# Stembrook Market Review — Second Quarter 2020

With unemployment reaching as high as 14.7%[1] and the economy expected to contract by -33.7%[2] in the second quarter after falling by -5%[2] in the first quarter, large cap U.S. equities are only down -3.1%[3] year-to-date. One might ask, "Why has the market rebounded despite the economic weakness?" While we view the extent of the recent rally with a healthy dose of caution and don't believe that the volatility is altogether behind us, there are a number of factors that have supported the quick bounce in equity prices. Most notably, central bank policy and fiscal stimulus have played a large role. As with the Global Financial Crisis, the U.S. Federal Reserve has used monetary policy to help the economy and credit markets weather the shock from the pandemic. In 2008, the Fed injected $4.5 trillion over 6 *years*. This year, the Fed has increased its balance sheet by over $7 trillion in a few *months* by liberalizing the types of assets they can purchase—a much more aggressive response. Additionally, Fed Chair Powell has vowed to keep rates low for the foreseeable future. As we highlighted in our last market review, fiscal stimulus has also been a massive support.

Another factor driving returns has been the expectation of future earnings rebounding. Remember that stocks tend to look past current earnings and almost always lead the economy out of recessions. It is also important to note that stock market returns and economic growth bear very little resemblance to one another over short and even intermediate-term horizons. The center chart below shows the rolling 5 year correlation between the two. Over most periods, that relationship is low or even negative.

Our proprietary models forecast long-term, pre-tax returns ranging from 1% to 4% for fixed income-like asset classes and 5% to 11% for equity-like asset classes (see table to the right). We maintain target weight allocations for equities and fixed income. We purchased risk assets after the initial selloff, which we continue to trim as markets recover. Our more detailed observations and current portfolio positioning are outlined in the following comments.

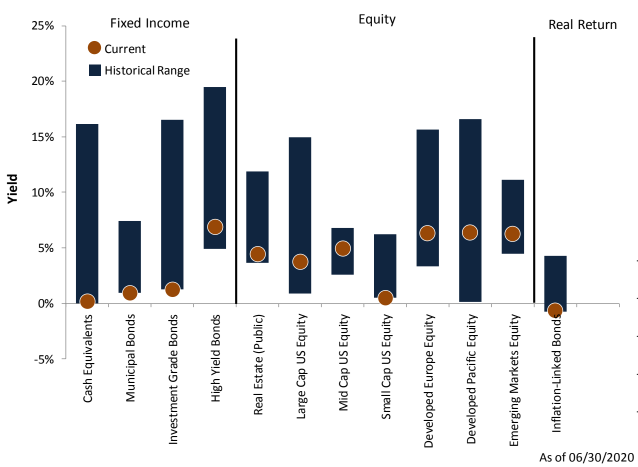
## Expected Market Returns and Risks
## 7-10 Year Horizon

**As of: 30-Jun-20**
Expected Risk and Return - 7-10 Year Horizon

| | | Pre-Tax Annualized Return | After-Tax Annualized Return | Volatility[1] |
|---|---|---|---|---|
| | Inflation | 1.3% | 1.3% | 3.1% |
| Fixed Income | Municipal Bonds | 0.8% | 0.8% | 4.4% |
| Fixed Income | Inflation-Linked Bonds | 0.5% | 0.2% | 5.6% |
| Fixed Income | Investment Grade Bonds | 1.0% | 0.5% | 6.7% |
| Fixed Income | High Yield Bonds | 3.7% | 1.8% | 13.2% |
| Equity | Real Estate (Public) | 4.6% | 2.5% | 17.5% |
| Equity | Broad Market US Equity | 8.9% | 7.0% | 16.9% |
| Equity | Developed Non-US Equity | 9.1% | 7.0% | 21.4% |
| Equity | Emerging Markets Equity | 10.6% | 7.0% | 29.6% |

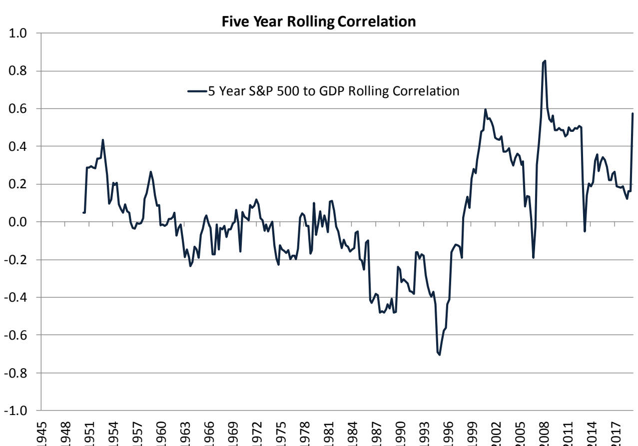
*A sampling of return expectations produced by our models. Expected returns are projections and are not guaranteed.*

## Yields Across Asset Classes



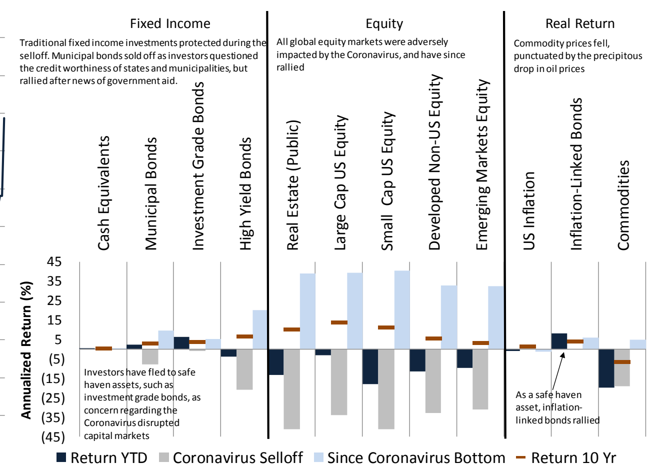

*Yields are an indicator of future returns. Orange dots show current yields, blue bars show historical ranges. Bond yields are generally low versus historical range.*

## The Economy and Equity Prices




*The relationship between economic growth and the equity market varies over time, but they tend not to move together over short and even intermediate-term periods.*

## Historical Market Returns




*Historical market returns as of June 30th, 2020. Note that looking backwards at recent returns is not a reliable method for predicting future returns.*

Stembrook Asset Management

## Global Asset Class Returns

| Asset Class Name | Last 10 Years | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Small Cap US Equity | S&P 500 11.2% | Real Estate 28.6% | Infl-Indx Bnd 14.0% | EM Eq 18.2% | Small Cap 41.3% | Real Estate 31.8% | Real Estate 2.8% | Small Cap 26.5% | EM Eq 37.3% | CPI 2.0% | S&P 500 31.5% |
| Large Cap US Equity | Small Cap 11.0% | Small Cap 26.3% | Real Estate 9.2% | Real Estate 17.6% | S&P 500 32.4% | S&P 500 13.7% | S&P 500 1.4% | HY Bnd 17.5% | Intl Eq 25.0% | Inv Grd Bnd 0.0% | Real Estate 28.7% |
| Real Estate (Public) | Real Estate 10.5% | EM Eq 19.2% | Inv Grd Bnd 7.8% | Intl Eq 17.3% | Intl Eq 22.8% | Inv Grd Bnd 6.0% | CPI 0.8% | S&P 500 12.0% | S&P 500 21.8% | Infl-Indx Bnd -1.8% | Intl Eq 22.8% |
| High Yield Bonds | HY Bnd 6.2% | Commod 16.8% | HY Bnd 4.5% | Small Cap 16.3% | HY Bnd 7.4% | Small Cap 5.8% | Inv Grd Bnd 0.5% | Commod 11.4% | Small Cap 13.2% | HY Bnd -2.1% | Small Cap 22.7% |
| Emerging Markets Equity | Intl Eq 4.8% | HY Bnd 15.2% | CPI 3.0% | S&P 500 16.0% | Real Estate 1.9% | Infl-Indx Bnd 4.6% | Intl Eq -0.2% | EM Eq 11.3% | Real Estate 8.7% | Real Estate -4.0% | EM Eq 18.6% |
| Developed Non-US Equity | EM Eq 3.1% | S&P 500 15.1% | S&P 500 2.1% | HY Bnd 15.4% | CPI 1.5% | HY Bnd 2.5% | Infl-Indx Bnd -1.4% | Real Estate 8.6% | HY Bnd 7.5% | S&P 500 -4.4% | HY Bnd 14.3% |
| Investment Grade Bonds | Inv Grd Bnd 3.1% | Intl Eq 7.8% | Small Cap 1.0% | Infl-Indx Bnd 7.2% | Inv Grd Bnd -2.0% | CPI 1.3% | Small Cap -2.0% | Infl-Indx Bnd 3.6% | Inv Grd Bnd 3.5% | Small Cap -8.5% | Infl-Indx Bnd 10.6% |
| Inflation-Linked Bonds | Infl-Indx Bnd 2.9% | Infl-Indx Bnd 6.5% | Intl Eq -12.1% | Inv Grd Bnd 4.2% | EM Eq -2.6% | EM Eq -1.8% | HY Bnd -4.6% | Inv Grd Bnd 2.6% | Infl-Indx Bnd 3.0% | Commod -13.0% | Inv Grd Bnd 8.7% |
| Inflation | CPI 1.5% | Inv Grd Bnd 6.5% | Commod -13.3% | CPI 2.0% | Infl-Indx Bnd -9.4% | Intl Eq -4.5% | EM Eq -14.8% | CPI 1.8% | CPI 2.1% | Intl Eq -13.3% | Commod 5.4% |
| Commodities | Commod -4.4% | CPI 1.5% | EM Eq -18.4% | Commod -1.1% | Commod -9.5% | Commod -17.0% | Commod -24.7% | Intl Eq 1.6% | Commod 0.7% | EM Eq -14.5% | CPI 2.1% |

*Returns are arranged in columns, by year. Each color represents a different asset class. Each year, the leaders and laggards tend to shift. Diversification across a range of asset classes can smooth returns and enhance growth.*

### Economic Backdrop

- **The economic fallout from the pandemic was felt across the globe in the second quarter, data improved toward the end of the quarter, but the impact will continue to be felt in the coming months.**
- Global economic output, as measured by GDP, is expected to plummet in the second quarter by –17.4% after a modest decline in the first quarter.[2] Inflation for the same country group is expected to fall to a lesser degree, with prices continuing to modestly increase by 1.4%.[4]
- GDP in Emerging Market economies is also expected to contract in the second quarter by –4.7%, mainly driven by weakness in Latin American and European countries. China's economy is expected to improve in the second quarter, increasing by 3.2%.[2]
- Business confidence remains tempered around the world. Despite rebounding from a low of 39.6 in April to its current level of 47.8, the global purchasing managers index remains below 50 in almost all countries. A level above 50 indicates expansion, while a level below 50 indicates contraction.[5]
- In addition to the Federal Reserve, other central banks have shown a willingness to expand their balance sheets to ensure the availability of credit to businesses negatively impacted by the pandemic.

### Equities

- **Global equity markets advanced 24% in the second quarter, but the rally has not reached the entire market.**[6]
- After a very weak first quarter, small cap stocks bounced back in the second quarter, up by 31.4%.[7]
- Technology stocks continued their reign of dominance, up 36%, as many of these businesses remained somewhat insulated and in some cases have benefited from the knock-on-effects of the pandemic.[8]
- Developed non-U.S. stocks were up 18.3%[9] and emerging markets returned 21.1%.[10]

### Fixed Income

- **After playing a defensive role in the first quarter, investment grade bonds continued to provide returns in excess of yields as central banks indicated that interest rates would remain low for the foreseeable future. The index was up 2.8% in the quarter.**[11]
- After a very challenging start to the year, high yield bonds bounced back in the second quarter, up 11.4%.[12]
- As the immediate concern of fiscal challenges for states and municipalities began to ease, municipal bonds bounced back, up 3.9% in the quarter.[13]

### Current Positioning

- In late April, **we increased our allocation to high yield bonds** for both taxable and tax-deferred portfolios as yields became more attractive during the selloff.
- We maintain our **overweight to developed non-U.S. and emerging market equities**, where valuations and long-term return potential remain attractive.
- We also maintain our **underweight to large cap U.S. equities.**
- We favor **lower priced, value-oriented equities, both in the U.S. and abroad,** which tend to outperform the broad market over time, with less volatility.
- We remain **overweight municipal bonds** for taxable investors.

Despite the recent rally in equity markets, we remain acutely aware that we are still in the midst of a global pandemic. We do think that there will be continued volatility and challenges in the coming months. At the same time, we continue to look for opportunities while managing risk.

We continue to focus our efforts on helping you meet your financial objectives by following our disciplined investment approach. Our approach uses return and risk models, incorporating fundamental valuations and tax-efficient strategies. This investment discipline is tailored to your individual situation in our continuing effort to craft and implement your customized investment solution.

As always, we thank you for placing your trust in our investment management and advice and welcome your questions and comments at any time.

Peter D'Agati  Thomas Kosinski

Peter D. D'Agati, CFA  Thomas Kosinski

## Endnotes and Sources:

**Text:**

(1) Bloomberg: BLS Total Unemployment in the United States. 4/30/20.
(2) Bloomberg, Stembrook Research: GDP measures are based on the most recent annualized quarterly, seasonally-adjusted data. Statistics are stated in inflation-adjusted terms. Aggregate Statistics are weighted by each country's GDP translated into USD. Where available, official estimates are used. Where official estimates are not available, GDP data is based on Bloomberg Contributor Forecasted GDP. Emerging Markets measures are based solely on Bloomberg Contributor Forecasted GDP. As of 6/30/20.
(3) Bloomberg: S&P 500. Total Return 12/31/19-6/30/20.
(4) Bloomberg, Stembrook Research: Aggregate inflation statistics are weighted by each country's GDP translated in to USD. As of 6/30/20.
(5) Bloomberg: Markit Global Purchasing Managers Index for Manufacturing and Service. As of 6/30/20.
(6) Bloomberg: MSCI ACWI Total Return. 3/31/20-6/30/20.
(7) Bloomberg: S&P 600 Total Return. 3/31/20-6/30/20.
(8) Bloomberg: NASDAQ 100 Total Return. 3/31/20-6/30/20.
(9) Bloomberg: MSCI EAFE Total Return. 3/31/20-6/30/20.
(10) Bloomberg: MSCI Emerging Markets Total Return. 3/31/20-6/30/20.
(11) Bloomberg: Bloomberg Barclays U.S. Aggregate Index Total Return. 12/31/19-3/31/20.
(12) Bloomberg: Bloomberg Barclays U.S. Corporate High Yield Index Total Return. 3/31/20-6/30/20.
(13) Bloomberg: S&P National Intermediate Term AMT Free Municipal Bond Index Total Return. 3/31/20-6/30/20.

**Charts:**

**Expected Market Returns and Risks, 7-10 Year Horizon: As of 6/30/20.**
Source: Stembrook Research.
(1) Volatility is measured in terms of Standard Deviation. Standard deviation is the statistical measurement of dispersion about an average, which depicts how widely a stock or portfolio's returns varied over a certain period of time. Investors use the standard deviation of historical performance to try to predict the range of returns that is most likely for a given investment. When an investment has a high standard deviation, the predicted range of performance is wide, implying greater volatility. If an investment's returns follow a normal distribution, then approximately 68 percent of the time they will fall within one standard deviation of the mean return of the investment, and 95 percent of the time within two standard deviations. For example, for a portfolio with a mean annual return of 10 percent and a standard deviation of two percent, you would expect the return to be between 8 and 12 percent about 68 percent of the time, and between 6 and 14 percent about 95 percent of the time. Source: Morningstar.

**Yields Across Asset Classes: As of 6/30/20.**
Sources: *Cash Equivalents Yields* since March 1976. Ibbotson, Federal Reserve Bank, Thomson Reuters, *Municipal Bond Yields* since March 1988. Barclays Capital, Charles Schwab, BofA Merrill Lynch, Standard & Poor's/Investortools Municipal Bond Indices, *Investment Grade Bond Yields* since March 1976. Barclays Capital, *High Yield* since December 1984. BofA Merrill Lynch, Barclays Capital, *Real Estate (Public) Earnings Yield* since March 1976. NAREIT all Equity, *Large Cap U.S. Equity Earnings Yield* since March 1976. Standard & Poor's, BARRA, *Mid Cap U.S. Equity Earnings Yield* since June 1991. Standard & Poor's, BARRA, *Small Cap U.S. Equity Earnings Yield* since December 1993. Standard & Poor's, BARRA, *Developed Europe Equity Earnings Yield* since March 1976. MSCI Europe, Standard & Poor's Europe 350, *Developed Pacific Equity Earnings Yield* since March 1976. MSCI Pacific, S&P/Citi PMI Asia Pacific, S&P Asia 50, *Emerging Market Equity Earnings Yield* since December 1998, *Inflation-Linked Bond Real Yield to Maturity* since March 1997. Citi Yield Book, Federal Reserve Bank. Note: Yields are not perfect predictors of future returns and should not be used in isolation.

**The Economy and Equity Prices**
Source: S&P 500 Total Return (Quarterly), BEA: Percent Change in Nominal GDP (Quarterly). Trailing 5 Year Rolling Correlations. 6/30/1946—3/31/20.

**Historical Market Returns: As 6/30/20.**
Coronavirus selloff: 2/19/20-3/23/20 Since Coronavirus Bottom: 3/23/20-6/30/20.
Source: Bloomberg, Stembrook Research.
Indices: Bloomberg Barclays U.S Treasury Bills 1-3 Month Total Return, Bloomberg Barclays Municipal Bond 5 Year (4-6) Total Return, Bloomberg Barclays U.S. Aggregate Bond Total Return, Bloomberg Barclays U.S. Corporate High Yield Total Return, FTSE All Equity REIT Total Return, S&P 500 Composite Total Return, S&P SmallCap 600 Total Return, MSCI EAFE Total Return, MSCI EM (Emerging Markets) Total Return, Consumer Price Index – U.S., S&P 10 Year U.S. TIPS Total Return, Bloomberg Commodity (Total Return) Index.

**Global Asset Class Returns: As of 12/31/19.**
Source: Thomson Reuters, Bloomberg, Stembrook Research.
Indices: Consumer Price Index – US, U.S. 30-Day Treasury Bills, Bloomberg Barclays U.S. Treasury Bills: 1-3 Month Index, Citigroup Inflation-Linked Index, S&P 10 Year US TIPS Index, Bloomberg Barclays U.S. Aggregate Bond Index, BofA Merrill Lynch U.S. High Yield Cash Pay, Bloomberg Barclays U.S. Corporate High Yield Index, Dow Jones Wilshire REIT Index, FTSE All Equity REIT Index, S&P 500 Composite Total Return, S&P SmallCap 600 Total Return, MSCI EAFE Index, MSCI EM (Emerging Markets) Index, Dow Jones AIG Commodity (Totl Ret) Index, Bloomberg Commodity Index.

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