

RESEARCH REVIEW

FOURTH QUARTER 2019

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The fourth quarter of 2019 brought broad-based gains across most major global asset classes and categories, punctuating an exceptionally strong calendar year that provided investors with handsome gains across nearly every corner of the global investment universe. Impressive performance throughout the year reversed the poor market performance in 2018, which, in contrast to 2019, included negative performance across most corners of the market observed by FEG. Critical to the market's gains in 2019 included three Federal Reserve (Fed) interest rate cuts and a resumption of balance sheet accommodation, a new asset purchase program by the European Central Bank (ECB), and a late-year Phase One trade deal between the U.S. and China. Broadly speaking, domestic assets relatively outperformed international assets through most of the year, with risk-on momentum failing to detract from the allure of fixed income—which experienced particularly strong performance, even in the face of historically-low interest rates. Real assets also participated in the market rally, particularly rate-sensitive REITs, while late-year seasonal pressures served as a headwind to energy infrastructure performance.



ECONOMIC UPDATE

Central Banks Take Action to Stem Growing Fundamental Headwinds

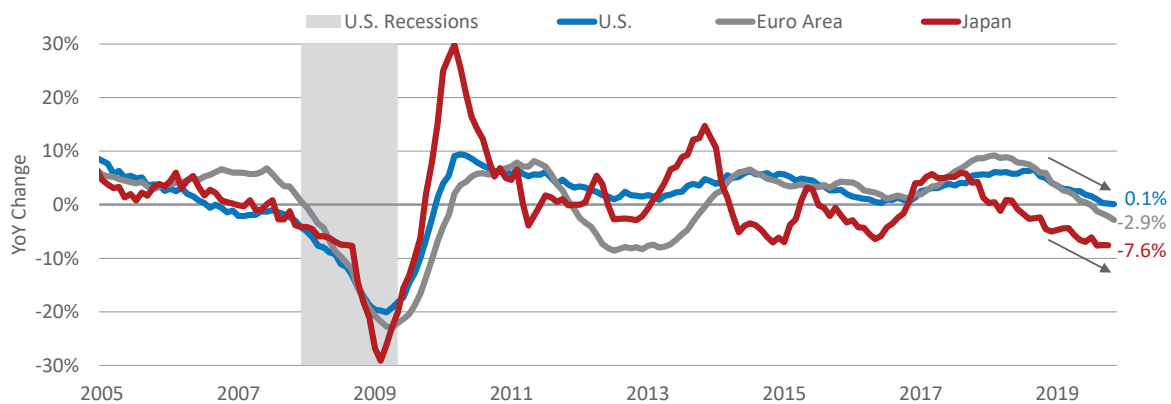
There was an abundance of market-moving events and themes in 2019, with notable examples including heightened global trade tensions between the U.S. and many of its key trading partners, particularly China, numerous inversions along the U.S. Treasury yield curve, mounting evidence of a global manufacturing recession, sharply declining global interest rates, geopolitical shocks in the already-volatile Middle East, the impeachment of President Trump by the House of Representatives, and numerous steps taken by global central banks intended to counterbalance global growth headwinds.

Despite a steepening “wall of worry,” most major areas of the global investment universe produced outsized performance for the year, highlighting the often-disconnected nature of economic data and market performance. Indeed, real GDP growth slowed meaningfully across both the U.S. and euro zone, with U.S. growth easing to 2.1% through the third quarter—the slowest growth rate since first quarter 2017—and euro zone growth cooling to 1.2%, its weakest pace in six years.

Japan was a particularly notable bright spot, with GDP growth accelerating to 1.7% through the third quarter despite the country’s Leading Economic Index (LEI) growth rate tumbling nearly 8% year-over-year through October, a post-global financial crisis low.

A number of factors on the near-term horizon have the potential to keep the current expansion on track, including the significant room for improvement in U.S.-China trade relations, the potential for fresh fiscal stimulus in 2020, the prospect for a return of synchronized global central bank balance sheet accommodation (QE), among other latent cycle-extending tailwinds.

GROWTH EXPECTATIONS DECLINING GLOBALLY
G-3 Leading Economic Index Growth



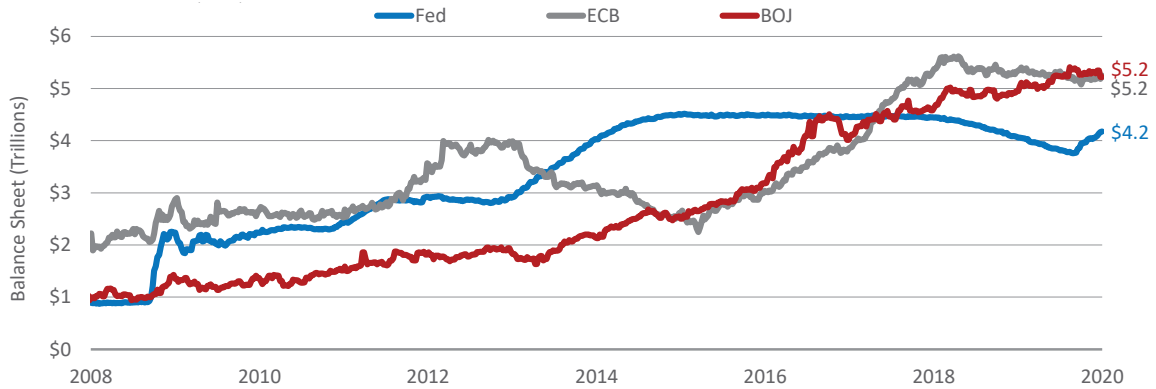
Data sources: Bloomberg, L.P., Conference Board Economic and Social Research Institute Japan; U.S. and Euro Area as of November 2019; Japan as of October 2019

The chart above highlights the growth headwinds facing policymakers in 2020, as these indices—as their names suggest—are designed to lead changes in the business cycle. Monetary authorities put forth a number of policy adjustments in 2019 that had the potential to reverse declining LEI growth rates, including three consecutive Fed interest rate cuts beginning in July, a resumption of Fed balance sheet expansion via the Treasury repo market, a lowering of the ECB’s deposit facility rate deeper into negative territory, and a fresh asset purchase program by the ECB beginning in November.

On October 11, the Fed announced it would begin purchasing T-Bills in order to replenish declining banking system reserve balances brought on by the previous quantitative tightening, which resulted in a more than \$700 billion reduction in the Fed’s balance sheet. Since last summer, the Fed’s balance sheet has increased by over \$400 billion.

In the eyes of the market, the combination of multiple Fed interest rate cuts and a material expansion in its balance sheet may be sufficient to keep the U.S. expansion on track, as both Fed funds and eurodollar futures have priced in just one potential 25 basis point Fed rate cut to begin in 2020. The means and scope by which the Fed seeks to cushion the U.S. economy during the next economic downturn, with a sub-2% federal funds rate and a balance sheet nearly 20% the size of the overall economy, may prove to be one of the most pivotal factors asset allocators face over the cyclical horizon.

THE FED'S BALANCE SHEET TURNS TO EXPANSION
G-3 Central Bank Balance Sheets (U.S. Dollars)

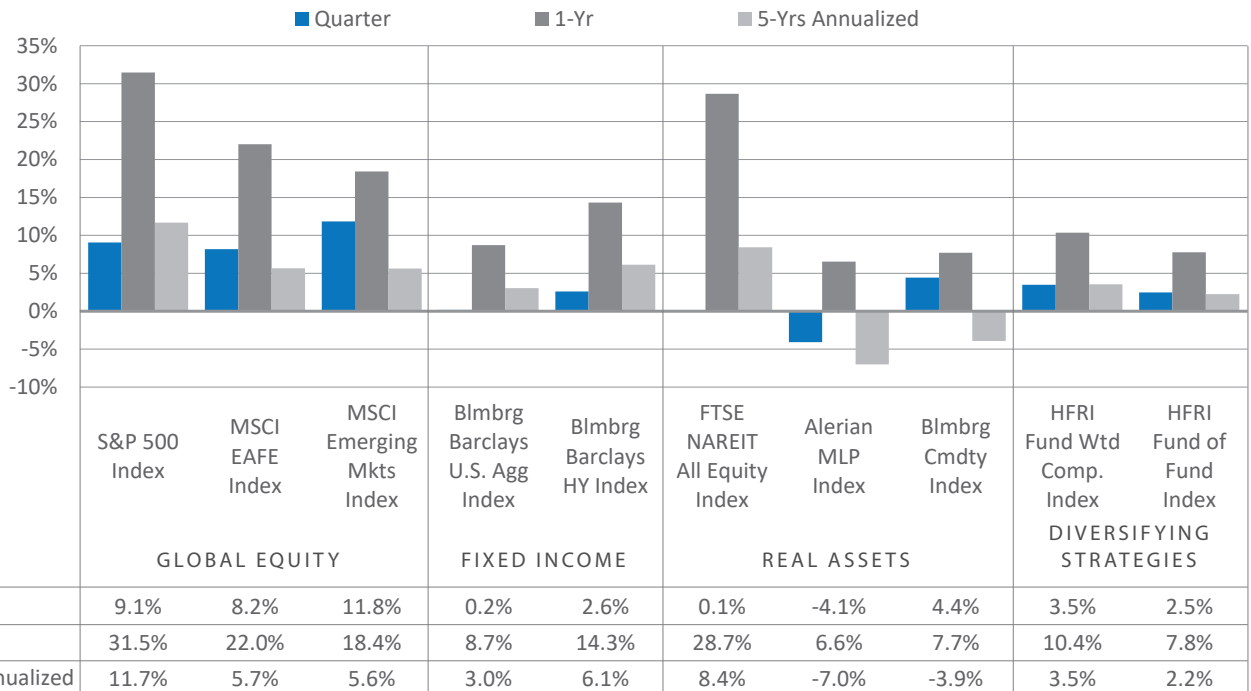


Data sources: Bloomberg, L.P.; FED, ECB, BOJ; Data as of January1, 2020

In summary, market performance across most major areas of the global investible universe was overwhelmingly positive in 2019 despite a weakening fundamental backdrop, particularly abroad. The return of stimulative monetary policy initiatives in the U.S. and euro zone was a crucial contributing factor that helped to explain the disconnect between strong market performance and a weakening economic backdrop, but it may have come at the expense of policymakers' ability to cushion their respective economies from future downturns.

MARKET RETURNS

FOURTH QUARTER 2019

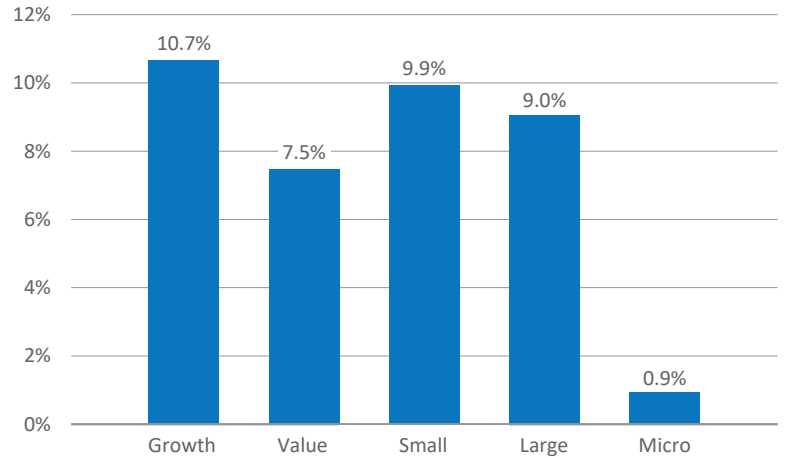


Data sources: Lipper, HedgeFund Research

GLOBAL EQUITY

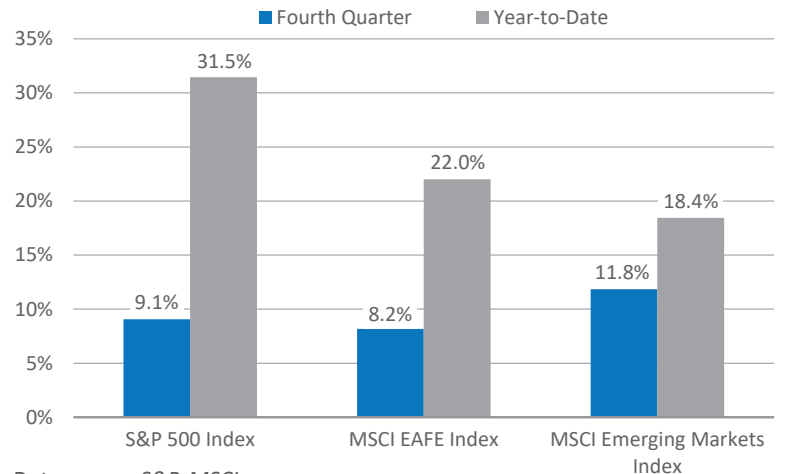
- Despite weakening economic growth, recession fears abated and the S&P 500 Index closed the year with a 31.5% return—the second-highest calendar-year return of the decade for the index. Moreover, the S&P 500 Index set 34 new record highs throughout the year.
- Growth stocks continued to outpace value stocks; however, there was a reversal in the market cap trend prevalent for most of the year resulting in small cap stocks finally outperforming large cap stocks.
- All sectors in the U.S. market had positive returns. Healthcare was the strongest sector, as the House passed a bill to lower drug prices in December and Elizabeth Warren’s poll numbers declined. Technology stocks also performed extraordinarily well amid a softening of trade tensions.
- Performance in Europe was driven not only by new strength in manufacturing and service sector surveys and the avoidance of U.S. imposing tariffs on EU autos, but also by secondary benefits of the Phase One trade deal between the U.S. and China.
- The British pound rallied strongly after Boris Johnson’s election, providing strong returns to U.S.-based investors. The UK market in local terms was weak, due in part to seemingly never-ending Brexit concerns. An announcement was made in December that there would not be an extension to the transition period beyond 2020, which applied pressure to the UK government to agree to a free trade deal with the EU.
- Japanese equities performed well in conjunction with the upward revision to the nation’s real GDP to 1.7%, a level not witnessed since 2017.
- Emerging market stocks, led by Asia, was the top-performing market across the globe in U.S. dollar terms. The announcement of Phase One of the trade deal with the U.S. relieved tension in the Chinese markets.

GROWTH AND SMALL LED VALUE AND LARGE U.S. Style Returns (Fourth Quarter 2019)



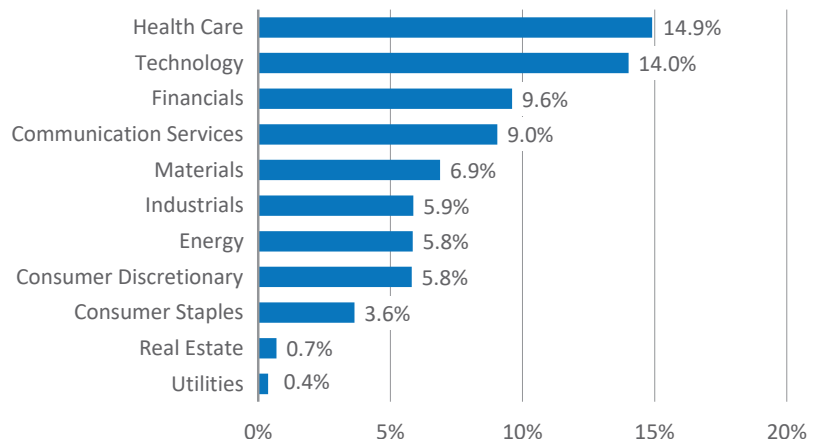
Data source: FTSE Russell

EMERGING RALLIED MOST WITH DECLINING TRADE TENSIONS Equity Indices Performance (Returns in U.S. Dollars)



Data source: S&P, MSCI

HEALTHCARE AND TECHNOLOGY OUTPACED OTHER SECTORS

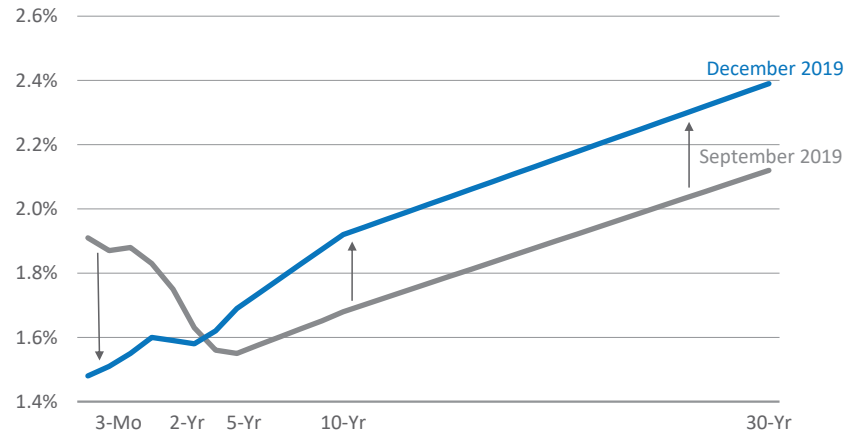


Data source: Russell

FIXED INCOME

- The Fed chose to leave rates unchanged at its December meeting after cutting rates three consecutive times from July to October 2019, as U.S. economic data surprised to the upside. The updated “dot plot” at the end of the year showed a downward trend in Fed members’ expectations of future rates, indicating an additional cut is more likely than a rate hike in coming months.
- In a reversal from the third quarter, rates moved moderately higher in the fourth quarter of 2019, with the 10-year Treasury hanging near 2%. However, early January 2020 saw rates dip once more, as safe-haven assets rallied with the sudden increase in U.S.-Iran tensions.
- During the fourth quarter, lower quality credits largely outperformed their higher quality peers. BBB-rated credits outperformed not only higher quality investment-grade securities, but also high yield credits.
- Repo markets remained benign through the remainder of 2019 despite concerns that a cash crunch at the end of the year could cause a spike in short-term rates similar to that witnessed in September 2019.
- Globally, negative yielding debt steadily decreased from its peak of nearly \$14 trillion in summer 2019, to just above \$10 trillion at the end of the year.
- China saw an uptick in default activity throughout 2019. The record number of defaults over the year began to spark investor concern regarding state support of Chinese companies.

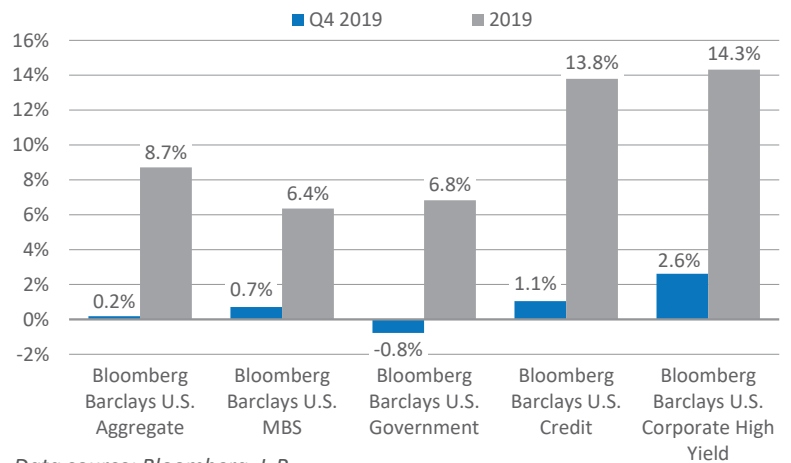
THE U.S. YIELD CURVE RE-STEEPENED IN THE FOURTH QUARTER



Data sources: Barclays, Bloomberg, L.P.

2019 WAS A GREAT YEAR FOR BONDS

Bond Indices Performance



Data source: Bloomberg, L.P.

REAL ASSETS

REAL ESTATE

- U.S. REITs closed the year with substantially positive returns due to continued macro economic support, including economic growth, low unemployment, and lower interest rates across longer duration Treasuries.
- Regional malls were the only subsector to finish the year with negative returns due to the ongoing wave of retail bankruptcies, as consumers shop more online. Other retail sectors—i.e., entertainment, fitness, and grocery—performed relatively well over the year, partly due to more diversified tenant profiles.
- Global REITs closed the fourth quarter outperforming their U.S. peers, as U.S. REITs saw valuations relative to other asset classes move towards parity.

NATURAL RESOURCES

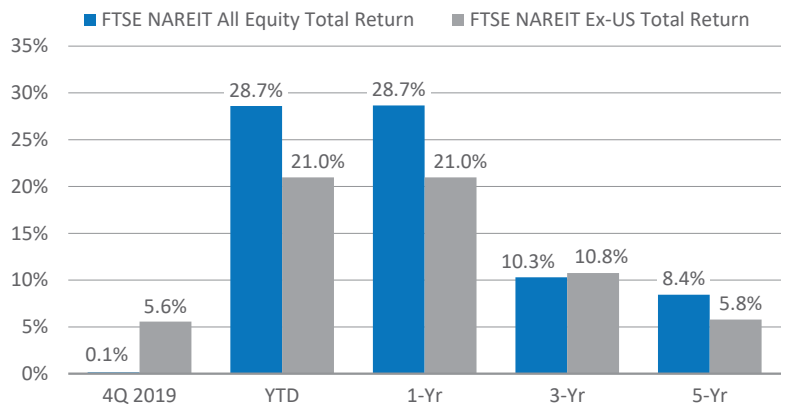
- Crude prices saw a modest increase, closing at \$61.06/BBL for a 1-Month contract, breaching the \$60 level for the first time since the first half of 2019. Oil pricing benefited from a tightening supply, declining imports, and an announcement of further OPEC production cuts starting in 2020.
- Weakness persisted, however, in natural gas, which faced declines throughout 2019 except for a brief upward spike in the fall.

MASTER LIMITED PARTNERSHIPS (MLPs)

- MLPs rallied in December with an 8.5% return to soften the quarterly decline and bringing year-to-date gains to 6.6%. The Alerian Midstream Index, which includes midstream C-corps, ended the quarter with positive returns bringing year-to-date returns to 24%, supported by stronger performance among C-corps constituents relative to their MLP peers.
- The MLP index has faced significant technical headwinds due to diminished fund flows over 2019. By the end of November, fund flows totaled \$140 million, compared to nearly \$6 billion in inflows for midstream energy two years prior. This has also driven a wedge between MLP and C-corp performance, as C-corps are eligible for wider inclusion in benchmarks.

REITs COULD NOT MAINTAIN THEIR STRONG 2019 PACE IN Q4

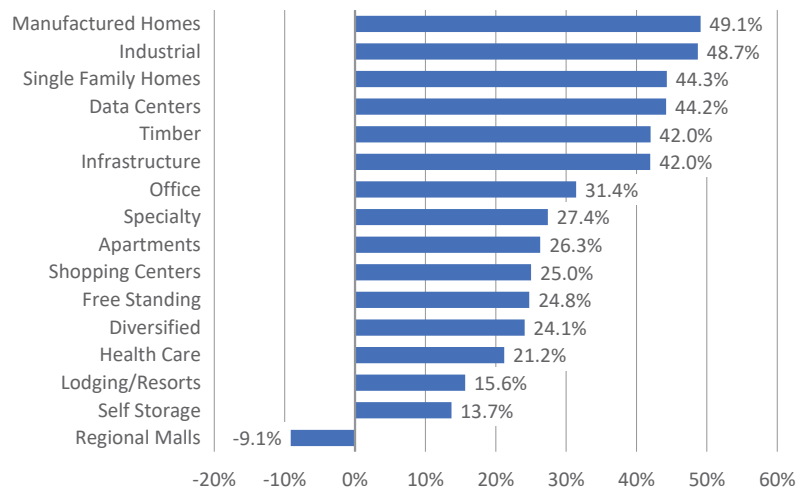
Domestic vs. International REIT Returns



Data source: NAREIT; Data as of December 31, 2019

SIX REIT SECTORS RETURNED OVER 40% FOR 2019

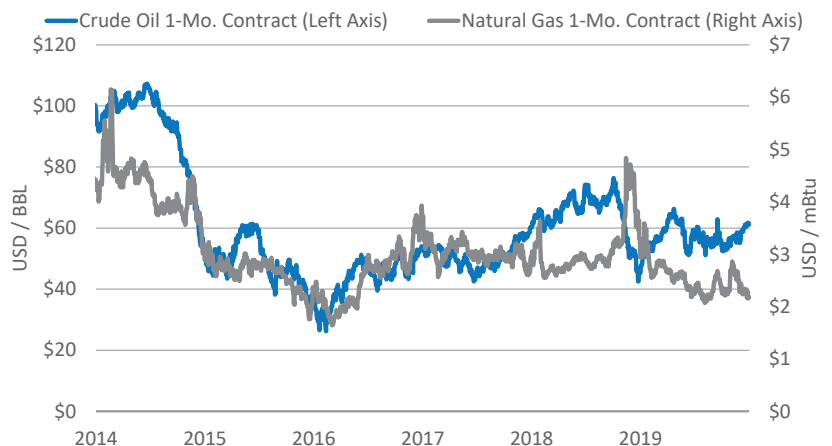
NAREIT Subsector YTD Returns



Data source: NAREIT; Data as of December 30, 2019

OIL BROKE THROUGH THE \$60 BARRIER

Crude Oil and Natural Gas One-Month Future Prices

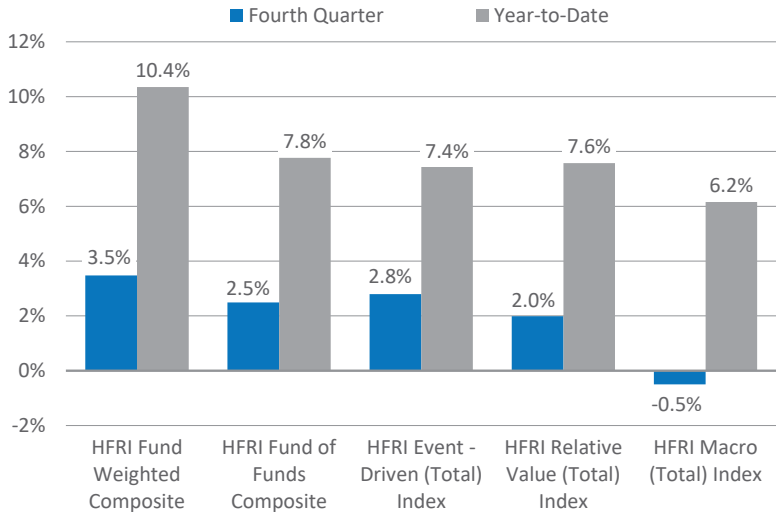


Data source: U.S. Energy Information Associates

DIVERSIFYING STRATEGIES

- Hedge funds finished 2019 on a high note marking the strongest performance year since 2009, the year in which markets were recovering from the global financial crisis. Nearly all strategies and sub-strategies posted gains in the quarter and for the year.
- Event-driven equity strategies benefited from progression across several catalysts. The special situations and activist-oriented sub-indices were the leading drivers within the broader event index.
- Returns for global macro strategies, while mostly positive, were the least profitable in the quarter and throughout the year. Discretionary managers tended to fare better than their systematic counterparts. Emerging market exposure was a key driver of that delta to the upside for discretionary managers.

HEDGE FUNDS BEST YEAR IN A DECADE HFRI Indices Performance (Returns in U.S. Dollars)



Data source: HedgeFund Research

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.dxml> 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. (HFR), 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-U.S. Index and JPMorgan Global Bond Non-U.S. 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.

The FTSE Nareit All Equity REITs Index is a free-float adjusted, market capitalization-weighted index of U.S. equity REITs.

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, and 6) U.S. Equity REITs comprise the FTSE Nareit All Equity REIT 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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All data is as of December 31, 2019 unless otherwise noted.

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Research and Investments Team as of date of publication.