MARCH 31, 2020

Market Commentary

Strategic Investment Group®

» GLOBAL MARKET REVIEW

» OUTLOOK & STRATEGY

» SPECIAL TOPIC

Contents

GLOBAL MARKET REVIEW

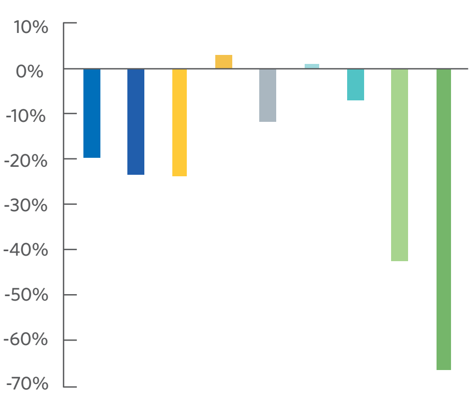
OUTLOOK & STRATEGY

SPECIAL TOPIC

Summary

Measures to contain the Coronavirus have put the global economy in a medically induced coma. The suddenness of the collapse in employment and output is unprecedented. The longer the coma, the higher the economic cost. Uncertainty about the timing of an eventual economic revival and the speed with which activity can recover is roiling financial markets. Equity market volatility spiked to record levels in March. Global equity markets fell between 20-25% in the first quarter and commodity prices plummeted, led by a 66% fall in oil prices. Safe haven assets rose. U.S. Treasuries, especially at long maturities, gained as did the U.S. dollar, which appreciated particularly strongly against emerging market currencies.

EXHIBIT 1:
Performance of Major Market Indices
Source: Bloomberg.
Year to date through March 31, 2020.



- S&P 500
- MSCI World ex-US
- MSCI Emerging Markets
- U.S. Aggregate Bond
- JPM EMBI Global
- Citi. WGBI Ex-US (LC)
- HFRX Eq. Wtd. Strategies
- GSCI Total Return
- GSCI All Crude

Economies Shut Down for the Duration

The rapid spread of the Coronavirus and subsequent measures to contain the contagion roiled markets through March. Over a third of the world's population is currently under lockdown. The closure of non-essential businesses, travel restrictions, and other measures are taking a toll on output and employment. A sharp retrenchment in consumer spending and corporate investment induced by fear and falling income are amplifying the downturn. Major economies are at risk of a self-reinforcing downward economic spiral triggered by demand shocks, supply shocks, and collapsing confidence.

Economic indicators are worrisome. U.S. new unemployment claims rose in February at 4.5 times the previous most rapid pace and reached 10 million by end-March. Coincident indicators of global economic activity also point to a sharp downturn. The OECD estimates that the median direct economic loss to advanced economy GDP is about 2% per month. Immeasurable indirect impacts would compound these declines. Emerging economies have been particularly hard hit by multiple shocks, including reduced export demand, collapsing commodity prices, a sudden stop of access to external financing, large capital outflows, and a strong dollar, as well as their own measures to contain contagion.

Global policymakers have rushed to respond to the crisis. The U.S. Congress passed a $2.2 trillion fiscal stimulus package providing funds to households, businesses, and the health care sector. The Fed slashed interest rates by 150 basis points to 0 – 25 bps, restarted its quantitative easing program, provided liquidity to poorly functioning domestic markets, eased access to dollar funding for foreign financial institutions, and initiated direct lending programs to U.S. corporations. Elsewhere, the ECB and Bank of Japan announced expansions to their asset purchase programs, while the Bank of England cut its benchmark interest rate by 0.5%. A wide range of European and Asian countries adopted fiscal stimulus packages. Governments around the globe are planning additional extraordinary measures to keep the global economy on life support.

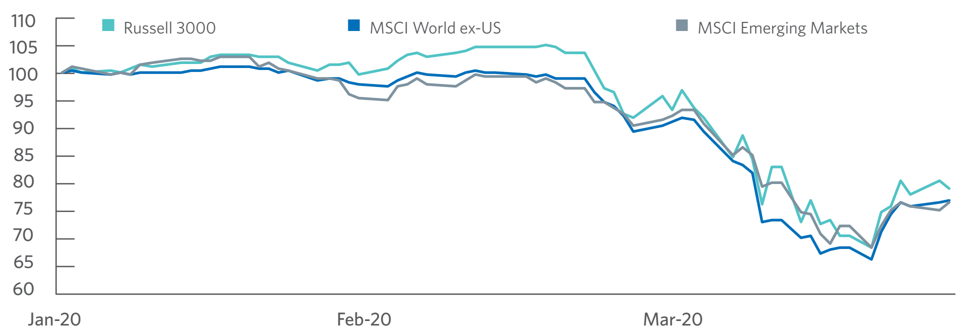
U.S. Equities Plunge into a Bear Market

U.S. equities took just 16 days to tumble 20% from their record high, easily eclipsing the previous record for swiftest fall into a bear market set in 1929 at 44 days (Exhibit 2). With losses of 10.9% in March, the S&P 500 ended the quarter 19.6% lower. Amidst the rout, the VIX index of implied U.S. equity market volatility, also known as the fear gauge, soared to a record high in mid-March.

Global Equities Tumble

The selloff was even more pronounced in global equity markets. The MSCI World ex-U.S. index of developed market stocks fell 23.3% in the first quarter as economic activity ground to a halt and investor and consumer confidence collapsed. Both European and Japanese bourses lost about 24% as measures to contain the pandemic took their toll.

EXHIBIT 2:
Global Equities Plunge
Source: Bloomberg.



Stocks across all sectors and market capitalizations suffered steep losses. The energy sector led declines, falling over 50% in the quarter as oil prices collapsed. Stocks in the financial sector lost about one third of their value. The healthcare sector outperformed others, falling 12.8% in the quarter. Small cap stocks struggled more than large, with the Russell 2000 index slipping 30.6% in the quarter, compared with the 20.2% decline of its large cap counterpart. Growth stocks (down 14.9% outperformed value (down 27.3%).

Emerging economies, especially those heavily reliant on short-term external financing, appear vulnerable. The MSCI Emerging Markets index lost 23.6%, with bourses in Latin America (down 46%) leading the decline. Emerging market currencies, excluding China, fell to their weakest level since the 1990s as companies and investors rushed to build reserves in dollars in the face of diminishing access to external financing and a withdrawal of foreign capital. Russia's rouble has lost 23% of its value since January, while the South African rand and Mexican peso depreciated by 18% and 25%, respectively, over the same period. Chinese markets fared notably better than other emerging markets. The MSCI China index lost 10.7% in the quarter. Initial indicators suggest that China, the previous epicenter of the virus, has been able to contain its spread. The government is easing the quarantine, people are returning to work, and output is picking up.

Fed Stabilizes Bond Markets

Amidst a flight to safety and fears of a sharp economic downturn, yields on safe haven assets hit all-time lows during the quarter. The yield on the 10-year U.S. Treasury note briefly touched 31 basis points intra-day, and the 10-year German bund yield fell to -55 basis points. Real yields on 10-year TIPS also reached record lows, reflecting the market's expectations for long-term disinflationary pressure from the downturn in economic activity. Inflation in the U.S. is now priced by the TIPS market to average less than 1% over the next 10 years, a post-GFC low.

Elsewhere, credit spreads rose sharply, with spreads on high yield bonds in the energy sector reaching historical extremes (Exhibit 3). U.S. high yield bonds lost 13% in the quarter, and there were a record number of "fallen angels", formerly investment grade bonds downgraded to high yield. The Fed stepped in to help calm investors, taking the unprecedented step of announcing that it would begin to buy investment-grade corporate bonds as a means of ensuring orderly markets.

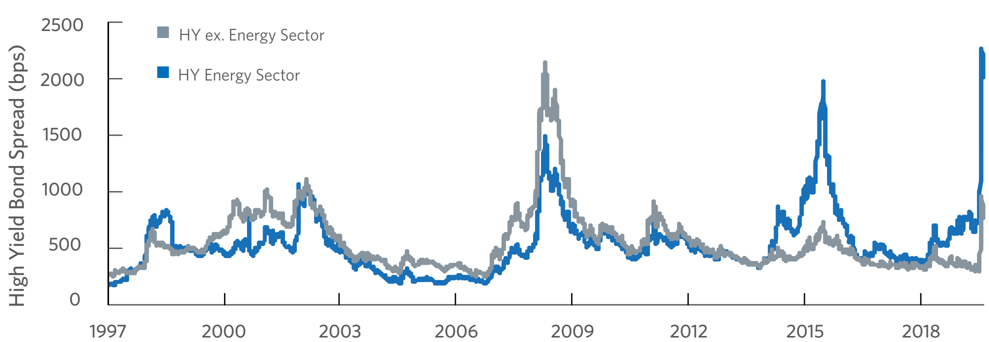
Equity Strategies Lead Hedge Funds Lower

The HFRX Equal Weighted Strategies Index fell 7.1% in the quarter, driven by weakness in directional equity and merger arbitrage strategies. Spreads on merger transactions widened considerably, reflecting heightened difficulty in financing and closing deals. Hedge fund managers have sharply reduced gross leverage to safeguard liquidity.

EXHIBIT 3:

High Yield Spreads Soar

Source: Bloomberg.



Real Assets — Oil Falls to 18-Year Lows

Oil prices crumbled from over $70/barrel in January to under $20/barrel in March (Exhibit 4 and Special Topic). An ill-timed price war between Russia and Saudi Arabia flooded markets with supply just as demand tumbled. With oil prices down about two thirds, the GSCI commodity index fell 41% in the quarter. In the real estate market, the NCREIF Open-End Funds Core Index (reported with a quarter delay) gained 4.4% in 2019, with 80% of the return driven by income. Transactions have collapsed in the face of the pandemic and rental income is at risk. TIPS prices rose as the real yield on 10-year TIPS fell to 0.7% from 1.9% in the course of the year through March.

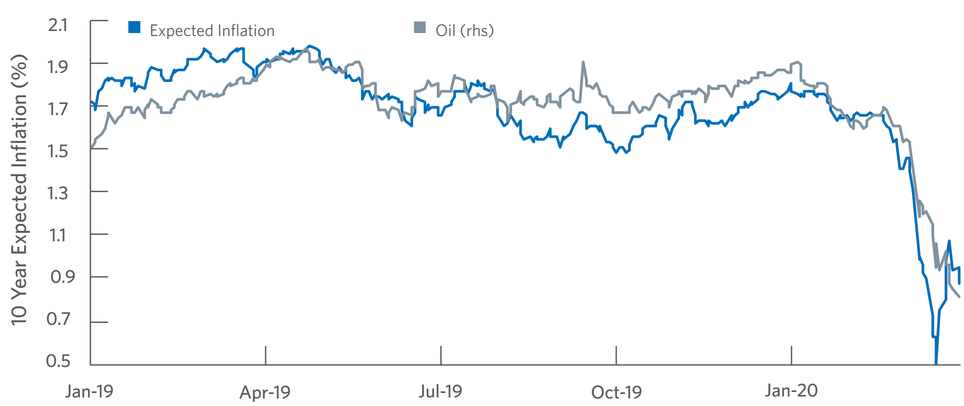
Private Equity — Valuations at Risk

The Thomson Reuters/Cambridge Index of U.S. private equity (reported with a two-quarter delay) gained 8.4% in the year through September. In the wake of the pandemic, private equity valuations appear at risk given their higher leverage than public markets. Businesses in the energy, travel, auto, retail and hospitality sectors are most at risk.

EXHIBIT 4:

Oil Slips on Slowing Demand and Surging Supply

Source: FRED.



Outlook & Strategy

Summary

The COVID-19 pandemic has plunged the global economy into its deepest crisis since the Great Depression. Policymakers are responding with unprecedented monetary and fiscal policy stimulus. The way forward is uncertain. The ultimate depth of the economic contraction and the severity of pressure on the financial system depend on the unpredictable path of the pandemic. Our current strategy focuses on valuation discipline, modest top-down portfolio tilts and well-calibrated security-specific risk. Following large market moves, we increased our equity and corporate credit allocation to neutral, slightly enlarged our duration underweight, and maintained our hedge fund overweight.

Unprecedented Speed and Depth

The COVID-19 pandemic has plunged the world into three interrelated crises: medical, economic and financial. The measures to contain the pandemic—social distancing, workplace closures, and travel restrictions—have placed the global economy into a medically induced coma.

The depth, speed, and unpredictability of the resultant contraction is unprecedented. In the U.S., 22 million jobs, 17% of the labor force, were lost in only four weeks. This compares to 8.8 million lost jobs over nearly two years during of the Great Financial Crisis (GFC). The IMF estimates that the global economy will contract by 3% in 2020, compared with 0.1% during the GFC. This forecast assumes a relatively benign course of the pandemic in which its impact fades in the second half of 2020 and there is no second wave. In this base case, global growth rebounds to 5.8% in 2021. A protracted pandemic, longer containment and a recurrence of a milder outbreak in 2021 would result in a 6% decline in global GDP in 2020 and a further 2.2% decline in 2021, despite large fiscal and monetary stimulus. The gap between the two scenarios highlights the unpredictable nature of the ultimate toll of the pandemic given the great uncertainty surrounding its ultimate extent and duration.

Policy Bazookas Galore

Policymakers are facing a dilemma: measures to contain the pandemic also crush the economy and roil financial markets. To mitigate the near-term damage to incomes and improve the prospects for an eventual recovery, governments and central banks are quickly deploying policy packages that dwarf anything witnessed even in the GFC.

Governments have deployed a staggering $8 trillion in fiscal support as of April 8, 2020. Germany, Italy, Japan and the U.S. are implementing fiscal packages amounting to 34%, 33.6%, 20.5% and 11.1% of their respective GDPs. These numbers are likely to increase with many governments working on further rounds of support.

Central banks have responded with similar vigor. The Fed adopted "QE Infinity" by announcing it would buy as many assets as needed to support the smooth functioning of markets and the transmission of monetary policy. As a result, its balance sheet expanded by more than $2 trillion in little more than a month, more than the combined amount deployed over 2½ years during the GFC under QE1 and QE2.

These measures have two main objectives. First, to keep the "economic lights on" by shielding households, firms, and state and local governments from the pandemic's impact. Second, to ensure orderly trading through liquidity support and by acting as buyer of last resort in dysfunctional markets.

Uncertainty, Questions and More Questions

Without a medical breakthrough, measures to contain the health crisis will continue to weigh heavily on global economies and markets. The uncertainty about the pandemic's path raises several key questions that we now consider.

How quickly will economies recover from the recession? The ultimate economic impact is extremely uncertain given the interplay of a range of unpredictable factors. These include the pandemic's ultimate medical toll, the extent, duration, and success of containment measures, the impact and duration of the dramatic tightening of financial conditions, the depth and duration of supply disruptions, behavioral changes and shifts in spending patterns, confidence effects, volatile commodity prices, and the efficacy of policy measures taken to mitigate the pandemic's economic impact.

Only a withdrawal of social distancing measures will allow economic activity to rebound. Without wide availability of a cure or vaccine, these measures will only be lifted gradually. This suggests that attaining pre-crisis levels of economic activity will be a process of years rather than quarters. Hopes for a V-shaped recovery are likely to be disappointed.

Will policy makers run out of ammunition? We do not think so. The only constraint is the political will to act. We are confident that the authorities will energetically counter any sign of a deepening crisis. However, once the crisis is over, restoring government debt and central bank balance sheets to sustainable levels will be a daunting task. For example, under its relatively benign baseline scenario, the IMF currently expects a U.S. budget deficit of 15.4% in 2020, up from 5.8% in 2019. In the case of the Fed, already announced measures are projected to lead to a doubling of its balance sheet to about half of U.S. GDP, an unprecedented level.

What is the risk of another financial crisis? The collapse in economic fundamentals has already triggered a repricing of financial assets and a spike in market volatility. As the economic crisis deepens, more market turmoil cannot be ruled out. During the turbulence in March, stress and dysfunction appeared in various market segments. A lack of liquidity, elevated transaction costs and price dislocations emerged across multiple markets including U.S. money markets, corporate bond markets and even extended into the U.S. Treasury market, the ultimate safe haven and normally the deepest and most liquid financial market in the world. Applying many of the lessons learned in the GFC, the Fed rapidly and successfully provided systematic liquidity backstops to all market segments affected by the turmoil. The Fed's ability and willingness to intervene makes us hopeful that a financial crisis of the GFC kind can be avoided.

This view is supported by the fact that prior to the pandemic, financial markets were relatively sound. While there were some areas of fragility, notably the high valuations of certain assets, the rapid growth and deteriorating quality of corporate bond markets, and the high levels of borrowing, some in foreign currency, of emerging market sovereigns and corporates, none of these posed systemic risk on the scale of the GFC. The current turmoil is a direct result of measures imposed to contain the virus, not a reflection of a fundamental financial market vulnerability.

What is the likely legacy of the crisis? Given its historic dimensions and impact, the pandemic could well bring about structural changes in economic, social, and political norms and arrangements. While it is early days, three relevant candidates for structural change come to mind:

First, even before the pandemic economic globalization had been under threat from protectionism and mounting populism. Pandemic-related restrictions on cross-border flows of people, goods and services have reinforced protectionist measures. Moreover, the pandemic has exposed the vulnerabilities of complex supply chains. If the pandemic leaves a legacy of reduced trade, the recovery will be subpar and the return to pre-pandemic levels of economic activity delayed.

Second, extreme economic hardship has tended to change consumer behavior in the past. Precautionary savings tend to increase, limiting the economic rebound and potential growth going forward. Changing patterns of consumer behavior could selectively hit different sectors and industries. For example, memories will have to fade fast for a quick rebound in holiday cruises.

Third, economic policymakers have entered a new world of massive stimulus measures implemented with unprecedented speed. Withdrawing this stimulus once the crisis is past will be tricky. Moreover, the legacy of the measures taken to combat the pandemic could be problematic. For example, the large increase in sovereign debt will constrain fiscal policy in the future, especially if debt service costs rise. In the case of the Fed, the rapid expansion of its balance sheet and tailored support to certain sectors could undermine its policy independence and inflation credentials.

Investing in Times of Crisis

Well-constructed portfolios should be robust across different states of the world, including economic and financial crises. This requires diversification and a disciplined investment process that is risk controlled and liquidity focused. Expected returns must be consistent with a risk profile appropriate to the investing institution. Abandoning an investment program during a crisis must be avoided as this locks in "crisis drawdowns" and prevents a rebound of the portfolio as the crisis fades. It is equally crucial to maintain adequate portfolio liquidity. In a crisis, continued or even increased draws will often coincide with substantial rebalancing needs in response to market moves.

Generating excess returns requires a thoughtful combination of top-down and security-specific active strategies. We believe that a disciplined valuation focus is crucial to identify attractive sources of active returns. We implement modestly sized top-down tilts and allocate most active risk to portfolio managers who focus on identifying bottom-up, security-specific strategies.

Asset Allocation

In response to the March sell-off in risk assets, we have reduced some of our modest top-down tilts. We closed our underweight to global equities but retained an underweight in U.S. equities relative to non-U.S. developed and emerging equities. Our U.S. equity portfolios remain significantly tilted towards value stocks, with the value-growth dislocation at extreme levels.

In fixed income markets, we have slightly accentuated our duration underweight as Treasury yields dropped when investors searched for shelter during the March sell-off. After the crisis-induced spread widening, we closed our underweight to U.S. credit but retained our tilt towards high yield bonds and away from investment grade credit. While fundamental pressure on many issuers will likely prevail, we feel confident that the Fed will continue its highly proactive stance to support credit markets which will limit the upside for credit spreads.

The current crisis has resulted in a multitude of dislocations across many markets. We strongly believe that this enhances the opportunity set for our hedge fund managers. We are therefore maintaining a solid overweight to hedge funds.

We maintain an underweight to real assets by keeping real estate below the long-term policy weight. We have, however, closed the underweight position to TIPS by shifting the duration exposure from nominal Treasuries to TIPS in light of a sharp drop in break-even inflation rates.

Oil Fuels Pandemic Fire

Oil prices fell by two thirds in the first quarter of 2020. This decline, a result of a rapidly slowing global economy and an ill-timed price war among major oil producers, is fueling the impact of the pandemic on markets. Companies in the energy sector as well as major oil exporters and their state oil companies have been particularly hard hit. From a macro perspective, the precipitous drop in oil prices has reinforced the disinflationary impact of the pandemic, pushing inflation expectations to record lows. This quarter's special topic considers the interplay of pandemic economics, financial markets, and oil.

Dwindling Demand, Soaring Supply

Measures to contain the pandemic are exacting a heavy economic toll. Lockdowns that have brought the transport sector to a halt and severely curtailed industrial output are dramatically depressing energy demand. As demand dwindled, Russia and Saudi Arabia engaged in an odd version of Russian roulette in which all barrels are loaded and each player takes turns shooting by flooding the market with additional supply. In the face of these demand and supply shocks, oil prices crumbled, falling from over $60/barrel in January to under $20/barrel in March (Exhibit 1).

Blow to Shale Producers and Oil Exporters

The sharp decline in the price of oil and the prospect of a protracted period of diminished demand have reinforced the market dynamics unleashed by the pandemic and measures to contain it. Concerns about the impact of a severe economic contraction on corporate profitability and ability to service a heavy debt load had caused credit spreads to widen significantly across all industries and sectors. With the collapse in the price of oil, the spike in spreads of high yield bonds issued by companies in the energy sector was especially sharp (see Exhibit 1).

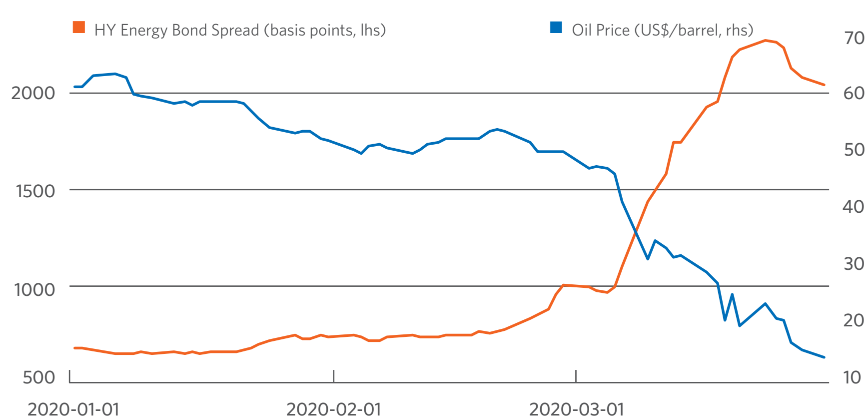
The U.S. shale industry in particular faces some unpleasant arithmetic. The oil price averaged $46 per barrel in the first quarter, below the $48-54 median breakeven price required to justify new wells. Oil prices at current levels (below $20/bbl.) are not sufficient to cover the median operating costs of existing wells, estimated to be $27-35 per barrel. If they were to persist, prices at current levels would call into question the viability of many shale producers, particularly those that have taken on large amounts of debt to finance the high capital intensity of shale oil production.

EXHIBIT 1:

High Yield Energy Bond Spreads Spike as Oil Plummets

Source: Bloomberg.

Data through March 31, 2020.



The prospects of major oil exporters are also grim. Countries like Saudi Arabia and other major exporters in the Gulf derive roughly 70% of their export revenue and 60-70% of their fiscal revenue directly from oil; their indirect economic reliance on this single sector is even greater. Oil exporters have been experiencing difficulties balancing their budgets since the oil price decline in 2014, and have resorted to increased debt issuance and drawing down currency reserves built when prices were higher. Oil exporters in the Gulf, normally associated with abundant surpluses, were already on an unsustainable path of burning through their large currency reserves. The additional blow to oil prices from the pandemic and price war has pushed prices well below the levels needed to balance the budgets of major exporters (Exhibit 2). Both Russia and Saudi Arabia have recently resorted to new large debt issuances to fill the gap in their finances. At current prices, they face a wrenching retrenchment in government spending in order to return to fiscal sustainability.

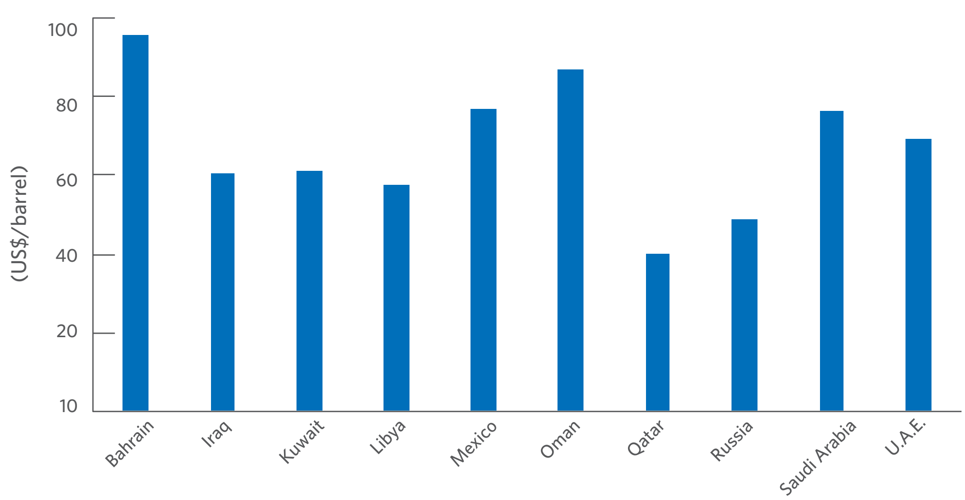
Contraction and Disinflation

The pandemic has created a truly unprecedented global economic contraction notable for its severity, unpredictability, and the speed with which output and employment has plummeted. The oil price war is heightening uncertainty, compounding already powerful disinflationary forces, and taking a particularly heavy toll on fragile industries and countries, reinforcing the pandemic's destructive power.

EXHIBIT 2:

Breakeven Oil Price for Major Producers

Sources: Bloomberg and IMF.



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). 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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