

RESEARCH REVIEW

OCTOBER 2017

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The U.S. economy appears to be gathering momentum, with two consecutive quarters of 3% or greater real GDP growth, continued improvement in many labor market measures, rebounding energy prices, and increasing inflation expectations, among others. Across the major asset categories, global equities continued to witness positive momentum through October, a theme also shared by below investment-grade credit. In real assets, energy infrastructure continued to struggle despite a rebound in energy prices.

Economic Update

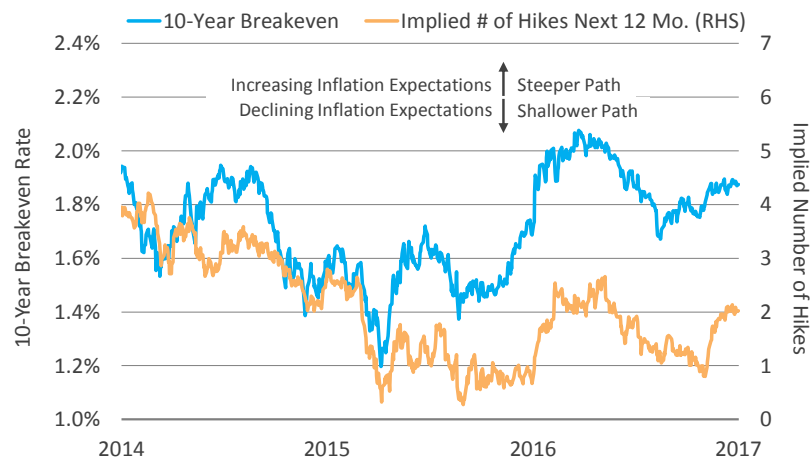
U.S. Economy Gathers Momentum

The U.S. economy suffered through a rough patch from early 2015 to late 2016 that was driven by a surging U.S. dollar, Chinese currency devaluations, and shifting central bank postures, among other headwinds. Since, many key economic factors have witnessed solid improvement. Inflation-adjusted GDP growth, for example, printed at 3.0% or higher for two consecutive quarters through the third quarter, propelling year-over-year growth to 2.3%, the strongest rate since third quarter 2015 (2.4%).¹ Additional positive signs include a rebound in monthly payrolls in October, a fresh low in the headline unemployment rate at 4.1%², rebounding inflation expectations, improving momentum in energy prices, and strong consumer sentiment.

Firming economic fundamentals—in particular inflationary expectations, which tend to be strongly correlated with oil price fluctuations—have helped to serve as a tailwind behind the expected path of Fed rate hikes over the coming 12 months. The Morgan Stanley *Market Implied Pace of Rate Hikes Index*, which uses pricing on eurodollar futures to generate an implied path of expected rate hikes in the coming year, concluded October at two expected hikes. This contrasts to the expectation of less than one rate hike reflected in early September data. Driven by a recent spike in crude oil prices, rebounding breakeven inflation expectations have likely served as a driving force behind the mounting sentiment for a steeper Fed tightening path over the coming quarters.

To conclude, the U.S. economy appears to have recently gathered steam, driven by firming economic fundamentals. This renewed strength has likely served as a tailwind behind the expected path of Fed rate hikes over the near term. In turn, anticipated rate hikes have the potential to truncate the ongoing business cycle expansion, which has lasted more than eight years as of this past summer—the third-longest business cycle expansion on record, according to National Bureau of Economic Research (NBER).

EXPECTED INFLATION AND IMPLIED PACE OF RATE HIKES



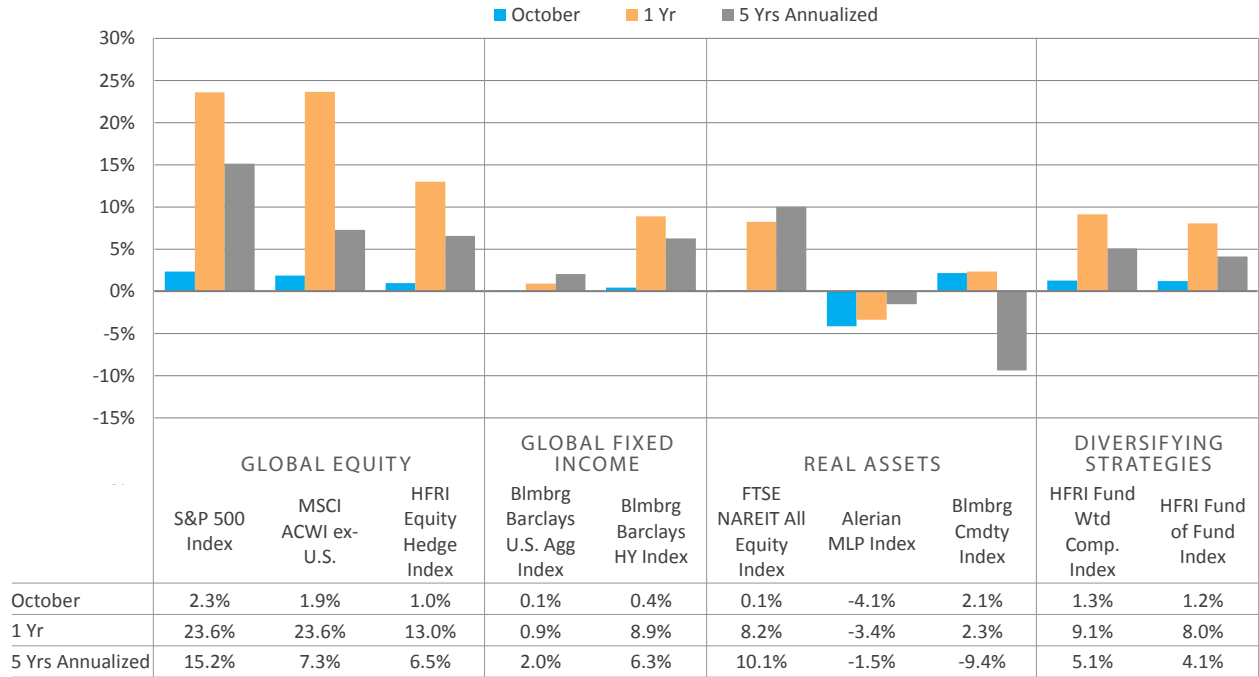
Data sources: Bloomberg, L.P., Morgan Stanley; Data as of 11/06/2017

¹ Bureau of Economic Analysis

² Bureau of Labor Statistics

Market Summary

OCTOBER 2017

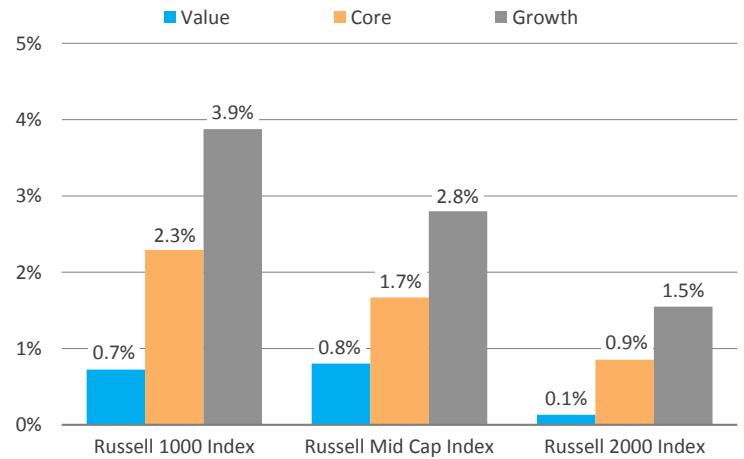


Data sources: Lipper, HedgeFund Research

Global Equity

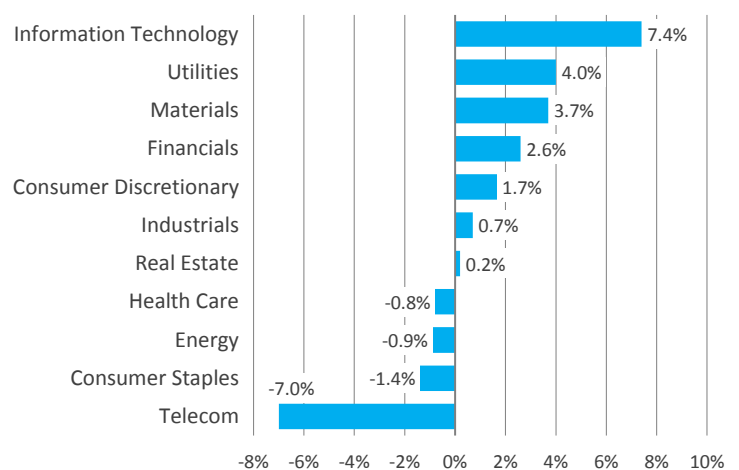
- U.S. equity returns were strong in October, driven by earnings growth. The market continued to seemingly ignore geopolitical risks, focusing instead on company earnings and potential fiscal and tax reform. Large cap stocks continued to outperform small cap stocks, reverting back from the brief small cap rally during the prior period.
- Strong returns in the technology sector helped growth continue to outperform against value. After the positive impact of hurricanes on energy prices in September, the energy sector lagged again in the month of October—in spite of rising oil prices—largely due to weaker reported earnings. Telecom stocks suffered from continued “cord-cutting” and a lack of demand for smartphone upgrades that harmed wireless carriers.
- International developed markets lagged emerging markets over the month, performing mostly in line with domestic markets. Global growth remained strong over the month, and the Bank of England signaled a positive outlook in the U.K. as they raised rates for the first time since 2007.
- Emerging and frontier markets had strong returns in October in spite of a strengthening dollar, as the region continued to outpace developed markets for the year. Asia, which comprises a significant weight in emerging markets indices, continues to be key driver of strength in the emerging markets. Taiwanese tech companies forecasted strong sales of semiconductors, and India benefited from government plans to spur growth.

OCTOBER RUSSELL INDICES PERFORMANCE



Data source: Russell

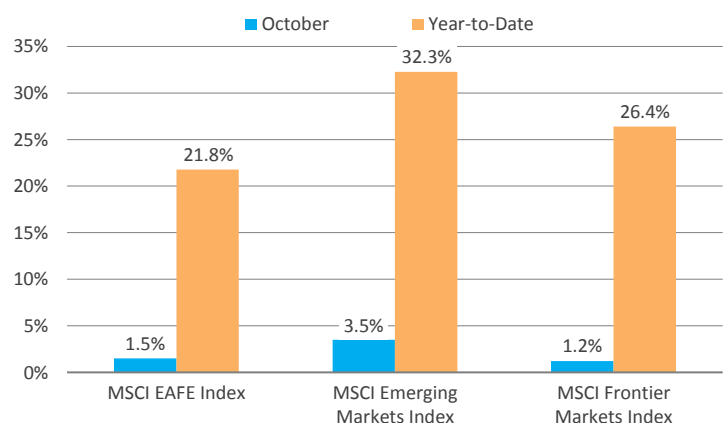
OCTOBER RUSSELL 3000 SECTOR PERFORMANCE



Data source: Russell

MSCI INDICES PERFORMANCE

Returns in U.S. Dollars



Data source: MSCI

Fixed Income

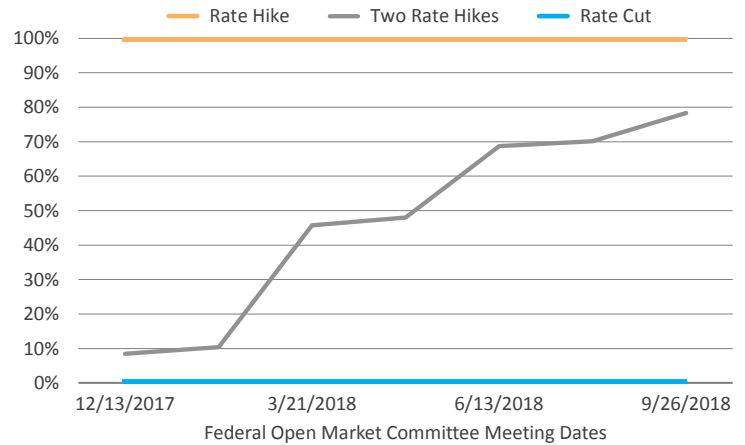
MARKET DRIVERS

- Markets anticipated that the Federal Reserve would continue to support gradual interest rate hikes and the gradual reduction of its balance sheet, with a market-implied 100% probability of a rate hike in December 2017.
- Jerome Powell, a former investment professional, was nominated to be the next Fed Chairman just after month-end. Expectations are that he will maintain viewpoints similar to those of the current Fed Chairwoman, Janet Yellen, although he may lean towards policies that favor less regulation.
- The European Central Bank’s plan to extend its bond buying program through September 2018 was a key factor that contributed to the euro falling against the dollar in October.
- The dollar strengthened amid continued signs of economic growth and rising rates in the U.S., contributing to dollar-denominated emerging market bonds outperforming those held in local currencies.

MARKET MOVEMENT

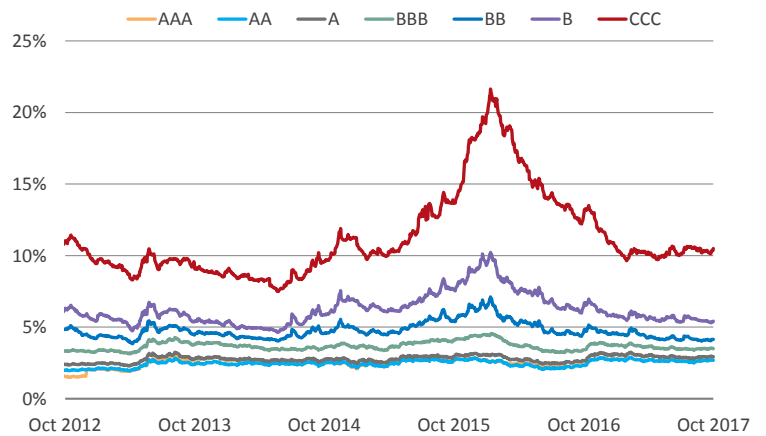
- The U.S. yield curve flattened slightly over the month of October, as the short end of the curve reflected the Fed’s intentions and continued to rise, while the long end remained relatively stable. Although a flat curve can be indicative of recessionary expectations, there remains ample steepness in the curve to quell any near term fears.
- Spreads of bonds with lower credit ratings, especially high yield bonds, have narrowed considerably. These compressed yields have fueled concerns that high-yield does not provide investors with adequate compensation for below investment-grade credit risk.

IMPLIED RATE HIKE PROBABILITY



Data source: CME Group

U.S. CORPORATE YIELD TO WORST PER CREDIT RATING



Data source: St. Louis Fed

Real Assets

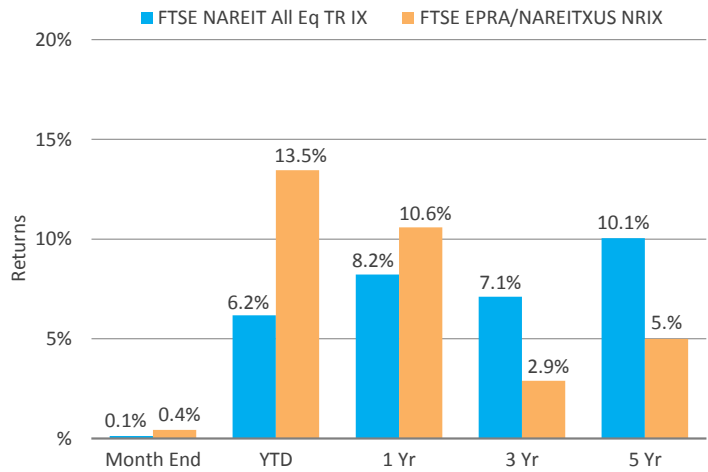
REAL ESTATE

- U.S. REITs were flat in October, but have posted positive single-digit returns year-to-date. Strength in the self-storage, hotel, and office sectors was offset by declines in the data center and infrastructure sectors during the month. Concerns about supply growth were a key factor in weaker performance for the month, as companies reported growing supply in multiple property types, specifically self-storage and data centers.

NATURAL RESOURCES

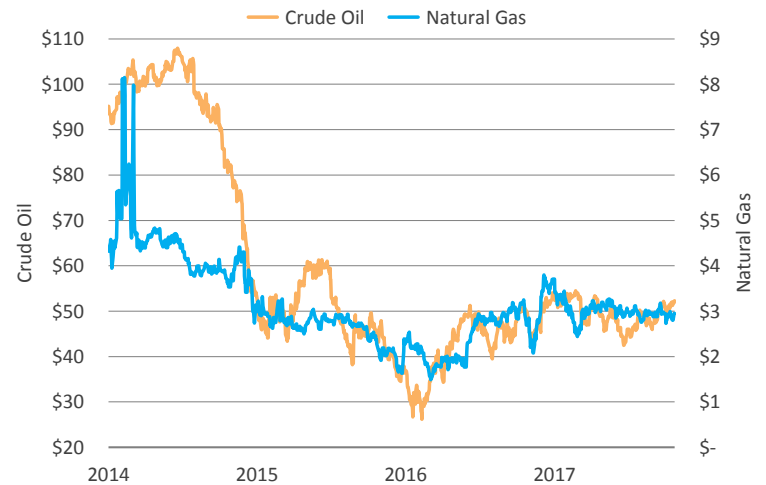
- Oil prices rose to their highest level in over two years by the end of October, driven by a combination of global economic expansion and continued declines in crude inventories. Since late August, sentiment in the oil market has improved significantly, as the supply/demand outlook continues to strengthen.
- Commodities gained approximately 2% during October, with energy, industrial metals, and livestock contributing to returns.¹ Gains in industrial metals—zinc, copper, and aluminum—were driven by demand exceeding supply by the largest margin in over a decade and potential future weakness in the dollar. Although agriculture remained a key area of weakness due to record-high inventories, livestock benefited from stronger exports.

DOMESTIC vs. INTERNATIONAL REIT RETURNS As of October 31, 2017



Data source: Bloomberg, L.P.

PRICE OF CRUDE OIL AND NATURAL GAS As of October 31, 2017



Data source: Energy Information Agency

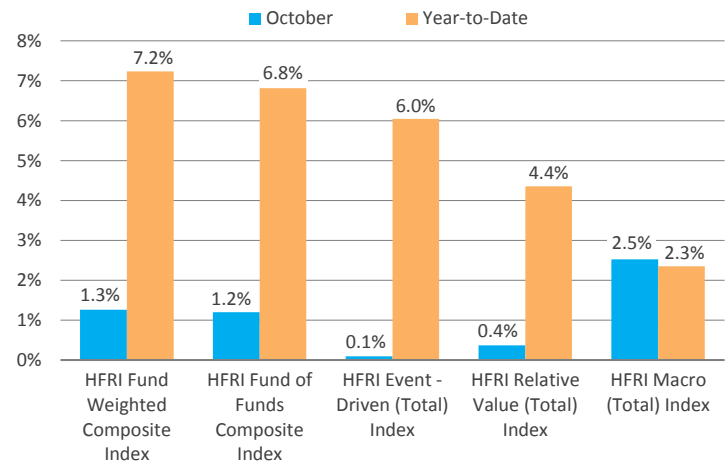
¹ Bloomberg, L.P.

Diversifying Strategies

- Systematic macro managers enjoyed a favorable trading environment, as many of the market trends that emerged late in the third quarter continued into October. Most notably, the U.S. dollar trend continued due to the acceleration of tax reform and stronger than expected U.S. economic data. Discretionary macro performance was more muted, as key policy announcements from the European Central Bank and the Federal Reserve were in line with market expectations.
- Certain event-driven strategies benefited from Caesars' emergence from bankruptcy. Caesars tends to be widely-held across event-driven managers, particularly those investing in corporate restructuring situations.

HFRI INDICES PERFORMANCE

Returns in U.S. Dollars



Data source: HedgeFund Research

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All data is as of October 31, 2017 unless otherwise noted.

INDICES

The Alerian MLP Index is a composite of the 50 most prominent energy Master Limited Partnerships that provides investors with an unbiased, comprehensive benchmark for this emerging asset class.

Barclays Capital Fixed Income Indices is an index family comprised of the Barclays Capital Aggregate Index, Government/Corporate Bond Index, Mortgage-Backed Securities Index, and Asset-Backed Securities Index, Municipal Index, High-Yield Index, and others designed to represent the broad fixed income markets and sectors within constraints of maturity and minimum outstanding par value. See <https://ecommerce.barcap.com/indices/index.xml> for more information.

The CBOE Volatility Index (VIX) is an up-to-the-minute market estimate of expected volatility that is calculated by using real-time S&P 500 Index option bid/ask quotes. The Index uses nearby and second nearby options with at least 8 days left to expiration and then weights them to yield a constant, 30-day measure of the expected volatility of the S&P 500 Index. FTSE Real Estate Indices (NAREIT Index and EPRA/NAREIT Index) includes only those companies that meet minimum size, liquidity and free float criteria as set forth by FTSE and is meant as a broad representation of publicly traded real estate securities. Relevant real estate activities are defined as the ownership, disposure, and development of income-producing real estate. See www.ftse.com/Indices for more information.

HFRI Monthly Indices (HFRI) are equally weighted performance indexes, compiled by Hedge Fund Research Inc. (HFX), and are used by numerous hedge fund managers as a benchmark for their own hedge funds. The HFRI are broken down into 37 different categories by strategy, including the HFRI Fund Weighted Composite, which accounts for over 2000 funds listed on the internal HFR Database. The HFRI Fund of Funds Composite Index is an equal weighted, net of fee, index composed of approximately 800 fund- of- funds which report to HFR. See www.hedgefundresearch.com for more information on index construction.

J.P. Morgan's Global Index Research group produces proprietary index products that track emerging markets, government debt, and corporate debt asset classes. Some of these indices include the JPMorgan Emerging Market Bond Plus Index, JPMorgan Emerging Market Local Plus Index, JPMorgan Global Bond Non-US Index and JPMorgan Global Bond Non-US Index. See www.jpmorgan.com for more information.

Merrill Lynch high yield indices measure the performance of securities that pay interest in cash and have a credit rating of below investment grade. Merrill Lynch uses a composite of Fitch Ratings, Moody's and Standard and Poor's credit ratings in selecting bonds for these indices. These ratings measure the risk that the bond issuer will fail to pay interest or to repay principal in full. See www.ml.com for more information.

Morgan Stanley Capital International – MSCI is a series of indices constructed by Morgan Stanley to help institutional investors benchmark their returns. There are a wide range of indices created by Morgan Stanley covering a multitude of developed and emerging economies and economic sectors. See www.morganstanley.com for more information.

Russell Investments rank U.S. common stocks from largest to smallest market capitalization at each annual reconstitution period (May 31). The primary Russell Indices are defined as follows: 1) the top 3,000 stocks become the Russell 3000 Index, 2) the largest 1,000 stocks become the Russell 1000 Index, 3) the smallest 800 stocks in the Russell 1000 Index become the Russell Midcap index, 4) the next 2,000 stocks become the Russell 2000 Index, 5) the smallest 1,000 in the Russell 2000 Index plus the next smallest 1,000 comprise the Russell Microcap Index. See www.russell.com for more information.

S&P 500 Index consists of 500 stocks chosen for market size, liquidity and industry group representation, among other factors by the S&P Index Committee, which is a team of analysts and economists at Standard and Poor's. The S&P 500 is a market-value weighted index, which means each stock's weight in the index is proportionate to its market value and is designed to be a leading indicator of U.S. equities, and meant to reflect the risk/return characteristics of the large cap universe. See www.standardandpoors.com for more information.

Information on any indices mentioned can be obtained either through your consultant or by written request to information@feg.com.

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Research and Investments Team as of date of publication.