Global Market Snapshot

Key Market/Economic Observations

United States

Rotation in Market Leadership, but Will it Last?

- Economic uncertainty created by trade tensions, coupled with a slowing global growth outlook, have helped push many investors to favor two market factors throughout the year: high growth and minimum volatility stocks. Case in point: the Information Technology (up 30.0%), Real Estate (29.5%), and Utilities (25.3%) sectors are leading U.S. markets higher year to date, with the S&P 500® up 19.9%.
- Performance in September was largely driven by "deep-value" stocks, that is, companies that have the lowest price-to-book ratios and where consensus believes there is little value to be had. This contrasts with traditional value companies that maintain a margin of safety or significant business competitive advantage, yet their market prices are below intrinsic value due to temporary factors. Until we see traditional value leading market performance, we remain skeptical of the rotation.
- We continue to see a path higher for U.S. equities. Specifically, solid market fundamentals, an accommodative Federal Reserve (Fed), and a supportive valuation backdrop (the current forward price-to-earnings of the S&P 500® is about the same level as it was during the 2018 high of 16.9 times) offer an environment for further upside. However, greater volatility would be the norm at this later stage of the business cycle. One area we continue to watch closely is next-12-month earnings-per-share estimates, which are currently at all-time highs; the trajectory of revisions will be equally important to watch, in our view.
- The September Institute for Supply Management® (ISM®) Manufacturing PMI® reading fell to 49.1 (less than 50 signals contraction) for the first time since August 2016. Overall, the PMI has been in a downtrend the last 12 months, with the economy weighed down by tighter financial conditions and the ongoing trade tensions between the United States and China. However, it is important to keep in mind that the PMI has dipped below 50 multiple times over the course of the current expansion, specifically in 2012 and 2013 and again in 2015 and 2016. Overall, our business cycle work continues to show we are in the later innings of the cycle.
- News of possible impeachment proceedings against President Donald Trump late in the month over his interactions with Ukrainian President Volodymyr Zelensky reinforced the volatility in global markets we have seen in recent months. In our view, it is too early to gauge overall market impact from just an inquiry, but we will continue to monitor the situation closely. Furthermore, the foundation of our investment philosophy is that markets are dynamic and ever-changing. Thus, we think comparing this political environment to previous periods might be overly simplistic and result in apples-to-oranges comparisons.
- As expected, the Fed lowered interest rates by 25 basis points (bps) to a targeted range of 1.75–2.00% at its September meeting. The PNC Economics team continues to see the recent cuts as "insurance adjustments," with a third cut (another 25 bps) coming in October. In our view, the U.S. economic backdrop is mixed, and the rising dissent in the Federal Open Market Committee reflects the belief that rate cuts are not absolutely warranted. However, investors continue to search for certainty and, unfortunately, have come to rely on the "sugar high" of continued widespread policy accommodation.
- Borrowing costs for overnight repurchase agreements (repos) spiked mid-month, generating concerns harkening back to the 2008 financial crisis regarding financial system

liquidity. The rise in dollar funding rates thus far has been chalked up to cash demands outpacing supplies following a combination of large Treasury auctions, quarterly tax payments due, and declining reserves as a result of the Fed's balance sheet normalization. While any type of liquidity shock warrants close attention, we believe the Fed was behind the curve and not prepared to provide immediate liquidity. Therefore, the technical supply-demand mismatch created a temporary liquidity gap in overnight repos and does not represent broader financial system stress like that seen in 2008, in our view.

Developed International Markets

Nontraditional Monetary Policy Tools Leading to "Even Lower for Even Longer" Realm

- The Organisation for Economic Co-operation and Development (OECD) cut its global growth outlook to 2.9% in 2019 and 3.0% in 2020. However, according to the World Bank, average global GDP growth since 1968 is 3.2% year over year. Therefore, the global economy is growing closer to the long-run average as opposed to slowing at an alarming rate, as many headlines seem to be indicating.
- The European Central Bank (ECB) lowered its deposit facility rate from -0.4% to -0.5% and will restart bond purchases of 20 billion euros per month in November. The ECB is also introducing a new two-tiered system that exempts banks' excess reserves from this negative deposit facility rate. For months, the ECB has been saying it would keep rates negative until at least 2020; however, at its latest meeting, the ECB said it would keep rates negative for "as long as necessary." Unfortunately, the ECB continues trying the same strategy, expecting a different result, but we do not anticipate this latest attempt will suddenly become successful either.
- The Bank of Japan (BOJ) held its policy rate steady at -0.1% last month, proving reluctant to cut rates further into negative territory. An October rate cut seems more likely, however, since the central bank is widely expected to collaborate with the government to sustain economic growth as a potentially detrimental sales tax hike went into effect on October 1. While the ECB took interest rates negative first, the BOJ has been the leader in unconventional monetary policy through its yield curve control, qualitative and quantitative easing measures, and outright buying of Japanese equities.
- The U.K. Supreme Court decided unanimously that the decision by Prime Minister Boris Johnson to suspend Parliament until mid-October was unlawful. British lawmakers passed legislation that forces Mr. Johnson to delay Brexit if he has not finalized a deal with European Union leaders by the October 31 deadline. Given this sequence of events, volatility has returned to U.K. markets (equities, fixed income, and currency). We continue to recommend exposure to developed international via active managers.
- Despite an uptick in geopolitical and economic growth concerns, developed market equities ticked up meaningfully over the month, with the MSCI ACWI ex-US Index up 2.9%. While it had a strong month, year-to-date performance is lagging the S&P 500 by about 750 bps. We believe a stabilization in trade tensions and an improvement in business confidence, coupled with a reprieve on the Brexit front, are critical for developed international to regain its footing.

Emerging Markets

Global Tailwinds Return as China Readies for Anniversary Celebration

- For the second month this year, the MSCI Emerging Markets Index is set to outpace the S&P 500. Leadership from the Financials sector reasserted itself this month, despite being a detractor for most of the year. A confluence of macro tailwinds pushing global interest rates higher and improving country-specific conditions (for example, in India) were net-positives for emerging markets (EMs) in September. We continue to monitor the protest situation in Hong Kong as China is preparing for its 70th anniversary celebration next month, amidst softening economic data and further monetary stimulus from the People's Bank of China (PBOC).

- Similar to the momentum-value rotation that occurred in U.S. markets earlier in the month, we saw that transition occur in EMs as well due to their Financials sector exposure. The Financials sector is nearly 25% of the EM Index compared to just 13% for the S&P 500. The sector has underperformed the broader EM Index for most of the year and, despite the strong performance this month, still lags the index by more than 300 bps. Furthermore, EMs have the added benefit of heavyweight technology/internet names rallying from easing trade tensions.
- Most economic data in China surprised to the downside in September. The second-largest economy in the world missed consensus estimates for both retail sales and industrial production, and growth rates for both decelerated from the previous month. Compared to a consensus expectation for 5.2% growth, industrial production grew just 4.4% on a year-over-year basis, its lowest growth rate in the last 10 years.
- As economic growth moderates, the PBOC continues to be proactive in providing monetary support. Earlier in the month, the bank lowered the required reserve ratio for banks to its lowest level since 2007. In our view, monetary policy typically has a lagged effect before it flows through to the overall economy. Therefore, while credit growth has slowed in recent months, the money supply is near all-time highs, indicating to us that loan growth and business activity could reaccelerate.
- Unusual in recent periods, South Africa, the sixth-largest country weighting (roughly 6%), outperformed the EM Index for the month. We do not believe this outperformance is sustainable, given that South Africa remains mired in the longest economic downturn since 1945, according to its central bank. The majority of South Africa's outperformance was driven by telecommunications giant Naspers Ltd. rather than a broad-based recovery of the country's equity market. This is yet another example highlighting our preference for the use of actively managed strategies in EM equities—an asset class that is notorious for numerous idiosyncratic risks at the regional, country, and individual security levels.

Commodities

Volatile Month in Oil Markets as Geopolitical Risks Return

- Crude oil was the largest driver of commodity performance and volatility after an attack on Saudi Aramco's refineries briefly halted 50% of Saudi Arabian production, which equates to 5% of global oil production. Prices initially spiked over 15% on the news in what was the largest one-day dollar increase ever. However, prices gave back nearly that entire move in the following week as Saudi officials reassured markets that production could be restored by the end of the month.
- The outlook for global crude oil demand continued to soften over the month, with weakness suggesting the potential for excess supply in 2020. OPEC may need to consider additional cuts to production to balance supply and demand next year. That said, crude oil has risen more than 20% year to date, and the increased potential for further confrontations between Iran and Saudi Arabia may sustain a higher geopolitical risk premium in prices, in our view.
- Agriculture prices had a strong month, with the swine flu's devastating impact on Chinese pork production continuing to have a significant impact on livestock prices. Livestock prices are benefiting from China's 40% plunge in the number of lean hogs as the impact of swine flu has worsened, driving U.S. exports to the highest level since 2017.
- Industrial metal prices finished modestly higher in September, with copper/steel up and aluminum down. Despite being up for the month, copper remains near its 52-week low and aluminum fell to a 1.5-year low late in the month. Aluminum demand has declined, with the outlook for uses in everything from beer cans to automobiles remaining subdued.

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