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Monthly Economic & Capital Market Update

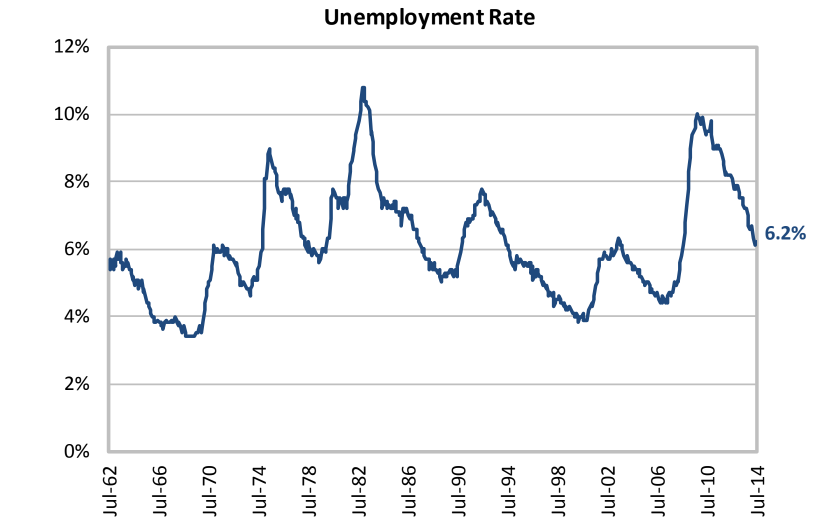
July 2014

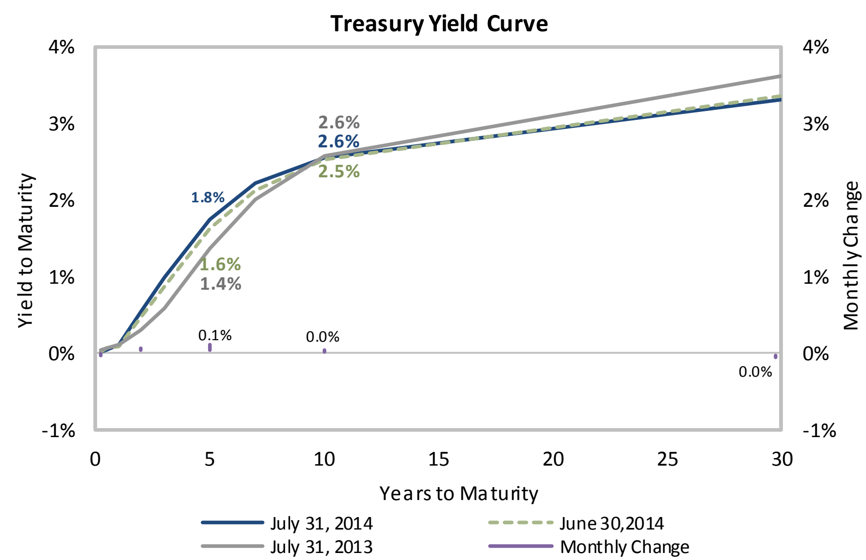
Economy

- The US economy continued along its path of slow growth in July, according to data released during the month. An improving labor market, expanding manufacturing sector, and increasing consumer confidence are acting as tailwinds for the economy, which is now in its sixth year of recovery following the 2008-09 recession.
- The FOMC met in July, reducing monthly asset purchases from $35B per month to $25B per month. The Committee believes that the economy is gaining strength and getting closer to achieving its dual mandate of maximum employment and price stability (2% inflation). QE3, the Fed's bond buying program, is expected to conclude at the Committee's October meeting. The next FOMC meeting will be September 16-17.
- The unemployment rate rose 0.1% to 6.2% in July. Nonfarm payrolls increased by 209,000, lower than expectations of 230,000. The previous months' figures were revised upwards by a combined 15,000 jobs. The labor force participation rate ticked up to 62.9% as more Americans returned to the labor market.
- Real GDP growth (annualized) for Q2 2014 was 4.0%, according to the BEA's first release, while Q1 was revised upwards to -2.1%. Second quarter GDP was the highest since Q3 2013, due primarily to a jump of 2.5% in consumer spending, which makes up more than 70% of the economy.
- Consumer prices, as measured by the Consumer Price Index, rose 0.3% in June. Core CPI, which excludes food and energy, increased 0.1%. Consumer prices were up 2.1% for the 12 months ending in June, while the core rate increased 2.1%.
- The Producer Price Index was up 0.4% in June. Excluding food and energy, the PPI also increased by 0.2%. The PPI rose 1.9% year-over-year ending June, while core prices also rose 1.8%.
- Housing market figures were muted in June. Housing starts (down 9.3% month-over-month) and building permits (down 4.2% month-over-month) greatly underperformed economist expectations. Meanwhile new home sales came in much weaker than expected, down 8.1%. However, existing home sales (up 2.6%) were positive, beating consensus estimates of 1.9%. The traditional 30-year mortgage rate ended July slightly higher than June at 4.2%.
- US manufacturing continued to expand in July, at a faster rate than in June, according to the ISM Manufacturing Index. The index rose to 57.1 in July from 55.3 in June; a figure over 50 implies expansion.

Yield Curve

- The spread between 2-year and 30-year Treasuries tightened 10 bps to 280 bps during the month.





Public Equities

- Domestic equities (S&P 500) outperformed international equities (MSCI EAFE) by 60 bps during July. Emerging markets were the best equity performers for the month at 1.9%, as EM continues to reverse its underperformance of developed markets in recent years.
- MLPs pulled back after four consecutive months of strong returns. The current distribution yield for the index is approximately 5.5%, up from a low of 5.2%. General Partner and Crude Oil Pipeline MLPs corrected the most (down 6%), while Coal MLP returned 5%. Other energy infrastructure MLP sectors traded down between -3% and -5% during the month.

Public Debt

- In July, high yield bonds earned a return of -1.3% as spreads widened 55 bps to 390 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 $1.2 trillion, up from $950 billion 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

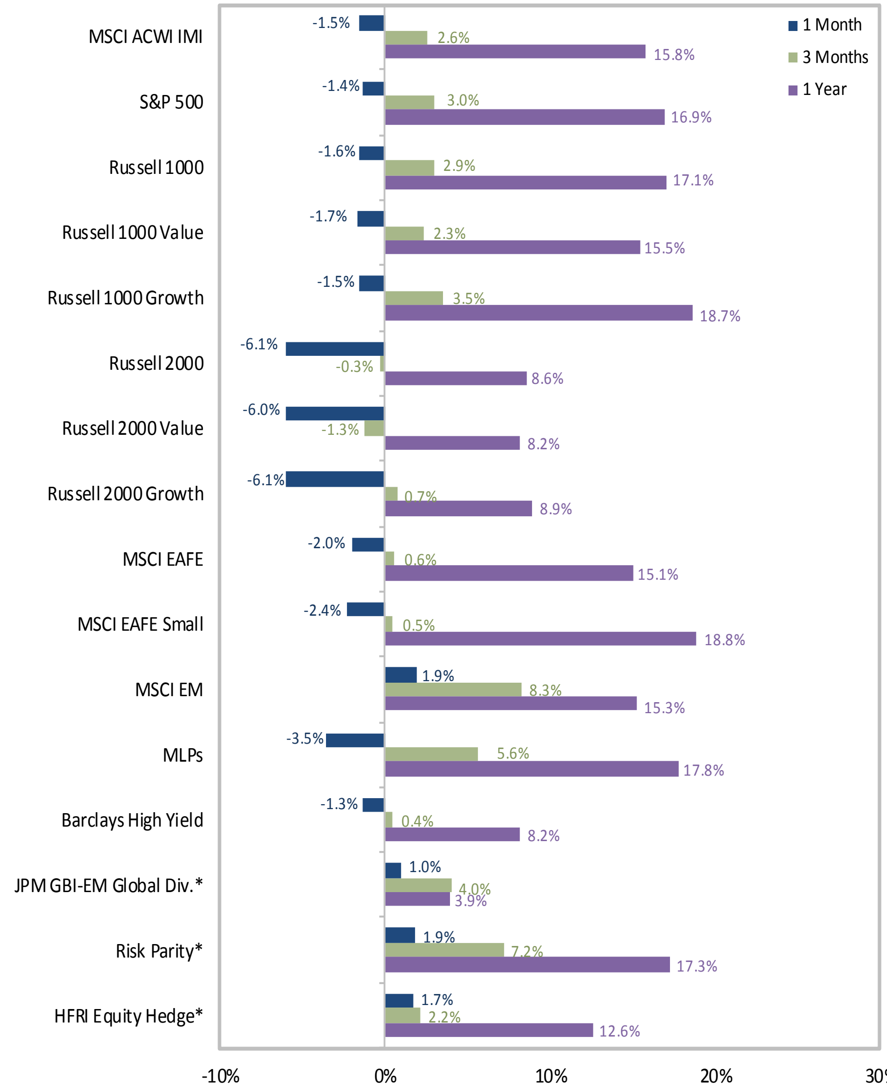
- The availability and aggressive terms from senior lenders has allowed debt levels to increase to a new cycle high of 5.8x EBITDA. This remains lower than the prior cycle high of 6.2x recorded in 2007. The willingness of senior lenders to reach deeper into capital structures and accept higher levels 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

- Risk parity continued with strong gains in June, and has been one of the best-performing asset classes of 2014.

Growth Hedge Funds

- The HFRI Equity Hedge Index posted a gain for the second quarter, despite the volatility that growth and momentum-oriented equities experienced. The HFRI Event-Driven Index generated a gain of 1.3% during the same time period.



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

Public Debt

- Core plus fixed income (US Universal) returned -0.3% for the month, performing in line with core bonds (US Aggregate).
- Government bonds also were slightly negative, returning -0.2% in July.
- Corporate bonds saw returns of -0.1% in July as investment grade spreads held constant at 100 bps. Corporate bond spreads have historically averaged 135 bps.
- Mortgage-backed securities returned -0.6% for the month as agency MBS spreads widened 10 bps to 35 bps, below the historical average of 65 bps.
- International bonds (Barclays Global Agg ex US) was the worst performer of fixed income assets, falling 1.3% during the month.

Private Debt

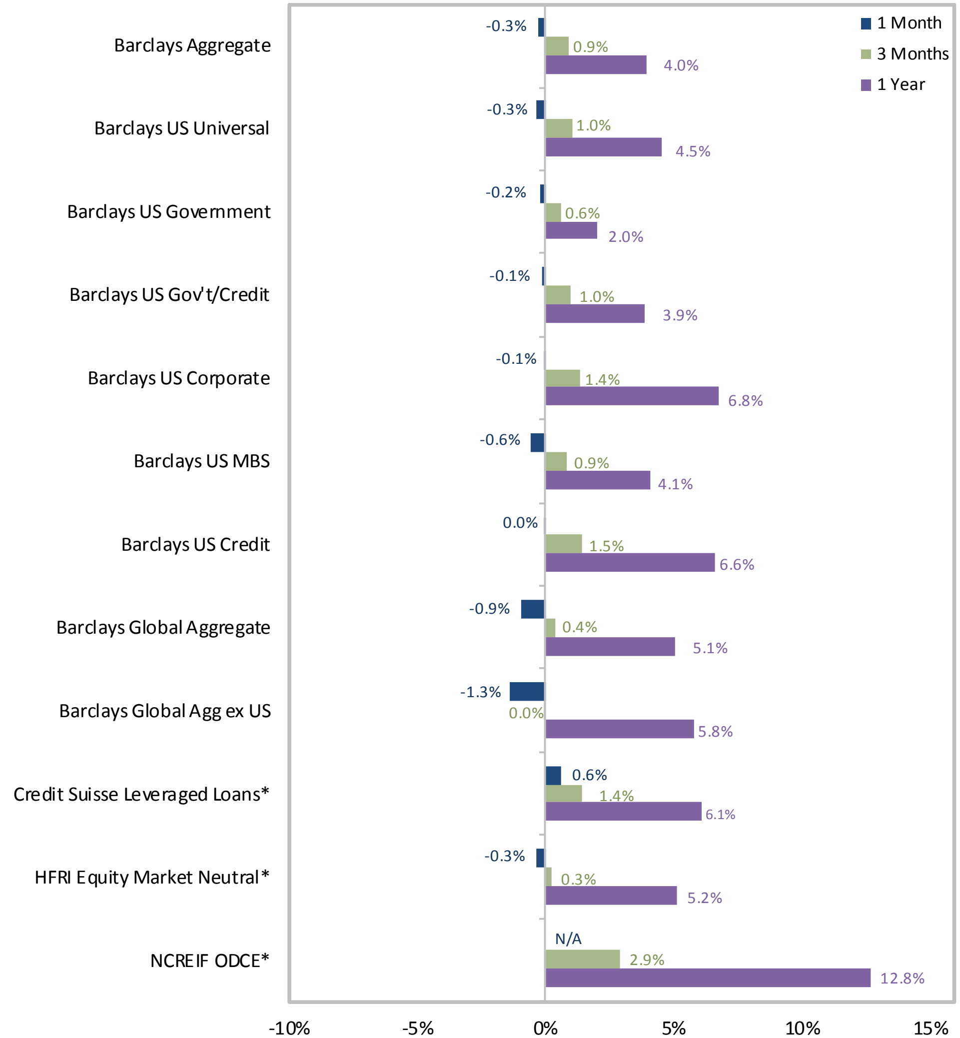
- Leveraged loans returned 0.6% in June and were up 6.1% for the 12 months ending June.

Relative Value Hedge Funds

- The HFRI Equity Market Neutral index was up slightly for the second quarter. Other relative value strategies, including mortgage/ABS relative value funds and corporate credit funds, continued to post gains as fixed income strategies benefited from ongoing spread compression.

Core Real Estate

- The preliminary Q2 return for core real estate is 2.9%, a modest improvement of 41 bps from the previous quarter. Through the first half of 2014, core real estate continues 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

July 31, 2014

Inflation

- TIPS were flat in July and are up 3.7% over the past year.

Deflation

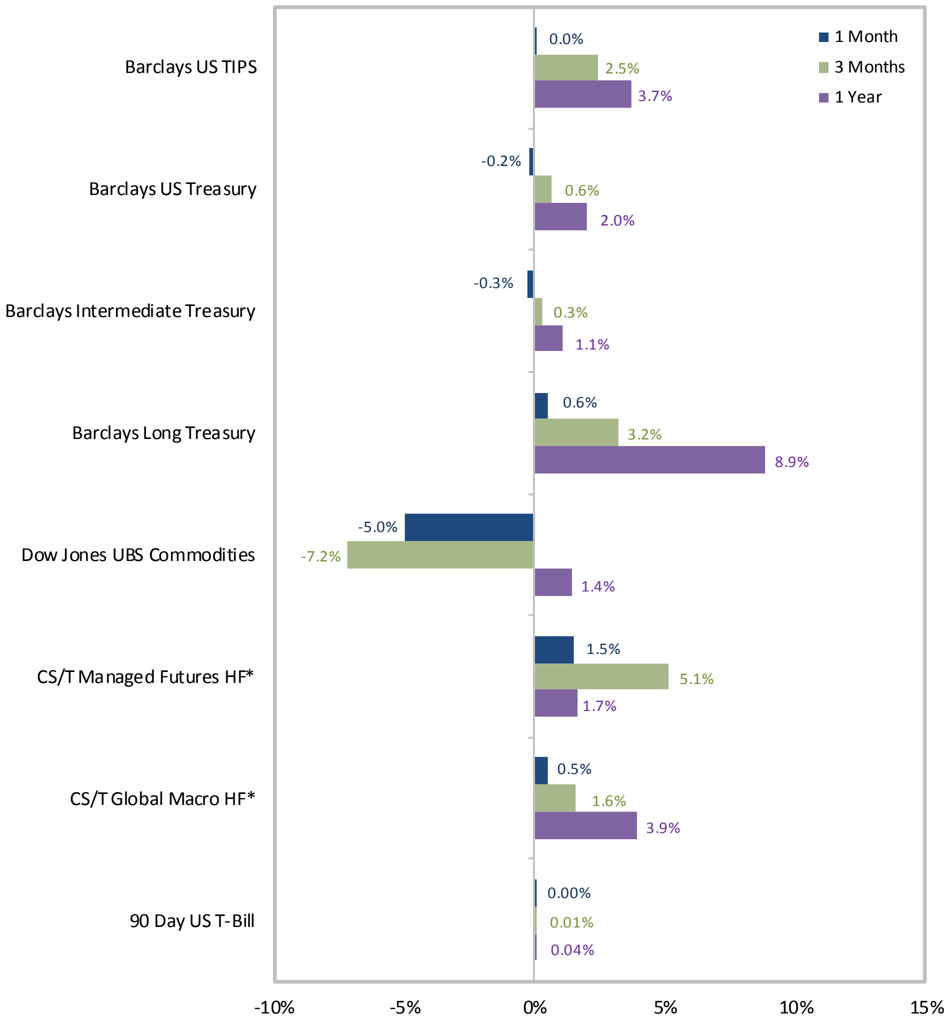
- Treasuries returned -0.2% during the month.
- Intermediate Treasuries returned -0.3% and long duration Treasuries returned 0.6%. Intermediate and long Treasuries have earned 1.1% and 8.9%, respectively, over the past year.
- Cash continues to offer virtually no return, as 90 Day T-Bills have gained just 4 bps over the past year.

Commodities

- Industrial metals were largely positive led by Zinc and Aluminum (both up 7%), while precious metals fell slightly during the month. All energy commodities declined during the quarter as bearish inventory reports came out for both crude oil and natural gas. Natural gas declined the most during the month, down -14%. Strong harvest expectations across agricultural commodities continued to drive down prices. All agricultural commodities declined during the month with corn declining the most, down -16%.

Tactical Trading

- Trend following was profitable for the second quarter, while discretionary global macro hedge funds generated mixed results.



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