Capital Markets Review
For the Quarter Ending June 30, 2022

STRATEGIC ASSET ALLIANCE
THE INSURANCE INVESTMENT SPECIALIST

Summary Capital Market Commentary – Q2/2022

- **Both shares and bonds were under pressure in the second quarter as investors moved to price in further interest rate rises and an increased risk of recession. Inflation continued to move higher in many major economies during the quarter.**

- Equity Markets
  - US equities fell in Q2 and posted the worst first half loss since 1970 and third worst first half performance since World War II. Investor focus was trained on inflation and the policy response from the Federal Reserve (Fed) for much of the period. The Fed enacted its initial rate hikes during the quarter and signaled that there would be more to come. Even so, the central bank admitted the task of bringing inflation down without triggering a recession would be challenging. The US economy looks robust, but signs of a slowdown are emerging. The 'flash' US composite purchasing managers' index (PMI) eased from 53.6 to 51.2 in June. The services component eased from 53.4 to 51.6, but the manufacturing output deteriorated from 55.2 to a two-year low of 49.6. Only twice has this fallen by more than 5.6 points; during the pandemic in 2020 and the financial crisis in 2008.

  - The second quarter saw further steep declines for eurozone shares as the war in Ukraine continued and concerns mounted over potential gas shortages. Higher inflation is also denting consumer confidence, with the European Central Bank (ECB) poised to raise interest rates in July. Continued disruption to gas supplies due to the war in Ukraine saw Germany move to phase two of its emergency energy plan. The next phase would involve rationing gas to industrial users, and potentially households as well. A flash estimate from Eurostat signaled inflation at 8.6% in June, up from 8.1% in May, with energy the biggest contributor to the rise.

Source: Schroders & SAA

Summary Capital Market Commentary – Q2/2022

- **Both shares and bonds were under pressure in the second quarter as investors moved to price in further interest rate rises and an increased risk of recession. Inflation continued to move higher in many major economies during the quarter.**

- Bond Markets
  - Bonds continued to sell off sharply, with yields markedly higher amid still elevated inflation data, hawkish central banks and rising interest rates. Bonds rallied into quarter-end amid rising growth concerns, slightly curtailing the negative returns. Data throughout the quarter showed inflation rates in major economies continuing to run at multi-decade highs, with various central banks raising interest rates and others signaling their intention to do so soon.
  - The US 10-year bond yield rose from 2.35% to 2.97% and the 2-year yield from 2.33% to 2.93%.
  - Corporate bonds suffered in the broad bond market sell-off, underperforming government bonds as spreads widened markedly. With mounting concerns over the economic outlook, high yield credit was particularly hard hit.

Source: Schroders & SAA

Asset Class Returns & Expectations

Asset Class	Forecast (Annualized)		Adverse Market Events								Actual Peeformance - Trailing 1YR at 6/30
	Pre-Tax Return	Risk	-0.5 STD	-1 STD	-1.5 STD	-2 STD	-2.5 STD	-3 STD	-3.5 STD	-4 STD	
Fixed Income											
U.S. Aggregate (Core Fixed)	2.60%	3.48%	0.86%	-0.88%	-2.62%	-4.36%	-6.10%	-7.84%	-9.58%	-11.32%	-10.29%
U.S. Municipal	2.10%	3.25%	0.48%	-1.15%	-2.78%	-4.40%	-6.03%	-7.65%	-9.28%	-10.90%	-8.57%
U.S. TIPS	2.10%	5.16%	-0.48%	-3.06%	-5.64%	-8.22%	-10.80%	-13.38%	-15.96%	-18.54%	-5.14%
U.S. High Yield	3.90%	8.24%	-0.22%	-4.34%	-8.46%	-12.58%	-16.70%	-20.82%	-24.94%	-29.06%	-12.81%
U.S. Leveraged Loans	4.70%	7.89%	0.76%	-3.19%	-7.14%	-11.08%	-15.03%	-18.97%	-22.92%	-26.86%	-2.78%
Equity & Alternatives											
U.S. Large Cap	4.10%	15.02%	-3.41%	-10.92%	-18.43%	-25.94%	-33.45%	-40.96%	-48.47%	-55.98%	-10.62%
U.S. Mid Cap	4.30%	17.06%	-4.23%	-12.76%	-21.29%	-29.82%	-38.35%	-46.88%	-55.41%	-63.94%	-14.69%
U.S. Small Cap	4.40%	19.61%	-5.41%	-15.21%	-25.02%	-34.82%	-44.63%	-54.43%	-64.24%	-74.04%	-16.88%
EAFE	6.50%	17.04%	-2.02%	-10.54%	-19.06%	-27.58%	-36.10%	-44.62%	-53.14%	-61.66%	-17.77%
EM Equity	6.90%	20.92%	-3.56%	-14.02%	-24.48%	-34.94%	-45.40%	-55.86%	-66.32%	-76.78%	-25.28%
Convertible Bond	4.50%	11.77%	-1.39%	-7.27%	-13.16%	-19.04%	-24.93%	-30.81%	-36.70%	-42.58%	-4.74%
U.S. REITs	5.70%	15.11%	-1.86%	-9.41%	-16.97%	-24.52%	-32.08%	-39.63%	-47.19%	-54.74%	-6.40%

Source: SAA & J.P.Morgan Capital Markets - November 2021

Key Take Aways:

- The chart above categorizes the trailing one-year returns of key asset class as of June 30, 2022, by how much the one-year return deviates from expected.
  - **In the worst case, the U.S. Taxable and Tax-Exempt Bond markets experienced negative returns that were between three and four standard deviations from an annualized return expected over a 7-to-10-year horizon (i.e. the edge of black swan events).**
    - It's the magnitude of this negative, fixed income performance shock that is temporarily wreaking havoc with mark-to-market balance sheets.
  - **Equity returns, meanwhile, were down more than fixed income in absolute terms but down a more modest one to one-and-a-half standard deviations from an annualized return expected over a 7-to-10-year horizon.**
    - For equity markets to have performed as poorly as fixed income markets on a relative basis, equity markets would need to be down 50% to 60% over the same one-year period.

Bond Math & Market Disruption

Key Take Aways:

- ❑ Investment-grade fixed income total return is almost entirely generated by embedded yield and always something to keep in mind when considering asset allocation.
- ❑ **Barring a need to liquidate a fixed income security to support operations and most likely generate a realized loss, a fixed income security's unrealized loss position will ultimately dissipate and then disappear upon maturity leaving only the return from its embedded yield behind.**

Source: Bloomberg, ICE Fixed Income Indices, * Through July 11, 2022

Fixed Income Yields

Index YTW	12/31/2021	3/31/2022	5/31/2022	6/30/2022	Chg Prior Month	Chg Prior Qtr	Chg Calendar Yr	CORE Current Real Yields	HEADLINE Current Real Yields
Aggregate	**1.75%**	**2.92%**	**3.38%**	**3.72%**	▲ **0.34%**	▲ **0.80%**	▲ **1.97%**	▼ **-2.18%**	▼ **-5.38%**
Intermediate Aggregate	**1.55%**	**2.81%**	**3.23%**	**3.60%**	▲ **0.37%**	▲ **0.79%**	▲ **2.05%**	▼ **-2.30%**	▼ **-5.50%**
U.S. Treasury	1.23%	2.42%	2.80%	3.09%	▲ 0.29%	▲ 0.67%	▲ 1.86%	▼ -2.81%	▼ -6.01%
U.S. 2-Yr Treasury	0.73%	2.32%	2.55%	2.97%	▲ 0.42%	▲ 0.65%	▲ 2.24%	▼ -2.93%	▼ -6.13%
U.S. 5-Yr Treasury	1.26%	2.45%	2.82%	3.04%	▲ 0.22%	▲ 0.59%	▲ 1.78%	▼ -2.86%	▼ -6.06%
U.S. 10-Yr Treasury	1.50%	2.33%	2.85%	3.01%	▲ 0.16%	▲ 0.68%	▲ 1.51%	▼ -2.89%	▼ -6.09%
U.S. 30-Yr Treasury	1.89%	2.44%	3.07%	3.16%	▲ 0.09%	▲ 0.72%	▲ 1.27%	▼ -2.74%	▼ -5.94%
U.S. Agency MBS	1.98%	2.99%	3.46%	3.77%	▲ 0.31%	▲ 0.78%	▲ 1.79%	▼ -2.13%	▼ -5.33%
ABS	1.13%	2.84%	3.37%	3.78%	▲ 0.41%	▲ 0.94%	▲ 2.65%	▼ -2.12%	▼ -5.32%
CMBS	1.88%	3.26%	3.80%	4.07%	▲ 0.27%	▲ 0.81%	▲ 2.19%	▼ -1.83%	▼ -5.03%
U.S. Credit	2.25%	3.52%	4.11%	4.58%	▲ 0.47%	▲ 1.06%	▲ 2.33%	▼ -1.32%	▼ -4.52%
A-Rated Corporates	2.11%	3.34%	3.91%	4.35%	▲ 0.44%	▲ 1.01%	▲ 2.24%	▼ -1.55%	▼ -4.75%
BBB-Rated Corporates	2.58%	3.89%	4.57%	5.10%	▲ 0.53%	▲ 1.21%	▲ 2.52%	▼ -0.80%	▼ -4.00%
Municipal Bond	1.11%	2.60%	2.92%	3.21%	▲ 0.29%	▲ 0.61%	▲ 2.10%	▼ -2.69%	▼ -5.89%
Taxable Municipal Bond	2.33%	3.48%	4.18%	4.29%	▲ 0.11%	▲ 0.81%	▲ 1.96%	▼ -1.61%	▼ -4.81%
U.S. High Yield	4.21%	6.01%	7.09%	8.89%	▲ 1.80%	▲ 2.88%	▲ 4.68%	▲ 2.99%	▼ -0.21%
Global Aggregate (USD)	1.32%	2.15%	2.59%	2.91%	▲ 0.32%	▲ 0.76%	▲ 1.59%	▼ -2.99%	▼ -6.19%
U.S. Agg. vs. Global Agg.	▲ **0.43%**	▲ **0.77%**	▲ **0.79%**	▲ **0.81%**	▲ **0.04%**	▲ **0.38%**	▲ **0.38%**	Using Core Inflation Rate at 6/30/2022 which was 5.9% down 0.1% from May.	Using Headline Inflation Rate at 6/30/2022 which was 9.1% up +0.5% from May
Curve Steepness: UST 2yr-10yr Spread (bps)	**77.0**	**1.0**	**30.0**	**4.0**	▼ **-14.0**	▲ **3.0**	▼ **-73.0**		
Curve Steepness: UST 5yr-30yr Spread (bps)	**63.0**	**-1.0**	**25.0**	**12.0**	▲ **9.0**	▲ **13.0**	▼ **-51.0**		

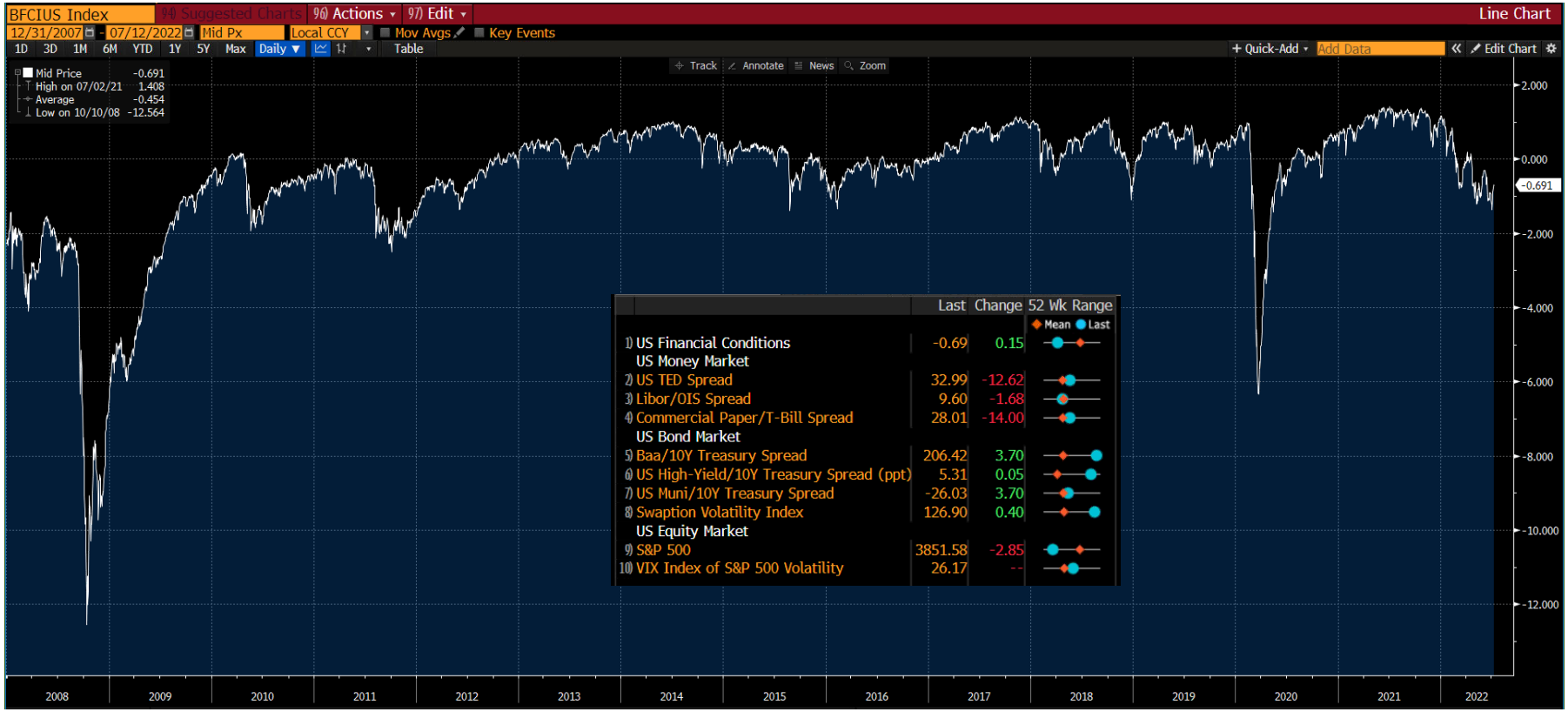
Source: Bloomberg Barclays Indices & BofA ICE Indices

Key Take Aways:

- ❑ Nominal market yields spiked again in June in response to the ongoing inflation debate and the Fed's expected actions to quash it.
- ❑ **Even though annualized core inflation fell slightly in June, annualized headline inflation increased to 9.1% in June. Headline inflation continues to be hugely problematic for the Fed, who really has no control over supply-driven inflation components such as food and energy.**
- ❑ To end on a positive note, higher reinvestment yields (double what they were on 12/31/2021 across many markets) will generate additional earned income and continue to increase book yields across all core fixed income portfolios.

Source: Bloomberg Barclays & ICE Fixed Income Indices

U.S. Financial Condition Index



Key Take Aways:

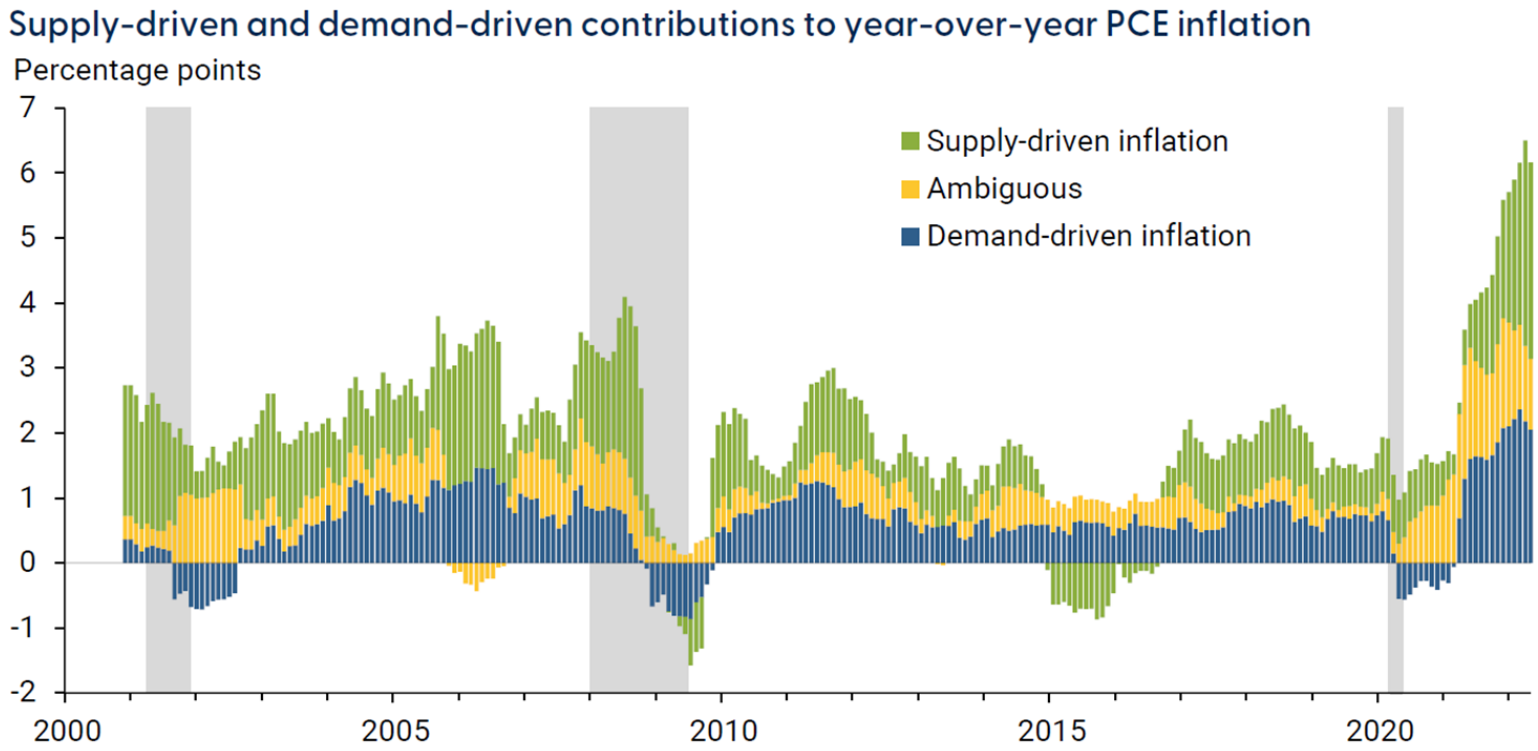
- The Bloomberg US Financial Conditions Index uses yield spreads and indices from Money, Equity, and Bond Markets to construct a normalized index. The values for this index are Z-Scores, which represents the number of standard deviations that current financial conditions lie above or below the historical average of the 1994 – 7/1/2008 (the period before the Great Recession).

- **As of July 12, 2022, financial conditions are continuing to tighten with the index -0.69 standard deviations below the average. Compared with the shocks from 2008/09 and Mar/Apr 2020, current financial conditions are, for the moment, only slightly negative.**

Source: Bloomberg

IMMEDIATE OUTLOOK

Inflation: How much influence does the Fed have?



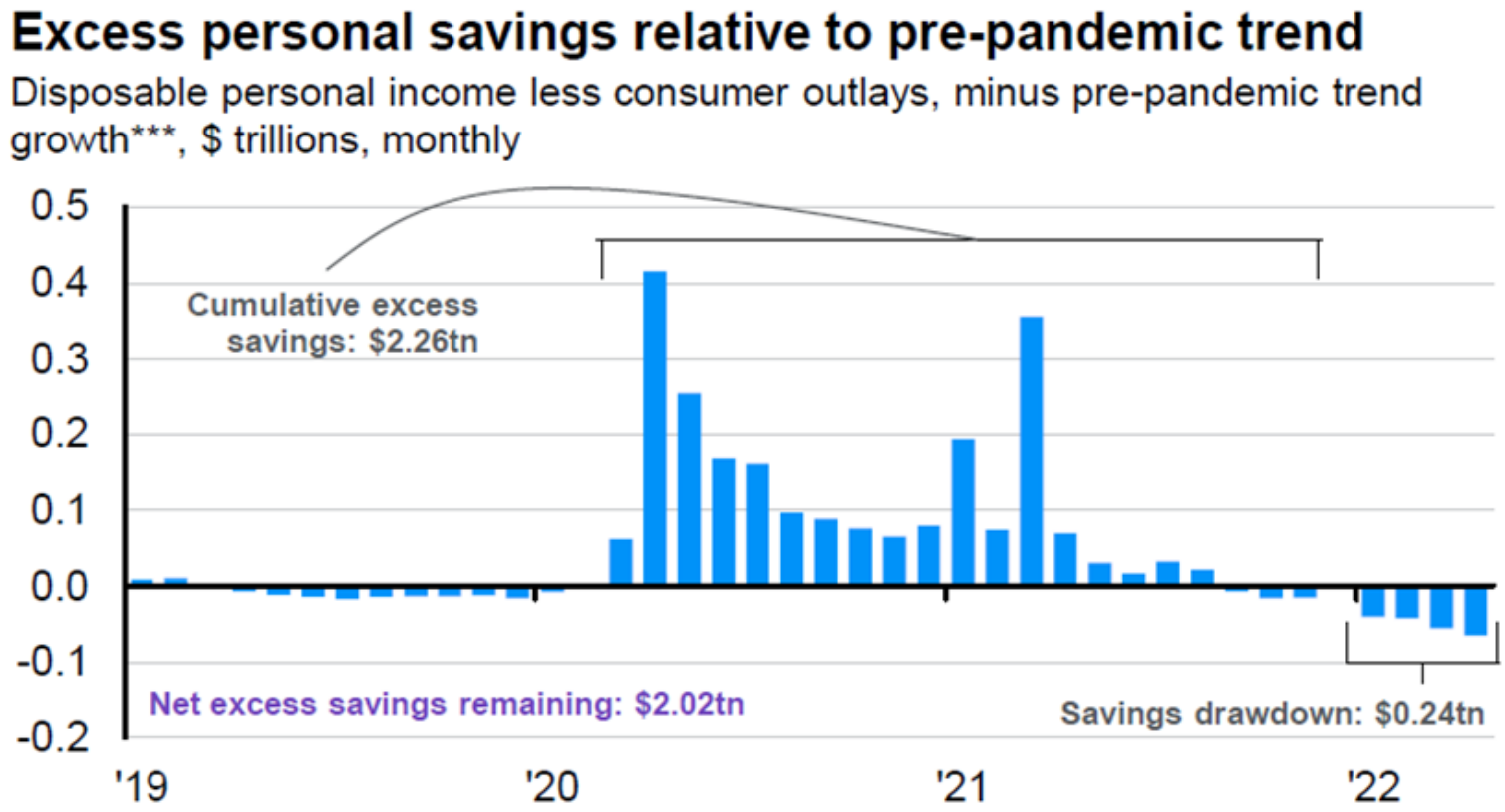
Key Take Aways:

- ❑ Analysis results showing that factors other than demand account for about two-thirds of recent elevated inflation highlight some risks for the economy as well as the precarious situation in which the Fed finds itself. Because supply shocks raise prices and suppress economic activity, the prevalence of supply-related factors raises the risk of entering a period of low growth and elevated inflation levels. This risk depends crucially on how long labor shortages and global supply disruptions persist.

- ❑ **BOTTOM-LINE: The Fed's policy actions to reduce aggregate demand (i.e. raising rates) only has direct influence on approximately 1/3 of the factors currently driving inflation.**

Source: Federal Reserve Bank of San Francisco, FRBSF Economic Letter dated June 21, 2022. *"How Much Do Supply and Demand Drive Inflation?"* by Adam Hale Shapiro

Another potential reason for persistent inflation…Excess Savings

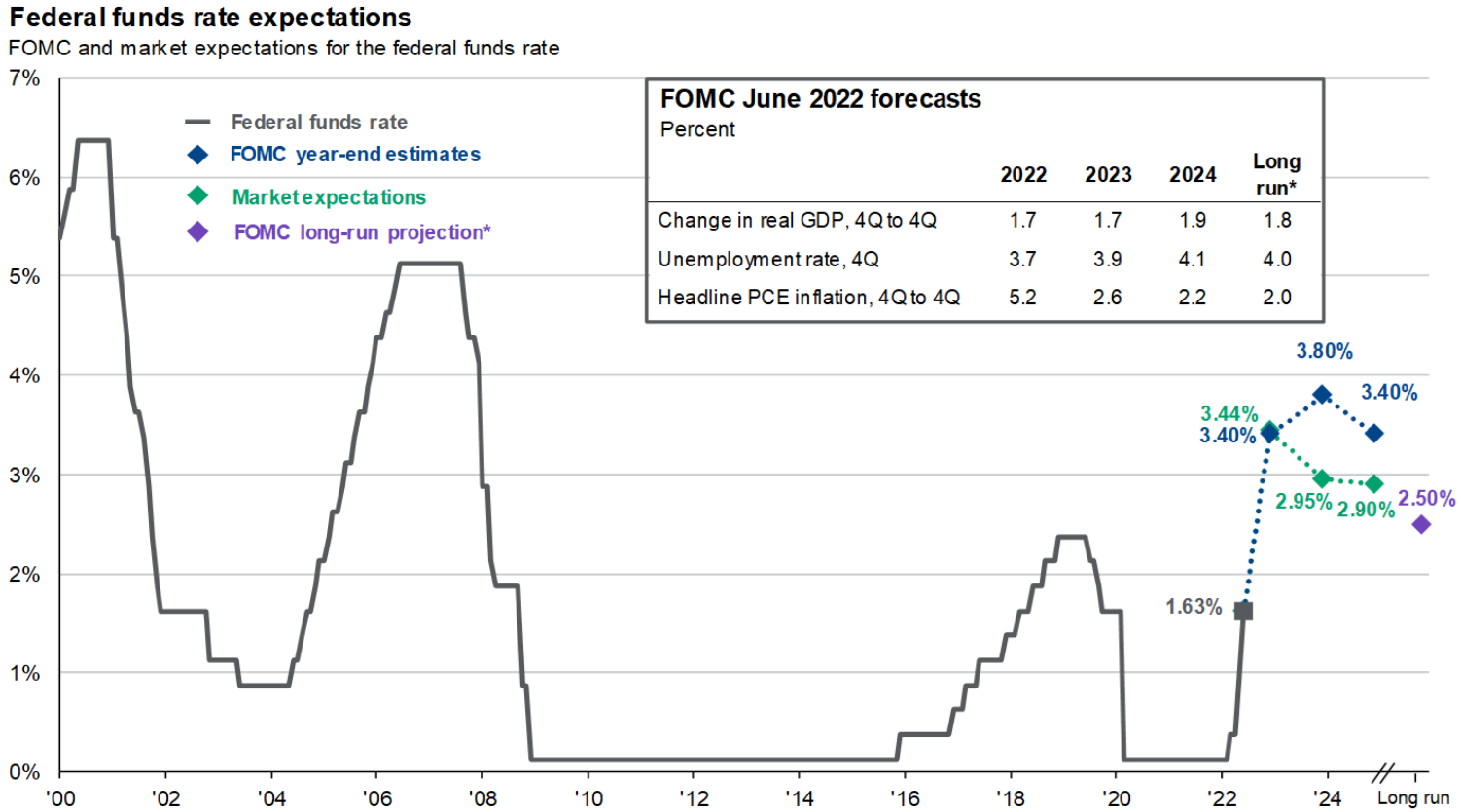


Key Take Aways:

- ❑ **Unlike the Great Recession in 2008/2009, U.S. consumers collectively are facing the current inflationary environment with significant wealth and savings. However, current levels of inflation have consumers reaching into their savings hoards to fund spending in 2022.**

- ❑ **With approximately $2T of excess savings remaining from the COVID miasma of 2020/2021, SAA expects these factors to constitute a "net" inflationary tailwind even as consumers begin to change or consider changing consumption behavior in the months ahead.**

The Fed & Interest Rates



FOMC June 2022 forecasts
Percent

	2022	2023	2024	Long run*
Change in real GDP, 4Q to 4Q	1.7	1.7	1.9	1.8
Unemployment rate, 4Q	3.7	3.9	4.1	4.0
Headline PCE inflation, 4Q to 4Q	5.2	2.6	2.2	2.0

Key Take Aways:

- ❑ **The Fed's finds itself between a rock and a hard place as markets currently expect the Fed to address inflation but then, paradoxically, to begin lowering rates soon thereafter in response to an expected recessionary environment within the next 12-18 months?**
- ❑ **This yin-yang struggle makes it extremely difficult for markets to price risk and SAA expects volatile markets to continue until we have an inflationary inflection point that markets believe despite the potential for recession and how a recession will be defined…**

Source: Bloomberg, FactSet, Federal Reserve, J.P. Morgan Asset Management. Market expectations are based off of the respective Federal Funds Futures contracts form December expiry. *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. Forecasts are not a reliable indicator of future performance. Forecasts, projections and other forward-looking statements are based upon current beliefs and expectations. They are for illustrative purposes only and serve as an indication of what may occur. Given the inherent uncertainties and risks associated with forecasts, projections or other forward-looking statements, actual events, results or performance may differ materially from those reflected or contemplated.
Guide to the Markets- U.S. Data are as of July 11, 2022.