Capital Markets Review
First Quarter 2019

STRATEGIC ASSET ALLIANCE

THE INSURANCE INVESTMENT SPECIALIST

Summary Capital Market Commentary – 1st Quarter 2019

- **GLOBAL FINANCIAL MARKETS**

- **Equity markets made gains in Q1, rebounding from a weak end to 2018 as concerns over the China-US trade dispute eased and major central banks grew more accommodative. Government and corporate bonds advanced.**

  - US equities rose +13.6% (S&P 500) and rallied to their largest quarterly gain since 2009 fueled by an increasingly dovish tilt in Federal Reserve commentary, apparent progress in US-China trade talks, and as the government shutdown ended.

    - The US delayed its plan to increase tariffs on US$200 billion of imports from China, amid constructive dialogue between US and Chinese trade representatives and growing optimism that the two countries can ultimately reach a trade agreement.

  - European equities +11.7% (MSCI Europe) gained in the quarter as central banks put quantitative tightening on hold and equity valuations appeared attractive. The ECB slashed its growth forecast to 1.1%, from 1.7%, and unveiled stimulus measures to revive the eurozone economy amid slowing growth, escalating Brexit risks, political uncertainty, and ongoing trade tensions.

    - A slowdown in manufacturing took a toll on economic growth in Europe. The eurozone Manufacturing Purchasing Managers' Index (PMI) fell below 50 in February for the first time since June 2013, indicating contraction.

  - Emerging markets (EM) equities rose +9.9% (MSCI EM) led by China. Optimism over a trade agreement with the US and ongoing government support for the Chinese domestic economy were beneficial.

Source: Schroders, Wellington & SAA

Summary Capital Market Commentary – 1st Quarter 2019

- **GLOBAL FINANCIAL MARKETS**

- **Global fixed income sectors generated positive returns in the first quarter. Sovereign yields declined sharply across most markets amid more dovish central bank policy actions and rhetoric, and concerns about deteriorating global growth. Corporate bonds rebounded strongly during the quarter, benefiting from falling government bond yields and tighter spreads. The US dollar ended mixed as dovish monetary policy balanced global growth anxieties, and the British pound rebounded as fears of a hard Brexit abated.**

  - US 10-year Treasury yields fell in Q1 by 30 bps, reaching their lowest level since late 2017. The three-month Treasury bill yield rose higher than that of 10-year bonds in March, in a sign of growing caution among investors over economic growth.

  - As the quarter ended, the Fed lowered its projections for US growth and reduced its expectations for interest rate hikes. The "dot plot" now shows no rate hikes this year and only one in 2020. The adjusted growth outlook caused the Treasury yield curve to invert - a signal historically associated with a pre-recessionary environment.

  - U.S. economic data released during the quarter was mixed. Despite a sharp, unexpected decline in nonfarm payroll growth in February, the labor market remained solid, with the unemployment rate declining to 3.8% and wage growth accelerating at the fastest rate since 2009, rising 3.4% year over year.

Source: Schroders, Wellington & SAA

Executive Summary - Key Capital Market Index Returns

Index	Asset Class	Jan-19	Feb-19	Mar-19	Q1 '19	Trailing 1 Yr	Trailing 3 Yr	Trailing 5 Yr
S&P GSCI Crude Oil	U.S. Equity	17.97%	5.82%	4.67%	**30.68%**	-4.27%	9.38%	-18.80%
Alerian MLP	Master Limited Partnerships	12.64%	0.27%	3.43%	**16.82%**	15.11%	5.69%	-4.73%
Dow Jones U.S. Select REIT	U.S. Real Estate	11.41%	0.97%	2.88%	**15.72%**	19.73%	5.29%	8.93%
S&P GSCI Commodities	U.S. Equity	8.99%	3.81%	1.61%	**14.97%**	-3.04%	6.18%	-12.61%
S&P Composite 1500 Growth	U.S. Equity	7.67%	4.13%	2.44%	**14.84%**	11.78%	15.62%	12.94%
S&P MidCap 400	U.S. Equity	10.46%	4.24%	-0.57%	**14.49%**	2.59%	11.24%	8.29%
S&P 500	U.S. Equity	8.01%	3.21%	1.94%	**13.65%**	9.50%	13.51%	10.91%
S&P Composite 1500	U.S. Equity	8.25%	3.31%	1.62%	**13.64%**	8.79%	13.34%	10.64%
MSCI World Index	U.S. Equity	7.81%	3.06%	1.38%	**12.65%**	4.61%	11.31%	7.38%
S&P Composite 1500 Value	U.S. Equity	8.89%	2.42%	0.72%	**12.32%**	5.54%	10.61%	7.96%
Dow Jones Industrial Average	U.S. Equity	7.29%	4.03%	0.17%	**11.81%**	10.09%	16.37%	12.21%
S&P SmallCap 600	U.S. Equity	10.64%	4.35%	-3.33%	**11.61%**	1.57%	12.55%	8.45%
MSCI World Ex. US Index	World Equity	7.16%	2.58%	0.62%	**10.60%**	-2.61%	7.84%	2.71%
BofA Merrill Lynch US Convertibles	U.S. Convertible Bond	6.96%	3.00%	0.00%	**10.17%**	7.75%	12.07%	7.11%
MSCI EAFE Index	International Equity	6.59%	2.56%	0.74%	**10.13%**	-3.22%	7.80%	2.81%
MSCI EAFE (Net)	International Equity	6.57%	2.55%	0.63%	**9.98%**	-3.71%	7.27%	2.33%
MSCI EM (Emerging Markets)	World Equity	8.78%	0.23%	0.86%	**9.97%**	-7.06%	11.09%	4.06%
Barclays Capital U.S. Corporate High Yield	U.S. Fixed Income	4.52%	1.66%	0.94%	**7.26%**	5.93%	8.56%	4.68%
Barclays Capital U.S. Corporate Investment Grade	U.S. Fixed Income	2.35%	0.22%	2.50%	**5.14%**	4.94%	3.64%	3.72%
S&P/LSTA US Leveraged Loan Index	U.S. Fixed Income	2.55%	1.59%	-0.17%	**4.00%**	2.97%	5.67%	3.62%
Barclays U.S. Government/Credit	U.S. Fixed Income	1.18%	-0.06%	2.12%	**3.26%**	4.48%	2.12%	2.78%
Barclays U.S. Treasury: U.S. TIPS	U.S. Fixed Income	1.35%	-0.01%	1.84%	**3.19%**	2.70%	1.70%	1.94%
10-Year US Treasury	U.S. Treasury	0.71%	-0.46%	2.84%	**3.10%**	5.59%	0.08%	2.57%
Barclays Capital U.S. Aggregate	U.S. Fixed Income	1.06%	-0.06%	1.92%	**2.94%**	4.48%	2.03%	2.74%
Barclays Capital Municipal Bond	U.S. Fixed Income	0.76%	0.54%	1.58%	**2.90%**	5.38%	2.71%	3.73%
Barclays Intermediate U.S. Government/Credit	U.S. Fixed Income	0.87%	0.09%	1.35%	**2.32%**	4.24%	1.66%	2.12%
Citigroup WorldBIG Index	World Fixed Income	1.42%	-0.54%	1.30%	**2.18%**	-0.39%	1.44%	1.01%
Merrill Lynch US Treasury Master	U.S. Fixed Income	0.47%	-0.28%	1.99%	**2.18%**	4.25%	1.07%	2.34%
5-Year US Treasury	U.S. Treasury	0.53%	-0.15%	1.49%	**1.88%**	4.43%	0.56%	1.65%
Citigroup 3-month T-bill	**Cash/Cash Equivalent**	0.20%	0.19%	0.21%	**0.60%**	2.11%	1.17%	0.72%

- **SAA BOTTOMLINE**: What a difference a quarter makes as the Federal Reserve did a complete about face regarding monetary policy and clearly signaled that rate hikes, while still data dependent, have been effectively placed on hold. Then throw in improving sentiments that U.S./China trade issues have eased and the markets took off nearly erasing the dismal end to 2018.

Indices sorted high/low by Q1 '19 performance.

Source: Zephyr StyleAdvisor

U.S. Fixed Income Sector Yields & Returns

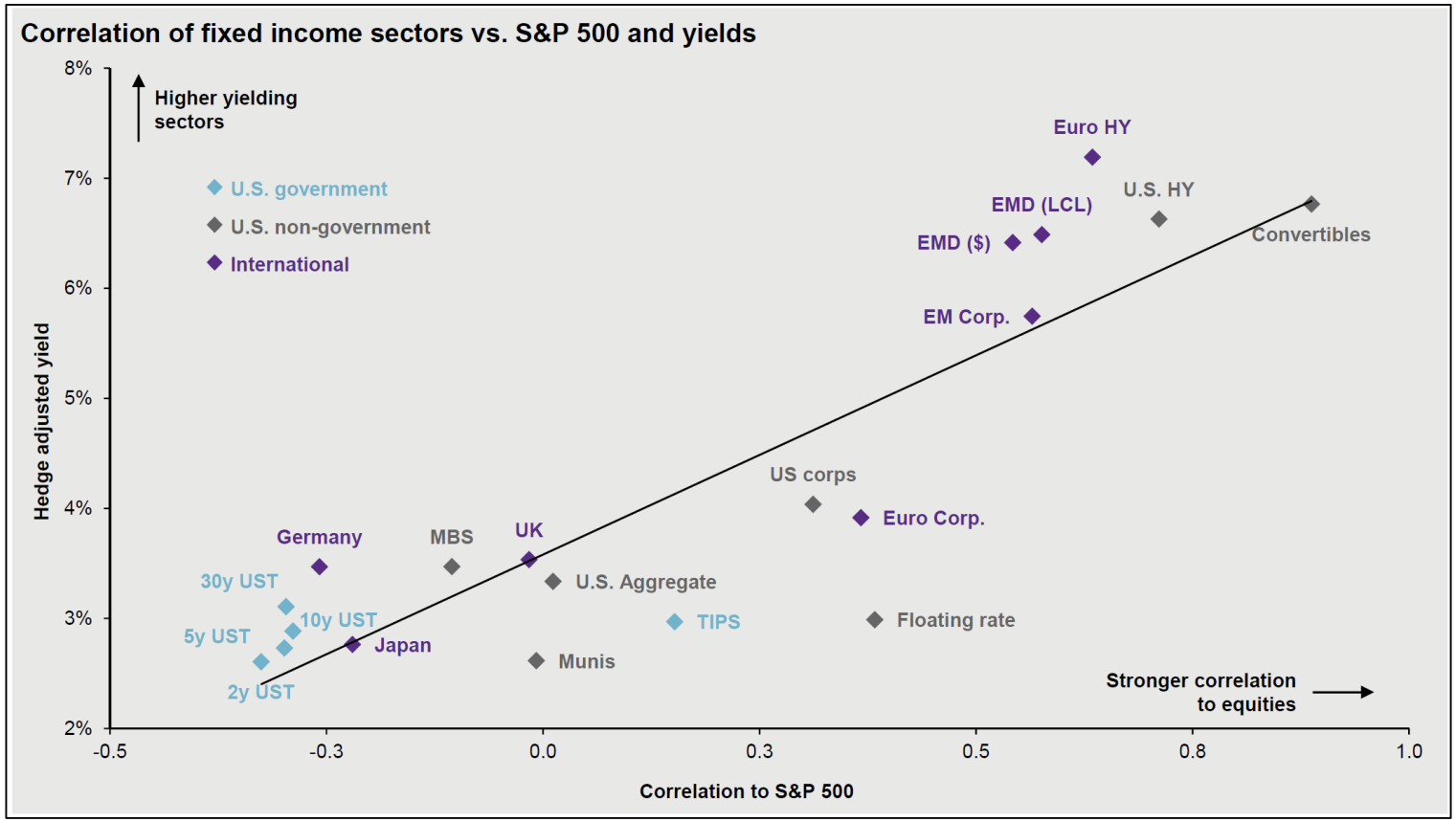
Index YTW	12/31/2014	12/31/2015	12/31/2016	12/31/2017	12/31/2018	3/31/2019
Aggregate	2.25%	2.59%	2.61%	2.71%	3.28%	2.93%
Intermediate Aggregate	2.00%	2.32%	2.37%	2.56%	3.13%	2.78%
U.S. Credit	3.01%	3.54%	3.29%	3.19%	4.09%	3.55%
U.S. Treasury	1.43%	1.73%	1.89%	2.19%	2.61%	2.38%
Municipal Bond	2.09%	2.11%	2.65%	2.36%	2.69%	2.32%
U.S. High Yield	6.61%	8.74%	6.12%	5.72%	7.95%	6.43%
U.S. 2-Yr Treasury	0.66%	1.05%	1.19%	1.88%	2.50%	2.29%
U.S. 5-Yr Treasury	1.65%	1.76%	1.92%	2.19%	2.51%	2.23%
U.S. 10-Yr Treasury	2.17%	2.28%	2.43%	2.41%	2.69%	2.41%
Global Aggregate (USD)	1.62%	1.77%	1.60%	1.66%	2.03%	1.77%
Change to Current Period						
Aggregate	▲ 0.68%	▲ 0.34%	▲ 0.32%	▲ 0.22%	▼ -0.35%	
Intermediate Aggregate	▲ 0.78%	▲ 0.46%	▲ 0.41%	▲ 0.22%	▼ -0.35%	
U.S. Credit	▲ 0.54%	▲ 0.01%	▲ 0.26%	▲ 0.36%	▼ -0.54%	
U.S. Treasury	▲ 0.95%	▲ 0.65%	▲ 0.49%	▲ 0.19%	▼ -0.23%	
Municipal Bond	▲ 0.23%	▲ 0.21%	▼ -0.33%	▼ -0.04%	▼ -0.37%	
U.S. High Yield	▼ -0.18%	▼ -2.31%	▲ 0.31%	▲ 0.71%	▼ -1.52%	
U.S. 2-Yr Treasury	▲ 1.63%	▲ 1.24%	▲ 1.10%	▲ 0.41%	▼ -0.21%	
U.S. 5-Yr Treasury	▲ 0.58%	▲ 0.47%	▲ 0.31%	▲ 0.04%	▼ -0.28%	
U.S. 10-Yr Treasury	▲ 0.24%	▲ 0.13%	▼ -0.02%	▬ 0.00%	▼ -0.28%	
Global Aggregate	▲ 0.15%	▬ 0.00%	▲ 0.17%	▲ 0.11%	▼ -0.26%	
U.S. Agg. vs. Global Agg.	▲ **0.63%**	▲ **0.82%**	▲ **1.01%**	▲ **1.05%**	▲ **1.25%**	▲ **1.16%**
UST 2yr-10yr Spread (bps)	**150.6**	**123.2**	**124.2**	**52.7**	**19.0**	**12.0**
UST 2yr-5yr Spread (bps)	**98.9**	**71.2**	**73.2**	**30.7**	**1.0**	**-6.0**
UST 5yr-10yr Spread (bps)	**51.7**	**52.0**	**51.0**	**22.0**	**18.0**	**18.0**

Note: Bloomberg Barclays Indices

- **SAA BOTTOMLINE**: With markets' growing concern over slowing global economic growth, the world's central banks responded with more dovish central bank policy actions and jawboning (especially the U.S. Federal Reserve). As a result, global government bond yields declined and spreads tightened across both investment grade and high yield credits.

Source: Bloomberg Barclays as of 3/31/2018

Q1-2019 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**: Even though interest rates declined in Q1-2019, core fixed income investment yields still fall between 3%-4%. With muted inflation, real yields on fixed income portfolios still remain positive.
- Also important to note that cash yields are now approximately 2.25%-2.40% making cash a viable option for allocation given recent market volatility.

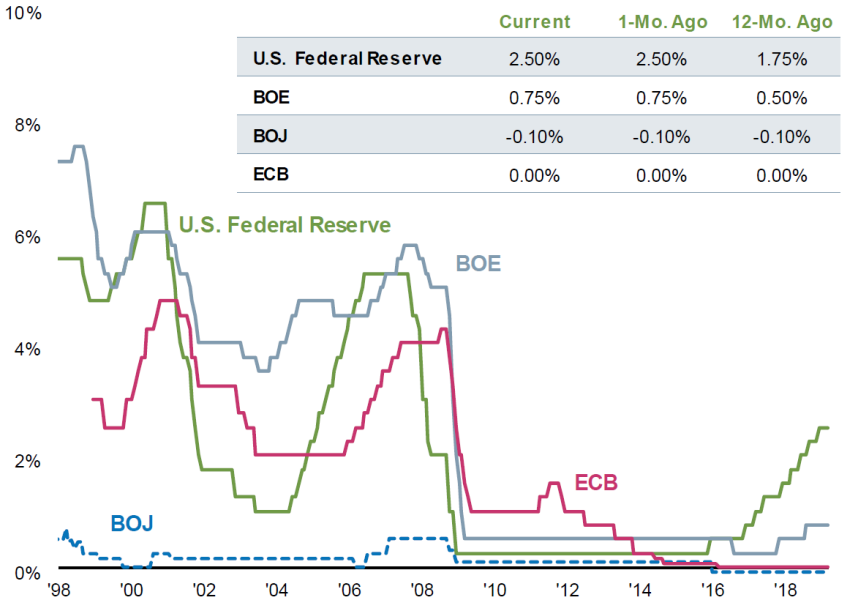
Source: Bloomberg, FactSet, ICE, J.P. Morgan Asset Management

INVESTMENT THEMES

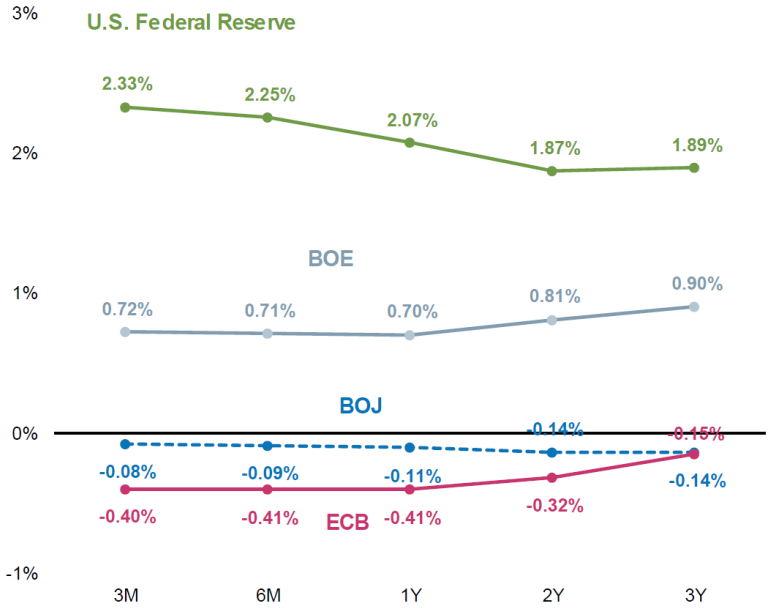
INTEREST RATES- Global Monetary Policy & Fed Rate Expectations

Central Bank Policy Rates

	Current	1-Mo. Ago	12-Mo. Ago
U.S. Federal Reserve	2.50%	2.50%	1.75%
BOE	0.75%	0.75%	0.50%
BOJ	-0.10%	-0.10%	-0.10%
ECB	0.00%	0.00%	0.00%



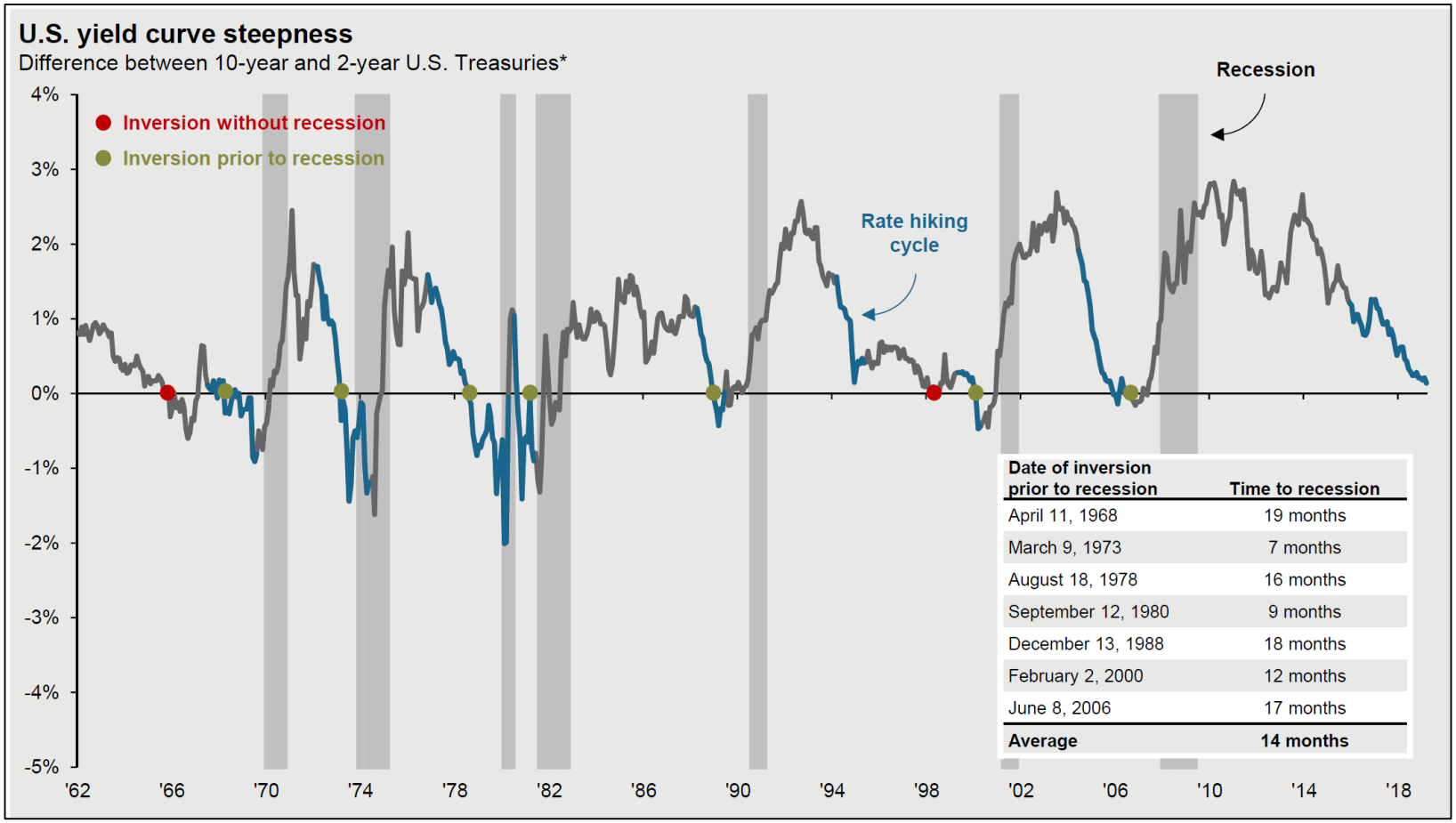
Market Expectations for Future Central Bank Rates



- **SAA BOTTOMLINE**: Lower for longer is what the worlds' central bank policy rates continue to signal; especially the U.S. Federal Reserve, whose monetary policy reversal and accommodative rhetoric arrived in early 2019.
- Although the U.S. Federal Reserve is an "independent" institution, the ongoing verbal assault directed toward Chairman Powell by President Trump along with two potential Fed Board of Governors nominees has the potential to clearly "politicize" the Fed.
- Still, markets are aware of but not driven by politics, and the markets are signaling that the worlds' central bank rates will remain low.

Source: Eaton Vance, Factset & Bloomberg as of 3/31/2019

INTEREST RATES - Yield Curve Inversion & Recession Forecasting

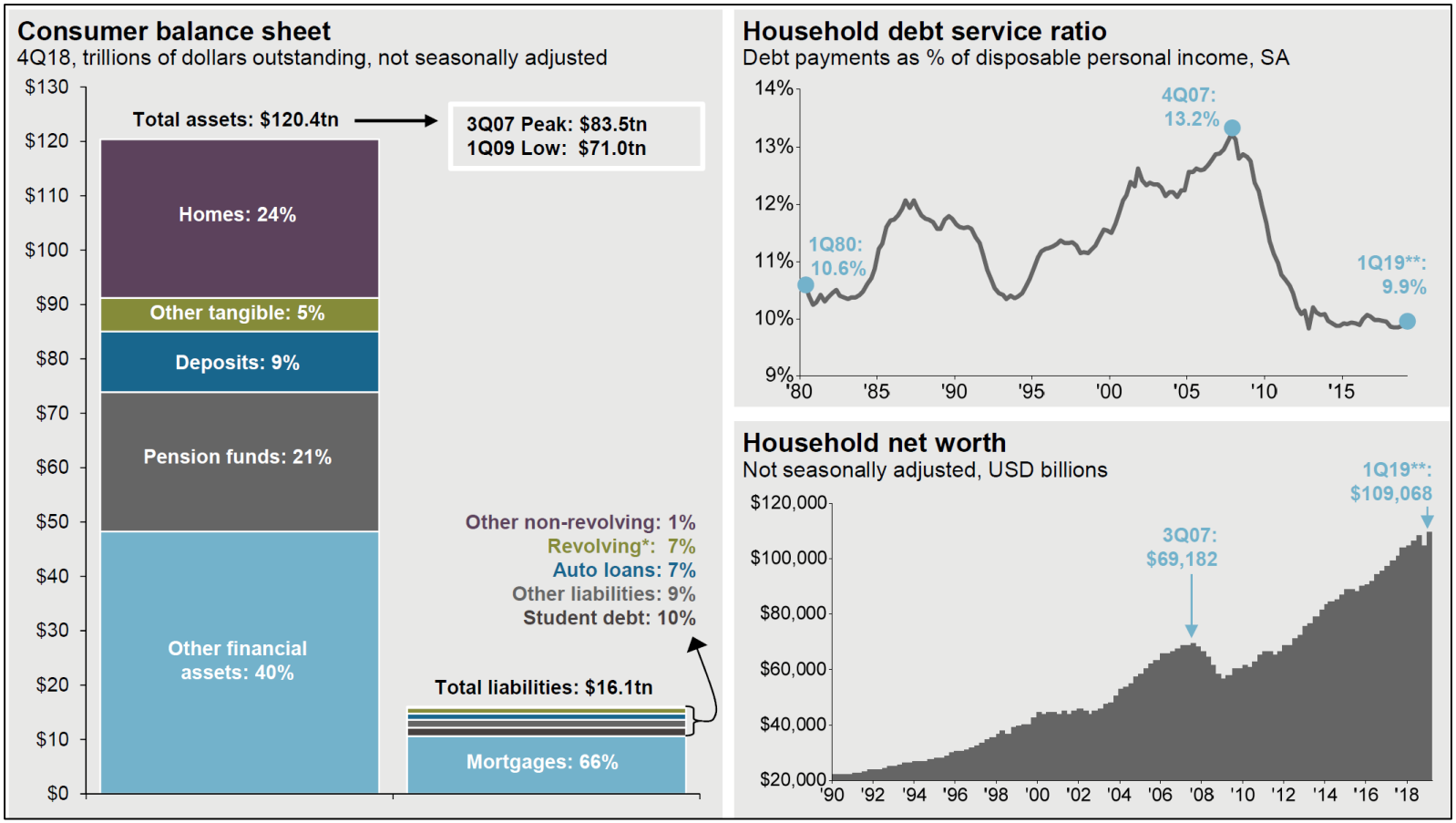


Date of inversion prior to recession	Time to recession
April 11, 1968	19 months
March 9, 1973	7 months
August 18, 1978	16 months
September 12, 1980	9 months
December 13, 1988	18 months
February 2, 2000	12 months
June 8, 2006	17 months
Average	**14 months**

- **SAA BOTTOMLINE**: While a yield curve inversion has historically been a decent predictor of recession, it has not always been the case as shown in the above exhibit. Although a steady curve inversion between the most widely watched metric, the spread between the 2yr and 10yr UST, has not occurred, there have been inversions during 2019 along other parts of the UST curve. Well-known economists are divided on this issue and its meaning in today's global economy; and, with the Federal Reserve's abrupt change in monetary policy posturing in 2019, the perceived danger of what a yield curve inversion signals is not as acute across markets…at least for the near term.

Source: FactSet, Federal Reserve, J.P. Morgan Asset Management

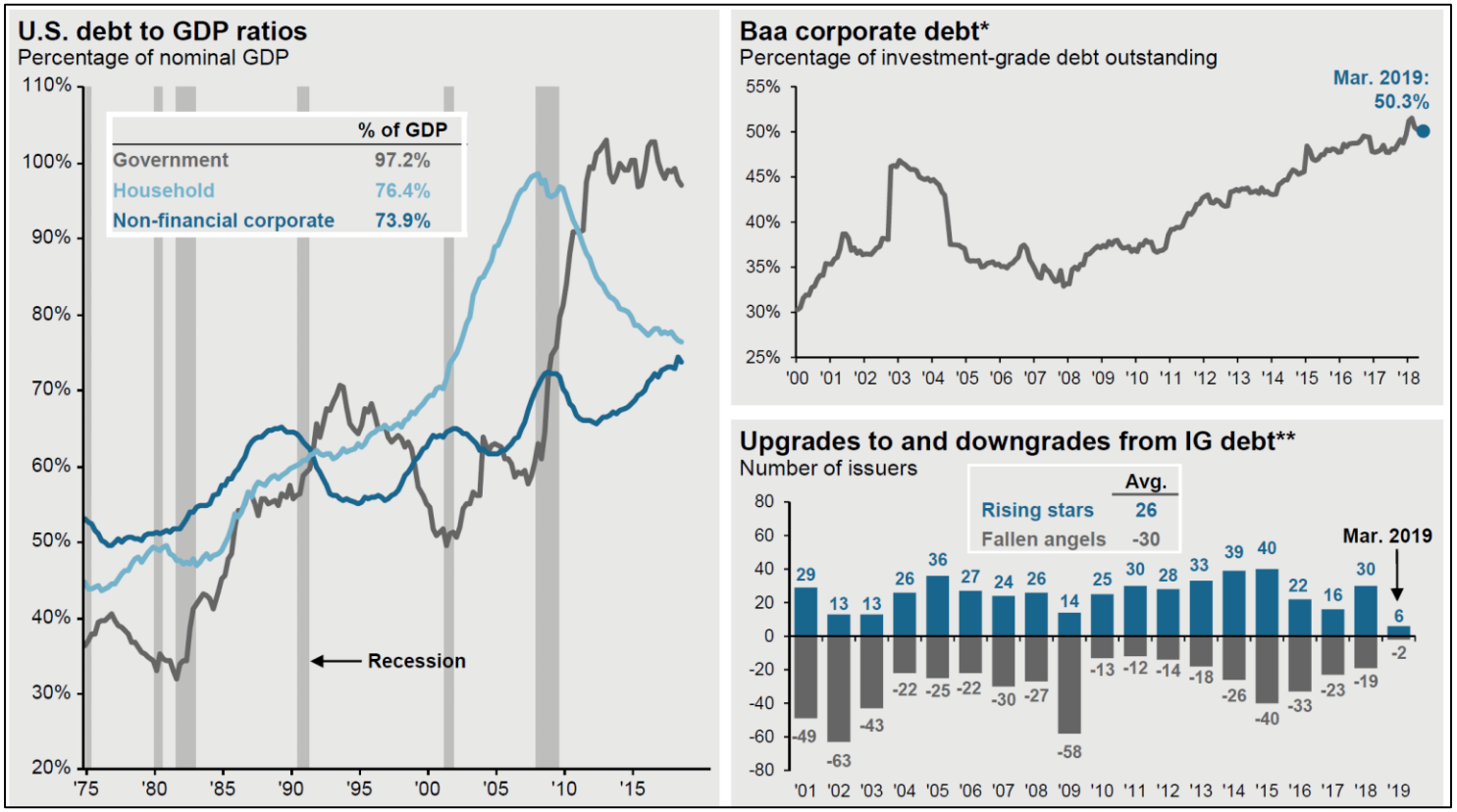
ECONOMIC GROWTH - U.S. Consumer Financial Health



- **SAA BOTTOMLINE**: As a whole, the U.S. Consumer is on solid footing as compared to 2007 just before the Great Recession. Given the U.S. consumer accounts for about 70% of U.S. GDP, this picture helps support the argument of continued slow economic growth.

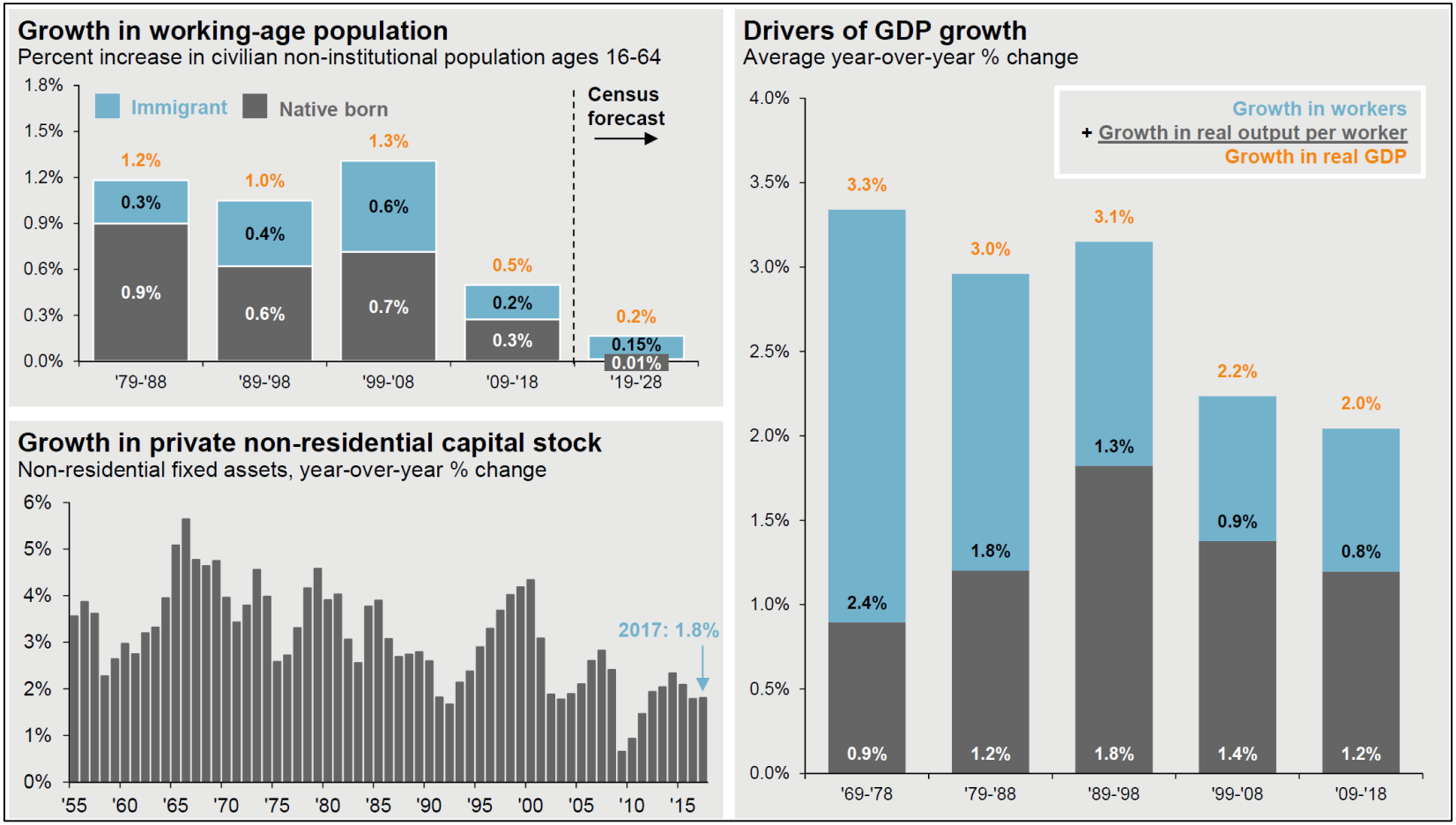
Source: FactSet, FRB, J.P. Morgan Asset Management; (Top and bottom right) BEA.

ECONOMIC GROWTH - U.S. Debt Levels (i.e. Leverage Ratios)



- **SAA BOTTOMLINE**: While the average credit quality of the corporate bond market continues to decline (i.e. % of BBB rated credits is increasing), it is not necessarily due to a decline in fundamentals but an increased use of debt capital as a result of very low interest rates. That said, corporate debt levels today are not too far the levels observed in 2008/2009 and consumer debt levels are markedly improved over the same period. Combined, the consumer and business sectors are much better positioned to address any potential economic distress as compared to 2008/2009.
- Offsetting steady business leverage and declining consumer leverage is the sharp rise in government leverage to support the economic recovery after 2008/2009. With fiscal deficits expected to be $1T for the next few years (at current budget levels), increasing leverage means that the U.S. will become more reliant on non-US investors to fund governmental expenditures which does raise longer-term national security concerns.

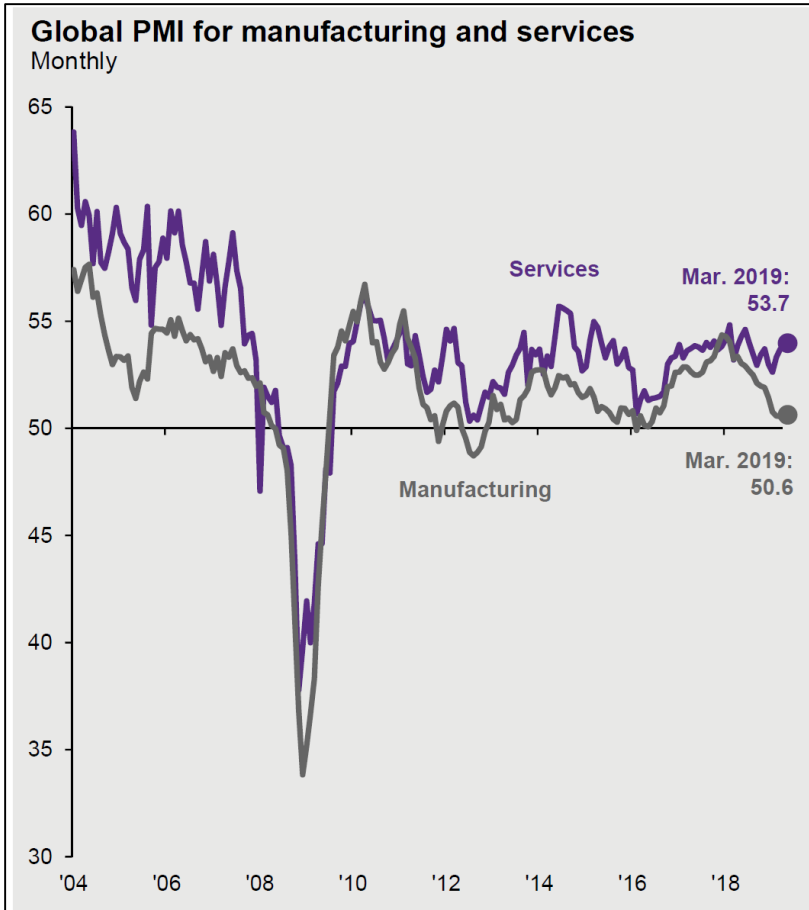
ECONOMIC GROWTH - Drivers of Long-Term U.S. Economic Growth

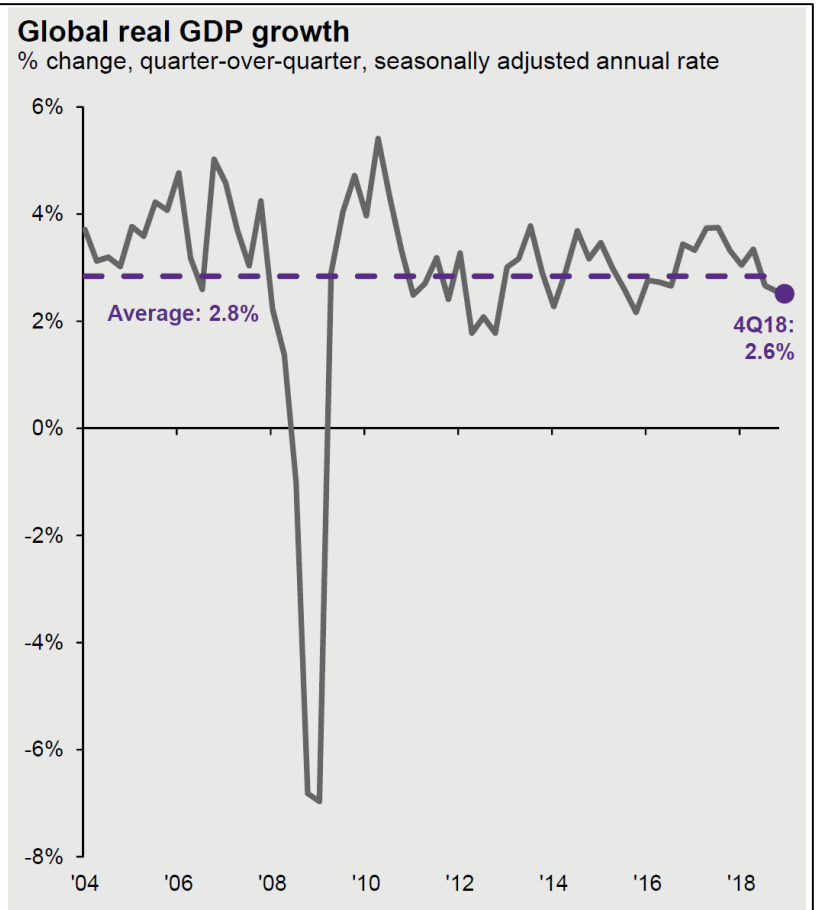


- **SAA BOTTOMLINE**: With measured economic growth driven by the supply of workers and the productivity of those workers, these exhibits highlight the pressures that the U.S. faces for sustained economic growth exceeding 2% annually. With demographics working against the U.S. (and the developed world more broadly), increased worker productivity is the only "real" answer and that statistic has been declining since 1998.

Source: J.P. Morgan Asset Management; (Top left) Census Bureau, DOD, DOJ; (Top left and right) BLS; (Right and bottom left) BEA.

ECONOMIC GROWTH - Global Perspective





- **SAA BOTTOMLINE**: As global PMI for services remains steady and expansionary more so than manufacturing, does the continued expansion of services, both globally and locally, suggest that the age-old GDP metric may not be capturing a material component of global economic activity? If so, is global GDP growth perhaps understated?

Source: J.P. Morgan Asset Management; (Left) Markit; (Right) J.P. Morgan Global Economic Research. PMI is the Purchasing Managers' Index. Real GDP growth is a GDP-weighted measure.