July 2017

Hawthorn Global Market Snapshot

Key Market/Economic Observations

United States

Stocks March Higher Despite High Profile Policy Failure

- Equity markets took the failure of a new health care bill surprisingly in stride, although more muted policy expectations appear to be affecting the market under the surface—sector/style leadership, interest rates, and currencies all appear to reflect less confidence in the administration's ability to move certain pro-growth policies forward.
- With health care reform basically off the table for now, we believe the administration's focus needs to rapidly shift to tax reform.
- Some investors have highlighted the revenue neutrality restriction in the current House budget proposal as a death-knell for material tax cuts this year or next. Conversely, other investors believe policy makers already have plans to work around this restriction.
- As a reminder, if a proposed tax bill is not revenue neutral, it fails the reconciliation test and would require 60 senate votes (not 51), meaning it would be dead-on-arrival.
- Congress may be planning to change the current baseline by which revenue neutrality is measured for fiscal 2018. If successful, policy makers could push through a fairly large tax cut and still remain within the strict budget parameters.
- There are multiple paths forward and, as such, it is still quite difficult to determine what the market has already priced in at this juncture.
- As policy expectations continue to unwind, the dollar has materially weakened. In our view, this is most advantageous for the United States and emerging markets while serving as a headwind to regions such as Europe and Japan.
- From a technical perspective, the dollar is still weak; however, its divergence from its 200-day moving average is approaching oversold levels.
- If the Federal Reserve (Fed) follows its currently projected tightening path or if we eventually see progress in Washington, we think the dollar would likely reverse course and strengthen.
- Finally, markets experienced a cyclical rotation in June that included the outperformance of financials, small capitalization stocks, and value stocks, along with rising interest rates, a steeper yield curve, and sharp positive reversals in manufacturing data.
- We believe this rotation represents a counter-trend rally that seems unsustainable based on our proprietary business cycle analysis. In recent weeks, we have already seen some of this rotation unwind: financials have underperformed, rates have fallen, and the curve has started to flatten again, while large cap and growth equities have resumed their leadership positions.

Europe

Taper Tantrum 2.0?

- European Central Bank (ECB) President Mario Draghi's June 27 acknowledgment that the tapering of central bank asset purchases (quantitative easing, or QE) is being contemplated given better economic data in the region has led to a significant increase in European interest rates.
- In short, Mr. Draghi said if the economy keeps improving, the ECB will taper QE. Otherwise, maintaining the current level of asset purchases would, in effect, make policy too accommodative amid stronger fundamentals.

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- We do not believe the current pace of yield increases in Europe is sustainable. However, interest rates seem likely to continue rising over time. We explore this topic further in the Strategy Views section on page 3.
- Broadly, we believe the policy environment will not become overly restrictive in the near term, and the growth backdrop coupled with relatively attractive valuations help support our favorable near-term view of European equities.

China

Better Than Expected June Data, but Soft Landing Still Our Base Case

- Real GDP growth held steady at 6.9% year over year for the second quarter—unchanged from the first quarter and slightly ahead of consensus. Nominal GDP growth fell, mostly a result of weaker global energy prices and recent inflation trends.
- However, several other key indicators reaccelerated. Industrial production growth picked up from 6.5% in May to 7.6% year over year, and retail sales increased 30 basis points (bps) to 11.0%. According to the PNC Economics team, dollar-denominated goods imports grew 16.3% year over year while exports grew 9.1%.
- A rapid re-acceleration in government spending (to +10% year over year) has been the main driver for better data (following late 2016/early 2017 tightening efforts), with China trying to support economic growth leading up to its fall Congressional meeting.[1]
- Government spending has been largely concentrated in the consumer/service-oriented sectors, including social security, employment, low income housing, education, and health, which in our view does not have the same "bang for the yuan" as infrastructure/transportation, for example.
- Unfortunately, China has not yet mastered the art of smooth adjustments to its economy. To us, these efforts feel a bit like jamming on the brake, then jamming on the accelerator, and so on.
- We do not believe this near-term fiscal stimulus will be enough to support a sustainable, broad-based acceleration in growth for long, particularly since financial/credit and housing market-related reforms are still a focus for the Chinese government.
- In general, emerging market (EM) equities continue to be strong in 2017, up 19.2%. We believe persistently low U.S. interest rates and a weaker dollar have been the key catalysts for this outperformance, but we do not expect this level of performance to be sustainable. Consequently, we are not inclined to chase EM performance and would look for a pullback before becoming more constructive on building out EM portfolio positions.

Japan

Stronger Yen a Headwind, but Monetary Policy Likely to Remain Accommodative

- The yen has strengthened 5% relative to the dollar since the beginning of 2017. Although Japanese equities have returned 10.4% year to date in dollar terms, they have underperformed other international markets.
- GDP is growing above trend, but a sustained firming of inflation will require both wages and prices to move higher to keep pace. As a result of sluggish wage growth and lower yen-denominated oil prices, the Bank of Japan (BOJ) appears likely to lower its inflation projections in the coming weeks.
- The BOJ is still a long way from meeting its policy normalization targets; therefore, we see a long runway for accommodative policy to continue.
- Relatively more attractive valuations compared with U.S. equities help support longer-term-oriented allocations to the region, and the BOJ's

[1] Nancy Lazar, Cornerstone Macro, July 18, 2017.

easy policy stance should help prevent material yen strengthening as the Fed and ECB consider further tightening.

Energy

Oil Prices Range-Bound Below 2017 Highs; Energy Could Be Largest Contributor to Second Quarter Earnings

- Despite bouncing off year-to-date lows of roughly $42.50 per barrel for West Texas Intermediate (WTI) crude, oil prices remain under pressure.
- Notably, U.S. shale producers continue to add to market supply, and Ecuador has publicly stated it intends to increase production, openly disregarding the OPEC production cut agreement.
- We do not believe Ecuador production will have a material impact on global supply, but it does underscore the challenges OPEC is facing in terms of maintaining a cooperative effort to raise prices.
- That said, recent data from the U.S. government have helped ease some fears that prices will fall materially from these levels, with crude and gasoline stockpiles decreasing.
- The Energy sector is expected to report the highest year-over-year earnings growth of all 11 sectors at 357.4%, primarily due to unusually low earnings in the year-earlier quarter.
- On a dollar-level basis, the Energy sector is projected to report earnings of $8.7 billion in second-quarter 2017 compared with just $1.9 billion in the year-earlier quarter. Given this projected $6.8 billion year-over-year increase in earnings, the Energy sector is expected to be the largest contributor to earnings growth for the S&P 500® as a whole. Excluding Energy, the blended earnings growth rate for the remaining 10 sectors would fall from 6.8% to 4.3%.[2]

Hawthorn Strategy Views

Inflation: A Single-Minded Pursuit?

A 2.0% inflation target has been the guiding principal of monetary policy for the ECB for many years. It seems to us, however, there are signs the ECB may be adopting a less dogmatic view on inflation, choosing to also consider the interaction of inflation, economic growth, and the stability of financial market conditions. By his own admission, ECB President Draghi acknowledged the relationship between economic growth and trend inflation has broken down since the sovereign debt crisis. The ECB believes this relationship will revert over time, but the PNC Economics team views lower inflation relative to growth as more of a structural phenomenon.[3]

Regardless of which view ultimately proves correct, the current reality is that inflation is quite a bit below 2.0% (1.3% year over year at the end of June). Still, as recently as its July 20 meeting, the ECB has acknowledged “unquestionable improvement” in the growth outlook while also noting a discussion about tapering asset purchases will take place in the fall. In our opinion, any tapering would likely be extremely gradual, but the ECB is focused on improving growth fundamentals in addition to meeting its inflation goals. We think financial stability is the reason. Sweden’s Riksbank, for example, is in the unusual, and potentially destabilizing, position of having a -0.5% policy interest rate along with robust 4.5% GDP growth, all because it has been unable to meet its inflation target. As a result, the Riksbank has recently suggested using a +/-1.0% band around a 2.0% long-run inflation target.

Some ECB members (namely Governing Council member Ewald Nowotny) have also suggested an easing of the 2.0% inflation goal by setting a range rather than a singular hard target. Reaching 2.0% inflation has been a challenge for many central

[2] All earnings data from FactSet Research Systems Inc.’s *Earnings Insight*, July 14, 2017.
[3] *Global Economic Highlights*, PNC Economics, July 19, 2017.

banks, and some are starting to finally acknowledge that monetary policy driven by just one variable may not be the best way forward.

Why has reaching 2.0% inflation been such a challenge? For starters, 2.0% is somewhat of an arbitrary target, actually suggested at a 1996 Fed meeting by none other than current Fed Chair Janet Yellen. Initially, then Chairman Alan Greenspan argued that a price stability target of 0–1% made more sense. Ms. Yellen, however, argued that near 0% inflation would prevent real yields from going negative at the zero lower bound in the rare event that such policy was required. From that point on, this became the standard for many central banks.

The potential problem with targeting 2.0% inflation is twofold.

- First, based on centuries of data (and as originally proposed by Mr. Greenspan in 1996), 2.0% is not inflation's "natural state." For 700 years, inflation in the United Kingdom averaged near 0%, as an example.[4]
- Second, inflation is a nonlinear occurrence that is difficult to precisely dial up or down. Inflation is often like "...pulling a brick across a table using an elastic band. Initially, the brick doesn't move because of the friction with the table. But at a tipping point the brick does move, and the friction simultaneously decreases, self-reinforcing the brick's acceleration."[5] Like inflation, it is hard to pull that brick across the table at a steady pace. Coaxing inflation from a high level back toward 2.0%, like in the 1990s, may be much easier than what central banks are hoping to accomplish today—pushing inflation away from its near-zero natural state toward 2.0%.

As central banks become more confident in the growth trajectories of their economies, it seems that some may consider relaxing certain inflation requirements. Given the discussion above, we think this is sensible and could help reduce future market distortions. As it relates specifically to the ECB, the central bank seems to be in the early stages of preparing the market for a slow reduction of monetary accommodation, even if inflation continues to fall somewhat short of the ECB's target. In Europe, there are a number of variables in play that will likely affect the near-term trajectory of interest rates as ECB policy evolves.

Factors pushing rates higher include:

- Central bankers will likely continue to discuss tapering in order to prepare markets for eventual action.
- Net bond issuance in certain regions has been very low, so additional future supply could push prices lower and rates higher.
- Rates are compressed (more so than U.S. rates during the Taper Tantrum in 2013), giving them more room to rise.

Factors keeping downward pressure on rates include:

- Central bankers will try to reassure markets that any tapering will be very slow.
- Productivity, economic growth, and the ultimate neutral policy interest rate are still likely to be quite low.
- Rapidly rising inflation is unlikely to force the ECB to tighten quickly.
- Investors often confuse tapering with policy rate increases. Currently, European rates reflect *both* expectations for tapering and faster interest rate increases. As the ECB's policy rate in unlikely to rise for some time, we believe this element of what is being priced into current rates will unwind.

There are numerous implications of an eventual taping of QE worth considering.

- A 10 bps increase in the 10-year German bund would translate into roughly a 3 bps increase in

[4] BCA Research, European Investment Strategy, July 20, 2017.
[5] Ibid.

the 10-year U.S. Treasury yield, all else being equal.[6]

- Tapering could encourage a steeper yield curve across European regions, which would help support areas of the market such as financials.
- Tapering may help encourage additional strength in the euro since there is less of a policy divergence between the U.S. (Fed) and Europe (ECB).

We still believe monetary policy will remain accommodative in Europe for quite some time. Nevertheless, as the ECB considers tightening policy even with inflation below target levels, we think investors should start to consider the possible market impacts. Finally, although hard to predict the if/when scenario, we should not lose sight of the brick analogy. The elastic band is currently having trouble pulling the brick forward, but like the brick, inflation could be subject to an unstable acceleration once enough pressure has been applied. For now, however, we think that risk remains relatively low.

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[6] Roberto Perli, "Another Taper Tantrum in the Making?", Cornerstone Macro, July 18, 2017. Note: This rate relationship is derived from a model of the U.S. term premium as a function of the German term premium and various other variables. The variables tend to control for common factors that affect U.S. as well as German rates. The model says when German term premiums move up independently (that is, not because of common factors but because of Germany-specific factors like ECB tapering), U.S. term premiums move up by less than a third of that (that is, 3 bps per 10 bps in Germany).

July 2017

Appendix

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

	Total Returns		
	Month to Date	Quarter to Date	Year to Date
S&P 500®	2.13%	2.13%	11.67%
Small Cap (Russell 2000)	1.49%	1.49%	6.55%
S&P 500 Value	0.84%	0.84%	5.73%
S&P 500 Growth	3.18%	3.18%	16.93%
S&P 500/Industrials-SEC	0.83%	0.83%	10.41%
S&P 500/Consumer Discretionary-SEC	1.62%	1.62%	12.79%
S&P 500/Consumer Staples-SEC	0.29%	0.29%	8.34%
S&P 500/Health Care-SEC	2.19%	2.19%	18.60%
S&P 500/Financials-SEC	0.61%	0.61%	7.53%
S&P 500/Real Estate-SEC	0.78%	0.78%	7.23%
S&P 500/Information Technology-SEC	5.55%	5.55%	23.74%
S&P 500/Telecommunication Services-SEC	-0.98%	-0.98%	-11.62%
S&P 500/Utilities-SEC	2.53%	2.53%	11.50%
S&P 500/Energy-SEC	0.36%	0.36%	-12.30%
S&P 500/Materials-SEC	2.65%	2.65%	12.11%
MSCI EM (Emerging Markets)	5.40%	5.40%	25.01%
MSCI FM Frontier Markets	1.11%	1.11%	17.17%
MSCI Europe	2.38%	2.38%	18.69%
MSCI China	6.28%	6.28%	32.81%
MSCI Japan	2.04%	2.04%	12.35%

Source: FactSet Research Systems Inc., Hawthorn

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

	Total Returns		
	Month to Date	Quarter to Date	Year to Date
Bloomberg Barclays US Aggregate	0.64%	0.64%	2.93%
Bloomberg Barclays Global US Treasury (1-3 Y)	0.18%	0.18%	0.64%
Bloomberg Barclays US Aggregate Government-Treasury (1-5 Y)	0.27%	0.27%	1.08%
Bloomberg Barclays US Aggregate Government-Treasury (5-10 Y)	0.68%	0.68%	2.82%
Bloomberg Barclays US Aggregate Gov.-Treasury-Intermediate	0.40%	0.40%	1.61%
Bloomberg Barclays US Aggregate Government - Treasury - Long	0.92%	0.92%	6.39%
Bloomberg Barclays US Treasury Inflation Protected Notes (TIPS)	0.46%	0.46%	1.32%
Bloomberg Barclays US Aggregate Credit-Corp.-Investment Grade	1.03%	1.03%	4.86%
Bloomberg Barclays US High Yield - Corporate	0.88%	0.88%	5.86%
Bloomberg Barclays US Floating Rate Notes Corporates	0.16%	0.16%	1.44%
S&P Municipal Bond Investment Grade	0.74%	0.74%	3.94%
S&P Municipal Bond High Yield	0.68%	0.68%	5.06%
GS Commodity Index	0.00%	0.00%	-10.24%
Alerian MLP	0.23%	0.23%	-2.43%

Source: FactSet Research Systems Inc., Hawthorn

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

Major Currencies	Current	1 Month Earlier	3 Months Earlier
Euro/U.S. Dollar	1.17	1.11	1.07
Australian Dollar/U.S. Dollar	0.79	0.76	0.75
Pound/U.S. Dollar	1.30	1.27	1.28
U.S. Dollar/Yen	111.12	111.57	109.09

Source: FactSet Research Systems Inc., Hawthorn