Global Market Snapshot

Key Market/Economic Observations

United States

Headlines Overshadow Fundamentals

- Escalating trade tensions and the Facebook-led selloff in technology, among myriad other headlines, placed downward pressure on markets in March. Despite tailwinds from earnings growth and generally solid economic data, markets had difficulty digesting the news flow.
- In our view, it has become clear that President Trump's intended trade target is China, but we continue to believe that the finalized trade legislation will be less disruptive than many market participants fear. Until then (in about 45 days), markets will react, both positively and negatively, to the day's headlines.
- The widespread steel and aluminum tariff exemptions, detailed in the administration's March 22 memo, largely declaw the original proposal by excluding most of the regions responsible for U.S. metal imports. Foreign retaliation against the metal tariffs will probably be commensurately smaller, and we think the final decision regarding China will reflect similar pragmatism.
- While the Federal Reserve's (Fed's) decision to raise interest rates by 25 basis points at the March Federal Open Market Committee meeting was expected, there are a number of additional takeaways worth considering.
  - Overall, the Fed still seems guarded against the idea that the economy has shifted into a meaningfully higher gear.
  - Fixed-income markets are not pricing in the Fed's forecasted rate hikes past 2018 (some market adjustment there could be necessary).
  - It is interesting to see the Fed's inflation forecast above its target in 2019 and 2020. This makes us think that when inflation eventually hits 2%, the Fed might not get too excited, given inflation has run so far below 2% for a number of years.
  - The net result is that we believe the 10-year Treasury yield will rise as 2018 progresses; however, we believe trading will be choppy, and the speed at which rates increase will be measured enough to avoid lasting disruptions in the economy or financial markets. We think equity market volatility is still likely as investors adjust to the shifting rate regime.
- April brings our first look at 2018 earnings, with the first-quarter reporting season commencing mid-month. For full-year 2018, S&P 500 earnings are forecast to grow more than 18.0%, with the largest contributions by Technology and Financials.
- Earnings growth is certainly a tailwind, in our view; however, equity market valuations are still an area of concern. Amid the presumption that interest rates and inflation are moving higher, and acknowledging the unknowable outcomes of numerous policy variables, what will investors pay for earnings? Even if 2018 earnings projections are realized, multiples will need to remain elevated to generate

historically average equity returns. Further, any degradation in historically elevated profit margins poses a risk to current earnings forecasts.

- For now we remain positive on equity markets, and believe some of the risks currently reflected in asset prices will ease. We think that as this occurs stocks can continue to advance. As for the near term, we take comfort in the following.
  - The S&P 500® is again showing technical resilience at the 200-day moving average.
  - The ratio of put options to call options (at a 2-year high) indicates sentiment may have finally shifted to a more cautious tone. This is usually a precondition to finding a near-term bottom.
  - High-yield credit spreads have not widened dramatically, so fixed-income markets are not signaling a material deterioration in fundamentals.
  - Some softness in U.S. economic data is indicating a temporary downshift in GDP growth in the first quarter. This has become a seasonal trend the past few years, and we believe growth will again accelerate throughout the rest of 2018.

Europe

Central Banks Move toward Tightening, While Politics Stay in Focus

- The final estimate for fourth-quarter 2017 Eurozone GDP came in at 2.7% year over year. Given that PMIs across the continent remain elevated (the Eurozone Composite PMI slipped only to a still-impressive 55.3 in March), it is likely these positive growth trends won't continue into the first quarter.
- Markets in Europe quickly sold off on the news of U.S. steel and aluminum tariffs; but they recovered as the news was digested. The European Union came forward with its retaliation plan, noting its intent to proportionately hit a range of U.S. goods. Only three weeks later, the Trump administration reversed course, granting the European Union, along with other allies, an exemption, though the White House demanded they negotiate "satisfactory alternative means" (which many interpreted as trade quotas). Regardless of what form the trade restrictions take, we believe the aggregate economic fallout will be small (Eurozone steel and aluminum accounts for less than 2% of total exports to the United States), though specific sectors and industries could be hit harder.
- Inflation remains a point of concern for the continent, as no major E.U. economy is hitting the European Central Bank's (ECB) goal of 2%. For the Eurozone, CPI growth dipped to just 1.1% year over year; individual countries posted similarly weak numbers. This low inflation makes it more difficult for the ECB to pull back its quantitative easing (QE) programs and, eventually, raise policy rates.
- There was some change in policy forecasts at the ECB's March policy meeting. The ECB dropped the pledge to buy more bonds if needed; however, ECB President Draghi asserted he would need to see CPI sustainably nearing the bank's goal of 2% before ending the QE program. PNC Economics expects the ECB to continue to taper monthly asset purchases through March 2019, with no move to raise rates until September 2019.
- While the continent stressed over cooling inflation, the Bank of England (BoE) was likely relieved as domestic price pressures eased. CPI fell more than expected from 3.0% to 2.7%. Inflation should continue to trend downward while growth remains steady, affording the BoE the opportunity to slowly raise policy rates over the coming year.
- Politics were a focus last month; both German and Italian parliaments dealt with coalition building. German Chancellor Angela Merkel formed her fourth government, while Italy's early March election led to a hung parliament. The end to nearly six months of parliamentary deadlock in Germany was greeted with relief, and financial markets appear used to political instability in Italy.

Japan

Bank of Japan (BOJ) Likely to Keep Policy Steady Even as Data Improve

- Economic data were mixed last month. Both industrial production and retail sales came in below expectations, while PMI leading indicators remained expansionary.
- In spite of encouraging inflation data, we believe the BOJ has no intention of changing monetary policy in the near term. The Abe administration still intends to increase the consumption tax in 2019; spring wage negotiations are underway; and given yen strength in recent months, it would be difficult for the BOJ to justify an abrupt change in policy as financial conditions tighten.
- While Japan was among the best performing regions for equities in 2017, equity market performance has significantly cooled in 2018. In local currency the Nikkei is down nearly 10% year to date; however, in dollar terms the index is about flat, given the appreciation of the yen versus the dollar.
- We continue to view Japan as a positive cyclical story. Our view is that earnings will continue to grow at a robust pace, monetary policy will remain accommodative compared with other global central banks, and economic reforms should begin to take hold.
- We will continue to track allegations surrounding a questionable land deal involving recently re-elected Prime Minister Abe and his wife. If the scandal escalates, in our view it would likely be a near-term risk to Japanese financial markets.

Emerging Markets

Solid Economic Data Amid Trade Talks

- Chinese economic data continue to deliver strong numbers in tandem with equity performance. Caixin PMI data for February, which focuses on small to mid-sized businesses, came in better than expected and reached its highest level in seven years. The report beat expectations primarily due to strong services PMI data, driven by strong employment data.
- As we expected, Chinese import-export data had a strong sequential rebound in February to offset the timing of the Lunar New Year compared with last year. Despite renewed trade policy rhetoric from the U.S. presidential administration, Chinese trade data did not indicate a ramp-up in construction materials ahead of tariff announcements.
- Trade data also confirm the message delivered by Chinese Premier Li at the annual National People's Congress in mid-March that "no one wins if China and the United States start a trade war." The comments were made as Premier Li spoke on similar themes from last year regarding economic reforms as well as trade complications with the United States. While U.S. protectionist policies could provoke unintended consequences, China contributes less than 1% of steel to the United States.
- We continue to have a favorable long-term outlook toward emerging market (EM) equities because the relative valuation discount versus the United States is wider than historical averages. In the short term, however, there are some signs that EM equities could take a breather after a 24% return over the past 12 months.
    - Money growth and credit trends have been signaling potential economic weakness in China for some time. Manufacturing PMI new orders and backlogs of orders have deteriorated in the past several months. These data tend to lead industrial profits and may be hinting toward a slowdown.
    - A meaningful slowdown in China would likely reverberate through broad EM corporate earnings. Earnings in EM remain very strong, but net earnings per share revisions have again turned negative; perhaps signaling a near-term slowdown.
    - Lastly, equity market breadth (a measure of contribution to index performance) has been a bit narrow, suggesting that only a few larger companies are currently driving the indexes.

Energy

Oil Price Advances Slow as Rising Rig Counts Counteract OPEC Cuts

- Oil prices fell on the Trump tariff announcements, but have since recovered to previous levels (as of this writing, West Texas Intermediate was trading at about $65 a barrel). The bull rally seen in the latter half of 2017 seems to have slowed. Prices have been more or less range bound (roughly between $60 and $65). With relatively balanced supply and demand, prices are expected to remain mostly unchanged through the remainder of the year.
- Toward the end of March Saudi Energy Minister Khalid al-Falih called for OPEC to extend its petroleum supply cuts through 2019. Since January 2017, OPEC and some non-OPEC countries (namely, Russia) have cut output by 1.8 million barrels per day to counteract surging U.S. output. These cutbacks have only modestly dragged oil prices higher, suggesting that extending the curbs will have a similarly underwhelming effect.
- Counteracting these oil cut extensions is the continuing increase in active crude oil rigs operating in the United States Though rig counts were mostly unchanged in March, according to Baker Hughes, they remain up 25% from year-earlier levels. Indeed, these rising rig counts contributed to the upwardly revised U.S. oil production forecasts from the U.S. Energy Information Administration, International Energy Agency, and OPEC in February.
- Under the original plans for President Trump's steel and aluminum tariffs, the oil and gas industry would have likely been among the hardest hit: Domestic oil and gas pipelines, for example, import nearly three-quarters of the steel used. As a result, this sector was among the hardest hit following news of the announcement. However, since then, exemptions for Canada and Mexico and subsequently other allies alleviated concerns.

Strategy Views

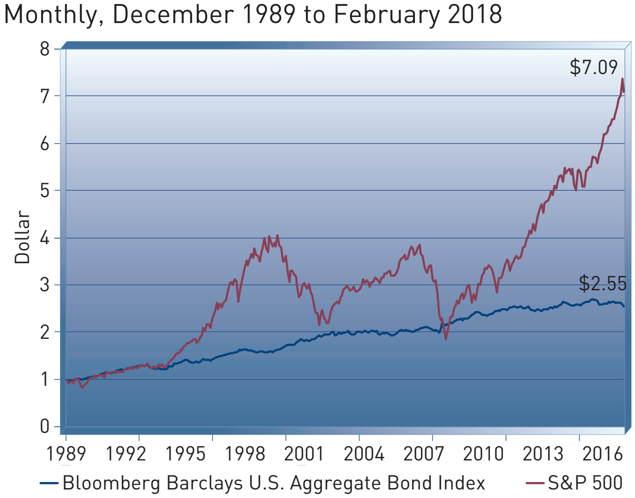
What Is Risk? Bonds, Volatility, and Human Behavior

For long-term investors looking to maximize their wealth, it is hard to justify large allocations to bonds. In fact, over 25-year periods, stocks almost always beat bonds. For perspective, there are only 10 months over the past 140 years in which a 25-year investment in bonds would have outpaced stocks. That is about 0.6% of the time.

This idea can also be viewed from a cumulative return perspective. To illustrate this point, a $1.00 investment made at the beginning of 1990 through February 2018 in a fixed-income only portfolio[1] would have grown to $2.55 after inflation, an annualized real return of 3.0%. An equity only portfolio[2] would have grown to $7.09 after inflation for an annualized real return of 7.2% (Chart 1).

Of course, it is well accepted by investors that stocks are riskier than bonds. Risk is often used synonymously with volatility. But for some, volatility may not be the most critical component when

Chart 1
Growth of $1 after Inflation
Monthly, December 1989 to February 2018



Source: FactSet Research Systems, PNC

[1] Bloomberg Barclays U.S. Aggregate Bond Index
[2] S&P 500 Index

thinking about the appropriate asset allocation. For some, risk may be missing a long-term-return target, a degradation of purchasing power, or a permanent loss of capital. For example, in Warren Buffet's 2014 annual letter to the shareholders of Berkshire Hathaway he expresses the idea that volatility should not be equated with risk. He believes that directly linking one to the other can lead to poor decision making. Mr. Buffet's point of view isn't applicable to all investors, but it does highlight the way one of history's most famous long-term investors thinks about risk.

In our view, human emotion may actually be the reason volatility often leads to poor investment results, therefore manifesting in actual risk. This leads us to another notion from Mr. Buffet's 2014 letter to shareholders. Mr. Buffet goes on to say that although volatility does not have to equate to risk, often times investor behavior makes stock ownership a risky proposition.

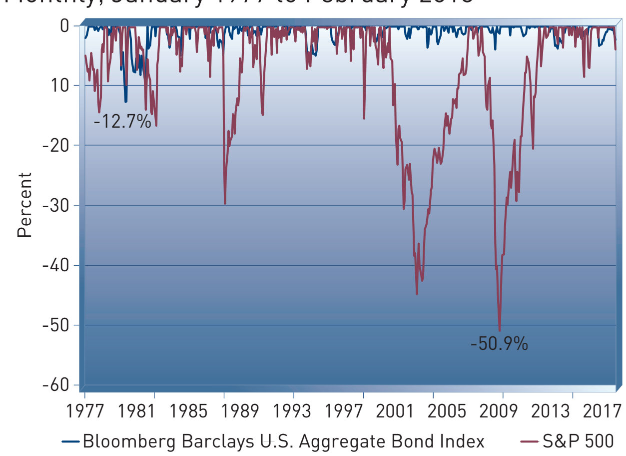
Humans have an instinct to make themselves feel safe, even when they may actually be accomplishing the exact opposite. For example, people who are afraid of air travel often opt to drive, despite the fact that you are 24,000 times more likely to die in a car accident than you are in a plane crash. When investing, the combination of market stress and human behavior often leads to suboptimal decision making (such as panic selling during a drawdown period). Looking at the 20-year period from 1994 to 2014, the average annual return for stocks was approximately 9%, and about 6% for bonds. So why was the average investor return closer to 4%? The answer, in large part, is poor decision making in the face of volatility.[3] Said another way, temporary market instability, so-called "noise" becomes true risk for investors only when decisions are made that are inconsistent with long-term objectives. So although it might be true that stocks almost always beat bonds over long periods of time, striking the right asset allocation balance may allow investors to better manage the emotional responses that lead to poor investment outcomes.

Especially in today's fixed-income market, managing behavioral biases may be the most compelling reason to include bonds in a portfolio. The income generated from bonds is still historically low, and with bond prices falling as rates slowly rise, the mark-to-market in bond portfolios is likely to be less than stellar. However, when equity market volatility increases to a point that makes us uncomfortable, it is often this stable part of our portfolio that quells the inclination to make rash decisions, allowing us to stick with our asset allocations when times get tough.

We are the first to admit that it is nearly impossible to get in, get-out, then get back in again at precisely the right moment. In the 40-year period starting in 1977, the S&P 500 had a negative annual return eight times. The Barclays Aggregate bond index has been positive in every one of those eight years. Over that same 40-year period, the largest equity drawdown was -50.9% in 2008. For bonds, -12.7% in the late 1970s (Chart 2).

The bottom line is that stocks may be considered risky in the short term, but over the typical long-term investment period (endowments/foundations aim to provide funding in perpetuity, and even a retiree at age 65 still needs to plan for at least 25 years) an all-equity portfolio nearly always maximizes wealth. Knowing this, rational investors should always choose equities; however, no one

Chart 2
Percentage Drawdown
Monthly, January 1977 to February 2018



Source: FactSet Research Systems, PNC

[3] Morgan Housel, *What Other Industries Teach Us about Investing*, MicroCap Leadership Summit, September 21, 2017. https://microcapclub.com/wp-content/uploads/2018/01/Morgan-Housel-on-What-Other-Industries-Teach-Us-About-Investing.pdf

invests this way. If an investor bought an S&P 500 index fund on January 1, 2008, the market value of their investments would have dropped almost 50% over the following year. For most investors that would be considered a terrifying outcome. Therefore, we are not suggesting that a 100% equity portfolio is appropriate for most investors, because the associated volatility could create liquidity issues and, perhaps more importantly, many sleepless nights. The data do highlight, however, the historical relationship among increased equity exposure, risk, and ultimate wealth maximization (return) over longer investment holding periods.

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Hawthorn Asset Allocation Playbook

As of March 30, 2018

Asset Class	Sub Asset Class	Favorability							Points of View
		-			Neutral			+	
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 volatility, 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					●			Defensive 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.