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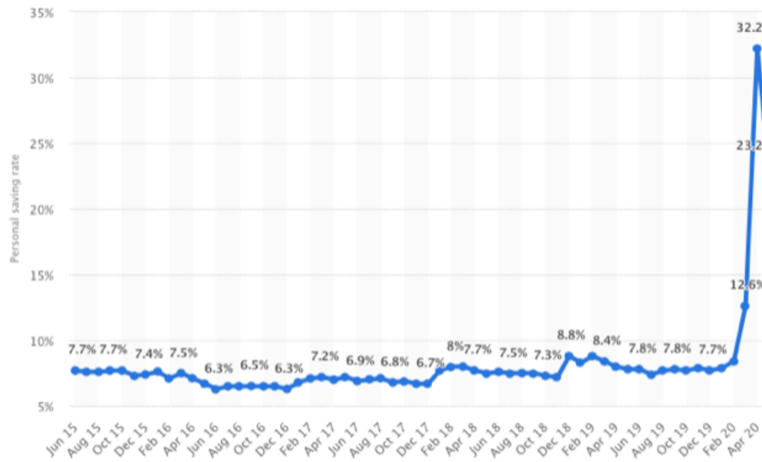
Market Review & Update

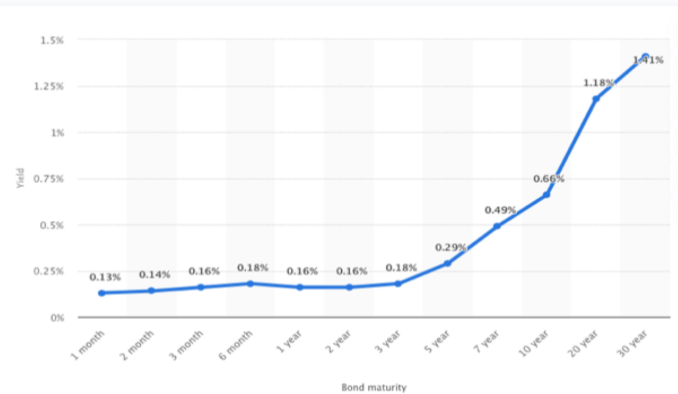
SUMMER 2020

After the first quarter saw stocks fall almost 35% in just six weeks, the US equity markets posted their best quarterly returns in over twenty years. The S&P 500 index was up 20%, recovering much of what was lost in the first quarter. The massive federal stimulus, both monetary and fiscal, helped individuals and businesses during the government mandated shutdown by providing a large policy backstop supporting the recovery. As evidenced by the chart to the left, we saw the personal savings rate jump from 7.7% to over 20% as the limited travel, dining, shopping, and other consumer discretionary spending options were closed and households saved the excess funds not being spent.



Part of the Federal Reserve's (Fed) economic stimulus program was a reduction in short term interest rates and much of the savings generated by businesses and individuals looks like it is being directed into very low yielding short term investments. As can be seen in the chart, interest rates on US Treasuries are less than 0.30% going out the first five years of maturities and even the ten-year rate is at 0.66%. Along with their suppression of short term rates, the Fed also engaged in direct buying of high-yield bond ETFs and individual investment-grade corporate debt in an effort to keep a lid on longer term rates as well. If the Fed meets its inflation target of 2%, investors in a 10 year US treasury note would be earning an inflation-adjusted negative 1.34% annually and investors in short term instruments will be falling even further behind at these levels. Even given those unappetizing prospects, the fund flow numbers show that many investors continue to place funds into the short-term fixed income market instead of US or international stocks even as the equity markets were recovering.

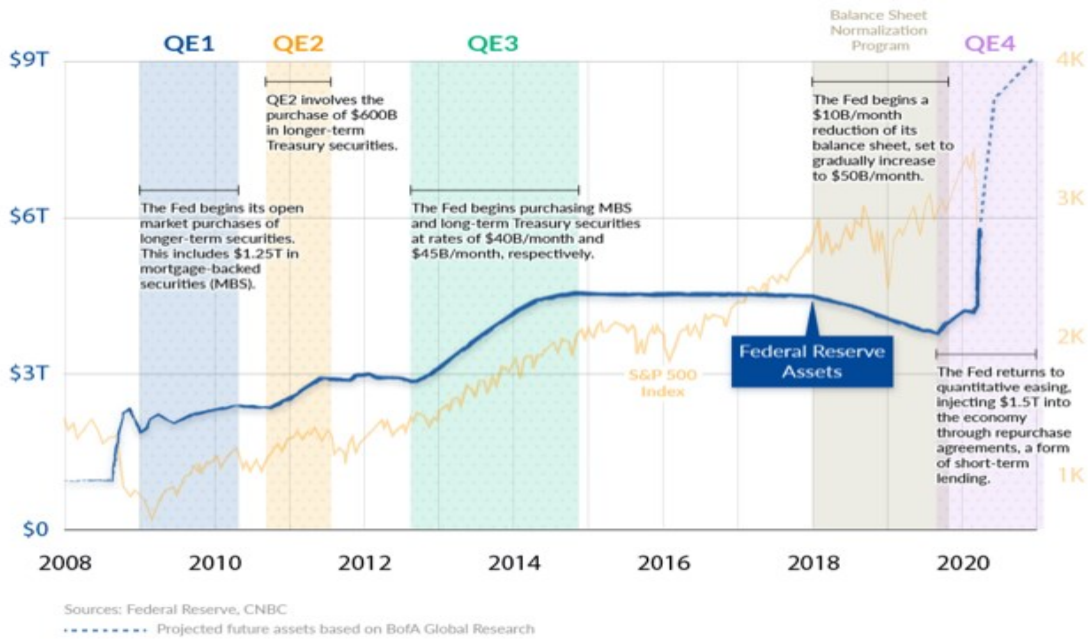
Treasury yield curve in the United States as of June 2020



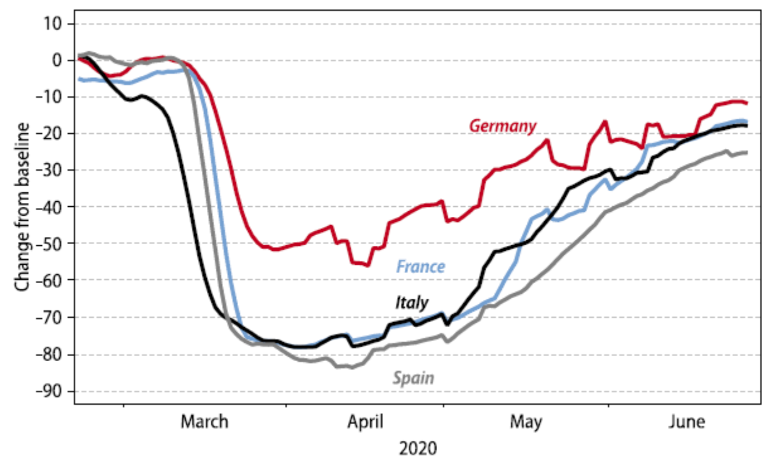
Fund flows

USD billions	AUM	YTD	2019	2018	2017	2016
U.S. equity	8,784	(51)	(85)	1	28	(8)
World equity	3,229	(25)	10	87	247	14
Taxable bond	4,327	(38)	414	121	389	215
Tax-free bond	833	(15)	105	11	34	32
Multi-asset	2,603	(41)	20	(10)	60	30
Liquidity	4,602	1,103	578	241	118	149

The Fed accomplished this feat of lowering interest rates by dramatically increasing its own balance sheet through the establishment of an unlimited bond-buying program. During the 2007-2009 housing-led recession, the Fed expanded its balance sheet from around $1 trillion to over $2 trillion to help stabilize the financial sector and the overall economy. Since that time, the Fed's balance sheet has drifted upwards until 2018 when the Fed began a slow reduction with plans to normalize their balance sheet. With the onset of the government shutdowns due to the coronavirus, the Fed returned to quantitative easing measures designed to provide liquidity and support to the economy. As state economies are re-opening the Fed will eventually have to reduce these measures. The challenge will be balancing off the potential negative effects that drawing down this support could have on the economy versus the specter of higher inflation if they leave such massive liquidity in the system. In 2016 the Fed clarified its inflation target as "symmetric" meaning there is no specific floor or ceiling. In other words if actual inflation was 1.5%-2.0% for the past five years, the Fed may target a range of 2.0%-2.5% for the next five years.



As we mentioned in our last client update, after a poor start in dealing with Covid, Europe has done a good job in reducing their virus numbers in most cases. Global central banks have also created varied stimulus programs for their economies that have achieved similar results as the US. Due to these two factors, developed countries in Europe are seeing a large uptick in mobility and some economic metrics. This may represent an opportunity for international markets to finally outperform the United States equity markets. Since the end of the financial crisis in 2009, the S&P 500 index has returned approximately 400% while an index of international equity markets has returned only 143%. Diversification into global equity markets over the past decade has not benefited portfolios as expected but we may see that situation change going forward.



We hope you and your family are all healthy and enjoying the summer! We will talk to you soon.

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