RVK

Capital Markets Review | 3rd Quarter 2019

September 30, 2019

Overview

Financial markets experienced bouts of volatility during Q3 as dominant market themes from the past few quarters persisted. Market participants noted that investor sentiment continued to be significantly influenced by signs of global economic weakness, geopolitical concerns largely stemming from ongoing tariffs and trade wars, and expectations for central bank policy actions. Specifically, trade tensions were cited by the International Monetary Fund as a key reason for recently lowering its estimate for global growth in 2019 from 3.2% down to 3.0%.

The US equity market ended the quarter 1.7% higher, as measured by the S&P 500, while economic headwinds and conflict escalations outside the US led international equity markets lower as the MSCI ACWI ex USA Index returned -1.8%. Yields on fixed income assets declined as growth and inflation expectations weakened. Market commentary was especially focused on the 0.3% decline in the 10-year Treasury yield, which reached near record lows, and the corresponding high return for long duration bonds. However, many investors were even more focused on the Treasury yield curve, which experienced continued inversion between multiple maturity points. Notably, the spread between the 3-month and 10-year sections of the yield curve reached negative 49 basis points—a degree of inversion largely within ranges that have preceded past recessions. Inversions between these sections of the yield curve have historically been a near-perfect indicator of a US economic recession occurring within the next 12- to 18-months.

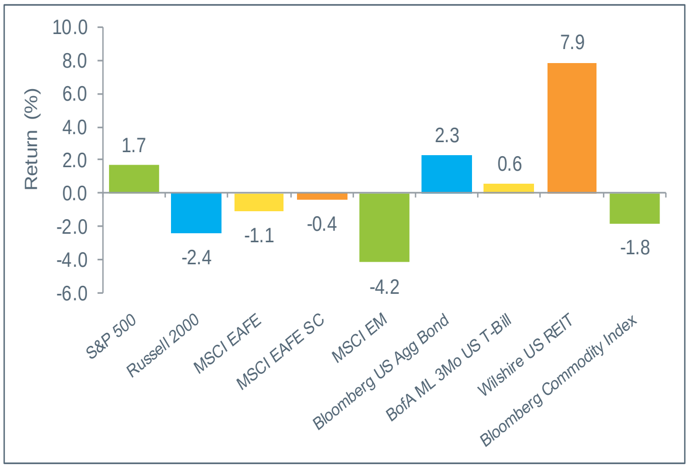
Global central bank policy also captured investor attention during the period. The European Central Bank responded to euro area weakness by announcing its intention to restart its quantitative easing program in November 2019. While the Bank of Japan left policy rates unchanged, a number of other foreign central banks, including the People's Bank of China, delivered accommodative policy messages and introduced programs intended to support economic growth. The Federal Reserve also took steps to mitigate developing concerns of weakening inflation and growth expectations, primarily by cutting policy rates by 0.25% at the September Federal Open Market Committee ("FOMC") meeting. While the interest rate cut was largely expected, market participants took note that two members favored rate cuts of 0.50% with another recommending no changes. Overall, the message received by the market was that the expected path of employment and inflation—whether positive or negative—is more uncertain than it appeared earlier in the year. Despite the September rate cut, futures markets are still pricing in nearly two additional rate reductions through year-end 2019.

Additionally, US dollar funding markets experienced an episode of pressure in mid-September that resulted in repo rates trading over 7% above the Federal Funds rate, apparently due to a confluence of idiosyncratic factors that restricted the availability of lendable cash in the marketplace. In response, the Federal Reserve announced a series of temporary open market operations to mitigate the pressure, and funding rates ultimately subsided to their expected ranges.

Trailing Period Market Performance (%)

	QTD	CYTD	1 Year	5 Years	10 Years
S&P 500	1.7	20.6	4.3	10.8	13.2
Russell 2000	-2.4	14.2	-8.9	8.2	11.2
MSCI EAFE	-1.1	12.8	-1.3	3.3	4.9
MSCI EAFE SC	-0.4	12.1	-5.9	6.0	7.5
MSCI EM	-4.2	5.9	-2.0	2.3	3.4
Bloomberg US Agg Bond	2.3	8.5	10.3	3.4	3.7
BofA ML 3Mo US T-Bill	0.6	1.8	2.4	1.0	0.5
Wilshire US REIT	7.9	27.2	18.4	10.2	13.1
Bloomberg Commodity Index	-1.8	3.1	-6.6	-7.2	-4.3

Quarter-to-Date Performance (%)



Key Economic Indicators

	Q3 2019	Q2 2019	Q1 2019	10 Year Average
Federal Funds Rate	1.90%	2.40%	1.68%	0.58%
Treasury - 1 Year	1.75%	1.92%	2.09%	0.71%
Treasury - 10 Year	1.68%	2.00%	2.74%	2.45%
Treasury - 30 Year	2.12%	2.52%	2.97%	3.24%
Breakeven Inflation - 5 Year	1.35%	1.54%	2.04%	1.75%
Breakeven Inflation - 10 Year	1.52%	1.70%	2.06%	2.01%
Breakeven Inflation - 30 Year	1.59%	1.76%	2.07%	2.14%
Barclays US Corp: Hi Yld Index - OAS	3.73%	3.77%	3.54%	4.89%
Capacity Utilization	77.88%	77.81%	77.82%	76.53%
Unemployment Rate	3.50%	3.60%	4.10%	6.38%
ISM PMI - Manufacturing	47.80%	52.10%	60.70%	54.41%
Baltic Dry Index - Shipping	1,823	1,354	1,055	1,323
Consumer Confidence (Conf. Board)	125.10	131.30	130.00	89.74
CPI YoY (Headline)	1.70%	1.60%	1.90%	1.76%
PPI YoY - Producer Prices	-0.20%	1.30%	2.70%	1.83%
US Dollar Total Weighted Index	$93	$91	$86	$82
WTI Crude Oil per Barrel	$54	$58	$65	$73
Gold Spot per Ounce	$1,472	$1,409	$1,326	$1,338

Asset Class Commentary

US Equity

US markets saw varied results during Q3 amid ongoing economic growth concerns, uncertainty surrounding US-China trade negotiations, and political risks spurred by the recently announced impeachment proceedings. The month of September was positive for most indexes, as key economic fundamentals continued to be reported at better than expected levels. Large-cap stocks were the only size segment to experience positive returns across all styles, with the S&P 500 Index returning 1.7%. Conversely, small-cap markets saw negative returns across all styles, with the Russell 2000 Index returning -2.4%.

A significant rotation from growth into value stocks occurred in September. With the exception of the mega-cap segment, the September shift caused the quarterly return of value stocks to exceed the return of growth stocks for the first time since Q4 2018. The largest spread was seen in the small-cap universe, with the Russell 2000 Value Index outperforming the Russell 2000 Growth Index by almost 6% during the month of September. Further, low-volatility stocks added to gains generated during the first half of the year, while high beta and momentum stocks notably reversed—the S&P 500 High Beta Index returned -3.0% for Q3 versus its Q2 return of 3.5%.

Despite positive performance across large-cap indexes, active management generally struggled in this segment during quarter. Similar to Q2, small-cap managers fared much better than their larger-cap counterparts. In addition, core and value-tilted managers performed relatively better than growth managers.

Non-US Equity

In contrast to the US market, developed international equity markets finished Q3 in negative territory. During the quarter, value stocks continued to underperform growth stocks, small-cap stocks outperformed their larger counterparts, and almost all developed market countries posted negative returns. Japan provided the highest positive returns, as second quarter growth figures announced in August revealed that it had grown at an annualized rate of 1.8%, which easily beat estimates. On the other hand, weakness in manufacturing drove the Purchasing Managers Index in Europe to its lowest level since 2013. After the Ministry for Economic Affairs stated that the slowdown was expected to persist for the coming months, the European Central Bank cut deposit rates and announced the restart of quantitative easing in an effort to promote growth.

Emerging markets fared worse than developed markets during the quarter. The Q2 outperformance of value stocks was short lived, as growth significantly outpaced value during Q3. Furthermore, larger-cap stocks lagged small-cap stocks. Returns in emerging markets continue to be driven by trade tensions between the US and China, and market trends reversed numerous times in reaction to new tariff announcements and indications of short-term postponement. Nearly all countries within emerging markets finished the quarter with negative returns with the exception of the positive returns generated by Taiwan, where returns were influenced by strong returns from Taiwan Semiconductor. South Africa trailed all other emerging market countries with a return of -12.6% due to increased concerns regarding political and economic instability.

Fixed Income

Bonds registered another strong quarter, with the Bloomberg US Aggregate Bond Index returning 2.3% for Q3. US Treasury yields fell across the curve, most notably in the longer-dated maturities. This movement propelled the Bloomberg US Government Long Duration Index which finished with a strong return of 7.8% in Q3, despite a -2.5% return in September, increasing the year-to-date return to 19.6%. Concerns for economic growth increased investor focus on the behavior between shorter- and longer-term maturities along the Treasury yield curve. In addition to the inversion experienced between the 3-month and 10-year US treasury maturities, the spread between 2- and 10-year US Treasury maturities ended August 27th in negative territory. While this specific inversion reversed course by quarter-end, market attention remains heightened for this commonly referenced recession indicator.

US investment-grade corporate spreads were volatile over the quarter, yet they ended exactly where they began. With assistance from the decline in Treasury rates, the Bloomberg US Corporate Index returned 3.1%. US high yield returns were more modest, with the ICE BofA ML US High Yield Index returning 1.2%. However, an interesting trend has developed this year, as the BB-rated portion of the index is outperforming the CCC-rated portion, despite the high yield index returning 11.5% year-to-date. Should this trend continue, it will be the first time in the history of the index that the BB-rated segment has outperformed the CCC-rated segment when overall index returns are in the double digits.

Hard currency emerging market debt continued to add to the gains experienced during the first six months of 2019. Country specific risks heavily impacted certain pockets of the asset class in Q3, however the hard currency JPM EMBI Global Diversified Index still generated positive returns of 1.5% in Q3 pushing year-to-date returns higher to 13.0%. Local currency emerging markets did lag slightly with a quarterly return of -0.8%, while remaining in positive territory in 2019 with a year-to-date return of 7.9%.

Diversified Hedge Funds

Following the industry's best first half performance since 2009, hedge funds produced lackluster returns during Q3, albeit with considerable dispersion across strategies. The Fund of Hedge Funds ("FoHF") strategies RVK follows closely produced returns between 0% and -1% during the quarter with year-to-date returns ranging from 3.0% to 8.0%. Dispersion among FoHF managers continues to be driven by varying allocations to Equity Long/Short ("ELS") managers. ELS strategies put up stellar returns through Q2, but most data sources indicate a significant pullback in Q3 due to September proving to be a particularly challenging month for stock picking. However, year-to-date long and short performance across ELS strategies remains satisfactory.

The HFRI Equity Hedge Index reported Q3 net returns of -1.1%, with year-to-date net returns currently standing at 8.1%. September marked the first month of negative alpha for the strategy group since November 2018, according to prime brokerage data. During the final weeks of the quarter, sharp rotations into under-owned cyclical industries created a hazardous trading environment that negatively impacted the long books of managers RVK follows closely. Factor rotations across momentum, growth, and value styles were the most acute. At the sector level, the spread between long and short investment is strong across most sectors with consumer staples, real estate, health care, and industrials investments leading the way.

The multi-strategy managers that RVK follows closely generally performed in-line with peers, according to data provided by HFR, although several managers with significant market-neutral ELS exposure gave up ground during September. Managers that lean more toward event driven styles fared better, but they may be challenged to produce strong results into year-end, as merger and acquisition activity slumped in Q3. Managers with systematic macro strategies were rewarded in Q3 amid the volatility, as stellar performance from directional fixed income trading in July and August far outweighed the impact from the September pullback; such strategies are now up 8.6% YTD, according to HFR.

Global Tactical Asset Allocation ("GTAA")

GTAA managers posted mixed and wide-ranging returns during Q3—both on an absolute basis and relative to a blend of 60% US equity and 40% US fixed income. Managers that saw positive returns, both on an absolute basis and relative to peers, generally held higher dedicated allocations to large-cap US equity markets. Other strategies that performed well against peers included managers with more idiosyncratic positions within international developed or emerging market currency, credit, and interest rates. Similar to recent prior quarters, GTAA manages that do not closely follow a multi-asset benchmark and those that avoided US equity positions struggled versus peers. Managers that lagged peers during the quarter continue to hold undervalued assets, such as emerging market equities and/or short positions in overvalued asset classes. Strategies that held active positions in small-cap US equities or certain industrial metals, such as copper, also tended to trail peers.

Diversified Inflation Strategies ("DIS")

Most DIS managers posted positive absolute returns during Q3. Performance ranged widely amongst managers RVK tracks and was once again bifurcated with the stronger performing managers generally having significantly larger allocations to REITs and, to a lesser extent, global listed infrastructure. Both of those asset classes saw positive returns during Q3 and have seen strong returns so far in 2019. DIS managers that trailed peers, while still providing positive returns, held relatively higher allocations to commodities, which struggled during the quarter largely due to the energy and agriculture sub-components. As inflation linked securities, such as TIPS, experienced positive performance in the quarter, they provided a tailwind for managers that had relatively higher exposure than peers. An exception to this TIPS tailwind came from managers who have hedged duration exposure within TIPS, which reduced the benefit of duration exposure. Year-over-year Headline CPI finished the quarter at 1.70%, representing a slight increase from the 1.60% level reported for June. Market-based indicators of expected future inflation, as measured by 10-year Treasury break-evens, once again decreased, falling to 1.52% in Q3 versus 1.70% at the previous quarter-end.

Real Estate

Core private real estate returned 1.3% during Q3 (on a preliminary basis), as reported by the NCREIF-ODCE Index, with the total gross return comprised of 1.1% income and 0.3% price appreciation. While the income component remained in-line with historical levels, price appreciation experienced a modest increase of 26 basis points compared to the relatively flat Q2 return. Investors in publicly traded real estate significantly outperformed their private market counterparts during Q3. Publicly traded real estate delivered an impressive Q3 return of 7.2%, as measured by the FTSE/NAREIT All REITs Index.

One recent industry trend is the continued weakness in the retail sector, which continued through Q3 as numerous large national retail chains, across discount and luxury stores, announced store closures and bankruptcy filings. The retail sector continues to experience significant headwinds, especially in apparel-based retail formats, as consumers' buying habits evolve. Consumer trends have been forcing retailers to move toward omni-channel formats, as opposed to solely brick-and-mortar or online business models. These issues in retail are occurring despite generally favorable conditions from a healthy US economy, strong consumer spending, and historically low unemployment. Going forward, continued weakness in the retail real estate sector is expected as property owners contend with increased vacancy from companies right-sizing their store footprints and online presence.

Disclaimer

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RVK

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