Market Update from PNC

January 7, 2016

Back to the Future: Global Market Unease

Global markets have had a tumultuous start thus far in the first few trading days of 2016, with a number of factors affecting market sentiment, triggering global equity markets to sell off. In the United States, the S&P 500® had its sixth-worst first trading day of the new year performance on Monday since 1928 (-1.53%). History has shown that reversion does tend to occur when markets have gotten off to a rough start, while we note the turnaround is typically not a quick occurrence (Table 1).

While the calendar may have changed to 2016, in this Market Update we address some of the widespread concerns markets are digesting, many of which have been with us since 2015, including:

- China – concerns over its growth, stock market, and currency;
- Oil prices – with West Texas Intermediate (WTI) and Brent Crude trading at more than 11-year lows;
- U.S. economy and the Federal Reserve (Fed) – manufacturing sector softness while services expand; and
- Geopolitical tensions – from the terrorist attacks in Paris in the fall to the refugee crisis, and most recently Saudi Arabia breaking diplomatic ties to Iran and North Korea claiming a successful hydrogen bomb test.

Table 1
S&P 500 Performance Following -1.5% Loss on First Trading Day of the Year
(5 Observations)

	+65 Days	+125 Days	+250 Days
Average	-3.8%	-3.7%	+8.1%
Median	-3.4%	-3.6%	+11.4%
% Positive	40.0%	40.0%	60.0%

Source: Strategas, PNC

China Woes Here to Stay

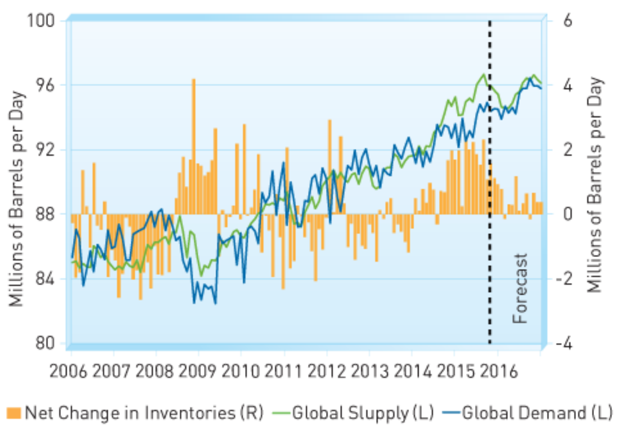
China showed on our radar screen throughout 2015, and we sought to reconcile the concerns over slowing economic growth with other macro factors and, most importantly, with China's stock market. Most market moving as of late has been the continued downward trend in PMI data out of China, supporting our view that the economy is weaker than headline GDP would suggest. PMI data for China are measured both by private- and state-owned enterprises providing two look-throughs. China Caixin Flash Manufacturing PMI trended below 50 for most of 2015, which signals contractionary territory versus expansionary, and is moving lower. For December, the Caixin Manufacturing PMI was 48.2, below the 48.6 in November. Official Manufacturing PMI for China was just a bit higher at 49.7 versus 49.6 in November. The PNC Economics team views PMI data as consistent with 6.5-7.0% year-over-year GDP growth. We note the trajectory of the PMI, which shows a declining trend beginning in 2014, diverging from the stock market which began its upward climb. We believe this is an important note, as unlike other countries, the linkage between China's economy and its stock market is much more limited.

In an attempt to squelch the exodus from the stock market, beginning in summer 2015 policy makers in China began instituting a series of measures in hopes of preempting a sharp market correction. Fundamentally, the glaring problem, in our view, is that these actions may have actually managed to send the exact opposite signal of the calm effect intended. China investors have long been skeptical of the stock market, preferring to invest in housing or bank deposits; the wild ride of the market combined with the recent government intervention, which we expect will continue, are likely not easing these concerns. For example, Chinese policy makers implemented so-called "circuit-breakers" that close the stock market if it falls precipitously. The unintended consequence is that volatility actually increases when markets get near these limits, with traders making a mad dash to sell before it is too late. With 2016 having only just begun, China's CSI 300 has been closed twice. Last night it traded for less than 30 minutes before the policy close at a decline of 7%. Interestingly, just this morning China announced it was suspending these circuit breakers, just days after their introduction. This is further evidence, in our view, of the continued untested intervention that is possible and likely to occur in the near term.

Financial market sentiment has increasingly been spooked by the yuan trading lower versus the dollar. As a reminder, we note that the yuan had appreciated 13% on average versus its trading partners from June 2014 and September 2015; given the weaker economic growth out of China, lower exports, and the fall in interest rates led by rate action from the People's Bank of China (PBOC), it seems to us that the yuan's decline should be less of a surprise.

So why the negativity surrounding the PBOC's depreciation moves? We noted back in July 2015 the likelihood that China would favor depreciating the yuan given the appreciation. In addition, this past fall the PBOC has resumed allowing the currency to decline against the dollar after the November 2015 decision by the International Monetary Fund to add the yuan to the special drawing rights (SDR) basket of reserve currencies. The PBOC is typically fairly stringent on its currency targets, and markets therefore are interpreting larger-than-normal price fix moves as indicating that slowing growth is indeed a concern for policy makers. Earlier this week, China lowered the yuan peg below 6.5 for the first time in almost five years and is currently on its seventh straight session of lower targets. Tolerance for a weaker yuan by China policy makers, despite an increased risk of capital exodus, further spooks global markets about growth. The PNC Economics team expects trend depreciation for the yuan in 2016-17.

Chart 1
Global Supply and Demand
Monthly, 1/06-10/15
Forecast through 12/16/15



Source: U.S. Energy Information Administration, PNC

Consequently, with China and other global factors at play, the dollar has strengthened further. The US Trade Weighted Dollar advanced over 10.5% in 2015. Going forward, PNC forecasts dollar appreciation but at a slower rate in 2016 and 2017, with the depreciation of China's currency as well as other commodity-heavy-producing country currencies easing relative to 2015.

For further details see our July 2015 *Market Update* on China, and our April 2015 *Investment Outlook, China: Slowing Not Breaking*.

Oil Lower for Longer

Oil prices resumed their fall as global supply glut continues (Chart 1). In December 2015, OPEC maintained its production guidance at near-record levels of 31.5 million barrels per day. Other changes in supply dynamics include the lifting of U.S. crude oil exports and a warm start to the winter in much of the country. Further, inventory data in the United States continue to show record supply. Reports this week that crude supplies at the delivery point for WTI in Cushing, Oklahoma, rose to an all-time high sent futures lower still.

Markets were hopeful for oil price stabilization in 2016, and we think the even further fall in prices is affirmation of oversupply for the foreseeable future. PNC economists point to the marked drop in U.S. energy exploration, as U.S. well rig counts dropped by 65% in December 2015 versus 2014, suggesting oil prices are likely to stabilize in 2016 and 2017.

Currently, markets are interpreting the sharp decline in energy prices as too much of a good thing. While there is little doubt that lower energy prices are a net positive for the major economies of the world, including the United States, Europe, Japan, and China, some negative impacts are certainly being felt in the shorter term. For example, U.S. high-yield "junk" bonds have suffered given their sizable exposure to energy companies, and industrial production in the United States has been hurt by the decline in drilling activity. The offset is that as net consumers of energy, the benefits to consumers and non-energy-related corporations are strong. We think it is also worth noting that recessions have historically never started with low oil prices; rather, high oil prices are to be feared.

For further discussion on oil prices as one of our themes, please see our January 2016 *Investment Outlook, Themes for the End of an Era: 2016 Outlook Part II*.

U.S. Economy Soft But Resilient

Softness in recent U.S. economic data has markets wondering what the outlook will be. Notably, U.S. manufacturing PMI data have been on a weakening trend. In November 2015, the Institute for Supply Management™ (ISM) Manufacturing PMI fell below 50, indicating contraction to 48.6 from 50.1 in October, with slower global demand and drops in commodity prices affecting the gauge, in addition to a stronger dollar. In December, activity weakened further, and the index contracted to 48.2. Offsetting these global macro factors is the continued strength in domestic demand, aided by the consumer. We note that the ISM Non-Manufacturing PMI has held up much better, and consumer sentiment surveys indicate the consumer remains positive. The strength in the U.S. employment picture and low gasoline and energy prices, coupled with a warm December, seem to be benefiting U.S. consumers. Overall, PNC expects GDP growth of 2.5% in 2016.

With the Fed returning to normalization in terms of monetary policy by raising interest rates in December 2015, market sentiment is now focused on the future path of interest rates. We note that the minutes from the December Federal Open Market Committee (FOMC) meeting support our view that subsequent rate hikes will be gradual. The PNC Economics team is forecasting three additional raises in 2016, at 25 basis points each (Table 2). The Fed's path may include adding some volatility as the markets adjust, since the FOMC forecasts four hikes while we expect three and the market is currently pricing in two. To be clear, this path will depend on the performance of the economy and inflation, so it is almost certain to change throughout the year.

Table 2
Federal Funds Target Rate

	12/16	12/17	12/18	Longer Run
FOMC Median Forecast (12/16/15)	1.40%	2.40%	3.30%	3.50%
PNC December Baseline Forecast	1.00	1.85	2.50	2.75
Federal Funds Futures Market (12/16/15)	0.82	1.35	1.75	

Source: FOMC, CME Group, PNC

Geopolitical Tensions

With the world already on high alert after the fall attacks in Paris, unrest in the global geopolitical realm has markets once again on alert. In another escalation of tensions in the Middle East, relations between

Saudi Arabia and Iran have deteriorated further, with Saudi Arabia cutting off diplomatic relations with Iran. This breakdown in communication will be at the forefront of U.S. concerns, alongside the crisis in Syria, and we think certainly will be a priority topic as we head into a presidential election year.

In addition this week, in a region that has been mostly quiet as of late, reports by the North Korean government suggest that North Korea successfully detonated a hydrogen bomb and triggered an earthquake of 5.1 magnitude. It is important to note the global skepticism surrounding the claims, notably from the United States. Regardless, the test claim reaffirmed the tensions between North and South Korea.

Never a pleasant topic, but unfortunately one to address in this day and age, we included the possibility of unforeseen geopolitical events as a theme in our January outlook for 2016. Our research shows that typically events of this nature not surprisingly have an immediate negative reaction in the related market where the terror occurred, and in many cases spilling over into other financial markets beyond its borders. History does also indicate that financial markets tend to recover over time, while the time period may vary (Table 3). It is our view that geopolitical tensions and stock market volatility are likely to remain heightened as we move through 2016. For further discussion, please see our January 2016 *Investment Outlook, Themes for the End of an Era: 2016 Outlook Part II*.

Table 3
Average Abnormal Stock Returns and Number of Days to Rebound to Previous Levels
Dow Jones Industrial Average

Event	Date	1 Day	6 Days	11 Days	Days to Recover
Lusitania Torpedoed	5/7/1915	-5.3%	-16.1%	-12.3%	21
Invasion of France	5/12/1940	-4.9	-16.2	-21.0	795
Pearl Harbor Attack	12/7/1941	-2.8	-3.1	-6.4	232
N. Korea Attacks S. Korea	6/25/1950	-4.8	-8.3	-11.0	57
Iraq Invades Kuwait	8/2/1990	-1.4	-5.8	-9.4	134
World Trade Center (WTC) Bombing	2/26/1993	-0.1	-0.2	-0.6	1
Oklahoma City Bombing	4/19/1995	0.5	1.6	2.2	1
WTC and Pentagon Attacks	9/11/2001	-7.1	-10.6	-7.9	40

Source: Chen & Siems, PNC

Conclusion

It is our view that stock market volatility will be elevated in the near term as the market continues to digest economic data, outlooks, and unforeseen events. What is not predictable is the timing of market declines; what is known is that, over the long term, stocks have tended to produce significant positive real returns after inflation. We remain optimistic regarding the U.S. economy and corporate earnings this year despite the financial market volatility to begin the year. As we showed at the start of this report (Table 1, page 1), a difficult start to a calendar year does not automatically doom us to a poor outcome. Please speak to your PNC Investment Advisor for further discussion regarding the appropriateness of your asset allocation to meet your goals and risk tolerance. We recommend systematic rebalancing to help control risk, and for qualified investors, it may make sense to consider the possible addition of alternative investments in an asset allocation to help control volatility. Please see our July 2015 *Investment Outlook, A New Simple Rule* for more on these topics.

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