We have frequently commented in this column that the reason investors watch the economy is for advance warnings about economic downturns. Every recession since 1947 has been accompanied by a downturn in stock prices as shown in the chart to the right. Prices typically peak several months before the economy starts to contract as investors reduce equity exposures while economic warning signs mount.

This year’s Covid-19 recession was the exception. The coronavirus pandemic took investors and the world by surprise. The stock market went from an all-time high in February to a -34% correction in less than five weeks as the economy went from robust health into a self-induced stall.

Having been surprised by the recession that started in March and probably ended in May, what’s to be gained by watching the economy now?

Other than watching for a renewed downturn on account of the pandemic, investors are watching the economy for two additional reasons: first, to get an idea of the growth rate of the recovery; and second, to see whether growth is likely to meet consensus expectations.

The economy apparently bottomed in April and started to recover in May. As indicated in the table above, consensus expectations are for strong growth in the third and fourth quarters, albeit off of very depressed starting points.

Investors are hoping for a V-shaped recovery with a sharp bounce back to pre-recession levels that would mean a quick recovery in employment, business revenues, and profits. Recent economic reports appear to have buttressed hope for a quick recovery. Employment increased 2.7 million in May and 4.8 million in June, and consumer confidence soared in June. But investors need to be cautious in interpreting the June economic data. The June jobs report was based on surveys from the week of June 13th, and the consumer confidence data was from surveys on June 18th. Both reports were completed before the increase in coronavirus infections in the South and West and the delay or roll-back of reopening plans in many states. We expect subsequent reports will show more muted results.

We continue to believe the recovery will not be V-shaped and is likely to be slower than current consensus expectations. Expectations are key. As John Maynard Keynes observed more than 80 years ago, if valuations are set by conventional wisdom, the successful investor must understand consensus expectations and then judge whether those expectations are warranted. We believe current expectations of the near-term course of the economy may be too optimistic. For now, investors should beware of excess enthusiasm – at least until a vaccine arrives.
**Equity:** "I'm a slow walker, but I never walk back.”  **Abraham Lincoln**

- June was a month of consolidation for the S&P 500. Although it started off strong, the S&P 500 traded between 3,000 and 3,200 for most of the month. This is not unexpected and was long overdue. Until the start of the month, the market had enjoyed a sharp rise from the low of March 23. Equity market recoveries typically take months and usually don’t enjoy a V-shaped comeback.

- Small caps and value stocks took leadership at the beginning of the month, but their momentum faltered after the first few days. Although small-cap has continued to show some relative strength, value has not. Small caps are benefiting from large weightings in sectors such as healthcare and technology, while value’s performance has been inhibited by the fact that financials, i.e. banks, are the dominant sector. The ongoing strength in small caps is an encouraging indicator of faith in an economic recovery.

- We continue to favor growth stocks in the current economic environment due to our outlook of a slow economic recovery and the ability of growth companies, by definition, to generate growth in a slow economy.

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**Market Returns:** Year-to-Date as of June 30, 2020

<table>
<thead>
<tr>
<th>Index</th>
<th>Year-to-Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>S&amp;P 500 (large cap)</td>
<td>6.14%</td>
</tr>
<tr>
<td>S&amp;P 400 (mid cap)</td>
<td>8.61%</td>
</tr>
<tr>
<td>Russell 2000 (small cap)</td>
<td>6.14%</td>
</tr>
<tr>
<td>Russell 1000 Growth</td>
<td>8.61%</td>
</tr>
<tr>
<td>Russell 1000 Value</td>
<td>8.61%</td>
</tr>
<tr>
<td>MSCI ACWI</td>
<td>9.81%</td>
</tr>
<tr>
<td>MSCI EAFE</td>
<td>6.14%</td>
</tr>
<tr>
<td>MSCI EM</td>
<td>5.28%</td>
</tr>
<tr>
<td>U.S. Agg. Bond*</td>
<td>5.14%</td>
</tr>
<tr>
<td>Intermediate Govt/Credit*</td>
<td>8.61%</td>
</tr>
<tr>
<td>High Yield*</td>
<td>21.20%</td>
</tr>
<tr>
<td>U.S. Govt*</td>
<td>5.02%</td>
</tr>
<tr>
<td>U.S. Long Treasuries*</td>
<td>-3.80%</td>
</tr>
<tr>
<td>US IG Corporate*</td>
<td>5.92%</td>
</tr>
</tbody>
</table>

*Source: Bloomberg “Bloomberg Barclays’ indices*

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**Fixed Income:** Risky Bonds Strong in 2Q; Increasing Quality of Portfolio Exposure in Second Half of 2020

- Risk assets continued to rally in the month of June in response to broad-based Federal Reserve support for the capital markets through the maintenance of zero rates and asset purchases.

- Corporate bonds and high yield bonds returned 9.0% and 10.2% respectively over the course of the second quarter, leading to substantial relative performance recovery versus the benchmark. Returns are as measured by respective Bloomberg Barclays’ indices.

- The Fed engineered a significant reduction in credit spreads (the rate premium over Treasury rates that corporate borrowers must pay) since the end of March. High yield spreads retraced more than half of their previous increases.

- Further outperformance of credit will depend on actual improvement in the economy as emergency monetary policy has pulled forward performance.
Market returns were positive once again for the month of June, although not by the magnitude experienced in April and May.

For the second quarter, the powerful recovery off March lows resulted in double-digit returns for the major market indices; the S&P 500 returned 20.5% while international developed and emerging market equities returned 14.9% and 18.1% respectively, as measured by the MSCI indices.

Signs of life emerged in some of the more beaten-down sectors such as small caps and energy stocks; small caps outperformed large caps for the month and the quarter. Despite this rebound in cyclical sectors, growth continued to outpace value for the month and the quarter as investors continue to favor secular growth industries and sectors in this uncertain environment. The rally in mega-cap technology stocks continued as the NASDAQ index returned 6.1% for the month and 30.9% for the quarter. The NASDAQ is positive year-to-date, up +12.7% while the S&P 500 is now down just over -3%; a remarkable recovery considering the severe drawdown from the market high on February 19th to the market low on March 23rd.

Within fixed income markets, credit performed in sync with equities as investment-grade corporate and high yield sectors returned 9.0% and 10.2% for the quarter respectively, as noted on page 2. In contrast, the U.S. Government Index was essentially flat for the quarter at 0.5%. Interest rates remain low across the yield curve with the 2-year Treasury yielding ~16 bps and the 10-year Treasury yielding ~65 bps.

Portfolio returns were positive overall for the month of June with aggressive portfolios outpacing conservative portfolios, reflecting the strength of equity markets during the period (see the accompanying chart).

The year-to-date portfolio return is now positive for the 40% stock/60% bond conservative portfolio, while the balanced portfolio (60% stocks/40% bonds) is just below breakeven at -0.6%. The aggressive portfolio (80% stocks/20% bonds) remains down -3.1% year-to-date. These hypothetical portfolio returns (shown above) are based on returns of the Bloomberg Barclays Aggregate Bond Index and on an equity composite made up of 70% the Russell 3000 Index and 30% the MSCI All Country World Index ex the U.S. It is not possible to invest in indices.

Fundamental portfolio models continue to be managed with a modest overweight to equities relative to their strategic benchmarks. During the month, an allocation change was made within the fixed income portion of the portfolio to upgrade quality following very strong returns in below-investment-grade credit sectors. The exposure to bank loans was swapped for mortgage-backed securities. Within equities, we maintain a preference for domestic versus international stocks, growth over value, and large caps over small caps. Fixed income portfolios continue to be managed with an overweight to credit sectors, although that overweight was reduced during the month as just noted.

Strategic allocations to quantitative portfolio models were unchanged in June.
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