



Key Investment Perspectives

July 2020

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Global Equities



The S&P 500 Index rose 20% in the second quarter — the market’s best quarter in over 20 years — to bring year-to-date (YTD) losses to just over 3%. This rise was a remarkable result, considering that the first half of the year was characterized by high volatility, an epic sell-off that ended the longest-ever bull market, and an equally epic rebound.

Recall that the US equity markets started 2020 on a strong note: The S&P 500 gained 3% by mid-January following a 33% return for 2019 as the shift in Federal Reserve (Fed) policy and a hot technology sector sent the market booming. However, the momentum stalled by the end of January when news of a mysterious illness in Wuhan City, China, surfaced. Investors initially shrugged off any serious concerns, and the S&P 500 climbed to an all-time high of 3,386 on February 19.

Immediately after that, however, the market quickly collapsed. The S&P 500 dropped by over 10% in six trading sessions. Reports of the rapid spread of the coronavirus (Italy, South Korea, and Iran) kept coming, and officials at the Centers for Disease Control and Prevention (CDC) told us to prepare for the worst. The news was startling, and the fear of potential damage to economies, corporate earnings, and daily life as we knew it was palpable.

By March 12, 16 trading days after reaching an all-time high, the US equity market declined into bear territory, the quickest fall in history and an official end of the bull market. Concerns mounted that the health crisis would turn into a financial crisis, leading the Fed to step in and take dramatic action: Cuts brought the benchmark rate to nearly zero, and officials pledged to do whatever it took to stabilize the market and the economy. After a 34% decline, the S&P 500 bottomed at 2,237 on March 23.

In April and May, the US economy experienced a decline not seen since the Great Depression. More than 30 million Americans filed for unemployment, GDP fell 4.8%,

June Market Data				
Asset Classes	1 Month	3 Month	YTD	1 Year
US All Cap	2.29	22.03	-3.48	6.53
US Large Cap	2.21	21.82	-2.81	7.48
US Small Cap	3.53	25.42	-12.98	-6.63
US Large Cap Growth	4.35	27.84	9.81	23.28
US Large Cap Value	-0.66	14.29	-16.26	-8.84
US Small Cap Growth	3.84	30.58	-3.06	3.48
US Small Cap Value	2.90	18.91	-23.50	-17.48
Developed International	3.42	16.40	-11.33	-4.71
International Emerging Markets	7.45	19.00	9.78	-3.16
US Treasury	0.09	0.48	8.71	10.45
US Investment Grade	1.96	8.98	5.02	9.50
US High Yield	0.98	10.18	-3.80	0.03
Municipal Bonds	0.82	2.72	2.08	4.45
Real Estate	2.31	13.25	-13.30	-6.47
Commodities	2.28	5.08	-19.40	-17.38

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

and broad economic activity measures plummeted to record lows. And yet the S&P 500 increased 12.8% in April and 4.8% in May. Coordinated global efforts of central banks and governments, including massive and timely interventions by the Fed, were undoubtedly factors behind the equity market rally. The flattening of the virus curve and the reopening of the global economy also provided investors with optimism.

As the calendar turned to June, optimism continued to rise as the number of business reopenings grew. New data indicated that the worst of the economic downturn might be in the rearview mirror. On June 6, a labor market report showed that 2.5 million new jobs were added in May, the most on record since 1939, and the unemployment rate dropped by 1.4 percentage points to 13.3%. The results were far better than economists had anticipated and provided support to the notion that the recovery may be underway. By June 8, the economy

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appeared more resilient than expected as air travel and restaurant sales showed signs of a rebound, and COVID-19 cases seemed to be plateauing. The S&P 500 gained 6% in a few short days, capping an astonishing gain of 45% from the March 23 trough.

The market was range-bound and choppy for the rest of the month, however, as data on the virus sent mixed signals and investors realized that the pandemic had not entirely dissipated. Gloomy economic forecasts from the Fed and a resurgence in new coronavirus cases — with alarming spikes in California, Arizona, and Texas — all contributed to the headwinds. Some states started to slow reopenings down while several others that had been reopening contemplated a course reversal. Overall, investors continued to balance signs of hope (economic improvements) with signs of concerns (new closures, a second wave of COVID-19, civil unrest, geopolitical discord) during the month. The S&P 500 ended up giving back some of its early returns, closing June at 3,100 and posting an increase of 2% for a YTD loss of just over 3%.

Even with the turnaround in the equity market, volatility remains stubbornly high. Implied volatility as measured by the VIX (CBOE Volatility Index) closed the month at 30 and has remained above 25 for all but one day since the end of February. Since 20 is the long-term average, this is another sign of investor concern.

In terms of winners and losers, small caps did slightly better in June than large caps (3.5% vs. 2%) but remain far below on a year-to-date basis (-13% vs. -3%). It is not surprising that small caps are more volatile, declining in downturns but rising more in the early phase of recoveries. Quality continues to be an outperformer and is the only factor with both positive returns this month (1.1%) and YTD (1.5%). Value did start to show some

life in the second quarter, but that trend reversed in June: Growth stocks returned 4.4% versus -0.7% for value shares.

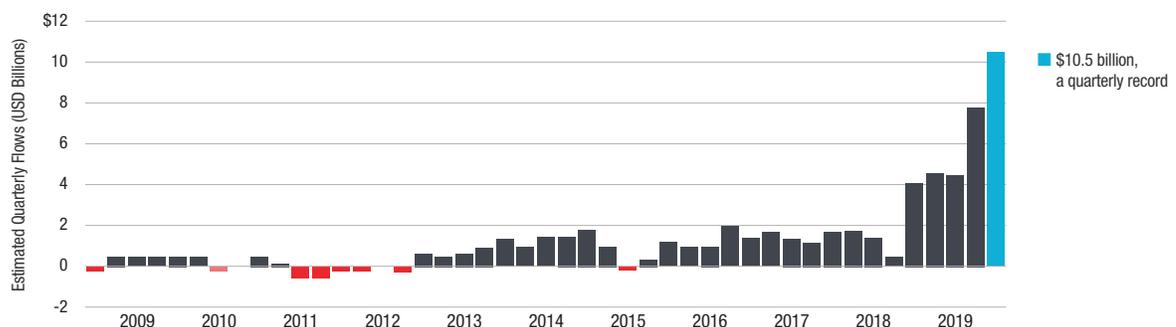
The Information Technology sector continued its strong rally in June, returning 6.9% for whopping gains of 30.4% for the quarter and 14.9% YTD, far surpassing all other sectors and the overall market. Consumer Services (Facebook and Google) and Consumer Discretionary (Amazon) were the only other sectors with positive returns (1.3% and 2.6% YTD, respectively). Microsoft, Apple, Amazon, Google, and Facebook (known as the Top 5) now make up 20% of the S&P 500 and continue to drive the index higher.

As their economies rebounded and COVID-19 cases fell in many countries, international markets outpaced US equities with developed markets returning 3.4% in June (-11.3% YTD) and emerging markets soaring with a 7.5% return (-9.8% YTD). European stocks were especially strong in June as economic data surpassed expectations. Additional fiscal stimulus in Germany, the largest economy in the European Union, and the European Central Bank's larger-than-expected expansion program also supported investor optimism.

Sustainable investing — More than feel-good

One relatively new investment area that has generated outperformance during the market turmoil is Environmental, Social, and Governance (ESG) investing. ESG investing (often called Sustainable investing) has soared in terms of both the product offerings available and the amount of money invested. Add in its growing record of strong performance, and even the skeptics are beginning to take notice.

Sustainable Funds U.S. Quarterly Flows



Source: Morningstar Direct. Data as of March 2020.

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At its core, ESG investing is an approach that evaluates securities based not only on traditional financial metrics but also on a firm's approach to environmental and social policies and its governance structure. More specifically, companies are rated on the soundness of balance sheets and income statements along with how they manage their environmental impact, how they treat their employees, and the strength of their governance framework. These factors are considered to both minimize risk and maximize opportunities and thus drive outperformance. ESG investing is also a way for investors to support their sustainability goals and align their portfolios and principles.

The roots of ESG Investing are found in Socially Responsible Investing (SRI), which involves using negative filters to align values with portfolios. Faith-based institutions were among the first adopters of SRI as they screened out "sin" stocks to avoid investing in activities considered morally objectionable. Today, investors of all types employ SRI to hold investments that reflect their core beliefs. One difference between SRI and ESG is that most SRI investors are willing to sacrifice returns as their values take precedence, but not so with ESG.

Many ESG investors are not only unwilling to give up "value for values" but expect that an ESG focus will improve their potential for better returns. The thesis is that a company that cares about the environment, looks after its employees and customers, and exhibits strong business ethics and good governance has less risk and better fundamentals, and it will be more resilient on the downside. Such investors consider ESG data as an untapped source of valuable information that provides a competitive advantage in the security selection process.

For example, many ESG investment managers consider climate change and global warming as investment risks, which is a view that is not universally shared among companies and investors. The idea is that a company that manages its overall environmental impact will address risks that others don't consider. These risks include losses due to a direct disruption to operations and the business risk associated with a difficult transition to a low-carbon economy in the future. Compared with competitors that are not contemplating such environmental issues, these companies will likely have lower risk profiles and the potential for cost savings through resource efficiency. ESG investment managers believe that these enterprises can produce better long-term outcomes for both investors and the world.

Stakeholder capitalism

Before the COVID-19 crisis, some questioned whether ESG considerations would be cast aside as people worried about the basics, including the pandemic's impact on their lives, the sharp moves in the market, and their health and wellness. But what has happened instead is that ESG issues — especially the "S" part — have become more of a focal point for many.

Milton Friedman (the famous American economist who championed free markets and monetary policy) held that a company must put the shareholders' value above all else, an ideology held by most. ESG managers and an increasing number of corporations reject this view. Instead, they support the notion of "stakeholder capitalism" — a philosophy where a corporation operates for the benefit of all its stakeholders, including customers, employees, suppliers, communities, and shareholders.

The crisis has shown a spotlight on this approach. Many companies pivoted to prioritize employees, establish new work-from-home capabilities, extend benefits, and implement protocols to protect the well-being of workers and customers. The companies that are doing this will likely have a more engaged workforce, appreciative customers, confident investors, and higher goodwill. The ones that aren't will probably not. There is already some evidence that companies addressing the issues of all stakeholders are providing better returns, demonstrating that the "S" in ESG matters.

Recent civil unrest has also focused attention on systemic social issues related to race, gender, income inequality, and more. Sustainable investors think that part of the solution is for more companies to operate from a stakeholder capitalism ("for the benefit of all") perspective, supporting diversity and inclusive policies and advancing long-term sustainability rather than short-term profit maximization. At a minimum, more investors are now supporting this approach and recognizing that corporations have a part to play in addressing these issues.

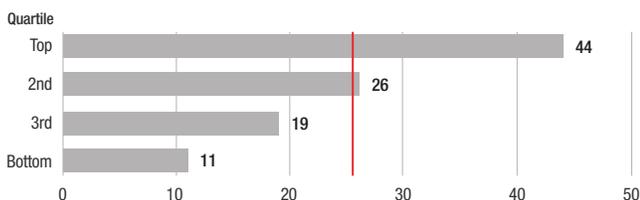
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Solid performance

When the markets declined dramatically during the first quarter, active and passive ESG funds were the clear winners, providing strong relative outperformance versus traditional funds. According to Blackrock, nearly all ESG index funds outperformed their parents' index, and Morningstar reported that 70% of US equity sustainable funds ranked in the top half of their category, with 44% finishing in the top quartile. These data points provide evidence that ESG investing can deliver competitive performance in all types of markets.

Compared with traditional investors, ESG managers tend to have a longer-term outlook and hold stocks of higher-quality companies with well-capitalized balance sheets and low ESG risk. Therefore, it is not surprising that they would provide capital protection and less volatility in a downturn. Some investors have suggested that the outperformance is just an energy story: ESG managers tend to be underweight traditional energy stocks that severely underperformed due to the decline in oil. But when you dig deep into attribution analysis, that only explains a fraction of the ESG's outperformance. Stock selection, rather than sector allocation, was the primary driver.

Sustainable Equity Funds
Q1 2020 Return Risk % By Morningstar Category



Source: Morningstar Direct. Data as of March 2020.

Walk the walk

When considering sustainable investing, attention is often focused only on an individual company. However, we think there is a clear benefit in expanding that perspective to use an ESG lens to select investment managers and construct sustainable portfolios. In short, investors should consider both the robustness of a manager's ESG investment process and how they manage their own firm. At Key Private Bank, we think that managers who demonstrate a commitment to firm-wide sustainability principles and have analyst and portfolio manager teams that are diverse in terms of gender, race, and background provide clear advantages for our clients.

Overall, there is an increasing shift toward viewing the world through a sustainability lens, and it would be wise for investors to take note. Rather than dismissing this trend as progressive investors pushing an agenda, it should be thoughtfully considered as an approach that embraces stakeholder capitalism for purposes of both better financial returns and a better environment and society. Sustainable investing as a niche area and values-based investors just seeking to do good are things of the past.

Fixed income

Fixed Income returns were mostly positive in June with US Treasuries (5-10 year maturities) returning 0.1%, resulting in a 9.6% YTD return. Interest rates were little changed across the curve as the economy reopened, and the broader market continued to stabilize. The 10-year Treasury note ended the month with a yield of 0.66%, up just 0.01% from May.

The credit market continued to rally as risk assets provided strong returns in June. Long-term investment-grade credit was the best performer, returning 2.5% for the month, which resulted in a quarterly return of 11.1%. High-yield bonds lagged investment-grade credit, returning just 1.0%. Unlike investment-grade credit, high-yield fixed income still hasn't recovered from the first quarter downturn and is negative on the year (-3.8%).

The most substantial YTD returns are in the long end of the Treasury curve as the Treasury index (20-30 year maturities) recorded a stunning 21.2%, far above returns for any other sector. The yield on the 30-year Treasury in June dropped slightly to 1.4%.

Following their strong showing in May (3.2%), municipalities returned 0.8% in June for a YTD return of 2.1%, providing another continuing sign of market normalization. High-yield municipals also rallied in May and June to recover much of their loss earlier in the year.

As we end the first half of the year, fixed income products have outperformed equities with the Barclay's US Aggregate Bond Index (a standard fixed income benchmark) up 6.1% compared with -3.1% for the S&P 500. However, with the rally in equities, the performance spread has narrowed. Treasury rates are unlikely to move meaningfully over the near-to-medium term given the Fed's plans to keep rates low for an extended time and its continued asset purchases of corporates, Treasuries, and mortgages. The strong market demand for risk-free assets reflected in the continuing asset flows into fixed income should also keep rates low.

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Alternatives

Commodities

WTI crude had a monthly return of 10.7% and closed at \$39.2/barrel. It continued its positive trend following the 88% resurgence in May from the unprecedented negative price in April (-\$37.63/barrel on April 20) due to the storage shortage when April futures expired. Oil prices continued to recover as positive economic data, supply cuts, and improving demand offset worries about increasing coronavirus cases and geopolitical discord.

While energy was once again the best monthly performer, metals and agricultural commodities posted strong returns as economic conditions improved. The S&P GSCI Commodities Index, a broadly diversified index covering 24 commodities, returned 5.1% in June following a substantial 16.4% gain in May. The index returns on a YTD basis are dismal however. Commodities are down 36.3%, primarily due to the severe drawdown in crude oil prices in the first quarter. The one bright and shiny spot for commodities for the first half of the year was gold (18.6%).

Real estate

Publicly traded real estate investment trusts (REITs) rose 2.3% in June but remained down 13.3% YTD. While the housing market is undergoing a robust V-shaped recovery, investors question the outlook for real estate overall. This is especially the case for retail and office space, given the shutdown of retail businesses and shifting to working from home due to COVID-19. In assessing its investment merits, it is essential to keep in mind that the real estate sector is diverse and composed of several different property types across various regions. Already in decline before the pandemic, retail will likely continue to suffer from the move to e-commerce.

However, the outlook and demand for the industrial/ data centers and multi-family sectors looks bright. There will undoubtedly be challenges in some areas of the office space sector with businesses reopening, the reconfiguring of spaces, and not everyone returning to downtown skyscrapers. Suburban office buildings that can adjust and offer flexible office spaces for multiple purposes may be part of the solution. Also, the lodging/ resort sector will likely have a strong recovery from its steep decline as the world opens up, and tired-of-being-shut-in consumers can take to the road.

Hedge funds

The HFRX Global Hedge Fund Index posted another strong month, rising 1.8% in June to bring YTD returns to a 1.1% decline. Overall, hedge fund returns continued to be positive across core sub-strategies, except for macro/CTA strategies, which were down 0.3% this month (-0.7% YTD) due to declines in systematic trend-following managers. Event-driven strategies were the best performing sub-strategy, returning 2.6% from gains in special situation and merger arbitrage and turned positive (1.6%) for the year. Relative value delivered monthly returns of 1.8% and was also positive YTD (1.1%). Equity hedge had a good month, rising 2.2% but remaining by far the worst performer for the year with a decline of 6.3%

Overall, hedge funds' relatively strong performance in this year of extreme volatility is a reminder of why hedge funds should be a part of a well-diversified portfolio. Hedge funds aim to deliver returns through a variety of return drivers and tend to have a low correlation with traditional assets. These attributes help lower portfolio volatility, protect capital in downturns, and enhance risk-adjusted returns

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Tactical Asset Allocation

De-emphasize equities but overweight to the US

Maintain a neutral stance to risk

Key Private Bank uses a proprietary, systematic approach informed by our Dynamic Allocation Research Tool (DART) to help guide our asset allocation decisions. In early March, DART's view on stocks turned negative, and we changed our recommendation to a modest underweight to equities. Since then, we have slightly moderated our view and now advise a neutral stance to risk. We further believe investors should play offense defensively and play defensive offensively as they must navigate two powerful yet countervailing forces: massive (and seemingly limitless) financial stimulus versus the uncertain path of a novel and previously unknown virus as an adequate medical response remains undefined.

This suggests emphasizing higher-quality domestic issues and de-emphasizing non-US, more-cyclical equities due to the safe-haven nature of the domestic marketplace. It also implies a preference for investment-grade corporate and municipal bonds over US Treasuries as Fed actions and massive US fiscal assistance continue to provide critical support.

Finally, we continue to maintain our recommendation that alternatives can provide valuable diversification benefits for the right client. We also continue to recommend holding a higher-than-average cash balance to enable investors to deploy capital as opportunities arise.

For more information on how the current market climate might impact your portfolio, [contact your Key Private Bank advisor.](#)

Key Private Bank Asset Allocation Recommendations as of July 2020

Tactical Asset Allocation

Stocks	Bonds	Cash	Alts/Diversifiers
Neutral	Neutral	Neutral	Emphasize – Client specific

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.

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About the Author

Linda Kelly is a Senior Lead Analyst with broad knowledge and experience in working with clients and portfolio managers on customized investment solutions. Her focus is on specialized, non-traditional investments including derivative strategies and values-focused investing. Linda's areas of expertise include structured notes for unique risk/return outcomes, covered call overlays for yield enhancement, protective put purchases for risk mitigation, as well as socially responsible, ESG, and impact investing. These strategies offer clients opportunities beyond traditional investments to meet their specific goals and/or align their investments with their values.

Linda has more than 25 years of industry experience. She joined KeyBank in 1998 in the capital markets division and transferred to Key Private Bank's investment management group in 2007, where she introduced and expanded our derivative-based offerings and developed our values-based investing capabilities. Before joining Key, Linda worked at a proprietary options trading firm and leading international bank in Chicago.

Linda received her BA from the College of Wooster and her MBA from DePaul University. She also holds a Certified Financial Planner™ designation and is actively involved in various non-profit boards.

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