CAPTIVE INTERNATIONAL CAYMAN AWARDS 2022 HIGHLY COMMENDED ASSET MANAGER—INDIVIDUAL Carl Terzer—CapVisor

CAPTIVE INTERNATIONAL US Awards HIGHLY COMMENDED

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Focus on Bonds

So, did you miss it? Peak bond yields, that is. It certainly looks like they might already be behind us now. If you missed it, take comfort in the fact that you've got a lot of company.

Many insurers we have spoken to over the last 6 months were still a bit shell shocked by last year's negative returns due to the rapid rise in interest rates. They were very concerned and expected a few more FED rate increases that could cause additional damage to bond market values. Early in Q4 of last year, the Street accurately predicted that the terminal rate would be between 5-5.5%. We are presently at a Fed rate of 5-5.25% as of the last 25 BP rise and bets are on that the Fed will now coast for a bit. With slow but promising progress in bringing down our sticky inflation, the likelihood of further increases is diminished unless progress stalls over the next couple of quarters. With

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Q1 Economic and Market Review

The first quarter ended with the Aggregate Bond Index generating a respectable 2.96% total return, but it was a bumpy ride getting there.

January was smooth enough, as ten-year Treasury yields fell from 3.9% to 3.5%, and corporate credit spreads tightened from 1.3% to an average 1.15% over comparable Treasurys. In February the flat road twisted when credit spreads widened ten basis points and ten-year Treasury yields rose to a quarterly high of 4.09% in early March.

The collapse in early March of Silicon Valley Bank (SVB) rekindled memories of the 2008 Global Financial Crisis (GFC). Credit spreads exploded 40 basis points to last year's widest levels, and volatility spiked. Capital raising halted and markets nearly shuttered. The market punished regional bank issues particularly hard.

The Biden Administration acted quickly to halt additional bank panic, calming the markets. Amidst the confusion, two-year Treasury investors rode a roller coaster as yields fell from 5.07% on Wednesday, March 8th, to less than 4% on Monday the 13th, back up to 4.25% on Tuesday, down to 3.89% on Wednesday, back up to 4.16% on Thursday, down to 3.84% on Friday, and back up to 4.17% the following Tuesday, March 21.

From the Lehman default in September 2008, to the COVID pandemic in March 2020, to the collapse of SVB this past month, crises seem to develop more quickly. Washington Mutual depositors withdrew $16 billion in ten days when the bank collapsed in 2008. Silicon Valley depositors withdrew $42 billion in eight hours. Fortunately, regulators also appear to be responding more quickly as well.

So far, larger financial institutions, subjected to higher capital standards and regulatory oversight following the GFC, appear to have weathered the storm well, and in fact may have benefited somewhat. According to Federal Reserve data, the 25 biggest U.S. banks grew deposits

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Q1 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.

$120 billion in the days after the SVB collapse. All U.S. banks below that level lost $108 billion over the same period, for the largest weekly drop in smaller bank deposits on record.

Let's hope the government's quick action contained the crisis, and policymakers find a way to reduce the threat of moral hazard creating even larger problems in the future.

Outlook

The Fed's tightening policy has been aggressive, in an effort to control stubbornly high inflation. We believe the growth rate of inflation has peaked, and that the Fed is close to holding short rates steady. As a result, we maintain durations near 100% of index levels for most portfolios.

Every tightening cycle, without exception, is marked with a financial crisis. Of course, any period's defining event is not known until after rates have begun to fall. Let's hope we have already experienced this period's inflection point.

However, hope is not an investment strategy and spreads have widened. Financial sector issues, a large component of the bond market, have been hit especially hard. We prefer the largest, most liquid bonds of institutions that were deemed "systemically important" after the GFC. Lower prices present opportunity, and we have selectively added to some positions. We have also added interest rate-sensitive housing bond positions.

We continue to like the credit quality of taxable municipal securities, although higher interest rates have slowed refinancings and reduced new issue supply.

The inverted yield curve presents an excellent opportunity for investors to invest in high quality, 1-3 year maturity, investment grade fixed. Extending from money market funds into the 1-3 year Government/Credit Index three months after the start of a yield curve inversion has generated an average of 7.7%total returns one year after the last six inversions, and 26% returns (8%annualized) three years later, dating back to 1978. Of course, past historical trends are not guaranteed to occur in the future, but we would like to discuss this opportunity with you in more detail.

Review

There are a few things that we can say with confidence about the current economic environment.

- **We have inflation. While recent readings have shown a moderating trend, inflation is still at levels the US economy hasn't experienced in several decades.**
- **We have a Federal Reserve that is attempting to combat inflation with a fast and aggressive cycle of**

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Q1 Economic and Market Review

increasing short-term borrowing rates.

- We have a very strong labor market. Unemployment is at multidecade lows.

This continued strength in the jobs market has only reinforced the Fed's confidence that they are pursuing the correct policy in continuing to increase interest rates.

While the impact of higher rates has so far appeared to be muted in most segments of the US economy there are number of nascent trends (some admittedly anecdotal at this point) that indicate the likelihood of a weakening economy in the months ahead:

- Credit conditions are tightening. Stress at local and regional banks is leading to tougher borrowing conditions, especially for small businesses.
- After being surprisingly resilient in 2022, corporate earnings are now trending down.
- Consumer sentiment and confidence are trending down.

We believe the path of employment will be the key factor in determining the level of weakness in the economy going forward. While job availability remains high and the unemployment rate is exceptionally low, we have begun to see some evidence that corporations that were focused on growth are now retrenching and beginning to refocus on cost savings and profitability. This has been especially true for large technology companies that are announcing layoffs at a pace not seen since the Global Financial Crisis.

> "We have a very strong labor market. Unemployment is at multidecade lows. This continued strength in the jobs market has only reinforced the Fed's confidence that they are pursuing the correct policy in continuing to increase interest rates."

Historically, when the labor market is strengthening, it usually does so gradually over several years. When it moves in the opposite direction, however, it tends to do so with brutal speed. When one company in an industry begins to scale back hiring or begins laying off workers, it becomes politically palatable for other companies to do the same. We fear this self-reinforcing trend may be beginning now. We hope we are wrong.

Outlook

Equity markets, thus far this year, have largely taken the potential for economic disruption in stride. In the first quarter of 2023 the S&P 500 Index had a total return of 7.48%. This followed a total return of 7.55% in the fourth quarter of 2022.

Counterintuitively, many market participants are actually cheering on forecasts of economic weakness. The logic is that if economic weakness leads to a cooling off of inflation and a weaker labor market, then the Fed will be able to stop raising rates and perhaps begin cutting rates. To this we would say be careful what you wish for. The direction of the economy is hard to control and even more difficult to predict. A deeper recession than forecast (aka a "hard landing") would certainly result in much weaker corporate earnings than are now being forecast, and it is difficult to foresee equity markets reacting positively in such a scenario.

While we are hoping for an economic "soft landing" we think it is sensible amidst this level of uncertainty to become incrementally more defensively positioned in our portfolios while the market remains relatively buoyant. We also stand ready to add to the companies that we think are strong long-term assets in the event of a market downturn. ☐

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Focus on Bonds

expectations near a 70% probability of a recession within the next few quarters, pressure

> **“Bonds are often misunderstood and typically aren’t nearly as exciting a venue for big gains or rapid wealth accumulation. The fact is that they should be paying attention as the bond market’s predictive value, based more on mathematical relationships than market sentiment, is much underrated.”**

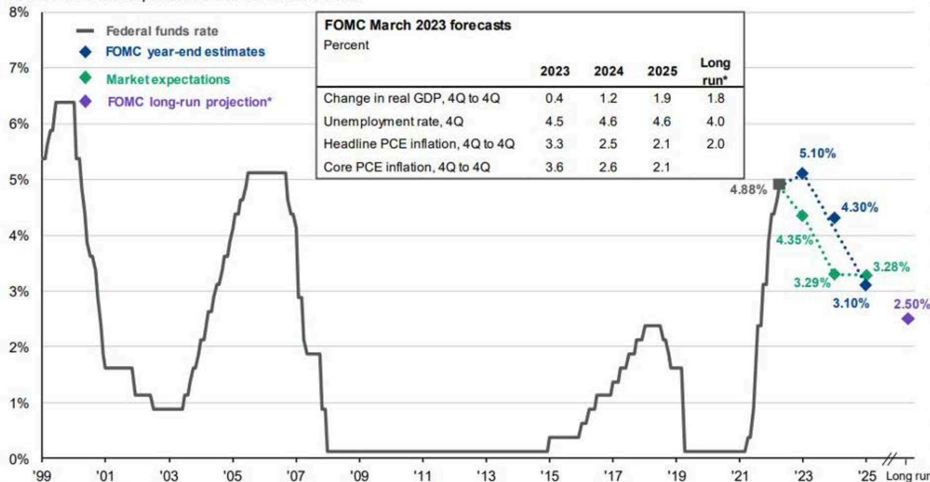
may be on the Fed to lower rather than raise rates. Figure 2 shows

Figure 1

Fed Rate expectations for rates going forward several years.

Note that Wall Street expects that Fed rate reductions will come faster, indicating an expectation that the Fed, when combined with the credit tightening effects of the bank crisis in Q1, may have already over-steered.

Figure 2



FOMC March 2023 forecasts
Percent

	2023	2024	2025	Long run*
Change in real GDP, 4Q to 4Q	0.4	1.2	1.9	1.8
Unemployment rate, 4Q	4.5	4.6	4.6	4.0
Headline PCE inflation, 4Q to 4Q	3.3	2.5	2.1	2.0
Core PCE inflation, 4Q to 4Q	3.6	2.6	2.1	

Source: JP Morgan 3/31/23

In late Q3 and early Q4 2022, we had urged that insurers use sidelined money for intermediate bonds and to lock-in the highest yields in more than a decade. Even past peak, we still believe that this advice makes sense. Many insurers were hesitant to invest in intermediate maturities as they were still smarting from last year’s damaging interest rise. Many chose to continue what they perceived to be a safer path; that of investing in high yielding short duration bonds or T-bills/

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Focus on Bonds

CDs. Why not with such attractive short rates? Well, this was the riskier strategy! By investing short, a bet would be placed that reinvestments of maturing securities could continually be made at attractive rates. With rates expected to be dropping within the next several quarters, that is highly unlikely to happen. This perceived "safer" path of investing short will most certainly result in underperformance over the next several year time horizon as reinvestment risk is quite high as indicated in figure 3.

The Treasury Yield curve indicates that the expected path of yields will decline rather steeply over the next 3 to 5 years.

A common mistake, that of buying high and selling low, is demonstrated in figure 4. Many investors made short term decisions in a panic during unfavorable market conditions. It is just those times when they need to continue to focus on their longer-term investment objectives. As bonds experienced their worst returns in history in 2022, money flooded out of bonds causing investors to realize losses: selling low.

Conclusions

Most investors pay very close attention to the stock market, the S&P 500 in particular. Perhaps this is because bonds are often misunderstood and typically aren't nearly as exciting a venue for big gains or rapid wealth accumulation. The fact is that they should be paying attention as the bond market's predictive value, based more on mathematical relationships than market sentiment, is much underrated. From the securities markets' perspective, bonds are very significant as their global value, at about $300 trillion,

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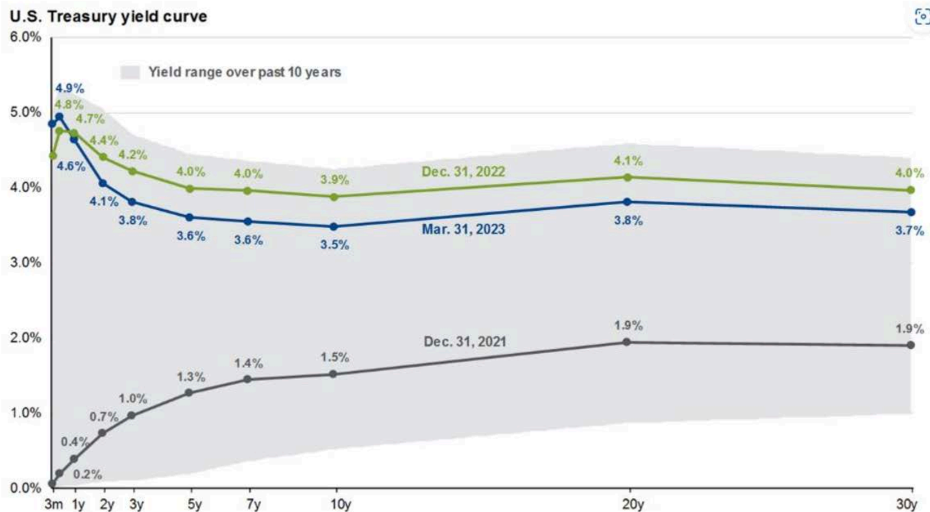
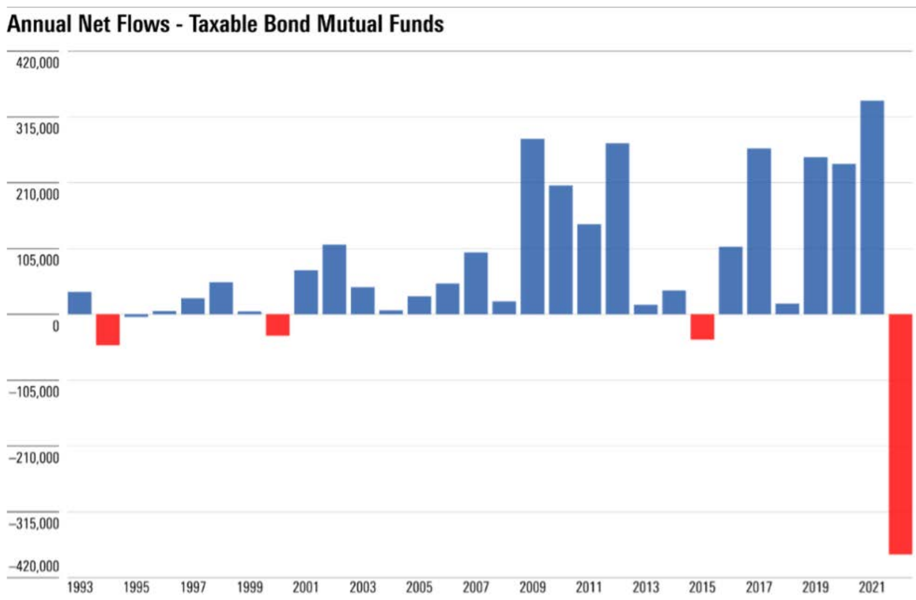
Figure 3



Source: JP Morgan 3/31/23

Figure 4



Source: Bloomberg, Morningstar DirectData as of March 20, 2023.

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Focus on Bonds

dwarfs the stock market's global size of about $125 trillion. US bonds are a significant portion, at 40% of this global bond market.

Many insurance company investors had a "stormy" year in 2022 with many losing surplus on their financial statements. Asset Class diversification did little to help stem losses since it is not uncommon in panic situations for historical correlations to go towards 1. Most insurance company investors with a longer-term perspective, and properly designed investment programs built to weather such storms, stuck to their plan. They know that such storms are cyclical and typically short and when they pass, normalcy returns.

We believe that the worst of this storm is over, but for a few more bumpy quarters, we'll see fair winds ahead as we await a new bull cycle for the economy and the markets. □

Carl Terzer Named Highly Commended - Captive International Cayman Awards

From Captive International: The 2022 Captive International Cayman Awards are our tribute to the stars and unsung heroes of the captive insurance industry on Cayman. It is their efforts and achievements that keep Cayman at the forefront of the captive insurance world.

Over the past few months, Captive International readers have cast hundreds of votes in support of service providers they believe are at the top of their game.

Every year, each category of awards becomes more competitive than before. Given the highly contested nature of the categories, in most cases we have named two additional highly commended companies or individuals that were runners-up.

CapVisor's Carl Terzer is recognized as "highly commended" in the Best Asset Manager category.

Upcoming Events

Carl Terzer and Travis Terzer will be attending the VCIA 2023 Annual Conference from August 7-10 in Burlington, VT. Travis is coordinating a session entitled, "Tips and Tricks of Managing Captive Service Providers," which will be held on Wednesday, August 9 from 1:30-2:30 p.m. We look forward to seeing you in Vermont this summer!

Carl E. Terzer, Principal & Editor in Chief CapVisor Associates, LLC

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