THIRD QUARTER MARKET THOUGHTS

WISH I MAY, WISH I MIGHT: WHAT'S NEXT FOR INVESTORS?

October 2017

INTRODUCTION

Investors, emboldened by an improved economic outlook and record low volatility, pushed equities even higher in the third quarter. Emerging markets, bolstered by China, continued to lead the way; they have gained 28% so far this year. They were followed by non-US developed markets, which have returned 20% in 2017, boosted by robust corporate earnings in Europe and Japan. In their ninth year of a bull run, US stocks were also in the black amid optimism around a tax overhaul working its way through Congress; domestic equities are up 14% this year.

The last three quarters have been a banner year for global stocks. The outperformance of international equities, in particular, has exceeded our expectations even as we began the year with an overweight recommendation for them. Their stellar returns are all the more significant when you reflect on the pessimism at the start of 2017: Europe was under a shroud of political uncertainty as a number of key elections loomed, investors were fretting over potential capital outflows from China as economic growth appeared to slow, and there were concerns around major shifts in US trade policy disrupting the global economic order. These risks—notwithstanding some outbursts on Twitter, tensions with North Korea and lingering political concerns in Europe—seemingly dissipated as the year went on, as if three wishes had been granted to investors. To this end, not only did consumer sentiment and economic indicators improve across Europe, Japan and China, but also the decline in perceived risks benefited the euro and emerging market currencies, which have rallied over 10% relative to the US dollar.

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However, now that the three wishes are spent and equities have scaled new heights, a colder reality sets in. Investors' desire for continued market stability—a big driver of returns for risky assets—in the year ahead may be wishful thinking as corporate earnings and fundamental valuations assume a greater role. With this in mind, we encourage investors to prioritize actions that reduce total portfolio volatility. We suggest using the outsized gains of US equities and high-yield bonds to rebalance safe-haven fixed-income exposure back to strategic targets. We also support adding assets, for instance, systematic-global macro or long-volatility strategies, which mitigate the effects of market drawdowns.

To be sure, this is less of a warning and more of a reminder that adhering to strategic asset allocation targets is the most effective long-term risk-management tool. That said, we still see opportunities driven by fundamentals in global markets and recommend investors maintain an overweight position in international equities. We believe a multi-year earnings recovery is underway in non-US developed markets, offering the possibility of elevated returns. Within emerging markets, equities offer the highest potential for total returns for public-market investors as corporate earnings and currencies benefit from the economic adjustments of recent years. While we view equities positively in a pro-risk environment, we are well aware that all wishes do not come true. To this end, we remind investors that a diversified investment program is best equipped to weather market uncertainty.

GLOBAL EQUITY MARKETS

Global equities posted another solid quarter with returns of 5.2%, according to the MSCI ACWI Index. Small-cap stocks bested large-cap equities. Returns, in US dollar terms, were boosted by a stronger euro, sterling and Canadian dollar. Energy, materials and information technology led performance; regionally, Norway, Italy and Portugal were top performers.

At home, the S&P 500 gained 4.5% and the Russell 2000 Index returned 5.7% for the three months ended September 30. Growth bested value; economic growth overshadowed the fallout from hurricanes and floods, and the threat of a nuclear outburst between the US and North Korea, confounding ever-expanding valuations of financial assets.

Emerging market stocks maintained their lead with gains of 7.9%, according to the MSCI Emerging Markets Index, aided by Brazil, Russia and China. Real estate was the top-performing sector, dominated by China. Energy took second place with higher oil prices fueling returns.

GLOBAL EQUITY MARKET RETURNS AS OF 09/30/2017				
Global Equity	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
MSCI ACWI	5.2%	18.6%	7.4%	10.2%
US Equity	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
S&P 500	4.5%	18.6%	10.8%	14.2%
Russell 1000 Growth	5.9%	21.9%	12.7%	15.3%
Russell 1000 Value	3.1%	15.1%	8.5%	13.2%
Russell 2000	5.7%	20.7%	12.2%	13.8%
Russell 2000 Growth	6.2%	21.0%	12.2%	14.3%
Russell 2000 Value	5.1%	20.5%	12.1%	13.3%
International Equity	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
MSCI EAFE	5.4%	19.1%	5.0%	8.4%
MSCI EAFE Hedged USD	3.4%	19.0%	7.9%	12.3%
MSCI EAFE Small Cap	7.5%	21.8%	11.1%	12.8%
MSCI Europe	6.4%	22.3%	4.4%	8.4%
MSCI Japan	4.0%	14.1%	7.7%	10.6%
MSCI Emerging Markets	7.9%	22.5%	4.9%	4.0%
MSCI Emerging Markets Small Cap	5.6%	14.9%	3.1%	4.6%
Alternative	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
HFRI Equity Hedge	3.6%	11.1%	4.6%	6.3%
HFRI Emerging Markets	5.1%	14.1%	4.5%	5.1%
HFRI ED: Activist	1.2%	11.1%	6.6%	10.6%
HFRI ED: Merger Arbitrage	0.9%	5.9%	3.8%	3.8%
HFRI Short Bias	-2.4%	-9.3%	-3.6%	-7.3%

In private equity, $40.8 billion of value exited public markets across 224 companies in the third quarter, a 20% drop from the earlier quarter as high valuations slowed down activity. That said, investor demand remains strong with the median size for US private equity funds at a record $239 million and $265 million for buyout funds; funds larger than $5 billion accounted for 54% of capital raised through the third quarter. While there was a 20% drop in the number of deals in the third quarter from the second, aggregate value fell only 6% in the same period as deal sizes got larger.

Within hedge funds, healthcare-focused approaches outperformed, with returns of 5.9%. They were followed by emerging-market strategies—dominated by Latin America and Asia—which were up 4.9%. Energy and basic materials gained following higher prices on the back of Hurricane Harvey. Sector-focused managers bested diversified equity; market-neutral strategies were also in the black. Special-situations strategies have gained momentum as hedge fund investors seek more idiosyncratic sources of return.

GLOBAL FIXED-INCOME MARKETS

US credit also fared well in the third quarter. The Barclays US Aggregate Index was in the black, pushing returns so far this year to just over 3.0%. High-yield debt was up 2.0% with spreads modestly tighter than the second quarter; the S&P LSTA Leveraged Loan Index returned 1.0% in the third quarter, bringing gains so far this year to 3.0%.

The Barclays Long Treasury Index gained 0.6%, the Barclays Long Credit Index was up 2.2%, and the Barclays Long Government/Credit Index returned 1.5%. Yields compressed 10 basis points in the third quarter for the Long Credit and Long Government/Credit Indices to 4.2% and 3.6%, respectively. The long Treasury yield remained unchanged at 2.8%.

As in public equities, emerging markets led the pack. Emerging-market local-sovereign debt returned 3.6%, clocking returns so far this year of over 14%, helped, in large part, by currency appreciation.

In private debt, fundraising has totaled $16.5 billion so far in 2017, already surpassing the $14.4 billion raised last year. Across the pond, fundraising totaled €10.4 billion in Europe, exceeding the €6.0 billion in 2016.

Within hedge funds, credit was up 1.4% for the quarter; relative-value arbitrage strategies were in the black for the three months ended September 30.

GLOBAL FIXED INCOME MARKET RETURNS AS OF 09/30/2017

Global Fixed Income	Quarter	1 Year	3 Yrs	5 Yrs
BC Global Aggregate	1.8%	-1.3%	1.3%	0.5%
BC Global Aggregate (USD Hedged)	0.8%	-0.2%	3.1%	3.1%
JPM EMBI Plus	2.2%	2.9%	6.3%	4.0%
JPM GBI-EM Global Diversified	3.6%	7.3%	0.3%	0.9%
Domestic Fixed Income	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
BC Aggregate Bond	0.8%	0.1%	2.7%	2.1%
BC Municipal Bond	1.1%	0.9%	3.2%	3.0%
BC TIPS	0.9%	-0.7%	1.6%	0.0%
BC US Treasury	0.4%	1.7%	2.0%	1.2%
BC US Long Treasury	0.6%	-6.4%	4.9%	2.8%
BC MBS	1.0%	0.3%	2.4%	2.0%
BC US Credit	1.3%	2.0%	3.9%	3.2%
BC US Long Credit	2.2%	2.9%	6.0%	4.7%
BC High Yield	2.0%	8.9%	5.8%	6.4%
BC Muni High Yield	1.5%	1.4%	4.6%	4.7%
S&P LSTA Lev. Loan	1.0%	5.3%	3.9%	4.1%
BC T-Bills	0.3%	0.6%	0.3%	0.2%
Alternative	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
HFRI Credit Index	1.4%	7.5%	3.6%	5.4%
HFRI ED: Credit Arbitrage	1.4%	8.1%	3.5%	5.2%
HFRI ED: Distressed/Restructuring	1.7%	10.7%	2.2%	5.4%

REAL ASSETS

Commodities gained 2.5% in the third quarter, according to the Bloomberg Commodity Index, helped by a decline in the US dollar. Energy futures were up 9.8% with the exception of natural gas, which was down 4.2%. Metals were up 6.5%, led by industrial metals which gained 9.9%; precious metals returned 2.3%. Steep contango—when the futures price of a commodity is above the expected future spot price—in agriculture resulted in a negative roll yield; wheat and lean-hogs contracts were in the red.

Within energy, our highest conviction strategies remain in private equity and credit as these managers appear best equipped to invest and manage assets amid what we believe will be a choppy recovery. We still believe asset selection is critical in energy; in the public markets, we favor midstream/Master Limited Partnerships or MLPs, as these companies repair their balance sheets and reset dividends for a strong outlook.

We are constructive on the mining sector 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 we have rated as neutral.

In real estate, US core property markets have normalized, but fundamentals remain healthy. Future value appreciation will likely come from income growth as opposed to compressions in the cap rate.

REAL ASSET RETURNS AS OF 09/30/2017	Quarter	1 Year	3 Yrs	5 Yrs
Bloomberg Commodity	2.5%	-0.3%	-10.4%	-10.5%
GSCI Commodity	7.2%	9.6%	-11.4%	-9.7%
Gold Spot	3.1%	-2.7%	1.9%	-6.3%
WTI Crude Oil Spot	12.2%	7.1%	-17.2%	-10.9%
BBG Commodity - Agriculture	-6.1%	-11.1%	-6.2%	-11.4%
BBG Commodity - Energy	9.8%	-2.9%	-26.6%	-17.7%
BBG Commodity - Industrial Metals	9.9%	24.0%	-1.3%	-4.5%
BBG Commodity - Precious Metals	2.3%	-6.6%	0.4%	-8.8%
S&P Global Natural Resource Equities	10.6%	19.9%	0.7%	0.5%
NAREIT Composite Index	1.3%	3.6%	10.2%	9.6%
NAREIT Global REIT Ex US	0.3%	-4.8%	3.0%	-
Alerian MLP	-3.0%	-3.7%	-12.9%	-0.6%

Rising interest rates will place upward pressure on cap rates but we expect growth, although at a slower pace, as capital flows chase income-yielding assets in the United States; the US remains the largest, healthiest and most diversified real-estate investment market. Relative value opportunities remain within non-core US real estate. We favor demographically-driven property sectors, and managers that are attentive to duration risk in the later innings of the expansion cycle. Capital markets constraints and pockets of distress in Europe and emerging markets may be appealing. Select subordinate-debt opportunities may yield attractive income streams, while providing a hedge against declining property values.

FINAL THOUGHTS

While we welcome the robust gains of 2017, it is beneficial to remind investors of this core investment principle: reduce exposure to assets that have outperformed expectations over a prolonged period. This especially holds true for US equities and high-yield bonds, which have provided outsized returns in recent years. We encourage investors to tap these asset classes as a funding source to ensure safe-haven fixed-income exposures are near strategic targets.

Furthermore, despite a positive outlook for global equities, we advocate balance and recommend investors seek out exposures that mitigate portfolio volatility should market stability break down. These include systematic global macro strategies and long-volatility exposures. With 2018 around the corner, we view equities positively in a pro-risk market environment. Still, we doubt the harmonious financial conditions we saw in 2017 can provide a similar backdrop for the coming year. In time, new trends will evolve. We remain vigilant and look forward to helping investors meet their long-term investment objectives.

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