Investment Strategy Update

October | 2020

Global equities have staged a tremendous rally on the coattails of global monetary and fiscal support, which have moved well ahead of earnings, thereby resulting in significant short-term multiple expansion. The rich valuations of global equities, particularly in the U.S., lends to a higher degree of market fragility in the near-term and indicates the need for corporate earnings to catch up to equity prices before we can expect to see any material upside in returns. Although the future remains somewhat clouded with economic and political uncertainty, the global economy exhibited signs of a strong economic recovery during the third quarter, particularly in the U.S. The combination of immediate and targeted action by the Fed, and an initial strong fiscal response by the U.S. government, supported a rapid recovery across most measures of economic activity in the U.S. While we are unlikely to witness a complete rebound in GDP to pre-COVID highs, it's reasonable to expect +30% GDP growth (annualized) in Q3, which represents a very strong recovery relative to prior recessions. Coinciding with the strong recovery in economic growth, we continue to see a rebound in unemployment and inflation. The Fed maintains communication that it intends to remain very supportive through 2023, and in lieu of yield curve control, this anchoring of short-term rates is unlikely to keep long-term interest rates at these low levels. Arguably, the Fed's current interest rate policy is likely to fuel higher economic growth and inflation, leading to an increasingly negative asymmetric risk/reward profile at the long-end of the yield curve, which will likely have implications on the equity risk premium and lead to a rotation in market leadership to more cyclically-sensitive parts of the market.

In this quarter's Investment Strategy Update, we highlight the trends in the economic recovery, specifically reviewing the substantial improvement in personal consumption, the case for further recovery in employment conditions, valuations in fixed income and equities, as well as the near-term implications of market sentiment on interest rates and the U.S. dollar. We maintain our pro-risk and pro-cyclical views to remain overweight to credit and value equities, and are now moving to an overweight in emerging markets. We remain relatively cautious in our active risk budget. We will continue to evaluate market conditions and expectations over the coming months, with particular attention to the COVID crisis, global economic conditions, and the U.S. election. We provide a summary of our rationale and supporting exhibits in the following sections, and we will continue to keep you apprised of our market perspectives and positioning.

ASSET CLASS	JULY	CHANGE	OCTOBER
Fixed Income vs. Equity	Neutral	≈	Neutral
Alternatives vs. Equity	Neutral	≈	Neutral
Alternative vs. Fixed Income	Neutral	↑	Overweight
Duration vs. Barclays Aggregate	Neutral	≈	Neutral
Credit vs. Government	Overweight	≈	Overweight
Investment Grade vs. High Yield	Neutral	≈	Neutral
High Yield vs. Bank Loans	Overweight	↓	Neutral
Large Cap vs. Small Cap Equities	Neutral	≈	Neutral
Growth vs. Value Equities	Underweight	≈	Underweight
Global ex-U.S. vs. U.S. Equities	Neutral	≈	Neutral
Emerging vs. Developed Equities	Neutral	↑	Overweight
Global REITS vs. Global Equities	Neutral	≈	Neutral
Commodities vs. Global Equities	Neutral	≈	Neutral

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ASSET CLASS	CHANGE	VIEW	SUMMARY OF RATIONALE
Fixed Income vs. Equity	≈	Neutral	Despite the strong recovery in economic growth during the third quarter, which would normally be expected to benefit equities coming out of a recession, equities have rallied well ahead of the economic recovery. As a result, valuations in both equities and fixed income are rich today, resulting in a neutral posture.
Alternatives vs. Equity	≈	Neutral	We maintain a neutral position in alternatives vs. equities, but we may allocate to long-short equity strategies with more beta exposure in lieu of market neutral/equity hedge to facilitate alpha-oriented opportunities that can benefit from the additional breadth of short positions. While equities are expensive today, we see modest upside over the medium-term, and remain neutral as a result.
Alternatives vs. Fixed Income	↑	Overweight	Given the rich valuations of government bonds and significant compression in credit spreads over the past six months, we are moving to an underweight in traditional fixed income exposures and are favoring strategies that provide more flexibility and/or potential for differentiated returns.
Duration vs. Bloomberg Barclays Capital Aggregate Bond Index	≈	Neutral	We believe that there is a negative asymmetric risk/return profile associated with interest rate exposure today, and although we remain neutral in duration, we are expressing this view as an underweight to fixed income, which is expected to result in less interest rate sensitivity in client portfolios.
Credit vs. Government	≈	Overweight	Despite a significant narrowing of credit spreads over the past six months, we continue to see reasonable risk-adjusted return opportunities in credit relative to government bonds and are remaining overweight as a result.
Investment Grade vs. High Yield	≈	Neutral	High yield bonds may present a more attractive valuation opportunity, but investment grade credit also continues to offer reasonable returns on a risk-adjusted basis. Therefore, we remain neutral.
High Yield vs. Bank Loans	↓	Neutral	We have modified our view to be neutral in high yield relative to bank loans. While loans may be slightly more risky today, given the higher exposure to sectors that are materially affected by COVID such as travel, leisure, retail, and gaming, these segments may also present select return opportunities as the economy recovers.
Large Cap vs. Small Cap Equities	≈	Neutral	Despite the strong economic recovery during the third quarter, which may present a return opportunity in small caps, we recognize that there is significant risk to smaller companies, which typically have weaker balance sheets and may be challenged for until the economy fully recovers. Therefore, we maintain a neutral posture relative to large caps at this time.
Growth vs. Value Equities	≈	Underweight	Value equities were beginning to exhibit technical signs of market support late in the third quarter, particularly on the heels of a growing economic recovery. Given the level of pessimism priced into value equities, we expect both higher upside in a cyclical recovery and more margin of safety in an unforeseen downturn.
Global ex-U.S. vs. U.S. Equities	≈	Neutral	Despite attractive relative valuations in Non-U.S. developed market equities, the structural headwinds that Europe faces with a unified monetary policy applied to differentiated economies increases the uncertainty regarding its ability to recover from this downturn. Similarly, Japan has already been battling deflationary pressure for decades, and was only recently beginning to gain momentum. Furthermore, despite overwhelmingly negative sentiment for the dollar, we are beginning to see signs of technical support, and there is a growing possibility that we may not see as much fiscal stimulus as the market anticipates. This may result in future dollar strength, and weigh on non-U.S. equity returns in dollars. Therefore, we are remaining neutral.
Emerging Markets vs. Developed Equities	↑	Overweight	Emerging economies are forecasted to deliver stronger economic growth in 2021 and have historically outperformed coming out of recessions. While we are moving to an overweight view in emerging markets, we continue to actively reassess this view, particularly with the pending U.S. election and the potential impact of foreign policy on large Emerging Markets constituents such as China.
Global REITs vs. Global Equities	≈	Neutral	While certain segments of the REIT market may be very challenged in this environment, the market is fragmented in terms of the impact of COVID, and the demand for higher yielding equities such as REITs is likely to increase due to very low government bond yields. Therefore, we remain neutral.

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Macroeconomic Outlook: Strong Recovery in Economic Growth

- The global economy exhibited signs of a strong economic recovery during the third quarter. As shown in Exhibit A, global manufacturing PMIs staged a V-shaped recovery, with most major economies signaling expansion (above 50). The IMF recently upgraded its estimates for global growth in 2021 to -4.4% (Exhibit B), an improvement from the prior estimate of approximately -4.9%. Most of the recovery in global GDP growth is attributable to the significant rebound of the U.S. economy. The estimate for U.S. GDP growth was upgraded from -8.0% to -4.3% in 2021, with only modest improvements in most other developed market economies. The combination of immediate and targeted action by the Fed, and an initial strong fiscal response by the U.S. government, supported a rapid recovery across most measures of economic activity in the U.S.

- Exhibit C shows the components of U.S. GDP growth on a quarterly basis from Q1 of 2008 through Q2 of 2020. Unlike the global financial crisis of 2008-2009, the COVID crisis and ensuing recession resulted in a much larger decline in Personal Consumption Expenditures, primarily due to the forced shutdown of the U.S. economy earlier this year. At the time that this letter is being written, Q3 GDP is not yet available. However, we can evaluate higher frequency data to assess the strength of the recovery. Specifically, we look under the hood of personal consumption expenditures, which is reported on a monthly basis, to assess the magnitude of this recovery.

- Personal Consumption is comprised of Goods (Durable and Non-Durable) and Services, which we show in Exhibit D. While we observed a meaningful decline in the consumption of Goods in Q2, this metric was somewhat buoyed by demand for Motor Vehicles & Parts, Furnishings & Household Equipment, and Food & Beverages – all of which were due to a very clear change in the behavior of consumers. Specifically, a fear of public transportation, migration away from cities to suburbs, enhancements to life at home, and continued hording of food supplies were all supportive to the demand for goods.

- Personal Consumption of Services, on the other hand, tumbled -41.8% during Q2, which represented the primary contribution to the decline in overall Personal Consumption, which is also shown in Exhibit D. Segments of the services sector such as Health Care, Transportation Services, Recreation Services, and Food Services & Accommodations were all dramatically impacted by the economic shutdown. Despite the reopening of many segments of the country's economy, COVID fears continue to weigh on consumer demand for many services, including but limited to Transportation, and Food Services & Accommodations.

EXHIBIT A: GLOBAL MANUFACTURING PMIS RECOVER[1]

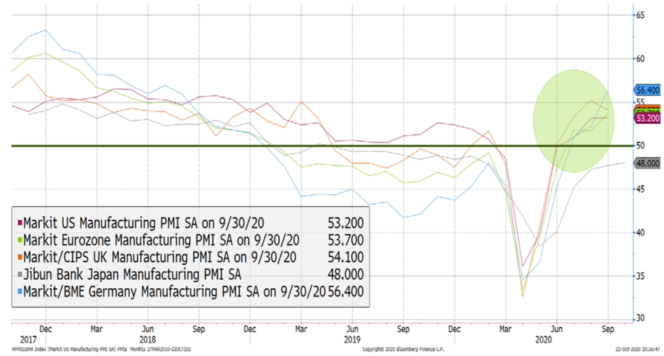


EXHIBIT B: IMF PROJECTIONS OF GLOBAL GDP GROWTH[1]

		Projections	
(real GDP, annual percent change)	2019	2020	2021
World Output	2.8	-4.4	5.2
Advanced Economies	1.7	-5.8	3.9
United States	2.2	-4.3	3.1
Euro Area	1.3	-8.3	5.2
Japan	0.7	-5.3	2.3
United Kingdom	1.5	-9.8	5.9
Canada	1.7	-7.1	5.2
Emerging & Developing Economies	3.7	-3.3	6.0
Emerging & Developing Asia	5.5	-1.7	8.0
Emerging & Developing Europe	2.1	-4.6	3.9

EXHIBIT C: COMPONENTS OF US GDP THROUGH 2Q20[1]

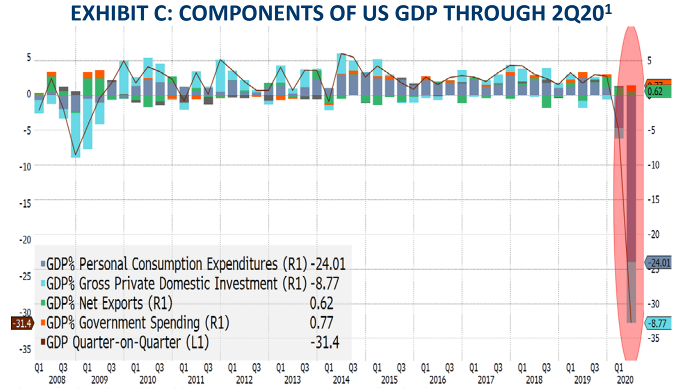
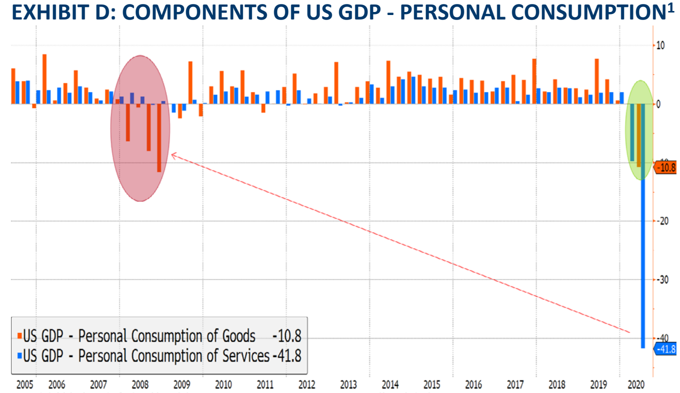


EXHIBIT D: COMPONENTS OF US GDP - PERSONAL CONSUMPTION[1]



[1]Source: Bloomberg

Macroeconomic Outlook: The Underlying Recovery in Personal Consumption

- Exhibits E – G show the monthly recovery in personal consumption through August (September data is not yet available at the time this letter was written). Despite a significant decline in Heath Care Services in Q2 (shown in blue in Exhibit E), we can observe a significant bounce in the monthly consumption of Health Care (orange) through August, on pace for a strong rebound in the third quarter, albeit likely short of pre-COVID highs. Health Care represents a significant portion of the overall services sector, and is therefore critically important to the economic recovery. While not shown here, other segments such as Food & Accommodations continues to recover at a slower pace, and Transportation Services have only modestly recovered. High frequency data of Seated Diners from Open Table and Traveler Throughput from the TSA both continue to show lackluster demand through October as well.

- On the bright side, Personal Consumption of Goods continues to gain momentum. One such example is shown in the consumption of Motor Vehicles & Parts (Exhibit F), which has surged to well above pre-COVID levels, with another month yet to report for the quarter. The newfound adoption of policies that favor a more flexible remote working environment, in combination with low interest rates, has fueled the desire for home ownership in rural areas and resulted in consumer demand for cars. Given the continued strength of weekly mortgage applications and home sales, these trends appear to have persisted through the month of September and into the Fall.

- Exhibit G clearly shows a spectacular rebound in Goods, most notably Non-Durable Goods, which has surged above pre-COVID levels. It is unlikely that we will see a full recovery in Services, however it appears that the rebound in Goods will likely make up for most of this shortfall, resulting in a very strong growth in Personal Consumption. Given the surprisingly positive Retail Sales data for the month of September, we are now well above prior highs for the Retail Sales Index. This indicates a persistently healthy consumer despite the fact that we have yet to see another round of stimulus get passed, an early indication that personal consumption may also show healthy growth for the month of September. While we are unlikely to witness a complete rebound in GDP to pre-COVID highs, it's reasonable to expect +30% GDP growth (annualized) in Q3, which represents a very strong recovery relative to prior recessions. Furthermore, several segments of the economy remain closed or suppressed due to COVID-19, namely Food Services & Accommodations, Transportation Services, Recreation Services, and Leisure/Entertainment. Therefore, we are likely to see another leg higher when the health environment improves, and the economy reopens.

EXHIBIT E: CONSUMPTION OF HEALTH CARE SERVICES REBOUNDING[1]

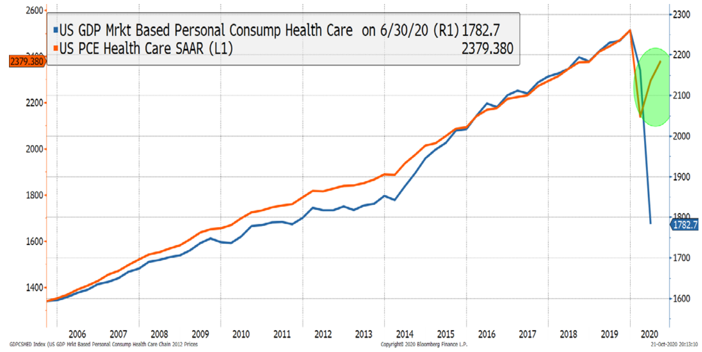


EXHIBIT F: CONSUMPTION OF MOTOR VEHICLES & PARTS SURGES[1]

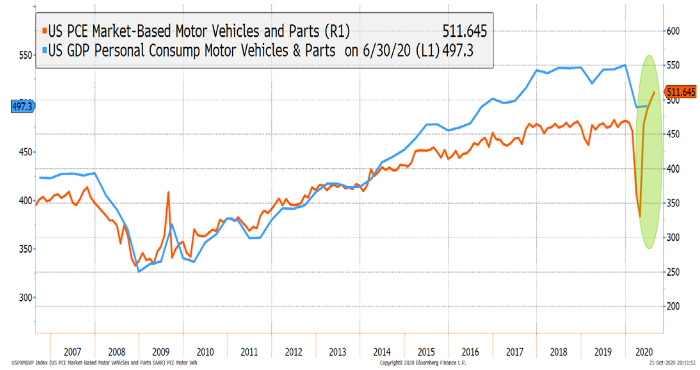


EXHIBIT G: CONSUMPTION OF GOODS ON PACE TO MAKE UP FOR MUCH OF THE SHORTFALL IN SERVICES[1]

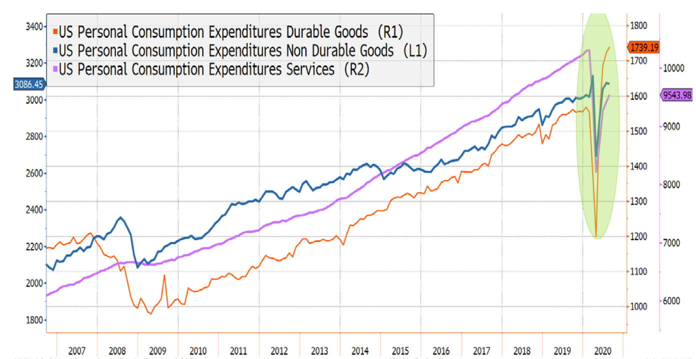
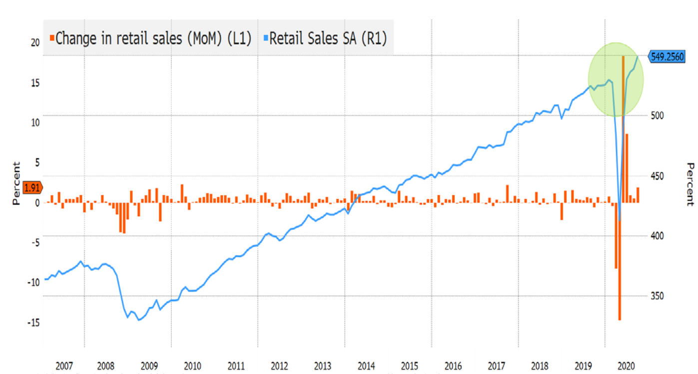


EXHIBIT H: RETAIL SALES RALLIES ABOVE PRE-COVID HIGHS[1]



[1]Source: Bloomberg

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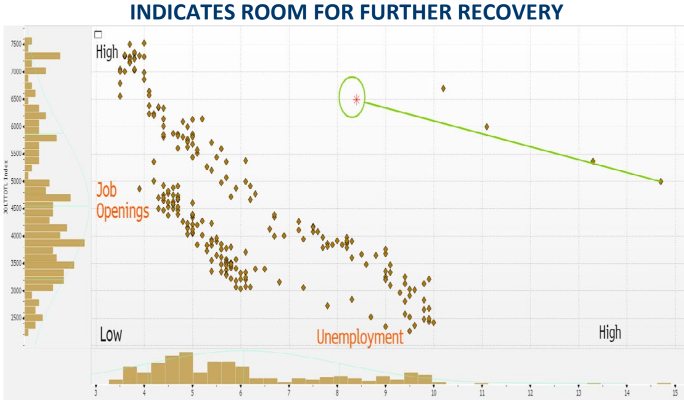
Macroeconomic Outlook: Employment & Inflation

- Coinciding with the strong recovery in economic growth, we continue to see a rebound in unemployment. While the pace of the improvement in employment will likely be more gradual, there are several factors that may indicate a higher possibility of a more rapid recovery in unemployment than what we have observed in prior recessions. Exhibit I, which plots Job Openings from the Bureau of Labor Statistics vs. Unemployment, indicates that the current level of job openings (as of August, circled in green) has historically coincided with much lower levels of unemployment. We show the trend of the last five observations in the green trend line, which demonstrates a rapid pace in the recovery of unemployment and a meaningful increase in job openings, with room for these observations to move towards the upper left quadrant (high job openings and low unemployment). Exhibit J shows that the recent NFIB report indicated a significant rise in the Small Business Job Openings Hard to Fill Index. We show this measure (inverted) versus the decline in unemployment to highlight the fact that the level of job openings that are hard to fill has also coincided with much lower levels of unemployment. Furthermore, eventual progress in advanced therapeutics and/or a vaccine may unlock a wave of job openings across the Services sector, and while this may not occur in the next couple of quarters, it's very possible in the next one-to-two years, which would likely be a catalyst for a faster recovery in unemployment relative to history.

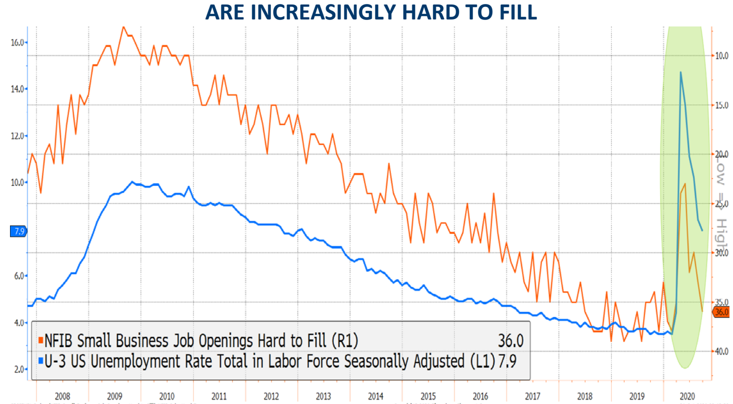
- The Core Consumer Price Index (Exhibit K) continues to show a healthy rebound in inflation, which has been primarily driven by a rise in the prices of Core Commodities, while Core Services continues to remain relatively suppressed. This trend is partially attributable to the tug of war in Transportation Commodities (i.e. automobiles and parts) vs. Transportation Services (i.e. airfares), another indication of the potential to unlock inflationary pressure resulting from a significant advancement in COVID treatments. Furthermore, the recent rise in the demand for housing and subsequent increases in prices is likely to contribute to further inflationary pressure. Breakeven inflation rates are also continuing to signal rising inflation expectations (Exhibit L), with a recent spike in the U.S. 2-year Breakeven Inflation Rate. This continued rise in breakeven inflation rates may create upward pressure in Long-Term Treasury Bond yields, which we discuss in the succeeding section.

EXHIBIT I: JOB OPENINGS (AUGUST) VS. UNEMPLOYMENT INDICATES ROOM FOR FURTHER RECOVERY



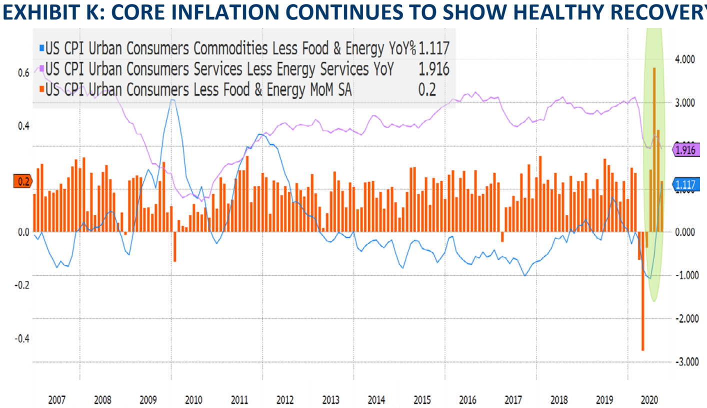
Source: Bloomberg

EXHIBIT J: SMALL BUSINESSES INDICATE THAT JOBS ARE INCREASINGLY HARD TO FILL



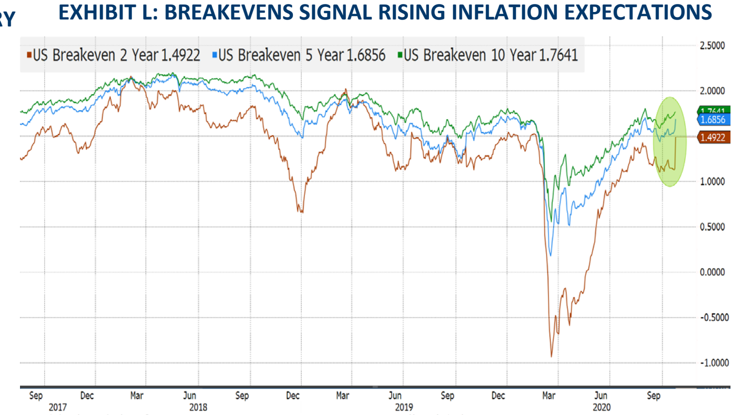
Source: Bloomberg

EXHIBIT K: CORE INFLATION CONTINUES TO SHOW HEALTHY RECOVERY



Source: Bloomberg

EXHIBIT L: BREAKEVENS SIGNAL RISING INFLATION EXPECTATIONS



Source: Bloomberg

Fixed Income View: Underweight, but Remaining Overweight Credit vs. Government Bonds

- The Fed maintains communication that it intends to remain very supportive through 2023, and in lieu of yield curve control, this anchoring of short-term rates is unlikely to keep long-term rates at current levels. Arguably, the Fed's current interest rate policy is likely to fuel higher economic growth and inflation, leading to an increasingly negative asymmetric risk/reward profile at the long-end of the yield curve.
- Exhibit M shows the U.S. Real 10-year Yield, which currently sits near record low levels (-91bps), indicating that nominal bonds are priced irrationally relative to the expectations currently reflected in breakeven inflation rates, as discussed on the previous page. Real yields at these levels signal both economic bearishness and arguably some signs of complacency, as investors appear to ignore the longer-term implications of the massive stimulus provided during this crisis. If history is any indication, there may be underpriced interest rate risk ahead, as nominal yields jumped rapidly in 2013 after real yields touched similar levels. While the 2013 "taper tantrum" was the result of change in Fed policy which is less likely in the near-term, it underscores the risk that the market can become too complacent, and the recent improvement in underlying economic data is fueling a gradual change in sentiment.
- This change in sentiment is reflected in the gradual steepening of the U.S. Treasury yield curve. Exhibit N shows the yield spread between the 10-year and 2-year Treasury Bonds, with recessions shaded in red. At this stage in the economic cycle, this steepening of the yield curve implies improving economic sentiment, growing interest rate risk, and the potential for a rally in cyclical stocks, which we address in the next session.
- Given that we are observing high relative valuations across traditional segments of the fixed income market, we are reducing our allocations to core fixed income in favor of more flexible mandates that provide exposure to opportunities in structured credit, which are expected to exhibit less interest rate risk and more attractive valuations. Given that credit spreads are still reasonably attractive relative to history (Exhibit O), particularly in high yield bonds, we remain overweight in credit relative to government bonds. We have also modified our views to be neutral in high yield relative to bank loans. While loans may be slightly riskier today, given the higher exposure to sectors that are materially affected by COVID such as travel, leisure, retail, and gaming, these segments may also present return opportunities as the economy recovers.

EXHIBIT M: REAL YIELDS ARE STILL AT HISTORIC LOWS AND MAY INDICATE HIGHER INTEREST RATE RISK AHEAD

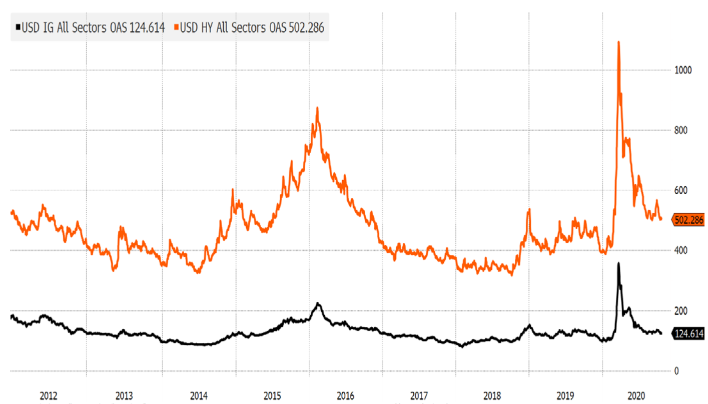
Source: Bloomberg

EXHIBIT N: U.S. 10 YR – 2 YR SPREAD

THE YIELD CURVE CONTINUES TO STEEPEN, SIGNALING EXPECTATIONS OF IMPROVING GROWTH & INFLATION

Source: Bloomberg

EXHIBIT O: CREDIT SPREADS COMPRESSED SIGNIFICANTLY FROM THE HIGHS IN MARCH, BUT STILL OFFER SOME VALUE



Source: Bloomberg

Equity View: Favoring Emerging Markets; Underweight U.S. Growth

- Global equities have staged a tremendous rally on the back of global monetary and fiscal support, which have moved well ahead of earnings, thereby resulting in significant short-term multiple expansion. Exhibit P plots the price-to-forward earnings ratio across major segments of the equity market relative to the past 15 years. This exhibit shows that nothing is cheap today. Despite rich valuations relative to history, Emerging Market equities trade at lower valuation multiples, are expected to deliver higher economic growth rates in 2021, and tend to outperform during global economic recoveries. Therefore, we are beginning to favor emerging markets.

- The rich valuations of global equities, particularly in the U.S., lends to a higher degree of market fragility in the near-term and indicates the need for corporate earnings to catch up to equity prices before we can expect to see any material upside in returns. We have already observed a strong recovery in U.S. economic growth during the third quarter, and consensus expectations for U.S. earnings growth is approximately +25% in 2021, according to FactSet. If these estimates prove accurate, then perhaps investors are not so exuberant, particularly given the low interest rate environment.

- When gauging the equity risk premium by the difference between the earnings yield of Global equities and the U.S. 10yr Treasury Yield (Exhibit Q), we can see significant valuation compression since the depths of this crisis in March. That being said, historically low bond yields are very supportive of equity valuations, particularly on an inflation adjusted basis, and there remains approximately $4.3 trillion in money market assets, which continues to come off the sidelines and provide more support for equities. This shows a different perspective that equities are not very expensive relative to history, provided that bond yields stay low. Unfortunately, we do see a risk of a rise in longer-term bond yields, and we may begin to see resistance in the more expensive segments of the market, such as growth equities. For example, Exhibit Q shows that the equity risk premium for value equities is significantly higher than growth equities. The potential opportunity in cyclically sensitive segments of the equity market is even more evident when looking at the dispersion in the YTD performance of equity factors (Exhibit R). Quality, Momentum, and Low Beta have exhibited very strong performance this year, while the more cyclically sensitive factors of Value and Size have largely underperformed. This type of factor dispersion is unusual and probably unsustainable. As the economy continues to recover, there is a significant likelihood that we see mean reversion in this relationship. As a result, we continue to favor value equities relative to growth equities.

EXHIBIT P: GLOBAL EQUITY VALUATIONS – NOTHING IS CHEAP[1]

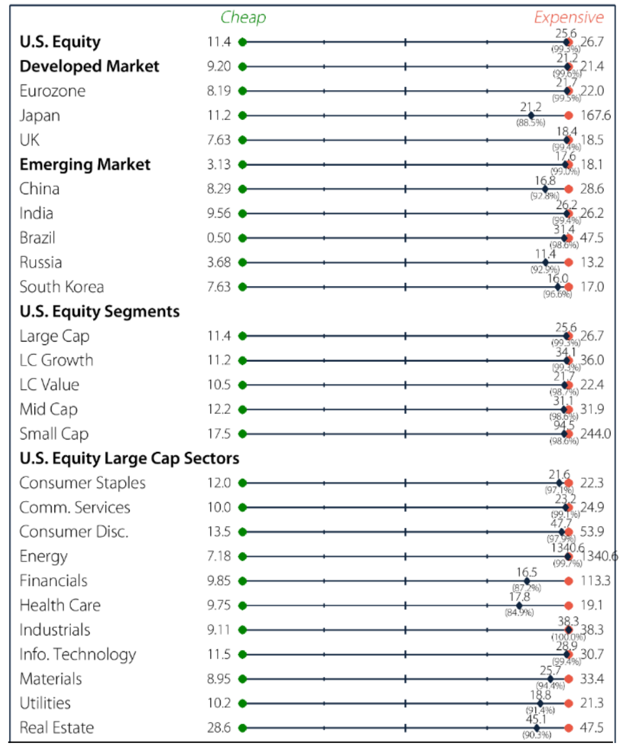


EXHIBIT Q: RISK PREMIUMS SUPPORTED BY BOND YIELDS[1]

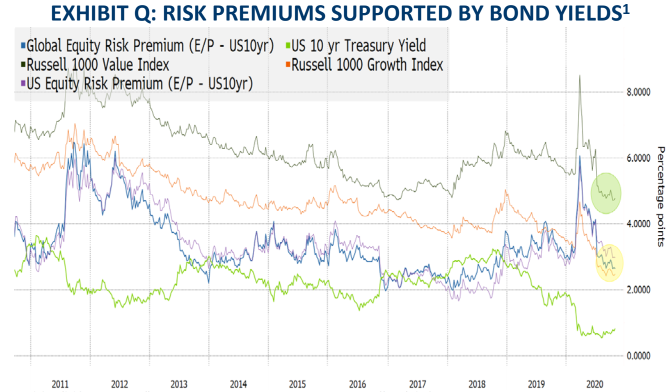
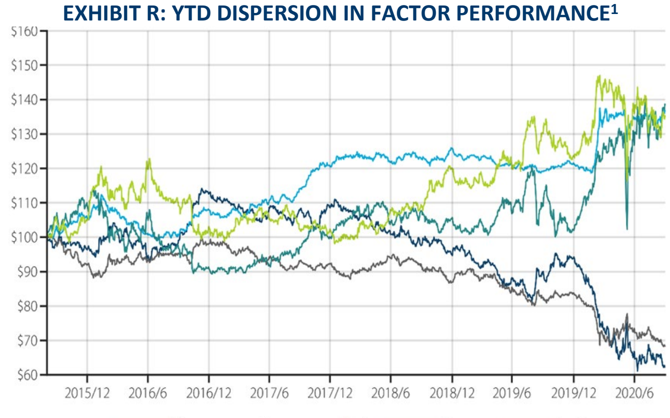


EXHIBIT R: YTD DISPERSION IN FACTOR PERFORMANCE[1]

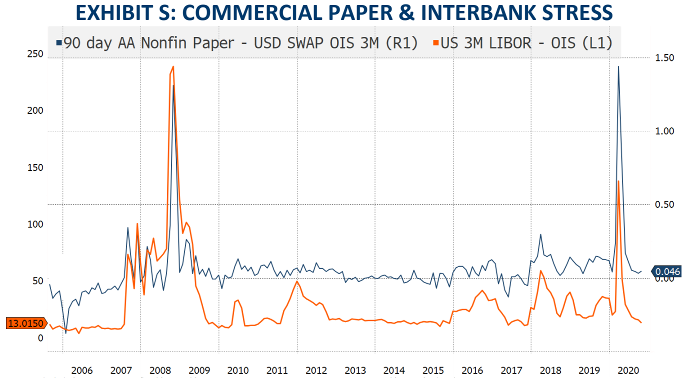


[1]Source: Bloomberg; Exhibit R reflects the Dow Jones U.S. Thematic Indexes.

Sentiment, Technicals, and Risk

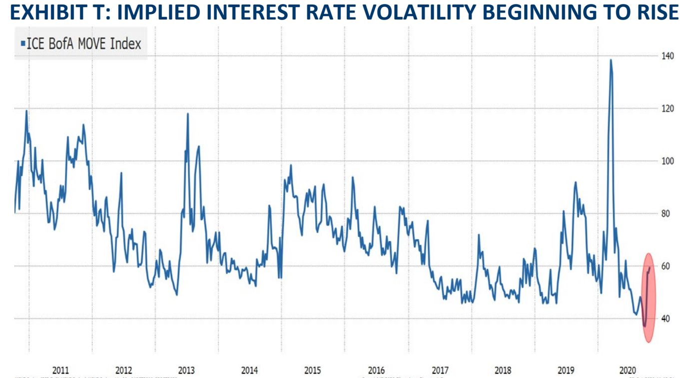
- Broad measures of risk are signaling limited systemic risk today, as credit spreads declined, liquidity improved, and interbank stress and corporate funding stress has subsided. As shown in Exhibit S, conditions have dramatically improved from the extreme levels of interbank stress (US 3M LIBOR – OIS) and Commercial Paper funding stress (90-day AA Paper – USD SWAP OIS) that we observed at the depths of the crisis, indicating an improvement in liquidity and corporate funding markets. While volatility has subsided in equity markets, the term structure of equity volatility continues to signal an expected increase in risk heading into the U.S. election, with expectations of much lower levels of volatility later this year and into 2021.
- We are beginning to see a gradual change in sentiment in fixed income markets, as the U.S. 10 year Treasury yield has been rising off the lows of 0.50% over the past several months. The ICE BofA Move Index tracks the implied volatility across the term structure of U.S. interest rates. The market has been pricing in very low implied interest rate volatility, particularly given the expectations that the Fed will maintain its current policy through 2023, however we are beginning to see a pick-up in the level of short-term implied volatility, which is a risk that we are focused on. As economic growth continues to improve, it reasonable to expect a continued rise in longer-term interest rates. This further supports our decision to underweight traditional fixed income.
- There are other signs of a potential change in market sentiment that are related to the improvement in economic growth, most notably in foreign exchange markets. The U.S. dollar (USD) has been in a persistent decline over the past six months on high expectations of further stimulus to support the U.S. economy. This has clearly become a consensus theme in currency markets, which introduces risk of a sharp shift in sentiment if the U.S. underwhelms expectations of future stimulus—a very plausible risk given the solid recovery in economic growth. From a technical perspective, Exhibit U shows the recent consolidation of the USD which is now showing some signs of support, similar to observations in late 2016 and 2018. In a similar way, gold is also a very crowded investment that has rallied significantly on expectations of further stimulus. Exhibit V plots the price of gold relative to futures positions in gold, which is now near historic highs and is arguably susceptible to the same risk as the USD—a continued economic recovery and less than expected stimulus. While gold may have diversification benefits to long-term strategic asset allocation portfolios, the shorter-term environment may prove to be challenging relative to expectations, which may eventually provide a more attractive entry point for longer-term investors. In closing, the U.S. election may have implications on the future of U.S. economic growth, stimulus, tax policy, and regulation. We will continue to evaluate market conditions and expectations following the election, and we look forward to keeping you apprised of changes in our views and portfolio positioning.

EXHIBIT S: COMMERCIAL PAPER & INTERBANK STRESS



Source: Bloomberg

EXHIBIT T: IMPLIED INTEREST RATE VOLATILITY BEGINNING TO RISE

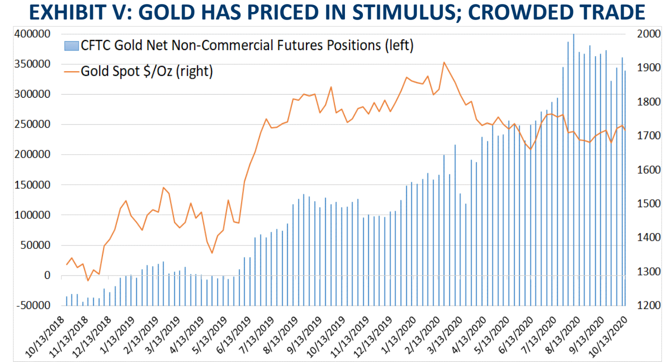


Source: Bloomberg

EXHIBIT U: USD CONSOLIDATING; POTENTIAL UPSIDE FROM HERE

Source: Bloomberg

EXHIBIT V: GOLD HAS PRICED IN STIMULUS; CROWDED TRADE



Source: Bloomberg

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