

Market Review & Outlook

2020 SECOND QUARTER

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Indexes (USD)	2Q 2020 (%)	YTD 2020 (%)	1-Year (%)	3-Year (%)	5-Year (%)
S&P 500	20.5	-3.1	7.5	10.7	10.7
MSCI EAFE	14.9	-11.3	-5.1	0.8	2.1
MSCI Emerging Markets	18.1	-9.8	-3.4	1.9	2.9
Barclays Aggregate	2.9	6.1	8.7	5.3	4.3
Barclays High Yield	10.2	-3.8	0.0	3.3	4.8
S&P Global Natural Resources	20.5	-19.1	-16.8	-0.1	0.9
MSCI US REIT Index	11.7	-18.5	-12.9	0.1	4.1

Source: Bloomberg

General Market Update

The global economy continued to be heavily impacted by the path of the COVID-19 virus during the second quarter, as governments globally struggled with re-opening strategies amidst a pandemic with few signs of abating.

Still, global equity markets, and risk-assets more broadly, performed extraordinarily well during the second quarter, fueled by the aggressive fiscal and monetary support that was deployed during the first quarter. Investors weighed the likelihood of a vaccine over the coming quarters and the possibility of further government support against the risk of economies closing back down as the infection rates rise. Optimism was rewarded.

As evidence of solid investor demand, equity issuance for 2020 has notably outpaced the 2019 comparable, while corporate debt issuance has broken month-over-month records, as investment grade and high yield issuers capitalized on record low interest rates and government support programs. Additionally, commodity prices generally rose over the quarter on expectations of increased demand, as a handful of economies reopened and risk sentiment improved.

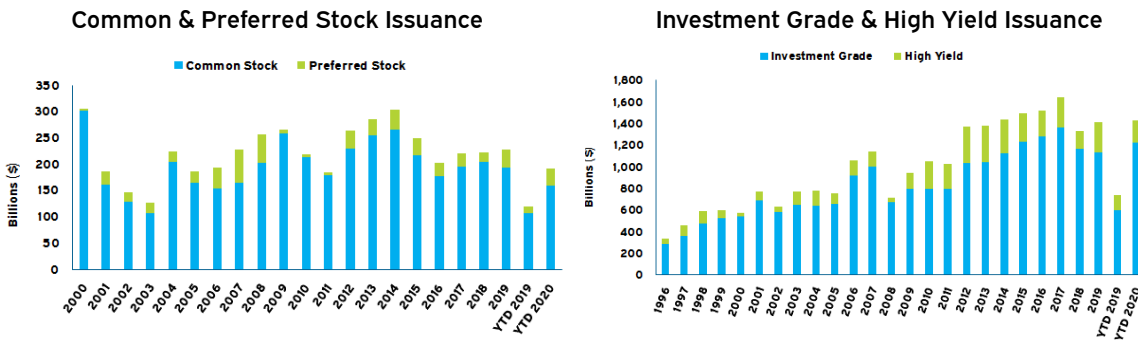


FIGURE 1

Source: Securities Industry and Financial Markets Association, as of June 30, 2020.

Economic data released during the quarter provided a mixed message of the global economic recovery, with some of last quarter’s record declines followed by record increases for some economic measures. Nonetheless, analysts continue to convey caution when assessing updates and forecasts due to the ongoing data collection challenges and inherent uncertainty in forecasting the path of the pandemic.

Economic Data

The global economy staged a modest comeback from the record declines and deterioration experienced in the first three months of the year. From April through June, US economic measures such as industrial production, broad housing indicators, and the unemployment rate, all suggested a more optimistic outcome versus initial estimates.

Within US payrolls, the market reacted positively to the decline from April’s unemployment rate of 14.7%, to the June unemployment rate of 11.1%. And while the improvement came with significant warnings from the Bureau of Labor Statistics regarding its accuracy due to collection and categorization challenges, it was nonetheless received by the market as an overall sign of increased stability in the labor market.

High frequency measures, including nearly-real-time measures such as retail sales and consumer mobility and engagement measures, also showed signs of improvement and suggested the return of some consumers and an increase in spending across related sectors.

More broadly, it also appears initial estimates of both global and US economic weakness might have been overly pessimistic, as captured by economic “surprise” indices that measure the degree of data misses against forecasts. As seen in the notable increase in Citigroup’s Economic Surprise Index (ESI), shown in Figure 2, most estimates have been notably lower than the actual or realized data.

Citigroup Economics Surprise Index (ESI) As of 6/30/2020

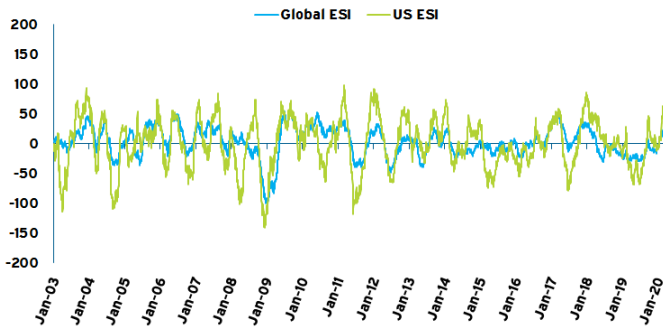


FIGURE 2

Sources: Citigroup and Bloomberg

In Europe, economic data released showed a similar snap-back recovery as the US for virus-impacted sectors. Still, European Central Bank (ECB) policy makers suggest the economic growth outlook remains skewed to the downside, with GDP expected to contract by roughly 8.7% this year due to notable uncertainty regarding consumer spending and business investment. Also, similar to the price action in the US rates market, the ECB's quantitative easing purchase program heavily influenced comparable yields, keeping them at historically low levels.

Further East, China has reportedly contained the domestic spread of the virus, or at least has it largely under control, which is helping the economy re-open faster than other countries and driving increases in supply and production. Indeed, official data suggests second quarter growth was 3.2%, versus -6.8% in the first quarter. On the demand side, consumer confidence has been improving, as seen in improvements in retail sales and the housing and property markets.

All that said, market tone deteriorated modestly in late June as infection cases across a number of countries, including the US, started spiking. This has been particularly so in regions that more aggressively re-started their economies despite the medical community's formal guidance and recommendations. This increased risk drove a deterioration in economic measures such as consumer sentiment and confidence, as investors started to question the pace and stability of the recovery. Safe-haven assets, such as US Treasuries, experienced a subsequent increase in demand.

Update on Stimulus Measures

In the US, the record stimulus measures launched to combat the crisis included over \$2.0 trillion as part of the CARES act, and multiples of that as part of the package of monetary policy measures deployed by the Federal Reserve.

And while both fiscal and monetary support measures have been noted as working to stabilize financial markets, programs and policies deployed by the Federal Reserve have been cited as the principal catalyst driving the material demand for risk assets.

With over \$2.2 trillion in cumulative purchases thus far driving the System Open Market Account¹ balance to nearly \$6.1 trillion, and expectations for the unlimited purchases to continue for the foreseeable future, the program is arguably the largest stimulative policy measure currently supporting the US economy.

¹The System Open Market Account (SOMA) represents the Federal Reserve's balance sheet.

Quantitative Easing programs have also been significant stimulus measures for other central banks. The ECB, the Bank of England, the Bank of Japan, the Bank of Canada, and a number of other central banks and monetary authorities have been executing programs of various size, composition, and pace since the onset of the crisis.

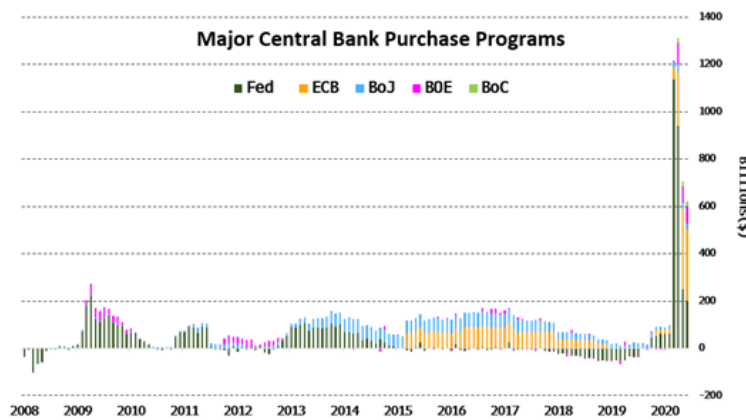


FIGURE 3

Source: Bloomberg

The Federal Reserve's corporate debt purchase programs, and specifically the Secondary Market Corporate Credit Facility, and its respective early purchases of ETF indices containing high-yield debt, have also been specifically noted as driving the increased confidence in corporate debt markets and the subsequent tightening of yield spreads. Other programs, such as the Commercial Paper Funding Facility and the US dollar swap lines, have also been highlighted as directly helping to mitigate the market dislocations experienced in mid-to-late March.

Still, it's noteworthy that actual usage of the programs has been generally less than expected. As the table in Figure 4 highlights, usage is below the program limit for some programs, and significantly less than usage during the 2007-2009 crisis. With the crisis being more akin to a natural disaster and less reflective of a typical financial crisis, it's been suggested usage may ultimately be less than otherwise expected.

Program	Current Usage (as of 7/1/2020)	Peak Usage	Program Limit	Treasury Backstop	GFC Peak Outstanding
Term Asset-Backed Securities Loan (TALF)	8.5	8.5	100	10	48
Municipal Liquidity (MLF)	16.1	16.1	500	35	-
Main Street Lending (MSLF)	0	0	600	75	-
Paycheck Protection Program (PPPLF)	68.1	68.1	Unlimited	-	-
Primary Market Credit (PMCCF)	0	0	500	50	-
Secondary Market Credit (SMCCF)	41.9	41.9	250	25	-
Money Market Mutual Fund Liquidity MMLF	20.6	53.2	Unlimited	10	146
Commercial Paper Funding (CPFF)	12.8	12.8	Unlimited	10	350
Primary Dealer Credit (PDCF)	2.5	33.4	Unlimited	-	148

FIGURE 4

Source: Federal Reserve

Still, market participants are quick to highlight this dynamic could change quickly as the virus continues to spread and economies consider shutting back down.

Equities

As suggested, fiscal and monetary stimulus measures released during the first quarter continued to be the dominate driver of equity performance across the second quarter.

Beginning March 23, which is largely considered when the full weight of monetary policy support was deployed, equity markets as measured by the S&P 500 rose by nearly 39% percent through the end of the second quarter. The impressive recovery resulted in quarterly performance of roughly 20%, representing the largest quarterly gain since 1998. By June 30, the S&P 500 was down by only 8.4% from its record reached on February 19, erasing approximately 75% of the total decline.

Global equity markets also performed well, with the MSCI ACWI and MSCI Emerging Market Index returning 18.7% and 17.3%, respectively. Consistent with markets being largely backstopped by fiscal and monetary authorities, expected equity volatility, as measured by the VIX, declined by 43% over the quarter. Through June 30, the index had declined by over 63% since the peak of fear experienced in late March. Still, the index remains elevated against longer-term averages.

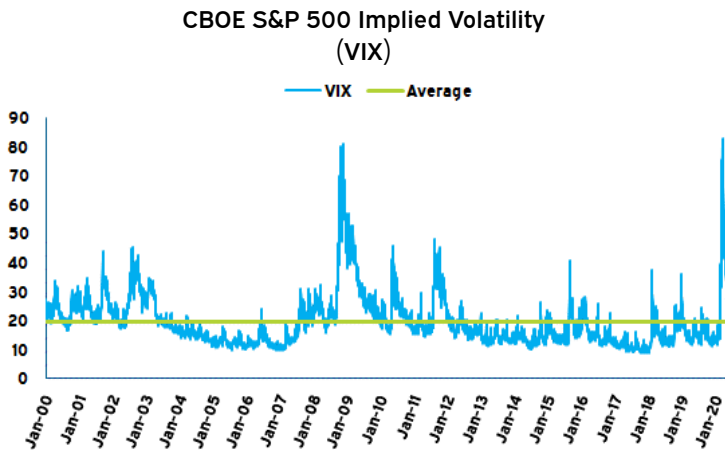


FIGURE 5

Source: Bloomberg

The notable improvement in equity markets will be heavily weighted against realized second quarter earnings, as well as any accompanying forward earnings guidance provided by companies. To the latter point, forward earnings projections are still being issued with a considerable margin of error, as many companies provided limited, if any, forward expectations due to the challenges of forecasting amidst the pandemic.

Overall, the S&P 500 is expected to report a decline in earnings of approximately -44.6% for the quarter, which, if realized, would represent the largest year-over-year

decline in earnings since the financial crisis in 2008. Further out, analysts are forecasting a solid rebound in 2021, with earnings expected to recover back to pre-COVID crisis levels.

Fixed Income

Global sovereign debt yields generally stabilized at historically low levels over the quarter. Accommodative central bank policy actions, including cuts to benchmark policy rates, and the deployment of record-sized quantitative purchase programs worked to suppress any pressures for higher yields. The lack of pressure was also notable considering the record issuance by sovereign entities to fund respective emergency fiscal programs.

In the US, the record net Treasury issuance of \$2.7 trillion over the quarter had a marginal impact on Treasury yields, with the curve steepening by less than 10 basis points as measured by the spread between the 2-year and 10-year nominal security. Consistent with the heavy influence by policy makers and the expectation that policy rates will remain at accommodative levels for the next few years, measures of interest rate volatility and term premium models returned to record low levels.

Outside of sovereign debt, corporate debt markets, including both investment grade and high yield markets, experienced record monthly issuance during the period. Corporations that drew heavily on credit lines during the heart of the crisis, and also firms with borrowing capacity, took advantage of the low rates and ultimately borrowed record amounts over May and June.

The corporate issuance was also met with solid investor demand, as evidenced by investment grade credit spreads declining to pre-crisis levels and high yield credit spreads declining notably from record highs. That said, high yield spreads remained elevated in relation to pre-COVID averages, largely on the expectation that further challenges lay ahead for high yield companies that are facing an uncertain economic future amidst the ongoing evolution of the pandemic.

US Dollar & EM Currencies

The US dollar depreciated against major trading partners, largely driven by the increased risk appetite from investors, but also due to expectations that respective economies are managing the COVID virus relatively better than the US. After hitting multi-year highs in March, the DXY index depreciated by roughly 1.7% during the second quarter.

At the country level, the dollar broadly depreciated against economies with commodity sensitive currencies amidst an improvement in commodity prices, spurred by China's economic reopening. This was most directly seen in the 12.6% appreciation of the Australian dollar against the US dollar, but also currencies like the Canadian dollar and the Mexican peso, which appreciated by 3.6% and 3.0%, respectively. The euro also appreciated against the dollar, rising 1.8%, as the euro area appears to be weathering the COVID crisis better than the US.

Against emerging market currencies, the US dollar broadly underperformed on the expectations for respective economies to open sooner than the US, as well as potential improvements in local economies' growth.

Looking Ahead...the Economy

The range of global economic growth, employment, and inflation expectations remains wide, as market participants highlight a limited ability to build any reliability into their forecasts due to the uncertain path of the virus.

For 2020, real economic growth forecasts² range from -0.6% to -10.5% for developed economies, and roughly 3.0% to -12% for emerging market economies. According to the International Monetary Fund, global growth is projected at -4.9% for 2020. This represents a decline from earlier estimates due to their assessment that the virus-imposed shut-down of some economies was more detrimental than previously thought, and that the recovery going forward will likely be weaker than previously expected for some economies.

²Bloomberg estimates provided by contributing market participants across financial institutions.

Expectations for employment are also reportedly challenging to estimate, particularly in light of some economies beginning to reopen and immediately experiencing an increase in infections, prompting a concern that they may need to reestablish aggressive distancing measures to include shutting economies back down. In the US, where infections started to rise towards the end of the quarter, expectations for the 2020 unemployment rate range from 7.7% to 12.0%, with a median estimate of 9.2%; for 2021 and 2022, median estimates are for the rate to be 7.6% and 6.0%, respectively. In light of the aggressive actions taken by fiscal and monetary authorities, inflation concerns will be a principal focus by market participants going forward. Over the quarter, inflation expectations, as measured by the difference between the 10-year nominal Treasury and the 10-year TIPS security, rose by approximately 41 basis points, to 1.34%, still well below historic averages.

Looking Ahead...Risk & Headwinds

Financial markets face a number of obstacles over the next few years, but for the rest of 2020 we anticipate a handful to be a principal focus of market participants.

1. Developments with the COVID-19 virus, including the increasing rate of infections juxtaposed with updates on potential vaccines, and likely stimulus measures, will dominate investor sentiment over the near-term.

During the latter half of June, as a number of economies started to re-open from mandated shut-downs, virus infection rates started to rise materially. While economies didn't immediately reinstate the shut-down measures, investors are nonetheless closely monitoring the ability of the economy to function in this environment.

2. The direction and shape of the global recovery, including economic growth, employment, and inflation, will be closely followed for signs of developing risks.

As noted, forecasting accuracy has been materially impacted due to the nature and severity of the crisis, which increases the risk of significant forecasting errors materially impacting markets once the data is realized. Thus far in the crisis, markets have held up fairly well when expectations were materially different than their respective data points, but this could change should the virus continue to rapidly spread and the recovery stall or reverse under the weight of a re-shuttering of the economy.

3. Additional fiscal and monetary stimulus is anticipated; however, uncertainty as to the timing and degree of support will weigh on markets until further clarity is provided.

On the fiscal side, the potential expiration of the expanded federal unemployment insurance at the end of July will be a principal risk to the expected path of recovery. According to Bureau of Labor and Statistics data, after spiking to a 20-year high of 32.4% in April, US personal savings as a percent of disposable income dropped to roughly 23% in May, and expectations are for that figure to continue declining through June. As unemployment insurance recipients are reportedly contributing meaningfully to that increased spending (lower savings), should fiscal authorities not extend the \$600 weekly supplement to state unemployment benefits, the expected decline in spending by the unemployed workforce could materially impact households and the broader economic recovery.

On the monetary side, clarity as to the extent policy makers intend to hold policy rates at record low levels will dominate the discussion, with explicit forward guidance and/or yield curve controls being the next policy options likely under

consideration. Additionally, any signals regarding the emergency programs and their utilization and ultimate termination will be a focus. As of now, emergency lending programs initially slated to end in September have been extended through December.

4. The US elections are expected to be a notable event during the fourth quarter, which will likely impact financial markets.

As polling has shifted to suggest an increased likelihood that former Vice President Joseph Biden will be the next President, financial markets have started to react to news related to his administration's potential economic policies. That said, with virus-related developments dominating the economic landscape over the near-term, election-related risks are not likely to be a major theme until later in the third quarter or early fourth quarter.

5. US equity valuations have returned to levels that may be inconsistent with such deep uncertainty regarding company and broader economic fundamentals.

One popular metric that we have cited in the past is the Cyclically-Adjusted P/E (CAPE), which compares a company's or index's current stock prices versus its average earnings over the rolling 10-year period. With the multiple near 30x (versus the post-war long run average of 19x), and on the basis of the aforementioned challenges forecasting earnings with limited corporate guidance, and considerable uncertainty surrounding the future path of the pandemic, future realized earnings could be a significant downside risk that isn't being appropriately captured.

6. Corporate debt spreads may also be priced too aggressively for the uncertainty that likely lies ahead.

Consistent with the argument for equity valuations, the sharp improvement in both investment grade and high yield spreads may be overly optimistic. While we believe that the risk adjusted opportunity is more attractive in the corporate debt markets versus outright equities, should realized earnings materially miss forecasts over the coming quarters, and/or defaults continue to climb and exceed current expectations, corporate balance sheets could come under pressure and subsequently drive spreads notably wider. Further, with research largely supporting that downgrades and corporate defaults typically take a few quarters to materialize after the first wave of economic deterioration, the recent improvement in spreads may have gotten ahead of itself. Still, in this risk scenario, exposure to the higher-quality section of corporate balance sheets through debt ownership would be preferred over outright equity exposure.

Meketa Actions Taken During the Quarter

The Meketa Fiduciary Management Investment Committee continued to be active during this period of market volatility, while maintaining a modestly defensive overall risk position. Specifically, within client-specific guidelines, we:

- Increased allocations to below investment grade credits,
- Made opportunistic investments in a distressed credit strategy,
- Initiated investments in the government-supported TALF program,
- Trimmed recent gains in gold-related equities,
- Trimmed recent gains in broader equity allocations,
- Faded pure interest rate-sensitive exposure (physical and overlays) with long credit.

Summary

The second quarter was largely defined by stock and bond investors taking opposite positions on risks and opportunities in the global economy, reflecting the unprecedented nature of the COVID-19 pandemic.

Equity markets posted extraordinary gains, as investors ignored near-term earnings deterioration (and economic data that revealed a global economy declining at a pace last experienced in the 1930s), and focused instead on the potential positive impact of fiscal and monetary policy on longer-term earnings in 2021 and beyond. While safe bonds remained largely locked at historically low levels, uncertainty surrounding the virus kept demand elevated for safe assets. And while measures of implied volatility across both asset classes returned to levels that reflect the full backstop by fiscal and monetary authorities, we suggest complacency in this environment is the wrong strategy. We continue to approach this economic environment cautiously, as we actively monitor market developments, and react accordingly when opportunities or risks present themselves.

As always, should you have any questions regarding your specific portfolio or broader development in financial markets, please feel free to reach out to your Meketa client team anytime.

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