Capital Markets Review | 2nd Quarter 2019

June 30, 2019

Overview

During the second quarter of 2019, most global risk assets added to gains realized during the first quarter, albeit with considerable bouts of volatility tied to heightened geopolitical tensions and the evolving China-US trade dispute. Strong returns realized in April were erased in May, as confidence in the steady pace of global economic expansion waned and the US threatened to impose additional tariffs on $300B worth of Chinese goods. Global central banks collectively reacted to the negative market sentiment with accommodative guidance that eased concerns and brought about renewed optimism in June. Central banks were also reacting to moderating growth expectations as the World Bank lowered its global GDP growth estimate for Calendar Year 2019 from 2.9% to 2.6%. The European Central Bank ("ECB") and Bank of Japan ("BoJ") both reaffirmed guidance maintaining low interest rates into 2020 and the ECB signaled the potential for additional interest rate cuts and quantitative easing should economic conditions deteriorate further. US interest rate markets, which were pricing in a rate increase as recently as six months ago, have turned dramatically. In fact, at one point in June, market based indicators discounted 100 basis points of easing over the coming year.

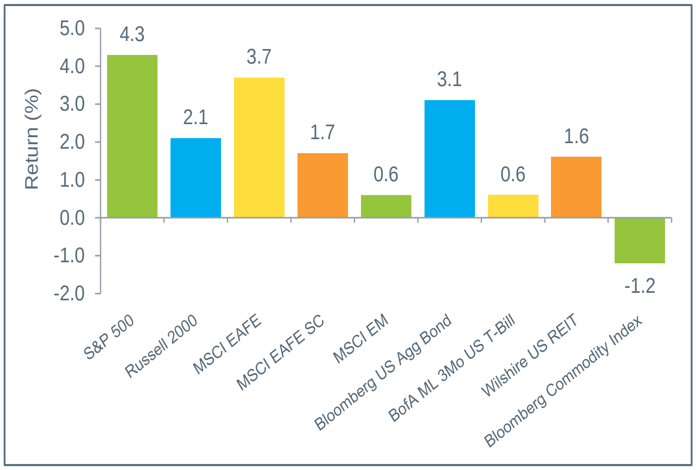
For the quarter, US equities outperformed international developed and emerging markets, and duration sensitive assets produced notable gains as yields fell across most developed economies. Yields on the 10-year Treasury note fell from 2.41% ending Q1 to 2.00% at the end of the second quarter, providing a strong pass-through to higher equity valuations via a lower discount rate. Commodities were the only major asset class to produce negative returns, with energy and industrial metals markets driving the complex lower. Oil market prices fell slightly despite potential supply disruptions tied to flaring diplomatic tensions involving Iran following tanker attacks in the Strait of Hormuz.

The economic data released during the quarter was largely consistent with slowing economic growth. While non-farm payroll growth in the US remained healthy in Q2, averaging 171,000 new jobs per month, it was below the 223,000 per month rate from 2018. Similarly, the Purchasing Managers' Indexes ("PMIs") for the manufacturing and service sectors fell from recent levels in the mid-50s to just above 50, indicating a slower expansion of economic activity in those sectors. While first quarter US GDP growth estimates came in with a strong reading of 3.1%, a closer read of the numbers indicated much of the contribution was attributable to increases in inventory, which is not typically a sustainable growth driver. Indeed, the Atlanta Federal Reserve GDP Nowcast, which attempts to estimate the pace of GDP growth in real time based on incoming economic data, read 1.3% for second quarter growth as of June 28. Taken together, the Federal Reserve is widely expected to lower interest rates during its July meeting with the Federal Open Market Committee ("FOMC") referencing both the US and global growth slowdown as basis for pursuing a more accommodative path for monetary policy.

Trailing Period Market Performance (%)

	QTD	CYTD	1 Year	5 Years	10 Years
S&P 500	4.3	18.5	10.4	10.7	14.7
Russell 2000	2.1	17.0	-3.3	7.1	13.4
MSCI EAFE	3.7	14.0	1.1	2.2	6.9
MSCI EAFE SC	1.7	12.5	-6.3	4.4	9.7
MSCI EM	0.6	10.6	1.2	2.5	5.8
Bloomberg US Agg Bond	3.1	6.1	7.9	2.9	3.9
BofA ML 3Mo US T-Bill	0.6	1.2	2.3	0.9	0.5
Wilshire US REIT	1.6	17.9	10.5	7.8	15.7
Bloomberg Commodity Index	-1.2	5.1	-6.8	-9.1	-3.7

Quarter-to-Date Performance (%)



Key Economic Indicators

	Q2 2019	Q1 2019	Q4 2018	10 Year Average
Federal Funds Rate	2.40%	2.43%	2.40%	0.52%
Treasury - 1 Year	1.92%	2.40%	2.63%	0.68%
Treasury - 10 Year	2.00%	2.41%	2.69%	2.49%
Treasury - 30 Year	2.52%	2.81%	3.02%	3.29%
Breakeven Inflation - 5 Year	1.54%	1.79%	1.49%	1.75%
Breakeven Inflation - 10 Year	1.70%	1.87%	1.71%	2.01%
Breakeven Inflation - 30 Year	1.76%	1.92%	1.82%	2.16%
Barclays US Corp: Hi Yld Index - OAS	3.77%	3.91%	5.26%	5.01%
Capacity Utilization	78.07%	78.41%	79.46%	76.29%
Unemployment Rate	3.60%	3.80%	3.90%	6.55%
ISM PMI - Manufacturing	51.70%	54.20%	54.30%	54.50%
Baltic Dry Index - Shipping	1,354	689	1,271	1,343
Consumer Confidence (Conf. Board)	121.50	131.40	126.60	87.71
CPI YoY (Headline)	1.60%	1.90%	1.90%	1.67%
PPI YoY - Producer Prices	0.40%	0.50%	1.30%	1.69%
US Dollar Total Weighted Index	$91	$92	$92	$82
WTI Crude Oil per Barrel	$58	$60	$45	$73
Gold Spot per Ounce	$1,409	$1,292	$1,282	$1,325

Asset Class Commentary

US Equity

US equity markets sustained the strong performance trends from the first quarter into the second quarter. All major indices finished in positive territory mostly buoyed by accommodative language from the FOMC and the potential for a short-term resolution in the China-US trade dispute. However, despite finishing the quarter positively, US markets did experience a mid-quarter drawdown. In May, all three major US indices dropped below their 200-day moving averages, but bounced back in June to close the month above that trend line. The quarter finished strongly in June, with the highest monthly S&P 500 return since 1955, at 7.0%, resulting in a return of 4.3% for the quarter.

The growth-led market continued into the second quarter, but saw slightly tightened spreads between growth and value. The period also saw a size reversal compared to Q1, as larger capitalization stocks outperformed their smaller cap counterparts, with the Russell 1000 Index outperforming the Russell 2000 Index by 2.2%. All sectors, with the exception of energy, posted positive returns with financials taking the lead as the S&P 500 financials sector returned 8.0% for the quarter. Similarly, low volatility and enhanced value led from a factor basis, with the S&P 500 Low Volatility Index outperforming all other factor groups.

Active management results were generally mixed during the quarter. Both growth and value managers in the small- and mid-cap segments experienced improved success rates during the quarter, while active large-cap managers struggled to keep up with the strong benchmark returns. **Exhibit 1** illustrates the quarterly trend of active management success rates, net of median asset class fees, in US equity.

Exhibit 1: US Equity Manager Success Rates

Source: eVestment.com

Non-US Equity

Developed international markets lagged domestic equities, but did have positive returns during the quarter with large-cap stocks outperforming their smaller counterparts. Growth stocks continue to outperform value stocks, with returns dispersion between the styles being significant over the past 10-year period as compared to historical spreads. Quarterly returns were positive across almost every country, with only Israel ending the quarter in negative territory. However, economic growth has been disappointing across multiple developed international countries. In response, the ECB has continued to provide guidance for continued negative rates until the middle of 2020. The BoJ has also communicated that negative rates will be sustained in an effort to spur growth.

Emerging markets equity returns did not keep pace with developed markets, but they broadly remained in positive territory despite emerging market small-cap stocks having slightly negative returns. Contrasting with the trend in developed international markets, value outperformed growth stocks during the quarter. Similar to the previous quarter, headlines and actions related to trade negotiations drove price action in emerging markets. In April, the market anticipated a potential resolution to trade tensions between the US and China. This positive sentiment reversed course when the Trump administration announced possible additional tariffs on China, as well as restricting Huawei, the Chinese telecom company, from doing business in the US. However, markets rallied in June after a temporary truce was struck between the two countries.

Fixed Income

US Treasury rates held relatively steady for the first half of the quarter, but notably declined later in the period. Markets were responding to trade war escalations, signs of moderating economic and job growth, and the potential for US interest rate cuts. US Treasury yields fell the most in the belly of the curve, leading to a slight curve steepening with the spread between 2- and 10-year maturities increasing to 0.25%. However, a commonly cited recession indicator, the spread between 3-month and 10-year maturities, has remained inverted since late May.

Despite a sluggish start, the Bloomberg US Aggregate Index finished with another strong quarter, returning 3.1%. Though investment-grade corporate spreads widened for much of the quarter, they reversed course in June to finish slightly tighter, and the decline in US Treasury yields helped propel the Bloomberg US Corporate Bond Index to a 4.5% return. In high yield corporate bonds, declining oil prices have hurt the energy sector, which has experienced eight defaults or distressed transactions so far this year. However, high yield issues, while more restrained from their outstanding first quarter, continued to provide positive returns, with the Bloomberg US High Yield Index returning 2.5%.

Emerging market debt also maintained its strong start to 2019. In early June, President Trump announced an agreement with Mexico that suspended previously scheduled tariffs, though a trade war continued to loom with China. The hard currency JPM EMBI Global Diversified Index returned 4.1%, and it has been one of the best performing areas of the bond market with an 11.3% return so far this year. Local currency emerging markets have also been strong, returning 5.7% for the quarter, and 8.7% for the year.

Diversified Hedge Funds

Hedge funds produced positive returns across all major strategy groups during the second quarter and the industry is experiencing the best start to a year since 2009. The Fund of Hedge Funds (“FoHF”) strategies that RVK follows closely produced returns between 1.0% and 3.0% during the quarter and now have year-to-date returns ranging from 3.5% to 9.5%. Dispersion among FoHF managers has largely been driven by varying exposure to Equity Long/Short (“ELS”) managers. Many funds have lowered exposure to generalist ELS managers to reduce beta exposure given the late cycle market environment. Those FoHFs that maintained exposure have been rewarded in 2019, but they also tended to underperform significantly during the drawdown in Q4 2018.

ELS managers have recorded positive alpha for seven straight months according to available prime brokerage data. The HFRI Equity Hedge Index reported year-to-date net returns of 9.4% through Q2, and remains the strongest performing broad hedge fund category. Notably, many of the managers that RVK follows closely reported positive performance in May amidst a mid-single-digit drawdown in equity markets. However, upside capture and alpha generation were marginal in June. Year-to-date, these measures are tracking at high levels relative to the current decade. Across the observable universe, the year-to-date spread between long and short investment attribution is nearing double digits. This long/short spread is positive across multiple market sectors, led by real estate, consumer staples, and healthcare, with utilities being the notable exception.

Multi-strategy managers that RVK tracks closely are generally performing above peers according to data provided by HFR, but again with considerable dispersion. Managers who maintain some directionality have outperformed those that target closer to market neutral portfolios. Finally, macro-oriented strategies, both Thematic Discretionary as well as Systematic Diversified, are finally experiencing a better period of performance, with both HFR sub-indices up in excess of 5.0% year-to-date.

Global Tactical Asset Allocation (“GTAA”)

GTAA managers posted positive absolute returns during the second quarter; however most still underperformed a blend of 60% US equity and 40% US fixed income given positive US equity returns as well as positive relative performance of fixed income versus other asset classes. Similar to the first quarter, performance across managers varied. Those with a greater reliance on a benchmark-aware investment process provided stronger peer-relative performance in a quarter where US large-cap equity, developed international equity, and US fixed income contributed to performance. In contrast, GTAA managers who avoid investing closely to a multi-asset benchmark and managers who avoid a US-constrained approach continue to hold significantly higher proportions of undervalued asset classes, such as emerging markets equity. In a continuation of a long-developing theme, positions in undervalued asset classes and short positions in overvalued asset classes continue to detract from peer-relative performance. Other examples of active share allocations that detracted over the quarter include US small-cap equities and industrial metals.

Diversified Inflation Strategies (“DIS”)

Despite low levels of inflation, most DIS managers posted moderately positive returns during the second quarter. Those who outperformed peers tended to deploy investment processes that do not explicitly target performance relative to the Consumer Price Index (“CPI”) and generally held larger allocations to global listed infrastructure. DIS managers that trailed peers held larger exposures to commodities, natural resource equities, and, to a lesser extent, REITs. Although TIPS contributed positively to returns for most managers, many that held TIPS allocations also maintained significantly higher commodity exposure relative to peers, which detracted from performance. While managers delivered negative returns in the fourth quarter and 2018, they have generally posted positive returns over the trailing twelve months, in spite of the low-inflation environment. Despite fluctuating around higher levels during the quarter, year-over-year Headline CPI finished Q2 at 1.60%, which was lower than the reading of 1.90% at the end of Q1. Market-based indicators of future inflation also remain low, as measured by 10-year Treasury break-evens, which decreased over the quarter from 1.87% to 1.70%.

Real Estate

Core private real estate returned 1.0% during the second quarter (on a preliminary basis), as reported by the NCREIF-ODCE Index, with the total return comprised of 1.01% income and -0.01% price appreciation. While the income component stayed in line with historical levels, price appreciation experienced a material decrease of 39 basis points compared to Q1. Investors in publicly traded real estate outperformed their private market counterparts during the second quarter. Publicly traded real estate delivered a second quarter return of 1.8%, as measured by FTSE/NAREIT All REITs Index.

After many quarters of anticipation and communicating moderate valuation adjustments, managers started the process of resetting expectations for retail property valuations. During the second quarter, the impact from some NCREIF-ODCE member firms materially writing down values of retail properties in their funds led to the slightly negative appreciation return component.

More specifically, those funds with mall properties, especially less desirable malls, commonly referred to as “Class B”, were most heavily impacted. Other forms of retail properties, such as grocery-anchored retail properties, held up better. During the second quarter, recent market transactions of retail properties led third-party appraisal firms to adjust valuations, which led to revisions in Net Operating Income (NOI) and discount rate assumptions that contributed to meaningful cap rate expansion. This process of resetting valuations will likely span multiple quarters and require more transactions before this segment of the market fully reaches a trough.

Disclaimer

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RVK

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