MARCH 31, 2019

Strategic Investment Group®

Market Commentary

» GLOBAL MARKET REVIEW

» OUTLOOK & STRATEGY

» SPECIAL TOPIC

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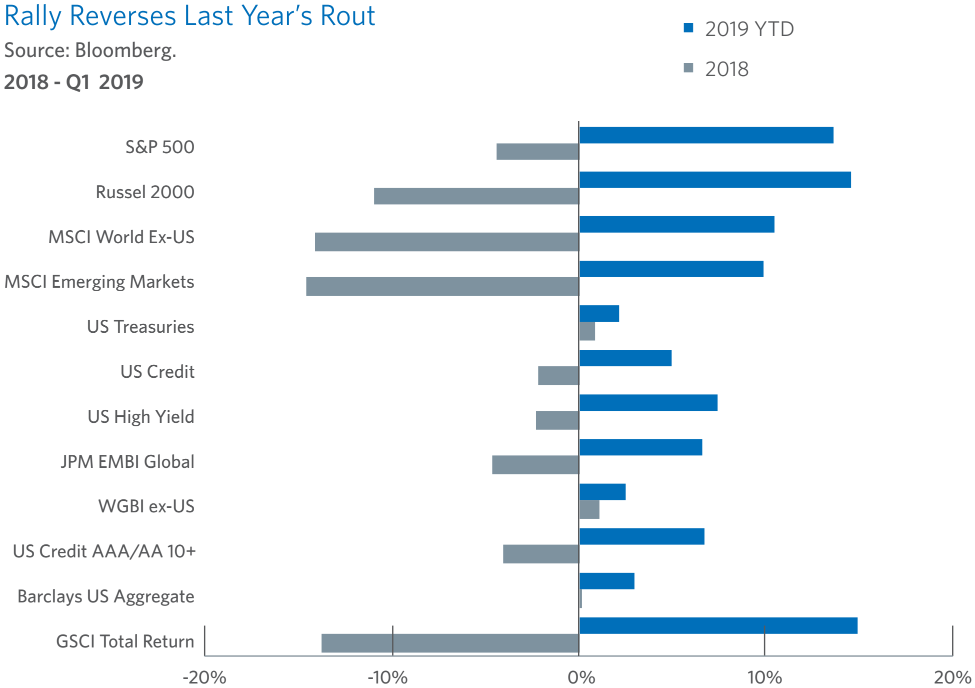
Summary

The strong rally of global equity markets in the first quarter was the mirror image of last year's fourth quarter rout. Fed Chair Powell's pivot to a more dovish stance promised a pause in rate hikes that refreshed markets. The ECB also signaled continued monetary ease. Expansionary policies in China to support a slowing economy further contributed to improved sentiment and a surge in Chinese shares. Global bond markets rallied across the credit spectrum. The U.S. yield curve briefly inverted, and the dollar rose. Commodities rebounded, fueled by soaring oil prices.

Sustained Rebound in U.S. Equities

U.S. equity markets enjoyed three months of gains in the first quarter, generating a cumulative increase of 14.0% in the Russell 3000. Fed Chair Powell's pivot toward a more patient approach to further Fed rate hikes was the primary impetus of the sharp rebound. The Fed's change of tone eased the concerns about slowing global growth that had bedeviled equity markets in the fourth quarter of last year. Nevertheless, fears over economic growth prospects continue to linger in the background. These concerns include the temporary inversion of the yield curve, the record length of the current U.S. business cycle, waning U.S. fiscal stimulus, continued weakness in Europe, high levels of policy uncertainty in the form of Brexit and trade disputes, and a Chinese economy made vulnerable by trade tensions and high debt levels.

EXHIBIT 1:
Rally Reverses Last Year's Rout
Source: Bloomberg.
2018 - Q1 2019



Markets enjoy a pause that refreshes courtesy of the Fed.

However, with the prospect of continued low rates, abundant liquidity, a laxer regulatory environment, and solid corporate earnings, the U.S. equity market resurgence in the first quarter was widely shared (Exhibit 2). Growth stocks handily outperformed value, although both generated double-digit returns in the quarter, while both small cap and large cap stocks gained about 14%. Most U.S. equity sectors also generated double-digit returns, with even the laggards, financials and healthcare, returning a respectable 8.5% and 6.3%, respectively. Overall, cyclical sectors outpaced defensive stocks in the climate of Fed-inspired renewed optimism over growth prospects.

Global Equity Markets Rally, But Lag U.S.

Non-U.S. markets also fared well, although not so well as the U.S. The MSCI World ex-U.S. index rose 10.4% in U.S. dollar terms, despite the slight drag to returns imposed by a rising dollar against most currencies. Canadian stocks led other developed markets, rising 15%. The MSCI European index returned 10.8%, supported by dovish signals by the ECB that helped dispel concerns over continued sluggishness in a European economy battered by Brexit bumbling, trade tensions, and high sovereign debt levels and financial sector fragilities in Italy.

Emerging equity markets rose 10% as all regions generated robust gains, with a particularly strong showing by Chinese markets. The China A-Shares market returned 33%, on the back of looser fiscal and credit policies, retail investor enthusiasm, record foreign investment, and the MSCI's move to increase the weight of China A-Shares in the Emerging Markets index. (Discussed in this quarter's Special Topic.)

Fed Pauses, U.S. Yield Curve Briefly Inverts

Dovish shifts by the Fed and the ECB dominated global bond markets. Citing limited inflationary pressure and increased threats to U.S. economic growth, the Fed suspended rate hikes and moderated the pace of slimming its balance sheet. Adjusting to the prospect of a prolonged suspension of rate hikes, the yield curve inverted, as the yield on 10-year U.S. Treasuries temporarily fell below 3-month rates (Exhibit 3). U.S. Treasury prices rose across maturities led by the long end, with the 1-10 year sector up 1.7% and the 10+ year sector returning nearly 5%. Credit markets also gained across the credit spectrum, led by the high yield sector, which rose 7.1% versus a gain of 3.0% for the investment grade sector.

The prospect of easier monetary policies by the Fed and the ECB contributed to declining yields in non-U.S. government bond markets as well. The yield on the 10-year German bund turned negative for the first time in two years. The World Government Bond Index, ex U.S. rose about 1.7%, while non-U.S. credit markets managed larger gains as improved sentiment led to a tightening of credit spreads. The prospect of easier external financing conditions supported emerging market bonds, with the EMBI Global index gaining 6.4%.

Hedge Funds Generate Modest Gains

The broad hedge fund universe struggled in the first quarter, with the HFRX Equal Weighted Index returning just under 1%. The environment for stock picking following a value framework was challenging, undermining performance for many managers. Low beta strategies lost ground, with the equity market neutral index falling 0.6%. High-beta long/short equity strategies, in contrast, led all others, gaining 6% in the wake of a resurgent U.S. equity market.

Real Assets-Commodities Resurgent

The moves by the Fed, China, and the ECB to ease concerns over slowing global growth underpinned the sharp rebound in commodity prices. Oil recorded especially strong gains, rising 32% after a dismal fourth quarter. As a result, the GSCI commodity index rose nearly 15%, reversing the losses of 2018. In the real estate market, the NCREIF Open-End Funds Core Index (reported with a quarter delay) gained 7.4% in 2018. The industrial sector led other property types due to healthy demand by e-commerce companies. Across regions, the West led owing to stronger urban growth. Overall, the real estate market continues to balance strong fundamentals in the form of rising rents and low vacancy rates against stretched valuations, low capitalization rates, and the potential threat of rising interest rates. TIPS prices rose as the yield on the 10-year TIPS declined to 53 basis points at end-March from 96 basis points at the start of the year.

EXHIBIT 2:
All Market Segments Rally, Reversing 2018's Rout
Source: Bloomberg.
Data through March 2019.

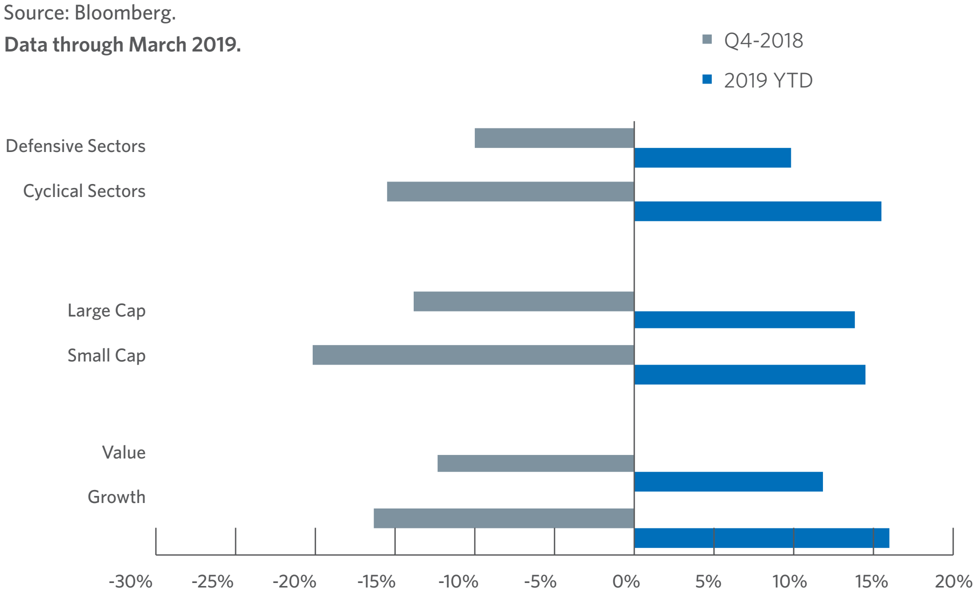
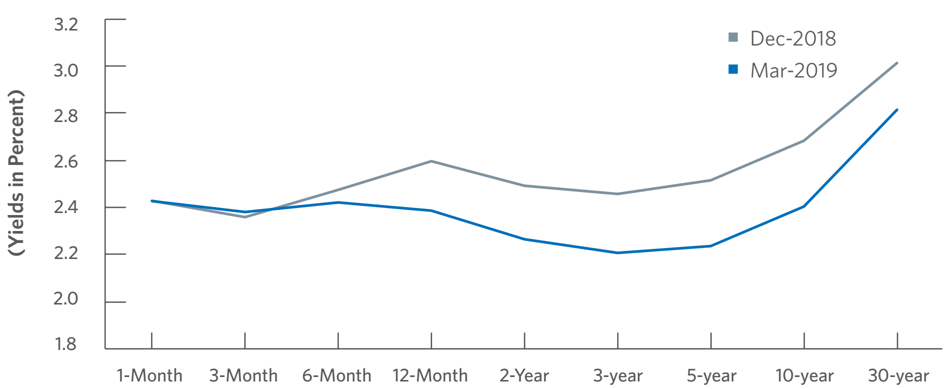


EXHIBIT 3:
U.S. Yield Curve Signals No Further Rate Hikes
Source: Bloomberg.
Data through March 2019.



Private Equity Returns Remain Robust

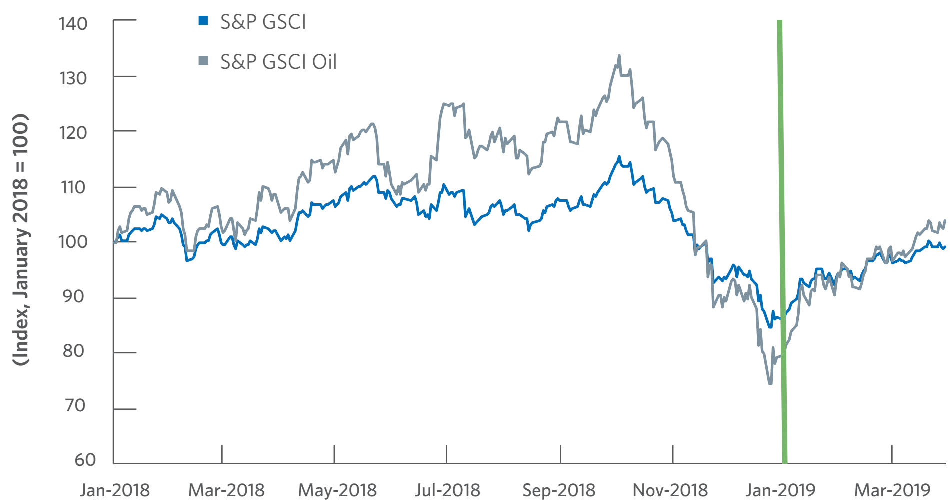
The Thomson Reuters/Cambridge Index of U.S. private equity investments gained 18.7% in the 12 months ended September 2018 (data reported with a six-month delay). Private equity fundamentals remain mixed. Multiples are attractive relative to the public markets and are supported by strong revenue and earnings growth. However, the pace of fundraising is robust, and leveraged buyouts are priced to perfection with multiples hovering near record levels.

EXHIBIT 4:

Commodity Price Rebound Fueled by Oil

Source: Bloomberg.

Data through March 2019.



Summary

Our investment stance remains cautious. Near-term prospects, supported by a shift to easier policies in the U.S., China, and Europe, are favorable. However, the very advanced stage of the U.S. economic and credit cycles, incipient inflationary pressures in the U.S., stretched asset valuations, and heightened risk of policy missteps cloud the medium-term outlook. We initiated an underweight to real estate due to record-high valuations. We remain underweight U.S equities, fixed income duration and investment grade credit, which are also richly valued. We continue to favor hedge funds as a powerful diversifier and a productive source of added value.

Global Economy - Down but Not Out

Global economic growth decelerated further in the first quarter of 2019 as countries representing 70% of global output entered a synchronized slowdown. The IMF expects global growth to fall to 3.3% in 2019 from 3.6% in 2018. In addition to country specific factors, key common drivers of global economic weakness include a decline in business confidence, tighter financial conditions, increased policy uncertainty, and plummeting trade growth. While the synchronized nature of the slowdown has raised fears of a self-reinforcing slide into a global slump, we are encouraged by recent data suggesting a likely stabilization or even a near-term acceleration of activity in key economies.

In the U.S., solid consumption growth, supportive monetary policy, and a rebounding housing market have kept GDP growth above trend. In China, robust fiscal and monetary policy support arrested the slump in manufacturing activity and underpinned solid first quarter GDP growth of 6.4% yoy. The rebound in China is good news for the euro area, where a sharp contraction in external demand had undercut output. There are also tentative signs that a resilient European service sector could mitigate further manufacturing sector weakness. Consumer confidence and retail sales are up, raising the prospect for a modest increase in European growth later this year.

Inflation - Subdued but Watch the U.S.

In most advanced economies, inflation never really recovered after the 2007-09 global financial crisis (GFC). With core and headline price increases well shy of central bank targets, policy makers in most developed countries are still struggling to raise inflation to protect their economies from a deflationary slide in inflation expectations. Of particular concern, is the limited scope for central banks to respond with conventional instruments should inflation and interest rates remain low when the next recession strikes.

In the U.S., however, the situation is quite different. Incipient inflation and wage pressures have been gradually building as the economy approaches the longest post-war recovery on record. With unemployment at lows not seen since the 1960s, the labor market has become increasingly tight and labor force participation is approaching pre-crisis levels.

The consequences of a rebound in wage inflation could be profound. Inflation expectations, which remain quite low, could adjust abruptly, triggering a spike in interest rates on investor fears that the Fed is falling behind the curve. Higher yields would undermine a key support of current lofty asset valuations. Alternatively, if corporations lack the pricing power to pass higher wages through to consumer prices, profit margins will fall. This eventuality would also weigh on stretched U.S. equity valuations.

The Fed Pivots and Markets Rally

The Fed's remarkable policy pivot following the December rate hike marked a watershed. The signal that the Fed was suspending further hikes, and slowing the pace of shrinking its balance sheet unleashed a V-shaped rebound in global equity and credit markets that largely reversed the rout of the last quarter of 2018. Chairman Powell attributed the need for the pivot to rapidly tightening financial conditions, rising global economic risks, and the desirability of lifting inflation expectations to levels consistent with the Fed's target.

While the Fed's pivot proved to be a powerful tonic for global markets, we believe that it will provide only temporary relief. An unanticipated increase in wage and inflationary pressures created by an economy operating above capacity would necessitate a resumption of the Fed's phased rate hikes and balance sheet slimming. The resultant rebound in interest rate expectations would recreate the conditions that contributed to the sell-off of the last quarter of 2018.

Mapping the Cycle - 1998 Reloaded?

By historical standards, the U.S. economy is very late in the cycle. At 118 months, the current expansion is now just three months shy of being the longest on record. The IMF has calculated that the U.S. business cycle ended 2018 in the 82nd percentile of its "early-to-late-cycle scale", exceeding peak readings ahead of the Great Financial Crisis.

Even more worrisome for financial markets, the IMF finds that the U.S. corporate credit cycle is now in the 100th percentile and is at its most stretched point in over three decades. The late stage of the credit cycle is characterized by rising debt levels, deteriorating underwriting conditions, worsening overall corporate credit quality, high leverage ratios, and weakened protective covenants. Credit conditions like these have in the past been harbingers of financial instability and economic downturns.

Recent Fed research has concluded that the "older" the cycle, the more likely its demise. It is therefore not surprising that the short-lived inversion of the U.S. Treasury yield curve in late March added fuel to fears of recession. While the March yield curve inversion was too short-lived to qualify as an "official" recession signal, we believe that a recession, while not imminent, is becoming an increasingly important risk looming on the horizon.

To better understand how the Fed pivot fits into this picture, we travel back in time to revisit the U.S. economy in the summer of 1998, when the Russia crisis and the collapse of LTCM created an abrupt tightening of financial conditions, not unlike the one experienced in the fourth quarter of 2018. By that point in 1998, the U.S. economy had entered the eighth year of a recovery from the previous recession and economic growth was beginning to decelerate. Just as in March of this year, the yield curve had come close to inversion. The flat yield curve prompted the Greenspan Fed to cut rates by 75 basis points, surprising markets. In response to the unanticipated Fed easing, financial conditions rebounded and economic growth recovered temporarily, before ultimately falling into the recession that began in March of 2001.

The episode of 1998 and our recent experience demonstrates the power of monetary policy to relieve a tightening of financial conditions. Easier financial conditions, in turn, can extend a late-stage business cycle. However, the power of the Fed to influence economic developments wanes over time and in certain economic conditions. While it is foolhardy to fight the Fed, the Fed is also realistic about its powers. The Fed is able to nudge the economy onto a desired path, not permanently forestall powerful structural forces.

Key Themes and Market Observations

The late stages of the business cycle generally mark the transition to a more challenging investment environment. Growth momentum tends to weaken, challenging corporate and household fundamentals. Cyclically narrow risk premiums and the prospect of tighter monetary policy create headwinds for risky assets and heighten the risk of adverse shocks to financial conditions.

The preceding analysis informs our active asset allocation decisions in four ways: First, while most economies have been decelerating, growth in aggregate is still solid, particularly in the U.S., and supportive policies can extend the cycle for awhile. A recession in 2019 seems unlikely. After that, our confidence declines swiftly, however. Second, with low nominal and real short-term interest rates, the ability of central banks to contain the impact of shocks to financial conditions is limited. In an environment with ample scope for policy accidents (trade wars, Brexit, populist pressures), there is an increasingly narrow path for a risk friendly outcome in the medium term. Third, we are concerned that an increase in inflation, which is not atypical late in the business cycle, would limit the ability of the Fed to stabilize financial conditions. Fourth, any extension of the business cycle is likely to accentuate already significant financial imbalances and the headwinds for risky assets.

Portfolio Construction and Asset Allocation

Our active asset allocation positioning is largely driven by asset class valuations. The exceptionally long and liquidity fueled expansion since the GFC has resulted in stretched valuations across both risky and safe-haven assets. Combining valuation signals with our belief that the current economic and credit cycles still have some (limited) room to run, we continue to keep active asset allocation tilts modest, and prefer instead to focus our active positions on stock-specific opportunities. The overall risk stance of our portfolios thus remains cautious, but close to policy.

We retain a modest underweight on equities by combining a solid underweight on U.S. equities with modest overweights on non-U.S. emerging and developed equity markets as well as cash. Within U.S. equities, we have established an overweight to value stocks because they are now very attractively valued relative to growth.

Within fixed income, we retain a U.S. duration underweight, in the expectation that U.S. yields will resume their upward move as a solid U.S. economy reasserts itself. We believe that the 1998 analogy might also play out in bond markets. Back then, the initial drop in bond yields that ensued after the Fed's surprising rate cuts was quickly reversed, with yields revisiting their cycle highs in the 12 months that followed. We retain a moderate underweight to credit in light of the mounting vulnerabilities of a very late stage credit cycle.

Within real assets, we retain our underweight to low-yielding TIPS. In addition, we recently initiated an underweight to real estate. After ten years of recovering from the GFC, real estate markets are now also in the late stage of their cycle. On an absolute basis, commercial real estate yields are at record lows, and on a relative basis private commercial real estate prices are high versus bonds and publicly traded real estate. While stretched valuations have been partially offset by strong property market fundamentals, we believe that this support will gradually weaken. We also believe that a cyclical deterioration of funding conditions would weigh on property prices.

We continue to overweight hedge funds. This reflects our view that stock-specific opportunities are likely to be the most promising source of added value in the quarters to come. Moreover, our low-beta approach to hedge fund investing provides valuable diversification benefits and helps dampen total portfolio risk.

China's Market Liberalization

China's prominence as the world's second largest economy, dynamic engine of global growth, voracious consumer of commodities, and aggressive exporter of manufactured goods is well established. In contrast, its domestic capital markets, while also quite large, have remained largely closed. We analyze below the implications of China's initiatives to liberalize its capital markets and place them in the context of its much broader economic restructuring program.

Unsustainable Economic Growth Drivers

The Chinese economy has more than doubled in real terms since 2009. This breakneck pace of growth has a shaky foundation: high levels of domestic savings and investment, and rapid credit growth. China's domestic savings represents 45% of GDP, largely reflecting household savings driven by a fledgling social safety net and aging population. Investment, at 43% of GDP, is almost as high and equally unsustainable (Exhibit 1). Domestic savings have largely been intermediated through the financial sector, fueling rapid credit growth. Credit since 2009 has expanded at twice the pace of the economy, propelling the stock of debt of the non-financial sector to over 250 percent of GDP, much of it extended to inefficient state enterprises and sectors with excess productive capacity.

China's Capital Markets Opening

Recognizing that growth based on excessive savings, investment, and debt is unsustainable, China has embarked on an ambitious liberalization program. This program aims at reducing savings in favor of consumption, reining in investment and credit growth, freeing the exchange rate, improving financial market regulation, and opening capital markets, including its domestic equity market.

Tight quotas, onerous qualification requirements, and strict currency controls impeded foreign participation in China's domestic equity market. The high volatility of a market dominated by retail investors and capriciously imposed trading controls further deterred foreign interest.

However, because of China's reforms, the domestic A-Share market is becoming increasingly accessible and attractive to foreigners. MSCI's recently announced plan to increase the proportion of China A-shares in the MSCI EM Index to 3% in November 2019 from only 0.35% in March 2018 represents a milestone in the liberalization process. (Including the offshore market, Chinese equities will increase to 32% from 30%.)

China's A-share market has a capitalization of $6.1 trillion, about 7% of *global* GDP, and is the world's second largest equity market after the U.S. ($32 trillion). Yet only about 3.5% of the China A-shares market is open to foreigners (Exhibit 2).

Opportunities and Risks

Strategic has been investing in the China-A share market since March 2018. We currently target a 5% overweight to the market in our emerging equity portfolio. Our overweight is motivated by the market's outsized scope for added value and diversification benefits. We also anticipated that early entrants would benefit from further market opening.

Over the long run, the increased integration of the Chinese equity market in global capital markets will likely reduce market inefficiency and the opportunities for active management, and increase the correlation of the Chinese market with others, thus reducing its diversification benefits. For now, however, China-A shares have a low correlation with other markets, offer opportunities for active management, and are fairly valued.

EXHIBIT 1:
China's Savings and Investment Imbalances
Source: IMF, WEO Data Base, April 2019 Vintage.

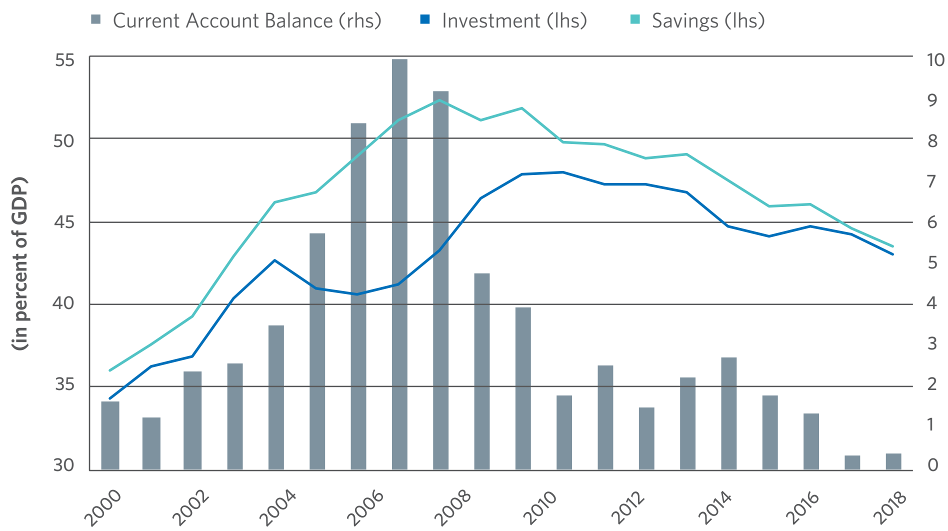
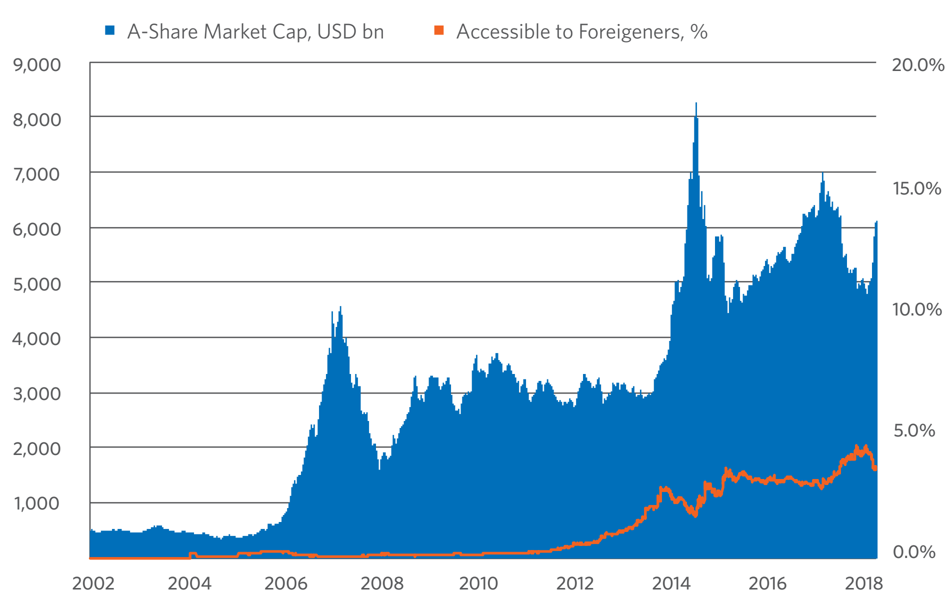


EXHIBIT 2:
China's A-Share Market and Foreign Participation
Source: Bloomberg.



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

Strategic Investment Group®

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

+1 703.243.4433 TEL
+1 703.243.2266 FAX

strategicgroup.com