April 2017

Hawthorn Global Market Snapshot

Key Market/Economic Observations

United States

First Signs of a Peak in Leading Economic Indicators; Stocks Stuck in Neutral

- U.S. stocks have paused since the beginning of March, currently sitting 2.4% below the best levels of 2017; up 4.4% year to date.
- The market has had to digest numerous macro developments, including the failure of the American Health Care Act (AHCA), military intervention in Syria, and a rising threat from North Korea.
- Geopolitical risks related to foreign military intervention will likely remain an overhang, but we believe the direct investment implications of such risks are often fleeting and hard to quantify.
- What is clearer, in our view, is the failure of the AHCA will delay progress toward tax reform. President Donald Trump has said he plans to "do health care first," and Treasury Secretary Steve Mnuchin said the August timeframe for tax reform is "not realistic." Why?
  - Leaving the Affordable Care Act (ACA) in place makes a deficit-neutral tax plan harder to achieve, as Congress will be given a baseline tax revenue assumption that includes the current ACA tax revenue.
  - Procedurally, if the 2017 budget resolution is not used to pass a new health care bill through reconciliation (51 senate votes), cross-aisle cooperation would be needed, which we view as another challenge.
- Politics aside, we believe the market is also reacting to a peaking process in the short-term economic cycle. Amid all the macro noise, markets continue to trend very closely with economic data. We are beginning to see evidence that our forecast for a near-term peak in economic data is materializing—regional manufacturing data, Markit PMI data, and Institute for Supply Management (ISM) PMI data were all off their highs based on March/April readings. Although these data remain at healthy levels, the pause in the financial markets seem to reflect at least some trepidation regarding the prospects for a sustained uptick in inflation and growth from current levels.
  - Interest rates are now at their lowest levels we have seen this year (10-year Treasury at 2.18%), and the yield curve continues to flatten (spread between 2-year and 10-year is almost back to pre-election levels).
  - Market expectations for future inflation have come down, and the Consumer Price Index, excluding food and energy, saw its first sequential decline in almost seven years in March.
  - Equity market leadership has clearly shifted in 2017, with large cap outperforming small, growth outperforming value, and cyclical sectors such as Energy, Financials, and Industrials all lagging.
- The Federal Reserve Bank of Atlanta estimates first-quarter U.S. real GDP growth was less than 0.5%. Our view is that first-quarter growth likely *under*estimates the underlying trend, but we also believe recent weakness in some key leading economic indicators could persist and serve as a lingering headwind to additional market momentum.
- On the positive side, investors should take comfort in the fact that stocks have remained quite resilient in the face of some potentially more significant stumbling blocks. We also believe that earnings in the first quarter should

be a bright spot, and our business cycle analysis would indicate that a recession is unlikely in the coming 12–18 months.

- Given higher-than-average valuations, we expect this environment to produce modest equity returns, with the potential for a pullback if our read on the shorter-term business cycle proves accurate.

Europe

Brexit Officially Begins; U.K. Snap Elections; and Weaker Inflation

- As expected, Article 50 of the Treaty of the European Union (EU) was triggered at the end of March, initiating the U.K.'s formal withdrawal process from the EU.
- Negotiations will now begin between the United Kingdom and EU regarding their political and economic relationship after the United Kingdom officially exits the union. The exit timeline is likely two years.
- PNC's international economics team believes Brexit's economic impact is highly uncertain, but more likely negative than positive.
- U.K. Prime Minister Teresa May surprised markets by announcing a "snap" election to be held June 8. The proposed early election would push the next scheduled election to 2022, avoiding any overlap with what will likely be the height of the two-year Brexit negotiations.
- In terms of central bank policy, the March inflation report shows no sign of a rising trend in Eurozone inflation; February's spike in HICP inflation was due to fluctuations in energy and food prices and the exchange rate, not to domestically generated price pressures, according to the PNC international economics team.
- The Eurozone's current inflation data do not meet European Central Bank President Mario Draghi's bar for justifying a withdrawal of stimulus. In January he stated that for policy to change, inflation must be (1) expected to be higher over the medium term, rather than just in the present; inflation must rise (2) durably, not transiently; faster inflation must be (3) self-sustained and expected to continue even with monetary stimulus withdrawn; and higher inflation must be expected (4) across the whole of the Eurozone and not just in a few pockets of strength (source: PNC international economics team email, March 31, 2017).
- The first round of the much-anticipated French election will take place on April 23. Polling suggests it will be a tight race, but it appears as though we will see Marine Le Pen (right-wing populist/eurosceptic) versus Emmamuel Macron (more moderate independent).
- A Le Pen win would likely rattle markets, although we believe it would be hard for her to actually withdraw from the EU given the ultimate need for parliamentary support.
- Given the more cyclical nature of European equity index composition, we still favor U.S. stocks as we move into second-quarter 2017.
- Although European equities (and developed international equities more broadly) maintain relatively more attractive valuations, our view that we could be seeing a peaking process in the shorter-term economic cycle keeps us somewhat cautious.
- That said, within international equity portfolios, we favor Europe over other markets given what we believe to be relatively stable fundamentals and the prospects for markets to be positively surprised (or at least relieved) by certain election outcomes.

China

Growth Surprises to the Upside

- Real GDP advanced 6.9% year over year in first-quarter 2017, up from 6.8% in the prior quarter. Nominal GDP also grew at the fastest pace in five years.
- Nominal GDP and credit grew at roughly the same rates in the first quarter, ending a long period in which credit growth outpaced that of economic output. If this single period observation becomes a sustainable trend, concerns about the sustainability of China's

growth trajectory will seem less urgent, in our view. However, China's fiscal deficit is still very large.[1]

- After 6.9% real GDP growth in the first quarter, the PNC Economics team's forecast for real GDP to grow only 6.5% in all of 2017 looks conservative, but it could still be on target if China aims to reduce its fiscal deficit.[2]
- The People's Bank of China continues to move rates higher in order to stem capital outflows as they guide the currency lower. Strength of the currency, capital outflows, and foreign currency reserve levels will remain an ongoing concern that could stress global markets if mismanaged.
- On balance, we believe growth will slow in the coming quarters which could exert some downward pressure on commodities and Chinese import demand. However, the downside appears to be less pronounced than some market participants had previously feared.

Japan

Recent Data Signal Little Need for a Change in Monetary Policy

- Nominal income growth in Japan remains sluggish, and is likely not fast enough to push trend inflation back toward the Bank of Japan's 2.0% target.
- Therefore, we see little risk of a hawkish shift in Japanese monetary policy in the near future.
- This should keep pressure on the yen, in turn serving as a tailwind for Japanese stocks. The daily correlation between the yen and the Nikkei 225 has been -0.96 over the past 5 years.
- That said, the exact opposite has materialized thus far in 2017. In fact, safe-haven assets such as gold, U.S. Treasuries, and the yen have all rallied. The yen has gained almost 8.0% versus the U.S. dollar from its postelection low.
- This subtle shift toward traditional safe-haven assets could be due to recent geopolitical worries and/or a growing concern regarding growth expectations.
- Whatever the underlying cause, if demand for the yen continues, Japanese stocks will likely find it difficult to regain momentum.

Energy

Oil Prices Bounce Off 2017 Lows; Rising U.S. Production Keeps a Lid on Prices

- West Texas Intermediate crude oil prices have recovered from March levels where prices dipped into the high $40s per barrel.
- Geopolitical concerns, seasonal factors (entering peak driving season), and further production cut rhetoric from OPEC have helped support oil markets in the near term.
- However, even as U.S. crude inventories fell by 840,000 barrels the week of April 14, stockpiles remain near record levels.[3]
- The U.S. oil rig count continues to rise, now up 113.0% from the lows of mid-2016.
- Our view is that production levels in the United States remain robust, likely keeping prices near $50–55 in the near term.
- The initial public offering (IPO) of Saudi Arabia's crown jewel, Saudi Aramco, adds an interesting wrinkle, in our view. It is likely in the interest of the Saudis to boost oil prices prior to the IPO. We believe this is perhaps the motivation behind their eagerness to extend OPEC cuts past the current June 2017 deadline, as well as their current overcompliance related to monthly cut quotes.

Hawthorn Strategy Views

A Familiar Pattern in Fixed Income

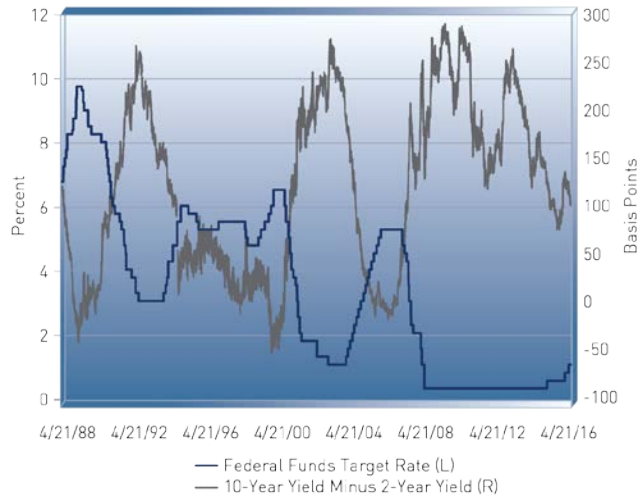
Coming into 2017, many investors made the assumption that rising inflation and higher growth

[1] PNC Economics, *International Economics Report*, April 17, 2017.
[2] Ibid.
[3] Data from the American Petroleum Institute.

expectations, along with a Federal Reserve (Fed) poised to tighten policy, would steepen the yield curve. What has happened, in fact, is the opposite. After peaking at 135 basis points (bps) on December 22, 2016, the spread between 10-year and 2-year Treasury bonds has steadily declined and now sits at 103 bps.

Perhaps the recent trend should not come as such a surprise given that when the Fed increases its policy rate, the curve typically flattens (Chart 1).

Chart 1
Yield Curve versus Federal Funds Target Rate
As of 4/19/17



Source: Bloomberg L.P., Hawthorn

Our read on the environment from our first-quarter 2017 *Strategy Insights:*

> *This is an atypical tightening cycle, but as we mentioned in our first-quarter 2016 Strategy Insights, it is worth noting that in all nine previous tightening cycles the yield curve has flattened in response. If growth and inflation expectations surprise to the upside, that could possibly translate into a steeper yield curve. However, in that scenario, it is also possible the Fed would be forced to raise interest rates more quickly, increasing the likelihood of a bear-flattening scenario (in which short rates rise faster than longer rates leading to a flatter yield curve) toward the end of 2017. In a scenario where the Fed chooses to allow growth and/or inflation to exceed forecasts without following an expedited tightening path, the curve would likely continue to steepen. This would become the biggest risk to our neutral duration positioning, as longer-dated rates would end up rising much more quickly than we currently anticipate. That said, we think longer rates have already adjusted to growth and inflation targets that may not come to fruition, which could lead to yields retracing their steps a bit, or at least slow some of the upward momentum we have seen.*

With the first quarter of 2017 now behind us, our view is that long rates did in fact adjust to growth expectations that may not materialize as quickly as markets had originally anticipated, leading to a retracement year to date. Shorter rates appear to be well anchored by the anticipated path of Fed interest rates hikes (the 2-year Treasury yield is essentially flat since December 22, 2016). However, longer-dated yields have been pressured as investors reassess the near-term growth outlook amid soft first-quarter growth and a policy agenda that has suffered some setbacks (the 10-year Treasury yield fell from 2.55% to 2.20% over the same period).

Given our view that we may be at an inflection point in the short-term term economic cycle, with leading economic indicators exhibiting some signs of peaking, the question now is whether weaker data and a stalling stock market will derail the Fed's forecasted policy trajectory. According to an analysis by Cornerstone Macro, the Fed is unlikely to be deterred by current conditions for the following three key reasons:[4]

- Weakness in equities and economic data are not dramatic at this stage.
- Financial conditions have not tightened significantly (that is, credit spreads, the U.S. dollar, and other variables).
- The Fed is now biased toward normalizing policy, and the economy can likely withstand a gradual move higher in interest rates.

[4] Cornerstone Macro, "Weaker Data and Weaker Stock Market: The Impact on Fed Policy," April 17, 2017.

We believe the Fed would take a pause if conditions declined materially, but our base case is still for two additional rate hikes in 2017. Given our view the economy will continue to grow at a slow pace, this likely means a bias toward curve flattening. The primary implication for bond portfolios is we still believe intermediate exposures will fair best. If long rates were to drift back below 2.0%, we would reassess our duration exposure.

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Appendix

Table 1: Equity Market Snapshot
(total returns in U.S. dollars; through April 19, 2017)

	Total Returns		
	Month to Date	Quarter to Date	Year to Date
S&P 500®	-0.94%	-0.94%	5.07%
Small Cap (Russell 2000)	-1.32%	-1.32%	1.11%
S&P 500 Value	-1.44%	-1.44%	1.81%
S&P 500 Growth	-0.52%	-0.52%	7.97%
S&P 500/Industrials - SEC	-0.67%	-0.67%	3.86%
S&P 500/Consumer Discretionary - SEC	-0.42%	-0.42%	7.99%
S&P 500/Consumer Staples - SEC	1.18%	1.18%	7.62%
S&P 500/Health Care - SEC	-0.92%	-0.92%	7.38%
S&P 500/Financials - SEC	-3.03%	-3.03%	-0.58%
S&P 500/Real Estate - SEC	2.69%	2.69%	6.32%
S&P 500/Information Technology - SEC	-1.06%	-1.06%	11.37%
S&P 500/Telecommunication Services - SEC	-0.03%	-0.03%	-4.00%
S&P 500/Utilities - SEC	0.73%	0.73%	7.17%
S&P 500/Energy - SEC	-2.96%	-2.96%	-9.44%
S&P 500/Materials - SEC	-1.38%	-1.38%	4.40%
MSCI EM (Emerging Markets)	-0.47%	-0.47%	10.96%
MSCI FM Frontier Markets	0.38%	0.38%	9.46%
MSCI Europe	-0.77%	-0.77%	6.78%
MSCI China	0.00%	0.00%	12.93%
MSCI Japan	-0.54%	-0.54%	4.07%

Source: FactSet Research Systems Inc., Hawthorn

Table 2: Fixed Income Market Snapshot
(total returns in U.S. dollars; through April 19, 2017)

		Total Returns	
	Month to Date	Quarter to Date	Year to Date
Bloomberg Barclays US Aggregate	1.10%	1.10%	1.93%
Bloomberg Barclays Global US Treasury (1-3 Y)	0.25%	0.25%	0.52%
Bloomberg Barclays US Aggregate Government - Treasury (1-5 Y)	0.50%	0.50%	0.89%
Bloomberg Barclays US Aggregate Government - Treasury (5-10 Y)	1.43%	1.43%	2.32%
Bloomberg Barclays US Aggregate Government - Treasury – Inter.	0.78%	0.78%	1.33%
Bloomberg Barclays US Aggregate Government - Treasury - Long	2.96%	2.96%	4.40%
Bloomberg Barclays US Treasury Inflation Protected Notes (TIPS)	0.54%	0.54%	1.81%
Bloomberg Barclays US Aggregate Credit - Corp - Investment Grade	1.35%	1.35%	2.59%
Bloomberg Barclays US High Yield - Corporate	0.41%	0.41%	3.12%
Bloomberg Barclays US Floating Rate Notes Corporates	0.08%	0.08%	0.79%
S&P Municipal Bond Investment Grade	1.07%	1.07%	2.40%
S&P Municipal Bond High Yield	1.51%	1.51%	4.20%
GS Commodity Index	-0.58%	-0.58%	-5.60%
Alerian MLP	-1.53%	-1.53%	2.36%

Source: FactSet Research Systems Inc., Hawthorn

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Table 3: F/X Market Snapshot
(through April 19, 2017)

Major Currencies	Current	1 Month Earlier	3 Months Earlier
Euro/U.S. Dollar	1.07	1.07	1.06
Australian Dollar/U.S. Dollar	0.75	0.77	0.75
British Pound/U.S. Dollar	1.28	1.24	1.23
U.S. Dollar/Japanese Yen	108.99	112.67	115.30

Source: FactSet Research Systems Inc., Hawthorn