Divergent Paths: 2015 Outlook Part I

“There are two paths you can go by, but in the long run, there’s still time to change the road you’re on.”
—from “Stairway to Heaven” by Led Zeppelin

Executive Summary

We believe 2015 will be a year of continued economic expansion for the United States. Global trends indicate a divergence of growth, with the U.S. economy forecast to expand at a faster pace than this year, while some other developed countries’ economies are forecast to experience slowing growth.

This year was one in which divergence began to take shape, with the continued economic expansion in the United States aided by good corporate earnings and a low-interest-rate environment. Joining the United States in continued growth were the United Kingdom, Canada, and a few others. Markets rewarded investors in U.S. stocks. Global markets did not fare as well, responding to slower growth and geopolitical concerns.

Volatility returned to markets in 2014 with heightened perceived risks. Leading were geopolitical concerns including tensions in Ukraine and the Middle East. Additionally, slowing global growth forecasts have afflicted markets with some apprehension over the outlooks for regions including the Eurozone, China, and Japan. We believe volatility is likely to remain at or above these levels in the near term, with flare-ups also possible from time to time moving through 2015.

With the continued strength in the U.S. economy, directionally the Federal Reserve (Fed) for the first time in many years is moving toward “monetary policy normalization” with the end of monthly asset purchases in October of this year and anticipation of an increase in interest rates in 2015. PNC projects the Fed will make its first increase in interest rates in July 2015. Strong corporate earnings helped the S&P 500® bounce back from midyear turmoil, strong corporate profits, low inflation, and rising asset prices, among other things. For 2014, PNC expects economic growth of 2.3% year over year, accelerating to 3.1% in 2015. Geopolitical concerns remain on the radar as the biggest risks to markets; also prominent is the fragility of the Eurozone and Japanese economies.

Our outlook for the United States for the rest of 2014 is for continued economic expansion, with several helpful tailwinds, including less fiscal drag and political turmoil, strong corporate profits, low inflation, and rising asset prices, among other things. For 2014, PNC expects economic growth of 2.3% year over year, accelerating to 3.1% in 2015. Geopolitical concerns remain on the radar as the biggest risks to markets; also prominent is the fragility of the Eurozone and Japanese economies.

PNC’s six traditional asset allocation profiles are shown on the back page of this outlook.

Led Zeppelin was a rock band founded in London in 1968 made up of guitarist Jimmy Page, singer Robert Plant, bassist and keyboardist John Paul Jones, and drummer John Bonham. Stairway to Heaven was composed by Page and Plant and is often rated among the greatest rock songs of all time. The band disbanded in 1980 following Bonham’s untimely death at age 32. Led Zeppelin was inducted into the Rock and Roll Hall of Fame in 1995.

E. William Stone, CFA®, CMT
Managing Director, Investment and Portfolio Strategy
Chief Investment Strategist

Marsella Martino
Senior Investment Strategist

Rebekah M. McCahan
Investment Strategist

Nicholas M. Srmag, CFA®
Fixed Income Strategist

Ryan Whidden
Senior Portfolio Strategist

Paul J. White, PhD, CAIA®
Director of Portfolio Strategy

Michael Zoller
Investment Strategist
We believe the U.S. economy will proceed along its expansion trajectory, leading global growth and diverging from major developed economies, such as the Eurozone and Japan, which in general are estimated to be slowing.

The economy continued to expand in 2014 (Chart 1). Early in the year, hampered by severe winter weather, the first-quarter growth rate disappointed at -2.1%. Naysayers to the weather effect were silenced with the sharp growth rebound in the second quarter, when the economy expanded at a 4.6% rate. The third-quarter GDP figure was around 3.9%. The PNC Economics team expects 3.0% growth in fourth-quarter 2014. For the full year, growth is estimated at 2.3%.

We believe 2015 will bring a year of above-trend real GDP growth. The PNC Economics team forecasts 3.1% growth for 2015. This includes views that:

- payroll job growth will maintain its current pace of around 230,000 new jobs per month; and
- the unemployment rate will decline to end 2015 at around 5.3%.

The expansion, which began in July 2009, is now more than five years old. This is in line with the average duration of expansions experienced since World War II. It is worth noting that more recent expansions have tended to trend much longer than those in earlier decades.

As we expected, earnings supported equity valuations, pushing the S&P 500 up. Earnings in fact exceeded our expectations. Geopolitical tensions brought market volatility back above 2013 levels, causing market blips from time to time. Through the first three quarters of the year, the S&P 500 on a total return basis rose 8.3%. Long overdue for a correction, in October the S&P 500 pulled back 5%, then just crossed the down 10% point. Timing was of the essence, a strong third-quarter earnings season resulted in 7.6% growth, far exceeding the initial 4.5% estimate. Thus investors, swayed by valuations, stronger earnings, and weakness elsewhere in the world, returned to U.S. equities.

Year-to-date, the S&P 500 on a price basis is up 10.8% as of November 19. Including the reinvestment of dividends, the S&P 500 has returned 12.9%. The S&P 500 has continued to set new highs, reaching 2,055 intraday on November 18. To put this in perspective, the S&P 500 was roughly 1,250 before the collapse of Lehman Brothers in September 2008. At its low, the S&P 500 reached 667 in 2009.

Looking at the Dow Jones Industrial Average (DJIA), this index has also pushed higher, past the prerecession peak of 14,000 set in 2007 and the 2013 year-end high of 16,500. The DJIA crossed the 17,000 mark in July 2014. Similar to the S&P 500, the DJIA experienced a correction in October, dropping about 6.5%. The DJIA has moved higher and is in new record territory once again in November, around 17,726 intraday, November 19.

As we consider the markets in 2015, we focus on a few uncertainties we believe are of concern to investors:

- timing of Fed interest rate hikes;
- global growth concerns, notably the Eurozone;
- U.S. politics;
- geopolitics; and
- jobs, wages and inflation expectations.

As the U.S. economy normalizes, there is less of a need for extraordinary interest-rate policy. Differences in market expectations versus the Fed view could affect markets adversely. PNC expects the first increase in the federal funds rate to come in July 2015.

We would be remiss if we were not to outline some of the political issues the U.S. Congress is set to act upon next year that could potentially drive headlines.

- The debt ceiling will once again need to be addressed in March 2015.
- Energy policy is likely to be addressed, leading with the Keystone pipeline debate.
- Other policy issues for next year include corporate tax reform, health care, and immigration, among others.

For the third year in a row, our outlook for the coming year includes the Eurozone as a risk factor. For 2015, the risk is an economic one to global growth. The Eurozone economy appears to be stagnating. Eurozone third-quarter GDP data were slightly better than expected, while still slow overall; growth was 0.2% for the region, up from 0.0% in the second quarter (Chart 2). Lower oil prices and European Central Bank easing are positives for the economy as the Eurozone continues to fight deflation. In addition, Russia remains a large risk to Germany as a trading partner, and thus to the Eurozone as a whole. France surprised on the upside, as did Spain, which is benefiting from structural reforms. Italy appears to be in a triple-dip recession.

In 2014, market volatility returned with several adverse geopolitical concerns. The Russia/Ukraine situation has quieted a bit; however, we are cautious, and we acknowledge that fallout from the sanctions could press economic conditions in trading partners. Tensions in the Middle East could from time to time also rattle markets, and there is always the risk of unforeseen events—political, geological, and meteorological—in other parts of the world.

Labor market conditions are certainly much improved since the Great Recession, while some data points, such as limited wage growth, continue to affect the United States. We discuss the labor market in further detail later in “Jobs” on page 7. The Fed has shown little concern about inflation, primarily because wage pressures are stable. Wage inflation seems to be hovering around 2%, where it has remained since the Great Recession.

The Consumer Price Index (CPI) has trended lower in 2014, in part due to lower energy prices. While indicators are not pointing to a structural rise in inflation, we do note that every so often markets overact. Higher inflation does not have to be present for there to be an inflation scare. All that is needed is the potential for higher inflation.

It is our intent to make educated projections for the coming year in this and next month’s Investment Outlooks. Since one cannot predict the future with any great

---

**Chart 2**

**Eurozone GDP**

<table>
<thead>
<tr>
<th>Country</th>
<th>2Q14</th>
<th>3Q14</th>
</tr>
</thead>
<tbody>
<tr>
<td>Germany</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>France</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>Italy</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>Eurozone</td>
<td>0%</td>
<td>0%</td>
</tr>
</tbody>
</table>

*Source: Bloomberg L.P., PNC*
certainty, our primary focus is on what is knowable. When determining a recommended asset allocation for our clients we focus on their:

- goals;
- risk tolerance;
- income needs;
- investment holding period; and
- personal situation.

In addition, when the PNC Investment Policy Committee (IPC) considers PNC’s general recommended allocations, it concentrates on the intrinsic valuation of possible investments and weighs the estimated risk versus reward.

Recap of 2014

As 2014 began, we wrote in our Investment Outlooks that we anticipated a year of continued modest economic expansion with several soft spots remaining. It was our view that the unemployment rate would continue to be a gap in the economic picture, and we projected that the Fed would end its monthly bond purchases (quantitative easing 3 or QE3).

Through the course of the year, the labor market continued along its path of slowish growth, with nonfarm payrolls picking up and the unemployment rate inching lower. But the participation rate remains a concern and wage growth continues to be limited. True to our projections, the Federal Open Market Committee (FOMC) voted to end QE3 as of the October 2014 meeting.

Our January 2014 Investment Outlook, Edge of Reason: 2014 Outlook Part II, noted that our historical review of stocks versus bonds reflected a shift in stock returns versus bond returns. The 10-year trailing return of stocks versus bonds indicated an outperformance for the first time since 2006, reflecting the latter years’ strong performance of the equity markets. While overall, equity markets have pressed higher, there were a few unanticipated events that roiled the markets in 2014.

Let’s review some positives and negatives of our views throughout the year.

- We recommended a baseline allocation of stocks relative to bonds.
- We were mindful that despite our expectation that the economic recovery would continue, the labor market would continue to be a hurdle.
- Our small but continued allocation to REITs provided positive performance.
- In late October, we trimmed our allocation to leveraged loans, adding to the absolute-return-oriented fixed-income strategies in anticipation of future rising interest rates.

We generally view any shortcomings during the year as failing to take advantage of some opportunities rather than a more serious error in analysis. We are seldom fully satisfied with our performance and remain committed and determined to learn from our missteps, which are an inevitable part of investing. We continue to examine the PNC investment hypotheses on a daily basis and weigh the risk versus reward of our investment recommendations and the investment products we recommend to clients.

U.S. Continued Economic Growth

Over the past few years, we have used several indicators to assess the sustainability of the economic recovery, which have so far proven effective. While in some spots growth remains uneven, overall the economic expansion continues. Looking ahead we use these indicators to focus on what matters in terms of the recovery.
For this study we use three main sustainability indicators:

- housing;
- consumer spending; and
- jobs.

**Housing**

Overall the trend in housing in 2014 reflected a continued improvement, while not quite keeping pace with 2013. The trend in home sales reflects continued, yet slow and somewhat disappointing, home sales (Chart 3). One notable trend change since the recovery has been the composition of starts. The percentage of multifamily starts has risen as the demand for rental units has grown (Chart 4).

Housing starts have recovered from lows seen a few years ago and trended higher in 2014. The last read in October, however, showed starts falling 2.8% month over month. But building permits continue to push higher and in October reached their highest reading since June 2008.

Price growth continues but has slowed (Chart 5). PNC Economics team believes prices will continue to grow at a mid-single-digit pace, consistent with income growth and sustainable over the long term.

PNC Economics team believes that fundamentals for housing demand are solid and will continue to improve.

- Households that put off buying homes during the recession and slow recovery add up to great pent-up demand.
- Affordability has ticked up a bit, but remains low by historical standards.
- Mortgage rates, which had risen slightly, are back down to low levels.
- Supporting the continued housing recovery in the near-term likely will be an improving labor

---

**Chart 3**

**Home Sales**

Source: U.S. Census Bureau, National Association of Realtors®, PNC

**Chart 4**

**Multifamily Housing Starts**

Source: U.S. Census Bureau, PNC

**Chart 5**

**S&P/Case Shiller® Home Price Index**

Source: Case-Shiller, PNC
market, increased access to credit, stock market gains, and improving consumer confidence.

**Consumer Spending**

Consumers have slowly become more confident, which generally has been a positive for consumer spending, which has trended higher during the recovery. The biggest benefit to consumer spending in 2014 was the drop in gasoline prices. Also, continued improvement in the labor market as well as financial markets has helped consumers. However, where consumer confidence has slowly improved, it has not returned to prerecession levels (Chart 6).

There are a number of reasons for the hesitant consumer. These include:

- limited wage growth;
- a higher saving rate, as consumers seem to be rebuilding their deposits;
- lower home prices, still off 11% from their peak in early 2007;
- while the stock market has risen, this tends to favor higher income households; and
- credit conditions remain tight.

On the one hand this deleveraging is a positive, as consumer balance sheets have gotten healthier since the recession, part of this involuntarily due to tighter credit standards (Chart 7). The flip side is that credit leads to spending, which supports economic growth. So while no credit bubble has developed, there could be some benefit to greater availability of some credit, which could provide a tailwind to economic growth.

Overall retail sales trended stronger in 2014 than in 2013. We pay particular attention to core retail sales. This measure removes some distortion from both the volatile automobile and gasoline sales. When looking for the underlying trend, it is helpful to view the year-over-year data for core retail sales, which helps remove the month-to-month noise (Chart 8).
Heading into the holiday shopping season, sales are poised to be stronger than last year, given the year-over-year improvement in nonfarm payrolls, the unemployment rate, strength of the stock market, and lower gasoline prices. PNC Economics team estimates the drop in gasoline prices alone from 2013 to 2014 puts about $39 billion back in consumers’ pockets.

PNC Economics team believes consumer spending growth will help support broad-based economic growth in the latter parts of 2014 and in all of 2015. Pent-up demand for big ticket items such as automobiles is a part of this (Chart 9).

As we indicated in the “Housing” section on page 5, there have been shifts in consumer trends, leading with housing choices.

**Jobs**

The jobs picture improved in 2014 and is much better since 2009. A few soft spots in employment continue to drag on the jobs market and affect economic growth.

Payroll jobs have added almost 230,000 jobs per month so far this year, adding about 2.7 million more employed this year versus last (Chart 10). The unemployment rate has trended lower, and now sits at 5.8%.

Slower to move is the participation rate, which has ticked down only modestly and has not returned to prerecession levels (Chart 11).

And most importantly to the U.S. consumer, wage growth has been limited. Average hourly earnings are up only around 2.0% over the past year, just slightly outpacing inflation (Chart 12). Research from the Fed has argued that there remains a large pool of long-term unemployed and...
discouraged workers that can be drawn back into the labor force as the economy expands. However, in order for individuals to ask for better wages they must feel comfortable about their current and future economic situations, which is not true at present.

PNC Economics team forecasts payroll gains at around the current pace of 230,000 per month for the fourth quarter of 2014 and in 2015. The unemployment rate should continue its gradual decline, ending 2014 close to 5.7% and ending 2015 at around 5.3%.

**Forecasting the Fed**

As the U.S. economy normalizes, there is less of a need for extraordinary interest-rate policy. Looking back at the impact of prior tightening cycles, specifically in 1994 and 2004, it can be seen that markets have tended to sell off following tightening, but they recover over time (Table 1).

Decisions from the Fed can have a significant impact on financial markets. We discussed in our August 2014 Topical Commentary, Federal Open Market Committee Rates Watch how markets react to increases in Fed policy rates.

Bonds and stocks react differently to rate increases (Table 2). Historically, the bond market has moved first, and the stock market has tended to react a few weeks later. This makes intuitive sense to us. Bond prices are far more sensitive to interest-rate

<table>
<thead>
<tr>
<th>Table 1</th>
<th>Fed Tightening Cycles</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Change</td>
</tr>
<tr>
<td></td>
<td>S&amp;P 500</td>
</tr>
<tr>
<td>1994—First Rate Rise 2/4/94</td>
<td></td>
</tr>
<tr>
<td>9 Months before</td>
<td>6.7%</td>
</tr>
<tr>
<td>3 Months before</td>
<td>2.7</td>
</tr>
<tr>
<td>3 Months after</td>
<td>-4.0</td>
</tr>
<tr>
<td>9 Months after</td>
<td>0.5</td>
</tr>
<tr>
<td>2004—First Rate Rise 6/30/04</td>
<td></td>
</tr>
<tr>
<td>9 Months before</td>
<td>14.5</td>
</tr>
<tr>
<td>3 Months before</td>
<td>1.3</td>
</tr>
<tr>
<td>3 Months after</td>
<td>-2.3</td>
</tr>
<tr>
<td>9 Months after</td>
<td>3.5</td>
</tr>
</tbody>
</table>

**Source:** Strategas Research Partners, PNC

<table>
<thead>
<tr>
<th>Table 2</th>
<th>Market Reaction to Past Fed Tightening</th>
</tr>
</thead>
<tbody>
<tr>
<td>2-Year Treasury</td>
<td></td>
</tr>
<tr>
<td>Reaction Started (weeks before first rate hike)</td>
<td>3</td>
</tr>
<tr>
<td>One-Month Change (basis points)</td>
<td>8</td>
</tr>
<tr>
<td>Two-Month Change (basis points)</td>
<td>10</td>
</tr>
<tr>
<td>S&amp;P 500</td>
<td></td>
</tr>
<tr>
<td>Reaction Started (weeks before first rate hike)</td>
<td>2</td>
</tr>
<tr>
<td>Peak to Trough (change)</td>
<td>-1.9%</td>
</tr>
<tr>
<td>Duration of Decline (weeks)</td>
<td>5</td>
</tr>
<tr>
<td>Trough to End of Tightening (change)</td>
<td>27.8%</td>
</tr>
</tbody>
</table>

**Source:** Cornerstone Macro, PNC
changes, which comprise the bulk of the underlying value of the investment. In contrast, interest rates are only one of many drivers in the stock market.

Looking to the Fed and markets for guidance, we can see that the FOMC dot plot (a chart that shows where FOMC members think the interest-rate benchmark is going) moved up a bit, with the end date now 2017 (Chart 13). The median view has the federal funds rate at 1.375% by the end of 2015, higher than the 1.13% in June 2014, with both the hawks and Fed Chair Janet Yellen moving up the median. The market appears to be pricing in the same terminal rate as the Fed, 3.75%, but later than the Fed does, in 2017. If markets were to catch up to the Fed, rates would go up across the board. We believe it will be important to watch the December FOMC meetings for further guidance. PNC expects the first increase in the federal funds rate to come in July 2015.

The dot plot comparative to yields suggests to us that the market will need to adjust if the market view approaches the Fed’s view. There is still time for markets to adjust; there could be changes to the dots; or there could be a combination of the two eventualities. Through this year, we expect that markets will be cautiously watching.

As a side note, central bank policy also has the potential to affect currency exchange rates. Those countries in which policy rates are increased first generally become relatively more attractive for investing. Capital may flow into these first-mover economies, boosting their currencies at the expense of others. The dollar specifically has risen, not just versus the euro but also against most major currencies, reflecting the improved economic outlook for the United States, in addition to being relatively more attractive from an interest-rate perspective. The outlook for the dollar, at least in the near term, can be viewed as more of the same. Global uncertainty plus continued strength in the U.S. economy are positives. We recommend caution on investing in the dollar specifically because history shows that predicting currency moves is most difficult.

**Stocks—Valuation and Fair Value**

In our December 2013 *Investment Outlook, Mind the Gaps: 2014 Outlook Part I*, we stated our belief that the pace of earnings gains was likely to accelerate slightly in 2014 versus 2013. We stated our expectation for mid-single-digit earnings growth in 2014, barring a greater-than-expected acceleration of global GDP. At the time we forecast 2014 S&P 500 earnings per share (EPS) would grow to $112-120, with a target of $116, consistent with our mid-single-digit expectations for global nominal GDP growth. At this time, we believe 2014 earnings will end slightly ahead of our initial estimate, representing approximately 7% growth versus 2013.

We expect mid-single-digit earnings growth in 2015, barring a greater-than-expected acceleration in global GDP growth. At this time we forecast 2015 S&P 500 EPS of $125-133, with a target of $128, consistent with our mid-single-digit expectations for global nominal GDP growth.

Combining this forecast with historical price-to-earnings (P/E) multiples based on various inflation rates results in an expected S&P 500 fair value multiple range of 15.8-16.4 times (Chart 14, page 10). We expect the CPI to rise 1.7% in both 2014 and 2015, in a sweet spot for valuation between 1% and 3%. According to this method,
using a conservative S&P 500 EPS estimate of $128 would yield a fair value range on the index of 2,025-2,100 with a midpoint of 2,050.

As we have in past December Investment Outlooks, we revisit Benjamin Graham’s method of dealing with cyclical earnings to better handle the volatile nature of earnings and economic cycles. In former times, analysts and investors paid considerable attention to the average earnings over a fairly long period in the past—usually 7-10 years. This mean figure was useful for ironing out the frequent ups and downs of the business cycle and was thought to give a better idea of a company’s earnings power than the results of the latest year alone.

This method also makes sense to us because investors should not pay high multiples for peak earnings or low multiples for trough earnings. The intention is to pay a reasonable multiple for earnings through an economic cycle.

Following Mr. Graham’s advice, we examined the price, earnings, and 10-year average earnings for the S&P 500 back to September 1936 (Chart 15).

The data are adjusted to account for inflation; in other words all earnings and S&P 500 data were revised to reflect current dollars using the CPI. For example, S&P 500 EPS for the four quarters ended September 1936 were $0.94, but we have revised the EPS to $16.19 to reflect the value in 2014 dollars. The historical S&P 500 levels are adjusted in the same manner. This allows us to make a better apples-to-apples comparison of valuation without the distortion of inflation.

Using this data we calculated what we will term a normalized P/E multiple for the S&P 500 over time. The study reinforces our earlier calculations that stock valuations remain supportive of higher S&P 500 levels. Using an S&P 500 level of 2,050, the index sells at 21.5 times our normalized EPS estimate for 2015 versus a long-term average of 16.5 times. It is worth noting that the S&P 500 sold more than 1-standard-deviation above the long-term average normalized multiple in the mid-1960s, which

---

**Chart 14**

*Average S&P 500 12-Month P/E by Inflation Range*

Source: Bureau of Labor Statistics; Strategas; Bloomberg L.P.; PNC

**Chart 15**

*S&P 500 Inflation-Adjusted Index and Earnings*

Source: Bureau of Labor Statistics; FactSet Research Systems, Inc.; Bloomberg L.P.; PNC

**Chart 16**

*S&P 500 P/E Ratio and Long-Term Government Bond Yield*

*(price to normalized earnings in 2014 dollars)*

Source: Bureau of Labor Statistics; FactSet Research
was a period marked by rising interest rates that followed a period of extremely low government yields and financial repression, similar to today (Chart 16, page 10). If the S&P 500 sold at a multiple of 1-standard-deviation above the long-term normalized multiple, it would imply a multiple of 22.7 times or a level of 2,230 for the S&P 500.

We also looked at historical normalized P/E ratios relative to Baa corporate bond yields. The resulting best-fit analysis points to a multiple of 17.5 times EPS, assuming a corporate bond yield of 5.0%. Using a 17.5-18.5 multiple on our normalized EPS estimate for 2014 produces a fair value S&P 500 range of roughly 1,725-1,825, or a median value of 1,775.

Preferring to err on the conservative side, and given the downside risks to the market, we are setting the 2015 PNC fair value range estimate for the S&P 500 at 2,025-2,250, with an expected value of 2,150. The 2,150 level, assuming a dividend yield of about 1.9%, should provide a total return of mid-single digits depending on where the S&P 500 closes for 2014. From a long-term perspective, we believe the S&P 500 appears neither wildly overvalued nor undervalued, but we believe it is positioned to provide real returns in excess of cash or bonds along with upside potential.

**PNC Current Recommendations**

PNC’s recommended allocations continue to reflect our positive view regarding the durability of the economic expansion while considering the continued downside risks inherent in the market and economic outlook:

- a baseline allocation of stocks relative to bonds;
- a tactical allocation to PNC Systematic Tactical Asset Rotation (STAR);
- a tactical allocation to real estate investment trusts (REITs);
- a tactical allocation to leveraged loans within the bond allocation;
- a tactical allocation to absolute-return-oriented fixed-income strategies within the bond allocation;
- an allocation to emerging markets within the international equity component;
- a preference for high-quality stocks;
- a tactical allocation to global bonds within the bond allocation;
- a tactical allocation of 52% value and 48% growth within U.S. large-cap stocks;
- a tactical allocation to global dividend-focused stocks; and
- an allocation to alternative investments for qualified investors.

**Baseline Allocation of Stocks Relative to Bonds**

Since one cannot accurately determine the short-term movement of stocks, we believe that investors should focus on what is knowable and controllable. The one thing investors can truly control is asset allocation reflective of their needs and risk tolerance. PNC’s six baseline asset allocation models are shown on page 20.

**Preference for High-Quality Stocks**

Any relapse to stressed capital markets or to another credit crunch from a financial crisis likely poses a higher threat to lower-quality and highly leveraged companies. Companies with weak balance sheets and less-robust business models have a much higher risk to their survival. Unfortunately, the economic outlook continues to be subject to continued downside risks in the wake of the financial crisis.
We favor a preference for high-quality stocks as a method of risk control against unexpected shocks to the economic system. This is also consistent with our explicit allocation to dividend-focused stocks.

**International Equities**

International equities offer a geographic diversification benefit and open the opportunity set to invest in firms around the world. Beyond the benefits of diversification and exposure to many of the world’s leading companies, there are other potential benefits to investing outside U.S. borders, including unique opportunities associated with Asia and Europe. Within the international equity component we recommend an allocation to emerging markets.

A reasonable assumption regarding returns is that the United States and other developed markets have similar long-term expected returns. Much of the difference is likely to come from currency gains or losses. We remain mindful of the currency risk inherent in international investing. While at times the weaker dollar makes international investing look more attractive than the underlying fundamentals might dictate, the reverse is true when the strong dollar punishes the international returns of U.S. investors.

**Allocation to Global Bonds within Bonds**

The strategic rationale for including global bonds in the portfolio rests on expanding the opportunity set within the investible bond universe. The Barclays Capital Global Aggregate Index, our proxy for high-quality global bonds, contains less than 40% U.S. issues (Chart 17). (For further details on global bonds, see the July 2011 *Investment Outlook, Pulling the Fourth Lever.*) We believe investors who decline to look outside the United States may be missing opportunities for diversification and perhaps enhanced returns.

A primary motivation for allocating to global bonds is to introduce currency exposure to a portfolio. Although currency adds another level of volatility to a portfolio’s fixed-income allocation, it provides for investors a natural hedge against devaluation of the dollar, which traditional domestic fixed-income asset classes cannot offer (Chart 18, page 13).

The prospect of higher global economic growth outside the United States is another motive for allocating fixed income globally. As world economies grow more quickly, international bond investors may have the opportunity to reap the benefits of tightening global credit spreads relative to the United States. More importantly, investors can take advantage of higher interest rates abroad to gain higher yields. The addition of the currency exposure that comes with an unhedged global bond can act to lower the correlation with U.S. bond returns (Chart 19, page 13).

In general, we suggest that active management makes the most sense in this allocation. Global bond index construction usually focuses on allocating more assets to countries with more outstanding debt. This may or may not be a good thing. Larger and more stable economies are likely to be able to support higher debt levels, but some fundamental analysis is likely helpful. We also believe that the current state of the global economy, with the large dichotomy between most developed and emerging economies...
In our opinion, it is likely that many managers’ allocations will differ greatly from the index. This also affects the risk metrics, typically to the upside in terms of volatility, index tracking error, and historical drawdowns. This was explicitly taken into consideration by the PNC IPC when it sized the recommended allocation to global bonds.

Given the concerns regarding how the United States will handle upcoming monetary and fiscal policy decisions, as well as what effects those decisions might have on the value of the dollar, we believe an allocation outside traditional fixed-income bond sectors is prudent. We believe the advantage of higher global growth and diversification benefits, along with the ability to benefit from currency exposure outside the dollar, make investing in the global bond sector a viable complement to traditional dollar-based fixed-income assets. This allocation can be seen as adding to PNC’s defensive posture on U.S. interest rates, with 10-year Treasury rates now above 2% and our view that yields will rise over time as the current economic soft patch and the flight to safety fade (Chart 20). We also see this as an opportunity to benefit from higher bond yields elsewhere in the world.

**Allocation to Leveraged Loans within Bonds**

We believe an allocation to leveraged loans within the bond portion of a portfolio should help defend against higher interest rates. Since leveraged loans are adjustable-rate instruments tied to short-term interest rates (typically the 3-month LIBOR), we believe holders should benefit from rising rates (Chart 21, page 14). If longer-term interest rates rise, we expect the shorter duration of leveraged loans should result in

---

1The March 2010 *Investment Outlook, Shakespeare for Primates*, provides details about leveraged loans.
Investment Outlook

much better performance relative to longer-duration fixed income, such as the Barclays U.S. Aggregate Bond Index.

In summary, this allocation could be characterized as lowering the portfolios’ interest-rate risk while raising their credit risk and correlation with equities. We believe it accomplishes this without a large impact on portfolio income. In our opinion, this correlation with equities, which we have noted since recommending the allocation, has become more apparent in the recent stock market downturn, allowing investors an attractive entry point.

Allocation to Absolute-Return-Oriented Fixed-Income within Bonds

We believe an allocation to absolute-return-oriented fixed-income strategy within the bond portion of a portfolio has several benefits, including:

■ defending against higher interest rates;
■ further expanding the opportunity set for fixed income; and
■ increasing exposure to credit.

Given our belief that the economy will continue to improve, strategies that protect against the risk of rising rates will become increasingly important. While we do not believe interest rates will necessarily move markedly higher in the near term, rate volatility has certainly increased, and we expect that the downside risk to holding excessive duration will increase the longer rates remain low. We believe it makes sense to further hedge against this risk while maintaining the ability to participate in upside credit potential. This is also consistent with our current tactical allocations to global bonds and leveraged loans.

<table>
<thead>
<tr>
<th>Periods of Rising Rates</th>
<th>Begin</th>
<th>End</th>
<th>10-Yr Yield Begin</th>
<th>10-Yr Yield End</th>
<th>Chg in 10-Yr Treasury</th>
<th>BAA Yield Begin</th>
<th>BAA Yield End</th>
<th>Change in BAA Yield</th>
<th>Change in BAA Spread</th>
<th>Total Return during Period</th>
</tr>
</thead>
<tbody>
<tr>
<td>Begin</td>
<td>12/30/08</td>
<td>6/10/09</td>
<td>2.05%</td>
<td>3.95%</td>
<td>190</td>
<td>7.97%</td>
<td>7.75%</td>
<td>-22</td>
<td>-212</td>
<td>BarCap U.S. Aggregate</td>
</tr>
<tr>
<td>End</td>
<td>10/8/10</td>
<td>2/8/11</td>
<td>2.39%</td>
<td>3.74%</td>
<td>135</td>
<td>5.62%</td>
<td>6.25%</td>
<td>63</td>
<td>-72</td>
<td>Driehaus Active Inc</td>
</tr>
<tr>
<td></td>
<td>9/22/11</td>
<td>10/27/11</td>
<td>1.72%</td>
<td>2.40%</td>
<td>68</td>
<td>5.04%</td>
<td>5.46%</td>
<td>42</td>
<td>-26</td>
<td>Blackrock SIO</td>
</tr>
<tr>
<td></td>
<td>1/31/12</td>
<td>3/19/12</td>
<td>1.80%</td>
<td>2.38%</td>
<td>58</td>
<td>5.07%</td>
<td>5.42%</td>
<td>35</td>
<td>-23</td>
<td>MetWest Unconstrained</td>
</tr>
<tr>
<td></td>
<td>7/25/12</td>
<td>8/16/12</td>
<td>1.40%</td>
<td>1.84%</td>
<td>44</td>
<td>4.73%</td>
<td>5.09%</td>
<td>-36</td>
<td>-8</td>
<td></td>
</tr>
<tr>
<td></td>
<td>12/6/12</td>
<td>3/11/13</td>
<td>1.59%</td>
<td>2.06%</td>
<td>47</td>
<td>4.55%</td>
<td>4.94%</td>
<td>39</td>
<td>-8</td>
<td></td>
</tr>
<tr>
<td></td>
<td>5/2/13</td>
<td>12/31/13</td>
<td>1.63%</td>
<td>3.03%</td>
<td>140</td>
<td>4.67%</td>
<td>5.37%</td>
<td>90</td>
<td>-50</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Total Return during Period:</th>
<th>BarCap U.S. Aggregate</th>
<th>Driehaus Active Inc (LCMAX)</th>
<th>Blackrock SIO (BSIIX)</th>
<th>MetWest Unconstrained (MWCIX)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>-0.47%</td>
<td>13.08%</td>
<td>10.77%</td>
<td>N/A</td>
</tr>
<tr>
<td></td>
<td>-3.09%</td>
<td>4.65%</td>
<td>0.55%</td>
<td>N/A</td>
</tr>
<tr>
<td></td>
<td>-1.68%</td>
<td>2.26%</td>
<td>-0.20%</td>
<td>N/A</td>
</tr>
<tr>
<td></td>
<td>-1.18%</td>
<td>3.29%</td>
<td>1.22%</td>
<td>3.71%</td>
</tr>
<tr>
<td></td>
<td>-1.21%</td>
<td>0.48%</td>
<td>0.31%</td>
<td>1.75%</td>
</tr>
<tr>
<td></td>
<td>-1.01%</td>
<td>2.42%</td>
<td>1.73%</td>
<td>2.23%</td>
</tr>
<tr>
<td></td>
<td>-3.04%</td>
<td>1.27%</td>
<td>0.63%</td>
<td>0.70%</td>
</tr>
</tbody>
</table>

Source: Bloomberg L.P., PNC

2The July 2013 Investment Outlook, Breaking the Bonds, provides details about absolute-return-oriented fixed income.
We believe the Fed will continue to support the economy as necessary until the economy can grow and function without additional monetary policy accommodation. This should lend itself to further credit spread tightening over the short to intermediate term. Even with spreads at relatively attractive levels compared with historical standards, we admit the absolute low level of yields increases the difficulty of adding alpha within spread sectors. This is one aspect in which we believe an absolute-return long-short approach can add value. Absolute-return strategies have the ability to exploit mispricing via both long and short positions and also expand the opportunity set of strategies typically not accessible by traditional long-only managers. Typical trading strategies include, but are not limited to, capital structure arbitrage, convertible arbitrage, event driven, and pairs trading.

Table 3 (page 14) illustrates the behavior of various products on the PNC platform consistent with the absolute-return-oriented fixed-income strategies during periods of rising interest rates. The strong relative performance in rising-rate environments is notable and is consistent with our expectation.

**Overweight of U.S. Large-Cap Value Stocks Relative to Growth**

We believe the majority of the seven components of our decision framework—

- earnings growth;
- interest-rate level;
- inflation;
- volatility;
- foreign growth;
- valuation; and
- yield-curve slope—

continue to support an overweight to U.S. large-cap value style relative to growth.

In particular, we focus on the yield-curve slope because the results of our analysis show that a steep curve is supportive of value style outperformance relative to growth. It is not a concrete rule that value outperformance over growth in a steep...

---

3The March 2011 *Investment Outlook, Quest for Value*, provides details about the value style recommendation.
yield curve always exists, but it is an indication of higher probability. Though recent Fed activities have flattened them to a degree, both the 2- to 10-year (Chart 22, page 15) and 10- to 30-year (Chart 23, page 15) Treasury slopes remain historically steep and supportive of a value overweight.

We continue to monitor the possibility that the typical impact of the steep yield curve might be derailed by:

- the credit cycle;
- capital constraints; or
- lack of loan demand.

Bank loan data seem to be past their worst levels, and we believe there are reasons for cautious optimism.

- Banks are showing a greater willingness to extend consumer loans (Chart 24).
- Bank loan quality has continued to improve, implying a tailwind to bank earnings and a possible turn in the deleveraging cycle (Chart 25).
- Bank capital ratios have more than recovered, which should allow for loan growth and likely help prevent relapse of financial crisis within the banking industry (Chart 26).

Our value allocation has underperformed in the market downturn, given its more cyclical exposure. We believe it will perform better as global growth concerns fade.

Allocation to Global Dividend-Focused Stocks

A global dividend-focused allocation expands the opportunity set to invest in high-quality dividend-paying stocks, where in some cases companies have exhibited faster dividend growth, essentially opening up the opportunity to invest in firms outside the United States, including emerging markets. In addition, focusing on the combination of dividends and dividend growth has historically been a winning combination.
The reinvestment of dividends greatly enhances an investor’s return and is a large component of the dividend-focused strategy. Over time, the compounding of dividends drives the total return. As an investor’s investment holding period increases, dividends typically comprise a larger portion of return. As a reference point, from 1926 to 1959 dividends contributed more than 50% to total returns for the S&P 500®.

We believe the global dividend-focused allocation is positioned to take advantage of global opportunities and diversify across countries and sectors (Chart 27). A globally generated income stream is inherently more diverse than one from a single country or region. This can help to avoid concentration in terms of end markets, which may drive sales and revenues. A global dividend allocation may also allow an investor to invest in sectors perhaps underrepresented by a particular country.

**Allocation to Alternative Investments**

We also believe alternative asset classes should be considered for qualified investors because they may provide an effective risk management tool for portfolios. Our argument is that if alternative and traditional investments are put on even footing with regard to expected returns, then solely by virtue of the two investments being different, the risk of the overall portfolio is reduced without altering the portfolio’s expected return. The risks may not be less, but they are in some ways different, so we believe this diversification may help manage overall portfolio risk.

Every action (or inaction) involves risk, and we believe investors should think about risk when they consider alternative investments. However, our research suggests that adding carefully selected alternative investments to a diversified portfolio of traditional investments may reduce the overall risk (as defined by the volatility of returns) of that portfolio without affecting expected returns. We believe that alternative investments should be considered as a tool for managing portfolio risk, not for adding risk to increase returns, for qualified investors.

As an example of the possible value alternatives, in particular hedge funds, can bring to a portfolio in the current environment, look at the correlation between the S&P 500 and the HFRX™ Macro Index (Chart 28, page 18). Low correlation with stocks at times when they are falling would be a distinct positive in terms of reducing the downside. While at times these two very different assets move nearly in unison, the hedge funds do have exposure to other factors than solely stocks and also might adapt to the environment by changing exposures. In fact, the HFRX Macro Index had significantly outperformed the S&P 500 during previous downturns since the late-April 2013 market peak (Chart 29, page 18).

Given the current market environment, including a number of factors (such as low returns on cash and occasional spikes in macroeconomic concerns) that could continue to result in increased volatility, we believe alternative investments are worthy of consideration for qualified investors.⁴

---

⁴ For more details, see our October 2009 Investment Outlook, Alternative Medicine, and our August 2009 white paper The Science of Alternative Investments.
Allocation to PNC STAR

The PNC STAR strategy uses broad exchange-traded funds to apply momentum exposure to industries, size, and international factors in a systematic way. We believe adding a small allocation of the PNC STAR strategy to a portfolio may help increase return without increasing risk and, with small allocations, may help marginally reduce risk (Chart 30).

In backtests, PNC STAR has produced excess returns with a volatility level similar to the benchmark S&P 500, resulting in a higher Sharpe ratio. In addition, the analysis has shown that the strategy has handled periods of crisis better than the S&P 500 and was generally quicker to recover. While past performance is not indicative of future results, historically this model has produced outperformance of just under 0.40% per month. In addition, the drawdown analysis has shown that the strategy has handled periods of crisis better than the S&P 500 did and was generally quicker to recover.

Momentum performance has dipped since the financial crisis, but appears to be regaining some momentum (to turn a phrase). If momentum continues to work in the future as it has historically, the strategy may lead to excess returns that should help improve the tactical allocation portfolios.

Allocation to REITs

The strategic rationale for including REITs in the portfolio rests on expanding the opportunity set for income investors. The REIT mandate requires at least 90% of income to be distributed to shareholders in the form of dividends. Given the nature of the dividend model, we believe REITs fare better with investors not aiming for quick capital gains but for dividend income and modest price appreciation. Over a long investment holding period, REITs have tended to outperform the S&P 500 on a total-return basis (Chart 31, page 19). The total-return perspective is unique for REITs in
that it has historically kept pace with or exceeded the broader market, with the additional benefits of:

- modest correlation with stocks;
- less market price volatility; and
- higher current returns.

REITs provide steady current-income-producing dividend yields competitive with investment-grade bonds, with the potential for increases in dividend and share price.

REITs allow shareholders to invest in commercial real estate while remaining liquid and leaving the management to professionals. REITs historically have had lower correlations versus other stocks, providing diversification benefits. Given the complex nature of the interrelated economies and industry fundamentals, leaving the investment in real estate to the professionals and buying for the long term into strong companies is a standing argument for long-term investing versus market timing. We believe the asset class should bring some diversification benefits in spite of the correlation tightening with the S&P 500.

REITs are not so much interest-rate sensitive as dependent on economic growth. Dividend growth rates have outpaced inflation over the past decade (Chart 32).
As of market close, Wednesday, November 19, 2014:

### Asset Allocation Recommendations

- **Current Tactical**
  - Preservation: 15%
  - Conservative: 35%
  - Moderate: 50%
  - Balanced: 55%
  - Growth: 65%
  - Aggressive: 100%

### Equity Allocation

- **Capitalization: Baseline**
  - 83% Large-Cap
  - 4% REIT
  - 4% Small-Cap
  - 9% Mid-Cap

- **Style: Overweight Value within U.S. Large Cap**
  - 48% Growth
  - 52% Value

### Global Positioning: Baseline Plus Global Dividend Focus and Smart Beta

- 20% International
- 5% Smart Beta-PNC STAR
- 75% Domestic

### Fixed Income Allocation

- **Credit Positioning: Core, Leveraged Loans, Global, and Absolute-Return Oriented**
  - 70% Core
  - 10% Leveraged Loans
  - 10% Absolute-Return Oriented
  - 10% Global

For qualified investors, we recommend an allotment to alternative assets of 20% of a balanced allocation to complement the traditional allocation.

The PNC Financial Services Group, Inc. (“PNC”) provides investment and wealth management, fiduciary services, FDIC-insured banking products and services, and lending of funds through its subsidiary, PNC Bank, National Association (“PNC Bank”), which is a Member FDIC, and provides specific fiduciary and agency services through PNC Delaware Trust Company. This report is furnished for the use of PNC and its clients and does not constitute the provision of investment advice to any person. It is not prepared with respect to the specific investment objectives, financial situation, or particular needs of any specific person. Use of this report is dependent upon the judgment and analysis applied by duly authorized investment personnel who consider a client’s individual account circumstances. Persons reading this report should consult with their PNC account representative regarding the appropriateness of investing in any securities or adopting any investment strategies discussed or recommended in this report and should understand that statements regarding future prospects may not be realized. The information contained in this report was obtained from sources deemed reliable. Such information is not guaranteed as to its accuracy, timeliness, or completeness by PNC. The information contained in this report and the opinions expressed herein are subject to change without notice. Past performance is no guarantee of future results. Neither the information in this report nor any opinion expressed herein constitutes an offer to buy or sell, nor a recommendation to buy or sell, any security or financial instrument. Accounts managed by PNC and its affiliates may take positions from time to time in securities recommended and followed by PNC affiliates. PNC does not provide legal, tax, or accounting advice unless, with respect to tax advice, PNC Bank has entered into a written tax services agreement. PNC does not provide services in any jurisdiction in which it is not authorized to conduct business. PNC Bank is not registered as a municipal advisor under the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Act”). Investment management and related products and services provided to a “municipal entity” or “obligated person” regarding “proceeds of municipal securities” (as such terms are defined in the Act) will be provided by PNC Capital Advisors, LLC, a wholly owned subsidiary of PNC Bank and SEC-registered investment advisor. Securities are not bank deposits, nor are they backed or guaranteed by PNC or any of its affiliates, and are not issued by, insured by, guaranteed by, or obligations of the FDIC or the Federal Reserve Board. Securities involve investment risks, including possible loss of principal.

©2014 The PNC Financial Services Group, Inc. All rights reserved.