Key Private Bank

Key Investment Perspectives

December 2020

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Market review

Capital markets were strong across the board in November as the contentious and emotionally charged election season wound down, and encouraging news regarding several COVID vaccines emerged. Although political and pandemic concerns remain, the market moved higher as a result of growing optimism. In fact, investors witnessed a record in November as the venerable Dow Jones Industrial Average exceeded 30,000 for the first time.

The election was too close to call when Americans went to bed on election night. It was only after four days of uncertainty and additional vote counting that the Associated Press (AP) finally declared a winner. While President Trump has not officially conceded and continues to challenge the election results, it looks likely that Joe Biden will be our next president.

While the Democrats maintained control of the House, the "blue wave" that many pollsters predicted, and some investors feared, did not occur.

The Democrats lost House seats, and Republicans only need to win one of two Senate run-off elections in Georgia in January to retain their majority. If the GOP maintains control of the Senate – which many political pundits consider likely – Biden will begin his term with a divided government. This result seemed to please investors: A divided government would seemingly reduce the risk of higher taxes, new regulations, and the potential passage of a progressive agenda. Overall, a Biden presidency and a Republican-controlled Senate is viewed as bullish for the economy, stocks, and other risk assets.

As the election drama continued, COVID cases resurged in the U.S. at an alarming rate following similar spikes in Europe. By mid-November, this third surge of new infections set daily records, eclipsing the highest daily counts of the previous peaks in the spring and summer. New outbreaks appeared throughout the country and were not limited to cities or populous states. As case counts increased and hospitalizations rose, some states started to impose new restrictions, including stricter mask mandates and tighter restrictions on gatherings – even family Thanksgiving dinners – while resisting full lockdowns. The CDC urged Americans not to travel over the holidays.

November Market Data

Asset Classes	1 Month	3 Month	YTD	1 Year
US All Cap	12.17	5.75	15.68	19.02
US Large Cap	11.78	5.09	16.06	19.41
US Small Cap	18.43	16.87	10.41	13.59
US Large Cap Growth	10.24	1.48	32.40	36.40
US Large Cap Value	13.45	9.21	-1.00	1.72
US Small Cap Growth	17.63	15.99	23.12	25.95
US Small Cap Value	19.31	17.82	-3.05	0.35
Developed International	15.35	8.45	4.36	8.25
International Emerging Markets	8.41	8.50	8.96	16.43
US Treasury	0.35	-0.46	8.25	7.64
US Investment Grade	2.79	2.31	9.41	9.76
US High Yield	3.96	3.41	5.13	7.24
Municipal Bonds	1.51	1.23	4.58	4.89
Real Estate	9.22	2.75	-7.39	-6.82
Commodities	3.51	1.45	-7.71	-3.06

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

During this troubling spike, Pfizer and BioNTech announced a vaccine that is more than 90% effective in protecting people from COVID-19. Moderna followed just two days later with its announcement of a vaccine with a 95% effectiveness rate. The vaccine news provided a huge spark to the market as investors looked forward to a future when life could return to normal.

Optimism grew further as President-elect Biden's administration started to take shape. Biden's selection of Janet Yellen, former chair of the Federal Reserve (Fed), as the secretary of the Department of the Treasury was generally viewed as prudent given her pro-stimulus stance and deficit sensitivity. Moreover, if confirmed, Janet Yellen will be the first woman to serve in that role.

Global equities

Following a challenging October, the global equity markets staged a strong recovery with broad participation and rotation into more cyclical sectors as investors cheered the promising vaccine news. Equities achieved new milestones, as both global and small cap stocks had their best month ever.

The rally began with the S&P 500 Index advancing an impressive 11% during the first two weeks, even as coronavirus cases continued to soar. This rally included a strong rotation away from the high-flying growth and tech stocks of 2020 to value stocks that would benefit from an accelerating economic recovery. The Russell 1000 Value Index was up 13.5% vs. a 10.2% return for the Russell 1000 Growth Index. Value has outperformed growth for three straight months now, although growth is still the clear winner on a year-to-date (YTD) basis, returning 32.4% versus a loss of 1.0% for value.

On a sector basis, the market's breadth continued to improve as more sectors joined the rally, a healthy sign for future returns. The more-cyclical Energy sector and small cap companies soared higher, returning 28.2% and 18.4%, respectively. Even the downtrodden Financials sector showed some strength, returning 16.9%.

Global equities also surged across Europe due to similar leadership from the small cap and Energy sectors. Among developed international countries, the UK, France, Italy, and Japan were regional leaders. Overall, the developed markets were up strongly, posting a 15.4% return. Emerging markets also performed well (+8.4%) as economic conditions in China continued to improve.

In a month full of big news, the S&P 500 Dow Jones Indices announced that Tesla, Elon Musk's electric car company, will join the S&P 500 Index in December. Tesla's stock price has quintupled this year, giving the company a $400 billion market value. The company met the S&P 500's listing requirement when it posted its fourth consecutive quarterly profit this summer. Tesla is positioned to be one of the 10 largest components when added to the benchmark on December 21.

Tensions arose between Treasury Secretary Mnuchin and Fed Chair Jerome Powell regarding a request that the Fed return stimulus money. This, combined with a delay in Congress's decision to fund a much-needed stimulus bill, and the continued increase in COVID cases caused some investor concern. But in November, investors seemed to focus on things to be thankful for, including promising vaccine progress and improving clarity in U.S. politics. In a fitting end to a month that turned toward optimism, the Dow Jones Index closed with its best monthly return (+12.1%) in three decades.

Fixed income market

Fixed Income returns were positive across the board in November, and narrowing credit spreads signaled investor optimism and confidence in the market.

Longer-term investment grade credit was the best performer in the month, returning 5.1% (+12.8% YTD) as risk assets rallied. With the volume of new issues satisfying demand, ongoing support by the Fed, and investor confidence in the recovery, inflows into investment-grade funds continued.

The Treasury yield curve continued to steepen as rates rose in the intermediate and long end with investors pricing in the potential for a rise in inflation; rates held steady on the short end, anchored by Fed policy. The 10-year Treasury note ended the month with a yield of 0.84%, down just 0.04% from October.

High-yield bonds also benefited from the risk-on environment in November, returning 4.0% (+4.18% YTD). The spike in the Energy sector, which makes up 10% of the high-yield market, contributed to the strong returns. Treasuries continued to lag.

Following a negative October, municipal bonds returned 1.5% in November, bringing YTD returns to 4.6%. As with corporate bonds, municipal bond funds continue to have strong positive flows. The municipal market is on pace for $450 billion in new deals in 2020, which would surpass its record issuance in 2016.

We reiterate our view that Treasury rates are unlikely to move meaningfully over the near-to-medium term given the Fed's plans to keep rates low for an extended time and its continued asset purchases. The strong market demand for risk-free assets reflected in the continuing asset flows into fixed income should also keep rates low.

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.

Alternatives

Commodities

Following a negative October due to fears of another lockdown, energy-related commodities soared as economic conditions improved. WTI crude oil returned a robust 26.2% in November, closing at $45.34/barrel. Yet, even with the strong November, energy continues to be the worst-performing sector of commodities this year (-36.5%).

Other commodity sectors were mixed as agricultural commodities did well (up 4.0%), but precious metals declined across the board. Gold lost some of its luster this month as it led the metals lower, declining by 5.2%. Notwithstanding, 2020 has been a breakout year for precious metals with record inflows and returns. On a YTD basis, gold is up 16.6% and silver 26.4%. Overall, the broad-based Bloomberg Commodity Index posted a positive 3.5% return in November, resulting in a negative 7.7% YTD.

Real Estate

Driven by renewed optimism for the economy, publicly traded real estate investment trusts (REITs) posted substantial gains in November, returning 9.2%.

Most subsectors were higher, and YTD losses for REITS overall were reduced to -7.4%.

The month was especially strong for regional malls, retail, and office space sectors, with returns of 31.1%, 23.8%, and 25.1%, respectively. All retail-focused real estate sectors have struggled this year given the ongoing move to e-commerce, shut-downs, and failures of small businesses, and the shift to working from home due to COVID-19. Even with a strong month, these sectors are still down on a YTD basis.

Performance of industrials, data centers, and self-storage are the bright spots in real estate. Although returns were weaker this month, YTD returns of 9.8%, 17.2%, and 8.2%, respectively, are strong.

Hedge Funds

The HFRX Global Hedge Fund Index posted solid returns for the month, gaining 3.0% to bring YTD returns to 4.4%.

Overall, hedge fund returns were positive across all core sub-strategies in November, resulting in positive YTD returns as well. Equity hedge strategies that have struggled for most of the year provided the best monthly returns (+4.8%), bringing YTD returns (+1.1%) into positive territory. Macro/CTA returns (+2.1%) also resulted in positive YTD returns (+1.6%). Event-driven and relative value strategies have been the strongest performers this year, with YTD returns of 6.9% for both. Event-driven managers have taken advantage of opportunities in distressed credit and increased corporate merger and special situation activity. Relative value managers who seek to exploit mispricing of securities have had success in security selection.

This year’s volatility reminds us why hedge funds and other alternatives should be considered an integral part of a well-diversified portfolio. Alternative strategies seek to deliver returns through various unconventional, unconnected strategies; thus, they tend to have low correlations with traditional risk assets. These attributes can help lower portfolio volatility, protect capital in downturns, and enhance risk-adjusted performance.

Research insights

Do nothing – Stay invested

Before the November election, market volatility was extremely high, given the political uncertainty, charged emotions on all sides, and fear of what the future held in store. The CBOE Volatility Index (VIX), also known as the “fear index,” climbed above 40 on October 28 only to drop to below 23 on the day following the election; it ended the month down 46%. The VIX was 20.6 at November’s end, close to its long-term average and its lowest level since February. Excessive fear is no longer driving investors, a good sign for equities and risk assets in general.

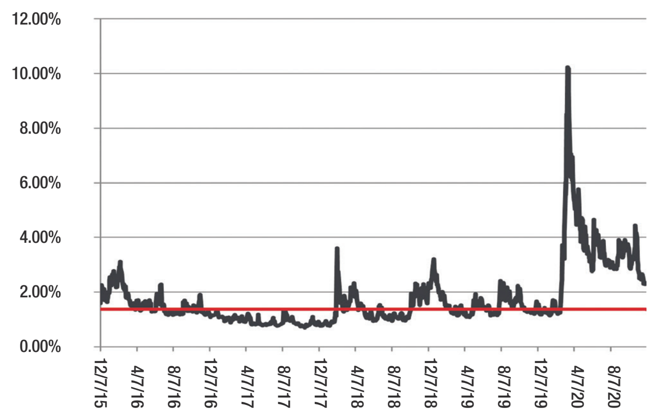
Prior to the election, some investors were understandably anxious as they worried about potential political outcomes and the risk of investment losses if the market declined. These investors often consider ways to ease their fears, including selling stocks and moving to cash, purchasing puts, or making significant moves in their portfolio.

History shows that while presidential policies may have some impact on the market, outcomes of an election are complicated and many factors are involved. Of course, a president’s impact on the economy and the markets depends on their ability to get legislation passed, and a divided government makes that more difficult. Often other news such as the positive vaccine results this month can easily overshadow presidential election results as well. The removal of uncertainty is also a powerful force that is often overlooked before the election but confirmed by historical post-election market trends.

Given this history and the fact that no one can know the results until the votes are counted, Key Private Bank generally advised worried investors to avoid making significant moves in their portfolios due to the election.

This included guidance against hedging the specific election event given the high costs and potential pitfalls with doing so (see chart directly below).

Estimated Cost (%) to Hedge a Large Cap Portfolio using a 3-month 5% OTM SPY Put Option

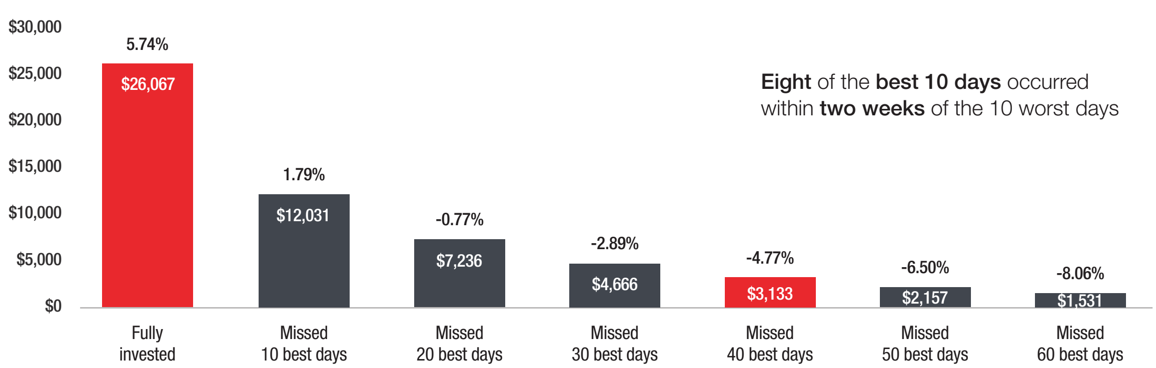


Sources: Bloomberg and Susquehanna

Our view on this issue was simple: Sometimes doing nothing is better than doing something, and this election was one of those times. With the markets up strongly in November, this has worked out well so far. Aside from the difficulty of market timing short-term portfolio changes, history shows it only takes missing out on a handful of the best days over a year to underperform the market significantly. Staying invested with a well-thought-out asset allocation that meets your goals and resisting changes to address an unknowable outcome is a winning strategy.

Impact of Being Out of the Market

Returns of the S&P 500 – Performance of a $10,000 investment between January 1, 2000 and June 30, 2020



Sources: Sources: Morningstar and JP Morgan Asset Management

Do something – Consider alternative strategies

There are, of course, many times when investors should consider portfolio changes, both big and small. If the equity market drop of 34% in March was just too much risk to bear or caused a reduction in needed liquidity, now could be an excellent time to consider rebalancing risk assets or aligning allocations with risk tolerances. Also, changes in personal circumstances often require revisions to portfolio holdings to meet specific needs.

Disciplined portfolio practices such as rebalancing and tax-loss harvesting also involve portfolio adjustments to keep overall investments balanced. Rebalancing ensures that your asset allocations are in line with your targets, and selling stocks in a loss position can help offset or eliminate capital gains, thereby increasing after-tax portfolio returns.

If long-term forecasts for returns or relationships among assets fundamentally change, investors would be wise to consider how such changes may affect their expected portfolio return and adjust accordingly. Key Private Bank believes that now is a good time to do just that as the future may be radically different from the past.

Challenge of 60/40

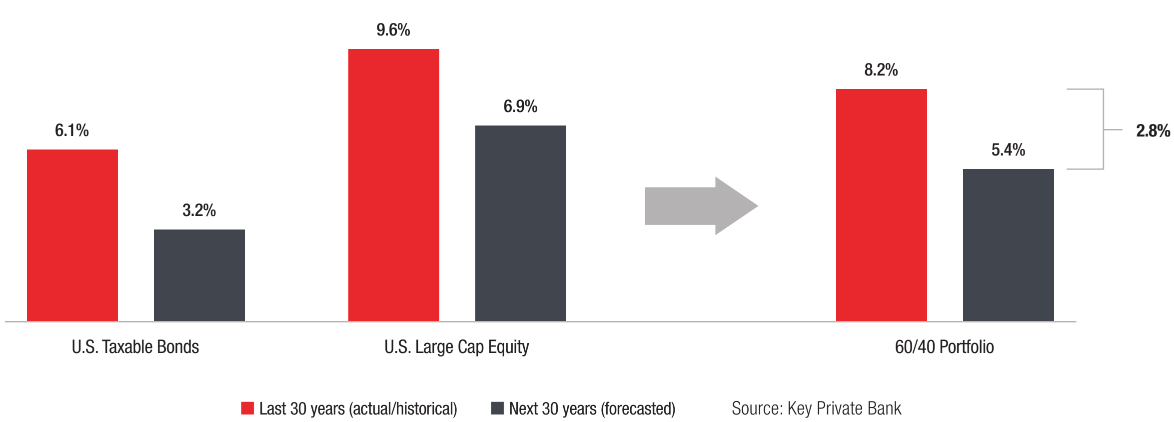
Given long-term asset projections for both equities and bonds, it is important to understand that while the 60/40 portfolio (60% equities and 40% fixed income) has served investors well (returning 8.2% over the past 30 years), it will likely not provide the same returns going forward.

This view primarily stems from the current low fixed income yields (i.e., the yield on the 10-year Treasury note is 0.81%) and likely anemic returns in the future. It is now expected that a 100% traditional fixed income portfolio may return less than 2% and a 60/40 portfolio just 5.4%.

Given these expectations for low returns, it is uncertain if fixed income will provide the portfolio stability and downside protection – rising returns when equities decline – that it has in the past.

With these forecasts for lower returns for several more years and limited downside protection from fixed income alone, it is prudent for investors to consider allocating to nontraditional investments. Such investments may include alternative strategies with risk/return profiles that fall between fixed income and equities (liquid alternatives, hedge funds, structured notes), private and opportunistic credit, and real assets. Of course, each approach has unique characteristics and entails other considerations. Still, by thoughtfully including some of these strategies alongside traditional strategies, investors may have a better chance to meet their income and return targets without taking undue risk.

Actual vs. Forecasted Annualized Returns by Asset Class



Source: Key Private Bank

Key Private Bank Asset Allocation Recommendations as of December 2020

Tactical Asset Allocation

Stocks	Bonds	Cash	Alts/Diversifiers
Emphasize	De-emphasize	Neutral	Emphasize–Client specific

Equity Geographic Emphasis

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

Fixed Income Emphasis

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

Goals-based planning

Investment opportunities and approaches are constantly evolving: Investors benefit by being open to new ideas, whether it means considering a new asset class or strategy or expanding the overall investment approach to include goals-based financial planning. Financial planning involves constructing a comprehensive picture of wealth and establishing goals that go beyond returns. Instead of determining investment policy and asset allocation targets based on a risk assessment alone, goals-based planning asks an investor to tackle bigger, more philosophical considerations about their portfolio's purpose.

By determining what is important and developing a complete financial picture, investors can seek to do more than beat a benchmark. A financial plan also provides an investor with expanded tools to create an optimal asset allocation mix to meet established income and return targets. Through Monte Carlo simulation, a model used to predict the probability of different outcomes, investors can see the estimated probability of success in reaching their goals with current and hypothetical portfolios. This analysis can be a tool to drive asset allocation adjustments, spending and saving decisions, and other portfolio changes, including reallocating some dollars to nontraditional alternative strategies.

Tactical Asset Allocation

Key Private Bank uses a proprietary, systematic tool called DART (Dynamic Allocation Research Tool) to help guide our 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, DART's signal changed in the summer to reflect an improving economic outlook, and we then adjusted our asset allocation to a neutral equity stance. More recently, DART has turned even more positive for risk assets such as equities.

Accordingly, we now recommend a slight overweight to equities relative to bonds. We also believe global markets look attractive. Thus, we encourage investors to reassess their exposure to non-U.S. equities and consider adding to positions in this area, which has lagged in recent years. Within fixed income, we prefer investment-grade corporate and high-quality municipal bonds over U.S. Treasuries. We expect that the U.S. economy will continue to gain strength, the Fed will remain supportive, and Congress should 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 who are experienced in successfully navigating volatile markets.

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

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

About the Author

Linda Kelly is a Senior Lead Analyst with broad knowledge and experience in working with clients and portfolio managers on customized investment solutions. Linda's areas of expertise include structured notes and other derivative-based strategies, as well as socially responsible, ESG, and impact investing. These strategies offer clients opportunities beyond traditional investments to meet their specific goals and/or align their investments with their values. In her role, she leads our sustainable investing efforts and oversees our ESG models of third-party managers.

Linda has over 25 years of industry experience joining KeyBank in 1998 in the capital markets division and transferring to Key Private Bank's investment management group in 2007 where she introduced and expanded our derivative based offerings and developed our values-based investing capabilities. Before joining Key, Linda worked at a proprietary options trading firm in Chicago.

Linda received her BA from the College of Wooster and her MBA from DePaul University. She also holds a Certified Financial Planner™ designation and is actively involved in various non-profit boards.