Key Investment Perspectives

Third Quarter 2021

by Brett Hillard, CAIA, CFA,® Managing Director, Portfolio Strategy and Multi-Strategy Research, KeyBank Investment Center

Capital markets

Risk assets ended the third quarter with a whimper after a strong start in July and August despite rising COVID hospitalizations and fatalities. US equities raced to multiple new all-time highs before peaking in early September, only to give back all of the previous gains in the quarter. Bonds did not provide much of a refuge as the increase in yields in the second half of September erased earlier gains. One area that continued to gain was in the commodities market, which was driven by a sharp increase in natural gas and oil prices.

Cross-asset relationships were peculiar in September: US equities and bonds declined during the month while commodities and the US Dollar (as measured by the US Dollar Index) increased. Since January 1990, this has only happened 10 times out of 380 months, or 2.6% of the time. September 2021 was the only month since 1990 which saw equities fall more than 2%, bonds fall more than 0.5%, commodities increase more than 2%, and the USD increase more than 1%.

Third Quarter 2021 Market Data

Asset Classes	1 Month	3 Month	YTD	1 Year
US All Cap	-4.49	-0.10	14.99	31.88
US Large Cap	-4.59	0.21	15.19	30.96
US Small Cap	-2.95	-4.36	12.41	47.68
US Large Cap Growth	-5.60	1.16	14.30	27.32
US Large Cap Value	-3.48	-0.78	16.14	35.01
US Small Cap Growth	-3.83	-5.65	2.82	33.27
US Small Cap Value	-2.00	-2.98	22.92	63.92
Developed International	-3.06	-1.06	8.81	27.39
Int'l Emerging Markets	-3.30	-6.44	1.97	19.81
US Treasury	-1.08	0.09	-2.50	-3.30
US Investment Grade	-1.05	-1.27	1.74	-1.05
US High Yield	0.89	-0.01	4.53	11.28
Municipal Bonds	-0.72	0.79	2.63	-0.72
Real Estate	-5.92	0.23	21.63	31.54
Commodities	4.98	6.59	29.13	42.29

Sources: S&P GSCI, Russell, Bloomberg, Key Private Bank.

What are the implications of this? It's too small of a sample size to draw definitive conclusions. However, it's likely that a lot of portfolios are not set up for these cross-asset moves. Given extremely low yields, we believe total returns from bonds will be modest at best for the foreseeable future and that the diversification benefit of bonds will be weaker compared with previous cycles. If inflation remains elevated longer than expected, bonds could be particularly challenged. We continue to advocate for enhanced diversification with other asset classes, including private real estate, real assets, private capital strategies, and hedge fund strategies.

September offered a panoply of risks for investors to concern themselves with, including inflation, rising interest rates, the Delta variant, a potential default of a large Chinese property developer (Evergrande), and continued Washington theatrics regarding stimulus and the debt ceiling. While all of these risks warrant diligent monitoring, we do not believe these will be enough to derail the current economic expansion and equity bull market at this point. Inflation and rising rates present the largest longer-term risks and could have the broadest impacts among those listed.

We believe China will be able to contain potential systemic risks and human ingenuity will continue to allow societies to better cope and limit severe effects of COVID. It is likely that a resolution will be reached in Washington that will kick the debt ceiling drama down the road. There are no economic or market reasons for the US to default: A default would be due to willingness and governing dysfunction. We believe politicians will ultimately reach an agreement due to the potentially severe short-term risks and the longer-term risks of the loss of credibility. The US economy and markets realize substantial benefits from the USD being the global reserve currency and having major commodities priced in the USD. To weaken the global reserve currency status intentionally would be a costly mistake.

Global equities

US equities were essentially flat for the quarter, but there was notable dispersion across size and style. US large caps increased modestly by 0.21% but small caps dropped by 4.36%. Small caps were hit by a "growth scare" that was partially driven by COVID concerns and a peak in the rate of change of macro indicators. Large cap growth continued to outperform, increasing 1.16% for the quarter compared with a decline of 0.78% in value stocks. The quarterly metrics mask a style shift in favor of value in mid-September. Value outperformed during the month reflecting signs that the growth scare was overdone, and rising rates and commodity prices benefited value indexes. Small cap value outperformed growth during September and the quarter: Small growth companies are more sensitive to higher interest rates. With continued strong earnings and flat prices, the price-to-twelve-month forward earnings ratio for the S&P 500 fell 5.7%, or from 22.6x to 21.3x. The PE ratio was 25.2x last year at the end of the third quarter.

In international equities, developed markets fared better compared with emerging markets. Developed international equity performance in local currency terms was positive, but after the effects of a rising USD, these stocks fell 1.06% for the quarter. Emerging markets were challenging, declining 6.44% for the quarter. Laggards included China and Brazil, with India, Russia, and Taiwan outperforming sharply. A rising dollar also negatively impacted USD returns for emerging market equities.

Fixed Income

Interest rates were range-bound during the quarter with the growth scare causing yields to fall through the month of July. However, rates increased during August and September as the scare moderated and the Fed signaled that its bond buying program could be scaled back shortly, with an expected decision in November. US five- and ten-year yields were mostly unchanged during the quarter. With low yields on bonds, returns were flat during the quarter. US high yield bonds outperformed investment grade corporates and were flat in the quarter, driven by coupon. High-yield spreads increased modestly during the quarter from 268 basis points to 289 basis points. If economic conditions remain robust, high-yield defaults should remain low, leaving higher returns from coupon. Spreads are historically tight, suggesting lower returns from spread compression going forward. Yield curves remained largely unchanged after flattening in the second quarter. This can be viewed as incrementally favorable as flattening curves suggest slower growth. After the Fed meeting in September, futures markets are forecasting the Fed may start to increase rates starting in the third or fourth quarters of 2022.

Alternatives

Real Estate

Returning 0.23%, public REITs modestly outperformed US equities during the quarter but sharply underperformed in September by dropping 5.92%. REITs were negatively impacted by the acceleration in the increase in rates in September. While data is not yet available from private core real estate markets, we expect higher returns compared with public REITs. Housing-related and industrial-related REITs outperformed materially for the quarter. Reopening sectors such as lodging and office underperformed after a strong second quarter. We believe high-quality private core real estate continues to be an attractive alternative to bonds given higher yields and total return potential. Real estate is a superior inflation hedge compared with bonds as well.

Commodities

Driven by the Energy sector, commodities continued to shoot higher, gaining 6.59%. Natural gas was up a whopping 59.58% as a result of tight inventories and concerns over adequate supplies during a colder winter. Oil gained 3.69% with tighter inventories due to constrained supply and higher oil demand as the global economy reopened. Industrial metals gained during the quarter but underperformed, while the broad agriculture sector fell modestly as a result of soybeans. With lower gold and silver prices, precious metals fell 2.71% during the quarter. Precious metals partially traded lower as a result of higher yields. Precious metals price movements are enigmatic at any given time and are sometimes being driven by yields, inflation, the USD, and/or systematic concerns. If energy prices continue to rise, discretionary consumer spending may start to be negatively impacted. High energy prices also increase politically influenced volatility.

Hedge Funds

A broad hedge fund index increased 0.6% for the quarter, led by equity hedge strategies and long-biased strategies. Benchmarking hedge fund strategies is challenging given the wide dispersion across strategies and even between managers within the same strategy such as hedge equity. Manager selection is critically important in selecting hedge funds. We continue to believe that a diversified portfolio of high-quality hedge fund or liquid alternative managers offers compelling risk-adjusted returns especially compared to bonds.

> *The mind that opens up to a new idea never returns to its original size.*
>
> **– Albert Einstein**

During a news briefing on February 12, 2002, US Secretary of Defense Donald Rumsfeld famously said, “Reports that say that something hasn’t happened are always interesting to me, because as we know, there are known knowns; there are things we know we know. We also know there are known unknowns; that is to say we know there are some things we do not know. But there are also unknown unknowns — the ones we don’t know we don’t know. And if one looks throughout the history of our country and other free countries, it is the latter category that tends to be the difficult ones.”

The past 18 months have shown that even “known unknowns” can have profound effects on society, the economy, and markets. Modern society has experienced pandemics before, but it is fair to say nearly everyone was surprised by COVID-19 and that it has changed many aspects of our lives in a short period of time. Markets were caught by surprise given the explosion in volatility and sharp price moves. In 2019, if an astute investor would have communicated the ever-present risk (albeit small) of a pandemic and how economies and markets could be affected, how much interest would have such a declaration been received?

Collective interest and questions of unidentified aerial phenomena (UAP) have increased the past several years, but investors and markets appear to be largely uninterested or unaware. While we realize that the concept of UAP is known, ultimately what the underlying causes and ramifications of those causes border the Rumsfeldian “unknown unknowns.” To be clear, we are not making any predictions or claim to have any unique insights on the causes of UAP. However, we do believe it’s valuable (perhaps entertaining, too!) to envision a wide array of events and outcomes, even for low-probability events.

On June 25, 2021, the Office of the Director of National Intelligence (ODNI) released a report titled “Preliminary Assessment: Unidentified Aerial Phenomena” to conform with a provision that was placed in the Intelligence Authorization Act for Fiscal Year 2021. The ODNI was required to assess the threat of UAP and note the progress that the Department of Defense Unidentified Aerial Phenomena Task Force (UAPTF) has made in understanding the threat of UAP. The UAPTF was formed in 2020 as a program within the US Office of Naval Intelligence with the goal of standardizing the collection and reporting of UAP. The federal government has sporadically created groups or programs within various agencies to monitor UAP at least since the end of World War II. As interest regarding UAP has waxed and waned, so has government support. The previous iteration was the Advanced Aerospace Threat Identification Program (AATIP) that received funding and support from 2007 to 2012.

The ODNI coordinated with a number of US government (USG) organizations to produce the aforementioned report.[1] A total of 144 eligible UAP events that occurred from 2004 to 2021 were covered by the ODNI based on standardized reporting and minimum required data. Five potential explanations are listed in the report, including airborne clutter, natural atmospheric phenomena, USG or industry development programs (i.e., classified projects), foreign adversary systems, and other. When discussing foreign adversary systems, the report specifically identifies China and Russia, which signals who the ODNI believes are the top competitors in terms of advanced technological development. The UAPTF is prioritizing better procedures, data gathering, and analysis to potentially explain UAP that demonstrate unusual patterns or flight characteristics. Of the 144 incidents covered, 18 had these characteristics. Most of the observations originated from US Navy reporting. The UAPTF is developing interagency standards for reporting and analysis and researching new ways to process captured data from various sensors such as radars. Specifically, the UAPTF is looking to capture data from the US Air Force and is already receiving data from the FAA.

[1] Input from the Undersecretary of Defense for Intelligence and Security, DIA, FBI, NRO, NGA, NSA, Air Force, Army, Navy, Navi/ONI, DARPA, FAA, NOAA, NGA, ODNI/NIM-Emerging and Disruptive Technology, ODNI/National Counterintelligence and Security Center, and ODNI/National Intelligence Council.

What are the near-term investment implications of UAP and the pursuit of a better understanding of the causes? We admit the implications are negligible assuming a low-probability event does not occur. However, longer-term implications could be material. Breakthrough technologies resulting from USG research and development in the pursuit of understanding UAP and evidence of extraterrestrial life could have profound impacts on economic growth, productivity, and the creation of new industries. How would markets react if it became accepted knowledge that at least some UAP were of extraterrestrial origin? We simply do not know.

Tyler Cowen, a George Mason University economics professor and columnist for The New York Times and Bloomberg Opinion, speculated on potential reactions. Mr. Cowen believes volatility could increase, the aerospace and defense sector could outperform, and the US dollar could rally given the perceived US advantages in military strength and technological advancement.

with several projects to develop technologies and design searches for evidence of extraterrestrial civilizations. A novel concept is to look for industrial pollution such as complex molecules that are only likely created intentionally.

In an interview with Scientific America on February 1, 2021, Mr. Loeb discussed the importance of pursuing "blue-sky" research projects and puts forth the concept of "Oumuamua's wager." He postulates that investing in enhanced extraterrestrial searches could revolutionize space science and technology and lead to breakthroughs in understanding the universe. If public interest in extraterrestrial civilizations leads to more investment in rigorous R&D, that has the potential for substantial long-term benefits. There are numerous ubiquitous technologies today that started as far-fetched experiments or projects driven by curiosity, exploration, or defense initiatives — in other words, experiments and projects with negligible near-term profit potential under reasonable forecasts.

Breakthrough technologies resulting from USG research and development in the pursuit of understanding UAP and evidence of extraterrestrial life could have profound impacts on economic growth, productivity, and the creation of new industries.

It seems logical that a civilization with advanced technology that could travel extreme distances even with drone technology would have superior weapons technology as well. Cowen's speculation that volatility would increase seems the most logical to us. It also seems logical that the US would fare better on a relative basis compared with other countries. Mr. Cowen puts forth a possibility that knowledge of extraterrestrials could create devoted followers or that groups of individuals could seek more leisure and risk with a "YOLO"[2] mentality.

Avi Loeb, a Harvard astrophysicist, believes that a space object, called Oumuamua (the Hawaiian term for "Scout"), that passed close to earth in late 2017 was likely a space sail that was extraterrestrial in origin. His conclusion is based on a combination of the object's shape, brightness, and acceleration that mimicked a comet but with no evidence of the object containing ice and evaporating gases that are present with comets. The out-of-consensus view has led to sharp criticism and accusations of ulterior motives. Mr. Loeb is involved

On October 4, 1957, the USSR successfully launched and deployed Sputnik 1, the first artificial earth satellite that triggered the "Sputnik Crisis." Collective anxiety increased in the US and among allies, given the perception that the USSR had a material technological advantage. President Dwight D. Eisenhower and the USG responded to the crisis with several initiatives that included transitioning the military-controlled National Advisory Committee for Aeronautics (NACA) to an expanded and civilian-controlled National Aeronautical and Space Agency (NASA). This launched the ensuing space race. Eisenhower also created the Advanced Research Projects Agency (which would later be known as the Defense Advanced Research Projects Agency) or ARPA to invest and develop emerging technologies for the military. ARPA pursued high-risk and potentially high-gain projects that could create breakthrough technologies. Since its founding, DARPA initiatives have contributed to weather satellites, GPS, drones, stealth technology, the internet, and mRNA vaccine technology (DARPA awarded Moderna $25M in 2013).

[2] "You Only Live Once"

In February 1966, the ARPANET initiative was begun to enable communications between remote computers. The underlying technology was inspired from multiple sources, including researchers in the US, UK, and France. The original goal of ARPANET was to allow large, powerful research computers around the country to communicate with each other. At the time, these types of computers were limited and scattered across various laboratories and universities nationwide. The first connection occurred in October 1969, and the scale and capabilities of the network grew sharply. Computers across the country were connected as well as facilities in the UK.

Email became available on ARPANET in 1971 and used the @ symbol to link a username to a destination server. We can thank Gary Thuerk of Digital Equipment Corporation for sending the first known mass marketing email to 400 clients on the ARPANET in 1978. He claimed that he generated $13 million in sales from that email. As the scale and technology advanced, ARPA worked with government agencies and private telecom companies to transition the network to civilian and commercial oversight. ARPANET was officially decommissioned in 1990. In 1989, Tim Berners-Lee is credited with creating the World Wide Web that utilized internet technology developed for ARPANET. The protocols he created are still in use today.

What does all of this have to do with investing and today's markets? First, long-term economic growth can be broken down into component parts such as workforce population growth and productivity. Productivity is a function of capital investment and technological advancement. Economic growth through higher productivity growth is a primary goal of all major economies: Productivity leads to higher standards of living through higher wages and corporate income. Second, the US equity markets have been the envy of the world for a number of years largely due to the tremendous growth and profitability of technology companies such as Apple, Google, Facebook, and Microsoft.

The economic growth and wealth creation that we have seen recently are somewhat a function of the high-risk and high-gain project initiated back in the 1960s. If our natural curiosity surrounding space exploration and the search for extraterrestrial life continues to inspire and spur quality R&D and "blue-sky" projects, there is a strong probability this will be positive in the long run. An open mind with a healthy dose of skepticism may help investors grapple with market shocks from "unforeseen" events as well as researchers turning "unknown unknowns" into known technologies.

1958

The military-controlled NACA transitions to NASA, an expanded and civilian-controlled agency that launches the space race.

1969

The first communications connection between large, powerful research computers takes place.

1978

Gary Thuerk of Digital Equipment Corporation sends the first known mass marketing email to 400 clients on the ARPANET.

1989

Tim Berners-Lee is credited with creating the World Wide Web that utilized technology developed for ARPANET.

Tactical asset allocation

Key Private Bank's Dynamic Allocation Research Tool (DART) continues to favor stocks relative to bonds based on positive readings within the three main pillars of the model: macroeconomic factors, investor psychology, and corporate fundamentals. The tool scores individual indicators and provides a comprehensive view of the relative attractiveness of different sections of the worldwide equity market and the overall attractiveness of equities and fixed income. In particular, investor psychology and macroeconomic factors remain favorable. Within corporate fundamentals, profitability is strong but valuations are moderately stretched. We believe the monetary and fundamental conditions are present for the economic expansion to continue. Bonds continue to present a low hurdle for equities to outperform.

Within international equities, the Key Private Bank Asset Allocation Committee moved to neutral positions for international developed markets and emerging markets. We were previously underweight international developed and overweight emerging markets. Our change in position is in accordance with the output from DART and the higher uncertainty with changing Chinese regulations. As China goes, so go emerging markets: China accounts for 37% of our selected benchmark.

We continue to recommend diversified allocations to real assets and alternatives largely in lieu of bonds. The combination of low yields and potential for rate increases and higher-than-expected inflation, real assets and alternatives may provide better return potential and diversification benefits to a portfolio. That said, we continue to view fixed income as an element of preservation within the context of a total portfolio and emphasize investment-grade, credit-oriented sectors over Treasuries and government debt. As always, we would welcome the opportunity to discuss our perspectives in greater detail.

Key Private Bank Asset Allocation Recommendations as of Third Quarter 2021

Tactical Asset Allocation

Stocks	Bonds	Cash	Alts/Real Assets
Emphasize	De-emphasize	Neutral	Emphasize–Client Specific

Equity Geographic Emphasis

United States	International – Developed	International – Emerging
Neutral	Neutral	Neutral

Fixed Income Emphasis

Duration	Treasuries/ Government	Investment Grade Corp.	High Yield
Neutral	De-emphasize	Emphasize	Neutral – Active Mgt.

For more information on how the current market climate might impact your portfolio, contact your Advisor.

About the Author

Brett Hillard, CAIA,® CFA,® is the Managing Director of Investment Research with the Portfolio Strategy Team and has over 10 years of investment analysis experience. He leads the alternative investment research and due diligence process at Key Private Bank and provides quantitative modeling for portfolio construction. Brett has expertise in evaluating hedge fund strategies, private capital strategies and traditional investments. He is integral in the management of several multi-asset strategies across high-net-worth individuals and institutions.

Brett joined Key in 2007 as an equity analyst with a focus on the Consumer Discretionary sector. Prior to joining Key, Brett worked at Apple Growth Partners, providing valuation analysis and reports for closely held companies. Brett holds a BA in Finance and Business Economics from Ohio University. He has also earned the Chartered Alternative Investment Analyst and Chartered Financial Analyst designations.

211004-1279830