JUNE 30, 2018

Strategic Investment Group®

Market Commentary

» GLOBAL MARKET REVIEW

» OUTLOOK & STRATEGY

» SPECIAL TOPIC

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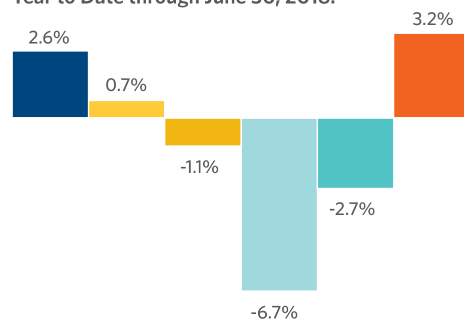
Summary

After a volatile start to the year, global equity markets returned to relative calm. U.S. equities managed modest gains in the first half of the year, while non-U.S. and in particular emerging equity markets lost ground. Global bonds generally declined, with only the U.S. high yield sector managing a small gain. Global growth remained strong, but there were signs of divergence. The U.S., buoyed by a pro-cyclical fiscal stimulus, experienced a pick-up in growth, while Europe and China showed signs of slowing. Monetary policies reflected this divergence, with the U.S. firmly on a tightening path, while central banks in Europe and Japan remained easy, contributing to an appreciation of the U.S. dollar.

EXHIBIT 1:
Performance of Major Market Indices
Source: Bloomberg
Year to Date through June 30, 2018.



U.S. equities outperform non-U.S. markets.

- Trade-Weighted $
- Non-U.S. Gov't. Bonds
- U.S. Gov't. Bonds
- MSCI Emerging Markets
- MSCI EAFE
- Russel 3000

Uneven U.S. Equity Gains

Following the volatility spike in February that saw a sharp but short-lived plunge in U.S. stock prices, markets were largely range-bound. Supported by strong earnings growth, an increasing pace of economic output, and relatively easy financial conditions, the Russell 3000 index rose by 3.2% in the first half of the year. These relatively modest returns, coupled with robust corporate earnings growth, contributed to an improvement in equity valuations, reducing the degree of market overvaluation.

There was a marked divergence of performance within the U.S. equity market (Exhibit 2). Growth stocks generated strong gains, outpacing the broader market by a wide margin, while value stocks declined. Small cap stocks handily outperformed their large cap counterparts and the broader market. Across sectors, technology and consumer discretionary shares generated especially strong gains, while telecom stocks suffered the steepest losses. The performance of a relatively small number of growth stocks—Facebook, Amazon, Netflix, and Google, or FANG—continued to account for the bulk of the broader market's gains. Trade tensions contributed to the relative underperformance of the shares of U.S. companies with high levels of revenue from China.

Non-U.S. Equities Stumble

Developed and emerging non-U.S. equity markets lost ground, with emerging markets falling sharply. The MSCI World ex-U.S. Index of developed stocks fell 2.6% in U.S. dollar terms in the first half of 2018. Both European and Japanese markets declined, reflecting in large part the

appreciation of the U.S. dollar. The shares of European and Asian automobile manufacturers underperformed the broader market, reflecting the prospect of higher U.S. tariffs on car imports.

Mounting trade tensions, a strengthening U.S. dollar, the prospect of reduced access to external financing, and concerns over the Chinese economy sent emerging markets sharply lower. These tensions exposed pockets of instability among emerging markets, including Argentina (that resorted to emergency IMF financing), and Turkey (that faced a plunging currency and mounting inflation, and fiscal and external deficits). The MSCI Emerging Markets Index fell 6.7% in the first half of the year, with newly added Chinese shares leading the decline (Exhibit 3).

Central Bank Policies Diverge, Bonds Fall

The Fed raised rates once more in June, bringing the target Fed Funds rate to 1.75% - 2.0%, and indicated that there would be two further rate hikes this year. The Fed's preferred indicator of inflation reached the target of 2%, while incipient wage pressure from a tight labor market and the large fiscal stimulus to an economy already operating above capacity pointed to increased inflationary pressure. Monetary policy in Europe and Japan, in contrast, remained easy, and was likely to remain so in the face of slowing growth.

Against this backdrop, U.S. Treasury securities declined by less than one percent in the first half of the year, and the yield curve flattened further, with the spread between the 2-year and 10-year U.S. Treasury note touching its post-GFC low (Exhibit 4). The decline of non-U.S. developed government bond markets was about double that of the U.S. Treasury market, while emerging government bond markets suffered the steepest decline, with the EMBI Global Index falling 5.3%. In the credit markets, U.S. investment grade credit fell, led by the long end of the maturity spectrum, while the high yield sector was the lone bright spot, gaining less than a quarter of a percent.

Hedge Funds Disappoint

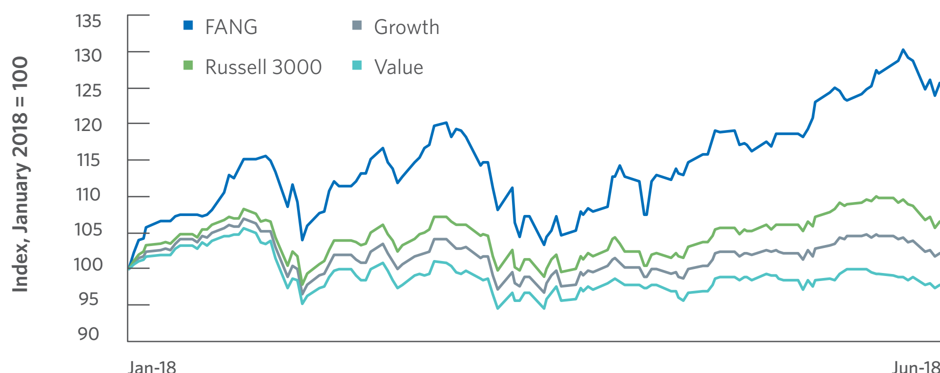
Overall hedge fund returns were lackluster. The HFRX Equal Weighted Index fell 1.1% in the first half of the year. Relative value strategies were the best performers among index constituents. Increased equity market dispersion helped equity market neutral and equity long short strategies, which also managed small gains.

EXHIBIT 2:

Divergent U.S. Equity Market Performance

Source: Bloomberg, and Strategic calculations

Year to Date through June 30, 2018.



Facebook, Amazon, Netflix, and Google dominate gains.

Real Assets Rise, Led by Oil

Real assets rose, led by a commodity rally fueled by oil prices. The GSCI commodity index gained 10.4% in the first half of the year led by a gain of 22.7% for the GSCI All Crude component of the index, as OPEC announced a more modest increase in production than previously expected. Real estate returns moderated, with the NCREIF Open-End Funds Core Index (reported with a quarter delay) gaining 7.1% in the 12 months ended March 2018, with the bulk of this gain reflecting income growth rather than price appreciation. While property fundamentals remain solid, compressed spreads between real estate and bond yields point to a vulnerability to rising interest rates. TIPS registered a slight gain of less than a quarter percent as real yields fell modestly.

Private Equity Returns Remain Robust

The Thomson Reuters/Cambridge Index of U.S. private equity investments gained 16.7% in the 12 months ended in December 31, 2017 (data reported with a six-month delay). While the pace of fund-raising remains strong and the industry remains awash with capital, investment activity does not appear excessive. However, LBOs are priced to perfection, with multiples near record levels.

EXHIBIT 3:

Chinese Equities Lead Emerging Markets Lower

Source: Bloomberg

Year to Date through June 30, 2018.

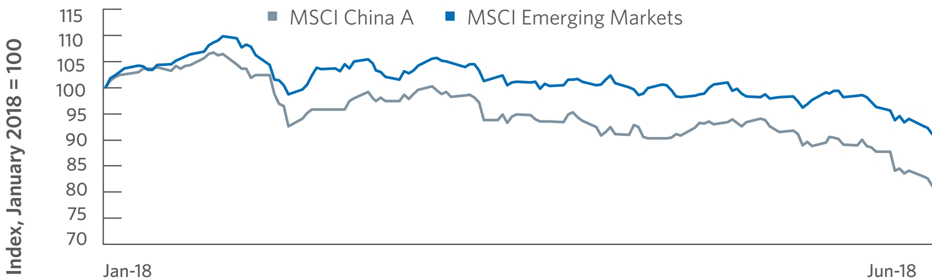
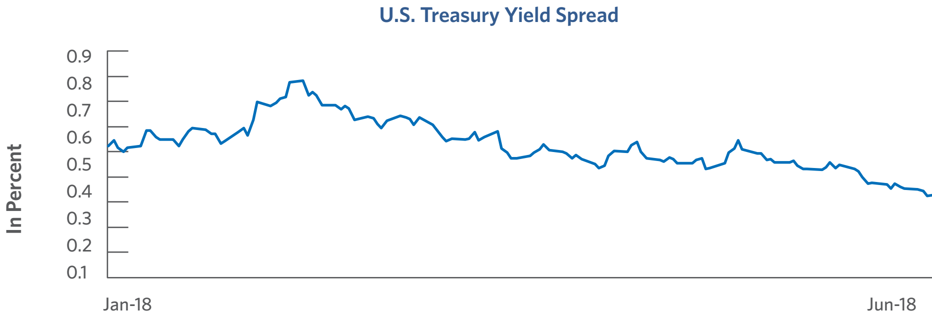


EXHIBIT 4:

U.S. Treasury Yield Curve Flattens Further

Source: Bloomberg

Year to Date through June 30, 2018.



Summary

Our 2018 half-time report reveals a more complicated investment environment. Last year's near-uniform advance of economic growth and risk assets has given way to diverging economic and market performance. Global growth remains robust, but is showing signs of plateauing. However, we do not see any signs of an imminent recession, but are carefully tracking the risk of escalating trade tensions. Our portfolio posture remains slightly conservative, combining equity and fixed income underweights with a hedge fund overweight.

Still Robust After All These Years?

The global economic backdrop remains robust even though the near-perfect combination of strong and synchronized global growth and low inflation is beginning to fray. Growth rates have started to diverge and inflation has been picking up.

In its recent World Economic Outlook Update, the IMF forecasts global growth in both 2018 and 2019 at a solid 3.9%, after 3.7% in 2017. However, growth rates have started to diverge, with strong fiscally driven acceleration in the U.S. and lower growth in Europe, Japan and China. In emerging markets, Latin American growth is likely to accelerate, while emerging Europe is expected to decelerate sharply.

As the global economic cycle is maturing and economic slack is burning off, inflation pressure is building. In the U.S. the Fed's price gauge is now right at its 2 percent target, while inflation indicators elsewhere are picking up in response to strong growth and higher energy prices.

The inflation trajectory will ultimately determine the speed at which central banks drain liquidity in the quarters to come. The Fed has arguably fallen behind the curve and is now leading the charge with seven interest rate hikes since December 2015. In June, the FOMC raised the medium-term target for its policy rate and is now signaling two additional rate hikes in 2018 and three in 2019. The ECB, in turn, has announced that it will curtail its quantitative easing program by the end of this year, while deferring rate hikes until the second half of 2019.

Tighter monetary and financial conditions will gradually erode the nearly decade long tailwind for the global economy and risk assets. We believe, however, that this final stage of the cycle could last longer than many expect. First, the unwinding of accommodative policies is proceeding more slowly than in previous cycles. Second, monetary tightening is being accompanied by a pro-cyclical fiscal policy in the U.S. and efforts by Chinese policymakers to keep Chinese growth on a stable trajectory. Both economies combined currently account for about half of global economic growth.

Assessing Geopolitical Shocks

Concerns about a global trade war and fears that an Italian exit from the euro would trigger a renewed Eurozone financial crisis have brought geopolitical risks to the fore. Research has shown, however, that while potentially disruptive over the short-term, most geopolitical shocks leave little lasting impact.

One study by Jeremy Siegel in *Stocks for the Long Run*, examines a long list of geopolitical events spanning a century of presidential elections, assassinations, wars, terrorist attacks, and other calamities. Siegel concludes that geopolitical shocks typically generate short-lived market turbulence, with little lasting impact on equity returns over the long run.

Among geopolitical shocks, the most potentially damaging are those that have a direct transmission channel to the global economic and financial system. When such a direct link is present, the risk of lasting damage increases.

Given the tight linkage between economic and global trade growth, we are concerned that a full-fledged trade war could create lasting damage. As explored more fully in this quarter's Special Topic, estimating the ultimate impact of the current bout of "tit for tat" trade measures is difficult in light of the uncertain range of products and countries affected, the scope of retaliation, the possibility of non-tariff responses, and the complex linkages created by global value chains and multinational companies. The inherent uncertainty of the ultimate extent and impact of increased tariffs poses a significant potential risk.

We are less concerned, in contrast, about the rise to power in Italy of a populist party with strong anti-euro views. As evidenced by a recent Eurobarometer poll, Italian supporters of the euro outnumber opponents by 2:1. Moreover, the ability of the EU authorities to cope with potential crises has vastly improved.

U.S. Assets Remain Expensive

Markets continue to reflect the post-crisis decade of extraordinarily low interest rates and abundant liquidity across the globe. Most risk assets are expensive, or at best fairly valued.

U.S. stocks remain overvalued by more than one standard deviation relative to long-term fair value. However, extraordinarily strong earnings growth and multiple compression in the U.S. have slightly narrowed the valuation gap to major non-U.S. markets which, according to our valuation metrics, remain within one standard deviation of fair value.

U.S. fixed income markets remain significantly overvalued. Real and nominal 10-year U.S. Treasury yields are in the 13th and 19th percentiles, respectively, of their long-run frequency distributions. Market expectations for short rates have finally begun to converge toward that of the Fed. However, the term premium remains quite low and represents the Treasury market's Achilles Heel. Rising inflation uncertainty and declining Treasury demand from both foreign investors and the Fed are likely to push the term premium and thus bond yields higher. Corporate bonds are also expensive. Spreads across the credit spectrum are about one standard deviation below their long-term average. Bond markets outside of the U.S. also appear overvalued, with negative yields still prevalent in Europe and Japan.

Real estate returns moderated in 2018 and have largely been driven by earnings growth rather than price appreciation. Real estate fundamentals are solid as tenant demand remains strong. Moreover, the market is supported by a diversifying combination of regional markets and multiple sectors driven by a varied set of fundamentals. Nevertheless, capitalization rates remain compressed, increasing the risk of repricing in the event of rising interest rates.

Private equity managers have benefited from a flood of investor capital, leading to record amounts of dry powder available for investment. While this level of new capital counsels caution, especially in certain segments of the market, middle market private equity investments remain relatively attractive.

Is It Time to Recession Proof Portfolios?

Of the 47 U.S. recessions recorded since 1802, 43 were preceded or accompanied by sizable stock market declines. With post-World War II stock market peaks leading business cycle peaks on average by only 5 months, any medium-term recession forecast should therefore be of concern to equity investors.

We previously reviewed the usefulness of the U.S. Treasury curve as a leading recession indicator. Analysis by the San Francisco Fed supports its predictive value, finding that in the past 60 years an inverted yield curve has invariably been followed by an economic slowdown and, except for once, by a recession. A simple rule of thumb predicts a recession within two years of a yield curve inversion.

Combining the two timing rules of thumb suggests no imminent recession likely to create a distinct macro risk to equities. While the U.S. yield curve has flattened substantially, it has not yet inverted. It is the inversion, not just curve flattening, that signals a recession.

Where to Take Active Risk?

Th logic underpinning our recent allocation decisions remains intact. We respond to valuation signals and are currently not guided by macro or geopolitical considerations. Overvalued U.S. stocks call for a modest underweight, partially against cash and partially against non-U.S. equities, which are more attractively priced. In light of overvalued U.S. Treasuries and tight credit spreads, we maintain portfolio duration well below benchmark and a modest underweight to credit risk. With real yields in the lowest historical quintile, we reaffirm our TIPS underweight, while keeping commodities and the real estate allocation at benchmark.

With the bulk of the post-GFC liquidity surge behind us, we expect returns of risk assets to moderate. In such an environment, active returns from bottom-up security selection decisions by our managers are particularly valuable. Hedge funds, as the purest way to access this skill-based alpha, should particularly benefit from the recent increase in price dispersion within asset classes and a gradual increase in overall market volatility. We therefore confirm our overweight allocation to hedge funds.

Tit for Tat Trade Tiff

In the broad sweep of human history, nothing has contributed more to the advancement of the material condition of humanity than trade. If this seems like hyperbole, consider the immiserating impact of its opposite, autarky, a state in which each economic entity must be self-reliant, producing by its own devices all of the necessities of life. The progress in trade liberalization since WWII, which saw the steady decline of tariffs and non-tariff barriers, is now being dismantled by its erstwhile chief architect with uncertain short and long run ramifications for growth, inflation, and financial market stability.

Tariffs in the Broader Policy Context

The tariffs being imposed across an expanding set of imports and countries should be seen in the context of other U.S. economic policies, as there are conflicting crosscurrents.

Fiscal policy is procyclical, adding substantial stimulus to an economy operating above capacity in the wake of an ongoing recovery that is already the second longest in U.S. history. Monetary policy, in contrast, is tightening and likely to become increasingly contractionary in the face of very low unemployment and incipient wage and price pressure. The stimulus from the recently enacted tax cut will likely speed the pace of monetary tightening.

The expansionary fiscal stance will widen the current account deficit, notwithstanding higher tariffs, by increasing the demand for imports. The combination of expansionary fiscal policy and tightening monetary policy is likely, as it has in the past, to lead to an appreciation of the dollar. Any such appreciation would also tend to widen the current account deficit by reducing the competitiveness of U.S. exports, while encouraging imports.

Impact of Protectionism

Calibrating the impact of higher tariffs is complicated and any projection is subject to a great deal of uncertainty. The policy crosscurrents outlined above complicate the analysis as they are likely to offset at least part of the impact of tariffs. The ultimate scope and level of tariffs imposed by the U.S. is uncertain as new measures are announced with almost daily regularity. The extent of the retaliatory measures taken by trading partners is also unknown. The impact of the specter of a trade war on confidence represents the biggest wild card, as a marked deterioration in sentiment would dwarf the direct impact of tariffs alone. Moreover, existing models have a limited ability to capture the impact on individual sectors as global supply chains are disrupted. Finally, short-term data are likely being distorted by avoidance measures that have led to stockpiling in anticipation of the imposition of tariffs. All of these reasons suggest that forecasts of the impact of tariffs should be taken with a grain of salt.

A recent analysis by the IMF considers already adopted tariffs on aluminum (10%), steel (25%), and on $50 billion worth of imports from China (25%), announced tariffs of a further 10% on $200 billion of Chinese imports, car tariffs (25%), comparable retaliatory measures by the affected parties, as well as a confidence shock. Since this analysis was undertaken, the U.S. has said that it might impose tariffs on all Chinese imports, totaling $500 billion. The IMF analysis suggests a short-term loss of global GDP growth of 0.5% from a baseline projection of 3.9%. The U.S. economy, which as the focal point of retaliatory measures is the hardest hit, would lose 0.8% from the baseline projection of 2.7% GDP growth. All

countries lose under this scenario, but the impact outside of the U.S. is partially mitigated by the redirection of trade away from the U.S. as corporations take steps to avoid tariffs.

While its short-run impact is significant, the IMF scenario is not expected to trigger an economic downturn. The impact on particular sectors could be quite significant, however. For example, steel prices have increased by 40% since the beginning of the year. The average price of washers and dryers sold in the U.S. rose by 20% in the three months through June. In financial markets, the shares of European and Asian automakers have underperformed the broad market, as have the shares of U.S. companies with a high level of sales to China. The disruption of global supply chains in a highly integrated world economy has potentially widespread, but essentially unknowable consequences.

There are already anecdotes of the unintended consequences of the tariffs arising due to the complexity of global supply chains and multinational firms. Whirlpool, for example, was an early beneficiary of tariffs on washers and dryers. However, the hoped-for benefits of these tariffs have been overwhelmed by subsequent tariffs on steel, a key intermediate good in the production of washers and dryers, resulting in pressure on Whirlpool's margins. Alcoa, an intended beneficiary of the aluminum tariffs, has seen its profit margin squeezed as aluminum produced by Alcoa in Canada is subjected to the new tariff.

We view the risk that the current trade tiff could escalate into a trade war as a key potential source of market instability, one that we are closely monitoring. We are particularly concerned that the uncertainty created could trigger a sudden change in sentiment and sharp market declines. Moreover, confidence effects could hurt consumer spending and corporate investment, slowing the pace of growth and innovation. While the extent of the short-term damage is unknowable, it is certain that a turn to protectionism would do significant cumulative harm to living standards over the long run.

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Strategic Investment Group

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Strategic functions as our clients' investment partner and co-fiduciary, effectively becoming an extension of their resources. Clients are then free to focus on their core missions, while we focus on providing the highly specialized portfolio management expertise that clients need to meet their investment goals. Depending on a client's needs and preferences, Strategic can orchestrate the management of an entire portfolio comprising multiple asset classes, focus on specific asset classes, such as alternatives (e.g., hedge funds, real estate, and/or private equity) or international investments, or manage strategies with high potential for adding value (e.g., portable alpha through investor-friendly turnkey structures). Customized liability-driven investing (LDI) solutions, whether through an integrated total portfolio approach or a targeted long-duration strategy, are also available, as are solutions that address mission-related investment objectives.

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