Investment Commentary: 2/2021

Global stocks generally retreated in January as market volatility escalated. However, emerging markets stocks and small-cap stocks bucked the global trend and rallied. Meanwhile, U.S. bonds declined as Treasury yields continued to rise.

- Against a backdrop of mixed earnings results, increasing volatility, continued lockdowns and vaccine distribution slowdowns, global stocks generally declined. The exceptions were emerging market (up 3.1%) and U.S. small-cap stocks (up 5.0%).
- Despite reaching several record levels in January, the S&P 500 Index ended the month lower, down 1.01%. A frenzy of online trading in select stocks triggered a surge in market volatility late in the month, which weighed on monthly performance.
- The U.S. economy contracted 3.5% in 2020, marking the first yearly decline in GDP since the financial crisis. However, GDP ended 2020 on a positive note, growing 4.0% (annualized) in the fourth quarter, near economists' estimates.
- The U.S. manufacturing, services, and housing sectors recorded modest monthly gains, and the unemployment rate remained unchanged. Relative to the U.S., economic data were generally weaker in Europe and the U.K.
- U.S. Treasury yields continued to climb in January, pressuring returns for most investment-grade bond sectors. The broad U.S. bond market declined but modestly outperformed global bonds.

"The swift and sizeable policy response from central banks and governments has managed to cushion the economic shock from the Covid-19 virus and helped lift markets around the world"

The swift and sizeable policy response from central banks and governments has managed to cushion the economic shock from the Covid-19 virus and helped to lift markets around the world. Although the second wave in Europe reminds us that the battle is far from over and until a vaccine is widely available, economies will likely remain constrained by measures aimed at slowing the spread of the virus. **It remains important that governments continue to support consumer incomes and businesses until a vaccine is available or the virus is brought under control. The extent to which this is done will be key to the outlook from here**.

Managing Risk with Interest Rates near Zero

High-quality Treasury bonds have been one of the best tools to manage risk in portfolios. **Historically government bonds have been a consistent source of income and a hedge against economic calamities (recession, depression, etc.) and bear markets in stock.** Overall, their track record of providing returns when the world starts to fall apart has been pretty good, see the chart on the next page.

In five of the six bear markets since 1990, including the recent Covid-19 crisis, bonds were able to generate capital gains (returns) that helped reduce overall risk in diversified portfolios. **However, that success has come at a cost of extremely low yield levels. At today's yields, U.S. Treasuries not only fail to provide a useful amount of yield to investors but are also less likely to generate capital gains and act as a hedge against further economic trouble**.

That being said, investors should not abandon treasury bonds, but simply be aware they are not likely to serve as well as the risk diversifiers they have in the past. A few things investors should consider when managing risk in portfolios are: given where inflation break-even rates are consider replacing some of your Treasury bonds with inflation protection bonds (TIPs); supplement portfolios with alternative assets that have a relatively low correlation to traditional stocks and bonds (real return, long/short, etc.); focus on asset class valuation, a lower valuation will reduce long-term risk; and make sure to rebalance portfolios-- an underappreciated aspect of portfolio management and an important tool to limit risk.

Bear Market	*Start*	*End*	*MSCI World Return*	*Yield Change for 10-Year U.S. Treasury Note*	*Capital Gain/Loss of 10-Year U.S. Treasury Note*[4]
First Gulf War	7/16/90	9/28/90	-21.3%	0.4%	-2.4%
LTCM	7/20/98	10/5/98	-20.3%	-1.3%	10.7%
TMT	3/27/00	10/9/02	-49.8%	-2.6%	21.9%
GFC	10/31/07	3/9/09	-57.8%	-1.6%	13.6%
Euro Crisis	5/2/11	10/4/11	-22.0%	-1.5%	13.7%
Covid-19 Crisis	2/19/20	3/23/20	-34.0%	-0.8%	7.8%
		Average	-34.2%	-1.2%	10.9%

Source: Datastream, MSCI, GMO

Changes to the Dow Jones Industrial Average (DJIA)

Recently the DJIA announced several changes to its holdings, which prompted several questions from our clients. The changes were as follows: stocks added- Salesforce, Amgen, and Honeywell; stocks deleted: Exxon Pfizer and Raytheon. The questions asked centered around why they would do this and what the likely impact is. A recent study by Ned Davis Research helped answer these questions, and provided three main reasons why it happened:

I. It was a technical response created by Apple's recent 4 for 1 stock split. The DJIA is a price-weighted index, which is unique, most indices are market-capitalization-weighted. So the lower price per share for Apple would have reduced the index weighting to technology stocks.

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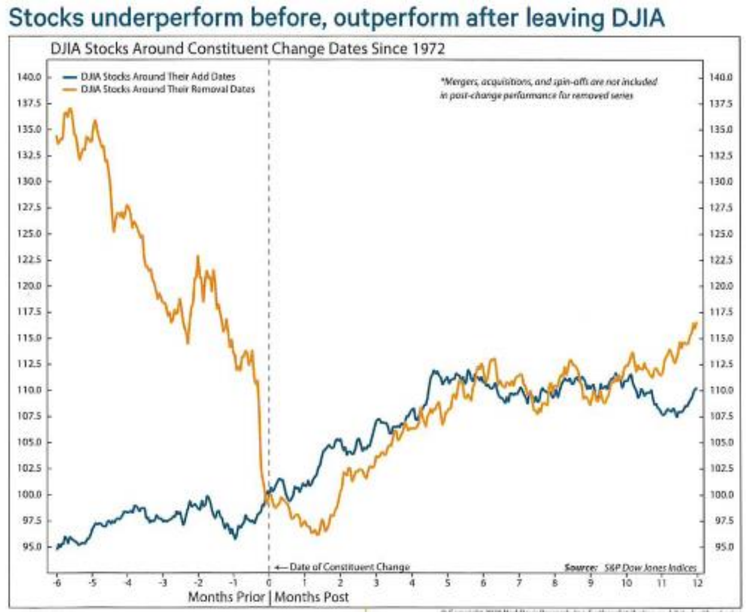
II. The plunge in the DJIA's tech sector weighting would have significant compared to the S&P 500—as much as 8% lower. To make up for this they added Salesforce as a replacement for Exxon in the index.

III. Due to the lack of 'FANG' (Facebook, Apple, Netflix, Google) stocks in the DJIA, the index has trailed the S&P 500 by 11.4% the past year. Something they were afraid would continue unless they changed the composition of the index.



What's most interesting, is that stocks that have been kicked out of the DJIA have actually outperformed the stocks added. The chart below shows how since 1972 the stocks kicked out have usually underperformed before leaving the index but gone on to outperform the ones added over the next 12 months. **Given the relative valuations of the stocks leaving vs. arriving, we wouldn't be surprised if this trend continues!**

The Federal Reserve Changes its Policy

The Federal Reserve's Chairman, Jerome Powell, recently revealed a change to its policy framework. Indicating a preference to 'average inflation' around its 2% inflation target. Alerting the financial markets that it will allow inflation to exceed the central bank's 2% target to further support the economy. The dovish shift, on top of existing stimulus measures, raised concerns about potential overshoots in the future and caused the U.S. dollar to drop, the 10-year Treasury yield to increase and the yield curve steepened sharply. The takeaway being the Federal Reserve is willing to change the rules and is committed to seeing higher inflation levels. **We don't believe there will be a sudden and dramatic shift in inflation expectations, however, we think it is wise for investors to start considering how they are positioned if inflation does start to increase. We will be!**

Closing Thoughts

Given the high degree of uncertainty around the outlook for the virus and a vaccine, we continue to believe it makes sense to aim for balanced and well-diversified portfolios while considering which areas one might want to add to when a successful vaccine is widely available. In this environment, we prefer a higher-quality strategy for both stocks and bonds and an emphasis on valuations relative to fundamentals. We also suggest some alternative strategies to help diversify portfolios given the reduced diversification that government bonds are likely to provide at current yields. If you have any questions on this commentary or would like to discuss your investment strategy give us a call.

\- **AWM Investments (September 2020)**