NEPC MARKET THOUGHTS

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NEPC is an independent, full-service investment consulting firm, providing asset allocation, traditional and alternative asset manager search, performance evaluation and investment policy services to institutional investment Programs and private clients. We offer our Market Thoughts to provide insight into recent market conditions, and to assist your interpretation of investment results. We encourage your comments and feedback, as well as any inquiries you may have about our firm or our consulting services.

A GLOBAL RESURGENCE? SPOTTING OPPORTUNITIES IN DISGUISE

Introduction

Equities started the year with a bang, turning in a strong performance globally. Domestic stocks continued their bull run—now in its ninth year—with gains of 6% in the first quarter. Investors also acknowledged the improving economic outlook beyond the US, pushing international stocks higher. Emerging markets led the charge with gains of over 11% in the first quarter with a weaker dollar adding to their momentum.

The recent robust performance of non-US equities is at odds with the doom-and-gloom outlook projected by markets. As investors' fears of economic and political instability in these regions have remained largely unfounded, assets have rebounded, leading to missed investment opportunities for some.

For instance, investors gave the cold shoulder last year to emerging market assets amid potential fears of a precipitous drop in currencies even as economic conditions began to improve. Their concerns extended to the likely fallout from punitive US trade restrictions espoused by the new presidency. However, as the Trump administration softened its stance on trade, emerging market equities and local-currency debt soared, besting US equities.

INTERNATIONAL EQUITIES OUTPERFORMED US STOCKS IN THE FIRST QUARTER.

Similarly, in non-US developed markets, investors largely overlooked the improving economic fundamentals in Europe, where the Eurozone has posted 14 consecutive quarters of growth. Instead, they fretted about the possibility that two French presidential candidates with radical views, including the far-right candidate, Marine Le Pen, would move on to the final round of the election, jeopardizing the future of the European Union. This scenario failed to materialize as Emmanuel Macron—running on a pro-European Union platform—won the first round of the elections and maintains a sizable lead in the polls over the controversial Le Pen in the days ahead of the final election on May 7. In response, European shares rallied and non-US developed market equities have outperformed US stocks so far this year.

To be sure, risks remain in these markets, be it from China's ongoing transition to a services-oriented economy from a manufacturing-focused one or from the anti-establishment sentiment sweeping across Europe that is threatening to upend the political order. That said, it is worth remembering that investing requires balancing risk and returns, and opportunities are often cloaked in pessimism.

With this in mind, we bring you our recommendations on current market opportunities. We have viewed these investment ideas through the prism of our key market themes—ranging from the continuing economic expansion in the US and the gradual pace of monetary policy tightening by the Federal Reserve, to the economic transition in China and the backlash against globalization in many developed markets. (For details on these key market themes and their implications for investors, please refer to NEPC's 2017 Annual Asset Allocation Letter.)

WE ARE POSITIVE ON RISK ASSETS OUTSIDE THE UNITED STATES.

We remain positive on risk assets outside the United States. More specifically, we recommend investors maintain an overweight position on non-US developed market equities as economic gains drive up corporate earnings. Importantly, implementation remains critical and we favor active small-cap equity and broad global equity strategies. In addition, we believe

emerging market assets are still compelling with equities offering below average valuations and local-currency debt carrying attractive total returns. We encourage investors to trim gains from domestic equities following their strong bull run and employ these to fund opportunities outside the United States. At home, stocks can continue their rally as global growth conditions improve but recent gains have been accompanied by soft corporate earnings growth. As such, we advise investors to maintain a disciplined rebalancing approach and reduce exposure to assets that have outperformed expectations over a prolonged period.

Global Equities

In the ninth year of a bull market, US equities had another solid quarter with the S&P 500 gaining 6.1% and the Russell 2000 Index returning 2.5% for the three months ended March 31. Growth bested value; healthcare and information technology led the pack while energy and telecom lagged.

Outside the United States, the MSCI EAFE Index was up 7.3% in the first quarter. Europe outperformed Japan; information technology, healthcare and consumer discretionary led performance while energy trailed. Emerging markets also had a strong showing buoyed by India's state election results and economic growth prospects in China. The MSCI Emerging Markets Index gained 11.4% and the MSCI Emerging Markets Small Cap Index was up 13%. So far this year, emerging markets have staged a robust comeback from the fourth quarter when they were beaten down by concerns around the US presidential election results. Information technology led sector performance, while Poland and India were the strongest performing countries.

Equity Index Returns as of 3/31/2017				
Global Equity	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
MSCI World	5.9%	12.5%	3.5%	7.2%
US Equity	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
S&P 500	6.1%	17.2%	10.4%	13.3%
Dow Jones Industrial Average	4.6%	16.8%	7.9%	9.4%
NASDAQ Composite	9.8%	21.4%	12.1%	13.8%
Russell 1000 Growth	8.9%	15.8%	11.3%	13.3%
Russell 1000 Value	3.3%	19.2%	8.7%	13.1%
Russell 2000	2.5%	26.2%	7.2%	12.4%
Russell 2000 Growth	5.3%	23.0%	6.7%	12.1%
Russell 2000 Value	-0.1%	29.4%	7.6%	12.5%
International Equity	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
MSCI EAFE	7.2%	11.7%	0.5%	5.8%
MSCI Emerging Markets	11.4%	17.2%	1.2%	0.8%
MSCI Europe	7.4%	9.8%	-1.5%	5.6%
MSCI UK	5.0%	7.4%	-2.6%	3.5%
MSCI Japan	4.5%	14.4%	6.0%	6.8%
MSCI Far East	5.9%	14.4%	5.9%	6.8%

Global Fixed Income

US fixed-income markets took in stride a well telegraphed hike in the Federal Funds rate in March, and are pricing in two more this year. The Bloomberg Barclays US Aggregate returned 0.8% in the first quarter, trailing domestic high-yield securities which returned 2.7%. As LIBOR inches higher, bank loans maintain their relative attractiveness against high-yield debt despite discount margins dipping below their historical median level.

Meanwhile, emerging market debt rebounded from a tough fourth quarter as fundamentals continued to improve and the dust settled on the US election results. Local currency debt was the top performer, gaining 6.6%.

Currency Markets

The US dollar (USD), which ended last year on a strong note, wavered in the first three months of 2017 as markets grappled with the uncertainties around the policies of the new administration. The US dollar declined against most developed market currencies in the first quarter with the DXY Index—which measures the dollar against a basket of developed foreign exchange currencies—down 1.7%. The Japanese yen strengthened against the US dollar in the beginning of 2017, appreciating nearly 5%.

Emerging market currencies appreciated around 5% in the first quarter, according to the MSCI ELMI Index, with Mexico, Brazil and Russia turning in a strong performance.

Commodity Markets

Commodities retreated in the first quarter, falling 2.3%, according to the Bloomberg Commodity Total Return Index. Mean reversion across the energy complex was partially offset by gains in both precious and industrial metals and the weakened US dollar. The energy sector was driven down by an increase in domestic oil production of approximately 400,000 barrels per day. Natural gas fell amid bountiful supply. In precious metals, gold and silver gained amid a weaker US dollar and renewed expectations for inflation. Industrial metals benefited from tight supply and an anticipated uptick in infrastructure spending. Aluminum advanced on reports that China was considering cutting production in efforts to alleviate pollution.

Agricultural prices declined as sugar, soybeans, soybean oil and soymeal weighed on the sector.

Pension Liability

Following a quarter of a sharp rise in interest rates, the first three months of 2017 provided a reprieve to rate movements on the long end. Driven by the slight drop in long Treasury and credit yields, the Citigroup Pension Liability Index fell to 4.12% on March 31 from 4.14% on December 31. As a result, pension liabilities are estimated to have increased by a modest 1.40% in the first quarter.

With strong market returns dominating portfolios, most pension plans likely saw their funded status increase this quarter. However, clients with liability-driven investment (LDI) strategies in place may have seen a more modest increase in plan funded status, as long-duration fixed income and other interest-rate hedging assets underperformed risky assets while still providing positive returns.

Fixed Income Index Returns as of 3/31/2017				
Global Fixed Income	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
BC Global Agg	1.8%	-1.9%	-0.4%	0.4%
JPM EMBI Plus	3.8%	7.4%	5.9%	5.0%
Domestic Fixed Income	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
BC Aggregate Bond	0.8%	0.4%	2.7%	2.3%
BC US Agg. Treasury	0.7%	-1.4%	2.1%	1.6%
BC US Credit	1.3%	3.0%	3.5%	3.7%
BC Mortgage Backed	0.5%	0.2%	2.7%	2.0%
BC Interm. Gov't/Credit	0.8%	0.4%	2.0%	1.9%
BC 1-10 Yr TIPS	1.1%	1.5%	1.5%	0.6%
BC High Yield	2.7%	16.4%	4.6%	6.8%
S&P LSTA Lev. Loan	1.1%	9.7%	3.6%	4.6%
3 Month T-Bills	0.1%	0.4%	0.2%	0.1%
10-Year Bond Yields	**Mar-16**	**Dec-15**	**Mar-15**	**Mar-14**
US	2.4%	2.4%	1.8%	1.9%
Germany	0.3%	0.2%	0.2%	0.2%
UK	1.1%	1.2%	1.4%	1.6%
Japan	0.1%	0.0%	0.0%	0.4%

Hedge Funds

Hedge funds started the year in the black with equity strategies leading the charge; healthcare and technology sectors contributed significantly to the overall index. Fixed income-based relative-value arbitrage came a close second to equities, supported by convertible bonds and credit-focused multi-strategies. Event-driven strategies tapered off towards the end of March but remained positive, posting a solid quarter. This may be attributed, in large part, to a strong restructuring environment earlier in the year, subsequently bolstered by merger arbitrage and special situations. Global macro was flat for the quarter, posting negative returns in January and March but was mildly positive in February. Quantitative, trend-following and systematic strategies were the main drivers of performance on both the upside and downside during the quarter.

Hedge Fund Industry Performance Overview as of 3/31/2017				
Composite	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
DJCS Hedge Fund Composite	2.1%	5.7%	1.9%	3.9%
Relative Value	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
DJCS Convertible Arbitrage	2.2%	9.4%	1.8%	3.3%
DJCS Fixed Income Arbitrage	2.3%	8.0%	3.1%	4.6%
DJCS Equity Market Neutral	2.1%	-2.2%	-0.6%	1.3%
DJCS Multi-Strategy	2.8%	7.9%	5.1%	6.9%
Event Driven	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
DJCS Event Driven	2.7%	10.4%	-0.8%	4.0%
DJCS Event Driven - Distressed	2.2%	10.9%	0.8%	5.3%
DJCS Event Driven - Risk Arbitrage	1.2%	4.9%	1.8%	2.3%
DJCS Event Driven - Multi-Strategy	2.9%	10.3%	-1.5%	3.5%
Equity Hedge	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
DJCS Long-Short Equity	3.5%	3.9%	2.4%	5.4%
DJCS Emerging Markets	4.3%	10.3%	4.0%	4.5%
DJCS Dedicated Short Bias	-5.0%	-26.3%	-7.6%	-12.8%
Tactical	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
DJCS Global Macro	0.2%	6.2%	2.6%	2.9%
DJCS Managed Futures	-1.0%	-11.6%	4.2%	0.6%
Traditional Markets	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
BC Aggregate Bond	0.8%	0.4%	2.7%	2.3%
S&P 500	6.1%	17.2%	10.4%	13.3%

Private Markets

Fundraising remained robust in the first quarter, totaling $110 billion for private equity and private debt. While only 7% of buyout deals totaled $1 billion or more, deals of less than $1 billion accounted for 57% of aggregate value. In private lending, the core middle market offers attractive risk-adjusted returns, given the stage of the credit cycle. European banks are still exiting leveraged loans due to regulatory pressures. The manager universe in Europe has become tiered with stronger managers enjoying superior deal flow and performance. Within real assets, oil prices remained volatile, ending the quarter above $50 a barrel after trading in the high $40s for most of March. Our highest conviction energy-focused strategies remain in private equity and credit as these managers appear best equipped to invest and manage assets amidst what we believe will be a choppy recovery.

We are becoming more constructive on mining over the mid-to-longer term and are actively seeking infrastructure opportunities; however, the impact of federal legislation remains uncertain. We are positive on energy, negative on timber, and neutral on agriculture, infrastructure and metals and mining. We prefer niche opportunities targeting assets within sectors with a neutral rating. In real estate, fundamentals remain healthy in the US core property market although valuations are at record highs and rental growth rates are showing signs of deceleration. We remain neutral on the sector as a flight to quality will favor US core real estate. We favor niche, cash flow-driven strategies, and managers that are attentive to duration risk given the current stage of the expansion cycle. Elsewhere, capital markets constraints and pockets of distress in Europe and emerging markets may be appealing.

Final Thoughts

Navigating investment risk is neither easy nor comfortable. That said, we firmly believe that a willingness to weather uncertainty, paired with an appropriate compensation for risk, accrues long-term benefits for investors. To this end, we encourage investors embrace global risk assets, whether through an overweight position in non-US developed market equities or by allocating to emerging market equities and local-currency debt. Furthermore, we recommend investors trim exposure to US equities and high-yield debt on the back of a prolonged period of strong investment returns. We hope to expand on these themes and more at NEPC's 22nd Annual Investment Conference on May 9-10 in Boston. The agenda covers a wide variety of topics, including impact investing and venture capital. In addition, we are excited to bring you a roster of accomplished external speakers. We hope you can join us and we look forward to seeing you next month.

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