CapVisor Associates, LLC
Quarterly Newsletter

CapVisor Associates, LLC

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Insurance Asset Management

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by

Carl Terzer

And, yet the US stock market continues its slow but steady rise. We know that it will stop, at some point, as all bull markets do. Will it be a crash, be a series of gentler corrections, or something else? Will it be caused by socio-political events , market fundamentals or other factors? How concerned should insurers be?

Many insurers have increased their exposure to the equity markets due to the long period of disappointing returns in the bond markets. Fed rate policy, which has held interest rates at artificially low levels for an extended period, has been the cause of

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Economic Review

by

John Saf
John Calamos
Matt Freund

We see a favorable backdrop for equities and convertible securities through the remainder of the year, although late-cycle pressures may increase going into 2018. Global growth has rebounded significantly, and we maintain our expectation for sustained and balanced global expansion through 2017. PMIs are converging and expanding, there is little risk of the U.S. overheating, the recovery in Europe is strengthening, and many emerging markets continue on favorable trajectories.

Global monetary policy should provide a near-term tailwind to equities and convertibles while not creating stiff headwinds for fixed income. We expect the Federal Reserve to maintain a gradual approach to increasing short-term rates. Other central banks have also begun to assume less accommodative stances, but we anticipate slow and deliberate approaches across the globe. As long-term rates are unlikely to soar, there are ongoing opportunities within the fixed income market.

We remain mindful of risk. Populist pressures have lessened in Europe, but elevated political uncertainty and contentious fiscal policy negotiations in the U.S. persist. North Korea's bellicose stance gives pause, as do strained U.S. ties with China and

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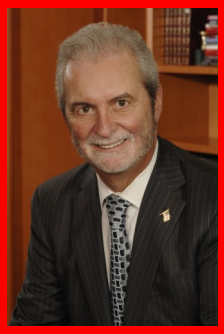
John SAF, CFA
Vice President, Co-Portfolio Manager
John Saf contributes 25 years of investment industry experience. Prior to joining Calamos in 2017, he served as a managing director and portfolio manager at Oppenheimer Investment Management (2006-2017). In this role, he was responsible for nearly $1 billion in assets, including insurance portfolios.



John P. Calamos, Sr.
Founder, Chairman and Global Chief Investment Officer
John P. Calamos, Sr. is Chairman and Global CIO of Calamos Investments, a firm he founded in 1977. With origins as an institutional convertible bond manager, the firm has grown into a global asset management firm. Mr. Calamos is often quoted as an authority on risk-managed investment strategies, markets and the economy. He received his B.A. in Economics and an M.B.A. in Finance from the Illinois Institute of Technology. He joined the United States Air Force after graduation and served as a combat pilot during the Vietnam War.

Economic Review

Russia, and evolving trade relationships. Central banks remain very accommodative, but unexpected shifts in monetary policy could have negative consequences for risk asset prices and real economic activity, particularly after years of unprecedented support. Corporate earnings are on the rise, but so too are levels of debt.

Market rotation is likely to continue, which may exact a steeper toll on higher-valued names. More broadly, we would not be surprised to see the market retrace ground in the midst of its advance— indeed, the absence of corrections over recent months is perhaps more surprising.

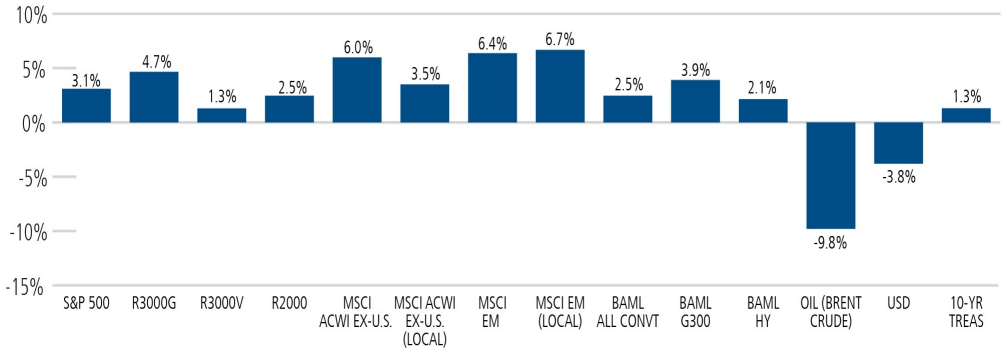
United States

We believe the U.S. is positioned for continued slow and stable expansion through 2017, framed by the larger synchronized global growth story (Figure 2). While many "hard" measures of economic activity are still less strong than "soft" measures, the Unemployment, leading economic indicators, capital expenditures, and purchasing manager's indexes (PMIs) are moving in the right direction; and inflation is well contained (Figure 3). Fiscal policy has encountered hurdles, but there has been more momentum on the pro-business regulatory front. Also, enacting tax reform—even to a lesser extent than originally ex-

MARKET REVIEW

During the second quarter, market participants looked through global geopolitical tensions and U.S. fiscal policy challenges, focusing instead on generally improving economic survey data, strong corporate earnings, contained inflation and well-behaved long-term interest rates. Stocks marched higher and convertible securities participated in a healthy measure of these gains. Emerging markets set the pace to beat, with a weaker dollar providing a supportive tailwind. Globally, growth led value. Although the Fed continued to tighten and announced its intention to slow its bond-buying activities sooner than many anticipated, U.S. Treasury bonds demonstrated continued resilience.

FIGURE 1. GLOBAL ASSET CLASS PERFORMANCE, 2Q 2017



Past performance is no guarantee of future results. Source: Morningstar and Bloomberg. Data shown in USD unless otherwise noted.

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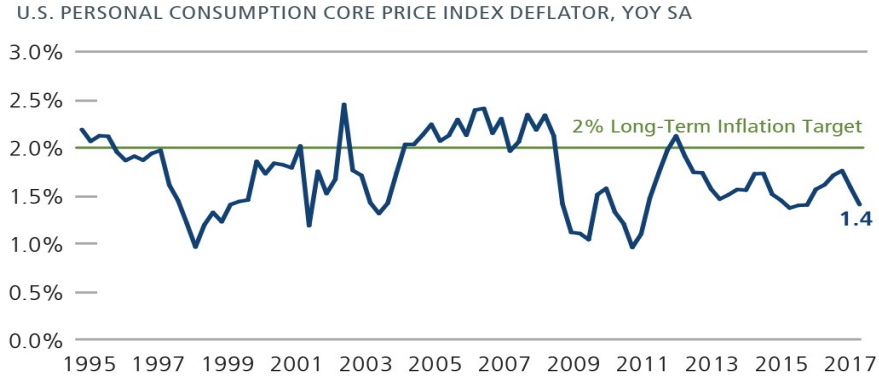
Economic Review

FIGURE 2. GLOBAL GROWTH IS REBOUNDING SIGNIFICANTLY

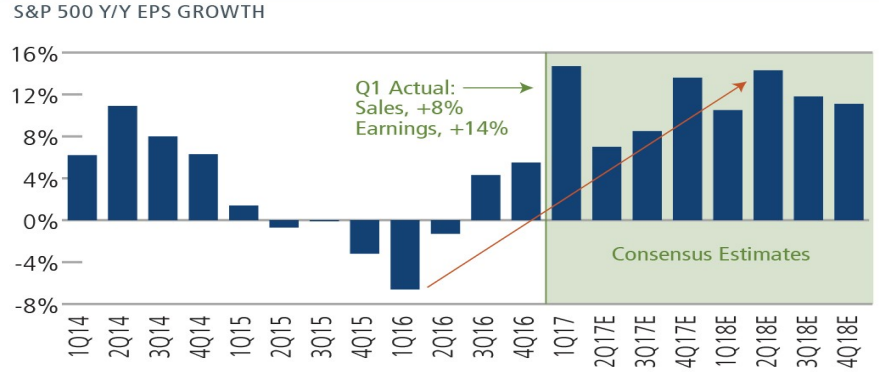
Source: Haver, Morgan Stanley Research as of 1Q17.

FIGURE 3. U.S. INFLATION IS CONTAINED



Source: Bloomberg. Data from 3/31/95 to 5/30/17.

FIGURE 4. ACCELERATION IN S&P 500 EARNINGS



Source: Thomson Financial, Morgan Stanley Research as of 6/23/17.

pected—should boost corporate spending and bolster U.S. economic growth.

We see broad global economic expansion underpinning the U.S. sales and profit cycle. Earnings growth is likely to accelerate through late 2017 or even further (Figure 4). There is a good deal of variation among sectors, however. Apart from energy and materials companies (which are each coming off a very low base), financials and information technology have the brightest earnings per share (EPS) prospects, while the more defensive sectors remain lackluster. Across our U.S. equity portfolios, we are favoring companies that should perform well in an environment of modest economic expansion and gradually rising interest rates. Financials are well represented in our portfolios as are technology names, although we are highly mindful of valuations.

Global and International

In our global and international strategies, we are favoring non-U.S. markets. Valuations appear more reasonable (Figure 5) and many countries are in earlier stages of economic recovery. We are emphasizing a blend of cyclical and secular growth opportunities, including in the financials and technology sectors. In contrast, we are underweighting defensive areas of the market, although we have found attractively valued securities within health care.

Our positioning reflects a constructive view of Europe.

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Economic Review

Matt Freund, CFA
Co-CIO, Head of Fixed Income Strategies, Senior Co-Portfolio Manager

As a Co-Chief Investment Officer, Matt Freund is responsible for oversight of investment team resources, investment processes, performance and risk. As Head of Fixed Income Strategies, he manages investment team members and has portfolio management responsibilities. He is also a member of the Calamos Investment Committee, which is charged with providing a top-down framework, maintaining oversight of risk and performance metrics, and evaluating investment process. Matt joined Calamos in 2016 and has 28 years of industry experience.

"Market rotation is likely to continue, which may exact a steeper toll on higher-valued names. "

Growth fundamentals continue to improve, with the Eurozone several years behind the U.S in its economic recovery. Liquidity conditions are very accommodative, issues in the banking system have begun to be addressed, and loan growth has picked up (Figure 6). Many companies have seen steady positive revisions to earnings expectations this year. Valuations are relatively attractive, with margins still near trough levels with considerable room for pick-up as top-line growth improves.

In Japan, we continue to emphasize export-oriented companies positioned to benefit from improving global growth and a weaker yen. Reasonable valuations and accommodative liquidity conditions provide a favorable landscape

FIGURE 5. GLOBAL VALUATIONS

AS OF 6/30/17

	FWD P/Ex	EPS CAGR 2016-2018	FWD Px/ SALES	SALES CAGR 2016-2018	EPS 2017E REVISION YTD
U.S.	19.0	16.7%	2.0	6.0%	+1%
Japan	14.5	21.6%	0.9	6.6%	-2%
Europe	15.8	39.0%	1.3	7.1%	+6%
EM	13.2	19.6%	1.3	8.3%	0%

Source: Bloomberg. Data in USD terms.

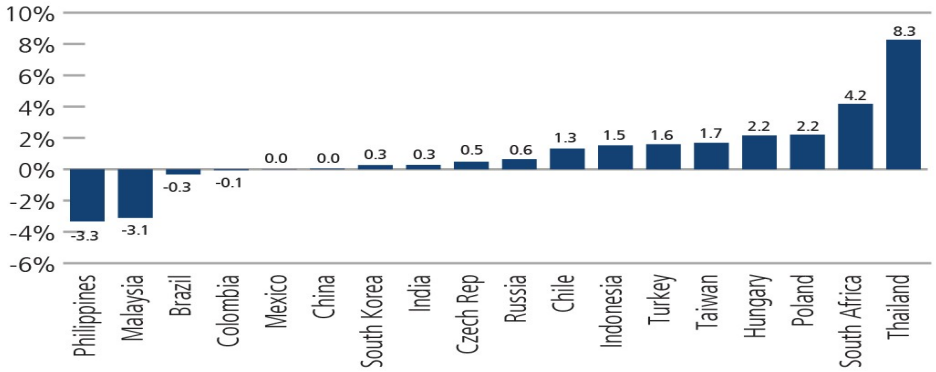
FIGURE 6. IMPROVING CREDIT CONDITIONS IN EUROZONE

EUROZONE BANK LENDING TO HOUSEHOLDS AND NONFINANCIAL CORPORATIONS

Source: Gavekal Data/Macrobond. Data through May 2017.

FIGURE 7. EM BALANCE SHEETS HAVE STRENGTHENED

EM CURRENT ACCOUNT BALANCE AS A % OF GDP, 3Y CHANGE
TRAILING FOUR QUARTERS, QUARTERLY



Source: Gavekal Data/Macrobond. Data as of January 2017, excluding Brazil (October 2014) and Russia (April 2017), the most recent data available.

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Economic Review

for our bottom-up security selection. By not discussing reduced accommodation over the medium term, the Bank of Japan has set itself apart as an outlier among major central banks, thereby limiting potential yen appreciation.

In the emerging markets, many countries are benefiting from strengthening economic fundamentals. Liquidity conditions are improving across many economies as inflation has eased and higher interest rates have attracted capital flows. These factors, along with balance sheet improvements over recent years (Figure 7), should help many emerging markets navigate interest rate rises in the developed markets. Against this backdrop, we continue to identify a breadth of opportunities. Still, our positioning is selective, emphasizing consumption-oriented themes and countries with favorable economic reform trajectories, such as India and China.

Fixed Income

Demonstrating that parallel shifts in the yield curve are rare, 10-year Treasury yields have remained contained in the wake of Fed hikes (Figure 8). We expect further flattening of the yield curve over these next months, with U.S. 10-year yields gently rising to 3% into 2018. That said, if the Fed does proceed with its intention to reduce its bond-buying activities before it finishes raising short-term rates, we would enter uncharted waters, and long-term rates could rise more quickly.

The Fed is unlikely to raise short-term rates more than one more time before year end. As we noted, while the U.S. economy is growing, expansion remains moderate with inflation still below the Fed's target. Further, although some other central banks are also moving to more normalized short-term rates, tightening is likely to be gradual, which should help contain long-term rates globally.

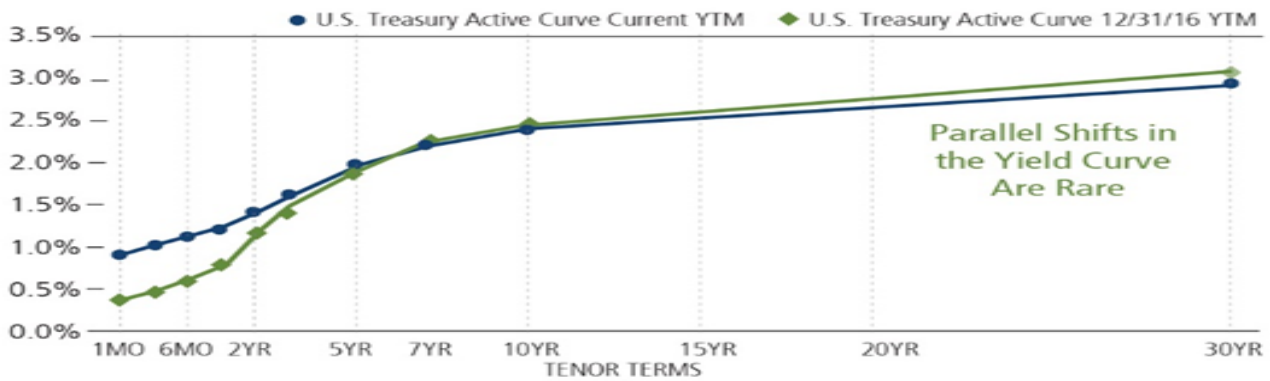
From a sector standpoint, we currently favor corporate bonds over Treasury and agency positions. In high yield, defaults are rising, but slowly and from historically low levels. Given range-bound interest rates and spreads over the first half of 2017, coupled with spreads trading well below long-run averages, we anticipate the high yield asset class is likely to generate a coupon-like return through the end of the year. However, our fundamental bottom-up analysis continues to lead us to opportunities that offer more attractive price return potential.

Conclusion

Steady and balanced global GDP growth, deliberate central bank policies, and favorable corporate earnings prospects support our positive outlook for equities and convertibles for the remainder of the year. Given our expectation for contained long-term rates and low inflation, the current landscape should sustain select opportunities within fixed income as well. Despite this broadly constructive view, uneven valuations in the market, fiscal policy challenges and political uncertainties underscore the importance of risk management. We expect volatility to increase in the months ahead and believe our portfolios are well positioned for this environment.

(It is to be noted that this article is a subset of an original piece published by Calamos Investments from their 2Q17 Calamos Economic Outlook .)

FIGURE 8. THE U.S. YIELD CURVE FLATTENS



Source: Bloomberg. Data as of 7/5/17.

Defying the Headlines…and Reason?

market distortions by pushing investors into equities. Insurers have followed this pattern somewhat, first by pursuing dividend producing portfolio strategies to supplement bond interest income in support of current income requirements. They have also looked for total return opportunities in domestic and non-US equity allocation to improve overall investment program performance. We welcome the expansion of asset class usage as most insurers have experience significant benefits of improved risk-adjusted returns through the diversification provided by the addition of low to inversely correlated assets classes (when compared to their predominately bond investment portfolios).

A look at the data

As so, many insurers with increased exposures are rightfully wary of the frightening negative headline blitz. Evidence supporting the articles is abundant and typically refer to current price/earnings (P/E) ratios. On 8/18/17 the S&P 500 P/E was 24.19, far above its historical mean of 15.66.

Another heavily referenced measure of market valuation is the Shiller PE10 ratio which is a refinement of the P/E ratio. The Shiller PE 10 in which the Price Earnings *ratio* is based on average inflation-adjusted earnings from the previous 10 years, known as the Cyclically Adjusted PE *Ratio* (CAPE *Ratio*)

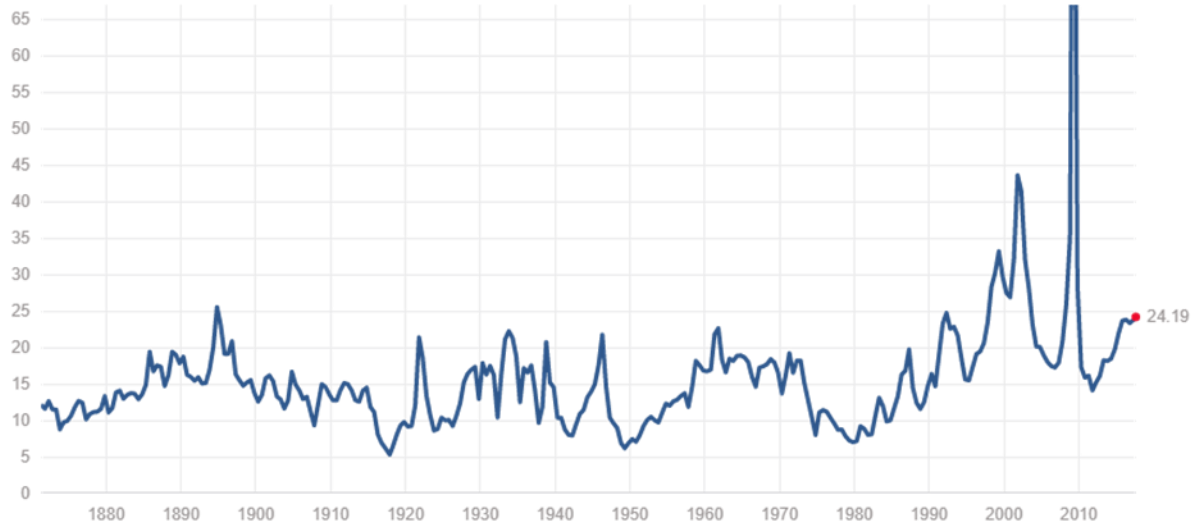
Of course, the CAPE ratio is a rear-view mirror valuation. It is not forward looking and provides guidance based upon historical market observations. Notwithstanding this backward-looking method of guessing the future, it remains an analytically sound methodology based upon market valuations' "reversion to mean".

Debate between Titans

Nobel laureate Robert J. Shiller, creator of the famous ratio generally needs no introduction. He says, "yes," , stocks are overvalued. Jeremy Siegel, the slightly less known Russell E. Palmer Professor of Finance at the Wharton School of the University of Pennsylvania says "no." These two titans of economics have faced off for many years, most recently at the 70th Annual CFA Institute Conference in Philadelphia, May 21-24. The topic: current market valuations.

Siegel questioned Shiller's CAPE ratio, which uses earnings data stretching back to 1871 by contending that "it is based on faulty data." While it has gained wide acceptance as an accurate gauge of

S&P 500 PE Ratio



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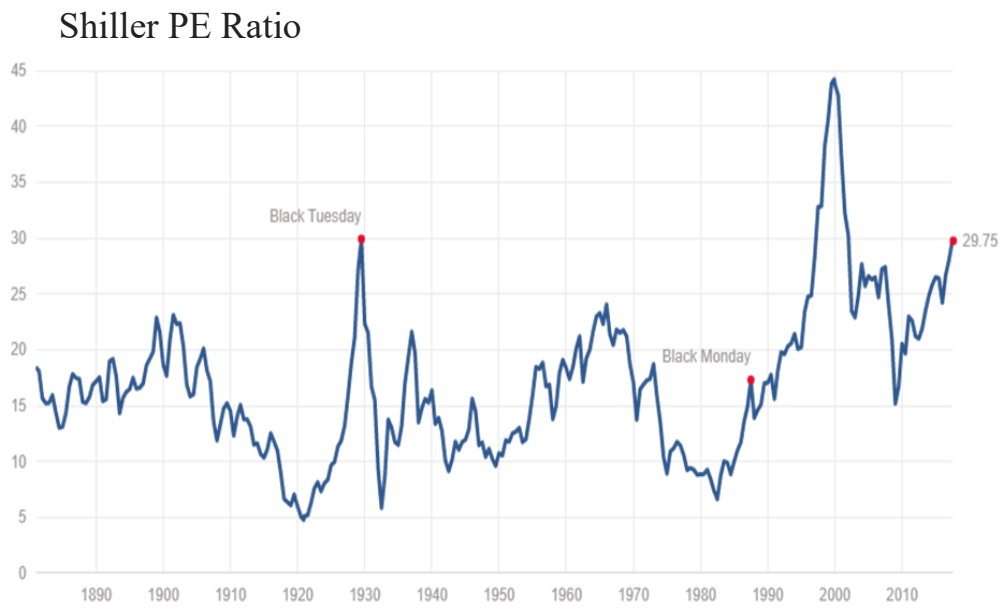
Defying the Headlines…and Reason?



the market by many, we are now in an unprecedented market environment. Siegel's point is that one cannot view the US stock market in a silo, meaning ignore other securities markets, and in particular, the US Bond market. He says, "The low-interest rate environment we have been in — and I think will be in for many years — makes stocks still definitely the asset of choice for your portfolio."

In a July 29th interview, Allen Greenspan weighed in stating that "By any measure, real long-term interest rates are much too low and therefore unsustainable," the former Federal Reserve chairman, 91, said in an interview. "When they move higher they are likely to move reasonably fast. We are experiencing a bubble, not in stock prices but in bond prices. This is not discounted in the marketplace."

The general consensus of Wall Street forecasters is that low interest rates will persist, and so Greenspan isn't alone in warning that they will break higher quickly as the era of global central-bank monetary accommodation ends. Thus far, the Fed has not been able to raise rates at the frequency stated. That could change.
"The real problem is that when the bond-market bubble collapses, long-term interest rates will rise," Greenspan said. "We are moving into a different phase of the economy -- to a stagflation not seen since the 1970s. That is not good for asset prices."

While Greenspan comments lagged the Shiller/Siegel debate by nearly two months, they are insightful to the discussion. He predicts that stocks will suffer with bonds as real interest rates surge. The underpinning of his view, known as the Fed Model, holds that as long as bonds are rallying faster than stocks, investors are justified in sticking with the less-inflated asset. Presently, this model shows U.S. stocks at one of the most compelling levels ever relative to bonds.

Back to the Debate

Shiller's response to Siegel addressed the current environment by saying that "The fact that long rates are so low suggests that there is a general feeling that we are in for a long period of secular stagnation,". He goes on to declare that "There is a secular stagnation narrative. This is not science, it's a narrative. Nobody can prove it right or wrong, but people believe it now. The last time we had this narrative was in the Great Depression."

Therefore, we are to conclude that the science and analysis supporting economic theory are valid but that market sentiment can distort expected market behaviors, perhaps over long periods of time. Is this an example of the conundrum of the self-fulfilling prophesy?

We make no predictions here but do recognize that:
1.Valuations are historically high by most measurements and possibly present danger and
2.Money flows to where it is best served, which is currently the equity markets

Therefore, it is entirely possible that this bull market is different from others and could continue until there are fundamental changes in the relationship between the US bond and equity markets, e.g. normalization of interest rate policy by the Fed. Of course, global markets will also have an impact but since inter-

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est rates are artificially low around the world, the market distortions, to varying degrees, are global as well.

For insurers, the bottom line is always to invest cautiously and prudently. They must invest to protect and assure their claims paying ability meeting their promises to policyholders. Bonds, the less volatile asset class, will always be the mainstay asset class for insurers. Strong financials, reliable claims experience and other factors will generally establish the appropriate amount of risk to be taken by an insurer's investment program. ERM and ALM analysis and techniques can provide sound guideline to the establishment of a reasonable risk profile for the company and the proper usage of risk assets, like equities.

Upcoming Events

Carl Terzer will be speaking at the Bermuda Captive Conference at the Fairmont Southampton Resort Sept 11-13 in Bermuda. We hope that you will have an opportunity to hear Carl speak.

CapVisor will also be attending the SCCIA Annual Conference at the Mills House in Charleston, S.C. Sept 12-14. Hopefully our Associate Rachel Libowitz will have an opportunity to meet with many of you!

CapVisor will be attending the CIC-DC Conference Sept 18-19 at the Marriott Metro Center in Washington DC. Al Heeg will be representing CapVisor at this event and will be moderating a few sessions. I hope that you have an opportunity to say hi to Al and talk to him about his new role at CapVisor.

Look for CapVisor as an exhibitor at NAMIC's Annual Convention at the Denver Convention Center in Colorado. This event takes place Sept. 24-27. Please stop by booth #636 and say hi to Rachel and Carl!

CapVisor will be in attendance at the TCIA Annual Conference in **Nashville, Nov 15-16.**

CapVisor will wind down our 2017 conference schedule at the Cayman Captive Forum at the Ritz Carlton in Grand Cayman November 28-30.

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