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Monthly Market Review

September 1, 2020

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A Shot in the Arm for Value Investing

COVID-19 vaccines could be the catalyst

Future historians may look back at August 2020 as a surreal yet momentous month. Congressional Republicans and Democrats went on recess without a fiscal stimulus bill. The two major political parties held the first-ever virtual conventions to nominate their presidential candidates. Instead of generating excitement among their base and winning over swing voters, it felt more like they were painting a grim picture of a divided America in order to stoke fear, anger, or both. One pronounced division appeared to be the sentiment on Main Street and Wall Street. Folks on Main Street were coping with real-life issues such as still elevated unemployment and school re-opening protocols. Some neighborhoods were battered by hurricanes or protests that turned violent and even deadly. Consumer confidence, as measured by the Conference Board survey, plunged to a new pandemic-era low due to the expiration of the extra unemployment benefits. Wall Street, however, was singing to a different tune as the anticipation of an uber-dovish Jackson Hole Fed symposium and the euphoria over tech shares and their stock splits drove equities to record highs -- the S&P 500 Index gained 7% and the NYSE FANG+ Index soared 21% for the month. These are gains more typically achieved over the span of a full year.

At the Jackson Hole symposium, Fed Chairman Powell delivered a seminal speech by announcing that the Fed will abandon its three-decade practice of pre-emptively raising rates to fight off inflation. The Fed will instead pursue a "flexible form of average inflation targeting." In plain English, the Fed will not raise rates until inflation overshoots the 2% target for an extended period. This dovish Fed stance, along with the risk-on tone of the market and declining daily new COVID-19 case counts in the U.S., helped steepen the yield curve by driving up the 10-year Treasury yield from 0.53% to 0.70%. It also sent the U.S. dollar lower. On the commodity front, gold surged to an all-time-closing-high of $2063 per troy ounce before falling into an over-due correction. Precious metals' bull market appears to be firmly intact especially given the Fed's new inflation targeting stance. Crude oil price grinded higher on continued U.S. production decline.

Politics will be front and center in the coming months. We still expect a fiscal stimulus bill to be passed unless politicians want to risk another economic contraction. All eyes will be on the upcoming three presidential debates between two septuagenarians, with the control of the White House and the Senate hanging in the balance.

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THE MIRACLE DRUG

In 1663, Italian physician Sebastiano Bado published a book on what he considered the most valuable treasure from South America. He told the story of Lady Ana de Osorio, wife of the Viceroy of Peru, being bed stricken with malaria in 1638. Her husband, Count of Chinchón, watched helplessly as she struggled with high fever and shaking chills. In came the governor of Loxa (today's Loja, Ecuador) with a box containing the powdered bark from cinchona trees that grew around Loxa. He claimed the powder was effective in treating malaria. Out of desperation, Countess Chinchón swallowed a bitter potion containing the powdered bark. Her fever and chills soon subsided and she was back to her vibrant self. Grateful for the cure, she bought large quantities of the bark for those suffering from malaria in Lima. A few years later, the Countess returned to Spain with the powdered bark, and it became widely used against malaria, which was endemic in Southern Europe.

The veracity of Bado's story was later disputed by historians, and many now credit Spanish Jesuit Padre Bernabé Cobo for first introducing the bark to Spain. Indeed, the cinchona bark was also called Jesuit's bark. Distinguished theologian John de Lugo was a fervent advocate for Jesuit's bark and had it analyzed by the pope's physician. The Jesuit College's apothecary even recorded the instruction on how the cinchona bark was to be used to treat malaria in as early as 1651.

The great 18th century Italian physician Bernardino Ramazzini was so impressed with the cinchona bark that he said it was to medicine what gunpowder was to the art of war. However, the remedy was controversial among Protestant physicians because it was introduced and promoted by Jesuits. Alexander von Humboldt, one of the most admired geographers, naturalists and explorers in the 19th century, lamented that "hatred of the Jesuits and religious intolerance lie at the bottom of the long conflict over the good or harm effected by Peruvian Bark."

In 1820, quinine was identified as the active substance in Jesuit's bark and, during WWII, it was widely used by soldiers against malaria in the Pacific Theater. The Japanese army gave the U.S. quite a headache when it occupied the Dutch East Indies, which was the world's largest producer of cinchona. With the supply of quinine cut off, the U.S. Army had to consider Chloroquine, the synthetic form of quinine first discovered in 1934. In 1955, Hydroxychloroquine (HCQ), a less toxic version of Chloroquine, was approved by the FDA. Over time, HCQ was also found to be effective in relieving the symptoms of rheumatoid arthritis, lupus, and Sjogren's syndrome, an autoimmune disease. Chloroquine and HCQ are both on the World Health Organization's Essential Medicines List and widely used around the globe.

Equity Markets Indices[1]	7/31/20 Price	8/31/20 Price	MTD Change	YTD Change
MSCI All Country World	552	585	6.0%	3.5%
S&P 500	3271	3500	7.0%	8.3%
MSCI EAFE	1820	1910	4.9%	-6.2%
Russell 2000®[2]	1480	1562	5.5%	-6.4%
NASDAQ	10745	11775	9.6%	31.2%
TOPIX	1496	1618	8.2%	-6.0%
KOSPI	2249	2326	3.4%	5.8%
Emerging Markets	1079	1102	2.1%	-1.2%
Fixed Income				
2-Year US Treasury Note	0.11%	0.13%	3	-144
10-Year US Treasury Note	0.53%	0.71%	18	-121
BarCap US Agg Corp Sprd	1.33%	1.29%	-4	36
BarCap US Corp HY Sprd	4.88%	4.77%	-11	141
Currencies				
Chinese Renminbi (CNY/$)	6.98	6.85	-1.8%	-1.6%
Brazilian Real (Real)	5.22	5.49	5.2%	36.3%
British Pound ($/GBP)	1.31	1.34	-2.1%	-0.8%
Euro ($/Euro)	1.18	1.19	-1.3%	-6.1%
Japanese Yen (Yen/$)	105.83	105.91	0.1%	-2.5%
Korean Won (KRW/$)	1191.15	1187.85	-0.3%	2.7%
U.S. Dollar Index (DXY)	93.35	92.14	-1.3%	-4.4%
Commodities				
Gold	1976	1968	-0.4%	29.7%
Oil	40.3	42.6	5.8%	-30.2%
Natural Gas, Henry Hub	1.80	2.63	46.2%	20.1%
Copper (cents/lb)	287	304	6.0%	8.7%
CRB Index	144	153	6.6%	-17.5%
Baltic Dry Index	1350	1488	10.2%	36.5%

Source: Bloomberg

In the wake of the COVID-19 outbreak, some physicians started using Chloroquine and HCQ as treatment since research conducted in 2005 had shown Chloroquine to be effective in curbing the spread of the SARS virus in cell cultures. However, the two drugs soon became political lightning rods after President Trump touted them, later claiming he was taking HCQ as a prophylactic. Many in the medical establishment and, of course, Trump's detractors, dismissed his endorsement of HCQ as dangerous and irresponsible. Their pushback got a huge boost on May 22nd, when *The Lancet*, one of the world's best-known medical journals, published an article which concluded that, based on data provided by Chicago-based Surgisphere Corp covering more than 96,000 COVID-19

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patients, HCQ was not only ineffective, but also deadly in some cases. The influential article quickly put a stop to several large randomized trials of HCQ for COVID-19. A few days later, however, the article was retracted as questions were raised about the validity of the data. The data integrity issue also prompted *The New England Journal of Medicine* to retract a paper that had used data from Surgisphere.

In spite of the retraction, HCQ has remained a polarizing issue. A video of physicians promoting it went viral, prompting major social media sites to block it for alleged misinformation. Dr. Harvey Risch, a respected professor of epidemiology at Yale who advocated the use of HCQ for early-stage COVID-19 infection, was repudiated by fellow professors, some with no medical background. Most of us are obviously unqualified to comment on HCQ's efficacy or the lack thereof in treating COVID-19, but it seems what should have been a medical debate has unfortunately morphed into a political battle with religious fervor.

QUEST FOR THR HOLY GRAIL

While the push for HCQ as a COVID-19 treatment was unsuccessful, President Trump was able to get the FDA to issue an emergency use authorization (EUA) for convalescent plasma therapy right before the Republican National Convention. There are also two monoclonal antibody therapeutics in phase 3 trials that could provide positive readouts in the coming months. However, these are not game changers in the scope of the pandemic; what the world desperately needs is an effective vaccine.

In the race to develop an effective vaccine, Russia got the bragging right by being the first to approve a vaccine called Sputnik V in early August but was widely criticized for not having conducted sufficient safety tests. China has three vaccines in the final stages of human testing across several countries, including Indonesia, Brazil, and the UAE. China's vaccine trials are so widespread that they even vaccinated 48 Chinese miners of a state-owned enterprise a few days before they departed for work in Papua New Guinea, which created quite a controversy in the impoverished island nation. China's state-owned Sinopharm has priced the vaccine at 1,000 yuan ($145) for two doses, but we suspect the vaccine will be used as foreign aid to some of China allies for geopolitical leverage.

Here in the U.S., Pfizer's vaccine, priced at about $40 for a two-dose regimen, has shown strong immunogenicity with mild to moderate fever in fewer than 20% of the participants in the trials. If all goes well, it could seek regulatory review in as early as October 2020. Other phase 3 trials include vaccines from Moderna and AstraZeneca.

With more than 160 entities worldwide working on vaccines for COVID-19, odds favor something safe and efficacious being approved and rolled out in volume by early 2021. What is unclear is how long the immune response triggered by the vaccine will last, and whether we will need regular shots beyond the initial two-dose regimen since the SARS-Cov-2 virus will continue to mutate.

THE CRESCENDO

The news of the FDA approving a COVID-19 vaccine, which may just be a few months away, should be well-received and may trigger another round of equity rally. However, we suspect the historic equity rally of recent months should have already discounted an effective vaccine in 2021, without which the Street's economic and earnings growth projections would have to be slashed materially. As such, after the initial euphoria, the vaccine approval may wind up being a "buy-the-rumor, sell-the-news" catalyst. After all, the highly-anticipated vaccine may mark the crescendo of a string of positive market drivers that started with the Fed's announcement of corporate bond purchases, including the riskiest investment-grade debt, on March 23rd and Congress' passage of the $2 trillion-plus CARES Act a few days later. After the vaccine approval news is digested, it will be hard to find incrementally more positive catalysts to keep on feeding the raging bull market. Investors will instead have to confront a transition period of elevated unemployment and potentially diminishing fiscal stimulus before a sufficient number of people are vaccinated to create the so-called herd immunity that will help get the global economy back on track. In short, it will be interesting to gauge how the equity market transitions from the liquidity-fueled and catalyst-driven rally back to a more "normal" fundamentals-based environment.

THE DEMISE OF VALUE INVESTING?

These are dark days for value investing, and COVID-19 has made things even worse for many beleaguered and demoralized value managers by damaging much of the "old" economy while boosting demand for technology, social media, and online services. On a year-to-date basis, the Russell 3000 Growth Index has gained 29% at the end of August while the Russell 3000 Value Index languished with a 10% loss. The gap is even more pronounced since the start of 2017 – the growth index has generated a cumulative total return of 122% vs. the value index's measly 18%. This persistent performance gap has triggered a vicious downward spiral for value stocks. Frustrated investors pulled money out of value funds and plowed the proceeds into growth and index funds that are dominated by mega-cap growth stocks, which further widened the gaps in performance and valuation. The success of growth stocks also begets more buying due to many investors' fear of missing out (FOMO). Fund managers with large exposure to these winners are also reluctant to sell despite acknowledgement of their elevated valuations. The bigger these stocks' weights in the benchmark become, the harder it will be for active fund managers to bet against them as it would increase their funds' tracking errors. As a sign of the lopsided adulation for growth and loathing against value, various academics and market pundits have been publishing papers supporting growth stocks' elevated valuations and rationalizing the demise of value investing.

The headwind for value investing is that many of the so-called value stocks are in the "old economy" – banks, auto makers, manufacturers, energy producers, etc. They face cyclical challenges such as weak demand, exceedingly low interest rates, and secular threats in regulatory burden on and technological disruptions to their business models. Growth stocks, on the other hand, are associated with the "new economy" and market share gains. Most investors would naturally prefer to own growth stocks than the has-beens.

History, however, has shown these investment styles to go in and out of favor, often in multi-year streaks. Believe it or not, from the inception of the Russell 3000 Growth and Value indices in mid-1995 to the end of 2019, they have generated nearly *identical* annualized total returns: 9.34% for growth and 9.48% for value. During the dot-com bubble era in the second half of the 1990s, the growth index far outperformed value. However, from 2000 through 2005, value investing was in vogue due to the implosion of the dot-com bubble, the housing boom, and the commodity super-cycle. The subsequent four-year period saw growth having an upper hand as the Great Financial Crisis dealt a big blow to the value camp that had a lot of exposure to financial services stocks. The two styles then generated similar returns for the period 2010 through 2016, before growth started to leave value behind in the current streak. The conventional wisdom for favoring growth stocks today, despite their stretched valuations, is that interest rates will likely remain low for long (thereby supporting higher valuations), and growth deserves a large premium for their scarcity value in a recessionary environment. That said, the recent surge in some of the market darlings mirrors the euphoria of the late stage of the dot-com bubble in early 2000.

The availability of an effective COVID-19 vaccine in the coming months may turn out to be the catalyst to finally jump start a value cycle. The premise is that the vaccine should lead to a gradual but sustainable cyclical recovery, an environment that has historically favored value stocks. As the cyclical recovery gains momentum, the market leadership will likely broaden out to include many stocks that are currently trading at levels substantially below their pre-COVID-19 ranges. A similar environment had occurred in 2016, the last time when value stocks outperformed growth. After initial market jitters about the weak growth in 4Q15 and China's currency devaluation, the macro outlook started to improve in early 2016 and the market subsequently rebounded with value stocks leading the way. Trump's surprise electoral victory that November further fueled value stocks' outperformance on the expectation of a stronger economy.

In the final analysis, given the massive runup and stretched valuations among some of the market darlings, we believe it is rational to practice a bit of buy-low-and-sell-high. We are not advocating a large rotation from growth into value, but we believe it is prudent to start harvesting some of the gains and plow the proceeds into laggards that have the potential to rebound in the eventual normalization process made possible by mass vaccination. COVID-19 vaccines may be just what the doctor ordered for the long-suffering value stocks.

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