RVK

Capital Markets Review | 3rd Quarter 2020

September 30, 2020

Overview

During the first two months of Q3, capital markets generally tracked the same trends that drove returns during the latter half of Q2, however volatility returned later in the period. After strong results in the first two months of the quarter, returns from risk assets reversed in September, due to growing concerns over a stagnating recovery and reduced confidence that the US Congress could agree on further fiscal stimulus. In addition, the upcoming US presidential and congressional elections offered another source of uncertainty affecting investors' expectations and sentiment. For the full quarter, global equity returns were generally positive and primarily driven by strong results from US large cap, international small cap, and emerging markets equities. In debt markets, Treasury yields across maturity points remained near depressed levels reached in Q2, with spreads tightening for some higher-yielding securities even as debt issuance continued to outpace levels from a year earlier. Oil prices were relatively stable during Q3, as compared to the sharp drop and rebound experienced in Q2, with most other commodity groups recovering some ground during the period.

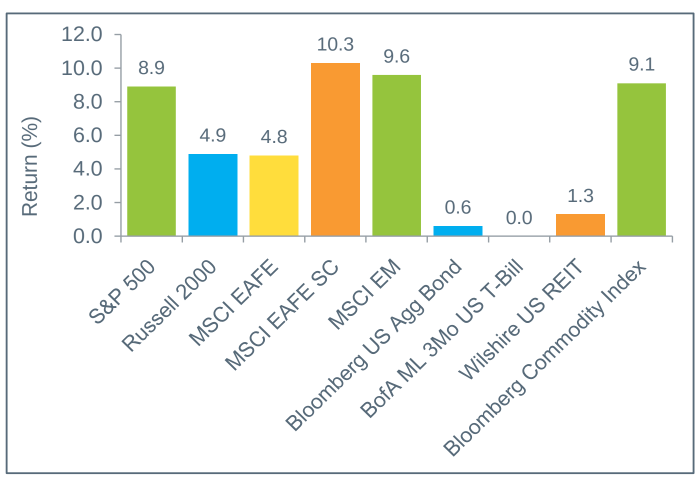
The Federal Open Market Committee (FOMC) maintained its accommodative stance and boosted sentiment further by announcing that it will move to average inflation targeting—indicating that it could accept future inflation levels above its stated 2% target. Market participants largely saw this as an indication that policy could remain supportive for longer than previously expected. Partly driven by the FOMC policy change, forecasts of future inflation incrementally increased during Q3, with 5-year breakeven inflation increasing from 1.2% to 1.5%. Unemployment levels remain a key focus of the FOMC given its mandate to maintain full employment. The unemployment rate continued to decline from its April peak of 14.7%, but the reported September rate remained elevated at 7.9%.

Investor attention was attuned to the ongoing negotiations in the US Congress regarding continued fiscal support for individuals, businesses, and local governments. Most economists view further stimulus as necessary to sustain the recovery; however, the level and composition of the stimulus are key points of contention. As of October 1st, the Atlanta Fed's GDPNow annualized estimate for Q3 growth stood at 34.6% which stands in stark contrast to the final reading of the Q2 GDP decline of -31.4%. From peak-to-trough, the non-annualized decline in real US GDP was -10.1%, according to JP Morgan, compared to a -4.0% decline during the Global Financial Crisis. Outside of the US, the European Central Bank and Bank of Japan kept monetary policy unchanged during the quarter. For calendar year 2020, the OECD released a projection in September for a -4.5% contraction in global GDP, which represented an improvement from its June projection for a -6.0% contraction. The OECD also forecasted a 5% rebound in global GDP in 2021 although it noted a high level of uncertainty around its estimate. China is expected to be a positive driver of growth in 2020 with a projected growth rate of 1.8% representing a sharp rebound following the country's year-over-year decline of -6.8% in Q1.

Trailing Period Market Performance (%)

	QTD	CYTD	1 Year	5 Years	10 Years
S&P 500	8.9	5.6	15.1	14.1	13.7
Russell 2000	4.9	-8.7	0.4	8.0	9.9
MSCI EAFE	4.8	-7.1	0.5	5.3	4.6
MSCI EAFE SC	10.3	-4.2	6.8	7.4	7.3
MSCI EM	9.6	-1.2	10.5	9.0	2.5
Bloomberg US Agg Bond	0.6	6.8	7.0	4.2	3.6
BofA ML 3Mo US T-Bill	0.0	0.6	1.1	1.2	0.6
Wilshire US REIT	1.3	-16.7	-17.7	3.7	8.0
Bloomberg Commodity Index	9.1	-12.1	-8.2	-3.1	-6.0

Quarter-to-Date Performance (%)



Key Economic Indicators

	Q3 2020	Q2 2020	Q1 2020	10 Year Average
Federal Funds Rate	0.09%	0.08%	0.08%	0.63%
Treasury - 1 Year	0.12%	0.16%	0.17%	0.75%
Treasury - 10 Year	0.69%	0.66%	0.70%	2.22%
Treasury - 30 Year	1.46%	1.41%	1.35%	2.98%
Breakeven Inflation - 5 Year	1.49%	1.17%	0.53%	1.72%
Breakeven Inflation - 10 Year	1.63%	1.34%	0.93%	1.95%
Breakeven Inflation - 30 Year	1.77%	1.56%	1.25%	2.07%
Barclays US Corp: Hi Yld Index - OAS	5.17%	6.26%	8.80%	4.76%
Capacity Utilization	71.42%	64.80%	73.56%	76.62%
Unemployment Rate	7.90%	11.10%	4.40%	6.14%
ISM PMI - Manufacturing	55.40%	52.60%	49.10%	53.74%
Baltic Dry Index - Shipping	1,725	1,799	626	1,133
Consumer Confidence (Conf. Board)	101.80	98.10	118.80	95.39
CPI YoY (Headline)	1.40%	0.60%	1.50%	1.73%
PPI YoY - Producer Prices	-1.20%	-2.20%	-1.50%	1.73%
US Dollar Total Weighted Index	117.35	120.86	122.82	104.33
WTI Crude Oil per Barrel	$40	$39	$20	$69
Gold Spot per Ounce	$1,886	$1,781	$1,577	$1,392

Asset Class Commentary

US Equity

In Q3, US markets continued their climb following the Q1 selloff, with sentiment bolstered by substantial pent-up consumer demand being released as businesses re-opened across parts of the country, continued accommodative monetary policy and support from past stimulus measures. Domestic equities delivered strong performance, albeit to a lesser extent than in Q2, with the S&P 500 hitting an all-time high in early September before a slight drawback to finish the quarter. The S&P 500 ended Q3 up 8.9%, with YTD returns of 5.6%. In a reversal from Q2, larger cap stocks fared best in Q3. The Russell Top 200 finished Q3 ahead of its smaller cap counterparts, returning 10.2%, while the Russell 2000 and Mid Cap indexes returned 4.9% and 7.5%, respectively.

Growth again led value across all market caps by a significant margin during Q3. The Russell 1000 Growth returned 13.2% and the Russell 1000 Value returned 5.6%, while the Russell 2000 Growth and Value indexes finished up 7.2% and 2.6%, respectively. Amazon, Apple, Facebook, Google, and Microsoft have been the primary drivers of the overall return of the S&P 500, with combined returns of 8.5% while the remaining 495 stocks collectively lost -2.9%. This differentiation maintained, and accelerated, a trend of technology-related mega cap stocks dominating overall market returns.

Active management largely struggled in Q3 as the majority of large and mid cap managers failed to keep pace with the strong market performance in Q3. However, large cap value and mid cap growth managers were generally more successful than active managers in other segments. Small cap growth managers were a bright spot, with the majority outpacing their benchmark during the quarter.

Non-US Equity

Developed international markets had a strong quarter, although the segment remains in negative territory YTD. Growth stocks outperformed value, while small stocks outpaced larger ones. The majority of developed market countries had positive returns for the quarter, with a few European countries leading the pack with double digit performance. Among sectors, only energy and financials posted negative returns as cyclical stocks continued to lag. However, this market performance wasn't reflective of on-the-ground economic data. In Europe, purchasing managers' index (PMI) levels dropped in August and September, as countries experienced further spread of the coronavirus. Active management fared well this quarter, with a majority of developed international equity managers beating their benchmarks in both the large and small cap universes.

Emerging markets outpaced developed markets during Q3. Similar to the developed international space, value stocks underperformed growth and small stocks outperformed large. Among regions, Asia and the Middle East saw double digits returns while Latin America and Eastern Europe delivered negative returns. By sector, energy and financials were slightly negative, and utilities provided the most significant underperformance in Q3. In China, stocks appreciated strongly, as its economy continued to recover at a pace suggesting the country will experience low-to-moderate growth for the calendar year. Active manager results in emerging markets were mixed, with roughly half outpacing their benchmarks during the quarter.

Fixed Income

The Bloomberg US Aggregate Index returned a modest 0.6% in Q3, ending the quarter with a yield of just 1.2% as Treasury yields remained at historic lows and credit spreads neared pre-pandemic levels. Although yields initially declined across the Treasury curve in the early part of the quarter, the curve steepened as longer-maturity yields rose modestly in August amid a record issuance of Treasury debt and the announcement of the new FOMC policy to shift to average inflation targeting.

Credit markets extended their rally as the hunt for yield continued, and the Bloomberg US Corporate Investment Grade Index returned 1.5% in Q3 despite record-setting issuance. With corporations seeking to take advantage of low rates, new supply reached $1.35 trillion for the year by mid-August, surpassing the previous full-year high with more than four months left in 2020. Non-investment grade issuance was also robust, setting its own record of $330 billion by the end of September. However, demand was also strong through most of the quarter, even amidst the highest default rates since the Global Financial Crisis, and the Bloomberg US High Yield Index returned 4.6%.

Emerging market debt also extended its rally, as the JPMorgan EMBI Global Diversified Index returned 2.3% in Q3. The quarter was led by a strong July with the index posting a 3.7% return, as accommodative central bank policies continued to suppress volatility. However, momentum slowed later in the quarter as uncertainty around the global economic recovery increased, leading to a -1.85% return in September, ending a five-month stretch of positive returns.

Diversified Hedge Funds

Broad hedge fund benchmarks indicated that the industry protected capital relatively well during the heightened equity market volatility in September. The HFRI Fund Weighted Composite Index added to Q2 gains with a return of 4.1% in Q3, bringing the index return into positive territory YTD at 0.5%. The positive performance in Q3 for the HFRI Hedged Equity and HFRI Event Driven indices, which returned 5.8% and 4.3%, respectively, helped contribute to the overall index returns. In contrast, strategies that pursue event-oriented and special situations strategies, particularly within credit markets, continued to struggle with YTD returns for most ranging from -2% to -5%. Managers who pursue less directional strategies within the relative value or market-neutral equity spaces lagged again in Q3, as equity markets finished the period with high absolute returns. However, in the more volatile September, these manager types generally outperformed market benchmarks.

Strategies which RVK follows closely have performed meaningfully better than indices might suggest. Multi-PM platforms focusing on alpha generation that remain market neutral again posted positive returns with continued strong alpha generation in Q3. Thus far in 2020, returns for underlying strategies have been widely positive across fundamental equity trading, index rebalancing, fixed income arbitrage, quantitative equity, and other core strategies. Other event-oriented strategies posted moderately positive Q3 returns, leaving YTD performance for many of these managers in positive territory.

Equity Long/Short (“ELS”) managers RVK follows closely have been able to generate a mix of long and short alpha in 2020, albeit with a wide dispersion in results. Prime brokers are reporting that September 2020 was the best month for overall stock selection alpha in the last decade. This is largely attributable to strong performance in growth-oriented shorts within the technology, consumer, and communication services sectors. Most managers RVK follows closely are running with moderately elevated gross and net exposure levels relative to the last decade. Fundamental strategies continue to perform well in 2020, while quantitative strategies continue to face headwinds.

Global Tactical Asset Allocation (GTAA)

GTAA strategies RVK follows closely generated positive returns in Q3 ranging from low to high single digits. As with past quarters, long-biased strategies reported mixed performance versus a static and less diversified blend of 60% US equity and 40% US fixed income. Though emerging market equities outperformed US and other developed markets in Q3, strategies that favored EM markets tend to have a value bias within these countries. This has represented a headwind throughout 2020 as the MSCI Emerging Market Growth Index has returned 12.4% versus -14.2% for the MSCI Emerging Market Value Index. Despite the strong returns from emerging markets, the value bias exhibited by some managers has caused them to lag peers.

Strategies that have kept risk at relatively higher levels and favored US or other developed markets had a strong quarter with returns ranging from mid to high single digits. Some of the positioning that drove this performance within markets included exposure to US cyclicals and European small cap equities as well as strong security selection within sectors such as consumer discretionary, energy, and healthcare. Multi-asset managers that intend to provide reduced correlations, lower volatility, and less market sensitivity had mixed performance versus long-biased GTAA managers during Q3. These strategies struggled compared to long-biased peers that held relative higher weightings to developed markets while performing in-line with managers that held an emerging market bias. However, these strategies generally protected better during the first quarter and are largely showing positive YTD performance.

Diversified Inflation Strategies (DIS)

Performance for DIS managers that RVK follows closely largely saw positive absolute performance during Q3, with many strategies posting returns in the low single digits. Commodities and TIPS indices generally fared better than REITs, listed infrastructure, and global natural resource equities. Divergence across managers within the space was relatively limited when compared to the wide spread in results for the YTD period. Strategies holding relatively larger weightings to TIPS and commodities have fared better than strategies that have favored other inflation sensitive assets. Broad REIT, listed infrastructure, and global natural resources equity indices have generated returns ranging from -15% to -20% falling short of the -12.1% return posted by the Bloomberg Commodity Index thus far in 2020. Over the course of the year, TIPS have dampened portfolio volatility and have acted as a source of downside protection in portfolios. Inflation, as measured by the year-over-year change in Headline CPI, increased over the quarter from 0.60% in June to 1.40% in September. Nevertheless, inflation levels remain below long-term averages. When looking at monthly CPI releases, all three months during the quarter saw increased inflation levels with the sharpest increases occurring in July and August. Market-based measures of future inflation expectations have also ticked higher, with 10-year breakeven inflation increasing over the quarter from 1.3% to 1.6%.

Real Estate

Core private real estate returned 0.5% during the third quarter (on a preliminary and gross of fee basis), as reported by the NFI-ODCE Index, with the total return comprised of a positive contribution of 1.0% from income and a negative contribution of -0.5% from price appreciation. While the income component remained relatively healthy and in-line with historical levels, price appreciation experienced a further decrease, albeit to a lesser degree relative to the prior quarter. Investors in publicly traded real estate outperformed their private market counterparts with a third quarter total return of 1.5%, as measured by the FTSE/NAREIT All REITs Index. Among publicly traded investments, the level of quarterly return volatility remains high given the correlation between REITs and public equity markets.

While the total return for core real estate remained subdued, it did improve from its low in Q2 despite continued uncertainty from the pandemic. Much of the upward trend in total returns can be attributed to the improved rent collection environment. Among the primary sectors, industrial, multifamily, and office have performed well and maintained high levels of collections. The noticeable exception has been in the retail sector, where rent collections plummeted in April—although the rate has steadily improved since bottoming. Current indications of rent collections within retail are close to 70%, which is a positive sign of recovery as more restrictions are relaxed nationwide.

Disclaimer

This document was prepared by RVK, Inc. (RVK) and may include information and data from Bloomberg, Morningstar Direct, eVestment.com, NCREIF, and Preqin. While RVK has taken reasonable care to ensure the accuracy of the information or data, we make no warranties and disclaim responsibility for the inaccuracy or incompleteness of information or data provided or for methodologies that are employed by any external source. This document is not intended to convey any guarantees as to the future performance of investment products, asset classes, or capital markets.

RVK

RVK was founded in 1985 to focus exclusively on investment consulting and today employs over 100 professionals. The firm is headquartered in Portland, Oregon, with regional offices in Boise, Chicago, and New York City. RVK is one of the ten largest consulting firms in the US, as reported by *Pensions & Investments' 2019 Special Report – Consultants*. Additionally, RVK received a notable award in April 2020 when it was named a Greenwich *Quality Leader* among large US investment consultants, based upon Greenwich Associates' 2019 study. Greenwich is an industry-recognized third-party firm which asks plan sponsors to rank their consultants on a series of key metrics. Notably, RVK is the only firm among large US consultants to receive an award for a third consecutive year.[1] RVK's diversified client base of over 190 clients covers 30 states, and covers endowments, foundations, corporate and public defined benefit and contribution plans, Taft-Hartley plans, and high-net-worth individuals and families. The firm is independent, employee-owned, and derives 100% of its revenues from investment consulting services.

[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

For more information about RVK, please refer to the following URL: https://www.rvkinc.com/about/about.php