Capital Markets Review
First Quarter 2021

STRATEGIC ASSET ALLIANCE
THE INSURANCE INVESTMENT SPECIALIST

REVIEW

Summary Capital Market Commentary – 1st Quarter 2021

- GLOBAL FINANCIAL MARKETS – EQUITIES
  - US equities gained during Q1, despite starting uncertainly. Unusual, highly targeted trading activity saw markets rattled in January (i.e. Robinhooders), before recovering as optimism over significant government stimulus took root. President Biden first confirmed a fiscal stimulus package of $1.9 trillion, which was followed up with an additional promise of $2 trillion in infrastructure spending. Energy, financials and industrials made strong gains while technology and consumer staples lagged.
  - European equities advanced in Q1. Hopes of global economic recovery supported sectors that fared poorly in 2020, such as energy and financials. Consumer discretionary stocks also performed well, notably car makers as Volkswagen announced ambitious electric vehicle targets. Underperformers were defensive areas that are less tied into the economic recovery, such as utilities and real estate. The flash manufacturing purchasing manager's index (PMI) for March reached a record high of 62.4, signaling strong growth (a reading above 50 signals expansion). However, rising Covid infection rates in some countries, and new lockdown curbs, cast doubt on the prospects for services, notably tourism.
  - Emerging market equities registered a positive return in Q1. This was despite weakness later in the quarter as EM vaccine programs lagged developed markets. A pick-up in daily new cases of Covid-19 led to renewed activity restrictions in some countries. Meanwhile, a marked increase in US Treasury bond yields pressured higher growth areas of the equity markets and accompanying US dollar strength was also a headwind for EM.

Source: Schroders & SAA

Summary Capital Market Commentary – 1st Quarter 2021

- GLOBAL FINANCIAL MARKETS – FIXED INCOME
  - Bond yields rose (prices fell) markedly in Q1 amid the swift continued rollout of Covid-19 vaccinations, expectations of a large US economic stimulus, and the specter of inflation.
    - The 10-year US Treasury yield rose from 0.91% to 1.74%, while the 2-year yield rose only modestly. From a total return perspective, the U.S. Treasury index was down 4.25% on the quarter – the worst quarterly return since the early 1980s when Paul Volker broke inflation's back by raising the Federal Funds Target Rate to 20%.
    - With broad consensus for economic improvement, some market participants have become concerned about the prospects for inflation and consequently for its impact to Fed policy that, for now, has clearly signaled low rates through 2023. Currently, the Fed's expectations for inflation remains moderate with projections of 2.2% core inflation in 2021, 2.1% in 2022 and a 2.0% long-run rate.
    - The more positive economic projections did not alter the Fed's stance on the current need for accommodation. As expected, the Fed did not raise the Fed Funds rate, nor did it alter the current pace of asset purchases.
    - Corporate bonds outperformed government bonds. Investment grade made negative total returns, the US dollar market particularly, as yields rose. High yield produced moderate positive returns amid healthy risk appetite and rising growth expectations.

Source: Schroders & SAA

Capital Markets' Performance

Index	Asset Class	Jan-21	Feb-21	Mar-21	1st QTR	Trailing 1 Yr	Trailing 3 Yr	Trailing 5 Yr
S&P GSCI Crude Oil	U.S. Equity	7.52%	18.07%	-3.70%	**22.26%**	46.27%	-21.90%	-8.22%
Alerian MLP	Master Limited Partnerships	5.84%	7.77%	6.91%	**21.95%**	103.13%	-2.98%	-1.30%
S&P SmallCap 600	U.S. Equity	6.29%	7.65%	3.33%	**18.24%**	95.33%	13.71%	15.60%
S&P GSCI Commodities	U.S. Equity	4.94%	10.58%	-2.15%	**13.55%**	50.22%	-4.93%	1.18%
S&P MidCap 400	U.S. Equity	1.50%	6.80%	4.67%	**13.47%**	83.46%	13.40%	14.37%
S&P Composite 1500 Value	U.S. Equity	-1.21%	6.29%	6.27%	**11.59%**	53.82%	11.84%	12.40%
Dow Jones U.S. Select REIT	U.S. Real Estate	-0.20%	5.33%	4.64%	**10.00%**	36.66%	7.55%	3.94%
Dow Jones Industrial Average	U.S. Equity	-1.95%	3.43%	6.78%	**8.29%**	53.78%	13.61%	15.99%
S&P Composite 1500	U.S. Equity	-0.68%	3.13%	4.37%	**6.91%**	58.73%	16.47%	16.15%
S&P 500	U.S. Equity	-1.01%	2.76%	4.38%	**6.17%**	56.35%	16.78%	16.29%
MSCI World Index	U.S. Equity	-0.97%	2.60%	3.38%	**5.04%**	54.76%	13.42%	13.98%
MSCI World Ex. US Index	World Equity	-1.05%	2.57%	2.64%	**4.17%**	46.51%	6.88%	9.48%
MSCI EAFE Index	International Equity	-1.06%	2.26%	2.40%	**3.60%**	45.15%	6.54%	9.37%
MSCI EAFE (Net)	International Equity	-1.07%	2.24%	2.30%	**3.48%**	44.57%	6.02%	8.85%
BofA Merrill Lynch US Convertibles	U.S. Convertible Bond	3.03%	3.08%	-3.15%	**2.87%**	74.13%	21.87%	18.78%
S&P Composite 1500 Growth	U.S. Equity	-0.20%	0.35%	2.59%	**2.74%**	60.98%	20.03%	19.04%
MSCI EM (Emerging Markets)	World Equity	3.09%	0.77%	-1.49%	**2.34%**	58.92%	6.87%	12.48%
S&P/LSTA US Leveraged Loan Index	U.S. Fixed Income	1.19%	0.59%	0.00%	**1.78%**	20.71%	4.13%	5.28%
Barclays Capital U.S. Corporate High Yield	U.S. Fixed Income	0.33%	0.37%	0.15%	**0.85%**	23.72%	6.84%	8.06%
Citigroup 3-month T-bill	**Cash/Cash Equivalent**	0.01%	0.01%	0.01%	**0.02%**	0.21%	1.45%	1.15%
Barclays Capital Municipal Bond	U.S. Fixed Income	0.64%	-1.59%	0.62%	**-0.35%**	5.51%	4.91%	3.49%
Barclays U.S. Treasury: U.S. TIPS	U.S. Fixed Income	0.33%	-1.61%	-0.19%	**-1.47%**	7.54%	5.68%	3.86%
Barclays Intermediate U.S. Government/Credit	U.S. Fixed Income	-0.28%	-0.82%	-0.78%	**-1.86%**	2.01%	4.36%	2.75%
5-Year US Treasury	U.S. Treasury	-0.33%	-1.49%	-0.60%	**-2.41%**	-1.91%	4.34%	2.04%
Barclays Capital U.S. Aggregate	U.S. Fixed Income	-0.72%	-1.44%	-1.25%	**-3.37%**	0.71%	4.65%	3.10%
Barclays U.S. Government/Credit	U.S. Fixed Income	-1.04%	-1.76%	-1.54%	**-4.28%**	0.86%	4.99%	3.36%
Merrill Lynch US Treasury Master	U.S. Fixed Income	-1.12%	-2.29%	-1.26%	**-4.61%**	-5.11%	4.07%	2.22%
Barclays Capital U.S. Corporate Investment Grade	U.S. Fixed Income	-1.28%	-1.72%	-1.72%	**-4.65%**	8.73%	6.20%	4.91%
Citigroup WorldBIG Index	World Fixed Income	-1.00%	-1.87%	-1.90%	**-4.69%**	3.99%	2.82%	2.64%
10-Year US Treasury	U.S. Treasury	-1.62%	-3.16%	-2.50%	**-7.10%**	-8.23%	4.64%	1.70%

❖ **SAA VIEW: The support of historically huge monetary and growing fiscal stimuli worldwide continues to help combat economic uncertainty as well as backstop the global markets as we move through the Year of The Vaccination. However, some market participants have become increasingly concerned about the prospects for inflation which helped pushed fixed income yields markedly higher during Q1.**

Indices sorted high/low by Q1-2021 performance.

Source: Zephyr StyleAdvisor

Fixed Income Yields

Index YTW	12/31/2019	12/31/2020	2/28/2021	3/31/2021	Chg Prior Month	Chg Prior Qtr	Chg 12/31/2019
Aggregate	**2.31%**	**1.12%**	**1.42%**	**1.61%**	▲ **0.19%**	▲ **0.49%**	▼ **-0.70%**
Intermediate Aggregate	**2.14%**	**0.83%**	**1.11%**	**1.29%**	▲ **0.18%**	▲ **0.46%**	▼ **-0.85%**
U.S. Treasury	1.80%	0.57%	0.84%	1.00%	▲ 0.16%	▲ 0.43%	▼ -0.80%
U.S. 2-Yr Treasury	1.56%	0.12%	0.13%	0.16%	▲ 0.03%	▲ 0.04%	▼ -1.40%
U.S. 5-Yr Treasury	1.68%	0.36%	0.71%	0.93%	▲ 0.22%	▲ 0.57%	▼ -0.75%
U.S. 10-Yr Treasury	1.91%	0.91%	1.39%	1.74%	▲ 0.35%	▲ 0.83%	▼ -0.17%
U.S. 30-Yr Treasury	2.38%	1.64%	2.11%	2.40%	▲ 0.29%	▲ 0.76%	▲ 0.02%
U.S. Agency MBS	2.54%	1.25%	1.62%	1.82%	▲ 0.20%	▲ 0.57%	▼ -0.72%
ABS	2.05%	0.45%	0.47%	0.56%	▲ 0.09%	▲ 0.11%	▼ -1.49%
CMBS	2.48%	1.28%	1.50%	1.71%	▲ 0.21%	▲ 0.43%	▼ -0.77%
U.S. Credit	2.79%	1.68%	1.98%	2.19%	▲ 0.21%	▲ 0.51%	▼ -0.60%
A-Rated Corporates	2.64%	1.52%	1.84%	2.03%	▲ 0.19%	▲ 0.51%	▼ -0.61%
BBB-Rated Corporates	3.19%	2.04%	2.35%	2.52%	▲ 0.17%	▲ 0.48%	▼ -0.67%
Municipal Bond	1.78%	1.07%	1.27%	1.18%	▼ -0.09%	▲ 0.11%	▼ -0.60%
Taxable Municipal Bond	3.04%	2.10%	2.32%	2.49%	▲ 0.17%	▲ 0.39%	▼ -0.55%
U.S. High Yield	5.19%	4.18%	4.25%	4.23%	▼ -0.02%	▲ 0.05%	▼ -0.96%
Global Aggregate (USD)	1.45%	0.83%	1.08%	1.16%	▲ 0.08%	▲ 0.33%	▼ -0.29%
U.S. Agg. vs. Global Agg.	▲ **0.86%**	▲ **0.29%**	▲ **0.34%**	▲ **0.45%**	▲ **0.11%**	▲ **0.16%**	▼ **-0.41%**
Curve Steepness: UST 2yr-10yr Spread (bps)	**35.0**	**79.0**	**126.0**	**158.0**	▲ **32.0**	▲ **79.0**	▲ **123.0**

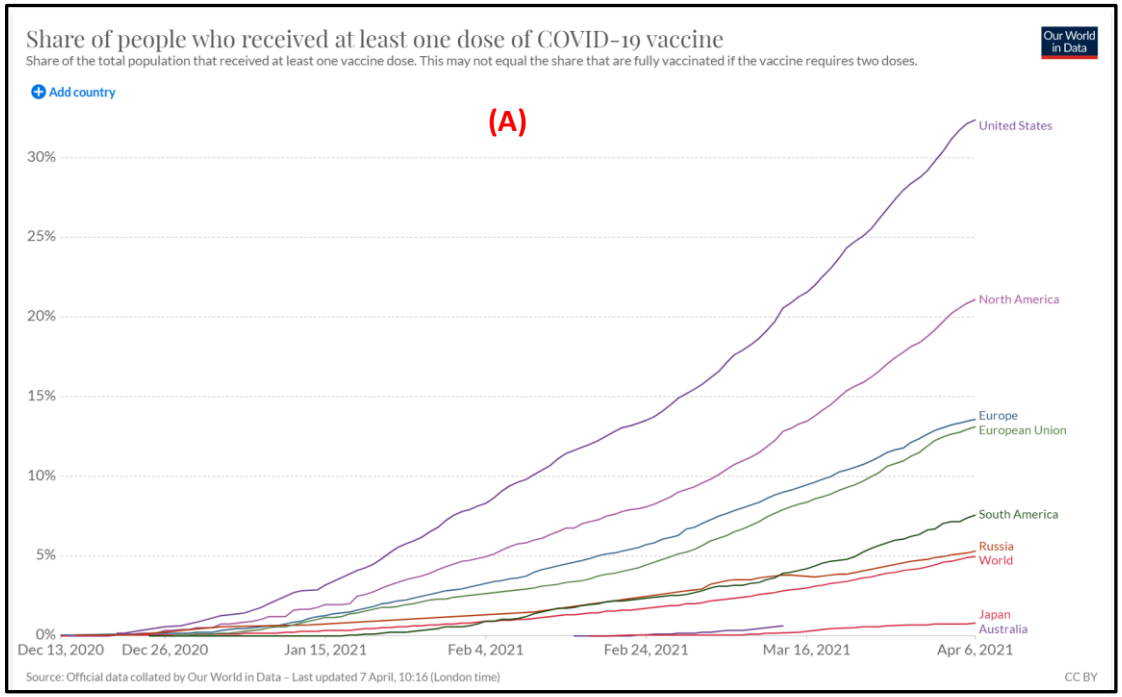
Source: Bloomberg Barclays Indices & BofA ICE Indices

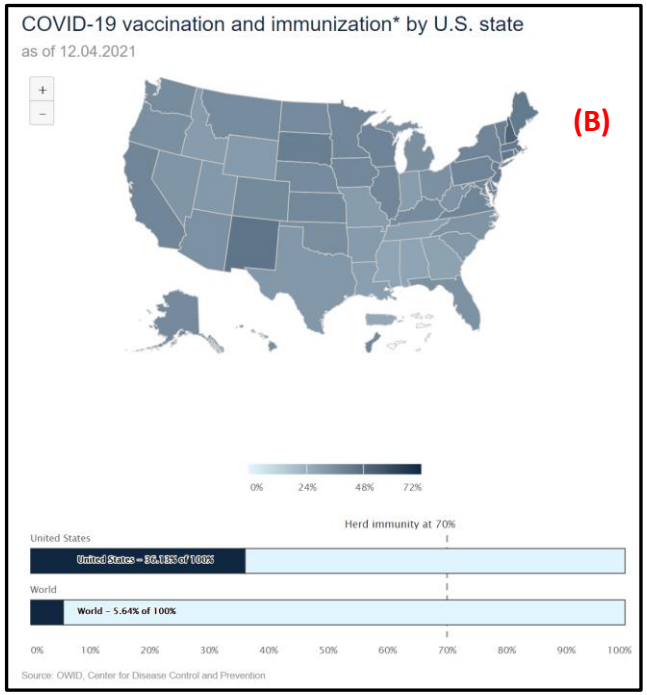
❖ **SAA VIEW: The U.S. is currently awash in fiscal stimulus with more expected via President Biden's infrastructure plan. Huge, prospective fiscal deficits and dramatically increasing money supply have some investors seeing the specter of inflation. Unclear as to whether unacceptable levels of inflation will materialize, fixed income markets were still spooked and pushed rates sharply higher during Q1 for longer-dated maturities (not directly controlled by Fed policy) with some variance by sector. While most fixed income sector total returns were negative for the quarter, reinvestment yields were significantly higher compared to 12/31/2020.**

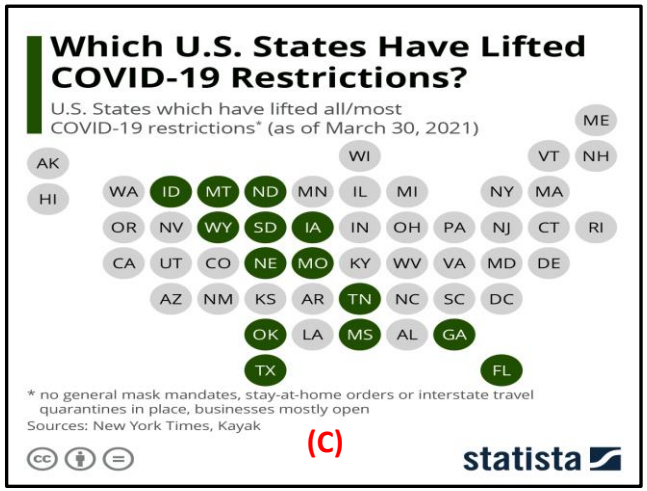
Source: Bloomberg Barclays & ICE Fixed Income Indices

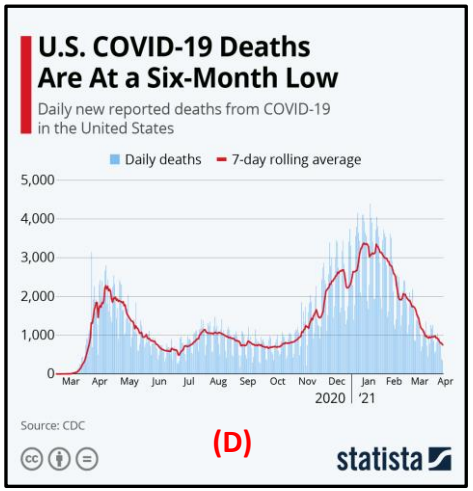
IMMEDIATE OUTLOOK

COVID-19 World/US Vaccination Update









SAA VIEW:

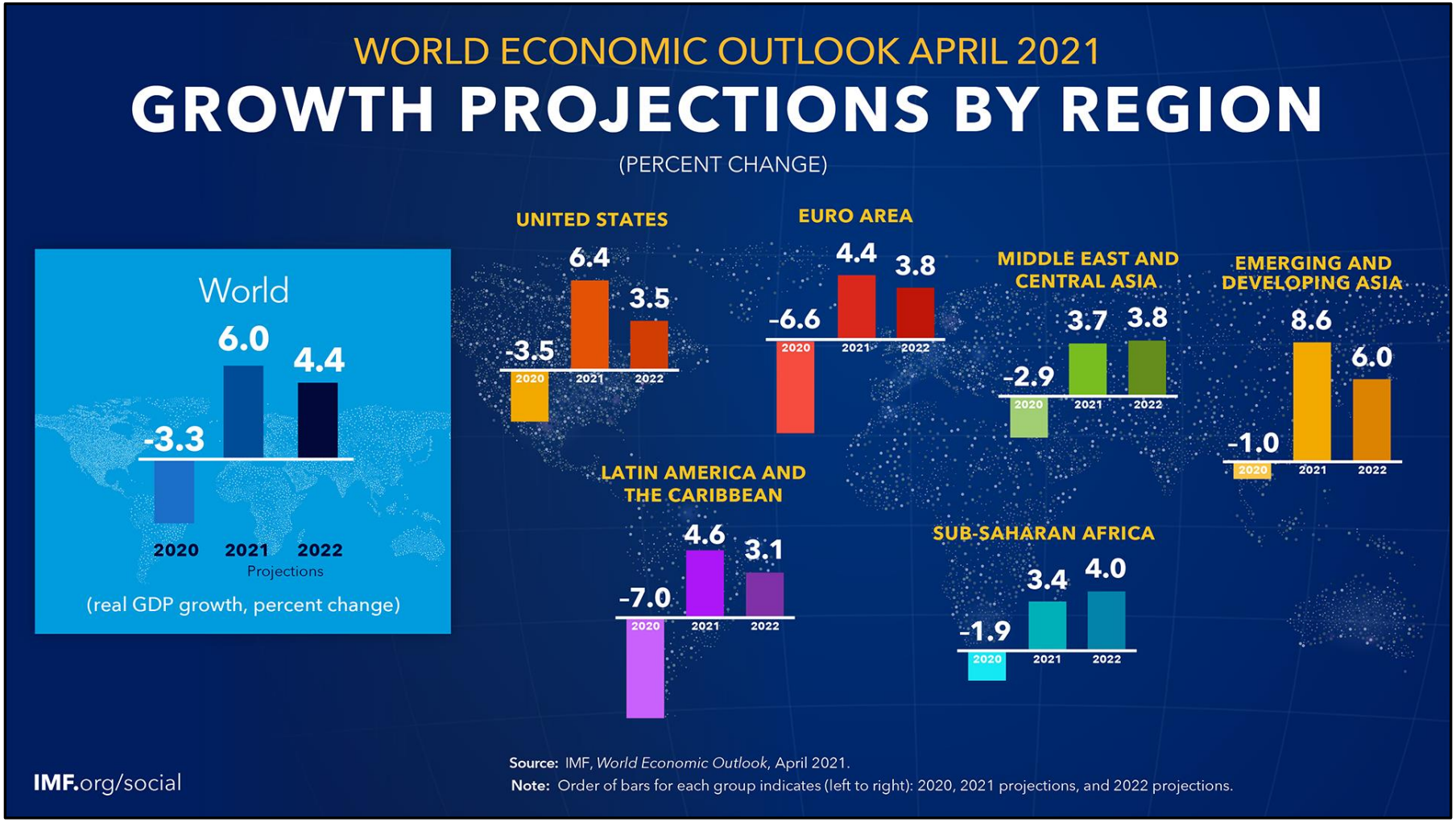
(A) What a difference 90 days makes as the U.S. went from nearly 0% to approximately 36% of the population receiving at least one vaccine dose.

(B) With the assumption that herd immunity is reached when 70% of the population is vaccinated, the U.S. is on pace to achieve this goal by late summer/early fall 2021.

(C & D) COVID fatigue, declining death rates, politics, and vaccination rates are all providing states varying degrees of motivation to lift COVID restrictions, reopen the economy, and hopefully avoid future COVID flare-ups.

Source: Statista, Our World In Data, OWID, CDC

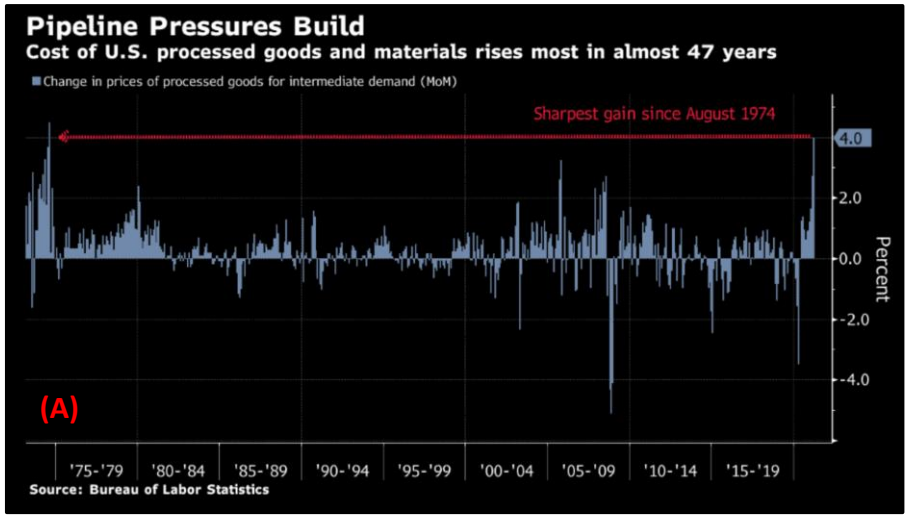
World Economic Outlook

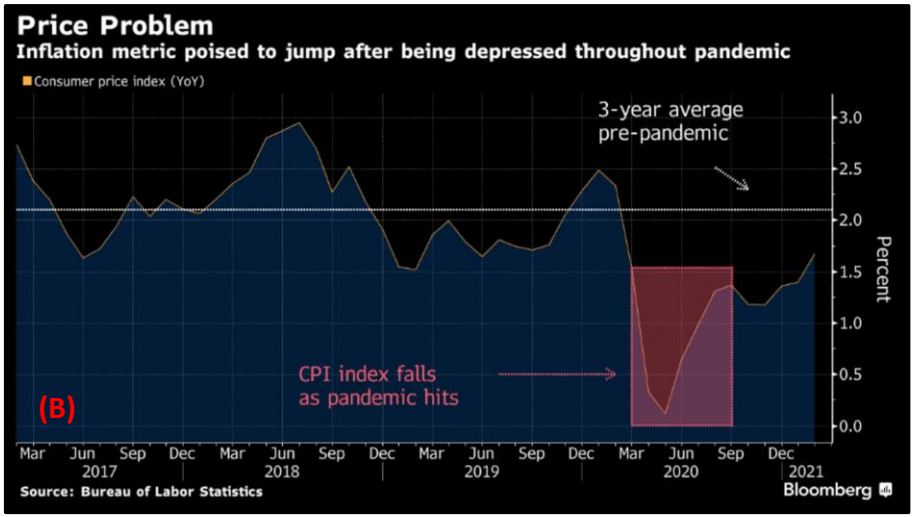


❖ **<u>SAA VIEW:</u> Assuming the world is emerging from the coronavirus pandemic, International Monetary Fund ("IMF") GDP estimates across the globe continue to be revised upward. However, these estimates are subject to high uncertainty due to: 1) the path of the pandemic given the current vaccine rollout and efficacy against new COVID strains; 2) world governments' policies to support their economies and citizenry in recovery; and 3) how financial conditions evolve and economies adapt to consumer behavioral changes and ongoing global supply chain disruptions.**

Source: IMF World Economic, April 2021

Inflation Coming? Oh Yes!



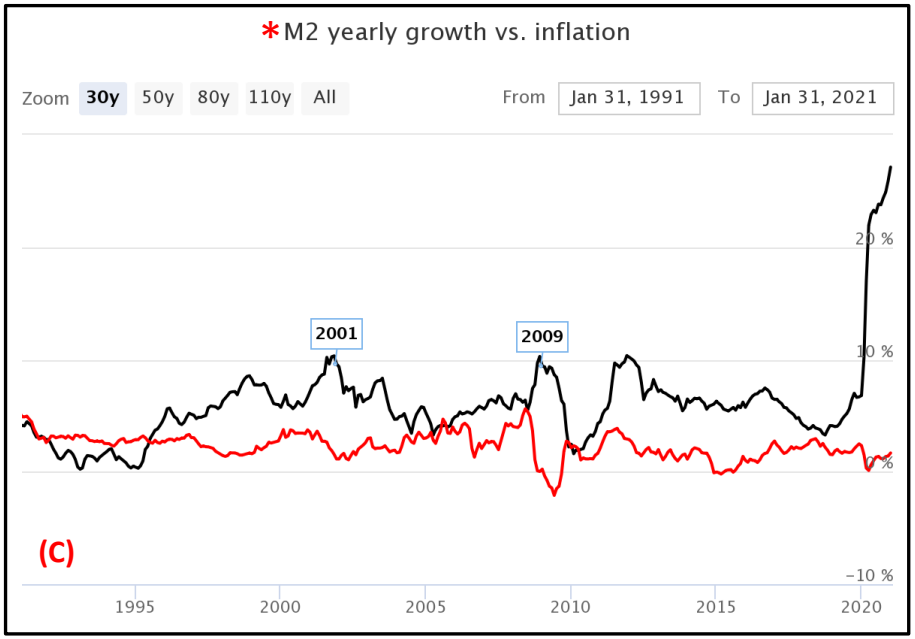


SAA VIEW:

(A) Global supply chains issues remain acute and materials costs for producing final goods have soared – expect "re-entry" inflation of varying degrees throughout the economy depending on the sectors' demand and supply relationship.

(B) Be mindful of the inflation calculation methodology during 2021 as the market attempts to interpret the Year-Over-Year inflation rate changes starting March-June 2021 using the exceedingly low base levels from March-June 2020.

(C) Even though monetary policy remains aggressive and fuels inflation runaway fears, the sharp increase in money supply is due more to a combination of aggressive fiscal policy and investor risk aversion.



*M2 is a calculation of the money supply that includes all elements of M1 as well as "near money." M1 includes cash and checking deposits, while near money refers to savings deposits, money market securities, mutual funds, and other time deposits. These assets are less liquid than M1 and not as suitable as exchange mediums, but they can be quickly converted into cash or checking deposits.

Source: FRED, Investopedia, Bureau of Labor Statistics, Bloomberg

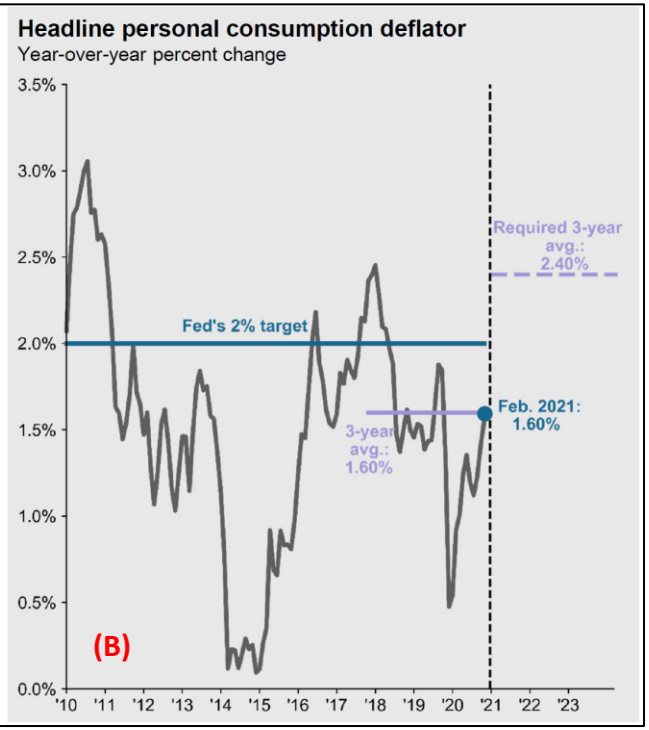
Real Inflation Coming? Unclear…

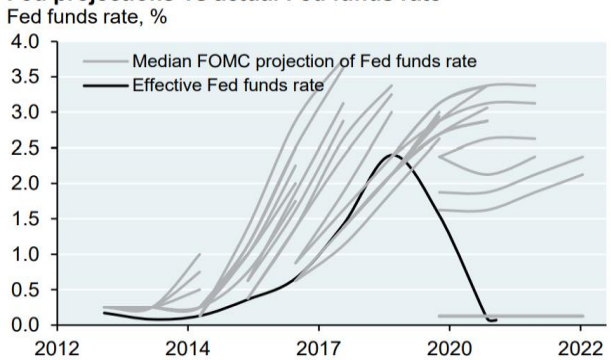
SAA VIEW:

(A) As of March 31, 2021, the 5yr, 5yr forward inflation rate was 2.2%, which was higher than the Fed's 2% average inflation target and subject to upward pressures as the economy reopens.

(B) Using actual year-over-year inflation of 1.60% as of February 2021, the Fed's policy will allow for higher inflation (i.e. above 2% target) over the short/intermediate term given the Fed's policy change last year to utilize an "average target" as opposed to "target" inflation metric.

(C) Even with the vast amount of data and information accessible to the Federal Open Market Committee (FOMC), the Fed's prognostication powers are worse than poor when it comes to growth and inflation forecasting.





Source: Federal Reserve, JPMAM. March 10, 2021.

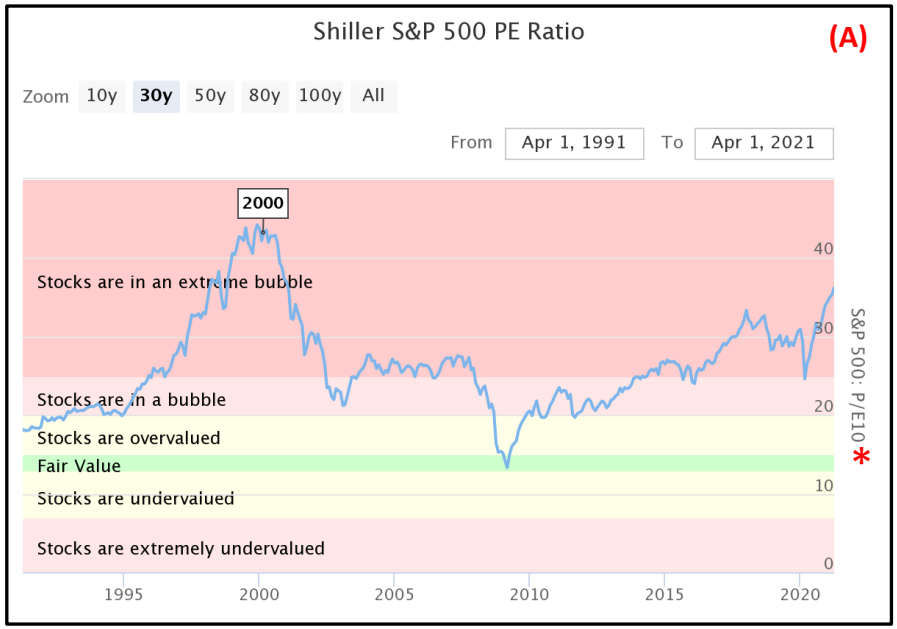
The Fed's decade of bad inflation forecasts

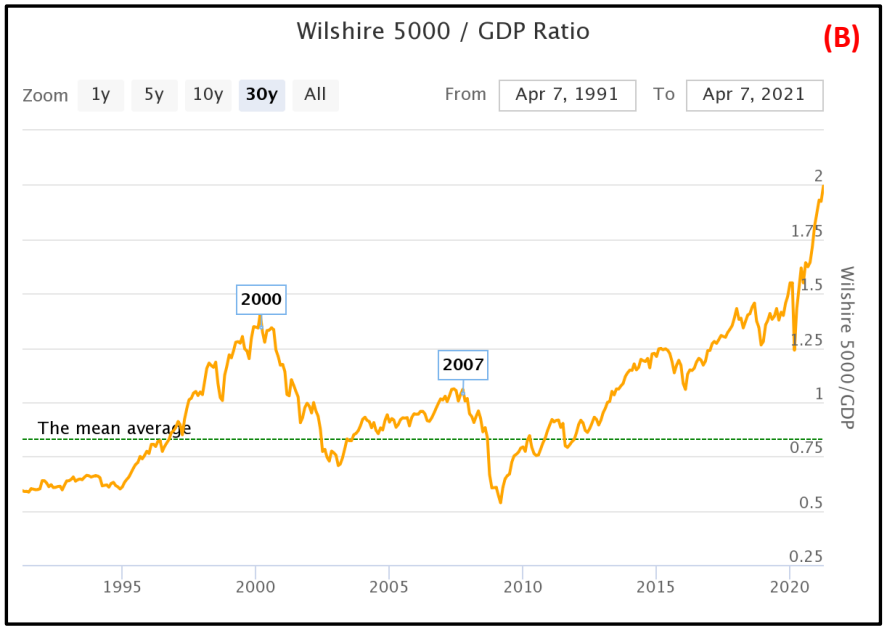
The chart on the left shows the Fed's projections of future rates (grey lines) compared to what they actually ended up being. The Fed was basically wrong about growth and inflation for the better part of a decade, consistently overestimating the need for policy tightening.

(C)

Source: Bureau of Economic Analysis, Federal Reserve, Federal Reserve Bank of St. Louis, J.P. Morgan Asset Management

Equity Markets – Flying Too High?





*The P/E 10 ratio is a valuation measure generally applied to broad equity indices that use real per-share earnings over 10 years. The P/E 10 ratio also uses smoothed real earnings to eliminate the fluctuations in net income caused by variations in profit margins over a typical business cycle. The P/E 10 ratio is also known as the cyclically adjusted price-to-earnings (CAPE) ratio or the Shiller PE ratio.

<u>SAA VIEW:</u> Two widely-followed metrics indicate the equity markets are overvalued, but are they?

(A) Shiller S&P 500 PE Ratio metric indicates equities have generally been overvalued to greater and lesser degrees for the last thirty years. Current level are gaining on levels seen just before the DotCom bust; however, the world's economy and markets are vastly different. While the metrics may be high, the comparative value to the year 2000 is suspect.

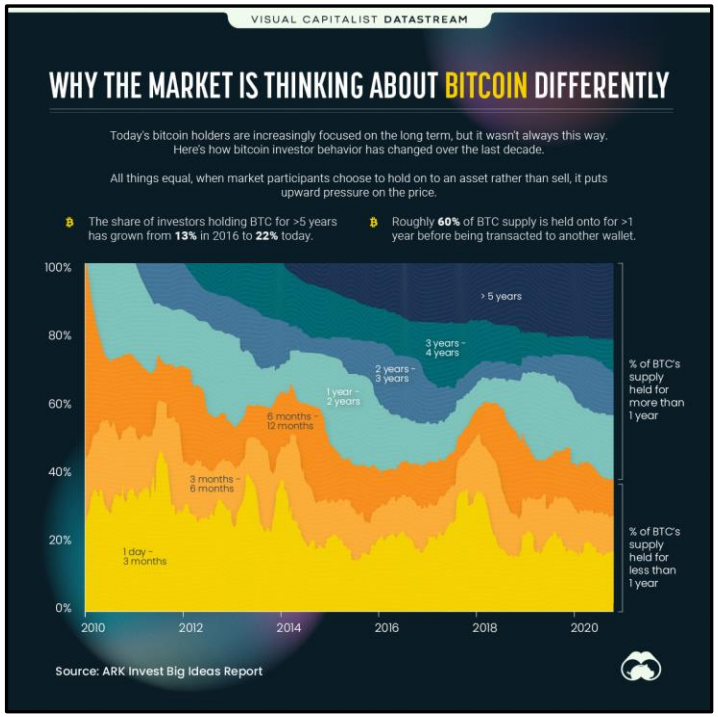
(B) Taking that suspicion, let's examine another metric often called the Buffet Ratio or the ratio of US Stock Market Capitalization-to-GDP. This metric paints an even more acute, overvalued equity picture. As with the Shiller metric, the situation remains the same in that the world economy and markets are vastly different and more interconnected making historical comparison less useful.

One consideration remains clear – the strong equity market performance has most likely tipped your organizations' asset allocations out of alignment. If that's so, then a rebalancing discussion and/or actions is warranted.

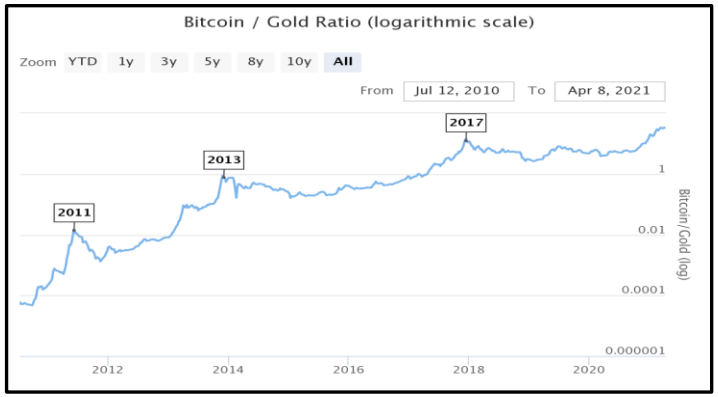
Source: Longtermtrends.com, Investopedia

LONGER-TERM THOUGHTS

Digital Currency Update



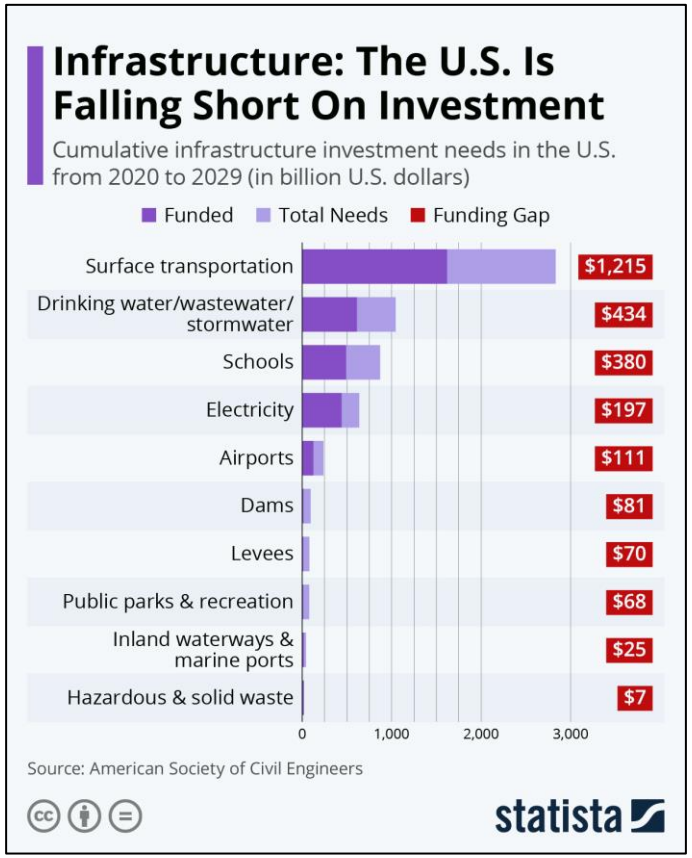
❖ **<u>SAA VIEW:</u> Bitcoin is a currency, an asset class, or bit of both? More like gold and a store of value? Fad or Fixture?**



❖ **<u>SAA VIEW:</u> China began a great experiment as it introduced a limited supply of digital currency to it citizenry. Although another surveillance tool for the Chinese government, it has also heightened concerns, once again, about the longevity and persistency of the world reserve currency – the U.S. Dollar.**

Source: Longtermtrends.com, Visual Capitalist

Infrastructure Long-Term Needs



<u>SAA VIEW:</u> The timing of President Biden's infrastructure plan happened to coincide with the most recent infrastructure report from the American Society of Civil Engineers (ASCE) which provides a summary and detailed overview of America's infrastructure needs to support the U.S. economy over the long-term.

- **The ASCE released its 2021 Report Card for America's Infrastructure. Compiled every four years, it comprehensively assessed 17 major infrastructure categories on a range of criteria such as capacity, condition, funding and public safety. They were then scored through a simple A to F school report card format. The good news is that the American infrastructure has improved, with the country's score climbing from a D+ in 2017 to a C- in 2021. It is the first time the U.S. has been out of the D range in two decades.**
- **Despite the progress, however, it was uneven with 11 out of 17 categories still having recorded D grades. Of the other six categories, five saw their grades increase while just one - bridges - experienced a decrease. While things are going in the right direction, the bad news is that the long-term infrastructure investment gap is continuing to grow with the report stating that the U.S. is only paying half as much as it needs. The investment gap has now climbed from $2.1 trillion over 10 years to nearly $2.59 trillion over 10 years.**

Source: Statista – Data Analyst, Niall McCarthy

Navigating The Ongoing Uncertainty

- **Looking Ahead 2021/2022**
  - COVID-19 Containment vs. The Economy
    - Recovery expectations continue to remain vaccination-dependent for 2021/2022 and will be uneven across states and industry sectors.
  - Inflation will occur but signals regarding its persistency and longevity will be mixed due to COVID-related supply/demand imbalances.
    - Expect the Fed to maintain its course through 2023 barring material changes regarding inflation and/or employment metrics.
  - ESG Trend Continues

- **Strategic Asset Allocation & Investment Policy**
  - On the investment front, the ongoing challenge to insurers/risk pools remains relatively low "nominal" yields and negative "real" yields across much of the investment-grade fixed income markets for the foreseeable future.
    - Smaller organizations now have access to more yield-oriented risk asset classes that may have a role in your organization' overall asset allocation.
    - How might your organization's excess portfolio liquidity be utilized more efficiently for increasing yield.
    - Consideration of new asset classes takes time and thoughtful Board education.
  - **Evaluate portfolio rebalancing due to strong risk asset performance and rising yields.**