Review of Q4 2020 and Current Capital Markets

February 23, 2021

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Executive Summary

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- <u>Equity and credit markets appreciated strongly during Q4 2020 (up 14.7% and 4.2% respectively)</u> and have continued to rally post-quarter through mid-February.
  - Trial data success for multiple vaccines (beginning Nov 9, 2020) has been a game-changer and further amplified the markets' rally (up 70%-80% since March lows). Investors are seeing light at the end of the tunnel and are viewing 2022 as the return to post-pandemic economic normalcy.
  - Reversing multi-year trends, cyclical value stocks outperformed growth and quality stocks over the past few months. This reversal is reflected in international markets outperforming US large-caps and value stocks outperforming growth (by roughly 600-700bps since Nov. 9, 2020). Economically-sensitive US small caps have been the best performer (up 39% vs. 16% for the MSCI ACWI index).
- <u>Corporate earnings continue to materially exceed expectations</u>
  - Q4 corporate earnings beat projections by a larger-than-normal magnitude (in the US, S&P 500 earnings were up 1% vs. an initial expectation of a 10% decline).
    - Analysts have been consistently upgrading earnings forecasts for 2020, 2021 and 2022 across most markets.
    - 2021 forecasts appear reasonable (assuming no additional long, large-scale lockdowns). Analysts' 2022 EPS may prove conservative, 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 (15%-20% higher).
    - *Relative* to Treasuries, valuations based on 2022 earnings appear reasonable but no longer highly undervalued.
  - Markets are already pricing in strong earnings growth in 2021 and 2022. Near-term risks include **a)** surge in cases due to new COVID virus strains, **b)** setbacks in vaccine distributions, **c)** potential fiscal, monetary, health or other policy changes or other geopolitical risks, and **d)** faster than anticipated inflation.

<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

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Strategic Asset Allocation View (7-years)

- Following the massive 70%-80% rallies from March lows, **we now expect mid-single digit nominal pre-tax equity returns (5.5%-6.5%) annually** over the next seven years.
  - Importantly, equity returns in any individual year over this seven-year period may vary widely from our annualized 7-year forecast.
  - We expect continued bouts of volatility over the next twelve months (COVID resurgence, potential delays in vaccine distribution, fiscal policy uncertainty and potential surge in inflation).
    - *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 at or below pre-COVID levels, despite continued uncertainty surrounding corporate credit fundamentals for certain COVID-affected borrowers.
- 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 Single-Digit
MSCI Emerging Markets		
FIXED INCOME		
US Treasury		Flat to Low Single-Digit
US Corp IG		
US Corp HY		Mid Single-Digit
US Corp Lev. Loans		
EM Sovereign USD		Low Single-Digit
EM Sovereign LC		
ALTERNATIVES, PRIVATE EQUITY, & REAL ESTATE		
Real Estate (Private)		Mid Single-Digit
Hedge Funds		Mid to High Single-Digit
Private Equity		High Single-Digit / Mid-Teens

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Tactical Allocation View

- <u>From a shorter-term standpoint (next 6-12 months),</u> we believe that equity markets' direction will be primarily driven by the risk factors listed earlier: **a)** new virus developments (i.e. new strains), **b)** pace and success of vaccine rollout, **c)** magnitude of near-term further stimulus packages, **d)** earnings trajectory vs. expectations, **e)** discussion surrounding potential next round of policy changes (i.e. infrastructure bill or corporate tax rates), and **f)** trajectory surrounding inflation.
- <u>Despite the nearly 80% rally from March lows, both bulls and bears have credible cases</u>
  - *In the bullish case,* corporate earnings may continue to accelerate much faster than expected. Interest rates are likely to remain low for longer. Additionally, significant stimulus and liquidity may underpin a continued attractive backdrop for stocks. Vaccine distribution is accelerating across most markets. Finally, in the US, post-election policies are generally less business unfriendly than feared. Equities could rise another 10% over the next 6-12 months.
  - *However, several risk factors could derail the market rally* including a) new virus strains and resulting slower economic recovery relative to expectations, b) hiccups with respect to vaccine distribution (as currently experienced in Europe) and c) faster than expected inflation. A 10% pullback is easily imaginable under this scenario.
- <u>Public fixed income yields and spreads are at record lows, with unattractive risk / reward.</u>
  - Elevated duration leads to high interest-rate risk for government bonds. Corporate bond spreads are now close to pre-pandemic levels despite still uncertain credit fundamentals for Covid-affected issuers.
    - While near-term further spread compression may occur given Fed support and liquidity, risk / reward is increasingly asymmetric towards the downside.
- <u>We believe compelling opportunities exist across private markets, especially among middle-market private equity strategies</u>.
  - Better potential for lower entry valuations vs. public markets via proprietary-sourced deals.
  - Broader value creation opportunities via sourcing, operational improvements, platform M&A and a wider range of exit options.
  - Mid-to-high-teens returns are possible across several different middle-market private-equity strategies.

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Economic Activity

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- <u>World economies experienced continued growth during Q4, despite a resurgence in Covid cases.</u>
  - US Real GDP increased at a 4.0% annualized rate Q/Q in Q4. Canada and Japan also experienced 3.0%-4.0% sequential growth. China's GDP continued its recovery with Q4 growth accelerating to 6.5% YOY. However, Eurozone GDP decreased 0.7% in Q4 as Covid surges drove increased lockdowns.
    - The IMF is presently forecasting 2020 global Real GDP declines of -3.5%, followed by a 5.5% recovery in 2021 and 4.2% in 2022. These forecasts have been revised upwards as economic data have surprised to the upside.
  - Global PMI indexes have consistently inflected upward with most returning to positive-growth.
    - The rebound has been more pronounced across manufacturing indexes vs. services indexes thus far.
  - Unemployment rates have declined steadily in the US and Canada but are ticking upwards across Europe.
  - Retail sales have returned to positive growth YOY across all major economies.
- <u>Economic activity may continue to surprise to the upside</u>
  - Despite current slowdowns associated with Covid surges and increased restrictions, economic activity has the potential to continue exceeding current expectations given:
    - Significant consumer savings leading to high post-vaccination spending on previously unavailable services and experiences driven by massive pent-up demand.
    - Resumption in global trade growth leading to strong factory utilization and manufacturing activity.
    - Business inventory restocking likely given low current inventory levels.
    - Pickup in business capital expenditures (deferred during the pandemic).
  - Further large-scale stimulus or targeted infrastructure spending packages could be further additive – provided they're not overdone.
  - However, potential surges in inflation bear watching as do movements in the 10-year Treasury yield.
    - US inflation expectations have ticked above 2% for the first time since 2013.
    - Producer prices increased 1.3% vs. the prior month (largest gain since Dec. 2009) and 1.7% YOY in January.
      - Spot prices for several commodities such as steel increased substantially over the past six months

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Vaccines and Political Developments

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- <u>Potential for Mass Vaccination in Developed Economies by Fall 2021</u>
  - Beginning on Nov. 9, 2020, several vaccine candidates (Pfizer, Moderna, AstraZeneca and Johnson & Johnson) released much-better-than-expected vaccine trial data. These companies also secured swift regulatory agency approval and purchase agreements from various governments.
    - In theory, current vaccine distribution policies should enable most developed nations to vaccinate significant portions of their populations by fall 2021.
    - However, several questions remain surrounding logistics, longevity of immunization and effectiveness against existing and new strains, 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>Relatively Benign Policy Outcomes Thus Far</u>
  - In the US, the Democrats achieved an electoral sweep of both the Presidency and Congress.
    - Near-term, it is highly likely they pursue an aggressive fiscal policy agenda including further large-scale stimulus, followed by a potential infrastructure bill.
    - Business-unfriendly policies such as corporate tax hikes seem to be lower-priority items near-term and will likely be deferred untill Covid is well behind us and the US economic recovery is on stronger footing.
    - Finally, under a Biden administration, the US is less likely to raise new tariffs or adopt unpredictable foreign policy stances. This is likely to be viewed favorably by financial markets.
    - Over the mid-term however, several risks remain such as a) potential increase in corporate tax rates, b) potential excise taxes on stock buybacks, and c) significant increases in the Federal minimum wage
  - Internationally, the EU and UK reached a trade deal surrounding Brexit thus avoiding a messy no-deal scenario.
    - Many details are still to be worked out and the UK's ability to more aggressive procurement efforts with regards to vaccines (relative to the EU) may stoke tensions.

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Capital Markets Review

Equity Markets - Performance

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- Global equity markets appreciated 14.7% during Q4 (and another 5.7% post quarter end).
  - During Q4, Intl. stocks outperformed US Large Caps and US value stocks outperformed US growth stocks (both reversals of multi-year trends).
  - Following positive vaccine trial news beginning on Nov. 9th 2020, markets with greater cyclical exposure have significantly outperformed less cyclical markets. Financials, energy and materials have been the best performing sectors post-vaccine news, while economically sensitive US small caps have substantially outperformed large caps over the past several months.
- 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 may continue to outperform for a *shorter-term period of 12-18 months* (earnings inflections due to operating and financial leverage and accelerating rollout of vaccine distribution buoying investor sentiment).
  - So, for those seeking *tactical* equity opportunities, we recommend adding - where appropriate - cyclical value exposure and increasing allocations to international and small-cap stocks at the margin vs. growth / quality. Please contact us to discuss how to apply these ideas before making such moves.

Equity Indices - (As of 02/12/2021)

	YTD Performance			Total Returns (%) - USD *				
	YTD 2021	2/19/20 3/23/20	3/23/20 - Present	Dec. Qtr	Annualized Returns 1Y	3Y	5Y	7Y
US Large Cap (S&P 500)	4.9%	-33.8%	77.8%	12.0%	17.9%	15.5%	17.7%	13.2%
US Small Cap (Russell 2000)	16.0%	-40.7%	130.9%	31.4%	37.3%	17.0%	20.3%	12.1%
MSCI EAFE	3.8%	-32.7%	67.5%	16.1%	11.5%	6.3%	11.3%	5.1%
MSCI Emerging Markets	10.8%	-31.2%	92.1%	19.7%	31.5%	10.0%	17.7%	8.5%
MSCI ACWI	5.7%	-33.6%	80.9%	14.7%	19.3%	12.5%	16.0%	10.0%
Russell 1000 Growth	5.6%	-31.4%	95.3%	11.3%	35.0%	24.8%	25.0%	18.5%
Russell 1000 Value	5.7%	-38.0%	73.7%	16.2%	7.0%	8.9%	13.0%	9.3%

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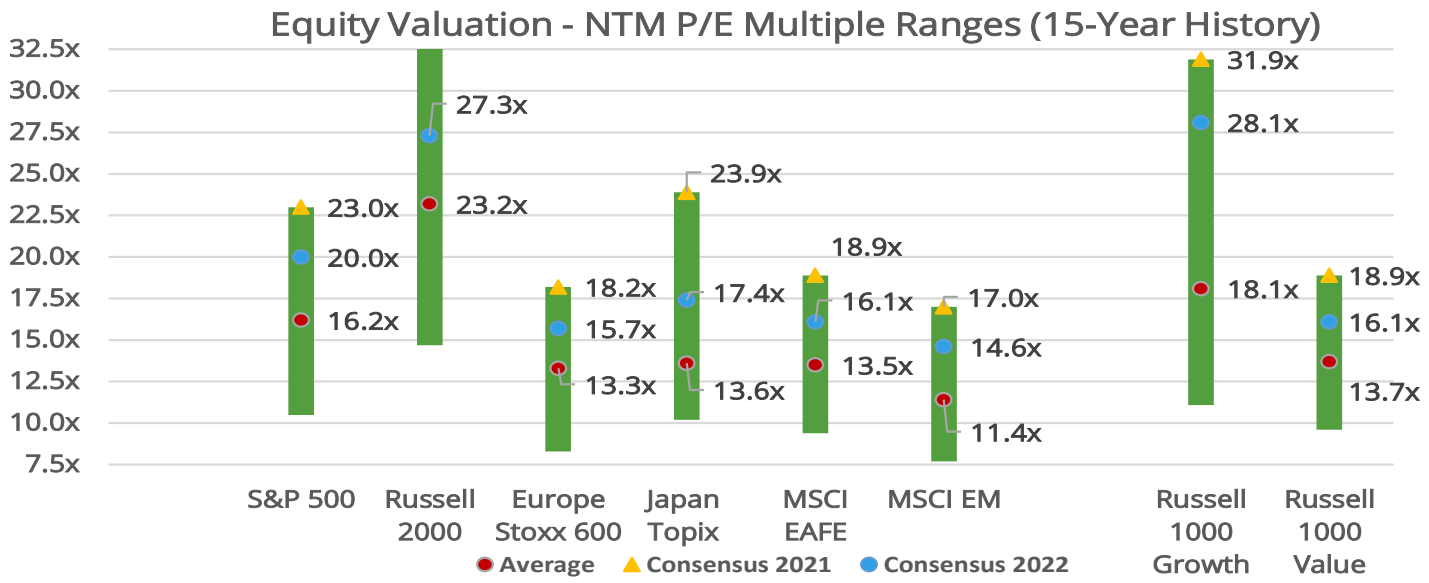
Equity Markets - Valuation

- Current equity valuations based upon 2021 forward earnings appear high, but corporate earnings are still not fully normalized and are suppressed by 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 15%-20% higher than historical averages.
    - Investors are clearly pricing in a strong global corporate earnings recovery with expectations continuing to increase. Should actual results disappoint lofty expectations, markets could be susceptible to pullbacks.
- However, relative to low interest rates, equity valuation multiples might be justified.
  - S&P 500 presently trades at 20.0x consensus 2022 earnings (consensus estimates may still be too low). If interest rates remain near present levels, this multiple 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.
    - We continue to monitor the recent rise in 10-Year Treasury yields (1.3% as of Feb 18, 2020 vs. 0.7% six months ago).



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Fixed Income Markets - Performance

- Fixed income markets have bifurcated during Q4 and into the new year.
  - Safe US Treasuries declined modestly during Q4 and have declined 1.7% post quarter-end as 10-Year treasury yields have increased to 1.3% from 0.7% at the end of Q3 2020 and from 0.9% at YE 2020.
  - However, credit assets (high yield bonds, leveraged loans, and EM Hard Currency sovereign bonds) rallied sharply as spreads narrowed. The rally intensified post the Nov 9th vaccine trial news and credit spreads have now tightened to pre-pandemic levels.
    - 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 as spreads declined in conjunction with strong EM risk-on credit sentiment.
  - EM local currency bonds increased sharply due to currency appreciation (consistent with broader EM risk-on sentiment post the positive vaccine trial news).
    - EM local currency bonds tend to be highly correlated with EM equities.

Fixed Income Indices - Characteristics and Performance in USD (as of 02/12/2021)

	ST Performance (%)				Annualized Returns				
	YTD 2021	2/19/20 3/23/20	3/23/20 -Present	Dec Qtr.	1Y	3Y	5Y	7Y	Duration (yrs)
US Treasury	-1.7	5.4	-1.7	-0.8	4.2	5.3	2.7	3.1	7.2
US Corp. IG	-1.8	-12.3	19.8	3.1	5.5	7.3	6.3	5.2	8.7
US Corp HY	1.3	-20.8	35.3	6.5	7.4	7.0	9.9	5.7	3.7
US Corp Lev. Loans	1.5	-20.6	31.0	3.8	4.1	4.2	5.9	4.0	NA
EM Sovereign USD	-0.9	-20.7	28.6	5.8	2.5	5.6	7.1	6.0	8.8
EM Sovereign LC	-0.1	-18.0	27.3	9.7	4.1	1.2	5.8	1.6	5.8
Barclays US Aggregate	-1.2	-0.9	5.1	0.6	4.4	5.6	3.8	3.7	6.2

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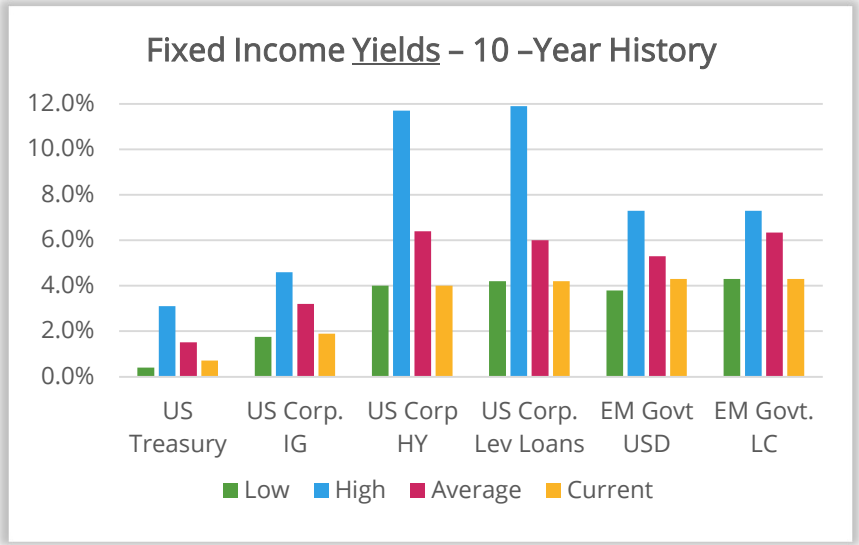
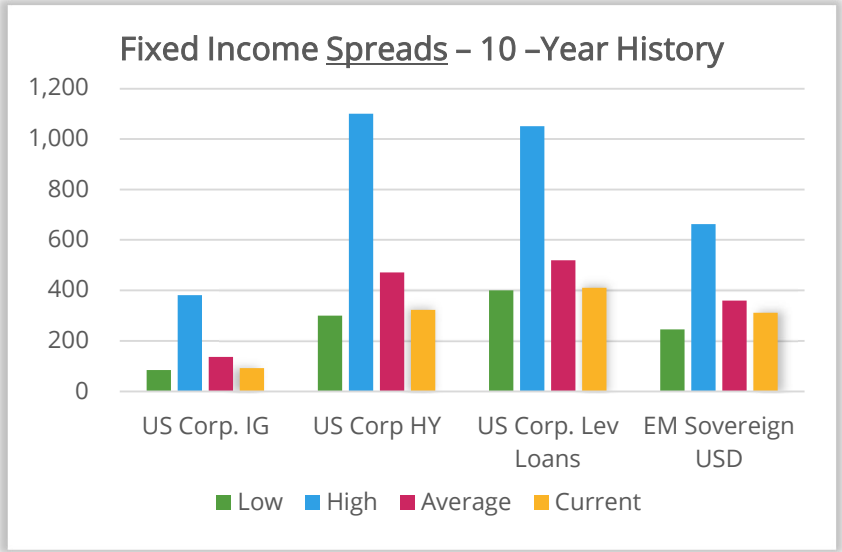
Fixed Income Markets - Valuation

- 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 pre-pandemic levels despite still uncertain credit fundamentals for borrowers whose earnings are still affected by COVID dynamics.
  - Abundant liquidity and generally improving economic data may buoy sentiment for investment-grade and high-yield bonds, leading to further spread compression.
    - However, when looking at current yields combined with spreads, risk / reward is clearly tilted towards the downside for publicly traded corporate credit (investment grade, high yield and leveraged loans).
  - *Even highly risky credit has rallied sharply* with high-yield for lower-quality (CCC) bonds now trading at spreads of only 675bps (versus over 1950bps in March). Less than 7% 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.





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Alternatives and Currencies

- Hedge funds had a solid quarter with all major sub-strategies posting positive returns.
  - The HFRX Equal-Weighted Strategies was up 4.5% in Q4.
  - Directionally-focused strategies such as long-short equities (+7.7%) and credit (+5.4%) performed especially well, while convert-arb also had another stellar quarter (+6.5%).
- Private real estate (as measured by the NCREIF Index) increased by 1.2% during Q4.
  - 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 Q4 and far eclipsed 2019 Q4 levels.
  - Underlying profit fundamentals generally improved across PE portfolio companies with most materially exceeding dire post-COVID budget plans.
  - Valuation markups also rebounded in Q4 for PE portfolio companies driven by improving underlying EBITDA and rising public and private comparable multiples.
- The USD continued to weaken during Q4 but has modestly firmed since then.
  - The Dollar Index depreciated 4.4% during Q4 as the Fed committed to a longer period of ultra-low short-term interest rates and the necessity for further government stimulus became apparent.
  - The Euro appreciated by 4.2% vs. USD during the quarter despite significant COVID resurgence and the resumption of lockdowns.
  - The Canadian dollar appreciated by 4.3% during Q4 (the Canadian economy has continued to recover and energy prices have continued climbing).
  - EM currencies appreciated sharply by 5.3% during Q4 and have remained relatively stable since then.

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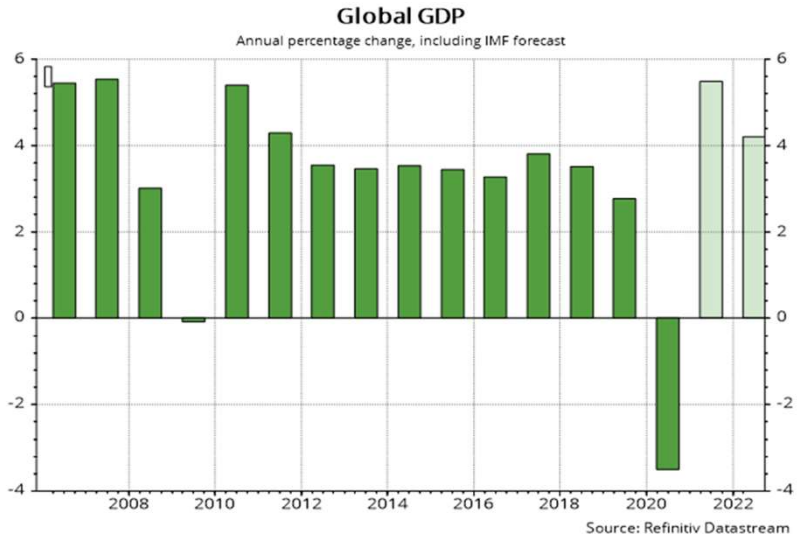
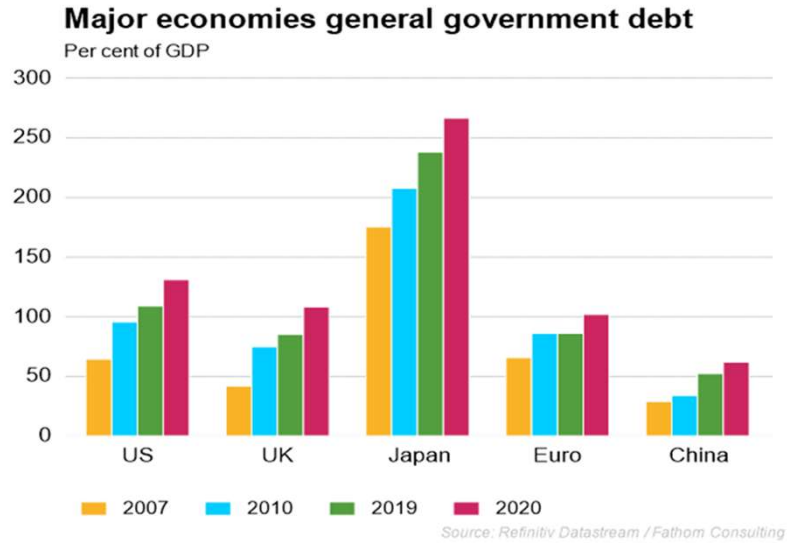
Economic Review

Global Real GDP Growth

- 2020 represented the sharpest Real GDP decline in modern times (-3.5% vs. -0.3% in 2008 during the Global Financial Crisis).
- However, the IMF is forecasting synchronized global recovery (5.5% GDP growth forecast for 2021 and 4.2% for 2022). The IMF has been consistently revising its forecasts upwards and may do so again given the significant stimulus still being deployed by most governments.
  - Advanced economies are forecast to grow at 4.3% nominal (and 3.1% Real) GDP growth rates for 2021 and 2022 while emerging economies are forecast to grow at 6.3% (and 5.1% Real) respectively during those years.
- 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 have spurred 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.





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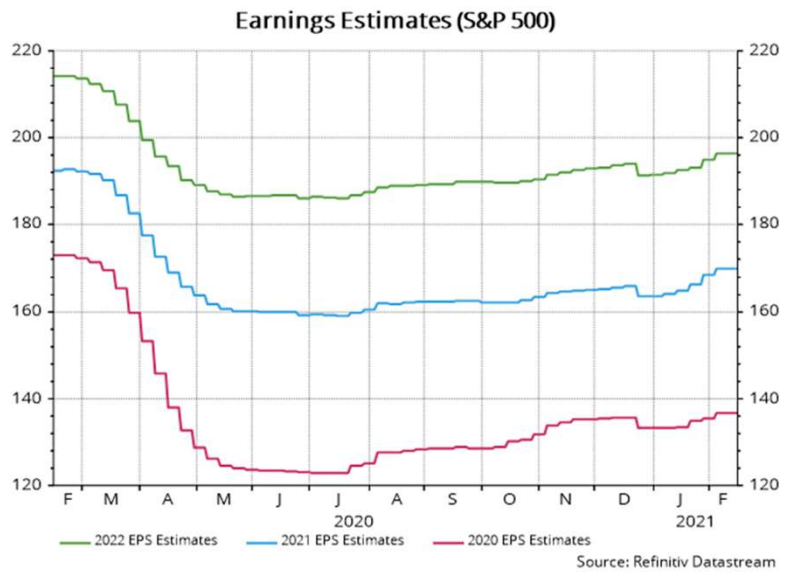
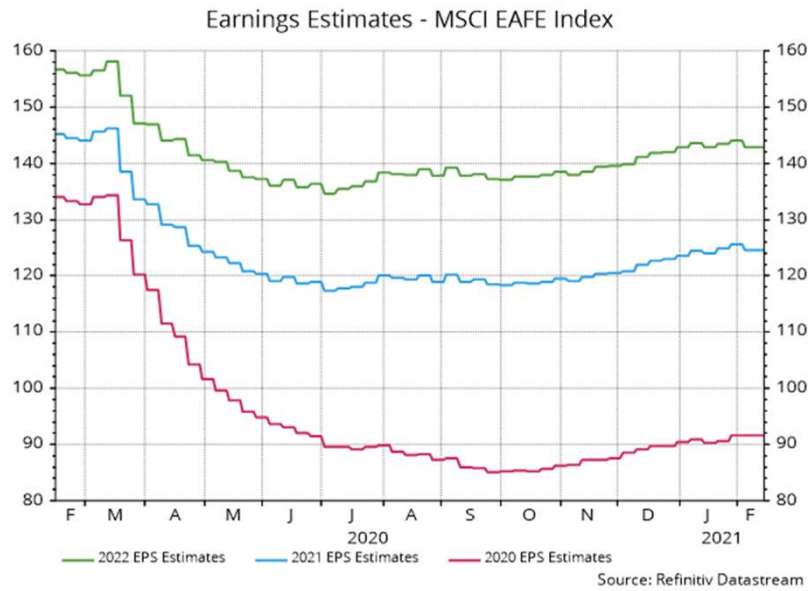
Global Corporate Profits

- Corporate profits declined significantly in 2020 relative to pre-pandemic expectations (23% in the US and 32% for the MSCI EAFE which represents intl. developed markets).
  - However, beginning in July 2020, analysts have been consistently boosting their forecasts for earnings across 2020, 2021, and 2022 upwards as economic and corporate earnings data has exceeded expectations.
  - Analysts now expect 2022 corporate earnings to surpass pre-pandemic 2020 earnings forecasts and to be within 10% of 2022 levels forecast originally made back in February 2020 (pre-pandemic).
- While consensus earnings forecasts have generally tended to be overly optimistic historically (especially for future years), we believe that current forecasts appear quite achievable.
  - The combination of significant pent-up consumer demand, massive stimulus, business inventory restocking, resumption in world trade growth and stringent cost controls augur well for continued strong corporate earnings growth.
    - Vaccine distribution efforts and ultimate vaccine adoption will play key roles in the timing of the recovery.
  - However, rising US producer inflation may curb profit margins if inflationary costs cannot be passed on.





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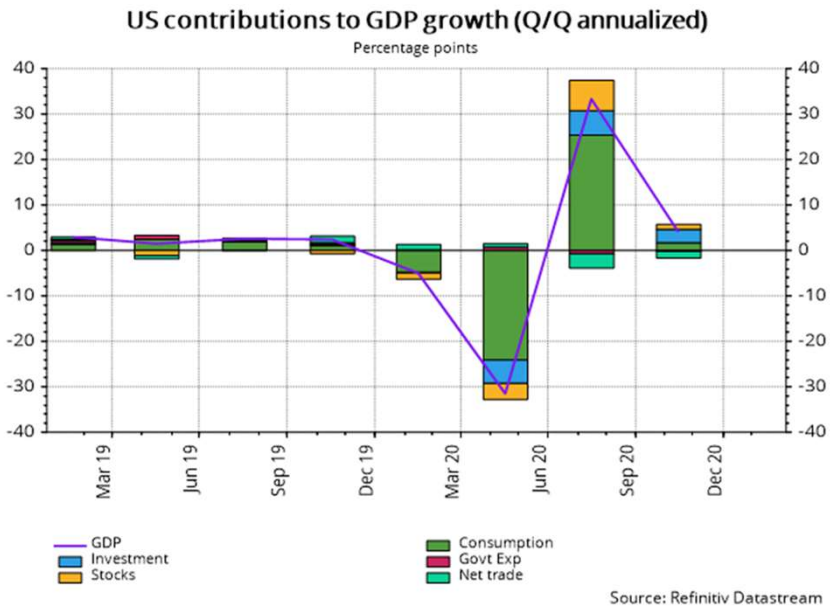
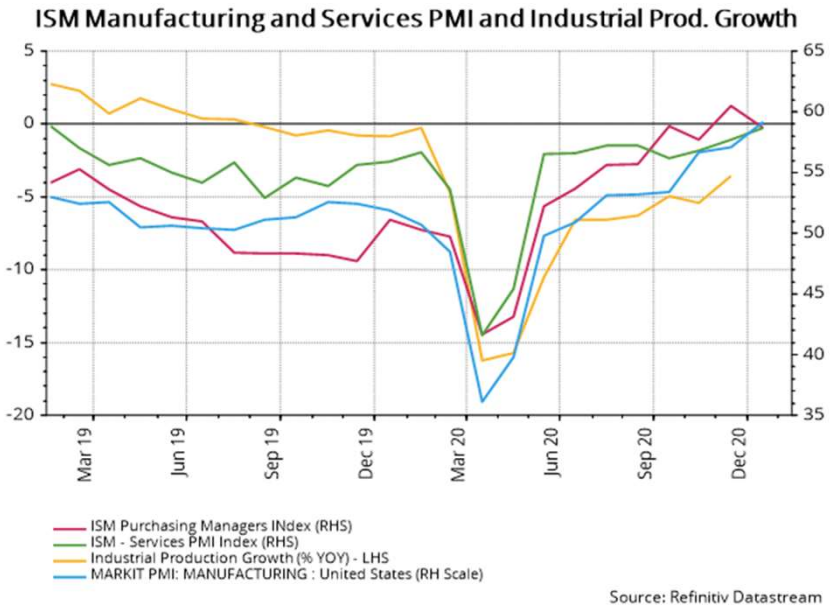
United States

- Real GDP grew by 4.0% Q/Q on an annualized basis in Q4 2020, with economists projecting 5.0%+ GDP growth in 2021 followed by a more normalized pace in 2022.
  - The recovery has been pronounced across both the manufacturing and services sectors.
  - Recent and likely upcoming further stimulus ($900bln in Dec. 2020 and potentially up to $1.9 trillion in early 2021) could further bolster the recovery and lead to upside vs. current forecasts.
- 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.
  - While there may be some slowdown especially in certain service sectors associated with the spike in winter-related COVID cases, this slowdown is likely transitory given the stimulus mentioned above.





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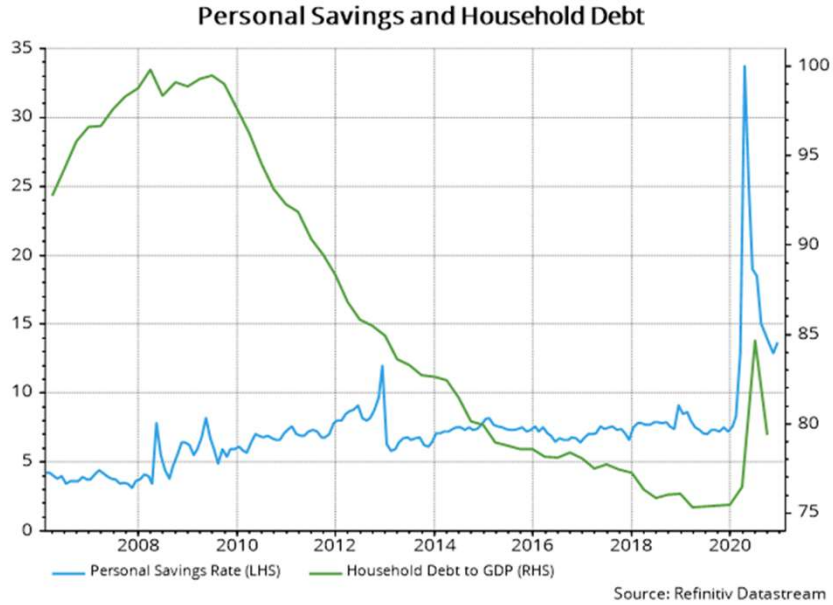
United States (Cont.)

- US employment levels have improved markedly since the April 202 lows, with corresponding sharp gains in retail sales.
  - The unemployment rate declined to 6.3% in January 2021 vs. 14.7% in April 2020 at the depths of the pandemic crisis.
    - The unemployment rate has even continued to decline over the past few months despite a resurgence in COVID cases and likely activity slowdowns in certain service industries (dining and hospitality).
      - 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.
    - However, accelerating vaccine availability and adoption 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 13% currently).
    - These elevated personal savings rates likely indicates potential significant pent-up demand for consumption.



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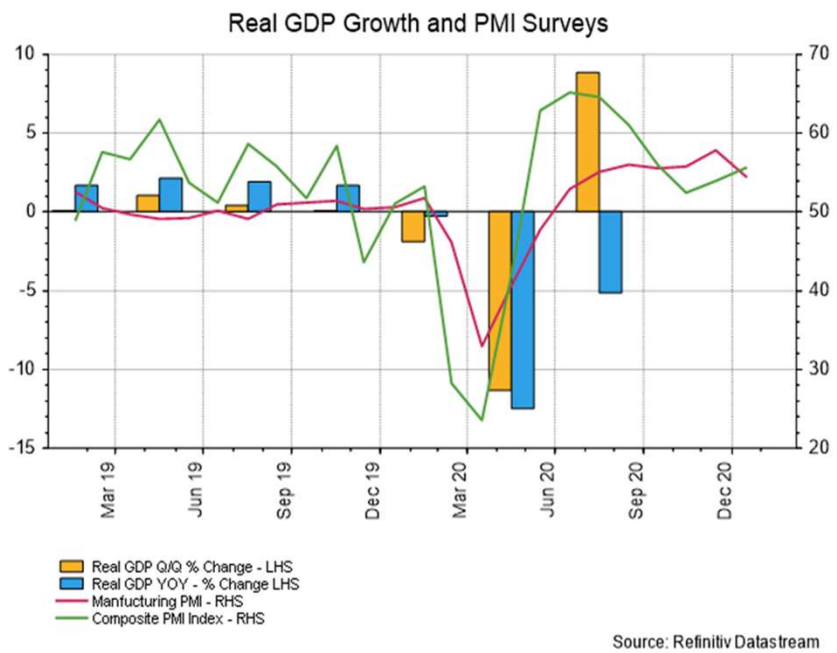
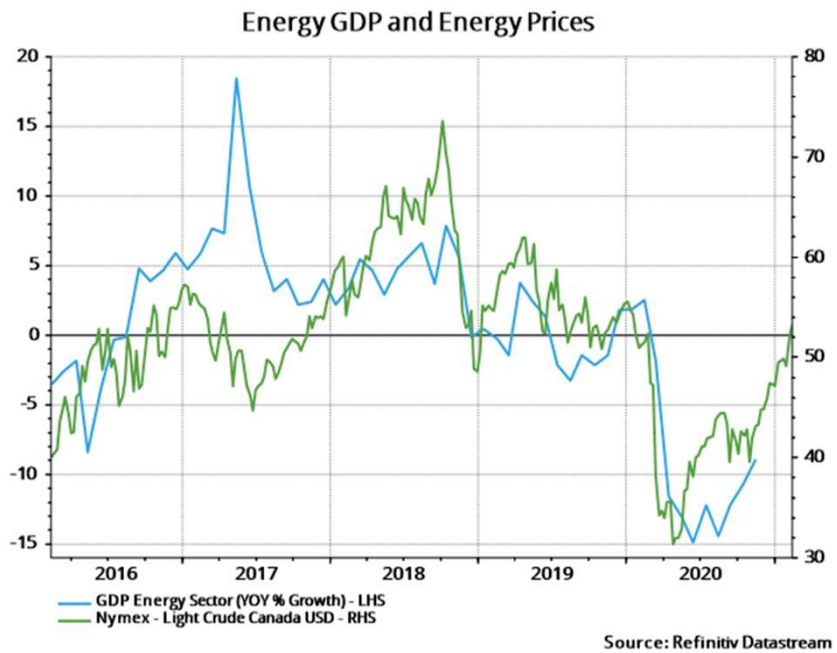
Canada

- Canada's economy likely experienced continued strong sequential recovery in Q4.
  - Q4 GDP is expected to improve 4% Q/Q (16% annualized) with both manufacturing and services PMI's showing growth during the quarter.
    - 2020 GDP is now forecast to decline at 5.5% YOY with a recovery of 4.0% in 2021.
  - 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.
  - PMI surveys still remain in growth territory despite winter increases in Covid cases.
  - The Canadian $ has continued to rally vs. the USD (presently at $1.27 vs. $1.45 in March).
  - Surging crude oil prices may also aid Canada's economic recovery going into 2021.





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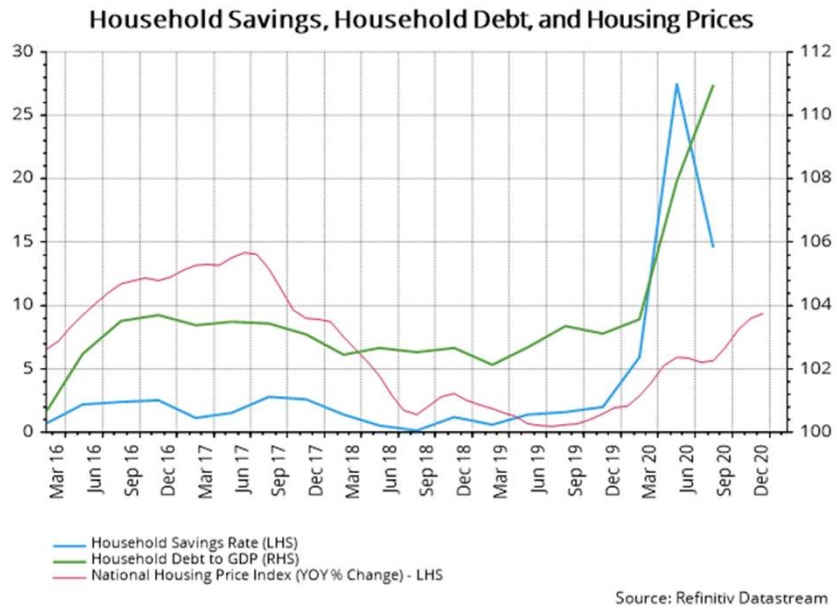
Canada (Cont.)

- <u>Canadian consumer indicators continued to improve significantly during Q4 2020.</u>
  - Unemployment rates have declined to sub 10% levels from the April peak of 12% (although employment declined over the last two months, with pandemic-hit sectors suffering most of the job losses).
  - Retail sales have shown accelerating YOY growth over the past quarter.
  - Household savings rates remain high at near 15% indicating substantial capacity for pent-up demand.
    - The increase in debt to GDP is driven by declines in GDP. This ratio should decline with economic recovery.
    - Any slowdown in the pace of retail sales and consumer activity associated with the resurgence in Covid cases should prove transitory.
  - 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 significant increases in new home sales and in housing prices (for single-family homes).



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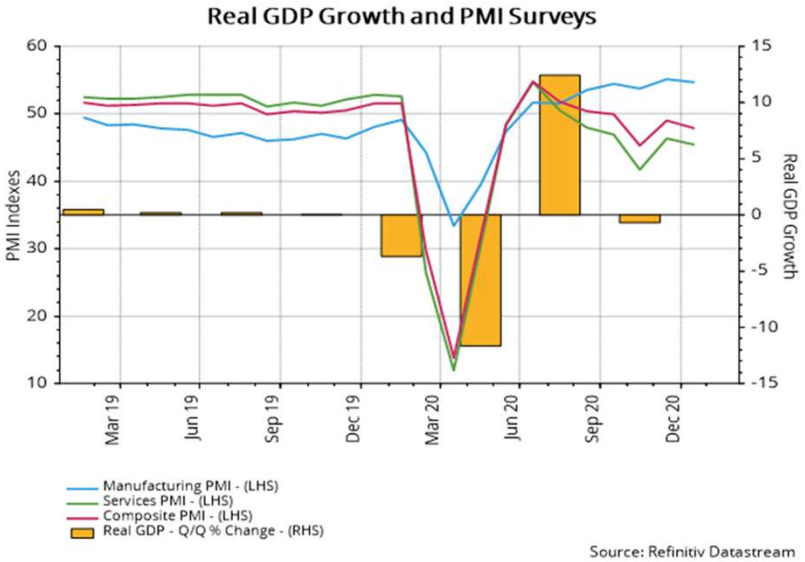
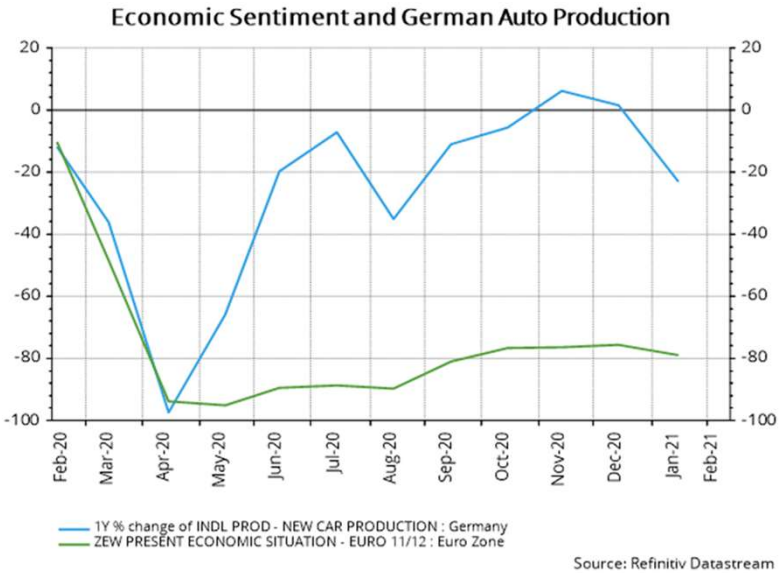
Eurozone

- Eurozone GDP growth turned modestly negative in Q4 (following Q3's sharp recovery).
  - Real GDP growth declined 0.7% Q/Q (2.8% annualized) in Q4 2020 (chart at L). The recovery momentum generated in Q3 faded during Q4 given a sharp resurgence in Covid cases and strict lockdown restrictions enacted by many European governments.
    - 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 downwards through Q4 and Germany's auto production has also declined post the New Year (chart at R).
  - The Eurozone thus far appears well behind other Western economies in terms of vaccine procurement and distribution.
    - Thus far, the EU has only vaccinated roughly 2.5% of its population (only received one dose), far behind the US at 6% (fully-vaccinated) and the UK at 15% (fully-vaccinated).
    - The European commission dithered in terms of negotiations with pharmaceutical companies, allowing more aggressive governments in the US, UK and elsewhere to lock up supplies.
    - Europe's economy recovery is likely to be further delayed until the pace of vaccination markedly improves.





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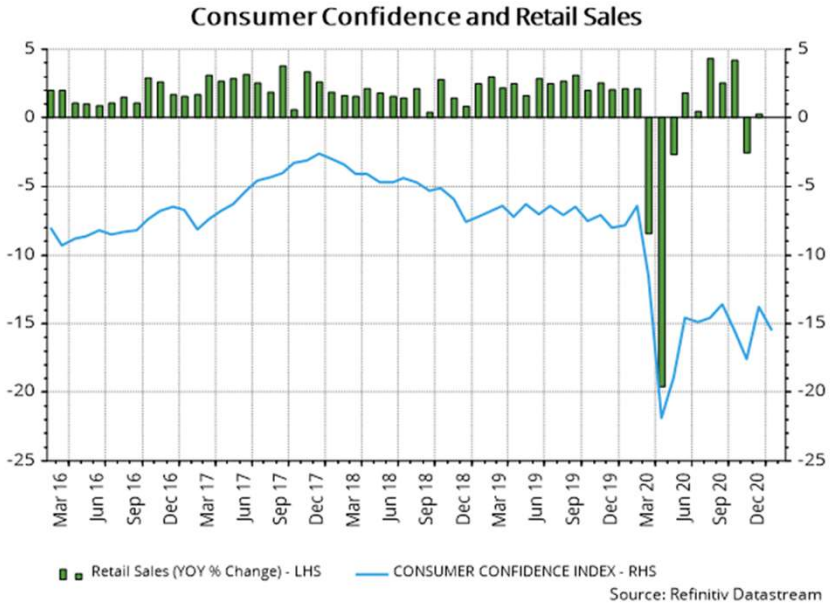
Eurozone (Cont.)

- Consumer indicators have been mixed since sharply recovering in Q3.
  - YOY retail sales declined again during Q4 following sharp recovery in the summer and early fall.
    - Current lockdown / restriction measures have been more severe in Europe vs. other Western economies and may continue to persist through Q1 2021 and into Q2 2021 due to European governmental delays in procuring and distributing vaccines.
  - 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.
    - Home price appreciation has remained steady and mortgage interest rates are at rock-bottom levels (in some cases even negative).



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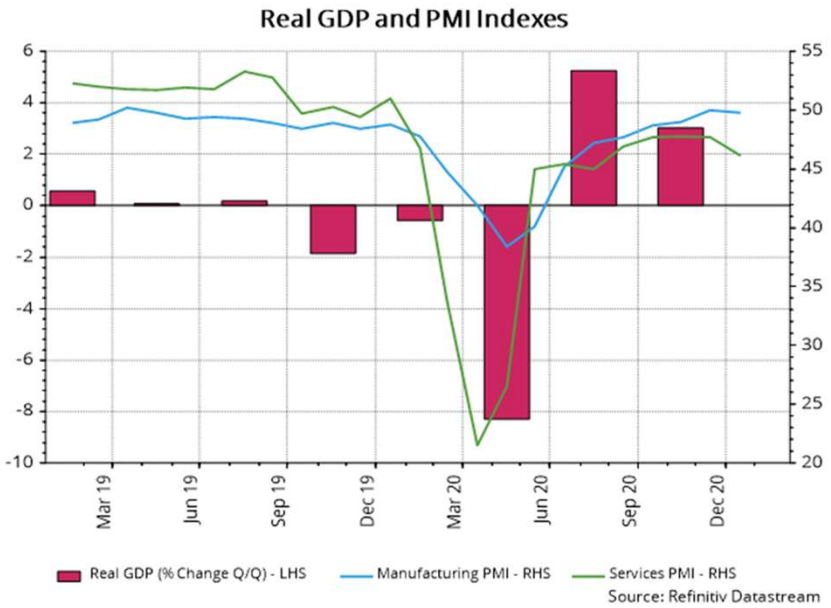
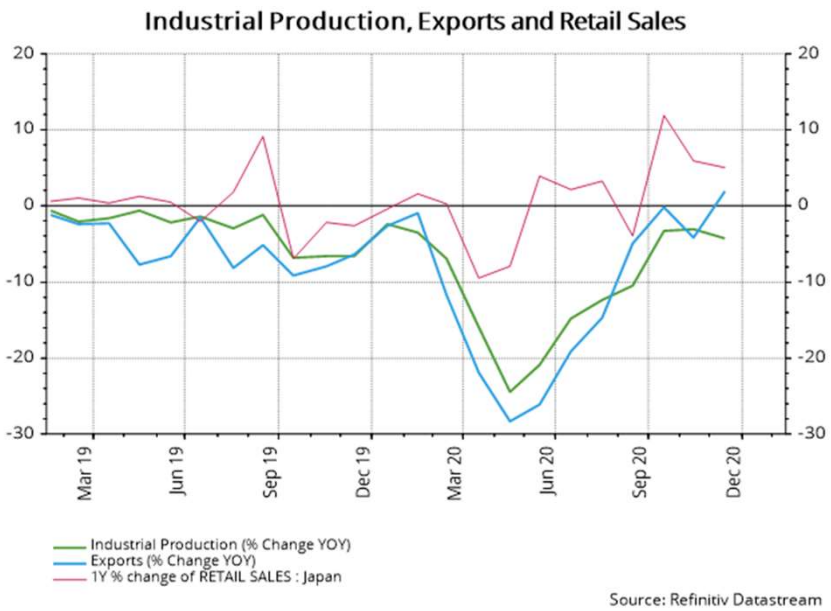
Japan

- Japan's economy continued to recover in Q4 (but at a slower rate than Q3)
  - Q4 Real GDP increased by 3% Q/Q 12% annualized) in Q4, following a 5.2% increase in Q3. For the full year 2020, Japan's Real GDP declined at 4.8%.
  - Japan's exports returned to positive growth YOY by quarter-end as global manufacturing activity rebounded.
  - Capital expenditures grew 4.5% Q/Q in Q4, the first increase in three quarters with leading indicators such as PMI indexes also recovering towards growth territory as well.
  - Domestic consumption rose 2.2% Q/Q vs. 5.5% growth in the previous quarter. However, new restrictions associated with spreading COVID cases may dent the domestic consumption recovery in the short term.
  - 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.





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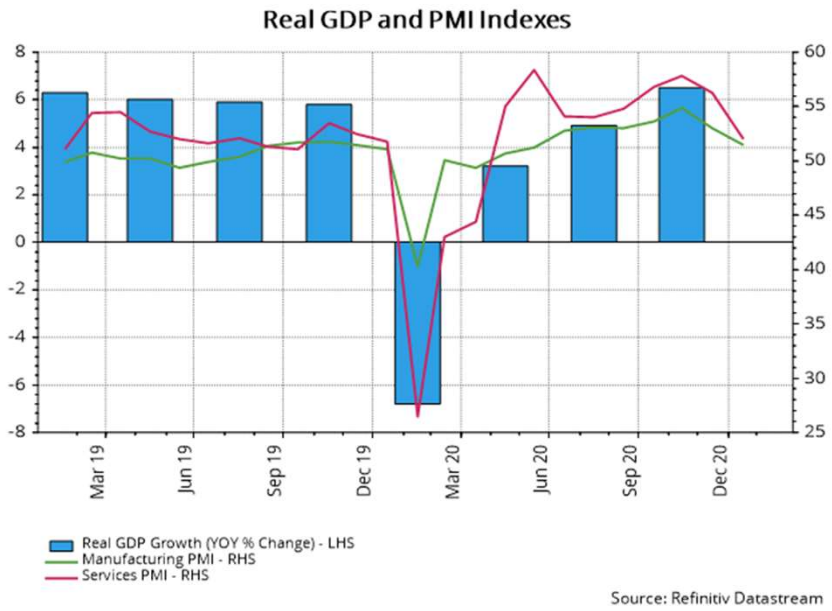
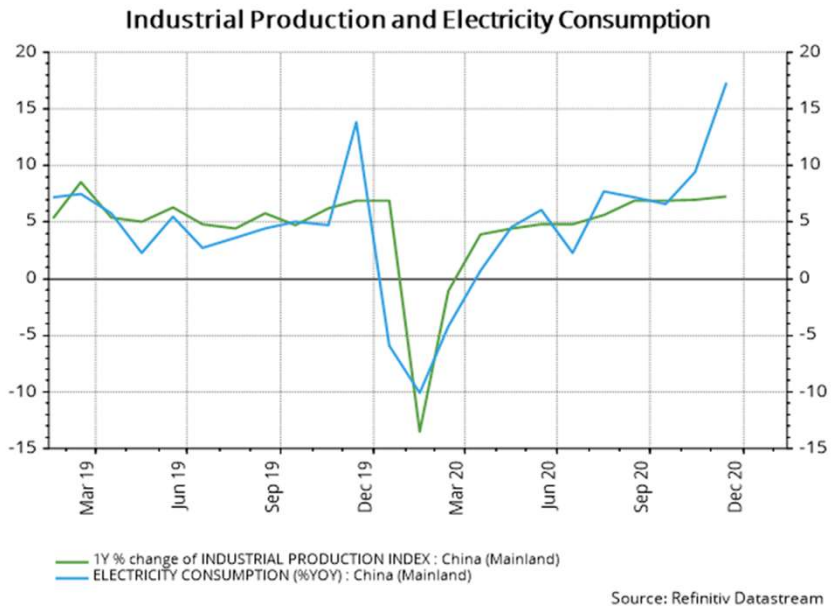
China

- China's Real GDP growth accelerated in Q4 to 6.5% YOY
  - Having largely successfully curbed the virus spread, China's economy is much further along in terms of returning to normalcy (relative to Western countries).
    - The IMF projects that China achieved 2.3% YOY Real GDP growth in 2020, the only major economy to show growth in 2020. The IMF forecasts above-trend 8.1% 2021 Real GDP growth with easy comparisons in Q1 2021.
  - Both manufacturing and services PMI indexes remained positive. Other measures such as industrial production and electricity consumption have also moved firmly into YOY growth territory.
  - China's export growth continued to surge at +15% YOY in Q4.
  - Importantly, the Chinese economy was able to demonstrate recovery despite a lack of large-scale infrastructure stimulus programs (deployed in previous China slowdowns).





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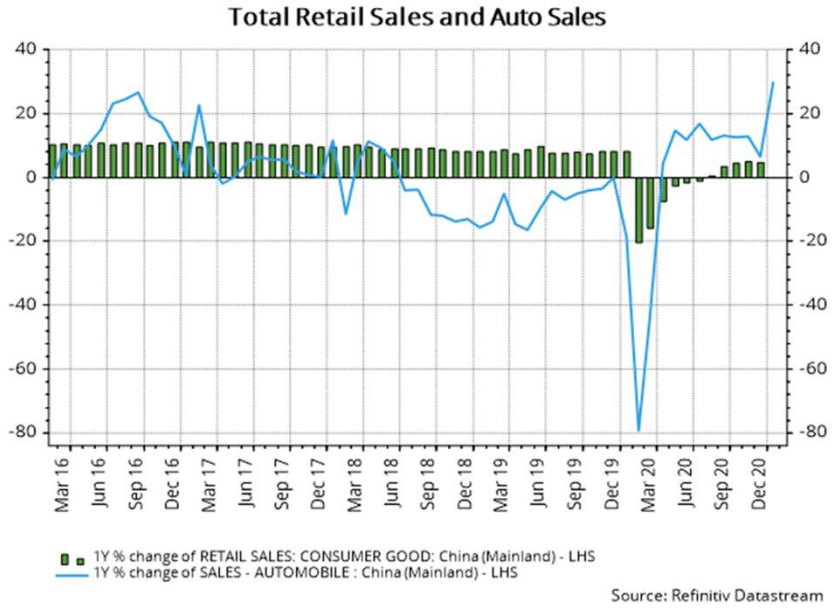
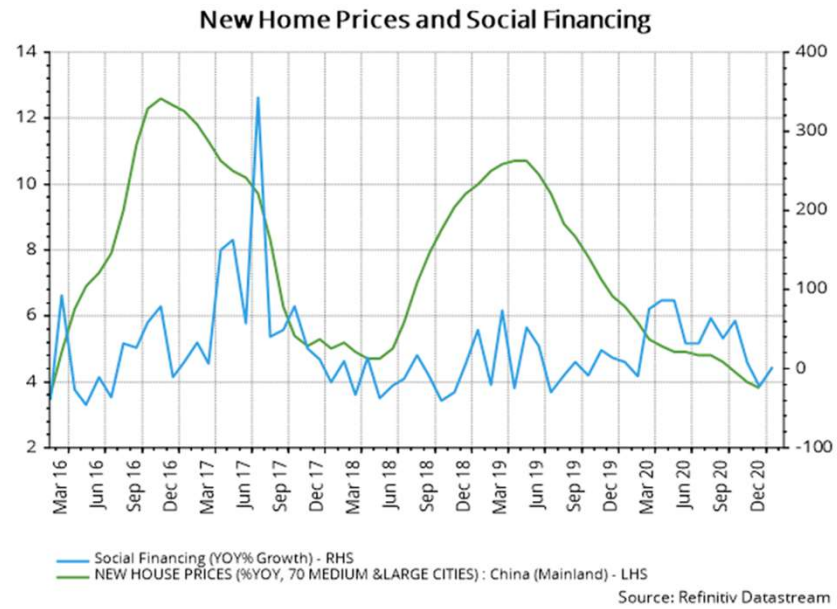
China (Cont.)

- <u>Chinese consumption is now recovering at a steady pace.</u>
  - Retail sales growth accelerated to 4.6% YOY in Q4 with all months showing 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 declined in recent months while social financing levels have remained steady. This decline may actually be healthy as it lessens the likelihood of monetary policy tightening.
  - 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.





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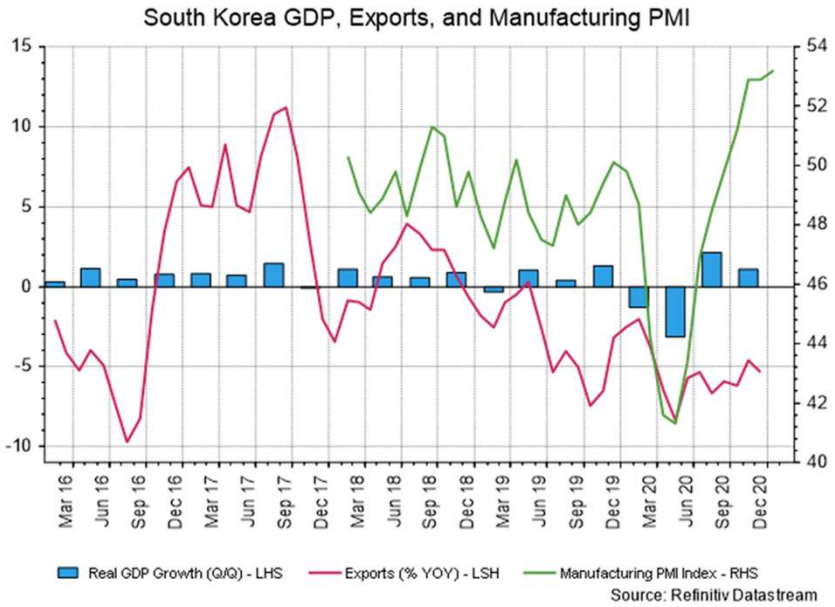
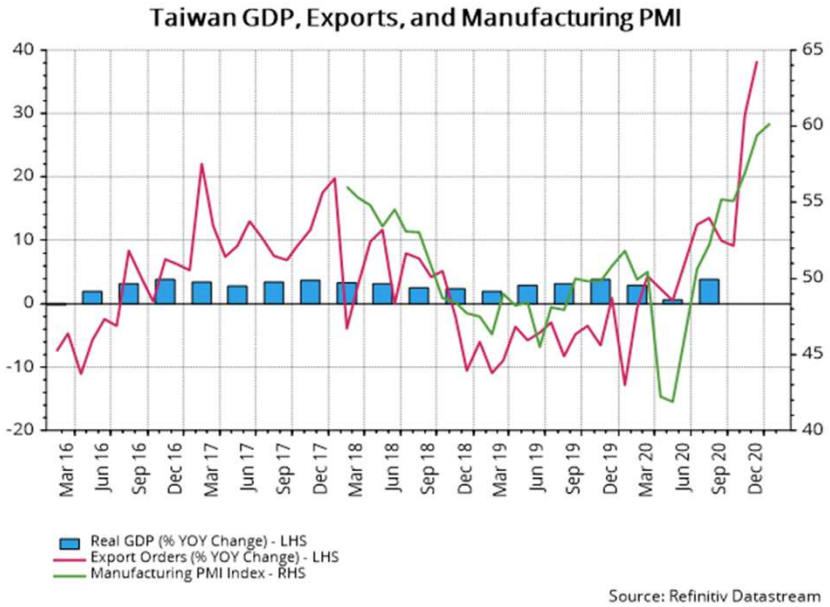
South Korea & Taiwan

- South Korea and Taiwan's economies both grew again in Q4.
  - South Korea's GDP expanded 1.0% Q/Q after a 2.1% increase in Q3. On a full-year basis, S. Korea's GDP declined only 1%.
    - Exports (roughly 35% of GDP) briskly increased sequentially in Q4 (+4.2% YOY) and manufacturing PMI's continued to inflect sharply upwards.
    - Recovery momentum should continue to gather pace driven by strong export prospects as global growth recovers and 5G deployments pick up speed.
  - Taiwan's GDP grew 4.9% YOY In Q4 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 Q4.
  - Going forward, Taiwan is well positioned to benefit from the 5G telecom rollout and demand for COVID-related biotech products.





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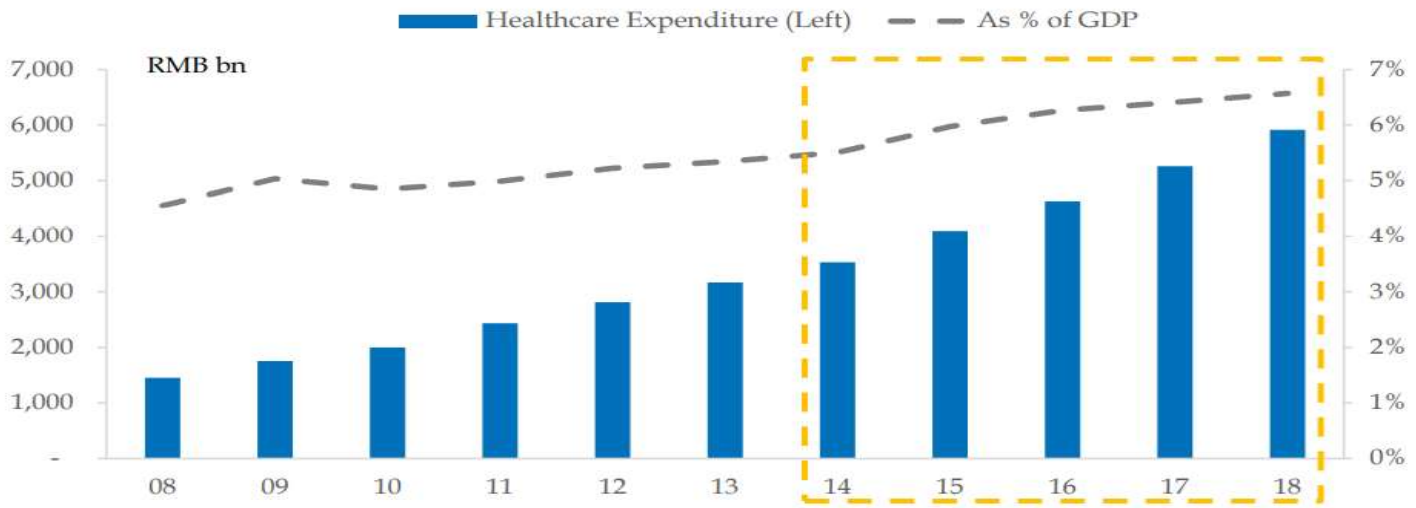
Special Topic: China Healthcare

Why Invest in China Healthcare?

- China healthcare sector expenditures have grown by 67% over the past five years. Going forward, analysts are projecting continued high-single digit annual growth (much faster than overall China GDP growth) driven by:
  - Favorable demographics (aging population), higher awareness and demand for healthcare, increasing insurance coverage and better healthcare infrastructure.
  - Aging population with large unmet needs in areas such as cancer, diabetes and cardiovascular diseases.
  - Influx of Western-trained native Chinese scientific and healthcare executive talent returning home.
    - Led to improving industry R&D capability driven by significant increase in R&D spend over the past 10 years.
    - Unprecedented level of innovation taking place in the biotech arena.
  - Favorable governmental emphasis and generally favorable regulatory policies (more efficient and streamlined drug approval policies).
  - Global multi-national healthcare companies ("MNC's") are increasingly looking for local partners.



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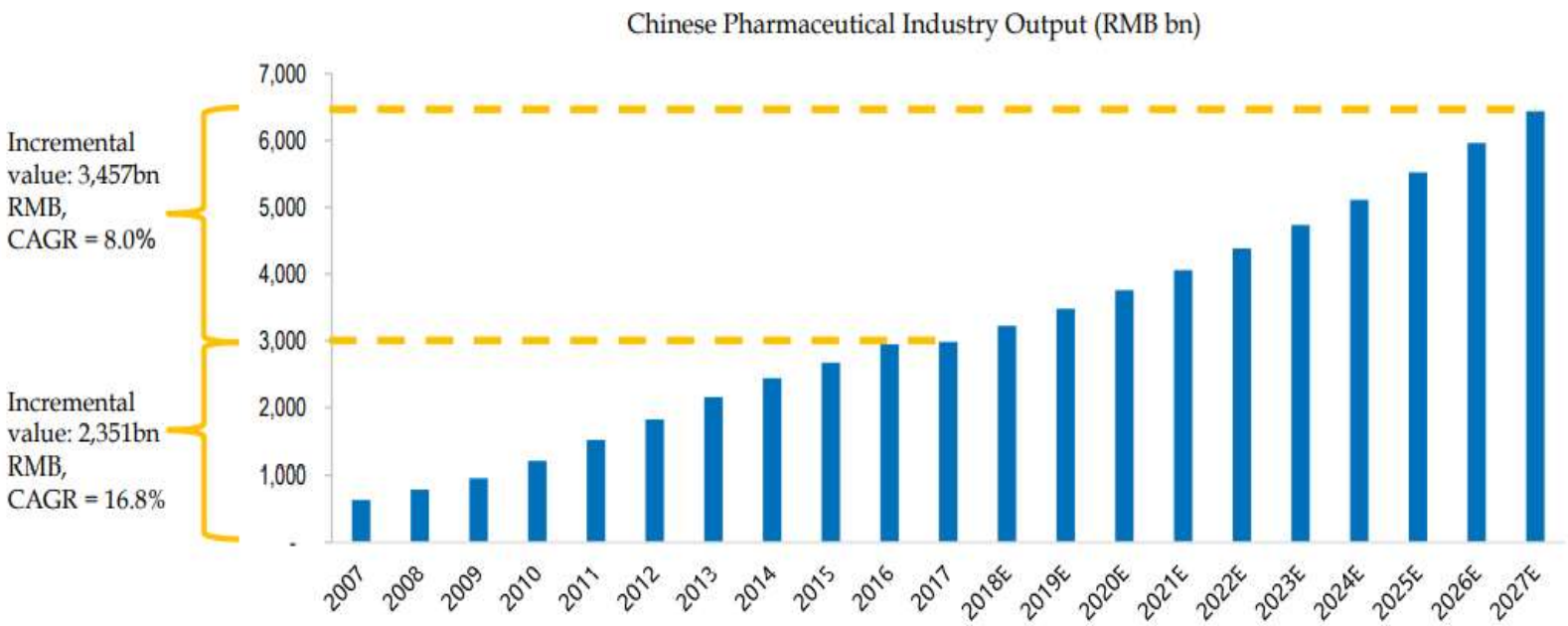
China Pharmaceutical Industry

- The outlook for the Chinese pharmaceutical industry appears especially robust given the factors mentioned on the previous page.
  - Growth is still expected to approximate 8% annually from 2018 through 2027 following a 16.8% CAGR over the previous decade.
  - Further industry consolidation is likely as the industry matures and governmental policies evolve.
- China's pharma industry is undertaking a transformation towards high-quality and innovation-focused development.
  - Beginning in 2015, China has embarked on significant drug regulatory reforms which have shortened the clinical trial process, sped up new drug registrations and encouraged innovation.
  - There has been an explosion in the number of new drug and clinical trial approvals over the past few years.



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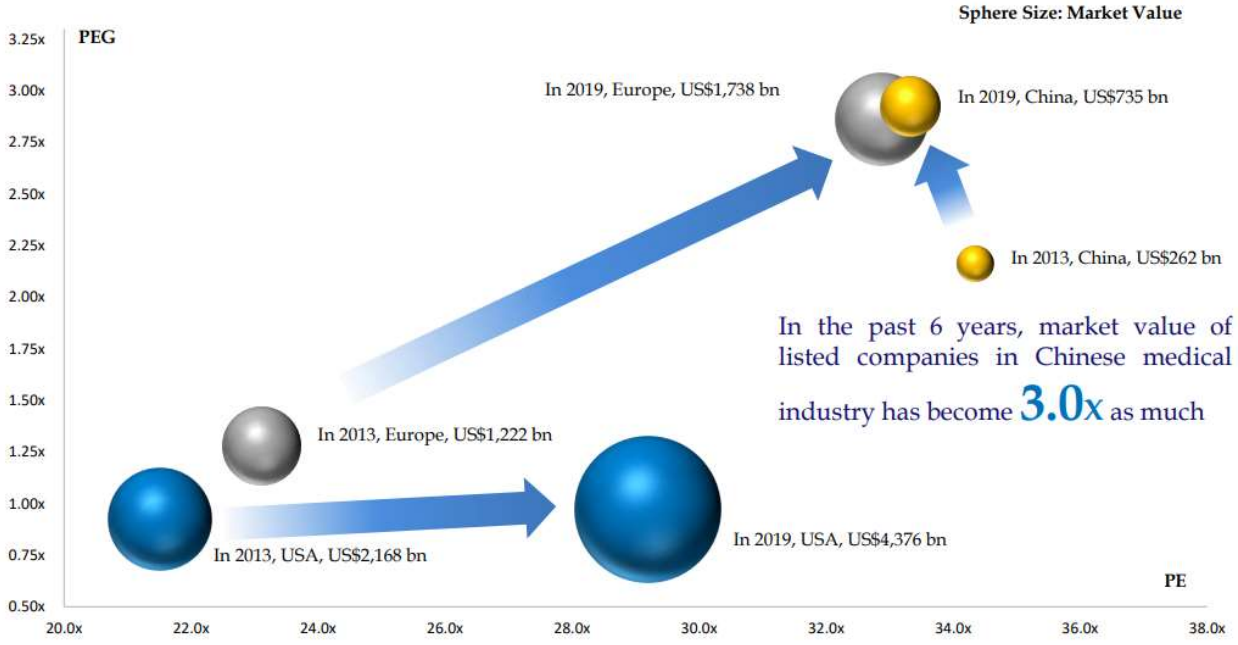
China Healthcare – Public Equity Market

- Despite the market value of listed China healthcare companies growing 3x from 2013-2019, the China public equities healthcare market size is only 19% that of the US listed market and 46% of Europe's listed healthcare market.
  - Analysts expect hundreds of Chinse healthcare companies to go public over the next decade. Even early-stage pre-revenue and pre-profit companies now have increased listing access via Hong Kong and mainland China exchanges.
- China healthcare companies' faster growth has been rewarded as the sector has outperformed the broader China stock market by 600bps annually over the past five years and 1200bps annually over the past three years.

Evolution of Global Healthcare Market Value (2013 - 2019)



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Surging China Healthcare IPO Market

- Driven by an overhaul of the country's health system and relaxed listing rules, the number of healthcare sector IPOs and secondary listings surged dramatically in 2020.
  - Through Nov 11, 2020, 60 companies raised $16.3bln via listings in Hong Kong, mainland China and elsewhere. That figure is 138% higher than the comparable amount raised during the same 2019 period.
  - Many international investors have broadened their focus from Western healthcare markets to Chinese markets and are often acting as cornerstone investors (committing to hold a large stake).
- The Chinese biotech sector is relatively nascent compared to the US and we expect that IPO and consolidation activity will flourish in the sector over the next decade.
- Active management is critical to select beneficiaries of this trend, to identify potential winners in terms of therapeutic and technological treatments, and to avoid potential frauds or companies that attract regulatory clouds.
- BCA is actively researching leading China healthcare-focused managers.
  - Key factors in selecting active managers include **a)** local expertise and knowledge, **b)** proficiency investing in and trading across China healthcare companies listed on various exchanges including H-Shares (Hong Kong), A-Shares (mainland China), and ADRs (US).
  - We seek managers who emphasize understanding biotech expertise (i.e. – therapeutic knowledge among manager staff, access to primary contacts within the scientific and health-care community, etc.)

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