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Monthly Economic & Capital Market Update

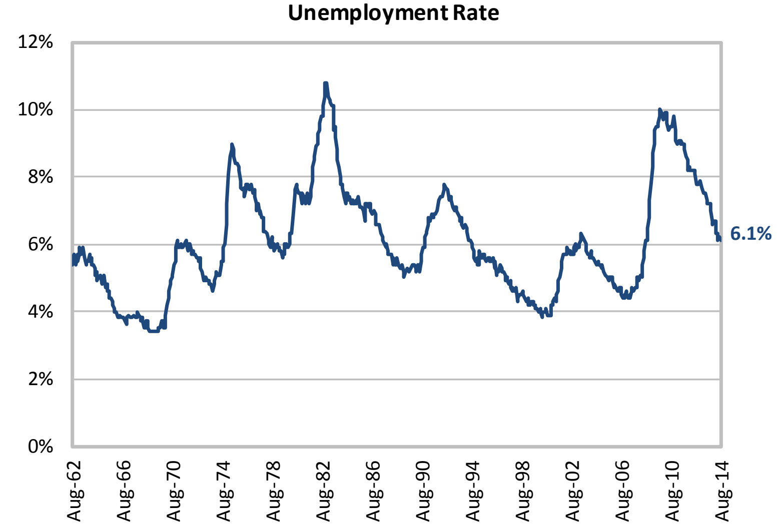
August 2014

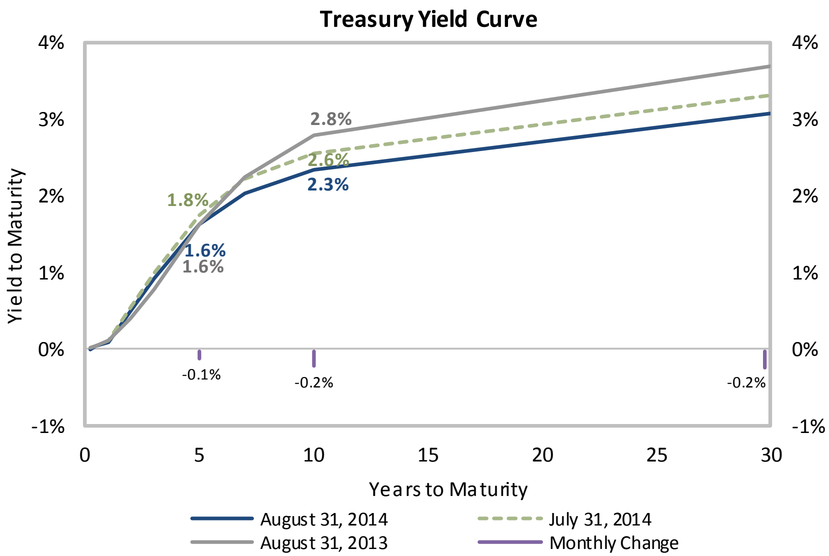
Economy

- The US economy continues to improve, according to economic data released during August. The S&P 500 reached 2,000 for the first time ever during the month, propelled by strong economic data and ongoing central bank accommodation around the world. The US Federal Reserve is expected to wind down its bond buying program, QE3, at its October meeting, and the focus has now turned to when the Fed will raise the Federal Funds rate from its current near-zero level. Meanwhile, it is likely that the European Central Bank will announce further stimulus measures, as both inflation and growth in the Eurozone have been below target.
- The unemployment rate fell ten basis points to 6.1% in August. Nonfarm payrolls increased by 142,000, lower than expectations of 225,000. June and July's figures were revised downward by a total of 28,000 jobs. The labor force participation rate fell to 62.8%, its lowest level since 1978, as demographics and other forces continue to weigh on the labor market. It is possible that the August figure will be revised upwards in coming months, however, as other recent macroeconomic data points have been positive.
- Real GDP growth (annualized) for Q2 2014 was 4.2%, according to the BEA's second release, a 0.2% upward revision from the first estimate. Increasing personal consumption, exports, and government spending were major contributors to the positive Q2 number. Real GDP growth for Q1 2014 was -2.1% annualized.
- Consumer prices, as measured by the Consumer Price Index, rose 0.1% in July. Core CPI, which excludes food and energy, also increased 0.1%. Consumer prices were up 2.0% for the 12 months ending in July, while the core rate increased 1.9%.
- The Producer Price Index rose 0.1% in July. Excluding food and energy, PPI increased by 0.2%. The PPI rose 1.7% year-over-year ending July, while core prices rose 1.6%.
- Data points from the housing market were positive in July, as housing starts, existing home sales, and building permits all came in higher than expected for the month. Low financing costs, low inflation, and a slowly recovering labor market continue to act as tailwinds for home buyers. The traditional 30-year mortgage rate fell during August, ending the month at 4.1%.
- US manufacturing expanded at its fastest rate since April 2011 in August, according to the ISM Manufacturing Index. The index rose to 59.0 from 57.1 in July; a figure over 50 implies expansion. The service sector in the US is also expanding. The ISM Non-Manufacturing Index rose to 59.6, its highest level since January 2008.

Yield Curve

- The spread between 2-year and 30-year Treasuries tightened 10 bps to 260 bps during the month.





Growth Assets

August 31, 2014

Public Equities

- Domestic equities (S&P 500) outperformed international equities (MSCI EAFE) by 420 bps during August. US small cap growth (Russell 2000 Growth Index, 5.6%) was the best-performing equity sector during the month.
- MLPs rebounded significantly in August following a pullback in July. The biggest headline during the month was the consolidation of the Kinder Morgan family of companies, with the parent company, Kinder Morgan, Inc., agreeing to buy its underlying MLPs, Kinder Morgan Energy Partners (NYSE: KMP) and El Paso Pipeline Partners (NYSE: EPB). As both MLPs are of meaningful size in the Alerian MLP Index, the takeover premiums associated with the announcement helped drive the index higher during the month. Additionally, yields compressed 39 bps with the Alerian Index settling at a 5.1% distribution yield at the end of August. Refined Products Pipeline MLPs (+10%) and Natural Gas Pipeline MLPs (+9%) led advancing sectors, while Natural Resource MLPs declined the most, down 2%.

Public Debt

- In July, high yield bonds earned a return of 1.6% as spreads tightened 25 bps to 365 bps. Historically, high yield spreads have averaged 520 bps.

Private Equity

- Deal value in the second quarter of 2014 was flat compared to the first quarter of 2014 at $80B. The US and rest of the world were down after large first quarter gains, but Europe's increase almost entirely offset the decline of the US and the rest of the world. Fundraising continued to be very strong, creating record levels of uninvested capital (dry powder). Globally, dry powder increased to $1.2T, up from $950B at the end of Q1. Accommodative debt markets and increasing levels of uninvested capital continue to sustain high deal prices and a challenging investment environment, according to managers.

Private Debt

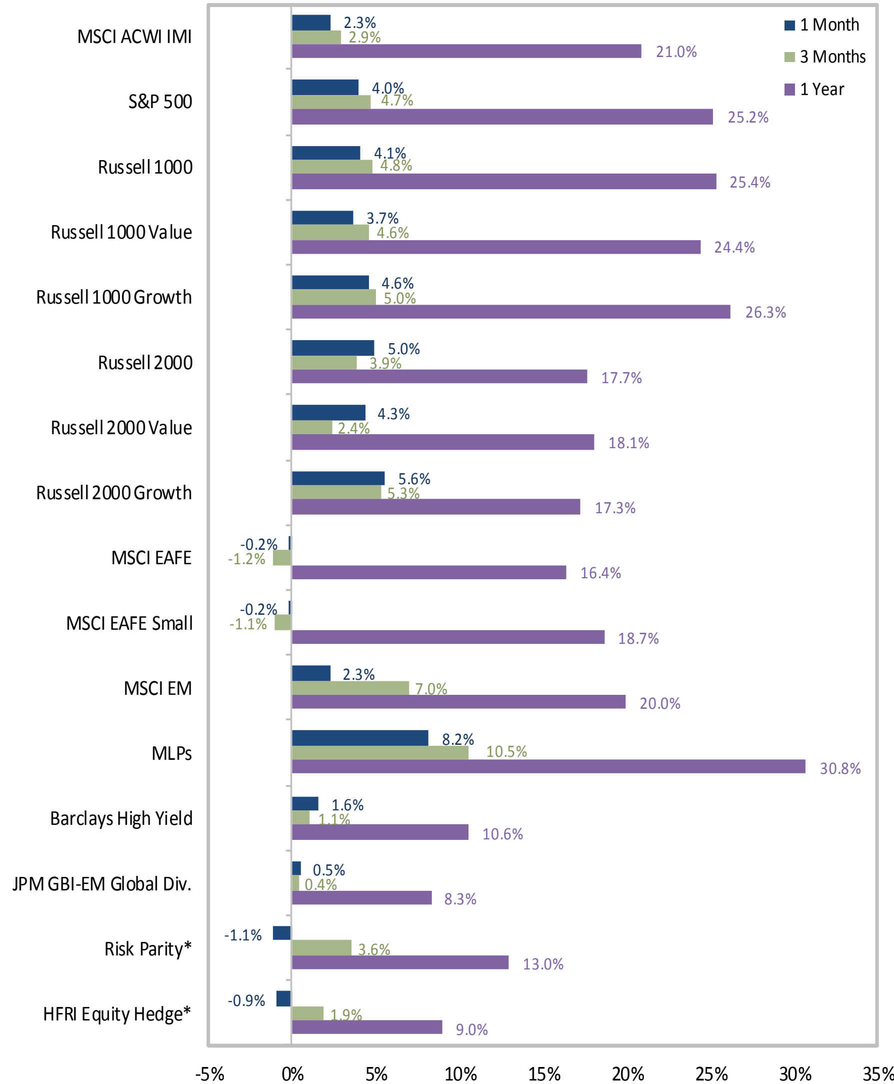
- The availability of credit and aggressive terms from senior lenders has allowed debt levels to increase to a new cycle high of 5.8x EBITDA. This remains lower than the prior cycle high of 6.2x recorded in 2007. The willingness of senior lenders to reach deeper into capital structures and accept higher levels of risk has been particularly challenging for mezzanine providers. According to data from S&P, mezzanine's share of new deal capital structures was 0% in the first and second quarters of 2014. This compares to a typical share of 5-10% over the prior ten years.

Risk Parity

- The rally in risk parity strategies year-to-date was set back slightly in July, with losses led by commodities allocations. Equities and credit also detracted.

Growth Hedge Funds

- Growth hedge funds were negative in July, in tandem with equity markets. Technology and energy-related funds posted the worst performance. Europe-oriented strategies also detracted. Event-driven strategies declined as distressed debt positions were marked lower.



* Data was not available at time of publication - data is previous month's.
Note: Risk Parity returns are based on an internally comprised benchmark.

Income Assets
August 31, 2014

Public Debt

- Interest rates in developed economies continue to remain low relative to historical levels. The 10-Year US Treasury ended August yielding 2.3%, well below its 20-year average of 4.4%. Yields in other notable countries, including Germany, Japan, Spain, and Italy, are also near record low levels.
- Core plus fixed income (US Universal) returned 1.1% for the month, performing in line with core bonds (US Aggregate).
- US Government bonds were also positive in August as yields fell, returning 1.0% for the month.
- Corporate bonds saw returns of 1.4% in August as investment grade spreads held constant at 100 bps. Corporate bond spreads have historically averaged 135 bps.
- Mortgage-backed securities returned 0.9% for the month as agency MBS spreads were unchanged at 35 bps, below the historical average of 65 bps.
- International bonds also saw positive returns, as the Barclays Global Aggregate ex US gained 0.2% in August.

Private Debt

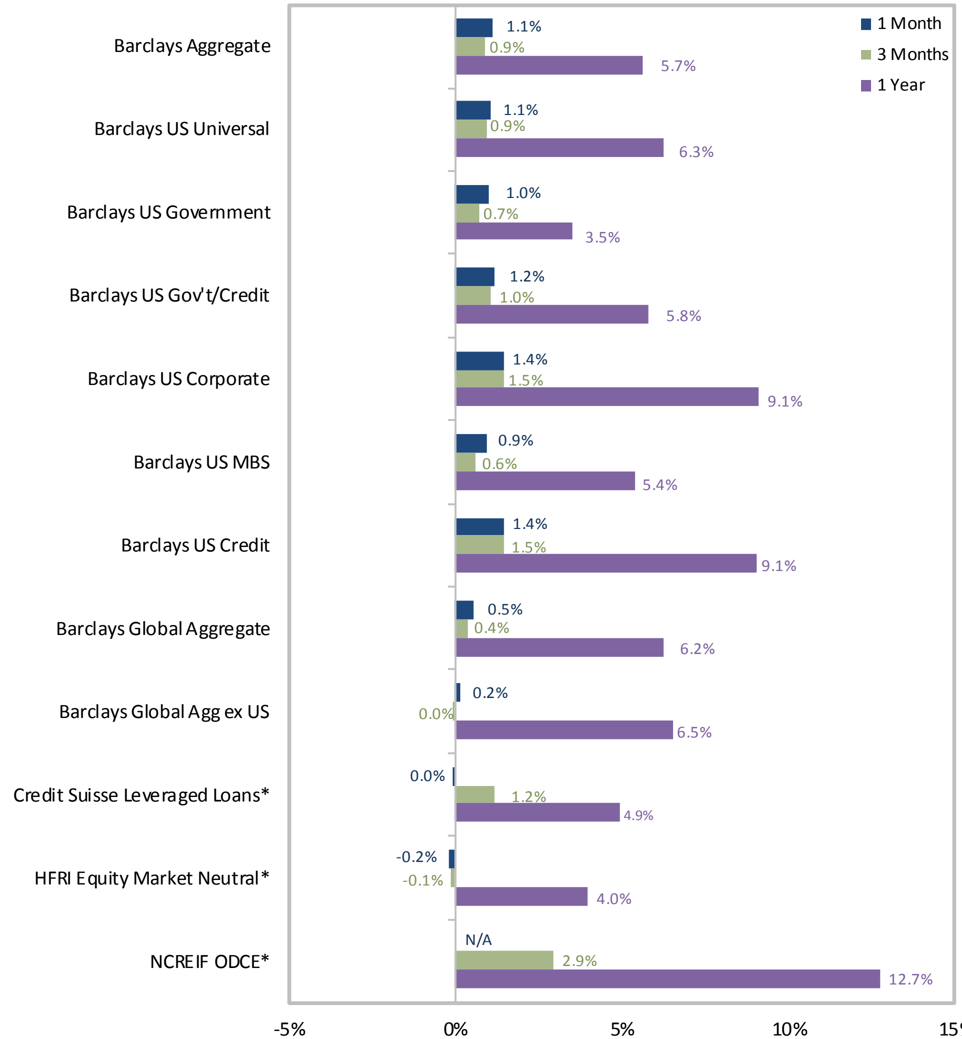
- Leveraged loans were unchanged in July and were up 4.9% for the 12 months ending July.

Relative Value Hedge Funds

- Market-neutral equity strategies were slightly negative in aggregate for the month of July. Other relative value strategies generated divergent performance. Asset-backed fixed income strategies performed well, while volatility and corporate credit related strategies detracted.

Core Real Estate

- Core real estate returned 2.9% during the second quarter, a modest improvement of 41 bps from the previous quarter. Through the first half of 2014, core real estate continued to perform well, having generated a 5.5% return for investors. While cap rate compression has been decelerating for most property sectors, net operating income growth has been fueling the recent strong results. Specifically, landlords have exercised their pricing power to push rents higher because of the improving economy and years of below-trend new property supply.



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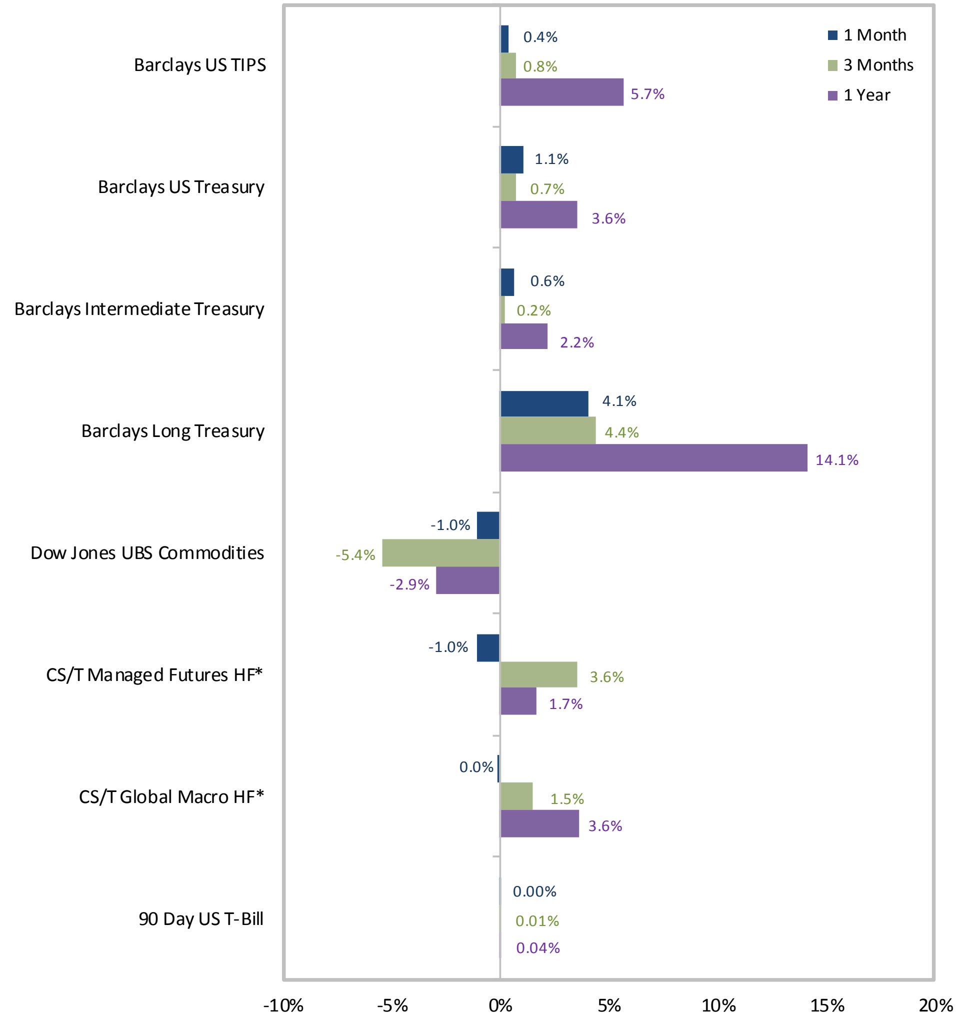
Diversification Assets
August 31, 2014

Inflation
- TIPS returned 0.4% in August and are up 5.7% over the past year.

Deflation
- Treasuries returned 1.1% during the month.
- Intermediate Treasuries returned 0.6% and long duration Treasuries returned 4.1%. Intermediate and long Treasuries have earned 2.2% and 14.1%, respectively, over the past year.
- Cash continues to offer virtually no return, as 90-Day T-Bills have gained just 4 bps over the past year.

Commodities
- Energy commodity prices were largely negative for the month of August, with Brent Crude Oil down -3% on slowing demand expectations from China and Europe as well as a strong dollar. Metals were mixed during the month with aluminum advancing +5% on slowing global production. Agriculture commodities were also mixed in their performance with cotton up 9% on falling inventories of older crop in storage and soybean prices declining 11% as the ideal Midwest growing conditions further supported expectations of a record output this year.

Tactical Trading
- Global macro strategies were flat for the month, leaving year-to-date performance slightly positive. Managed futures strategies detracted, with the largest losses coming from currency trading.



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