MarketDesk Research

Asset Allocator's Guide

2H 2020

July 10, 2020

Welcome to the MarketDesk Research Asset Allocator Guide for 2H 2020. The goal of this report is to simplify the asset allocation process, ask targeted questions to understand key drivers, and build investment conviction. The analysis is designed to break down a complicated market narrative and focus on what matters. Below is a summary of MarketDesk Research's asset allocation views for the next 12 months. Up/down arrows indicate a positive (▲) or negative (▼) change in view since the prior semi-annual asset allocation report.

● Underweight (UW) ● Neutral (N) ● Overweight (OW)

Asset Class	Allocation View				Rationale
	Chg.	UW	N	OW	
U.S. Equities					
U.S. Large Caps		•	•	●	Monitor tech OW; Underperformed in recent rally, but could outperform if second infection wave occurs
U.S. Mid Caps		•	●	•	Valuation discount to Large; Nice mix of small-caps' higher growth & large-caps' business model stability
U.S. Small Caps		•	●	•	Potential upgrade in near-term, but risk / reward not favorable after rally; Sentiment tied to reopening
International Equities					
Developed		•	•	●	Central banks responded more aggressively with stimulus; More defensive sector exposure than EM
Europe		•	•	●	Significantly exposed to global growth/trade; Brexit path remains murky; Improving EU member relations
Emerging		•	●	•	High correlation to DM; Struggling to contain COVID-19; Benefits from increased global stimulus
Asia-Pacific		•	●	•	U.S.-China relations undergoing seismic shift & not finished; Emerging economies = increasing consumption
Latin America		●	•	•	Region struggling to combat COVID-19; Domestic policy uncertainty in Brazil, Argentina, Chile, & Mexico
Fixed Income					
Quality		•	•	●	Corporate health weakening before the COVID-19 outbreak; Credit risk elevated over next 12 months
High Yield	▲	•	•	●	Spreads likely to continue tightening due to Fed stimulus; Use to generate income
U.S. Treasuries		•	●	•	Steady purchase demand from Fed; Import to stabilize portfolio, but do not expect much yield
Invest. Grade		•	●	•	Increasing duration risk in IG bonds; Rising BBB exposure = downgrade risk
Duration		●	•	•	Expect more of credit's return to come from yield than duration; Interest not likely to move before 2022
Alternatives					
REITs		•	●	•	Investor sentiment overly pessimistic in our view; Technicals present attractive setup (see *Sector Insights*)
MLPs		•	●	•	Negative energy sentiment weighing on MLPs; Attractive yield with defensive energy exposure
Commodities		•	●	•	Weak growth & strong USD weighing on physical demand; Lack of inflation reduces investor demand
U.S. Sectors					
Comm Svcs		•	•	●	Mixture of high growth Interactive Media & low beta Telecom; The "Stay at Home Sector"
Tech		•	•	●	Valuation composite +2.7 std vs 5yr average; Technical setup is concerning
Health Care		•	•	●	2020 election risk subsiding; Sector could face pent up demand as high margin elective surgeries resume
Cons Disc		•	●	•	Amazon & online retailers driving sector higher; Second infection wave = Big risk
Energy		•	●	•	Oil demand collapse leading to dwindling storage supply and plunging prices; Long road to recovery
Industrials		•	●	•	Face low capacity utilization & disrupted supply chain as manufacturers try to restart production lines
Utilities	▲	•	●	•	Prefer Utilities over Cons Stples as defensive play; Technicals present an attractive set up
Financials	▼	●	•	•	Low interest rates & deteriorating credit quality priced in, but stalling loan growth may not be
Materials		●	•	•	Ability to raise prices if production costs increase; Stimulus could lead to inflation & sector provides hedge
Cons Stpls		●	•	•	Consumers are stocking up on low margin basic essentials; Low beta will underperform in rally
U.S. Equity Factors					
Growth		•	•	●	Top performing factor 11 of last 12 months; Low inflation = Future earnings less negatively impacted
Defensive Sectors		•	•	●	Be prepared to quickly rotate to defensives if case counts continue to increase
Quality		•	•	●	Economic uncertainty high due to coronavirus; Prefer high quality late cycle; HY-IG spread elevated
Momentum	▲	•	•	●	Blended EPS resilient during market sell off; Ideal sector exposure, but monitor tech & health sector OWs
Value		•	●	•	Low valuations provide a buffer late cycle, but Value ETFs do not provide good "Value" exposure
Cyclical Sectors		•	●	•	Limited upside in our view while the economy reopens and investors can assess the economic damage

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Global Investment Recap & Outlook

The world is dramatically different today compared to just six months ago. 1H 2020 global market themes included: (1) a global health pandemic; (2) an unprecedented global economic shutdown; (3) extraordinary monetary and fiscal stimulus from central banks and countries; (4) skyrocketing unemployment; and (5) social unrest.

THE STATE OF GLOBAL FINANCIAL MARKETS

The first half of 2020 was a roller coaster for investors. First, markets plunged as a health pandemic shutdown the global economy. Then, markets roared back as central banks and governments flooded financial markets with monetary stimulus and interest rate cuts. Unprecedented stimulus measures were a big market tailwind in 1H 2020. To put the stimulus effect into numbers, the S&P 500's second quarter +20.2% return was the biggest quarterly gain since the fourth quarter of 1998 when it posted a +20.9% gain.

The trend of COVID-19 case counts dominated market sentiment in 1H 2020. Charts showing new case counts became the most scrutinized financial market data as investors transformed into epidemiologists. Market volatility surged as investors attempted to decipher the investment applications. Companies of all sizes all around the world lost revenue, which they will not be able to recapture, during the economic shutdown. Unemployment surged. Global economic activity entered a self-induced coma.

The asset class data on page 4 shows the aftermath. The market recovery off March lows is concerning to us. To put it in perspective, the S&P 500 was only down -3.2% in 1H 2020, while Asia-Pacific was down -5.5%. Developed and emerging markets are down -11.1% and -10.4%, respectively. In the U.S., the consumer discretionary sector is +2.6%. In the course of normal market events, these returns do not make sense. However, the introduction of global stimulus measures mean the current market environment is far from normal. As a result, it was not wise to fight stimulus measures and market sentiment during 1H 2020. As long as stimulus measures remain in place, the path of least resistance will remain upward in our view.

INVESTMENT OUTLOOK

As we enter 2H 2020, COVID-19 case counts are on the rebound in the U.S. The case counts appear connected to a premature economic reopening as individuals let down their guard and resumed normal activities. From our perspective, it is increasingly clear the global pandemic is not going away anytime soon.

The investment implications are significant. Fear and uncertainty are powerful motivators. Consumers are changing their habits, and businesses are putting plans on hold. Below are four themes we are following in 2H 2020:

(1) COVID-19 Case Count Is the #1 New Financial Metric - U.S. total case count declined in April, flatlined in May, and surged in June (**Figure 6**). A continued divergence in DM and EM case counts could delay the EM recovery (**Figure 27**).

(2) Expect Volatility to Remain High - Volatility could remain elevated in 2H 2020 due to a triple threat. **Figure 5** highlights three scenarios that historically led to higher volatility and could converge in 2H 2020: a presidential election, negative 1H performance, and COVID-19.

(3) Expensive Equity Markets & Historically Low Yields (Page 6) - Equities trade at historically expensive valuations. Bonds trade at historically expensive valuations with low absolute interest rates. We believe this will: (1) cause average annual returns, in both the equity and credit markets, to remain low in the 2020s and (2) force investors to search for assets outside of bonds to stabilize and diversify their portfolio.

(4) Stimulus Bringing Credit Spreads back into line with historical averages - The Federal Reserve unleashed a wave of stimulus measures to support the U.S. economy (**Figure 36**). The stimulus efforts span the municipal bond market, big and small private companies, and money and commercial market funds. In our view, the size and diversity of the programs indicate the Fed's commitment to support the U.S. economy, which should help support credit markets and tighten spreads (**Figure 37**).

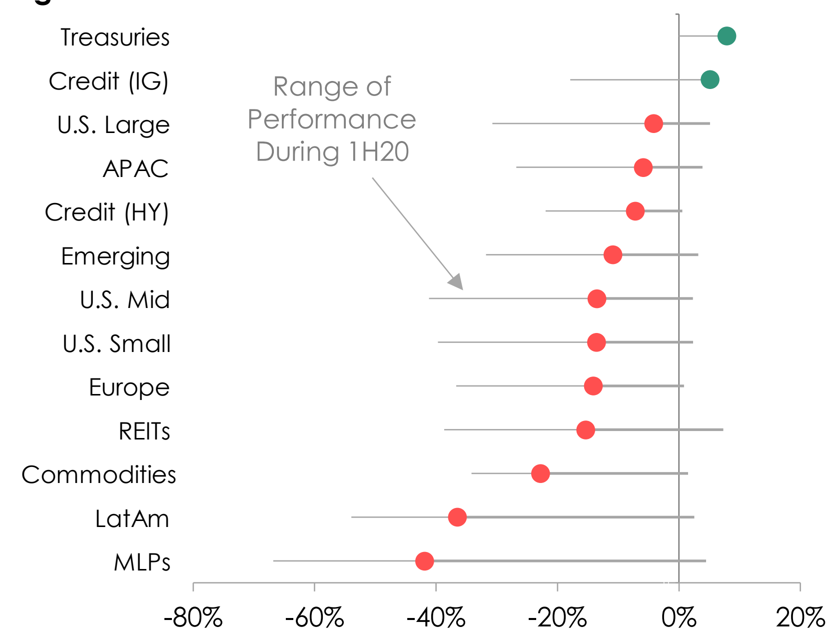
Asset Class Performance

This page provides a recap of total returns and asset flows across various asset classes during the prior semi-annual period. It includes current valuation metrics (NTM P/E & P/B) as well as current dividend yields.

Asset Class	Total Return (%)			Valuation & Yield			Asset Flows[1]		Price Chart
Global Equities	**1H'20**	**1Yr**	**3Yr**	**NTM P/E**	**P/B**	**Div Yld**	**1H'20**	**Last 2Yrs**	**Last 2Yrs**
U.S. Large Caps	-3.2	7.4	35.2	21.7x	3.5x	1.81%	↑ 2%		
U.S. Mid Caps	-12.8	-7.0	6.7	20.6x	2.0x	1.54%	0%		
U.S. Small Caps	-13.0	-6.6	6.1	57.2x	1.8x	1.41%	↑ 1%		
Europe	-13.0	-6.0	0.1	17.6x	1.6x	2.39%	↓ -3%		
Asia-Pacific	-5.5	0.8	8.8	14.8x	1.7x	1.59%	↓ -13%		
Latin America	-35.7	-34.2	-22.4	14.8x	1.6x	3.70%	↓ -9%		
Developed	-11.1	-5.0	1.9	17.8x	1.6x	2.60%	↓ -4%		
Emerging	-10.4	-4.3	3.7	14.4x	1.7x	2.07%	↓ -8%		
U.S. Sectors									
Comm Svcs	-0.5	8.4	7.5	26.9x	3.1x	0.98%	↑ 27%		
Cons Disc	2.6	8.6	48.3	38.3x	8.5x	1.16%	↓ -7%		
Cons Stpls	-5.6	3.8	16.1	19.2x	5.6x	2.73%	↑ 4%		
Energy	-34.6	-35.3	-32.2	-108.6x	1.2x	5.93%	↑ 32%		
Financials	-23.7	-14.0	-0.1	14.3x	1.1x	2.61%	↓ -9%		
Health	-0.8	10.7	33.5	16.4x	4.6x	1.57%	↑ 13%		
Industrials	-14.6	-9.2	7.3	25.3x	4.4x	2.17%	0%		
Materials	-7.1	-1.4	11.6	21.6x	2.5x	2.07%	↑ 4%		
Tech	14.9	35.8	99.3	24.9x	8.8x	1.12%	↑ 9%		
Utilities	-11.0	-2.1	20.0	17.2x	1.9x	3.40%	↑ 13%		
Fixed Income									
Treasuries	8.6	10.4	17.2	-	-	1.63%	↑ 6%		
Invest. Grade	6.5	11.6	23.5	-	-	2.96%	↑ 31%		
High Yield	-5.1	-1.5	7.8	-	-	5.16%	↑ 20%		
Alternatives									
REITs	-13.9	-6.9	6.7	17.4x	2.3x	3.88%	↓ -5%		
MLPs	-38.6	-44.6	-46.7	22.6x	1.1x	15.42%	↓ -9%		
Commodities	-22.8	-20.5	-12.3	-	-	2.02%	↑ 11%		

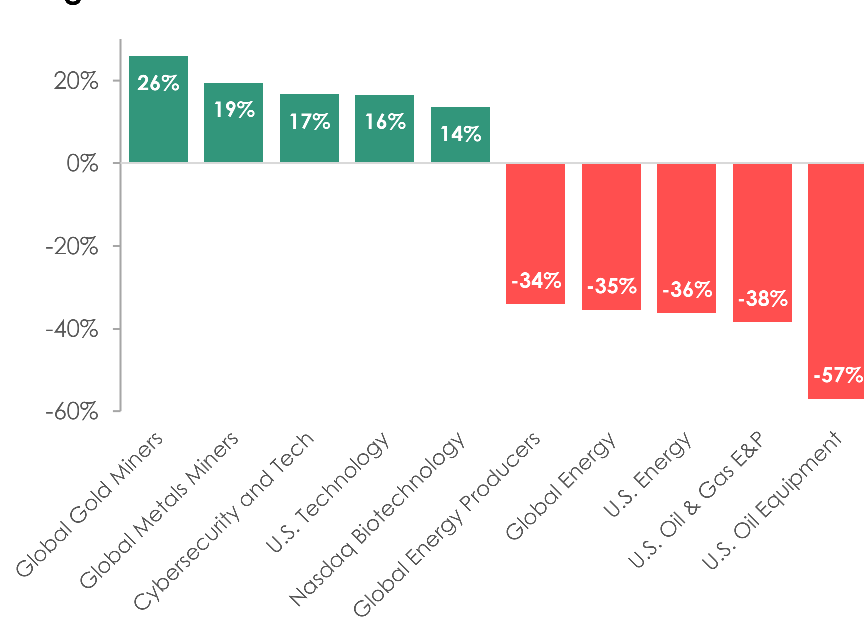
[1] *Asset Flows are calculated using 5 largest ETFs for each category.*

Figure 1: Asset Class Performance — 1H 2020



Source: MarketDesk Research

Figure 2: Global Sector Performance — 1H 2020

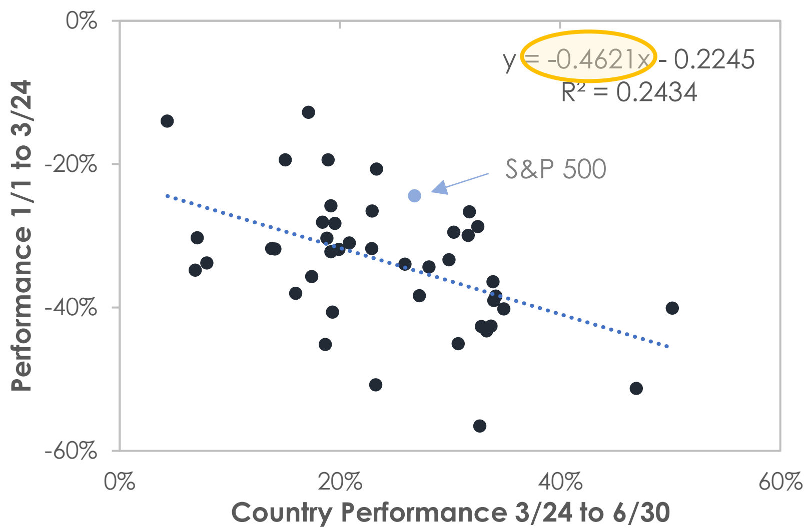


Source: MarketDesk Research

Charts That Will Shape 2H 2020

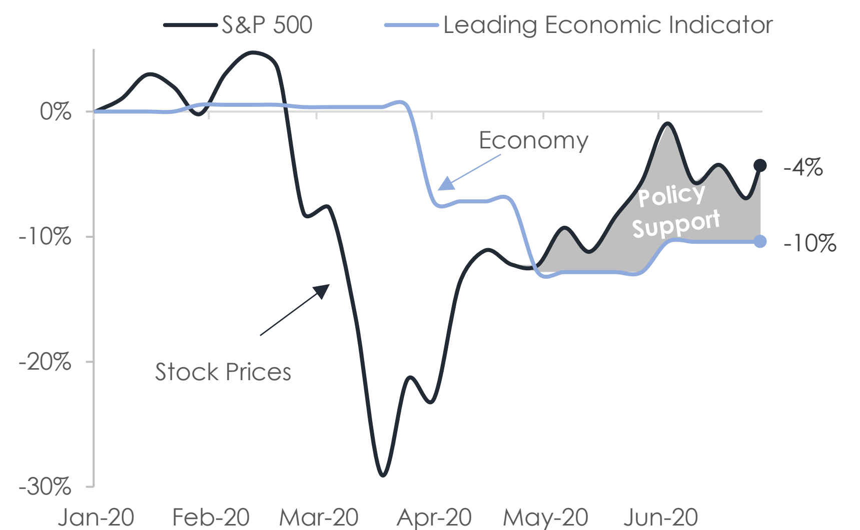
Below are six charts that define major market themes right now. In our view, the topics mentioned below will shape markets during the upcoming semi-annual period.

Figure 3: Country Returns Highlight Lack of a Trend in 1H20...



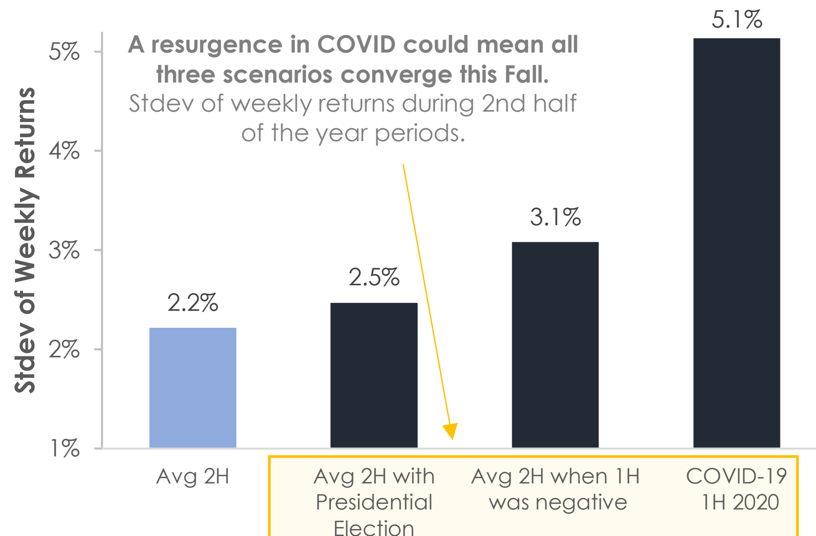
Source: MarketDesk Research, Johns Hopkins

Figure 4: ...as Central Banks Held up Stocks & Economy



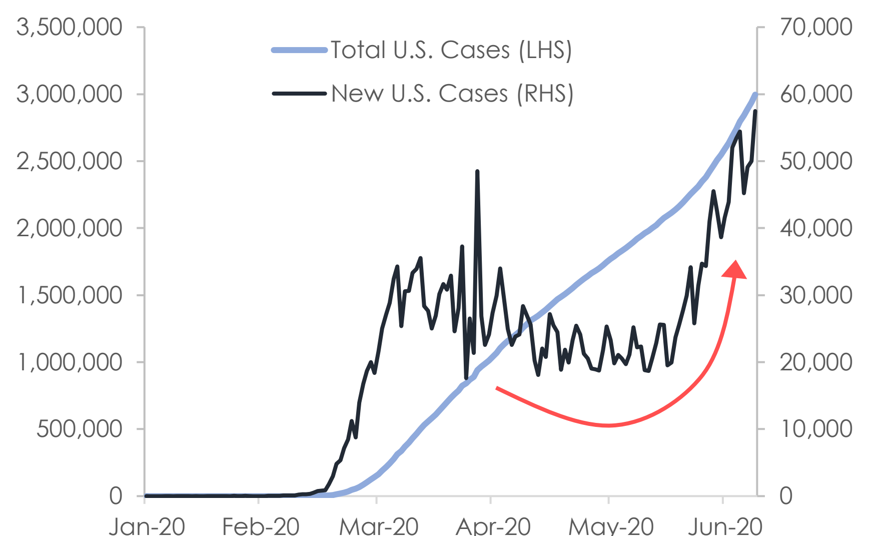
Source: MarketDesk Research. Note: Data incorporates 1985-2020.

Figure 5: Anticipate More Volatility with Triple Threat



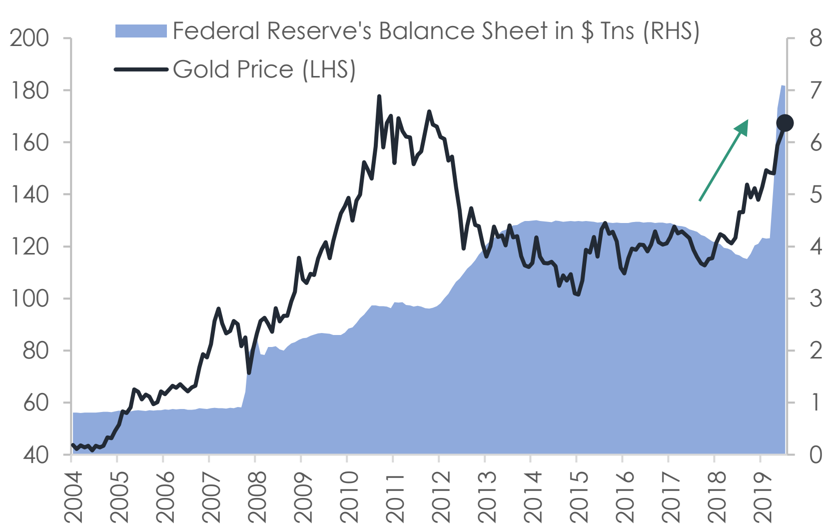
Source: MarketDesk Research, U.S. Conference Board

Figure 6: New Cases Will Drive Market Sentiment



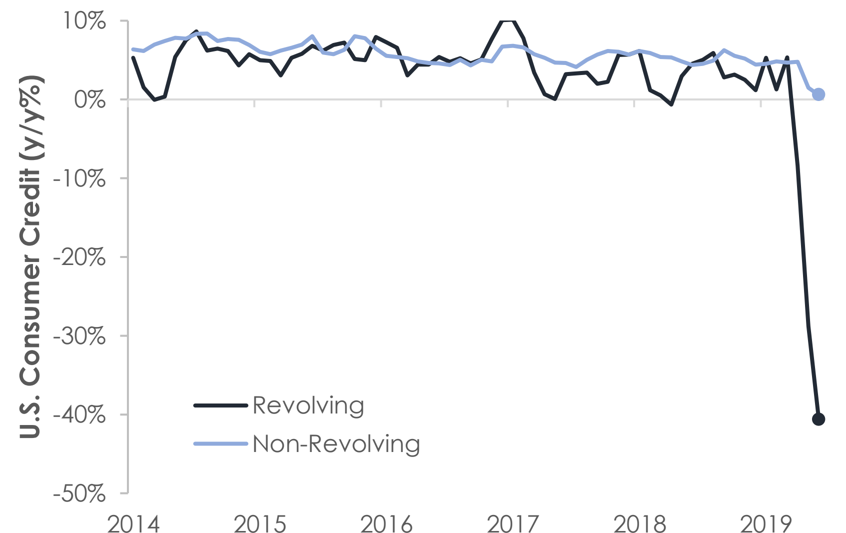
Source: MarketDesk Research

Figure 7: Gold Correlated to Fed Balance Sheet Growth



Source: MarketDesk Research

Figure 8: U.S. Consumer Saving & Paying Down Credit Cards



Source: MarketDesk Research

Asset Allocation Framework

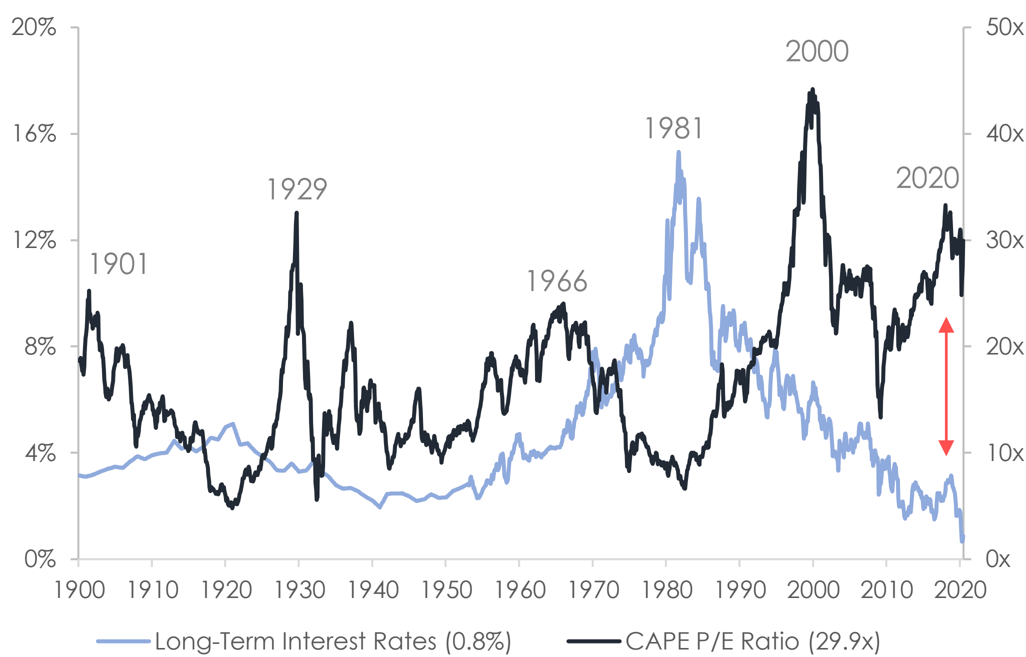
Asset Class — Equity vs Credit

► **In our view, public market returns will be challenged over the next decade.** Equities trade at historically expensive valuations. Bonds trade at historically expensive valuations with low absolute interest rates. We believe this will: (1) cause average annual returns, in both the equity and credit markets, to remain low in the 2020s and (2) force investors to search for assets outside of bonds to stabilize and diversify their portfolio. In preparation, investors should start evaluating alternative opportunities both within and outside of the public markets. These investments could take the form of real assets (e.g. infrastructure, real estate, commodities), public investments that provide indirect private market exposure, or direct investments in private equity.

► **Real Assets:** Infrastructure - important to understand energy exposure via MLPs (TOLZ); Real Estate - sector ETFs (VNQ, VNQI, XLRE) and / or individual REITs (see tactical Trade IDs USEQ.2020-01 and USEQ.2020-08); Commodities - precious metals, such as gold and silver (GLD, BAR, SILV)

► **Indirect Private Market Exposure**: PE managers - gain exposure to management fees (BX, KKR, CG, APO); BDCs - equity / credit exposure to private companies (Note: BDCs face significant credit risk today, so we believe it is better to wait 12-24 months and re-evaluate. This is NOT a near-term trade, but investors should familiarize themselves with the space.)

Figure 9: Multi-Decade Extremes Leave Few Options



Source: MarketDesk Research, Robert Shiller

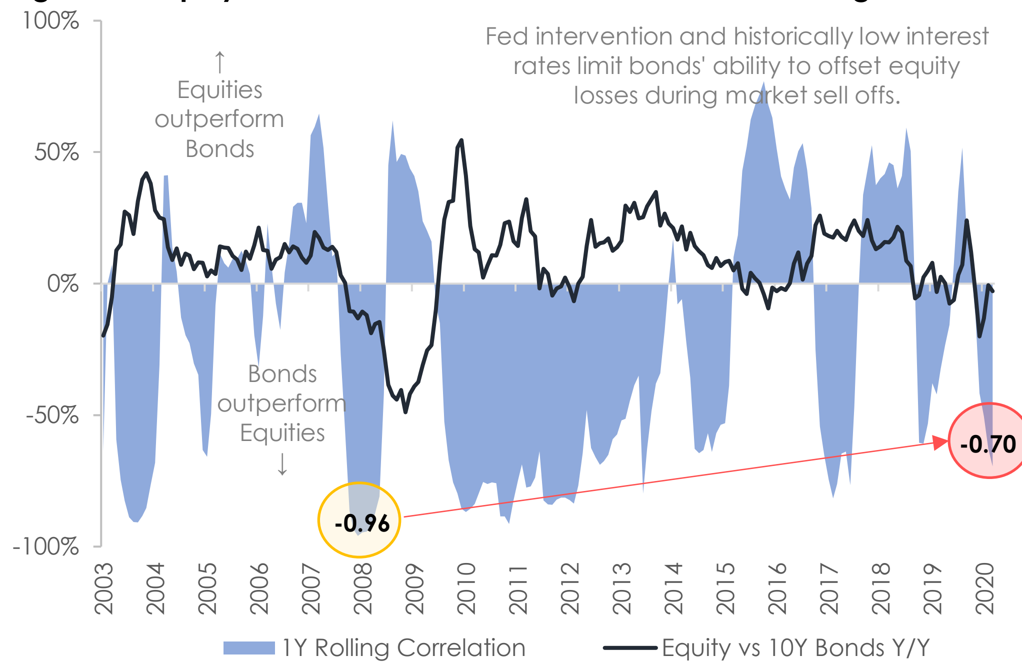
Expensive Equity Valuations & Historically Low Interest Rates …

● The equity and credit markets leave investors with a tough decision to make. Invest in expensive equities, or generate less interest income.

● From an equity perspective, the Shiller CAPE P/E ratio sits at 29.9x compared to the average 17.1x since January 1881. Valuation is closely correlated with future returns. Higher valuations usually mean lower future returns, and vice versa.

● From a credit perspective, long-term U.S. interest rates sit at historic lows. This has two investment implications: (1) lower interest income and (2) lower capital appreciation (assuming rates do not go negative).

Figure 10: Equity & 10-Year Interest Rate Correlation vs Rolling Return



Source: MarketDesk Research

Bonds Do Not Provide Same Level of Protection Due to Falling Correlations …

● Figure 10 charts the rolling 1-year correlation between the Russell 3000 and 10-year U.S. treasury bond (blue fill) vs the relative 1-year rolling return between the Russell 3000 and 10-year U.S. treasury bonds (black line).

● The correlation was low in the early 2000s, increased during the 2008 financial crisis, and steadily declined in the 2010s. **A high correlation between equities and interest rates provides portfolio diversification (e.g. as equities and rates both fall, bond appreciation can offset a portion of equity losses).**

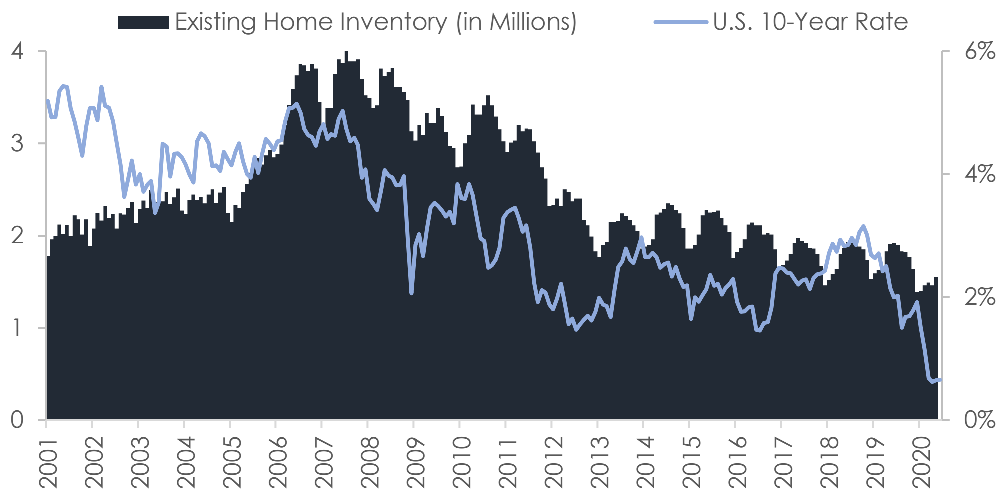
● As the correlation declined, bonds' diversification benefit fell. This can be seen in the differential in rolling return in 2008 vs the recent

Unfolding Economic Stories

► **The U.S. economy is shifting amid the global health pandemic.** The three charts below highlight unfolding economic stories. First, U.S. existing home inventory sits at a 20 year low. Second, money velocity remains low despite the surge in M2 money supply. Third, used car prices, which trailed new car prices recently, could rebound as consumers search for an alternative to public transportation and car manufacturers struggle to maintain production levels.

► **Actionable Ideas:** Housing: See Trade ID USEQ.2020-05. Used Car Prices: Auto dealerships and auction houses (SAH, CPRT, GPI, LAD, ABG, AN), and online car sellers (CVNA, VRM).

Figure 11: U.S. Existing Home Inventory

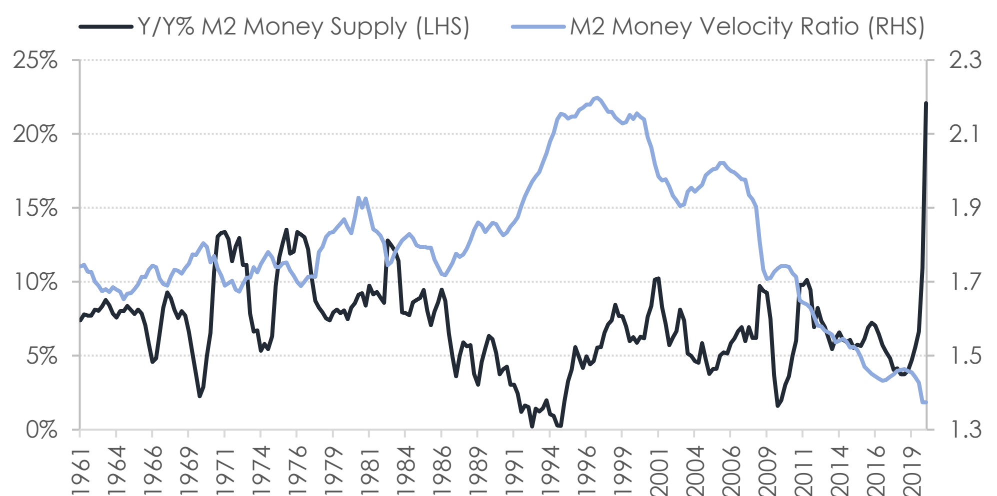


Source: MarketDesk Research, National Association of Realtors

U.S. Existing Home Inventory Sits at 20-Year Low …

- Figure 11 charts U.S. existing home inventory over the past 20 years. Housing inventory is significantly below 2008 housing crisis levels and currently sits at a 20 year low.
- The recent COVID-19 outbreak changed life priorities, which includes home buying decisions. The U.S. could experience a housing migration over the next few years as consumers accelerate home buying decisions.
- Refer to trade ID USEQ.2020-05 published on 5/29/2020 for our tactical U.S. housing position.

Figure 12: U.S. M2 Money Supply & Velocity

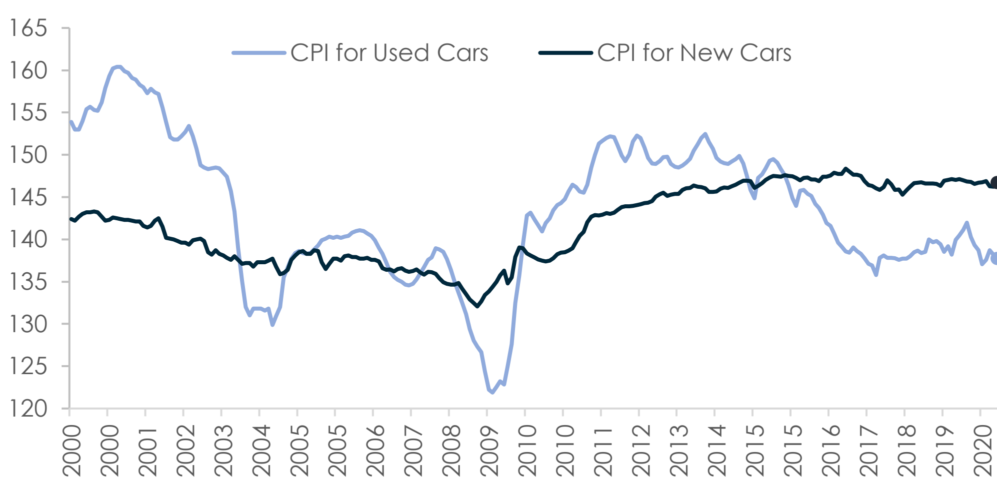


Source: MarketDesk Research, Federal Reserve System

Low Velocity of Money Indicates Inflation Likely Subdued Despite Fed Stimulus …

- Figure 12 compares M2 money supply vs velocity. M2 money supply includes cash, deposits, and easily convertible near money. Money velocity is the number of times one dollar is used to purchase final goods / services.
- Federal Reserve asset purchases stoked inflation fears, but the risk appears low near term. While money supply surged, money velocity moved down. Money velocity usually increases as banks lend more. The velocity drop indicates banks are accumulating assets on balance sheets instead of circulating money.

Figure 13: New vs Used Car Prices



Source: MarketDesk Research, St Louis Federal Reserve

Used Car Prices Continue to Trail New Car Prices, But That Could Change …

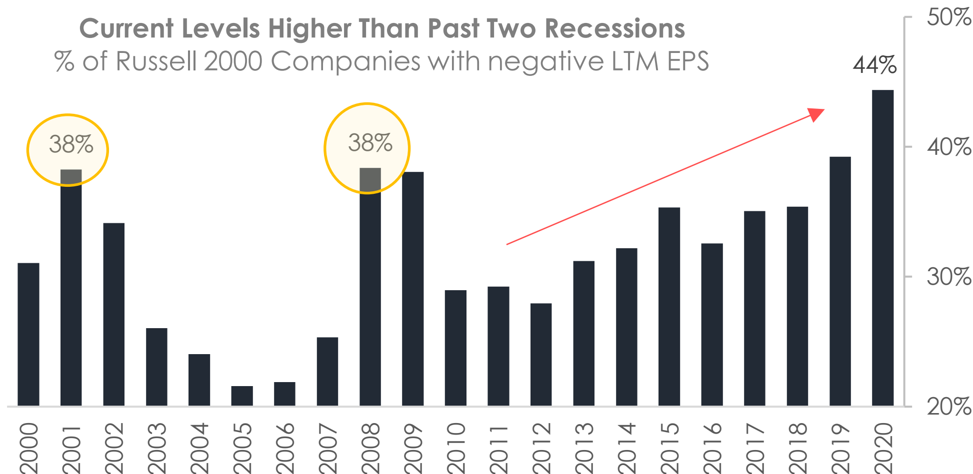
- Figure 13 charts the U.S. Labor Department's consumer-price index for both used and new cars since 2000. While new car prices remained stable the past five years, used car prices declined in 2016 and continue to trail new cars.
- Car manufacturers face supply chain constraints and lower production. A drop in new car production could lead to higher new car prices, which would increase the financial benefit from owning a used car. Used car prices also tend to benefit from economic downturns as consumers search for lower priced vehicles.

Size — Large Caps vs Small Caps

► **In our view, large cap equities remain attractive in 2H20 for three fundamental reasons.** First, 44% of small companies had negative LTM EPS at the end of May 2020. Second, small cap leverage is significantly higher than large cap leverage. Third, small caps have a lower average free cash flow margin and trade at an EV / FCF premium vs large caps.

► **Actionable Ideas**: In the small cap space, we believe investors should focus on growth (VBK, IWO), quality, and value. Unfortunately, there is not a small cap quality ETF, and small cap value ETFs are poorly constructed. You can find the MDR small cap quality and value models in the latest edition of *Factor Views* .

Figure 14: Negative LTM Earnings - % of Russell 2000



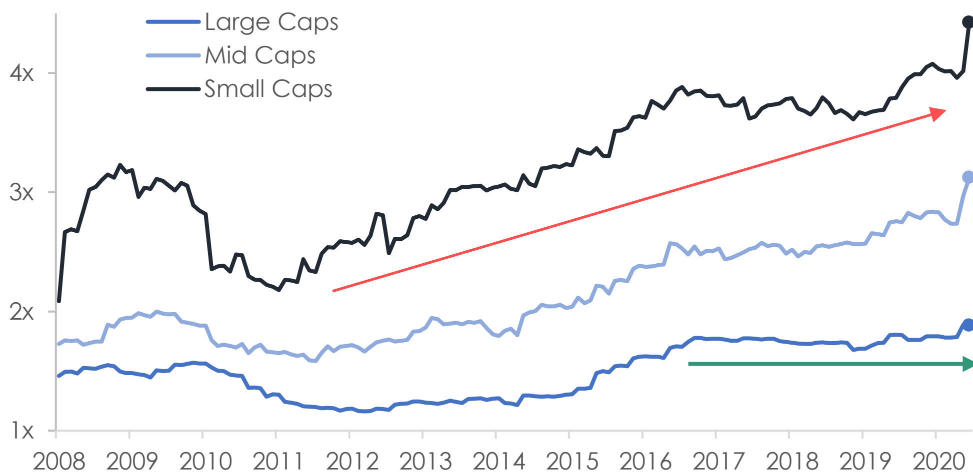
Source: MarketDesk Research

Increasing Percentage of Russell 2000 Companies Not Making A Profit …

• Figure 14 graphs the percentage of Russell 2000 companies with negative LTM EPS by year since 2000.

• The number of small cap companies losing money continues to increase and recently surpassed the 2008 financial crisis high of 38%. The rate of decline in small cap financial health is concerning given the current economic slowdown, especially given small caps tend to be more vulnerable to economic downturns.

Figure 15: Financial Leverage (Net Debt / EBITDA Ratio) - Large vs Small



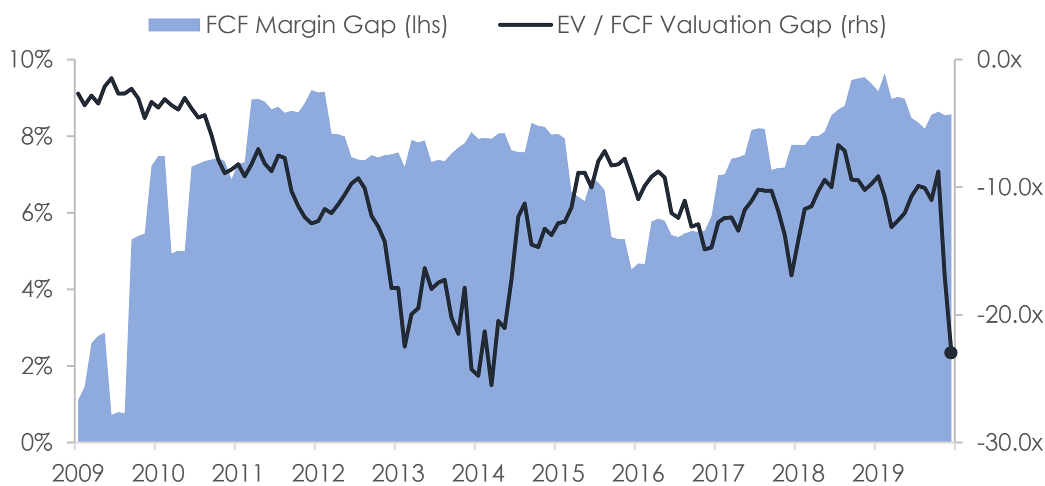
Source: MarketDesk Research

Leverage Adds to List of Small Cap's Financial Issues …

• Figure 15 charts Net Debt to EBITDA for U.S. large, mid, and small caps from 2008 to today. Small and mid-cap leverage ratios soared during this period. While large cap leverage also increased since 2008, the growth rate was less severe.

• The data indicates U.S. small and mid-cap stocks appear more exposed to an economic downturn than large caps due to their leverage. In our view, leverage is a negative right now due to credit market volatility and economic uncertainty.

Figure 16: FCF Margin & EV / FCF Valuation Gaps - Large vs Small



Source: MarketDesk Research

Small Caps Offer Higher FCF Margins, but Trade at a Lower EV/FCF Multiple …

• Figure 16 charts the historical free cash flow (FCF) margin gap between large caps and small caps. It also charts the relative EV / FCF valuation gap between large and small caps.

• Large caps tend to generate higher FCF margins. The FCF margin gap widened since 2017 as large caps generated higher margins, while small caps FCF margins compressed.

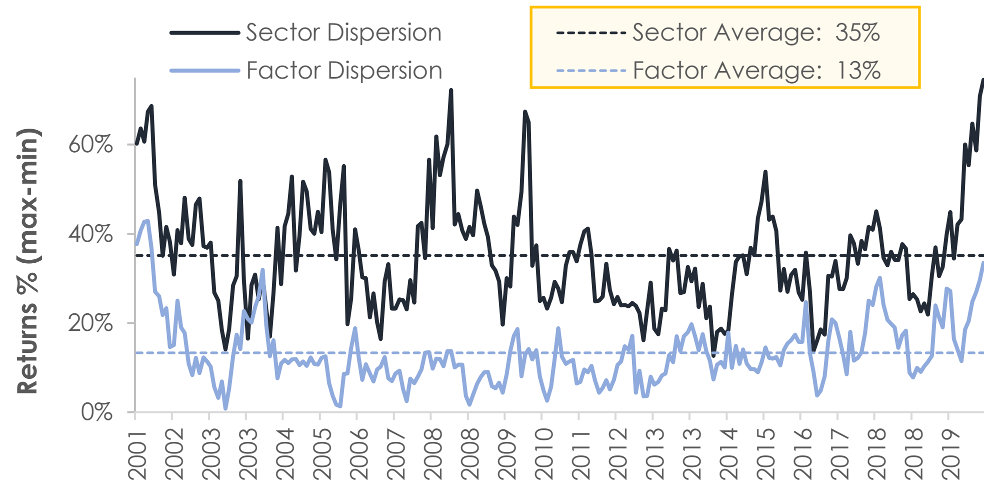
• The recent economic shutdown showed the importance of cash. Right now, large caps offer more cash flow at a lower multiple.

Factor Tilts — Growth, Quality & Momentum

► **Investors often do not pay enough attention to a factor's sector composition when making allocation decisions.** Markets experienced an extreme example this year as sector dispersion jumped above 70%. At the start of July, growth and momentum offer the most attractive sector exposure in our view. (Note: You can find the latest sector composition in the latest *Factor Views* .)

► **Actionable Ideas:** Growth and Momentum remain our top overweights; You can find the current factor model portfolios in the latest edition of *Factor Views* .

Figure 17: Importance of Sector Composition in Factors

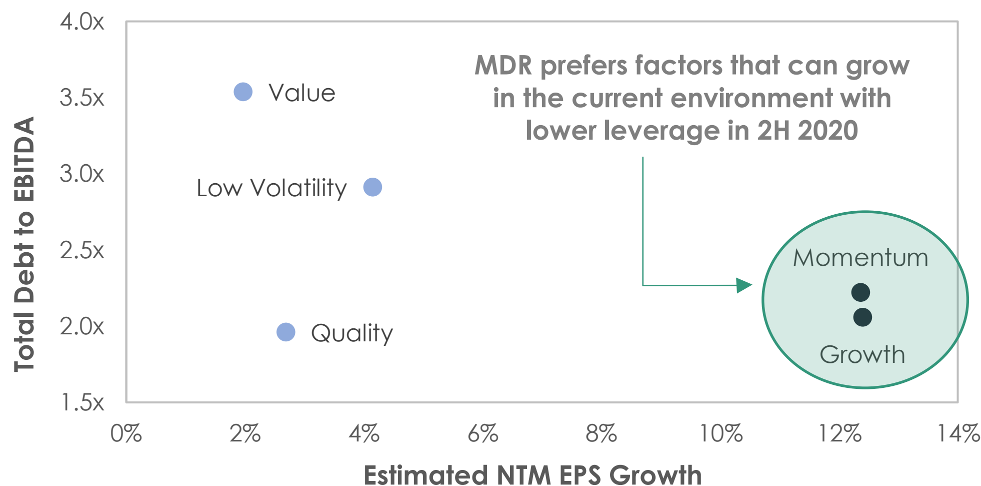


Source: MarketDesk Research

Sector Composition Significantly Impacts Factor Performance …

- Figure 17 charts sector vs factor dispersion. Dispersion is calculated as the performance gap between the top performing sector / factor and the bottoming performing sector / factor.
- Sector dispersion tends to be much wider than factor dispersion. This highlights the importance of understanding sector composition when allocating across investment factors. Right now, we prefer growth and momentum sector composition.

Figure 18: Factor NTM EPS Growth vs Total Debt to EBITDA

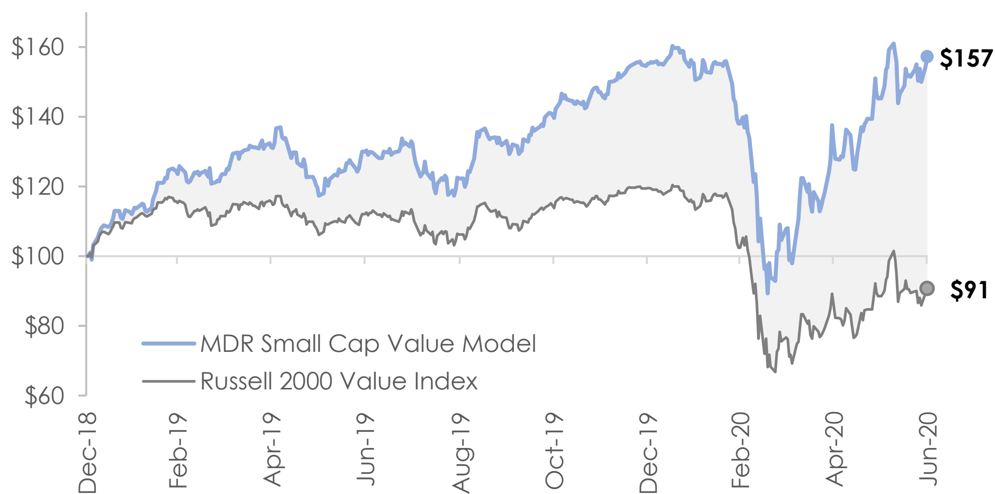


Source: MarketDesk Research

Balancing Earnings Growth with Credit Risk in the Current Market Environment...

- Figure 18 charts total debt to EBITDA vs estimated NTM EPS growth across five main investment factors.
- In the current market environment, we believe investors should be focused on earnings growth and avoiding credit risk. Momentum and growth currently have the highest NTM EPS growth estimates with low leverage.

Figure 19: MDR Small Cap Value Model Portfolio



Source: MarketDesk Research

Portfolio Construction Matters, Especially When Trying to Capture Factors …

- Figure 19 compares the performance of the MDR small cap value portfolio against the Russell 2000 Value Index (ETF ticker: IWN).
- Traditional value indexes use valuation as a significant input. However, value is more than simply a cheap valuation. When constructed correctly, value should aim to purchase *attractive securities* at low valuations. The MDR small cap value portfolio screens out low quality value companies, which provides a "deeper" level of value.

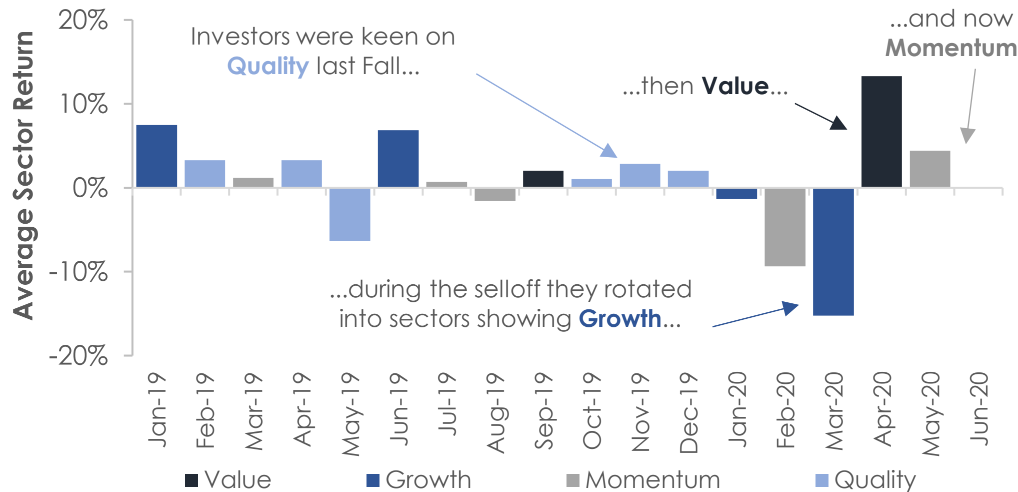
U.S. Sectors — Drivers of Risk & Return

► **Overweight:** Tech (a "safe haven" sector, but monitor stretch valuations); Communication Services (the "stay-at-home" sector); Health Care (resumption of elective surgeries would be a positive, but watch for 2020 election risk)

► **Neutral:** Cons Disc (online retailers holding up performance as restaurants and hotels struggle); Real Estate (overly pessimistic investor sentiment); Industrials (weak capacity utilization); Utilities (low beta with attractive yield); Energy (strong negative sentiment already priced in, which makes it difficult to UW)

► **Underweight:** Financials (weak credit growth, low rates); Materials (economic uncertainty); Consumer Staples

Figure 20: LTM Sector Performance through the Factor Lens

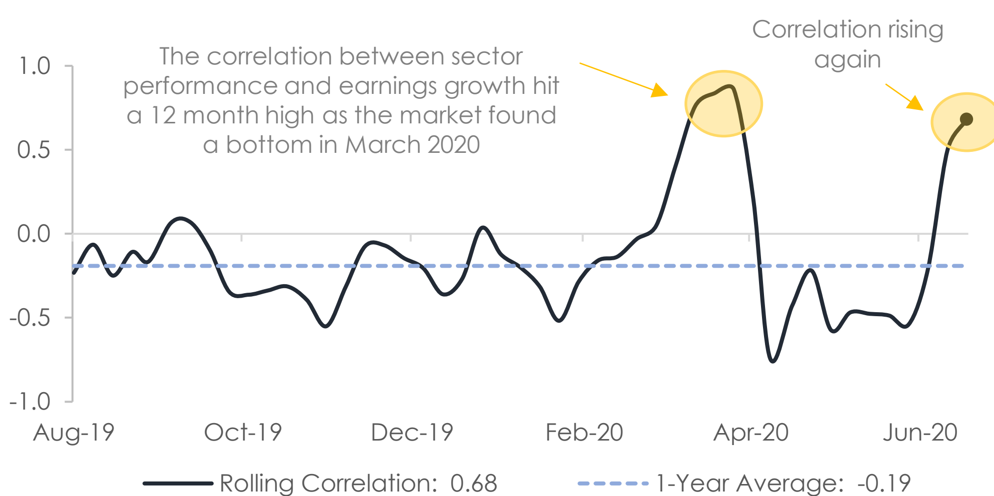


*Source: MarketDesk. **Value** (NTM P/E), **Growth** (average NTM & LTM EPS growth), **Quality** (Profit Margin), and **Momentum** is based on previous 3-month returns.*

Tracking Sector Performance Through the Factor Lens …

- Figure 20 graphs the average monthly sector return starting in 2019. It overlays the factor that drove sector performance each month.
- The factors driving sector performance tell a story of how markets arrived at this point. In the fall of 2019, investors prioritized sectors with high quality characteristics. During the March sell off, investors rotated to higher growth sectors. In April, investors moved into value sectors that offered a margin of safety. Momentum drove sector performance in May and June as investors chased what worked the best.

Figure 21: Sector Earnings Importance Indicator

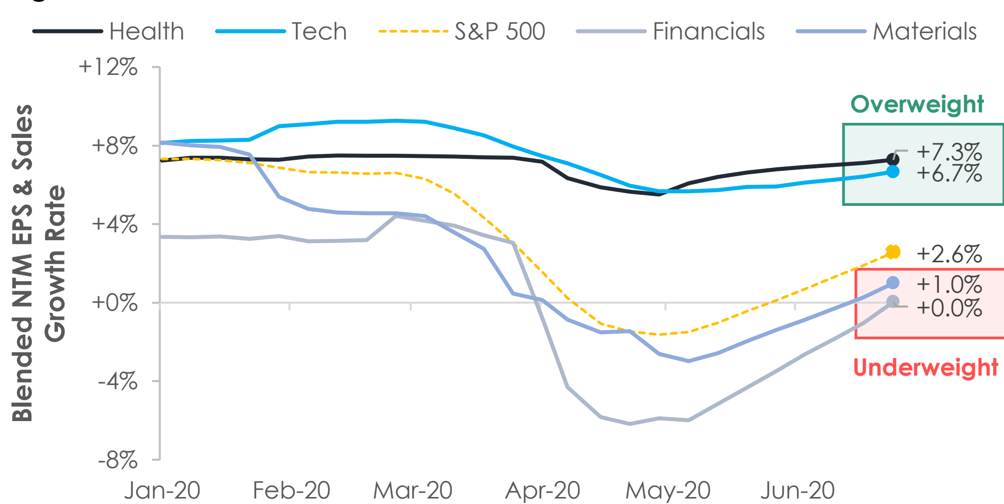


Source: MarketDesk Research

Earnings Importance Indicator Jumps as Investors Focus on Future Earnings…

- Figure 21 charts the sector earnings importance indicator, which is measured as the rolling 3-month correlation between NTM EPS revisions and performance. A higher correlation indicates the performance trend is more directionally accurate based on EPS revisions.
- Earnings importance dropped in 2H 2019 as the market rallied. As the pandemic took hold, earnings became more important in March. The indicator fell again as the market rallied, but surged again in June as investor focus turned back to earnings.

Figure 22: Blended NTM Sales & EPS Growth Rates



Source: MarketDesk Research

MDR Sector OWs Remain Focused on Sales & EPS Growth …

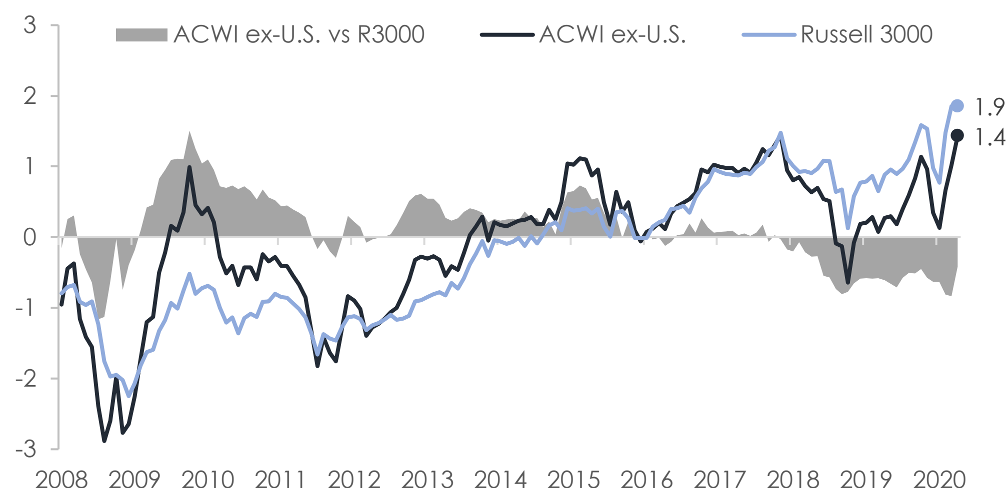
- Figure 22 charts the blended NTM sales and EPS growth rate for health care, tech, financials, and materials vs the S&P 500.
- The health care and tech blended growth rates are both ~7%, which is above the S&P 500's 2.6%. Financials and materials blended growth rates are 0% and 1%, respectively. We believe sector growth rates will have a significant impact on sector performance over the next 12 months. As a result, we remain OW health care and tech and UW financials and materials.

Global — U.S. vs International

► **In our view, U.S. Equities** remain more attractive than international equities in 2H 2020 despite the U.S.-International valuation gap. U.S. IP investment remains strong, which is a significant contributor to the growing tech sector gap between U.S. and international equities. In our view, the higher U.S. tech sector exposure is more attractive long-term. U.S. dollar weakness and normalizing U.S. economic growth vs international markets represent risks to U.S. stock outperformance.

► **Actionable Ideas:** Rebalance U.S. equity profits into international equity to decrease U.S. concentration risk. The direction of COVID-19 case counts is tough to predict, but an improvement could lead to an international stock rally.

Figure 23: Valuation Composite - U.S. vs International



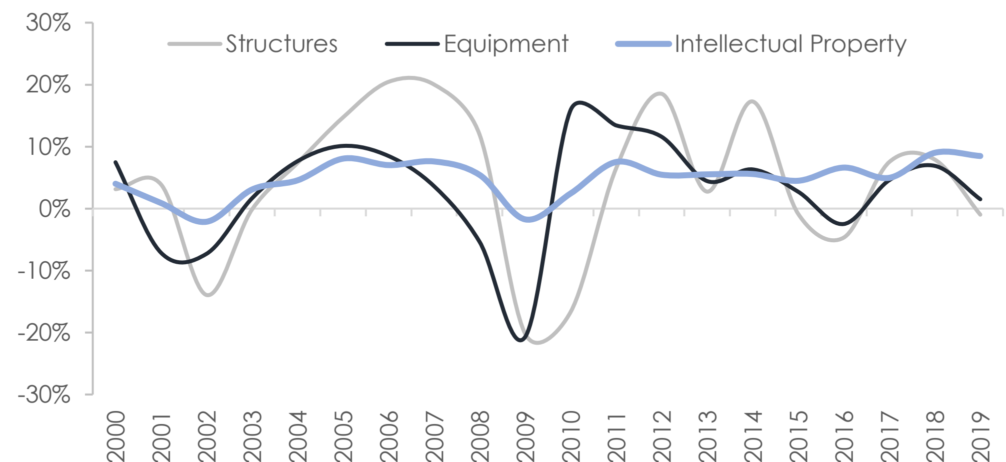
Source: MarketDesk Research

U.S. Valuations Are Expensive vs International Peers, But …

● Figure 23 charts the valuation composite of the Russell 3000 Index vs the MSCI ACWI ex-U.S. Index since 2008.

● U.S. equities trade +1.9std vs their historical valuation composite, while international equities trade +1.4std vs their historical valuation composite. The two valuation composites diverged in early 2018. We attribute the divergence to sustained dollar strength and a more resilient U.S. economy.

Figure 24: Y/Y Growth of U.S. Intellectual Property Investment



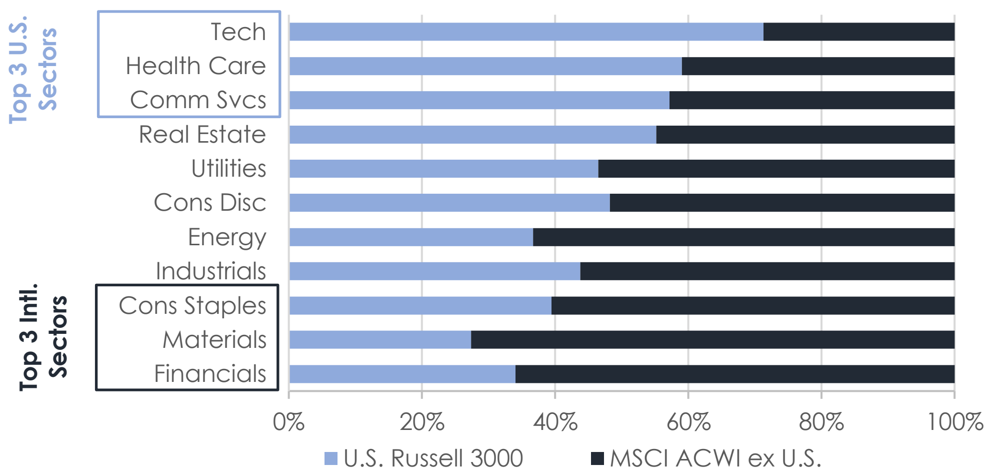
Source: MarketDesk Research, U.S. Bureau of Economic Analysis

… Y/Y Growth in U.S. IP Investment Remains Consistently Strong …

● Figure 24 charts the y/y growth of U.S. intellectual property investment since 2000. For reference, the chart includes the y/y growth of both structures and equipment.

● The chart shows Y/Y IP investment is more consistent and less subject to economic cycles than structures and equipment. In general, IP business models are less asset intensive and generate stronger margins. Consistent U.S. IP investment significantly impacts the U.S. stock market's sector makeup.

Figure 25: U.S. vs International Sector Exposure



Source: MarketDesk Research

… Causing U.S. Sector Exposure to be More Attractive than International

● Figure 25 compares the current sector makeup of the Russell 3000 Index vs the MSCI ACWI ex-U.S. Index. The top 3 U.S. sector overweights are tech, health care, and communication services. The top 3 international sector overweights are financials, materials, and consumer staples.

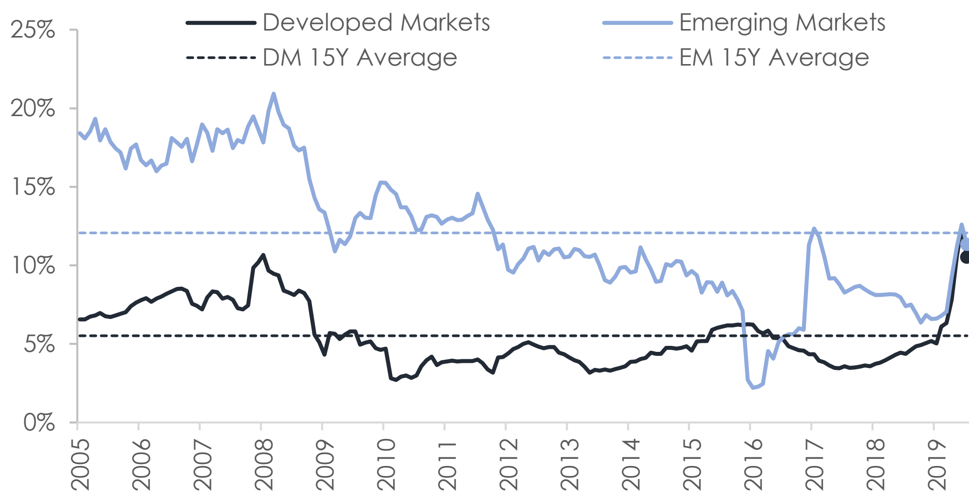
● U.S. stocks are more expensive than their international peers. However, the sector differences justify higher U.S. valuations in our view. Financials face low interest rates, while materials face uncertain global growth.

International — Emerging vs Developed

► **In our view, developed market** (DM) equities are more attractive than emerging market (EM) equities for two reasons. First, DM central banks responded more aggressively with stimulus measures. Second, DM countries are more successful in battling the health pandemic than EM countries. Due to the high DM / EM correlation and similar return profiles since 2018, we prefer DM's stronger stimulus response, more defensive sector exposure, and ability to combat the health pandemic.

► **Actionable Ideas:** Maintain overweight exposure to MSCI EAFE Index

Figure 26: Y/Y M2 Money Supply Growth - DM vs EM



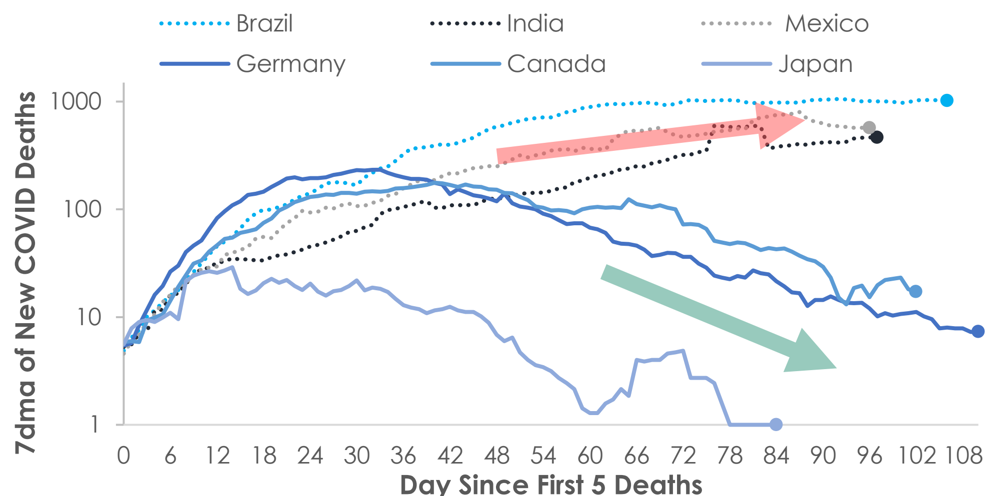
Source: MarketDesk Research, Central Banks. Note: DM includes U.S., EU, Japan, UK, & Canada. EM includes Brazil, Russia, India, Indonesia, China, & South Africa.

DM Central Banks Expand Money Supply More Aggressively than EM Central Banks

- Figure 26 charts the y/y growth in M2 money supply of DM vs EM the past 15 years. Average y/y DM money supply growth (+5.5%) was historically lower than EM money supply growth (+12.1%). More recently, DM money supply y/y growth moved above its 15-year average and caught up with EM.

- In our view, DM central bank stimulus could help DM economies bridge the downturn. While it could create a delayed liquidity wave benefitting EM, we believe the benefit will take time to work through the global economy.

Figure 27: Daily Confirmed New Death Rates - DM vs EM



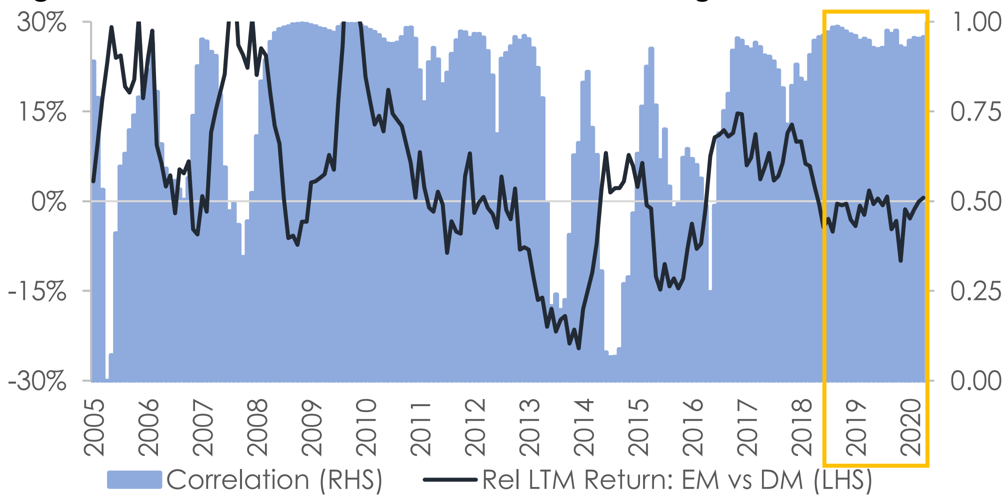
Source: MarketDesk Research

DM Countries More Successful in Battling the COVID-19 Outbreak …

- Figure 27 charts the 7-day rolling average of new confirmed COVID-19 deaths across six DM (solid lines) and EM (dotted lines) countries. Each country's timeline starts on the first day five deaths were reported and then tracks new deaths over the following 100 days.

- In general, DM countries are more successful than EM countries in containing the COVID-19 pandemic and lowering the death rate. As a result, we believe EM economies will face a longer, more difficult economic recovery than DM economies.

Figure 28: EM vs DM - Relative Y/Y Return & Rolling 1Y Correlation



Source: MarketDesk Research

International Markets Remain Highly Correlated (DM vs EM) …

- Figure 28 updates the rolling 1Y DM / EM correlation, which stayed above 0.9 since May 2018. Over that time period, the relative DM / EM performance gap swung between +/-5%. In addition, both DM and EM have similar betas vs the S&P 500.

- In our view, the high DM / EM correlation and similar betas require a more thematic approach to international markets. For now, we prefer DM's more defensive sector exposure, stronger stimulus response, and success in battling the ongoing health pandemic.

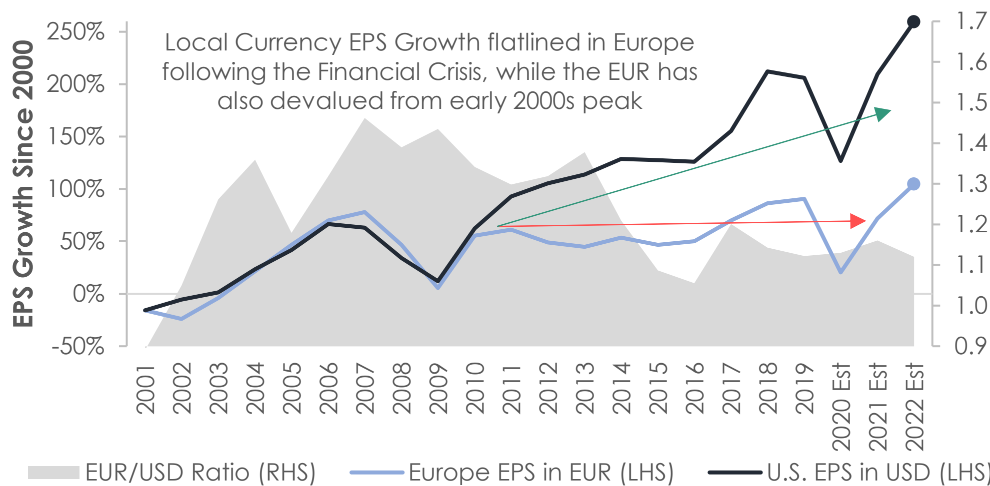
Allocations to Global Regions

► **Europe**: Developing into an attractive region on the back of multiple catalysts: (1) improving EU relations, (2) ECB fiscal stimulus via asset purchases, and (3) government programs kept employees connected to companies. (ticker: VGK)

► **Asia:** Developed Asia and China both outperformed the ACWI ex-U.S. the past 12 months. The recent outperformance, plus regional instability related to China, make us cautious. Refer to the June 26 *Friday Strategist* for our tactical Hong Kong position.

► **Latin America:** The region remains a contrarian play due to COVID-19 and political stability. Refer to the May 15 *Friday Strategist* for more details on our contrarian, tactical position.

Figure 29: Europe — Emerging from a Lost Decade?

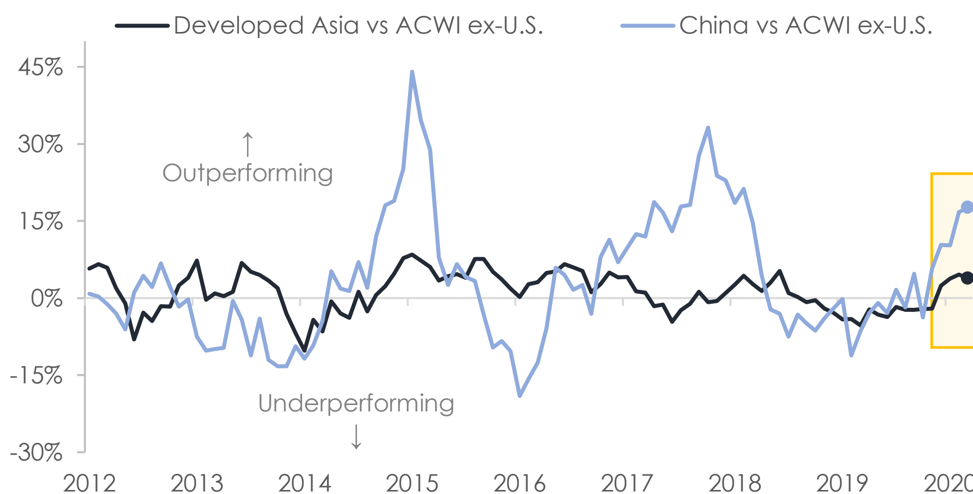


Source: MarketDesk Research

Europe Exiting from A Decade Long Economic Stall …

- Figure 29 charts the EUR/USD conversion rate (grey fill), Europe region EPS in local currency (blue line), and U.S. EPS in USD (black line).
- The chart shows the headwinds European stocks faced the last decade. The Euro weakened vs USD. European local currency EPS in Europe trailed sideways, while U.S. EPS surged.
- However, Europe is becoming more attractive in our view. The region appears to be handling COVID-19 well, and forward EUR/USD indicate the Euro is stabilizing.

Figure 30: Asia — Y/Y Relative Return vs ACWI ex-U.S.

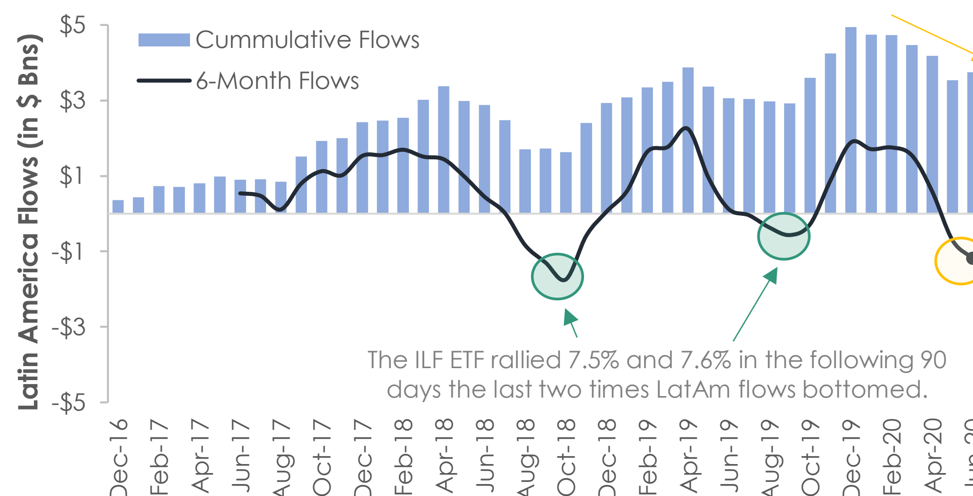


Source: MarketDesk Research

Asia's Recent Outperformance Gives Us Pause Amid Policy Instability …

- Figure 30 charts the rolling relative returns of developed Asia and China vs MSCI ACWI ex-U.S. Index. Both developed Asia and China outperformed over the past 12 months. The outperformance follows underperformance in 2019, which we attribute to the U.S.-China trade war and weak global growth.
- We are neutral / cautious on the Asia region given the recent outperformance. In addition, we believe China represents a risk to regional instability. However, we are tactically OW Hong Kong (*see header section above*).

Figure 31: Latin America — Asset Flows Highlight Contraian Opportunity



Source: MarketDesk Research. ***Note:*** *Flows are calculated using the 5 largest Latin America regional and single country ETFs.*

Looking Past Political Instability & COVID-19 Issues for a Tactical LatAm Position …

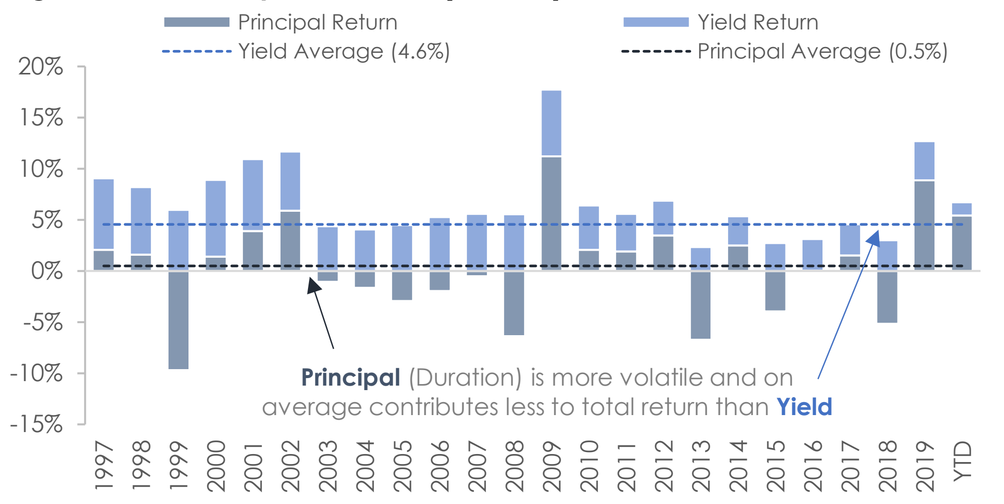
- Figure 31 charts the cumulative ETF flows for the iShares ILF Latin American ETF since the start of 2017. Overlaid is the rolling 6-month flow average.
- From a fundamental view, LatAm continues to struggle against COVID-19. The region also faces volatile currencies and political instability. Investors are fleeing the region, but recent data indicates flows could be slowing, and possibly bottoming. In two prior periods, ILF rallied +7% when cumulative flows bottomed.

Credit Duration — Long vs Short

► **Avoid Long Duration.** Declining credit quality continues to be a bigger risk (see page 15), but we believe long duration will cause interest rate risk to rise in the future. While interest rate risk is low today given the Federal Reserve expects rates will not move before 2022, it will increase as rates rise. As a result, we expect duration to have less of a positive impact on fixed income total returns in the coming years. In our view, long duration is not worth the risk. Instead, investors should position in the short to mid duration credit segments.

► **Actionable Ideas:** Short to Mid Duration Bond ETFs - IG (ticker: VCIT) and HY (ticker: HYG, SHYG)

Figure 32: U.S. Corporate Bond (AAA-A) Total Return - Duration vs Yield

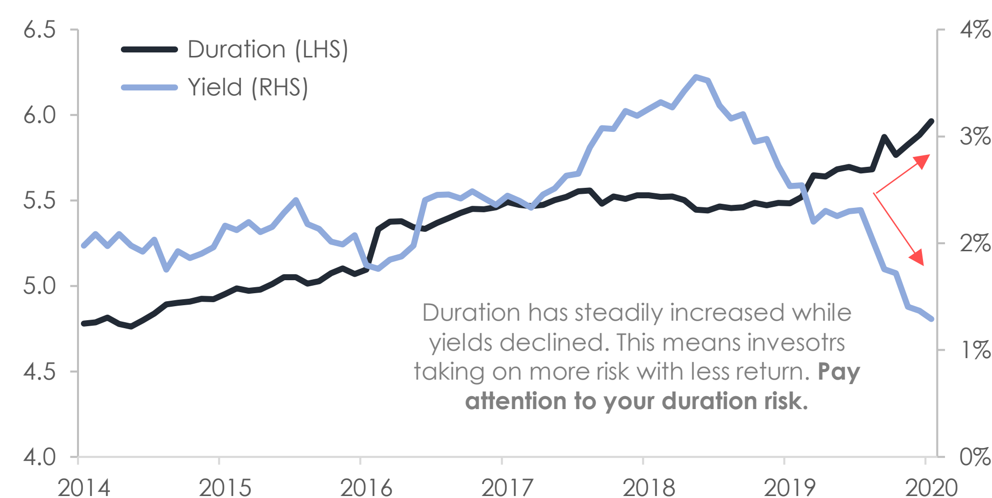


Source: MarketDesk Research

Duration's Impact on Credit Returns Unlikely to Repeat …

- Figure 32 graphs the annual total return generated by the AAA-A U.S. corporate bond index. Total return is further classified into principal return, which we view as a proxy for duration, and yield return.
- 2019's principal return, which was boosted by interest rate cuts, was the highest since 2009. The positive duration impact continued into 2020 as the Fed further cut interest rates. With rates at historic lows, we believe yield will be more impactful than duration.

Figure 33: U.S. Bond Aggregate Index - Diverging Duration vs Yield

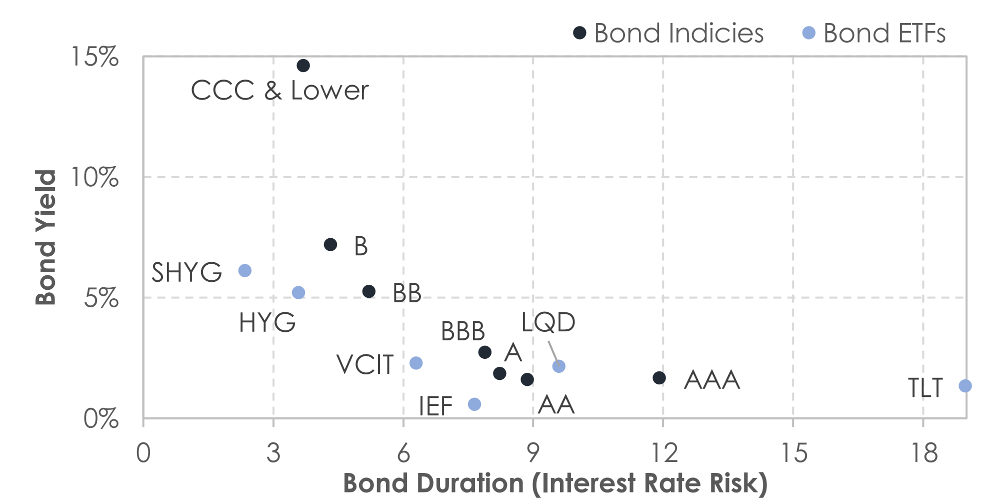


Source: MarketDesk Research

Investors Take on Higher Interest Rate Risk In Exchange for Less Yield …

- Figure 33 charts duration vs yield for the U.S. bond aggregate index. Yield dropped from 3.3% at the end of December 2018 to 1.3% at the end of June 2020. Duration increased from 5.5 to 6.0 over the same time period.
- The duration and yield moves mean investors are earning less yield but taking on more interest rate risk. With interest rates at historic lows, current yields may not be compensating investors enough for the extra interest rate risk.

Figure 34: Balancing Risks Across Fixed Income - Duration & Quality



Source: MarketDesk Research

Mapping Duration & Quality Risks Across Fixed Income…

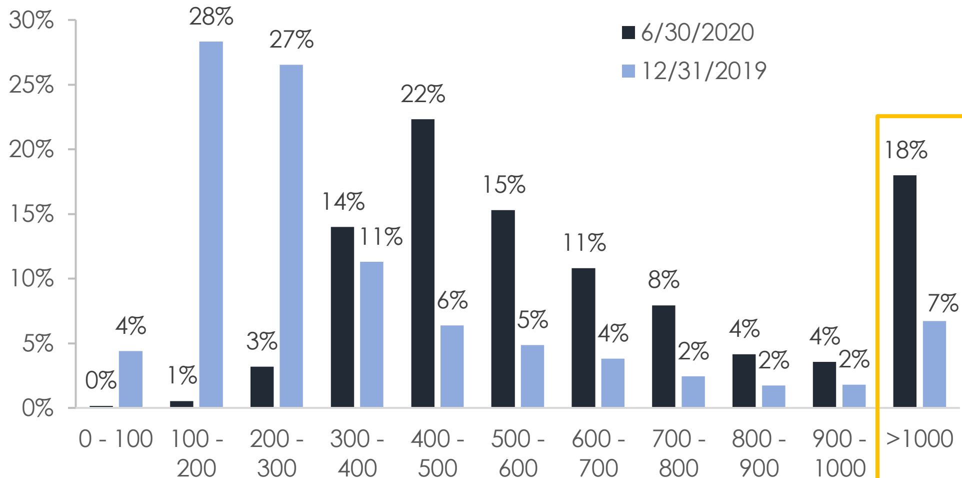
- Figure 34 charts current yield vs duration across various fixed income classes. In general, IG bonds have lower yields and higher duration, while HY has higher yields and lower duration.
- Investors need to be aware of the duration risk they take on. While interest rates appear unlikely to move materially in either direction, higher duration exposes investors to more interest rate risk if rates decline. Credit quality is a higher risk today given the economic downturn, but duration could be a bigger risk in the coming years.

Credit Quality — IG vs HY

► **Credit Quality** will continue to be a material risk in the current market environment. However, we believe investors are compensated to move down the credit quality spectrum due to wider credit spreads. The last time the HY-IG credit spread hit current levels was in 2011 and 2016, HY outperformed IG over the next 12 months. In addition, investor sentiment continues to be boosted by Federal Reserve stimulus measures.

► **Actionable Ideas:** Position at the higher end of the IG spectrum (ticker: QLTA) and high-yield (ticker: FALN); In our view, the low end of the IG spectrum faces downgrade risk as the volatility settles and companies restart operations.

Figure 35: Stressed & Distressed USHY Holdings Today vs 12/31/2019



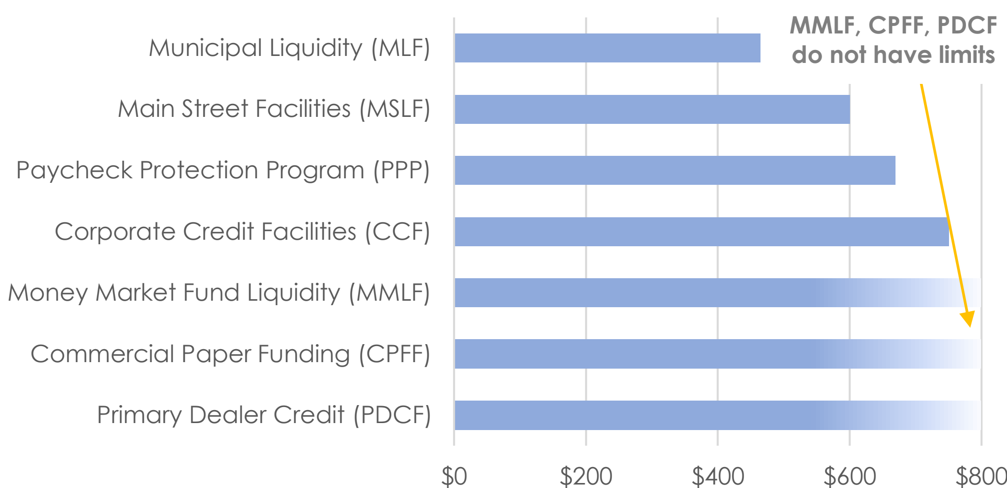
Source: MarketDesk Research

Amount of 'Stressed' & 'Distressed' Bonds Surges in 2020 …

● Figure 35 charts the amount of 'stressed' and 'distressed' debt in USHY. We classify bonds with an option adjusted spread (OAS) above 1000bps (e.g. 10%) and/or a credit rating of CCC or below as 'distressed'. We classify bonds with an OAS of 600-1000 (e.g. 6-10%) as 'stressed'.

● There was a surge in 'stressed' and 'distressed' debt from 12/31/2019 to 6/30/2020. Economic shutdowns related to the ongoing health pandemic are a significant contributor to the increase.

Figure 36: Federal Reserve Stimulus



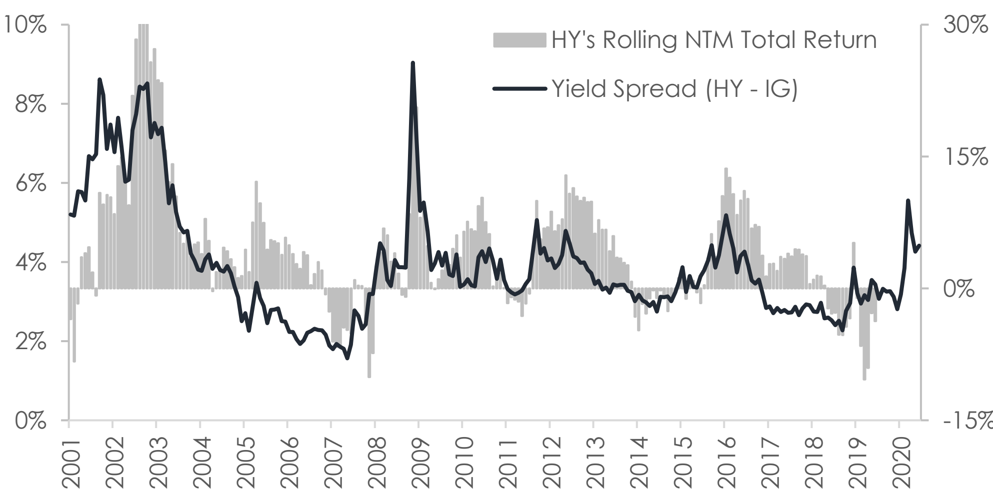
Source: MarketDesk Research, Federal Reserve

Federal Reserve Takes Swift Action to Support Credit Markets …

● Figure 36 shows Federal Reserve stimulus measures enacted to support the U.S. economy and credit markets. Each of the programs is used to ease pressures with the U.S. financial system.

● The stimulus efforts span the municipal bond market, big and small private companies, and money and commercial market funds. In our view, the size and diversity of the programs indicate the Fed's commitment to support the U.S. economy, which should help support credit markets.

Figure 37: Historical HY-IG Spread vs Rolling NTM Returns



Source: MarketDesk Research

History Indicates High Yield Bonds Can Outperform Given Current Spreads …

● Figure 37 charts the historical HY-IG spread (black line) vs HY's rolling NTM total return relative to IG (grey fill). The HY-IG spread last reached current levels in 2011 and 2016. As the chart indicates, HY outperformed IG in the period following each credit spike.

● While we acknowledge the elevated credit risk within high yield today, we believe investors are compensated for assuming the extra risk.

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