Economic & Investment Perspectives

Figure 1: Returns – 5/31/2020 (Source: Bloomberg, Yahoo)
Conditional formatting: green (high) to red (low) for each time period;

Bonds	ETF	MTD	YTD	Max Draw Down	Current vs. 52-wk High	Current vs. 52-wk Low
US Aggregate Fixed Income	AGG	0.7%	5.6%	-11.5%	-1.4%	11.5%
Non-US Fixed Income	BNDX	0.4%	1.9%	-9.1%	-3.0%	6.6%
High Yield	HYG	2.9%	-4.5%	-23.7%	-6.9%	22.1%
Global Equity						
Global ACWI IMI	SPGM	4.2%	-10.0%	-34.9%	-12.6%	34.3%
United States	VTI	5.4%	-5.6%	-36.5%	-10.9%	40.4%
International Developed	EFA	5.4%	-14.1%	-35.1%	-15.3%	30.4%
Emerging Markets	EEM	3.0%	-15.9%	-35.0%	-18.5%	25.3%
Equity by Region						
United States	VTI	5.4%	-5.6%	-36.5%	-10.9%	40.4%
Europe	IEUR	5.8%	-16.3%	-38.5%	-17.0%	35.1%
Asia ex-Japan	AAXJ	1.1%	-12.0%	-30.7%	-15.4%	22.1%
China	MCHI	1.7%	-4.8%	-26.3%	-10.1%	22.0%
Japan	EWJ	7.1%	-6.5%	-31.5%	-8.8%	33.2%
Latin America	ILF	7.2%	-39.6%	-56.0%	-41.9%	32.0%
US Equity						
US S&P 500	IVV	4.8%	-5.0%	-35.3%	-10.4%	38.5%
NASDAQ 100 QQQ	QQQ	6.6%	10.0%	-30.5%	-1.7%	41.5%
Eqwt S&P 500	RSP	4.8%	-12.1%	-40.7%	-15.4%	42.7%
US Mid Cap	IJH	7.3%	-13.9%	-44.1%	-16.5%	49.4%
US Small Cap	IWM	6.6%	-15.8%	-43.9%	-18.6%	45.2%

Global equities continued to rally in May as positive news about various vaccine trials, declining infection and death rates spurred hopes for a rapid recovery from the economic carnage wrought by the COVID-19 pandemic. Unprecedented levels of stimulus from Congress, the Fed, global governments and central banks has effectively stabilized markets for the time being. Performance estimates (Figure 1) and highlights include the following:

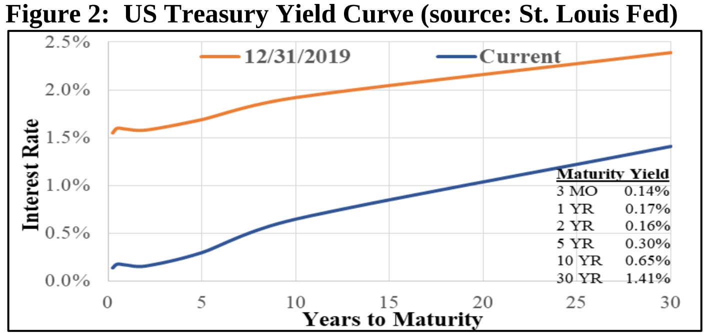
- Global stocks (SPGM) rose 4.2% and are now -10.0% YTD.
- US Equity: The broad market (VTI) rose 5.4% in May to cut YTD losses to -5.6%. The S&P 500 (IVV) gained 4.8% (-5.0% YTD), while the S&P 400 Midcap (IJH) and Russell 2000 small cap (IWM) each gained about 7% this month but remain down 14-16% YTD. The Nasdaq 100 (QQQ) rose another 6.6% in May and is actually up 10% YTD, illustrating and amplifying the concentration of stock returns in recent years, led by a small group of technology and e-commerce stocks.
- Non-US Equity: Developed market stocks (EFA) gained 5.4%, (-14.1% YTD) and emerging markets (EEM) rose 3.0% in May (-15.9% YTD).
- Fixed Income: Bonds have been solid in 2020 due to strong returns from US Treasuries. The US Aggregate bond index (AGG) rose 0.7% in May (+5.6% YTD). Non-US bonds (BNDX) rose 0.4% (+1.9% YTD), and high yield (HYG) gained 2.9% but remain down 4.5% YTD.

Global stock markets have now regained approximately two-thirds of the losses from the February-March drawdown.

Interest Rates and the Economy

Interest rates were stable in May and remain near historic lows amid concerns over the economic impact of the pandemic. US Treasury yields fell precipitously in March as the Fed cut interest rates to near zero. The Fed has pledged to do whatever it takes in order to keep markets stable and liquid, minimize the impact of the virus-related shutdown and improve chances for economic recovery. Figure 2 graphs the US yield curve, which plots yields (Y-axis) for various maturities (X-axis) of US Treasuries.

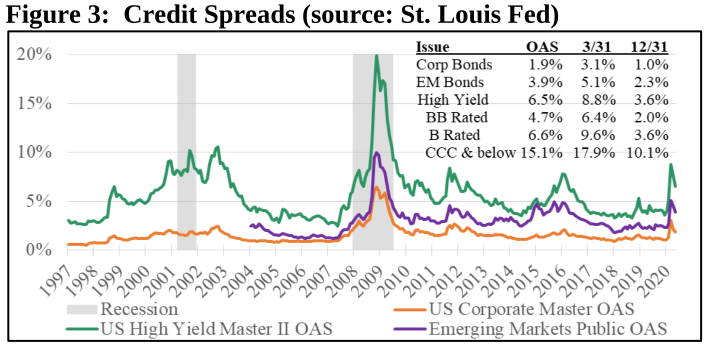
Figure 2: US Treasury Yield Curve (source: St. Louis Fed)



For bonds other than US Treasuries, we focus on the option-adjusted spread (OAS) between various bond yields and comparable US Treasuries to gauge investor optimism. High spreads signal fear, while low spreads signal a strong risk appetite. As illustrated in Figure 3 below, credit spreads spiked in February-March but have decreased notably since, erasing roughly half of the pandemic related increase. As spreads rise, credit issues tend to generate negative returns; falling spreads lead to stronger returns.

- Investment-grade US corporate bonds currently carry a 1.9% yield premium over Treasuries vs. 1.0% at year end.
- High yield (non-investment-grade) bond spreads are now +6.5% over Treasuries, down from +8.8% in March but still significantly higher than +3.6% at year-end. The riskiest bonds (rated CCC & below) currently yield 15.1% more than Treasuries due to the significant exposure to energy debt.
- Emerging market credit spreads are +3.9% vs. +2.3% on 12/31.

Figure 3: Credit Spreads (source: St. Louis Fed)

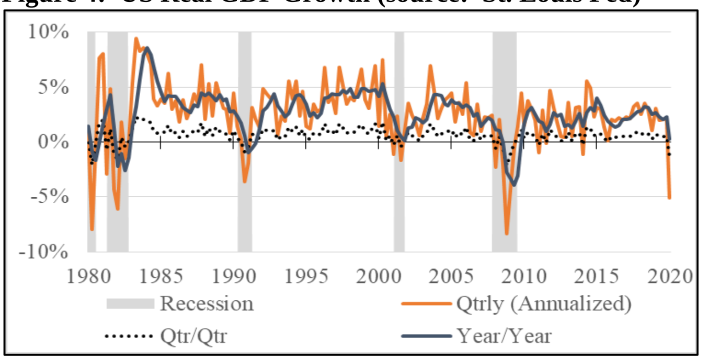


Economic Data and Metrics to Watch

Global equity markets have recovered roughly two-thirds (average) of the losses sustained earlier in the year when markets panicked over the dire health and economic implications of the pandemic. Credit spreads have tightened measurably, though they remain elevated amid economic uncertainty. The rapid recovery of financial markets implies that investors believe that economic recovery will be sharp (V-shaped), but only time will tell.

US real (inflation-adjusted) GDP was reported to have declined 5.0% in Q1 of 2020. (Note: GDP stands for Gross Domestic Product, the value of all goods and services produced in the US.) This number is misleading; the US economy did not decline by 5%. The headline number (-5%) is an annualized growth rate, extrapolating a one quarter growth rate to a yearly rate, i.e. assuming that the economy rose or fell by the same rate for four consecutive quarters. Real GDP fell only 1.3% versus Q4 of 2019 and is actually up 0.3% versus one year ago. Figure 4 graphs the quarterly, annualized and year-over-year GDP growth rates.

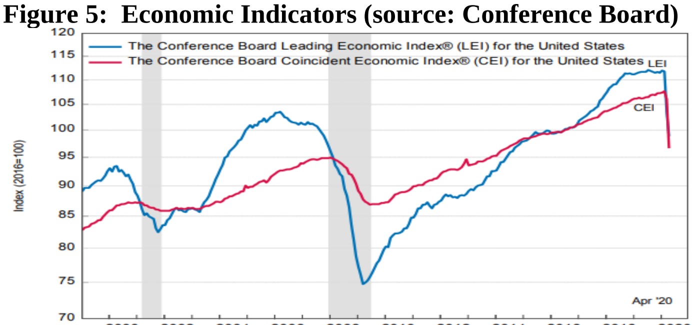
Figure 4: US Real GDP Growth (source: St. Louis Fed)



The lines track each other very well, but the annualized quarterly number (orange line) is much more volatile. It is important to understand the difference because the growth rate for Q2 is going to be much worse due to the pandemic-related shutdown. Estimates vary, but economists expect the headline number for real GDP growth in Q2 to be -30% or worse. This would mean that the economy would have actually contracted by -8.5% versus Q1 and -8.8% versus Q2 of 2019. (This will still be a terrible result.) Likewise, as the economy begins to recover, we are likely to see positive headline growth rates at unprecedented levels.

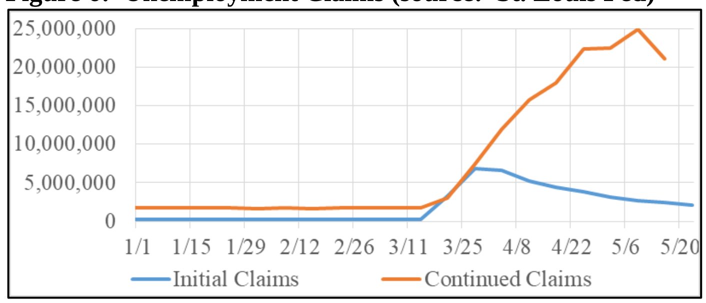
Because GDP data is only reported quarterly in arrears, it is a history lesson, not a predictor of future economic activity. The Conference Board publishes a monthly Leading Economic Index (LEI, Figure 5) based on 10 variables, including unemployment, home building, interest rates, money supply, manufacturing and sentiment data as well as stock market returns.

Figure 5: Economic Indicators (source: Conference Board)



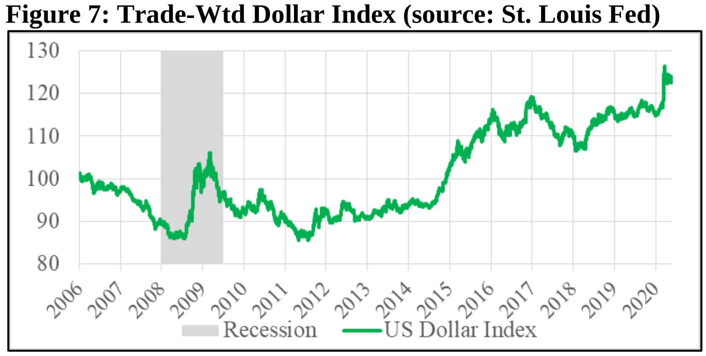
The sharp drops in the LEI and CEI (Coincident Economic Index) indicate that we are likely in recession now. We must wait for the May index reading to further gauge where things stand. Meanwhile, unemployment data is released on a weekly basis. Here again, the reported numbers can be misleading. In the past 10 weeks, over 40 million people have filed for unemployment for the first time. While this is a stunningly awful number, the more important data is the number of continued claims (Figure 6), i.e. the number of people continuing to collect unemployment benefits. The most recent data indicates that there are approximately 21 million continued claims, so a large portion of those who lost their jobs during this crisis have gone back to work, found other jobs, or are otherwise no longer collecting unemployment. Because the consumers account for two-thirds of GDP, the pace at which people get back to work is critical for the economy.

Figure 6: Unemployment Claims (source: St. Louis Fed)



Another key factor to watch is the US dollar (Fig. 7). The trade-weighted index illustrates the dollar strength in recent years, spiking even higher during the current crisis. This is one reason that US stocks and bonds have performed so well relative to the rest of the world. A strong dollar benefits US financial assets but harms US profits by making exports more expensive to foreign buyers. A weaker dollar will benefit US exporters and non-US assets (international and emerging market stocks and bonds).

Figure 7: Trade-Wtd Dollar Index (source: St. Louis Fed)



Bottom Line

The rally off of March lows implies that investors believe that economic recovery from the virus-related global recession will be quick, but these gains must be validated by in-coming data. Current and leading indicators suggest that we are in recession, but the depth and duration is unknown. Unemployment data offers important clues regarding the pace of recovery, but as with any recession, corporate profits will take time to heal. There will be bankruptcies (many in retail already), defaults, and permanent job loss. True recovery is likely to take months or even years. It is impossible to call the tops and bottoms of markets in the best of times, so we remain invested at long-term target weights, diversified globally, and will rebalance opportunistically.