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Q2 2020 MARKET COMMENTARY

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Comebacks

What a difference three months can make. After one of the worst quarters in recent memory, the markets came roaring back in the second quarter. In the quarter, investors demonstrated a willingness to look through poor near-term economic data and believe that a recovery was on the horizon – nearly the complete opposite of what happened in the first three months of the year.

In a time period characterized by a global pandemic and social and political unrest, it may have been hard to find a silver lining, but investors' optimism shined through. The market's movement off its March 23 lows is one of the great recoveries of our time. Everyone loves a good comeback story and we have a series of historic sports comebacks that line up with each major asset class in the quarter.

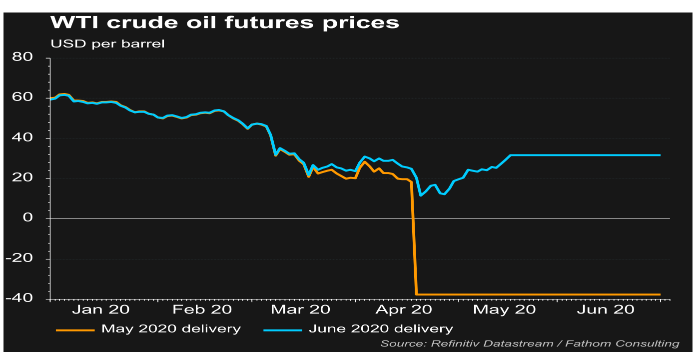
Domestic equities – 2004 Red Sox

In one of the most improbable comebacks of all time, the gritty 2004 Boston Red Sox became the first and only team to recover from a 3–0 deficit in a seven game Major League Baseball playoff series, defeating the New York Yankees to take the American League Championship Series. Speaking of improbable comebacks, let's talk about the domestic stock market.

Coming off the worst quarter since 1987, the U.S. stock market put up its best quarterly showing since 1998, with the S&P 500 returning 20.54% in the second quarter. That's one year's worth of returns (and then some) in just three short months. Stocks rose as investors demonstrated a willingness to look past what was expected to be poor economic data tied to COVID-19 related lockdowns. In other words, equity investors were already pricing in a recovery.

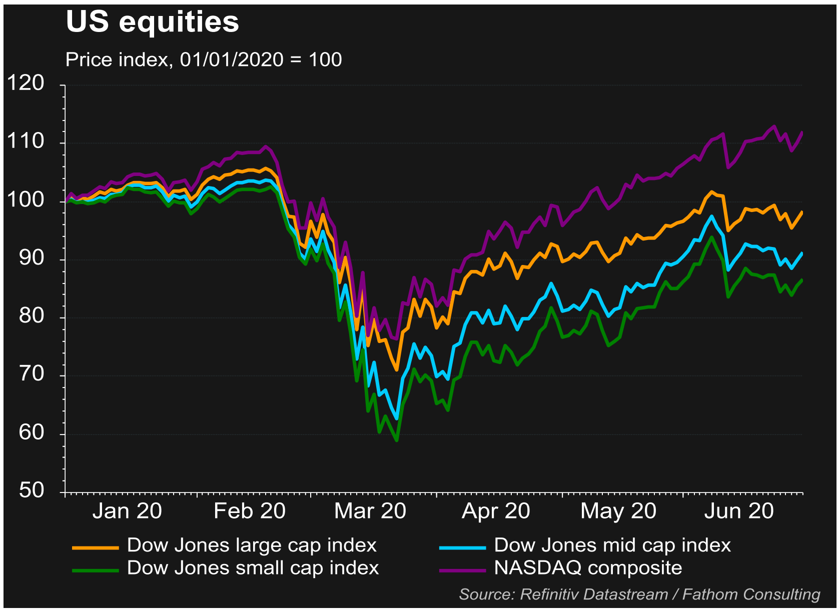
Coming into the second quarter, there were serious concerns about the falling demand for oil after companies around the globe instituted work from home policies. Poor demand paired up with a supply glut led to something that had never happened before – the price of WTI crude went negative in late April, meaning those storing oil had so much supply on hand they were essentially paying people to take the excess. Despite this, energy was the best performing market sector for the quarter with a return of 32.14%. Energy stocks performed very well because equity investors believed the sector had fallen too far and oil would recover in the future. Thus, stocks in industries from oil drillers to exploration and production companies came roaring back to life in the second half of the quarter.

WTI Goes Negative in the Quarter



With energy performing so well, value must have outperformed growth this quarter, right? Nope – and it wasn't even close. Growth outperformed value by more than 1,300 basis points in the quarter as the Russell 1000 Growth and Russell 1000 Value put up returns of 27.84% and 14.29% respectively. How could value underperform by such a huge margin when deep cyclical sectors such as energy and even materials outperformed in the quarter? The answer is twofold. First, while cyclical sectors performed well, so did technology. Technology has infiltrated so many aspects of daily life that, as of late, the sector seems to perform well in markets that are up, down and sideways. The chart below, which shows how the technology-heavy NASDAQ composite faired relative to other broad indices, demonstrates this well. The index held up well on a relative basis on the way down and opened up a notable performance gap during the recovery as well.

Tech-heavy NASDAQ Leads the Way



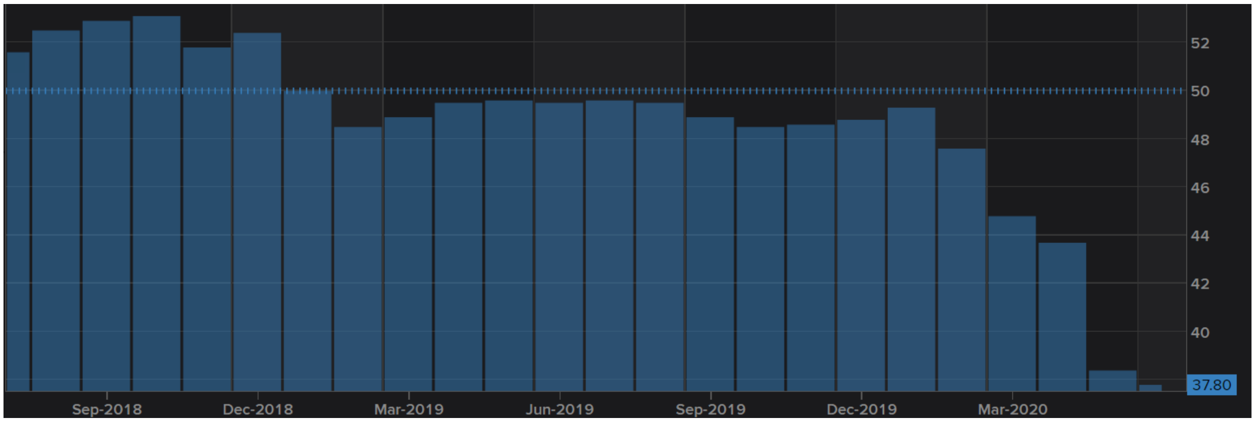
The second reason is that while energy and materials performed well their exposures in most value portfolios and indices is still quite low, making up less than 10% of the Russell 1000 Value combined. This contrasts with technology, which often makes up a significant portion of growth funds and indexes – close to 40% of the Russell 1000 Growth. Thus technology's performance in either direction can and did have a much more meaningful impact – and suggests there may be quite a bit of sector risk in growth portfolios right now.

Foreign equities – 1995 Indiana Pacers

This may be a little obscure to all but a few avid NBA fans, but in game 1 of the 1995 Eastern Conference Finals, with the Indiana Pacers trailing the New York Knicks by six points with less than 20 seconds to go, Pacers star Reggie Miller managed to put up eight points in nine seconds to win the game. He nailed a three pointer, stole the inbound, and hit another three – all in less than four seconds. He then grabbed another rebound and hit two free throws to win the game. A furious comeback if ever there was one. Speaking of furious comebacks, let's discuss the international markets.

After a challenging first quarter, international equities posted strong absolute returns in the second quarter with the MSCI EAFE posting 14.88%. While a strong return in any quarter, foreign stocks yet again lagged their U.S. counterparts. One of the countries within the EAFE index holding back relative returns was Japan. Similar to the U.S., Japan has seen significant fiscal stimulus designed to help prop up its economy during the pandemic. However, coming into the year, the country was already on somewhat shaky ground economically, with consistently weak manufacturing data. The chart below shows that Japan's PMI has been below 50 (a level below 50 indicates manufacturing activity is contracting) since early 2019. With less than stable grounding and renewed fears of deflation, Japanese equity investors are pricing in a somewhat less robust recovery.

Japanese PMI in Contraction Territory Since Early 2019



Source: Refinitiv Eikon as of 6/30/2020

While country-by-country performance was a mixed bag in the Eurozone, Germany performed quite well, with a return of 26.54%. German equities began to take off in mid-May after Germany and France announced that they would offer up a recovery fund made up of €500 billion (approximately $543 billion) worth of grants to sectors and regions of the European Union that were hit hardest by the COVID-19 pandemic.

Emerging markets also underperformed the U.S. a bit, with a return of 18.08%. China in particular lagged. Like every nation, China has had to deal with the economic impact of the coronavirus. Since it was the first country to enter the crisis, it was also the first to emerge. While China is far from out of the woods on the coronavirus front, a renewed focus was put back on trade tensions with the U.S.

Fixed income – 1992/1993 Buffalo Bills

It's hard to believe now, but the Buffalo Bills were one of the most dominant NFL teams in the 1990s, making it to the Super Bowl in four consecutive years – only to lose all four games. That said, the Bills were on the winning end of one of the greatest comebacks in football history. During an AFC playoff game against the Houston Oilers in January 1993, the Bills trailed the Oilers 35–3, a seemingly insurmountable deficit. However, the Bills came back to win with backup quarterback Frank Reich, who over the course of his nine year career in Buffalo had only won six games.

If we look at the bond market, investment-grade fixed income was the starting quarterback and below investment grade was the benchwarmer. But coach put in the back up in the second quarter and it worked out very well. During the quarter, the Bloomberg Barclays High Yield Corporate Bond Index put up a double digit return of 10.18%, more than tripling the more modest, but still respectable 2.90% return provided by the Bloomberg Barclays Aggregate Index.

High Yield Bonds – Don't Call it a Comeback

	Q2 2020
Bloomberg Barclays Agg	2.90%
Bloomberg Barclays High Yield	10.18%

During the quarter the Federal Reserve (Fed) announced that it would purchase corporate bonds by buying into corporate bond ETFs, believing this would allow them to enter the corporate space in an efficient and diversified manner. The markets took this as a sign that the Fed was going to make sure the credit markets did not seize up. As such, corporate bonds up and down the credit spectrum performed well, with riskier, below-investment-grade bonds performing exceptionally well.

The same held true in the muni market to a degree. Municipal bonds struggled in the first quarter as investors worried that state and local municipalities might suffer revenue setbacks in light of the pandemic. In an effort to keep the money spigot open for these economies, the Fed initiated an expanded Municipal Lending Facility, purchasing state and local debt. The muni market stabilized as a result and performed well in the second quarter.

Summary – 1988 Los Angeles Dodgers

Let's finish up with another baseball comeback. In 1988, the Los Angeles Dodgers came into the World Series versus the Oakland As as heavy underdogs. However, a dramatic event in the first game would turn the tide in short order. With two outs in the bottom of the ninth inning and the Dodgers trailing 4 – 3, injured player Kirk Gibson was, surprisingly, sent in to pinch hit. The rest is history. Gibson hit a two-run home run to win the game and limped around the bases…before performing the greatest arm pump in history.

Why end with this comeback? We need that positive visual of Kirk Gibson pumping his arm right now. Seriously, watch it again. The stock market has come a very long way since its March 23 lows, but there is still a lot of worry. COVID-19 cases are back on the rise, social unrest is the highest it has been since the 1960s, and the presidential election is in a few months. We are living through a scary and volatile time. But as Americans, we are wired to be optimistic, and I am confident this too shall pass. Looking at how well the stock market performed in the second quarter, it would appear many investors agree.

Second Quarter Capital Markets Returns

Index	Q2 2020
S&P 500	20.54
Russell 1000 Value	14.29
Russell 1000 Growth	27.84
Russell Mid Cap	24.61
Russell Mid Cap Value	19.95
Russell Mid Cap Growth	30.26
Russell 2000	25.42
Russell 2000 Value	18.92
Russell 2000 Growth	30.58
MSCI EAFE	14.88
MSCI Emerging Markets	18.08
Bloomberg Barclays Aggregate	2.90
Bloomberg Barclays High Yield	10.18
Bloomberg Barclays Treasury 1 - 3 Year	0.25
ICE BofA US Muni	2.66
Bloomberg Commodity	5.08
DJ Commodity Gold	12.07
FTSE NAREIT Equity REIT	13.25

Source: Morningstar Inc. as of 6/30/2020

Important Disclosures

Investment return and principal value will fluctuate, and it is possible to lose money by investing. Past performance is not a guarantee of future results.

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Investing in lower-rated debt securities (commonly referred to as junk bonds) involve additional risks because of the lower credit quality of the securities in the portfolio. The investor should be aware of the possible higher level of volatility, and increased risk of default. Bonds are subject to interest rate risk. As the prevailing level of bond interest rates rise, the value of bonds already held in a portfolio decline.

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