Economic & Investment Perspectives

Figure 1: Returns – 6/30/2020 (Source: Bloomberg, Yahoo)
Note: Conditional formatting within periods – Green (highest) to Red (Lowest). Returns for periods greater than one year are annualized.

Bonds	ETF	MTD	Q2	YTD	Max Draw Down	Current vs. 52-wk High	Current vs. 52-wk Low
US Aggregate Fixed Income	AGG	0.7%	3.1%	6.3%	-11.5%	-0.9%	12.0%
Non-US Fixed Income	BNDX	0.5%	2.9%	2.4%	-9.1%	-2.6%	7.1%
High Yield	HYG	-0.6%	7.3%	-5.1%	-23.7%	-7.8%	20.9%
Global Equity							
Global ACWI IMI	SPGM	3.8%	19.3%	-6.6%	-34.9%	-9.9%	38.4%
United States	VTI	2.3%	22.0%	-3.4%	-36.5%	-9.3%	43.0%
International Developed	EFA	3.5%	15.4%	-11.1%	-35.1%	-13.6%	33.0%
Emerging Markets	EEM	6.6%	17.9%	-10.4%	-35.0%	-13.7%	32.9%
Equity by Region							
United States	VTI	2.3%	22.0%	-3.4%	-36.5%	-9.3%	43.0%
Europe	IEUR	3.8%	16.9%	-13.1%	-38.5%	-15.0%	38.3%
Asia ex-Japan	AAXJ	7.4%	16.3%	-5.5%	-30.7%	-9.5%	30.6%
China	MCHI	7.7%	14.7%	2.5%	-26.3%	-3.5%	30.9%
Japan	EWJ	-0.1%	12.1%	-6.6%	-31.5%	-9.6%	32.0%
Latin America	ILF	6.4%	19.6%	-35.7%	-56.0%	-38.9%	38.8%
US Equity							
US S&P 500	IVV	1.9%	20.4%	-3.2%	-35.3%	-9.1%	40.6%
NASDAQ 100 QQQ	QQQ	6.3%	30.3%	16.9%	-30.5%	-1.4%	50.1%
US Large Growth	IWF	4.3%	27.7%	9.6%	-33.5%	-1.7%	49.7%
US Large Value	IWD	-0.7%	14.2%	-16.3%	-39.4%	-18.9%	33.9%
US Eqwt S&P 500	RSP	1.5%	21.6%	-10.8%	-40.7%	-14.5%	44.2%
US Mid Cap	IJH	1.3%	24.1%	-12.8%	-44.1%	-15.7%	50.9%
US Small Cap	IWM	3.5%	25.6%	-12.9%	-43.9%	-16.0%	49.7%

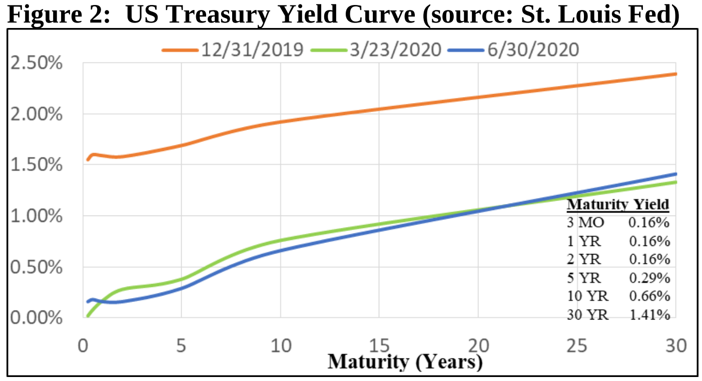
After recording the worst quarterly performance since 2008 during the first quarter (Q1) of this year when markets melted down due to health and economic fears surrounding the Covid-19 pandemic, the S&P 500 achieved its best quarter since 1998 in Q2. Even though the virus spread and infection rate continued to rise in the US and abroad, markets rallied strongly as trillions of dollars were pumped into the economy and markets by the Federal Reserve (Fed) and Congress as well as their global counterparts. Figure 1 (above) lists returns for various markets. Performance notes for the quarter include the following highlights:

- Global equities (SPGM) gained 19.3% in Q2 (-6.6% YTD).
- US Equity: US stocks (VTI) rose 22.0% in Q2 and are -3.4% YTD. The “risk on” tenor of the market was evident in Q2 as small (IWM) and mid-sized stocks (IJH) returned 25.6% and 24.1%, respectively, versus +20.4% for the S&P 500 (IVV). Within the US, growth stocks continued beat value by a wide margin (IWF +27.7% vs. IWD +14.2% in Q2), widening the growth/value disparity year-to-date (+9.6% vs. -16.3%).
- Non-US Equity: International developed markets (EFA) rose 15.4% and emerging markets (EEM) gained 17.9% in Q2. Chinese stocks continue to perform well (MCHI +14.7% in Q2, +2.5% YTD) despite being the original epicenter of the pandemic. Latin American stocks (ILF) gained 19.6% during Q2, but not nearly enough to offset Q1 losses (ILF -36% YTD).
- Bonds: The Barclays US Aggregate index rose 2.9%, and High Yield bonds were up 10.2% as credit spreads decreased in Q2.

Interest Rates and the Economy

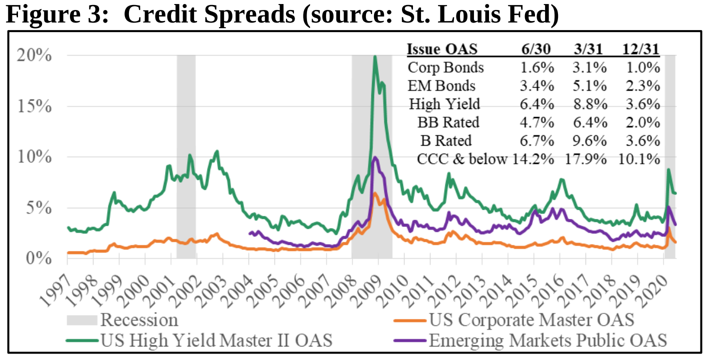
US interest rates remain near historic lows amid concerns over the economic impact of the pandemic. The Fed cut interest rates to near zero in March, and bond yields sank as investors retreated to the safety of US Treasuries, driving prices up and yields down. Figure 2 graphs the US yield curve, which plots yields (Y-axis) for various maturities (X-axis) of US Treasuries. Rates are well below 2019 levels but have barely moved since March 23, the date of the stock market bottom. Belief that the Fed will keep rates low has been a primary driver of equity returns.

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 rather than the absolute yields. High spreads signal fear, while low spreads signal a strong appetite for risk. As illustrated in Figure 3 below, credit spreads spiked to panic levels in March but have moderated since as the Fed injected significant liquidity into credit markets, buying individual bonds and ETFs. Investment-grade US corporate bonds currently carry a 1.6% yield premium over Treasuries, down from 3.1% on 3/31. High yield bond (non-investment-grade) spreads are now 6.4%, down from 8.8% three months ago but still almost double year-end levels; the riskiest bonds (rated CCC & below) still carry a 14.2% yield premium. Emerging market credit spreads spiked from 2.3% to 5.1% in Q1 but have eased to 3.4% now.

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



A Tale of Two Quarters

Global equity markets collapsed in the first quarter (Q1) amid grim news about the spread and severity of the pandemic. The global economy was shuttered as governments issued stay-at-home orders, quarantines and travel bans. Financial markets reacted swiftly and negatively. Markets rebounded strongly in the second quarter (Q2) as trillions of dollars in liquidity and stimulus were injected into markets and the economy by the Fed, Congress, global central banks and governments. Figure 4 compares the Q1, Q2 and year-to-date (YTD) returns and drawdowns for global markets (proxied by ETFs). Highlights follow the table.

Figure 4: Estimated 2020 Returns & Drawdowns (Yahoo)

Note: Conditional formatting within periods – Green (highest) to Red (Lowest)

Bonds	ETF	Q1	Q2	YTD	Max Draw Down	% of loss recovered
US Aggregate Fixed Income	AGG	3.1%	3.1%	6.3%	-11.5%	92%
Non-US Fixed Income	BNDX	-0.4%	2.9%	2.4%	-9.1%	71%
High Yield	HYG	-11.6%	7.3%	-5.1%	-23.7%	67%
Global Equity						
Global ACWI IMI	SPGM	-21.7%	19.3%	-6.6%	-34.9%	72%
United States	VTI	-20.8%	22.0%	-3.4%	-36.5%	75%
International Developed	EFA	-23.0%	15.4%	-11.1%	-35.1%	61%
Emerging Markets	EEM	-23.9%	17.9%	-10.4%	-35.0%	61%
Equity by Region						
United States	VTI	-20.8%	22.0%	-3.4%	-36.5%	75%
Europe	IEUR	-25.7%	16.9%	-13.1%	-38.5%	61%
Asia ex-Japan	AAXJ	-18.8%	16.3%	-5.5%	-30.7%	69%
China	MCHI	-10.7%	14.7%	2.5%	-26.3%	87%
Japan	EWJ	-16.6%	12.1%	-6.6%	-31.5%	70%
Latin America	ILF	-46.3%	19.6%	-35.7%	-56.0%	31%
US Equity						
US S&P 500	IVV	-19.6%	20.4%	-3.2%	-35.3%	74%
NASDAQ 100 QQQ	QQQ	-10.3%	30.3%	16.9%	-30.5%	114%
US Mid Cap	IJH	-29.7%	24.1%	-12.8%	-44.1%	64%
US Small Cap	IWM	-30.6%	25.6%	-12.9%	-43.9%	64%
US Equity Sectors				**(sorted)**		
Technology	XLK	-11.9%	30.4%	14.9%	-33.8%	104%
Cons Discretionary	XLY	-21.4%	30.5%	2.6%	-38.4%	90%
Communications	XLC	-17.3%	22.4%	1.3%	-33.0%	81%
Health Care	XLV	-12.6%	13.4%	-0.9%	-30.0%	84%
Cons Staples	XLP	-13.0%	8.5%	-5.6%	-26.5%	64%
Basic Materials	XLB	-26.2%	25.8%	-7.1%	-39.2%	77%
Real Estate	XLRE	-19.2%	13.2%	-8.6%	-40.8%	58%
Utilities	XLU	-13.4%	2.7%	-11.1%	-38.9%	47%
Industrials	XLI	-27.0%	16.9%	-14.6%	-44.1%	56%
Financials	XLF	-31.8%	11.9%	-23.7%	-44.3%	41%
Energy	XLE	-50.5%	31.9%	-34.7%	-64.6%	36%

Fixed Income: US investment-grade bonds (AGG) were effective diversifiers in Q1, logging positive returns as stocks crashed. Gains continued into Q2 leading to positive YTD returns for US (AGG) and non-US (BNDX) bonds. Conversely, high yield "junk" bonds (HYG) fell hard in Q1 as credit spreads spiked but recovered in Q2 as the Fed stabilized markets and credit spreads by buying bonds and ETFs; HYG is down just 5% YTD.

Global Equities: Global equities (SPGM) fell 35% from February highs, bottoming on March 23rd before rallying 17% by the end of Q1; SPGM rallied another 19% in Q2 and is now down 6.6% YTD. At the highest level, Q1 and Q2 were polar opposites:

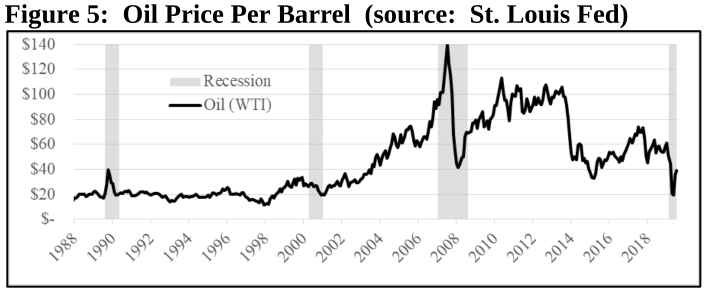
- Global stocks (SPGM) fell 22% in Q1 and gained 19% in Q2.
- US equities (VTI) fell 21% in Q1 and rose 22% in Q2.
- Non-US developed markets (EFA) fell 23% in Q1, then gained 15% in Q2; emerging markets (EEM) fell 24%, then rose 18%.

The quarters were classic examples of "risk off" (Q1) and "risk on" (Q2) behavior by investors. As the market melted down in Q1, riskier assets were hit hard, including high yield bonds (HYG -12%), emerging market stocks (EEM -24%), small (IWM -31%) and mid cap stocks (IJH -30%), while US bonds (AGG +3%) earned positive returns and the largest US tech stocks (Nasdaq 100 QQQ) fell "only" 10%. By contrast, riskier issues generally gained the most in Q2: high yield (HYG +7%); small (IWM +26%) and mid cap stocks (IJH +24%); and energy (XLE +32%).

Large US stocks have performed exceptionally well throughout 2020, powered by high-profile tech, internet and e-commerce stocks that have grown revenues and earnings as people worked from home and increased their on-line activity. The tech sector (XLK +15% YTD) was led higher by strong YTD returns from Microsoft (MSFT +29%), Apple (AAPL +24%) and Alphabet (GOOGL +6%), while consumer discretionary (XLY +2.6% YTD) rode Amazon gains (AMZN +49%), and the communications sector (XLC +1.3% YTD) benefitted from Netflix (NFLX +41%) and Facebook (FB +11%). These stocks account for about 45% of the Nasdaq 100 (QQQ), which is up 17% this year!

At the opposite end of the spectrum, the energy sector (XLE) lost half of its value in Q1 before rallying 32% in Q2 to finish the first half of 2020 down 35%, tracking the price of oil, which fell from over $60 per barrel to just below $40 today (Figure 5).

Figure 5: Oil Price Per Barrel (source: St. Louis Fed)



Outside of the US, Asian stocks (AAXJ -6% YTD) have held up, led surprisingly by China (MCHI +2.5% YTD). European stocks (IEUR) are still down 13% this year, but Latin American stocks (ILF -36% YTD) have fared much worse, led lower by Brazil (EWZ -39%) amid severe virus and corruption concerns.

Bottom Line

Markets have recovered a significant portion of earlier losses. Massive liquidity and stimulus has stabilized markets, but economies will only fully recover when demonstrable progress is made in containing and treating the virus. We are not there yet.

Figure 6: New Covid-19 Cases (source: Johns Hopkins)