



1. Economic and Market Environment

After one of the quickest equity market contractions in recent years, the second quarter saw one of the fastest rebounds, confirming our belief at TreeTop that rash decisions to sell destroy value for the long-term investor. We are cautiously optimistic as daily infection rates continue to decline in most regions and governments gradually ease the lockdowns. However, the shock of this health crisis on our societies is not to be underestimated and our hearts at TreeTop go out to those who have been affected by it. I want to personally thank all our clients for their continued trust during these volatile times and our employees who have worked hard to serve our clients.

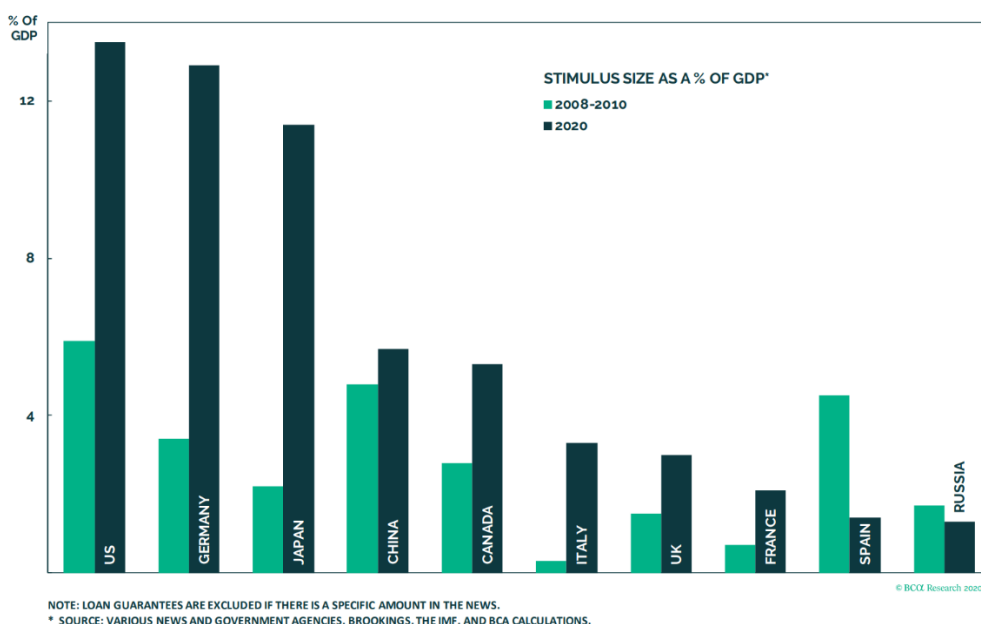
As the global pandemic situation appears to improve, banks, governments and think tanks are assessing the economic impact of the crisis and drafting policies to kick-start the recovery process. As of June, *The Economist* estimates the GDP of China will grow 1%, the US will contract 3.8%, and the Euro Area will contract 8% YoY in 2020. While the final numbers remain uncertain, no economists expect growth in 2020 outside of Asia.

	CHINA	USA	EURO AREA	TREETOP VIEW
GDP % change in 2020 vs. 2019	+1%	-3.8%	-8%	China was the first country to control the virus and should be the least affected economically
Current account as % of GDP for 2020	+0.8%	-1.9%	+1.8%	The US will need to continue to borrow from the rest of the world
Government budget deficit for 2020	-6%	-14%	-8.2%	All governments will borrow extensively
10-year government bond interest rate	2.5%	0.8%	-0.3%	Interest Rates in the U.S and euro area are at historic lows and central banks quantitative easing should keep them low

Source: The Economist

The health crisis has also resulted in higher government spending and deficits. The research firm BCA released estimates on the size of fiscal stimulus across the world, as shown in the graph below. The stimulus ranges from < 2% of GDP in Russia to > 12% in the US. This level of government spending is unprecedented and much higher than that in 2009. In the short-term, the massive stimulus could support the global economy and asset prices, but it is financed by increased borrowing. European countries, the US, Japan and China have the capacity to finance the deficits with central bank purchases thanks to their economic power. However, countries like Russia, India and Brazil should be careful not to create a currency crisis on top of the problems they already have.

Global Fiscal Policy Relief: Will It Be Enough?



Source: BCA Research

The most aggressive monetary expansion was taken by the US central bank, the Federal Reserve (the FED), to keep credit flowing into the US economy. The FED slashed its main benchmark interest rates close to zero and started buying significant amounts of US government debt. In addition, for the first time, the FED started a direct lending program with American corporates, which allowed distressed companies, such as cruise ship operators, to survive the pandemic. These measures caused the FED balance sheet to expand from USD3.9trillion in mid-March to USD6.1 trillion in June¹. The response in Europe has been somewhat slower and more disparate. Nevertheless, the European Central Bank has ensured European government bond yields stay very low. There are also now active discussions between the European partners to launch a common fiscal program to offset the impact of the crisis.

We believe that the aggressive spending programs by governments was needed to avoid a global depression. Without the government support, the economic lockdowns would have resulted in massive permanent job cuts and bankruptcies. This would have caused a vicious cycle of plunging confidence and lower investment, which could have led to further layoffs and bankruptcies. However, such aggressive monetary measures will **have major consequences for investors**. Firstly, interest rates are likely to stay lower for longer periods to support highly indebted governments, households and companies. This is generally good for the stock market, but the outlook for fixed-income investments is less clear, as most government bonds and investment-grade corporate bonds yield close to zero. At the same time, any slight increase in interest rates could quickly lead to significant capital losses in government bonds, as shown in the table below. Government bonds will only perform well if interest rates become deeply negative. While possible in theory, this would force banks to charge interests on their deposits, which is hard to put into practice.

¹ <https://www.brookings.edu/research/fed-response-to-covid19/> Copyright 2020 The Brookings Institution

1-YEAR TOTAL RETURN OF 10-YEAR GOVERNMENT BONDS AT DIFFERENT TARGET RATES						
TARGET RATE	US	GERMANY	FRANCE	SWITZERLAND	JAPAN	UK
2.0%	-9.2%	-19.4%	-16.2%	-19.3%	-15.6%	-14.0%
1.5%	-5.3%	-16.0%	-12.6%	-15.9%	-12.0%	-10.4%
1.0%	-1.2%	-12.3%	-8.8%	-12.2%	-8.2%	-6.5%
0.5%	3.3%	-8.8%	-5.0%	-8.6%	-4.2%	-2.3%
0.0%	7.7%	-4.2%	-0.4%	-4.0%	0.3%	2.1%
-0.5%	12.5%	0.3%	4.2%	0.5%	4.9%	6.8%
-1.0%	17.5%	5.1%	9.0%	5.2%	9.8%	11.7%
-1.5%	22.9%	10.1%	14.1%	10.2%	14.9%	16.9%
-2.0%	28.4%	15.4%	19.5%	15.6%	20.3%	22.4%

NOTE: CIRCLES DENOTE LIKELY RETURN IN SEVERE RECESSIONS.
 EXPECTED ONE YEAR TOTAL RETURN ASSUMES THAT THE 10-YEAR YIELD REACHES THE TARGET RATE FROM CURRENT LEVELS; CALCULATED AS THE SUM OF YIELD, ROLLDOWN
 AND EXPECTED PRICE RETURN BASED ON CURRENT DURATION AND CONVEXITY.

Source: BCA Research

Another major investment implication of this crisis is the necessity to diversify, both by geography and by sector. Certain regions and companies are likely to face significant financial distress despite the aggressive measures taken by governments. At Treetop, our **global investment approach** is by nature well diversified without sacrificing long term return potential. Our consistent focus on Asia has paid off in 2020 as China was the first country to exit its self-imposed economic lockdown. This resulted in better economic growth and strong stock performance compared to the rest of the world. As shown on the graph below, the MSCI China Index (in yellow) has been one of the best performing major markets, outperforming the S&P 500 (in orange) and the MSCI Europe (in green).

GLOBAL STOCK INDEX PERFORMANCE SINCE JANUARY



Source: Bloomberg

In conclusion, most countries have taken the right measures to avoid complete economic implosions, protecting the earning power of companies over the long term. This is positive news for the global stock market, which is reflected in the earnings estimates of global indices. According to Bloomberg, consensus expects earnings per share over the next 12 months to be 'only' 10% lower for the S&P500, 6% higher for the MSCI China and 4% lower for MSCI Europe compared to the last 12 months. While more expensive than a few weeks ago, valuation levels do not appear excessive with the MSCI Europe trading on 19x the next 12 months' earnings, the S&P500 trading on 23x and finally the MSCI

China trading on 15x. For all these reasons, we continue to believe that the global stock market remains one of the best financial assets for the long-term investor².

2. Our convictions

Fortunately, most of our investments recovered a significant part of their losses over the last three months, showing that, as for the market in general, one should not sell a good company in a panic. **ASSTEAD** and **UNITED RENTALS**, the leading rental equipment businesses in North America, have more than doubled since they bottomed in mid-March as construction continues to do better than the rest of the economy and politicians are drafting big infrastructure plans. **IWG's** (formerly Regus) stock had a very wild ride but also recovered a significant part of its recent losses. The Company plans to use its strong balance sheet and its leading position in office outsourcing to take over some of its bankrupt competitors. **IWG**, with its flexible outsourced office network, could become an ideal solution in a post pandemic world. It has buildings in cities but also in smaller towns and in the countryside, a potentially interesting solution for large corporates willing to offer geographic flexibility to their employees. **NORWEGIAN FINANS**, the leading consumer credit business in the Nordics, rebounded strongly as the region, and Norway specifically, has done a good job at containing the virus and limiting economic harm. With its strong balance sheet and excellent cost structure, we think that the Company will be able to grab market share from its weaker competitors. Our investments in China generally did very well this year compared the rest of the world as the country was the first to emerge out of the lockdown and the economy has recovered well. **VIPSHOP**, China's leading online apparel discounter, continues to do well and should benefit from brands needing to sell excess inventories. **MAN WAH**, the largest recliner sofa brand, is benefitting from the trend of consumers upgrading their interiors after being forced to stay home for a long period of time.

A very interesting development for us in recent months has been the resurgence of the convertible bond market with several companies issuing bonds as a better alternative amidst volatile equity markets and expensive high yield credit. There were broadly two types of convertible bond issuance, those done by distressed companies to repair their balance sheets and those done by growth companies raising capital for development opportunities. At TreeTop, we are generally focused on the latter and try to avoid distressed businesses, especially those with challenged business models. We initiated positions in a few new convertible bonds, including **TRICIDA**, an emerging biotech with a promising treatment for chronic kidney disease, **COHERUS BIOSCIENCES**, a leading American company in bio-similar medicines, and finally **BAOZUN**, the largest digital and e-commerce consultant for brands in China. We believe that these three convertibles bonds have attractive risk-reward characteristics² as they have some yield and the underlying businesses have good balance sheets, providing good valuation downside protection thanks to the bond floors. The bonds also have low conversion premiums and the underlying businesses have significant room to grow, which should result in good stock performance².

BAOZUN is a leading e-commerce partner and consultant in China for local and international brands. The Company was founded by Qiu Wenbin in 2007, a graduate from the prestigious Tsinghua University, after his successful experience in building an e-commerce channel for the Dutch company Phillips. Phillips became **BAOZUN's** first client, after which they quickly gained a number of new clients, including Li Ning, one of the largest sportswear brands in China. A transformative step for **BAOZUN** was the seed investment from Alibaba (the Chinese Amazon) in 2010 which gave them more financial resources and privileged access to e-commerce data. Today, **BAOZUN** works with over 200 brands and is the largest company in its sector. This dominant position makes it possible for **BAOZUN** to offer a turn-key omni-channel solution for brands, solving all their e-commerce needs from digital marketing to logistics. We have been following the Company for a while but had two main concerns which prevented an investment - the stock was always very expensive, and the Company had low margins with no clear plan to improve them. Fortunately for us, the stock de-rated significantly in recent months and the Company decided to issue a convertible bond to raise growth capital. This gave us a great opportunity to buy a very interesting business at reasonable valuation. **BAOZUN** also

² No guarantee of result or performance

proved in recent months its ability to improve margins as the business gained scale. The business model has proved very resilient during the pandemic, growing sales at a time most businesses were suffering because of the lockdown.

COHERUS BIOSCIENCES is a \$1.3 billion market capitalization biosimilar company from Silicon Valley, California. The company was founded by Mr. Denis Lanfear in 2010, the current CEO and Chairman, and has transformed from a small start-up into a company with \$450mn of revenue and \$100mn of profit thanks to the development and commercialization of biosimilars. Biosimilars are a new category of drugs standing between generics and truly innovative drugs. This new family of medicines emerged as most recent innovative drugs are complex biological compounds and not simple chemical molecules anymore. The complexity of these biological compounds created the possibility to have molecules with the same treatment effectiveness but slightly different composition and therefore not entirely patent protected³. These biosimilars are attractive for the patient as they are generally much cheaper than the original biologic but have the same effectiveness. Biosimilars also tend to be more attractive for drugs companies than simple generics as they are more complex to develop and require more legal and scientific development work, which usually results in higher barriers to entry and better pricing power. Analysts expect the biosimilar market to grow from approximately \$11bn to \$35bn by 2025⁴ and we think that **COHERUS BIOSCIENCES** could be a prime beneficiary of this trend. In recent years, the company has demonstrated its ability to successfully bring a biosimilar drug to market, and to quickly gain and sustain market share despite new competition entering the market. The Company also has a strong pipeline of drugs that have significant revenue potential, with downside risk limited at the current price given minimal value attributed to pipeline drugs.

Lastly, we have initiated a position in the convertible bond of **TRICIDA**, an American early-stage pharmaceutical company with a potentially revolutionary treatment for chronic kidney disease (CKD). CKD is one of the most prevalent and costly diseases in the world with an estimated 30mn patients suffering from it in the US alone. In its initial stage, most people can live with the disease without too many life adjustments, but in later stages patients must make drastic changes to their diet and often have to have several weekly dialysis treatments, a costly, painful and time-consuming procedure. Over the last few years, **TRICIDA** has developed a polymer that is taken orally, which appears to relieve several symptoms for the sickest patients⁵. The company has already successfully completed a Phase III clinical study and is currently undergoing a final accelerated approval process by the FDA. The exact financial outcome for this Company is very difficult to assess, but this is where convertible bonds come in handy. Pharmaceutical businesses are very interesting candidates for convertibles as their business outcomes are generally binary. Stocks in these sectors either tend to go up or down a lot, which makes traditional equity investments nerve wracking. Convertible bonds on the contrary usually benefit from the bond floor, which has the potential to limit downside but also capture most of the upside thanks to their options on the underlying stock. We have had some excellent investments in the past using this technique, such as **HORIZON PHARMACEUTICALS**, and we hope that both **TRICIDA** and **COHERUS BIOSCIENCES** will follow this exciting trajectory.

In conclusion, we continue to be excited by the potential of our current investments. In this new world, CEOs and entrepreneurs continue to strive for excellence in delivering solutions for their clients, which we think will eventually pay off for their shareholders.

³ For those interested in better understanding biosimilar and biologics, I recommend to watch the video below <https://www.youtube.com/watch?v=G3U7cmMWWOM>

⁴ <https://www.marketsandmarkets.com/Market-Reports/biosimilars-40.html>

⁵ For our scientifically-minded readers, here are more details on the Veverimer, the medicine developed by Tricida, <https://www.tricida.com/veverimer/>

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