First Quarter 2017

Great Expectations

Introduction

In last year’s first-quarter 2016 Strategy Insights, Year of the Monkey, we asked whether 2016 could represent a paradigm shift in U.S. politics. Our answer was (and still is) a resounding yes. We wrote:

We think the potential exists for the 2016 election to become a turning point in American politics, since it is likely to set the course for a number of major policy decisions including, but not limited to, tax reform, the Affordable Care Act, entitlements, and foreign policy. With so little in the way of legislation getting passed during President Obama’s gridlocked tenure, there is significant pent-up demand and pressure coming from both sides of the aisle to get much more accomplished during the next administration.

With a predominantly Republican Congress and a political-establishment outsider set to take control of the White House in 2017, the potential paradigm shift is much bigger than we anticipated. Thus far the results of the 2016 election have unleashed widespread economic and financial market optimism as investors anticipate increasing political clarity on a number of fronts. The now ubiquitous equity market acronym TINA¹ (“There Is No Alternative”) appears to be getting replaced by her more “optimistic” sister ANITA (“Act Now, Initiate Trump Allocations!”).

Since the election, financial asset prices have quickly recalibrated to reflect the expected Trump agenda of:

- outperformance of financial stocks, reflecting these higher interest rates and hopes for the rollback of burdensome regulations;
- small cap outperformance in the face of a much stronger dollar and potentially disruptive trade policies enacted by the new administration; and
- health care underperformance amid uncertainty related to the future of the Affordable Care Act.

The key, of course, will be the evolution from campaign rhetoric and posturing to detailed architecture, design, and policy implementation. Although it’s hard to be an outright contrarian in the current market, the future is far from certain. The sustainability of recent market moves depends on policy makers’ ability to deliver on their promises.

For now, the fundamental backdrop still poses some distinct challenges—valuations are elevated, significant credit expansion appears unlikely, global growth has yet to show signs of a meaningful acceleration, and productivity gains have been rather poor. That said, optimism can be a powerful force in the markets, and we believe positive “animal spirits” may be the biggest wildcard during first-half 2017, with investors digesting and interpreting policy changes and beginning to predict winners and losers. As we move into the second half of 2017, some evidence of follow-through will be very important. Higher interest rates, higher inflation, and a stronger dollar may begin to weigh on sentiment if investors are not convinced of meaningful change.

In many ways, the outcome for financial markets could be binary in 2017, with expectations high for fiscal policy to propel fundamental growth. If investors continue to believe that broad tax

¹ TINA was an acronym originally coined by Margaret Thatcher that meant “there is no alternative” to global capitalism. The term has more recently been used by investors to signify the fact that with bond yields so low, “there has been no alternative” to owning equities.
cuts/reforms, infrastructure spending, and reduced regulation will steepen the U.S. growth trajectory, then it is easy to make the case for a late-cycle bull market surge and possibly an extension of the current business cycle. However, if clear progress is not made and in rather short order, or adverse international political or trade developments were to occur, optimism may very well give way to pessimism and increasingly bearish sentiment, as well as possibly cause a rapid end to the current cycle. Ultimately, we expect fiscal stimulus to take the reins from increasingly impotent monetary policy, creating an environment that is likely to prove more fundamentally supportive than what we have seen in recent years. But there is still a long list of worries, including high and rising debt levels, stretched valuations, rising interest rates, a stronger dollar, a lack of productive capital investment, and geopolitical instability.

"It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity, it was the season of Light, it was the season of Darkness, it was the spring of hope, it was the winter of despair, we had everything before us, we had nothing before us..."2

In this issue of Strategy Insights, we present our 2017 outlook for the economy and some key asset classes.

The Economy

Uncertainty has been far from a U.S.-centric phenomenon. Throughout 2016, we witnessed a number of what were considered “lower-probability” events become realities. Whether referring to the Brexit vote, the proliferation of negative interest rate policies, or Donald Trump’s election victory, forecast-busting outcomes have known no bounds. To us, we think the global economy continues to be in a state of heightened uncertainty, creating an environment in which the distribution of outcomes is quite broad, both positive and negative. In such environments, we believe investors must be patient as well as flexible, reserving the right to adapt as economic and market conditions evolve. Over the long term, the economic cycle is extremely important because as it goes, so goes the market. Chart 1 shows the close relationship between the ISM Manufacturing Index (a popular business cycle metric) versus the year-over-year performance of the S&P 500®.

In the United States, the Trump administration’s plans to cut taxes and boost infrastructure spending certainly have the potential to boost economic growth, in our view. However, quantifying the actual magnitude of that improvement in growth is extremely difficult. Details of any proposed policy changes are not yet known, and there are a number of variables that could turn the stimulus efficacy-dial up or down. For example, will interest rates and/or the U.S. dollar rise enough to diminish any new growth tailwinds? Will tax reform be accompanied by significant limitations on deductions? Will any approved spending package be as robust as currently presumed considering an all-Republican government? These are all questions that remain unanswered, and the outcomes are likely to have a large impact on the way companies

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2 Charles Dickens, A Tale of Two Cities (1812-70). Also, the title of this Strategy Insights is intended to be a play on words reflecting the well-known Dickens novel as well as our view that the bar has been set very high for the markets/economy in 2017.
and consumers behave in 2017 and beyond, and ultimately will be a key determinant of the multiplier effect any policy changes might have on GDP growth. Globally, the multiplier effect of fiscal spending has declined over the last 20 years. In 1998, 1 unit of government spending created 6.8 units of GDP. Today, that same unit of spending creates 4.2 units.3

The Long-Term View
Let us start with what we do know. This should help give us a basis for discussing the potential impact of the shifting political regime. From a longer-term perspective, potential economic growth has been reduced in recent years, with certain secular headwinds (that is, aging populations, slowing productivity gains, lack of capital investment, high debt levels) constraining economies around the world, including the United States (Chart 2).

Specifically as it relates to leverage, debt burdens remain quite high globally and will likely continue serving as a secular overhang to longer-term growth prospects. According to data from the Federal Reserve Bank of Saint Louis, total U.S. public debt as a percent of GDP is in excess of 100%. From 1990 through the financial crisis, this ratio oscillated in the 55–65% range and was even lower prior to that period. Global debt statistics paint a similarly overleveraged picture. Last year, the McKinsey Global Institute reported that “global debt has grown by $57 trillion and no major economy has decreased its debt-to-GDP ratio since 2007. High government debt in advanced economies, mounting household debt (although this has improved in the United States since the financial crisis), and the rapid rise of China’s debt are areas of potential concern.”4

The credit super-cycle that was a boon for global growth has likely ended, in our view, representing a challenge for future long-term growth trends. Geopolitical risks, especially de-globalization and protectionist trends, will also likely weigh on multiyear growth. Secular issues like this are hard to ignore, and they do not often quickly reverse course. Regardless of the noise created by evolving monetary and fiscal policies, long-term trends in sustainable economic growth are primarily driven by just three factors—productivity advancements, growth in the labor force, and productive capital stock. Currently, financial markets seem hopeful that the new administration will be able to introduce policies that boost productivity and capital investment. We believe success in these areas is

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3 Cornerstone Macro, 2017 Outlook (January 2017).
4 McKinsey Global Institute, “Debt and (not Much) Deleveraging” (February 2015).
absolutely critical to accelerating and sustaining a faster pace of global growth.

**The Short-Term View**

That said, shorter-term cyclical recoveries are always possible within longer-term secular trends. In fact, the latter part of 2016 represented such a period. Chart 3 (page 3) shows trends in the Institute for Supply Management (ISM) Manufacturing index, a dataset we often use to help track fluctuations in the business cycle. One can clearly see the cyclical movements apparent within the longer-term downtrend. Amid all the macro noise generated in 2016 (that is, central bank policy changes, unforeseen geopolitical events, oil price volatility), U.S. stocks actually tracked quite closely to the underlying economic data. Chart 4 is a good example of this dynamic. Although the election was a positive catalyst for higher equity prices and interest rates, positive economic data surprises in the latter part of 2016 could have also easily explained these moves, regardless of the election outcome.

The obvious question is, “Where do we go from here?” Analysis of other leading economic indicators suggest the ISM Manufacturing index is likely to have peaked at the end of 2016, with some renewed pressure likely heading into early 2017 (depicted in Charts 5 and 6). This seems reasonable as we are entering a period of seasonal slowness for manufacturing activity. Despite this, data from our proprietary recession analysis indicate we will likely not see a recession in 2017. As such, we do not believe we will enter a full contraction/recession, but the economy is still exhibiting signs of slowing down.

Ultimately, our view is that growth is unlikely to accelerate significantly in the coming quarters, but
we also think the outcome of the election is likely to boost confidence enough in the near term to support at least a modest improvement in overall economic conditions. Measures of economic confidence at year-end 2016 support this thesis. For example, the NFIB’s Small Business Optimism index experienced a postelection spike in improvement to 98, two points shy of this cycle’s all-time high of 100.3—largely on expectations for a relatively more pro-business political environment. Additionally, the National Association of Home Builders (NAHB) confidence index surged to 70 in December, the strongest level since July 2005. Builders seem to be looking past the near-term increase in interest rates and focusing on expectations for stronger economic growth. This is consistent with other business sentiment indicators (consumer confidence, small business optimism) that have also climbed on views of a relatively more pro-business political environment.

From a global perspective, we would say the shorter-term economic backdrop is also somewhat mixed. We would categorize growth in Europe and Japan as still slow, but stable. The European Central Bank (ECB) extended its asset purchase program recently, and still appears committed to providing easy monetary conditions to encourage growth and inflation. Forecasts for Japanese GDP growth hover around 1%, which should be enough to slowly decrease the output gap, as well as push inflation higher over time. Since June, manufacturing PMI data in both regions have meaningfully improved, certainly a welcome sign for short-term growth. However, more robust growth in the United States and Europe may not be enough to pull up emerging market economic prospects as emerging economies are now much more dependent on China (which has its own set of challenges) and intra-emerging market trade than in the past. 5

The Impact of Trump

No one knows how the new administration is going to affect the economy. Parallels to 1981 (Ronald Reagan’s administration) may be a bit unfair, in our view, given an economic backdrop that is actually quite different (Table 1). At the start of the Reagan administration, the economy was experiencing very high inflation, higher levels of unemployment, and an astronomic 18% federal funds rate, but relatively lower debt-to-GDP and stock valuations. Certainly, the scope to reverse course and improve all of these items—reduce inflation, create jobs, reduce interest rates, and stimulate credit growth and valuations (all major market and economic tailwinds)—was quite large in the early 1980s. Today we are starting from a very different place.

In lieu of making any grand predictions, let’s evaluate the building blocks of economic growth—the labor market and productivity growth. Through that lens, we must consider what is “normal” as well as the economy’s current state. 6 Over the past 10 years, U.S. productivity has declined from a postwar annual average of about 2.0% to about 1.0%, with the past five years averaging only 0.5%.

Table 1

<table>
<thead>
<tr>
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<tbody>
<tr>
<td>Real GDP Year over Year</td>
<td>0.0%</td>
<td>1.6%</td>
</tr>
<tr>
<td>Consumer Price Index (CPI)</td>
<td>12.5%</td>
<td>1.6%</td>
</tr>
<tr>
<td>Core CPI</td>
<td>12.2%</td>
<td>2.1%</td>
</tr>
<tr>
<td>LEI Year over Year</td>
<td>-4.3%</td>
<td>1.1%</td>
</tr>
<tr>
<td>ISM Manufacturing</td>
<td>53.0%</td>
<td>53.2%</td>
</tr>
<tr>
<td>Industrial Production Year over Year</td>
<td>-0.8%</td>
<td>-0.9%</td>
</tr>
<tr>
<td>Unemployment Rate</td>
<td>7.2%</td>
<td>4.6%</td>
</tr>
<tr>
<td>Avg. Hourly Earnings Year over Year</td>
<td>8.5%</td>
<td>2.4%</td>
</tr>
<tr>
<td>Federal Funds</td>
<td>18.0%</td>
<td>0.5%</td>
</tr>
<tr>
<td>10-year Treasury</td>
<td>12.4%</td>
<td>2.4%</td>
</tr>
<tr>
<td>U.S. Dollar (DXY)</td>
<td>90.4%</td>
<td>100.0%</td>
</tr>
<tr>
<td>S&amp;P 500 PE</td>
<td>9.1%</td>
<td>20.6%</td>
</tr>
<tr>
<td>Debt/GDP</td>
<td>31.1%</td>
<td>105.0%</td>
</tr>
<tr>
<td>Household Debt/Disposable Income</td>
<td>65.7%</td>
<td>103.6%</td>
</tr>
<tr>
<td>Existing Top Tax Rate</td>
<td>70.0%</td>
<td>39.6%</td>
</tr>
<tr>
<td>New Top Tax Rate</td>
<td>28.0%</td>
<td>33.0%</td>
</tr>
</tbody>
</table>

Source: State Street, Bloomberg L.P., DoubleLine Funds

5 BCA Research, Emerging Market Strategy, “Key EM Issues Going into 2017” (December 2016).

6 Analysis provided by John P. Hussman, PhD, president and founder of Hussman Funds.
During all of these periods, rarely has the eight-year growth rate (that is, two terms of a presidency) of productivity been higher than 3.0%. With these statistics in mind, and considering current rates of unemployment as well as labor market demographics, what might a plausible scenario analysis look like in terms of forecasting potential growth in GDP over the next four to eight years (Table 2)?

Although we think there is a case to be made that successful policies have the potential to boost growth over the next four to eight years, the current expectations for the magnitude of that growth appear to have decoupled from what one may consider likely or reasonable given the above analysis. The path of these growth outcomes, however, is far from certain. Cyclical overshoots and undershoots can always cause growth to temporarily diverge from its longer-term trend. Federal Reserve Bank of New York President William Dudley echoes our belief that “spending and tax changes from the incoming administration of President-Elect Donald Trump should focus on measures that lift the productive capacity of the U.S. economy.”

To summarize our view for the U.S. economy in 2017 relative to 2016—better, but current expectations are setting the bar high. PNC Economics forecasts GDP growth of 2.4% in 2017, with two additional interest rate hikes of 0.25% each. We also believe we will continue to see some upward pressure on inflation, and the dollar will likely stay strong as interest rate differentials expand between the United States and other large global economies. Oil prices are currently hovering around $50 per barrel (a 100% year-over-year price increase), and average hourly earnings continue to trend steadily higher. Both factors should support higher inflation in 2017. Deflationary pressures from abroad will slow the rate of inflation, however, so we are only expecting a moderate increase.

China will likely continue to export deflation to the rest of the world because of the yuan’s persistent depreciation, even with domestic inflation in China rising. To quote our 2016 outlook, “…another year of tepid global growth,” but now with the hope of fiscal policy stimulus laying the groundwork for some fundamental improvement and growth re-acceleration.

Table 2
Forecasting Potential GDP Growth over the Next Four to Eight Years

<table>
<thead>
<tr>
<th>View</th>
<th>Productivity Growth Rate</th>
<th>Unemployment Rate in 2024</th>
<th>Qualitative Factors</th>
<th>Annual GDP Growth Rate (next 8 years)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pessimistic</td>
<td>0.50%</td>
<td>6.00%</td>
<td>7 years of current economic expansion</td>
<td>0.70%</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Already low unemployment rate of 4.6%</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Even U-6 rate is just 1.4% above precrisis levels</td>
<td></td>
</tr>
<tr>
<td>Optimistic</td>
<td>2.00%</td>
<td>4.00%</td>
<td>Successful policies boost productivity back to 2.0%</td>
<td>2.40%</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Unemployment rate continues to fall</td>
<td></td>
</tr>
<tr>
<td>Really Optimistic</td>
<td>2.80%</td>
<td>4.00%</td>
<td>Productivity explodes</td>
<td>3.20%</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Unemployment drops</td>
<td></td>
</tr>
</tbody>
</table>

Source: Adapted from Weekly Market Comments, “Economic Fancies and Basic Arithmetic,” Hussman Funds (December 12, 2016)

8 BCA Research, Emerging Market Strategy, “Key EM Issues Going into 2017” (December 2016).
Public Equities
Domestic/United States

Our outlook for domestic equities in 2017 is one of cautious optimism. We believe prices can still move higher even from their current rather lofty levels, but current upward momentum is mostly a function of the potential for an acceleration in growth on the heels of any policy changes the new administration might begin to implement next year (that is, tax reforms/repatriation, infrastructure spending, regulatory relief, etc.): higher asset prices are not likely to be a function of a significant improvement in underlying fundamentals (that is, for revenues, margins, and earnings). That said, the chance of recession still remains quite low in our view (our proprietary recession probability model does not forecast a recession in 2017), inflation is accelerating but at a manageable pace, and additional interest rate increases should still be rather methodical and data-dependent; therefore, we think equity risks are somewhat balanced between the upside and downside as we enter 2017. Recently, markets have shrugged off a number of potential stumbling blocks, choosing to focus instead on the positives and largely ignore the negatives. The question is, will that continue?

Fundamentals
Revenue growth has been sluggish ever since the end of the 2008 financial crisis, but 2016 marked a turning point for revenue growth. The estimated revenue growth rate for the S&P 500 in fourth-quarter 2016 is now 5.1%. If achieved, it will mark the first time the index has seen year-over-year growth in sales for two consecutive quarters since the third and fourth quarters of 2014 when growth hit 4.6% and 0.5%, respectively. It would also mark the highest year-over-year revenue growth reported by the index since first-quarter 2012 (5.3%), with 10 out of 11 sectors projecting year-over-year growth, led by Utilities (Telecommunication Services is the one sector detractor). However, we think this pickup in revenue has been helped by things such as a substantial improvement in commodity prices (namely, oil) relative to this time last year, as opposed to the more preferable growth driver—an increase in demand.

However, we have not given up hope on improved demand just yet, as a strong fiscal stimulus package is likely to benefit both consumers and corporations. To the extent we get a meaningful tax cut at the individual level, we would expect to see consumer spending accelerate. Of course, any additional increases in the price of oil/gasoline, core inflation, and/or interest rates could become near-term headwinds for the consumer, partially offsetting any increase in spending. At some point, though, higher reinvestment rates will enable savers to generate a little more return on their cash, which we view as good news. We see housing continuing to fare well through at least mid-2017, with still low interest rates remaining a tailwind. The supply/demand dynamics of the industry remain healthy, as inventories are still very low relative to history. Toward the end of 2017, however, we think housing may begin to slow, becoming less of a growth engine for the economy.

Currently, consensus estimates project a robust start to 2017, with revenue growth of 8.5% in the first quarter and 6.2% in the second quarter. However, the fiscal 2017 estimate is only 5.9%, suggesting a deceleration coming in the second half of the year. Of course, a large portion of the growth rate is due to the Energy sector (projected to grow revenue at 28% next year), as much easier year-over-year comparisons set a very low bar. The Information Technology sector is projected to grow 6.8% in 2017, in a distant second place. We do not see a material uptick in demand growth, nor rapid enough implementation of new policies by the incoming administration, to justify these lofty growth rates. As such, we think estimates may need to be adjusted lower.

Much of the earnings growth generated post-2008 can be attributed to broad-based margin improvement, as companies have been dependent on cost-cutting and elevated share repurchase activity (buybacks alone may have added 100-200

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basis points (bps) to growth per annum\(^{10}\) to drive growth. The S&P 500’s operating margin peaked in February 2015 at 14.3% and has been in a shallow, declining trend ever since. Margins have fallen about 4.2% since that time, but still sit approximately 150 bps above the 30-year average. We see additional pressure on margins likely in 2017 mostly due to the rising cost of labor (wages) in an already tight (and likely to tighten further) labor market, higher input costs and commodity prices, as well as higher interest rates (translating into a higher cost of capital for many companies). These headwinds, along with the fact that the majority of cost-cutting is firmly in the rear view mirror at this later stage of the cycle, lead us to believe that margins will struggle to remain flat at-best in 2017, absent any potential one-time/step-up benefits associated with tax reforms, which certainly could be meaningful.

In terms of earnings specifically, the estimated earnings growth rate for fourth-quarter 2016 was 5.2% as of the end of the third quarter, but has since fallen roughly 200 bps, with 8 out of the 11 sectors reducing growth expectations, led by Materials.\(^{11}\) As Nick Raich, founder of The Earnings Scout recently noted,

> Normally, the weakening earnings expectations in third-quarter 2016 earnings season would have led to falling [equity] prices; however, the Trump victory caused investors to ignore current [earnings] estimate revision weakness as their optimism on his potential policies has grown. The hope is these policies will lead to significant upwards [earnings] estimate revisions in the future. It has been over 40 days since Trump was elected and we still are waiting to measure those improving expectations. Instead, we have seen S&P 500 earnings growth estimates for the 1Q 2017, 2Q 2017, FY 2017 and FY 2018 periods all go lower since election night. The rapid rise in stock prices, without confirmation in estimate revisions, is why we are cautious on stocks.\(^{12}\)

Even still, if the S&P 500 reports earnings growth in the fourth quarter, it will mark the first time the index has seen year-over-year growth in earnings for two consecutive quarters since fourth-quarter 2014 and first-quarter 2015. Consensus projects a robust start to 2017 for earnings, with growth of 11.2% in the first quarter and 10.6% in the second quarter. For fiscal 2017, earnings growth is estimated at 11.5%, suggesting a rather strong, stable growth trajectory over the course of the year. Again, we see the impact from the Energy sector skewing projections to the high side, as earnings for the sector are projected to grow 343% year-over-year, followed by Materials, up “just” 16.0%. A word of caution is necessary here, as a sustained strong and/or rising U.S. dollar from present levels has the potential to become an earnings headwind for large multinationals and may begin to put pressure on earnings estimates as 2017 progresses. Bank of America Merrill Lynch’s Equity Strategy Team estimates a 10% increase in the U.S. dollar (as measured by the DXY) would translate into a $3-4 per share decline in S&P 500 earnings.\(^{13}\)

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Capital expenditures have been in a weakening trend for quite some time. It’s a theme we have written about extensively in past publications—the missing link necessary to help stimulate growth. Could 2017 be a turning point for capital expenditure activity? According to Evercore ISI, “corporate spending activity on buybacks and dividends has overtaken capital investment as the largest use of corporate cash flow, but the pace and breadth of S&P buyback activity has started to slow.”\(^{14}\) Indeed, FactSet’s latest Buyback Quarterly report indicates the dollar value of S&P 500 repurchases is down 28% since third-quarter

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13 Subramanian, “2017–The Year Ahead: Euphoria or Fiscal Fizzle?"
2015. Some of that decline may be related to challenging comparisons (third-quarter 2015 was the fifth largest value on record since 2005) and a pause leading up to the election. However, Evercore ISI suggests “...with cash returns (that is, buybacks plus dividends) as a percentage of cash flow elevated, corporate credit costs increasing, and growth accelerating, the economic backdrop that supported the [post-financial crisis] surge in repurchases is fading and the breadth of buybacks is likely to narrow.”

Of course, the outlook for buybacks may begin to improve going forward, with the U.S. election results keeping open the possibility of tax cuts and a repatriation holiday, which could ultimately give companies more cash to deploy. We would still prefer to see this freed-up capital go toward capital expenditures, however. If business confidence and economic growth begin to improve and subsequently earnings growth begins to re-accelerate in 2017, it would not be surprising to us to see a commensurate uptick in capital expenditures, particularly coming off such a low base. That said, this is not our base case expectation.

Valuation

By most valuation metrics we track, the market still appears fully valued, as prices continue to rise much faster than any improvement in underlying fundamentals. And yet, investors (and consequently stocks) have largely ignored concerns about stretched valuations, particularly in the sharp rally following the November election.

By our own calculations, the 12-month forward price-to-earnings (P/E) ratio for the S&P 500 is 18.2 times (x) as of this writing, which is well above its five-year (15.0x) and 10-year average (14.4x) multiples. The cyclically adjusted P/E ratio (CAPE) for the S&P 500 stands at roughly 26.5x, well above the top end of its historical range of 9.4–22.7x and more than one standard deviation above its median. Many investors justify these high valuations as being a function of the historic lows in interest rates we have seen in the wake of the financial crisis. However, with interest rates and inflation now rising in tandem, this shrinks the relative valuation advantage stocks have had over fixed income investments—material headwinds for multiple expansion from present levels, in our view. An acceleration in growth can certainly help offset these headwinds, but with volatility likely to remain elevated in 2017, the risk premium is being compressed even further. Net-net, based on these market dynamics, we think only modest multiple expansion is possible.

PNC’s midpoint forecast for 2017 S&P 500 earnings per share is $125 (+6% year over year). In this base case, multiples will still need to remain somewhat elevated (especially in the face of higher interest and inflation rates) in order to generate solid overall equity market returns. At $125 per share, the P/E multiple on the S&P 500 would need to increase from approximately 18.2x as of this writing to 20.0x in order to generate a 10% price return in 2017. For perspective, the long-term historical average P/E for the market is somewhere in the 14–15x range. Over the longer term (that is, beyond five years), we still think equity market returns will be below historical averages.

Technicals

The rally in the stock market following the presidential election in November 2016 ranks as the fourth best since 1928. Despite it being a surprisingly sharp move, the S&P 500 does not appear substantially “overbought” or euphoric on a technical basis as we head into 2017. While it would be natural to expect the market to take a breather in early 2017, other technical indicators suggest the market has some additional room to run. In particular, positioning data suggest investors are still modestly net short the S&P 500. Also, even though our feeling is that prices have advanced past fundamentals, a resurgence of retail-investor participation in the stock market has the potential

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16 PNC's estimated valuation range, defined as one standard deviation of historical data for the S&P 500 going back to 1881.
to be a major tailwind, in our view. Looking at net-flow data since 2009, $795 billion has flowed out of domestic equity mutual funds and exchange-traded funds (ETFs) while almost $1.5 trillion flowed into bond vehicles. A reversal of this flow trend in the face of falling bond prices and fear of missing out on a rising stock market has the potential to be a powerful force in favor of equities. However, a reduction in corporate share buybacks has the potential to offset some of the increase in retail demand.

Stock market “breadth” (that is, participation) is used in technical analysis to help gauge the direction and robustness of market moves. It is a simple measure of the number of companies advancing relative to the number declining. Positive breadth occurs when more companies are moving higher than are moving lower—a bullish signal. When this trend reverses course, it is considered a bearish signal. Breadth is meaningfully broader today than it was a year earlier when we were developing our 2016 investment outlook for Strategy Insights. In fact, the 10 largest stocks in the S&P 500 have contributed only 20% of the year’s gain. In 2015, the 10 largest stocks were responsible for all of the year’s performance. As such, breadth poses less of a concern for us this year and we think the market is somewhat less vulnerable on a technical basis, as a result.

The correlation among S&P 500 stocks fell to a 10-year low in December. In fact, according to Strategas Research, the presidential election was the first macro event in the last 18 months where correlations have actually declined. As correlations have moved lower, high yield spreads have tightened and are now sitting at 52-week lows for nine sectors of the S&P 500. With this kind of backdrop, we see 2017 shaping up to be a stock picker’s market (that is, a better environment for active managers; Charts 7 and 8).

**Developed International**

Global growth has largely stabilized in developed regions, but we are not yet seeing signs of any material acceleration. However, the recent weakening of currencies relative to the U.S. dollar may help Europe and Japan in terms of driving a rebound in trade-related activity and, ultimately, growth. Financial asset prices in these regions have already begun pricing in potential improvement, with the MSCI Europe index up over 5% and the

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18 Strategas Research Partners, “Three Cheers for the Great Rotation” (December 9, 2016).
19 Ibid.
20 Ibid.
Japanese Nikkei 225 up almost 20% since the U.S. election.

Despite the potential for a modest re-acceleration in growth, we expect political noise in Europe to remain elevated, if not increase substantially, over the next 12 months, with its four largest economies facing major political milestones:

- Following the Brexit vote last June, the United Kingdom is expected to trigger Article 50 by the end of first-quarter 2017, which will formally start the negotiations/proceedings to exit the European Union (EU).
- French general elections will take place in April/May 2017.
- Germany is set to elect a new chancellor between August and October 2017.
- Following the failure of Matteo Renzi’s constitutional reform referendum in Italy in December, there has been tremendous support from all political parties to move up general elections originally planned for 2018 into 2017.

Taken together, this means that more than 60% of European GDP faces various degrees of political uncertainty in 2017. At this point, we are not anticipating any major political crises in Europe in 2017, but the risks certainly exist. Will we see a continuation of the populist wave seen during Brexit and the U.S. elections?

We anticipate the fallout from the failure of the Italian referendum as potentially boosting support for other populist, Eurosceptic political parties (that is, pro-EU membership withdrawal) in the region, some of which are already on the rise in Germany, the Netherlands, and France. We would not be surprised to see rhetoric ramp up particularly regarding the potential for a “Frexit” (that is, France exit from the EU) and/or “Nexit” (Netherlands exit) either, though we assign a low probability of occurrence. With all of this discord, we see increasing strains on country relations and the potential over time to reduce the number of “clear” European allies.

Thus far, the cost of populism seems very low: economic data in the United Kingdom have not yet been materially negatively affected and equity markets have largely shrugged off the news. But a continuation of populist political trends would likely lead to greater instability and questions regarding the viability of the common currency union.

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. Based on this, we think the better chance for outperformance in 2017 is in domestic equities, but we continue to look for better, more opportunistic entry points to add to our developed international portfolio exposure(s), as relatively attractive valuations abroad bode well for longer-term investments.

**Emerging Markets**

After shooting out of the gates in 2016, emerging markets will again underperform U.S. equities as 2016 comes to a close. In late summer, the S&P 500 trailed broad emerging market ETFs by about 8%. As of late December, this gap not only evaporated, but the S&P 500 was also outperforming by close to 4.0%. We think emerging markets are very likely to remain under pressure in 2017 based on the following key reasons.

- Following the Federal Reserve (Fed) rate hike in December, there is a high likelihood of several more rate hikes to come in 2017, even though we still expect the Fed to pursue a rather slow, data-dependent path.
- The U.S. dollar has strengthened and is likely to continue to do so in 2017.
- Risks of protectionist measures taken by a Trump administration are significant and would not be positive for China or emerging markets.
- We do not expect dramatically higher commodity prices in 2017 from current levels. Although the production agreements from both OPEC and non-OPEC countries will likely have an impact on global supply,
providing an upward bias to energy prices, North American shale is likely to ramp production as prices rise, capping the potential price increase.

As such, we think these items put fundamental pressure on emerging market economies and may again drive a widening of emerging market credit spreads. This does not set the stage for a positive/healthy backdrop for emerging market equities in 2017.

Obviously, China is a big factor for emerging markets. China and those countries heavily tied to China, such as South Korea, Taiwan, South Africa, and Malaysia, represent roughly 60% of the MSCI Emerging Markets benchmark index. “As goes China, so goes the rest of emerging markets,” in our view. China appears to be fairly stable at the moment but still has its own set of challenges that have been somewhat out of the headlines and under the radar for much of 2016 (for example, potential asset bubbles, ballooning debt levels). However, we think China may come back into focus in 2017. After spending a good portion of the year pumping even more credit into the economy, policy makers are now attempting to pull back the reins and introduce rather stringent capital controls. Such actions include restrictions on the following: 21

- outbound mergers and acquisitions-related activity;
- personal uses of bank cards;
- issuance of dual-currency credit cards;
- tax increases on imported cars;
- gold imports; and
- disclosures of cash holdings by travelers to Macau.

The capital controls raise a red flag for us, signaling that outflows are accelerating again. As Nancy Lazar, Head of Economic Research at Cornerstone Macro notes, “Conditions within China must be bleak, if so much capital is trying to flee. And capital forcibly trapped there is unlikely to be productive. Naturally, inbound investment will dry up.” This is not good news for China’s economy, because it acts like a de facto tightening of financial conditions and is likely to become a headwind for growth unless it reverses course in short order.

Emerging markets have accounted for roughly half of global GDP growth over the past 10 years, but we think those days are in the rear view mirror. The most recent investment boom in China (that is, in terms of infrastructure and hard assets put in place over the past cycle) is unlikely to repeat, if ever, in our view. The tools they have left to further stimulate economic growth from present levels are likely not as powerful. We do not see a hard landing for China, but neither do we see a quick resolution nor massive re-acceleration in growth.

In terms of valuation, emerging market equities are still trading above average on an absolute basis. Even with the swoon in emerging markets equities following the election, the forward P/E ratio for the MSCI Emerging Markets index is still 110 bps ahead of its 10-year average multiple of 12.4x—unjustified, in our opinion. Further, emerging market equities look only marginally cheaper relative to developed international equities, trading at a relative-forward P/E of 0.85x versus the 10-year average of 0.87x. Given that many emerging market economies are significantly more leveraged than they have been historically, and the likelihood of sluggish growth continuing at least in the shorter term, we do not view current valuations as compelling. To the extent emerging market equities remain under pressure and continue to struggle in terms of relative (under)performance, at some point in 2017 we would expect a much more favorable buying opportunity and will be watching closely for signs of that to materialize.

**Equity Portfolio Positioning**

Investors should remain selective, focusing on themes that are likely to persist through 2017, such as domestic revenue/earnings exposure, the consumer, housing, financials, energy, and dividend growth stories, broadly speaking. Although we like the infrastructure theme on a very long-term basis,

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infrastructure stocks have already re-rated in anticipation of the potential near-term benefits from a new infrastructure spending package/bill. Our valuation work suggests large and mid-cap domestic equities are relatively more attractive than small caps, particularly following the massive moves small cap equities have experienced just since November 2016. That said, neither large- nor mid-cap equities are outright “cheap” relative to history either, and small-cap companies may enjoy an outsized benefit from changes in tax policy and regulation while also being more insulated from risks associated with a stronger dollar. Given that small caps are the most expensive capitalization category (presently trading at 4.1 multiple turns above their 10-year average forward P/E of roughly 24.5x) in an already fully valued market (that is, 3 multiple turns above the 10-year averages for both mid caps and large caps), it does not leave much headroom for higher long-term future returns at current valuations, even though 2017 could see continued momentum.

Low-volatility shares that led the market in first-half 2016 (that is, Utilities, Telecommunication Services, REITs) have struggled more recently and may continue to do so if real yields continue to rise. As yield remains rather scarce in the current environment, dividend growth looks more attractive to us—companies with sustainable free cash flow generation and the ability to raise payouts over time without harming their balance sheets.

More Attractive:
- U.S. equities;
- Financials, Health Care, and Consumer Discretionary sectors;
- Value;
- Mid and large caps; and
- High domestic exposure, dividend growth, operating leverage, and tax cut beneficiaries.

Less Attractive:
- China and emerging markets;
- Consumer Staples, Telecommunication Services, and Materials sectors;
- Growth;
- Small caps; and
- Interest rate sensitive companies and/or those with large near-term debt maturities, and high emerging markets exposure.

Private Equity/Private Investments

Over the last 10 years, our capital market projections have largely been in a declining trend (that is, for both equities and fixed income), with much of this decline concentrated in the past five to six years. Indeed, our expected returns for equities and fixed income have fallen by approximately 150 bps and 100 bps, respectively, over this period. We think there has been a cyclical downshift in investment returns, largely a function of the following key items:
- where we presently stand at this stage of the business cycle (later innings);
- sluggish overall economic growth;
- peaking corporate profits and margins;
- lack of meaningful capital investment activity;
- stretched valuations (at least by historical standards), which do not leave room for material multiple expansion; and
- earliest innings of a slow, but protracted interest rate tightening cycle.

The implications from these views, of course, have had a material impact on how we think about designing portfolios for our clients. Implications range from long-term strategic asset allocation positioning to shorter-term tactical exposures, risk-taking/mitigating, shortfall risks, and so forth.

With this as the backdrop, it has become increasingly important to consider the role(s) alternative investment options and, more specifically, private equity might play in portfolios. This consideration is especially important for investors with significant, ongoing income needs and/or long-term liability streams and obligations.
A recent study (highlighted in Chart 9) concluded that in order to achieve a 7.5% return, investors must take on nearly three times as much risk as they did roughly 20 years ago, with private equity becoming a key component of the asset allocation mix.

No doubt this has fueled a shift toward higher allocations to private equity across a broad spectrum of investors, including both individuals and institutions. As you can see in Chart 10, family offices have the largest current and targeted allocations to private equity investments, more than double that of endowments and foundations. As a result of the rather broad interest and participation in the industry, private equity fundraising levels are well above their long-term average of $387 billion per year, although this level has been roughly flat (in the $550–600 billion range) since 2013.23

In general, however, Hawthorn does not subscribe to the so-called “Yale Model,” where allocations to private equity and other alternative investments can easily exceed 50% of a total portfolio because of the inherent illiquidity effect of private investments in portfolios. We also think the size of allocations to private investments should ultimately be determined by an investor’s unique circumstances, such as time horizon, liquidity/spending needs, and/or any possible regulatory constraints. For a more detailed review of private equity and other private investments, including definitions, illiquidity effects, mechanics, access, and so on, please see

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23 Hamilton Lane Annual Investor Meeting, September 2016.

**Current State of the Private Equity Industry**

Chart 11 (page 14) depicts a series of private equity market and sentiment indicators relative to 2006 and 1999 vintage years with high-low ranges for each metric and an assessment of relative attractiveness, as measured on a scale from green (favorable) to red (unfavorable). Data were compiled by Hamilton Lane, one of the largest direct and fund of funds private equity investment firms in the world. As shown in the diagram, most sentiment indicators remain in positive/favorable territory, with only purchase and leverage multiples firmly planted in negative/unfavorable territory. We think this sets the stage for a favorable backdrop for private equity investments heading into 2017.

**Time Arbitrage**

We think there is a strong case to be made for investors taking a longer-term orientation, particularly in today’s volatile market. Indeed, we think the reward-risk potential for many investments improves with time and private equity is one such investment. By definition, private equity forces investors to take a longer-term view by locking up capital commitments over predefined multiyear horizons (typically 7–10 years). It also generally forces investors to remain invested regardless of what the public markets are doing, and this can be an especially valuable attribute in periods of elevated volatility where the natural instinct may be to “time the market.” With the pendulum swinging more recently toward short-termism and fast-money investment strategies, we think this creates an opportunity at the opposite end of the spectrum for patient, long-term private equity investors.

**Historical Returns**

As patchwork Chart 12 depicts, private equity has outperformed most other asset classes since 2005, with 2009 being the one exception. “In July 2016, in an update of a previous study, business school professors at the Universities of Chicago, Oxford, and Virginia found that, although in recent years [private equity] funds had not done much better...”

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**Chart 12**

**Performance by Asset Class**

<table>
<thead>
<tr>
<th>Year</th>
<th>Emerging Market Equities</th>
<th>REITs</th>
<th>Emerging Market Equities</th>
<th>High Grade Bonds</th>
<th>REITs</th>
<th>High Grade Bonds</th>
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</table>

Source: Bloomberg L.P., Hamilton Lane Investment Database
than stock market averages, those raised between 1984-2005 had outperformed the S&P 500 or its equivalent benchmarks in Europe, by 300–400 bps per year net of fees.\textsuperscript{24,25} Can private equity repeat the absolute returns achieved in the past? That is an impossible question to answer, of course. A better question might be, can private equity outperform in today’s low return environment? We think the answer to this question is likely yes—on average, over the next 10 years.

Table 3 highlights a few select asset classes and our 10-year capital market return and volatility assumptions and calculate their Sharpe ratios. Over long horizons, we believe private equity has the potential to outperform most other asset classes (as do private debt and private real estate) on both an absolute and risk-adjusted returns basis (that is, even after de-smoothing the return series for volatility).

At a time when the expected returns on traditional (that is, publicly traded) asset classes are likely to be below historical norms, it has become increasingly important to consider the role of private equity in investment portfolios. When carefully selected, we believe private equity has the potential to add incremental return in an otherwise low-return environment, in addition to improving the overall risk profile of portfolios through the diversification benefits offered by certain strategies.

### Fixed Income

#### Yield Curve and Duration

As with the economy, there are still a number of secular factors in place that will likely enable a lower-for-longer interest rate environment to persist, including a global savings glut, demographic trends, and high and rising debt levels. That said, we must acknowledge the possibility that the outcome of the U.S. election has fundamentally changed the interest rate environment in some way. Even if over the longer-term it is not dramatically altered, the market’s anticipation of potential changes (higher growth and inflation, a more hawkish Fed) may be all that matters in the short run for interest rate movements.

After taking advantage of the postelection increase in yields to move from short to neutral duration in our strategic portfolios, we expect to maintain neutral duration positioning throughout 2017. Our view is that benchmark neutral duration in fixed income portfolios best balances our belief that although interest rates are likely to gradually move higher over time, the visibility for growth and inflation is even more unclear and may somewhat temper the rise in yields.

Global growth remains a concern that could still weigh on longer-term U.S. interest rates, and ultimately we expect the short end of the U.S. yield curve to rise more quickly than longer-dated maturities. Shorter maturities appear poised to rise roughly 25–30 bps per quarter in 2017, while we see only about half that move for longer yields.\textsuperscript{26}

<table>
<thead>
<tr>
<th>Table 3</th>
<th>10-Year Capital Market Assumptions for Select Asset Classes</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Asset Class</strong></td>
<td><strong>Total Return</strong></td>
</tr>
<tr>
<td>Private Debt</td>
<td>9.70%</td>
</tr>
<tr>
<td>Private Equity</td>
<td>12.80%</td>
</tr>
<tr>
<td>Private Real Estate</td>
<td>9.05%</td>
</tr>
<tr>
<td>Global Infrastructure</td>
<td>6.75%</td>
</tr>
<tr>
<td>Dev. International Equities</td>
<td>8.80%</td>
</tr>
<tr>
<td>Domestic Equities</td>
<td>7.35%</td>
</tr>
<tr>
<td>Emerging Market Equities</td>
<td>10.95%</td>
</tr>
<tr>
<td>Hedge Funds</td>
<td>5.25%</td>
</tr>
<tr>
<td>High Yield Bonds</td>
<td>5.55%</td>
</tr>
<tr>
<td>Investment-grade Bonds</td>
<td>3.00%</td>
</tr>
<tr>
<td>Real Estate Investment Trusts</td>
<td>7.05%</td>
</tr>
</tbody>
</table>

Source: Hawthorn 2017 Capital Market Projections

\textsuperscript{24} Robert Harris, Tim Jenkinson, and Steven Kaplan, “How Do Private Equity Investments Perform Compared to Public Equity?”, *Journal of Investment Management* 14, no. 3 (2016).


\textsuperscript{26} Thomas Tzitzouris, “U.S. Yield Forecast: Is There Another Tantrum in Store for 2017 and Beyond,” Strategas Research Partners (December 14, 2016)
Another factor to consider is that global central banks are likely to maintain extreme monetary policy accommodation, further exacerbating the differential between U.S. and global interest rates, another potential headwind for longer-term rates.

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.

**Central Banks**

Perhaps our 2016 forecast for “global central bank divergence” is an even better characterization for our 2017 forecast. We did, of course, see policy divergence among major central banks in 2016; however, the pace of Fed tightening was substantially less than we had anticipated entering 2016. PNC’s official rate hike forecast heading into 2016 was for three hikes; we thought we might only get two, and we actually got one. After the Fed’s latest 25 bps increase in December, the market seems even more convinced of the continuation of a moderate tightening trajectory. We expect the European Central Bank and the Bank of Japan to remain firmly in easing mode throughout all of 2017, promoting a continuation of the spread divergence between interest rates in the United States and those regions. For example, the spread between the 10-year U.S. Treasury bond and the 10-year German bund has averaged about 150 bps over the past few years. Today, that spread has widened to about 230 bps, and we think this elevated spread differential is likely to persist.

Although perhaps more influential at the short end of the curve, we believe monetary policy divergence will have some influence across the entire term structure. Higher U.S. inflation expectations and term premiums should be important factors in global interest rate differentials. Currently, we see further decoupling of the inflation outlook between the United States and other international developed economies. An increase in oil prices will likely increase headline inflation globally, but core inflation is firming relatively more quickly in the United States.

Lastly, the more dramatic term premium increase in the United States has been driven by the election results. In addition to higher growth expectations, myriad spending proposals, and the presumption of an increase in the budget deficit likely translates into the issuance of additional Treasuries. This should drive the U.S. term premium even higher in order to clear the additional supply in the market, again supporting global rate divergences.

We think the level and sustainability of the interest rate differentials between the United States and regions such as Europe and Japan are critical factors for the strength of the U.S. dollar. The wider the rate differential, the more upward momentum likely in the dollar. We identify a rising dollar as an important risk to the global economy since it helps serve to tighten overall global financial conditions. It also may be a governor on how fast the Fed is able to normalize monetary policy.

**High Yield**

Our view on high yield starts with the economy. Given our expectations for a continuation of modest economic growth in 2017, we view the overall environment as generally supportive of high yield credit. We expect default rates should continue to moderate, if not fall from present levels, as higher
energy prices relative to last year help stabilize credit conditions in that sector.

Ultimately, we do not believe 2017 will mark the end of the business cycle, but growth is likely to remain somewhat sluggish, and credit fundamentals support our view that we are closer to the end of the credit cycle than the beginning. Currently, we see a number of cross currents in the high yield marketplace.

We expect the U.S. dollar to continue to strengthen throughout 2017, likely pressuring the economy and corporate earnings at some point during the year. While the dollar’s strong appreciation (hitting a 14-year high as of this writing) is a sign of rising optimism for the U.S. economy, it will also begin to weigh on multinational corporations, particularly those with heavy international revenue exposure. A fair portion of high yield revenues, close to 25%, comes from overseas, so a stronger dollar may have a negative impact on revenues amid already sluggish sales growth. Indeed, some companies have already started to modestly dial back their 2017 forecasts as a result of the dollar’s appreciation. A continued unbridled rise in the U.S. dollar could, at some point, begin to have a destabilizing effect on the global economy and is something we will be watching closely in 2017. 

Rising interest rates are an obvious headwind across all of fixed income, but one we view as a particular concern in certain areas of the high yield market. Convexity, or the nonlinear relationship between interest rate movements and a bond’s price, is near an all-time low for BB bonds. Simply put, this means that BB prices are even more sensitive to movements in interest rates than might normally be expected.

From a technical perspective, high yield issuance fell in 2016 and is likely to fall again in 2017, reducing supply; at the same time, demand will likely remain solid, with investors continuing to search for relative yield opportunities—a positive market dynamic for high yield. Also, the unwinding of negative yielding assets around the globe has created additional opportunities for investors. Since the end of July, positive yielding assets have increased by some $3 trillion. This has effectively translated into $3 trillion of additional investment options versus just six months ago when the proliferation of negative yielding assets continued to push investors out the risk curve. A continuation of this trend could affect high yield demand if investors can once again find some attractive yields in higher rated credits.

Headline default rates are likely to fall as energy-related high yield stabilizes. Our view is that investors are likely to see this relative improvement versus last year and become increasingly confident about the fundamentals of the asset class. The opposite was certainly true in early 2016, with oil prices falling sharply and the entire asset class coming under tremendous pressure. Default rates may also benefit from a recent decline in the number of banks reporting a tightening of lending standards. Data from the most recent Senior Loan Officer Survey detail the percentage of banks tightening lending standards falling from a multiyear high of 11.6% in April 2016 to just 1.5% as of October 2016.

High yield valuations are still a concern for us, with the market experiencing a great deal of spread tightening throughout 2016. This led to robust returns, in excess of 15%, which if maintained through year-end 2016, would be the third best year for high yield in the last 20 years. Although we believe high yield can have another good year, replicating 2016 performance will be difficult. There is still scope for some spread tightening, even after the 400+ bps spread decline we saw in 2016. Spreads are currently in the mid to high 400 bps range, below the historical average; however, spreads tend to bottom in the low 300 bps range, so further tightening from current levels is possible, in

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27 Bank of America Merrill Lynch Global Research, Bloomberg.
30 BofA Merrill Lynch High U.S. Yield Index.
our view. If spreads continue to tighten in 2017, that could help offset any moderate rise in Treasury rates.\footnote{Federated, 2017 Outlook: Solid Tailwinds for High Yield” (December 16, 2016).}

Our current conviction regarding high yield is not pound-the-table positive or negative. We are coming off an extremely good year for high yield, so we believe returns are likely to moderate some in 2017. That said, conditions are in place for the asset class to generate respectable returns. Often highly taxable investors are best served in the municipal universe, and we do not believe the current value in the high yield market makes a compelling case to the contrary.

**Municipals**

Interest rate volatility was the hallmark of the municipal market in 2016. As PNC’s municipal fixed income team put forth in its 2017 market outlook: “With the wide range of interest rates experienced over the year, investors who entered the sector during mid-summer with rates at all-time lows will have markedly different performance from investors who held municipal bonds for the entire year.”\footnote{PNC Municipal Fixed Income, Market Outlook 2017.} Looking to 2017, the team believes municipals are in a favorable position compared to other fixed income sectors, especially since current prices reflect many worst-case outcomes for the asset class. From a duration perspective, we share the team’s belief than the intermediate part of the curve likely performs best.

The election has had—and may continue to have—a significant impact on municipal bond valuations. Table 4 provides a broad overview of how certain proposed policies might affect the sector.

From a credit perspective, the recent uptick in municipal credit spreads may provide some opportunity. It is unclear that the price volatility (spread-widening) seen postelection reflects any deterioration in credit fundamentals. Our view on the municipal credit landscape remains constructive, consistent with our overall credit view. Corporate default rates have started to flatten in coordination with the stabilization in oil prices, and municipal credit spreads often lag spreads in the corporate market. Given our view of stable (perhaps marginally better) economic growth in 2017, we believe the credit environment remains unchanged. That said, we believe credit selection is always important, with idiosyncratic risks related to pension funding and liquidity having the potential to affect bond pricing in certain areas of the municipal market.

<table>
<thead>
<tr>
<th>Policy</th>
<th>Policy Summary</th>
<th>Municipal Valuation Impact</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax Reform (Corporate and Individual)</td>
<td>Lower, simpler, and pro-growth.</td>
<td>Negative</td>
</tr>
<tr>
<td>Health-Care Reform</td>
<td>Repeal and replace the Affordable Care Act. Maximize choice and create a dynamic health-insurance market.</td>
<td>Negative</td>
</tr>
<tr>
<td>Regulatory Reform</td>
<td>Review to identify and eliminate unnecessary regulations.</td>
<td>Positive</td>
</tr>
<tr>
<td>Transportation and Infrastructure</td>
<td>Invest $550 billion.</td>
<td>Neutral</td>
</tr>
<tr>
<td>Border Security</td>
<td>Reform legal immigration, enhance border security.</td>
<td>Neutral</td>
</tr>
</tbody>
</table>

*Source: www.greatagain.gov, PNC Capital Advisors*
Energy

The Energy sector, in combination with significant oil price volatility, was a major source of market disruption in 2016. Credit markets, for example, were closely tied to oil prices for the majority of 2016, especially during the first half of the year (Chart 13). Anxiety regarding the high yield credit market spilled over into equities more broadly, serving as a primary catalyst for the early 2016 stock selloff. Notice in Chart 13 that the bottom in energy prices and high yield also marked the bottom for equities (mid-February). Despite the rebound in oil prices and equities, energy earnings are still projected to be down 75% for all of 2016, serving as a major drag on overall index earnings per share. We believe energy headwinds will fade into the background in 2017 as prices begin to stabilize at higher levels. Even so, challenges will likely remain for companies whose revenues are tied directly to oil, with prices remaining quite low compared to the post-financial-crisis average, in our view.

Outlook for Oil

Our base case for oil prices in 2017 is a further stabilization of prices in the $55–65 per barrel range. In November 2016, OPEC and other large non-OPEC oil producers, namely Russia, surprised the market by finally reaching a deal to cut production; the first such deal since 2008. We believe the execution of this agreement and the level of compliance with stated output reductions will be the primary drivers of oil price movements in first-half 2017. According to analysis by BCA Research, “Even if actual cuts only amount to 60–70% of the volumes agreed at OPEC’s November 30 meeting in Vienna, we expect OECD storage levels—combined commercial inventories of both crude oil and refined products—to fall some 10% by the end of [third-quarter] 2017.”

From a practical perspective, it is likely we will see higher compliance than what might be expected given the main players’ (Russia and Saudi Arabia) “need” for higher prices. Both countries have exhausted meaningful percentages of their foreign reserves (Russia 16%, Saudi Arabia 30%) in order to fund government expenses since mid-2014. Also, higher export revenues will allow both nations to issue more debt, which has been identified as sorely needed to fund stated political agendas over the next few years. Finally, there are individual country quotas and third-party production verification features to the agreement, which we think also increase the likelihood of a higher compliance percentage. We will continue to monitor developments related to the production cut agreement, but we feel as though the deal has the potential to become an important underlying support beam for prices in 2017. It is worth noting, however, that the agreement officially expires in June 2017, but with an option to extend for an additional six months if deemed appropriate by OPEC.

Another critical element of forecasting global supply will be the response by other key producers at higher price levels. Specifically, U.S. shale is likely to have a significant impact on the longer-term price of oil, in our view. Prices will need to move higher from current levels (roughly $50 per barrel) to entice the level of capital investment...
necessary to meet long-term demand, but we think
the required/breakeven price is certainly lower than
in the past given the advancement of
unconventional methods of extraction and
production. Near term, the largest U.S. shale plays
have breakeven prices in the $45–50 per barrel
range. Given the current economics, the natural
rebalancing of the market already underway, and
the OPEC production deal that is likely to affect
global supply figures late in the first quarter, we
think shale production will bottom in first-half 2017.
Ultimately, any incremental growth in U.S. shale
production has the potential to lower the price
needed to satisfy global demand, remaining a
sizable headwind for prices over the long run.

What are the downside risks to our 2017 oil price
outlook? Although we would “take the under” on the
Fed’s forecasted three interest rate hikes for 2017,
an increasingly hawkish Fed could affect oil prices.
If real interest rates rise faster on the short end of
the curve, leading to a flatter yield curve, history
tells us oil prices are likely to moderate. Also, if
higher relative U.S. rates promote a stronger dollar,
we may begin to see some reduction in global
demand. Emerging markets are also vulnerable to
rising to U.S. rates, another potential demand
headwind.

A much lower level of compliance than currently
projected from the OPEC deal would certainly affect
the fundamental rebalancing the market is
currently factoring into prices.

We believe the market is currently factoring in the
possibility for a more energy-friendly political
backdrop in 2017. As with most policy expectations
at this early stage, little is known about actual
implementation, so this will remain a key area of
uncertainty as 2017 progresses.

**Energy Sector Equities**

Expectations for a stabilization/rise in oil prices
seems to have generated momentum in Energy
sector equities heading into 2017. Since Election
Day, the Energy sector broadly is up over 10%, and
many large players, including Exxon Mobil
Corporation and Chevron Corporation, are starting
to push back toward their all-time highs. As a
result, the Energy sector now trades with
expectations for higher prices, and the bargain-
basement valuations of early 2016 are harder to
find.

That said, as our forecast would suggest, we believe
oil prices move higher in 2017. Although some
caution in the near term may be advisable given
recent sector price moves, we think strength can
continue. It will be important to see supportive
shifts in supply and demand as we move through
2017 to sustain this upward momentum, and any
signs of a material slowdown in economic growth
could also undermine sector performance.

**Master Limited Partnerships (MLPs)**

We believe that the potential for higher oil prices
will be a positive for MLPs in 2017. At the very least,
the massive headwind from the 75% drop in oil
prices from $102 to $25 a barrel has dissipated.
Along with general asset class sentiment, a stability
in energy prices helps relieve much of the concerns
related to cash distributions, debt, and coverage
ratios. In our view, cash distributions are critical,
and the resumption of more widespread distributi o n
growth would likely give a meaningful boost to the
sector.

As it relates to the high-dividend nature of MLPs,
one must also consider the impact of rising interest
rates on performance. We believe that although
MLPs have shown some sensitivity to interest rates
over shorter periods of time, there is no
relationship that would suggest a rising interest
rate environment could create sustained problems
for MLPs. Conducting a simple linear regression
over the past 20 years of the monthly change in the
10-year U.S. Treasury yield versus the monthly
change in the Alerian MLP Index results in almost
no relationship between the two data series. To the
extent rapidly rising rates affect oil prices,
challenges could emerge, but generally higher
rates do not equate to lower MLP prices. Certain
MLPs with large amounts of floating rate debt
exposure may also be challenged, but the majority
of the sector’s debt is at a fixed rate.

From a macro perspective, it is also worth paying
close attention to the regulatory environment in
2017. Any policy movement related to tax reform could promote a shifting landscape for MLPs. On the corporate side, MLPs would be relative losers in any corporate tax reduction because they are not subject to corporate tax. On the personal side, if tax rates are reduced, the MLP tax advantage would become somewhat less attractive to investors. In a worst-case scenario, MLPs are included in some major tax overall that fundamentally changes the tax structure of these partnerships. This is not something we expect, but it is worth acknowledging the possibility.

We believe MLPs with larger capitalizations will be better able to manage through an uncertain regulatory environment, as well as be more flexible around increasing costs of capital (rising interest rates) in a lower-for-longer oil price environment. What we saw for the majority of 2016 was lower quality MLPs bouncing back from the brink of bankruptcy, while higher quality, fee-based MLPs lagged behind. That said, higher quality MLPs have largely maintained dividend growth, with a few holding distributions steady in order to boost coverage over the next few years. We maintain the view that over the next five to seven years, higher quality MLPs will outperform their smaller, lower quality counterparts.

Over the longer term, we think MLPs provide investors with an attractive risk/reward profile, offering compensation for their patience in the form of high dividend yields (something difficult to come by in today’s market). Additionally, compared to other yield-oriented securities such as REITs, utilities, and corporate bonds, MLP valuations are not nearly as stretched. Specifically when compared to REITs and utilities, MLPs are less often thought of as traditional “bond proxies.” For this reason, we think MLPs could outperform these asset classes in 2017.

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**Balanced Portfolio Asset Allocation**

**Baseline**
- Equities 55%
- Bonds 20%
- Alternative 20%
- Cash 5%
- Bonds 20%
- Equities 48.5%
- Alternative 23.5%
- Cash 8.0%

**Equity Baseline**
- US 69%
- International Developed 22%
- Emerging Markets 9%

**Fixed Income Baseline**
- Core Municipal 100%

**Tactical**
- Core Municipal 82.5%
- U.S. Core Taxable 17.5%

**Alternative Baseline**
- Private Equity 35%
- Private Debt 5%
- Hedge Funds 40%
- Private Real Estate 20%

**Tactical**
- Private Equity 30%
- Private Debt 4%
- Hedge Funds 49%
- Private Real Estate 17%

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