Key Private Bank

Key Investment Perspectives

November 2020

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Market overview

October is historically the most volatile month of the year for the stock market. In fact, two of the worst stock market collapses in US history — the Great Depression (October 24, 1929) and Black Monday (October 19, 1987) — occurred in October. This year's October effect started with the news that President Trump had tested positive for COVID-19 and ended with the US reporting nearly 100,000 new COVID cases — its highest-ever daily case record. Public health experts have repeatedly warned that the pandemic had not gone away, and the potential of an autumn rebound in cases was the likeliest scenario. According to the CDC, the percentage of positive tests for COVID-19 is increasing across all regions it tracks. On a positive note, the rise in COVID-19 cases has so far not led to either runaway hospitalization levels or an increase in deaths (Chart 1).

The pandemic's resurgence prompted several countries (France, Germany, the UK) to reinstitute lockdown measures across Europe. Restaurants, gyms, and hotels are closing once again, and residents have been asked to remain in their homes. As a result of the reinstated restrictions, most economists now expect Europe's GDP to contract during the fourth quarter, which could result in the euro area falling back into a recession.

Post-Lockdown Economy

Although US GDP rose by a record 33.1% (annualized rate) during the third quarter, its largest increase ever, the economy's size is still 3.5% below that of the fourth quarter of 2019. While the US economy has shown considerable resilience since it emerged from the nationwide shutdown, the risk of a virus-led slowdown is quite possible, as the recent slump in Europe highlights.

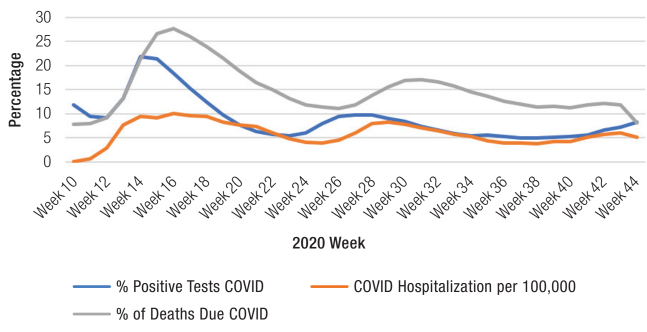
During the height of the pandemic, the US Congress and the Federal Reserve (Fed) provided unprecedented support to help mitigate the crisis's impact. With a resurgence in cases triggering renewed concerns, investors are calling for another round of stimulus to help boost economic activity. Markets are

Table 1 — Market Data

October Market Data				
Asset Classes	1 Month	3 Month	YTD	1 Year
US All Cap	-2.16	1.11	3.14	10.15
US Large Cap	-2.41	0.92	3.83	10.87
US Small Cap	2.09	4.24	-6.77	-0.14
US Large Cap Growth	-3.40	1.56	20.11	29.22
US Large Cap Value	-1.31	0.24	-12.74	-7.57
US Small Cap Growth	0.76	4.39	4.67	13.37
US Small Cap Value	3.58	4.08	-18.74	-13.92
Developed International	-3.70	-1.00	-9.53	-5.00
Int'l Emerging Markets	2.24	2.32	0.51	7.52
US Treasury	-0.94	-1.89	7.88	6.95
US Investment Grade	-0.18	-1.84	6.44	7.05
US High Yield	0.51	0.42	1.13	3.49
Municipal Bonds	-0.30	-0.75	3.02	3.59
Real Estate	-3.35	-5.80	-15.21	-16.01
Commodities	1.41	4.64	-10.85	-8.75

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

Chart 1 — National COVID Activity Indicator



Sources: CDC, KPB

increasingly concerned that the economic recovery could turn anemic without further support, leading to widespread labor disruptions, a prolonged period of high unemployment rates, and increased social unrest. Investor concerns were best reflected in Wall Street's favorite volatility gauge, the VIX ("fear index"), which shot up to 39 to reach its highest level since June. The VIX had fallen to 21 in August after registering all-time highs of 83 in March.

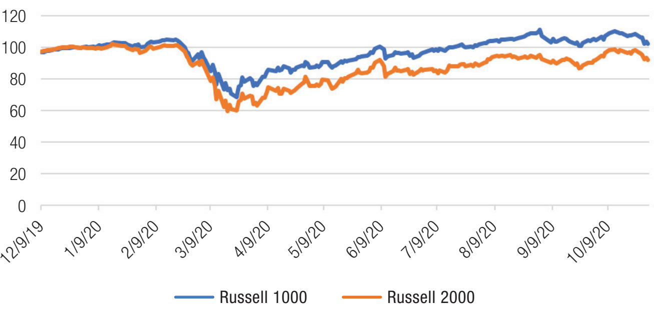
On a positive note, the US Food and Drug Administration (FDA) approved the antiviral drug Veklury® (Remdesivir) for use in adult and pediatric patients for the treatment of COVID-19 when hospitalization is required. The drug is the first treatment for COVID-19 to receive FDA approval. Similarly, three companies are expected to report Phase III trial results of COVID-19 vaccines in the coming weeks. AstraZeneca, in partnership with Oxford; Pfizer, in collaboration with BioNTech; and Moderna have all been conducting final-stage tests composed of tens of thousands of volunteers for several months now. They are expected to report their findings before the year-end.

Global equities

October started with a bang: The S&P 500 Index had not only recouped all of its losses from September (down 3.8%) by the second week but was within 2% of reaching an all-time high. However, rising COVID-19 cases, the declining probability of a stimulus deal, and lower-than-expected earnings from certain mega-cap stocks led to its reversal during the final week of the month (down 5.6%). As a result, the S&P 500 fell by 2.7% during October. Rising COVID-19 cases and uncertainty around US elections drove investors to cash as almost all other assets fell, including long-term Treasuries (-3%) and gold (-0.9%). While the S&P 500 has increased by 2.8% year-to-date (YTD), this performance is largely the result of a few mega-cap stocks: The top 50 companies in the S&P 500 (Nifty 50) have outperformed the other 450 by 16.1% YTD (+9.1% for Nifty 50 versus -7% for the others).

Value stocks outperformed growth equities for the second straight month. The Russell 1000 Growth index fell 3.4% in October versus a decline of 1.3% for the Russell 1000 Value index. However, the growth index has outperformed the value index on a YTD basis by almost 33% (+20.1% versus -12.7%). While large caps were down for the second consecutive month, the small cap Russell 2000 Index (+2.1%) and the Russell Mid-Cap Index (0.6%) increased as cyclicals, and smaller companies held their own. Small caps are down 6.8% YTD, while mid-caps are down 1.7% (Chart 2).

Chart 2 — Russell 1000 (Large Cap) has Outperformed Russell 2000 (Small Cap)



Sources: Bloomberg, Russell, KPB

On a sector basis, Utilities (+5%) rallied as investors piled into lower-risk options. Communications Services rose as well (+0.5%) thanks largely to Google, which increased 10%. Cyclicals (Materials, -0.8%; Financials, -1%; Industrials, -1.5%) outperformed non-cyclicals (Technology, -5.2%; Healthcare, -3.7%). Fear of another lockdown drove the COVID-19-exposed sectors of Energy (-4.3%) and Real Estate (-3.3%) lower again. On the factor front, Size (-1%) was the only outperformer as Momentum (-3.2%), Minimum Volatility (-3.5%), and Quality (-3.9%) all underperformed the S&P 500.

We can largely attribute the S&P 500's YTD performance to five mega-cap stocks (Google, Amazon, Apple, Microsoft, and Facebook), which have returned 39% on a cap-weighted basis this year. The remaining stocks in the S&P 500 are down 4.8%. The rally since the March drop has also led to valuation increases: The price-to-earnings (P/E) multiple for the S&P 500 currently stands at 20x — the highest in nearly 20 years. The S&P 500 P/E, excluding the top five, is a more modest 17.8x, closer to its long-term average of 16.1x.

The international equity market tumbled largely due to Europe's underperformance (-6.7%); fears of an impending recession drove investors toward sovereign bonds. Japan outperformed other developed markets (-1.6%) as COVID-19 cases continued to ease across Japan and Asia. The FTSE Emerging Markets Index rose 2.2% for the month as emerging markets were helped by positive news from China, where third-quarter GDP rose by 4.9%.

Fixed income is a zero-rate world

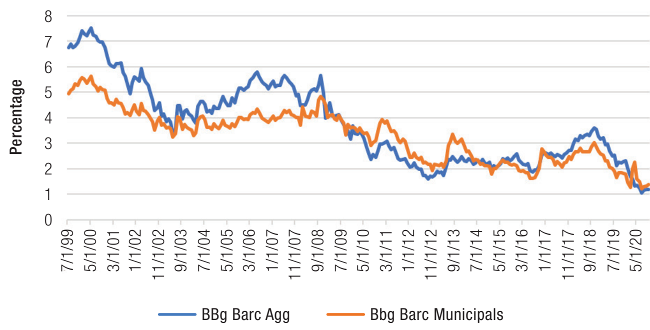
The unprecedented market volatility observed during March persuaded the Fed to cut interest rates to near zero and also provide additional liquidity in the form of unconventional monetary action. Since then, the Fed has bought over $3 trillion in Treasuries and mortgage-backed securities and instituted programs to support financial markets, including money market funds, municipal debt, and corporate bonds. The result of this extraordinary action resulted in bond yields falling to all-time lows. The last time the Fed implemented similar policies was during the Global Financial Crisis (GFC) of 2008. However, while short-term rates (3-year and below) fell significantly at that time, longer rates remained elevated — the yield on 30-Year Treasuries stayed relatively flat at 3% from 2009 to 2012. However, recent Fed actions and market expectations of “lower for longer” have caused long-term rates to decline sharply and remain anchored at extremely low levels (the yield on 30-Year Treasuries is currently 1.6%). The futures market suggests that the average market participant expects rates to stay at these levels for several more years.

We’re not in Kansas anymore

The traditional 60/40 portfolio — 60% S&P 500 and 40% Bloomberg Barclays Aggregate Bond Index (Agg) or 40% Bloomberg Barclays Municipal Bond Index (MI) — has been the linchpin of a typical investor’s portfolio. By simply rebalancing annually over the past forty years, investors would have been able to earn an annualized return of nearly 10%. Portfolio returns were propelled by stocks and bonds, which delivered an average annual return of nearly 7.5% in the case of the Agg and 6.5% for MI. Looking ahead, the probability of bonds delivering similar performance seems highly unlikely given the fact that the current yields of the Agg and MI stand at 1.2% and 1.4%, respectively: History has shown that starting bond yields account for roughly 90% of prospective fixed income returns (Chart 3).

Both indices (the Agg and the MI) are dominated by low-yielding, long-duration securities representing a subset of the fixed income universe. The Agg is dominated by US government-related securities (Treasuries, agency debt, and mortgages represent approximately 70% of the index) and investment-grade corporate bonds (about 28%); this represents less than half of the US fixed income universe. Since its inception some 40 years ago, the fixed income universe has become significantly more diversified through the issuance of securities like high-yield debt, commercial mortgage-backed fixed income,

Chart 3 — Yields Have Declined to Historic Lows



Sources: Bloomberg, KPB

leveraged loans, and preferred stock. However, the Agg continues to exclude all such higher-yielding, diversifying structures. Similarly, the MI also represents less than half of the municipal bond universe; it is debt-weighted, which means that the benchmark is dominated by a few state-issued, general obligation bonds (e.g., California, New York).

Hope versus strategy

High-quality bonds such as US Treasuries and investment-grade municipal bonds have historically offered several benefits to a typical portfolio. For one, they have provided high (after-tax) nominal and positive real (after-inflation) income. At the current low level of rates, traditional bond strategies are unlikely to help meet investor income and return targets. Similarly, high-quality bonds in the past have been a ballast to risk-asset (e.g., equities) volatility and have provided much-needed stability in times of market volatility. With rates falling to rock-bottom levels, it is unlikely that traditional bonds will provide a meaningful hedge against equity market losses. For example, the Agg fell in both September (-0.1% return versus -3.8% for the S&P 500) and October (-0.5% return versus -2.7% for the S&P 500) of this year (Table 2 on page 4).

Table 2

Spread over Treasuries			
Fixed Income Type	**10/31/2020**	**2020 Widest**	**Spreads at 12/31/2019**
Leveraged Loan	541	1047	471
High Yield	550	1100	335
Investment Grade	131	373	93
Agency Bonds	18	10	53
Agency Mortgages	50	40	130
CMBS AAA	97	77	260
CLO AAA	145	408	128
Municipal AAA	20	150	5
Municipal HY	280	525	150
Private Credit	700	1500	450

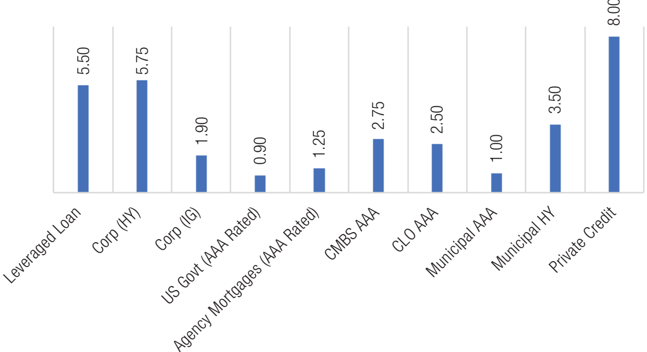
Sources: Bloomberg, JP Morgan, Morgan Stanley, KPB Estimates

Very low and negative yields have been a feature of the European and Japanese economies for many years. Unfortunately, the zero-yield bond world has finally arrived at our doorstep, and it is unlikely to go away anytime soon. Going forward, if investors are to achieve returns in line with expectations based on history, they should consider incorporating nontraditional fixed income strategies in a risk-conscious manner. Diversifying strategies like private credit, inflation-linked securities, high-yield debt, and asset-backed securities can enhance income and total return potential and potentially provide stability during times of market stress. While allocation to traditional high-quality assets like Treasuries and municipals is important for liquidity and stability purposes, investors should consider reducing their exposure to them and think about reallocating to complementary investment options to improve returns.

Maintaining a high-quality, low-volatility fixed income portfolio and seeking attractive long-term returns are not contradictory goals: Fixed income active management works. Historically, most active portfolios have handily exceeded benchmark returns through bottom-up security selection, sector rotation, and investing in complex, less-liquid areas of the bond market. By utilizing a flexible investing approach and expanding the horizon of fixed income beyond traditional securities, investors can still reach their long-term return goals (Chart 4).

Importantly, investing in the current zero-rate environment will involve some trade-offs. Most notably, investors interested in adding nontraditional investments

Chart 4 — **Estimated Yield (as of 10/31/2020)**



Sources: Bloomberg, JP Morgan, Morgan Stanley, KPB Estimates

such as opportunistic credit, real assets, and other strategies need to consider that it involves embracing a level of illiquidity. By combining some of these alternative strategies with conventional fixed income, investors will likely be better off and bridge the gap between expected and desired outcomes.

Fixed income market

Treasury rates were largely flat across the short end of the yield curve but rose in the intermediate- and long-term parts of the curve as investors started to price in the potential of rising inflation. The 10-Year Treasury ended the month with a yield of 0.88%, up 0.19% from September. The combination of record Treasury issuance and investor confidence over the state of recovery drove investors away from safe, low-yielding securities and into higher-risk assets.

Short-term Treasuries were modestly negative for the month (-0.04%), bringing YTD total returns to 3.1%. Intermediate- and long-duration bonds declined once again; for the month, intermediate Treasuries (5–10 years) fell 1% while long-dated Treasuries declined by 3%, taking total returns to 8.9% and 17.7% YTD, respectively.

Despite ongoing pandemic-related concerns, the credit market held steady and delivered modestly negative returns (-0.2%). Investment-grade spreads widened modestly (11 basis points); on the other hand, spreads in the high-yield market narrowed (16 basis points) as bond investors expected that the reopening process would largely remain intact. The market believes that Congress will eventually reach an agreement on a comprehensive stimulus bill, and the Fed will continue to provide ample liquidity.

After five consecutive months of positive returns, municipal bonds fell 0.3% in October. Fundamentals for high-quality municipals remain strong as rising property values and better-than-expected retail sales have enabled tax-related revenues to hold up well.

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.

Alternatives

Commodities

After posting an unprecedented negative price earlier in the year (-$37.63 on April 20), WTI crude oil prices have steadily improved. However, prices in October fell by 10% to $36 as fears of another lockdown took a toll. Gasoline demand has remained steady at 8.6 million barrels per day, an increase of 60% from April lows but 9% below the same period last year.

Alongside energy, other commodities also fell in October. The Commodities Index dropped for the second consecutive month (-3.6%); the index is down 35.7% YTD.

Real Estate

Posting a loss of 3.2% return for the month, publicly-traded real estate investments declined for the second month in a row; REITs are down 16.4% on a YTD basis. Real estate securities struggled as the impact of another pandemic-related shutdown drove investors elsewhere. Retail and office space 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 is expected to remain robust in a post-COVID world.

Hedge Funds

The HFRX Global Hedge Fund Index posted slightly negative returns for the month, slipping 0.2% during October (+1.4% YTD). Hedge fund returns were negative across most core strategies. The only strategy to deliver positive returns for the month (+0.4%), relative value, is now up 4.5% YTD. Equity (-0.5%), macro (-0.5%), and event-driven (-0.2%) strategies all fell. On a YTD basis, equity and macro are down 3.5% and 0.4%, respectively, while event-driven is up 4.4%.

This year's volatility reminds us why hedge funds should be considered 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

Key Private Bank uses a proprietary, systematic strategy called DART (Dynamic Allocation Research Tool) to help guide asset allocation decision-making. In March, DART's view on stocks turned negative, and we changed our recommendation to a modest underweight to equities. However, in the summer, DART's signal changed to reflect a positive economic outlook: We then adjusted our asset allocation to a neutral equity stance. DART has been recommending a shift away from international markets to the US due to the safe-haven nature of the US dollar and marketplace.

We maintain our neutral recommendation for fixed income and prefer investment-grade corporate and municipal bonds over US Treasuries. We expect the US economy to remain open, the Fed to continue to provide support, and Congress to eventually pass further fiscal assistance. Given the current market environment, we remain in favor of a modest allocation to high-yielding, opportunistic fixed income strategies provided by skilled active managers experienced in successfully navigating volatile markets.

We also believe that maintaining an allocation to alternatives can provide worthwhile diversification benefits for the right clients. Please contact your advisor to determine which strategies may be best for your circumstances.

Key Private Bank Asset Allocation Recommendations as of November 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

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 built 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 Chartered Financial Analyst (CFA®).

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