CAPSTONE FINANCIAL ADVISORS

Quarterly Investment Perspective

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Key Points:

- *Stocks closed out their best quarter in more than twenty years, while bonds continued to appreciate in value despite declining stock market volatility. Stocks could once again experience considerable episodes of volatility in the second half of the year; however, we cannot exclude a further rise in stock prices as economic activity continues to increase.*
- *Economists generally agree that the quarter that ended in June was likely the worst of the downturn and that we are now in a recovery phase. The significant rise in U.S. coronavirus cases has prompted renewed restrictions, which are likely to slow down the economy's revival. The economic recovery will falter but is unlikely to stop.*
- *We have been positioning portfolios to both participate in market upside and defend against downside risk; this includes: Maximizing diversification across stock holdings; maintaining an overweight to U.S. large-cap stocks; positioning bonds to hold up for when stocks go down; and rebalancing portfolios back to their target (neutral) allocations.*

Market Review & Outlook

Stocks have recovered significantly since March

Stocks closed out their best quarter in more than twenty years. The global stock market rose nearly 20%[1] from April to June as volatility subsided. Stocks staged a remarkable recovery from the first quarter's decline. Stimulus from the government and central banks around the world, coupled with the relaxation of some COVID-19-driven economic restrictions, aided the market rebound. Despite sliding corporate earnings, a severe economic recession, and a resurgence in coronavirus cases in many states, U.S. stocks are close to where they started the year while international stocks are down a little over 11%. (See **Figure 1**.)

Bonds have further increased in value

High-quality bonds (those issued by governments, municipalities, and corporations with low-default risk), have continued to appreciate in value despite declining stock market volatility. High-quality bonds typically hold steady (or even slightly decline in value) when stocks move up sharply, or when economic activity picks up. Despite this, bond returns have increased further, amid central bank commitments to purchasing them in an effort keep interest rates low around the world. Additionally, investor demand for safe bonds remains strong amid continued uncertainty about the future.

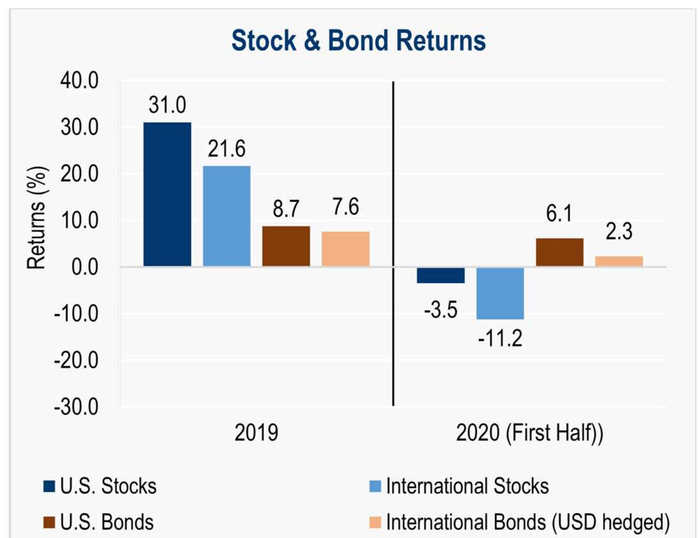

Figure 1. Despite a severe downturn in corporate earnings and the global economy compared to 2019, stock markets are down modestly so far in 2020 with the help of an unprecedented amount of stimulus from governments and central banks around the world. The central bank stimulus, especially from the Federal Reserve, has also contributed to bonds returns, particularly investment-grade bonds, which have posted positive returns so far this year.

U.S. stock returns are represented by the Russell 3000 Index. International stock returns are represented by the MSCI ACWI Ex USA IMI. U.S. bond returns are represented by the Barclays Aggregate Bond Index. International bond returns are represented by the Barclays Global Aggregate Ex USA Hedged Index. Their performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is not a guarantee of future results. Source: Morningstar, Russell, MSCI, Barclays. Data as of 06/30/2020.

Stock market volatility is likely to increase again

We have no special expertise in forecasting market moves; however, there is enough uncertainty surrounding COVID-19, the U.S. presidential election, relations with China, and the general economy to conclude that stocks could once again experience considerable episodes of volatility in the second half of the year. With that said, stock markets are not likely to go back down to the March lows, given the extraordinary amount of economic stimulus being deployed globally. While stock markets will likely still be very choppy, there is too much support in place (with more likely still to come) for markets to collapse again like they did back in late February and March.

Stocks could still continue to move much higher

The markets are being driven by optimism about the potential for economic improvement down the road – so, we cannot exclude a further rise in stock prices. At this point, however, we have only begun to see initial signs of a real cyclical recovery in the economy. With most activity, we are nowhere close to pre-crisis levels. (See **Figure 2**.) There is a lot of opportunity for real improvement in economy, and eventually, corporate earnings over the next two quarters. Granted, there will need to be other catalysts along the way such as progress on a vaccine or drug therapies to fight the virus. As we get closer to moving past this pandemic, the recovery in stocks will likely broaden out to sectors and areas of the market that are still beaten down.

Economic Review & Outlook

The global economic downturn has bottomed

Economists generally agree that the quarter that ended in June was likely the worst of the downturn, as many important data points that measure economic activity worldwide appear to have bottomed. Many major countries in Europe and Asia have largely contained the outbreak so far, which has enabled their economies to reopen slowly. So far, China is leading the global recovery as it has managed to get its economy nearly back in full motion. In the U.S., economic activity across the board is still in a nascent stage following recent re-openings. Despite what seems to be the beginings of a recovery, the economic picture in the U.S. remains bleak. Nearly 20 million jobs have been shed since February, and (as mentioned earlier) consumer spending is materially below pre-pandemic levels.

Consumer Spending: Up Again, But Has a Long Way to Go

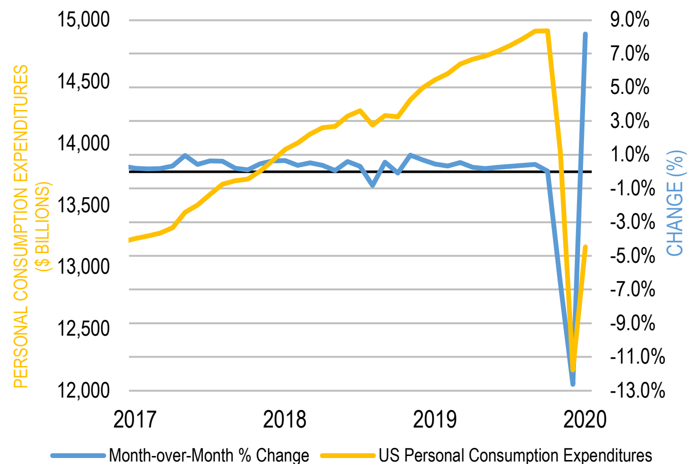

Figure 2. The monthly change in consumer spending shows more than a full "V recovery"; while in level terms, the recovery has only been about one-third of the way toward pre-pandemic levels.

Sources: Bureau of Economic Analysis, YCharts
Personal Consumption Expenditures data is a measure of how much consumers are spending each month on goods and services.

Economic recovery will falter, but unlikely to stop

The significant rise in U.S. coronavirus cases has prompted renewed restrictions on business and social gatherings and will likely slow down the economy's revival in certain regions and industries. Rising COVID-19 cases also have the potential to hamper business and consumer sentiment, and hence spending activity. However, we doubt that a return to the nationwide (not to mention global) synchronized closures that occurred in March and April is in the cards. The preservation of limited health care system capacity prompted the original shutdowns. Going forward, a more local or region-by-region approach will likely be vital in conserving health care resources.

The economic recovery will falter but is unlikely to fully stop, especially given ongoing stimulus from the Federal Reserve and likely additional support from Congress. Economic support from international governments is likely to continue as well. European Union nations most recently came to an agreement on a new €750b stimulus package to help countries' economies recover from COVID-19. Additionally, the world should be better prepared to handle a resurgence of coronavirus cases with greater hospital capacity, more widely available personal protective equipment, and more knowledge about the disease and treatment for COVID-19 patients. The economic recovery should continue and eventually gain steam next year once a vaccine or viable treatment becomes available.

On the Minds of Investors

Should a top-heavy stock market worry us?

A large portion of the U.S. stock market today is concentrated in a handful of stocks. The technology companies included in these top stocks are drawing attention for their perceived sway on the market as a whole. This has led to some concern among investors that such a small group of stocks having such a heavy influence on performance may mean that there is more risk in the market than usual. Historically, however, it is not unusual for the market to have concentration in a handful of large stocks. In fact, it has been larger in the past. (See **Figure 3**.)

Regardless, concentration risk at the top of the market is something we take into consideration when designing portfolios. Our diversified approach to portfolio construction, which includes investing in stocks of all sizes located around the world, helps to significantly reduce potential concentration risk. For example, the top 5 stocks in a typical Capstone portfolio currently averages around 11% of the total stock allocation[2], versus 21% for the U.S. stock market. As such, a top-heavy U.S. stock market is something we pay close attention to, but it does not worry us given our client portfolio design.

Should we expect big-tech stock outperformance

Big-tech stocks, commonly referred to by the "FAANG" moniker—Facebook, Amazon, Apple, Netflix, and Google—have posted impressive market-beating gains over the past decade. The gains have been a result of strong earnings growth and high expectations. These tech stocks may benefit from the fact that growth is scarce in this current recession, and from the greater demands being placed on the digital world in times of COVID-19. Some analysts expect large tech stocks like these to continue powering higher, partly because of changes in consumer behavior during the pandemic that have boosted their business models.

Historically, the largest ten companies in the U.S. stock market have always included big technology companies. Firms dominating the market in the past (like AT&T, IBM, General Motors, and General Electric) have often been on the cutting edge of technology (at the time) within their industries. So, should we expect the largest stocks to continue such strong outperformance going forward? In order for the current top stocks to outperform going forward, as with any stock, it will require new positive developments that continually exceed current (arguably very high) expectations. Historically, stocks that reached the top-ten largest company list have not subsequently resulted in consistent long-term outperformance. (See **Figure 4**.)

Weight of Top-5 Stocks by Market Capitalization in US Stock Market, 1969–2020

Figure 3. The combined market capitalization weight of the 5 largest stocks, around 21% as of May 2020, has been higher in the past and is not *that* out of the ordinary from a historical perspective.

Sources: S&P Dow Jones Indices. The five largest stocks the U.S. are currently Microsoft, Apple, Amazon, Google, and Facebook. Data as of 5/20/2020.

Annualized return in excess of market for stocks after joining list of 10 largest US stocks, 1927–2019

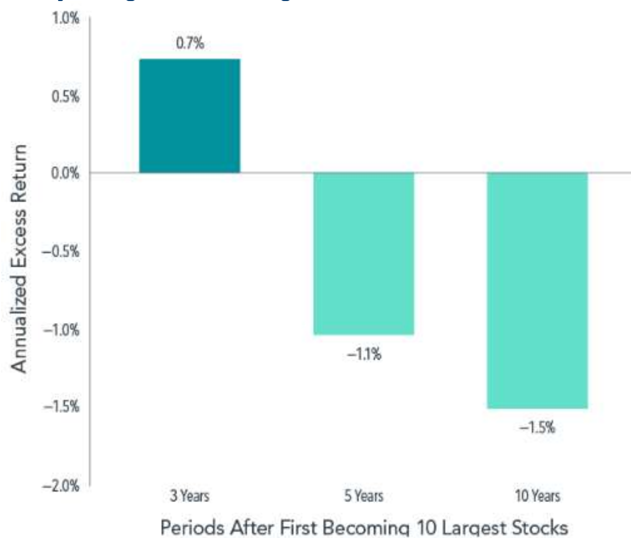

Figure 4. Charting the performance of stocks following the year they joined the list of the 10 largest firms, these stocks outperformed the market by an annualized 0.7% in the subsequent three-year period. However, over five- and 10-year periods, these stocks underperformed the market on average.

Source: Dimensional [3], using data from CRSP and Compustat. Includes all US common stocks. Largest stocks identified at the end of each calendar year by sorting eligible US stocks on market capitalization using data from CRSP. Market is represented by the Fama/French Total US Market Research Index. Excess return for each stock is the difference in annualized compound returns between the stock and the market, computed from the first month following initial classification in the top 10. Stocks in the sample are required to have at least 36 months of returns data following classification in the top 10.

Portfolio Management

Positioning portfolios to both participate in market upside and defend against downside risk

From both a health and economic perspective, we are past what is likely the worst of the pandemic. However, there is long way to go. While scientists are making progress on potential drug treatments, COVID-19 cases are up in many regions, record unemployment persists, the U.S. election is fast approaching, and rhetoric with China is once again escalating. As such, we have been positioning client portfolios to both participate in market upside and defend against downside risk in the following ways:

Maximizing diversification across stock holdings

Our investment philosophy around diversification helped portfolios weather the worst of the storm earlier this year. Subsequently, it also allowed portfolios to participate in the strong market rally that followed. Broad diversification across stock holdings will help portfolios get through considerable volatility that we are likely to see in the second half of the year.

We have positioned client portfolios to maintain exposure to traditional “growth” sectors in order to participate in transformational advances within health care and technology. Growth sectors have fared relatively well so far throughout the crisis. While we have allocations to these stocks, we do not think it is appropriate to be overly concentrated in them at this time. As such, client portfolios also maintain exposure to traditional “value” sectors. Value sectors, such as financial, industrial, energy, and real estate stocks, tend to be more economically sensitive, and have underperformed throughout the crisis. However, these value sectors currently present the most opportunity for when we inevitably see a real cyclical recovery in the economy.

Maintaining an overweight to U.S. large-cap stocks

In late-March we increased portfolio allocations to U.S. large-cap stocks. This shift has benefited portfolios so far, and we continue to maintain this overweight. Given their relative strength, U.S. corporations should be more insulated should global stock markets fall again amid this ongoing crisis. Additionally, sturdier large companies will likely be better able to withstand the economic slowdown, particularly if it lasts longer than expected.

We continue to believe that the U.S. economy will be much better positioned for recovery compared to many other major economies abroad. This is due to the unprecedented amount of economic stimulus being injected into the U.S. economy, and the fact that the U.S. already had a relatively stronger economy going into the crisis.

Positioning bonds to hold up when stocks go down

Our commitment to a balanced portfolio—by structuring bond allocations to have a focus on government and other investment-grade securities—helped to offset some of the stock market volatility. Going forward, our high-quality bond allocations will act as much-needed portfolio stabilizers, offsetting portfolios against inevitable stock market declines.

Investment-grade bonds have a lower risk of default. During a recession, particularly during a long one, the risk of default tends to increase. Additionally, US Treasuries and other government securities tend to do better in a weaker economy. We have positioned clients bond allocations to maintain a high-quality bias towards investment-grade bonds, and to remain duration-neutral relative to the broad bond market. This is to better ensure that when the markets fall, bond allocations can continue to serve as an effective ballast for portfolios.

Rebalancing portfolios back to target

Despite the stock market's strong rally and confidence in a quick rebound from the recession, we remain cautious and are maintaining a neutral allocation to stocks in client portfolios. We achieve this by rebalancing portfolios back to target allocation when markets trend upward.

Earlier in the year, our disciplined approach to portfolio rebalancing helped to opportunistically position portfolios for a market recovery by trimming from overweight bond positions and adding to stocks that were significantly discounted. After the recent stock market surge, our rebalancing activity has shifted to risk-management by trimming from now overweight stock positions and adding to bond positions.

Bringing portfolios back to their neutral stock and bond asset allocation targets should help to mitigate risk in portfolios from a potential major setback in the stock market. This should help if the resurgence of COVID-19 cases and hospitalizations gets to a point where more severe lockdowns need to be implemented again.

Our Portfolio Trade team continues to monitor portfolios closely and systematically, while rebalancing portfolios when it makes sense to do so. As always, our team will be methodical when implementing these processes, and will be mindful of tax consequences, cash flows, and other client-specific needs. Disciplined rebalancing throughout the turmoil has helped clients' portfolios, and we are as confident as ever that a disciplined approach to rebalancing will continue to add value over time.

Capstone's investment principles remain constant during good times and bad times in the markets, helping clients create clear goals, properly diversify and balance portfolios based on those goals, minimize portfolio cost and taxes, and maintain long-term discipline.

Asset allocation target based on one's financial plan

We have been actively analyzing client investment plans as part of our normal ongoing financial planning process. One of the main outcomes of this process is to determine whether the amount of stocks that one has in their portfolio is still appropriate. While it is rare that short-term market movements alone result in a needed strategic asset allocation change, there are occasions when aspects of one's financial objective and situation changes. If you have recently had a material change to your financial objective or situation, please reach out to us.

Sources & Notes

[1] Global stocks as measured by the MSCI ACWI IMI NR USD, returned +19.83% from 4/1/20 to 6/30/20. Source: Morningstar Direct.

[2] Represented by the 5 holdings in a Capstone "Growth Asset" model. Data as of 06/30/2020.

[3] Source: Dimensional. https://us.dimensional.com/perspectives/large-and-in-charge-giant-firms-atop-the-market-is-nothing-new

Important Disclosure Information

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