FAIRGREEN CAPITAL PARTNERS

FAIRGREEN CAPITAL PARTNERS WHITEPAPER

MARCH 2021

What will the post COVID Vaccine Economy look like?

WWW.FAIRGREENCAPITALPARTNERS.COM

BIG PICTURE

As we approach the end of the first quarter of 2021 with vaccines being distributed nationwide/worldwide, which will eventually lead to herd immunity against the virus, it is interesting to consider how businesses and the markets will respond. It is clear that "business as usual" will not be status quo, pre-pandemic. Some changes are obvious (known knowns), but most are likely subject to much uncertainty (unknown unknowns). It has become clear that many industries can operate with employees working remotely. It took a global pandemic for most organizations to finally embrace technologies that had been readily available for over a decade. Of course, many companies can only operate with their employees at their place of employment. Several industries flourished during the lockdown while others suffered painfully; a tale of two cities, as Dickens would put it!. Over 100,000 bars and restaurants permanently closed. Some will return, but most will not – this is not Darwinism at its best. The travel restrictions decimated the airline, hotel and cruise-ship industries, and it remains uncertain how long it will take them to restart. How long will it take to replace the jobs lost? How many of these lost jobs will be from a systematic shift in how life is now lived? What are the economic implications in the US and abroad? Will the recovery, when it happens, be bifurcated, or other, globally? Lastly, what now looks more attractive/less unattractive from an investor's perspective?

DOMESTIC ECONOMY AND MARKETS

Despite the detrimental effects of COVID-19, which resulted in lockdowns, travel restrictions, high unemployment and widespread economic pain, the U.S. Equity market posted solid returns, finishing the year near all-time highs. US fixed income continued its rally with rates to end 2020 at or near historic lows. What does that mean for expectations in 2021? Capital market expectations by the largest investment banks do not paint a pretty picture. In traditional fixed income, it's clear that the demand for any kind of yield and the U.S. Government's need to keep rates low will continue to suppress interest rates, but increased volatility would not be a surprise.

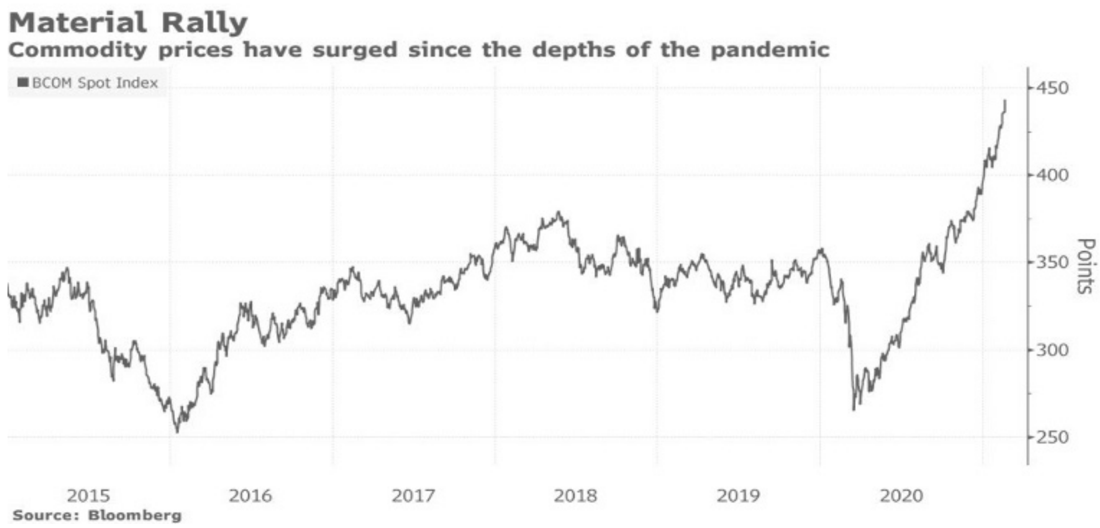
U.S. Equities seem poised for a correction, but that has been the prediction for several years, and though there have been significant equity index declines during this cycle, they have been short-lived. P/E ratios of the S&P 500 have expanded in nine of the last ten years, going from near 15 in 2012 to over 38 in 2021. The CAPE (cyclically-adjusted price-earnings) Ratio is at its second highest point in its history (please see below graph).

[Source: Irrational Exuberance, by Robert Shiller]

Mean reversion happens, and only time will tell when that next takes place. This credit cycle expansion, primarily sponsored by government financial infusions, has been remarkable. The average credit cycle in the U.S. since World War II is usually just over six years. <u>We are double that length of time in the current cycle.</u>

Other considerations.

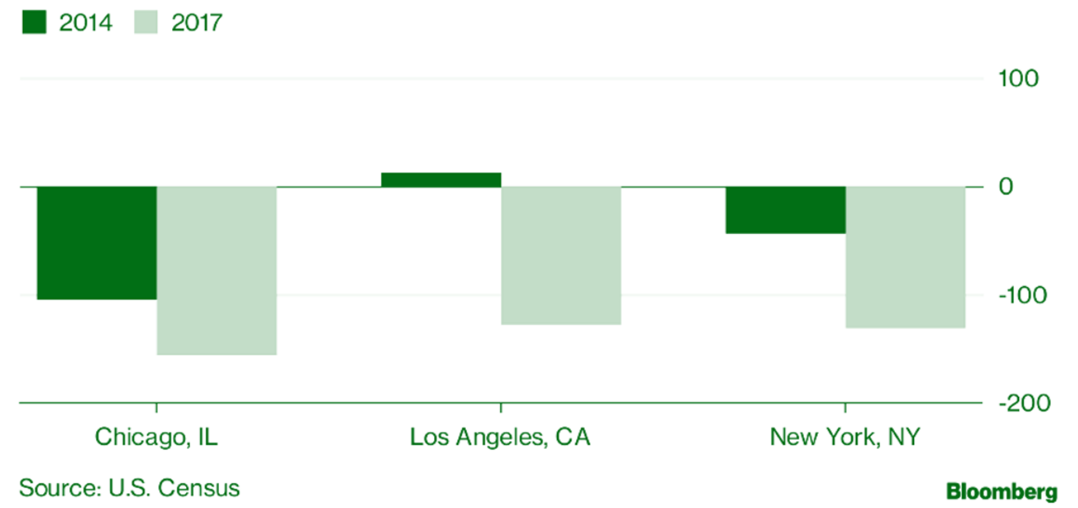
Inflation, which has been relatively benign since memory serves, is starting to appear. Commodity prices have rallied as inflation expectations have risen.



Energy is the most prominent and impactful sector in which this rally is taking place. Another example would be lumber, where prices have spiked, doubling in the last quarter. This impacts construction, most notably the number of affordable new housing starts. Massive pent-up demand for world travel and entertainment will allow the airlines and hotels that are currently offering substantially discounted rates to stay afloat, and the opportunity to charge inflated prices once borders open back up to tourism (and such practicing the old economic theory of maximizing consumer surplus).

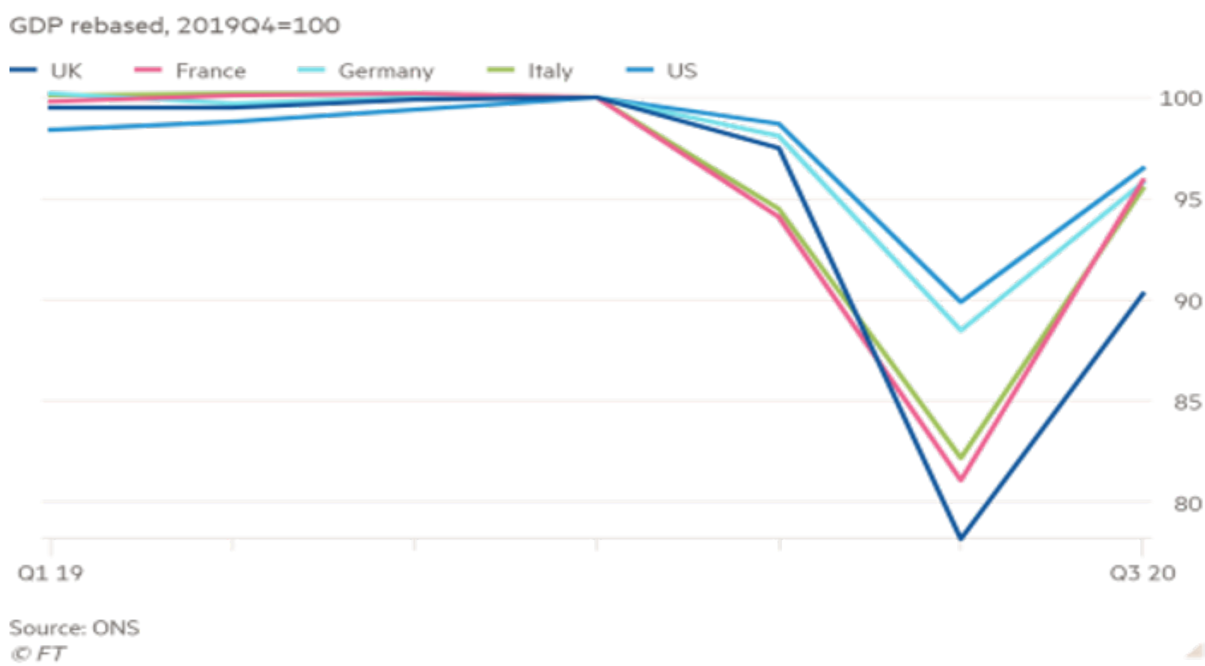
When inflation does spike, and it will, it will negatively impact (and impair) fixed-income investments, which are offering very low yields currently.

Both residential and commercial real estate present a problem for some, and a boon for others. People and businesses were leaving poorly managed and problem-plagued cities like Chicago and NYC before the pandemic, and this has accelerated now and is very unlikely to reverse. The below chart shows net migration per day in 2014 and 2017, which has since increased exponentially.



Last year's turmoil, in addition to years of government mismanagement, increased taxes and now crime, are driving both people and businesses out of cities such as Los Angeles, San Francisco, Seattle and Portland in large numbers. While this is very bad economically for these cities/states, it is a boon for others that have much more attractive living, social, and socio-economic characteristics such as Austin, Charlotte, Nashville and Miami, to name a few. As mentioned in the first paragraph, companies are now much more comfortable having their employees work remotely. The demand for inner-city office space will be diminished long term; this impact will not show up in the near future as most office leases are long-term in nature, but it will undoubtedly have a meaningful effect further down the road.

This discussion has been focused on the US, but I would be remiss to exclude the old fallen empire (The Brits and BREXIT) from this paper as it has broad ramifications for the global economy, not just the U.K. and the E.U. The U.K. experienced a COVID-sponsored unprecedented decline in GDP last year. That was before the BREXIT deals were ratified at the end of 2020.

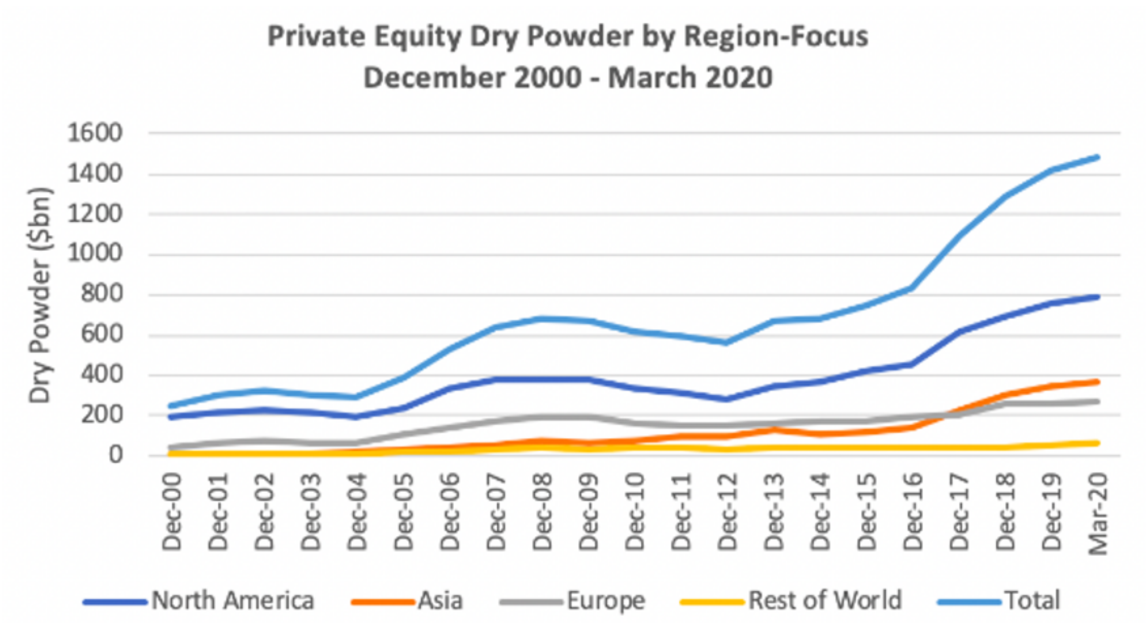


The end result financially is unsure, but increased volatility and unintended economic consequences on both sides are inevitable, impacting them all and reverberating outside their geographic boundaries.

CONCLUSIONS

The large liquid fixed income and equity markets are presented with significant challenges and lower expected returns going forward than investors have experienced and enjoyed over the last decade. At the same time, it is unlikely that decision-makers and trustees on large investment plans will adjust their actuarial assumptions to more realistic levels. To achieve or at least come close to achieving these actuarial assumptions, where amongst overall asset allocations, can sophisticated investors find alpha and premia investment opportunities going forward?

We would argue that less liquid/illiquid equity and fixed income present that opportunity. Many institutional investors have already come to that conclusion, and most of the reliable managers in those spaces are at capacity and having difficulty deploying capital that has already been committed. Areas such as upper-middle market direct lending and private equity have become very popular and now appear to be a crowded trade. Committed capital may not be called for a very long time, and where does the investor "park" the capital which needs to be immediately liquid when called?



We believe that carefully considered management teams of illiquid and specialized lower-middle market strategies can offer impressive risk-adjusted return potential. It is a large and fragmented market with significant alpha potential, and the larger investment managers are too big to play in this space. This presents a legitimate opportunity where smaller, capacity-constrained managers and strategies can thrive. <u>I cannot stress enough that manager selection and due diligence are crucial.</u> Most investors are aware they can get paid for locking up their money for extended periods. They may not consider the additional benefit that illiquid investments present from a volatility standpoint. These investments are not subject to daily market fluctuations and volatility. Typically, the only time that the NAV in illiquid investments manifests itself is when it has been determined that there is a permanent impairment. That results in lower volatility overall. At FairGreen Capital Partners we are vetting high quality, experienced managers in the Lower Middle Market space and where prudent, making introductions to qualified investors as well as investing our own Partner capital in these highest-conviction managers.

AUTHOR

JAMES FADEL, CFA

HEAD OF RESEARCH

Mr. Fadel is Head of Research at FairGreen Capital Partners. In his previous role, Mr. Fadel was Vice President of US Consultant and Client Relations at Nikko Asset Management ($250 billion AUM). He was responsible for nurturing and developing new business relationships with consultants, pension plans, endowments, and foundations. Prior to Nikko Asset Management, Mr. Fadel held Senior Investment Manager and Head of Portfolio Research positions at The Marco Consulting Group, where he advised clients on asset allocation, manager selection, and investment strategy based on their financial objectives. Previously, Mr. Fadel was a Vice President on the Derivatives Trading desk at Société Générale where he executed institutional clients' trades, provided market insight, and established hedge strategies before transitioning to New Business Development of Institutional Clients. Mr. Fadel graduated from Miami University and is a CFA charterholder.

in

FAIRGREEN CAPITAL PARTNERS

CONTACT

INVESTMENTS@FAIRGREENCAPITAL.COM