



Reiner Financial Group's Investment

Reiner Financial Group

Second Quarter 2020

Second Quarter 2020 Key Takeaways

For most of the second quarter, financial markets seemed to defy grim economic news, the continued spread of COVID-19, and worldwide protests against racial inequality. Global equities performed strongly for the quarter. The S&P 500 Index gained an incredible 21% and, as of June 30, is now down only 3% for the year, despite the huge drawdown in March. Developed international and emerging-market (EM) stocks gained 17% and 19%, respectively, and outperformed U.S. stocks in late May and June.

Enormous levels of money printing and government spending certainly helped the investor mood. Central banks around the world provided unprecedented support to markets and economies. On the fiscal side in the United States, trillions in direct payments and loans have been or are going to be delivered to impacted citizens and businesses. The level of stimulus globally already surpasses by far what was issued during the 2008 financial crisis.

Short-term interest rates are now near zero or negative in most of the developed world. The 10-year Treasury yield fell slightly this quarter but has revolved around 0.7% for some time. Also, investment-grade corporate bond spreads narrowed. Accordingly, core bonds gained another 3%.

Non-core flexible bond funds and floating-rate loan funds, which take on more risk than core bonds but have higher expected returns, rebounded strongly from their poor first quarter performance, meaningfully outpacing core bonds this quarter.

Trend-following managed futures funds gave back much of their strong positive returns from the first quarter, as many market trends have sharply reversed since March.

While markets have rebounded, we should steel ourselves for a potential double-dip back down to the late-March market lows, most likely caused by disappointing developments on the virus/medical front. There are also other uncertainties around the November election or the ongoing U.S.-China dispute that could disrupt financial markets. This is why we maintain a healthy allocation to core investment-grade bonds, despite very low yields. They are one of the few investment classes that should appreciate if the economic recovery stalls or faces a setback.

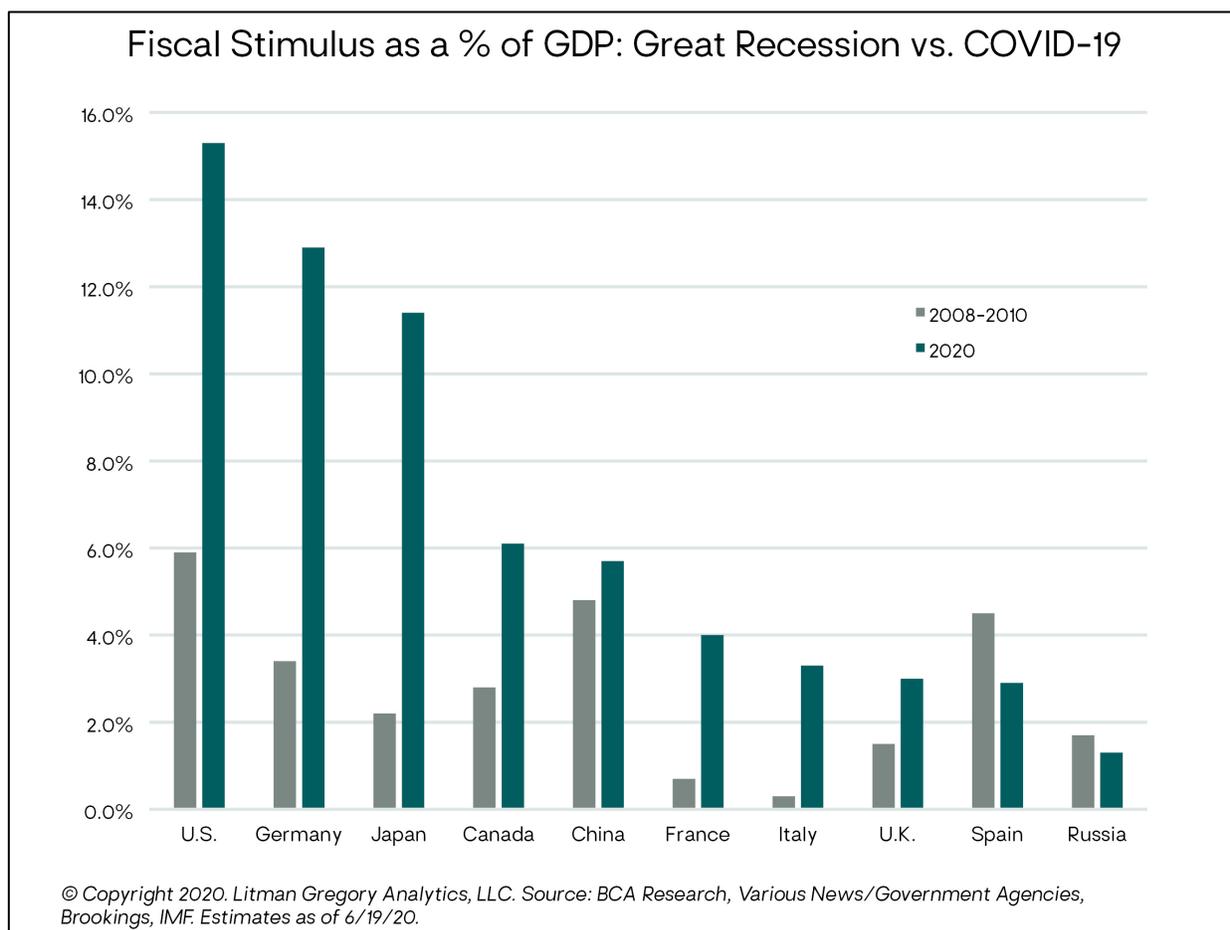
Still, we see several ways for our portfolios to outperform over the next five to 10 years. If a more benign public health scenario plays out, there is a good chance we'll get a sustainable, albeit uneven, global economic recovery. Along with low interest rates and the monetary and fiscal policy response, this would support the view that equities and fixed-income credit sectors are relatively attractive compared to core bonds. Non-core, flexible, and actively managed bond funds should do quite well in this event.

Overall, we are comfortable with our current portfolio positioning, which balances a variety of shorter-term risks against attractive medium- to longer-term return opportunities.

Second Quarter 2020 Investment Newsletter

For most of the second quarter, financial markets seemed to defy grim economic news, the continued spread of COVID-19, and worldwide protests against racial inequality. Global equities performed strongly for the quarter and rewarded investors who remained invested. From the March 23 low, the U.S. equity market soared 40%, recording its best return ever over any 50-day period.

Enormous levels of money printing and government spending certainly helped the investor mood. Central banks around the world provided unprecedented support to markets and economies. On the fiscal side in the United States, trillions in direct payments and loans have been or are going to be delivered to impacted citizens and businesses. The level of stimulus globally already surpasses by far what was issued during the 2008 financial crisis.



Second Quarter Market Recap

In the second quarter, larger-cap U.S. stocks gained 21% and smaller-cap stocks climbed 25%. Despite the medical, economic, and social turmoil all around, the U.S. market is down just 3% year to date (as of June 30) and only 8% below its all-time high on February 19.

However, there is a distinct style (or factor) bifurcation beneath the surface: The Russell 1000 Growth Index is up 10% on the year, while its Value sibling is down 16%. That is a stunning 26-percentage-point difference. Or, from another angle, the S&P 500 technology sector is up 12% on the year, while the financials, industrials, and energy sectors are down 24%, 14%, and 35%, respectively.

Looking overseas, developed international stocks rose 17% and EM stocks gained 19% in the second quarter. For the year, they are down 11% and 10%, respectively. As in the United States, growth indexes are meaningfully outperforming value indexes overseas. The U.S. dollar depreciated slightly during the quarter, providing a modest tailwind to foreign market returns for dollar-based (unhedged) investors such as ourselves.

Finally, in the fixed-income markets, core bonds gained almost 3% for the quarter, as Treasury yields dropped slightly (falling bond yields imply rising bond prices) and investment-grade corporate bond spreads narrowed, rallying along with the equity markets. Riskier credit-sensitive sectors within the fixed-income universe posted very strong gains, making up ground from their first quarter losses. Floating-rate loans and high-yield bonds gained nearly 10%, leaving them around 5% underwater for the year.

Second Quarter Portfolio Performance & Key Performance Drivers

The incredible rebound in risk-asset markets—stocks, corporate bonds, and other credit markets—in the second quarter provided a strong tailwind for our portfolios.

As a reminder, in mid-March, as the S&P 500 plunged 25%, we added an increment back to U.S. stocks in balanced portfolios, funded from lower-risk assets. As the market continued to drop, we were prepared to add another increment to U.S. stocks. But (no) thanks to the Federal Reserve’s massive “whatever it takes” monetary interventions, we did not get the chance; the market reversed course about 10% above our trigger point. We do not rule out the possibility U.S. stocks will revisit their March lows (2,237 on the S&P 500) and are ready to act again when a compelling opportunity arises.

In the meantime, we are comfortable with current portfolio positioning, which balances a variety of shorter-term risks against attractive medium- to longer-term return opportunities, across a range of macroeconomic scenarios and potential market outcomes. As of quarter-end, our balanced portfolios are slightly underweight to equities overall—comprising an underweight to U.S. stocks, a neutral allocation to developed international stocks, and an overweight to EM stocks.

As highlighted above, global equities performed strongly for the quarter. While the U.S. market was the best performer, foreign markets gained momentum, outperforming the S&P 500 from late May to quarter-end.

We continue to expect superior returns from international and EM stocks over our five-year tactical time horizon. First, overseas stocks are more reasonably priced. For example, EM stocks’ cyclically adjusted P/E ratio is near its lowest point in 35 years of data. Second, foreign economies and their markets are generally more sensitive to global growth, so as the world recovers from the pandemic, foreign stock prices should outperform U.S. stocks. Finally, in a sustainable recovery, we would expect the U.S. dollar to decline, as it is generally a safe-haven currency that depreciates in the face of strong global growth. A falling dollar would further enhance foreign stock returns for U.S.-dollar-based investors (as foreign earnings are translated into more dollars).

Our portfolios’ fixed-income exposure remains well-diversified, including core investment-grade bond funds (providing recessionary/bear-market ballast to the portfolio) and flexible, actively managed credit- and income-oriented funds, including a tactical position in floating-rate loans in some portfolios. All these non-core fixed-income sectors meaningfully outperformed the core bond index, enhancing our portfolios’ absolute and relative performance for the quarter.

Along with stocks and bonds, the third broad asset class grouping in portfolios is diversifying alternative strategies. Trend-following managed futures funds gave back much of their strong positive returns from the first quarter, as many market trends sharply reversed off the March 23 stock market bottom. The diverse performance of these investments reflects their beneficial portfolio role.

Finally, in aggregate (and with only a few exceptions), our active equity and fixed-income managers outperformed their respective benchmarks for the quarter—another reversal compared to their relative performance in the first quarter.

Closing Thoughts

So where does this leave us? The successful containment of COVID-19 is not a foregone conclusion. The resurgence of cases in the southern and western United States, not to mention in several EM countries like Brazil and India, is concerning. Local U.S. authorities have so far refrained from large-scale rollbacks of their reopening efforts. But if strict, widespread lockdowns return, the global economic recovery will be more drawn out, which would be a negative surprise for markets. There are also other uncertainties around the November election or the ongoing U.S.-China dispute that could disrupt financial markets.

But we also hold a cautiously optimistic view that with the recent uptick in COVID-19 cases, the overall social policy response won't need to be as draconian. Therefore, the economic impact should be less extreme than during the first wave. If a more benign public health scenario plays out against a backdrop of extremely loose fiscal and monetary policy, there is a good chance we'll get a sustainable, albeit uneven, global economic recovery. It's unlikely to be a sharp V-shaped recovery, but something more gradual, with fits and starts along the way and with some sectors and industries doing much better than others. If so, corporate earnings are likely to rebound as well.

Measured against very low interest rates—and with fears of severe recession (or worse) off the table thanks to the policy response—this would support the view that equities and fixed-income credit sectors are relatively attractive compared to core bonds. Our meaningful portfolio exposures to non-core, flexible, and actively managed bond funds should do quite well in this event.

Furthermore, within the equity universe, a global economic recovery, likely accompanied by a declining dollar, would be a tailwind for international and EM stock markets relative to U.S. stock markets, for the reasons discussed earlier. Our globally diversified equity exposure and overweight to EM stocks should boost portfolio returns.

In our actively managed equity portfolios, we would not be surprised to see value investing and value/cyclical stocks take the leadership reins from growth stocks, potentially marking a new cycle of relative performance in favor of value. Our portfolios would benefit from this change in leadership.

In sum, we see several ways for our portfolios to outperform over the next five to 10 years. But we should also steel ourselves for a potential double-dip back down to the late-March market lows, most likely caused by disappointing developments on the virus/medical front.

As always, it is paramount that our investment management be guided by a strategy that meets the risk/return profile of the clients we serve. And we need to keep a long-term perspective with an eye on near-term risks so that we remain disciplined through the inevitable downdrafts when fear in the markets is palpable.

—Reiner Financial Group 07/13/2020

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