Quarterly Market Letter

September 2020

Pump Priming Stops, Slowing the Recovery for Now. Blue Wave?

Macroeconomic Developments

- Pause in asset inflation: major central banks are maintaining, but not yet expanding their monetary policy support.
- The world economy took a huge hit from the coronavirus pandemic in March/April, but it is adapting to the virus and will hopefully contain it with the help of a vaccine before too long. An unprecedented policy stimulus has allowed **global GDP to rebound from the Q2** plunge but the recovery is uneven and the outlook opaque as renewed restrictions are being imposed around the world. We are now in a slower phase of the recovery, but momentum is still visible: September's relatively strong batch of emerging market **manufacturing PMIs** suggests that recoveries in industrial production continued last month. However, the recovery may likely remain incomplete. Eye-popping quarterly growth readings mask the sustained depressed employment and profits, which could slow the recovery, as will fading policy supports.
- The more important **U.S.** lever in Q4 is fiscal, where odds of a Congress/White House deal are diminishing. After a final round of extra unemployment benefits that is currently being disbursed, any further fiscal support will likely have to wait until 2021. The withdrawal of fiscal support will reduce disposable income in Q4 to roughly the pre-pandemic level. This will weigh on consumer spending, probably by less than initially feared. While health care and macroeconomic policy are likely to remain obstacles to a complete recovery, private sector behavior has proved surprisingly resilient.
- **U.S. elections:** As of now, the betting odds for the 'next President' are 59.1% for Joe Biden and 36.8% for Trump. Senate control favors the Democrats (64.8%) with the Republicans at 35.1%. For control of the House, the Democrats odds are 86.5% against 13.4% for the Republicans. Hence the odds of a Democrat 'clean sweep' are 33% (0.591 x 0.648 x 0.865).[1] A "blue wave" in which Democrats gain unified control of Washington is becoming more likely. It would sharply raise the probability of a fiscal stimulus package of at least $2 trillion in 2021.[2] A recessionary unemployment rate and depressed incomes following the expiry of government aid programs will push the pocketbook votes toward Joe Biden, while social unrest will likely boost voter turnout, giving an edge to Democrats.

[1] Electionbettingodds.com
[2] Goldman Sachs

- **World trade** rebounded to 2019 levels, but not everybody is sharing in this recovery equally. World trade volumes will decline 9.2% this year according to the WTO. China was the first to spring back to its feet – exports are now higher than ever – while some of the EM export powerhouses are struggling to catch up. Part of the explanation for the divergence lies in differences in recovery boosting policies. EM currencies have only recovered about half of their losses against the dollar so far, as have commodity prices. Likewise, even excluding tourism, services exporters have struggled and in a fashion unseen during the GFC. U.S. trade deficit swelled to its largest since 2006 in August. President Trump has frequently pointed to the trade deficit as a gauge of his trade policies' success. The growing gap gives him little to brag about heading into the 2020 election.

- **COVID-19:** EM mobility continued to recover in early September as diagnosed COVID-19 infections stabilized – with some exceptions. It contrasts starkly with the U.S. and Europe, where recovery has lost some steam amid a resurgence of infections. On the fiscal front, the U.S. and UK highlight the risk from an abrupt unwind of an emergency stimulus. Absent action, we look for a sharp slowing in both countries into the year-end. Complacency is likely to become a broader issue as the 2H20 growth rebound is likely to take policymakers' focus off next year's fiscal drag when planning 2021 budgets. Renewed national lockdowns across EM appear unlikely, but recovery could be stop-start in nature.

- **Central banks** intend to raise inflation signaling a commitment to accommodation. Balance sheets continue to expand, with many EM central banks now engaging in QE. While their ability to deliver on this is less clear, they may have reached the limits of their toolkits. They project current policy stances to deliver a sustained inflation undershoot. Neither the ECB nor the BoJ expects to get close to its inflation objective through 2022.

- **Inflation** has been largely disconnected from business cycle ups and downs over the past 30 years. U.S. unemployment fell to a 50 year low pre-COVID but inflation did not go up as the Phillips Curve would have predicted.[3] Most central banks have some variant of the Phillips Curve as the main driver of their inflation models, which might have contributed to interest rates falling to a lower level than would otherwise have been the case.

Global Drivers

Global Growth

Broad-based Chinese growth and solid gains in U.S. consumption. Global growth has moderated from its torrid midyear pace.

Recent **U.S. PMI data** for September confirmed that activity in the manufacturing sector is holding up, though service sector PMIs were less buoyant. The housing market is recovering

[3] VTB Capital, Global Macro Jottings, Growth Trends, Sept 2020

strongly, reflecting low mortgage rates. The weaker-than-expected **U.S. employment** report for September confirms that the pace of labor market improvement has slowed through the third quarter.

The global economy's rebound from the lows of Q2 has been impressive. Output has surged as lockdown restrictions have eased and some economic activities have been restored. Economic policy also helped, particularly fiscal policies that sustained household incomes despite a collapse in hours worked. After the remarkable rebound in Q3, growth will inevitably slow in the quarters ahead. A second wave of coronavirus infections during the northern hemisphere winter could lead to tougher social distancing restrictions. That may already be underway in Europe.

The Chinese economy seems to still be on a recovery trajectory. Stronger industrial profits growth and a recovery in activity led by stronger credit expansion and infrastructure spending have been the key factors. The consensus base-case is a recovery in global GDP growth in 2021, with China leading the way.

Ex-China GDP will finish this year nearly 5% below pre-crisis levels.[4] Although treatment has improved and mortality rates have decreased, COVID-19 has not been contained and new cases globally have moved back to their mid-year highs. At the same time, there is no evidence that fiscal policy is moving to offset the run-off in emergency stimulus.

What looks like the **Japanification of the Eurozone** i.e. low growth, deflation and zombie banks must surely be high on the agenda. Despite a surge in liquidity and a significant expansion in the size of the ECB's balance sheet (now greater in size as a percentage of GDP at 54% compared with 33% for the Fed), there are also signs in the PMI data for September that the Eurozone economic recovery is losing momentum.[5]

Fed Policy Outlook

The Fed indicated it has no plans to inject any fresh stimulus at this point, although interest rates will stay near zero until at least 2023.

The Fed's updated projections suggest three-plus years just to reach 2% inflation, let alone a sustained overshoot to raise average inflation to 2%. Fed funds will stay near the zero lower bound over the coming years. Under the new average inflation targeting framework, the Fed now aims "to achieve inflation moderately above 2% for some time so that inflation averages 2% over time." The Federal Reserve bought corporate bonds for the first time in its history, and likely outside the range of its charter. Fed Chair Jerome Powell reiterated that the Fed is prepared to adjust asset buying as needed, as it has stopped net liquidity expansion around two months ago. Treasury purchases have been offset by a reduction in liquidity in several support programs, no more corporate bond purchases, as well as the formidable issuance of U.S. treasuries.

No new measures (yield caps, larger QE) were introduced, but the Fed stands ready to act if the economy slows too much.

Commodities

A surprising comeback. Commodities are set up for a new dawn, and already initial strength is broadening out.

Bearish trend for the U.S. dollar (USD): consequence of a weaker USD is improving

[4] J.P. Morgan Outlook, Global Data Watch, October 2020

[5] VTB Capital, Global Macro Jotting, Eurozone Deflation, Sept 2020

commodity prices. Copper broke out of a downtrend that started in mid-2011. The S&P Metals & Mining SPDR (XME) is also trying to break out of a downtrend that started in mid-2018. If we exclude energy prices, global commodity price indices recovered to a level surpassing the multi-year average. Iron ore and agricultural products made an especially strong comeback. This will obviously play into the hands of commodities exporters, mainly EMs, but the effects are likely to be temporary as they come more from a pandemic-induced disruption in supply chains rather than a structural shift.

Commodities (at an asset class level) have seen a familiar market breadth pattern emerge, which points to a cyclical bull market.

EM Investment Outlook

Secular lows in bond yields and record highs in equity markets. The environment for EM assets remains positive. EM real yields remain positive and EM currencies are generally under-valued.

U.S. equity valuations are both very expensive (vs history) and very cheap (vs bonds). Global equities look to be in a new bull market, but confirmation is still pending (ex-U.S.). It seems all that matters is liquidity and how that translates into real yields. Significant expansion in central bank balance sheets together with the sharp increase in budget deficits and debt levels in the major economies, raises the prospect of debt monetization and/or financial repression i.e. negative real rates.

The current environment is one of rising risk appetite, as easing liquidity conditions in EMs and lower external risks brought about, in part by the onset of a weaker dollar, has narrowed spreads. However, we've recently seen spreads widen again amidst rising concerns. The constructive tone in EM can be measured by the fact that primary issuance continues to accelerate and is now set to post two consecutive months of record supply. The counter-argument is often supply indigestion; however, this has not yet developed into a theme.

Defensive assets are extremely expensive - perhaps no surprise, given the still substantial demand for safe assets and global surge in central bank asset purchase programs. Emerging Markets: a big part of the 2020 recovery thesis is the global monetary policy pivot. Not many have noticed, but EM central banks have been particularly aggressive in easing policy. Given some of the cycle indicators have already begun to stabilize for EM, we should see a cyclical upturn across emerging economies in the coming months and quarters.

EM assets will increasingly focus on U.S. election scenarios and this will likely necessitate paring down risk over the coming weeks.

Risks

There are numerous ongoing geopolitical tensions but the near-term risks stem primarily from a scenario of a second wave of the pandemic. Large debt restructurings in Argentina and Ecuador have concluded, but focus now shifts to U.S. elections.

- **Second wave of COVID-19 cases**: Even before the renewed lockdowns in various regions and countries, there was already a broad acceptance that the level of GDP will be permanently lower than it would have been in the absence of the pandemic. Higher unemployment and higher debt appear inevitable but there are also implications for equality, financial stability and long-term growth potential. Premature withdrawal of fiscal policy would hurt consumer spending. By compensating households and businesses for incomes lost during this period of depressed activity, government and central bank balance sheets have borne much damage from the coronavirus shock.

- **U.S. Presidential Election (3 November):** Democrat intention is to increase the U.S. corporate tax to 28%, impose a wealth tax, as well as to add regulatory pressure on the big tech companies and to push-back against further easing of regulatory policy on U.S. banks. Should Joe Biden win and the Democrats secure control of the House of Representatives, many investors expect a weaker dollar and a lift for EMs. But a drawn-out, disputed election would be far messier. In a stampede out of riskier assets and a rush for the safe haven dollar, the bull case for EMs is likely to be overlooked. The market 'surprise' would be a win for President Trump and retained control of the Senate.
- **Weak U.S. economic recovery** if more stimulus is not enacted. Failure to pass adequate and timely stimulus endangers the U.S. economic recovery.
- Chief risk is that **'fiscal cliffs' in the U.S. and elsewhere cause growth to stall**, leading to a "double dip" and a far greater need for balance sheet restructuring. Backstopping financial conditions is the largest, fastest and broadest-based increase in debt and deficits since WWII era with slower growth and near or below zero yields for longer, pointing to lower returns.
- Regardless of who wins the Presidential Election in November, the president will be faced with what many commentators would regard as an unsustainable fiscal position. The Fed and the Treasury might just monetize the debt i.e. more QE or an actual transition to informally adopting Modern Monetary Theory (MMT), arguing that Japan is doing it with debt levels of 250% of GDP without too much damage to the economy. Even prior to the pandemic, the U.S. budget deficit was 4-5% of GDP, historically unusually high at that stage of the U.S. economic cycle (until February, the U.S. economic expansion was the longest on record even though the pace of GDP growth over the course of the cycle was one of the softest).[6] The U.S. net national savings rate registered a record decline in the Q2 and the U.S. current account posted a record deficit in the same quarter. Overall, this worsens the U.S. positions as a world debtor. U.S. non-financial debt is at a record 300% of GDP and U.S. equities as a percentage of GDP stands at a record 267% compared to previous highs of 181% in 2007 and 202% in 2000. These are warning signals that the so-called **Everything Bubble** is at risk of implosion not just for equities but also for credit markets.
- Substantially higher quantities of government debt, central bank reserves, and broad money have raised **concerns about inflation**. Inflationary economic policy is offsetting an extremely disinflationary economic shock at present. So policy decisions made this year are unlikely to mean a surge in inflation. But having borne such damage, public sector balance sheets will be weaker after this crisis. The capacity for further large increases in government debt without generating inflation is diminished. So, although the risks to inflation in the near-term are that it resets lower in response to disinflationary headwinds from the crisis, further out the risks are that inflation is higher and more volatile than it has been in

[6] VTB Capital, Global Macro Jottings, Uncertainty Persists, Sept 2020

the past 25 years. That remains a risk, not a certainty. Policy decisions, or shocks, that could cause that higher inflation have yet to happen.

- United Kingdom: No-trade-deal **Brexit** would lower GDP by 1ppt by 2022. Increased trade frictions and a negative reaction from financial markets would more than offset looser policy settings.

Emerging Market Equities

We would expect above-average volatility going into year-end due to many factors: (1) global economic data appears to be generally weakening as stimulus benefits have run its course (2) there are early indications of a potential second wave of COVID-19 infections in many countries that could lead to more lockdowns (3) a contested U.S. election may add to geopolitical uncertainties. In this market environment, we would expect defensive positioning to relatively outperform. As a result, we expect to pare back some of our winners from 3Q and use the proceeds to moderately increase our defensive exposure. Our research docket is focused on new opportunities in India and Brazil.

Especially if the U.S. election results face a prolonged outcome, we would expect the dollar to weaken (as it did during Bush-Gore in 2000 and Nixon's impeachment in 1974), which in turn would provide a tailwind to emerging markets equities. As EM countries rebound from pandemic-induced slowdowns, we believe the demand for the dollar may come down as well.

Country Updates

Argentina

Central Bank to allow greater volatility in peso.

After months of intense negotiations, the Argentine government reached agreement with 99% of bondholders to restructure its debt. Argentina outlook changed to stable from negative by Moody's on debt restructuring. As a result, its annual debt service on the newly restructured debt will remain below USD 5bn until 2024, but it will spike markedly thereafter.[7] Imbalances pose a difficult choice for BCRA. Corporate debt maturities have halved Argentina's net international reserves, to just $6.8bn. Confronted with the choice to correct the imbalance via currency devaluation, the BCRA this week kicked the can down the road by imposing tighter capital controls. The biggest surprise was new restrictions on firms' access to official-rate dollars to service FX debt. Due to the decrease in foreign reserves, corporates with monthly f/x debt maturities above US$1mm through March 31st, 2021 must present a debt restructuring plan to the Central Bank, which should consider at least a 2-year extension of 60% of the maturities.

Brazil

Industrial output printed another solid performance. Approval rates of the Bolsonaro administration increased to 40%.

PMI release for September shows manufacturing indicator continues strong, close to 65.0, the highest level in the history of the index for Brazil, recovering most of the loss during the pandemic. SELIC hit a record low of 2.0% after a 25bps cut in August 2020. Inflation rate of August 2020 LTM was 2.44%, down from 4.31% in December

[7] Moodys, Rating Action: Moody Affirms Argentina's Ca Rating, Changes Outlook to Stable, Sept 2020

2019. Gradual loosening from lockdown restrictions and operations going back to normal, unemployment rate reached 14.3% in August.[8]

Despite some frustration with the volume of direct investments, they remain more than sufficient to finance the current account gap. The positive surprise regarding the current account balance and the net inflow of foreign portfolio investments mean the external sector data will not become a source of concern.

Mexico

Industrial activity registers 22 months in negative territory.

Banxico decreased the base interest rate to 4.25 from 5% through two consecutive cuts of 50 bps and 25 bps in August and September. September Inflation rate stood at 4.1% (target: 3.0% +/- 1%).[8]

S&P lowered Mexico's 2020 economic decline estimate to 10.4% from 8.5% yet mentioning that this not necessarily mean another credit rating downgrade.[8] In late September, President Obrador met with the energy regulators to discuss his energy memorandum sent in July. They agreed Pemex and CFE will be favored and they will review the current legal framework and if necessary, propose a new energy reform next year.

China

Economic momentum firmly on an upward trend. Solid fundamentals support further CNY appreciation.

Remarkable recovery continues delivering stronger-than-expected activity readings. CNY strength is mainly market-driven, with little evidence of PBOC intervention. Uncertainties related to the U.S. election and implied capital outflows point to two-sided risks ahead. While the U.S. election outcome won't end the conflict it will affect the tactical approaches the U.S. government takes in a number of areas. FTSE Russell said it will add Chinese government bonds (CGBs) to its flagship World Government Bond Index (WGBI) from October 2021, subject to final confirmation in March 2021. This is a recognition of China's reform work in enhancing the market for easier foreign participation.

Growth is expected to improve further in the near term, comfortably exceeding 5.0%. Household consumption remains a drag, while industrial and service production and fixed investment are supporting growth. In light of the continued solid economic data, Chinese policymakers seek to strike a balance between supporting growth and preventing long-term risks.

Turkey

CBRT delivered a hawkish surprise.

Against market consensus, Turkey's Central Bank (CRBT) tightened its main policy rate (one-week repo) by 200 bps to 10.25%.[9] This marks the first monetary policy tightening action by a major EM central bank since the start of the COVID-19 crisis. Foreign exchange reserves have kept plummeting. Although the recent dollar weakness might have slowed the lira's decline, there remains downside potential for TRY.

GDP contracted 9.9% y/y in 2Q20 and 11% q/q. The TRY has depreciated 15% since July 1st, reaching a record high of 7.84.[8] Given the foreign reserves deterioration, currency depreciation and current account deficit, S&P downgraded

[8] BCP Securities, Economic Outlook and Emerging Markets Top Picks: 4Q20 October, 2020
[9] Gramercy, EM Weekly: A Qualitative and Quantitative Emerging Markets Review, Sept 2020

the sovereign to B+ while Fitch revised its outlook to negative.

In August, President Erdogan announced the biggest natural gas discovery ever in the Black Sea of 320bn cubic meters, with claims that it can reach Turkish consumers by 2023 and would significantly reduce gas import needs. Controversy in the Eastern Mediterranean continues as Turkey continues its gas exploratory activities, which are currently disputed by Cyprus and the EU. Additionally, the country has pledged its military support to Azerbaijan in the ongoing conflict with Armenia, while it continues with its presence in Libya in Northern Africa.

Russia

Geopolitical tensions surrounding the poisoning of Alexey Navalny and Russia's involvement in the political crisis in Belarus.

This volatility has prompted the central bank to pause its policy easing cycle, and any further easing is unlikely to resume until next year, when fiscal consolidation starts to weigh on demand and inflation.

Ukraine

President Zelenskiy will participate in the annual EU-Ukraine summit.

Speculation about a possible upcoming Eurobond deal by Ukraine. Such a transaction, in combination with some relatively minor cut of the budget deficit, would help Ukraine to make it through the end of this year without another IMF tranche with its cumbersome conditionality on anti-corruption and judicial reform.

The government once again emphasized the privatization of state-owned enterprises, estimating realistic proceeds from such asset sales between USD 200-500mm in 2021.[10] Centenaro (CEEN) was once again included in the top-priority privatization list. Other large-scale energy objects for privatization are several (five) provincial electricity distribution networks.

Ukraine's corporate sector was significantly disrupted during H1 20. A drop in industrial demand for electricity only served to increase downward pressure on electricity prices, ultimately helping catalyze the DTEK Energy default, but also adding to the issue of payment arrears in the sector (affecting DTEK Renewables).

Nigeria

Oil reform bill to privatize the Nigerian National Petroleum Company (NNPC).

It proposes creating a limited liability corporation into which the ministers of finance and petroleum would transfer NNPC assets. The government would then pay cash for shares of the company and it would operate as a commercial entity without access to state funds. The changes could make it easier for the struggling company to raise funds. However, the bill does not require the government to sell shares in the company and, unlike previous reform proposals, does not set a deadline for privatization to be completed. The legislation would also amend controversial changes to deep offshore royalties made late last year by cutting the royalty that companies pay the government for offshore fields producing less than 15,000 barrels per day to 7.5% from 10%. It would change a price-based royalty too, so that it kicked in when oil prices climbed above $50 per barrel, rather than $35.[11]

[10] Centre For Economic Strategy, Privatisation in Ukraine: high jump after years of crawling?, March 2020

[11] Reuters, Nigeria Would Turn NNPC into LC, Amend Royalties Under Draft Oil Reform Bill, Sept 2020

Mozambique

Downgraded in September to CCC by Fitch

Mozambique Liquefied Natural Gas Project (LNG) project is expected to start production in 2024 representing an investment of USD23b and is expected to generate about USD38b in revenue.[12] Security forces have been battling a low-level insurgency for months against militants suspected of having links to Islamic State.

Zambia

Government requests a six-month delay on Eurobond interest payments

Debt-restructuring process less than a year before general elections. The government issued a consent solicitation to holders of their global bonds asking for suspension of upcoming debt service payments on October 14th, January 30th and March 20th. The credit has been under distress and headed for a restructuring for some time. The government has failed to make credible commitments on the policy front, mend IMF relations, provide adequate transparency on debt, or progress with renegotiation of Chinese debt. The latter accounts for roughly 30% of total external debt.[13]

A group of 14 hedge fund and traditional bond investors indicated they would not support a proposal by the debt-laden country to suspend debt interest payments, unless it provided more clarity over its debts and came to the negotiating table. The unknown scale and nature of debts owed to China add significantly to the risks.

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] REDD Intelligence, Insurgency in Mozambique poses risk for E23bn LNG Project, says Total's CEO, October 2020
[13] The Guardian, China Steps in as Zambia Runs Out of Loan Options, Dec 2019

Important Additional Disclaimers and Other Legal Information

This material is distributed for informational purposes only. This material is confidential and is not to be shown or given to any person other than the person who is an intended recipient and is not to be forwarded, copied, transmitted, distributed, or otherwise reproduced in any manner whatsoever. The discussions and opinions in this newsletter are for general information only, and are not intended to provide investment advice. While taken from sources deemed to be accurate and reliable, RVX Asset Management, LLC ("RVX") makes no representations concerning the accuracy of the information in the letter or its appropriateness for any given situation. Any statements regarding future events constitute only subjective views or beliefs, are not guarantees or projections of performance, should not be relied on, are subject to change due to a variety of factors, including fluctuating market conditions, and involve inherent risks and uncertainties, both general and specific, many of which cannot be predicted or quantified and are beyond our control. Future results could differ materially and no assurance is given that these statements are now or will prove to be accurate or complete in any way. RVX shall not be responsible for the consequences of reliance upon any opinion or statements contained herein, and expressly disclaim any liability, including incidental or consequential damages, arising from any errors or omissions. Information and references to RVX's Emerging Markets Equity Portfolio pertain to RVX's Emerging Markets Model Portfolio. Information and references to RVX's Global Opportunity Fund ("RVXGO" or the "Fund") pertain to RVX's investments and customer allocations in the related Fund. RVX provides investment management services primarily to the Fund, as such it shares common ownership with RVX Clients of RVX who pay RVX a fee for all assets under management and who also invest in the Funds are not charged additional fees directly by the Fund.