Capital Markets Review
Fourth Quarter 2018

STRATEGIC ASSET ALLIANCE

THE INSURANCE INVESTMENT SPECIALIST

Summary Capital Market Commentary – 4th Quarter 2018

- **GLOBAL FINANCIAL MARKETS**

- **Global equities posted sharp declines in Q4 on persistent concerns over global trade and slowing economic growth.**
  - US equities declined, with especially steep falls in December. The Federal Reserve raised rates, as expected. Warnings from several high profile IT firms fanned fears that earnings growth may slow.
  - European equities also declined, with trade tariffs, slower Chinese growth and Brexit combining to form a difficult environment. Data continued to point to slowing momentum in the eurozone economy.
  - The FTSE All-Share Index fell over the period, with global developments setting the tone for the market. Sterling fell in response to political noise around Brexit, with worries of a “no deal” departure from the EU coming to the fore again.
  - Japanese equities lost value, with weakness coinciding with periods of yen strength as the currency continued to be viewed as a "safe-haven" at times of increased uncertainty.
  - Emerging markets equities lost value with the familiar array of global trade and growth concerns weighing on returns. Brazilian equities and the real rallied ahead of the market-friendly election outcome; confirmed in late October.

Source: Schroders, Wilbanks, Smith & Thomas & SAA

Summary Capital Market Commentary – 4th Quarter 2018

- **GLOBAL FINANCIAL MARKETS**

- **Fixed income markets wrestled with the complicated interplay among the Fed's rate hikes, slowing economic growth, geopolitical uncertainty (i.e. trade tensions, Brexit, etc…) and volatile equity markets that drove investors to seek the safety of government bonds.**
  - Fixed income returns were driven primarily by Fed action on the short end of the yield curve and increasing concerns about the health of the economy at the long end. Those competing forces led to rising short rates, falling long rates, and continued flattening of the yield curve. Credit-sensitive sectors, including high-yield and bank loans, had provided the highest returns coming into the market correction and were hit hardest by the flight to quality in the last three months of the year. Long-term bonds, which suffered as rates rose earlier in the year, provided the best returns in the quarter as the flight to quality and diminished inflation expectations led to more demand and higher prices for longer maturities.

- **U.S. Government Shutdown**
  - Politics aside, the U.S. Government shutdown will not just impact the 806,000 federal and estimated 4.1 million federal contract workers across the U.S. A multiplier effect is beginning to spillover across the country that will take time to reserve once the shutdown ends. These spillover effects will impact consumer behavior, investor sentiment and, ultimately, U.S. GDP results. Yet another variable for investors to consider in addition to those above already mentioned.

Source: Schroders, Wilbanks, Smith & Thomas & SAA

Executive Summary - Key Capital Market Index Returns

Index	Asset Class	Oct-18	Nov-18	Dec-18	Q4 '18	2018	Trailing 2 Yr	Trailing 3 Yr	Trailing 5 Yr
10-Year US Treasury	U.S. Treasury	-0.60%	1.44%	3.01%	**3.86%**	-0.03%	1.01%	0.62%	2.62%
5-Year US Treasury	U.S. Treasury	0.10%	0.86%	1.85%	**2.83%**	1.46%	1.09%	0.91%	1.42%
Merrill Lynch US Treasury Master	U.S. Fixed Income	-0.53%	0.90%	2.22%	**2.60%**	0.80%	1.61%	1.46%	2.23%
Barclays Capital Municipal Bond	U.S. Fixed Income	-0.62%	1.11%	1.20%	**1.69%**	1.28%	3.34%	2.30%	3.82%
Barclays Intermediate U.S. Government/Credit	U.S. Fixed Income	-0.14%	0.45%	1.34%	**1.65%**	0.88%	1.51%	1.70%	1.86%
Barclays Capital U.S. Aggregate	U.S. Fixed Income	-0.79%	0.60%	1.84%	**1.64%**	0.01%	1.76%	2.06%	2.52%
Barclays U.S. Government/Credit	U.S. Fixed Income	-0.87%	0.47%	1.86%	**1.46%**	-0.42%	1.77%	2.19%	2.53%
Citigroup WorldBIG Index	World Fixed Income	-1.22%	0.34%	2.01%	**1.11%**	-1.32%	2.96%	2.62%	1.07%
Citigroup 3-month T-bill	Cash/Cash Equivalent	0.18%	0.18%	0.20%	**0.57%**	1.86%	1.35%	0.99%	0.60%
Barclays Capital U.S. Corporate Investment Grade	U.S. Fixed Income	-1.46%	-0.17%	1.47%	**-0.18%**	-2.51%	1.86%	3.26%	3.28%
Barclays U.S. Treasury: U.S. TIPS	U.S. Fixed Income	-1.43%	0.48%	0.55%	**-0.42%**	-1.26%	0.85%	2.11%	1.69%
S&P/LSTA US Leveraged Loan Index	U.S. Fixed Income	-0.03%	-0.90%	-2.54%	**-3.45%**	0.44%	2.26%	4.83%	3.05%
Barclays Capital U.S. Corporate High Yield	U.S. Fixed Income	-1.60%	-0.86%	-2.14%	**-4.53%**	-2.08%	2.60%	7.23%	3.83%
Dow Jones U.S. Select REIT	U.S. Real Estate	-2.55%	4.85%	-8.59%	**-6.61%**	-4.22%	-0.31%	1.97%	7.89%
MSCI EM (Emerging Markets)	International Equity	-8.70%	4.13%	-2.60%	**-7.40%**	-14.25%	8.69%	9.65%	2.03%
BofA Merrill Lynch US Convertibles	U.S. Convertible Bond	-6.05%	1.27%	-4.68%	**-9.31%**	0.15%	6.71%	7.94%	5.95%
Dow Jones Industrial Average	U.S. Equity	-4.98%	2.11%	-8.59%	**-11.31%**	-3.48%	11.20%	12.94%	9.70%
MSCI EAFE Index	International Equity	-7.95%	-0.11%	-4.83%	**-12.50%**	-13.36%	4.32%	3.38%	1.00%
MSCI EAFE (Net)	International Equity	-7.96%	-0.13%	-4.85%	**-12.54%**	-13.79%	3.82%	2.87%	0.53%
S&P Composite 1500 Value	U.S. Equity	-5.74%	2.58%	-9.70%	**-12.68%**	-9.29%	2.13%	7.32%	5.98%
MSCI World Ex. US Index	World Equity	-7.93%	-0.07%	-5.14%	**-12.73%**	-13.64%	3.82%	3.64%	0.83%
MSCI World Index	World Equity	-7.32%	1.19%	-7.57%	**-13.31%**	-8.20%	6.29%	6.91%	5.14%
S&P 500	U.S. Equity	-6.84%	2.04%	-9.03%	**-13.52%**	-4.38%	7.93%	9.26%	8.49%
S&P Composite 1500	U.S. Equity	-7.13%	2.09%	-9.27%	**-13.97%**	-4.96%	7.29%	9.17%	8.25%
S&P Composite 1500 Growth	U.S. Equity	-8.29%	1.67%	-8.87%	**-15.03%**	-0.82%	12.01%	10.62%	10.17%
S&P MidCap 400	U.S. Equity	-9.55%	3.12%	-11.32%	**-17.28%**	-11.08%	1.67%	7.66%	6.03%
Alerian MLP	Master Limited Partnerships	-7.99%	-0.83%	-9.36%	**-17.30%**	-12.42%	-9.52%	-1.06%	-7.31%
S&P SmallCap 600	U.S. Equity	-10.48%	1.50%	-12.07%	**-20.10%**	-8.48%	1.80%	9.46%	6.34%
S&P GSCI Commodities	Commodities	-5.84%	-11.28%	-7.75%	**-22.94%**	-13.82%	-4.53%	0.50%	-14.52%
S&P GSCI Crude Oil	Commodities	-10.50%	-22.08%	-11.01%	**-37.94%**	-20.49%	-9.03%	-3.66%	-22.44%

- **SAA BOTTOMLINE**: September 2018 marked the 10th anniversary of the collapse of Lehman Brothers and the beginning of the Great Financial Crisis - that date also marked the turning in the market cycle. Given events during Q4/18, perhaps we, too, have reached another turning point? Beginning in October 2018, investor focus shifted away from the cozy expectations of 2016/2017 driven by low market volatility, loose monetary policy, and steady, synchronized global growth. The pivot toward gloomier expectations was visceral and swift as investors' concerns focused on: 1) The risk that the Fed will overshoot as it seeks to normalize interest rate policy; 2) The fallout from political and geopolitical skirmishes and trade conflicts. As Q4 progressed, the gloom deepened further and market volatility exploded. Prices declined across virtually all asset classes, except government bonds. However, during periods of shifting expectations and increased volatility, the markets typically react much worse than fundamentals indicate. Volatility will reign for the foreseeable future as the markets closely observe the pace of global growth and strength of corporate earnings. Being mindful of the long-term view, strategic asset allocation, and rebalancing will be key during 2019.

Indices sorted high/low by Q4 '18 performance.

Source: 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	9/30/2018	12/31/2018
Aggregate	2.48%	2.25%	2.59%	2.61%	2.71%	3.46%	3.28%
U.S. Credit	3.18%	3.01%	3.54%	3.29%	3.19%	4.00%	4.09%
U.S. Treasury	1.44%	1.43%	1.73%	1.89%	2.19%	2.95%	2.61%
Municipal Bond	3.15%	2.09%	2.11%	2.65%	2.36%	2.86%	2.69%
U.S. High Yield	5.64%	6.61%	8.74%	6.12%	5.72%	6.24%	7.95%
U.S. 2-Yr Treasury	0.38%	0.66%	1.05%	1.19%	1.88%	2.82%	2.50%
U.S. 5-Yr Treasury	1.74%	1.65%	1.76%	1.92%	2.19%	2.95%	2.51%
U.S. 10-Yr Treasury	3.03%	2.17%	2.28%	2.43%	2.41%	3.06%	2.69%
Global Aggregate (USD)	2.11%	1.62%	1.77%	1.60%	1.66%	2.15%	2.03%
Change to Current Period							
Aggregate	▲ 0.80%	▲ 1.03%	▲ 0.69%	▲ 0.67%	▲ 0.57%	▼ -0.18%	
U.S. Credit	▲ 0.91%	▲ 1.08%	▲ 0.55%	▲ 0.80%	▲ 0.90%	▲ 0.09%	
U.S. Treasury	▲ 1.17%	▲ 1.18%	▲ 0.88%	▲ 0.72%	▲ 0.42%	▼ -0.34%	
Municipal Bond	▼ -0.46%	▲ 0.60%	▲ 0.58%	▲ 0.04%	▲ 0.33%	▼ -0.17%	
U.S. High Yield	▲ 2.31%	▲ 1.34%	▼ -0.79%	▲ 1.83%	▲ 2.23%	▲ 1.71%	
U.S. 2-Yr Treasury	▲ 2.12%	▲ 1.84%	▲ 1.45%	▲ 1.31%	▲ 0.62%	▼ -0.32%	
U.S. 5-Yr Treasury	▲ 0.77%	▲ 0.86%	▲ 0.75%	▲ 0.59%	▲ 0.32%	▼ -0.44%	
U.S. 10-Yr Treasury	▼ -0.34%	▲ 0.52%	▲ 0.41%	▲ 0.26%	▲ 0.28%	▼ -0.37%	
Global Aggregate	▼ -0.08%	▲ 0.41%	▲ 0.26%	▲ 0.43%	▲ 0.37%	▼ -0.12%	

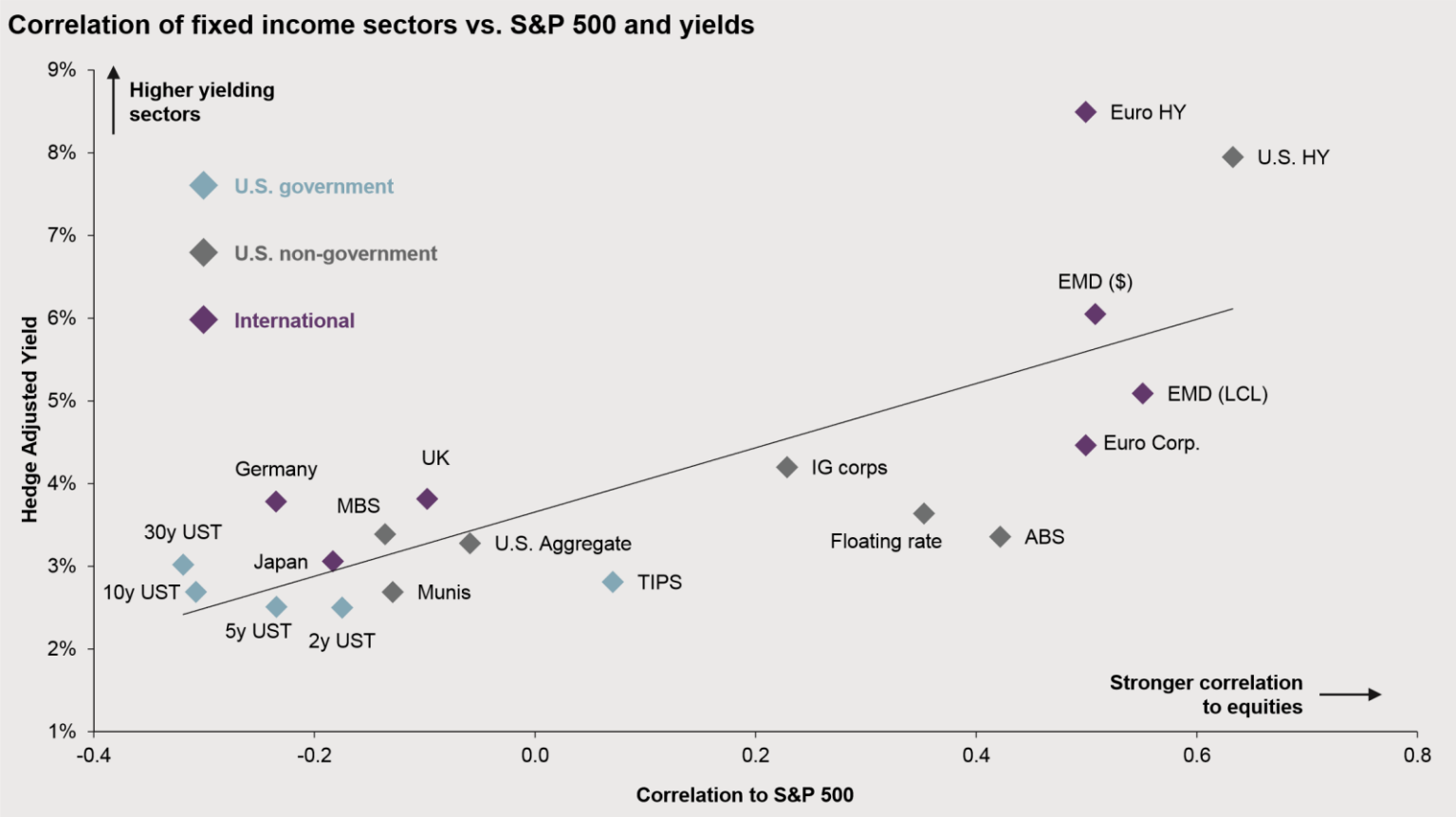
U.S. Agg. vs. Global Agg.	▲ **0.37%**	▲ **0.63%**	▲ **0.82%**	▲ **1.01%**	▲ **1.05%**	▲ **1.31%**	▲ **1.25%**
UST 2yr-10yr Spread (bps)	**264.8**	**150.6**	**123.2**	**124.2**	**52.7**	**24.0**	**19.0**
UST 2yr-5yr Spread (bps)	**136.1**	**98.9**	**71.2**	**73.2**	**30.7**	**13.0**	**1.0**
UST 5yr-10yr Spread (bps)	**128.7**	**51.7**	**52.0**	**51.0**	**22.0**	**11.0**	**18.0**

Note: Bloomberg Barclays Indices

- **SAA BOTTOMLINE**: The bond market grappled with changing expectations and interplay among the Fed's Rate Policy, slowing global economic growth, and volatile equity markets that herded investors to the safety of risk-free assets (i.e. government bonds). The moment of truth will be at hand when the Fed decides between sticking with its long-scripted plan to continue raising rates in 2019 or pausing in light of the slowing growth and high volatility of the fourth quarter. The gap between FOMC estimates of its future path and the path expected by the markets as measured by the Fed-funds futures has widened, and the Fed's decision on whether to pause at the current level, which is what the money market forward contracts are predicting, or continue to hike in 2019 will be a big driver of both the stock and bond markets over the course of the next 12 months. Again, being mindful of the long-term view, strategic asset allocation, and rebalancing will be key during 2019.

Source: Wilbanks, Smith & Thomas, SAA & Bloomberg Barclays as of 12/31/2018

Q4-2018 U.S. Fixed Income Sector/S&P 500 Correlation - Yields

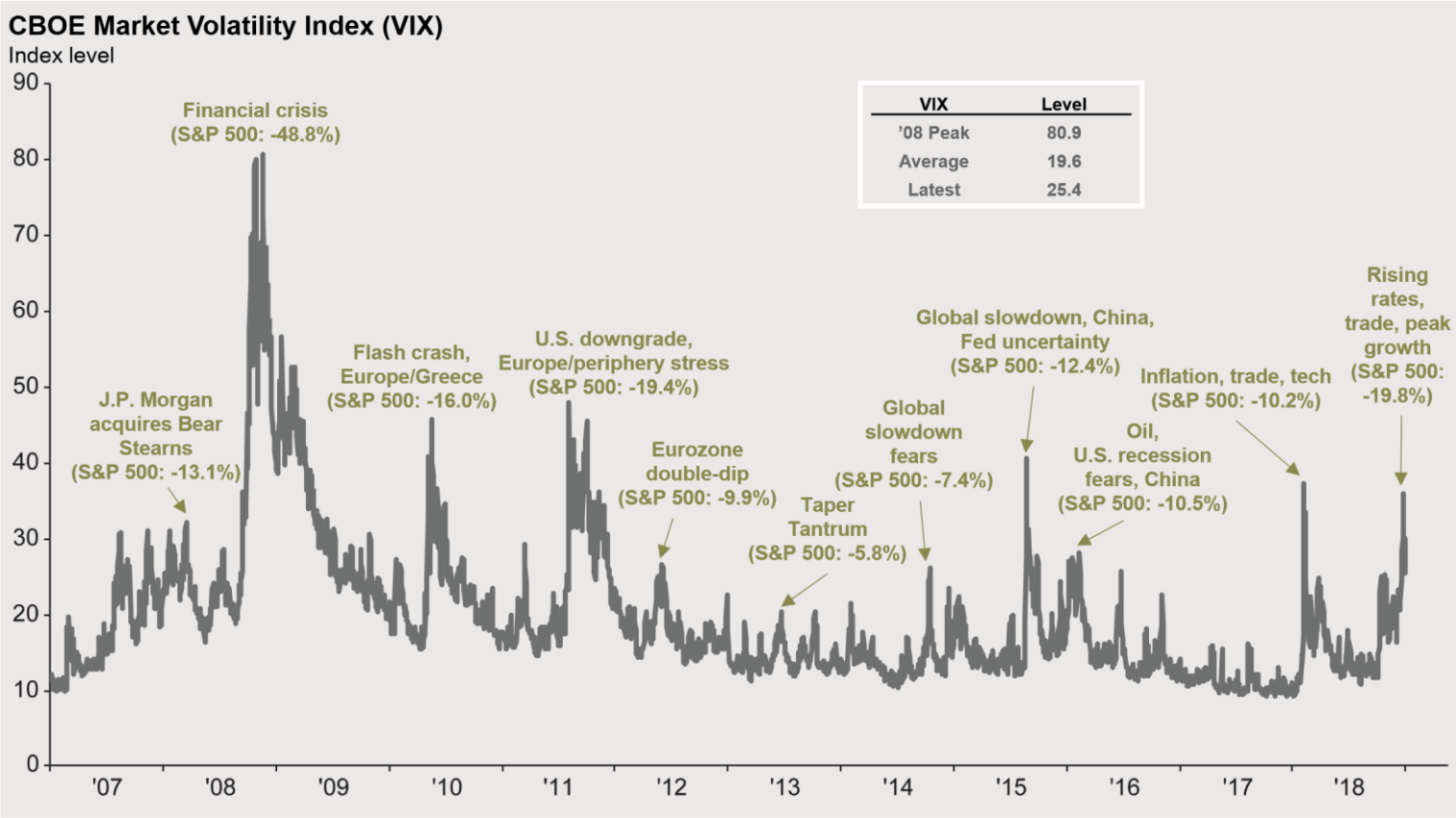


- **DEFINITIONS:** Correlations are based on 10-years of monthly returns for all sectors. International fixed income sector correlations are in hedged U.S. dollar returns except EMD local index. Yields for all indices are in hedged returns using three-month LIBOR rates between the U.S. and international LIBOR.
- **SAA BOTTOMLINE**: With core fixed income investment yields solidly between 3%-4%, the raw earnings power of fixed income portfolios has increased. With muted inflation, real yields on fixed income portfolio are now also positive.
- Also important to note that cash yields are now approximately 2.25% making cash a viable option for allocation given recent market volatility.

Source: Bloomberg, FactSet, ICE, J.P. Morgan Asset Management

KEY INVESTMENT THEMES FOR 2019

Equity Market Volatility – Was December That Bad?

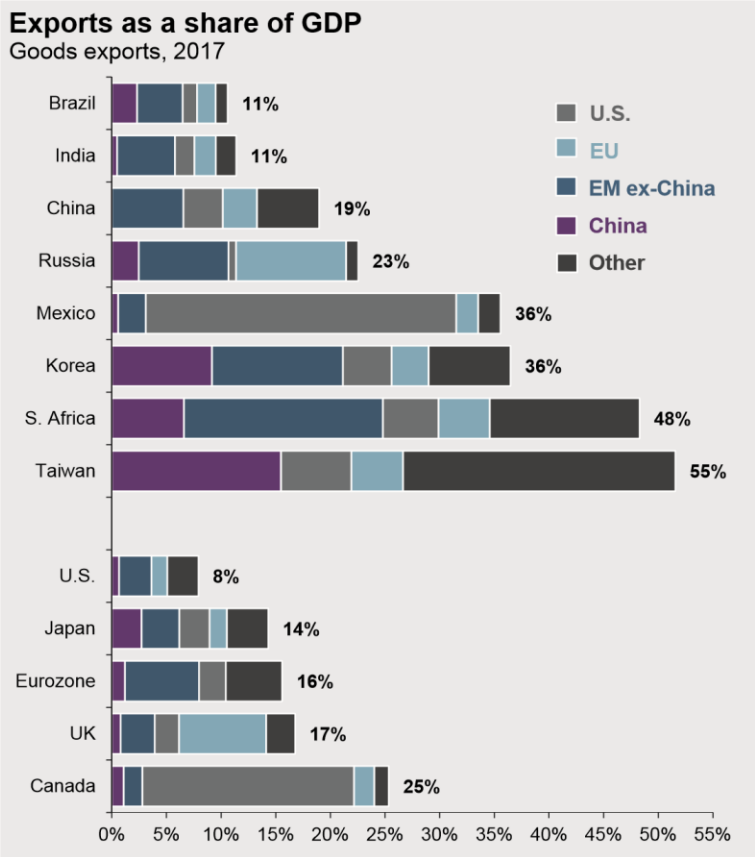


VIX	Level
'08 Peak	80.9
Average	19.6
Latest	25.4

- **DEFINITION:** The Volatility Index, or VIX, is a real-time market index started in 1993 that represents the market's expectation of 30-day forward-looking volatility. Derived from the price inputs of the S&P 500 index options, it provides a measure of market risk and investors' sentiments. It is also known by other names like "Fear Gauge" or "Fear Index."
- **SAA BOTTOMLINE**: Even with abysmal December equity performance, the media sensationalized the news (of course). While market volatility spiked in December, the chart above helps place that volatility in context with other periods of significant volatility. While December returns flouted historical results (i.e. December is usually a positive month), the market volatility was high but not outrageous; especially compared against 2008/2009. SAA expects markets to remain volatile as they absorb and process near-term geopolitical headlines, economic growth reports, and soon-to-be-released Q4 earnings reports.

Source: CBOE, FactSet, J.P. Morgan Asset Management.

Global Trade



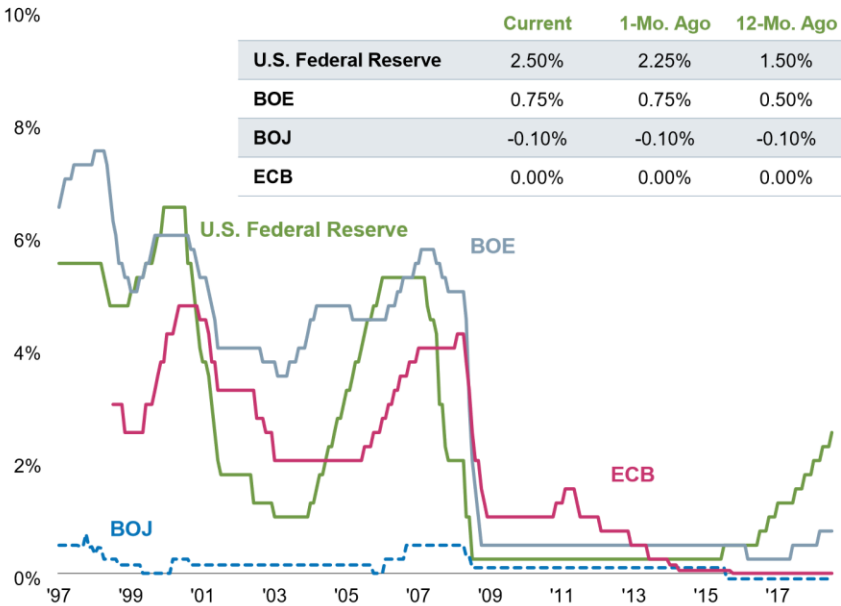
- **SAA BOTTOMLINE**: With trade tensions continuing between US/China, global trade continued to post modest growth through October 2018 (Left chart). Given the March 1, 2019 deadline given to China by the US to wrap up a trade deal, the markets will remain mostly in limbo regarding future expectations even as more recent trade statistics are released. Of more import (pun intended), is exports as a share of GDP for various global economies (Right chart). While the types of exports will vary wildly, the sheer size of exports as a percentage of GDP provides some idea as to which economies may be subject to greater economic hardships should a US/China trade war truly emerge. As SAA and many others have already stated, the impact of a US/China trade war will have both intended and unintended consequences; unknown as to which type of consequences will be worse.

Source: FactSet, J.P. Morgan Asset Management; (Left) CPB Netherlands Bureau for Economic Policy Analysis; (Right) IMF. as of 12/31/2018

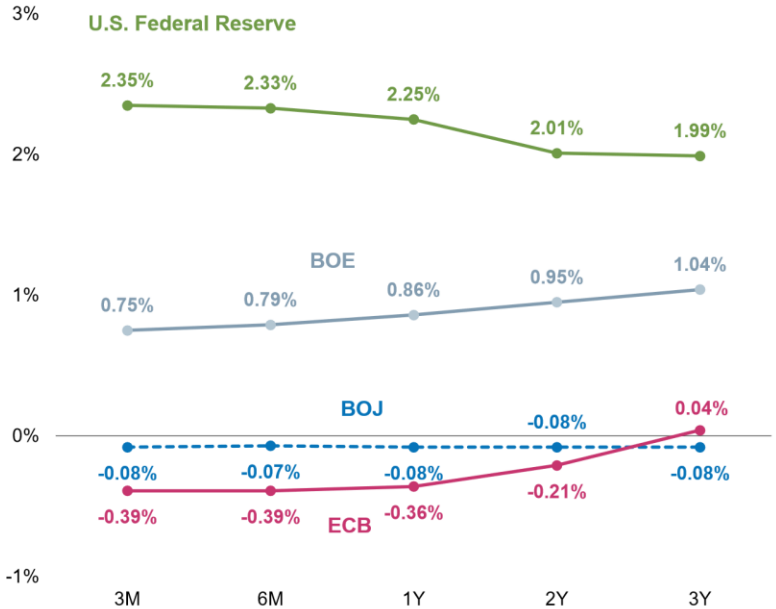
Global Monetary Policy – Rate Levels

Central Bank Policy Rates

	Current	1-Mo. Ago	12-Mo. Ago
U.S. Federal Reserve	2.50%	2.25%	1.50%
BOE	0.75%	0.75%	0.50%
BOJ	-0.10%	-0.10%	-0.10%
ECB	0.00%	0.00%	0.00%



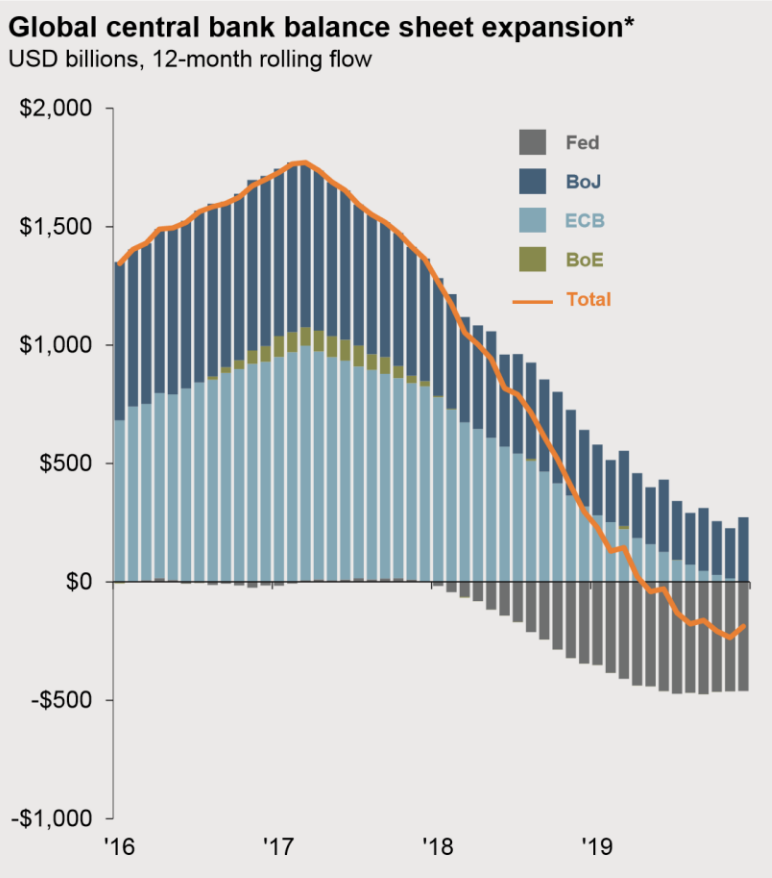
Market Expectations for Future Central Bank Rates

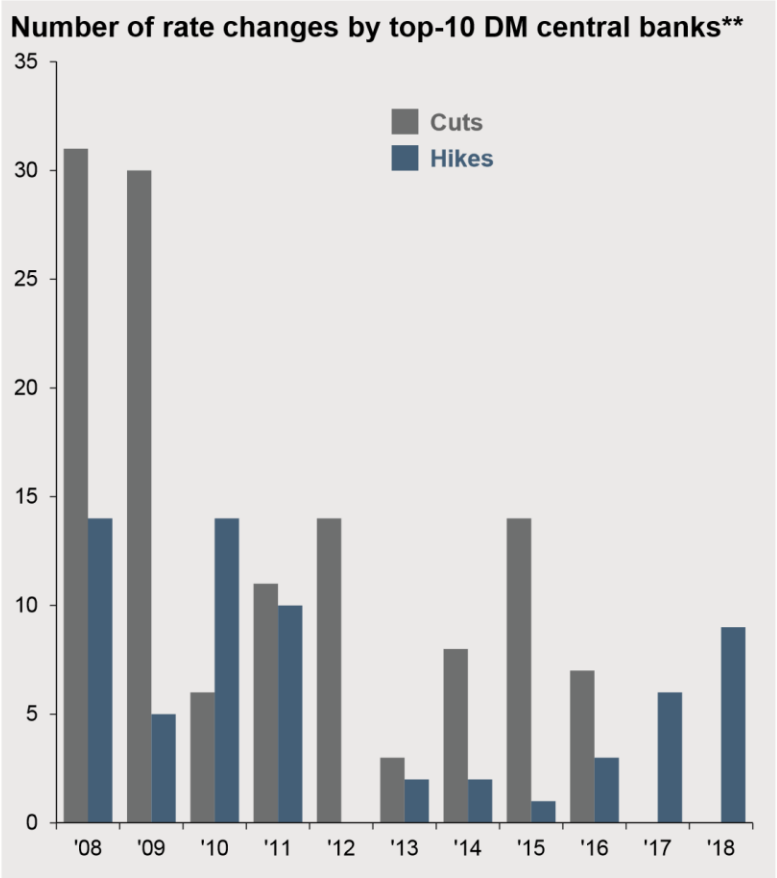


- **SAA BOTTOMLINE**: What a difference a calendar quarter makes as market expectations changed abruptly regarding Fed policy. Just from last quarter, market expectations had yields rising to 2.70% by 9/30/2019 and then steady out three years. As of 12/31/2018, market expectations have rates effectively flat by 9/30/2019 but falling by 25+ bps out three years (i.e. recession risk). This material shift in market expectations has been driven by investors' concerns that the Fed has overshot its efforts to "normalize" monetary policy. Additionally, even if the Fed pauses the rise in rates as recent communications imply, ongoing "autopilot" actions to reduce the Fed's balance sheet will continue to tighten monetary policy.

Source: Eaton Vance, Bloomberg, & Factset as of 12/31/2018

Global Monetary Policy – Balance Sheet & Rate Changes

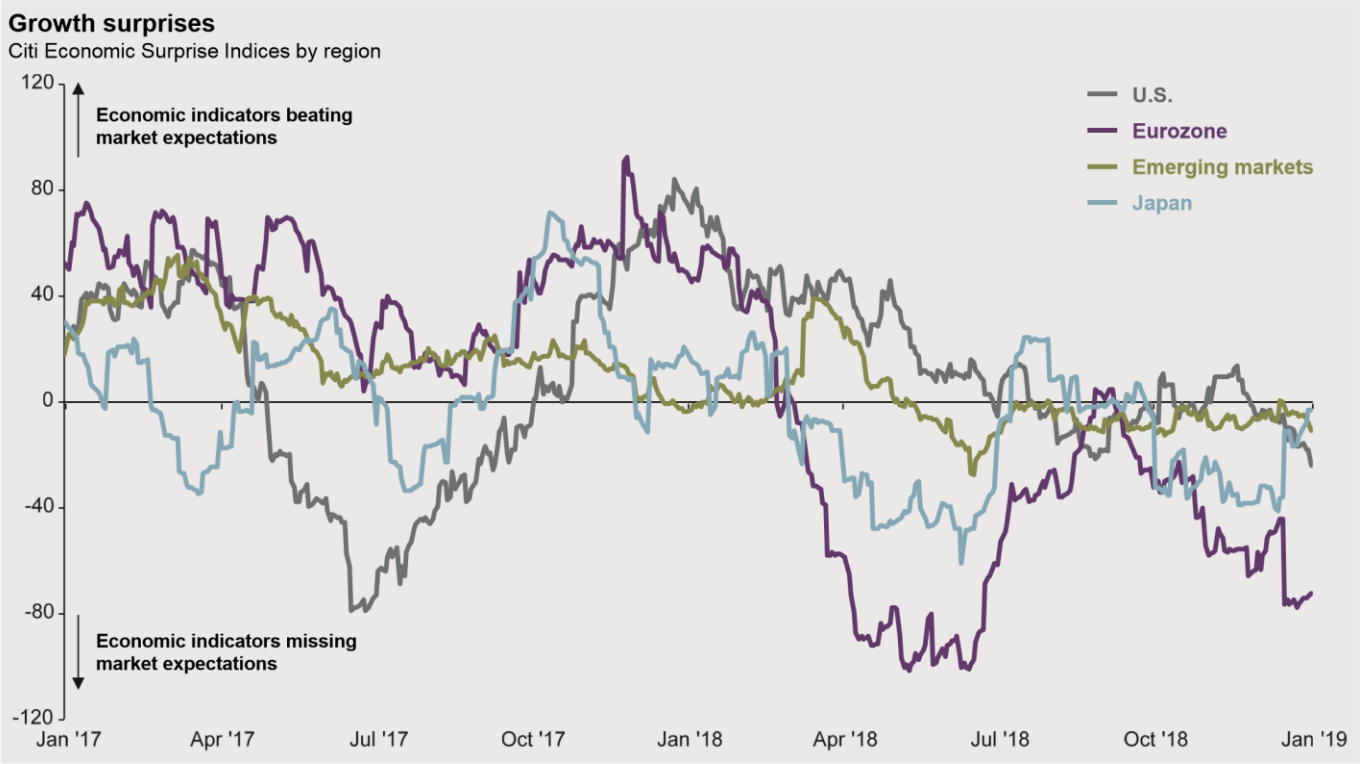




- **SAA BOTTOMLINE**: As mentioned on the prior slide, the world's central banks are, in aggregate, reducing their balance sheets (i.e. tightening monetary policy) with the U.S. leading the way. The world's economies have been accustomed (or addicted) to loose monetary policy for an extended period. With the monetary tightening beginning in earnest during 2017 (again with the US leading the way), the world's economies are adapting (or in recovery). As these source of economic stimulus are slowly removed from the system, how will tighter credit affect consumption, business investment, and sentiment (i.e. GDP growth expectations).

Source: J.P. Morgan Asset Management as of 12/31/2018

Global Growth - Surprises

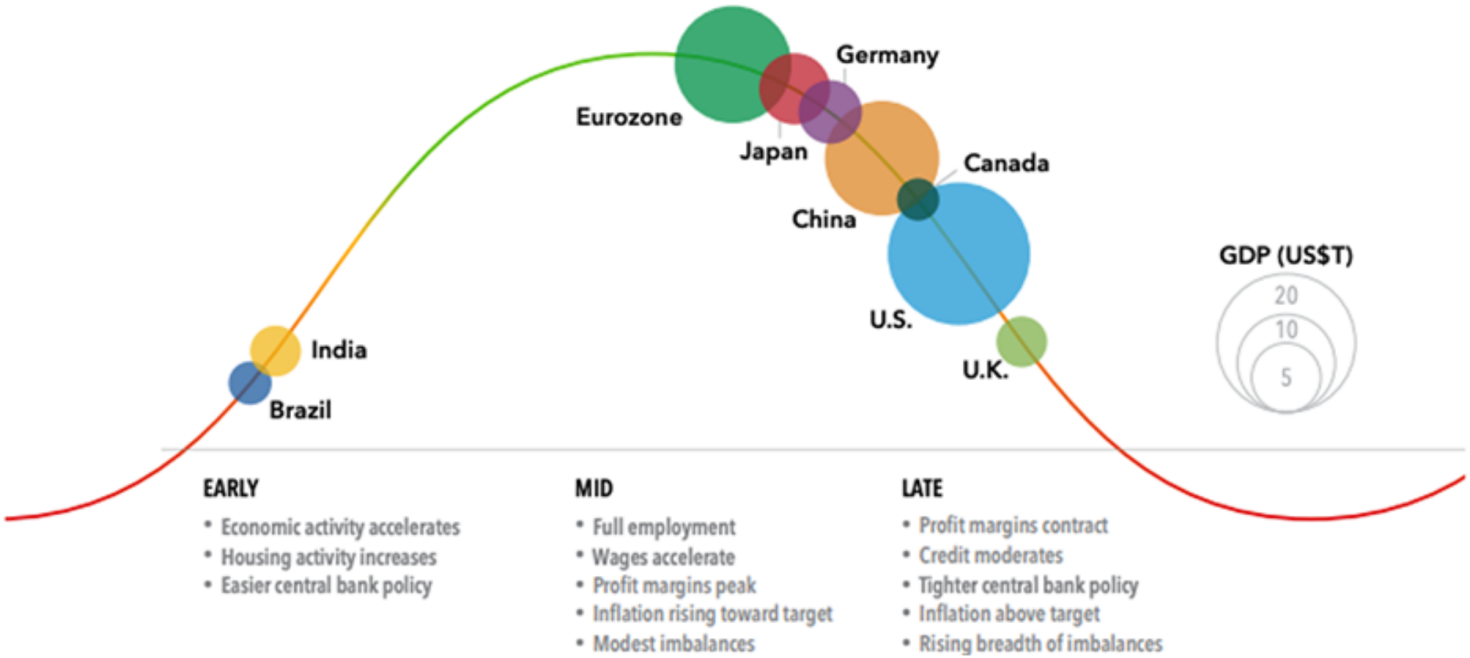


- **DEFINITION:** The Citi Economic Surprise Index is a 90-day weighted moving average of surprises in economic indicators relative to consensus. A positive reading means that the data releases have been stronger than expected and a negative reading means that the data releases have been worse than expected.
- **SAA BOTTOMLINE**: A metric that may be new to some of the readers, but is becoming more widely viewed as market volatility increased and expectations remain fleeting and fragile. Overall, the major world's economies have been mostly disappointing through Q4 and trending negative. These types of metrics become keenly important as they help shape investor sentiment. While sentiment is rather nebulous, it is real and its sway over the markets was harshly felt during Q4 as market prices fell sharply. Was Q4's sentiment change pervasive or temporal? Once negative sentiment spills over to consumers and changes their outlook and behavior, the key driver for GDP growth will be muted (i.e. consumer spending). With Q4 earnings season set to kick off in mid-January, the results and tone of those reports will either help settle investors' nerves after a wildly negative fourth quarter or serve as a catalyst for more volatility.

Source: Citi, FactSet, J.P. Morgan Asset Management.

The Economic Cycle

U.S. economy, among first to reach late cycle, continues to lead the pack.



Sources: Capital Group, FactSet.

- **SAA BOTTOMLINE**: Late-stage economic cycle characteristics are showing in varying degrees across the world's largest economies: 1) rising inflation; 2) tighter central bank policy 3) less credit availability, and 4) shrinking profit margins. While the debate regarding prospective expectations and implications ensues, all these factors are in play and will have fundamental roles in shifting and shaping investor sentiment during 2019. While the world's major economies continue to diverge and global momentum slows, China remains the real wild card given its own slowing economic growth (6.5% officially and slowest pace since 2009), debt levels, and the potential impact of a protracted US/China trade war. Depending on the depth of any Chinese economic weakness, China's economic struggles could export more volatility to other parts of the world.

Source: Wilbanks, Smith & Thomas & SAA