



# Capital Markets Review Third Quarter 2019

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The views expressed are those of Strategic Asset Alliance. They are subject to change at any time. These views do not necessarily reflect the opinions of any other firm.



**STRATEGIC ASSET ALLIANCE**  
THE INSURANCE INVESTMENT SPECIALIST FOR 25 YEARS

# Summary Capital Market Commentary – 3<sup>rd</sup> Quarter 2019

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## ● GLOBAL FINANCIAL MARKETS

- **Slowing economic growth is no longer a forecast, it is a fact. Growth in the second quarter slowed to 2.3% year-over-year after averaging 2.9% in 2018. Moreover, recent data suggest growth will decelerate further in the third quarter to a more trend-like 2% pace.**
  
- **However, the U.S. economy is walking a tightrope. On one end, rising political uncertainty has caused business confidence to weaken, which may in turn slow hiring decisions; on the other, the cyclical sectors of the economy are relatively stable.**
  - Political uncertainty remains elevated and has caused businesses to slow investment spending given the unclear outlook. Even amidst the strong likelihood of further interest rate cuts from the Fed, companies will look more toward a resolution on trade, rather than cheaper financing, to reconsider spending plans. Further softening in business spending may lead to a weakening in hires. Importantly, hiring declines tend to precede recessions, while a surge in layoffs tends to happen after a recession has started, suggesting hiring declines may be a better forward-looking indicator for the economy.



# Summary Capital Market Commentary – 3<sup>rd</sup> Quarter 2019

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## ● GLOBAL FINANCIAL MARKETS

- Global central banks have changed tack, moving away from tightening and toward easing monetary policy. The Federal Reserve (Fed) cut interest rates for the first time in a decade and appears to be on a path of easing.
- Yields have collapsed in recent months, as recession risks rise and fear about the global economy grows. In the developed international markets, the European Central Bank cut rates deeper into negative territory in September and resumed asset purchases, which it had only recently concluded at the end of 2018. The Bank of Japan maintains easy monetary policy. Globally, this has made the hunt for yield even more challenging.
- In the third quarter of 2019, the trade dispute between the two largest economies in the world took many twists and turns, which has added further pressure on business confidence, raised concerns over global economic growth, and should lead to further volatility in equity markets.
  - The negative effects of the trade dispute have been mainly felt in the manufacturing sector. Global manufacturing PMI is below 50, pointing that the sector is sinking. Meanwhile, the services sector is still in expansionary territory, for now, due to the strength of the consumer; especially the U.S. consumer.





## ECONOMIC BACKDROP



# 10 Year Treasury Rate – About face...

**FRED** — 10-Year Treasury Constant Maturity Rate



Shaded areas indicate U.S. recessions. Source: Board of Governors of the Federal Reserve System (US) myf.red/g/p2Mx

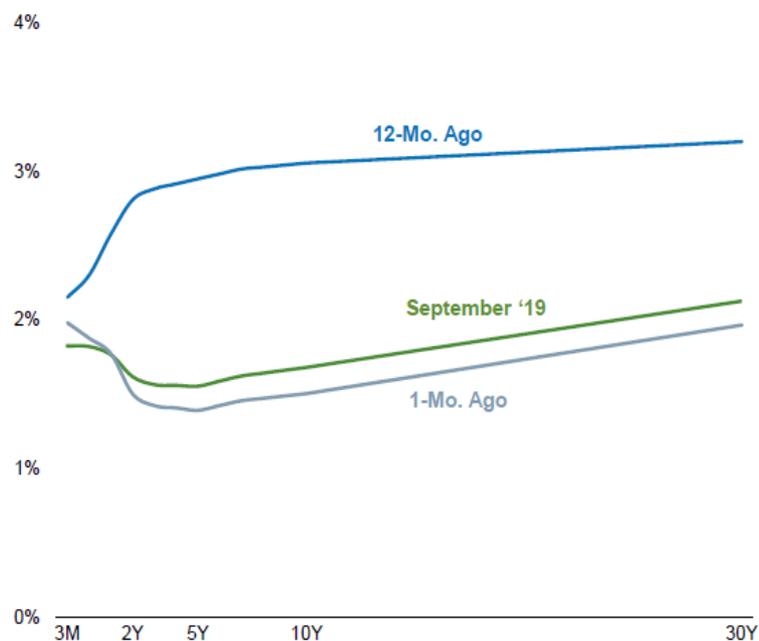


# Treasury Yields

## Fixed Income

### U.S. Treasury yields

#### U.S. Treasury Yield Curves



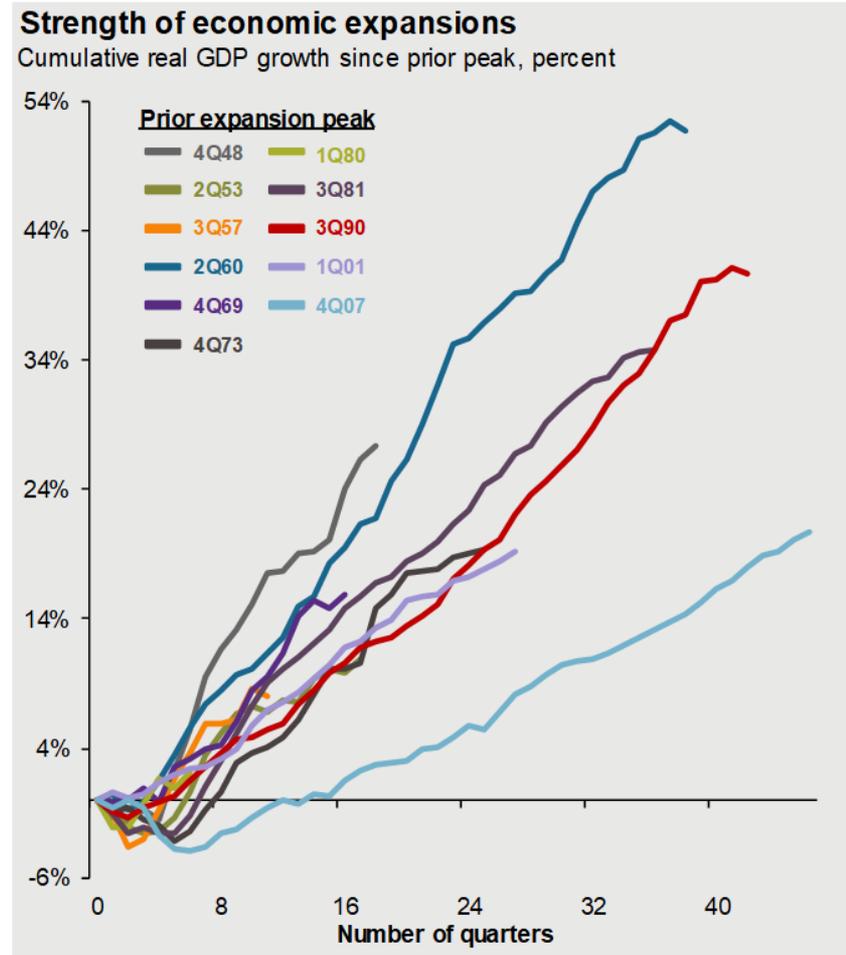
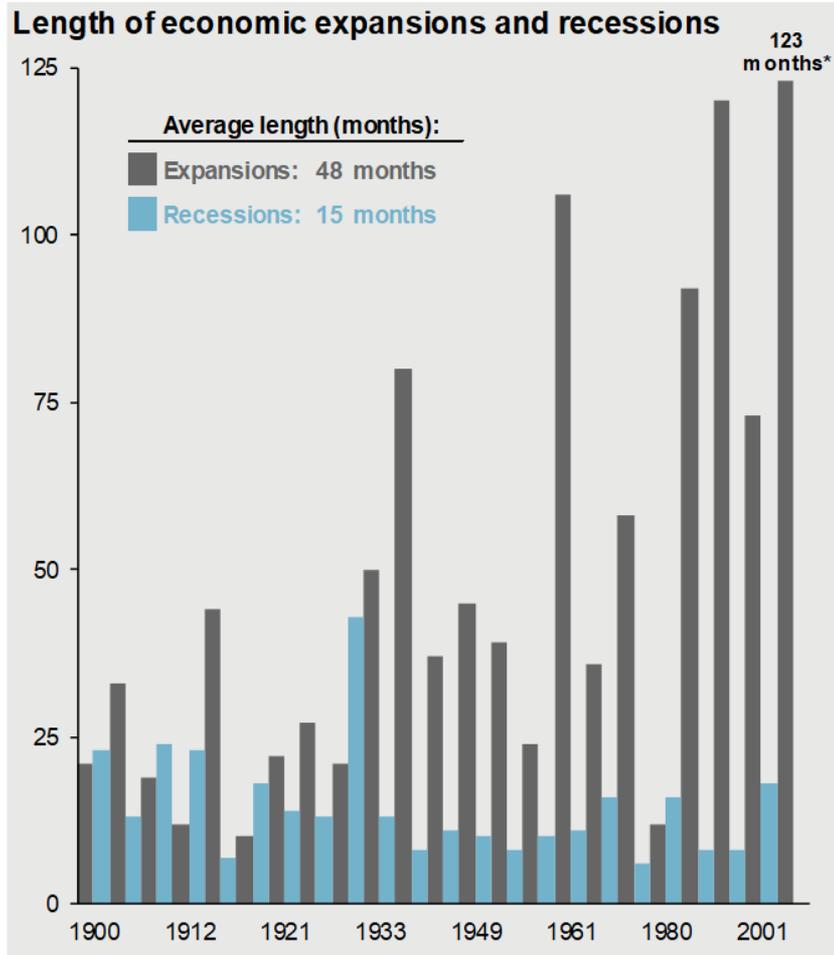
#### Yields & Performance

Security	Yield (%)			Total Return (%)	
	Current	1-Mo. Ago	12-Mo. Ago	1-Mo.	12-Mo.
3-mo. Treasury	1.82	1.98	2.15	0.17	2.39
6-mo. Treasury	1.82	1.87	2.30	0.17	2.64
2-yr. Treasury	1.62	1.50	2.81	-0.13	4.37
3-yr. Treasury	1.56	1.42	2.88	-0.31	5.94
5-yr. Treasury	1.55	1.39	2.95	-0.62	9.16
10-yr. Treasury	1.68	1.50	3.05	-1.41	15.15
30-yr. Treasury	2.12	1.96	3.20	-3.08	27.40

Source: Factset, Morningstar as of 9/30/19. Data provided is for informational use only. Past Performance is not a reliable indicator of future results. See end of report for important additional information.



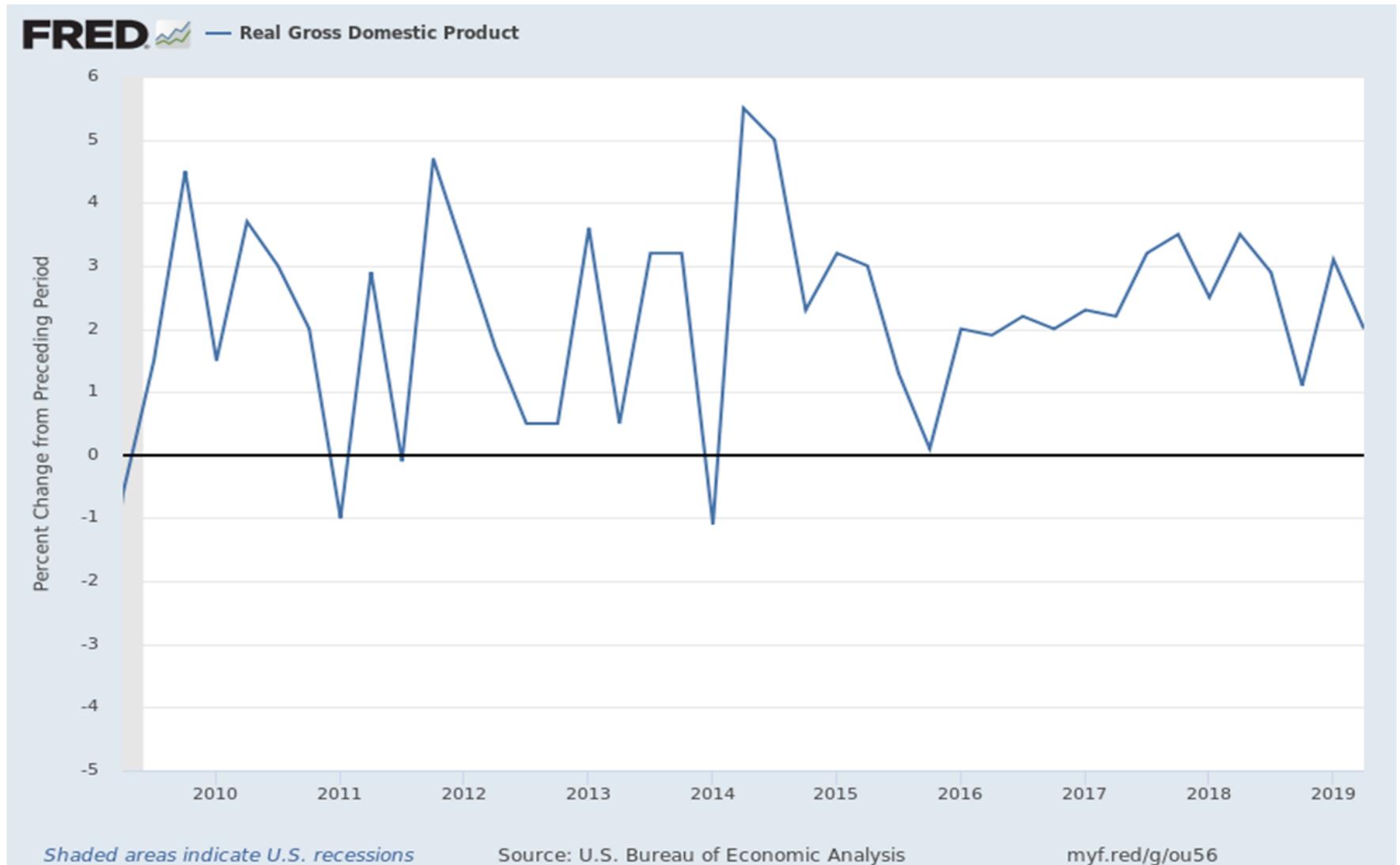
# Historical Economic Expansions



Source: BEA, NBER, J.P. Morgan Asset Management. \*Chart assumes current expansion started in July 2009 and continued through September 2019, lasting 123 months so far. Data for length of economic expansions and recessions obtained from the National Bureau of Economic Research (NBER). These data can be found at [www.nber.org/cycles/](http://www.nber.org/cycles/) and reflect information through September 2019. Past performance is not a reliable indicator of current and future results.  
*Guide to the Markets – U.S.* Data are as of September 30, 2019.

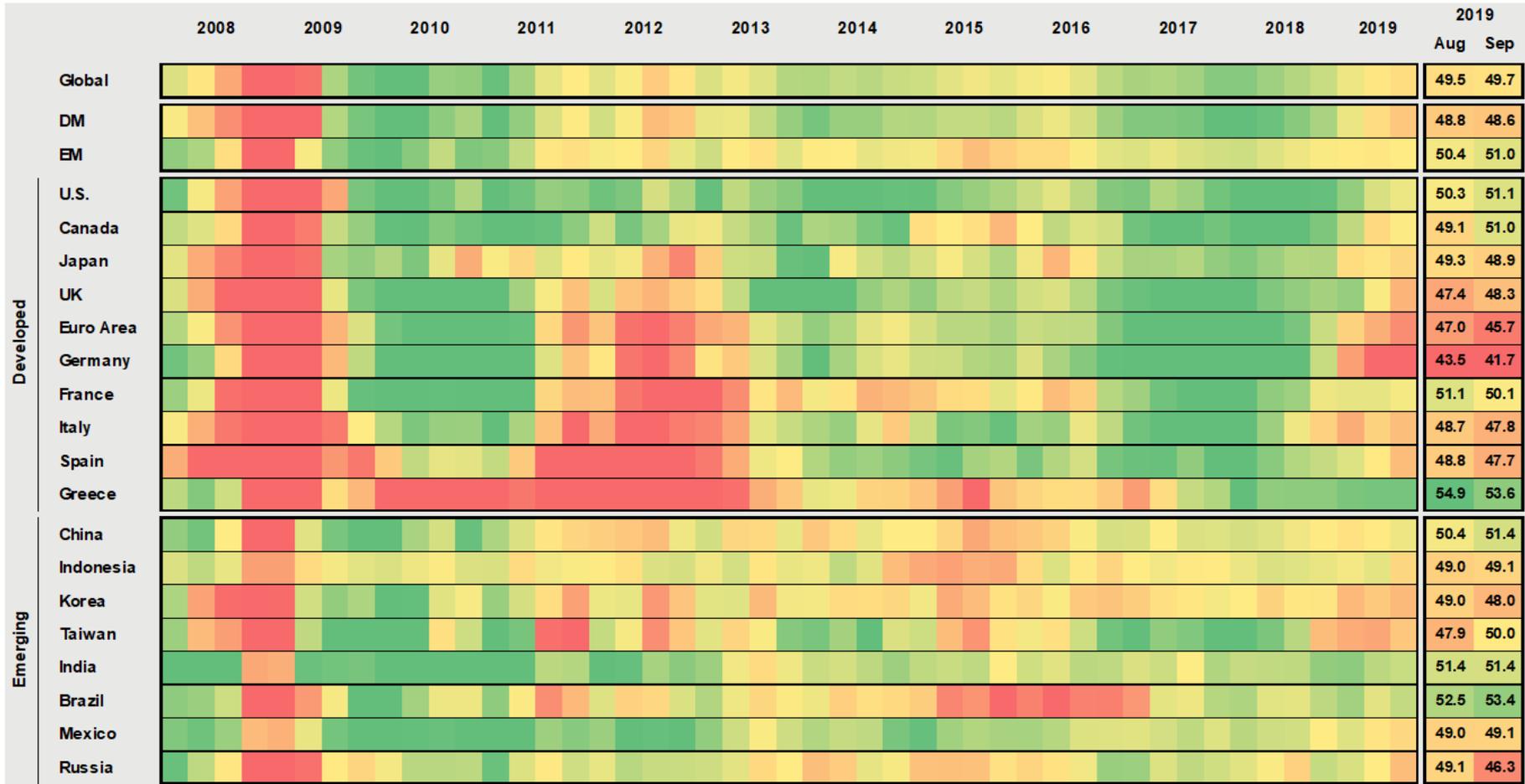


# GDP Growth – More of the same or slowing?



# Global Manufacturing

Global Purchasing Managers' Index for manufacturing, quarterly



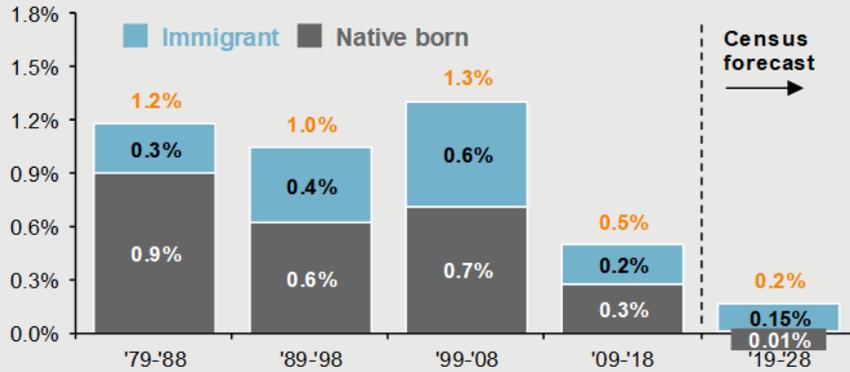
- Conditions not as favorable globally. The U.S. ISM Manufacturing index has dropped to 47.8, the lowest level in 10 years - trade issues may be flowing through...



# Long-Term Drivers of GDP Growth

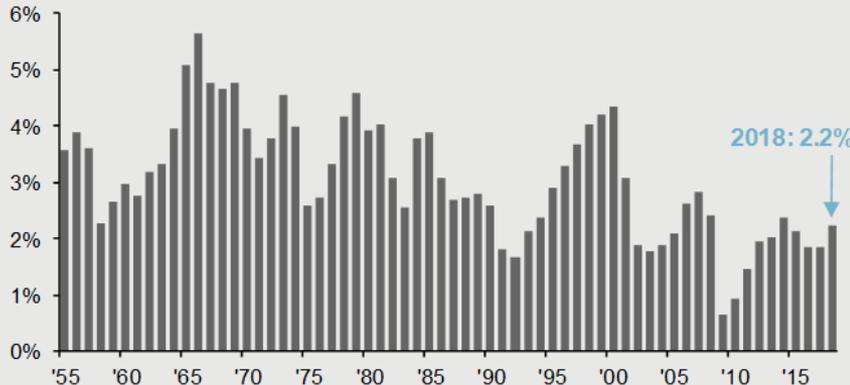
## Growth in working-age population

Percent increase in civilian non-institutional population ages 16-64



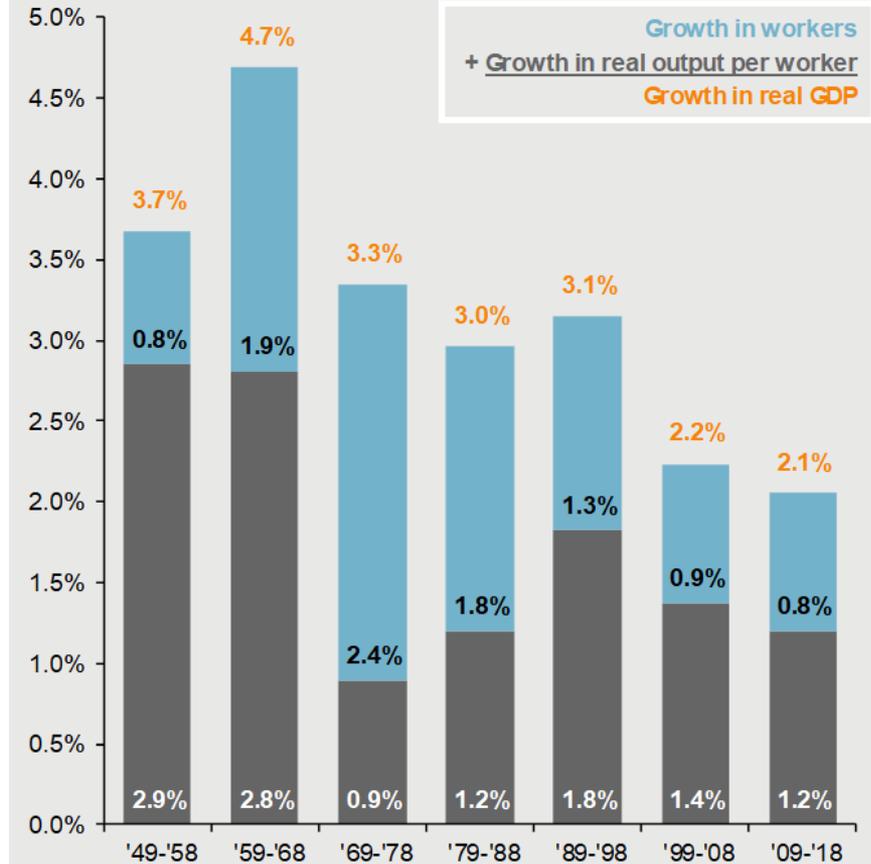
## Growth in private non-residential capital stock

Non-residential fixed assets, year-over-year % change



## Drivers of GDP growth

Average year-over-year % change



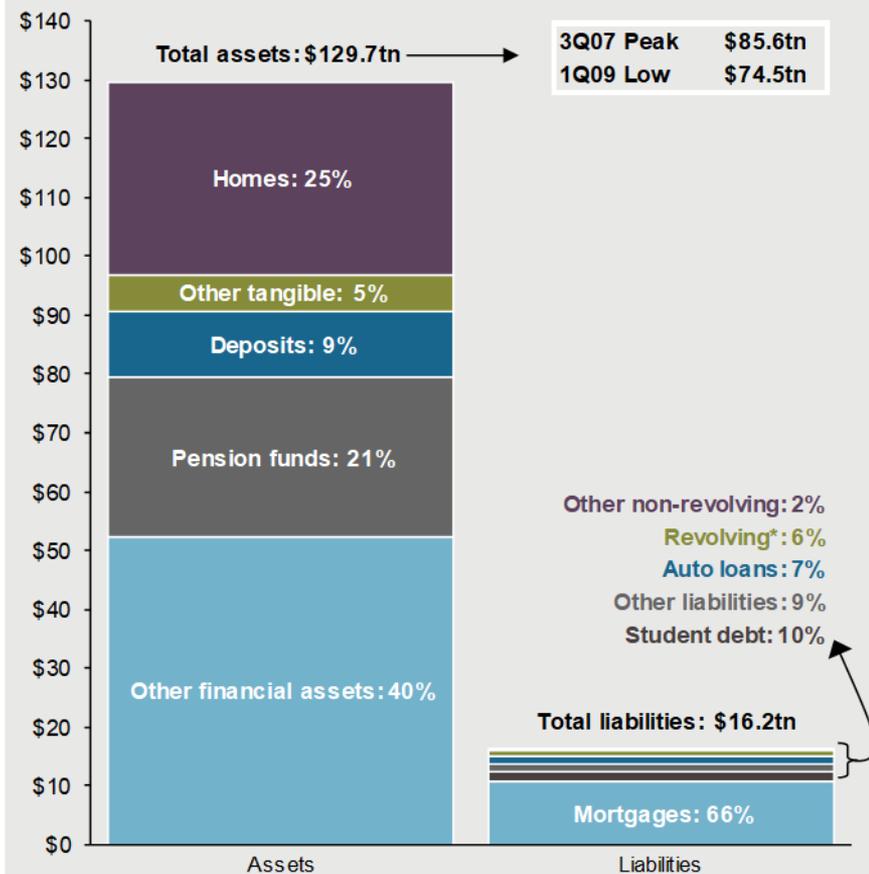
Source: J.P. Morgan Asset Management; (Top left) Census Bureau, DOD, DOJ; (Top left and right) BLS; (Right and bottom left) BEA. GDP drivers are calculated as the average annualized growth in the 10 years ending in 4Q18. Future working-age population is calculated as the total estimated number of Americans from the Census Bureau, per the September 2018 report, controlled for military enrollment, growth in institutionalized population and demographic trends. Growth in working-age population does not include illegal immigration; DOD Troop Readiness reports used to estimate percent of population enlisted. Numbers may not sum due to rounding. *Guide to the Markets*—U.S. Data are as of September 30, 2019.



# GDP Growth & Components – Falls to the consumer....

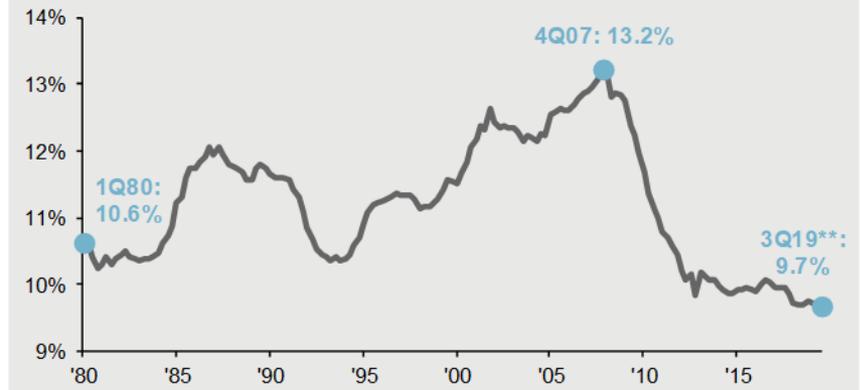
## Consumer balance sheet

2Q19, trillions of dollars outstanding, not seasonally adjusted



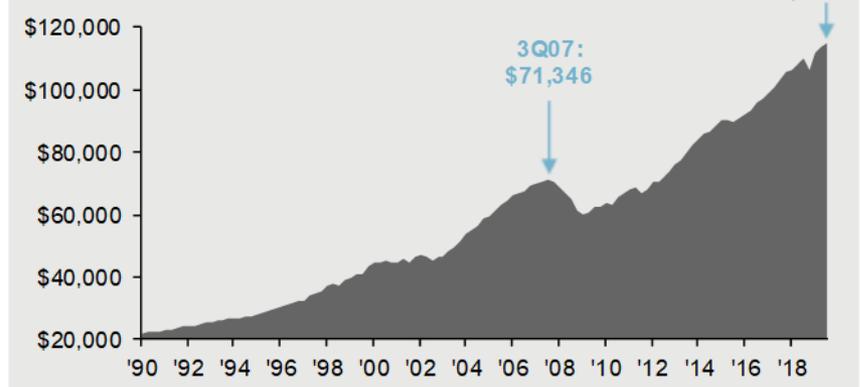
## Household debt service ratio

Debt payments as % of disposable personal income, SA



## Household net worth

Not seasonally adjusted, USD billions



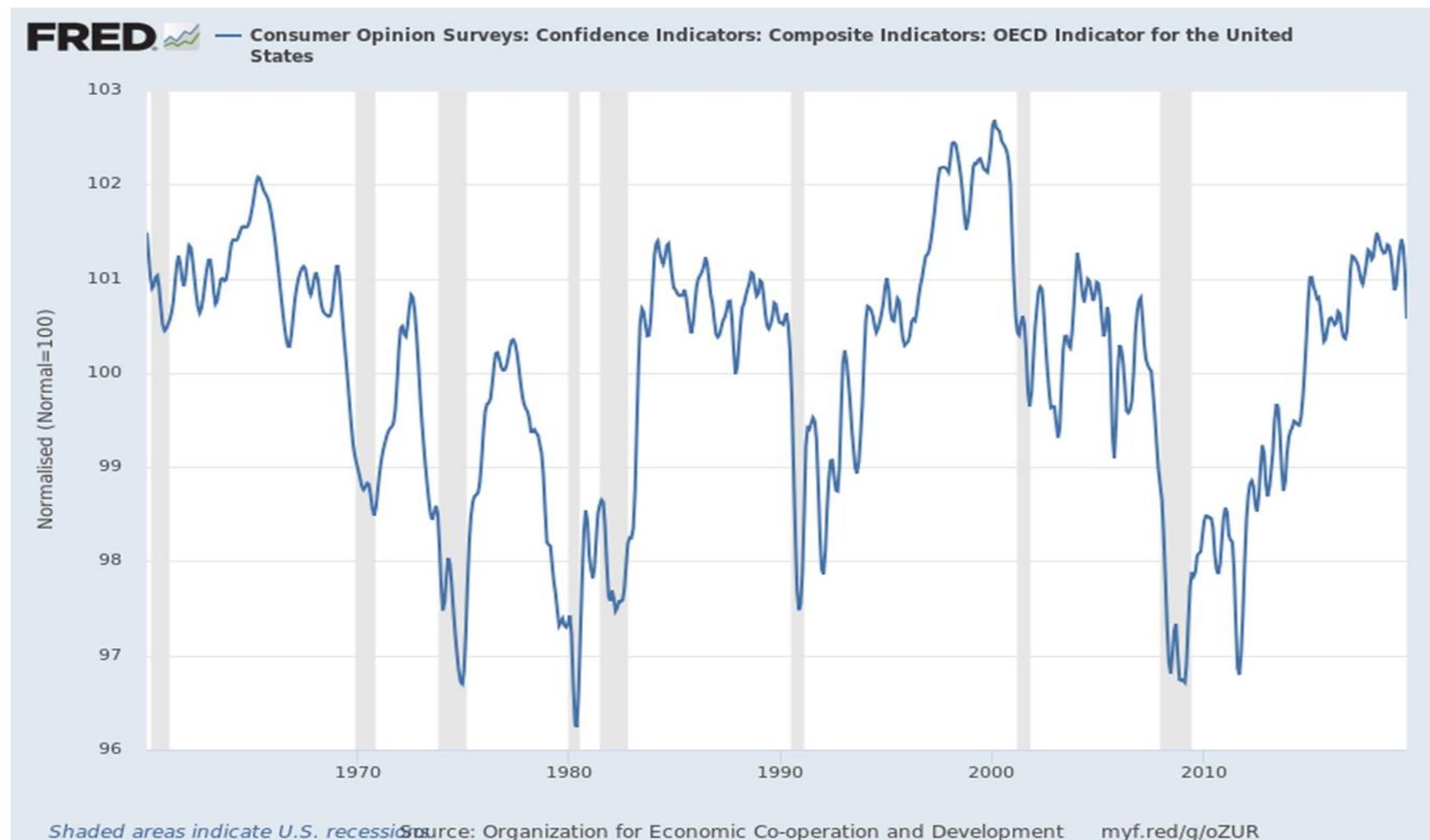
Source: FactSet, FRB, J.P. Morgan Asset Management; (Top and bottom right) BEA.

Data include households and nonprofit organizations. SA – seasonally adjusted. \*Revolving includes credit cards. Values may not sum to 100% due to rounding. \*\*3Q19 figures for debt service ratio and household net worth are J.P. Morgan Asset Management estimates.

Guide to the Markets – U.S. Data are as of September 30, 2019.



# Consumer Confidence – A Key Component



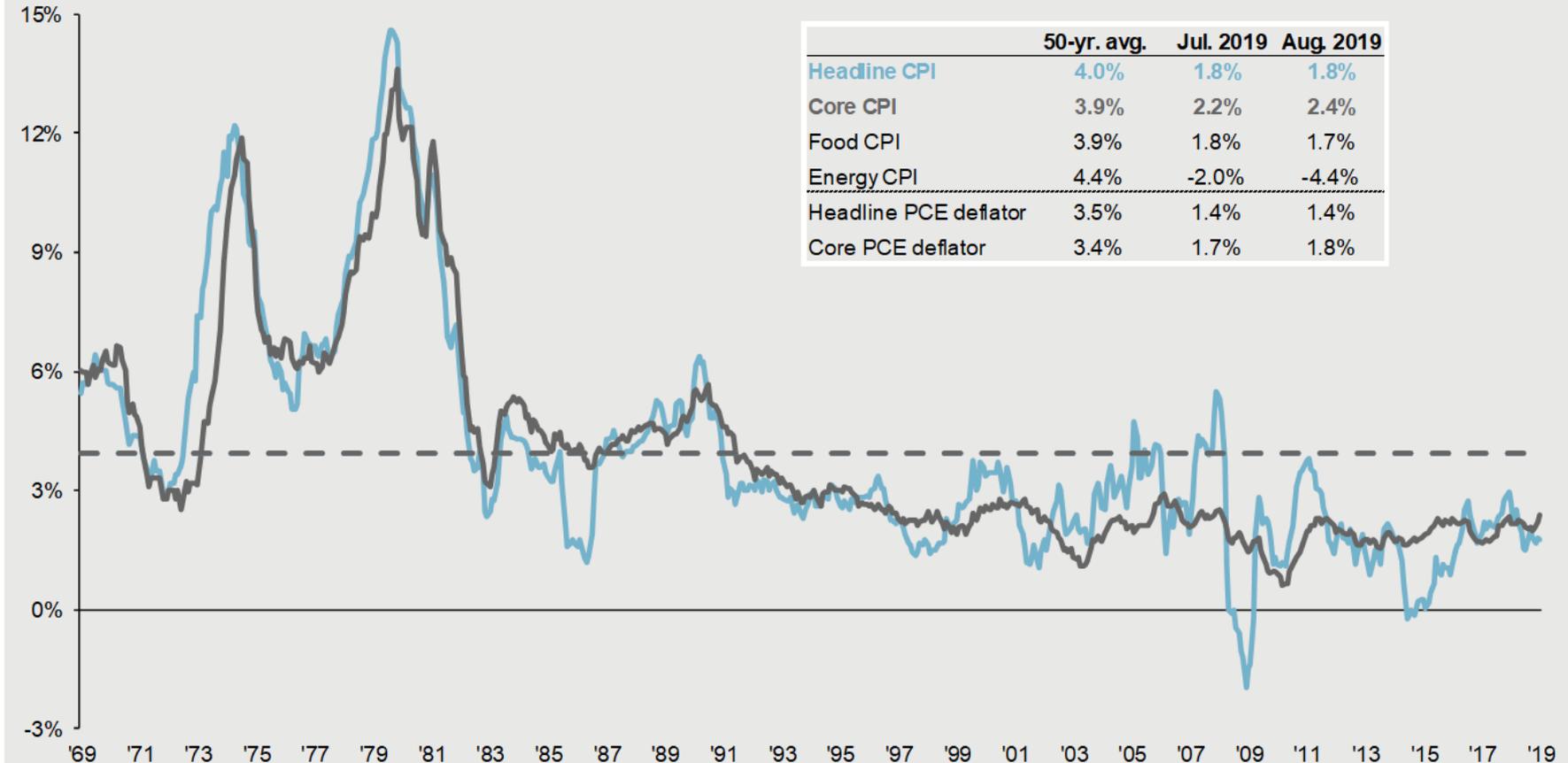
- Confidence has been strong the U.S. but uncertainty related to the trade wars, the election and other issues could take its toll.



# Inflation – Still below the Fed’s target

## CPI and core CPI

% change vs. prior year, seasonally adjusted



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

CPI used is CPI-U and values shown are % change vs. one year ago. Core CPI is defined as CPI excluding food and energy prices. The Personal Consumption Expenditure (PCE) deflator employs an evolving chain-weighted basket of consumer expenditures instead of the fixed-weight basket used in CPI calculations.

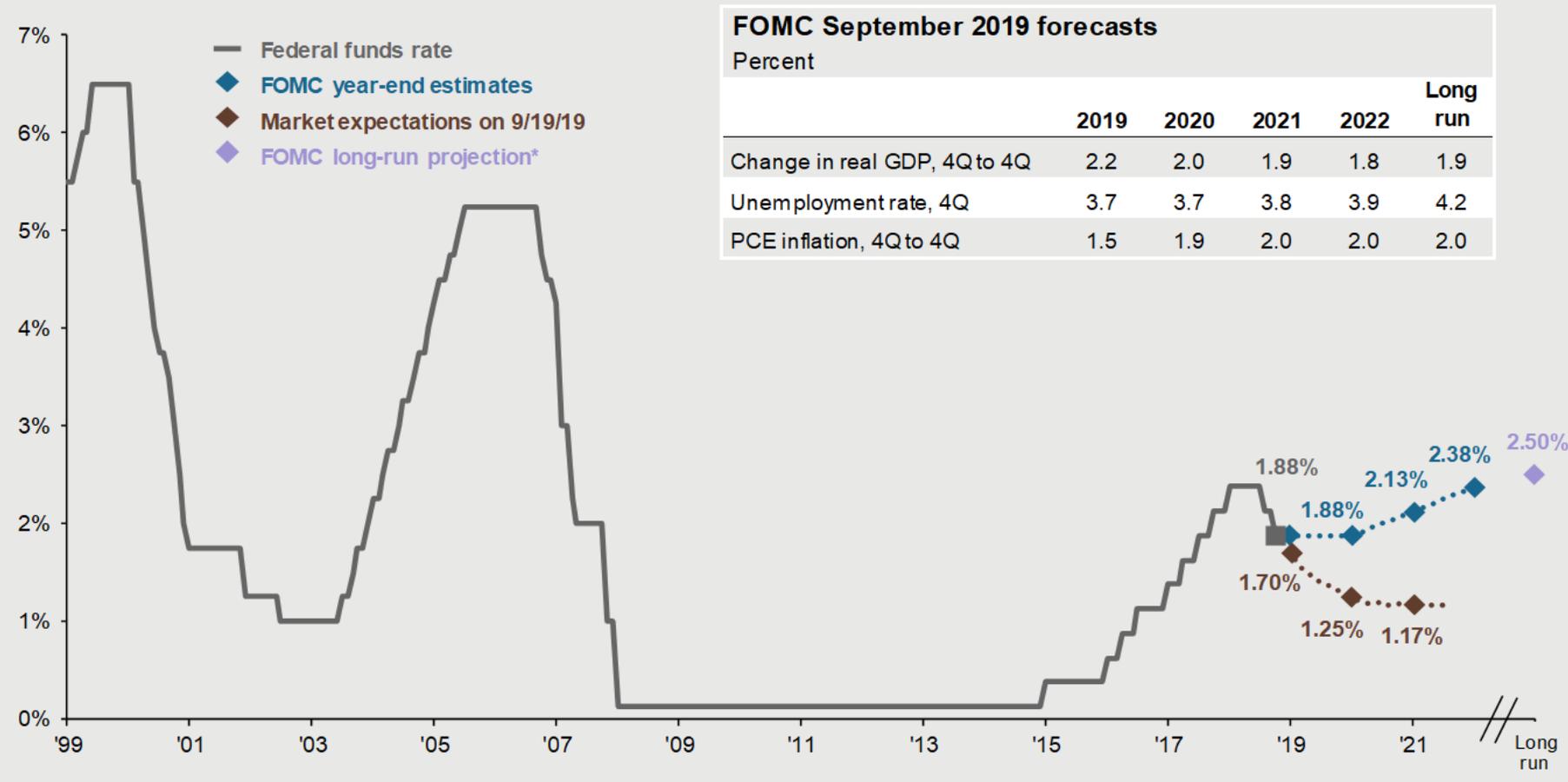
Guide to the Markets – U.S. Data are as of September 30, 2019.



# FOMC Estimates – Complete Reversal

## Federal funds rate expectations

FOMC and market expectations for the federal funds rate



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

Market expectations are the federal funds rates priced into the fed futures market as of the following date of the September 2019 FOMC meeting and are through August 2022. \*Long-run projections are the rates of growth, unemployment and inflation to which a policymaker expects the economy to converge over the next five to six years in absence of further shocks and under appropriate monetary policy.

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## FINANCIAL MARKETS



# Historical Asset Class Returns

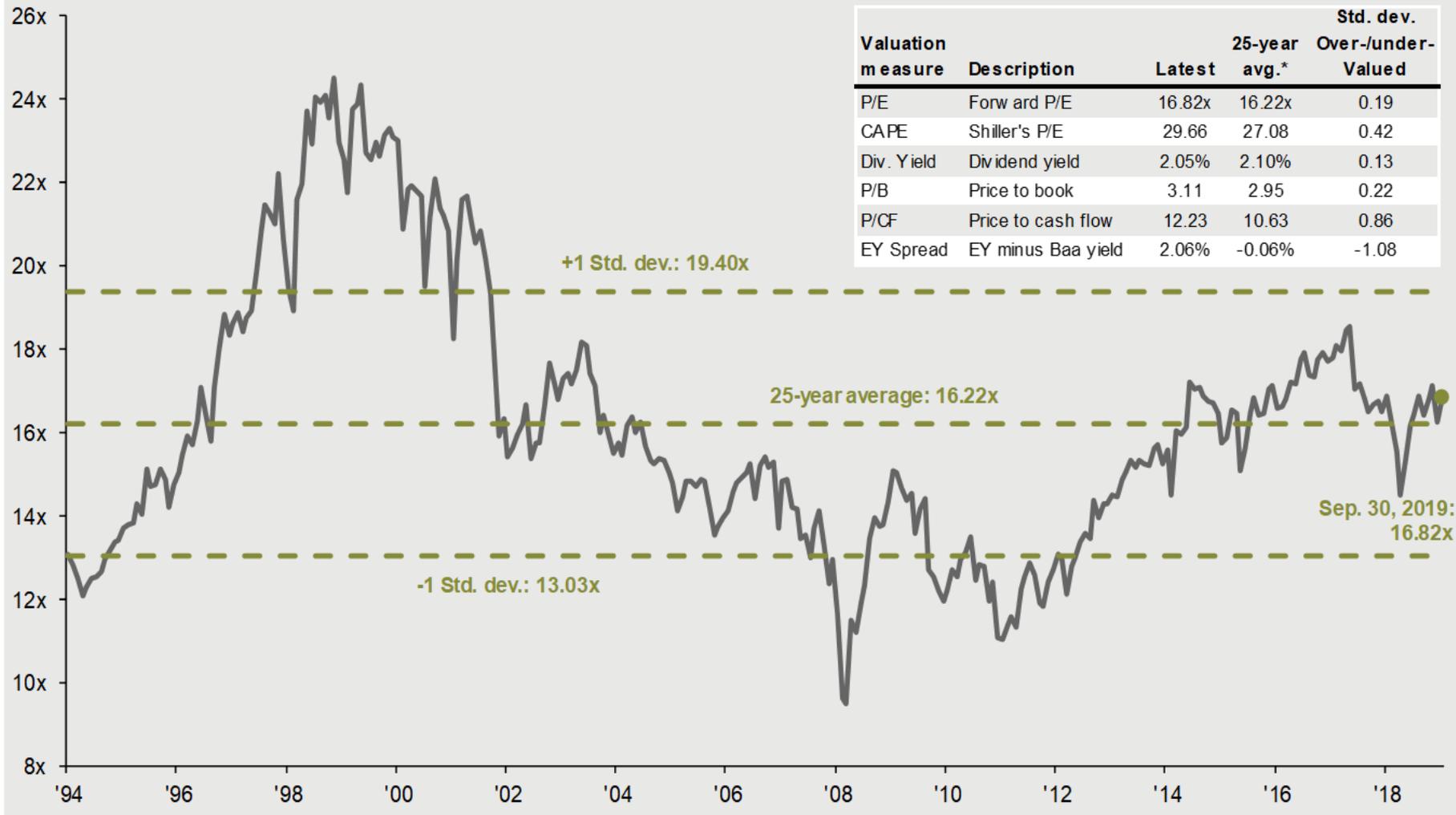


																2004 - 2018	
2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	YTD	Ann.	Vol.
REITs 31.6%	EM Equity 34.5%	REITs 35.1%	EM Equity 39.8%	Fixed Income 5.2%	EM Equity 79.0%	REITs 27.9%	REITs 8.3%	REITs 19.7%	Small Cap 38.8%	REITs 28.0%	REITs 2.8%	Small Cap 21.3%	EM Equity 37.8%	Cash 1.8%	REITs 28.5%	REITs 8.5%	REITs 22.4%
EM Equity 26.0%	Comdty. 21.4%	EM Equity 32.6%	Comdty. 16.2%	Cash 1.8%	High Yield 59.4%	Small Cap 26.9%	Fixed Income 7.8%	High Yield 19.6%	Large Cap 32.4%	Large Cap 13.7%	Large Cap 1.4%	High Yield 14.3%	DM Equity 25.6%	Fixed Income 0.0%	Large Cap 20.6%	EM Equity 8.3%	EM Equity 22.1%
DM Equity 20.7%	DM Equity 14.0%	DM Equity 26.9%	DM Equity 11.6%	Asset Alloc. -25.4%	DM Equity 32.5%	EM Equity 19.2%	High Yield 3.1%	EM Equity 18.6%	DM Equity 23.3%	Fixed Income 6.0%	Fixed Income 0.5%	Large Cap 12.0%	Large Cap 21.8%	REITs -4.0%	Small Cap 14.2%	Large Cap 7.8%	Small Cap 18.6%
Small Cap 18.3%	REITs 12.2%	Small Cap 18.4%	Asset Alloc. 7.1%	High Yield -26.9%	REITs 28.0%	Comdty. 16.8%	Large Cap 2.1%	DM Equity 17.9%	Asset Alloc. 14.9%	Asset Alloc. 5.2%	Cash 0.0%	Comdty. 11.8%	Small Cap 14.6%	High Yield -4.1%	DM Equity 13.3%	Small Cap 7.5%	Comdty. 18.6%
High Yield 13.2%	Asset Alloc. 8.1%	Large Cap 15.8%	Fixed Income 7.0%	Small Cap -33.8%	Small Cap 27.2%	Large Cap 15.1%	Cash 0.1%	Small Cap 16.3%	High Yield 7.3%	Small Cap 4.9%	DM Equity -0.4%	EM Equity 11.6%	Asset Alloc. 14.6%	Large Cap -4.4%	Asset Alloc. 13.1%	High Yield 7.3%	DM Equity 17.6%
Asset Alloc. 12.8%	Large Cap 4.9%	Asset Alloc. 15.3%	Large Cap 5.5%	Comdty. -35.6%	Large Cap 26.5%	High Yield 14.8%	Asset Alloc. -0.7%	Large Cap 16.0%	REITs 2.9%	Cash 0.0%	Asset Alloc. -2.0%	REITs 8.6%	High Yield 10.4%	Asset Alloc. -5.8%	High Yield 8.8%	Asset Alloc. 6.2%	Large Cap 14.5%
Large Cap 10.9%	Small Cap 4.6%	High Yield 13.7%	Cash 4.8%	Large Cap -37.0%	Asset Alloc. 25.0%	Asset Alloc. 13.3%	Small Cap -4.2%	Asset Alloc. 12.2%	Cash 0.0%	High Yield 0.0%	High Yield -2.7%	Asset Alloc. 8.3%	REITs 8.7%	Small Cap -11.0%	Fixed Income 8.5%	DM Equity 5.2%	High Yield 11.0%
Comdty. 9.1%	High Yield 3.6%	Cash 4.8%	High Yield 3.2%	REITs -37.7%	Comdty. 18.9%	DM Equity 8.2%	DM Equity -11.7%	Fixed Income 4.2%	Fixed Income -2.0%	EM Equity -1.8%	Small Cap -4.4%	Fixed Income 2.6%	Fixed Income 3.5%	Comdty. -11.2%	EM Equity 6.2%	Fixed Income 3.9%	Asset Alloc. 10.3%
Fixed Income 4.3%	Cash 3.0%	Fixed Income 4.3%	Small Cap -1.6%	DM Equity -43.1%	Fixed Income 5.9%	Fixed Income 6.5%	Comdty. -13.3%	Cash 0.1%	EM Equity -2.3%	DM Equity -4.5%	EM Equity -14.6%	DM Equity 1.5%	Comdty. 1.7%	DM Equity -13.4%	Comdty. 3.1%	Cash 1.3%	Fixed Income 3.3%
Cash 1.2%	Fixed Income 2.4%	Comdty. 2.1%	REITs -15.7%	EM Equity -53.2%	Cash 0.1%	Cash 0.1%	EM Equity -18.2%	Comdty. -1.1%	Comdty. -9.5%	Comdty. -17.0%	Comdty. -24.7%	Cash 0.3%	Cash 0.8%	EM Equity -14.2%	Cash 1.8%	Comdty. -2.5%	Cash 0.8%



# S&P 500 – Valuations

S&P 500 Index: Forward P/E ratio





## APPENDIX – ABOUT SAA



# Who We Are

## Alton Cogert, President & CEO



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**Email:**  
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- **Alton R. Cogert, CFA, CPA, CAIA, CGMA, President and Chief Executive Officer**, founded Strategic Asset Alliance in 1994.
- Mr. Cogert has written several articles for BestWeek, including: “Piercing the Seven Deadly Myths of Insurance Investing,” “Achieving Higher Risk Adjusted Returns,” “Outside Money Managers Performance Depends Upon How Well They’re Managed,” “The Search for a Truly Customized Investment Benchmark,” and “The Roller Coaster Ride Of Interest Rates: How To Protect Against Falling Off The Track.”
- He has served as a technical advisor to the NAIC Invested Assets Working Group. He is a former member of the Board of Directors and former chairman of the Investment Committee of the National Alliance of Life Companies. He has been a guest lecturer at the University of Texas, and is editor of Insurer Investment Strategies.
- Prior to founding SAA, Mr. Cogert accumulated more than twenty years of financial institution experience, including over ten years experience in senior financial management. He is a Chartered Financial Analyst, a Certified Public Accountant and a Chartered Alternative Investment Analyst. Mr. Cogert holds a BS from the Wharton School of the University of Pennsylvania and an MBA from the University of Southern California.



# Who We Are

## Daniel Smereck, Managing Director



**Phone:**

(207) 706-9288

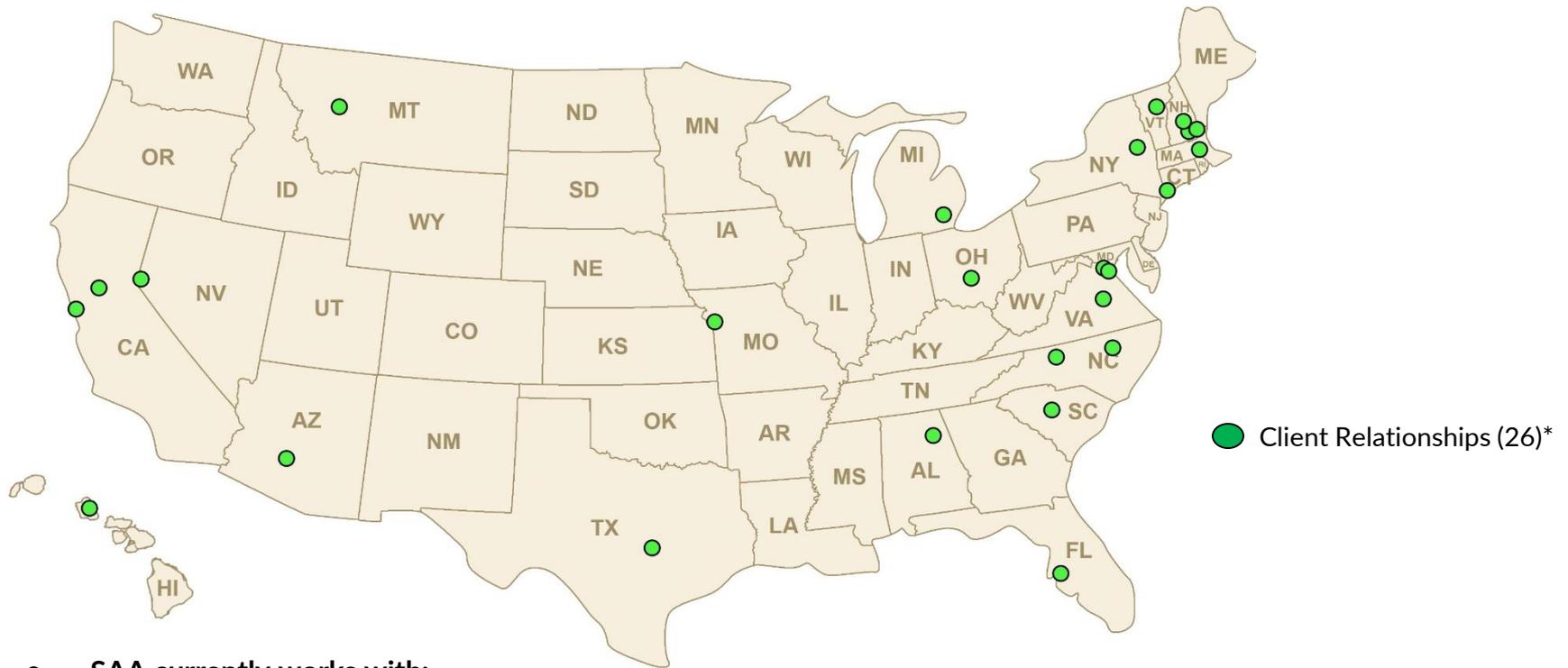
**Email:**

[dsmereck@saai.com](mailto:dsmereck@saai.com)

- **Daniel G. Smereck, Managing Director**, is the primary consultant for SAA's governmental risk pooling clients. Mr. Smereck has over twenty years of experience across investments, insurance, corporate finance, statistical analysis, and information technology.
- Prior to joining Strategic Asset Alliance in 2003, Mr. Smereck was Senior Vice President and Chief Investment/Information Officer for a large, regional medical malpractice insurer where he was responsible for treasury, asset management and information technology.
- Mr. Smereck has a BS in Managerial Finance, and an MBA from the University of Nevada, Las Vegas, and an MS in Finance from the Carroll School of Management, Boston College.



# Who We Work With



- **SAA currently works with:**
  - 46 Insurance Companies within 26 Client Relationships w/ ~\$7.8 Billion in Invested Assets\*
- **Since SAA's inception in 1994, we have worked with:**
  - More than 100 clients across the insurance industry including Life, Health, P&C, State Regulators, Rating Agencies, Reinsurance and Governmental Risk Pooling organizations



# What Services Do You Receive?

## Summary of Deliverables

<b>SWOT Analysis</b>		Initial SWOT Analysis of the investment process, providing blueprint and priority ranking for improvement
<b>Asset Allocation</b>		Advice on the current investment asset allocation and risk profiles, subject to current insurance regulations
<b>Policy Review</b>		Review, consultation and recommendations about the client's investment policy and guidelines
<b>Benchmarking</b>		Advice on establishing benchmarks for the various investment managers
<b>Ongoing Monitoring</b>		Ongoing monitoring of investment portfolio holdings and risks
<b>Manager Evaluation</b>		Review, consultation and recommendations about the performance of the investment managers
<b>Performance Reviews</b>		Performance reporting and monthly/quarterly review with management
<b>On-site Attendance</b>		Attendance and performance reporting at Finance/Investment Committee meetings
<b>Manager Selection</b>		Recommendations and assistance in selecting outside investment managers, when/if necessary.
<b>Peer Analysis</b>		Development of an annual peer group analysis
<b>Ad Hoc Analysis</b>		Ad hoc investment related analysis as necessary



# Our Investment Philosophy

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## Investment Process

- Asset allocation drives the great majority of returns based on historical studies
- Accountability & Transparency is key within the overall process



## Active Management Makes Sense for Fixed Income Mandates Due to:

- The less efficient nature of the asset class due to its over the counter structure
- The necessary customization involved in managing insurer fixed income portfolios



## Passive Management Makes Sense for Developed Market Equity Mandates

- In general, passive management makes more sense for developed market equity mandates (Large Cap, Mid Cap, Small Cap) due to:
  - The greater level of efficiency in these markets
  - The higher level of fees associated with managing active equity mandates
  - The difficulty in outperforming benchmarks given the fee drag and adjusting for risk



## In general, we don't believe alternatives such as hedge funds, private equity, etc., make sense for insurers due to:

- The high level of fees, potential lack of liquidity, agency problems and impact to capital ratios

