



333 Bush Street  
 San Francisco, CA 94104  
 (415) 263-5400  
 www.statefundca.com

Date: May 5, 2017

**TO: MEMBERS, INVESTMENT COMMITTEE**

<b>I. AGENDA ITEM # AND TITLE :</b>	Agenda Item 5 – Market Outlook and Economic Update
<b>II. NAME AND PROGRAM:</b>	Treasury and Investments
<b>III. ACTIVITY:</b>	<input checked="" type="checkbox"/> Informational <input type="checkbox"/> Request for Direction <input type="checkbox"/> Action Proposed <input type="checkbox"/> Exploratory
<b>IV. JUSTIFICATION:</b>	<input checked="" type="checkbox"/> Standard/Required Item <input type="checkbox"/> Board Request – New Item <input type="checkbox"/> New Topic from Staff

**V. EXECUTIVE SUMMARY:**

The purpose of the attached is to illustrate the current dynamics of the economy and capital markets, with a particular focus on the implications that the Trump agenda and the current Federal Reserve policy may have on the U.S. outlook. Additionally, we provide our view on the expected portfolio returns of the P&C universe.

**VI. ANALYSIS:**

Consumer, business, and investor confidence has surged post-election in anticipation of higher growth rates from expected tax and regulatory reforms. However, high levels and debt and aging demographics continue to be a headwind for growth, calling into question whether Trump’s policies, if passed, can meaningfully change the low levels of growth the U.S. has witnessed since 2009. Additionally, the Fed has started to move the Fed Funds rate higher and expectations are they will continue to tighten in 2017 and 2018. Higher interest rates and a stronger dollar could also act as a headwind on growth. Our base case is for modestly higher interest rates in 2017 and 2018. However, with meaningful policy change on the table, both monetary and fiscal, we expect volatility around this baseline.

**VII. RECOMMENDATION:**

Our fixed income portfolio strategy in this environment has the following structural elements:

- Maintain overall portfolio duration position at target level
- Stay overweight the spread sectors
- Heightened focus on individual security selection
- Dry Powder – Tactically assume defensive yield curve positions
  - Front end yield curve exposure
  - Floating rate securities and amortizing securities
- Selectively pare risk positions on strength
- Be prepared to take advantage of volatility



Partnership at Work™

# US Economic & Capital Market Outlook

May 18, 2017

The material contained in this presentation has been prepared solely for informational purposes by New England Asset Management Limited ("NEAM Limited") and New England Asset Management, Inc. ("NEAM, Inc.") and is not to be distributed outside of the organization to which it is presented. The material is based on sources believed to be reliable and/or from proprietary data developed by NEAM, but we do not represent as to its accuracy or its completeness. This is not an offer to buy or sell any security or financial instrument. Certain assumptions, including tax assumptions, may have been made which have resulted in any returns detailed herein. Past performance results are not necessarily indicative of future performance. Changes to the assumptions, including valuations or cash flows of any instrument, may have a material impact on any results. Please consult with your tax experts before relying on this material. Additional information is available upon request. This document and its contents are proprietary to NEAM. They were prepared for the exclusive use of Gen Re Life. Neither this document nor its contents are to be given or discussed with anyone other than employees, directors, trustees or auditors of Gen Re Life without our prior written consent. Any reference in this presentation to "NEAM" is defined as NEAM Limited and NEAM, Inc. NEAM Limited is a subsidiary of NEAM, Inc. NEAM Limited is regulated by the Central Bank of Ireland. NEAM Limited is authorized by the Central Bank of Ireland and subject to limited regulation by the Financial Conduct Authority. Details about the extent of our regulation by the Financial Conduct Authority are available from us on request. NEAM Limited is not registered with the SEC. Because this is intended to be an overview please note that some services described in this presentation may not be available to all clients in certain jurisdictions.

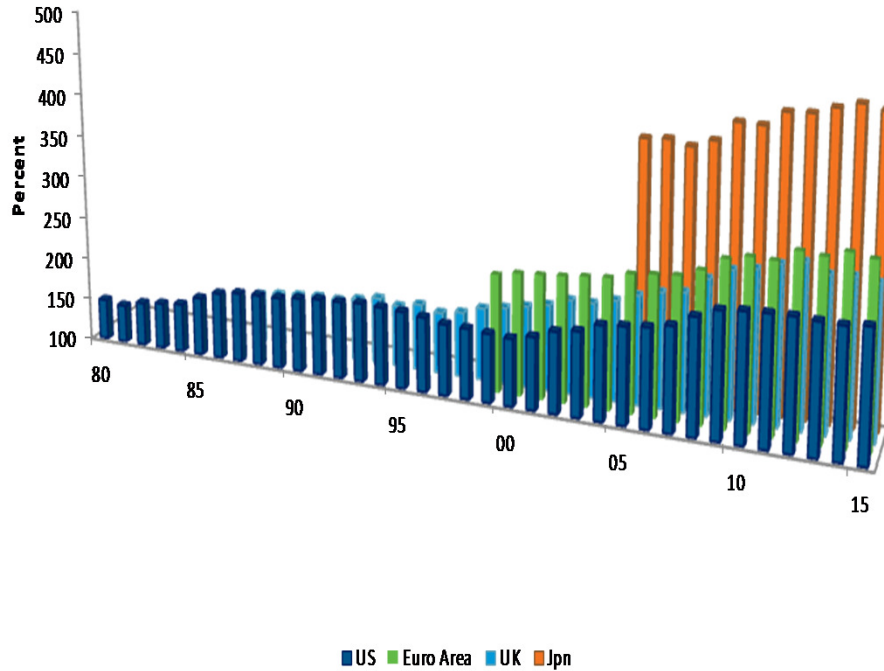
State Compensation Insurance Fund  
Investment Committee – May 18, 2017  
Open Agenda Item 5 – Market Outlook and Economic Update

- The Inherited Conditions
- The Trump Agenda
- Outlook for Rates and Spreads
- Return and Strategy Implications

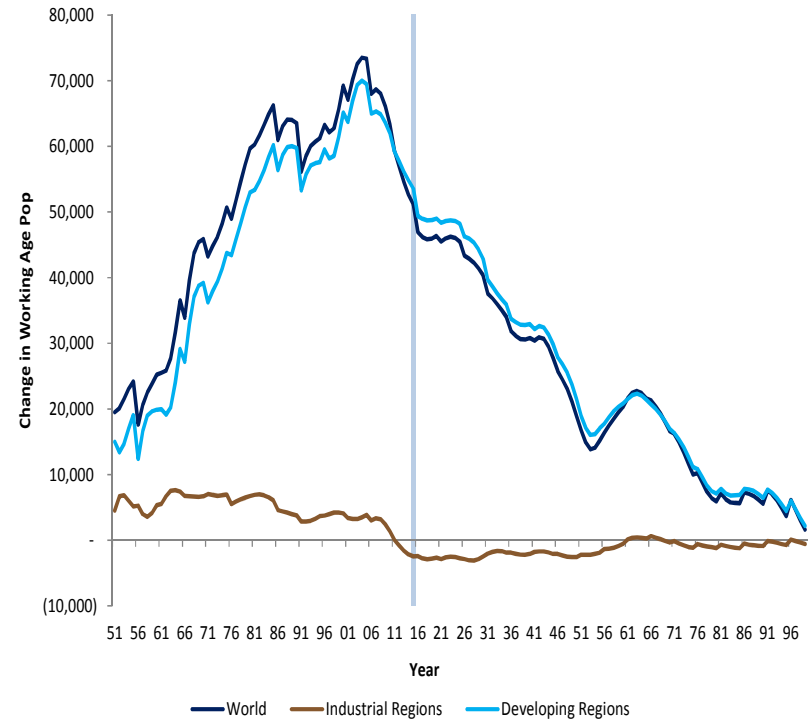
# Inherited Conditions – Debt & Demographics



## Domestic Debt to GDP



## Working Age Population Change



Source: ESTAT/ CAO/ ONS/ BEA/ Haver/ NEAM

Source: UN/ Haver/ NEAM. Industrial Regions: Europe & North America plus Japan, Australia & New Zealand. Developing Regions: All regions of Africa, Asia (ex Japan), Latin America, and the regions of Melanesia, Micronesia and Polynesia.

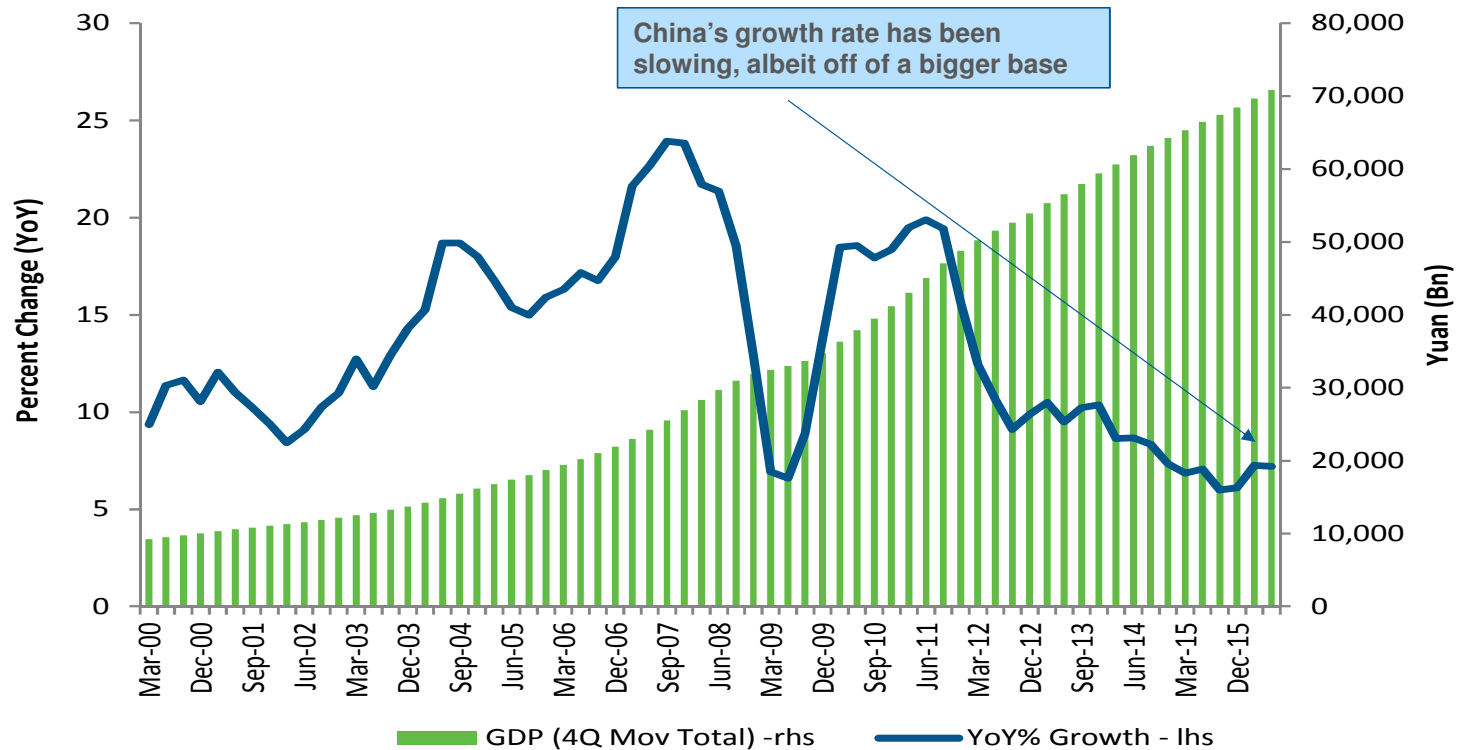
Partnership at Work™

Proprietary & Confidential | ©2017 New England Asset Management, Inc. |

# Inherited Conditions - China Slowdown



## GDP Growth



Source: CNBS/ Haver/ NEAM

Partnership at Work™

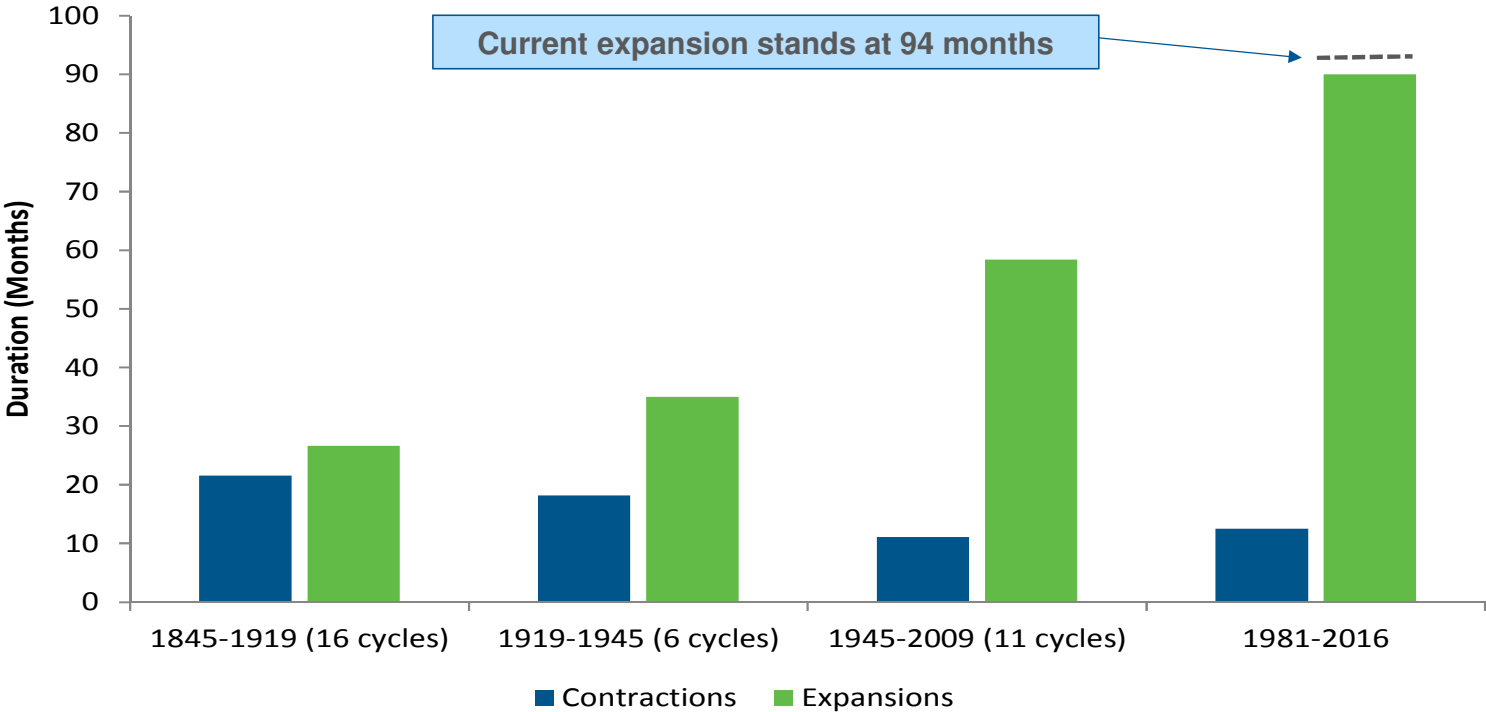
Proprietary & Confidential | ©2017 New England Asset Management, Inc. |

State Compensation Insurance Fund  
 Investment Committee – May 18, 2017  
 Open Agenda Item 5 – Market Outlook and Economic Update

# U.S. Business Cycle Evolution



**Business Cycles (Expansions and Contractions Over Time)**

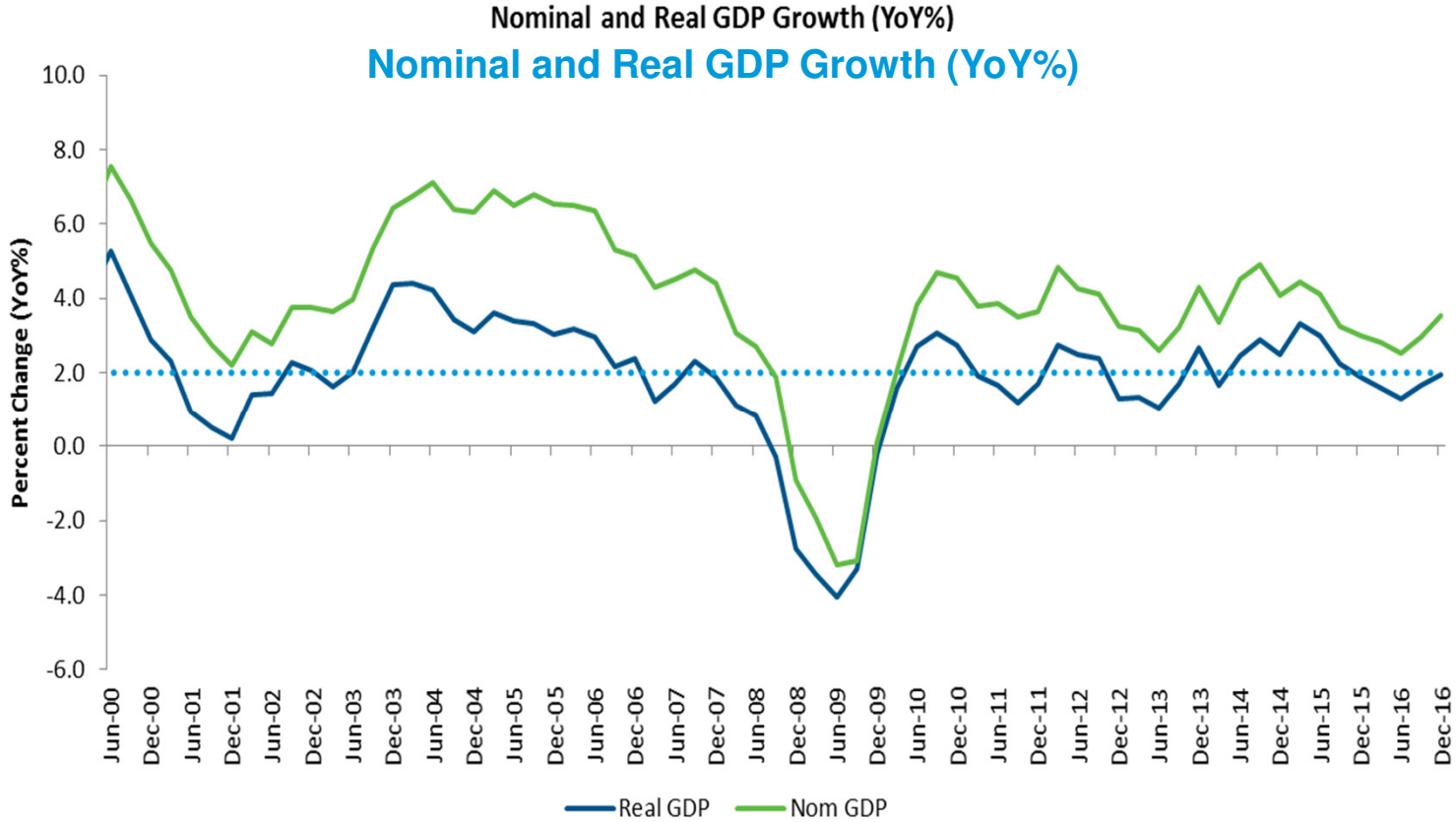


Source: NBER/ NEAM

Partnership at Work™

Proprietary & Confidential | ©2017 New England Asset Management, Inc. |

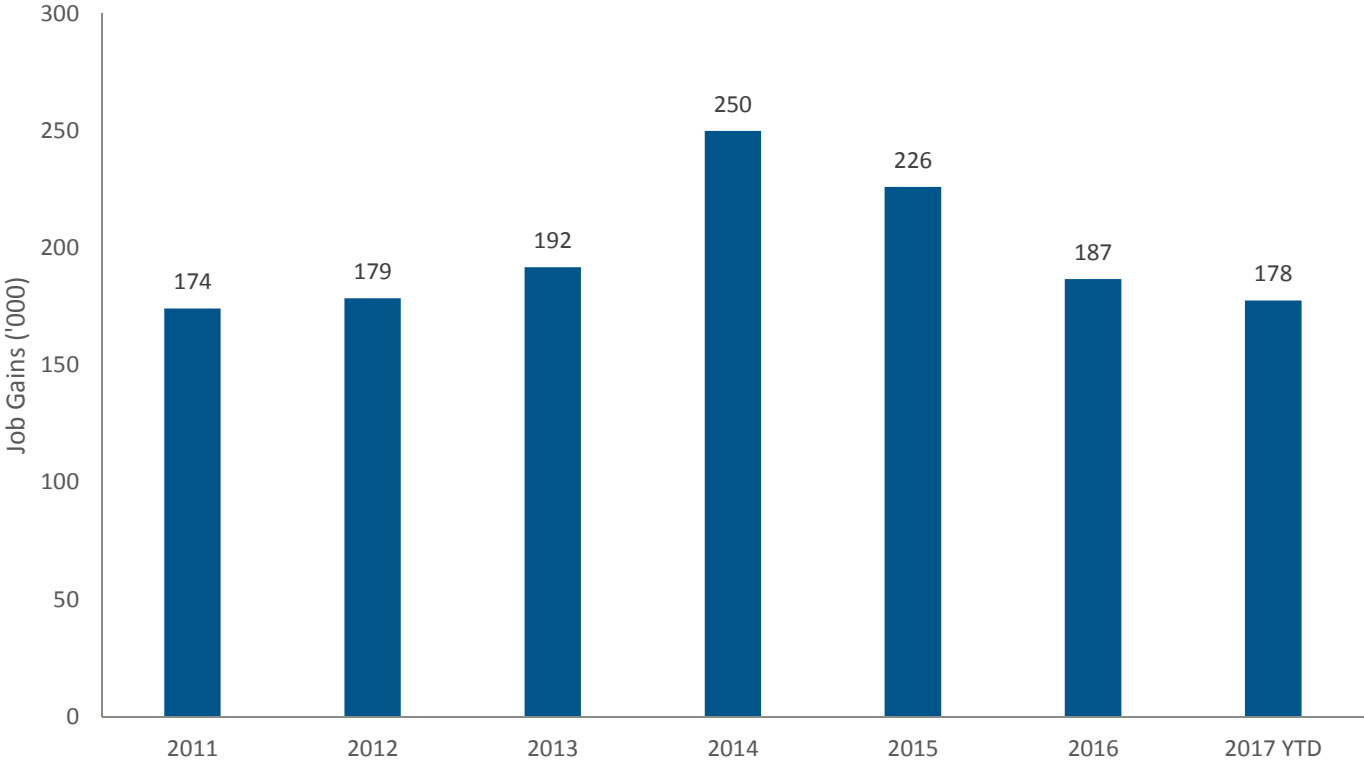
# U.S. GDP Growth



# U.S. Payroll Growth Still Solid, But Has Peaked



### U.S. Monthly Average Payroll Gains



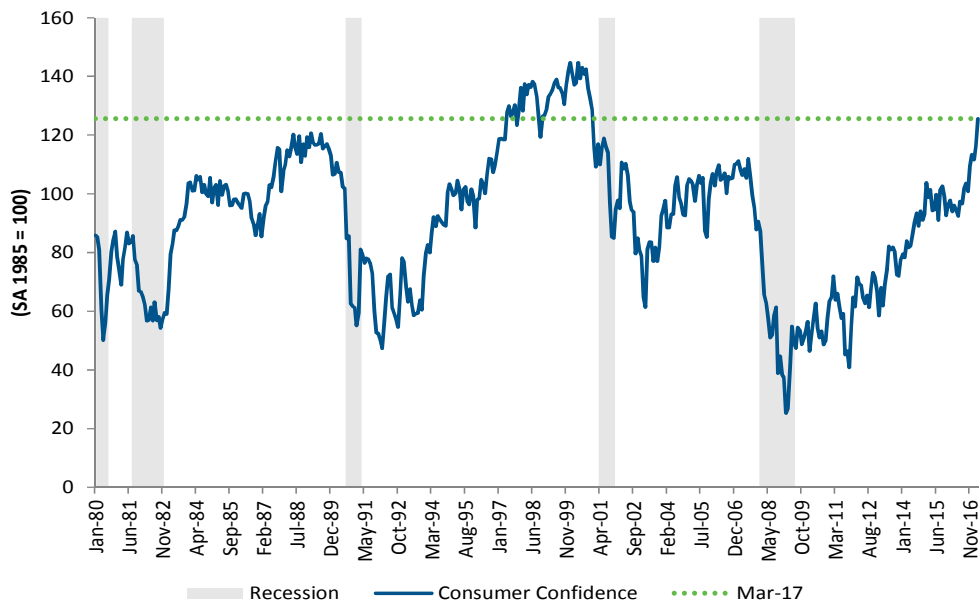
Source: BLS, Haver, NEAM

Partnership at Work™

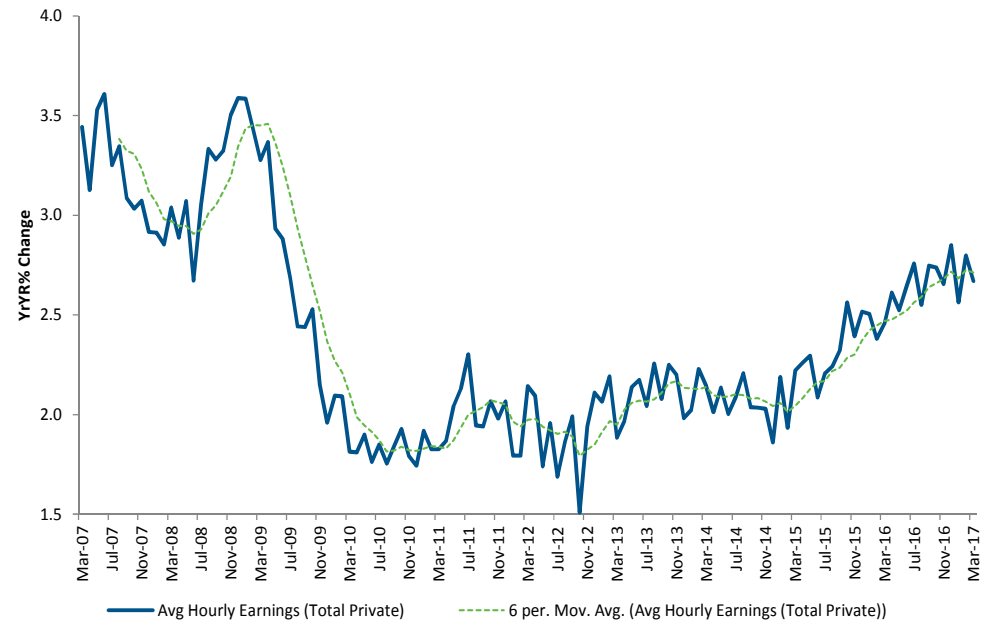
Proprietary & Confidential | ©2017 New England Asset Management, Inc. |



## Consumer Confidence



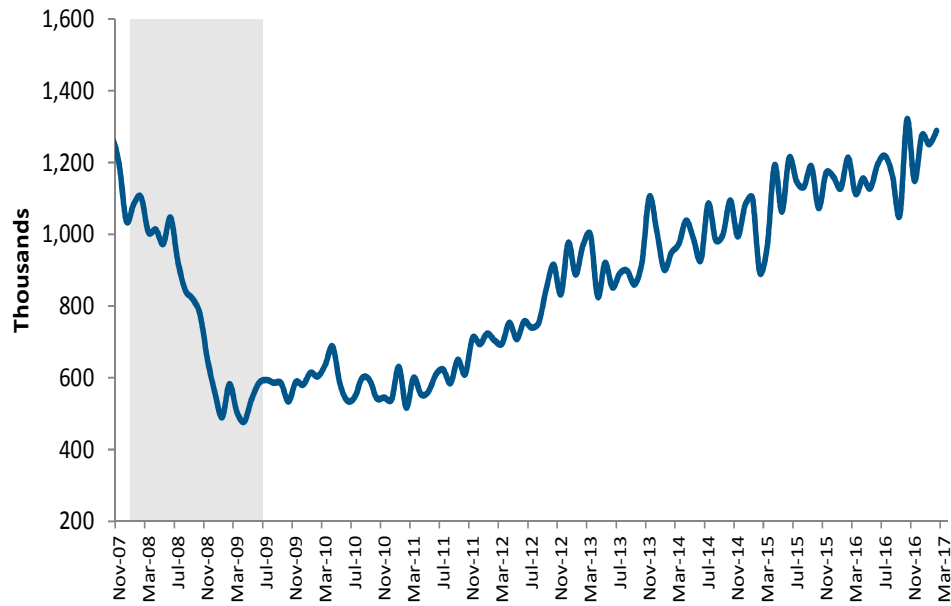
## Average Hourly Earnings



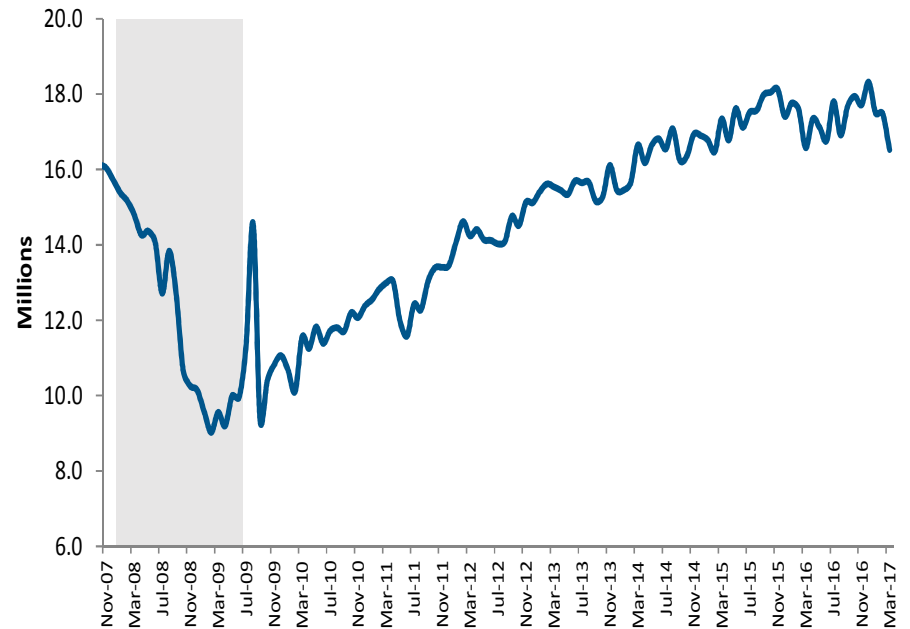
# Sales of “Big Ticket” Items in U.S.



## Housing Starts



## U.S. Auto Sales



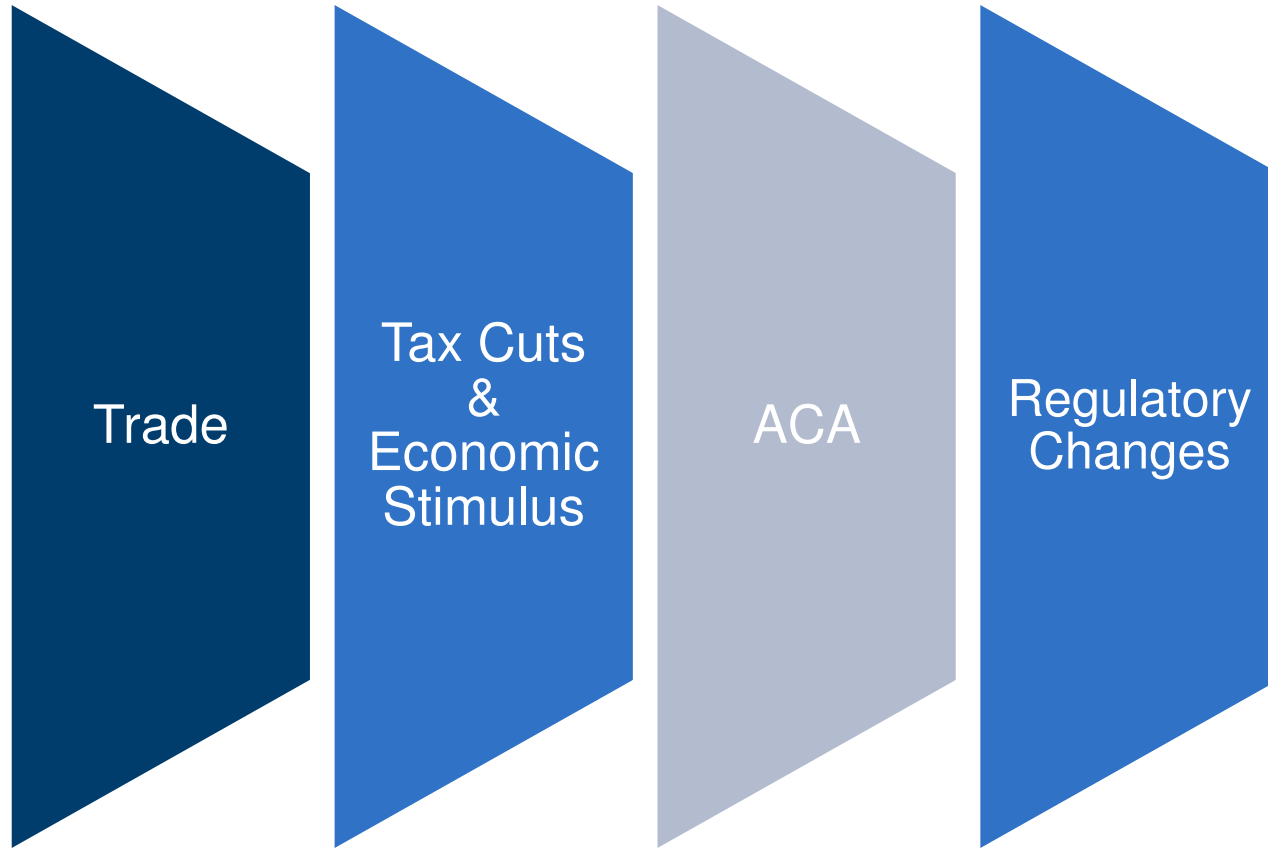
Source: Census Bureau/ BEA/ NBER/ Haver/ NEAM

Partnership at Work™

Proprietary & Confidential | ©2017 New England Asset Management, Inc. |

State Compensation Insurance Fund  
 Investment Committee – May 18, 2017  
 Open Agenda Item 5 – Market Outlook and Economic Update

# Trump - Priorities Year One



# Trump – First Days

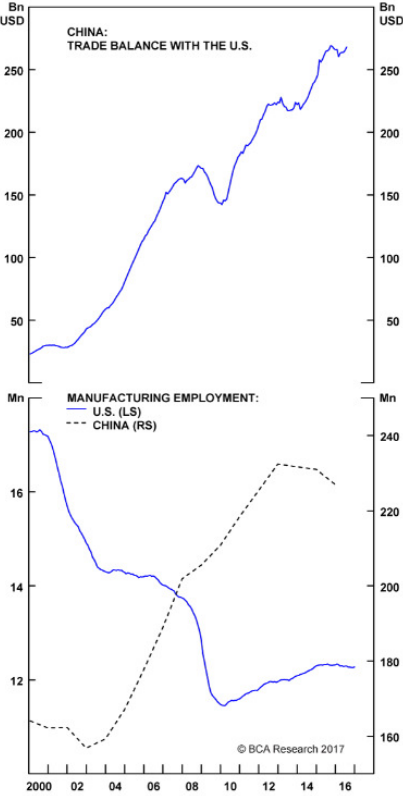
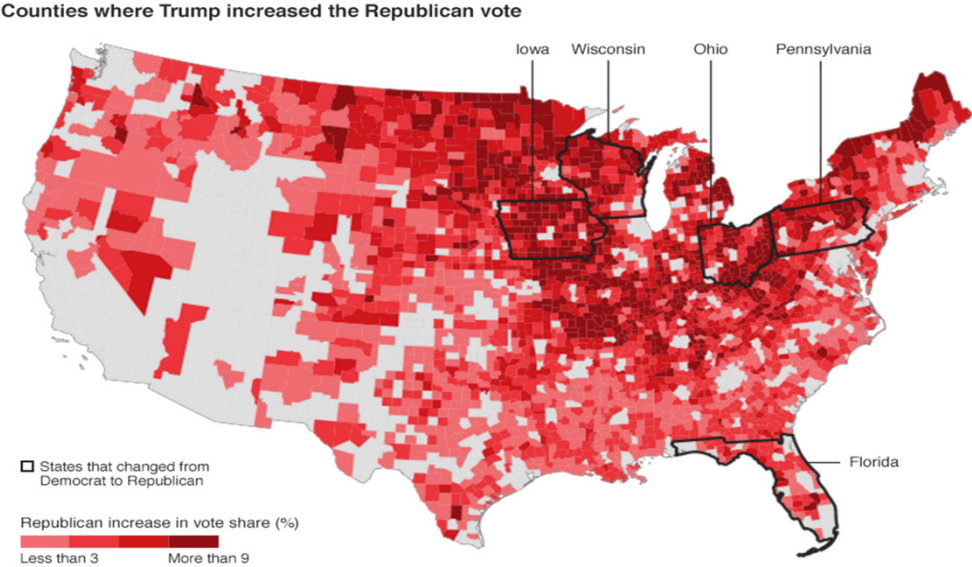


Partnership at Work™

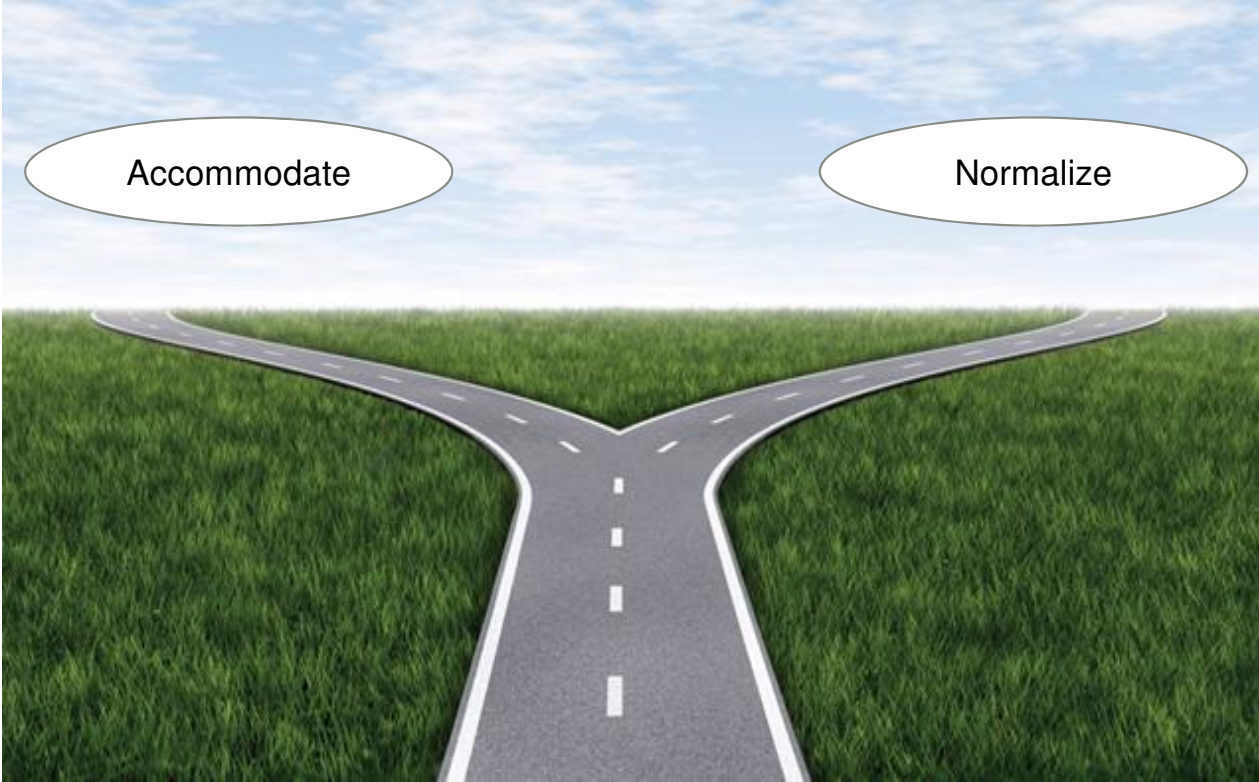
Proprietary & Confidential | ©2017 New England Asset Management, Inc. |

State Compensation Insurance Fund  
Investment Committee – May 18, 2017  
Open Agenda Item 5 – Market Outlook and Economic Update

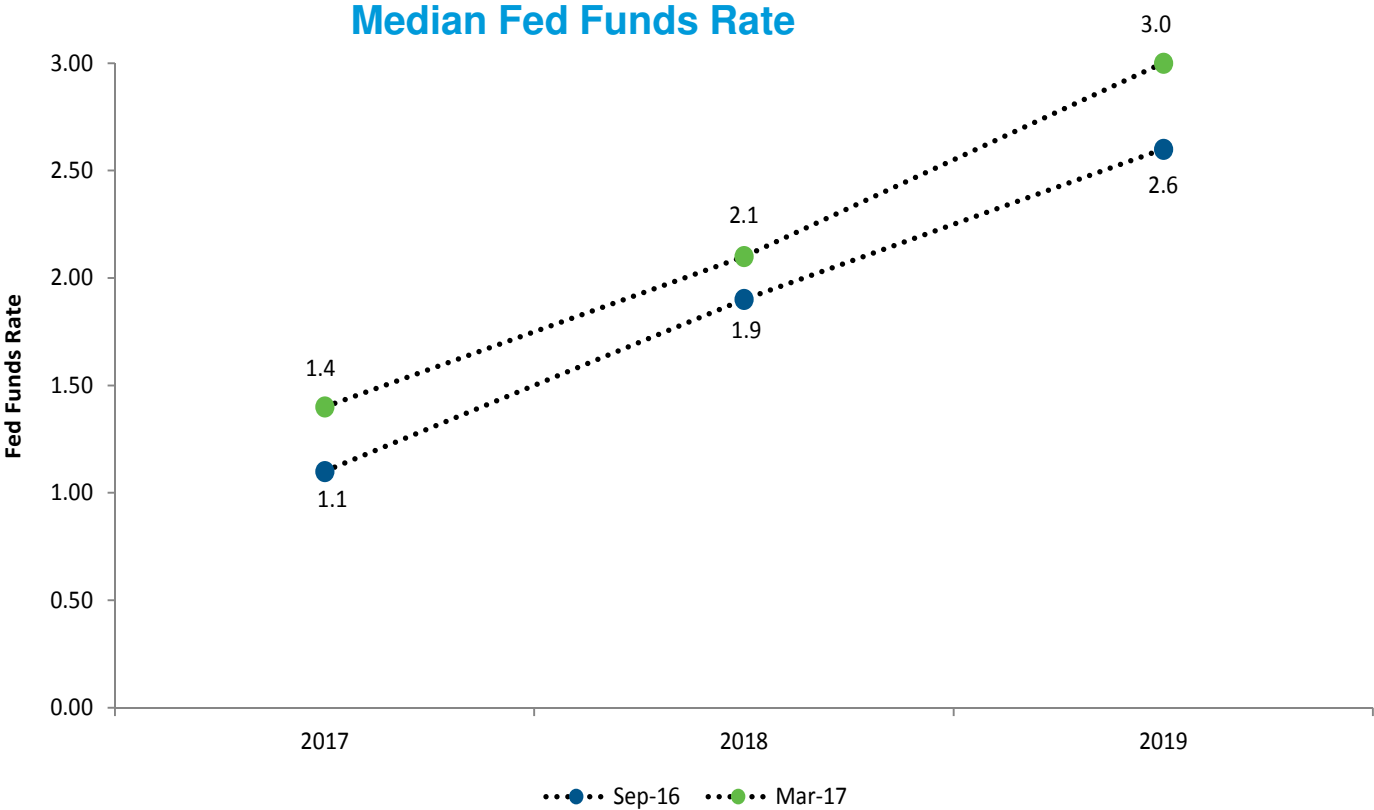
# Election Demographics



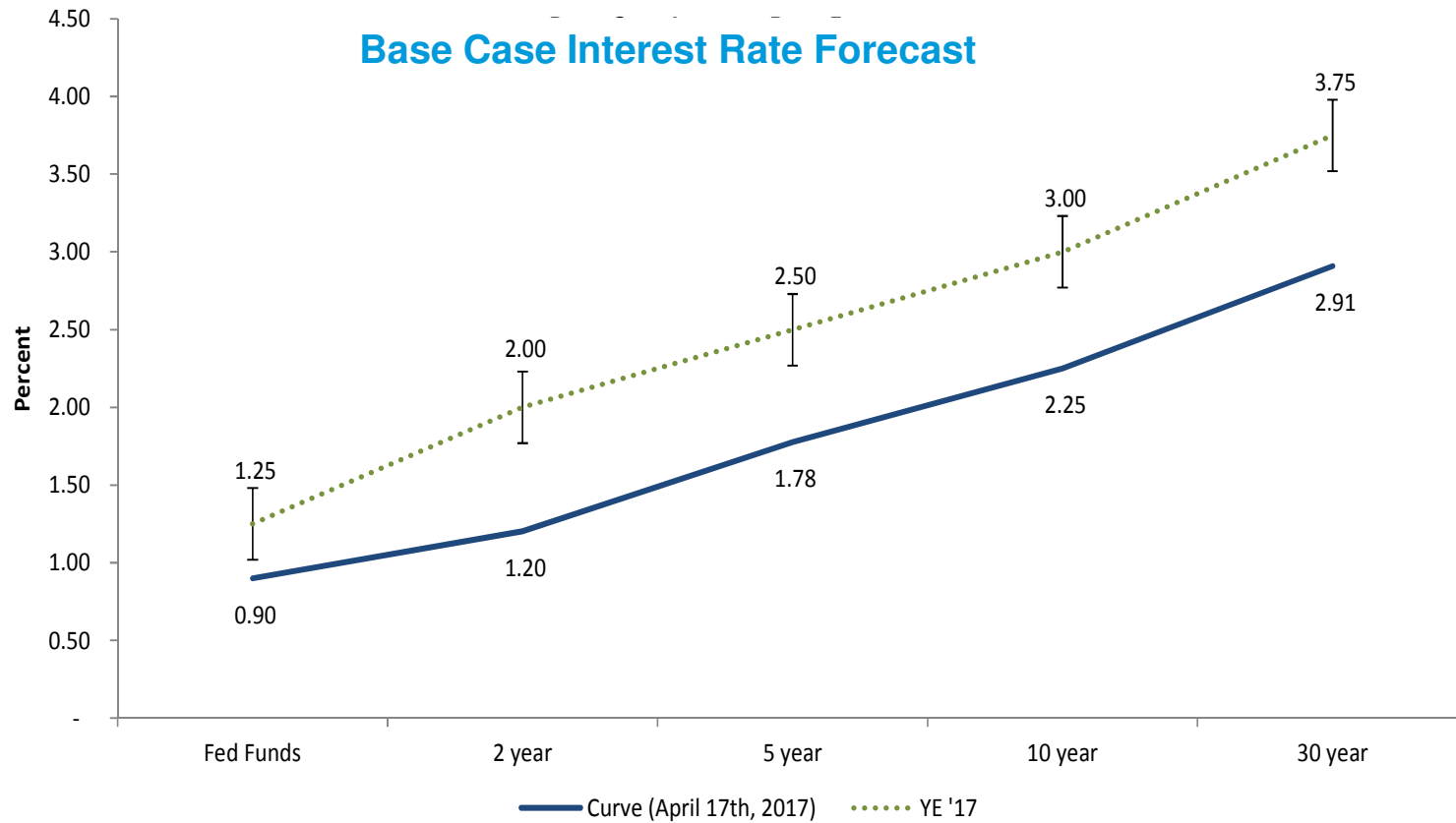
# Central Bank Policy Divergence



# Median Fed Funds Rate



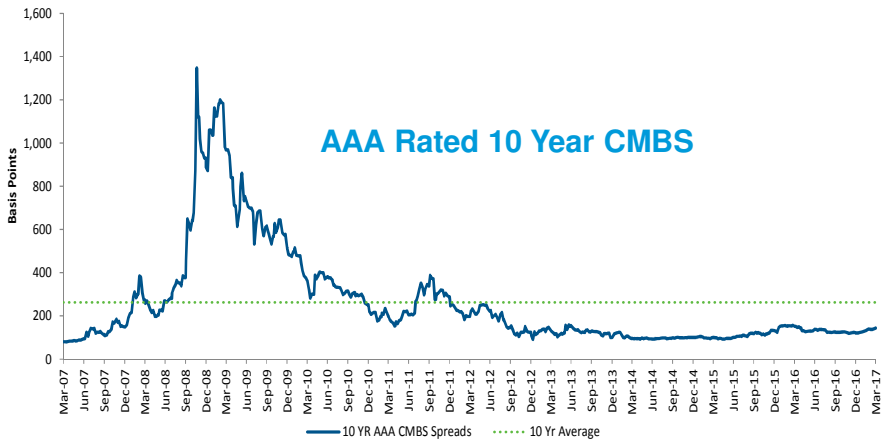
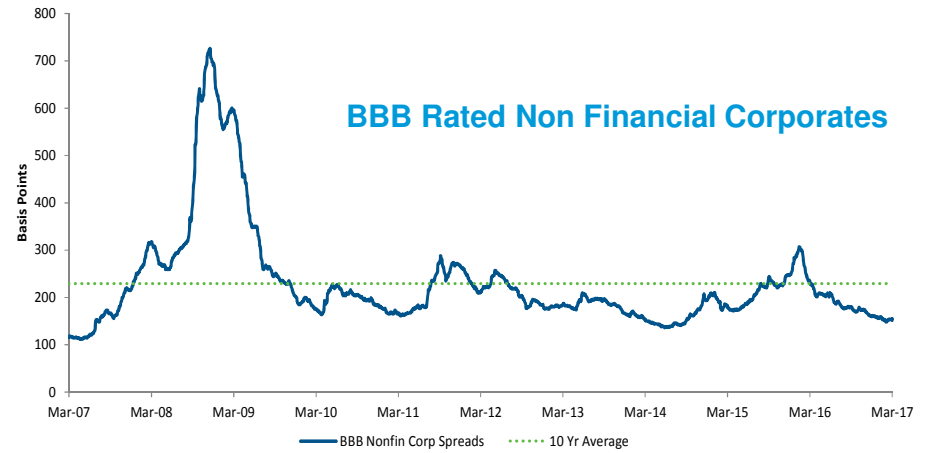
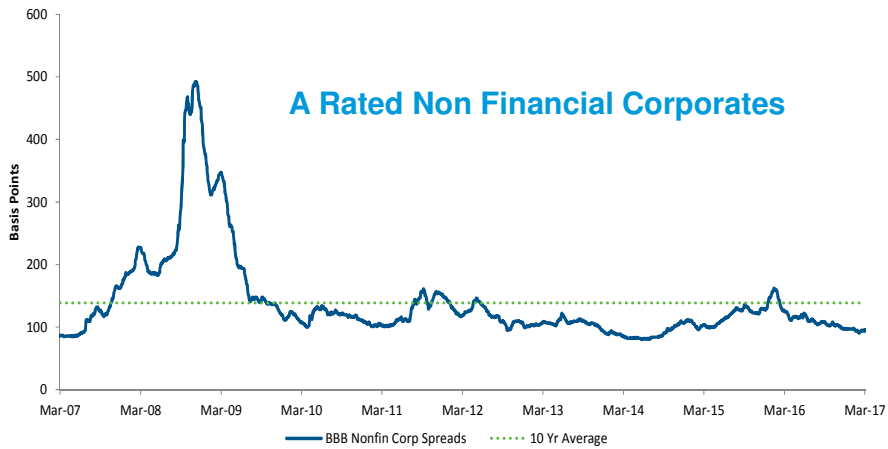
# Interest Rate Forecast



Source: NEAM



# Fixed Income Market Spreads



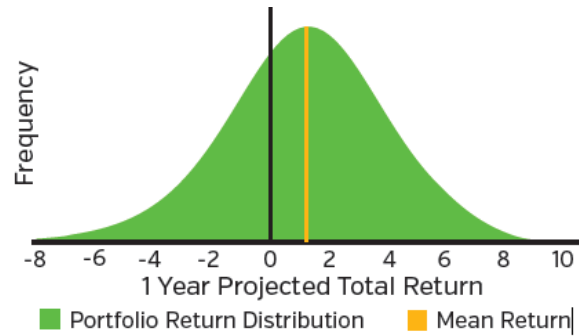
# Projected Returns – P&C Industry Fixed Income Portfolios

Projected 1-Year Horizon Return (%) – Market Value Basis									
			Interest Rate Shift						
			Lower Rates			NC	Higher Rates		
			-200	-100	-50	0	+50	+100	+200
Spread Change	Wider	Extreme	(1.00)	(3.30)	(4.80)	(6.43)	(8.15)	(9.84)	(13.14)
		Moderate	3.09	0.68	(0.88)	(2.58)	(4.30)	(6.00)	(9.30)
		Benign	6.49	4.00	2.41	0.66	(1.12)	(2.89)	(6.34)
	NC	No Change	8.82	6.26	4.64	2.83	1.01	(0.81)	(4.36)
	Tighter	Benign	9.65	7.04	5.40	3.58	1.73	(0.11)	(3.70)
		Moderate	10.38	7.78	6.13	4.31	2.46	0.61	(3.03)

## Key Takeaways

- NEAM believes 2017 returns will be slightly lower than 2016 returns
- Estimated mean return for 2017 is 1.18%
- Probability of a negative total return is 1 in 3

	P&C Universe Proxy
Mean Expected Return	1.18%
Standard Deviation of Return	2.74%
Probability of Negative Return	31.0%
Yield	2.60%
Effective Duration	4.85



Source: NEAM

# Strategy Implications



- Our base case is for modestly higher interest rates in 2017 and 2018. However, with meaningful policy change on the table, we also expect volatility around the baseline.
- Our fixed income portfolio strategy in this environment has the following structural elements:
  - ✓ Maintain overall portfolio duration position at target level
  - ✓ Stay overweight the spread sectors
  - ✓ Heightened focus on individual security selection
  - ✓ Dry Powder – Tactically assume defensive yield curve positions
    - Front end yield curve exposure
    - Floating rate securities and amortizing securities
  - ✓ Selectively pare risk positions on strength
  - ✓ Be prepared to take advantage of volatility