

## Overview

The third quarter of 2016 was generally positive for risk assets. Global equity and credit markets rallied with both developed and emerging markets adding to gains realized earlier in the year. July was a particularly strong month for equities as volatility sparked by the UK referendum vote in June subsided. Government bond returns were mainly flat during the third quarter, though long duration assets in the US underperformed other global developed markets as the market began to price in a Federal Reserve (“Fed”) interest rate hike. Commodity returns were mixed during the quarter, with energy and agricultural commodities giving back prior gains while precious metals performed well.

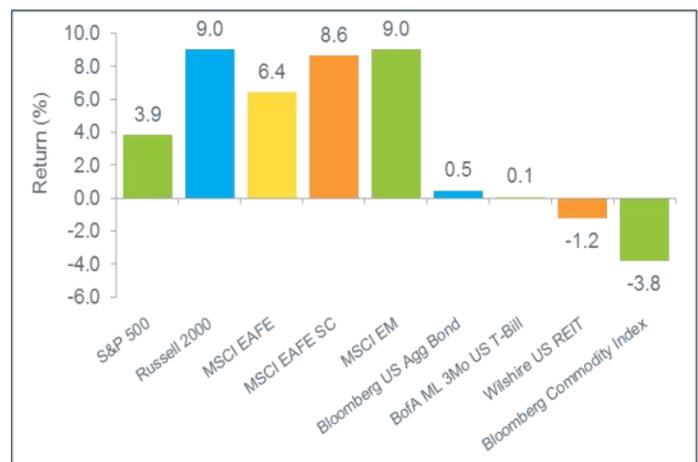
In the US, the Fed again held interest rates steady at the September meeting, although several members of the FOMC voiced dissent. US economic data released during the third quarter continued to indicate moderate economic expansion. GDP growth for the second quarter was revised upward to 1.4%, and the quarter-end Atlanta Fed GDP Now Forecast predicted GDP growth for Q3 of 2.4%. Similarly, ISM PMI data pointed to expansion in both the manufacturing and non-manufacturing sectors, with the former averaging 51.2 over the quarter and the latter averaging 54.7. Despite positive economic indicators, the majority of FOMC members see reason to remain cautious on raising interest rates. This outlook is supported by core PCE, which remains below the Fed’s 2.0% target, and the 5-year/5-year forward inflation expectation rate (a measure of long-term inflation compensation), which finished the quarter at 1.75%. Further buoying the case to remain cautious is evidence of continued slack in labor markets. While the economy added an average of 192,000 jobs per month during the third quarter, the unemployment rate increased to 5.0% as the Labor Force Participation rate climbed to 62.9% from 62.7% at the end of Q2. Finally, although not explicitly stated by the FOMC, market participants view a rate increase during the Fed’s November meeting as unlikely given its proximity to the Presidential election. However, the implied probability of an increase during the December meeting remains above 50%.

In the UK, the Bank of England (“BOE”) announced preemptive measures to counteract potential negative effects of the Brexit vote. In August, BOE Governor Mark Carney announced an interest rate cut of 0.25% and an expansion of the Bank’s quantitative easing program by 70 billion pounds over the coming six months. The rest of Europe took a more measured response to Brexit. European Central Bank President Mario Draghi reaffirmed the bank’s existing monetary policy in its September meeting with forecasts for Eurozone GDP growth remaining largely unchanged. One of the more interesting developments came from the Bank of Japan, as it announced further measures to stimulate its economy and bring about inflation by targeting a 0.00% interest rate on the 10-year government bond.

### Trailing Period Market Performance (%)

	QTD	YTD	1 Year	5 Years	10 Years
S&P 500	3.9	7.8	15.4	16.4	7.2
Russell 2000	9.0	11.5	15.5	15.8	7.1
MSCI EAFE	6.4	1.7	6.5	7.4	1.8
MSCI EAFE SC	8.6	5.2	12.3	11.1	4.4
MSCI EM	9.0	16.0	16.8	3.0	3.9
Bloomberg US Agg Bond	0.5	5.8	5.2	3.1	4.8
BofA ML 3Mo US T-Bill	0.1	0.2	0.3	0.1	0.9
Wilshire US REIT	-1.2	9.7	17.9	15.8	5.9
Bloomberg Commodity Index	-3.8	8.9	-2.6	-9.4	-5.3

### Quarter-to-Date Performance (%)



## Key Economic Indicators

		As of	6/30/2016	3/31/2016	10 Year Average
Federal Funds Rate	0.29%	9/30/2016	0.30%	0.25%	0.98%
Treasury - 1 Year	0.59%	9/30/2016	0.45%	0.59%	1.01%
Treasury - 10 Year	1.60%	9/30/2016	1.49%	1.78%	2.91%
Treasury - 30 Year	2.32%	9/30/2016	2.30%	2.61%	3.72%
Breakeven Inflation - 1 Year	0.95%	9/30/2016	1.17%	2.10%	0.91%
Breakeven Inflation - 10 Year	1.61%	9/30/2016	1.44%	1.63%	2.03%
Breakeven Inflation - 30 Year	1.75%	9/30/2016	1.61%	1.79%	2.25%
Bloomberg US Corp: Hi Yld Index - OAS	4.80%	9/30/2016	5.94%	6.56%	6.01%
Capacity Utilization	75.52%	8/31/2016	75.50%	74.90%	76.21%
Unemployment Rate	5.00%	9/30/2016	4.90%	5.00%	6.99%
ISM PMI - Manufacturing	51.50%	9/30/2016	53.20%	51.80%	51.91%
Baltic Dry Index - Shipping	875	9/30/2016	660	429	2,608
Consumer Confidence (Conf. Board)	104.10	9/30/2016	97.40	96.10	74.40
CPI YoY (Headline)	1.10%	8/31/2016	1.00%	0.90%	1.78%
PPI YoY - Producer Prices	-2.10%	8/31/2016	-2.00%	-2.30%	1.86%
US Dollar Total Weighted Index	\$90	9/30/2016	\$90	\$91	\$78
WTI Crude Oil per Barrel	\$48	9/30/2016	\$48	\$38	\$79
Gold Spot per Ounce	\$1,316	9/30/2016	\$1,322	\$1,233	\$1,189

## Asset Class Commentary

### US Equity

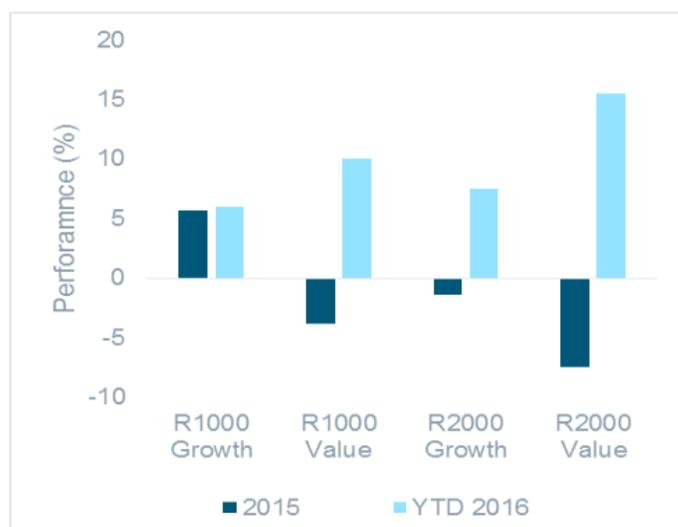
US equity markets finished the quarter with positive returns as the Russell 3000 Index returned 4.4%. Returns were positive across all market capitalizations and styles. In an environment of muted volatility, there was a notable reversal in sector performance as income-oriented stocks posted negative returns. For example, telecom services and utilities sectors within the S&P 500 returned -5.6% and -5.9%, respectively. Despite negative third quarter performance, these sectors remain top contributors to overall index performance for the year-to-date. More economically sensitive sectors, such as technology, industrials, and financials, outperformed during the third quarter. As a result, high beta investment styles led all other factor styles, with the S&P 500 High Beta Index returning 12.2%.

Growth moderately outperformed value with the Russell 3000 Growth Index returning 4.9% versus 3.9% for its value counterpart. Year-to-date, value indices continue to outperform growth across all sizes and styles. The Russell Microcap Index returned 11.2%, which established micro-cap as the best performing cap range during the quarter. Smaller-cap indices have also performed well year-to-date, led by the Russell 2000

Value index, which has returned 15.5% in 2016.

Figure 1 shows the market's shift towards favoring smaller-cap, value-biased stocks compared to 2015, when the market predominantly favored large-cap growth stocks. This shift is representative of a small-cap rally and highlights a change in market style leadership from growth to value.

Figure 1: Change in US Equity Style Leadership



## Non-US Equity

After a weak second quarter, developed international markets saw strong, positive returns in the third quarter, on both an absolute basis and relative to the broad U.S. equity market. The style trend reversed, with value outperforming growth stocks and small-cap outperforming large-cap. Country returns were largely positive with only a few in the red.

Emerging markets continued their rally for the year and outperformed all other equity regions. Growth outperformed value for the quarter, but value stocks lead for the year-to-date. In contrast to developed markets, small-cap stocks in emerging markets, while returning 7.6% in Q3, could not keep pace with the rally in larger stocks. China and Brazil were key contributors to overall performance. China's second quarter GDP growth rate of 6.7% exceeded consensus estimates, while sentiment around Brazil improved following the removal of President Dilma Rousseff. Finally, OPEC agreed to limit output, which should provide short-term support for emerging market countries heavily tied to the price of oil.

## Fixed Income

There was little interest rate movement during the quarter amid uncertainty around whether the Fed would raise rates. After rates came down in the second quarter, the Treasury yield curve moved slightly higher, detracting from the performance of rate-sensitive fixed income. Credit spreads tightened for the quarter, led by a continued resurgence of energy and commodity credits. The BofA ML US High Yield Index returned 5.5%, as lower quality credits appreciated significantly. However, the high yield bond default rate was slightly higher than the long-term average.

Money market reforms, which became effective on October 14, 2016, drove many investors to transition from prime money market funds to government money market funds in order to avoid floating NAVs and liquidity restrictions. This migration of assets had a noticeable effect on short-dated fixed income securities. **Figure 2** illustrates the spread of the 3-month LIBOR rate over the 3-month Treasury rate (TED spread). The spread widened due to increased demand for government securities coupled with reduced demand for short-dated

bank debt and commercial paper.

**Figure 2: TED Spread Widening**



## Diversified Hedge Funds

Hedge funds built on a positive second quarter by posting strong returns again in the third quarter. The Fund of Hedge Fund ("FoHF") managers that RVK closely follows were up anywhere from 2% to 4% during the quarter and have in most cases recovered losses from earlier in the year. Preliminary peer group data show that this was the best quarter for FoHFs since the fourth quarter of 2013. Drivers of returns for the group came from Equity Long/Short ("ELS"), Event Driven, and Credit strategies. Within ELS, prime brokerage data show that managers were able to generate alpha on both the long and short sides of their portfolios in Q3 with particular strength coming from long positions in the energy, materials, and technology sectors. Short positions proved successful in the healthcare and consumer-oriented sectors. The ELS managers RVK closely follows have generally recovered from a difficult first quarter and are approaching positive territory. A similar story can be told for multi-strategy managers, who benefitted from strong performance within ELS as well as within merger-arbitrage and other event-driven strategies. The best performing group was Distressed Credit, which peer based indices show returned in excess of 5% representing the second straight quarter in which distressed managers returned 5% or more. Macro funds, which had provided attractive returns through the second quarter, gave back some gains during the third quarter.

## GTAA

Most managers outperformed a non-tactical portfolio comprised of 60% US equity and 40% fixed income during the quarter, which has presented a relatively high performance hurdle in recent years. Compared to the wide dispersion in strategy performance during the first two quarters of 2016, GTAA managers provided a relatively narrow range of performance during the third quarter. Those among the top performing managers avoided or de-emphasized US large-cap equity exposure in favor of emerging market equity and credit-sensitive fixed income. Managers with overweight exposure to Japan were also rewarded. Despite strong performance for the broader group during the quarter, those with larger positions in cash, yield-oriented US equity, and MLP exposures lagged the group by the widest margin. Managers that recently reduced volatility targets, increased cash, and reduced risky asset exposure also performed poorly. Risk parity managers lagged the broader group considerably, but still performed within expectations on a risk-adjusted basis and provided positive returns. Alpha-oriented managers with global relative value approaches also lagged the broader group with flat to modestly negative performance.

### Diversified Inflation Strategies (Real Return)

Performance for Diversified Inflation Strategies in the third quarter ranged from modest to strong while nearly all managers continued to build on what is becoming a notable year for the asset class. During the quarter, performance of various inflation-sensitive assets varied and manager performance mirrored this trend. For the second consecutive quarter, managers with larger TIPS allocations tended to lag peers; however, this exposure was not as much of a key differentiator as it had been in previous quarters. Managers that introduced commodity exposure at the expense of natural resource equity, which correlated more heavily with the global equity rally, tended to underperform. Managers also benefitted from high yield exposure, which experienced gains partially from the rally of energy assets. Finally, managers that recently reduced US real estate and added global infrastructure allocations were rewarded in the third quarter.

## Real Estate

Core real estate continued a trend of delivering modest, positive returns, with the third quarter seeing a nearly equal mix of income and appreciation driving a 2.1% return for the NCREIF-ODCE Index. The public real estate space did not fare as well, as the FTSE NAREIT All REITs Index posted a -1.0% return for the quarter. In general, increasing property valuations coupled with strong fundamentals, such as rental growth and occupancy, fueled solid returns in core real estate. However, indications of potential moderation in real estate returns began to surface during the quarter. Most notable was the year-over-year declines in apartment rent growth seen in certain major metro markets, such as New York and San Francisco.

While strong property-level fundamentals coupled with constrained supply would usually signal a construction boom, development loans have become difficult to obtain as CMBS financing has fallen out of favor. Perhaps with the 2008/2009 financial crisis still in mind, bankers are exercising caution during this phase of the cycle. Lenders are also showing restraint in mortgage financing, as current cap rates are at a 220 basis points premium to newly-originated debt, compared to an 80 basis points premium prior to the downturn. As a result of a tight lending environment, transaction volumes have declined steadily year-over-year. Despite the aforementioned liquidity yields, real estate still offers attractive yield relative to other income-oriented asset classes, suggesting that investors will continue to maintain a healthy appetite for real estate exposure.

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