Key Investment Perspectives

November 2019

Global Equities

New all-time highs. What comes next?

United States

The somewhat gloomy outlook that preceded the US Federal Reserve's (Fed's) first interest rate cut this summer seems to have given way to renewed optimism: Not only is a recession in the rear view, many investors now expect an acceleration of US economic growth. Several factors are driving this optimism, most notably the encouraging news on the US-China trade spat, a stronger-than-expected October payroll report, a slight improvement in manufacturing numbers, and some indication from the services sector that the slowdown in manufacturing may not pull down the rest of the economy after all. Third quarter GDP growth came in at 1.9%—better than the 1.6% consensus estimate but the weakest this year—while third quarter corporate earnings growth for S&P 500 companies is exceeding expectations (-1% vs -3%), with 78% of the companies that have reported beating predictions.

The Fed once again played an important accommodative role by obliging market expectations with a third interest rate cut while announcing the expansion of its balance sheet (the Fed insists this is not Quantitative Easing). Although the Fed did signal a pause in rate cuts going forward, it looks like the trifecta of cuts has achieved the Fed's main goal of utilizing monetary stimulus to prolong the economic recovery. Unsurprisingly, risk assets rallied in October, and this has continued into November. Conversely, the yield on the 10-year Treasury note rose to 1.94% in early November, after dropping to as low as 1.47% in September.

October Market Data

Asset Classes	1 Month	3 Month	YTD	1 Year
US All Cap	2.15	1.83	22.68	13.49
US Large Cap	2.12	1.99	23.09	14.15
US Small Cap	2.63	-0.40	17.18	4.90
US Large Cap Growth	2.82	2.04	26.77	17.10
US Large Cap Value	1.40	1.93	19.46	11.21
US Small Cap Growth	2.85	-2.40	18.62	6.40
US Small Cap Value	2.42	1.67	15.55	3.22
Developed International	3.45	3.73	16.28	10.30
International Emerging Markets	4.20	0.78	11.99	13.61
US Treasury	0.07	2.59	7.78	11.08
US Investment Grade	0.61	3.10	13.89	15.37
US High Yield	0.28	1.04	11.71	8.38
Municipal Bonds	0.18	0.94	6.94	9.42
Real Estate	1.01	7.28	28.49	23.26
Commodities	1.24	-2.78	9.96	-10.01

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

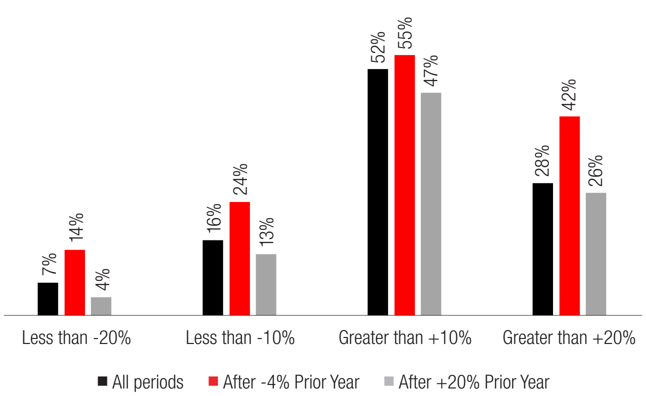
The major US equity indices have now posted multiple new all-time highs over the last couple of weeks, with cyclicals propelling performance while defensive sectors either retreated or remained flat. International markets received the biggest boost in this risk-on environment and outperformed US equities.

We continue to believe that a balanced approach to risk is still appropriate despite the market's newfound animal spirit. As a result, we are maintaining our neutral positioning between stocks and bonds. Over the last few months, our tactical asset allocation model (DART) has been trending in favor of international markets at the expense of the US. We are closely watching these signals but remain ever-so-slightly overweight the US for now. We are also maintaining our defensive tilt within US equities via low-volatility and high-quality exposures.

Return expectations over the next 12 months

In our January 2019 edition of the *Key Investment Perspectives*, we wrote that any time the S&P 500 drops by 4% or more over a 12-month period (as it did in 2018), the outcome with the highest relative likelihood in the following 12 months is one where the S&P 500 registers a 20% total return or more. We have reproduced the chart from the January publication below, and you will notice that the greater-than-20% outcome has the highest relative likelihood of 14% (42% - 28%) compared with all other possibilities. As of November 8, the S&P 500 (including dividends) was already up 25.5% year-to-date. Barring a market swoon in the coming weeks, this year's performance would match the probability we highlighted in January.

Probability of Outsized Return Over the Next 12 months (S&P 500 1928–2019)



Source: Key Private Bank

In the same spirit, we determined the likely performance of the S&P 500 after a 12-month return of 20% or more (gray bar in the chart). It turns out that the likelihood of an outsized return over the next 12 months is slightly lower than what you would expect in any typical 12-month period. As shown in the chart above, in each of the four outsized return possibilities considered, the S&P 500 has a lower probability than typical. If we hazard a guess, we would say the S&P 500 is likely to deliver subdued performance in 2020.

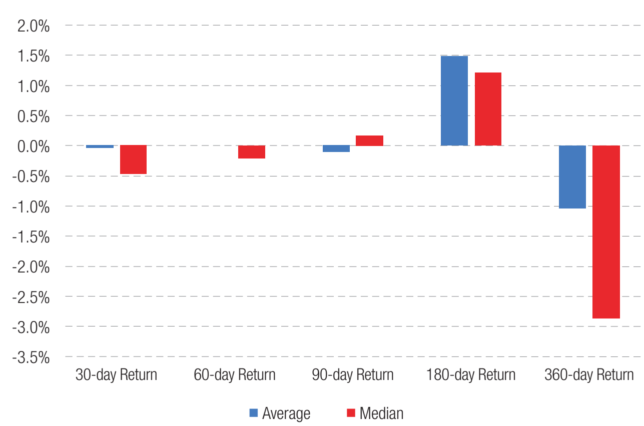
Understanding the implications of all-time highs

With the market notching new all-time highs, we answer two questions in this issue that we believe are top-of-mind for many investors, especially those still sitting on the sidelines. The first question is: "How does the market perform after an all-time high?" Using data from January 1928 to October 2019, we show that the S&P 500's performance in the short window (30, 60, and 90 days) after reaching an all-time high is indistinguishable from how it would typically perform. In other words, the market does not assign any special importance to a new all-time high in the trading days and months immediately following that achievement.

However, 180 days after an all-time high is reached, the data suggests that the S&P 500 on average registers a return that is higher (1.5%) than typical. We think that herd mentality is partly responsible for this higher performance. Investors that stayed on the sidelines during a rally to new highs are unlikely to rush into the market immediately. However, they do so after waiting for some months out of the fear of missing out (FOMO), especially if there are short-term selling pressures that provide good entry points.

Lastly, our research finds that there is a reversal that occurs when performance is viewed over a somewhat longer window, in this case 360 days. On average, we find that the S&P 500 is lower (-1.0%) than typical 360 days after reaching an all-time high. The median performance compared with typical (-2.9%) is even worse. We believe this reversal is due primarily to valuation multiple contraction, as all-time highs often coincide with peak valuations.

S&P 500 Excess Return After Hitting All-Time High



Source: Key Private Bank

The second question we address is: "How soon after an all-time high does a recession typically occur?" Conventional wisdom suggests that all-time highs are often products of irrational market exuberance that then results in boom and bust cycles. Admittedly, some of this is colored by recency bias from the Global Financial Crisis, when the S&P 500 peaked a mere two months before the official start of the recession. The answer to this second question, according to our research, is a little more nuanced.

First, a few observations. Our research finds that all-time highs are rare, occurring only about 5% of the time. They also tend to occur in clusters, and it is highly unlikely for an all-time peak to occur during a recession, especially in the early months of a downturn. In fact, of the 14 recessions that have occurred since 1928, there was only one (1929, the start of the Great Depression) when the S&P 500 reached new highs after the official start of the recession.

Due to the clustering of all-time highs, several occur in the months and years leading to most of the recessions we analyzed. Justifying the choice of one or all proved a challenge, so we anchored our analysis on the National Bureau of Economic Research (NBER) official recession start month, with the assumption that the recession started on the first day of the month. From the recession start date, we then looked back to find the last all-time high prior to this date. This data is shown in the table below.

We find that the median number of days before the official start of a recession and the previous all-time high is 353 days. However, as shown in the table, there is a broad range, making this median somewhat misleading. Excluding the 1980 recession, when the previous all-time high occurred several years earlier (January 1973), the start of every recession since 1957 occurred a year or less after the S&P 500 reached an all-time high. We can thus conclude that each time the S&P 500 hits a new record high, the occurrence of a recession within the next 12 months is not a far-fetched possibility. We will be watching economic data closely to determine if such unfolds again.

US equities

In October, the Russell 3000 index was up 2.2% with small cap equities (+2.6%) slightly outperforming large cap (+2.1%) stocks. Growth (+2.8%) recovered marginally from last month's underperformance against value (+1.5%) and still dominates value by +7% year-to-date despite value's much-trumpeted recent resurgence. Healthcare (+4.8%) was the best performing sector, although it remains the second-worst sector in terms of performance on a year-to-date basis due largely to perceived political risks. Technology (+4.1%) was equally strong, while Energy (-2.4%) remained in the doldrums and is barely up (+1.3%) on the year.

All-Time Highs and Recessions

NBER Recession Start Date	S&P 500 Prior High Date	Days Between
August 1, 1929	July 31, 1929	1
May 1, 1937	September 6, 1929	2,794
February 1, 1945	September 6, 1929	5,627
November 1, 1948	September 6, 1929	6,996
July 1, 1953	September 6, 1929	8,699
August 1, 1957	August 2, 1956	364
April 1, 1960	August 3, 1959	242
December 1, 1969	November 29, 1968	367
November 1, 1973	January 11, 1973	294
January 1, 1980	January 11, 1973	2,546
July 1, 1981	November 28, 1980	215
July 1, 1990	June 4, 1990	27
March 1, 2001	March 24, 2000	342
December 1, 2007	October 9, 2007	53
Median		**353**

Sources: NBER, Key Private Bank, S&P

From a factor perspective, Low Volatility (-0.2%) had a dreadful month, giving back almost all of its third quarter relative outperformance over the S&P 500. However, this performance is in line with our expectations, as the Low Volatility factor tends to underperform during risk-on and rising interest rate environments. Momentum (+0.6%) also lagged the S&P 500 while Quality (+2.2%) matched it.

Developed ex-US

Developed international markets (+3.5%) had a stellar month, outperforming the US for the second consecutive month. Major economies like Germany (+5.9%) and Japan (+5.0%) recorded strong gains that were aided by the announcement that the US and China had reached a partial Phase One agreement in principle and by a strong euro (in the case of Germany). With positive Brexit news, the UK pound rallied more than 5% against the US dollar, helping to offset the poor local currency returns of the UK equity market.

Emerging markets

Emerging markets were the strongest regional equity market in October, with Russia (+8.6%), Taiwan (+7.7%), and Brazil (+6.3%) leading the pack. Brazil cut interest rates for the second consecutive month to a new all-time low of 5% and approved pension reforms that are projected to save the government $200 billion over the next 10 years.

Fixed Income

A small dent is recorded in the long bond as the Energy sector hurts high yield.

US Treasuries were flat for the month with the long bond losing 86 basis points (bps)—although it is still up 18.7% year-to-date—while the intermediate bond was up 29 bps. Investment-grade corporate bonds (+0.6%) outperformed high yield (+0.3%). All sectors within high yield were positive with the exception of Energy (-2.3%), which was a severe drag on the overall index.

Alternatives

Returns are muted across the board.

Hedge funds

The HFRX Global Hedge Fund index was up 0.3%, bringing its year-to-date performance to +6.2%. Event-driven strategies (+1.3%) had a solid month while macro and CTA (Commodity Trading Advisor) strategies (-1.4%) struggled.

Real estate

US REITs were up 1.0% with manufactured homes (+7.3%) leading the pack. Manufactured homes are up 54% year-to-date and have annualized at over 24% each of the last 10 years. Self-storage (-6.6%), malls (-4.1%), and hotels (-3.0%) were the worst performers.

Commodities

The S&P GSCI was up 1.2% led by precious metals; palladium was up 6.7% while silver rose (+6.2%), with energy (+0.9%) pulling the index down. Industrial metals (+1.7%) were up with the exception of iron ore (-5.9%) and nickel (-2.1%) even though both metals are still up about 60% on a year-to-date basis.

Tactical Asset Allocation

Neutral on equities.

Using our Dynamic Allocation Research Tool (DART), we continue to maintain a defensive stance in our tactical asset allocation recommendations. DART's macroeconomic pillar remains at its worst possible level, driven by the weak macro expectations data (e.g., PMI and business conditions indices). The investor sentiment pillar is improving, although it is still at a neutral level. The corporate fundamentals pillar is also unchanged, remaining positive and reflecting the strength of the corporate sector with the consumer as the linchpin.

We remain neutral in our stock and bond positioning and overweight the US at the expense of international markets while emphasizing low volatility stocks. We continue to maintain a neutral duration within our fixed income portfolios.

The table on page 5 summarizes our current top-level tactical asset allocation recommendations.

Key Private Bank Asset Allocation Recommendations as of November 2019

Stocks	Bonds	Cash	Alts/Diversifiers
Neutral	Neutral	Liquidity Source	Emphasize

Equity Geographic Emphasis

United States	International – Developed	International – Emerging
Emphasize (defensive tilt)	De-emphasize	De-emphasize

Fixed Income Sector Emphasis

Treasuries	Investment Grade Credit	High Yield
Neutral	Neutral	De-emphasize

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