DECEMBER 31, 2018

» GLOBAL MARKET REVIEW

» OUTLOOK & STRATEGY

» SPECIAL TOPIC

Strategic Investment Group®

Market Commentary

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Summary

Global equities plunged in the fourth quarter as investors pondered a litany of woes including tighter monetary policy, slowing global growth, lofty tech valuations, economic policy disarray, and a peak in earnings. The fourth quarter's ruthless rout reversed previous gains in the U.S. market and compounded losses elsewhere. The U.S. yield curve flattened in 2018 as the Fed tightened and the dollar rose. Oil, which fell 40% in the fourth quarter alone, and emerging equities suffered the steepest declines for the year. Cash led all other assets and, with U.S. Treasuries, was one of the few assets to eke out gains in 2018.

Best and Worst of Times for U.S. Equities

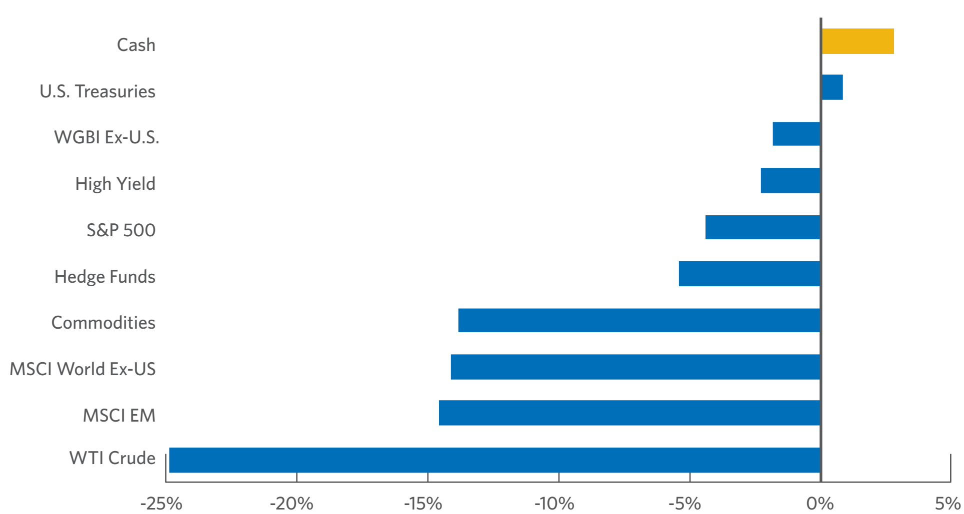
The year in the U.S. equity market was one of extremes. It began with a bang in January with the S&P 500 up nearly 6%, but experienced a revival of volatility in February. The market then gradually recovered culminating in September in new highs and a record for the longest market rally in history. The rout of the fourth quarter, capped by December's 9.0% decline of the S&P 500, reversed these gains and resulted in the worst annual loss since 2008. This reversal reflected pessimism over the sustainability of global economic and corporate earnings growth in the face of rising trade tensions, tighter liquidity conditions, a slowing Chinese economy, and the vulnerability posed by high levels and declining quality of the debt of U.S. corporations and emerging market sovereigns.

EXHIBIT 1:

Cash is King in 2018

Source: Bloomberg.

Year to Date through December 2018.



Few havens escape steep declines in 2018.

There were few bright spots in the U.S. equity market. Both large (-4.8%) and small (-11.0%) cap stocks fell for the year, as did growth (-2.1%) and value (-8.6%) shares. Virtually all sectors also lost ground. The rise and fall of tech darlings Facebook, Amazon, Netflix, and Google (FANG) was a particularly striking feature of the market. Building on stellar gains in 2017, these shares continued to rise through August, with the valuation of Apple and Amazon surpassing $1 trillion, only to fall thereafter (Exhibit 2).

Global Stocks Unhinged by Uncertainty

All major global equity markets suffered substantial losses in 2018, with the MSCI World ex-U.S. index tumbling 14.1%. A combination of slowing economic growth, high debt levels, tighter financial conditions, a rising dollar, and a panoply of policy missteps were the dominant drivers of the decline. Chinese equity markets dropped most, with China A-Shares losing one third of their value on fears of diminishing growth, dangerously high debt levels, and disrupted trade. European equities (-14.9%) were roiled by a chaotic Brexit process, a budget crisis in Italy, a slowing German economy, and impaired export growth. Crises in Turkey and Argentina reminded investors of the risks to emerging markets posed by economic mismanagement, heavy indebtedness, and excessive reliance on external financing in a period of tightening global liquidity. With all regions sharply lower, the MSCI EM index fell 14.6% in 2018.

Fed Tightens, U.S. Yield Curve Flattens

With four increases in 2018, the Fed has raised its policy rate nine times from near zero in 2015 to a still low 2¼ - 2½%. Following the December rate hike, speculation mounted that the pace of tightening was set to slow in the face of reduced economic growth prospects, limited inflationary pressure, and financial market turmoil. Although yields on longer term U.S. Treasuries rose, mainly reflecting an increase in real yields, yields on the short end of the yield curve rose faster, leading to a flattening of the curve throughout the year (Exhibit 3). Sovereign bond markets outside of the U.S. declined, with the bulk of these losses resulting from the appreciation of the dollar against most currencies. The WGBI ex-U.S. index and the JP Morgan EMBI fell by 1.9% and 4.6%, respectively in dollar terms.

U.S. credit spreads remained compressed throughout most of 2018, but rose in the fourth quarter in sympathy with the equity market rout. U.S. investment grade credit was little changed, outperforming the high yield market, which fell by 2.1% in 2018. Corporate debt has increased substantially in recent years and the credit quality and protective covenants of corporate debt have been eroded. The share of corporate debt at the lowest investment grade rating (BAA) has increased substantially and now represents over 50% of the outstanding stock of investment grade corporate debt (Exhibit 4 on page 4). Rapid credit growth and deteriorating credit quality are classic harbingers of vulnerability.

Hedge Funds Disappoint

Hedge funds as a group struggled in 2018 as equity alpha proved elusive to most managers. The HFRX Equal Weighted Strategies index declined by 5.4%, its worst annual performance since 2011. No sub-strategy index generated positive returns, with the higher beta equity long/short strategy leading the decline, falling 9.4% and underperforming the S&P 500.

EXHIBIT 2:

Rise and FAll of FANG Stocks

Source: Bloomberg.

Data through 2018.

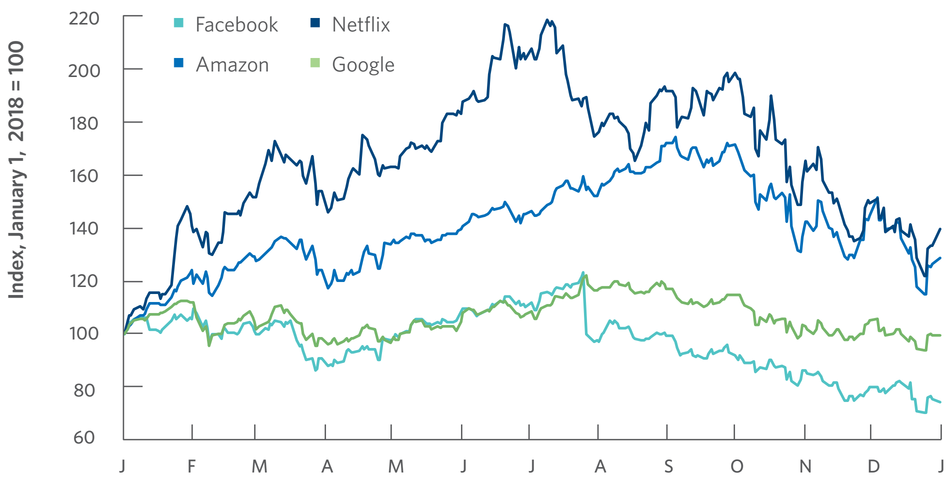


EXHIBIT 3:

U.S. Yield Curve Flattens Further

Source: Bloomberg.

Data through 2018.

Real Assets- Commodities Slide on Oil

Oil fueled broader commodity price movements in 2018. Following strong gains in the first nine months of the year, oil prices plunged by nearly 40% in the fourth quarter in the face of fears over slowing global economic growth and abundant supply. As a result, the GSCI commodity index lost 13.8% in 2018. Precious metals, in contrast, were some of the few commodities to shine in 2018, gaining 5.2%. Real estate returns remained supported by strong fundamentals in the form of rising rents and low vacancy rates. Valuations, however, are stretched, and low capitalization rates are potentially vulnerable to rising interest rates. The NCREIF Open-End Funds Core Index (reported with a quarter delay) gained 7.7% in the 12 months ended September 2018. TIPS lost ground as the yield on the 10-year TIPS rose by 52 basis points in 2018.

Private Equity Returns Remain Robust

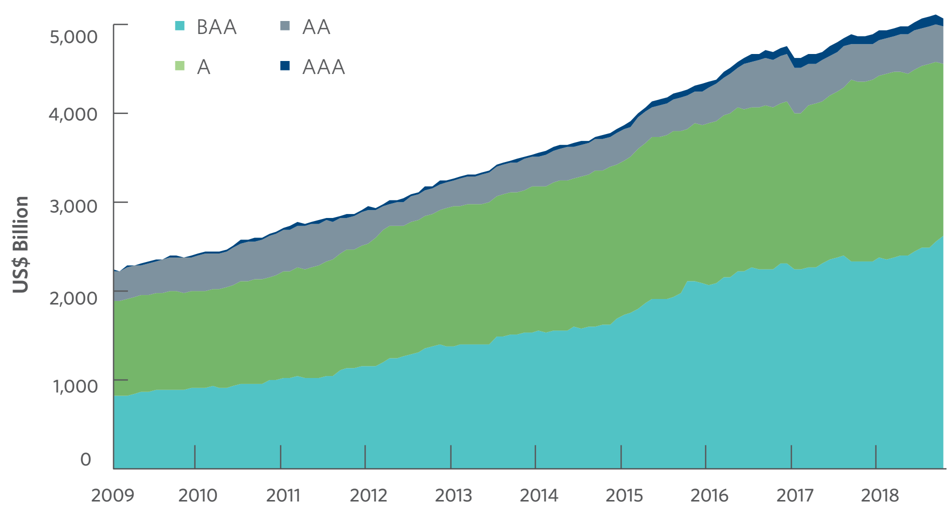
The Thomson Reuters/Cambridge Index of U.S. private equity investments gained 17.7% in the 12 months ended June 2018 (data reported with a six-month delay). Market dynamics and valuations remain mixed. The pace of fundraising is robust and investment activity rose further in 2018. Leveraged buyouts are priced to perfection with multiples hovering near record levels. However, these lofty valuations compare favorably to the public markets and are supported in part by strong revenue growth.

EXHIBIT 4:

Credit Quality of U.S. Corporate Debt Deteriorates

Source: Bloomberg.

Data through 2018.



Summary

The fourth quarter delivered high drama. Christmas Eve arrived on the verge of a U.S. equity bear market; New Year's Eve on the cusp of a strong rebound. Lingering concerns about a global slowdown, policy errors, and geopolitical landmines will continue to keep investor sentiment in flux this year. We are more sanguine about global economic prospects than are those fearing a near-term recession, and believe that slightly improved valuations and their wide dispersion will create good prospects for active managers. We retain a modest underweight to stocks and balance credit, duration, and real asset underweights with overweight allocations to hedge funds and cash.

Is (Economic) Winter Coming?

Weak fourth-quarter economic data for the U.S., China and the Eurozone triggered fears of a full-blown global economic slump. A view behind the headlines reveals a less alarming picture, however. In our view, the global economy is decelerating onto a more moderate but still resilient late-cycle growth trajectory, not on the verge of a precipice.

Fresh off a fiscal-policy induced sugar-high, the U.S. economy shows little sign of slipping into recession. Monetary policy continues to be accommodative and there is no indication that the Fed is inclined to trigger a slump through aggressive tightening. Worries about the contractionary effects of quantitative tightening (QT) also appear overblown as term premia, a key transmission channel, have hardly budged since the Fed started the gradual normalization of its balance sheet. Moreover, the New York Fed's yield-curve based recession model places the probability of a recession in 2019 at only 21%. Robust consumption, moderate business spending, and mildly supportive fiscal and monetary policies are the main bulwarks against a slowdown. Nevertheless, real U.S. GDP growth is set to slow considerably to 1.75% in 2019 from a peak of 4.2% yoy in the second quarter of 2018.

Chinese GDP growth slowed to 6.4% yoy in the fourth quarter, confirming the trend deceleration of the economy. The government's squeeze of the shadow banking sector to address financial vulnerabilities combined with signs that the trade war with the U.S. was beginning to hurt manufacturing activity and profits renewed fears that the world's growth engine might sputter. Notwithstanding these concerns, we remain convinced that Chinese policy makers will deploy their formidable policy toolbox to engineer a gentle deceleration of economic growth. Indeed, they have already eased monetary and fiscal policy to arrest the most recent loss of momentum. A stable Chinese economy with continued strong demand for imports is good news for global economic activity and the prices of manufactured goods and commodities.

Europe significantly undershot its growth potential in the second half of 2018 as a mix of external and homemade shocks weighed on economic activity and sentiment. Lower global growth and higher tariffs undercut export demand and business sentiment. Compounding these external factors, the looming Brexit threat and worries about anti-European populism in Italy and possibly in France further undermined sentiment. Mitigating these forces, monetary policy remains easy while fiscal policy in the largest European economies will likely also provide a small positive economic impulse.

Fearing Fear Itself

Measures of financial conditions based on short- and long-term interest rates, credit spreads, equity prices, and exchange rates capture the main financial market forces affecting economic prospects. The channel between financial conditions and the economy flows both ways, opening the door for vicious and virtuous cycles. This feedback loop between financial conditions and economic fundamentals was a major element of the dynamics driving the fourth quarter's rout of global equity markets.

During the fourth quarter, fears of a slowing global economy and the risk of further damage from a range of policy missteps sharply tightened financial conditions in major economies and raised the specter of a self-reinforcing cycle of falling asset prices and weaker economic growth. By signaling a slower pace of tightening, the Fed helped to break this cycle. Equity markets rebounded and credit spreads narrowed, thus easing financial conditions and economic downside risks.

We draw a number of conclusions from the dynamics of the fourth quarter and our long observation of the relationship between financial conditions and underlying economic fundamentals. First, the less rising inflationary pressure constrains the Fed's room to maneuver, the easier it is to forestall a vicious feedback loop between financial conditions and economic fundamentals. Second, a substantial external economic shock or major policy mistake typically tightens financial conditions, thereby amplifying the original shock. Third, the more overvalued are markets, the more likely are tighter financial conditions as valuations mean-revert. Finally, fear is a powerful self-fulfilling force capable of precipitating the feared event through a self-reinforcing feedback loop.

What Might Go Wrong?

While the cyclical position and policy setting in the major advanced economies and China point to a moderately robust fundamental backdrop for financial markets, an unusually rich set of risks tempers our optimism.

Policy errors are high on our list of concerns. Trade tensions have already been reflected in slowing global trade and economic activity in China and Europe. Any escalation of these tensions could severely damage global growth, with significant spillovers to investor sentiment and markets.

In the U.S., the ongoing government shutdown represents another policy risk. According to a recent estimate by the Fed, a prolonged shutdown could shave up to one percentage point off quarterly growth. With expected yoy GDP growth in the first quarter of 2.1%, a prolonged shutdown would significantly alter expectations.

In Europe, the risk of policy errors and political accidents has increased. Besides substantial Brexit risks (see our Special Topic that follows), the EU's parliamentary elections in May could channel more populist anger against European institutions as recently experienced in Italy and to some extent in France. While we are confident in the stability of the Eurozone, uncertainty created by policy miscues are capable of undermining the European economy by hurting consumer and business confidence.

We continue to keep a watchful eye on inflation in the U.S. The U.S. economy is operating at full capacity and its current growth rate is above potential. The labor market is tight and incipient wage pressures have increased. After ten years of low post-crisis inflation, it is likely that markets are underestimating the risk of an uptick in inflation that would require a policy response by the Fed and trigger a market reaction similar to the taper tantrum in 2013.

Key Themes and Market Observations

Ten themes currently guide our allocation decisions.

First, markets are too pessimistic about growth in the U.S., China and the Eurozone. Higher-than-expected growth in 2019 would provide a positive backdrop for markets.

Second, the Fed signaled only a temporary pause in the rate hike cycle to calm markets. Once financial conditions ease sufficiently, or inflationary pressures emerge, the Fed will resume hiking.

Third, external shocks can trigger self-reinforcing cycles of deteriorating economic fundamentals and rising market risk premia. This can exacerbate the impact of external shocks.

Fourth, markets are too optimistic about continued low inflation in the U.S.

Fifth, policy uncertainty is unprecedentedly high. A widely used indicator of global policy uncertainty, the Economic Policy Uncertainty Index, ended 2018 at a record level.

Sixth, equity valuations have eased. We estimate that non-U.S. developed and emerging stock markets are now about 10 percentage points below fair value. U.S stocks remain rich, at 19 percentage points above fair. At the same time, earnings expectations across most global markets have moderated.

Seventh, quality stocks in the U.S. have lost most of their valuation advantage. They are now within striking distance of fair value relative to the overall stock market.

Eighth, valuation dispersion across individual stocks remains high. This suggests a generous opportunity set for value-focused active strategies.

Ninth, U.S. Treasury yields are too low. We expect a rebound of real yields, inflation expectations and term premia.

Tenth, while investment grade and high-yield credit in the U.S. is now fairly valued, credit fundamentals and liquidity conditions have deteriorated.

Portfolio Construction and Asset Allocation

Our portfolio allocation is a reflection of market valuations, economic fundamentals, and the heightened uncertainty from policy errors and geopolitical risks. In light of these crosscurrents, we continue to target total portfolio risk at near policy benchmark levels.

Our top-down allocations remain modest. We implement a small underweight position to global equities by underweighting U.S equities against overweights to non-U.S. equities and cash. During the past quarter, we further reduced our U.S. equity exposure in favor of emerging equities where valuations had become more attractive. Our preference for emerging markets among non-U.S. stocks partially reflects the elevated event risk in Europe and the expected rebound of Chinese demand for emerging market exports. We responded to the mean-reversion of quality stock relative valuations by neutralizing our quality tilt in U.S. equities. We also initiated an overweight to U.S. value stocks to exploit the pronounced stock-level valuation dispersion in the market.

We maintain a solid underweight to U.S. Treasury duration. We expect bond yields to rise as expectations for U.S. inflation and the pace of Fed rate hikes increase. We also expect a gradual increase in term premia as the Fed continues asset sales aimed at normalizing its balance sheet. Our credit underweight remains modest, reflecting our concerns over deteriorating market credit quality and liquidity.

We continue to underweight real assets reflecting a large underweight to TIPS, motivated by our view that real yields remain unsustainably low. We maintain our neutral allocation to real estate and commodities.

We confirm our hedge fund overweight as the valuation dispersion at the security level remains elevated. With our hedge fund portfolio tilted toward managers who generate alpha from security selection we are confident that hedge funds will continue to add value and provide much-needed portfolio diversification.

You Brexit. You Buys It.

Having sold the British people a bill of goods on Brexit, PM Theresa May paid a steep political price in January, suffering the largest parliamentary defeat in modern British history. While the defeat was decisive, it did nothing to clarify the future of U.K. and EU relations. The political stakes are high; the economic stakes even higher; and there is no clear path forward.

Deeply Entangled Economies

The EU economy is the second largest in the world and the U.K. is its second largest member. The depth of their integration extends far beyond tariff elimination to include common regulatory standards, mutual recognition of professional qualifications, "passporting" of financial services, unimpeded foreign direct investment (FDI), and free labor movement.

The proximity of these two large economies and their frictionless borders have encouraged ever-deeper trade relations. The EU is the U.K.'s largest trading partner, with EU-related imports and exports accounting for 30% of U.K. GDP. About 45% of the U.K.'s exports are to the EU and 53% of the U.K.'s imports come from the EU. U.K. and EU firms share deeply integrated supply chains, with inputs crossing borders many times in the manufacturing process. Nearly half of the U.K.'s imports and exports of intermediate goods are with the EU.

The financial sectors of the U.K. and the EU are also deeply intertwined, as there are few barriers to cross-border trade in financial services. U.K. banks underwrite half of the debt and equity issued by EU businesses and are counterparties to over half of the OTC interest rate derivatives traded by EU companies and banks. U.K. asset managers invest £1.4 trillion on behalf of EU clients. Financial services generate 7% of U.K. GDP and 11% of tax revenue, half of which derive from business with the EU.

Brexit's Dynamics of Disintegration

Brexit would likely unleash dangerously disruptive dynamics. An increase in trade costs and frictions would reduce trade volumes and GDP and increase unemployment. Productivity improvements would be impeded by reduced competition, fewer opportunities for specialization, and lower FDI. Lower productivity and falling migration would reduce potential output. Uncertainty would boost risk premiums on U.K. assets, contributing to a tightening of financial conditions. Inflation would rise as higher tariffs and falling sterling hit consumer prices. Monetary policies to counter rising inflation would add to the contractionary forces unleashed by Brexit.

Some of Brexit's ill effects would be immediately felt. Border bottlenecks would quickly disrupt supply chains. Financial services now freely provided across borders could cease abruptly with changing regulations. Uncertainty would immediately widen risk premiums on U.K. assets, tighten financial conditions, reduce credit availability, and undercut sterling. Tighter financial conditions and slower output growth would erode the credit quality of U.K. borrowers, hurting bank profitability and financial sector stability.

Other effects would be longer lasting. The ending of the mutual recognition of product quality and safety standards would necessitate a lengthy recertification process. The restructuring of the economy away from export industries to produce goods now imported would be a prolonged process. Reduced productivity growth would also be an enduring feature of a less open and competitive post-Brexit economy. With lower productivity growth and reduced migration– EU migrants represent 5% of the U.K. labor force and a much higher share in certain industries – trend growth would remain below its pre-Brexit trajectory for a sustained period.

The Bad and the Ugly

Brexit has no good outcome. Anything short of a reversal of the decision to leave the EU will exact a heavy economic toll. The magnitude of the toll will depend on the degree of economic integration salvaged in the post-Brexit world. The Bank of England estimates that in the best Brexit case of a continued close economic partnership with the EU and an orderly transition process, U.K. GDP would be between 1¼ - 3% below its pre-Brexit trend by 2023. In a disorderly "no-deal, no-transition" Brexit, U.K. GDP would be 8% below trend, unemployment would increase to 7½% from 4.1%, inflation would peak at 6½% from 2%, house prices would fall by 30%, and commercial property prices by 48%. Although the Brexit's impact would be concentrated on the U.K., the EU would not be spared. The IMF estimates that a disorderly Brexit would cut long-run EU GDP by 0.8-1.5% from trend.

Brexit is but one of the panoply of policy missteps now amplifying global market uncertainty. Heightened uncertainty created by unpredictable policies coupled with high valuations across assets are the main reasons for our current conservative investment posture.

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.

For more information, please email us at inquiries@strategicgroup.com.

Strategic Investment Group®

30th Anniversary 1987 2017

1001 Nineteenth Street North
16th Floor
Arlington, VA 22209 USA

+1 703.243.4433 TEL
+1 703.243.2266 FAX

strategicgroup.com