CAPITAL MARKETS REVIEW
2nd Quarter 2014

June 30, 2014

OVERVIEW

During the second quarter, capital markets added to first quarter gains by delivering generally positive returns in a muted volatility environment. Global equity markets rose broadly, with emerging market equities slightly outperforming developed market equities. Fixed income markets benefited from narrowing credit spreads and falling real interest rates. In particular, longer-term treasuries benefitted from the yield curve flattening, which stemmed from lower consensus expectations for economic growth. Finally, geopolitical instability in the Middle East continued to support real asset prices.

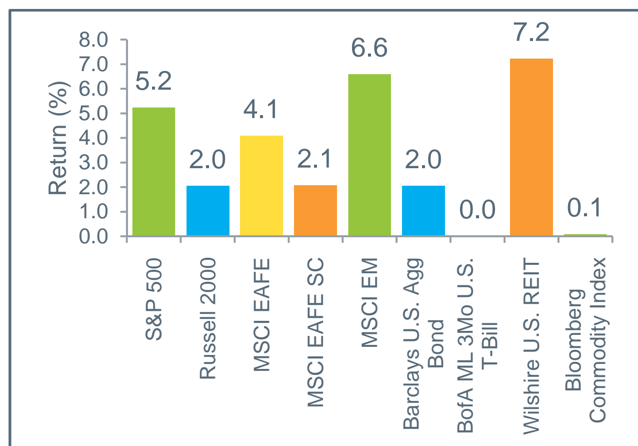
In the U.S., first quarter GDP growth was revised downward to -2.9% and the IMF reduced its 2014 U.S. growth forecast from 2.8% to 2.0%. The decline in anticipated U.S. growth is largely attributable to negative growth in the first quarter, which is expected to be partially offset by a recovery in the latter part of the year. Despite a weak Q1 GDP reading, recent data releases suggest a strengthening labor market and accelerating economic expansion. A key indicator, the ISM Purchasing Managers Index, averaged 55.2 during the second quarter, up from the first quarter level of 52.7 and decidedly above the average since 2009. In June, the unemployment rate fell to 6.1%, the lowest rate since September 2008; however, the level of long-term unemployment and underemployment remains above pre-crisis levels. The minutes from the Fed's June meeting revealed it would end its quantitative easing program by October, and that it has no set date to raise rates. Many market analysts don't expect the Fed to raise interest rates until the first half of 2015.

On the international front, the European Central Bank (ECB) announced several policy changes intended to increase liquidity for stressed banks and businesses. The benchmark policy rate was lowered by 10 basis points to 0.15%, bringing the interest rate on excess deposits to -0.10%. The negative rate requires banks to pay the ECB interest on excess reserves, which incentivizes banks to extend credit to the economy. The ECB also announced a long-term loan program targeted toward peripheral Europe's most stressed banks. China reduced the reserve requirement ratios for banks that lend to small- and medium-sized business, as well as agricultural borrowers. The move is part of the PBOC's plan to encourage lending outside the highly levered real estate sector. In Japan, anticipation of Prime Minister Abe's reform announcements bolstered the country's efforts to reflate the currency. In India, equities rallied in response to the election of Prime Minister Narendra Modi, who is generally viewed as a business-friendly politician.

TRAILING PERIOD MARKET PERFORMANCE (%)

	QTD	CYTD	1 Year	5 Years	10 Years
S&P 500	5.2	7.1	24.6	18.8	7.8
Russell 2000	2.0	3.2	23.6	20.2	8.7
MSCI EAFE	4.1	4.8	23.6	11.8	6.9
MSCI EAFE SC	2.1	5.5	29.1	15.2	8.8
MSCI EM	6.6	6.1	14.3	9.2	11.9
Barclays U.S. Agg Bond	2.0	3.9	4.4	4.9	4.9
BofA ML 3-Month U.S. T-Bill	0.0	0.0	0.1	0.1	1.6
Wilshire U.S. REIT	7.2	18.1	13.5	24.0	9.6
Bloomberg Commodity Index	0.1	7.1	8.2	2.0	0.9

QUARTER-TO-DATE PERFORMANCE (%)



KEY ECONOMIC INDICATORS

		As of	3/31/2014	12/31/2013	10 Year Average
Federal Funds Rate	0.09%	6/30/2014	0.06%	0.07%	2.08%
Treasury - 1 Year	0.10%	6/30/2014	0.11%	0.11%	0.63%
Treasury - 10 Year	2.53%	6/30/2014	2.72%	3.03%	4.05%
Treasury - 30 Year	3.36%	6/30/2014	3.56%	3.97%	4.69%
Breakeven Inflation - 1 Year	1.46%	6/30/2014	1.79%	1.50%	1.09%
Breakeven Inflation - 10 Year	2.24%	6/30/2014	2.14%	2.23%	2.11%
Breakeven Inflation - 30 Year	2.35%	6/30/2014	2.28%	2.36%	2.45%
Barclays US Corp: Hi Yld Index - OAS	3.37%	6/30/2014	3.58%	3.82%	6.00%
Capacity Utilization	79.10%	5/31/2014	79.30%	78.50%	76.50%
Unemployment Rate	6.30%	5/31/2014	6.70%	6.70%	6.40%
ISM PMI - Manufacturing	55.30%	6/30/2014	53.70%	56.50%	52.10%
Baltic Dry Index - Shipping	850	6/30/2014	910	2,277	3,487
Consumer Confidence (Conf. Board)	85.18	6/30/2014	83.86	77.54	81.93
CPI YoY (Headline)	2.10%	5/31/2014	1.50%	1.50%	2.40%
PPI YoY - Producer Prices	2.40%	5/31/2014	1.70%	1.40%	2.90%
US Dollar Total Weighted Index	$76	6/27/2014	$77	$76	$84
WTI Crude Oil per Barrel	$105	6/30/2014	$102	$98	$60
Gold Spot per Ounce	$1,327	6/30/2014	$1,284	$1,206	$687

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U.S. Equity

The U.S. stock market ended Q2 on a strong note despite the headwind of negative U.S. GDP data revisions and geopolitical instability experienced early in the quarter. Large- and mid-cap stocks outperformed their smaller counterparts, with micro-cap lagging all other market cap groups. By quarter end, value stocks outpaced growth stocks despite mixed performance throughout the quarter.

Active managers struggled to keep pace with the strong returns produced by large- and mid-cap indices. Small-cap managers were more likely to outperform, as the Russell 2000 ranked near median in the U.S. small-cap peer group. Based on a non-cyclically adjusted, 12-month trailing P/E ratio, U.S. equities appear priced at or near fair value. Mid-cap value stocks exhibit the richest P/E ratio, currently at 120% of the 20 year average, whereas large-cap growth stocks appear relatively cheap, trading at 87% of the 20 year average.

The energy sector led equity returns for the quarter, benefitting from supply uncertainty, followed by the utilities sector, which remains attractive to yield-oriented investors. Similarly the U.S. REIT index had a strong quarter, outperforming all other broad U.S. equity indexes. In response to weak economic growth and low interest rates, many managers are positioning their portfolios to capture cyclical growth opportunities anticipated in the latter half of the year.

Figure 1 provides an indicator of collective, active manager performance by displaying the median three-year rolling excess returns, gross of fees, for active U.S. large-, mid-, and small-cap managers calculated using each strategy's preferred benchmark. The recent struggle is due, in part, to high correlations between stock movements, mainly driven by macroeconomic events. As stock price movement exhibits higher dispersion the performance of active management may reverse course.

Figure 1: U.S. Active Manager Returns

Non-U.S. Equity

Developed international markets generated strong absolute returns in Q2. Value outperformed growth, but still lags over longer periods. Small-cap stocks underperformed large-cap stocks in

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developed markets. Financials and information technology stocks experienced weakness while supply concerns resulting from regional instability in the Middle East fueled an energy sector rally. In developed regions, European markets lagged while Canadian markets provided the most attractive returns. The ECB lowered rates, providing downward pressure on the Euro; however, the Euro actually strengthened to a 2009 high versus the U.S. Dollar. Finally, despite an increase in the consumption tax from 5.0% to 8.0%, Japanese markets rose meaningfully.

Emerging markets outperformed domestic and developed international markets. Large-cap outperformed small-cap stocks, reversing a trend from past quarters. Initially, Russia and surrounding markets weighed heavily on the MSCI Emerging Markets Index, as turmoil in the Ukraine persisted. However, concerns quickly dissipated, and Russian stocks responded with a greater than 10% return in May. India equities generated double digit returns due to expected economic and social reforms resulting from the election of Prime Minister Narendra Modi. Finally, there were notable changes to the index with the demotion of Greece to an emerging market and the promotion of Qatar and the UAE, which had been classified as frontier markets.

Fixed Income

The Barclays U.S. Aggregate Index returned 2.0% for the second quarter pushing year-to-date returns to near 4.0%. These gains were surprising, as many market participants were anticipating rising rates. The opposite occurred due to slower than projected economic expansion and a yield spread advantage of the U.S. over many G8 nations.

U.S. Treasuries gained 1.4% for the quarter with the U.S. Long Treasury Index gaining an impressive 12.1% year-to-date. A historically low volatility environment contributed to a 2.4% return for mortgage-backed securities. Reduced refinancing activity helped agencies post 29 basis points of excess returns. Credit led all sectors with a 2.7% return for the quarter. Long credit benefited from a flattening yield curve and outperformed intermediate credit on an absolute and duration-adjusted basis. Due to strong demand, year-to-date corporate debt issuance is on pace to beat last year's issuance amount by 10%. The appetite for yield continued in Q2 as lower quality investment-grade securities (BBB) returned 3.4% for the quarter and 7.2% year-to-date, compared to 1.2% and 2.4% for AAA securities, respectively.

The Barclays Global Aggregate Index returns were in line with the U.S. Aggregate Index. Due to compelling valuation opportunities, emerging market debt returned 5.8% in Q2 as measured by the JPMorgan Emerging Bond Index+. While hard currency indices have outpaced local indices year-to-date, local currency offerings outperformed broad emerging market debt in June. With global growth on a slow, yet steadily improving trajectory, and developed market exports rising, emerging market currencies could generate healthy returns in the second half of 2014.

Hedge Funds

Hedge funds were up broadly during the second quarter despite a difficult long/short equity environment in April. Initial estimates show multi-strategy funds of hedge funds with high RVK client exposure up from 1.0% to 2.5% in Q2, bringing year-to-date returns in the range of up 1.8% to 4.0%. Within long/short equity, the technical rotation away from momentum and growth stocks continued into the first few weeks of April, triggering losses for a number of managers. Managers that rotated to value names or decreased gross exposure early in the second quarter were rewarded for defensive positioning. Gains in May and June more than offset earlier losses with long/short equity managers ending the quarter firmly in positive territory. Credit managers continued to perform well, benefiting from the positive carry associated with the strategy and narrowing credit spreads. Some managers capitalized on idiosyncratic events in distressed, lower quality, and asset backed credits, helping to buoy returns. Estimates also show positive returns for the quarter within systematic and discretionary macro strategies. Discretionary managers benefited from long equity exposure and a renewal of the reflation trade in Japan. Systematic managers captured positive trends in energy and agricultural commodities, rates, and equities.

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Global Tactical Asset Allocation (GTAA)

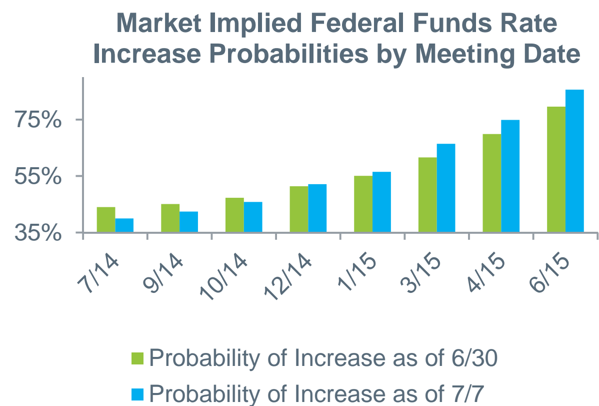
Global Tactical Asset Allocation (GTAA) strategies posted solidly positive results for the second straight quarter. Risk parity strategies that target equal risk contributions from multiple asset classes significantly outperformed those that follow a blended 60% equity and 40% fixed income approach. Exposure to inflation-sensitive themes, income-oriented equities and emerging markets allocations provided modest tailwinds driven by strong performance in REITs and emerging markets. Cash positions, short-term high quality fixed income and positions in lower-volatility, absolute return holdings detracted from the performance of a number of managers that recently increased exposure to lower volatility areas. Over the past twelve months, strategies with larger U.S. equity allocations have outperformed those with higher exposure to foreign developed equity, and especially those with emerging markets equity. In the second quarter, this trend reversed as emerging market equities rebounded from weak performance in 2013. Similarly, managers with allocations to REITs and energy equities posted stronger returns reversing another recent trend.

Diversified Inflation Strategies (Real Return)

Diversified Inflation Strategies (DIS) extended strong performance that began in early 2014. Poor performance among several inflation-sensitive asset classes including TIPS, REITs, commodities and natural resource equities in 2013 became additive to returns in Q2 for managers that maintained exposure. REITs and MLPs provided the largest gains and managers with persistent strategic weights to natural resource equities were also rewarded. Those with allocations to emerging markets inflation-linked bonds performed well. Heavier weightings to TIPS dragged somewhat on returns despite a quarter of respectable performance. Strategies with heavier commodities exposures lagged significantly given relative weakness in the asset class. Most DIS managers provide beta sensitivity relative to CPI, and are likely to provide lackluster returns in environments with low, stagnating or declining inflationary expectations. Core CPI increased slightly in Q2 from 1.7% to 2.0% with expectations for future inflation remaining close to the Fed's long-term 2.0% target.

Figure 2 illustrates the implied probability of a Fed Funds target rate increase at upcoming Fed meeting dates. The recent positive jobs data boosted the implied probability of a rate increase as shown in the difference between the readings as of 6/30 and 7/7.

Figure 2: Interest Rate Increase Probability



Real Estate

Core U.S. Real Estate continued to show positive performance, as evidenced by preliminary returns between 2.0% and 3.0% for the NCREIF-ODCE Index constituent funds during Q2. Trailing one-year returns for the index were between 9% and 14%. The FTSE NAREIT All Equity REITs Index returned 7.0% illustrating strength in publicly-traded securities. Major U.S. commercial property types improved in the second quarter, including office, retail, industrial, and apartment markets. The office market expansion has been driven by private sector job growth, particularly in areas with heavy concentrations of technology and energy companies. According to CBRE, 45 of 63 of the largest regional markets have experienced declines in office and industrial vacancy for 16 quarters in a row. Private Real Estate fundraising remained strong with 33 funds closing, representing $16 billion in aggregate capital raised, with a majority of the assets flowing to North American focused funds. Additionally, approximately $7.5 billion was closed by debt-focused funds during Q2, showing continued investor appetite for the strategy.

Data Sources: Bloomberg, eVestment.com, J.P. Morgan Asset Management, www.ncreif.org.