March 2017

Hawthorn Global Market Snapshot

Key Market/Economic Observations

United States

Stocks Take a Breath in March

- After a strong start to 2017, the equity market has struggled to make additional headway in March.
- Despite this, volatility has remained surprisingly low. The S&P 500® had gone a near-record 109 days without closing down more than 1.0% until the streak was broken on March 21.
- The two biggest market-moving events this month served as initially positive catalysts for stocks, even though as a whole the S&P 500 was little changed since the end of February.
    - President Donald Trump made a speech to Congress that was widely received as constructive by the market, and the S&P 500 responded by jumping 1.4% on March 1. That said, stocks gave back those gains in subsequent days.
    - The Federal Reserve's (Fed) March meeting also served as a positive catalyst for the market. A less hawkish outlook than markets feared propelled stocks to another strong one-day gain.
- The Fed increased its benchmark interest rate by another 25 basis points in March. There was no shift to the median rate forecast for this year and 2018 (still three hikes each year); 2019 shifted up slightly, with the median forecast moving from 2.875% to 3.0%. The long-run forecast held constant at 3.0%.
- From the market's reaction, it was clear to us that the consensus expected more hawkish guidance: interest-rate-sensitive equities were up, emerging markets were up, high yield was up, bonds rallied, the yield curve flattened, and the dollar fell. For now, markets are operating within a very constructive backdrop of higher growth expectations and a Fed that appears to be successfully managing market expectations.
- Our view continues to be that equity market momentum can persist in the short term. Many investors remain optimistic regarding the potential for tax reform and deregulation, while economic survey data (small business optimism and consumer confidence, for example) also reflect positive sentiment. Policy follow-through will be key later in the year, and we have seen some evidence that implementation may take longer than the market anticipates.
- We believe markets also may be taking a pause as investors wait for so-called "hard data" (that is, business investment, industrial production, and GDP) to confirm the optimistic survey data. We believe improved confidence must ultimately translate into stronger hard data to support the market at current levels. At this stage, it is not completely clear whether that will be the case.
- Our view continues to be that leading economic indicators may be at or nearing a cyclical peak.
    - The PMI (a data series we track very closely in our business cycle work) is in the twenty-third percentile of its near 70-year distribution, with the important New Orders component in the ninth percentile.
    - Examining data going back to 1948, the equity market was up 64% of the time in the year following a top-quartile PMI reading. However, during those years broad market returns were also usually below average.
    - Since 1950 there have been 26 years in which the return on the S&P 500 was positive in both January and February. Of those years, the market finished out the year positive 92% of the time (but with an average drawdown of 10% along the way).

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- The yield curve has flattened since the end of 2016, and credit spreads have recently ticked slightly higher. Neither development is alarming to us at this stage, but we will continue to look to the fixed income markets for signals regarding the trajectories of economic growth, inflation, and risk expectations.

Europe

European Central Bank (ECB) Leaves Policy Unchanged; Dutch Populism Loses

- As expected, the ECB left its key policy rate unchanged at its March Governing Council meeting. The central bank's monthly bond purchases are set to fall from €80 billion to €60 billion beginning in April and ending in December (the program's current end date).
- Solid economic fundamentals across the region have prompted discussion regarding when the ECB may consider tightening monetary policy. According to the most recent policy statement, the ECB still expects to keep interest rates at or below current levels for an extended period of time.
- ECB President Mario Draghi has stated that any increase in inflation must be durable and widespread across the Eurozone for the ECB's policy stance to change.
- According to PNC's international economics team, weak labor cost growth (a key determinant of trend inflation) will give the ECB ample runway to keep monetary policy extremely accommodative, meaning it may only slowly reduce asset purchases in 2018.
- In the Dutch election, Prime Minister Mark Rutte's center-right party won parliamentary seats by a wide margin instead of populist candidate Geert Wilders' anti-European Union (EU)/anti-Islam party. The Dutch election was viewed as a good near-term gauge of the strength/pervasiveness of European populism.
- The more critical issue for the markets, in our view, is the upcoming French presidential election(s) on April 23/May 7. Issues and societal divisions run much deeper there (certainly relative to the Netherlands).
- The spread between 10-year German and French bonds widened significantly in February, evidence that the French election is likely causing some degree of market anxiety.
- Still, based on the outcome of the Dutch election, it looks as though betting markets are marginally reducing odds of a Marine Le Pen (populist candidate) victory in France.
- Italy remains another important risk. Euroscepticism in Italy is on the rise according to recent polling data, and without speculating about election results, we expect headline risk may persist for some time.
- With more elections to come this year across the EU, we think populist political risks remain at the forefront for the markets.

China

Prioritizing Currency Stability over Growth[1]

- The People's Bank of China (PBOC) raised benchmark rates 0.1% after the Fed's 0.25% increase in the federal funds target range.
- Prior Chinese rate hikes in late January and early February demonstrate that the PBOC is prioritizing exchange rate stability over domestic growth in setting monetary policy. Higher Chinese interest rates will help discourage capital outflows, making it easier to conserve the foreign reserves it uses to prevent the yuan from depreciating.
- Increases in the policy rates will eventually pass through to higher borrowing costs for corporations and households. If China continues to try to match U.S. interest rate hikes, we believe it could eventually squeeze the cash flow of highly indebted Chinese corporations.
- We continue to view a free-floating yuan as a market risk (although perhaps low probability in 2017):

[1] Information in this section provided by William Adams, Senior International Economist, The PNC Financial Services Group.

- If the Fed is forced to raise rates faster than expected, China will likely be forced to either increase rates and risk corporate defaults, or allow the currency to free float.
  - This could lead to a rapid depreciation versus the dollar, causing downward pressure on global commodity prices, squeezing U.S. manufacturing profit margins, and intensifying U.S.-China trade frictions.
  - Recent PBOC actions, however, suggest the central bank is either not currently leaning toward a free-floating yuan devaluation scenario or we have not yet reached that tipping point.
- For now, tightening monetary policy in China may serve as an increasing global growth headwind as we move into second-half 2017.

Japan

Inflation Stuck in First Gear

- The Bank of Japan (BOJ) maintained its current monetary policy and forward guidance at its March Policy Meeting.
- Given the BOJ's view that quantitative easing will continue until the year-over-year increase in inflation exceeds 2.0% in a stable manner, we believe policy accommodation will remain in place for quite some time.
- So far this year, inflation remains well below target—January headline Consumer Price Index (CPI) was 0.4% in year-on-year terms, while CPI less fresh food was just 0.1% and CPI less fresh food and energy was only 0.2%.
- Over the medium term, we believe this should keep some pressure on the yen. However, the yen has appreciated versus the dollar this year, pressuring Japanese stocks.
- Japanese equity valuations certainly appear more attractive compared to the United States; however, a path to sustaining a higher growth trajectory that would drive meaningful multiple expansion is becoming less clear.
- Further, when adjusting for differentials in index sector weightings between the United States and Japan, the valuation gap between forward price-to-earnings (P/E) ratios shrinks:
  - Non-sector-adjusted forward P/E: United States 17.1 times (x) versus Japan 13.5x.
  - Sector-adjusted forward P/E: United States 17.1x versus Japan 15.9x.

Energy

Renewed Pressure on Prices

- In the February *Global Market Snapshot*, we said that "with many asset managers positioned for rising oil prices, a shift in sentiment could lead to a swift move in prices."
- Since that time, West Texas Intermediate crude prices have dropped over 10% after various reports highlighted the following:
  - Increasing skepticism regarding compliance with OPEC's production freeze/agreement put in place last fall;
  - North American shale production ramping faster than expected;
  - Global stockpiles/inventories increasing much faster than anticipated; and
  - Questions regarding the strength/sustainability of overall global oil demand.
- U.S. oil rig counts also continue to increase, with prices still well above last year's lows. Since bottoming in May, the U.S. rig count has increased from 316 to 631.
- Our view is that oil prices will likely stay near $50 a barrel in the near term and potentially drift higher later in the year.

Hawthorn Strategy Views

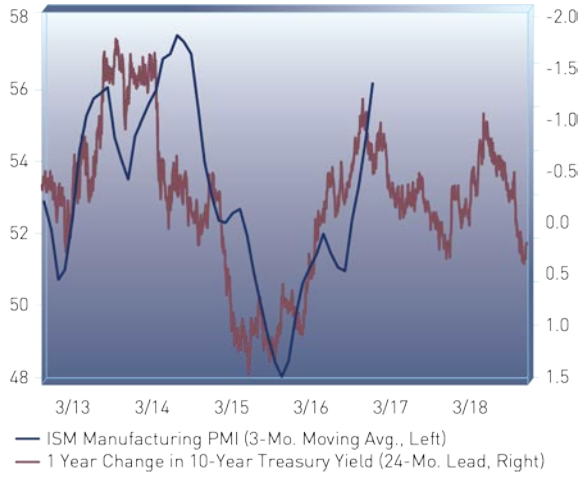
Where Do We Go from Here?

Our business cycle research is beginning to suggest a peaking process may be underway for the leading economic indicators we track. Yes, leading indicators (PMI, for example) have been very strong recently, and this likely means we can expect solid coincident and lagging economic data points in the coming months. It also seems possible that the recent spate of better economic data has been an underappreciated aspect of the market's recent strength. However, because the market itself is a leading economic indicator, we must attempt to forecast data series like PMI to understand the market's likely future path.

To that end, we track and analyze various data series that we believe can help us predict the direction of PMI and, therefore, the market (with some reasonable degree of confidence). Chart 1 is one example of why we think PMI may be in the earliest stages of peaking.

We think the trend of PMI may help us gauge how the market might behave over the next year. Using history as a guide, as well as data recently gleaned from Empirical Research Partners, from current PMI levels "the odds favor slower growth, higher inflation, tighter monetary policy, a flatter yield curve and so-so equity returns. Stocks have a good chance of outperforming bonds."[2] Style leadership is unclear based on historical patterns, but growth-at-a-reasonable-price (GARP) strategies tend to do quite well.

Chart 1
PMI Data May Be Peaking



Source: FactSet Research Systems Inc., Hawthorn

As highlighted in the U.S. section on page 1, PMI and its New Orders component are sitting at rather lofty statistical levels relative to history. From these levels, historically, during the following 12 months:

- Growth as measured by real GDP or industrial production slowed about 75% of the time.
- The Fed is also usually tightening during these periods, which tends to act as a countervailing force against the current growth momentum.
- The yield curve flattened about 80% of the time.
- Equity markets were most often higher over the coming year, generally outperforming bonds but also generating below-average returns.

It is often easier to predict the direction of the economy than to forecast exactly how markets will react to a change in economic momentum. That said, we try to understand how markets have reacted in the past to help inform our views. If we are correct, and PMI data (or leading indicators more broadly) are near an inflection point, the odds would favor portfolio positioning that reflects some of these historical trends.

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[2] Empirical Research Partners, "A Hot PMI: Ride It or Rotate the Other Way?" *Portfolio Strategy* (March 2017).

Appendix

Table 1: Equity Market Snapshot
(total returns in U.S. dollars; through March 21, 2017)

	Total Returns		
	Month to Date	Quarter to Date	Year to Date
S&P 500®	-0.70%	5.20%	5.20%
Small Cap (Russell 2000)	-2.79%	-0.52%	-0.52%
S&P 500 Value	-1.86%	2.60%	2.60%
S&P 500 Growth	0.29%	7.50%	7.50%
S&P 500/Industrials - SEC	-1.54%	3.66%	3.66%
S&P 500/Consumer Discretionary - SEC	-0.10%	6.16%	6.16%
S&P 500/Consumer Staples - SEC	0.46%	7.17%	7.17%
S&P 500/Health Care - SEC	-0.28%	8.52%	8.52%
S&P 500/Financials - SEC	-3.53%	1.72%	1.72%
S&P 500/Real Estate - SEC	-2.69%	1.80%	1.80%
S&P 500/Information Technology - SEC	0.93%	10.79%	10.79%
S&P 500/Telecommunication Services - SEC	0.66%	-2.22%	-2.22%
S&P 500/Utilities - SEC	0.46%	7.09%	7.09%
S&P 500/Energy - SEC	-2.27%	-7.85%	-7.85%
S&P 500/Materials - SEC	-0.77%	4.54%	4.54%
MSCI EM (Emerging Markets)	4.02%	13.08%	13.08%
MSCI FM Frontier Markets	3.12%	9.59%	9.59%
MSCI Europe	3.57%	7.02%	7.02%
MSCI China	4.20%	15.22%	15.22%
MSCI Japan	1.67%	6.64%	6.64%

Source: FactSet Research Systems Inc., Hawthorn

Table 2: Fixed Income Market Snapshot
(total returns in U.S. dollars; through March 21, 2017)

	Total Returns		
	Month to Date	Quarter to Date	Year to Date
Bloomberg Barclays US Aggregate	-0.33%	0.54%	0.54%
Bloomberg Barclays Global US Treasury (1-3Y)	-0.04%	0.19%	0.19%
Bloomberg Barclays US Aggregate Government - Treasury (1-5Y)	-0.09%	0.25%	0.25%
Bloomberg Barclays US Aggregate Government - Treasury (5-10Y)	-0.28%	0.57%	0.57%
Bloomberg Barclays US Aggregate Gov - Treasury - Intermediate	-0.15%	0.34%	0.34%
Bloomberg Barclays US Aggregate Government - Treasury - Long	-1.21%	0.72%	0.72%
Bloomberg Barclays US Treasury Inflation Protected Notes (TIPS)	-0.54%	0.77%	0.77%
Bloomberg Barclays US Aggregate Credit - Corp-Investment Grade	-0.55%	0.90%	0.90%
Bloomberg Barclays US High Yield - Corporate	-1.08%	1.82%	1.82%
Bloomberg Barclays US Floating Rate Notes Corporates	0.13%	0.67%	0.67%
S&P Municipal Bond Investment Grade	-0.19%	0.87%	0.87%
S&P Municipal Bond High Yield	-0.76%	2.19%	2.19%
GS Commodity Index	-6.12%	-7.23%	-7.23%
Alerian MLP	-3.93%	1.18%	1.18%

Source: FactSet Research Systems Inc., Hawthorn

Table 3: F/X Market Snapshot
(through March 21, 2017)

Major Currencies	Current	1 Month Earlier	3 Months Earlier
Euro/U.S. Dollar	1.08	1.05	1.04
Australian Dollar/U.S. Dollar	0.77	0.77	0.73
British Pound/U.S. Dollar	1.25	1.25	1.24
U.S. Dollar/Japanese Yen	111.88	113.65	117.70

Source: FactSet Research Systems Inc., Hawthorn