Second Quarter 2020 Key Takeaways

For most of the second quarter, financial markets seemed to defy grim economic news, the continued spread of COVID-19, and worldwide protests against racial inequality. Global equities performed strongly for the quarter. The S&P 500 Index gained an incredible 21% and, as of June 30, is now down only 3% for the year, despite the huge drawdown in March. Developed international and emerging-market (EM) stocks gained 17% and 19%, respectively, and outperformed U.S. stocks in late May and June.

Enormous levels of money printing and government spending certainly helped the investor mood. Central banks around the world provided unprecedented support to markets and economies. On the fiscal side, the U.S. government delivered trillions in direct payments and loans to impacted citizens and businesses. The level of stimulus globally already surpasses by far what was issued during the 2008 financial crisis.

Short-term interest rates are now near zero or negative in most of the developed world. The 10-year Treasury yield fell slightly this quarter but has revolved around 0.7% for some time. Also, investment-grade corporate bond spreads narrowed. Accordingly, core bonds gained another 3%. One bi-product of the low Treasury bond yields is low mortgage rates, leading to skyrocketing numbers of re-financings, good news for homeowners.

With Federal Reserve bond-buying as a backstop for the overall bond market, mortgage-backed bonds, one of the biggest beneficiaries of the Fed's bond buying, recovered nicely in the quarter. The PIMCO Income fund, a multi-sector bond fund owned in our portfolios, holds 37% of its investments in non-agency residential mortgages and gained 6.48% for the quarter, 3.55% better than the overall bond market (U.S. Aggregate Bond Index).

The performance of alternative strategies, which aim to produce positive returns with limited correlation to traditional markets (stocks and bonds) was adequate this quarter, **following a disappointing showing in the first quarter**. The role alternative investments serve in our portfolios is to offer an alternative to bonds, but without the interest rate risk. I've been concerned that bonds will perform poorly when interest rates eventually rise, which has been a real possibility given that interest rates are at historical lows and have nowhere to go but up. I still believe that rates will rise eventually, but the Federal Reserve has made clear that it has no intention of raising interest rates any time soon, so it's a safe bet that we're in for an extended period of low rates. With the risk of rising rates off the table, for now at least, I'm re-thinking the need for alternatives in our portfolios.

While markets have rebounded, we should steel ourselves for a potential double-dip back down to the late-March market lows, which will most likely be caused by disappointing developments on the virus/medical front. There are also uncertainties around the November election and the ongoing U.S.-China dispute that could disrupt financial markets. This has me thinking about ways to reduce risk in our more conservative balanced portfolios. Core bonds (high grade corporate bonds and Treasuries) are one of the few investment classes that should appreciate if the economic recovery stalls or faces a setback. Given the dramatic rebound in stocks since the March 23, 2020 lows, this looks like a good time to reduce risk in our more conservative portfolios, and adding an increment of core bonds in place of equities would do just that.

I see several ways for our portfolios to outperform over the next five to 10 years. If a more benign public health scenario plays out, there is a good chance we'll get a sustainable, albeit uneven, global economic recovery. Along with low interest rates and the monetary and fiscal policy response, this would support the view that equities and fixed-income credit sectors are relatively attractive compared to core bonds.

Overall, I'm comfortable with our current portfolio positioning, which balances a variety of shorter-term risks against attractive medium- to longer-term return opportunities.

Second Quarter 2020 Investment Letter

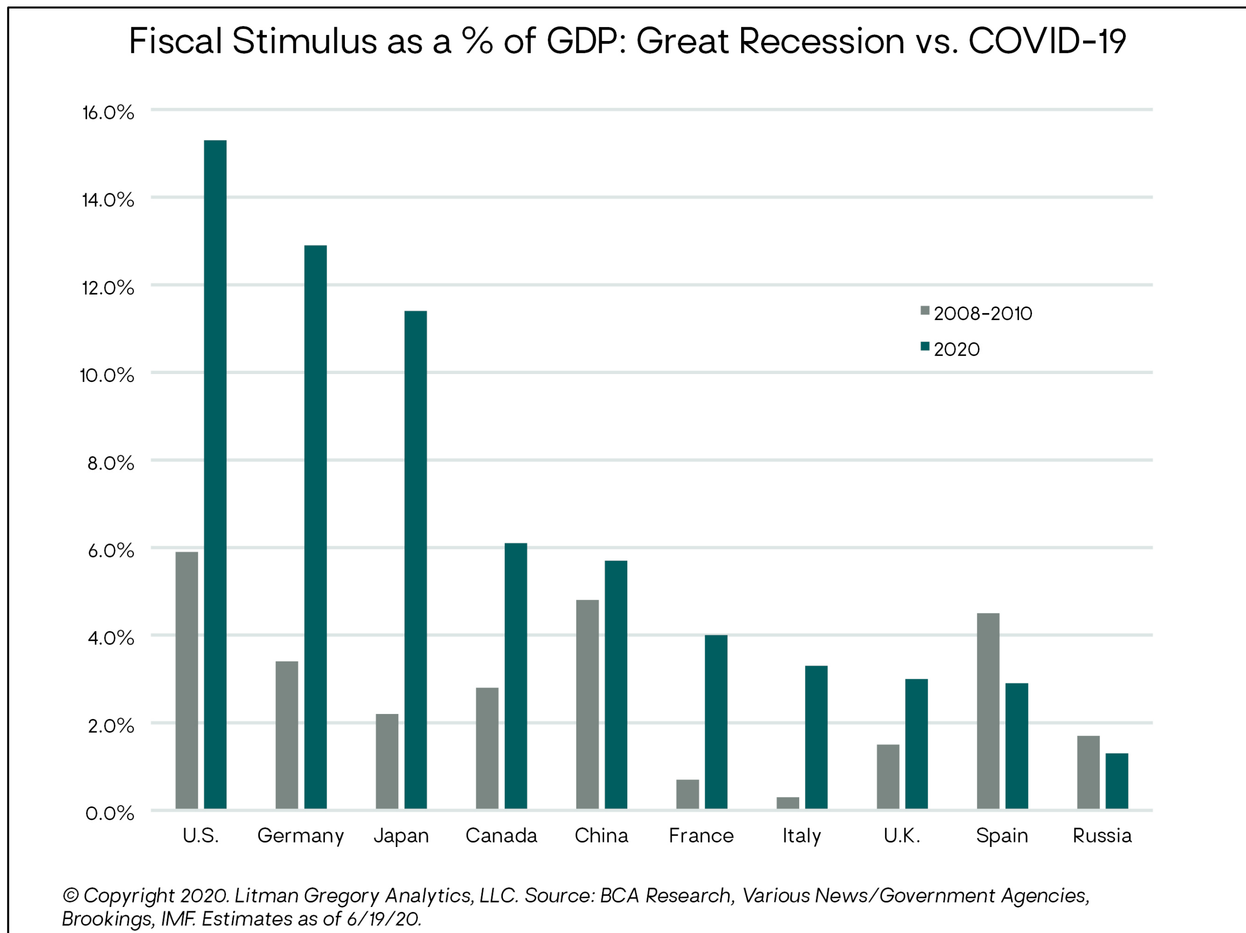
For most of the second quarter, financial markets seemed to defy grim economic news, the continued spread of COVID-19, and worldwide protests against racial inequality. Global equities performed strongly for the quarter and rewarded investors who remained invested. From the March 23 low, the U.S. equity market soared 40%, recording its best return ever over any 50-day period.

Enormous levels of money printing and government spending certainly helped the investor mood. Central banks around the world provided unprecedented support to markets and economies. On the fiscal side in the United States, trillions in direct payments and loans have been or are going to be delivered to impacted citizens and businesses. The level of stimulus globally already surpasses by far what was issued during the 2008 financial crisis.

Second Quarter Market Recap

In the second quarter, larger-cap U.S. stocks gained 21% and smaller-cap stocks climbed 25%. Despite the medical, economic, and social turmoil all around, the U.S. market is down just 3% year to date (as of June 30) and only 8% below its all-time high on February 19.

However, there is a distinct style (or factor) bifurcation beneath the surface: The Russell 1000 Growth Index is up 10% on the year, while its Value sibling is down 16%. That is a stunning 26-percentage-point difference. Or, from another angle, the S&P 500 technology sector is up 12% on the year, while the financials, industrials, and energy sectors are down 24%, 14%, and 35%, respectively.



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So, for many companies, things are not nearly as sanguine as they may appear looking only at the S& P 500 Index. Much of the gain in the S&P 500 index year-to-date comes from its top five holdings, which currently represent 23% of the index: Microsoft, Apple, Amazon, Google, and Facebook. These five companies sport year-to-date returns of between 12% and 66% as of this writing.

To illustrate this divergence in results within the stock market, consider the performance of two funds held in our portfolios: the Schwab U.S. Dividend fund (comprised of primarily mature Value companies); and the ARK Innovation fund (comprised of young Growth companies). For the quarter, the Schwab U.S. Dividend fund earned 16.10%, a decent enough return, at least until you consider the 61.43% return earned by the ARK Innovation fund. The ARK Innovation fund has large positions in shares of Tesla, Square, Roku, and Pinterest, whereas the Schwab U.S. Dividend fund has as some of its largest positions United Parcel Service, Pepsico, Altria, and Exxon Mobile. It really is the tale of two markets: the cyclical stocks selling at deep discounts but poised to do well if the economy returns to normal; and the growth stocks, companies poised to benefit most from a continuation of the stay-at-home economy.

Looking overseas, developed international stocks rose 17% and EM stocks gained 19% in the second quarter. For the year, they are down 11% and 10%, respectively. As in the United States, growth indexes are meaningfully outperforming value indexes overseas. The U.S. dollar depreciated slightly during the quarter, providing a modest tailwind to foreign market returns for dollar-based (unhedged) investors such as ourselves.

Finally, in the fixed-income markets, core bonds gained almost 3% for the quarter, as Treasury yields dropped slightly (falling bond yields imply rising bond prices) and investment-grade corporate bond spreads narrowed, rallying along with the equity markets. Riskier credit-sensitive sectors within the fixed-income universe posted very strong gains, making up ground from their first quarter losses. Floating-rate loans and high-yield bonds gained nearly 10%, leaving them around 5% underwater for the year.

Second Quarter Portfolio Performance & Key Performance Drivers

The incredible rebound in risk-asset markets—stocks, corporate bonds, and other credit markets—in the second quarter provided a strong tailwind for our portfolios.

As a reminder, in Mid-April, with the S&P 500 continuing its rebound from the March 23, 2020 lows (a 34% peak to trough decline), I added an increment back to U.S. stocks in all our portfolios (adding between 4% and 7%, depending on the model), funded from lower-risk assets. I concurrently shifted assets away from international stocks and into U.S. stocks across all models. The result of these changes was a significant increase in exposure to stocks in general, and an even greater shift in exposure to U.S. stocks relative to international stocks. Much of the additional exposure to U.S. stocks went to Growth stocks (versus Value stocks) and came from adding the ARK Innovation fund (ARKK) to our growth-oriented portfolios. The intent of adding the ARK fund was to take advantage of the fall in the market to invest in growth stocks at a reasonable price. I also wanted our growth portfolios to increase exposure to the types of stocks benefitting from the COVID crisis. From its April 21, 2020 addition, to the end of the quarter, the ARK fund was up a whopping 40.90%. So far so good.

Despite the impressive rebound is stocks from the lows, I don’t rule out the possibility that U.S. stocks will revisit the March lows (2,237 on the S&P 500) and I’m ready to act again if a compelling opportunity arises. In the meantime, I like how our portfolios are positioned, but remain concerned that uncertainties around the November election, COVID, and the ongoing U.S.-China dispute, could disrupt financial markets. This has me thinking about reducing risk in our more conservative balanced portfolios. Core bonds (Treasuries and investment grade corporate bonds), despite their paltry yields, are one of the few investment classes that should appreciate if the economic recovery stalls or faces a setback. Given the dramatic rebound in stocks since the March 23, 2020 lows, this looks a good time to reduce risk, at least in our more conservative portfolios. More to come…

Our current portfolio allocations balance a variety of shorter-term risks against attractive medium- to longer-term return opportunities, across a range of macroeconomic scenarios and potential market outcomes. As of quarter-end our balanced portfolios are slightly underweight U.S. Equities (despite the shift away from international stocks), neutral to developed international stocks (Europe, Japan, Australia, etc.) and overweight emerging market stocks.

As highlighted above, global equities performed strongly for the quarter. While the U.S. market was the best performer, foreign markets gained momentum, outperforming the S&P 500 from late May to quarter-end.

I continue to expect superior returns from international and EM stocks *over a longer-term five-year tactical time horizon*. In the near-term, I expect European stocks will pose a drag on performance for international developed stocks. At question is the ability of the European Union to respond appropriately to the COVID crisis without igniting the flames of disagreement between Southern and Northern members. Is it possible that this flame will turn to a raging fire and burn down the fragile house built by the EU's 28 member countries? It's that possibility that has me concerned, once again, about a breakup of this fragile union. That said, international stocks, including the emerging markets, are more reasonably priced than U.S. stocks.

For example, Emerging markets stocks' cyclically adjusted P/E ratio is near its lowest point in 35 years of data. Second, foreign economies and their markets are generally more sensitive to global growth, so as the world recovers from the pandemic, foreign stock prices should outperform U.S. stocks. Finally, in a sustainable recovery, I would expect the U.S. dollar to decline, as it is generally a safe-haven currency that depreciates in the face of strong global growth. A falling dollar would further enhance foreign stock returns for investors in un-hedged foreign equity funds (like those in our portfolios), as foreign currencies are translated into more dollars.

Our portfolios' fixed-income exposure, through the PIMCO Income fund, remains well-diversified. The PIMCO fund invests in multiple bond sectors, including but not limited to mortgage-backed bonds, corporate high yield bonds, emerging markets bonds, and Treasury bonds. While the fund sports an impressive track record, the recent COVID-related sell-off in both stocks and bonds exposed shortcomings of the PIMCO Income fund as a hedge against the stock market. From February 19, 2020 (the peak) to March 23, 2020 (the trough), the fund's price declined 13.72%. The Vanguard Intermediate Term Bond fund, by contrast, saw its price fall just 2.41% over the same period. Since March 23, 2020, the PIMCO Income fund has rebounded nicely, but the degree of its price decline has alerted me to its limitations as an absolute hedge against dramatic scenarios like the COVID crisis.

Along with stocks and bonds, the third broad asset class grouping in portfolios is diversifying alternative strategies. The Litman Gregory Alternative Strategies fund earned 7.64% for the quarter, but the fund continues to fall short of expectations, losing 3% year-to-date and seeing its share price decline by 14.25% between February 19, 2020 and March 23, 2020. A price decline of that magnitude would be perfectly acceptable if the fund were producing attractive longer-term results, but for the 1, 3 and 5-year periods – periods covering both bull and COVID markets -- the fund earned just 0.03%, 1.89% and 2.47% respectively. In its defense, most of its peer funds in the Alternatives space have generated even worse results over the same trailing 1, 3, and 5-year periods. Being one of the best funds is a disappointing category (Alternatives) doesn't justify keeping the fund, especially when both fund and category have failed to deliver on their biggest promise: to offer decent absolute returns, uncorrelated with the stock and bonds markets.

The role alternatives serve in our portfolios is to offer an alternative investment to bonds and stocks, with less interest rate risk than bonds and less market risk than stocks. Until recently, I've been concerned that bonds will perform poorly when interest rates rise, which has been a distinct possibility given the low level of interest rates. I still believe that rates will rise eventually, but the Federal Reserve has made clear that it has no intention of raising interest rates any time soon, so it's a safe bet that we're in for an extended period of low rates. With the risk of rising rates off the table, for now at least, I'm re-thinking the need for alternatives in our portfolios. This, and the disappointing results of the alternative category during the COVID crisis and last several years, has me re-thinking alternatives in our portfolios. More to come soon…

Closing Thoughts

So where does this leave us? The successful containment of COVID-19 is not a foregone conclusion. The resurgence of cases in the southern and western United States, not to mention in several EM countries like Brazil and India, is concerning. Local U.S. authorities have so far refrained from large-scale rollbacks of their reopening efforts. But if strict, widespread lockdowns return, the global economic recovery will be more drawn out, which would be a negative surprise for markets. There are also other uncertainties around the November election or the ongoing U.S.-China dispute that could disrupt financial markets.

That said, I hold a cautiously optimistic view that because the recent spike in COVID-19 cases has been accompanied by continued *declines* in COVID-related deaths the overall social policy response won't need to be as draconian. Therefore, the economic impact should be less extreme than during the first wave. If a more benign public health scenario plays out against a backdrop of extremely loose fiscal and monetary policy, there is a good chance we'll get a sustainable, albeit uneven, global economic recovery. It's unlikely to be a sharp V-shaped recovery, but something more gradual, with fits and starts along the way and with some sectors and industries doing much better than others. If so, corporate earnings are likely to rebound as well.

Measured against very low interest rates—and with fears of severe recession (or worse) off the table thanks to the policy response—this would support the view that equities and fixed-income credit sectors are relatively attractive compared to core bonds. Our meaningful portfolio exposures to non-core bond funds should do quite well in this event.

Furthermore, within the equity universe, a global economic recovery, likely accompanied by a declining dollar, would be a tailwind for international and EM stock markets relative to U.S. stock markets, for the reasons discussed earlier. Our globally diversified equity exposure and overweight to EM stocks should boost portfolio returns.

Also, with a return to "normal" life and less staying at home, I would not be surprised to see Value/Cyclical stocks take the leadership reins from Growth stocks, potentially marking a new cycle of relative performance in favor of Value. Our portfolios would benefit from this change in leadership, given the predominance of the Schwab U.S. Dividend fund in our portfolios.

I see several ways for our portfolios to perform well over the next five to 10 years. But I think we should also steel ourselves for a potential double-dip back down to the late-March market lows, most likely caused by disappointing developments on the virus/medical front.

As always, it is paramount that our investment management be guided by a strategy that meets the risk/return profile of each of you, the clients we serve, but also the financial planning goals set by each of you. If your goals have changed, please be sure to keep us informed so that your portfolio continues to serve your needs appropriately.

Best,

Kelly D. Kane, ChFC, CFP