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Source: Morningstar Direct
After a rocky start to the year, almost all major asset classes have continued to respond positively into the second quarter and are positive year-to-date.

The month began with investors speculating the Federal Open Market Committee might raise rates in June however this expectation was quickly quelled as US job growth numbers fell short of expectations and inflation remained well short of the Fed’s 2% target.

US equity returns were modestly positive in May as investors digested mostly lukewarm economic data.
  - The S&P 500 returned 1.8% and the Russell 2000 gained 2.3% on the month.

The prospect of rising rates sent a scare through emerging markets as the MSCI EM Index declined 3.7% and was primarily driven by falling equity prices and currency depreciation in Latin America. This decline was also felt in local currency debt as the JP Morgan GBI-EM Global Diversified Index fell 5.4% in May but remained up 7.7% on the year.

US fixed income returns were mostly neutral as the 10 year Treasury yield increased one basis point to 1.84% on the month and the Barclays US Aggregate Bond Index was flat.

US high yield issues saw continued marginal spread compression and returned 0.6% as represented by the Barclays US Corporate High Yield Index.

The Citigroup WGBI Index fell 1.5% as government bond yields in developed countries continued to move slightly higher and the US dollar rallied.
2016 Capital Markets Key Themes
US economic cycle and US central bank policy are at the forefront of major cyclical and secular forces informing our Assumptions and Actions

- These factors interact to create a supportive environment for risk assets in the near term but ultimately push long term capital market forecasts lower relative to history

The US economy is nearly 7 years removed from the previous recession but the health of US consumers can extend the expansion

- Prolonged US economic cycle has the potential to push the US dollar higher

Persistent US Dollar strength tightens global monetary conditions and materially weakens the US corporate earnings profile

- A strong dollar strains international borrowers with dollar based debt
- Outsize credit growth in Asia, specifically China, at risk from a stronger US dollar

Influence of central bank policies in the developed world remain broadly supportive for risk assets but come with long term effects

- US policy is slowly diverging from Europe and Japan but gradual expected pace of hikes provides a positive backdrop for US equities and credit in the near term
- Extraordinary central bank measures from Europe and Japan continue to expand and support a strong bias to equities in these markets
**Key Themes**

- **US economic expansion continues as Federal Reserve begins policy shift**
  - Economic conditions and health of US consumers remain supportive for growth
  - US Corporate earnings quality has weakened under pressure from profit margin declines

- **Central Banks continue to dictate the global investment outlook**
  - Subdued market expectation of Fed action over next 36 months; a surprise Fed rate increase poses risk to both US equities and interest rates
  - ECB and BoJ likely to maintain and expand accommodative monetary policies
  - Easing in China is broadly stimulative in the near term but currency policy is unpredictable

- **Rise of political populism fuels equity and currency market uncertainty**
  - Populist movements are destabilizing for the established political and economic order posing a risk for the cohesion of the European Union and global trade relationships
  - However, elevated risk offers an opportunity should market sentiment be overly pessimistic

- **Large currency adjustments across most emerging countries have provided a foundation to support improved capital market returns**
  - Continued political and economic reform is needed across EM to stimulate economic growth
  - Chinese Yuan (RMB) depreciation has been incremental relative to other EM FX adjustments and fears of further adjustment remain an over-hanging concern

- **Embrace illiquidity in opportunistic credit and private credit strategies**
  - Stressed credit liquidity magnifies the scale of price movements in traditional credit assets
  - Credit markets ability to absorb an exodus from crowded positions is challenged
Near Term Broad Market Performance Summary as of 5/31/2016

Source: Bloomberg, Standard and Poors, Russell, MSCI, Barclays, Citigroup, JP Morgan

*1 Yr Range: Represents range of cumulative high/low daily index returns for an investment made one year ago
Long Term Broad Market Performance Summary as of 5/31/2016

Source: Bloomberg, Standard and Poors, Russell, MSCI, Barclays, Citigroup, J.P. Morgan
US Economic Indicators

Inflation has increased off lows

Unemployment steadily improving

Corporate profits lower off cyclical highs

Manufacturing trending higher after dip

Source: Bloomberg, Federal Reserve, Bureau of Labor Statistics

Source: Bloomberg, Bureau of Economic Analysis

Source: Bloomberg, Institute for Supply Management
Inflation remains muted

Europe unemployment trending lower

Manufacturing continues to lag

Leading indicators mostly neutral

Source: Bloomberg, Japan Ministry of Internal Affairs and Communications, Eurostat

Source: Bloomberg, OECD, Eurostat

Source: Bloomberg, OECD, Eurostat

Source: Bloomberg, OECD
Emerging Market Economic Indicators

**EM inflation is varied by country**

- Most Recent
- 1 Yr Previous

**Relatively healthy Debt/GDP ratios**

**Marginal improvement in account balances**

**EM is greater than 50% of global output**

Source: Bloomberg

Source: Bloomberg, IMF
Equity volatility decreasing off recent highs

Treasury volatility has declined recently

Currency volatility remains elevated

Commodity volatility has increased

Source: Bloomberg, CBOE

Source: Bloomberg, Merrill Lynch

Source: Bloomberg, Deutsche Bank

Source: Bloomberg, Merrill Lynch
Central Banks

Major central bank policy divergence

Fed’s projected policy rate firming above market expectations

Many developed central banks have maintained low interest rates

EM central bank policies vary by country economic conditions

Source: Bloomberg, Federal Reserve, Bank of Japan, ECB, NEPC

Source: Bloomberg, Federal Reserve, NEPC

Source: Bloomberg

Source: Bloomberg

Source: Bloomberg
Global valuations are mixed

Earnings growth has trended lower

Margins declining outside of EM

Global equity returns have been mostly negative over one year
US Equity

Valuations near or above historical norms

Growth recovery marked by inconsistency

Profit margins lower off highs

Trailing performance has been mixed

Source: Bloomberg, Standard and Poors, Russell

Source: Bloomberg, Bureau of Economic Analysis

Source: Bloomberg, Standard and Poors, Russell

Source: Bloomberg, Bureau of Economic Analysis
International Equity

**PE levels varied by region/country**

- Europe
- Japan
- United Kingdom

- PE Ratio
- +1 Std Dev
- -1 Std Dev
- 5/29/2015
- 5/31/2016

**Margins elevated but not at extremes**

- MSCI EAFE

**Returns positive in short term**

- MSCI EAFE
- EAFE (Local)
- EAFE Small Cap
- EAFE SC (Local)

**Global growth remains subdued**

Source: Bloomberg, MSCI, FTSE *UK represented by FTSE 100 Index

Source: Bloomberg

Source: Bloomberg, MSCI

Source: Bloomberg, MSCI
Regional valuations show divergence

- Slowing growth in major economies
- Profit margins in line with history
- Recent rally in EM but one year returns mostly negative

Source: Bloomberg, MSCI

Source: Bloomberg

Source: Bloomberg, MSCI

Source: Bloomberg, MSCI
MSCI ACWI returns led by Energy and Materials in short term

S&P 500 broadly positive in short term

Returns positive across EM in short term

Global energy sector weight has fallen

Source: Bloomberg, MSCI
Source: Bloomberg, Standard and Poors
Source: Bloomberg, MSCI
Source: Bloomberg, MSCI
Developed currencies mostly positive versus the dollar recently

EM currencies suffered in unique fashions over the past year

Yen expected to decline versus USD

Dollar strength has retreated slightly year

Source: Bloomberg
Source: Bloomberg
Source: Bloomberg, Federal Reserve
Spread levels above historical medians

Returns marked by recent credit and high yield rally

Similar yield/duration tradeoff among major US indices

Yields have mostly declined
International Developed Fixed Income

**European periphery yields at small premium relative to Germany**

[Bar chart showing OAS or Equivalent (bps) for various European periphery countries compared to Germany, with data points for 5/31/2016 and 5/29/2015.

Source: Barclays, Bloomberg. *European periphery spreads are over equivalent German Bund*

**Global yields are at or near historic lows**

[Bar chart showing 10Y Govt Yield for various countries, with data points for Month End Yield, 3-Mo Previous Yield, and 1 Yr Previous Yield.

Source: Bloomberg]

**Low global yields relative to duration**

[Graph showing yield versus duration for various indices like WGBI, BC Multiverse, BC Glob Infl-Linked, BC EuroAgg, BC Pan-Euro HY.

Source: Bloomberg, Citigroup, Barclays]

**Global bonds positive in USD terms**

[Bar chart showing 3 Month Return and 1 Yr Return for various indices like WGBI (Local), WGBI (USD), WGBI ex US (Local), WGBI ex US (USD), BC Multiverse Infl-Linked.

Source: Bloomberg, Citigroup, Barclays]
Emerging Markets Fixed Income

**Spreads have widened recently**

- EM yields higher versus global counterparts

**Emerging market bond yield changes have varied directionally**

**Currency effect pronounced in EMD returns**
Rates

Treasury yield curve relatively stable

Japan yield curve has shifted downwards

Global yield curves trending lower

Global yields have trended lower over long term

Source: Bloomberg
Long duration yields have fallen over last few years

Lower yields driven by low inflation expectations and real rates

Yields are low but spreads above historic averages

Returns recently positive

Source: Bloomberg, Citigroup, Barclays

Source: Bloomberg, US Treasury, Barclays, NEPC

Source: Bloomberg, BofA Merrill Lynch, Barclays *No index for 20+ year corporate

Source: Bloomberg, Barclays
Inflation and Real Rates

US real yields have decreased slightly

Global real yields mostly negative

US inflation expectations remain low

Global inflation expectations have seen small recent uptick

Source: Bloomberg

*3-Mo data not available for Germany 4 year rate

Source: Bloomberg
Inflation Sensitive Growth Assets

Yields higher relative to last year

Gradual recovery in occupancy rates

PE Ratios near or above averages

MLPs have rebounded after selloff

Source: Bloomberg, Alerian, Nareit, Standard and Poors

Source: Bloomberg, CB Richard Ellis

Source: Bloomberg, US Census Bureau

Source: Bloomberg, Alerian, Nareit, Standard and Poors
Commodities

Backwardation in major commodity futures

Precipitous fall in oil prices with slight recovery

US fuel production closing gap with consumption

Commodity indices negative over one year after oil-induced decline

Source: Bloomberg

Source: Bloomberg, US Department of Energy

*Crude oil and liquid fuels

Source: Bloomberg, Standard and Poors
• Past performance is no guarantee of future results.

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• Information on market indices was provided by sources external to NEPC. While NEPC has exercised reasonable professional care in preparing this report, we cannot guarantee the accuracy of all source information contained within.

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