# Capital Markets Review | 3rd Quarter 2017

**September 30, 2017**

## Overview

Expectations for continued global growth, as well as US fiscal policy stimulus, were again cited as the primary factors driving equity markets to record levels. Indeed, the S&P 500 index returned nearly 4.5% over Q3, while the MSCI ACW Ex US index rose approximately 6.2%. Oil markets also traded higher during the period, albeit within recent ranges, with WTI crude reaching $52 per barrel. While no material price action occurred on the announcement, market participants noted Standard & Poor's downgrade of China from AA to A+, suggesting deterioration of economic fundamentals in the world's second largest economy could be a risk to global growth going forward.

Global monetary policy was also in focus, with the Federal Open Market Committee ("FOMC") announcing its intent to start its balance sheet normalization strategy in October. The announcement elicited limited price action, as market commentary suggested the policy change was well telegraphed through speeches by policy makers and FOMC meeting minutes. Foreign central banks, including the European Central Bank ("ECB"), the Bank of England, and the Bank of Japan, also discussed potential monetary policy actions, however, market participants suggested discussions were more balanced overall versus discussions earlier in the year. The US dollar re-priced accordingly during the last month of the quarter while finishing slightly weaker compared to the beginning of the period.

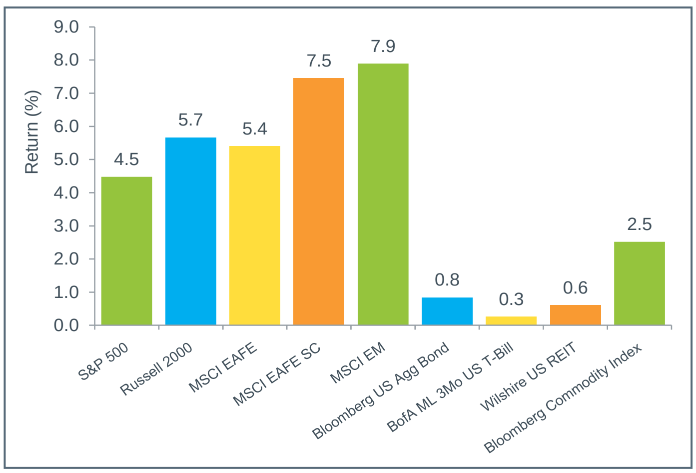
Late in the period, a speech given by FOMC Chair Janet Yellen drove the implied probability of a December rate hike to nearly 80%, versus roughly 40% in late August. The Chair's speech covered a number of topics with material implications for US monetary policy, but most surprising was her suggestion that the FOMC may not be measuring inflation accurately. While near-dated policy sensitive asset prices adjusted appropriately, longer-date asset price movement was more muted as market participants suggested the likelihood that she will not be re-nominated as the Chair weighed on the market reaction.

Finally, US interest rates reached 2017 lows for key maturities before rising late in the period which was generally attributed to a renewed sense of optimism regarding the economic growth outlook. The 10-year Treasury traded lower to nearly 2.0% early in the quarter on increased geopolitical risks, but then rose higher to end the quarter over 2.3% on potential fiscal stimulus measures announced by the US administration. Still, the yield curve flattened materially during the period on the increased likelihood of further rate hikes by the FOMC amidst a general lack of confidence in long-run economic growth prospects.

### Trailing Period Market Performance (%)

| | QTD | CYTD | 1 Year | 5 Years | 10 Years |
|---|---|---|---|---|---|
| S&P 500 | 4.5 | 14.2 | 18.6 | 14.2 | 7.4 |
| Russell 2000 | 5.7 | 10.9 | 20.7 | 13.8 | 7.8 |
| MSCI EAFE | 5.4 | 20.0 | 19.1 | 8.4 | 1.3 |
| MSCI EAFE SC | 7.5 | 25.4 | 21.8 | 12.8 | 4.6 |
| MSCI EM | 7.9 | 27.8 | 22.5 | 4.0 | 1.3 |
| Bloomberg US Agg Bond | 0.8 | 3.1 | 0.1 | 2.1 | 4.3 |
| BofA ML 3Mo US T-Bill | 0.3 | 0.6 | 0.7 | 0.2 | 0.5 |
| Wilshire US REIT | 0.6 | 2.4 | 0.1 | 9.5 | 5.6 |
| Bloomberg Commodity Index | 2.5 | -2.9 | -0.3 | -10.5 | -6.8 |

### Quarter-to-Date Performance (%)



## Key Economic Indicators

| | | As of | 6/30/2017 | 3/31/2017 | 10 Year Average |
|---|---|---|---|---|---|
| Federal Funds Rate | 1.06% | 9/30/2017 | 1.06% | 0.82% | 0.51% |
| Treasury - 1 Year | 1.31% | 9/30/2017 | 1.24% | 1.03% | 0.59% |
| Treasury - 10 Year | 2.33% | 9/30/2017 | 2.31% | 2.40% | 2.64% |
| Treasury - 30 Year | 2.86% | 9/30/2017 | 2.84% | 3.02% | 3.50% |
| Breakeven Inflation - 1 Year | 1.24% | 9/30/2017 | 0.72% | 2.06% | 0.82% |
| Breakeven Inflation - 10 Year | 1.85% | 9/30/2017 | 1.74% | 1.98% | 1.98% |
| Breakeven Inflation - 30 Year | 1.93% | 9/30/2017 | 1.85% | 2.09% | 2.18% |
| Barclays US Corp: Hi Yld Index - OAS | 3.47% | 9/30/2017 | 3.64% | 3.83% | 6.11% |
| Capacity Utilization | 76.12% | 8/31/2017 | 76.66% | 75.91% | 75.92% |
| Unemployment Rate | 4.20% | 9/30/2017 | 4.40% | 4.50% | 6.99% |
| ISM PMI - Manufacturing | 60.80% | 9/30/2017 | 57.80% | 57.20% | 52.37% |
| Baltic Dry Index - Shipping | 1,356 | 9/30/2017 | 901 | 1,297 | 2,126 |
| Consumer Confidence (Conf. Board) | 119.80 | 9/30/2017 | 117.30 | 124.90 | 75.25 |
| CPI YoY (Headline) | 2.20% | 9/30/2017 | 1.60% | 2.40% | 1.74% |
| PPI YoY - Producer Prices | 3.30% | 9/30/2017 | 2.20% | 3.80% | 1.88% |
| US Dollar Total Weighted Index | $88 | 9/30/2017 | $91 | $94 | $80 |
| WTI Crude Oil per Barrel | $52 | 9/30/2017 | $46 | $51 | $77 |
| Gold Spot per Ounce | $1,280 | 9/30/2017 | $1,242 | $1,249 | $1,253 |

## Asset Class Commentary

### US Equity

US small cap stocks outperformed large cap stocks, with the Russell 2000 index returning 5.7% versus the Russell 1000 index return of 4.5%, and across all market capitalizations growth stocks continued to outperform value. Within the large cap growth segment, information technology, health care, and financial stocks outperformed other sectors over the period. Managers targeting these sectors generally benefited from the exposure, but delivered mixed results relative to their respective indices. While large cap value stocks delivered lower absolute returns, most managers with heavier exposure to the energy, financials, and materials sectors were able to deliver excess returns.

Conversely, small cap growth managers faced challenges during the period, partly due to strong performance in biotechnology stocks. Managers view this space as too speculative or low quality, but the industry has been performing well over the past year. Still, despite growth's continued leadership, small and micro cap value stocks did provide improved absolute returns after tepid results in the first half of 2017. Performance of small cap value managers with exposure to cyclical and economically sensitive sectors generally improved, as these segments rebounded during the quarter.

### Non-US Equity

Developed international stocks performed well on an absolute and relative basis when compared to their domestic counterparts, but trailed relative to emerging markets. Value stocks outperformed growth in developed markets while underperforming in emerging markets, however performance varied across market cap. Small caps continued to outperform large in developed markets, while large outperformed small cap in emerging markets. This rally was broad based, with only two developed countries within the MSCI EAFE index returning negative performance. European market returns heavily influenced market performance, as ECB policy makers scaled-back expectations for the removal of accommodative monetary policy.

Emerging markets were again the best performing equity asset class, extending its lead against developed markets for the year. Growth stocks materially outperformed value, while small caps lagged for both the quarter and year-to-date periods. Managers holding significant positions in large technology companies, such as Alibaba and Tencent, were rewarded with above market returns. The weaker dollar, one of the largest factors influencing emerging markets, continues to support respective exposures, while solid earnings growth across international markets is also cited as driving positive performance. The rally in crude oil also contributed to performance, as energy was one of the best performing sectors.

## Fixed Income

The Bloomberg Barclays US Aggregate Bond index returned 0.8% in Q3, as a slight increase in yields was not enough to keep bonds from posting a positive return. Mortgage-backed securities did not respond significantly even as the FOMC detailed its plan to decrease its mortgage purchases in order to wind down its balance sheet, while credit spreads have continued to slowly tighten. By the end of the quarter, high yield credit spreads reached a three-year low while investment grade credit spreads matched its lowest point since 2007.

A majority of active core fixed income managers outperformed their benchmark, as most took in more income than the benchmark while others have reduced the interest rate sensitivity of their portfolio. Conversely, many high yield credit managers have underperformed as low quality and distressed credits have driven market returns.

Local currency emerging market debt continues to post strong performance as the JPMorgan GBI-EM Global Diversified index returned 3.6% for the quarter. It has been one of the strongest performing asset classes on a year-to-date basis, with a return of 14.3%. The weakening dollar has been the most significant contributor to performance for non-dollar debt for the quarter.

## Diversified Hedge Funds

Hedge funds largely provided positive performance, with fundamental and event-driven strategies leading while macro oriented managers continued to struggle. Multi-Strategy manager returns were generally positive during the quarter, but have experienced wide dispersion year-to-date. Managers that RVK tracks who pursue a more directional and event-driven style of investing have posted returns in the 7 to 10% range, while managers using a less directional, relative value oriented approach are up just 2 to 3%, on average.

The best performing broad hedge fund category for both the quarter and year-to-date has been traditional Equity Long-Short (ELS). Indeed, prime brokerage data indicate that 2017 continues to be one of the strongest years for total alpha generation since 2010, and managers have generally performed well on both an absolute and risk-adjusted basis, with long positions driving a majority of returns and short positions efficiently hedging market directionality. Strong inter-sector dispersion following company earnings reports has been a recurring theme reported by managers, creating an advantageous environment for long/short positioning.

The Funds of Hedge Funds (“FoHF”) managers RVK follows closely generated returns between 0.7% and 2.0% during the quarter, generally trailing the peer group based benchmarks. Many of these managers have scaled-back overall exposure to pro-cyclical strategies, like ELS and Credit, as valuations have richened and credit spreads have tightened. Managers have instead allocated to less directional quantitative, macro, and volatility oriented funds. As a result, several FoHFs are not participating in the market’s upside to the degree one might otherwise expect.

## Global Tactical Asset Allocation (“GTAA”)

Performance for GTAA Managers continued to build on a strong year for most strategies. Quarterly returns varied widely given a diverse group of managers, but most core GTAA allocation managers outperformed a static US 60/40 portfolio both during the quarter, and also year-to-date. Generally, those that ranked among the top of peers tended to rely on value-oriented investment processes that have resulted in significant equity, fixed income, and currency exposure within emerging markets. Some managers that anticipated increasing interest rates and consider the valuations of other asset classes expensive held larger cash positions leading to underperformance relative to peers. Several diversifying absolute return-oriented global macro discretionary strategies trailed the rest of the group in what has become a disappointing year for these managers. Many of these strategies have positioned for an environment of central bank policy divergence, increasing interest rates in the US and a stronger dollar environment, which has not materialized. Most risk parity strategies, especially those with larger corporate credit and energy commodity exposures, provided some of the strongest returns over the quarter.

## Diversified Inflation Strategies ("DIS")

DIS performed relatively well, with some even outperforming a static US 60/40 portfolio despite a low-inflation environment. This occurred in a quarter where inflation levels remained low, but rose from 1.6% in June, to 2.2% based on the most recently available headline CPI release in September.

Although there were strong performers in the group some strategies did experience headwinds. Specifically, those with heavier overall fixed income exposure, including floating rate fixed income and TIPS, lagged relative to peers. Further, most managers with a lack of natural resources equity and/or an emphasis away from the energy and industrial metals sectors underperformed peers. However, there were managers that overcame significant TIPS allocations and performed strongly given emerging market currency allocations and tactical commodities over-weights.

Nonetheless, DIS managers that strategically avoided TIPS allocations in favor of infrastructure, REIT equity and fixed income exposure ranked toward the top of the peer group; and managers with natural resource equity allocations, or commodity allocations focused on energy and industrial metals also delivered stronger relative performance compared to peers.

## Real Estate

The core private real estate index, NCREIF-ODCE, returned 1.9%, on a preliminary basis, during Q3, comprised of 1.1% income and 0.8% appreciation. Market participants characterized this as another quarter of normalizing returns reinforcing investor expectations of lower returns going forward as the market enters the later stages of the recovery. Investors in publicly traded real estate trailed their private market counterparts during the quarter as measured by FTSE/NAREIT All REIT's index return of 1.2%.

Real estate valuations remain healthy, supported by continuing strength in the overall economy. In September, upward revisions to US growth supported capital markets and real estate valuations.

After a multi-year reprieve from Atlantic hurricanes making landfall, the US experienced two devastating storms. Harvey and Irma brought significant flooding and damage to the greater Houston area and many parts of Florida. Despite initial estimates of over $100 billion in losses, RVK was relieved by reports that management staffs and tenants were safe, and that the properties owned by funds managed on behalf of our clients weathered the storm relatively well. Reports indicate the impact included damage to roofing, signage, sheet rock, windows and landscaping. Reportedly, the extent of the damage to properties has been well within the boundaries of insurance coverages and managers do not expect material impacts to their fund's performance.

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