RVK

Capital Markets Review | 2nd Quarter 2020

June 30, 2020

Overview

The disconnect between investor risk appetite and economic conditions reached staggering levels during the second quarter. These conditions were largely fueled by fiscal relief and liquidity reinforcing programs implemented by governments and global central banks in response to the COVID-19 pandemic and the resulting economic shutdowns. The S&P 500 rebounded sharply as its forward P/E ratio reached levels last seen during the tech bubble. Equity markets outside the US produced similarly positive returns for Q2, although they remain deeper in the red in 2020 compared to broad domestic indexes. In general, the funding pressures markets experienced in the first quarter abated, as various programs enacted by the Federal Reserve proved successful in restoring normal capital markets activity. Risk assets were consistently bid higher, with nearly every major asset class producing strong returns.

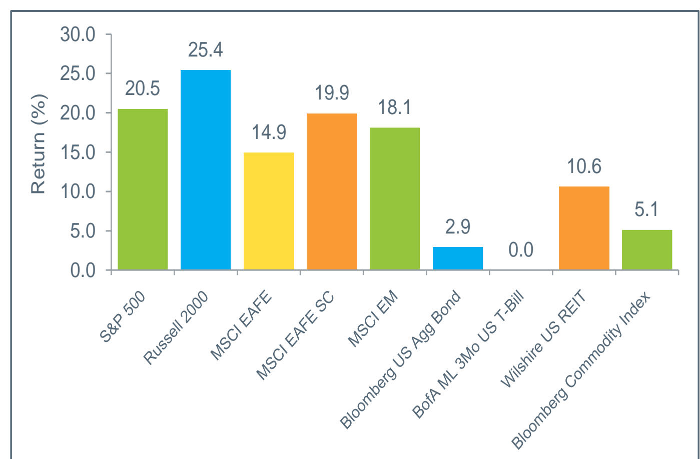
While economic data generally pointed to a bottoming of global GDP growth during the month of April, the modest economic recoveries in May and June lagged significantly behind the ”V” shaped recovery seen in the pricing of risk assets. The Atlanta Fed’s GDPNow estimate for Q2 US growth, as of July 1st, indicated a 36.8% annualized economic contraction, a recession more severe than experienced in 2008-09. At the same time, the NASDAQ and Dow Jones Industrial Average experienced their best quarters since 2001 and 1987, respectively, while equity issuance in the US hit a record of $184 billion. On the debt side, the first half of 2020 also saw record issuance in corporate credit. Companies with investment grade ratings issued in excess of $1.2 trillion during the first six months of the year, double the amount realized over the same period in 2019. Additionally, companies with junk ratings saw year-over-year increases in issuance of close to 40%. In a sign that market participants continue to look past the near-term effects of the pandemic and the unprecedented new supply coming to market, credit spreads narrowed across the quality spectrum. Despite the tightening of spreads, a potential wave of corporate defaults remains likely, as the number of defaults for companies with liabilities in excess of $50 million increased to 76, a level last seen during the financial crisis in Q1 2009.

Amid the negative trends that were observed during the quarter, there were encouraging indicators in the form of lower than expected unemployment rates and higher than anticipated non-farm payroll growth. Many professional forecasters had anticipated an unemployment rate approaching 20% by quarter-end, following the 20.8 million job losses announced in April. In fact, the June employment report indicated an unemployment rate of just 11.1%. Going forward, the economy remains in a precarious position, as personal current transfer receipts, including $1,200 checks sent to many American households and expanded unemployment benefits, kept incomes elevated during the economic shutdown. It remains to be seen whether markets can maintain their trajectory if these income replacing programs are not renewed, especially if further lockdowns are necessary.

Trailing Period Market Performance (%)

	QTD	CYTD	1 Year	5 Years	10 Years
S&P 500	20.5	-3.1	7.5	10.7	14.0
Russell 2000	25.4	-13.0	-6.6	4.3	10.5
MSCI EAFE	14.9	-11.3	-5.1	2.1	5.7
MSCI EAFE SC	19.9	-13.1	-3.5	3.8	8.0
MSCI EM	18.1	-9.8	-3.4	2.9	3.3
Bloomberg US Agg Bond	2.9	6.1	8.7	4.3	3.8
BofA ML 3Mo US T-Bill	0.0	0.6	1.6	1.2	0.6
Wilshire US REIT	10.6	-17.8	-12.3	4.0	9.2
Bloomberg Commodity Index	5.1	-19.4	-17.4	-7.7	-5.8

Quarter-to-Date Performance (%)



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Key Economic Indicators

	Q2 2020	Q1 2020	Q4 2019	10 Year Average
Federal Funds Rate	0.08%	0.08%	1.55%	0.64%
Treasury - 1 Year	0.16%	0.17%	1.59%	0.76%
Treasury - 10 Year	0.66%	0.70%	1.92%	2.28%
Treasury - 30 Year	1.41%	1.35%	2.39%	3.05%
Breakeven Inflation - 5 Year	1.17%	0.53%	1.70%	1.72%
Breakeven Inflation - 10 Year	1.34%	0.93%	1.79%	1.95%
Breakeven Inflation - 30 Year	1.56%	1.25%	1.81%	2.08%
Barclays US Corp: Hi Yld Index - OAS	6.26%	8.80%	3.36%	4.80%
Capacity Utilization	64.80%	72.72%	77.10%	76.72%
Unemployment Rate	11.10%	4.40%	3.50%	6.15%
ISM PMI - Manufacturing	52.60%	49.10%	47.80%	53.76%
Baltic Dry Index - Shipping	1,799	626	1,090	1,155
Consumer Confidence (Conf. Board)	98.10	118.80	128.20	94.33
CPI YoY (Headline)	0.60%	1.50%	2.30%	1.73%
PPI YoY - Producer Prices	-2.20%	-0.90%	1.90%	1.52%
US Dollar Total Weighted Index	120.86	122.82	114.72	103.65
WTI Crude Oil per Barrel	$39	$20	$61	$70
Gold Spot per Ounce	$1,781	$1,577	$1,517	$1,373

Asset Class Commentary

US Equity

US equity markets snapped back significantly in Q2 despite weakening economic conditions and uncertainty around upcoming earnings releases. Much of the positive optimism was driven by the impact of government programs, trial data for COVID-19 vaccines and treatments combined with the phased openings of states across the country. The swift rally saw the S&P 500 index turn positive YTD, with QTD returns as high as 25% in early June before finishing Q2 up 20.5% and down -3.1% YTD. The positive performance was realized across all market caps, with smaller stocks faring best. The Russell 2000 and Mid Cap indexes returned 25.4% and 24.6%, respectively, while the Russell Top 200 lagged behind its smaller-cap counterparts, finishing Q2 up 20.9%.

Growth continued to outperform value by a significant margin during Q2 across all market caps. The Russell 1000 Growth returned 27.8% while the Russell 1000 Value returned 14.3%. Meanwhile, the Russell 2000 Growth and Value indexes finished Q2 up 30.6% and 18.9%, respectively. An increase in risk sentiment saw investors shifting away from the low volatility names that provided downside protection during the Q1 sell-off.

Active managers generally struggled to keep up with their respective benchmarks in Q2. However, small cap managers in the value and growth segments fared better compared to managers focusing on other style and size groups. Additionally, large-cap value managers performed better, relative to their respective benchmarks, than their large cap core and growth counterparts in Q2.

Non-US Equity

Developed international markets had a strong quarter, although they lagged both US and emerging markets. During Q2, value stocks underperformed growth, while small-cap stocks outperformed their larger counterparts. Each developed country index generated positive returns for the quarter and the vast majority saw double digit returns. Sector performance was broadly positive as well, although energy stock returns were more tepid. Markets were bolstered by government programs, as the European Commission announcing $2.7 trillion in support while Japan has committed approximately $2.1 trillion to fiscal stimulus. Despite these programs, the near -term macro outlook remains poor, as Eurozone GDP is forecasted to have dropped double digits during Q2.

Emerging markets outpaced the developed international space, but lagged the US market. Similar to other regions, value stocks underperformed growth, while small-cap outperformed large-cap stocks. All emerging countries and sectors saw positive returns for the quarter. Latin America, a laggard in Q1, experienced a reversal, with countries such as Brazil and Argentina leading the region higher. This trend materialized despite Brazil now having the second-highest infection and death rate from

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COVID-19 in the world. During the quarter, Brazil went from having fewer than 6,000 reported cases to well over one million.

Fixed Income

The Bloomberg US Aggregate Bond Index had another relatively strong quarter, returning 2.9% in Q2. In contrast to Q1, investor appetite for risk returned, leading to a strong recovery in credit. Meanwhile, US Treasury yields saw little movement across the curve. It was a weak quarter for government bonds as all short and intermediate maturities were yielding below 1%.

Corporate debt provided the main narrative for Q2. A supportive Fed helped propel the beginning of a recovery that saw few periods of slowdown throughout the quarter. While a spike in COVID-19 cases threatened to disrupt the rally in June, a better-than-expected jobs report and the Fed's announcement of its plan to purchase corporate bonds helped the segment finish the quarter on a positive note.

BBB-rated bond returns led all investment grade credit, even as the total of "fallen angels" (companies formerly rated as investment grade downgraded to high yield) already surpassed the previous full-year record high in 2009 based on data from J.P. Morgan. Some of these fallen angels helped bolster high-yield returns in Q2 as spreads narrowed, briefly dipping below 600 basis points in late June for the first time since early March. While the lowest-rated debt made a comeback late in the quarter, it lagged early on, perhaps indicating some hesitation by investors to go too far down in quality amid continued market uncertainty. Overall, the Bloomberg US Credit Index and US High Yield Index returned 8.2% and 10.2% in Q2, respectively.

Emerging market debt enjoyed its own rally, erasing most of its losses from the first quarter. Central banks around the world have provided extensive stimulus, and the gradual reopening of economies has helped investors restore confidence in the sector. The JPMorgan EMBI Global Diversified Index returned 12.3%, with nearly every country in the index having positive returns.

Diversified Hedge Funds

Broad hedge fund benchmarks indicate the industry recovered relatively well from Q1 drawdowns. The HFRI Fund Weighted Composite Index is down -3.5% YTD after a 9.0% gain in Q2, led higher by the HFRI Hedged Equity Index, which finished the quarter up 13.6%. In contrast, strategies that pursue event-oriented and special situations strategies, particularly within credit markets, were down from -5% to -7% YTD on average. Managers who pursue less directional strategies within the relative value or market-neutral equity spaces lagged in Q2 as the market recovered, but are some of the better performing strategies YTD, down approximately -1% according to HFR. The only broad index category in positive territory is Thematic Macro, up 2.6% YTD after a 5.0% gain in Q2.

Strategies that RVK follows closely have performed significantly better than indices would imply. Multi-PM platforms that focus on alpha generation, as opposed to directional market bets, held up in well during Q1, and produced gains in the mid-single digits to mid-teens in Q2. This is a spectacular run of alpha generation for managers who maintain market neutrality. Gains have been widespread across fundamental equity trading, index rebalancing, fixed income arbitrage, quantitative equity, and other core strategies. Other event-oriented managers are marginally positive YTD on average after posting Q2 returns in the 5% to 10% range.

Within the Equity Long/Short (ELS) space, managers captured a good amount of upside via alpha generation on the long side of their portfolios in Q2. RVK has seen managers it follows gradually add exposure to higher-quality cyclical companies in recent months, and has noted elevated exposure across the technology, communications, and healthcare sectors. In aggregate, prime brokerage data indicate that ELS managers have added to net exposures recently, while reducing gross back toward the 20th percentile over the trailing 12 months. Exposure to crowded long names has persisted, which is a factor RVK continues to monitor with its current favored managers.

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Global Tactical Asset Allocation (GTAA)

GTAA managers largely provided positive absolute returns during Q2. Even with positive absolute returns, long-biased strategies reported mixed performance versus a static and less diversified blend of 60% US equity and 40% US fixed income. Long-biased strategies that had relatively weaker performance versus peers tended to have more exposure to emerging market equities, which slightly underperformed US and other developed markets. Within emerging market equities, growth equities once again outpaced value by a significant margin as the MSCI Emerging Market Growth Index returned 22.2% versus 14.0% for the MSCI Emerging Market Value Index. This trend detracted from the performance of managers tilted toward value stocks within emerging markets. In some cases, managers that underperformed on a relative basis also reduced their beta exposure to some degree during the quarter as equity markets began to rebound following the lows seen in March. Though these strategies lagged, they still saw positive absolute returns during the quarter. Multi-asset managers that intend to provide reduced correlations, lower volatility, and less market sensitivity mostly underperformed long-biased GTAA managers. However, strategies within this group that saw stronger relative returns held idiosyncratic positions, such as long exposure to Ukraine, Egypt, and South Africa, which contributed to returns.

Diversified Inflation Strategies (DIS)

Performance across DIS managers that RVK tracks closely was largely positive during Q2, with returns ranging from the high-single digits to the high-teens. Due to relatively strong performance across a number of risk assets, managers with larger TIPS allocations tended to underperform peers as generally riskier assets saw a bounce back from poor Q1 performance. However, managers with relatively larger TIPS allocations have still generally outperformed peers YTD. Strong performing strategies in Q2 also tended to hold higher relative allocations to commodities. Though commodities did not keep up with other segments of the market, it did provide positive absolute returns in Q2. DIS managers that saw relatively stronger performance also generally held higher allocations to REITs, global listed infrastructure, and/or global natural resource equities in varying proportions. Inflation, as measured by the year-over-year change in headline CPI, decreased over the quarter from 1.50% in March to 0.60% as of June 30. As viewed through monthly CPI releases, April and May both reported slight decreases in inflation with June seeing an increase, in part due to higher gasoline and food prices. Additionally, 10-year Treasury break-evens, a market-based measure of future inflation expectations, increased over the quarter from 0.93% to 1.34%.

Real Estate

Core private real estate returned -1.6% during the second quarter (on a preliminary basis) as reported by the NCREIF ODCE Index, with the total return comprised of 0.9% from income and -2.5% from price appreciation. While the income component remained relatively healthy and in line with historical levels, price appreciation experienced a further meaningful decrease following the prior quarter’s negative return. Investors in publicly traded real estate regained some ground during the second quarter and outperformed their private market counterparts by a wide margin. Publicly traded real estate delivered a second quarter total return of 14.0%, as measured by the FTSE NAREIT All REITs Index. This level of quarterly return volatility is to be expected given the high level of correlation between REITs and public equity markets.

While the total return for core private real estate was negative, it did beat many expectations going into the quarter, as much of the impact from COVID-19 remains unknown. There was considerable uncertainty regarding the level of rent collections across property sectors, beginning with those due in April. As the second quarter progressed, trends started to emerge. Unsurprisingly, the hospitality and retail sectors fared the worst due to shelter-in-place orders. Other sectors, such as industrials and multifamily, have performed in-line with expectations. Industrials were bolstered by increased demand from online consumer spending, while multifamily was stable due to the necessity-based attributes of the sector. It is also worth highlighting that transaction activity, which is a key input in the appraisal process, was scarce in Q2. Much of the negative price appreciation reported by managers stemmed from reduced income growth assumptions and increased reserves for credit losses as opposed to cap rate expansion.

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[1]Between July and October 2019, Greenwich Associates conducted interviews with 1,100 individuals at 896 of the largest tax-exempt funds in the US–including corporate and union funds, public funds, endowments and foundations–with either pension or investment pool assets greater than $150 million. Study participants were asked to provide quantitative and qualitative evaluations of their asset managers and investment consultants, including qualitative assessments of those firms soliciting their business and detailed information on important market trends. RVK is one of three firms recognized in the large investment consultant category. The ratings may not be representative of any one client's experience with RVK; rather they are representative of those clients submitted and that chose to participate in the survey. The results are not indicative of RVK's future performance.

To read the Greenwich article, please refer to the following URL: https://www.greenwich.com/asset-management/five-factors-distinguish-best-class-consultants-average-practitioners

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