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July • August | 2020

Institutional Perspectives

Monthly investment analysis and insights from Wilmington Trust Investment Advisors

ON THE RECORD

Low Visibility: Flying on Instruments

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Tony Roth
Chief Investment Officer

Never before in my career can I recall such a stark disconnect. There is a high degree of uncertainty among forecasters on the trajectory of the economy, while on the other hand, markets indicate a significant amount of optimism, as reflected in domestic equity valuations. It is tempting to join the fray and take a side of those arguing adamantly based on either the economic (bear) or market (bull) case. In point of fact, now is not the moment to be making bold calls and taking potentially reckless bets. Nobody knows how our public health care or political landscapes will look at year end. Accordingly, now is patently a time for patient discipline and risk management. We maintain a slight underweight to risk with a focus on diversification, quality, and organic growth.

At this point, the crisis in the United States and around the world remains, at its root, a health-related one, and we are monitoring data around the virus very carefully. The situation is complex.

Cases are rising in parts of the country that, until now, had not yet been dramatically impacted by the virus but continue to decline in the earliest and hardest-hit states. A portion of the increase in cases is attributable to much higher levels of testing, roughly 2.5 times the testing available in April and early May. However, in recent weeks, states like Arizona, Florida, and Texas are exhibiting much higher positive test rates, hospitalizations, and proof of contagion indicating an estimated effective reproduction number well north of 1* (Figure 1).

* Rt is the average number of people who become infected by an infectious person; if Rt is above 1, the virus will spread quickly, but when Rt is below 1, the virus will stop spreading. https://rt.live/.

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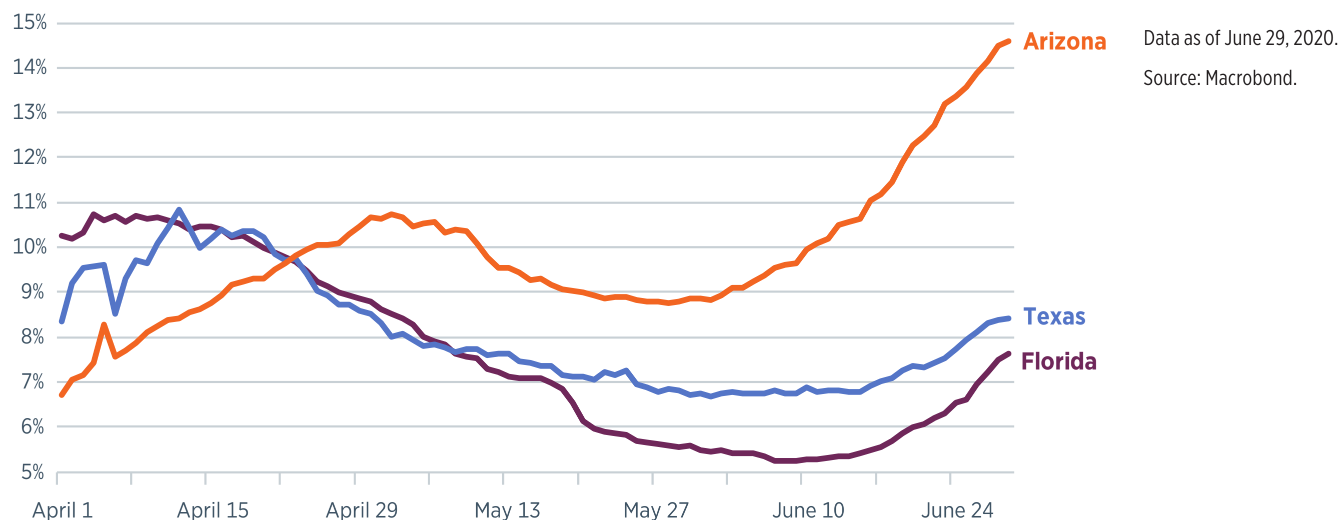
Figure 1

Positive test rates creeping up

Positive test rates by state



Data as of June 29, 2020.

Source: Macrobond.

We layer on the clinical progress made in therapeutic and hospital treatment, which is contributing to lower death rates, and the future path of the health crisis becomes even less visible, so we need to rely on instruments, lest we fly blind.

Additionally, of those testing positive and being hospitalized in recent weeks, reports indicate many more are younger (below the age of 65) than was the case earlier in the pandemic. While this likely means a short-term drop in the COVID-19 mortality rate, it is also possible that milder or asymptomatic cases from younger individuals will lead to increased spreading to more vulnerable cohorts of the population. We then layer on the clinical progress made in therapeutic and hospital treatment, which is contributing to lower death rates, and the future path of the health crisis becomes even less visible, so we need to rely on instruments, lest we fly blind.

From an investment standpoint, policy remains a critical determinant. We believe it is likely that future government-mandated mitigation efforts will be more limited—in fact "surgical"—than they were in March and April, limiting economic harm. At the same time, any material rollbacks in the economic reopening plans could lead to a plateauing of the economic data. One thing is for sure, the virus is not going away any time soon and its presence will continue to exercise a strong hold on the economy.

The economic recovery

Focusing on the U.S., the initial economic recovery has by many accounts been quicker and more robust than most economists expected, but as of the end of June, activity remains well below pre-COVID levels. Activity in some consumer sectors like housing and autos has clawed back from the March–April lows thanks to pent-up demand, an aversion to public transportation, direct stimulus checks, and generous unemployment benefits. Retail sales have also recovered to "just" –8% below January pre-COVID levels. However, the majority of data points are still far below pre-COVID levels. And for comparison, the degree of contraction remains well below the depths of the financial crisis.

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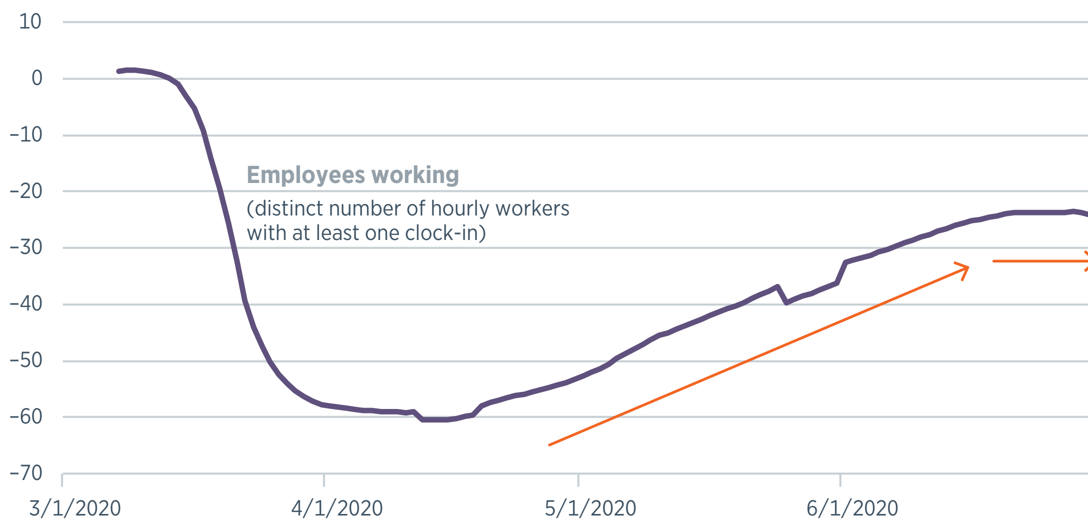
Figure 2

Slowing in the pace of labor market improvement

Homebase small business employment (% change from January 2020, 7-day moving average)



Data as of June 30, 2020.

Sources: Macrobond, Homebase.

The trajectory of the economy also depends heavily on whether the fiscal transfer spigots remain wide open, slow to more of a trickle, or stop altogether.

Hopes for a straight-line, "V-like" recovery are overly optimistic, in our view, and we are concerned that improvements in the labor market will slow in the second half of the year. We are already seeing the second derivative taper off in some of the real-time labor data sources (Figure 2).

In particular, there is quite a bit of "churn" in the weekly unemployment claims numbers; a large number of people are indeed being rehired in areas of the country that are reopening, but the week of June 19 saw 1.5 million people laid off for the first time this year and filing for unemployment insurance—an observation that is cause for concern. Nearly 6.5 million have lost their jobs in the four weeks since economies reopened, and there is a steady drip of headlines of large employers making permanent job cuts and restructuring.

A second wave of layoffs is as much of a risk as a second wave of the virus. As we approach the original deadline for Paycheck Protection Program (PPP) recipients to spend funds, small businesses will have their loans converted to grants and be free to lay off additional workers (an aside: I invite you to listen to our recent Wilmington WealthWise podcast on the subject of PPP). Separately, September 30 marks the end of the period by which airlines receiving bailout funds under the CARES Act cannot engage in involuntary job cuts; layoffs in that sector are almost certain after that date. Many companies, including some large airlines, have indicated their intention to run leaner once permitted to do so, which should be good for forward productivity but certainly not for the labor market.

The trajectory of the economy also depends heavily on whether the fiscal transfer spigots remain wide open, slow to more of a trickle, or stop altogether. The $600 per week boost to unemployment insurance that 30 million people receive right now has greatly contributed to the recovery in spending described earlier. Those additional

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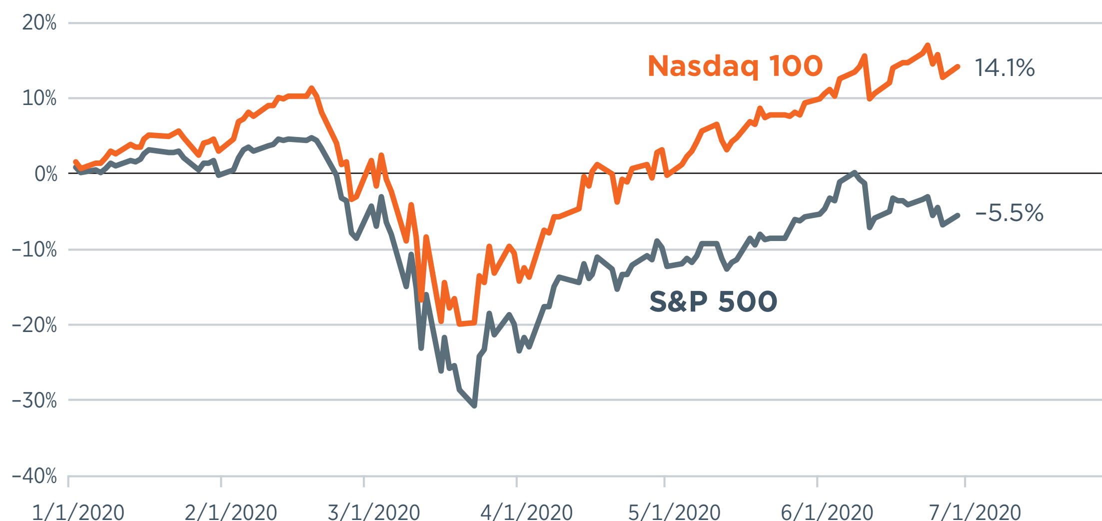
Figure 3

U.S. equity markets have been resilient

Year-to-date performance of U.S. large-cap equity indices



Data as of June 29, 2020.

Source: Macrobond.

Indices are not available for direct investment. Past performance cannot guarantee future results.

Investor fund flows into bonds have far outpaced those into equities since the onset of the crisis, which could provide support for a broader equities rally.

benefits are, however, scheduled to end on July 31, unless Congress acts. Subsequent rounds of stimulus from Washington are needed, possibly on the order of $1–$1.5 trillion this year alone. But with each additional round of fiscal support, Republicans and Democrats experience increasing difficulty in reaching an agreement, particularly as it relates to the challenge of structuring unemployment insurance in a way that supports the consumer while not disincentivizing Americans from returning to work.

The markets

When we add to these virus- and economic-related risks the fact that 183 companies in the S&P 500 have withdrawn earnings guidance for 2020 and 54% fewer companies than average are issuing guidance for the second quarter, investors are very much operating with reduced visibility. Let us also not forget that we are just four months from a U.S. presidential election. In our view, the markets have yet to price election risk into the broad market or specific sectors, such as health care, energy, and financials. Against this backdrop, the performance of the U.S. equity market may seem perplexing, with the S&P 500 down just –6% year to date and –10% off all-time highs; the tech-heavy Nasdaq 100 Index is actually 2.5% above pre-crisis highs (Figure 3).

Admittedly, valuations are not a great metric for predicting equity returns over a 6–12 month horizon; rather, they are more suggestive of longer-term returns, and they become even less so during economic inflection points. Still, we find it hard to ignore the fact that the S&P 500 is trading at more than 21 times forward one-year earnings estimates—a number that has not seen such high levels since just before the tech bubble burst in 2000—and which will only move higher if those earnings estimates are as optimistic as we assess them to be.

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Anyone claiming high conviction regarding the virus or the path of the economy is in our view misinformed at best and disingenuous at worst.

In this fragmented environment, a cautious but not overly defensive positioning is warranted. After all, the Federal Reserve's extraordinary response has been quite effective in adding liquidity to the market and reducing risk premiums across asset classes. We also note that investor fund flows into bonds have far outpaced those into equities since the onset of the crisis, which could provide support for a broader equities rally.

We retain a slight underweight to equities in client portfolios, while continuing to diversify within those equity holdings. High-growth, mega-cap stocks—many residing in the tech sector—have offered attractive optionality to investors, outperforming in the drawdown but also offering robust organic growth, if at elevated valuations. It is also important to have exposure to active management with a more discerning eye for both valuations and quality in an environment where a faster-than-expected recovery would likely see value or cyclical stocks outperform.

There are many uncertainties on the road ahead, given the nature of the virus and the economic contraction. Anyone claiming high conviction regarding the virus or the path of the economy is in our view misinformed at best and disingenuous at worst. Instead, we believe the key at this time to achieving one's long-term goals is humility, patience, and equanimity.

Please note that this is a combined July/August issue. While we won't publish *Capital Perspectives* until September, we will be in touch via *Wilmington Wire* blog posts and our *Wilmington WealthWise* podcast series.

Have a good summer,

To stay in the know, be sure to read our Wilmington Wire blog posts and listen to our Wilmington WealthWise podcasts for real-time updates.

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The Fed and Yield Curve Control

Luke Tilley
Chief Economist

At a glance:

- **There is a stronger chance than in previous years that the Fed will implement yield curve control (YCC), which involves setting target interest rates and then achieving them by buying or selling Treasuries**
- **The Fed would be keen to keep long-term rates low to support the economy without driving its balance sheet ever higher, and YCC could do just that**
- **Reasons not to resort to QE are that it's expensive and there is an uncertain impact on rates, which could push yields into negative territory**
- **A risk of YCC is that the government seizes on the opportunity and continues exorbitant debt issuance in the post-COVID recovery, leading to high inflation and interest rates**
- **The Fed is likely to take some actions to influence long-term interest rates; we expect rates to remain low for quite some time, which is supportive of the economic recovery and of risk assets**

When the Federal Open Market Committee (FOMC), meets on July 28–29, it is unlikely to make any significant changes to monetary policy, in our view. We don't expect the members to change interest rates or make any material changes to asset purchases. After quickly ramping up purchases to fight the COVID-induced market crisis and buying more than $2 trillion combined of Treasuries and mortgage-backed securities (MBS), the pace has slowed sharply to a still-high $120 billion per month. The Fed could offer more guidance to the market on how long that will last, or perhaps announce a plan to slow those down, now that markets appear to have ample liquidity and are no longer in crisis mode.

Later in the year or into 2021, we believe there is a stronger chance than in previous years that the FOMC will implement a strategy known as yield curve control (YCC), something it has not done in 70 years. There are several compelling reasons to consider the strategy now, which explains why several members of the FOMC, including John Williams of the first-among-equals New York Fed, have already voiced support for its consideration in recent months. Of course the case for YCC is not a slam dunk, as it would carry with it numerous risks, with political risk at the very top.

Yield curve control defined

YCC is exactly what it sounds like: The Fed exerting control over interest rates along the yield curve or some section of the curve. More pointedly, the Fed is setting target interest rates and then achieving them by buying or selling Treasuries in the market. The Fed has traditionally exerted precise control over the federal funds rate (FFR), a single interest rate that banks charge one another for overnight loans. The combination of them controlling that rate and messaging about future moves influences longer-term rates as you move out the curve. In the 2008–2010 global financial crisis, the Fed went further by using quantitative easing (QE) to put downward pressure on longer-term rates without a specified target. YCC would be another step further in setting those precise targets.

Figure 1 shows a hypothetical curve (well above today's rates) for illustrative purposes with a different target for each maturity. If the Fed set a target of 1.0% for the 10-year Treasury yield and yields in the market started to drift higher, it would buy 10-year Treasuries to push yields back down. If yields drifted below their target, they would sell Treasuries into the market to push yields back up. It's worth saying this is exactly how the Fed manages its primary policy tool, the FFR.

Importantly, the example in Figure 1 is the most rigid example of YCC and there are alternatives that would more likely be employed. For example, the Bank of Japan has targeted its 10-year yield at 0% since 2016, and held the overnight rate below zero at –0.1%, but has not announced specific targets for any other maturities. The result for Japan is that interest rates for all maturities between overnight and 10 years have

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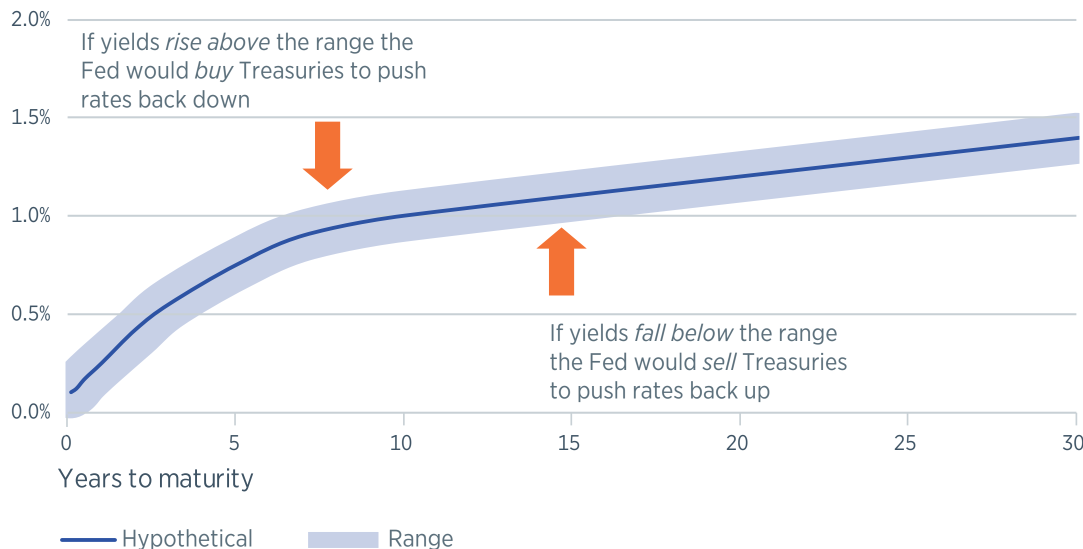
Figure 1

Hypothetical Treasury yield curve control



Source: WTIA.

We believe there is a stronger chance than in previous years that the FOMC will implement a strategy known as yield curve control (YCC), something it has not done in 70 years.

remained in that tight corridor, and longer-term maturities from 15 to 30 years are allowed to rise higher and fluctuate with economic conditions.

In the U.S., Lael Brainard, a Fed governor since 2014, gave a speech in November 2019, perhaps presciently, outlining strategies the Fed could employ the next time it found itself with an FFR target of zero and felt the need to provide more accommodation. She gave a detailed proposal where the Fed would use conditional forward guidance for the traditional short-term rate, indicating the Fed would not be raising the FFR for a certain number of years, and would then utilize YCC for maturities, up to that same number of years. Also, Figure 1 shows the Fed exerting control to the upside and downside to hit target rates, but there are arguments to only have a ceiling, and permit rates to fall lower than those ceilings if the market pushes them there.

Why not just do quantitative easing again?

It is natural to ask why the Fed wouldn't simply use the same tools that it has in the past, namely forward guidance and then QE as it did in three successive waves in the global financial crisis. This is certainly a possibility and very much on the table. The two strongest arguments for YCC are that QE is expensive and that it has an uncertain impact on rates—and could even push them into negative territory.

By "expensive," we mean QE generates massive liquidity in the banking system that could lead to higher inflation if not properly managed. Recall that QE is simply stating that the Fed will buy a predetermined dollar amount of securities in total, or announcing it will continue to buy at a monthly rate until some specified criteria is met. The first three rounds of QE from 2008–2015 boosted the Fed's balance sheet by fivefold (Figure 2). The Fed had only just started to reduce its holdings in 2018–2019 before finding a new normal "floor" in September 2019. The central

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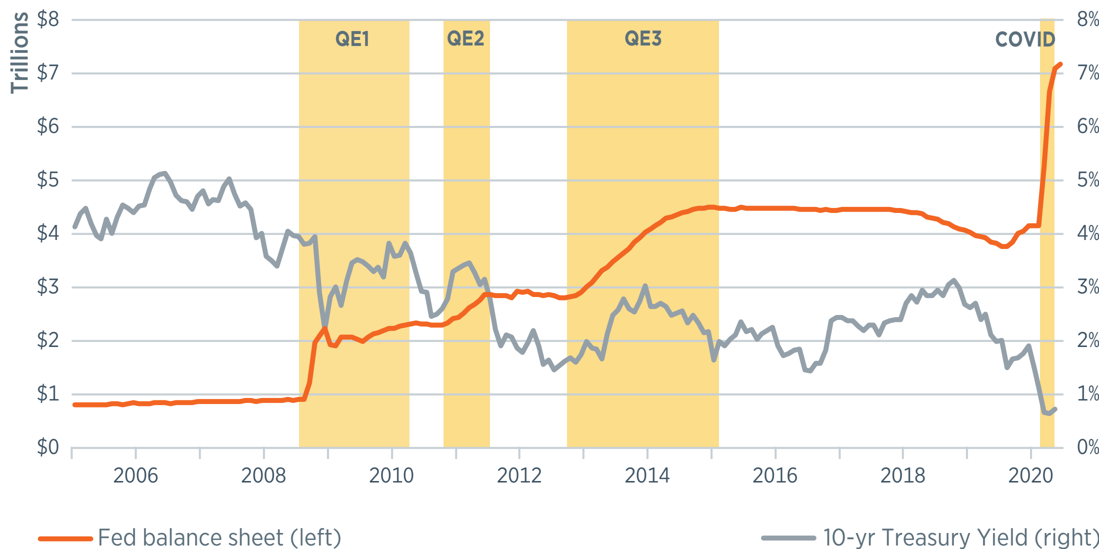
Figure 2

Total Federal Reserve balance sheet assets ($ trillions)



Data as of June 30, 2020.

Sources: Federal Reserve, WTIA.

In our view, the Fed would be keen to keep long-term rates low to support the economy without driving its balance sheet ever higher, and YCC could do just that.

bank's response to the COVID-19 crisis added $3 trillion total to its balance sheet already, $2 trillion of which is from the asset purchases.

In our view, the Fed would be keen to keep long-term rates low to support the economy without driving its balance sheet ever higher, and YCC could do just that. There is ample evidence that the Bank of Japan has spent less using YCC than it would have under a QE program to achieve the same result. This comes from the sheer power of a central bank's words and credibility: If it says it will achieve a certain target rate, bond market investors are leery of pricing that is too far afield of that target.

The second reason that QE might lose some luster in this environment is the uncertain impact on rates. Think about how QE works: The Fed says it is going to buy *a specified dollar amount* of Treasuries with the goal of pushing down long-term rates, but it does not have a specific target or goal for those rates. The risk, or the unknown, is the behavior of interest rates.

Estimated impacts of the first three rounds of QE vary widely, but at the high end some studies conclude a single round might have pushed down the 10-year yield by 120 basis points (1.20%). Over 2Q 2020, the average yield for the 10-year was just 0.68%. With today's starting point, a newly announced large QE program could run the risk of pushing yields into negative territory. Were the Fed to hold the overnight rate at zero, that would mean not just negative rates, but an inverted yield curve in negative territory, likely not the outcome the Fed is looking for. With YCC, the Fed says it is going to *target a specific interest rate(s)* and *stands ready to buy or sell* securities to achieve that rate. If rates were moving too low for comfort, the Fed can adjust.

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The Fed is challenging to predict. We don't expect major policy changes anytime soon, but as we exit the crisis and move closer to recovery, the Fed is likely to take some actions to influence long-term interest rates.

Yield curve control carries risks, too

As we said at the start, YCC carries risks, too. At the market level, the risk would be that the Fed targets some low rates and economic growth and inflation want to push those rates ever higher, forcing the Fed to buy more securities than it intended. We doubt that will be the outcome, given the hit to the economy. Additionally, if growth is strong enough to push rates higher, then the Fed could slowly extricate itself from YCC.

The second risk is political. The Fed engaged in YCC during WWII and for several years after. We will not delve into that deeply here except to say that those efforts came when the Fed was more a captive agent of the U.S. Treasury and Congress. The effort to keep rates low at that time was to help the government finance spending at low rates. As we discussed in a recent podcast episode (U.S. Federal Debt—From Bubble to Balloon), a central bank that lacks independence and does the bidding of the government lays the groundwork for excessive borrowing and spending only to ultimately generate rampant inflation and high interest rates.

In fact, the battle to end the Fed's subservience led to the Treasury-Fed Accord in 1951 and established the independence the Fed enjoys to this day. Today, the risk of engaging in YCC is that the government seizes on the opportunity and continues exorbitant debt issuance in the post-COVID recovery, leading down the path to high inflation and interest rates. We think the independence of the Fed is well established and also well appreciated by most members of Congress, so we would not expect this worst-case scenario would play out, but these are unprecedented days.

Low rates for quite some time

The Fed is challenging to predict. We don't expect major policy changes anytime soon, but as we exit the crisis and move closer to recovery, the Fed is likely to take some actions to influence long-term interest rates. We believe the current environment pushes them to consider a form of YCC as an alternative to the QE programs it has used in the past. The details of a YCC program, which we have not discussed, are important, too. These will include which maturities to target, how much of a band to put around those targets, and what kind of communications to provide about the length of the program. But ultimately, these considerations could be more manageable and less risky than a QE program. We again emphasize that such a program is not imminent, in our view. No matter which program the Fed chooses, we expect interest rates to remain low for quite some time, which is supportive of the economic recovery and of risk assets.

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ASSET CLASS OVERVIEW

Equities

Andrew Hopkins, CFA
Head of Equity Research

AS OF JUNE 30, 2020

	Month	YTD	Trailing 12-month return
S&P 500 Index	2.0%	-3.1%	7.5%
Russell 2000 Index	3.5%	-13.0%	-6.7%
MSCI EAFE Index	3.4%	-11.3%	-5.1%
MSCI Emerging Markets Index	7.4%	-9.8%	-3.4%

Sources: FactSet, Bloomberg. Investing involves risks and you may incur a profit or a loss. Past performance cannot guarantee future results. Indexes are not available for direct investment.

What we are seeing now

Equity markets were mixed in June as progress toward reopening the economy throughout the country is moving in fits and starts. Some Southern and Western states appear to have opened too quickly and the concomitant rate of infections has risen too quickly causing a pause in the reopening process. Small cap outperformed large cap in June while growth outperformed value yet again. The pullback in reopenings is causing harm to the cyclical recovery names most exposed to the coronavirus. Banks have been through the latest stress test with the outcome being a moratorium on stock buybacks and no dividend increases in the third quarter.

What's changing

The pace of the rebound in the economy is certainly looking as if it will be pushed well into 2021 as a resurgence in cases will take time to work through. Fiscal help is a big question as the impact of the virus lingers, the Paycheck Protection Program (PPP) is set to expire, and many look for a continuation of the support perhaps in a more limited fashion. There needs to be incentive for people to return to jobs. Looking to the latter part of the year, we expect a vaccine around year end, which will take some time to roll out to the masses. The sooner companies respond to the digital economy as a new and lasting way of doing business, the better off they will be. In many ways, the new way of using digital assets to conduct business will create efficiencies that will last past the coronavirus issues.

What we expect

If the Democrats win the White House and Congress, there could be significant changes in taxes that will be a drag on earnings expectations for next year. On the positive side, long-term low interest rates enabled by the Fed holding short rates low for the foreseeable future has created a positive view on equities as longer-duration equities are discounted at low rates allowing for higher-than-normal valuations.

The impact from the coronavirus will likely linger and we may see an upturn in cases as we approach flu season later in the year. Working-from-home plays including technology/5G/cloud should continue to work as the rebound in the economy becomes more muted vs. the most recent bounce from the worst levels. Getting used to wearing masks in public, particularly indoors and crowded outdoor spaces, should become the norm until medicines are available. Equity market valuations remain relatively full with an expectation of a vaccine later this year built into expectations. We believe the market will trade in a range until progress is made on a treatment.

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Investment Positioning

Portfolio targets effective July 1, 2020, for institutional clients with Private Hedge Funds

Growth & Income

	Strategic Asset Allocation (long term)	Tactical Asset Allocation (short term)
Equities		
U.S. Large-Cap	27.5%	Underweight
U.S. Small-Cap	5.5%	Neutral
International Developed	15.8%	Neutral
Emerging Markets	5.5%	Underweight
Fixed Income		
U.S. Investment Grade–Taxable	24.2%	Neutral
High-Yield–Taxable	3.0%	Underweight
U.S. Investment Grade–Tax-exempt	0.0%	Overweight
Real Assets		
U.S. Inflation-Linked Bonds	1.0%	Underweight
Global REITs	1.5%	Neutral
Other	1.5%	Underweight
Private Hedge Funds	12.5%	Overweight
Cash & Equivalents	2.0%	Overweight
Total	100.0%	

Note: Totals may differ slightly from the allocation building blocks due to rounding.

TAA, or Tactical Asset Allocation, represents our *current recommendation* for each model strategy.

SAA, or Strategic Asset Allocation, represents our *current benchmark* allocation for each model strategy.

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For an overview of our asset allocation strategies, please see the disclosures.

Source: WTIA.

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Indexes are not available for direct investment. Investment in a security or strategy designed to replicate the performance of an index will incur expenses, such as management fees and transaction costs that would reduce returns.

Past performance cannot guarantee future results. Investing involves risk and you may incur a profit or a loss.

An overview of our asset allocation strategies: Wilmington Trust offers seven asset allocation models for taxable (high-net-worth) and tax-exempt (institutional) investors across five strategies reflecting a range of investment objectives and risk tolerances: Aggressive, Growth, Growth & Income, Income & Growth, and Conservative. The seven models are High-Net-Worth (HNW), HNW with Liquid Alternatives, HNW with Private Markets, HNW Tax Advantaged, Institutional, Institutional with Hedge LP, and Institutional with Private Markets. As the names imply, the strategies vary with the type and degree of exposure to hedge strategies and private market exposure, as well as with the focus on taxable or tax-exempt income.

Model Strategies may include exposure to the following asset classes: U.S. large-capitalization stocks, U.S. small-cap stocks, developed international stocks, emerging market stocks, U.S. and international real asset securities (including inflation-linked bonds and commodity-related and real estate-related securities), U.S. and international investment-grade bonds (corporate for Institutional or Tax Advantaged, municipal for other HNW), U.S. and international speculative grade (high-yield) corporate bonds and floating-rate notes, emerging markets debt, and cash equivalents. Model Strategies employing nontraditional hedge and private market investments will, naturally, carry those exposures as well. **Each asset class carries a distinct set of risks, which should be reviewed and understood prior to investing.**

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Disclosures Continued

Allocations:

Each strategy is constructed with target weights for each asset class. Wilmington Trust periodically adjusts the target allocations and may shift away from the target allocations within certain ranges. Such tactical adjustments to allocations typically are considered on a monthly basis in response to market conditions. The asset classes and their current proxies are: large–cap U.S. stocks: Russell 1000® Index; small–cap U.S. stocks: Russell 2000® Index; developed international stocks: MSCI EAFE® (Net) Index; emerging market stocks: MSCI Emerging Markets Index; U.S. inflation-linked bonds: Bloomberg/Barclays US Government ILB Index; international inflation-linked bonds: Bloomberg/Barclays World exUS ILB (Hedged) Index; commodity-related securities: Bloomberg Commodity Index; U.S. REITs: S&P US REIT Index; international REITs: Dow Jones Global exUS Select RESI Index; private markets: S&P Listed Private Equity Index; hedge funds: HFRI Fund of Funds Composite Index; U.S. taxable, investment-grade bonds: Bloomberg/Barclays U.S. Aggregate Index; U.S. high-yield corporate bonds: Bloomberg/Barclays U.S. Corporate High Yield Index; U.S. municipal, investment-grade bonds: S&P Municipal Bond Index; U.S. municipal high-yield bonds: Bloomberg/Barclays 60% High Yield Municipal Bond Index / 40% Municipal Bond Index; international taxable, investment-grade bonds: Bloomberg/Barclays Global Aggregate exUS; emerging bond markets: Bloomberg/Barclays EM USD Aggregate; and cash equivalents: 30-day U.S. Treasury bill rate.

All investments carry some degree of risk. Return volatility, as measured by standard deviation, of asset classes is often used as a proxy for illustrating risk. Volatility serves as a collective, quantitative estimate of risks present to varying degrees in the respective asset classes (e.g., liquidity, credit, and default risks). Certain types of risk may be underrepresented by this measure. **Investors should develop a thorough understanding of the risks of any investment prior to committing funds.**

Quality ratings are used to evaluate the likelihood of default by a bond issuer. Independent rating agencies, such as Moody's Investors Service and Standard & Poors, analyze the financial strength of each bond's issuer. Ratings range from Aaa or AAA (highest quality) to C or D (lowest quality). Bonds rated Baa3 or BBB and better are considered **Investment Grade.** Bonds rated Ba1 or BB and below are **Speculative Grade** (also **High Yield**.)

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