RockCreek

Covid-19 Rollercoaster

Q3 2020

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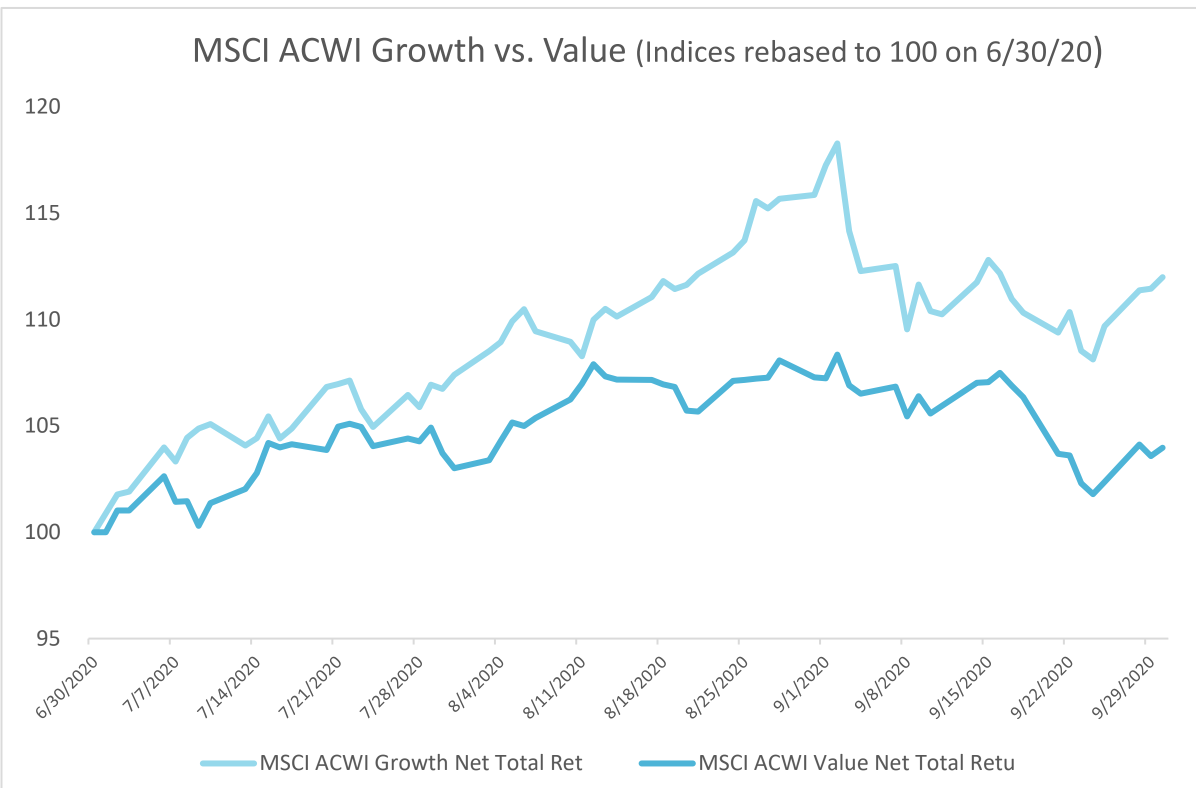
MACRO REVIEW & OUTLOOK

COVID-19 ROLLERCOASTER

After two quarters of startling reversals in markets and the economy, Q3 was easier on the nerves. Investors stayed upbeat in July and August, even as Covid-19 spread further around the world and economic projections remained dire. True — in September, sentiment shifted, and equities drifted downwards, with the first negative month since Covid-19 lockdowns hit in March. But the decline was modest.

Key to keeping markets cheerful: further government help for the economy. That is still just a hope in the U.S. — and unlikely before the election, however much the White House and Congressional Democrats talk. Without that — as the weekly and monthly economic data have begun to show — the Corona recession shock will reverberate for some time. Business closures, rising long-term unemployment, and a renewed climb in daily Covid-19 infections across much of the West will continue to take a toll on the global economy. Most economists expect output at the end of this year to be below the level of a year earlier. But first, we will get GDP numbers that mislead.



Source: MSCI

As we noted last quarter, the sharper than expected rebound in economic activity that began in May meant that going into Q3, the economy was doing much better than during the worst of the pandemic lockdown. Even if output was completely flat in August and September, the Q3 GDP numbers in the U.S. and many other countries would show a big quarterly jump from Q2's depressed average. More important for investors is what will happen in Q4 and beyond. The private sector economic motor remains hamstrung by Covid-19 and dependent on fiscal and monetary help. As for most of this strange year, what governments and central banks do — on health policy, fiscal stimulus, and money — will play an enormous role in the outturn.

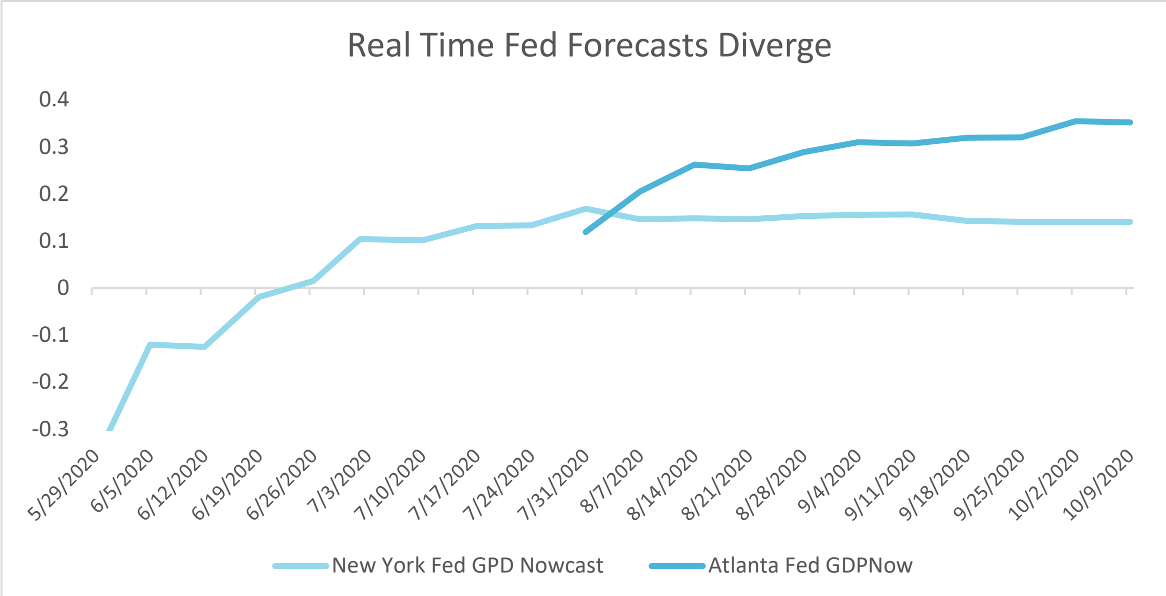
China, where the virus originated, was earlier to lock down its economy and quicker to open up. That made China the exception in the second quarter, when the second-largest economy in the world began to pull out of recession. South Korea, with a quick and effective response to Covid-19, was hurt by dampening trade and exports. In Q3, China will again be the exception. Expect a positive number, but not as big as for the U.S. This comparison will also be misleading: China's economic recovery has continued in recent months, helping to pull up numbers for the global economy. And forecasters from the OECD to the IMF expect China to show overall growth for 2020. This sets it apart from other major economies — both emerging and advanced — which are widely expected to end the year with output below that of a year earlier.

WHAT DID WE LEARN IN Q3?

1. THE GLOBAL ECONOMY IS STILL IN THE THROES OF AN UNPRECEDENTED SHOCK; POLICY MAKERS HAVE NOT YET GOT THEIR ARMS AROUND WHAT IS HAPPENING

Whatever GDP number that the U.S. reports on October 29 will come as a surprise to someone. Even the economists in the Federal Reserve system cannot agree on what happened: "nowcast" projections based on real-time data and models of the past range from an annualized increase in GDP of as low (!) as 14% from the New York Fed to as high as 35% from the Atlanta Fed. The latest numbers from the IMF show less gloom for 2020, with the global economy expected to shrink by 4.4%, after the stronger than expected early summer rebound. But this shift is again misleading. What has just happened — a petering out of economic strength in recent weeks — means that the IMF, along with other forecasters, now expects a slower recovery going forward. For advanced economies, overall output is now expected to shrink by nearly 6% in 2020 followed by growth of 3.9% next year.

The challenge for governments: combining economic policy with a more effective response to the health challenge. A binary choice between the economy and public health does not work, and risks getting the worst of both worlds. New research shows that consumers and businesses adjust their behavior in response to the health threat as much as to government-enforced restrictions on economic activity. What is essential is to insist on the — apparently simple — public health guidelines of mask-wearing, social distancing, and handwashing while governments do a much better job of testing and tracing.



Source: Atlanta Fed, New York Fed, and Bloomberg

2. ONE THING IS CLEAR: MORE FISCAL STIMULUS IS NEEDED URGENTLY AS TEMPORARY MEASURES ROLLED OFF IN Q3, SLOWING RECOVERY.

Normally conservative economic institutions, from central banks to the International Monetary Fund, are all now agreed: governments should stop worrying about fiscal deficits and debt — at least for now — and start spending more and taxing less. For much of the third quarter, markets in the U.S. behaved as if a new stimulus package was a sure thing. Dimming hopes of Congressional compromise between the Republicans' preferred $1 trillion and Democrats' insistence on a number above $2 trillion were an important factor behind the S&P's September stumble. Economic data also showed that as temporary stimulus rolled off in August and September, economies weakened. In Australia, France and the U.K., governments have announced new measures to sustain recovery. These focused on keeping cash flowing to individuals and some businesses on the brink.

In the U.S. confusion on fiscal continues. At RockCreek, we have thought for some time that more fiscal stimulus was both badly needed — to replace unemployment benefits that ended in August and to offset the growing fiscal drag from state and local governments — but unlikely before the November election. President Trump's bout with Covid-19 revived hopes that a White House push would get a package over the line. Senate Republicans remain the obstacle. The President has faced a choice from Senator Mitch McConnell between pressing reluctant Senators to support more fiscal spending and forging ahead with a Supreme Court confirmation for Judge Amy Coney Barrett. What will be critical in any package is that funding is supplied to those most in need. The lending programs in the original CARES act did not do this successfully. Many smaller businesses were unable to get funding, which was channeled through big institutions to larger enterprises. And much of the facilities aimed at the smaller and midsized companies

— the Paycheck Protection Program for small businesses and "Main Street" lending facility — remain unused.

Central banks, meanwhile, continued to do their best in Q3 to support economic demand with monetary policy. The slowing pace of recovery shown in the "real-time" data indicates that was not enough by itself and it was not effective in helping the groups that needed it most. Stock market gains have been large, but most of those go to those with higher income, as the top 10% of households own 80% of stocks. The Federal Reserve rolled out a new long-term statement of policy during the Jackson Hole Economic Symposium in August, stating they expect to keep interest rates very low for a very long time. In addition, the Fed called out the economic wastefulness and risks to society of overly slack labor markets and unnecessarily high unemployment. Markets got the message, but they still don't expect inflation to exceed the 2% target.

3. PUBLIC INVESTMENT IS IN FAVOR – AT LEAST INTELLECTUALLY; CAN GOVERNMENTS MAKE IT HAPPEN EFFICIENTLY AND IN TIME?

In the immediate turmoil of the Coronavirus Recession, governments rushed to put in place emergency income support — for unemployed individuals and businesses forced to shut down. Some economists and policymakers support more of the same, concerned that if governments embark on longer-term spending projects the consequences for debt and deficits will be damaging and difficult to reverse. But most are now moving in favor of a substantial boost to public investment. In Europe, politicians have promised a major push to "green" the economy. There are echoes in the U.S. with calls to "Build Back Better" which for many means "build back green". In the face of California wildfires and devastating hurricanes, not to mention crumbling bridges, poorly ventilated schools, and spotty rural internet coverage, it is hard to argue that more — and better-designed — public spending is not needed. New research also shows that investing in R&D has a big payoff for society; left to itself, the private market will not do all the basic research that we need to power future gains in productivity and living standards.

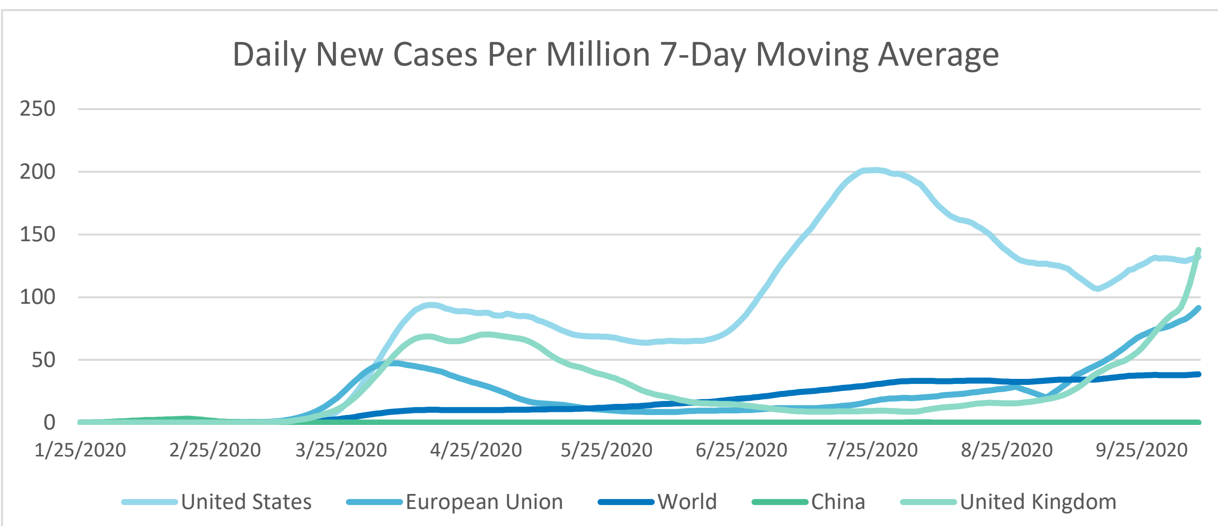
4. THIS RECESSION – UNUSUALLY – HAS HURT THE SERVICE ECONOMY MOST, FROM TRAVEL TO HOSPITALITY TO PERSONAL SERVICES; THIS IS BAD NEWS FOR JOBS IN BOTH RICH, AND MANY POORER, ECONOMIES

Covid-19 and the pandemic-induced lockdown have made this a lopsided recession. Countries like the U.S. and the U.K. and companies that depend on services have been hurt more than those — including China and Germany — where industrial production and manufacturing play a bigger role. The damage to some sectors, notably travel, tourism and hospitality, has been enormous. Once-thriving cities, such as New York and London, now feel strangely quiet.

As we try to fathom out how and when the pandemic will subside, it is hard to know which of its impacts will linger. As working from home moves from being essential to business continuity in the lock-down to optional, what does that mean for office space and cities? A shift of this magnitude in economic constraints also opens up possibilities and opportunities for companies and investors smart enough to spot them. At the same time, Covid-19 has both revealed and worsened economic and social divisions in the U.S. and elsewhere. Measures to address these divisions are of paramount importance to investors as well as society at large.

5. COVID, COVID, COVID

Finally, it really is still all about the disease. For a time in the late spring, it seemed as if lifting lockdown orders might be enough to promote a sustained recovery and that the virus could be tamed. That was always an illusion. The resurgence of new daily infections in the U.S. in July spread Covid-19 across the country. Attempts to restart normal schooling in August and September — especially important to allow a return to work for many parents — foundered on renewed infections. Infections — and the death toll — in the U.S. are extraordinarily high. In Europe, infections had been brought down to very low levels before reopening began. But there too, a relaxation of travel and other restrictions soon led to an uptick in cases that accelerated rapidly in some countries, prompting new restrictions ranging from a two-week halt to bars and restaurants in Paris to a six-month slowdown in the U.K.



Source: Our World in Data

Encouragingly, there is also increasing research showing lock downs may be less helpful except in extreme situations versus a more rigorous and disciplined use of masks and social distancing. Looking ahead, it is fair to pin hopes for a sustained global recovery on a vaccine. Now widely accessible Personal Protective Equipment and widespread scientific progress on developing and testing potential vaccines has defied reasonable expectations: this is truly good news.

PUBLIC EQUITIES

Equity Markets	Q3 2020
US Large Cap (S&P 500 TR)	8.9%
Nasdaq	11.2%
US Small Cap (Russell 2000)	4.9%
Japan (TOPIX)	5.0%
Europe (MSCI Europe)	0.2%
China (CSI 300)	11.2%
Global EM (MSCI EM)	9.7%

Bond Markets	Q3 2020
US 2yr	-2.2
US 10yr	2.8
US 30yr	4.5
German 10yr	-6.8
German 30yr	-9.9
UK 10yr	5.7
UK 30yr	13.9
JGB 10yr	-1.2
JGB 30yr	0.4

Currency Markets	Q3 2020
DXY	-3.6%
EUR	4.3%
GBP	4.2%
JPY	2.4%
MSCI EM Currency Index	2.7%

Commodity Markets	Q3 2020
Crude Oil (WTI)	2.4%
Nat Gas	44.3%
Gold (Spot)	5.9%
Steel (Rebar)	-2.3%
Ag & Livestock (Bloomberg)	12.1%

RCG HF Indices	Q3 2020
All Hedge Funds	5.3%
Equity Hedge	7.2%
Absolute Return	1.8%
Equity Market Neutral	1.6%
Event Driven	4.1%
Global Macro	3.1%

The third quarter was strong for global equity investors with the MSCI ACWI gaining +8.1%, however, warning signs on the macroeconomic front and unexpected volatility in September left investors with much uncertainty heading into the U.S. election and the end of the year. Exposures to large technology, e-commerce, and other new economy businesses that were able to continue operating throughout the health crisis drove performance. Since consumers were largely unable to spend across a large swath of the global economy — hotel, travel, concerts, sporting, dine-in restaurants, and elective health procedures, they directed disposable income and government stimulus money towards online and stay-at-home goods and services. Equity prices reflected this as e-commerce, internet & technology, gaming, home goods, and consumer durable stocks became increasingly crowded and momentum based.

Contrasting the positive momentum in sectors such as technology, energy stocks were decimated amid falling demand for fossil fuels while our RockCreek renewable energy basket performed well. Financial stocks — primarily banks — continued to be dogged by meager net interest margins and weakened lending businesses. Severe pressure in commercial real estate led to underperformance from REITs and although certain biotech stocks were beneficiaries of speculative bets on a Covid-19 winner, the larger sector was weighed down by falling hospital profitability as well as overhanging risks of stricter drug price controls and single-payer health. These areas within healthcare tend to get a lot of attention around election time.

It proved too early to rotate into out-of-favor value stocks during Q3, but many investors are assessing how much longer to stay on the sidelines of a rotation. The September selloff saw high-flying technology stocks suffer the brunt of the pain while some of the forgotten cyclical stocks like Caterpillar and Deere moved steadily higher. During this brief pause in the trend of Q3, certain investors increased exposure to the financial sector, specifically banks with high capital provisions, growing fee incomes, and profitable brokerage businesses.

It will be important to monitor how well the global economy can hold up if we have hit the peak of fiscal stimulus measures. In recent weeks we have seen a sea of layoffs — Shell, Dow Chemical, Disney, Marathon Petroleum, American Airlines, and United Airlines — and there are sure to be more layoff announcements as companies announce Q3 operating results. A contested U.S. election is perhaps the biggest near-term risk to equities due to the state of limbo it might put the federal government in and the vitriol it would add to an already combustible political environment. On the other hand, a decisive resolution to this highly unusual election one way or the other might help reduce the equity risk premium and support equity valuations. If Joe Biden wins as polls are strongly indicating, his policy team is emphasizing that his administration would likely push for increased spending ahead of raising taxes and regulation to help support the economy in its current state. A trifecta of another round of fiscal spending, a de-escalation of trade tensions, and a major step forward towards a Covid-19 vaccine could provide a healthy backdrop for equities at a minimum for the first half of 2021 — something that seems to be impacting markets already. Such a scenario could also accompany a modest uptick in interest rates, which would affect the equity market's pricing of equity duration and pressure the valuation premium enjoyed by high growth stocks. We may see a regime change across markets that benefit value stocks that have been left behind. In this scenario, Japanese and European stocks might also start catching up with the U.S. given their relative overweight to old economy sectors.

EMERGING MARKETS EQUITIES

Index	Q3	YTD	1-Year
MSCI Emerging Markets	9.6%	-1.2%	10.5%
MSCI Emerging & Frontier Markets	9.5%	-1.3%	10.3%
MSCI EM Asia	11.9%	8.0%	21.5%
MSCI EM EMEA	1.8%	-20.0%	-12.1%
MSCI EM Latin America	-1.3%	-36.1%	-29.4%
MSCI Frontier Markets	8.3%	-8.8%	-2.7%

Source: MSCI as of 9/30/20.

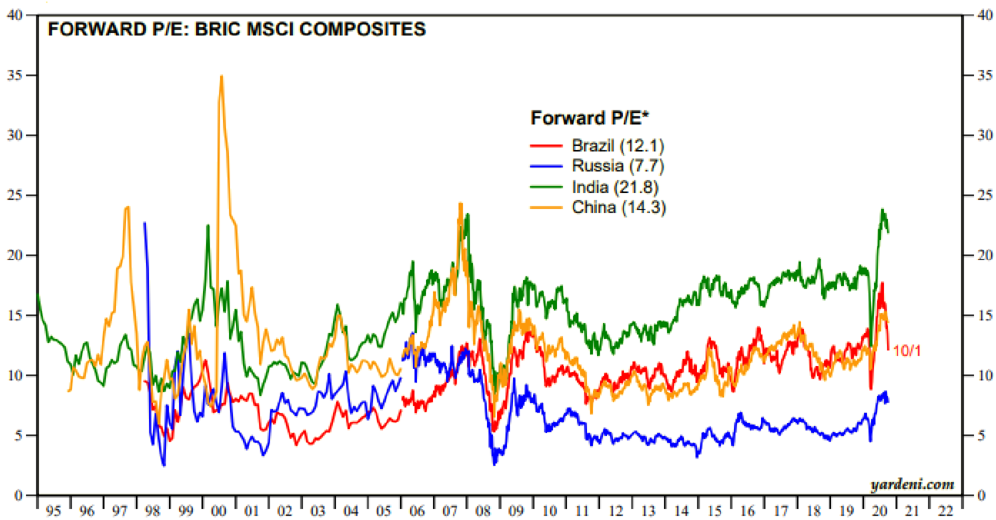
Emerging Market ("EM") equities returned +9.6% in Q3 2020 outperforming major global and developed market equities. Performance was sharply skewed towards Asia as the rest of EM mostly languished for the quarter. Only four out of 23 EM markets outperformed the broader MSCI EM Index in Q3 — China, Taiwan, Korea, and India — with 11 of the underperformers delivering a negative return. Significant dispersion across industrial sectors persisted as tech-driven businesses (notably e-commerce and IT hardware/components manufacturers) delivered double-digit returns and financials and cyclical-industrial stocks were largely flat. This performance was not surprising as it mirrors the generally positive economic outlook for North Asia where early and widespread anti-Covid-19 preventive measures have been successful and government policy measures have been supportive of financial markets. North Asian technology businesses are flourishing as global demand for e-commerce services, enhanced connectivity, and streaming and gaming content skyrocketed during the pandemic. Meanwhile, EM markets with heavy dependence on commodities and / or tourism remain depressed (e.g., Russia, Brazil, Thailand, and the Philippines) as do countries that went into the pandemic-led downturn already experiencing serious economic problems (e.g., Turkey, India, and Indonesia).

The economic impacts arising from the Covid-19 pandemic have been harsh on many emerging economies. Excluding North Asia, consensus expectations forecast EM GDP to contract by approximately 6.5% in 2020. Underlying this forecast are divergent drivers as the economic impacts from Covid-19 are not fully captured in infection rates. As an example, tourism accounts for over 20% of Thailand's GDP. Despite the country's relatively quick rebound from the pandemic, the virtual cessation of travel globally has devastated the country's hospitality industry. By comparison, India continues to battle widespread proliferation of the Covid-19 virus despite the country's early and drastic measures aimed at containing the spread of infections. This, in turn, has led to rolling lockdowns around the country that have utterly derailed economic recovery (in Q2 2020 India's GDP shrank 23%). Individual countries' policy measures have also impacted economic outcomes. Despite extremely high levels of Covid-19 infections, Brazil's economy has benefited from large-scale direct transfers to low-income workers and sharply increased exports of agricultural products to China — its expected GDP contraction for 2020 is estimated to be 6.5% followed by a 3.6% rebound in 2021. Mexico, on the other hand, is expected to experience more than a 10% contraction in 2020, the country's deepest recession since the Great Depression of the early 1930s. The Mexican government's meager fiscal response to Covid-19 has led to depressed consumption and the situation in the U.S. has led to a collapse of tourism dollars. Tourism represents 8.5% of Mexican GDP and it is expected to take years for activity to reach 2019 levels.

In the EMEA region, Turkey took center stage during the quarter with equities continuing to sell off. Easy monetary conditions acted to prop-up consumption (and imports), but this has exacerbated the country's chronic balance of payments crisis as exports and tourism have collapsed, as has the Turkish lira. The dollarization of the Turkish economy is not a far-fetched conclusion at this point in the cycle. South Africa also experienced a tough quarter. The government's stringent lockdowns have plunged the country into a deep recession and GDP contraction for 2020 is expected to be the worst among OECD members at 11.5%. The rest of Africa is not much better. Real per capita GDP in the Sub-Saharan region of Africa is projected to contract by 5.4% in 2020 according to IMF estimates. This will bring per capita GDP almost back to its 2010 levels. The pandemic is set to increase extreme global poverty for the first time in decades, with 26 to 39 million people thrust into extreme poverty in sub-Saharan Africa alone.

Against a backdrop of economic troubles and uncertainty across EM more generally, China, Korea, and Taiwan stand apart. Each applied effective action to thwart the spread of the Covid-19 virus as well as applying appropriate fiscal and monetary measures to ensure economic stability as the crisis played out. China quickly rebounded from the global downturn in Q2 and is now forecasted to see GDP expand 2% in 2020 (the only major economy expected to grow this year). Taiwan and Korea are not far behind and both will experience only marginal GDP declines in 2020. Nonetheless, geopolitics remains a worry for the region as SINO-U.S. tensions have been heating up in advance of the U.S. presidential election. While Phase 1 of the China-U.S. trade deal remains intact, various actions from both sides (e.g., closures of Consulates, mutual provocations concerning Taiwan, and China's actions to limit Hong Kong's political autonomy) have fueled concerns over the long-term direction of relations between the world's leading economic powers. In the run-up to the U.S. election, China tensions will remain a popular theme for both the Trump and Biden campaigns. Nonetheless, whoever wins the presidency, the competing economic and geopolitical ambitions of China and the U.S. will continue to be at the forefront of both countries' political agendas in 2021 and beyond.

Relative valuation is also a positive factor supporting EM equities as forward P/Es and P/BVs are at a substantial discount to those of developed markets as shown below. Among the BRIC economies, Russia and Brazil are showing the lowest forward P/E's — this is understandable given how commodity stocks still dominate the countries' indices. In the case of Russia, we also think a number of political risks are priced in and will continue to weigh on valuations for some time. China continues to show attractive valuation levels despite its strong performance this year and is far from its 2007 peak levels.



* Price divided by 12-month forward consensus expected operating earnings per share. Monthly through December 2005, weekly thereafter.
Source: I/B/E/S data by Refinitiv

The prospect of dollar weakness and supportive monetary conditions should accelerate the recovery of EM economies as they dig-out from the 2020 downturn. Countries in EM are opting to pursue different remedies than traditional deleveraging and fiscal cuts. In fact, the IMF and the World Bank are recommending EM countries to borrow more in order to invest in sustainable development. Against this backdrop, consensus expectations call for a broad-based economic recovery across EM in 2021 with GDP growth rebounding by approximately 6.5% (led by Asia). While there are risks embedded in this outlook (e.g., a resurgence of Covid-19 infections and/or delays in the roll-out of vaccines, lapses in fiscal support if governments pull life-lines too early, unraveling of SINO-U.S. relations), we remain positive on the outlook for EM equities. The majority of EM remains in negative territory YTD (most down double-digits) and most industrial sectors are also posting negative returns in 2020. While this is understandable given the substantial hit that most EM companies have endured in 2020, the prospect of recovery is all but certain as effective vaccines will eventually arrive, and money will remain plentiful and cheap. Institutional investors — who have been net-sellers of EM equities in 2020 — will regain their appetite for risk assets once a clear path to normalization of activity and earnings is understood.

FIXED INCOME

Volatility in the U.S. fixed income market has evaporated, and it showed during the third quarter. The headline 10-year Treasury yield traded within just a 22-basis point range — there were multiple single days in March with moves of the same or greater magnitude. Ultimately the 10-year Treasury Yield ended the third quarter at 0.69%, just three basis points above where it began the quarter. At the same time, the Treasury curve saw a modest steepening in the belly of the curve. The 3-month yield slipped six basis points to 0.10% and the 30-year yield was higher by five basis points to 1.46%. In aggregate, the Bloomberg Barclays U.S. Treasury Index increased 0.2%.

While nominal yields have been well pegged by the Federal Reserve, real yields (e.g., yields on Treasury Inflation Protected Securities ("TIPS")) were on the move during Q3. The 5-year real yield declined 35 basis points to finish at -1.22% after falling to an intra-quarter low of -1.41% in August. With the nominal 5-year yield edging down just one basis point to 0.28%, it implies the market's expectation for consumer price inflation over the coming half-decade increased by 0.34% during the quarter but still stood at just 1.50% — interesting given the Federal Reserve's new approach to fulfilling its inflation mandate. With real yields falling further into negative territory, the environment is set up well for zero yielding assets that can retain their inflation-adjusted value. The most notable example being gold that rose 5% during the quarter and cryptocurrencies also traded higher with the rally in real rates.

Two notable developments out of the Federal Reserve drove dynamics in the U.S. fixed income market. First, the Federal Open Market Committee ("FOMC") signaled its expectation that it will keep rates lower for longer. At its September meeting, the policy setting Committee established their projections for the federal funds rate — all 17 meeting participants forecast that rates will hold steady through next year, while 13 forecast that this will be the case through 2023. Second, at this year's virtual Jackson Hole conference Chairman Jerome Powell gave a highly anticipated speech on the Fed's monetary policy review and resulting amendments to the FOMC's policy stance. The most notable change was the Committee's introduction of "inflation averaging," i.e., the Committee will seek to achieve inflation that averages 2% over time rather than 2% inflation over intermediate periods. As a result, the Committee will allow inflation to run "moderately" above 2% after periods when inflation has been "running persistently below two percent" with the expectation that this policy will be more effective in anchoring long-term inflation expectations at the 2% level.

As risk sentiment steadied further, high-quality spread products saw outperformance to Treasuries with the Bloomberg Barclays U.S. Corporate Investment Grade Index gaining 1.5% as spreads tightened 16 basis points to 1.44%. The Bloomberg Barclays U.S. Aggregate Bond Index finished the quarter 1.2% higher.

In Europe, bonds outperformed with Italy 3.4%, Spain 1.7%, and Germany 0.5%. The exception was U.K. gilts that contracted -1.3% during the quarter. Contributing to the pullback was the reemergence of Brexit as the geopolitical topic du jour in mid-September. Trade discussions between the U.K. and E.U. were complicated by the U.K. government's Internal Market Bill that seeks to change the terms of trade between the U.K. and Northern Ireland, a point that the E.U. argues is in violation of their withdrawal agreement. Negotiators have recently been granted a one-month extension, extending talks to mid-November at which point a limited free trade agreement is expected to be reached, but the closer we get to yearend the greater the likelihood of adverse scenarios. Further volatility and sterling and gilts can be expected.

Many positive factors are supporting EM economies and financial markets longer term. While sustained global recovery remains dependent on the release and widespread distribution of effective Covid-19 vaccines, financial conditions are currently — and are likely to remain — supportive for equity markets generally. The U.S. Federal Reserve announcements ensure that easy monetary conditions will persist for the foreseeable future. With U.S. rates locked in near zero, EM rates, which have fallen precipitously and across the board in 2020, have room to fall further. Meanwhile, spreads between EM and DM debt should continue to attract flow into EM bonds and are also supportive for EM currencies.

With government bonds across major economies and of all maturities set to deliver a negative real return at maturity, the outlook and opportunity set for fixed income is looking very limited. With rates pegged near zero the risk mitigating characteristics of the allocation has effectively been eliminated. Investors will want to take mark-to-market gains on their bonds and diversify and be opportunistic within fixed income allocations. Consider including assets that can protect against rising inflation (e.g., TIPS, gold) or reallocating to fixed income alternatives (e.g., low volatility liquid alternative strategies with idiosyncratic sources of return). Fixed income can still serve a role in managing the liquidity needs of a portfolio, so looking towards high-quality spread products — e.g., agency MBS — can also be considered.

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PUBLIC CREDIT

Credit markets continued their recovery during the third quarter, led by lower-rated paper against a backdrop of stronger than expected consumer spending and the continued support of the Fed. CCC debt finished the quarter gaining 7.4%, followed by B's at 4.5%, and investment grade at 1.5%. Overall, High Yield ("HY") traded up 4.6% with spreads falling from 650 bps to 550 bps throughout the quarter, ending at a yield of 5.8%. The same dynamic played out in structured credit markets, with lower-rated paper performing the strongest. The "fallen angel" downgrade cycle has slowed dramatically and remains well under the dire bank forecasts earlier this year. This is largely due to record issuance (and healthy demand) that has shored up balance sheets with significant cash on hand. The Investment Grade ("IG") segment of the market currently has the highest duration in two decades (just shy of nine years, up from six years in 2004) with all-time low yields, but is reasonable given the Fed is promising near-zero rates until at least 2023 and direct support through market purchases. Empirical evidence of steady IG demand versus other asset classes could be seen in the dislocation between IG and cash equity trading over the latter-half of the quarter when IG volatility pushed even lower, while equity volatility spiked.

Outside of IG, the default cycle continues to progress, albeit at a slower pace than expected. Leveraged loans and HY defaults this year have roughly matched the 2001/2002 combined total of $127 billion but remain short of 2009's record $185 billion. Chapter 11 bankruptcies remain about 50% higher on a year-over-year basis as well. That has not stopped investors from searching for opportunities in this negative real-yield environment. During August, Ball Corp (producer of aluminum cans and packaging), priced the lowest-ever high yield issuance with a 10-year bond at 2.875%. As fundamentals show signs of stabilization and we move closer to a vaccine, investment opportunities in oversold credits start to look compelling, especially if another round of fiscal stimulus is announced. Cyclical industries such as machinery, retail, materials, and even energy look like decent risk-adjusted opportunities in this environment.

On the flip side, the strong performance of technology, as well as in other more defensive/secular sectors such as pharmaceuticals and consumer staples has led to many of these issuers to trade at rich valuations. In the distressed segment of the market there remains significant stress across lodging, leisure, gaming, and travel, but with interesting pockets of opportunity. For example, during the quarter we saw GOGO sell its commercial in-flight Wi-Fi business to Intelsat (a satellite company currently in bankruptcy) for $400 million and a creditor-friendly resolution of terms with Argentina on their defaulted bonds. Wirecard, a German fintech company and one of Europe's fastest-growing electronic payments companies grew revenues from 2010 to 2018, by over 640% and EBITDA grew by 665%. The stock has traded up over 15x since 2010, reaching a market cap of just over $30 billion. After the company was exposed as a giant fraud with a $2 billion cash hole, the stock cratered from $60 to $0.44. While the equity is almost certainly worthless, the company's convertible debt, revolver facilities, and HY bonds offer potentially significantly higher recovery values from current levels. Elsewhere in Europe, with financials comprising a much larger percentage of the market than in the U.S., the space is even more sensitive to the economic backdrop. One positive sign of improving sentiment was the ECB's approval for Monte Dei Paschi to dispose of €8.1 billion of NPLs to the state-owned AMCO with a much lower capital raising requirement (only ¼ the previously required amount).

In Asia, where credit markets are concentrated in financials and property developers, we saw policies moving to tighten overleverage in the space. First, banks will need to include additional financing in measuring exposure to the property sector and should incorporate on- and off-balance sheet financing of properties and products, such as perpetual bonds and asset backed securities. Second, new mortgages should not exceed 30% of total new loans. Earlier in the quarter, it became clear that China Evergrande (the country's most highly levered property developer) was facing a cash crunch and reportedly sought government help (the company has $122 billion of outstanding debt, half of which comes due within a year), likely spurring the new government limitations. Additionally, the company had triggered an obligation to buy back stock in one of its subsidiaries after it failed to meet a listing deadline. But counterparties agreed not to enforce the provision, enabling the company to conserve cash, which has since led to a stabilization in the firm's debt prices. These are the types of opportunities we are seeing currently in the market — highly technical with contingent outcomes but offering significant upside to depressed prices.

Looking ahead, the focus for credit investors will be the impact of the stimulus cliff on consumer spending. We have already seen a marked decline in consumer spending on groceries, retail, and restaurants since fiscal stimulus lapsed in July. Previously, stimulus measures had actually increased aggregate personal income, providing a lifeline for businesses' top-line sales. Absent a new stimulus bill or an earlier-than-expected vaccine rollout, a sustained decline in consumer spending could trigger further defaults/bankruptcies over the coming quarter.

PRIVATE CREDIT

Private credit valuations continued to recover as the U.S.-leveraged finance markets saw credit spreads tighten given the strong monetary support from the Federal Reserve. Across direct lending strategies, strong performance made up some of the mark to market losses from the first quarter though not to the same extent that the public credit markets recovered. The primary reason for the more muted gains is that direct lending firms tend to focus on smaller to mid-sized companies whose outlook continues to remain uncertain in light of the Covid-19 pandemic. Within the direct lending ecosystem, those focused on underwriting investments in non-sponsored borrowers have generally not dealt with issues regarding non-payment from their existing borrowers given these companies tend to have a more robust capital structure prior to the crisis. However, investments that utilized leverage and were more exposed to Covid-19 impacted sectors have faced headwinds including default and restructuring. Special situation and distressed investments have been monetizing gains in public market investments since April as spreads have normalized close to pre-Covid levels and are now turning their focus towards more attractive opportunities in debt restructuring and private rescue financing.

In real estate credit, the combination of a sudden capital vacuum and decreased go forward supply pipeline for build-to-core projects has created interesting opportunities to provide financing to high-quality sponsors at low leverage levels. Over the quarter, we saw an increase in secondary market forced selling of loans on existing assets void of construction risk. Those GPs that have recently raised Funds began to deploy capital seeking to acquire performing loan portfolios from distressed borrowers at a discount to par. The expectation is that as forbearance agreements and other short-term “band-aid” solutions expire the investment pipeline will grow exponentially over the coming quarters.

Looking forward, we continue to be positive towards hard asset-based investments with upfront cash flows (e.g., Asset-Based Finance). We are currently seeing a compelling opportunity set for providing lending against the embedded value of an asset (EV) with favorable coupons. Also favorable are asset classes that tend to pay relatively higher excess coupons for which there are sound underwriting disciplines and fundamentally driven borrower behavior.

Special situation-oriented investments in the pan-Asia region continue to be particularly compelling. While many institutional investors continue to associate the region with growth and have historically committed to public or private equity investments, the primary drivers of private credit — bank retrenchment, borrower demand for tailored finance solutions, and investor appetite for differentiated returns — continue to provide impetus to the asset class in the region. However, despite the positive backdrop for credit strategies, data from Preqin suggests that allocations to Asia focused private credit strategies represent less than 7% of total global private credit assets. In fact, the amount of dry powder represents only 1/24th of that for U.S. opportunities and 1/6th of that for European opportunities.

Within the region, the opportunity set in China and Australia is especially fertile. In China, the government has provided liquidity support for sectors hard-hit by the pandemic such as export, travel, and retail with a redistribution of liquidity titling towards SOE and large corporates. However, in the property sector, various tightening measures remain with targets to stabilize pricing and expectations. In fact, the government recently released “window guidance” to manage property developers’ debt level and overall leverage. As a result, weaker developers are likely to fail, there is likely to be continued industry consolidation, and restructuring opportunities will rise. This has created opportunities to provide rescue and special situation financing to borrowers collateralized with high-quality assets at reasonable LTVs. In Australia, while the pandemic has not been as severe as other countries, there continues to be significant distress in the hotel, student accommodation, and office sectors. Traditional financing sources such as large syndicates and underwriters are unable to raise funds and are walking away from committed term sheets, retail funds are still unable to raise additional capital while current funds trade at ~5-15% discounts to NAV, and offshore banks active in the market have reduced balance sheet commitment to the region and are losing staff. As a result, distressed borrowers are approaching hard funding deadlines (debt maturities, option expiries, acquisition settlements) without firm funding. This allows private capital to come in and provide short-term financing at very attractive levels for real estate development projects that are significantly de-risked through pre-sales.

PRIVATE EQUITY & VENTURE CAPITAL

	Q2 2020	YTD 2020	1-Year	3-Year
N. America Private Equity	**8.6%**	**0.7%**	**7.6%**	**14.2%**
Buyout	7.6%	-2.0%	5.3%	12.3%
Venture Capital	10.7%	7.3%	12.8%	18.4%
Europe Private Equity	**5.9%**	**-6.5%**	**1.2%**	**11.0%**
Buyout	5.7%	-7.0%	0.4%	10.4%
Venture Capital	7.5%	1.1%	13.9%	20.4%
Asia Private Equity	**9.0%**	**4.2%**	**9.4%**	**13.8%**
Buyout	2.7%	-6.5%	-4.7%	4.7%
Venture Capital	12.5%	10.5%	18.3%	20.3%

Source: Burgiss

Global private equity markets rebounded in the second quarter of 2020, bringing year-to-date returns for Asia and North America into positive territory, while Europe is still negative. The Covid-19 outbreak and subsequent changes in consumer behavior have driven a significant acceleration of tech-enabled services (e.g., telehealth and online education), as well as the adoption of new productivity tools (e.g., Zoom and Slack) that have enabled the current work-from-home reality. E-commerce penetration in the U.S. has reached an estimated 23%, advancing 2.5 years ahead of the prior trend line, while the need for internet connectivity and data storage has never been greater. Conversely, several sectors, especially those that have typically been associated with buyout strategies, continue to have a long road to recovery, including travel and hospitality, restaurants, construction, oil and gas, and live events. This dichotomy can be observed in the divergence between venture capital returns and buyout returns in 2020, as venture capital strategies have outgained buyout strategies by 800bps to 1800bps during the first half of the year, depending on the region.

Deal activity also picked back up as volumes trended back towards 2019 levels, with approximately $400 billion of deal volume in the U.S. alone. Of note, digital-native bank Chime raised a $485 million Series F financing round that valued the company at $14.5 billion, making Chime the most valuable private VC-backed fintech company in the U.S., taking the crown from Robinhood. Enthusiasm has been much more tepid for traditional brick and mortar banks, which appear to be one of the few remaining value plays in the current market environment. There has been a more-or-less wholesale rejection of the regional and community bank space, with many high-quality banks trading at or below tangible book value. Many of these banks have been net beneficiaries of the recent government stimulus packages as many customers have turned to these banks for PPP loan administration and the related fee income has been highly accretive to profitability.

In August, RockCreek's investment partner startup accelerator Y Combinator hosted Demo Day for its first-ever totally virtual batch, which saw 197 startups highlighted from an application pool of more than 12,000. HotPlate, a service that enables unemployed chefs to cook, sell, and deliver food prepared from the confines of their homes, is a great example of companies tackling everyday challenges with broader implications for how workers monetize their labor going forward. Another company empowering self-employed labor is Substack, an online platform that provides writers publishing, payment, analytics, and design infrastructure to support their own subscription newsletters, with several writers rumored to be earning in excess of $1 million per year.

Perhaps the most covered story in the third quarter was the fascinating saga of ByteDance's pending divestment of popular video app TikTok. In late July, President Trump hinted to reporters that his Administration was considering a potential ban of the popular app in response to geopolitical concerns. Microsoft quickly emerged as an interested acquirer of TikTok's U.S. operations, and shortly thereafter Walmart announced it would be joining the bidding party. To the surprise of many, Oracle emerged as a dark horse bidder and moved into pole position once Microsoft decided to end its pursuit. During the process, President Trump's Administration announced a deadline for a final sale, raising the stakes for all parties to get a deal done. A deal has started to take shape, with it appearing that Oracle and Walmart will acquire a 20% stake in TikTok while ByteDance continues to hold the remaining 80%. The deal is still under review by U.S. regulators, and it appears likely that an independent board of directors will be assigned to the company, with significant input from the Administration. ByteDance, which has an estimated private valuation north of $100 billion making it the most highly valued VC-backed private company in the world, has indicated a willingness to publicly list its shares on one of the U.S. exchanges should the deal be approved. However, it will be interesting to watch how this saga affects future U.S. listings of Chinese tech companies, as Ant Financial, the financial services arm of Alibaba, recently spurned U.S. exchanges in favor of a dual Hong Kong/Shanghai listing that could see the company fetch a record-setting valuation of $250 billion.

The other major story in private markets during the quarter was a scorching IPO market, as several high-profile companies made their trading debuts to significant fanfare. The most notable offering was cloud-data-warehousing provider Snowflake, which became the largest software IPO of all time after achieving a market cap of nearly $70 billion on its first day of trading. Warren Buffett got in on the action as Berkshire Hathaway purchased an allocation of $480 million at the IPO price. Not only was this notable for being Mr. Buffet's first-ever tech IPO investment, but it was also Berkshire Hathaway's first participation in an IPO since Ford Motor Company. Other notable IPOs during the quarter included Sumo Logic, JFrog, Lemonade, Unity Technologies, and GoodRx, as well as the direct listings of Palantir and Asana. Upcoming tech IPOs for investors to keep an eye on, aside from ByteDance and Ant Financial, include Airbnb, Coinbase, and Databricks.

REAL ESTATE

Few segments of the economy have felt the Covid-19 crisis so immensely as real estate, where uncertainty and disruption are greatly delaying decision-making processes. According to data from Real Capital Analytics, commercial real estate transaction activity in the Americas has fallen 40% in 2020 through September 6th versus a year ago. The drop in transaction volume in Asia Pacific is 38% year-over-year and 22% in Europe, the Middle East and Africa (EMEA). The rates of decline for all three global regions have steepened since mid-year. Cross-border investment has slowed significantly and is likely to remain muted as travel restrictions and logistical challenges hamper activity. Transaction volume has been focused only on the stronger -performing sectors.

The retail and hospitality sectors continue to be the most directly hit, reflecting reduced consumer spending and a pullback in both personal and business travel. In fact, these two sectors alone account for 92% of total troubled assets to date compared to just about half the total distressed volume in the 2008 crisis.

Logistics market demand has slowed and there has been a slight uptick in vacancies. Overall, the market remains relatively healthy as sectors such as medical supplies, groceries, and e-commerce prove to be resilient drivers for warehouse demand. According to JLL, prior to the pandemic, about 35% of industrial leasing activity was related to e-commerce but as much as 50% of leasing activity has already been tied to the online retail industry in 2020. This has been the result of increased e-commerce activity as more retail companies have been increasingly transitioning to online sales channels that require more warehousing space than brick-and-mortar retailers. In fact, Prologis estimates that e-commerce retailers need as much as three times the warehouse space to generate comparable revenues relative to brick-and-mortar sales.

Global office leasing activity was 59% lower than a year ago while vacancy rates have started to creep up across the regions. The office sector is also expected to incur stress in effective rents. It is expected that effective rents will fall 10.4% nationally this year and as much as 21% in New York and other larger CBD markets. Many companies continue to push back returning to the office, with some already planning to telecommute well into 2021. Whether the increased availability of remote working infrastructure will have long-term effects on office demand remains to be seen. However, the long-term nature of office leases means that it may take some time for vacancy rates to reflect the real trend.

Sustained travel restrictions and challenges to perform due diligence have seen markets with deep pools of domestic capital and higher transparency prove more resilient and outperform the broader market. As uncertainty continues, we remain focused on deploying capital into defensive strategies, diversifying portfolios, and looking to operationally critical sectors such as the industrial and multifamily sectors as well as burgeoning sectors such as digital real estate which includes data centers, spectrum, and fiber.

Although economic headwinds persist and capital deployment to funds has slowed, debt markets are stabilizing, and near-record levels of dry powder remain in the market. As investor sentiment shifts toward deal sourcing, we believe there is ample capital that is seeking to take advantage of dislocations and distressed opportunities that are emerging in the market. As we look ahead, a broader recovery in the capital markets should accelerate price discovery and enable investors to better underwrite opportunities across different sectors and risk profiles.

One area we are seeking to increase exposure to and believe presents a long-term secular opportunity is the single-family rental ("SFR") sector, and more specifically, the build-for-rent ("BFR") sector. For context, BFR assets are built specifically for rentals and have higher margins than other single-family assets given the attractive spread between yield on cost to build such assets and the cap rate on stabilized assets. Demand for the product has only increased since the pandemic as de-urbanization has accelerated due to millennials seeking out more space and moving more into the suburbs. Furthermore, practicing socially distancing is much easier in a separate stand-alone unit compared to a multi-family unit. Currently, approximately 6% of new single-family homes are purpose-built for-rent, which would result in approximately 700,000 new units over the next ten years. Given the strong demographic trends, it is likely that there will be much greater demand for such units than the current pace of production, which could result in a significant shortfall presenting a multi-decade opportunity for investors.

IMPACT

In 2020, both prior to, and as we emerge from, the pandemic, investors have come to see returns in their impact and sustainable investments. Given our long history investing sustainably, we are not resigned to the troubling realities of climate change but motivated to redouble our innovation efforts. For this reason, we were early participants in the FinTech and EdTech booms — investing around the thesis that access to financial services and education have the potential to deliver social good at scale. Of course, some bets have a longer, choppier road. Consider the rise in CleanTech investing in the late 2000s and early 2010s — sustainable investing had seen a 10x increase in venture investment between 2000 and 2008 (from approximately $400 million to $4.2 billion over that period). At RockCreek, we are constantly studying these existing opportunities and watching the trajectory of new impact opportunities.

Our team has found digital health to be a promising investment area. Health tech and digital health activity have quietly increased since 2010, having grown from slightly more than 2% of total VC investment to almost 6% in 2019. In the third quarter, Teledoc, one of the leading providers of virtual doctor visits, announced a deal to absorb Livongo Health, a digital health company historically focused on diabetes care, for $18.5 billion, creating an ~$37 billion remote health company. Likewise, the third quarter brought strong public markets reception to GoodRx's IPO, which has consistently been trading well above its $33 IPO since its offering in early September. GoodRx offers free drug coupons for discounts on medications and has been building a telemedicine platform. Although this theme has been thrust into focus principally because of the Covid-19 crisis, telemedicine and remote visits constitute only a small piece of the digital health landscape. We believe that personalized and lower-cost care, transparent access to one's healthcare data, and the potential for technology to support independent, dignified living, among other themes expressed by investors in the space will drive impact and investment outcomes.

In the third quarter, investors began to receive concrete data on the successes and failures of distanced learning through the pandemic. As long-time believers and investors in EdTech, we thought it appropriate to highlight some concerning and tragically expected data on education outcomes through this pandemic. A recent Ithaka S+R study focused on higher-ed, executed in conjunction with the Council of Independent Colleges and its members, highlighted that Pell recipients were the most adversely affected by the pandemic, with the largest deficit between actual and predicted graduation rates. Surprisingly, graduation rates for fourth-year Spring 2020 students were higher than predicted overall– approximately 1.0% higher across the study's broad sample. Pell recipients, on the other hand, were approximately 1.2% lower than predicted. The graduation rate for underrepresented minority students and female students was 1.0% and 0.5% lower than predicted, respectively. Likewise, in the K-12 context, according to a study published by the Rand Corporation, a mere 30% of teachers in high-poverty schools reported that all or nearly all of their students had internet access at home. As we continue to invest in this area, we are reminded that education solutions must be more inclusive — RockCreek's recent investment in accessible broadband connectivity for those without high-quality, cost-effective, and reliable internet is one way we are addressing this gap in education outcomes.

2020 has remained an active year for impact investors up and into the third quarter, investing in these themes and in broader socially responsible investments. Capital has continued to move towards private and public active strategies along with sustainability-focused ETFs and mutual funds at breakneck speed. Morningstar estimates net inflows into sustainable mutual funds in the first half of 2020 totaled $20.9 billion, compared with $21.4 billion for all of 2019. In the context of active public equities, one area that has picked up steam in Q3 is the investor response to the EU's Green Deal, which was passed earlier this year and aims to create a carbon-neutral EU by 2050. The multi trillion-dollar endeavor has European investors looking at direct clean energy investment in wind and solar assets, hydrogen, electrification, and other climate related investments.

ROCKCREEK UPDATE

This Sunday marked the International Day of the Girl, an annual campaign launched by the United Nations to amplify young female voices, stand up for their rights, and advocate for their education. This year's theme, "My Voice, Our Equal Future," focused on adolescent girls demanding and implementing the change they want to see in the world. We applaud the intelligent, thoughtful women that constitute Team RockCreek and thank our clients and partners for being allies towards this important cause. A culture of diversity, equity, and inclusion runs throughout RockCreek with over 80% of our management team and Advisory Board coming from diverse backgrounds. RockCreek has always believed that new talent and diversity in investments leads to stronger returns for our clients. Since inception, RockCreek has invested over $6.2 billion with diverse firms and over $2.1 billion in women-owned firms. The RockCreek internship program, which has had over 350 interns so far, historically includes over 80% women and diverse interns and looks to cultivate the next generation of investment professionals. To commemorate this year's International Day of the Girl, RockCreek has made a donation to support Big Brothers, Big Sisters of America, which invests in children's futures across the United States.

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