

Global Market Review

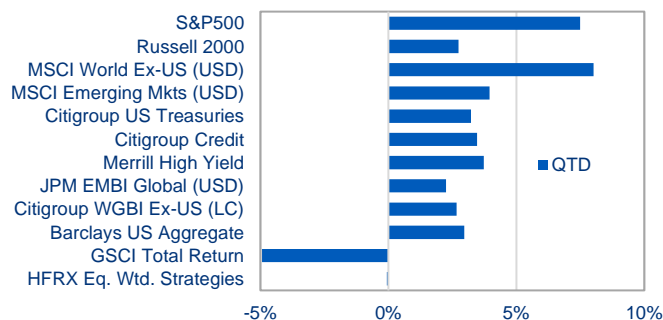
Summary

Notwithstanding the failure of three regional banks in the U.S. and of a global systemically important bank based in Switzerland, U.S. and non-U.S. equity markets ended the quarter with healthy gains. The equity market rally was fueled in part by speculation that March's mini banking crisis would push the Fed and other major central banks to slow the pace of policy tightening (see Special Topic). Reflecting this expectation, U.S. tech stocks enjoyed particularly strong gains, although concerns over the profitability and soundness of the banking sector drove U.S. bank stocks sharply lower. In expectation of easier monetary policies ahead, global bond markets joined in the equity rally. Yields most sensitive to the policy tightening cycle fell especially sharply. The decline in U.S. yields contributed to the depreciation of the U.S. dollar against most major currencies.

Exhibit 1

Performance of Major Market Indices

Source: Bloomberg. Year to date through March 31, 2023.



Equity markets rallied despite mini banking crisis.

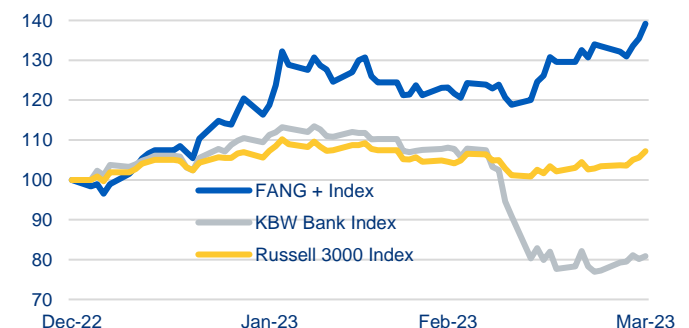
U.S. Equities Rally Despite Bank Mayhem

The failure of Silicon Valley Bank (SVB) followed in quick succession by the shuttering of two other smaller banks undermined confidence in the soundness of U.S. regional banks, sending their shares sharply lower. The broader U.S. equity market shrugged off the banking sector turmoil, however, buoyed by a surge of large-cap growth stocks in the tech sector included in the FANG index (Exhibit 2). The rally in the broad market and tech stocks in particular was driven in part by a sharp adjustment in expectations for the future path of U.S. monetary policy. Sentiment shifted to the expectation that the Fed would slow the pace of policy tightening to reduce the risk of precipitating a full-blown banking crisis.

Exhibit 2

Large Cap Tech Stocks Surge as Banks Plunge

Source: Bloomberg. Index. January 1, 2023 = 100.



The S&P 500 rose 7.5% in the first quarter. Gains so far this year have been heavily concentrated on growth stocks (up 13.9%) and large cap stocks (up 7.5%). Value stocks, in contrast, have generated only a small gain of 0.9%, in part reflecting the heavy share of banks and financials in the value index. Stocks in the tech and telecom sectors led all others, rising 21.1% and 20%, respectively in the quarter. Financial and energy sector stocks, in contrast, fell 5-6%.

Non-U.S. Equities Also Rally

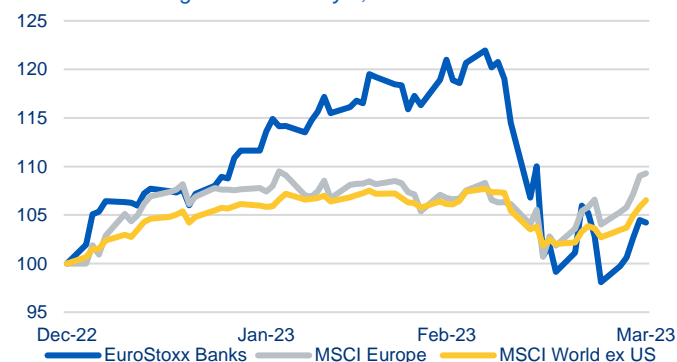
The Swiss Central Bank presided over a shotgun wedding of UBS and Credit Suisse (CS) to prevent a disorderly failure of Credit Suisse, whose collapse would have had a major impact on the global banking system. Despite the threat posed by the

loss of confidence in CS and a sharp decline in European bank stocks, European equity markets gained 10.6% in the first quarter (Exhibit 3). The MSCI World ex-U.S. index also rose, returning 8.0%. Hopes for a moderating pace of inflation, largely reflecting a fall in energy prices, contributed to the European equity market rally as did coincident indicators of economic activity suggesting that business confidence and activity were picking up.

Exhibit 3

EU Equities Rally Despite Bank Turmoil

Source: Bloomberg. Index. January 1, 2023 = 100.



Emerging equity markets rose 4% in the first quarter. Chinese markets performed particularly well, gaining 5.3% for the quarter. The main catalyst for the Chinese market's gains appeared to be a continued economic rebound driven by pent-up demand released following the end of the zero-COVID policy, and a corresponding increase in manufacturing output. Across regional emerging markets, Asian stocks gained 4.6% in the first quarter, while Latin American bourses rose 3.1%. Emerging markets in Europe, the Middle East and Africa lost ground, however, falling 2.2%.

Markets Reassess Path of Monetary Policy

Major central banks raised rates in March, continuing the fight against inflation despite banking sector turmoil. However, the Fed moderated its rate hike to 25 basis points, in part reflecting concerns over the impact of tighter policies on banking sector stability. Nevertheless, the current U.S. tightening cycle remains the steepest since 1982. The ECB, for its part, did not slow its pace of tightening in response to the loss of confidence in CS, arguing that the European banking system was sound and that the ECB had the tools to achieve both price and financial stability. It raised its policy rate by 50 basis points in March, the sixth consecutive increase of that magnitude.

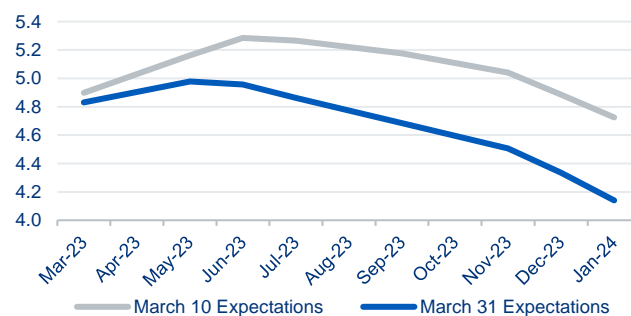
Despite these policy rate increases and reiterated central bank commitments to fight inflation, yields fell across advanced economy bond markets. The yield of the 2-year U.S. Treasury note, which is especially sensitive to changes in the direction of monetary policy, fell sharply as markets reassessed their expectations for the future path of monetary policy (Exhibit 4). While the entire U.S. Treasury yield curve shifted lower, it remained steeply inverted between 3-month and 10-year maturities and continued to signal a risk of recession. The decline in the 10-year U.S. Treasury yield was driven almost

entirely by a fall in real yields, leaving implied average expected inflation over the next 10 years constant at about 2¼%.

Exhibit 4

Bank Turmoil Spurs Reassessment of Policy Path

Source: Bloomberg. Expected Fed Funds rate in percent.



Reflecting these yield movements, U.S. Treasuries returned 3.2% in the first quarter. In the credit markets, investment grade (up 3.1%) and high yield bonds (up 3.6%) also generated gains as yield spreads tightened marginally.

Outside of the U.S., the WGBI ex-U.S. index of advanced sovereign bonds rose 3.7% in the first quarter, reflecting easing headline inflation. The EMBI index of emerging market sovereign bonds returned 2.2% for the quarter, despite mounting fears over the debt servicing capacity of many emerging and especially frontier markets.

Hedge Funds Tread Water

The HFRX equal weighted hedge fund index was little changed in the first quarter. The recent performance of the industry has highlighted the importance of constructing hedge fund portfolios to minimize market beta and focus on strategies that seek to exploit the wide valuation dispersion across securities.

Real Estate Pressured by Rising Yields

Real estate as measured by the NCREIF Open-End Funds Core Index (reported with a delay) rose 6.6% in the 12 months through December 2022. Low cap rates, rising yields, and tighter financing conditions have pressured all property types. Offices, which fell 3.4% over the period, face low occupancy rates as office workers continue to prefer working from home. Industrial, hotel and multi-family properties, in contrast, generated strong gains.

Private Equity Feels Funding Pressures

The Thomson Reuters/Cambridge Index of U.S. private equity (reported with a delay) declined 1.7% in the 12 months through December 2022 as funding conditions deteriorated. Venture capital (VC) strategies lost 7.4% reflecting a combination of high valuations, uneven earnings prospects, a drop-off in investor inflows, and limited IPO activity. Although the collapse of Silicon Valley Bank, known as the bank of venture capital, raised initial concerns, most VC firms moved quickly to diversify their banking relationships.

Outlook & Strategy

Turbulent Transition to Tighter Policies

As global economic policy makers grapple with the highest inflation rates in 40 years and markets confront the most rapid pace of U.S. interest rate hikes since 1982, investors face two key questions. First, will the Fed and other major central banks succeed in taming inflation without triggering a deep recession? Second and relatedly, are the failures of Silicon Valley Bank, Signature Bank, and Credit Suisse one-off events, or signs of widespread financial market fragility? In the current environment of heightened policy and economic uncertainty, hazarding a view on these questions is more than usually fraught. For the moment, it appears that headline inflation is falling and that decisive action by regulators has prevented widespread contagion from March's mini banking crisis. However, recession risk, as measured by the deeply inverted Treasury yield curve, remains high, and there is a continued risk that further financial market fault lines will be uncovered by tighter monetary conditions. Faced with these uncertainties, we raised portfolio liquidity by reducing our allocation to hedge funds to neutral from overweight and shifting these assets to short-term U.S. Treasuries. We continue to consider hedge funds to be an attractive source of portfolio diversification and value added, but we now place a premium on liquidity. Our other active asset allocation positions across and within asset classes remain unchanged. As always, these are driven by our assessment of relative valuations. Adding value through security selection remains our main focus. Valuation dispersions are still wide, and we continue to consider the prospects for adding value through active security selection to be highly favorable. Focusing on active security selection as the main source of added value has the further benefit of broadening and diversifying the sources of portfolio return.

Price and Financial Stability and Growth

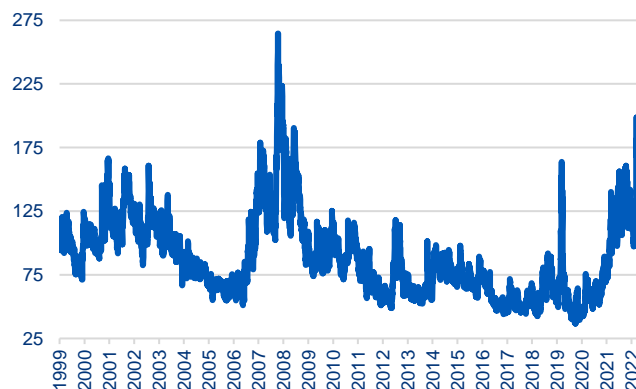
Balancing price and financial stability while avoiding a hard economic landing is the major challenge facing global central

banks. Adjusting to higher yields and increased volatility after years of easy money is the chief challenge facing investors. The expected path of monetary policy shifted abruptly in the wake of the March mini banking crisis as markets expected central banks to slow the pace of tightening to soften the blow of tighter money on financial stability. As reflected in the MOVE index measuring expected volatility in the U.S. Treasury market, the uncertainty surrounding the future path of monetary policy and bond yields is unusually high, exceeded only during the Great Financial Crisis (Exhibit 1).

Exhibit 1

Macro Uncertainty Reflected in High Interest Rate Volatility

Source: Bloomberg. MOVE index of implied U.S. Treasury volatility.

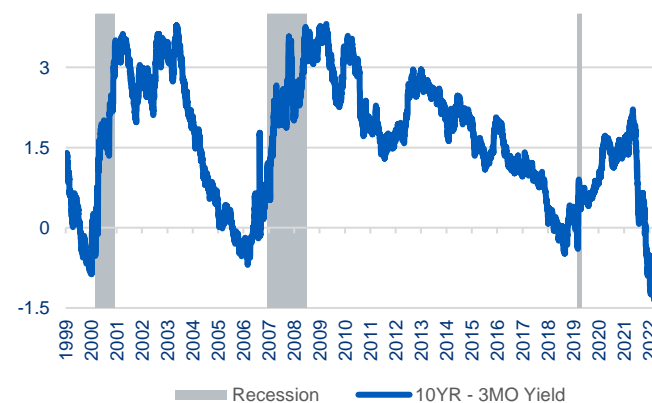


Despite the repricing of the expected path of future policy rates, the U.S. yield curve remains deeply inverted, suggesting a high probability of a recession (Exhibit 2).

Exhibit 2

Deeply Inverted U.S. Yield Curve Points to Recession Risk

Source: Bloomberg. 10YR minus 3MO U.S. Treasury yield in percent.



The combination of heightened uncertainty and volatility in the future path of policy rates and Treasury yields and the high probability of an economic recession poses significant market risks. A recession would undermine profitability and creditworthiness, while higher discount rates and volatility in the bond market would undercut asset prices. Moreover, the transition to higher yields and tighter liquidity has the potential to uncover additional market vulnerabilities similar to those of March's mini banking crisis.

Given these risks, we place a high premium on increasing portfolio diversification, exploiting a broad range of independent sources of added value, and maintaining sufficient liquidity to rebalance the portfolio to take advantage of shifts in the relative attractiveness of different asset classes and market segments. Our overall expected portfolio risk remains about in line with the benchmark, and our active positioning across asset classes and within market segments remains driven by our assessment of fundamental valuations. We see continued strong prospects for active management aimed at exploiting security level valuation anomalies. We therefore remain focused on deriving the bulk of our added value from active security selection by skilled managers.

U.S. Equity Market Remains Overvalued

Overall, we retain a slight underweight to public equities, reflecting a significant underweight to the U.S. market and smaller overweight positions in developed and emerging non-U.S. equities. The U.S. equity market remains overvalued and movement in the U.S. equity market is heavily influenced by a small number of mega-cap stocks which have come to dominate overall market capitalization. Within the U.S. equity market, value stocks remain favorably priced, especially relative to the lofty valuations accorded to growth stocks. We therefore retain our tilt toward value in the U.S. equity portfolio.

We retain an overweight allocation to developed and emerging non-U.S. equity markets. This overweight is motivated primarily by the relatively attractive valuations of non-U.S. markets. Developed market valuations are at multi-decade lows relative to the U.S., while emerging equity markets are at 15-year lows. In addition, the risk of earnings compression is higher in the U.S. market, where profit levels have been well above trend, than in non-U.S. markets where valuations appear much better supported by sustainable profits. The significant overvaluation of the U.S. dollar further supports an overweight to non-U.S. markets. A reversion of the U.S. dollar to fair value would result in translation gains on holdings of non-U.S. assets.

Hedge Fund Allocation Reduced to Neutral

We decreased our allocation to hedge funds to neutral from a significant overweight. In taking this action, our primary motive was to increase portfolio liquidity and thus enhance our ability to respond nimbly to changes in relative valuations across asset classes. Despite this move, hedge funds remain, in our view, a key element of a multi-asset class portfolio. They have the benefit of helping to diversify portfolio exposures away from market beta while also providing a broad stream of independent sources of value added. Our hedge fund portfolio remains designed to minimize market beta and focus on strategies that seek to exploit the wide valuation dispersion across securities.

Real Estate Pressured by Rising Yields

Low cap rates and rising yields are eroding commercial real estate valuations across all property types. The property sector is also vulnerable to a retrenchment in bank lending spurred by

the turmoil across regional banks, which provide nearly three quarters of bank lending to commercial real estate (CRE). Banks and the CRE sector have a symbiotic relationship. Both face challenges which in combination could pose broader economic risks. The office sector faces the additional pressure of low occupancy rates due to the persistent popularity of remote work. We have responded by temporarily suspending our investments in open-ended real estate funds and being particularly deliberate in new investments in closed-end funds. Despite the challenges faced by the sector, we retain a neutral allocation to real estate. Rising rents have provided an important inflation hedge. Moreover, CRE is highly diversified and certain sectors of the property market – notably industrial, multi-family housing, and hotels – are benefitting from high demand and rental income growth.

Venture Capital Hurt by Tighter Funding

Private equity investments, especially the most speculative, have also been pressured by rising interest rates. Venture capital firms in particular have been hurt by higher funding costs, the drying up of capital inflows, and an inhospitable IPO market. Strategies focusing on revenue growth rather than profitability have been hardest hit. In contrast, private equity strategies favoring investments in firms in the industrial and consumer sectors with solid earnings growth have been relatively resilient to more costly and less readily available funding. Our allocation to venture capital will continue to be calibrated to reflect our assessment of the higher volatility of those investments relative to other forms of private equity.

QT and High Funding Needs

Liquidity in the U.S. Treasury market has deteriorated as the U.S. Treasury funds large deficits while the Fed pursues a policy of quantitative tightening (QT) to reduce its holdings of government and other securities. The outlook for the smooth functioning of the U.S. Treasury market is further clouded by debt ceiling brinkmanship, as well as leverage and asset liability mismatches in banks and other financial institutions. Yields remain at about fair value and the probability distribution of future returns has become more symmetrical. We are therefore retaining our neutral position to duration. The outlook for credit is mixed as firms face higher financing costs and the possibility of reduced credit availability. In view of these uncertainties, we are retaining a slight underweight to credit, despite the scope for value added in the credit markets.

Looking ahead, much hinges on the continued functioning of the U.S. Treasury market and the ability of global central banks to tame inflation while balancing price and financial stability. The former is threatened by brinkmanship over the debt ceiling and the collision of QT with the high funding needs of the Treasury. The latter is vulnerable to the risk of market instability as positions predicated on easy money lose that support. In this environment, we place a premium maintaining liquidity to rebalance the portfolio as relative valuations change, and on enhancing portfolio robustness through broad portfolio diversification.

Special Topic

Price versus Financial Stability

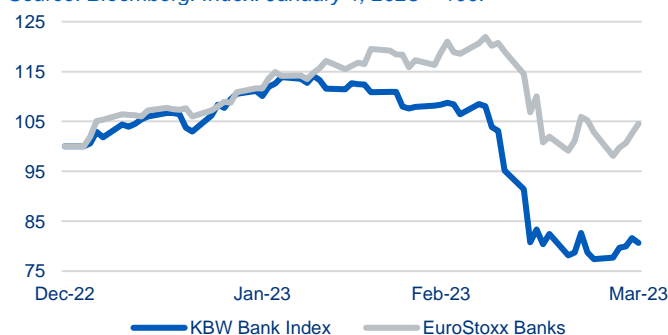
The March mini banking crisis was an unintended consequence of the abrupt shift by the Fed and other major central banks from a long period of extraordinarily easy monetary policy to a rapid tightening focused on fighting inflation. The period of easy money encouraged investors to move out the risk spectrum and to increase leverage, thus compressing risk premiums and contributing to froth in highly speculative rolls of the dice from crypto, to SPACs, meme stocks, and beyond.

We now face the risk that hidden pockets of leverage previously papered over by ample liquidity could be suddenly revealed. As monetary and financial conditions tighten, asset prices and leveraged positions predicated on the persistence of easy money become vulnerable. At extremes, leveraged positions can become subject to margin spirals. In these vicious cycles, falling asset prices trigger margin calls, leading to the forced sales of assets that further pressure prices and result in additional margin calls.

Where these vulnerabilities lie and how they will manifest themselves as central banks scrape away the protective veneer of abundant liquidity is unpredictable. One example is last September's U.K. LDI crisis that roiled the gilt market until the Bank of England's forceful intervention prevented a margin spiral from spinning out of control. The March mayhem across U.S. regional banks and Credit Suisse is another example of how positions that appear safe when yields are low can become highly unstable and trigger a broader contagion (Exhibit 1).

Exhibit 1 Bank Stocks Plummet in Wake of SVB Failure

Source: Bloomberg. Index. January 1, 2023 = 100.



Tightrope of Monetary Tightening

Both of these examples highlight the difficult task facing major central banks. Fighting inflation and maintaining financial stability can be conflicting. The tightening of credit conditions to fight inflation can trigger financial instability that requires targeted injections of liquidity to resolve and discourages

central banks from further rate hikes. The bond market reaction to the U.S. regional banking crisis was in part driven by an appreciation of the delicate balancing act facing central banks, and the potential conflict they face in seeking to maintain both price and market stability.

In the immediate aftermath of March's mini-crisis, the yield on the 2-year U.S. Treasury note plunged from about 5.1% to a low of 3.8% as markets reversed their expectations for the future path of U.S. monetary policy (Exhibit 2).

Exhibit 2 Markets Reprice Path of Monetary Policy

Source: Bloomberg. Yields in percent.



The moves in the 2-year Treasury note and the expected path of the Fed funds rate appear to reflect two key judgments by the market. First, in striking the balance between price and market stability, the Fed will lean toward a slower pace of rate hikes. Second, and relatedly, the turmoil in the banking sector has itself contributed to a tightening of monetary conditions that will help reduce inflationary pressures and thus support the Fed's first objective of restoring price stability.

This market view has been reinforced by the actions of the Fed, which reduced the pace of rate hikes to 25 basis points in the March 22 FOMC meeting. Moreover, the Fed and the FDIC engaged in targeted injections of liquidity into the banking sector that together approached the levels reached in 2008 during the Great Financial Crisis.

The market was also right to suppose that the banking crisis would tighten financial conditions and thus help ease price pressures. Two developments contributed to this tightening. First, the banking crisis accelerated a reduction of bank deposits and the money supply that had been ongoing. In addition, banks reacted to the turmoil by tightening standards for commercial and industrial loans to firms.

For the present, the March mayhem across U.S. regional banks appears to have been contained with contagion limited to a few banks. The lasting impact of this event is a reminder of the turbulent nature of the transition from easy to tight policies and of the delicate balancing act central banks face in restoring price stability while avoiding a potentially highly destructive financial crisis.

Note: Opinions expressed herein are current as of the date appearing in this material and are subject to change at the sole discretion of Strategic. This document is not intended as a source of any specific investment recommendations.