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Capital Markets Review and Outlook

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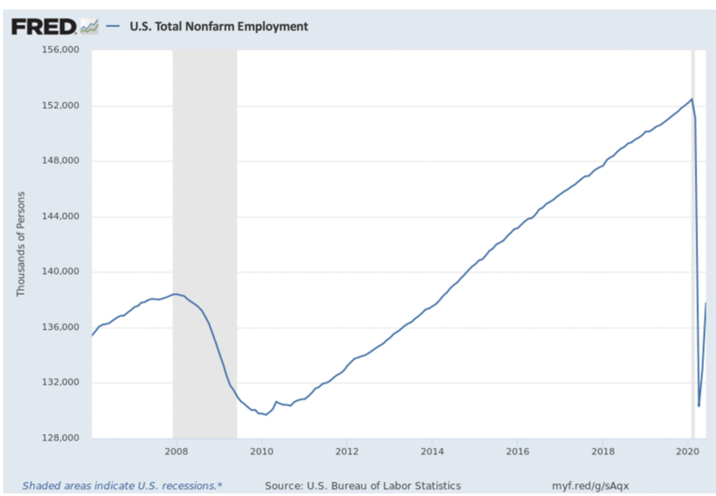
Economy and Outlook

In the first half of June, lockdowns eased in the developed parts of the world on signs of a declining rate in Covid-19 infections. However, a renewed resurgence in the latter half of the month, especially in several parts of the United States, led to a reimposition of some earlier restrictions. Worldwide infections from the Covid-19 coronavirus have almost doubled in just a month and are now approaching 11.5 million with over 530,000 fatalities based on the monitoring of the virus at Johns Hopkins University. The United States has the greatest number of confirmed cases (2.9 million) and accounts for almost 25% of the total reported number of deaths. The reopening of economies has led to a rebound in economic activity, although from depressed levels. In the U.S., gains have been seen in a wide range of economic indicators from consumer spending to industrial production. The magnitude and swiftness of the job losses followed by the recent rebound are shown in the chart on the left. After the loss of over 22 million jobs since the peak in employment at the end of February, employment surged a combined 7.5 million in May and June as companies recalled laid-off and furloughed workers. The Institute of Supply Management (ISM) manufacturing index, which reflects a broad picture of the manufacturing sector, posted its second consecutive monthly increase and broke back above 50 with a reading of 52.6 for the month of June. Readings above 50 reflect expansion. While millions of Americans are still out of work as shown in June's 11.1% unemployment rate, the government's massive stimulus measures to help the economy weather the effects of the pandemic have made a significant difference. Despite the job losses, household income is nearly 4% above pre-pandemic levels due to the trillions of dollars in stimulus money and enhanced jobless benefits. Signs of economic recovery are also visible in other parts of the world. Manufacturing sectors



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are growing in several countries including China, France, Australia, Vietnam, Malaysia and Ireland. In addition to government stimulus programs, central banks across the world continue to provide supportive monetary policies to mitigate the negative economic fallout from the global pandemic. In June, the U.S. Federal Reserve opened a $500 billion lending program to help support large corporations in the issuance of new debt. This marks the last of 9 emergency programs from the Fed to backstop the lending markets.

As we have written over the past few months, an effective vaccine for the Covid-19 coronavirus is the lasting solution to the global crisis. On this front, there continues to be rapid progress. Just six months into the worst global health crisis the world has faced in over a century, there are more than 100 vaccines in development globally, with 16 vaccines in human clinical trials, and at least 3 that are starting Phase 3 trials in July. There have also been positive developments with therapeutics to help alleviate the effects of the virus. The anti-viral drug Remdesivir has shown promising results. In the meantime, governments and central banks will need to continue their fiscal and monetary stimulus policies to help support economies and employment.

<u>Equity Markets</u>

In June, the equity markets built further on the strong gains from the prior two months, but at a slower pace, as the economy reopened from a near standstill. The broad domestic equity market represented by the Russell 3000 Index rose +2.3% for the month which brought its return for the 2nd quarter of the year to a very strong +22%. Year-to-date, the Russell 3000 Index is now down just -3.5%. Long-term investors should note that despite the highest volatility in decades in the financial markets, the annualized returns for the past three and five years for the broad U.S. equity market are now both 10%, while the 10-year annualized return is 13.7%. In terms of capitalization, Small Cap outperformed Large Cap for the second consecutive month with Small Cap ahead by +132 bp as investors anticipate a cyclical economic recovery. Year-to-date, however, Large Cap continues to dominate Small Cap by a significant margin with an outperformance of +1,020 bp. Differentiation by style continued its trend this year with Growth outperforming Value across capitalizations by +94 to +501 bp in June. Year-to-date, Growth has outperformed Value significantly by an average of +23 percentage points, one of the largest leads ever over a 6-month period. Economically sensitive companies powered the stock market rally and led to a third consecutive month of Cyclicals outperforming Defensives by an even larger margin than the prior two months. Information Technology and Consumer Discretionary were the standouts in June with gains of +7.1% and +5% respectively, while Utilities (-4.7%) and Health Care

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(-2.4%) were the laggards. The dominance of Cyclicals in the sharp market rebound after the steep stock market losses at the end of the first quarter is reflected in the fact that while the overall market is down modestly (-3.5%) for the first half of the year, Technology is up a strong +15% and Consumer Discretionary has increased +7.2% for the same period. Out of the 11 major S&P 500 sectors, these are the only two with positive returns for the first half of 2020. A better coronavirus backdrop (relative to the United States) for international developed countries together with better than expected economic readings led to investment outperformance for these international markets. This was further enhanced by the -0.9% decline the trade-weighted dollar index. As a result, the MSCI EAFE Index which represents developed markets outside the U.S., rose +3.4%, while Emerging Markets gained an even stronger +7.4% in June. While both developed and emerging markets had strong returns for the second quarter of the year with returns of +14.9% and +18.1% respectively, they underperformed the broad U.S. equity market by -630 to -780 bp for the first half of 2020.

Fixed Income Markets

Despite the rally in the broad equity markets for the third consecutive month, U.S. Treasury yields were barely changed in June. The yield on the 10-year Treasury note increased by just 1 bp to 0.66%, while the 5-year note's yield declined by 1 bp to 0.29%. There was no change in the yield on the 30-year Treasury bond which remained at 1.4%. The Treasury coupon curve also remained unchanged for the month with the 2-year/30-year spread remaining at +125 bp. Over the second quarter, the spread steepened by +13 bp bringing the year-to-date steepening to +44 bp.

Unlike the Treasury market, the corporate bond market notched its third consecutive month of strong gains. Investment grade corporate bond spreads tightened by 22 bp in June leading to +142 bp of outperformance over duration-matched Treasuries for the month. New issuance of corporate bonds took a breather after the blistering issuance pace for the past two months. Net new issuance in June was $93 billion which brought total net issuance for the first half of this year to $864 billion, more than double the $356 billion in issuance for all of 2019. The strong tone in the corporate bond market resulted in a continuation of the flattening trend in both the corporate credit curve as well as the quality curve. Longer maturity corporate bonds outperformed short and intermediate maturity issues by an average of +127 bp, while BBB rated bonds outperformed Single-A rated issues by +84 bp. In contrast to the equity markets, the Financial, Health Care and REITS sectors in corporate bonds were the best performers with excess returns of over +500 bp, while Consumer Cyclical Services lagged (+53 bp). For the month of June, the Investment Grade Credit Index posted a total return of

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+1.8% bringing its return for the first half of 2020 to +4.8%. The High Yield sector's performance was more muted compared to the Investment Grade sector. The spread of the High Yield Index tightened by 11 bp in June producing a total return of +1% for the month. Like the Investment Grade sector, lower quality high yield bonds outperformed higher rated issues in June. The Single B Index gained +0.25%, while the Caa Index had a return of +2.4%, and distressed issuers rated Ca and lower had a return of +5.7% for the month. The best performing sectors in June included Oil Field Services and Finance Companies each with returns of over +4%. Health Care and Leisure were laggards with -1% returns. For the first half of the year, the High Yield Index posted a total return of -3.8%. Despite the sharp rally in the high yield market over the past three months, spreads remain materially wide this year. At the end of June, the spread of the overall High Yield index was +626 bp compared to +336 at the end of 2019. Default risk is now elevated, especially in the lower quality sectors. At the end of June, the Moody's High Yield Downgrade-to-Upgrade ratio was 17.8% compared to the peak of 10% during the Great Financial Crisis. For the third consecutive month, the non-dollar government bond market outperformed its U.S. counterpart. In addition to the broad decline in the value of the U.S. dollar, non-dollar government bond yields also declined versus relatively unchanged U.S. Treasury yields. As a result, the non-dollar government bond market posted a return of +1% for the month in contrast to the 0.1% return for the U.S. Government bond market. This widened the non-dollar market's lead for the second quarter to +250 bp. However, for the first half of 2020, the non-dollar market with a return of +1% significantly lags the +8.6% return for the U.S. government bond market.

				Returns as of 6/30/20 (In %)			
		Month	2nd Qtr	YTD	1 Year	3 Years	5 Years
Russell 3000®	US AllCap Equity	2.3	22.0	-3.5	6.5	10.0	10.0
Russell 1000®	US Large Cap Equity	2.2	21.8	-2.8	7.5	10.6	10.5
Russell 1000® Growth	US Large Cap Growth	4.4	27.8	9.8	23.3	19.0	15.9
Russell 1000® Value	US Large Cap Value	-0.7	14.3	-16.3	-8.8	1.8	4.6
Russell Midcap®	US Mid Cap Equity	1.8	24.6	-9.1	-2.2	5.8	6.8
Russell Midcap® Growth	US Mid Cap Growth	2.3	30.3	4.2	11.9	14.8	11.6
Russell Midcap® Value	US Mid Cap Value	1.1	19.9	-18.1	-11.8	-0.5	3.3
Russell 2000®	US Small Cap Equity	3.5	25.4	-13.0	-6.6	2.0	4.3
Russell 2000® Growth	US Small Cap Growth	3.8	30.6	-3.1	3.5	7.9	6.9
Russell 2000® Value	US Small Cap Value	2.9	18.9	-23.5	-17.5	-4.3	1.3
MSCI ACWI ex-US	Global Equity ex-US	4.5	16.1	-11.0	-4.8	1.1	2.3
MSCI EAFE	Global Developed Mkts Equity	3.4	14.9	-11.3	-5.1	0.8	2.1
MSCI EM	Emerging Mkts Equity	7.4	18.1	-9.8	-3.4	1.9	2.9
Bloomberg/Barclays US Agg	US Core Fixed Income	0.6	2.9	6.1	8.7	5.3	4.3
Bloomberg/Barclays US Interm. Agg	US Intermediate Fixed Income	0.4	2.1	4.7	6.6	4.3	3.4
Bloomberg/Barclays US Credit	US Corporate Bonds	1.8	8.2	4.8	9.1	6.1	5.5
Bloomberg/Barclays US MBS	US Mortgage Backed Securities	-0.1	0.7	3.5	5.7	4.0	3.2
Bloomberg/Barclays US Corp HY	US High Yield	1.0	10.2	-3.8	0.0	3.3	4.8
FTSE Non-US WGBI	Global Fixed Income ex-US	1.0	3.0	1.0	0.9	2.9	3.3

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