SEPTEMBER 30, 2018

Strategic Investment Group®

Market Commentary

» GLOBAL MARKET REVIEW

» OUTLOOK & STRATEGY

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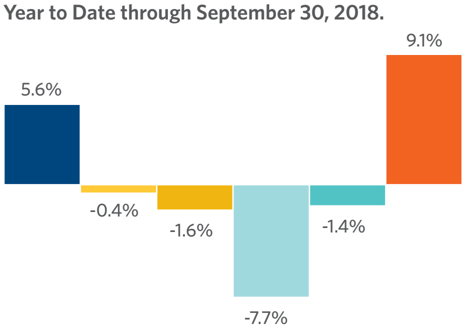
Summary

Global economies and markets diverged in 2018. Buoyed by a strong pro-cyclical fiscal stimulus and relatively easy financial conditions despite Fed tightening, U.S. economic and corporate earnings growth has outpaced most other countries. The U.S. equity market remains near all-time highs and the current rally is now the longest in history. Other equity markets, in contrast, have floundered. Emerging equity and currency markets have been particularly hard hit by a rising dollar, tighter external financial conditions, mounting trade tensions, a slowing Chinese economy, and the underlying vulnerabilities created by high debt levels accumulated over the years of easy money.

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



Equity markets diverge as the U.S. strongly outpeforms.

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

U.S. Equities Enjoy Record Long Rally

Major U.S. equity markets reached new highs in September as the current rally set a record for longevity. The Russell 3000 rose 9.1% through September, while the S&P 500 gained 10.6%. The protracted rally enjoys a number of fundamental supports. The economic backdrop of strong economic growth, subdued inflation, relatively easy financial conditions despite tighter Fed policies, and a pro-cyclical fiscal stimulus has buoyed corporate earnings and encouraged stock buy backs. U.S. equity market volatility remains relatively low, despite periodic spikes.

Despite this strong fundamental backdrop and rosy recent performance, there are signs of unease. With both the U.S. economic recovery and equity market rally setting endurance records, concerns are rising about potential turbulence from late cycle dynamics. The cost of hedging large declines in the S&P 500 in the options market (as measured by the SKEW index), for example, has surged.

Within the U.S. equity market, growth stocks have outpaced value and the broader market by a wide margin so far this year. Much of the outperformance of growth shares reflects the exceptionally strong gains of a few, very large high tech stocks, including the so-called FANG stocks of Facebook, Apple, Netflix, and Google that have enjoyed a stellar if turbulent rise. Apple became the first company to be valued at over $1 trillion in August, with Amazon surpassing the same threshold just weeks later. Buoyed by these mega tech stocks, the technology sector has handily outpaced all others, followed by companies in the healthcare sector. Shares in the consumer staples, telecom, and financial sectors, in contrast, have declined.

Emerging Market Sentiment Sours

Developed and emerging equity markets have lagged the U.S. so far this year, largely reflecting the relative weakness of their economies. Policy divergence has also played a role. The large, pro-cyclical U.S. fiscal stimulus has boosted the U.S. economy and corporate profitability while most other economies have maintained a relatively tighter fiscal stance. The Fed's steady pace of monetary tightening as other major central banks remain relatively accommodative has buoyed the U.S. dollar against a broad basket of currencies, undermining the return on non-dollar assets to U.S. investors. Against this backdrop, the MSCI World ex-U.S. index of advanced economy equity markets declined by 1.5% in U.S. dollar terms through September. European bourses led the decline of advanced economy markets, reflecting concerns over slowing growth, the uncertain outcome of the Brexit negotiations, and the decision of the populist Italian government to target an increased budget deficit over the strenuous objections of the EU. Japanese equities, in contrast, enjoyed a modest gain on signs of some success by the Bank of Japan in reflating an economy that has teetered on the edge of deflation for decades.

Emerging equity markets have suffered most from the divergence in economic performance and policies. The MSCI emerging markets index is down 7.7% through September (Exhibit 2). The dollar's strength, tightening external financial conditions as the Fed normalizes U.S. monetary policy, uncertainties created by trade tensions, a slowing Chinese economy, and the accumulation of debt, much of it in foreign currencies, during the years of abundant global liquidity are contributing to the fragility of emerging economies, equity markets, and currencies (Exhibit 3). Countries reliant on external flows to finance large current account deficits and credit expansion, such as Argentina and Turkey, are especially vulnerable as portfolio flows into emerging markets have slowed and in some cases reversed.

Fed Tightens, Bonds Fall

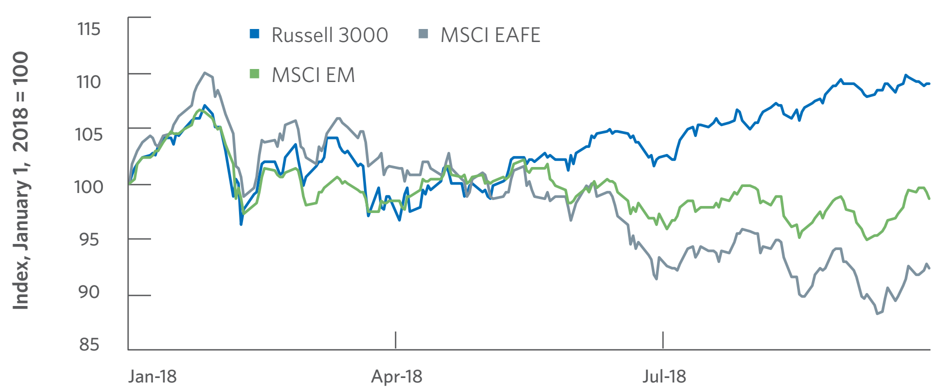
The FOMC raised rates in September for the third time in 2018, and signaled that it would raise rates once more this year and continue its announced deliberate pace of balance sheet contraction. Notwithstanding the increase of 10-year yields to above 3%, the U.S. Treasury yield curve remained relatively flat. Within the U.S. bond market, only the high yield sector has enjoyed modest gains so far this year. Treasuries and investment grade credit in contrast have declined, with long-duration securities falling most. Outside of the U.S., both the WGBI of advanced economy government bonds and the EMBI Global index of emerging market bonds fell.

EXHIBIT 2:

Divergent Global Equity Market Performance

Source: Bloomberg, and Strategic calculations.

Year to Date through Septemer 30, 2018.



Hedge Funds Disappoint

The HFRX Equal Weighted Index shed 1.5% so far this year as most strategies lost ground. Relative value strategies were the best performers among index constituents, gaining 2.6%.

Real Assets Rise, Fueled by Oil

Crude oil prices rose above $80 per bbl over supply concerns (Exhibit 4). Reflecting a YTD gain of 21.2% in the GSCI All Crude index, the GSCI commodity index is up 11.8% YTD. Real estate returns moderated, with the NCREIF Open-End Funds Core Index (reported with a quarter delay) gaining 6.9% in the 12 months ended June 2018. TIPS registered a slight gain of less than a half percent as real yields fell modestly.

Private Equity Returns Remain Robust

The Thomson Reuters/Cambridge Index of U.S. private equity investments gained 16.0% in the 12 months ended June 2018 (data reported with a quarter delay). Investment activity does not appear excessive despite the large flows into the market.

EXHIBIT 3:
Dollar Rise Roils Emerging Currency Markets
Source: Bloomberg, and Strategic calculations.
Year to Date through September 30, 2018.

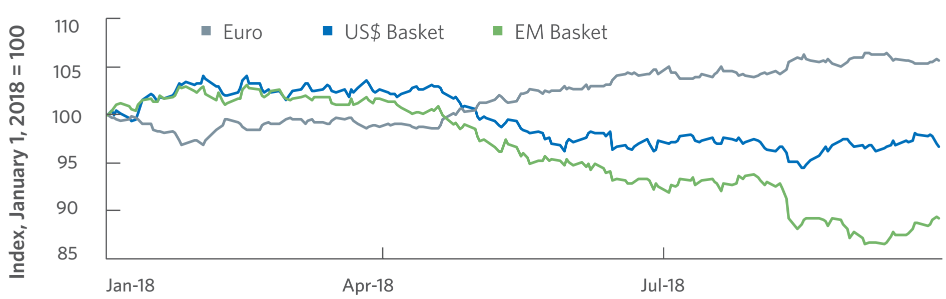
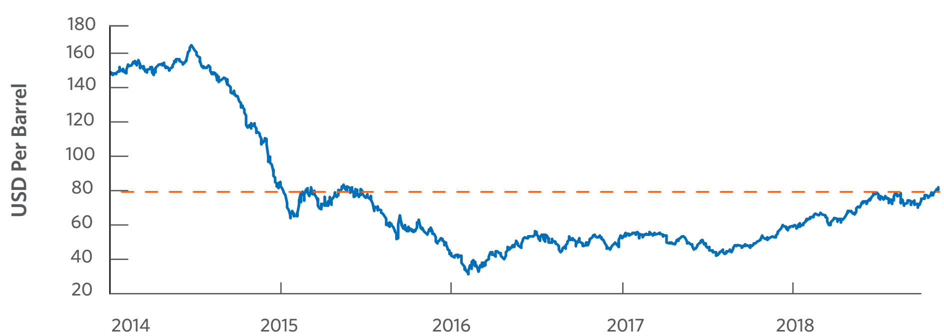


EXHIBIT 4:
Brent Crude Oil Surpasses $80
Source: Bloomberg.
Data through September 30, 2018.



Summary

The narrative in financial markets has changed. Risk-friendly economic optimism is gradually giving way to end-of-cycle caution. We do not share concerns about an imminent economic downturn, in the U.S. or globally, but we do believe that positive surprises will be increasingly scarce. Even in the final innings of the current cycle, we are reluctant to time markets. Instead, we stick to a disciplined, valuation-based asset allocation with only modest top-down tilts. The overall portfolio stance remains conservative, with underweights to U.S. equities and interest-rate sensitive assets. We are overweighting hedge funds to add value and diversification through largely security-based bottom-up strategies.

Taking the Pulse of the Global Economy

Global economic activity has remained solid across most major regions thanks to accommodative financial conditions and highly expansionary U.S. fiscal policy. There are, however, cracks appearing in the growth story. Regional economic divergence will eventually give way to slower growth and higher inflation across most economies.

The U.S. economy is on track to grow well above trend in 2018, thanks to a hefty dose of pro-cyclical fiscal stimulus. This boost will begin to unwind in 2019 and beyond, lowering growth rates from this year's elevated levels. In Europe, 2018 growth has disappointed after last year's unexpected spurt. In addition to headwinds from higher oil prices (+70% since June 2017), there is some evidence that uncertainty about the economic environment weighed on trade growth and manufacturing activity, particularly in capital-goods producing sectors. Unlike the U.S., European economies did not benefit from a fiscal boost. Chinese economic growth has slowed recently but there are indications that policymakers will stimulate the economy to prevent any sudden loss of momentum. In emerging economies, growth remains mostly stable, aside from idiosyncratic shocks in Turkey and Argentina. There are signs, however, that late-cycle U.S. interest rate increases are creating head-winds for economies that depend heavily on foreign capital inflows to finance external imbalances.

While global non-energy and food price inflation remains largely subdued, wage and the U.S. economy is operating above long-term potential, boosting wage and price pressures, which are likely to continue to build in the quarters to come. Past business cycles suggest that inflation tends to pick up only at the very end of an expansion, when resource constraints begin to bite. We believe that we have not yet seen that final cyclical burst in inflation in the U.S.

Our analysis suggests that investors will soon be faced with a more difficult environment. While growth will likely remain solid in the near term, headwinds are gaining force. Fading fiscal stimulus and gradually tightening financial conditions will guide growth rates lower in most economies. At the same time, higher U.S. inflation will likely trigger more rate hikes by a Fed that has signaled its willingness to push interest rates into restrictive territory, something that markets are currently not prepared for. The combination of fading growth momentum and rising interest rates will likely create typical end-of-cycle turbulence for investors. The degree of turbulence will in part depend on the ability of Chinese policymakers to stabilize growth in an economy which, over the past two years, has accounted for about a third of global growth.

The economic landscape could be further complicated by geopolitical developments capable of amplifying emerging cyclical pressures.

Geopolitical Wild Cards

Most geopolitical events have only short-lived effects on financial markets. To elicit a more sustained reaction, such events must directly affect the economy or markets. Both of the hotspots that we are currently monitoring satisfy this condition: a global trade war and a resurgence of the Eurozone crisis.

Escalating protectionist rhetoric and policies, particularly between the U.S. and China have deepened our concern over a trade war. Rising tariff barriers could wreak havoc on a highly integrated global economy that is increasingly dependent on intricate international supply chains. The IMF estimates in its most recent World Economic Outlook that a full-fledged trade war could "cost" the U.S. about 1 percent of GDP with most of the impact likely in the first year. China would suffer even more in the short-term while the long-term cost of a trade war would "only" be half a percent of GDP relative to a no tariff baseline. For the advanced and emerging economies gathered in the G-20 group of countries, the overall effect will be a 0.5% knock to GDP with most of the impact in the near term. These estimates, which we consider conservative, suggest substantial economic dislocations with sizeable effects on financial markets.

We are somewhat less worried about a resurgence of a Eurozone crisis in the context of Italy's budget struggle with the European Union. Despite the recent increase in risk premia on Italian assets, we believe that Italy's commitment to the Euro, which is shared by the government and its citizens, will be the key to preventing a re-run of the Eurozone crisis. Any signs suggesting an erosion of this commitment would substantially raise the risk of a crisis flare-up, likely to spark a collapse in economic confidence and investor risk appetite..

How is It All Going to End?

As markets embrace a "late-cycle narrative", two questions are paramount: first, how far are we from the next recession, and second, might it rival the Great Financial Crisis (GFC) of a decade ago?

With respect to the first question, we reiterate last quarter's reference to the U.S. yield curve as a powerful recession lead indicator. Once the difference between longer-dated yields and short-term interest rates becomes negative, a recession tends to follow within two years of the inversion. While the yield curve has flattened since early 2017, it has not inverted. According to a yield-curve based recession model estimated by the New York Federal Reserve, the probability of a recession within the next year was a mere 14.5% at the end of September. Combining the yield curve signal with the relatively solid economic picture supported by stimulative fiscal policy in the U.S. and accommodative monetary policy in many large economies, we conclude that a recession is not imminent.

That still leaves the second question regarding the severity of the next recession: Are we about to face another GFC? To answer this question, it is helpful to revisit the three key components of the GFC: a debt crisis, a liquidity crisis, and a deep recession. The debt crisis gripped the household sector in the U.S. and other developed economies when record low interest rates and a house price boom generated ever more leverage on household balance sheets. Exploding mortgage debt combined with a surge in financial engineering to produce a proliferation of securitized assets dependent on short-term funding. When the housing boom turned into a bust, impaired bank balance sheets called the solvency of large parts of the financial sector into question. The debt crisis morphed into a liquidity crisis that engulfed large parts of the banking sector and money markets. The liquidity crisis, in turn, pushed the global economy to the brink of a catastrophic depression that was only narrowly averted thanks to massive monetary and fiscal stimulus.

Our analysis suggests that it was the liquidity crisis that turned a debt crisis into the Great Financial Crisis. While we believe that debt crises have been and will remain a recurring feature of financial history, we are confident that improved regulation has substantially fortified the banking sector and money markets, thereby reducing the risk of slipping into another catastrophic financial crisis in the near-term.

Porfolio Construction

The construction of our portfolios is driven by the long-term objectives and constraints of our clients. Any deviation from long-term allocation targets is guided by a disciplined valuation-based framework informed by our top-down analysis. The difficulty of timing markets as well as business cycles, limits the risk we are willing to allocate to top-down asset allocation strategies. Any asset class over- and underweights will be relatively modest in most environments, and driven by divergences from fair value. Our quest for a well-diversified and robust portfolio tends to bias our active risk budget towards security-specific, bottom-up strategies.

At present, we are implementing four major asset class calls across portfolios: First, we are holding a modest underweight to global equities. The structure of the underweight reflects the wide valuation gap between U.S. equities and non-U.S. markets. It is implemented by underweighting U.S. equities which continue to be about one and a half standard deviations expensive relative to fair value. Part of the U.S. equity underweight is offset with small overweights to non-U.S. advanced and emerging equities.

Second, in fixed income markets we maintain duration and credit underweights. Even after the most recent increase in U.S Treasury yields, bonds remain substantially below fair value. With U.S. inflation about to increase in the final stretch of the business cycle and the Fed likely to hike interest rates beyond what is currently anticipated, yields have considerable scope to rise further. In credit markets, we continue to hold a modestly defensive stance. Credit spreads are tight relative to long-term averages even as market fundamentals have eroded. The average credit quality of the investment grade sector has declined with the lowest rating (BBB) now accounting for almost 40 percent of the non-financial U.S. investment grade segment. This compares to 31 percent in 2000 and 22 percent in 1990. Underwriting standards have declined and issuer leverage has increased. For now, these deteriorating credit conditions are partially offset by strong economic and corporate earnings growth.

Third, we retain our modest underweight to real assets with commodities and real estate held at policy weights while TIPS are underweighted. Real yields continue to be low and are likely to rise as capacity constraints intensify.

Fourth, we are retaining an overweight to hedge funds. Our hedge fund portfolio is structured to deliver predominantly skill-based alpha with returns that have very low correlation to other asset classes in the portfolio. This provides attractive diversification at a time when it is difficult to find asset classes that are attractively valued. We believe that increasing market volatility and high valuation dispersion within equity markets provides bottom-up managers in our hedge fund portfolio an attractive opportunity set.

In sum, we believe that our conservative investment stance, which keeps portfolio risk closely in line with policy risk, is appropriate given opportunities and challenges of the current environment. We acknowledge the difficulty of market timing by limiting the size of our top-down allocation strategies, calibrating these moves by the degree of divergence from fair value, while relying largely on highly diversified security-specific bottom-up strategies.

Strategic Investment Group

Strategic, a pioneer in dedicated Outsourced CIO (OCIO) solutions since 1987, offers a comprehensive service platform for managing customized portfolios for institutional investors. Our proprietary process combines active portfolio management, rigorous risk management, and open architecture manager selection.

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.

We strive to build enduring partnerships with our clients by strengthening their investment programs through a dynamic, value-enhancing investment process, sound governance framework, and world class client service. Our mission is to empower investors through experience, innovation, and excellence.

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