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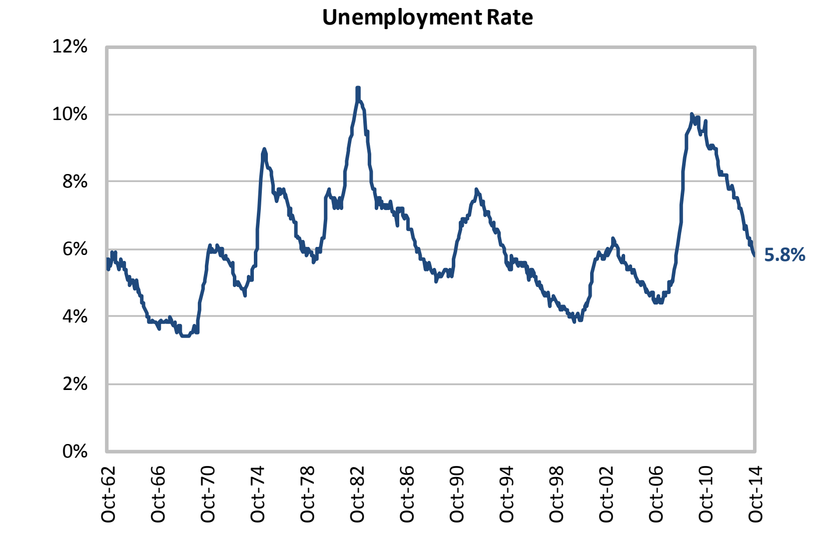
Monthly Economic & Capital Market Update

October 2014

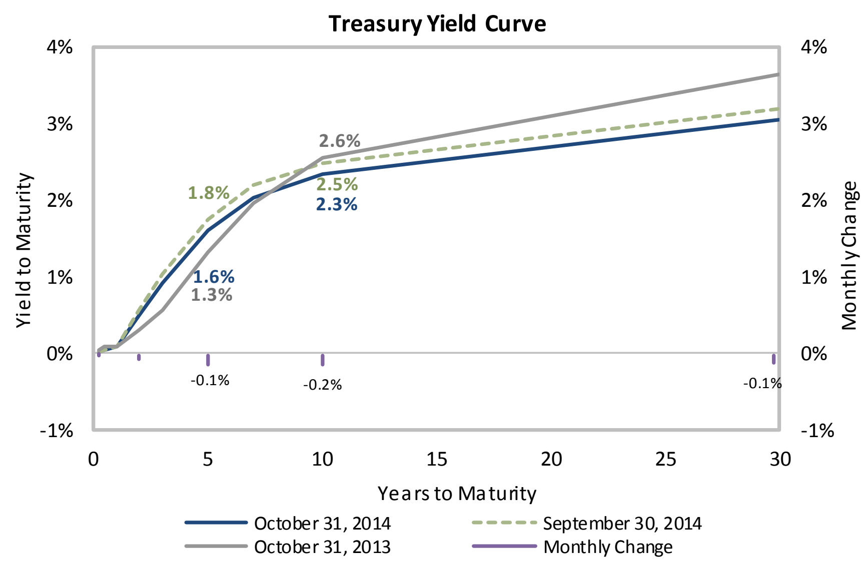
Economy

- The Federal Open Market Committee (FOMC) announced the end of its asset purchase program, QE3, at its October meeting. Over the 25-month duration of the program, the Federal Reserve expanded its balance sheet by more than 50% through the purchase of mortgage-backed securities and US Treasuries in an effort to stimulate borrowing and economic activity. Equity market participants were among the main beneficiaries of the actions taken by the Fed, as the price of the S&P 500 Index rose 36% during QE3. Investors will continue to focus on the Fed over the coming months as the central bank is likely to raise interest rates from historically low levels in 2015.
- The unemployment rate fell from 5.9% to 5.8% in October, its lowest level since July 2008. Nonfarm payrolls increased by 214,000, coming in below economists' expectations of an increase of 230,000. The US economy has now added over 200,000 jobs in each month since February; a gain of 200,000 new jobs is typically viewed as solid progress towards an improving labor market. Figures for September and August were revised upward by a total of 31,000 jobs. The improving labor market played a key role in the Fed's decision to take QE3 off the table during the month.
- Consumer prices continue to increase at a rate below the 2.0% long-run target set by the Fed. The Personal Consumption Expenditure (PCE) Index, the Fed's preferred measure of prices, increased 1.4% year-over-year in September. In addition to labor market measures, the Fed is taking price and wage inflation into consideration when determining the appropriate time to raise rates. Wage inflation, as measured by average hourly earnings, was 2.0% for the 12 months ending October. Wage growth that continues to come in near the level of inflation means Americans are experiencing limited increases in purchasing power, a headwind for US demand.
- Real GDP growth for the third quarter of 2014 was 3.5% annualized according to the initial estimate from the Bureau of Economic Analysis. All components of GDP were positive contributors to the higher-than-expected number with the exception of private inventory investment, which contracted slightly. This initial estimate of GDP will be revised twice in coming weeks as more information is collected. Real GDP growth for the second quarter of 2014 was 4.6% annualized.



Yield Curve

- The spread between 2-year and 30-year Treasuries tightened 5 bps to 260 bps during October. Over the past year, short-term rates have risen as the date of the expected Fed rate hike approaches, while long-term rates have rallied as global growth concerns and low foreign rates have kept long Treasury rates low.



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Growth Assets

October 31, 2014

Public Equities

- The global equity market was led higher by domestic stocks during a volatile month of October. The S&P 500 was down nearly 6% in the middle of the month, but rallied to finish in positive territory. The US market (S&P 500, 2.4%) outperformed international (MSCI EAFE, -1.5%) by 390 basis points, while US small cap stocks reversed trend and outperformed large cap. An improving US economy and continued strong domestic earnings brought investors back to the small cap space during the month.
- All MLP subsectors declined in October. Upstream MLPs (-15%), which are sensitive to movements in commodity prices, suffered as both crude oil (-12%) and natural gas (-6%) fell. During the month MLPs traded down for seven consecutive days, returning -13%, as the asset class was caught in a broad energy sector sell off triggered by the drop in crude oil prices. MLPs quickly snapped back the following two trading days, gaining 9%.

Public Debt

- High yield bonds returned 1.2% as spreads tightened 10 bps to 415 bps. Over the past 20 years, high yield spreads have averaged 525 bps.

Private Equity

- Deal value has remained flat throughout 2014 as managers compete against increasingly acquisitive strategic buyers. While competing for new deals, managers have benefited from the same dynamic by selling portfolio companies to the same buyers. Exits via a strategic sale are 50% higher in 2014 than they were in 2011, 2012, and 2013. Fundraising continues to be very strong, and managers are taking advantage to raise larger pools of capital with shorter fundraising cycles than the period since 2007. Fundraising has persisted despite record high levels of uninvested capital. Accommodative debt markets and increasing levels of uninvested capital continue to sustain high deal prices with new LBOs pricing at >11x EBITDA in Q3 2014, an all-time high according to S&P Leveraged Commentary and Data.

Private Debt

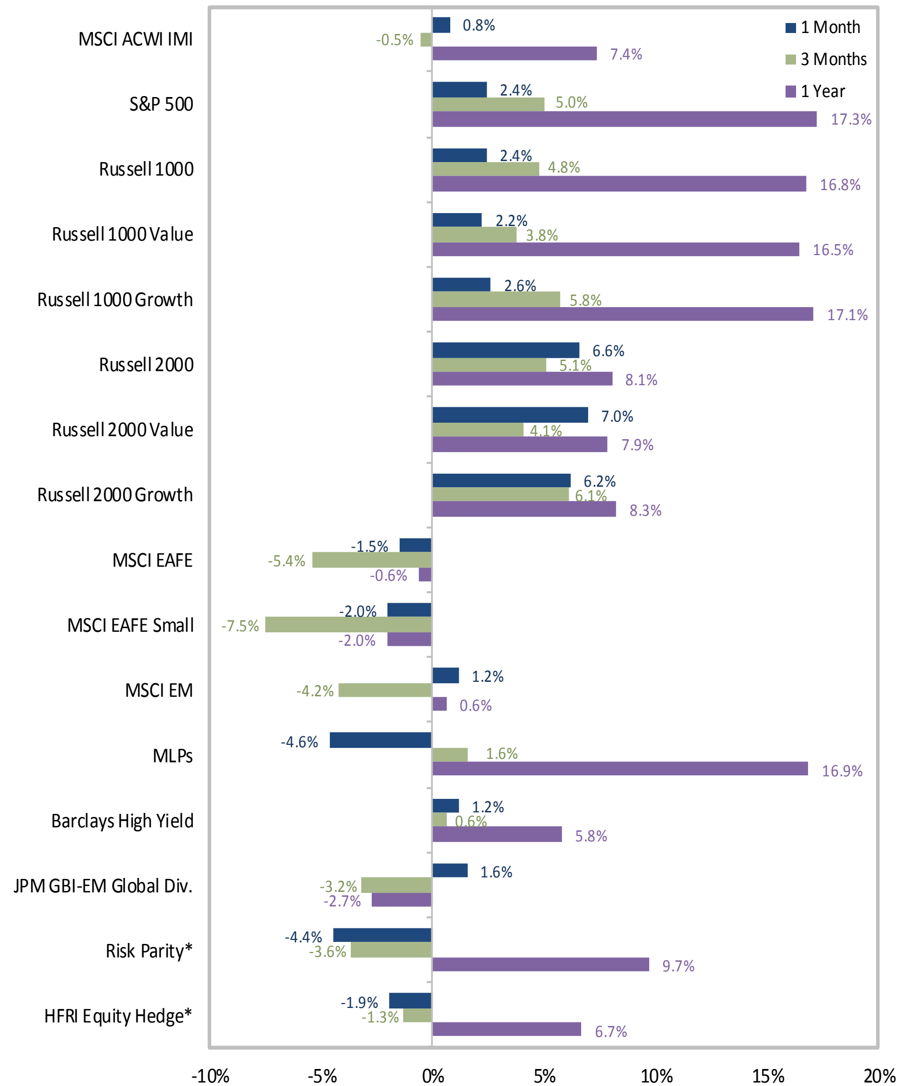
- Availability and aggressive terms from senior lenders has allowed debt levels in the larger end of the market to increase to another new cycle high of 5.9x EBITDA. This remains lower than the prior cycle high of 6.2x recorded in 2007. As the credit cycle has progressed, credit standards and spreads among lenders to private equity sponsors have decreased. Some managers have reported an improved pricing environment for senior lenders since May 2014 resulting in 25-50 bps of return premium. The opportunity for distressed buyers of corporate paper still appears to be a few years away as accommodative debt markets and economic momentum support low default rates.

Risk Parity

- Risk parity strategies detracted in September, with losses led by allocations to commodities. Rising yields and global stock declines also weighed on performance.

Growth Hedge Funds

- Both long/short equity and event-driven indices fell during September. Distressed debt funds and energy-oriented stock pickers were among the largest detractors.



* 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

- Interest rates in most developed economies fell during October and remain low relative to historical levels. The 10-year US Treasury ended October yielding 2.3%, well below its 20-year average of 4.4%. Yields in foreign developed countries remain very low; the Barclays Global Aggregate ex-US Index ended October yielding just 1.3%.
- Core and core plus fixed income performed similarly during the month, both gaining 1.0%.
- US Government bonds were also positive in October as yields fell, returning 0.9% for the month.
- Corporate bonds returned 1.0% in October as investment grade spreads widened 10 bps to 120 bps. Corporate bond spreads have averaged 145 bps over the past 20 years.
- Mortgage-backed securities also returned 1.0% for the month as agency MBS spreads were tightened 5 bps to 25 bps, below the 20-year average of 60 bps.
- International bonds were the worst-performing fixed income sector during October, with the Barclays Global Aggregate ex-US Index returning -0.7%.

Private Debt

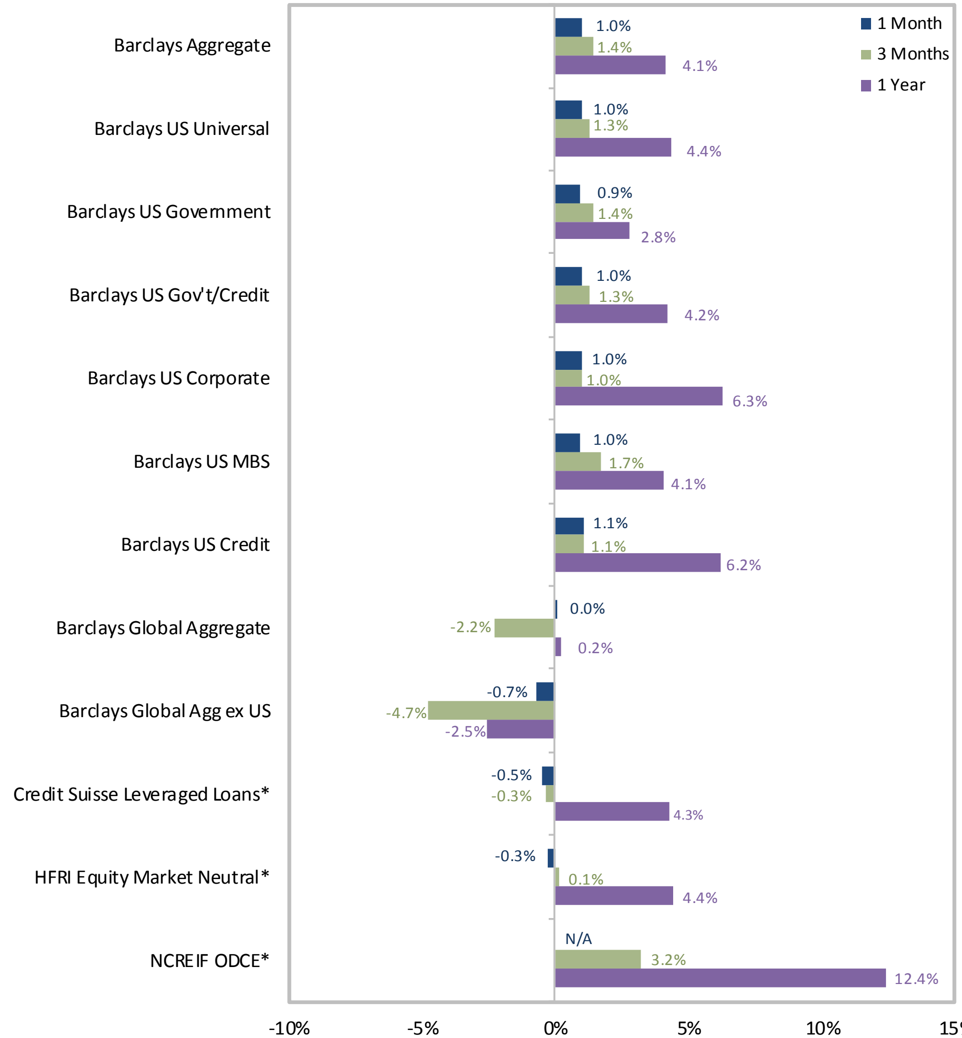
- Leveraged loans declined slightly in September and were up 4.3% for the 12 months ending September.

Relative Value Hedge Funds

- Relative value indices were negative for the month of September, with credit and fixed income arbitrage strategies causing the largest losses. Equity market neutral strategies contributed.

Core Real Estate

- Core real estate returned 3.2% in the third quarter, the best quarter for the NCREIF ODCE Index in a year. The strong performance was fueled by an increase in occupancy rates, which created higher income levels for most properties throughout the US. Appreciation returns for office and industrial properties have also shown a steady increase over the last 18 months. Finally, new construction projects have maintained at a modest volume, creating favorable supply-demand metrics in several key markets.



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Diversification Assets

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Inflation

- TIPS returned 0.9% in October and are up 1.9% over the past year.

Deflation

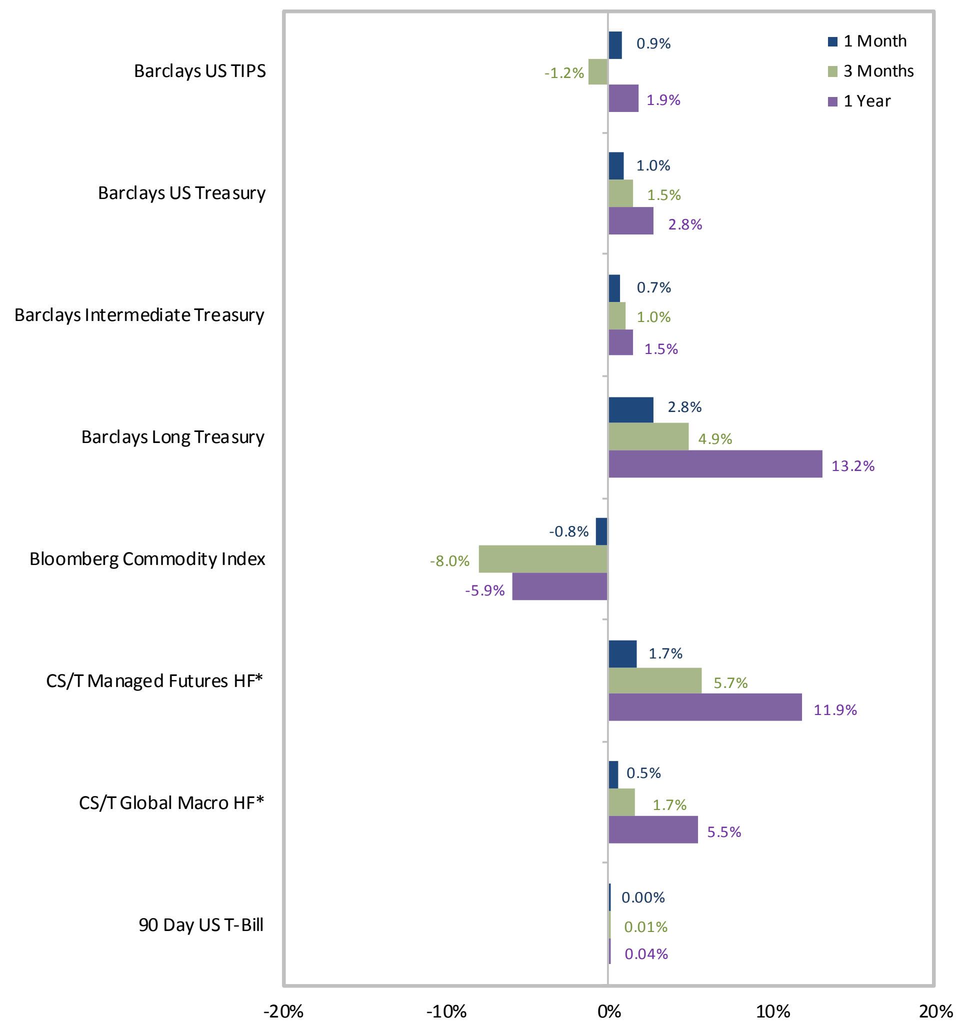
- Treasuries advanced as yields fell during October, returning 1.0%.
- Intermediate Treasuries returned 0.7% and long duration Treasuries returned 2.8%. Intermediate and long Treasuries have earned 1.5% and 13.2%, respectively, over the past year.
- Cash continues to offer virtually no return, as 90-Day T-Bills have gained just 4 bps over the past year.

Commodities

- Amid record US production levels for several grains, agriculture commodities broadly increased during October due to strong current demand both domestically and from exports. Lean hogs (-19%) corrected sharply from their recent highs in October. All energy commodities declined in association with the fall in crude oil prices (-12% during the month). Precious metals were modestly lower this month while nearly all industrial metal commodities generated positive returns, with aluminum (+7%) advancing the most.

Tactical Trading

- Diversification hedge funds had another good month in September, with managed futures again being the largest contributor on gains from trend-following strategies. Global macro also performed well.



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