Commentary
Charitable Asset Management

Q2 2020

Q2 Tactical & Market Summary

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The uncertainty that has plagued 2020 thus far, continued in the 2nd quarter as the global economy suffered from an unprecedented shock in March and April driven by government-imposed lockdowns to contain the spread of the COVID-19 pandemic. Policy makers responded with massive, broad-based fiscal and monetary stimulus to support affected workers and businesses in record time. Economic data in May indicates that the stimulus support and re-opening plans are working, and the economic recovery has begun.

However, risks to recovery remain with increased geo-political tensions between the United States (US) and China over Hong Kong and concerns around the further handling of COVID-19 crisis across the world. As countries ease lockdown measures, the disease may regain traction, forcing affected economies into a second lockdown.

For the 2nd quarter, the team chose to reduce risk assets deploying proceeds into bonds. Heightened levels of risk aversion, deteriorating equity forecasts and concerns over economies re-opening too quickly, drove our decision. In addition, the rebalance allows us to bring our duration closer to benchmark.

Overall, we continue to believe impacts from COVID will prove transitory with the expectation for improved economic growth in the second half of 2020 and into 2021. The re-opening push has begun globally, but the path forward will likely be choppy with lingering uncertainty about a potential second wave and a phased approach limiting capacity for businesses allowed to re-open. High frequency data such as an uptick in mortgage applications, increasing mobility data and an uptick in railroad traffic point to a pick-up in activity while the recent surprise in employment suggest business are re-hiring. Further, the unprecedented amount of stimulus and commitment from central banks, to improve the functioning of markets and support economic growth, provide a tailwind for the recovery. In our view, recent developments are indicative of the early stages in economic recovery and suggest a heavily defensive position is less warranted. However, given the myriad of risks, our approach is to target selective risk assets rather than position the portfolio with a full-on pro-growth stance.

Tactical

In the 2nd quarter, we chose to continue to maintain our multi-year overweight position to US large cap equities. Across the remaining US equity space we continued to hold our neutral view on mid cap equities and moved underweight in small cap equities. Specifically, both European and US small caps are challenged by weak medium-term momentum indicators as investors worry they may be more impacted by weak economic growth given their higher leverage profiles. US small caps in particular have similar return forecasts to other equity segments but are more vulnerable to the impact of social restrictions on their business models and come with higher risk.

From a bottom up perspective, equities are balancing a good macro environment with waning price momentum, mixed earnings sentiment and stretched valuations. This view is moderated by the significant policy response providing an additional tailwind. As such, we maintained a slight overweight to equities overall, as there is material dispersion at the regional level. The US is the top ranked region supported by strong long-term momentum indicators and positive earnings and sales estimates which offsets weak valuations. The potential bottoming of PMIs, better risk appetite and a weakening US dollar bolster emerging markets. The forecast for Pacific equities ranks poorly, driven mainly by negative momentum and sentiment indicators for Japan.

During the quarter, we chose to maintain our slight underweight to developed market equities and maintain a neutral position in emerging market equities.

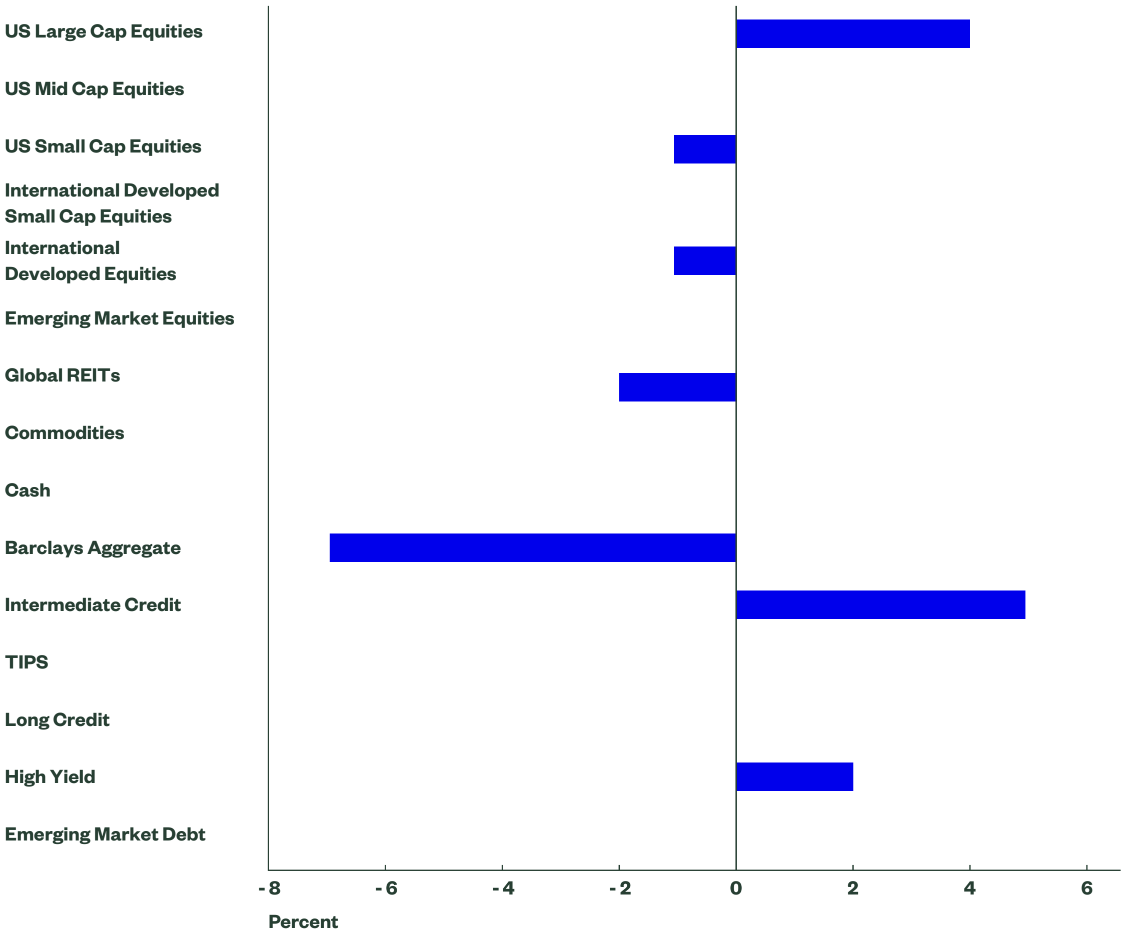
After closing out the overweight position in REITs in the 1st quarter, the team chose to take the position underweight in the 2nd quarter. REITs rank poorly across all factors in our model. Higher financial leverage, greater volatility and weak long-term price momentum weigh on the outlook. The prospects for REITs continue to decline as recent underperformance has weighed on momentum while relatively poor and declining expectations for sales and earnings drag on sentiment. In addition, record unemployment and restrictive social distancing guidelines continue to stifle demand as the retail, hospitality and food services industries remain under extreme duress. This, combined with a consumer demand shift to online shopping is likely to materially impact cash flows and dividends for REITS in 2020.

During the quarter, the team chose to tilt the fixed income exposure towards credit to reflect our preference to take risk in the credit space, which appears well supported as compared to our concerns about near-term risks for equities. With yields near multi-decade lows, valuations appear rich rendering government bonds unattractive in a multi-asset class portfolio. High yield bonds remain supported on several fronts from valuation to policy support and should benefit from investors looking to add yield in the current environment. As a result, we sold US aggregate bonds moving further underweight with proceeds deployed into high yield bonds.

Figure 1
Allocation for 70/30 Trust Portfolio

Source: State Street Global Advisors CAM, Global Plus.

Figure 2
Asset Class Overweights/ Underweights



Source: As of 06/30/2020. The Allocations, weights are as of the date indicated, are subject to change, and should not be relied upon as current thereafter.

2nd Quarter Market Commentary

Risk assets saw a rebound in April on the back of unprecedented fiscal and monitory support early in the quarter. Oil prices rallied back sharply from the lows recorded early in the quarter on demand recovery and coordinated supply cuts by OPEC+ countries. However, the US dollar weakened in late-May and June amid improved economic sentiment and reversed the gains it accrued in March. On the other hand, sovereign bond yields of developed markets stabilised at low levels amid the accommodative quantitative easing programs of central banks.

Policymakers delivered on multiple fronts in the context of the persistence and spread of the pandemic and supporting the economy. Early in the quarter, governments worldwide imposed lockdowns, shuttered businesses, closed borders and ramped up large scale-testing in varying degrees. Monetary policy stimulus followed suit with central banks introducing a variety of liquidity programs, opening a range of swap lines and launching targeted asset purchase programs.

On the fiscal side, efforts were delayed but were substantive with advanced economies announcing US$9 trillion in support overall. In general, the stimulus programs announced during the quarter were broad based and targeted. For instance, central banks waded into the credit markets with an aim to stabilise corporate financing and governments announced direct allocation to affected households and businesses. Details of further fiscal packages are still evolving but key central banks have committed to near zero interest rates through 2022.

Economic indicators collapsed globally during the first half of the quarter. The US alone lost over 20 million jobs in April with historic declines in retail sales, manufacturing and housing. However, more recently, by end-May and in June, a steady stream of encouraging data emerged, which suggests economic activity troughed in April. US labor market, retail sales and manufacturing data rebounded strongly in May.

The NAHB Housing Market Index registered record gains in June, indicating a solid rebound in housing. Euro area Composite Purchasing Managers' Index (PMI) also rebounded in June, led by a recovery in services PMI. The recovery in economic activity is likely to continue across the euro area with Germany leading the charge.

UK June Flash PMIs provided positive signals regarding bottoming of economic activities. Complemented by a normalisation in production activity, China's macro data confirmed the news flow, led by domestic demand recovery in infrastructure, real estate and auto sectors. China's exports have also been resilient in the second quarter.

Global Equities

Equity markets rebounded during the quarter as MSCI All Country World Index registered solid returns of 19.39%. The stimulus packages announced by central banks and various governments, increasing economic activity as a result of the easing of lockdown measures and positive net flows into markets on optimism that a COVID-19 vaccine is in the offing led to market sentiments turning cheerful during the quarter.

The Chicago Board Options Exchange's CBOE Volatility Index (VIX), a market sentiment indicator, continued to tail off with a decline of over 43%, indicating a decrease in market volatility. Overall, risk assets continued to gain ground, building on the strong performance witnessed in the last week of March.

The S&P 500 Index gained 20.54% during the quarter. Consumer discretionary (+32.86%) and information technology (+30.53%) were the best performing sectors and consumer staples (+8.12%) and utilities (+2.73%) posted the lowest returns. Mid- and small-cap companies delivered better gains with the S&P Midcap 400 Index rising by 24.07% and the Russell 2000 Index gaining 25.42%.

MSCI Europe gained 15.57% for the quarter in US dollar terms. Among sectors, information technology (+26.46%) and materials (+23.61%) were top performers while energy (-3.02%) languished at the bottom. At the country level, MSCI Germany and MSCI Netherlands were the best performers in the region, posting returns of 27.15% and 24.90%, respectively, in US dollar terms, while MSCI United Kingdom posted a relatively modest return of 7.79%. MSCI Pacific performed in line with the global indices during the second quarter and gained 14.19% in US dollar terms. MSCI Australia (+28.96%) and MSCI New Zealand (+28.07%) were the best performers in the region. Other markets also gained during the period with MSCI Japan returning +11.64%, MSCI Hong Kong returning +9.16% and MSCI Singapore returning +9.55%.

The broad measure of emerging markets, the MSCI Emerging Markets Index, was up 18.18% for the quarter in USD terms. All the countries in the index posted gains for the quarter with Latin America (+19.22%) performing the best at the regional level followed by EM Europe (+19.11%) and EM Asia (+17.91%). At the country level, the top performing markets included MSCI Argentina (+43.70%) and MSCI South Africa (+27.49%). Markets at the bottom of the list were MSCI Egypt (7.31%) and MSCI Qatar (7.21%). Although China's virus containment efforts were deemed relatively successful, MSCI China was up by only 15.37%.

Global Fixed Income

Global bonds (Bloomberg Barclays Global Aggregate Bond Index — USD Hedged) returned 2.42% over the quarter. Bond yields trended lower as central banks introduced massive stimulus measures and cut policy rates to help counter the swift decline in financial markets earlier in the year. Against the backdrop of a risk-on sentiment, lower equity volatility and loosening financial conditions, spread products broadly outperformed government bonds during the quarter.

Investment grade (IG) option-adjusted spreads (Bloomberg Barclays US Aggregate Corporate Index) tightened by 122 bp to end the quarter at 150 bp over treasuries. Even as the US Fed commenced purchases of individual corporate bonds under the Secondary Market Corporate Credit Facility, June sentiment was challenged somewhat by the rising number of new COVID-19 cases and a potential slowdown in reopening plans.

Fixed-rate, gross IG supply for Q2 was about US$830 bn, bringing the 2020 year-to-date cumulative supply to US$1,375 bn, the fastest start to a year on record and 95% ahead of the pace in 2019. Leverage in US IG hit an all-time high of 2.7x in 1Q as IG companies' EBITDA declined, despite the data reflecting just a month of impact from COVID-19.

High yield (HY) spreads tightened by 255 bp to end the quarter at 627 bp (Bloomberg Barclays US Corporate High Yield 2% Issuer Capped Index). CCC-rated bonds led the recovery with a gain of 11.59% over 2Q followed by returns of +9.85% and +9.06% for Bs and BBs, respectively.

In 2Q 2020, US$82.2 bn worth of bonds defaulted or completed a distressed exchange and the par-weighted US HY default rate rose to a 10-year-high of 6.19%. 2Q saw a large gross HY supply of US$145.5 bn, exceeding the prior record of US$121.2 bn in 2Q14. The market also saw US$42 bn worth of fallen-angel supply over the quarter.

Market-based inflation expectations for the US, as measured by five-year break-evens, increased by 64 bp over Q2, ending at 1.17%. Overall, US TIPS gained 4.24% in Q2 and outperformed nominal bonds of similar maturities. A steady rise in oil prices has been the most important driver of the increase in front-end break-evens.

Commodities

Commodities (as measured by the Bloomberg Commodities Total Return Index) gained 2.3% in June and 5.1% for the quarter. Energy led the way as crude oil prices rebounded from a sell-off in Q1.

- The Energy sector posted a robust return with West Texas Intermediate (WTI) crude oil returning over 23.0% during the quarter, staging a dramatic comeback after falling to record lows in April. A rise in fuel demand after major economies started easing lockdown measures along with record output cuts by the OPEC countries and its allies drove oil prices higher.

- The industrial metals index advanced by 6.9% in June and 12.3% for the quarter. The precious metals sub-index returned 15.0% for the quarter, led by silver and gold. Gold saw its biggest quarterly advance since early 2016 and concluded the second quarter up 12.1% as fears over rising coronavirus cases and ultra-low interest rates boosted demand for the safe-haven metal. Silver surged 29.2% in Q2, erasing its loss for the year while copper recovered much of the ground lost in the first three months of 2020.

- The agriculture sector gained 1.8% in June but was down 4.9% for the quarter. Coffee (-17.8%) and Wheat (-14.5%) were the worst performers. Cotton was up by 15.9%.

Real Estate Investment Trusts (REITs)

Real estate investment trusts (REITs) as indicated by the FTSE EPRA Nareit Global Real Estate Index gained 2.7% in June and 10.8% for the quarter, while Dow Jones US Select REIT returned 1.8% in June and 9.1% for the quarter. Nearly all sectors recorded gains and certain real estate investment trust sectors that especially suffered during the pandemic-induced crisis — including regional malls and shopping centers — came off their lows in the second quarter.

According to a recent survey done by the National Association of Real Estate Investment Trusts (Nareit), there is an improvement in rent collections for most sectors, suggesting that retail re-openings across many parts of the US in May had a positive economic impact on retail REITs.

* Nareit's survey includes listed equity REITs that own and operate between 10% and 20% of commercial real estate in the US.

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* This figure is presented as of June 30, 2020 and includes approximately $69.52 billion of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated.

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