Review of Q3 2020 and Current Capital Markets

November 13, 2020

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- <u>Equity and credit markets appreciated strongly during Q3 2020 (up 8.1% and 4.3% respectively)</u> and have continued to rally post-quarter through mid-November.
  - Equities have now appreciated 50%-60% since March lows driven by a) massive fiscal and monetary stimulus leading to large increases in liquidity, b) much better than expected economic data and corporate earnings (vs. dire expectations) and c) faster than expected progress towards COVID vaccines.
    - However, the sharp resurgence in COVID cases in the US and Europe may lead to a stalling in economic recovery.
    - Meanwhile, the apparent success of the Pfizer vaccine may buoy investor sentiment and lead investors to view Covid-related slowdowns as transitory and look forward to 2022 (as a representative "normal" year).
- <u>Corporate earnings have materially exceeded dire expectations thus far</u>
  - Q3 corporate earnings surpassed analyst projections by a larger-than-normal magnitude (in the US, S&P 500 earnings were only down 7% YOY vs. an initial expectation of a 25% decline).
    - Analysts have been upgrading earnings forecasts for 2020 and 2021 across US and Asian emerging markets.
    - 2021 analyst forecasts appear reasonable (assuming no large-scale lockdowns for long durations). Additionally, 2022 earnings may very well eclipse pre-COVID run-rate levels for many markets, especially if full vaccine distribution is achieved by late 2021.
    - Credit default rates are also pacing well below expected levels thus far.
- <u>However, equity valuations are elevated relative to historical averages</u>
  - Equity market valuations are highly elevated based on 2021 earnings. Even when looking at 2022 "normalized" earnings, markets are still trading well above historical averages.
    - We do acknowledge that relative to extremely low-yielding Treasury bonds, equity valuations based on 2022 earnings appear quite attractive.
  - Near-term risks include a) potential new lockdowns associated with widespread virus resurgence, b) setbacks or delays surrounding vaccine development, and c) potential policy changes (in the US post-election) or geopolitical risks such as Brexit negotiations.

<u>We are incorporating these views into portfolio positioning by:</u>

- Adjusting equity exposures within public equities (modestly adding cyclical exposure)
- Increasing allocations to private equity and other private strategies

Strategic Asset Allocation View (7-years)

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- Following the massive 50%-60% rallies from March lows, **we now expect mid-single digit nominal annualized pre-tax equity returns (6%-7%)** over the next seven years.
  - It is important to note that equity returns in any individual year over this seven-year period may be highly divergent from our annualized 7-year forecast.
  - We expect continued bouts of volatility over the next 6-9 months (COVID resurgence and potential lockdowns coupled with potential post-US election policy uncertainty, especially if democrats win a senate majority).
    - *We recommend investors maintain some dry powder and opportunistically add to risk assets at lower price levels.*
- **High-yield and leveraged loan credit spreads have meaningfully tightened since the March lows** and are now close to pre-COVID levels, despite continued uncertainty surrounding corporate credit fundamentals.
- Relative to public markets, *we forecast significantly higher returns for risk assets across private market strategies* (i.e private equity and stressed / distressed credit funds).

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/High Single-Digit
MSCI Emerging Markets		
FIXED INCOME		
US Treasury		Low Single-Digit
US Corp Investment Grade		
US Corp High Yield		Mid Single-Digit
US Corp Levered Loans		
EM Sovereign USD		Mid Single-Digit
EM Sovereign Local Currency		
ALTERNATIVES, PRIVATE EQUITY, & REAL ESTATE		
Real Estate (Private)		Mid/High Single-Digit
Hedge Funds		
Private Equity/Credit		

Tactical Allocation View

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- From a shorter-term tactical standpoint (next 6-12 months), we believe that equity markets' direction will be primarily driven by: a) severity of restrictions surrounding surging COVID cases, b) progress towards successful approval and mass rollout of COVID vaccines, and c) any potential policy changes from unexpected election outcomes (i.e. if Democrats win the US senate majority) or geopolitical events (such as a no-deal Brexit).
- Despite the nearly 60% rally from March lows, both bulls and bears have credible cases to make
  - *In the bullish case,* corporate earnings may continue to accelerate much faster than expected. Interest rates are likely to remain lower for longer. Additionally, significant stimulus and liquidity underpin a continued attractive backdrop for stocks. Confirmation of an effective and safe vaccine(s) would further buoy investor sentiment. Finally, in the US, the election results look favorable for equities with a divided government likely (lower potential for major policy changes). Equities could rise another 15% over the next 6-12 months.
  - *However, several risk factors could derail the market rally* including a) increasing waves of virus reoccurrence leading to slower than expected economic recovery and lower corporate earnings relative to expectations, and b) potential for unexpected election results or other geopolitical surprises. A 10%-15% correction is easily imaginable under this scenario.
  - Within public equities, we generally advocate a neutral geographic weighting (vs. the MSCI ACWI benchmark).
- Corporate credit spreads (both investment grade and high-yield) have materially compressed
  - Spreads are now close to pre-pandemic levels despite still uncertain corporate credit fundamentals.
  - While near-term further spread compression may occur given Fed support and liquidity, risk / reward is increasingly asymmetric towards the downside.
- However, we believe compelling opportunities exist across private markets, especially among middle-market private equity strategies (discussed as a Special Topic later in this report).
  - Proprietary-sourced deals lead to better potential for lower entry valuations vs. public markets.
  - More opportunities to drive value creation via sourcing, operational improvements, platform M&A and a wider range of exit opportunities.
  - Mid-to-high-teens returns are possible across several different middle-market private-equity strategies (direct buyout, secondaries, co-investments, and GP stakes).

Economic Activity

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- World economies experienced sharp sequential snapbacks in economic growth during Q3, as Western economies began to re-open their economies and China continued its recovery (having exited lockdowns earlier).
  - US GDP increased at a 33.1% annualized rate Q/Q in Q3. Eurozone GDP increased at an even faster annualized rate of 50.0% (+12.7% Q/Q), with Canada's GDP also forecasted to improve 9% Q/Q in Q3. China's GDP continued its recovery Q3, with growth accelerating to 4.9% YOY.
    - The IMF is presently forecasting 2020 global GDP declines of -4.4%, followed by a 5.2% recovery in 2021 and 3.5% annual growth from 2022-2025.
  - Global PMI indexes have consistently inflected upward with most returning into positive growth territory.
    - The rebound has been more pronounced across manufacturing indexes vs. services indexes thus far.
  - Unemployment rates have declined sharply in the US and Canada but are ticking upwards across Europe.
  - Retail sales have returned to positive growth YOY across all major economies.
    - Well higher-than-average personal savings rates indicate significant potential pent-up demand.
- Economic progress is showing signs of stalling in Q4 as COVID cases surge across many nations.
  - COVID cases are reaching all-time highs in Europe and the US whereas there does not appear to have been material second waves in Asian countries thus far.
    - Europe has already started to implement restrictions and it is uncertain whether the US may follow (especially if guidelines change under a new administration).
    - Hospitalizations are also starting to reach prior peak levels although mortality rates are well lower (given better understanding of the virus and effective treatments).
  - However, recent vaccine trial data was extremely positive for Pfizer, and other similar vaccines may also show positive safety and efficacy data as well.
    - Investors may look past economic weakness over the next six months as transitory and focus on recovery potential towards late 2021 and 2022 once vaccines are made available in mass to the general public.

Vaccines and Political Developments

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- <u>Significant positive trial data from Pfizer likely to lead to vaccine approval shortly.</u>
  - On Nov. 6, Pfizer released much-better-than-expected vaccine trial data with 90% effectiveness across test subjects (well higher than the 50% effectiveness threshold mandated by the FDA for approval).
    - Other vaccines utilizing similar technology such as Moderna's vaccine are also expected to show positive results.
    - As such, it is quite likely that vaccine doses will be available for critical workers by year-end 2020 and more broadly for public dissemination by Summer or Fall 2021.
  - Several questions remain surrounding vaccine logistics, longevity of immunization and effectiveness, and ultimate vaccine adoption.
    - Therefore, it may still take longer than expected for consumer and business behaviors to completely normalize.
    - The pace of such normalization will impact the ultimate level and trajectory of corporate earnings.
- <u>The US Presidential Election appears likely to deliver business-friendly outcomes</u>
  - As things stand today, media networks have declared Joe Biden the winner of the US Presidential election. While President Trump is pursuing an aggressive litigation strategy, the lawsuits appear to have low probability of altering the election outcome.
  - Importantly, it appears that Republicans will narrowly retain a Senate majority (there are two runoff elections in Georgia in January where they will be favored).
    - A divided government will likely prevent the Biden administration from passing progressive legislation that would be viewed as overly unfriendly to business (i.e. raising corporate tax rates).
    - On the flip side, the next stimulus bill's passing may be delayed, and the magnitude of the stimulus package is likely lower than had the Democrats effected a clean sweep of the Presidency and Senate.
  - Additionally, under a Biden administration, the US is less likely to raise new tariffs or adopt unpredictable foreign policy stances. This predictability is likely to be viewed favorably by financial markets.

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Capital Markets Review

Equity Markets - Performance

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- Global equity markets appreciated 8.1% during Q3 (and another 7.5% post quarter end).
  - During Q3, US stocks continued to outperform international stocks and US growth stocks significantly outperformed US value stocks (also continuing a multi-year trend).
  - However, since the end of September, there has been a rotation towards international stocks and towards US value and US small-cap stocks that have greater cyclical exposure (as we have flagged in prior memos).
    - This rotation was especially pronounced over the two-day period Nov 9th – Nov 10th where US value stocks outperformed US growth stocks by over 8% (one of the largest magnitudes in recent times).
    - Over the past several years, value stocks have mounted brief periods of outperformance which then rapidly gave way towards a prolonged period of underperformance.
- Over our 7-year forecast period, we continue to believe that stocks of high-quality companies will continue to outperform given their better business models, superior earnings growth and strong returns on capital.
  - However, we do believe that conditions are emerging where more cyclical value stocks <u>might</u> finally outperform for a shorter-term period of 12-18 months (earnings inflections due to operating and financial leverage, lower valuation multiples, and likely availability of vaccines buoying investor sentiment).
    - As such, we are recommending clients add cyclical exposure at the margin.

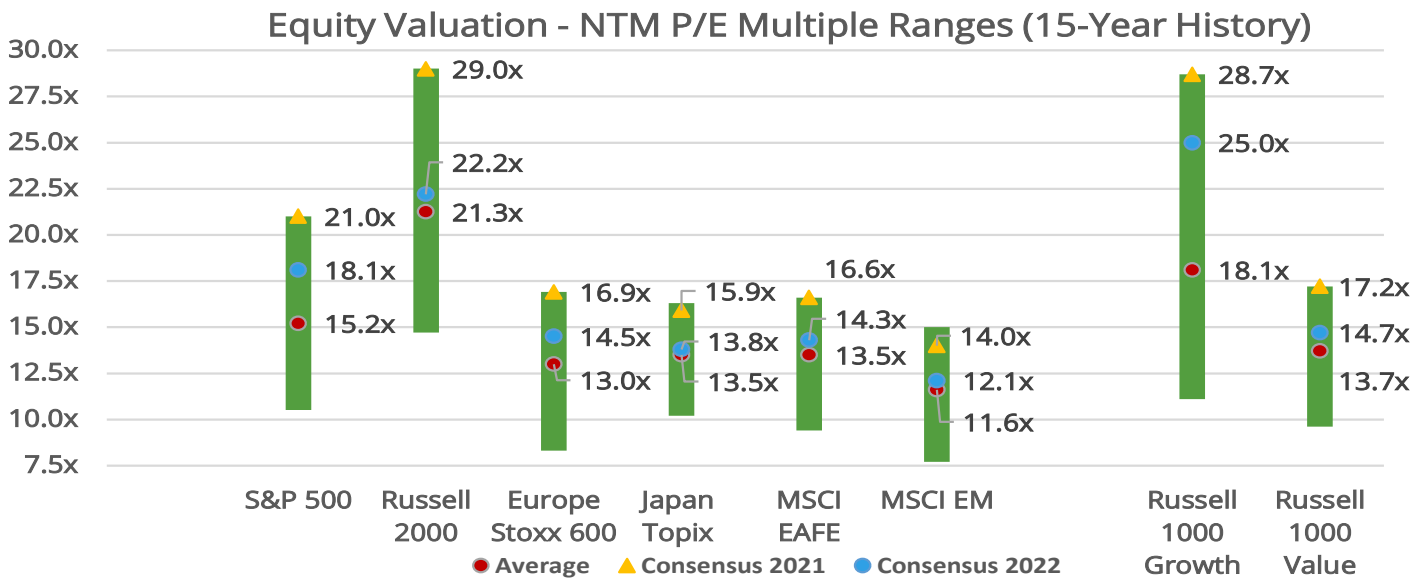
Equity Indices - (As of 11/11/2020)

	YTD Performance			Total Returns (%) - USD *				
	YTD	Feb 19-23-Mar	23-Mar - Present	Sept 30-Nov. 11	Sept. Qtr	1Y	3Y	5Y
US Large Cap (S&P 500)	11.8%	-33.8%	61.0%	6.4%	8.8%	17.3%	12.9%	13.0%
US Small Cap (Russell 2000)	5.3%	-40.7%	74.7%	15.3%	4.9%	10.5%	7.1%	9.4%
MSCI EAFE	0.6%	-32.7%	50.7%	8.3%	4.8%	3.9%	2.8%	5.8%
MSCI Emerging Markets	7.8%	-31.2%	58.1%	9.1%	9.6%	14.5%	3.9%	9.7%
MSCI ACWI	8.7%	-33.6%	59.4%	7.2%	8.1%	13.6%	8.8%	10.4%
Russell 1000 Growth	29.6%	-31.4%	73.1%	4.3%	13.2%	37.5%	21.5%	19.1%
Russell 1000 Value	-3.4%	-38.0%	54.4%	9.3%	5.6%	0.3%	5.5%	7.9%

**Returns are annualized except for Sept. Qtr, Sept-Nov 11 period, and YTD returns which represent actual performance*

Equity Markets - Valuation

- Current equity valuations based upon 2021 forward earnings appear high, but corporate earnings are still not fully normalized and are penalized from pandemic effects.
  - Therefore, investors are looking past 2021 results and are focusing on 2022 earnings as the first "normal" year post COVID.
    - Multiples based upon 2022 earnings appear 10%-15% higher than historical averages.
    - Admittedly, uncertainty surrounding 2022 earnings remains higher than normal (depending upon the course of the virus and the adoption and effectiveness of any vaccines).
- However, relative to ultra-low interest rates, equity valuation multiples might be justified.
  - S&P 500 presently trades at 18.1x consensus 2022 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.



Fixed Income Markets - Performance

- Fixed income markets benefitted from risk-on sentiment during Q3, with rallies in credit extending after quarter-end.
  - US Treasuries were relatively flat as interest rates held steady over the quarter, but have declined 1.6% post quarter-end as 10-Year treasury yields have increased by roughly 25bps.
  - Credit assets (high yield bonds, leveraged loans, and EM Hard Currency sovereign bonds) rallied sharply as credit spreads narrowed. The rally has continued through Nov. 11th with the positive Pfizer vaccine announcement serving as an additional catalyst.
    - Investors have aggressively chased yield as the Fed has committed to keeping interest rates lower for longer.
    - Underlying corporate earnings have been significantly better than expected driven by better-than-expected demand and aggressive cost management.
  - EM hard currency (USD) bonds rallied strongly despite flattish US Treasury yields as spreads declined.
  - EM local currency bonds appreciated modestly during the quarter and more sharply post quarter-end due to currency appreciation as well as falling local interest rates.

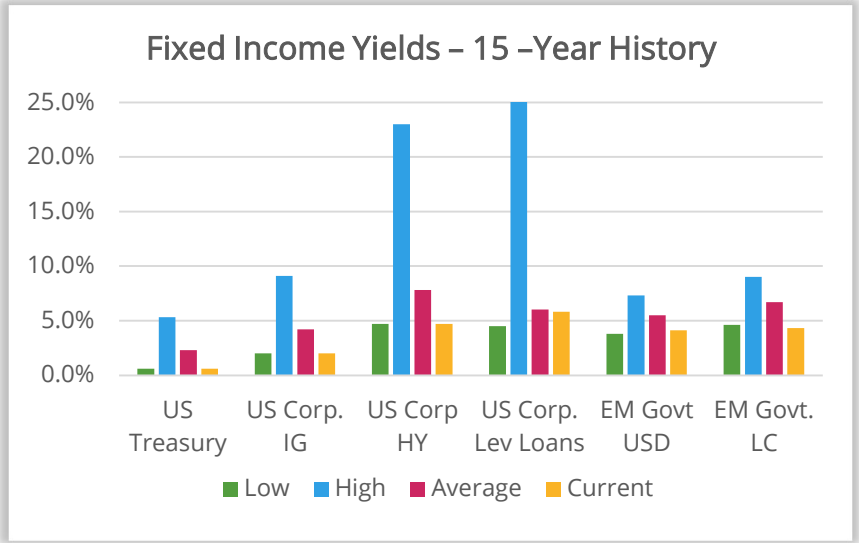
Fixed Income Indices - Characteristics and Performance in USD (as of 11/11/2020)

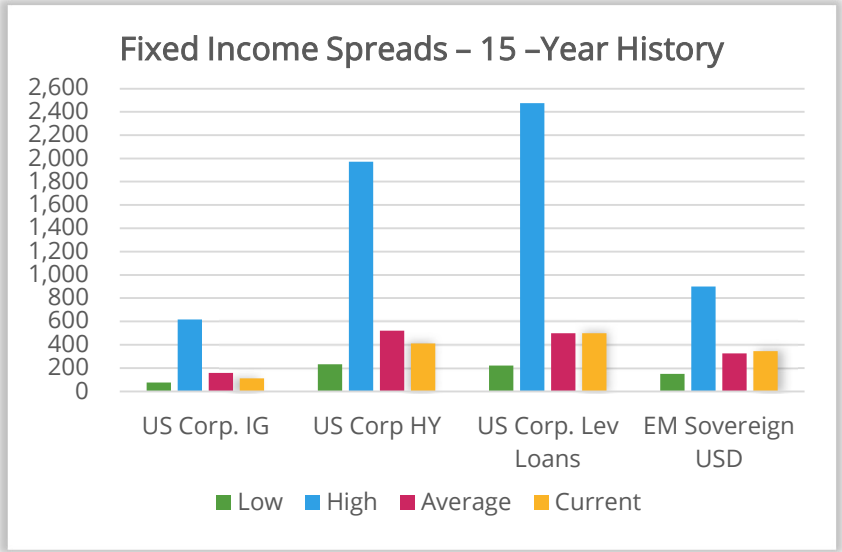
	YTD Performance (%)					Annualized Returns				Duration
	YTD	Feb 19-23-Mar	23-Mar -Present	30-Sep 11-Nov	Sept. Qtr.	1Y	3Y	5Y	7Y	(yrs)
US Treasury	7.2	5.4	-0.6	-1.6	0.2	7.8	5.0	3.7	3.3	7.2
US Corp. IG	7.2	-12.3	19.1	0.5	1.5	9.2	6.7	6.2	5.5	8.8
US Corp HY	4.2	-20.8	29.8	3.5	4.6	6.4	5.5	7.3	5.5	3.6
US Corp Lev. Loans	1.2	-20.6	26.7	1.9	4.1	3.2	3.6	4.5	3.7	NA
EM Sovereign USD	2.2	-20.7	25.9	2.7	2.3	4.2	4.6	6.2	5.9	8.7
EM Sovereign LC	-1.1	-18.0	21.8	4.9	1.1	1.4	1.7	4.4	0.4	5.7
Barclays US Aggregate	6.3	-0.9	5.2	-0.5	0.6	7.2	5.1	4.2	3.9	6.2

** Returns are annualized except for Sept. Q, Sep-Nov. period, and YTD returns which represent actual performance*

Fixed Income Markets - Valuation

- Absolute yields at multi-year lows across both government debt and corporate credit. Given high duration, the risks from movements in interest rates are asymmetric to the downside.
- Corporate spreads (investment grade and high yield) have compressed meaningfully
  - IG and HY spreads have both compressed to near pre-pandemic levels despite still uncertain credit fundamentals and a likely slowdown in near-term economic activity (given sharply rising COVID cases)
  - 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 still bifurcated* within high-yield for higher-quality (BB) bonds vs lower-quality (CCC) bonds with spreads of roughly 800bps. Less than 10% of the high-yield bonds and loans are presently trading at distressed levels (spreads of greater than 1,000bps), compared with over 25% in March.
- We prefer obtaining credit exposure through private stressed and distressed debt strategies.
  - These strategies can invest in smaller off-the-run restructurings and rescue financings with higher yields.





Alternatives and Currencies

- Hedge funds had a solid quarter with all major sub-strategies positive.
  - The HFRX Equal-Weighted Strategies was up 2.3% in Q3.
  - Convertible-arbitrage strategies (+7.5%) were the star performer. Directionally-focused strategies such as long-short equities (+3.6%) , credit (+3.9%) and event-driven (+2.9%) also fared well.
- Private real estate (as measured by the NCREIF Index) increased by 0.7% during Q3.
  - Average cap rates remained relatively stable across property types.
    - It remains to be seen whether commercial real estate operating fundamentals weaken once rent forbearance periods expire or are not extended further.
- Private equity deal activity increased sequentially in Q3 although remain lower on a YOY basis.
  - Underlying fundamentals generally improved across PE portfolio companies with most exceeded dire post-COVID budget plans.
  - Valuation markups also rebounded in Q3 for PE portfolio companies driven by improving underlying EBITDA and rising public and private comparable multiples.
- The USD continued to weaken during Q3 and has modestly declined since then.
  - The Dollar Index depreciated 3.6% during Q3 as the Fed committed to a longer period of ultra-low interest rates and the necessity for further government stimulus became apparent.
  - The Euro has appreciated by 4.4% during the quarter as European economic growth experienced strong sequential improvement post re-opening.
  - The Canadian dollar has appreciated by 2% during Q3
  - EM currencies also experienced appreciation of 2.7% during Q3.

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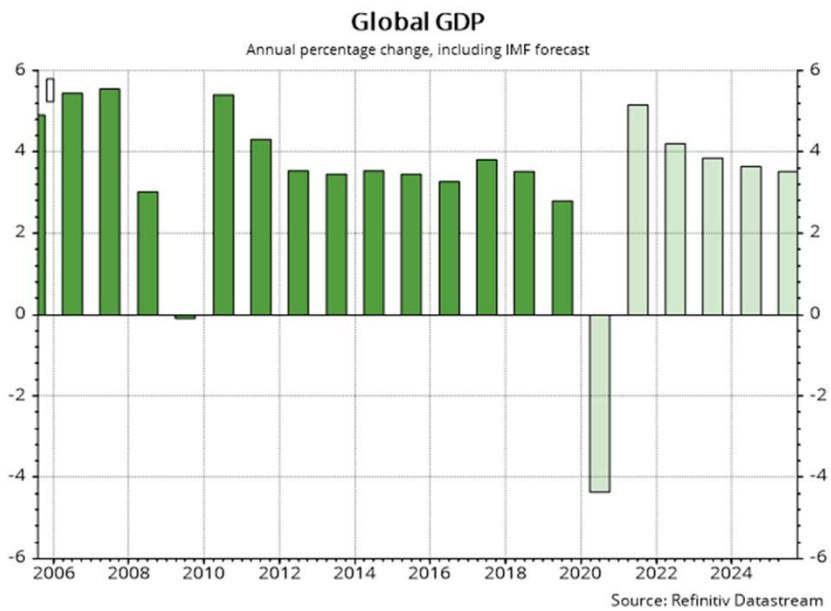
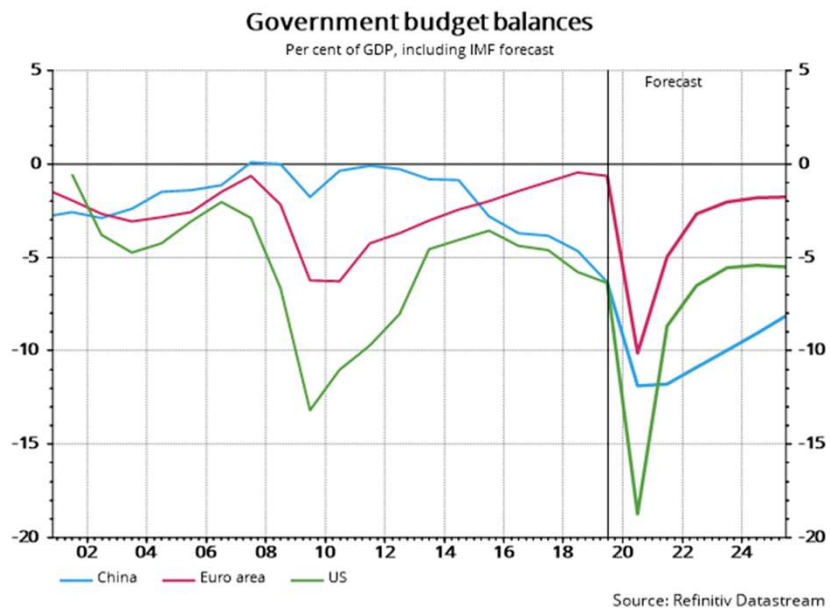
Economic Review

Global GDP Growth

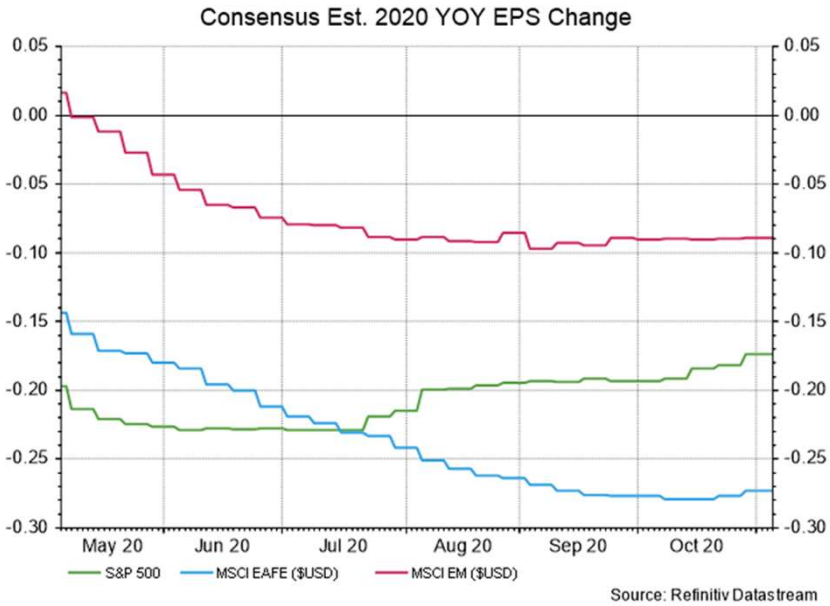
- The IMF is forecasting a 4.5% decline in global Real GDP in 2020, followed by a 5.2% rebound in 2021. The projected 2020 decline is less severe than originally forecast.
  - The hit projected to US and European economies is more severe than that forecasted for Asian economies
    - Economists are US and European 2020 Real GDP declines of 3.5% and 7.5% respectively, whereas Chinese GDP is expected to grow 2% YOY in 2020.
- Governments globally have enacted massive support programs to blunt the negative effects of the pandemic.
  - These programs are causing government deficits to spike to historically high levels across various regions.
  - Rolling second-waves of infections especially in the US and Europe is likely to necessitate further stimulus
  - 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.

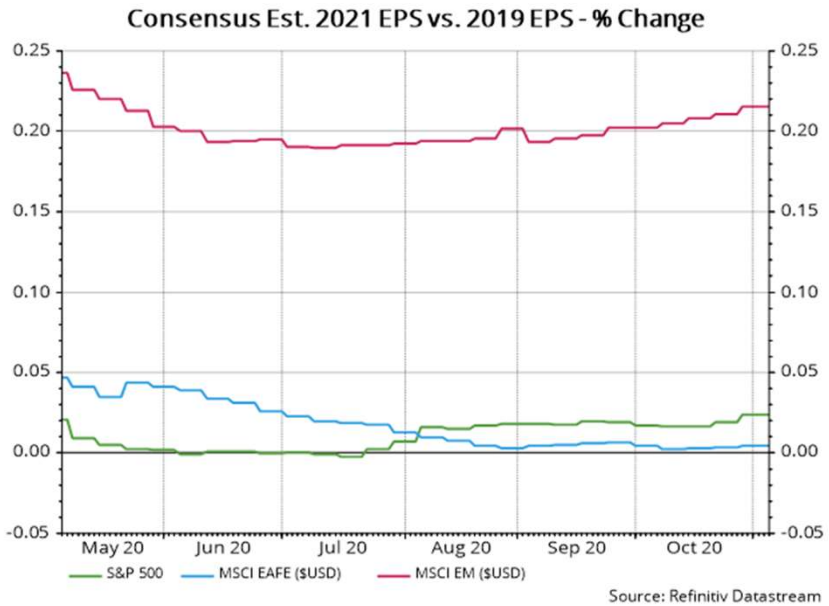




Global Corporate Profits

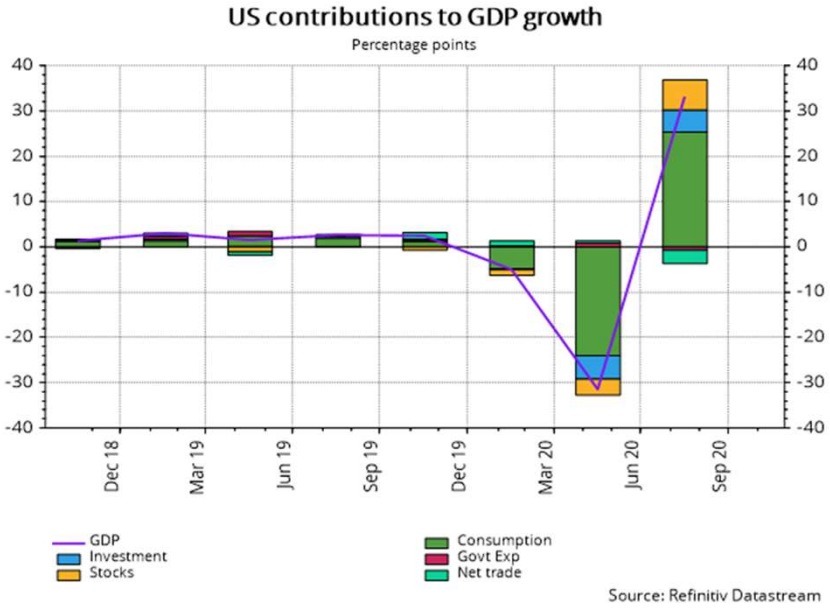
- Corporate profits will meaningfully decline in 2020. However, corporate earnings have materially exceeded initial dire projections (driven by better-than-expected demand coupled with aggressive cost measures)
- Analysts are presently projecting a sharp recovery in 2021, with consensus 2021 earnings forecasts 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 surprisingly realistic,* given a) better-than-expected-end market demand and cost controls to date and b) likely availability of a vaccine by second-half 2021.
  - *However, potential 2021 and 2022 EPS outcomes still may have a wide range of dispersion*. Much will depend upon the extent of economic damage, any permanent shifts in consumer or business behavior, the timing regarding widespread Covid-19 vaccine availability, ultimate vaccine efficacy and consumer uptake.

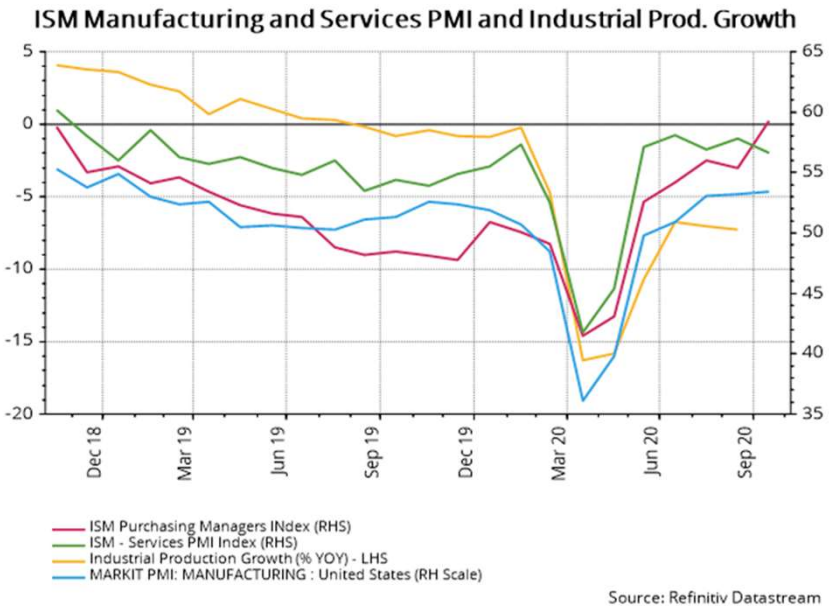




United States

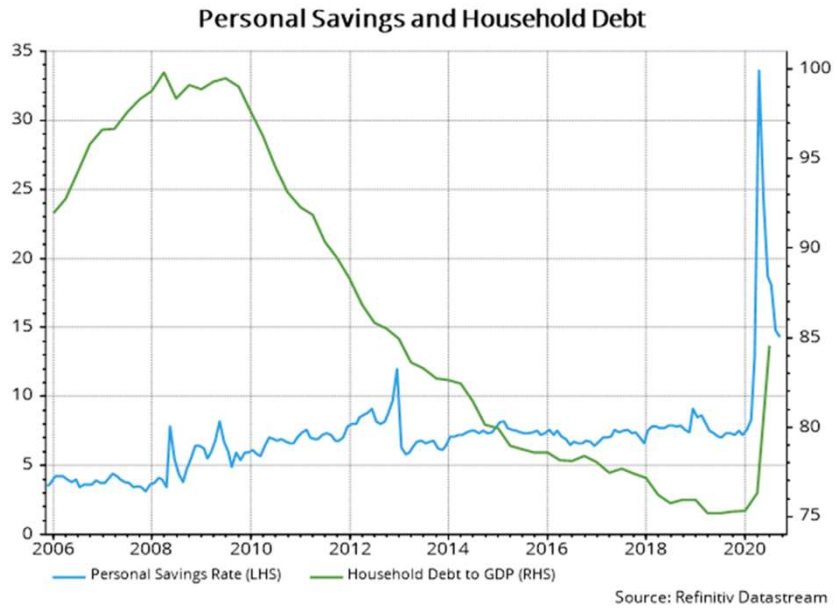
- Real GDP Growth improved 33.1% Q/Q on annualized basis in Q3 2020, with economists projecting more modest q/q growth in Q4 2020, followed by 3.8% growth annually in 2021.
  - The recovery has been pronounced across both the manufacturing and services sectors, with manufacturing continuing to show an upwards trajectory
  - 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 followed by sustained strength.
  - Economic data from May onwards 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 are experiencing high resurgences in COVID cases, and a new stimulus package has yet to be approved.





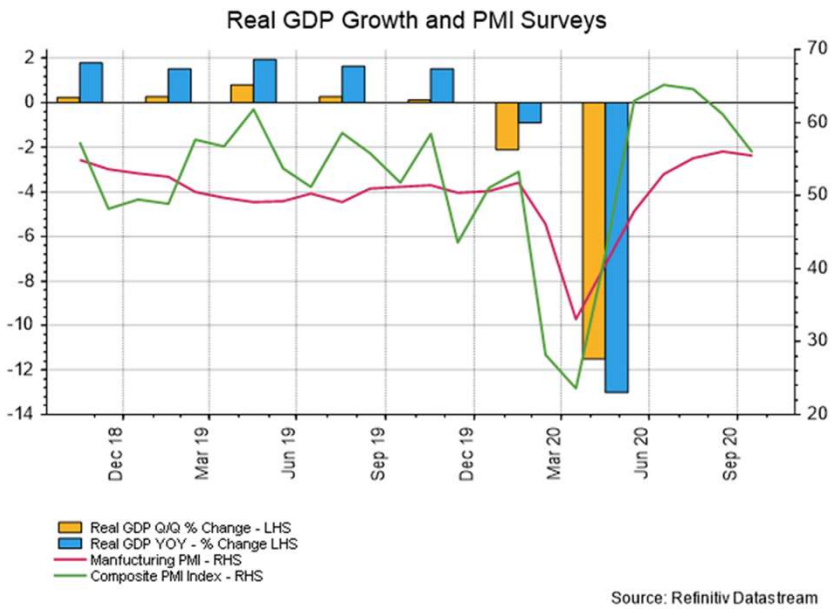
United States (Cont.)

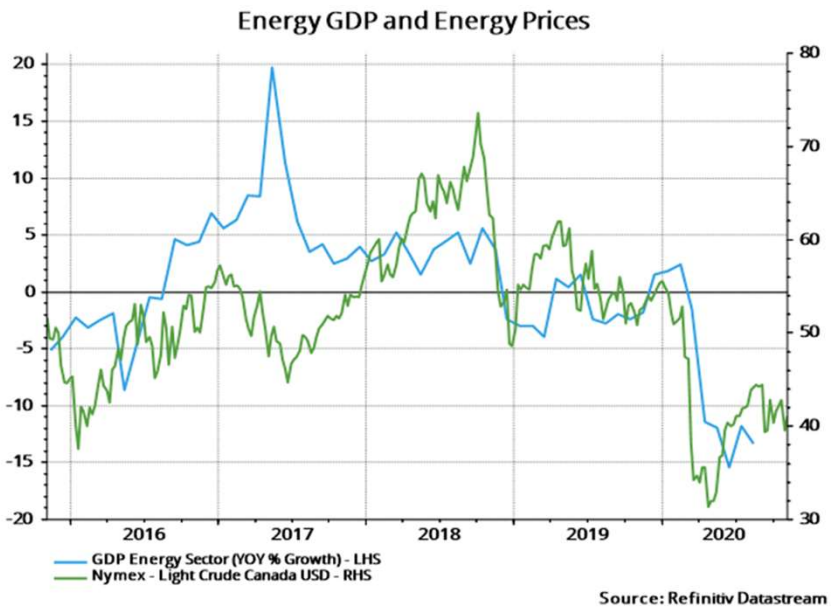
- US employment levels have improved markedly since the April lows, with corresponding sharp gains in retail sales and consumer confidence
  - The unemployment rate declined to 6.9% in October vs. 14.7% in April at the depths of the pandemic crisis
    - The sustainability of this recovery will be dictated by the course of the pandemic over the next few months with some service sectors (restaurants and hospitality) possibly facing slowdowns as colder weather approaches.
    - 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 ultimate economic recovery efforts.
    - The recent positive Pfizer vaccine trial news (if the vaccine is ultimately proved successful) should drive further employment gains as economic activity approaches normalcy over late 2021 and into 2022.
  - Massive government stimulus has mitigated much of the negative effects from unemployment, with personal savings rates spiking to levels above 30% (before moderating towards 15% currently).
    - These elevated personal savings rates may indicate potential significant pent-up demand, a positive harbinger for consumption into the upcoming holiday season and into 2021.



Canada

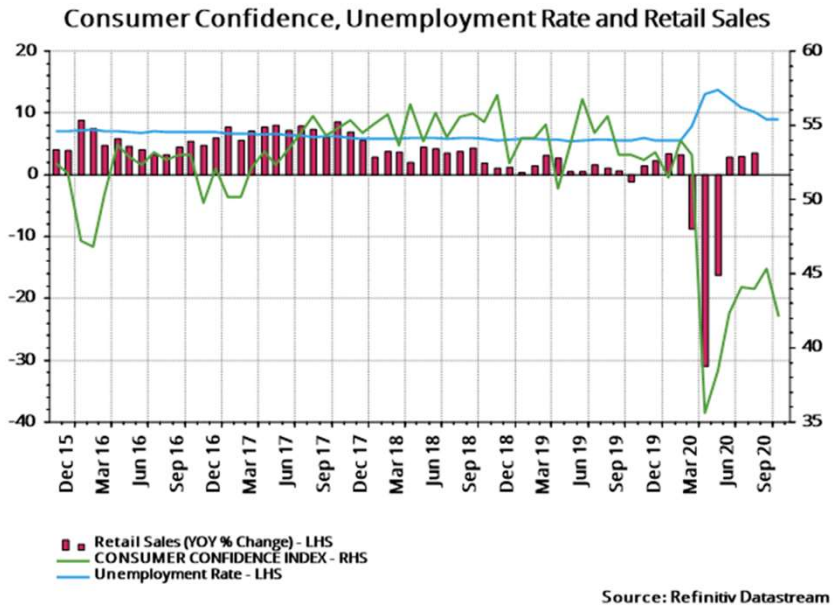
- <u>Canada's economy experienced a strong sequential recovery in Q3.</u>
  - Q3 GDP is expected to improve 10% Q/Q (40% annualized) with both manufacturing and services PMI's showing sharp acceleration.
    - 2020 GDP is now forecast to decline at 6.6% YOY vs. an 8.2% decline projected earlier this summer.
    - However, PMI indicators are showing signs of flattening out or decelerating entering Q4.
  - The areas hit hardest by the pandemic (entertainment, hospitality, and food services) have recovered off their troughs, yet remain 30%-45% below pre-pandemic levels.
  - The Canadian $ has continued to rally vs. the USD (presently at $1.30 vs. $1.45 in March).
  - Stabilizing crude oil prices may also aid Canada's economic recovery going into 2021.

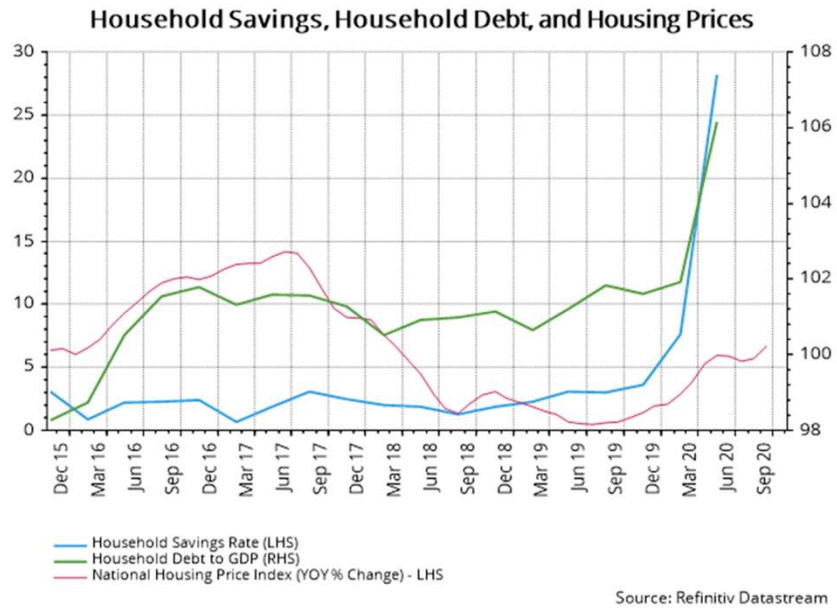




Canada (Cont.)

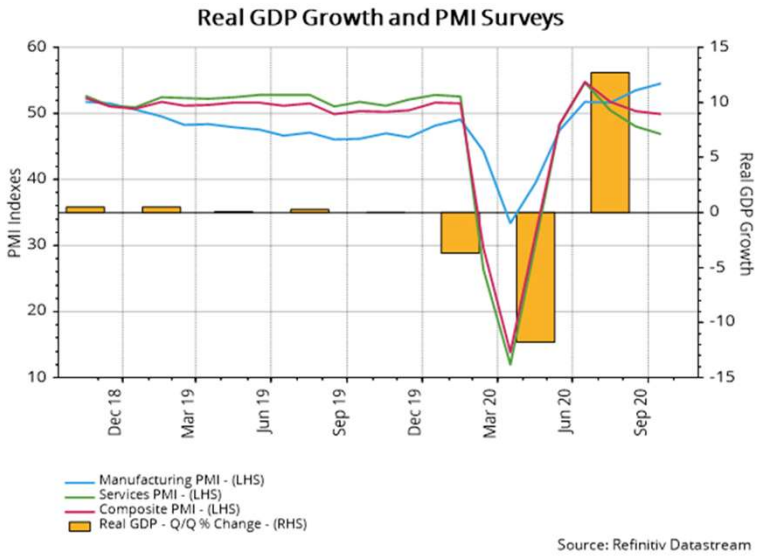
- Canadian consumer indicators improved significantly over the Q3
  - Unemployment rates have declined to sub 10% levels from the April peak of 12%.
  - Retail sales have shown YOY growth over the past three months.
  - Household savings rates spiked to 28% over the summer, indicating substantial capacity for pent-up demand
    - The increase in debt to GDP is driven by the decline in GDP and this ratio should decline as the economy continues to recovery.
    - However, the pace of retail sales and consumer activity may slow over the upcoming months given the resurgence in Covid cases.
  - The Canadian government has aggressively provided benefit and wage support to unemployed workers through programs such as the Canada Emergency Wage Subsidy and the Canada Recovery Benefit.
  - Housing activity accelerated throughout the quarter with record highs in new home sales and steady increases in housing prices (for single-family homes).

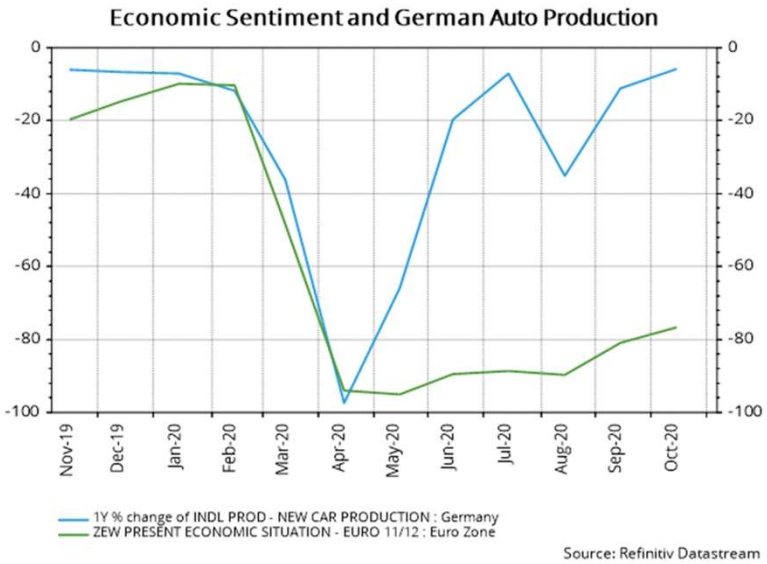




Eurozone

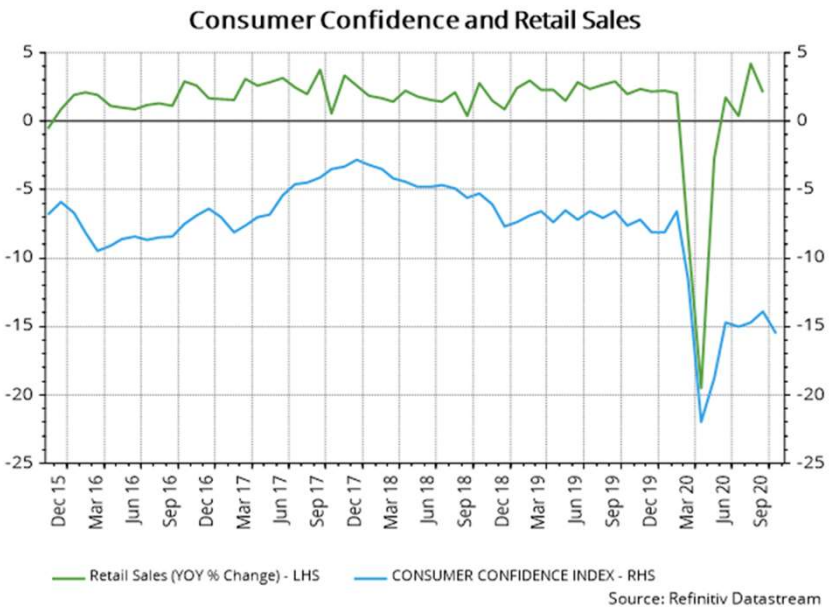
- Eurozone GDP and general business confidence declined significantly during Q2 with signs of recovery emerging in Q3.
  - Real GDP growth improved 12.7% Q/Q (50.8% annualized) in Q3 2020 (chart at L). The recovery was broad-based as European countries lifted lockdowns over the summer and as global growth improved (benefitting European exports).
    - EU GDP is expected to decline by 7.9% in 2020 followed by a 4.2% recovery in 2021.
  - Leading indicators such as PMI indexes inflected sharply upwards through Q3 and Germany's auto production has also rebounded well off April lows (driven by strength in exports to China – chart at R).
  - However, a sharp resurgence in Covid cases has prompted increased restrictions in many European countries, which will likely stall Europe's recovery momentum entering into the winter months.
    - Services PMI's have returned to negative levels and French business confidence ticked downwards in October.
    - Brexit negotiations may add further risk to European geo-political sentiment.
    - On the other hand, positive vaccine development should greatly benefit Europe (as European economies have greater exposure to cyclical sectors).

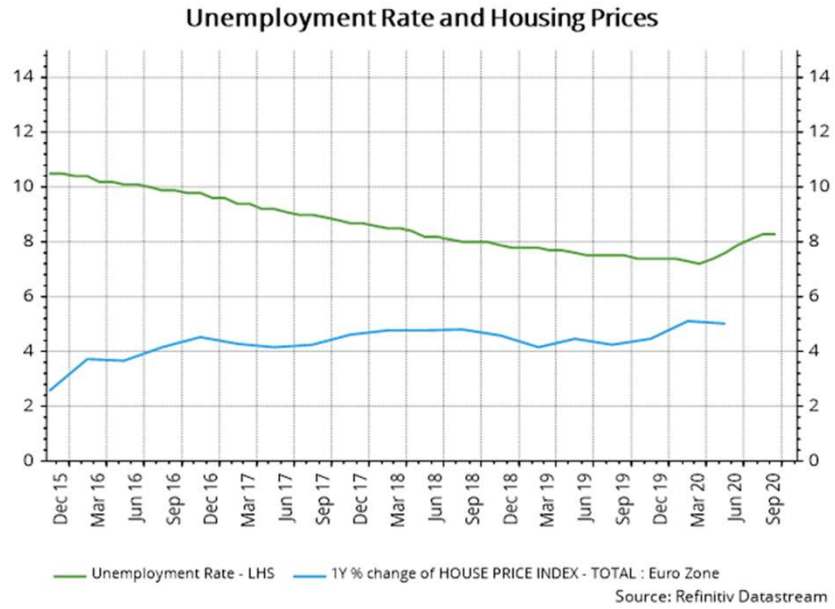




Eurozone (Cont.)

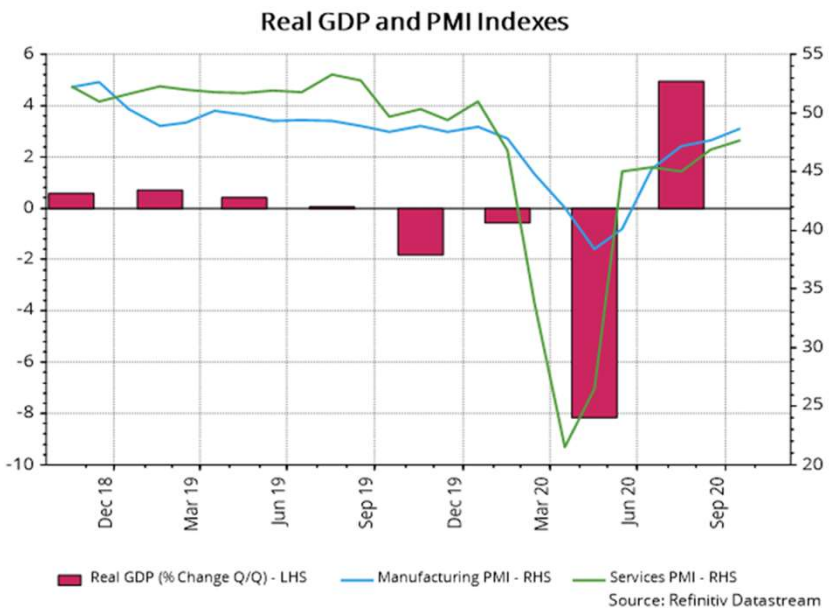
- <u>Consumer confidence and retail sales have rebounded steadily since April lows</u>
  - Retail sales have returned to YOY growth for several months, but the rate of improvement is beginning to decelerate.
  - Retail sales growth may return to negative territory on a YOY basis if current lockdown / restriction measures are maintained for an extended duration.
  - Eurozone unemployment rates have thus far held relatively steady, but are beginning to increase
    - 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).

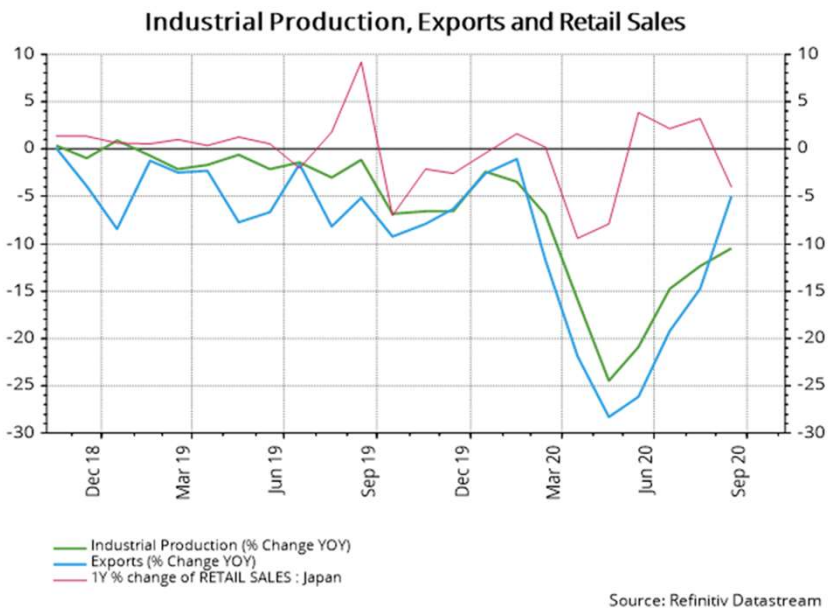




Japan

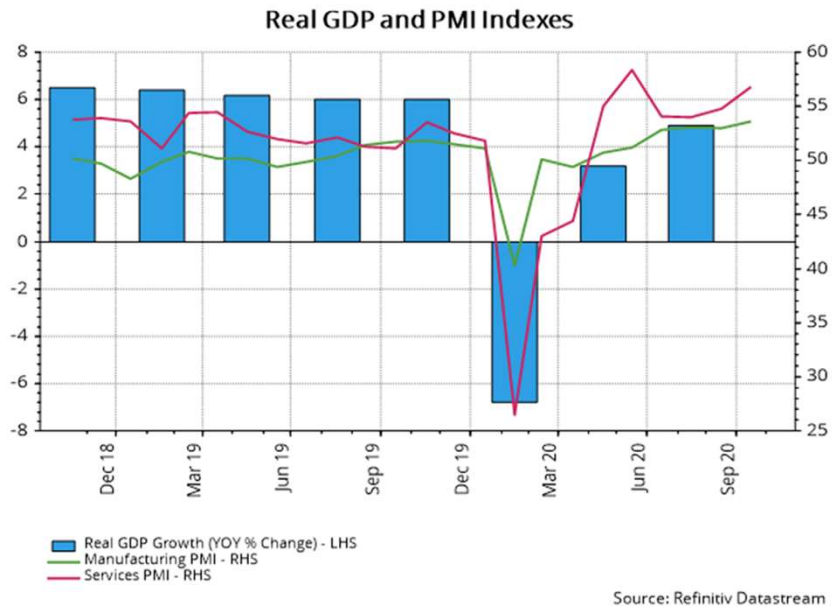
- Japan's economy recovered nicely in Q3 (but at a slower rate than the US or Europe)
  - Q3 GDP increased by 5% Q/Q (20% annualized) in Q3, following a 7.9% decline in Q2.
  - Leading indicators such as the PMI indexes are recovering towards growth territory.
  - Japan's economy is highly exposed to global trade.
    - Industrial production and exports are clearly inflecting upwards which is a positive sign for Japanese corporations.
    - However, core machinery orders (a proxy for capital spending) likely fell 0.3% in Q3.
  - Significant stimulus measures (25%+ of GDP) have thus far headed off surges in unemployment and bankruptcies.
    - Retail sales growth has been choppy although comparisons vs. the prior year are muddied due to the consumption tax hike that went into effect in fall 2019.

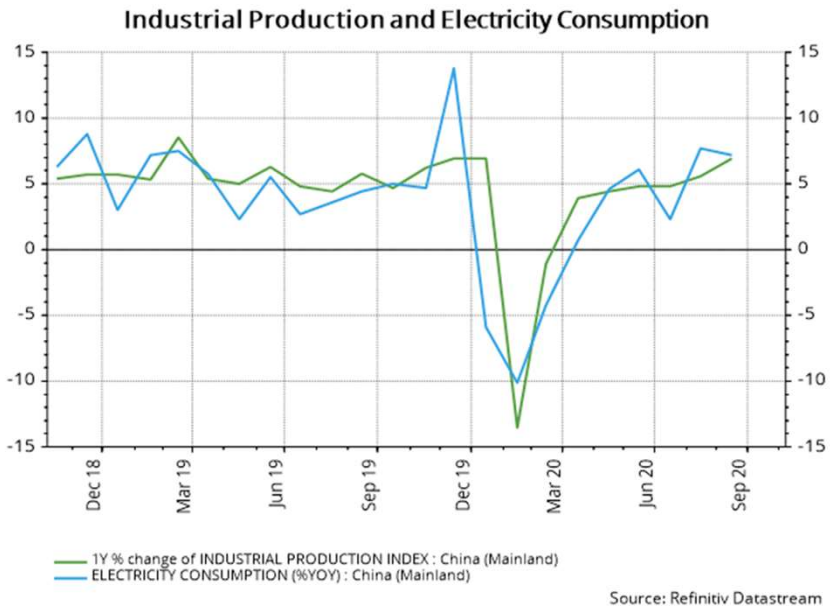




China

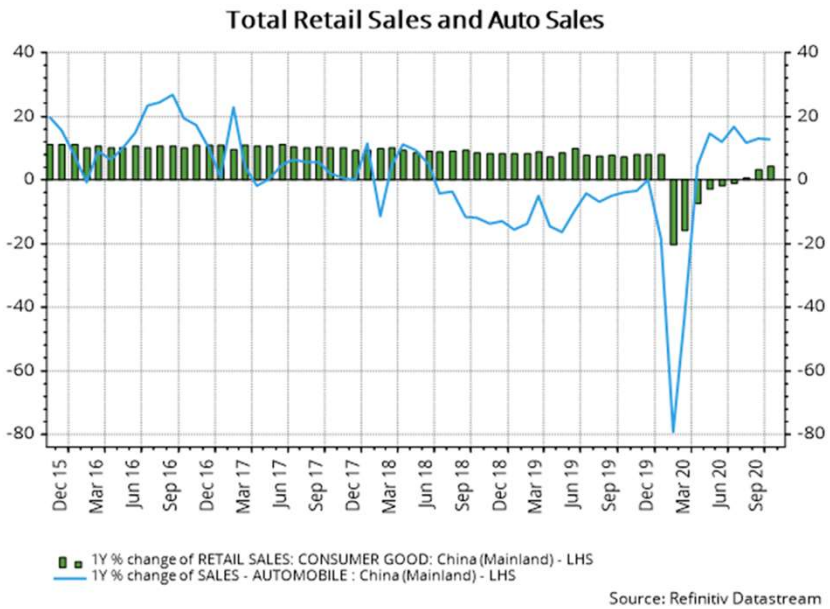
- <u>The Chinese economy's Real GDP growth accelerated in Q3 to 4.9% YOY</u>
  - Having largely successfully curbed the virus spread, China's economy is further along in terms of returning to normalcy (relative to Western countries).
    - The IMF projects that China will achieve 1.9% YOY Real GDP growth in 2020, the only major economy to show growth in 2020.
  - Both manufacturing and services activity continue to inflect positively. Other measures such as industrial production and electricity consumption have also moved firmly into YOY growth territory.
  - China's trade volumes recovered sharply in Q3 with exports up 10.2% YOY.
  - Importantly, the Chinese economy was able to demonstrate recovery despite a lack of large-scale infrastructure stimulus programs (deployed in previous China slowdowns).

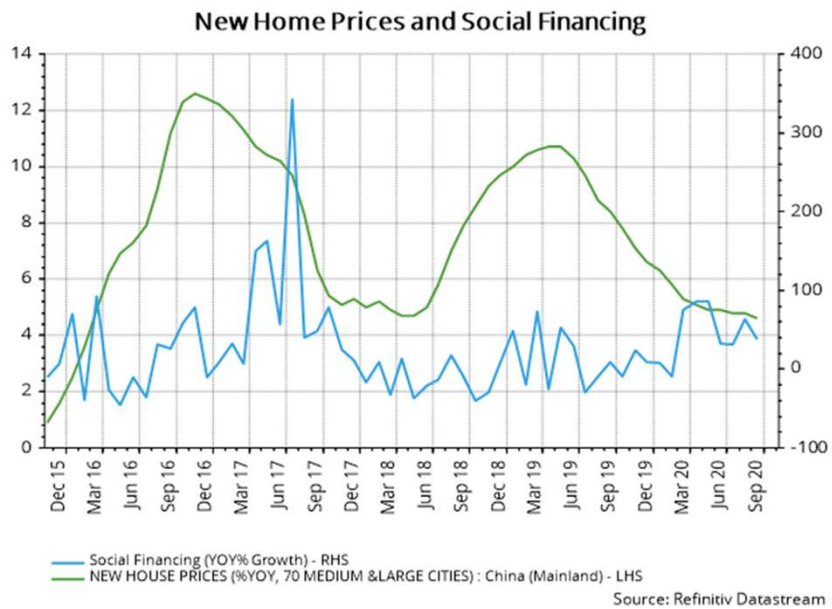




China (Cont.)

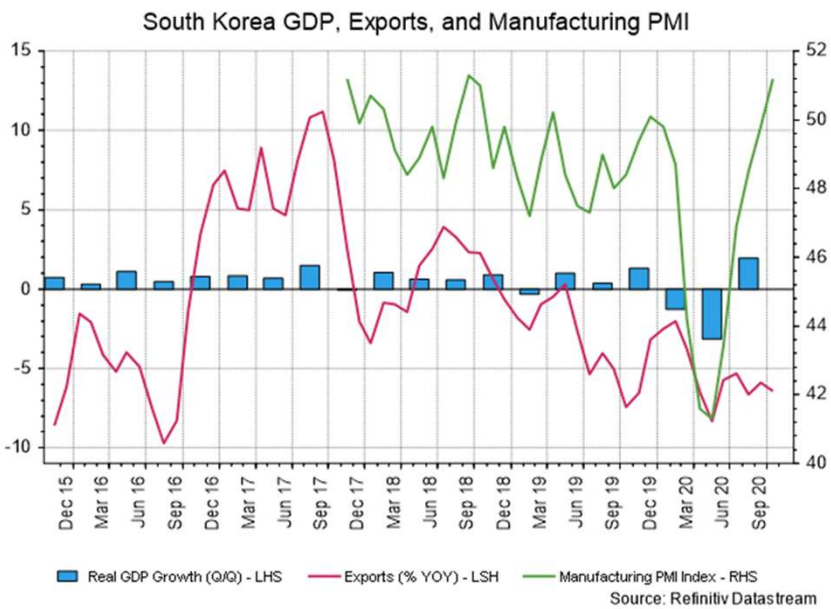
- <u>Chinese consumption is now recovering at a steady pace.</u>
  - Retail sales growth accelerated to 4.3% YOY in October, the second consecutive month of YOY growth.
  - Sales of larger-ticket items (homes, autos) and luxury goods have largely rebounded, whereas service-oriented sectors such as dining and entertainment are still below pre-pandemic levels, but beginning to recover at a faster pace.
  - New home price appreciation has generally remained stable as has social financing.
  - 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 economies returned to sequential growth during Q3.
  - South Korea's GDP declined 1.3% YOY (but expanded 1.9% Q/Q) in Q3. Exports (roughly 35% of GDP) increased 15.6% sequentially in Q3 but still remain negative on a YOY basis.
  - South Korean manufacturing PMI's returned to growth territory and have continued inflecting upwards.
  - However, domestic consumption remains relatively muted and was flat Q/Q in Q3.
  - Taiwan's GDP grew 3.3% YOY In Q3 driven by strong global demand for its tech exports and returning consumer confidence
    - In addition to the strong export growth, manufacturing PMI's increased sharply during Q3.
  - Going forward, Taiwan is well positioned to benefit from the 5G telecom rollout and demand for COVID-related biotech products.



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Special Topic: Private Equity

Why Private Equity Now?

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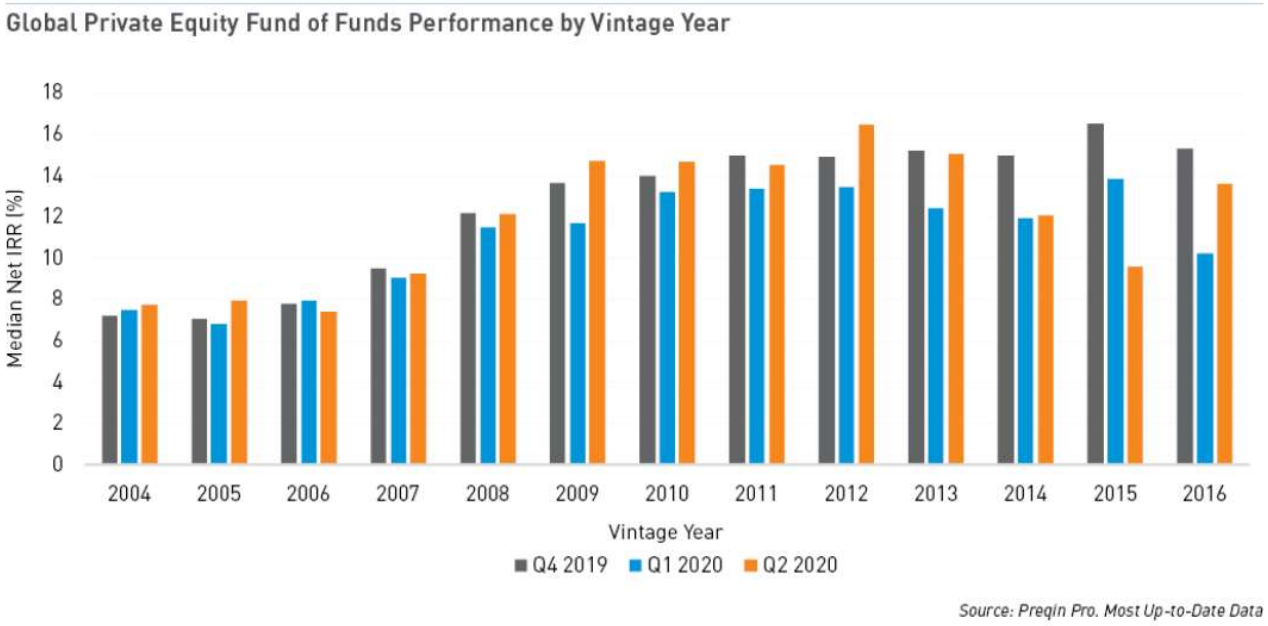
- We expect only modest 7-year annualized returns in the *public* equity markets (6.0%-7.0%). At the same time, achieving these returns is much less certain.
  - Questions surround the ultimate recovery and longer-lasting effects of the pandemic.
  - Significantly elevated global government debt levels create uncertain longer-term consequences.
  - Populism (de-globalization) has grown in response to rising income inequality.
  - Valuations are more elevated (relative to history), especially for higher-quality companies.
    - Earnings growth potential is largely known and potential for valuation multiple expansion limited.
- In contrast, the *private* markets (especially in the middle-market) offer significantly higher opportunities for value creation, and as such, greater potential for mid-teens annual returns.
  - Many more companies leads to value-creation potential through deal-sourcing advantages.
  - Better opportunities to materially enhance financial results through operational initiatives (customer growth, cost efficiencies, capital expenditure programs).
  - Ample opportunities to execute bolt-on M&A transactions which a) increase scale, b) drive down initial purchase multiples, c) improve margins through synergies and d) enhance companies' competitive positioning.
- Ideally, we would like to create well-diversified Private Equity Programs for BCA clients
  - We aim to create a diversified platform of middle-market PE fund investments across primary buyout, secondaries, and co-investment funds.
  - BCA has identified several top-tier managers with proven edges in sourcing, operating expertise, and M&A execution and integration capabilities.
  - 2020 and 2021 vintage funds offer potential mid-to-high teens net IRRs and 1.7x+ net MOICs.
    - Examples include Oak Hill, Brightstar, Orangewood, Blackrock Secondaries, Portfolio Advisors and Pathway Capital.
    - Focus on selecting managers that emphasize J-Curve mitigation or elimination.

Private Equity - Performance

- Private equity has delivered attractive returns over the past 15 years and has significantly outperformed the global public equity markets.
  - Since 2004, PE has delivered 12% average IRRs across vintage years. This return compares favorably to the 5.3% annualized return achieved by public equities across the same time frame.
  - PE funds launched in years soon after economic or financial market crises tend to outperform (as seen in the mid-teens median return for vintage years 2009-2011). The chart below shows vintage-year returns as measured at the quarter-ends of Q4-'19, Q1-'20 and Q2-'20.
- The dispersion among PE fund returns (especially in buyout strategies) is also much higher than the dispersion among public equity manager returns.
  - As such, the potential for alpha generation through selecting best-in-class private equity managers is far greater than in the public markets.



Private Equity Strategies

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Fund Type	Description	IRR / MOIC	Pros and Cons
Buyout	Direct purchases of middle-market businesses (EBITDA of 5mm-100mm)	High-teens and 1.7x-2.2x	• Highest return potential with higher dispersion across managers; • More deal-specific risk and potentially longer J-Curve
Secondaries	Purchase LP stakes at discounts or assist GPs with asset re-positionings	Mid-to-high teens; 1.5x	• More diversified in terms of fund types, vintages and underlying portfolio companies • Less returns dispersion among managers • Faster pace of distributions • Limited or no J-Curve
Co-Investments	Fund invests alongside GPs in specific deals	High-teens, 1.7x-2.0x	• Lower fees • Limited J-Curve • Higher diversity • Potential adverse selection bias
GP Stakes	Fund buys ownership stakes in PE firms	Mid-to-High teens; 1.5x+	• High cash yield • MOIC should be achieved through fund distributions through year 10 with upside potential on future distributions / liquidation • Unclear exit path
Venture / Late-Stage Growth	Buying companies with rapid-growth potential (currently loss-making)	20%+ / 3.0x+	• Potential for significantly higher returns • Much higher risk (early-stage tech companies)

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