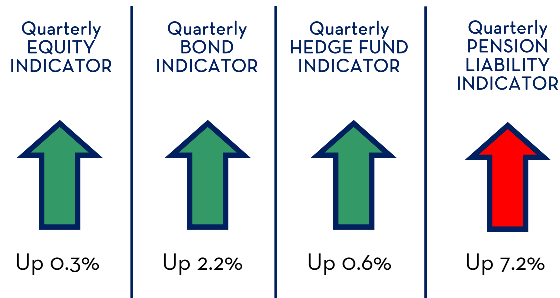
MARKET THOUGHTS

SECOND QUARTER 2016 VOLUME 42



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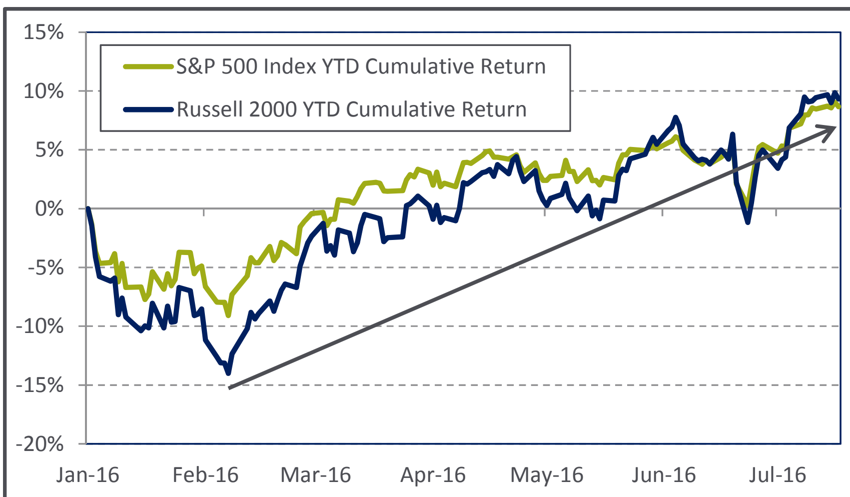
THE BREXIT CLUB: THOUGHTS ON POLITICAL RISK AND THE MARKET RALLY

Introduction

Markets witnessed quite a surprise in the second quarter as the United Kingdom voted to leave the European Union. Concerns of increased political risk in the UK and Europe briefly jolted equity and currency markets across the globe. Risk assets sharply sold off but quickly reversed as market concerns abated. US markets followed suit and ultimately continued their rally as the S&P 500 ended the quarter up 2.5% and US high yield bonds rose 5.5% (Exhibit 1). Outside the US, emerging markets demonstrated resiliency to finish the quarter in positive territory. Developed market equities modestly recovered with the MSCI EAFE down only 1.5%. Meanwhile, developed market government bond yields marched lower to record levels: 10-year UK yields declined 60 basis points and the US Treasury yield fell below 1.5%. While in Germany and Japan, yield curves extended further into negative terrain.

Exhibit 1: 2016 US Equity Performance



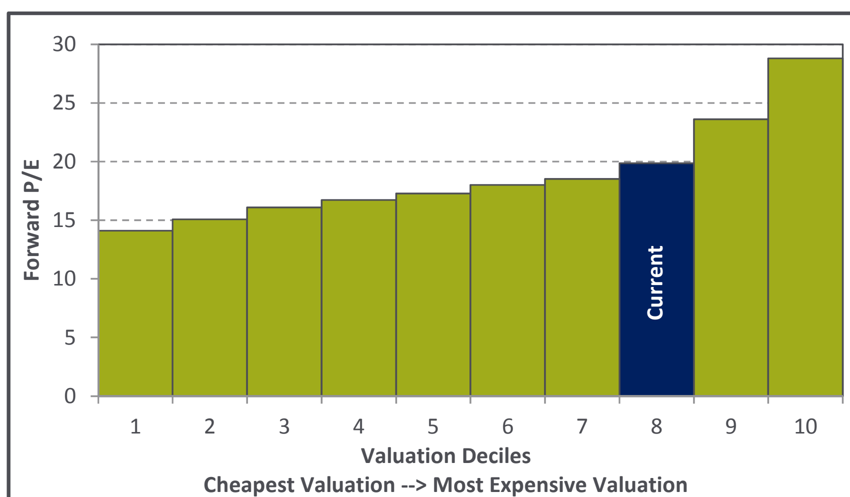
Source: Bloomberg

The fleeting shock of the United Kingdom's EU referendum vote has now passed with equities in the US and UK pushing beyond record highs. Yet a lingering question remains following the Brexit vote. What would motivate voters in the United Kingdom to walk away from over 40 years of economic and political orthodoxy? Political scientists will dissect the outcome for years to come but for many UK voters the culmination of low growth and limited wage gains manifested itself as a populist fervor against the "establishment." This voter psychology in the UK likely resonates broadly among the developed world. In the years following the 2008 Global Financial Crisis, subdued economic growth and economic uncertainty have given rise to increased political dissent. Irrespective of political orientation, the fault lines of secular low wage gains and income inequality has eroded the established political order across the developed world. While the ramifications of greater political dissent are unknown, political risk is likely to remain an ongoing concern for financial markets.

In contrast to the emerging markets, investors are generally unfamiliar with material political risk in developed markets. Nevertheless, the course of action is the same for the two markets during times of elevated stress. We encourage investors to look past the political risk with a focus on long-term fundamentals and objectively assess the valuation opportunities offered by a market. To this end, we believe equity markets in Europe and Japan provide a favorable return outlook with attractive valuations relative to the US. The unprecedented central bank support in Europe and Japan provides a positive backdrop of improved corporate earnings and elevated risk premia, supporting an overweight equity position. For investors implementing a partial strategic currency hedge, we recommend a larger overweight as developed market currency risk is largely an uncompensated one. While

in the emerging markets, recent strength in equities and currencies reinforces the commitment to both equity and fixed income allocations. These markets continue to offer reasonable equity valuations, undervalued currencies, and high real interest rates relative to the developed world. We encourage investors to maintain current targets as we believe future return expectations in the emerging markets adequately compensate investors relative to long-term risks.

Exhibit 2: Historical Distribution of S&P 500 Forward P/E



Source: Bloomberg

In the US, equity and credit markets have rallied considerably from the lows seen in February. At that time, domestic stocks and high-yield bonds offered a compelling entry point for investors. Subsequently, high yield credit spreads have fallen to long-term averages while the rapid ascension of US equity prices has pushed valuation multiples to their upper ranges relative to history (Exhibit 2). In light of this, we believe the risk-return profile of high yield remains attractive but we recommend investors trim their exposure to US equity. NEPC has long advocated the benefits of a disciplined rebalancing approach. This holds true today for US stocks, as a process of reducing exposure to assets that have outperformed expectations and increasing exposure to assets that have underperformed are fundamental to our investment philosophy.

Rebalancing opportunities can also be found in developed market government bond exposure. Japan and many European yield curves are deeply negative with 30 year rates hovering near zero. As such, we recommend investors review their exposure to benchmark focused global bond strategies and look to eliminate Citigroup World Government Bond Index (WGBI) based strategies. While US interest rates have rallied significantly in 2016, US duration continues to hold a vital place in a diversified risk balanced portfolio. That being said, we encourage investors to reaffirm their duration exposure. For liability driven investors, this includes rebalancing both long Treasuries and long credit while reviewing hedge ratio targets. Similarly, we encourage total return investors to trim long Treasuries and risk parity exposure following recent outsized gains. Furthermore, with long-term inflation expectations near historical lows, we recommend investors preserve US duration exposure with a strong bias towards TIPS over US core bonds.

Global Equity

The S&P 500 managed to end June modestly positive and returned 2.5% in the second quarter. The Russell 2000 had a strong quarter as 9 out of the 10 economic sectors registered positive returns. From a sector basis, the more defensive sectors led the market higher with Energy, Telecommunications, Utilities and Health Care. Sectors lagging in the quarter were Consumer Discretionary, Information Technology, and Industrials.

Equity Index Returns as of 6/30/2016				
Global Equity	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
MSCI World	0.3%	-4.7%	4.9%	4.4%
US Equity	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
S&P 500	2.5%	4.0%	11.7%	12.1%
Dow Jones Industrial Average	1.4%	1.8%	6.3%	7.6%
NASDAQ Composite	-0.6%	-2.9%	12.5%	11.8%
Russell 1000 Growth	0.6%	3.0%	13.1%	12.3%
Russell 1000 Value	4.6%	2.9%	9.9%	11.4%
Russell 2000	3.8%	-6.7%	7.1%	8.4%
Russell 2000 Growth	3.2%	-10.8%	7.7%	8.5%
Russell 2000 Value	4.3%	-2.6%	6.4%	8.1%
International Equity	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
MSCI EAFE	-1.5%	-10.2%	2.1%	1.7%
MSCI Emerging Markets	0.7%	-12.1%	-1.6%	-3.8%
MSCI Europe	-2.7%	-11.2%	2.0%	1.0%
MSCI UK	-0.7%	-12.1%	0.7%	1.7%
MSCI Japan	1.0%	-8.9%	2.7%	4.2%
MSCI Far East	1.0%	-9.3%	2.8%	4.0%

Across the developed world, equity markets declined following the UK's decision to leave the EU before rallying in the final days of the quarter. Ireland and Italy led developed markets lower, selling off 9.9% and 9.7% respectively. In local terms, Japanese equity markets declined nearly 7%. While, for US dollar investors, Japan equities returned a positive 1% as the Yen approached a 2 year high against the dollar. The Yen has rallied considerably for the year and continues to benefit from its perceived safe-haven status. Similar to the US, energy was the top sector in developed markets, returning roughly 11.5% while consumer discretionary stocks were one of the weakest returning -8.2% for the quarter.

Within emerging markets, investors looked past the Brexit fears and recognized ongoing positive developments. Latin America was a particular focus, where favorable election results in Peru and further progress in the impeachment process in Brazil led to those markets returning 16.9% and 13.3%, respectively. In contrast, China equi-

ty markets continued to waver, trailing the broader benchmark with a return of -1.7%. From a sector perspective, consumer staples stocks performed the best, returning 4.2% for the quarter.

Global Fixed Income

The second quarter illustrated the current dichotomy within fixed income: safe-haven assets rallied significantly, while risky assets also outperformed as investors continued to search for yield. Globally, the 10 year German bund broke into negative territory, falling 28 bps to -0.13%. In Japan, 10-year bond yields continued to move lower, settling at -0.22%. At home, the U.S. 10 year Treasury yield compressed 29 bps, nearing its all-time low at 1.49%.

The Barclays Aggregate returned 2.2%, while US High Yield returned 5.5% for the quarter. Overall, credit was broadly supported by lower quality sectors. Non-credit risk assets also performed well, as emerging market local debt returned 2.7% in the quarter with a strong rebound in June of 5.9%. For the year, emerging local debt remains one of the best performing risk assets in fixed income, returning over 14%.

Fixed Income Index Returns as of 6/30/2016				
Global Fixed Income	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
Citi WGBI	3.4%	11.3%	2.6%	1.2%
JPM EMBI Plus	6.0%	13.2%	7.1%	6.4%
Domestic Fixed Income	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
BC Aggregate Bond	2.2%	6.0%	4.1%	3.8%
BC US Agg. Treasury	2.1%	6.2%	3.5%	3.5%
BC US Credit	3.5%	7.6%	5.3%	5.2%
BC Mortgage Backed	1.1%	4.3%	3.8%	3.0%
BC Interm. Gov't/Credit	1.6%	4.3%	3.0%	2.9%
BC 1-10 Yr TIPS	1.3%	3.3%	1.6%	1.6%
BC High Yield	5.5%	1.6%	4.2%	5.8%
S&P LSTA Lev. Loan	2.9%	0.9%	2.8%	3.8%
3 Month T-Bills	0.1%	0.1%	0.1%	0.1%
10-Year Bond Yields	**Mar-16**	**Dec-15**	**Mar-15**	**Mar-14**
US	1.5%	1.8%	2.4%	2.5%
Germany	-0.1%	0.2%	0.8%	1.2%
UK	0.9%	1.4%	2.0%	2.7%
Japan	-0.2%	0.0%	0.5%	0.6%

Currency Markets

Leading up to the UK referendum in late June, currency movements were mixed as the likelihood of a "remain" vote was expected. Following the surprise Brexit decision, currency pairs were extremely volatile as the US dollar and Japanese yen rallied substantially. Demand flowed into "safe haven" currencies as the British pound depreciated heavily with double digit percentage declines on the day following the UK referendum. Emerging market currency returns were mixed in the second quarter with many currencies benefitting from higher commodity prices and positive political developments. As stated in previous Market Thoughts, currency markets are likely to exhibit heightened volatility and we encourage investors to strategically hedge a portion of their developed market currency exposure.

Commodity Markets

Commodities posted another strong quarter as the Bloomberg Commodity Index's 12.8% return represented the best quarterly return for the index since 2010. In the energy sector, oil prices continued to recover breaching $50 despite an overhang in US inventories. Among precious metals, gold prices benefited from a demand for safe haven assets and expectations the Federal Reserve would hold policy rates at current levels. Industrial metals also rallied, benefiting from low inventories and higher demand expectations due to stimulus in China. Furthermore, in the agriculture sector, soybean prices reached a 2 year high as flooding in Argentina raised concerns of tighter global supplies.

Pension Liability

Pension discount rates declined to 3.6% as of June 30, nearly 30 basis points (bps) lower than first quarter levels according to the Citigroup indices. Supporting this decline was a 31 bps decline in 30-year Treasury yields and a modest decline in credit spreads according to the Barclays Capital Long Credit Index.

The decline in interest rates had a negative impact on the liabilities of our clients' pension plans, which are estimated to have increased 7.2% in the quarter and 17.1% for year. Clients who have implemented LDI strategies have most likely seen gains during the quarter from their long-duration assets but the funded status of most pension plans has likely declined in the quarter. However, this primarily impacts economic and accounting results rather than IRS contribution determinations due to the various legislative funding relief acts (MAP-21, HATFA, and the BBA of 2013 and 2015) that allow for higher discount rates to be utilized.

Hedge Funds

The second quarter began on a positive note as distressed oriented and activist strategies recovered losses following a difficult first quarter. However, the shock of the Brexit vote at the end of quarter resulted in turmoil across many sub-strategies. Among the major sub-strategies, credit-linked approaches led the way in positive performance. Credit strategies broadly benefited from tightening high yield spreads associated with lower credit quality sectors. Structured credit continued to perform well in the second quarter as mortgage-backed and consumer-backed securities produced positive returns. Event-Driven strategies produced mixed result for the quarter. The early gains in merger arbitrage were muted by volatility surrounding the Brexit vote but the recent uptick in merger and acquisition activity is likely to be a positive tailwind. Results for macro strategies were also mixed as

Hedge Fund Industry Performance Overview as of 6/30/2016				
Composite	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
DJCS Hedge Fund Composite	0.6%	-4.2%	2.5%	2.9%
Relative Value	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
DJCS Convertible Arbitrage	2.6%	0.1%	1.2%	2.5%
DJCS Fixed Income Arbitrage	1.0%	-0.4%	2.4%	4.1%
DJCS Equity Market Neutral	-3.2%	-1.5%	1.0%	1.1%
DJCS Multi-Strategy	1.2%	1.2%	5.9%	6.0%
Event Driven	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
DJCS Event Driven	2.1%	-10.4%	0.1%	1.3%
DJCS Event Driven - Distressed	1.9%	-5.2%	1.4%	3.2%
DJCS Event Driven - Risk Arbitrage	0.6%	0.7%	1.6%	1.5%
DJCS Event Driven - Multi-Strategy	2.2%	-12.4%	-0.5%	0.3%
Equity Hedge	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
DJCS Long-Short Equity	-1.2%	-5.0%	4.5%	4.0%
DJCS Emerging Markets	1.8%	-2.4%	2.4%	2.2%
DJCS Dedicated Short Bias	-6.3%	4.3%	-8.4%	-10.2%
Tactical	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
DJCS Global Macro	0.7%	-3.9%	1.5%	3.1%
DJCS Managed Futures	-2.2%	5.4%	6.5%	2.3%
Traditional Markets	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
BC Aggregate Bond	2.2%	6.0%	4.1%	3.8%
S&P 500	2.5%	4.0%	11.7%	12.1%

some trend strategies struggled with the sharp market movements. In the equity space, volatile price reversals within industries continue to pose challenges for long-short equity. However, yield related equity sectors performed well benefiting some long biased strategies.

Private Markets

Global private buyout deal value was $88 billion, more than twice of what was transacted in the first quarter. Exit volume also increased over the first quarter but totals for 2016 are down nearly 33% from the prior year period as IPO activity continues to be subdued. The private debt space remains attractive as direct lending spreads have increased across the capital structure in 2016. The increase in credit spreads is partially attributed to Business Development Companies ("BDCs") exiting the lending market due to significant stock underperformance. NEPC continues to advocate allocations to direct lending and for investors to embrace the illiquidity premium in private credit strategies.

In real assets, we are positive on energy, negative on timber, and neutral on agriculture, infrastructure, and metals and mining. NEPC continues to evaluate energy-related investment opportunities, although the stress on company balance sheets has alleviated as commodity prices have rallied off their lows. Our highest conviction remains in private equity, as these managers appear best-equipped to invest and manage assets amidst a volatile commodity recovery.

In real estate, we remain neutral on US private core real estate and REITS. While valuations in primary markets are well above past peak levels, fundamentals are strong and pricing remains attractive on a relative basis to US Treasuries. We are positive on value-add and opportunistic real estate and believe select European strategies remain attractive. For non-core real estate in the US, we favor cash flow-driven, niche-focused managers who are disciplined and attentive to the current stage of the expansion.

Final Thoughts

As witnessed in the second quarter, political risk does not simply reside in the ether but at times can have a profound and volatile influence on financial markets. NEPC firmly believes a risk-aware and diversified portfolio best serves investors' ability to weather such events and a multitude of economic environments over the long term. Even so, a risk balanced portfolio is a starting point and we encourage investors to trim assets that have recently outperformed expectations, such as US equities and developed market government bonds. Furthermore, we recommend investors continue to overweight non-US developed market equities as risk premia remain elevated. Additionally, a risk balanced approach is the foundation of our investment philosophy; to this end, we recommend investors maintain an appropriate level of US duration exposure with a strong bias towards TIPS over nominal government bonds.

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