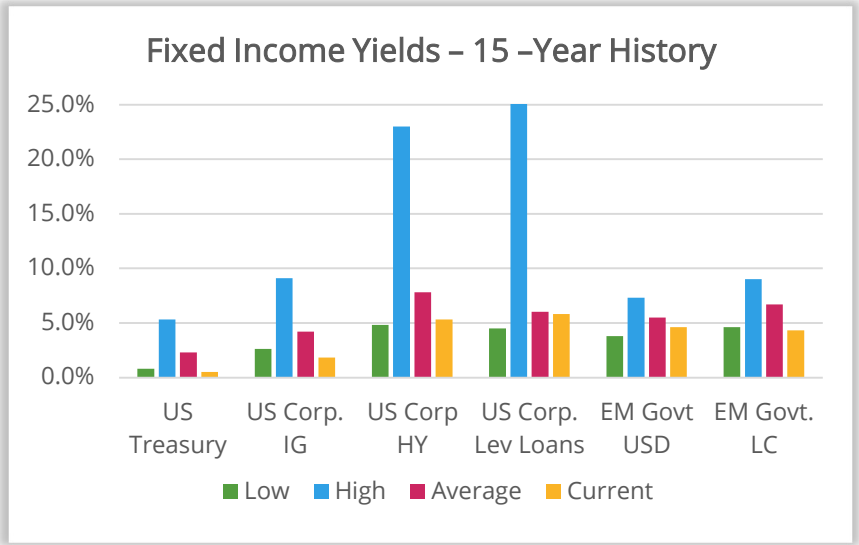
Fixed Income Indices - Characteristics and Performance (as of 8/7/2020)

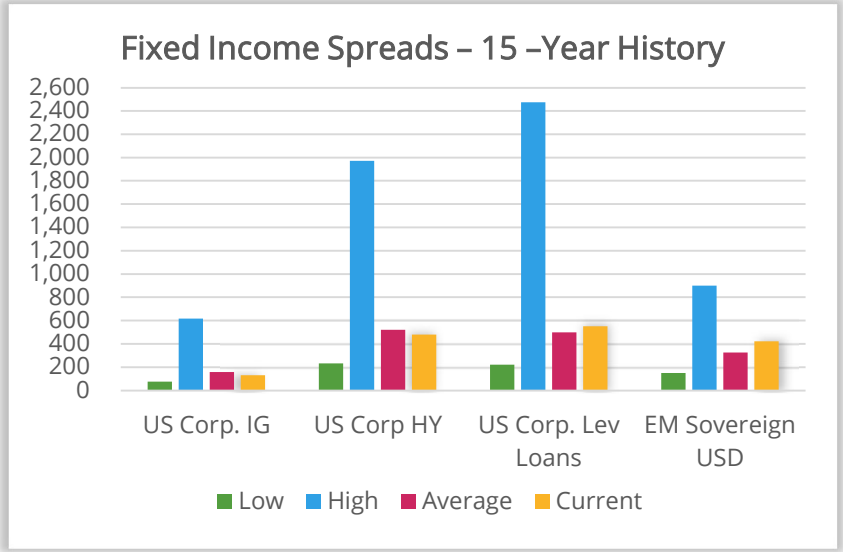
	YTD Performance (%)			Total Returns (%) *					
	YTD	Feb 19-23-Mar	23-Mar -Present	June-Qtr	1Y	3Y	5Y	7Y	Duration (yrs)
US Treasury	9.8	5.4	1.8	0.5	9.2	5.8	4.1	3.7	7.3
US Corp. IG	8.9	-12.3	20.9	9.0	11.1	7.3	6.4	5.8	8.8
US Corp HY	1.3	-20.8	26.3	10.2	5.8	4.7	6.2	5.5	3.6
US Corp Lev. Loans	-2.3	-20.6	22.2	9.7	-0.2	2.6	3.4	3.3	NA
EM Sovereign USD	2.2	-20.7	25.9	12.3	4.1	4.9	6.3	6.1	8.5
EM Sovereign LC	-4.6	-18.0	17.4	9.6	-1.9	0.0	2.9	-0.2	5.9
Barclays US Aggregate	7.8	-0.9	6.7	9.6	8.6	5.6	4.5	4.2	6.5

** Returns are annualized except for June-Qtr and YTD returns which represent actual performance*

Fixed Income Markets - Valuation

- Absolute yields at multi-year lows for government debt. Given higher duration relative to history, the risks from movements in interest rates are asymmetric to the downside.
- Corporate spreads (investment grade and high yield) have compressed meaningfully
  - Despite weakened corporate credit fundamentals and an economic recovery at a very nascent stage, IG and HY credit spreads have tightened significantly and are now close to historical averages
  - The Fed may further buoy sentiment for investment-grade and higher-quality high-yield bonds through continued direct bond purchases and through purchases of select bond ETFs.
    - However, when looking at current yields combined with spreads, risk / reward is tilted towards the downside for publicly traded corporate credit (investment grade, high yield and leveraged loans)
  - Valuations are bifurcated within high-yield for higher-quality (BB) bonds vs lower-quality (CCC) bonds. While the overall high-yield bond index spread has narrowed to 480bps (vs Treasuries), a significant 14% of the index is still trading at distressed levels (spreads of greater than 1,000bps).
- We prefer obtaining credit exposure through private distressed debt strategies





Alternatives and Currencies

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- Hedge funds had a strong quarter with all major sub-strategies positive.
  - The HFRX Equal-Weighted Strategies was up 6.4% in Q2, one of the best quarters in recent years.
  - Directionally-focused strategies such as long-short equities (+8.2%) , credit (+8.6%) and event-driven (+7.5%) fared better whereas less-correlated strategies such as global macro (+1.0%) and equity market-neutral (+3.0%) fared worse.
- Private real estate (as measured by the NCREIF Index) was modestly negative at -1.0% during Q2
  - Average cap rates remained relatively stable across property types. However, cap-rate spreads have widened significantly since March as investors are increasingly fearful regarding commercial real estate prospects.
    - It remains to be seen how much commercial real estate operating fundamentals weaken once rent forbearance periods expire or are not extended further.
- Private equity deal closures remained relatively stable while exits plummeted during Q2.
  - However, the composition of closed deals sharply shifted from full-scale buyouts to more targeted financing investments such as PIPES.
  - Many PE firms were in triage mode, marking down portfolio companies and attempting to shore up liquidity for troubled leveraged holdings.
- The USD depreciated modestly during Q2 and more significantly since quarter-end
  - The Dollar Index depreciated 1.2% during Q2 and an additional 4.0% post quarter-end vs a basket of developed market currencies.
  - The Euro has appreciated by 7.1% (5.0% since the end of June) as Europe has done a better job in controlling COVID second-wave resurgences.
  - The Canadian dollar has appreciated by 4.5% since the end of March due to better COVID spread prevention and a rebound in crude oil prices.
  - EM currencies have experienced more modest appreciation of 2.8% since the end of March.

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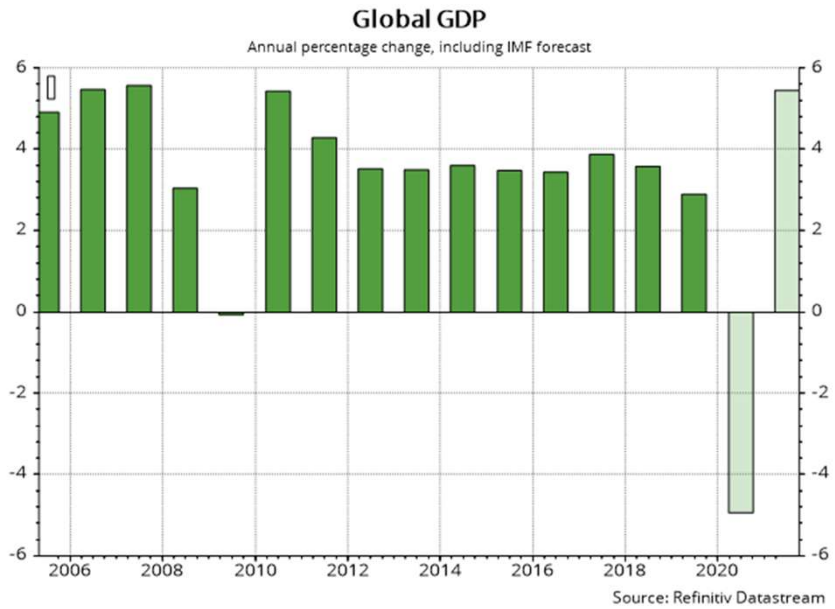
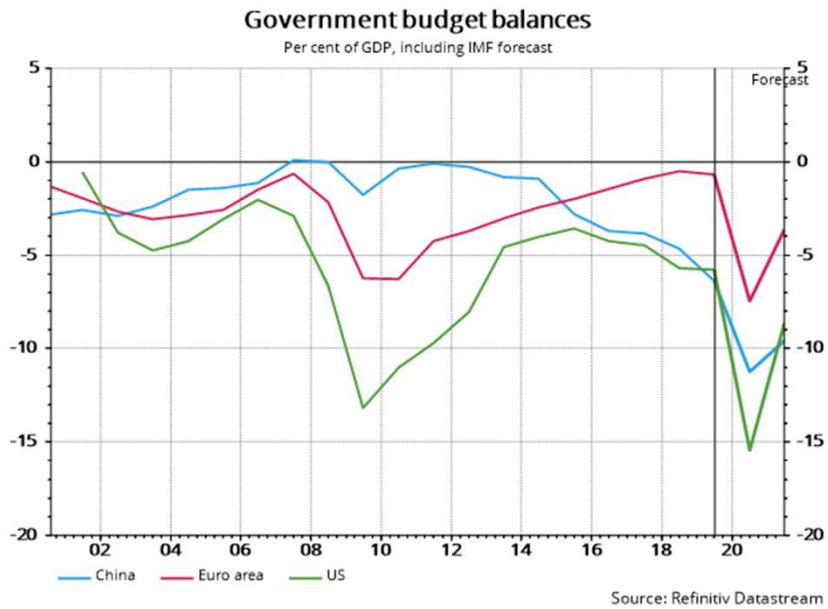
Economic Review

Global GDP Growth

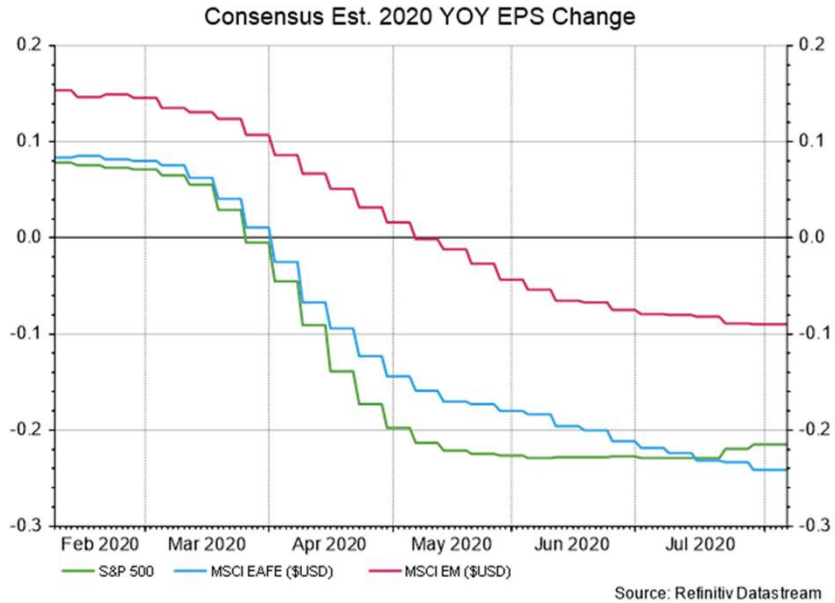
- The IMF is forecasting a 4.9% decline in global Real GDP in 2020, followed by a 5.4% rebound in 2021. The 2020 forecasted decline is greater than that experienced during the financial crisis.
  - The hit projected to US and European economies is more severe than that forecasted for Asian economies
    - The IMF is forecasting US and European 2020 GDP declines of 8% and 10% respectively, although several investment banks have recently revised forecasts upwards based upon re-opening progress to date.
- Governments globally have enacted massive stimulus programs to blunt the negative effects of the pandemic
  - These programs are causing government deficits to spike to historically high levels across various regions.
  - While debt service is currently manageable given ultra-low interest rates, the ability to reduce deficits post-pandemic and the long-term effects of such elevated debt levels remains unknown.

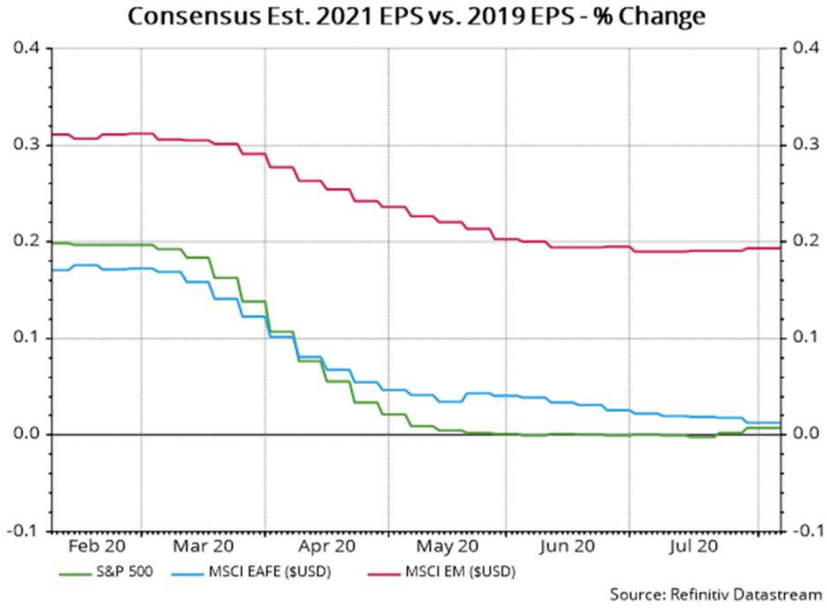




Global Corporate Profits

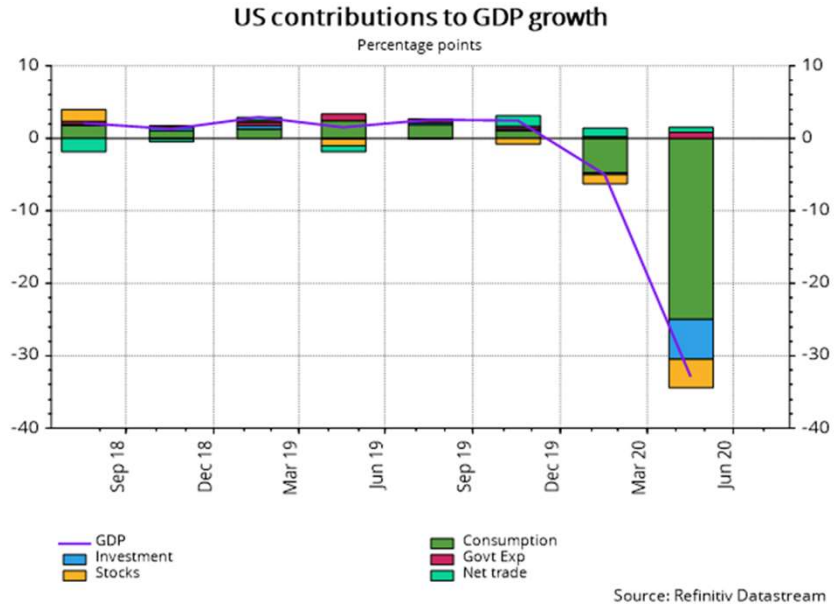
- Corporate profits will meaningfully decline in 2020. However, analyst revisions for both 2020 and 2021 earnings estimates have stabilized.
- Analysts are presently projecting a sharp recovery in 2021, with consensus 2021 earnings forecast generally exceeding earnings achieved in 2019. Consensus 2022 earnings show further growth with earnings projections well exceeding pre-COVID 2020 estimates.
  - *We believe consensus forecasts are presently too optimistic* and instead forecast 2021 earnings rebounding to 80%-85% pre-Covid-19 "trend" levels across markets.
    - We forecast a return to pre-COVID 2020 earnings levels during 2022.
  - *Potential 2021 and 2022 EPS outcomes show an abnormally wide range of dispersion*. Much will depend upon the extent of economic damage caused, any permanent shifts in consumer or business behavior, the timing regarding widespread Covid-19 vaccine availability, ultimate vaccine efficacy and consumer uptake.
  - Simply put, the economy (and corporate earnings) cannot recover until consumer and business behavior largely returns to pre-COVID times (unlikely to occur without a safe and effective vaccine).

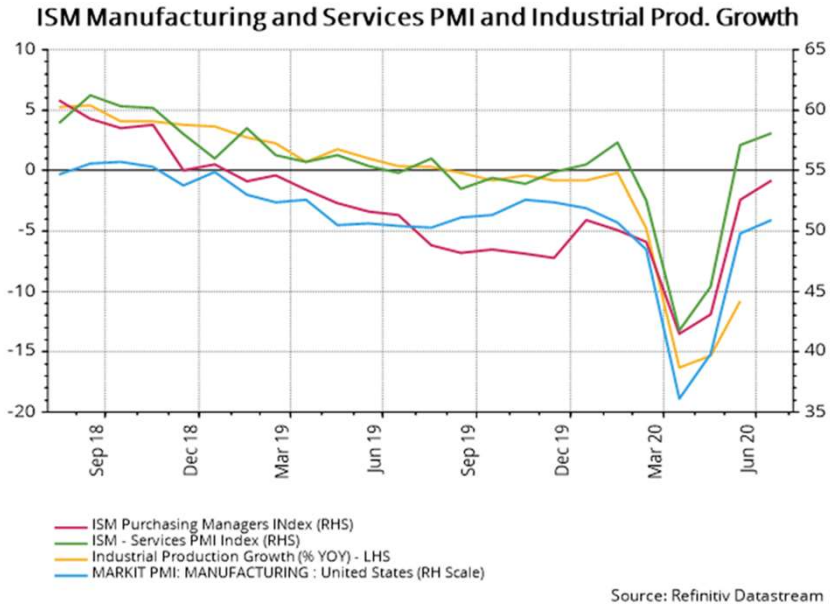




United States

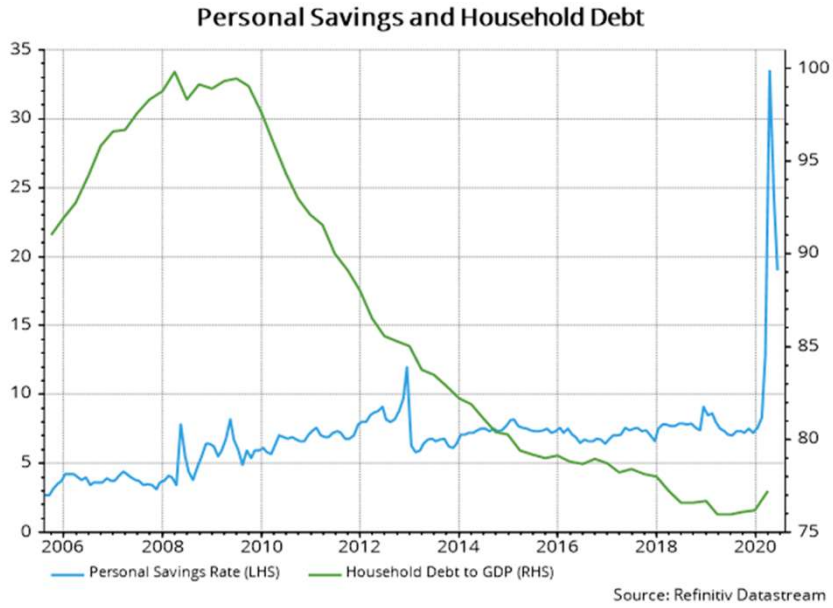
- Real GDP Growth declined 32.9% Q/Q on annualized basis in Q2 2020, with economists projecting a sharp recovery in Q3 followed by continued recovery in Q4 and into 2021.
  - Both the manufacturing and services sectors were simultaneously impacted during the economic lockdowns experienced in April and May.
  - Significant fiscal stimulus of $3 trillion (roughly 15% of GDP) coupled with exceptionally loose monetary policy cushioned the economic blow and set the stage for significant initial pent-up demand upon re-opening.
- Leading indicators such as Manufacturing and Services PMI Indexes have all shown sharp rebounds off the April lows.
  - Economic data from May through July consistently surpassed consensus expectations by wide margins, which contributed to the sharp rally across US equity markets.
  - However, the economic recovery may show signs of stalling as several regions of the US have experienced recent resurgences in COVID cases.





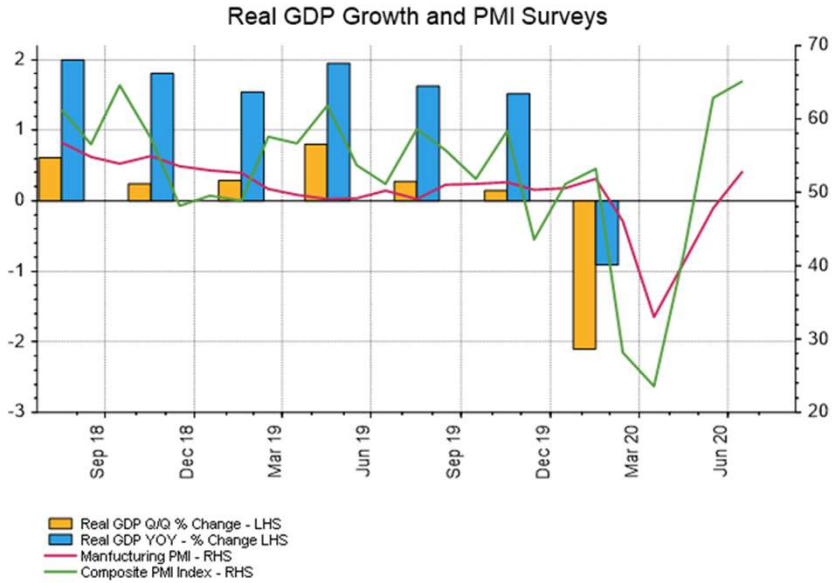
United States (Cont.)

- US unemployment has markedly increased, with corresponding declines in retail sales and consumer confidence
  - The unemployment rate spiked to 14.7% in April (higher than that experienced during the financial crisis), but has since moderated to 10.2% following economic re-opening
    - Economists are projecting a further decline to less than 9% by year-end 2020 and 7% by year-end 2021.
    - The service sector (retail, hospitality, dining) initially suffered the most; however, job losses are spilling over to the manufacturing and professional sectors as well.
    - At this point, the level of permanent job loss is unknown. The longer the pandemic lasts, the greater potential for job losses to shift from temporary to permanent, thereby further complicating economic recovery efforts.
  - Massive government stimulus has mitigated much of the negative effects from unemployment, with personal savings rates spiking to levels above 30% (before moderating towards 20% currently).
  - These elevated personal savings rates may indicate potential significant pent-up demand, a positive harbinger for consumption in H2 2020 and into 2021.

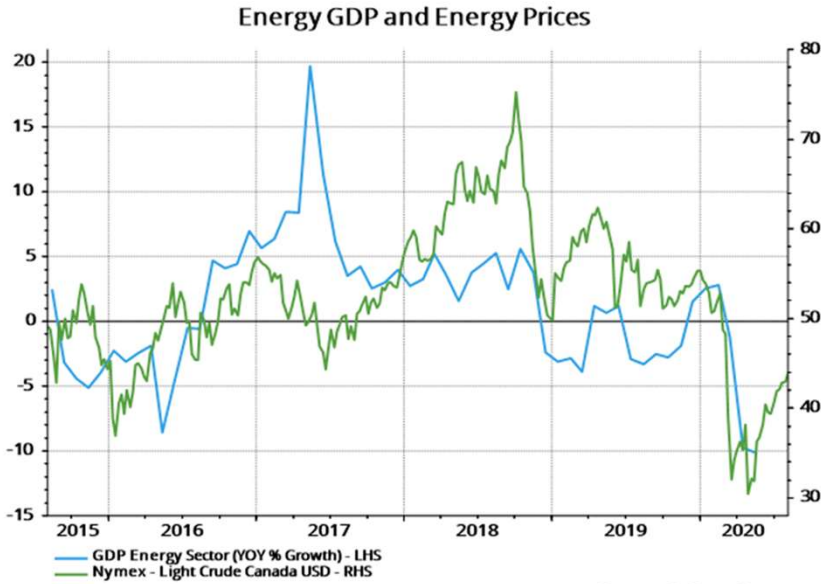


Canada

- <u>Canada's economy experienced a swift, sharp decline in Q2. However, leading indicators are rebounding strongly off depressed levels</u>
  - Q2 GDP is expected to decline 12% Q/Q (48% annualized), a worse level than that experienced in the US, as Canada shut down its economy sooner and remained shut for longer.
    - The IMF is projecting a 2020 GDP contraction of 8.4% followed by a 4.9% rebound in 2021
  - However, these shutdown measures have thus far proven more successful at curbing virus resurgence (relative to the US)
    - As a result, Canada may recover faster relative to the US over the second half of 2020 with initial evidence emerging in the sharp rebound in the Composite PMI Index (principally driven by service-sector recovery)
    - High-frequency mobilization and hours-worked data suggests a brisk 35% annualized Q3 GDP rebound
  - The Canadian $ has sharply rebounded vs. the USD (presently at $1.35 vs. $1.45 in March)
  - Stabilizing crude oil prices may also aid Canada's economic recovery.



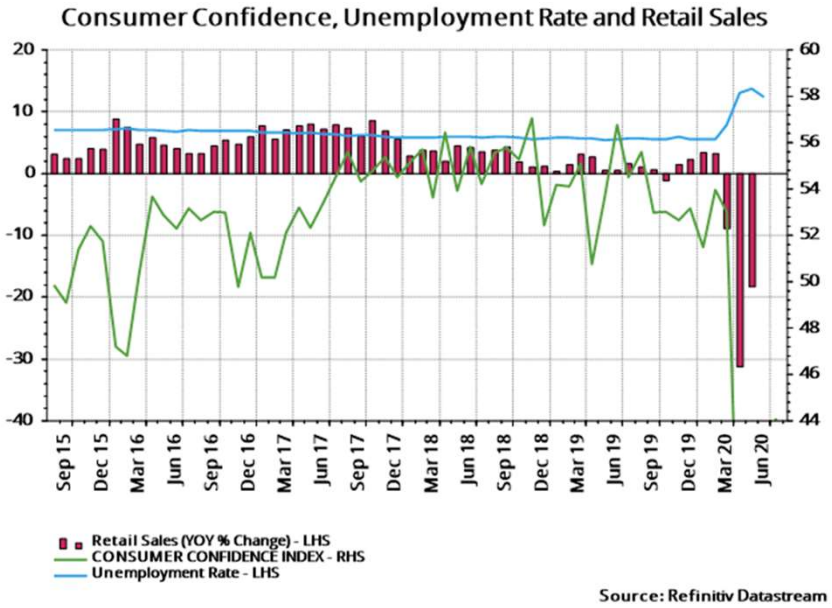
Source: Refinitiv Datastream

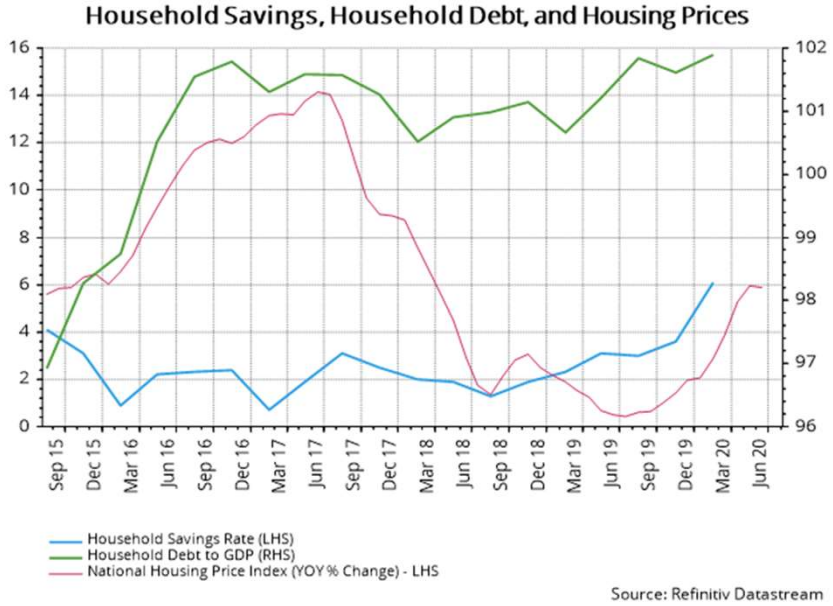


Source: Refinitiv Datastream

Canada (Cont.)

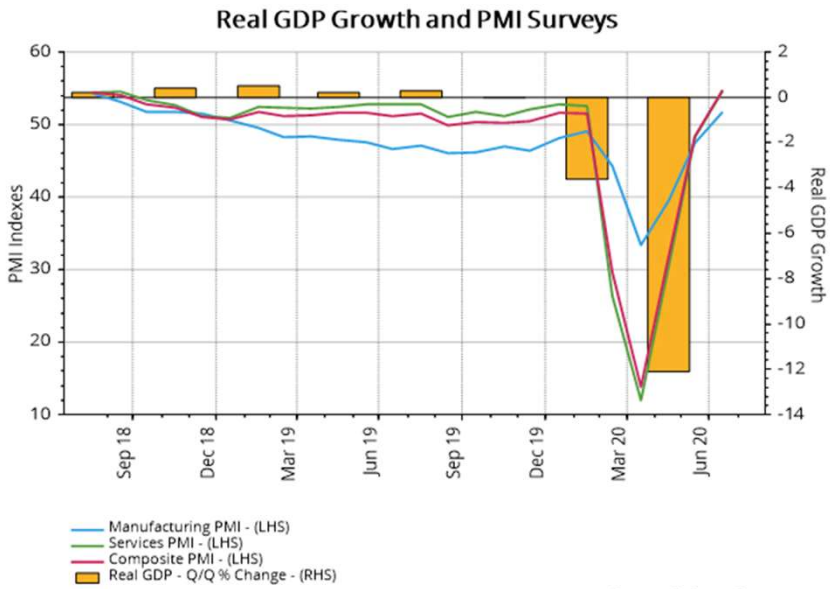
- <u>Canadian consumer indicators are still showing signs of stress.</u>
  - Unemployment rates spiked markedly while consumer confidence plunged in April and May.
  - Retail sales are still down substantially YOY (unlike in the US where retail sales have returned to positive YOY growth).
  - Home price appreciation has remained stable thus far in 2020. However, it remains to be seen whether home price appreciation continues, given the increasingly negative circumstances faced by Canadian consumers.
  - Canadian household debt has increased over the past five years with the savings rate having fallen during that time frame. However, similar to the US, the household savings rate is beginning to move up which may lend support to the economy through pent-up consumer demand.



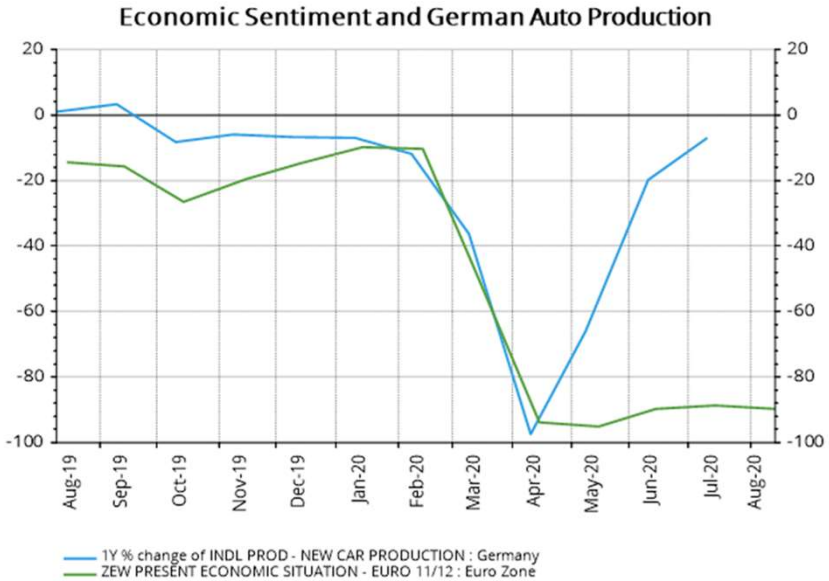


Eurozone

- Eurozone GDP and general business confidence declined significantly during Q2 with signs of recovery emerging.
  - Real GDP growth declined by 12.1% Q/Q in Q2 2020 (-48.4% annualized). This decline was larger than that experienced by the US as the Eurozone's lockdowns were more stringent.
    - The European Commission is now forecasting an 8.7% decline in 2020 GDP with recovery to pre-COVID levels not expected till 2022.
  - Recognizing the unprecedented gravity of the economic declines, Eurozone member governments have deployed significant stimulus and have even approved a common-funded COVID recovery package.
    - Historically, inter-country squabbles would have rendered such a swift passage unimaginable.
  - Leading indicators such as PMI indexes are inflecting sharply upwards and Germany's auto production has also rebounded well off April lows (driven by strength in exports to China).
  - However, overall business sentiment remains quite fragile and recent COVID case upticks in Spain and other European nations bear watching.



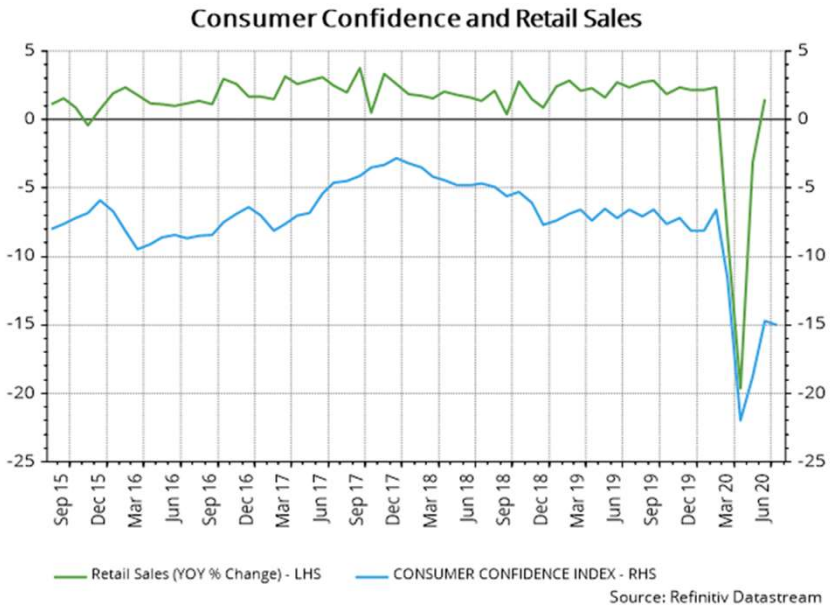
Source: Refinitiv Datastream

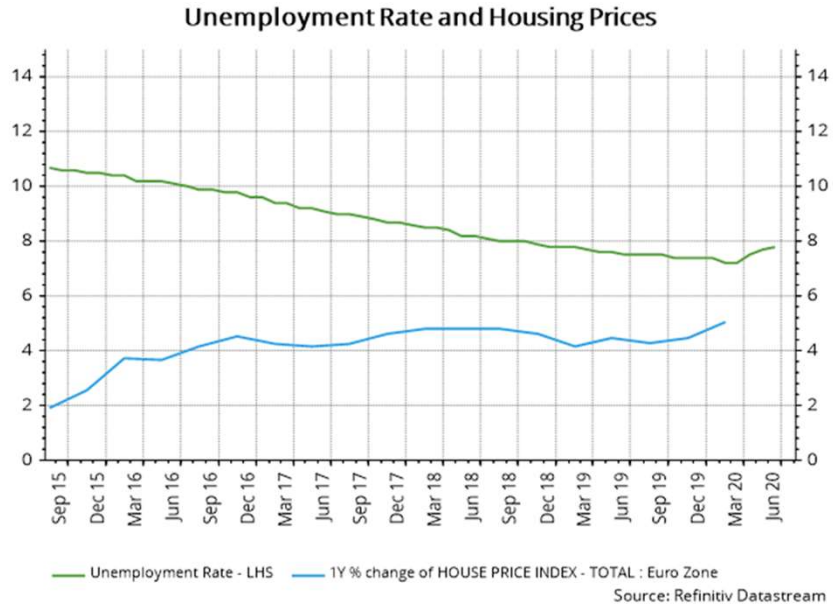


Source: Refinitiv Datastream

Eurozone (Cont.)

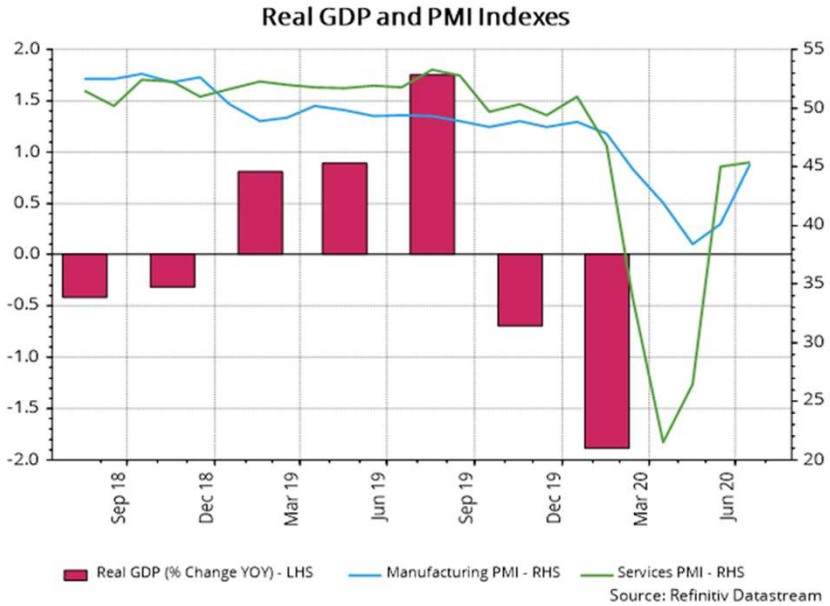
- Consumer confidence and retail sales have rebounded from April lows
  - Eurozone unemployment rates have thus far held relatively steady.
    - Employee-friendly labor laws coupled with wage-replacement-based fiscal stimulus has thus far kept massive layoffs at bay.
    - However, job losses are accelerating in the region and bear further watching.
    - Home price appreciation has remained robust and mortgage interest rates are at rock-bottom levels (in some cases even negative).
  - Given a more stable employment backdrop, European consumers may be better positioned to withstand longer-lasting Covid-19 disruption.

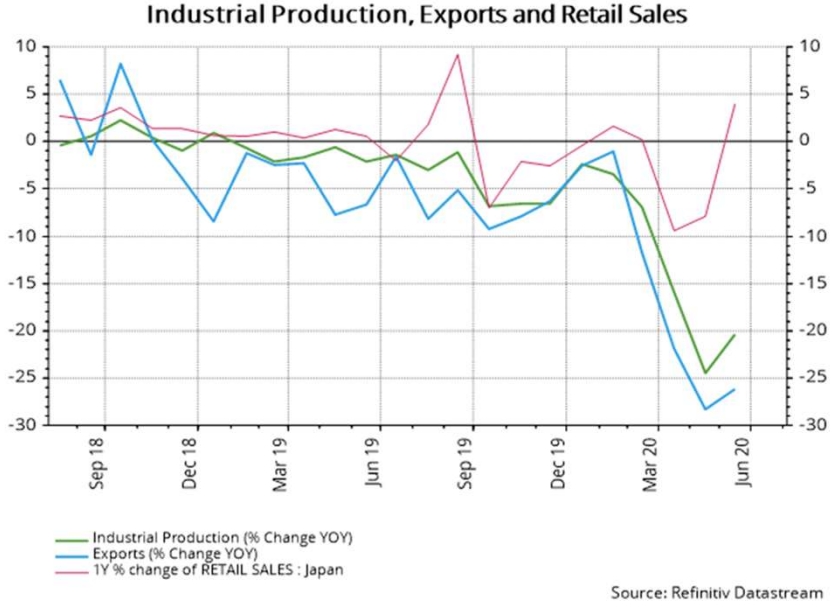




Japan

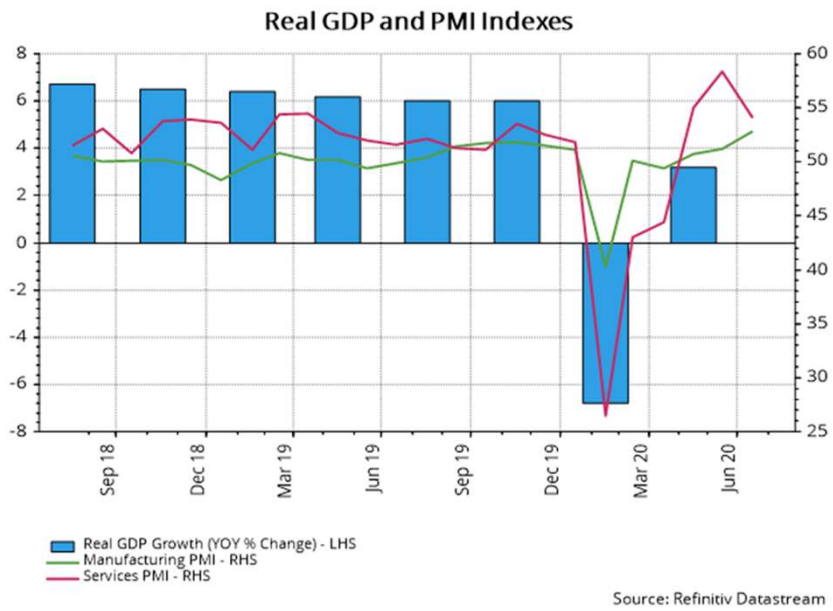
- Japan's economy contracted sharply in Q2 and has been slower to recover relative to other economies.
  - Q2 GDP is forecast to decline at a 26% annualized rate (less than other economies given that Japan did not enact widespread lockdowns).
  - The pandemic exacerbated an already slowing domestic economy which was still facing headwinds from 2019's consumption tax hike.
  - Leading indicators such as the PMI indexes are recovering but have not yet returned to growth territory.
  - Japan's economy is highly exposed to global trade
    - Industrial production and exports remain still remain depressed, although seem to be bottoming.
  - Significant stimulus measures (15%+ of GDP) have thus far headed off surges in unemployment and bankruptcies.
    - However, given the highly lackluster recovery thus far, further stimulus is rapidly needed.

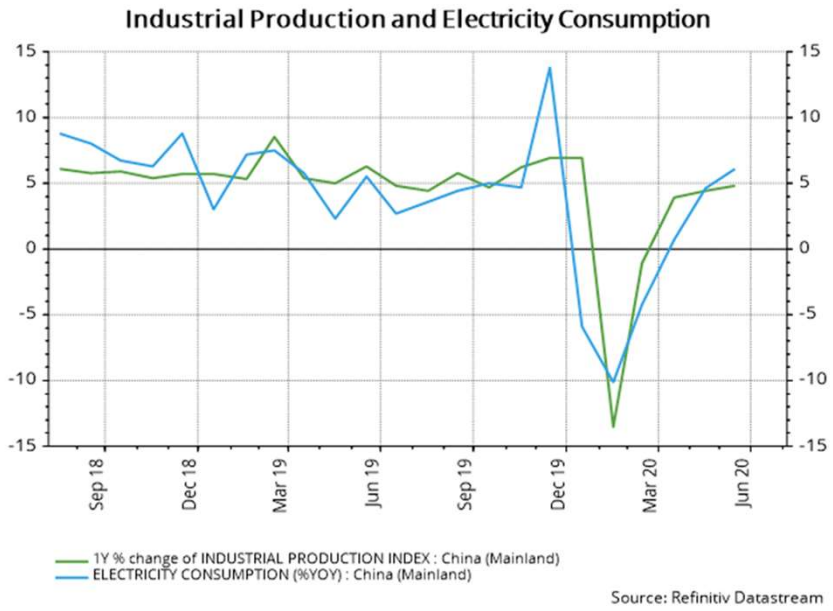




China

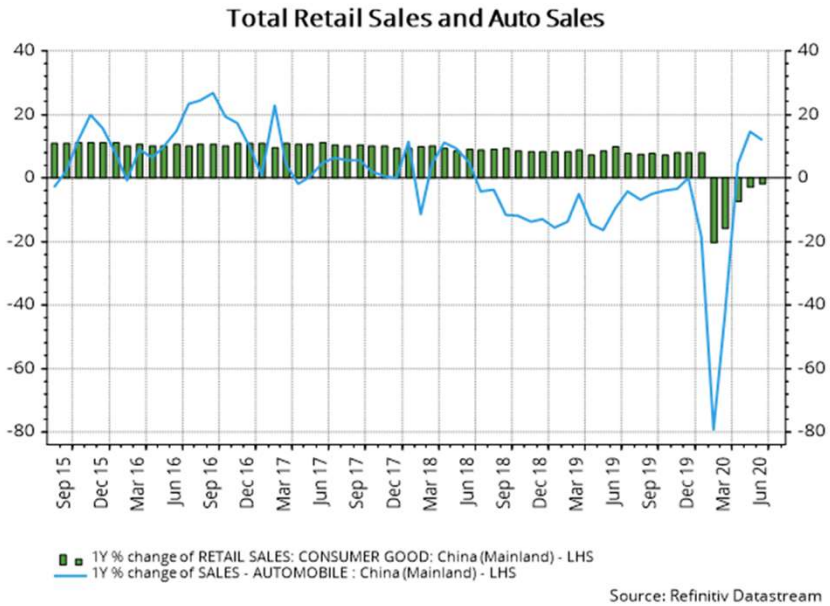
- <u>The Chinese economy returned to YOY growth in Q2, a bright spot among dismal global data.</u>
  - Having largely successfully curbed the virus spread, China has clearly returned to growth during Q2.
  - China GDP increased 3.2% YOY in Q2, with growth faster than initially expected.
  - Both manufacturing and services activity have returned to growth. Other measures such as industrial production and electricity consumption have also moved firmly into YOY growth territory.
    - Manufacturing activity would have been even stronger had Western demand for finished goods not evaporated due to economic shutdowns.
  - Importantly, the Chinese economy was able to demonstrate recovery despite a lack of large-scale infrastructure stimulus programs (deployed in previous China slowdowns).

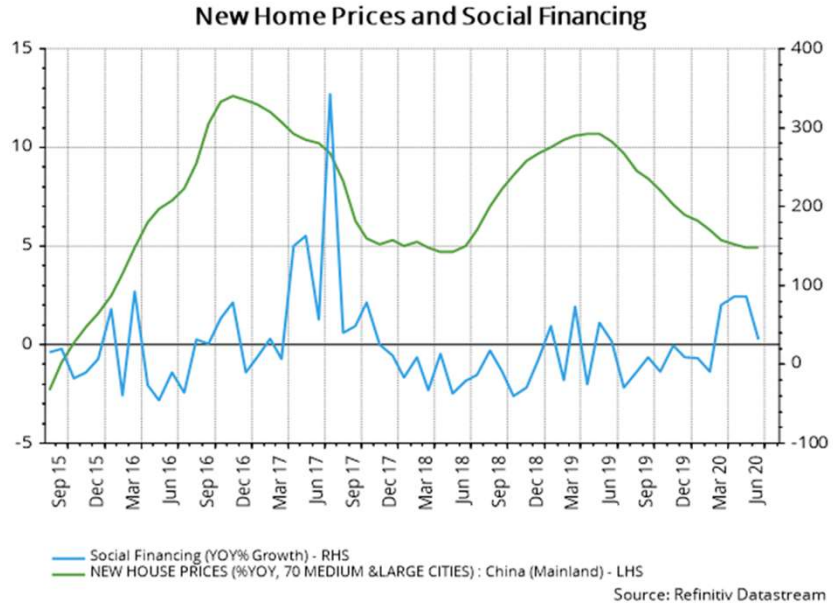




China (Cont.)

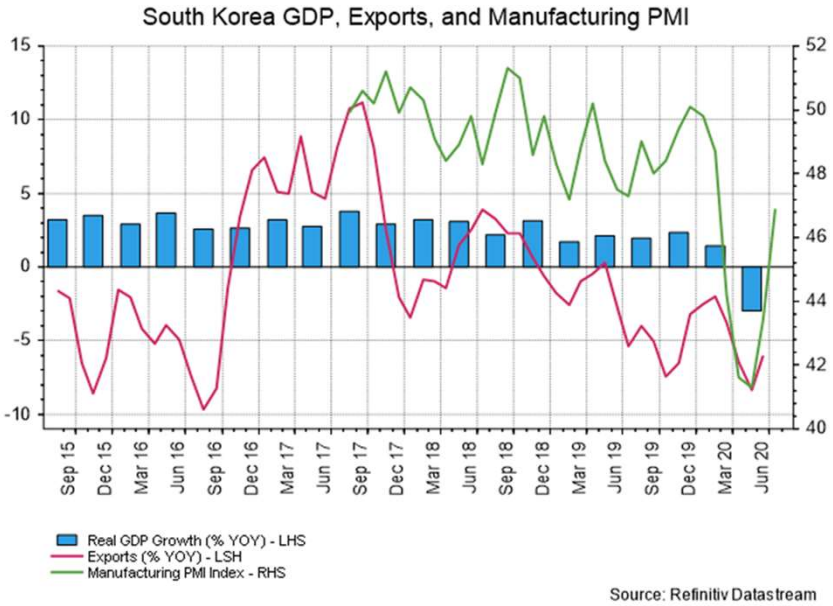
- <u>Chinese consumption is recovering but at a slower pace than manufacturing</u>
  - Retail sales are still modestly negative on a YOY basis.
  - However, sales of larger-ticket items (homes, autos) and luxury goods have largely rebounded, whereas service-oriented sectors such as dining and entertainment are still well below pre-pandemic levels.
  - New home price appreciation has remained stable but the slowdown in social financing (admittedly volatile) bears watching.
  - Thus far, the government's current stimulus program has been modest compared with its own prior history and relative to the programs enacted by Western governments.
    - China has not enacted large-scale infrastructure or industrial stimulus, preferring to focus on targeted efforts such as providing greater support for state-owned businesses and encouraging increased lending to small businesses.
    - China faces a delicate balance with high and growing debt balances. Previous large China stimulus programs have resulted in surges in global growth, with especially positive effects on emerging markets.

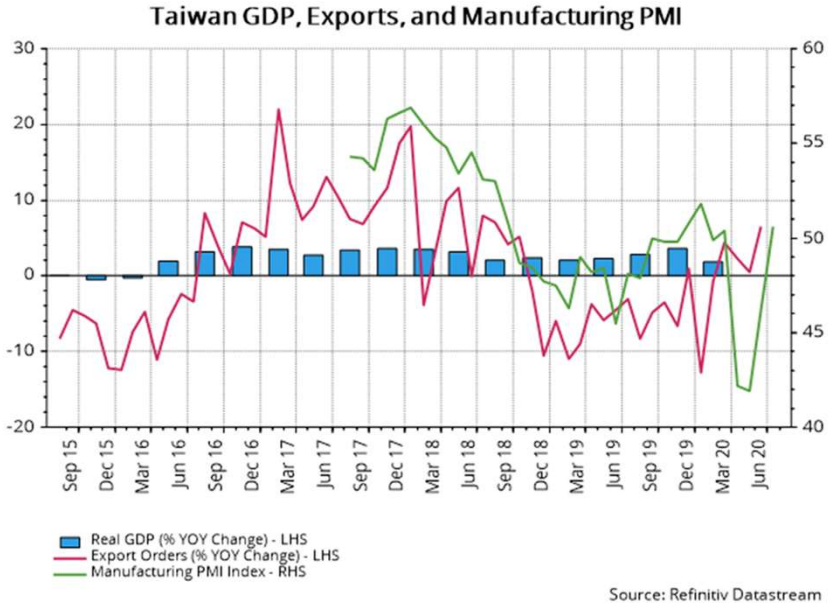




South Korea & Taiwan

- South Korea and Taiwan experienced much lower economic declines relative to Western economies during Q2.
  - South Korea's GDP declined 3.3% Q/Q in Q2, its worst performance since 1998. Export declines (roughly 35% of GDP) accounted for the bulk of GDP reduction with consumption also slowing.
  - South Korean manufacturing PMI's are showing signs of improvement but have still not returned to growth.
  - Taiwan's GDP is forecast to decline 0.7% YOY In Q2 as strict border control measures dented tourism
    - However, strong global demand for Taiwan's technology exports helped buffer the slowdown.
    - Additionally, lower mobility restrictions within the country helped insulate consumer spending relative to Western economies.
  - Taiwan PMI and export data have returned to YOY growth boding well for the back-half of 2020.
    - Taiwan is well positioned to benefit from the 5G telecom rollout and demand for COVID-related biotech products.





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Special Topic:
US Elections and Potential Implications

US Presidential and Congressional Elections

- Presidential Election (Nov. 3, 2020)
  - President Trump's and Joe Biden's policy agendas are presently very different, with potentially significant implications for equity markets.
  - National polls show Biden with a steady but narrowing lead. Swing-state polls are tightening.
    - The betting markets presently forecast a 60% probability of a Biden victory.
- Congressional Elections
  - The House presently has a strong Democratic majority which is projected to be maintained. However, it is far more questionable whether Republicans maintain their slim Senate majority.
  - The makeup of Congress (i.e. same-party majority across both chambers or split-party makeup) is crucial towards enacting significant legislative policy.
    - The potential for passing significant legislative policies is much higher when there is same-party alignment across the President, House of Representatives and the Senate. Examples of such legislation include (Trump tax cuts – 2017) and Obamacare (2009/2010).
    - However, the prospects for partisan gridlock and maintenance of the "status-quo" increases when party representation is mixed. The difficulty faced by the current US Congress in passing the next Stimulus package is a case in point.
  - Given the sharply different policy agenda proposed by Biden vs. the status quo, it is crucial for investors to monitor developments and prospects around the US Senate elections.
- Potential Market Implications
  - The election results may likely impact both US and international stock markets.
    - Policy differences may impact investors' perceptions surrounding US attitudes to corporate and shareholder constituencies.
    - Geopolitical considerations may impact the US dollar and other currencies.

Trump vs. Biden – Key Policy Differences

	TRUMP	BIDEN
Business Taxes:	▪ Maintain current corporate tax rate at 21%	▪ Increase corporate tax rate to 28% which could impact S&P 500 earnings by 5%-10% ▪ Implement minimum 15% tax for businesses earning above certain thresholds
Individual Taxes:	▪ Maintain current income tax rates and potentially increase middle-class tax rates ▪ Possibly reduce capital gains tax rates	▪ Increase highest marginal tax rate from 37% to 39.6% ▪ Increase tax rates on capital gains and dividends to ordinary income tax rates (for earners above certain thresholds)
Climate/Energy:	▪ Supports oil drilling, fracking and other fossil fuels ▪ Maintain US withdrawal from international climate accords ▪ Lower or roll-back EPA auto emission regulations	▪ Aims to achieve 100% clean energy by 2035 – proposes $2 trillion in spending over first four years ▪ Reinstate US into Paris climate accord ▪ Substantially increases auto emission regulations
Healthcare:	▪ Repeal Obamacare ▪ However, has not proposed a replacement plan ▪ Does not support Medicare / Medicaid expansion	▪ Bolster Obamacare with a Public-Option choice ▪ As of now, does not support "Medicare for All"
China:	▪ Increased tensions with tariffs likely an economic weapon of choice ▪ Not likely to work with allies jointly to achieve trade / intellectual property treaties	▪ Will take a hard line on China steel dumping and intellectual property infringement ▪ Would remove agricultural tariffs ▪ More likely to work with allies to apply joint pressure
Europe / International Alliances	▪ Likely to increase tariffs on Europe ▪ Likely to continue to shun international alliances such as NATO	▪ No / limited tariffs on European goods ▪ Likely to restore alliances (similar to under the Obama administration)
Regulation:	▪ Promotes pro-business, low regulation environment ▪ Regulatory activities may be politically motivated (i.e. certain scrutiny on technology companies)	▪ Likely to increase business regulations especially within the financial and energy sectors ▪ Increased risk towards mandating large technology company break-ups

Potential Election Outcomes - Implications

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	TRUMP VICTORY Split Congress	BIDEN VICTORY Split Congress	BIDEN VICTORY Democratic Congress
Potential Equity Market Impact	▪ Favorable given pro-business, low regulation and low-tax general viewpoint ▪ China and Europe tensions may increase offsetting some of the above positive effects ▪ US markets may continue to outperform given unpredictable foreign policy approach	▪ Neutral given many of Biden's more progressive policies (perceived as more market unfriendly) are less likely to pass ▪ Increased geopolitical stability may actually be viewed positively	▪ Likely negative as many of Biden's progressive policies are likely to pass ▪ Increased corporate taxes would negatively affect US corporate earnings ▪ International markets likely to outperform US markets
Sector Beneficiaries	▪ Cyclicals and domestic-focused companies ▪ Financials, healthcare, oi l& gas and defense ▪ Domestic small-mid cap industrials	▪ Technology – assuming secular growth rewarded while regulatory impact is muted ▪ Industrials ▪ Multi-nationals	▪ Defensive and secular growth ▪ "Clean Energy" – solar, fuel-cell ▪ Utilities ▪ Consumer Staples ▪ Infrastructure
Sector Losers	▪ Multi-nationals (consumer staples) ▪ Agricultural commodities ▪ US retailers (if additional tariffs are enacted)	▪ Financials	▪ Financials, Healthcare (pharma) ▪ Energy (oil & gas) ▪ Retail – minimum wage pressures ▪ Potentially "Big Tech" if regulatory scrutiny is increased markedly

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