Capital Markets Review | 4th Quarter 2019

December 31, 2019

Overview

The fourth quarter of 2019 was a strong period for global equity markets, with representative US, developed non-US, and emerging market indexes each substantially adding to gains realized earlier in the year. Emerging markets led with returns of 11.8%, while US markets added 9.1% to calendar year returns. Credit markets also finished in positive territory, as supportive financial conditions and a general risk-on market sentiment drove spreads to tighten across the quality spectrum. The only major asset class to struggle in Q4 was long duration government bonds, although the losses sustained were minimal in the context of a very strong year that saw yields fall considerably on longer maturity debt.

Full-year gains for the S&P 500 Index finished at 31.5%, though performance did not appear to derive meaningfully from earnings growth. Rather, valuations, defined by the 12-month forward P/E ratio, climbed throughout 2019. Forward P/E ratios began the year roughly in line with their 10-year average of 14.9, but finished at 18.3, while year-over-year earnings growth estimates were roughly flat. Valuations in this range are among the highest seen during the post-crisis economic expansion, only historically surpassed to a significant degree during the early 2000s tech bubble.

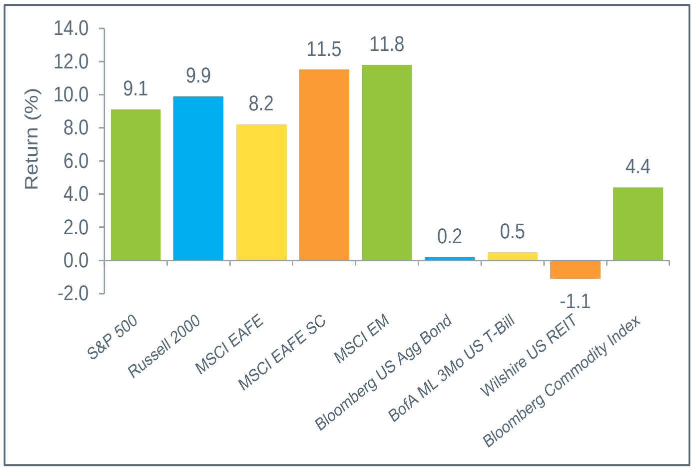
Falling discount rates drove valuations and performance for US equities during the first half of the year, but increases in Q4 appeared more directly tied to optimism around international trade. Bilateral negotiations between the US and China resulted in an announced "Phase One" trade agreement, including a partial rollback of tariffs, which de-escalated trade tensions to a degree. Markets reacted positively to speculation around the prospects of this agreement throughout the quarter with much tied to its successful implementation. The most recent World Bank Global Economic Prospects report cited weakness in global trade and investment as key factors contributing to the global growth slowdown realized in 2019—much of it directly related to trade tensions between the US and China. The report found that 2019 global GDP growth forecasts fell by 0.2% from June's estimate to 2.4%. Emerging market economies, the traditional engine for global growth, saw 2019 growth estimates fall 0.5% over the prior period, to 3.5%.

US economic data released during Q4 was generally positive—although softness remains in some key sectors, such as manufacturing. By December, the Institute for Supply Management (ISM) Purchasing Managers Index (PMI) was below 50 for the 5th straight month, indicating contraction in the manufacturing sector. However, job growth in the US continues to be positive, with monthly non-farm payrolls expanding by an average of 184,000 per month during Q4 and the unemployment rate finishing the year at 3.5%. The US remains a bright spot for growth in developed economies, while much of Europe and Japan continue to struggle. Global central banks remain accommodative, though the market expects little additional help from the Federal Reserve in 2020. During its most recent meeting, the Federal Reserve Open Market Committee (FOMC) did not forecast any additional rate cuts in 2020.

Trailing Period Market Performance (%)

	QTD	CYTD	1 Year	5 Years	10 Years
S&P 500	9.1	31.5	31.5	11.7	13.6
Russell 2000	9.9	25.5	25.5	8.2	11.8
MSCI EAFE	8.2	22.0	22.0	5.7	5.5
MSCI EAFE SC	11.5	25.0	25.0	8.9	8.7
MSCI EM	11.8	18.4	18.4	5.6	3.7
Bloomberg US Agg Bond	0.2	8.7	8.7	3.0	3.7
BofA ML 3Mo US T-Bill	0.5	2.3	2.3	1.1	0.6
Wilshire US REIT	-1.1	25.8	25.8	6.9	11.9
Bloomberg Commodity Index	4.4	7.7	7.7	-3.9	-4.7

Quarter-to-Date Performance (%)



Key Economic Indicators

	Q4 2019	Q3 2019	Q2 2019	10 Year Average
Federal Funds Rate	1.55%	1.90%	2.40%	0.61%
Treasury - 1 Year	1.59%	1.75%	1.92%	0.74%
Treasury - 10 Year	1.92%	1.68%	2.00%	2.40%
Treasury - 30 Year	2.39%	2.12%	2.52%	3.19%
Breakeven Inflation - 5 Year	1.70%	1.35%	1.54%	1.75%
Breakeven Inflation - 10 Year	1.79%	1.52%	1.70%	2.00%
Breakeven Inflation - 30 Year	1.81%	1.59%	1.76%	2.13%
Barclays US Corp: Hi Yld Index - OAS	3.36%	3.73%	3.77%	4.81%
Capacity Utilization	77.32%	77.42%	77.69%	76.66%
Unemployment Rate	3.50%	3.50%	3.70%	6.25%
ISM PMI - Manufacturing	47.20%	47.80%	51.70%	54.22%
Baltic Dry Index - Shipping	1,090	1,823	1,354	1,278
Consumer Confidence (Conf. Board)	126.50	126.30	124.30	91.32
CPI YoY (Headline)	2.30%	1.70%	1.60%	1.78%
PPI YoY - Producer Prices	1.90%	-0.20%	0.50%	1.83%
US Dollar Total Weighted Index	$91	$93	$91	$83
WTI Crude Oil per Barrel	$61	$54	$58	$72
Gold Spot per Ounce	$1,517	$1,472	$1,410	$1,348

Asset Class Commentary

US Equity

US markets enjoyed a strong finish to the year amid de-escalation of the US-China trade war and accommodative monetary policy. The quarter saw high single and low double digit returns for major indexes across all size segments and styles. Large- and mid-cap stocks lagged slightly behind small-cap stocks, with the Russell 2000 Index returning 9.9% and the S&P 500 and Russell MidCap Indexes returning 9.1% and 7.1%, respectively. The strong quarter pushed the S&P 500 Index to a return of 31.5% for the year. This marked the 18th time since 1930 that the index has surpassed 30% in a calendar year indicating that, on average, these high return environments have occurred approximately once every 5 years.

The rotation to value seen in September was reversed across all market caps in Q4, although both value and growth saw high single to low double digit returns. The Russell 2000 Growth and MidCap Growth Indexes outperformed their value counterparts in the first two months of the quarter; however, value returns outpaced growth in the small and mid-cap segments in December. Additionally, high beta stocks reversed their underperformance from Q3, with the S&P 500 High Beta Index returning 13.5% in Q4 compared to its Q3 return of -3.0%. High momentum stocks generally outperformed low-volatility stocks in the quarter as well.

Active managers struggled to keep up with strong benchmark returns in Q4. The success realized by many small-cap managers during the first 9 months of the year reversed as the group struggled to generate excess returns. In contrast, more mid-cap managers experienced better rates of success. In addition, value-tilted managers performed notably better versus their respective indexes compared to growth and core managers during the quarter.

Non-US Equity

Developed international markets delivered strong absolute returns in Q4, but they still lagged both domestic and emerging markets. Yet again, value stocks underperformed growth, while small-cap stocks outperformed their larger counterparts for the quarter. By country, returns for the quarter were positive almost across the board, with only Belgium ending in slightly negative territory. However, Q4 returns were largely driven by multiple expansion, as growth continues to be weak in developed international markets. While the Purchasing Managers Index (PMI) in Europe showed improvement over the last few months, investor attention was more focused on the continued growth struggles in Germany. Additionally, Japan reported GDP growth of just 0.2% in the third quarter, which was below estimates. In response to current trends, the European Central Bank and the Bank of Japan left rates unchanged.

Emerging markets outperformed all other broad equity regions in Q4. Growth stocks outperformed value during the quarter and finished the year with over twice the return of the value segment. In contrast to developed markets, large-cap emerging market stocks outperformed their small-cap counterparts. Returns in emerging markets were largely lifted by the announcement of the initial phase of a trade deal between China and the US, potentially indicating a thaw in the ongoing trade war. The agreement, which is expected to be signed in January, will cancel previously announced new tariffs and roll back some existing ones. However, complete details regarding this agreement are still not public, and it is unclear what effect it will ultimately have on growth expectations.

Fixed Income

After a solid first three quarters supported by declining rates, the Bloomberg US Aggregate Index finished the year more subdued, returning just 0.2% for the final quarter. While yields on the short-end continued to decline, those of 3-year maturities and longer rose, creating a steeper US Treasury curve. This was a negative outcome for longer dated bonds, which had previously benefitted from past declines. The Bloomberg US Government Long Duration Index fell sharply, finishing the quarter with a -4.1% return, but the index still ended the year in positive territory with a return of 14.7%.

Corporate credit fared better than the broader index for the quarter, as strong economic data signaled optimism for the sector. Spreads tightened over the quarter, and the Bloomberg US Corporate Index returned 1.2% to add to an already-impressive annual return of 14.5%. With more risk-on sentiment, high yield also finished on a high note, with the Bloomberg US High Yield Index returning 2.6% for the quarter. However, the late resurgence in CCC-rated paper was not enough to overcome a weak energy sector, which had dragged on performance throughout the year, and higher-rated debt continued to lead the way.

Hard currency emerging markets debt also added to a strong year, boosted by continued softness in global growth as well as an initial trade deal between the US and China announced in December. The JPM EMBI Global Diversified Index posted 1.8% in the final quarter to finish the year up 15.0%. A weakened US dollar was particularly beneficial to local currency emerging markets, which returned 5.2% in Q4.

Diversified Hedge Funds

Hedge funds finished the year on a positive note, as the vast majority of strategies in the space added to gains realized earlier in the year. Equity Long/Short (ELS) strategies were the best performers during Q4, returning 5.9% according to the HFRI Equity Hedge Index. Managers benefitted both from tail-winds provided by their beta exposure, as well as from a generally good stock-picking environment for alpha generation. The managers RVK follows closely reported positive contributions from stock selection in both long and short names across their portfolios, and prime brokerage data indicates that 2019 was the best year for stock selection alpha in the last decade. Indeed, the HFRI Equity Hedge Index return for 2019, at 13.9%, was the best returning year for the index since 2013. Transitioning into 2020, data indicates that managers are maintaining relatively high levels of gross exposure compared to history, with net exposure closer to long-term averages.

Returns for Multi-Strategy Funds and Funds of Hedge Funds (FoHFs) were positive during the quarter and for the year, although with considerable dispersion across managers based on their styles. Funds that strive to maintain low equity beta exposure generally had good alpha generation years, but they produced absolute returns that appear unremarkable in the context of the upward trajectory of global equity markets. Multi-strategy managers of this sort that RVK follows generated returns ranging from approximately 6% to 7%, while those with an event-driven style who take on moderate beta exposure produced significantly higher returns in the low- to mid-teens.

Similarly, FoHFs that maintained significant strategic exposure to Long/Short Equity and Long/Short Credit outperformed funds that rotated towards diversifying, market neutral strategies. In particular, Systematic Macro managers were a detractor to results during Q4, returning -1.5% according to the HFRI Macro Systematic Diversified Index. The reversal in interest rate trends in September and October caught many Systematic Macro managers off guard, though the index still produced positive annual returns of 7.1%, its strongest year of returns since the oil market sell-off in 2014.

Global Tactical Asset Allocation (GTAA)

Most GTAA managers showed positive absolute performance in 2019, though they generally underperformed a static and less diversified blend of 60% US equity and 40% US fixed income. Nearly all GTAA managers underperformed this measure due to the extraordinarily strong 2019 performance of US large-cap equities compared to most of the other diversifying global asset classes included within GTAA strategies. Performance varied widely across the manager universe in both 2019 and Q4. Generally, those with the strongest returns in 2019 held higher relative allocations to US equities as opposed to developed international or emerging market equities. Within emerging markets, growth equities once again outpaced value, which detracted from performance on a relative basis for managers with significant exposure to value. For reference, the MSCI Emerging Markets Growth Index returned 25.1% in 2019 and 13.7% for Q4, versus 12.0% and 9.9%, respectively, for the MSCI Emerging Markets Value Index. Managers that maintained significant short positions to US large-cap equities significantly lagged peers over the course of the quarter and calendar year. More idiosyncratic positions that helped the relatively stronger performing managers included exposures to commodity contracts, such as oil, and dedicated precious metal allocations. Among multi-asset managers intending to provide reduced correlations, lower volatility, and less market sensitivity, most outperformed their moderate return targets of cash +5%, although they still lagged long-biased GTAA managers significantly.

Diversified Inflation Strategies (DIS)

Performance of DIS managers ranged widely throughout both Q4 and the calendar year, though nearly all managers provided significantly stronger than typical positive absolute returns. In addition, nearly all managers with CPI-relative return targets exceeded those targets for the year. Managers with larger TIPS allocations tended to underperform peers for the year despite still achieving their own real return expectations. DIS managers that outperformed peers by the widest margins emphasized allocations to REITs, global listed infrastructure, and/or global natural resource equities in varying proportions. DIS manager performance was generally strong as both inflation- and market-based measures of future expected inflation increased. Inflation, as measured by the year-over-year change in Headline CPI, increased over the quarter, from 1.70% in September to 2.30% in December. 10-year Treasury break-evens, a market-based measure of future inflation expectations, also increased over the quarter from 1.52% to 1.79%. During Q4, managers that outperformed peers on a relative basis generally held higher allocations to global natural resource equities, listed infrastructure, and REITs, as these asset classes benefited more from changes to inflation and market based measures of future inflation.

Real Estate

Core private real estate returned 1.5% during the quarter (on a preliminary basis), as reported by the NCREIF-ODCE Index, with the total return comprised of 1.0% income and 0.5% price appreciation. While the income component stayed in-line with historical levels, price appreciation experienced a modest increase of 0.2% compared to the relatively flat Q3 return. Investments in publicly traded real estate trailed their private market counterparts during Q4, as publicly traded real estate delivered a total return of 0.6% in Q4, as measured by FTSE/NAREIT All REITs Index. Overall, the private real estate market continues to have a mostly positive outlook, with elevated property valuations supported by strong underlying economic and employment trends and moderating return expectations. However, there were two meaningful developments over the course of the year that have the potential to continue weighing on investor returns.

The first development is the weakness in regional mall assets anchored by traditional apparel-based tenants and big-box centers. Investors have been experiencing negative impacts to asset valuation as appraisers incorporate more transactional data into their processes. It is anticipated that recent transactions at reduced valuations will continue to put downward pressure on overall retail sector returns.

The second development was the decision of the FOMC to reverse course and begin lowering rates, which lowered borrowing costs and is expected to be accretive to overall returns in the current economic environment. For some market participants, the rate change signaled a need to emphasize real estate strategies able to generate attractive risk-adjusted returns through growing net operating income and rents rather than relying on cap rate compression.

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