JUNE 30, 2020

Strategic Investment Group®

Market Commentary

» GLOBAL MARKET REVIEW

» OUTLOOK & STRATEGY

» SPECIAL TOPIC

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Summary

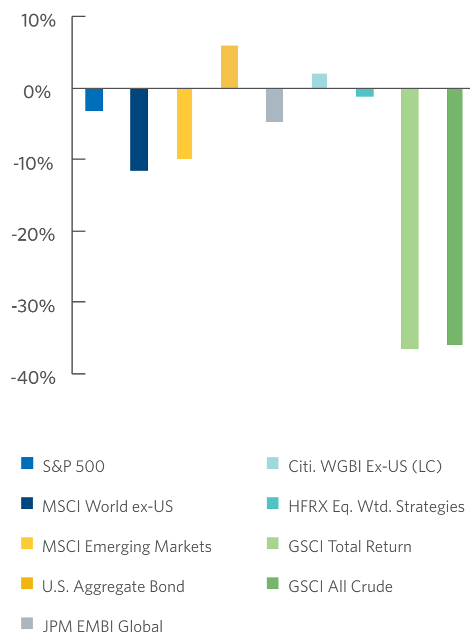
Following a precipitous decline in the first quarter, global equity markets rebounded sharply in the second, with the U.S. leading the way. The rebound largely reflects massive fiscal and monetary stimulus measures by countries around the world, as well as the ebb and flow of sentiment in the face of heightened uncertainty. Nevertheless, most risk assets remain down for the year. Long-dated U.S. Treasuries, in contrast, are the best performing asset, reflecting expectations for slow growth and low inflation. Oil prices jumped 95% in Q2, yet remain down 36%, echoing these expectations.

EXHIBIT 1:

Performance of Major Market Indices

Source: Bloomberg.

Year to date through June 2020.



Despite rebound in Q2, risk assets still down in 2020.

Highly Uncertain Economic Outlook

The global economic outlook is grim. How grim remains highly uncertain. The abrupt, policy-induced decline of the global economy is unprecedented in its suddenness. Its magnitude rivals that of the Great Depression. Many economies contracted by an annualized 25-40% in a single quarter. Global joblessness is 10 times worse than at the peak of the Great Financial Crisis, a milestone reached in just three months. Whether the measures taken to contain the contagion that triggered this sudden stop in economic activity will have to be renewed remains an open question, and therein lies tremendous uncertainty. Against this inauspicious and volatile economic backdrop, global equity and credit markets staged a surprisingly sharp rebound in the second quarter, recouping a large portion of the steep losses of the first (Exhibit 2).

U.S. Equities' Record Rebound

The U.S. stock market has taken investors on a wild roller coaster ride this year. After a peak-to-trough fall of about one third, the S&P 500 set a record for the shortest bear market in history, rebounding some 40% from its March 23 low. The market's second quarter gain was the highest quarterly gain since 1998. At quarter end, the S&P 500 was down a mere 3% for the year, and only 7.8% from its all-time high, despite job losses of over 40 million between March and June and the prospect that the U.S. economy will suffer in 2020 its deepest economic contraction since the Great Depression.

The recovery was highly concentrated on the usual suspects of mega-cap, growth stocks in the tech sector. Following years of outsized gains by the likes of Facebook, Amazon, Netflix, Microsoft, Apple, and Google (FANMAG), the S&P 500 index has never been more concentrated on a few names, with 10 stocks representing nearly 30% of the total

capitalization of the index (See Special Topic). Extending this trend, large cap growth stocks have outperformed other market segments so far this year, rising 5.2% versus the 15.7% decline of large cap value stocks. The tech sector has outperformed all others in 2020, gaining 7%, compared with steep declines of stocks in the energy (-36.1%), financial (-24.4%) and industrial (-15.3%) sectors.

Global Equities Also Resurgent

The stark disconnect between dire fundamentals and resurgent asset prices was also prominent in non-U.S. equity markets. As was the case in the U.S., the main drivers of the rally were fiscal and monetary stimulus as well as improved sentiment on prospects for easing the lockdown. The MSCI World ex-US index of developed equity markets rose 15.3% in the second quarter. Nevertheless, it remains down 11.5% so far in 2020.

The second quarter bounce of emerging equity markets was even bigger. The MSCI Emerging Market index jumped 18% in the quarter, with all regions enjoying double-digit gains. The index nevertheless remains down about 10% so far this year. Chinese equities represent the sole bright spots across emerging markets, with China A-Shares up 4.7% so far in 2020. Despite a slight gain in the second quarter, emerging market currencies remain near their weakest level since the 1990s in the face of diminishing access to external financing and a withdrawal of foreign capital from local markets.

Fed Holds Down Yields and Spreads

In contrast to the rosier outlook of the equity markets, U.S. Treasuries continue to price in subpar growth and disinflationary pressure. Reflecting this pattern, U.S. Treasuries with maturities of 10 years or longer have returned 21.2% so far this year. Advanced sovereign bond markets outside of the U.S. gained about 1% in the first half of 2020 as yields have remained at very low and negative levels. The Fed's corporate bond purchases supported a narrowing of U.S. credit spreads despite a record level of issuance (Exhibit 3). Spreads on investment grade bonds narrowed, contributing to the 10.6% return on long-maturity investment grade bonds so far in 2020. U.S. corporate bond issuance in the second quarter set an all-time record, bringing total issuance to over $1 trillion this year, as companies rush to lock in low borrowing costs and shore up their cash positions.

Hedge Funds Make Further Modest Gains

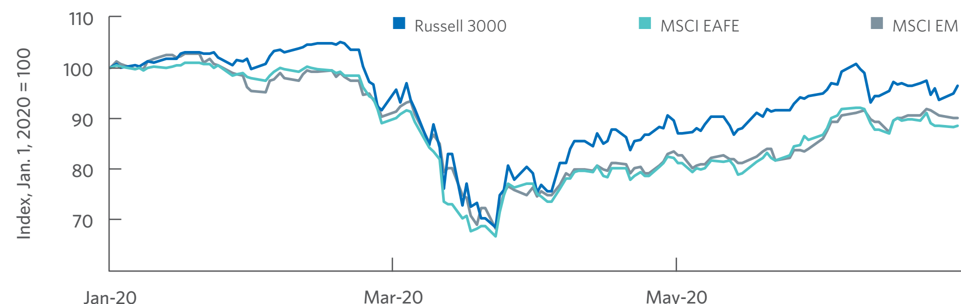
Hedge funds participated in the rebound across global equity and credit markets. The HFRX Equal Weighted Strategies index rose 6.4% in the second quarter, yet remains down 1.1% so far in 2020. Convertible arbitrage strategies have had the highest return, while strategies with equity market exposure have lagged so far in 2020.

EXHIBIT 2:

Global Equity Roller Coaster Turns Up in Q2

Sources: Bloomberg and Strategic calculations.

Year to date through June 2020.



Oil Slips Death's Shackles

The miraculous resurrection of crude oil prices in the second quarter (+95%) after the death spiral of the first, owes much to the agreement reached in June by Saudi Arabia, Russia, and other major producers to limit production thus ending a ruinous fight for market share (Exhibit 4). Despite the recovery, oil prices remain down nearly 36% so far in 2020, driving the GSCI down 39% over the same period. In the real estate market, the NCREIF Open-End Funds Core Index (reported with a quarter delay) gained 3.9% in the twelve months through March 2020, with nearly all of the return driven by income. TIPS prices are up so far this year. The real yield on 10-year TIPS remained in negative territory (-0.7%) at end-June.

Private Equity Transactions Way Down

The Thomson Reuters/Cambridge Index of U.S. private equity (reported with a two-quarter delay) gained 14.9% in the year through December. While it is premature to assess the impact of the pandemic on valuations, it is likely to be significant given private equity's higher leverage than the public market. Since the pandemic began, transaction volume has fallen sharply.

EXHIBIT 3:

U.S. Credit Spreads Narrow with Fed Help

Sources: Bloomberg and Strategic calculations.

Year to date through June 2020.

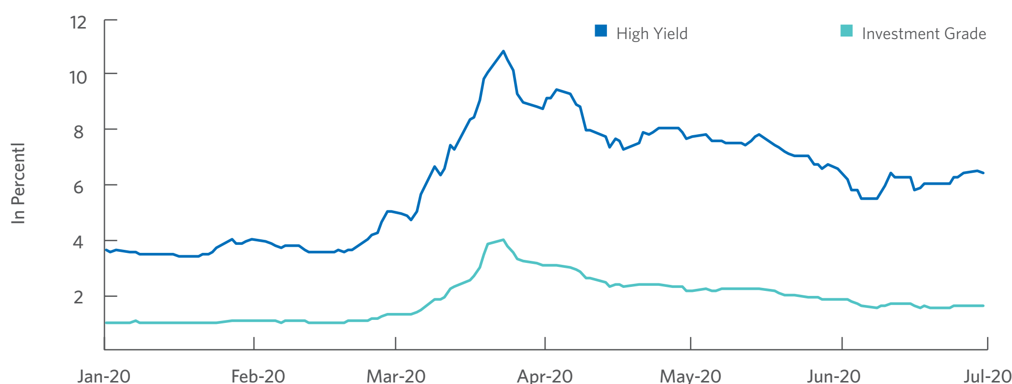


EXHIBIT 4:

Excess Supply, Falling Demand Spark Oil Price Volatility

Source: Bloomberg.

Data through June 2020.

Summary

Economies are tentatively reopening and the world is emerging in fits and starts from an artificially induced economic coma. Despite great uncertainty over whether the easing of the lockdown will be brief or lasting, massive fiscal and monetary support has helped global equity and credit markets recover most of their pandemic-induced losses. In this volatile environment, our investment stance remains cautious. We have reinstated a small underweight to global equities and slightly reduced our duration underweight. We remain overweight hedge funds to benefit from the rich opportunity set created by crisis-related dislocations.

Economies Fitfully Emerge from Coma

The speed of the COVID-19 global economic collapse is unprecedented; its magnitude rivals that of the Great Depression. The IMF's latest forecast projects a 4.9% fall in global output this year; nearly triple the decline during the Great Financial Crisis (GFC). The contraction in advanced economies is projected to be the largest since WWII, with the U.S. falling by 8%, and the euro area and the UK both down by 10.2%. Emerging market economies are projected to fall by 3%, their first contraction in 60 years. China, the lone relative bright spot, is expected to grow a mere 1%. Even with a projected rebound of 5.4% next year, global activity levels would remain some 6.5% short of pre-pandemic estimates.

While the lockdown phase of the current recession was highly synchronized across economies, different recovery patterns are beginning to emerge. China's recovery, which leads others by about two to three months, has surprised on the upside. In the U.S., by contrast, the initial rebound is showing signs of stalling. High-frequency data suggest a slowdown caused by renewed pandemic flare-ups across large parts of the U.S.

Key Risks in Highly Uncertain Times

The unprecedented collapse in economic activity, uncertainty about the course of the pandemic, and reliance on the most aggressive policy response outside of war-time have left the global economy vulnerable to a worryingly long list of risks.

Pandemic Waves: The ominous possibility of a second wave of contagion in the fall weighs heavily on the outlook and heightens uncertainty. In the event of a second wave, the IMF projects that, rather than rebounding by 5.4% in 2021, the global economy would stagnate because of containment measures and the impact of deteriorating sentiment on financial markets. A second wave would also increase the risk of economic scarring from bankruptcies, capital destruction, and loss of labor skills and motivation leading to lasting declines in productivity growth. A prolonged pandemic would further intensify the long-term blow to productivity from trade disruption and broken supply chains. Finally, the longer the pandemic persists, the more it will exacerbate already high levels of income inequality, sowing the seeds for continued social disruption. With the economic recovery a function of success in the fight against COVID-19, the return to pre-pandemic economic conditions will likely require an effective vaccine. Until then, any effective response to the pandemic will involve some constraints on interactions between economic

agents. Delays in the development of a vaccine or any renewed threat of contagion may trigger a deeper and longer lasting economic setback.

Human Behavior: How people respond to the risk of contagion is also highly uncertain. In the near term, there is a danger, as we have already seen in some areas, of lockdown fatigue, leading to risky behavior fueling the spread of the virus and delaying an eventual rebound. This is most evident in those parts of the U.S. that had been previously largely unscathed by the virus. Over the longer term, changing patterns of consumer and firm behavior induced by the pandemic could trigger wrenching dislocations in a wide range of economic sectors, including transport, real estate, retail, and travel and leisure.

Policy Mistakes: The policy response to limit economic destruction and maintain orderly markets has been swift and substantial. Cuts by the Fed have brought policy rates effectively to zero, while the pace of asset purchases to ease liquidity conditions and ensure orderly markets has exceeded those of the GFC. Other major central banks have also eased significantly. Moreover, massive fiscal stimulus packages have been initiated across the globe. In the U.S., the CBO projects that, assuming that no further stimulus measures are adopted, the U.S. fiscal deficit in 2020 will hit nearly 18% of GDP, the largest since 1945, pushing Federal debt to 108% of GDP, from 79% in 2019.

While initial policy initiatives in the U.S. found bi-partisan support, the consensus on fiscal policy appears to be fraying. Concerns are growing that further fiscal stimulus would increase already high debt levels, necessitating a difficult adjustment over the medium term.

The experience of Japan after the stock and real estate market collapse in 1990 should serve as a cautionary tale against policy vacillation. Significant corporate deleveraging following the bursting of the bubble triggered a long and brutal balance sheet recession—Japan's "Lost Decade(s)". Ineffective monetary policy and, more importantly, insufficiently aggressive and sustained fiscal policy kept the Japanese economy in a state of low-inflation and low growth from which it still has not fully emerged.

There are two key lessons from Japan's experience. First, if your economy does not respond sufficiently to monetary policy, use fiscal policy. Second, a half-hearted application of fiscal policy raises the risk of being trapped in a deflationary equilibrium where monetary policy loses its power, real interest rates rise despite zero nominal policy rates, and debt levels spiral ever higher.

Geopolitical Surprises: Pre-pandemic geopolitical tensions are beginning to resurface. Discord between the U.S. and China is threatening to renew protectionist pressures on the global economy. World trade and economic activity are joined at the hip. Damage to one is therefore bound to hurt the other. At a time when global supply chains have already come under severe pressure from the global economic lockdown, renewed trade tensions would hurt the prospects for economic recovery.

Pre-existing Conditions: Even before the uncertainty created by the pandemic, financial markets appeared richly valued, risk premiums compressed, and interest rates on safe haven assets unsustainably low. Moreover, non-bank leverage was high. Both sovereign and corporate debt was elevated across advanced and emerging market economies and credit quality had been deteriorating. The pandemic is exacerbating these pre-existing vulnerabilities, raising the risk of mishap in corporate bond markets and certain emerging economies.

Inflation Inflection?

Over the next 18-24 months, we expect disinflationary forces to dominate. The deflationary shock to demand will dominate the inflationary shock arising from reduced supply.

In the medium- to longer-term, however, we see the risk of rising inflation if the eventual recovery is more rapid than expected and governments fail to appropriately calibrate their policy response. The Fed and other major central banks may seek to ease the burden of sharply higher debt through artificially low interest rates and bond yields for years to come, despite a rebound in economic activity. Inflationary pressure could be further fueled by a continued rollback of globalization. Limitations on the free flow of goods, services, capital and labor as well as the attempt to shorten supply chains could unwind some of the disinflationary gains from globalization in the past decades.

Engines Off and Risk On?

The disconnect between the collapse in economic growth and the second-quarter surge in risk assets is striking. Although most economic data paint a grim picture and the outlook remains highly uncertain, investors appear beguiled by hopes for a relatively smooth ride into a rosy post-pandemic future. In an environment of great uncertainty, we believe that macro calls are unreliable guides to portfolio positioning. While it is certain that the pandemic will one day lift, when and how that happy outcome will materialize is unknown, and as we have just seen, the risks to achieving a sustained economic rebound are many.

In this environment, we are intensifying our focus on long-term valuation metrics to guide our active portfolio management decisions. This approach has stood the test of time and yielded positive results over the long run. It is inherently a far less risky approach than using judgments on the direction of the economy to guide active asset allocation decisions.

Asset Allocation Driven by Fundamentals

While following a focus on fundamental valuations, we have initiated a number of active equity asset allocation decisions to take advantage of excesses created by wild swings in market prices so far this year. In late March, following the very sharp pandemic-induced decline in U.S. equity prices, we reduced our U.S. equity underweight to neutral on the grounds that the price decline had returned U.S. equity valuations to fair levels. After the sharp and lopsided rebound in prices during the second quarter, we reinstituted our U.S. equity underweight in early June as valuations once again appeared stretched.

Our models suggest that U.S. stocks are trading about 20% above fair value while non-U.S. stocks are 10-25% cheap to fair value. Consequently, our U.S. underweight is combined with overweights to non-U.S stocks in emerging and developed markets. We retain our solid tilt towards value stocks, mainly in the U.S., as the value-growth dislocation has become extreme and is now eclipsing the lofty levels of the peak of the tech bubble some 20 years ago. Recent U.S. equity market dynamics have been lopsided with gains concentrated on a few mega-cap tech stocks, resulting in increasing levels of market concentration (See this quarter's Special Topic).

In fixed income markets, we slightly trimmed our longstanding duration underweight in early June, after U.S. Treasury yields had broken through the upside of a tight pandemic trading range. We retain our neutral stance on corporate credit despite headwinds in the form of high leverage, a poor outlook for profits, and record new debt issuance. While credit spreads have narrowed substantially following the spike early on in the crisis, we are confident that aggressive monetary easing, including the Fed's program to purchase investment grade and high yield corporate bonds, will keep a lid on spreads. We continue to favor skilled managers operating in niche areas of the credit markets as a way to add value, an approach that we expect to be especially rewarding in the current environment.

Pandemic-related dislocations are also creating opportunities for hedge funds and opportunistic investments. We therefore are retaining our overweight to hedge funds and funding managers seeking to exploit dislocations in the credit sectors.

We retain a small underweight to real estate as valuations remain stretched and the fundamental backdrop has deteriorated. We are maintaining prudent debt levels in our real estate investments to navigate economic volatility.

Market Concentration

In recent years, a few mega-cap growth stocks in the tech sector have dominated market returns and come to represent an ever-larger share of total market capitalization. Besides leading to record levels of concentration, this lopsided performance has had important implications for active portfolio management, equity valuations, and market risks.

Strong Returns, Stretched Valuations

A few mega cap high tech stocks – affectionately called FANMAG for Facebook, Amazon, Netflix, Microsoft, Apple, and Google – have enjoyed returns that far exceed other stocks in the S&P 500 (Exhibit 1). This has led to increasingly high capitalizations and valuations for these stocks and record high market concentration (Exhibit 2).

The market domination by the few is occurring in a broader context of extraordinary price movements. These include the fastest ever recovery from a bear market that propelled the market up by nearly 40% from its low, a high level of three-standard deviation daily market moves, and signs that crowd psychology, rather than fundamentals, is driving some individual stock price movements.

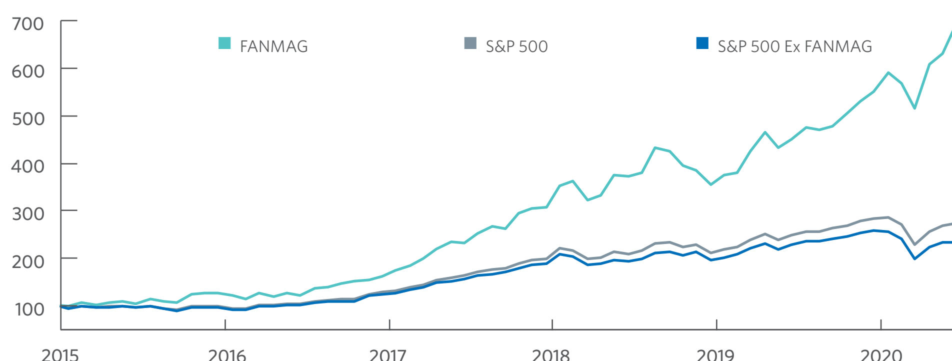
The recent market dynamic is far from the norm. Typically, companies with the largest market capitalizations underperform the broader market. Over long periods, the underperformance of the 10 largest stocks relative to the rest of the market has been substantial, averaging over 1% per year during the past 40 years. Since 2015, however, this normal trend has reversed. The largest capitalization stocks have outperformed by a wide margin, with the degree of outperformance so far this year approaching 25%.

The domination of the market by a few mega-cap stocks has wrong-footed active managers by complicating the difficulty of active management in two ways. First, it has significantly narrowed the opportunity set for active managers. Failing to hold the hot few hurts relative performance. Second, the size of the performance penalty for not investing in these names has grown to high levels given their degree of outperformance. Buying into the FANMAG growth story has been the key to outperformance, despite valuations justified by little more than expectations for continued extraordinary growth.

From Concentration to Calamity

This is not the first time that a small number of big, growth-oriented market darlings have skyrocketed. In the past, these periods of concentration and high valuation have been the tip of the iceberg of broader market excesses and instability and harbingers of a generalized market decline. The "Nifty Fifty"

EXHIBIT 1:
Mega Cap Tech Stocks Far Outstrip Market Returns
Source: Bloomberg. Index, 1/1/2015 = 100.



was such a group in the early 1970s, temporarily commanding valuations that, as now, were not justified by fundamentals. More recently, there have been in the past 40 years four instances including today in which the ten largest constituents of the S&P500 have represented 25% or more of the market. On the previous three occasions, the subsequent market decline averaged 20%.

Could This Time Be Different?

Great fortunes have been lost believing that, "This time is different." The arguments supporting this claim change from time to time, but all ultimately mask signs of froth and growing market risk. The current rationalization is as follows. The favored few will continue to grow rapidly and over time ultimately justify their current valuation. The top 10 are all household names and global leaders with scalable business models providing innovative and widely appreciated services in sectors that represent the future and are currently benefiting from lax anti-trust enforcement and light taxation. Their sustained outperformance is an indicator of strength, not risk.

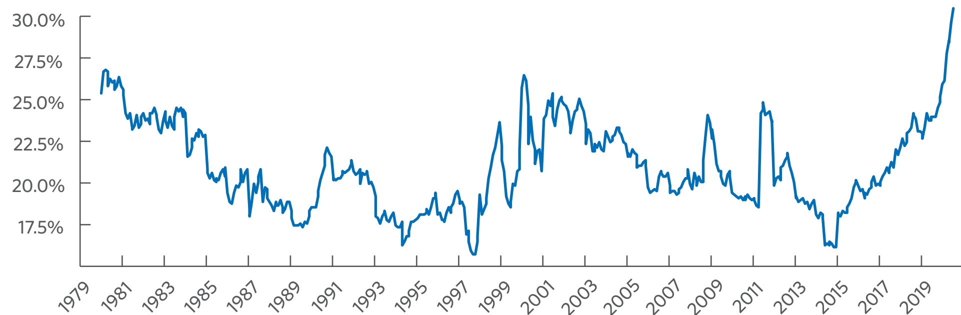
As in the past, there are many plausible stories justifying the current market dynamic. Time will tell whether this time is truly different.

EXHIBIT 2:

Market Concentration at Four-Decade High

Sources: Compustat and Strategic.

Data through June 2020.



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