IFAM Capital
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Rally Continued, but Pace Slowed

August 2020

Mixed style factor performance, inflation risks remained low

Key Observations

- The rebound in global assets continued in August, led by U.S. large cap equities, but value showed signs of life in Europe and China pulled emerging market equities into positive territory year-to-date.
- Sustained upside inflation risks remain low despite recent stimulus measures, but inflation dynamics are fluid.
- We encourage investors to keep their investment horizon in focus and not allow emotions to influence portfolio positioning.

Market Recap

Expectations that U.S. policymakers would complement ultra-accommodative monetary policy with additional fiscal stimulus extended the rebound in global risk assets through August. Large-cap technology stocks led the U.S. rally again with notable returns from Apple (+18.7 percent) and Amazon (+10.8 percent), lifting the S&P 500 Index 7.2 percent in August. The disparity between US large cap growth and value equities continued, with the Russell 1000 Growth index (+30.47 percent YTD, +10.32 percent in August) outpacing the Russell 1000 Value index (-9.35 percent YTD, +4.14 percent in August). Although small-cap stocks trailed their large-cap counterparts, the Russell 2000 Index ended 5.6 percent higher. While growth continued to lead value stocks within domestic equities, small-cap value stocks led the rally within international developed stocks and lifted the MSCI EAFE Index 5.1 percent. The MSCI Emerging Market Index rallied 2.2 percent, led by a 4.4 percent return on Chinese equities, and ended August in positive territory year to date.

Global fixed income returns were relatively muted in August. Treasury yields rose slightly, and credit spreads narrowed. Consequently, Core U.S. bonds fell 0.8 percent, and U.S. High Yield gained 1 percent. TIPS returned 1.1 percent and benefited from higher inflation expectations and the Fed's commitment to keeping rates low until inflation sustainably exceeds its 2 percent target.

Real assets, namely commodities, benefited from a weaker U.S. dollar (-1.3 percent in August). However, returns on REITs and MLPs were just 0.8 percent and 0.5 percent, respectively, as reopening risks emerged.

Inflation Conditions

Following a series of fiscal and monetary policy measures to support economic growth, some market participants are wondering if inflation is poised to rise significantly in the near term and how to protect one's portfolio. In our view, a sharp sustainable uptick in inflation seems unlikely at this time. However, we believe that inflation conditions are dynamic and both the line between Federal Reserve lending and spending is thinning. At the same time, fiscal policymakers appear willing to pass another round of stimulus. Therefore, we will continue to monitor policy for signals of rising inflation risks. In short, we hold the view that what policymakers say has less impact on longer-term inflation expectations than what they do.

The CARES Act included a provision to provide the Fed with $454 billion to fund its lending facilities. On March 26, Fed President Jerome Powell appeared on NBC's TODAY show and stated, "When it comes to this lending, we're not going to run out of ammunition, that doesn't happen." What Powell said rang an inflationary tone. However, what the Fed did was less inflationary. Through July, it had not used 76 percent of the funds earmarked for its facilities. During his press conference following the July FOMC meeting, a reporter asked Powell why utilization was lower than expected. He replied, "market participants, anticipating that the Fed would backstop risk assets, stepped in to purchase securities in those markets." In short, the Fed achieved its policy objective (financial market stability) with words, not actions.

In short, inflation is difficult to predict, but government policies and private sector financial conditions offer directional clues. As long as household and business conditions remain tight, we believe deleveraging and lower consumption trends are likely to persist in the near term. Our inflation outlook will hinge on these dynamics, government policy and the speed of economic recovery.

Market Outlook

From an asset allocation perspective, we continue to update and evaluate our capital market assumptions and assess the implications for our client's portfolios. In the absence of any changes in objectives or cash needs, we advocate for maintaining the established strategic asset allocation that's rooted in fundamentals. Timing markets correctly is very challenging, especially in today's environment. We encourage investors to keep their investment horizon in focus and not allow emotions to influence portfolio positioning.

For more information, please contact any of the professionals at IFAM Capital.