RVK

Capital Markets Review | 2nd Quarter 2018

June 30, 2018

Overview

The US dollar strengthened significantly relative to a trade weighted basket of currencies during the second quarter of 2018, reversing a trend of weakening that began over a year earlier. This tightening dollar liquidity environment and the escalating trade tensions between the United States and its global trading partners put significant pressure on non-US assets. Emerging market equities fell 8.0% during the quarter, and local currency-denominated emerging market debt fell more than 10.0%. Developed international equities also declined, further exacerbating losses experienced in Q1. As has often been the case over the last several years, US equities were a bright spot. The heightened equity market volatility that characterized the first quarter of 2018 softened to a degree during Q2, as the S&P 500 produced three straight months of positive returns. US high yield credit markets produced positive returns as well, though the investment grade market declined as the yield curve flattened.

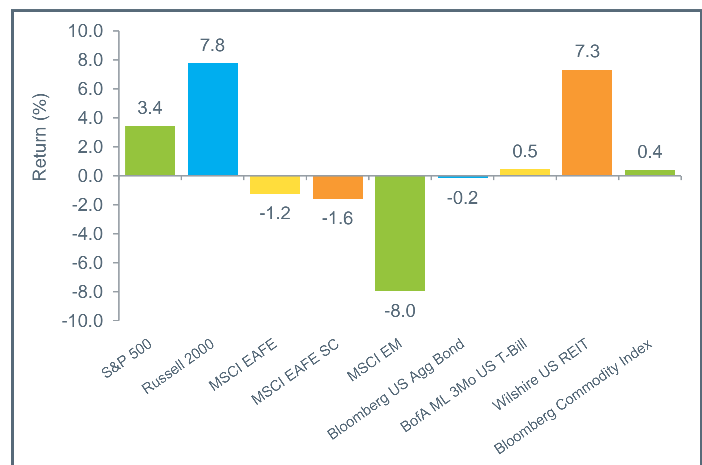
Economic data released during the quarter continue to indicate a strong economic expansion in the United States. According to the Bureau of Economic Analysis, first quarter GDP grew at an annual rate of 2.0%. The GDP Nowcast, an indicator tracked by the Federal Reserve Bank of Atlanta to measure GDP growth in real time, recently forecasted second quarter GDP growth of nearly 4.0%. The labor market remains strong as well. Though unemployment rose to 4.0% during the quarter from its recent lows of 3.8%, the increase was largely tied to a rise in labor force participation. Non-farm payroll growth averaged in excess of 210,000 jobs per month during the quarter. Despite what appear to be relatively tight labor market conditions, wage growth has remained subdued. With this backdrop, the Federal Open Market Committee ("FOMC") raised the Federal Funds rate to a range between 1.75% and 2.00% during its June meeting. The continued robust US economic activity also flowed through to heightened expectations for additional interest rate increases. By quarter-end, the market implied an over 50% probability of the FOMC raising the rate for a fourth time this year at its December meeting.

In other developed markets, the European Central Bank ("ECB") projected slowing economic growth from 2.5% in 2017 to 1.7% by 2020, while Japan forecasted growth of 1.5% for fiscal year 2019, indicating more optimism than the average economist forecast of 0.8%. Despite signs of slowing growth in Europe, the ECB confirmed its plan to reduce its bond buying with a target to halt purchases by December while likely keeping the deposit rate of -0.04% steady until mid-2019. The Bank of Japan also confirmed that its deposit rate would remain unchanged at -0.01% while committing to continued asset buying.

Trailing Period Market Performance (%)

	QTD	CYTD	1 Year	5 Years	10 Years
S&P 500	3.4	2.6	14.4	13.4	10.2
Russell 2000	7.8	7.7	17.6	12.5	10.6
MSCI EAFE	-1.2	-2.7	6.8	6.4	2.8
MSCI EAFE SC	-1.6	-1.3	12.4	11.3	6.8
MSCI EM	-8.0	-6.7	8.2	5.0	2.3
Bloomberg US Agg Bond	-0.2	-1.6	-0.4	2.3	3.7
BofA ML 3Mo US T-Bill	0.5	0.8	1.4	0.4	0.4
Wilshire US REIT	7.3	-0.7	1.6	7.9	7.6
Bloomberg Commodity Index	0.4	0.0	7.3	-6.4	-9.0

Quarter-to-Date Performance (%)



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Key Economic Indicators

		As of	3/31/2018	12/31/2017	10 Year Average
Federal Funds Rate	1.91%	6/30/2018	1.67%	1.33%	0.37%
Treasury - 1 Year	2.33%	6/30/2018	2.09%	1.76%	0.54%
Treasury - 10 Year	2.85%	6/30/2018	2.74%	2.40%	2.55%
Treasury - 30 Year	2.98%	6/30/2018	2.97%	2.74%	3.38%
Breakeven Inflation - 1 Year	1.42%	6/30/2018	2.24%	0.85%	0.75%
Breakeven Inflation - 10 Year	2.13%	6/30/2018	2.06%	1.98%	1.95%
Breakeven Inflation - 30 Year	2.12%	6/30/2018	2.07%	2.02%	2.14%
Barclays US Corp: Hi Yld Index - OAS	3.63%	6/30/2018	3.54%	3.43%	5.90%
Capacity Utilization	77.86%	5/31/2018	77.19%	77.07%	75.70%
Unemployment Rate	4.00%	6/30/2018	4.10%	4.10%	6.91%
ISM PMI - Manufacturing	60.20%	6/30/2018	60.80%	58.20%	53.07%
Baltic Dry Index - Shipping	1,385	6/30/2018	1,055	1,366	1,544
Consumer Confidence (Conf. Board)	126.40	6/30/2018	130.00	128.60	79.13
CPI YoY (Headline)	2.90%	6/30/2018	2.20%	2.20%	1.60%
PPI YoY - Producer Prices	4.00%	6/30/2018	2.70%	4.20%	1.58%
US Dollar Total Weighted Index	$90	6/30/2018	$86	$87	$81
WTI Crude Oil per Barrel	$74	6/30/2018	$65	$60	$74
Gold Spot per Ounce	$1,253	6/30/2018	$1,325	$1,303	$1,286

Asset Class Commentary

US Equity

US equity markets delivered positive results across all market caps and styles for the quarter. The S&P 500 Index returned 3.4%, buoyed by strong performance in the energy sector as oil prices continued to rise throughout the quarter. Continuing a first quarter trend, the technology and consumer discretionary sectors also drove market performance as the S&P 500 Technology and Consumer Discretionary Indices returned 7.1% and 8.2%, respectively.

Increasing global trade tension pushed investors toward the more domestically-oriented small and micro cap segments of US equity markets and away from larger cap, multinational companies. Passive ETF flows into the small cap space amassed upon global trade concerns as investors sought insulation, as well as the opportunity to invest in a segment expected to be more directly supported by the recent tax reform. As a result, active management in the small cap space faced challenges during the quarter as low quality, lower cap, non-earning stocks outperformed as the positive flows lifted less-liquid areas in the small cap segment.

Despite positive performance across large cap indices, macroeconomic headwinds weighed on returns during the quarter. Active large cap growth and value managers generally fared well as secular growth trends and continued strong corporate earnings provided a positive stock-picking environment.

Value outperformed growth in small cap, while growth continued to outperform value in large cap. Further, momentum and growth continued their first quarter leadership, while low volatility and high dividend stocks notably reversed as the S&P 500 Low Volatility High Dividend Index returned 5.1% versus its first quarter return of -1.1%.

Non-US Equity

Developed international markets struggled again, ending the quarter in negative territory. While growth stocks were slightly positive, value stocks brought down the overall market. Small cap stocks fared worse than large cap stocks. Improved growth forecasts for the European Union (“EU”) leading into this year have given way to reduced forward expectations for economic growth. Complicating forecasts have been a number of temporary factors weighing on the EU, such as weather, strikes, and political turmoil.

Emerging markets had a challenging quarter, by far the worst performing equity asset class this year as fears of an impending trade war and a strengthening US dollar rattled investor confidence. Growth stocks outperformed value, continuing the trend across most equity markets. Additionally, large cap stocks outperformed small cap

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stocks. Despite being a target of protectionist trade measures, China was one of the best performing countries within the space. From a sector perspective, technology stocks continued to dominate, now representing almost 30% of the MSCI Emerging Markets Index.

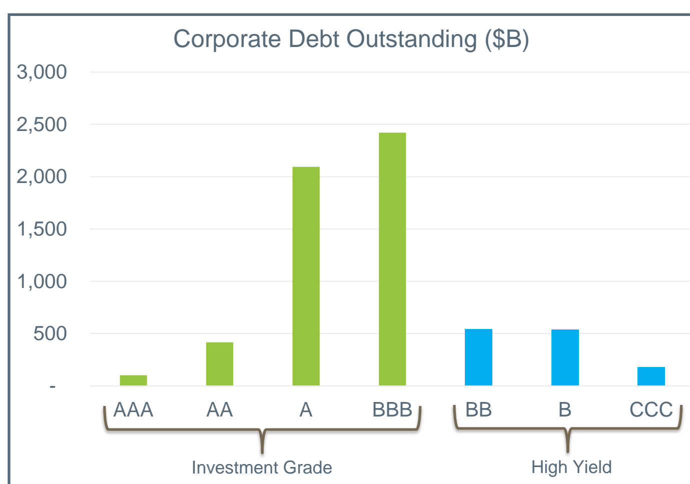
Fixed Income

The Bloomberg Barclays US Aggregate Index returned -0.2% as interest rates slightly increased and the Treasury yield curve flattened during the quarter.

The option-adjusted spread on investment grade corporate bonds increased from 1.17% to 1.30%. Conversely, high yield bonds, which have a higher concentration toward energy issuers, saw spreads narrow slightly as oil prices continued to rise. Accordingly, the Bloomberg Barclays US Corporate Investment Grade Index returned -1.0% for the quarter and underperformed the Bloomberg Barclays Corporate High Yield Index which returned 1.0%.

The proportion of BBB-rated bonds within the Bloomberg Barclays US Corporate Investment Grade Index has steadily grown from 34% to 48% over the last 10 years. The significant size of the BBB-rated corporate bond space as represented in **Figure 1** could profoundly affect both investment grade and high yield markets if a wave of downgrades were to occur. Relatedly, in conversations with investment managers over the past few quarters a general trend of de-risking through the rotation out of BBB-rated securities has been observed.

Figure 1: BBB-Rated Corporate Bonds



Source: Bloomberg Barclays

The JP Morgan GBI-EM Global Diversified Index returned -10.4% for the quarter representing the second worst quarter for local currency emerging market debt since the creation of the index in 2003. A confluence of factors led to such a large loss in emerging market debt including the strengthening of the US dollar, turmoil in Turkey and Argentina, and escalating trade wars which have led to increasing import tariffs globally.

Diversified Hedge Funds

Hedge funds produced marginally positive returns during the second quarter, building on the gains realized in Q1. The Funds of Hedge Fund ("FoHF") strategies RVK follows closely saw returns between 0.0% and 2.0%, and are generally up between 1.0% and 4.0% in 2018. Most FoHF managers have lowered net exposures and rotated away from traditional strategies such as long/ short equity in favor of more diversifying exposures. Those that have generated strong returns year-to-date tend to have exposure to one or more top performing discretionary macro strategies, and have generated strong alpha within their remaining traditional long/short equity buckets. Managers that have significant systematic macro or managed futures exposure have suffered as those strategies remain largely negative year-to-date. Within long/short equity specifically, alpha generation during the second quarter deteriorated somewhat relative to the first quarter, though it was still modestly positive according to prime brokerage data. Short rallies in May and June in particular made for a tougher stock picking environment and several managers suffered as a result. Still, the HFRI Equity Hedge Index is up 1.2% YTD through June, and the managers RVK follows closely have generally produced returns above this benchmark.

The second quarter was also positive for the multi-strategy hedge fund managers tracked by RVK, with returns across several strategies buoyed by performance from merger-arbitrage, as several large strategic deals closed during June. At an industry level, hedge funds have been reducing gross leverage since it reached its highs in mid-February. Net leverage has come down as well, a phenomenon which is particularly acute within multi-strategy and macro funds, where net exposures across prime brokerage desks fell from an average of 51% in May to just 29% in June.

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Global Tactical Asset Allocation ("GTAA")

GTAA managers mostly provided negative returns in the second quarter and most dramatically underperformed a static, US-centric 60/40 portfolio of stocks and bonds. Globally-oriented managers that rely on fundamental value based investment processes have increasingly allocated to emerging markets exposures, which are believed to be undervalued across asset classes. This positioning was a significant detractor during the quarter, as strong gains in the US dollar resulted in added pressure to certain emerging economies, leading to a difficult quarter for emerging markets equities and currencies. In developed markets equity allocations, these managers' value orientations also detracted as value stocks underperformed their growth counterparts in developed international equity and in the US. Yield-oriented and US-biased managers also lagged a static 60/40 US-centric portfolio, but placed near the top of the peer group due to strong returns in the MLP and REIT sectors which rebounded after a difficult first quarter. Risk parity managers performed relatively strongly compared to most other multi-asset peers given performance tailwinds from inflation sensitive asset classes including TIPS and commodities.

Diversified Inflation Strategies ("DIS")

DIS portfolios mostly provided strong returns in the second quarter as inflationary pressures persisted. Headline CPI increased to 2.90% YoY as of the most recent June release, and the spot price for West Texas Intermediate crude oil rose nearly 14% to $74 per barrel over the quarter. In response, most other inflation-sensitive asset classes provided strong performance led by asset classes such as US REITs, energy related exposures in commodities, natural resources equities, MLPs, and global listed infrastructure. Although performance among DIS managers diverged widely, most provided positive returns that outpaced a US-centric 60/40 portfolio of stocks and bonds. One exception relates to managers who have allocated heavily to emerging markets currencies in an effort to provide potential offset to US inflation. Those positions led to some of the widest manager underperformance relative to peers over the quarter. Additionally, managers that relied on positions in TIPS while short-selling nominal Treasuries to control duration (commonly referred to as a breakeven trade) generally underperformed managers with more long-only exposure to inflation sensitive asset classes.

Real Estate

The core private real estate index, NCREIF-ODCE, returned 2.0% (on a preliminary basis) during Q2, comprised of 1.0% income and 1.0% appreciation. This represented a slight decrease compared to last quarter's appreciation component of total return. Investors in publicly traded real estate significantly outperformed their private market counterparts during the quarter as measured by FTSE/NAREIT All REITs Index return of 8.3%. The storage and lodging sectors led a dramatic turnaround from the previous quarter when the index returned -6.7%.

Real estate valuations remain elevated, supported by continued strength in the overall economy with increases from personal consumption and business investment. The potential for increased discretionary spending by consumers due to the recent tax reform has been cited as additional support for valuations in this asset class.

During Q2, investors in private real estate continued to see modest returns and are placing increasing importance on the income component of total return. Outside of the continued expansion in the industrial sector, valuation improvements are expected to be driven by assets that can improve net operating income results rather than relying on cap rate compression to drive property valuation.

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