Capital Markets Review | 1st Quarter 2017

March 31, 2017

Overview

Global risk assets rallied during the first quarter of 2017, driven largely by continued positive expectations for US fiscal policy, as well as continued improvements in global economic growth and inflation, more broadly. Duration sensitive assets, however, traded with less conviction and direction, as sovereign debt yields of developed economies ended the quarter relatively unchanged. Globally, commodities were mixed, but traded down as a broad category, and the dollar weakened against a trade weighted basket of currencies. Precious metals were supported by the weaker dollar and continuation of low interest rates, and posted positive returns around 11.5%. Oil prices declined during the quarter, as increased US shale production offset production cuts announced by OPEC in November of last year.

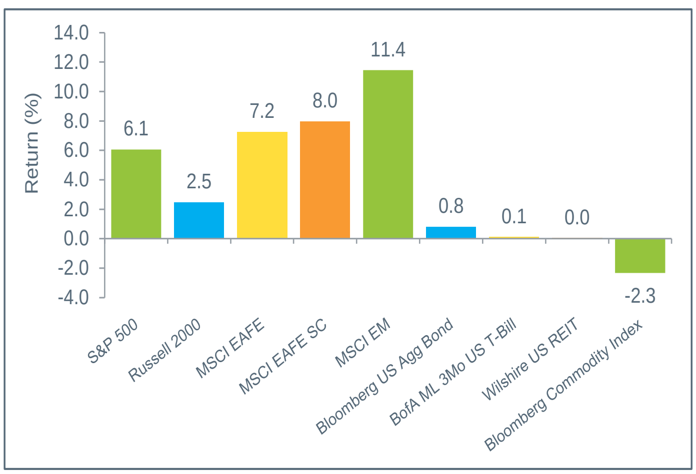
In the US, the new administration provided few details regarding proposed pro-growth policies, which may include infrastructure spending, tax reform, and easing of regulations. Nevertheless, elevated valuations in domestic equity markets suggested that investors anticipate positive changes and are comfortable with near-term equity risk. US economic fundamentals likely supported this positive sentiment, with indicators such as retail sales, ISM PMI, Personal Consumption Expenditures, and Non-Farm Payroll growth posting performance consistent with gradual improvement. This environment also prompted the FOMC to raise policy rates at its March meeting. The Committee cited strengthened labor market conditions and progress toward its inflation objectives as key decision drivers while guiding markets toward two additional rate hikes this year. Even though US rates over the quarter were largely unchanged, the potential for a more hawkish Federal Reserve drove interest rate volatility higher over the period. Specifically, the 2-year Treasury yield reached a multi-year high of 1.37% before trading back to 1.27% at the close of the quarter. The 2Y / 10Y yield spread tightened throughout the period, retracing much of the widening experienced post-election, suggesting a modest decline in longer-run growth expectations. Market implied inflation expectations remained unchanged to marginally higher.

International markets outperformed US domestic markets, largely as a result of the aforementioned improvements in global growth and inflation. That said, emerging markets generally outperformed developed, with market participants reacting to improvements in earnings expectations amidst the backdrop of a marginally weaker US dollar. In Europe, the European Central Bank ("ECB") noted improvements in euro-zone economic fundamentals, highlighting strong business surveys, unemployment rates at a 7-year low of 9.49%, and inflation measures consistent with the ECB's 2.0% target. Though policy rates remained unchanged, ECB President Draghi stated that new supplements to the QE program are increasingly unlikely, which resulted in some relative price action. The Bank of Japan similarly held policy rates steady, but did not suggest that tightening is on the horizon, as the country's core CPI is barely positive at 0.1%.

Trailing Period Market Performance (%)

	QTD	CYTD	1 Year	5 Years	10 Years
S&P 500	6.1	6.1	17.2	13.3	7.5
Russell 2000	2.5	2.5	26.2	12.4	7.1
MSCI EAFE	7.2	7.2	11.7	5.8	1.1
MSCI EAFE SC	8.0	8.0	11.0	9.2	3.0
MSCI EM	11.4	11.4	17.2	0.8	2.7
Bloomberg US Agg Bond	0.8	0.8	0.4	2.3	4.3
BofA ML 3Mo US T-Bill	0.1	0.1	0.4	0.1	0.7
Wilshire US REIT	0.0	0.0	2.0	9.8	4.4
Bloomberg Commodity Index	-2.3	-2.3	8.7	-9.5	-6.2

Quarter-to-Date Performance (%)



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Key Economic Indicators

		As of	12/31/2016	9/30/2016	10 Year Average
Federal Funds Rate	0.82%	3/31/2017	0.55%	0.29%	0.70%
Treasury - 1 Year	1.03%	3/31/2017	0.85%	0.59%	0.76%
Treasury - 10 Year	2.40%	3/31/2017	2.45%	1.60%	2.76%
Treasury - 30 Year	3.02%	3/31/2017	3.06%	2.32%	3.60%
Breakeven Inflation - 1 Year	2.06%	3/31/2017	1.27%	0.95%	0.87%
Breakeven Inflation - 10 Year	1.98%	3/31/2017	1.97%	1.61%	2.00%
Breakeven Inflation - 30 Year	2.09%	3/31/2017	2.10%	1.75%	2.22%
Barclays US Corp: Hi Yld Index - OAS	3.83%	3/31/2017	4.09%	4.80%	6.09%
Capacity Utilization	76.06%	3/31/2017	76.04%	75.64%	76.14%
Unemployment Rate	4.50%	3/31/2017	4.70%	4.90%	7.00%
ISM PMI - Manufacturing	57.20%	3/31/2017	54.50%	51.70%	52.11%
Baltic Dry Index - Shipping	1297	3/31/2017	961	875	2,398
Consumer Confidence (Conf. Board)	125.60	3/31/2017	113.30	103.50	74.61
CPI YoY (Headline)	2.40%	3/31/2017	2.10%	1.50%	1.77%
PPI YoY - Producer Prices	3.70%	3/31/2017	1.90%	-0.10%	1.92%
US Dollar Total Weighted Index	$94	3/31/2017	$96	$90	$79
WTI Crude Oil per Barrel	$51	3/31/2017	$54	$48	$78
Gold Spot per Ounce	$1,249	3/31/2017	$1,152	$1,316	$1,225

Asset Class Commentary

US Equity

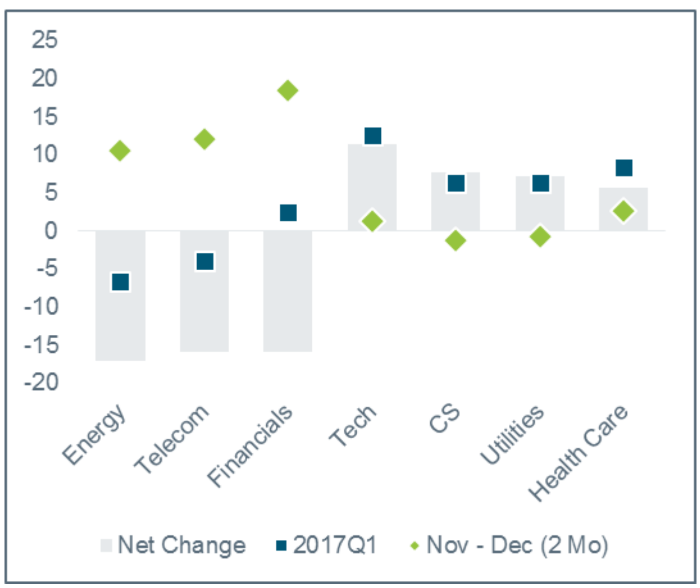
As suggested, US equity markets finished the quarter in positive territory, despite a general slowdown across market caps and styles during March. The Russell 3000 Index returned 5.7% as markets favored large cap, growth-oriented names, as well as momentum and quality factors, largely as a result of expectations for continued improvements in US fundamentals to drive improved corporate earnings.

The technology sector benefitted most notably from this shift, with the Russell 3000 Technology Index posting a return of 12.7%. This marks a notable reversal from the fourth quarter of 2016, which favored small cap, value-oriented names, as well as more economically-sensitive sectors that would have potentially benefited more from fiscal stimulus and easing of regulations versus other sectors of the market.

With investors preferring growth stocks at the expense of value, the Russell 1000 Growth posted strong gains, returning 8.9% versus 3.3% for its value counterpart. Further, large cap outperformed small cap with the Russell 1000 Index returning 6.0% versus 2.5%, and 0.4% for the Russell 2000 and Russell Micro Cap indices, respectively.

Figure 1 shows how sector leadership reversed during the quarter. Specifically, those sectors that performed well post-election on expected fiscal spending have subsequently slowed, while sectors providing stable expectations for corporate earnings, such as technology, consumer staples, utilities, and health care, have rebounded to post strong gains.

Figure 1: S&P 500 Sector Performance



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Finally, as suggested, the first quarter was further marked by strong S&P earnings growth and continued muted volatility. Specifically, the year-over-year earnings growth rate for the S&P 500 was estimated at 9.2% by FactSet, which would mark the highest growth rate since 2011. Combining this with lower levels of stock correlation and investor comfort with market risks led to an environment where active manager performance generally improved over the quarter.

Non-US Equity

In a reversal from last quarter, international equity growth stocks outperformed value in both developed and emerging markets. Similarly, sector leadership rotated from energy to technology, healthcare, and consumer discretionary largely for the same reason as US equities. From a regional standpoint, emerging markets outperformed developed markets with India, Korea, and Mexico all posting mid-teen returns for the quarter. Conversely, commodity sensitive economies such as Canada and Norway lagged notably, returning between 1.0% and 2.0% for the quarter.

Underpinning the positive international equity performance was the expectation, supported by improving economic fundamentals, that the global economy is on more stable footing than previously believed. This was especially true in the UK, where recent economic data showed a steady expansion in the face of potentially leaving the EU Common Market. Other notable political news includes the Dutch election reaffirming the establishment party, which resulted in modest price action. Further, investors will be highly attuned to France and Italian elections during the second quarter, where the outcomes could put the future of either country's participation in the EU Common Market at risk.

Fixed Income

Short-dated global rates continued to be impacted by global central bank policy actions, while longer-dated rates reacted to broader economic developments and expectations for continued, albeit modest, improvements in global growth. Short-dated rate moves were highlighted as providing more attractive opportunities for equivalent duration investors, although longer-dated investors saw the lack of price action alongside minimal credit spread moves as more of a "coupon clipping" quarter. Indeed, the Bloomberg Barclays Aggregate Bond Index returned 0.8% for the quarter, while bond issuance throughout the US, with the exception of municipals and agencies, was comparable to prior quarters.

Upcoming elections in several European countries drove an uptick in volatility for rates markets, despite the steady improvement in economic data. The Citigroup World Government Bond Index (Unhedged) returned 1.6% for the quarter, while the hedged version of the index finished the quarter flat. The JPMorgan EMBI Global Diversified Index, which measures hard currency emerging markets debt, returned 3.9%.

Comparatively, performance for local currency emerging market bonds was driven by appreciation in the Mexican peso, Russian ruble, and Brazilian real. It returned 6.5% for the quarter, as measured by the JPM GBI-EM Global Diversified Index (Unhedged).

Diversified Hedge Funds

Hedge fund strategies provided solid returns during the quarter, as most managers benefitted from lower correlations, less direct monetary policy involvement amidst no measureable changes in fiscal policy, and continued strong equity and credit performance as a result of positive investor sentiment.

Fund of Hedge Funds managers that RVK follows closely generated returns anywhere from 0.5% to 2.0% during the quarter, slightly trailing in aggregate the HFRI FoF Composite Index, whereas multi-strategy funds averaged similar returns near 2.0%, but with wider dispersion across investment managers. Return drivers in these portfolios came largely from fundamental equity and credit strategies, with direct multi-strategy funds additionally benefitting from continued sizeable allocations to merger-arbitrage.

Within long/short equity, prime brokerage data indicates that the first quarter was the best quarter for alpha generation since 2010, as managers were able to capitalize on both long and short sides of portfolios. Attractive opportunities were broad based, as the telecommunications, financials, consumer, and materials sectors proved to be particularly fertile ground for alpha generation.

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Generally, risk appetite appears to be improving across the broader hedge fund industry, as evidenced by rising levels of gross exposure across long/short equity, multi-strategy, and macro hedge fund strategies. Further, peer group based indices point to equity managers generating the strongest returns during the quarter. However, distressed debt managers continued to lead the way over the trailing 12-month period by posting returns near 20%.

Not all hedge fund sectors performed as well, however, with broad macro strategies largely posting negative performance over the quarter. The lack of unanticipated central bank activity over the quarter, and fairly benign rate and currency moves, likely played a factor in the underperformance.

Global Tactical Asset Allocation ("GTAA")

Most GTAA managers outperformed an undiversified and static 60/40 portfolio of US large cap equity and US fixed income. Managers that held to disciplined value-oriented processes, especially those with fewer constraints on emerging market allocations, outperformed peers. US-oriented strategies, especially those with biases toward income-oriented exposures, moderately underperformed both traditional long-oriented GTAA managers and a static 60/40 allocation. This occurred as income oriented sectors, including REITs and MLPs, slightly underperformed US and global equities for the quarter.

Macro-discretionary strategies lagged the furthest due to a weakening of the US dollar and Japanese yen against major currencies, in spite of positive contributions from relative value interest rate positions. Risk parity managers underperformed a static 60/40 portfolio over the quarter, largely due to lackluster performance in commodities, but nevertheless remained near the median performance of traditional GTAA managers.

Diversified Inflation Strategies (Real Return)

Inflation sensitive markets provided divergent performance in a quarter characterized by little change to long-term inflation expectations. This was evidenced by the breakeven inflation markets, as measured by the difference between nominal Treasuries and Treasury Inflation Protected Securities ("TIPS"), ending the quarter largely unchanged.

That said, over the quarter, several managers with allocations to economically sensitive subsets of the infrastructure asset class (such as toll roads, airports, and rail transport) performed well as these sectors continued to outperform. Managers with heavier exposure to commodities, REITs, and natural resources underperformed, while those with significant TIPS allocations, who structurally avoid natural resource exposure, performed toward the midpoint of the group during the quarter.

Real Estate

Despite a few modest signs of softening in the market, such as more favorable lease terms and concessions, the residential and commercial real estate markets continued to be supported by a generally positive outlook for US economic growth.

After posting strong returns in 2016, the industrial sector reversed course and finished slightly negative for the quarter. However, much of the investment thesis remains intact for industrial real estate assets in 2017. The supply of industrial space continued to be absorbed at-or-above market rates by demand for 30 foot clear height, as well as increased presence of e-commerce retailers servicing "last mile" locations, and demand from small businesses for appropriate space.

Investors in public real estate markets regained ground that was lost in the fourth quarter of 2016, as the FTSE/NAREIT All REITs Index returned 3.0% for the quarter. Core real estate investors entered 2017 with continued expectations that income returns would represent the majority of the total return, as opposed to prior years where capital appreciation returns were the primary driver. As evidence, the Core index, NCREIF-ODCE, returned 1.8% (preliminary basis) during the quarter with income returns accounting for 1.1%.

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