Callan

Market Environment

Third Quarter 2014

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GRACE LEGACY CAPITAL

Market Environment 3Q14: U.S. Economy

The U.S. economy continued to improve with 2nd quarter GDP revised upward to an annualized 4.6% while conditions in Europe and Japan worsened. GDP in the euro zone was flat during the 2nd quarter, largely due to a decline in Germany's output. Japan's GDP shrank 7.1% (annualized) in the 2nd quarter in the wake of an increase in the sales tax from 5% to 8%.

- 2nd quarter real GDP revised sharply upward
  - 2Q real GDP revised to +4.6% (annualized) and is up 2.6% year-over-year
  - This figure represents a big uptick following the cold weather induced -2.1% result in Q1
- Vehicle sales strongest since January 2006
  - Car sales jumped 5.5% in August as automaker incentives interacted with a stronger economy and rising consumer confidence
  - Light truck sales surged 7.2% in August to their highest level since December 2005
- 2nd quarter profits rise
  - Corporate profits up 8.4% in 2nd quarter, most since 2010
  - August retail sales strongest in 4 months
- Housing more mixed
  - S&P/Case-Shiller composite index of 20 metropolitan areas gained 6.7% in July (year-over-year), below expectations for a 7.3% rise
  - Home prices are still rising, though at a slower rate than what we have seen over the past couple of years
- Labor market improves
  - Unemployment rate 6.1% in August, lowest since 2008
  - Labor force participation rate equaled its cycle low of 62.8%, its lowest level since early 1978
- Inflation remains benign
  - Core and headline CPI +1.7% year-over-year as of August
  - While CPI readings are slightly below the Fed's target of 2%, deflation risks in the U.S. do not appear to be a concern
  - Meanwhile, euro zone inflation fell to 0.3% in September, the lowest rate since 2009 and well below target

Market Environment 3Q14: Fixed Income

An improving U.S. economy put upward pressure on rates, but a significant yield advantage relative to other developed markets helped to dampen this effect. While the U.S. economy gained traction, news from Europe and Japan was far bleaker with euro zone GDP barely positive in the 2nd quarter versus a +4.6% print in the U.S. Foreign investors were lured to the relatively high yields in the U.S. market, propelling the dollar sharply higher. U.S. Treasuries offered a 57 bp premium over German bunds as of quarter-end, a 15-year high, as investors weighed the prospects of U.S. interest rate hikes against the likelihood of more accommodative policy in the euro zone.

- The Barclays Aggregate Index returned 0.2% and is up 4.1% YTD, a result that has exceeded most expectations for full year returns in 2014
  - The yield curve continued to flatten with the 30-year U.S. Treasury yield dropping 13 bps and the 5-year U.S. Treasury rising 16 bps
  - The yield on the 10-year U.S. Treasury closed at 2.52% and traded in a relatively narrow range throughout the quarter
  - Agency mortgage-backed securities and corporate bonds underperformed like-duration U.S. Treasuries
- High yield underperformed investment grade as the sector was hit by outflows
  - The Barclays High Yield index returned -1.9% with the corporate sector of the Barclays Aggregate down 0.1%
- TIPS underperformed nominal U.S. Treasuries
  - Barclays TIPS Index returned -2.0% for the quarter
  - Barclays U.S. Treasury Index returned +0.3%
- Hedged non-US fixed income performed well in the 3rd quarter but U.S. dollar strength eroded returns for unhedged investors
  - Barclays Global Aggregate ex-US Index returned +1.8% (hedged) and -5.4% (unhedged)
  - U.S. dollar strengthened 7% versus the euro and 8% versus the yen as investors were attracted to U.S. yields and prospects for higher rates
  - Yields sank to all-time lows in several countries after the ECB unexpectedly cut rates in early September
  - Spain and Italy now yield less than the U.S. and the spread between U.S. and Germany 10-year bonds is highest in 15 years
- Emerging market debt also hit with local currency EMD faring the worst
  - JPM EMBI Global Diversified Index returned -0.6%
  - Local currency trailed with the JPM GBI-EM Global Diversified posting a -5.7% return
- Municipal bonds continued to perform well amid strong technicals and improving fundamentals
  - Barclays Muni Bond index up 1.5% for the quarter with the shorter duration Barclays Muni 1-10 Year Blend +0.8%

Market Environment 3Q14: Global Equity

The S&P 500 Index hit an all-time closing high on September 18th before trailing off through the end of quarter. For the full quarter, however, returns were muted given declines of 1.4% in both July and September bookending a 4% rally in August. The strength in U.S. large cap stocks masked significant weakness among small caps, which posted sharp declines in what was this sector's worst relative performance versus the S&P 500 since the late 1990's.

US Equity

- S&P 500 gained 1.1% for the quarter, bringing YTD performance to 8.3%
- Large caps outperformed, followed closely by midcaps
  - Russell Top 200: +1.7%, Russell Midcap: -1.7%
- Small caps sank (Russell 2000: -7.4%)
- High quality outperformed low quality for first time in more than two years. Growth outperformed value across the capitalization spectrum.
  - S&P HQ: +1.1%, S&P LQ: -2.0%
  - Russell 1000 Growth: +1.5%, Russell 1000 Value: -0.2%
- Within the S&P 500, the Energy sector performed worst as oil and gas prices fell
  - Energy returned -8.6%; Utilities also posted a sharply negative return (-4.0%)
  - Health Care (+5.5%) and Technology (+4.8%) were the best performing sectors

International Equity

- Local currency returns were largely flat, but strength in the U.S. dollar relative to other currencies hurt
  - MSCI EAFE Local: +0.9%; MSCI EAFE US$: -5.9%
- U.S. dollar gained 7% vs the euro and 8% vs the yen
  - Japan's local market did well (+5.9%) but given yen weakness, this translated to -2.2% for U.S. investors
- EM equities lagged developed markets in local terms; however, more muted currency effects allowed EM to outperform developed in U.S. dollar terms
  - MSCI EM Local: +0.7%, EM US$: -3.4%
- Growth outperformed value and small caps trailed
  - EAFE Value: -6.2%, EAFE Growth: -5.5%;
  - EAFE Small Cap: -7.8%
- BRICs posted mixed results:
  - Brazil -8.6%; +1.2% YTD
  - Russia -15.1%; -19.5 YTD
  - India +2.3%; +24.7% YTD
  - China +1.5%; +1.0 YTD

Market Environment 3Q14: Liquid Real Assets

Performance of real assets varied in the 3rd quarter, but was generally negative.

- Inflation remained subdued
  - CPI dropped 0.2% in August and inflation has been below Fed's 2% target for 27 consecutive months
  - Headline and Core CPI both 1.7% year-over-year as of August
- TIPS underperformed nominal U.S. Treasuries on diminished inflation expectations
  - Barclays U.S. TIPS Index returned -2.0% vs +0.3% for the Barclays U.S. Treasury Index
- Bank Loans posted negative returns amid outflows and risk-off sentiment
  - S&P/LSTA Leveraged Loan index -0.5%
- Commodities experienced huge volatility in the quarter
  - S&P GSCI and Bloomberg Commodities Index fell sharply (GSCI: -12.5%, BCI: -11.8%).
  - Grains were broadly negative with Corn (-26%) experiencing the most dramatic slide
  - Energy and Precious Metals also traded down sharply
    - Gold (S&P Spot) -8.4%
    - Brent Crude Oil -16%
- REITs experienced a sharp slide in September while MLPs gained momentum from a large corporate restructuring in August
  - NAREIT Equity: -3.1%
  - Alerian MLP: +2.7%

GRACE LEGACY CAPITAL

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Domestic Fixed Income

The 10-year U.S. Treasury traded in a 29 bp range in the 3rd quarter, hitting a low for the year (2.34%) on August 28th and an intra-quarter high of 2.63% on September 18th before closing the quarter at 2.52%. An improving U.S. economy put upward pressure on rates, but a significant yield advantage relative to other developed markets helped to dampen this effect. While the U.S. economy gained traction, news from Europe and Japan was far bleaker with euro zone GDP barely positive in the 2nd quarter versus a +4.6% print in the U.S. Foreign investors were lured to the relatively high yields in the U.S. market, propelling the dollar sharply higher. The Barclays Aggregate Index returned 0.2% in the 3rd quarter with U.S. Treasuries performing the best. Both corporates and mortgages underperformed like-duration Treasuries for the quarter. High yield corporate bonds sank nearly 2% as the sector endured heavy outflows amid concerns over rich valuations. Bank loans, also hit by outflows, returned -0.5% as measured by the S&P/LSTA Index. TIPS underperformed nominal Treasuries by a significant margin as inflation expectations fell. The Barclays U.S. TIPS Index fell 2.0% versus a return of +0.3% for the U.S. Treasury Index. The curve continued to flatten with the 30-year yield dropping 13 bps and the 5-year yield rising 16 bps as investors contemplated the timing of eventual rate hikes.

Global Bonds

Hedged non-U.S. fixed income posted positive returns in the 3rd quarter as yields dropped on anemic growth, mounting deflationary pressures and geopolitical concerns, but significant appreciation in the dollar eroded returns for U.S. investors. The Citigroup WGBI returned 1.5% (hedged) while the unhedged version returned -3.8%. The ECB unexpectedly cut rates to record lows in August to spur growth and stave off deflation. Germany’s economy shrank 0.2% in the 2nd quarter and euro zone inflation fell to 0.4% in September; the weakest in 5 years and well below target. Japan's economy suffered its worst contraction since 2009 with 2nd quarter GDP shrinking by an annualized 7.1% in the wake of a sales tax hike from 5% to 8%. Yields in a number of developed markets hit all-time lows with 2-year government bonds trading below 0% in eight countries after the ECB cut rates. The relatively attractive yields offered in the U.S. and expectations for higher rates propelled the dollar higher versus most currencies. The dollar gained 7% versus the euro and 8% versus the yen.

Emerging markets U.S. dollar-denominated debt posted small declines after rallying earlier in the year. The JPM EMBI Global Diversified Index returned -0.6% for the quarter. Local currency debt fell more sharply given broad-based currency weakness versus the U.S. dollar. The JPM GBI-EM Global Diversified posted a -5.7% return for the quarter. The Russian ruble and Brazilian real fell 14% and 10%, respectively, against the dollar.

Tax-Exempt Fixed Income

The municipal market posted solid returns in the 3rd quarter, outperforming taxable bonds. The Barclays Muni Bond Index has posted positive returns in each of the first nine months of this year, a first-time occurrence. Though tax-exempt yields have been largely influenced by the direction of the U.S. Treasury market, minimal issuance and strong demand has provided a strong technical backdrop for the sector all year. Supply, at $225 billion, is down 11% from last year (through September). The Barclays Muni Bond Index returned 1.5% in the 3rd quarter and is up 7.6% y-t-d. As in the taxable market, yields on longer maturities have fallen the most. Long maturities (over 22 years) returned 2.3% for the quarter (12.7% y-t-d) while the Barclays 1-10 Year Blend was up 0.8% (4.1% y-t-d). Lower quality again outperformed high quality for the quarter, with Baa-rated municipal bonds up 2.2% for the quarter and 12.2% y-t-d. The most defensive sector, pre-refunded bonds, returned a meager 0.3% for the quarter and is up only 1.7% y-t-d.

Domestic Equity

The S&P 500 Index hit an all-time closing high on September 18th before trailing off through the end of quarter. For the full quarter, however, returns were muted (S&P 500: +1.1%) given declines of 1.4% in both July and September bookending a 4% rally in August. The strength in U.S. large cap stocks masked significant weakness among small caps, which posted sharp declines (Russell 2000: -7.4%) in what was this Index's worst relative performance versus the S&P 500 since the late 1990's. Midcap stocks declined more modestly (Russell Midcap: -1.7%). Growth outperformed value across the capitalization spectrum and high quality outperformed low quality (S&P HQ: +1.1%, LQ: -2.0%) for the first time in over two years. Within the S&P 500, the Energy sector (-8.6%) sank with falling oil and natural gas prices and Utilities was the only other sector to post a negative return (-4.0%). Technology (+4.8%) and Health Care (+5.5%) posted the strongest gains from a sector perspective.

International Equity

While local currency returns were largely flat for the quarter, major strength in the U.S. dollar relative to many foreign currencies pushed non-U.S. equity returns well into negative territory (MSCI EAFE Local: +0.9%, EAFE US$: -5.9%). Relatively attractive yields offered in the U.S. and expectations for higher rates propelled the dollar higher versus most currencies. The dollar gained 7% versus the euro and 8% versus the yen and appreciated versus most emerging markets currencies as well. The effects were notable; Germany's local market return was -3.7% but in U.S. dollar terms investors endured a 11.2% loss. Japan's local market did well (+5.9%) but given the weakness in the yen, the number translated to a -2.2% return for U.S. investors. As in the U.S., growth outperformed value in developed markets (EAFE Growth: -5.5%, Value: -6.2%) and small caps trailed larger issues (EAFE SC: -7.8%).

Emerging Markets

Emerging market equities lagged developed markets stocks in local terms; however, more muted currency effects allowed EM to outperform developed in U.S. dollar terms (MSCI EM Local: +0.7%, EM US$:-3.4%). Of the BRICs, India was the best performer with a 2.3% result and the country is up nearly 25% YTD. China (MSCI China: +1.5%) also posted a positive return while Brazil (MSCI Brazil: -8.6%) and Russia (MSCI Russia: -15.1%) suffered sharp declines.