RVK

Capital Markets Review | 4th Quarter 2017

December 31, 2017

Overview

Price action across global financial markets continued to be driven by expectations of ongoing economic growth and generally accommodative central bank policies, with equity markets trading to record levels and global sovereign debt yields continuing to trade within recent ranges. The S&P 500 Index returned 6.6% during Q4, while the MSCI ACW Ex US Index rose 5.0%. For the year, the S&P 500 Index rose 21.8%, but was outpaced by the 27.2% gain of the MSCI ACW Ex US Index. Global commodity and oil markets also experienced a strong year-end, with oil markets breaking out of recent ranges to trade at multi-year highs.

Expectations of a modest acceleration in US inflation were cited as a major factor driving Treasury yields over the quarter, with the 10-year break-even inflation rate rising approximately 0.14%. This was the result of the 10-year nominal Treasury yield rising by approximately 0.08% and the 10-year Treasury Inflation Protected Securities ("TIPS") yield declining 0.06%, as market participants expressed concerns about inflation pressures building from continued low unemployment levels and robust US economic growth.

The nominal Treasury curve continued to flatten over the quarter. Market participants suggest that recent and expected monetary policy actions, as well as expectations for increased Treasury issuance amidst fiscal stimulus policies, are driving short-maturity and mid-maturity yields higher. Comparatively, longer-dated yields proved stable, and reportedly continue to be heavily influenced by relatively modest expectations for sustained US economic growth and building inflation expectations.

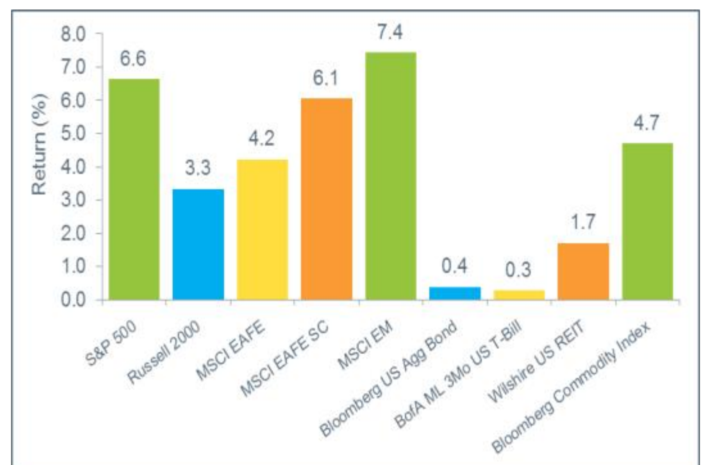
The Federal Open Market Committee ("FOMC") increased policy rates during its December meeting, setting the new target range for the Federal Funds rate at 1.25% to 1.50%, with market participants citing minimal price action after the announcement due to it being widely anticipated. This increase was the third in 2017, with the FOMC again highlighting an improving economy and healthy labor market as the chief rationale behind their decision to raise rates. The FOMC also began to unwind positions held in the System Open Market Account in October, as announced at the September FOMC meeting.

Finally, the US dollar continued to depreciate over the quarter, weakening by 1.0% against major currencies amidst continued economic improvements across developed international and emerging markets. The depreciation over the quarter contributed to a total dollar depreciation of nearly 10% for the year.

Trailing Period Market Performance (%)

	QTD	CYTD	1 Year	5 Years	10 Years
S&P 500	6.6	21.8	21.8	15.8	8.5
Russell 2000	3.3	14.6	14.6	14.1	8.7
MSCI EAFE	4.2	25.0	25.0	7.9	1.9
MSCI EAFE SC	6.1	33.0	33.0	12.9	5.8
MSCI EM	7.4	37.3	37.3	4.3	1.7
Bloomberg US Agg Bond	0.4	3.5	3.5	2.1	4.0
BofA ML 3Mo US T-Bill	0.3	0.9	0.9	0.3	0.4
Wilshire US REIT	1.7	4.2	4.2	9.3	7.3
Bloomberg Commodity Index	4.7	1.7	1.7	-8.5	-6.8

Quarter-to-Date Performance (%)



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Key Economic Indicators

		As of	9/30/2017	6/30/2017	10 Year Average
Federal Funds Rate	1.33%	12/31/2017	1.06%	1.06%	0.43%
Treasury - 1 Year	1.76%	12/31/2017	1.31%	1.24%	0.54%
Treasury - 10 Year	2.40%	12/31/2017	2.33%	2.31%	2.59%
Treasury - 30 Year	2.74%	12/31/2017	2.86%	2.84%	3.46%
Breakeven Inflation - 1 Year	0.85%	12/31/2017	1.24%	0.72%	0.79%
Breakeven Inflation - 10 Year	1.98%	12/31/2017	1.85%	1.74%	1.96%
Breakeven Inflation - 30 Year	2.02%	12/31/2017	1.93%	1.85%	2.17%
Barclays US Corp: Hi Yld Index - OAS	3.43%	12/31/2017	3.47%	3.64%	6.07%
Capacity Utilization	77.86%	12/31/2017	76.05%	76.60%	75.81%
Unemployment Rate	4.10%	12/31/2017	4.20%	4.30%	6.97%
ISM PMI - Manufacturing	59.70%	12/31/2017	60.80%	57.80%	52.59%
Baltic Dry Index - Shipping	1,366	12/31/2017	1,356	901	1,911
Consumer Confidence (Conf. Board)	122.10	12/31/2017	120.60	117.30	76.11
CPI YoY (Headline)	2.10%	12/31/2017	2.20%	1.60%	1.70%
PPI YoY - Producer Prices	3.30%	12/31/2017	3.30%	2.10%	1.81%
US Dollar Total Weighted Index	$87	12/31/2017	$88	$90	$80
WTI Crude Oil per Barrel	$60	12/31/2017	$52	$46	$76
Gold Spot per Ounce	$1,303	12/31/2017	$1,280	$1,242	$1,266

Asset Class Commentary

US Equity

US equity markets delivered strong broad-based performance during Q4, with the S&P 500 Index posting its ninth consecutive positive calendar year dating back to 2009. US growth stocks led value stocks in Q4, and large cap stocks similarly outpaced small cap stocks during this period. This quarter's trends were also representative of market performance as a whole during 2017, with the S&P 500 Growth Index outperforming its value counterpart by 12.1% for the year, and the S&P 500 Index outperforming its small cap counterpart by 8.6% over the same period. Despite this bifurcation, all market capitalizations and styles posted positive results for 2017.

Active management delivered mixed results during both the quarter and year, but value managers generally outperformed over both time periods, with the weaker returns from their respective indices acting as lower hurdles. In contrast, active growth managers faced headwinds due to underweight exposure to a range of high-performing stocks and sectors as biotechnology and pharmaceuticals continued to drive growth equity index performance in small cap. Meanwhile strong and narrow performance in technology drove growth equity index performance in large cap. Information technology broadly led all sectors during both Q4 and 2017, as the S&P 500 Information Technology Index returned 9.0% and 38.8% for the quarter and year, respectively. A small subset of companies particularly dominated broad market returns in 2017, with FAANG (Facebook, Amazon, Apple, Netflix, and Google), averaging returns of nearly 50% during 2017. As a result, many active managers with light or absent exposure to this lineup of companies experienced difficulty in keeping pace with their respective benchmarks.

Non-US Equity

Developed international markets had a strong quarter, and though they lagged the US market, they outpaced the domestic market for 2017. The outperformance of value stocks last year did not persist, with growth stocks solidly outperforming for the quarter and year. Small cap also outperformed large cap for both Q4 and 2017. In Japan, Shinzo Abe's multi-year stimulus appears to be taking hold, with the core consumer price index rising 0.9% in November from a year earlier. However, the stimulus still trails its initial expectations, as inflation remains below the regime's 2% target. In Europe, meanwhile, the European Central Bank announced that it will taper its bond purchase program starting in 2018.

Emerging markets outperformed domestic and developed international markets for both the quarter and year. Small cap stocks outperformed large cap stocks this quarter, but lagged for the year. The 2017 global growth

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rally has been starkly evident in emerging markets, as the gap in returns between styles eclipsed those surfacing across other asset classes. This disparity between growth and value is driven primarily by a small number of stocks in the Asia technology sector. In particular, Tencent and Alibaba make up about one fifth of the MSCI Emerging Markets Growth Index, and accounted for approximately 40% of the return spread versus the value index. Consequently, relative overweight or underweight positions to these stocks strongly influenced the performance of many active managers during 2017.

Fixed Income

The Bloomberg Barclays US Aggregate Bond Index returned 0.4% for the quarter, and ended the year with a return of 3.5%. The flattening yield curve during the quarter and year detracted from the performance of short duration bonds, while contributing to the performance of long duration bonds. A flatter yield curve has caused some tactical investors and portfolio managers to shorten the duration of their portfolios as the perceived relative value of shorter-dated securities has increased.

Investment grade and high yield credit spreads started the year below long-term averages and continued to grind tighter. This trend of overall long-term tightening was not without a few momentary spikes in yields. One of those spikes occurred in November, in response to lackluster earnings in the telecommunication and healthcare sectors.

Arguably, the best performing sub-asset class within fixed income over the course of 2017 was non-dollar denominated emerging market debt, which returned 15.2% as measured by the JPM GBI-EM Global Diversified Index. Important drivers of this performance included the improving fundamentals and stabilizing political environments experienced by many countries during the year. Venezuela has been a prominent exception to this trend of stabilization. Venezuelan President Nicolas Maduro announced in November that the country would seek to restructure its global debt. As a result, exposure to Venezuela was a key performance factor for active emerging market debt managers during the quarter.

Diversified Hedge Funds

The majority of hedge fund strategies delivered another solid quarter, as most fundamentally-oriented managers benefitted from low inter-stock correlation and a positive return environment across most underlying global risk assets. The Fund of Hedge Funds managers that RVK follows closely generated returns between 1.0% and 2.5% during the quarter. These funds have largely trailed their peer-group-based benchmarks over the course of 2017, as many continue to struggle to identify scalable opportunities in a market characterized by tight credit spreads and equity valuations near cyclical highs. Over the last several years, many of these managers have rotated out of traditional hedge fund strategy staples like equity long/short and into strategies with lower “beta”, or sensitivity to changes in the pricing and income generation of global risk assets. The increasingly conservative positioning across hedge fund strategies is likely to serve managers well in the event of a significant market correction, but will likely continue acting as a headwind during periods of strong performance for higher -risk asset classes like global equities.

Quarterly returns for multi-strategy hedge funds were positive, but suffered in November in large part due to the suit filed by the Department of Justice against AT&T in its bid to acquire Time Warner Cable. Previous mergers of this type have historically avoided justice department scrutiny, and many funds were caught off guard as spreads between the stocks of the target company and its acquirer widened significantly. Equity long/short trading was broadly a source of positive performance across Q4, however, and was also the best performing broad hedge fund category for the year. Despite being materially hedged against market tailwinds, the managers that RVK tracks closely were able to generate a wide positive spread between significant long gains and modest short losses, though alpha generation industry-wide suffered in Q4 compared to prior quarters this year.

Global Tactical Asset Allocation (“GTAA”)

GTAA managers provided strong performance in Q4 to finish an already successful 2017. Although performance diverged widely across managers, both global equity and global fixed income markets were

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broadly supportive during the quarter, providing a welcome backdrop for most multi-asset strategies. Although GTAA managers performed well in absolute terms, most modestly underperformed relative to a static, undiversified blend of 60% US equity and 40% US fixed income. The modest underperformance of tactical managers relative to this static benchmark was generally most pronounced for managers who adhere to value-oriented investment processes. Although some value-oriented managers have increasingly allocated capital to the relatively under-valued emerging markets space — positioning that contributed during the quarter — these managers also broadly observed high valuations across most global asset classes, and many have held larger than typical cash allocations as a result. In addition to the detraction of cash over both the quarter and year, another key detractor for these predominantly value-oriented managers in 2017 has been the underperformance of value relative to growth.

During Q4, systematic multi-asset managers, including risk parity and managed futures managers, were an exception to the trend of underperformance, as these managers generally outperformed the static 60/40 blended benchmark. Given a quarter and year where the most volatile asset classes tended to provide the strongest gains, lower volatility multi-asset managers lagged most of their peers within the highly varied category of GTAA managers, given their focus on limiting volatility and downside risk in favor of diversification.

Diversified Inflation Strategies (“DIS”)

Performance for Diversified Inflation Strategies in Q4 ranged widely, with managers providing positive performance in a quarter where market-based measures of future expected inflation increased. The Bloomberg Commodity Index gained 4.7%, while the S&P Global Natural Resources Index gained 8.6% over the quarter, led by gains in the energy and industrial metals subcomponents. During this time, Headline CPI remained steady after finishing the year at 2.10% which represented a slight decrease from the 2.20% level reported at the end of Q3. In comparison, market expectations of future inflation increased from 1.85% to 1.98% based on the 10-year Treasury break-evens. Managers with heavy commodity futures exposure and natural resource equity exposure led their peer groups, while managers that avoid such exposures in lieu of larger concentrations to global listed infrastructure and REITs generally lagged. Those with significant exposure to TIPS tended to experience near-median performance. When comparing managers with significant TIPS exposure to one another, those with natural resource equity and/or commodity exposure generally outperformed, while those with larger floating rate and high yield fixed income allocations generally underperformed.

Real Estate

The core private real estate index, NCREIF-ODCE returned 2.1% (preliminary) in Q4, comprised of 1.1% income and 1.0% appreciation. This quarter caps off a year of substantial normalization of returns, reinforcing investor expectations of lower returns going forward as we enter the later stages of the recovery. Investors in publicly traded real estate outperformed their private market counterparts during the quarter as measured by the FTSE/NAREIT All REITs Index return of 2.4%.

Real estate valuations remain healthy, and are supported by continued strength in the overall economy with increases from personal consumption, business investment and state and local government spending. In December, US Q3 GDP was revised upwards, giving capital markets positive signals that further supported valuations while coming off the heels of two significant natural disasters in Houston and Florida.

In 2017, there was a reduction in transaction volume year-over-year for commercial real estate. While there was a slight pick-up in industrial sector deal flow, the three other primary sectors experienced a pull-back in deals. Many view this decrease in transaction volume as a healthy signal as opposed to an ominous warning. Transaction volume peaked in 2015 and has moderated since due to a wide range of factors, including more rigorous lending standards, increased borrowing costs, and a generally elevated level of investor risk aversion driven by the hard lessons learned during the Great Financial Crisis. Discussions with managers have revealed expectations that these trends will hold into 2018 and likely beyond, as additional rate hikes are anticipated.

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