Economic & Investment Perspectives

Figure 1: Returns – 8/31/2020 (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
US Aggregate Fixed Income	AGG	-0.8%	6.8%	-11.5%	-1.1%	12.1%
Non-US Fixed Income	BNDX	-0.8%	2.6%	-9.1%	-2.6%	7.1%
High Yield	HYG	0.0%	-0.3%	-23.7%	-4.0%	25.9%
Global Equity						
ACWI Global Equity	ACWI	6.0%	4.8%	-34.8%	-0.6%	54.5%
United States	VTI	7.1%	9.4%	-36.5%	-0.5%	61.9%
International Developed	EFA	4.7%	-5.2%	-35.1%	-7.8%	42.0%
Emerging Markets	EEM	2.9%	-0.1%	-35.0%	-3.9%	47.9%
Equity by Region						
United States	VTI	7.1%	9.4%	-36.5%	-0.5%	61.9%
Europe	IEUR	4.5%	-6.0%	-38.5%	-8.1%	49.5%
Asia ex-Japan	AAXJ	3.9%	6.2%	-30.7%	-2.0%	46.9%
China	MCHI	5.8%	18.5%	-26.3%	-2.1%	51.3%
Japan	EWJ	6.8%	-1.3%	-31.5%	-4.5%	39.4%
Latin America	ILF	-5.6%	-34.2%	-56.0%	-36.6%	42.1%
US Equity						
US S&P 500	IVV	6.9%	9.6%	-35.3%	-0.6%	59.1%
NASDAQ 100 QQQ	QQQ	10.9%	39.2%	-30.5%	-0.6%	78.8%
US Large Growth	IWF	10.2%	30.2%	-33.5%	-0.6%	77.7%
US Large Value	IWD	4.0%	-9.4%	-39.4%	-12.3%	44.9%
US Eqwt S&P 500	RSP	4.3%	-2.4%	-40.7%	-6.4%	57.9%
US Mid Cap	IJH	3.6%	-5.5%	-44.1%	-8.7%	63.4%
US Small Cap	VTWO	5.5%	-5.4%	-43.8%	-8.3%	63.0%

Global equities continued to rally in August, fueled by low interest rates (TINA – there is no alternative) and trillions of dollars of monetary and fiscal stimulus. Performance highlights for the month and year-to-date (YTD) include the following (Figure 1):

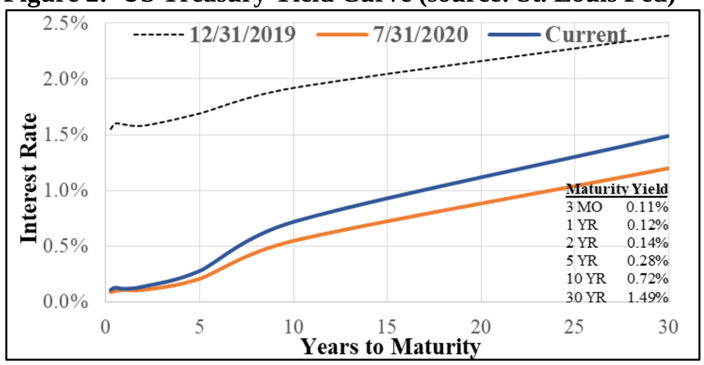
- Global stocks rose 6.0% (ACWI) and are +4.8% YTD.
- US Equity: US stocks (VTI) rose 7.1% in August and is now +9.4% in 2020! The S&P 500 (IVV) gained 6.9% (+9.6% YTD), but mid- and small-cap stocks continue to lag; mid-caps (IJH) gained 3.6% for the month (-5.5% YTD) and the small stocks (IWM) gained 5.5% in August (-5.4% YTD). Growth stocks (IWF +10.2%) continue to trounce value stocks (IWD +4.0%) and lead by a widening margin YTD (+30.2% vs. -9.4%), led by technology stocks, while energy (XLE -38.5% YTD) and financial stocks (XLF -17.3% YTD) have struggled. Other sectors with negative YTD returns include utilities (XLU -6.6%), real estate (XLRE -4.8%), and Industrials (XLI -3.3%).
- Non-US Equity: Developed market stocks (EFA) gained 4.7% in August (-5.2% YTD); emerging markets (EEM) rose 2.9% (-0.01% YTD). Chinese stocks (MCHI) are +18.5% this year.
- Fixed Income: The US Aggregate index (AGG) fell 0.8% in August but remains +6.8% YTD. High yield bonds gained 1.0% as credit spreads tightened (+1.7% YTD).

In aggregate, global stocks have regained all of their losses from the February-March drawdown, but returns vary significantly. We will discuss this disparity on page 2.

Interest Rates and the Economy

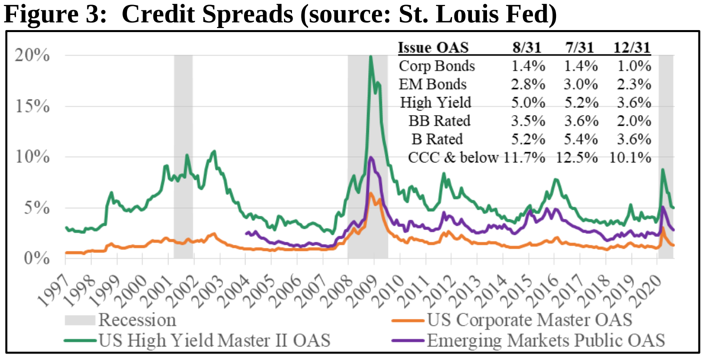
While stocks continued to rally in August, bond prices fell as interest rates rose, though rates remain near historic lows. Figure 2 graphs the US yield curve, which plots yields (Y-axis) for various maturities (X-axis) of US Treasuries. Short-term yields remained at basically zero as the Federal Reserve (Fed) signaled their clear intention to keep interest rates low for years to come. Longer-term rates rose as inflation expectations increased marginally: July's core CPI (Consumer Price Index excluding Food and Energy) was +1.6% versus a year ago, and core PCE (Personal Consumption Expenditures ex-Food and Energy, the Fed's preferred inflation metric) came in at +1.3%. This remains stubbornly below the Fed's 2% target, and they stated their intention to allow inflation to rise above 2% sustainably before raising rates.

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; 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; conversely, falling spreads lead to stronger returns. Spreads declined marginally in August as seen in the panel inset in Figure 3 below.

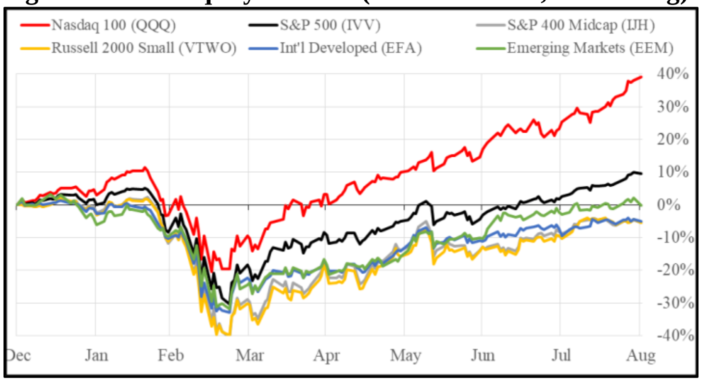
Figure 3: Credit Spreads (source: St. Louis Fed)



Uneven Recovery: Disparate Equity Returns

Given the global economic carnage caused by the pandemic, the stock market recovery has been stunning. While economists agree that it will take several years to recover pre-Covid GDP levels, global stocks notched all-time highs in August, led higher by the US and China. But the strong headline returns mask an uneven recovery, one that has been led by a small number of technology and e-commerce stocks. Figure 4 puts the equity recovery in perspective, comparing various segments of global stocks.

Figure 4: 2020 Equity Returns (source: Yahoo, Bloomberg)



Amazingly, the Nasdaq 100 index (QQQ) is up almost 40% this year, and the S&P 500 (IVV) is up 10%. By contrast, small (VTWO) and mid-cap (IJH) stocks are each *down* more than 5% in 2020. International developed market stocks (EFA) are down 5% this year, and emerging market equities (EEM) are flat. Why is there such a wide disparity of returns, especially in the US?

Equity indices are generally weighted by market capitalization (stock price times the number of shares outstanding for each index constituent). This methodology places much larger weights on the largest stocks, and therefore the performance of a few very large companies can drive the returns of an entire index. For example, the Nasdaq 100 (QQQ) is a highly concentrated index with 57.8% of its weight in just 10 stocks (Figure 5).

Figure 5: QQQ Top 10 Holdings (source: ETF.com)

Name	Symbol	% Assets	YTD Return
Apple Inc	AAPL	13.9%	77%
Microsoft Corp	MSFT	11.2%	44%
Amazon.com Inc	AMZN	10.9%	87%
Facebook Inc A	FB	4.6%	43%
Alphabet Inc A	GOOGL	3.6%	22%
Alphabet Inc Class C	GOOG	3.6%	22%
Tesla Inc.	TSLA	3.4%	496%
NVIDIA Corp	NVDA	2.7%	128%
Adobe Inc	ADBE	2.0%	56%
PayPal Holdings Inc	PYPL	2.0%	89%
Total Top 10		**57.8%**	

All ten of these huge companies are in technology, electric vehicles and/or e-commerce businesses, and their 2020 returns have been incredible, as illustrated in the table above. The earnings of these companies have held up very well this year as the pandemic has led to more and more virtual activity, communication and e-commerce, and investors have been handsomely rewarded. With over half its weight in ten stocks that are up massively this year, the strong Nasdaq 100 (QQQ) returns make sense (+39% YTD).

While not as concentrated as the Nasdaq 100 (QQQ), the S&P 500 (IVV) still has 29% of its weight in its largest 10 constituent stocks. These same technology and e-commerce stocks have led the S&P 500 to a year-to-date gain of 10%, while the average stock in the index is still down 2% in 2020. (Note: TSLA is not in the S&P 500.) This concentration and the resulting sector exposures and biases also explain much of the performance disparity between growth and value index returns (Figure 6).

Figure 6: US Equity Sectors (source: Yahoo Finance)

			Index Exposures by Sector			
Sector	**Symbol**	**YTD Return**	**Nasdaq 100 (QQQ)**	**S&P 500 (IVV)**	**Russell 1000 Growth (IWF)**	**Russell 1000 Value (IWD)**
Technology	XLK	35.7%	45.1%	24.0%	37.7%	10.2%
Consumer Cyclical	XLY	20.5%	16.9%	10.6%	15.2%	6.9%
Communication Services	XLC	18.5%	20.1%	10.8%	11.5%	9.4%
Healthcare	XLV	7.3%	7.6%	14.8%	15.0%	14.3%
Consumer Defensive	XLP	5.5%	4.8%	7.4%	5.3%	8.5%
Basic Materials	XLB	3.8%	0.0%	2.2%	0.7%	3.9%
Industrials	XLI	-3.3%	2.6%	8.4%	4.8%	12.3%
Real Estate	XLRE	-4.8%	0.3%	2.8%	2.3%	4.9%
Utilities	XLU	-6.6%	0.7%	3.1%	0.0%	5.9%
Financial Services	XLF	-17.3%	2.0%	13.2%	7.5%	18.4%
Energy	XLE	-38.5%	0.0%	2.8%	0.1%	5.3%

The construction of the various indices leads to significantly different exposures across the eleven industry sectors defined by Standard & Poor's. The table above lists the sector exposures of various index ETFs and is sorted by 2020 year-to-date returns for the sectors, illustrating that the better performing indices have proportionally more exposure to the sectors with stronger returns. The Nasdaq 100 (QQQ) has 82% of its weight in the top 3 performing sectors (technology, consumer cyclical, communications) and has little to no exposure to the worst performing sectors (energy, financials, utilities, real estate, industrials). The profile of the Russell 1000 Growth index (IWF) is very similar, and that index is also up over 30% in 2020. Conversely, the Russell 1000 Value index (IWD) has only about a quarter of its weight in the top three sectors, and about 47% of its weight in the five sectors worst performing sectors; as a result, this index is *down* 9% YTD.

Bottom Line

Global equities and debt have substantially recovered Q1 losses. Stock returns, in aggregate, have clearly been driven by a small cohort of technology and e-commerce stocks, which have continued to grow earnings, stock prices and their representative share of US and global stock markets and indices during the pandemic-related upheaval in 2020. In order for this rally to continue, one of two things needs to happen: Either this small group of huge tech companies must continue to lead the market higher, or the rest of the stocks, industries and sectors need to stabilize and grow. While nothing is impossible, it is unlikely that the ten stocks listed in Figure 5 will be able to replicate their extraordinary performance during the second half of 2020 and beyond. Therefore, future stock market returns will most likely need to be driven by broad, organic economic recovery and growth.

Current and leading indicators suggest that global economic prospects are improving from crisis lows but remain below pre-pandemic levels. Full economic recovery will depend on progress against the virus. Given the outperformance of mega-cap tech stocks this year, we expect future returns to be driven by small and mid-sized US stocks and non-US stocks which will benefit from global health and economic recovery and a weaker US dollar in the wake of massive US debt and money supply increases.