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Amadeus Wealth Alternatives
Your Compass to Alternative Investments

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In this week's recap: Stocks power higher, while the Dow makes a few changes.

Weekly Economic Update

Presented by Edward Papier, CIMA® CFF, August 31, 2020

THE WEEK ON WALL STREET

Stocks advanced relentlessly last week on positive COVID-19 developments, encouraging economic data, and a supportive policy shift in the Fed's approach to its target inflation rate.

The Dow Jones Industrial Average increased by 2.59%, while the Standard & Poor's 500 jumped 3.26%. The Nasdaq Composite index leaped 3.39% for the week. The MSCI EAFE index, which tracks developed overseas stock markets, rose 1.19%.[1-3]

STOCKS POWER HIGHER

Investors pushed stock prices higher all week as hopeful news came with each new day, from the announcement of a potential treatment for COVID-19 to news that U.S. and China negotiators had met by videoconference. Despite another high new jobless claims number, other economic data released during the week indicated a continuing economic recovery, further supporting investor enthusiasm for stocks.[4]

The Fed's announcement of a shift in its inflation policy, which suggested that rates are likely to remain low for a long time, helped push the market higher. The momentum carried over into Friday, leaving the S&P 500 and NASDAQ Composite at new record highs and the Dow Jones in positive year-to-date territory.[5]

CHANGES IN THE DOW INDUSTRIALS

It was announced last week that the Dow Jones Industrial Average will be undergoing some changes. Starting Monday, August 31, Salesforce.com, Amgen, and Honeywell International will be added to the 30 stocks in the Dow Industrials and Exxon Mobil, Pfizer, and Raytheon Technologies will be removed.[6]

In part, these changes were prompted by Dow-component Apple, which plans a four-to-one stock split on Monday, August 31. The Dow Jones Industrial Average is a price-weighted index, and Apple's split reduces the impact of technology on the index. The new changes are an attempt to mitigate that issue.[7]

THE WEEK AHEAD: KEY ECONOMIC DATA

Tuesday: ISM (Institute of Supply Management) Manufacturing Index.

Wednesday: ADP (Automated Data Processing) Employment Report. Factory Orders.

Thursday: Jobless Claims. ISM (Institute of Supply Management) Services Index.

Friday: Employment Situation Report.

QUOTE OF THE WEEK

"Fed bugs are people with a faith-based belief in the power of central banks (and central bankers) to engineer economic growth using "monetary policy," despite decades of history and current evidence to the contrary."

JEFF DEIST

Market Index	Close	Week	Y-T-D
DJIA	28,653.87	+2.59%	+0.40%
NASDAQ	11,695.63	+3.39%	+30.35%
MSCI-EAFE	1,902.25	+1.19%	-6.61%
S&P 500	3,508.01	+3.26%	+8.58%

	Treasury	Close	Week	Y-T-D
	10-Year Note	0.74%	+0.11%	-1.18%

Sources: The Wall Street Journal, August 28, 2020; Treasury.gov, August 28, 2020
Weekly performance for the Dow Jones Industrial Average, Standard & Poor's 500 Index, and NASDAQ Composite Index is measured from the close of trading on Friday, August 21, to Friday, August 28, close. Weekly performance for the MSCI-EAFE is measured from Friday, August 21, open to the Thursday, August 27, close. Weekly and year-to-date 10-year Treasury note yield are expressed in basis points.

OF NOTE

For a number of years now we've been familiar with an alternative investment referred to as Structured Notes. We were never enamored of them as we were under the impression they were simply vehicles created by the large banks to extract fees which couldn't be ascertained. We have however recently become more enamored of them, since Amadeus now has a relationship with an intermediary firm which has created a competitive marketplace for these investments, permitting us to choose among the best quotes offered by the many participants. Here's an introduction to Structured Notes:

Structured notes are referred to as notes as they are debt obligations of the large banks, Citibank, JP Morgan, Credit Suisse, etc., and as such, if these entities go bankrupt, the issuers could default on the notes since they back them. So, if you think there's a possibility the issuing bank can go belly up, these vehicles wouldn't be appropriate for you to invest in.

When positioned correctly, Structured Notes can be a good "bridge to the risk gap" in portfolios. Structured Notes are investments designed to offer investors a level of downside investment protection against market declines, while still allowing investors to participate in upside market appreciation. With markets once again at all-time highs, their timing couldn't be better.

When considering Structured Notes, it is important to understand how they are created. A Structured Note is a "wrapper" containing a zero-coupon bond and an options package, Puts and Calls, which are bought and sold. To reiterate, both the options and the bond are obligations of the issuer; it is therefore critical to be comfortable with the issuer, like with any bond you buy, before purchasing a Structured Note.

Structured notes can be explained by breaking them down into four simple variables:

1) Maturity – Every Structured Note has a maturity date, similar to a bond. Typical maturities range from 1-5 years.

2) Underlying or Reference Asset – The Structured Note's performance is linked to the price return of an underlying, or reference asset. The most common Structured Note underlyings include stock indices, like the S&P 500 for example, individual stocks, or ETFs.

3) Payoff – This is what the investor receives at Maturity. Payoffs generally come in two forms: Growth or Income Notes. With Growth Notes, investors receive a percentage of the price appreciation of the Underlying Asset at maturity. With Income Notes, investors lock in a "fixed annual return" that gets paid out quarterly, similar to how a bond yield works.

4) Protection – This is the primary reason why investors use Structured Notes. With almost all Structured Notes, they come with a level of downside investment protection, meaning at Maturity, as long as the Underlying is not down by more than the Protection amount, the investor gets his or her full principal back.

At this point you may be thinking, "I can get downside market protection with enhanced upside? What's the catch?" Clearly, there is an opportunity cost attached to buying a Structured Note because you can't simply get protection and enhanced upside without sacrificing something. With Structured Notes, that "something" is the dividend. Structured Notes are linked to the price return of the Underlying Asset exclusive of its dividend. Bonds and options do not produce dividends.

The vast majority of Structured Notes issued are linked to major indices and ETFs, a simple reflection of the standard portfolio most clients hold. Most notes issued also fall into one of two types: growth notes and income notes.

1. Growth Notes – A growth note's upside return is explained by its "participation rate." A very common example would be a 5-year growth note linked to the SPY. It might have a 150% participation rate and 30% downside protection. At maturity in 5 years, if SPY is up 50% the note would return 50% times 1.50 (the participation rate) or 75%, while if the SPY drops 40% the note would only participate in the 10% of losses realized below the 30% level of downside protection.

2. Income Notes – An income note has a fixed coupon, so it will not participate in upside returns the way a growth note will. However, an income note can produce impressive returns even if the underlying asset return is negative over the term of the Note. Income notes have a protection level for both the principal invested as well as the coupon payments. If an income note has, for example, a 30% coupon protection level then coupons will be paid as long as the underlying asset hasn't fallen more than 30% at each payment date, often semi-annually. An income note on SPY might theoretically have an 8% annualized coupon with 20% coupon protection. If SPY spends all of 2020 trading sideways, sometimes slightly positive and sometimes slightly negative, that 8% coupon will be paid out 2% each quarter, thus producing equity linked income where owning SPY outright fails to do so. By utilizing a combination of growth and income notes, you could diversify the return profile in the equity portion of your portfolio.

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Know someone who could use information like this?

Please feel free to send us their contact information via phone or email. (Don't worry – we'll request their permission before adding them to our mailing list.)

CITATIONS:

1. The Wall Street Journal, August 28, 2020
2. The Wall Street Journal, August 28, 2020
3. The Wall Street Journal, August 28, 2020
4. CNBC.com, August 27, 2020
5. CNBC.com, August 27, 2020
6. The Wall Street Journal, August 24, 2020
7. CNBC, August 20, 2020

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The Wall Street Journal, August 28, 2020
The Wall Street Journal, August 28, 2020
treasury.gov, August 28, 2020