FOURTH QUARTER MARKET THOUGHTS

Resetting Expectations for 2019 and Beyond

February 2019

The new year couldn't come quickly enough for investors. Not only did most major asset classes end 2018 in the red, but also US equities suffered their worst December since the 1930s. This wave of risk aversion was felt broadly as safe-haven fixed income rallied with Treasury yields declining in the final weeks of last year.

Still, those looking to 2019 for respite may be disappointed. We believe investors, accustomed to the extended period of calm in the markets, need to reset their expectations and brace for higher levels of volatility. In addition, the US economy has entered the late stage of its expansionary cycle, negatively skewing the range of market outcomes in the coming years. As a result, our investment outlook reflects a more risk-averse posture. That said, the late stage of an expansionary economic cycle does not imply the end of the cycle. For now, we see scant evidence to suggest a recession is imminent in the United States. To this end we caution investors from shunning equities as stocks can still offer positive returns in the near term.

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We believe equities offer an attractive entry point with the potential of rebounding from their December lows. We encourage investors to rebalance their developed-market equity exposure and increase US stocks closer to index target weights. At the same time, we maintain our overweight position in emerging-market stocks. Despite the negative sentiment related to emerging economies in 2018, we see trade relations potentially improving between the United States and China, offering a tail wind for investors this year.

Looking back, investors had few places to hide in 2018. Using a proxy of 10 major asset classes, core bonds were the only ones to avoid negative territory, finishing a rounding error above zero. While the magnitude of losses for 2018 was far less than 2008 or 2000, the breadth of asset classes performing poorly was unparalleled over the last 30 years.

While we believe the widespread selloff in equities in December presents an appealing rebalancing opportunity, our longer-term view underscores our more defensive stance. The US economy being in the late phase of a market cycle will be a focal point for investors, with economic risks and credit defaults likely becoming more pronounced in the years to come. As such, we have reset our outlook relative to the start of 2018 with a bias towards selling low-quality credit and increasing safe-haven fixed-income exposure. Economic trends suggest higher levels of volatility are in the offing, a common occurrence during the late phase of a market cycle. Where there is volatility, there is not only higher risk, but also greater tactical opportunities for investors. Investors should be prepared to take advantage of these dynamic opportunities in a volatile market environment by deploying safe-haven debt back into US equities and other risky assets.

GLOBAL EQUITIES

Stocks across the board took a severe beating in the fourth quarter with the MSCI ACWI Index down 12.8%; energy, the worst performing sector, lost 20.2%. The MSCI EAFE Index was in the red at 12.5%.

In the US, stocks recorded their worst quarter in more than seven years with the S&P 500 bleeding 13.5% as investors fretted over the trade dispute between the United States and China, and the pace of interest rate increases. Domestic equities also posted their worst December since the 1930's as large-cap equities outperformed small caps and value bested growth.

Emerging market stocks, which underwent a correction earlier in the year, outperformed developed markets with the MSCI EM Index falling 7.47% for the quarter. Brazil was the best performing country, buoyed by President-elect Jair Bolsonaro's pick for chief economic advisor and his pledge to sell state-owned companies. Asia lagged, pulled down by declines in China, Korea and Taiwan. Healthcare and information technology were among the worst performing sectors, losing 15.4% and 15.1%, respectively.

GLOBAL FIXED INCOME

In the US, high-yield spreads—particularly in the lower-rated CCC-segment—widened significantly in the fourth quarter. The burgeoning BBB-rated segment is a concern for investment-grade and high-yield debt investors. Double the size of the high-yield market, the growth in the BBB-segment has been driven largely by issuance, an increase in mergers and acquisitions, and credit downgrades from A to BBB. Widespread downgrades among BBBs could lead to an oversupply in high-yield securities and pressure prices.

For the three months ended December 31, the Bloomberg Barclays Aggregate rose 1.6% and the Bloomberg Barclays US Long Treasury was up 4.2%. The Bloomberg Barclays High Yield fell 4.5% and the S&P LSTA Leveraged Loan Index lost 3.5% during the same period.

Global Equity Market Returns as of 12/31/2018				
Global Equity	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
MSCI ACWI	-12.8%	-9.4%	6.6%	4.3%
US Equity	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
S&P 500	-13.5%	-4.4%	9.3%	8.5%
Russell 1000 Growth	-15.9%	-1.5%	11.1%	10.4%
Russell 1000 Value	-11.7%	-8.3%	7.0%	5.9%
Russell 2000	-20.2%	-11.0%	7.4%	4.4%
Russell 2000 Growth	-21.7%	-9.3%	7.2%	5.1%
Russell 2000 Value	-18.7%	-12.9%	7.4%	3.6%
International Equity	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
MSCI EAFE	-12.5	-13.8%	2.9%	0.5%
MSCI EAFE Hedged USD	12.2%	-11.0%	2.6%	3.8%
MSCI EAFE Small Cap	-16.0%	-17.9%	3.7%	3.1%
MSCI Europe	-12.7%	-14.9%	2.1%	-0.6%
MSCI Japan	-14.2%	-12.9%	3.4%	3.1%
MSCI Emerging Markets	-7.5%	-14.6%	9.3%	1.6%
MSCI Emerging Markets Small Cap	-7.2%	-18.6%	3.7%	1.0%
Alternative	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
HFRI Equity Hedge	-8.3%	-6.9%	3.6%	2.3%
HFRI Emerging Markets	-4.3%	-11.1%	4.3%	1.4%
HFRI ED: Activist	-12.0%	-11.3%	1.1%	2.2%%
HFRI ED: Merger Arbitrage	0.0%	3.2%	3.7%	3.2%

Within hedge funds, distressed and restructuring strategies were down 5.6% in the fourth quarter, losing 1.6% in 2018, according to the HFRI ED: Distressed/Restructuring Index. The HFRI ED: Credit Arbitrage Index declined 2.1% in the fourth quarter, but was up 2.1% for the year.

Outside the US, emerging markets were in the red for 2018 with local debt, the worst performing, down 6.2% for the year. However, local currency debt proved to be one of the few bright spots for the quarter, posting a gain of 2.1%

We believe the cyclical growth of credit markets, deteriorating quality and high leverage are creating opportunities for distressed debt investors. Safe-haven fixed-income assets are also becoming increasingly appealing, given the lack of adequate compensation for taking on credit risk. However, select opportunities may exist in niche lending and collateralized loan obligations (CLOs).

Global Fixed Income Market Returns as of 12/31/2018				
Global Fixed Income	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
BC Global Aggregate	1.2%	-1.2%	2.7%	1.1%
BC Global Aggregate (USD Hedged)	1.7%	1.8%	2.9%	3.4%
JPM EMBI Plus	-0.7%	-5.4%	4.0%	4.0%
JPM GBI-EM Global Diversified	2.1%	-6.2%	5.9%	-1.0%
Domestic Fixed Income	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
BC Aggregate Bond	1.6%	0.0%	2.1%	2.5%
BC Municipal Bond	1.7%	1.3%	2.3%	3.8%
BC TIPS	-0.4%	-1.3%	2.1%	1.7%
BC US Treasury	2.6%	0.9%	1.4%	2.0%
BC US Long Treasury	4.2%	-1.8%	2.6%	5.9%
BC MBS	2.1%	1.0%	1.7%	2.5%
BC US Credit	0.0%	-2.1%	3.2%	3.2%
BC US Long Credit	-1.6%	-6.8%	4.9%	5.1%
BC High Yield	-4.5%	-2.1%	7.2%	3.8%
BC Muni High Yield	0.3%	4.8%	5.8%	6.5%
S&P LSTA Lev. Loan	-3.5%	0.4%	4.8%	3.1%
BC T-Bills	0.6%	1.9%	1.0%	0.6%
Alternative	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
HFRI Credit Index	-3.1%	-0.3%	4.7%	3.2%
HFRI ED: Credit Arbitrage	-2.1%	2.1%	6.6%	3.6%
HFRI ED: Distressed/Restructuring	-5.6%	-1.6%	6.4%	1.8%
HFRI Relative Value	-3.2%	-0.2%	4.1%	3.2%

REAL ASSETS

The Bloomberg Commodity Index declined 9.4% in the fourth quarter and 11.2% for the year. Most commodities (and the index) remain in contango—when the futures price of a commodity is above the expected future spot price—resulting in negative roll yield. We maintain a neutral view on commodities. Energy was the worst performing sub-sector, as oil prices were pressured by concerns of oversupply fueled by high inventories and stronger-than-expected production in Iran. Natural gas posted losses of 2.3% in a volatile quarter marked by low inventory levels and fluctuating weather forecasts. Precious metals strengthened towards the end of 2018, bolstered by the selloff in equities and expectations for higher real interest rates.

We remain positive on natural resource equities, believing they offer a more efficient exposure to commodity markets. However, they are also not immune to market volatility, losing 16.8% and 12.6% for the fourth quarter and year, respectively. The lack of recent investment in energy and mining has constrained supply; however, demand forecasts remain solid. For both sectors, we believe there are attractive opportunities for private equity and debt investment, though implementation options remain limited in the mining sector.

Meanwhile, in real estate, real estate investment trusts (REITs) were down 6.0% in the fourth quarter. There is meaningful dispersion across property types in both valuation levels and capital flows. Broadly speaking, REITs, hurt by rising interest rates, are trading at discounts to their private-market counterparts.

In private core real estate, the NCREIF ODCE Index posted another year of stable returns, generating 8.4% in 2018. As yield spreads continue to tighten, we still favor managers capable of growing income at the property level, rather than relying on general market appreciation (which we expect will slow). We also prefer certain core-plus, real estate debt, or tactical core strategies to augment existing core real estate allocations. In the non-core real estate space, we believe that demographically-driven sectors (healthcare, data centers, workforce housing) and select international exposures offer the potential to outperform the broad market.

Real Asset Returns as of 12/31/2018				
	Quarter	1 Year	3 Yrs	5 Yrs
Bloomberg Commodity	-9.4%	-11.2%	0.3%	-8.8%
GSCI Commodity	-23.0%	-15.4%	6.3%	-10.0%
Gold Spot	7.5%	-1.6%	6.5%	1.2%
WTI Crude Oil Spot	-38.0%	-24.8%	7.0%	-14.3%
BBG Commodity - Agriculture	0.2%	-10.8%	-6.8%	-9.1%
BBG Commodity - Energy	-25.8%	-12.7%	-1.0%	-18.5%
BBG Commodity - Industrial Metals	-8.7%	-19.5%	7.7%	-3.2%
BBG Commodity - Precious Metals	6.8%	-4.6%	5.1%	-0.9%
S&P Global Natural Resource Equities	-16.8%	-12.6%	12.4%	-0.5%
NAREIT Composite Index	-6.0%	-3.9%	4.7%	8.3%
NAREIT Global REIT Ex US	-6.7%	-8.9%	-1.2%	-
Alerian MLP	-17.3%	-12.4%	-1.1%	-7.3%

FINAL THOUGHTS

While 2019 may prove to be a challenging year, investment opportunities can be found in emerging markets and US equities should we see a selloff like the one in December. However, on balance, we encourage investors to adopt a more risk-averse stance by raising their holdings of safe-haven fixed income and reducing lower-quality credit exposure. While we do not believe a recession is imminent, the potential for adverse economic outcomes has expanded. As such, we are evaluating the movement of market metrics, such as the Treasury yield curve, which would warrant a more defensive position; should the curve invert, we are likely to encourage investors to materially increase holdings of safe-haven fixed income. We hope to expand on these thoughts and themes at NEPC's 24th Annual Investment Conference on May 7-8 in Boston. We plan to explore a wide variety of topics through the prism of this year's theme, *Transitions*. In addition, we are excited to bring you a roster of accomplished external speakers. We hope you can join us and we look forward to seeing you in May.

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- Past performance is no guarantee of future results
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