SECOND QUARTER MARKET THOUGHTS

3000 Reasons to Rebalance

July 2019

Financial markets the world over have posted a string of impressive wins so far this year, much like the reigning World Cup champions, the United States women's soccer team. Something else they have in common: the unequal distribution of earnings.

For instance, within equities, the S&P 500 Index, which breached a new high of 3000 points, is far outpacing international stocks with its year-to-date returns of over 18%. To this end, just as the US women's soccer team's stellar performance reinforces the case for pay equity and equal treatment, we remind investors to use their gains from high-performing assets to rebalance their portfolios.

Our recommendation to rebalance comes amid a clash in sentiment as investors oscillate between a buoyant stock market and pessimistic economic signals from the bond market. These seemingly contradictory points of view have fueled robust gains in interest-rate markets, an unusual occurrence caused by sovereign bond yields declining the world over even as risk assets show little sign of faltering.

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At NEPC, we believe these mixed signals are the new normal. We see no meaningful signs of an impending US recession and find the current investment dynamic to be a common characteristic of the late stage of an economic cycle. In addition to rebalancing gains from US equities, we recommend potentially trimming exposure to non-US developed equities where risks are tilted more to the downside, especially in Europe. Where appropriate, we believe holding total equity exposure marginally below strategic targets is a sensible posture, given the disparate messages from equity and bond markets.

In fixed income, we advocate reducing exposure to lower-quality credit amid a substantive decline in credit spreads since the beginning of the year. In addition, we recommend assets that serve as dry powder in times of market stress, for instance, Treasuries, cash equivalents and shorter-term maturities in safe-haven debt. With the US yield curve remaining flat and inverted at certain points, we encourage a shorter-duration bias for non-LDI investors with Treasuries yielding around 2% across most parts of the yield curve.

Moving to emerging markets, we maintain an overweight posture in equities and are supportive of increasing the relative size of emerging stocks compared to total equity exposure as developed market positions in the portfolio are rebalanced. We are optimistic of some form of resolution to the ongoing trade dispute between the United States and China, and we believe even a narrow agreement between the two nations will remove a headwind for stocks in emerging markets and Asia.

GLOBAL EQUITIES

In the US, large-cap financials led the charge with returns of 8.4% in the second quarter. The MSCI ACWI Index increased 3.6%, with financials up 6.6%; energy was the only outlier, losing 0.8%.

During the same period, the HFRI Equity Hedge Index gained 1.7%. There was a wide dispersion in the performance of emerging markets hedge funds with those concentrating on India and China taking the biggest hits, losing 1.5% and 1.6%, respectively; strategies focused on Eastern Europe and Latin America led with returns of 7.2% and 4.4%, respectively.

Earnings for S&P 500 companies for the second quarter are estimated to fall 3.0% from a year ago; this forecast comes on the back of a 4.1% fall in the first quarter, according to FactSet data. The last time around earnings were down two consecutive quarters was in 2016. We continue to closely monitor growth estimates and valuation multiples.

In private equity, fundraising totaled $111.5 billion in the second quarter, just shy of the $113.1 billion raised in the previous quarter, and lower than the quarterly one-, three- and five-year averages, according to data provider Preqin. Additionally, the number of funds raised, at 267, was the lowest since 2013. While the current pace of fundraising is on track to match the total dollar amount raised last year, the number of funds is expected to shrink by a fourth at the present rate.

Global Equity Market Returns as of 6/30/2019				
Global Equity	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
MSCI ACWI	3.6%	5.7%	11.6%	6.2%
US Equity	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
S&P 500	4.3%	10.4%	14.2%	10.7%
Russell 1000 Growth	4.6%	11.6%	18.1%	13.4%
Russell 1000 Value	3.8%	8.5%	10.2%	7.5%
Russell 2000	2.1%	-3.3%	12.3%	7.1%
Russell 2000 Growth	2.7%	-0.5%	14.7%	8.6%
Russell 2000 Value	1.4%	-6.2%	9.8%	5.4%
International Equity	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
MSCI EAFE	3.7%	1.1%	9.1%	2.2%
MSCI EAFE Hedged USD	2.8%	2.2%	9.8%	5.9%
MSCI EAFE Small Cap	1.7%	-6.3%	9.1%	4.4%
MSCI Europe	4.5%	1.9%	9.1%	1.3%
MSCI Japan	1.0%	-4.2%	8.1%	4.5%
MSCI Emerging Markets	0.6%	1.2%	10.7%	2.5%
MSCI Emerging Markets Small Cap	-1.0%	-5.1%	5.5%	0.5%
Alternative	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
HFRI Equity Hedge	1.7%	0.5%	6.8%	3.5%
HFRI Emerging Markets	1.1%	0.5%	6.4%	2.6%
HFRI ED: Activist	2.3%	-1.8%	5.5%	4.0%
HFRI ED: Merger Arbitrage	0.6%	3.7%	4.8%	3.5%

For the three months ended June 30, the value of US buyouts—a combination of confirmed and yet-to-close deals—rebounded from the first quarter to $160.4 billion as transactions totaling $2.5 billion or more accounted for 26% of deal activity, according to data from PitchBook.

In venture capital, funds invested, at $31.5 billion, were down from $34.5 billion in the first quarter, but they were still higher than recent averages, according to PitchBook. Buyout exits totaled a lackluster $62.0 billion in the second quarter. In contrast, venture exits hit a new high of $138.3 billion during the same period, bringing total liquidity this year to $188.4 billion while surpassing 2018's record of $127.2 billion; the main driver of this wave of liquidity were the hefty IPOs—all over $10 billion—of Lyft, Uber, Slack, Pinterest and Zoom Video.

GLOBAL FIXED INCOME

In fixed income, spreads for investment-grade credit were little changed, at 119 basis points, amid steady demand. In contrast, spreads on the riskier CCC-rated segment of high-yield debt widened as much as 70 basis points, underscoring investor concerns around credit risk associated with the late stage of an economic cycle. The Bloomberg Barclays Aggregate and the Bloomberg Barclays US Long Treasury indexes were up 3.1% and 6.0%, respectively, in the second quarter. The Bloomberg Barclays High Yield Index gained 2.5% and leveraged loans returned 1.6%, according to the S&P LSTA Leveraged Loan Index. Net outflows continued for high-yield and levered loan funds, while investment-grade funds experienced net inflows during the quarter.

In the same period, credit hedge funds maintained their positive trajectory with the HFRI ED: Credit Arbitrage Index gaining 3.1% and the HFRI ED: Distressed/Restructuring Index up 1.8%.

Global Fixed-Income Market Returns as of 6/30/2019

Global Fixed Income	Quarter	1 Year	3 Yrs	5 Yrs
BC Global Aggregate	3.3%	5.8%	1.6%	1.2%
BC Global Aggregate (USD Hedged)	2.9%	7.8%	3.0%	3.8%
JPM EMBI Plus	4.4%	11.7%	3.5%	4.2%
JPM GBI-EM Global Diversified	5.6%	9.0%	4.2%	-0.5%
Domestic Fixed Income	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
BC Aggregate Bond	3.1%	7.9%	2.3%	2.9%
BC Municipal Bond	2.1%	6.7%	2.6%	3.6%
BC TIPS	2.9%	4.8%	2.1%	1.8%
BC US Treasury	3.0%	7.2%	1.3%	2.5%
BC US Long Treasury	6.0%	12.3%	1.3%	5.7%
BC MBS	2.0%	6.2%	2.1%	2.6%
BC US Credit	4.3%	10.3%	3.7%	3.9%
BC US Long Credit	7.0%	15.0%	5.3%	5.8%
BC High Yield	2.5%	7.5%	7.5%	4.7%
BC Muni High Yield	2.7%	7.8%	5.3%	6.4%
S&P LSTA Lev. Loan	1.6%	4.2%	4.9%	3.1%
BC T-Bills	0.7%	2.4%	1.4%	0.9%
Alternative	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
HFRI Credit Index	1.9%	3.2%	5.8%	3.4%
HFRI ED: Credit Arbitrage	3.1%	7.5%	8.2%	4.4%
HFRI ED: Distressed/Restructuring	1.8%	0.4%	6.9%	1.7%
HFRI Relative Value	1.8%	3.4%	5.1%	3.3%

Outside the US, emerging market debt rallied with local currency-denominated debt posting a return of 5.6% for the quarter. External emerging market sovereign debt continued its strong run, returning 4.4% for the quarter. Valuations and fundamentals remain favorable for emerging economies given the Federal Reserve's more dovish stance.

That said, we believe current spread levels do not fully reflect the underlying credit risks in the market, increasing the appeal of safe-haven fixed-income assets. The significant growth of credit markets since the financial crisis, accompanied by deteriorating credit quality and increasing amounts of leverage, may eventually attract investors of distressed debt. Niche lending emerging market debt (local), and investment grade collateralized loan obligations (IG-CLOs) offer the potential for risk compensation given their structural nuances and opportunity for credit selection.

REAL ASSETS

Publicly-traded real assets were volatile, but ultimately positive, in the second quarter with a modest retreat by the Bloomberg Commodity Index. The price of WTI Crude Oil was moderately down and natural gas posted losses of 13% for the three months ended June 30. Industrial metals gave up gains on concerns around the ongoing trade dispute between the United States and China.

Equities in the energy, agriculture, and metals and mining sectors were up 0.4%, 1.3% and 2.0%, respectively. We remain positive on natural resource equities, believing that these securities offer more efficient exposure to commodity markets.

Real Asset Returns as of 6/30/2019	Quarter	1 Year	3 Yrs	5 Yrs
Bloomberg Commodity	-1.2%	-6.8%	-2.2%	-9.1%
GSCI Commodity	-1.4%	-11.5%	1.6%	-13.3%
Gold Spot	9.0%	12.5%	2.2%	1.2%
WTI Crude Oil Spot	-3.3%	-21.5%	6.4%	-11.2%
BBG Commodity - Agriculture	4.5%	-4.2%	-10.3%	-9.7%
BBG Commodity - Energy	-4.6%	-14.3%	-0.5%	-18.2%
BBG Commodity - Industrial Metals	-7.2%	-11.0%	6.4%	-3.0%
BBG Commodity - Precious Metals	7.1%	7.6%	-0.8%	-1.3%
S&P Global Natural Resource Equities	1.3%	-4.0%	11.4%	0.7%
NAREIT Composite Index	1.7%	12.6%	6.2%	8.7%
NAREIT Global REIT Ex US	0.9%	10.4%	4.5%	7.9%
Alerian MLP	0.1%	3.1%	-0.4%	-7.2%

Midstream energy was modestly positive for the quarter as investors weighed improving fundamentals with compressing yields after a strong showing in the first quarter. NEPC continues to be constructive on the long-term macro drivers for the sector, as a chunk of North America's oil and gas infrastructure needs to be constructed and/or redeveloped.

Meanwhile, in real estate, real estate investment trusts (REITs) were up 1.7% in the second quarter, according to the FTSE NAREIT Equity REITs Index, bolstered by strong fundamentals and softening long-term interest rates. All subsectors were in the black, with the exceptions of retail and office. Property types with strong secular trends, for instance, industrial and data centers, remain to be strong performers. Overall, REITs ended the second quarter trading at a 14% premium to net asset values; however, a wide dispersion in valuations within property types remains.

FINAL THOUGHTS

Our message is a bit more defensive as we encourage investors to harvest the stellar returns reaped so far in 2019. With global equity and interest-rate markets posting strong gains this year, we revert to a simple principle of reducing exposure to assets that have exceeded expectations. Specifically, we encourage investors to cut back on lower-quality credit and rebalance equity exposure by paring positions in developed markets. We still find emerging market stocks promising and maintain our overweight position on them. At the same time, we encourage investors to consider assets that can serve as dry powder in times of market stress. To this end, we remind investors of the benefits of a diversified and balanced portfolio as risks associated with the late stage of an economic cycle are skewed towards the negative but can offer positive returns for investors for an extended period before the final whistle is blown.

DISCLAIMERS AND DISCLOSURES

- Past performance is no guarantee of future results
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