CAPITAL MARKETS REVIEW
3rd Quarter 2015

September 30, 2015

RVK

OVERVIEW

U.S. Dollar strength and weaker than anticipated global demand contributed to broad declines for most risk assets in Q3. Equity markets in emerging market and commodity-sensitive countries suffered the greatest losses, largely in response to weakening economic indicators in China and a subsequent devaluation of the Yuan. Overall, global equity markets suffered declines, as earnings growth expectations deteriorated in light of weakening global demand. Fixed income markets provided a modest buffer for investors, as a flight to quality resulted in lower interest rates in developed markets.

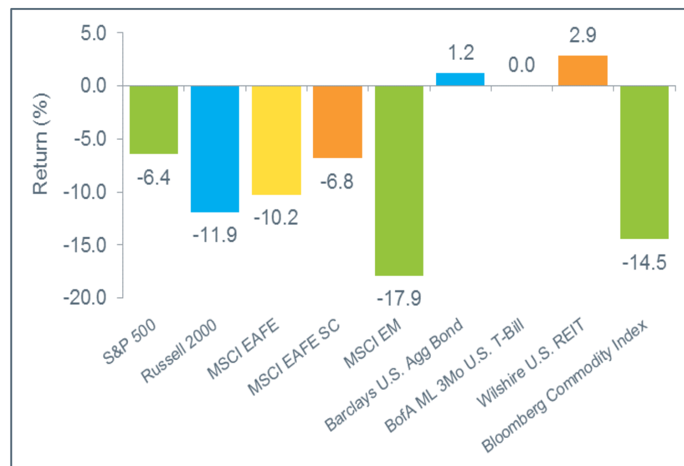
Perhaps the most significant event of the quarter was the unexpected decision by the People's Bank of China (PBOC) to devalue the Yuan against the U.S. Dollar. The first devaluation, which occurred on August 11th, reduced the value of the Yuan by 1.9% against the Dollar and amounted to the largest such cut by the PBOC since its currency peg began in 1994. By the end of the week the Yuan had fallen by 4.4% against the Dollar. The PBOC's action acted as a catalyst for a significant recalibration of global growth expectations. Global equity markets responded with a greater than 8% decline from August 18th to August 25th. The VIX (a measure of U.S. Equity volatility) rose to an intra-day high above 40, representing its highest level since the Global Financial Crisis. Citing downside risks to its forecast in emerging markets, the Organization for Economic Co-operation and Development (OECD) lowered its 2015 global growth forecast from 3.1% to 3.0%, and its 2016 forecast from 3.8% to 3.6%.

Current and expected economic performance in the United States remained stronger relative to international markets, but weaker relative to its 2014 performance. U.S. second quarter GDP growth was revised up to a healthy 3.9% annualized rate, but more recent economic data suggested weakening growth and inflation. Measures of market-based inflation expectations fell significantly quarter over quarter, with the 5-year breakeven rate falling from 1.7% in June to 1.1% at the end of September. The Purchasing Managers Index finished the quarter at 50.2, barely indicating expansion in the manufacturing sector. Finally, labor markets showed signs of weakness with monthly non-farm payroll gains averaging 167,000 per month in Q3 compared to an average of 260,000 per month during 2014. The U.S. was also not fully immune to emerging market volatility. In fact, at the September Federal Open Markets Committee (FOMC) meeting, the Federal Reserve cited moderating inflation and downside risks to global growth as reasons to leave the Federal Funds rate unchanged. Although most committee members still project an initial rate hike in 2015, the Fed Funds futures market suggests a low probability of an increase prior to 2016.

Trailing Period Market Performance (%)

	QTD	CYTD	1 Year	5 Years	10 Years
S&P 500	-6.4	-5.3	-0.6	13.3	6.8
Russell 2000	-11.9	-7.7	1.3	11.7	6.5
MSCI EAFE	-10.2	-5.3	-8.7	4.0	3.0
MSCI EAFE SC	-6.8	2.6	0.3	7.3	4.7
MSCI EM	-17.9	-15.5	-19.3	-3.6	4.3
Barclays U.S. Agg Bond	1.2	1.1	2.9	3.1	4.6
BofA ML 3Mo U.S. T-Bill	0.0	0.0	0.0	0.1	1.3
Wilshire U.S. REIT	2.9	-3.0	11.7	12.5	6.8
Bloomberg Commodity Index	-14.5	-15.8	-26.0	-8.9	-5.7

Quarter-To-Date Performance (%)



KEY ECONOMIC INDICATORS

		As of	6/30/2015	3/31/2015	10 Year Average
Federal Funds Rate	0.1%	9/30/2015	0.1%	0.1%	1.4%
Treasury - 1 Year	0.3%	9/30/2015	0.3%	0.2%	0.3%
Treasury - 10 Year	2.0%	9/30/2015	2.4%	1.9%	3.2%
Treasury - 30 Year	2.9%	9/30/2015	3.1%	2.5%	3.9%
Breakeven Inflation - 1 Year	-1.8%	9/30/2015	0.7%	1.5%	1.0%
Breakeven Inflation - 10 Year	1.4%	9/30/2015	1.9%	1.8%	2.1%
Breakeven Inflation - 30 Year	1.6%	9/30/2015	2.0%	1.9%	2.4%
Barclays US Corp: Hi Yld Index - OAS	6.3%	9/30/2015	4.8%	4.7%	5.7%
Capacity Utilization	77.6%	8/31/2015	77.4%	78.2%	76.7%
Unemployment Rate	5.1%	9/30/2015	5.3%	5.5%	7.0%
ISM PMI - Manufacturing	50.2%	9/30/2015	53.5%	51.5%	52.4%
Baltic Dry Index - Shipping	900	9/30/2015	800	602	2,810
Consumer Confidence (Conf. Board)	103.0%	9/30/2015	99.8	101.4	75.1
CPI YoY (Headline)	0.0%	9/30/2015	0.1%	-0.1%	2.1%
PPI YoY - Producer Prices	-4.1%	9/30/2015	-2.6%	-3.3%	0.0%
US Dollar Total Weighted Index	$92	9/30/2015	$90	$92	$78
WTI Crude Oil per Barrel	$45	9/30/2015	$59	$48	$81
Gold Spot per Ounce	$1,115	9/30/2015	$1,172	$1,184	$1,130

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U.S. Equity

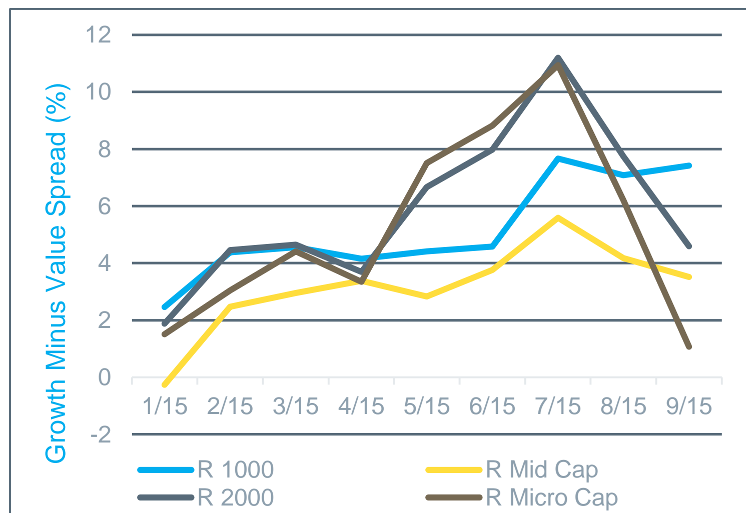
U.S. Equity markets ended the quarter in negative territory in response to the global sell-off in August and September. The increased volatility benefited active management during the quarter.

The Russell 2000 and Microcap indices suffered the largest losses, finishing the quarter at -11.9% and -13.8%, respectively. Large-cap stocks fared the best, but still ended the quarter in negative territory with the Russell 1000 returning -6.8%.

Marking a significant reversal, biotechnology stocks pulled back sharply in August and September, contributing heavily to the negative performance in the Russell 2000 and Microcap indices. This sub-sector, which has returned nearly 400% over the past ten years, saw its largest decline since 2014Q1, returning -16.0% during the quarter and effectively erasing 2015 gains.

While growth leadership in large- and mid-cap indices persisted during the quarter, spreads significantly narrowed in small- and micro-cap indices as markets punished speculative growth names. **Figure 1** plots cumulative 2015 YTD growth vs. value spreads. Notable growth leadership during the year took a sudden turn beginning in August in the small- and micro-cap indices as biotechnology stocks began to sell off. This resulted in an abrupt drawdown in small- and micro-cap growth stocks.

Figure 1: Growth vs. Value



Non-U.S. Equity

During the quarter, developed international markets trailed their domestic counterparts, with the exception of the small cap sector. Value continued to underperform growth across international markets as measured by the MSCI

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indexes. Although small cap stocks still suffered losses, they significantly outperformed larger cap stocks and, in fact, represent one of the few global equity asset classes that have preserved a positive return thus far in 2015.

Dispersion of developed country returns was high; however, returns were uniformly negative as a result of the concerns surrounding China. In addition, a country's economic ties and proximity to China was directly correlated to the level of underperformance, with developed Asian countries suffering the most. After the European Central Bank meeting this quarter, President Draghi attempted to reassure investors by stating that they would augment the current stimulus if emerging markets continue to deteriorate.

Emerging markets were the worst performing equity asset class for Q3. On a relative basis, growth continued to outperform value, while small cap outperformed large cap. Greece and Brazil fell even farther than China this quarter, as economic and political challenges persist in both countries.

Fixed Income

The Barclays U.S. Aggregate Bond Index was up 1.2% for the quarter. The Fed's decision to delay raising the Fed funds rate fueled gains for interest rate sensitive fixed income. Intermediate and long term rates fell during the quarter, and higher quality fixed income proved to be the most effective diversifier to equity markets. The Barclays U.S. Treasury Long Index was up 5.1%.

In credit markets, there was a definitive bias toward higher quality bonds. High yield bonds were down -4.9% as measured by the BofA ML U.S. High Yield Master II Index. The energy sector, which makes up nearly 13% of the index, was down 16.1%, as energy prices retreated back near recent lows. Defaults on energy sector bonds are expected to significantly increase in 2016 unless energy prices increase.

Global government bonds performed in line with U.S. Treasuries, as rates also declined in many developed economies. However, the dual impact of a strengthening U.S. Dollar and economic weakness in emerging markets amplified losses for local currency emerging market bonds, which were down -10.5% as measured by the JPM GBI-EM Global Diversified Index. Hard currency emerging market debt has now outperformed local currency for ten consecutive quarters.

Diversified Hedge Funds

Hedge funds gave back a meaningful portion of the gains that accrued through the first two quarters of the year and are now roughly flat year-to-date. Performance among managers that RVK tracks varied significantly, with those employing a more opportunistic, event-oriented investment style substantially underperforming more diversified relative value approaches. August, and especially September, were particularly painful, as the market sell-off negatively impacted most fundamental strategies. Relative skill with sector positioning and crowding factors determined whether managers were able to navigate the market turmoil successfully.

Macro managers generally fared well during the quarter, particularly those implementing systematic or trend following strategies that captured the persistent decline of energy prices. Lastly, spread widening in credit markets led to a difficult quarter for corporate fixed income and distressed strategies, which are now negative year-to-date.

GTAA

Continuing a theme for the year, investors were generally not rewarded for diversification. As a result, most GTAA managers underperformed a traditional U.S.-oriented 60/40 allocation. However, partial exceptions occurred in certain risk parity strategies, lower-volatility diversifying global macro approaches and managed futures. Generally, GTAA managers with larger allocations to U.S. equities and larger allocations to rate-sensitive fixed income benefited relative to peers as the yield curve flattened, credit spreads widened, and U.S. equity markets suffered less than international equity markets. Managers with substantial allocations to emerging markets equities, emerging markets currencies, and U.S. high yield underperformed by the widest margin. Lower-volatility global macro strategies generally provided the strongest protection relative to a 60/40 portfolio

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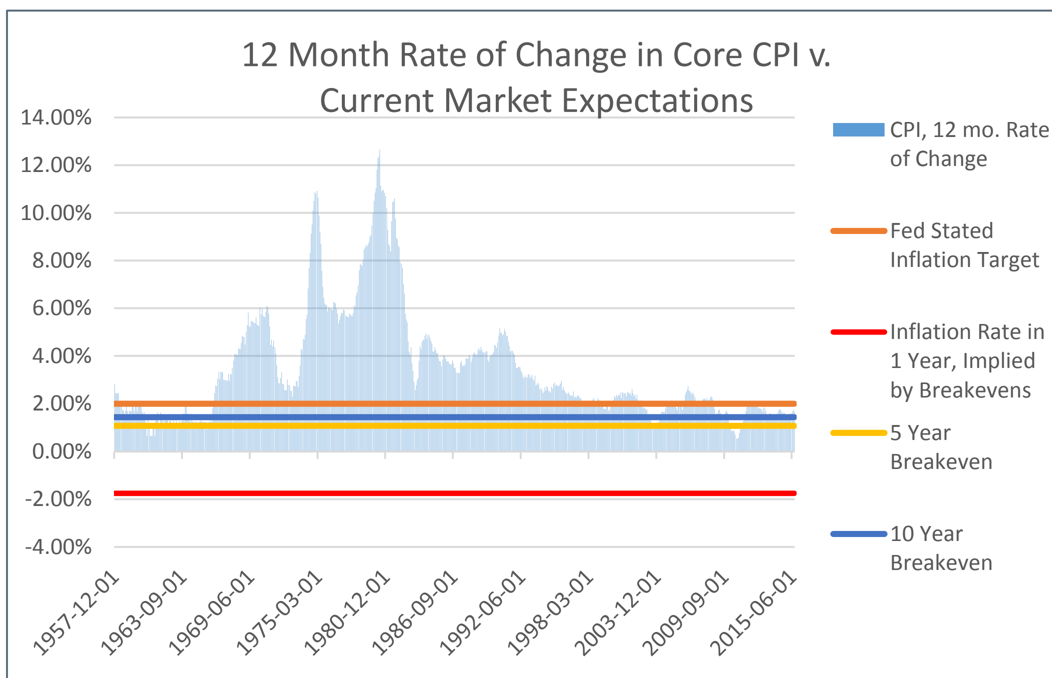
Real Return

Diversified Inflation Strategies (DIS) managers added another difficult quarter to an already difficult year, as inflation-sensitive assets performed poorly due to continued reduction of inflation expectations. Key drivers of reduced expectations included emerging market currency devaluations (considered disinflationary for U.S. investors), decreased growth expectations of major Southeast Asian economies, and oversupplied commodity markets. Due to particular weakness in energy markets, managers with larger natural resource equities allocations underperformed those with higher allocations to REITs and TIPS.

Illustrating just how weak inflation expectations have become, **Figure 2** shows an implied 12-month inflation rate (represented by the red line) of only -1.75%. It is worth noting that according to data dating back to 1957, Core CPI has never decreased over any twelve month period. Notwithstanding the market's forward-looking views on inflation, most DIS managers believe that inflationary prospects are considerably underpriced.

Figure 2: Market Implied Inflation



Real Estate

Despite relative outperformance in recent years, even public real estate was not immune to recent global market volatility. The FTSE/NAREIT All REITs Index finished a rocky quarter with a 0.8% return. Key drivers of the relatively weak return were a significant sell-off in REITs and anxiety related to the potential of the Fed to increase interest rates.

Private real estate in the U.S. was impacted less by market turmoil, as evidenced by the 3.7% quarterly return in the NCREIF-ODCE Index (benchmark for U.S. Core Real Estate Funds). The index continued its historic run, recording its 22nd consecutive positive quarterly return. This has produced a trailing five-year return of 14.0%. Demand for real estate in the domestic market remains strong with vacancy declines and rent growth occurring across major property types during the third quarter, according to CBRE.

Globally, capital continues to flow into Real Estate. According to Preqin, private real estate funds raised over $47 billion year-to-date, far exceeding the fundraising levels for all of 2014. Rich valuations in Core Real Estate has pushed investors into riskier opportunistic real estate. Funds in this risk profile closed on $28.2 billion during the third quarter versus only $2.2 billion raised during the same quarter in 2014.

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