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global

The Challenges of Market Distortion

Gina Sanchez, CEO

September 19, 2019

Agenda

- I. **Economic Outlook** – Cooling Momentum, Mounting Headwinds
- II. **Market Dynamics** – Fundamentals vs. Valuation
- III. **Market Distortions** – Challenging Expectations



**Economic
Outlook**

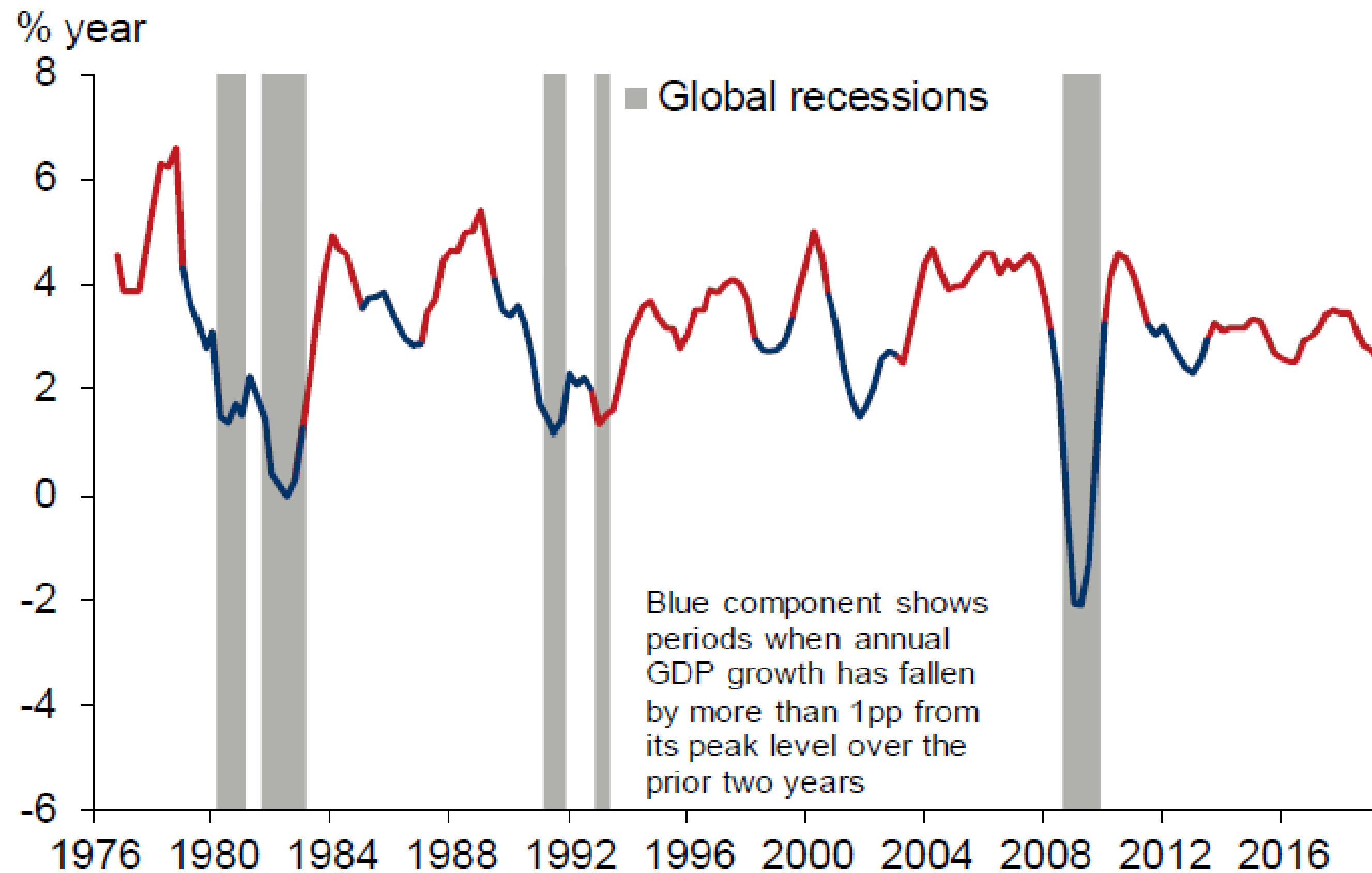
***Cooling
Momentum,
Mounting
Headwinds***

Global Outlook

- The trade war has slowed global GDP growth estimates for 2019 to 2.6%.
- Central Bank policy loosening may counter tariff effects, but may also be less effective than before when it comes time for the rebound. Estimates for 2020 are now 2.5%.
- However, the risks continue to the downside if tariffs weigh on confidence or dollar strength.

Global recession still unlikely

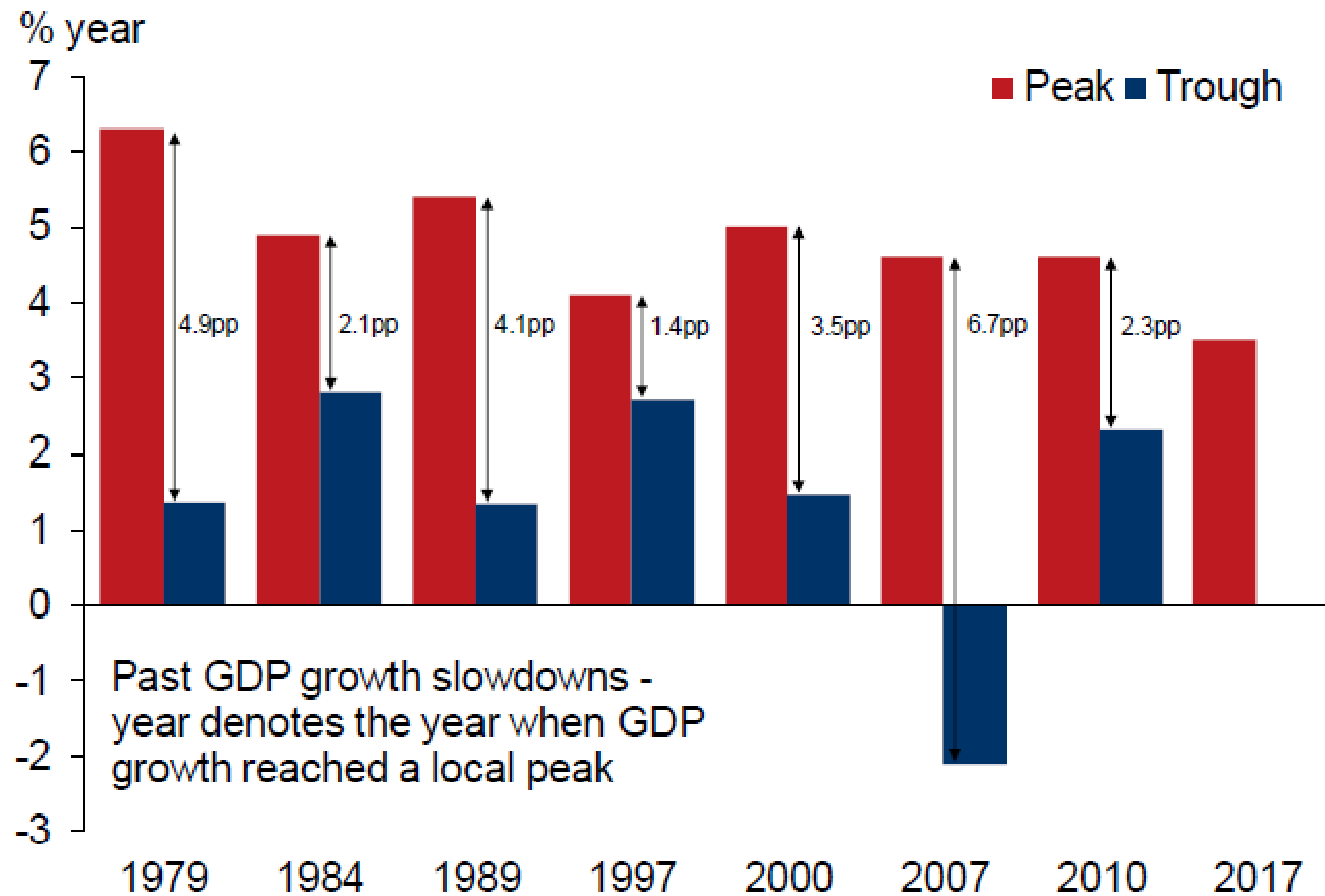
World GDP



Source : Oxford Economics/Haver Analytics

Global growth slowing in successive cycles

Global GDP

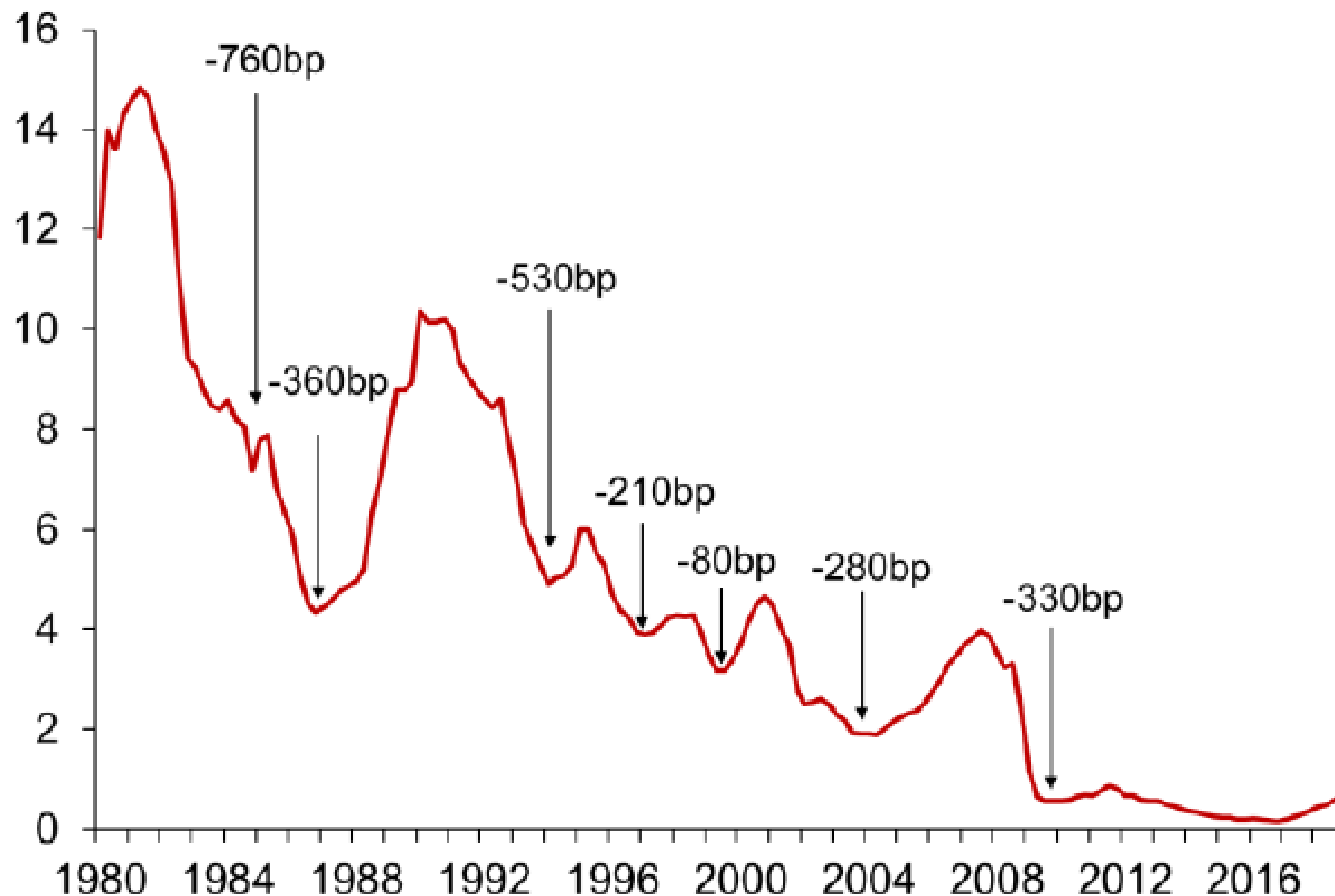


Source : Oxford Economics/Haver Analytics

Monetary policy tools are less effective

G7 central bank policy rate

%, average across G7

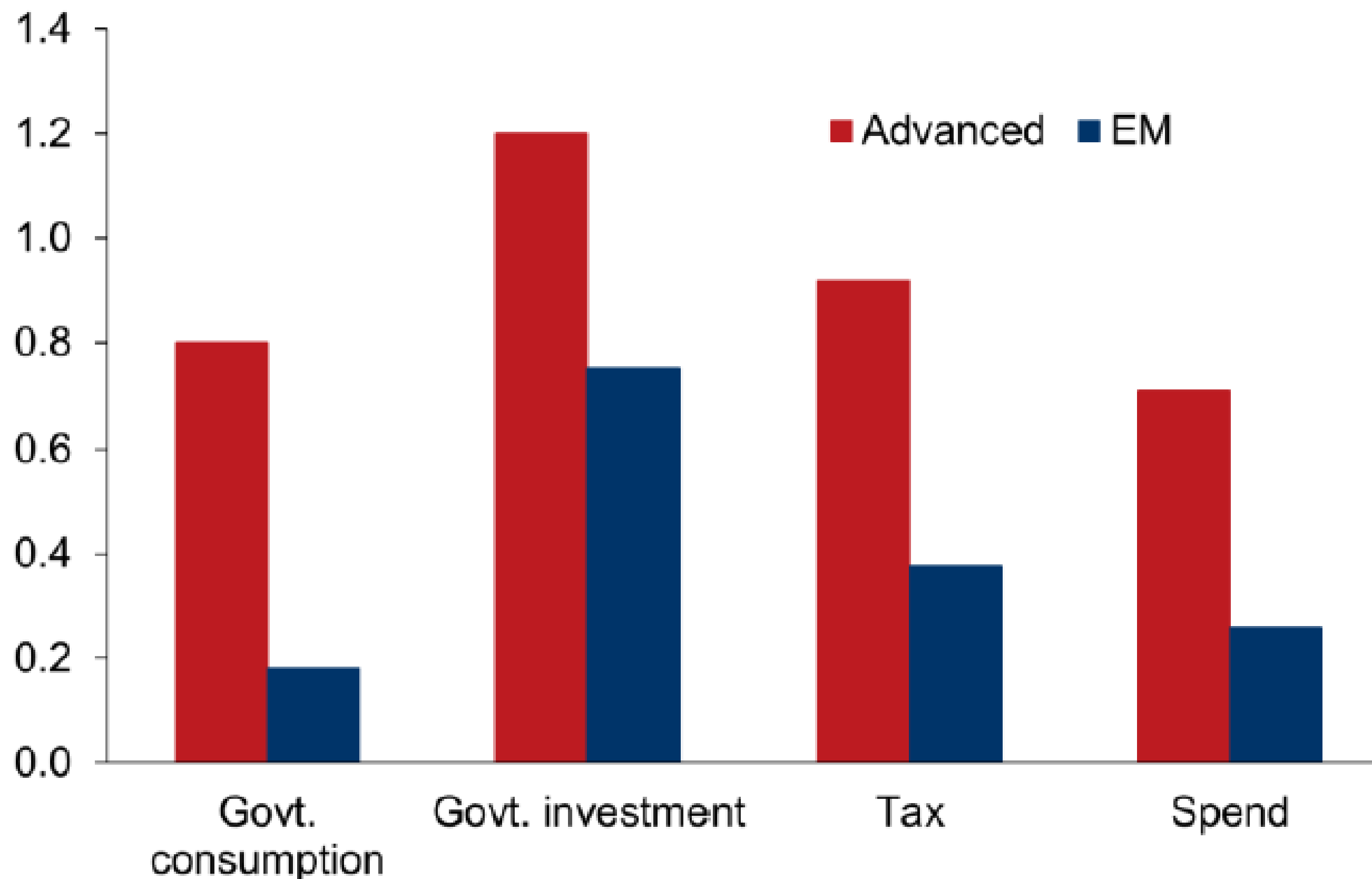


Source : Oxford Economics/Haver Analytics

But fiscal policy could still be an option

Fiscal multipliers, advanced and EM economies

Multiplier (estimated)



Source : Oxford Economics/Ilzetzki et al (2011), Batini et al (2014)

Trade war remains highest downside risk

What do you see as the top 3 downside global economic risks over the next two years?



Source : Oxford Economics Global Risk Survey

Geopolitical tensions vs. economic fragility



Global Outlook – Advanced Economies

United States

- GDP growth in 2019 will cool to 2% and 1.6% in 2020 as China weights on output.
- Current estimates include 0.3% drag from expected tariffs.

Eurozone

- GDP growth for 2020 has been revised down to 1.1% from 1.2% with industrial weakness and weak CPI at 0.9%.
- The ECB cut deposit rates 10% and re-activated asset purchases to combat the slowdown.

Japan

- Growth remains subdued given weak exports and a slow down in capital spending resulting in 0.8% GDP growth in 2019.
- GDP will slow to 0.2% in 2020 after the consumption tax hike.

United Kingdom

- The UK economy continues to look more fragile as Brexit drags on and impacts the domestic economy.
- GDP will likely only rise 1.2% in 2019 and 1.1% in 2020.

Global Outlook – Emerging Economies

China

- The economy continues to slow while the external outlook is clouded by weak global trade and US-China frictions.
- China will likely undertake further policy easing.

India

- Private consumption is dragging down GDP growth to 5.6% for 2019 and 5.6% in 2020.
- The central bank could cut 75 bps from the RBI.

Turkey

- Q2 GDP surprised to the upside and sentiment surveys are recovering.
- 2019 GDP growth is now expected to be 0.1% from -1.5%.

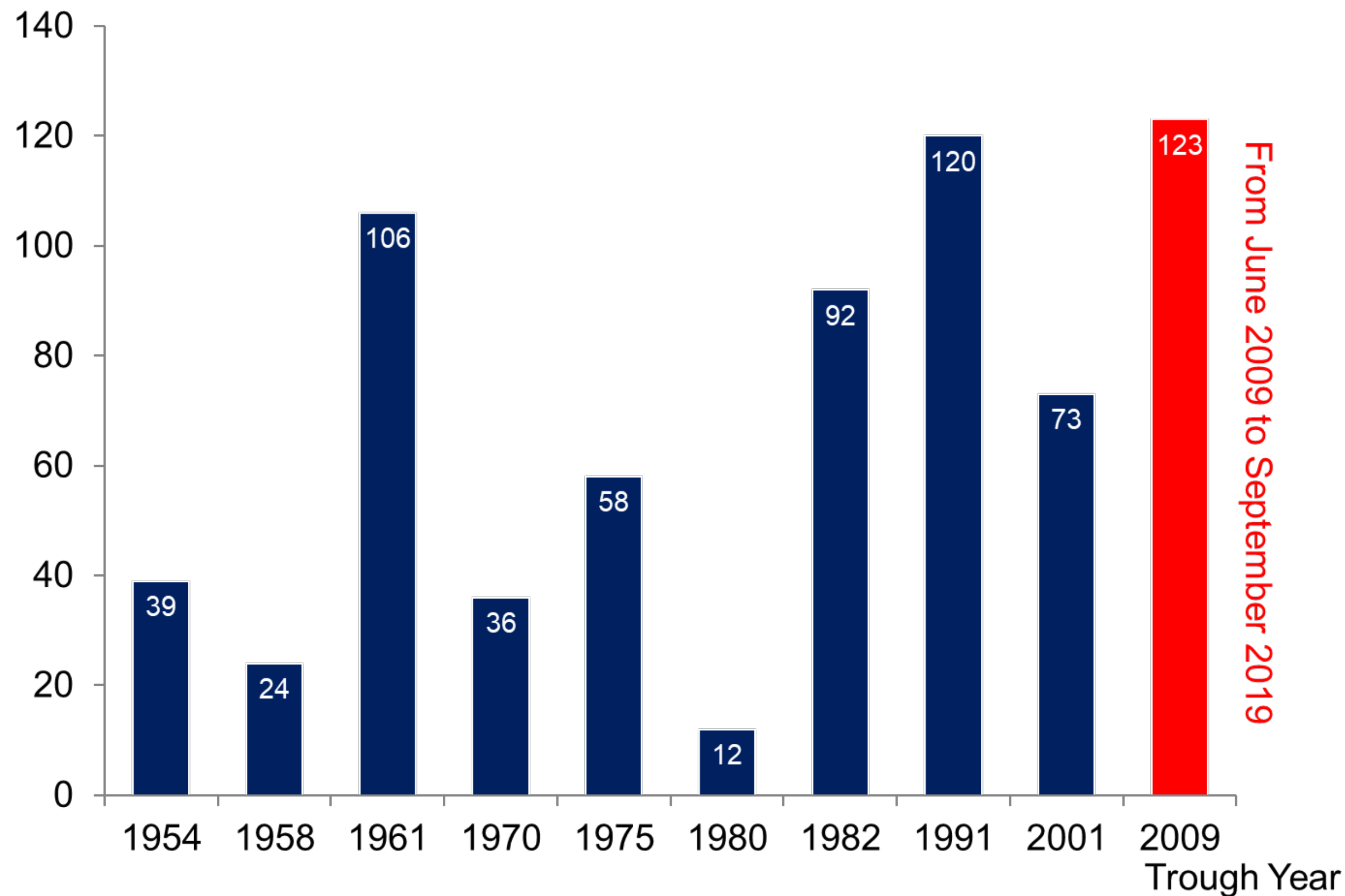
Mexico

- Industrial and investment data continue to miss expectations.
- The overall economic outlook remains uncertain.
- Consumption remains positive.

US economic expansion – long...

US: The longest economic expansion on record

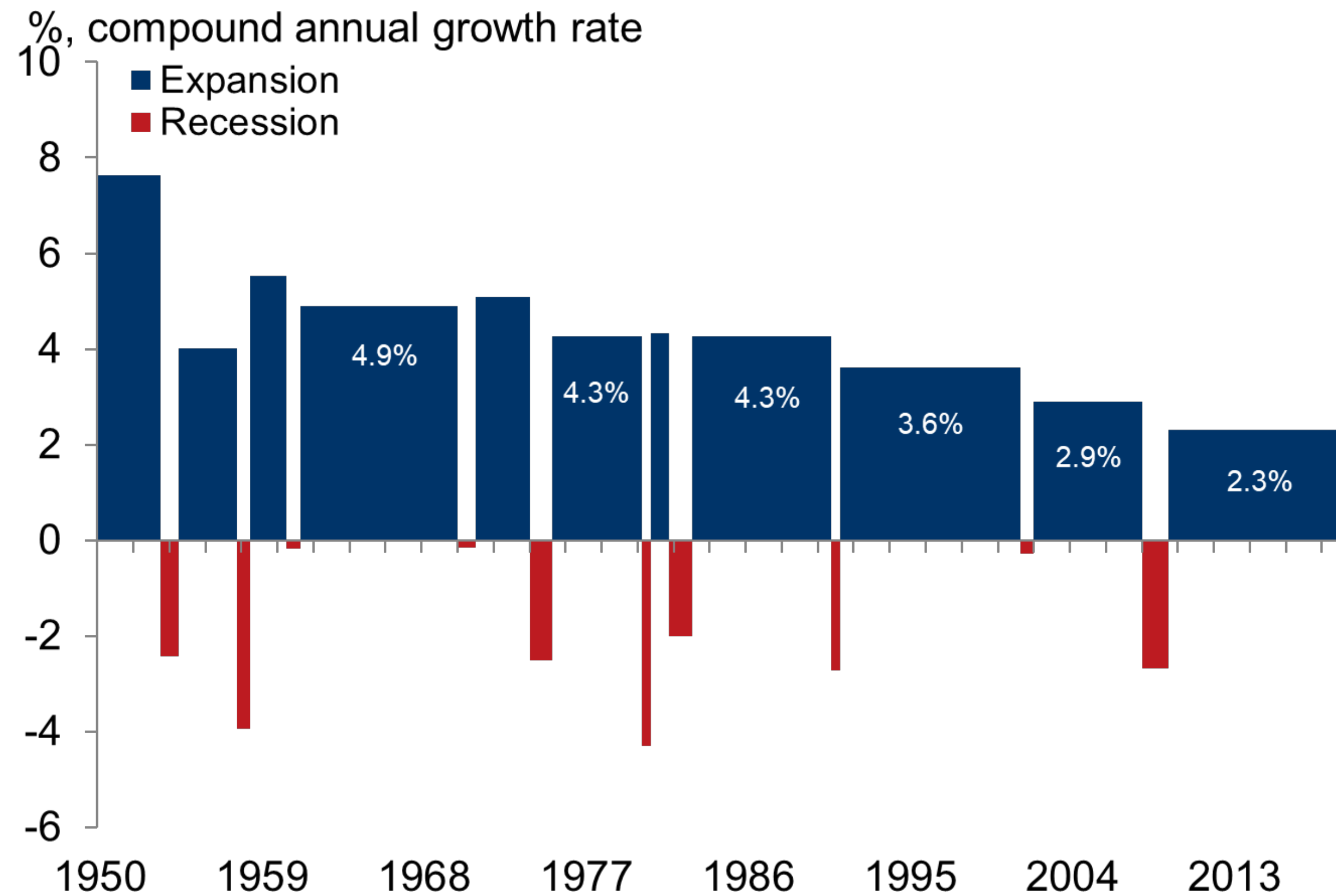
Number of months, Trough to Peak



Source : Oxford Economics, NBER

...and slow

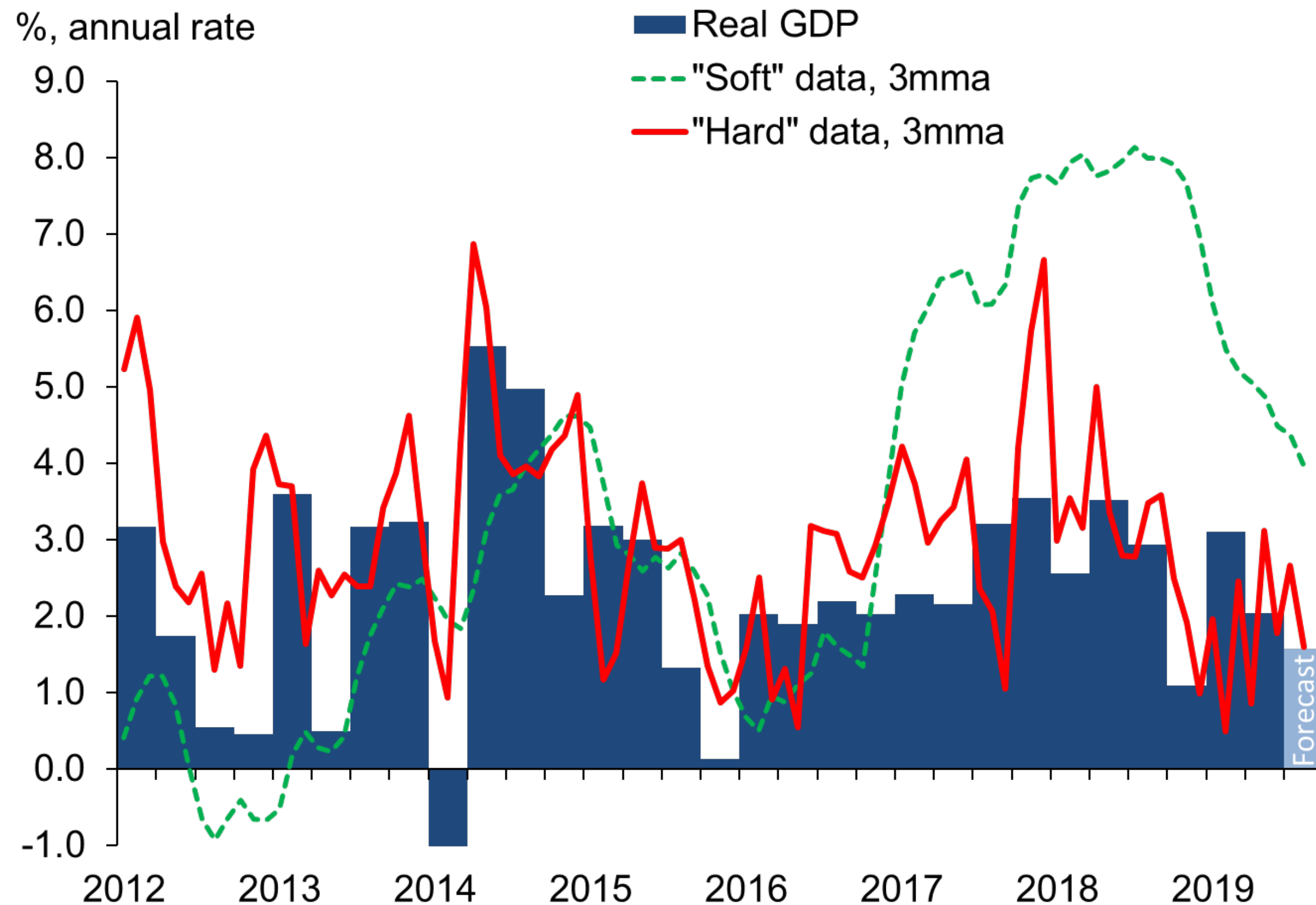
US: Expansions and Recessions



Source : Oxford Economics/Haver Analytics

US economic momentum falling

US: Economic Momentum Indicator

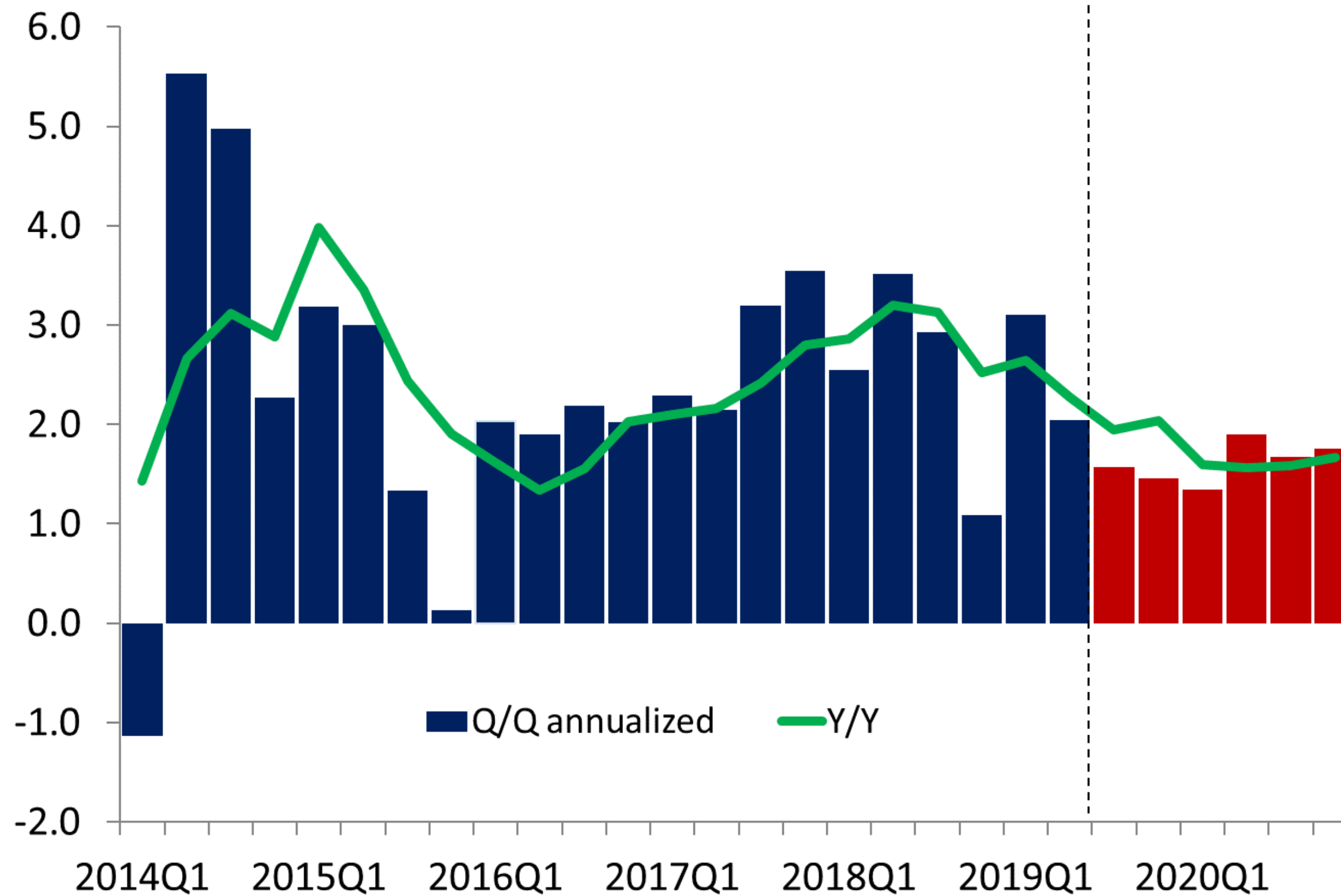


Source: Oxford Economics

US Growth slowing to 1.6% in 2020

US: Real GDP growth

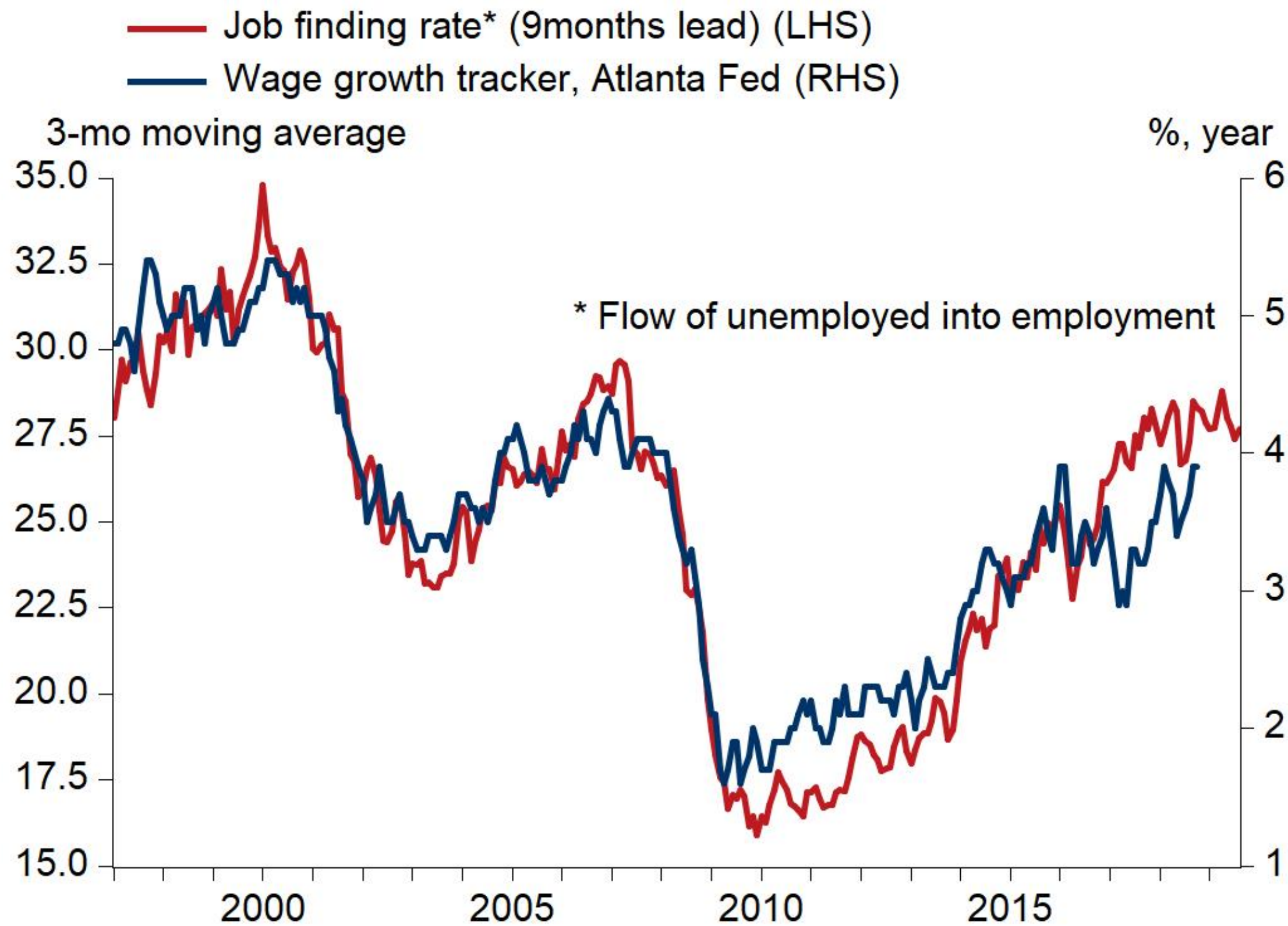
Percent, change



Source: Oxford Economics

US wage growth stuck at 3%

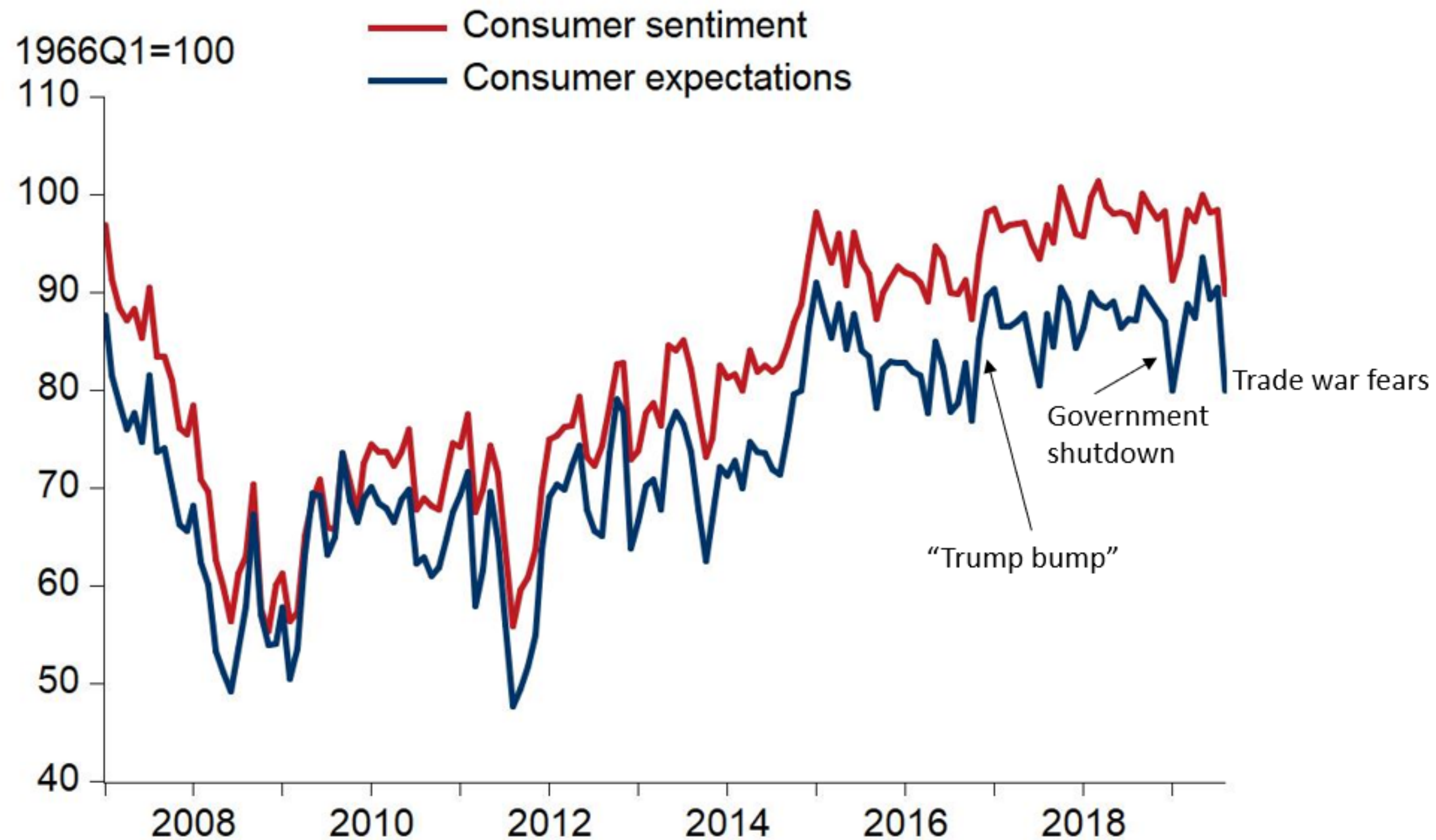
US: Wage growth not likely to accelerate much from here



Source: Oxford Economics/Haver Analytics

Trade weighing on sentiment

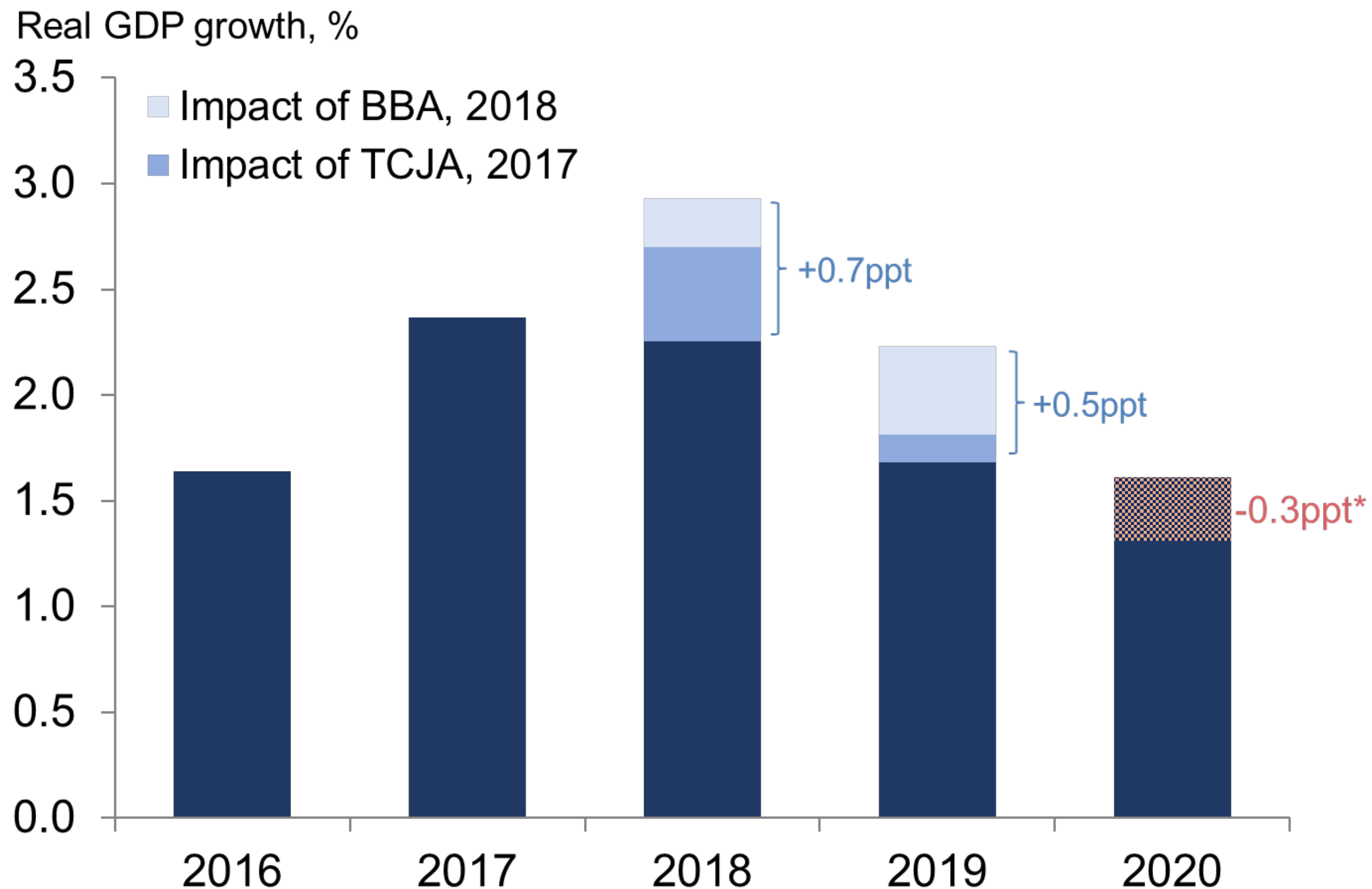
US: Consumer Sentiment



Source: Oxford Economics/Haver Analytics

Fiscal stimulus fading

US: Contribution of fiscal stimulus to growth



Source: Oxford Economics

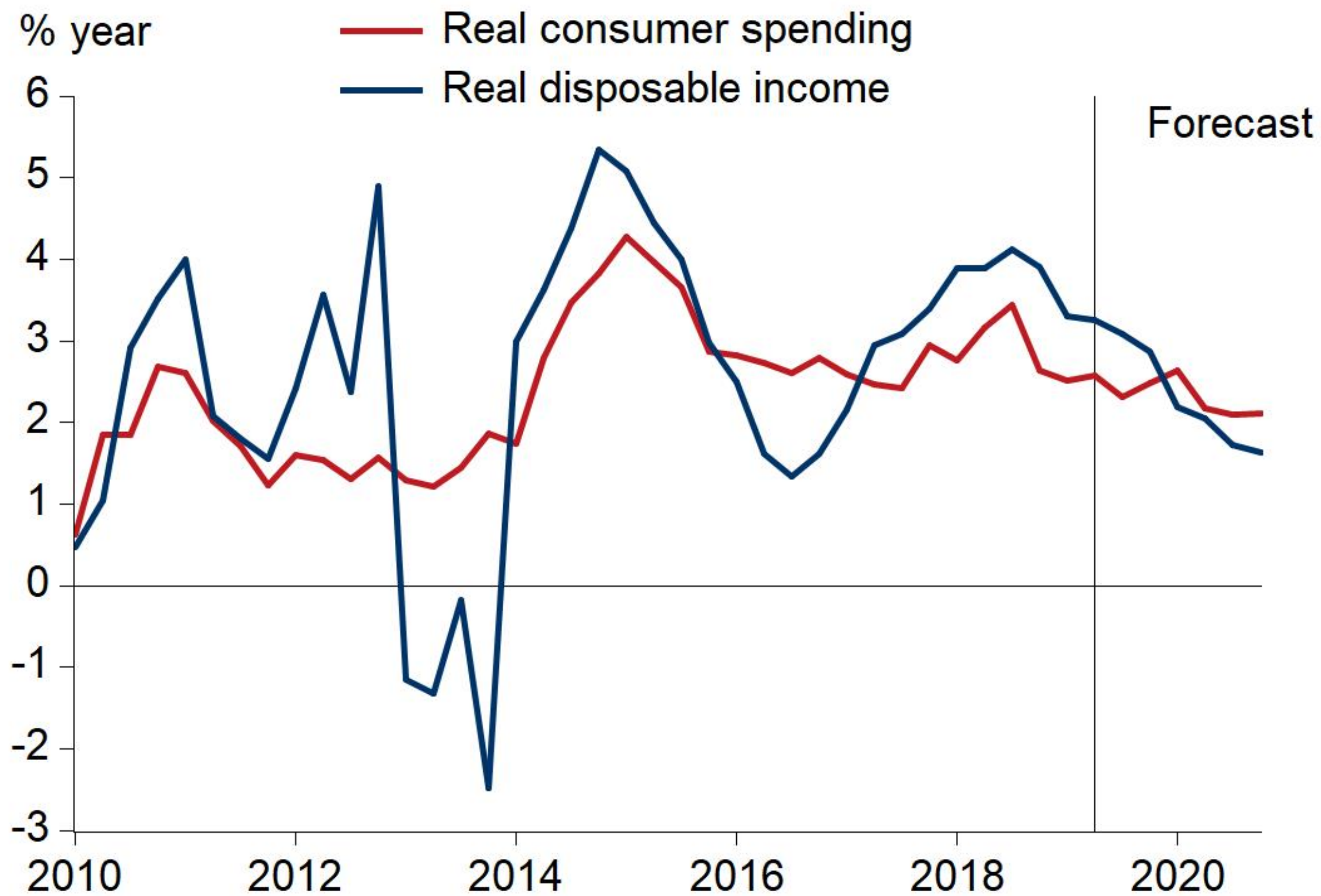
BBA, 2018 = Bipartisan Budget Act of 2018

TCJA, 2017 = Tax Cuts and Jobs Act of 2017

*Fiscal cliff risk if Congress hadn't extended BBA spending

Slower income growth means slower spending

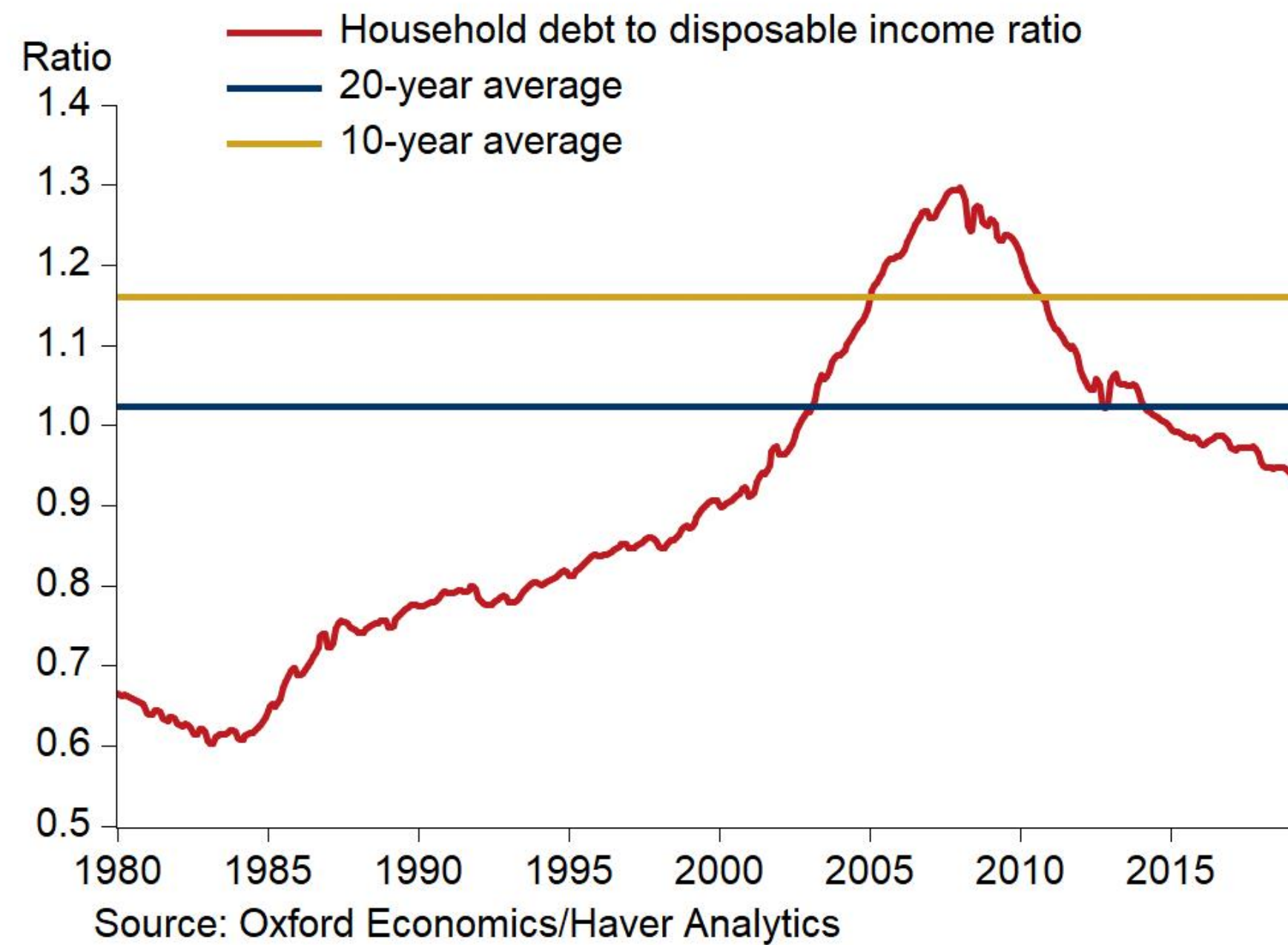
US: Consumption and income



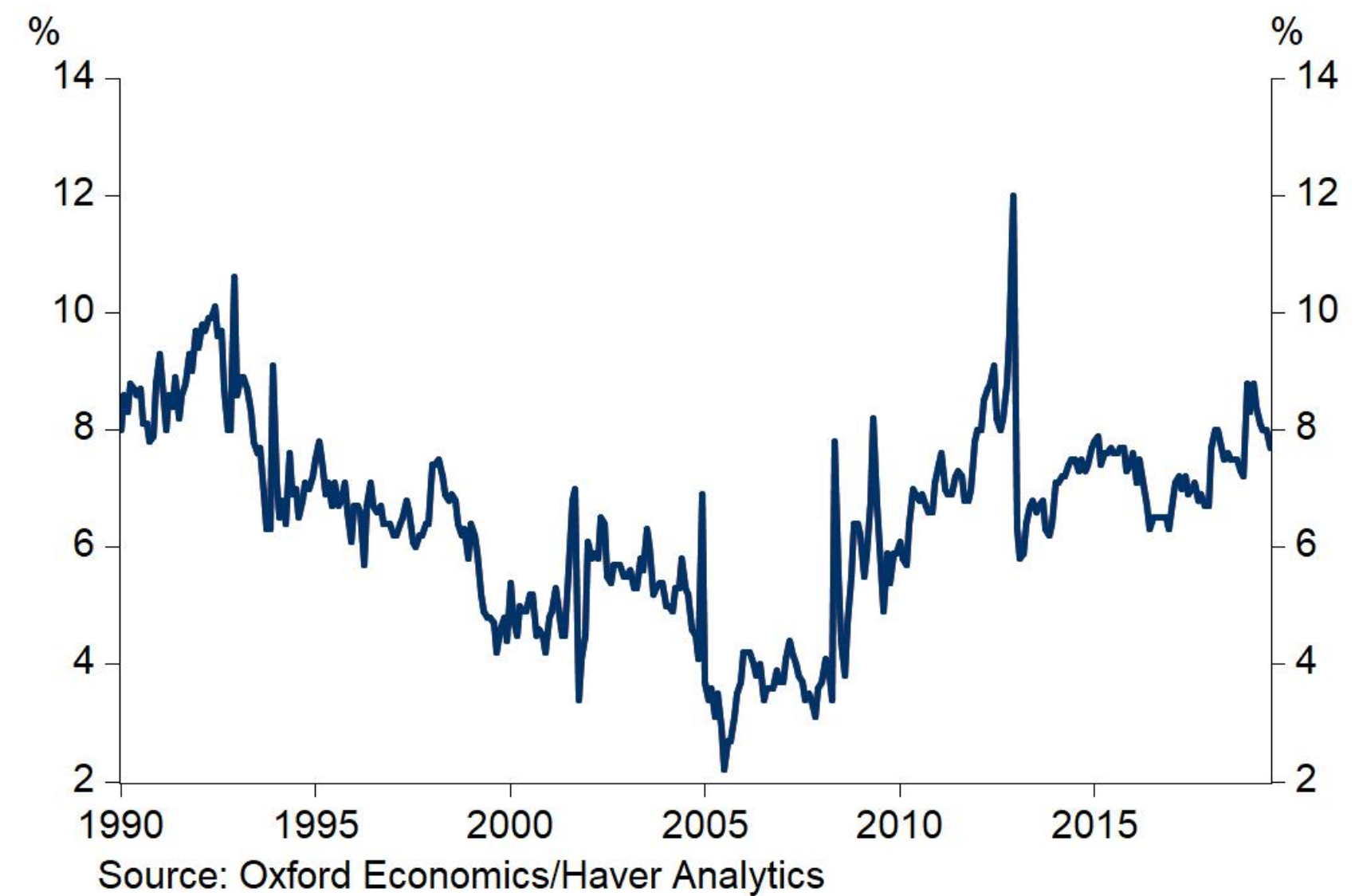
Source: Oxford Economics

Consumption buffers

US: Household debt to disposable income

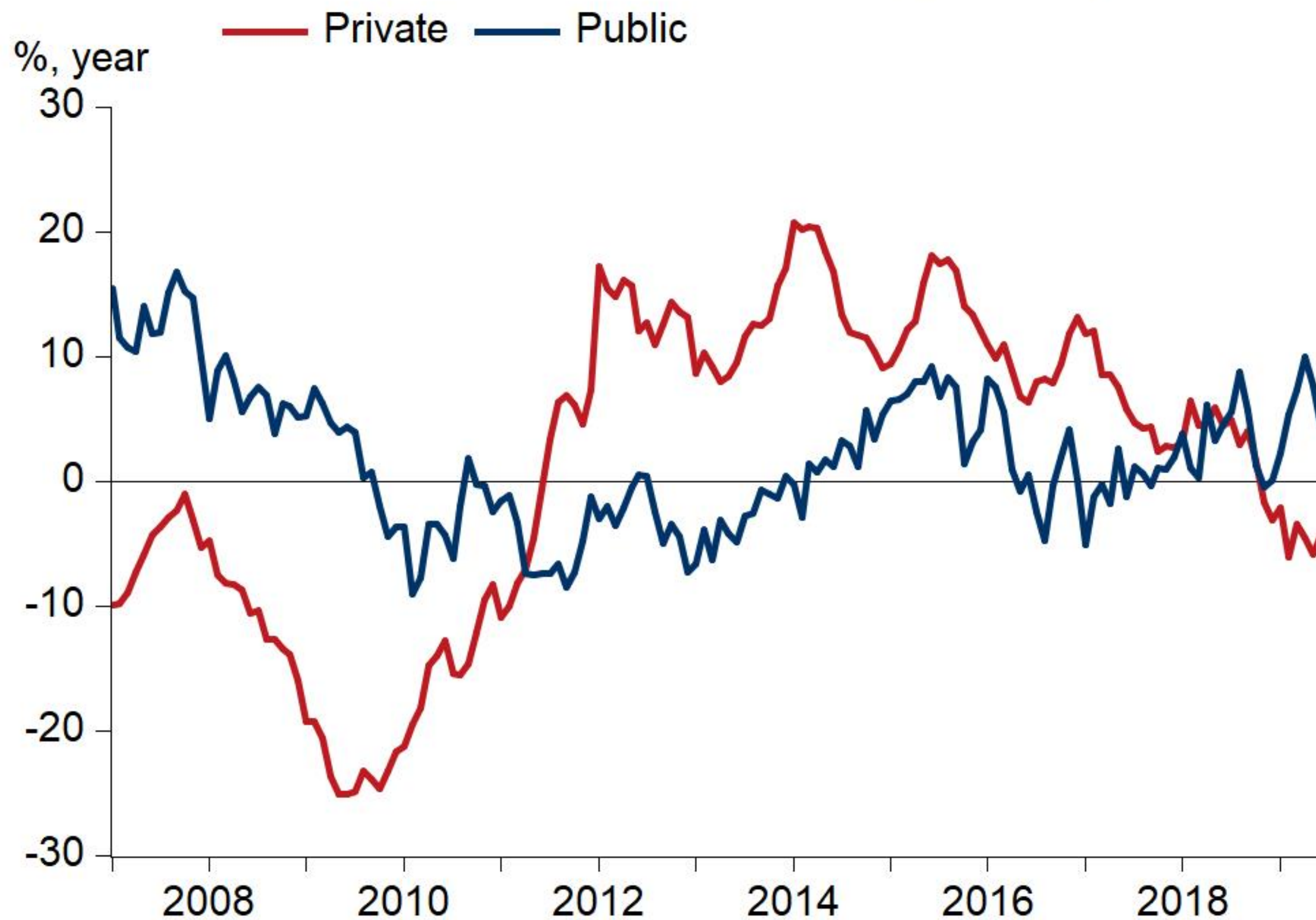


US: Personal savings rate



Public construction offsetting private

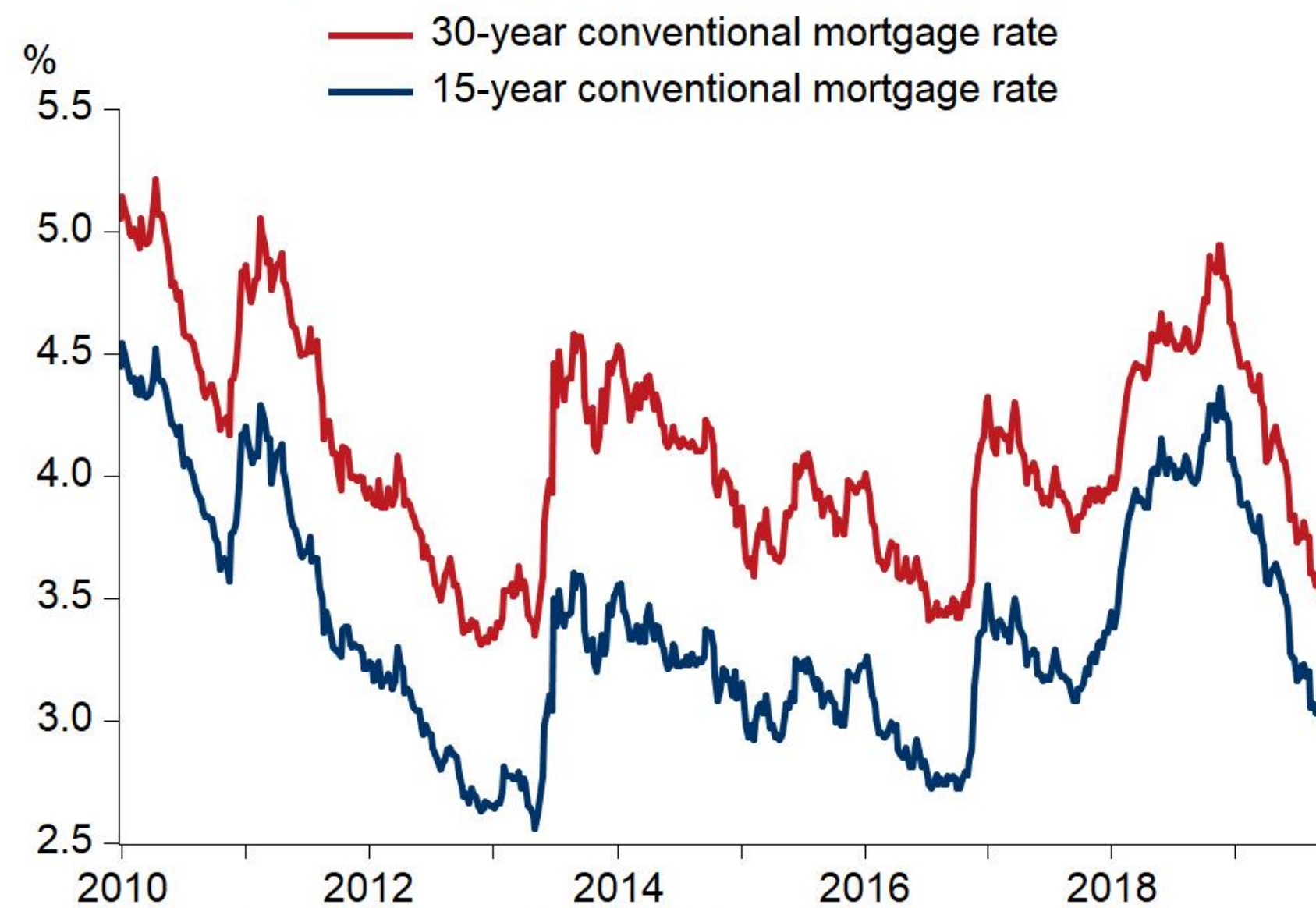
US: Private & public construction spending



Source: Oxford Economics/Haver Analytics

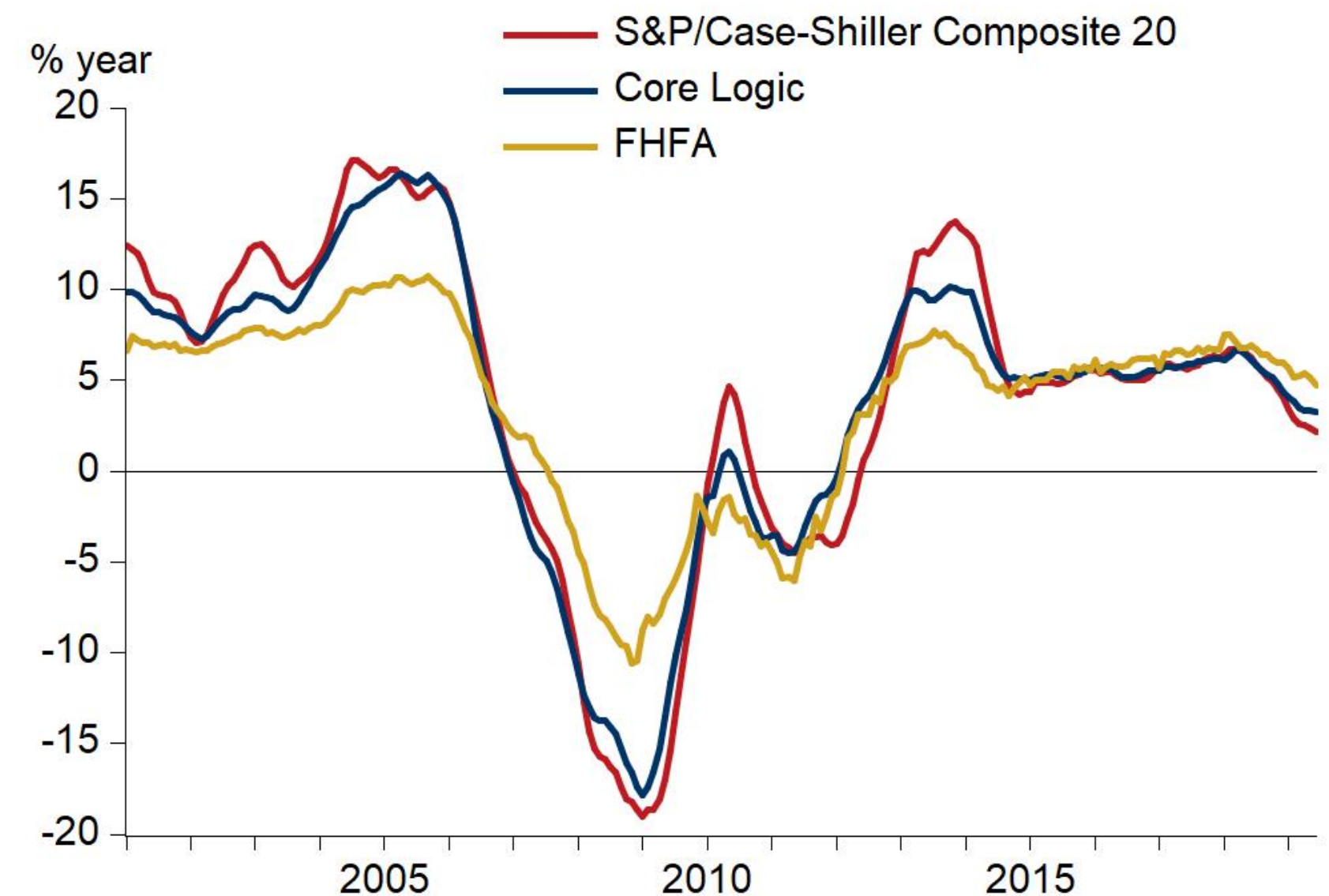
Low mortgage rates and slow home price inflation

US: Weekly mortgage rates



Source: Oxford Economics/Haver Analytics

US: House price inflation

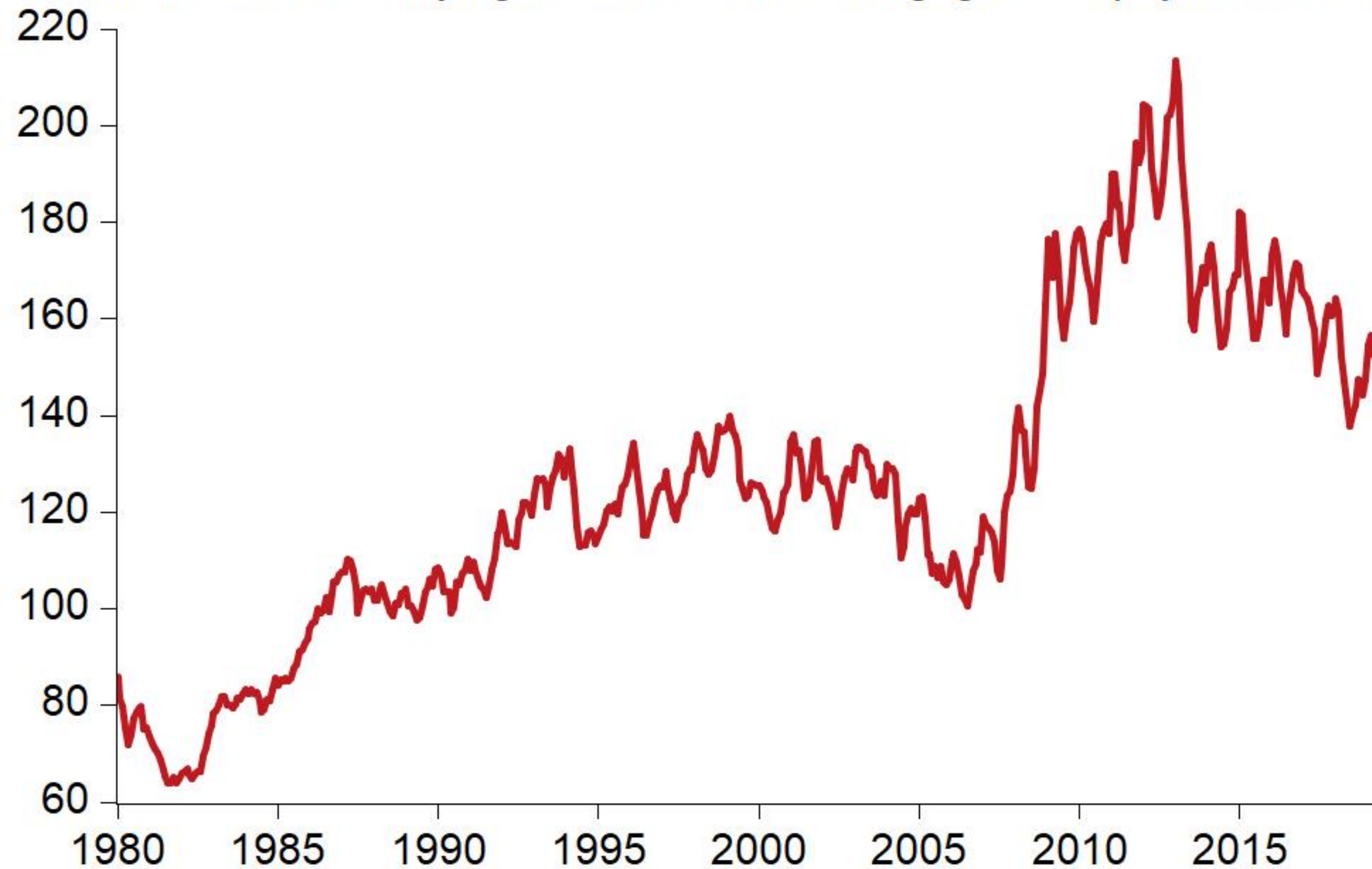


Source: Oxford Economics/Haver Analytics

Affordability rebounding

US: Housing affordability

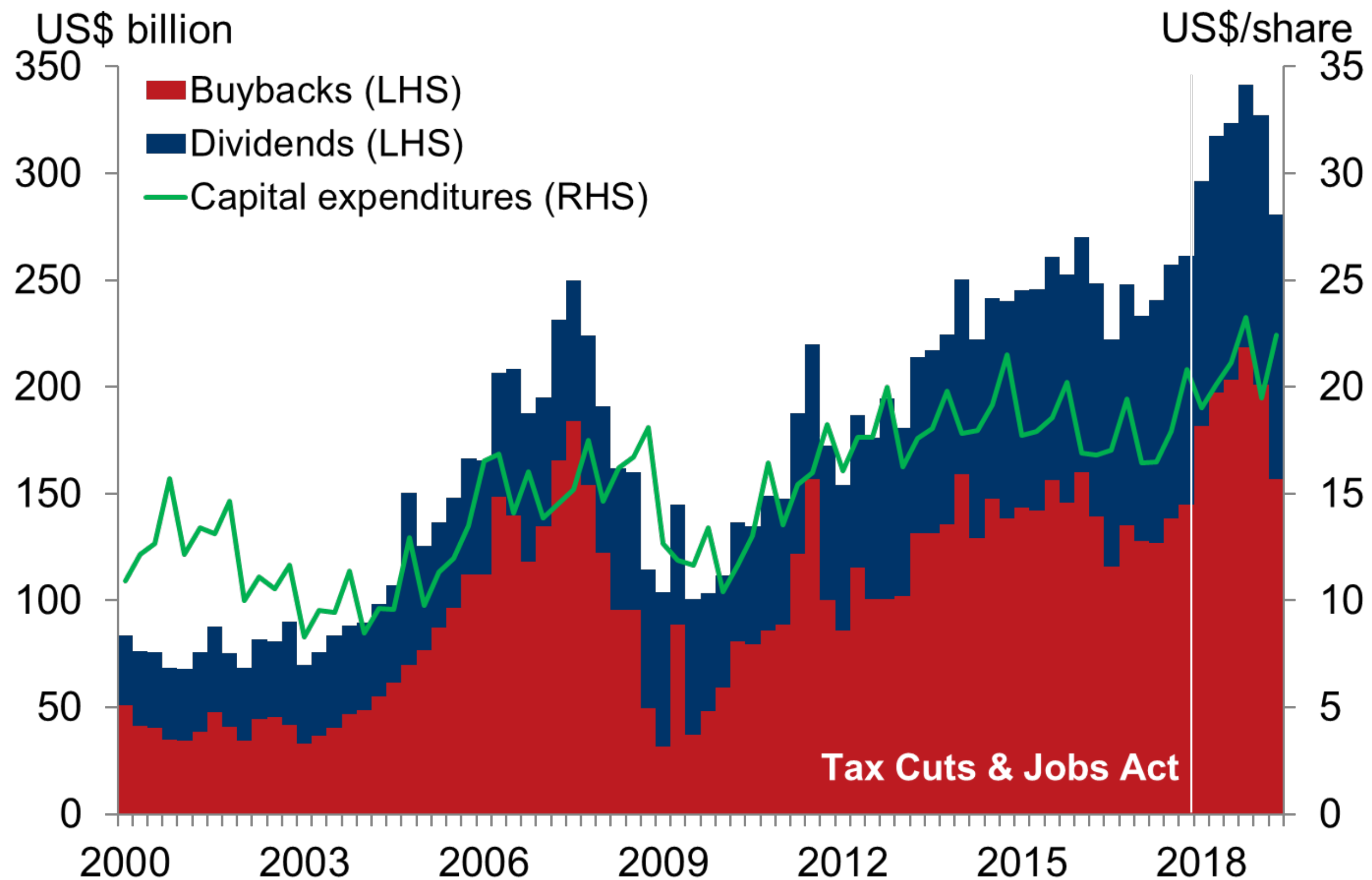
Median Income=Qualifying Income w/ 20% mortgage downpayment=100



Source: Oxford Economics/Haver Analytics

Where the tax cuts really went...

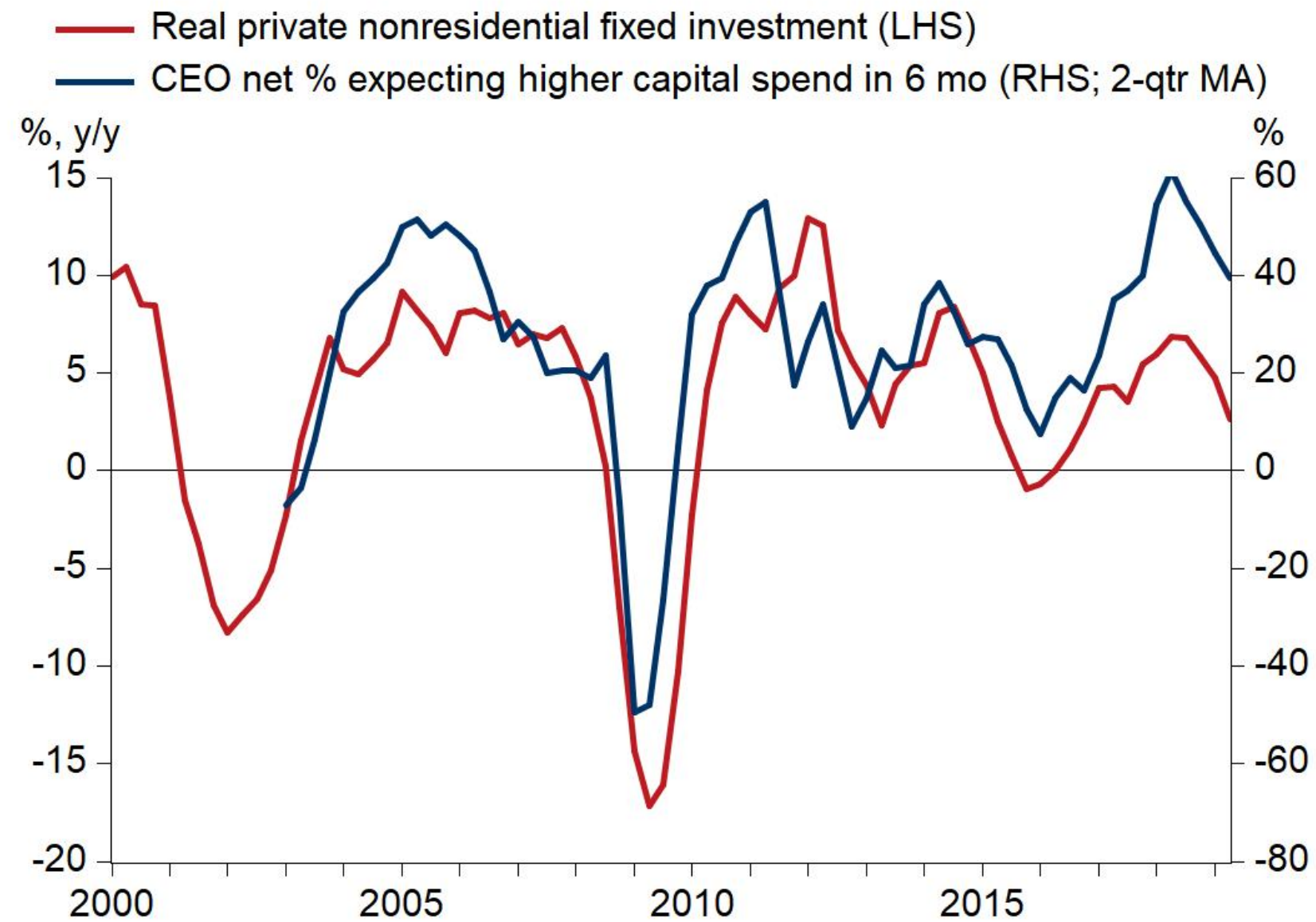
US: S&P 500 Capital Allocation



Source : Oxford Economics/Bloomberg

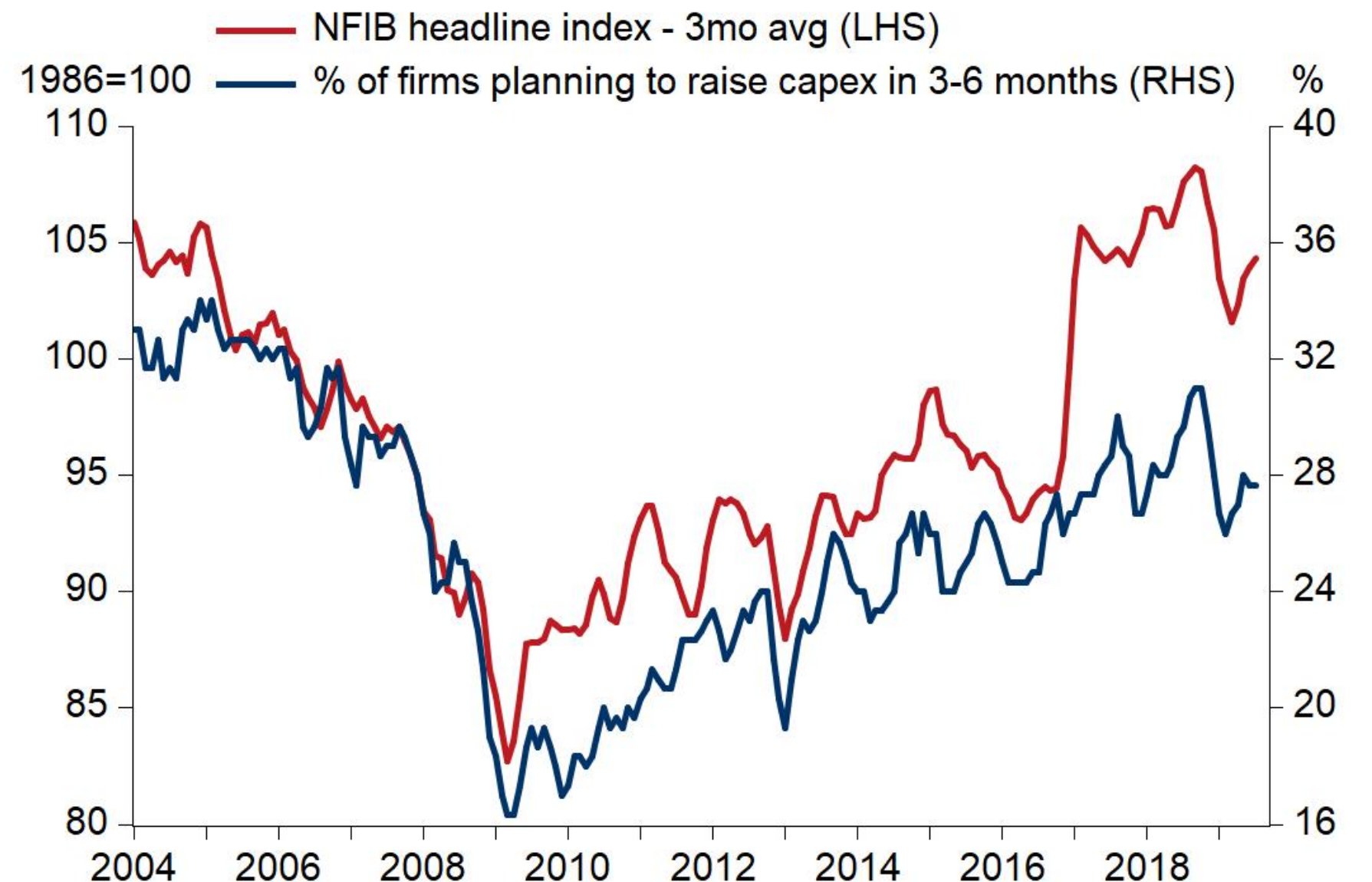
Soft business confidence

US: CEO Economic Outlook Index



Source: Oxford Economics/Haver Analytics

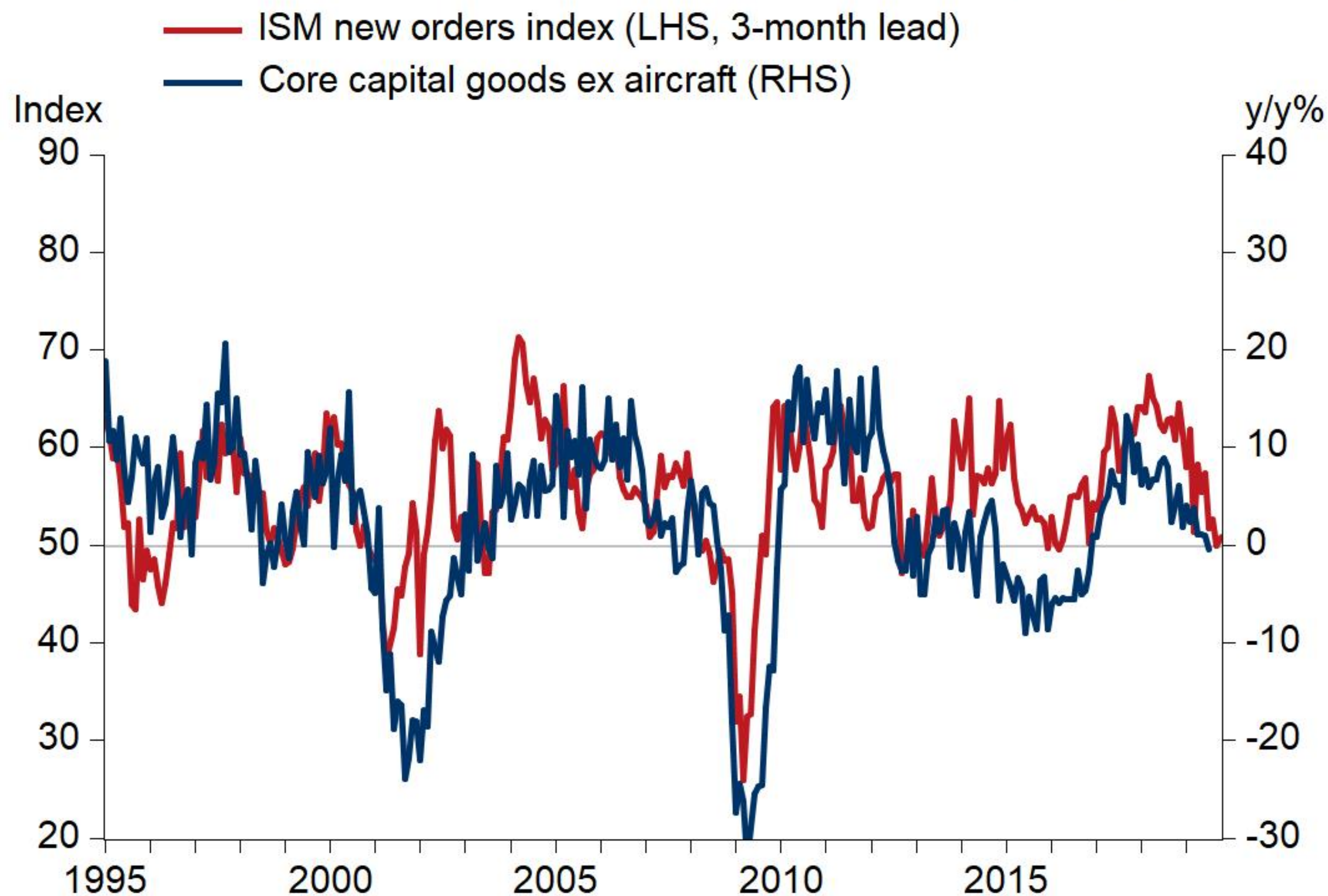
US: NFIB Small Business Optimism Index



Source: Oxford Economics/Haver Analytics

Manufacturing activity stalled

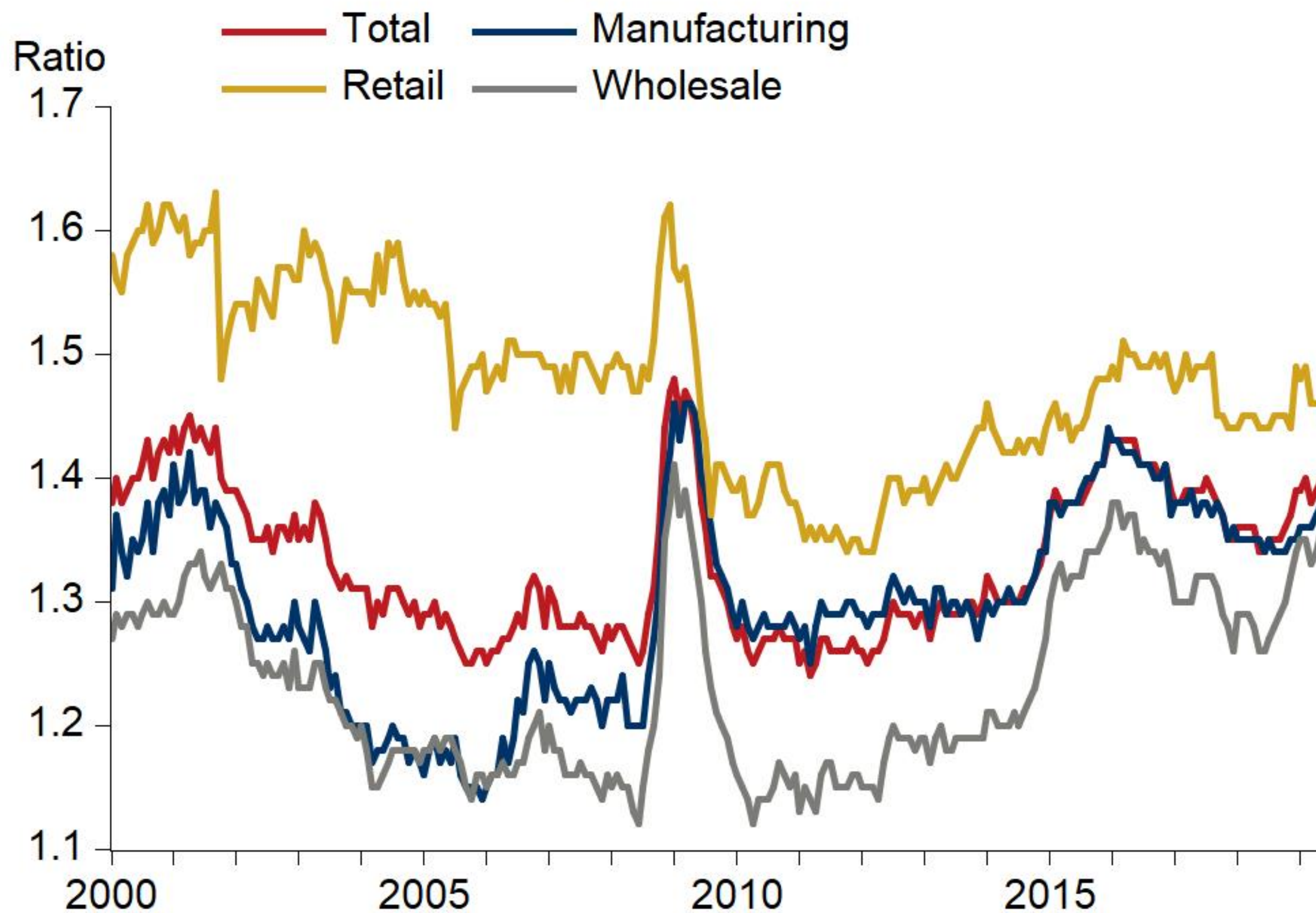
US: ISM new orders lead core orders capital gds orders



Source: Oxford Economics/Haver Analytics

Inventory overhang

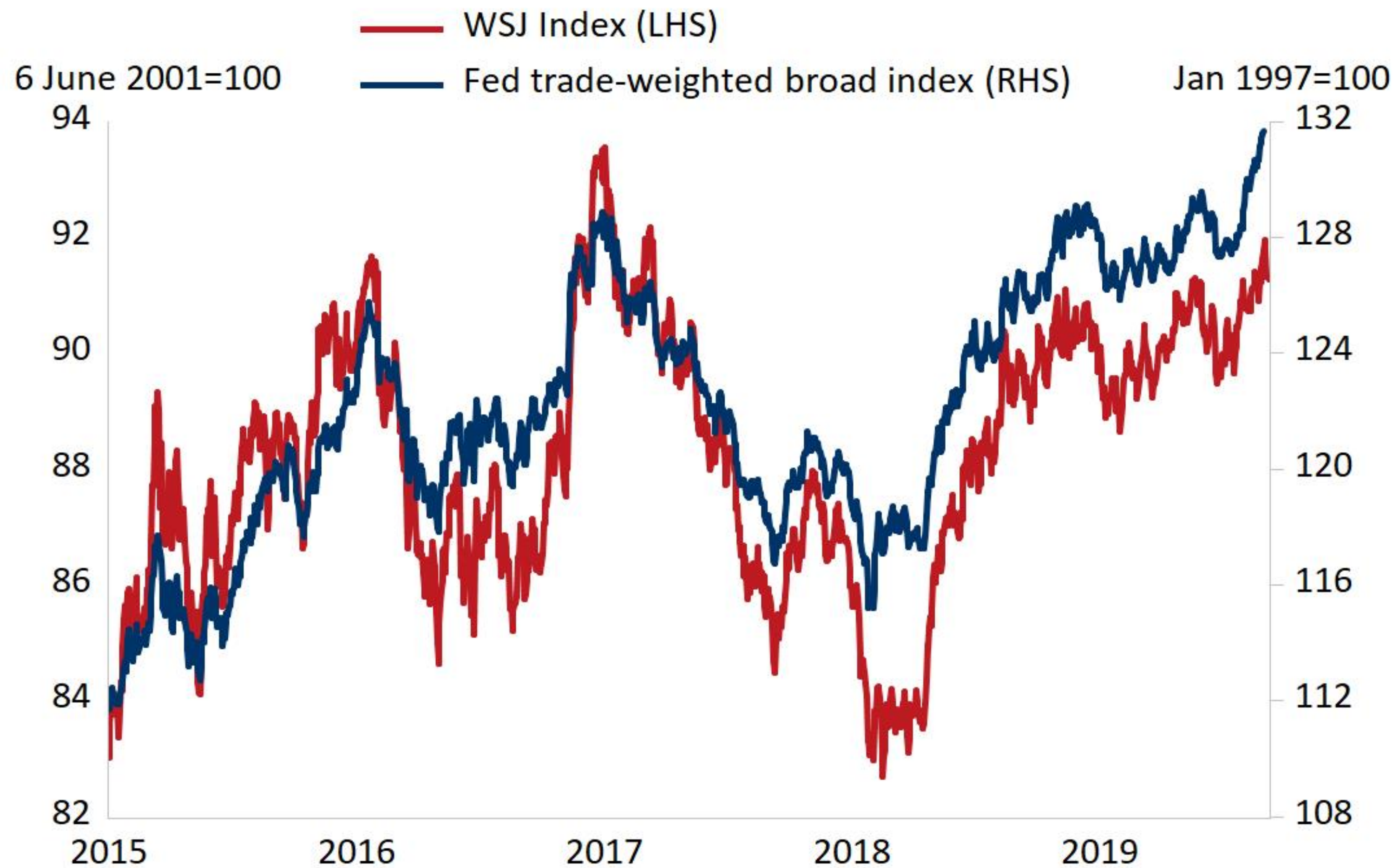
US: Business inventory to sales ratio



Source: Oxford Economics/Haver Analytics

Strong dollar remains a headwind

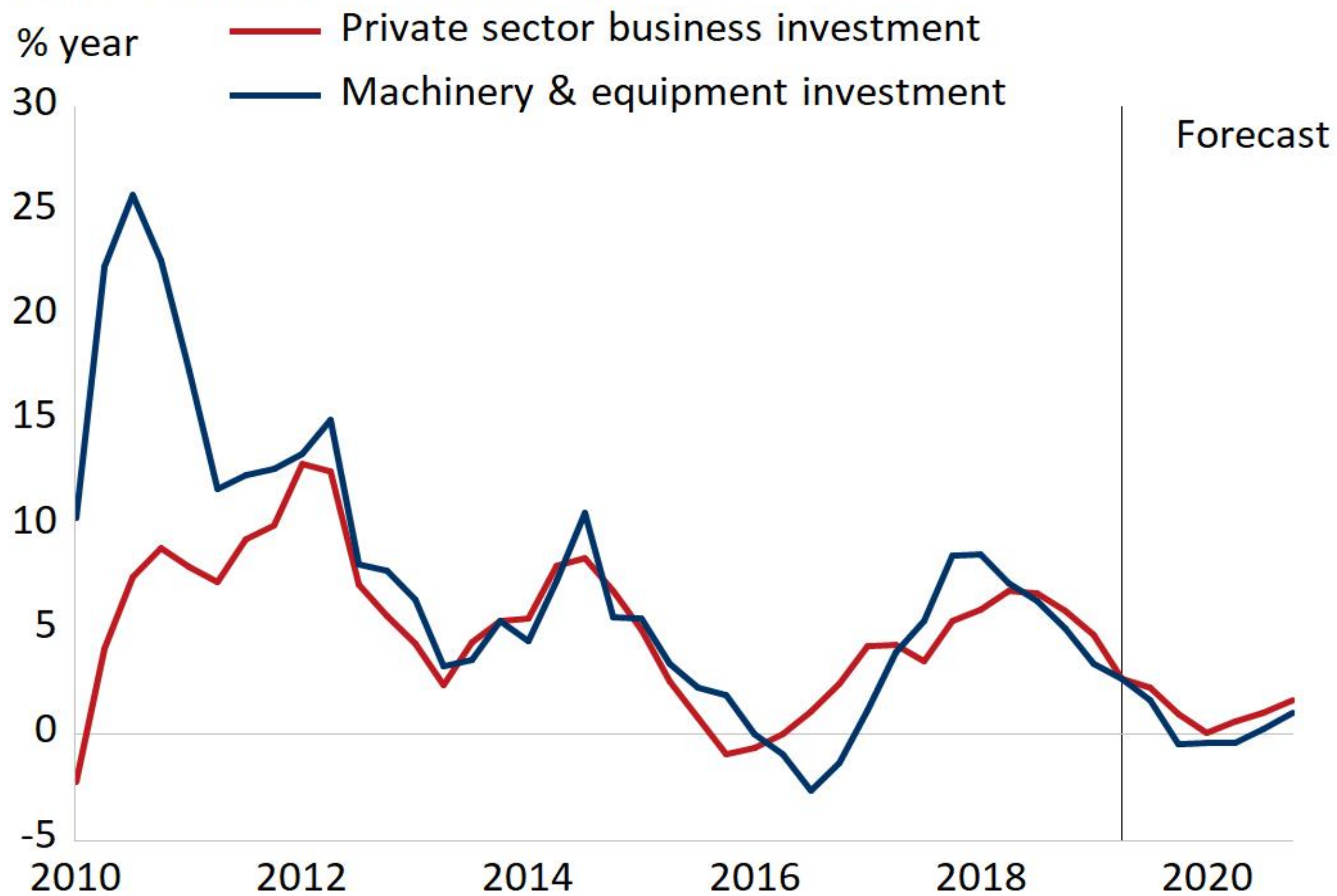
US: A stronger US dollar



Source: Oxford Economics/Haver Analytics

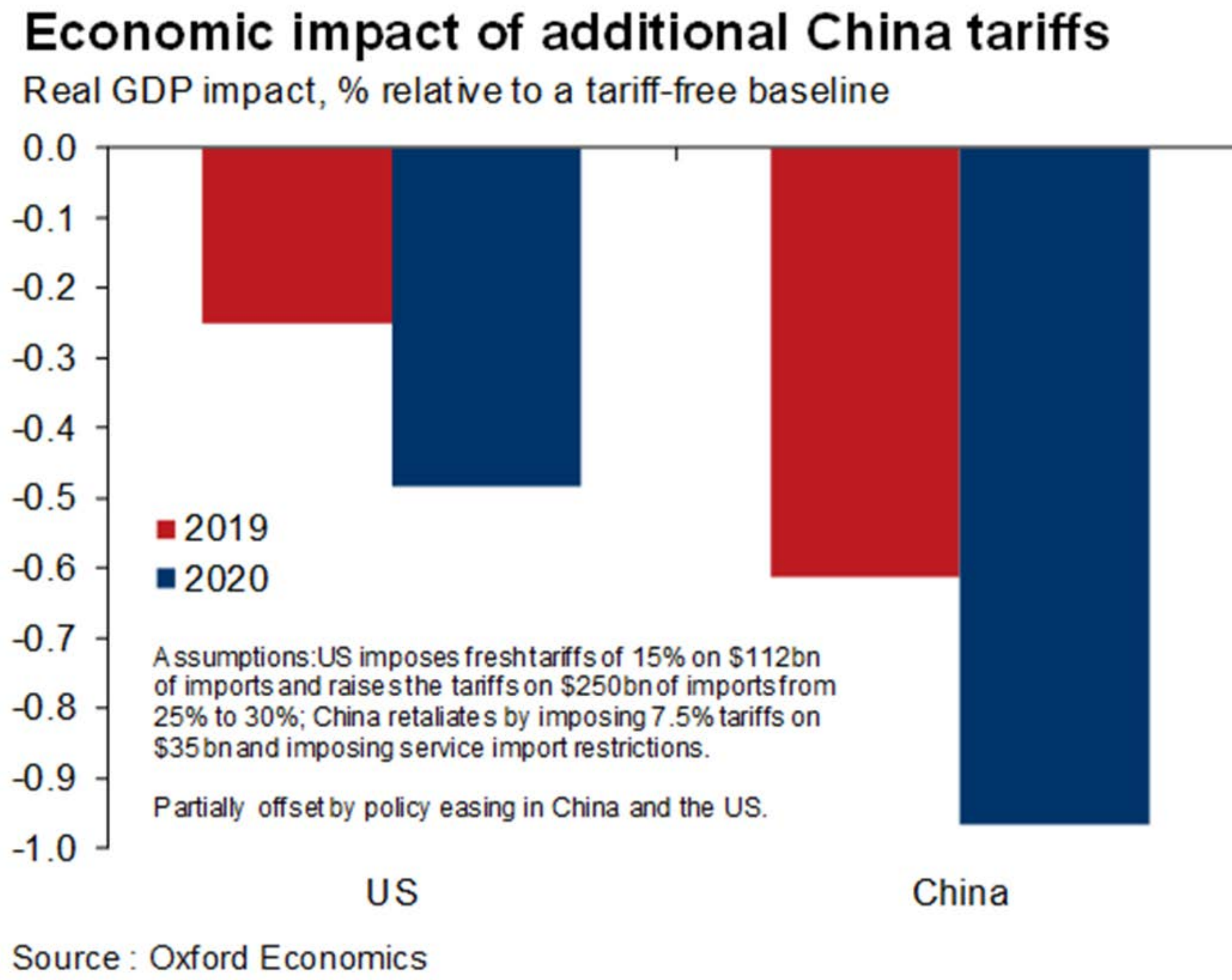
Business investment to slow

US: Business investment



Source: Oxford Economics

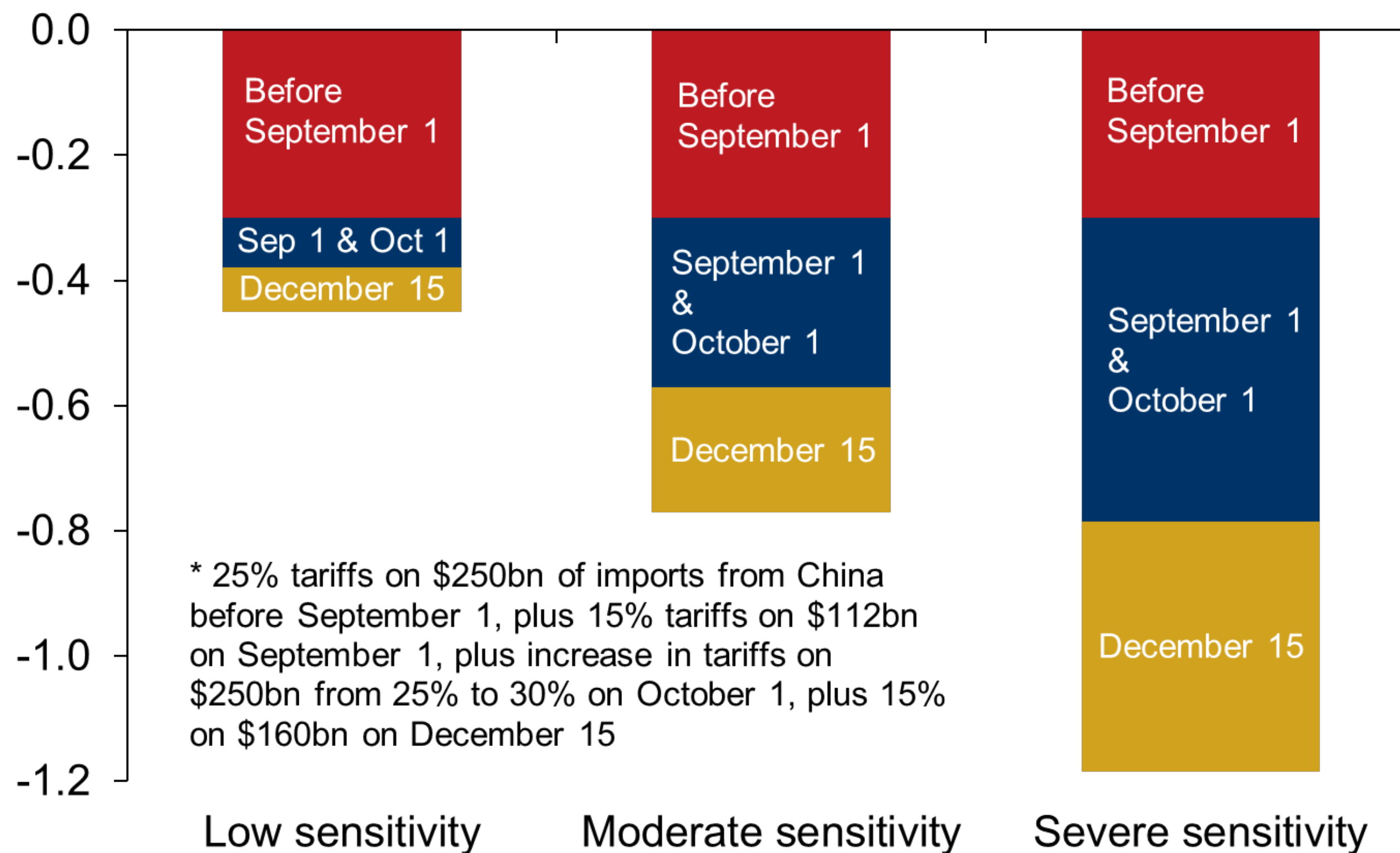
Tariff Impacts



Tariff Scenarios

US: Real GDP drag from China tariffs*

% GDP in 2020 relative to no tariffs baseline

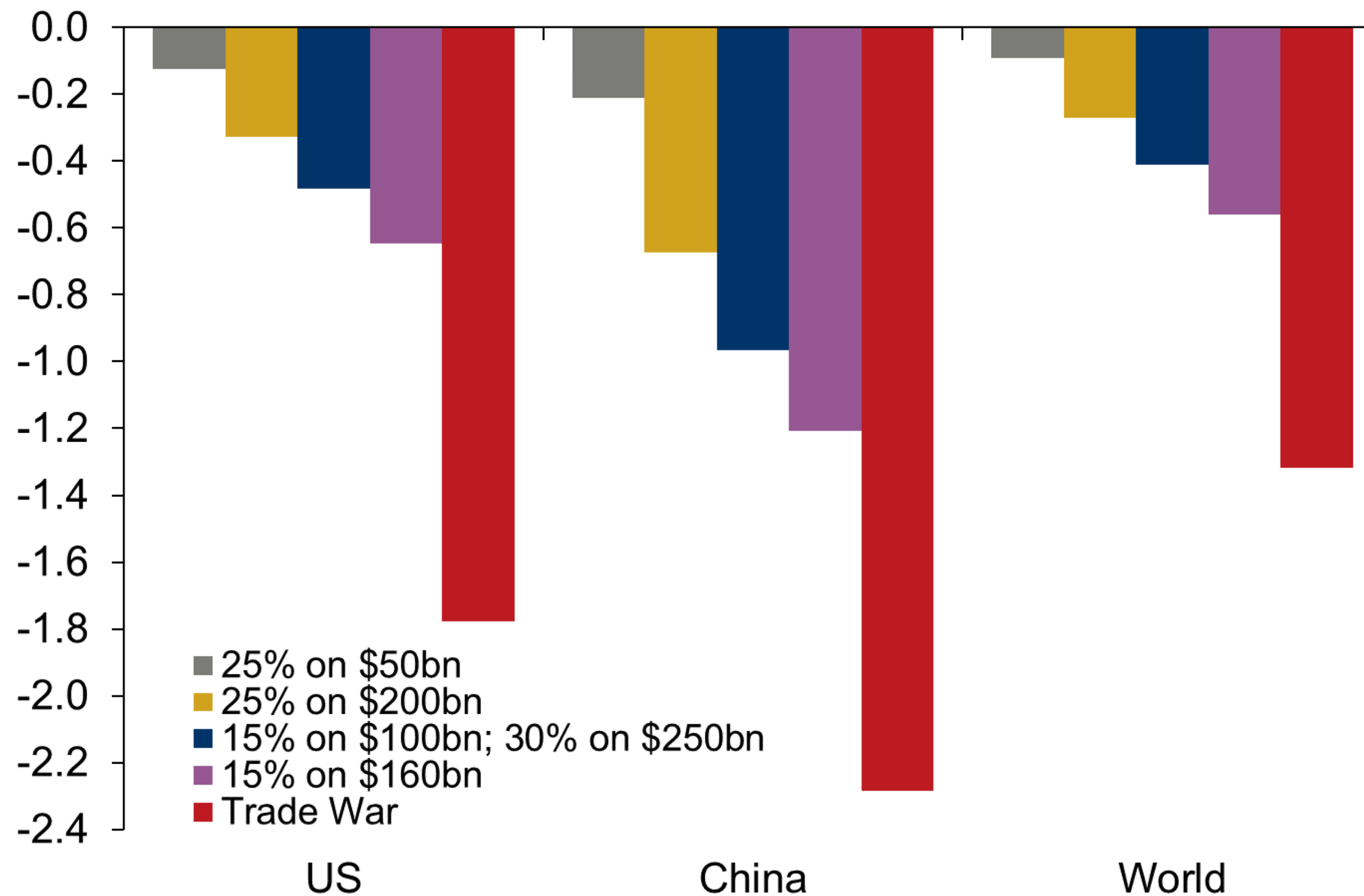


Source : Oxford Economics

Trade War

From bilateral tariffs to all-out global trade war

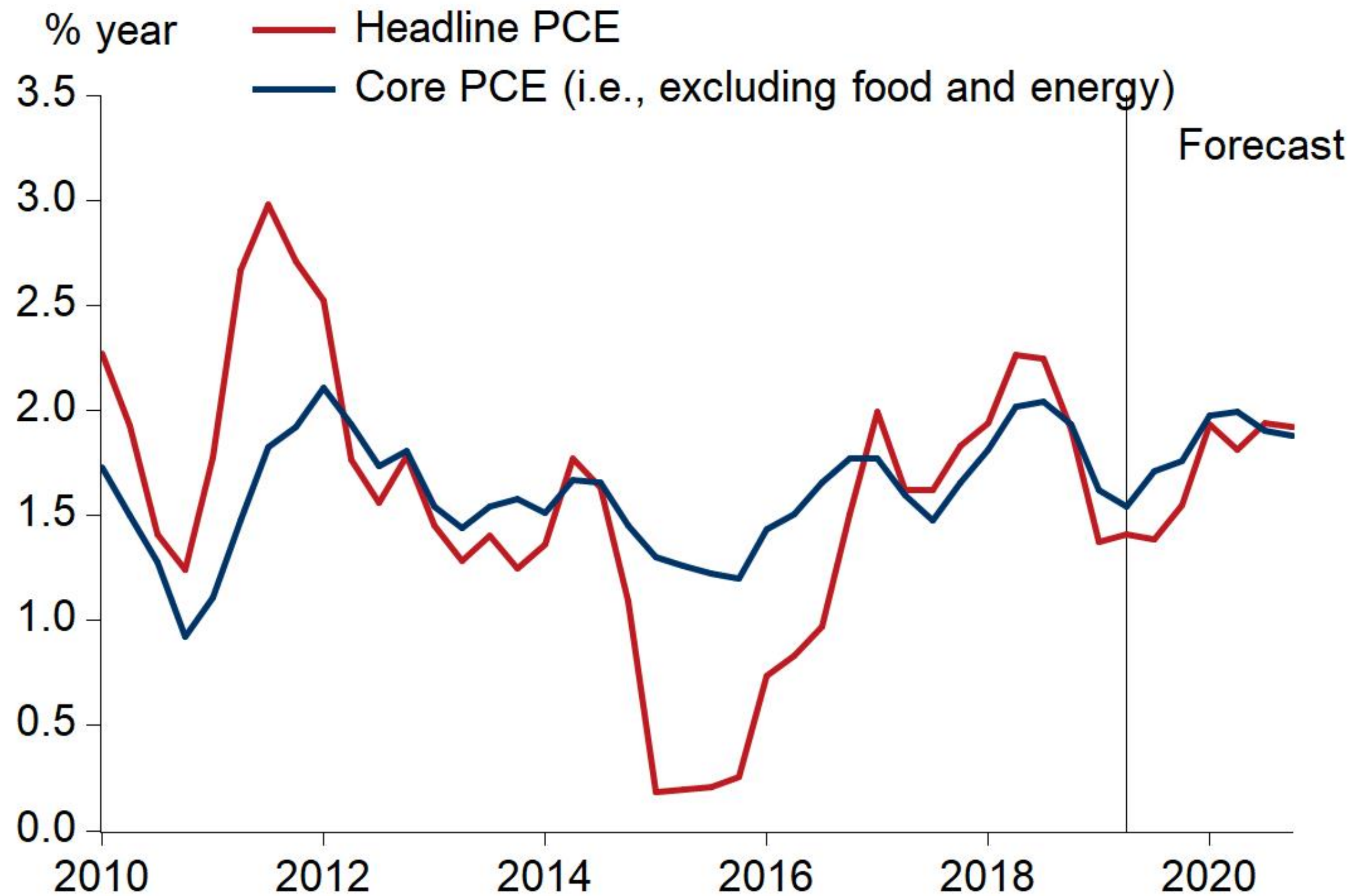
Real GDP impact, 2020, %



Source : Oxford Economics

Persistent low inflation

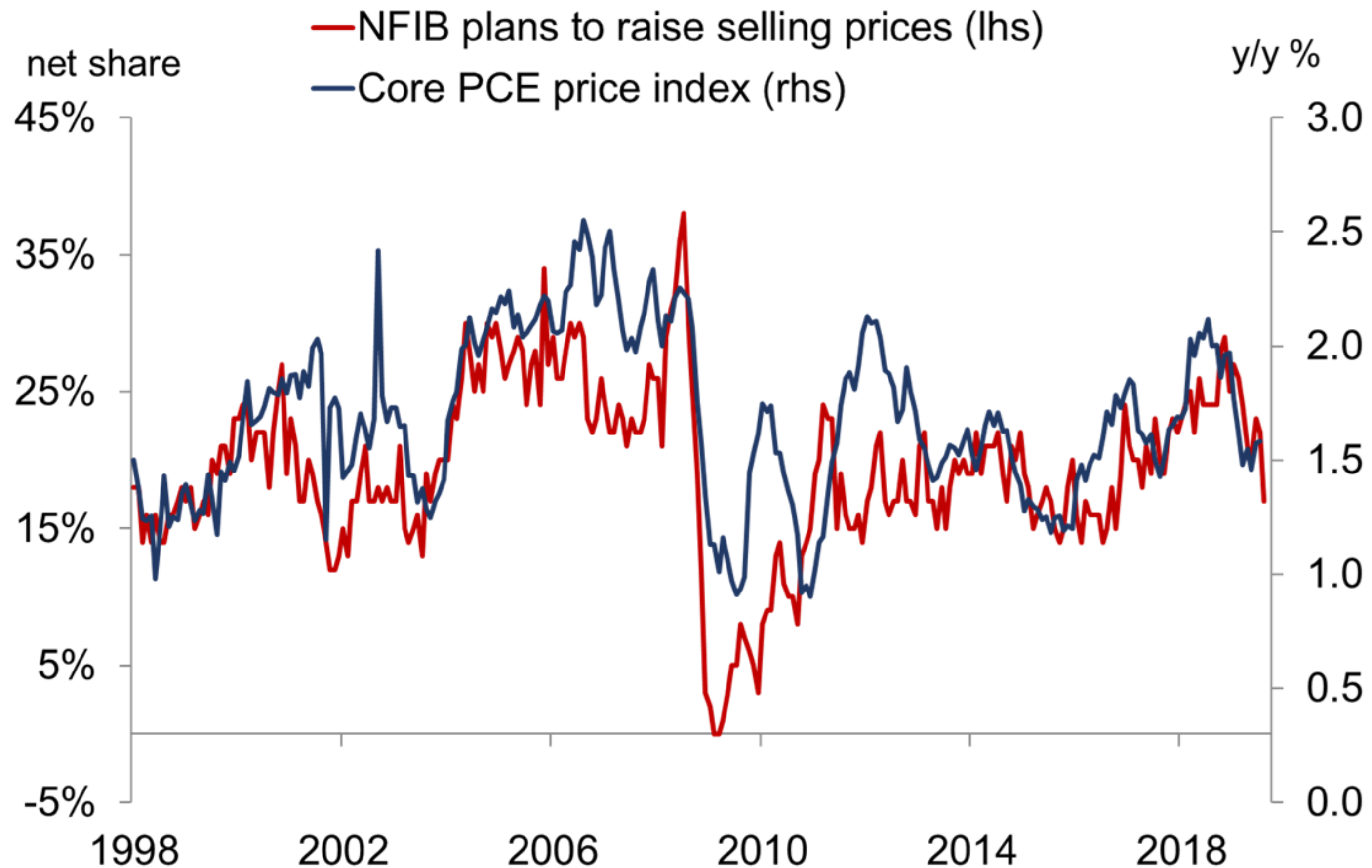
US: Headline and core PCE prices



Source: Oxford Economics

Limited corporate pricing power

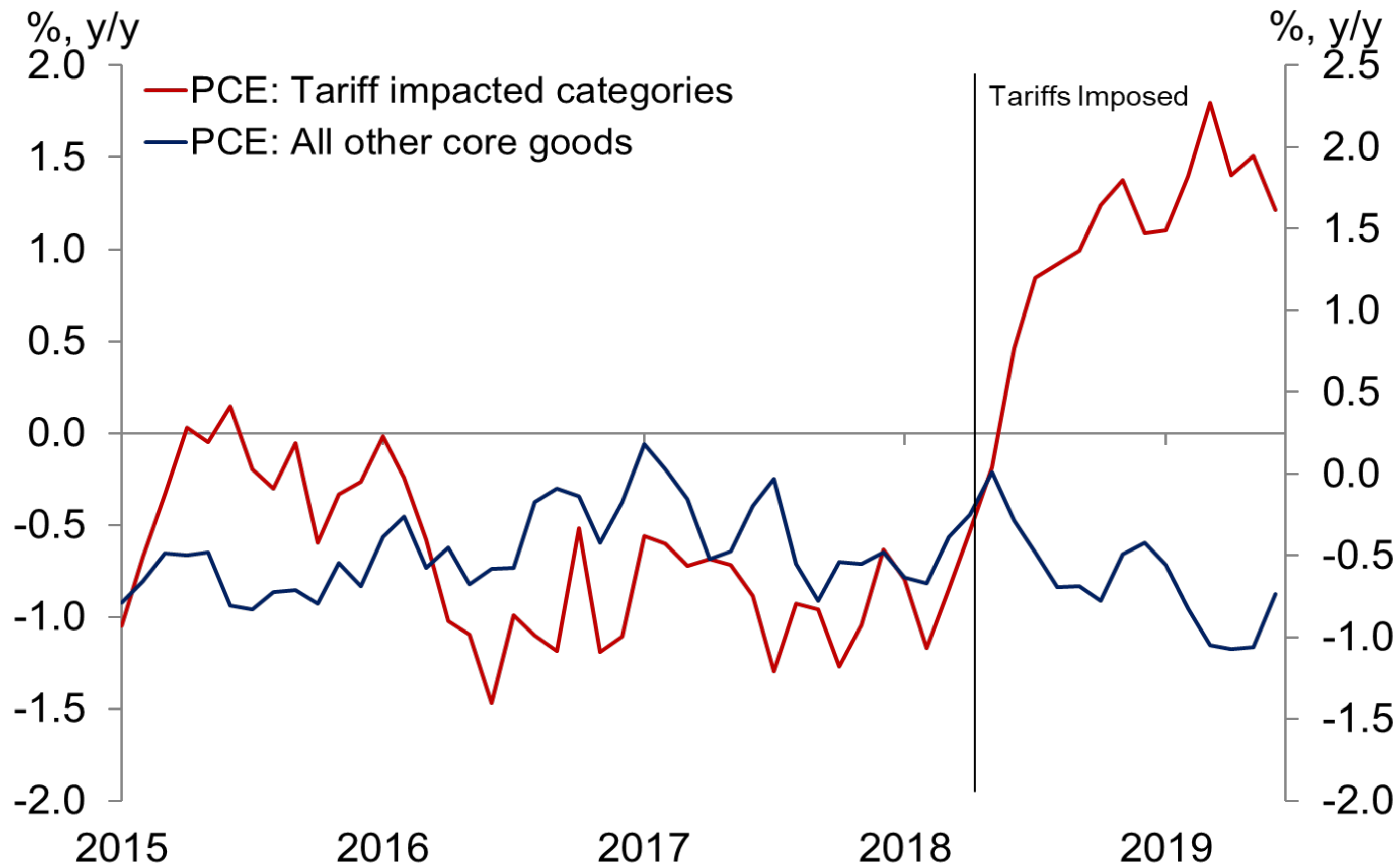
US: Small businesses' pricing power is fading



Source : Oxford Economics/Haver Analytics

Tariffs will drive inflation

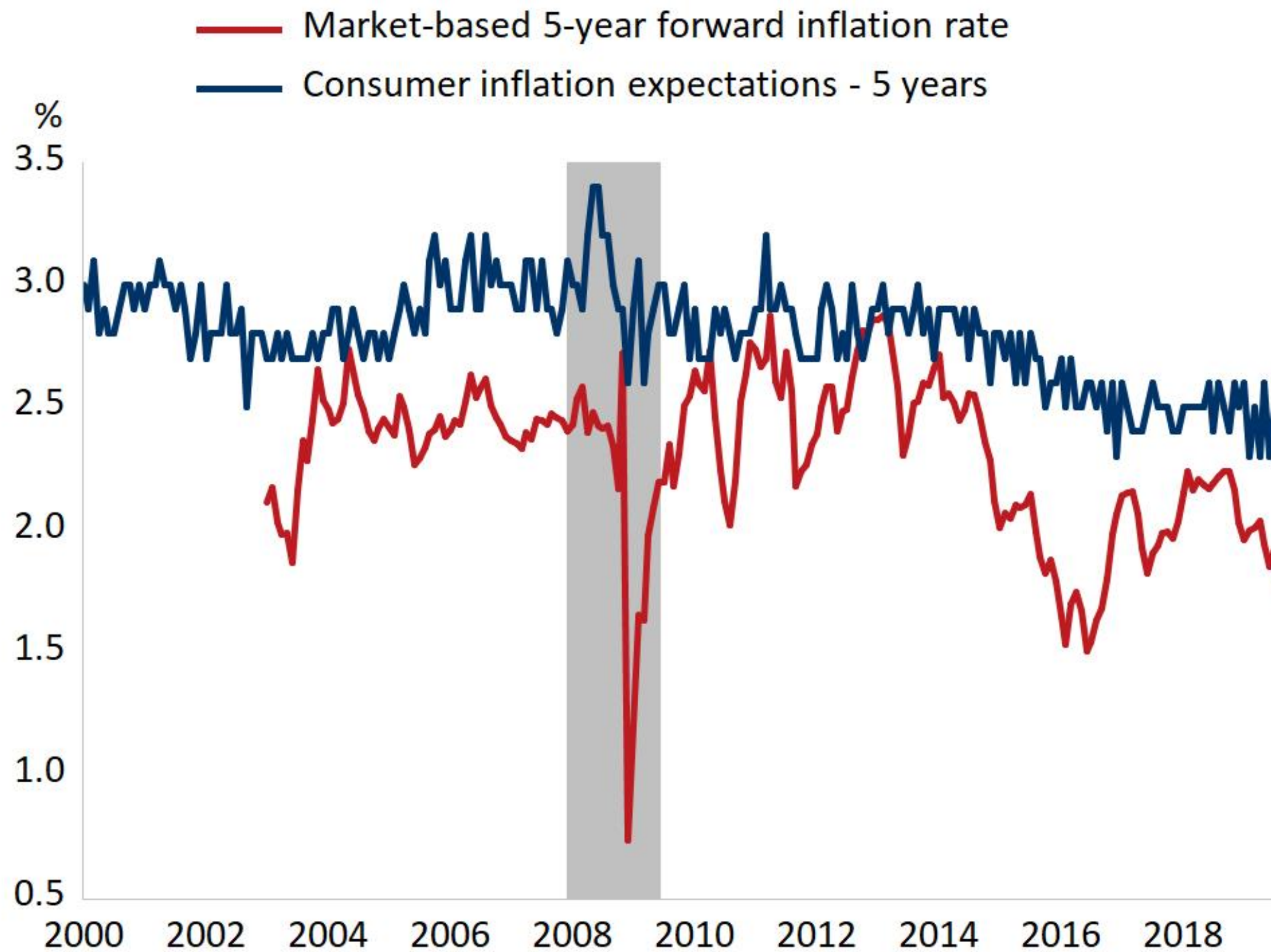
US: Inflationary Impact of Tariffs



Source : Oxford Economics/Haver Analytics

Inflation expectations continue to fall

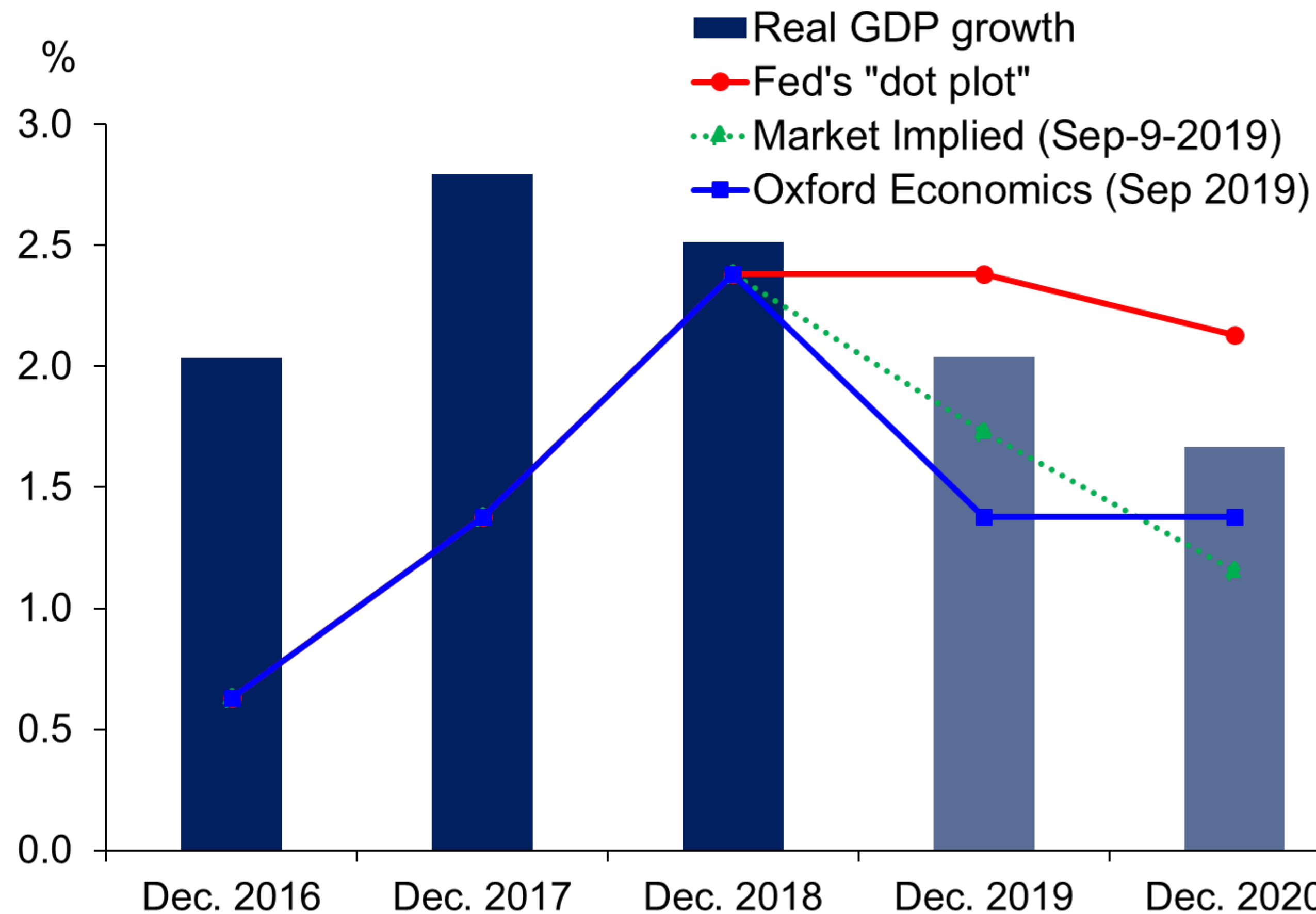
US: Inflation expectations



Source: Federal Reserve Board/Haver Analytics

Opens the door for four cuts in 2019

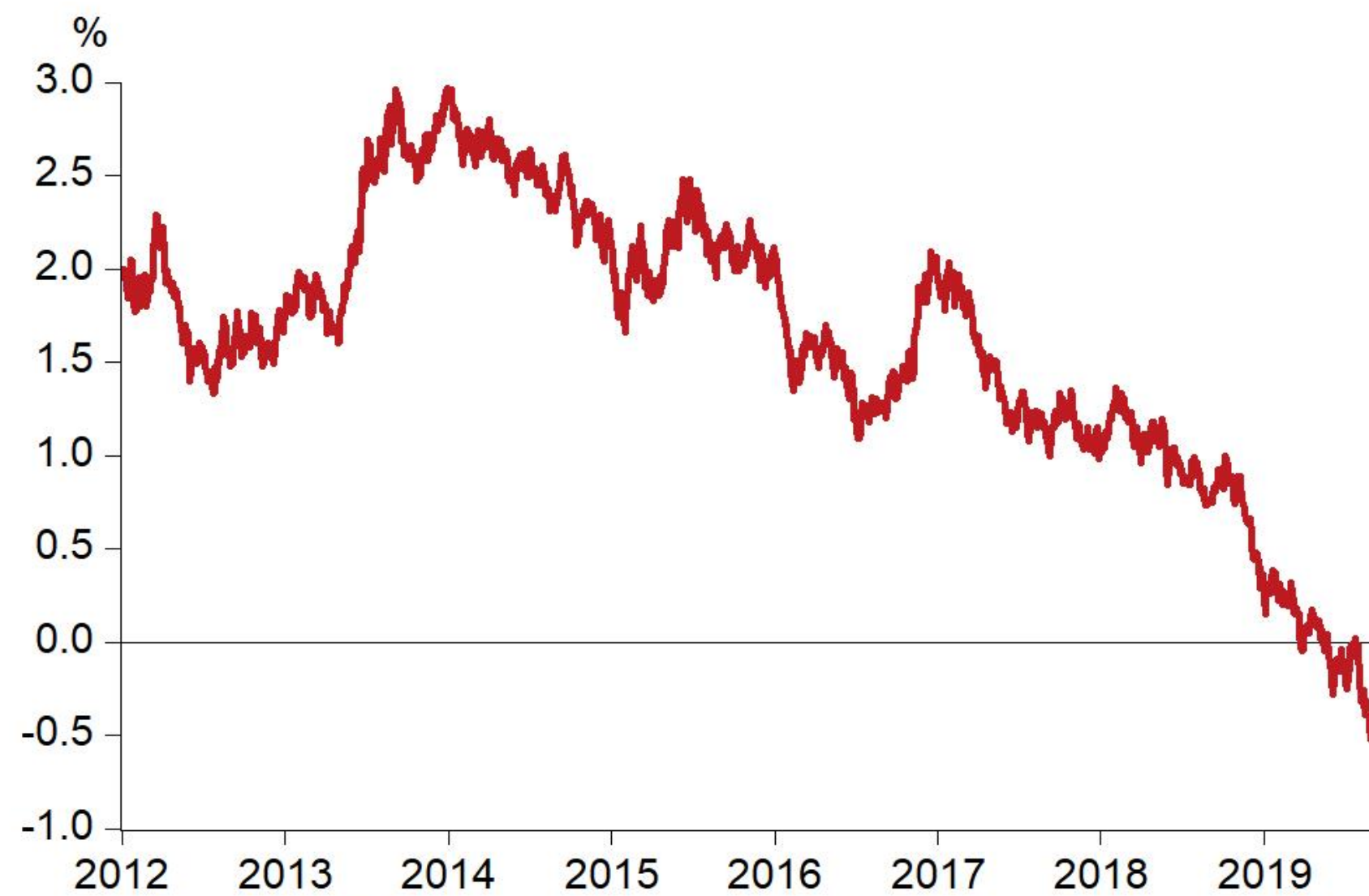
US: Federal funds rate & GDP expectations



Source: Oxford Economics/Federal Reserve

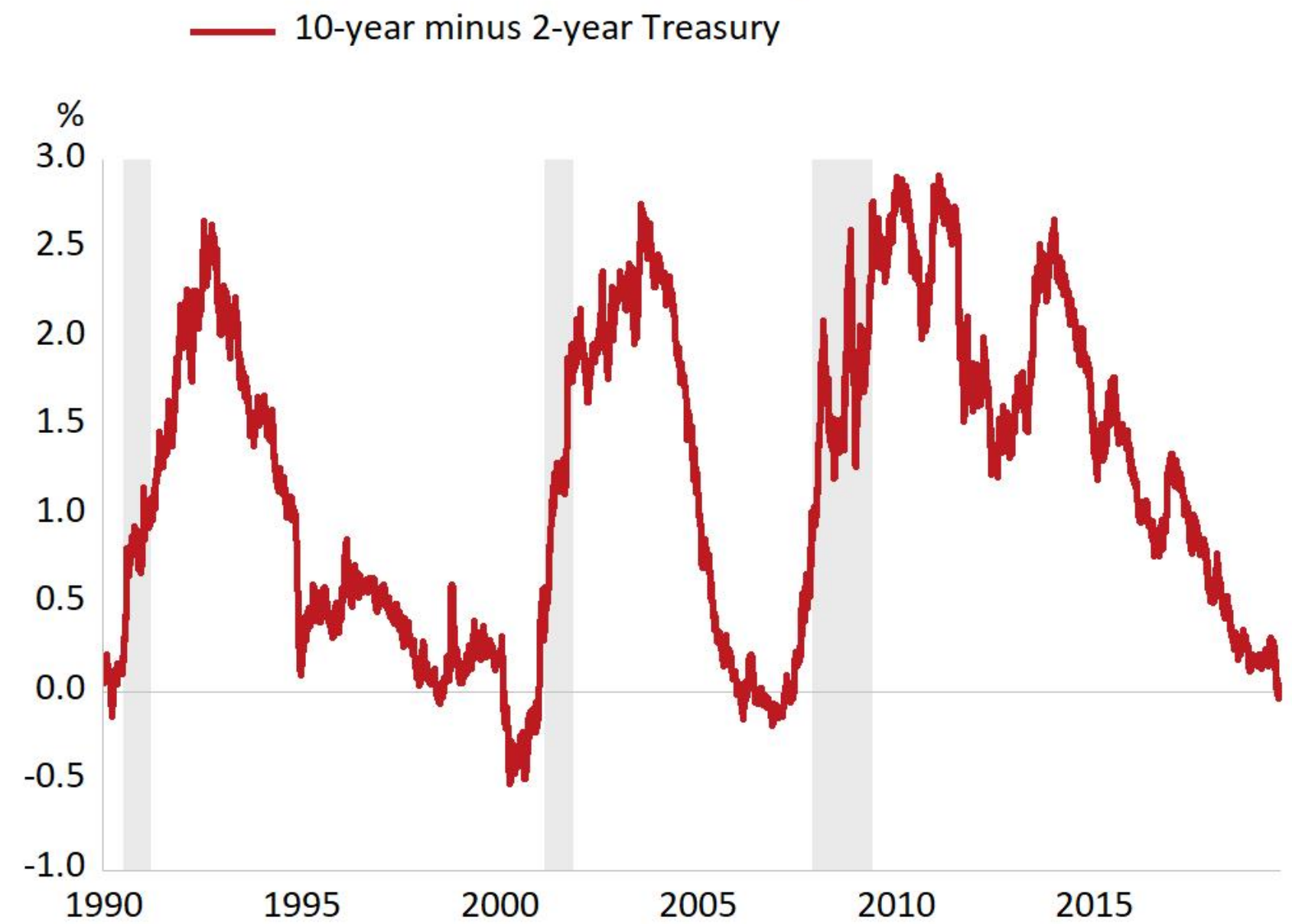
Treasury yield curve inverts further

US: Treasury 10year - 3month spread



Source: Oxford Economics/Haver Analytics

US: Yield curve has been flattening

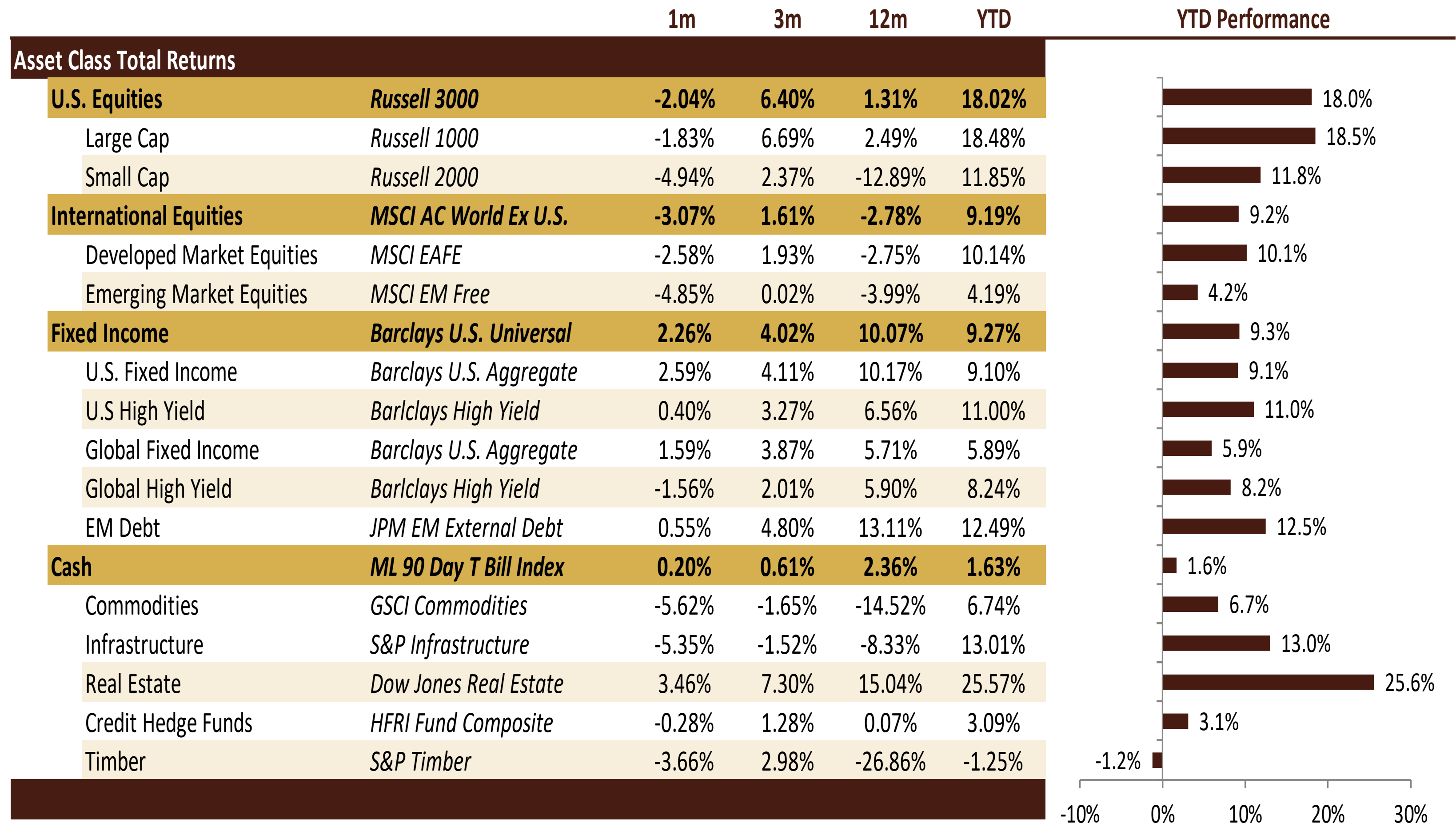


Source: Oxford Economics/Haver Analytics

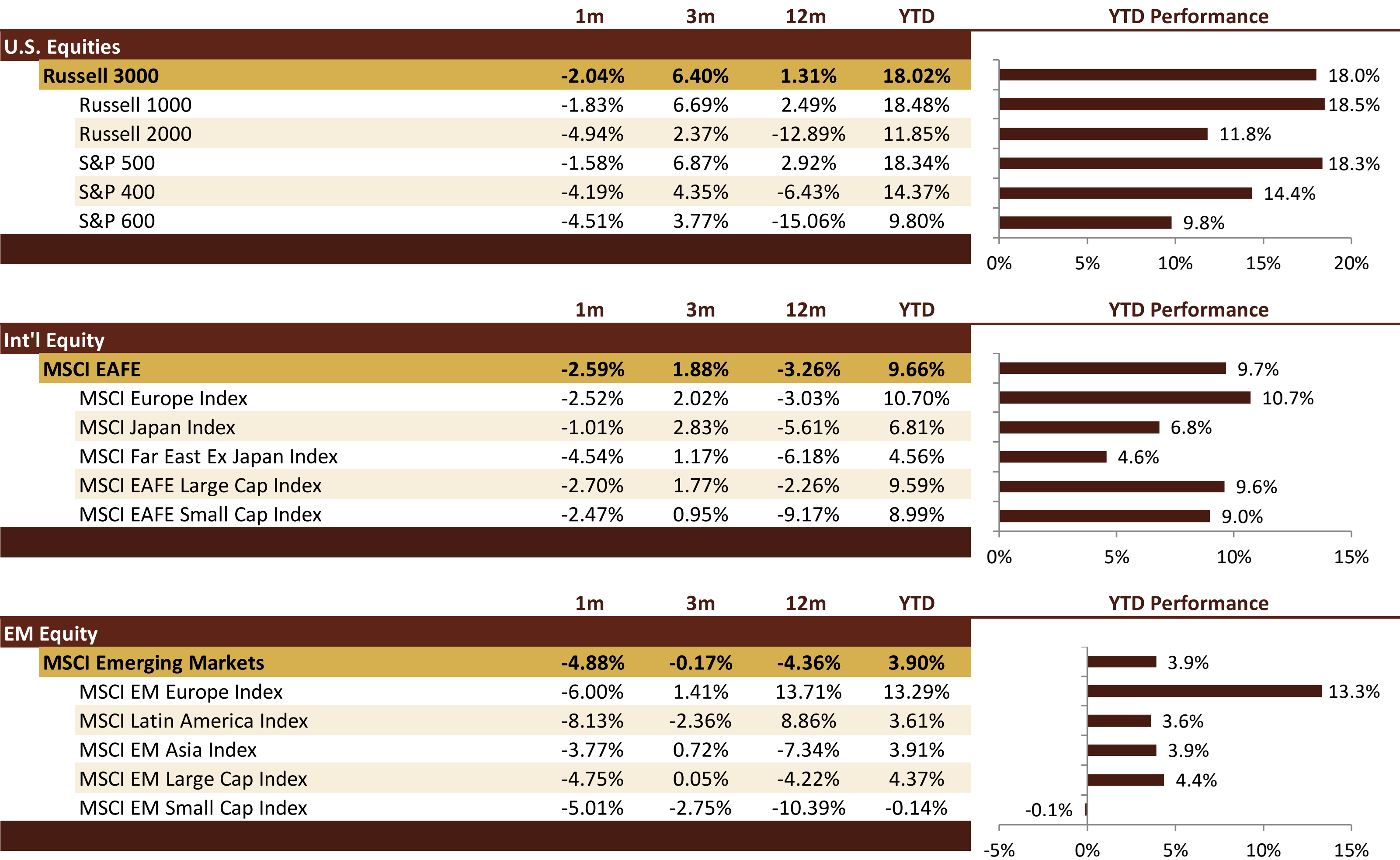
Market Dynamics

***Fundamentals vs.
Valuations***

Market Snapshot

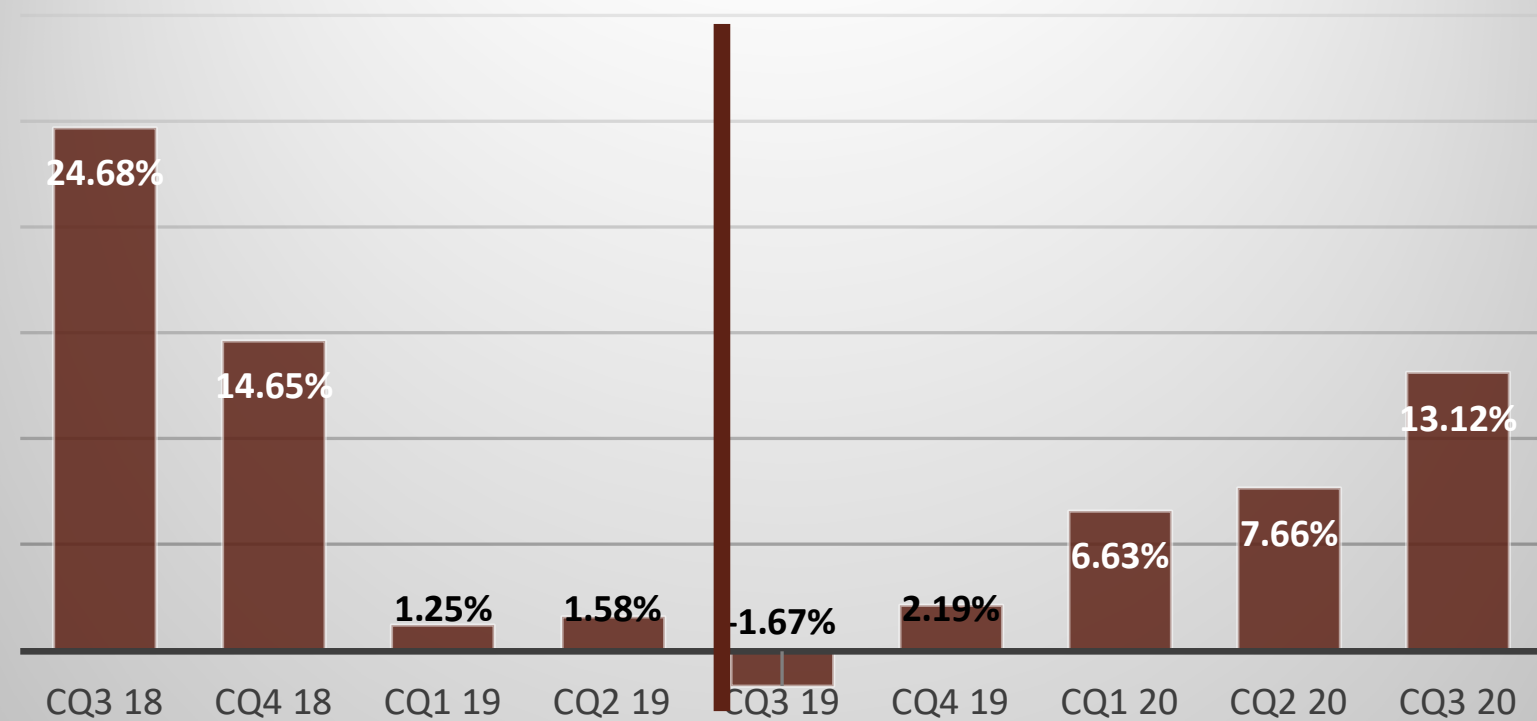


Equity Market Snapshot

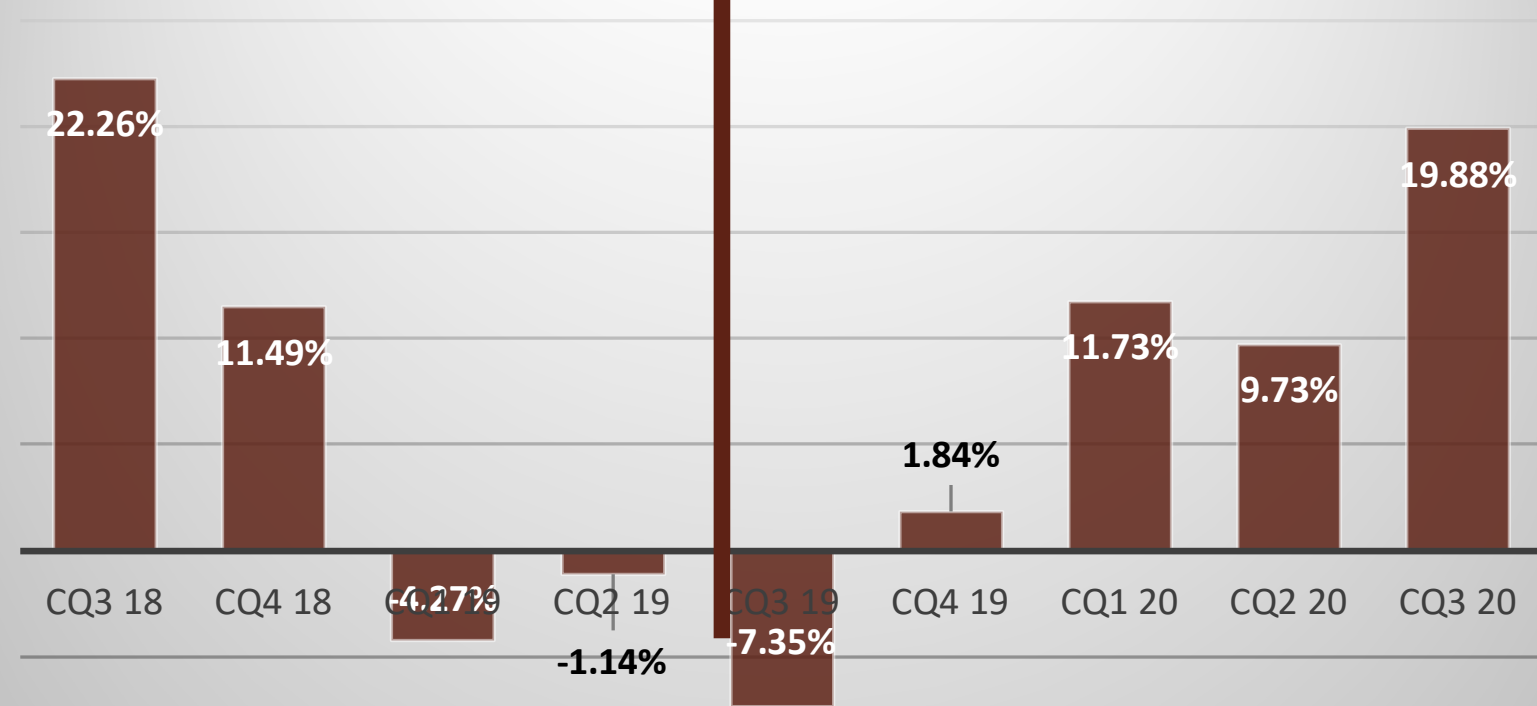


U.S. Equity

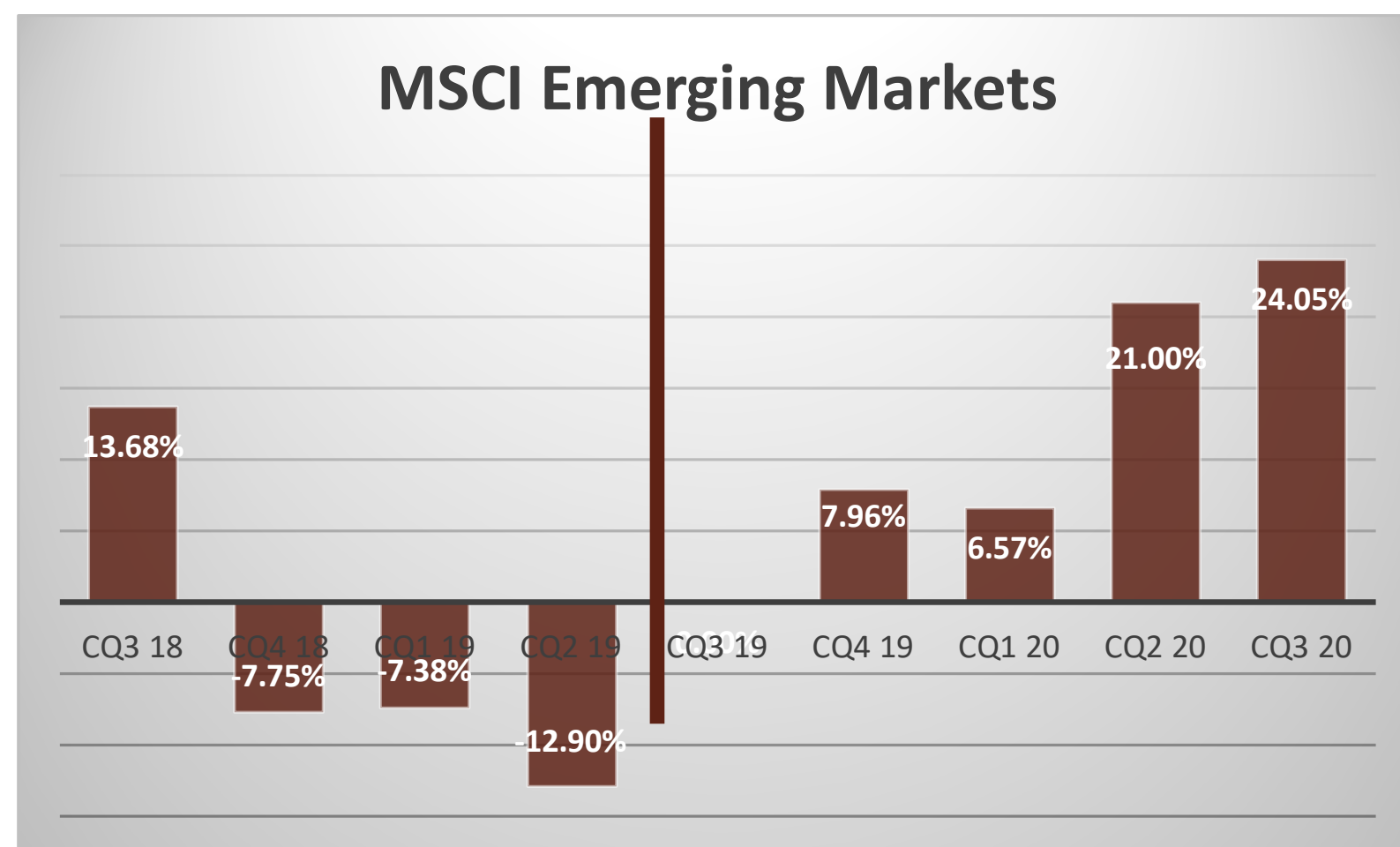
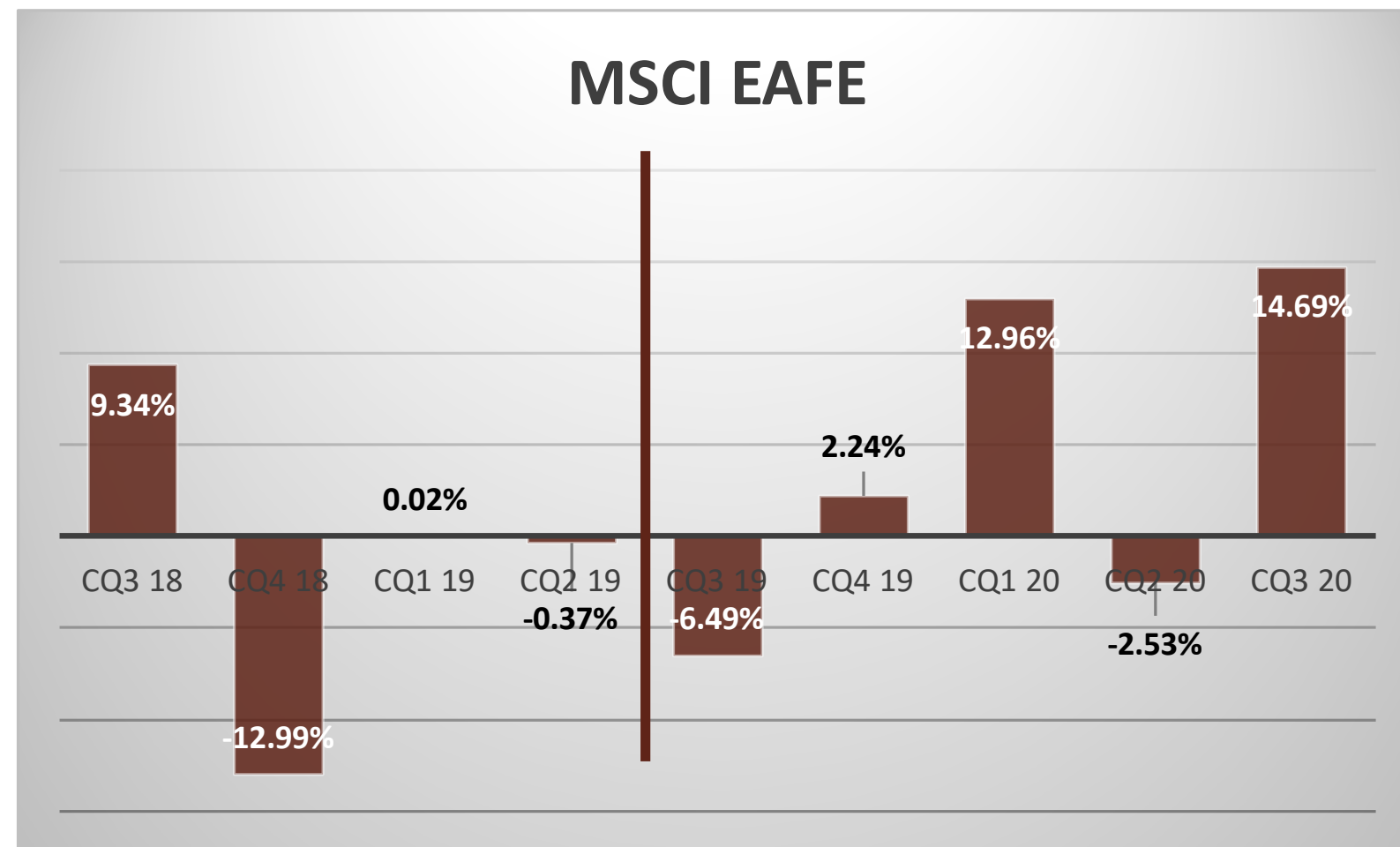
S&P 500 Earnings Growth



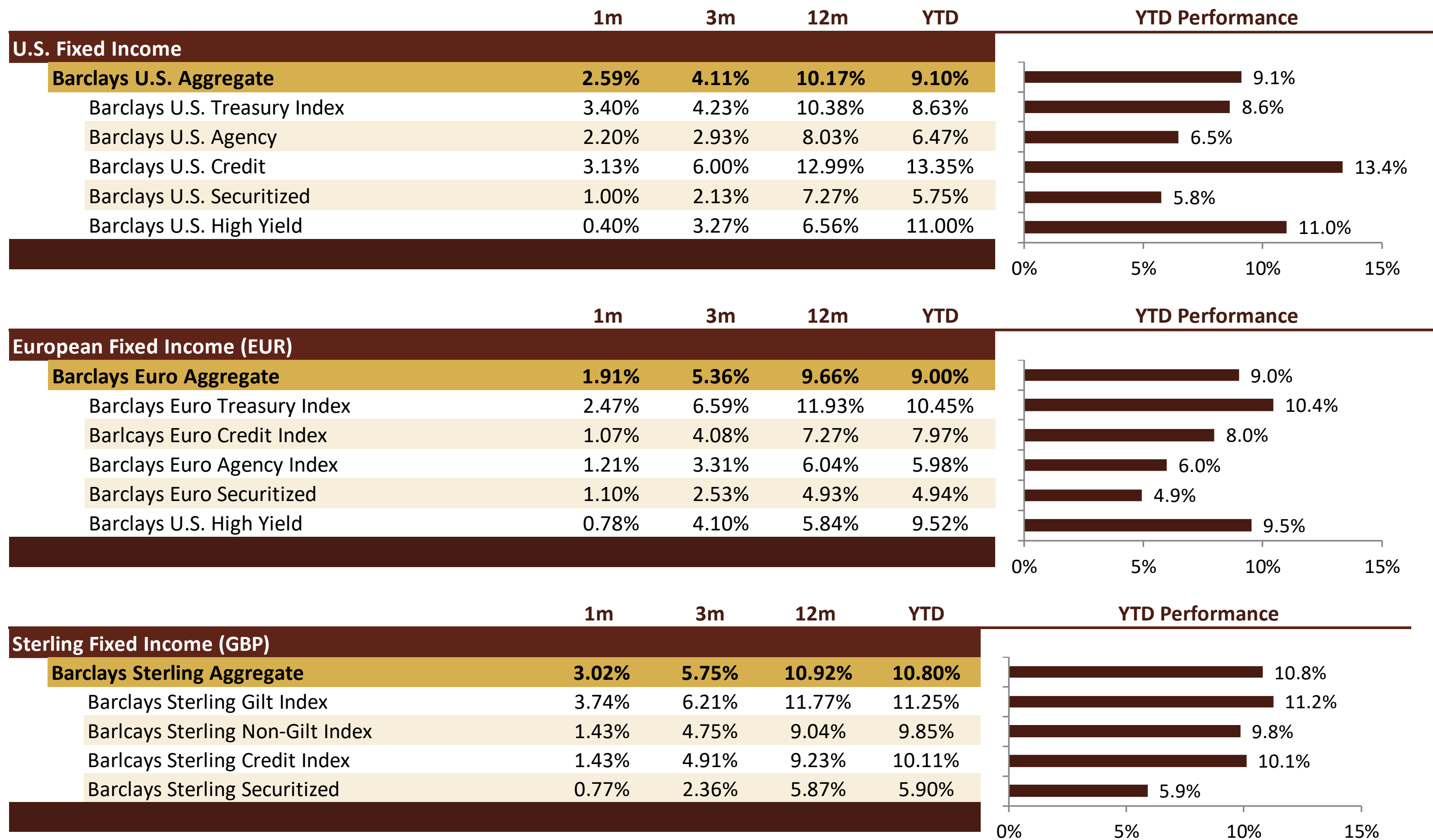
S&P 600 Earnings Growth



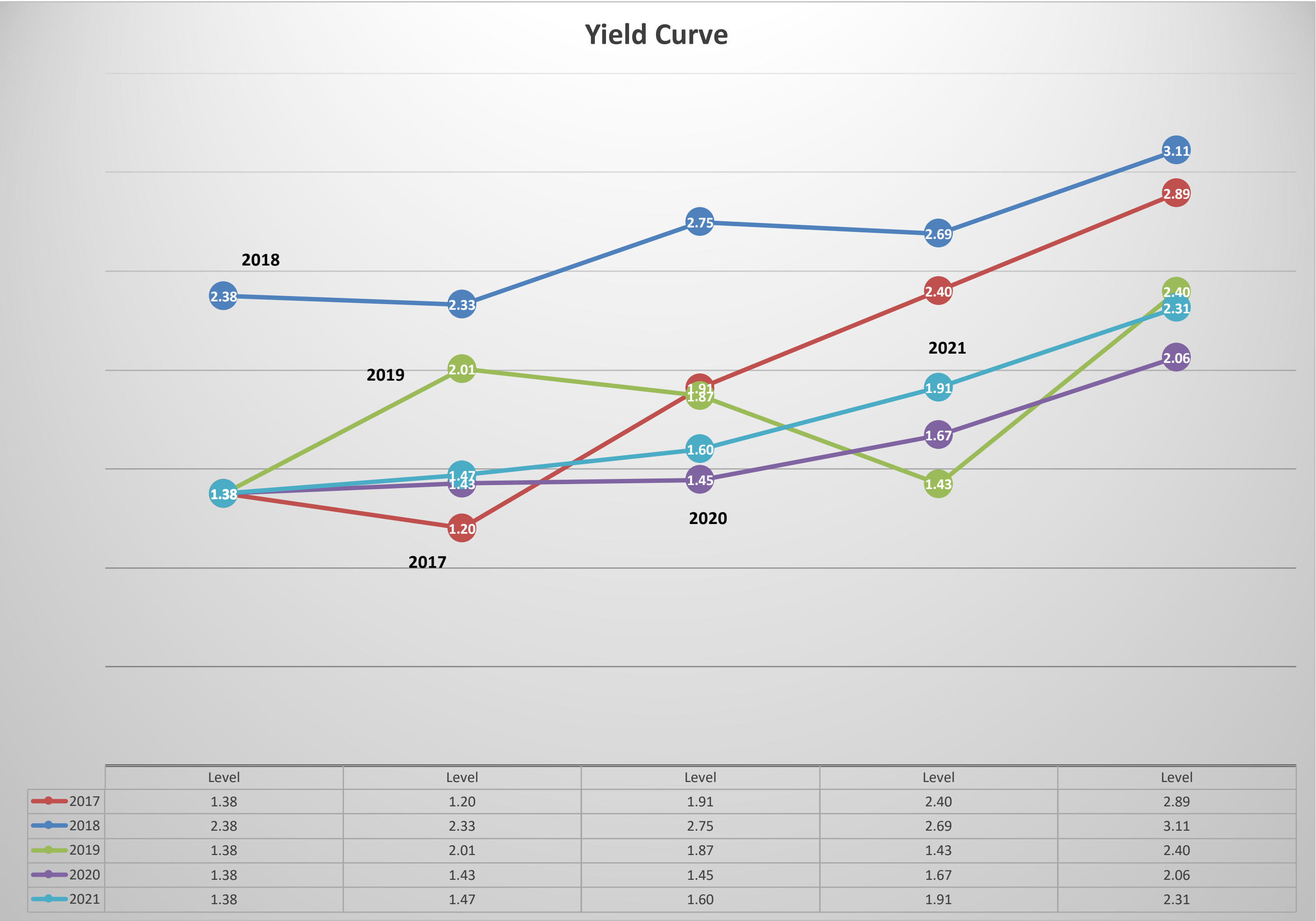
International Equity



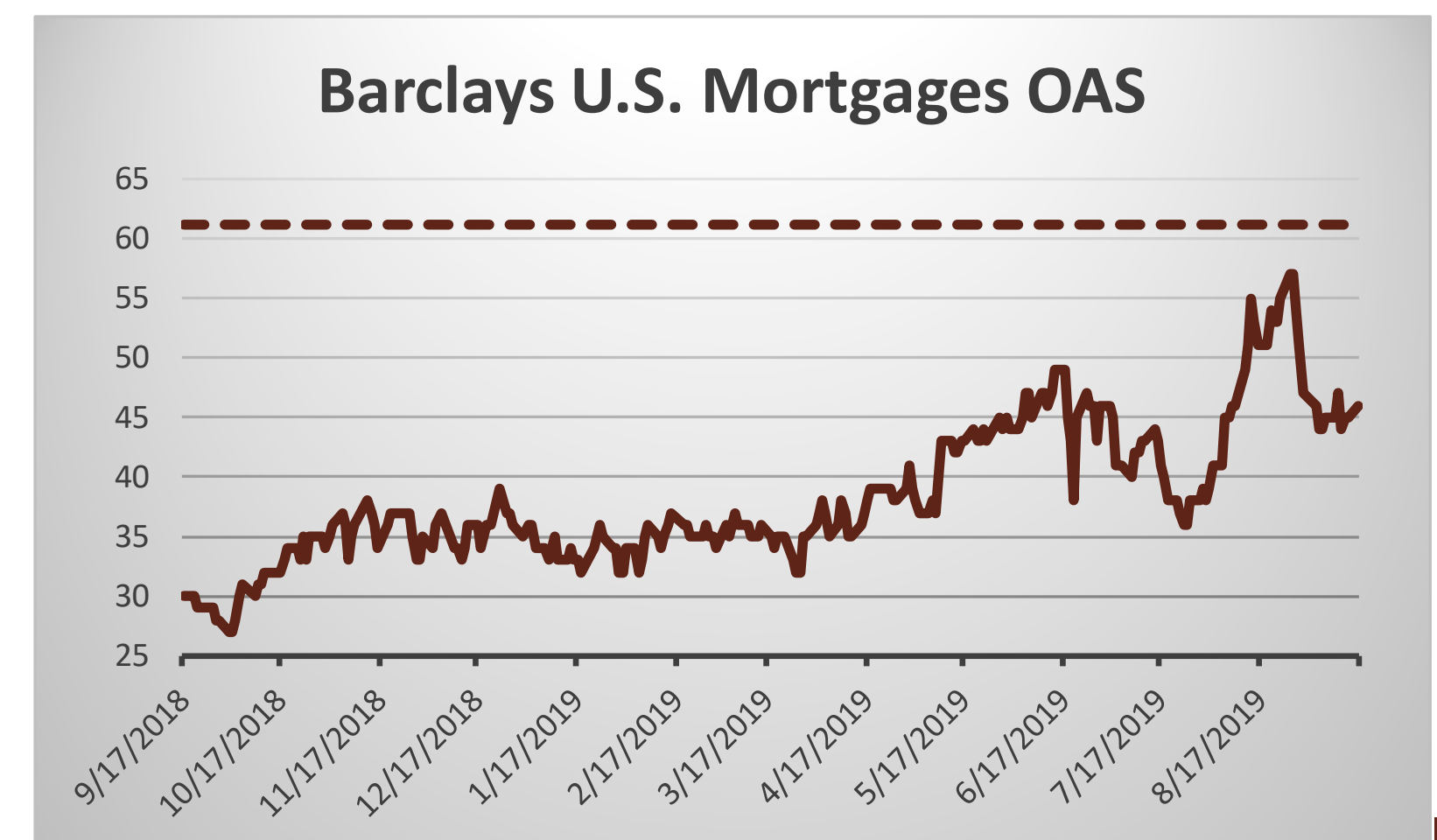
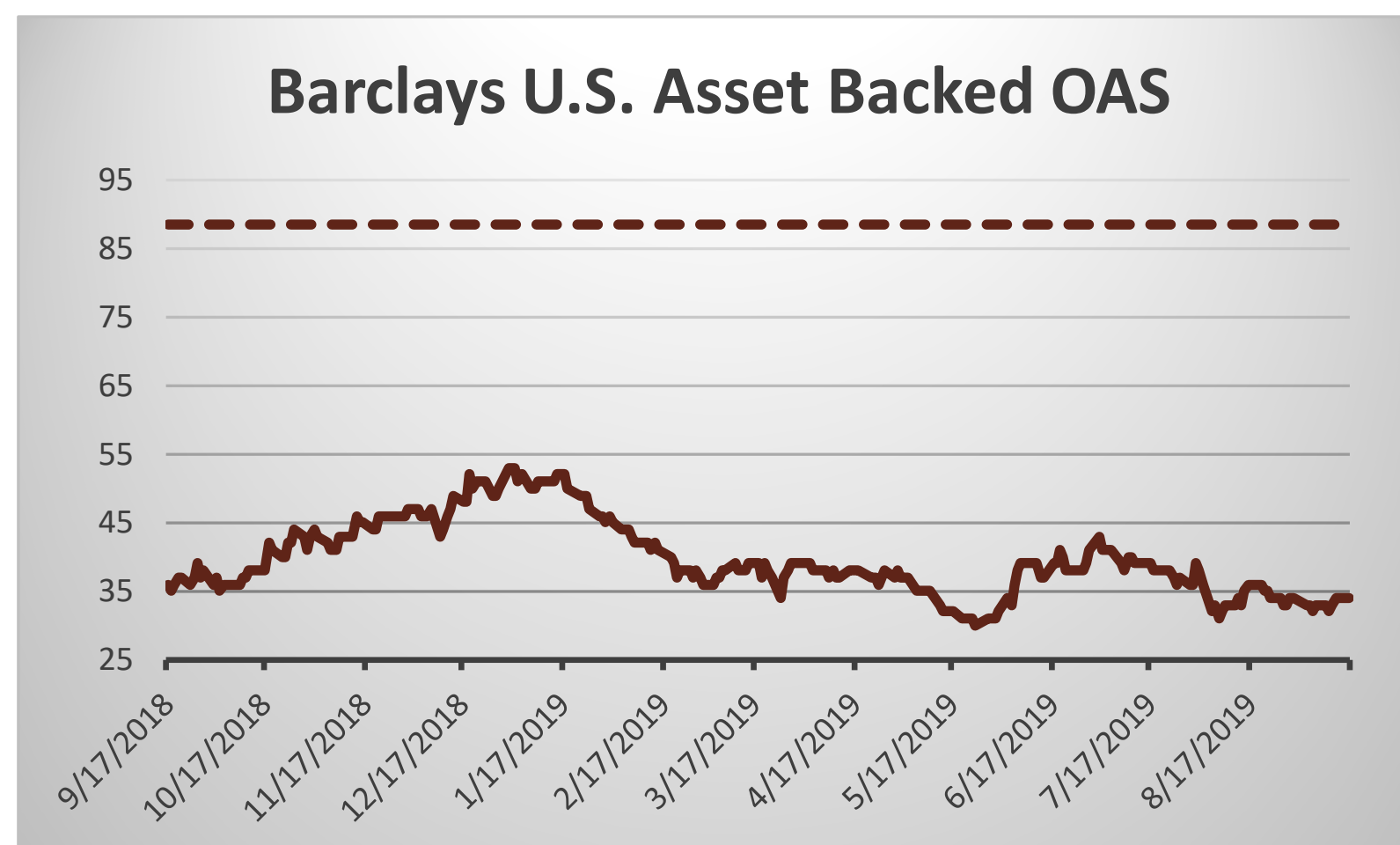
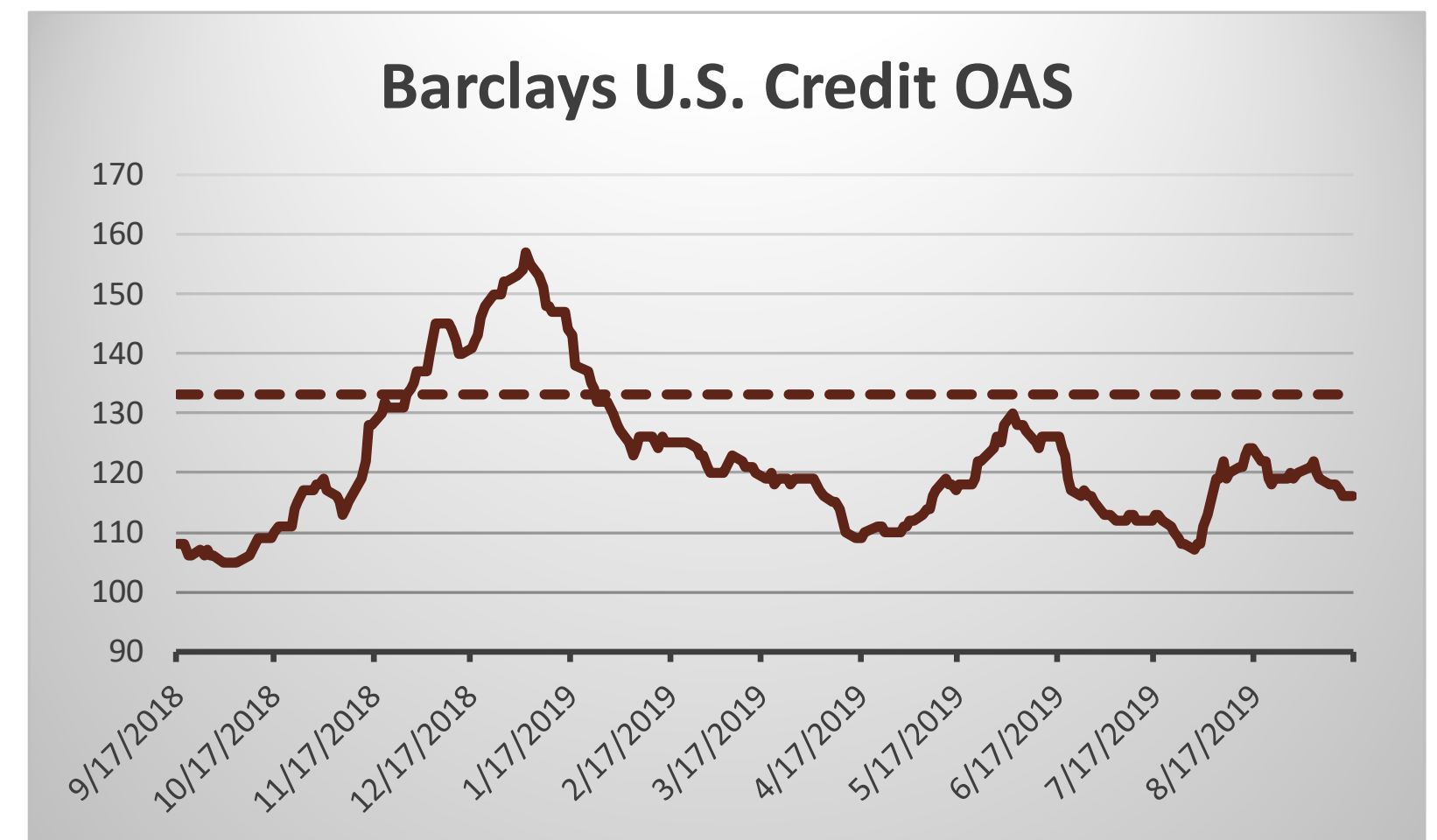
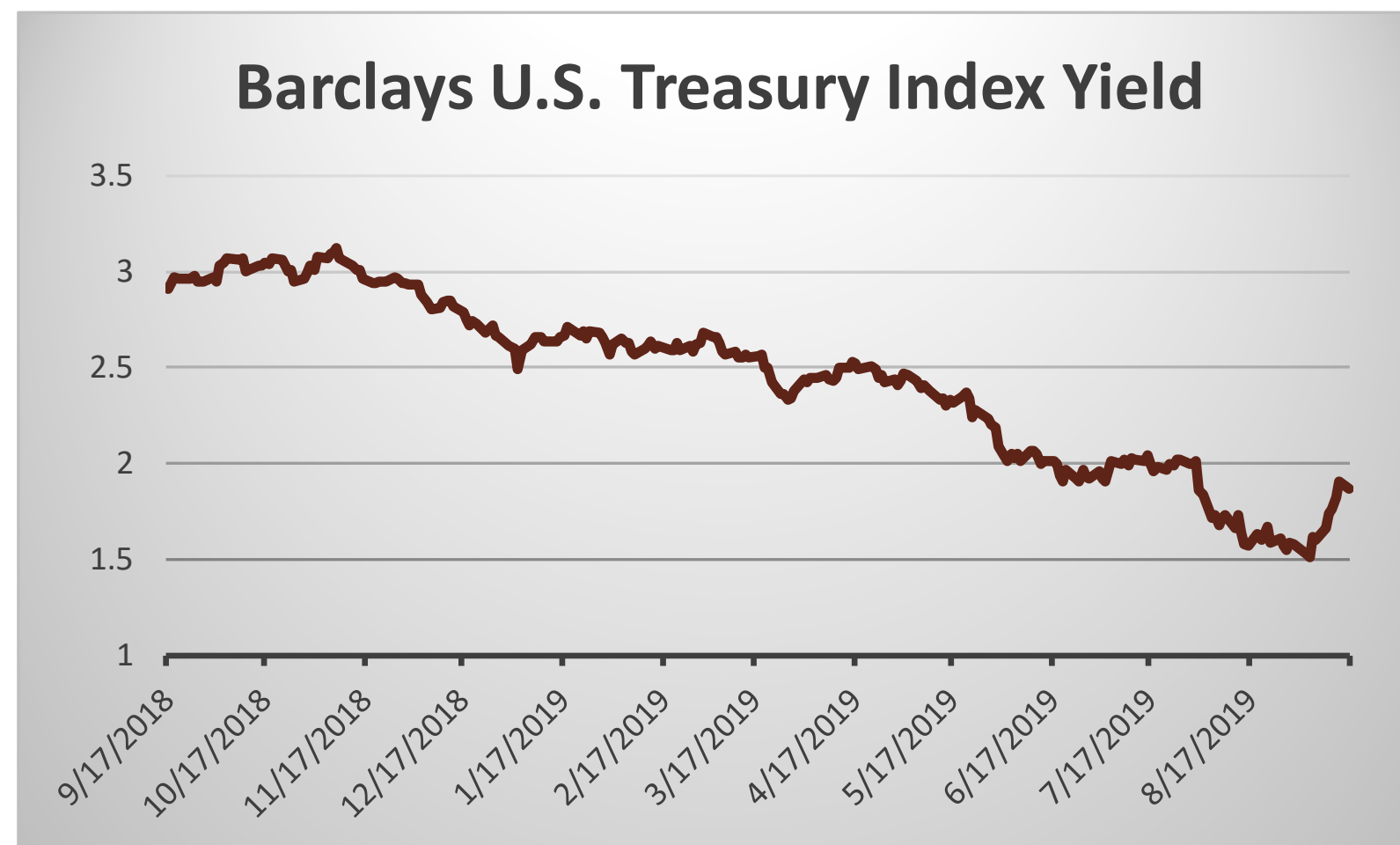
Fixed Income Market Snapshot



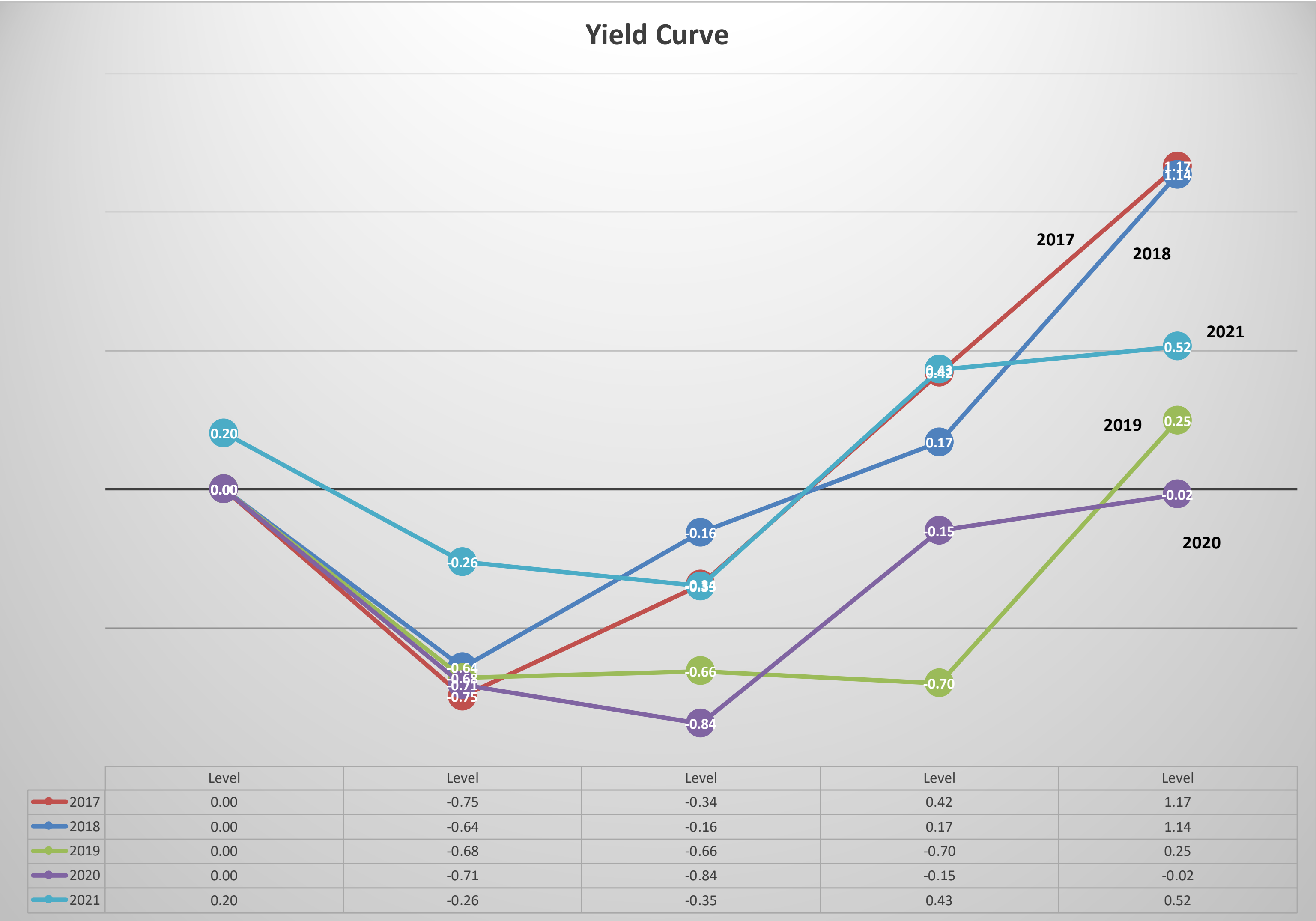
U.S. Treasury Yield Curve



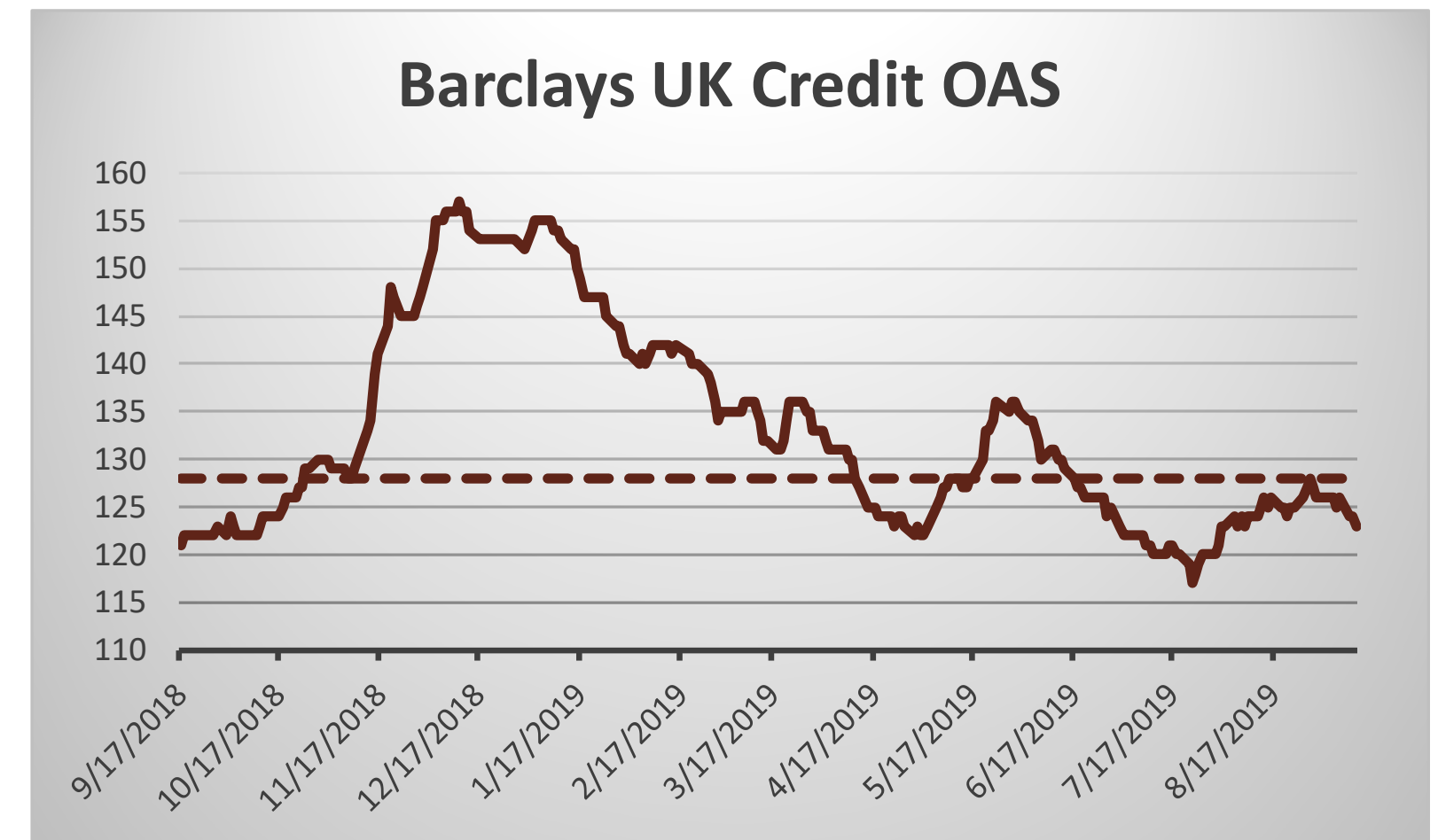
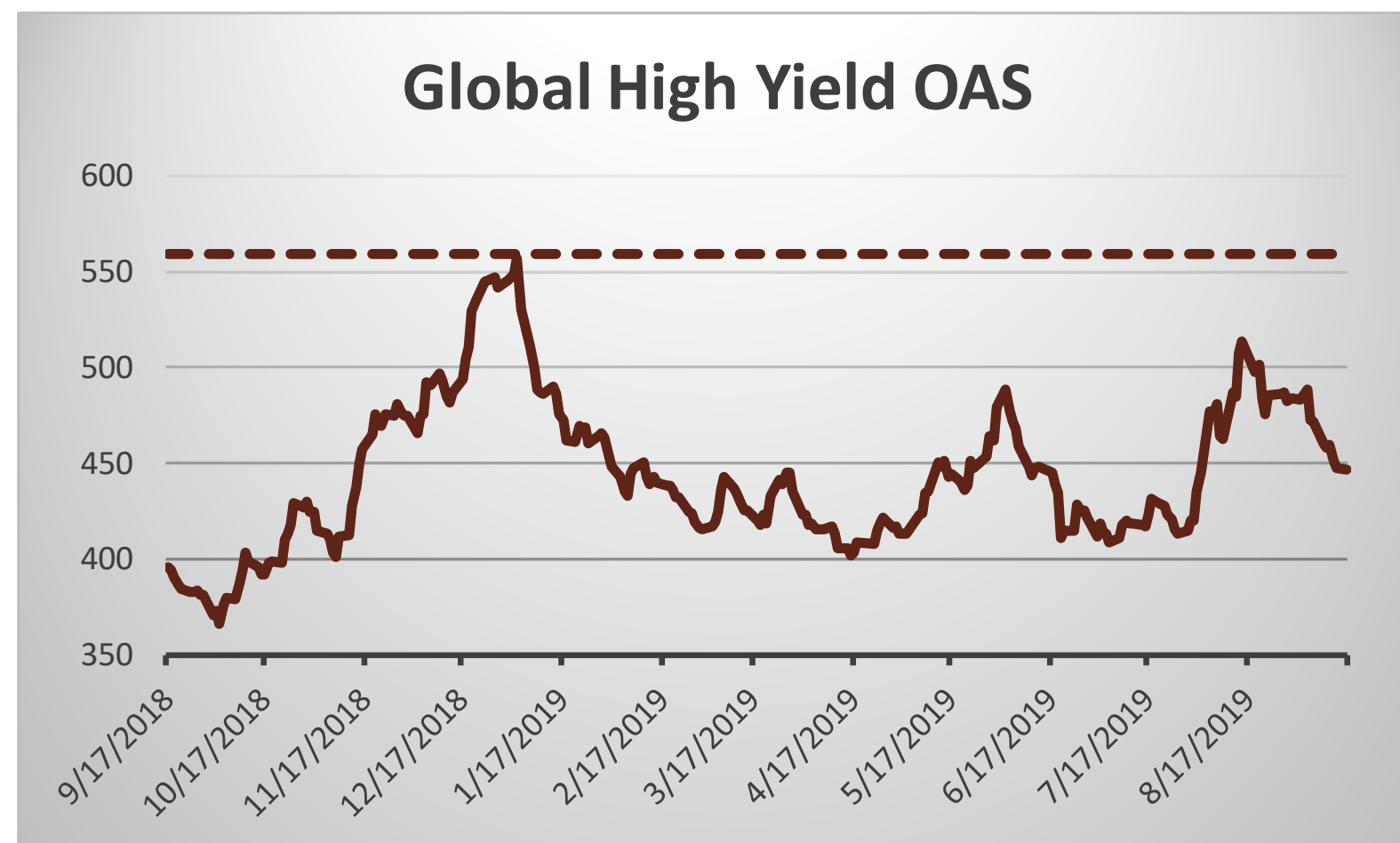
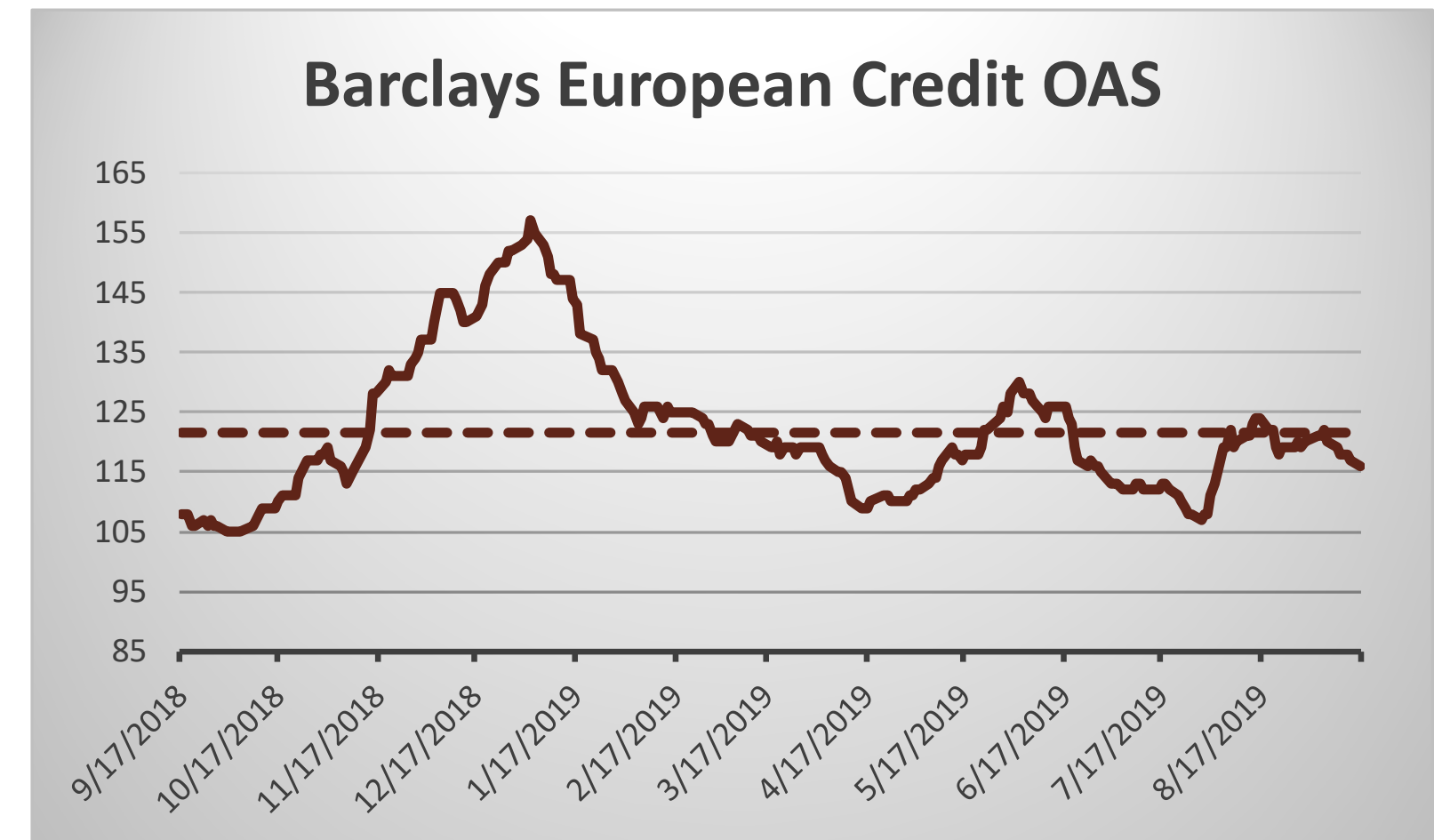
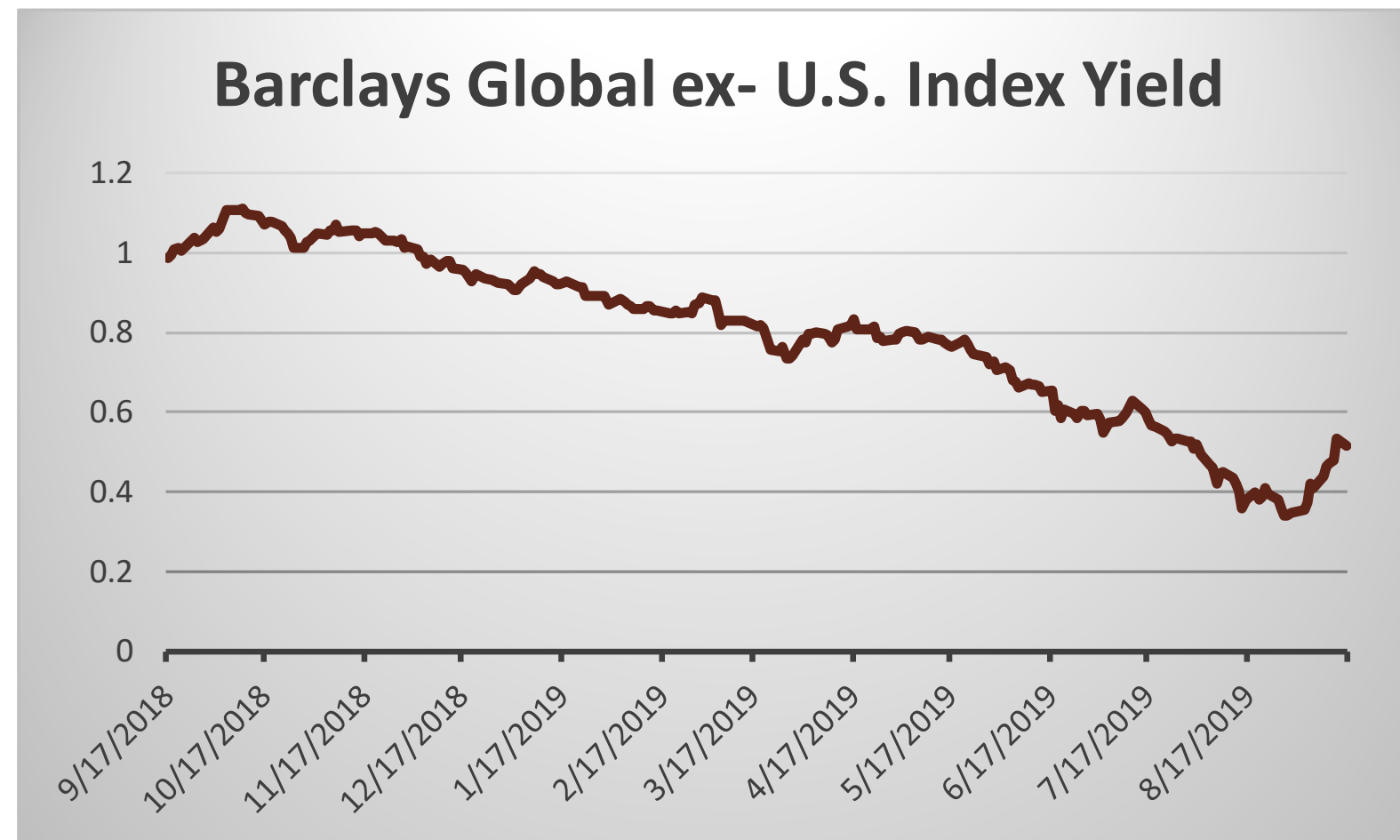
U.S. Fixed Income



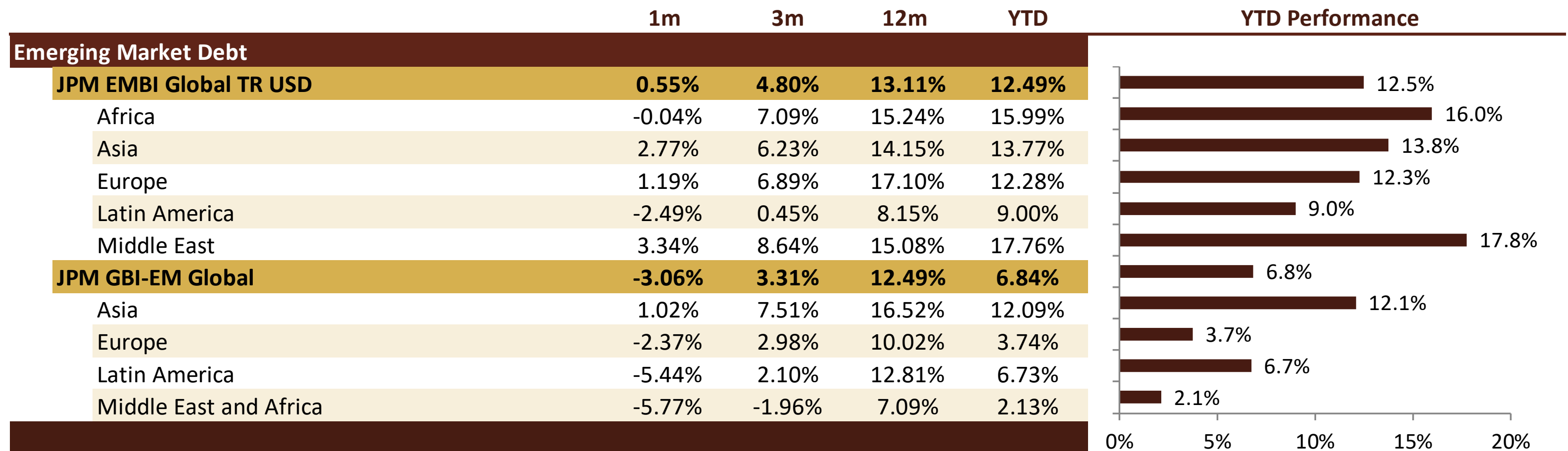
German Bund Yield Curve



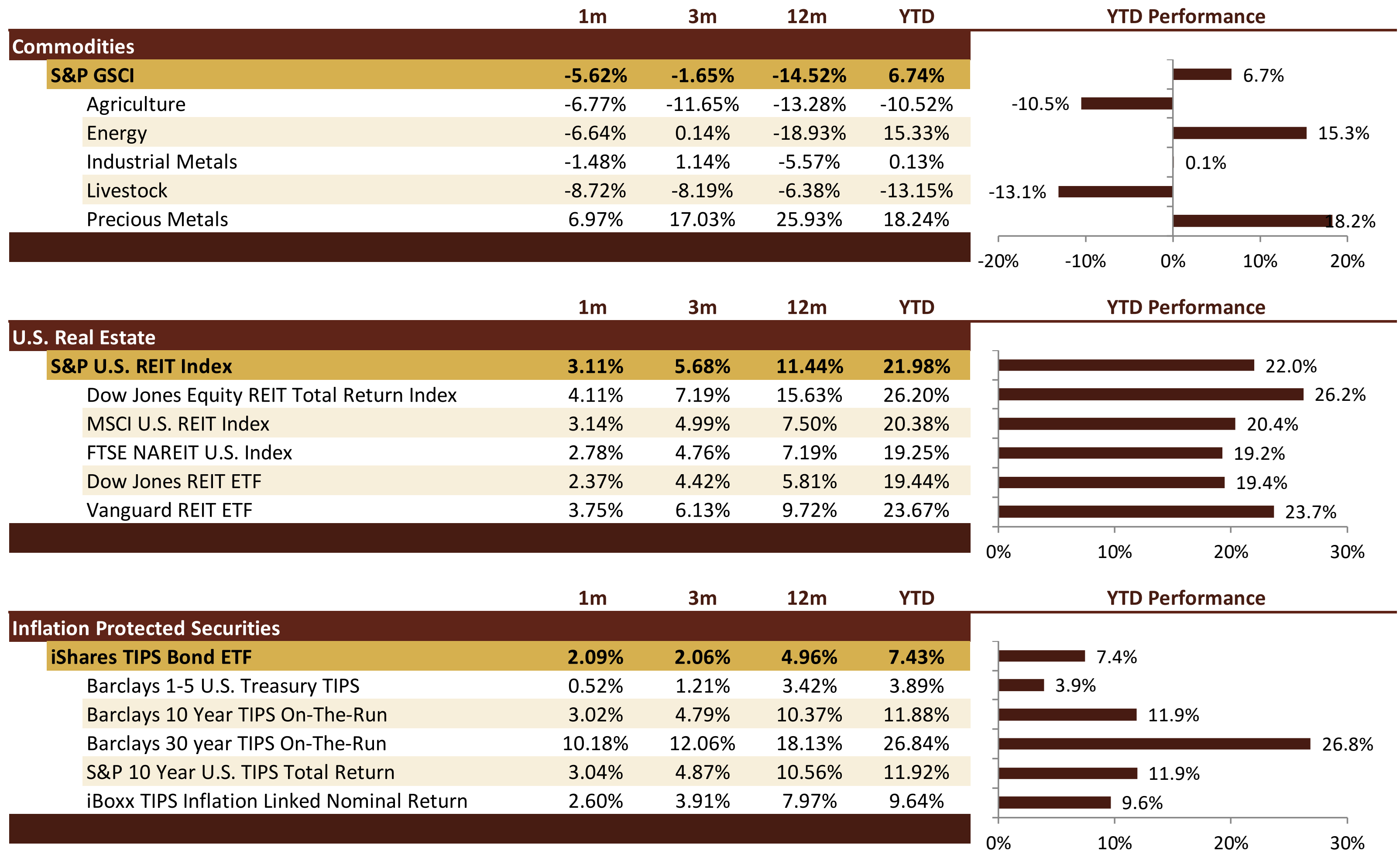
Global Fixed Income



Fixed Income Market Snapshot



Real Assets Market Snapshot

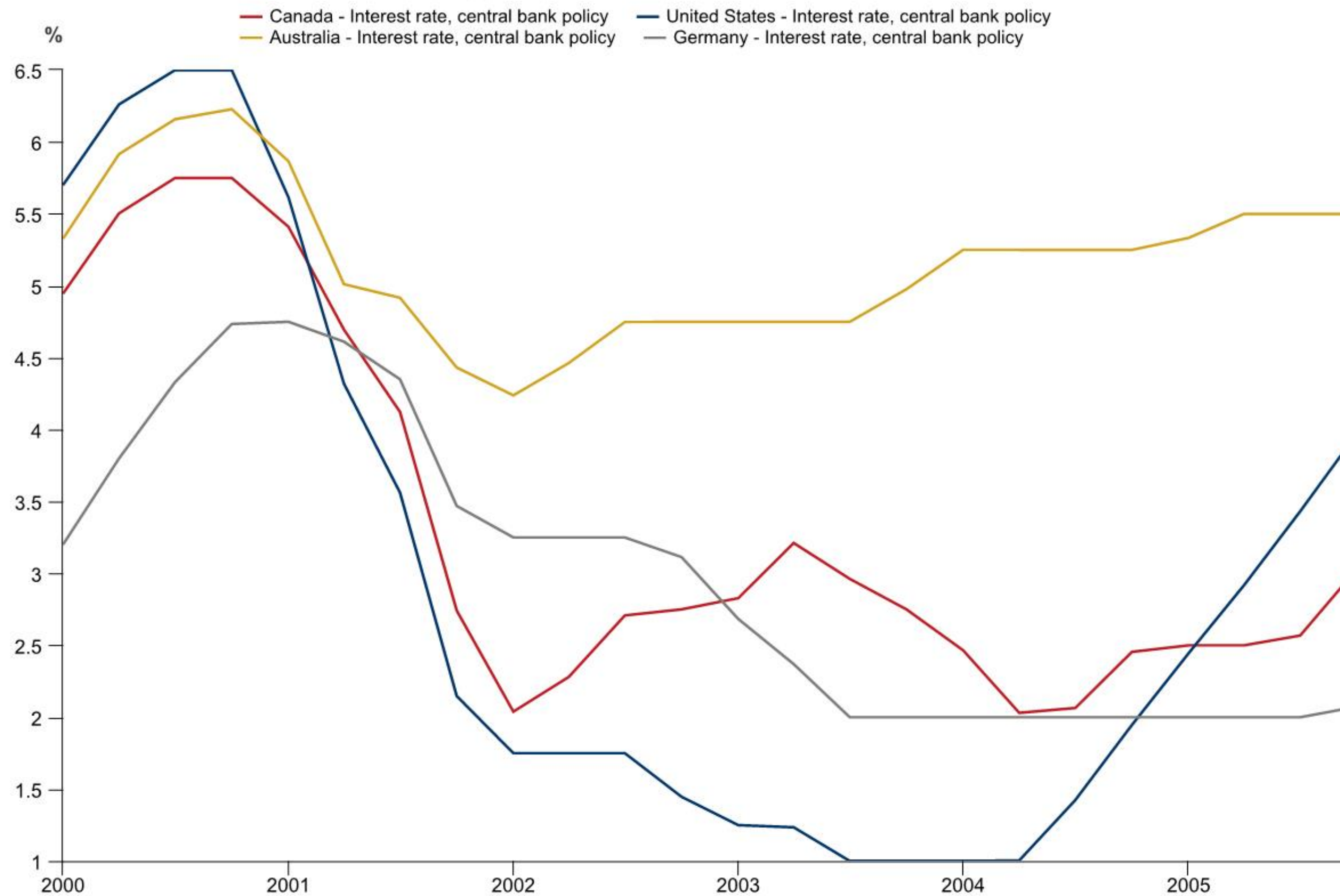


Market Distortion

***Challenging
Expectations***

Step 1: Add Generous Liquidity

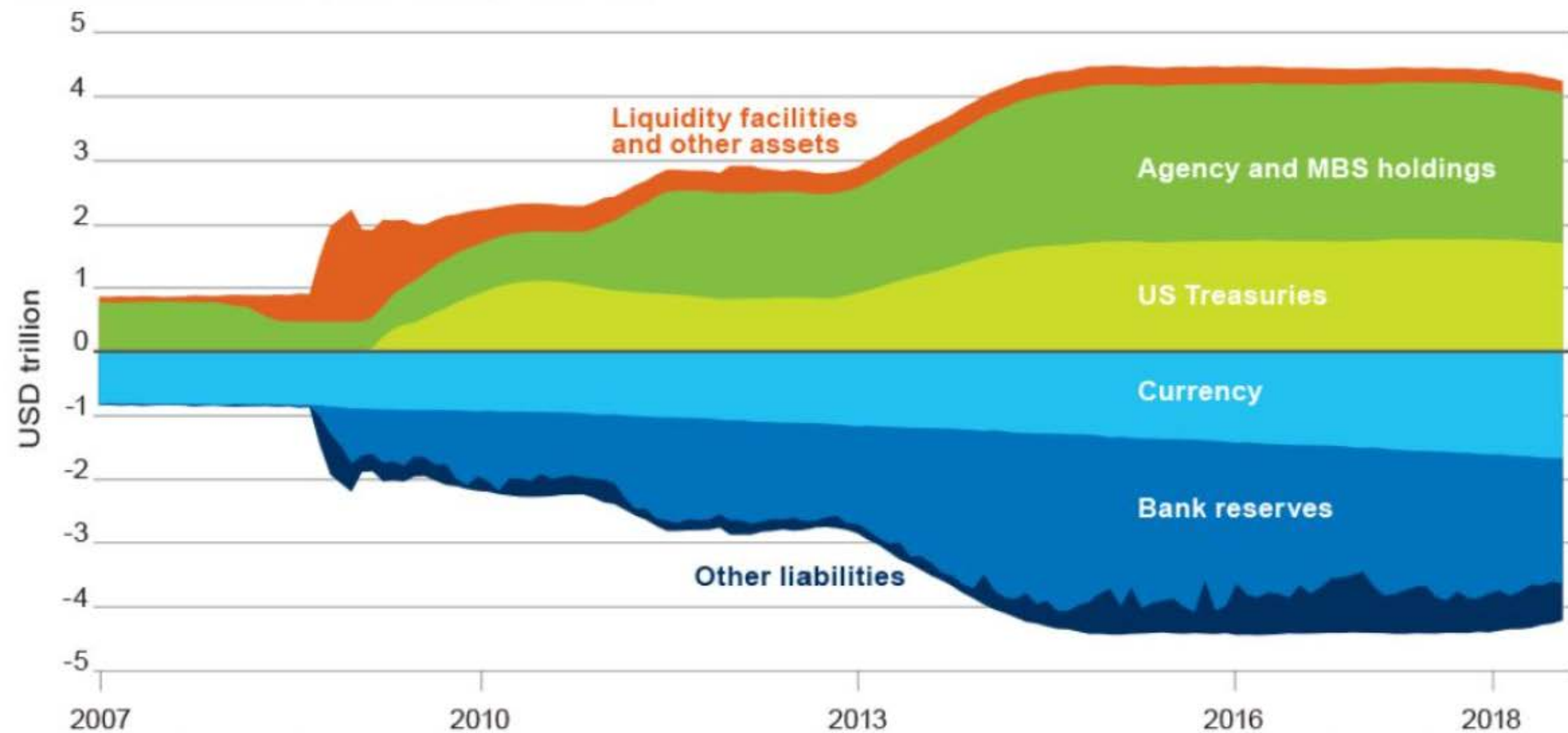
Interest rate, central bank policy



Source: Oxford Economics

Step 2: Plus some good intentions

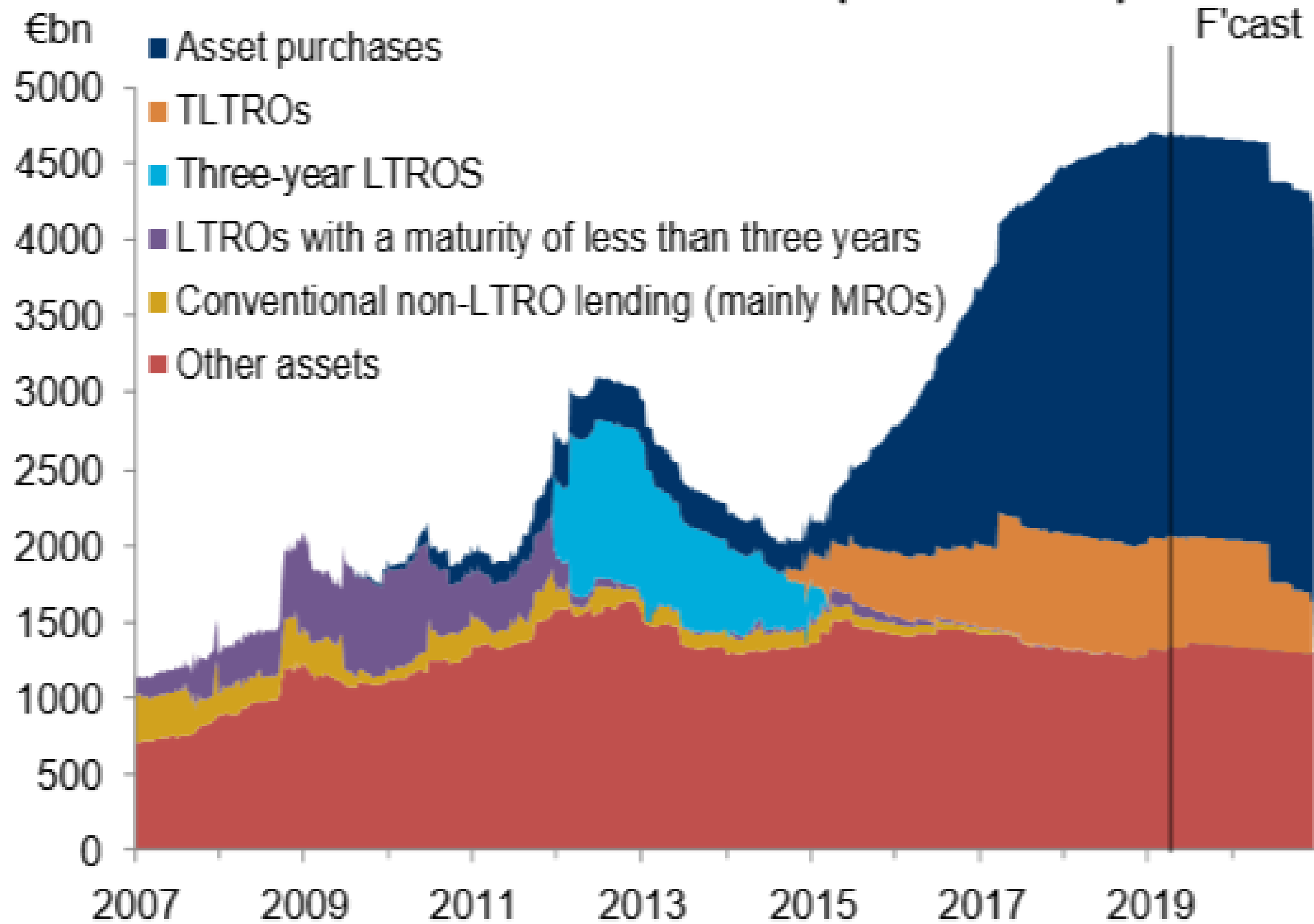
Breakdown of Fed's balance sheet, 2007-2018



Sources: BlackRock Investment Institute and Federal Reserve, with data from Thomson Reuters, August 2018. Notes: The chart shows the breakdown of the Fed's total assets and liabilities.

Step 2: Add more good intentions

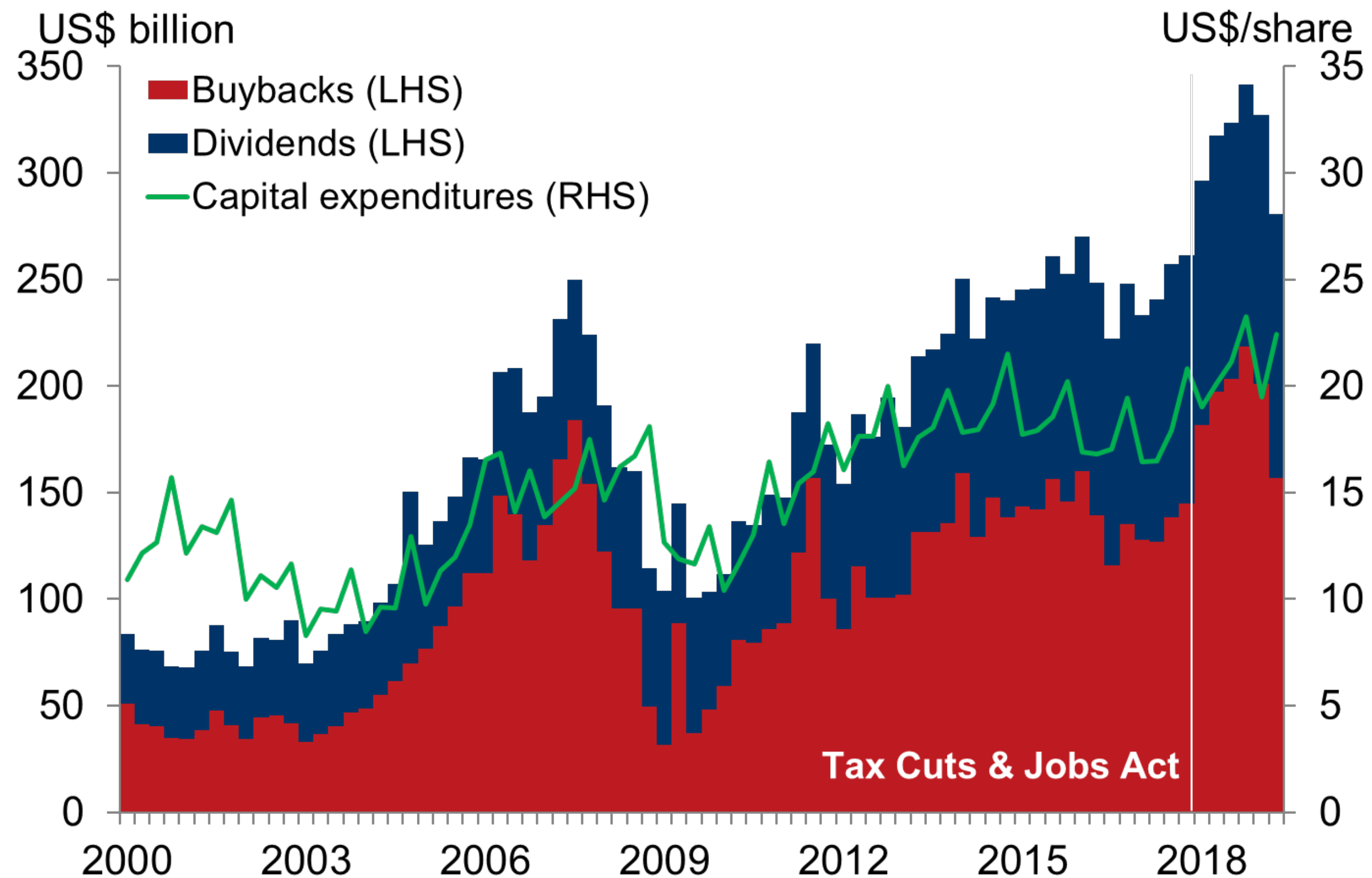
Eurozone: ECB Balance sheet (asset side)



Source: Oxford Economics/Haver Analytics

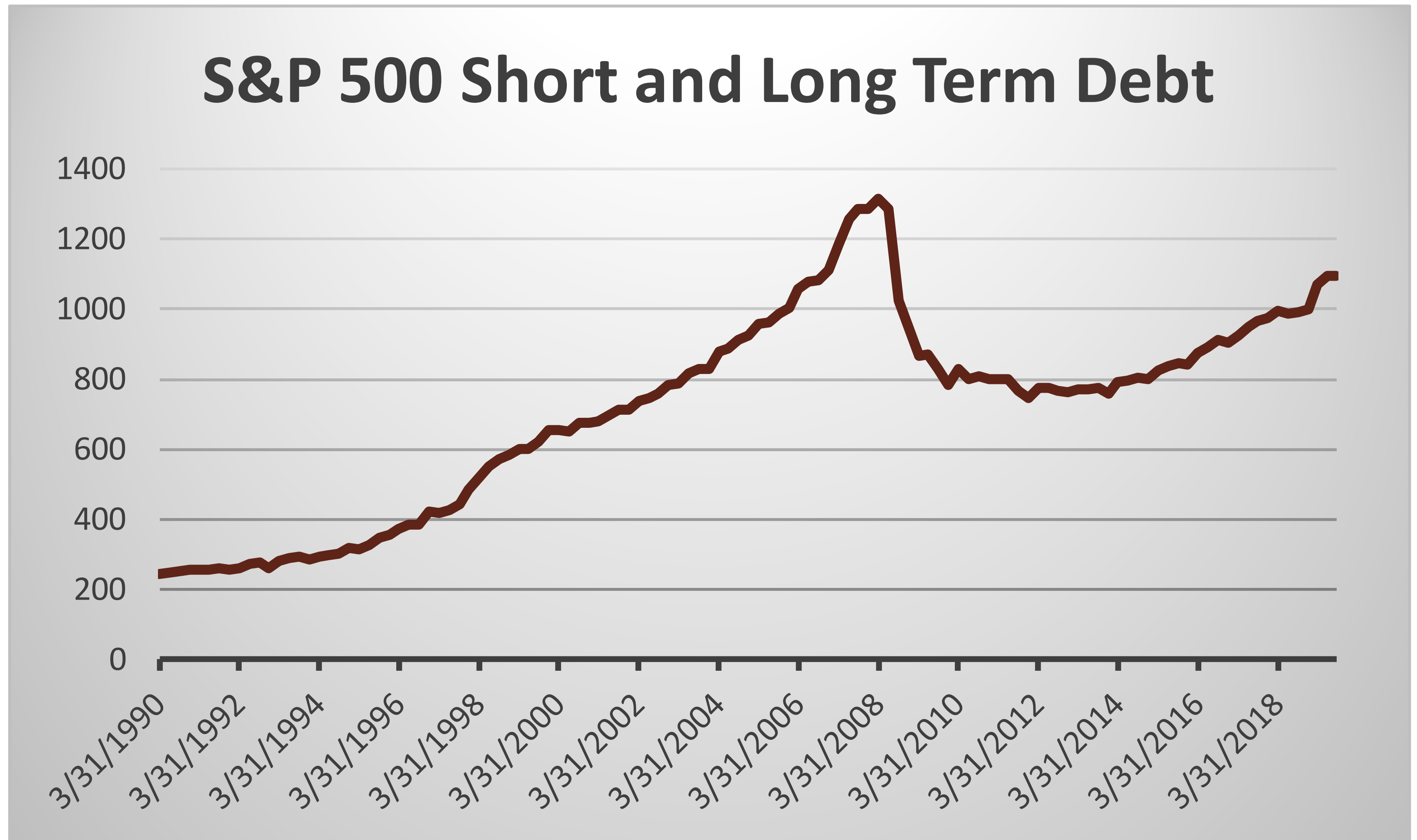
Step 3: Sprinkle in some greed

US: S&P 500 Capital Allocation



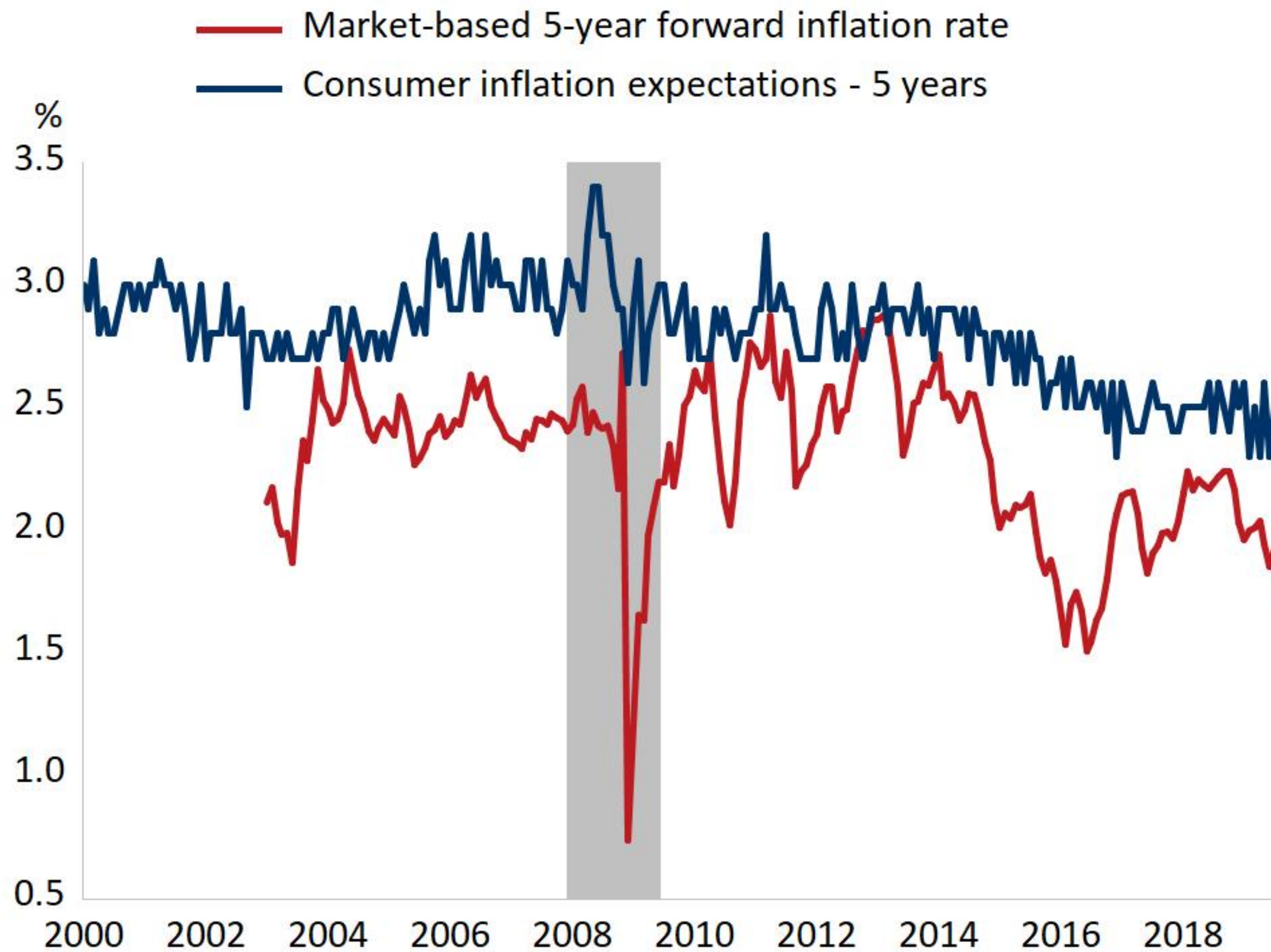
Source : Oxford Economics/Bloomberg

Step 3: Add more greed



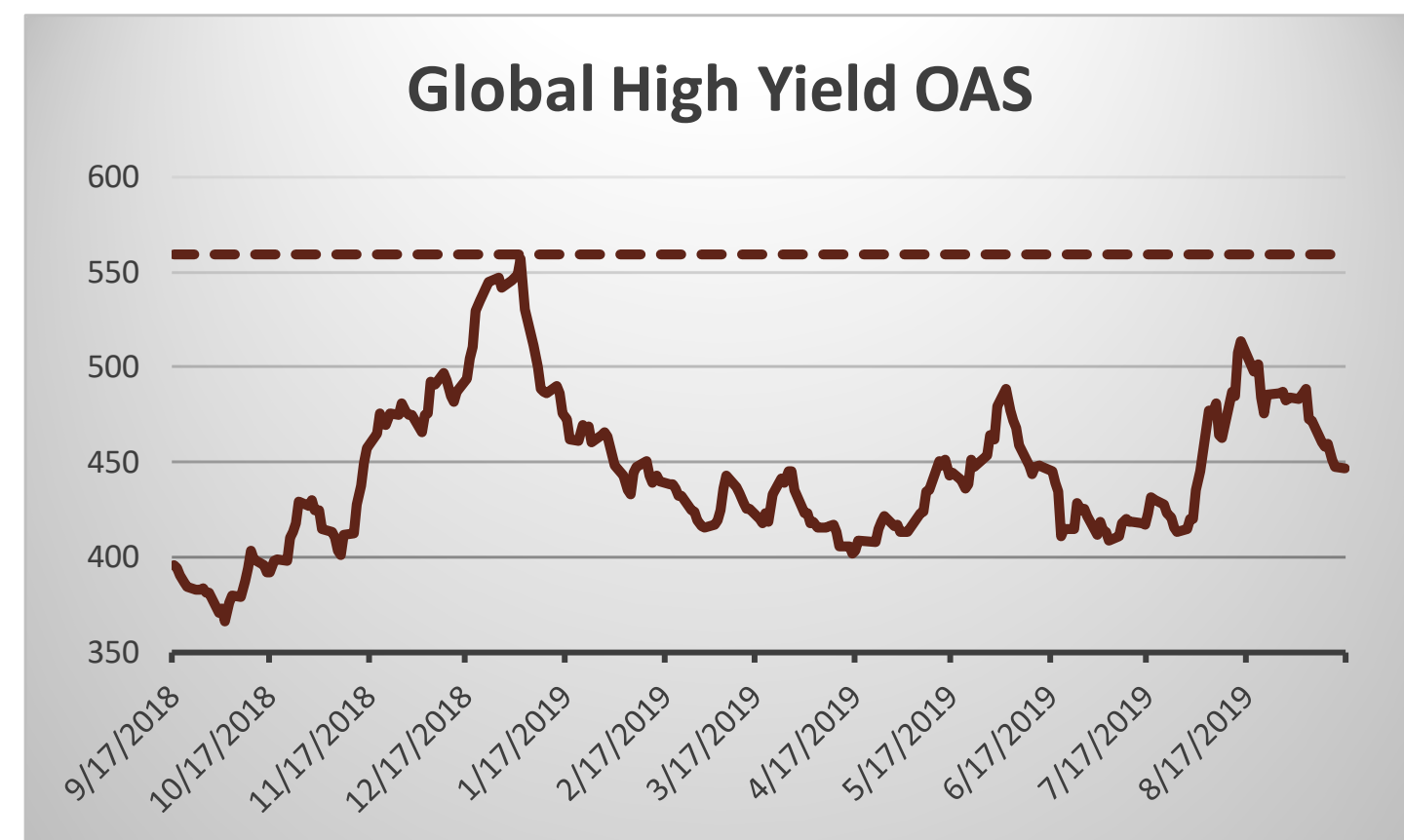
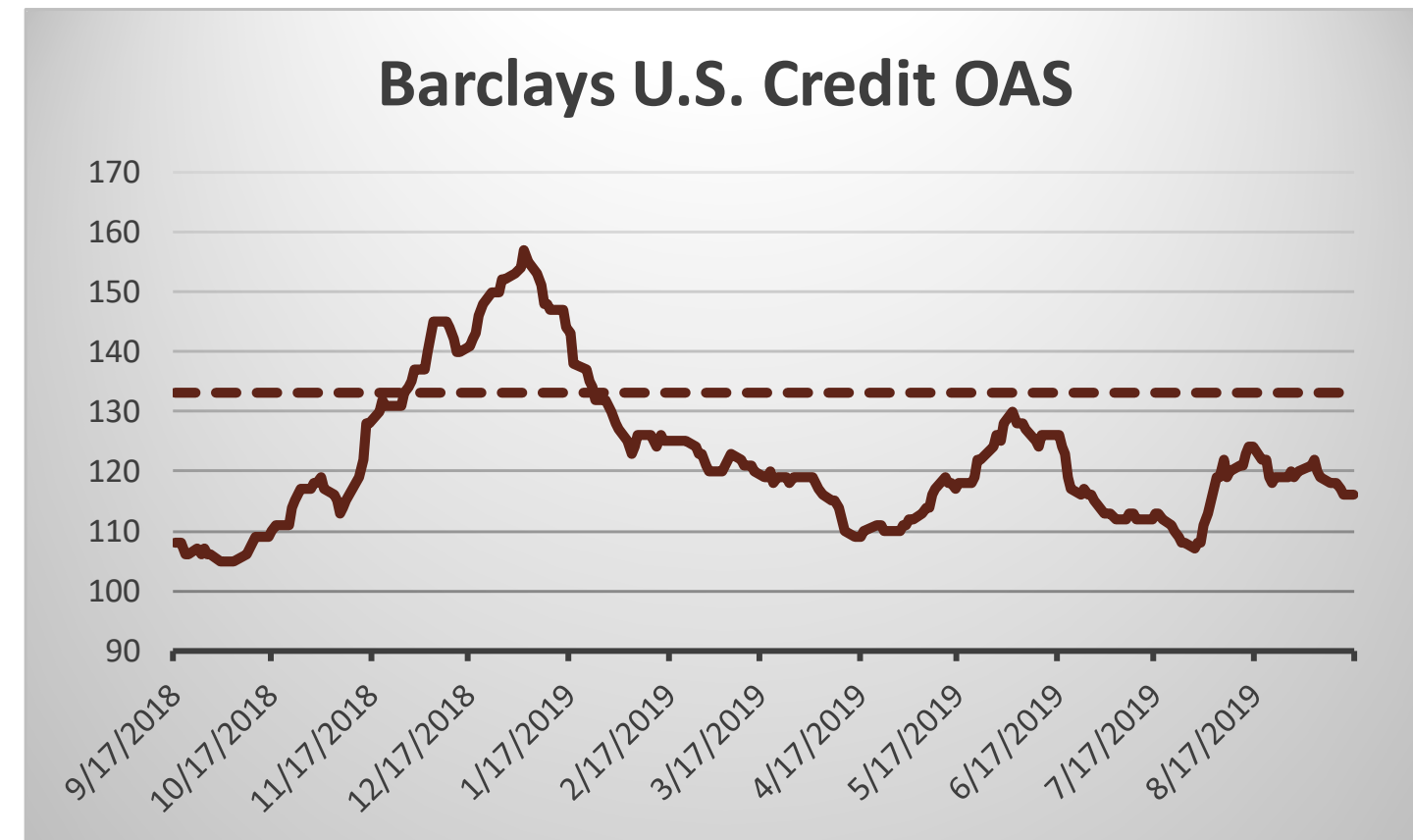
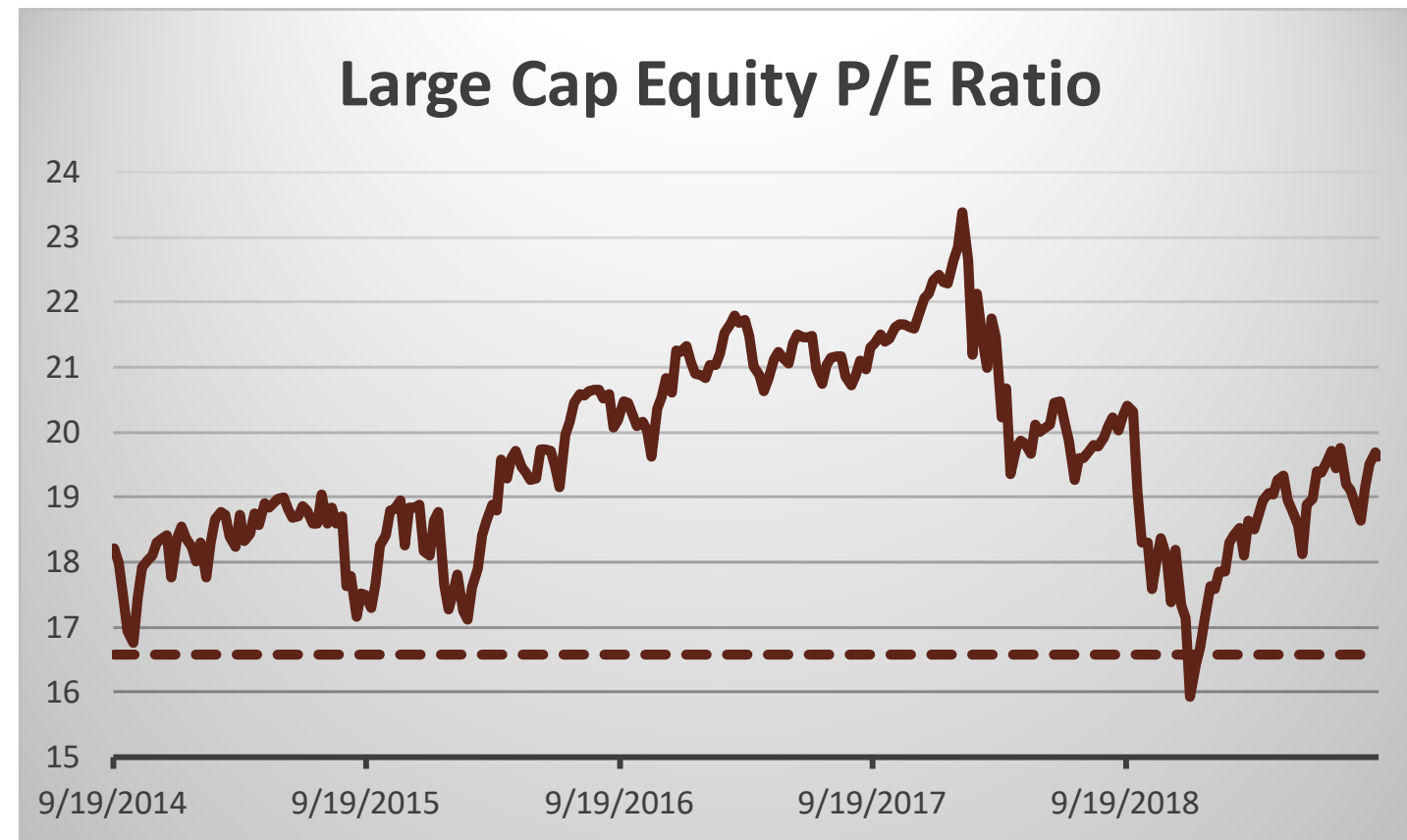
Step 4: Stir in some delusion

US: Inflation expectations



Source: Federal Reserve Board/Haver Analytics

Step 5: Ignore the real inflation

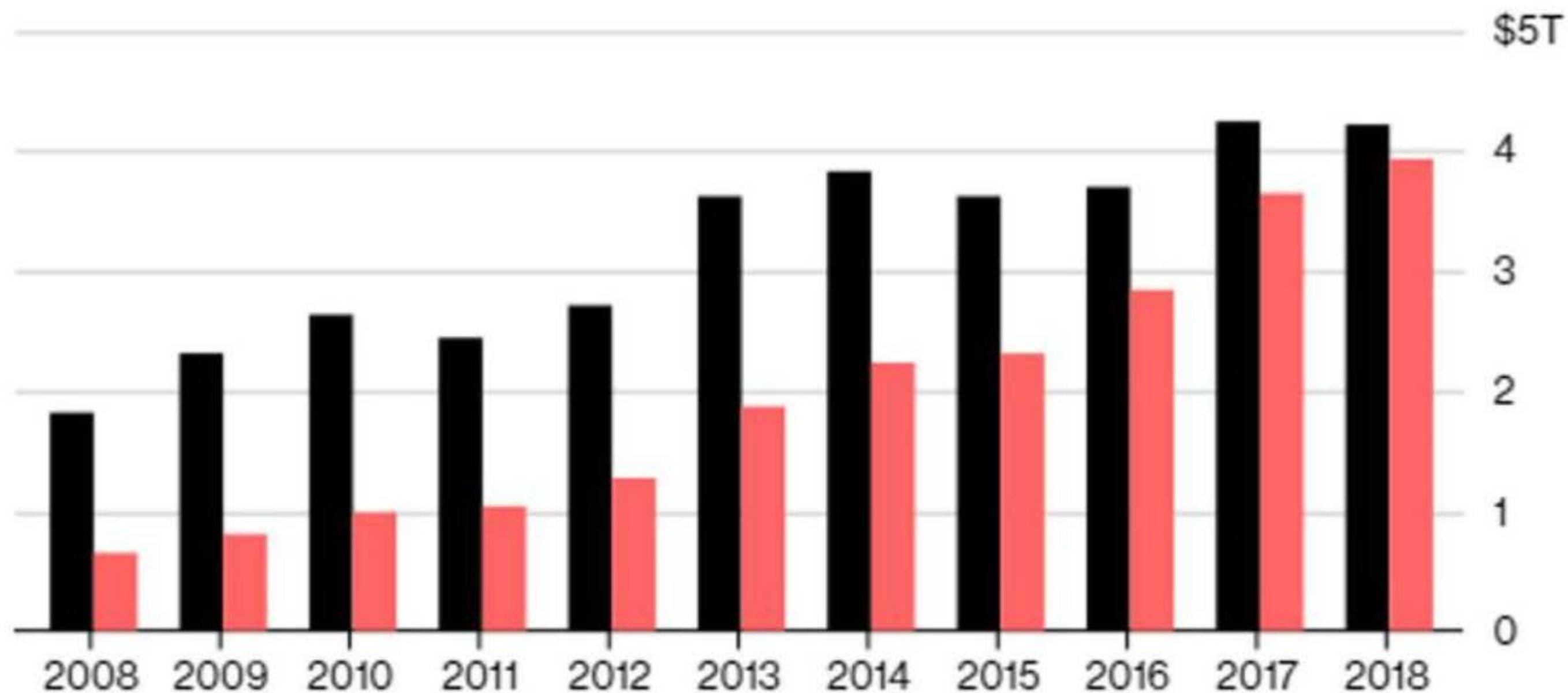


Step 6: Add a pinch of stupidity

Indexing on the Rise

Passive U.S. equity funds could soon overtake their active peers

■ Active ■ Passive



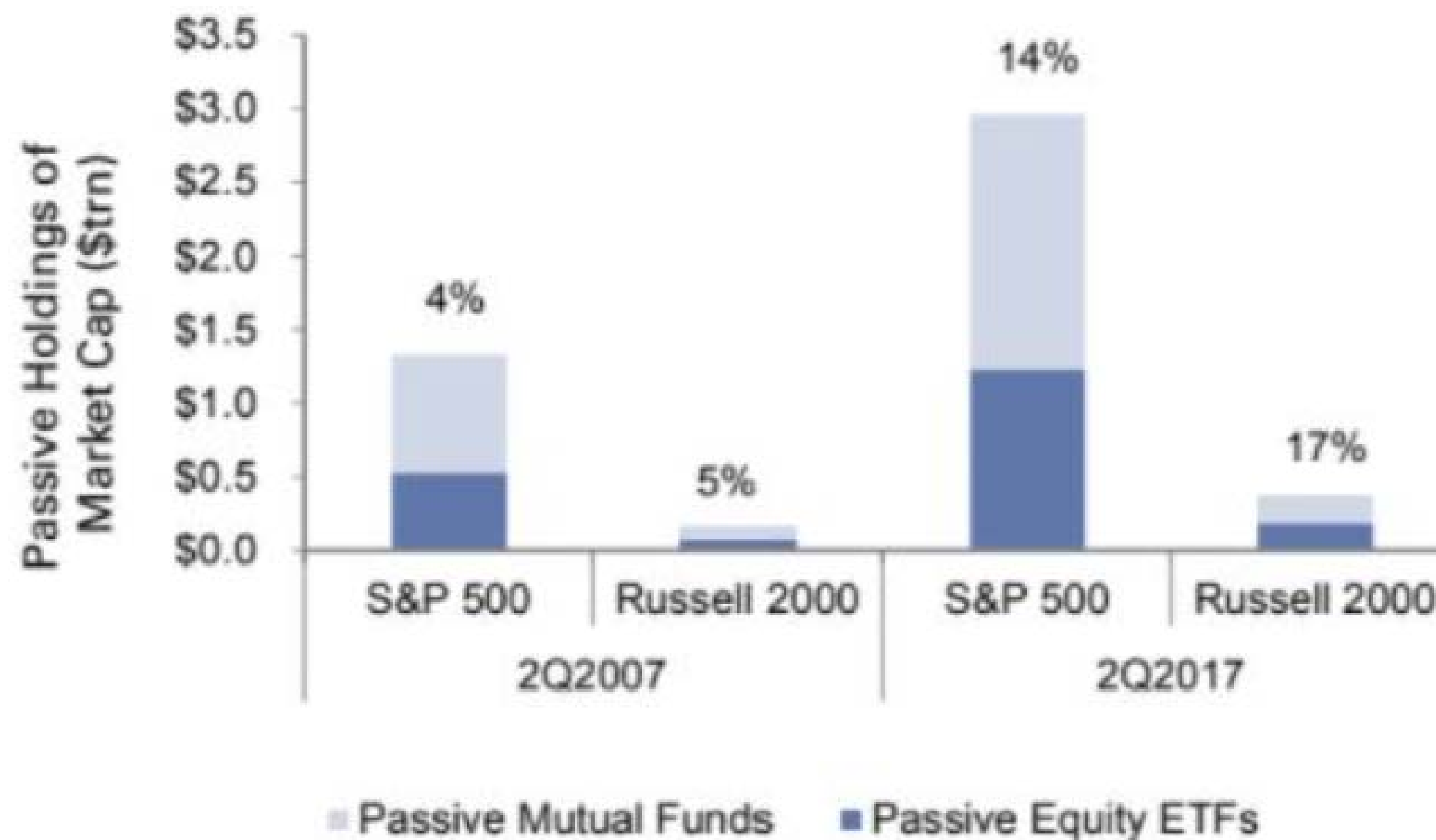
Source: Morningstar Inc.

Note: 2018 data as of Nov. 30

Step 6: Add a pinch of stupidity

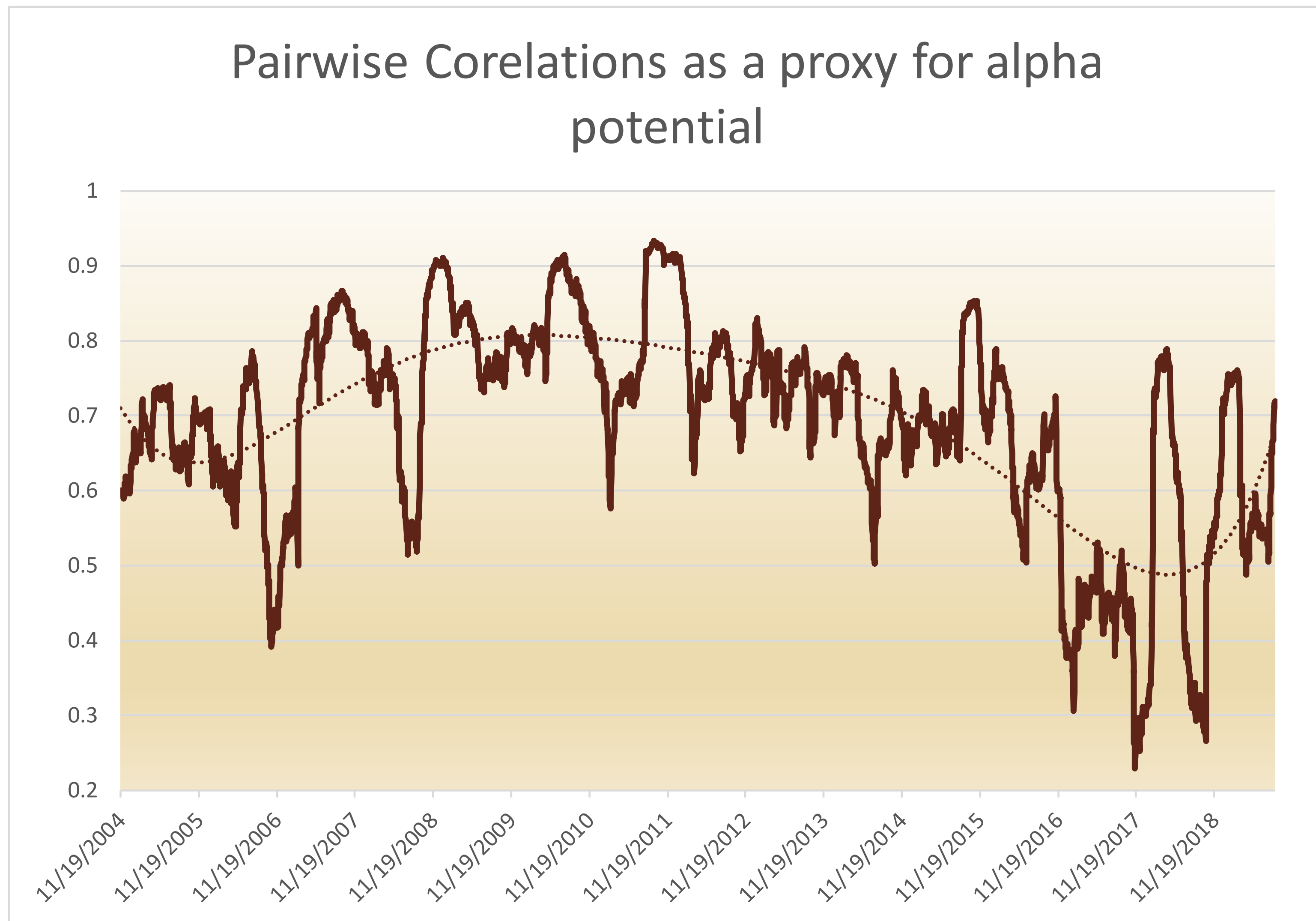
Exhibit 6: Equity ETFs and Passive Mutual Funds now hold 14% of the S&P500 in aggregate, up from 4% a decade ago

Estimated dollar holdings of stocks in the S&P500 of passive funds in aggregate



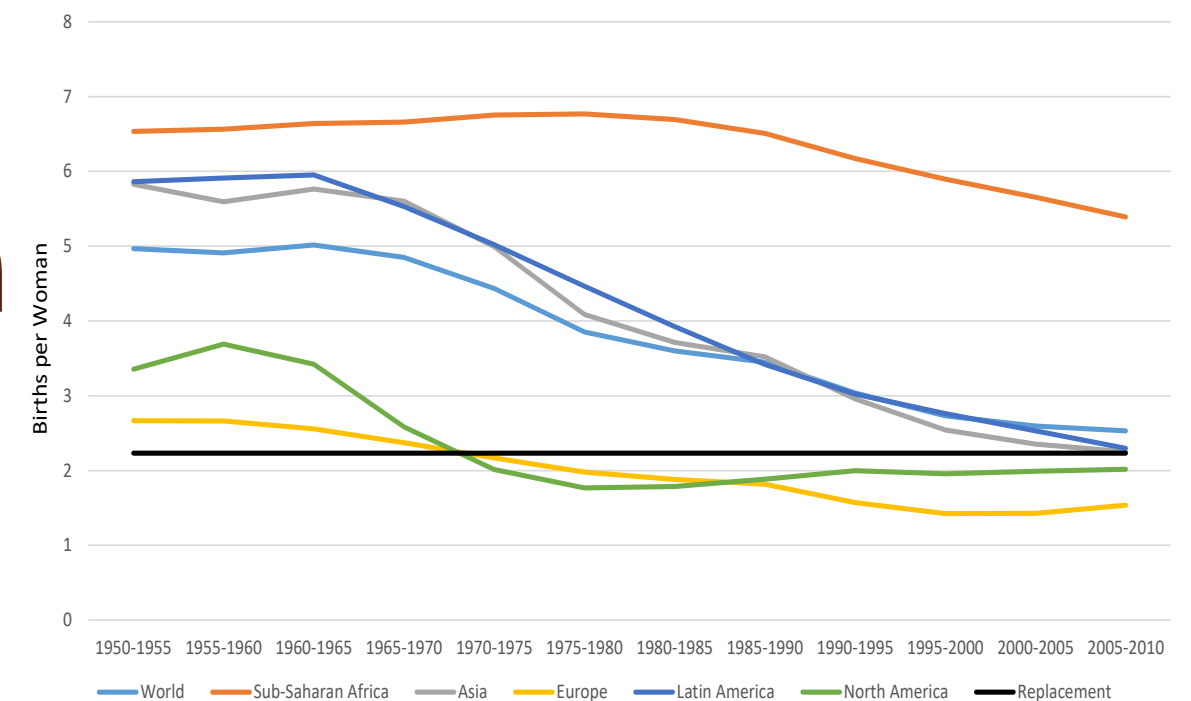
Source: FactSet, Bloomberg, Goldman Sachs Group, Inc.

Step 7: Plus a self-sustaining information loop

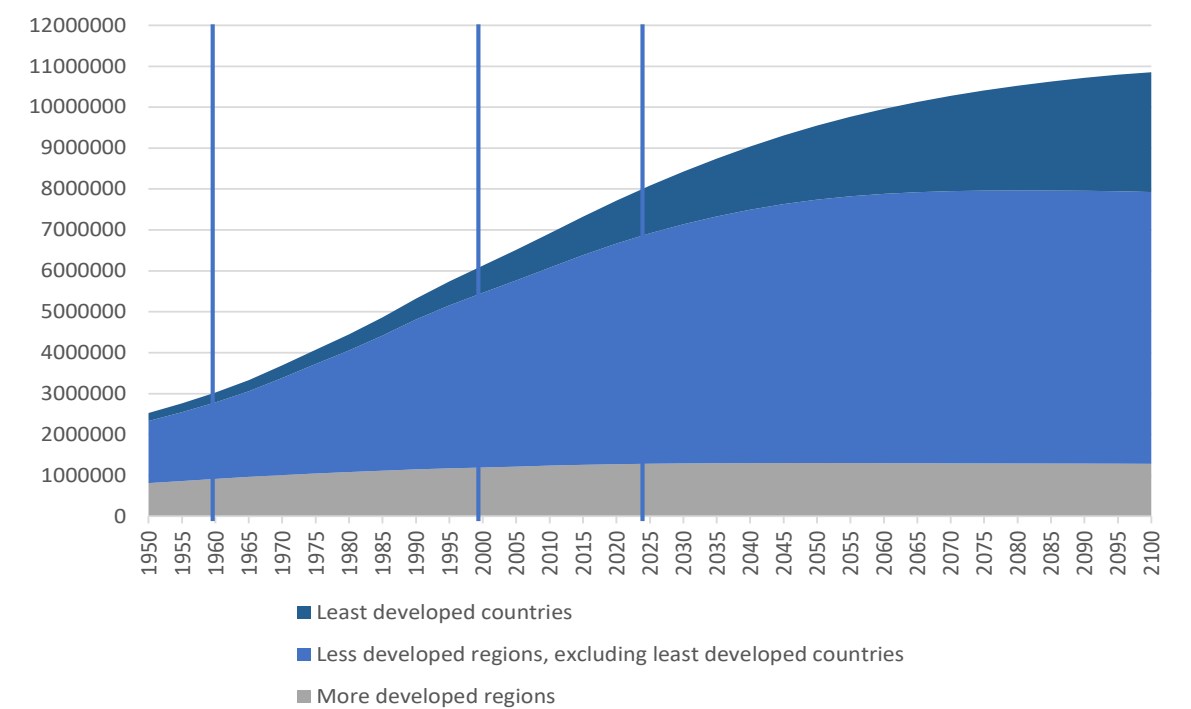


Debt + Passive Investing + Demographics

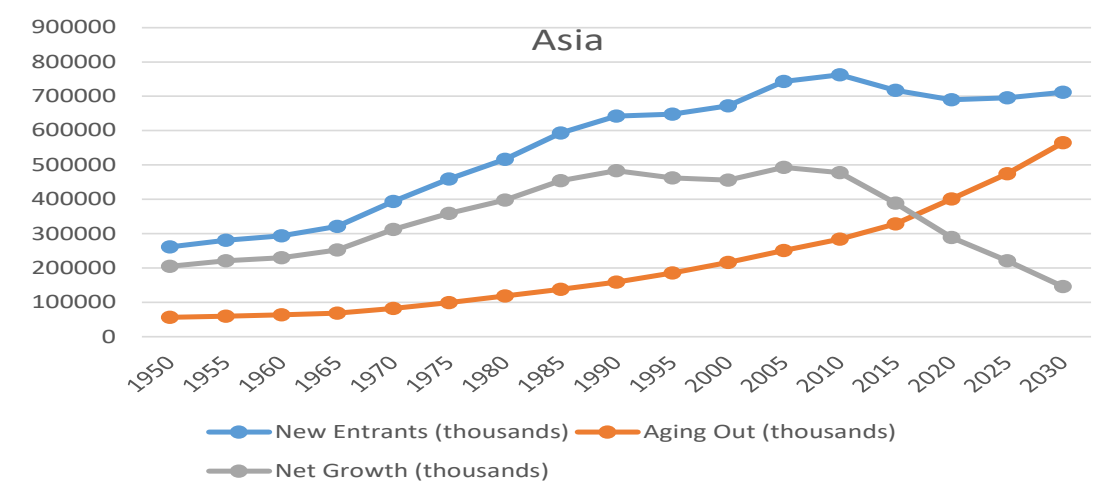
➤ World Fertility Rates Fallin



➤ Slowing Population



➤ Peaking Labor Markets



+ Deregulation + Inequality

- **Deregulation collapse tax receipts and explodes long term liabilities (debt, environmental, social, etc.)**
- **Feeds systematic underinvestment in socioeconomic and productivity boosting capital (education, infrastructure, etc.)**
- **Poorly implemented globalization fuels inequality**
- **Populist backlash fuel bigger booms and**

Equals a troubling trend

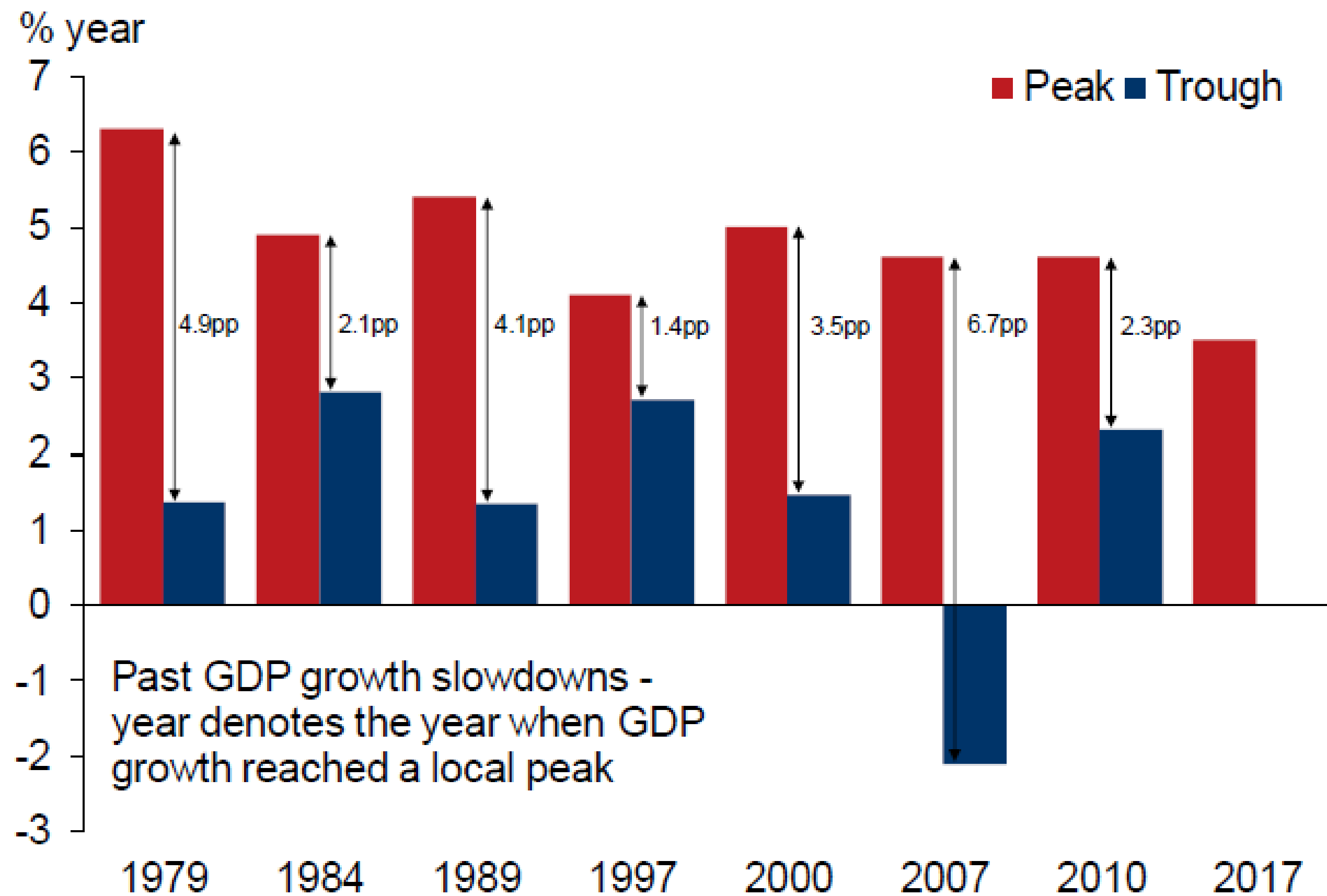
US: Expansions and Recessions



Source : Oxford Economics/Haver Analytics

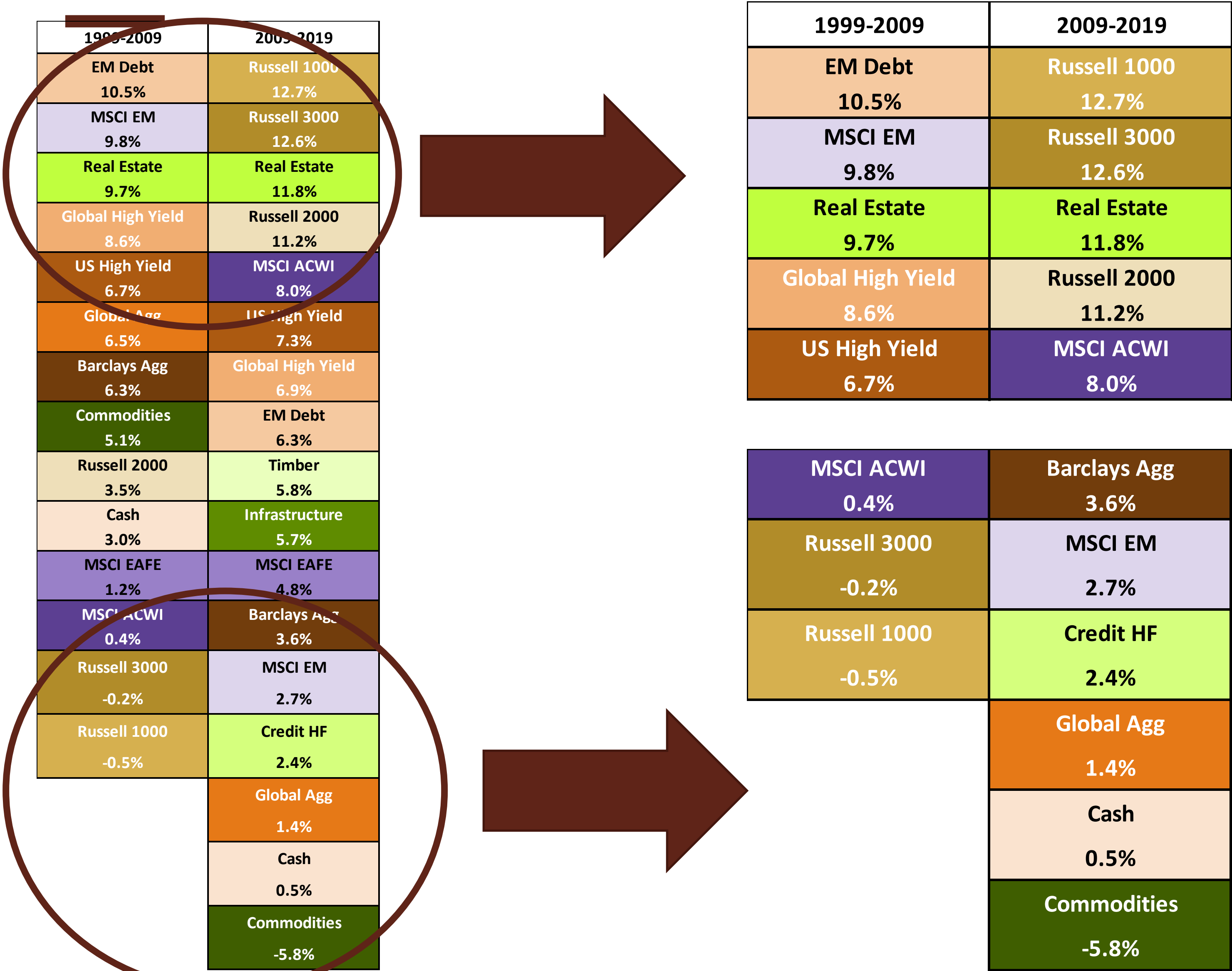
EM Not Bailing US out

Global GDP



Source : Oxford Economics/Haver Analytics

Result: Misallocation



Ten Year Periodic Table

2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Infrastructure 78.8%	Infrastructure 35.2%	Infrastructure 14.5%	Timber 22.0%	Russell 2000 38.8%	Real Estate 27.2%	Real Estate 2.1%	Infrastructure 21.9%	MSCI EM 37.3%	Cash 1.9%	Real Estate 27.1%
MSCI EM 78.5%	Real Estate 26.9%	EM Debt 8.5%	Global High Yield 19.6%	Russell 3000 33.6%	Russell 1000 13.2%	EM Debt 1.2%	Russell 2000 21.3%	Timber 34.4%	Barclays Agg 0.0%	Russell 1000 21.8%
Global High Yield 59.4%	Russell 2000 26.9%	Barclays Agg 7.8%	Real Estate 18.9%	Russell 1000 33.1%	Russell 3000 12.6%	Russell 1000 0.9%	US High Yield 17.1%	MSCI EAFE 25.0%	US High Yield -2.1%	Russell 3000 21.5%
US High Yield 58.2%	MSCI EM 18.9%	Real Estate 6.0%	EM Debt 18.5%	Infrastructure 29.8%	Infrastructure 7.7%	Barclays Agg 0.5%	Global High Yield 14.3%	MSCI ACWI 24.0%	Global Agg -2.1%	Russell 2000 18.2%
Credit HF 38.9%	Russell 3000 16.9%	US High Yield 5.0%	MSCI EM 18.2%	MSCI ACWI 22.8%	Barclays Agg 6.0%	Russell 3000 0.5%	Timber 13.0%	Russell 1000 21.7%	Credit HF -2.5%	MSCI ACWI 17.3%
Timber 38.0%	Timber 16.4%	Global Agg 4.4%	MSCI EAFE 17.3%	MSCI EAFE 22.8%	EM Debt 5.5%	Cash 0.1%	Russell 3000 12.7%	Russell 3000 21.1%	Real Estate -4.0%	Infrastructure 16.6%
MSCI ACWI 34.6%	Russell 1000 16.1%	Global High Yield 3.1%	Russell 1000 16.4%	Timber 19.8%	Russell 2000 4.9%	MSCI EAFE -0.8%	Russell 1000 12.1%	Russell 2000 14.6%	Global High Yield -4.1%	MSCI EAFE 13.6%
MSCI EAFE 31.8%	US High Yield 15.1%	Russell 1000 1.5%	Russell 3000 16.4%	US High Yield 7.4%	MSCI ACWI 4.2%	MSCI ACWI -2.4%	Commodities 11.4%	Global Agg 10.5%	EM Debt -4.6%	Commodities 13.1%
Real Estate 30.8%	Global High Yield 14.8%	Russell 3000 1.0%	Russell 2000 16.3%	Global High Yield 7.3%	US High Yield 2.5%	Global High Yield -2.7%	MSCI EM 11.2%	Global High Yield 10.4%	Russell 1000 -4.8%	US High Yield 11.8%
Russell 1000 28.4%	MSCI ACWI 12.7%	Cash 0.1%	MSCI ACWI 16.1%	Credit HF 6.9%	Timber 2.1%	Credit HF -4.4%	EM Debt 10.2%	Real Estate 9.8%	Russell 3000 -5.2%	EM Debt 11.7%
Russell 3000 28.3%	EM Debt 12.0%	Commodities -1.2%	US High Yield 15.8%	Real Estate 1.8%	Cash 0.0%	Russell 2000 -4.4%	MSCI ACWI 7.9%	EM Debt 9.3%	MSCI ACWI -9.4%	Global High Yield 9.2%
EM Debt 28.2%	Credit HF 10.2%	Credit HF -3.6%	Credit HF 7.7%	Cash 0.1%	Global High Yield 0.0%	US High Yield -4.5%	Real Estate 7.6%	US High Yield 7.5%	Russell 2000 -11.0%	MSCI EM 7.7%
Russell 2000 27.2%	Commodities 9.0%	Russell 2000 -4.2%	Infrastructure 5.0%	Commodities -1.2%	Credit HF -1.8%	Global Agg -6.0%	Credit HF 5.0%	Commodities 5.8%	Infrastructure -11.7%	Barclays Agg 7.6%
Commodities 13.5%	MSCI EAFE 7.8%	MSCI ACWI -7.3%	Barclays Agg 4.2%	Barclays Agg -2.0%	MSCI EM -2.2%	Timber -7.5%	Barclays Agg 2.6%	Credit HF 3.9%	MSCI EAFE -13.8%	Timber 5.3%
Global Agg 7.5%	Barclays Agg 6.5%	MSCI EAFE -12.1%	Global Agg 4.1%	MSCI EM -2.6%	Global Agg -3.1%	MSCI EM -14.9%	Global Agg 1.5%	Barclays Agg 3.5%	Commodities -13.8%	Global Agg 4.5%
Barclays Agg 5.9%	Global Agg 4.9%	Timber -16.9%	Cash 0.1%	Global Agg -3.1%	MSCI EAFE -4.9%	Commodities -32.9%	MSCI EAFE 1.0%	Cash 0.9%	MSCI EM -14.6%	Credit HF 3.6%
Cash 0.2%	Cash 0.1%	MSCI EM -18.4%	Commodities 0.1%	EM Debt -6.6%	Commodities -33.1%	Infrastructure -35.1%	Cash 0.3%	Infrastructure -5.6%	Timber -17.7%	Cash 1.7%

SBCERA Assumptions

		SBCERA Portfolio (Physicals + Futures)	Benchmark	20 Year Historical	15 Year Historical	10 Year Historical	5 Year Historical	10 Year Estimated
Equity	US Equity	10.00%	60.00%	6.49%	9.09%	13.35%	9.60%	6.35%
	US Large Cap	8.60%		6.39%	9.14%	13.49%	9.85%	6.16%
	US Small Cap	1.40%		7.88%	8.37%	11.59%	6.41%	7.98%
	International Equity	17.70%		4.74%	7.07%	8.61%	5.51%	
	Developed Ex-US	10.50%		3.63%	5.27%	5.00%	1.89%	6.89%
	Emerging Markets	7.20%		7.01%	8.09%	4.07%	0.38%	9.98%
	Private Equity	15.70%		6.49%	9.09%	13.35%	9.60%	8.02%
	Total Equities	43.40%						
Fixed Income	US Fixed Income	0.80%	40.00%	5.10%	4.26%	3.91%	3.35%	2.48%
	Global Ex-US Fixed Income	5.70%			3.28%	1.70%	0.29%	2.61%
	Global High Yield Bonds	13.50%		8.02%	7.51%	8.02%	3.91%	5.58%
	Emerging Market Debt	9.80%		9.18%	7.42%	7.06%	4.66%	6.05%
	Cash*	-0.30%		1.83%	1.39%	0.52%	0.95%	0.74%
	Total Fixed Income	29.50%						
Alternatives	Commodities	2.00%		-0.42%	-5.22%	-5.58%	-13.14%	4.62%
	Infrastructure	1.80%			7.58%	7.55%	-8.32%	6.65%
	Real Estate	4.30%		10.51%	8.31%	13.31%	8.99%	7.03%
	Timberland	0.80%			3.40%	6.76%	3.25%	3.29%
	(Credit) Hedge Funds	18.20%				3.19%	0.00%	3.58%
	Total Alternatives	27.10%						
	SBCERA Portfolio	100.00%						6.68%
	Benchmark		100.00%					4.80%
								1.88%



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