RVK

Capital Markets Review | 3rd Quarter 2018

September 30, 2018

Overview

Continued US economic growth and monetary policy divergence from global trade partners drove domestic equity and interest rate markets higher during the third quarter of 2018, while international growth expectations broadly continued to slow. Geopolitical risks, particularly those driven by newly imposed trade tariffs, were cited as dampening near-term expectations for economic growth outside the US. That said, near the end of the third quarter, it was announced that Canada had joined the agreement previously struck by the US and Mexico to rename and reform NAFTA, which modestly eased regional economic tensions.

The US Federal Open Market Committee ("FOMC") continued to raise policy rates, increasing the target range for the federal funds rate to 2.00% - 2.25% at the September meeting. The committee again cited both realized and expected labor market inflation conditions as major drivers behind their decision. The rate increase was largely expected, as was the removal of the word "accommodative" from the FOMC statement language. The FOMC also increased its estimate for GDP growth in 2018 from 2.8% to 3.1%. In international monetary policy, the European Central Bank left policy rates unchanged, but the committee did note that the expansion experienced in 2017 had considerably weakened in the first half of 2018. The committee forecasted stable, but slightly lower growth than previously anticipated, with annual GDP growth expected to decrease from 2.0% in 2018 to 1.8% in 2019. Elsewhere, the Bank of Japan also left policy rates unchanged at their respective meeting, while the Bank of England increased its policy rate by 0.25%, to 0.75%.

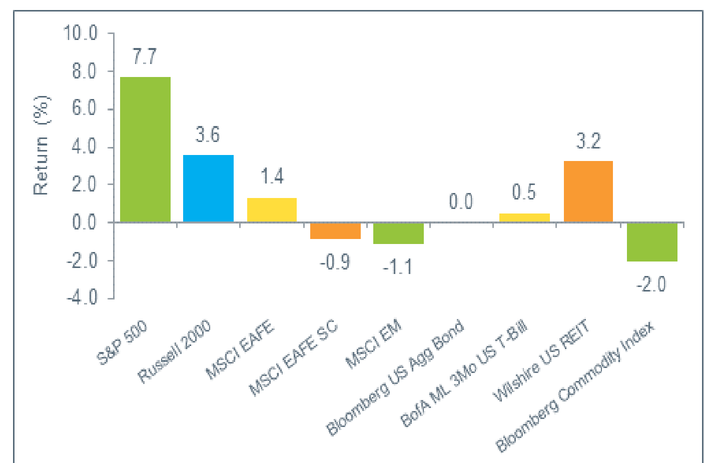
US economic fundamentals broadly continued to strengthen over the third quarter. Hiring activity in August was revised higher, and hiring remained strong in September, resulting in a decrease of the unemployment rate to 3.7%; the lowest level since 1969. In addition, hourly earnings increased 2.8% year-over-year, while the labor participation rate remained unchanged despite a 150,000 increase in the labor force. In contrast, growth across major developed and emerging international economies generally weakened. Higher US interest rates, a stronger US dollar, and the expected impact from US tariffs, were cited as primary factors affecting economic fundamentals. Relatedly, the World Bank lowered its 2019 GDP growth estimate for the Asia Pacific region down from 6.1% to 6.0%, citing trade frictions.

US equities experienced another strong quarter of returns while international equity returns were fairly tepid by comparison. Global sovereign debt yields were mixed, with US yields rising notably against those of its major trading partners and the 10-year nominal Treasury rate ended the quarter above 3%. Market participants suggested that US real yields were driven higher by both current economic growth and expectations for the continued increase of policy rates. Local emerging market debt, meanwhile, finished the quarter with negative dollar-based returns amidst the significant depreciation of many emerging market currencies.

Trailing Period Market Performance (%)

	QTD	CYTD	1 Year	5 Years	10 Years
S&P 500	7.7	10.6	17.9	13.9	12.0
Russell 2000	3.6	11.5	15.2	11.1	11.1
MSCI EAFE	1.4	-1.4	2.7	4.4	5.4
MSCI EAFE SC	-0.9	-2.2	3.7	8.0	9.7
MSCI EM	-1.1	-7.7	-0.8	3.6	5.4
Bloomberg US Agg Bond	0.0	-1.6	-1.2	2.2	3.8
BofA ML 3Mo US T-Bill	0.5	1.3	1.6	0.5	0.3
Wilshire US REIT	3.2	4.8	6.6	9.8	7.6
Bloomberg Commodity Index	-2.0	-2.0	2.6	-7.2	-6.2

Quarter-to-Date Performance (%)



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Key Economic Indicators

		As of	6/30/2018	3/31/2018	10 Year Average
Federal Funds Rate	2.18%	9/30/2018	1.91%	1.67%	0.37%
Treasury - 1 Year	2.59%	9/30/2018	2.33%	2.09%	0.55%
Treasury - 10 Year	3.05%	9/30/2018	2.85%	2.74%	2.52%
Treasury - 30 Year	3.19%	9/30/2018	2.98%	2.97%	3.35%
Breakeven Inflation - 1 Year	1.18%	9/30/2018	1.42%	2.24%	0.74%
Breakeven Inflation - 10 Year	2.14%	9/30/2018	2.13%	2.06%	1.95%
Breakeven Inflation - 30 Year	2.16%	9/30/2018	2.12%	2.07%	2.13%
Barclays US Corp: Hi Yld Index - OAS	3.16%	9/30/2018	3.63%	3.54%	5.78%
Capacity Utilization	78.10%	9/30/2018	77.46%	77.21%	75.74%
Unemployment Rate	3.70%	9/30/2018	3.80%	4.10%	6.86%
ISM PMI - Manufacturing	59.80%	9/30/2018	58.70%	60.80%	53.33%
Baltic Dry Index - Shipping	1,540	9/30/2018	1,385	1,055	1,400
Consumer Confidence (Conf. Board)	138.40	9/30/2018	128.80	130.00	81.04
CPI YoY (Headline)	2.30%	9/30/2018	2.80%	2.20%	1.54%
PPI YoY - Producer Prices	3.00%	9/30/2018	4.10%	2.70%	1.44%
US Dollar Total Weighted Index	90.11	9/30/2018	89.97	86.27	81.20
WTI Crude Oil per Barrel	$73	9/30/2018	$74	$65	$73
Gold Spot per Ounce	$1,193	9/30/2018	$1,253	$1,325	$1,295

Asset Class Commentary

US Equity

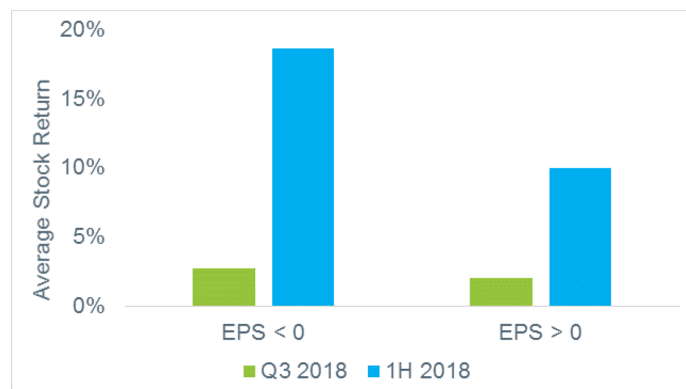
US equity markets delivered broad-based gains across market capitalizations and styles during the third quarter. Despite lingering trade war tensions, the S&P 500 Index posted its best single quarter return since Q4 2013 amidst a period of strong corporate earnings and broad-based economic growth. The S&P 500 Index returned 7.7% during the third quarter, led by health care, industrials, and the re-classified communication services sector.

Growth continued to outpace value as the Russell 1000 Growth Index bested all other US equity indices, returning 9.2% for the quarter. For the year-to-date period, the Russell 1000 Growth Index has outperformed its value counterpart by 13.2% as the two indices returned 17.1% and 3.9%, respectively. 'FAANG' stocks, the primary drivers of large cap performance for the first half of 2018, faltered in September. The group posted tepid gains for the quarter as a whole, weighed down by reduced sentiment for Facebook and Netflix.

Active management generally struggled in large cap equity in the third quarter, though active small cap managers fared better than their counterparts in the large cap space. Market support for quality companies with positive earnings generally benefitted active small cap stock pickers. This marks a notable reversal from previous quarters, where markets generally favored lower quality, lower cap, and non-earning companies.

Figure 1 illustrates the impact within the small cap space from stocks with negative earnings per share ("EPS") outpacing stocks with positive EPS during the first half of 2018. This trend weakened in Q3, partially driven by a pause in the rally among small cap biotechnology and software stocks which had been a persistent headwind to active managers in the space.

Figure 1: Small Cap Return Disparity



Non-US Equity

Developed international markets are still in negative territory year-to-date, despite large cap stocks generating positive returns in Q3. Value continued to underperform growth, but the differential was less significant during the third quarter than in many past periods. Small cap stocks

trail large cap stocks for the year-to-date period after underperforming again in the third quarter.

Regionally, the ongoing deceleration of European economic growth continued. European Central Bank President Draghi expressed concerns over trade disputes with the United States and a subsequent loss of investor confidence, as well as the many negotiation issues surrounding Brexit. In Japan, meanwhile, Prime Minister Abe won another term and, in contrast to Europe, economic growth picked up slightly over the course of the year.

Emerging markets were hit harder than their developed market counterparts this quarter, ending the third quarter with losses. Across most emerging markets, weakening currencies took their toll on dollar-based equity returns. In contrast with other regions, value significantly outperformed growth within emerging markets equities. As with the rest of the world, small cap stocks underperformed their large cap counterparts during the quarter. Among other headwinds faced by the emerging world were newly placed US tariffs on an additional $200 billion of Chinese goods, as protectionist US trade policies continued to garner market attention. Also during the quarter, China shifted their fiscal policy toward a more expansionary stance with measures to infuse banks with additional capital and increase infrastructure spending.

Fixed Income

The Bloomberg US Aggregate Index was effectively flat for the quarter. However, performance of the underlying sectors of the index varied widely. US government bonds faced greater headwinds than their corporate counterparts, as a parallel increase in rates across the Treasury yield curve led to negative performance for Treasuries. The long end of the yield curve experienced the largest rate-driven losses, with the Bloomberg US Long Term Treasuries Index returning -2.9% for the quarter. Meanwhile, in a reversal of the first half of the year, investment grade corporate spreads tightened from 1.3% to 1.1%, and the Bloomberg US Corporate Investment Grade Index returned 1.0%.

In general, low quality bonds fared better than high quality bonds during the third quarter. BBB bonds, the largest segment of the investment grade corporate index, returned 1.4%, compared to AAA bond returns of just 0.1%. Non-investment grade bonds similarly experienced a spread tightening which was more pronounced in the lower quality portion of the market. The Bloomberg Corporate High Yield Index returned 2.4%.

Emerging markets debt generally stabilized over the quarter, with the JPM EMBI Global Diversified Index returning 2.3%. However, this stabilization was not enough to overcome continued strengthening of the dollar, which pushed local currency returns significantly lower as indicated by the third quarter return of -1.8% for the JPM GBI-EM Global Diversified Index. Turmoil continued to surround Turkey and Argentina, although the Turkish lira improved late in the quarter after the central bank increased its benchmark rate from 17.75% to 24.00% despite opposition to continued hikes from President Erdogan.

Diversified Hedge Funds

The hedge fund industry produced modestly positive returns during the third quarter of 2018 as measured by the HFRI Fund Weighted Composite. However, funds did not generally keep pace with US equity market gains during the months of July and August, even on a beta-adjusted basis. Prime brokerage data indicated good alpha generation through the first half of the year from Equity Long/Short funds (“ELS”), but stock selection effects turned negative in July and early August. Increased volatility among technology stocks negatively impacted some ELS strategies, many of which maintain significant long exposure to the technology sector. Though still near the high end of its cyclical range, hedge fund net exposure to technology was reduced during September and is now in the 90th percentile compared its past allocation history, down from the 99th percentile earlier in the year.

The Fund of Hedge Fund (“FoHF”) managers RVK follows closely produced returns between 0.25% and 1.10% during the quarter. Several FoHF managers continue to benefit from outsized allocations to a few specific funds within the macro discretionary thematic and multi-strategy relative value spaces. Funds without allocations to these specific managers are generally trailing competitors by 1.5% to 2.0% year-to-date, as other defensive strategies, to which FoHFs have rotated capital in recent years, have struggled to generate returns.

Managers within the multi-strategy space experienced significant dispersion during the third

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quarter, with returns ranging from -1.1% to 2.5%. Some of this dispersion was tied to capital allocation and the sizing of specific deals within merger-arbitrage. The high profile Qualcomm/NXPI deal broke down in July, detracting significantly from returns for some managers, though the quarter was otherwise quite strong for merger-arbitrage investors.

Global Tactical Asset Allocation ("GTAA")

GTAA managers provided mixed results and a wide dispersion of returns in the third quarter. Most significantly underperformed a static, undiversified blend of 60% US equity and 40% fixed income. In a continuation of a theme that has emerged throughout 2018, top-down, value-oriented GTAA managers have posted negative returns in a year where value oriented equity holdings have significantly underperformed those with a growth orientation. For example, several managers have identified emerging markets equities as significantly undervalued relative to US equities, and this positioning detracted considerably over the quarter given the significant performance differential between the two asset classes. Similarly, many managers that provided the strongest performance relative to peers over both the quarter and year have focused exclusively on US equities and held overweight exposure to yield-oriented, energy-sensitive sectors. Others that outperformed peers over the quarter include fundamentally driven, top down managers who began the quarter with more US equity exposure. Many GTAA managers experiencing the worst performance held idiosyncratic exposure to weak, currency-driven markets such as Turkey.

Diversified Inflation Strategies ("DIS")

Nearly all DIS managers posted negative returns in the third quarter, with only a moderate divergence in performance. Headline CPI decreased over the quarter from 2.80% in June to 2.30% at the end of Q3, which coincided with headwinds across several inflation sensitive asset classes. Managers with larger exposure to TIPS, commodities and emerging markets currencies performed least favorably among the peer group as all three asset classes were simultaneously negative amid rising yields in the US and a stronger US dollar. Other detracting factors included meaningful declines in non-energy subcomponents of the commodities complex including agriculture, industrial metals and precious metals. Managers with a larger emphasis on energy in their commodity and natural resource equity holdings provided moderately stronger performance than peers. The strongest performers of the group generally held more concentrated exposures to global listed infrastructure equities, hybrid securities and spread sensitive fixed income alongside REIT equities, REIT hybrid securities and fixed income securities issued by REITs.

Real Estate

Core private real estate returned 2.1% during Q3 (on a preliminary basis), as tracked by the NCREIF-ODCE Index, with the total return comprised of 1.0% income and 1.1% appreciation. This represented a 5 basis point uptick over last quarter for the appreciation component of total return, while the income return component remains in line with historical levels. Investors in publicly traded real estate generally underperformed their private market counterparts during the third quarter, as measured by FTSE/NAREIT All REITs Index return of 0.7%. Publicly traded real estate continued to experience price volatility over the third quarter, but managed to maintain a positive total return year-to-date.

The real estate investment space continues to be monitored for potential risks that could disrupt valuations in a meaningful way. International trade tensions, tight labor markets, historically low unemployment and rising interest rates all have the potential to significantly impact property valuations. While real estate valuations remain elevated, many view real estate pricing as currently supported by strong and rising property income levels, which are, in turn, driven by a continued expansion in the overall economy.

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