HEIJIN CAPITAL

HEIJIN CAPITAL BI-WEEKLY INVESTMENT COMMENTARY

May 3rd – May 17th, 2020

Commentary Overview

Market Snapshot

INDEX	CLOSE	2 WEEKS	YTD
Dow Jones Industrial Average	23,685	-0.27%	-17.95%
S&P 500 Index	2,863	+0.74%	-12.10%
NASDAQ	9,014	+3.49%	-0.85%
10-yr Treasury Yield (% yield)	0.64%	+0.00%	-1.24%
WTI Oil ($/bbl)	$29.65	+30.16%	-51.44%
Bonds	$117.03	+0.05%	+4.73%

*bonds are represented by the iShares Core U.S. Aggregate Bond ETF (NYSEARCA:AGG)

Global Macro

Analysis On Italian Sovereign Debt: Part 2

Guest writer, Ocean Salazar-Ferrer

Since the start of the coronavirus-induced lockdowns, global central banks have adopted aggressive monetary easing and asset purchases to mitigate economic slowdowns and liquidity issues. Prior to the crisis, the BOJ and ECB were already in negative rate territory, whereas the US Federal Reserve had lowered its target rate by 75bp since mid-2019 to 1.75%. The European response to the COVID-19 crisis is most important to watch because of years of slow growth and quantitative easing prior to the pandemic. Italy experienced one of the worst outbreaks of the Eurozone and had been dealing with ballooning public debt before the crisis. This scenario exacerbated a 2019 Q4 real GDP contraction of -0.3% with a Q1 contraction of -4.7%. Italy is now on track to suffer a real GDP contraction of 8-13% in 2020. The European Commission is predicting a large increase in Italian public debt as government revenues decrease with GDP. Despite this, yields on Italian public and private debt are relatively low compared to historical averages and recent government bond sales have indicted good investor demand. Despite this demand and ECB QE, Italian sovereign yields have risen, widening the Italy-Germany 10-year spread to levels reminiscent of the 2018 political uncertainty (Figure 1). Subsequently, the Italian government debt CDS spread between the 2 and 10 year has tightened substantially (Figure 2). Both measures indicate are signaling near-term risks to the Italian economy that are not currently reflected in current BTP yields. However, based on an independent analysis of Italian government finances, even credit derivatives may not be correctly pricing in Italian sovereign debt default risk. Given Italy's large amount of debt held by economies, a significant change in default risk could have a domino effect on financial institutions and markets.

Firstly, current estimates from the Italian government in their Economic and Financial Document (DEF) from late April is too conservative on forecasted budget deficit and debt/GDP ratio. They estimate a -8% GDP contraction in 2020 (before stimulus) and targets its budget deficit at 10.4% of GDP. However, these estimates are really an unrealistic best case scenario. Bloomberg Economics forecasts GDP growth to contract by -13.2% in 2020. Assuming a) a -13% level of GDP contraction and b) government primary budget and interest expense projectons remain unchanged in nominal amounts, the government deficit could be upwards of €170B (Figure 3). This would suggest an increase in the debt/GDP level to 166% and a deficit 14% of GDP. These are levels unseen since the 2009 during the financial crisis. Debt/GDP will be dependent on the Italian GDP outlook (Figure 4). Still, this model has conservative assumptions. The Italian government's deficit could rise above the 14% level if tax cuts, additional government spending, or a prolonged economic downturn were to occur.

Just this week, prime minister Conte announced tax cuts woth €4B, which will inevitably add to the deficit. The Italian government is likely to continue these unanticpated fiscal measures, increasing the budget deficit past earlier projections. The Conte government, together with other Western European countries, has been pushing for isuuance of regional EU bonds, or 'coronabonds', to finance recovery from the crisis. This plan, has sparked an debate on how to finance recovery for the EU's weakest economies. Northern EU countries, led by Germany and the Netherlands argue that this is unfeasible without massive changes to the EU oversight of finances of other member states. German Chancellor Angela Merkel rejected the measure, asserting it would be "time-consuming and difficult". However, regionally issued EU bonds seem to be the only way out for Italy, especially if its chronic low GDP growth continues. The key to exiting the debt cycle for Italy is to continue lowering its interest expense year over year until it can raise its total budget balance to a surplus. Given the unprecedented increase in public debt and the threat of a slow recovery, Italy's hopes of decreasing its debt burden seem unattainable. As seen in Figure 5, the ECB's effective refinancing rate has been the key driver of the Italian government's interest rate expense and YoY change in total debt. It can also be inferred that there is a bidirectional causal relationship between Italian yearly interest expense and YoY change in total debt, meaning they both affect each other. However, the ECB's monetary easing is counteracting this driver, keeping Italy's interest expense relatively stable. This said, Italy's interest payments are likely to remain relatively stable for the foreseeable future. In order to keep their debt from growing, the Italian government will need to run budget surplus of 3-4% of GDP over the next 4 years, assuming a strong economic recovery. This scenario is extremely unrealistic. What will need to happen to prevent Italian debt rising uncontrollably is either:

1) The ECB will have to continue its QE program, likely more aggressively, until either the Italian economy miraculously starts growing consistently above 3% per year.
2) The issuance of regional EU bonds control lending costs for Italy and other southern European countries.
3) A possible, eventual rise of a Salvini government that pushes for Italy's exit of the Eurozone.

Given Italy's somber macroeconomic outlook, the probability of a higher-than a forecasted debt burden, and a downtrend of demand for Italian debt, markets have yet to fully factor in risks associated with Italian sovereign debt and decreased efficacy of ECB quantitative easing. This has been somewhat reflected in Italian sovereign debt credit default swap spreads. However, the market has yet to factor in the medium- and long-term implications of Italy's debt increases. If Italy were to require a bailout from the European Stability Mechanism (ESM), it would harm the Eurozone currency and investor confidence. In the short-term, increasing borrowing costs for Italy could lead to defaults and slower economic growth. European banks that have both a high relative exposure to Italian sovereigns and increasing bad debt would be affected first. Intesa San Paolo and other Italian banks have received rating cuts from Fitch in relation to these two factors.

Other banks such as Caixabank (Spain) and Credit Agricole (France) have a heavy sovereign debt exposure to Italy. Financial institutions such as these are likely to take a slight hit to their balance sheets if decreasing investor demand for Italian sovereign debt starts to effect bond valuations. More importantly, for Italian banks such as Intesa, lending interest rates will have to rise, opening the door to corporate defaults and slow domestic economic growth. Questions may arise of the ECB's ability to combat increasing deflationary risks given their bloated balance sheets. Maintaining a high level of QE with negative rates for a long period of time to address Southern European countries' economic weakness and high debt levels is not a sustainable solution. Even before the COVID-19 lockdowns, the rate of saving among European households had been increasing, with a deflationary effect on the HICP, which has fallen significantly below the ECB's 2% target (Figure 6).

Finally, it is important to identify whether or not ECB policy is being effective in maintaining investor demand for Italian sovereign debt. The latest bid/cover ratio for Italian sovereign debt auctions has trended down the past 1-2 years, alluding to decreasing investor demand for sovereign debt despite the ECB asset purchases. It is unlikely that the ECB will be able to combat this at the current levels of asset purchases, however massive they are. To sustain the sovereign debt increases necessary for Italy's budget deficit this year, the ECB will likely have to further ramp up asset purchases.

Figure 1. Germany-Italy 10-year spreads

Figure 2. Italian govt. debt CDS 2-10 year spread

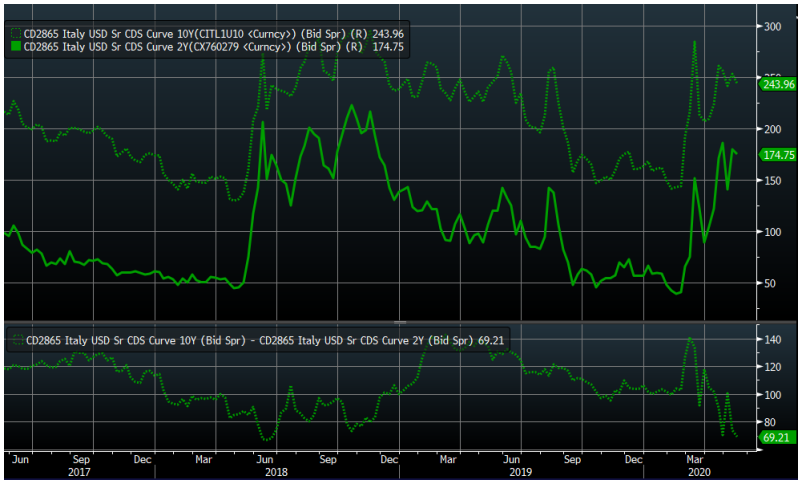


Figure 3. Government deficit forecast

Assumptions	Values
Forecasted GDP growth YoY	-13%
Forecasted Additional Spending	55,000
Interest Expense	50,000
Change in Interest Expense	-17%
Government Revenues % GDP	47%
Government Expenditures % GDP	55%

Forecast	Values
Nominal GDP (Forecast)	1,241,513
Forecast Expenditures	862,546
Debt/GDP	164%
Deficit	(133,898)
Deficit/GDP	11%

Other Assumptions and Notes:
GDP measured as nominal
No Tax Cuts
All Values In Euros (MM)

Figure 4. Italian Debt/GDP Forecast

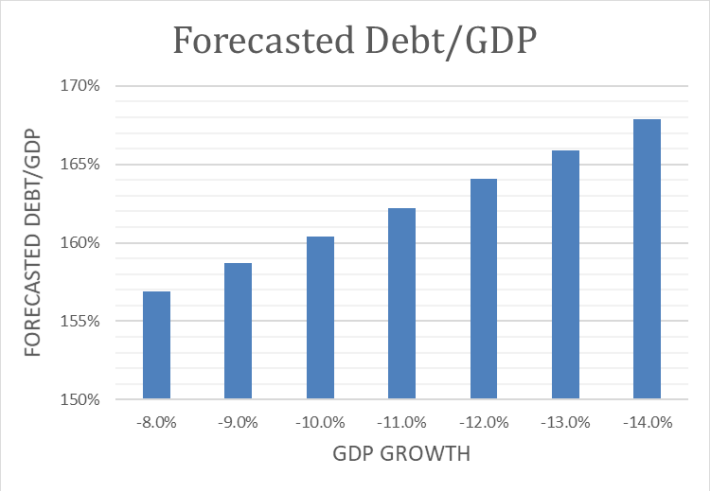


Figure 5. ECB ERR, Interest Expense & YoY Change of Govt Debt

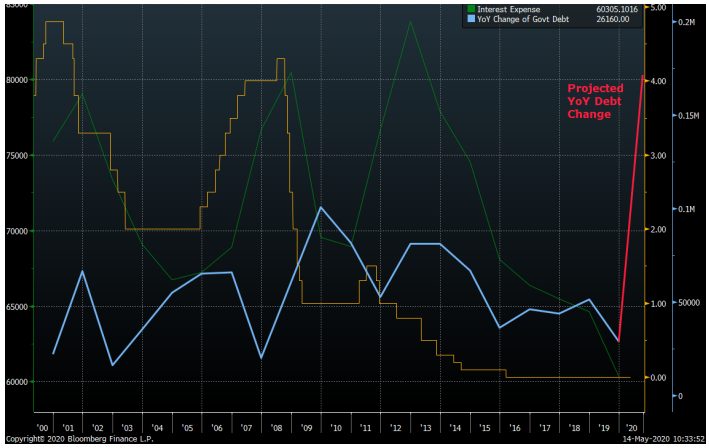


Figure 6. EC Consumer Confidence

Sector Analysis

The Future of Luxury Fashion

Coronavirus has hit every sector of the market hard, it is clear that this is so much more serious than previous global health scares such as SARS or Swine flu. This increase in fear factor has seriously weakened short to medium term confidence significate and has even started to affect some pessimists 5-10-year market outlook. Its impact on the real economy—job losses, GDP declines and so on—is set to be extensive. And it is within this decline in which opportunities lie, anyone who has experience in the market knows that rarely are events priced incorrectly and that the market tends to only over or under-react.

Heijin expects 2020 to be an awful year for the luxury goods sector, with forced store closures, GDP fallings and unemployment rising and subsequently, household's disposable income falling, Luxury goods sector revenues are expected to be at a decade low. Shop closure hit Luxury brands much harder than the high street. The luxury sector was already under competitive strain before coronavirus due to the influx of mid-range firms such as suit supply who now offer 'luxury' level clothes, with free tailoring on their products at high street prices.

Thus, the luxury sector in recent years has already had to adapt in ways of improving the customer experience, through providing refreshments and snacks, private views, launch events in stores, and customers dealing with the same member of staff each time they shop at their branch so personal relationship is made, all of this added value is wiped away by COVID.

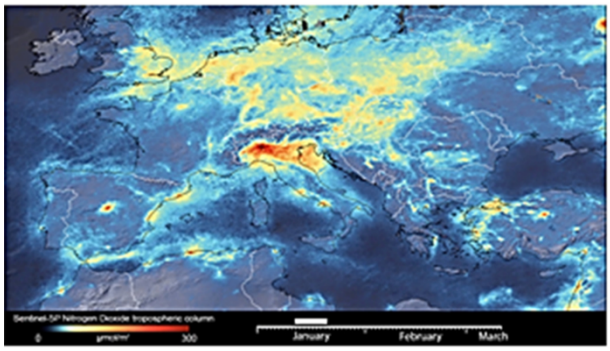
Moreover, this crisis is worse for luxury goods sector than the credit crunch of 08' as the Asian market, which accounts for the vast majority of luxury good purchases was largely unaffected by the 08' crisis, unlike the current pandemic where it was China who was patient 0. Brand owners such as LVMH felt the tremors of Covid-19 rather early on in the year as the virus swept through china, the citizens of which in 2019, accounted for 90% of growth in the sector. What's more, the virus hit the 'fashion hubs' of Europe particularly hard with Paris, Milan and London some the worst affected areas in Europe, thus causing further disruption to supply routes and the all-important fashion weeks. Despite signs of recovery already in Asian markets, we expect the Luxury Goods market to experience a contraction of roughly 30%. It is vital to additionally note that Chinese consumers took more than 150 million trips abroad with 50% of luxury good purchases being made outside the mainland, especially in Europe. Thus although domestic demand will recover relatively soon as there are already signs of it picking up, we will not see the recovery progress until Air-travel bans have been lifted and people can begin to travel for leisure pursuits.

It is easy to say that this is merely a speedbump for luxury brands to 'get over' and carry on. However, a more nuanced view is that this will completely revolutionise fashion for the better.

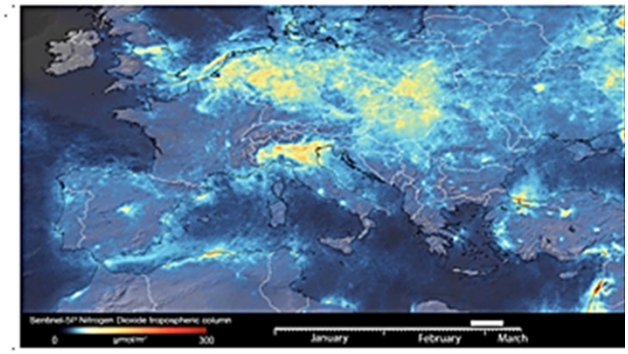
Of course, the obvious change is the transition to online sales during Covid-19. Even before the coronavirus pandemic, e-commerce sales represented the bulk of overall retail sales growth in the US $600 billion in online sales accounted for over half of all retail growth last year. And projections say e-commerce sales may go as high as $6.5 trillion in 2023. This has pulled up some potential pitfalls and red flags that well-established fashion house has never had to worry about before. We see that online presence has been heavily neglected by the high-end brands as previously there were social stigmas that it would reduce the value and exclusivity of the brand. And due to such views in the fashion industry, many have lagged in regards to social media presence and online sales. In these tough times as customers cannot go into store, it is even more important for companies to have a channel between themselves and their customer. Fashion houses should take inspiration from some of the fast-fashion brands such as Boohoo, ASOS and pretty little thing, who have millions of dedicated followers and post engaging content on their social media platforms.

Of course, it is a fine balance between organically growing ones following to entice 'would-be customers' with chic and elegant adverts and doing what fast fashion brands often do, relying on Z-list celebrities to push their products. It will be extremely tough for companies to get the right balance. However, in the future as the baby boomer generation who valued the process of going into store retire and the 'online generation' (Gen-Z, millennials etc) grow older and start to become the customer for these fashion houses, online interaction and in particular social media presence will become a key asset for all fashion brands, in particular luxury brands.

Another key factor is environmental responsibility. A positive from this pandemic is the environmental improvements that have been made, many of our readers would have seen images of the canals of Venice with beautifully clear water and images such as the figure below that shows air pollution down up to 30% in populated areas.



Before Lockdown



After Lockdown

From this, we see that we can make a change and that this is a human issue, not a planetary one. It is imperative that we use this as a platform to carve a 'new world' of environmental responsibility from this, the recovery itself needs to be 'green'. This is true of all sectors, not just luxury brands. As concern for the environment is set to increase after the virus as many previous 'non-believers' have seen what progress can be made in such a short time. Brands will have to rethink the way some of their products are made (ie leather, fur etc) as well as what is done with unsold stock. Especially in this pandemic, there will be a monumental build-up of unsold stock from past seasons that the 'luxury' customer will not want: dealing with this in an environmentally friendly manner will certainly be a challenge. As many companies have faced massive backlash in the past from the press for burning unsold items so not to diminish the 'value' brand. It is clear that this will need to change, as the demand for fashion to become greener and less morally dubious continues.

Some firms have already attempted to take such steps. An example of this new trend in environmentally sustainable high-end fashion is Stella McCartney who uses re-engineered cashmere & ethically sourced wool, organic cotton & recycled textiles. In 2014, Stella McCartney introduced Clevercare, a simple, five-step labeling system to help consumers care for and prolong the life of their clothing through mindful garment care. The brand is also careful with its selection of suppliers, many of whom are small businesses are artisans in Europe. When not designing her own products, Stella McCartney collaborates with numerous NGOs and environmental conservation organizations as well, including Wildlife Works and Parley for the Oceans. Moreover, to help the current pandemic, the directors of Burberry including chief executive Marco Gobbetti said on 24 April they would be taking a 20% reduction in their base salary and fees until June. This will be donated to the Burberry Foundation COVID-19 Community Fund. Burberry also said it was retooling its factory in West Yorkshire to start making PPE kit for medical staff. The company has also donated over 100,000 pieces of PPE to date. This could be the beginning of a new face of fashion that can still enjoy breakthrough trends and pieces, yet without the needless waste and apparent disregard for the environment in previous years.

Heijin has always been a long term bull in the luxury goods market, as it has proven to be a robust and thriving sector that has weathered crises very well, we expect the same for the future. Heijin acknowledges that earning will be dire for Q1 and Q2, however, we expect to see a marked recovery towards the end of Q3, and as we progress into 2021 an even more pronounced recovery. Heijin has never been one 'take a punt' on anything regardless of our long-term view, as being too early is the same as being wrong. We believe that although this market will, of course, recover as there will always be a demand for luxury, the intelligent investor would hold off and let the situation develop further. One should wait and see which firms use the pandemic to adapt to the changing world, and which ones remain set in their ways, soon to become stagnant, before looking to open a position.

General Analysis

Auction-Driven Markets

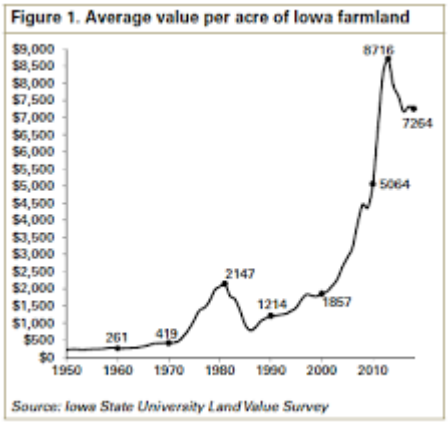
We are continuingly of the view that periods of economic distress and panic remain the most opportune for investing. This is a belief held by the majority of financial institutions, yet the behavior of public equity markets in such times suggests a contradictory reality. For instance, the market sell-off at the beginning of the COVID-19 pandemic, drove the major averages into bear territory —defined as drop of 20% or more from a recent high—at the fastest pace in history and corroborates the existence of this conflict between investors' words and their actions. If periods of economic distress are indeed most auspicious, then an understanding of the critical factors which drive such sell offs can help investors improve their decision making in periods of crisis. Our research on the subject conclusively points to two major elements most responsible for sell-offs:

1. **Tangible Economic Stress.** Historically, major economic developments with real consequences on the economy set off panic selling in public markets. In the Great Recession of '08 the crisis in subprime mortgages threatened the viability of U.S housing market and eventually rippled through to the global economy leaving the DJIA and other major averages more than halved. Similarly, the COVID-19 pandemic has put economic activity to a halt and tipped the world economies into recession in addition to its effect on markets. When we account for this and the fact that institutions sell more than retail investors whenever there are sharp drops in market levels, sell offs are in part justified because large institutional investors such as pension funds have sizeable obligations which they need to fulfill and must consequently liquidate part of their holdings. Nonetheless other markets are also exposed to economic disruptions but few experience them as often and on a scale comparable to public equity markets. This led us to consider the possibility of there being a second element driving sell-offs.

2. **Auction-Driven Markets.** Consequent research on several markets allowed us to draw on comparisons and lessons across different asset classes. In particular, there seems to be a fundamental difference in how asset values change in public stock markets as opposed to private markets.

In private markets transactions typically take place between informed intelligent buyers and sellers. When an investor seeks to buy property in real estate, they typically have close to perfect information about the market for the property, surrounding properties' asset values and cash flows and etc. The seller is also as informed and because these factors have the most influence on the negotiations the result is a pricing of assets that is arrived to quite logically and through a hard-fought negotiating process. One thus observes that changes in the value of assets

underlying such transactions are quite steady in nature and tend to only significantly change over long periods of time. Take for instance the price action for farmland in Iowa:



The chart shows that the only significant changes in farmland value only take place over decades.

Percent change in dollar value of "good" farmland

	January 1, 2018 to April 1, 2018	April 1, 2017 to April 1, 2018
Illinois	0	-1
Indiana	0	+3
Iowa	+1	+2
Michigan	*	*
Wisconsin	+3	+3
SEVENTH DISTRICT	+1	0

Over shorter periods of time ranging from 4 months to a year, farmland values are relatively stable.

In other private markets where assets underlying the transactions are productive assets the same can be observed. Nevertheless, it is important to note that such markets are not immune to sharp changes as the crisis of '08 did significantly affect housing values, however, when private markets experience large disruptions they are usually solely the result of black swan economic events or of significant changes in supply and/or demand.

In public stock markets the frequency of sell-offs suggests that something otherwise occurs especially since in many cases—but not all—sharp drops in market levels are followed by sharp rallies meaning they're often the result of panic. For example, since dropping into bear territory at the beginning of the pandemic the Dow Jones Industrial Average DJIA is up 27% from its low of 18,591.93 on March 23 to 23,685.42. Yet stocks represent common shares of ownership in a company's profit; by definition these are productive assets, why still, do asset values change more drastically and more often than in other similar markets? The answer lies in the fact that public equity markets worldwide function off of a bid-auction system of pricing. Yes, just as in private markets, prices are in part determined by supply and demand but this is only in part. The price of shares is also determined through a bid-ask process similar in nature to an auction. Buyers, sellers and market makers—defined as a dealer in securities or other assets who undertakes to buy or sell at specified prices at all times—are constantly engaged in a back and

forth bidding process with a lot less than perfect information on the assets which they are trading often leaving room for emotion and illogical on-the-spot decision making to enter the equation. Simply put unlike private markets, prices are not necessarily solely the result of negotiated transactions between intelligent buyers and sellers but rather that of a host of other factors often resulting in both undervalued and overvalued companies. In essence this is why steep market drops create opportunities for outsized returns in stock investing.

Notwithstanding this fact taking advantage of this process is by no means easy and in fact, it is often wise for casual investors and most professionals, as most fail to outperform the indices, to abstain from timing the market. Nevertheless, it will serve investors well to remember that stock markets are auction-driven in nature such that times of crisis bring about numerous possibilities for the shrewd capitalist; though they'd do just as well to remember the preceding fact.

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