Key Investment Perspectives

June 2020

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Global Equities

After a dismal March, coordinated global efforts helped drive risk assets higher in both April and May as the virus case curve started to flatten, and the gradual process of reopening the global economy began. Markets also took hope that potential COVID-19 treatment options have begun to emerge and that a coronavirus vaccine could be available before the end of the year. At the same time, all 50 US states have started the reopening process in phases. Both China and South Korea have largely reopened, including schools. In Europe, most countries have begun easing restrictions, including those on schools and sporting activities.

Continued investor optimism has led to a broad-based rally where almost every sector and factor recovered considerable lost ground. The S&P 500 Index continued to march upward and posted a 4.8% gain in May, while the small cap Russell 2000 Index increased by 6.5% in the month. Equity markets seem to have priced in a sharp economic turnaround. It took the S&P 500 only 16 days to move from a bull to a bear market — the fastest such decline on record — and the upswing has been just as dramatic. After hitting its trough on March 23, the S&P 500 had technically entered bull territory (20% above its low) by April 7; by the end of May, it had advanced by approximately 36% from its bottom. It is noteworthy that currently, during the nation's most significant economic crisis in 90 years, the US equity market is trading only 10% below its all-time high. While earnings are expected to take a substantial hit in the near term, investors are betting that policy support will provide a backstop for earnings.

Although the trade-weighted US dollar index fell by 1.2% during May, providing a boost to non-US equities, US stocks still outperformed their non-US counterparts by 1.8% (4.8% vs. 3%). Although both European and Japanese stocks performed well (both up 5.9%), US equities outpaced developed market (4.1%) and emerging market (0.6%) indices.

May Market Data

Asset Classes	1 Month	3 Month	YTD	1 Year
US All Cap	5.35	2.89	-5.63	11.46
US Large Cap	5.28	3.44	-4.91	12.54
US Small Cap	6.51	-5.18	-15.95	-3.44
US Large Cap Growth	6.71	10.45	5.23	26.25
US Large Cap Value	3.43	-4.61	-15.70	-1.64
US Small Cap Growth	9.45	1.74	-6.65	7.32
US Small Cap Value	2.87	-12.95	-25.65	-14.69
Developed International	4.57	-3.63	-14.26	-2.43
International Emerging Markets	1.04	-7.66	-16.03	-4.99
US Treasury	-0.25	3.28	8.61	11.36
US Investment Grade	1.56	-0.68	3.00	10.03
US High Yield	4.41	-3.39	-4.73	1.32
Municipal Bonds	3.18	-1.81	1.24	3.98
Real Estate	1.71	-9.99	-15.26	-7.33
Commodities	4.34	-10.42	-21.20	-17.06

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

For the month, US equities also handily outpaced other major assets, including gold (by 2.5%), Treasuries (by 4.5%), and investment-grade corporate bonds (by 3.1%). However, on a year-to-date (YTD) basis, US equities (-5.0%) have underperformed most asset classes except non-US equities.

Another sign of a market thaw was evident from the VIX, an index designed to measure equity market volatility. The VIX (also known as the "Fear Gauge") rises during times of market turbulence and starts to level off as volatility recedes. The indicator rose to an all-time high of 83 on March 16 to surpass its past peak of 80 during the 2008 Global Financial Crisis (GFC), although it has since declined by more than 60% to end the month at 28. While the decline is reassuring, the VIX is still well above its historical average of 20 and more than twice the value seen at the beginning of the year.

May flowers

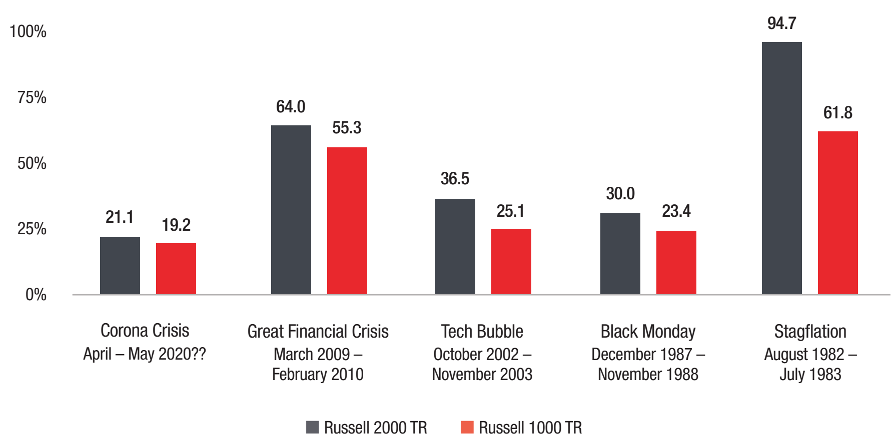
All sectors posted positive returns for May. Communication services led the way, returning 7.4% as it continued its strong run this year. The sector is now up 1% YTD. Technology had a strong showing as well, returning 7.2% through month-end. Healthcare also turned positive for the year (1.7%) after posting a substantial 3.3% gain for the month. Bond proxies and defensive sectors like real estate (1.8%) and consumer staples (1.7%) all lagged in the broader market as investors continued to pay for growth.

Among factor groups, Momentum (up 6.8%), Quality (5.9%), and Size (5.3%) led during the month amid the strong market recovery. Value (0.8%) and Minimum Volatility (4.3%) lagged as defensive positions came under pressure. Quality has remained an outperformer throughout the recovery and maintained its dominance over other factors. It is now up 0.4% YTD, followed by Momentum (-5%) and Minimum Volatility (-5.8%).

The Dividend factor outperformed the S&P 500 during both the 2000 – 2002 tech-led downturn and the 2008 global financial crisis (GFC). This time around, however, the factor underperformed both during the downside (down 13.7% vs. S&P's decline of 12.4% in March) and on the upside (up 16.4% during April and May vs. 18.2% for the S&P 500). Dividend payers tend to be stable, value-orientated companies, and reside in sectors like Financials, Consumer Staples, and Utilities. The nature of the pandemic and subsequent recovery has led investors to dismiss value and low volatility in favor of high-growth sectors like Technology and Communication Services, which tend to retain excess cash flows. There is also a growing concern that many dividend payers will suspend or cut their dividends. In the first five months of 2020, 18 companies within the S&P 500 have lowered their dividends, and another 40 have announced dividend suspensions. During the full year of 2009, the year following the GFC, 10 S&P 500 companies suspended dividends while 68 cut them.

While small cap stocks traditionally lag their larger cap peers in a downturn, they tend to outperform during rebounds. Accounting for nearly half of US economic activity, smaller companies are generally cyclical and tend to bear the brunt of an economic downturn. Earlier this year, the small cap Russell 2000 Index slid 41% from peak to trough, while the large cap Russell 1000 dropped 34%. However, smaller companies also tend to be the largest beneficiaries in the recovery phase of an economic cycle. Consider the latest few downturns and recoveries: In each of them, small cap stocks handily outperformed their large cap counterparts (see the graph below). Investors seem to be betting once again that small cap stocks, which tend to have lower overseas exposure, will benefit more from US economic stimulus and recovery.

1-Year Performance After a Bear Market

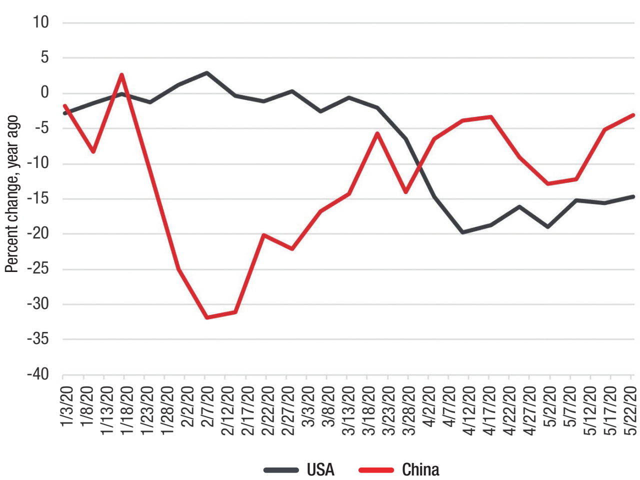


Sources: Morningstar, Key Private Bank

Debt, deficit, and deflation

The COVID-19 pandemic resulted in most of the world's population being confined to their homes, causing economic activity to stagnate and supply chains to stretch to the breaking point. At its peak, more than half of the world's population and 90% in the US were under some form of movement restriction. The extraordinary situation led to both the US Congress and the Federal Reserve (Fed) providing one of the largest economic stimuli in history. Congress has already sanctioned nearly $3 trillion in spending to battle the economic crisis. Additionally, the Fed has pledged an additional $2.3 trillion in new facilities to support businesses and local governments directly. The combination of the stimulus and the flattening of the disease curve has helped the expectation that the US economic contraction may be bottoming, and there are several early signs that economic activity may be picking up (see graph below). Data indicate that the Chinese economy has mostly returned to pre-COVID levels, whereas the US recovery is starting to take shape.

Coronavirus China and US Economic Activity Tracker



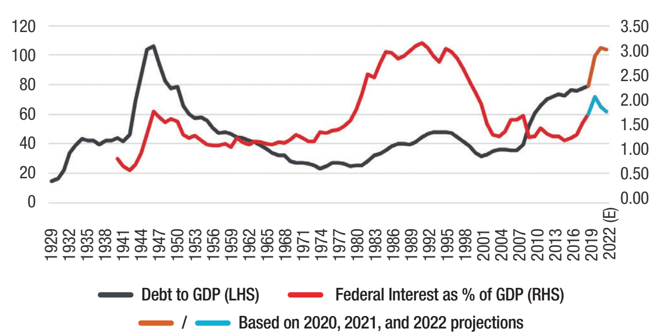
Sources: Goldman Sachs, Key Private Bank

While risk assets have shown a remarkable recovery, the economic news has remained abysmal. During the first quarter, the US economy contracted on an annualized basis by 5.0%, while China and the euro area fell by 14.4% and 34.7%, respectively. While the Chinese economy has largely reopened, both US and the euro area will likely feel the real impact of the shutdown during the second quarter. To try and ease the burden of the COVID-induced lockdown, governments around the world have gone into a borrowing and spending spree. The US Treasury is expected to borrow some $3 trillion during the current quarter to finance the COVID-related spending programs enacted so far, bringing the projected 2020 fiscal-year deficit to around $4.5 trillion (15% of GDP). While spending to protect businesses and households was necessary to protect the economy from financial ruin, one of the distressing results of this record borrowing is that we will likely be dealing with the consequences for years to come.

The US government has two broad strategies it can adopt to reduce its debt burden, neither of which is cost-free.

The first option is to follow the austerity policies most governments implemented after World War II. Funding the war led to the US borrowing at an unprecedented rate, resulting in a debt-to-GDP ratio of 106%. Higher taxes, demographic-boom-led growth, controlled spending, and high inflation helped drive the gross debt-to-GDP ratio down to 28% (see graph below).

Federal Government Debt and Its Cost



Sources: CBO, OMB, Bloomberg, Key Private Bank

A demographic boom similar to the one experienced by the US in the 1950s and 1960s is unlikely. Similarly, austerity in the form of higher taxes is generally frowned upon in an aging society like ours. Older populations (the median US age has moved up to 38 years vs. 28 years in 1970) tend to favor lower taxes and prefer high public spending on healthcare (Medicare) and pensions (Social Security).

Further, higher taxes can result in higher inflation and lower growth. Higher inflation is generally beneficial for a young workforce (rising wages); on the other hand, retirees dislike inflation since they work less and rely on their savings and pensions for income. They also tend to spend more of their income on inflation-sensitive items (food, healthcare, etc.) than their younger cohorts.

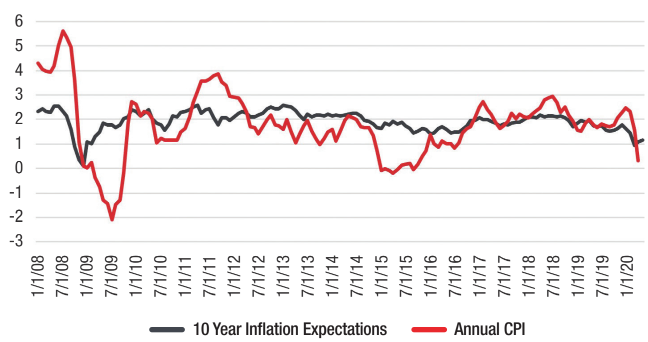
The second option is to focus on keeping interest rates (the cost of financing debt) very low and try to grow out of the problem over time, which is Japan's approach. In its latest fiscal year, Japan's debt as a percentage of its GDP was an incredible 239%. Although Japan has been supporting ever-increasing deficits for almost three decades, its interest rates are currently below zero.

A country that issues debt only in its local currency, maintains a flexible exchange rate, and regulates its central bank rarely experiences a borrowing crisis. If citizens of a country own the debt issued by that country, the country owes money to itself. In theory, bond investors should be asking for higher interest rates to absorb an ever-larger supply of debt. However, such pressures are alleviated when the central bank keeps key interest rates very low and purchases large amounts of government debt. At the same time, regulators compel institutions (banks, insurance companies, corporations, etc.) to keep excess reserves in government securities.

The Bank of Japan has set its benchmark rates at -0.10% and owns more than 50% of the total Japanese central government debt. Other Japanese institutions own an additional 40% of that debt. To support the US economy, the Fed has reduced interest rates to near zero, increased its balance sheet by purchasing $3 trillion of US government securities since mid-March, and pledged to keep interest rates low for the foreseeable future. Further, the Fed will continue to buy large quantities of US government securities.

A common concern among opponents of such a strategy is the fear that deficit financing inevitably leads to higher inflation and low growth. In the current economic environment where economic activity has plummeted, unemployment is likely to stay elevated, and demand remains subdued for some time; large deficits are unlikely to lead to high inflation rates in the short run. Historically, inflation has fallen during and after recessions as the economy takes time to normalize. Indeed, markets believe that higher inflation is unlikely to be a significant concern anytime soon. Investors currently expect inflation to average 1.2% for the coming decade, versus the long-term average (past century) of 3.2% and 1.8% over the last 10 years (see graph below).

Actual and Expected Inflation



Sources: Bureau of Labor Statistics, Bloomberg, Key Private Bank

The US government has a difficult decision to make in terms of how much stimulus to offer and which measures to implement tomorrow to manage the resulting debt overhang. In economic theory, there is no such thing as a free lunch, and society will have to address the additional spending in one form or another. Austerity is one option, financial repression (keeping rates low for longer) another. We will likely be dealing with the spillover effects of the pandemic for many years to come.

Fixed income

Treasury rates were mostly flat across most of the yield curve as Fed purchases of US Treasuries kept a cap on yields. The 10-Year Treasury ended the month with a yield of 0.65%, up 0.03% from April. Treasury rates rose modestly at the very front (less than 1-Year) and long ends (20+ Year) of the curve: The combination of record Treasury issuance and investor confidence over the state of recovery drove investors away from safe but low-yielding securities and into higher-risk assets. Overall, Treasury rates are unlikely to move significantly in the near term as the Fed continues its record purchases, and market demand for risk-free assets remains robust.

Short- and intermediate-term Treasuries were modestly positive for the month (0.1% and 0.3%), bringing their YTD total returns to 3.0% and 9.5%, respectively. Long-duration bonds broke their record-breaking streak as the newly issued 20-Year Treasury saw limited market interest. For the month, long-dated Treasuries posted a return of -1.9%, taking total returns to 21.1% for the year.

Despite ongoing economic strains, the credit market rallied alongside other risk assets and delivered strong returns. Investment-grade spreads continued to tighten based on optimism over the reopening of the global economy and news that the Fed had purchased $1.3 billion in credit-related ETFs. The US Credit Index was up 1.6% for the month and 3.3% for the year. The high-yield market was also helped by a combination of the energy market recovery and record retail inflows. A strong showing in March (4.5%) was followed by another positive performance in April (4.4%). Since their March highs, high-yield spreads have compressed by a remarkable 450 basis points (bps).

After struggling in March and April, municipalities returned 3.2% in May, their best performance since September 2009. The broad-based municipal rally is another sign of the broader capital markets normalization. It has benefited from crossover buyers (banks, insurance companies, etc.) hunting for bargains along with the return of retail investors. While investment-grade municipals have rallied the most, high-yield municipals have participated in the rally as well with yields on bellwether credits moving lower.

As a reminder, we prefer a modest overweight to investment-grade bonds and reiterate the importance of maintaining a quality bias in the fixed income allocation. We believe the distress and default cycle has only just begun and are thus taking a cautious approach to fixed income investing.

Alternatives

Commodities

After posting an unprecedented negative price last month (-$37.63 on April 20), WTI crude oil spiked 88% in the month of May to $35.49, marking its best monthly performance. The energy rally was driven in part by a dramatic oil production decline in the US, where the active rig count is down to 301, the lowest level in over three decades. At the same time, demand for oil started to increase as mobility across the US began to rise. Demand for gasoline reached 7.253 million barrels per day, an increase of 45% from April lows and 20% below the same time last year.

While energy was the best performer, most commodities posted strong returns in May. Signs of bottoming economic data suggest that investors are willing to bet that demand for commodities is bouncing. That enthusiasm led the S&P GSCI Commodities Index to return 16.4 % in May, its best monthly performance since May 2009.

Real estate

Publicly traded real estate investments declined by 0.3% during the month and are now down 19% for the year. Real estate securities, which are highly correlated to interest rates, struggled as rates remained mostly flat for the month. Retail and office remained trouble spots as investors continued to assess the long-term impact of COVID-19 on consumer and business behavior. Industrial and healthcare remained bright spots as demand for e-commerce and medical facilities are expected to remain robust in a post-COVID world.

Hedge funds

The HFRX Global Hedge Fund Index posted another strong month, rising by 1.4% in May (-2.8% YTD). Overall, hedge fund returns were positive across all core strategies. Event-Driven (up 2%) and Multi-Strategy (up 2%) rose the most for the month but are down 1% and 0.8% YTD, respectively. Macro/CTA strategies, which were up 0.2% for the month, have delivered the highest return this year and are down a modest 0.5% YTD. Equity Hedge Funds posted another strong month (1.3%) but remain the worst performer YTD (-8.3%).

This year's volatility is a good reminder of why hedge funds should be an integral part of a well-diversified portfolio. Alternative strategies tend to have low correlations with traditional risk assets and seek to deliver returns through a variety of unconventional, unconnected strategies. Hedge funds can help lower portfolio volatility and enhance risk-adjusted performance.

Tactical Asset Allocation

De-emphasize equities but overweight to the US

Key Private Bank uses a proprietary, systematic strategy called DART (Dynamic Allocation Research Tool) to help guide our asset allocation decision-making. In March, DART's view on stocks turned negative. Consequently, we changed our recommendation to a modest underweight to equities and will maintain that stance until DART's signal changes to positive. Similarly, DART recommends a shift away from the international markets in favor of the US due to the safe-haven nature of the domestic marketplace.

We maintain our neutral recommendation to fixed income but prefer investment-grade corporate and municipal bonds over US Treasuries as the massive US fiscal assistance and Fed actions continue to provide support to US businesses. Similarly, given the current market environment, we continue to favor a modest allocation to high-yielding opportunistic fixed income strategies, but only through skilled active managers. They have experience in successfully navigating volatile markets.

We are maintaining our recommendation that alternatives can provide valuable diversification benefits for the right client. We are also recommending holding higher-than-average cash balances to enable investors to deploy capital as opportunities arise.

Key Private Bank Asset Allocation Recommendations as of June 2020

Tactical Asset Allocation

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

Equity Geographic Emphasis

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

Equity Factor Emphasis

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

Fixed Income Emphasis

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

For more information, contact your Key Private Bank advisor.

About the Author

Ather Bajwa is a Senior Lead Research Analyst responsible for the areas of Fixed Income, Real, and Alternative Assets at Key Private Bank. Ather has more than 15 years of experience working in portfolio analysis roles within fixed income, equities, asset management, funds investing, and alternative asset areas.

Ather collaborates with investment professionals across the firm to develop fixed income and real asset models to optimize investor returns and craft strategic plans for fund managers based on their criteria. In that role, he manages and creates models, identifies new fund opportunities, maintains and develops a strong network of contacts with outside managers, conducts manager meetings, writes due diligence reports, reviews and updates fund reports, and recommends investments funds.

Previously, he served as the Director of Research for SGL Investment Advisors, Inc. While at SGL he build complex financial valuation and pro-forma models to forecast earnings quality, project financial statements, and evaluate enterprise value.

Ather is a Certified Public Accountant (CPA), holds an MBA in Finance from the University of Montana, and is a Certified Financial Analyst charterholder.