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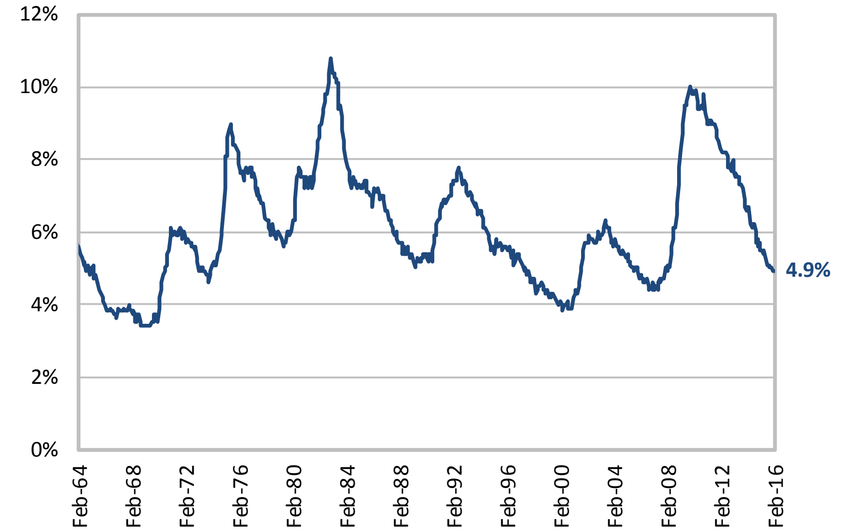
Monthly Economic & Capital Market Update

February 2016

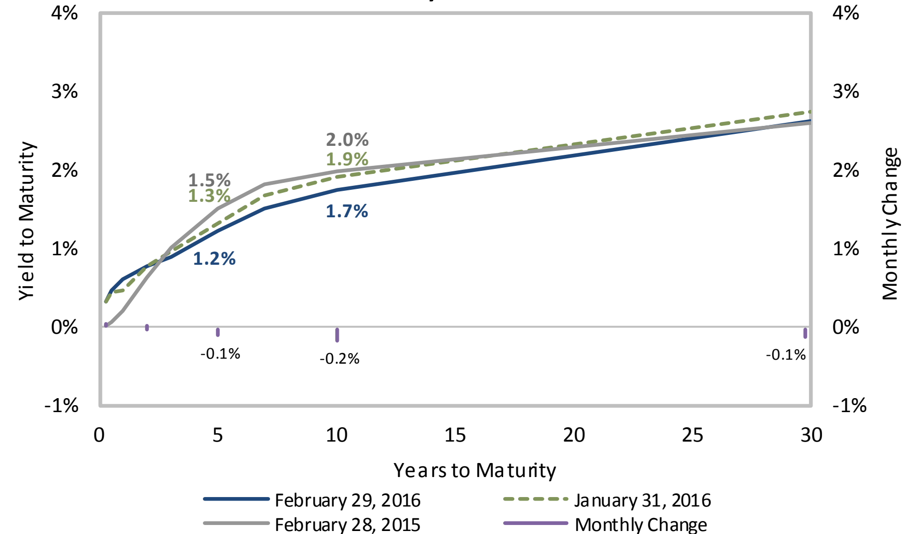
Economy

- Data releases from February showed the US economy continuing along its positive, albeit slow growth trajectory. Compared to the end of January the labor market improved, the service sector expanded, and manufacturing remained muted. Financial market expectations for a US recession increased to begin the year as equity markets sold off more than 10% through the middle of February, but rebounded to end the month as investors reassessed the risks facing the global economy. While the recovery in the US is now into its eighth year, the length of the expansion alone does not mean a recession is inevitable and macro indicators currently suggest a recession is not the most likely scenario in 2016.
- The February employment report showed mixed results for the US labor market. Employers added 242,000 jobs during the month, exceeding market expectations of 200,000 new jobs. The unemployment rate remained at 4.9%, its lowest level since February 2008. Additionally, revisions to figures from December and January resulted in 30,000 more jobs than previously reported for those months. However, strong job gains have yet to meaningfully flow through to wage gains for employees. Average hourly earnings declined slightly in February and were up just 2.2% over the past 12 months. In recent quarters wage gains have been stronger than earlier in the expansion, but remain subdued from a historical perspective.
- Real GDP growth for the fourth quarter of 2015 was revised up from 0.7% to 1.0% during February, bringing the growth rate to 2.4% for the 2015 calendar year; the Bureau of Economic Analysis will revise the fourth quarter growth rate once more in coming weeks. For the first quarter of 2016, the Atlanta Federal Reserve's GDPNow model is forecasting 2.2% (annualized) growth.
- The service sector continues to drive US growth, while manufacturing has contracted in recent months. The ISM non-manufacturing purchasing managers' index (PMI) for February showed the service sector expanded for the 73rd consecutive month, while the manufacturing index saw a 5th straight month of contraction.



Yield Curve

- Bond yields have fallen with the flight to quality to begin 2016. During February the 10-year Treasury yield declined 18 bps to 1.74%.
- The spread between 2-year and 30-year Treasuries declined 13 bps to 184 bps in February. Over the past 30 years this spread has averaged 165 bps.



Public Equities

- Global equity markets were mixed during the month, with most indices closing flat to slightly down. Small cap stocks outperformed large in both US and international developed markets. Emerging markets, after a rough January, closed February slightly negative, returning -0.2%.
- MLPs traded down sharply mid-month, but recovered to around flat in the back half of February. Large cap MLPs outperformed smaller cap MLPs. Refined products pipelines (+8%) and natural gas pipelines (+1%) performed well as transport volumes remained strong in these sectors. Crude oil pipelines (-3%) and gathering & processing MLPs (-4%) declined as low crude oil prices continued to prohibit exploration & production companies from meaningful new drilling, which has lowered forward volume expectations. General partner MLPs returned -4% as slowing distribution growth expectations continue to negatively impact these companies.

Public Debt

- High yield bond carry overwhelmed a slight deterioration in spreads in February, leading to a 0.6% return for the month.
- Local currency EM debt continued its positive start to 2016, returning 1.4% in February. Brazil and Russia's currencies were among advancers against the dollar.

Private Equity

- The easy availability of credit and record levels of dry powder have driven purchase price multiples to record high levels, according to S&P Leveraged Commentary and Data. Market participants noted a widening bid/ask spread as lenders began to tighten, and public market volatility combined with peak earnings has given some buyers pause. However, the aggregate deal value in 2015 rose 16% YoY and the average deal size reached its highest level since 2007.

Private Debt

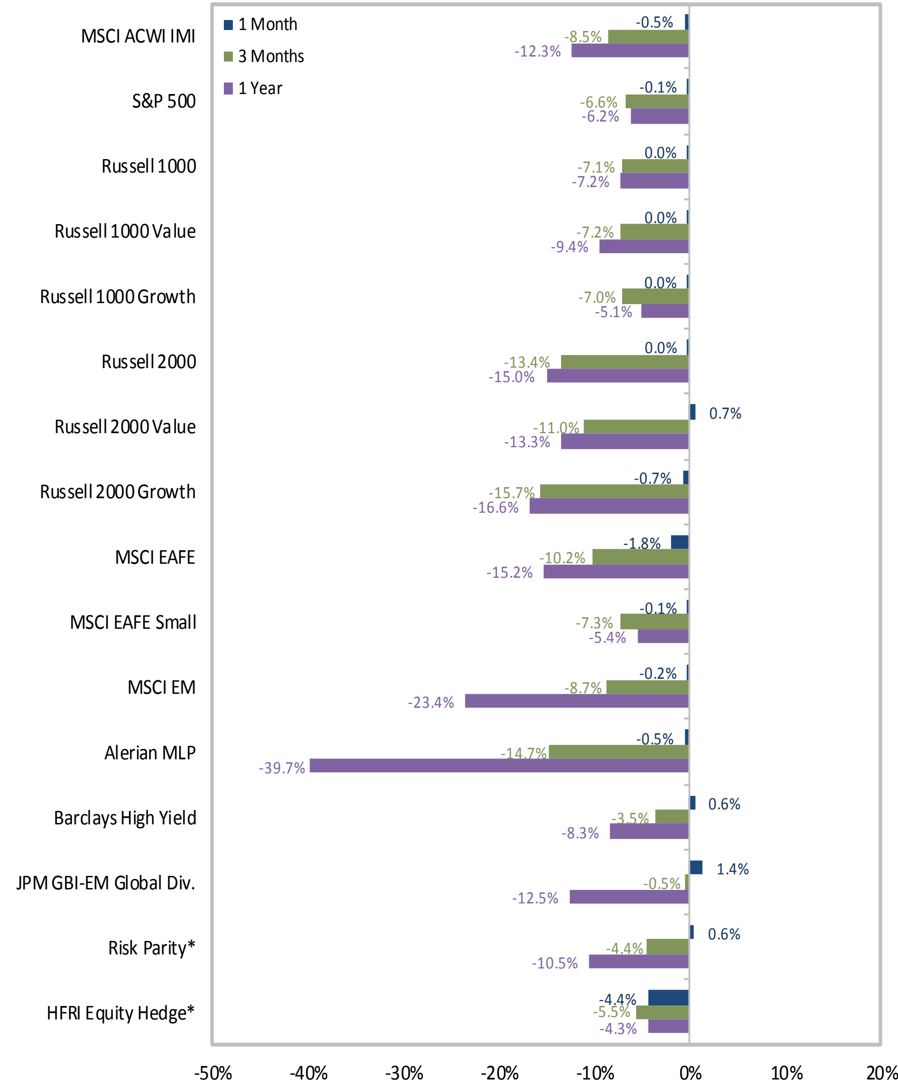
- Following five years of expanding leverage multiples, 2015 saw a slight cooling in the sponsored loan market. Increased attention to regulatory lending guidelines, as well as some natural trepidation with overall credit statistics, led to the slowdown. For deals that are getting done, market participants noted a reduction in unitranche lending in favor of more traditional debt structures.

Risk Parity

- Risk parity strategies posted mixed performance in January, ranging from slightly positive to slightly negative. Nominal and inflation-linked bonds contributed while equity and commodity positions detracted.

Growth Hedge Funds

- Growth hedge funds detracted in January. Both equity long/short and event-driven strategies detracted across sub-strategies. The largest losses were in growth-oriented equity and activist strategies, while merger arbitrage was close to flat.



* Data was not available at time of publication – returns are previous month's.
Note: Risk Parity returns are based on an internally comprised benchmark.
All returns are USD.

Income Assets

February 29, 2016

Public Debt

- Rates fell sharply in the first half of the month, as uncertainty was spawned by a multitude of issues: falling oil prices, equity market volatility, and recession concerns. Subsequently, expectations for further rate hikes in the US were curtailed for 2016. The 10-year Treasury fell 31 bps to 1.63% at one point, a three-year low, then rose to end the month 18 bps lower.
- Investment grade credit spreads were higher by as much as 19 bps before rallying to end the month up only three bps and return 0.8% for the month. Speculation of a brewing recession and concerns over earnings pressure in the banking industry in light of lower rates weighed on spreads mid-way through the month. Issuance slowed in February to $101B, but year-to-date levels are ahead of the pace for the same period in 2015. At 184 bps, spreads are at levels seen last in mid-2012 and 58 bps wider than the 25-year median level.
- Although they lagged investment grade credit, securitized sectors continue to be a relative safe haven with agency MBS, ABS, and CMBS all posting positive returns for the month. CMBS outperformed MBS and ABS with a 0.8% return as spreads paused their recent widening spell.
- International bonds gained 3.5% in February as the USD weakened and yields fell in the Eurozone and Japan.

Private Debt

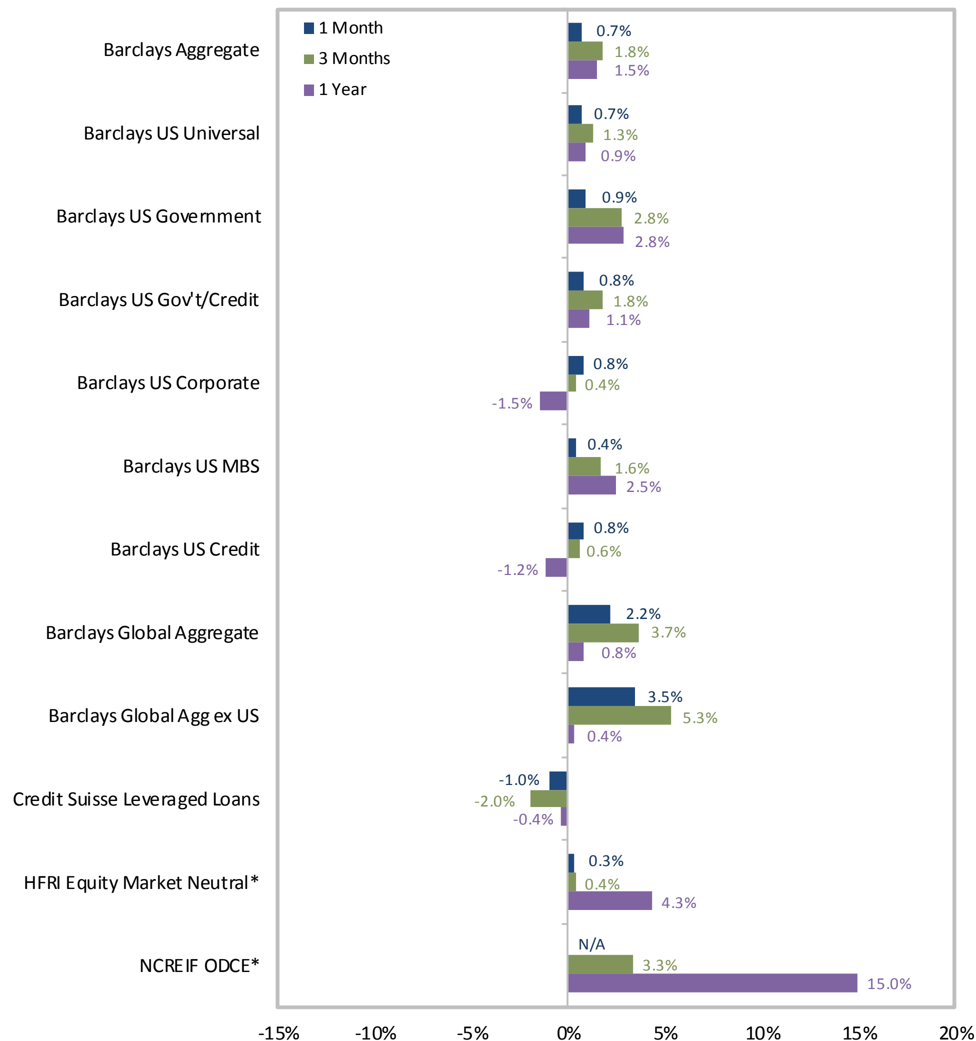
- Bank loans fell for the seventh straight month, as average prices fell below $90, the lowest level since June 2010. Retail outflows have continued unimpeded with zero counterbalance from CLO issuance, which stands at a fraction of the year-to-date level seen last year.

Relative Value Hedge Funds

- Equity market neutral strategies contributed, while fixed income-based strategies detracted. The largest losses were in convertible arbitrage and asset-backed strategies.

Core Real Estate

- Core real estate continued to perform well with a total return of 3.3% for the fourth quarter of 2015, as measured by the NCREIF ODCE Index. As a result, the 2015 calendar year return for the Index was 15.0%, the strongest year since the financial crisis for real estate. Supportive supply and demand fundamentals and continued economic growth have fueled strong returns in recent years.



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Diversification Assets

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Inflation

- TIPS returned 1.1% in February as real rates fell along with nominal US Treasury yields. Breakeven inflation expectations expanded in the short-end of the curve but remained stable past the 10-year point. As of the end of February, the breakeven inflation rate for the 10-year TIPS was 1.4%, up 2 bps for the month.

Deflation

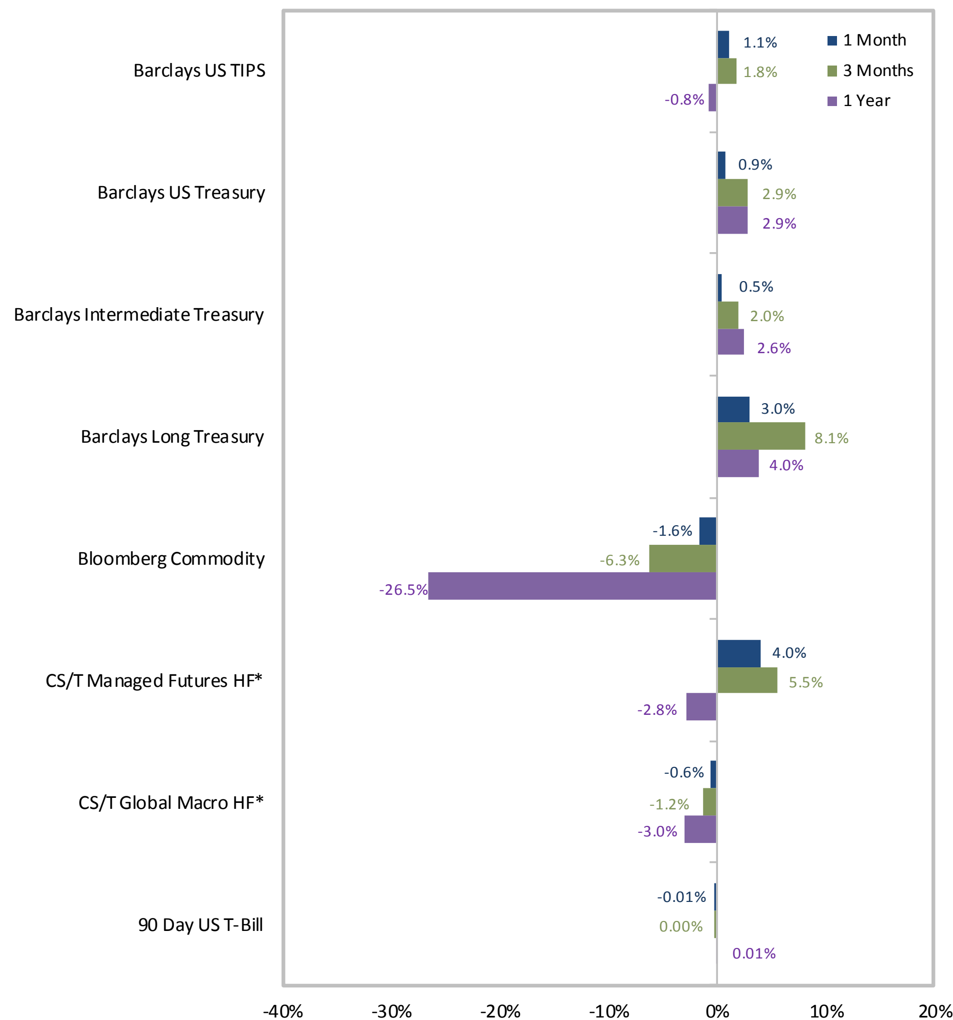
- Long Treasuries provided the downside protection investors have come to expect with yields falling 13 bps for the 30-year Treasury, helping push the Barclays Long Treasury Index return to 3.0% for the month. For the year the Index is up over 8%.
- Cash continues to offer no return, with 90-day T-Bills adding just 1 basis point over the past year.

Commodities

- Industrial (+3%) and precious (+9%) metals advanced in February as production cuts in several metals markets supported prices. Elevated expectations for Chinese industrial demand drove copper prices higher. Gold advanced 11% during the month on flight to quality trades and expectations of further accommodative monetary policy actions globally. The agriculture sector declined as advances in both livestock and softs were more than offset by declines in grains. The energy sector declined as WTI crude oil fell 7% during the month and Brent crude oil was down 1%. However, early steps to rebalance the oil market have begun, including evidence of global production declines and discussions of a production freeze between Russia and other OPEC nations. Natural gas declined sharply during the month (-26%) as inventories continued to build, US production continued to climb despite the low rig count, and mild winter conditions have reduced heating demand.

Tactical Trading

- Diversification hedge funds were positive in January, with CTAs posting strong gains. Discretionary global macro funds detracted modestly.



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