Global Market Snapshot

Key Market/Economic Observations

United States

Oil Rises and Treasury Yields Push Higher; Flatter Yield Curve Debate

- Trade and geopolitical tensions ebbed and flowed in April, and while volatility levels remained higher than last year, the Cboe Volatility Index® moved lower toward the end of the month. Despite the noise, economic indicators and corporate earnings remain supportive, and ultimately domestic indexes traded higher in April. Year to date, the return for the S&P 500® is hovering just above flat.
- While not much progress has been made on the China/U.S. trade front, the consensus is that an all-out trade war is unlikely. See the *Strategy Views* section (page 5) for more detailed insight. The perceived threat of further geopolitical deterioration eased near the end of April, as North Korea announced it would halt nuclear missile testing. In reality, an adverse outcome in North Korea wasn't being reflected in asset prices, so markets did not meaningfully benefit from these developments.
- Oil prices shot up in April, breaking through the $70 per barrel mark as crude inventories fell below average levels. Despite evidence of lower stockpiles, OPEC signaled its continued support of surplus cuts in an effort to reduce supply—a position it has held since 2017. U.S. West Texas Intermediate (WTI) crude futures are up more than 13% year to date, and we believe domestic energy producers stand to benefit from increased profitability.
- The backup in U.S. Treasury yields has been notable, with the 10-year yield rising over 30 basis points from April lows, now testing the 3.0% level. The rise in oil prices and inflation expectations are playing a large role in the short-term move.
- In the near term, we expect 10-year Treasury yields will settle near 3.0%, as growth and inflation expectations have largely converged with reality (limiting the upside surprise factor). Extreme net-short positioning in 10-year Treasury futures will likely serve to limit a swift move higher. We continue to believe yields are biased higher over the longer term, but perhaps not to the extent some market participants fear. Other key takeaways are:
    - We believe moving toward a neutral duration positioning is prudent for those who have been short. Our view is that we may have already seen the largest increase in rates this cycle, having gone from 1.35% in mid-2016 to near 3.0% today. Even if rates drift higher for a period, timing the precise top would likely be extremely difficult.
    - Further, the flattening of the yield curve continues to garner attention from investors. We are watching the yield curve, but it serves as only one input into our business cycle analysis. It is true that the curve has inverted before six of the last seven recessionary bear markets, but the lead time is often unpredictable. For example, the lead-up was 21 months before the peak in 2007, but only 2 months in 1980. Currently, in combination with other economic signals, the yield curve is not yet a major concern.
    - PNC continues to believe the Federal Reserve (Fed) will maintain its course of gradual interest rate increases and expects inflation will continue to move toward the Fed's 2% target. PNC expects the Fed will increase interest rates for the second time in 2018 at the June Federal Open Market Committee meeting, and then a third time later in the year.

- The first read of first-quarter 2018 GDP was 2.3%. This reading was higher than consensus estimates for 1.8% growth, but softer than the fourth-quarter 2017 reading of 2.9%. The slowdown comes as market participants await the potential boost from recently enacted fiscal stimulus, which we believe will help encourage growth as we move through 2018. A seasonally weak GDP report in the first quarter has been a trend over the last few years, and PNC expects economic growth to rebound; we forecast 2.8% GDP growth in 2018.
- Halfway into first-quarter 2018 earnings season, profits for domestic companies are over 9% stronger than initially forecast. The estimated blended growth rate for the S&P 500 is now 22.9%, higher than the 11.3% projected at the start of the quarter. Profit margins have expanded beyond 11% and are estimated to maintain these wide levels in the remaining quarters of 2018. The reduction in the corporate tax rate seems to be the primary driver, offsetting higher wage pressures as well as other rising costs. The Information Technology sector is far exceeding analysts' estimates for both profits and sales, with notably strong results from Facebook, Inc. (FB), Microsoft Corporation (MSFT), and Intel Corporation (INTC), among others. The growth rate for the Information Technology sector is now 38.1%, considerably higher than the initial 17.5% estimate. Consumer Discretionary earnings are led by Amazon.com (AMZN), which beat earnings estimates by over 150%, the second strongest quarterly upside surprise in over five years.
- We remain positive on equity markets in general, and while volatility has eased from earlier-year levels, it is likely to be a choppy year for trade. We would urge investors to look past short-term volatility this year, as we believe equity markets have further upside.

Europe

Slowing Momentum, but Outlook Remains Positive; Brexit Still a Bit of a Sticky Wicket

- Eurozone macro data continue to point to a loss of momentum, but generally the outlook remains positive. Notable highlights include the 0.8% contraction in industrial production in March for the Eurozone—the third straight monthly decline. It should be noted that the tumble in the Eurozone economic surprise index does not necessarily mean economic or market weakness, but rather just that analysts may have become too optimistic with regards to their economic forecasts. For example, the four-point decline in the IHS Markit Eurozone Manufacturing PMI® since December is slightly misleading, as the index remains extremely elevated, relative to historical averages, at 56.6.
- Possibly due in part to the cooling economic data, European markets are struggling compared to their U.S. counterparts. During the first quarter, the S&P 500 lost only a little more than 1% while the STOXX® Euro 600 lost almost 5%. But markets advanced in April (the STOXX Euro 600 was up nearly 3% through the first three weeks of April) on comparatively strong earnings.
- The minutes for the March 8 European Central Bank meeting revealed the policy committee to be cautious overall, with members mostly focusing on risks from trade conflicts and the relative strength of the euro. The biggest issue for the central bank right now appears to be inflation. Members noted that increased volatility in exchange rates could hamper inflation, while also noting the bank will not make any significant policy changes (including ending net asset purchases) until a more sustained and resilient inflation outlook is achieved.
- The stronger euro is partly responsible for the cooler inflation rates. The euro appreciated 15% against the dollar between March 2017 and March 2018. This stronger currency hampers price pressures. As a result, the year-on-year growth rate in the Consumer Price Index slowed from 2.0% in February 2017 to 1.3% today. Give that the euro has eased against the dollar recently, that inflation obstacle should subside. And, the tight labor market (the unemployment rate has fallen to a 10-year low) should support broader price appreciation.

- Despite garnering exemptions for the Trump administration's steel and aluminum tariffs, European markets, especially the more export-oriented ones like Germany, continue to struggle amid each flare-up of trade tensions between China and the United States. Indeed, there are reports German companies are concerned their machines and cars made by subsidiaries in China and exported to the United States will suffer just as much as all-Chinese-produced goods. The cooling of trade tensions between the two biggest economies recently may help bolster European stocks. Indeed, when China announced the removal of ownership limitations on the domestic auto industry, German carmaker stocks, in particular, benefited on the news.
- Brexit and the ongoing unknowns involved in Britain's divorce from the European Union remain sources of uncertainty. Though some progress has been made (a transitional deal was announced), several contentious issues are obstacles, mostly notably the Ireland border issue. With a lack of consensus within Britain, and even within the majority Conservative Party, this will likely remain a complication for the foreseeable future.

Japan

Bank of Japan Remains on Hold, for Now

- Economic data were relatively mixed over the last month, as both industrial production and retail sales came in below expectations while core machine orders surprised to the upside. First-quarter Tankan survey results highlighted continued capital expenditure plans across Japanese businesses, but indicated a divergence between large and small company sentiment. Large manufacturers in the survey were becoming more cautious about business conditions whereas small businesses are the most optimistic in 30 years.
- We believe the sentiment divergence between large- and small-cap businesses is largely attributed to the impact of a strong yen. On a year-over-year basis, the yen strengthened against the dollar by nearly 5% in the first quarter, creating pressure toward profitability metrics for large-cap multinational companies.
- However, as the Bank of Japan (BOJ) continues to talk back plans to taper monetary stimulus even in the next few years, the yen has already weakened by nearly 3% in just the last month. We continue to believe investors have overestimated the BOJ's timing to reduce stimulus, as a relatively stronger yen would dampen economic growth and at certain levels would potentially require the central bank to intervene.
- Foreign exchange dynamics continue to affect international investors. Yen strength in the first quarter, coupled with the market downturn, led to general underperformance for dollar-hedged strategies. Our long-term preference is for international equity exposure to be largely unhedged from a currency perspective; however, we currently maintain currency hedges within some of our allocations to Japan and Europe. A combination of market positioning, such as record net-long euro futures positioning, rising U.S. interest rates, and diverging economic performances (such as data surprising indexes), seems to have encouraged the dollar's recent advance, helping our hedged positions. Further supporting the dollar, the U.S. interest rate premium over Germany has never been higher, and the interest rate premium over Japanese government bonds may be enough to begin enticing Japanese asset managers to boost their unhedged U.S. bond allocations.
- Through mid-April, the Nikkei has outperformed the S&P 500 over both the last 30 days and year to date. We believe Japanese investments continue to find support from improving economic fundamentals coupled with significant monetary stimulus provided by the BOJ.

Emerging Markets

Emerging Market Stocks under Pressure

- Trade skirmish headlines have taken their toll on emerging market equities, as the MSCI Emerging Markets (EM) index was down nearly 4% in the last month, compared to a positive reading on developed international indexes. Both Chinese and Russian equities experienced a sharp selloff, and the two countries comprise a combined 30% of the EM index.

- Despite the turbulence in equity markets, Chinese economic data for the month were encouraging. GDP growth for the first quarter came in as expected at 6.8%.
- Pressures from potential global trade disruptions are being felt by commodity-centric countries, as the central banks of both Brazil and Peru lowered policy rates at their last meetings in anticipation of lower industrial production. Brazil's central bank indicated it may lower rates further at its next meeting in May, and the country's benchmark rate is already at its lowest level in history.
- In reaction to monetary tightening from the Fed, emerging market central banks have been reacting to changes in interest rate policy. While central banks in China and Turkey have been raising interest rates, other countries indirectly involved in global trade disputes, such as India and Mexico, have been keeping rate hikes on hold in recent weeks.
- In the near term, we would watch the underlying strength of the dollar. Since making its year-to-date low in mid-February, the U.S. Dollar Index is up about 3.4%. EM countries running current account deficits, and any devaluation of their own currencies against the dollar, may increase their global borrowing costs and weigh down their economies. We have seen broad EM markets trade with moves in the dollar over the past few years, and may be seeing it again.

Energy

Crude at Its Highest Since 2014 on Tighter Supply Outlook

- After a quarter-long consolidation, WTI prices broke above a key technical level of $68 per barrel in early April, reaching the highest level since 2014, offering an indication the current uptrend remains intact.
- The strength in oil prices has been driven by production cuts in Saudi Arabia and Russia, aided further by supply disruptions in Venezuela and Nigeria. In April, oil ministers from OPEC and Russia indicated their wish for the oil market to tighten further in order to spur long-term investment.
- However, rising oil prices have incentivized additional U.S. production amid falling breakeven prices. As such, the trend in declining global inventories could reverse as producers hedge crude oil exposure at current prices to lock in a portion of margins.
- The U.S. Energy Information Administration is guiding for global crude oil supply to increase an average of 2.5 million barrels per day in 2018, with 72% of that growth attributable to U.S. supply growth, and an additional 24% of that growth originating from other non-OPEC suppliers. This dynamic should allow for additional earnings growth among oil producers.
- The Saudi Aramco initial public offering poised for 2018-19 alongside fiscal dependence in the near term, creates an incentive for the current dynamic to remain in place, likely supporting oil prices at or near current levels.
- The shift toward better capital discipline and a focus on return on capital invested has helped spur the recent rally in the Energy sector since late March. The Energy sector has risen 6.9% compared to a 0.5% decline in the S&P 500. Offering additional support, earnings are again trending higher after reaching the lowest level since early 2000.
- Lastly, the cyclically adjusted price-to-earnings ratio, which views valuations on an inflation-adjusted and long-term basis, continues to indicate modestly attractive valuations for the sector. These factors, when combined with being broadly underowned and a propensity to outperform in the later stages of an economic cycle (eventually giving rise to inflation), offer evidence the sector could continue its recent bout of outperformance.

Strategy Views

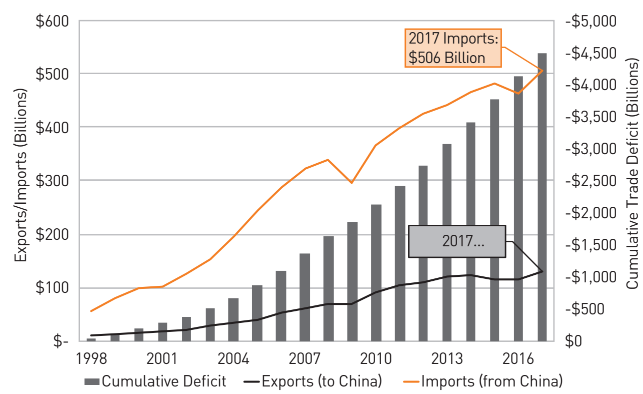
U.S./China Trade Update: Rise in Trade War Rhetoric Leads to Market Unrest

- Continued trade tensions drove elevated levels of market volatility throughout the month, as the U.S.-China tariff exchange continued to unfold. In early April, President Donald Trump served the United States's latest volley, asking the office of the United States Trade Representative (USTR) to consider raising by $100 billion the amount of Chinese goods subject to special tariffs. This would be in addition to the $50 billion proposed in late March. The White House request was in response to China's announced $50 billion in retaliatory tariffs. We continue to believe the likelihood of an all-out trade war remains low; however, the longer this perilous rally continues, the higher the probability of an actual trade war becomes. It remains our base case that the United States and China will likely find a more pragmatic solution, with the ultimate economic impact being lower than some investors fear, especially relative to announced U.S. fiscal stimulus. However, investors should expect further market turbulence over the near term as each country attempts to strengthen its negotiating position. Below we take a quick look at where things stand with regard to U.S./China trade, Chinese ownership of U.S. Treasury bonds, dollar-to-yuan valuation, and potential outcomes.

U.S./China Trade—Where Are We Today?

- For investors, understanding the psychology of President Trump and President Xi Jinping is an important component of forecasting the potential paths of recent trade hostilities. President Trump is likely eager to follow through on campaign promises and notch a win leading into midterm elections, with his current sights appearing to be set on narrowing the U.S. trade deficit with China. On the other side of the table we have President Xi, who is coming off a unanimous vote in March by Chinese lawmakers to remove term limits on his presidency. The significance of this should not be understated, in our view, as the ruling effectively has made President Xi the most powerful leader of the country since the term limits were put in place in the early 1980s. The U.S trade tariffs likely serve as an international (and public) challenge, and President Xi probably does not want to appear weak in response. However, U.S. tariffs on an additional $100 billion in Chinese goods may put China at a potential crossroads.
- In 2017 the United States exported $130 billion worth of goods to China, on which China has announced $50 billion in tariffs (Chart 1). Thus, there are approximately $80 billion in goods available for additional tariffs (much less than the $100 billion in additional tariffs the U.S. is now considering). So, if China makes good on its pledge to "counterattack with great strength," it may need to get creative. It may be difficult to forecast how China would respond to any further trade restrictions, but we think it is fair to say that future retaliatory actions have the potential to shake markets. Taking a deeper look at the original Chinese tariffs on U.S. goods, the inclusion of soybeans caught markets (and probably the White House) by surprise. It showed that China was willing to absorb some internal pain in order to directly hit President Trump and some of his strongest supporters (Midwest farmers). Currently

Chart 1
U.S. and China Trade Last 20 Years—Goods Exports/Imports



Source: Census Bureau, PNC

China, the largest buyer of U.S. soybeans, imports about one-third of all its soybeans from the United States.[1] The soybeans are primarily purchased to feed livestock needed to produce the meat consumed by China's 1.38 billion people. China will probably look to buy soybeans from other countries; however, given global supply (excluding the United States) and China's large demand, soybean prices are likely to go up for Chinese manufacturers and people. If nothing else, this gives a bit of insight into China's resolve to aggressively respond to U.S. trade restrictions.

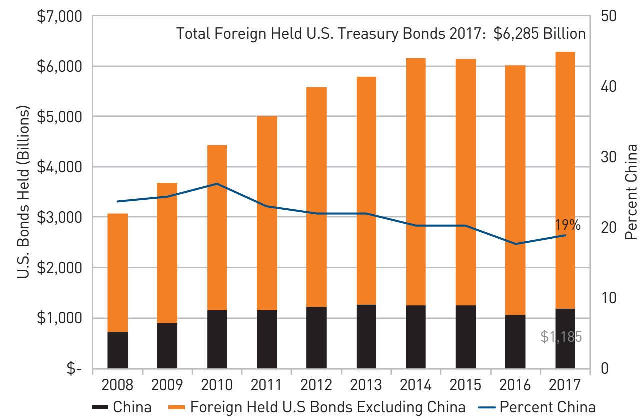
- This leads us to a final point on U.S./China trade. In 2017, the United States imported $506 billion worth of goods from China. Therefore, the USTR has significantly more latitude in its ability to tariff Chinese goods than vice versa. It is important to remember, in our view, that the United States has probably already exhausted its ability to tax goods that would have a minimal impact on the U.S. economy (they had trouble identifying the original $50 billion worth of goods). Additionally, if the United States imposes additional trade restrictions on China, we think the administration should consider the impact on American workers. According to the U.S. Department of Commerce, in 2015 (latest data available) U.S. exports of goods and services to China supported as estimated 911,000 jobs domestically.[2] China also has employment concerns should trade tensions escalate. With hundreds of millions of manufacturing workers, restricted access to its largest export market would surely create problems. In summary, there are enough disincentives to make us believe the end result will fall short of something that is truly destabilizing to the global economy.

China's Largest Import: U.S. Bonds

- China was the largest foreign holder of U.S. bonds through 2017 with approximately $1.18 trillion of U.S. paper (Chart 2). However, China's Treasury holdings make up only 6% of all U.S. Treasuries outstanding (Chart 3).

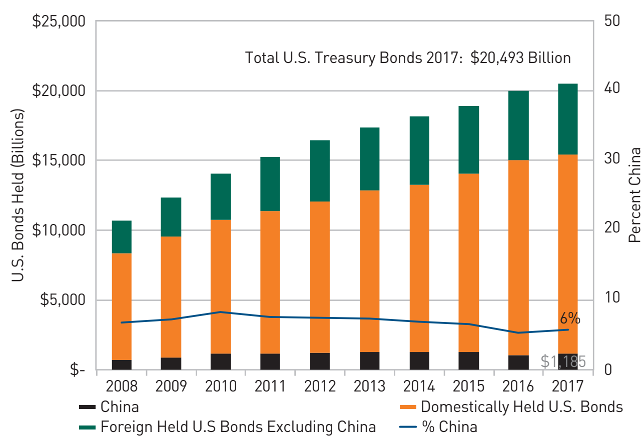
China is clearly an important creditor, but it is one of many in a fairly diversified pool of buyers. Thus far there has been little talk of China reducing its Treasury portfolio, likely because the impact could be equally troubling for both countries. Any large-scale reduction of U.S. Treasury bonds by China could significantly affect the global investment community, drive up U.S. yields across the curve, and make it more expensive for the United States to finance government

Chart 2
Foreign Held U.S. Treasury Bonds
(2008-17)



Source: U.S. Department of the Treasury, PNC

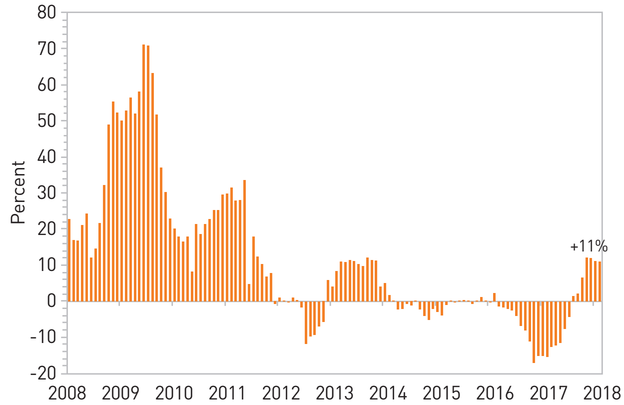
Chart 3
Total U.S. Treasury Bonds
(2008-18)



Source: U.S. Department of the Treasury, PNC

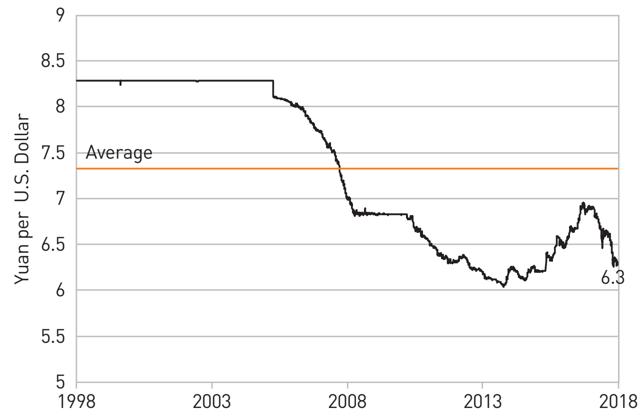
[1] http://www.scmp.com/news/china/diplomacy-defence/article/2141051/china-not-expecting-any-soybean-supply-problems-short.
[2] https://ustr.gov/countries-regions/china-mongolia-taiwan/peoples-republic-china.

Chart 4
Chinese Holdings of U.S. Treasury Bonds, Year over Year Percentage Change



Source: U.S. Department of the Treasury, PNC

Chart 5
Yuan per U.S. Dollar
(1998-2018)



Source: China Foreign Exchange Trade Center, PNC

operations. However, China may also suffer certain self-inflicted wounds in this scenario, and a lack of Chinese demand could, at least in part, be absorbed by other buyers:

- When considering credit quality, there are few options for China to invest outside of U.S. bonds other than much lower-yielding European and Japanese bonds.
- U.S. yields would likely rise quickly, leading to significant losses to China's remaining Treasury holdings.
- The effect would likely strengthen the yuan relative to the dollar, making Chinese exports less attractive to the rest of the world (the opposite of what they probably want to achieve); see more on this below.

- Given the above, we do not see a reduction in China's Treasury holdings as a likely threat. In fact, China's holdings of U.S Treasury bonds has actually increased through early 2018, up 11% year over year (Chart 4).

Yuan Devaluation?

- Since removing the hard peg of 8.28 yuan per U.S. dollar in July 2005, the yuan has appreciated by 24% versus the dollar through early 2018 (Chart 5). However, this has not been without Chinese intervention. For example, in July 2008 the Chinese government halted any further yuan appreciation as demand for Chinese exports slowed due to the Great Financial Crisis (this hold was in place until June 2010). With the exchange rate at 6.3 yuan per U.S. dollar, the yuan is trading at its strongest level against the dollar since 2015 and not far off its strongest level since the peg was removed. A Chinese-led devaluation of the yuan should be an area to watch as trade discussions evolve. A weaker yuan will likely make Chinese exports more attractive to other countries, muting the impact of U.S tariffs. We would not expect a yuan devaluation program to be part of China's trade retaliation, but it could be part of a broader Chinese strategy. Any rapid devaluation would probably have ripple effects across markets (starting with emerging markets). We saw this play out in 2014-16 as China battled capital outflows and EM equities fell nearly 20%.

Going Forward

- In early April, Chinese President Xi adopted a more market-friendly tone in his highly anticipated speech at the Boao Forum for Asia, marking his first public speaking engagement since the escalation in trade restrictions. President Xi promised to reduce import duties on a broad spectrum of goods from the United States as well as improve foreign investment conditions. The largest takeaway from President Xi's speech, however, was an openness to enforce protections of intellectual property (IP) rights for foreign firms.

Markets largely responded kindly to President Xi's conciliatory comments, advocating for "dialogue rather than confrontation." As the United States and China continue to jockey for negotiating position, the biggest hurdle remains IP related to its "Made in China 2025" initiative. The "Made in China 2025" initiative, led by President Xi, is a program to boost technologically advanced sectors like robotics, biotechnology, and aerospace to the forefront of the Chinese economy. The White House and U.S. trade representatives have claimed that the Chinese government has forced U.S. companies in these and other related fields to transfer IP and trade secrets to state-run or state-supported Chinese businesses as passage to do business in the country. Conversely, Chinese firms, technologically advanced or otherwise, are able to operate in the United States largely unencumbered. Finding a middle ground on IP will be critical to the outcome of trade negotiations.

- In summary, elevated equity valuations, a Fed with somewhat limited ability to manage economic shocks given still historically low interest rates, and globally integrated supply chains put markets in a jittery mood. For this reason, we have seen large swings in equity markets largely driven by the day's trade headlines. Although we believe the trade overhang will slowly dissipate as we move through the year, any further escalations (real or implied) could continue to weigh on markets over the near term. For now, investors seem to have turned their attention away from trade as we are now halfway through earnings season. A follow-through on lofty earnings expectations, which we have seen thus far, may be critical for a market that has recently been on edge. We believe that companies will continue to update guidance relative to the tax bill, and thus far next quarter's earnings guidance seems to be trending in a positive direction.

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