ARX
FUND MANAGEMENT

ARX Market Commentary **"Riders On The Storm"**

"There's a killer on the road" *-Jim Morrison*

The Coronavirus is posing the biggest threat to the financial markets since the Global Financial Crisis in 2008. Things are getting *real*. We briefly detail our thoughts and outlook below.

Why Are Markets Reacting This Way?

- Because investors fear the unknown. Assets are priced based on future expectations, and nobody knows how the Coronavirus will affect the global economy when all is said and done. You never see the catalyst for a market meltdown coming, and this is no exception.
- The economic impact of Coronavirus is already being felt through travel restrictions, quarantines, and the cancellation of conferences and large events. GDP growth around the world will be hit in Q2, and the only question is whether the impact will be transitory or protracted, which would result in a Global Financial Crisis type scenario, or worse.
- Heading into 2020, most financial markets were priced to perfection. Stock indices made new historical highs just last month, interest rates were near historical lows, and corporate bond spreads over treasuries were at cycle tights. With investors no longer willing to accept less return for more risk, markets are taking the elevator down.
- The Fed and other central banks have precious little dry powder to fight the crisis and have now lost control. The Fed was slow to raise rates after the Financial Crisis ended, and the Fed Funds rate entered 2020 at 1.50-1.75% vs. 5.25% heading into the Financial Crisis.

What's Happening Now?

- It's either "risk-free" or it's something else. When markets shift from "greed" to "fear", risk-free assets such as US Treasuries, Agencies, and Gold are well bid and everything else is for sale.
- Liquidity for "everything else" is going away, beginning with equities and lower quality bonds. When this happens, prices gap lower until there is simply no bid for risky assets.
- Large banks are no longer the liquidity provider of last resort. Stricter regulation after the the Financial Crisis caused banks to rein in their balance sheets. Because of this, the Fed can no longer rescue markets by injecting liquidity into the banking system.

Our Market Outlook.

- We are living in a binary world. If the narrative this week is focused on containment, then risky assets and interest rates will rip higher. If not, we anticipate a 2008 disaster scenario.
- Tighter bank regulations and the rise of the ETF means asset managers have replaced banks as the liquidity providers of last resort. It will be difficult for governments to rescue markets with the banks no longer serving this role.

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- Lower quality banks are at risk. The sharp drop in interest rates hurts bank net interest margins. Also, a protracted slowdown will result in more loan losses, particularly for banks exposed to vulnerable sectors such as energy.
- The Russia-Saudi Arabia oil price war is extremely bad for highly leveraged US energy companies, which are heavily represented in High Yield ETFs. We believe ETF managers will have a hard time selling the underlying bonds to meet investor redemptions, which have already spiked over the past few weeks.
- Floating rate funds, which have been sold as a substitute for conservative short-term bond funds, are particularly at risk. These funds are comprised of junk rated leveraged loans and will behave like high yield funds in a liquidity driven panic.

What This Means For ARX QSFs.

- Our existing active QSFs are performing above our projections as rates have dropped fast and the bid for our high-quality holdings remains strong.
- Future earnings will be lower but still positive, reflecting the return opportunities in the bond markets and bank space.
- Our funds are built for capital preservation and maintain high levels of diversification and liquidity at all times.
- We anticipate very attractive risk-adjusted opportunities will emerge in high quality commercial paper and short corporate bonds, and we are positioning our funds to capitalize.
- We will likely increase our allocation to a diversified mix of FDIC-insured bank products as rates in other government-guaranteed products fall.
- Our proprietary credit process identifies the strongest banks offering attractive rates in a low yield environment.
- We place assets with banks that meet 3 criteria:
    - Strong credit ratings.
    - Well capitalized.
    - Large balance sheets so our positions don't represent a disproportionate amount of a bank's deposit or equity base.
- ARX actively managed QSFs are customized to offer fully government-guaranteed or prime money market level products to accommodate settlements of any size.

The Doors – "Riders On The Storm"

https://open.spotify.com/track/5j5VvsEHLlWT6IaEKSGDj9?si=KXc6U94bQ9-6-SwE0Lb_qQ

Honorable Mention. The Smiths – "Panic"

https://open.spotify.com/track/64D3dzWyj0GpQT1AHx4kbK?si=PwPAaNHHQWKY91NmPeuDMA