DECEMBER 31, 2021

Strategic Investment Group®

Market Commentary

» GLOBAL MARKET REVIEW

» OUTLOOK & STRATEGY

» SPECIAL TOPIC

Contents

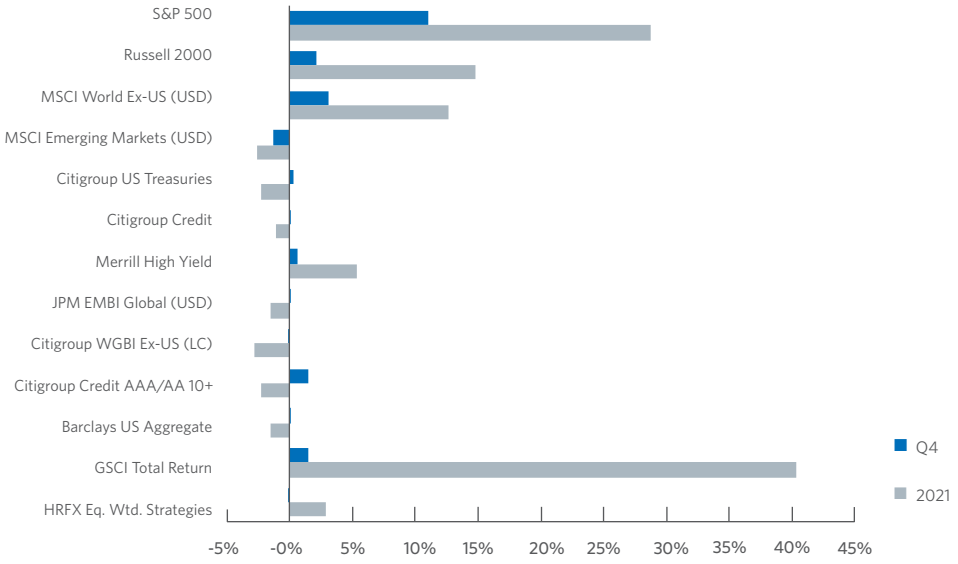
Summary

Advanced economy equity markets rose strongly in 2021, recording a third successive year of double-digit gains. U.S. equities led other markets by a wide margin. Emerging equities, in contrast, lost ground, weighed down by steep Chinese market declines. With U.S. inflation hitting 40-year highs, government bond and investment grade credit prices fell, but yields and spreads still closed the year at low levels. Oil prices surged, fueling a 40% gain in the GSCI commodity index. Looking ahead, mounting inflationary pressure and the prospect of tightening monetary conditions are likely to be the main concerns facing global markets.

U.S. Equity Markets End Year on High Note

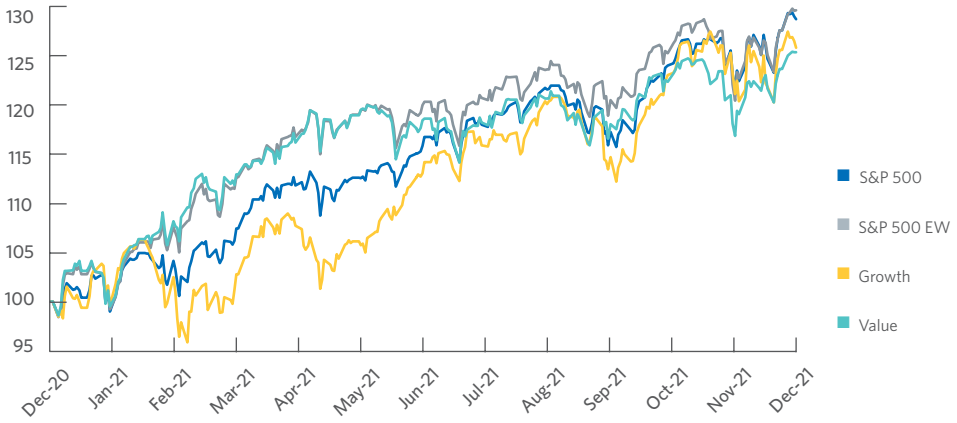
Following a lackluster gain in the third quarter, the S&P 500 rose 11% in the fourth quarter, bringing the return for the year to 28.7%. Last year marked the third successive year of double-digit U.S. equity market gains. The annual average return over this period was 26% for a paper gain in wealth of almost $20 trillion. U.S. markets last year were supported by a combination of strongly rising earnings, hopes that the Fed would be able to quell inflationary pressure without derailing the recovery, and signs that Omicron, while quite contagious, was much less virulent than other variants.

EXHIBIT 1:
Performance of Major Market Indices
Source: Bloomberg.
Year to date through December 31, 2021.



Global equities and commodities surged higher in 2021.

EXHIBIT 2:
Broad Based U.S. Equity Rally
Source: Bloomberg. Index January 1, 2021 = 100.



U.S. equity market gains last year were broad based, with the return on the equal weighted S&P 500 index slightly exceeding that of the market-cap weighted index (Exhibit 2). Growth and value stocks generated equally outsized returns in 2021, with both exceeding 25%. However, small cap stocks (+14.8%) lagged large cap (+26.5%).

Loose monetary policy, ultra-low credit spreads, and the wealth generated by high equity returns have created extraordinarily easy financial conditions in the U.S. and other advanced economies. While these conditions have supported a strong economic rebound, they have also contributed to speculative froth and fueled record levels of IPO activity, much of it via SPACS, as well as high levels of corporate debt and loan issuance. Retail traders were especially active again last year, contributing to frenzied trading in meme stocks and crypto currencies and amplifying valuation anomalies.

Emerging Equities Weighed Down by China

The MSCI World ex-U.S. index of advanced equity markets rose 3.1% in the fourth quarter, bringing last year's return to 12.6%, the third successive year of double-digit gains averaging 14.1%. Stock prices advanced last year despite rising inflationary pressure in the E.U. and U.K. and slowing growth momentum, especially in the service sector, as Omicron triggered lockdowns and behavioral changes.

Emerging equity markets declined 1.3% in the fourth quarter and 2.5% for the year. A decline in Chinese equities weighed on the broader index. In a year of strong returns across major equity markets, China was a significant outlier (Exhibit 3). A slowing Chinese economy, concerns over the solvency of Evergrande and other heavily indebted property developers, as well as a regulatory crackdown on the tech sector and vehicles used by foreign investors to gain access to Chinese equities, contributed to a 22.4% decline of the Chinese component of the emerging equity market index. Latin American bourses also suffered steep declines, falling 13.1%, in the face of slowing growth, an uneven response to the pandemic, rising inflation, and high debt levels. In contrast, emerging equities in Europe, the Middle East and Africa (EMEA) gained 14.3%. .

Fixed Income

As explored in greater detail in this quarter's Special Topic, the Fed struck an increasingly hawkish tone over the course of the year, indicating a readiness to begin trimming its bloated balance sheet and raise rates three times in 2022. The ECB, in

EXHIBIT 3:

Chinese Declines Weigh on Emerging Equity Market Index

Source: Bloomberg. Index January 1, 2021 = 100.

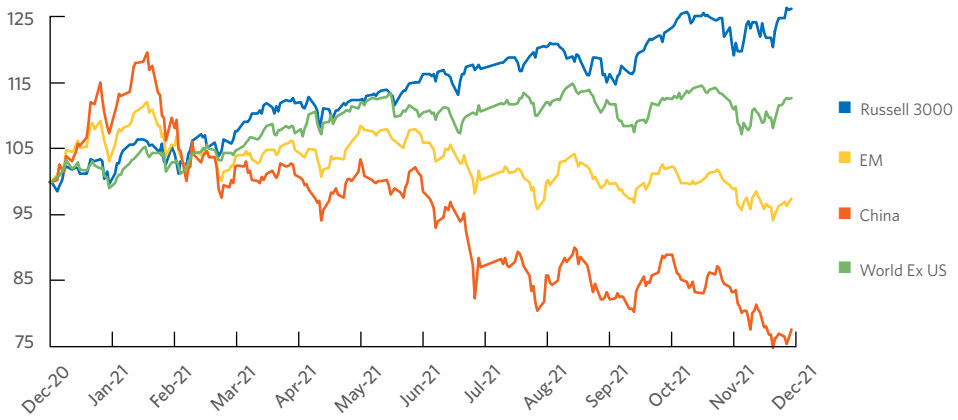
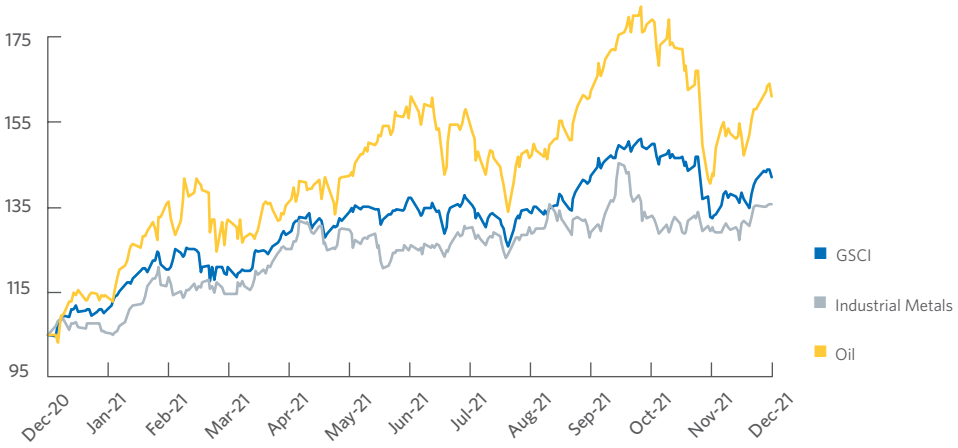


EXHIBIT 4:

Supply Constraints Send Commodity Prices Higher

Source: Bloomberg. Index January 1, 2021 = 100.



contrast, has so far taken the view that the recent rise in inflationary pressure was likely to be temporary, attributable mainly to supply chain disruptions and high energy prices. The Bank of England surprised markets by being the first G7 central bank to raise rates (by 15 basis points to 0.25%). Many advanced and emerging economy central banks raised rates to address the global phenomenon of mounting price pressures.

U.S. Treasury yields rose across the maturity spectrum in 2021, and the yield curve steepened. Nevertheless, yields remained at very low levels at year end, despite inflation uncertainty. The broad index of Treasury prices declined 2.3% in 2021. In the credit markets, investment grade bond prices fell 1.6% last year, while high yield bonds advanced 5.4%. In both cases, yield spreads remained narrow at year end. Outside of the U.S., the WGBI ex-U.S. index of developed sovereign bonds lost 9.7% in 2021, while the EMBI emerging market bond index fell 1.5%.

Hedge Fund Returns Vary with Market Beta

Hedge funds, as measured by the equal-weighted HFRX index, gained to 2.9% in 2021. Among strategies, equity hedge with its large market beta generated the strongest returns in 2021, rising 12.1%. With the exception of macro, which fell 0.8%, all other strategies generated positive returns in 2021.

Commodities Prices Spike

The combination of resurgent global economic activity and supply bottlenecks contributed to strongly rising commodity prices in 2021. Oil price rises have been especially noteworthy, rising 55% in 2021, but other commodity prices including industrial metals and foodstuffs have jumped higher, contributing to a 40.4% increase in the GSCI index in 2021 (Exhibit 4). The NCREIF Open-End Funds Core Index (reported with a delay) returned 13.6% in the 12 months through September 2021. Capital appreciation accounted for the bulk of the return as real estate prices rebounded from COVID write-downs. Industrial properties enjoyed the strongest gains, while hotels and retail properties continued to suffer the ill effects of COVID. The real yield on 10-year TIPS rose marginally in 2021 but remained negative (minus 1%).

Private Equity

Private equity returns have been buoyed by public market gains and a flood of cash into the market. The Thomson Reuters/Cambridge Index of U.S. private equity (reported with a delay) gained 54.1% in the 12 months through September 2021. Venture capital returns led all other segments in a cash-fueled frenzy of rising valuations. Global M&A activity in 2021 reached record levels, rising 64% from 2020. Dry powder amounting to over $1.5 trillion and well-funded SPACs have pushed purchase price multiples for buyouts to high levels.

Summary

Last year has the hallmarks of a watershed. Relative price stability gave way to mounting inflationary pressure, and global central banks started to transition from highly accommodative to tighter policies. We are coming to the end of a long period of very easy financial conditions created by an extraordinary expansion of central bank balance sheets, low policy rates, and massive fiscal stimulus. While expansionary policies had the intended effect of securing a breathtakingly fast recovery from the global economy's pandemic-induced collapse in 2020, they also had many unintended consequences. In an environment of abundant global liquidity and rapid economic and earnings growth, asset prices soared to unwarranted heights and global debt levels rose to all-time highs. With liquidity abundant, merger and IPO activity reached record levels and deals were struck at high prices. SPACs (aka "blank check" companies) were able to raise vast sums on little more than hope. Retail investors played an outsized role in markets, pushing meme stocks and cryptocurrencies to lofty levels. FOMO triumphed over fundamentals. Valuation spreads widened. Notwithstanding rising inflation and increasingly hawkish central banks, bond yields and spreads stayed low. The key question now facing markets is whether the Fed and other central banks will be able to quell inflation without derailing the recovery, popping stretched asset valuations, or rendering high debt levels unsustainable. Current market dynamics suggest that the jury is still out. We are therefore cautiously positioned, significantly underweight overvalued assets, while actively seeking to exploit large and plentiful valuation anomalies.

U.S. Equities Remain Overvalued

U.S. equities have performed well recently, achieving double-digit gains in three successive years. A combination of easy financial conditions and strong earnings growth helped propel U.S. equities 28.7% higher last year. Despite a large increase in earnings, the U.S. equity market became increasingly overvalued (Exhibit 1). The U.S. market's overvaluation relative to non-U.S. markets also widened. Within U.S. equities, valuation dispersion remains high, increasing the opportunity for active management. In particular, value stocks remain much more attractively priced than growth stocks.

Our current positioning vis-à-vis the U.S. equity market reflects the market's overvaluation, the high valuation dispersion within the market, and the attractive pricing of value stocks. We maintain a significant underweight to U.S. equities. We believe that our lineup of skilled active managers will continue to profitably exploit valuation anomalies within the market through active security selection. Finally, we have tilted our equity portfolios to seek to benefit from the outperformance of attractively priced value stocks as overpriced growth stocks revert to more justified valuations.

Non-U.S. Markets Are More Attractive

Outside of the U.S., European and emerging equity markets are about fairly valued. Like the U.S., the valuation dispersion within non-U.S. markets is wide, increasing the scope for value added. Given their relative attractive valuation, we have a slight overweight to developed and emerging non-U.S. equities. Overall, however, including our significant underweight to U.S. equities, we remain underweight global equities. From current valuation levels, we expect that global equities will deliver a below average risk premium relative to cash over the medium term.

We maintain a small overweight position to the China "A" shares market in light of its attractive valuation and the rich opportunities the market offers for adding value through active security selection. The "A" shares market provides some diversification benefits. Relative to broad emerging market indices and other Chinese markets, it has materially higher exposure to health care, consumer staples, and industrials, and lower exposure to communication services, information technology, and consumer discretionary. The "A" shares market is also liquid. Unlike many other emerging equity markets, trading is active and deep. Turnover in the "A" shares market is second only to the U.S. Two key features of the "A" shares market increase the scope for value added through security selection. First, under-researched small- and mid-cap stocks make up a large share of the market. Second, retail investors, who are generally less informed and disciplined, account for a large share of trading volume. Finally, by adopting this overweight, we are in effect anticipating the increasing weight of the China "A" shares market in key benchmark indices. We are currently considering the merits of increasing our position.

Hedge Funds for Diversification and Alpha

We continue to believe that an overweight allocation to hedge funds is advantageous in this environment and expect that our managers will continue to add significant value over the benchmark. Two main considerations underpin this view. First, most asset classes are fully valued. In some cases, such as U.S. equities and U.S. Treasuries, the degree of overvaluation is significant. Maintaining an overweight allocation to a low beta hedge fund portfolio contributes meaningfully to portfolio diversification away from these overvalued assets. Our hedge fund overweight complements our positioning within asset classes to benefit from a reversion to fair valuations.

EXHIBIT 1:

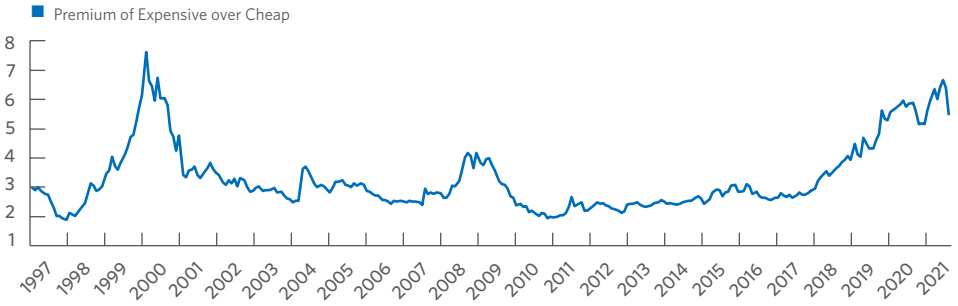
U.S. Equity Overvalued. Other Markets Closer to Fair.

Source: Strategic. Equity price to fair value of 1. At current levels, the U.S. market is 62% above fair. Data through December 2021.

EXHIBIT 2:

Wide Valuation Dispersion Creates Alpha Opportunities

Sources: Bloomberg and Strategic calculations. Data show the ratio of the top to bottom quintile of global stocks ranked by valuation through December 2021.



Recent market dynamics characterized by hyperactive retail traders, pockets of froth and hidden leverage, and wide valuation spreads create, in our view, a particularly favorable environment for active security selection aimed at exploiting valuation anomalies (Exhibit 2). The particularly large scope for adding value is the second main factor driving our significant overweight position to hedge funds.

Bond Yields and Spreads Remain Low

Yields have been at historic lows for an extended period, creating, in our view, an asymmetric payoff function in which yields are far more likely to rise than to fall. Adjusted for inflation, Treasury yields became increasingly negative last year across the maturity spectrum. As already discussed, we now appear to be at a major inflection in global inflation and monetary policy. Yields are rising and seem set to continue to do so. We believe that our significant duration underweight will continue to add value as yields adjust to rising inflation, higher policy rates, and quantitative tightening.

Credit spreads over Treasuries are quite narrow for both investment grade and high yield bonds (Exhibit 3). Although partially justified by very low default rates, these low spreads have persisted despite a steady erosion of investor protections and a jump in corporate debt issuance. With spreads at such narrow levels, we maintain an underweight to credit risk. Our active positioning also includes a credit barbell approach combining U.S. Treasuries on one end of the barbell and strategies in higher yielding segments of the market at the other. In our view, the high yield sector offers attractive opportunities for adding value through security selection.

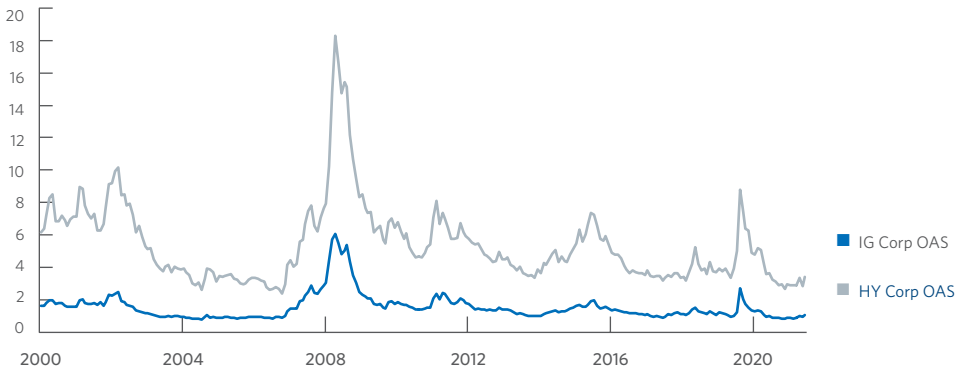
Inflection Points Are Turbulent

Inflection points are typically turbulent. Given the uncertainty created by the current period of transition, we are conservative in our overall positioning relative to market risk while being aggressive in our hunt for value added. We believe that a focus on fundamental valuation as our ultimate guide for portfolio positioning will continue to serve us well.

EXHIBIT 3:

Investment Grade and High Yield Spreads Remain Narrow

Source: Bloomberg. Option-adjusted corporate yield spreads over Treasuries in percent. Data as of January 12, 2022.



"Transitory" or "Severe Threat"

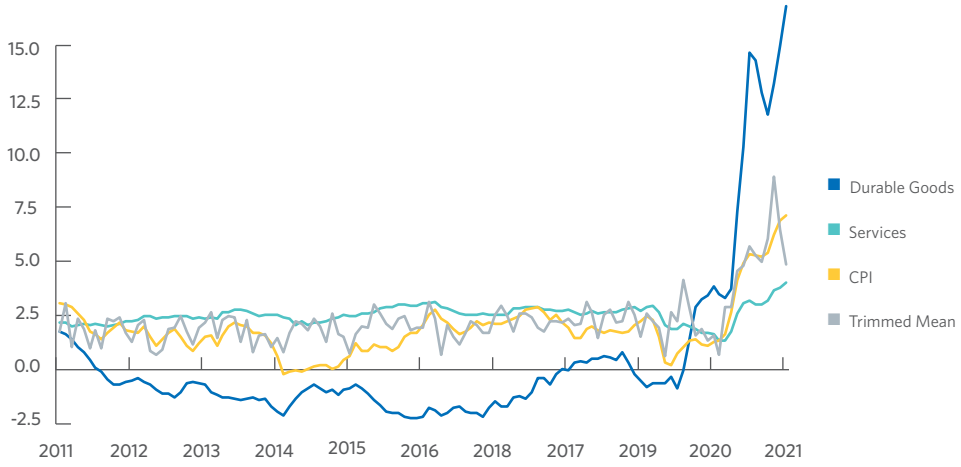
The Fed has grown increasingly hawkish following several months of sustained increases in inflation. When price pressures first emerged early last year, the Fed characterized them as "transitory." By December, when inflation hit 40-year highs, the Fed deemed it a "severe threat."

Markets face a key question. Will the Fed be able to dampen inflationary pressure without undermining the high asset valuations and debt levels that have been built up over a prolonged period of easy financial conditions? Much hinges on the pace and persistence of price increases, the Fed's response to them, and, crucially, whether the experience of high inflation becomes embedded in expectations. In this quarter's Special Topic, we explore recent inflation dynamics and consider the implications of tighter policies.

Inflation Dynamics

The jump in inflation has a number of noteworthy features. First, durable goods prices, which had been in a long secular decline relative to services, spiked 17% (yoy) in December (Exhibit 1). This jump reflects an equally dramatic shift in consumption patterns from services to durable goods since the pandemic. Real consumer spending on durables is 21% higher than its pre-pandemic peak, while real spending on services has not yet recouped pre-pandemic levels. The shift in consumption coupled with Covid-induced supply chain disruptions have resulted in some eye-popping price increases, including a 37% increase in the prices of used cars and trucks. Second, price pressures appear widespread and cannot be attributed to transitory shortages in used cars or other heavily demanded items. The trimmed mean measure of inflation that nets out such outliers was up 4.9% (yoy) in December and there is evidence of price pressures, notably in the form of higher wages, in the service sector notwithstanding the shift in consumption away from services. Moreover, commodity prices are way up. Gasoline prices in the U.S. rose by nearly 50% last year. Third, the labor market is tight and in flux. Unit labor costs rose 6.3% (yoy) through the third quarter of 2021. Job openings are near record levels (10.6 million) even though there are 3.6 million fewer people in the workforce than before the pandemic. The quits rate of 3% of total employment is at record levels. The risk of a wage price spiral is mounting.

EXHIBIT 1:
U.S. Inflation Hits 40-Year Highs
Source: Bureau of Labor Statistics. Percent change from a year ago. .



Inertia and Expectations

Inertia is the essential feature of inflation dynamics and the relative stability of expectations lies at the heart of inflation inertia. Expectations informed by past experience become self-fulfilling as they are embedded in contracts that affect future inflation outcomes. The most pernicious manifestation of this dynamic takes the form of contracts indexed to inflation. Such contracts, like the one concluded last year between John Deere and the UAW, automatically push inflation forward, making it even harder to break the cycle.

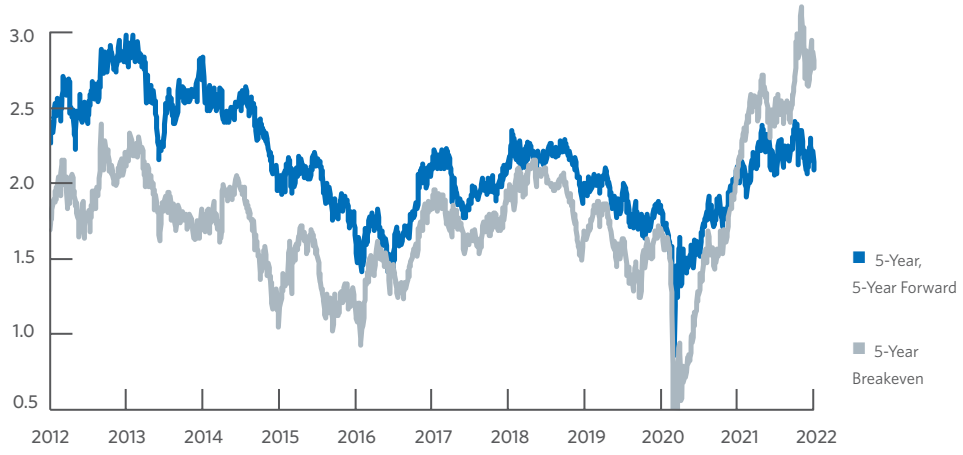
So far, market-based measures of inflation expectations are up significantly but remain relatively contained. In mid-January, market-based measures suggested expectations that inflation would average 2.8% over the next five years, and moderate substantially in the subsequent five years (Exhibit 2). By these measures, the bond market had faith that the Fed would be able to contain inflation without hurting the recovery or making high asset valuations and public and private sector debt levels untenable. Survey data, however, paint a more worrisome picture. The expectations of professional forecasters are for much higher inflation than suggested by the market. Consumer expectations are higher still. By these survey-based measures, the Fed has fallen behind the curve, and faces a difficult task of re-anchoring expectations to relative price stability.

The realization of the "severe threat" is not inevitable. Although price pressures are broad based, supply bottlenecks coupled with the dramatic shift in consumption are major pieces of the inflation puzzle. An easing of bottlenecks, a normalization of consumption patterns, and a retrenchment of the massive monetary and fiscal stimulus provided in the wake of the pandemic would do much to relieve inflationary pressure and preserve expectations for a modest near-term increase in inflation. Nevertheless, with yields still quite low and inflation rising, we retain a solid duration underweight.

EXHIBIT 2:

Market-Based Inflation Expectations

Source: FRED. Inflation expectations measured by the difference between the yield on U.S. Treasuries and TIPS.



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 businesses, 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., venture capital/private equity, real estate, and/or hedge funds) or international investments, or manage strategies with high potential for adding value. Customized liability-driven investing (LDI) solutions, whether through an integrated total portfolio approach or a targeted long-duration strategy, are also available, as are solutions that address mission-related investment objectives.

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