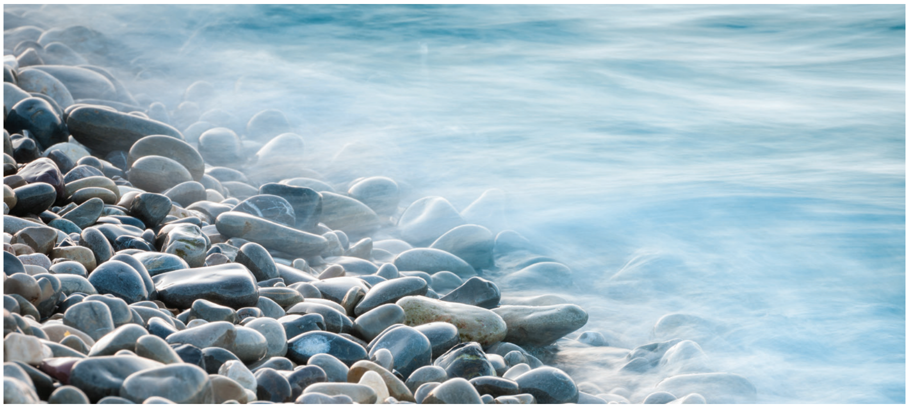
Perspectives

Keeping you informed and engaged about macroeconomic trends and market events



Under Pressure

"When we long for life without difficulties, remind us that oaks grow strong in contrary winds and diamonds are made under pressure."

—Dr. Peter Marshall

THIN SUMMER MARKETS were struck by a self-reinforcing cycle of lower commodity prices, inflation expectations and asset prices, each seeming to confirm the other's dire outlook for the global economy. The initial trigger for the instability was China, where the authorities' management of the bursting of the country's stock market bubble and messy decision to devalue the currency in August left investors severely unimpressed. Fears over China's slowdown and subsequent falling demand for raw materials, coupled with excess supply, meant a further step down for commodity prices. The U.S. Federal Reserve's decision to leave U.S. interest rates unchanged, despite reasonably strong domestic economic indicators, further riled investors and revived uncertainty about the timing and pace of U.S. interest rate increases.

By the end of the quarter, global markets were a sea of red, and even the U.S. stock market finally succumbed to selling pressure, though the S&P 500's -6.4% decline was better than just about any other equity asset class. U.S. small capitalization stocks and most international indices reached correction territory, falling by over 10%, while emerging market stocks got clobbered, declining -17.9%. When the opening days of October revealed slowing global economic data, including China's September Caixin Manufacturing PMI at 47.2, a 78-month low (50 considered neutral), and a U.S. jobs report showing only 142,000 jobs created in September, investors had a reasonable basis to wonder if this market cycle may have peaked and the worst may still be ahead.

While at six years this global recovery is one of the longest on record, it has also been one of the weakest as growth has been unusually muted and unsynchronized across regions. Holding back growth has been

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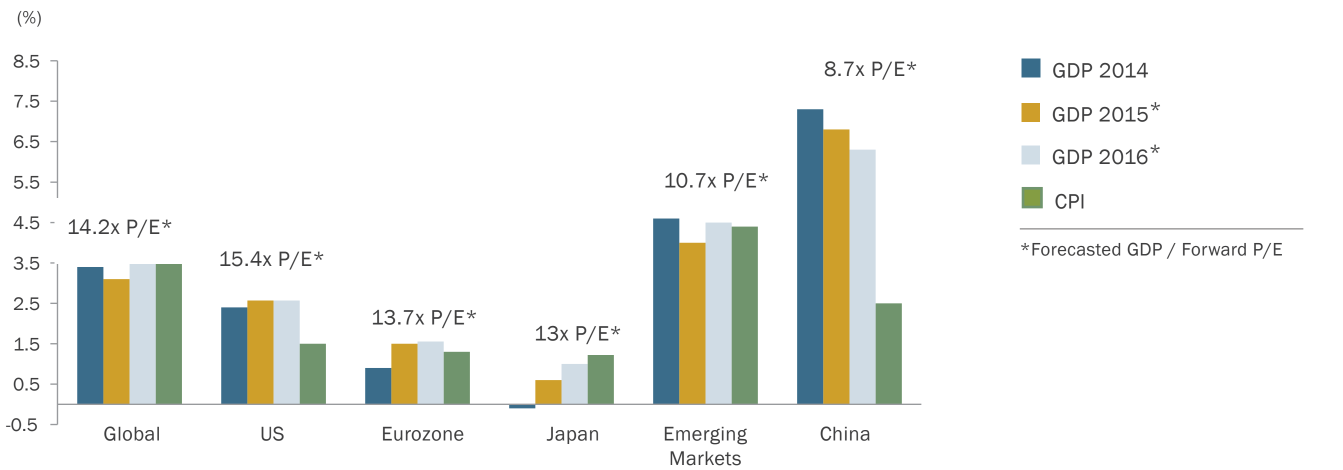
Subpar Growth Outlook Improved by Benign Inflation Forecasts & Attractive Valuations



SOURCE: Bloomberg.

unusually tight fiscal policy and credit conditions, our legacies from decades of unrestrained deficit spending and a collapse of the banking sector that has in many ways been overcorrected with regulation.

That said, while conditions may be softer than what we would expect, they are hardly flashing red. Indeed, purchasing managers' indices in the U.S., Eurozone, and Japan look healthy, labor markets have improved significantly, and credit growth is finally positive across all three regions. To be sure, the same cannot be said for the emerging markets, which are experiencing a long, drawn-out and painful adjustment. Brazil and Russia are mired in recessions, and Chinese growth continues to decelerate as exports and manufacturing cool. And yet, as far as China is concerned, the presence of persistent disinflationary pressures, current account surpluses, flexible exchange rates and adequate foreign exchange reserves gives policymakers in the region better control over liquidity conditions. We also expect China to ease fiscal and monetary policy further, and see growing evidence that consumption is becoming an ever more important driver for economic growth. In our view, China is undergoing an economic transformation, not a hard landing, and markets are still struggling to calibrate what that shift means, not just for China but for other emerging market nations as well as the rest of the world.

What lies ahead? Short-term movements in the market are impossible to predict with certainty, but there are reasons for concern. While sentiment has never been overly giddy, neither have we witnessed the kind of panic usually seen at bottoms. Market volatility often precedes profit trouble, making this earnings season critical. Notably in the U.S., earnings growth has either flattened or started to drop, depending on which measure is used. If it becomes clear that earnings power is at risk, stocks will likely drop from current levels. Finally, bottoms are usually formed when the most hated asset classes refuse to fall any further. Commodities and emerging markets are playing that role, and for now they are still oscillating.

On the other hand, the conditions for a severe and sustained bear market don't seem to be in place. While U.S. stock valuations are full, they are far from bubble territory like we experienced in 1999-2000. It is also worth noting that irresponsible use of leverage has often been a key component of the financial crisis episodes of the past. Currently both consumers and financial institutions have significantly reduced debt over the past eight years. Much of this debt has moved to the government's ledger but they are better able to handle it.

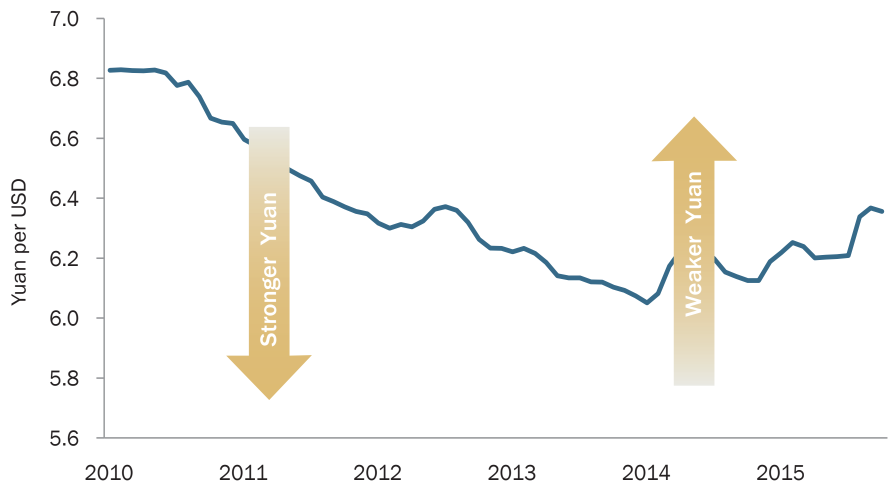
Perhaps the most compelling argument for markets to revive is valuations, which look reasonable if not downright cheap in some pockets of the world. For example, developed international stocks are on our radar given their poor relative performance, attractive valuations and dividend yields. Most foreign central banks are accommodating while our Fed is about to raise rates. The strong dollar should help foreign earnings. Moreover, earnings are closer to the bottom of the cycle overseas versus near the top in the U.S. We can therefore be constructive on equities even if the outlook suggests ongoing subpar global economic growth, and even though risks remain, because enough of those concerns are reflected in stock market prices.

Global Economic Overview: The China Syndrome

China's contribution to recent market volatility and the downshift in global growth forecasts have fueled heavy pessimism in the global investment community. Some feel that the broader impact of the economic and financial transition underway in the world's second largest economy may have been underestimated. Many investors and policymakers are gripped by concerns that a meltdown in Chinese economic growth or financial markets could have similar global impact. Indeed, when the U.S. Federal Reserve decided not to raise rates at its September meeting, it was in part due to global developments. Likewise, in October, the International Monetary Fund (IMF) cuts its global growth forecasts to 3.1% for 2015, -0.3% lower than in 2014, citing rising downside risks given an environment of declining commodity prices, reduced capital flows to emerging markets and pressure on their currencies, and increasing financial market volatility.

Notwithstanding the risks, a review of economic fundamentals in the developed world suggests a continuation of many key growth trends. Furthermore, there is increasing evidence that China is at a turning point in its economic transition from an industrial to consumer focused economy. Also a factor is the role central banks continue to play in providing policy support. Indeed, we expect the European Central Bank and Bank of Japan to extend and even expand their quantitative easing programs in light of the downside risks created by financial market volatility. Elsewhere, the Bank of England and Bank of Canada should remain sidelined in hiking rates until the middle of next year. Even the Fed's course is unchartered now after they decided to hold the policy rate steady on September 17 due to heightened concerns about global developments. With central bank policy supportive or at least restrained, and fundamentals hanging tough, the global economy would seem capable of weathering some storms.

Surprise Yuan Devaluation Left Markets Disoriented



SOURCE: Bloomberg.

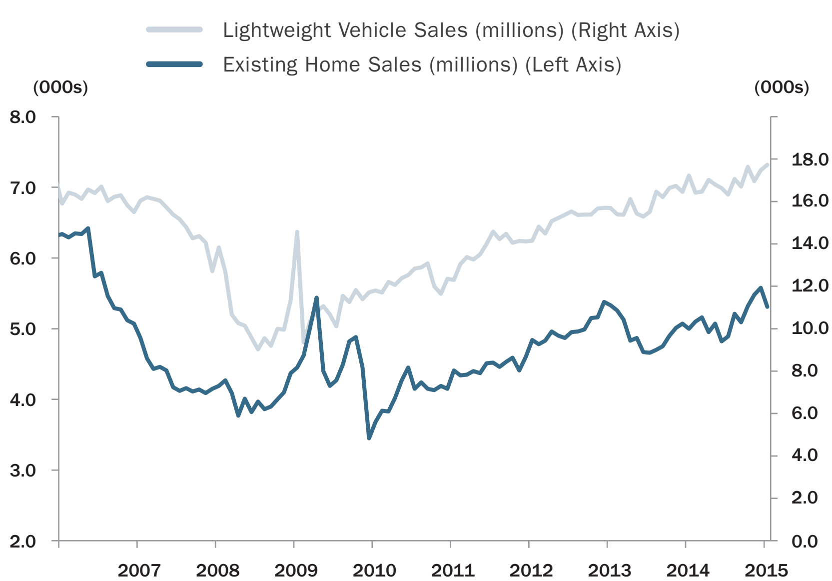
U.S. Economy: Back in Business

The U.S. economy roared back to life in the second quarter following a subdued start to 2015. Real GDP increased at a 0.6% annualized pace in the first quarter with activity stifled by poor weather conditions, a West Coast port strike, and reduced investment by energy companies. The reversal of two of the three factors that dampened activity in Q1 fueled a significant swing in output with real GDP expanding at a 3.7% annualized pace. Consumer spending increased at a solid pace supplemented by another strong gain in residential construction activity while the unleashing of pent-up demand for exports created by the port strike boosted volumes in Q2.

Business investment also increased in the second quarter although the pace was curtailed by another large pullback by energy companies. Outside of this sector, however, U.S. companies increased spending on non-residential structures and, to a lesser degree, equipment. Even after seeing profit growth slip in the recent quarter, corporate balance sheets remain in good condition and financial institutions reported having increased access to capital for both commercial and industrial loans and mortgages on non-residential properties. Unfortunately, though, financial market volatility appears to be taking its toll, as a survey of CEO confidence showed a slip to 48, down from 58 in the second quarter of 2015 (a reading of more than 50 points reflects more positive than negative responses).

Not so for consumers, as the Conference Board's measure of confidence improved to 103.0 in September, back to January's high. And this euphoria was positively translated into economic activity as an easing in credit conditions by financial institutions boosted borrowing activity which was supplemented by consumers redeploying some of the cash saved from falling energy costs. In fact, a pickup in auto sales saw the per capita rate return to its long-term trend level for the first time since before the recession. Likewise, home sales reached their highest level since just after the recession this summer.

Auto and Home Sales Make a Comeback

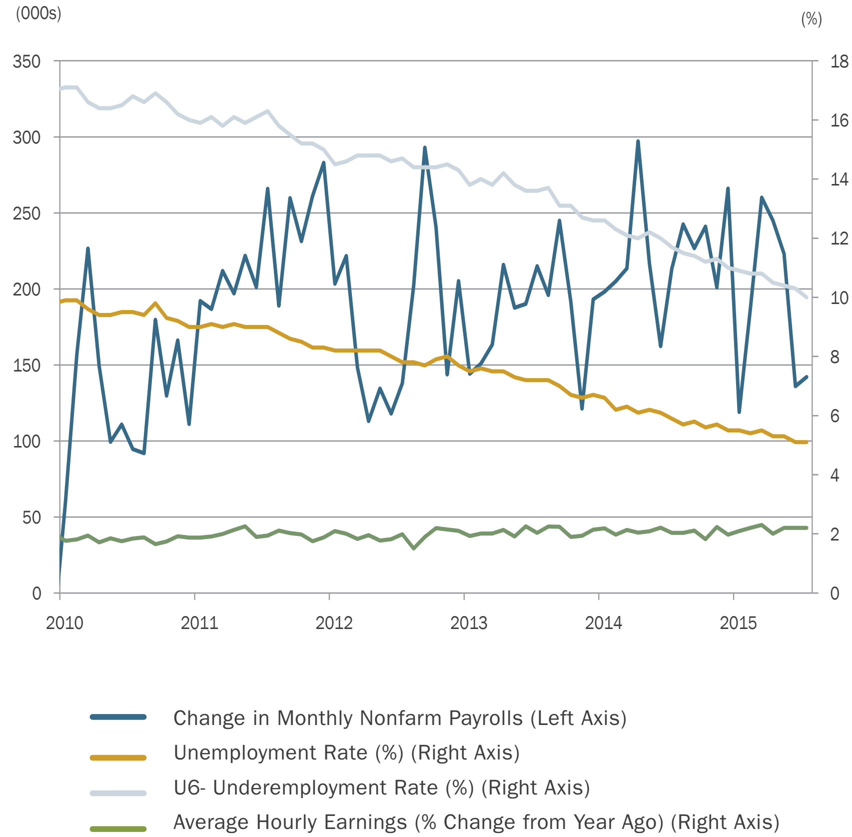


SOURCE: Bloomberg.

Losing some steam, however, was the labor market, as the September jobs report showed monthly payroll growth of just 142,000, and a downward revision to August payrolls from 173,000 to 136,000. In 2015, job growth has averaged 198,000 per month, compared with an average monthly gain of 260,000 in 2014. Even so, the unemployment rate at 5.1% is within the Fed's estimated full-employment range of 4.9% to 5.2%. And while the so-called "U6" measure of underemployment remains high at 9.6%, it has declined from 10.3% in August and 17.1% at its peak in 2010. Unfortunately, the tightening of labor market conditions has yet to generate strong wage growth, which is running at a lackluster 2.2% year-over-year pace. That said, the Federal Reserve's Beige Book for September indicated that companies reported increasing wage pressures and skilled labor shortages which may portend an improvement in wage growth to come.

It was therefore curious, if not confounding, to see the Fed choose to stand pat at its September meeting, citing concerns about global developments and growing risks to downside inflation. While it is true that headline inflation has trended lower recently due to declines in energy prices, core inflation has held steady at 1.8% year-over-year growth. The Fed has previously acknowledged disinflationary pressure from lower oil prices and a stronger dollar as transitory, and has emphasized their belief that full employment and above-trend economic growth should facilitate a return to target inflation over the medium term. While the Fed officially described the impact of the drop in U.S. equity prices and the slowdown in China and EM economies as having only "small" effects on domestic activity, their decision to delay in the midst of market volatility seemed highly tactical. Regardless, an increase in rates would seem to be at hand, though again, the pace of their course has been well telegraphed to be slow, steady, and data-dependent. Expectations are lining up for a December or early 2016 move, and we expect the fallout to be fairly limited and the overall impact anti-climatic.

U.S. Labor Market Loses Some Steam in Q3



SOURCE: Bloomberg.

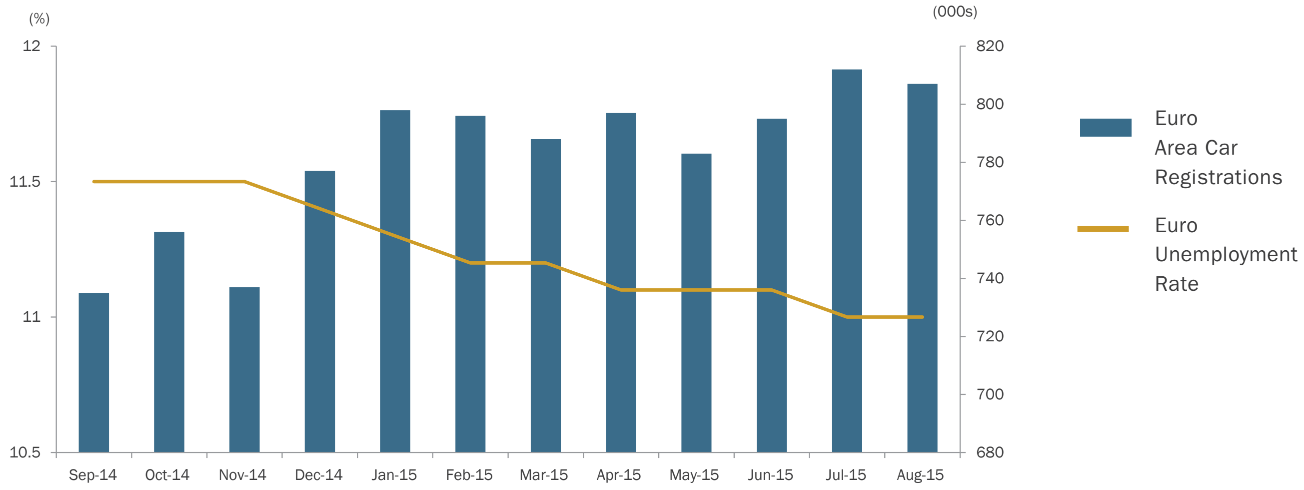
Developed International Economies: Gaining Pace

European equities were among the hardest hit in the recent China-induced global rout, especially curious given that China is the destination of only 3.7% of eurozone exports and 5.4% of German exports. The downbeat global mood is overshadowing encouraging data that show the recovery of the eurozone economy is gaining pace as its labor market and credit conditions improve.

Indeed, as of September, the EU's employment figures have fallen to their lowest level since June 2011—standing at 9.5% for the entire 28-member bloc. Additionally, youth unemployment shows signs of dropping after years of posting above-average figures. New car registrations across Europe are positive and mortgage data, especially in the U.K., is picking up. The EU Commission's economic sentiment indicator for the eurozone countries increased to 105.6 from a previous level of 104.1 in September, and consumer spending is on the rise. And even though industrial production and manufacturing remain below potential, eurozone PMI was recorded at 53.9 in September, its best quarter in four years, a recovery driven in large part by the weak euro.

Reflecting these improvements, overall EU GDP was recorded at a 1.5% annualized pace in Q2, with increases in growth in all member states except France where GDP remained stable. Even more encouraging, previously hopeless countries like Spain are seeing a much stronger recovery, albeit from a low base, than originally envisioned. Besides the ECB and low energy prices, Spain has also benefitted from a number of Prime Minister Rajoy's reforms to kick-start growth, including making it less expensive for companies to fire permanent workers, a reduction in the corporate tax rate from 30% to 25%, and an overhaul of the banking system.

Eurozone Economic Data Shows Promising Turnaround



SOURCE: Bloomberg.

As such, it was surprising and a bit disheartening to see the euro area's inflation rate turn negative in September for the first time in six months, falling -0.1% year-over-year. With the ECB's inflation target just below 2%, pressure is building on the ECB to bolster stimulus, and at a recent European Parliament hearing in Brussels ECB president Mario Draghi reiterated the bank's commitment to expand its €1.1 trillion QE program should it be needed to avert deflation.

The ECB's vigilance remains ever important to not only growth but also stability, as political tension in Europe continues to wax and wane. For now, Greece has settled after the eurozone approved an €86 billion bailout package in exchange for a raft of austerity measures and wide-ranging market-friendly reforms under strict external supervision. More pressing has been the economic and political strains created by the influx of migrants and asylum seekers to Europe—at least 350,000 immigrants crossed the EU's borders in January through August 2015, compared with just 280,000 during the whole of 2014. This refuge crisis is creating turmoil and uncertainty across the bloc, and will be a key issue in David Cameron's renegotiation of Britain's EU membership, on which the British population will vote in 2016.

Regarding the U.K., growth was reported at 2.4% year-over-year in Q2, marking the ninth consecutive quarter of above 2% expansion for the country. In contrast to other developed nations, wage growth is on fire, with compensation rising 4.7% from a year earlier, the biggest jump since 2007. With inflation stuck stubbornly at zero, British consumers' spending power is stronger than ever, and is evidenced by a steamy housing market and solidly expanding services sector.

In contrast, Japanese economic data has been less resilient than we would have hoped, with the most notable disappointment a decline in consumer price inflation of -0.1% in August. This news, coupled with wage data that showed retracement from gains earlier this year, is a setback to the Bank of Japan's 2% inflation target, and alongside the recent firming in the currency, supports the case for further monetary policy easing. With GDP contracting by -1.2% annualized in the second quarter, and government budget conditions better than forecast, there is leeway for President Abe to produce a stimulus package. It was no surprise then that by late September, President Abe had declared the beginning of "Abenomics 2.0." With inspiring rhetoric, he boldly called for a $5 trillion Japanese economy, and described the catalysts to get there in detail, including raising the nation's fertility rate, providing free preschool education and tax credits for families, boosting social security benefits, and offering tax breaks to corporations creating employment opportunities for women and retirees. Fiscal and monetary policy supports, coupled with the boon of low commodity prices, should align for a rebound in growth in the coming quarters, especially if Asia-related angst settles down.

> "Tomorrow will definitely be better than today! From today Abenomics is entering a new stage. Japan will become a society in which all can participate actively."

– President Shinzo Abe announcing Abenomics 2.0, an updated plan for reviving the world's third-largest economy, setting a GDP target of ¥600 trillion.

China & Emerging Economies: Burning Up

China bears do not lack for evidence: in September, the Caixin Manufacturing PMI index fell to 47.3, its lowest reading in seven years, while the official PMI was recorded at 49.8, only slightly above a three-year low and still in contraction territory. Factory production in August grew 6.1% year-over-year in August, weaker than expected. Fixed asset investment increased at a 10.9% pace year-over-year for the January-August period, also shy of forecasts. Industrial enterprises' profits dropped -1.9% in the January–August 2015 period compared with the same months in 2014, when industrial revenues grew 1.3%.

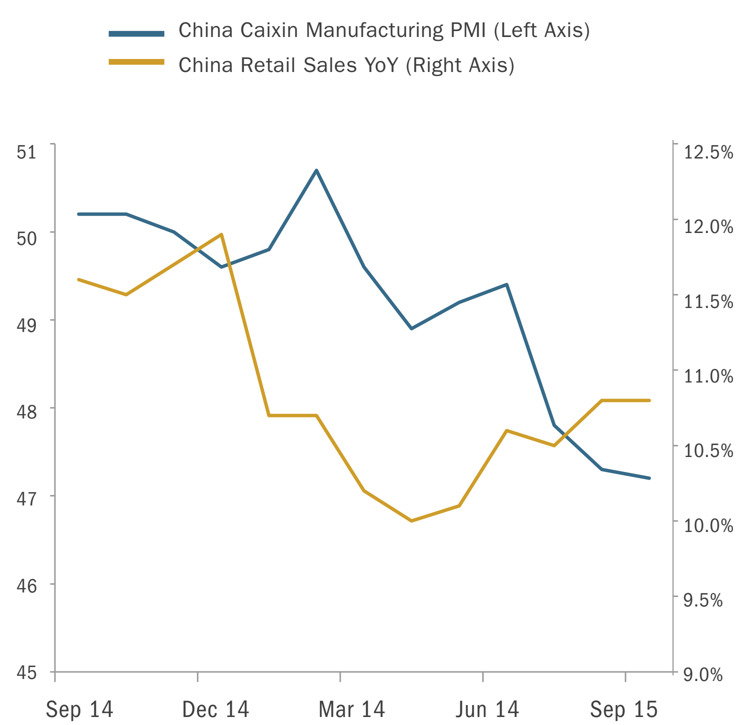
While this weakness is stunning, consider that commodity-related sectors—for example, smelting and mining—are driving the losses. And, perhaps most importantly, industrial enterprises are now only a subset of all enterprises in China, representing just 35% of GDP.

Importantly, China's consumer sector is growing nicely, which is easily overlooked when viewing economic progress through the traditional lens of manufacturing activity. Chinese retail sales have exceeded expectations, increasing 10.8% in August from a year before. Certain monthly consumer metrics also paint a more positive picture of the economy, with movie box office sales, airline passenger counts, and 4G mobile subscriptions all showing impressive year-over-year growth.

While the recent market turmoil is sure to have an impact on growth, we believe it is still possible that China will meet its 2015 GDP target of 7%. We expect many of the government supports stepped up since the central bank acted to devalue the yuan will support growth. Among those efforts have been interest rate cuts and a further drop in the reserve requirement ratio by the PBoC, reform measures focused on state-owned enterprises, as well as targeted stimulus including lowering a property down-payment requirement for the first time in five years and cutting a tax on passenger-vehicle purchases.

Outside of China, the biggest economic news in the quarter came from India, which continues to be a shining star, and Brazil, whose fiscal collapse is nothing short of catastrophic. India surprised to the upside by posting 7% year-over-year GDP growth in Q2, as Modi-induced euphoria continues to buoy growth. In further support of expansion, the Central Bank of India cut interest rates more than anticipated in September to 6.75% in a bid to fuel credit expansion after inflation eased to 3.7%. In contrast, the economic outlook for Brazil continues to deteriorate. High unemployment, even higher inflation, and a worsening fiscal stance caused a cut in the country's credit rating to junk status this fall, which will further pressure already tense negotiations for economic reforms.

China's Manufacturing Losses Are Being Met with Consumption Gains

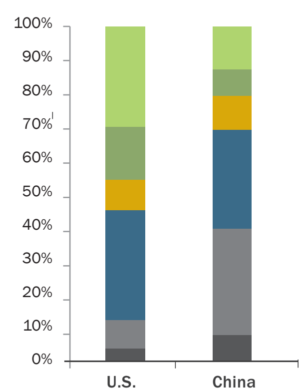


SOURCE: Bloomberg.

As Incomes Rise, China's Consumption Is Shifting

	China	U.S.
Well-being	11%	28%
Fun / discretionary purchases	8%	17%
Mobility and connectivity	10%	11%
Housing	27%	32%
Food	30%	8%
Clothing / personal apearance	13%	5%

SOURCE: Bloomberg.



Global Market Outlook: Correction or Inflection?

Global equities declined amid worries about the economic slowdown in China and the implications for global growth. Then, the Federal Reserve's decision to defer 'lift-off' of U.S. interest rates only served to exacerbate the sense of uncertainty in the markets. In the eurozone, the autos sectors came under severe pressure after revelations that Volkswagen had misled regulators on emissions from diesel vehicles. Weak Chinese economic data was a drag on emerging markets while Brazil was also a focus as S&P downgraded the country's debt to non-investment grade. The third quarter was broadly positive for global bonds, as commodity price weakness and fears over global economic growth led investors to seek out 'safe havens'. REITs made a comeback, while commodities circled the drain. Hedged strategies provided relative, though not necessarily absolute, protection, and showed their diversification benefits.

U.S. equities flounder as the Fed head fakes

U.S. equities performed poorly, in line with global equities, as markets fretted about the extent of the economic slowdown in China and emerging markets, and what that might mean for global growth. While the Fed delayed its much-anticipated 'lift-off" of U.S. interest rates, this was not taken as a positive signal by investors. Markets instead focused on comments made by Fed Chairwoman Janet Yellen at the subsequent news conference, where she cited worries about the world economic outlook in explaining the decision to delay a rate hike. When considered with the fact that forecasts for third quarter earnings now call for a -5.5% decline from a year ago, it is little wonder that the S&P 500 recorded a -6.4% loss in the quarter.

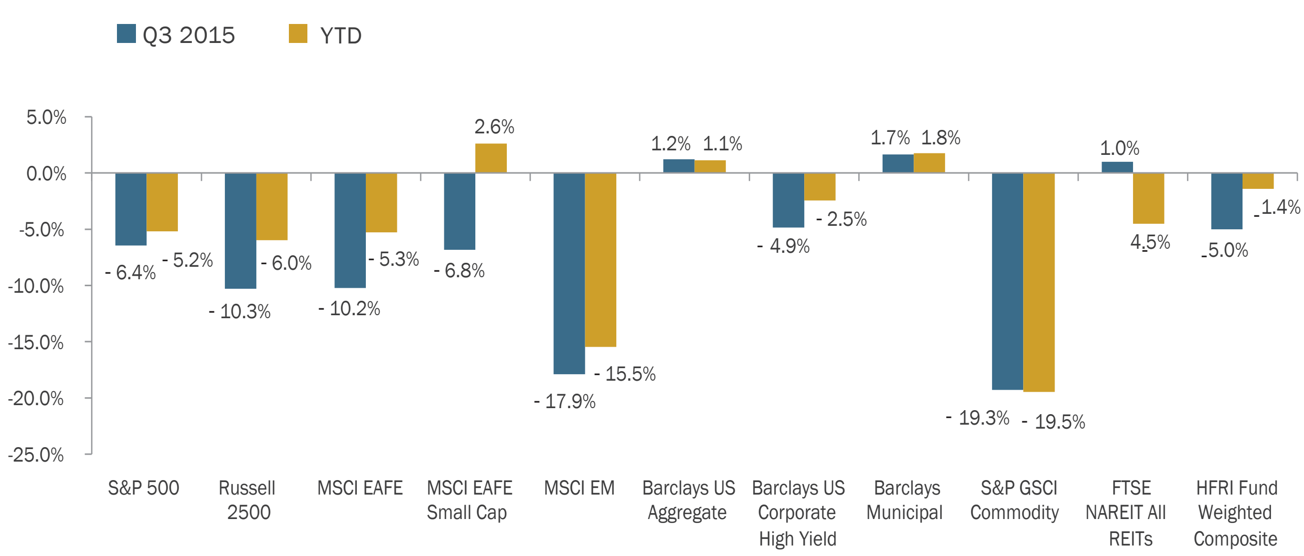
Amid this "risk-off" environment, the equity market's bond proxies perfomed well, notably utilities, which was the only sector to rise. The defensive consumer staples sector also performed relatively well. The resources sectors continued to weaken, while healthcare's strong run came to an abrupt end after Democratic presidential hopeful Hillary Clinton tweeted an attack on pharmaceutical pricing.

Mergers-and-acquisitions activity remained brisk, adding to an estimated $3.2 trillion in deals announced for the year to date —on track to match 2007's record pace. Teco Energy shares rose 50%, the biggest percentage gain in the S&P 500, as it agreed to be acquired by Canadian utility Emera for $6.5 billion in cash. Netherlands-based Altice bought Cablevision for about $17.7 billion in cash and debt, adding the New York–based cable system operator to a growing portfolio of U.S. assets; Cablevision shares advanced 36%. The prospect of an extended period of low crude oil prices spurred consolidation in the energy sector. The quarter was bookended by deals for pipeline operators: Marathon Petroleum purchased MarkWest Energy Partners for $20 billion in July, while Energy Transfer Equity announced it was acquiring Williams for almost $38 billion in September. Other large deals announced in the quarter included Berkshire Hathaway's $37 billion purchase of Precision Castparts.

As for smaller capitalization stocks, the Russell 2000 lost a whooping -11.9% as the market rout caused perceived riskier asset classes to underperform.

However, by the end of the quarter, small-cap stocks were returning to favor given investor concerns about global growth since large-caps derive a significantly higher percentage of their earnings from outside the U.S. In terms of

Painful Losses Recorded in All Market Segments Except High Quality Bonds



SOURCE: Bloomberg.

style, growth stock continued to strongly outperform value, thanks to the superior earnings growth demonstrated by companies in the healthcare, technology, and consumer discretionary sectors. A recovery in depressed energy shares or a rise in short-term interest rates benefitting the financials would likely shift that dynamic.

Fear and fraud shake the developed international equity markets

Likewise in distress was the developed international stock market, as the MSCI EAFE index posted losses over -10% with stocks in Japan, the UK, and Europe sinking over concerns about global growth. Smaller capitalization companies held their value better, though the MSCI EAFE Small Cap index nevertheless posted losses of -6.8%. M&A activity has helped buoy returns in this market segment, allowing international small capitalization stocks to retain gains on a year-to-date basis despite market pressures.

European countries had the mildest losses, with Denmark delivering the best relative performance, trailed by Ireland, Italy and Finland. All sectors saw negative returns, although healthcare and telecommunications held up better than the rest. Auto stocks were among the worst performers over the period, due in part to expectations that a slowing Chinese economy would see reduced demand. Further pressure was then heaped on the sector after revelations that VW had misled regulators in emissions tests on its diesel vehicles. VW set aside €6.5 billion in provisions and the scandal ensured that Germany's DAX was one of the weakest European indices in the quarter.

The Japanese stock market came under heavy selling pressures in the third quarter as the benchmark TOPIX Index fell -11.8%, amidst slowing global growth and worse-than-expected data for the Japanese economy. Stocks slid to an eight-month low while the Japanese yen strengthened as the currency saw inflows based on its perceived 'safe haven' status. Amazingly enough, equity market valuations are now down to levels at or below those seen at the outset of Abenomics. Despite enormous progress on profit and profitability improvements, approximately 50% of Japanese companies are once again trading below their book value. With dividend yields at 2% in a market where the 10-year Japanese government bond pays only 34 basis points, it would seem likely fundamentals will soon come into focus, though there is no telling how long Asia-related market angst may taint prospects.

EM Leaders and Laggards Have Traded Places in Just Nine Months

2014 (%)		YTD through 9/30/2015 (%)	
TOP 5			
Egypt	29.33	Hungary	23.34
Indonesia	26.59	Russia	8.70
Phillipines	25.58	India	– 5.26
India	23.98	United Arab Emirates	– 6.09
Turkey	18.71	Philippines	– 6.35
BOTTOM 5			
Columbia	– 19.79	Turkey	– 31.69
United Arab Emerates	– 26.87	Indonesia	– 33.35
Hungary	– 27.44	Columbia	– 35.76
Greece	– 39.64	Brazil	– 39.38
Russia	– 46.27	Russia	– 52.27

SOURCE: Bloomberg.

Emerging market equities seemingly reach capitulation

Emerging markets registered sharp declines as U.S. interest rate hike uncertainty, concerns over the health of the Chinese economy, political risk, and commodity price weakness all contributed to risk aversions. In emerging Asia, India held up the best, while China, for obvious reasons, lagged. South Africa was down sharply and underperformed with rising expectations for tightening in global liquidity acting as a headwind for the market. Turkey also lagged, given the news that coalition negotiations, following indecisive elections, failed and fresh elections will take place in November. Meanwhile, the Turkish government joined U.S.-led attacks on ISIS in Syria and Iraq, but also cracked down on the Kurdistan Workers Party, leaving the group to end its ceasefire with the government. Although a third bailout deal was agreed, Greece also struggled, as the imposition of capital controls means banks are now expected to require a sizable recapitalization.

Latin American markets offered no respite as commodity price declines ravaged returns in this corner of the world. Colombian equities were impacted by lower oil prices and sharply falling peso (down -16.6%). Likewise, Brazil recorded a steep decline as the macro outlook deteriorated and the government went back on a commitment to a primary surplus in 2016, prompting a credit rating downgrade to junk status.

Russia was in the crosshairs after a larger-than-expected -4.6% decline in second quarter GDP was reported and oil prices continued to spiral downward.

Corporate bonds in crisis; munis and Treasuries market's only salvation

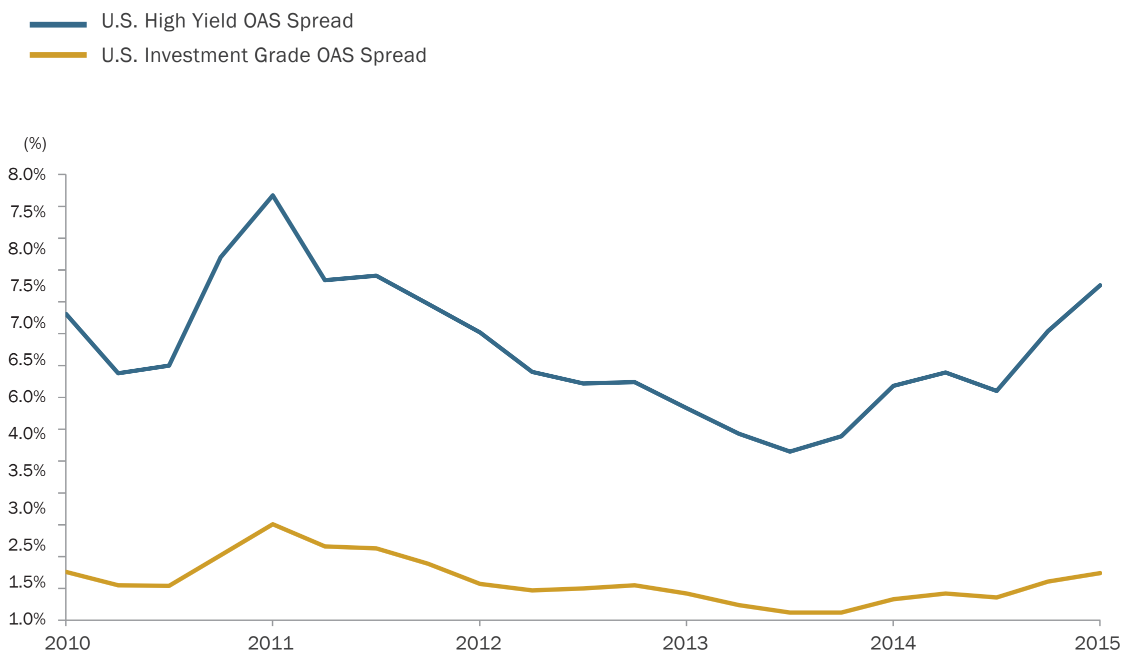
High-yield corporate bonds are often called equities with a coupon, in part because their performance is more closely correlated with that of stocks than Treasury bonds. The third quarter provided another example of that paradigm. Equities had a terrible quarter, and the high-yield corporate bond market recorded the worst total return since 2011. Likewise, the investment-grade corporate market has struggled in recent months. Yields are back at cycle highs, while the yield on the 10-year Treasury is almost 100 basis points lower now than at the end of 2013. With spreads this wide, and defaults still projected to be low, we believe both the high yield and investment grade corporate market are poised to produce decent total returns in the month ahead.

In contrast, government securities have returned to being overvalued in the most recent flight-to-quality market move, with yields on longer Treasury notes and bonds near the lower bounds of their ranges of the past two years. However, it should be noted that in the two-year segment of the curve, yields have increased in anticipation of a higher federal funds rate. Thus, the yield curve has flattened by more than 100 basis points since early last year. A flatter yield curve provides less protection to longer maturities from what could be a prolonged rise in the federal funds rate.

The "risk off" environment also boosted prices of securitized debt, including mortgage-backed securities (MBS) and asset-backed securities (ABS). These sectors enjoy relatively strong liquidity, which attracted investors who moved away from riskier sectors such as high yield and emerging markets bonds, where trading at efficient prices can become even more difficult in a significant downturn. MBS and ABS both benefited from their relative insulation from the turbulence in international financial markets and volatile commodity prices.

Finally, municipals once again put in a heroic performance, with yields down approximately 30 basis points since mid-July. While this is usually the time of year when new-issue calendars become sufficiently heavy to push yields higher, demand has been strong enough to absorb new issues at lower, not higher, yields. This strong performance is all the more impressive given the overhang of Puerto Rico's credit woes.

Corporate Bond Yields Blow Out In Sympathy with Equities



SOURCE: Bloomberg.

Hedged strategies find vindication

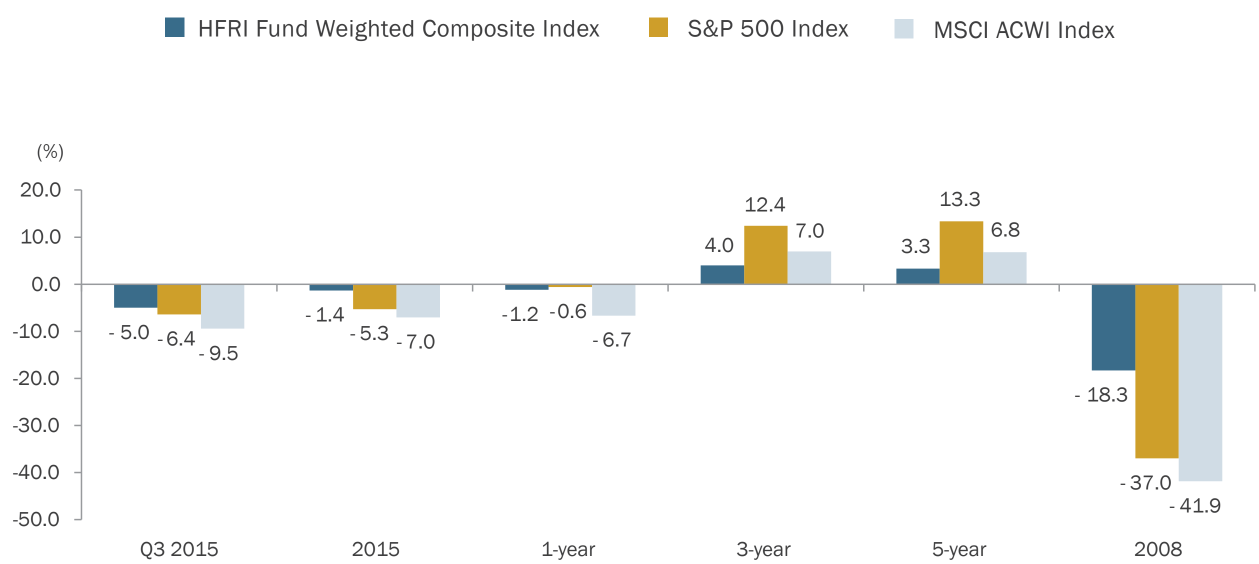
After lagging the long-only markets since the Great Recession, hedged strategies once again proved their mettle as returns for the quarter and on a year-to-date basis showed the largest performance gap to traditional equity benchmarks since 2008. Quantitative macro and CTA strategies posted gains in the quarter, pushing year-to-date returns to only modest losses. In contrast, equity and credit-sensitive event-driven strategies were the weakest segment of the asset class, as exposure to positions in Glencore, Valeant, and high yield credit were caught up in market turmoil. Equity hedge and relative value strategies were down, but much less than traditional market exposures, and have been among the most sought-after hedge fund segments in these volatile times. As always, it is important to note that strategy-specific characteristics, including net exposure, leverage, sector concentration, and idiosyncratic positions, contribute to large differentiation between the best and worst performing within the hedged strategy segment.

Real estate roars back

Real estate investments rallied back in the third quarter, reflecting growing investor perceptions that REITs have been undervalued. Investor concerns about the impact of rising interest rates on REITS helped depress share prices earlier this year, which may have helped set the stage for their third-quarter rebound. U.S. returns were particularly strong, given the strength of the housing market, with sectors like self-storage, apartments, and manufacturing housing leading gains. Overseas REITs were strong relative performers, though the FTSE EPRA/NAREIT Global Real Estate Index still lost over -5% in Q3. European real estate was strong, gaining almost 6%, but other regions like Middle East/Africa, Latin America, and the Asia/Pacific region posted double-digit losses.

Looking ahead, the potential negative impact of rising interest rates remains a key concern for REIT investors. However, the majority of REITs have improved their balance sheets since the last downturn and appear as a group to remain more conservatively leveraged than the last boom in the mid-2000s. Moreover, upcoming maturities for many REITs over the next few years still carry interest rates that far exceed current borrowing costs, so even a 100-basis-point rise in rates from here would have a negligible impact on cash flow, at least over the medium term. With real estate becoming a dedicated GICS (Global Industry Classification Standard) sector in 2016, there is strong technical support for the asset class as the investor base expands and coverage and awareness improve. We therefore see opportunity in the asset class at current levels, and particularly favor global exposure and real estate operators that are less sensitive to U.S. interest rates.

Not Since 2008 Have Hedge Funds Performed As Well



SOURCE: Bloomberg.

Commodities crisis reaches a crescendo

Once again, commodities suffered breathtaking declines in the quarter, with the energy segment leading losses. It is now true that almost all commodities are trading at 10-year lows, and the asset class would seemingly have reached capitulation. While global growth concerns may keep the asset class in a rut, it is worth noting that there is growing evidence that the previous sharp falls in prices are prompting the supply cuts necessary for a sustained recovery. For example, the mining company Glencore dominated the headlines this quarter, and they are not alone in pulling back, as there have also been substantial cuts in investment in the oil industry.

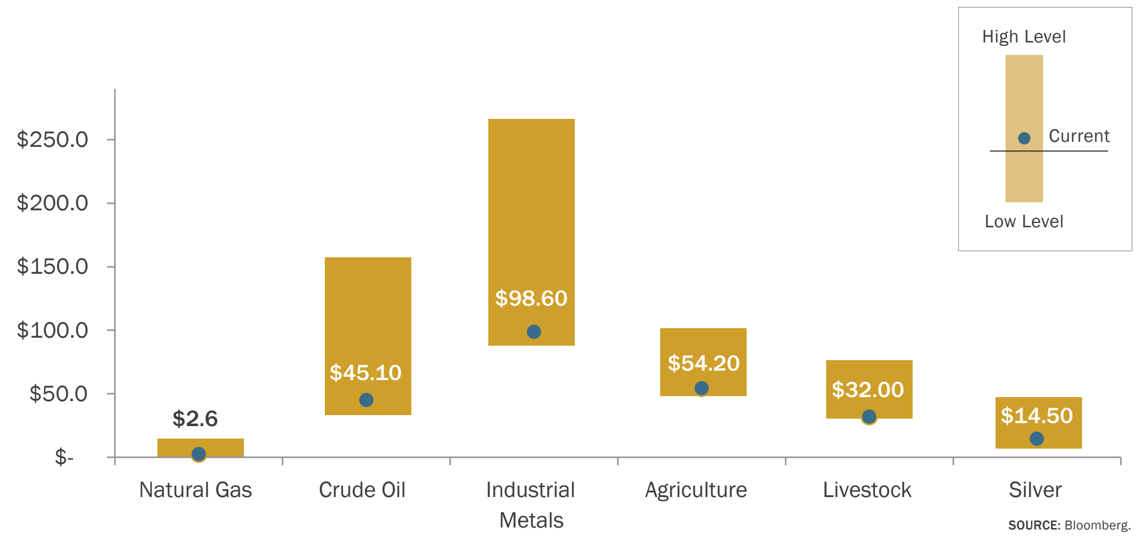
Looking ahead

The bursting of the stock-market bubble in China in late June, followed by an unexpected depreciation of the yuan against the U.S. dollar in mid-August, has led to substantial financial-market reverberations in both developed and emerging markets. We do not believe that the bull market in global equities has ended; however, the character of the bull market certainly has changed.

Since the beginning of 2015, other equity markets (notably Japan and the countries of the eurozone) have found increased favor among investors. Volatility notwithstanding, it is our expectation that monetary policies will remain far more expansionary and for longer in Japan, Europe and the rest of the world than in the U.S. It is our strong conviction that developed economies will not only avoid recession but will actually step up the pace of growth in the year ahead. Our expectation is that the bull market in the U.S. still has a few of years of life left in it, as share prices rise with underlying profitability. However, the Federal Reserve's decision to stand pat in September suggests that the Fed is more than data-dependent. It is also market-dependent (and China-dependent). We worry that U.S. equities will be impacted by indecisive Fed policy, as well as the headwinds that a strong U.S. dollar creates. Without the cushion of low valuations that is a benefit to other segments of the global equity markets, we are less sanguine about the prospects for the S&P, though we remain core long-term investors. As for emerging markets, we believe defensive is the best offense, focusing on investments geared to profit from the rise of the middle class. We are playing a long game with our investments in emerging markets, but believe it will one day prove to be a game worth played.

In the months ahead, investors will be looking for evidence that China's growth slowdown is not becoming unmanageable. As third-quarter reporting season begins for corporate America, we will likely hear the refrain of China's slowdown and a stronger dollar as excuses for earnings misses. And while we feel confident global monetary policy will prove to be a catalyst in most respects, the Fed's path seems fraught with challenges. If these issues weren't enough to keep investors on edge, other questions also loom, including, once again, "Will the government shut down or not?" These risks are real, and must be kept in perspective. Yet while we continue to monitor downside risks, we find that the fundamentals of positive growth and accommodative policy still support our positioning, and believe prudence will prevail in staying the course through this volatility.

Commodity Prices at 10-year Lows



SOURCE: Bloomberg.