Key Private Bank

Key Investment Perspectives

February 2020

Global equities

Coronavirus – a rude awakening

Introduction

When the closing bell rang on January 17, the S&P 500 Index appeared to be riding on an ever-rising crest of a wave. Not only was the US equity market up over 3% for the year, it had also notched six new all-time highs in just 12 trading days. With nine trading sessions to go for the month, there was still the remote chance that the market could total 15 all-time highs — something that had not happened since June 1955. It seemed foolish to bet on a decline in the S&P 500, especially after the extraordinary momentum garnered from last year's Teflon market.

Yet that's exactly what happened. In those final two weeks of January, the market gave back all its year-to-date gains and more, ending the month marginally in the red. Why?

One word: coronavirus. According to the World Health Organization, coronaviruses are a large family of viruses that cause illnesses ranging from the common cold to more severe diseases such as Middle East Respiratory Syndrome (MERS) and Severe Acute Respiratory Syndrome (SARS). The coronavirus that is taking center stage today is a new strain, one that has not been previously identified in humans. First detected in December last year in Wuhan City in Hubei Province (China's seventh-largest city with a population of 11 million), the coronavirus COVID-19 has now infected more than 64,460 people across 28 countries, including the US.* By February 18, the death toll from the disease (1,875 people) had more than doubled that of SARS from almost two decades ago. SARS killed 774 people worldwide over an 8-month period, while the coronavirus is just into its second month.

With outbreaks like the coronavirus, we are naturally most concerned about the human tragedy. There are small but encouraging signs that the situation may be stabilizing as the number of new reported cases in Wuhan, the epicenter of the outbreak, declined in recent days (although a spike due to a change in the way the Chinese authorities are accounting for confirmed cases caused a major spike in mid-February). We are hopeful that we will soon see significant improvement.

January Market Data

	1 Month	3 Month	YTD	1 Year
US All Cap	-0.11	6.68	-0.11	20.53
US Large Cap	0.11	6.89	0.11	21.39
US Small Cap	-3.21	3.68	-3.21	9.21
US Large Cap Growth	2.24	9.99	2.24	27.94
US Large Cap Value	-2.15	3.65	-2.15	14.88
US Small Cap Growth	-1.10	7.12	-1.10	13.91
US Small Cap Value	-5.39	0.21	-5.39	4.38
Developed International	-2.30	2.57	-2.30	11.12
International Emerging Markets	-4.56	2.37	-4.56	5.90
US Treasury	2.44	1.56	2.44	8.96
US Investment Grade	2.34	2.93	2.34	14.53
US High Yield	0.03	2.36	0.03	9.40
Municipal Bonds	1.80	2.36	1.80	8.65
Real Estate	0.76	-1.38	0.76	13.69
Commodities	-10.82	-4.61	-10.82	-3.76

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

It is still too early to estimate the economic impact of the coronavirus, but all indications are that it is likely to be serious. China's position as a key supply chain gateway and second-largest economy in the world, representing about 20% of global gross domestic product (GDP), makes this uncharted territory for the global economy. Already, sales survey data in China point to figures that are at the lowest levels since 2016, and first quarter GDP is almost assuredly going to show a significant deceleration in growth, with some forecasts of 0% expansion. At the moment, the impact on the US and eurozone economies remains small, but this may not be the case for long if the outbreak is not brought under control soon.

So, what should investors do while we wait?

Discipline in the face of uncertainty

Faced with uncertainty, many market participants often react in a knee-jerk way to reduce exposure to risk assets in favor of safe havens. Emotions overtake disciplined investment philosophies, a well documented phenomenon in behavioral finance. Although this is a natural and very human response, it is counterproductive for long-term investing. Brave contrarian investors often take the opposite side of this trade, swooping in to buy beaten-down shares at reduced prices. But these investors can be wrong. In fact, the value investing mindset that underpins this contrarian investment style has been in the doghouse for over a decade — and there are no signs of a sustained resurgence any time soon.

What investors often forget is that there is always an underrated but powerful third option when faced with uncertainties such as the coronavirus: do nothing. At first, doing nothing may sound like a cop out. After all, our short-term-oriented investment world incentivizes us to take a stand on explicit buys and sells. However, our industry conveniently ignores the fact that by standing pat, investors are implicitly buying their current portfolios and selling everything they don't own.

To keep us even-keeled, we developed a systematic tactical asset allocation process 18 months ago. Today, this model is recommending a balanced risk approach, and we are adhering to this. In essence, we are standing pat. In the next sections, we will discuss the underlying principles that govern this process, looking beneath the hood to describe how the model works and sharing the insights that it is now providing.

DART: Our Dynamic Allocation Research Tool

We have always maintained a strong belief in the efficacy of tactical asset allocation. We believe that markets are mean-reverting over long periods while they trend over short periods. Academic research and practitioner analyses support our view that harnessing publicly available data can shed light on the attractiveness of various asset classes over the intermediate term (12 — 18 months). We therefore expect to add incremental returns to our clients' portfolios by overweighting attractive asset classes at the expense of unattractive ones.

The resource that we developed to help guide us in a systematic fashion is what we call DART, our Dynamic Allocation Research Tool.

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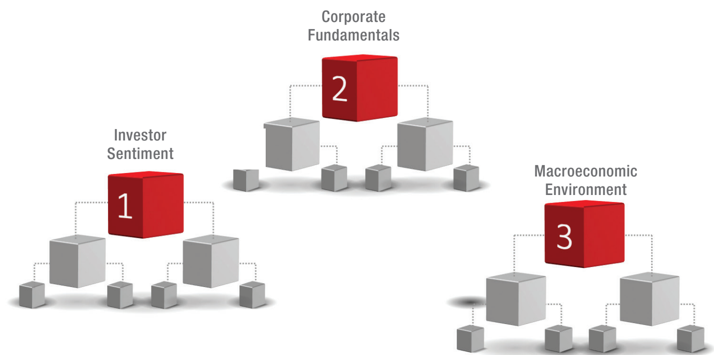

Sources: Key Private Bank

The goal of DART is to help calibrate the level of attractiveness or unattractiveness of different asset classes, e.g., stocks vs. bonds, US vs. non-US equities. For our investment team, DART ensures that we have a cohesive and consistent framework for decision-making.

There are three main and equally important pillars governing DART. We chose an equal-weighted approach because we do not pretend to know which of these pillars would be most predictive of future asset class returns at different points in time.

The three pillars are Corporate Fundamentals, Macroeconomic Environment, and Investor Sentiment. Each pillar is composed of several underlying factors, which are also equal-weighted. The factors are normalized for easy comparison and combination. Our calibration of the overall DART score involves two important elements: the Absolute Score and the Trend Score (defined as the linear growth rate of the Absolute Score over a 6-month period), which are equally important. The inclusion of a Trend Score allows DART to capture inflection points in the market, avoiding late entries into asset classes that are losing steam and enabling early entry into those gaining steam.

When aggregated, these scores range from -12 (worst) to +12 (best), and they have been calibrated to correspond with varying degrees of tactical underweight or overweight relative to equities, as depicted below.

DART Pillars	Value +	Trend =	Total
Investor Sentiment	-2 to +2	-2 to +2	-4 to +4
Corporate Fundamentals	-2 to +2	-2 to +2	-4 to +4
Macroeconomic Environment	-2 to +2	-2 to +2	-4 to +4
Grand Total	**-6 to +6**	**-6 to +6**	**-12 to +12**

Total Model Score Interpretation							
Model Score	+12 to +10	+9 to +6	+5 to +3	+2 to -2	-3 to -5	-6 to -9	-10 to -12
Interpretation	Full overweight	Modest overweight	Slight overweight	Neutral	Slight underweight	Modest underweight	Full underweight

Sources: Key Private Bank

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Below are brief descriptions of DART's three pillars and what they are telling us today.

Corporate Fundamentals

The health of the corporate sector is often a strong barometer for measuring how various asset classes would perform. Deteriorating fundamentals in the corporate sector provide early warning signals before a recession, and strengthening fundamentals are typically associated with expansionary periods.

To measure the strength of the corporate sector, this pillar focuses on two important variables: valuation and profitability. DART uses a variety of valuation measures, from earnings-based (forward and historical), free cash flow-based, and sales-based to dividend-based calculations. To capture profitability, DART uses several measures of profitability (e.g., profit margins and operating cash flow to capital expenditure) and measures of earnings quality (e.g., return on equity, return on invested capital, and return on assets).

At the end of January, the Absolute Score of the Corporate Fundamentals pillar was at its maximum level (+2), underscoring the buoyant health of US corporations. However, the Trend Score was at its minimum level (-2), mostly due to the spillover effects from the US-China trade war and weakness in the Manufacturing sector. Overall, the Corporate Fundamental pillar is currently at 0.

Macroeconomic Environment

The focus of the Macroeconomic Environment pillar is to capture the impact of leading, coincident, and lagging macroeconomic variables on asset class returns. Some of these variables include the Business Conditions Index, the Institute for Supply Management (ISM) PMI and Non-Manufacturing Indices, measures of inflation, capacity utilization, industrial production, unemployment claims, personal consumption, and housing starts. In addition, DART's Macroeconomic Environment pillar captures market variables such as the shape of the yield curve, credit spreads, and currency momentum.

At the end of January, the Absolute Score of the macroeconomic pillar was at its minimum (-2), as it has been for the last several months due to the general global economic weakness that was most pronounced in the summer and fall of last year. The good news is that the Trend Score has now improved over the last three months to 0 from -2, capturing the knock-on effects of the synchronized easing by global central banks. Overall, the Macroeconomic Environment pillar is currently at -2.

Investor Sentiment

Academic research supports the view that actions of market participants, whether rational or irrational, impact the performance of asset classes in the short and intermediate terms. Within the Investor Sentiment pillar, we capture shorter-term market variables that include price momentum, revisions to analysts' earnings estimates, changes in credit risk ratings, various measures of market risk, and the actions of informed buyers and sellers (e.g., large institutional investors, hedge funds, and foreign investors). The goal here is to measure and calibrate the pulse of investors: Are they bullish, neutral, or bearish?

At the end of January, the Absolute Score of the Investor Sentiment pillar was at 0, the same level at which it has been for the last three months. The Trend Score was also at 0. Overall, the Investment Sentiment pillar is at 0, implying that investors are neither bullish nor bearish.

DART score as of January 2020

Combining the scores of the three pillars, the overall score for DART stood at -2 (i.e., neutral) at the end of January. As a result, our posture remains neutral between stocks and bonds, unchanged by the coronavirus outbreak.

		Russell 3000			Total Model Score
		Investor Sentiment	Corporate Fundamentals	Macroeconomic Indicators	
January 2020	Absolute Value	0	2	-2	0
	Trend	0	-2	0	-2
	Pillar Total	0	0	-2	-2

Sources: Key Private Bank

Asset class performance

US equity

The Russell 3000 Index was down marginally (-0.1%), with large cap equities up slightly (+0.1%); small cap stocks (-3.2%) bore the brunt of the coronavirus selloff. Cyclical sectors — Energy (-11.5%) and Basic Materials (-5.9%) — were the biggest losers, while Technology (+3.9%) and Utilities (+3.2%) held up well. Value (-2.4%) again underperformed growth (+2.0%).

Developed markets ex-US equity

Developed international markets (-2.3%) underperformed the US. Most countries were in the red, with the exception of Portugal (+2.5%), Israel (+1.0%), and Switzerland (+0.7%).

Emerging market equity

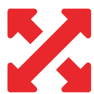
Emerging markets (-4.4%%) were the hardest hit by the coronavirus outbreak, with China and Taiwan both down by 4.8%. The other major countries that pulled the index down included South Africa (-9.3%), Thailand (-8.7%), and Brazil (-7.0%).

Fixed income

Interest rates fall as high-yield credit spreads widen

US Treasuries were up 2.4% as investors sought a safe haven, pushing interest rates down. The long bond index was up 6.9%, while the intermediate bond index was up 1.4%.

Within credit segments of fixed income, high-yield was flat (0.0%), hurt by the Energy sector's 1.7% decline and a 54 basis point (bp) rise in option-adjusted spreads. Investment-grade fixed income (+2.3%) enjoyed robust performance.



Alternatives

Slump in commodity prices but solid hedge fund numbers

Hedge funds

The HFRX Global Hedge Fund Index was up 0.4%, helped by macro/CTA (+0.8%) and relative value (0.7%) but hurt by equity hedge (-0.3%) strategies, in particular, equity market neutral (-1.5%).

Real estate

US REITs were up 76 bps, adversely affected by the usual suspects: malls (-11.4%), hotels (-10.6%), and retail (-8.3%). Manufactured homes (+5.4%), residential (+3.7%), and apartments (+3.5%) were the best-performing sectors.

Commodities

The S&P GSCI was down 10.8%, its worst return since November 2018. Unsurprisingly, the outbreak of the coronavirus was the major culprit, causing major slumps in the crude (-15.3%) and industrial metals (-7.1%) markets. Gold (+4.0%) was the rare positive commodity, owing to its defensive attributes.

Tactical asset allocation

Still neutral

The table below summarizes our current top-level tactical asset allocation recommendations.

Key Private Bank Asset Allocation Recommendations as of February 2020

Stocks	Bonds	Cash	Alts/Diversifiers
Neutral	Neutral	Liquidity Source	Emphasize

Equity Geographic Emphasis

United States	International – Developed	International – Emerging
Neutral	Neutral	Neutral

Fixed Income Sector Emphasis

Treasuries	Investment Grade Credit	High Yield
Neutral	Neutral	De-emphasize

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

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*Official count as of today, February 14, 2020.
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