CapVisor Associates, LLC

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Summer 2019 Newsletter **Volume 11, Issue 3**

Inside This Issue

Cycle Conclusion - Part 2

In this article, part 2, we will focus our attention on equities. Insurers typically invest the bulk of their surplus assets in equities and to a lesser extent, other risk assets such as alternatives. While surplus assets are less sensitive to the liquidity requirements of reserve assets supporting liabilities and claims payments, they certainly impact the financial strength of an insurer.

In part 1 of this article, we focused on first quarter economic and market conditions, namely: 1) fairly strong but slightly declining economic (GDP) growth rates; 2) our historically long bull market cycle in US stocks which started with the inflection point shortly after the great recession in 2008; and 3) the US bond market's recent inflection, in 2015, shifting from a generally declining to a rising interest rate environment. Identifying the inflection points of past cycles is easy; determining those that lie ahead is quite difficult. This last article also focused on the US bond market, the mainstay of insurance company portfolios.

Our context for the previous edition was that everything seems to move in cycles: the economy, the stock

Continued on page 5

Economic and Market - 2nd Quarter Review and Outlook

Fixed Income Review

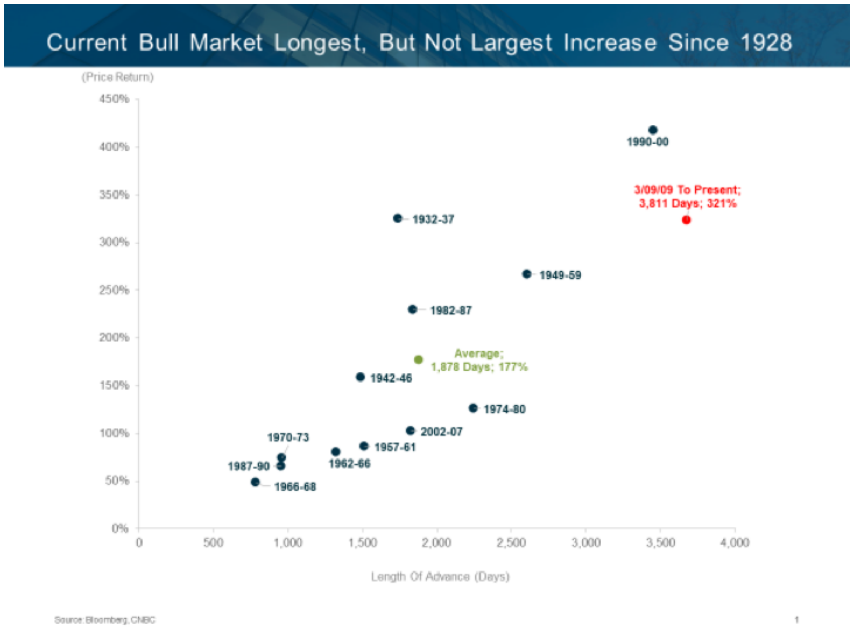
The Intermediate Government/Credit Bond Index returned 2.59% and the longer maturity Aggregate Bond Index returned 3.08% in the second quarter, as lower interest rates and tighter credit spreads propelled fixed income returns.

After a tumultuous end to 2018, and subsequent rally in the first quarter, investment grade credit spreads continued their march tighter to begin the second quarter, falling in mid-April to the tightest levels since the third quarter of 2018.

Economic review

Having surpassed the ten year mark, the current expansion is the oldest on record, and one month longer than the ten year tech boom that lasted from 1991-2001. The boom beginning in 2009 is also the slowest on record.

The current economy has experienced cumulative



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Michael J. Stafford Jr., CFA, Managing Director, Director of Fixed Income Investments - Mr. Stafford is Managing Director and Director of Fixed Income Investments for ASB Capital Management and is a member of the ASB Fixed Income Council. He has 25 years of experience in the institutional fixed income business, and previously served as Chief Investment Officer of The St. Paul's (now Travelers) life insurance subsidiary, and Portfolio Manager with Bank of America, Legg Mason, and First National Bank of Maryland. Mr. Stafford is a Chartered Financial Analyst, a past president and director of The Baltimore Security Analysts Society, and has taught investment analysis in the MBA program at Johns Hopkins University. He is a graduate of Georgetown University and earned an MBA from Loyola University of Maryland.

Economic and Market - 2nd Quarter Review and Outlook

real GDP growth of only about 20% from its prior peak, versus more than 40% for the 1990's tech boom, and greater than 50% during the 1961-69 expansion.

In the second quarter, increased trade tensions and the prospect of slower GDP growth drove interest rates lower.

Strategists estimate that tariffs on the original $200 billion of Chinese imports will reduce 0.1% of annual GDP growth for every two months they remain in place this year. As a result, expectations for real GDP have declined to 2% from the 2.5% - 3% range.

May's employment report underwhelmed, providing justification for a rate cut in July. Monthly payrolls increased only 75,000, with revisions to previous months fully offsetting the weak gain. The increase in average hourly earnings, which investors watch closely for signs of increasing inflation, also disappointed, slowing to 3.1% year-over-year.

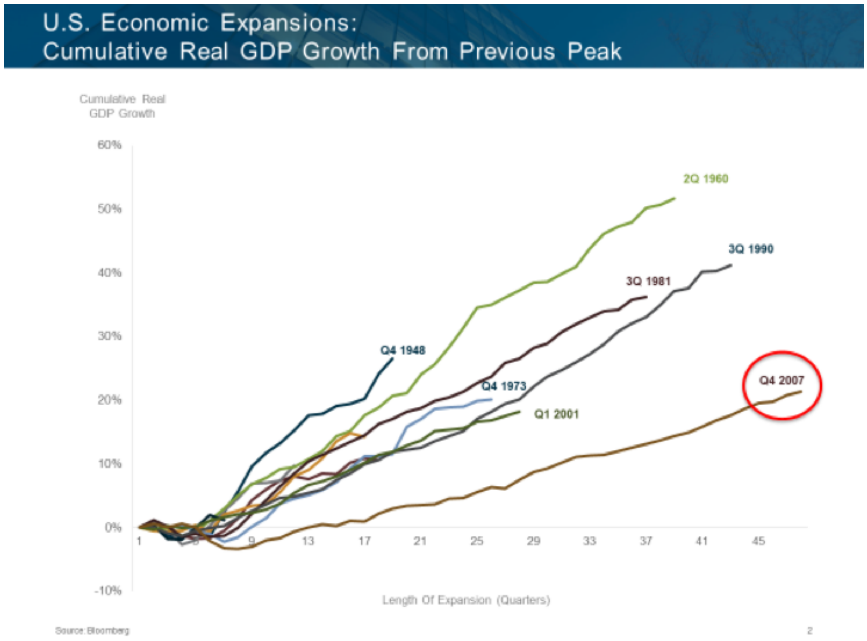
America's economy is the cleanest shirt in the laundry bag as global growth remains slower than U.S. growth. Over $13 trillion of sovereign debt carries negative interest rates.

Market Review

As investors ponder the Fed's next move, Cleveland Fed chief Loretta Mester recently suggested that "cutting rates at this juncture could reinforce negative sentiment about a deterioration in the outlook even if this is not the baseline view."

A late July rate cut is not certain, but the financial markets are trading as if it is. One maxim suggests, "bull markets don't die of old age, the Fed has murdered every one of them."

Continued on page 3



Economic and Market - 2nd Quarter Review and Outlook

The negatively sloped yield curve forewarns the Fed that it needs to lower short term rates to lessen the impact on economic growth, lest our central bankers take the fall for prematurely ending a very old expansion.

Outlook

Our portfolio durations are positioned close to benchmark levels. In the June FOMC minutes, the Fed noted that, "although growth of household spending appears to have picked up from earlier in the year, indicators of business fixed investment have been soft." The committee expressed increased uncertainty about its outlook for sustained economic expansion and a strong labor market, and noted that inflation pressures remain muted. The market began to price in expectations for three rate cuts before the end of the year, and a 100% probability that the Fed would announce a 0.25% reduction in the target range for short term rates at the next FOMC meeting on July 31. . (In fact, subsequent to this writing the Fed announced a 25 basis point easing 7/31)

In most portfolios we are positioned to take advantage of a steeper yield curve resulting from lower short term rates. A barbell strategy, offsetting short and long bonds to achieve a duration target, outperforms as yield curves flatten. A portfolio structure overweighting maturities concentrated near the portfolio duration target outperforms in a steepening yield curve environment.

We remain overweight spread assets, especially corporate bonds, taxable municipal bonds, and commercial mortgage-backed securities. Our residential mortgage-backed security position is more conservative, as we remain cautious given the risk of higher refinance activity in today's

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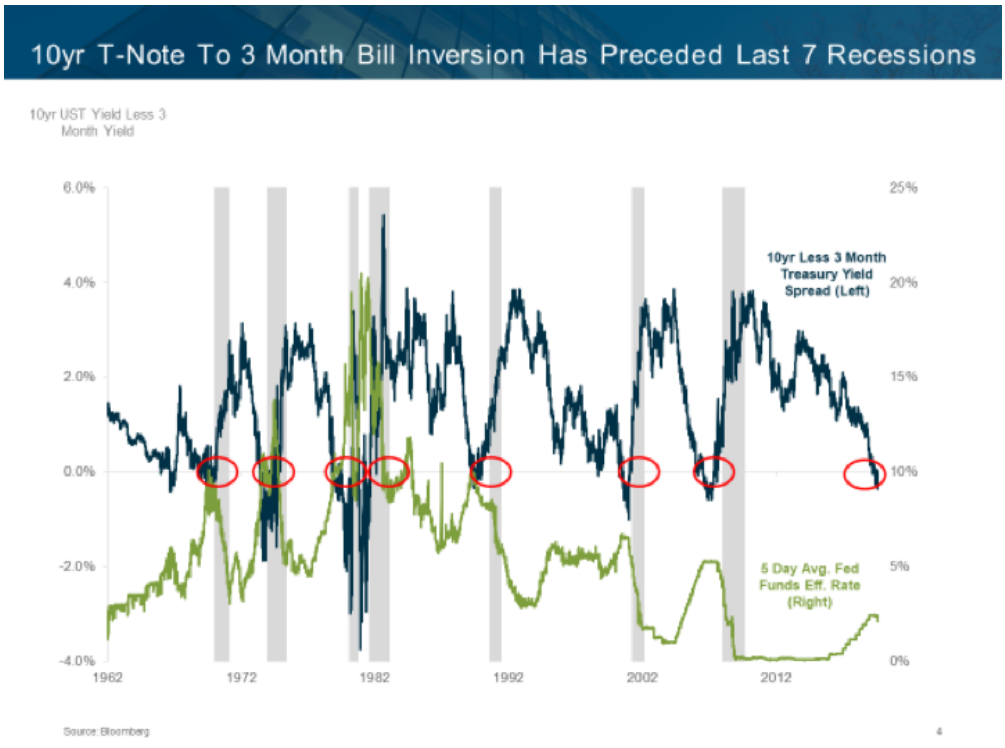
Economic and Market - 2nd Quarter Review and Outlook



lower interest rate environment.

The first half of the year produced strong returns for both equity and fixed income investors. As income investors, our objective is to protect the strong gains of the first half of the year as a more difficult investing environment unfolds over the next two quarters. ☐

Cycle Conclusion - Part 2

market, the bond market…most things in nature and nearly all things in investing. Therefore, understanding those cycles and trying to identify signs of possible inflection points is a worthy pursuit.

In the graph below, note the inflection point in the S&P 500 index, which marked the inception of the recent and lengthy bull run in stocks. One can easily see that the current bull cycle has been quite long vis-a-vis the cycles preceding it. Therefore, conventional wisdom has expected a cyclical change, from a bull to a bear market, for some time now. Why hasn't this happened?

Well, in part, this extended cycle could be explained by market distortions. These distortions resulted from unprecedented Federal Reserve actions, namely holding interest rates at, or near, zero for an extended period in an effort to reverse the great recession and spur economic growth through increased market liquidity.

Figure 1 (p. 6) illustrates the zero-interest rate policy from 2008 to 2015. Figure 2 (p. 6) shows that both nominal and real yield for (treasury) bonds have been painfully low, particularly since 2008. These factors, caused by Fed policy, forced bond investors to search for yield. More specifically, insurers needed to explore more risky asset classes to obtain the required rates of return to support their businesses. Equities, particularly "dividend aristocrat" strategies, often out-yielded investment grade bonds, provided a solution as did other risk assets like high yield bonds, convertibles, preferreds, etc. Funds flowing into the equity market in this

Continued on page 6

Cycle Conclusion - Part 2

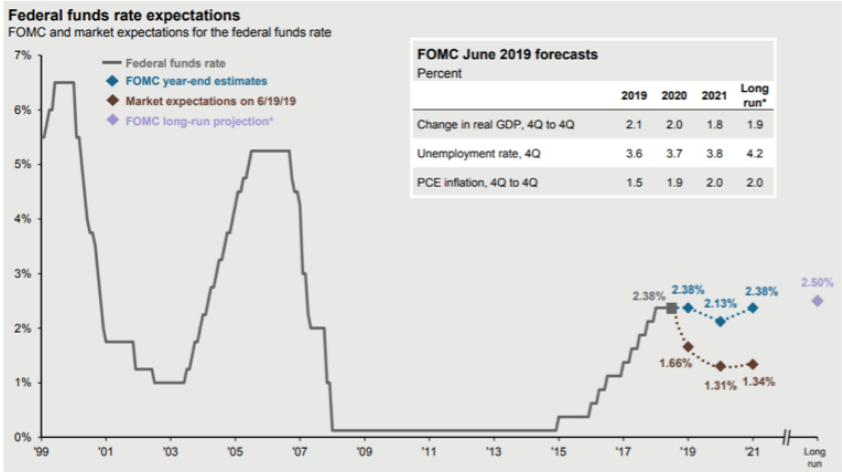
risk-on environment served to sustain the bull market, perhaps past its normal cyclical period.

So, when do we reach the inflection point? With the recent significant increase in equity market volatility, which began in February 2018 and continues to date, many predicted that the cyclical change from bull to bear was upon us. Many Wall Street experts predicted as much pointing out historically high P/E's (stock price to earnings ratios) as well as the newer and perhaps more ominous measurement: the CAPE ratio.

Figure 3 (p. 7) plainly shows this concern. Note that leading up to the recent period of market volatility, P/E ratios broke through their 25-year averages: a pricey stock market. Notwithstanding the correction in the fourth quarter of 2008 (-14.68%). the CAPE ratio is still alarmingly high although P/E ratios are now more normalized.

Continued on page 7

Figure 1



FOMC June 2019 forecasts
Percent

	2019	2020	2021	Long run*
Change in real GDP, 4Q to 4Q	2.1	2.0	1.8	1.9
Unemployment rate, 4Q	3.6	3.7	3.8	4.2
PCE inflation, 4Q to 4Q	1.5	1.9	2.0	2.0

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

Figure 2

	Average (1958-YTD 2019)	Jul. 31, 2019
Nominal yields	6.00%	2.02%
Real yields	2.34%	-0.11%
Inflation	3.67%	2.13%

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

Cycle Conclusion - Part 2

A look ahead

While a cyclical change for the equities market is inevitable, this bull may still have more room to run. The Fed reversed their position of the planned 2-3 rate raises for 2019 and instead held rates steady in January and then, dropped rates (25 BPs) in July. Political pressures may have had an impact but two other, more fundamental factors were involved in that decision. First, take a look back at Figure 1 (p. 6). You will see the significant discrepancy in where the Fed thinks future interest rates should be and where the market thinks rates will go. This disparity resulted in the inverted yield curve discussed in part 1 of this article series. An inverted yield curve has been a fairly accurate predictor of a recession and the Fed does not want overtightening (raising interest rates) to be its cause. Second, US as well as global GDP growth has been slowing. Trade wars and other socio-political factors as well as some, but not all, economical fundamentals are weakening. Th Fed wanted, and perhaps needed, to demonstrate that they are proactively trying to head off a recession given these circumstances.

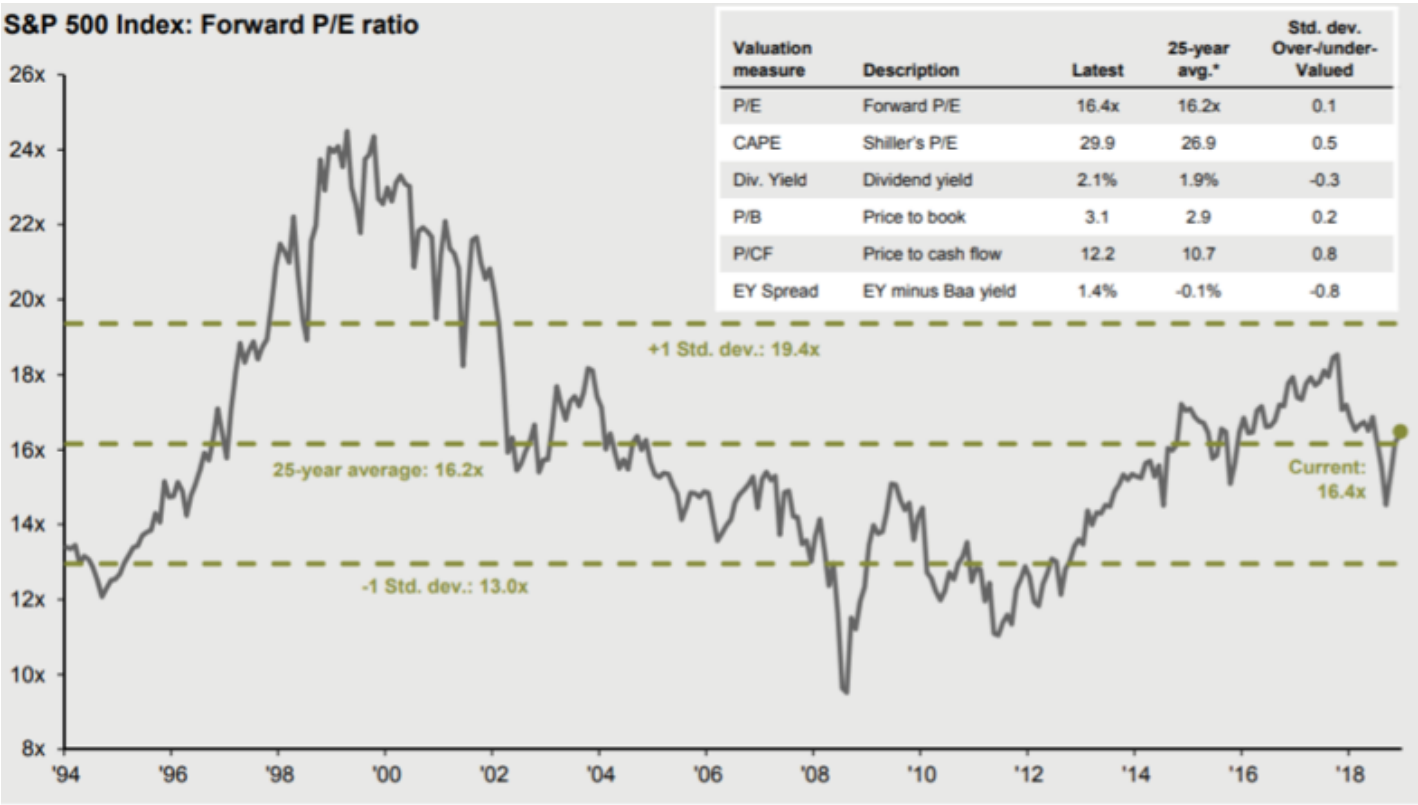
While the equity market may still have some meaningful upside for investors, fund flow and general investment trends are definitely in a risk-off mode. We have witnessed a flight to safety (generally investment grade bond) and equity positions are often being de-risked into defensive equity strategies.

Key Takeaways

- Fed rate reductions may prolong the aging bull cycle and possibly avoid recession
- However, higher levels of equity market volatility may signal an inflection point in this cycle is approaching
- Projected long-term US Large Cap equity returns are expected to be closer to mid-single digits rather than the average 13% annualized returns experienced over the last 10 years
- Insurers with significant exposure to risk assets should consider if/how/ when it makes sense to de-risk portfolios. ☐

1 Wikipedia: The cyclically adjusted price-to-earnings ratio, commonly known as CAPE, Shiller P/E, or P/E 10 ratio, is a valuation measure usually applied to the US S&P 500 equity market. It is defined as price divided by the average of ten years of earnings (moving average), adjusted for inflation.

Figure 3



Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-Valued
P/E	Forward P/E	16.4x	16.2x	0.1
CAPE	Shiller's P/E	29.9	26.9	0.5
Div. Yield	Dividend yield	2.1%	1.9%	-0.3
P/B	Price to book	3.1	2.9	0.2
P/CF	Price to cash flow	12.2	10.7	0.8
EY Spread	EY minus Baa yield	1.4%	-0.1%	-0.8

Source: FactSet, FRB, Robert Shiller, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management.

Upcoming Events

1.The SCCIA 20th Annual Executive Educational

Conference is taking place September 10-12, 2019 at Hyatt Place in Charleston. CapVisor will be exhibiting and Carl Terzer will also be speaking Tuesday September 10 as part of the Captive Academy from 2:15 - 3:00 pm in a session entitled Role of a Bank & Investment Advisor. We hope that you will be able to join the session and visit Carl Terzer and Grant Davis at the CapVisor exhibit area.

2. The 124th NAMIC Annual Convention is September 22-25 at the Gaylord National Resort & Convention Center in National Harbor, MD. CapVisor will be exhibiting. Please stop by booth 102 and say hi to Carl Terzer and Rachel Libowitz

3. The CIC-DC Annual Conference is Oct 21-22 at the Marriott Metro Center in Washington DC. Paul Deeley will be attending representing CapVisor Associates so hopefully you will have a chance to see him there!

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