IN THIS ISSUE

MARKET BRIEF 2
ECONOMY 4
EQUITY 5
FIXED INCOME 6
ALTERNATIVES 7
DISCLOSURES 8

MARKET REVIEW
JUNE 2020

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ECONOMY AND STOCK MARKET DIVERGING PATHS

Over the last couple of months, many market commentators and investors have been scratching their heads as the economy and stock market moved in opposite directions. The U.S. economy appeared to be in free fall due to the COVID-19 lockdown policies for non-essential services, while the stock market experienced a swift rebound that began in late March and has continued mostly uninterrupted into early June. The U.S. unemployment rate spiked to its highest level since the Great Depression at 14.7% in April as tens of millions of Americans lost their jobs. The U.S. economy contracted 5.0% in the first quarter and economists project a 34.4% GDP decline in the second quarter, the largest decline in the post-World War II era. Meanwhile, the S&P 500 surged 12.82% in April, the index's third best month since 1940, and added an additional 4.76% gain in May. Since the market bottomed on March 23, the S&P 500 rebounded 36.59% through the end of May and retraced around 70% of the decline from the recent market peak on February 19. The diverging paths of the economy and stock market in recent months may seem difficult to reconcile, but history shows they do not move in lockstep.

STOCKS DO NOT MOVE IN TANDEM WITH THE ECONOMY

The gap between a contracting economy and rising stock market is often a normal occurrence during recessions. Research from Bloomberg's Chief Equity Strategist Gina Martin Adams on the 14 U.S. recessions since the Great Depression found that stock market lows have preceded the end of the economic recessions by 136 days on average. The 2001 recession was the only outlier where the market bottomed after the recession ended. Excluding 2001, stocks bottomed 170 days on average prior to the end of recessions. One possible explanation for why the market consistently rebounds before the economy is that favorable factors for market rallies are often in place well before recessions end. These factors sometimes include monetary and fiscal stimulus and lower market interest rates.

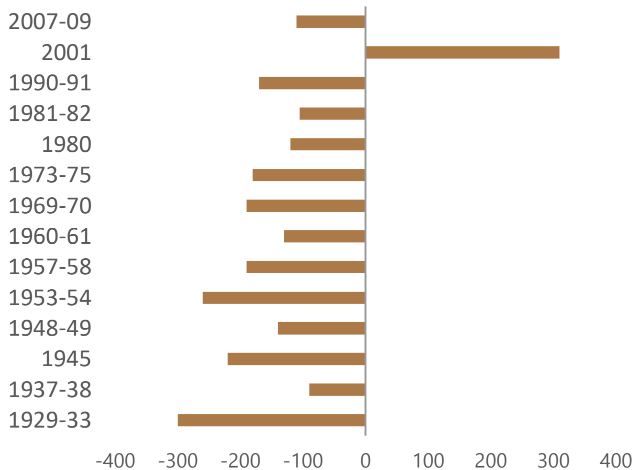
The initial catalysts that helped the stock market bottom in late March appear to be the extraordinary monetary policy measures taken by the U.S. Federal Reserve and the historically large and rapid fiscal stimulus implemented by the U.S. Congress. The Fed's COVID-19 related lending facilities and asset purchases have totaled $2.3 trillion thus far, resulting in an expansion of its balance sheet by 65% to $7.1 trillion. The Fed's unofficial backstopping of the corporate credit market resulted in record bond issuance. Corporations have issued over $1 trillion in debt this year, double the pace of last year. Fiscal stimulus from Congress in the amount of $2.8 trillion is around 13% of U.S. 2019 GDP. The combined programs from the Fed and Congress represent almost 25% of U.S. 2019 GDP. Stocks rallied in response to these aggressive stimulus actions based on investors' expectations that these measures would ease liquidity strains and possibly prevent a worst-case scenario of widespread bankruptcies.

Another factor that likely contributed to the stock market rebounding before the economy is that markets are forward looking in theory, so asset prices should reflect the outlook for both the near-term recession and subsequent economic recovery. Anticipation for an economic recovery grew over the last several weeks amid signs of the slowing spread of COVID-19 and the gradual economic reopenings in many parts of Asia, Europe and North America. In addition, labor statistics showed temporary layoffs have accounted for a significant majority of the massive increase in unemployment since mid-March. The large proportion of temporarily unemployed U.S. workers compared to workers who lost their jobs on a more permanent basis suggests a high percentage may reenter the labor force later this year. An improvement in some economic data reported since late May appears to be providing tentative signs the economy might be advancing toward turning the corner in the coming months.

Bloomberg's Adams has noted the severity of the GDP decline matters less for stocks than the duration of recessions. In the 11 recessions during the post-World War II era, the depth of economic contractions is not correlated with the size of stock market declines. However, market declines and recoveries are correlated with the length of recessions. Shorter recessions typically are associated with smaller market declines and quicker market recoveries. The 2020 U.S. recession is expected to be the shortest recession in the post-World War II era at only 2 quarters long. Thus, the rapid pace of the stock market's rebound in recent months does not seem out of step with market history.

STOCKS REBOUND BEFORE THE ECONOMY

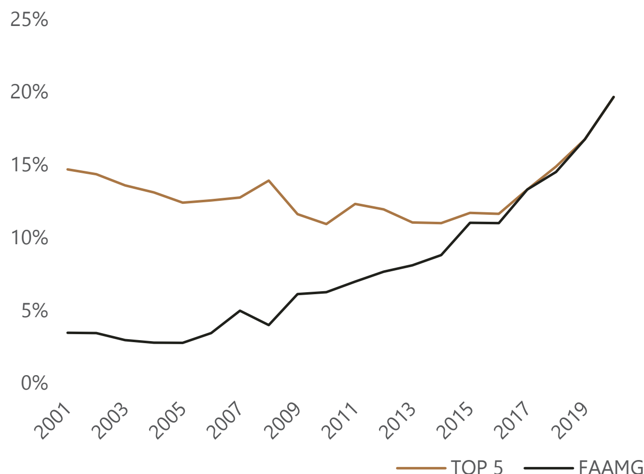
STOCKS LOW RELATIVE TO RECESSION END



Source: Bloomberg
Past performance does not guarantee future results.

S&P 500 LARGEST HOLDINGS

TOP 5 HOLDINGS AND FAAMG WEIGHTS IN S&P 500*, AS OF MAY 2020



Source: Morningstar. Past performance does not guarantee future results.
*FAAMG = Facebook, Apple, Amazon, Microsoft, and Alphabet

THE STOCK MARKET IS NOT THE ECONOMY

The difference in composition of the economy and stock market likely contributes to the decoupling between the two during periods of economic distress. Small businesses are the lifeblood of the domestic economy, but are largely not represented in the stock market. Small businesses generate over 40% of U.S. economic activity and companies with less than 1,000 employees employed 59% of U.S. workers in 2019. The U.S. Small Business Administration defines small businesses as companies with a maximum number of employees ranging from 250 to 1,500, depending on the industry. In contrast, the average S&P 500 company has 51,742 employees. The S&P 500 accounts for 85% of the U.S. stock market's value, and the 100 largest companies in the S&P 500 have an average of 135,010 employees and account for 56% of the U.S. stock market's value.

A comparison of cash on hand indicates that, on average, larger companies have more resources than smaller companies and are better positioned to weather financial hardship. Cash on hand measures the number of days a company can continue to pay its operating expenses with its available cash and highly liquid short-term investments if the company's cash inflows were to stop. J.P. Morgan estimates the median small business' cash on hand is 27 days. Data from Bloomberg shows the S&P 500's median cash on hand is 211 days. This suggests larger companies can keep their business running longer during periods of severe economic distress without needing to obtain additional capital.

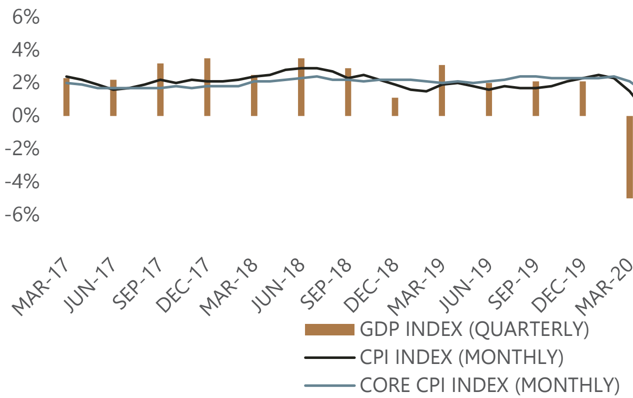
A few notable large capitalization stocks have been especially disconnected from the economy this year. This cohort is commonly referred to as FAAMG and includes Facebook (FB), Apple (AAPL), Amazon (AMZN), Microsoft (MSFT), and Alphabet (GOOGL) which was formerly named Google. FAAMG are the five largest individual components of the S&P 500 by market capitalization, commanding a hefty weight currently around 20% of the index and around 17% of the total U.S. stock market. Each FAAMG member had a positive return this year through May, with an average return of 14.91%. AMZN and MSFT are leading the FAAMG pack with returns of 32.17% and 16.85%, respectively. FAAMG has far outperformed the year-to-date returns of -4.97% for the S&P 500 and -15.95% for the Russell 2000 small cap index which is viewed as being more closely aligned with the actual economy. FAAMG's strong performance was driven by investors' belief that some of these companies are beneficiaries of the current environment as the COVID-19 lockdown measures increased demand for e-commerce, cloud computing, home entertainment, and services to facilitate remote working. In addition to FAAMG, other technology stocks in the S&P 500 Software industry including Adobe (ADBE) and ServiceNow (NOW) are also viewed as beneficiaries of the lockdown measures and have enjoyed strong relative performance as exemplified by the S&P 500 Software industry's 16.11% return this year.

Although the last several months have been confusing for many investors, they will find it useful to remember that history shows stock prices almost always bottom before the end of a recession. An unprecedented amount of monetary stimulus and Congressional relief in March and April most likely prevented widespread corporate defaults and allowed many American companies to furlough instead of permanently separate from workers. This allowed equity market participants to look past ugly economic data and focus on what the recovery would look like once some semblance of normalcy returned. Finally, the disproportionate representation in the S&P 500 of a small group of companies with massive market capitalizations, business models that are not closely tied to economic cycles and significant cash cushions have also been major drivers of the widening gap between strong stock market gains and historically poor economic data.

ECONOMY

GDP AND CONSUMER PRICES

MARCH 2017 THROUGH APRIL 2020

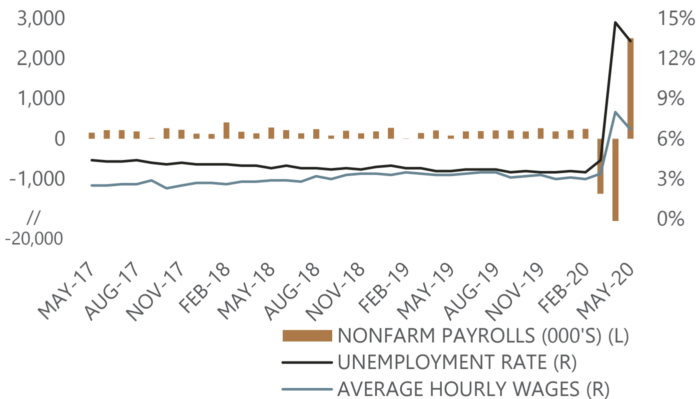


Source: Bloomberg

- U.S. economic growth in the first quarter contracted at an annual rate of 5.0%, slightly steeper than the 4.8% drop first estimated. Consumer spending was marginally stronger than first reported, but fell short of fully offsetting weakness in business investments.
- A potential second wave of COVID-19 later this year and a re-escalation of tensions with China are top concerns. Economists forecast an annualized 34.4% contraction of GDP in the current quarter and an annual contraction of 5.7% for the full year of 2020.
- Consumer prices, excluding food and energy, dropped 0.4% in April, the largest month-over-month decline for the Core Consumer Price (CPI) index since 1957. The apparel and transportation categories were the weakest components of the Core CPI basket in April.

LABOR MARKET

MAY 2017 THROUGH MAY 2020

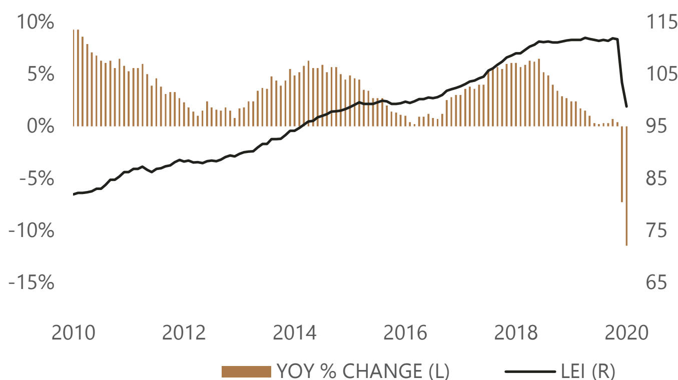


Source: Bloomberg

- One of the biggest surprises in economic data came from the May employment report. According to the Labor Department, the U.S. added a stunning 2.5 million jobs during the month, far exceeding the estimated loss of 8.3 million. This surge in jobs from the 20.7 million lost in April was the largest one-month gain in U.S. history.
- The leisure and hospitality industries accounted for almost half of the jobs gained in May with 1.2 million people returning to work. These areas of the labor market suffered the worst employment shock amid the COVID-19 pandemic amounting to a cumulative 7.5 million lost jobs in March and April.
- The unexpected job gains resulted in the unemployment rate dropping to 13.3% in May from 14.7% in April.

LEADING ECONOMIC INDICATORS

APRIL 2010 THROUGH APRIL 2020



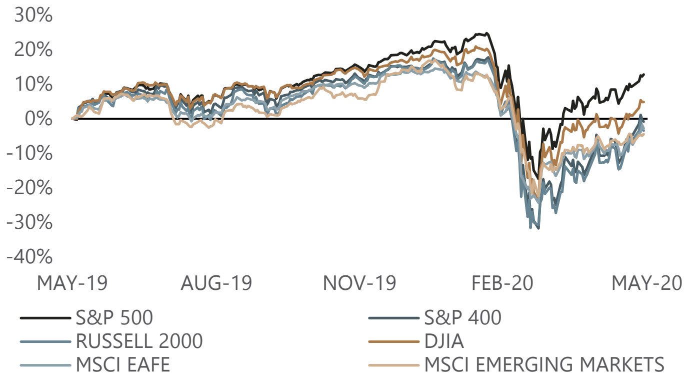
Source: Bloomberg

- The Conference Board Leading Economic Index (LEI), used as a gauge on future U.S. business activity, continued to deteriorate in April after posting the largest decline in the index's history in March. The LEI fell 11.5% from the same period a year ago, and dropped 4.4% in April following a 7.4% decline in the prior month.
- Stock prices and favorable interest rate spreads made positive contributions to the index, much of which was a result of the Federal Reserve's swift response to mitigate the economic impact of lockdown measures and to support financial conditions.
- The breadth and depth of the decline in the LEI suggests headwinds for the prospects of a sharp economic recovery from what is almost certain to be the first U.S. recession since 2008-2009.

EQUITY

TRAILING 12-MONTH EQUITY RETURNS

PRICE APPRECIATION, MAY 2019 THROUGH MAY 2020

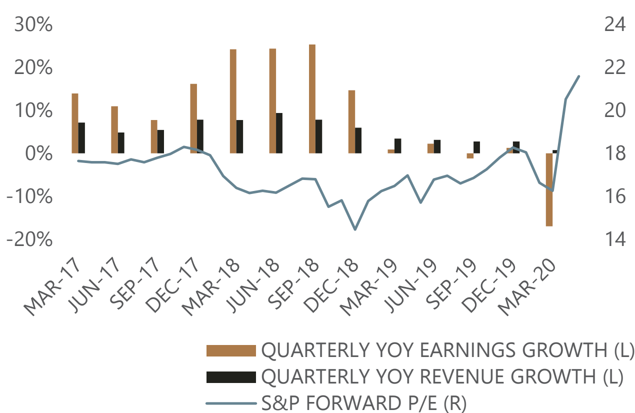


Source: Bloomberg. Past performance is no guarantee of future results.

- April's historic stock market rebound extended into May, as many U.S. equity indexes gained close to 5% or better. Smaller capitalization stocks led the market with the S&P 400 and Russell 2000 rising 7.31% and 6.51%, respectively. Optimism continued among some investors as many states relaxed their lockdown measures and began to experience gradual economic relief.
- The S&P 500 and Dow Jones Industrial Average crossed the psychologically important levels of 3,000 and 25,000, respectively, for the first time since March. The technology sector heavy Nasdaq Composite returned to positive territory for the year after gaining 22.38% over the last two months; it is 3.45% away from its all-time high reached on February 19.

S&P 500 YOY EARNINGS & REVENUE GROWTH

BY QUARTER, MARCH 2017 THROUGH MAY 2020

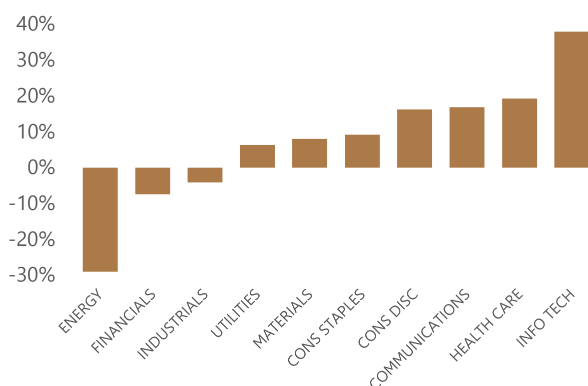


Source: Bloomberg

- First quarter earnings reporting season is almost complete with results reported from 98% of S&P 500 companies. Earnings are on track for a 17.03% year-over-year decline, more than double analysts' initial estimate for an 8.28% decline. Revenue growth of 0.76% is below analysts' estimate for 1.21% growth.
- Consumer discretionary and financials are faring the worst among sectors with first quarter earnings contractions of 68.87 and 40.94%, respectively.
- Analysts forecast the earnings contraction to accelerate in the second quarter with a 43.73% drop followed by declines of 25.31% and 11.87% in the third and fourth quarters, respectively. Analysts project earnings to rebound 25.90% in 2021 after falling 21.88% in 2020, the worst year since 2008.

S&P 500 SECTORS 12-MONTH PRICE RETURNS

MAY 2019 THROUGH MAY 2020



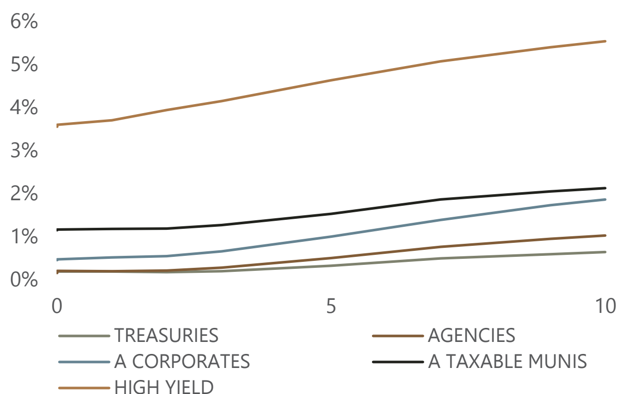
Source: Bloomberg

- All 11 sectors gained for a second consecutive month, in stark contrast with February and March when all sectors declined. Technology once again led all sectors with a 7.05% monthly return, extending its year-to-date advance to a 7.96% return, which is more than 5% ahead of the next best sector, consumer discretionary.
- Strong performance from the technology sector and lagging performance from energy and financials contributed to the S&P 500 Growth index beating the S&P 500 Value index for a fifth straight month. The growth index's 3.67% gain this year is 18.38% above the 14.71% loss for the value index.

FIXED INCOME

CURRENT YIELD CURVES

YIELD CURVES AS OF MAY 2020

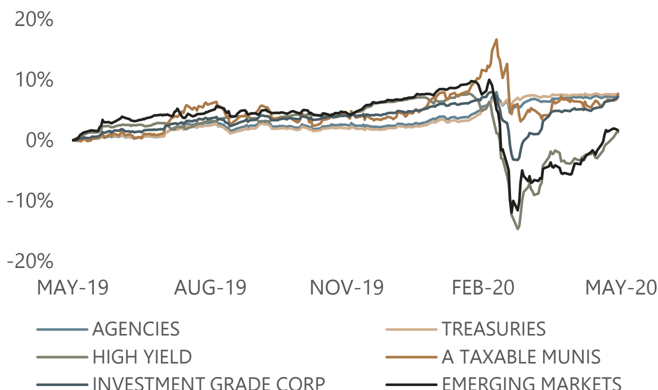


Source: Bloomberg

- In May, U.S. Treasury securities maturing in one year or less and those with maturities of ten years or more experienced an increase in yield. Meanwhile, maturities ranging from two years to ten years experienced a slight decline in yield.
- Yields on below investment grade bonds have increased significantly more than the other bond segments shown in the accompanying chart amid the COVID-19 pandemic. The economic uncertainty related to lockdown measures has led bond investors to favor higher quality corporate credits.
- As was the case in April, single A-rated taxable municipal bonds offered higher yields than single A-rated corporate bonds in May. This likely signals that investors expect the creditworthiness of municipalities to be more adversely impacted by the COVID-19 pandemic than large corporations.

12-MONTH RETURNS, TAXABLE BOND SEGMENTS

MAY 2019 THROUGH MAY 2020

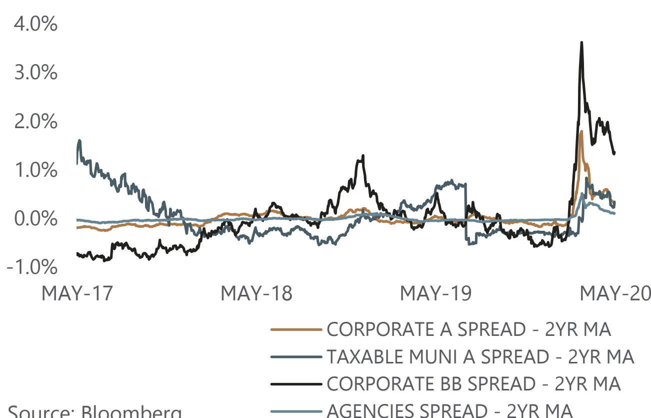


Source: Bloomberg. Past performance is no guarantee of future results.

- The three highest quality fixed income sectors shown (U.S. Treasuries, U.S. Agencies and A-rated taxable Municipals) each generated a return of over 7% during the last twelve months.
- U.S. Treasury bonds and U.S. Agency bonds have set the pace in the bond market over the last twelve months, as indexes representing both have generated a return of approximately 7.7% over the period of June 2019 through May 2020.
- Amid heightened economic uncertainty, the two lowest quality sectors (High Yield and Emerging Markets) generated a more modest twelve-month return of 1-2%.

SPREAD VS. TREASURY LESS 2-YR MOVING AVG

MAY 2017 THROUGH MAY 2020

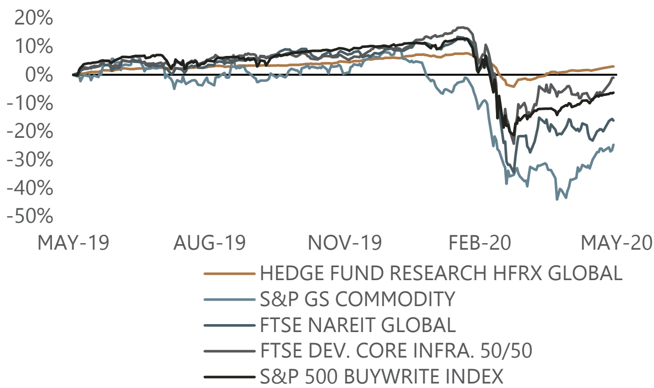


Source: Bloomberg

- The yield spreads to similar maturity Treasury securities for all of the fixed income sectors shown in the accompanying chart remained above their two-year averages as of the end of May.
- As optimism grew about economic reopenings through May, all of the fixed income sectors shown in the accompanying chart experienced spread tightening during the month.
- All of the fixed income sectors shown in the accompanying chart have wider spreads now than they did prior to the onset of the COVID -19 pandemic. BB-rated corporate bond spreads have experienced the most spread widening while agencies have experienced the least.

ALTERNATIVES

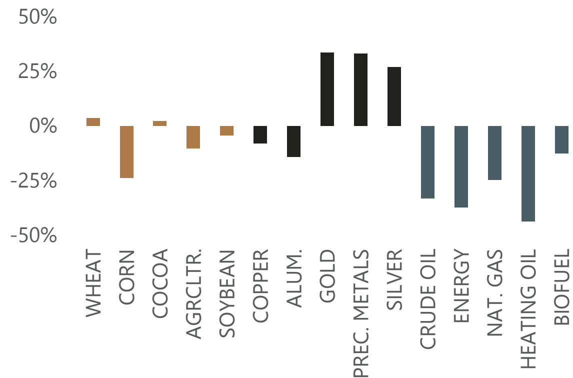
ALTERNATIVES, 12-MONTH RETURNS
MAY 2019 THROUGH MAY 2020



Source: Bloomberg. Past performance is no guarantee of future results.

- The broad trade-weighted commodity asset class, as measured by the S&P GSCI, surged nearly 20% in May, marking its best monthly performance since 2009.
- The S&P GSCI Index's more than 50% exposure to energy commodities was the primary catalyst for May gains, as the price of U.S. crude oil futures active contracts gained more than 60% during the month.
- The global hedge fund asset class has navigated the bear market in global stocks and the recent rally relatively well. The HFRX Global Hedge Fund Index declined 4.3% from the U.S. stock market peak of February 22 through May 31 compared to a loss of 10.2% for the Russell 3000 Index over the same period.

COMMODITIES, 12-MONTH SPOT RETURNS
MAY 2019 THROUGH MAY 2020



Source: Bloomberg. Past performance is no guarantee of future results.

- After suffering dramatic declines in March and April, global crude oil prices rallied in May amid expectations for increased demand related to the ongoing gradual reopenings of many countries from COVID-19 lockdowns.
- Favorable supply dynamics also helped oil bounce back in May. Voluntary production cuts from OPEC and its allies combined with involuntary production reductions driven by financial stress in the U.S. shale space further created an improved supply backdrop.
- While gold advanced 2.6% in May to continue its impressive two-year rally, silver prices surged 19.4% against a backdrop of supply disruptions related to lockdowns in major silver producing countries including Peru and Mexico.

ATG Trust Company
1 South Wacker Drive, 24th Floor
Chicago, Illinois 60606
atgtrust.com

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There are risks involved with investing including possible loss of principal and the value of investments and the income derived from them can fluctuate. Investing for short periods may make losses more likely.

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