Capital Markets Review | 1st Quarter 2021

March 31, 2021

Overview

Vaccination rates in the US outpaced much of the developed world, with 28% of Americans having received a first dose of the vaccine by quarter-end compared to just 11% in the Eurozone and less than 5% in much of Asia. COVID-19 cases and hospitalizations fell considerably from winter highs in the US, as the economy tilted towards reopening. The newly elected Biden administration, finding itself with a slim majority in the Senate after the special election in Georgia, moved quickly to enact the $1.9 trillion American Rescue Plan through the filibuster-proof budget reconciliation process. Following this initial legislative victory, Democrats pivoted to focus on a new infrastructure plan worth as much as $2 trillion, as the Senate Parliamentarian ruled in favor of allowing multiple reconciliation bills in the same fiscal year.

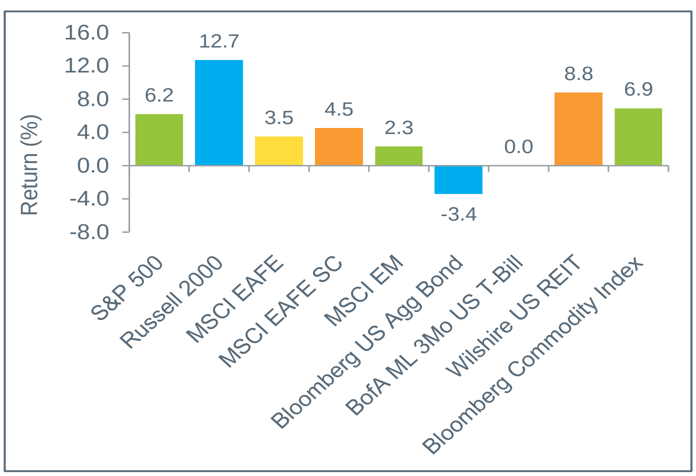
On the monetary policy side, the Federal Open Market Committee (FOMC) reiterated its commitment to average inflation targeting centered around a 2% level during its March meeting, and announced its intent to maintain current asset purchases of at least $120B per month until substantial progress is made toward full employment. The Fed increasingly considers broader measures to determine full employment, as Jerome Powell and members of the FOMC made repeated reference to the employment-to-population ratio in addition to traditional measures such as the unemployment rate. With the reopening in motion and prospects for fiscal stimulus well above the year-end consensus, interest rates on the 10-year treasury bond rose from 0.93% to 1.74% during the quarter, while 5Y/5Y forward inflation expectations rose more modestly from 2.03% to 2.20%. The median member of the FOMC does not anticipate raising interest rates until mid-2024. However, Fed Funds futures markets priced in up to four rate hikes by that time, with the first coming as early as December 2022.

The impact of increasing interest rates rippled through other asset classes. The S&P 500 returned 6.2%, driven primarily by resurgent returns from value stocks, outperforming developed non-US and emerging markets as dollar strength proved a headwind for foreign stocks. Within fixed income, the movement in rates proved challenging as most groups delivered negative returns in Q1 with higher yielding, lower quality issues faring best and producing moderately positive results. Commodity markets continued on an upward trajectory despite the strong dollar environment, buoyed by market expectations for higher global growth. The IMF revised its 2021 forecast for global GDP growth to 6.0% from 5.2% just six months prior. Growth revisions in the US were most significant, as the IMF bumped 2021 US growth expectations to 6.4% in its April release, up from its October estimate of 3.1%. Such optimism for US economic activity was common across forecasters from banks and professional economists. Recent data releases leave room to be optimistic. In March, the unemployment rate fell to 6.0% and non-farm payrolls increased by 916,000. The ISM Manufacturing and Services PMIs came in at 64.7% and 63.7% respectively, the latter of which is an all-time high.

Trailing Period Market Performance (%)

	QTD	CYTD	1 Year	5 Years	10 Years
S&P 500	6.2	6.2	56.4	16.3	13.9
Russell 2000	12.7	12.7	94.8	16.4	11.7
MSCI EAFE	3.5	3.5	44.6	8.8	5.5
MSCI EAFE SC	4.5	4.5	62.0	10.5	8.0
MSCI EM	2.3	2.3	58.4	12.1	3.7
Bloomberg US Agg Bond	-3.4	-3.4	0.7	3.1	3.4
BofA ML 3Mo US T-Bill	0.0	0.0	0.1	1.2	0.6
Wilshire US REIT	8.8	8.8	34.7	5.0	8.5
Bloomberg Commodity Index	6.9	6.9	35.0	2.3	-6.3

Quarter-to-Date Performance (%)



Key Economic Indicators

	Q1 2021	Q4 2020	Q3 2020	10 Year Average
Federal Funds Rate	0.06%	0.09%	0.09%	0.63%
Treasury - 1 Year	0.07%	0.10%	0.12%	0.74%
Treasury - 10 Year	1.74%	0.93%	0.69%	2.12%
Treasury - 30 Year	2.41%	1.65%	1.46%	2.86%
Breakeven Inflation - 5 Year	2.60%	1.97%	1.49%	1.73%
Breakeven Inflation - 10 Year	2.37%	1.99%	1.63%	1.93%
Breakeven Inflation - 30 Year	2.31%	2.00%	1.77%	2.05%
Barclays US Corp: Hi Yld Index - OAS	3.10%	3.60%	5.17%	4.70%
Capacity Utilization	74.40%	74.63%	72.45%	76.54%
Unemployment Rate	6.00%	6.70%	7.90%	6.00%
ISM PMI - Manufacturing	64.70%	60.50%	55.40%	53.86%
Baltic Dry Index - Shipping	2,046	1,366	1,725	1,118
Consumer Confidence (Conf. Board)	109.70	88.60	101.80	97.04
CPI YoY (Headline)	2.60%	1.40%	1.40%	1.73%
PPI YoY - Producer Prices	5.90%	-0.50%	-1.20%	1.20%
US Dollar Total Weighted Index	114.05	111.65	117.35	105.42
WTI Crude Oil per Barrel	$59	$49	$40	$68
Gold Spot per Ounce	$1,708	$1,898	$1,886	$1,413

Asset Class Commentary

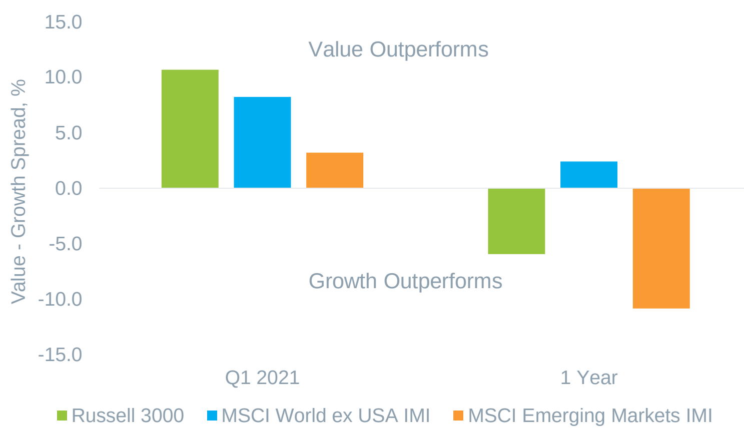
US Equity

US equity markets opened 2021 with solid performance in Q1, driven by the passage of the American Rescue Plan and hopes for a full reopening of the US economy with an ahead-of-schedule vaccine rollout. After poor performance at the start of Q1, the S&P 500 Index bounced back to finish the quarter up 6.2%. The forward P/E ratio of the S&P 500 Index remains above historical levels with investor sentiment supported by expected improvements in company earnings growth compared to the subdued levels reported during 2020.

In Q1, value continued to outperform growth, to a much greater extent than in Q4 2020, across the market capitalization spectrum, while small-cap stocks also significantly outperformed their larger-cap counterparts. During the quarter, the Russell 1000 Value Index returned 11.2% versus 0.9% for the Russell 1000 Growth Index. Similarly, the Russell 2000 Value Index returned 21.2%, compared to 4.9% for the Russell 2000 Growth. The prospect of increased economic activity contributed to strong performance in the energy and financial sectors. Momentum across growth-oriented technology stocks continued to wane due to pressures from relatively elevated valuation levels and a higher discount rate on future cash flows caused by rising Treasury yields.

Figure 1 illustrates the sharp rebound in value stocks in Q1 across regions. However, for the trailing 1 year period, growth stock returns remain higher than their value counterparts within the US and Emerging Markets.

Figure 1: Value-Growth Return Spreads (03/31/2021)



Active manager performance was mixed again in Q1. Mid-cap managers continued their success, with strong positive median manager excess returns across all styles. In the large-cap space, core and growth managers performed well, while value managers struggled to keep up with the strong value stock returns in Q1. Finally, small -cap growth and value managers struggled to outpace their respective benchmarks while small-cap core managers had a strong quarter.

Non-US Equity

While developed international equity lagged the US market in Q1, it did provide positive absolute returns. The rotation into value stocks continued with growth stocks finishing in negative territory. Small-cap stocks also outperformed large-cap stocks. Energy and financials were the best performing sectors while consumer staples and utilities trailed the general market. The majority of the developed countries had positive equity market returns, however New Zealand experienced double digit negative returns as economists forecasted a potential recession in the country. Unlike the US, Europe has seen another rise in infections and vaccine distribution has been slow. Many countries in Asia, developed and emerging, that initially contained the virus have also struggled on the vaccination front. However, the Eurozone purchasing managers' index still gained momentum pointing to increasing economic activity. Median manager performance indicates that active management within the developed non-US space delivered mixed results versus their benchmarks in Q1.

Emerging market equity ended Q1 with positive returns, but underperformed developed markets. Value stocks outperformed growth and small-cap outperformed large, but the spreads between these groups were not as significant as in developed markets. Materials and real estate were the best performers and technology stocks continued to hold up. Negative returns from China weighed on regional performance. Overall, there was significant dispersion by country with Saudi Arabia returning 16.5% while Turkey returned -20.2%. Active management in emerging markets continued to add value in Q1 and median manager excess returns indicate significant alpha production over the last twelve months.

Fixed Income

The Bloomberg US Aggregate Index declined -3.4% in Q1 as Treasury yields rose abruptly. The yield movement was primarily driven by investors reacting to potential inflationary pressure caused by a strong economic recovery supported by better-than-anticipated vaccine distribution in the US, expansive fiscal policy, and pent up consumer demand. The 10-year Treasury yield increased to 1.7% as of March 31, 2021, from an initial level of 0.9% as of December 31, 2020.

The combination of low yields and rising rates created a challenging environment for fixed income. However, sub-investment grade rated debt continued outperforming the broader market, a trend also seen in Q4 2020. The Bloomberg US Credit Index declined -4.5%, while the Bloomberg US High Yield Index returned 0.9% in Q1, largely carried by the lowest quality debt, with Caa-rated debt returning 3.6%.

Emerging market debt faced headwinds during the quarter, particularly debt denominated in local currency, as increased US stimulus and an improving US economy contributed to a strengthening US dollar. Local currency denominated debt as measured by the JPM GBI-EM Global Diversified Index (unhedged) returned -6.7%, underperforming both hard currency and corporate emerging market debt.

Diversified Hedge Funds

Hedge fund returns in Q1 were positive in aggregate, though with considerable dispersion across strategies and trading styles. The HFRI Fund Weighted Composite Index returned 6.1% in Q1, outperforming its asset weighted counterpart, which returned just 2.2% as managers with smaller asset bases took advantage of relative strength in small- and mid-cap stocks. Given the style shifts seen in equity markets, managers with growth tilts lagged peers. Widespread underperformance across the technology, media, and telecom sectors was a persistent theme, while the pandemic recovery story bolstered managers involved in the energy, materials, and financials sectors. Short alpha was particularly challenged, with prime brokerage data pointing to one of the worst quarters on record for stock picking on the short side.

Two unusual exogenous events left their mark on the manager landscape – a widespread, yet short-lived, deleveraging driven by "Reddit list" stocks and retail investors in January, and extreme volatility across several large stocks in the communication services and financials sectors connected to Archegos Capital in March. Neither of these events meaningfully impacted any of RVK's recommended direct managers, though a Fund-of-Hedge-Fund manager with relatively high exposure to Reddit-linked names modestly underperformed.

In Q1, the HFRI Fund of Fund Composite Index returned 2.5% with all broad category HFR Indices indicating positive returns. Event Driven strategies in particular posted strong returns, as Distressed and Special Situations managers produced returns in the 8-

10% range amidst robust capital markets activity and continued economic recovery. The HFRI Relative Value Multi-Strategy Index returned 3.1%, roughly in line with many of the multi-strategy managers RVK follows closely. The HFRI Systematic Macro Index returned 4.2% as trend followers in particular were positioned well to benefit from the reflation trade that saw oil prices, metals, stocks, and the dollar move higher, with government bonds moving lower.

Global Tactical Asset Allocation (GTAA)

GTAA strategies RVK follows closely largely generated positive absolute returns in Q1, ranging from low- to mid-single digits. Long-biased strategies performed well, though with some divergence, versus a static and less diversified blend of 60% US equity and 40% US fixed income. Generally, strategies that have continued to maintain a value bias relative to peers outperformed in Q1. Many of the strategies that outperformed peers have continued adding to alternative exposures which aim to increase idiosyncratic risks as opposed to equity market beta. While emerging market equities generally lagged other risk assets in Q1, the MSCI Emerging Markets Value Index returned 4.2% versus 0.6% for the MSCI Emerging Market Growth Index. While some managers have reduced their overweight to the region, this reversal within EM provided a tailwind for many GTAA strategies RVK tracks, as these managers have largely maintained their value biases in the region.

Multi-asset managers that intend to reduce correlations, volatility and market sensitivity posted mixed returns in Q1. Although some strategies posted positive absolute returns, the space generally underperformed long-biased managers that held relatively higher exposures to global equity markets. Over the trailing 12-month period, long-biased strategies have drastically outperformed absolute return focused peers. However, it is important to note that these absolute return strategies have lower return targets and provided better downside protection compared to the long-biased strategies in early 2020.

Diversified Inflation Strategies (DIS)

DIS managers that RVK follows closely largely generated positive absolute performance during Q1, ranging from low- to mid-single digits. For the quarter, traditional inflation-sensitive assets such as commodities, listed infrastructure, natural resource equities, and REITs posted positive absolute returns. Strategies with higher relative weights to these asset classes generally outperformed peers with higher relative exposures to TIPS, as the increase in yields during the quarter was a drag on performance. Broad commodities returned 6.9%, as measured by the Bloomberg Commodity Index. However, some strategies with relatively higher commodity allocations still lagged peers given the negative returns from their TIPS exposure. Inflation, as measured by the year-over-year change in Headline CPI, was reported as 2.60%, an increase from 1.40% at year-end 2020. The one month rise of 0.6% in March was the largest increase, on a seasonally adjusted basis, since August 2012. Inflation pressures during the last 12 months have largely been driven by increased energy prices, particularly gasoline. Market-based measures of future inflation expectations moved higher in Q1 with 10-year breakeven inflation increasing from 1.99% to 2.37%.

Real Estate

Core private real estate generated a positive 2.1% return in Q1 (on a preliminary and gross of fee basis), as reported by the NFI-ODCE Index, with the total return comprising of 1.0% income and 1.1% price appreciation. While the income component improved over the prior quarter and is more in line with historical levels, price appreciation rebounded meaningfully by 0.7% from the level recorded in Q4 2020. Investors of publicly traded real estate outperformed their private market counterparts by a meaningful margin. Publicly traded real estate delivered a first quarter total return of 8.5%, as measured by FTSE/NAREIT All REITs Index. Among publicly traded securities, return volatility remains high given the correlation with public equity markets.

Private real estate transaction volumes remain anemic relative to levels prior to 2020 on a year-over-year basis, however there continue to be indications of improved deal flow. With the widespread rollout of COVID-19 vaccines underway, investors are gaining confidence that much of the impact from the pandemic is behind them. Additionally, the most recent round of government stimulus appears to be aiding investor sentiment. These drivers of positive morale, along with pent up demand for capital deployment from investors, have contributed to the positive price appreciation embedded in the improved total return in Q1.

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RVK

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[1]Between July and October 2019, Greenwich Associates conducted interviews with 1,100 individuals at 896 of the largest tax-exempt funds in the US–including corporate and union funds, public funds, endowments and foundations–with either pension or investment pool assets greater than $150 million. Study participants were asked to provide quantitative and qualitative evaluations of their asset managers and investment consultants, including qualitative assessments of those firms soliciting their business and detailed information on important market trends. RVK is one of three firms recognized in the large investment consultant category. The ratings may not be representative of any one client's experience with RVK; rather they are representative of those clients submitted and that chose to participate in the survey. The results are not indicative of RVK's future performance.

To read the Greenwich article, please refer to the following URL: https://www.greenwich.com/asset-management/five-factors-distinguish-best-class-consultants-average-practitioners

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