June 2017

Hawthorn Global Market Snapshot

Key Market/Economic Observations

United States

Fed in Focus; Technology Stumbles

- The outcome of the June Federal Reserve (Fed) meeting was almost entirely as we expected.
    - The federal funds rate was increased by 25 basis points (bps).
    - The Fed's rate forecast, as presented in the "dot plot," was largely unchanged, with a small downward revision (from 3.0% to 2.9%) in 2019.
    - The Fed indicated it will likely begin to shrink the balance sheet "this year."
- Although Fed Chair Janet Yellen recognized a softening in inflation, her comments indicate to us the expectation of an additional interest rate increase in 2017.
- The bond market's reaction was somewhat counterintuitive, with the 10-year Treasury yield falling to 2.15%. Our view is investors may be responding to the Fed's acknowledgment of below-target inflation while making the assumption this condition may not be as transitory as the Fed statement may suggest.
- Given our view that macro momentum from a cyclical acceleration in global growth may have peaked, we do not believe an additional rate increase this year is a foregone conclusion. It is clear that the Fed's intention is to continue on a path toward tighter policy; however, economic stability will likely be a critical element of the Fed's ability to execute this plan.
- Our view is that the Fed's balance sheet contraction will ultimately be a very slow process, with the Fed going to great lengths to avoid a market disruption.
- We think the impact on interest rates and the slope of the yield curve will be small. Estimates suggest the Fed's balance sheet expansion led to 100 bps of term premium compression. If we assume the balance sheet shrinks $1.6 trillion over the next five years,[1] it could result in a term premium increase of only 9 bps per year.
- Treasury auctions have been 2.5 to 3 times oversold, so it is likely the market can absorb the additional supply.
- The market provided ammunition for both risk-on and risk-off camps this month.
    - Risk-on: Financials are acting better even in the face of lower yields; the dollar is starting to firm again; gold is coming off recent highs; and industrials are outperforming.
    - Risk-off: The yield curve continues to flatten; oil has weakened further; and there has been a significant reversal in Information Technology stocks.
- We believe the Information Technology sector was due for a pullback, but the medium-term outlook for growth sector equities is still favorable. The Information Technology sector was trading 13% above its 150-day moving average and has still not revisited that smoothing mechanism for 235 trading days. In that regard, we could see additional short-term pressure on the sector; however, we still believe the sector can outperform throughout the completion of this business cycle, despite generally stretched valuations.
- Our overall market view remains largely unchanged—we are not yet at the end of the current business cycle and bull market.

[1] Estimates put forth by Cornerstone Macro.

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However, we are likely in the latter stages of both, and volatility may pick up as leading indicators of the economy soften. For now, we favor trends more representative of the risk-off variety, including a flatter yield curve, persistently low interest rates, and a continuation of the type of defensive equity market leadership we have seen year to date.

Europe

Economic Expansion Continues; U.K. Snap Elections

- The Eurozone economy expanded 1.9% year over year in the first quarter of 2017, the fastest growth in two years.
- Positive trends in employment data reinforce the idea that the Eurozone is growing above trend and should no longer be considered an economy in crisis.[2]
- If recent growth trends continue, the European Central Bank (ECB) may begin a glacially slow tapering of its quantitative easing (QE) program in early 2018.
- According to PNC economists, if the ECB waits "well beyond the horizon" of the conclusion of QE to initiate an increase in its benchmark interest rate, a policy rate hike is unlikely before 2019.
- A backdrop of increased economic stability and a central bank likely to withdraw stimulus very slowly should be positive for European equities, in our view.
- That said, European stocks have been consolidating since the beginning of May (and are comparatively more vulnerable to any deterioration in global growth versus the United States), so we continue to look at credit markets for signs of more material strain. To date, high yield spreads in Europe are at multiyear lows, and we remain overweight Europe within international equity allocations.
- In the United Kingdom, Prime Minister Theresa May's Conservative party underperformed in the recent snap elections, resulting in a hung Parliament.
- Our view is the election results will create additional uncertainty surrounding Brexit negotiations (U.K. market/currency unfriendly). However, longer term this likely means a "softer" Brexit is more probable (U.K. market/currency friendly).

China

Data Mixed in May, but a Slowdown Is Still Unfolding

- During May, certain measures of the economy such as credit growth and PMI surveys continued to slow. However, there was stabilization in industrial production and retail sales data.
- Economic activity in China is by no means collapsing, but the government has pulled back on certain stimulus efforts that were important drivers of the global reflation trade in 2016. On balance, we expect economic activity in China will continue to slow.
- We believe it is important to monitor the degree to which Chinese economic data moderate because trends in Chinese economic activity historically have been significant influences on both interest rates and inflation globally.
- In general, emerging market (EM) equities have been very strong in 2017 (up 17.6%). We believe persistently low U.S. interest rates and a weaker dollar have been key catalysts for this continued outperformance.
- EM economies and earnings growth also stabilized in 2016, but we believe tailwinds from these areas are much diminished, and that share prices have decoupled from fundamentals—aggregate EM manufacturing PMI has rolled over; EM currencies have not

[2] William Adams, PNC Senior International Economist, Market Update, June 14, 2017.

been affected by falling commodity prices (very unusual); and net earnings revisions are now negative.

- Our view is that EM equities provide a better opportunity for higher long-term returns because of more attractive valuations (EM stocks are up 8% since 2010 versus U.S. stocks up 125%), but it may only be a matter of time before certain fundamentals reassert themselves, leading to a near-term pullback.

Japan

Muted Wage Growth and Inflation; Equity Markets Try to Gather Momentum

- First-quarter GDP was revised down to 1.0% annualized growth from the 2.2% preliminary reading. Consensus looked for an upward revision to 2.4%.
- Wage growth was also sluggish, even amid a tight labor market.
- This backdrop continues to promote inflation trends that are well below the Bank of Japan's (BOJ) 2.0% target.
- As a result, Japan's quantitative and qualitative easing programs are likely to continue well into the future. It is possible the BOJ slows its asset purchases, but this seems only likely if a scarcity of government bonds means that interest rates can be held at current levels with fewer purchases.
- Japanese equities have tried to gather momentum in 2017, even in the face of a strengthening yen. The Nikkei recently made a 17-year high in U.S. dollar terms and continues to make a trend change higher after a multidecade bear market.
- Strength in the currency could eventually be problematic for Japanese equities, but the continued action by the BOJ will likely support risk assets in the region even though economic fundamentals remain challenged. Investors sold $10 billion (net) of Japanese equities in the first quarter, which leaves room for a reversal in fund flows.

Energy

Price Pressure Persists

- Efforts by OPEC to balance the supply and demand dynamics of the crude oil market have been muted by resilient U.S. shale producers.
- Even as OPEC members have agreed to extend production cuts another nine months, Brent crude oil has fallen 13%.
- According to data from the International Energy Agency, non-OPEC supply will grow faster than demand in 2018. This means U.S. shale will likely continue to exert downward pressure on energy prices.
- Technology continues to advance amid U.S. shale producers, and productivity gains are likely to push breakeven price levels lower in the coming years.
- Goldman Sachs estimates that with reasonable productivity gain forecasts, a number of large shale production hubs can push their breakeven price below $40 per barrel by 2020, with overall production not peaking until 2030.[3]

Hawthorn Strategy Views

Thinking About the Next Recession

In today's world of heightened political tensions, geopolitical risks, and financial market skepticism, negativity seems more prevalent than a rosy outlook of the future. Quite frankly, this is often the case when it comes to making predictions about the economy and financial markets. Explaining the myriad risks that exist and demonstrating a skeptical point of view is much more likely to garner people's undivided attention compared to painting a picture of *everything is going to work out*...even if the latter is the more probable outcome. "Pessimism can be hard to distinguish from critical thinking and is often taken more seriously than optimism, which

[3] Goldman Sachs Global Investment Research.

can be hard to distinguish from salesmanship and aloofness."[4] Even as the Great Financial Crisis approaches its 10-year anniversary, the pain is still fresh in investors' minds. Because the trauma of 2008 is so easy to recall, being negative about the future can be more intellectually satisfying. It may even be that a more pessimistic forecast is accurate from time to time, but our world (financial markets included) has a long history of adapting to short-term adversity with largely successful long-term outcomes.

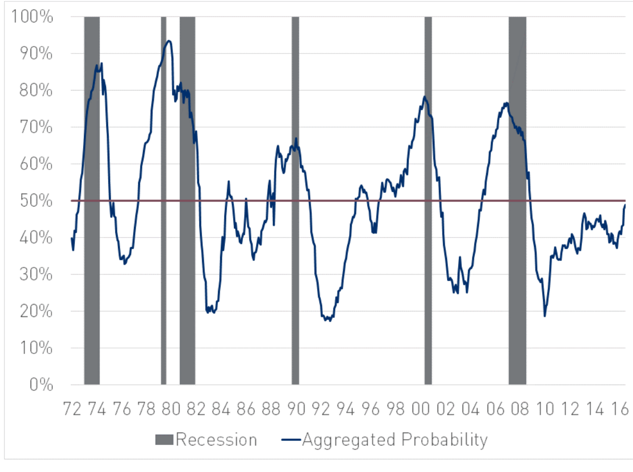
So how does this philosophical discussion apply to our current view of the world? As described above, we often find it easy to talk about things such as high debt levels, extended valuations, and pervasive political risk. We believe these variables are extremely important to consider when investing, and they may even skew the risk/reward balance toward risk in today's market. We also think cyclical global macro-economic momentum is beginning to slow, and that could lead to near-term market volatility. That said, we think it is important to fight the urge to get too negative too soon. The current business cycle (and bull market) may be in its later stages, but we believe there is still time on the clock.

Our recession indicator (a combination of about a dozen economic and financial market variables) has served as a useful warning tool since the early 1970s. As seen in Chart 1, once the 50% probability of recession threshold is breached, on average the economy enters a recession eight quarters later. Although we are steadily trending higher, now at 49%, we have yet to start the eight-quarter countdown.

Although the current expansion is the third longest in the postwar era, old age is never the root cause of an economic contraction. Two things usually lead to slower growth: Fed tightening and/or economic imbalances. The Fed's June meeting confirmed to us that the Fed intends to continue tightening monetary policy. The question is, how much tightening can take place before having an adverse effect on growth? Data from Fed researchers Thomas Laubach and Kathryn Holston suggest the real neutral rate of interest is 0.4%, meaning if interest rates increase in line with the Fed's dot-plot forecast, policy will become restrictive by early 2019.[5] Assuming rates affect the economy with a lag, we have time before the next recession.

As we suggest, there are always data points that may indicate "the end is near." The flattening of the yield curve in 2017 is currently among the most popular. However, a flattening yield curve alone is not a threat, and it has historically been associated with rising stock prices and continued economic growth.[6] According to Oppenheimer, "we see below-average recession risk until the curve inverts. As it stands, the direction and the level of the yield curve is on par with the mid-1990s and the mid-2000s—prior bull market periods."[7] Many years can pass before a flat curve turns inverted, and the current flattening may be more indicative of global central bank policy (that is, term premium) than a clear indictment of medium-term growth prospects.

Chart 1
Recession Probability - Aggregate - Monthly



Source: FactSet Research Systems Inc., Hawthorn

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[4] Morgan Housel, "The Seduction of Pessimism," June 13, 2017.
[5] BCA Research, Global Investment Strategy, "The Timing of the Next Recession," June 16, 2017.
[6] Josh Brown, "The Reformed Broker: Flattening Is Not Threatening," June 18, 2017.
[7] Oppenheimer & Co., "Technical Analysis: Inflection Points," June 17, 2017.

To be clear, we believe the business cycle is in its later stages, and certain economic imbalances are starting to emerge—consumer credit is rising, student loan debt is soaring, and auto loans are back to pre-2008 levels. This is leading to higher default rates even amid low levels of unemployment. Once the unemployment rate begins to rise, it is usually only a matter of time before a recession. In fact, when the three-month moving average of the unemployment rate has risen by one-third of a percent, the United States has never escaped a recession in the postwar period.[8] An argument can be made that the current unemployment rate underestimates the actual slack in the labor market, but various measures suggest labor market slack is generally similar to levels seen during the later stages of previous cycles. The current state of economic imbalances, however, is not as dramatic compared to the last few recessions. As a result, the next recession may not be particularly deep.

However, we continue to believe valuations are stretched to the point where the impact on asset prices may be disproportionally large versus the impact on the actual economy. For now, however, we believe the current cycle can continue.

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[8] BCA Research, “Global Investment Strategy. The Fed’s Dilemma,” May 12, 2017.

Appendix

Table 1: Hawthorn Asset Allocation Playbook (as of 5/31/17)

Asset Class	Sub Asset Class	Favorability –			Neutral			+	Points of View
Equities				●					
U.S.	Large Cap					●			Relative valuation and vulnerability to overall market volatility cause us to favor mid and large over small; especially when considering the magnitude of small cap outperformance in 2016. That said, if we start to see tangible momentum on the policy front, small-cap companies may enjoy an outsized benefit from changes in tax rates and regulation.
	Mid Cap					●			
	Small Cap			●					
Non-U.S.	Intl. Large/Mid Cap				●				Even though developed international valuation multiples are about flat year over year and appear relatively more attractive versus domestic equities, we see more potential risks and disruptions and relatively fewer positive growth catalysts in the coming year.
	Intl. Small Cap			●					
	Emerging Markets		●						Fundamental pressures stemming from slowdown is China, falling commodity prices, negative earnings-per-share revisions.
Fixed Income				●					
U.S.	Short Muni Fixed Income			●					With the possibility of longer-term rates remaining range-bound, we favor intermediate-duration fixed income. To date, core fixed income has outperformed short, and we believe this trend will persist for the balance of 2017.
	Core Muni Fixed Income				●				
	U.S. High Yield			●					Overall credit conditions remain favorable, but credit spreads are tight, leaving high yield less room to outperform.
	U.S. Leveraged Loans				●				Perhpaps more attractive than high yield given their place higher in the capital structure and protection from rising rates.
	U.S. TIPS				●				A reasonable hedge if inflation overshoots current expectations; however, that is not our base case forecast.
Non-U.S.	Global Bond				●				
	Unconstrained Bond						●		Flexibilitty 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						●		
	Private Debt					●			
	Private Equity							●	
Hedge Funds	Equity Long/Short					●			Can generate outperformance in a market where the overall risk/reward balance may be skewed toward risk. Equity market correlations are falling, and the removal of extreme monetary policy accommodation, which compressed the cost of capital across the quality spectrum, should help swing the performance pendulum back in favor of certain hedge fund strategies. However, should the market move steadily higher with little volatility, these allocation will likely underperform.
	Event Driven					●			
	Relative Value					●			
	Directional					●			
Cash						●			
Tactical Allocations						●			
Tactical	Master Limited Partnerships				●				Massive headwind from oil price drop appears gone; valuation is not nearly as stretched versus other yield-oriented areas of the market.
	Infrastructure				●				We still like the long-term theme, but valuation is a headwind.
	Currency Hedged Europe					●			The dollar may not appreciate to the extent it did in 2016; still hard to make the case that it will weaken dramatically, in our view.
	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.

Source: Hawthorn

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Table 2: Equity Market Snapshot
(total returns in U.S. dollars; through June 19, 2017)

	Total Returns		
	Month to Date	Quarter to Date	Year to Date
S&P 500®	0.99%	3.46%	9.74%
Small Cap (Russell 2000)	2.75%	1.76%	4.27%
S&P 500 Value	2.09%	1.70%	5.04%
S&P 500 Growth	0.11%	4.94%	13.90%
S&P 500/Industrials-SEC	2.46%	5.84%	10.66%
S&P 500/Consumer Discretionary-SEC	-0.72%	2.84%	11.53%
S&P 500/Consumer Staples-SEC	-0.42%	3.47%	10.05%
S&P 500/Health Care-SEC	2.51%	4.94%	13.73%
S&P 500/Financials-SEC	4.82%	2.68%	5.27%
S&P 500/Real Estate-SEC	2.64%	3.48%	7.15%
S&P 500/Information Technology-SEC	-2.05%	4.84%	18.02%
S&P 500/Telecommunication Services-SEC	0.88%	-3.41%	-7.24%
S&P 500/Utilities-SEC	1.35%	6.47%	13.28%
S&P 500/Energy-SEC	2.13%	-4.19%	-10.60%
S&P 500/Materials-SEC	2.25%	3.57%	9.64%
MSCI EM (Emerging Markets)	-0.05%	5.20%	17.28%
MSCI FM Frontier Markets	0.36%	5.96%	15.56%
MSCI Europe	-0.52%	8.32%	16.56%
MSCI China	0.48%	8.62%	22.66%
MSCI Japan	1.52%	5.68%	10.58%

Source: FactSet Research Systems Inc., Hawthorn

Table 3: Fixed Income Market Snapshot
(total returns in U.S. dollars; through June 19, 2017)

	Total Returns		
	Month to Date	Quarter to Date	Year to Date
Bloomberg Barclays US Aggregate	0.30%	1.86%	2.69%
Bloomberg Barclays Global US Treasury (1-3 Y)	-0.04%	0.23%	0.50%
Bloomberg Barclays US Aggregate Government-Treasury (1-5 Y)	-0.01%	0.56%	0.95%
Bloomberg Barclays US Aggregate Government-Treasury (5-10 Y)	0.33%	2.11%	3.01%
Bloomberg Barclays US Aggregate Government-Treasury-Inter.	0.10%	1.04%	1.58%
Bloomberg Barclays US Aggregate Government - Treasury - Long	1.43%	5.03%	6.50%
Bloomberg Barclays US Treasury Inflation Protected Notes (TIPS)	-0.71%	-0.17%	1.09%
Bloomberg Barclays US Aggregate Credit-Corp.-Investment Grade	0.61%	2.85%	4.11%
Bloomberg Barclays US High Yield-Corporate	0.22%	2.26%	5.02%
Bloomberg Barclays US Floating Rate Notes Corporates	0.11%	0.45%	1.16%
S&P Municipal Bond Investment Grade	0.12%	2.20%	3.54%
S&P Municipal Bond High Yield	-0.01%	1.69%	4.38%
GS Commodity Index	-4.12%	-7.58%	-12.25%
Alerian MLP	-3.67%	-9.20%	-5.62%

Source: FactSet Research Systems Inc., Hawthorn

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Table 4: F/X Market Snapshot
(through June 19, 2017)

Major Currencies	Current	1 Month Earlier	3 Months Earlier
Euro/U.S. Dollar	1.12	1.11	1.07
Australian Dollar/U.S. Dollar	0.76	0.74	0.77
British Pound/U.S. Dollar	1.28	1.29	1.24
U.S. Dollar/Japanese Yen	110.68	113.01	113.02

Source: FactSet Research Systems Inc., Hawthorn