Global Market Snapshot

Key Market/Economic Observations

United States

Markets Grappling with a Complex Backdrop

- Investors were faced with a lot to digest in May: Trade war concerns, interest rates (moves both up and down), and debates over "peak earnings" were among the confluence of variables vying for investor attention. Adding to the list were rising oil prices, a strengthening dollar, and an uptick in political uncertainty in Italy, Spain, and North Korea.
- Despite all the noise, we believe U.S. fundamentals remain sound. The S&P 500® has recovered from losses earlier in the year and has generated a total return including dividends (as of May 31, 2018) of approximately 2.0% year to date.
- Trade concerns appeared to momentarily fade from the headlines, before resurfacing with a vengeance. Mere days after U.S. Treasury Secretary Steve Mnuchin announced the United States and China had put the trade war on hold, President Donald Trump reversed course, softening that message. We continue to believe an all-out trade war is unlikely, but neither do we expect a lot of trade peace in the short run. For further information, please see our in-depth discussion of China/U.S. trade relations in our May 2018 *Global Market Snapshot*.
- U.S. economic data remain on solid ground, with PNC forecasting an acceleration in second-quarter 2018 GDP growth versus a seasonally softer first quarter. For 2018, PNC maintains our GDP forecast at 2.8%. Inflation data have come in generally as expected, with April headline inflation at 2.5% year over year versus the prior reading of 2.4%. The April Producer Price Index (PPI) softened more than anticipated, to 2.6% year over year, versus the prior reading of 3.0%. In our view, these data should not alter the current path of Federal Reserve (Fed) rate hike expectations.
- The Fed kept interest rates unchanged at its May Federal Open Market Committee (FOMC) meeting. The most critical takeaway may be the Fed's use of the word "symmetric" when describing its tolerance for inflation related to its stated 2.0% target. This suggests to us little worry of an overheating economy and indicates a tolerance for inflation to potentially run a bit above 2.0%. In our view, this underscores the Fed's willingness to be data-dependent, yet patient, when it comes to tightening monetary policy.
- PNC believes the Fed will maintain its course of gradual interest rate increases, and forecasts an interest rate hike for the second time in 2018 at the June FOMC meeting, and then a third time in December.
- U.S. 10-year Treasury yields have been volatile—moving initially higher on continued solid economic growth prospects and higher oil prices—recently reaching 3% in mid-May, before falling back to 2.8%. The fairly rapid decline appears largely driven by safe-haven flows from European sovereign bonds as Italian yields spiked over 100 basis points (bps) on increased political risk. We continue to believe yields are biased higher over the longer term, but perhaps not to the extent some market participants fear.
- The first-quarter earnings season far surpassed expectations in an exceptionally strong start for 2018. S&P 500 earnings growth exceeded 24% for the quarter versus a year earlier, outpacing the initial estimate at the end of March of approximately 17%. Revisions for the first quarter were the strongest we've seen over the last 10 years (and that includes coming off the 2008-09 recession period). Four of the last five quarters have seen double-digit growth, and analysts estimate similar growth in each of the remaining quarters this year.

- Despite the tax cut and strong earnings, we're seeing oil and gasoline prices, as well as raw material costs, increase and the dollar strengthen over the last month or so. Higher gas prices shave off a portion of the tax cut benefits to consumers, higher input costs erode gross margins, and the stronger dollar eats into profits from multinational companies.
- We believe some multiple pressure can ease as we move through the year. In our view, interest rates are going to have a harder time moving swiftly higher than the consensus expects, inflation seems reasonably contained for now, and the trade issues should find a negotiated solution that isn't significantly disruptive to the global economy. However, even if S&P 500 earnings reach $160 per share this year (equating to 20%-plus year-over-year growth), an 18 times price-to-earnings (P/E) multiple is needed to generate an "average" total return year of about 9-10%. We remain positive on U.S. equity markets in general, owing to continued strong fundamentals, but do not see material multiple expansion as the key driver of the market over the remainder of 2018. Therefore, significant upside in equity prices may be difficult to achieve.

Europe

Growth Is Slowing but Remains Steady; Politics May Be the Biggest Risk

- The downshifting of European economic activity continued, with real first-quarter GDP growth for the Eurozone slowing in year-over-year terms from 2.8% to 2.5%. Forward-looking indicators suggest these trends will persist, at least in the near term: The IHS Markit Eurozone Manufacturing PMI® dipped to 55.5 in May, down from 60.6 at the start of the year.
- It is important to emphasize, however, that although these data suggest the Eurozone is slowing, the risk of recession is minimal as overall growth remains healthy. Indeed, the aforementioned Manufacturing PMI is still high relative to historical averages. Also noteworthy, the economic slowdown in the region appears consistent with the European Central Bank's (ECB's) expectations and forecast assumptions.
- Though largely under the radar until late May, the political stalemate in Italy took a rather serious and surprising turn as a veto by President Sergio Mattarella spooked the markets; new Italian elections seem necessary. In yet another surprising twist, the Five Star Movement and the Northern League political parties reached a revised governing coalition late on May 31.
- Initial news of the failed coalition alarmed global markets, leading to a rapid sell off in both Italian and European stocks. Similarly, bonds in Italy, and to a lesser extent those across Europe, also came under extreme pressure. The yield on the Italian two-year bond jumped 2 percentage points immediately following the news. At the same time, the news pressured an already weak euro, driving it lower relative to the dollar. Markets have since calmed as the situation has reached a near-term resolution. Please see the *Strategic Views* section (page 4) for further information.
- Earnings season in Europe is winding down. With almost all companies in the STOXX® Euro 600 index having reported, EPS growth is up more than 10% year on year, an impressive number, particularly given the very tough year-over-year comparison (25% growth in first-quarter 2017), but weaker than the growth experienced in the United States this year. According to analysis from BofA Merrill Lynch, only 46% of Euro STOXX 600 companies beat their earnings estimates, the lowest proportion since 2013. The outlook for earnings over the coming year remains cautiously optimistic.
- Uncertainty surrounding Brexit also continues to grow. Most recently, there are reports the United Kingdom will require a longer transition period than initially anticipated until a formal clean break can be completed; U.K. Prime Minister Theresa May is contemplating requesting a two-year extension.
- With heightened and lingering political risks, we believe the ECB may choose to extend its asset purchase program rather than begin

a tapering program later this year. Although certainly not an ideal long-term solution, the continuation of easy monetary policy may help support financial asset prices in the short term. As we believe valuations in Europe are relatively more attractive than the U.S., we favor domestic equities in the near term given the likelihood of more political/headline risks abroad versus a steady U.S. economy that is being further supported by significant fiscal stimulus.

Japan

As Growth Stalls, the Economy and Markets Benefit from a Weakening Yen

- Economic conditions in Japan have been weakening lately. Like the Eurozone, Japan also had a slower first quarter. Following eight consecutive quarters of growth, Japan's GDP contracted in the first quarter. The 0.3% quarter-on-quarter decline was weaker than expected (fourth-quarter 2017 growth was also revised down from 0.4% to 0.1%). Inflation, or lack thereof, is also becoming a problem as core inflation came in at just 0.7% year over year, its lowest level since September. Topline Consumer Price Index (CPI) inflation also dropped sharply from 1.1% to 0.6% year over year. Both numbers are now well below the Bank of Japan's (BOJ's) target of 2%, a target not hit since early 2015.
- Despite these trends, there are still reasons to be cautiously optimistic, as select leading indicators are pointing toward improved growth. Unlike the Eurozone, Japan saw growth improve in April. The Nikkei Japan Manufacturing PMI® rose from 53.1 to 53.8 between March and April, and the Services PMI increased from 50.9 to 52.5. At the same time, the Leading Index remains elevated at 104.4, which is four points above its 10-year average.
- The BOJ's late-April monetary policy statement was mostly unchanged from the prior statement. The central bank's short-term policy rate remains -0.1%, its target for the 10-year government bond yield is "around 0%," and it continues to buy stock-exchange-traded funds and real estate investment trusts at annual rates of 6 trillion yen and 90 billion yen, respectively.
- After appreciating nearly 10% from the start of the year through March, the yen has been losing ground relative to the dollar. As of this writing, it is now nearly unchanged on a year-to-date basis. As an export-based economy, the Nikkei 225 Stock Average index is highly correlated with the value of the yen. Since the yen peaked in late March, the Nikkei has appreciated nearly 9%, handily outpacing the 5.5% return seen in the S&P 500 over the same period.

Emerging Markets

Economic Data and Equity Prices Affected by Dollar's Rapid Rise

- Trade skirmish headlines have taken their toll on emerging market equities, as the MSCI Emerging Markets (EM) index is down nearly 4% since mid-April, compared to a positive reading on developed international indexes. While we do not expect trade-related tensions to result in an all-out trade war, it may not be a smooth ride for export-focused nations in the near term.
- Additionally, on a trade-weighted basis, the dollar has strengthened about 4% since mid-April. We believe a combination of global growth and monetary policy divergence has pressured emerging market currencies to the detriment of their debt and equity prices. While we think fundamentals within most emerging market regions are on solid footing, the currency impact in the near term could offset positive economic growth. For example, many emerging market economies have accumulated large amounts of dollar-denominated debt. As the dollar rises relative to their own currencies, that debt becomes more difficult to service.
- As emerging markets react to tightening monetary policy from the Fed, not only are currencies weakening at a rapid pace, but interest rates are rising as well—not a particularly favorable backdrop for EM equities in the short run. Turkey was the latest country to experience a decline in its local currency, and the central bank held an emergency

meeting to raise its policy interest rate by 300 bps. While Turkey is primarily a closed economy, its largest trading partner is actually the United States, underscoring the potential stress from a rapidly rising dollar.

- Although we still like the asset class longer term, emerging market equities may continue to underperform as the momentum in the dollar continues grinding higher.

Energy

Energy Outperformance Continued on Improved Earnings Outlook, Higher Crude Prices

- Energy remains the best performing S&P 500 sector across both the three- and six-month time horizons and has outperformed the S&P 500 by about 4% year to date. The combination of an increase in oil prices, improving fundamentals, and positive revisions to earnings estimates have helped spur an uptick in investor interest.
- The Energy sector grew earnings by 93% in the first quarter (largely a function of relatively easy year-over-year comparisons) and provided the highest upside surprise of any sector, beating expectations by 12%. While sales underwhelmed expectations by 3%, stronger operating margins drove the bottom line.
- Crude oil was bolstered early in May by signs that oil producers remain committed to their newly found capital discipline. Rising geopolitical risk due to the specter of U.S. sanctions against Iran and Venezuela also helped move prices higher.
- However, prices were then pressured lower as Russia and Saudi Arabia discussed increasing output to offset potential losses in global supply, leading to West Texas Intermediate crude prices falling below $70 per barrel. From a supply/demand perspective, the recent comments from Russia and the Saudis will likely affect the market to some degree, but net-net the move will probably only serve to replace estimated lost supply from Iran and Venezuela (about 1 million barrels per day in total).
- Energy sector stocks have reacted negatively to the potential for an increase in oil production, but we believe oil prices will stabilize as these comments are digested, and the sector can continue to perform reasonably well versus the broad market.

Strategy Views

Italian Politics Giving Market Agita

The ascension of populist ideologies within the European Union (EU) serves as the latest chapter in the seemingly neverending saga of Italian political and economic stagnation. On May 27, President Mattarella chose to block the incoming coalition (formed by the left-leaning Five Star Movement and right-leaning Northern League populist parties) by rejecting the Minister of Finance nomination of Paolo Savona. The rejection temporarily halted the populists' bid to form a new government and left Europe's fourth-largest economy on the brink of political crisis. However, political instability is nothing new to Italy. In fact, the next leadership group to come into power will be the country's 67th government in the last 70 years. So, if political instability is the norm, then why are markets reacting so negatively this time around?

In short, because Eurosceptic rhetoric is the closest it's ever been to becoming Eurosceptic policy. The combination of a leaked document outlining how and when Italy could leave the Eurozone, in conjunction with the nomination of Mr. Savona (the mastermind behind said plan), meant the pieces for an exit from the EU may be falling into place. Could Italy actually be on the brink of leaving the Eurozone? In our view, we assign a very low likelihood of occurrence (likely in the 5-10% range), but it's definitely not a zero probability. In fact, the most recent development in the Italian political saga was the surprise reformation of a political government between the Five Star and Northern League. Now, Giovanni Tria will be finance minister rather than the Eurosceptic professor, Mr. Savona. For the time being, this prevents the need for a new snap election.

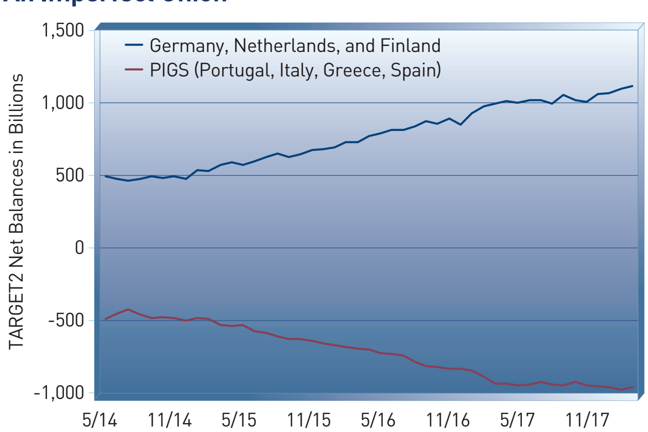
The focus will likely shift to policies surrounding spending and tax cuts, but investors will still need to consider the newly formed government's stance on EU membership. In fact, Mr. Savona will still be part of the Finance Ministry, just not leading it, so the market must continue to consider the risk of rising anti-EU sentiment within the government. Regardless, there are still many lingering unknowns, and we suspect volatility-inducing headlines to ebb and flow over the coming months.

An Imperfect Union—a Quick Look Back

The European Economic and Monetary Union (also known as the European Union or EU) was established in 1999 to facilitate the four key freedoms: the movement of goods, services, people, and capital. Member countries adopted a single currency, the euro, to replace their respective national currencies, while simultaneously establishing a single, area-wide monetary policy to be controlled by the independent ECB. These ideals still hold true today, but increasing inequality between member countries has spurred pockets of populism, particularly in more politically volatile countries, such as Italy. Despite the ECB's efforts to balance the natural disparities among the region's economies, the imbalances appear to be worsening, according to Trans-European Automated Real-Time Gross Settlement Express Transfer System (TARGET2) data. Simply, these data represent cross-border transactions that show money leaving Portugal, Italy, Greece, and Spain (affectionately referred to as the "PIGS") to find a new home in Germany, the Netherlands, and Finland (Chart 1). Populists, or Eurosceptics, have used this situation to their advantage, proposing that Italy's problems may be better solved by dropping out of the EU's currency union.

This dynamic has put the ECB in a difficult position, given its plan to begin normalizing extremely

Chart 1
An Imperfect Union



Source: Bloomberg L.P.

accommodative monetary policy beginning in September of this year. While softer economic data and lower-than-expected inflation have already cast doubt on whether the ECB should move forward with monetary tightening, Italian machinations may actually be the catalyst to force a reconsideration. In 2012, ECB President Mario Draghi stated, "the ECB is ready to do whatever it takes to preserve the euro," serving as a reminder of the dedication the central bank has in maintaining its monetary union. Additionally, the ECB's asset purchasing program has acted as a lifeline for the PIGS, as the ECB became a structural buyer of debt, providing easy monetary policy that allowed these highly indebted countries to maintain stability. A removal, or tapering, of these structural purchases without new buyers could spike bond yields higher, making the fiscal situation even more difficult for Italy. Bloomberg recently reported that Moody's is considering a cut to Italy's credit rating from Baa2, which is already the second-lowest investment grade rating. While there is a one-tier buffer before falling below investment grade, it's important to note that the ECB's purchase program only allows for the purchasing of investment grade debt, potentially compounding an already tenuous situation.

Ultimately, the political situation in Italy remains fluid, even considering the newly formed government coalition. While structural reforms aimed at addressing Eurozone imbalances seem unlikely in the near term, the EU may have to conceive new solutions to address the wider imbalances across member countries over time. The ECB's dedication to preserving the euro may also play a key role, as a decision to maintain asset purchases beyond September could bring a much-needed reprieve to rising yields in Europe's peripheral economies. Simply put, the political will to maintain the euro area is very strong.

What Happened and How Did We Get Here?

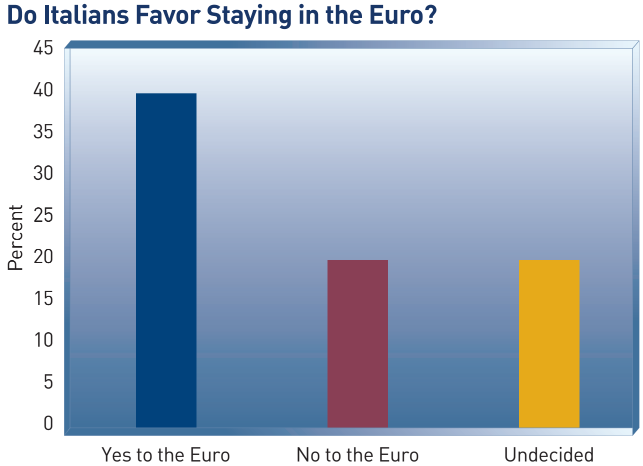
On March 4, Italian parliamentary elections closed with no party able to attain the necessary majority. Thus two major political factions were forced to come together to break the deadlock. Rising from the negotiating table was an unlikely partnership between the Northern League and the left-leaning Five Star Movement, which together were able to amass a majority of parliamentary seats. To be clear, these two parties' share little in the way of ideological commonalities, but found common ground in what they believed was a solution to the country's problems: an exit from the EU's currency union.

Where Do We Go from Here?

If new elections ever did become necessary, polls in Italy show the populist parties continue to hold leads over pro-EU parties, suggesting another election may be déjà vu all over again. Interestingly, according to a recent poll by EUmetra, the majority of Italians still favor staying in the EU (Chart 2). It is particularly notable that the new governing coalition of the Five Star Movement together with the Northern League is not at all representative of the majority view on this critically important issue.

People will likely continue to compare the current situation in Italy to the Greek Debt Crisis of 2010-11. Both countries certainly have their challenges. However, Italy's economy is 10 times larger, with €2.3 trillion in public debt (7 times the amount in Greece); Italy's problems, if left unchecked, have the ability to significantly affect global capital markets. The une ECB meeting will be of great interest to investors. Before the new deal was reached between the Five Star Movement and the Northern League parties, many assumed the ECB would surely continue its bond purchase program past the anticipated end date later this year. The ECB's comments will be closely watched for clues on the future of monetary policy, with important market implications, especially for interest rates and currencies.

Chart 2
Do Italians Favor Staying in the Euro?



Source: Cornerstone Macro, PNC

What to Do with European Stocks?

While Italy is the fourth-largest economy in the EU, its equity market is relatively small at just 4% of the MSCI Europe index. Nonetheless, Italian equities have been positive drivers of European equity performance in 2018, despite recent volatility. A breakdown of the Italian FTSE MIB index by sector reflects the importance of Financials and Energy on the region's overall stock performance (Table 1). The Energy sector has been supported by rising oil prices, and Financials had strong first-quarter earnings, generating an upside surprise of 14.2% (compared to 5.3% for S&P 500 banks). Looking at Italian bank fundamentals today, we believe their capitalization has significantly improved, as seen by their Tier 1 capital ratios sitting at the highest level on record. Bank stress tests instituted by the ECB should also provide some level of oversight that was not in place during the euro-area debt crisis circa 2011; these tests are similar in nature to the stress tests overseen by the Fed. Finally, despite good performance this year, valuations suggest Italian stocks are back to their cheapest level relative to broader Europe since 2012. Given Italy's small percentage of overall European stock indexes, positive developments in the banking sector, and overall lack of clarity that still exists relative to Italy's ultimate fate, we believe it is premature to move meaningfully out of European equities.

Table 1
Sector Weights

Sector	FTSE MIB	S&P 500
Consumer Discretionary	13.8%	12.9%
Consumer Staples	1.8%	6.7%
Energy	18.6%	6.2%
Financials	32.5%	14.2%
Health Care	1.6%	13.9%
Industrials	12.4%	10.0%
Information Technology	0.0%	25.9%
Materials	0.0%	2.9%
Real Estate	0.0%	2.7%
Telecommunication Services	4.6%	1.8%
Utilities	14.7%	2.8%

Source: Bloomberg L.P.

Movement in Currency Markets May Have the Most Direct Impact on U.S. Investors

Since the Italian general election in early March, the euro had already lost more than 5% against the dollar. Italy's renewed political turmoil pushed the euro to a 2018 low against the dollar at the end of May. Although we think broad collateral damage from the instability in Italy is unlikely, one potential transmission mechanism is via currency markets.

Potential impacts include:

- A stronger dollar has the potential to tighten financial conditions in the United States. In particular, an appreciating currency can weigh on multinational corporate earnings and those reliant on international exports.
- This may be a boon to small-cap stocks that are more insulated from currency fluctuations.
- Investments in emerging market equities may be affected by a stronger dollar. Historically, a strong dollar has been a headwind for emerging market stocks. Certain emerging market regions have accumulated large amounts of dollar-denominated debt. A rising dollar makes these debts harder to service.
- A rising dollar has the potential to slow the pace of Fed rate hikes. A strengthening dollar is a headwind for inflation, and the Fed is unlikely to rapidly hike rates in the face of stagnating inflation or a further tightening of financial conditions.

The bottom line is we will continue to track the developing political situation in Italy very closely, but for now, recent developments point to a less disruptive outcome. We expect heightened volatility to persist over the balance of the year, not only a function of recent political developments in the Eurozone, but also the laundry list of headline risks that the market has continued to wrestle with so far this year. It is unlikely to be a quiet summer. Despite this rather complex backdrop, we do not foresee making significant portfolio changes in response to these largely headline-related risks. We recommend looking past these shorter-term disturbances and staying the course with your investment program.

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Hawthorn Asset Allocation Playbook

As of: 6/1/2018

Asset Class	Sub Asset Class	Favorability: -			Neutral			+	Points of View
Equities					●				
U.S.	Large Cap					●			Relative valuation causes us to narrowly favor large over small. Small Caps have outperformed year to date as investor concerns related to trade and, more recently, a stronger dollar have driven them to seek protection from less exposed small cap stocks. Smaller companies may also benefit from positive tax reform-related forward guidance, however, valuations remain quite expensive at 22.5 times on a forward earnings basis. 30% of small cap indexes like the Russell 2000® still have no earnings, so be selective when investing in the asset class.
	Mid Cap				●				
	Small Cap				●				
Non-U.S.	Intl. Large/Mid Cap				●				Valuations appear relatively more attractive versus domestic equities, potentially creating attractive long-term opportunities in many international markets. Still largely accommodative monetary policy by global central banks and solid earnings momentum should also provide additional support. However, political risk is again elevated and economic momentum has weakened versus what we are seeing in the United States.
	Intl. Small Cap				●				
	Emerging Markets		●						Although we like emerging market (EM) for the long term given current valuations, we believe the rally to be overextended. The shorter-term bear case for EM equities rests mainly on tightening in China, as well as the newfound strength in the dollar. Year-to-date, EM has underperformed both developed international and U.S. markets.
Fixed Income				●					
U.S.	Short Muni Fixed Income			●					Although interest rates may drift higher given solid economic momentum, we believe we may have already seen the bulk of the move higher in rates for this business cycle. Therefore, we favor positioning fixed income portfolios in the intermediate part of the curve.
	Core Muni Fixed Income					●			
	U.S. High Yield			●					The credit cycle is aging, and valuations should become an increasing headwind for below-investment-grade bonds. Leveraged loans, although more senior in the capital structure, have seen issuance balloon in recent years while covenants have weakened. Given our view on interest rates, credit risk may be starting to outweigh the protection from higher rates.
	U.S. Leveraged Loans			●					
	U.S. TIPS			●					Less value in TIPS with breakeven inflation rates now around 2.20%. We prefer to hedge inflation over the long-term via our equity exposure.
Non-U.S.	Global Bond			●					Although we are not overly negative on credit given the strength of the economy, we do believe slowly shifting to higher-quality areas of fixed income is sensible given the level of spreads. Unconstrained funds have reached for yield in lower-rated credits.
	Unconstrained Bond				●				
	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. Some banking deregulation may open this space up to more traditional bank lending, however.
	Private Equity				●				Opportunity in new/less efficient markets, and a more diverse investable opportunity set; for example via secondaries and "co-investment" options. That said, as with public markets, valuations are exteneded.
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 years past. We believe differentiated return streams can add value in today's market versus a tradtional equity/bond portfolio.
	Event Driven					●			
	Relative Value					●			
	Directional					●			
Cash					●				

Tactical Allocations						●			
Tactical	**Master Limited Partnerships**					●			Performance has suffered after a strong start to the year. Markets penalized the sector after a potentially unfavorable tax ruling, however we believe the overall impact will be small. Stronger fundamentals and rising energy prices 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					●			Stable economic conditions, improving earnings growth, and relatively attractive valuations put European equities in a good position despite recent political volatility. The currency hedge has been additive to 2018 performance.
	Currency Hedged Japan					●			Valuations are attractive, earnings growth is strong, and consumer confidence is high. We still like the currency hedge as the BOJ remains easy relative to the Fed and yen positioning (now net long) is no longer supportive of a move higher.
	Energy						●		With higher and more stable oil prices, better capital discipline, and attractive relative valuations, we believe Energy sector equities can outperform the broad market on a tactical basis.
	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. Banks are historically correlated with increases in cap ex which we believe will continue this year.
	Structured Note (Drawdown)				●				Ability to earn a coupon while waiting for a more attractive entry point into equities can be an attractive strategy. However, cash has become more palatable given the rise in short-term interest rates.