SEPTEMBER 30, 2020

Strategic Investment Group®

Market Commentary

» GLOBAL MARKET REVIEW

» OUTLOOK & STRATEGY

» SPECIAL TOPIC

Contents

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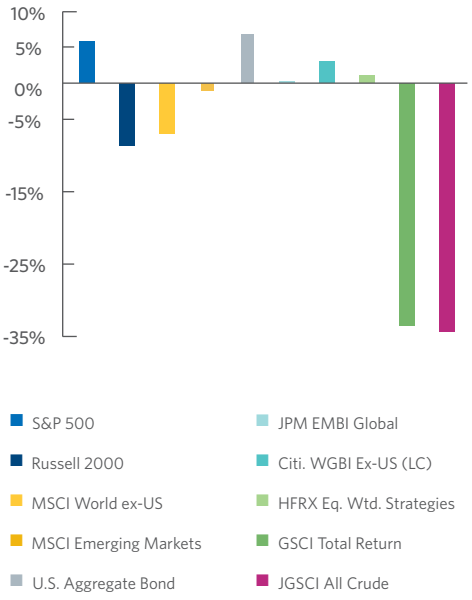
Summary

Despite strong gains in the second and third quarters and massive policy stimulus, global equity and credit markets remain down so far this year, with the notable exceptions of China and the U.S. Returns within and across markets have diverged widely reflecting the differential impact of the pandemic and the varying strength of the policy response. Disinflation and a highly uncertain economic outlook have buoyed long-dated sovereign bond prices. Commodity prices, in contrast, have plummeted on economic concerns. The virus is expected to do lasting harm to potential output keeping the global economy below its pre-pandemic growth path for many years.

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



Weak economic fundamentals favor safe haven assets.

Widely Divergent U.S. Equity Returns

Following a strong rebound from March lows, U.S. equities are up 5.6% so far this year, although performance has been widely divergent. Massive policy stimulus, near record low real yields, and hopes for a strong economic rebound in a post-COVID world are the main drivers of the disconnect between weak economic fundamentals and lofty equity market valuations. Sectors most affected by the lockdown and changes in consumer behavior, such as retail, travel, restaurants, financials, and energy have lagged, while less contact-intensive sectors, such as IT, have soared (Exhibit 2). Reflecting this dynamic, the tech sector has led all others, gaining 29% so far this year. The energy sector, in contrast, is down 50%, reflecting plunging oil prices and the uncertain economic outlook. The financial sector has also suffered, falling 22% so far in 2020 owing to low profitability and concerns over asset quality, including in particular real estate loans. Among style segments, growth stocks remain the dominant performers, gaining 23% so far in 2020 versus the 12.2% decline in value stocks. Large cap stocks have outperformed their small cap counterparts by a wide margin. Reflecting the outsized performance of a few mega-cap tech stocks, the U.S. equity market is more concentrated than any time since the peak of the tech bubble.

Equity Returns Diverge Across Countries

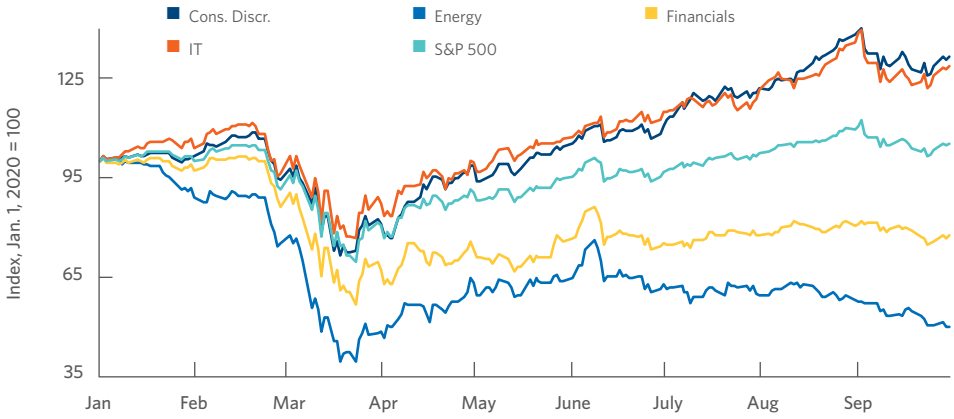
China and the U.S. are among the few equity markets to have registered gains in 2020 (Exhibit 2). European equity markets are down on concerns that Europe's economic recovery is at risk from a resurgence in COVID cases necessitating renewed containment measures. U.K. equities

EXHIBIT 2:

Divergent Impact of Pandemic Evident in Sector Returns

Source: Bloomberg, Index, January 1, 2020 = 100.

Year to date through September 2020.



and sterling have suffered from continued chaos in the Brexit negotiations. As a result, the FTSE 100 index is down 24% in U.S. dollar terms so far this year. The sectoral divergence in developed non-U.S. equity markets is similar to that of the U.S. The tech sector leads others with positive gains, while all other sectors have declined, with the energy and financial sectors falling most.

The pandemic has revealed fragile fault lines among emerging market economies heavily dependent on external financing. There have been large portfolio outflows from emerging markets this year. Latin American bourses are down 37% while emerging equity markets in Europe, the Middle East and Africa have fallen 22%. In contrast, Asian emerging markets, buoyed by a resurgent Chinese economy and strong Chinese equity returns have gained 11%.

Disinflation Prevails Over Massive Stimulus

Since the onset of the pandemic, advanced economy central banks have aggressively deployed liquidity measures equivalent to 11% of their combined GDP to boost output and employment and prevent the amplification of the COVID shock throughout the financial system. Fiscal policy support to ease the loss of household income and forestall business bankruptcies has also been massive, equivalent to 9% of advanced economy GDP, contributing to record deficits and rapidly rising debt. Despite these heroic efforts, the IMF forecasts an unprecedented 4.5% decline in global GDP this year. The ILO estimates that global economic output losses so far this year are equivalent to 400 million full-time jobs.

Plummeting demand and large output gaps have kept inflation across advanced economies well below targeted levels despite the massive stimulus. Reflecting safe haven demand and expectations for subpar growth and quiescent inflation well into the future, bond yields remain near historic lows across advanced economy markets. Long-term U.S. Treasuries have returned 21.4% so far this year, a performance bettered only by U.S. large-cap growth stocks, which are up 24.3%. Advanced government bond markets outside of the U.S. have also registered strong gains, with the WGBI index up 7.1% so far in 2020.

Weak Economy Weighs on Real Assets

Commodity prices are down by about one third so far this year as supplies remain abundant and demand growth uncertain. Oil prices (down 34%) have been particularly volatile reflecting both the impact of the pandemic on demand and the effects of

a price war earlier in the year. In the case of real estate, the pandemic has raised questions about the long-term prospects for malls, restaurants, cinemas, hotels, and offices in the face of changing preferences for shopping, travel, leisure activities, and working from home. Against the backdrop of this uncertainty and much reduced transaction volume, the NCREIF Open-End Funds Core Index (reported with a quarter delay) gained 1.3% in the twelve months through June 2020, with all of the return driven by income. The real yield on 10-year TIPS has fallen from 0.8% at the beginning of the year into negative territory (-0.5%) at end-September, reflecting grim economic prospects and low inflation expectations.

Private Equity: Fund Flows and Dry Powder

The Thomson Reuters/Cambridge Index of U.S. private equity (reported with a delay) gained 4.1% in the year through June. Private equity valuations rebounded in the second quarter buoyed by public market gains. Capital flows to private equity funds have remained resilient despite the pandemic and the number of funds in the market is at an all-time high. Dry powder available for deals is double the level of 2015.

EXHIBIT 3:

U.S. and China Outpace Other Equity Markets

Source: Bloomberg. Index, January 1, 2020 = 100.

Year to date through September 2020.

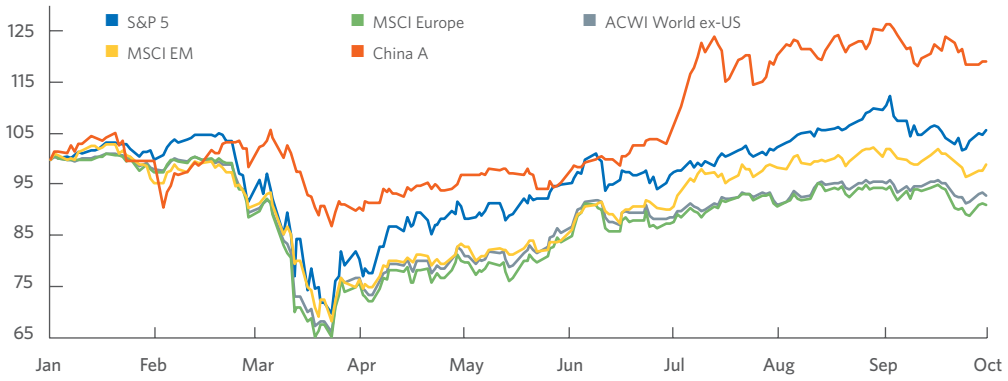
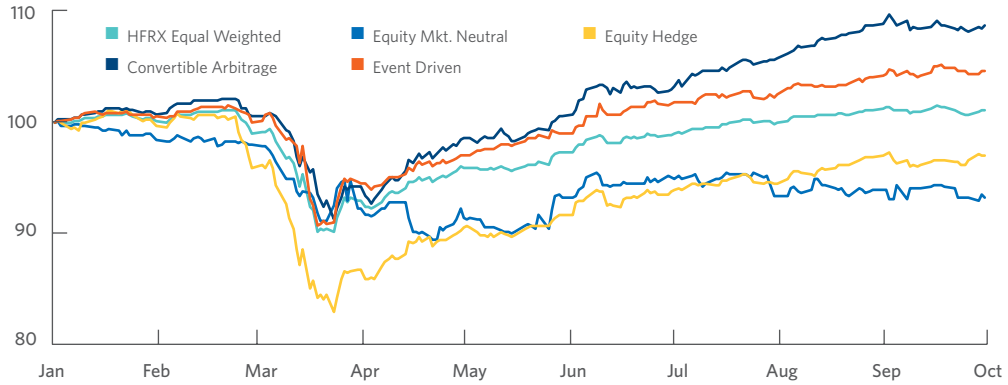


EXHIBIT 4:

Wide Divergence Across Hedge Fund Strategies

Source: Bloomberg. Index, January 1, 2020 = 100.

Year to date hrough September 2020.



Summary

Nine months into the pandemic, the virus continues to dominate the economy, the markets, and much else besides. Although major risk assets have recouped much of their initial losses, the pandemic is leaving a trail of dislocation across equity and bond markets. These dislocations create attractive opportunities for top-down and security-specific strategies. We retain a solid underweight to richly valued U.S. equities which is offset in part by overweights to non-U.S. equities and hedge funds. We also retain our duration underweight in the U.S as risk premiums and inflation expectations remain compressed despite the Fed's recent redoubled commitment to push inflation higher.

An Unprecedented Recession

The COVID recession and the ensuing rebound have no historical precedent (see this quarter's Special Topic). The lack of a useful template has fueled uncertainty and set the stage for pronounced economic surprises, both good and bad. After a drop in economic activity that was steeper and faster than any recession in modern history, the rebound in the second quarter was equally swift, surprising forecasters and markets.

The downturn was led by the service sector, which is typically relatively resilient in a recession, rather than manufacturing, which usually leads the economic cycle. In the upturn, consumption rebounded faster than expected while investment lagged with firms stymied by the highly uncertain economic outlook.

The IMF estimates that global real GDP will likely contract by 4.4% in 2020 and then grow 5.2% in 2021. This assumes that the recovery will slow from its initial pace as the pandemic continues to spread and social distancing and other containment measures only gradually recede in 2021 assuming a vaccine is widely available. The uncertainty around these forecasts is profound. Depending on the course of the pandemic, real GDP growth in 2021 is projected to fall between 2.2% and 5.7%.

The depth of the recession has varied across economies. The stringency of containment measures, the relative size of the service sector, and the forcefulness of the policy response have been the key factors underlying the divergent outcomes. The projected 2020 contraction in the U.S. (-4.3%) compares favorably to the Euro Area (-8.3%) while China stands out as the only major economy likely to grow in 2020 (+1.9%).

Which Way Out of the Crisis?

While economic uncertainty remains exceptionally high, two factors will be crucial in determining the path out of the crisis. First, the course of the pandemic will be the ultimate driver of economic and market outcomes. Monetary and fiscal policy measures aimed at mitigating the worst effects of the pandemic and the measures taken to contain it will also continue to have an outsized impact on economies and markets. The first factor is inherently unpredictable. The second is subject to conflicting forces and susceptible to significant and costly missteps.

The response of individuals to the pandemic, which has varied widely within and across countries and over time, adds a further layer of uncertainty. In a study of the impact of social distancing on mobility as a proxy for economic activity, IMF researchers found that in advanced economies voluntary social distancing had a larger negative impact on economic activity than officially mandated lockdown measures. This result suggests that merely relaxing official restrictions on social interaction will not be sufficient to guide the economy out of the crisis unless households and firms are confident that it is safe to let down their guard and return to life as it was before the pandemic. This, however, is unlikely until a vaccine is developed, distributed, and widely accepted as safe and effective, all of which pose unique challenges.

In the meantime, monetary and fiscal policies will have to stabilize economies and financial markets and, in a second step, mitigate scarring from the severe economic disruption caused by the pandemic. Central bankers and fiscal policymakers have so far not disappointed. In the U.S., the Fed has mobilized the entire arsenal of interest rate, balance sheet, and forward guidance levers while adding targeted liquidity support to stabilize financial conditions and ensure the smooth operation of markets.

Given the drastic nature of the economic shutdown, the focus of the initial policy response had to be on the replacement of lost income of households and firms. Fiscal policy makers in advanced and emerging economies rose to the challenge, providing $11.7 trillion globally or over 12 percent of global GDP in fiscal support without which the global recession would have undoubtedly become a worldwide depression.

Time should be on the side of relief from the pandemic's current chokehold on the global economy. With every day that passes, the arrival of a vaccine and therefore a rebound in mobility and economic confidence becomes more likely. On the fiscal policy side, however, there is cause for concern. With most economies still nowhere close to a full recovery and some experiencing renewed headwinds as the pandemic flares up again, the first signs of fiscal fatigue are emerging. Too little fiscal support could have tragic consequences.

We expect a gradual recovery ultimately fueled by a vaccine and highly stimulative monetary and fiscal policies. However, we also expect that the pandemic will have lasting harmful economic effects due to the disruption caused by bankruptcies, high levels of unemployment, and the need to reallocate resources in the face of changed consumer behavior and business practices. In addition, the pandemic will leave a long-term legacy of sharply higher public and private sector debt and elevated inflationary pressure. Social tensions associated with income and wealth inequality made more acute by the pandemic in a number of countries, and notably the U.S., are likely to remain prevalent. These persistent pandemic legacies will pose public policy challenges for many years to come.

Future Path of Value versus Growth

The pandemic has amplified pre-existing dislocations within equity markets. Growth stocks have become ever more expensive relative to value stocks. Some valuation measures now signal an overvaluation of approximately three standard deviations for major U.S. and non-U.S. indices. Within the MSCI ACWI index, growth stocks have outperformed value stocks by 30 percent this year alone. In line with the continued dislocation of value and growth stocks, the concentration of the U.S stock market has also increased. The top ten companies in the S&P 500 index which are dominated by a few mega cap high tech growth stocks now account for nearly a third of the entire index capitalization.

To assess whether the value-growth dislocation presents an attractive investment opportunity we consider three plausible, but, in our opinion, ultimately unpersuasive arguments put forward to justify the lofty valuations of growth stocks.

First, some argue that the outperformance of growth stocks is merely a reflection of relative earnings

and therefore fundamentally supported. Our analysis suggests that the outperformance of growth is not supported by relative earnings. Since 2016, growth has outperformed value by 75% for stocks included in the All-Country World Index while the earnings increases of growth stocks have been only 11% higher than value.

Others posit that the decline in interest rates has a larger impact on growth companies whose cash flows are further in the future. Our analysis of data since 1926 reveals no evidence that changes in interest rates have had a significant impact on the relative returns of value versus growth stocks.

Finally, some contend that systematic factors at the company level (such as superior operating leverage, network effects, and winner-take-most business models) permanently enhance the performance of growth firms. While these factors are plausible explanations for the recent widening divergence in returns and valuations between growth and value, we do not believe that a company can benefit from these factors for a sustained period. Rather, we expect the benefits to be temporary and susceptible to being eroded by regulation, tax policies, and competitive pressures.

While it is difficult to time the normalization of the current extreme divergence in the valuations of growth and value stocks, we believe that three potential catalysts could trigger a correction. First, as has often been the case in the past, a cyclical revival, possibly due to positive vaccine news, could spark a rebound of economically sensitive value stocks. Second, antitrust enforcement, enhanced privacy standards, or post-election tax changes could also trigger a correction. Finally, given the extent to which growth has outperformed value without substantial fundamental support, the dislocation could eventually collapse under its own weight.

Asset Allocation

Active risk in all portfolios is guided by our strict focus on divergences between market prices and our assessment of fundamental valuations. This holds at the security level where strategies are implemented by our managers and for top-down asset allocation and structuring decisions taken by Strategic.

Given the pronounced uncertainty at the macro-level, we are sticking to modest top-down asset class and structuring tilts. We retain a small underweight to total equities, where a solid underweight to the U.S. market is partially balanced by small overweights to non-U.S. developed and emerging equity markets. We also retain our value tilt in the U.S. and other major markets. We believe that the wide valuation dispersion now prevailing within public equities represents the best opportunity to add value that we have seen in 20 years.

In fixed income, we retain a duration underweight while keeping the credit allocation in line with policy benchmarks. The combination of gradually emerging cyclical tailwinds once the pandemic lifts and the Fed's renewed commitment to raise inflation will likely drive bond yields at the long end of the Treasury curve higher. We are closely monitoring credit markets. Liquidity pressures and deteriorating credit quality due to the pandemic have so far been eased by the Fed's aggressive stance, but this balance is fragile.

Our hedge fund overweight expresses our conviction that the pandemic has created opportunities for managers who have the ability to exploit dislocations flexibly wherever they arise.

We remain comfortable with our underweight to real estate. Relatively demanding valuations are coinciding with increasingly challenging fundamentals in multiple market segments.

The current environment created by the pandemic has heightened uncertainty and posed special challenges to active management. Nevertheless, we believe that the wide valuation dispersions and market dislocations just described improve the prospective opportunities to add value through a disciplined approach focused on exploiting the now very wide divergence between market pricing and fundamental valuations. We are positioned accordingly.

Disconnects and Uncertainties

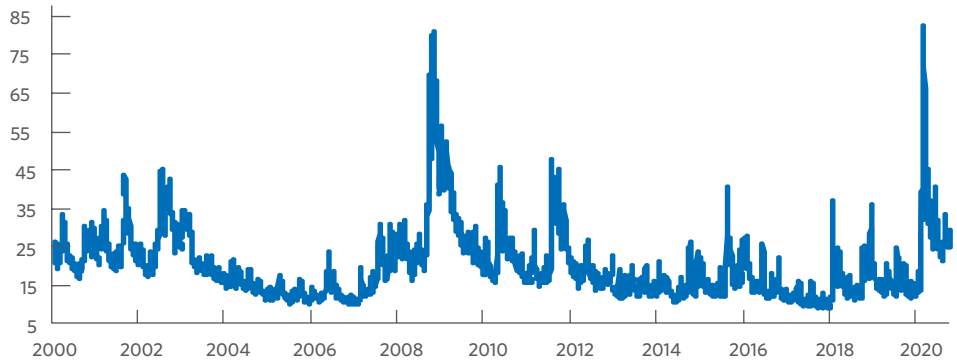
Unprecedented has become an overworked word this year. Yet, since the onslaught of COVID-19, its frequent use seems justified. Notable developments meriting superlatives include: Most rapid collapse in U.S. output and employment. Deepest decline in U.S. output since the Great Depression. Largest and most rapid policy response resulting in the largest Fed balance sheet and widest U.S. fiscal deficit since WWII. Biggest expected decline in global GDP since the Great Depression encompassing the highest proportion of countries. Most rapid U.S. equity market collapse followed by the strongest rally in history resulting in the shortest U.S. equity bear market of all time. Highest reading on the VIX index, a gauge of near-term expected U.S. equity market volatility (Exhibit 1). Most concentrated U.S. equity market since the 2001 tech bubble. Highest level of corporate bond issuance. And this far from exhaustive list does not consider the unprecedented extent of wildfires in the West, the number of hurricanes in the U.S. (three shy of the record set in 2005), or the magnitude of the global health crisis (worst since 1918). It is little wonder that such extremes have resulted in disconnects and uncertainty.

Ailing Economy, Hale and Hearty Market

The U.S. economy has experienced wide swings this year. After falling off a cliff in the first quarter, output has rebounded sharply. Nevertheless, output and employment remain well below pre-pandemic levels and this shortfall is likely to persist. However, lingering economic weakness has not deterred the U.S. equity market, which touched an all-time high in August and remains above pre-pandemic levels. The U.S. is the only major equity market besides China to have experienced gains so far this year, yet the U.S. economy is projected to decline by 4.3% in 2020, compared to GDP growth of 1.9% in China.

There are several plausible explanations for this apparent disconnect between the fortunes of the economy and the market. The unprecedented size and rapid deployment of the policy response has supported equities. Despite widening deficits and rising debt levels, U.S. Treasury securities yields remain near record lows, further boosting equity prices. Some speculate that investors are looking beyond the pandemic in anticipation of a rapid economic recovery in a post-COVID world. Others point to the highly skewed nature of the market rebound led by a few mega-cap growth stocks in the tech sector, while the retail, travel, hospitality, financial, and energy sectors remain sharply lower. In

EXHIBIT 1:
Record U.S. Equity Market Volatility (VIX Index)
Source: CBOE. Data through October 20, 2020.



this view, the pandemic has mainly hurt contact-intensive service sectors, while tech stocks have profited from the pandemic-induced trend to work, shop, and be entertained at home. Despite these reasons, the near record price level, lopsided market action, and high valuation of the U.S. equity market seem unsustainable in the face of the wide range of near- and long-term uncertainties investors face.

Uncertainties in the Short Term

In the near term, the main source of uncertainty is the path of the pandemic and the response to it by households, firms, and governments. The recent resurgence of COVID-19 in areas where the virus seemed contained and its spread to areas previously left relatively unscathed highlight the unpredictable nature of how the global health crisis will unfold. The containment measures imposed by governments have varied widely across and within countries and over time, amplifying uncertainty. The response of individuals to the pandemic has also varied as evidenced by highly divergent standards of compliance with containment measures to widely differentiated attitudes to an eventual vaccine (the timing of which is itself unknown). Even when these near-term uncertainties are resolved, the long-term impact of the pandemic will remain a lingering unknown.

Uncertainties in the Long Term

The risk of long-term economic scarring from the pandemic is the main source of medium-term uncertainty. Whether the tens of millions made jobless by the pandemic will return to equally productive employment when it passes is unknown. The economy may also experience lingering ill effects from the high level of bankruptcies triggered by the pandemic. Changes in consumer preferences and business practices may necessitate a reallocation of resources that could pose a long-term drag on productivity. The rapid accumulation of debt from already high levels is a further source of instability that may eventually require a painful adjustment. Taken together, these near- and medium-term uncertainties suggest that global growth may remain below its pre-pandemic trend for many years to come. Compounding the years of lost life from COVID-19 deaths, currently estimated at 2.5 million for the U.S., the ongoing output loss due to the gap between the pre- and post-pandemic global economic growth path could well be the most costly legacy of a year of superlatives.

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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