Market Commentary

Strategic Investment Group®

JUNE 30, 2019

» GLOBAL MARKET REVIEW

» OUTLOOK & STRATEGY

» SPECIAL TOPIC

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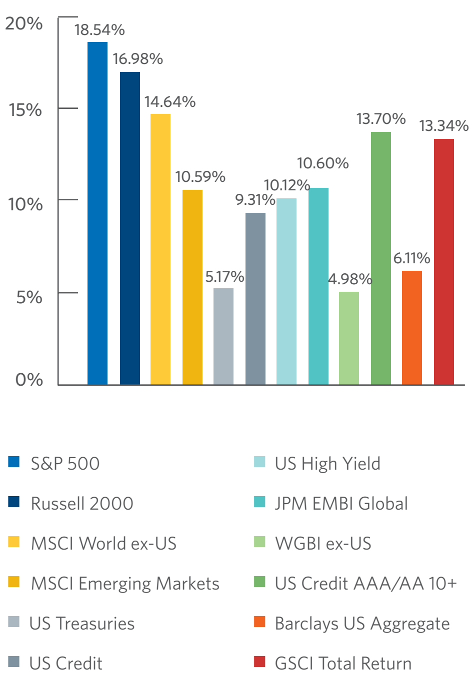
Summary

Global equity markets climbed higher in the second quarter, although the ascent was less steep than the first and punctuated by periodic slides. At mid-year, most equity markets had generated strong gains. Global bond markets also registered significant price increases as credit spreads compressed and sovereign bond yields and term premiums fell to low and in many cases negative levels. Geopolitical tensions sent oil prices soaring. The dollar was little changed against a broad index of currencies, while the euro and sterling declined, the latter reflecting Brexit chaos.

EXHIBIT 1:
Performance of Major Market Indices
Source: Bloomberg.
Year to date through June 30, 2019.



Risk assets soar as safe haven yields fall.

U.S. Equities Feast on Doves

Following three straight months of gains in the first quarter, U.S. equities rose less rapidly and steadily in the second. Nevertheless, the S&P 500 generated its largest first half advance in two decades, returning 18.5%. The siren song of cooing doves at the Fed overcame mounting signs of the need for caution in the face of stretched valuations, slowing growth at the late stage of a record long U.S. business cycle, and high levels of policy uncertainty stemming from trade tensions and Brexit.

Most segments of the U.S. equity market have enjoyed double-digit returns so far this year. Growth stocks continue to outperform value by a significant margin, while large cap stocks maintain a modest lead on their small cap counterparts. Reflecting this dynamic, the valuation of growth stocks appears increasingly stretched, while that of value shares remains attractive. Returns were more widely dispersed across sectors. Technology handily outpaced all other sectors, followed by industrials, consumer discretionary, and telecom. Healthcare, up 7.4%, was the laggard and the only sector limited to single-digit returns for the year to date.

Ebullient Equities, Brooding Bonds

Equity and bond markets are sending starkly divergent messages. The upward trajectory and full valuation of most global equity markets imply a rosy outlook for output and earnings growth. Low sovereign bond yields, negative term premiums, the inversion of the U.S. yield curve, and the mounting stock of debt carrying negative yields, in contrast, suggest a less sanguine view of the sustainability of the global business cycle (Exhibit 2 on next page).

Undeterred by these conflicting crosscurrents, global equity markets powered ahead in the first half of the year. The MSCI World ex-U.S.

Index rose 14.6%. Continental European bourses, including in particular France and Germany, led developed markets higher, gaining 15.8%. Japanese shares also advanced, although at about half the pace of Europe. Emerging equity markets rose 10.6%, with China A shares, up 28.3%, leading other markets (Exhibit 3). Frontier markets also delivered double digits, gaining 11.9%.

Risk Up; Yields and Spreads Down

Global bond markets present a paradox. Outstanding credit is at very high levels and in the U.S. is above pre-crisis peaks. Moreover, credit quality and investor protections have been significantly eroded. Nevertheless, credit spreads are compressed and term premiums in the U.S. and Europe are at negative levels. The nominal yield on global bonds totaling about $13 trillion is negative, including almost $10 trillion in sovereign issues. Accounting for inflation, the yield on about $25 trillion in outstanding global bonds is negative in real terms, including virtually 100% of yen-denominated bonds, 90% of bonds in euros, and 87% in sterling.

Against this paradoxical backdrop, U.S. Treasuries generated strong returns, led by issues at the long end of the maturity spectrum, as the 10-year U.S. Treasury yield briefly dropped below 2% in June and the U.S. yield curve remained inverted for the entire month of June. U.S. credit markets also rose sharply, led by long-duration, investment-grade credit. The high yield sector, which was up 9.7% in the first half of the year, lagged owing to its shorter duration. Yields in developed and emerging bond markets outside of the U.S. also declined, with German 10-year bund yields touching an all-time negative level in June. The WGBI ex-U.S. index of developed sovereign bonds was up 5.2% through June, while the EMBI Global Index of emerging sovereign bonds has gained 10.5%.

Hedge Funds

Hedge funds overall continue to post lackluster returns, with the HFRX Equal Weighted Index up 2.1% through June. Beta heavy strategies lead all others, buoyed by rising equity markets. Macro strategies, which were well positioned for the drop in yields across developed bond markets, have also performed relatively well.

EXHIBIT 2:

Global Equities Surge Ahead, Despite Signals for Caution

Source: Bloomberg, and Strategic calculations.

Data through June 30, 2019.

Oil and Gold Shimmer and Shine

Tankers exploding in the Persian Gulf and heightened tensions between the U.S. and Iran sent oil prices sharply higher, propelling the GSCI All Crude Index up 28.8% in the first half of the year (Exhibit 4). Geopolitical tensions and easy money also boosted gold prices, which rose 9.9%. Broader commodity markets, however, posted more modest returns. In the real estate market, the NCREIF Open-End Funds Core Index (reported with a quarter delay) gained 6.6% in the 12 months through March 2019. Industrial properties led other sectors due to strong leasing by e-commerce companies. The West led other areas owing to the rapid growth of cities in the region. TIPS prices rose as the yield on the 10-year TIPS declined to 55 basis points at end-June from 96 basis points at the start of the year.

Private Equity

The Thomson Reuters/Cambridge Index of U.S. private equity investments gained 14.1% in the 12 months through March 2019 (data reported with a three-month delay). Buyout valuations are high, fundraising robust and dry powder abundant. The hot IPO market also suggests froth (see Special Topic). Nevertheless, multiples remain attractive relative to the public markets and are supported by strong earnings growth.

EXHIBIT 3:

China Leads Emerging Markets Higher

Source: Bloomberg.

Year to date through June 30, 2019.

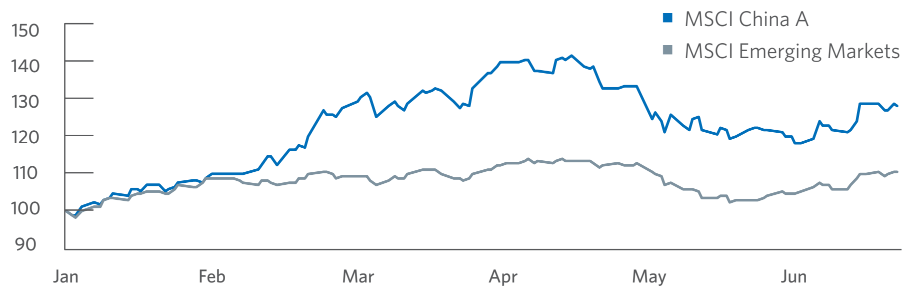
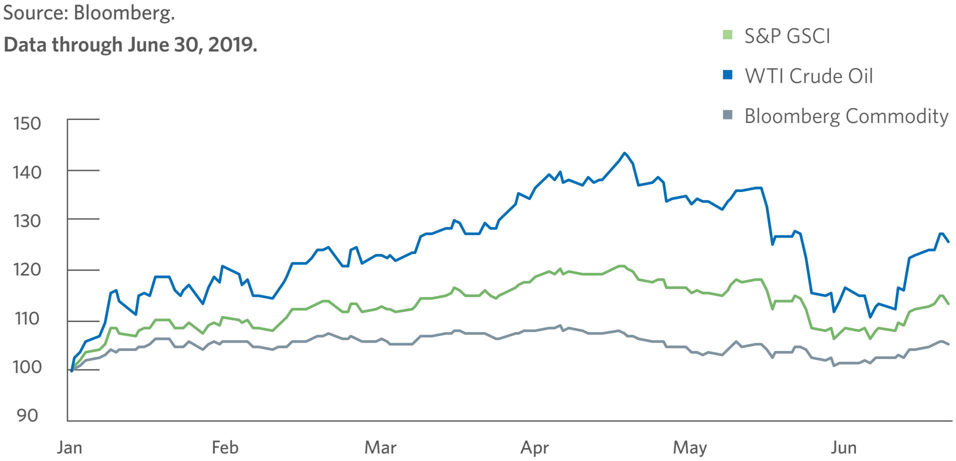


EXHIBIT 4:

Oil Prices Spike with Geopolitical Tensions

Source: Bloomberg.

Data through June 30, 2019.



Summary

As the global economy continues to decelerate, major central banks are preparing investors for lower interest rates. Market reactions have diverged as U.S equity markets flirt with all-time highs while bond markets send recession signals. The Fed appears to hold the key to the puzzle. If its insurance cuts delay the end of the business cycle equities will win over bonds. As uncertainties abound we confirm a cautious top-down investment stance. Valuation-driven underweights to equities, duration, credit and real estate are combined with an overweight to hedge funds and cash. We continue to prefer active risk from a large number of small and well diversified bottom-up security level positions over top-down strategies.

The Global Slowdown Continues

A slump in global manufacturing activity has extended the economic slowdown in the world's major economies. While partially driven by a slowdown in the global consumer electronics cycle, the decline also coincides with a sharp decline in global trade volumes. It is increasingly apparent that the trade war has moved from headlines and Twitter feeds to hard economic data.

Uncertainty about future tariffs, the outlook for export demand, and impeded access to established import channels is depressing business confidence and investment activity in major economies. While the interplay of 20 years of rapidly growing global value chains and sharply lower global tariffs has produced significant productivity gains for the global economy, it also made the system more vulnerable to any disruption in international trade flows. Given the complex structure of most value chains, we are concerned that the longer-term effects of an extended trade war could easily be underestimated.

Solid service sector growth has partially offset the slump in global manufacturing activity, while solid consumer spending has offset weak private sector investment. Over time, however, these prevailing dynamics may not hold. As service sector activity continues to account for growing portions of global value chains, it remains susceptible to weakness in the manufacturing sector and becomes an increasing liability to global growth as a whole. Similarly, consumer confidence will eventually respond to lower growth and income and no longer be able to serve as a crutch for waning private investment.

The slowdown has been synchronized across economies. U.S. GDP growth likely remained close to trend in the second quarter, but growth momentum has been fading throughout the quarter. In the Eurozone, economic disappointment has not abated. Sub-trend GDP growth has weakened further in Q2 with most recent warnings by the German Bundesbank suggesting that the Eurozone's biggest economy might have contracted last quarter. In China, the economy continued its bumpy ride. Second quarter growth slowed again after a brief policy-induced rebound in the first quarter.

U.S. Yield Curve Sends a Recession Signal

We previously reviewed the usefulness of the U.S. Treasury yield curve as a leading recession indicator. In the past 60 years an inverted yield curve has invariably been followed by an economic slowdown and, with one exception, by a recession. A simple rule of thumb predicts a recession within two years of a yield curve inversion.

In June, the U.S. Treasury curve inverted between the 10-year and the three-month segment, generating the dreaded recession signal. In a slight modification of the New York Federal Reserve's recession probability model, which converts the slope of the yield curve into recession probabilities, our own calculations suggest that the probability of a recession within 18 months is 92%. While the explanatory power of the model is limited, the result is a stark reminder that the end of the current cycle is near, bar any major policy changes.

As in past business cycles, the long lead time of the yield curve signal implies a recession warning at a time when GDP growth is still close to trend. This dissonance presents policymakers and market participants with the challenge of making decisions based on expected rather than actual fundamentals.

Fed - Servicing an Engine in Mid-Flight

Since the Great Financial Crisis the U.S. Federal Reserve has played an ever-more pivotal role in the U.S. economy and in global financial markets. The Fed's aggressive and skilled crisis response following the Lehman collapse arguably prevented a Depression in the U.S. and paved the way for the current recovery that has become the longest on record. The combination of zero interest rates and multiple rounds of quantitative easing created a wall of liquidity which fueled a decade-long risk rally. During this episode, the Fed's effectiveness depended on the clarity of its mission, effective communication, and independence from political interference.

We are concerned that all three of these institutional strengths might be compromised, which could jeopardize the Fed's medium- to long-term ability to safeguard balanced non-inflationary growth and financial stability. The Fed has been facing increasing political pressure to lower rates in support of the domestic economy. Additionally, the market perception of a "Powell Put" that will generate policy easing whenever risk assets are under severe selling pressure has also begun to erode the efficacy of the Fed's policy.

The Fed's monetary policy review which got under way last year is a far-reaching project that comprises the formulation and measurement of the Fed's dual goal of price stability and maximum employment, the Fed's communication strategy, and its toolkit to affect the monetary stance of the U.S. economy. There have been more questions than answers and, at times, all too publicly aired dissent about how far the U.S. economy is from its dual goal. Similarly, reduced confidence in analytic work horses like r* and the Taylor rule and well-publicized doubts in established communication tools like the dot plot has challenged the Fed's ability to instill confidence in economic agents and market participants. The current discussion of a switch from targeting 2% core-PCE inflation to an "average rule" (which would currently call for an "inflation overshoot" to make up for years of falling short of the 2-percent target) could compromise well-anchored inflation expectations. Particularly if it were to coincide with increased political interference and market pressures.

Questions and Observations

First, will Fed insurance rate cuts avert a recession? Fed Vice-Chair Clarida has made repeated references to the Fed's 75 basis point insurance rate cuts in 1995 and 1998. In both cases, not unlike today, the economy had begun to decelerate even though GDP growth was still close to trend. After the cuts, growth reaccelerated. This suggests that timely rate cuts can at least extend the cycle. In a marked difference to today, however, the yield curve, had not yet inverted at the time of the rate cuts, suggesting that the economy had not progressed as far in the cycle as today. Comparing 1995 and 1998 with the pre-recession events in 1990, 2000 and 2006, it stands out that the Fed did not respond nearly as swiftly once the yield curve had inverted and the economy had started to decelerate. We conclude that while swift Fed easing could extend the cycle, these cuts will not occur in a vacuum. Without an end to the simmering trade conflicts, they might prove too little too late.

Second, is there a price to pay for insurance cuts? If insurance cuts work, they extend the business cycle by providing extra liquidity, which will tend to stretch valuations of risky assets and fuel economy-wide leverage. This could pose a risk to financial stability. The extension of the business cycle could also raise the risk of an inflation overshoot.

Third, how powerful is the "Powell Put"? It worked well late last year when the Fed pivot away from "autopilot rate hikes" became a powerful antidote to the sharp drop in risk assets. However, the effectiveness of the put is likely to wear off. The more frequently the Fed defends risky assets, the more it compromises financial stability by dislocating valuations and preparing the ground for even more painful market corrections.

Fourth, is inflation down and out? We don't think so. There are indications, that post-GFC slack and dislocations are fading. Wages and prices have started to behave more in line with standard cyclical patterns. This suggests a build-up of inflation pressure which could surprise markets at a time when markets and policymakers are least prepared. We are concerned that a switch to a (formal or informal) make-up inflation rule by the Fed could add fuel to any late-cycle inflation pressure.

Fifth, who is right: optimistic equity markets or pessimistic bond markets? Probably both. In the short term, equity markets tend to benefit from rate cuts, even if the yield curve's recession signal proves accurate in the longer term. In the case of a successful insurance cut, yields would likely increase until the stimulus has run its course or inflation pressures call for monetary tightening, thereby paving the way for the next recession.

Portfolio Construction and Asset Allocation

In a complex end-of cycle macro environment, valuation signals remain the North Star of our top-down strategies. It remains difficult, however, to find attractive asset classes as valuations in both risky and safe-haven markets have become ever more stretched. We therefore prefer allocating active risk to bottom-up stock selection via manager selection.

After a solid second quarter which saw U.S equities outperform non-U.S. stocks we retain our underweight to global equities. We construct the underweight by combining a solid underweight to U.S. equities (which we estimate to be approximately 24% expensive) with small overweights to developed non-U.S. and emerging equity markets as well as cash. We retain our overweight to value stocks, which have further cheapened relative to growth stocks.

The sharp drop in Treasury yields challenged our duration underweight in the second quarter. Against a history that dates back to 1871, 10-year nominal yields are now trading in the second percentile. In light of these extremely stretched valuations we retain our duration underweight. While we acknowledge that the GFC has demonstrated that bond yields can drop even further, we believe that in the near- to medium-term yields will likely rebound in expectation of a rerun of the events in 1995 and 1998. Back then 75 basis point insurance rate cuts by the Fed led to a pick-up in growth and inflation expectations. A modest credit underweight is balancing the headwinds from the very late stage in the credit cycle and the likely cyclical support from Fed rate cuts.

Valuation signals continue to support our underweight allocation to real assets. Against more than 50 years of historical data, TIPS yields are trading in the 8th percentile of monthly outcomes. We believe that this does not provide any value cushion even in the case of an unexpectedly quick end to the U.S. business cycle. Our recently established underweight to real estate also remains in place. The moderation of real estate returns in 2019 has been consistent with record low capitalization rates.

Our overweight to hedge funds is consistent with excessive valuations in many risky and safe-haven assets. The overweight pushes active risk into a mostly market neutral allocation which has produced attractive and uncorrelated returns over most time periods.

Land of the Unicorns

In 2004, Google went public valued at what was then an astonishing $23 billion on the back of revenues of $2.7 billion and net earnings of $286 million. Large IPOs are now commonplace. Many, however, are unprofitable. Unicorns – private start-ups priced over $1 billion – are proliferating. Uber, to take one example, went public this year valued at $82 billion despite losses of $3 billion in 2018. This quarter's special topic considers the current dynamics of late-stage venture capital.

Fundraising Froth

Private equity funds, including venture capital, have been attracting heavy inflows in recent years. Last year saw near record inflows into U.S. venture capital funds – $55 billion – and this year is on track to match that pace (Exhibit 5 on next page). Outside of the U.S., SoftBank's $100 billion Vision Fund, the world's largest investor in tech firms, is transforming the venture landscape and an equally large Vision Fund II is on the horizon.

Changing Structure of Late Stage Venture

These flows are changing the structure of venture capital in several important ways. First, venture capital funds have been getting much larger. This is significant because venture funds have traditionally been small given the limited opportunity set and the need for a highly selective process to increase the odds of identifying promising start-ups. Second, venture-backed companies are going public later as they can easily benefit from multiple rounds of pre-IPO financing. This dynamic has inflated valuations and increased the share of assets in late-stage venture start-ups. Third, firms at IPO are older and larger. The number of U.S. venture backed private companies with valuations of $1 billion or more (147) has never been higher. Globally, such firms have a record valuation of $582 billion. With investors prioritizing revenue growth over profitability, the losses of these firms are commensurately large. The proportion of money-losing firms going public (81%) is at the same level as during the tech bubble of 1999-2000.

The dynamic of venture capital funding has an inexorable logic. Flows into venture capital funds must be monetized. However, pre-IPO valuations have been so bid up by multiple rounds of financing, that the gain from going public has been eroded (Exhibit 6 on next page). The need to monetize investments in late-stage venture capital, rather than private-to-public arbitrage gains, appears to be the motivation for going public.

Potential Spillovers – the Case of WeWork

While venture capital remains a small market segment, there are cases with potentially systemic implications. WeWork, for example, is soon to go public with a $47 billion valuation despite losses of $1.9 billion in 2018. It is the largest tenant of offices in New York and other major cities. Considered by some to be a tech company and thus meriting the inflated valuations common to the sector, WeWork's business model resembles a traditional leasing company. Its highly leveraged financial structure depends on short-term tenant leases to fund long-term leases for office space. While its financing structure is akin to a bank, WeWork has no capital buffer, no stable source of financing, no profits, and no lender of last resort. In a downturn, WeWork would face losing short-term funding as occupancy and rents decline rendering it unable to meet its liabilities.

Sign of the Times

Venture capital is inherently a high-risk undertaking that requires a highly selective approach and merits a portfolio allocation that appropriately calibrates the risk. The dynamics unleashed by record flows into the sector are yet another manifestation of the need for caution in a liquidity-fueled, late-stage business cycle.

EXHIBIT 5:

U.S. Venture Capital Fund Flows at Near-Term Peak

Source: Strategic.

Data through May 15, 2019.

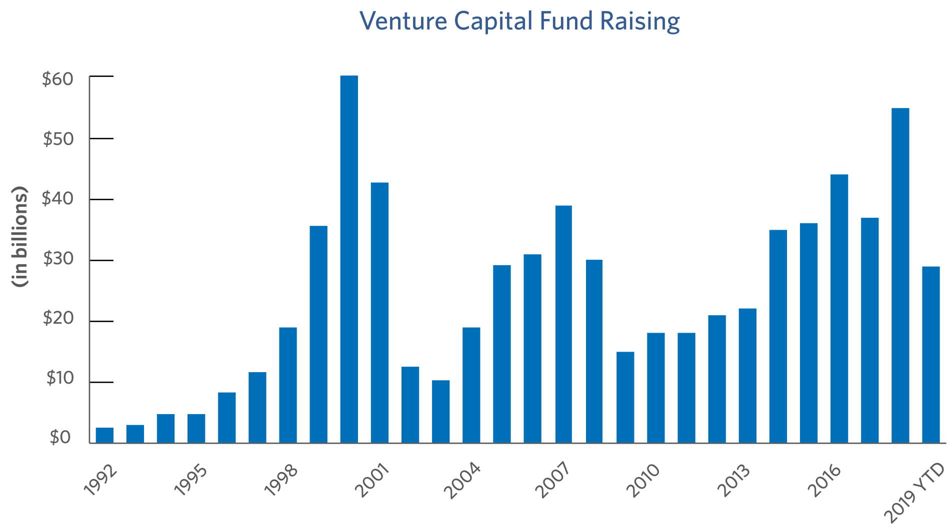
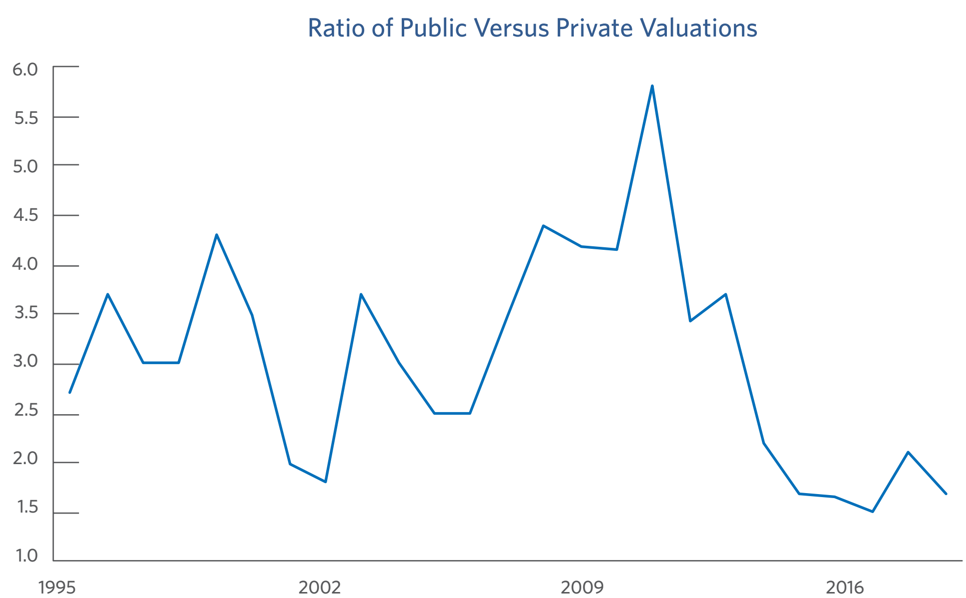


EXHIBIT 6:

Realized Gain from Going Public Falls

Source: Sand Hill Econometrics.

Data through April 2019.



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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