Asset Strategy Consultants

MARKET REVIEW

Third Quarter 2020

We are pleased to present *Market Review,* featuring a discussion of the Capital Markets during the Third Quarter 2020 and a summary of historical performance for the major asset style passive indices for the period ending September 30, 2020. We hope you find the information useful and helpful in your investment considerations.

We welcome your comments.

Robert G. "Bobby" Merrick, III
Principal & Director of Non-Profits
410-528-8282
www.assetstrategyconsultants.com

ASSET STRATEGY CONSULTANTS

Founded in 1991, Asset Strategy Consultants provides investment consulting services to institutional clients representing $11.1 billion under advisement. Headquartered in Baltimore, Asset Strategy Consultants has offices throughout the East Coast.

THE MACROECONOMIC ENVIRONMENT

Alphabet Soup: V, W, L, U, or K?

While certain sectors of the economy have rebounded more quickly than many expected, the trajectory of the recovery is still unclear. Rising COVID-19 cases in the U.S. and Europe, stalled negotiations around much-needed fiscal stimulus, and election-related volatility are top of mind as we enter the fourth quarter. While the third quarter rewarded investors with mostly positive returns, September results were largely in the red as these concerns were reflected in market performance. In Europe and the United Kingdom, renewed uncertainty around Brexit further added to investor caution.

There is no consensus as to the forward-looking shape of the recovery. Some argue that a "V" scenario is in the works, but an equal number wonder whether this is sustainable given all of these headwinds. The newest alphabetic indicator—"K" —refers to the uneven aspect of the recovery, with certain segments of the population being hit much harder than others.

Housing was a bright spot in the quarter with pending home sales rising to a record high in August, according to the National Association of Realtors. Notably, growth in mortgage purchase applications (+39% y-o-y as of Sept. 25) is one of the few economic indicators that is above pre-COVID levels. Consumer confidence also improved; the Conference Board's Index rose to the highest level in six months but remains well below pre-pandemic levels. The unemployment rate, which peaked at 14.7% in April, fell to 8.4% in August. However, of the 22 million jobs lost from February to April, only 11 million have been added since. This compares to a loss of 9 million from 2007-09. Lower-income, less-skilled, and tourism-related jobs have been the hardest hit, furthering concerns over the widest income inequality gap in history. The leisure and hospitality sectors have gained back only half of the jobs lost thus far, which has disproportionately affected lower-income workers. Initial jobless claims in state programs continue to surpass 800,000 per week, and continuing claims hover around 12 million (the average for 2017-19 was under 2 million).

The unemployment rate, which peaked at 14.7% in April, fell to 8.4% in August. However, of the 22 million jobs lost from February to April, only 11 million have been added since. This compares to a loss of 9 million from 2007-09.

Second quarter GDP was -31.4% (annualized), the largest decline on record. However, Federal Reserve projections announced at its August meeting call for 2020 real GDP to be -3.7% y-o-y, slightly better than the -6.5% figure expected in June. A September survey of economists by *The Wall Street Journal* estimates 3Q GDP growth will be nearly +24% (annualized).

Of note, the Fed altered its monetary policy framework in a meaningful way in August. It announced that its focus would be on employment and, given that inflation has been persistently below its 2% target, it said it would "aim to achieve inflation moderately above 2% for some time so that inflation *averages* 2% over time." This comment suggests that the Fed will strive to raise inflation above the target for an unknown period of time. It further stated its intention to continue to support markets with asset purchases. Notably, Fed and market expectations are for no rate hikes until at least 2023. While inflation remains low (CPI: +1.3%; Core: +1.7% as of August) with few visible signs of acceleration, whispers of caution are beginning to emerge. The size of the deficit combined with expected fiscal stimulus could pave the way for higher inflation, and a continued trend toward de-globalization could raise the costs of production at home. The Congressional Budget Office estimates a $3.3 trillion deficit this year, three times that of last year.

Outside of the U.S., central banks continued to act aggressively to provide support via rate cuts, asset purchase programs, and other forms of stimulus.

Outside of the U.S., central banks continued to act aggressively to provide support via rate cuts, asset purchase programs, and other forms of stimulus. According to data from the International Monetary Fund, nearly $10 trillion in stimulus measures globally have been announced thus far, equating to 11% of global GDP. In addition to rising COVID-19 cases in the U.K. and Europe, uncertainty resurfaced around Brexit when Prime Minister Boris Johnson threatened to rewrite clauses pertaining to the treatment of Northern Ireland, leading to disarray and the resignation of the head of the government's legal department. The OECD met in September and acknowledged that the global economy had performed better than expected but that tremendous uncertainty remains. It estimated that global GDP would contract by 4.5% in 2020, slightly better than the 6% drop predicted in June. And while the 2021 projection is for 5.0% growth, it expects "considerable differences" across countries. China is the only country that is expected to have positive growth in 2020 (+1.8%), and while the outlooks for the U.S. (-3.8%), and the euro zone area (-7.9%) have brightened from earlier projections, they remain uncertain, and forecasts have become more cloudy for many emerging market countries. ■

EQUITY MARKETS

U.S. stock indices continued to rebound from the 1Q plunge; the Russell 1000 was up more than 50% from the low reached on March 23. The S&P 500 Index was up 8.9%, bringing its year-to-date result to 5.6%. However, returns among constituents painted starkly different pictures. Consumer Discretionary (+15%) was the best-performing sector while Energy (-20%) was the worst. YTD, a handful of sectors remain in the red while others are up double-digits. Technology (+29%) and Energy (-48%) share the leader/laggard awards. The pandemic has cast a pall over certain sectors while rewarding others; online retail stocks have soared 60% this year, the home improvement sector is up over 30%, but hotels/cruise lines, airlines, and commercial REITs have dropped over 40%.

A similar and related picture emerges with style indices. The tech-heavy Russell 1000 Growth Index (+13.2%) was again the best performer, and its gain is just shy of 25% YTD. Conversely, the Russell 1000 Value Index was up only 5.6% in the quarter, and it has lost nearly 12% this year. The dispersion between growth and value is near an all-time high and equally stark in small and midcap stocks for both the quarter and YTD.

Strong stock performance has been concentrated among a few names in the market. The top five stocks (Facebook, Microsoft, Amazon, Alphabet, and Apple) in the S&P 500 account for 23% of the Index and 33% of the performance. The S&P 500 YTD return would be negative if these stocks were excluded.

Outside of the U.S., equity index returns were positive across developed and emerging markets (MSCI ACWI ex-USA: +6.3%; MSCI Emerging Markets: +9.6%) but both remain down YTD (-5.4%; -1.2%). As in the U.S., growth outperformed value. Among countries in both developed and emerging markets, returns varied widely with some countries posting double-digit gains and others suffering double-digit losses. The U.S. dollar lost ground versus most developed market currencies. ■

FIXED INCOME MARKETS

U.S. Treasury yields held steady over the course of 3Q in spite of strong equity markets and better-than-expected economic data. The 10-year U.S. Treasury yield closed the quarter at 0.69%, up 3 basis points from June 30 but off far more sharply from the year-end level of 1.92%. Its yield hit an all-time low of 0.52% in August. TIPS (Bloomberg Barclays US TIPS: +3.0%) strongly outperformed nominal U.S. Treasuries for the quarter as 10-year breakeven spreads widened from 134 bps to 163 bps. The Bloomberg Barclays US Aggregate Bond Index gained 0.6%, with the corporate and commercial mortgage-backed sectors performing the best. Supply hit record levels as companies rushed to take advantage of ultra-low interest rates. The Bloomberg Barclays High Yield Bond Index was up 4.6% and is now roughly flat YTD. High yield and leveraged loan default rates (5.8% and 4.3% y-o-y as of September, according to data from JP Morgan) continued to trend higher but remain below levels reached in the Global Financial Crisis. Energy and retail sectors have been the hardest hit, with default rates that are approaching 20% for loans and bonds. Downgrades among high yield bonds and loans as well as “fallen angels” (downgrades from investment grade to high yield) reached record levels while recovery rates are near record lows. Separately, municipal bonds (Bloomberg Barclays Muni Bond Index: +1.2%) benefited from favorable supply/demand dynamics.

Downgrades among high yield bonds and loans as well as “fallen angels” (downgrades from investment grade to high yield) reached record levels while recovery rates are near record lows.

Broad-based U.S. dollar weakness dampened hedged returns in the quarter. The Bloomberg Barclays Global Aggregate ex-US Bond Index rose 4.1% (unhedged) and 0.7% (hedged). Emerging market debt indices posted solid results (EMBI Global Div: +2.3%; GBI-EM GI Div: +0.6%) but remain down from year-end (-0.5%; -6.3%). ■

REAL ASSETS

Real asset returns were mixed in the third quarter. Falling oil prices hurt MLPs (Alerian MLP: -16.3%) while gold (S&P Gold Spot Price: +5.3%) hit an all-time intraday high in August ($2,005/ounce). The Bloomberg Commodity Index gained 9.1% with all sub-components except Energy up sharply. REITs were mixed (FTSE Nareit: +1.4%) for the quarter and YTD performance is striking: Lodging/Resorts (-49%); Regional Malls (-54%); Office (-30%); and Shopping Centers (-45%) suffering from COVID-19 lockdowns while Data Centers (+26%) and Industrial (+9%) saw gains. TIPS (Bloomberg Barclays TIPS: +3.0%) did well as inflation expectations rose from depressed levels. The 10-year breakeven spread widened from 1.34% to 1.63% over the quarter. ■

CLOSING THOUGHTS

The alphabet soup of recovery scenarios reflects a myriad of best guesses, and while hints of a "V" scenario were evident this summer, its likelihood has been dampened by rising COVID-19 cases and a knock-on effect on consumer confidence and demand, especially in hard-hit sectors of the economy. A tense election further adds to the potential for market volatility. Yields in fixed income are unquestionably paltry, with some questioning whether the asset class can play the role it has traditionally served. Equity valuations are expensive by multiple metrics, with the financial health of many businesses highly uncertain. This is a challenging environment for investors, yet ASC's advice remains to adhere to a disciplined investment process that includes a well-defined long-term asset allocation policy. ■

Source: Asset Strategy Consultants and Callan Associates

Stay safe and healthy

If there is anything we can do to assist you and your organization during this time, please do not hesitate to reach out. All of you remain in our thoughts, and we hope that you and your families remain safe and healthy.

PRELIMINARY RETURNS FOR VARIOUS PERIODS: 3Q20

		July	August	September	Last Quarter	Year to Date	Last Year	Last 3 Years	Last 5 Years	Last 10 Years	Last 15 Years
EQUITY	1 Russell:3000 Index	5.68	7.24	(3.64)	9.21	5.41	15.00	11.65	13.69	13.48	9.13
	2 Russell:1000 Index	5.86	7.34	(3.65)	9.47	6.40	16.01	12.38	14.09	13.76	9.28
	3 Russell:1000 Growth	7.69	10.32	(4.70)	13.22	24.33	37.53	21.67	20.10	17.25	11.95
	4 Russell:1000 Value	3.95	4.13	(2.46)	5.59	(11.58)	(5.03)	2.63	7.66	9.95	6.35
	5 Russell:Midcap Index	5.87	3.52	(1.95)	7.46	(2.35)	4.55	7.13	10.13	11.76	8.62
	6 Russell:Midcap Growth	7.99	2.72	(1.40)	9.37	13.92	23.23	16.23	15.53	14.55	10.51
	7 Russell:Midcap Value	4.72	3.96	(2.27)	6.40	(12.84)	(7.30)	0.82	6.38	9.71	7.07
	8 Russell:2500 Index	3.98	4.53	(2.59)	5.88	(5.82)	2.22	4.45	8.97	10.81	7.92
	9 Russell:2500 Growth	5.47	4.50	(0.77)	9.37	11.58	23.37	13.36	14.19	14.06	10.28
	10 Russell:2500 Value	3.01	4.54	(3.85)	3.54	(18.39)	(12.62)	(2.69)	4.65	8.01	5.75
	11 Russell:2000 Index	2.77	5.63	(3.34)	4.93	(8.69)	0.39	1.77	8.00	9.85	7.03
	12 Russell:2000 Growth	3.44	5.87	(2.14)	7.16	3.88	15.71	8.18	11.42	12.34	8.90
	13 Russell:2000 Value	2.06	5.39	(4.65)	2.56	(21.54)	(14.88)	(5.13)	4.11	7.09	4.93
	14 S&P:500	5.64	7.19	(3.80)	8.93	5.57	15.15	12.28	14.15	13.74	9.19
	15 S&P:400 Mid Cap	4.61	3.51	(3.25)	4.77	(8.62)	(2.16)	2.90	8.11	10.49	8.21
	16 S&P:600 Small Cap	4.11	3.99	(4.70)	3.17	(15.25)	(8.29)	(0.33)	7.20	10.57	7.50
	17 MSCI:ACWI ex US	4.46	4.28	(2.46)	6.25	(5.44)	3.00	1.16	6.23	4.00	4.09
	18 MSCI:EAFE	2.33	5.14	(2.60)	4.80	(7.09)	0.49	0.62	5.26	4.62	3.73
	19 MSCI:EM	8.94	2.21	(1.60)	9.56	(1.16)	10.54	2.42	8.97	2.51	5.81
	20 MSCI:ACWI	5.29	6.12	(3.22)	8.13	1.37	10.44	7.12	10.30	8.55	6.46
FIXED INCOME	21 Blmbg:Aggregate	1.49	(0.81)	(0.05)	0.62	6.79	6.98	5.24	4.18	3.64	4.48
	22 Blmbg:Gov/Credit	2.01	(1.16)	(0.05)	0.78	8.04	8.03	5.86	4.66	3.87	4.63
	23 Blmbg:Credit	3.08	(1.27)	(0.27)	1.50	6.39	7.50	6.19	5.75	4.92	5.44
	24 Blmbg:Corporate High Yld	4.69	0.95	(1.03)	4.60	0.62	3.25	4.21	6.79	6.47	7.10
	25 Blmbg:Municipal Bond	1.68	(0.47)	0.02	1.23	3.33	4.09	4.28	3.84	3.99	4.37
	26 Blmbg:US TIPS	2.30	1.09	(0.37)	3.03	9.22	10.08	5.79	4.61	3.57	4.21
	27 Blmbg:Glob Agg ex USD	4.44	0.29	(0.58)	4.14	4.77	5.48	3.07	3.60	1.35	3.18
	28 S&P:LSTA Levg Loan	1.96	1.49	0.63	4.14	(0.66)	1.06	3.10	4.01	4.24	4.44
	29 ML:US Treasuries 1-3 Yrs	0.10	(0.02)	0.03	0.10	3.05	3.58	2.64	1.80	1.28	2.29
	30 LIBOR - 3 Month	0.02	0.02	0.02	0.06	0.58	1.07	1.88	1.47	0.89	1.66
	31 3 Month T-Bill	0.02	0.01	0.01	0.04	0.64	1.10	1.69	1.20	0.64	1.29
REAL ASSETS	32 Blmbg:Commodity TR Idx	5.71	6.76	(3.35)	9.07	(12.08)	(8.20)	(4.18)	(3.09)	(6.03)	(4.82)
	33 GS Commodity Index	3.80	4.59	(3.64)	4.61	(33.38)	(27.84)	(9.46)	(7.88)	(8.84)	(9.30)
	34 MSCI:US REIT Index	4.10	0.85	(3.19)	1.63	(17.12)	(17.76)	0.31	3.99	7.90	5.85
	35 Alerian:MLP Index	(3.55)	0.52	(13.62)	(16.26)	(46.16)	(48.35)	(20.75)	(11.58)	(4.17)	1.17
	36 DJB:Glbl Infrastructure	1.98	(0.38)	(3.20)	(1.67)	(13.28)	(9.84)	1.11	5.40	7.86	7.74
	37 US DOL:CPI All Urban Cons	0.51	0.32	–	–	–	–	–	–	–	–

Source: Callan Associates