Key Private Bank

Key Investment Perspectives

October 2020

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September Market Data				
Asset Classes	1 Month	3 Month	YTD	1 Year
US All Cap	-3.64	9.21	5.41	15.00
US Large Cap	-3.65	9.47	6.40	16.01
US Small Cap	-3.34	4.93	-8.69	0.39
US Large Cap Growth	-4.71	13.22	24.33	37.53
US Large Cap Value	-2.46	5.59	-11.58	-5.03
US Small Cap Growth	-2.14	7.16	3.88	15.71
US Small Cap Value	-4.65	2.56	-21.54	-14.88
Developed International	-2.37	5.96	-6.05	2.06
Emerging Markets	-2.11	8.96	-1.69	9.50
US Treasury	0.14	0.17	8.90	8.04
US Investment Grade	-0.29	1.54	6.64	7.90
US High Yield	-1.03	4.60	0.62	3.25
Municipal Bonds	0.02	1.23	3.33	4.09
Real Estate	-2.66	1.19	-12.27	-12.15
Commodities	-3.35	9.07	-12.08	-8.20

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

Market review

Investment markets, in general, fell during September. There was a small resurgence in COVID cases around the world, and areas already hard hit by the virus reported increases in the number of cases after months of successful virus suppression. An increasingly contentious United States presidential election cycle and political rhetoric regarding an empty Supreme Court seat also upset markets. On average, September has traditionally experienced the lowest return in equity markets of any month during the year, and this year was no exception. Many assets had negative returns for the month, though hedge fund categories did provide some ballast during the downturn. While economic growth continues to expand worldwide after shutdowns earlier in the year, the recovery pace has noticeably slowed.

COVID-19 continues to ebb and flow around the world. In the United States, the R0—a mathematical term that indicates how contagious an infectious disease is—crept up to 1.04, signaling an increase in the virus's spread.

When the R0 rises above 1.0, each person with the virus infects on average more than one other person, which expands the virus's reach. R0s below 1.0 signify contraction of the virus. Hospitalizations also trended higher in the second half of the month for the first time since early July, but they are still well below levels seen earlier in the year. And although the US hit a grim milestone during September when COVID-19 deaths passed 200,000, fatalities attributed to the virus were steadily declining throughout the month. Despite the recent uptick in confirmed cases, fewer cases are as severe as they were during the early months of the pandemic: New infections are in younger, stronger, generally healthier people who are better able to withstand infection. There have been some struggles with school reopenings around the country, but contingency plans have worked in areas where they have been triggered, and life continues to creep back to some form of normalcy.

As school boards and industries have been able to plan for virus contingencies, they have been better able to shift policy when necessary. Consumer spending also continues to rise.

Slightly more distressing is the growth in cases in the eurozone and the UK, which began in August and continued through September. Still, economic sentiment remains high there as well. Company surveys continue to show expanded business production and optimism from shutdown lows. In emerging markets, cases in Brazil and India appear to have peaked, but fatalities continue to mount. There remains a threat that a resurgence in the fall or winter will damage the past few months' economic recovery gains. In the United States, in the near term, we expect targeted restrictions rather than larger-scale shutdowns to continue as trace data becomes more prevalent. Many communities, companies, and school districts have weighed their options, considered potential scenarios, and have better plans in place for circumstances than they did when the first wave hit in March of this year.

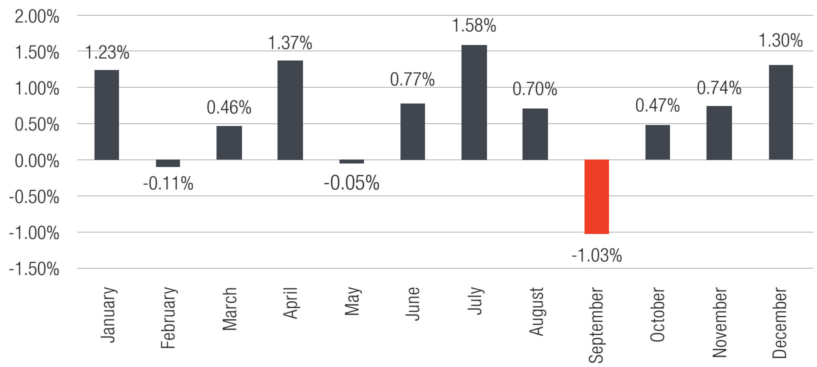
Global equities

The broad US equity market, as measured by the Russell 3000 Index, fell 3.6% during September on COVID-19 resurgence fears, slowing economic rebound data, and perceived market volatility in the hotly contested US presidential race. US large cap equities faced a small factor rotation: The Russell 1000 Growth Index dropped by 4.7% while the Russell 1000 Value Index declined by only 2.5%. The rotation to cheaper valuation and higher cyclicality may have resulted from profit-taking in the sectors and stocks that have outperformed so far this year. Materials and Industrials—traditional cyclical sectors—fared better than the structurally challenged Financials and Energy sectors. The FAAMG stocks (Facebook, Apple, Amazon, Microsoft, and Google) continue to be viewed as possessing strong durability in the future. However, they did contribute to the underperformance of growth stocks during September. US small cap equity also trended lower during the month, finishing 3.3% below August's close.

In international equity markets, the FTSE Developed Ex-US Equity Index fell 2.4%. The higher percentage of cyclical and cheaper valuation stocks provided a higher short-term floor for the market. Two-thirds of the negative performance was due to the US dollar strengthening on a resurgence of COVID cases in the eurozone and the UK. Japanese equity was a bright spot, rising 0.3% the month on continued economic recovery, COVID containment, and political stability in the transition of power away from long time Prime Minister Shinzo Abe. Emerging market equity fell by 2.1%.

September has been the poorest month for returns during the year for the S&P 500 Index. One of three months during the year with negative returns, it is the only one that has a significantly negative performance. September's negative returns this year were driven by increased COVID-19 resurgence risks, heightened political rhetoric, and the increased likelihood of a contested presidential election in the United States. Many market participants have bid up the cost of protection against market downturns through the US election cycle, in effect pricing in the probability of market volatility before the actual event occurs.

S&P 500 Average Performance by Month (1928-present) Average Return



Sources: Bloomberg, Key Private Bank

US Presidential election volatility: Perception vs. reality

In ancient Greece, the word "pharmakon" denoted both medicine and poison. The term evolved because the Greeks understood that the same plant or herb that in small doses would help cure maladies would cause harm in larger doses—hence the two meanings that seem contradictory. The dichotomy lends itself well to describe behaviors during this global pandemic and the hotly contested US presidential and congressional elections. While many investors have chosen to try to shift asset allocations or hedge perceived risks associated with the election to smooth their expected ride through the election season, these actions may not have the desired effect.

Markets hate the unexpected; they hate surprises. They deal well with perceived risks already baked into current prices. Hedgers want their actions to be preventative medicine, but they may be searching for the antidote to an overlarge dosage if history is any indication. Broad economic trends, fiscal and monetary policies, and real interest rate environments are the principle drivers of investment performance, overshadowing election shocks that may already be priced into forward asset prices.

First, we explore a primer on what is at stake later this year.

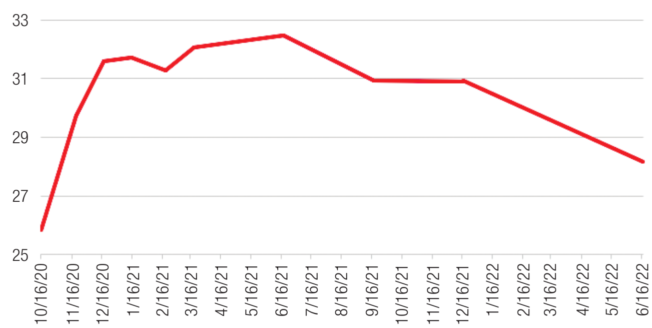
On November 3, in addition to a US presidential race that is closely contested based on recent polling, we will elect all 435 members of the House of Representatives and 35 members of the Senate. Many political pundits, particularly Nate Silver of fivethirtyeight.com, believe that only a fraction of those races are tightly competitive. Republicans would have to win nearly 80% of the 50 or so tightly contested races to control the House. There is currently a 53-to-45 Republican majority in the Senate with two independent senators who caucus with the Democrats. There are 10 Republican incumbents locked in close races and two Democrat incumbents at risk of losing their seats. It is more likely that the Democrats will control the Senate after the election than Republicans control the House, but the odds of each occurring are below 50%.

Outside of political uncertainties, there are also economic concerns. The global coronavirus pandemic had an uptick in reported cases and hospitalizations late in September. Controlled school openings show early successes but are still causing trepidation among parents, students, and investors alike. Investors also fear that the Federal Reserve may not be willing to use all of the tools at its disposal unless necessary, increasing perceived volatility in the marketplace. These are all longer-term uncertainties; they have no set timeframes, but their perceived volatilities are being combined with election risk and priced into the expected volatility. Investors know these risks exist and have worked through scenarios of how to proceed as more theories become facts in the coming weeks and months.

Because the investment market in general and equity markets particularly dislike uncertainties, they oscillate more in the short term while searching for the proper level. Known as market volatility, it is measured by the standard deviation of returns over time. The most prevalent measure of market uncertainty in the US is the VIX Index, which is a futures market measure of 1-month forward implied volatility in the S&P 500 Index: It is the expected annualized standard deviation over the next month in the S&P 500. Said another way, it is how much investors expect the market to move over the next month, measured continuously to allow for comparisons throughout time. Investors also call it the “fear gauge” because it is a concrete way to hedge adverse movements in the index over time. A higher number indicates an expectation of more movement in the stock market and signifies that more assets will be required to hedge against adverse movements.

The VIX has a long-term average of 17-20 but surged to an all-time high of 80 in March of this year as COVID-19 caused economic shutdowns around the globe—a genuine surprise. The index tends to increase as markets decline and decrease as markets increase: Investors fear market retractions and adjust their risk-taking willingness when markets rise. Investors can hedge unexpected volatility in the stock market by buying VIX futures for the month that overlaps the unexpected volatility. Since the measure always looks forward to the next month, October futures, which expire on the third Friday of the month, include expected Election Day volatility. Even though the market has had a strong upward trend over the past few months, the VIX futures price has remained steady and even increased recently as the presidential election nears. In summary, investors are paying high premiums to hedge against an election surprise.

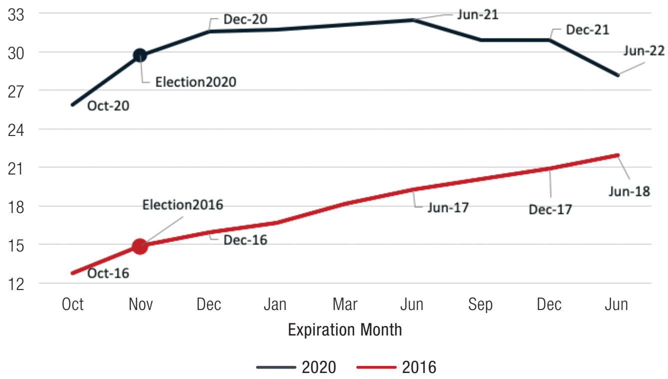
VIX Futures Price by expiration date



Sources: CBOE, Key Private Bank

The current term structure of the VIX reveals some interesting developments. Investors are paying high prices to hedge uncertainty between the election date and the end of the year. This approach coincides with election expectations and suggests that the presidential election winner may not be known until late in the year. The absolute level of the VIX (in the low 30s) is exceptionally high for a rising market. Its price is more in line with markets which have extremely divergent potential paths rather than a market that has a few well-defined outcomes. One candidate will win, and future expectations will follow. Having clarity one way or the other is good for risk assets. Compare this forward expectation to the expectation going into the contested 2016 election, which was also close in the polls and subject to impassioned rhetoric on both sides (See chart on page 4).

2020 vs. 2016 VIX Term Structure as of 9/30 for each year



Sources: CBOE, Key Private Bank

Political Scenarios	S&P % Calendar Year Returns	Years
Unified Government	14.9	30
Democratic President	14.5	22
Republican President	16.1	8
Unified Congress	10.8	32
Dem President/Rep Congress	15.9	10
Rep President/Dem Congress	8.5	22
Split Congress	12.1	14
Democratic President	16	4
Republican President	9.9	10
All Years	12.6	76

Sources: CFRA Research, S&P Dow Jones Indices, Forbes.

Even though the 2016 presidential election was closely contested, and the results would change the future economic backdrop, the volatility was priced into the election. The stock market was much lower than it is today. This historical trend suggests that risk-averse hedgers in 2020 may have overpriced the movement resulting from a contested election and that the VIX may be too high.

Remember, paying for a hedge on a portfolio only pays off when the price paid for it is less than the volatile event's market movement. For this to happen, the event has to be unexpected: It must be a surprise to market participants. In this election cycle, the nearer-term volatility effects could very well prove to be smaller than expected. Recent polls have shown an increasing likelihood that the presidential winner will be known much quicker than previously feared, at some point between election night and the November 23 deadline for mail-in and absentee ballots. As such, a likely scenario is that the market calms as closure nears. Since volatility stems from unpredictable outcomes, it stands to reason that it will lessen as the outcome becomes more apparent.

There are three potential outcomes for this election cycle. (For simplicity, we're assuming that the Democrats will maintain control of the House.) There can be a Democratic sweep, wherein the party controls both the presidency and Congress by gaining seats in the Senate. Second, there can be a Joe Biden Democrat-led White House with a Republican-controlled Senate. And finally, the status quo can reign, whereby Donald Trump wins the White House and the Senate continues to be under Republican leadership. In all of those scenarios, monetary policy is likely to remain accommodative. A stimulus will also be needed to continue the recovery from coronavirus shutdowns. Historically, all of the scenarios provide the environment for strong stock market performance over time.

The real policy differences between the scenarios will not emerge until the economy is on sturdier ground. A Democratic sweep would possibly lead to higher taxes and regulation in subsequent years but lower risks of crippling tariffs. In contrast, a Democratic White House and GOP Senate could lower uncertainty, lower risks of tax hikes, slightly more regulation, and lower tariff risks. A favorable tax environment would continue in the status quo scenario, but tariff risks and uncertainty would both be higher. The levers would be different, but the overall effect could be similar under all of the scenarios. Barring a strong resurgence of deadly COVID clusters around the country, consumer confidence will continue to grow gradually, hopefully to pre-COVID levels.

Instead of being risk-averse in the current market environment, there are other ways to weather potential short-term market volatility. Long-term investors can deal with the volatility and—returning to our "pharmakon" reference—get their medicine in small doses by investing in diversified portfolios managed in a risk-aware manner. Disciplined risk management and measured shifts in allocation have better long-term relative-return potential than large short-term allocation shifts. By keeping the long-term picture in perspective, many portfolios can emerge from difficult market periods in strong positions to succeed as we move forward. It is better not to fall victim to headline risks and use a research-based and systematic asset allocation process to diversify client portfolios.

Key Investment Perspectives

At Key Private Bank, we utilize our proprietary DART model to inform our discussions on asset allocation, risks, and market trends. We are aware of confirmation bias and strive to minimize its poisonous influence by maintaining multiple viewpoints in discussions. This approach allows us to identify potential risks and work through scenarios in which those risks may manifest in market returns. We believe the cost of wholesale portfolio changes in the near term is too great of a dose of medicine given the similarity of the potential outcomes' effects. We view the smaller, right-sized dose as diversifying, being a continued market participant, and meeting alpha goals over the long term.

Fixed Income

US bonds generated tepid returns during September, with the Bloomberg Barclay's US Aggregate Bond Index down 0.15% for the month. US Treasuries finished the monthly slightly higher at +0.2%, while the Bloomberg Barclay's US Corporate Bond Index fell by 0.3%. Municipal bonds ended the month virtually unchanged. The largest move occurred in high-yield corporate bonds, which fell 1.0% on increasing on doubts about a full economic recovery. The US bond market seems to be in a holding pattern as the Federal Reserve has stated that it plans on keeping rates near zero for the next few years. In fact, the US 10-year Treasury yield has remained around 65 basis points since April.

While economic trends in the United States continue to improve, the pace of improvement has slowed. The Federal Reserve continues to have ammunition to combat adverse market conditions, but September was a month in which bonds were in a holding pattern.

Commodities

The Bloomberg Commodity Index fell in tandem with risk assets during September, losing 3.4%. Agricultural products did well, rising 4.1%, but crude oil (-6.5%), energy (-8.0%) and gold (-4.2%) all lagged. Energy and traditional natural resources have been some of the worst-performing assets during the year, possibly fueling environmentally-focused outperformance. The Precious Metals Index also fell 5.7% in September on a small uptick in real interest rates, though year-to-date returns remain strong at +21.9%. Gold has tracked the index on a year-to-date basis, returning slightly less than the index at +21.4%. Silver was the largest detractor in the index: After a strong start to the second quarter, it fell back to earth (-17.8% during September) but remains up 27.4% for the year.

Real Estate

Public real estate (REITs) lagged the equity markets, falling 4.5% during September. Apartments, manufactured homes, office space, shopping centers, and regional malls were the leading sectors detracting from performance due to increased worries about the pace of economic recovery. The relative winners in the space were single-family homes (-1.8%), infrastructure (+0.3%), and self-storage (+3.7%)—the relative winners and losers during the month mirror year-to-date trends. COVID restrictions and potential changes to the future of office space have caused speculation against the weaker sectors. In contrast, infrastructure spending, stimulus, and a possible move away from city centers contribute to the outperformers' relative success.

Hedge Funds

Global hedge funds outpaced global equity returns during September, falling 0.2%. Absolute return strategies performed well, rising 0.3%, as did multi-strategy and merger arbitrage strategies, up 1.1% and 0.9%, respectively. Event-driven and macro-themed portfolios also performed well: Managers found better opportunities as dislocations among asset classes continued, and the perceived future path of economic growth became cloudier. Equity hedge fund returns were flat while market-neutral equity funds underperformed slightly, falling 0.4%. Overall, fundamental stock pickers, who use pure fundamental analysis to build high-conviction long books and diversified short books of structurally challenged industries and companies, remain favorites within the space.

Tactical Asset Allocation

We remain neutral in our equity allocation after increasing from an underweight earlier in the summer. Economic trends continue to improve, although at a slower pace than earlier in the summer. But we believe the threat of a prolonged sell-off is mitigated by the potential for more stimulus on both a fiscal and monetary basis. While developed international equity has shown promise over the past two months, we continue to prefer US equity. We choose to have more exposure to the structural winners and sectors within the domestic equity market and limit our exposure to the more cyclical European stocks. COVID-19 cases have been rising substantially within the eurozone, and the Brexit divorce between the UK and the eurozone has the potential to get messy later in the year.

In fixed income, we continue to emphasize high-quality investment-grade corporate debt while limiting exposure to government securities; we are neutral with respect to high-yield debt while preferring active management in that space. We continue to advocate alternative investments for suitable clients, as low yields could lead to lower future returns in the fixed income allocations and thus limit the downside protection historically present in the asset class. Within alternatives, we recommend a diversified hedge-fund portfolio that emphasizes idiosyncratic risks rather than beta exposure as the potential drivers of returns moving forward. Such a portfolio can deliver attractive returns with volatility similar to that of a traditional bond portfolio.

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 October 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.

About the Author

Don Saverno is a Senior Lead Research Analyst at Key Private Bank. His areas of expertise include: international and emerging markets third-party equity solutions, hedge funds and other alternative assets, and derivatives-based solutions.

Prior to joining Key Private Bank, Don provided investment risk management solutions and worked as an options market maker and proprietary derivatives trader. He has worked in the financial industry since 1999.

Don earned his BA, with Honors, in English from West Virginia Wesleyan College and his MBA from the University of Chicago Booth School of Business with concentrations in Finance, Corporate Strategy, and Managerial & Organizational Behavior.

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