Hawthorn Strategy Insights
Year of the Monkey

Investors will face challenges in the markets in 2016 while dealing with increased volatility and other factors. In this issue of Strategy Insights, we present our 2016 outlook for the economy and several key asset classes, and we look into perhaps the most pivotal event of the year—the U.S. presidential election.

Introduction
According to the Chinese Zodiac, 2016 is the Year of the Monkey. Under this sign, the three key elements traditionally dominating the tone for the year are metal (gold/wealth), water (wisdom/caution), and wind (change). Although the field of astrology may be highly subjective, we think this could be a fitting starting point for our 2016 outlook. When each element is combined with the typical personality traits of monkeys—smart, naughty, wily, and vigilant—we think this characterization closely parallels our views on the investment landscape for the year. Investors will be challenged to “outsmart the monkey” (that is, the markets) in 2016 while dealing with increased volatility, heightened geopolitical tensions, and the ever-present winds of change with regard to not only market dynamics but also global monetary and fiscal policies.

Presidential Election Cycles and the Markets
Although the election isn’t until November 8, 2016, we have already been inundated with myriad debates, ads, polls, and predictions, with momentum and discord in this regard only accelerating from here. With the election expected to dominate the news flow, we thought it would be useful to examine the impact of the presidential election cycle on the markets while also considering how investor portfolios could be affected, for better or worse, in 2016.

Do Presidential Election Cycles Move Markets?
“...A 2012 CFA Institute member survey posed a simple question: Will the outcome of the election have an effect on the economy? A larger-than-expected 80% of survey respondents said [Yes] that it will have an important impact on the economy [and markets] going forward.”

First-Quarter 2016

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1 http://www.chinesefortunecalendar.com/2016/
Investment professionals clearly believe in the power of election cycles, but is there any hard evidence to support this claim?  

Stock market historian Yale Hirsch, founder and editor of *The Stock Trader’s Almanac*, was instrumental in developing numerous popular trading strategies over the years, including the “January Barometer,” “Santa Claus Rally,” “Sell in May and Go Away,” and “Presidential Election Cycle Theory.” His theory on election cycles hypothesized that stock market performance follows, on average, a predictable pattern corresponding to each year of a four-year presidential term.  

As highlighted in Chart 1, since 1928 the worst years for stock market performance are typically the first two years of a presidential term, with the second year, on average, being the worst performer overall. The second year of a term tends to be when presidents try to “make their mark” and define their presidency/legacy by tackling difficult issues and, we have found, often implementing unpopular policies. A recent example of this is the Affordable Care Act (ACA, also known as Obamacare), which was signed into law by President Obama in 2010, during the second year of his first term in office. While the policy itself has been controversial, it did not derail overall market performance in 2010, with the S&P 500® total return registering just over 15%. However, the policy was a game-changer for the Health Care sector, which turned out to be the worst performer in the index that year, returning only 2.9%. Hirsch’s 2005 *Stock Trader’s Almanac* also notes that “wars, recessions and bear markets tend to start or occur in the first half of the term.” Also weighing on performance in Year 2 of a term, bear market bottoms occur in the second year more often than in any other year. The third year (that is, the pre-election year) tends to be the strongest performer by far, on average, of all four years, registering a robust 17.8%. Not surprisingly, the third year is most often when first-term politicians try to help boost their own approval ratings and re-election odds heading into campaign season by exercising various actions to boost economic growth. Conversely, “returns on bonds tend to be higher during the first half of a presidential term and weaker in the second half. That’s presumably because the pre-election stimulus that boosts stocks tends to raise inflation and hurt bonds.”  

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3 https://www.stocktradersalmanac.com/AboutUs.aspx  
President Obama’s second term in office has been a bit of an anomaly, though with regard to market performance. Years 1 and 2 (2013 and 2014) were exceptionally strong, with the S&P 500 returning 32.4% and 13.7%, respectively, outpacing the long-run averages shown in Chart 1 (page 2). We attribute this to highly stimulative monetary policy (that is, quantitative easing) early in the term that has since run its course. Lacking this catalyst in 2015, equity performance was nowhere near the long-run average of greater than 17%. We have not seen much in the way of pro-growth policies implemented in 2015, with a number of political impasses in Washington having helped to delay action on this front. It is also likely that the unprecedented uncertainties surrounding Federal Reserve (Fed) policy and rate liftoff timing have further compromised the election cycle theory.

**Thoughts on the 2016 Election**

With a more polarized electorate than perhaps ever before, is the 2016 election “much ado about nothing”? Can we actually get anything accomplished this time around? In this section, we examine some of the unique attributes of the 2016 election in an attempt to address these questions.

At the end of October 2015, we finally got some clarity and movement on a couple of key issues that had been largely at a standstill for most of the year, more or less solidifying the short-term fiscal policy outlook. The Senate passed legislation that will “suspend the debt ceiling through March 2017, set budget levels for the next two years, relax caps on sequestration, and modestly reform Social Security Disability Insurance.” This effectively means investors should set their sights on the medium-term horizon, later in 2017, for the new administration’s policy efforts to really kick into overdrive.

With President Obama nearing the end of his second term, the 2016 election is what is considered an open election, which creates extra uncertainty for the markets since the outcome is anybody’s guess, especially at this early stage. Also, markets historically underperform during open elections compared with incumbent re-elections. Dan Clifton, head of policy research at Strategas, pointed out recently that “the last two open presidential election years also marked the end of the economic cycle and both 2000 and 2008 were negative for equities.” We are not calling for a recession, but it is a cyclical pattern that we believe bears watching, further adding to uncertainty.

The current political climate in Washington looks relatively more favorable for a Republican president, since the party will most likely be able to hang on to its majority in the House in 2016. The Democrats would need to pick up

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30 seats to win back the House from Republicans—a near impossibility, in our opinion. The Senate majority is still up for grabs though, with eight Republican seats considered “at risk.” Whichever party wins the White House will most likely capture the Senate, but it is likely to be a narrow margin of victory regardless. According to a recent article by Cornerstone Macro, another Democrat in the White House will face a divided government and a pretty steep uphill battle to advance his or her agenda. Interestingly, the combination of a Democrat president and Republican House/Senate historically bodes well for stock market performance, as opposed to a scenario where one party is completely in control.

One thing is certain: We expect heightened volatility and uncertainty to remain the name of the game in 2016.

**Are We Headed for a Political Paradigm Shift in 2016?**

Yes, we think the potential exists for the 2016 election to become a turning point in American politics, since it is likely to set the course for a number of major policy decisions including, but not limited to, tax reform, the ACA, entitlements, and foreign policy. With so little in the way of legislation getting passed during President Obama’s gridlocked tenure, there is significant pent-up demand and pressure coming from both sides of the aisle to get much more accomplished during the next administration.

Before delving into these various issues, we need to take a quick look at two guiding principles of the parties for context and perspective: the role and size of government and regulation. Republicans generally believe in the “less is more” philosophy—that we, as a society, are effectively better off when all branches of government play a lesser role in regulating industries and the economy. In this view, people and companies should succeed or fail based on their merits and the results of their actions, rather than on government intrusion. As such, Republicans are typically looking to shrink the size and scope of government wherever possible. On the other hand, Democrats generally believe in the “more is more” philosophy—that we, as a society, are generally better off when government takes a more hands-on approach, especially when it comes to helping the disadvantaged. As such, Democrats are typically looking to expand the size and scope of government by creating new programs and providing additional social services. This dichotomy is also apparent when it comes to the parties’ philosophies on regulation. Generally speaking, most Democrats believe in a high degree of government oversight while Republicans tend to prefer more limited government involvement.

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With that as the backdrop, let us start with taxes. Not surprisingly, the Republican candidates are proposing sweeping personal and corporate level tax cuts, which will have varying degrees of market-moving implications.

A few Republican candidates would like to reduce or eliminate the home mortgage interest deduction and/or the property tax deduction—not good news for the still-recovering housing industry. Others are focused on reinvigorating domestic-based industrial companies by making the tax treatment of capital expenditures friendlier, as well as changing the tax code so as to only tax income earned in the United States. The view is that this specific change would not only help stem the increasing trend toward re-domiciling overseas into lower tax rate countries/jurisdictions, but it would also help facilitate greater ease of capital/profits repatriation—win-wins for the companies and investors. Lower (or even no) taxes on dividends and capital gains "would boost the after-tax return on investment and would likely push up equity market multiples," says Andy Laperriere, head of policy research at Cornerstone Macro. We believe success on this front would be a plus for investors, broadly speaking. However, real estate and investment trust and master limited partnership investments, in particular, would become "relative" losers in this scenario.11

With the dramatic decline in energy prices over the last year and the outlook still fairly unfavorable, the economic rationale for using investment and production tax credits (ITC/PTC) to incentivize investment in the renewable energy industry is weak—definitely on the chopping block as far as most Republican candidates are concerned. Suffice it to say the Democrats have largely opposing views on each of these items. Some recurring themes so far in the campaign season include raising taxes on traditional oil and gas companies as well as on dividends and capital gains, extending tax credits and subsidies to the renewable energy industry, and initiating a tax on out-of-state Internet sales.

Surprisingly, in mid-December 2015, Congress took a few steps toward resolving some of these key fiscal policy dilemmas by unveiling a $650 billion bipartisan-sponsored tax package extending over the next 10 years, in combination with a new 2016 budget proposal. In an effort to finally drive through some meaningful "pro-growth" legislation, the tax package largely favors the Republicans (rolling back taxes), while the budget deal favors the Democrats (increasing defense and health-care-related discretionary spending). Key items in the proposed tax package include:

- five more years of bonus/accelerated depreciation in an effort to spur investment/capital spending;

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- lifting the crude oil export ban in exchange for a multiyear extension of renewable energy tax credits;
- a number of permanent tax credit extensions (for example, research and development); and
- delayed implementation of numerous health care/insurance-related taxes from the ACA.

Passage of the tax package and budget would not necessarily mean any of these issues are off the table, but it does provide some clarity for businesses and investors in the short to medium term, which should ultimately help support growth. The big question remains: How much would a new Republican administration reverse course on any of these particular issues? That answer is not at all clear at this stage, but since the proposals were not one-sided, we believe they have a better than average chance of remaining intact.

Next up is the Affordable Care Act, perhaps the most polarizing and controversial issue of the 2016 election. If a Republican wins in 2016, investors can likely expect significant changes across the board. Hospitals, insurance, and other managed care providers are likely to be the most harmed in this scenario. The Democrats are much more focused on high-cost specialty drug pricing than tweaking the ACA at the margins, and biotechnology and pharmaceutical stocks have already been severely impaired as a result.

Entitlement reform is also a key issue in 2016. According to the Congressional Budget Office, outlays for the largest federal program, Social Security, are expected to increase from 4.9% of GDP in 2015 to 5.7% in 2025.

Federal outlays for the other major health care programs, including Medicare, Medicaid, and the Children’s Health Insurance Program, are projected to increase even more rapidly, growing from 5.1% of GDP in 2015 to 6.4% in 2025. As a recent report from Cornerstone Macro highlighted:

> When it comes to Medicare, Medicaid, and the ACA, which amounts to more than a quarter of the federal budget, there is little common ground. Republicans want to move toward a premium support system for Medicare, cut and block grant Medicaid to the states, and repeal the ACA. Democrats favor marginal changes to these programs—if not expansions—paid for with higher taxes.

While the parties are at opposite ends of the spectrum on this issue, the rapid acceleration in entitlement spending over the next decade makes

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reaching a resolution on this issue imperative. Therefore, any potential reduction in Medicare coverage, or reimbursement levels, in the name of compromise would no doubt pose a sizeable threat to the overall state of the health care industry and significant risks for many investors, especially if a Republican wins.

With all of the tragic terrorist events and heightened geopolitical tensions of late, foreign policy has become an especially hot-button issue for the 2016 election. Rightly or wrongly, the perception that President Obama and his administration have been weak on foreign policy has forced both parties to take a harder line on this issue. Year-over-year defense spending is already expected to rise modestly in 2016, a function of easing sequestration in a recent bipartisan deal, after basically eight straight years of declines. As a result, we see a favorable outlook for aerospace and defense-related stocks.

Obviously, each of these issues will affect the market to varying degrees depending on who ultimately wins the election. As we get more clarity on who the primary candidates will be and a better look at each of their refined campaign platforms, we will revisit these issues should our views change.

Which Sectors and Industries Typically Benefit?

Table 1 highlights sectors and selected industries likely to be affected by the 2016 election. This may be used as a road map for investors in examining and weighting their portfolio sector exposures. We expect those with a plus sign (+) to be positively affected by the winning party, minus sign (−) to be negatively affected, and no sign at all to be more or less unaffected. We note that a sector or industry may have the same outcome regardless of the winning party (for example, the Energy sector has two plus signs), but for very different reasons. In the case of Energy, Democrats favor extending alternative energy tax credits and subsidies, as well as reinvigorating the carbon tax proposal, Republicans favor more offshore drilling and shale fracking, fast-tracking Keystone XL, and supporting a more diversified energy policy overall.

<table>
<thead>
<tr>
<th>Table 1</th>
<th>Sectors, Selected Industries, and the Presidential Election Cycle</th>
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<tbody>
<tr>
<td>Sectors</td>
<td>Democrat</td>
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<tr>
<td>Consumer Discretionary</td>
<td>−</td>
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<tr>
<td>Consumer Staples</td>
<td>+</td>
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<td>Energy</td>
<td>+</td>
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<td>Financials</td>
<td>−</td>
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<td>Health Care</td>
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<td>Industrials</td>
<td>+</td>
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<td>Information Technology</td>
<td>+</td>
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<tr>
<td>Materials</td>
<td>−</td>
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<tr>
<td>Telecommunication Services</td>
<td>+</td>
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<td>Utilities</td>
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<td>Select Industries:</td>
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<tr>
<td>Alternative Energy</td>
<td>+</td>
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<tr>
<td>Aerospace/Defense</td>
<td>+</td>
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<tr>
<td>For-Profit Education</td>
<td>−</td>
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<tr>
<td>Housing</td>
<td>−</td>
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<tr>
<td>Insurance</td>
<td>+</td>
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<tr>
<td>Master Limited Partnerships</td>
<td>−</td>
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<tr>
<td>Municipal Bonds</td>
<td>+</td>
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<tr>
<td>Natural Resources</td>
<td>−</td>
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<tr>
<td>Real Estate Investment Trusts</td>
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Source: Cornerstone Macro, Strategas Research Partners, Hawthorn estimates
Conclusion

We think the 2016 presidential election will have important ramifications for investors and the markets, since both political parties are eager to move forward on a number of key policy decisions such as tax reform, the Affordable Care Act, entitlements, and foreign policy. While overall market performance may be somewhat subdued again in 2016, especially compared with prior election cycles, it is likely to be anything but a straight-line trajectory from beginning to end. Proper asset allocation is critical when uncertainty abounds, and we believe 2016 is to be such a year.

Let us now turn to our 2016 outlook, beginning with the economy.

The Economy in 2016

As we enter 2016, the global economy remains characterized by dichotomies. Countries, regions, and sectors tied to the production of commodities are still struggling, with little prospect of near-term revival, while net consumers of commodities are enjoying a tailwind from deeply depressed prices. Industrial and manufacturing sectors are slumping, while services and consumer-oriented sectors are, if not strong, at least growing at a solid pace. These themes appear evident in the largest economies, China and the United States. Additionally, developed countries such as the United States and United Kingdom that took early, aggressive action in response to the global financial crisis have tightened or have signaled they will soon tighten monetary policy, while those that delayed taking any action (for example, the Eurozone) seem to remain firmly in stimulus mode. While the alignment is not perfect, in combination these dichotomies create yet another one—emerging markets are weak and perhaps still weakening while, on the whole, developed economies are improving.

In prior issues of Strategy Insights, we have explained our view that, since 2001, the effective transfer of income and wealth from high-cost, capital-intensive, low-saving-rate countries (the United States) to low-cost, labor-intensive, high-saving-rate countries (China) created a secular savings glut that helped put downward pressure on inflation and real interest rates. In essence, this was a deflationary boom in which global potential output grew much faster than global aggregate demand. Financial capital flooded into emerging markets, and investment in physical capital ran at a torrid pace. Commodity prices soared, and balance sheets ballooned with debt.

The global financial crisis destroyed a great deal of financial wealth and cost many people their jobs. As a consequence, global aggregate demand fell sharply and has been slow to recover. However, in our opinion, the crisis did not really reduce the growth of global potential output. Indeed, in order to maintain demand, countries such as China pumped up investment spending,
creating additional capacity at an even faster pace and exacerbated the problem.

Where does this leave us? Unfortunately, not in the best of places. We believe we remain in a disinflationary global environment but are no longer in a boom. Global demand is weak and likely to remain so for some time, while excesses built up over the last 10-15 years are being worked off. In a nutshell, excess capacity in certain sectors (for example, energy, commodities, real estate) and countries (for example, China) has been built up, with much of this concentrated in emerging markets. According to the International Monetary Fund, the share of global GDP devoted to investment (Chart 2) has been increasing over the last 15 years, driven by a rapid acceleration in emerging markets that more than offset the declining investment share in developed economies (Chart 3). As the Bank Credit Analyst (BCA)\(^1\) asserts, however, investment as a share of GDP is starting to decline in emerging markets (Chart 4, page 10).

BCA cites four structural reasons why investment spending as a share of GDP is likely to experience a secular decline:

- waning appetite for leverage;
- excess capacity in capital-intensive industries such as resource extraction;
- slower workforce growth reduces need for capacity growth; and
- rising importance of firms/industries requiring little physical capital.

At the same time, BCA argues there is little reason to expect the global saving rate to fall. As we discussed in our First-Quarter 2015 Strategy Insights, there has been no aggregate deleveraging since the financial crisis. From that perspective, the capacity to spend has not improved. Some segments, such as the U.S. household sector, have

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deleveraged, but aside from autos, the “new smarter consumer” is not rushing to spend. Indeed, the U.S. saving rate appears to have shifted upward, breaking a 46-year pattern of progressively lower lows.15 Meanwhile, having already taken on debt to support ailing economies, few governments seem to be in a position to further increase their deficits. Due to high profit margins and relatively weak capital expenditures, U.S. businesses have been in the unusual position of providing funds to the rest of the economy, that is, net saving. While we expect margin pressure in the United States, we see potential for margin expansion in other developed economies. Hence, businesses are unlikely to be the source of a significantly lower global saving rate. We believe the upshot is that we are likely to remain in an environment of relatively weak global demand and downward pressure on inflation and real interest rates.

Against this backdrop, the United States stands out as a veritable pillar of strength, in our view. PNC’s Economics team expects U.S. GDP to grow roughly 2.5% in 2016, with inflation rising modestly from recent levels—seemingly a fairly consensus view. The essence of the growth story is that job and wage growth will likely sustain solid demand growth despite weakness in net exports and softening of industrial sectors, most notably energy.

On the inflation side, the consensus is that it will rebound somewhat once the downward pressure from energy prices and currency appreciation subsides. All of which makes perfect sense to us. Given our perspective on the global situation, we are a bit more concerned about drag from abroad, from weakening industrial activity, and from likely margin compression. Nonetheless, absent global growth constraints, the outlook for U.S. growth and inflation would almost surely be higher, and we are comfortable that 2.5% growth with a moderate increase in inflation adequately reflects our global disinflationary view.

With the dollar already quite strong, 2.5% U.S. growth is not, in our view, going to be strong enough to boost overall global growth. The days when the U.S. consumer could/would “float the global boat” are over, and the eagerly anticipated day when the Chinese consumer can/will float that boat has not yet arrived. As noted above, investment as a share of global GDP is waning, and governments are not in a position to spend aggressively. We believe the upshot is another year of tepid global growth.

15 Cornerstone Macro, “Charts We at CSM Are Thankful for” (November 25, 2015).
Equities

Our general outlook for U.S. equities paints an underwhelming picture compared with average historical returns. Returns will likely remain subdued in 2016, mainly due to continued earnings growth pressures and full valuations. Of course, the S&P 500 could still hit new highs thanks to TINA (There Is No Alternative), especially considering that we believe the chance of recession is low, inflation is moderate, and the pace of interest rate increases should be slow in 2016. However, we think equity risks are skewed to the downside, and the higher prices move, the more compressed the risk premium becomes. We believe investors should remain selective, focusing on strategies that tend to perform well in volatile markets. Beta exposure alone is no longer sufficient, in our view.

Fundamentals

Broad market returns that resemble the historical average of roughly 10%\textsuperscript{16} may be difficult to achieve in 2016 absent multiple expansion. The median stock on the New York Stock Exchange at the end of November 2015 was trading at 25.6 times its latest 12-month earnings, the highest price-to-earnings (P/E) ratio in history barring when earnings collapsed in the last two recessions. The average annual return when the median stock P/E is at current levels is almost zero.\textsuperscript{17} The year 2016 will anniversary the plunge in oil prices and the sharp upward move in the dollar, likely easing year-over-year comparisons for the Energy sector and multinational corporations. However, revenue growth is likely to remain subpar. Third-quarter 2015 marked the first time the S&P 500 has experienced three consecutive quarters of year-over-year revenue declines since 2009; it also marked the largest single year-over-year decline in revenue since third-quarter 2009 (-11.5%). Analysts project that the fourth quarter will mark yet another quarter of revenue contraction, led by Energy. Excluding Energy, third-quarter revenue growth improved from -3.9% to a still paltry 1.0%. Five out of ten sectors reported revenue declines for the quarter—Energy, Industrials, Utilities, Materials, and Information Technology.

With sluggish revenue growth since the end of the 2008 financial crisis, earnings growth has largely depended on margin expansion, a waning tailwind in 2016. Margins today are about 1% above the prior cycle peak and 3% above the average since the early 1950s. Additional pressure on margins could come in the form of rising wages, strengthening commodity prices, and/or higher interest rates. These potential headwinds, along with the fact that much of the low-hanging fruit on the expense side of the ledger has already been picked, lead us to believe that margins have likely peaked for the cycle.

\textsuperscript{16} Ten percent represents the long-term average total return from 1928 through 2014. Going forward, we expect average returns to be closer to 8-9% over very long horizons.

\textsuperscript{17} Ned Davis Research, Price/Earnings and Price/Sales Higher than 2000 and 2007 (December 9, 2015).

TINA (There Is No Alternative) is a phrase used often by British Prime Minister Margaret Thatcher in the 1980s. Today people are using it to describe the current market dynamic of very low interest rates, leading to stocks being the only alternative for investors to earn any return.
As of this writing, in order for the S&P 500 to return 10% (assuming 2% from dividends) based on PNC’s midpoint earnings-per-share (EPS) forecast for the S&P 500 of $124, the P/E multiple would need to expand from about 16.5 times to 18.1 times—likely difficult to achieve in an environment where the Fed is tightening policy and global growth is generally slow. Analyzing the relationship between historical P/E multiples and inflation results in an expected P/E in the range of 15.8-16.4 times, assuming inflation remains between 1% and 3% in 2016. Applying these multiples to our EPS forecast of $124 results in an uninspiring range for the S&P 500 of 1,959-2,033. After closing out 2015 at 2,043, a decline in the S&P 500 during 2016 is a very real possibility.

We believe revenue growth may define the winners and losers in 2016. Although broadly negative, earnings growth trends have been quite diverse among U.S. companies. In third-quarter 2015, 18% of companies increased revenues by more than 10%, and 33% increased revenues by up to 10%. Conversely, 49% experienced revenue contraction. The Telecommunication Services, Health Care, and Financials sectors saw the most consistently positive revenue growth in 2015, while Energy and Materials were the worst. Focusing on active managers with a selective, bottom-up approach emphasizing companies with strong businesses, pricing power, and revenue growth is likely to be critical. Index tracking investments may expose investors to unwanted risks, failing to distinguish companies that stand a better-than-average chance of increasing revenue and consequently growing their earnings base in the face of potentially contracting profit margins.

**Capital Deployment**

A series of large mergers have led to industry consolidation in 2015. Capital spending remains stagnant, and stock prices have been bolstered by buybacks rather than real organic growth. Companies that have dedicated free cash flow to share buybacks have outperformed companies spending on capital expenditures by more than 200 basis points per year on average since 2009. Dividends and buybacks are on track to hit $1 trillion for the first time ever in 2015, according to S&P Capital IQ. We think this may be a sign of impaired ability to grow revenues rather than a healthy distribution of cash to shareholders. Rather than invest for long-term growth, many companies are trying to buy near-term growth through mergers and acquisitions.

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18 Jason Trennert “What’s It All About, Alpha? The Good the Bad and the Ugly,” Strategas (November 16, 2015).

Source: FactSet Research Systems Inc., Hawthorn
acquisitions (M&A). Along with general global growth concerns, we think some of this behavior is attributable to the uncertain policy outlook. As seen in Chart 5 (page 12), M&A volumes tend to crest around market tops, a potential warning sign since volume has recently surged beyond the levels that preceded the last two market peaks.

**Market Internals**

So-called stock market “breadth” (or broad participation) has deteriorated since the beginning of 2014. Since January 2014, the share of S&P 500 companies trading above their 200-day moving average has declined from 70% to just below 40%. Market returns in 2015 have been driven by a few of the largest index constituents due primarily to the escalating valuation premium applied to their earnings (Chart 6). In our view, this type of market will be vulnerable to bouts of increased volatility in 2016.

**International Equities**

**Developed Markets**

We continue to favor the Eurozone and Japan over the United States as we move into 2016. This view hinges on three primary factors:

- U.S. stocks are more expensive than either the Eurozone or Japan, even after adjusting for sector weight differentials.

- As the Fed raises rates, the European Central Bank (ECB) and Bank of Japan (BOJ) are likely to remain in easing modes for quite some time. Therefore, the liquidity backdrop clearly favors the Eurozone and Japan.

- We believe there is more room for a cyclical expansion of earnings growth in the Eurozone and Japan. Profit margins in these regions remain historically depressed, leaving greater scope for expansion versus peaking U.S. margins (Chart 7).
Emerging Markets

External growth tailwinds for emerging markets seem to be diminishing, namely the debt-fueled consumption binge in developed markets, the investment-fueled double-digit growth rate in China that sparked a commodity bull market, and the pent-up consumption/credit demand from the emerging market crisis in the 1990s.

We remain skeptical of short-term rallies in emerging market assets and maintain our underweight allocation heading into 2016. From a valuation perspective, emerging market equities look marginally more attractive, but much of the valuation correction has been concentrated in a few heavily weighted sectors (Energy, Materials, and Financials). An analysis of equal-weighted emerging market indexes leads to a less favorable valuation conclusion. As debt has risen, net profit margins and earnings for nonfinancial companies have dropped to near 2008 lows. As U.S. interest rates slowly rise, portfolio outflows and diminishing foreign direct investment may continue to exert downward pressure on emerging market currencies. Currency depreciation makes further foreign investment less attractive and increases the burden of external debt denominated in other currencies (mainly the dollar).

Fixed Income

Central Banks

At the risk of sounding like a broken record, we believe global central bank divergence will remain an important theme throughout 2016. Unemployment and inflation reached levels that allowed the Fed to finally lift interest rates in December 2015. Conversely, we expect the ECB, BOJ, People’s Bank of China, and other central banks to continue stimulative policy actions. As a consequence, we believe interest rates will diverge even further, although we expect the increase in U.S. rates to be slow. PNC’s Economics team expects three rate increases in 2016 starting in March. Our own view is that there may only be two hikes, likely starting in June. If rates do move three times, we think the increases will be back-end-loaded. Interestingly, it may be how quickly the Fed decides to normalize its balance sheet rather than the level and path of interest rate hikes that has an outsized influence on yields. Ned Davis Research is calling for the Fed to slow or stop the rollover of securities by third-quarter 2016. Since yields would probably be higher if it were not for the Fed’s bond purchases, this policy reversal may play an important role in the readjustment of yields back toward normal levels. The Fed’s balance sheet policy will bear monitoring in the months ahead, as will the potential impact of other countries (China) selling Treasuries to support their currencies. It is worth noting that in the Fed’s December statement, it concluded that its
balance sheet would remain stable until the path to rate normalization is well underway. This may mean no balance sheet adjustments until well into 2016, or even 2017.

**Yield Curve**

Historical analysis indicates that the yield curve tends to flatten after the Fed begins to hike interest rates. In fact, this has been the pattern in each of the last nine tightening cycles (Table 2). We believe this will occur in 2016 as well. Consequently, we are looking to slowly extend our short duration positioning, especially in the event of any unforeseen spike in longer-term yields. Of course, the pace of interest rate hikes will have a significant impact on the magnitude of yield curve moves because the market is currently pricing in a much flatter trajectory than is implied by the Fed. Also, as other central banks try to keep their own rates low, we think the relative attractiveness of U.S. interest rates could support the longer end of the curve. However, upside surprises in either inflation or inflation expectations and/or above-consensus U.S. GDP growth of greater than 2.5% could steepen the curve.

Quantitative easing has certainly had a strong influence on the level of bond yields to date, so the yield curve could behave uncharacteristically during this tightening cycle. That said, our base case for 2016 is for incremental interest rate increases across the curve, with the short end rising more quickly. Although the initial 25-basis-point increase would have little impact in isolation, it was a landmark policy shift and potentially the beginning of a new phase of rate dynamics. The market has already brought forward expectations for future increases. However, there is still a significant disconnect between market expectations and the path that the Fed is signaling (roughly 160-basis-point differential in the implied year-end 2018 federal funds rate). The risk is that the market’s rate expectations continue to be pulled forward, causing even more significant interest rate fluctuations and volatility.

**Credit**

Credit instruments continue to show strains amid concerns that global growth is slowing and U.S. profit margins are declining just as the Fed is drawing the curtains on its easy-money policies. Consistent with recent data, labor markets tend to get “tight” right before the Fed starts to hike rates, a phenomenon usually accompanied by rising wages. As stated in a recent Strategas publication:

### Table 2

<table>
<thead>
<tr>
<th>Beginning Date of Tightening Cycle</th>
<th>Ending Date of Tightening Cycle</th>
<th>Beginning Spread</th>
<th>Ending Spread</th>
<th>Basis Point Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>7/17/65</td>
<td>12/6/65</td>
<td>23</td>
<td>-8</td>
<td>-31</td>
</tr>
<tr>
<td>11/20/67</td>
<td>4/3/69</td>
<td>6</td>
<td>-3</td>
<td>-9</td>
</tr>
<tr>
<td>1/15/73</td>
<td>4/25/74</td>
<td>21</td>
<td>-49</td>
<td>-70</td>
</tr>
<tr>
<td>8/31/77</td>
<td>2/15/80</td>
<td>55</td>
<td>-22</td>
<td>-77</td>
</tr>
<tr>
<td>9/26/80</td>
<td>5/5/81</td>
<td>-30</td>
<td>-100</td>
<td>-70</td>
</tr>
<tr>
<td>9/4/87</td>
<td>2/24/89</td>
<td>74</td>
<td>-13</td>
<td>-87</td>
</tr>
<tr>
<td>2/4/94</td>
<td>2/1/95</td>
<td>119</td>
<td>22</td>
<td>-97</td>
</tr>
<tr>
<td>6/30/99</td>
<td>5/16/00</td>
<td>22</td>
<td>-41</td>
<td>-63</td>
</tr>
<tr>
<td>6/30/04</td>
<td>6/29/06</td>
<td>146</td>
<td>3</td>
<td>-143</td>
</tr>
<tr>
<td><strong>Mean</strong></td>
<td></td>
<td></td>
<td></td>
<td><strong>-72</strong></td>
</tr>
</tbody>
</table>

*Source: Ned Davis Research, Hawthorn*
In the past, 4% to 4.5% growth in average hourly earnings is where labor’s rising share of corporate profits has begun to squeeze margins of weaker issuers. But in today’s lower productivity environment, this level now appears to be about 2.6%. Once wages push decidedly above this level we can expect spreads (and defaults) to rise until the start of the next business cycle. At present, we’re still just below these levels, but spreads and wages are both drifting higher and suggest that the cycle is now maturing. 19

Strategas goes on to point out that spreads tend to widen just after margins peak, with spreads not compressing again for 18-24 months. Based on this analysis, if margins peaked in late 2014, then spread compression is unlikely until 2017.

High-yield bonds and leveraged loans have come under pressure as investors reassess the health of these markets. This comes on the heels of voraciously absorbing several years of heavy issuance at tighter spreads. At the same time, credit agencies and analysts are projecting rising defaults, as dealmakers struggle to place new issues. Although energy has certainly been at the forefront of distress in the high-yield market in 2015, the challenges are likely more systemic and pervasive in nature. Standard & Poor’s recently reported the percentage of junk bonds trading at distressed levels (that is, spread of 10+%) is the highest in five years. Of the 361 distressed issues, 113 are in the oil and gas sector while 248 are from other sectors. We believe this pattern could continue for some time and that meaningfully wider spreads may be required to make this market attractive once again, especially for highly taxed investors (including Hawthorn clients). The recent liquidation of Third Avenue’s high-yield mutual fund is an example of the current credit risk in high yield, as well as potential liquidity issues for investors looking to withdraw capital in a timely manner.

Municipals

Throughout 2015, we saw a stark contrast in performance between tax-exempt and taxable bonds. Investment-grade and high-yield municipals returned 1.65% and 1.99%, respectively, during the third quarter, while taxable corporate bond returns entered negative territory driven by concerns over falling commodity prices, slowing global growth, and lingering Fed uncertainty. In an environment where these concerns are likely to persist, we believe municipals will outperform taxable corporates, since the impact of global events usually has a more muted impact on this market given its domestic focus and retail-centric, buy-and-hold investor base.

19 Thomas Tzitzouris, “5 Macro Charts to Shed Light on the HY Story” (December 9, 2015).
Generally, we believe the outlook for state revenues in 2016 is solid. The economy continues to grow at a slow but stable pace, and many of the fiscal concerns are largely diminished. From a technical perspective, supply and demand fundamentals may become slightly less favorable after five straight years of negative net supply. There is a continued need for more infrastructure funding, and a push to issue before additional rate increases is likely. From a value perspective, municipal bonds are currently trading at attractive historical levels relative to taxable bonds (Treasuries). For example, longer-dated high-grade (20-year, AAA rated) municipals trade at a discount to equivalent maturity U.S. Treasuries. Although municipal bond income is tax-free, their yields on maturities greater than 20 years are higher than yields on taxable Treasury bonds. By historical standards, this relationship represents an attractive crossover opportunity for tax-exempt investors. Our view on municipal credits is that the overall market is sound, and the credit events in Chicago and Puerto Rico are likely idiosyncratic developments that will have little, if any, broader market implications.

Finally, the tax policy debates during 2016 will be a key focus for market participants, but likely even more so for municipal bond investors. As an example, Jeb Bush’s tax proposal would create a maximum personal tax rate of 28%, including a 20% tax rate on interest income, which would effectively reduce the taxable equivalent yields of tax-exempt securities. All else equal, this would make these bonds less attractive. On the other hand, Mr. Bush’s plan would also eliminate the deduction for state and local income taxes, increasing the demand for state tax-exempt paper. Although policy developments along these lines represent longer-term risks, they should not be ignored as we progress through the election year.

Commodities

Historically, commodities have a natural boom-and-bust tendency, driven by momentum and long-term so-called “super-cycles,” defined as multidecade price trends. Super-cycles differ from shorter-term fluctuations in that they are typically demand driven, following the trajectory of world GDP, and span a much longer time period with upswings of 10-35 years and taking as many as 20-70 years to complete a cycle. In the most recent cycle, voracious demand from China’s investment boom and rapid investment growth throughout emerging markets played an outsized role in global GDP growth and broad commodity demand. Now that these trends have reversed, along with the introduction of abundant supply, commodity prices in general are likely to remain under significant pressure.

**Energy**

Near-term factors have played a part in the recent fall in oil prices. However, the tide was destined to shift, as commodity prices have a natural tendency to overshoot in both directions at the inflection points in a cycle. High prices make new production attractive and incentivize investment in new, often higher-cost production technologies and sources (for example, fracking and oil sands). Not surprisingly, higher energy prices also help encourage the development of substitutes (for example, wind and solar power) and often precipitate changes in behavior to avoid paying such high prices (that is, conservation and substitution). Eventually, the intersection of more production and less demand leads to a sharp reversal in the super-cycle, which usually leads to years of lower prices. This is where we are today, in our opinion. According to Ned Davis Research, “we’re now 4.8 years into the seventh super-cycle bear since the late 1700s. While the average bear market lasts nearly 20 years, we’ve found that most of the price damage is done by year 6.”

So, what happens next?

Although we believe significant downside from current levels is unlikely, we also think energy prices will remain under pressure throughout 2016. It is likely that prices recover, but only modestly, as we move through the year. We believe that $45-50 per barrel for West Texas Intermediate (WTI) crude oil is a reasonable base case forecast.

Macroeconomic conditions will remain negative for energy prices, in our view. We continue to believe that the dollar will remain strong as the divergence of monetary policy across major central banks accelerates. Energy commodities tend to be particularly sensitive to the yuan since China has historically been such a large consumer. We believe further depreciation of the yuan against the dollar is likely in 2016, serving as an important headwind for energy prices. Utilization rates in China are falling, especially within the manufacturing and construction sectors, meaning spare industrial capacity is increasing even as China has doubled its strategic oil reserves. Oil inventories across Organisation for Economic Co-operation and Development (OECD) countries remain unusually high after consistent builds throughout 2015. Further perpetuating this dynamic, OPEC is unlikely to agree to a coordinated output reduction. With the United States and Russia now producing at levels comparable to Saudi Arabia and OPEC members striving for market share, OPEC is no longer as effective as a cartel. The removal of Iranian sanctions is another important macro-level variable. Currently, Iran has 38 million barrels of oil in floating storage that could be quickly introduced to the market, not to mention Iran’s capacity to produce, which reached a 2011 presanction high of 3.6 million barrels per day.

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Micro-level dynamics are a bit more positive, in our view. In 2015, global oil demand grew at the second quickest pace in more than 10 years. Also, non-OPEC output could contract (led by U.S. shale) in 2016, which would be the first decline since 2008. However, global inventories remain elevated and may continue to grow into second-half 2016, which would effectively cap prices in the near to medium term. The United States may be the first region to begin experiencing a market rebalancing in second-half 2016. Poor economics at a sustained $40 per barrel will likely force most U.S. shale producers to reduce capital expenditures (capex) significantly, making net production growth all but impossible. Indeed, global drilling and completion spending, a significant component of overall sector capex, has already fallen almost 30% from the 2014 peak. The United States and Canada account for more than 75% of this reduction in spending. With capex falling at such a rapid pace, it would be no surprise if U.S. drilling and production were to decline commensurately. This dynamic may lead WTI to narrow the trading gap with Brent as we move through 2016. Ultimately, we believe sharper declines in U.S. shale output coupled with growing global demand should help the market begin to rebalance as we move into second-half 2016. However, with OPEC unlikely to reduce production, global oil stocks may still modestly increase. On balance, this leads us to believe that the market will begin to stabilize, but we are likely to see low price levels for all of 2016 (Table 3).

**Master Limited Partnerships**

The difficulties of a lower-for-longer commodity price environment, even for midstream master limited partnerships (MLPs), cannot be overlooked. Midstream companies have contracts with exploration and production (E&P) companies to use the pipelines and storage facilities for their oil. With prices around $40 per barrel, the E&P companies are experiencing a great deal of pain, in many cases having problems even paying their debt. We believe it is likely that midstream MLPs as a group will further reduce investment spending in 2016, postponing or foregoing growth opportunities to support the growth of their distributable cash flows. In this environment, it is difficult to predict the structure of future contracts, and some market participants have even questioned whether current contracts will need to be renegotiated. In other words, although largely insulated from direct commodity price exposure, the medium-term outlook for midstream MLPs is uncertain with oil prices

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**Table 3**

<table>
<thead>
<tr>
<th>Key Energy Price Factors</th>
<th>Downside Risks</th>
<th>Upside Risks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Higher Iranian exports</td>
<td>Delay in Iranian nuclear agreement implementation</td>
<td></td>
</tr>
<tr>
<td>Continued improvement in technology</td>
<td>Stronger consumer leading to further demand</td>
<td></td>
</tr>
<tr>
<td>China/emerging market slows more than forecast</td>
<td>Geopolitical disruptions</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Fed turns move dovish</td>
<td></td>
</tr>
</tbody>
</table>

**Source:** Hawthorn

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at these levels. Fundamentals remain fairly resilient, but we believe there will likely be some deterioration in coverage ratios heading into next year as hedges roll-off, production slows, and the cost of capital increases. Further, MLPs as an asset class have a large retail ownership base, and we think fear regarding the precipitous drop in oil prices (rational or not) has only served to exacerbate the downward pressure.

As investors focused on longer-term trends, we maintain our positive long-term outlook for the industry and see the current weakness as an attractive entry point for long-term investors to dollar cost average into positions. As markets work through the current state of oversupply and crude prices begin to stabilize (which admittedly may take time), we expect that sentiment is likely to improve as a clearer path for a more balanced supply/demand picture emerges. A recovery in prices will also provide some assurance that E&P companies will be able to maintain production volumes at levels that support robust long-term contracts with midstream companies. Even in this environment, we view the majority of midstream MLP dividends as sustainable, with the potential for long-term growth.

**Real Estate**

We view the environment for real estate as largely supportive as we move into 2016. We believe broad property demand will be supported by steady GDP growth and continued capital flows into real estate assets. That said, sector bifurcation is possible as the Fed begins to hike rates, and supply/demand imbalances evolve. For example, the retail sector is facing headwinds from record level store closures (more than 5,000 through third-quarter 2015), but apartment demand is being supported by job gains, and an increase in interest rates may even be a boon for the sector as higher residential mortgage rates affect homeownership affordability.

**Multifamily**

Multifamily (that is, apartments) remains our favorite real estate sector, and we believe the overall fundamental landscape remains healthy. With five straight years of positive operating income growth, multifamily has now surpassed the length of the last cycle, 2005-08. We think that the current cycle can extend through at least 2016 due in part to a robust demand backdrop that is likely to persist. Although supply is increasing, completions fell sharply toward 100,000 units after the credit crisis, and higher projected permits and starts are only now translating into the completion levels likely needed to meet pent-up demand.

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24 For a more extensive discussion, see the Fourth Quarter 2015 Strategy Insights, Multi-Family REITs: Stronger for Longer.
demand and new household formation. In our view, the wild cards in this scenario are the amount and pace of pent-up demand that will be released as the economy and labor market continue to firm. We believe it will be slow but steady. As such, we expect the supply/demand imbalance to remain stable, only having a minor effect on national vacancy rates in the near to medium term.

From a valuation perspective, our assessment, based on a variety of metrics, is that multifamily REITs fall somewhere between fairly and attractively valued. The potential for rising interest rates is also an important consideration. Over the past 20 years, we have found an inverse relationship between the trajectory of interest rates and apartment real estate investment trust (REIT) performance. However, interest rate movements are just one input into a much more complex equation determining the likely strength of multifamily REITs. History has shown that if interest rates are rising for the “right” reasons (that is, an improving economy), real estate still performs quite well. For example, between the last two recessions, the 10-year U.S. Treasury increased from 3.6% to 5.03% over a five-year period. During that time, apartment REITs produced an average annual total return of 23%, well in excess of its 14% historical average.

We think improving fundamentals in the industry and positive secular dynamics within multifamily help set the stage for a stronger-for-longer scenario playing out this cycle. Further, short-term market dislocations (driven by factors such as a rate hike) could create an even more compelling value proposition in 2016, in our view. As we note in the next section, record private equity capital flows into real estate hard assets and specialty real estate funds would serve to help provide strong underlying valuation support for the asset class.

**Private Funds versus REITs**

Record levels of capital have flooded into private real estate funds, reflecting continued strong investor demand. The amount of capital raised in third-quarter 2015, $37.5 billion, by closed-end private real estate funds was the highest amount ever for a single quarter. Yet fund managers have not been able to keep pace with these flows, with large amounts of cash still waiting to be deployed. At $244 billion, closed-end private funds are holding the highest amount of dry powder since 2007. There is some concern over whether or not managers could overallocate capital to projects with diminishing returns simply to avoid returning uninvested capital to their investors—an undesirable outcome for all parties. We think this backdrop is ultimately supportive of real estate market prices and valuations to some degree, but it offers a less compelling investment case for increasing portfolio exposure to private real estate alternatives as we move into 2016. On balance, we prefer the liquidity of REITs.

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