RVK

Capital Markets Review | 2nd Quarter 2016

June 30, 2016

Overview

The second quarter of 2016 was characterized by a broad based rally across commodities, a stable US dollar, and a flight to safety on the back of the UK's referendum vote to leave the European Union. The current six month pause in cyclical US dollar strength and the corresponding commodity bounce provided support for emerging market assets. Both hard and local currency emerging market debt saw gains, and emerging market equities added to Q1 returns following a strong June. In developed markets, the surprise Brexit vote led to sharp initial declines in equities, though markets recovered quickly following a series of dovish statements from central banks. Long duration assets outperformed short duration, and gold rallied as investors sought to reduce risk.

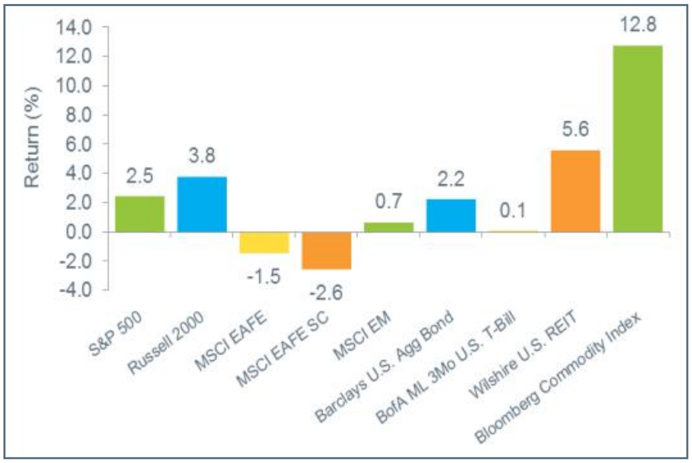
In the US, market expectations for a June interest rate hike swung from as high as 35% in late May, down to 0% after disappointing May payroll numbers were released. The Federal Funds Rate was held constant during the quarter with Janet Yellen indicating that future increases are anticipated to be data dependent. In general, the quarter's first half saw softer-than-expected economic data, with some pundits worried about a slowdown and possible global recession. Employment growth in the US seemed to confirm this view, as non-farm payrolls grew by an average of just 77,500 per month in April and May after averaging 196,000 during Q1. The ISM PMI, which measures the health of the manufacturing sector, pointed to tepid growth as well, with readings in April and May of 50.8 and 51.3, respectively. By June, however, the data showed improvement as 287,000 jobs were added and the ISM PMI rose to 53.2. On the inflation front, the FOMC's preferred measure of market based inflation compensation, the 5Y/5Y Forward Inflation Expectation Rate, which captures the expected 5 year inflation in 2021, remained well below the Fed's target of 2%. Short-term labor market conditions appear to be tightening as wage growth, a key indicator for the FOMC, continued to improve. Recent data show nominal wages growing at 2.6% year-over-year in the private sector marking the highest reading since 2009.

Uncertainty around the Brexit vote dominated the news flow in late June and catalyzed a flight to safety across risk assets. Recent data show that 36% of outstanding global developed market government debt is now yielding less than 0%. However, investors continue to have an appetite for risk where yields remain positive. For example, after being locked out of international capital markets for the past 15 years due to a 2001 default, Argentina came back to the global bond market in April with a $16.5B debt issuance that was more than four times oversubscribed, the largest for an EM economy on record.

Trailing Period Market Performance (%)

	QTD	CYTD	1 Year	5 Years	10 Years
S&P 500	2.5	3.8	4.0	12.1	7.4
Russell 2000	3.8	2.2	-6.7	8.4	6.2
MSCI EAFE	-1.5	-4.4	-10.2	1.7	1.6
MSCI EAFE SC	-2.6	-3.2	-3.7	4.8	3.6
MSCI EM	0.7	6.4	-12.1	-3.8	3.5
Barclays U.S. Agg Bond	2.2	5.3	6.0	3.8	5.1
BofA ML 3Mo U.S. T-Bill	0.1	0.1	0.2	0.1	1.0
Wilshire U.S. REIT	5.6	11.1	22.8	12.5	7.0
Bloomberg Commodity Index	12.8	13.2	-13.3	-10.8	-5.6

Quarter-to-Date Performance (%)



Key Economic Indicators

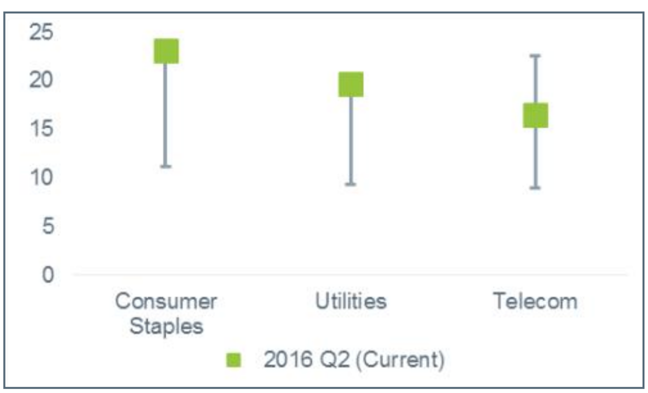
		As of	03/31/2016	12/31/2015	10 Year Average
Federal Funds Rate	0.30%	6/30/2016	0.25%	0.20%	1.07%
Treasury - 1 Year	0.45%	6/30/2016	0.59%	0.65%	1.09%
Treasury - 10 Year	1.49%	6/30/2016	1.78%	2.27%	2.97%
Treasury - 30 Year	2.30%	6/30/2016	2.61%	3.01%	3.77%
Breakeven Inflation - 1 Year	1.17%	6/30/2016	2.10%	0.85%	0.92%
Breakeven Inflation - 10 Year	1.44%	6/30/2016	1.63%	1.58%	2.05%
Breakeven Inflation - 30 Year	1.61%	6/30/2016	1.79%	1.76%	2.27%
Barclays US Corp: Hi Yld Index - OAS	5.94%	6/30/2016	6.56%	6.60%	5.98%
Capacity Utilization	75.37%	6/30/2016	74.85%	75.37%	76.29%
Unemployment Rate	4.90%	6/30/2016	5.00%	5.00%	7.00%
ISM PMI - Manufacturing	53.20%	6/30/2016	51.80%	48.00%	51.90%
Baltic Dry Index - Shipping	660	6/30/2016	429	478	2,654
Consumer Confidence (Conf. Board)	98.00	6/30/2016	96.10	96.30	74.48
CPI YoY (Headline)	1.00%	6/30/2016	0.90%	0.70%	1.80%
PPI YoY - Producer Prices	-2.00%	6/30/2016	-1.90%	-2.70%	2.00%
US Dollar Total Weighted Index	$91	6/30/2016	$90	$94	$78
WTI Crude Oil per Barrel	$48	6/30/2016	$38	$37	$80
Gold Spot per Ounce	$1,322	6/30/2016	$1,233	$1,061	$1,177

Asset Class Commentary

US Equity

US equity markets finished the quarter in positive territory across all market capitalization ranges and styles, with the Russell 3000 Index rising 2.6%. Historically stable sectors such as utilities, consumer staples, and telecom continued to post strong gains as market volatility persisted and notably rallied in the final week of the quarter amidst the uncertainty created by the UK’s EU referendum. **Figure 1** plots current price-to-earnings (“P/E”) ratios for these three sectors compared to their ten year range. These areas of the market have experienced inflows as market volatility increases, effectively serving as safe havens. When compared to their historical averages, valuations for these sectors appear stretched.

Figure 1: Current vs. 10 Year P/E Ratio Range



The energy sector posted the strongest gains as oil prices steadily recovered, with the S&P 500 Energy Index returning 11.6%. It is now the third-best performing sector year-to-date within the S&P 500 Index. The strong returns from bond equivalency stocks and the energy sector led value indices to outperform their growth counterparts. Additionally, low volatility indices continued to post strong returns during the quarter with the S&P 500 Low Volatility Index returning 6.8%. Year-to-date, low volatility and high dividend strategies continue to lead factor performance.

While the returns for the US equity market remain positive, second quarter EPS growth for the S&P 500 Index is expected to decline for the fifth consecutive quarter, which would represent the longest streak of year-over-year earnings declines in the equity markets since the Great Recession.

Non-US Equity

Broad measures for developed international markets exhibited weakness during the quarter and underperformed domestic equities. The style trend continued as growth outpaced value with the MSCI EAFE Growth Index ending the quarter relatively flat at -0.1%, while the MSCI EAFE Value Index returned -2.8%. Small caps detracted value, lagging large cap developed stocks. The uncertainty created by the UK's EU referendum is expected to result in a near-term slow-down in the EU, particularly in the UK. The European Economic Union ("EMU") was the worst performing developed region.

Emerging markets lagged domestic equities during the quarter, but performed better than developed international equity and have provided the highest returns among equity regions in 2016. Value underperformed growth for the quarter, but is still ahead year-to-date. Latin America led the emerging market rally with countries like Brazil and Peru posting double-digit returns. After a 20-hour debate by Brazilian senators, President Dilma Rousseff was suspended pending impeachment proceedings. Of considerable note, Raghuram Rajan resigned from the Bank of India, the country's central bank. Mr. Rajan's structural reform has been viewed as an integral part of India's recent prosperity.

Fixed Income

Virtually all fixed income sectors posted positive performance as interest rates fell and credits improved during the quarter. Notably, the Long US Government/ Credit Index posted a return of 6.6% for the quarter and 14.3% year-to-date. Utility and industrial bonds outperformed financial bonds as energy and commodity prices continued to rebound. Residential mortgage-backed securities underperformed Treasuries as an uptick in mortgage refinancing meant an increase in prepayments.

The downward movement in interest rates was a headwind for floating rate bank loans which returned 2.9% as measured by the S&P/LSTA Leveraged Loan Index. Comparatively, the BofA ML US High Yield Index returned 5.9% – the largest quarterly return since the fourth quarter of 2011.

The Citigroup Non-US World Government Bond Index returned 4.0% as government bond yields throughout Europe and Japan pushed deeper into negative territory. There was a mixed currency effect in developed markets with the Japanese yen appreciating by nearly 10% while the British pound depreciated by over 6% following the Brexit decision. Energy exporting countries, many classified as emerging markets, have performed particularly well. Both local currency and hard currency emerging markets debt posted strong returns for a second consecutive quarter.

Diversified Hedge Funds

After a poor first quarter, the hedge fund industry performed better during the second quarter of 2016, though Fund of Hedge Fund ("FoHF") portfolios are still down between 2.5% to 3.0% year-to-date based on available peer group based benchmarks. Most of the FoHF managers RVK follows closely have performed roughly in line with peers year-to-date, with any dispersion explained to a large degree by strategy allocation. Managers focused more on fundamental long-short equity and credit have suffered greater losses than those who seek diversification through a wider mix of strategies. On the direct side, multi-strategy managers as a group continued to outperform their FoHF counterparts. The multi-strategy funds in RVK's universe have benefitted from higher exposure to merger-arbitrage, which has performed very well in 2016 and has offset some of the negative attribution from elsewhere in the portfolio. Hedged equity managers produced positive returns during Q2 and recovered a portion of their first quarter loss, though the stock picking environment remains difficult. Prime brokerage data indicates that five of the last six months have been negative for alpha generation in long/short equity, with May being the lone exception. Where funds have generated alpha, it has come primarily from the consumer and energy sectors, while telecom and materials have been particularly poor for stock selection. Across other hedge fund strategies, distressed debt managers led the way in credit during the second quarter, and macro oriented strategies added to Q1 gains and are the best performing group year-to-date.

GTAA

Global Tactical Asset Allocation ("GTAA") funds provided varied results for the second quarter, with many significantly outperforming an undiversified static portfolio of 60% US large cap equity and 40% US fixed income. Those that outperformed by the widest margins tended to follow fundamental value-oriented processes that have led to higher allocations to emerging market debt, high yield fixed income, and REITs. Managers with these exposures have been able to offset the slight underperformance of emerging market equity exposure that many of those same strategies have also favored. Those who have targeted exposure to lower-volatility equity sub-strategies have also benefitted significantly. GTAA managers with larger secular US allocations also outperformed a static 60/40 allocation, especially those who have added diversification via MLP exposure and yield-oriented asset classes. Developed market foreign equity exposure detracted from most of the underperforming GTAA managers. In particular, among these managers, a consensus trade emerged that involves Japanese equity exposure combined with hedged exposure to the yen. Managers that have featured this exposure meaningfully lagged the group over the quarter. Less-traditional strategies that simultaneously target multiple uncorrelated positions and reduced volatility have underperformed over the quarter, particularly those managers that positioned for interest rate increases in the US. Those that have introduced additional credit exposure, however, provided positive performance. Risk parity strategies performed especially well over the quarter as longer duration fixed income, commodities, TIPS, and global equity all provided positive performance.

Diversified Inflation Strategies (Real Return)

Diversified Inflation Strategies provided strong performance with relatively narrow divergence for the second consecutive quarter. Most strategies significantly outperformed major world equity and fixed income indices, in addition to US Treasury Inflation Protected Securities (“TIPS”). The quarter’s positive performance occurred despite mixed indications among several inflationary measures which highlights the short-term fluctuations that may occur. For example, Headline CPI only increased modestly from 0.9% to 1.0% while the market’s expectations of future inflation in 10 years actually decreased from 1.8% to 1.5%. Commodities, especially energy, provided strong performance over the quarter in a welcome reprieve from the longer-term trend of negative performance. Managers with larger commodities exposure and energy allocations performed the strongest. In a quarter of robust performance among most inflation-sensitive assets, managers with larger TIPS allocations tended to lag the group despite still outperforming several major equity market indices.

Real Estate

Due to the prolonged low-interest rate environment occurring globally and the economic uncertainty brought upon by the recent Brexit vote, the real estate sector proved to be an attractive option during the second quarter as investors sought the perceived safe-haven of property as well as the continued strong dividends yields relative to global interest rates. Listed real estate securities posted a strong quarter as the FTSE EPRA/NAREIT Developed Index returned 3.7%, bolstered mostly by the North America sector returning 6.5% as a result of a strengthening US dollar and the relative economic stability in the region.

The private real estate sector experienced themes similar to listed real estate as evidenced by a 2.1% return in the NCREIF-ODCE Index during the second quarter. The muted, positive return continues the trend since 2010 of steady returns in core and domestic real estate, though the proportion of gains attributed to appreciation relative to income have declined in 2016. Despite slowing return growth in domestic real estate, capital from foreign investors is flowing into the US in increasing proportions. **Figure 2** illustrates that the US share of all cross-border transaction volume has climbed to over 30% thus far in 2016. Though valuations are surpassing pre-crisis peaks in certain sectors, international investors continue to be attracted to the strong fundamentals of the US real estate market, such as low vacancy rates and consistent rent growth.

Figure 2: US Share of Cross-Border Global Commercial Real Estate Transaction Volume

Disclaimer

RVK

RVK was founded in 1985 to focus exclusively on investment consulting and today employs over 100 professionals. The firm is headquartered in Portland, Oregon, with regional offices in Chicago and New York City. RVK is one of the ten largest consulting firms in the US (as defined by Pensions & Investments) and has a diversified client base of over 190 clients covering 28 states. This includes endowments, foundations, corporate and public defined benefit and contribution plans, Taft-Hartley plans, and high-net-worth individuals and families. The firm is independent, employee-owned, and derives 100% of its revenues from investment consulting services.

