Investment Commentary: 9/2020

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Global stocks delivered another strong monthly return in August alongside better-than-feared earnings results, improving economic data, and positive news regarding several Covid-19 vaccines. U.S. stocks generally led their developed markets counterparts, while emerging markets stocks lagged overall. Government bond yields rose, and core global bond returns declined modestly for the month.

- U.S. stocks were up 7.2%, posting their largest monthly gain since April
- European stocks continued to rally, up 4.3%, despite an increase in the number of Covid-19 cases in several countries. Economic data improved, and risk assets appeared to benefit from the July announcement of the European Union recovery fund.
- Emerging market stocks posted modest gains of 2.2%, largely due to solid performance in China.
- Rising U.S. Treasury yields weighed on core bond returns, down 0.8%, while inflation protection and high-yield bonds finished the month up close to 1%

"The swift and sizeable policy response from central banks and governments has managed to cushion the economic shock from the Covid-19 virus and helped lift markets around the world"

The swift and sizeable policy response from central banks and governments has managed to cushion the economic shock from the Covid-19 virus and helped to lift markets around the world. Although the second wave in Europe reminds us that the battle is far from over and until a vaccine is widely available, economies will likely remain constrained by measures aimed at slowing the spread of the virus. **It remains important that governments continue to support consumer incomes and businesses until a vaccine is available or the virus is brought under control. The extent to which this is done will be key to the outlook from here**.

Managing Risk with Interest Rates near Zero

High-quality Treasury bonds have been one of the best tools to manage risk in portfolios. **Historically government bonds have been a consistent source of income and a hedge against economic calamities (recession, depression, etc.) and bear markets in stock.** Overall, their track record of providing returns when the world starts to fall apart has been pretty good, see the chart on the next page.

In five of the six bear markets since 1990, including the recent Covid-19 crisis, bonds were able to generate capital gains (returns) that helped reduce overall risk in diversified portfolios. **However, that success has come at a cost of extremely low yield levels. At today's yields, U.S. Treasuries not only fail to provide a useful amount of yield to investors but are also less likely to generate capital gains and act as a hedge against further economic trouble**.

That being said, investors should not abandon treasury bonds, but simply be aware they are not likely to serve as well as the risk diversifiers they have in the past. A few things investors should consider when managing risk in portfolios are: given where inflation break-even rates are consider replacing some of your Treasury bonds

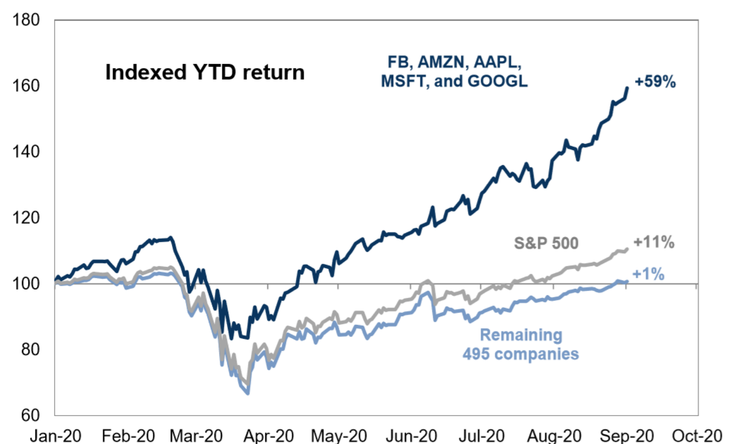
with inflation protection bonds (TIPs); supplement portfolios with alternative assets that have a relatively low correlation to traditional stocks and bonds (real return, long/short, etc.); focus on asset class valuation, a lower valuation will reduce long-term risk; and make sure to rebalance portfolios-- an underappreciated aspect of portfolio management and an important tool to limit risk.

Bear Market	*Start*	*End*	*MSCI World Return*	*Yield Change for 10-Year U.S. Treasury Note*	*Capital Gain/Loss of 10-Year U.S. Treasury Note*[4]
First Gulf War	7/16/90	9/28/90	-21.3%	0.4%	-2.4%
LTCM	7/20/98	10/5/98	-20.3%	-1.3%	10.7%
TMT	3/27/00	10/9/02	-49.8%	-2.6%	21.9%
GFC	10/31/07	3/9/09	-57.8%	-1.6%	13.6%
Euro Crisis	5/2/11	10/4/11	-22.0%	-1.5%	13.7%
Covid-19 Crisis	2/19/20	3/23/20	-34.0%	-0.8%	7.8%
		Average	-34.2%	-1.2%	10.9%

Source: Datastream, MSCI, GMO

Concentration Risk

Below are a couple of charts that illustrate how concentrated returns have been in the S&P 500 this year. The first chart below shows the top 5 stocks in the S&P 500 Index (Microsoft, Apple, Amazon, Google, and Facebook) have reached close to 25% of the total market concentration. This is by far the largest concentration we have seen in the S&P 500 in the past 30 years. The second chart shows the dramatic divergence in the performance of the top 5 stocks, up 59% thru August, compared to the remaining 495 stocks basically flat. This level of concentration is reminiscent of the late 1990s and not necessarily a healthy sign for the market as a whole. As we write this commentary, these stocks and many leading growth stocks are in the process of correcting some of the excesses of the past year. It's a good reminder that when certain stocks or strategies get too popular or become a "sure-thing" it's usually a good time to step aside. The 5 stocks listed above are all great companies, however we'd suggest some patience before buying until the current shake-out clears out some of the excesses.



Source: FacSet, Goldman Sachs Global Investment Research. As of September 1, 2020.

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Changes to the Dow Jones Industrial Average (DJIA)

Recently the DJIA announced several changes to its holdings, which prompted several questions from our clients. The changes were as follows: stocks added- Salesforce, Amgen, and Honeywell; stocks deleted: Exxon Pfizer and Raytheon. The questions asked centered around why they would do this and what the likely impact is. A recent study by Ned Davis Research helped answer these questions, and provided three main reasons why it happened:

I. It was a technical response created by Apple's recent 4 for 1 stock split. The DJIA is a price-weighted index, which is unique, most indices are market-capitalization-weighted. So the lower price per share for Apple would have reduced the index weighting to technology stocks.

II. The plunge in the DJIA's tech sector weighting would have significant compared to the S&P 500—as much as 8% lower. To make up for this they added Salesforce as a replacement for Exxon in the index.

III. Due to the lack of 'FANG' (Facebook, Apple, Netflix, Google) stocks in the DJIA, the index has trailed the S&P 500 by 11.4% the past year. Something they were afraid would continue unless they changed the composition of the index.

What's most interesting, is that stocks that have been kicked out of the DJIA have actually outperformed the stocks added. The chart below shows how since 1972 the stocks kicked out have usually underperformed before leaving the index but gone on to outperform the ones added over the next 12 months. **Given the relative valuations of the stocks leaving vs. arriving, we wouldn't be surprised if this trend continues!**

The Federal Reserve Changes its Policy

The Federal Reserve's Chairman, Jerome Powell, recently revealed a change to its policy framework. Indicating a preference to 'average inflation' around its 2% inflation target. Alerting the financial markets that it will allow inflation to exceed the central bank's 2% target to further support the economy. The dovish shift, on top of existing stimulus measures, raised concerns about potential overshoots in the future and caused the U.S. dollar to drop, the 10-year Treasury yield to increase and the yield curve steepened sharply. The takeaway being the Federal Reserve is willing to change the rules and is committed to seeing higher inflation levels. **We don't believe there will be a sudden and dramatic shift in inflation expectations, however we think it is wise for investors to start considering how they are positioned if inflation does start to increase. We will be!**

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Closing Thoughts

Given the high degree of uncertainty around the outlook for the virus and a vaccine, we continue to believe it makes sense to aim for balanced and well-diversified portfolios while considering which areas one might want to add to when a successful vaccine is widely available. In this environment, we prefer a higher-quality strategy for both stocks and bonds and an emphasis on valuations relative to fundamentals. We also suggest some alternative strategies to help diversify portfolios given the reduced diversification that government bonds are likely to provide at current yields. If you have any questions on this commentary or would like to discuss your investment strategy give us a call.

- AWM Investments (September 2020)