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HEIJIN CAPITAL BI-WEEKLY INVESTMENT COMMENTARY

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Market Snapshot

INDEX	CLOSE	2 WEEKS	YTD
Dow Jones Industrial Average	25,015	-2.90%	-13.35%
S&P 500 Index	3,009	-1.88%	-7.64%
NASDAQ	9,757	+0.32%	+7.31%
10-yr Treasury Yield (% yield)	0.64%	-0.07%	-1.24%
WTI Oil ($/bbl)	$38.49	+3.69%	-36.96%
Bonds	$118.01	+0.03%	+4.73%

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

Global Macro

Is The USD At Risk Of Losing Its Reserve Currency Status?

A quick history lesson of how the U.S. Dollar become the world's reserve currency.

The Federal Reserve Bank was created in 1913 in response to the unreliability and instability of a currency system based on banknotes issued by private banks. At that time, the U.S. economy had overhauled Britain's as the world's largest, but Britain was still the world's commercial hub, with much of it transacted in British pounds. Moreover, most developed countries pegged their currencies to gold to create stability in currency exchanges when conducting global trade. However, when WWI broke out in 1914, many countries dropped out of the gold standard to be able to pay their military expenses with paper money, which in return devalued their currencies. Three years into the war, Britain, which was still following the gold standard to maintain its financial superiority, found itself having to borrow money for the first time. The United States became the lender of choice for many countries willing to buy dollar-denominated U.S. bonds. In 1919, Britain was finally forced to abandon the gold standard, which decimated the bank accounts of international merchants who traded in pounds. By then, the dollar had replaced the pound as the world's leading reserve.

By 1944 the U.S. had amassed the largest stockpile of gold out of any other modern developed country - mostly because it was selling guns & ammunition to the Allies during WW2, receiving payment in gold. This put other countries such as Britain at a disadvantage as the country was almost depleted of all gold reserves and was entering into a heavy recession. That summer, 44 allied nations met in Bretton Wood in New Hampshire to devise a new strategy to facilitate global trade without putting countries at a disadvantage. The arrangement, which came to be known as the Bretton Woods Agreement, established that the central banks would maintain fixed exchange rates between their native currencies and the U.S. dollar. In turn, the United States would redeem U.S. dollars for gold on demand. Countries had some degree over the currencies in situations wherein their currency values became too weak or too strong relative to the dollar. They could buy or sell their currency to regulate the money supply.

The demand for Treasury securities coupled with the deficit spending needed to finance the Vietnam War caused the United States to flood the market with paper money. With growing concerns over the stability of the dollar, the countries began to convert dollar reserves into gold. The demand for gold was so high & unsustainable that President Richard Nixon was forced to intervene and de-link the dollar from gold, which led to the floating exchange rates that exist today. Although there have been periods of stagflation—high inflation and high unemployment—the U.S. dollar has remained the world's reserve currency.

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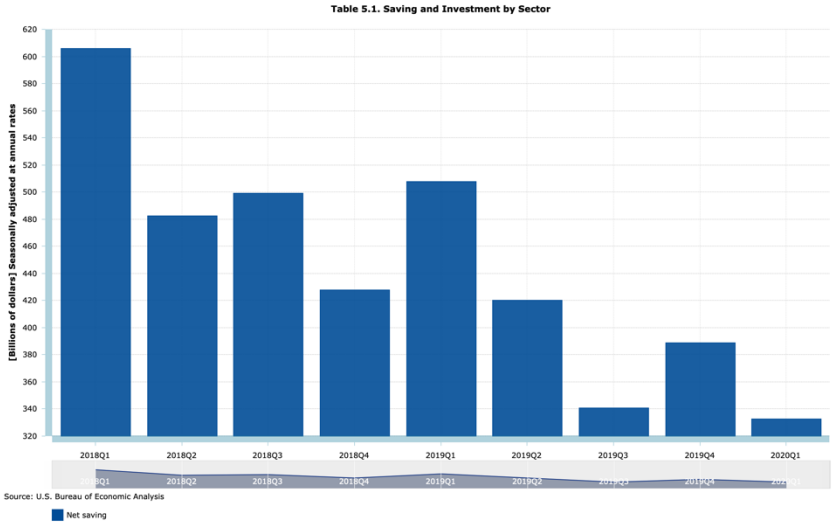
In the present day, more than 60% of all foreign bank reserves are denominated in U.S. dollars, according to the IMF. Many of the assets are in cash or U.S. bonds, such as U.S. Treasuries. Moreover, approximately 40% of the world's debt is denominated in U.S. dollars. The reserve status of the U.S. dollar is mainly based on the size and strength of the U.S. economy and the dominance of the U.S. financial markets. Despite massive deficit spending, trillions of dollars in foreign debt, and the unbridled printing of U.S. dollars, U.S. Treasury securities remain the "safest store of money." The trust and confidence that the world has in the United States' ability to pay its debts have kept the dollar as the most redeemable currency for facilitating world commerce.

This is likely to change - and here's why.

Already damaged by the impact of the Covid-19 pandemic, U.S. living standards are about to be tested as never before. At the same time, the world is having severe doubts about the once widely believed presumption of "American exceptionalism". Currencies set the equilibrium between the following two parameters — domestic economic fundamentals and foreign perceptions of a nation's strength (or weakness). This balance is shifting, and a crash in the dollar could well be in the making. The roots of this problem were amplified by a heavy shortfall in domestic U.S. savings. In the first quarter of 2020, net national saving (which includes savings of households, businesses, and the government sector) fell to 1.4% of national income. This was the lowest reading since late 2011 and one-fifth the average of 7% from 1960 to 2005.



A combination of lacking domestic savings and a big appetite to invest & grow has forced the U.S. to take great advantage of the dollar's role as the world's primary reserve currency and draw heavily on surplus savings from abroad to make up the difference. But at what cost? To bring in external capital, the U.S. has run a deficit in its current account every year since 1982 (this is not breaking news). However, Covid-19, and the economic crisis it has triggered, is slowly testing the breaking point between saving and the current-account. The primary culprit: ballooning government budget deficits. According to the Congressional Budget Office, the

federal budget deficit is likely to soar to a peacetime record of 17.9% of the GDP in 2020 before hopefully receding to 9.8% in 2021.

To sum it up, strong downward pressure is now building on already sharply depressed domestic savings. Compared with the situation during the GFC in '08, when domestic saving was a net negative for the first time on record, averaging -1.8% of national income from Q3 2008 to Q2 2010, a much sharper drop into negative territory is now likely, possibly plunging into the unknown -5% to -10% zone.

Reserve currency or not, the dollar will not be spared under these circumstances. The critical question is what will spark the decline?

One must simply look at how the U.S. has changed over the past few years under Trump's leadership. Protectionist trade policies, withdrawal from the building blocks of globalization such as the Paris Agreement on Climate, Trans-Pacific Partnership, World Health Organization and traditional Atlantic alliances, disastrous mismanagement of Covid-19 response, together with wrenching social turmoil not seen since the late 1960s, are all painfully visible signs of America's sharply diminished global leadership.

In our opinion, the coming collapse in the dollar will have three main implications:

1. It will be inflationary, but, in conjunction with what is likely to be a weak post-Covid economic recovery, provides us another reason to worry about an onset of stagflation—the harsh combination of weak economic growth and rising inflation that will wreak havoc on financial markets.
2. Furthermore, we can expect to see a sharp widening of America's trade deficit. Protectionist pressures coupled with a trade-fallout with over 100 different nations – namely the Chinese bilateral imbalance — will backfire and divert trade to other, higher-cost, producers, effectively taxing beleaguered U.S. consumers.
3. Finally, in the face of America's poorly timed wish for financial decoupling from China, who will fund the saving deficit of a nation that has finally lost its economic & political privilege? Most importantly - at what cost (interest rate) will this funding be sourced?

Of course, betting against the U.S. and most notably the Fed is a losing game (just look at stock markets recently), but there will come the point to all the money printers in the world will not be able to save the U.S. from the financial havoc that it has coming. For now, all we can do is speculate & strategize on the outcomes of how the U.S. will deal with the up and coming economic recession and how it will look coming out the other side.

Sector Analysis

When Will The UK Food And Bevarge Industry Bounce Back?

The Food and Beverage industry has been devastated by COVID. Restaurants, bars and Pubs once an integral part of day to day life, for many months have been completely empty. Following on from some of the points made in the above piece about adaptability we have seen massive contrasts from various retailers. Some have been extremely fast to adapt and change, offering their food on delivery service provides such as Deliveroo and Uber Eats, even doing “pick-up-pints" in some locations. Whereas as some firms have been comparatively slower to react, simply cutting off their workforce and shutting shop until lockdown passes. The fate of the hospitality industry is at the very forefront of the mind of many of the globe's leaders, as the industry provides a colossal amount of tax revenue to state coffers as well as employing an extraordinary amount of people, for example, 10% of the United Kingdoms workforce is employed in this sector. From the 4th of July, Pubs, restaurants and bars will be allowed to reopen their doors under stringent lockdown rules as we begin to experience the ‘new normal’. We expect to see a sharp uptake in the number of Pub, restaurant and bar-goers on the 4th as polls suggest people are largely fed up with lockdown and are looking forward to the feeling of normalcy a trip to a local establishment may provide.

Heijin’s’ first choice for the ‘hospitality rebound’ is JD Wetherspoons (LSE:JDW) - J D Wetherspoon plc is a pub company operating in the United Kingdom and Ireland. The company operates nearly 900 pubs, including the chain of Lloyds No.1 bars, and a growing number of Wetherspoon hotels. The companies business model of focusing on cheap food and alcohol was brilliant before and may fair even better now many households digressional incomes has fallen significantly. If we look back to 2008, the company performed brilliantly, rapidly recovering and steadily increasing sales, resulting in pre-tax profit rising 75% in the decade. The company is perhaps one of the best performers during the lockdown and one of the best prepared for coming out of lockdown. The group already had an emphasis on frugality, yet having furloughed the workforce early they have further saved their bottom line, and the group expects to be profitable by the end of the year. As we look to the future, JDW is expected to go from strength to strength with strong earnings growth forecasted over the next 3 years and they have embarked on a process of debt reduction. Wetherspoons is an institution in the United Kingdom, the company has used simple economies of scale to undercut its competitors and put locations in seemly every town and city in the country. Moreover, even before COVID, Wetherspoons was able to reduce its workforce and improve productivity through ordering table service via their app, an already well-established feature for their many customers, which may make the transition to the new normal much easier for the home of Britians’ cheap pints.

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Another interesting pick for us is Marston's brewery (LSE:MARS). Marston's plc is a British brewery, pub and hotel operator with over 1400 locations. Marstons is another firm who performed swiftly and efficiently when lockdown hit, furloughing the large majority of staff, and cutting the pay of those who stayed. Despite COVID, earnings are expected to grow significantly in the next 5 years.

Despite this, the new lockdown rules may only be marginally better for these establishments' bottom lines then operating a takeaway service. This is because a recent study found that with a one-meter spacing rule, bars could operate at up to 75% capacity, whereas at the current 2-meter level it is only 40%. Moreover, one must also factor in the likelihood of a second lockdown following another peak. Although both these choices are long term holds, it is still somewhat of a risk to buy before we have a clearer picture of the future. Thus, a safer choice would be a long time interest of ours; Diageo (NYSE:DEO).

Diageo plc is a British multinational beverage alcohol company, operating in more than 180 countries and produce in more than 140 sites around the world. It was the world's largest distiller and owns some of the biggest brands in the beverage market (Johnnie Walker, Crown Royal, JεB, Buchanan's and Windsor whiskies, Smirnoff, Cîroc and Ketel One vodkas, Captain Morgan, Baileys, Don Julio, Tanqueray and Guinness). It has a low PE ratio compared to the industry average and has had a steady increase in earnings over the past 5 years at an average of 8.4%. The company has a brilliant return on equity (over 30%). Diageo is a brilliant choice for any portfolio, it holds solid, reputable brands which have been industry leaders for decades, and is extremely well ran by its excellent management. Diageo won't be making headlines for the biggest market movers, however, its slow but steady growth make it an excellent pick for the long term.

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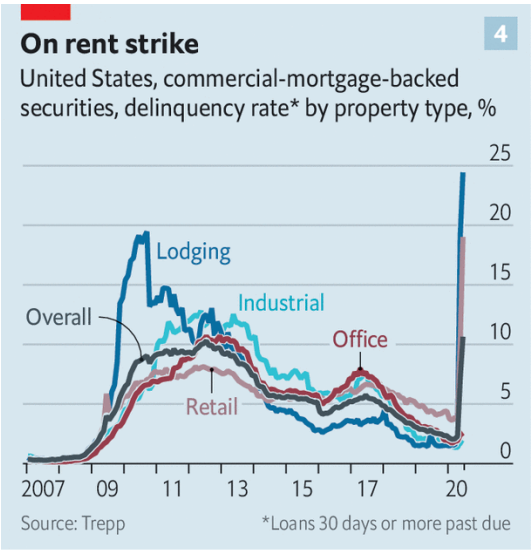
Real Estate

The Commercial Real Estate Crisis

While stock markets are having a marvelous recovery, a recovery in commercial real estate is not yet in sight. Especially since recent COVID-19 numbers in the US confirmed that a second wave of the coronavirus is likely, landlords need to decide whether to keep investing in their losing properties or default to their borrowers. Although some analysts suggest there will also be a v-shaped recovery in CRE, we think that won't be the case and that COVID-19 will shape commercial real estate for the decades to come.

One of the significant news events this week was that Blackstone, the PE firm that manages more than half a trillion dollars, is more than 30 days delinquent on one of its business hotel portfolios. Even though it is just a relatively small debt facility of $274 million and Blackstone had already written off the investment before COVID-19, it still demonstrates that even large investors are willing to walk away from their investments, leaving creditors sitting on the properties. If the coronavirus numbers in the US continue to deteriorate, more and more investors could decide to give up their investments, flooding the market with properties and leading to severe distress in the financial sector. Indeed, in the hospitality sector, more than 25% of collateralized mortgage-backed security loans were at least 30 days delinquent, with another 7.5% fewer than 30 days late.



The Economist

Within the hospitality sector, the business hotel will likely face the most challenging recovery. While resorts and holiday hotels will benefit immediately from the government opening up the economy, especially as many citizens plan to spend their holidays within their own country, it will likely take some time until companies again will allow business trips. And even then, it might take years to return to pre-COVID-19 levels, as the forced introduction of remote working technologies will make many business trips unnecessary.

However, even beyond hospitality, CRE will be hit severely. For instance, many companies have announced they extend their work from home arrangements even beyond the pandemic. Consequently, there will be significantly less demand for office space. The combination of decreased demand with increased supply due to the booming real estate market of the past years could lead to significant vacancy rates and thus defaults. Moreover, if a significant portion

of the population keeps working from home beyond COVID-19, fewer people will eat restaurants and shop in retail stores and malls, leading to a slump in retail commercial real estate markets.

Our opinion at Heijin is that COVID-19 will have a lasting impact on the people for the upcoming years, promoting behaviour that will ultimately hurt the commercial real estate sector. Especially in cities such as New York, there have been huge CRE projects in the past couple of years, developers and investors will suffer severe losses. Consequently, we are amongst other bearish on Empire State Realty Trust (NYSE:ESRT), SL Green Realy (NYSE:SLG), and Vornado Realty Trust (NYSE:VRNO). However, we also think there will be some bargain deals for knowledgeable investors. Moreover, we see potential in the housing market and data center real estate markets (NASDAQ:EQIX).

Investment Analysis

The Growing Importance Of Adaptability & M&A In Today's World

We all know that the world we are living in today is changing rapidly every day, which makes companies thrive and die faster than ever before. That is why businesses need to think through whether their business models have the adaptability to ensure they can survive and navigate this rather frenetic world.

For most corporations, the past 6 months most definitely did not fall in-line with the expectations they had set out at the beginning of FY 2020. A factor that determines a significant portion of a corporation's performance is the environment it operates in. Normally, management can pivot the operations in a direction that places the corporation in a more favourable environment and therefore optimising short-term or long-term performance. For some companies this translates into opening up operations in markets that are yet to mature, entering niche markets where there is a competitive advantage to be acquired, and more. Chasing a more favourable environment or striving for adaptability is why companies pay absurd premiums to acquire much smaller rivals that sometimes only offer one product/service. Business is as much about growing as it is about surviving.

Facebook itself was (still is) prone to changes in consumer preference in the social media/network space. But its astute M&A activities have transformed into a social media powerhouse that is now significantly more diversified and adaptable. Without WhatsApp, Instagram, and dozens of others it would be much less attractive from an investor's standpoint. They have indeed created a track record of being able to eye out the next key players of social media that is enviable by many. The question is will they be able to do so for the next 10, 20, 50, 100 years?

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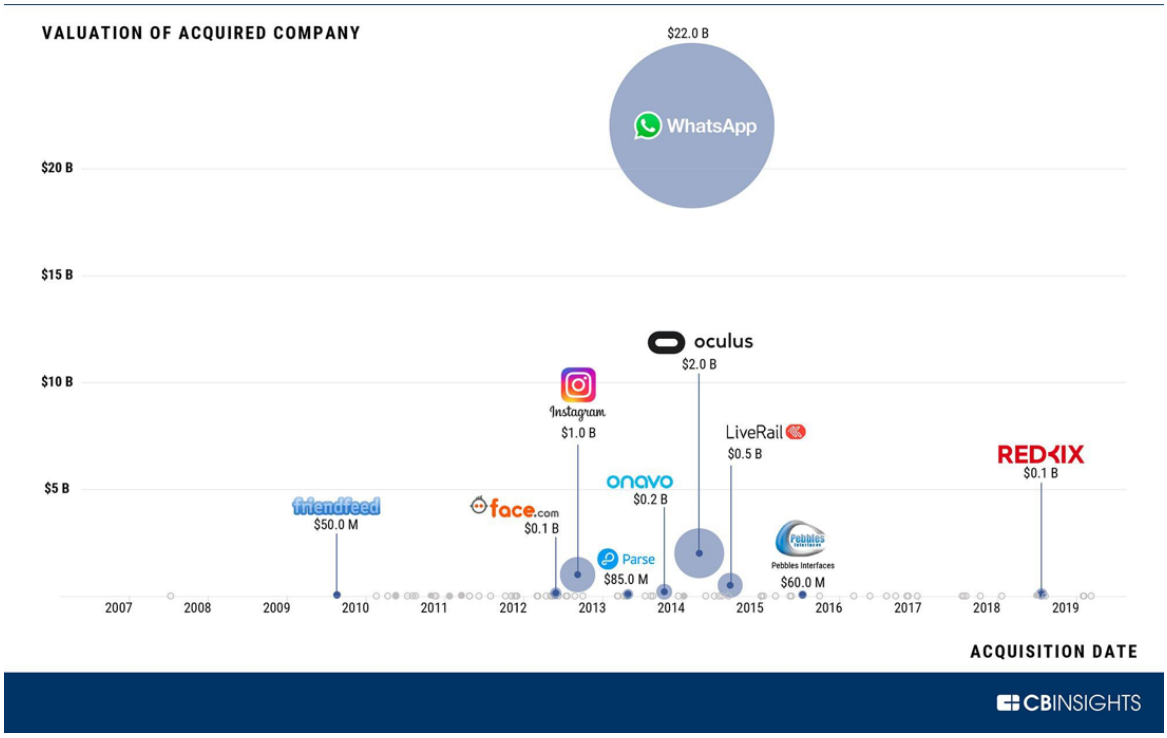

Today's giants and most dominant companies started out as ones that grew to dominate in a segment of a market with a specific or range of products or services. The ability to transition and become adaptable to lead entire industries is a stage not many manage to get to. And every single day these giants should still have teams that are on the lookout for which companies could take it all away from them. It only takes one start-up or unknown competitor to wipe a whale out. And sometimes this only means one failed acquisition, such as Yahoo's several unsuccessful attempts to takeover Google when it had just begun (now Yahoo belongs to Verizon Media and Google is valued at almost a trillion USD). Or when Yahoo acquired Tumblr for >US$1bn and Verizon Media let it go for US$3m to the owner of WordPress. The ability to differentiate a "fad" from an ever-growing core and underlying trend is what also dictates today's winners and losers.

Another factor that companies need to be wary of is the loss of direction or focus. Adaptability is important but if one tries to have their fingers in every pie, they will not be able to retain any sense of control over the long-run, which ends up destroying them. As Steve Schwarzman says to his colleagues, it is vital to not overcommit or overstretch yourself as that can easily backfire. For instance, Elon Musk is simultaneously running SpaceX, Tesla, SolarCity, and the Boring Company. But all these companies operate individually and there is no need to make them crossover or fall under the same corporate umbrella. Musk himself may be overcommitting, but until today it seems as though he has been able to astutely steer multiple ships and to build out

incredible teams. However, trying to manage a multitude of sometimes significantly different operations (core & non-core) under one company can be a death warrant. In our view, Amazon is one that needs to be careful as a mega-company with so many different operations running can pose risks despite all their business-lines focusing on the "technology" aspect. But all in all, Jeff Bezos and his team have been exemplary in ensuring the long-term survival and adaptability of Amazon. At the end of the day, what is paramount is whether there are synergies or not.

In this COVID-19 crisis, we've seen companies that had business models that thrived and proved to be highly adaptable. For instance, Givaudan proved to be very resilient as they compensated for lower growth in fine fragrances with high single or even double-digit growth in consumer products under which fabric care, home & personal care excelled.

The importance of adaptability was perhaps best laid out by Darwin: It is not the strongest of the species that survives, nor the most intelligent that survives. It is the one that is the most adaptable to change. This evidently also applies to companies or any other type of organisation or even nation-state.

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