RVK

Capital Markets Review | 2nd Quarter 2017

June 30, 2017

Overview

Global risk assets continued to perform well during the second quarter of 2017, with gains broadly supported by strengthening economic data related to global inflation, job growth, and corporate fundamentals. In contrast to prior run-ups in risk assets, the past quarter was marked by high levels of sector and market factor dispersion. This created significant opportunities for skilled active managers and generated tailwinds for strategies with heavy growth and cyclical biases. Geographically, emerging markets outperformed developed, while international markets generally outperformed US markets.

Gains across most risk assets occurred despite persistent political divisiveness in the US, heightened geopolitical risks (most notably in North Korea), and a range of other international issues. Although positive economic fundamentals have thus far supported 2017 market gains, it is possible that unanticipated global central bank policy and US political events could have a larger influence on markets through the remainder of the year.

US interest rates experienced heightened volatility during the quarter before abruptly rising in the last week. Given expectations of additional actions by central banks over the next several quarters, volatility of global rates may remain high, which could lead to headwinds for longer-duration strategies.

The US dollar depreciated against major currencies, including over 7% against the euro. At the same time, UK and euro sovereign debt spread levels to US Treasuries reached year-to-date lows on continued signs of economic growth across these respective international economies. Late in the quarter, a number of foreign central bank policy makers provided guidance regarding the potential removal of accommodative policy measures over the near term. This action surprised market participants, driving a broad repricing of policy-sensitive international assets, including higher interest rates for short and medium-term sovereign debt yields.

Asset Class Commentary

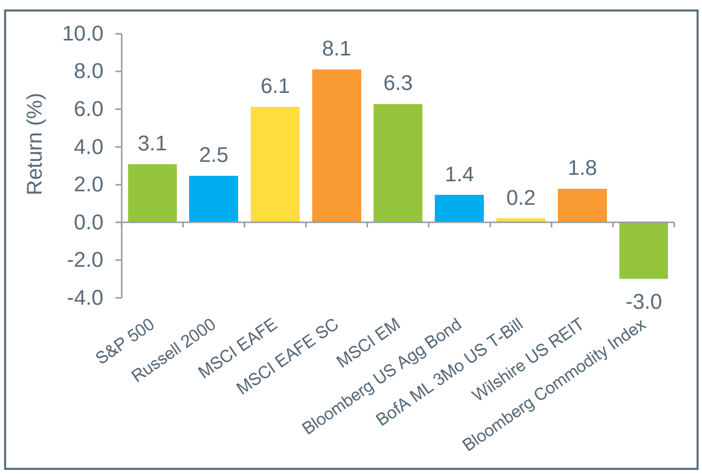
US Equity

Domestic equity markets continued to rally during the second quarter, albeit at a slower rate and with less volatility. Expectations for fiscal stimulus were again supportive of markets during the quarter, as was the positive tone from the Federal Open Market Committee ("FOMC") regarding near-term economic growth and inflation expectations. Equities

Trailing Period Market Performance (%)

	QTD	CYTD	1 Year	5 Years	10 Years
S&P 500	3.1	9.3	17.9	14.6	7.2
Russell 2000	2.5	5.0	24.6	13.7	6.9
MSCI EAFE	6.1	13.8	20.3	8.7	1.0
MSCI EAFE SC	8.1	16.7	23.2	12.9	3.4
MSCI EM	6.3	18.4	23.7	4.0	1.9
Bloomberg US Agg Bond	1.4	2.3	-0.3	2.2	4.5
BofA ML 3Mo US T-Bill	0.2	0.3	0.5	0.2	0.6
Wilshire US REIT	1.8	1.8	-1.7	9.3	5.6
Bloomberg Commodity Index	-3.0	-5.3	-6.5	-9.3	-6.5

Quarter-to-Date Performance (%)



Key Economic Indicators

		As of	3/31/2017	12/31/2016	10 Year Average
Federal Funds Rate	1.06%	6/30/2017	0.82%	0.55%	0.61%
Treasury - 1 Year	1.24%	6/30/2017	1.03%	0.85%	0.67%
Treasury - 10 Year	2.31%	6/30/2017	2.40%	2.45%	2.70%
Treasury - 30 Year	2.84%	6/30/2017	3.02%	3.06%	3.55%
Breakeven Inflation - 1 Year	0.72%	6/30/2017	2.06%	1.27%	0.84%
Breakeven Inflation - 10 Year	1.74%	6/30/2017	1.98%	1.97%	1.99%
Breakeven Inflation - 30 Year	1.85%	6/30/2017	2.09%	2.10%	2.20%
Barclays US Corp: Hi Yld Index - OAS	3.64%	6/30/2017	3.83%	4.09%	6.12%
Capacity Utilization	76.57%	6/30/2017	75.83%	76.03%	76.03%
Unemployment Rate	4.40%	6/30/2017	4.50%	4.70%	7.00%
ISM PMI - Manufacturing	57.80%	6/30/2017	57.20%	54.50%	52.19%
Baltic Dry Index - Shipping	901	6/30/2017	1,297	961	2,287
Consumer Confidence (Conf. Board)	118.90	6/30/2017	124.90	113.30	74.90
CPI YoY (Headline)	1.60%	6/30/2017	2.40%	2.10%	1.75%
PPI YoY - Producer Prices	2.20%	6/30/2017	3.70%	1.90%	1.90%
US Dollar Total Weighted Index	$91	6/30/2017	$94	$96	$79
WTI Crude Oil per Barrel	$46	6/30/2017	$51	$54	$78
Gold Spot per Ounce	$1,242	6/30/2017	$1,249	$1,152	$1,238

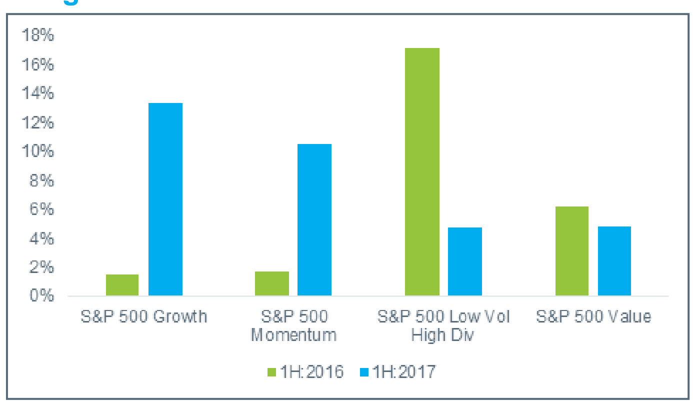
provided positive returns across all market caps and styles, but with significant dispersion across sectors and market factors. Most notably, growth continued its strong run, with the Russell 3000 Growth Index posting returns of 4.7% for the quarter and 13.7% year-to-date, versus 1.3% and 4.3%, respectively, for its value counterpart. Health care posted the quarter's highest sector gains, with the Russell 3000 Health Care index returning 7.3%. Meanwhile, falling oil prices continued to hurt the energy sector, with the Russell 3000 Energy Index returning -7.4%. Despite more muted returns during the quarter, technology continued to lead all sectors year-to-date.

Large cap stocks continued to outpace small cap stocks, with the exception of micro cap. The Russell 1000 Index returned 3.0%, versus 2.7% and 2.5% for the Russell Mid-Cap and Russell 2000 Indices, respectively. Momentum pulled well ahead of other market factor indices during the quarter, as the S&P 500 Momentum Index posted a return of 4.4%.

The large cap segment of the financials sector produced especially strong June returns due to a confluence of factors, including: interest rate increases, increased IPO underwriting, and greater allowances for using excess cash to increase dividends and share buybacks. The Russell 3000 Financials sector returned 3.9%, building on its 3.0% return during the first quarter.

In some ways, US equity performance thus far in 2017 represented a reversal of the trend experienced during the same period in 2016. As seen in **Figure 1**, during the first half of 2016, low volatility sectors and securities viewed as "bond proxies" performed well. In contrast, 2017 has proven to be more favorable for high momentum, high growth areas of the market. It is unclear whether economic fundamentals will be strong enough to sustain this trend throughout the remainder of the year. However, at minimum, this rapid market rotation illustrates the importance of establishing sufficient factor diversification in order to dampen portfolio volatility.

Figure 1: Low Vol vs. Growth and Momentum



Non-US Equity

International equity markets continued to react positively to signs of strengthening economic growth across both developed and emerging markets, driving equity and sovereign debt yields higher. However, geopolitical risks (including North Korea, French elections, and US fiscal policy) drove higher volatility. As in the US, international growth equity broadly outperformed value. Developed small-cap equities outperformed large-cap equities, while emerging markets equities narrowly edged out developed markets equities. As would be expected during periods of growth leadership, healthcare and technology led performance from a sector standpoint, with materials, energy, and telecom lagging.

From a country perspective, political developments drove a generally risk-on repricing of assets. France and the Netherlands withstood the anti-globalization political forces, which reduced political uncertainty and supported higher asset prices. Italy likewise benefited from political tailwinds, as it successfully closed two failed banks without experiencing broader contagion in the financial sector. In the UK, the “Hard Brexit” camp fared poorly in the snap election, raising the probability of a more globally integrated UK. On the other side of the political spectrum, Brazil’s markets sold off as bribery accusations against the president surfaced during an ongoing investigation into political corruption.

The outlook for non-US equities by most market participants appears to be cautiously optimistic. Supportive developments include reduced political uncertainty and positive indicators of GDP and earnings growth. This, coupled with more reasonable valuations in comparison to the US, supported the ACW ex US Index’s 300 bps of quarterly outperformance versus the Russell 3000.

Fixed Income

The FOMC raised the Federal Funds rate by 0.25% during its June meeting, citing developments in labor markets and expectations for higher inflation over the near-term. FOMC statements and minutes from previous meetings suggest the Committee believes the current level of job growth is sufficient to keep downward pressure on the unemployment rate. In addition, wage growth is likely to be supported by employment gains and an unemployment rate hovering around the level of full employment.

As expected, given recent inflation data and the June increase in the targeted Federal Funds rate, the yield curve flattened considerably during the second quarter. As a result, longer duration bonds outperformed other fixed income segments with a return of 4.4%, as measured by the Bloomberg Barclays Long US Government/Credit Index. Overall, the Bloomberg Barclays Aggregate Bond Index posted a solid second-quarter return of 1.4%. Mortgage-backed securities were the weakest component of that index, as the Fed’s hawkish stance caused uncertainty for the asset class.

Unsurprisingly, given the general risk-on sentiment of the second quarter, credit spreads tightened for both the BofAML US Corporate Index and the BofAML US High Yield Index. However, because of the sharp drop in oil prices, struggling energy companies that make up a substantial component of most high yield bond indices suffered, causing CCC-rated bond yields to widen, and allowing investment grade corporate bonds to outperform their high yield counterparts.

Emerging markets debt continued to be a top performer in 2017. Hard currency EMD returned 2.2% for the quarter and 6.2% for the year-to-date, as measured by the JPM EMBI Global Diversified Index. Local currency EMD performance was bolstered by the weakening of the US dollar during the quarter, and returned 3.6% for the quarter and 10.4% for the year-to-date as measured by the JPM GBI-EM Global Diversified Index (Local).

Diversified Hedge Funds

The hedge fund industry continued to produce positive returns for the quarter, though they cooled slightly from the pace set in the first quarter. The fund of hedge fund managers tracked by RVK generally produced positive returns, despite the fact that positioning was generally defensive.

Direct multi-strategy managers outperformed their fund of funds counterparts, but there was considerable dispersion across strategies. Notably, event driven managers, which tend to be more directional, were up between 4-7% year-to-date, and had a generally strong quarter. On the flipside, relative value and market neutral oriented strategies failed to capitalize on the quarter’s beta-driven tailwinds and improved stock picking environment. Equity Long/Short (“ELS”) managers continued to experience a notable recovery, as the HFR Equity Hedge Index was the best performing broad hedge fund category thus far in 2017. The ELS managers

RVK follows closely, successfully navigated this environment by capturing a significant portion of the market upside while limiting downside losses during bouts of market volatility – exactly the profile we generally hope to see from these types of strategies. From a positioning perspective, ELS managers in aggregate continued adding gross exposure, but maintained net exposure at relatively consistent levels. The technology sector was a notable exception, where net exposure across ELS strategies approached all-time highs as managers sought to capitalize on what they viewed to be an especially rich opportunity set.

As measured by the HFRI Fund Weighted Composite, the industry has now generated positive returns in 15 out of 16 months dating back to March 2016. Macro strategies continued to lag other sectors, however, as systematic strategies were whipsawed by interest rate movements in 2017.

Global Tactical Asset Allocation (“GTAA”)

Relative to an undiversified and static portfolio comprised of 60% US equity and 40% fixed income, performance across the GTAA manager universe was mixed in the second quarter. The stronger-performing tactical managers either avoided or de-emphasized US large cap equity exposure in favor of foreign developed equity, emerging market equity, and credit-sensitive fixed income. Managers with overweight positions in European and Japanese equity exposures fared particularly well. In some cases, managers also derived their outperformance from avoiding broad US large cap market exposure in favor of significant sector-specific concentrations within US equities.

Exposure to commodities and commodity-sensitive sectors proved to be a key detractor for managers with weaker relative performance. Although emerging markets equities broadly provided a strong boost to returns, managers with a preference for value-oriented investing within emerging markets equities underperformed.

Diversified Inflation Strategies (Real Return)

Performance for Diversified Inflation Strategies in the second quarter varied widely, as commodities exposure (or lack thereof) served as the defining characteristic that separated strong manager returns from disappointing ones. The Bloomberg Commodity Index posted a negative return of -3.0%. The energy subset of the index posted a particularly weak return of -9.7%, driven largely by a -9.8% decline in WTI Crude Oil spot prices. The year-over-year change in headline CPI (lagged by one month) declined over the quarter from 2.4% to 1.9%. Simultaneously, market expectations of future inflation as measured by five and ten-year Treasury break-evens also declined by 0.29% and 0.24%, respectively. Both estimates of future inflation hover around 1.7%, below the Federal Reserve’s stated 2.0% inflation target.

Real Estate

Core real estate returns mirrored those experienced in the first quarter. Gains were moderate with income comprising more than half of the quarter’s total return. The core index, NCREIF-ODCE, returned 1.7% (on a preliminary basis) during the quarter, reinforcing investor expectations of lower returns going forward as we enter the later stages of the recovery. The ODCE income return was 1.1%, with appreciation contributing the remaining 0.6%. Investors in publicly traded real estate fared somewhat better during the quarter, as measured by the FTSE/NAREIT All REIT’s Index’s return of 2.4%.

Real estate valuations remain at elevated levels. However, with the exception of a small cohort of high-end luxury properties in a few gateway cities, fundamentals remain intact. From a sector perspective, the industrial sector continues to perform well and dominates manager conversations. Although e-commerce is a major driver of near-term underperformance in the retail sector, the disruptive force it exerts may be healthy for the sector in the long-term. Despite the headwinds, retail is not “dead,” but simply experiencing an evolving landscape.

Disclaimer

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RVK

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