CAPITAL MARKETS REVIEW
1st Quarter 2015

March 31, 2015

OVERVIEW

In a reversal of a multi-year trend, U.S. equity markets underperformed both developed international and emerging markets during the first quarter of 2015. A big driver of this trend was the introduction of divergent monetary policies by central banks throughout the developed world, which exerted pressure on both asset prices and exchange rates. The Federal Reserve, having exited its quantitative easing program in late 2014, continues to signal its willingness to raise interest rates at the earliest signs of inflation. In contrast, the European Central Bank and Bank of Japan continued to pursue aggressive monetary easing. The impact of these policies on current and expected interest rates led to a strengthening of the U.S. dollar which raises concerns regarding U.S. exports and the dollar value of earnings generated in foreign currencies.

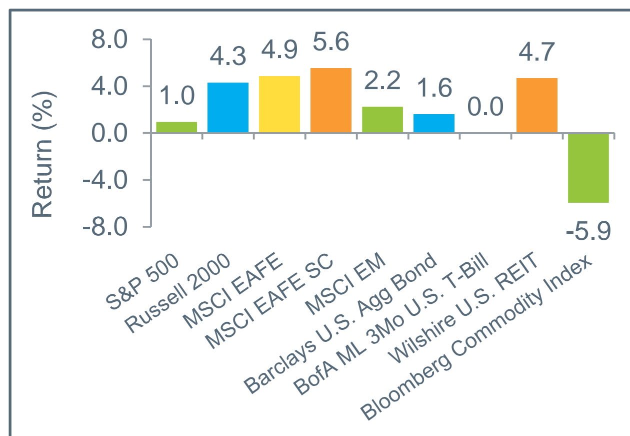
An additional headwind in the U.S. was the apparent weakening of economic growth, as several key indicators came in below expectations. While the unemployment rate remained steady at 5.5% in March, additional non-farm payroll jobs came in well below expectations at 126,000 with January and February estimates being revised downward as well. In the manufacturing sector, the ISM PMI, which averaged a level of 56.4 through the final three quarters of 2014, fell throughout the quarter and ended March at 51.5. Despite softer-than-expected economic data, minutes from the March Federal Open Market Committee meeting indicated that several participants were looking to June for an initial rate hike. The Board remains divided however, with Janet Yellen and others appearing to be more willing to wait for stronger wage inflation before considering an increase in the Federal Funds rate.

Globally, much attention was focused on oil prices, as OPEC producers refused to yield to pressure to cut production. Generally, non-OPEC producers also declined to curtail production despite lower prices due to the need to generate sufficient cash flow to service existing debt. In addition to price pressure from oversupply, weaker than expected global demand magnified downward pressure on oil prices. In Europe, Greece's Syriza leadership reached an agreement with the Troika to maintain the country's funding for several months, while Greece works to put together a package of reforms. It remains to be seen what the final proposal will look like, and whether Greece will be forced to maintain a primary account surplus of 4.5% as was agreed upon in the prior bailout agreement. In light of these trends, the IMF cut its 2015 global growth forecast by 0.3% to 3.5% in January citing persistently low levels of investment globally.

TRAILING PERIOD MARKET PERFORMANCE (%)

	QTD	CYTD	1 Year	5 Years	10 Years
S&P 500	1.0	1.0	12.7	14.5	8.0
Russell 2000	4.3	4.3	8.2	14.6	8.8
MSCI EAFE	4.9	4.9	-0.9	6.2	4.9
MSCI EAFE SC	5.6	5.6	-2.9	8.8	6.2
MSCI EM	2.2	2.2	0.4	1.7	8.5
Barclays U.S. Agg Bond	1.6	1.6	5.7	4.4	4.9
BofA ML 3Mo U.S. T-Bill	0.0	0.0	0.0	0.1	1.5
Wilshire U.S. REIT	4.7	4.7	25.2	16.1	9.6
Bloomberg Commodity Index	-5.9	-5.9	-27.0	-5.7	-3.6

QUARTER-TO-DATE PERFORMANCE (%)



KEY ECONOMIC INDICATORS

		As of	12/31/2014	9/30/2014	10 Year Average
Federal Funds Rate	0.06%	3/31/2015	0.06%	0.07%	1.53%
Treasury - 1 Year	0.23%	3/31/2015	0.21%	0.10%	0.34%
Treasury - 10 Year	1.92%	3/31/2015	2.17%	2.49%	3.26%
Treasury - 30 Year	2.54%	3/31/2015	2.75%	3.20%	3.99%
Breakeven Inflation - 1 Year	1.46%	3/31/2015	-0.21%	-0.19%	1.08%
Breakeven Inflation - 10 Year	1.78%	3/31/2015	1.68%	1.97%	2.16%
Breakeven Inflation - 30 Year	1.87%	3/31/2015	1.90%	2.11%	2.38%
Barclays US Corp: Hi Yld Index - OAS	4.66%	3/31/2015	4.83%	4.24%	5.67%
Capacity Utilization	78.37%	3/31/2015	79.41%	79.40%	77.13%
Unemployment Rate	5.50%	3/31/2015	5.60%	5.90%	6.90%
ISM PMI - Manufacturing	51.50%	3/31/2015	55.10%	56.10%	52.40%
Baltic Dry Index - Shipping	602	3/31/2015	782	1,063	2,922
Consumer Confidence (Conf. Board)	101.30	3/31/2015	93.10	89.00	75.40
CPI YoY (Headline)	0.00%	2/28/2015	0.80%	1.70%	2.20%
PPI YoY - Producer Prices	-3.40%	2/28/2015	-0.40%	2.20%	3.00%
US Dollar Total Weighted Index	$92	3/31/2015	$85	$81	$77
WTI Crude Oil per Barrel	$48	3/31/2015	$53	$91	$82
Gold Spot per Ounce	$1,184	3/31/2015	$1,185	$1,208	$1,093

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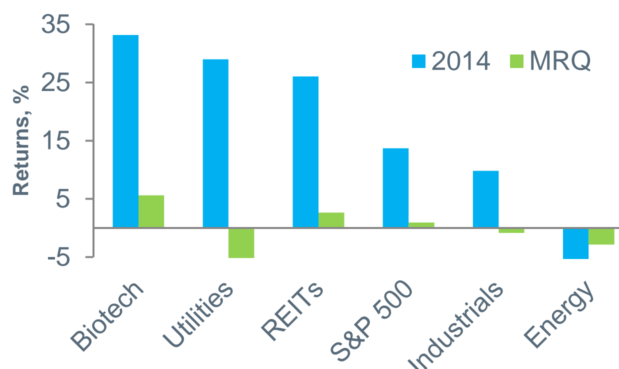
U.S. Equity

The U.S. equity market provided volatile results, with the Russell 3000 Index generating negative returns in January and March, but a positive 1.8% return for the quarter due to a strong February rally. Growth stocks outperformed, with the Russell 3000 Growth Index exceeding the Russell 3000 Value Index by over 450 basis points during the first quarter. Despite managers citing relatively attractive valuations in the large-cap segment, small- and mid-cap stocks outpaced large-cap stocks during the quarter.

The outperformance of small-cap stocks continues a trend that started in the fourth quarter of 2014. One cause for this disparity is the strengthening of the U.S. dollar which provides a greater earnings drag on companies with a larger percentage of revenues derived from exports to non-U.S. regions. Companies with substantial sales in foreign markets tend to occupy the large-cap segment.

Figure 1 illustrates the first quarter returns of several key sectors and industries within the S&P 500 Index. Biotechnology stocks continued to show strength even after posting the best performance in the S&P 500 Index in each of the past five years. Utilities experienced a small reversal after a strong 2014, while REITs continued to appreciate. The Industrials and Energy sectors lagged to start the year partially due to oil price volatility.

Figure 1: S&P 500 Sector & Industry Returns



Non-U.S. Equity

Developed international markets significantly outperformed the U.S. market. Similar to the U.S., growth outperformed value and small-cap outperformed large-cap. Asia, bolstered by a rally in Japan, outpaced other regions. Deflation concerns regarding the potential exit of Greece from the EU continued to weigh on European markets; however, performance remained positive despite these concerns. In January, the European Central Bank initiated a quantitative easing ("QE") program that entails a €1 trillion bond purchase program. Including Japan's QE program, an additional $2 trillion will be added to the global monetary base by the end of 2016.

Emerging markets lagged developed markets, but produced a positive quarter. Russia was the

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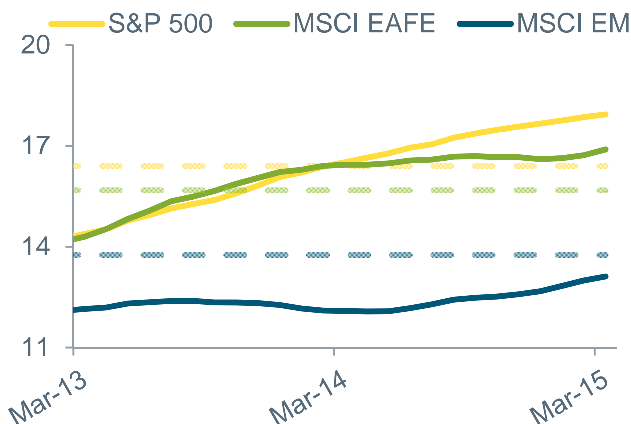
top performing emerging market country this quarter after trailing other countries substantially in 4Q14. Greece was demoted to emerging status in 2014 due to its fragile economic condition. Consequently, Greece has negatively impacted the performance of emerging markets. Frontier markets continued their recent downward trend although longer-term return periods remain attractive. **Figure 2** shows the current valuation disparity of the U.S., developed international and emerging market regions. The MSCI EAFE Index is relatively cheaper than the S&P 500 Index, but both are above their long-term averages. The MSCI EM Index remains below its long-term average.

Figure 2: Rolling 1 Year P/E v. 10 Year Average



Fixed Income

Fixed income markets were volatile in the first quarter, but treasury yields and credit spreads by the end the March were only slightly changed from the previous quarter end. As rates fell in January, the Barclays Aggregate returned 2.1% for the month – the strongest one-month return since December 2008. However, a rebound in rates in February detracted from performance. The Barclays U.S. Aggregate Index returned 1.6% for the quarter. Despite heightened volatility, rates only dipped marginally in the middle and long end of the curve. Accordingly, long bonds continued to perform well; the Barclays Long U.S. Government/Credit Index gained 3.4% in the first quarter and 15.7% for the trailing one-year period.

High yield bonds, which include relatively high exposure to the energy sector, suffered in the fourth quarter. However, as the price of oil began to stabilize, the high yield market rebounded. The Barclays U.S. High Yield Index returned 2.5% and outperformed investment grade credit, which posted a 2.2% return as measured by the Barclays U.S. Credit Index. Securitized investments performed in line with long-term expectations. Municipal bond issuance was relatively strong for the last two quarters while, at the same time, state and local government debt service continued to gradually decline. Municipals produced moderately positive performance for the quarter.

In international bond markets, with many countries implementing monetary policy changes, exchange rate volatility intensified. As such, currency exposure continues to play a prominent factor in the performance of global fixed income. Local currency emerging markets debt underperformed hard currency for the eighth consecutive quarter due to the relative strength of the U.S. dollar. The JPM GBI-EM Global Diversified Index returned -4.0% versus 2.0% for the JPM EMBI Global Diversified Index.

Diversified Hedge Funds (DHF)

Hedge funds performed well in the first quarter. Multi-strategy funds and Funds of Hedge Funds produced average returns in the 2-3% range, outperforming both global 60/40 portfolios as well as the S&P 500 Index for the first time since the fourth quarter of 2012. In January, while the S&P 500 Index fell, multi-strategy hedge funds generally protected capital and managed to produce positive returns for the month. The same effect repeated in March. Early indications show that managers generated significant alpha on the long side of their books, but that the short selling environment was more difficult. In general, equity-oriented hedge fund returns were buoyed by biases toward small- and mid-cap stocks, which outperformed large cap stocks, as well as sizable active bets within the healthcare sector. Credit strategies recovered slightly from a difficult fourth quarter last year, but Systematic and Discretionary Macro strategies led the way with returns averaging 3-5%. These strategies have generally maintained short positions in the Euro and have traded well around movement in global interest rates. RVK has noted increased optimism amongst managers regarding catalyst-driven and activist-oriented investments.

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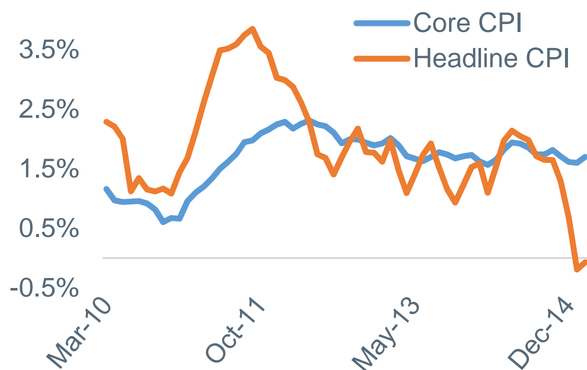
Global Tactical Asset Allocation (GTAA)

Despite many GTAA managers providing positive returns, a relatively undiversified U.S. 60/40 portfolio outperformed most GTAA managers in the first quarter. Managers with larger U.S. allocations underperformed peers; partially due to the weak performance of U.S. equities relative to other developed markets. Managers positioned for lower yields on long-dated bonds benefitted as yields declined, though cash exposures detracted. The strongest performing managers were heavily allocated to foreign developed equities and some managers benefited from short exposure to certain foreign developed markets relative to the U.S. dollar. Managers with heavy commodity, natural resource, and energy-related exposure lagged, especially those that had tactically increased commodities positions after the decrease in energy prices in 4Q14. Valuation sensitive strategies favored emerging market exposures which continued to underperform most foreign developed markets. Less traditional strategies that structurally limit equity beta exposure and seek highly diversified sources of return performed relatively well. Risk parity strategies benefitted from declining yields and positive equity performance.

Diversified Inflation Strategies (Real Return)

Inflation indicators and performance among DIS managers both varied widely in the first quarter. Core CPI, which excludes food and energy expenses, was up 1.7% YoY in February, compared to a 1.6% YoY change in the fourth quarter. As shown in **Figure 3**, Headline CPI, a more-volatile measure which includes food and energy expenses, dropped to 0.0%.

Figure 3: Core CPI vs. Headline CPI



The reduction in headline CPI reflects the influence of energy prices on the inflation measure. DIS managers with larger agricultural and energy commodities exposures lagged as the agricultural and energy segments of the Bloomberg Commodity Index returned -8.8% and -8.2%, respectively. Relatively few DIS managers allocated to precious metals, but those that did benefitted modestly as it was the only commodity segment to generate positive returns. Managers that allocated heavily to REITs, TIPS, and floating rate bonds outperformed those that favored natural resource equities. While 5- and 10-year breakeven inflation increased modestly, short-term inflation expectations increased dramatically over the quarter as the 1-year increased from -0.2% to 1.5%. Managers with shorter-duration floating rate exposure benefitted from depressed credit spreads in lower grade measures, even as higher-grade credit spreads remained relatively stable.

Real Estate

Transaction activity in the U.S. commercial real estate market remains robust as evidenced by the 34.0% YoY increase in transaction volume. Healthy market conditions coincided with positive returns for the NCREIF-ODCE Index which generated 3.4% during 1Q15 and 13.5% over the trailing twelve months, representing continued, stable growth in the U.S. core real estate market. Publicly-traded real estate securities also returned a positive quarter, as the FTSE NAREIT All REITs Index returned 4.1% during 1Q15.

As property values rise, cap rates in certain property sectors are approaching pre-recession lows or have surpassed it in other sectors, including central business districts and apartments. However, the average cap rate to 10-year Treasury spreads stand higher when compared to prior market peak measures, implying that market participants are pricing higher risk premiums than before the downturn. Investor interest in real estate remains strong, as closed-end private real estate funds closed $29 billion of capital during 1Q15, and hold $231 billion in dry powder available for investment. Outside of the U.S., investors continue to focus on opportunities in Europe, largely due to the low interest rate environment brought about by the ECB's QE program.

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