Review of Q1 2020 and Current Capital Markets

May 14, 2020

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Executive Summary

Capital Markets

- <u>Equity and credit markets declined sharply during Q1 2020.</u>
  - A tale of two halves. Given positive early-year economic and corporate earnings trends, equity markets modestly appreciated through mid-February. However, as Covid-19 spread globally, markets plunged swiftly from Feb 19th through March 23rd, before beginning a rally in the last week of the quarter.
  - Both equity and credit markets rallied sharply in April, driven by slowing Covid-19 new case growth rates, massive fiscal stimulus, and aggressive Central Bank monetary policy.
- <u>Corporate earnings trajectories are highly uncertain</u>
  - As several economies have shut down temporarily, 2020 constitutes a "lost year" for corporate earnings.
    - Earnings may potentially decline 25%-35% from pre-Covid levels during 2020.
  - Therefore, investors are looking forward to 2021 and 2022 to ascertain whether earnings recover to pre-Covid-19 "Trend" levels.
- <u>Valuations are mixed across equity markets.</u>
  - Markets are trading at reasonable levels based on pre-Covid "trend" earnings, especially when considering the historically low interest rate backdrop.
  - However, uncertainty remains extremely high on many fronts (health, economic and corporate earnings). The pace and magnitude of economic and corporate earnings recovery are largely unknown at this point.
    - Equity valuations based on BCA 2021 earnings forecasts (which at this time are highly speculative and lower than consensus projections) are well-above historical averages.

<u>How we are incorporating views into portfolio positioning:</u>

- Given highly uncertain expected returns across public equity and credit asset classes, we advocate increasing exposure to alternative investments with lower volatility and expected reductions in downside exposure.
  - opportunistic and long/short credit
  - merger-arbitrage strategies
- We see opportunities in private credit and 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 higher expected returns across risk assets (equity, credit, hedge funds, private debt / equity) relative to our last update in February 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/High 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, PRIVATE EQUITY, & REAL ESTATE		
Real Estate (Private)		Mid Single-digit for RE; Mid-Single Digit+ for HFs Low-mid-Double Digits for Private Equity
Hedge Funds		
Private Equity / Private Debt		

Tactical Allocation View

- From a shorter-term tactical standpoint (next 12 months), we see extreme uncertainty and consequently wide ranges of possible values over the next year which leaves us cautious over the near-term. As markets sort through highly elevated uncertainty levels across health, economic and corporate conditions, we expect considerable volatility to continue over this period.
- Following the 33% rally from March lows, equity markets are trying to balance highly divergent potential 12-month outcomes
  - *On the one hand*, equity markets could easily surpass February peaks given a) potential for pent-up consumer demand, b) massive liquidity within the financial system, c) rock-bottom interest rates for multiple years and d) potential for faster discoveries of viable Covid-19 vaccines.
  - *On the other hand*, several risk factors may impede this recovery including potential waves of infection reoccurrence, job losses that move from temporary to permanent, cautious consumer and business spending, and volatility associated with the US election.
  - Within public equities, we would advocate slightly overweighting the US (until closer to the US election) and EM Asia, while underweighting Europe.
- High yield and leveraged loan markets spreads are trading well outside historical averages.
  - Normally, these levels of spreads would constitute opportunities to broadly overweight the asset class.
  - However, security selection is increasingly paramount given sharp degradation in companies' liquidity and short-term financial performance, coupled with high uncertainty surrounding time until and magnitude of eventual recovery.
- We are increasingly interested in private credit strategies (direct lending) and distressed debt (discussed in more depth later in the presentation).
  - Post disruption from Covid-19, several private-equity portfolio companies are facing liquidity issues and seeking mid-term financing solutions.
  - Increasing amounts of high-yield bonds and leveraged loans are facing downgrades, leading to stress among CLO holders. CLOs are becoming forced sellers, leading to both the underlying loans and in some instances the entire CLO tranches trading at attractive levels.

Economic Activity

- Global economic activity progressively declined throughout the quarter, with April plunging further and likely representing a bottom. Initial positive acceleration in January and February quickly gave way to sharp Covid-19 based deceleration, with the US and European economies effectively shut via stay-at-home restrictions and service-sector business closures.
  - US GDP declined at a 4.8% annualized rate Q/Q in Q1. Europe's declines were even steeper at an annualized decline of 13.2% (3.8% Q/Q). China's GDP decline of 6.8% Y/Y was the country's first GDP contraction on record.
    - We expect GDP declines to accelerate to 30%-40% annualized Q/Q in Q2 across developed economies, though with China demonstrating a sequential growth pickup. Economic activity should improve sequentially in Q3 2020, followed by further acceleration in Q4 and into 2021.
  - Unemployment rates are spiking globally. In the US, initial unemployment claims reached 30 million over a 4-week period, with the unemployment rate expected to surpass 20%. The vast majority of the job losses are occurring within the services sectors. While employment is expected to recover once the health crisis abates, the level of recovery remains to be seen.
- Governments have implemented massive stimulus / support payments programs, attempting to soften the blow and "buy time" while the health crisis abates.
  - These significant stimulus programs have accounted for roughly 5%-15% of countries' annual GDP:
    - The US swiftly implemented a generally well-crafted \$2 trillion fiscal stimulus plan (with an additional proposal to broaden to almost \$3 trillion or 15% of GDP) with benefits directed towards multiple constituents.
      - When factoring in loans to affected companies, the stimulus expands to almost \$5 trillion (25% of GDP!).
    - Canada has deployed \$100 billion (roughly 5% of GDP) thus far to combat rising unemployment.
    - Japan has deployed almost \$1 trillion (almost 20% of GDP), although much of the stimulus consists of tax deferral programs rather than direct fiscal injection.

Economic Activity (continued)

- <u>Central banks have slashed interest rates and adopted highly accommodative monetary policy,</u> increasing liquidity and increasing confidence in capital markets functioning normally.
  - Sovereign yields are at record lows, with US Treasury rates near zero and European rates negative.
  - The US Fed has aggressively expanded its purchases of Treasuries and mortgage-backed securities:
    - Within the first week, the Fed bought $650 million (it took them six months to buy that much during the Financial Crisis).
    - The Fed has further expanded its scope to purchase municipal bonds and corporate credit (even high-yield bond and corporate-bond ETFs are on the table!).
  - International central banks have also expanded assets purchases but in a more limited fashion.
- <u>Oil prices declined significantly throughout the quarter</u>, as demand evaporated during a time of increasing supply.
  - Saudi Arabia and Russia engaged in a costly and ill-timed price war with both nations ramping up oil production in early March. Brent oil prices declined to $29 in May from $60 in late February.
  - As economies further shut down due to Covid-19 spread, oil demand declined precipitously just as supply began ramping up. US WTI oil prices even briefly reached negative prices in April as the oil traders did not want to take physical supply as oil storage capacity levels were almost completely full.
  - While lower energy prices may prove beneficial to consumers as economies recover, they are highly negative for US shale energy producers, Canadian oil producers, and Latin American nations such as Brazil and Mexico.
    - 12% of the US high-yield bond market is composed of highly indebted energy companies. Default rates are forecast to spike among these levered companies.
    - Energy-producing EM's in Latin America and Russia experienced marked currency depreciation and widening spreads for their sovereign hard-currency (USD) debt.

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Capital Markets Review

Equity Markets - Performance

- Global equity markets declined sharply during Q1 2020 but have since rallied significantly.
  - March 2020 featured stunningly swift declines. Markets fell 30%-35% from February peaks with indiscriminate selling affecting nearly all sectors and geographies.
    - This fastest decline in history was driven by fears surrounding spreading Covid-19 disruption (and investors pricing in massive economic disruption) and exacerbated by tightening liquidity across many asset classes.
  - Equity markets began rallying in late March as central banks and governments implemented aggressive policy actions, both in terms of injecting liquidity and deploying fiscal stimulus.
    - The response by the US Federal Reserve and government was swifter and larger than many international nations, which partially accounts for US equity outperformance since the market rally. Additionally, international markets (especially certain emerging markets) have been impacted by currency weakness.
    - April's 10.7% MSCI ACWI appreciation (+12.7% for the S&P 500) has been one of the best months on record. Time will tell whether the rally marks the beginning of a new equity bull market (or resembles a bear market rally often witnessed during longer-lasting recessions).
  - The Q1 corporate earnings season highlighted the strength and resiliency of US large-cap technology / e-commerce companies. More broadly however, most companies withdrew 2020 earnings forecasts.

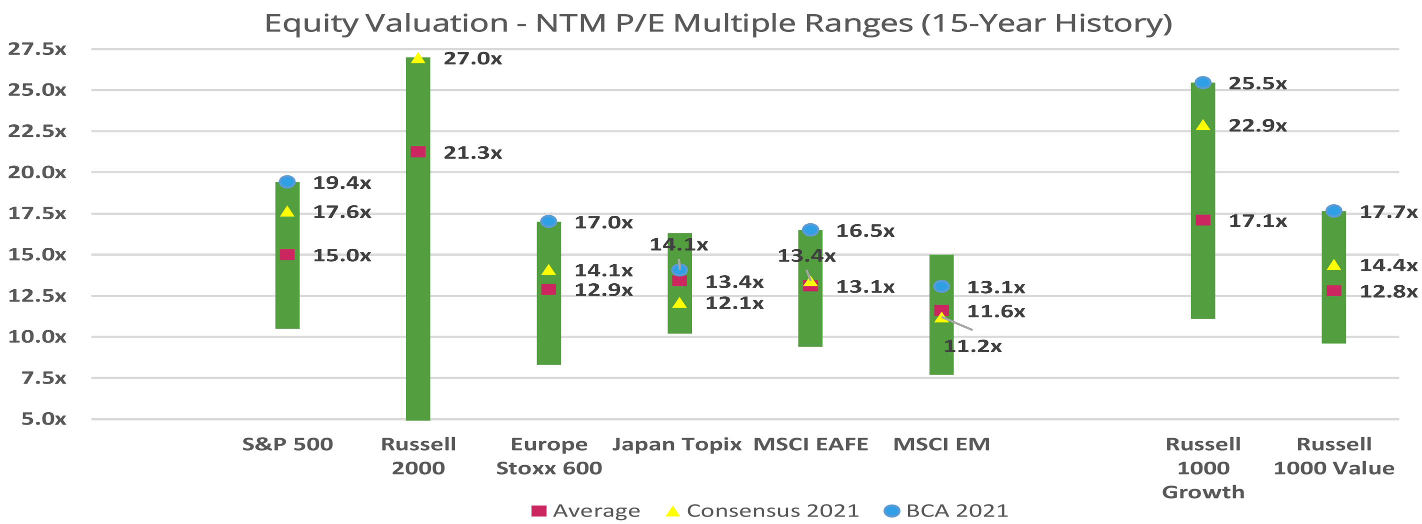
Equity Indices - (As of 05/08/2020)

	YTD Performance			Total Returns (%) - USD *				
	YTD	Feb 19-23-Mar	23-Mar - Present	Mar-Qtr	1Y	3Y	5Y	7Y
US Large Cap (S&P 500)	-8.9%	-33.8%	31.1%	-19.7%	3.2%	8.4%	8.3%	10.3%
US Small Cap (Russell 2000)	-19.9%	-40.7%	32.9%	-30.6%	-14.3%	-0.1%	2.9%	6.1%
MSCI EAFE	-18.2%	-32.7%	22.5%	-22.8%	-10.0%	-1.4%	-0.4%	1.6%
MSCI Emerging Markets	-17.8%	-31.2%	20.6%	-23.6%	-10.9%	-0.2%	-0.1%	0.2%
MSCI ACWI	-12.7%	-33.6%	28.1%	-21.4%	-2.6%	4.2%	8.7%	5.9%
Russell 1000 Growth	0.8%	-31.4%	34.6%	-14.1%	15.6%	16.2%	13.5%	14.8%
Russell 1000 Value	-19.0%	-38.0%	29.4%	-26.7%	-9.4%	1.1%	3.5%	6.5%

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

Equity Markets - Valuation

- Current equity market valuations appear high on a next-twelve-months (NTM) forward earnings basis, given severely depressed 2020 earnings due to economic shutdowns.
  - Investors are looking past 2020 and focusing on 2021 and 2022 for potential recovery towards pre-Covid “trend” corporate earnings.
    - BCA’s qualitatively based estimates for 2021 are lower than consensus, which we suspect will fall throughout 2020. In applying our forecasts to various equity markets, we have viewed the 2021 recovery potential vs. pre-Covid baselines. For most markets, we project 2021 earnings recover to 75%-85% of pre-Covid levels.
- Valuation multiples are higher than historical averages based on 2021 consensus and BCA projections but in-line with these averages based on pre-Covid trend earnings.
  - The level of uncertainty regarding 2021 and 2022 earnings forecasts is much higher than normal.
    - Economies are just beginning to loosen self-imposed shutdown restrictions and it is unclear the extent of permanent damage, as well as the impact of potentially long-lasting changes in consumer and business behavior.
  - We forecast that equity multiples will remain well-above historic norms given extremely low interest rates, coupled with continuing high levels of fiscal stimulus.



Fixed Income Markets - Performance

- Fixed income markets delivered bifurcated performance during Q1.
  - US Treasuries appreciated 8.1% as interest rates declined significantly due to economic disruption.
  - Credit assets (high yield bonds, leveraged loans, and EM Hard Currency sovereign bonds) experienced double-digit declines as credit spreads widened, reflecting concerns regarding rising default rates over the next few years.
    - Liquidity evaporated in the credit markets through much of March, with extremely wide bid/ask spreads.
    - From March 16th through March 23rd, leveraged loans experienced the five worst performance days in their entire history.   Several ETFs traded at meaningful discounts to NAVs, indicating underlying stress.
    - Even perceived high-quality assets such as AAA-municipal bonds experienced significant dislocation.
  - EM local currency bonds depreciated sharply due to currency depreciation.
  - Similar to equities, credit has rallied sharply since March 23rd driven by improved sentiment around Fed-related liquidity actions.

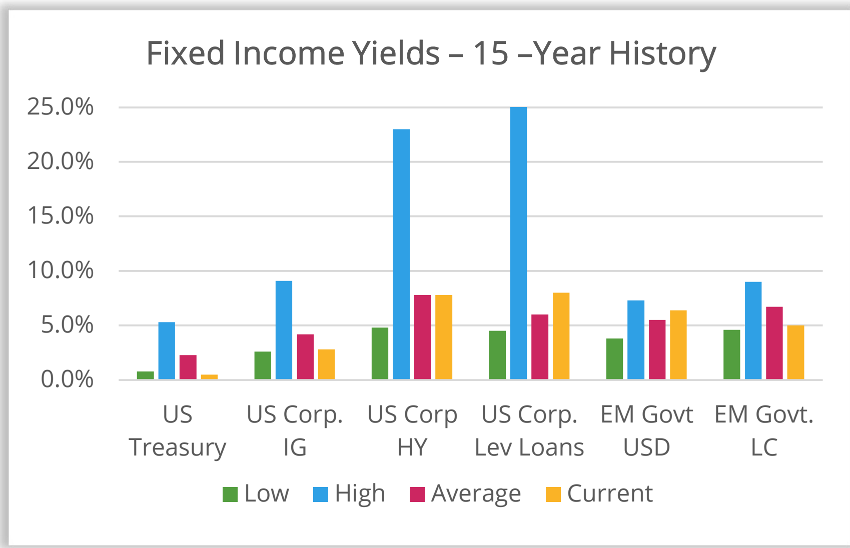
Fixed Income Indices - Characteristics and Performance (as of 5/8/2020)

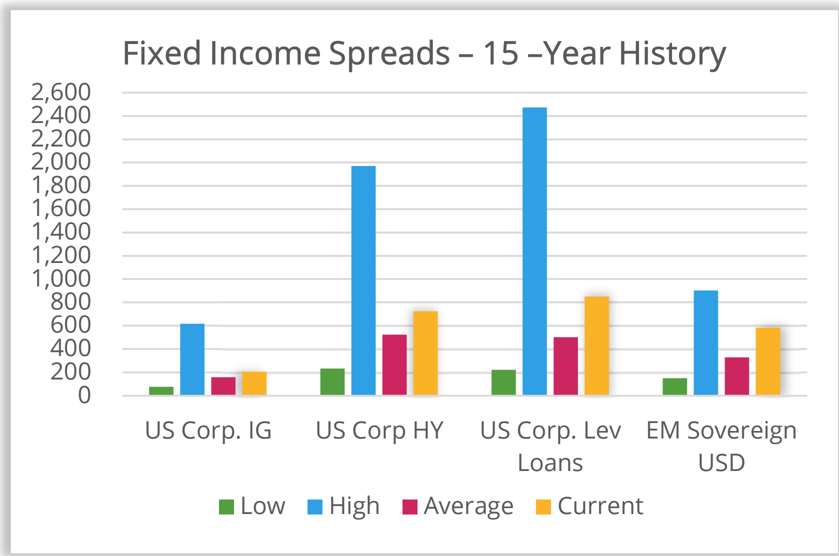
	YTD Performance (%)			Total Returns (%) *					
	YTD	Feb 19-23-Mar	23-Mar -Present	Mar-Qtr	1Y	3Y	5Y	7Y	Duration (yrs)
US Treasury	8.5	5.4	0.6	8.2	13.5	5.8	4.0	2.4	7.1
US Corp. IG	0.0	-12.3	11.1	-3.6	8.8	5.3	4.6	4.6	8.2
US Corp HY	-8.2	-20.8	14.5	-12.7	-3.3	2.1	3.6	5.8	4.2
US Corp Lev. Loans	-8.7	-20.6	14.3	-13.1	-6.1	0.7	1.9	4.0	NA
EM Sovereign USD	-10.0	-20.7	11.0	-13.4	-3.4	1.3	3.3	5.2	7.5
EM Sovereign LC	-11.4	-18.0	9.0	-14.9	-4.3	-1.1	-0.2	-0.8	5.5
Barclays US Aggregate	4.5	-0.9	3.4	3.2	10.2	5.1	3.8	3.3	6.1

** Returns are annualized except for Mar-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) are still well wider than historical averages but have tightened meaningfully from March 23rd lows.
  - Investors are pricing in a worsening credit cycle with rising defaults, with a large increase in downgrades of bond ratings already occurring.
  - In a V or Shallow-U shaped-recovery, spreads would likely tighten in later 2020 and further into 2021. However, if economic damage persists or a recovery takes longer, more companies in sectors affected by Covid-19 would default and spreads could widen back to March levels or, in the worst case, to levels seen during the financial crisis (represented by the blue bars in graphs below).
  - The Fed may buoy sentiment for investment-grade and higher-quality high-yield bonds through direct bond purchases and through planned purchases of select bond ETFs.
  - Valuations are extremely bifurcated within high-yield for higher-quality (BB) bonds vs lower-quality (CCC) bonds. While the overall high-yield bond index spread is at 745bps (vs Treasuries), a significant 23% of the index is trading at distressed levels (spreads of greater than 1,000bps).





Alternatives – Performance and Valuation

- Private real estate generated stable 0.7% returns in Q1.
  - Average cap rates remained stable across property types. However, cap rate spreads increased significantly to 575bps (versus 370bps on average). Real estate investors are pricing in increased risks from potentially higher vacancies and lower net operating income stemming from potential future rent reductions.
- Private equity fundraising and deal closures remained strong in Q1. However, deal activity declined significantly since, with some private-equity backed deals cancelled in April and May.
  - PE Index returns are reported with a one-quarter lag (March quarter returns available in June). However, publicly traded private equity firms (Apollo and KKR) have stated that several portfolio companies will incur valuation markdowns and face elevated liquidity concerns.
- Hedge funds had a difficult quarter with all major sub-strategies negative.
  - Directionally-focused strategies such as long-short equities (-13.7%) fared worse whereas less-correlated strategies such as event-driven (-5.5%) fared better. Funds utilizing leverage faced steep declines due to "forced-selling" of positions to meet liquidity constraints.

Alternatives Indexes - Characteristics and Performance (as of 04/30/2020)

	Averages			Total Returns (%) - USD					
	Cap-Rates*	Cap Rate Spread	EV / EBITDA **	Mar-Qtr	YTD	1Y	3Y	5Y	7Y
Hedge Funds - Eq. Weighted				-7.1%	-4.4%	-0.4%	-0.5%	0.2%	0.7%
Hedge Funds - Weighted Comp.				-10.8%	-6.6%	-3.4%	1.2%	1.5%	2.6%
Real Estate - Private **	6.3%	570		0.7%	0.7%	5.3%	6.4%	7.6%	8.9%
Private Equity ***			11.8x			7.7%	14.7%	11.5%	13.8%

** Based on average nationwide cap-rates across asset classes with spread vs. 10-year Treasuries as of Dec 19*

*** Real estate returns derived from NCREIF Property Index; spread expressed in basis points*

**** Private equity average deal multiple for completed buyouts in most recent quarter*

**** Perfomance based on Cambridge Associates Index (reported with one quarter lag) - hist. returns dated as of 9/30/19 and are therefore not comparable on an apples-to-apples basis with other asset classes*

Currencies – Performance and Valuation

- The USD appreciated significantly in Q1 in a flight to safety.
  - The Dollar Index appreciated 2.3% vs a basket of developed market currencies.
  - The EM currency index declined 6.8% vs the USD. Asian currencies depreciated less whereas Latin American, Russian and South African currencies experienced much greater depreciation.
  - The CAD dollar weakened 7.7% vs the USD, with declines driven by steeply declining oil prices.
  - With US interest rates near zero and with the US facing twin current and capital account deficits, one might assume that the USD should weaken in the future. Furthermore, periods of synchronized global economic growth (which may occur post Covid-19) have usually resulted in USD weakness.
    - However, at BCA, we note that currencies can defy normal expected relationships for protracted periods. As such, we do not explicitly factor currency forecasts into our asset class return assumptions.

Currencies - Characteristics and Performance (As of 05/08/2020)

	Statistics (vs. USD)*				Total Returns (%) - vs. USD **					
	Current	Low	High	7-Year Average	Mar-Qtr	YTD	1Y	3Y	5Y	7Y
Canadian $ (CAD)	1.39	1.00	1.46	1.25	-7.6%	-6.7%	-3.1%	-0.6%	-2.8%	-4.6%
Euro	0.92	0.72	0.96	0.86	-1.6%	-3.3%	-3.2%	-0.2%	-0.7%	-2.7%
British Pound (GBP)	0.81	0.58	0.87	0.71	-6.4%	-6.4%	-4.6%	-1.4%	-4.4%	-3.2%
Japenese Yen	106.71	94.31	125.63	110.01	1.0%	1.8%	3.2%	2.0%	2.3%	-1.1%
Chinese Remimbi (CNY)	7.07	6.04	7.18	6.54	-1.7%	-1.6%	-4.1%	-0.8%	-2.6%	-2.0%
Korean Won	1,220	1,008	1,286	1,125	-5.2%	-5.2%	-4.2%	-2.5%	-2.3%	-1.6%
Taiwan USD	29.88	28.98	33.79	30.82	-0.9%	0.4%	3.5%	0.3%	0.5%	-0.2%
Brazilian Real	5.73	2.00	5.84	3.30	-22.8%	-29.8%	-31.4%	-17.6%	-12.3%	-14.0%
Mexican Peso	23.65	11.98	25.35	17.30	-20.0%	-20.0%	-19.3%	-6.7%	-8.5%	-9.3%
US Dollar Index	99.73	79.09	103.30	92.98	2.7%	3.5%	2.2%	0.2%	1.0%	2.9%

** low indicates a stronger currency vs. USD and high indicates a weaker currency vs. USD except for the USD Index*

*** returns are annualized except for Mar. Qtr and YTD which are actual returns*

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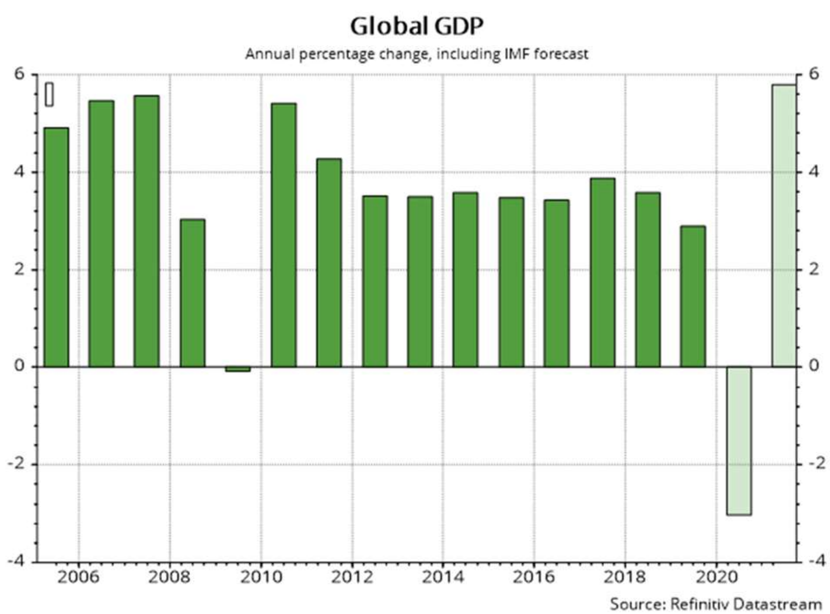
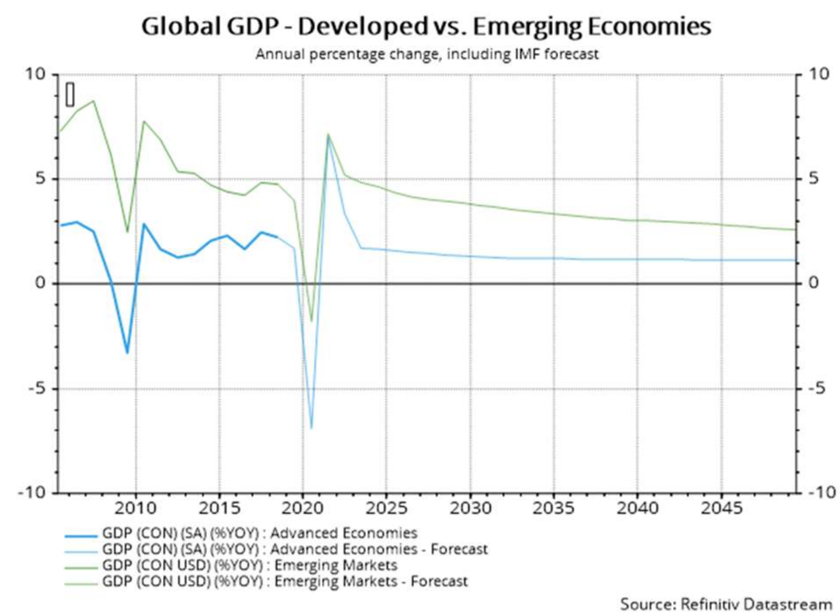
Economic Review

Global GDP Growth

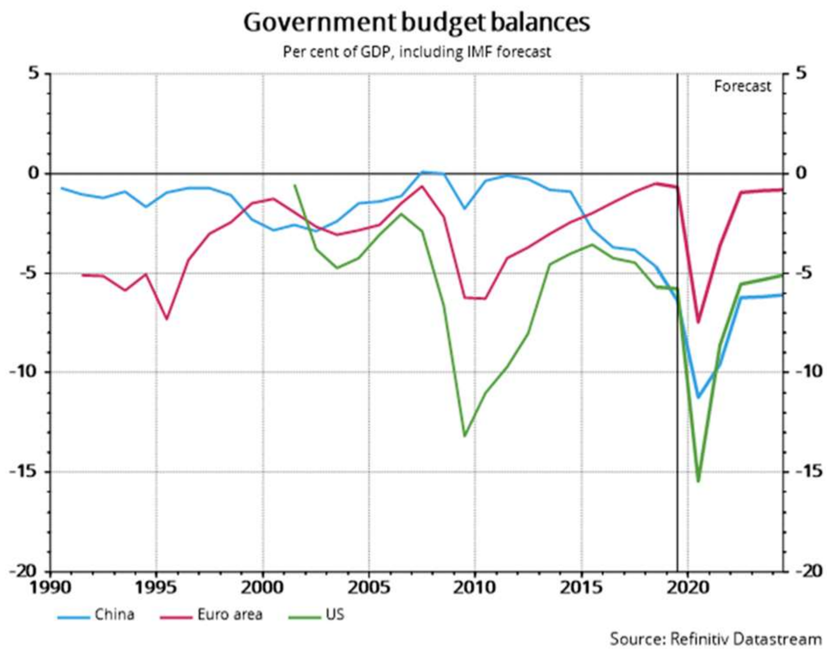
- The IMF is forecasting a 3% decline in global Real GDP in 2020, followed by a sharp rebound in 2021. The 2020 decline is much greater than that experienced during the financial crisis.
  - Q2 2020 will bear the worst declines at potentially down 20%-30% across many Western economies. Q3 will likely be down Y/Y but show sequential improvement while Q4 should yield significant sequential improvement and possibly Y/Y improvement as well.
- Both developed and emerging economies will experience large 2020 GDP declines.
  - GDP declines across advanced economies are projected at over 5% in 2020. EM declines (while less in reported magnitude) are also severe as EM's generally need at least 4.5% GDP growth to be considered healthy.
    - Developed economies have greater ability to enact large scale stimulus programs given better fiscal balances and less volatile currencies.

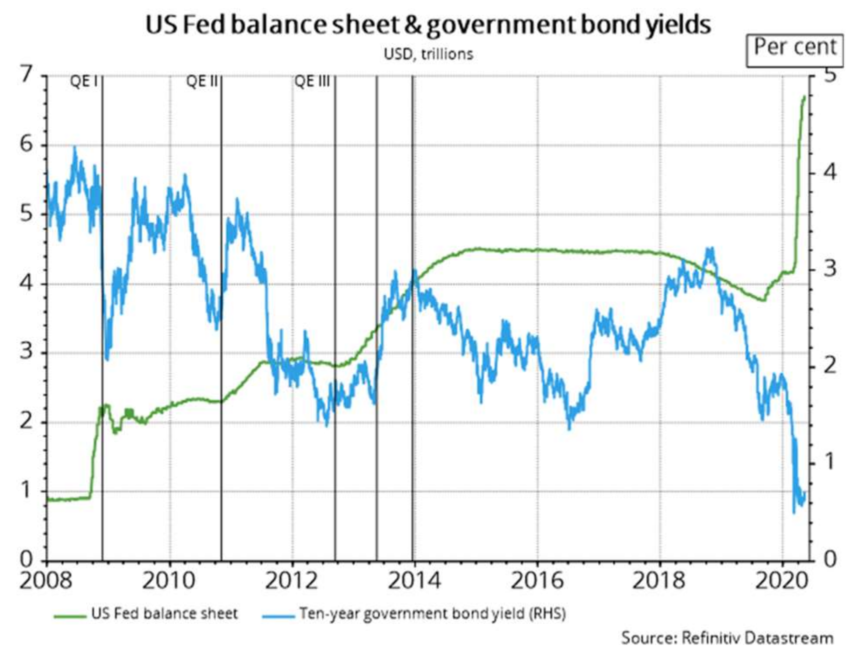




Global Policy Response

- <u>Policy makers have initiated large scale fiscal and monetary policy responses.</u>
  - Stimulus programs enacted thus generally range between 5%-15% of annual GDP(!)
    - Thus far, the US has enacted $3 trillion of stimulus (15% of GDP) versus $800 billion over the first two years of the financial crisis
    - Canada has deployed roughly $100 billion of stimulus (5% of GDP) while Japan has deployed $1 trillion (close to 20% of GDP).
  - Budget deficits are projected to exceed financial crisis levels before tightening in 2021 and beyond.
  - Central banks (most notably the US) have slashed short-term interest rates and are expected to maintain historically low interest rates well into the economic recovery.
  - The US Fed has implemented the most comprehensive asset purchase program and has expanded its balance sheet by almost $2 trillion since late March (already exceeding levels during the financial crisis).
  - Will debt overhang impair future growth, as some studies have suggested?

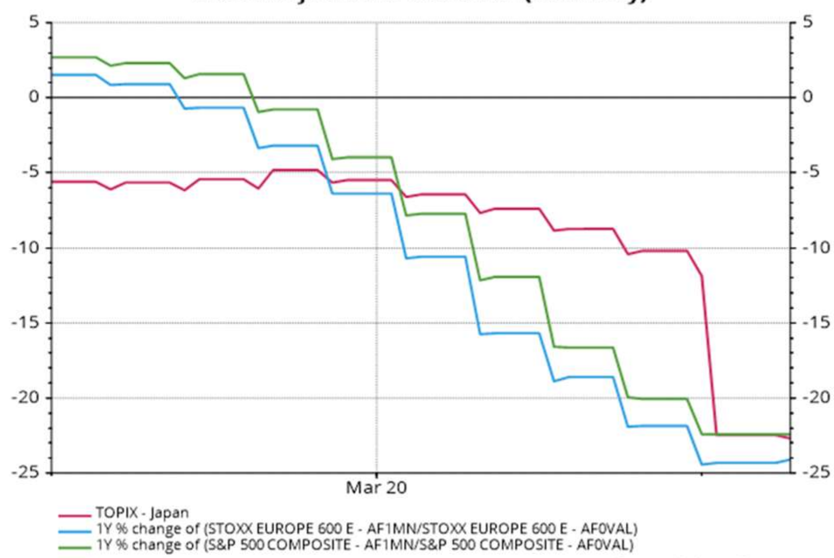




Global Corporate Profits

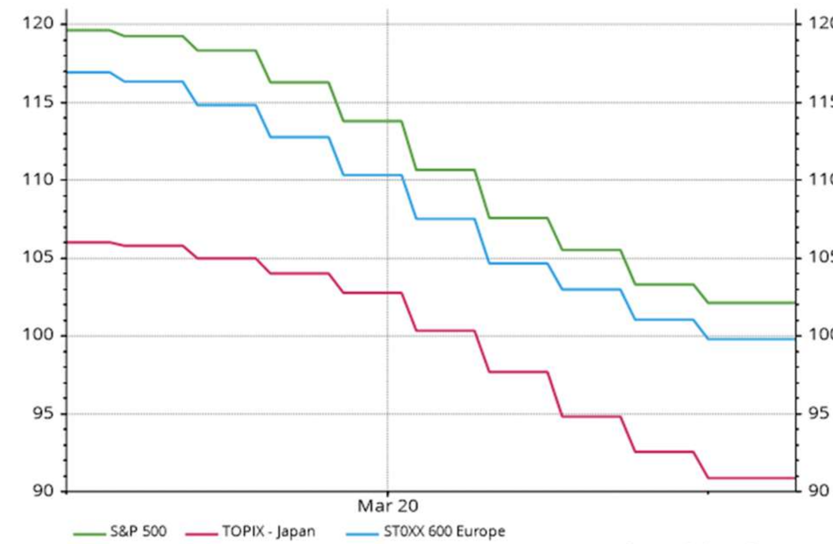
- Corporate profits are forecast to meaningfully decline in 2020.
  - At the beginning of the year, sell-side analysts were projecting 7%-10% 2020 Y/Y earnings growth.
  - Post Covid-19, analysts are now projecting 20%-25% Y/Y earnings declines in 2020 across developed markets.
- Analysts are presently projecting a sharp recovery in 2021, with consensus 2021 earnings forecast generally exceeding earnings achieved in 2019.
  - There is considerable debate about whether the recovery will be V, U, L or W shaped.
  - *We believe consensus forecasts are presently too optimistic* and instead forecast 2021 earnings rebounding to 75%-85% pre-Covid-19 "trend" levels across markets.
  - *Potential 2021 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 and the timing regarding widespread Covid-19 vaccine availability.

2020 Projected EPS Growth (as of May)



Source: Refinitiv Datastream

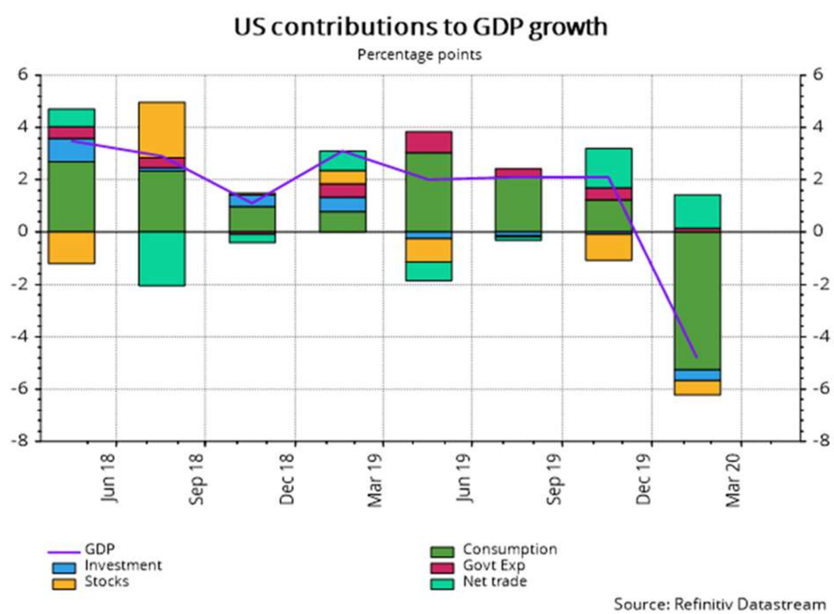
2021 EPS relative to 2019 EPS (indexed)

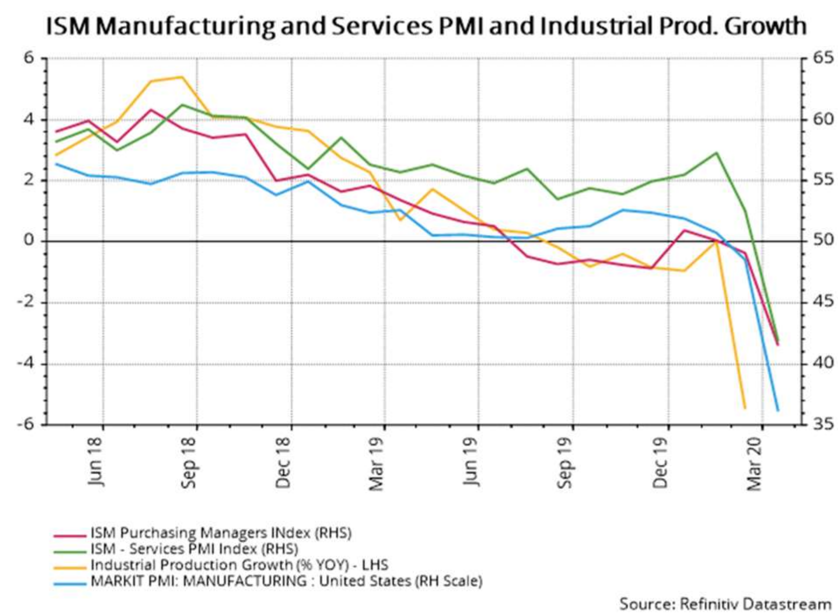


Source: Refinitiv Datastream

United States

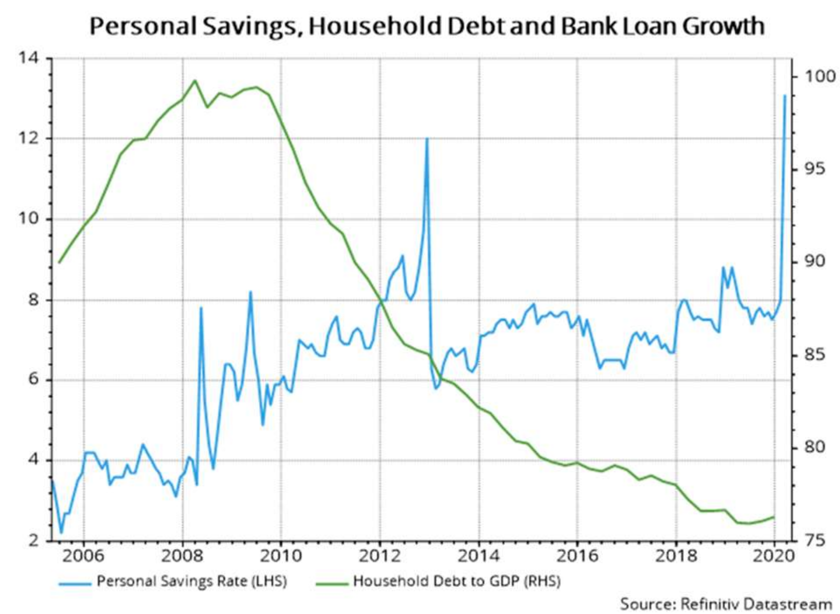
- Real GDP Growth declined 4.8% Q/Q on annualized basis in Q1 2020, with economists projecting record 30%-40% annualized declines in Q2 followed by recovery in the second half of the year
  - Unlike prior periods of manufacturing declines (2015-2016 China-related and energy slowdown and 2019 trade war), both manufacturing and service sectors were impacted simultaneously.
  - On a positive note, several US public corporations noted signs of stabilization in late April, with many citing sequential improvement in May data.
  - The US government has unleashed massive fiscal stimulus of $3 billion (roughly 15% of GDP). The magnitude of this stimulus program is striking when compared to the $800 billion deployed over the first two years of the financial crisis.
  - Thus far, the stimulus measures have been broad-based in terms of constituencies reached.
    - However, given that consumer spending accounts for 70% of US GDP, future stimulus programs aimed at increasing direct monthly payments to US consumers are presently being considered.





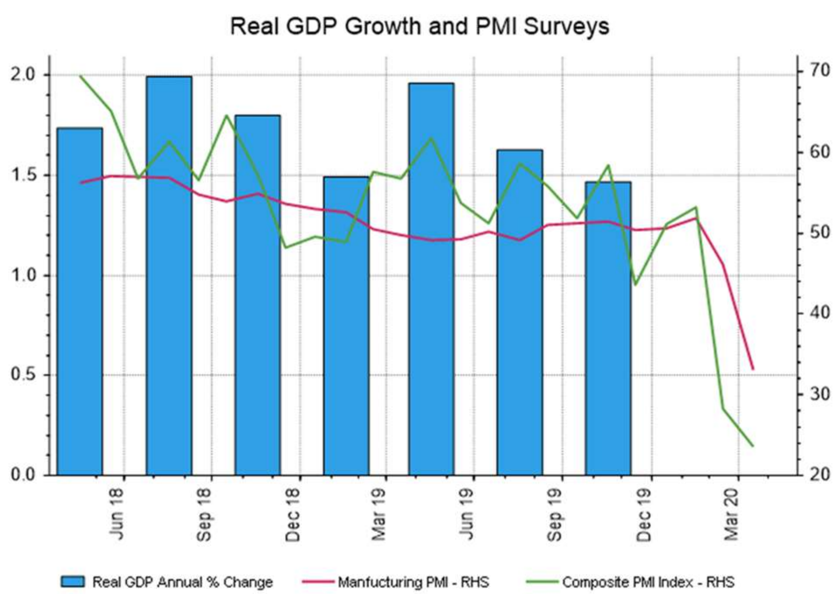
United States (Cont.)

- <u>US unemployment has markedly increased while consumer confidence and retail sales plunged.</u>
  - 33 million Americans have filed for unemployment since the Covid-19 crisis began, with the unemployment rate reaching 14.7% in April (the highest level since the Great Depression).
    - Economists are projecting that the unemployment rate may peak over 20% and likely remain high at over 10% by year-end 2020.
    - The service sector (retail, hospitality, dining) has suffered the most; however, job losses are spilling over to the manufacturing and professional sectors as well.
    - Employment is expected to rapidly rebound as economies loosen social mobility restrictions.
  - Massive government stimulus should mitigate some of the negative effects from unemployment.
  - Fortunately, consumer balance sheets and personal savings rates are in much better shape entering the Covid-19 crisis than right before the financial crisis.



Canada

- <u>Canada's economy is facing additional pressures from plunging crude oil prices</u>
  – Q1 GDP is projected to decline at 3% Q/Q with March representing the worst monthly drop in recent history. Thus far, the services sector has been hit harder than manufacturing.
  – Economic pressures are likely to intensify given the sharp decline in crude oil prices since early March.
    - With the energy sector at 11% of GDP, including indirect activities, changes in conditions affecting Canada's energy sector can sharply affect the broader Canadian economy with a lagged effect.
  – To mitigate the negative impacts from Covid-19, the government has enacted a roughly $100 billion stimulus program (roughly 5% of GDP).
    - Canada has a relatively low government debt to GDP ratio versus other developed nations. As such, Canada may be better able to deploying larger fiscal measures.



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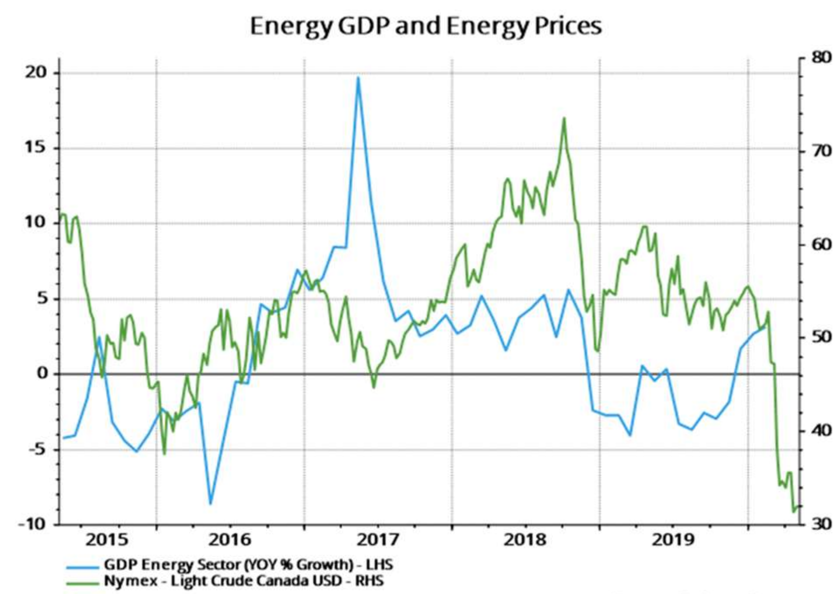

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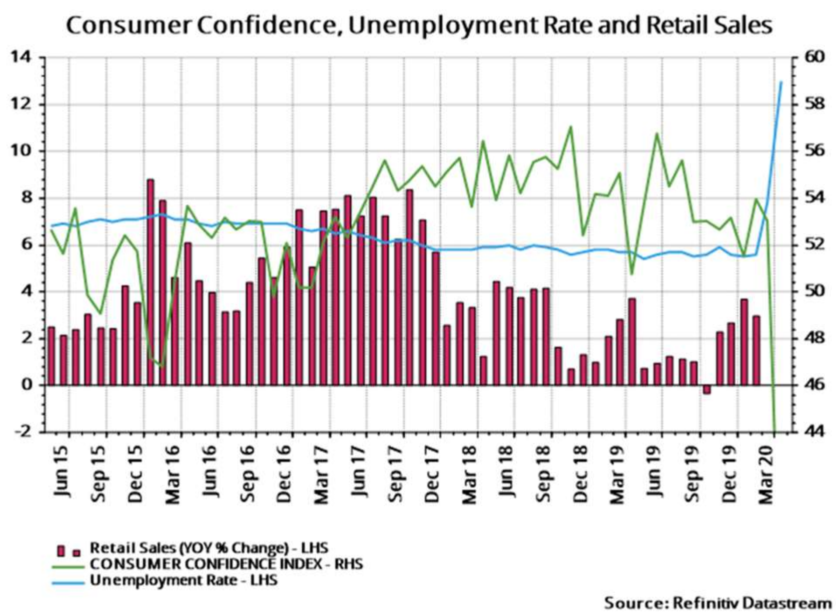
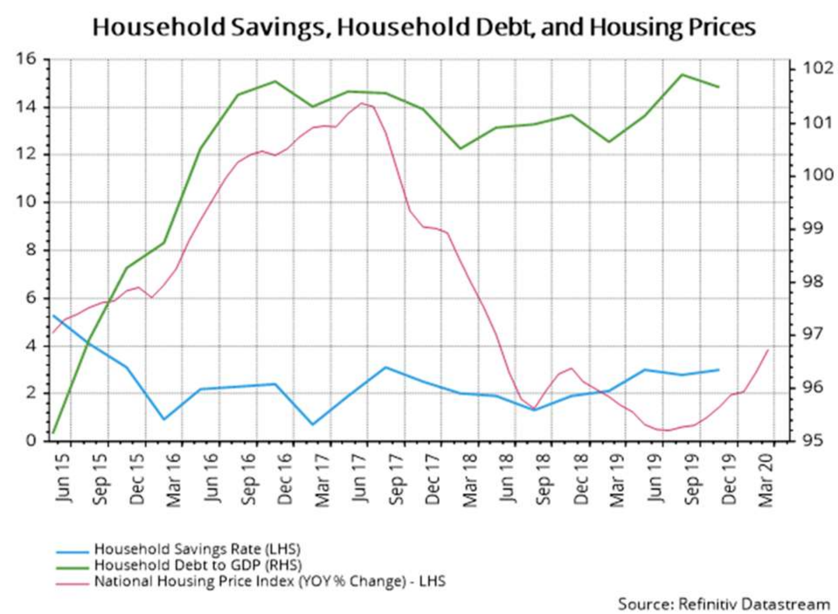
Canada (Cont.)

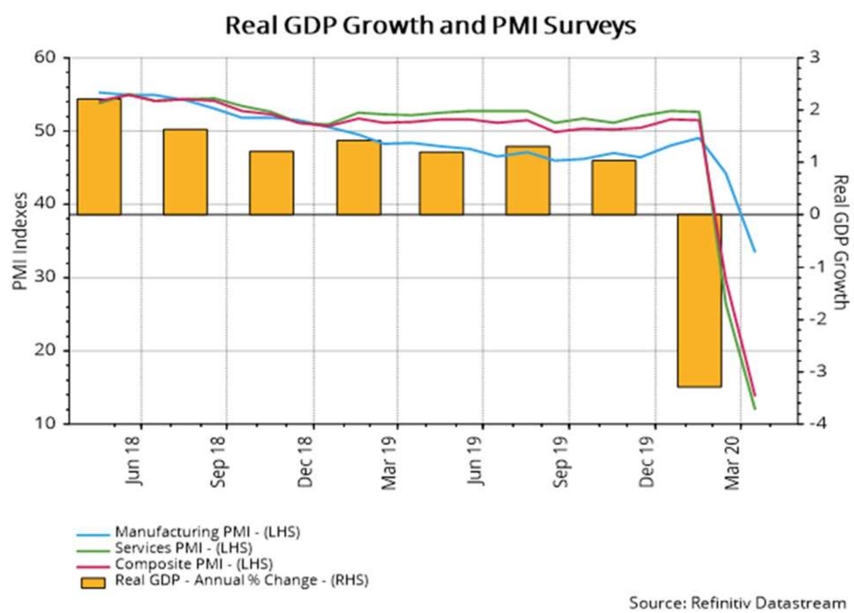
- <u>Canadian consumer indicators are showing signs of stress.</u>
  - Unemployment rates have spiked markedly while consumer confidence has plunged, which bodes poorly for near-term retail sales data.
  - Home price growth has accelerated from mid-2019 levels. However, it remains to be seen whether 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. Relative to the US consumer, Canadian consumers may require greater levels of fiscal support to weather the crisis.

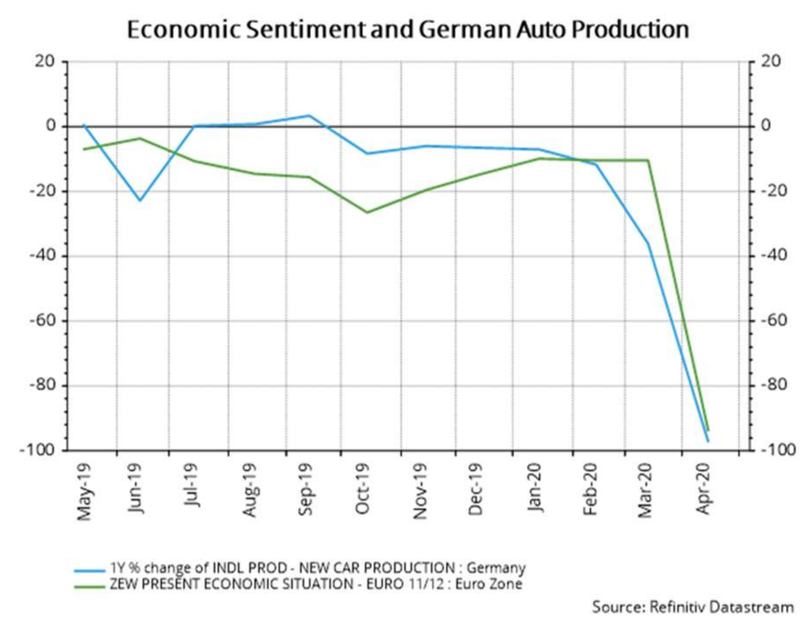




Eurozone

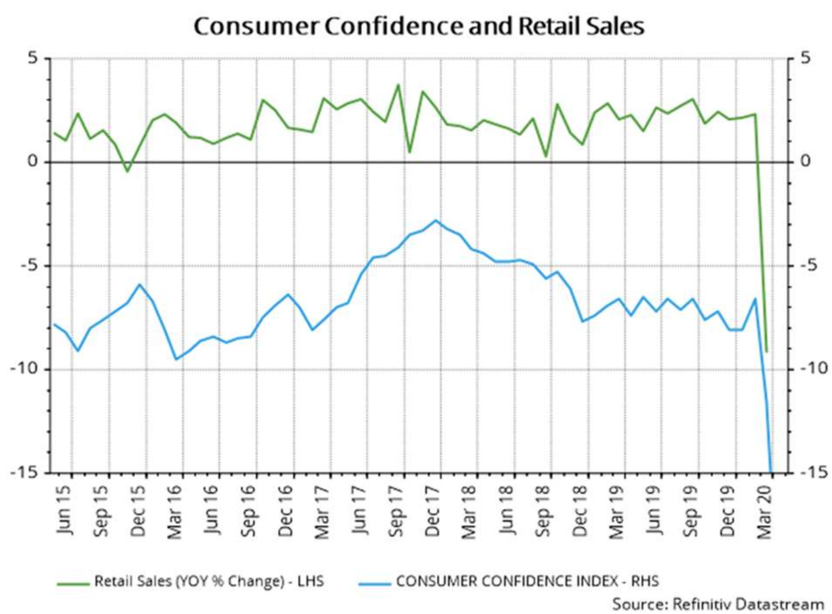
- <u>Eurozone GDP and general business confidence has weakened significantly.</u>
  - Real GDP growth declined by 3.8% Q/Q in Q1 2020 (13.2% annualized) with much further deceleration ahead
    - The European Commission is forecasting a 7.7% decline in 2020 GDP.
  - Both the manufacturing and services PMI indexes declined to anemic levels.
  - General economic sentiment, business confidence and manufacturing (evidenced by German auto production) has fallen off a cliff.
  - Italy has felt the most dramatic impact, both from a health and economic standpoint.
  - The potential for widespread Eurozone economic damage is so high that the European Commission is approving large-scale country-level fiscal deficits. This position would have been unthinkable previously due to Europe's sovereign debt crisis in 2012.

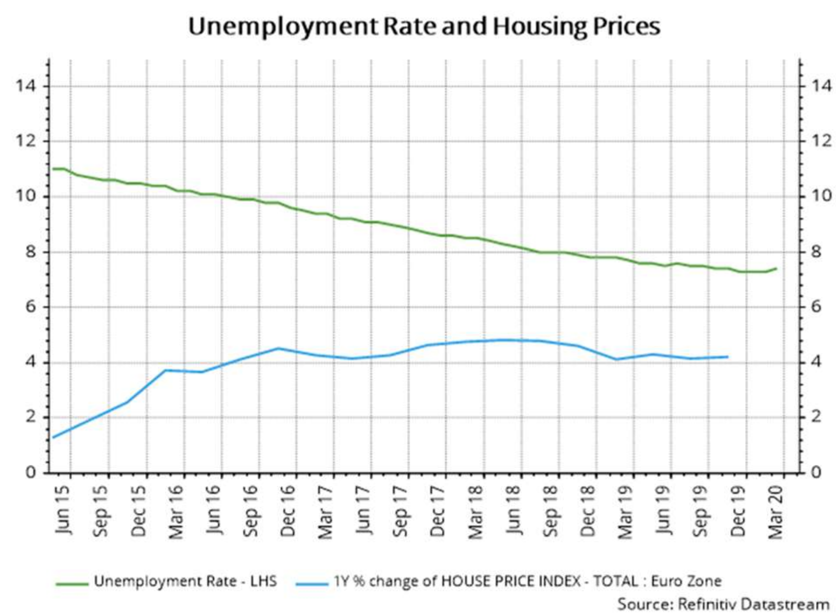




Eurozone (Cont.)

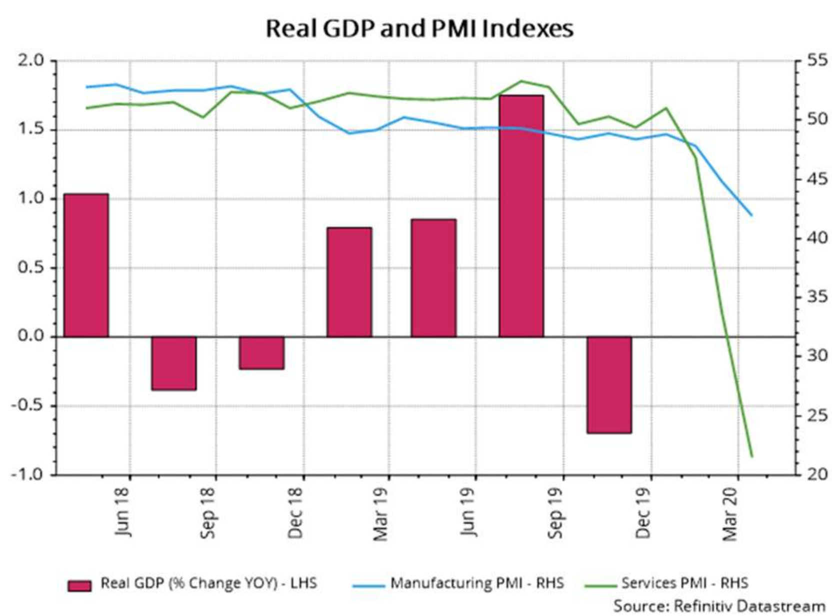
- <u>Consumer confidence and retail sales growth sharply declined in March.</u>
  - However, Eurozone unemployment rates have thus far held relatively steady.
    - Employee-friendly labor laws coupled with wage-replacement-based fiscal stimulus has thus far kept massive layoffs at bay.
    - Home price appreciation has remained robust and interest rates are at rock-bottom levels (in some cases negative).
  - Given a more stable employment backdrop, European consumers may be better positioned to withstand longer-lasting Covid-19 disruption.

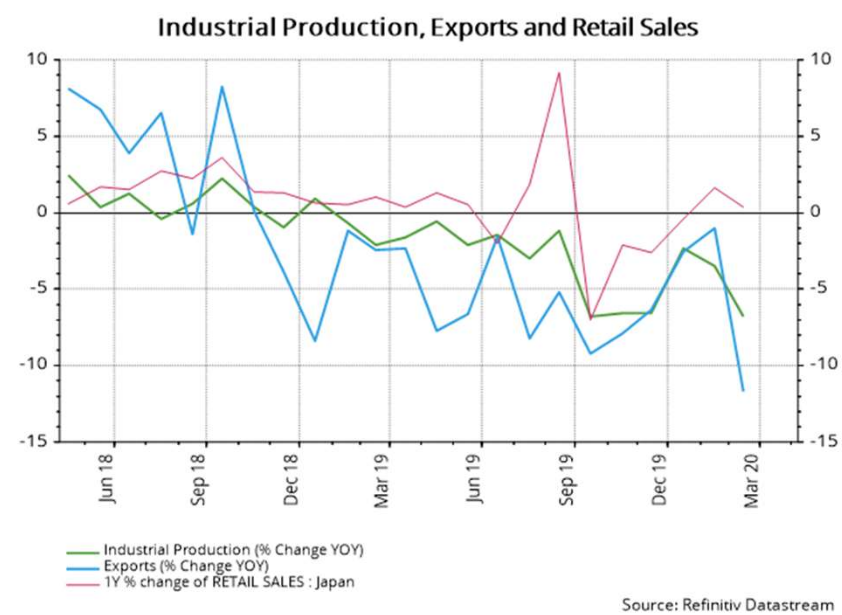




Japan

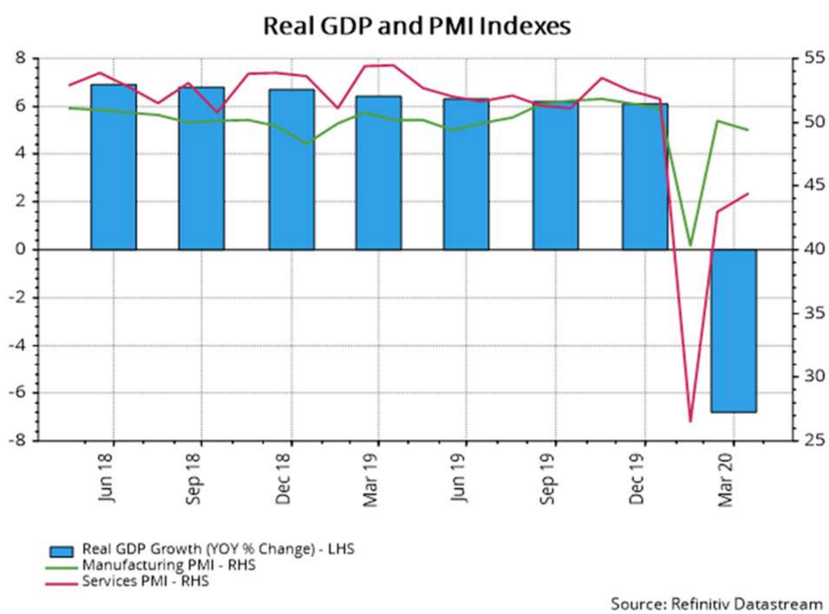
- <u>Following the Oct 2019 sales tax hike, Japan's economy was already facing headwinds.</u>
  - Manufacturing PMIs have thus far held up better than Services PMIs.
  - Japan is far more exposed to global trade than the US with exports comprising 17% of GDP vs 11% for the US. China is Japan's largest trading partner. The nascent improvement in industrial production and exports was sharply deterred by Covid-19.
  - Retail sales have held up better than expected although there is significant noise due to the October 2019 sales tax hike impacting consumer buying patterns.
    - The plunge in consumer confidence does not bode well for retail sales growth over the next few months.
  - On the plus side, Japan has been less negatively affected by Covid-19 in terms of cases and deaths, which may enable a faster recovery.
  - Furthermore, the government has enacted a $1 trillion stimulus program (roughly 20% of GDP) to mitigate negative economic effects. However, much of the stimulus is based upon tax deferrals.

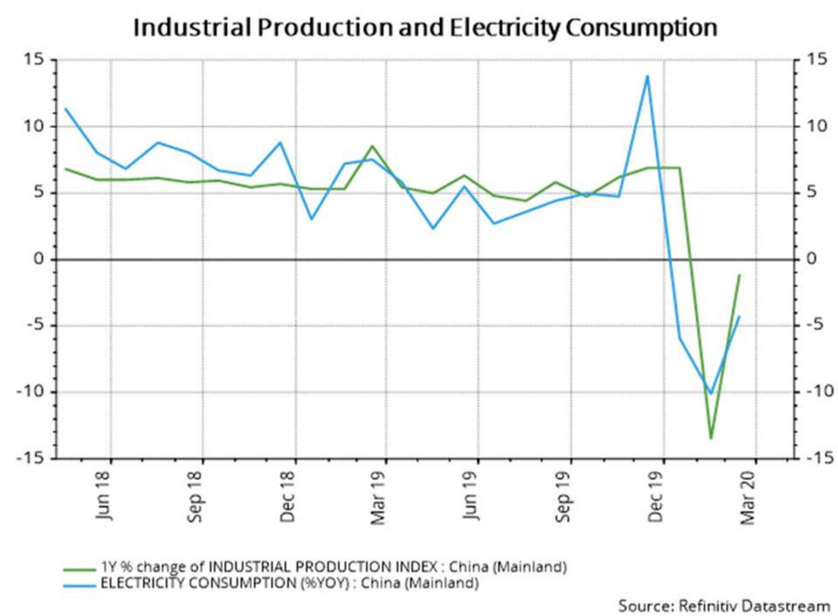




China

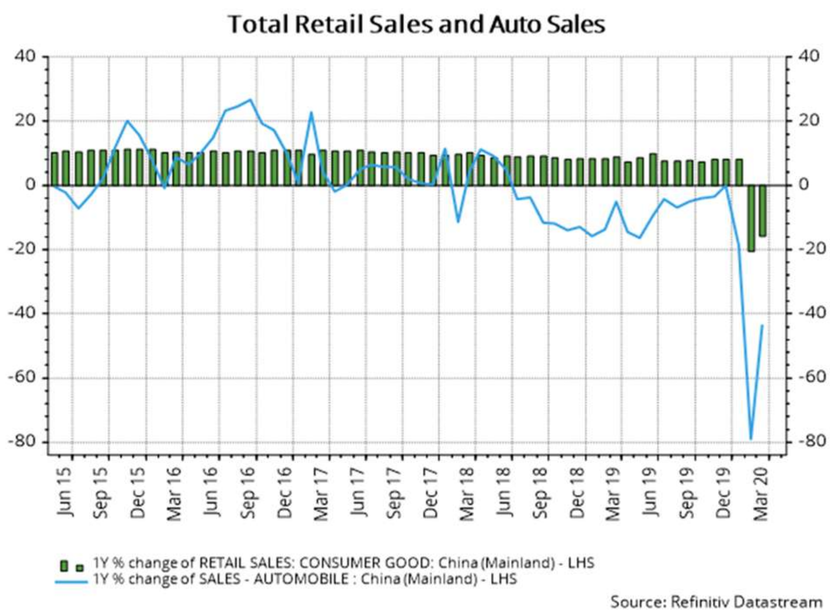
- <u>The Chinese economy is showing signs of recovery exiting Q1.</u>
  - With the virus originating in Wuhan, China felt the negative effects before the West. With stringent lockdown measures enacted, China seemingly contained the virus within Wuhan and has thus far avoided large-scale second waves of infections upon reopening the economy.
  - China's manufacturing economy is showing clear signs of revival as seen in the uptick in PMI, industrial production and electricity consumption data.
  - Numerous US publicly traded corporations stated that China supply chain and manufacturing operations were operating at close to normal capacity in April.
  - Manufacturing activity would have been even stronger had Western demand for finished goods not evaporated due to economic shutdowns.

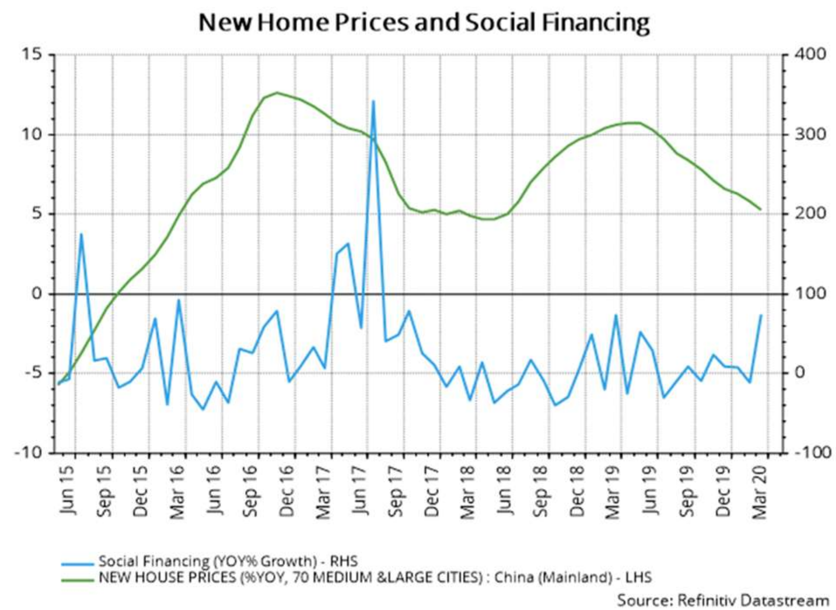




China (Cont.)

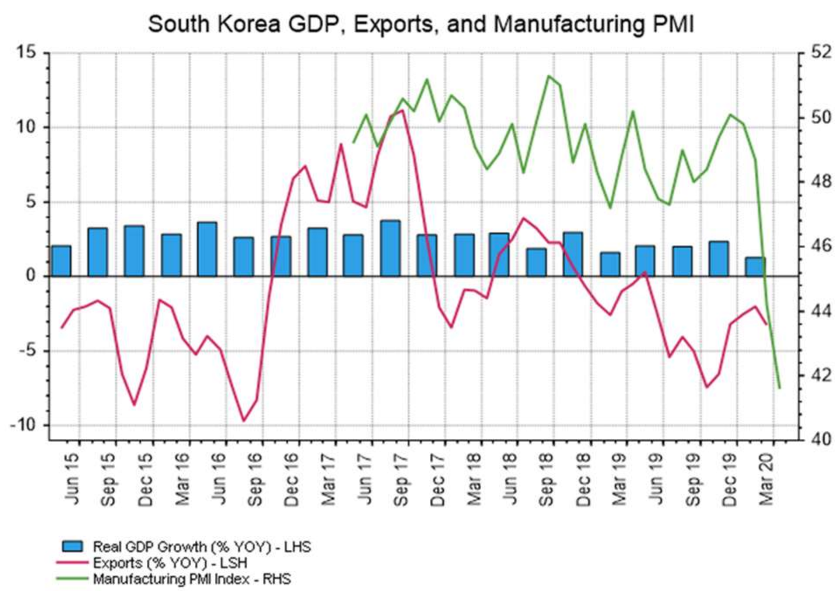
- <u>Chinese consumption has been slower to recover.</u>
  - March retail sales growth of -16% modestly improved from February levels.
  - Sales of larger-ticket items (homes, autos) and luxury goods have rebounded at a faster rate than service-oriented sectors such as dining and entertainment.
  - Access to credit is improving with Total Social Financing (admittedly volatile) growing rapidly.
  - 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.
    - However, Chinese unemployment is rising, and China may be pressured to enact greater stimulus to maintain social order.
    - 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

- Both South Korea and Taiwan responded aggressively to the Covid-19 crisis, which led to relatively muted economic damages in Q1 relative to the rest of the region.
  - South Korea and Taiwan GDP both grew modestly in Q1 on a Y/Y basis, but declined 1.5% Q/Q, the fastest contraction since the financial crisis.
  - Manufacturing PMIs in both regions declined materially in April, which may threaten the nascent stabilization in exports which are crucial to both countries' economies.
    - Exports are an especially important contributor to South Korean GDP at roughly 35% of GDP.
    - Korea and Taiwan should both benefit from an uptick in the global semiconductor and electronics sectors later in 2020 and in 2021.
- To mitigate economic damage, Korea has deployed $200 billion of stimulus (12.5% of GDP) while Taiwan has deployed $35billion (roughly 5% of GDP) thus far.



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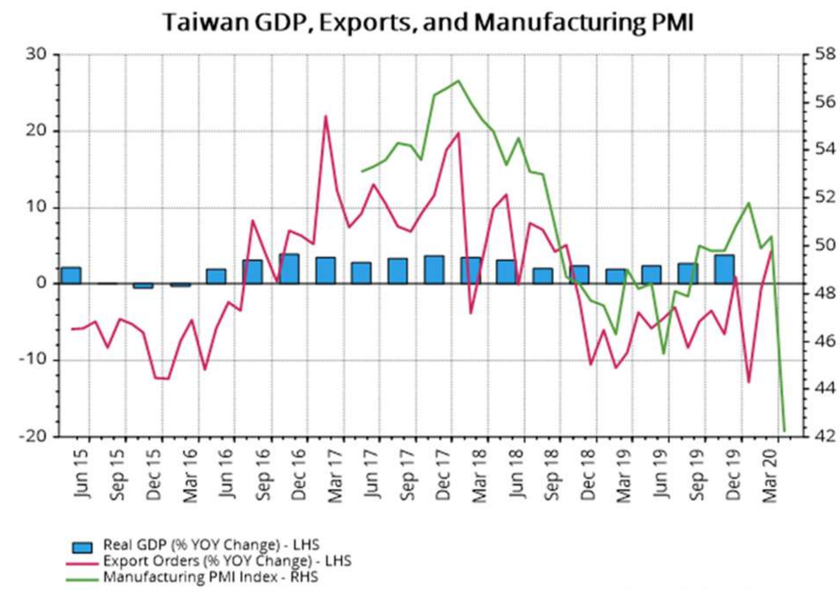

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Special Topic: Direct Lending and Distressed Debt

Private Credit Opportunity – Direct Lending

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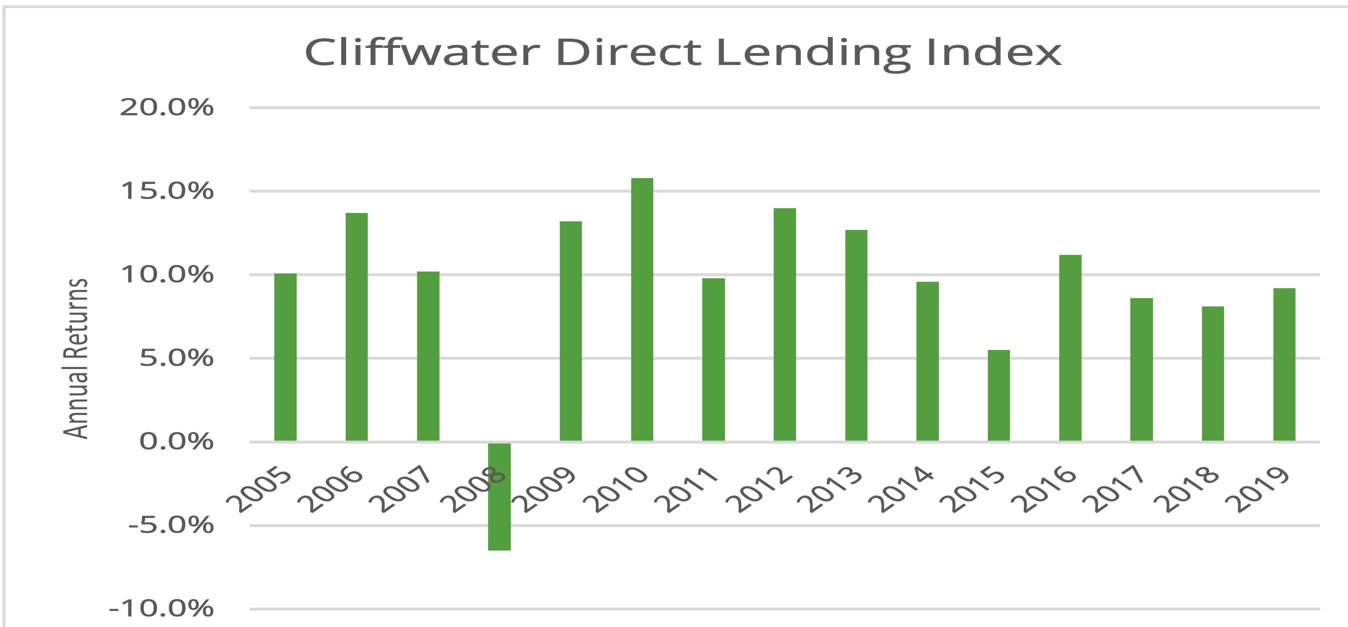
- What is Direct Lending?
  - Loans made by non-bank lenders to privately-owned companies, many of which are backed by private equity funds. Loans are typically made to finance acquisitions or for liquidity management purposes.
  - Direct lenders focus on middle market businesses that have proven customer bases and stable cash flows. However, these companies lack the size to tap public fixed income markets or receive rating agency coverage (typical company EBITDA ranges between $50mm-$100mm).
  - The direct lending market is sized at $600billion globally.
- Significant opportunities exist to provide debt capital to middle market companies.
  - Middle market private equity has grown rapidly in recent years with over 11,100 PE-backed deals completed since 2016. This has filled the void left as middle market lending by banks dropped precipitously over the past 15 years due to stricter regulations regarding reserve ratios and capital charges.
  - Private equity portfolio companies are facing significant revenue and EBITDA contractions.
    - An estimated $700-$900 billion (in terms of AUM) worth of private equity portfolio companies may be facing stress (out of the $2.1 trillion broader industry).
    - Many are high-quality businesses facing temporary liquidity challenges and are unable to obtain financing from traditional lenders or capital-constrained private equity funds.
- Direct Lending funds offer investors attractive potential returns with better downside protection.
  - For investors, direct lending funds offer annual returns 300-500bps higher than publicly traded leveraged loan and high-yield funds. These higher yields compensate for direct lending's higher illiquidity.
  - Most direct lenders invest in senior secured debt and are positioned at the top of the capital structure.
  - The privately-negotiated nature of transactions permits lenders to conduct extensive due diligence on potential borrowers and secure financial covenants.
    - In contrast, most syndicated loans are larger and attract competitive pools of capital thus leading to fewer protections for lenders in terms of financial covenants.
    - Presently, 80% of leveraged loans are covenant-lite, increasing the chance of lower recoveries upon default.

Private Credit Opportunity – Direct Lending

– Since private loans are not subject to daily pricing, investors may avoid valuation volatility in stressed markets.
– Direct lending has delivered consistent high-single to low-double digit annualized returns.
  - Importantly, over the 1992-2019 period, direct lending generated a 6.1% annualized return over its worst five-year period. This contrasts with every other asset class which generated negative annualized returns over their worst five-year periods.
  - Direct lending has outperformed other credit asset classes during years of negative equity returns



Private Credit Opportunity – Direct Lending

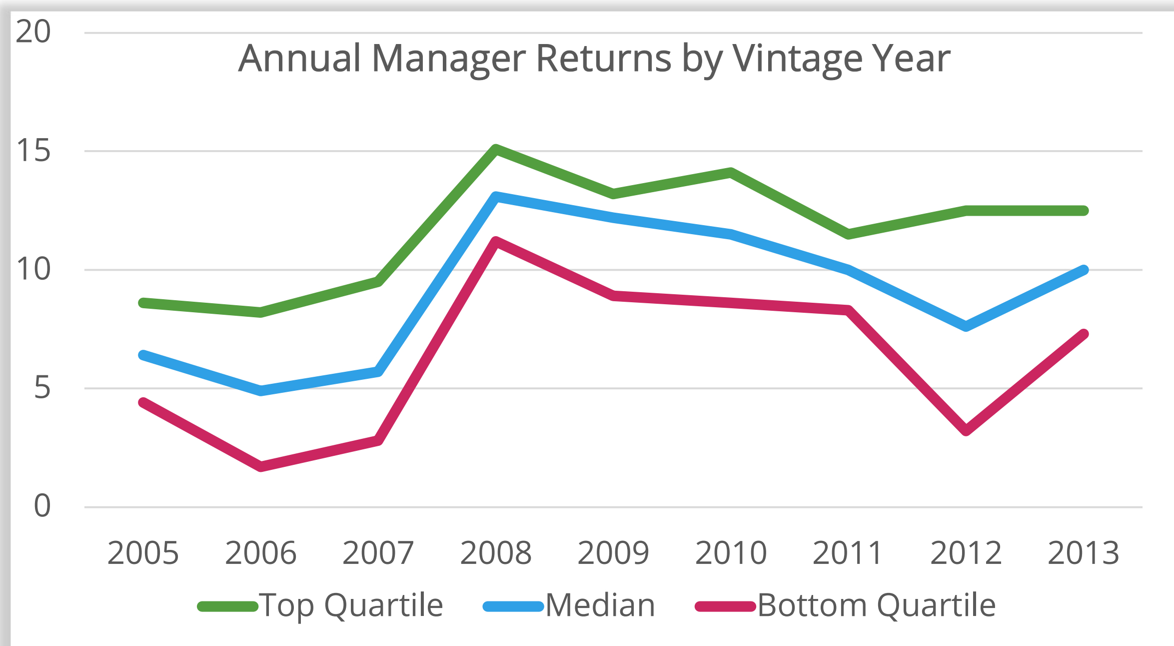
- Direct lending funds offer significant benefits to private equity sponsors.
  - Direct loans are privately negotiated transactions. Borrowers can rely on price and transaction closing certainty, while management teams can avoid the distraction of having to go through the syndication process.
  - Direct lending funds work in partnership with sponsor companies and are more willing to provide customized lending solutions.
- Manager vetting is absolutely crucial in selecting direct lending funds
  - Direct lenders rely on transactions backed by private equity sponsors to drive the majority of deal flow.
  - Managers who have developed deep sponsor relationships have significant competitive advantages.
    - Broader sponsor networks leads to more proprietary, deeper and harder to replicate deal pipelines.
  - Incentives must be aligned between direct lending firms and the suppliers of capital (most often their LPs)

Distressed Debt Credit Strategy

- What is Distressed Debt?
  - Distressed debt refers to bonds bought from companies that are either in bankruptcy or on the verge of it.
  - In the public markets, debt is considered distressed if spreads are greater than 1,000 bps vs Treasuries.
  - Distressed debt funds target annual unlevered returns of 15%-20%, higher than direct lenders and similar to private equity.
  - Presently, $75 billion of dry powder exists among distressed debt funds. However, several pre-eminent firms such as KKR, Highbridge and Oaktree are raising new distressed funds, anticipating the rising default cycle.
- Why Invest in Distressed Debt Now?
  - Given the enormous Covid-19 related disruption, defaults and bankruptcies are likely to significantly increase over the next 12-18 months.
    - April marked the fifth highest month on record for corporate defaults.
    - Ratings agencies are forecasting default rates to increase to 10%-13% by 2021 (versus 3.3% historically).
  - Over $600 billion worth of securities (25% of the US high-yield and leveraged loan markets) are trading at spreads over 1,000bps wide of US Treasuries, levels indicating distress.
    - The US High Yield Distressed index is down 42% YTD.
    - Valuation dislocations in the leisure, hospitality and travel sectors have widened materially post Covid-19.
  - Limited dry powder to invest versus the likely potential distressed supply over the next few years.
  - Private equity portfolio companies are also facing significant liquidity challenges.
  - CLOs (the largest owners of leveraged loans) are likely to become forced sellers of marked-down underlying leveraged loans.
  - Multiple opportunities to win:
    - If companies can recover without entering bankruptcy, the distressed debt will appreciate markedly (pull-to-par).
    - In a reorganization, distressed debt investors can influence the bankruptcy proceedings. In many cases, investors will swap their debt for new equity in an attractively positioned, recapitalized company.

Distressed Debt Credit Strategy

- <u>High Manager Level Dispersion Lends Itself to Alpha via Manager Selection.</u>
  - In most cases, managers endeavor to earn high returns through negotiation (using the leverage they have as creditors under the bankruptcy code).
  - Most distressed managers have strong financial analytic skills as well as deep ability to understand legal documents and corporate structures.
  - Managers must fully understand their rights under relevant governance documentation.
  - Returns are derived from accurately assessing enterprise value, forming coalitions and obtaining consensus and effecting the best risk-adjusted corporate reorganizations.



Returns are highest for fund vintage years during and immediately post the financial crisis (2008-2010)

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