SEPTEMBER 30, 2019

Market Commentary

» GLOBAL MARKET REVIEW

» OUTLOOK & STRATEGY

» SPECIAL TOPIC

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Summary

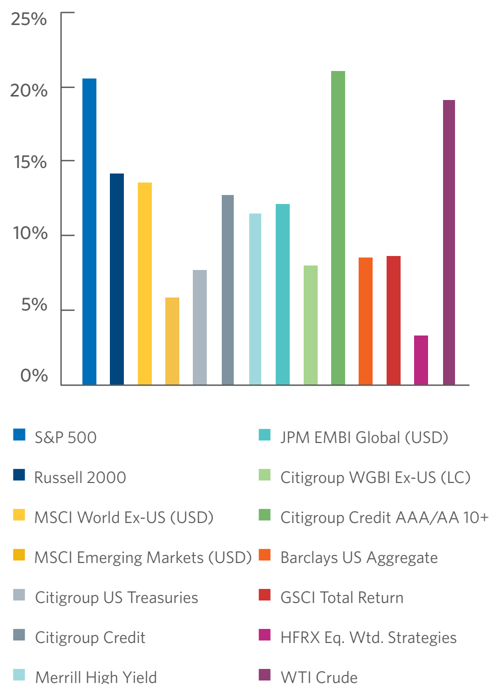
U.S. equity and bond markets rose modestly in the third quarter, adding to earlier strong gains, while non-U.S. markets mostly lost ground. Erratic trade policies contributed to market volatility and took a heavy toll on global trade volumes, manufacturing output, and export-oriented economies. Continued Brexit chaos and geopolitical concerns further eroded market sentiment. Monetary policy once again provided a salve to these largely self-inflicted wounds. Commodity prices fell during the quarter, led by oil, despite tanker seizures in the Straits of Hormuz and drone attacks on key refineries in Saudi Arabia. Long U.S. Treasury yields touched all-time lows, and the U.S. dollar and gold rose

EXHIBIT 1:

Performance of Major Market Indices

Source: Bloomberg.

Data through September 30, 2019.



Global equity and bond markets are up so far this year.

U.S. Equities: Equanimity in Adversity

Despite an eventful third quarter, U.S. equity markets managed to advance modestly. Capricious twists and turns in the Sino-U.S. trade war appeared to be the main market driver. Other potentially destabilizing developments included the initiation of impeachment proceedings, intensifying Brexit follies, faltering manufacturing output, falling trade volumes, ebbing growth in Europe and China, and tanker seizures and refinery bombings in the Middle East. Offsetting these disruptions, two rate cuts by the Fed, renewed monetary stimulus by the ECB, and expansionary policies in China helped calm markets. The rise in the third quarter added to already strong returns earlier in the year, pushing the S&P 500 up over 20% so far this year, and contributing to broad-based gains.

Within the U.S. equity market, growth and large cap stocks have handily outperformed their value and small cap counterparts this year, extending a longstanding trend that has led to a significant overvaluation of growth stocks relative to value (Exhibit 2). All market segments enjoyed double-digit gains in the first nine months of the year, as have all sectors except energy and healthcare. The tech sector, which is up over 29% through September, remains the best performer.

Uncertainty Plagues Non-U.S. Equities

Developed and emerging equity markets lost ground in the third quarter, falling 0.9% and 4.2%, respectively, in dollar terms with currency movements contributing to the decline. In Europe, a faltering German economy, plummeting manufacturing output, and Brexit concerns weighed on sentiment (Exhibit 3). Emerging equity markets across all regions fell, with the largest declines in

European, Middle Eastern, and African (EMEA) markets, which fell 8.2%. Asian emerging equity markets fared better, losing only 4.2%. Weighed down by concerns over the continuing impact of the trade war on exports and output, Chinese equities fell 5.1%. So far this year, developed non-U.S. advanced and emerging equity markets are up 13.6% and 5.9%, respectively. The domestic China A-Shares market, up 24.6% in the first nine months, remains the best performer.

Negative Yields, Positive Returns

Uncertainty engendered by erratic trade policies, geopolitical risks and slowing growth has spurred a flight to safety. Central bank action, including balance sheet expansion and the imposition of negative policy rates, has also depressed yields. The stock of global debt trading at negative nominal yields has risen from virtually zero in 2014 to about $15 trillion, representing 26% of all bonds in the world (Exhibit 4). The vast bulk of European and Japanese sovereign bonds are trading at negative yields. In Germany, the entire sovereign yield curve from three months to 30 years had negative nominal yields, suggesting that markets are expecting negative rates to be a long-term phenomenon. Negative yields are not limited to sovereign issues. Yields on almost $1 trillion in investment grade corporate bonds, or 7% of the total, are also negative.

In the U.S., bond yields remain positive in nominal terms and there seems to be little appetite in the Fed for negative policy rates. Nevertheless, yields across the maturity spectrum remain low and the Treasury yield curve has been inverted since late May, raising recession fears. The yield on the 30-year Treasury touched an all-time low in the quarter, falling below 2%. Trade tensions, growth concerns, and the Fed, which cut rates by 25 basis points for the first time since the great financial crisis in June and again in September, contributed to falling yields. As a result, U.S. Treasuries and investment grade debt with maturities of ten years or more have enjoyed strong gains so far this year, rising about 20%. Outside of the U.S., bond market performance has also been solid in the first nine months of the year. The WGBI index of developed sovereign bonds gained 5.4% while the EMBI index of emerging sovereigns rose 12.1%.

Hedge Funds

Hedge funds overall have returned 3.4% in the first nine months of the year. Among strategies, the relatively high beta equity long/short segment has performed best, returning 7.9%, while merger arb strategies have lagged all others, declining 1.7%.

EXHIBIT 2:
U.S. Growth Stocks Extend Lead on Value
Source: Bloomberg.
Data through September 30, 2019.

Real Assets

Commodity prices have been volatile, fueled by geopolitically induced swings in oil prices on the one hand, and abundant supply and concerns over slowing global growth on the other. After gaining 28.8% in the first half of the year, the GSCI Crude Index fell 7.5% in the third quarter. In the real estate market, the NCREIF Open-End Funds Core Index (reported with a quarter delay) gained 5.5% in the year through June 2019. Industrial properties continued to outperform other property types while the retail sector lagged. Real estate valuations remain stretched and property yields are at historic lows. The real yield on 10-year TIPS has fallen precipitously from an already low level of 96 basis points at the beginning of the year to 15 basis points at end September.

Private Equity

The Thomson Reuters/Cambridge Index of U.S. private equity gained 12.5% in the year through June (preliminary data; reported with a quarter delay). While returns remain strong, and multiples are attractive relative to public markets, fund raising is robust, LBOs are priced to perfection, valuations for VC-backed companies are at record levels, and 2019 is on track to be a record year for IPOs.

EXHIBIT 3:

Erratic Policies Weigh on Gloal Trade and Manufacturing

Source: Bloomberg.

Data through September 30, 2019.

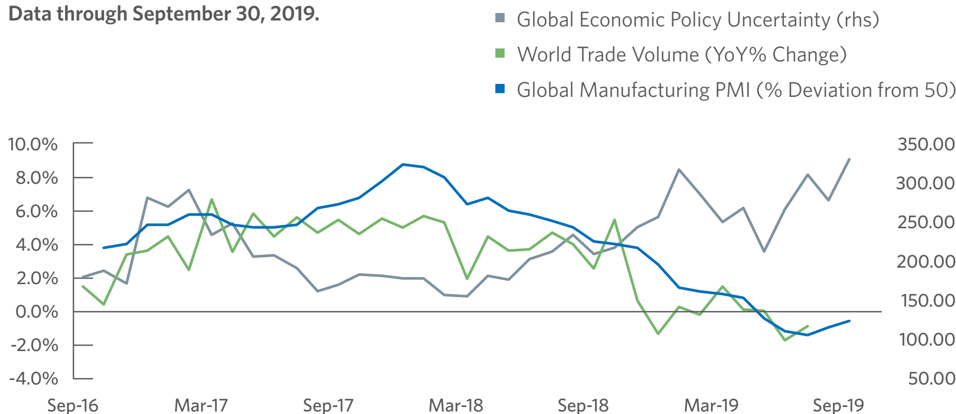


EXHIBIT 4:

Stock of Bonds Priced at Negative Yields Soars

Source: Bloomberg.

Data through September 30, 2019.

Summary

The global economy is experiencing a synchronized slowdown, largely triggered by trade disputes and heightened policy uncertainty. While U.S. stocks and bonds have risen strongly this year, markets appear fragile and susceptible to wide swings with the ebb and flow of trade tensions. In response to the broad-based slowdown, a wide range of central banks in advanced and emerging economies have eased monetary conditions, mitigating the forces of decline while perpetuating overextended asset valuations. Our investment strategy remains disciplined and driven by deviations of market prices from fair value in the expectation that increasingly stretched valuations will mean revert.

Did Policy Kill the Recovery?

Growth in major developed and emerging economies has slowed further as manufacturing activity, global trade, and business confidence have slumped. The IMF has further reduced its 2019 global growth forecast to 3%, the slowest rate since the Great Financial Crisis, down from 3.6% in 2018.

The ascendance of protectionism is a prime driver of the slowdown. In the U.S., manufacturing output and business confidence have fallen, curtailing capital expenditure. In the more trade dependent euro area, falling exports have taken a larger toll on output, and in particular on the production of industrial and capital goods. The pace of growth in China, which has accounted for one third of global growth in recent years, has also slowed largely because of declining trade volumes.

In addition to trade tensions, a number of country- and sector-specific factors have contributed to the synchronized global declines in the pace of growth.

- Global automobile output has fallen by 3% because of tighter emission standards in Europe and China and the expiration of tax incentives to purchase new cars in China.
- Efforts by the Chinese authorities to ease the economy away from dependence on debt-fueled growth also contributed to the reduced pace of growth.
- In the U.S., the fading short-lived economic boost provided by tax cuts in late 2017 is contributing to weaker growth. Moreover, Fed rate hikes prior to this year and gradual moves to reverse quantitative easing also played a role in the slowdown, notwithstanding the 50 basis point cut in the Fed funds rate this autumn. The Fed's shadow Fed funds rate measure – which estimates the impact on monetary conditions of both changes in rates and asset purchases and sales – has risen by 540 basis points since 2014, the most pronounced tightening since Paul Volcker's rate hikes of 1979/80.
- Growth in the U.K. has also slowed, reflecting declining investment and business confidence due to a chaotic Brexit process.
- Among major emerging markets, the slowdown in China has hurt Asian economies more broadly. Policy uncertainty has undermined confidence in Mexico. A mining disaster triggered a recession in Brazil. The financial and economic crisis in Argentina intensified, while the Turkish economy was buffeted by domestic policy missteps and geopolitical turmoil.

Risks of U.S. Recession

The U.S. yield curve was quite flat and the term premium compressed in 2018 and early this year. The yield curve inverted in May as three-month T-bill rates exceeded 10-year Treasury bond yields and remained inverted through mid-October. The inversion of the yield curve, a reliable harbinger of recession, compounded concerns over the sustainability of the longest uninterrupted recovery in modern U.S. economic history.

We doubt that this time will be different and the U.S. will avoid a recession. We hold this view even though the Fed has cut rates by 50 basis points this year and markets anticipate a further 40-50 basis point reduction in the Fed funds rate by the end of 2020. The Fed is not acting alone. Given the global nature of the slowdown, central banks in advanced and emerging countries representing some 70% of the global economy have also eased monetary policy. Despite these moves, we doubt that rate cuts and other steps to ease monetary conditions will counter the ongoing negative impact of trade tensions on output and investment. Moreover, financial market vulnerabilities in the form of overvalued assets, declining risk and term premiums, and the erosion of credit covenants and investor protections increase the susceptibility of markets and broader economy to changes in sentiment.

While a recession has, on average, followed within 12-18 months of a yield curve inversion, the range of uncertainty around this average is large, reflecting the relatively small sample size and idiosyncratic conditions of each business cycle.

It is also difficult to judge the likely magnitude of the downturn. We believe that a recession comparable to another Great Financial Crisis (GFC) is unlikely, however. Households and banks are in a much stronger financial position now than they were in the period preceding the GFC. As a result, current high levels of corporate leverage, stretched asset valuations, and market vulnerabilities built up in the years of extraordinarily low yields are unlikely to trigger another liquidity crisis and market meltdown.

In sum, while a U.S. recession by the end of next year has become quite likely, we are reasonably confident that adequate safeguards are in place to prevent a re-run of the GFC.

Mean Reversion or a New World?

The drawn-out and shallow economic recovery from the GFC with its combination of record-low interest rates and unorthodox monetary policies has resulted in significant dislocations in financial markets, particularly in the U.S. To decide whether these dislocations reflect a new world or are merely temporary deviations from a longer-term equilibrium is crucial for the design of our valuation-driven investment strategy.

In the U.S. Treasury market, nominal U.S. bond yields are currently close to all-time lows while real yields are near zero. These valuations are consistent with the expectation of economic stagnation and disinflation over the medium- to long- term. For these yields to persist, we would have to have entered a new world of rolling financial crises and deflationary stagnation. While we think that a recession is likely, and this likelihood is largely priced into bond yields, we are confident that the economy is resilient enough to rebound from a short-term set back.

Similar reasoning applies to equity markets. U.S. equity markets have become substantially overvalued, in part helped by low interest rates and the search for returns in a low yield environment. We estimate that U.S. stocks are trading about 30 percent above fair value. Within equity markets, the decade-long underperformance of non-U.S. stocks relative to the U.S. by more than 800 basis points annually has resulted in a significant divergence in the relative attractiveness of these markets. A similar persistent pattern of widening valuation dispersions is also evident within the U.S. market. Growth stocks have outperformed value stocks by more than 500 basis points annually over the past five years.

We believe that these divergences in relative valuations across international markets and within the U.S. market are unsustainable and present an opportunity as prices mean revert to reflect fundamentals. We are positioned accordingly.

Portfolio Construction and Asset Allocation

We remain true to our risk sensitive, price aware investment philosophy that leads us to favor undervalued assets over those trading far above fair value. The widening of these valuation dispersions, while painful as they occur, creates an opportunity for significant value added.

In this environment, we maintain a solid underweight to U.S. equities that we partially offset by small overweight positions to developed and emerging non-U.S. markets. Within emerging markets, we hold an overweight to domestically traded Chinese stocks ("A shares") where a retail driven market offers disciplined portfolio managers significant opportunities to add value. In the U.S., we favor value stocks, which have underperformed growth stocks for the better part of the past decade. The dispersion between expensive and cheap stocks in the U.S. is now at levels only surpassed during the excesses of the tech bubble in the late 1990s, increasing the likelihood of mean reversion.

In fixed income markets, we confirm our duration underweight. With 10-year nominal yields close to all-time lows and real yields approaching zero, we believe that the risk of sharply higher yields is substantial. While yields could fall further in the event of a recession, we believe that an impending downturn is already largely reflected in the term structure. Over the medium-term, as term premiums, inflation expectations, and real yields revert to levels that are more normal, a short duration position should be rewarded. We therefore continue to combine our below-policy duration stance with a modest underweight to credit as credit fundamentals have deteriorated in line with the late stage of the business cycle.

Our valuation analysis continues to support our underweight to real assets. With 10-year TIPS yields trading near all-time lows, there is ample room for yield increases. We therefore maintain our longstanding underweight to TIPS. We also maintain our recent move to underweight real estate. Although property fundamentals in the form of high levels of employment and occupancy rates remain favorable, real estate valuations are high and property yields are at historic lows. An eventual increase in yields and tightening of credit availability would undermine much of the rationale for current rich property valuations.

Although we are concerned by the apparent froth in the level of fundraising and dry powder in the private equity market and the absurd valuations of some recent venture capital-backed IPOs, we maintain a neutral position to private equity. We do not believe that private equity investment lends itself to market timing and prefer instead to rely on broad diversification across cycles and the judgment of our managers to avoid the extremes of exuberant valuations.

With valuations stretched in most asset classes, we continue to overweight hedge funds which combine significant alpha potential with minimal market exposure and are likely to be able to exploit the wide valuation dispersion apparent in many markets.

2019 Idea Lab

This year's Idea Lab combined keynote addresses, in-depth workshops, interactive panels presented by Strategic's investment team, and preeminent guest speakers from the academic, policy, and investment worlds. Our keynote dinner speaker was Dan Ariely, Professor of Psychology and Behavioral Economics at Duke University. Over lunch the next day, Adam Tooze, Professor of History and Director of the European Institute at Columbia University, gave the keynote address. While it is impossible to do justice to the depth of the discussions during the two-day forum, four areas were particularly noteworthy. We consider these below

Portfolio Construction & Risk Management

The Strategic team set the stage with a focus on the analytics and disciplined approach needed to construct well-diversified portfolios capable of generating sustained value added. The key is to focus on fundamental valuations, the riskiness of each active position, and the interaction of all positions in the portfolio when determining top-down positioning and manager selection. In the current environment of unsustainably low bond yields, we maintain a significant underweight to duration. We also judge U.S. equities, which have strongly outperformed other international markets since the Great Financial Crisis (GFC), to be significantly overvalued, warranting an underweight. Within U.S. equities, we have initiated a tilt toward value stocks as the long string of outsized returns for growth at the expense of value stocks has made value quite attractive. Real estate valuations, flattered by low yields and ample liquidity, have also risen to unattractive levels and we have reduced their allocation accordingly. While top down insights into fundamental misvaluations like these have added material value historically, we find manager selection to be a more robust, consistent, and sustainable source of value added. This is because manager selection encompasses a vast breadth of independent decisions, as well as greater opportunity to gain an information advantage. Ultimately, sound investment governance requires a stable foundation of analysis, a disciplined process, and keen judgment born of experience, a foundation that Strategic has continuously strengthened for over 30 years.

Behavioral Finance and Life

Dan Ariely's keynote address ranged from humorous insights into the dynamics between a mother and her son's soon-to-be wife, the best way to encourage the poor to save, and the most effective motivator of workers – no, it is not money. Professor Ariely reminded us that, like a rocket ship, the best way to direct behavior in desired directions is to reduce friction and increase fuel. Through a series of case studies drawn from field research, Professor Ariely shared insights, some practical, others tongue-in-cheek, on influencing behavior. How did the mother know which of her son's girlfriends was destined to be his wife? Simple, the future wife was the only one she hated. An effort to promote savings in poor villages in Kenya discovered that higher interest rates, gifts, and prizes were far less effective than a public record shared with the family of whether savings targets had been met. A study of worker motivation found that while salary and benefits were important, nothing was a stronger motivator and boost to morale than respect, encouragement, and recognition of a job well done.

Persistent Tremors of Great Financial Crisis

The lunch keynote address given by Adam Tooze highlighted the continuing reverberations of the GFC and their impact on current global political, economic, and market fault lines. In Tooze's view, the GFC shattered a long-enduring consensus that economic policy need only focus on promoting open markets, free trade, prudent fiscal policies, and price stability. With markets seen to be largely self-correcting toward a stable equilibrium, this "Washington Consensus," as it was known, enjoyed wide support in advanced economies across parties of all stripes, rendering politics largely irrelevant to economic policy. This consensus collapsed with the market crash and prolonged

economic slump that followed the GFC. Populism, protectionism, and fiscal profligacy have risen in its place, precipitating policy uncertainty, market volatility, and steep declines in global trade and industrial output. Whether a new consensus can be forged around enduring principles remains an open question. In the meantime, we can expect the trade war between China and the U.S. to continue and global economic policy making to remain fractious.

Politics, Policies, and Financial Stability

Syndicated columnist Jonah Goldberg also attributed the current caustic tone of political discourse to a post-GFC feeling of betrayal at the hands of elites managing a rigged system. Without strong political parties to channel and temper the disillusionment, social media amplifies the most extreme impulses of the crowd. Even the normally placid realm of monetary policy is in flux. A panel on monetary policy and the late stage of the credit cycle highlighted the conflicting pressures faced by global central banks. With policy rates low, central bank balance sheets bloated, bonds totaling $15 trillion bearing negative nominal interest rates, and the late stage credit cycle exhibiting signs of excess, the ability of global central banks to address an eventual economic slump is limited. Meanwhile, policy uncertainty in the form of trade tensions and Brexit are increasing the risks of recession and financial instability and central banks appear ill equipped to respond to renewed challenges.

We hope that this overview of highlights from Strategic's 2019 Idea Lab encourages you to join us at the Idea Lab planned for 2020. It promises to be every bit as insightful and entertaining as this year's forum.

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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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