ACIMA PRIVATE WEALTH

August 1, 2020

Economic & Investment Perspectives

Figure 1: Returns – 7/31/2020 (Source: AJO, FactSet)
Conditional formatting: green (high) to red (low) for each time period; Returns for periods greater than one year are annualized.

Bonds	ETF	MTD	YTD	Max Draw Down	Current vs. 52-wk High	Current vs. 52-wk Low	% of loss recovered
US Aggregate Fixed Income	AGG	1.3%	7.7%	-11.5%	-0.1%	13.3%	102%
Non-US Fixed Income	BNDX	1.0%	3.4%	-9.1%	-1.8%	8.1%	81%
High Yield	HYG	5.1%	-0.3%	-23.7%	-3.5%	26.5%	85%
Global Equity							
Global ACWI IMI	SPGM	4.4%	-2.5%	-34.9%	-5.9%	44.6%	83%
United States	VTI	5.7%	2.1%	-36.5%	-4.1%	51.2%	89%
International Developed	EFA	2.0%	-9.4%	-35.1%	-11.9%	35.7%	66%
Emerging Markets	EEM	8.3%	-2.9%	-35.0%	-6.5%	43.9%	82%
Equity by Region							
United States	VTI	5.7%	2.1%	-36.5%	-4.1%	51.2%	89%
Europe	IEUR	3.4%	-10.1%	-38.5%	-12.1%	43.0%	69%
Asia ex-Japan	AAXJ	8.2%	2.2%	-30.7%	-2.1%	41.3%	93%
China	MCHI	9.3%	12.0%	-26.3%	-6.3%	43.0%	121%
Japan	EWJ	-1.1%	-7.6%	-31.5%	-10.6%	30.6%	66%
Latin America	ILF	8.4%	-30.4%	-56.0%	-32.9%	50.5%	40%
US Equity							
US S&P 500	IVV	5.9%	2.5%	-35.3%	-3.7%	48.9%	89%
NASDAQ 100 QQQ	QQQ	7.3%	25.5%	-30.5%	-1.5%	61.2%	139%
US Large Growth	IWF	7.8%	18.2%	-33.5%	-0.2%	61.3%	122%
US Large Value	IWD	4.0%	-12.9%	-39.4%	-15.7%	39.3%	60%
US Eqwt S&P 500	RSP	5.0%	-6.4%	-40.7%	-10.2%	51.4%	75%
US Mid Cap	IJH	4.6%	-8.8%	-44.1%	-11.8%	57.7%	73%
US Small Cap	IWM	2.9%	-10.4%	-43.9%	-13.6%	53.9%	69%

Global equities continued to rally in July despite worsening news regarding the spread and impact of the Covid-19 virus. Unprecedented levels of stimulus from Congress, Federal Reserve (Fed), global governments and central banks stabilized markets, and hope for progress on treatment and vaccines drove markets higher. Performance highlights include the following (Figure 1):

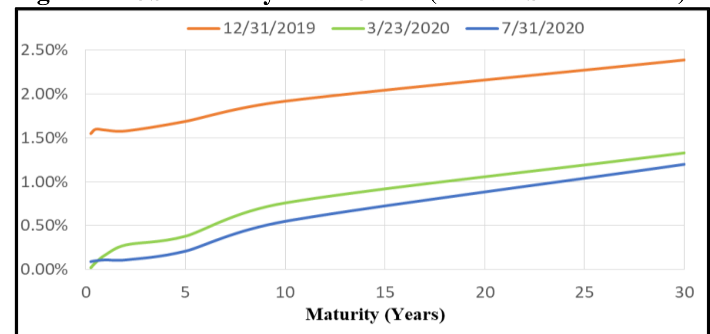
- Global stocks rose 4.4% (SPGM), now -2.5% YTD.
- US Equity: US stocks (VTI) rose 5.7% in July and is now +2.1% in 2020. The S&P 500 (IVV) gained 5.9% (+2.5% YTD), while mid- and small-cap stocks continue to lag; the S&P 400 Midcap (IJH) gained 4.6% for the month (-8.8% YTD) and the Russell 2000 small cap index (VTWO) gained 2.9% (-10.4% YTD). The largest technology stocks (QQQ – Nasdaq 100) continue to lead, up 7.3% in July (+25.5% YTD) while the average stock in the S&P 500 (RSP – Equal-wtd S&P 500) rose 5.0% for the month (-6.4% YTD).
- Non-US Equity: For the month, developed market stocks (EFA) gained 2.0% (-9.4% YTD) and emerging markets (EEM) rose 8.3% (-2.9% YTD). China shares (MCHI) have been a standout, up 9.3% in July and +12.0% so far this year.
- Fixed Income: Bonds have been solid in 2020 due to strong returns from US Treasuries. The US Aggregate bond index (AGG) rose 1.3% in May (+7.7% YTD). High yield bonds (HYG) gained 5.1% as credit spreads tightened (-0.3% YTD).

In aggregate, global stocks have regained most of the losses from the February-March drawdown, but returns vary significantly.

Interest Rates and the Economy

Interest rates are telling a different story than equities. While stocks continued to rise, interest rates declined in July and remain near historic lows amid concerns over the economic impact of the pandemic and the belief that the Fed will keep rates low for years to ensure economic recovery (and service the rapidly-growing US debt). Figure 2 graphs the US yield curve, which plots yields (Y-axis) for various maturities (X-axis) of US Treasuries.

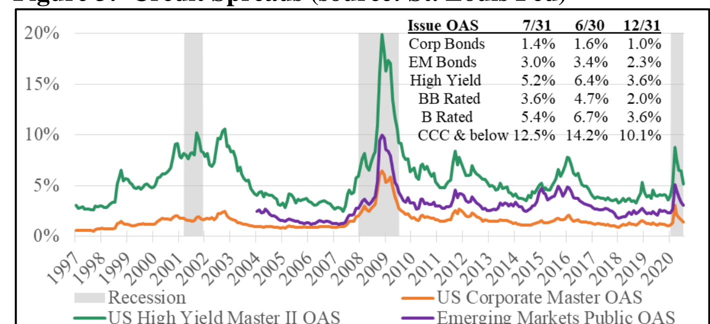
Figure 2: US Treasury Yield Curve (source: St. Louis Fed)



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 significantly since, erasing most of the pandemic fear-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 1.4% yield premium over Treasuries vs. 1.0% at year end.
- High yield (non-investment-grade) bond spreads are +5.2% over Treasuries, down from highs of +10.6% in March, versus +3.6% at year-end. The riskiest bonds (rated CCC & below) currently yield +12.5% over Treasuries, down from a high of +19.6% in March but still above the +10.1% at year-end.
- Emerging market credit spreads are +3.0% vs. +2.3% on 12/31.

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



Financial Markets vs. The Economy

The US Bureau of Economic Analysis (BEA) just reported that real GDP grew at an annualized rate of -32.9% in the second quarter (Q2). (Note: Real GDP stands for Gross Domestic Product, the value of all final goods and services produced in the US, adjusted for inflation.) As discussed here several months ago, this number is misleading; the US economy did not actually decline by nearly one-third. The headline number (-32.9%) is an annualized growth rate that assumes that the economy rose or fell by the same rate for four consecutive quarters. Real GDP actually fell 9.5% versus Q1 and is now down 10.6% this year. Figure 4 lists recent US GDP data as well as reported and actual growth rates.

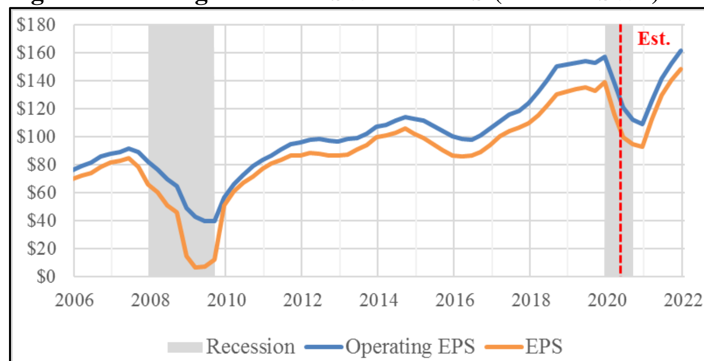
Figure 4: US Real GDP Growth (source: St. Louis Fed)

Quarter	Real GDP $Billions	Reported% Annualized	%Change Qtr/Qtr	%Change Year/Year	%Change since 12/31
2019 Q2	$ 19,020.60	1.5%	0.4%	2.0%	na
2019 Q3	$ 19,141.74	2.6%	0.6%	2.1%	na
2019 Q4	$ 19,253.96	2.4%	0.6%	2.3%	na
2020 Q1	$ 19,010.85	-5.0%	-1.3%	0.3%	-1.3%
2020 Q2	$ 17,205.82	-32.9%	-9.5%	-9.5%	-10.6%
2020 Q3 est.	*$ 17,696.32*	*11.9%*	*2.9%*	*-7.6%*	*-8.1%*

This economic performance is the worst on record but it is important to understand the numbers because growth rates for Q3 and beyond are going to be highly volatile as well. The Federal Reserve Bank of Atlanta forecasts that the annualized growth rate for real GDP will rebound to +11.9% in Q3; this would rank among the highest quarterly growth rates in history, but the economy would have actually only grown by 2.9% versus Q2 and will still be -8.1% versus 2019 year end. (See Figure 4 above.)

Despite the dire economic data, markets have recovered substantially since the panic selling of the first quarter, fueled by unprecedented proactivity by the Fed through loans to businesses and purchases of bonds and ETFs (investment grade and high yield bonds). Investors seem to be betting that economic recovery will be sharp (V-shaped). As discussed on page 1, credit spreads have tightened, though they remain slightly elevated amid defaults and bankruptcies. Global stocks have recovered most of their losses. The stock market anticipates economic growth, but how far ahead is the market looking? Figure 5 graphs the actual and estimated earnings per share (EPS, rolling 4-quarters) for the S&P 500.

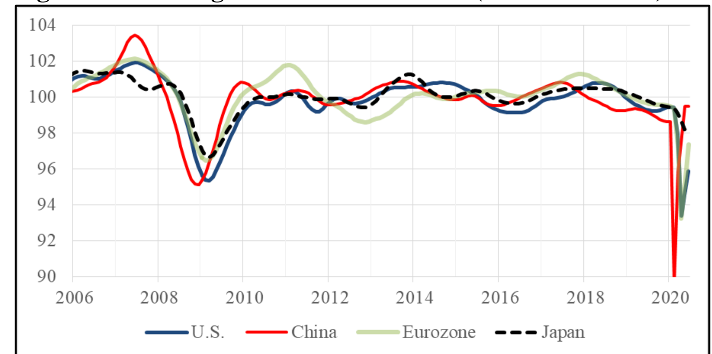
Figure 5: Rolling 12-month S&P 500 EPS (source: S&P)



Reported and operating earnings have clearly been negatively impacted by the pandemic-related economic downturn. Standard & Poors forecasts that year-over-year earnings growth will trough by the end of 2020 but will not recover to pre-pandemic levels until the end of 2021. While this is still another year-and-a-half away, it is worth noting that it took over four years for S&P 500 EPS to recover after the Great Financial Crisis, and it took over five years for the S&P 500 index to fully recover to new highs.

It is very difficult to accurately forecast economic growth, but the Organization for Economic Cooperation and Development (OECD) produces Composite Leading Indicators for the US and other countries and regions which have proven somewhat predictive of future economic growth. Figure 6 (below) graphs the leading indicators for the US, China, Eurozone and Japan, which together comprise about two-thirds of the global economy.

Figure 6: Leading Economic Indicators (source: OECD)



The sub-components of each index selected by OECD vary across countries and regions but generally include factors that represent significant economic importance: employment, interest rates, construction, durable goods, stock market levels, business and consumer confidence. The graph indicates that the US and Eurozone have followed similar paths and remain at levels at or below those observed in 2008-9. Japan's economy has been more stable but appears to be weakening. China, on the other hand, weakened rapidly but has fully recovered according to this metric. Some regions appear more poised for true recovery than others.

Another key factor to watch is the US dollar (Figure 7), which has strengthened in recent years, spiking even higher before falling toward pre-pandemic levels since March. A strong dollar benefits US financial assets; a weaker dollar benefits US exporters and non-US assets (non-US stocks and bonds).

Figure 7: Trade-Weighted US Dollar (source: St. Louis Fed)

Bottom Line

Global equities and debt have substantially recovered Q1 losses. The rally reflects investors' belief that economic recovery from the global recession will be quick. Current and leading indicators suggest that global economic prospects are improving, but full recovery will depend on progress against the virus. Given heavy debt issuance and money printing in the US, we would expect the dollar to continue to weaken, favoring non-US assets, especially in countries showing sustainable progress on the health front.