**Asset Class Reviews**

**September 2015**

**PRIM Investment Team**

*This document focuses on the macroeconomic outlook, valuation, sentiment, and momentum of the public markets asset classes on a quarterly basis. Each asset class is assigned a rating which represents the recommendations of the Public Markets team.*

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| **SUMMARY OF VIEWS** | **Negative** | **Negative to Neutral** | **Neutral** | **Neutral to Positive** | **Positive** | **Change** |
| **U.S. Large Cap Equities** |  |  | o |  |  |  |
| **U.S. Small Cap Equities** |  |  | o |  |  | ↓ |
| **Developed Non-U.S. Equities** |  |  |  | o |  |  |
| **Emerging Markets Equity** |  |  | o |  |  | ↓ |
| **Rates** |  |  | o |  |  | ↑ |
| **Spreads** |  | o |  |  |  | ↓ |
| Investment Grade |  | o |  |  |  |  |
| High Yield | o |  |  |  |  | ↓ |
| Bank Loans |  | o |  |  |  |  |
| EMD $ |  | o |  |  |  | ↑ |
| EMD Local |  | o |  |  |  | ↑ |

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| Equities – Key Takeaways |
| U.S. Large Cap Equities:   * Federal Reserve decided to keep rates unchanged. * Consumer Confidence climbed to 103.0 in September as unemployment fell to 5.1%.   U.S. Small Cap Equities:   * Russell 2000 P/E (NTM) was 23.2x (1.3 standard deviations above 5-yr average of 19.6). * SMID Cap equities earnings growth at 14.7% vs. 21.5% one year ago.   Developed Non-U.S. Equities:   * Real GDP growth in the Eurozone rose to 1.7% in 3Q15 vs. 1.5% in 2Q15. * Weak demand in China hurts Japanese exporters.   Emerging Markets Equity:   * Surprise devaluation of the Chinese Yuan in August sent EM markets reeling. * Brazilian President Rousseff implicated in corruption scandal. S&P downgrades Brazilian debt to junk. |

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| Fixed Income – Key Takeaways |
| Rates & Spreads:   * Front end rates are above their 5yr averages while long end rates remain lower than average. * All spread sectors have widened on the quarter and are wider than their 5yr averages * Fed’s reluctance to raise rates in September indicates that US economy is not on a self-sustained path to recovery. * For this reason we remain caution on spread sectors despite their valuations. |

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| Public Equities |  |  | $24.5 bn / 41.8% of Fund |

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| U.S. Large Cap Equities | NEUTRAL |  | $8.7 bn / 14.8% of Fund |

Market Data & Indicators

1. Macro:  **NEUTRAL to POSITIVE**

* U.S. Large Cap Equities fell -6.4% in 3Q15 as investors reacted to events in China.
* Despite recent rhetoric that a rate move is warranted, the Federal Reserve decided to keep rates unchanged at their September meeting.
* US Gross Domestic Product was revised to 3.9%, up from the previous estimate of 3.7% in 2Q15 in the Commerce Department’s final assessment.
* WTI fell -23.9% during 3Q15 ($48.4 a barrel vs. $63.6 in 2Q15) in response to weak demand from China. Also, producers in the Middle East continued to pump despite the growing global supply glut.
* Unemployment continued its fall toward historic lows in 3Q15 at 5.1% vs. 5.3% in 2Q15, however, wage growth and jobs added fell below economist’ expectations.
* U.S. manufacturing expanded at a slower pace in September: The US Purchasing Managers Index (PMI) fell to 50.2 vs. 53.5 in June.
* The U.S. Dollar Index appreciated +0.8% in 3Q15 and still remains relatively strong, up 12.1% over the last year.
* Risks for US economy:
  + Major slowdown in China and Emerging Markets reduces global demand.

1. Valuation: **NEUTRAL** **to** **NEGATIVE**

* SP500 P/E (NTM) cheapened in 3Q15 at 15.1x but remain above the 14.0x 5yr average (0.6 standard deviations above average). This compares to P/E of 16.4x on 6/30/2015.
* SP500 profit margins remain elevated at 10.6% vs. 10.1% 5yr average (1.3 standard deviations above the average).
* SP500 earnings growth (NTM) continues to rebound from record lows in 1Q15: 7.2% vs. 10.0% 5yr average (-0.9 standard deviations below the average). SP500 earnings growth (NTM) was at 4.3% on 3/31/2015.
* Price-to-Book at 2.4x remained above the 2.2x 5yr average (0.7 standard deviations above the average)

1. Sentiment: **NEUTRAL**

* We view low volatility and high consumer confidence as contrarian indicators.
* Volatility spiked in 3Q15 as the VIX closed September at 24.5 vs. a 5yr average of 17.9. The highest month-end reading since November 30, 2011.
* Consumer Confidence climbed to 103.0 in September, up from 99.8 at the end of 2Q15. (1.8 standard deviations above the 5yr average of 74.7).

1. Momentum: **NEGATIVE**

* S&P 500:
  + All measures of Momentum are negative; the 50DMA, 200DMA and the 200DMA-50DMA.
  + The 50DMA crossed the 200DMA in a “death cross” on August 24.

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| U.S. Small Cap Equities | NEUTRAL |  | $2.3 bn / 3.9% of Fund |

Market Data & Indicators

1. Macro: **NEUTRAL to POSITIVE**

* See Macro comments from US Large Cap Equities above.
* Small Cap investors are optimistic the Fed will raise interest rates at a slow and measured pace.
* With the exception that Small Caps are relatively more insulated than Large Caps from a strong dollar.
* The US economy is likely in the mid-to-late cycle of its business cycle, which can last for an extended period (M&A pickup, profit growth peaking, credit growth strong, monetary policy still stimulative but slowing).
* Small caps are particularly sensitive to two factors:
  + Level of interest rates and cost of financing.
  + Strength of US consumer.

1. Valuation: **NEUTRAL**

* Russell 2000 P/E (NTM) was 23.2x vs. 26.4x at the end of last quarter (1.3 standard deviations above 5-yr average of 19.6).
* US Small Cap profit margins fell to 4.10% vs. 4.22% in 2Q15, below the historical average of 4.6% (-2.3 standard deviations below average).
* Expected earnings growth rose to 26.2% vs. 21.9% in 2Q15 and is approaching the historical 5-yr average of 29.2 (-0.5 standard deviations below the mean).
* SMID Cap equities have witnessed their expected earnings growth (NTM) drop significantly, 14.7% vs. 21.5% one year ago.

1. Sentiment: **NEUTRAL** **to** **NEGATIVE**

* We view low volatility and high consumer confidence as contrarian indicators.
* Volatility spiked in 3Q15 as the VIX closed September at 24.5 vs. a 5yr average of 17.9. The highest month-end reading since November 30, 2011.
* Consumer Confidence climbed to 103.0 in September, up from 99.8 at the end of 2Q15. (1.8 standard deviations above the 5yr average of 74.7).

1. Momentum: **NEGATIVE**

* Russell 2000:
  + All measures of Momentum are negative; the 50DMA, 200DMA and the 200DMA-50DMA.
  + The 50DMA crossed the 200DMA in a “death cross” on August 24.

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| Developed Non-U.S. Equities | NEUTRAL to POSITIVE |  | $9.6 bn / 16.3% of Fund |

Market Data & Indicators

1. Macro: **NEUTRAL to** **POSITIVE**

* Eurozone outlook positive:
  + European Central Bank quantitative easing program is supportive of markets.
  + Real GDP growth in the Eurozone rose to 1.7% in 3Q15 vs. 1.5% in 2Q15.
  + The Euro remained flat for the quarter at 1.12 as of 9/30/2015.
  + The weak Euro has boosted recovery expectations in Europe for 2015.
  + Unemployment remains high at 11.0%, but steadily dropping from 12.1% two years ago.
* Japan mixed:
  + Japanese markets were down -11.7% in USD terms in Q3.
  + Weak demand in China hurts Japanese exporters.
  + Japanese markets benefit from its nation’s corporate governance policies, Abenomics pro-shareholder agenda, and a weaker yen (-2.1% in Q3).

1. Valuation: **NEUTRAL to** **POSITIVE**

* MSCI World Ex-US P/E (NTM) fell to 13.8x vs. 15.2 in 2Q15, approaching the 5yr average of 12.9x, (0.5 standard deviations).
* Earnings growth (NTM) weakened in 3Q15: 7.8% vs. 8.1% in 2Q15 (-1.3 standard deviations below the mean of 12%).
* Net margins in Europe at 7.6% are above the 5-yr average of 7.4%, but well below the US at 10.6%, leaving room for margin expansion, especially considering the weak Euro.
* Japanese net margins remain relatively high at 5.6% vs. 4.3% 5-yr average (2.0 standard deviations above the mean)

1. Sentiment: **NEUTRAL**

* European markets remain volatile as the Euro Stoxx 50 Volatility closed 3Q15 at 32.0, unchanged from last quarter.
* Consumer confidence in the Eurozone rose to 105.6 vs. 103.5 last quarter, well above the 5-year average of 98.5.

1. Momentum: **NEGATIVE**

* MSCI World ex US:
  + All measures of Momentum are negative; the 50DMA, 200DMA and the 200DMA-50DMA.
  + The 50DMA crossed the 200DMA in a “death cross” on August 24.

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| Emerging Market Equities | NEUTRAL |  | $4.0 bn / 6.8% of Fund |

Market Data & Indicators

1. Macro: **NEGATIVE**

* Emerging markets fell -17.8% in Q3, underperforming Developed Markets (EAFE), down -10.2%, by 7.6%.
* Chinese equities fell steadily through Q3, down -22.7%.
* Surprise devaluation of the Chinese Yuan in August sent global markets reeling.
* Relatively low oil prices are generally positive for the Emerging Markets. The majority of EM countries are oil importers, for example India.
* Two notable exceptions are Russia and Brazil, both of which are large exporters of oil and materials. Weak oil and commodity prices are a major negative for these two countries.
* Brazil had a particularly tough quarter, down -33.6%. The corruption scandal in Brazil has snowballed to include high level political leaders, including President Dilma Rousseff.
* In September, the S&P downgraded Brazil’s sovereign debt to junk.

1. Valuation: **NEUTRAL to POSITIVE**

* MSCI EM appears close to fairly valued with P/E (NTM) at 10.7x (0.1 standard deviations above its 5-year average of 10.6). The MSCI EM P/E is well below the S&P 500 P/E at 15.1x and the MSCI World Ex-US P/E of 13.8x.
* Projected earnings growth (NTM) at 10.1% is similar to growth estimates for EM in 2014. This compares to growth estimates (NTM) for the S&P 500 of 7.2% and the MSCI World Ex-US of 7.8%.

1. Sentiment: **POSITIVE**

* Volatility rose in Q3. The VXEEM (CBOE Emerging Markets ETF Volatility Index) closed 3Q15 at 34.0 vs. 21.4 in 2Q15 and the 5yr average of 24.9 (1.0 standard deviations above the mean). On August 24, the VXEEM spiked to 56.1, the highest reading since November 2011.

1. Momentum: **NEGATIVE**

* MSCI Emerging Markets:
  + All measures of Momentum are negative; the 50DMA, 200DMA and the 200DMA-50DMA.
  + The 50DMA crossed the 200DMA in a “death cross” on August 24.

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| Public Markets Fixed Income NEUTRAL |  |  | $13.0 bn / 22.2% of Fund |

Market Data & Indicators

1. Rates: **Neutral**

* Curve steepened in 3Q15.
  + 10’s-30s is 5 bps steeper in 3Q15 and 11 bps flatter in last twelve months.
  + 2’s-10’s is 30 bps flatter in 3Q15 and 52 bps flatter in last twelve months.
* Curves are flatter than their 5yr averages
  + 10’s-30s is 82 bps vs 100 5yr avg.
  + 2’s-10’s is 141 bps vs 191 5yr avg.
* Mixed economic data have driven investor speculation that the Federal Reserve may raise interest rates later than expected.
* Rates have recently reversed rising trend from beginning of the year.
* Unemployment has improved to 5.1% in September but wage growth and participation rates may continue to provide cover from pending Fed rate hikes.
* Market expectation of inflation as measured by TIPS 5yr5yr forward inflation is 1.73%. This is:
  + 46 bps below year end.
  + Below the Fed’s target of 2.0%.
  + Below the 5yr average of 2.5%
* The Fed elected to maintain its zero interest rate policy at its September meeting. As of quarter end market expectations of Fed months were at 16% for October, 415 for December and 48% for January.
* Correlation benefit of STRIPS remains negative

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| Date | 30 Day (avg. = -30.3%) | 60 Day (avg. = -30.9%) | 90 Day (avg. = -31.0%) |
| 9/30/15 | -45.7% | -43.1% | -43.9% |
| 6/30/15 | -59.6% | -36.5% | -22.5% |
| 3/31/15 | 15.4% | -28.0% | -38.9% |
| 12/31/14 | -54.3% | -46.0% | -42.0% |
| 9/30/14 | -20.3% | -23.0% | -27.8% |

* Rates have rallied from mid-year peaks while the Fed has remained patient.
* Concerns around the impact of growth in China have contributed to the recent rally in rates.

Spreads: **Negative to NEUTRAL**

* Credit spreads in Investment Grade, High Yield and Bank Loans were all wider during the quarter and wider from a year ago.
* Investment grade credit 160 bps over UST (107 bps one year ago and 140 5yr average).
* HY credit 662 bps over UST (440 bps one year ago and 525 5yr average).
  + Z Scores for credit spreads were 0.7 (IG) and 1.3 (HY).
  + Spread between IG and HY is 502 vs. 385 5yr avg. (1.5 z-score).
* Bank loans spreads are at 547 (vs. 493 10yr average).
* EMD $ spreads 463 vs. 381 at the end of Q2.
  + 5yr average is 334
  + Z Score = 2.5
* EMD Local spread over 5yr TSY is 573 vs 515 at the end of Q2.
  + 5yr average is 513
  + Z Score is 1.9
* Valuations have cheapened across all spread assets.

1. Sentiment: **Negative to NEUTRAL**

* Momentum:
  + 200 DMA, 50 DMA and 50D MA – 200 DMA are all negative indicating momentum factors favor higher spreads.
* Spread Volatility in HY has picked up
  + Daily spread volatility of HY index was 41bps in 3Q15 after falling to a low of 12bps in 2Q15.
* Liquidity conditions, as measured by the spread between 3M LIBOR and 3M T-Bills, have widened slightly but are still at historically low levels.
  + 33bps as of September 30th. Six bps wider than previous quarter end
  + 5yr avg = 26 bps
  + Z Score = 0.8
  + Continuation of positive liquidity conditions as provided by the Fed may support risk assets.
* Volatility has increased. MOVE Index: 81.6 vs 92.3 previous quarter end
  + 77.1 5yr avg.
  + Z Score = 0.3