Key Investment Perspectives

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Global equities

Markets climb a wall of worry. Of all the sayings in the investment world, this is probably the most fitting description of what happened in April. Despite experiencing Great Depression-like levels of economic decline in a world overrun by COVID-19 uncertainty, the S&P 500 Index advanced 12.8% in April, its best month since January 1987.

The economic backdrop last month was simply unprecedented. In just six weeks from mid-March to the end of April, more than 30 million Americans filed for unemployment insurance, a figure that represents almost 20% of the US workforce. The surge in unemployment has now more than erased the 26 million jobs created since the prior recession ended 11 years ago. GDP fell 4.8% in the first quarter, but the steepness of the contraction is not fully conveyed in that figure given that economic activity was relatively normal through the end of February. April's Consumer Confidence Index® recorded its largest decline in more than 40 years, while the ISM Manufacturing PMI® for April fell to 41.5 (less than 50 is a contraction). We could go on. Yet since bottoming at 2,237 on March 23, the S&P 500 Index rallied more than 30% to finish April at 2,912 and is now down "just" 9.3% in 2020 year to date (YTD). One might have expected this type of rally would be reserved for the emergence of a vaccine for COVID-19, a cure, or at least clear visibility on what restarting the economy might look like. So far we have none of these. Why the aggressive rally in US equities then?

April Market Data

	1 Month	3 Month	YTD	1 Year
US All Cap	13.24	-10.33	-10.42	-1.04
US Large Cap	13.21	-9.78	-9.68	0.09
US Small Cap	13.74	-18.47	-21.08	-16.39
US Large Cap Growth	14.80	-3.54	-1.39	10.84
US Large Cap Value	11.24	-16.70	-18.49	-11.01
US Small Cap Growth	14.89	-13.76	-14.71	-9.22
US Small Cap Value	12.34	-23.60	-27.72	-23.84
Developed International	7.63	-16.08	-18.00	-11.33
International Emerging Markets	9.62	-13.17	-16.89	-11.82
US Treasury	0.64	6.29	8.89	14.27
US Investment Grade	5.24	-0.91	1.42	9.88
US High Yield	4.51	-8.78	-8.75	-4.11
Municipal Bonds	-1.26	-3.61	-1.88	2.16
Real Estate	8.83	-17.72	-16.68	-8.30
Commodities	-1.54	-18.48	-24.47	-23.18

Sources: S&P GSCI, Russell, Barclays, Key Private Bank

We see three possible explanations:

1. The first possible explanation is rather simple: The market is getting it wrong. Investors in this camp view the current unprecedented economic circumstances as incompatible with a V-shaped recovery in asset prices. They see the meaningful risk of a potential second wave of infections, unknowable complications in restarting the global economy, and likely risks of an eventual spike in corporate and household bankruptcies. In other words, these investors consider the recent move in equities to be nothing more than a bear market rally. A sober appraisal of the current environment might find this explanation difficult to refute.

2. The second possible explanation is that the market is simply looking through this dislocation and remains optimistic that we will ultimately have a meaningful recovery despite the complicated economic environment.

   This argument is centered on the timing and magnitude of an earnings recovery from the COVID-19 shock. Since the beginning of the year, US sell-side analysts have cut aggregate earnings expectations for S&P 500 Index constituents by 14% for 2020 and by just 1% for 2021. This appears on the surface to be consistent with the 9.3% price decline in the S&P 500 YTD. That said, the challenges with this argument are that (1) analyst earnings estimates tend to lag current events and (2) current events are nearly impossible to accurately capture in a corporate earnings model, given the uncertainty.

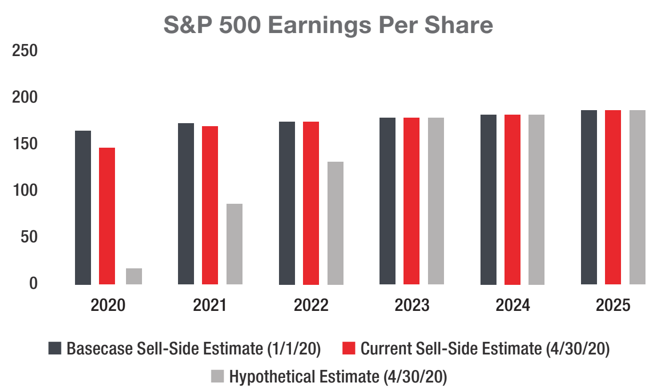
   Luckily, earnings estimates do not need to be exact to enable us to approximate how much is priced in if we take a longer view. To that end, we constructed an aggregate Discounted Cash Flow (DCF) model to estimate the fair value of the earnings lost due to COVID-19 and then compared that to the decline in the S&P 500 Index since its pre-COVID19 baseline. This exercise is inexact and requires us to use several simplifying assumptions, but here's what it looks like: The dark grey bars in the S&P 500 Earnings Per Share graph represent the baseline S&P 500 earnings stream as estimated by sell-side analysts as of January 1, 2020, i.e., before COVID-19 disruption. The red bars represent the relatively current S&P 500 earnings outlook as estimated by sell-side analysts as of April 30, 2020. Finally, the light grey bars represent a hypothetical earnings outlook for the S&P 500 Index in which we assume baseline earnings decline by 90% in 2020, 50% in 2021, and 25% in 2022, with full recovery occurring in 2023. This hypothetical scenario assumes a much larger earnings decline than is currently envisioned by the sell-side analyst community, and it is meant to err on the side of excess. We value each of these earnings streams using a very simple DCF model that includes a constant 7% discount rate and a long-term earnings growth rate of 2%. Interestingly, the fair value of the hypothetical earnings scenario (the light grey bars) is approximately 7% lower than the pre-COVID-19 baseline outlook (fair index value of 3,109 vs 3,358).

   Translated roughly, if the market believes that earnings will rebound to normal by 2023, then the S&P 500 Index should be approximately 7% lower than it was on January 1. Thus, the aggressive rally in April might be interpreted as a return to that implied price level.

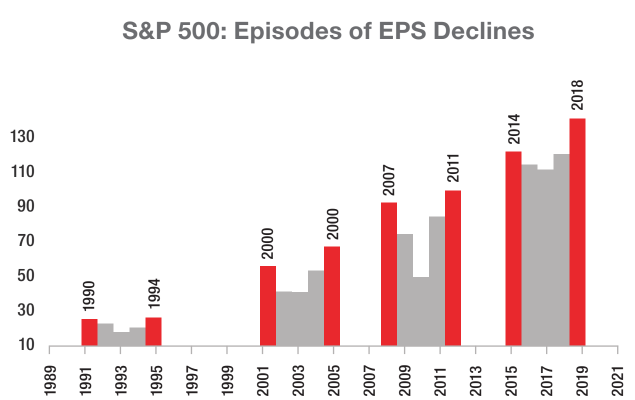
Outlook	Index Fair Value (DCF)
Baseline (Sell-side at 1/1/20)	3,358
Hypothetical earnings scenario	3,109
Difference	-7.4%

Sources:Key Private Bank

   Importantly, this explanation relies on earnings recovering to pre-COVID-19 levels in three years. Although there is precedent for this assumption, some investors see this outcome as a best-case scenario.



Sources: Reuters, Key Private Bank



Source: Cornerstone Macro

3. The third possible explanation for April's market strength is that it comes as a result of the massive and timely interventions of the Federal Reserve (Fed), which arguably halted what would have otherwise been a liquidity-driven financial crisis. Recall that the S&P 500 Index bottomed on March 23, which was the same day that the Fed announced it was removing the cap on its newly launched Asset Purchase Plan (QE). The program was initially sized at $700 billion worth of Treasuries and mortgage-backed securities; that cap was removed on March 23, and we effectively entered the era of Unlimited QE. On the same day, the Fed announced various credit facilities aimed at supporting corporate credit, asset-backed loans, and Main Street lending, which in aggregate were worth $900 billion.

Date	Program	Size (Bn)
3/15/2020	Asset Purchase Plan (QE; 500bn UST, 200bn MBS)	700
3/17/2020	Commercial Paper Funding Facility (CPFF)	100
3/18/2020	Money Market Liquidity Facility (MMLF)	100
3/23/2020	Asset Purchase Plan QE	Unlimited
3/23/2020	Primary Market Corporate Credit Facility (PMCCF)	100
3/23/2020	Secondary Market Corporate Credit Facility (SMCCF)	100
3/23/2020	Term Asset-Backed Loan Facility (TALF)	100
3/23/2020	Main Street Lending Program (MSLPF)	600
4/6/2020	PPP Lending Facility (PPPLF)	350
4/9/2020	Municipal Liquidity Facility (MLF)	500
4/9/2020	Increase of PMCCF and SMCCF, Include HY ETFs	750

Sources: Reuters, Key Private Bank

Not only did the Fed expand capacity meaningfully but it also broadened the types of assets that it stands ready to support, including those until now considered to be outside the scope for direct purchase. On April 9 the Fed announced its intention to purchase formerly investment-grade rated corporate bonds that had been downgraded to junk status because of the crisis, and it pledged wider support for the high-yield market through the purchase of index-tracking ETFs.

With the Fed effectively buying junk bonds, the inference was clear: No risk asset should be considered off-limits, and equities could very well be next if trouble persists. Part of the record rally in the S&P 500 Index that we saw in April was likely driven by the market's response to the ample liquidity provided by the Fed as well as a renewed appreciation that the Fed is not out of ammo and likely never will be.

The aggressive rally in equities amidst a fragile economic outlook was not just a US phenomenon: Similar narratives unfolded globally. For the month, developed international equities and emerging market stocks were up 7.6% and 9.6%, respectively.

Fixed income

US Treasuries are the global safe-haven asset, and as such one might reasonably expect small negative returns in an aggressive risk-on rally in equities. That was not the case in April, when US Treasuries returned 0.6% and brought the YTD return to 8.9%. Returns were highest at the long end of the curve, where 30-year US Treasuries returned nearly 2.0% for the month. The 30-year bond ended the month yielding just under 1.3%.

Corporate bonds rallied this month. In the investment-grade space, bonds returned 5.2%, while high-yield bonds returned 4.5%. As a reminder, we prefer a modest overweight to investment-grade corporate bonds but reiterate the importance of maintaining a quality bias in fixed income. The concentration of the Energy sector in the junk bond market was responsible for its lag relative to investment-grade fixed income. Investors struggled to evaluate the prospects of oil exploration and production (E&P) companies in a world where oil futures contracts had recently traded at a negative price.

Alternatives

Commodities

On April 20 we witnessed history as WTI Crude Oil futures closed at -$37.63. That's not a typo! Negative oil prices, as absurd as that sounds, are another instance of nonconventional market outcomes that one would struggle to find in finance textbooks, just like negative interest rates. As it turns out, the story was slightly less alarming than the headline implied. The oil futures that expired on April 20 settle in physical delivery, and because of weak oil demand brought on by COVID-19, storage capacity had essentially run out in Cushing, Oklahoma, where delivery takes place. The negative oil price represented compensation that the seller was forced to offer the buyer to arrange last-minute alternative storage solutions. Accordingly, futures prices recovered the following day as the next month's contract rolled into play. However, oversupply concerns remain.

While crude oil had a memorable month, the rest of the commodities space was less noteworthy: The Bloomberg Commodities Index was down by 1.5% for the month.

Real Estate

Real estate investment trusts (REITs) rallied by 8.8% in April and are now down 16.7% for the year. Although interest rates have declined materially, which is positive for real estate prices, questions around future cash flow remain. Retail space is ground zero for this: We've seen initial estimates that just under 40% of retail rent was collected in April. Longer-term, office space may come under pressure as businesses rationalize how much space they need in a post-COVID-19 world. Work-from-home has been a success story in this forced experiment.

Hedge Funds

The HFRX Global Hedge Fund Index rose by 2.7% in April, bringing YTD returns to a decline of 4.3%. Equity hedged strategies, which capture equity long/short and equity market neutral strategies, were the best-performing substrategies, returning 4.1% for the month (down 9.8% YTD). Elsewhere, global macro/CTA strategies were up 0.6% in April and essentially flat for the year, having done well to protect capital during the March sell-off.

Volatility this year reminds us why hedge funds are an important part of a diversified portfolio. They tend to be less correlated with traditional assets and are exposed to a multitude of return drivers, which taken together can protect capital in a downturn and improve portfolio risk-adjusted returns.

Key Private Bank Asset Allocation Recommendations as of May 2020

Tactical Asset Allocation

Stocks	Bonds	Cash	Alts/Diversifiers
De-emphasize	Neutral	Emphasize	Emphasize

Equity Factor Emphasis

Value	Quality	Momentum	Low Volatility
De-emphasize	Emphasize	De-emphasize	Emphasize

Equity Geographic Emphasis

United States	International – Developed	International – Emerging
Emphasize	De-emphasize	Neutral

Fixed Income Emphasis

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

For more information about how the market climate is impacting your portfolio, contact your Key Private Bank Advisor.

About the Author

Justin Tantalo has 15 years of experience in investment management, both in Asset Allocation and Fund Management. As a Senior Vice President with Key Private Bank, Justin applies his expertise in Asset Allocation and helps oversee the equities and alternatives third-party manager research effort.

Justin received an MA in Economics from the University of Waterloo (Canada) and BA in Economics from the University of Western Ontario (Canada). Justin is a CFA Charterholder.