March 2018

# Hawthorn Global Market Snapshot

## Key Market/Economic Observations

### United States

*Market Volatility Finally Returns as Investors Closely Eye Interest Rates and Inflation*

- After an unusually strong start to 2018, the S&P 500® experienced its fastest 10% decline from an all-time high. The S&P 500 returned over 7.5% through late January, but sentiment quickly turned bearish. The speed of the decline, coupled with investor complacency, made the correction feel even more jarring.
- The S&P 500 was down 10.2% from January 26 to February 8, briefly touching formal correction levels (that is, a market reversal of 10% from peak to trough). This was a "normal" correction in terms of magnitude, as 10% drawdowns typically occur once a year.
- What triggered the market correction and subsequent spike in volatility? It can be difficult to point to one factor, but we think a shift in market psychology drove the sharp market movements. Investors realized that interest rates and inflation would not remain low forever. We believe markets will ultimately digest higher interest rates and inflation expectations, but the current pace of yield movements should not be expected into the future.
- Although U.S. equity markets remain notably more volatile when compared with the unusual calm of 2017, markets seem to have refocused on the solid fundamental backdrop of synchronized global growth and stronger corporate earnings. The S&P 500 showed technical support, bouncing off its 200-day moving average and recovering over 5% of the drawdown.
- More than 75% of S&P 500 companies have reported fourth-quarter earnings through mid-February. The blended earnings growth rate sits at 15.2%, outpacing the consensus estimate of 11.0%. This robust earnings growth was driven in large part by improvement in top-line sales; 78% of all reporting companies beat their sales estimates. Although multiples will need to remain relatively high to achieve solid equity market returns in 2018, the improving earnings backdrop will help relieve some of this pressure.
- Economic data still indicate to us a healthy economic backdrop.
  - For January, the ISM® Manufacturing Purchasing Managers' Index (PMI®), a leading economic indicator and key component of our business cycle analysis, continued to show expansionary economic activity with an index reading of 59.1. We view stability at these levels as a positive and consistent with our view that the business cycle is in a late-cycle acceleration.
  - Recent inflation results have probably assured a March rate hike and put upward pressure on interest rates across the curve. Debate now turns to whether the Federal Reserve (Fed) will revise guidance and signal four rate hikes in 2018 versus current median, and PNC, expectations of three.

### Europe

*Yields Rising with Increased Volatility in Equities; Bank of England Priming for Rate Hikes*

- European economic momentum continues to accelerate. Despite a modest pullback in the

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IHS Markit Eurozone Manufacturing PMI to 59.6, the Composite PMI increased to 58.8. Other indicators confirm these positive trends, with the unemployment rate (now at 8.7%) falling to levels not seen since 2009.[1]

- In light of this positive momentum, the European Commission raised its Eurozone GDP forecasts for this year and next. The growth forecast for 2018 is now 2.3% (up from 2.1%) and for 2019 moved to 2.0% (up from 1.9%). But the European Commission warned financial market volatility poses a threat to its outlook, arguing asset prices are vulnerable given current valuations and risks could expose or exacerbate the debt overhang of many member countries.
- Like in the United States, volatility spiked over the past month. The Euro Stoxx 50 Volatility Index (VSTOXX, the European counterpart to the VIX[2]) nearly tripled in early February. The European spike appears to be in response to U.S. market volatility rather than any underlying shift in fundamentals. Since December, European bond yields have trended higher. For example, the German 10-year bund yield nearly doubled since the start of the year, though further increases have since slowed. Though rising inflation expectations may have played a role, it appears expectations revolving around central bank policy were the bigger culprit. While rate hikes at the European Central Bank (ECB) remain distant, the ECB is withdrawing stimulus via a reduction in its quantitative easing bond purchases.
- The political backdrop remains an issue. So far, both German and U.K. markets appear to be weathering their political difficulties, but a flare up in political uncertainty could spoil markets.
- At the last meeting, the Bank of England strongly suggested a rate increase was forthcoming, and likely sooner than markets were expecting. For the May 2018 meeting, the market-implied odds of a 25-basis-point rate hike increased substantially from just 36% in mid-January to 64.4% on February 15, reinforcing the challenge global central banks now face in terms of balancing the strength and momentum of global growth with the need to tighten monetary policy.

## Japan

*The Inflation Comment Heard Round the World*

- We believe investors continue to misinterpret both the Bank of Japan's (BOJ's) intent to slow its monetary stimulus programs and Japanese inflation expectations. The BOJ's stimulus includes a ceiling on interest rates, effectively targeting a 0% yield on the 10-year Japanese Government Bond. Furthermore, the December reading for the Consumer Price Index (CPI) was a modest 1.0%, while core CPI (excluding fresh food and energy) was only 0.3%. Both readings are still well below the BOJ's 2% inflation target; therefore we think the BOJ will continue to champion extreme monetary policy accommodation.
- As the U.S. Dollar Index hit a new three-year low in mid-February, the Japanese yen strengthened against both the dollar and the euro, reaching its highest level since late 2016. While dollar weakness supported yen strength, strong Japanese economic data in January also contributed.
- In spite of strong economic data, a persistently "too strong" yen could begin to pressure economic growth. We believe the BOJ will maintain its monetary stimulus should the yen continue to appreciate alongside favorable economic data.
- As expected, Governor Haruhiko Kuroda was officially nominated for a second term at the BOJ. If appointed, he will be the first governor to serve two terms since 1954,

[1] Unemployment started rising in the Eurozone in 2008 but didn't peak until 2013. The last time the unemployment rate was at 8.7% was 2009.

[2] The CBOE Volatility Index® is a measure of volatility expectations in the S&P 500 that is implied by current pricing in the options market.

potentially signaling to investors that the BOJ's current trajectory and stance on monetary policy will remain intact.

- While Japan was among the best performing regions over the last 12 months, the Tokyo Stock Price Index (TOPIX) declined over 10% during the volatility spike in early February and has yet to recover from those losses. Consensus expectations are for flat year-over-year earnings growth in 2018, largely a function of difficult earnings comparisons from 2017. Japanese corporate fundamentals remain strong, and we believe monetary policy will remain more supportive than some market participants seem to be anticipating.

## Emerging Markets

*Healthy Economic Data from China Confirm Currency Strength*

- Chinese economic data posted solid results to start the year. Caixin PMI data for January, which focuses on small to mid-sized businesses, came in better than expected and reached the highest level in seven years.
- The last time the yuan was this strong relative to the dollar (August 2015), the People's Bank of China (PBOC) caught markets off guard by significantly depreciating the currency. We do not view this as a key risk today, as the PBOC has maintained language that its monetary policy is "prudent and neutral."
- On Sunday, February 25, China announced it would seek to end term limits for the head of state, effectively allowing President Xi Jinping to stay in power indefinitely. President Xi would be the first president to do so since the Mao Zedong era. While we believe Mr. Xi will continue to focus on corporate reform, improving transparency and accountability for investors, the move also heightens potential geopolitical risks.
- As an example of ongoing reform efforts, the founder of Chinese insurance conglomerate Anbang was charged with "economic crimes" for fraud and embezzlement. The actions taken by the party are a stark reminder that while Chinese equities have performed extremely well over the last 12 months, there is further risk investing in a socialist market economy.
- As we have said, relative valuation differentials lead us to believe that emerging market (EM) equities have greater long-term return potential than many developed markets, but we are mindful of a number of lingering risks (the lagged effect of China slowing, commodity price interdependence, and currency movements, among others).
- In the very short term, our view is that continued outperformance of EM equities rests largely on the trajectory of the dollar. If the dollar begins to strengthen, it will become a near-term headwind to EM outperformance.

## Energy

*Oil Price Advances Slow; Energy Sector Leads S&P 500 Earnings*

- The outlook for oil prices remains firmly hinged on the pace and trajectory of U.S. production. In mid-February, the EIA, the IEA, and OPEC[3] each raised their oil production growth estimates and subsequently lowered their price forecasts. As a result, the consensus view is that OPEC may once again extend its production cuts, especially in light of Saudi Arabia's decision to lower its production in March 2018.
- PNC Economics believes oil prices will hover around $60 per barrel for the remainder of the year. This should support continued Energy sector earnings growth, although sector performance continues to lag the broader equity market.
- West Texas Intermediate (WTI) crude oil prices responded to the spike in U.S. stock market volatility by falling $5 in a week. The price per barrel of WTI recovered slightly, and after briefly falling below its

[3] U.S. Energy Information Administration (EIA), International Energy Agency (IEA), Organization of the Petroleum Exporting Countries (OPEC).

50-day moving average, is now trading at that threshold (prices remain well above both the 100- and 200-day moving averages).

- The number of active rigs in the United States continues to rise, with growth accelerating more recently. Since the start of the year, 50 rigs have been brought online, with most of those made active within the last two weeks.
- Finally, we will be paying close attention to oil prices due to their strong correlation with inflation breakeven levels. A dramatic move lower in oil, which we are not expecting, would likely lead to lower bond yields.

# Strategy Views

## What Happens When the Economy Gets Stimulus It Doesn't Need?

As investors consider recently enacted fiscal stimulus at this later stage of the business cycle, initial enthusiasm in the short run is also being accompanied by a number of longer-term concerns and considerations. According to BCA Research, the tax cuts and spending deal may add about 0.8% to GDP in 2018 and another 1.3% in 2019.[4] However, many questions remain. In this section we attempt to answer three that we think are critically important for investors.

- What is the size of the fiscal package?
- What are the interest rate implications of an increase in the budget deficit?
- How might a stimulus package of this size affect an economy that is already quite healthy by most measures?

### *Size of the Stimulus*

Analysis of the aggregate size of recently enacted and proposed fiscal measures can help one appreciate the potential impact of these policies. For context, December 2017 brought the passage of the Tax Cuts and Jobs Act of 2017, which should provide net tax cuts for individuals, small businesses, and corporations of over $200 billion in 2018.[5] On February 8, 2018, Congress passed the Bipartisan Budget Act of 2018, which is expected to increase federal borrowing by approximately $150 billion per year in both 2018 and 2019. Analysts forecast that the deficit will rise to 5.5% of GDP in 2019, up from 3.3% last year. These estimates include the impact of the tax cuts, disaster relief spending ($45 billion), military spending ($165 billion), and nondefense discretionary items ($131 billion), spread over the next two years. Any additional infrastructure spending would add to these figures.[6]

### *Increasing the Deficit Means Increasing the Supply of Treasuries*

In order to fund the expanding deficit, the government will likely need to increase the issuance of Treasury bonds. In a market that has already experienced a precipitous rise in interest rates this year, many investors are concerned that an increase in the supply of Treasuries could push interest rates even higher, potentially jeopardizing economic growth and market valuations.

Our view is the net effect of additional Treasury supply will be higher interest rates in 2018, but the impact may not be as dramatic as some fear. In general, we view the extra issuance as having the same outcome as the shrinkage of the Fed's balance sheet: both will increase the supply of Treasuries that must be absorbed by investors. In recent years, global quantitative easing programs exceeded all net government issuance for the major economies. In fact, the amount of government bonds available for private sector purchase was negative in 2015, 2016, and 2017. The supply balance should turn positive in 2018 and 2019 as central bank balance sheet tapering goes into effect. Government bonds will now have to compete for private sector investment dollars, perhaps necessitating an increase in real yields.

Therefore, more issuance, everything else equal, should increase the term premium[7], which along with inflation and growth expectations is a

[4] BCA Research. US Bond Strategy. "The Next Recession: Later but Deeper," February 23, 2018.

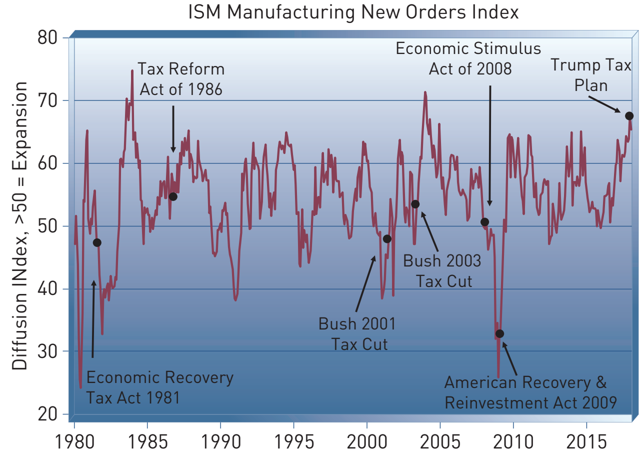
[5] Strategas Research Partners.

[6] BCA Research. US Bond Strategy. "The Two-Stage Bear Market in Bonds," February 20, 2018.

[7] The term premium is the additional yield investors often require in order to commit capital to bonds with longer maturities, versus simply holding a series of shorter maturity bonds.

component of Treasury yields. Economists estimate that for 2018 the extra issuance will be similar to the amount by which the Fed will shrink its balance sheet. Previously, estimates indicated that balance sheet shrinkage alone would increase the term premium this year by about five to seven basis points. Therefore, additional Treasury issuance to fund deficit spending should increase yields by a similar amount. This outcome, although not inconsequential, is consistent with our view that the bias for interest rates is higher, but the majority of the upward move in Treasury yields may actually be behind us this cycle. In fact, we think it is possible that interest rates move lower in the very short term. The bond market has already adjusted quite a bit this year, with expectations largely converging with Fed forecasts. Also, according to the Bank of America Merrill Lynch Global Fund Manager Survey, investors have reduced bond allocations to the lowest level in the 20-year history of the survey. Market expectations and current investor positioning increase the likelihood that we see a retracement in interest rates before they resume their ascent. An understanding of the interest rate backdrop is important for investors who fear that rapidly rising rates (in part driven by greater Treasury issuance) will have a materially negative impact on fixed income returns and equity market valuations in 2018.

Chart 1
**Fiscal Stimulus and the Business Cycle**




*Source: Cornerstone Macro, PNC*

### *Late Cycle Stimulus and Inflation Fears*

What is unusual about the current expansionary fiscal policy, other than the fact that an all-Republican Congress is passing a deficit-increasing spending package, is that it is occurring at a time when the economy really doesn't need additional stimulus. It is extremely unusual to get a significant boost in fiscal stimulus when key economic indicators are so positive (Chart 1). Specifically, this chart examines the ISM New Order Series[8], for which the December reading was in the 98th percentile of all its readings and is at the highest levels since 2004.

For risk assets, the combination of stronger growth and a slow-moving Fed was a recipe for success in 2017. The concern in 2018, however, is that the timing of fiscal stimulus could be inflationary, therefore changing that dynamic. Simply said, giving the economy a jolt of stimulus when it doesn't necessarily need it could aggravate the low inflation narrative that has underpinned the market for so long. Data have already indicated some budding signs of inflation, and an earnest increase in price levels may force the Fed to tighten policy in a more aggressive manner. If inflation advances beyond the Fed's 2.0% target, the central bank will have less flexibility to provide the market with support if and when negative shocks occur. In large part, we believe this is what spooked investors in late January. We think inflation is on the rise, and at this very low level of unemployment, will likely move higher throughout the year as the economy continues to expand. However, we believe the move higher should be orderly in nature, allowing the Fed to follow its currently projected policy path. The January employment report showed that wages grew at their fastest year-over-year pace in eight years, and that triggered further inflation concerns. The good news is other measures of wage growth, such as unit labor costs, are not indicating runaway pressure, and the Fed's preferred measure of inflation (Personal Consumption Expenditures Index)

[8] The ISM Manufacturing index is based on data compiled from a nationwide survey of purchasing and supply management executives. Survey data include *new orders*, production, employment, and other series that often serve as a good indication of the future growth trajectory of the economy.

is still below 2.0%. Rising levels of inflation may have been an important catalyst for a sustained increase in market volatility, but if our view proves accurate, the Fed will not be forced to adopt a policy path that significantly counteracts newly passed fiscal stimulus. Although we believe rising inflation pressure is ultimately a primary risk to the economic cycle, it is normal and expected in the later innings of a business cycle. However, if inflation is kept in check, current fiscal policy may lengthen the duration of the ongoing economic expansion.

Ultimately, we believe interest rates and inflation are likely to move higher, but we expect they will move in a slower and more orderly manner. We think fears of rapidly rising rates and inflation should be less of a concern for investors, and 2018 can be another positive year for equities. Rising interest rates and inflation may increase the likelihood of heightened market volatility in the coming quarters, but we see recent market moves as a healthy return of risk (at least relative to the record low volatility experienced in 2017) rather than as a harbinger of a sustained market downturn.

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## Hawthorn Asset Allocation Playbook

As of 3/1/2018

| Asset Class | Sub Asset Class | Favorability - | | | Neutral | | | + | Points of View |
|---|---|---|---|---|---|---|---|---|---|
| **Equities** | | | | | ● | | | | |
| **U.S.** | Large Cap | | | | | ● | | | Relative valuation, and vulnerability to what we believe will be an increase in overall market volatility in 2018 cause us to narrowly favor large over small. Smaller cap companies could benefit from positive tax reform-related forward guidance; however, valuations remain quite expensive at 25x on a forward earnings basis. |
| | Mid Cap | | | | ● | | | | |
| | Small Cap | | | | ● | | | | |
| **Non-U.S.** | Intl. Large/Mid Cap | | | | | ● | | | Valuations appear relatively more attractive versus domestic equities, potentially creating attractive opportunities in many international markets. Still largely accommodative monetary policy by global central banks and strong earnings momentum should also provide additional support for international equities. A weaker dollar will likely be less of a tailwind, however. |
| | Intl. Small Cap | | | | ● | | | | |
| | Emerging Markets | | | ● | | | | | Although we like emerging markets for the long term given current valuations, we believe the rally to be overextended. The shorter-term bear case for emerging market equities rests mainly on China, which has a significant impact on performance with a weight of over 25% of the emerging markets index. |
| **Fixed Income** | | | | ● | | | | | |
| **U.S.** | Short Muni Fixed Income | | | ● | | | | | With the likelihood of longer-term rates remaining well below long-run averages, we favor intermediate-duration fixed income. While mindful of the numerous crosscurrents affecting interest rate movements, we will not attempt to time our duration positioning, even though we think that rates may drift higher in 2018. |
| | Core Muni Fixed Income | | | | ● | | | | |
| | U.S. High Yield | | | ● | | | | | The credit cycle is aging, and valuations should become an increasing headwind for most below-investment-grade issuers. Leveraged loans remain more attractive than high yield given their seniority in the capital structure, thus potentially providing more protection from higher interest rates. |
| | U.S. Leveraged Loans | | | | ● | | | | |
| | U.S. TIPS | | | | ● | | | | Although inflation looks poised to rise later in 2018, the outlook is far from certain. We prefer to hedge inflation over the long term via our equity exposure. |
| **Non-U.S.** | Global Bond | | | | ● | | | | |
| | Unconstrained Bond | | | | | | ● | | Flexibility provides for diversification if rates should steadily rise (a primary risk to fixed income in this market). |
| | Emerging Market Bond | | | ● | | | | | |
| **Alternatives** | | | | | | ● | | | |
| **Private** | Private Real Estate | | | | | ● | | | Key drivers include a still relatively constrained supply backdrop, modest leverage levels, and the fact that capital flows into the asset class are becoming increasingly global (that is, investor demand is quite robust). |
| | Private Debt | | | | | ● | | | Middle market lending in the corporate sector is still quite constrained, continuing to create opportunities for private debt investors. We continue to see investors rewarded with a substantial illiquidity premium for taking on unrated, smaller-sized loans. |
| | Private Equity | | | | | | ● | | Opportunity in new/less efficient markets, and a more diverse investable opportunity set, for example, via secondaries and "co-investment" options. |
| **Hedge Funds** | Equity Long/Short | | | | | ● | | | A transition from a primarily macro-driven market environment to a more fundamentally driven one will be positive for these alpha generating strategies. Central banks now appear more committed to a steady normalization of interest rates than they have been in the past. However, should the market move steadily higher with little volatiliy, these allocations will likely underperform |
| | Event Driven | | | | | ● | | | |
| | Relative Value | | | | | ● | | | |
| | Directional | | | | | ● | | | |
| **Cash** | | | | | ● | | | | |

| Tactical Allocations | | | | | | ● | | | |
|---|---|---|---|---|---|---|---|---|---|
| Tactical | Master Limited Partnerships | | | | | ● | | | While sentiment has been poor through much of 2017, we believe management teams' commitment to less equity issuance (less dilution) and stronger coverage ratios could spur investor interest given currently depressed valuations and underweight energy positioning among equity portfolio managers. |
| | Infrastructure | | | | | ● | | | Defesnive qualities and income potential that we like in this market. |
| | Currency Hedged Europe | | | | ● | | | | Stabilizing economic conditions, improving earnings growth, relatively attractive valuations, and a still-supportive central bank put European equities in a good position heading into 2018 . |
| | Currency Hedged Japan | | | | | ● | | | Valuations are attractive, earnings growth is strong, consumer confidence is high, and technically the chart of the Nikkei 225 shows a long-term structural breakout after recent strength. |
| | U.S. Banks | | | | | | ● | | We think valuations, the regulatory backdrop, and the continuation of this business cycle are compelling reasons to tilt toward U.S. banks within value allocations. |
| | Structured Note (Drawdown) | | | | | ● | | | Ability to earn a coupon while waiting for a more attractive entry point into equities can be an attractive strategy, especially versus cash. |