November 2017

Hawthorn Global Market Snapshot

Key Market/Economic Observations

United States

Earnings Continue to Support the Market; Stocks Wobble but Remain Near Record Highs

- Earnings grew 6.1%, the fifth consecutive quarter of positive growth (90% of S&P 500® companies have reported). Revenue growth also beat expectations, up 5.8%, with positive results from every sector excluding Telecommunication Services and Utilities.
- Consensus estimates for full-year 2017 earnings are estimated at 9.6%, given the stellar earnings results in the first half of the year. However, companies likely will be facing more difficult comps in the fourth quarter, and our expectations for 2017 earnings growth remain slightly below consensus, at $126–129, implying mid- to high-single-digit earnings growth.
- The high yield market has shown some signs of stress, recently closing at a seven-month low. The move lower was an accurate signal for a small uptick in volatility in the equity market, but we believe perspective is important: the S&P 500 has broken the record for consecutive trading days without a 1% intraday move (now at 65 days) and remains just below record highs. Although high yield credit spreads have increased, they are still below 400 basis points (bps), which is historically tight, and are only back to levels seen in August. The market experienced similar credit spread widening in March and August of this year, both of which proved largely inconsequential for equity markets. Also, most of the spread widening has been concentrated in the Telecommunication Services and Health Care sectors, not indicative of widespread/systemic credit issues.
- There are a number of provisions in both the House and Senate tax plans that have the potential to significantly affect the market and economy, perhaps none more important than the timing of the corporate tax rate reduction.
- The House bill (passed the week of November 13) provides far more stimulus in the short run compared with the Senate bill. This is largely due to the Senate's decision to delay the corporate tax change until 2019. The impact on earnings and economic growth in 2018 would have to be significantly revised should the corporate tax rate cut be delayed in the final legislation.
- Deregulation continues to be an important theme for the administration and the market. This month, a bi-partisan group of senators reached a deal to lift the Systemically Important Financial Institution (SIFI) designation for banks under $250 billion in assets. This proposal removes a significant regulatory burden from regional banks.
- Both the Producer Price Index (PPI) and the Consumer Price Index (CPI) for October indicated a further widening between the two data sets. PPI growth accelerated to 2.8% while CPI decelerated to 2.0%, and that spread for producer prices is now the highest since 2011. The spread widening seems to be happening to a larger degree with core indexes, which exclude volatile prices such as food and energy costs. This is a development we will continue to monitor as wage growth continues to fall short of expectations this year.
- October industrial production beat expectations, coming in at 2.9% growth year over year. While hurricane reconstruction efforts acted as a tailwind, commodity-linked industries and mining projects grew

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more than expected despite an overall decline in oil rigs for the month. Offsetting those efforts was a drop in motor vehicle production, which has slowed for three consecutive months.

Europe

European Central Bank to Taper Asset Purchases in 2018; Economy Continues to Improve

- On October 26, the European Central Bank (ECB) moved to cut its monthly bond purchases from 60 billion euros to 30 billion euros starting in 2018, extending the program through September. The central bank also reiterated its commitment to keep interest rates at current levels and continue the reinvestment proceeds from maturing asset purchases for the foreseeable future, maintaining the open-ended nature of its quantitative easing (QE) program. While avoiding a similar taper tantrum episode that occurred in 2013, European stocks have declined since the ECB announcement. For example, from the day of the announcement through November 14, country index returns have been as follows: United Kingdom, -1.41%; Germany, -1.91%; Ireland, -2.40%; France, -3.11%; Italy, -3.38%; and Spain, -3.94%.
- For the first time in over a decade, the Bank of England raised its policy rate from 0.25% to 0.5%. The minutes from the monetary policy committee meeting indicated policy makers remained concerned about the U.K. economy and, in particular, the impact from Brexit; however, inflation estimates remain positive.
- European companies reported better-than-anticipated earnings for the third quarter, with 92% of STOXX® Europe 600 index constituents accounted for as of November 16. Sales growth of 5.1% exceeded estimates by 1.6%, and earnings growth of 2.5% bested consensus by 180 bps. The positive surprise was primarily driven by commodity-linked sectors, and while Financials also beat earnings estimates the growth rate was still -18%.
- The European economic confidence index surged to 114 in October, its fifth consecutive monthly increase, with sentiment improving across all sectors.
- Improving sentiment, strong leading indicators, and accelerating growth are likely to spur further improvement in the labor market, which carries additional slack compared with that of the United States. We view this as a positive in the sense that additional capacity expansion is unlikely to spur a troublesome bout of wage inflation for companies. Further, the difference between potential and realized GDP remains below equilibrium at -0.7, indicating room for additional expansion as the spread narrows and eventually closes.

China

A Balancing Act: Growth, Debt, and Leverage

- October economic data were indicative of some slowing of growth in China. Fixed asset investment, retail sales, and factory output all slowed, reflecting the government's effort to curb stimulus.
- Beijing has imposed more stringent pollution controls while also restricting home purchases in some of China's big cities. Now that Xi Jinping has consolidated power after the 19th Communist Party Congress, he has the runway to impose his pro-reform agenda over the next five years.
- Due to higher-than-expected growth of 6.9% in the first half of this year, the government's 2017 target of 6.5% seems well within reach. As such, the government is able to turn its focus to controlling economic excess and overcapacity.
- While we believe a severe deceleration of growth remains unlikely, a modest slowdown seems to be unfolding. We think the two-year mini-growth cycle in China has crested, which should be a headwind for global growth and commodity prices at the margin.
- We continue to feel that emerging markets as a whole represent an attractive region from a long-term perspective. That said,

there could potentially be some near-term underperformance given the relationship between the dramatic move higher in emerging market equities in 2017 and the potential for weaker economic performance in China moving into 2018.

Japan

Firming Economic Backdrop Supported by Easy Policy Environment and Reform Efforts

- Recently re-elected Prime Minister Shinzo Abe remains committed to all available measures and tactics to boost government spending and fight deflation. Prime Minister Abe recently proposed a 2 trillion yen policy package that focuses on free early childhood education as an attempt to “revolutionize” human resource development and boost productivity. In further efforts to increase consumption, he is making a renewed push for corporations to boost wages by at least 3%.
- The Bank of Japan (BOJ) left monetary policy unchanged at its most recent meeting, as expected. What did change was the BOJ’s inflation estimate for fiscal 2018, revised down from 1.1% to 0.8%. The longer-term inflation forecast remained unchanged, with the BOJ still targeting long-term inflation at 2%.
- While the BOJ’s exchange-traded fund purchase program remains a focus of monetary policy, at 6 trillion yen per year, it is clearly a secondary commitment compared to yield curve control. During the BOJ’s press conference, BOJ Governor Haruhiko Kuroda confirmed no adjustments were needed to equity purchases, stating the bank’s goal is to provide a ceiling on the risk premium of Japanese equities relative to both Japanese government bonds and global equities (that is, to help keep relative valuations in check).
- Post-snap elections, the Nikkei index reached its highest level since 1999. Contributing to the Nikkei’s recent peak are better-than-expected corporate earnings, growing 16% with 8 of 11 sectors beating estimates. Export-oriented companies posted strong results, supported by a weaker yen versus last year’s third quarter.
- Economic data were mixed over the last month, with the headline CPI for October missing expectations of 0.1%, coming in at -0.2%. That contrasts with the October PPI at a higher-than-expected 3.4% versus the consensus estimate of 3.1%.
- The preliminary reading for third-quarter GDP was 1.4%, just below expectations of 1.5%. The prior reading was revised higher to 2.6% from 2.5%.
- As part of its ongoing commitment to environmental, social, and governance (ESG) issues, Japan’s $1.3 trillion Government Pension Investment Fund (GPIF) announced it is searching for two customized solutions that focus on environmental issues, one specific to Japanese equities and one global. The announcement follows a decision earlier in the year to implement three customized indexes that track companies focused on broad ESG initiatives. Japanese corporations typically have low governance ratings relative to global peers, but we believe the steps taken by the GPIF may encourage a focus on improved governance and subsequent earnings quality.

Energy

Oil Prices Hover Near 2017 Highs

- Oil prices reached a new year-to-date high on November 6, with Middle East geopolitical tensions continuing to escalate. Beginning with the leadership purge within Saudi Arabia in the first week of November, the uneasy relations between Saudi Arabia and Lebanon as well as Iran by proxy intensified when the Lebanese prime minister not only announced his resignation unexpectedly on November 4 but also did so from Saudi Arabia.
- With OPEC production cuts set to expire at the end of first-quarter 2018, investors await the outcome of its bi-annual meeting on November 30. With the price of Brent crude up over 40% from November 14 of last year, it is widely expected OPEC will extend its production cut agreement to the end of 2018.

- During President Donald Trump's recent visit to China, it was announced the administration signed a deal with China's largest oil company, Sinopec, to explore and develop a $43 billion natural gas pipeline and liquefied natural gas export terminal in Alaska. The deal is nonbinding, however, and would require significant upfront costs to build an 800-mile pipeline across the state.
- OPEC currently has a production cut in place of 1.8 million barrels per day; however, according to Bloomberg L.P., about 40% of those cuts are occurring from factors outside the control of the producing countries. Venezuela experienced unplanned production cuts due to worker strikes, while oil fields in Iraq and Nigeria were affected by ongoing armed conflict.
- In its November 14 oil market report, the International Energy Agency slightly lowered demand estimates for 2018 based on expectations for ongoing oversupply in first- and second-quarter 2018. This is in contrast with OPEC's recent monthly report, estimating global demand will increase in 2018. The offsetting effects from both reports suggest to us oil prices should remain range-bound in the near term.

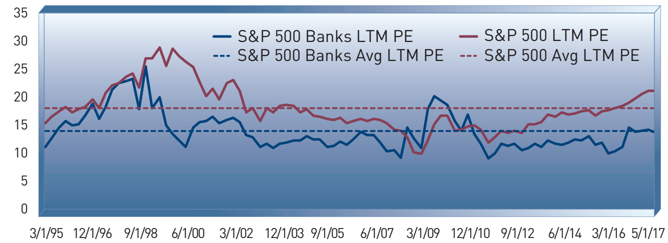
Hawthorn Strategy Views

Taking a Look at U.S. Banks

We believe that within the value portion of portfolios, there is a case to be made for a targeted exposure to U.S. bank stocks. We acknowledge the nuances on a company-by-company basis, but this commentary is meant to address our thoughts on broad exposure to the industry.

From a trailing price-to-earnings perspective, S&P 500 banks are trading slightly below their average (13.9x versus 14.0x), while the broad S&P 500 is firmly above its own average over the same period (Chart 1). From this perspective, expected forward returns for banks are less likely to be challenged by extended valuation levels over the longer term.

Chart 1
Trailing 12-Month Price-to-Earnings History: S&P 500 Banks versus S&P 500



Source: FactSet Research Systems Inc., Hawthorn

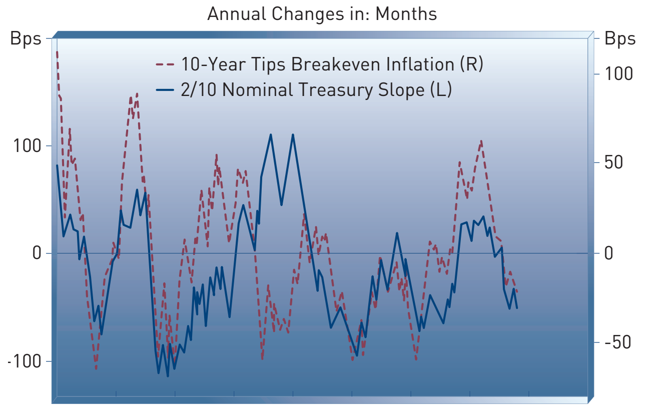
As a near-term catalyst, the administration appears to be following through on its plans for deregulation. In our opinion, the confirmation of Randal K. Quarles as the Federal Reserve's (Fed's) vice chair for supervision should lead to easier stress tests, for example, and the Fed itself is considering adjustments to some of the strictest interpretations of the Volcker Rule in hopes of supporting bond market liquidity. Both Democrats and Republicans have started to consider whether the criteria for SIFI status of $50 billion in assets is too strict and therefore unintentionally decreasing available credit to small businesses. In fact, on November 13, a bi-partisan group of senators reached an agreement to lift the SIFI designation for banks under $250 billion in assets. This proposal removes a significant regulatory burden from regional banks. Deregulation alone should provide a positive tailwind to the sector.[1]

Higher interest rates would likely help banks further, but they are not guaranteed. We believe there is a case to be made that the path of least resistant for interest rates is higher:

- Financial conditions continue to ease.
- The unemployment rate is likely to push below 4.0% in 2018, leading to firmer inflation.
- Positioning in the 10-year Treasury is significantly net long.
- The global economy continues to grow.
- The market might be underpricing the Fed's tightening path.
- The potential for fiscal stimulus could further boost growth.

[1] Strategas Research Partners, "Reiterating Strategas' Most Strongly Held View: Overweight Financials," October 16, 2017.

Chart 2
Possible Change in Yield Curve



Source: BCA Research

Ultimately, we believe the curve will flatten due to Fed tightening, but the Fed is likely to keep rates low enough to encourage a move higher in inflation. This means either inflation begins to pick up, allowing the Fed to hike as planned, or the Fed slows the pace of tightening to encourage higher inflation. Either way, if inflation breakevens move higher, the yield curve will likely steepen in the near term (Chart 2), which could help support bank earnings.

Tax reform may help, but it also is not guaranteed. By our calculations, banks would enjoy a roughly 4% increase in earnings per share from a reduction in the corporate tax rate to 23%. The benefit jumps to 6% from a tax cut to the currently proposed 20% rate. This positive earnings impact is above average when looking at the broad market impact.[2] Despite well-publicized challenges, we believe evidence supports the passage of a tax bill in early 2018. Our view is that the market is not properly reflecting the probability of a tax bill passing.

We think the interest rate and yield curve component of the pro-bank story is the most uncertain. As theory suggests, the 10-year yield equals the market expectation for the average federal funds rate over the next 10 years, plus a term premium. For example, the market expectations for the average federal funds rate over the next 10 years is currently 2.61% (current 10-year rate of 2.40% = 2.61% average federal funds over the next 10 years + [-21 bps] of term premium). Market expectation for the average federal funds rate over the next decade may be too high. Consider that the average expected federal funds rate over the next 10 years is unlikely to be higher than the Fed's terminal rate in this cycle. The peak federal funds rate would have to be close to 3% for the average funds rate over the next 10 years to equal 2.61%. That is higher than the 2.75% that the persistently optimistic Fed dot plot forecast suggests.[3]

In our view, the most likely driver of a near-term move higher in interest rates is the term premium. Factors that could move the term premium higher in the near term include:

- Fed balance sheet runoff;
- the reduction of QE in Europe; and
- the need to finance fiscal packages via an increase in Treasuries supply.

In combination, these factors could push the term premium from -20 bps well into positive territory.[4]

For argument sake, let us assume the average federal funds rate over the next 10 years is 2.50% and the term premium moves from -20 bps to +20 bps. That allows about 30 bps of upside on the 10-year yield from current levels. This may feel conservative and/or simplistic, but it is one way to look at the rate backdrop.

We feel that valuations, the regulatory backdrop, and the probability for a continuation of the business cycle are compelling enough to outweigh some of the rate uncertainty. Therefore, our conclusion is a positive outlook for U.S. banks as we move into 2018.

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[2] By our calculations, the S&P 500 would enjoy a 4% earnings growth benefit from a reduction of the corporate tax rate to 20%.
[3] Cornerstone Macro, "Why the Ten-Year Rate May Be Too High: A Simple Explanation," November 15, 2017.
[4] Ibid.

Appendix

Table 1
Equity Market Snapshot (total returns in U.S. dollars, through November 16, 2017)

	Total Returns		
	Month to Date	Quarter to Date	Year to Date
S&P 500®	0.57%	2.92%	17.57%
Small Cap (Russell 2000)	-0.99%	-0.14%	10.78%
S&P 500 Value	0.02%	1.17%	9.76%
S&P 500 Growth	1.00%	4.31%	24.66%
S&P 500/Industrials-SEC	-1.10%	-0.89%	13.11%
S&P 500/Consumer Discretionary-SEC	1.24%	3.38%	15.72%
S&P 500/Consumer Staples-SEC	3.69%	2.24%	8.96%
S&P 500/Health Care-SEC	0.56%	-0.21%	20.06%
S&P 500/Financials-SEC	-1.51%	1.38%	14.03%
S&P 500/Real Estate-SEC	3.90%	4.69%	12.42%
S&P 500/Information Technology-SEC	1.52%	9.39%	39.32%
S&P 500/Telecommunication Services-SEC	-2.72%	-10.13%	-14.35%
S&P 500/Utilities-SEC	1.96%	5.95%	18.53%
S&P 500/Energy-SEC	-1.29%	-1.94%	-8.44%
S&P 500/Materials-SEC	-1.27%	2.55%	18.77%
MSCI EM (Emerging Markets)	0.59%	4.12%	33.42%
MSCI FM Frontier Markets	-0.36%	0.86%	26.35%
MSCI Europe	-1.48%	-1.00%	22.21%
MSCI China	3.08%	7.18%	53.71%
MSCI Japan	0.69%	5.33%	20.74%

Source: FactSet Research Systems Inc., Hawthorn

Table 2
Fixed Income Market Snapshot (total returns in U.S. dollars, through November 16, 2017)

	Total Returns		
	Month to Date	Quarter to Date	Year to Date
Bloomberg Barclays US Aggregate	-0.04%	0.02%	3.16%
Bloomberg Barclays Global US Treasury (1-3 Y)	-0.13%	-0.20%	0.50%
Bloomberg Barclays US Aggregate Government-Treasury (1-5 Y)	-0.15%	-0.25%	0.84%
Bloomberg Barclays US Aggregate Government-Treasury (5-10 Y)	-0.02%	-0.20%	2.39%
Bloomberg Barclays US Aggregate Gov-Treasury-Intermediate	-0.11%	-0.24%	1.31%
Bloomberg Barclays US Aggregate Government-Treasury-Long	1.15%	1.07%	7.16%
Bloomberg Barclays US Treasury Inflation Protected Notes (TIPS)	0.36%	0.58%	2.31%
Bloomberg Barclays US Aggregate Credit-Corp.-Investment Grade	-0.34%	0.06%	5.25%
Bloomberg Barclays US High Yield-Corporate	-0.82%	-0.40%	6.58%
Bloomberg Barclays US Floating Rate Notes Corporates	0.05%	0.33%	2.21%
S&P Municipal Bond Investment Grade	0.16%	0.32%	4.61%
S&P Municipal Bond High Yield	0.64%	0.28%	4.55%
GS Commodity Index	0.02%	3.83%	-0.07%
Alerian MLP	-2.43%	-6.47%	-11.73%

Source: FactSet Research Systems Inc., Hawthorn

Table 3
F/X Market Snapshot
(through November 16, 2017)

Major Currencies	Current	1 Month Earlier	3 Months Earlier
Euro/U.S. Dollar	1.18	1.18	1.17
Australian Dollar/U.S. Dollar	0.76	0.79	0.79
Pound/U.S. Dollar	1.32	1.33	1.29
U.S. Dollar/Yen	112.81	111.70	111.80

Source: FactSet Research Systems Inc., Hawthorn