MEMORANDUM FROM:

John Morgan

DATE: 20 July 2020
SUBJECT: **The disconnect between Wall St. and Main St.**

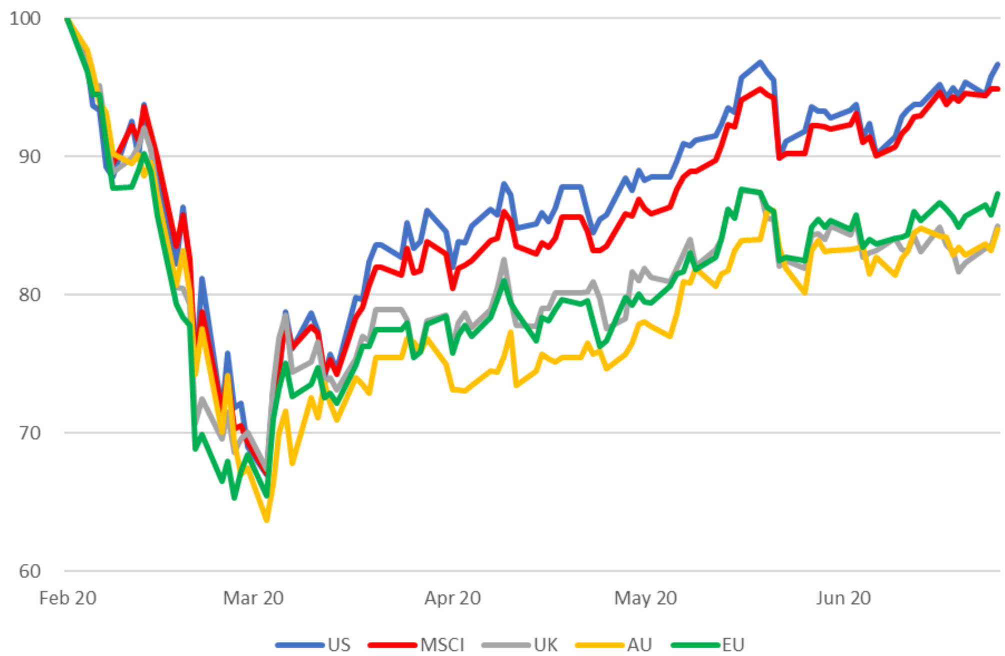
Two months ago, I wrote a paper, where I expressed the view that I expected that markets would re-test their lows of 23 March. Fortunately, I didn't put a date on that expectation, because as I write this memo global markets have in fact gone up in that time. Yet, we are all still suffering both economically and the pandemic persists. Unemployment is up. GDP is down … a lot and bankruptcies are on the rise. So, why is there such a difference between what the equity markets and the real world are telling us, or as is being coined "The disconnect between Wall St and Main St".

In this memo I will attempt to provide some context to that conundrum and lay out how we are managing the uncertainty.

* * * * *

Since late March, US markets have recovered all but 5% of their previous high and most global markets having realised losses of around 35%[1] have all recovered more than half. (Exhibit 1)

Exhibit 1 Global Equity Market performance
(21 Feb – 15 July 2020)

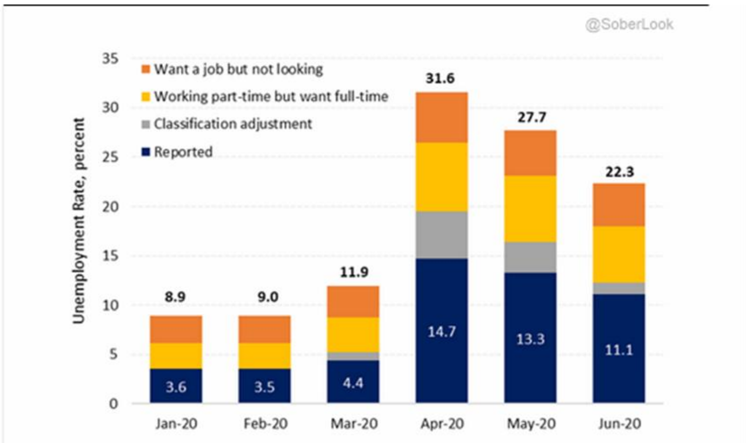


Note *US – S&P 500, MSCI ACWI, UK – FTSE 100, AU – S&P 200, EU – Stoxx 600*
Source: *Investing.com, CTE analysis*

1 *We note that in the GFC, global markets ultimately lost approximately 50% of their value before recovering.*

Yet, we still seem to be in the most extreme economic crisis since the Great Depression, with limited visibility on its end. Unemployment has soared in all countries and permanent unemployment has spiked quicker than the GFC[2]. Global GDP fell in the past quarter by the largest quantum ever recorded. The USA (15% of global GDP), recently realised a record high of 71,000 new COVID cases, almost double its early April high. In response, it is reimposing shutdowns in many large states including Texas, California and Florida. US GDP fell in Q1 by 5% and a materially higher fall is expected for the June quarter. Unemployment having hit 31% in April is at 22%, still 13% higher than in January 2020. (Exhibit 2). These economic conditions are being felt across the globe.

Exhibit 2 - US total unemployment

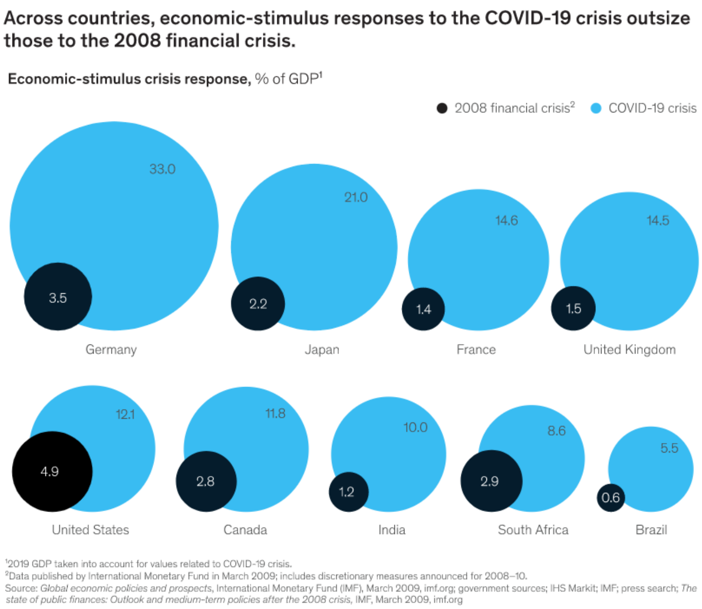


Notes: Figures capture a broader set of those outside the labor force that are not officially counted as "unemployed". As noted by the BLS, a subset of those "employed but not at work for other reasons" should have been recorded as "unemployed on temporary layoff"

Source: Bureau of Labor Statistics

The response has been staggering. USD10 trillion of global government support was announced in the first two months and more is being considered. This is three times more than the response to the 2008–09 financial crisis (Exhibit 3).

Exhibit 3



Source: McKinsey & Company

---

2 *We include all people receiving financial assistance that is from a government source.*

I will return to the global stimulus package shortly, but I would like to address the common arguments put forward to explain this market resurgence.

The "V shaped" Recovery

In this argument, it is claimed that this crisis was not brought about by an economic event, that we have seen the worst of it and as such, as soon as we can get through the crisis, which will be soon, we will quickly return to normal. The recent "surge" in spending and employment are evidence of this.

This argument ignores the damage that has already been done including the creation of long-term permanent employment, incurrence of record levels of sovereign and corporate debt and the flow on impact of the acceleration of structural change, such as online retail.

Further, the western world is now in its fifth month of the pandemic and despite the financial response and months of shutdowns, we are still experiencing a surge in the spread of the virus. The improvements to date are from record lows and as yet we are unable to calculate the new mid-term stability. Recent estimates are that the US will take 2-3 years to reach its previous GDP output.

It's a Technology Rally

Many argue that the recovery has been led by stocks that will benefit from the impact of COVID (i.e. technology and healthcare). This argument holds some water but there are flaws here.

a) Exhibit 1 above shows the movement in five equity market indices. It highlights that the recovery has been better for the S&P 500 and the MSCI ACWI. The US index is heavily weighted to technology and healthcare[3]. The MSCI being 58% weighted to the US is similarly affected by these technology and healthcare stocks.
b) However, other markets with limited weighting to these industries have recovered as well. Australia's index, for example, is dominated by Financials (25%) and Materials (20%). Only 16% of its index is represented by IT and Healthcare.

Markets are Forward Looking

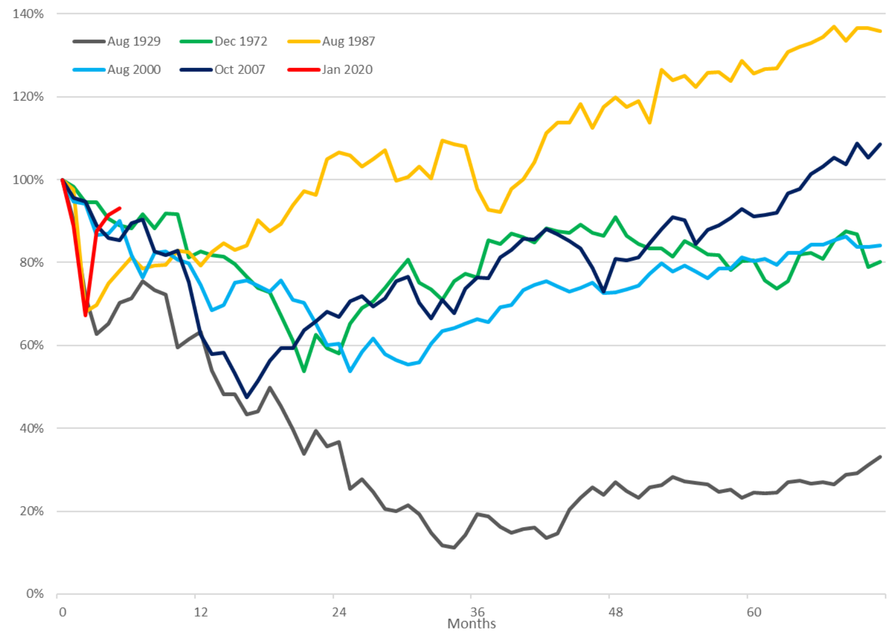
I have heard some people remark that markets are forward looking and are looking through the current crisis to better conditions when we emerge. I see flaws in this argument:

a) We still have no idea when we will come out the other side of the crisis or its long-term effect. The US and many other countries are still experiencing increases in COVID cases months after the peak was estimated.
b) Share prices are based on future earnings. In an unprecedented act, many companies are unwilling to provide earnings forecasts so what is being used to set these close to record prices?
c) Most major shocks start with an economic or financial crisis or a major catastrophic event. Markets react and then things start to get better. As Exhibit 3 shows, it generally takes markets years to fully assess the impact of the crisis and then get on with the recovery phase. This is not the case this time. This is not an economic or financial crisis. It's a health pandemic that will have economic and financial impact down the road. Yet, although we still don't fully understand the economic impact, the markets have returned to normal.
d) If markets always looked through the fog, then they would never crash as markets will always get better … eventually. Yet we have many extended periods of markets downturn.

---

[3] *Information Technology and Healthcare represent 41.2% of the index.*

Exhibit 3 – The last 6 Major Crises and months to recover



Note: Shows the performance of the S&P 500 index (except for 1929 crash which uses Dow Jones index data) from its highest point pre the crash to pint of return or six years hence.
Source: Dow Jones, Standard & Poors, CTE analysis.

The "Fed Put"

Similar to the early parts of the GFC, the Fed stepped in to protect the liquidity of the US Treasuries market at a time of liquidity failure. The US Treasury market is effectively the basis for pricing of all global assets. If this were not functioning it would have resulted in a complete breakdown of asset pricing.

So, since early February the Fed has bought USD1.7T of federal debt, equivalent to 163% of the US government's entire net issuance in 2019. But that wasn't enough. Other markets were failing. So the Fed stepped in participating in the primary and secondary markets across markets including corporate bonds (USD 750B), state and local-government debt (USD 500B) and mortgage-backed securities (>USD 300B) as well as opening its "Main Street Lending Programme", to purchase loans to small and medium-sized businesses. We also understand that the Fed has a structure in place to fund the acquisition of equities, should the need arise.

By stating that it will do "Whatever it takes", the markets believe the "Fed Put" now exists across most asset classes but certainly equities. It is the belief that the Fed has eliminated tail risk that is stimulating this surge across all markets.

There is an old investment mantra: "Don't fight the Fed". However, I was listening to Janet Yellen[4] last week and in spite of the Fed's efforts she stated that she "expects very high levels of bankruptcy and defaults and … that there are limits to what the Fed can do to protect investors from losses and the market seems not to be fully pricing in the downside risk".

* * * * *

So, if the above explanations don't effectively explain the disconnect, what does?

Simply put: Economics 101. Supply and Demand. We share the view put forward that the only reason for the markets' buoyancy is that the unprecedented financial injection has raised the levels of cash available and that, absent other options, much of this has been injected into the equities and debt markets. Our concern is that while it has had a positive impact in creating liquidity in markets and thus far prevented

---

4 *Immediate past US Fed Chairperson*

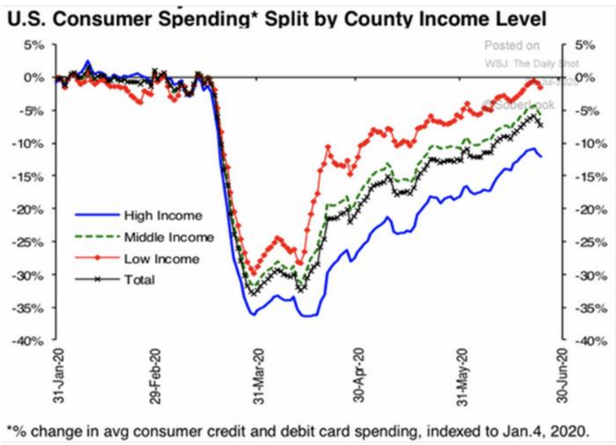
further fear and limited financial collapse, the creation of a short-term wealth effect has had unforeseen negative effects and ultimately is unlikely to prevent much of the inevitable economic pain.

The Short-Term Wealth Effect.

As mentioned, more than $10T has been injected into the global economy through a variety of mechanisms. Many governments have entered into programs to support workers while they are in a stage of "temporary" unemployment. This has had two unfortunate side-effects. Firstly, there is a section of this group who are earning materially more than when they were either employed or unemployed. The University of Chicago estimates that in the US, two-thirds of workers who are eligible for unemployment insurance receive more than what they lost in earnings.

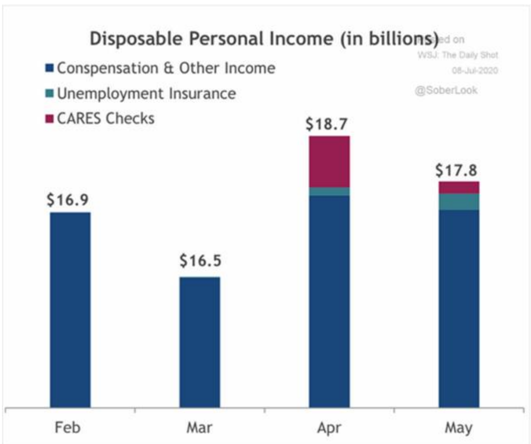
Exhibit 4 shows that spending in the US, especially amongst low income earners, has almost returned to pre-pandemic levels, achieving its desired effect. But, Exhibit 5 highlights that there has actually been an increase in disposable income in the US between February and May. Hence the program has also boosted wealth in the short-term[5].

Exhibit 4



Source: Hugo Ste-Marie, Portfolio & Quantitative Strategy Global Equity Research, Scotia Capital

Exhibit 5



Source: SunTrust Private Wealth Management

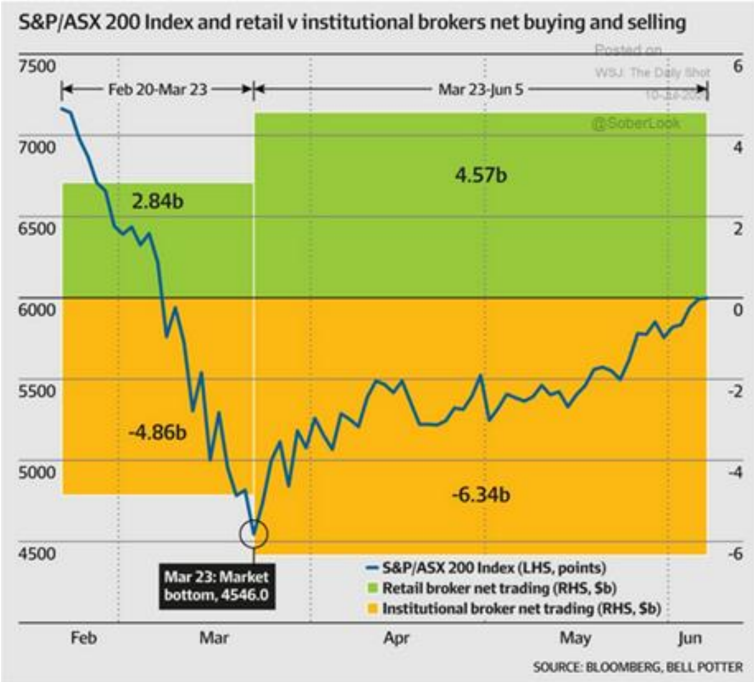
But how does this affect the markets? Well, in addition to improved spending there has also been a significant increase in US consumer savings rates and this, combined with the restrictions of the lockdown, has led to a surge in retail investing. Exhibit 6 shows the net retail investor buying and the corresponding net selling by institutions of equities in Australia between March and June. While institutions are leaving the market, retail investors are entering it. It is concerning to think that the recovery is being driven by participants who theoretically have the least level of market knowledge and are arguably simply following a "Fear of Missing Out" (FOMO) strategy.

This is not just an Australian phenomenon. In the US since the start of the shutdowns there has been a substantial increase in the opening of retail brokerage accounts and retail investor activity. Robinhood, an online US retail broker, saw its investment positions double from mid-February to mid-May. Etrade and TD Ameritrade experienced a 150% increase in accounts opened in Q1 2020 compared to the Q1 2019. For many investors this is their first experience in investing.

---

5 *This is similar to the situation in Australia, where the Jobseeker program has increased unemployment benefits by almost 100% and employers are now complaining that they cannot get workers to return to work.*

Exhibit 6



This phenomenon has been exacerbated by the "There is Nothing Alternative" (TINA) factor. With US and Australian bonds yielding less than 1% and bank deposits effectively at 0%, there are very few alternatives for the retail investment dollar.

The Risks Ahead

We have a market run that is being heavily driven by a short-term surge in personal wealth and retail investors with a FOMO mentality. The question is, therefore, "What happens when the government subsidies terminate or are tapered, employment does not return as quickly as expected and consumers start to lose their recent surge in confidence?" Well we see the following risks ahead.

A "Fiscal Cliff" or "Fiscal Slope"

Central governments worldwide are walking a fine line. When can they start to wind back the stimulus without causing long-term damage? In the US, on 25 July the $600 Pandemic Unemployment Assistance program will end, unless extended[6]. This will reduce average unemployment benefit for Americans by more than 60%. Deutsche Bank estimates that the termination of this program may reduce US GDP by 3-5% Q3 2020.

In Australia, the JobSeeker and JobKeeper programs are due to end in September. The Australian Bureau of Statistics estimates 20% of the workforce were affected by job loss between April and May, substantially higher than the 7.1% unemployment figure reported number. Some 1.5m Australians or 13% of the workforce relied on Jobseeker. Were this to end abruptly without a substantial decline in under-employment the impact would be substantial.

---

[6] *Negotiations are underway to extend this program in some form, but they are not expected to conclude prior to 25 July. This is further complicated by the fact that we are four months away from an election.*

While we remain confident that as a result of the ongoing destabilisation of the pandemic, all governments will extend their fiscal programs in some form[7], they are likely to be less than currently offered, thus reducing the wealth effect and will further increase sovereign debt and exacerbate the longer-term effects.

"The 2nd Wave"

Let's not get into the semantics of when the 1st wave ends and the 2nd wave begins. Suffice to say, only last week we set the new global record of 237,000 daily cases. That's 1.7% of the entire case load on what is generally recognised as day 174[8]. In March, it was being predicted that most countries would reach peak daily infection sometime in April. Oops.

Every day that this virus remains not under control, results in lower revenue for businesses, increased costs and lower revenue for governments as well as greater disruption to all aspects of the global economy. This will increase the size of permanent unemployment broadly but more so in the heavily impacted industries (Travel, hospitality etc) and the term of the drag on GDP.

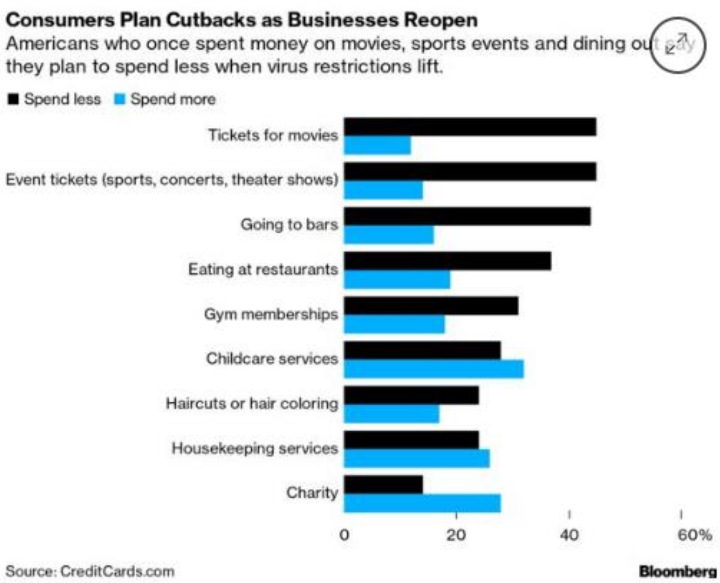
Ongoing Social Distancing

For a considerable period of time; at least until the comprehensive application of a working vaccine, social distancing will be part of our community fabric. This will create revenue (fewer tables in restaurants) and expenditure (greater separation requirement in offices) pressures for most businesses. This leads to lower profits and lower growth.

Corporate Bankruptcy

We have already witnessed a substantial increase in corporate bankruptcies this year. This will continue as the level of central bank primary and secondary bond buying declines and revenues do not improve. While there is no doubt that there will be winners out of this crisis (e.g. Zoom), there will be many industries and companies subjected to long-term revenue pressure. Exhibit 7 below, highlights that even after lockdowns are removed, many consumers intend to spend less across a wide range of industries.

Exhibit 7



---

[7] *On 20 July, the Australian government announced that it will extend the JobKeeper initiative but in a limited sense.*

[8] *22 January 2020: The day of first cases recognition in China.*

Another factor that will play out here is the impact of accelerated structural change. The migration to online shopping will reduce the time physical retail has to respond. The use of web-based communication systems will have immediate revenue impact on the business travel industry when it finally ramps up and the increased acceptance of remote working will have a more accelerated impact on the commercial real estate markets.

Permanent Job Losses

Fiscal stimulus will reduce the impact of COVID temporarily, however an obvious flow on effect from corporate bankruptcy for some and lower profits for others will be permanent unemployment. This will be exacerbated by businesses that because of pressure during the crisis will not be able to maintain previous work force levels.

While some businesses will come through this stronger and have already started to increase their numbers, they will not pick up all of the slack and it will take many years for this crisis to work its way through the system. It is not possible to calculate what this number is, but it is likely that it will be higher than the GFC as the level of industry destabilisation has been pervasive.

Impact of COVID on Emerging markets

While acknowledging the risk of generalisation, most developed nations have the double benefit of better medical facilities and better access to emergency capital to assist in their fight against COVID. Emerging markets will not be so fortunate. We have recently seen the impact that the virus is having on emerging markets such as Brazil and India. Their ability to respond is still being tested. Their inability to meet international debt payments as a result of material economic disruption that stems from this crisis will have a contagion effect on developed economies.

* * * * *

The "So What"

Last week, I read two quotes from the CEO's of JP Morgan and Citibank that capture my view perfectly.

> ***"I don't think anybody should (be) simply feeling like the worst is absolutely behind us and it's a rosy path ahead… We don't want people … simply thinking the world is a great place and it's a V-shaped recovery." Michael Corbat - Citigroup CEO***
>
> ***"This is not a normal recession. The recessionary part of this you're going to see down the road… You will see the effect of this recession. You're just not going to see it right away because of all the stimulus." Jamie Dimon - JPMorgan CEO***

This occurred on the day they had, along with Wells Fargo, just announced a USD28 billion increase to their provisions for potential losses on loans, swelling them to USD83 billion. Of specific interest is how this Dimon quote contradicts his views from only 6 weeks ago when he predicted "pretty good odds of a fast economic rebound starting in the third quarter thanks to the US government's stimulus programs and the strength of the consumer going into the pandemic and … a fairly rapid recovery"

We still consider that the markets have it wrong and that the realisation that this is not a V-shaped recovery will have a material impact on equity markets. We feel that triggers for this include the winding back of fiscal stimulus, increased corporate bankruptcy, improved clarity around stable permanent unemployment levels and any Emerging Market default.

As such we continue to remain underweight global and domestic equities. Our current focus is seeking out opportunities in areas where we believe macro factors will have lesser impact and where we may be able to avoid the rump of the risks ahead. Currently, that is primarily in the areas of dislocated and distressed assets. Fortunately, or otherwise, we have a lot to choose from and are likely to for some time.

As always, I appreciate your feedback, comments and questions.

Stay Healthy

DISCLAIMER

This information is for Australian wholesale investors only pursuant to section 761G(7) of the Corporations Act (Commonwealth).

This document may provide performance data for the CTE Investments' Asset Trusts. It does not constitute an offer nor an invitation by CTE, nor financial product advice for and on behalf of CTE to any person to buy or sell any security, investment product and/or financial product or to participate in any other transactions and does not release the recipient from exercising his/her own judgment.

It is not a recommendation to invest and may not include all the information that an investor needs to make an investment decision. It does not consider any person's particular financial needs, objectives or circumstances and should not be construed as tax, accounting or legal advice. Before entering into any transaction, investors should independently consider the financial risks as well as the legal, credit and accounting consequences of that transaction and consult their own legal, financial, tax, accounting and other professional advisors as appropriate.

CTE does not guarantee the rate of capital or income return of any investment, the meeting of the investment objectives, the performance nor repayment of capital from the Trusts. Any references to past returns, dividend yields and interest rates are for the purpose of example and are no guarantee of future returns.