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The Colony Group

MARKET PERSPECTIVES

QUARTER TWO 2020

Risk assets staged an epic rebound during the second quarter following March's historic declines. U.S. stocks posted their strongest gains in over 20 years, with the S&P 500 returning 20.5% during the quarter. Since U.S. stocks marked their low point on March 23, the market has risen 40%, its strongest 100-day gain since 1933.

The recovery in risk assets was not limited to the U.S., as international equities staged an impressive rally of their own. The MSCI EAFE Index increased 14.9%, and the MSCI Emerging Markets Index was up 18.1%.

Bonds recorded a second consecutive quarter of solid returns, with the Barclays U.S. Aggregate Bond Index returning 2.9%. Riskier bonds outperformed this quarter, led by the Barclays High Yield Corporate Bond Index's return of 10.2%. While interest rates remained relatively stable throughout the quarter, in stark contrast to last quarter's precipitous decline, credit spreads (the yield of a bond relative to a U.S. Treasury security with a similar maturity) tightened, driving higher returns for investment-grade and high-yield bonds.

Investors are struggling with the dichotomy between the strong performance of investment markets and the recessionary global economy. With unemployment hovering at levels last seen during the Great Depression and second-quarter GDP growth expected to decline at a steeper pace than during the Great Financial Crisis (GFC), it is hard for some investors to understand why stock prices continued to move higher. As such, we were not surprised to see markets stall a little in June after two consecutive months of strong gains.

Second-quarter returns serve as a reminder that markets are discounting mechanisms, focused on the horizon rather than the shoreline. Market participants are seemingly convinced that the world will move past the pandemic at some point. When it does, the global economy may be primed for a strong recovery impelled by record fiscal and monetary stimulus. While this stimulus has generally been positive, it has created dilemmas that are worthy of further exploration.

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Price Discovery

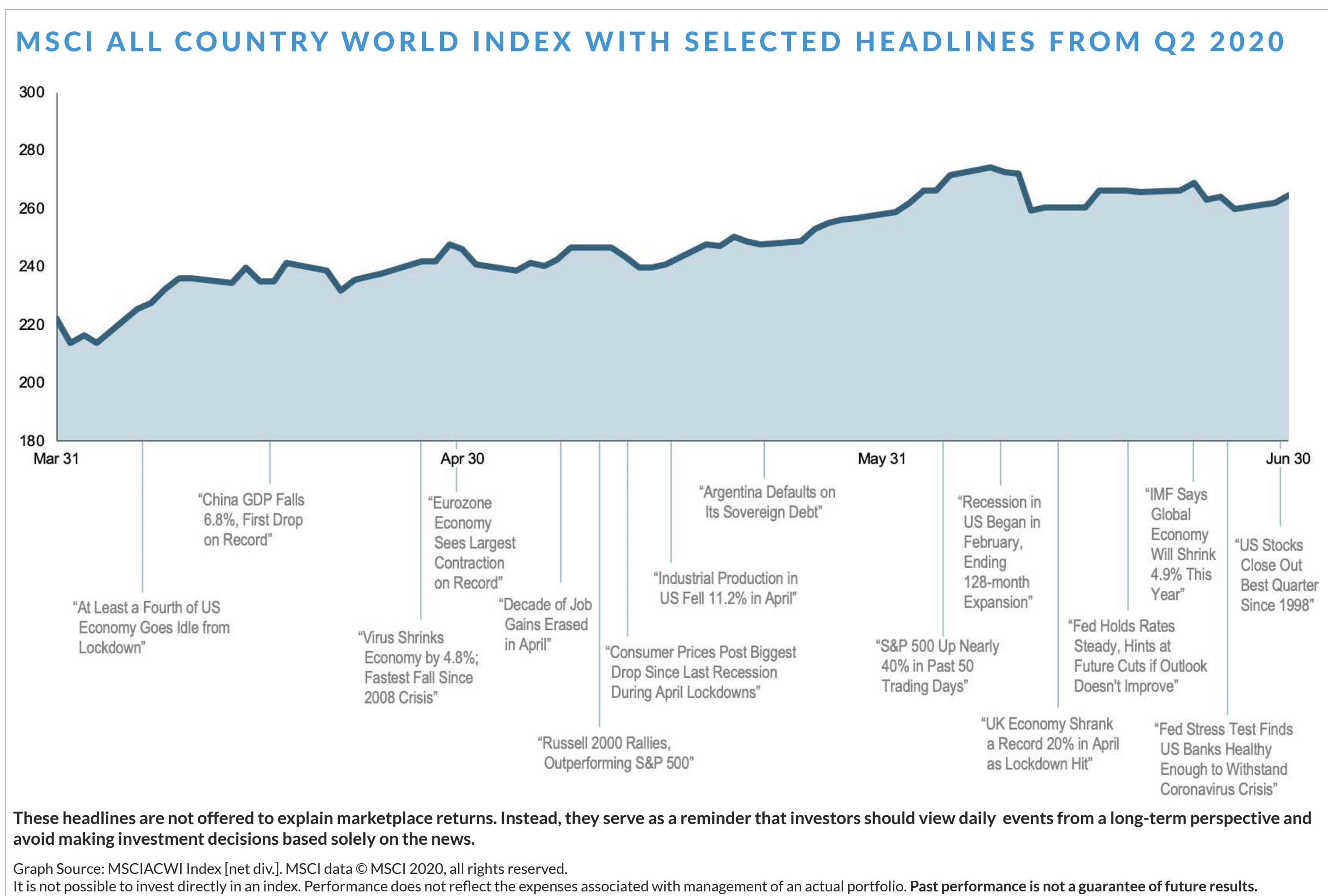
The Federal Reserve (Fed) has received mostly high grades for its policy response to the COVID crisis. Chairman Powell acted decisively during the early phases of the upheaval to boost liquidity while politicians deliberated over details of a stimulus package. The Fed quickly restarted policies used during the GFC to restore confidence in the financial markets. Ironically, these same policies drew widespread criticism during the GFC. Many accused the Fed of creating a moral hazard as some companies were bailed out despite their reckless behavior that contributed to the crisis. Very few people are repeating those accusations today as the global economy was effectively closed by fiat.

The Fed's policy does carry potentially adverse consequences, however. We believe that quantitative easing may be corrupting one of the market's primary functions: price discovery. Quantitative easing, often referred to by its acronym QE, is a form of unconventional monetary policy in which a central bank purchases securities directly in the open market. Since these purchases are funded by "printed" money, they cause an increase in the money supply, encourage lending, and fuel investment.

The magnitude of QE has been staggering and has made substantial impacts on the markets the Fed is targeting. Coming into the year, the U.S. central bank owned a little more than $4 trillion of securities. By the end of June, its balance sheet had grown by $3 trillion to over $7 trillion. Its purchases of Treasury notes and mortgage-backed securities has driven up prices and pushed down yields (higher prices cause lower yields on fixed coupon securities). For example, the yield on the 10-year Treasury note has declined from 1.92% at the start of the year to 0.66% at the end of June. Since many securities are valued using Treasury yields, this has served to raise the prices of a wide swath of investments. In fact, one could attribute much of the rise in equities to the math of a lower discount rate.

WHAT THIS MEANS

Markets play an important role in helping companies raise capital. They allow individuals to earn higher returns on their savings by effectively and efficiently transferring their savings to companies in need of capital. Markets benefit from the collective wisdom of their participants, relying on participants' ability to make appropriate capital-allocation decisions. Many participants trust that the markets will rationally price securities as they seek to balance supply and demand.



These headlines are not offered to explain marketplace returns. Instead, they serve as a reminder that investors should view daily events from a long-term perspective and avoid making investment decisions based solely on the news.

Graph Source: MSCIACWI Index [net div.]. MSCI data © MSCI 2020, all rights reserved.
It is not possible to invest directly in an index. Performance does not reflect the expenses associated with management of an actual portfolio. **Past performance is not a guarantee of future results.**

Today, we are concerned that central banks may be distorting the markets' ability to objectively price securities. The introduction of new, exceedingly large participants that are not motivated by economics has pushed prices, in some cases, beyond intrinsic value. While the Fed's direct purchase activities have thus far been limited to select markets, it is having indirect impacts across a much wider array of asset classes.

This phenomenon likely explains some investment anomalies observed over the past decade. Recall that QE programs started in earnest during the GFC. Over the subsequent years, we have experienced the longest period of outperformance by growth stocks relative to value stocks, a decline in interest rates to historically low levels (in some cases below zero), and unusually tight credit spreads. There may yet be more inconsistences that result from this latest wave of QE.

Narrow Leadership

QE may also be partly responsible for causing historically high levels of concentration in the S&P 500 index. A focus on indices, such as the S&P 500, has intensified over the past couple of decades thanks in part to the growing use of exchange traded funds (ETFs) and open-end index mutual funds. The S&P 500, composed of 500 large-cap U.S. companies, is among the most commonly used benchmarks to evaluate the performance of "the market" due to its broad representation across industries. Nevertheless, we are uncertain it is properly reflecting the performance of the average stock in its current construct.

The wave of excess liquidity induced by the Fed through its QE programs has found its way into the stock market. As investors have increased their use of passively managed strategies, like those employed by index funds and ETFs, the benchmark's largest companies have grown larger. This happens because most benchmarks weight their constituents by equity market capitalization (total equity value, measured by multiplying the share price times the number of shares outstanding).

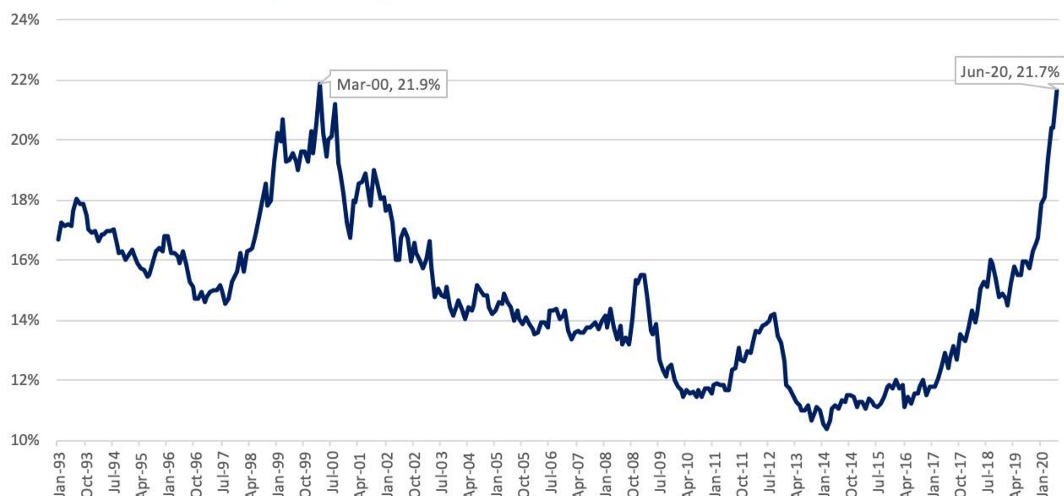
As the equity market's leadership has narrowed, the S&P 500 has grown more concentrated. Indeed, the index's five largest stocks comprise just under 22% of the total, a historically high level. These five companies – Microsoft, Apple, Amazon.com, Alphabet (the parent company of Google), and Facebook – are all technology companies that are largely immune to, or even benefit from, social distancing requirements. Moreover, each exhibits characteristics that investors currently find desirable: strong balance sheets with large amounts of cash, low levels of debt, and prodigious cash-flow generation. These factors have combined to create a virtuous circle of outperformance for both these stocks and the index.

WHAT THIS MEANS

History suggests that index concentration is not sustainable. There are many past examples of sectors or companies becoming outsized as a percentage of the S&P 500, followed by prolonged periods of underperformance.

The dotcom bubble, which peaked in 2000, was the last time the S&P 500 reached a similar level of concentration. By March of 2000, the top five names in the index grew to almost 22% of its total value. A quartet of the largest names in the index – Microsoft, Intel, Cisco, and Dell – were anointed the Four Horsemen. This in some respects reminds us of today's FAANG stocks, a group of five of the largest stocks in the index (Netflix replaces Microsoft in the acronym). Two decades on, Cisco and Intel still trade below where they traded in 2000. Dell was taken private at a price well below its 2000 peak. Lastly, Microsoft took approximately 15 years to meaningfully push above its 2000 peak.

There are numerous examples of the S&P 500 concentrating around sectors. Technology peaked at over 30% of the index in 1999. It is



only now approaching a similar weighting in the index. Energy stocks comprised 16% of the index in 2008 before cratering to a current weighting of less than 3%. Financial service companies made up approximately 22% of the index leading up to the GFC. Today, the Financial Select Sector SPDR ETF (XLF) is priced below where it was in May 2007.

We are not predicting the demise of the S&P 500's top five holdings, and we've seen periods of excess last for a long time. These are good companies that should continue to do well from a fundamental standpoint. Good companies only make for good investments if they are purchased at reasonable prices, however.

Conclusion

As we write this, the U.S. is struggling to contain the coronavirus as new cases are rising in several states. We wrote in a recent market update (*Let's Waltz*) that we expected curbing the spread of COVID-19 would be a complicated dance, with steps forwards, sideways, and backwards. Similarly, we expect the economic recovery to follow a similar pattern.

Many in the media have written about the concept of the cure being worse than the disease, meaning that efforts to contain the virus have caused more damage than the virus itself. We are not going to comment on this debate; however, we note that a similar argument can be made as it pertains to the economy.

The Fed and Congress have reacted strongly to the crisis in support of the economy, steps that appeared to be necessary. Other countries have implemented similar policies as well. While we are hopeful that this policy medicine will lead to a quicker recovery, we also note that there may be adverse side effects from such strong dosing.

COLONY SPOTLIGHT

The Colony Group's Institutional Practice Celebrates 10 Years of Fiduciary Excellence

The Colony Group is proud to announce that its Institutional Advisory practice has been certified by the Centre for Fiduciary Excellence (CEFEX) for the tenth-straight year. This milestone represents its continuing commitment to fiduciary excellence.

As one of only 140 firms worldwide to achieve the Investment Advisor Certification by CEFEX, The Colony Group subjects itself to this rigorous annual evaluation so that it continues to adhere to industry high standards and demonstrate its commitment to its fiduciary responsibilities.

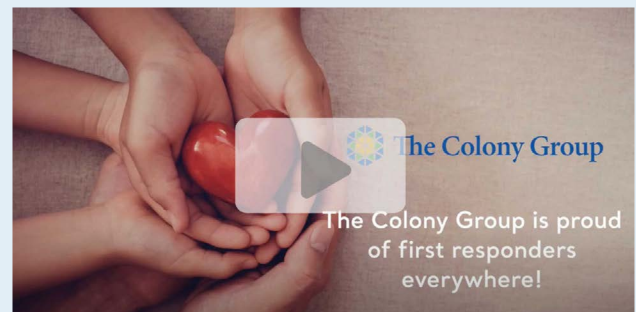
The Colony Group's Institutional Advisory practice first received the CEFEX® Investment Advisor certification in 2010 as a part of CapGroup Advisors, which merged into The Colony Group in 2015.

Colony's Stories of Giving Back During The COVID-19 Crisis

Supporting those in need is embodied in our culture of giving back through our Colony Cares program. Our Colony Group team has stepped up to help our communities locally, nationally and globally, and those that have been affected during this critical time.

We created this video honoring the many selfless acts of our team members and their loved ones.

Click on the image below to watch our video.



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