Inside This Issue

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What's Ahead for 2022

We have already seen that market volatility is at much higher levels than over previous quarters. I attribute this primarily to the fact that we are in a political and economic transition period. We are moving:

- out of the economic drag due to the covid pandemic
- away from the “easy money” policies implemented to safeguard against recession
- toward a period of sustained higher price inflation for the next several quarters
- toward increasing wage inflation accompanied by lower workforce participation levels
- toward global political uncertainties and threateningly higher hostility levels at such hotspots as Russia/Ukraine and China/southeast Asian neighbors

The VIX index (Figure 1 p.3) measures the expectation of stock market volatility over the next 30 days implied by S&P 500 index options. The VIX index level as of January 18, 2022 was 22.79. It is interesting to note that since the pandemic induced recession (grey area) volatility levels have remained

Continued on page 3

4th Quarter Economic and Market Review

Fixed Income Review

The bond market ended the year with a whimper. The Bloomberg Aggregate Index return was flat for the quarter at 0.01%, a better result than the -1.54% return for the full year. During the quarter the slope of the yield curve flattened. Treasuries ten years and longer rose in price, while the price of shorter maturity Treasuries fell. The shift between two- and ten- year maturities flattened the curve 60 basis points, from 1.77% at the beginning of the quarter to 1.17% at the end of the year. In mid-March the curve, at 2.36%, was as steep as it has been since 2015.

This flattening of the yield curve is inconsistent with signs of a strengthening economy. A steep curve suggests economic strength, with investors who are worried about long term inflation requiring greater compensation for investment in longer-term bonds. Conversely, a flatter curve portends a weaker economic outlook, with investors demanding less compensation for investment in longer maturity bonds relative to short maturity instruments. The slope of the yield curve is often a good predictor of the economic cycle, and today’s dramatically flattened curve, amidst record employment and before the Fed has begun to raise short interest rates, is an unusual sign warning of a potentially weaker economy ahead.

As we ponder possibilities for 2022, we remember that for several of the last few years most market participants incorrectly forecasted higher interest rates for the new year. As we enter 2022 the consensus view that rates will rise seems stronger than it has been in the recent past.

We also believe that it would be important to have portfolios positioned for higher rates. Market prices indicate bond investors expect three or four quarterly 25 basis point increases in the Fed Funds rate over the course of 2022. The Fed has begun reducing the size of monthly secondary market bond purchases, and may end its quantitative easing program by March.

The biggest change over the past quarter has been the persistence of inflation and the Federal Reserve’s increased sense of urgency to fight it. This year’s rise in consumer prices is the most extreme in thirty years. We believe that while inflation is likely to remain in the 3% to 4% range for a

Continued on page 2

4th Quarter Economic and Market Review

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Spencer C. Smith is the Director of Equity Investments for ASB Large Cap Core Equity and Portfolio Manager of Chevy Chase Trust, our affiliate firm. He has more than 25 years of industry experience. Mr. Smith is responsible for the management of all institutional equity portfolios at ASB Capital and Chevy Chase Trust. Mr. Smith works closely with the research team at Chevy Chase Trust, where he was previously Director of Research before assuming his current role. Prior to joining Chevy Chase Trust, Mr. Smith was Managing Director, Portfolio Manager and co-head of the Washington D.C. office of Fiduciary Trust Company International. Before that, Mr. Smith was an investment professional at Morgan Stanley, Emerging Markets Management LLC, and Riggs Investment Management Corporation. Mr. Smith earned a Master of Business Administration from the Yale School of Management.

protracted period, recent increases near 7% are likely a peak.

As the Fed tightens monetary conditions to control inflation, the capital markets will become more volatile as investors gauge the severity and length of time of the rate hikes, or total number of increases for this cycle. We expect investors to struggle with this question all year.

Fixed Income Outlook

Like the consensus, we believe rates will rise in 2022 and we expect to have our portfolios positioned for higher rates throughout most of the year. We also expect rate volatility to increase, and that we will adjust the interest rate risk profile of most portfolios more frequently in 2022 than we did in 2021. Actively managed portfolios will need to react to oversold or overbought technical conditions, responsive to changing economic data and changing circumstances.

Job growth is so strong that we anticipate the unemployment rate may fall from 4% today to less than 3% over the next year or two. Inflation is the worry of consumers, businesses and the Fed. Corporate earnings remain strong, and we remain committed to investment in the additional yield that corporate, mortgage-backed, and municipal securities provide over treasuries.

Equity Market Review

The final quarter of 2021 saw continued strength in equities especially for US large cap stocks. The S&P 500 added 11.02% in the fourth quarter and finished the year with a total return of 28.68%. This followed the 2020 total return of 18.39%.

The strength of these returns is seemingly incongruent with two years of a global pandemic that led to the deepest recession since WWII, severely disrupted global supply chains and caused millions of deaths. Even more remarkable, from the market bottom of the initial Covid scare on March 23rd, 2020 through December 31st, 2021 the S&P 500 enjoyed an astounding total return of 118.97%.

The above results were unpredictable (although plenty of rational has been fabricated for them in hindsight). Where the market ends this year is equally unpredictable. Yet this is the time of year when the large sell-side banks roll out their year-end market forecasts with great confidence while spending very little (in most cases zero) time accounting for the past year's missed forecasts.

Equity Strategy

Except for two brief drawdowns (one at the end of 2018 and another at the beginning of 2020) US equity markets have essentially gone in one direction (up) since the nadir of the financial crisis in March of 2009.

Unsurprisingly, long periods of being rewarded for taking risk begets more risk taking. This has led to shiny object syndrome in some corners of the market including mania meme stocks and multi-billion-dollar technology companies with negative earnings and little revenue. These are not investments based on any rational financial analysis. They are investments that have increased in price, and seemingly for that reason alone, they have serially attracted additional investment.

Continued on page 3

4th Quarter Economic and Market Review

At the end of 2021 we started to see the air begin to leak from some of the most bloated of these securities. That trend has continued into the first trading days of 2022. Whether this will continue going forward we don't know, but we sleep well at night not participating in investments that make little sense to us.

Our approach is to stick to investing in assets based on their financial merit - companies with outsized profitability, strong industry positioning and stellar balance sheets. Even in an equity market that is in general richly valued relative to history, we are still able to identify and invest in such assets at reasonable prices.

What's Ahead for 2022

Figure 1[1]

Figure 2[1]

elevated as compared to previous years. More importantly, just a few weeks into 2022 we have seen a dramatic increase in volatility as seen in Figure 2.

Late last year the Federal Reserve (Fed) announced that its ultra-easy monetary policy, implemented at the beginning of the pandemic, would be coming to a close. First, the Fed said it would accelerate the reduction of its monthly bond purchases and more recently, specifically at the 12/14-15 FOMC meeting, the Fed announced more drastic action against the inflation threat. Many of the questions from both sides of the aisle center on inflation, which is running at close to a 40-year high. After declaring the 2021 inflationary build-up "transitory" for much of the year, the Fed has reversed its thoughts on inflation which have now reached a level requiring action: a 7% annualized rate in December. This new Fed view entails making aggressive policy moves in response to the sustained and rising inflation threat. Federal Reserve Chairman Jerome Powell said during the mid-December meeting that the economy is both healthy enough and in need of tighter monetary policy. He told committee members, "As we move through this year… if things develop as expected, we'll be normalizing policy, meaning we're going to end our asset purchases in March, meaning we'll be raising rates over the course of the year." He further commented, "At some point perhaps later this year we will start to allow the balance sheet to run off, and

Continued on page 4

What's Ahead for 2022

that's just the road to normalizing policy." More ominous was his declaration that the Fed is expecting to raise rates three, perhaps four times this year in quarter percentage-point increments. Will that be enough to curb inflation? Shortly after the Fed meeting, JP Morgan & Co. Chief Executive Officer Jamie Dimon told analysts, "My view is a pretty good chance there will be more than four. It could be six or seven." Swaps markets currently indicate between three and four standard quarter-point hikes for this year and around six by the end of 2023. "I expect more interest rate increases than is in the implied curve," Dimon shared.

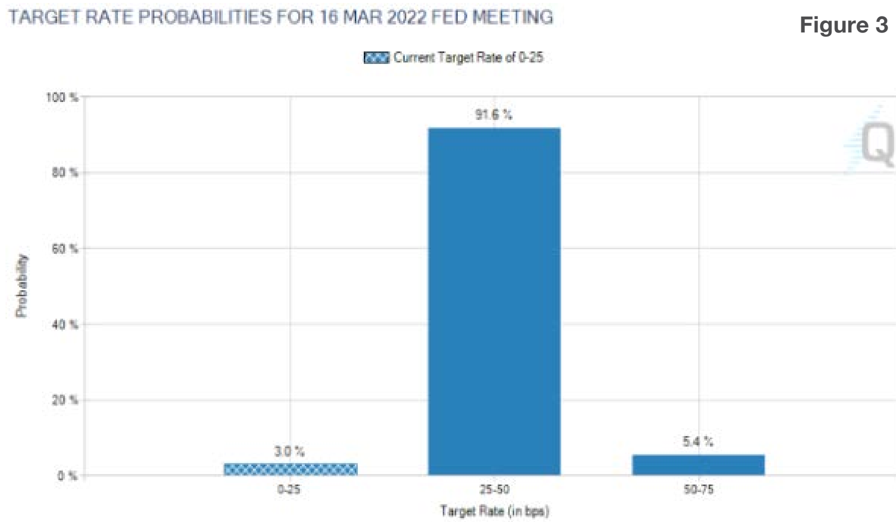

Figure 3

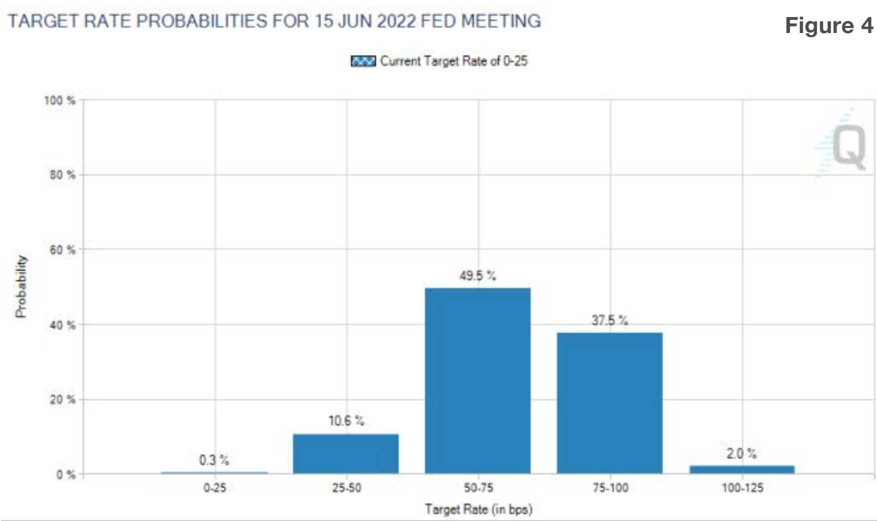

Figure 4

The FedWatch tool[2] calculates unconditional probabilities of Federal Open Market Committee (FOMC) meeting outcomes. Probability of a rate hike is calculated by adding the probabilities of all target rate levels above the current target rate. Figures 3-6 indicate the expected rate levels at each of the next four FOMC meetings through the end of 2022.

> "US and global economic recovery from the pandemic may face continued headwinds related to inflation even as supply chain issues subside."

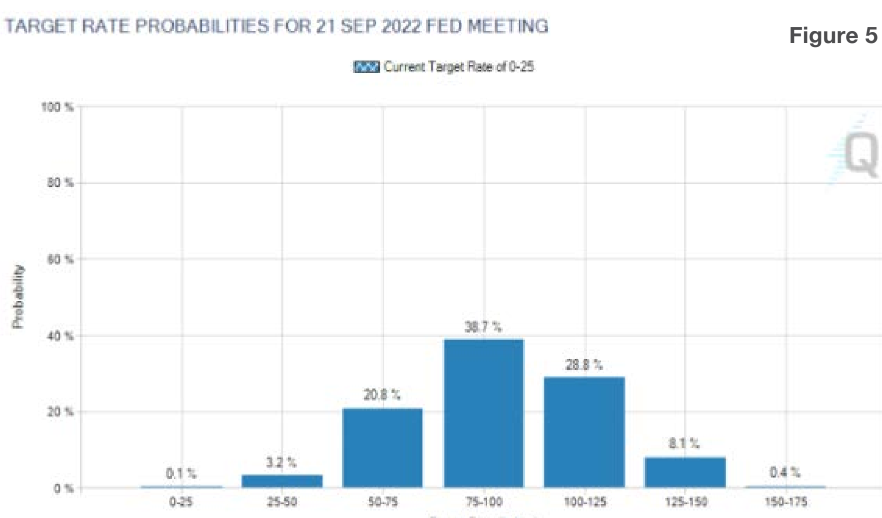

Figure 5

Probabilities of possible Fed Funds target rates are based on Fed Fund futures contract prices assuming that the rate hike is 0.25% (25 basis points) and that the Fed Funds Effective Rate (FFER) will react by a like amount. Toward the second half of 2022, figures 5 and 6 show the longer-term projections.

Continued on page 5

What's Ahead for 2022

In summary, the prediction is that there is about an 80% probability of rates exceeding 100-125 BPs by year end and a 38% probability of it being even higher. Therefore, it appears that more than three 25Bps increases is the markets best guess for 2022.

With a large percentage of Insurers' portfolios invested in investment grade bonds, they face a very difficult situation in rising rate environments. Rising interest rates create market value declines for bond portfolios. The sensitivity of an insurer's bond portfolio to changes in interest rates can be measured by a portfolio's duration. For example, if a bond portfolio has a duration of 6.6 years, which is approximately the duration of the Bloomberg Barclays Aggregate (AGG) index at the time of this writing, a 1% increase in interest rates will reduce the portfolio's market value by 6.6%.

When interest rates are rising, particularly when coupled with high inflation rates, it should be expected that both businesses and consumers will cut back on spending. This spending reduction will typically cause company earnings to fall and therefore stock prices to drop. One noted exception would be financial stocks. Historical observations indicate that this initial reaction reverses over time and the stock market tends to produce positive returns with time (see figure 7).

After a period of very low wage inflation, the recent inflationary surge has been accompanied by a similar increase in wage inflation as indicated in figure 8.

Another wild card affecting the performance of the US and global stock and bond markets is the likelihood of international conflict.

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Figure 6

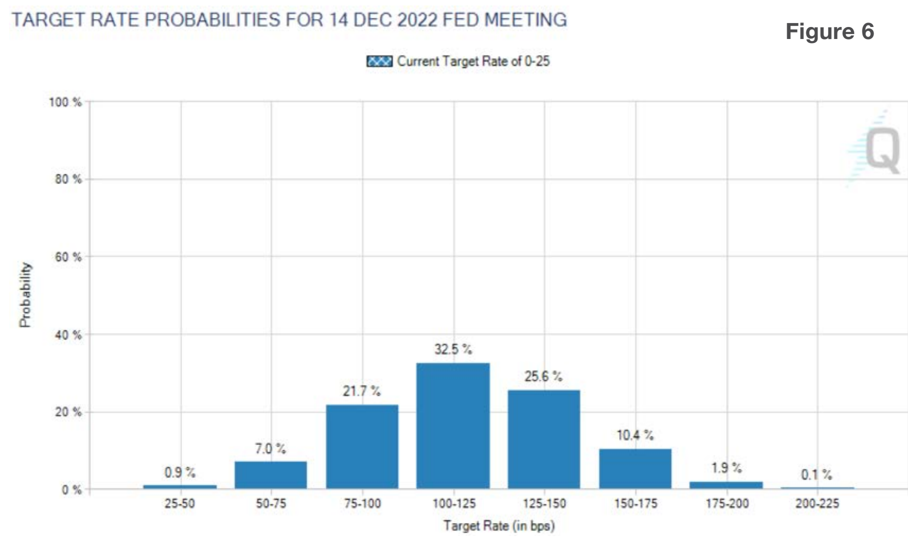
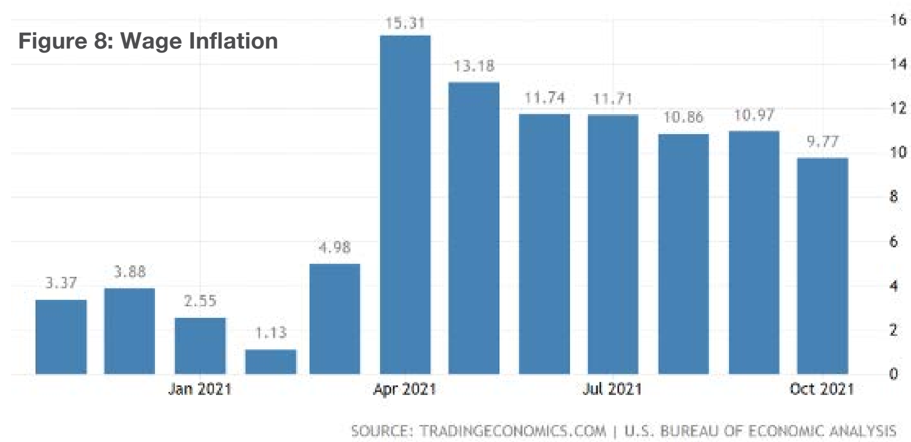


Figure 7: Value stocks tend to outperform around the first rate hike
as of January 13, 2022

Source: Goldman Sachs

	Median returns			
	Months PRECEEDING first rate hike		Months FOLLOWING first rate hike	
	6 months	3 months	3 months	6 months
S&P 500	6 %	5 %	(6)%	5 %
Long/short factors				
Valuation (low vs. high)	5 %	3 %	1 %	5 %
Momentum (high vs. low)	2	(5)	7	2
Growth (high vs. low)	1	(2)	(4)	1
Size (R2K vs. SPX)	0	1	(2)	0
Bal. Sheet (strong vs. weak)	(1)	(3)	4	(1)
Dividend yield (high vs. low)	(1)	2	3	(1)
Volatility (low vs. high)	(3)	(0)	4	(3)
Margins (high vs. low)	(4)	(3)	3	(4)
Returns (high vs. low)	(6)	(3)	4	(6)

Figure 8: Wage Inflation



What's Ahead for 2022

Crisis Group has published their top ten concerns for this year[3]. While several geographic areas have been sources of concern for many years, recent political confrontations with China and Russia appear to more highly volatile and perhaps more dangerous to US market performance at this time.

Takeaways and investment ideas for insurers

- US and global economic recovery from the pandemic may face continued headwinds related to inflation even as supply chain issues subside. Expect real (after inflation) returns to pale in comparison to the last several years.
- Interest rates are entering a cyclical change posing the likelihood of a continuance of negative “real” (after inflation) returns for investment grade bonds. Increasing duration in search of yield would be a terrible idea as it would increase the sensitivity to rate increases. Accepting more credit risk and/ or less liquidity might be the only solutions in this market. Private Placements, rated for favorable treatment for insurers, could prove to be an interesting asset class addition to portfolios.

Top ten: Ukraine (Russia/USA/NATO); China/USA; Israel/Palestine; Iran/USA/Israel; Afghanistan; Yemen; Haiti; Myanmar; Ethiopia and African Islamist militants

- Rising rates will also serve to initially cause increased stock market volatility and downward price pressure but a rebound could be expected for the latter half of the year. Insurers may want to consider additional equity diversification. Small allocations to global developed markets might make sense since they are expected to outperform the US after many years of underperformance. Emerging markets may suffer through the immediate periods of adjustment to the new interest rate regimes; however, they should produce strong longer-term returns. At this time, we would suggest avoiding China due to unpredictable political risk.

[1] https://www.google.com/search?q=vix&oq=vix&aqs=chrome..69i57j35i39l2j46i199i291i433i512j46i199i433i465i512j69i60l2j69i61.888j0j4&sourceid=chrome&ie=UTF-8

[2] https://www.cmegroup.com/trading/interest-rates/countdown-to-fomc.html#

[3] https://www.crisisgroup.org/global/10-conflicts-watch-2022

Buyer Beware

In today’s markets, many investments are touted as “safe” by virtue of a credit rating or a label like “senior” or “loan”. But many of the investments that are deemed to be secure are anything but, and buyers should beware, particularly insurance companies that, by virtue of needing yield combined with capital treatment considerations, have invested (and continue to invest) heavily in these assets.

In that context, insurers should be reminded that markets are a clearing place for buyers and sellers, and incentives matter. Charlie Munger once said, “Show me the incentive and I will show you the outcome”. Nothing is more important to emphasize in today’s bubble. In that vein, our advice would be to recognize that return per unit of risk in many markets is at all-time lows, and for investors to avoid, as much as possible, further increasing their exposure to grossly overvalued assets.

Continued on page 7

Buyer Beware

Daniel Zwirn is CEO/CIO of Arena Investors, a global institutional asset manager that provides creative solutions for those seeking capital in special situations. Arena originates unlevered, privately negotiated, asset backed, senior secured investments in insurance capital efficient vehicles. Arena has deployed ~$3b into 270 credits in micro transactions ($10m-$30m) with superior risk adjusted returns relative to mega sized credit shops.

On the seller side, ballooning balance sheets and incredible amounts of excess liquidity have turned investment managers into asset managers – that is, firms motivated to grow assets under management, which necessitate them offering products that are scalable (and "sell-able"), to the tunes of hundreds of billions of dollars. According to a joint study by the Thinking Ahead Institute and Pensions & Investments[1], the assets under management of the 500 largest asset managers in the world reached a new record in 4Q2021 of $119.5 trillion, a 14.5% year-over-year increase, and an increase of 85% over the past 10 years. Many of these managers have become so large that for those that manage hundreds of billions of dollars, doing deal sizes below $100 million (or even $250 million) today is just not economically justifiable.

Related to the above story, the average debt multiple on middle-market loans continues to increase (now at ~7 times, as shown in the graph to the left from Pitchbook data), ignoring EBITDA adjustments, which remain on an upward trend, and also ignoring that, as S&P Global recently cited, "marketing EBITDA generally doesn't provide a realistic indication of future earnings and … companies consistently overestimate debt repayment[2]. Together, these meaningfully understate future leverage and credit risk[3]. In fact, what is a "senior loan" is actually a combination of yesterday's senior loan plus a high yield bond.

The fact that buyers are taking comfort from ever longer lender advance rates, weak covenants, and low cost, while lenders are taking comfort from how much buyers are willing to pay (thus creating a falsely "comforting" low loan-to-value), reminds one of the two proverbial "drunken sailors" propping each other up.

Turning to "safety," issuers (the sellers) have taken advantage of the current times as well. For example, one can look at the annual amount of investment grade bond issuance[4], which is up about 5 times over the past 25 years.

As of 2019[5], the outstanding issuance in the BBB US bond market exceeds

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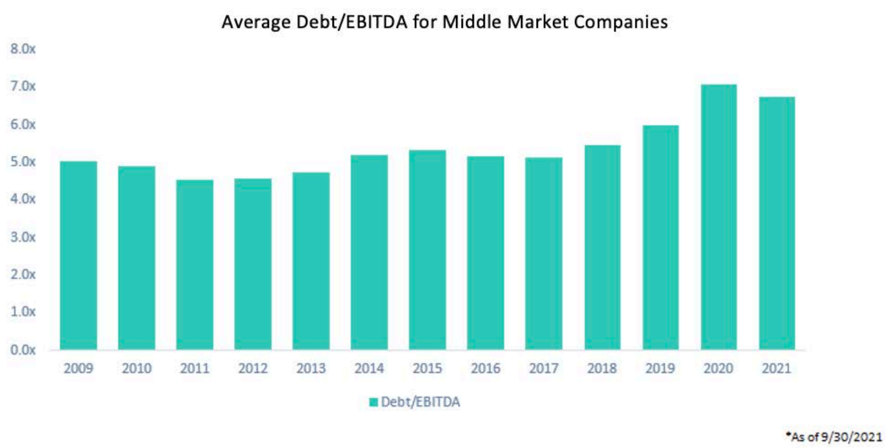
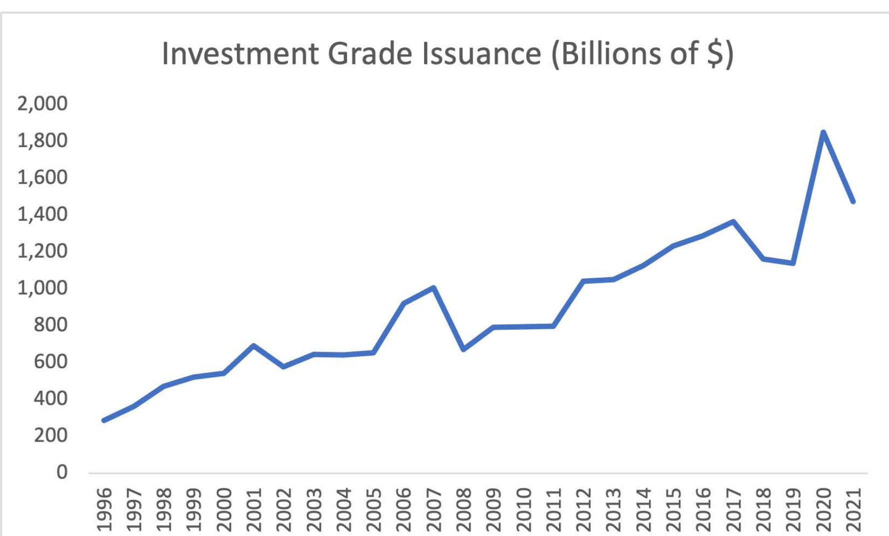




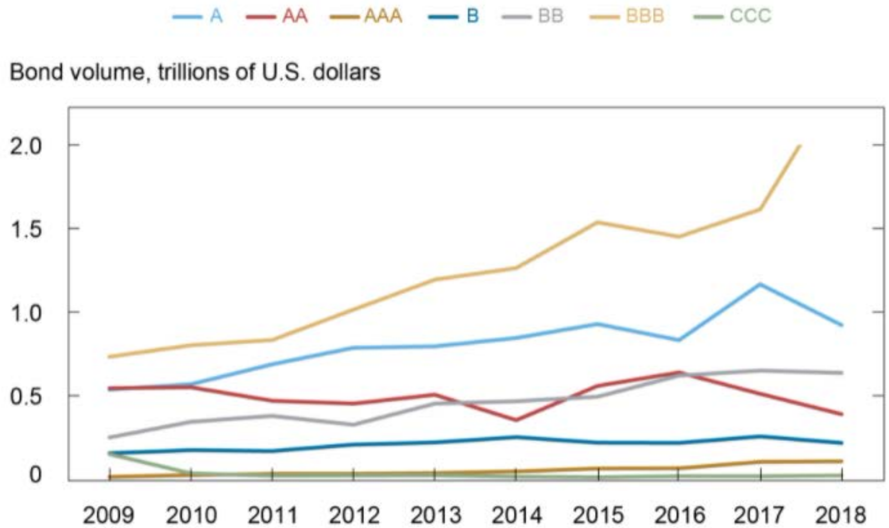
Buyer Beware

the entirety of the speculative-grade bond market. Given that BBB connotes "investment grade," the correspondingly highly efficient capital treatment for these bonds on the balance sheets of insurance companies leads issuers to contort credits to fit agencies' minimum standards for this label.

What is not widely recognized is that such purported safety does not equal quality. Rather, today's BBB corporate bond is yesterday's BB[6]. Given the "investment grade rating" threshold of BBB, it is no surprise that issuance by companies deemed to be on the BBB threshold has boomed since the financial crisis, as shown in the graph to the right.

And with $7 trillion globally in "BBB," one can only wonder whether the underlying credit quality matches such ratings, with yields[7] going from just over 10% in early 2009 to just over 3% today, and given that qualifying as investment grade today allows for 50% + more leverage (as measured by debt divided by EBITDA) versus 2008[8].

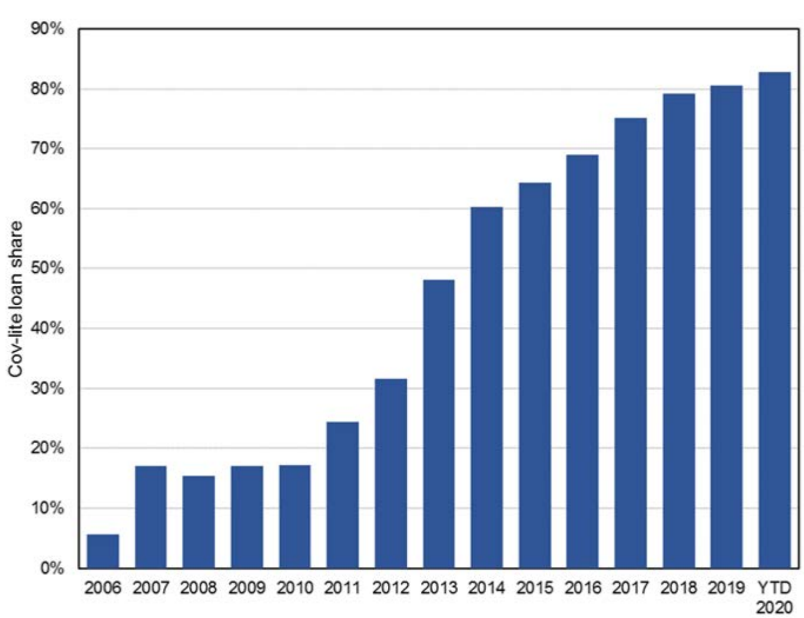
The Stock of Bonds Outstanding Issued by BBB-Rated Firms Tripled in Size from 2009 to 2018



Sources: S&P Capital IQ; Thomson Reuters.

This phenomenon is also due, in large part, to rearview mirror analysis. For example, take CLO equity, which, "didn't lose money" in the 2008 crisis. If you ignore the structurally better collateral and covenants at that time (versus today), and believe that investors will actually have "strong hands" to hold these securities if they go down 80-90 points, I guess one could make that case. But otherwise, it is hard to imagine this not being a bubble that will result in losses. On the former point re: covenants, note the graph to the left showing the share of "covenant-lite" loans.

Share of Covenant-Lite Loans in Outstanding Leveraged Loans (S&P LCD data)

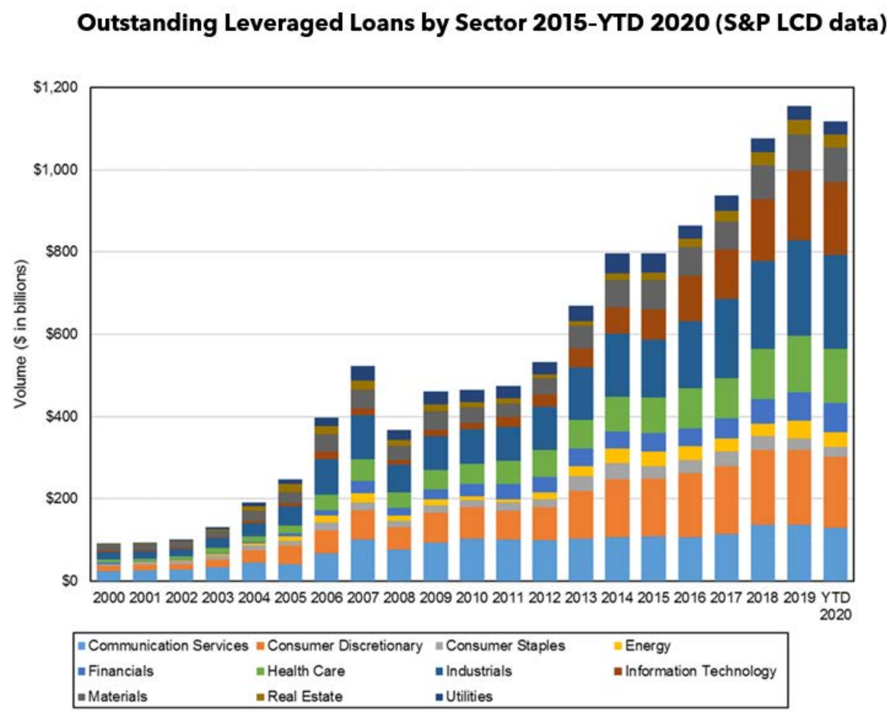


The much lower asset quality (versus 2008) would necessarily imply lower recoveries. And then, further, even assuming a "V" shaped journey from trough to recovery, few current owners will hold all the way through like they did in 2008. A 2020 Federal Reserve note[9] cited that only about 7.5% of CLO equity tranches were owned by insurance companies, pension funds and depository institutions whereas nearly 50% were held by households and mutual funds[10].

Continued on page 9

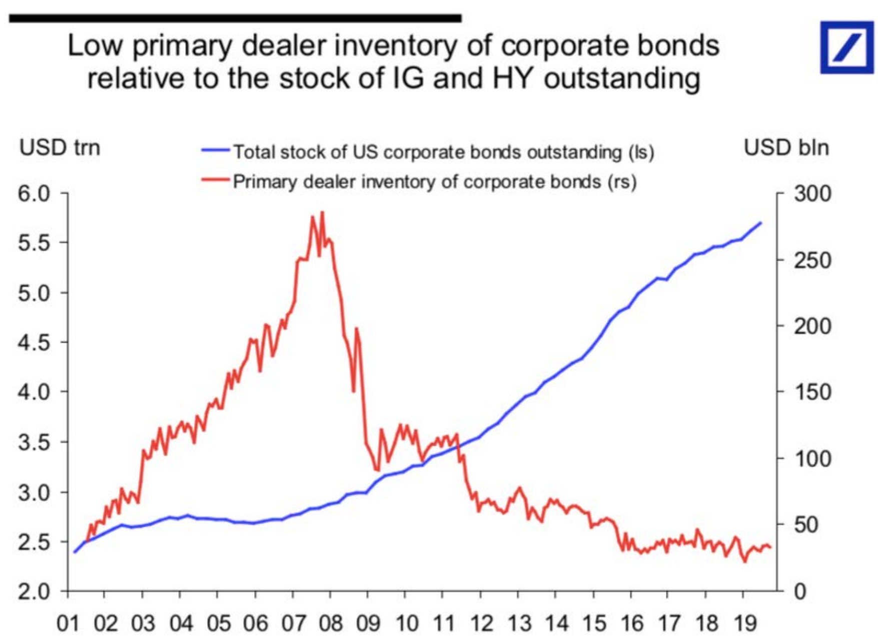
Buyer Beware

And then marry that with the extreme increase in issuance over that same period, as shown in the graph to the right. To us, this screams of supply driven by demand (caused by looking through the rear view mirror), and certainly not a trade we would pile into.



And finally, there is the fact that liquidity will not be there when you actually need it. Dealers no longer maintain liquidity in these securities, and even when they did (let's go back to 2002 and the WorldCom fraud), there was nary a bid, leading to the bank debt and bonds of other related (non-fraudulent) companies trading down materially. In today's post-Volker Rule world (where dealers do not maintain inventory and must have a closely matched book, and thus hold much less inventory, as shown in the graph by Deutsche Bank below), one can only imagine the pain that may come.

And again, this in the context of extremely compressed yields, as shown in the graph on p.10 for the last ~40 years across Baa, Aaa, 30-year mortgages and 10-year Treasuries.



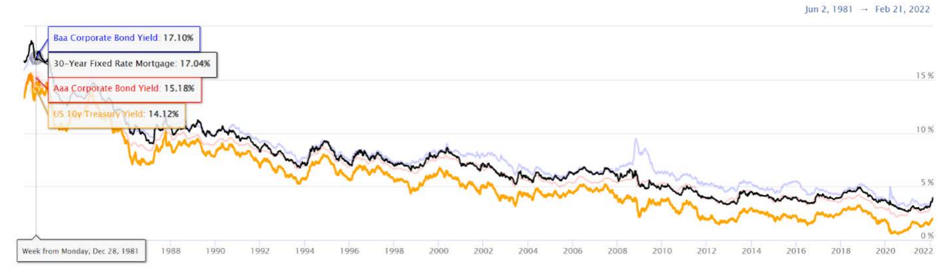
All of what has been described may take a long time to materialize. After all, many of the holders of today's paper do not need to mark to market and are hence, "strong hands". As one example, according to AM Best[11], US Insurers' Holdings in Collateralized Loan Obligations Have Grown by 77% Since 2016 from $75.1 billion to $132.7 billion. And an even cursory search of CLO on LinkedIn retrieves 23,000 results – these are not people who wake up in the morning saying, "should I do a 180?" but are rather feeding the beast further and further and will only be displaced by an explosion (which they will work tirelessly to prevent).

But if there is a race to the door (which doesn't have to be macro or even

Continued on page 10

Buyer Beware

economically driven – e.g., WorldCom), it will be a stampede of epic proportions. That's not to say there aren't investments that are uncorrelated, or even negatively correlated and can be defensive in such times, and that is also not to say that one cannot find investments that are both uncorrelated and can create upside convexity. Such opportunities are, by their nature, limited in supply and require their own expertise to source and manage, but can be found through the right partners and are worth the effort to find, particularly in today's environment. May you stay safe in these bubbly times…



[1] https://www.thinkingaheadinstitute.org/research-papers/the-worlds-largest-asset-managers-2021/

[2] Note, assuming 20% EBITDA adjustments and 80% cashflow conversion, this would imply true leverage (debt to unlevered free cash flow) of 11x.

[3] https://www.spglobal.com/ratings/en/research/articles/220208-ebitda-addbacks-continue-to-stack-12264363

[4] Source: S&P Global

[5] https://www.spglobal.com/en/research-insights/articles/the-bbb-u-s-bond-market-exceeds-3-trillion

[6] Zwirn, Daniel, Kyung-Soo Liew, Jim and Ajakh, Ahmad. "This Time Is Different, but It Will End the Same Way: Unrecognized Secular Changes in the Bond Market since the 2008 Crisis That May Precipitate the Next Crisis." The Journal of Fixed Income, Fall 2019. https://eprints.pm-research.com//17511/21697/index.html?27788

[7] https://fred.stlouisfed.org/series/BAMLC0A4CBBBEY

[8] https://seekingalpha.com/article/4259460-increasing-share-of-bbb-rated-bonds-and-changing-credit-fundamentals-in-investment-grade

[9] https://www.federalreserve.gov/econres/notes/feds-notes/who-owns-us-clo-securities-an-update-by-tranche-20200625.htm

[10] This compares to insurance companies, pension funds and depository institutions owning over 60% of the senior tranches.

[11] https://www.businesswire.com/news/home/20210126005820/en/Best%E2%80%99s-Special-Report-Rated-US-Insurers%E2%80%99-Holdings-in-Collateralized-Loan-Obligations-Have-Grown-by-77-Since-2016

Upcoming Events

1. The CICA International Conference in Tucson, Arizona is coming up on March 6th-9th. Carl Terzer and Travis Terzer will be in attendance. We hope you stop by booth #20 to see us.

2. CapVisor will be attending the NCCIA annual conference in Durham, NC from May 1st-4th. We will also be exhibiting.

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