Inside This Issue

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2010-19: Reflecting on the "Teen Years"

Easy money + low rates + low taxes + low reinvestment = record cash flows & an exploding stock market!

Since this year is also the start of the 2020s, we thought we'd take some time to reflect back on the "teen years." While many of the themes have been discussed widely, some of the numbers may surprise you.

- In the last 10 years, the US labor force was basically flat, rising from 158.0 million to 158.7 million (a 0.4% increase).
- The number of people outside the labor force (defined as not working and not seeking work) grew from 80.7 million to 95.5 million. This is consistent with an aging population.
- The 1.8% average GDP growth rate for the past decade was well below average.

But despite this low economic growth, asset values did something extraordinary. They decoupled from the economy and rose dramatically. Total US National Assets (which includes personal,

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4th Quarter Bond Market Review

I enjoy writing the fourth quarter commentary. Other than the highlights of the quarter, it provides an opportunity to look back at some of the prominent events of the entire year. And what a year it was. Coming into 2019, the market was expecting the Federal Reserve to hike rates two or three times. In the end, the Fed cut rates three times, with the final cut coming at the October meeting in what was viewed mainly as an insurance cut. It was (and still is) viewed as the last rate change for the foreseeable future. Market expectations were for the Fed to shrink its balance sheet and for yields to rise, in effect keeping rates from going negative, as is the case for many other central banks. Instead, the Fed restarted buying Treasury securities (but please don't call it quantitative easing) and expanded its balance sheet, and the market reacted with lower yields and a flatter yield curve.

Inflation was expected to rise and get to the Fed's 2% target. Other than a small rebound in the fourth quarter as crude oil prices trended higher, breakeven inflation rates generally fell throughout the year and never did reach 2% at any point in 2019. A tight labor market has the potential to push wage inflation higher, but after peaking in February of last year, hourly earnings fell seven of the remaining ten months. The U.S. is at generational lows in unemployment but the mix of jobs (less goods-producing employment than service sector employment) is preventing any material wage pressures. As such, we are not expecting a wage push increase in inflation.

Sector returns varied across the fixed income markets, as they always do, but each finished the year well ahead of expectations. You could say the market was caught by surprise a few times throughout the year but none of them strong enough to derail the huge demand for yield. Entering 2019, corporate credit was in disarray from the spread widening and negative returns as 2018 came to a close. For 2019, investment grade credit had its best performance since 2009. The lower end of investment grade and the top of high yield produced the best returns. Our exposure to triple-B and above issuers was rewarded as was our selective use of double-B credits.

And more than just an honorable mention, all hail the consumer who has pulled the domestic economy from the dire predictions of certain contraction once the Treasury curve inverted in August last year. Employment growth was probably a major contributor to strong consumer spending, as employers added over 2 million jobs in 2019.

Looking at some of the fourth quarter statistics, the Bloomberg Barclays Intermediate Government/Credit Index, our benchmark for total return portfolios, returned .37%. The fourth quarter was the smallest of 2019's quarterly returns but added to an impressive full-year which returned 6.80%. For this high-grade, intermediate maturity index, nine

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4th Quarter Bond Market Review

of the 12 months of 2019 had positive returns. For the broader fixed income market, the Bloomberg Barclays US Aggregate Index returned 18 basis points for the fourth quarter—another breather quarter of a 2019 that saw an 8.72% full-year return. The slowing performance in the fourth quarter was mainly due to government securities. All indications were for a Treasury market ahead of itself when 10-year yields fell through 1.5% at the end of August last year. Treasury yields drifted higher throughout the fourth quarter with the 10-year Treasury ending the year at 1.92%. Coupon income balanced the price drop of intermediate Treasuries, providing a total return of only a few basis points. On the other hand, intermediate credit kept up its impressive quarterly performance with almost a 1% gain in the fourth quarter. Any amount of issuance was met with very strong demand.

It seemed as though the more issuers brought to market, the more investors wanted. Spreads tightened throughout the year and finished at the lows (1). Credit returns, like governments, were higher for longer maturity bonds versus short maturities.

Switching gears to the municipal bond market, 2019 was also a year of extremes. In the broader sense, I can't really just say "municipal bond market" without identifying if the issue was tax-exempt (traditional municipal bonds) or taxable (not new, but a market that came into its own in 2019). Taxable municipal bonds grew to about a 17% share of the overall market as issuers refunded older, higher coupon issues. Demand for traditional municipal securities, as measured by mutual fund inflows, set a record at over $94 billion. Since mutual fund purchases are just one aspect of the market, even that amount does not fully quantify the desire for tax-free income. The fourth quarter also saw a continuation of the strong demand for individual securities (which is how we manage portfolios at Howe & Rusling), especially in high tax states.

The Bloomberg Barclays Quality Intermediate Municipal Bond Index, our benchmark for tax-free portfolios, returned .86% in the fourth quarter, bringing the total for 2019 to 5.88%. The intermediate maturity market drew eleven of the 12 months into positive returns. A-rated bonds outperformed the broad market as investors sought out yield. While we expect new issuance to pick up in 2020, we also expect demand to remain strong. Most of the conditions which led to a healthy municipal bond market in 2019 are still in place as we move into 2020.

> **"... all hail the consumer who has pulled the domestic economy from the dire predictions of certain contraction once the Treasury curve inverted in August last year."**

Looking ahead to the new year, we believe performance in 2020 for most if not all sectors in the fixed income market will be driven more by coupon income than the price appreciation the market experienced in 2019. We agree with most Street economists that yields will be lower at the end of 2020, but only marginally. The Fed has done a fine job of getting the markets comfortable with no rate changes this year, leading to a range-bound Treasury market as the most likely outcome. Credit spreads in corporate and municipal debt are at or very near historically tight relationships. We do not anticipate a dramatic spread widening event, though we are always vigilant for the off chance our economy weakens to reignite recession fears. For corporate bonds, demand should remain strong as yields, when viewed from a global perspective, are still quite attractive. In the municipal bond sector, the SALT cap (limited deduction for state and local taxes) is still in place, and it is an election year, which will keep the debate of higher taxes at the forefront of investors' decisions—both of which will lead to strong demand for tax-free income. Our strategic allocations in the new year will attempt to capture as much incremental income as possible relative to our desire to maintain high quality portfolios. We should enjoy another year of positive fixed income returns, but at levels that typify a nice jog and not a sprint. □

John joined Howe & Rusling in June 2018 as Director of Fixed Income. In that role, John is responsible for managing the firm's fixed income strategies including taxable and tax-exempt portfolios. John has more than 35 years in the fixed income markets, beginning his career at Bank of America where he managed fixed income mutual funds as well as individual portfolios for high net worth and institutional clients. More recently, John joined us from Comerica Bank where he built out an active fixed income management group which offered Common Trust Funds and customized fixed income portfolios. He received his Bachelor's of Science in Finance from the University of Illinois at Urbana-Champaign. Outside of work, John enjoys taking long walks and watching SEC football.

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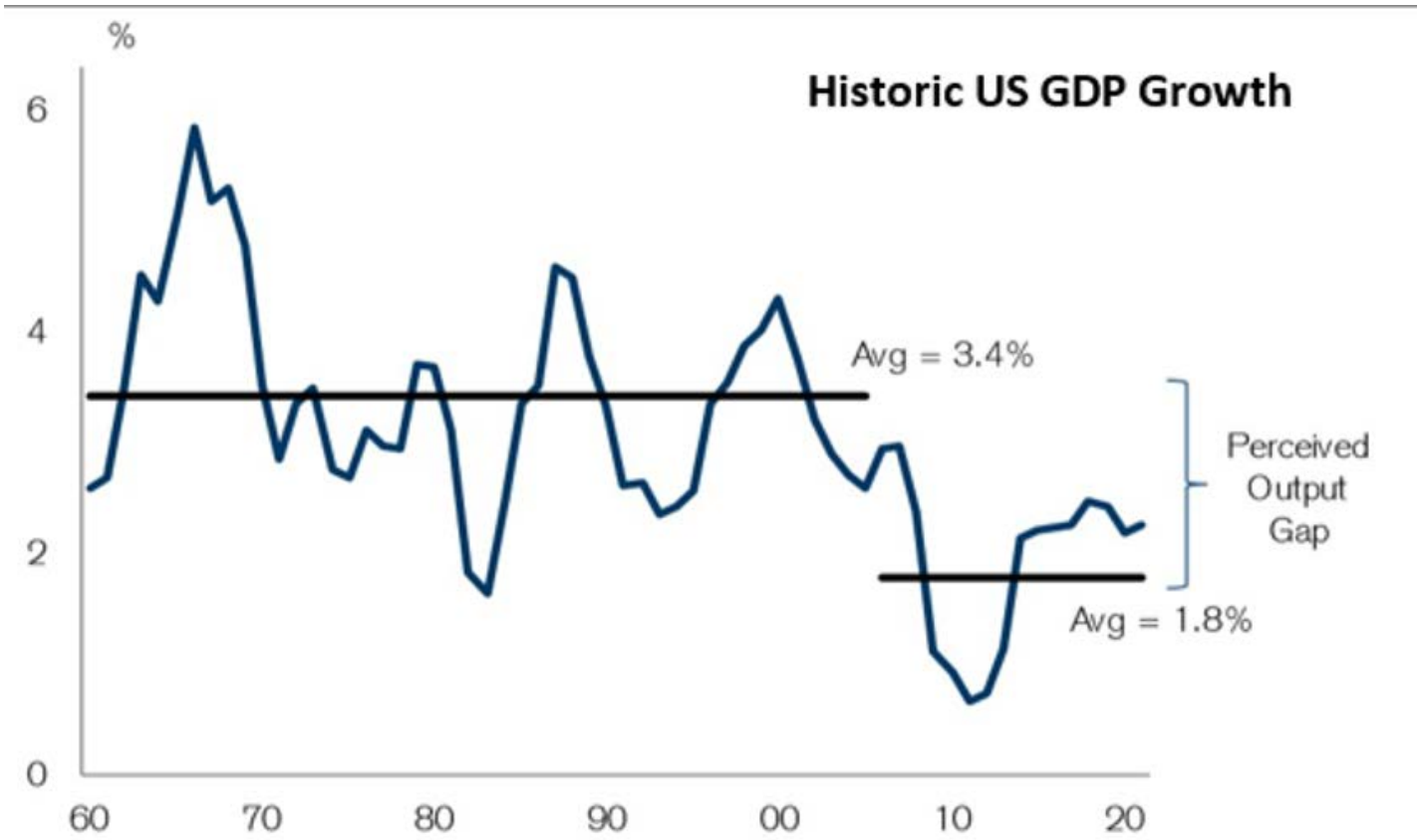

Note: Real GDP; 5-Year Moving Average
Source: BEA, **Haver Analytics®**, Credit Suisse

Stefan ten Brink, Managing Director
Mr. ten Brink joined the Firm in January 2011 from Petercam Asset Management in Amsterdam. He has 22 years of investment advisory experience, having co-managed the having co-managed the Ahold Pension Fund prior to joining Petercam. He has 18+ years experience with the HOLT framework.

Mr. ten Brink holds a degree in Logistics & Economics from Arnhem Business School and an MBA from Nijmegen University. Stefan is a Certified European Financial Analyst (CEFA).

Van Hulzen Asset Management
www.vaminstitutional.com

corporate, small business and non-profit assets) grew from $87 trillion to $145 trillion (a 66% increase).

US stock prices rose by 13.5% annually during the past decade while corporate revenues grew less than 4%. On the surface, the disconnect in asset prices (including stock prices) and economic activity makes little sense. But several factors combined to produce outsized asset price gains. So let's dive below the surface and learn what happened.

Factor #1: The Federal Reserve

A balance sheet is comprised of assets and liabilities. Add up all the assets, subtract the liabilities and what is left is net worth, the equity value. This is true for individuals, for businesses and for the country. We already mentioned the $58 trillion rise in total US assets. But is that an increase in equity value? Did the country suddenly become THAT much wealthier? Well, no. Because the Fed flooded the markets with cheap money and the government issued more debt and spent more than it earned.

A number as large as $145 trillion is staggering and hard to even conceive.

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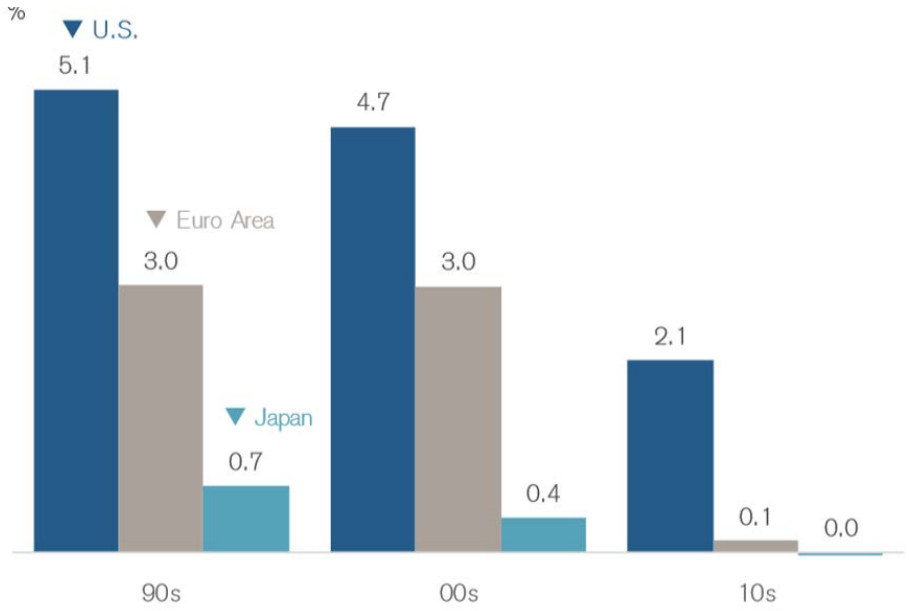
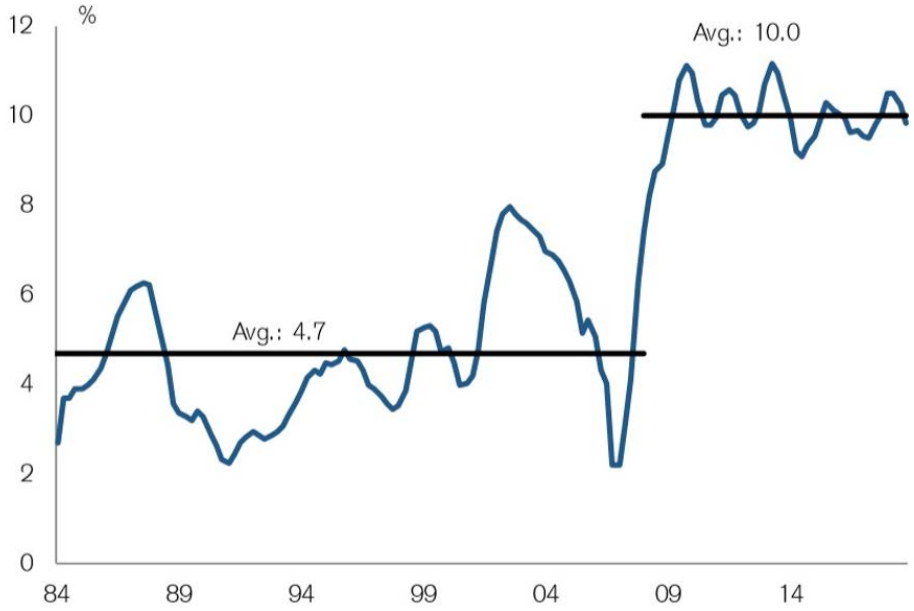


Note: German base rate used prior to 1999 for Euro area
Source: Federal Reserve, ECB, BOJ, Haver Analytics®, Credit Suisse



Note: Russell 1000 prior to 1990, S&P 500 after 1990; Trailing 4Q basis; 4Q Moving Average
Source: Standard & Poor's, Russell, FactSet, Credit Suisse

Another very large number is the $127 trillion in unfunded liabilities (social security, medicare, federal pensions, etc). And national debt (total principal value of marketable and non-marketable securities) rose from $10 trillion to $23 trillion during the decade. The annual government spending has risen from $2.7 trillion to $4.8 trillion. The US monetary base rose from $0.8 trillion to $3.3 trillion. You get the picture. Much of the rise in the value of total assets can be attributed to cheap money and additional debt. After all. the Federal Reserve dropped rates from 4.7% to 2.1% during the decade.

Low rates encourage borrowing and leverage, which in turn are allocated into assets and ventures, pushing up asset prices. Corporations also borrow at lower rates and are able to reduce interest costs and buy back shares of their own stock.

Factor #2 Corporate Cash Flows

The chart to the left shows the change in free cash flow (FCF) inside US corporations. After decades averaging 4.7% FCF, suddenly US companies had substantially more cash flow. While there are many reasons for a rise in cash flow, a few stand out. In a slower economic environment, businesses tend to shift business models to free up cash flow. Free cash flow has historically correlated with dividends and share buybacks. As cash flows have risen, so have buybacks. A share buyback reduces the number of outstanding shares and raises the value of the remaining shares. While this action does not increase the value of the entity, it does raise the "per share" price of the stock.

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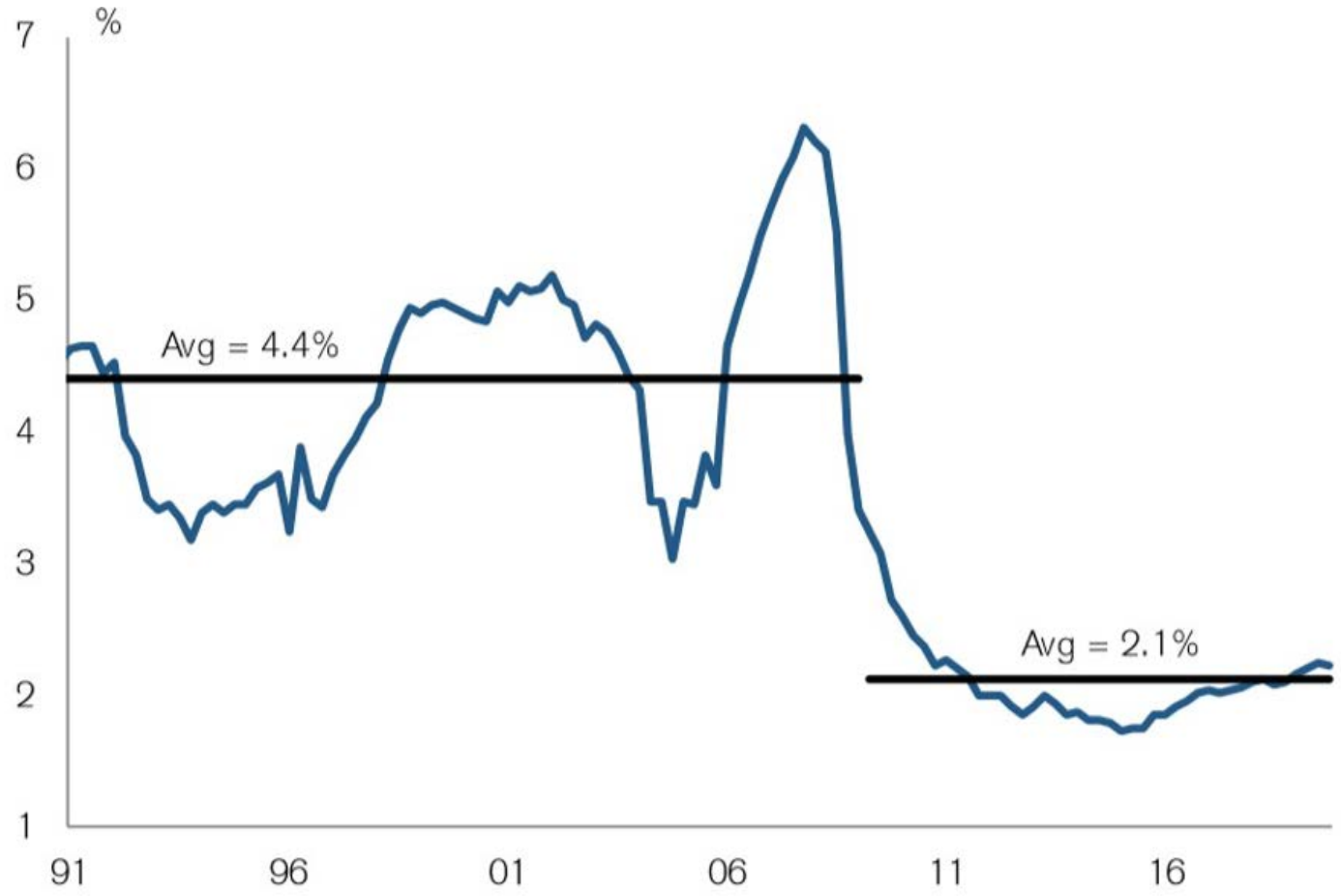

Note: S&P 500; Trailing 4Q basis
Source: Standard & Poor's, FactSet, Credit Suisse

Interest as a Percent of Sales declined from an average of 4.4% to 2.1%. This drop is due to the lower interest rate decisions by the Federal Reserve and increases corporate profits. As asset prices rise, the ability to borrow expands. More money can be borrowed (at low rates) without over- levering the company. During periods of rising stock prices, additional borrowing can appear benign and be used for acquisitions, buybacks and other corporate actions. But when prices turn lower, and asset values decline, those debts quickly become magnified and quickly erode equity value.

Additionally, corporate taxation dropped from an average of 31.7% in 2011 to 19.9% in 2019. Despite making more money in 2019, corporations are expected to pay roughly $120 billion less in taxes than they paid in 2008. In case you are wondering, personal income tax rose to $1.725 trillion from $1.158 trillion (2008) and payroll taxes rose to $1.256 trillion from $0.858 trillion. A combined $956 billion increase. So, while not an exact offset, individuals are paying more and corporations are paying less. This again translates into higher profits and higher stock prices. If you are fortunate enough to own a large portfolio of stocks then perhaps your gains outpaced your taxes. But for many people, this is not the case. and asset values decline, those debts quickly become magnified and quickly erode equity value.

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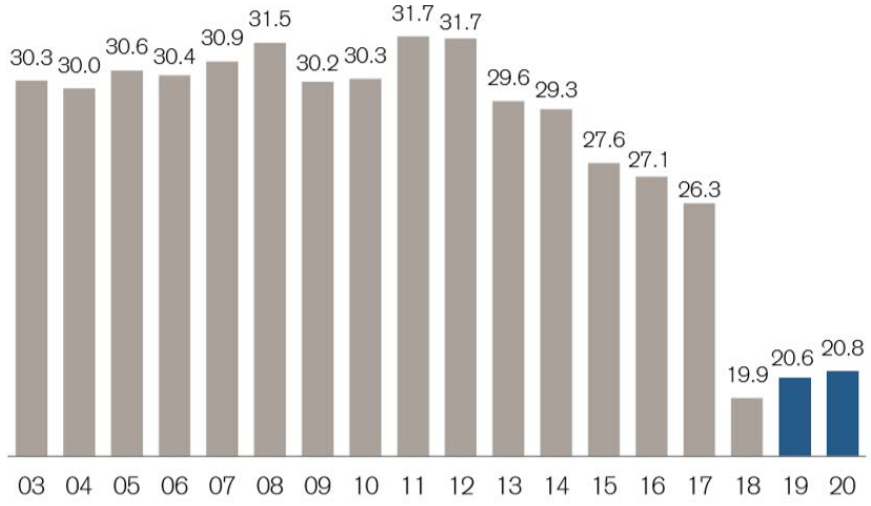
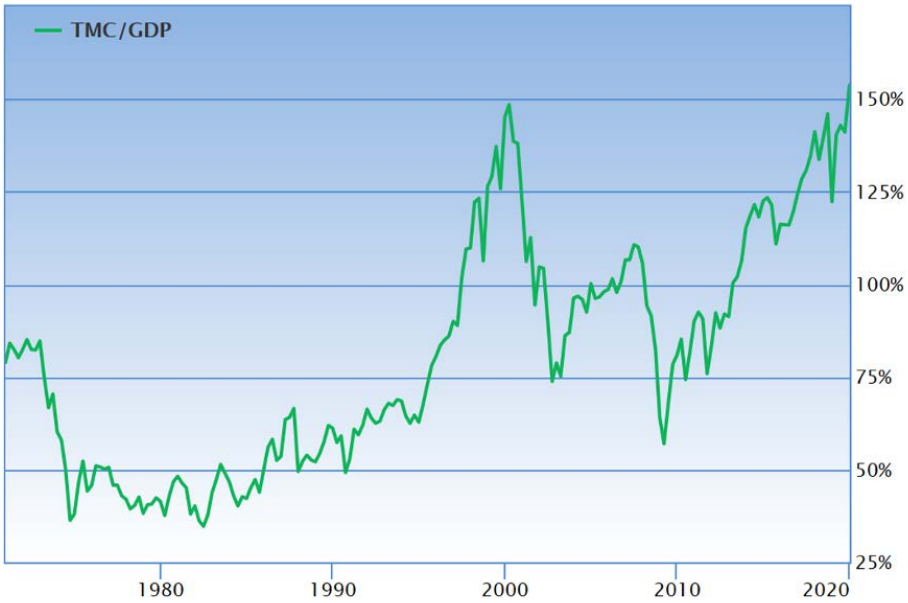
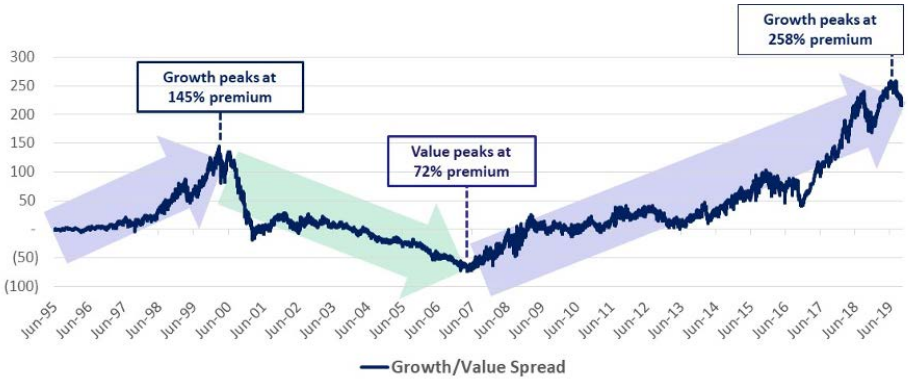


Note: S&P 500; Pro-forma effective tax rate, estimates for 2019 and 2020
Source: Standard & Poor's, Thomson Financial, FactSet, Credit Suisse





This All May Be True, But Isn't The P/E Still Reasonable?

Despite a P/E ratio that is only somewhat overvalued by historic measures, it is important to remember that much of the margin expansion has come from low interest rates and low tax rates and an abundance of easy money.

Other measures are not so benign. One of the broadest measures of market extremes is to compare the size of the US total stock market to the size of the US economy (GDP). Historically, the stock market has been slightly smaller than the total economy. In the chart in the middle, the 2000 "dot- com" bubble reached a level where stocks were 48% larger than GDP. At the end of 2019, stocks reached an all-time extreme level of 153% of the size of the GDP.

And let's not forget how we got here. The last 4-5 years have been all about Big Tech. The top five tech stocks (Apple, Microsoft, Alphabet, Amazon & Facebook) make up 18% of the total market cap of the S&P 500. These stocks have fueled a record dispersion between growth and value stocks, a phenomenon we've highlighted many times. Not only do these types of dispersions typically normalize, but this kind of concentration in a small number of stocks is not healthy for the overall market. In the past, it has led to under-performance.

It would be wise to recognize that the central bank will continue to be a major player in asset prices. Central bank activities in developed countries have taken a much more active approach to stabilizing asset prices. We consider central banks to be the ultimate backstop for markets during recessions and market crashes. But it is unusual

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for central banks to be engaging in such large open market operations and easy money activities during a time when employment is high and asset prices are rising.

In addition to the Federal Reserve, consumption is extremely important. Below are some interesting data points with regard to the health of the consumer. While employment is high, debt levels are rising rapidly. Total consumer debt has passed $4 trillion. Much of that is backed by assets like houses, but the fastest growing segments include cars and tuition debts. Wages are not keeping up with expenses. Despite reports of low official inflation, the cost of major purchases are certainly outpacing income. As we begin the 2020's, asset prices still have support from a very accommodating Fed, high employment and easy corporate conditions.

- Consumers are feeling confident and spending money. Stock prices can continue to rise absent major unforeseen problems. On the other hand, margins are at extreme levels, multiples are high and much has been priced into stocks.
- The strong US dollar makes foreign investment difficult.
- Emerging market stocks are far cheaper than US stocks, but a strong currency reduces returns and has been a drag on portfolios for several years.
- The election cycle is likely to produce social polarity and could test consumer confidence.

Long periods of rising asset prices tend to lull investors to sleep. And no one ever went broke taking profits. After agreat year like last year, taking some risk off the table – perhaps by shifting some of your "full risk" equity allocation towards covered calls - can be a very prudent move.

Sunday Morning Quarterback

We believe 2018 marked a new cycle of volatility, which could persist for several more years. Markets are likely to be choppy and sideways moving, an environment which is ideal for covered calls (because option prices rise when volatility is elevated). We are not calling for an imminent recession or a major market crash. But we do believe there will be some significant pullbacks in the coming years. We continue to be cautious and believe that in times like these, investors should reduce risk and focus more on income than growth.

Nobody likes a "Monday Morning Quarterback" who goes on about decisions the coach should have made in Sunday's game. We think it's more productive to make some adjustments to our approach in preparation for the difficult game. Maybe call us Sunday Morning Quarterbacks. ☐

THEN & NOW	FY 2000	FY 2019
MEDIAN INCOME (+10%)	$30,423	$33,600
NEW HOME COST (+94%)	$161,121	$313,926
NEW CAR COST (+74%)	$22,067	$38,432
TUITION COST (+112%)	$11,260	$23,857
HEALTH CARE COST (+117%)	$5,332	$11,573

Upcoming Events

CICA International Conference is March 8 – 10 at the Westin Mission Hills Golf Resort & Spa in Rancho Mirage, CA. CapVisor is exhibiting at booth #613. Stop by to see Carl Terzer and Paul Deeley.

NCCIA Annual Conference is in Durham NC May 13-15 at the Washington Duke Inn & Golf Club. Carl Terzer and Grant Davis will be in attendance. Both will be speaking and moderating sessions. Stay tuned for more details.

Bermuda Captive Conference is at the Fairmont Southampton hotel. Carl Terzer will be in attendance.

IASA 2020 Annual Educational Conference & Business Show is at the St. Louis Convention Center in St. Louis MO, Jun 7-10. CapVisor is exhibiting at booth #444. Paul Deeley will be speaking. Stay tuned for details on his session. Our newest associate Debbie Leich will also be at the CapVisor booth so stop by and meet her please!

TCIA 10th Annual Conference is at the Renaissance Hotel in Nashville, TN from June 22-24th. Carl Terzer and Grant Davis will be representing CapVisor.

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

Press Release! Meet Debbie Leich

Gainesville, GA –February 3, 2020, – CapVisor Associates, is pleased to announce that Deborah Leich has joined the organization as Managing Director. "Debbie is a seasoned and well-known insurance asset management professional with a strong reputation for contributing her valuable insurance experience and significant investment expertise to provide optimized investment results to insurers", said Carl Terzer, CapVisor's Principal and Founder. "Debbie will utilize the benefits offered through CapVisor's unique business model to provide industry-leading asset management solutions and analytic capabilities working collaboratively with insurance clients to improve their investment result and competitive positioning."

In her role as Managing Director and Senior Consultant, Ms. Leich will be specializing in investment strategy design, strategic asset allocation, ALM, , risk management, investment manager evaluation, selection and oversight, for domestic and international insurers, reinsurers and alternative risk transfer programs (captives and self-insurance pools).

Prior to joining CapVisor, Debbie was a Director of Institutional Markets at Victory Capital and previously a Senior Investment Manager at Munder Capital for 20 years (Victory Capital purchased Munder Capital in 2014). Her responsibilities included investment advisory and relationship management over large and complex insurance and other institutional accounts.

Debbie graduated with a BA in Economics from the University of Michigan and has an MBA from Wayne State University. She is also Series 6, 62 and 63 licensed.

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