Key Private Bank

# Key Investment Perspectives

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## Global Equities

In terms of influence, the Federal Reserve (Fed) is clearly the premier institution in global markets. Changes in its policy rate or pace of asset purchases have an outsized impact on market pricing, liquidity, and risk-taking sentiment amongst investors in almost all assets. Because of this, any move the Fed makes is closely anticipated and endlessly scrutinized. That's why its most recent policy announcement was so keenly followed.

In late August, Fed Chairman Jay Powell rolled out changes to the way the central bank would prioritize its dual mandate of maintaining both price stability and maximum employment. In acknowledging the shortfalls of its "broad-based and inclusive goals" of full employment, the Fed announced it would shift its inflation target from 2% to "2% on average," thereby allowing for a period of inflation greater than 2% to account for previous shortfall. On the surface it sounds like a subtle change to policy language; however, the change codifies the Fed's willingness to tolerate a higher-than-2% inflation rate if/when we ever get there. The implication was clear: The Fed should be expected to delay raising interest rates if inflation rises, and we should instead expect it to allow additional upward pressure on prices to support its recently emphasized mandate of maximum employment. Unsurprisingly, the Fed was ambiguous on the details and did not provide guidance on the time period policy makers would use in considering "average" inflation. The trailing 10-year inflation rate using the Core Personal Consumption Expenditures Price Index (the Fed's choice of inflation measures) has averaged just 1.6%, so there is ample slack for the Fed to work with already. St. Louis Fed President James Bullard was on the record that future inflation could be allowed to run half a percentage point above the 2% target "for quite a while." August seemed to mark a new level for Fed dovishness.

**August Market Data**

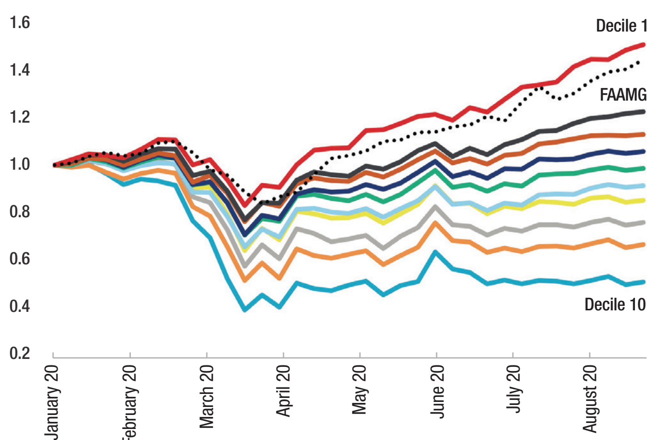
| Asset Classes | 1 Month | 3 Month | YTD | 1 Year |
|---|---|---|---|---|
| US All Cap | 7.24 | 15.93 | 9.39 | 21.44 |
| US Large Cap | 7.34 | 16.14 | 10.43 | 22.50 |
| US Small Cap | 5.63 | 12.40 | -5.53 | 6.02 |
| US Large Cap Growth | 10.32 | 23.98 | 30.47 | 44.34 |
| US Large Cap Value | 4.14 | 7.53 | -9.35 | 0.84 |
| US Small Cap Growth | 5.87 | 13.71 | 6.15 | 17.28 |
| US Small Cap Value | 5.39 | 10.68 | -17.71 | -6.14 |
| Developed International | 5.30 | 12.24 | -3.77 | 7.63 |
| International Emerging Markets | 2.24 | 19.60 | 0.43 | 13.23 |
| US Treasury | -1.10 | 0.13 | 8.75 | 6.98 |
| US Investment Grade | -0.81 | 1.31 | 6.85 | 6.47 |
| US High Yield | 0.95 | 6.72 | 1.67 | 4.71 |
| Municipal Bonds | -0.47 | 2.04 | 3.31 | 3.24 |
| Real Estate | 0.14 | 6.36 | -9.87 | -8.05 |
| Commodities | 6.76 | 15.43 | -9.04 | -3.90 |

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

Dovish Fed policy has been an important driver of the impressive recovery of equity prices since the market bottomed in late March. The decisive slashing of policy rates and aggressive asset purchases induced investors to return to the market, and in August the S&P 500® Index reached new record highs. The index ended August up 57% from March lows, and it took just five months to return to record levels. That is an impressively short cycle for such a profound economic event. Put in context, it took more than six years for the S&P 500 to reach new highs from the start of the drawdown in both the Tech Bubble of 2000 and the Global Financial Crisis (GFC) of 2007.

Nothing about this market recovery has been ordinary. Not only has it been faster than in the aftermath of comparable crises, but it's been narrower in scope too. Even though the S&P 500 reached new record highs in August and finished the month up nearly 10% for 2020, more than 50% of the stocks in the index were still down for the year. The leadership and outperformance of the FAAMG mega-cap growth stocks (Facebook, Apple, Amazon, Microsoft, Google) have helped power the cap-weighted index to new highs. These top-five stocks in the S&P 500 now account for almost 23% of the index, a record level of concentration.

**Performance Deciles of S&P 500 Constituents**




Sources: S&P, Reuters, Key Private Bank

A traditional recovery in equity markets is typically led by economically sensitive stocks that were overly discounted during the sell-off. In other words, value and cyclical equities typically outperform during the early phases of recovery. The current rebound has instead been led by resilient growth stocks that have been grinding toward higher and higher valuations. For example, Apple was up more than 75% on a year-to-date (YTD) basis through the end of August and trading at nearly 35x forward earnings. During the month, Apple's market cap surpassed $2 trillion to make it the world's most valuable company, eclipsing the $1.9 trillion market cap of recently listed Saudi Aramco in Saudi Arabia (with its 300 billion barrels of oil reserves).

The narrow leadership of growth stocks this year is not a new phenomenon: Growth stocks have performed better than value equities for more than a decade now. This year that dynamic has gone parabolic; while the growth/value divergence is most dramatic in US large caps, the gap is found across geographies and cap sizes. Wherever you look, growth has trounced value.

**Year-to-Date performance thru Aug. 31, 2020**

| | Growth | Value | Difference |
|---|---|---|---|
| US Large Cap | 30.5% | -9.4% | +39.8% |
| US Mid Cap | 15.5% | -10.8% | +26.3% |
| US Small Cap | 6.2% | -17.7% | +23.9% |
| International | | | |
| – Europe | 5.3% | -16.7% | +21.9% |
| – Japan | 7.0% | -10.0% | +17.0% |
| Emerging Markets | 13.5% | -12.2% | +25.7% |

Sources: MSCI, Russell, Key Private Bank

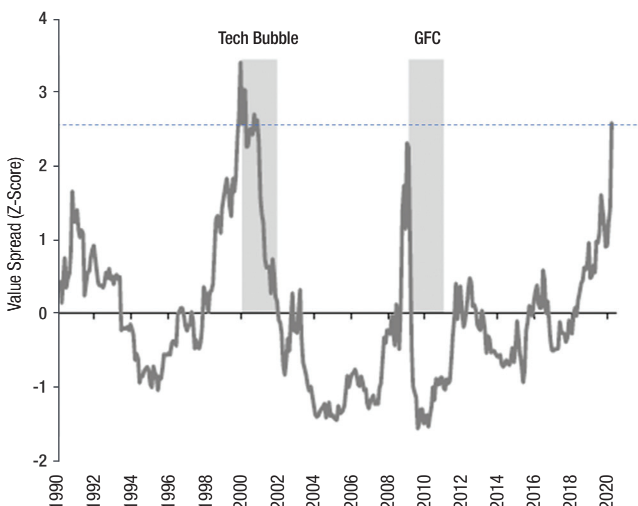
Why is this the case? Why have investors been flocking to growth stocks? Here are a few leading narratives that we've heard:

- Growth stocks in industries like communications, technology, software, and pharmaceuticals typically have exciting storylines that captivate investors. Many are key beneficiaries of digital disruption, and the recent backdrop of COVID-19 has only accelerated this momentum.
- Lower nominal GDP growth creates growth scarcity, which may result in a scarcity premium for those stocks that demonstrate resilience and staying power in growing earnings.
- Growth stocks tend to do well in a lower interest rate environment, which favors securities with longer-dated cash flows.

These stylized arguments in favor of growth possess some degree of truth, but they overly simplify what is otherwise a complicated, noisy, and confounding history of growth over value. Our research into the topic reveals more nuanced results. When we explored the falling interest rates argument, using both Treasury futures and term premiums, we found that interest rates and interest rate risk explain less than 10% of growth's outperformance over value since the GFC. When we analyzed the growth scarcity argument, we had a difficult time reconciling growth's strong outperformance in 2017/18 just as a coordinated global GDP growth cycle emerged. Growth was less scarce in that environment but still meaningfully outperformed. We're also aware that the academic research remains inconclusive on the relationship between GDP growth and corporate earnings. The leading narratives attempting to explain growth's outperformance disappoint when you dig deeper into the data.

The perennial argument for value stocks is reversion to the mean. Proponents of value argue that at some point the value spread, which is broadly defined as the valuation premium of growth stocks over value stocks, becomes stretched relative to what the fundamentals might warrant. At these higher valuations, growth stocks are quicker to disappoint lofty expectations, while cheaper value stocks might find it easier to positively surprise on their lower expectations. AQR Capital Management tracks global value spreads; according to its analysis, growth stocks are in the 99th percentile in terms of being expensive compared to value. The only time growth has been more expensive was at the peak of the Tech Bubble in 2000.

**Valuation Spreads (Growth minus Value)**




Sources: AQR, Key Private Bank

Valuation spreads are close to all-time highs, reflecting that growth businesses have a far stronger earnings outlook compared to value. Netting faster growth with richer valuations is not as simple as it sounds: Growth is expensive for a very good reason, and valuations can be a poor tether for relative performance. At Key Private Bank, we appreciate the uncertainty in the growth vs. value equation and advise a balanced approach. Trying to time when value will turn around is not worth the risk in our opinion. Instead, given the uncertainty about how the COVID-19 recovery will play out, we continue to favor a quality bias in equity portfolios. Quality equities are those with relatively higher margins, higher returns on capital, and lower financial leverage.

## Equities

The S&P 500 Index was up 7.2% for the month for its best August since the mid-1980s, bringing 2020 YTD returns to 9.7%. Growth shares outpaced value stocks by more than 6% during the month at 10.3% vs 4.1%, respectively. Equity investors continued to price in an increasingly dovish Fed and meaningful progress on the COVID19 vaccine front, where there is now chatter that a vaccine could receive fast-track approval from the FDA by as early as November.

The Russell 2000 Index of US small cap stocks was up 5.6% for the month but remains down 5.5% in 2020. Similar to growth over value, large caps have meaningfully outperformed small caps this year.

Internationally, developed markets ex-US were up 5.3% during the month while emerging markets rose 2.2%. China has been a bright spot in international markets despite the challenges that it faces in trade wars and political flareups in Hong Kong and along the border with India. The onshore Chinese A share market is up more than 25% this year.

## Fixed Income

The Bloomberg Barclays Aggregate Bond Index (Agg) was down 0.8% in August. Treasuries fell 1.1%, investment-grade corporates were down 1.4%, and mortgages were essentially flat in the month. The Agg is still up 6.8% on a YTD basis as yields across the curve have come down sharply: Index yields have declined over the past year by approximately 100 basis points (1.00%), from 2.13% to just 1.15%.

Unless the zero bound on interest rates breaks down in the US, investors should expect future long-term returns from bonds to be weak. Investors have grown accustomed to attractive returns and diversification in their fixed income allocation: A 30-plus-year bull market in rates will do that. But going forward, the lower bound on rates will be tough to accommodate optimistic expectations, and investors should consider that a balanced allocation to bonds might return just 1-2% annually. At Key Private Bank, we're carefully contemplating implications for traditional asset allocation and evaluating if an alternative approach might be warranted.

## Alternatives

### Commodities

While the Bloomberg Commodity Index was up 6.7% in August, it is still down 9% for the year. Interestingly, precious metals were mixed, with gold down 0.4% while silver was up more than 17%. Gold is up 26.6% this year and has commanded more than its regular share of mind as investors consider its role in a portfolio. In August we published a Key Questions article, How Has Our View on Gold Evolved?, revisiting our view on gold in an investment portfolio.

Even though we've historically seen a very narrow use for gold as an investment, we noted that there were three conditions that could trigger a tactical recommendation. Gold can be an attractive asset in an environment where 1. real interest rates decline to zero or below, 2. increased coordination occurs between the Fed and the Treasury to finance expanding fiscal deficits, and 3. geopolitical events occur that might destabilize the value of the US dollar. We've moved closer to each of these conditions over the past year, and spot gold prices have responded accordingly.

Energy was up during the month, with crude oil gaining 5.1% and natural gas increasing 37%.

### Real Estate

Up 0.6% in August, public real estate investment trusts (REITs) continue to lag equity markets. The diversified index is now down almost 10% for the year. COVID-19 has shaken up the outlook for various property types, and the result has been a wide dispersion of returns. The biggest beneficiaries have been data centers, infrastructure, and industrial, with YTD returns of 32.5%, 14.0%, and 11.7%, respectively. For context, single-family home REITs are flat YTD. The biggest losers for the year are regional malls (down 51.1%) and lodging/resorts (down 47.7%). Retail overall is down 37.3% YTD as the trend toward e-commerce did nothing but accelerate through the lockdown.

### Hedge funds

Global hedge funds were up 1.5% in August, bringing year-to-date returns to 1.8%. The universe of hedge fund strategies has experienced a wide dispersion of returns. The worst-performing segment is equity long/short, with the HFRX Equity Hedge Index down nearly 3% this year. On average, event-driven and relative value managers have performed best and are each up approximately 4.2%.

Broadly speaking, hedge funds behaved as expected during the drawdown in the first quarter of 2020, outperforming a traditional 60/40 portfolio by approximately 300 basis points. Going forward, elevated volatility and uncertainty should make for an opportunity-rich environment for hedge fund managers. We continue to recommend a diversified basket of low-beta hedge funds for appropriate portfolios, where we believe investors can earn returns of 5-7% annually with volatility similar to core bonds.

## Tactical Asset Allocation

We last changed our tactical asset allocation earlier in the summer when we increased our equity allocation to neutral to reflect improving economic trends and visibility around the impact of COVID-19. Within equities we continue to favor the US vs. developed international markets and remain neutral with regard to emerging markets. The US continues to be the most dynamic market and is home to a disproportionate share of digital disruptors. In the emerging markets, China scores well on this front too. We do not want to be positioned against either.

Within fixed income we prefer investment-grade corporate bonds over Treasuries based on the potential for further spread tightening. Spreads have tightened meaningfully since March highs and ended August near their long-term averages. We believe that the impact of the Fed's intervention will push spreads even tighter. As previously mentioned, a balanced allocation to bonds has relatively low expected returns. Accordingly, some investors might consider a low-beta hedge fund portfolio, funded predominantly from fixed income, as a potential return enhancer.

**Key Private Bank Asset Allocation Recommendations as of August 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. |

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

## About the Author

Justin Tantalo has 15 years of experience in investment management, both in Asset Allocation and Fund Management. As a Senior Vice President with Key Private Bank, Justin applies his expertise in Asset Allocation and helps oversee the equities and alternatives third-party manager research effort. Justin received an MA in Economics from the University of Waterloo (Canada) and BA in Economics from the University of Western Ontario (Canada). Justin is a CFA Charterholder.

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