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Bonds: A Roller-Coaster Ride

As we head toward the end of 2019, we look back on a turnaround year for interest rates and therefore, bonds. What surprises lie ahead and how should insurers position their portfolios?

As a quick recap, for 7 years, interest rates were held at/near zero percent to soften the landing of the great recession in 2008 and help steer us to recovery by implementing an "easy money" policy. After a number of years during which rates broke all historical precedent, the FED, or more specifically the FOMC*, began raising interest rates in December 2015. Steady FED rate increases followed this first increase as the economy finally showed signs of regaining its footing after years of little growth and a lot of sideways movement.

Robust growth, based upon new policies that reduced taxes, promoted business regulatory relief, and other policies helped to revive economic performance. As US economic fundamentals strengthened, rate increases stair-stepped their way up in 25 basis point increments. The FED's transparency and corresponding predictability of these rate

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Economic and Capital Market Outlook

Over the past several weeks, there has been movement on both Brexit and the resolution of U.S. – China trade dispute. These have been two major structural impediments to global growth. We are changing our base case outlook to consider the resolution of both trade issues and Brexit in the 1Q 2020. This is not meant as endorsement on a positive outcome for either, but rather, a belief that resolving these barriers will lead to fixed investment, consumption and economic growth.

1. We are expecting domestic economic growth between 1.8% and 2.0% for 2019. However, massive global central bank stimulus combined with lower interest rates and progress on Brexit and U.S. – China Trade issues are enough for us to revise our outlook upward for global growth in 2020. While the current slow growth environment will help keep interest rates low, we may begin to see rates bottom as expectations for growth increase.

2. Global central banks have shifted to a more accommodative tone during the past year. This year's shift toward monetary stimulus contrasts policy theme in 2018, when the Federal Reserve was pushing interest rates higher and the ECB had ended its Quantitative Easing program. A more stimulate monetary policy will serve as a catalyst for global growth. *However, we expect the Fed will take a pause in its move to lower rates by December to reassess the need to reduce rates further.*

3. Corporate earnings are coming in stronger than expected; however, earnings growth will remain under pressure as revenue growth slows and profit margins are pressured over the near term. We still expect labor costs to be scrutinized in the fourth quarter, and we expect an increase in lay-offs to support operating margins. The rosy employment market, which has been the strength in the recovery, will likely deteriorate by the end of the year.

4.The trade war with China has contributed to the slowing domestic economic growth rate. We expect that Trump wants a trade deal nailed down with China heading into his re-election campaign in 2020. Recently, President Trump and Chinese President Xi Jinping agreed to renewed trade talks; however, it is not clear how substantive these talks are. Discussions include lowering U.S. hostile initiatives toward Huawei and a commitment from China to buy large amounts of American agriculture products. Our base case is that a resolution to the U.S. – China trade dispute will result in increased fixed investment and provide stimulus to global economic growth.

5. Boris Johnson has a deal with the European Union for the United Kingdom to exit the E.U. The next step is to get it through the U.K. parliament.

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Prior to forming Winthrop Capital Management, Greg was the Chief Investment Officer and Senior Portfolio Manager for Oppenheimer Asset Management and its subsidiary, Oppenheimer Oppenheimer Investment Management. There he was responsible for the oversight of the fixed income investment process. Greg also served as the Chief Investment Officer and Senior Portfolio Manager with Conseco Capital Management (40|86 Advisors). In addition to his investment management responsibilities at CCM, Greg was President and Trustee of the 40|86 Series Trust and the 40|86 Strategic Income Fund. Also, Greg had responsibility for the $1.2 billion real estate and private equity portfolio.

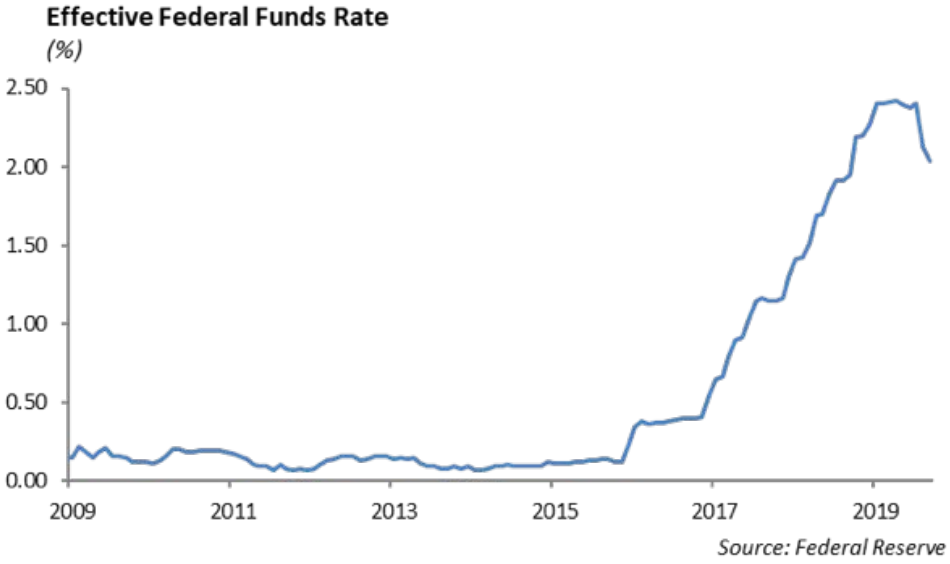
He holds a B.B.A. from the University of Wisconsin and an M.B.A. from Indiana University. He is a Chartered Financial Analyst, a member and former President of the CFA Society of Indianapolis, a former Trustee of the Indiana Public Employee Retirement System and has served as a member on the ACLI's Committee on State Regulation of Investments. In addition, he serves as an independent trustee of the FEG Absolute Access Fund, LLC and is a member of the National Federation of Municipal Analysts. Greg has over 30 years of investment management experience.

The deal includes Northern Ireland remaining part of the U.K. customs union, which would allow seamless trading with Ireland to remain. As Lloyd Christmas once said, *"So, you're saying there's a chance."*

6. Liquidity in the credit markets has been difficult at times over the past year. After a surge in new issues in the third quarter, we expect new issue volume to decline significantly heading into year end. At this point, we do not see a significant shift in the credit cycle; however, the seeds are planted for some deterioration in credit. Leveraged loans and commercial real estate are both drawing significant capital, and valuations appear excessive.

The Federal Reserve – We Expect a "Pause" in December

The Fed has hinted its concern that weaker business activity and investment could lead to slower hiring and consumer spending. The Fed has been on an accommodative push to lower rates in an effort to mitigate the impact of slowing global growth on the domestic economy. In addition, the Fed has signaled that it expects the economy to continue on a path of steady growth with the help of recent interest rate cuts. If there is meaningful progress in trade negotiations with China and a path is cleared for Brexit, we believe the Fed will pause its push to lower interest rates further in order to reassess the economic environment. This will put pressure on the 10 year U.S. Treasury, which has traded up to 1.75%



The Fed's Balance Sheet

As the Fed has reduced the size of its balance sheet over the past two years, the reduction in the bond portfolio resulted in a reduction in reserves held at the Fed. The reduction in spare reserves that are used to support inter-bank lending resulted in the instability in repo rates last month. This week, the Fed announced an increase in monthly bond purchases of up to $60 billion per month in an effort to stabilize the short term lending market known as repurchase agreements. By growing the balance sheet, the Fed will only be buying short term Treasury Bills and without providing any additional monetary accommodation. The Fed will then adjust both the timing and amounts of bill purchases, and they might continue the buying into the second quarter of 2020. The additional liquidity aims to provide a backstop for the Fed to support repo rates and to maintain interest rates where they intend.

Economy – Expect a Shift toward Growth in 2020

We expect GDP for the year to come in 1.8%, much slower than the pace we were seeing last year. Over the past

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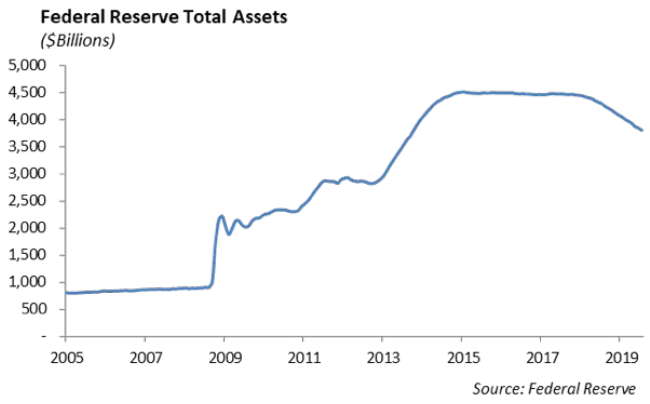

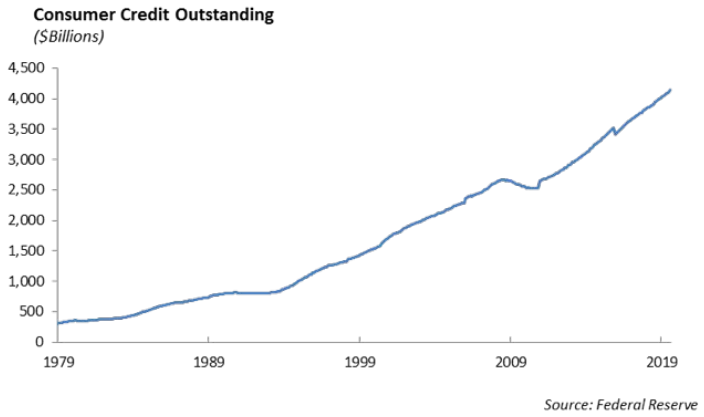

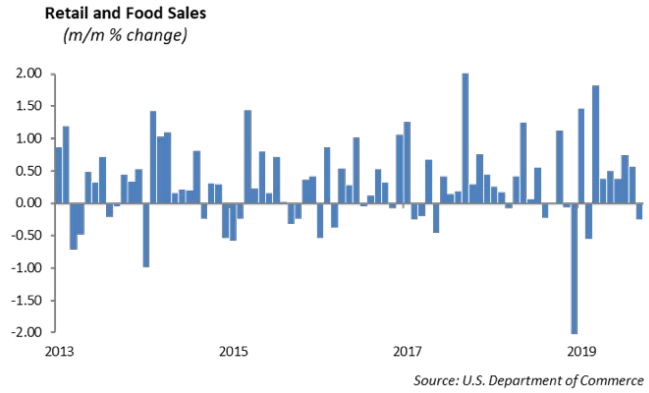

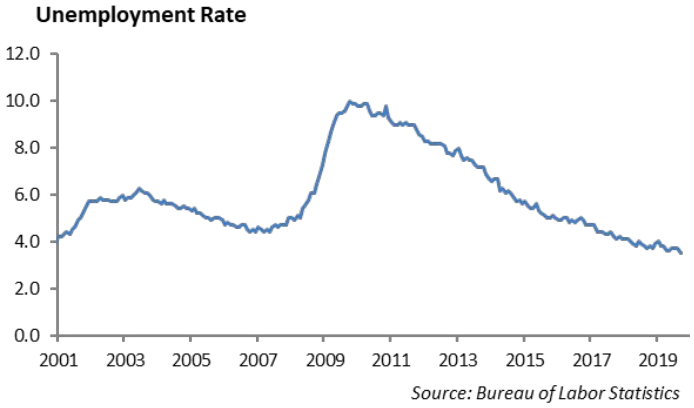

Economic and Capital Market Outlook

year, the economy benefited from the tax reform in 2018; however, most of that surge has already worked through the economy. Now, there are forces that are working to counter the stimulus from the tax reform, including the uncertainty over trade policy with China, the concern over the disarray in Europe and Brexit, and the chronic bi-partisan politics affecting domestic policy initiatives. As each of these issues approach a more likely resolution, business investment and consumption should benefit. However, the global economy is slowing, and the domestic economy is showing signs of slow growth as well. In spite of a solid employee report last week, the manufacturing and service sectors continued to show signs of slowing last month.

One issue that continues to be ignored is the significant growth in debt and the impact that it has on long term economic growth. Domestic debt is growing in all areas, including federal, state and local governments, student loans, credit cards, auto loans, and corporate debt.

Consumer spending is a major contributor to the domestic economy. Over the past year, we have seen evidence of some slowing in the consumer sector. The Commerce Department reported that retail sales in September fell by -0.3%, the largest amount in seven months.

The economy added 136,000 jobs in September according to the Labor Department. The U.S. consumer is generally able to find work, which supports wage growth. The unemployment rate shifted to a 50 year low of 3.5% in September from 3.7% in August. At the same time, wage pressure is still relatively low. Job gains combined with low unemployment buffers the U.S. economy from weakness and supports wage growth, which in turn helps to spur consumer spending.

During the Financial Crisis, the economy lost over 8 million jobs over two years. Since 2010, the economy has produced nearly 22 million jobs, driving the rate of unemployment down to 3.5%. We are concerned that this rate of job growth and unemployment will not hold up into next year given the pressure on corporate earnings and the growing list of companies announcing restructurings and lay-offs. Earlier this month, HP announced a plan to reduce headcount by 7,000 to 9,000 employees.

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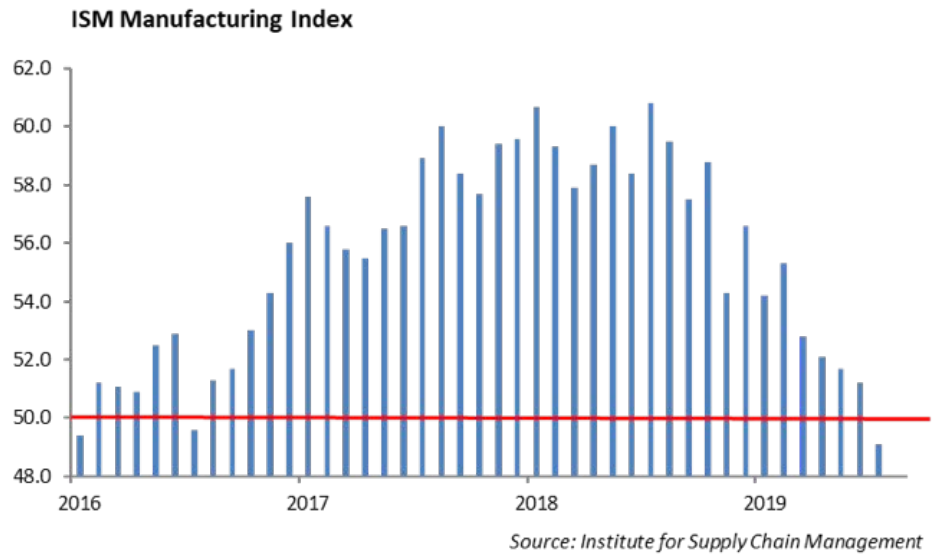

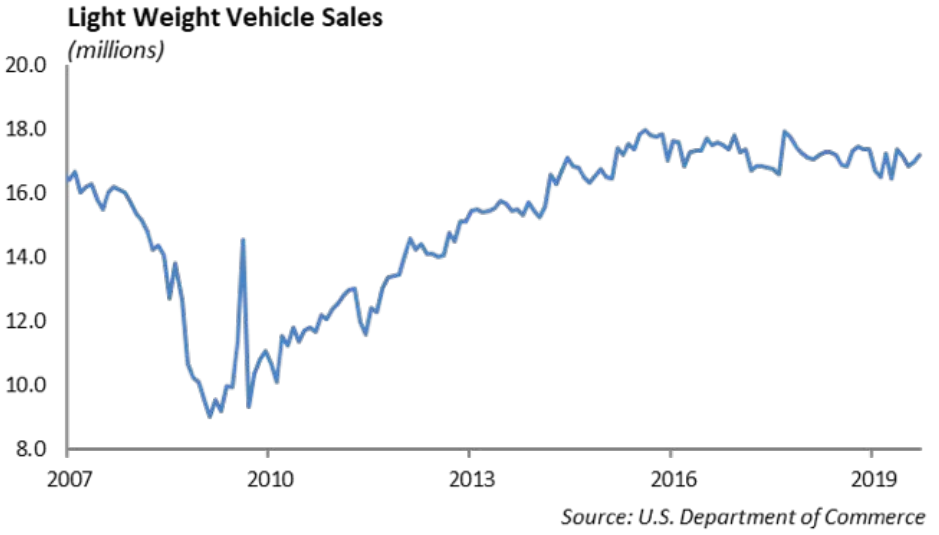

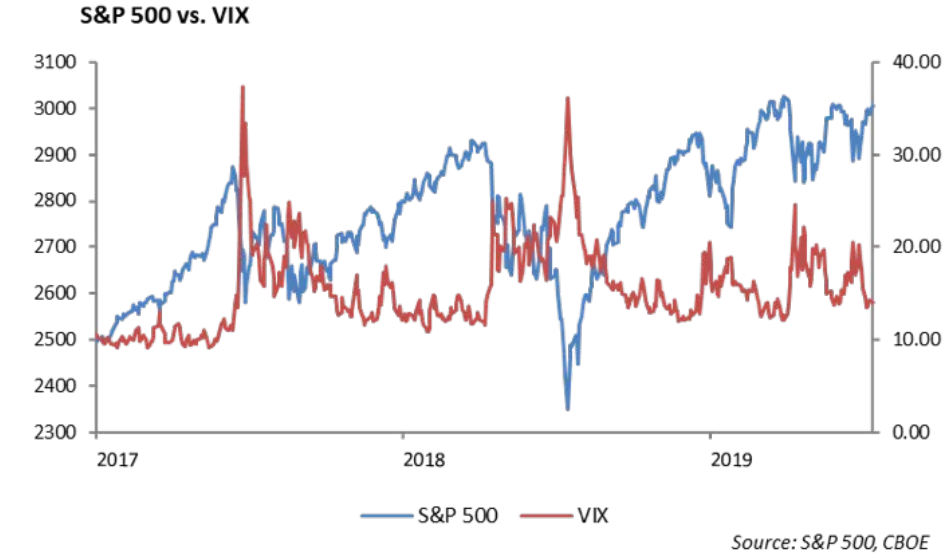

The Institute for Supply Management (ISM) tracks both manufacturing and U.S. services sector activity each month. A reading above 50 shows growth, while a reading below 50 indicates a contraction in activity. The ISM manufacturing index dipped to 47.8 in September, its lowest level since June of 2008. The manufacturing sector has shown decelerating growth since August of 2018. This is a clear sign that the trade war with China and slowdown in Europe has an impact on manufacturing in the U.S. We expect trade flows with China this year to grow at its slowest pace since the Financial Crisis.

At the same time, auto sales are still tracking near 17 million units. We expect to see this figure begin to dip as general slowdown grips the domestic economy and the UAW strike at GM impacts production.

Equities

The equity market has been extremely resilient this past year with the S&P 500 returning over 18% to investors in 2019. In spite of massive monetary stimulus and a strong labor market, equities have hit resistance at the 3000 level on the S&P 500. While we are encouraged by the potential resolutions to structural barriers in the market, we are expecting compressed returns in financial assets over the next several years.

Small cap and mid cap stocks are undervalued, and we expect to reallocate from large cap over the next quarter. Small cap stocks generally perform well when private credit is expanding.

We have been slow to increase exposure to international stocks; however, with the potential for resolutions on trade and Brexit, we expect to increase exposure on both developed and emerging markets over the next quarter. ☐

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increases allowed the markets to adjust gradually causing little disruption. These higher interest rates provided “insurance”, giving the FED some room for adjusting rates downward if and when needed to soften future economic downturns. Therefore, despite it’s slowing of the economy affect, this “tightening” policy was generally welcomed by Wall Street. However, not without consequence. Many felt that since the drastic FED rate manipulation of holding rates near zero, for so long, set a dangerous precedent. It showed a new tolerance for significant intervention and distorted normal market forces forcing investors into riskier assets, most notably US equities, and possibly causing unwanted “bubbles” that would need to be dealt with in the future.

Then, late last year everything changed: a rate policy turnaround. Many of the catalysts for our economy’s robust growth were offset by increasing political discourse and uncertainty, and increasing trade hostilities, primarily with China. These factors overwhelmed the now-fading catalysts in charting the course of the US economy. Even in the face of a dimming outlook, the FED raised rates one more time last December with a rationale of strong economic indicators in most areas. The bond market strongly disagreed with that assessment and the result was an inverted yield curve, a fairly reliable predictor of a coming recession.

Accordingly, the FED acquiesced, and reversed itself roughly 30 days after the December rate increase and began a rate reduction cycle as can be seen in the chart above. This mea culpa and rapid reversal of rate policy reduced the concern over economic deceleration and provided the market with the sense that a near-term recession could be avoided.

As one would expect, a reversion to an “easy” money trend rewarded the markets with outsized returns in both stocks and bonds. Subsequently, periodic reports of progress in trade negotiations has reinforced

positive market trends providing investors with stellar returns in both the bond and stock markets. Through the time of this writing investment grade bonds have returned a whopping, but not unexpected**, 8.47% YTD, by far the highest returns since 2010 and 2011 at 6.54% and 7.84% respectively. The average return over the last 10 years was a shade over 3.5 %. There is a similar story for US equity returns with the S&P 500 returning over 27% YTD (see chart above), the highest return over the last 10 years with the exception of the 32.39% return in 2013. Investors rejoiced in this terrific comeback for last year’s dismal -4.38% return.

Notwithstanding the rosy market returns, global economic growth rates continue to decelerate as tariffs and other socio/ political confrontations created economic headwinds. Increasing uncertainty

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surrounding global conditions hospitable for growth have not yet dampened the US securities market's momentum just yet.

Looking ahead

The last scheduled FOMC meeting of 2019 will take place in mid-December and market expectations are that the Fed will hold rates steady even with disappointing economic data of late. For clear direction on rates going forward, the FED is looking for a material change to the economic outlook. Neither the slowing economic data nor the lower risk of trade related ecomonic weakness are enough to prompt easier monetary policy or a return to a rising rate cycle. However, we believe that the bar for a rate cut will remain much lower in 2020 than the bar for a rate hike. In fact, should the FED hold rates steady in December as expected, the likelihood for another rate cut would be higher than that for a rate increase in 2020. Given how much easing has already taken place this year and the current condition of the economy, signs from the FED are that rates will probably hold steady well into 2020. Unless there are significant economic or market events, we expect that the Fed will retain a dovish bias and hence the risks remain slightly tilted toward additional rate cuts.

Below are the latest Fed funds futures' probabilities of future rate changes by:

- Dec 2019 - **down** by at least 25 bps: 0.0% same as projection
- Dec 2019 - **up** by at least 25 bps: 3.7% same as projection
- March 2020 - **down** by at least 25 bps: 25.8% up from 22.1% last projection
- March 2020 - **up** by at least 25 bps: 2.7% down from 2.8% last projection
- June 2020 - **down** by at least 25 bps: 45.6% up from 45.1% last projection
- June 2020 - **up** by at least 25 bps: 2.0% same as last projection

Impeachment proceedings, trade negotiations, a 2020 US Presidential election, North Korea/Russia/China military aggression, et.al. may weigh heavily on the economy/markets and will certainly play a role in influencing upcoming FED decisions. However, no matter the politics or economic policy, it is highly unlikely that investors will again see the kinds of returns recently experienced for some time. ☐

* Federal Open Market Committee
** Bond market values increase when interest rates decrease

Smart Yield Still Exists

Notwithstanding a stellar year in the investment grade bond market, with Bloomberg Barclay's Aggregate bond mandates returning over 8% YTD (as of 9/30/19), insurance company investors need to be wary. This anomalous year, with the highest returns in over 10+ years, is most unlikely to be repeated. Consider the following:

Fundamentals and Flows	Investment Grade	Short Duration Investment Grade	Private Credit	Short Duration BB-B Rated
YTD Flows (billions)	$69.1	$39.5	$22.6	$0.9
Yield (Yield to Maturity)	2.3%	1.9%	7.6%	5.2%
Rate Risk (Mod Duration)	6.3 Yrs	1.9 Yrs	0.3 Yrs	1.9 Yrs
Credit Risk (Debt/EBITDA)	2.9x	2.9x	5.6x	3.8x

As of 9/30/2019. Source: Morningstar Direct, Preqin, Asset Flow Categories: Morningstar Institutional Mutual Funds, Preqin Private Credit.

Credit fundamentals and flows as of 9/30/19

- **US Interest rates have headed downward once again.** After a rising rate cycle that began in December 2015 through January 2019 rates now appear to have possibly stabilized, which may reduce return expectations for bond investors going forward.
- **The world is running low on yield again.** $15 trillion of global government debt has negative yields. US bond yields have remained positive, but historically low.
- **This has left investors scrambling for yield.** Investment grade, short duration investment grade, and private credit categories face significant risks. These categories are, along with the core/aggregate mandates, the most popular for insurers and typically make up 50- 90% of their portfolios.
- **Historically high risks** plague each of the 3 chosen asset classes. Investment grade bonds (which would include core/ aggregate mandates) face *historically high interest rate risk.* Short duration investment grade bonds face *sub-2% yields*. Private credit faces *historically high credit risk.* For these reasons, investors should consider diversifying their credit portfolios with an overlooked asset class: short duration BB-B rated bonds.

For insurance companies seeking to improve the yield and diversification of their bond portfolio, or de-risk a portion of their equity portfolio in the tail end of a bull cycle, BB-B rated short duration

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Smart Yield Still Exists

Peter Duffy, CFA
Deputy Chief Investment Officer – Credit, Senior Portfolio Manager, Senior Managing Partner

Mr. Duffy has been with Penn Capital since 2006. As Deputy CIO of Credit, he is responsible for supporting the CIO in guiding the firm's credit strategies. Mr. Duffy chairs the Credit Risk Committee and serves as a Senior Portfolio Manager for Penn Capital's Defensive, Short Duration High Yield, and Multi-Credit Spectrum strategies. He is also a member of the firm's Executive Team, which oversees the firm's overall corporate strategy and management.

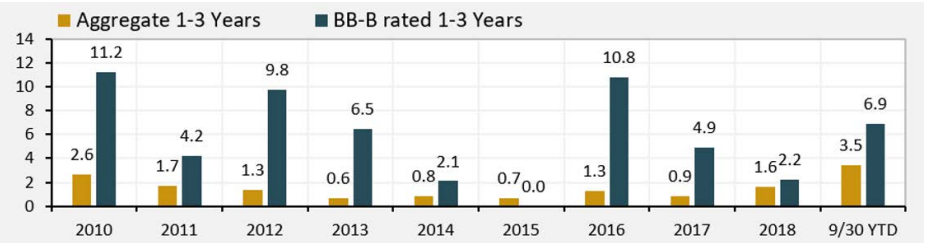
Prior to joining Penn Capital, Mr. Duffy was a Director for Deutsche Asset Management's global high yield debt team. Previously, he was with GE Capital and was a management consultant at Arthur Andersen LLP. He received a BS in Finance summa cum laude from Villanova University and an MBA from The Wharton School of the University of Pennsylvania.

Last 20-year growth of $100 and performance by asset class

Last 20Y	Ann. Return	Std. Dev.	Sharpe Ratio	2001 Recession	2008-09 Recession
BB-B 1-3Y	**6.95**	**5.23**	**0.97**	**4.36**	**6.62**
Corp IG	6.02	5.20	0.81	7.44	1.72
Treasury	4.67	4.42	0.66	5.74	9.02
Agg Bond	5.04	3.45	0.94	6.45	7.54
Agg 1-3Y	3.31	1.37	1.17	6.44	7.98
S&P 500	6.33	14.59	0.37	-7.18	-35.46

As of 9/30/2019. Source: Morningstar Direct. Indices: ICE BofAML BB-B 1-3 Year, ICE BofAML Corporate, ICE BofAML Treasury, BbgBarc Aggregate Bond, BbgBarc Aggregate Bond 1-3 Year, S&P 500.

BB-B vs Aggregate Short duration calendar year returns (%)



As of 9/30/2019. Source: Morningstar Direct. Indices: BbgBarc Aggregate Bond 1-3 Year, ICE BofAML BB-B 1-3 Year.

bonds can also improve the risk-reward characteristics of an insurance company's portfolio due to their low correlation to typical stock and bond holdings. Strategic asset class expectational corrections for BB-B rated short duration bonds to investment grade bonds is 0.20%; for large cap stocks it is 0.68% *(JP Morgan Long Term Capital market assumptions).*

Short duration BB-B rated bonds remain overlooked, having not been flooded with recent flows. As result, the bonds exhibit fundamentals in line with historic norms, not at the extremes of more popular asset classes.

An overlooked anomaly, short duration BB-B bonds provided durable income over the last 2 recessions while participating in the upside of ensuing bull markets. The bonds exhibited investment grade-like downside with a speculative grade-like upside, which we believe are ideal characteristics given current market uncertainties.

The short duration BB-B anomaly exists for 3 reasons and doesn't appear to be going away anytime soon. We believe the bonds will continue to be overlooked.

1. *High Yield Investors Seek Higher Yield:* As maturity approaches, bond yields move incrementally lower, deemed less risky by the market. This makes them less attractive to high yield funds, who sell or avoid the lower yielding bonds.

2. *Rating Agency Maturity Inefficiencies:* rating agencies don't distinguish between short and long maturity bonds from the same issuer. A short maturity bond may exhibit investment grade risk but receive a speculative rating due to the issuer's longer-term bonds. This typically results in less interest from investors.

3. *Large strategies and ETFs can't scale a $150bn bond market:* The larger the AUM, the smaller the investment opportunity. Large strategies can't target $500mm issues (ICE BofAML BB-B 1-3 Yr Index median issue size) and maintain liquidity, opting instead to avoid or expand the space to 5+ year maturities and CCC ratings.

The result of these industry dynamics is an asset class exhibiting favorable risk-return characteristics, targetable by smaller and disciplined investors and is particularly appealing to conservative insurance company investors. Given the

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Smart Yield Still Exists

historically high risks of the fixed income market, short duration BB-B rated bonds should be considered within a diversified portfolio. ☐

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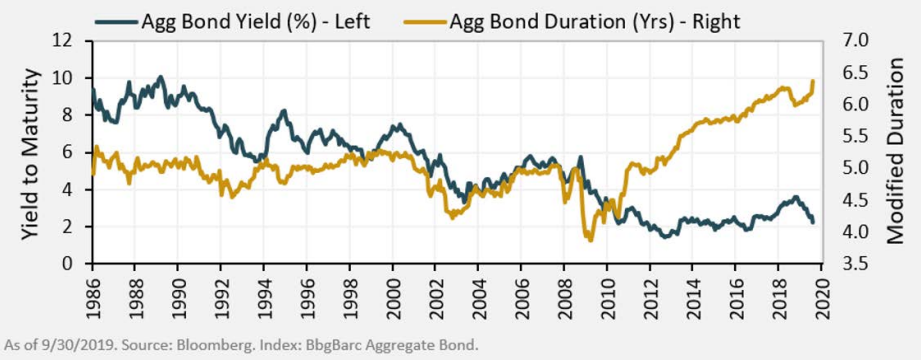
Historically low yield and high interest rate risk



Upcoming Events

1.Carl Terzer will be speaking at the World Captive Forum which takes place Jan 27-29, 2020 at the JW Marriott Miami Turnberry Resort & Spa in Aventura FL. Carl Terzer's session is Wed Jan 29 at 9:45 and is entitled "Using Active and Passive Management in Captive Portfolios". Hopefully you can attend this informative session!

2. CapVisor will be exhibiting at the 2020 CICA International Conference March 8-10, 2020 at the Westin Mission Hills Golf Resort & Spa in Rancho Mirage, California. Our booth is #614. We hope that you will be able to stop by and say hi!

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