Capital Markets Review | 1st Quarter 2019

March 31, 2019

Overview

Risk assets and fixed income markets performed well over the first quarter, largely driven by a more accommodative stance by the Federal Open Market Committee ("FOMC"). Indeed, the global equity market, as represented by the MSCI All Country World Index, rose over 12% during the quarter, while fixed income markets benefited from the shift in interest rate expectations. Volatility markets also declined back to record low levels on the message of greater accommodation by the FOMC. Positive returns were generated despite declining growth forecasts in Asia and Europe, weak global inflation, market uncertainty caused by geopolitical risks, such as Brexit, and global markets destabilized by ongoing trade wars.

At its March meeting, the FOMC maintained policy rates in the range of 2.25% to 2.50%. While the decision was largely expected by market participants, the message delivered through the Summary of Economic Projections, which suggested policy makers are not likely to raise rates in 2019, was less expected. Specifically, members changed their 2019 expected policy rate increases to zero, down from two increases as delivered at the January FOMC meeting. The FOMC also announced changes to its balance sheet policy, which suggested further policy accommodation. The European Central Bank also delivered a more accommodative message during the quarter while cutting 2019 GDP growth estimates from 1.9% to 1.1%.

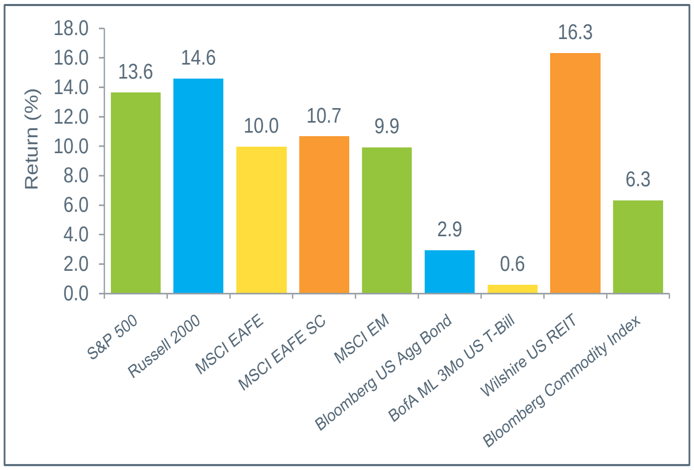
As previously noted, interest rates declined notably over the period amidst signs of weakness in economic growth and a continued lack of inflationary pressure. During the quarter, the 10-year nominal Treasury yield fell to 2.39%, a level not seen since 2017, while the yield curve continued to flatten and even invert across certain maturities. The curve inversion in the 3-month to 10-year segment garnered the most attention due to its reliability as a leading indicator of recessionary pressures. While the inversion only lasted a few days, market participants focused on the implications of the broader yield curve movement on expectations for near-term recessionary risks. Based on a survey of economists conducted by the Wall Street Journal, odds of a recession in the next 12 months remained at 25% throughout the quarter representing an increase from 13% compared to March 2018. The labor market has not yet reflected recessionary fears as US employment remains at record levels, with the labor force participation rate remaining steady and average hourly earnings improving.

Global sovereign debt yields for developed countries were also under pressure, with German and Japanese 10-year nominal yields trading at sustained negative yields amidst continued deterioration in economic fundamentals. Economic weakness was also notable in Italy, as data reported during the quarter suggested Italy slipped into a technical recession at the end of 2018.

Trailing Period Market Performance (%)

	QTD	CYTD	1 Year	5 Years	10 Years
S&P 500	13.6	13.6	9.5	10.9	15.9
Russell 2000	14.6	14.6	2.0	7.1	15.4
MSCI EAFE	10.0	10.0	-3.7	2.3	9.0
MSCI EAFE SC	10.7	10.7	-9.4	4.5	12.8
MSCI EM	9.9	9.9	-7.4	3.7	8.9
Bloomberg US Agg Bond	2.9	2.9	4.5	2.7	3.8
BofA ML 3Mo US T-Bill	0.6	0.6	2.1	0.7	0.4
Wilshire US REIT	16.3	16.3	20.9	9.1	18.3
Bloomberg Commodity Index	6.3	6.3	-5.3	-8.9	-2.6

Quarter-to-Date Performance (%)



Key Economic Indicators

	Q1 2019	Q4 2018	Q3 2018	10 Year Average
Federal Funds Rate	2.43%	2.40%	2.18%	0.47%
Treasury - 1 Year	2.40%	2.63%	2.59%	0.63%
Treasury - 10 Year	2.41%	2.69%	3.05%	2.52%
Treasury - 30 Year	2.81%	3.02%	3.19%	3.33%
Breakeven Inflation - 5 Year	1.79%	1.49%	2.03%	1.73%
Breakeven Inflation - 10 Year	1.87%	1.71%	2.14%	2.01%
Breakeven Inflation - 30 Year	1.92%	1.82%	2.16%	2.16%
Barclays US Corp: Hi Yld Index - OAS	3.91%	5.26%	3.16%	5.21%
Capacity Utilization	78.80%	79.50%	79.28%	76.02%
Unemployment Rate	3.80%	3.90%	3.80%	6.70%
ISM PMI - Manufacturing	55.30%	54.30%	60.80%	54.28%
Baltic Dry Index - Shipping	689	1,271	1,540	1,385
Consumer Confidence (Conf. Board)	131.40	126.60	134.70	85.41
CPI YoY (Headline)	1.90%	1.90%	2.70%	1.60%
PPI YoY - Producer Prices	1.40%	1.40%	3.70%	1.55%
US Dollar Total Weighted Index	$92	$92	$90	$82
WTI Crude Oil per Barrel	$60	$45	$73	$73
Gold Spot per Ounce	$1,292	$1,282	$1,193	$1,315

Asset Class Commentary

US Equity

US equity markets rebounded strongly during the first quarter, with all major indices across size and style finishing in positive territory. The S&P 500 Index returned 13.6% during the quarter, marking its best quarterly return since the third quarter of 2009, and the best first quarter return since 1998. This sharp reversal from a dismal fourth quarter was most prominent during January and February, but was challenged during March upon concerns of slowing global economic growth and a collapse in bond yields.

The broad-based rally was led by growth stocks as the Russell 3000 Growth Index outperformed its value counterpart by 4.3%. Smaller-capitalization stocks outpaced their large-cap counterparts, but the mid-cap segment provided the highest returns. Returns were positive across all sectors during the quarter, led by technology as the S&P 500 Information Technology Index returned 19.9%. There was dispersion among factor returns as the high beta, momentum, and quality stocks drove market returns higher. The S&P 500 High Beta Index returned 18.1%, outperforming all other factor groups, while the S&P 500 Enhanced Value Index returned 9.5%.

Active management results were mixed in light of the risk-on environment that favored higher-growth and higher-momentum stocks. Large- and small-cap growth managers fared moderately well, despite a rally in biotechnology, buoyed by strong performance across broad growth-focused sectors. Conversely, performance among value managers was generally more challenged as the market reaction to fewer expected rate hikes weighed more heavily on value-oriented sectors, such as financials.

Non-US Equity

Developed international markets generated positive returns during the quarter, but did not keep pace with the strong US equity returns. Growth stocks significantly outperformed value stocks, and small-cap returns exceeded large-cap returns. The positive returns from developed markets were generated despite the continued economic slowdown in Europe. Negative indicators for this region include poor production and growth data from Germany, France, and Italy. The improved investor sentiment is likely due, in part, to the ECB announcing renewed lending to commercial banks and a commitment to a low deposit rate throughout 2019.

Emerging markets finished the quarter with similar returns as developed international markets. Growth stocks also outperformed value stocks in emerging markets. However, in contrast to developed markets, large-cap stocks outperformed small-cap. China was a key driver of emerging market equity returns as it generated the highest return among emerging market countries. This positive quarterly result occurred despite weakening economic growth in China and the ongoing trade dispute with the US. One positive driver of sentiment for emerging markets equity was the forecast for fewer rate increases in the US, which reduced upward interest rate pressure for some emerging market countries, such as South Korea and India, which maintained and cut rates, respectively.

Generally, the positive returns from many non-US countries were seen as a rebound from the sharp drawdown experienced in the fourth quarter. In addition, the potential for increased stimulus within Europe and China combined with the possibility for thawing in relations between the United States and China lifted investor expectations. However, economic and political challenges remain at the forefront of discussions with managers, as volatility persists within this asset class.

Fixed Income

Aided by US Treasury rates declining across all maturities, the Bloomberg US Aggregate Index began the year strong, returning 2.9% for the quarter. While the rate decline was marginal at the shortest maturities, those dated one-year and longer fell between 0.21% and 0.28% in near-uniform fashion, exacerbating both the flattening and inverting trends of the yield curve. At quarter end, the one-month T-bill had a higher yield than Treasury securities between one- and ten-years. The decline in yields was particularly beneficial to longer dated assets, with the Bloomberg US Government Long Index returning 4.6%. The spread between the two- and ten-year maturities continued to narrow, ending the quarter at just 0.14%, increasing concerns of a possible recession on the horizon.

As investors returned to their risk-on sentiment, corporate spreads tightened after a brief widening in the fourth quarter to help boost returns in the sector. Lower-rated debt was particularly positive, with the ICE BofAML US High Yield Master II Index returning 7.4%, the best start to a year in the history of the index, which dates back to 1986. The Ca-D rated portion of the index saw exceptional gains of 17.5% during the first quarter.

Following disappointing returns in 2018, emerging market debt rallied to start the year. Hard currency EMD posted the strongest performance as the JPM EMBI Global Diversified Index returned 7.0%, the best quarter for the index in almost nine years. While a strengthening dollar dampened local currency returns, the JPM GBI-EM Global Diversified Index still managed a 2.9% return for the quarter.

Diversified Hedge Funds

The first quarter of 2019 began on a positive note for the hedge fund industry, with each of the major strategy groups posting positive returns. The HFRI Fund Weighted Composite Index produced a return of 5.9%, its best result since the third quarter of 2009, largely driven by gains within the Long/Short Equity universe (“ELS”). The HFRI Asset Weighted Composite Index, which is more balanced across hedge fund strategies, realized a more muted return of 3.1%. These strong results follow an extremely difficult fourth quarter. In general, however, the managers RVK follows closely were able to protect capital well during the Q4 drawdown and are above their prior established high water marks.

Within ELS, managers tracked closely by RVK were able to capture a meaningful portion of the first quarter market rebound, while also generating positive short alpha. Prime brokers are reporting that March was the best month for short alpha generation since January 2016. From a sector perspective, long-short spreads produced the most relative appreciation in the health care, consumer discretionary, and consumer staples sectors. While the stock picking environment in Q1 was good for many managers, aggregate hedge fund positioning remains far from aggressive, with average net exposure levels for domestically-based managers near the bottom decile since 2010 according to prime brokerage data.

The multi-strategy managers RVK follows closely produced generally good results in Q1, with performance varying predictably by manager style. Firms that maintain limited market sensitivity or are biased toward market neutrality generated positive alpha and generally recovered from their Q4 drawdowns, while event driven multi-strategy funds with some directionality had very strong quarters. Fund of Hedge Funds produced good results as well, but, in aggregate, have not fully recovered from losses realized in Q4.

Global Tactical Asset Allocation ("GTAA")

Most GTAA managers reported positive returns during the first quarter, though still underperformed a blend of 60% US equity and 40% US fixed income given the strong equity market returns. The positive absolute performance across managers is a reversal from the negative returns generated in 2018 and, more specifically, the fourth quarter. Performance across GTAA managers varied during the quarter, as the strongest performers held higher allocations to US equity and credit sensitive fixed income. GTAA managers with larger exposures to emerging markets and international equities saw positive returns during the first quarter, albeit lagging peers with higher allocations in US equities. GTAA mangers that trailed peers were those with either explicit short positions against US markets or managers with more idiosyncratic positions within international or emerging country currencies. Some of the distinctive positions that negatively impacted managers include short exposure to the US dollar, Australian dollar, or New Zealand dollar, as well as long exposure to the Japanese yen or Turkish lira.

Diversified Inflation Strategies ("DIS")

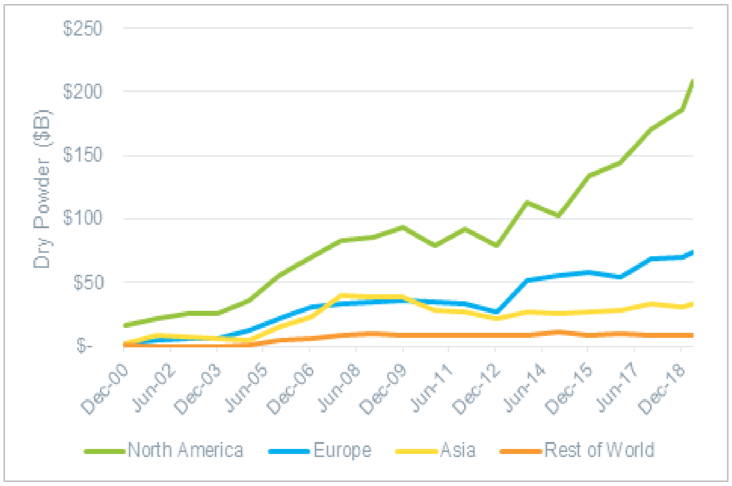
Most DIS managers provided strong returns during the first quarter. Performance across managers ranged widely and was bifurcated. The best performing DIS managers generally held significantly larger allocations to asset classes such as REITs, natural resource equities, global listed infrastructure, and commodities, which all rebounded during the first quarter. DIS managers that trailed peers, though still providing positive returns, held larger exposure to inflation linked securities such as TIPS. Although TIPS posted positive returns during the quarter, riskier asset classes with higher volatility generally outperformed in a reversal from the fourth quarter of 2018. Despite decreasing earlier in the quarter, year-over-year Headline CPI finished the quarter at 1.90%, which was the same reading as of December 31, 2018. Market-based indicators of future inflation, as measured by ten year Treasury breakevens, increased over the quarter from 1.71% to 1.87%.

Real Estate

Core private real estate returned 1.4% during the first quarter (on a preliminary basis), as tracked by the NCREIF-ODCE Index, with the total return comprised of 1.0% income and 0.4% price appreciation. This represented a 34 basis point decline over the prior quarter for the appreciation component of total return. The income return component declined 1 basis point remaining in line with historical levels. Investors in publicly traded real estate significantly outperformed their private market counterparts during the first quarter. Publicly traded real estate experienced a snap-back from its negative performance in 2018 with a monthly return of 11.4% in January. The first quarter total return was 16.7%, as measured by FTSE/NAREIT All REITs Index.

Demand for real estate investment strategies continued its multi-year rise from both domestic and foreign investors. The search for yield and potential for capital appreciation continued to attract investors committing capital to a variety of strategies. Last year, the dry powder in the commercial real estate market, defined as the amount of capital that has been committed to a private capital fund minus the amount that has been called by the general partner for investment, held by closed-end fund managers increased to an all-time high of $325B, as tracked by Preqin. This data also shows that levels of dry powder are increasing year-over-year irrespective of whether it will be deployed in core or non-core strategies. **Exhibit 1** illustrates that this upward trend has been similar across regions, with the US attracting the most investor capital followed by modest increases in the Europe and Asia regions.

Exhibit 1: Regional Dry Powder in Private RE



Disclaimer

This document was prepared by RVK, Inc. (“RVK”) and may include information and data from Bloomberg, Morningstar Direct, 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 Chicago and New York City. RVK is one of the ten largest consulting firms in the US (as defined by Pension & Investments) and received a noteworthy award in 2018 as it was named a Quality Leader among large US consultants by independent research firm, Greenwich Associates. RVK’s diversified client base of over 190 clients covers 30 states and includes 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.