DECEMBER 31, 2019

Strategic Investment Group®

Market Commentary

» GLOBAL MARKET REVIEW

» OUTLOOK & STRATEGY

» SPECIAL TOPIC

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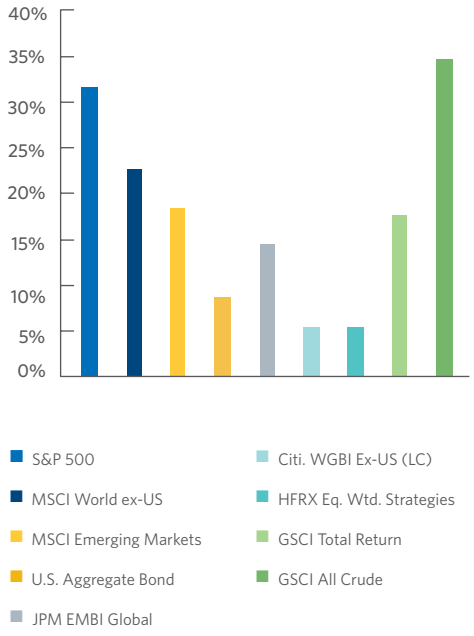
Summary

If Oscar Wilde was correct to define a cynic as someone "who knows the price of everything and the value of nothing", then markets in 2019 were a cynic's dream. U.S. equities reached record highs and non-U.S. equities rose sharply despite rich valuations and lackluster earnings growth. Easy monetary policies and continued, if slowing, global growth provided the impetus for the gains. Bouts of volatility, triggered by trade tensions, declining global trade and manufacturing growth, and geopolitical concerns, punctuated the year's returns. Global bond markets also rose, in spite of low real yields, compressed credit spreads, and high debt levels.

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



All assets enjoyed strong gains, regardless of valuations.

U.S. Equities Reach Record Highs

The S&P 500 surged over 31% in 2019, the best annual performance in six years. All three major equity indices hit fresh highs. The year's gains were widely spread across all sectors, market capitalizations, and growth and value shares. Growth and large-cap stocks outperformed value and small, but all enjoyed returns above 25%. Tech stocks led all sectors, rising over 47% in 2019. Two tech stocks each with a market cap of $1 trillion – Apple and Microsoft – accounted for about 15% of the gain of the S&P 500. Other major contributors included Facebook, Alphabet (Google), and Amazon.

The foundation for the stellar performance of the U.S. equity markets in 2019 was not as solid as one might hope. The main impetus for the gains was a renewed turn to monetary ease by the Fed. The high returns reflect multiple expansion that further stretched valuations as corporate earnings growth declined (Exhibit 2 on next page). The outsized return of mega-cap tech stocks further concentrated the market. Moreover, the global economy grew at its slowest pace since the Great Financial Crisis, as trade barriers and policy uncertainty weighed on manufacturing output, trade volumes, and corporate investment. However, consumer spending, especially in the U.S., was buoyant, as the jobless rate fell to low levels and wage growth picked up.

Non-U.S. Equities Soar through Headwinds

Although lagging U.S. equities, the gains enjoyed by non-U.S. bourses were extraordinary, especially considering headwinds in the form of heightened geopolitical risks, as well as low growth in corporate earnings, the global economy, and trade volumes. The MSCI World ex-U.S. index

returned 22.5% in 2019. As was the case in the U.S., the bulk of the gains in global equity markets stemmed from multiple expansion, rather than earnings growth. Among advanced markets, European equities led, rising 23.8% with the support of continued easy conditions courtesy of the ECB and improved prospects for an orderly Brexit process. Japanese equities also had a strong year, rising about 17% on signs of stronger economic growth.

Despite slower economic growth in Brazil, India, Mexico, and Russia and financial crises in Argentina and Venezuela, emerging equity markets gained 18.4% in 2019, capped off by a surge of 7.5% in December. Hopes of easing trade tensions and a weakening U.S. dollar fueled the December spike. Among emerging markets, Chinese equities were the strongest performers, with China A-shares soaring 37.5% for the year. Reports that profits at China's industrial firms and retail sales grew at a faster-than-expected pace eased investor concerns over a slowdown in the world's second largest economy.

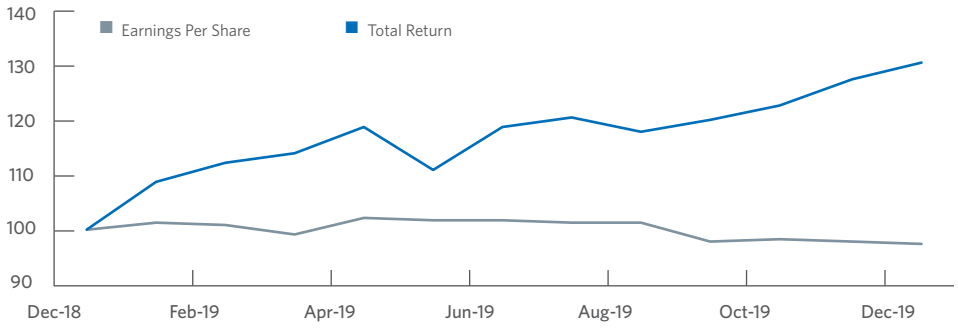
Global Yields and Spreads Fall Further

Global bond markets also rose, undeterred by high levels of sovereign and corporate debt, deteriorating credit quality and investor protections, and a starting point of very low yields and narrow credit spreads (Exhibit 3 on page 3). The U.S. yield curve, which had been inverted for much of the year sparking recession concerns, steepened as short-term rates fell faster than long-term yields. Reflecting this dynamic, the 10+ year U.S. Treasury index gained 14.9% compared with the 5.2% return of the 1-10 year index. U.S. corporate bonds also gained, with the high-yield sector (up 14.1%) handily outperforming investment grade issues (8.9%), as the reach for yield continued. Outside of the U.S., developed bond markets also rose, with the WGBI ex-U.S. index of developed country sovereign bonds gaining 5.3%. Emerging market sovereign bonds performed about in line with the U.S. high-yield market, with the JP Morgan EMBI Global index returning 14.4%.

Market Beta Dominates Hedge Fund Return

The HFRX Equal Weighted Index rose 5.4% in 2019. All sub-indices except equity market neutral strategies posted gains. Directional strategies strongly outperformed market-neutral and relative value, as market beta dominated returns, and stock prices rose with little regard to relative valuations. Equity Hedge was the top performer in 2019, gaining 10.7%. A strong appetite for mergers and acquisitions fueled by cheap debt and modest economic growth pushed the HFRX Event Driven index 10% higher. Last year was the fourth-best year on record for merger and acquisition activity, with the combined value of global deals reaching $3.9 trillion, just 4% shy of 2018's total.

EXHIBIT 2:
Equities Soar despite Earnings Weakness
Source: Bloomberg. Russell 3000 Index, Jan. 1 2019 = 100.



Real Assets: Oil Fuels Commodities Ascent

The GSCI index rose nearly 18% in 2019. Oil price gains – up 35% – were the main contributor to the increase of the GSCI (Exhibit 4). Precious metals and especially gold rose sharply, as low yields on the dollar and other major currencies and geopolitical concerns fueled interest in the ultimate safe haven. TIPS also rose, as the real yield on the 10-year TIPS fell to 0.15% from 0.96% during the year. In the real estate market, the NCREIF Open-End Funds Core Index (reported with a quarter delay) gained 4.6% in the year through September 2019. Real estate valuations remain stretched and property yields are at historic lows.

Private Equity: Solid Returns, Torrid Flows

The Thomson Reuters/Cambridge Index of U.S. private equity (reported with a quarter delay) gained 8.4% in the year through September. While returns remain strong, and multiples are attractive relative to public markets, other indicators suggest a degree of froth. Capital is flowing into private equity at a torrid pace. LBOs are priced to perfection, with EBITDA multiples at record levels. Valuations for VC-backed companies are elevated, with revenue rather than profit driving pricing. Last year set a record for public market exits, with mega-IPOs including Uber, Lyft, Zoom, Pinterest, and Beyond Meat. The number of U.S. venture backed private companies with valuations of $1 billion or more reached record levels.

EXHIBIT 3:

U.S. Corporate Debt Mounts as Credit Quality Erodes

Source: Bloomberg.

Data through December 2019.

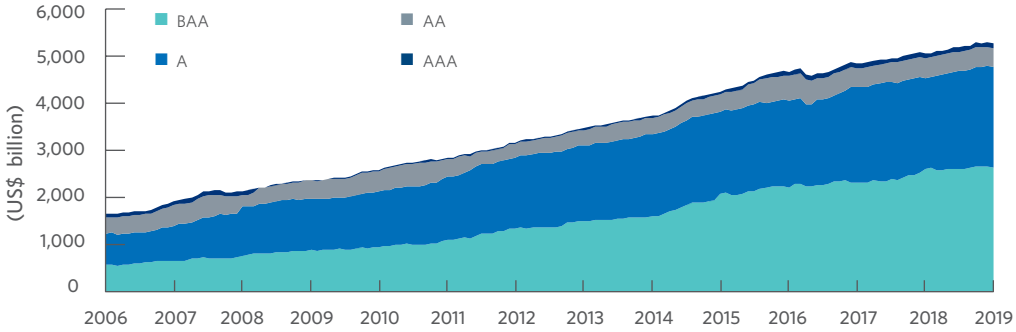
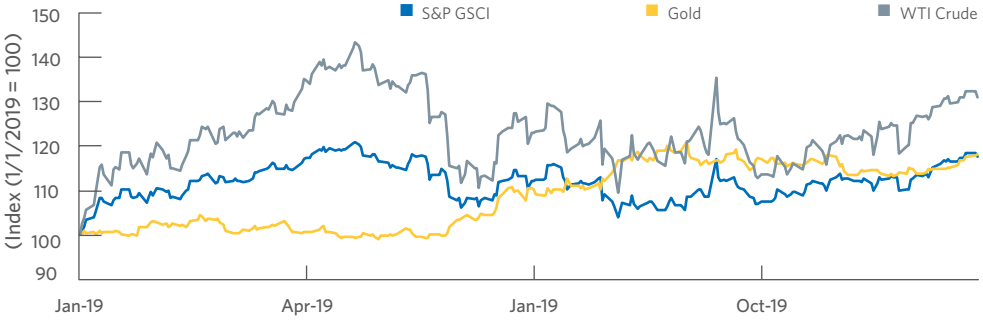


EXHIBIT 4:

Oil Leads Commodities Higher

Source: Bloomberg.

Data through December 2019.



Summary

The past decade transformed central bankers into masters of the economic and financial universe. After saving the global economy from descent into a severe depression, major central banks opened a powerful monetary umbrella to shield the world from further economic and financial calamity. Unprecedented monetary ease propelled risky and safe-haven assets alike, delivering a decade of outstanding returns and low volatility. As we enter a new decade, however, monetary policy fuel is running low, the business cycle is at a late stage, valuations across most asset classes are stretched, headwinds are building, and policy uncertainty is high. Against this backdrop, we are tilting portfolios away from expensive equities, bonds and real assets and towards hedge funds and cash. Within equities, we remain overweight value stocks.

A Decade of Central Bank Insurance

In the wake of the Great Financial Crisis (GFC), central bankers were the only policy game in town. Their extraordinary measures of monetary easing averted the collapse of the global economy and facilitated the recovery of financial markets. As a result, risk assets and safe-haven bonds soared for a decade, and in the U.S., the economic recovery from the GFC became the longest expansion on record. By pulling out all monetary policy stops and promising "to do whatever it takes" to stabilize the economy and markets, central banks provided comprehensive insurance for economic agents and market participants, thereby dampening volatility and keeping economic growth on a steady, if lackluster path.

The Legacy of Unorthodox Monetary Policy

Mounting financial market anomalies and vulnerability are the dark side of a decade of central bank activism (See this quarter's Special Topic, "Nothing Succeeds Like Excess.") Equity markets soared even as bond markets signaled slow growth and entrenched disinflationary forces. Valuations in the U.S. equity market grew increasingly stretched as share prices rose despite falling earnings. A small group of mega-cap growth stocks, especially those in the tech sector, generated outsized returns, leading to the highest concentration of the U.S. stock market since the tech bubble. Apple, to take one trillion-dollar example, rose 86.2% in 2019 even as earnings declined, resulting in its P/E ratio doubling from about 13 to 27.

Bond market anomalies also emerged. Yields on advanced economy sovereign bonds fell to secular lows, as central banks anchored the short end of the yield curve and expectations for continued low inflation led the term premium to collapse. In Europe and Japan, the stock of bonds priced to have negative yields reached $17 trillion, accounting for the lion's share of their sovereign bond markets. In some countries, negative nominal yields reached as far as 30 years out the maturity spectrum. In Europe, even some corporate bonds had negative nominal yields. Credit spreads on corporate bonds in the U.S. narrowed notwithstanding high levels of issuance, deteriorating corporate balance sheets, declining credit quality, and eroding

creditor protections. Companies mostly mobilized debt to buy back equity thereby boosting their equity price, not investment.

Signs of excess are also apparent in private markets. New investments have been flowing to private equity funds at a torrid pace and IPO pricing has reached fanciful levels. In the case of real estate, valuations are full and property yields, mirroring the real yields on TIPS, are at historic lows.

The Fed on the Horns of a Dilemma

In addition to these deepening financial market vulnerabilities, monetary policy makers face two critical problems: First, after years of administering ever-stronger monetary drugs, the withdrawal of the spiked monetary punch bowl is fraught with risk. The U.S. economic slowdown and sharp but temporary market decline that followed the Fed's moves to normalize policy in 2018 highlighted the extent to which markets and the economy have become addicted to monetary ease. The Fed's subsequent return to monetary accommodation reinforced the perception that its insurance coverage would remain indefinitely in place. The Fed appears trapped: continued stimulus will deepen market dislocations while tighter policies could trigger market turmoil.

Second, with the end of the business cycle approaching, the Fed's ability to fight a future downturn is impaired. Rates are lower than they have typically been at the end of previous cycles and its balance sheet remains bloated. Central bankers are already calling for fiscal policy to play a more active role in the event of a downturn, despite already high sovereign debt. Although the appetite for such policies has grown on both sides of the Atlantic, we doubt that timely and decisive fiscal action would be taken in the event of a renewed downturn.

A Complicated U.S. Backdrop for 2020

Growth in most major economies has slowed for the past two years. The IMF is forecasting that the U.S. economy will slow further this year and the next as the trade war and the waning effects of the 2017/18 fiscal stimulus take their toll. The decline in the manufacturing sector and corporate investment has so far been mitigated by service sector growth and solid consumer demand in response to a tight labor market and gradually increasing wages.

There are significant downside risks. Rising tensions between countries – notably the U.S. and Iran – and eroding social cohesion within countries – notably in France and Hong Kong– have the potential to precipitate a downturn. The risk of continued contraction of global trade flows due to renewed tensions between the U.S. and its European, Chinese, and North American trading partners, as well as the uncertainty engendered by Brexit further weigh on economic prospects.

Despite these risks, already slowing economic growth and the inherent vulnerability of late stage cyclical dynamics, markets have converged on a very rosy scenario for the U.S. economy, predicated on solid economic growth, stable inflation, and continued monetary ease for as far as the eye can see. In this rosy scenario, real yields will remain abnormally low for the indefinite future, enticing investors to seek returns in ever more creative, and risky, ways, thus sustaining stretched valuations.

We are concerned that the current optimism is misplaced. It glosses over the high level of policy uncertainty in the U.S., and elsewhere, the very real risk of renewed trade tensions, geopolitical fault lines, and the vulnerabilities that have been building in financial markets during a decade of extraordinary global monetary ease. The outlook for the U.S. economy will depend on whether the Fed's renewed easing of monetary conditions will suffice to avert the recession signaled by last year's inversion of the U.S. Treasury yield curve. The optimistic outlook is also vulnerable to a pickup in inflation, perhaps from wage pressures in the tight U.S. labor market, which would restrict the Fed from maintaining monetary support.

Stretched Market Valuations

A decade of extreme monetary ease has pushed valuations in most asset classes into expensive territory. In the U.S., the combination of lackluster earnings growth and strong risk appetite has pushed domestic stocks further into overvalued territory. Our own valuation model now suggests that domestic stocks are about 30% above fair value. While other major equity markets are attractively valued relative to U.S. stocks, they are at best fairly valued on a stand-alone basis.

Within equity markets, especially in the U.S. and emerging markets, the value-growth dislocation has become extreme, as growth stocks have continued to enjoy outsized gains. By our measurement, growth stocks are more than one standard deviation expensive relative to value, largely reflecting the impact of tech sector stocks that accounted for a disproportionate share of the U.S. market's 31% gain last year. The pricing dynamic based on multiple expansion rather than earnings growth in U.S. and non-U.S. markets alike is a worrisome sign of a growing disconnect between equity prices and their fundamental value. Current conditions are reminiscent of the 2001 tech bubble, which led to an eventual violent correction.

In U.S. bond markets, valuations are dislocated across the credit and maturity spectrum. Sovereign yields are still within striking distance of all-time lows, in both real and nominal terms. These extremes suggest that markets anticipate persistent disinflation. Government bonds appear particularly vulnerable to an increase in the term premium, which has recently revisited cyclical lows and is still well below its long-term average. Increased inflation uncertainty in the U.S. could result in a reversion to more normal levels of compensation for investing at longer maturities. Alternatively, higher European sovereign yields, triggered by more expansionary fiscal policy, would reduce foreign demand for U.S. government debt and boost the term premium and yields.

Corporate bond spreads over U.S. Treasuries are now within striking distance of this cycle's lows. At the same time, underwriting standards have deteriorated. As a result, credit spreads and covenant protections are razor thin just at the point in the cycle when company fundamentals tend to deteriorate and default rates, which have been quite low hitherto, pick up.

Within real assets, U.S. real estate valuations are rich and property yields are at historic lows. After a further decline last year, the real yield on 10-year TIPS is unsustainably low.

We carefully construct our hedge fund portfolios to minimize exposure to broad equity and credit market movements, favoring managers that are diversifying to one another and generate value added largely through security selection. This approach has the benefit of diversifying the rest of the portfolio away from expensive equity and credit markets. Moreover, we believe that record-high valuation spreads between securities and relatively low intra-market correlations constitute a promising environment for our approach to hedge funds.

Portfolio Positioning

We retain modest top-down tilts in line with valuation signals across asset classes. We maintain a small underweight to equities through a solid U.S. underweight balanced by a small overweight to non-U.S. developed equities and cash and a somewhat more pronounced overweight to emerging market equities. We continue to tilt the U.S. portfolio noticeably towards value stocks to benefit from a reversal of the very large value-growth dislocation.

In fixed income markets, we retain a solid U.S. duration underweight coupled with a small underweight to credit. We combine a solid underweight to investment grade credit with an overweight to the BB- and B-rated sectors to benefit from security selection opportunities in the less efficient market segments. We also carry a small opportunistic allocation to non-U.S. bond markets to benefit from attractive real yield and idiosyncratic credit opportunities.

We maintain an underweight to real assets by keeping TIPS and real estate below policy weight. We balance these underweights with the above-policy positions in hedge funds and cash.

Nothing Succeeds Like Excess

Signs of Froth

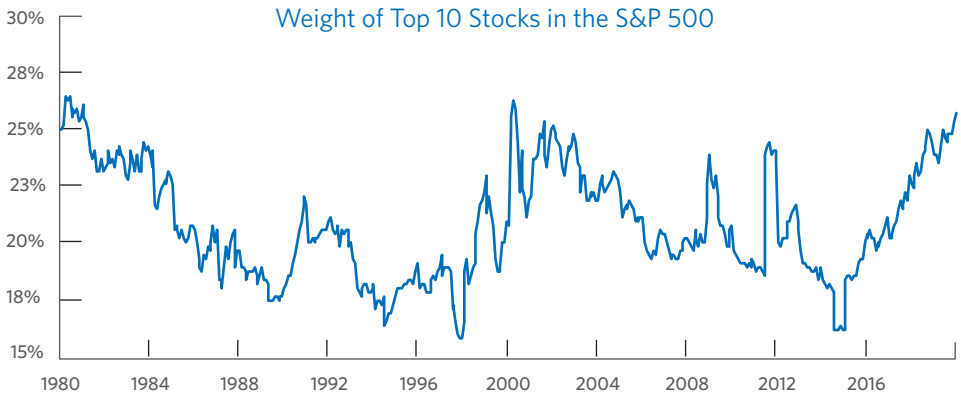
Virtually all assets rose sharply in 2019, with little regard to valuation or potential vulnerabilities. Across global equities, fully or richly valued markets enjoyed significant gains despite stagnant earnings. Multiples expanded and valuations deteriorated. In the U.S., a small number of mega-cap tech stocks have dominated returns in recent years. As a result, the concentration of the market is at levels not seen since the peak of the 2000 tech bubble (Exhibit 1).

Private equity funds, which have attracted massive inflows, are also showing signs of excess. Unicorns – private start-ups priced over $1 billion – are proliferating. Large IPOs priced with an eye toward revenue growth rather than profitability are commonplace. Uber, to take one example, went public in 2019 valued at $82 billion despite losses of $3 billion in 2018.

Last year set another near record for mergers and acquisitions. Easy financing, modest economic and earnings growth, and sharp disparities in corporate valuations are fueling merger activity.

In a market dynamic in which relatively expensive assets become ever more over-priced and momentum dominates market dynamics, disciplined, value-based active strategies suffer. The dominant performance of mega-cap tech stocks in the U.S. market has especially hurt strategies shunning overpriced growth stocks.

EXHIBIT 1:
Market Concentration Near Tech Bubble Peak
Sources: Compustat and Strategic.
Data through 2019.



A similar dynamic of prices disconnected from valuation is also evident in global bond markets. Bonds generated solid returns in 2019 – especially for longer maturity issues and those at the low end of the credit spectrum – despite real and nominal yields at secular lows, compressed credit spreads, high levels of corporate and sovereign debt, and deteriorating credit quality and creditor protections. The share of corporate bonds at the lowest rung of investment-grade credit is at record highs, accounting for 50% of the total.

This dynamic, while painful, has also created opportunity. Value stocks – those with a relatively low P/E ratio – are now more than one standard deviation cheap relative to their growth counterparts. Value shares are the most attractive they have been since the tech bubble (Exhibit 2 on page 8). Moreover, valuation dispersion across stocks – historically a predictor of good prospects for active management – has increased to levels exceeded only at the peak of the tech bubble.

Realizing Value

We are already witnessing moves to unlock the value created by recent market dynamics. The attractiveness of value stocks has reached such an extreme that active managers normally focusing on growth stocks have been enticed to stray from their natural habitats. Moreover, managers that actively adjust their style tilt have increasingly favored value stocks.

Recent trends in corporate activity also appear to be attempts to unlock value. The sharp increase in share buybacks reflects one way that firms whose shares are cheap are creating value. Walgreen's move to seek a private equity buyer is an extreme example of this dynamic. The recent spike in merger activity is also partly motivated by companies seeking to capitalize on mispricing. Xerox, for example, is using its fully valued shares to merge with Hewlett Packard, a competitor priced at a more attractive valuation, in the expectation that the combination will have a higher value.

Finally, recent developments in the IPO market suggest that investors are imposing stricter discipline. WeWork's decision to pull its planned IPO and the decline of Peloton's shares in response to disappointing earnings, despite unexpectedly strong revenue growth, are examples.

More Fundamentally Based Pricing Ahead?

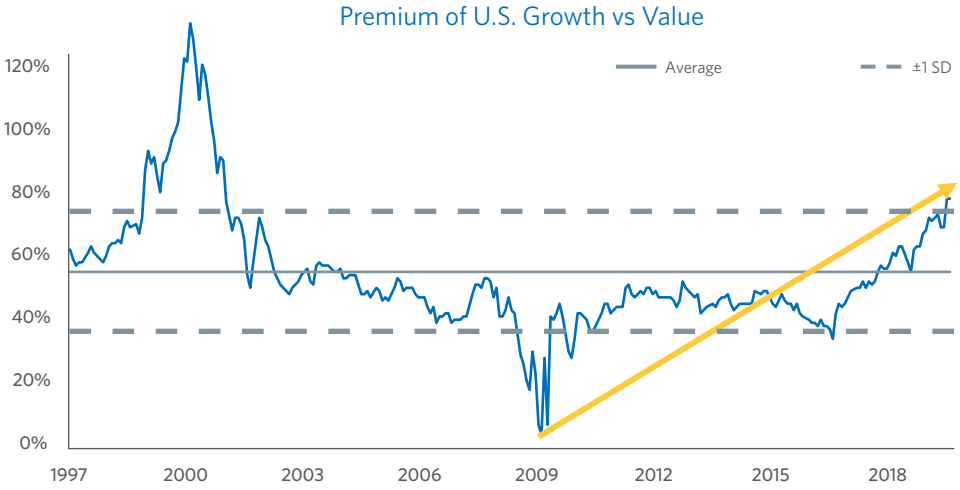
The recent past has conformed to Oscar Wilde's adage that "nothing succeeds like excess". While such market dynamics can persist, they sow the seeds of an eventual reversion that restores fundamental values, at times violently. Indicators of the environment for active management – like the wide dispersion of stock valuations – point to improved prospects for active strategies focused on fundamental valuation. Recent moves to unlock value also point in this direction.

EXHIBIT 2:

Value Stocks Are Increasingly Attractive

Source: Bloomberg and Strategic.

Data through 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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