# Capital Markets Review | 3rd Quarter 2021

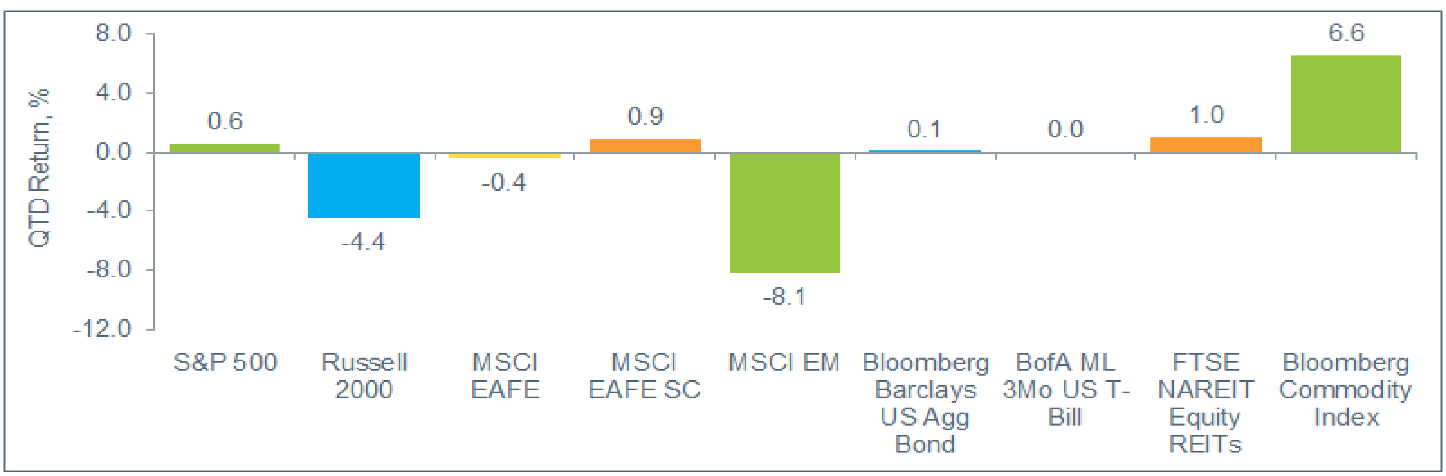
September 30, 2021

## Overview

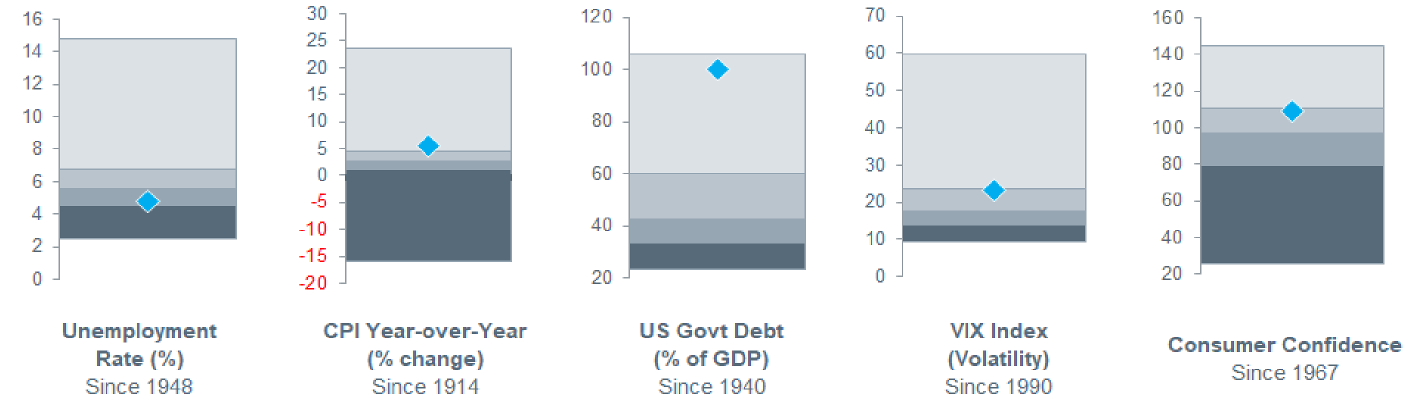
The economic recovery slowed in Q3 compared to the rapid pace experienced in the first half of 2021. The recovery was impeded by a surge in COVID-19 infections as the delta variant spread around the world. The surge of infections, and resulting return to cautionary behaviors in developed markets, maintained the trend of consumers focusing on goods, rather than services and experiences, further straining global supply chains. Emerging market economies that export raw and finished goods to developed markets experienced pandemic-related disruptions as well. The supply chain disruptions, along with rising energy prices, prompted a number of downward revisions to Q3 and 2021 GDP growth estimates. The IMF lowered its forecast for 2021 US GDP growth by a full 1.0%, while some international banking institutions reduced their estimates for Q3 growth by over 5%. With this as a backdrop, risk assets posted uneven returns in Q3, with a bias toward the downside. The relative strength of the Dollar aided US assets compared to developed non-US and emerging markets, as the S&P 500 finished with a gain of 0.6%, though returns were negative outside of the large-cap space. Developed non-US markets finished the quarter with a –0.4% return, while emerging markets suffered a more severe drawdown of -8.1%. A similar pattern played out among credit assets, with US corporates outperforming emerging market corporates. Higher quality fixed income struggled as well, particularly as markets gained clarity around the Federal Reserve's likely tapering schedule.

Chinese equity markets, now firmly in bear market territory, led emerging market returns lower. To bring about its vision for common prosperity, the Chinese Communist Party increased its regulatory oversight for a number of industries. The regulatory crackdown, covering businesses including online for-profit schools, tutoring apps, ride hailing companies, and e-commerce giants, was both comprehensive and swift. The aggressive regulatory tactics caught market participants off guard, and Chinese equities declined considerably as a result. At the same time, China Evergrande, an overleveraged property developer, moved towards a default as it missed interest payments on its offshore debt. Reports that the company was attempting to trade unfinished apartments to substitute for returns on its wealth management products, or give apartment buyers in one city heavy discounts on finished product elsewhere further contributed to fears that an Evergrande collapse could have ripple effects across the Chinese economy, if not properly managed. *(continued on next page)*

### Quarter-to-Date Performance



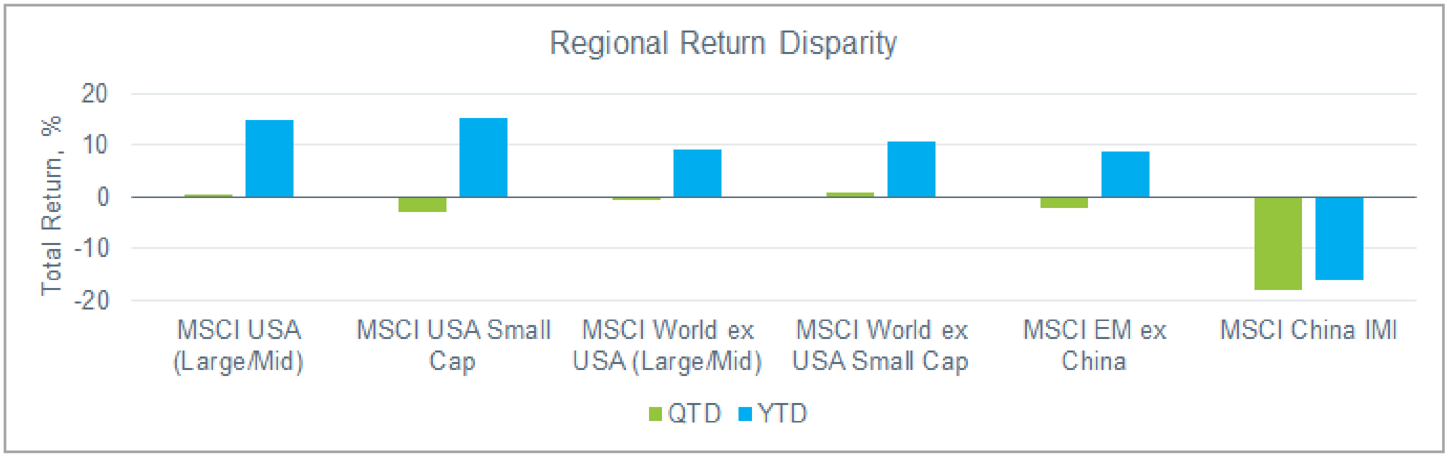
Historical Ranges of Key Economic Indicators




Economic conditions in the US remained on solid footing, though labor market frictions continued to weigh on job growth relative to expectations. There were only 194,000 jobs added in September—far below the average pace of 607,000 jobs added over the first eight months of 2021. Furthermore, while job openings remained near all-time highs—above 10 million in August—and pandemic-related enhanced unemployment benefits expired, labor force participation actually declined 0.1%, concerning market participants. Despite these concerns, Q3 was still a strong quarter for job creation, as the unemployment rate fell from 5.9% in June to 4.8% in September. Other economic indicators continued to point to a robust expansion. The ISM Manufacturing and Services PMIs ended September at 61.1 and 61.9, respectively, with levels above 50 indicating expansion. Supply constraints remained, contributing to a higher than desired level of inflation at 5.4% to end the quarter. The Federal Reserve has recently acknowledged inflationary forces have been more persistent than initially thought, and at least half of the Federal Open Market Committee (FOMC) members at the September meeting projected the first rate hike as soon as 2022. Prior to June, the median FOMC member foresaw no rate hikes until 2024. With rate hikes largely off the table in the near term, investor focus remained on the tapering of the Federal Reserve's $120B monthly asset purchase program, with a consensus building for an official announcement in November to curtail purchases by an expected $15B per month.

## Expanded Review of Key Economic Indicators

| | Q3 2021 | Q2 2021 | Q1 2021 | 10 Year Average |
|---|---|---|---|---|
| Federal Funds Rate | 0.06% | 0.08% | 0.06% | 0.63% |
| Treasury - 1 Year | 0.09% | 0.07% | 0.07% | 0.74% |
| Treasury - 10 Year | 1.52% | 1.45% | 1.74% | 2.05% |
| Treasury - 30 Year | 2.08% | 2.06% | 2.41% | 2.76% |
| Breakeven Inflation - 5 Year | 2.53% | 2.50% | 2.60% | 1.76% |
| Breakeven Inflation - 10 Year | 2.38% | 2.34% | 2.37% | 1.94% |
| Breakeven Inflation - 30 Year | 2.29% | 2.28% | 2.31% | 2.03% |
| BB US Corp: Hi Yld Index - OAS | 2.89% | 2.68% | 3.10% | 4.55% |
| Capacity Utilization | 76.44% | 75.38% | 74.40% | 76.51% |
| Unemployment Rate | 4.80% | 5.90% | 6.00% | 5.82% |
| ISM PMI - Manufacturing | 61.10% | 60.60% | 64.70% | 54.15% |
| Baltic Dry Index - Shipping | 5,167 | 3,383 | 2,046 | 1,210 |
| Consumer Confidence (Conf. Board) | 109.30 | 127.30 | 109.70 | 100.27 |
| CPI YoY (Headline) | 5.40% | 5.40% | 2.60% | 1.80% |
| PPI YoY - Producer Prices | 11.80% | 9.40% | 5.90% | 2.04% |
| US Dollar Total Weighted Index | 114.08 | 112.24 | 114.13 | 106.73 |
| WTI Crude Oil per Barrel | $75 | $73 | $59 | $66 |
| Gold Spot per Ounce | $1,757 | $1,770 | $1,708 | $1,422 |




## US Equity

US equity markets cooled off in Q3, compared to recent quarters, as the S&P 500 finished relatively flat and smaller cap stocks generated negative returns. The spread of the delta variant throughout the country slowed consumer spending, although the overall recovery remained on course.

Concerns over high inflation, due to continued stimulus from the Federal Reserve and supply chain disruptions, continue to be a major theme in the US that contributed to moderated investor sentiment. These concerns were balanced with generally positive earnings results released during the quarter.

Large-cap growth turned in modestly positive returns in Q3 while small-cap and value stocks generally struggled. The Russell 1000 Growth Index returned 1.2% for the quarter versus -0.8% for the Russell 1000 Value Index. Meanwhile, the Russell 2000 Value Index returned -3.0% versus -5.7% for the Russell 2000 Growth Index.

In Q3, certain cyclical sectors reversed from prior trends. For example, energy stocks finished in negative territory after generating cumulative returns of over 80% across the previous three quarters. Industrials and materials were the worst-performing sectors while financials, utilities, and communication services were the strongest performers.

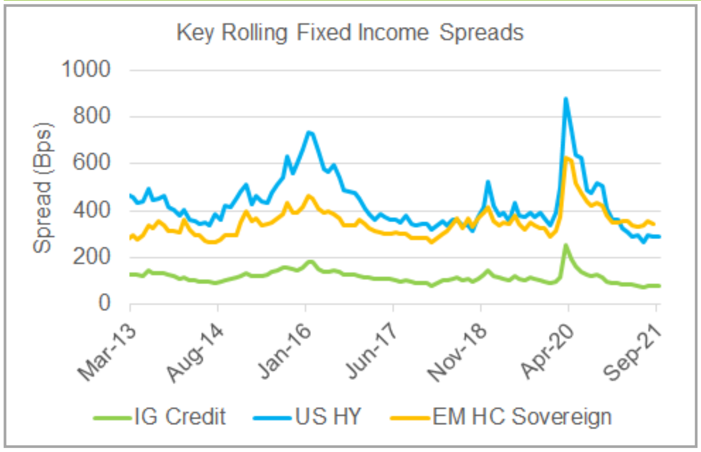
Active management performed well in Q3, with the exception of large-cap managers, as a majority of small- and mid-cap managers outpaced their benchmarks.

## Non-US Equity

Similar to the US equity markets, developed international market returns were muted in Q3. The MSCI EAFE Index was slightly negative with growth stocks outperforming value, although value stocks are still ahead year-to-date. Small-cap stocks outperformed their larger counterparts. As re-opening efforts have continued, improved consumer spending has lifted the Eurozone economy. Inflation in September was the highest in a decade, and according to the European Central Bank, the economy will be back to pre-pandemic levels by year-end. On the other hand, Japan continues to struggle, as the delta variant curbed consumer spending and supply chain disruptions impacted progress.

Unlike developed markets, emerging markets experienced significant negative returns in Q3 driven by market volatility in China due to its regulatory crackdown. Prior performance from China had contributed to the outperformance of growth and mega-cap stocks. Subsequently, due to this latest volatility in Q3, value stocks outperformed growth and small-cap stocks outperformed large. China's regulatory actions were wide ranging, addressing everything from socioeconomic considerations to national security. For instance, for-profit tutoring was banned to ease pressure on students, leading to slashed revenue estimates for certain companies. While other countries have pursued similar measures, the reforms in China have been abrupt and broad, leading to investor concerns of similar future disruptions.

# Fixed Income and Multi-Asset Commentary





## Fixed Income

The Bloomberg US Aggregate Index was flat, finishing with returns of 0.1% in Q3, while remaining down -1.6% year-to-date. Treasury yields rose in Q3 in light of inflation concerns sparked by supply chain constraints and sustained economic growth. Speculation over the timing of Federal Reserve tapering was also a contributing factor to the slight move in rates. The 10-year Treasury yield marginally rose to 1.52% as of September 30 from 1.45% as of June 30.

Low-rated debt remained a source of outperformance in a market starved for yield. The Bloomberg US Credit Index was flat, returning 0.0% QTD with BBB-rated debt marginally outperforming higher-rated debt.

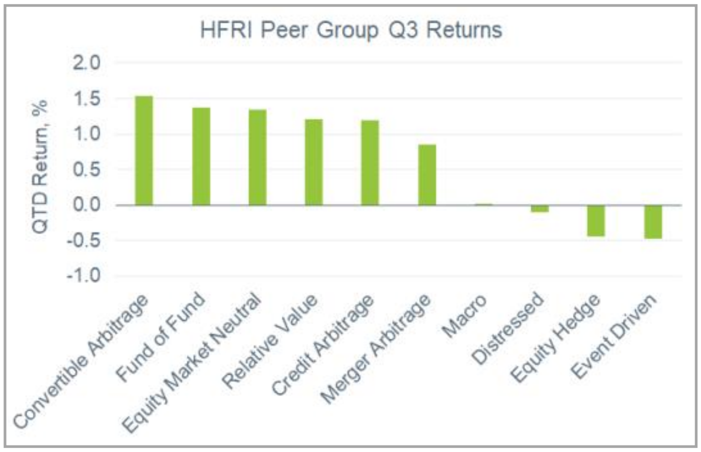
In contrast, the Bloomberg US High Yield Index returned 0.9% in Q3 while the Credit Suisse Leveraged Loan Index returned 1.1%. Below investment grade debt has outperformed other segments meaningfully year-to-date, with high yield and bank loans returning 4.7% and 4.0%, respectively, as measured by the aforementioned indices.

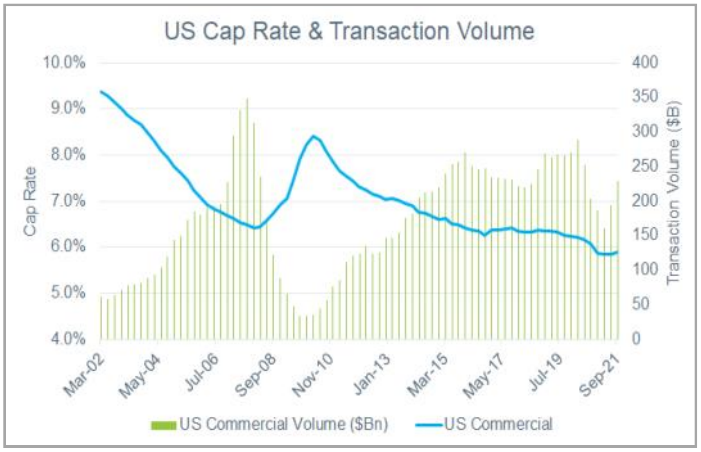
Emerging markets corporate debt continued to outpace local currency and hard currency sovereign debt, with local currency being a laggard in part due to a strengthening US dollar. The JPM CEMBI returned 0.1% in Q3 and is up 1.2% year-to-date, while the JPM GBI-EM GD Index declined -3.1% and -6.4% over the same periods, respectively.

## Multi-Asset

Global Tactical Asset Allocation strategies that RVK follows closely generated disparate results in Q3. The top performing long-biased GTAA strategies incorporated inflation protection subcomponents, particularly in energy commodities, which continued to reward investors. These long-biased strategies also produced differentiated results compared to the modest performance of a less diversified blended benchmark of 60% US equity and 40% US fixed income. Multi-asset managers that target reduced correlations, volatility, and market sensitivity also produced disparate absolute returns, though with a narrower relative range compared to long-biased peers that held relatively higher long exposures across asset classes globally.

Diversified Inflation Strategies that RVK follows closely continued to generate strong positive absolute performance. Managers with higher commodities and TIPS exposures posted the strongest positive absolute returns. Commodities led the way, with the Bloomberg Commodity Index posting a 6.6% return, largely driven by gains in energy. Inflation, as measured by the year-over-year change in Headline CPI, was reported as 5.4% for September, a significant increase from 2.6% at the end of Q1. The sharp rise has been notable, but is somewhat magnified by comparisons to depressed CPI readings from 2020. Market-based measures of future inflation expectations remain around 2.38%, similar to the level of 2.34% observed in Q2 for the 10-year breakeven inflation measure.




## Diversified Hedge Funds

After a strong first half of the year, hedge fund returns moderated during Q3, with the HFRI Fund Weighted Composite Index finishing the quarter roughly flat. The Asset Weighted composite, which relies far less heavily on directional long/short equity strategies, produced a modest gain of 0.6% in Q3.

Heightened levels of capital markets activity continued to provide fertile ground for event-oriented traders. However, merger activity in the US cooled following the appointments of Lina Khan and Jon Kanter to run the Federal Trade Commission and Department of Justice, respectively, with both individuals viewed as taking a more hawkish stance on antitrust policy. Spreads widened in some names as a result, giving patient managers the opportunity to add capital at attractive levels. As market volatility picked up in September, several of the multi-strategy funds RVK follows closely generated significant positive alpha, as positions in many of these portfolios tend to be either fully hedged or rely on short-term, company-specific catalysts that are less correlated to broad pull backs in equity markets. Hedged equity strategies, which had led the way in the first half of 2021, captured some of the downside, finishing the quarter with a -0.4% return according to the HFRI Equity Hedge Index.

The notable positive outlier for the broad industry during Q3 were trend-following managers. The SocGen Trend Index produced a return of 2.9%, driven by gains in energy markets and in the US Dollar.

## Real Estate

Core private real estate generated a positive 6.6% return in Q3 (on a preliminary and gross of fee basis), as reported by the NFI-ODCE Index, with the total return comprising of 1.0% income and 5.6% price appreciation. While the income return continues to trend in line with historical levels, price appreciation exceeded expectations and previous levels, such as the 2.6% return recorded in Q2. Investors in publicly traded real estate underperformed their private market counterparts by a meaningful margin. Publicly traded real estate delivered a fairly flat total return in Q3, as measured by the FTSE/NAREIT All REITs Index. Among publicly traded securities, return volatility remains high given the correlation with public equity markets.

Real estate continues to recover from the impact brought on by the pandemic. All four primary sectors of real estate: industrial, multifamily, office, and retail contributed to the strong third quarter returns, with industrial and multifamily continuing to lead. While managers in this asset class continue to focus on longer-term real estate trends, it is worth highlighting that on a trailing one-year basis, the NFI-OFCE returned 14.6%. This double-digit return highlights the recovery that has taken place in core private real estate from the depths of the pandemic-related correction one year prior. Notably, this current rebound far exceeds the two negative quarterly returns experienced in 2020.

# Disclaimer

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RVK

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*[1]Between July and October 2020, Coalition Greenwich (formerly known as Greenwich Associates) conducted in-person and phone interviews and online surveys with 856 individuals at 704 of the largest tax-exempt funds in the US–including corporate and union funds, public funds, endowments and foundations, insurance general accounts, and healthcare organizations, with either pension or investment pool assets greater than $150 million. Study participants were asked to provide quantitative and qualitative evaluations of their asset managers and investment consultants, including qualitative assessments of those firms soliciting their business and detailed information on important market trends. RVK is one of three firms recognized in the large investment consultant category. The ratings may not be representative of any one client's experience with RVK; rather they are representative of those clients that chose to participate in the survey. The results are not indicative of RVK's future performance.*

*To read the Greenwich press release, please refer to the following URL: https://www.greenwich.com/press-release/covid-19-crisis-put-investment-consultant-advisory-capabilities-test*