Capital Markets Review
Third Quarter 2018

STRATEGIC ASSET ALLIANCE

THE INSURANCE INVESTMENT SPECIALIST

Summary Capital Market Commentary – 3rd Quarter 2018

- **GLOBAL FINANCIAL MARKETS**

- **Global equities made gains in Q3, primarily due to US market strength. Political uncertainty and trade concerns weighed on other regions.**
  - US equities significantly outperformed other major regions. Economic growth and earnings data remained extremely robust, ultimately overshadowing concerns surrounding the escalating US-China trade war. The US initially targeted $34 billion of Chinese products with a 25% tariff in early July. Tariffs on another $16 billion began in late August, before a 10% tariff was implemented on a further $200 billion of Chinese goods in September (set to rise to 25% in January). Despite these measures, the US equity bull market became the longest in history on August 22nd.
  - Eurozone equity gains were modest. Banks were generally weaker amid concerns over exposure to emerging markets as well as worries over the Italian budget. On the economic front, growth for the second quarter of 2018 was revised up to 0.4% quarter-on-quarter, compared to the initial estimate of 0.3%. Forward-looking activity indicators continued to point towards expansion, albeit at a more subdued pace than at the start of 2018.
  - Japanese equities saw strong gains amid a weaker yen and greater clarity on the medium-term policy outlook following Prime Minister Abe's re-election as his party's leader.
  - Emerging markets equities lost value, with US dollar strength and trade tensions weighing. China underperformed as the US implemented tariffs on a total of $250 billion of Chinese goods.

- **Core government bond yields rose over the quarter due to positive economic data, particularly from the U.S. This outweighed a bout of safe haven demand in August caused by concerns related to emerging market instability, trade tensions and political issues in Europe.**
  - Stability in growth and employment figures allowed the Federal Reserve (Fed) to enact its widely anticipated increase in the federal funds rate by 25 basis points. The committee dropped its long-standing description of monetary policy as "accommodative", and reaffirmed its outlook for further gradual hikes into 2019. U.S. 10-year yields rose from 2.86% to 3.06%.

Source: Schroders, Wellington & SAA

Executive Summary - Key Capital Market Index Returns

Index	Asset Class	Jul-18	Aug-18	Sep-18	Q3'18	YTD	Trailing 1 Yr	Trailing 3 Yr
Dow Jones Industrial Average	U.S. Equity	4.83%	2.56%	1.97%	**9.63%**	8.83%	20.76%	20.49%
S&P Composite 1500 Growth	U.S. Equity	3.31%	4.87%	0.49%	**8.87%**	16.73%	24.59%	19.59%
S&P 500	U.S. Equity	3.72%	3.26%	0.57%	**7.71%**	10.56%	17.91%	17.31%
S&P Composite 1500	U.S. Equity	3.57%	3.30%	0.34%	**7.35%**	10.47%	17.69%	17.26%
Alerian MLP	Master Limited Partnerships	6.58%	1.58%	-1.57%	**6.57%**	5.90%	4.89%	4.43%
S&P Composite 1500 Value	U.S. Equity	3.86%	1.50%	0.16%	**5.60%**	3.89%	10.30%	14.37%
MSCI World Index	World Equity	3.15%	1.28%	0.60%	**5.10%**	5.89%	11.84%	14.18%
S&P SmallCap 600	U.S. Equity	3.16%	4.83%	-3.17%	**4.71%**	14.54%	19.08%	19.41%
BofA Merrill Lynch US Convertibles	U.S. Convertible Bond	0.65%	3.52%	-0.25%	**3.93%**	10.43%	12.15%	11.83%
S&P MidCap 400	U.S. Equity	1.76%	3.19%	-1.10%	**3.86%**	7.49%	14.21%	15.68%
S&P GSCI Crude Oil	U.S. Equity	-5.28%	2.76%	5.41%	**2.60%**	28.11%	48.57%	2.94%
Barclays Capital U.S. Corporate High Yield	U.S. Fixed Income	1.09%	0.74%	0.56%	**2.40%**	2.57%	3.05%	8.15%
S&P/ LSTA US Leveraged Loan Index	U.S. Fixed Income	0.74%	0.40%	0.69%	**1.84%**	4.04%	5.19%	5.32%
MSCI EAFE Index	International Equity	2.47%	-1.92%	0.91%	**1.42%**	-0.98%	3.25%	9.77%
MSCI World Ex. US Index	World Equity	2.47%	-1.87%	0.83%	**1.38%**	-1.04%	3.20%	9.87%
MSCI EAFE (Net)	International Equity	2.46%	-1.93%	0.87%	**1.35%**	-1.43%	2.74%	9.23%
S&P GSCI Commodities	U.S. Equity	-3.53%	1.08%	3.93%	**1.34%**	11.84%	22.91%	3.17%
Barclays Capital U.S. Corporate Investment Grade	U.S. Fixed Income	0.83%	0.49%	-0.36%	**0.97%**	-2.33%	-1.19%	3.12%
Dow Jones U.S. Select REIT	U.S. Real Estate	0.55%	2.98%	-2.73%	**0.72%**	2.56%	4.59%	6.88%
Citigroup 3-month T-bill	Cash/ Cash Equivalent	0.16%	0.17%	0.17%	**0.50%**	1.29%	1.57%	0.80%
Barclays Intermediate U.S. Government/ Credit	U.S. Fixed Income	0.03%	0.59%	-0.40%	**0.21%**	-0.76%	-0.96%	0.91%
Barclays U.S. Government/ Credit	U.S. Fixed Income	0.08%	0.65%	-0.67%	**0.06%**	-1.85%	-1.37%	1.45%
Barclays Capital U.S. Aggregate	U.S. Fixed Income	0.02%	0.64%	-0.64%	**0.02%**	-1.60%	-1.22%	1.31%
Barclays Capital Municipal Bond	U.S. Fixed Income	0.24%	0.26%	-0.65%	**-0.15%**	-0.40%	0.35%	2.24%
5-Year US Treasury	U.S. Treasury	-0.30%	0.75%	-0.70%	**-0.26%**	-1.33%	-2.03%	-0.49%
Merrill Lynch US Treasury Master	U.S. Fixed Income	-0.45%	0.78%	-0.98%	**-0.66%**	-1.75%	-1.64%	0.28%
Barclays U.S. Treasury: U.S. TIPS	U.S. Fixed Income	-0.48%	0.72%	-1.05%	**-0.82%**	-0.84%	0.41%	2.04%
Citigroup WorldBIG Index	World Fixed Income	-0.12%	0.01%	-0.80%	**-0.90%**	-2.40%	-1.39%	1.89%
MSCI EM (Emerging Markets)	International Equity	2.28%	-2.67%	-0.50%	**-0.95%**	-7.39%	-0.44%	12.77%
10-Year US Treasury	U.S. Treasury	-0.72%	1.13%	-1.49%	**-1.10%**	-3.75%	-4.02%	-1.12%

- **SAA BOTTOMLINE**: US equities advanced in Q3 to significantly outperform other major regions. Economic growth and earnings data remained robust, and this ultimately overshadowed simmering concerns around the escalating US-China trade war. With the US equity bull market becoming the longest in history on August 22nd, markets are growing more concerned with longer-term revenue growth as positive earnings surprises due primarily to tax law changes diminish prospectively.
- Core government bond yields rose over the quarter due to positive economic data, particularly from the US.

- Indices sorted high/low by Q3 '18 performance.

Source: Schroders, SAA, and Zephyr StyleAdvisor

U.S. Fixed Income Sector Yields & Returns

Index YTW	12/31/2013	12/31/2014	12/31/2015	12/31/2016	12/31/2017	6/30/2018	9/30/2018
Aggregate	2.48%	2.25%	2.59%	2.61%	2.71%	3.29%	3.46%
U.S. Credit	3.18%	3.01%	3.54%	3.29%	3.19%	3.94%	4.00%
U.S. Treasury	1.44%	1.43%	1.73%	1.89%	2.19%	2.71%	2.95%
Municipal Bond	3.15%	2.09%	2.11%	2.65%	2.36%	2.67%	2.86%
U.S. High Yield	5.64%	6.61%	8.74%	6.12%	5.72%	6.49%	6.24%
U.S. 2-Yr Treasury	0.38%	0.66%	1.05%	1.19%	1.88%	2.53%	2.82%
U.S. 5-Yr Treasury	1.74%	1.65%	1.76%	1.92%	2.19%	2.73%	2.95%
U.S. 10-Yr Treasury	3.03%	2.17%	2.28%	2.43%	2.41%	2.85%	3.06%
Global Aggregate (USD)	2.11%	1.62%	1.77%	1.60%	1.66%	1.99%	2.15%
Change to Current Period							
Aggregate	▲ 0.98%	▲ 1.21%	▲ 0.87%	▲ 0.85%	▲ 0.75%	▲ 0.17%	
U.S. Credit	▲ 0.82%	▲ 0.99%	▲ 0.46%	▲ 0.71%	▲ 0.81%	▲ 0.06%	
U.S. Treasury	▲ 1.51%	▲ 1.52%	▲ 1.22%	▲ 1.06%	▲ 0.76%	▲ 0.24%	
Municipal Bond	▼ -0.29%	▲ 0.77%	▲ 0.75%	▲ 0.21%	▲ 0.50%	▲ 0.19%	
U.S. High Yield	▲ 0.60%	▼ -0.37%	▼ -2.50%	▲ 0.12%	▲ 0.52%	▼ -0.25%	
U.S. 2-Yr Treasury	▲ 2.44%	▲ 2.16%	▲ 1.77%	▲ 1.63%	▲ 0.94%	▲ 0.29%	
U.S. 5-Yr Treasury	▲ 1.21%	▲ 1.30%	▲ 1.19%	▲ 1.03%	▲ 0.76%	▲ 0.22%	
U.S. 10-Yr Treasury	▲ 0.03%	▲ 0.89%	▲ 0.78%	▲ 0.63%	▲ 0.65%	▲ 0.21%	
Global Aggregate	▲ 0.04%	▲ 0.53%	▲ 0.38%	▲ 0.55%	▲ 0.49%	▲ 0.16%	

U.S. Agg. vs. Global Agg.	▲ **0.37%**	▲ **0.63%**	▲ **0.82%**	▲ **1.01%**	▲ **1.05%**	▲ **1.30%**	▲ **1.31%**
UST 2yr-10yr Spread (bps)	**264.8**	**150.6**	**123.2**	**124.2**	**52.7**	**32.0**	**24.0**
UST 5yr-10yr Spread (bps)	**128.7**	**51.7**	**52.0**	**51.0**	**22.0**	**12.0**	**11.0**

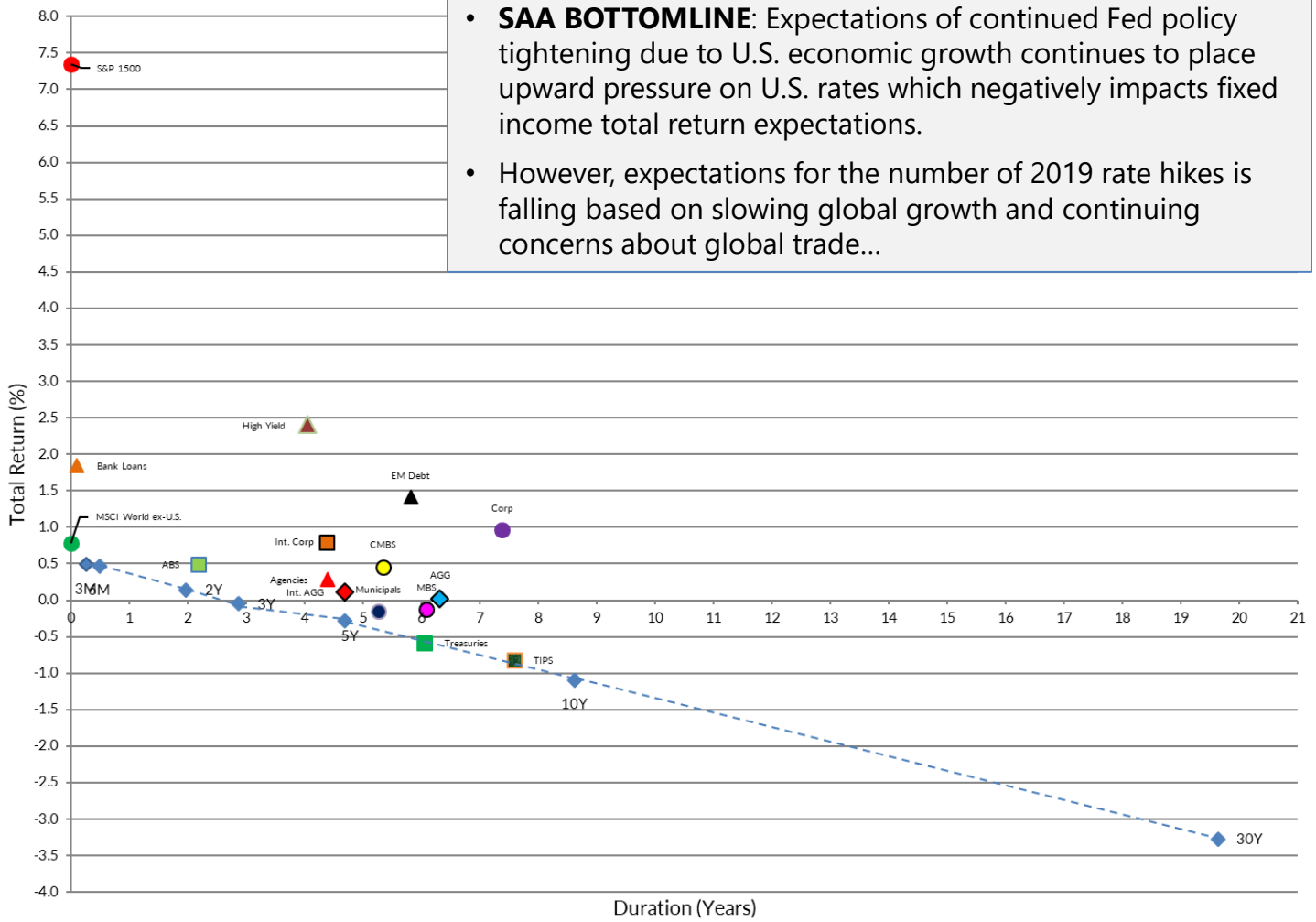
Note: Bloomberg Barclays Indices

- **SAA BOTTOMLINE**: The difference between U.S. and Global yields still remains pronounced at 1.31% as the expectation of further Fed rate hikes continues the active policy divergence between the U.S. and other developed markets' central banks; although the rest of the world's monetary policy is slowly becoming less accommodative.
- Additionally, the UST yield curve continued to flatten as the 2/10 spread is only 24 bps. When 2/10 year yields meet, recessions typically follow according to history. However, a number of economists suggest that this "barometer" is broken as a result of the unprecedented central bank bond purchases as part of quantitative easing policies worldwide since 2009.

Source: Bloomberg Barclays as of 9/30/2018

Q3-2018 Fixed Income Sector/Duration - Total Return

- **SAA BOTTOMLINE**: Expectations of continued Fed policy tightening due to U.S. economic growth continues to place upward pressure on U.S. rates which negatively impacts fixed income total return expectations.
- However, expectations for the number of 2019 rate hikes is falling based on slowing global growth and continuing concerns about global trade…



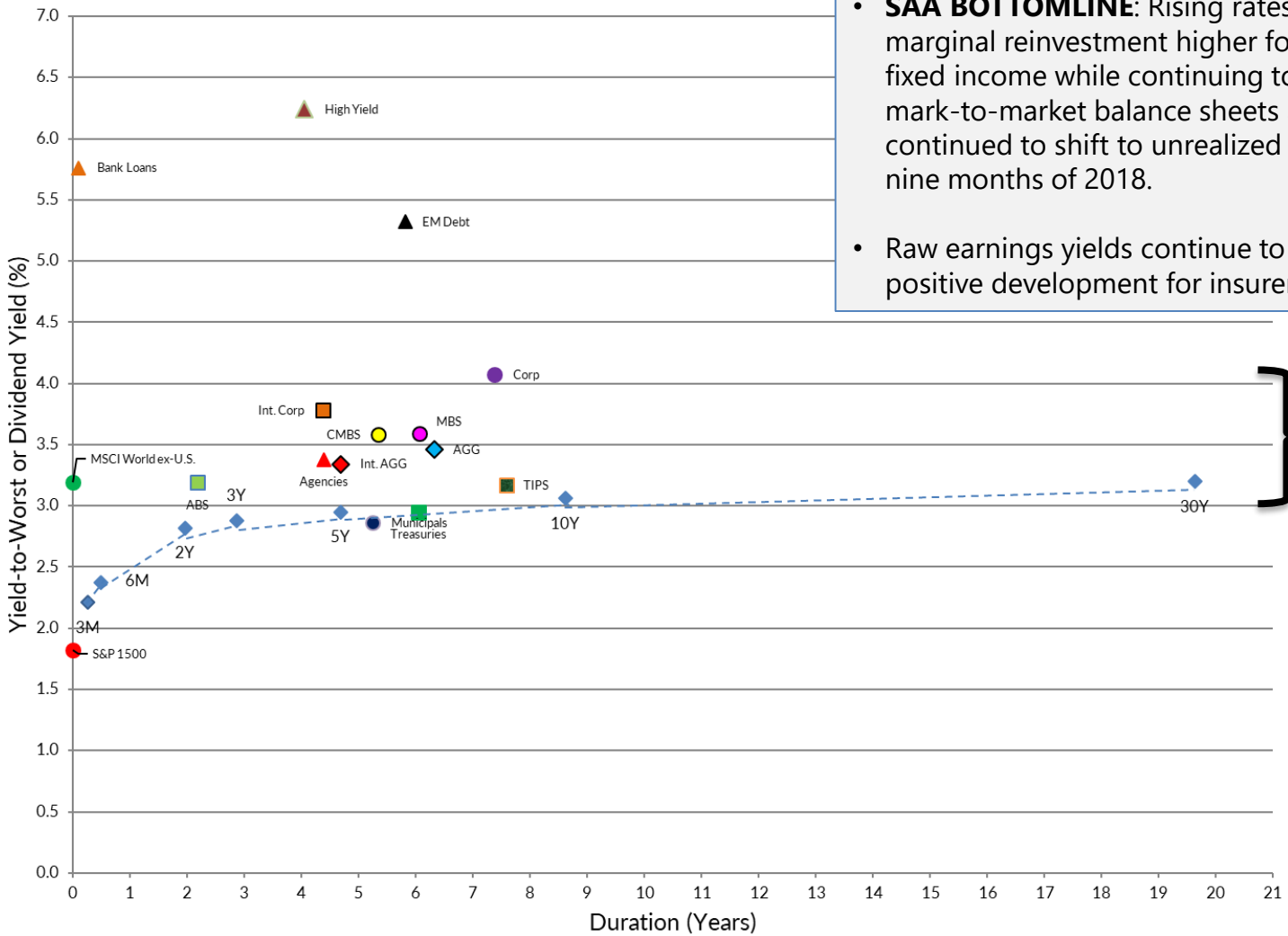
STRATEGIC ASSET ALLIANCE
THE INSURANCE INVESTMENT SPECIALIST

The information contained herein has been obtained from sources believed to be reliable, but the accuracy of the information cannot be guaranteed.

Source: Bloomberg Barclays

Q3-2018 U.S. Fixed Income Sector/Duration - Yields

- **SAA BOTTOMLINE**: Rising rates continue to push marginal reinvestment higher for investment-grade fixed income while continuing to wreak havoc across mark-to-market balance sheets as unrealized gains continued to shift to unrealized losses during the first nine months of 2018.
- Raw earnings yields continue to rise – a longer-term positive development for insurers.



New money and reinvestment yields have risen for U.S. investment grade fixed income and now range from 3.00% to 4.25%

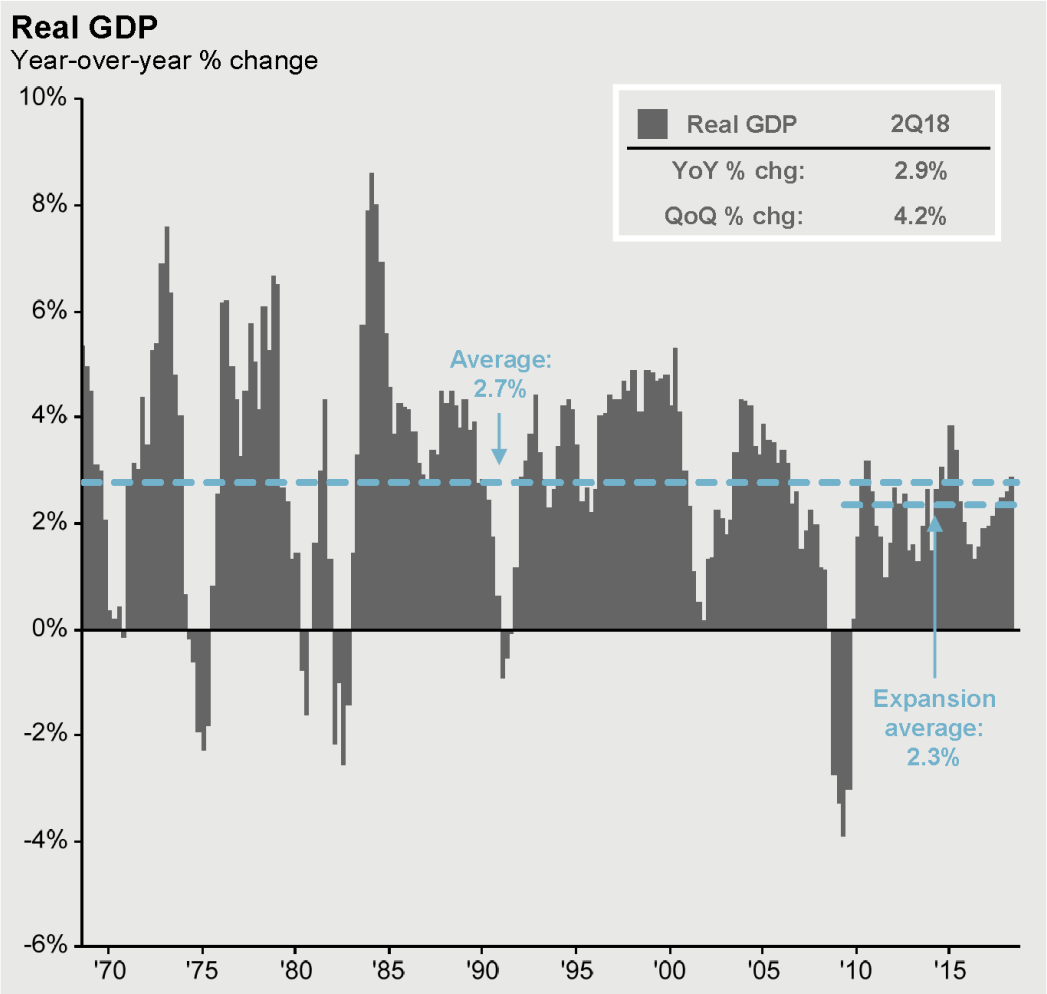
STRATEGIC ASSET ALLIANCE
THE INSURANCE INVESTMENT SPECIALIST

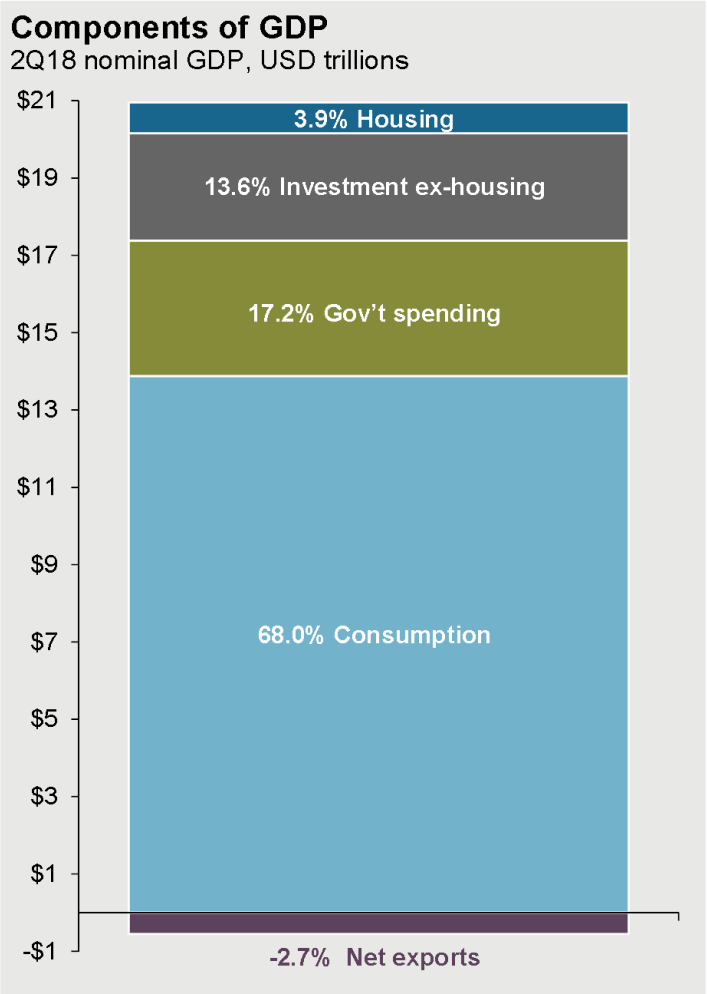
The information contained herein has been obtained from sources believed to be reliable, but the accuracy of the information cannot be guaranteed.

Source: Bloomberg Barclays

KEY INVESTMENT THEMES FOR Q3-2018

U.S. Economy (Slowly moving ahead…)



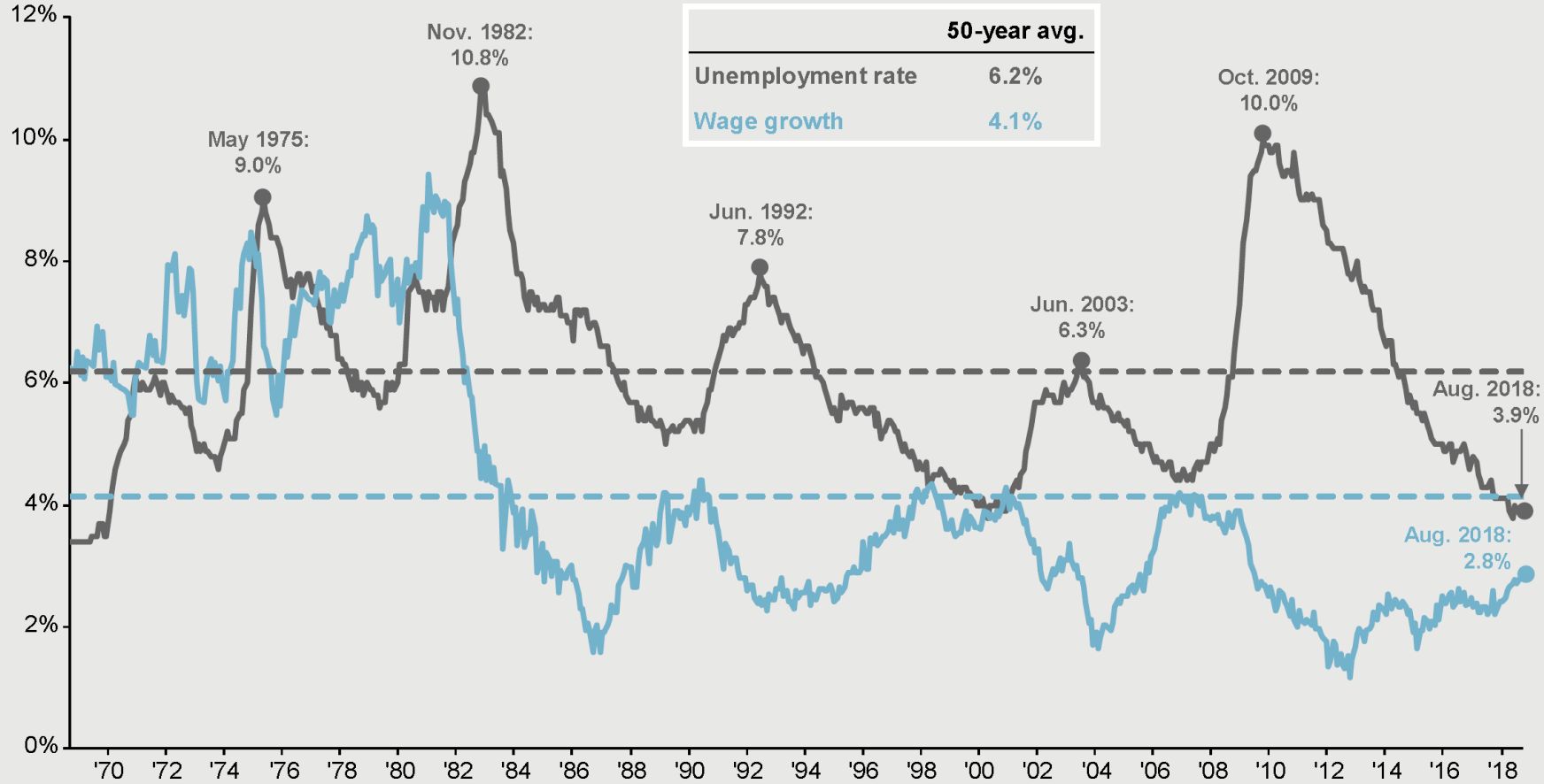


- **SAA BOTTOMLINE**: Recent economic growth accelerated as tax cuts spurred both consumer and business spending. However, average growth of the current expansion has lagged the historical average. The near-term issue is trade and further escalation of tariffs will negatively impact future growth as well as investor sentiment. The long-term issue is productivity as this is what drives U.S. GDP growth.

Source: BEA, Factset, & J.P. Morgan Asset Management

U.S. Employment & Wages

Civilian unemployment rate and year-over-year wage growth for private production and non-supervisory workers
Seasonally adjusted, percent



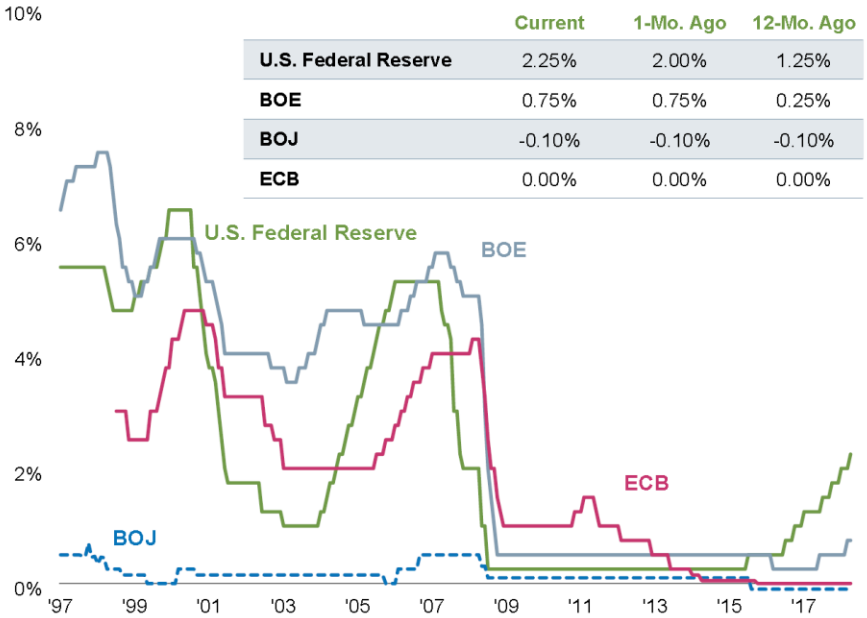
- **SAA BOTTOMLINE**: The potential for wage inflation and its impact on Fed policy remains a concern, but has yet to materialize even with two major factors limiting labor force growth: 1) demographic drag of retiring baby boomers; and 2) tighter immigration restrictions. More importantly, labor force shortage has longer-term implications regarding productivity and economic growth.

Source: BLS, Factset, & J.P. Morgan Asset Management

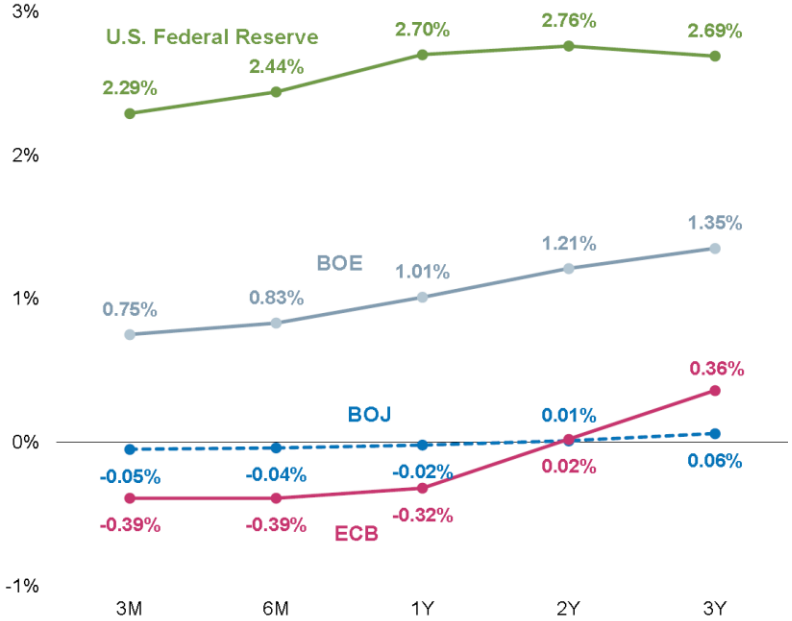
Global Monetary Policy

Central Bank Policy Rates

	Current	1-Mo. Ago	12-Mo. Ago
U.S. Federal Reserve	2.25%	2.00%	1.25%
BOE	0.75%	0.75%	0.25%
BOJ	-0.10%	-0.10%	-0.10%
ECB	0.00%	0.00%	0.00%



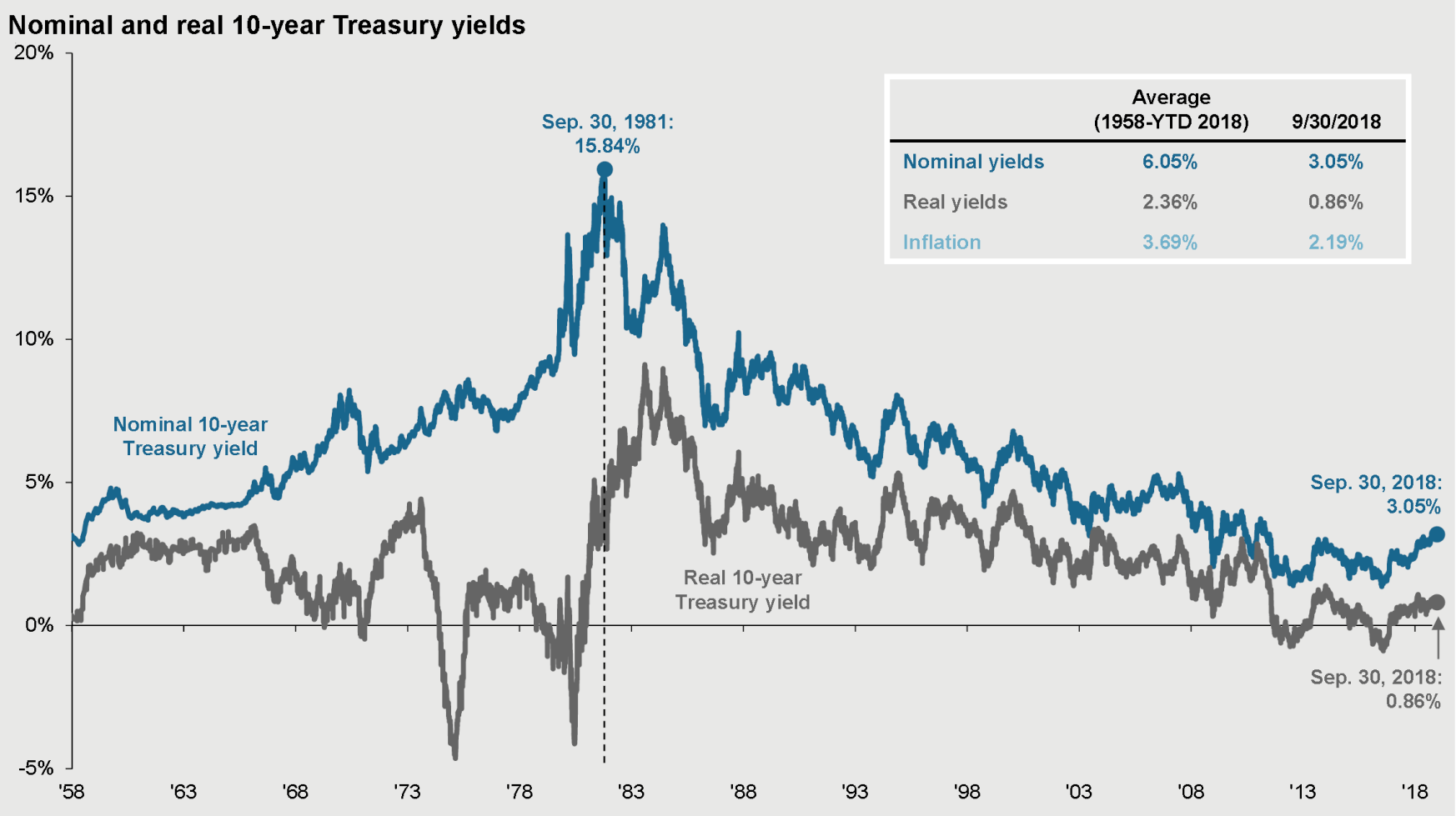
Market Expectations for Future Central Bank Rates



- **SAA BOTTOMLINE**: While the U.S. leads the way with regard to tightening monetary policy, the rest of the world is beginning to resolutely follow. Currently, the Fed is more concerned with overly expansive monetary policy and its impact on asset prices (i.e. bubbles) than they are with higher inflation.

Source: Eaton Vance, Bloomberg, & Factset as of 9/30/2018

U.S. Interest Rates & Inflation



	Average (1958-YTD 2018)	9/30/2018
Nominal yields	6.05%	3.05%
Real yields	2.36%	0.86%
Inflation	3.69%	2.19%

- **SAA BOTTOMLINE**: With real yields turning positive as a result of the Fed's policy moves, fixed income investor returns now outpace inflation (for the time being). This shift to positive yields has contributed to increased volatility across riskier asset classes since investors can now find similar yields using higher quality fixed income securities and not lose purchasing power parity.

Source: BLS, Factset, Federal Reserve & J.P. Morgan Asset Management

U.S. and International Equities

MSCI All Country World ex-U.S. and S&P 500 Indices

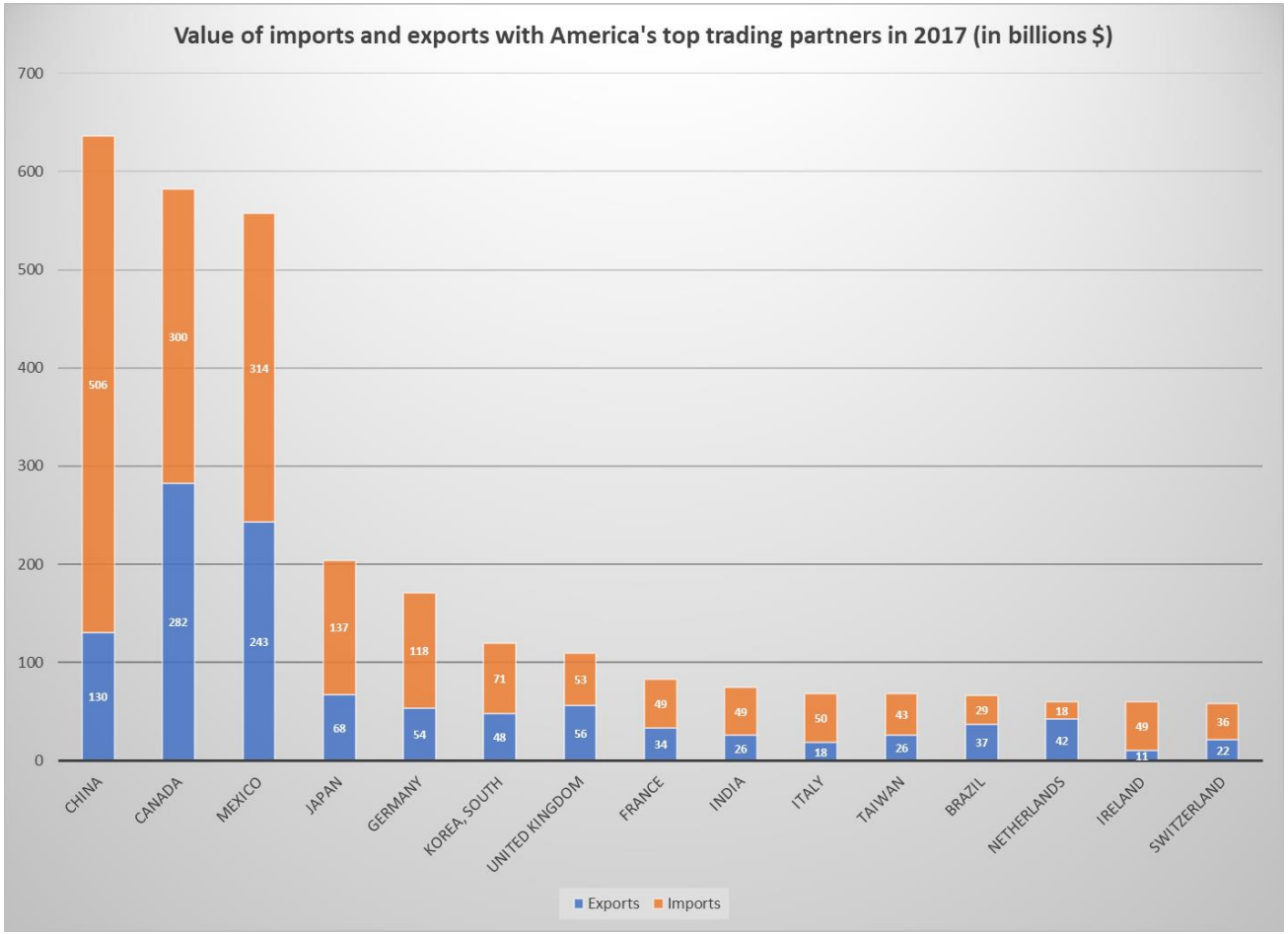
Dec. 1996 = 100, U.S. dollar, price return

	P/E	20-yr. avg.	Div. Yield	20-yr. avg.
S&P 500	16.8x	15.9x	2.0%	2.0%
ACWI ex-U.S.	12.9x	14.3x	3.4%	3.0%
As % of U.S.	*77%*	*90%*	*173%*	*149%*

- **SAA BOTTOMLINE**: With U.S. equities having solidly outperformed international equities since 2012, it may be easy to overlook the benefits of having international equity exposure longer-term given the diversification benefits and yield advantage. Remaining focused on forward-looking valuation metrics and economic trends remains critical.

Source: FactSet, MSCI, Standard & Poor's, & J.P. Morgan Asset Management

Trade Impacts (Talk vs. Tariff)



- **SAA BOTTOMLINE**: If trade saber-rattling continues to morph into hard tariffs, the drag on global growth and investor sentiment will quicken. Although it may take some short-term pain, the worlds' major economies are aligned to reach "trade agreements" that are mutually beneficial before investors and consumers begin to bear more negative consequences (both intended and unintended).

Source: U.S. Census Bureau