Economic & Investment Perspectives

Figure 1: Returns – 11/30/2020 (Source: Yahoo!, ACIMA)
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	1.2%	7.4%	-11.5%	-1.3%	12.0%
U.S. Treasury Bonds	GOVT	0.5%	8.1%	-6.2%	-4.5%	5.4%
Investment Grade Corp Bonds	LQD	3.8%	10.8%	-26.9%	-0.8%	31.7%
Muni Bonds	MUB	1.6%	4.4%	-15.3%	-1.3%	16.6%
High Yield	HYG	3.4%	2.5%	-23.7%	-2.9%	27.3%
Non-US Fixed Income	BNDX	0.4%	4.3%	-9.1%	-0.3%	8.5%
Emerging Markets Bond	EMB	4.2%	3.2%	-27.5%	-2.9%	33.9%
Global Equity						
ACWI Global Equity	ACWI	11.8%	11.1%	-34.8%	-1.3%	63.8%
United States	VTI	11.8%	15.7%	-36.5%	-0.9%	70.5%
International Developed	EFA	14.3%	2.5%	-35.1%	-2.3%	53.4%
Emerging Markets	EEM	9.0%	9.2%	-35.0%	-2.9%	61.9%
Equity by Region						
United States	VTI	11.8%	15.7%	-36.5%	-0.9%	70.5%
Europe	IEUR	16.4%	0.4%	-38.5%	-1.9%	59.6%
Asia ex-Japan	AAXJ	8.1%	16.0%	-30.7%	-2.8%	60.5%
China	MCHI	2.7%	25.0%	-26.3%	-5.8%	59.6%
Japan	EWJ	10.6%	9.6%	-31.5%	-3.0%	54.7%
Latin America	ILF	25.0%	-21.6%	-56.0%	-24.5%	69.3%
US Equity						
US S&P 500	IVV	10.9%	14.1%	-35.3%	-0.6%	64.9%
NASDAQ 100 QQQ	QQQ	11.2%	41.5%	-30.5%	-1.3%	81.7%
US Large Growth	IWF	10.3%	32.4%	-33.5%	-1.5%	80.3%
US Large Value	IWD	13.4%	-1.0%	-39.4%	-4.7%	57.4%
US Eqwt S&P 500	RSP	14.3%	7.7%	-40.7%	-2.0%	74.1%
US Mid Cap	IJH	14.3%	6.7%	-44.1%	-2.5%	83.7%
US Small Cap	VTWO	18.4%	10.7%	-43.8%	-2.3%	90.3%

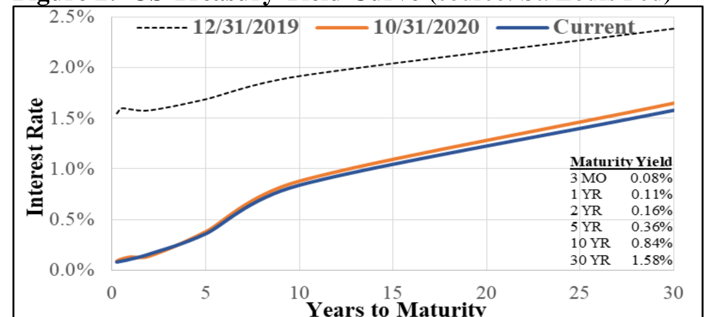
Equity markets rocketed higher in November as investors looked past the immediate health and economic risks associated with the worsening pandemic, focusing instead on the promise of the light at the end of the tunnel (vaccines). The completion of US elections also removed a significant set of uncertainties, allowing investors to look ahead with more clarity (regardless of one's political preference). Regions, countries and sectors that had lagged YTD surged the most this month. Performance highlights for the month and year-to-date (YTD) include the following (Figure 1):

- Global stocks (ACWI) rose 11.8% and are +11.1% YTD.
- US Equity: US stocks (VTI) rose 11.8% in November (+15.7% YTD). The S&P 500 (IVV) rose 10.9% (+14.1% YTD), while small-caps (VTWO) gained a record 18.4% in November (+10.7% YTD). Energy stocks (XLE) rallied 28.0% (-35.6% YTD), and financials (XLF) gained 16.8% (-7.6% YTD).
- Non-US Equity: Developed market stocks (EFA) rose 14.3% this month (+2.5% YTD), and emerging markets (EEM) rose 9.0% (+9.2% YTD). Latin American stocks (ILF) rose 25.0% in November but are still -21.6% so far in 2020.
- Fixed Income: The US Aggregate bond index (AGG) gained 1.2% in November (+7.4% YTD). US Treasuries (GOVT) were flat for the month but are up 8.1% in 2020. Corporate bonds (LQD) rose 3.8% (+10.8% YTD) and high yield bonds (HYG) rose 3.4% (+2.5% YTD) as credit spreads tightened. Emerging market debt (EMB) rose 4.2% (+3.2% YTD).

Interest Rates and the Economy

Figure 2 graphs the US yield curve, which plots yields (Y-axis) for various maturities (X-axis) of US Treasuries. Short-term yields are near zero and will likely remain there for years to come, according to the Federal Reserve (Fed). Long-term rates moved slightly lower this month. In theory, long-term yields should rise in anticipation of rising debt issuance to finance pandemic relief, economic stimulus and future infrastructure spending, but the belief that the Fed will "manage" the yield curve through asset purchases and quantitative easing has kept a lid on interest rates.

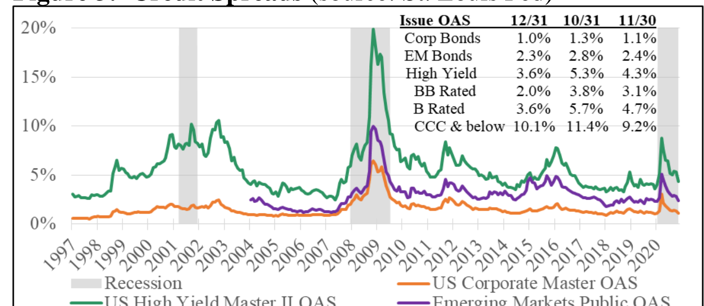
Figure 2: US Treasury Yield Curve (source: St. Louis Fed)



For bonds other than US Treasuries, we focus on the option-adjusted spread (OAS) between various bond yields and comparable US Treasuries. High spreads signal fear; low spreads signal a strong risk appetite. As illustrated in Figure 3 below, credit spreads have almost completely erased the pandemic fear-related spike of February-March, including a measurable decline in November, confirming the "risk-on" mood in the equity markets.

- Investment grade corporate bonds yield 1.1% over comparable Treasuries, now nearly unchanged versus 2019 year-end.
- Emerging market bonds carry an average yield premium of +2.4% versus +5% in March and +2.3% at 2019 year-end.
- High yield (non-investment grade) spreads had spiked to almost 9% before falling to +4.3% today, marginally above 2019 year-end levels (+3.6%). The riskiest bonds (rated CCC & below) now carry credit spreads below pre-pandemic levels.

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

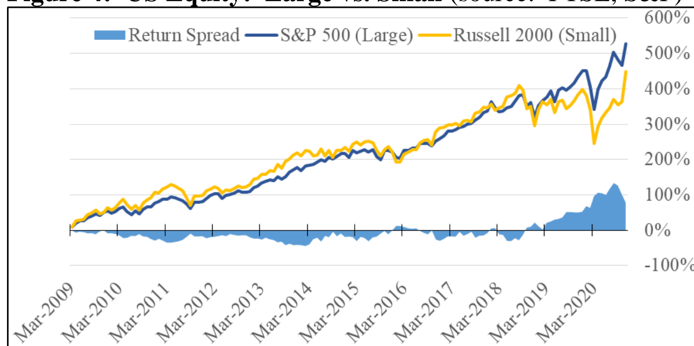


Significant Reversal of Equity Leadership

November marked a notable reversal of well-established patterns observed in recent years, especially in 2020. Over the past few years, stock returns have been dominated by a handful of large technology stocks (as discussed here on multiple occasions), but previously under-performing markets, segments and sectors roared back this month. While one month's performance does not constitute a change in trend, the shift bears noting.

The Russell 2000 small-cap index posted its strongest monthly return in the 40+ year history of the index (+18.4%), out-performing the S&P 500 (large-cap stocks), which gained 11.0% in November. To put this relative performance in perspective, Figure 4 below graphs the returns of large (S&P 500) and small stocks (Russell 2000) since March, 2009, the stock market bottom during the Global Financial Crisis (GFC). The shaded area measures the cumulative return spread between the two indexes, i.e. the total return of the S&P 500 minus the Russell 2000 return.

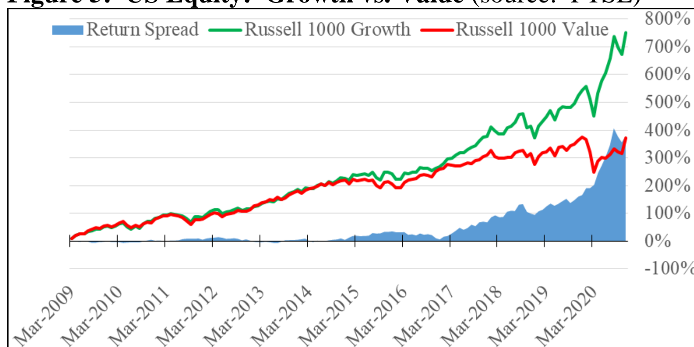
Figure 4: US Equity: Large vs. Small (source: FTSE, S&P)



Small stocks tend to out-perform early in the economic cycle as accommodative Fed policy (low short-term interest rates, steep yield curve) and fiscal stimulus (government spending) fuels rapid economic expansion; this was, indeed, the case following the GFC. The Russell 2000 out-performed the S&P 500 through the middle of 2018 (though the relative performance advantage actually peaked in 2014). Large stocks (S&P 500) trounced their smaller counterparts during the 2018 market correction, the 2019 recovery, and the recession/recovery of 2020, powered by the extraordinary performance of huge tech and e-commerce stocks. November's strong small-cap returns are a big step toward reversing a trend that has been in place for several years.

A comparison of growth and value indexes offers a vivid example of disparate returns in recent years. Figure 5 graphs the returns of the Russell 1000 Growth and Value indexes and the cumulative spread between them (Growth minus Value) since the GFC.

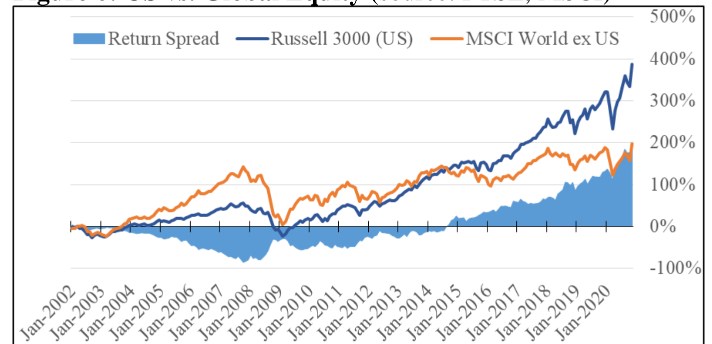
Figure 5: US Equity: Growth vs. Value (source: FTSE)



The historical out-performance of value stocks (lower P/E, lower earnings growth) over growth stocks (higher earnings growth and P/E) has been well researched and documented, but the most recent economic cycle is an exception. From March, 2009, through 2014, value and growth stocks logged similar returns, but growth has trounced value since, especially in the last four years. One explanation for the strong performance of growth stocks might be consistently low interest rates, which make future earnings more valuable based on present value or discounted cash flow analyses. The dominance of growth stocks accelerated in 2019 and persisted through the 2020 selloff and recovery as increasing online and e-commerce activity resulted in earnings growth for tech stocks despite the pandemic. As a result, the Growth index has out-performed its Value counterpart by 380% in recent years! The resurgence of value in November is a drop in the bucket.

The strong performance of large growth/technology stocks has also led to significant out-performance of US stocks over non-US equity in recent years. Figure 6 graphs the returns of US (Russell 3000) and non-US equity (MSCI World ex US index) back to 2002 to illustrate the secular rotation of leadership; the shaded area marks the cumulative spread (US minus non-US).

Figure 6: US vs. Global Equity (source: FTSE, MSCI)



While US equities under-performed non-US stocks in the mid-2000s (powered by China's meteoric rise and a weaker US dollar), US stocks have out-performed since 2009 as the dollar strengthened, Europe struggled (debt crises, Brexit), growth in China moderated, and US tech stocks soared. Non-US equities out-performed US stocks in November (+15.3% vs. +12.2%), but this did little to reverse the trend in place over the past few years.

Bottom Line

November was a stunning, record-breaking month for stocks. Investors aggressively shifted into "risk-on" mode, driving broad US and global equity indexes to new all-time highs and pushing credit spreads back down to pre-pandemic levels. Markets hate uncertainty, and several significant unknowns were removed: US elections are behind us, and the promise of effective vaccines to fight the pandemic are on the horizon. What remains to be seen is whether or not the shift in sentiment is sustainable.

The narrow leadership provided by ultra-large US technology stocks in recent years has resulted in enduring out-performance of the S&P 500 over small-caps and non-US equity indices, as well as a dramatic underperformance of traditional value stocks. November marked a sharp reversal of these trends, but what happens next? True global economic recovery should favor small- and mid-cap stocks in the US, as well as foreign stocks and bonds as the US dollar weakens (debt, deficits and money printing) and growth resurges abroad, especially in emerging markets.

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