THIRD QUARTER MARKET THOUGHTS

Investment Advice from Winnie-the-Pooh's Eeyore

October 2019

As we look back at the extended string of impressive wins scored by capital markets in 2019, the past three years, or even the last 10 years, we are left predicting a more subdued outlook for returns in 2020 and beyond.

To borrow from Winnie the Pooh's gloomy Eeyore, they're funny things, low returns. You never have them till you're having them. This sobering realization comes with some tough choices for investors: take on more risk, rebalance or get used to the lower returns.

That said, we want to remind investors to take comfort from the prolonged spate of robust investment gains—going back as far as a decade—so far. Portfolios have benefited even in the face of anemic economic growth as low interest rates emboldened investors to pay more for a dollar of future earnings. Case in point: Through the third quarter of this year, the S&P 500 Index had posted returns of 20%. Not to be left behind, bonds, which carry a lower risk profile, have also kept up. The Bloomberg Barclays US Aggregate Bond Index has earned over 8% for the year, while high-yield debt has gained over 11%. The biggest surprise of all: long-Treasury bonds have posted equity-like returns of nearly 20%.

Naively optimistic, Winnie the Pooh often asks his pal, Eeyore, "Lovely day, isn't it?" Like Eeyore, we wish we could say yes, these gains will persist, but we can't. These successes create new future challenges. For investors, this period of strong gains will likely be followed by a period of more modest returns as it is increasingly unlikely that the forces driving equity returns can carry on indefinitely.

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As the curtain falls on 2019, we feel the need to foreshadow our scaled down return assumptions for capital markets that we will unveil in the new year. We forecast returns of less than 5% for US large-cap stocks, the largest allocation in most portfolios; this estimate will likely create structural challenges for the portfolios of investors whose return objectives exceed 7%. Our five-to-seven-year return forecast—based on yield movements in 2019—was 3.0% this year for the US Aggregate Bond Index; our five-to-seven-year return assumption, as of the end of the third quarter, is nearly 70 basis points lower at 2.3%. Our return forecast for 2020 for US equities over a similar period is potentially bleaker and could be more than 100 basis points lower than our 2019 assumption due to strong returns, heightened valuations, and high profit margins.

Challenging times call for challenging decisions. At NEPC, we see three potential courses of action:

1. Investors can seek **higher returns by taking on more risk** in the portfolio or shift to markets that have lagged in recent years, potentially offering a higher risk premium. Drawing on Eeyore's despondent wisdom, a little consideration, a little thought for other asset classes, can make all the difference. Emerging market equities and debt can offer greater gains but require a tolerance for more

volatility and a willingness to replace high-performing assets, such as developed market equities, to fund a larger allocation to emerging markets.

2. Investors should be prepared to **rebalance** their portfolios when markets sell off. With the US economy in the later stages of its market cycle, we expect higher levels of volatility, as described in one of our key market themes, *Late Cycle Dynamics*. These pockets of volatility, such as the one from December 2018, can serve as attractive entry points for investors to add to assets.

3. Investors can **accept** the prospect of lower investment returns, working within their organization to structure goals, cashflows and outcomes within a framework of lower returns relative to the last 30 years. We know this is easier said than done but we are standing by to help: we view part of our mandate to assist investors in setting appropriate long-term objectives, while also seeking ways to improve the efficiency of their portfolios.

GLOBAL EQUITIES

US equities were a mixed bag in the third quarter with the S&P 500 Index gaining 1.7% and the small-cap Russell 2000 Index losing 2.4%. There was a sharp reversal of growth and value strategies across the capital spectrum in the final month of the quarter with value outperforming growth by 3.6% and 5.9% across large and small caps, respectively. The reversal fueled losses in technology and healthcare hedge fund strategies of 1.5% and 2.5%, respectively. NEPC continues to recommend a balanced equity exposure across value and growth strategies globally.

Global Equity Market Returns as of 9/30/2019				
Global Equity	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
MSCI ACWI	0.0%	1.4%	9.7%	6.6%
US Equity	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
S&P 500	1.7%	4.2%	13.4%	10.8%
Russell 1000 Growth	1.5%	3.7%	16.9%	13.3%
Russell 1000 Value	1.4%	4.0%	9.4%	7.8%
Russell 2000	-2.4%	-8.9%	8.2%	8.2%
Russell 2000 Growth	-4.2%	-9.6%	9.8%	9.0%
Russell 2000 Value	-0.6%	-8.2%	6.5%	7.1%
International Equity	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
MSCI EAFE	-1.1%	-1.3%	6.5%	3.3%
MSCI EAFE Hedged USD	1.8%	1.6%	8.3%	6.0%
MSCI EAFE Small Cap	-0.4%	-5.9%	5.9%	6.0%
MSCI Europe	-1.8%	-0.7%	6.6%	2.4%
MSCI Japan	3.1%	-4.7%	6.2%	5.6%
MSCI Emerging Markets	-4.2%	-2.0%	6.0%	2.3%
MSCI Emerging Markets Small Cap	-4.6%	-5.5%	1.3%	-0.1%
Alternative	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
HFRI Equity Hedge	-1.1%	-1.2%	4.8%	3.5%
HFRI Emerging Markets	-2.0%	2.1%	3.9%	2.4%
HFRI ED: Activist	0.4%	-1.7%	3.2%	3.7%
HFRI ED: Merger Arbitrage	1.0%	4.3%	4.5%	3.8%

International stocks were increasingly volatile for the three months ended September 30 amid concerns around the global fallout from the ongoing trade war between the United States and China. The MSCI EAFE Index posted a modest loss of 1.1% as gains from defensive sectors, such as utilities and consumer staples, offset losses from cyclical sectors such as energy and materials. Japanese equities recorded gains of 3.1%, while European stocks were in the red at 1.8%; emerging market equities and China were harder hit, losing 4.2% and 4.7%, respectively.

In private equity, fundraising totaled $168 billion in the third quarter, exceeding the amounts raised in the previous two quarters and the quarterly three- and five-year averages, according to Preqin. During the same period, US buyout activity slowed, totaling $150 billion, compared to a quarterly average of $190 billion in the prior four quarters, according to PitchBook. Venture capital deal activity also slowed to $28 billion in the three months ended September 30; however, as of the third quarter, VC deal value had already surpassed the annual totals of 2009 through 2017, which average $51 billion per year. Venture capital exit activity totaled $35 billion, above historical quarterly averages, but far short of the $141 billion of exit value in the second quarter fueled by a spate of large and high-profile IPOs.

Global Fixed-Income Market Returns as of 9/30/2019				
Global Fixed Income	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
BC Global Aggregate	0.7%	7.6%	1.6%	2.0%
JPM EMBI Global Diversified	1.5%	11.5%	4.6%	5.7%
JPM GBI-EM Global Diversified	-0.8%	10.1%	3.1%	0.6%
Domestic Fixed Income	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
BC Aggregate Bond	2.3%	10.3%	2.9%	3.4%
BC Municipal Bond	1.6%	8.5%	3.2%	3.6%
BC TIPS	1.3%	7.1%	2.2%	2.4%
BC US Treasury	2.4%	10.4%	2.2%	2.9%
BC US Long Treasury	7.9%	24.7%	4.1%	6.7%
BC MBS	1.4%	7.8%	2.3%	2.8%
BC US Credit	3.0%	12.6%	4.3%	4.5%
BC US Long Credit	5.6%	19.8%	6.5%	6.9%
BC High Yield	1.3%	6.3%	6.1%	5.4%
BC Muni High Yield	2.8%	10.0%	5.9%	6.0%
S&P LSTA Lev. Loan	1.3%	3.4%	4.3%	3.6%
BC T-Bills	0.6%	2.4%	1.5%	1.0%
Alternative	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
HFRI Credit Index	0.1%	1.8%	4.5%	3.4%
HFRI ED: Credit Arbitrage	1.4%	6.5%	6.7%	4.5%
HFRI ED: Distressed/Restructuring	-1.6%	-2.8%	4.4%	1.9%
HFRI Relative Value	0.2%	2.0%	4.0%	3.3%

GLOBAL FIXED INCOME

In this late stage of the US economic cycle, investors are favoring higher-quality credit and safe-haven fixed-income assets. Long-only high-yield and levered-loan funds continued to see net outflows, while investment-grade funds witnessed net inflows in the third quarter.

US bond markets were in the black for the quarter with the Bloomberg Barclays Aggregate posting gains of 2.3%, the Bloomberg Barclays High Yield up 1.3%, and S&P LSTA Leveraged Loan Index returning 1.3%; the Bloomberg Barclays US Long Treasury gained 7.9% in the third quarter underscoring the demand for safe-haven investments. Issuance so far this year in the high-yield market has surpassed that of 2018, with nearly 50% of the new issuance in double-B-rated bonds. To this end, we advocate caution in this segment given the tight spread and high issuance levels.

Within hedge funds, performing credit was positive with the HFRI ED: Credit Arbitrage Index gaining 1.4%, but distressed credit was in the red with the HFRI ED: Distressed/Restructuring Index down 1.6% due to the volatility in the energy sector.

Outside the US, emerging market debt (EMD) posted mixed results in the third quarter. Local currency-denominated debt posted losses related to currency weakness but was in the black for the trailing twelve-month period. External EMD sovereign debt and corporate bonds were up during the quarter. The fundamentals for emerging markets are still favorable, but volatility remains elevated.

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 offer the potential for risk-compensation, given their structural nuances and the opportunity for credit selection.

REAL ASSETS

The Bloomberg Commodity Index fell 1.8% in the third quarter, as lower oil and agriculture prices offset gains in precious metals and natural gas. Metals and mining, energy and agriculture equities lost 9.2%, 5.5% and 3.4%, respectively. We continue to believe that natural resources equities offer a more efficient way to gain exposure to commodities than direct ownership.

After a strong front-end of the year, midstream energy sold off in the third quarter as investors weighed

Real Asset Returns as of 9/30/2019				
	Quarter	1 Year	3 Yrs	5 Yrs
Bloomberg Commodity	-1.8%	-6.5%	-1.5%	-7.2%
GSCI Commodity	-4.2%	-16.3%	1.5%	-11.7%
Gold Spot	4.4%	23.4%	3.8%	4.0%
WTI Crude Oil Spot	-7.1%	-26.1%	4.3%	-9.9%
BBG Commodity - Agriculture	-6.1%	-4.9%	-9.6%	-7.2%
BBG Commodity - Energy	-4.5%	-21.5%	-0.8%	-16.8%
BBG Commodity - Industrial Metals	2.4%	-2.1%	5.8%	-1.7%
BBG Commodity - Precious Metals	5.3%	20.4%	0.9%	2.2%
NAREIT Composite Index	7.4%	19.7%	9.1%	10.9%
NAREIT Global REIT Index	6.0%	16.0%	6.3%	8.3%
Alerian MLP	-5.0%	-8.1%	-2.5%	-8.6%

improving fundamentals with compressing yields. Performance between MLPs and C-corps is still diverging, with the Alerian MLP Index underperforming the Alerian Midstream Energy Index with losses of 5.0% for the quarter. Midstream dividend yields remain compelling, given the supportive long-term macro drivers and near-term concerns regarding production growth related to insufficient funding in the upstream part of the value chain.

REITs were up 7.4%, bringing year-to-date returns to 27.4%. All subsectors were positive amid declining interest rates and relatively strong fundamentals. Property types with robust demographic drivers, for instance, data centers, industrial and healthcare, are the strongest contributors to performance. Overall, the REIT sector ended the third quarter trading at a 20.2% premium to net asset values, although discounts can still be found in retail and office REITs.

In private real estate, core returns remain modest with the NCREIF ODCE Index reporting a preliminary 1.3% gross return for the quarter. Retail continues to lag with shopping malls falling out of favor as industry participants downsize and/or file for bankruptcy. The wide dispersion in performance among underlying funds indicates that some managers have succeeded at adding alpha, likely through a combination of pro-active portfolio management and strong assets.

FINAL THOUGHTS

The robust run of assets in equities, interest-rate markets and credit is impressive, but its longevity is uncertain. Investment returns of the last decade are unlikely to be duplicated in the next one. Given the decline in interest rates and slowing inflation trends, we expect our forecast for capital markets to be meaningfully lower than a year ago for both the near-term and long-term assumptions. Those taking the time to position not only their investment portfolio, but also their organization will be best prepared to successfully navigate a future of lower returns. While we would prefer to offer up a more exuberant message, we are prepared to help our clients develop resilient but efficient portfolios to manage through periods of volatility and capture asset returns where available. To end with Eeyore lamenting his imperfect tail, it’s not much of a market, but we are all sort of attached to it.

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- Past performance is no guarantee of future results
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