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Capital Markets Review | 4th Quarter 2020

December 31, 2020

Overview

In Q4, multiple fundamental developments reinforced market sentiment and kept many investors positioned to add incremental risk despite the relatively weak economic environment and ongoing global pandemic. Importantly, two closely watched coronavirus vaccine trials from Pfizer/BioNTech and Moderna released promising efficacy results leading to emergency use authorizations from the FDA, allowing market participants to pull forward expectations for normalized economic activity for much of the developed world in 2021. Investors also reacted favorably to completed negotiations around new fiscal stimulus following the November US elections, which culminated in a $900B package being signed into law under a larger omnibus spending bill. The package included new supplemental unemployment benefits of $300 per week for the 6.7% of unemployed Americans, as well as another one-time round of stimulus checks in the amount of $600 for most individuals. Meanwhile, the Eurozone passed its own €750 billion stimulus plan in December as part of a larger budget, backed by joint debt. Central banks, the Federal Reserve (Fed) in particular, remained highly accommodative. The Fed reiterated its commitment to maintain monthly asset purchases, currently at $120 billion, and zero interest rates until significant progress is made toward its goal of full employment.

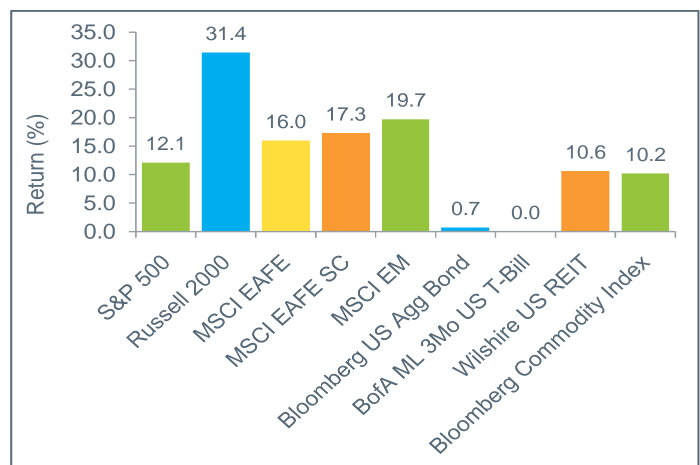
Given the backdrop of supportive monetary and fiscal policies, risk assets posted another quarter of stellar returns. Broad equity market indices provided double-digit gains as the S&P 500, MSCI ACWI Ex-US and MSCI EM Index returned 12.1%, 17.0%, and 19.7%, respectively. The S&P 500 Forward Price-to-Earnings ratio ended the quarter at 22.6, a valuation level last experienced during the dot-com era tech bubble. At the same time, the CY2020 earnings of the S&P 500 fell an estimated 16% year-over-year according to preliminary data from FactSet. Non-US equities were aided in part by a modest rotation toward cyclical and value stocks, as well as a weaker dollar, which depreciated against a trade weighted basket of foreign currencies. Commodities also benefited from the weaker dollar and an uptick in inflation expectations with the 5Y/5Y forward breakeven inflation rate moving above 2.0% during Q4 for the first time since July 2019. Government bonds were the only broad asset class to experience negative returns as increased inflation expectations flowed through to modestly higher nominal interest rates.

Though financial markets have rebounded from the sharp drawdown in early 2020, global economic activity remains well off its pre-pandemic peak. The World Bank Global Economic Prospects report estimated that 2020 world GDP shrank by 4.3% compared to a year earlier. Meanwhile, the Federal Reserve Open Market Committee indicated that it does not anticipate raising the Federal Funds rate until 2023 or later, and market implied expectations for a rate hike are consistent with that timeline. Considerable uncertainty remains with respect to the pace of economic recovery going forward, though household balance sheets remain strong, leaving room for optimism should the pandemic be brought under control.

Trailing Period Market Performance (%)

	QTD	CYTD	1 Year	5 Years	10 Years
S&P 500	12.1	18.4	18.4	15.2	13.9
Russell 2000	31.4	20.0	20.0	13.3	11.2
MSCI EAFE	16.0	7.8	7.8	7.4	5.5
MSCI EAFE SC	17.3	12.3	12.3	9.4	7.8
MSCI EM	19.7	18.3	18.3	12.8	3.6
Bloomberg US Agg Bond	0.7	7.5	7.5	4.4	3.8
BofA ML 3Mo US T-Bill	0.0	0.7	0.7	1.2	0.6
Wilshire US REIT	10.6	-7.9	-7.9	4.3	8.3
Bloomberg Commodity Index	10.2	-3.1	-3.1	1.0	-6.5

Quarter-to-Date Performance (%)



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Key Economic Indicators

	Q4 2020	Q3 2020	Q2 2020	10 Year Average
Federal Funds Rate	0.09%	0.09%	0.08%	0.63%
Treasury - 1 Year	0.10%	0.12%	0.16%	0.75%
Treasury - 10 Year	0.93%	0.69%	0.66%	2.17%
Treasury - 30 Year	1.65%	1.46%	1.41%	2.92%
Breakeven Inflation - 5 Year	1.97%	1.49%	1.17%	1.72%
Breakeven Inflation - 10 Year	1.99%	1.63%	1.34%	1.94%
Breakeven Inflation - 30 Year	2.00%	1.77%	1.56%	2.06%
Barclays US Corp: Hi Yld Index - OAS	3.60%	5.17%	6.26%	4.73%
Capacity Utilization	75.54%	71.42%	64.80%	75.56%
Unemployment Rate	6.70%	7.90%	11.10%	6.07%
ISM PMI - Manufacturing	60.70%	55.40%	52.60%	53.79%
Baltic Dry Index - Shipping	1,366	1,725	1,799	1,109
Consumer Confidence (Conf. Board)	88.60	101.80	98.10	96.31
CPI YoY (Headline)	1.40%	1.40%	0.60%	1.73%
PPI YoY - Producer Prices	-1.30%	-1.20%	-2.20%	1.27%
US Dollar Total Weighted Index	111.65	117.35	120.86	104.86
WTI Crude Oil per Barrel	$49	$40	$39	$68
Gold Spot per Ounce	$1,899	$1,886	$1,781	$1,403

Asset Class Commentary

US Equity

US equity markets finished strong in Q4 following a period of heightened volatility due to a drawn-out election process and uncertainty around coronavirus vaccine development earlier in the quarter. Negotiations around another US fiscal stimulus package stalled in October and spikes in coronavirus infections contributed to the S&P 500 Index returning -2.7% for the month. In the latter half of the quarter, optimism around vaccine authorization, the announcement of additional stimulus in December and the prospect of further fiscal support drove positive investor sentiment.

This quarter marked the end of a consistent string of growth-led quarters. A market rotation toward cyclical stocks accelerated in November with value stocks outperforming their growth counterparts, largely fueled by the potential impact of vaccine distribution. In Q4, the Russell 1000 Value Index returned 16.3% in Q4, versus 11.4% for the Russell 1000 Growth Index. Similarly, the Russell 2000 Value Index was up 33.4% in Q4, compared to 29.6% for the Russell 2000 Growth Index. The prospect of lockdowns easing in 2021 also contributed to strong performance for the energy and financial sectors as well as small-cap stocks, with the Russell 2000 Index up 31.4% relative to the S&P 500 Index returning 12.1%. Overall, broad US indexes finished the volatile year at record high levels.

Active manager performance was mixed in Q4. The median manager excess returns across styles in mid cap were positive joining large cap growth managers as bright spots for the quarter. Median excess returns indicate that managers in other US equity asset classes struggled to outpace their respective benchmarks. For the year, small cap growth managers were the lone group to experience broad success as indicated by positive median excess returns.

Non-US Equity

Developed international markets had another strong quarter of returns, continuing a rebound that started in Q2. In a reversal from the rest of the year, value stocks outperformed growth, while small stocks continued to beat their larger counterparts. Nearly all developed market countries saw double-digit positive returns for the quarter, led by several European countries and Australia. In particular, some of the previously harder hit European countries fared well. Cyclical sectors outperformed overall with energy leading the pack, though all sectors experienced positive returns in Q4. A post-Brexit trade deal was reached near quarter-end reducing the economic uncertainty within the region. More specifically, securing continued free trade of goods between the United Kingdom and the European Union calmed investor sentiment. Active management saw split results during the quarter, with a majority of small cap developed international equity managers beating their benchmarks

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while the majority of large cap managers underperformed.

Emerging markets outpaced developed during the quarter continuing the trend for the third quarter in a row. Mirroring developed, emerging market value stocks outperformed growth while small stocks continued their outperformance of large since Q2. Latin America experienced a sharp reversal, leading the emerging regions, all of which experienced double-digit returns. All sectors posted positive performance for the quarter led by technology, but more value-oriented sectors were not far behind. The Asia-Pacific Regional Comprehensive Economic Partnership (RCEP) free trade agreement was signed in November and is expected to be implemented in mid-2021. Arguably the largest free trade agreement in history, covering over 30% of global GDP, it is expected to meaningfully support continued regional growth over the long-term. Active manager results in emerging markets were mixed, with just over half outperforming their benchmarks during the quarter.

Fixed Income

The Bloomberg US Aggregate Index returned a modest 0.7% in Q4, capping off a 7.5% YTD return and an overall strong year for US fixed income, supported by record fiscal and monetary stimulus. In Q4, the Treasury yield curve steepened as front end rates remained anchored near zero, a sign of the Federal Reserve's continued support, while yields for intermediate- and long -dated maturities increased over Q4. However, rates across the Treasury yield curve remained depressed versus historical levels.

The Bloomberg US Credit Index returned 2.8% in Q4, outperforming the broader fixed income market. Despite record-setting new issuance, credit spreads continued to tighten, compressing to 92 bps, their lowest levels since February. Lower-quality issues outperformed higher-quality across the ratings spectrum, with BBB-rated debt returning 4.0% to lead investment-grade credit. Non-investment grade credit fared even better, as the Bloomberg US High Yield Index returned 6.5%.

Emerging market debt also ended the year on a high note, with the JPM EMBI Global Diversified Index returning 5.8% for the quarter. However, the hard currency index was overshadowed by its local currency counterpart, as the JPM GBI-EM Global Diversified Index returned 9.6%. FX currency returns were particularly strong, led by dollar weakness following the US presidential election and growing optimism for a continued economic recovery as vaccines are distributed more broadly.

Diversified Hedge Funds

The hedge fund industry posted double-digit gains in consecutive years for the first time since 2009-2010 as the HFRI Fund Weighted Composite Index returned 10.7% in Q4, bringing YTD returns to 11.6%. Equity Long/Short ("ELS") managers led the way, reporting a Q4 return of 14.5% and a full-year return of 17.5% in one of the best alpha-generating years for fundamental equity managers in recent memory. In general, these strategies served as an effective buffer during the Q1 drawdown and captured an asymmetric portion of the market rebound later in the year. In particular, Q4 was a good period for strategies with smaller cap and value-oriented exposure. For the year, key drivers of positive performance observed in manager portfolios were short value and long growth biases, low volatility factor exposure, and sector tilts toward popular consumer and technology stocks.

Fund of Hedge Fund ("FoHF") managers also had a good year, reflecting broader trends in the industry, outperforming comparable multi-strategy funds according to data from HFR. The HFRI FoF Composite Index finished 2020 with a return of 10.3% compared to just 6.1% for the HFRI RV Multi-Strategy Index. The multi-strategy funds RVK follows closely generally outperformed these indices, but with considerable dispersion across managers and investment styles. Market neutral platforms tended to post the best results, with returns anywhere from the low double-digits up to the mid-30s. More directional managers with lower quality corporate and structured credit exposure pre-pandemic lagged the broad recovery after significant Q1 drawdowns and ended the year with more modest gains. Capital markets activity was robust in 2020, with record corporate debt and equity issuance, as well as significant new issuance in the convertibles and evolving SPAC market. Many managers were able to take advantage of the short-term price inefficiencies tied to this heightened level of capital markets activity, especially against the backdrop of the higher volatility environment.

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Global Tactical Asset Allocation (GTAA)

Performance across GTAA strategies RVK follows closely generated positive absolute returns in Q4 ranging from mid-single-digits to low double-digits. However, long -biased strategies reported mixed performance versus a static and less diversified blend of 60% US equity and 40% US fixed income. Broadly speaking, strategies that have kept higher levels of risk and equity exposure have tended to outperform peers that opted to keep equity allocations relatively muted. While broad emerging market equity returns kept pace with US equity returns during the year, most strategies that favored EM equity allocations have maintained a value bias within the region. This has represented a headwind as the MSCI Emerging Market Growth Index returned 31.3% versus 5.5% for the MSCI Emerging Market Value Index in 2020.

Multi-asset managers that intend to provide reduced correlations, lower volatility and less market sensitivity posted positive Q4 returns, though generally lagged long-biased peers. Over the course of the year, these strategies struggled compared to long-biased peers that held relatively higher weightings to developed markets equity while performing in-line with managers that held an emerging markets bias. For the year, these strategies generally protected better during the drawdown in Q1 and are largely showing positive absolute returns.

Diversified Inflation Strategies (DIS)

Performance for DIS managers that RVK follows closely largely generated positive absolute performance during Q4, while producing mix results for the full year. For the quarter, most traditionally inflation-sensitive asset classes were drivers of positive returns. In Q4, strategies with relatively larger allocations to segments with higher historical volatility, such as REITs, listed infrastructure and global natural resources, generated stronger relative returns versus peers. While strategies with higher relative allocations to TIPS and commodities struggled versus peers in Q4, this group generally fared better during the full year. Though broad commodities, as measured by the Bloomberg Commodity Index, have returned -3.1% in 2020, managers with relatively larger commodity allocations tended to benefit from higher TIPS exposure which dampened portfolio volatility and acted as a source of downside protection in Q1. Inflation, as measured by the year-over-year change in Headline CPI, was reported as 1.40% matching the same level as reported at the end of Q3. For the year, inflation was largely driven by increased prices in used cars and trucks along with food, though these increases were partially offset by declining energy prices. Market-based measures of future inflation expectations moved higher with 10-year breakeven inflation increasing over the quarter from 1.63% to 1.99%.

Real Estate

Core private real estate returned 1.3% in Q4 (on a preliminary and gross-of-fee basis), as reported by the NFI-ODCE Index, with the total return comprised of 0.9% income and 0.4% price appreciation. While the income component remained relatively healthy and in-line with historical levels, price appreciation rebounded meaningfully from a negative return in Q3. Investors in publicly traded real estate outperformed their private market counterparts by a meaningful margin. Publicly traded real estate delivered a fourth quarter total return of 9.2%, as measured by 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.

Private real estate transaction volumes remain anemic and are down more than 50% on a year-over-year basis. The market did show indications of thawing in the fourth quarter as investors in industrial and multifamily assets came to the market with renewed interest in completing deals. This comes after two consecutive quarters of little to no activity due to the uncertainty around property valuations caused by the pandemic. This increased activity is important as the transactions contribute to establishing a floor for valuations given that measurable market activity is incorporated into appraisal processes.

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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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