Quarterly Market Letter

June 2020

Fed's Balance Sheet Expands, Risk Assets Go Up. Justified Or Irrational Exuberance Again?

Macroeconomic Developments

- The mood music in financial markets has improved: it was the **best quarter in 11 years**, but the rally concentrated in the tech sector. Emergency financing has been deployed. The Fed has so far been the most generous, adding around 3 trillion to its balance sheet of now over 7 trillion dollars, while ECB and BoJ added 1 trillion each (however, the Fed has been 'tapering' its purchases of U.S. Treasuries to about USD 20B a week during June).[1] The Federal Reserve must bail out the entire global dollar system[2] (which has increased notwithstanding efforts to de-dollarize by some countries). We shall see if the American version of Draghi's "whatever it takes" either entails saving the world, or just the U.S.

- Fed "**wealth effect put**": to do anything and everything to keep the stock market at elevated levels. If making safe heavens unattractive does not suffice, the Fed may simply resort to equity purchases. Is this a bubble? Maybe, unless all fundamental benchmarking converges to better metrics going forward. Likewise, the problem with bubbles is that no one knows how long they will last.

- **EM reopening:** higher risk, higher reward than in DM. EM reopening has, so far, avoided a demonstrable, widespread pickup in COVID-19 infection rates. If medical outcomes avoid left tails, EM credit, EM equities and EM FX have the most room to run. Emerging markets attracted over $32B in portfolio flows in June, a substantial jump from just $3B in May.

- Monetary expansion could mean the beginning of a trend in **USD weakness**, which should bode well for commodities and EM. Cyclical improvement should undermine "safe haven".
    - Dollar strength: Dollar fundamentals have looked poor for a while due to (i) the currency's high valuation, (ii) Fed rate cuts, which have eroded the greenback's carry advantage, and (iii) politically motivated

[1] Expertise Asia, The End of State Finances, July 10, 2020.

[2] Since the Great Financial Crisis, the global role of the US dollar has increased driven primarily by issuance of international debt securities (from USD 6T in 2008 to USD 12T). The global financial markets are even more now dependent on the US dollar, and a single source of liquidity - the Fed. https://www.bis.org/publ/arpdf/ar2020e2.htm.

efforts toward "de-dollarization" by some countries.

- With cyclical risks now easing, the risk/reward in Dollar shorts is improving. If the global economy continues to recover over the next 1-2 years, the trade-weighted Dollar likely has downside- probably in excess of 20%.
- Over the short term, however, two factors are likely to prevent sharp depreciation: i) investors will move back to non-U.S. equities only gradually, (relative underperformance over the last five years); ii) tensions between the U.S. and China could put downward pressure on the Yuan.

- **EM Pacific-Asian economies should perform best**, and Western Europe outperform the U.S.
- While the trade-off between virus-containment and near-term growth is present everywhere, the tension is diminished across much of Europe and Asia. These regions have been far more successful in reducing the outbreak and limiting its reemergence. Moreover, a set of region-specific circumstances support stronger growth: more effective and targeted labor policies in Europe and a sharp boost to tech shipments in Asia.
- **No near-term sudden stop for EM**, but medium-term fragilities remain. The prospect of widespread near-term funding distress appears to have been at least postponed if not averted. Medium-term fragilities exposed by political and institutional fragilities on the one hand, and low growth and high indebtedness on the other.
- **U.S. election**: Biden is leading Trump by high single-digits in national polls and several key swing-state polls. The election is most likely to affect the economy via market sentiment and possible regulatory changes under a new administration (because legislation will be difficult to pass).

Global Drivers

Global Growth

Global growth is stabilizing with data still improving. Evidence of a Chinese economic recovery and an increase in some commodity prices supports the notion of a global economic recovery that is looking V-shaped. As factories reopen, global industrial production momentum is rebounding sharply from a post-WW2 low. Activity has generally been better than expected. The J.P. Morgan Global Manufacturing Output PMI surged a record 7.9pts in June – adding to a previous record – 6.6pt jump in May, when the global recovery began with global retail sales jumping, and mobility data urge continuing into June.[3] However, renewed coronavirus outbreaks in some parts of the world have added reasons to expect the recovery to slow in the months ahead. The worst of the pandemic-induced economic slump seems to have occurred in March and April. The bounce in activity is global in nature. As factories reopen, global industrial production momentum is rebounding. However, it is likely to remain below trend for at least 18 months.

United States

JPM forecasts 12% (annualized rate) 2H20 GDP growth in the U.S.[4] More states reported record rises in new COVID.

[3] Markit Economics, News Release, J.P. Morgan Global Manufacturing PMI, June 1 2020

[4] J.P. Morgan Outlook, You Can't Always Get What You Need

The U.S. is experiencing the deepest economic contraction since the post World War II slump in 1946. Activity is rebounding, however, a resurgence of COVID-19 cases and the expiration of fiscal measures are near-term risks. The COVID-19 situation has worsened notably in the U.S. over the last few weeks, with states representing more than half of the U.S. population moving to pause or reverse reopening plans. The previous upward trend in the U.S. seems to have stalled, due partly but not entirely to developments in the affected southern and western states. Most estimates don't have U.S. GDP reaching its 4Q 2019 level until the end of 2021, and that's assuming there is no meaningful second wave of COVID-19. Business failures and prolonged unemployment are doing long-term damage as well. Growth and the labor market can be expected to remain impaired well through 2021. More fiscal support will be necessary soon, or else income and spending will fall sharply and household financial stress will rise.

Euro Area

The Euro Area is undergoing the largest economic stimulus in over 50 years. The EU rescue fund is an important first step towards a mutual fiscal capacity for the Euro Area.

There was a relatively bullish tone as the ECB announced a larger-than-expected PEPP increase of 600 billion EUR. This was also combined with longer calendar guidance (to June 2021) and a longer reinvestment horizon (to at least 2022). The bullish ECB support could be instrumental in the euro recovery as economies continue to reopen. Fiscal policy across the euro area – most notably in Germany – is being loosened substantially.

Fed Policy Outlook

The Fed has responded with an expanding toolkit. The clear message is that it remains committed to using all its available tools to support the economy. Disinflationary pressures will dominate near term. Potential yield curve inversion is something to monitor as far as equities are concerned.

The Fed acted quickly to stabilize the financial markets, after announcing it would begin buying corporate bonds and municipal bonds, with yield curve control under consideration. The FOMC announced they expect to maintain rates at the current level until they are "confident that the economy has weathered recent events and is on track to achieve its maximum employment and price stability goals." While it's sending a message of accommodative policy, the Fed's balance sheet shows that there has been a modest contraction lately. The Fed has actually been "tapering" its purchases of U.S. Treasuries to USD 4.5bn per day. Fed's balance sheet has fallen for the fourth consecutive week and now stands at USD 6.92tn.[5] The main reasons for the decline are a drop in repo liquidity, reflecting a normalization in money markets, and a fall in leverage and inventory positions of Primary Dealers. This is insufficient to match the impending surge in US Treasury debt issuance and suggests a risk of a drain in market liquidity and a spike in Treasury yields if the Fed does not ramp its balance sheet again.

The Fed now takes small steps towards holding down Treasury yields: it left its policy stance broadly unchanged, but it did strengthen its forward guidance a little – by publishing interest rate projections that show nearly all officials believe the fed funds rate will still be at near-zero at end-2022. It also indicated that it will continue

[5] The Federal Reserve

to purchase Treasury and agency securities "at least at the current pace", although that isn't much of a policy 'bazooka' given that the pace of the Treasury purchases has slowed significantly.

Commodities

Not just another OPEC+ cut. Oil is heading towards $45-$60[6].

Oil traded higher on renewed demand and an expected recovery as economic activity normalizes. Oil prices upbeat reflecting the same pickup in economic activity that was captured across asset classes. Crude got an additional boost from headlines that OPEC+ was nearing an agreement to extend its cuts through July at its original 9.7 mob/d quota. Base metal prices surged on stronger than expected demand rebound in China.

EM Investment Outlook

Liquidity vs fundamentals? "Don't fight the Fed" but "Don't Bank On The Fed Put". Some equity prices seem to have little correlation with current economic fundamentals nowadays. Although valuations are almost useless to time the market, they surely matter in the long run. Stay nimble.

Bull Case

Fiscal policies to support developed economies and China. Risk-on and Fed´s massive monetary policy, weakens USD, lifts commodities, EM. Eventual treatment and vaccine to control COVID-19.

Bear Case

The duration and severity of the economic impact of a second and even a third wave of COVID-19. Stagflation (decelerating GDP growth and higher inflation due to excess printing of money). Asset inflation bubble: the liquidity driving up asset prices in financial markets but does little to help the real economy.

FED and massive inflows have buoyed markets. There is a wall of cash out there, but there is arguably a mismatch between what is happening in equity markets and the real economy, especially in the U.S. where some market valuations look extreme. For equity bulls there is evidence of a Chinese economic recovery and an increase in some commodity prices supports the notion of a global economic recovery that is looking V-shaped (PMI data from the slump in March to the bounce-back recorded in June). Fear of a second virus wave and weaker than expected earnings point to a slower than expected economic recovery. Positivity surrounding a potential effective treatment for the virus (Remdesivir).

March's record selloff in emerging-market stocks and bonds has gone into reverse. Q2 marked the best quarterly performance in nearly 11 years, reversing a significant part of its losses after getting off to the worst start to a year on record, -24% in Q1 2020[6]. After a rocky Q1, EM have had an impressive Q2 rebound and look to be on more solid footing for the quarter ahead. EM Asia has led the way in equity and currency markets and is still poised to outperform. The prospect of easy central bank policy continuing for the foreseeable future is the critical factor.

Ongoing policy support may spur further gains in risky assets against the backdrop of a gradually recovering global economy and continued support by central banks. EM markets rose driven by bigger than expected policy support (via monetary, fiscal, and balance sheet) and

[6] J.P. Morgan: Best Quarter in Nearly 11 Years, July 2020

better economic recovery than forecasted, hence the MSCI EM Index (net) rose 7.0% in June, outperforming DM (+2.5%). Among regions, EM Asia was the best performer (+7.8%) followed by LatAm (+5.2%) and EMEA (+3.2%).[6] As of June 30th the U.S 10y Treasury yield was at 0.66%. So far, there has not been any major correction in the equity markets, presumably because investors believe that the Fed and the other major central banks will continue to provide support in the form of expanding their balance sheets further through an increase in asset purchases and the provision of liquidity to the banking system. However, it cannot be taken for granted that central banks can be guaranteed always to stand behind the equity markets.

Looking ahead, the next economic cycle might end up being little different from the 2009-2019 economic cycle. That cycle was characterized by the weakest-ever (but longest) economic expansion, record global debt-GDP, a persistent downtrend in fixed asset investment and productivity and a US economy that could not withstand a peak in the fed funds rate cycle of 2.5%.[7] The next cycle will be saddled with a legacy of much higher debt and with unprecedented central bank intervention.

Risks

Another wave, a trade war between the U.S. and China and the U.S. elections all loom as potential headwinds.

The breadth and depth of the COVID-19 induced global recession poses a uniquely difficult challenge. Central Banks and governments around the world have endeavored to provide a safety net for their individual economy until a vaccine for COVID-19 is developed, using the most aggressive monetary and fiscal policies in history. In many developed countries the unemployment rate for those under 25 is north of 20%, and it is going to remain high.[8] The BLM protests in the U.S. may be a foreshadowing of events to come around the globe if a global recovery is stymied by the lack of a vaccine before mid-2021.

- **Some valuations look stretched:** apparent disconnect between equity markets and the real economy showing only a modest pick-up in GDP growth. The OECD's composite leading indicators have increased from their lows but are still below the long-term average. The OECD contends that the recovery globally is still "fragile".
- Global liquidity is expected to increase by about 25% for all this year and is a key factor in explaining the uplift in risk-assets. The threat for equity markets is a seemingly persistent dependence on central bank liquidity triggering **irrational exuberance and potential financial bubbles.**
- **Increasing risks of defaults.** An increase in corporate defaults seems inevitable. U.S. corporate debt-GDP already stood at 50%[7] and policymakers acknowledged through the course of last year, the potential risks associated with the leveraged loan market. 50% of the US investment grade corporate bond market was BBB-rated.[7]
- **Growing protectionism globally.** Trade volume will rebound as the global economy recovers, but the trade environment and attitudes toward globalization have changed. The U.S. – China War has and will continue to disrupt supply chains and add to uncertainty. Any escalation in U.S. – China tensions could knock us back again. The deterioration in U.S.

[7] VTB Capital, Global Macro Jottings, July 2, 2020
[8] Macro Tides, July 2020, MacroTides.com

– China relations remains a major source of concern but, at least over the short term, both sides will prioritize economic recovery and attempt to avoid a serious escalation.

- **Geo-political tensions** between China and India, and North Korea and South Korea.
- The **U.S. Presidential Election** in November is moving onto investors' agenda and the opinion polls give the Democrats a high-single digit lead.

Emerging Market Equities

In aggregate, emerging markets had the best quarter in over eleven years, rebounding strongly after the quick spread of the COVID-19 virus and the ensuing economic havoc in 1Q. While the performance of the asset class is roughly 90% of the way back to pre-pandemic prices, the rally has not been broad-based as the North Asian countries (China, Taiwan, South Korea) have relatively outperformed the rest of EM. We would attribute some of this premium to a strong initial handling of the pandemic and a well-built health care infrastructure that is quickly able to handle subsequent flare-ups. Since technology is also a large component of these economies, the recent strong move in the Information Technology sector globally also provided a tailwind to performance.

While many EM companies are currently attractive from a bottom-up basis, we continue to be very selective on our country exposure given heightened volatility in many underlying currencies. The twin crises of the pandemic and oil price volatility continue to create a mixed bag of winners and losers, as evidenced by recent IMF comments on possible interventions and aid packages to many countries by year-end.

Going into 3Q, political risk remains elevated in Brazil where multiple government officials have resigned due to Bolsonaro's controversial handling of the pandemic. Given yet another investigation into alleged corruption within the administration and a significant economic reliance on commodities that are dependent on a resumption of global growth, we expect to remain underweight in the near term. Political risk is also high between China and the U.S., as well as between China and Hong Kong. There appears to be broad bipartisan support within the U.S. government to match heated rhetoric with actual policy initiatives against China, which we believe would create unnecessary volatility in an already unstable global economic environment. We are also monitoring recent border skirmishes between China and India, as well as a flare-up of tensions between North and South Korea. Despite this backdrop, we would expect further traction on potential vaccines and antibody treatments to COVID-19 before year-end, increased monetary stimulus by global central banks, and significant fiscal stimulus in most large economies to continue to elevate equity markets.

We had above-average portfolio activity in 1Q to improve the quality and concentration of our portfolio; we remain confident in this positioning and would not expect any wholesale changes in the near-term. Our research docket is focusing on two countries where we are underweight: India is the cheapest it has been in years and China is seeing a strong economic rebound that may not be fully captured yet in certain sectors. We may increase our allocations to both countries as opportunities arise.

Country Updates

China

Impressive rally since March. Chinese equity markets are at a five-year high.

Despite the rapid recovery, policymakers have no intention of taking their foot off the accelerator – notwithstanding recent increases in market rates. Monetary easing will continue in 2H20, led by credit expansion, critical for the ongoing investment-led recovery. PMI readings for June (both NBS and Markit) echoed the strong activity data for May. Recent increases in key financial market interest rates have been attributable to PBOC normalization from aggressive measures earlier. Real estate is already illustrating positive YoY growth while manufacturing lags. Elevated deficit does not imply aggressive stimulus.

Chinese equities have staged an impressive rally since March. The rally is a combination of factors including robust economic reopening/recovery, well-contained COVID-19 resurgence risk, supportive macro policy and positive government rhetoric towards the equity market, improving corporate earnings trends, undemanding valuations, and rising retail participation.

Chinese equity markets are at a five-year high. China would want to reduce its dollar dependency and ensure a move towards a multi-polar currency system, though this is likely to be a slow process. Cross-Border Capital points out that China's share of the USD 140tn pool of global liquidity (defined as total savings and credit) now stands at 25% compared with just 6% two decades ago.[9]

Brazil

Fiscal consolidation undermined by the crisis. Deteriorated social conditions make the scenario for reforms challenging.

President Bolsonaro is trying to reduce political tension while COVID-19 cases near 1.5 million. Industrial production rose 7% month over month in May however it still remains 20% below February levels. Fiscal deficit at 16.5% of GDP this year. Government's measures announced so far and additional steps to contain the negative impact of the COVID-19 crisis should increase the primary deficit. Gross debt is expected to exceed 90% of GDP, but mostly domestic. Low inflation, due to lower commodity prices and the collapse of domestic demand, will likely lead the central bank to lower the policy rate to 2.0% for a prolonged period. Declining current account deficit, high FX reserves and low external net debt should keep the risk of a balance-of-payments crisis low.[10]

Mexico

Vulnerable rating.

Mexico will continue to suffer from the global contraction and from the reduced volumes of international trade. Domestically, it will not help that there is no fiscal stimulus in response to the health crisis, while monetary policy stimulus won't be far-reaching. The President's commitment to fiscal discipline is likely welcomed by fixed income investors and ratings agencies. It is unclear, however, if it will be enough to eventually avoid additional ratings downgrades that would strip the sovereign from the IG rating.

[9] J.P. Morgan, Global Data Watch, July 2, 2020
[10] Credit Suisse, Global Economics Quarterly: A Year Like No Other

Argentina

Two key drivers: lockdowns and the debt restructuring. Macro imbalances and uncertainties predate these drivers.

Argentina has announced its second offer to exchange sovereign bonds, open until August 4th. The offer improves the terms over the initial offer made in April, offering to pay 53 to 61[11] cents on existing bonds. Argentina has missed its bond payments since April; the offer now includes a bond for accrued and unpaid interest.

The intensification of macroeconomic imbalances given strong monetization of fiscal spending foreshadows a macroeconomic adjustment post-quarantine. Economy to contract 12%.[11]

Ecuador

Positive agreement, but with high implementation risks.

Ecuador reached a debt restructuring agreement with a large proportion of bondholders. The deal facilitates an IMF agreement, but the tradeoff for higher cash flows is slower reduction in debt ratios. The rally in bond prices is justified by better-than-expected cash flows, a speedy resolution, and low deal completion risks. Nevertheless, high exit yields are warranted by election risks and large implementation risks for the sizable fiscal adjustment.

Russia

Authorities stick to orthodox policy toolbox.

The government and the financial system were well prepared for this crisis thanks to the constant threats of sanctions from the West over the last five years. Relative to other emerging and developed countries, the central bank and the government are running extremely conservative policy. The central bank keeps one of the highest real interest rates in the region. The government remains reluctant to spend all its fiscal reserves, instead focusing more on borrowing in the domestic market. Underlying fundamentals for the RUB remain generally supportive: Russia's current account surplus, while lower, still stands above that of other EM high yielders, as do Russia's FX reserves.

Turkey

Risks to the lira. Reserve loss to remain under the spotlight.

The monetary expansion and the credit stimulus that followed the pandemic-driven shock added pressure on the lira. The authorities responded to the depreciation – driven by the monetary expansion and challenging balance of payments backdrop – by drawing down the central bank's already-low gross non-gold FX reserves. The central bank appears to have sold more than $50bn in FX through state banks so far this year. The extent of the drain is masked by an increase (equivalent of $10bn) on 20 May of the central bank's swap deal with Qatar and an increase of about $25bn in the stock of the central bank's currency swap transactions with local banks. [10]

The country's scheduled external debt repayments are smaller in 3Q than in 2Q, which might ease the pressure on the lira/reserves in the near term. Further reserve loss would aggravate investor concerns around Turkey's external debt repayment capacity, but we do not doubt it.

South Africa

SARB bought some time for the government, but further ZAR weakness likely consequence.

[11] HSBC Global Research, Argentina Debt Second Offer; Improved Terms

The economy is re-opening despite worsening COVID-19 cases. There are tentative signs of a pick-up in activity but also growing evidence of the economic destruction from the lockdown. Fiscal pressures are clear. Tax revenues have fallen circa 20% on a year ago, despite soft expenditure numbers. The budget deficit doubled in the first three months of FY20/21 (ending March). Non-residents remain net sellers of government bonds, placing focus on local financing and the imperative for credible fiscal adjustment.

The monetary policy was the main mechanism to ease the negative impact on economic activity. South African GDP to contract 11% this year. The MPC cut the policy rate by 250bps, to 3.75%. It also gave a hand to the government by starting purchases of government bonds, at a fairly small size (totaling 0.6% of GDP). Although the government introduced the fiscal package (10% of GDP, of which 8% is credit guarantees scheme, tax relief measures and budget reprioritization), it did not clarify what will be its main financing sources and how is it going to solve the fiscal sustainability problem that earlier in March led to the downgrade of SA's rating to below investment grade from all three major rating agencies.[12]

We thank you for your continued support.

The RVX Team
RVX Asset Management LLC
20900 NW 30th Avenue, Suite 401
Aventura, FL 33180
www.RVX-AM.com | Phone: +1-305-363-6890
Fax: +1-305-675-0394

[12] HSBC: South Africa: 100 Days of Lockdown.

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