ProShares 2020 Mid-Year Outlook

June 11, 2020
by Investment Strategy Team of ProShares

Markets Continued Remarkable Recovery – Despite the Pandemic, Tentative Reopening Trade Tensions, and Political Unrest

KEY OBSERVATIONS
The Recovery Continued

The month of May closed with a challenging brew of the lingering pandemic, tentative reopening, trade tensions, and political unrest. Markets, however, continued their remarkable recovery. The month ended with the S&P 500 37% higher than its March 23 low.

A Growth-Driven Market
An unusual aspect of the pandemic-driven sell-off and hope-filled recovery was that growth stocks outperformed during both the sell-off and the recovery. Technology stocks had a lot to do with this outcome, many of which were spared from—or even benefited from—the effects of the lockdown. Regardless of how we got here, growth stocks are now trading at valuation levels not seen since the tech bubble.

U.S. Growth Stocks at a Premium over U.S. Value Stocks
Relative Price-to-Book Ratio of U.S. Equity Growth vs. Value

Source: December 31, 1995 to May 29, 2020. Growth stocks measured by the S&P 500 Growth Index and value stocks measured by the S&P 500 Value Index.

By definition, growth stocks are supposed to be more expensive than value stocks. On average, the price-to-book ratio of growth stocks is well more than double that of value stocks. But this most recent period of underperformance by value stocks has now placed the price-to-book of growth stocks at roughly 3.5 times that of value stocks, a premium exceeded only at the height of the tech bubble.

Is the answer to rotate to value stocks? Value stocks may very well be cheap for a reason. If you remember the tech bubble, many growth stocks were defined by eyeballs on a website, possibly a sock puppet mascot (remember Pets.com?), and speculative growth. Perhaps not today. The S&P 500 Growth Index sports more than triple the return on assets of the S&P 500 Value Index for 2019. And even if the S&P 500 Value Index comes through eventually, long periods of underperformance can make tilting toward value feel a lot like the gambler's dilemma. A better choice may be to consider

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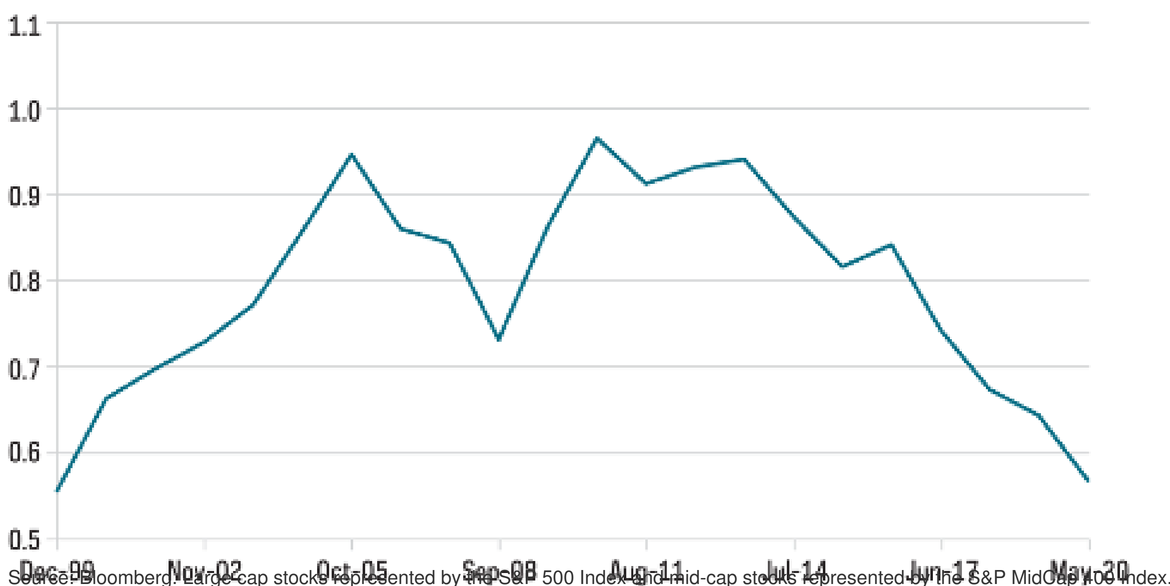
quality metrics of stocks—such as moderate leverage and earnings stability.

In the second installment of ProShares Dividend Viewpoint, we note that low-quality stocks—such as those in the bottom quintile of credit ratings—have seen the preponderance of recent dividend cuts. A high-quality approach, which was defined in our Viewpoint article with regard to credit ratings and individual payout ratios, may be an effective response to today's challenging investing environment for both dividend resiliency and total return. In our equity highlights sections below, we'll dig deeper into the benefits of high quality and how stocks that have consistently grown their dividends can fit the bill.

Mid Caps on Sale
Mid-cap stocks haven't been this cheap relative to large-cap stocks since the end of 1999. What followed was an 11-year period of mid-cap outperformance, where, thanks to the bursting of the mega-cap bubble and the great financial crisis, large caps returned just over 0.5% annualized, while mid caps returned over 7% annualized.

Even after nearly a decade of underperformance following those years of outperformance, mid caps have held nearly a 2% per year advantage over large caps across the last three decades. Not bad for the "forgotten" asset class. So, is it a "no-brainer" to load up on mid caps today? Back to that pesky quality idea... The S&P MidCap 400® does exhibit some lower-quality attributes compared to the S&P 500. One data point—return on assets (ROA), which measures how profitable a company is in relation to its total assets—is 40% lower for mid caps. Here again, consistent mid-cap dividend growers may provide a quality mid-cap alternative for exposure to this often-overlooked slice of the equity markets.

Relative price-to-book ratio of U.S. mid-cap to large-cap stocks (annual from 12/31/98 to present)



Source: Bloomberg. Large-cap stocks represented by the S&P 500 Index and mid-cap stocks represented by the S&P MidCap 400 Index.

A (Partial) Credit Recovery
The Federal Reserve's unprecedented intervention in the corporate bond market, along with the reduction of the Federal Funds Rate to zero, has had a profound impact on the bond market. Investment-grade and high-yield credit spreads have tightened substantially from the early days of the lockdown but remain higher than their long-term averages. Of note, both the investment-grade and high-yield credit curves are noticeably steeper than the U.S. Treasury curve, as of the last trading day of May 2020. We'll unpack the investment implications in our fixed-income highlight section below.

PERFORMANCE RECAP
All green in the month of May.

Returns of Various Common Market Segments

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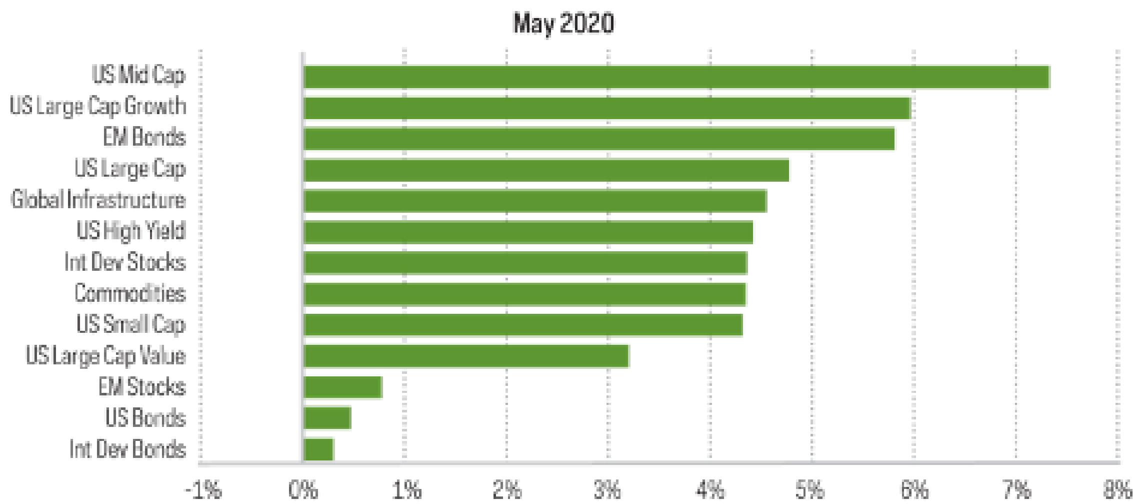

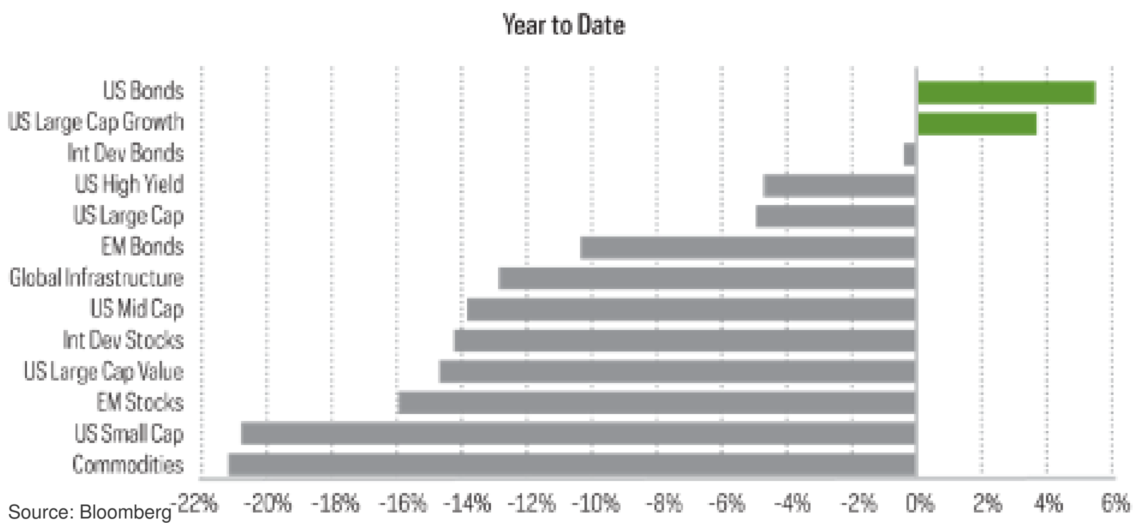

Source: Bloomberg

By Kieran Kirwan, CAIA
Senior Investment Strategist
EQUITY PERSPECTIVES

Do Fundamentals Matter? Q1 Earnings Takeaways
The Q1 earnings season is just about complete (97% of the S&P 500 have reported through May 29), and while it doesn't yet tell us much about the damage from COVID-19 (Q1 included only a couple of weeks of the shutdown), there are still performance lessons to be learned. We came into 2020 with expectations for roughly 10% earnings growth for 2020, which struck many as high, considering growth was trending lower throughout 2019 and had turned negative for Q3.

We noted at the time that dividend growth stocks were well positioned given one key attribute: the relative stability of their earnings, which is something we consider to be an aspect of quality. So, while the impact of the pandemic clearly changed the robust growth expectations, it also serves as a proof point on why stocks with quality attributes like earnings stability and good credit ratings matter—especially in times of market stress.

Q1 earnings show a year-on-year decline of almost 15% for large-cap stocks, and progressively worse results further down

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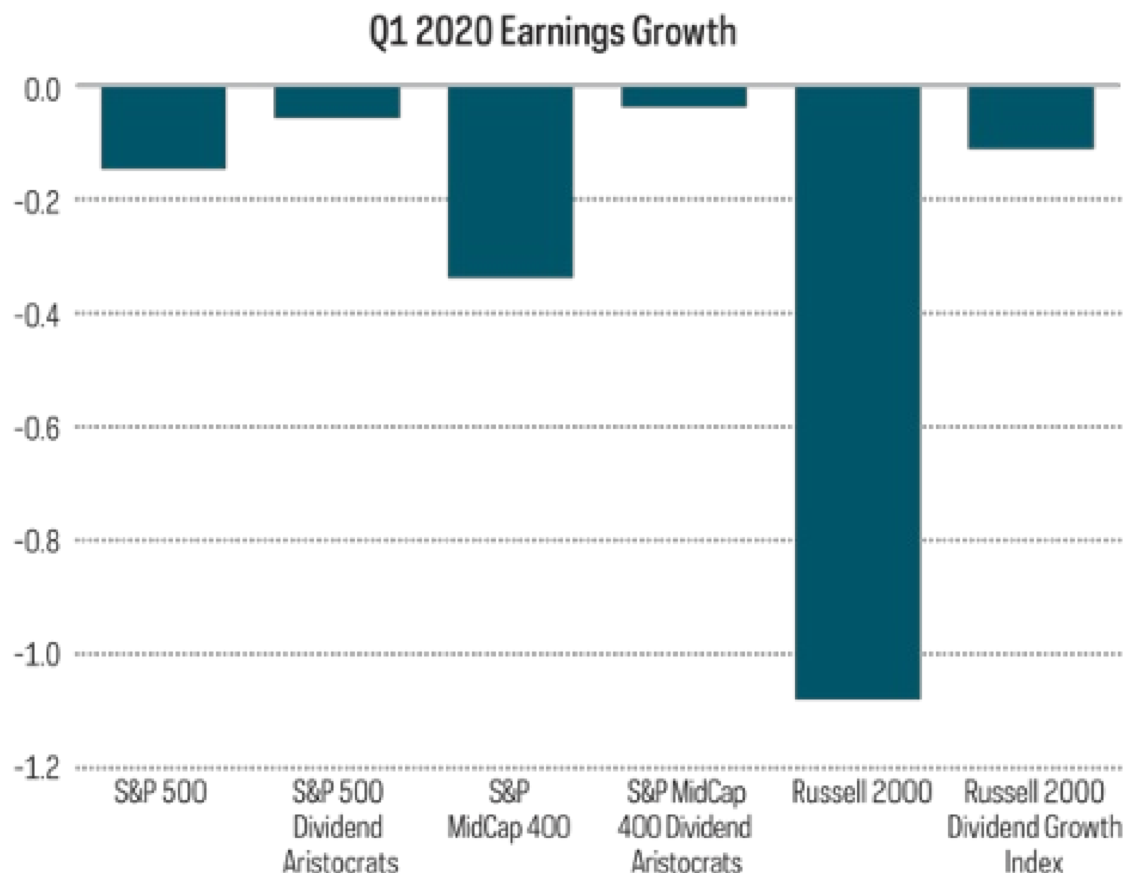
the capitalization spectrum. Again, Q1 accounted for only the initial weeks of the shutdown, so there will be more to learn later. That said, while not immune to economic weakness, quality dividend growth benchmarks have demonstrated notable resiliency in their earnings thus far.*

*As of May 29, 2020, the S&P 500 returned -4.98% year to date, while the S&P 500 Dividend Aristocrats Index, which represents U.S. large cap dividend growth strategies, returned -10.75%.



Source: FactSet

Looking ahead, this earnings resiliency, along with other key attributes of quality such as balance sheet strength and durable business models, may potentially be more important than ever at a time when comparatively few companies are issuing guidance. To date, only 46 companies of the S&P 500 have issued guidance for Q2, an amount well below average, while almost 200 names from the S&P 500 have withdrawn or confirmed their previous withdrawal of fiscal year 2020 guidance.

The Outlook for Dividend Stocks

The question of the sustainability of dividends has drawn much attention since the onset of the pandemic. It’s a fair question to ask, especially since extremely low rates on fixed income have driven many yield-focused investors to equity income strategies. If corporate revenues and earnings are going to be pressured by a muted economic recovery, the logic goes, won’t dividend cuts and suspensions be among the most obvious responses?

Yes and no, it turns out—and there are important distinctions to be made. A company’s ability to make dividend payments is often viewed as being more resilient than its earnings during recessions. As an example, the S&P 500 earnings dropped over 77% in 2008, and many feared similar drops in the following year’s dividends.

2009 dividends also fell, but by a more resilient amount of approximately 20%. In short, total market earnings fell a lot more than total market dividends.

Among the stocks in the S&P 500, there have been approximately 50 negative dividend actions thus far, which are defined as either a dividend cut or a suspension. Somewhat surprisingly, more companies have raised their dividends than cut them. But as the economic fallout becomes clearer, analysts are expecting more companies to announce negative dividend actions.

While it’s still early, the negative dividend actions thus far in 2020 may offer some valuable clues to help investors navigate the minefields over the coming few quarters. Our analysis shows the cuts have been disproportionately found in lower-quality companies (as defined by credit ratings) with higher yields. In fact, 72% of the negative dividend actions thus far

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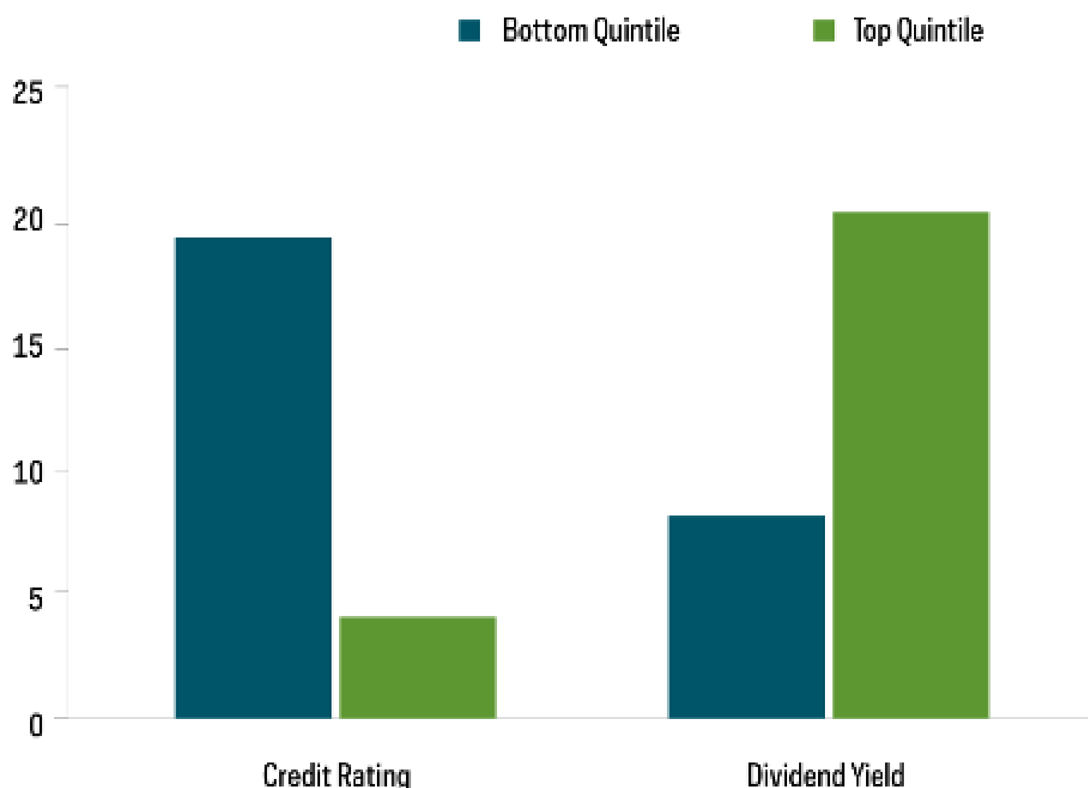
have come from companies in the bottom two quintiles of credit ratings. Over half of the cuts have come from the two quintiles of highest-yielding stocks. This is intuitive, of course, in that higher-yielding stocks tend to be of lower quality and lower-quality stocks generally have the least amount of financial flexibility to sustain a prolonged period of financial stress.

Where's the Risk?
Dividend Cutters by Credit Rating and Dividend Yield 1/1/20-5/11/20



Sources: Bloomberg, ProShares

The upshot here is that investors have a choice in their dividend strategies: investing in companies with relatively high payouts versus those that have grown dividends. Dividend growth companies, represented by the S&P 500® Dividend Aristocrats®, as a group have outperformed the high-yield companies of the DJ US Select Dividend Index—over time and across recent periods which include the pandemic. Looking at underlying quality metrics also reveals a greater portion of the Dividend Aristocrats carry higher credit ratings than the high-yield benchmark, potentially indicating greater dividend stability moving forward.

By Daniel Bush, CFA
Investment Strategy Analyst
FIXED INCOME PERSPECTIVES

Bonds Did Their Job
Bond returns remained positive in the month of May as the equity rally continued. Despite the equity market's dramatic rebound, bonds are still at the top of the leader board in 2020 (as shown in the earlier performance recap chart), having

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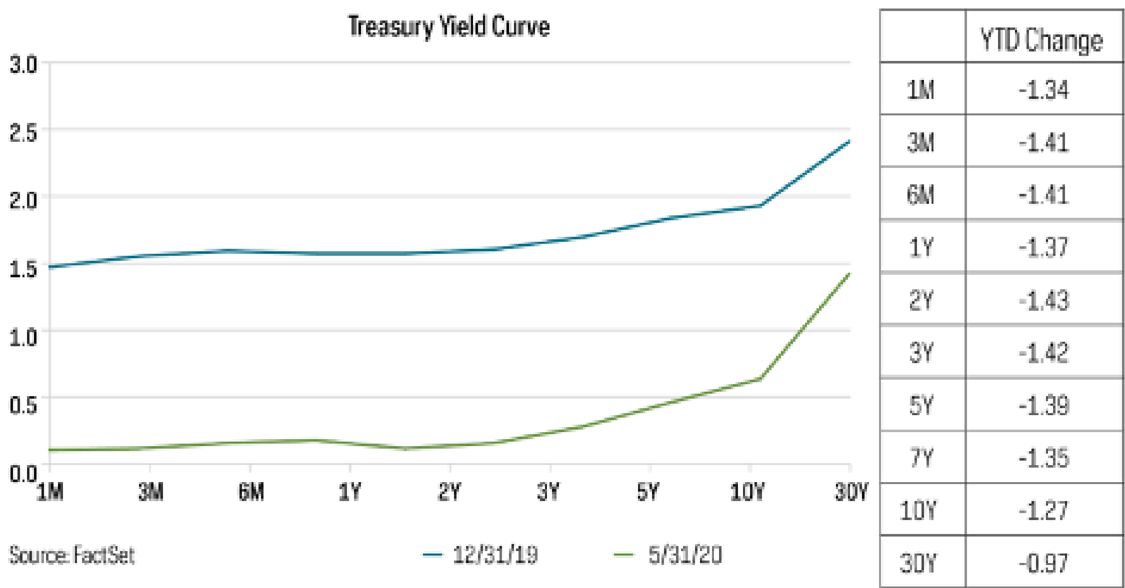
done their job serving as a buffer during the pandemic-driven sell-off. Treasuries, known for being a safe haven for investors, rallied over 5% from February 19 through March 23, while the S&P 500 tumbled nearly 34% in the same period. Interest rates—which fall when bond prices rise—fell across the curve. In fact, every point on the curve has fallen more than 100 basis points (bps), other than the 30-Year Treasury, which has fallen 97 bps year to date.



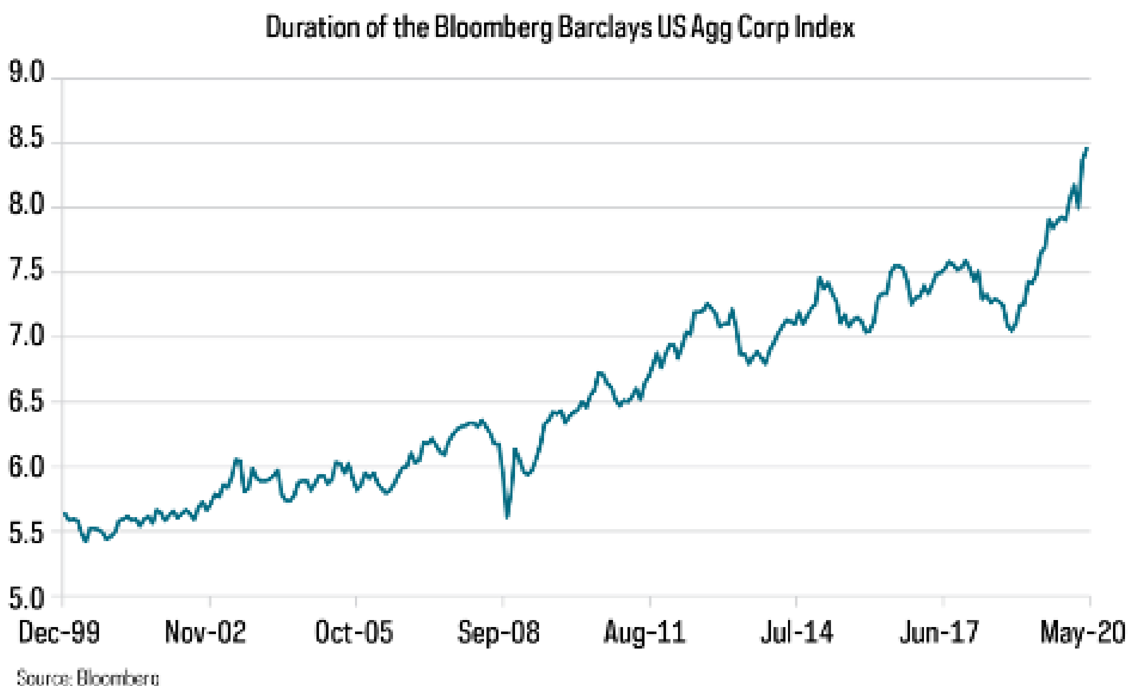
	YTD Change
1M	-1.34
3M	-1.41
6M	-1.41
1Y	-1.37
2Y	-1.43
3Y	-1.42
5Y	-1.39
7Y	-1.35
10Y	-1.27
30Y	-0.97

The Fed Takes Care of Spreads

Interest rates remain near historic lows, but what about credit spreads? Earlier this year, spreads widened dramatically as fears of COVID-19 contagion roared across the globe—that is, until the Fed announced on March 23 that it would move beyond its traditional toolkit and actually purchase corporate bonds. Since that day in March, investment-grade credit spreads have tightened, but remain over 80 bps higher as of May 29 than they were at the start of the year.

Duration—What, Me Worry?

The yield curve remains upwardly sloping. And in a world where interest rates are at historic lows, fixed-income investors may be tempted to purchase longer-term bonds. But what about when rates eventually rise? As shown below, the duration (or interest rate risk) of the U.S. Corporate Bond market continues to tick up and up.



Some may view the possibility that the Fed will engage in yield-curve control as giving the green light to taking duration risk. But most Fed watchers see yield-curve control being deployed in the two- to five-year range and see a strong possibility that interest rates would rise—and prices fall—for maturities beyond five years.

What About Credit?

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As we noted, both the investment-grade and high-yield credit curves are quite a bit steeper than the U.S. Treasury curve. While the difference between 10-year and 2-year Treasury yields is just over 50 bps, the difference between those same maturities on investment-grade BBB bonds is over 150 bps. Those longer-term corporate bonds do come with duration risk. It's notable that the S&P 500 remained down 9.56% by the end of May since the market peak on February 19, while interest rate-hedged investment-grade bonds have performed nearly on par, down 9.57% as measured by the FTSE Corporate Investment-Grade (Treasury Rate-Hedged) Index. One might expect equity markets to be more sensitive to economic downturns than investment-grade credit. This may indicate a good entry point for a position in an interest rate-hedged bond portfolio.

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Source for data and statistics: Bloomberg, FactSet

The different market segments represented in the chart use the following indexes: US Large Cap: S&P 500 TR; US Large Cap Growth: S&P 500 Growth TR; U.S. Large Cap Value: S&P 500 Value TR; U.S. Mid Cap: S&P Mid Cap TR; U.S. Small Cap: S&P U.S. 600 SC TR; International Developed Stocks: MSCI Daily TR NET EAFE; Emerging Markets Stocks: MSCI Daily TR Net Emerging Markets; Global Infrastructure: Dow Jones Brookfield Global Infrastructure Composite; Commodities: Bloomberg Commodity TR; U.S. Bonds: Bloomberg Barclays U.S. Aggregate; U.S. High Yield: Bloomberg Barclays Corporate High Yield; International Developed Bonds: Bloomberg Barclays Global Agg ex-USD; Emerging Market Bonds: DBIQ Emerging Markets USD Liquid Balanced.

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