Key Market/Economic Observations

United States

Easing of Key 2018 Risks Allows Multiples to Re-Expand amid Slowing but Stable Growth

- In late 2018, we believed investors were pricing in too much risk. Now we question if investors have gone too far in the other direction. We believe the re-expansion of valuation multiples the market has enjoyed in 2019 is likely justified. However, investors will likely need to see continued progress toward resolving concerns from 2018, including:
  - more rate hikes by the Federal Reserve (Fed) — these appear to be off the table for now;
  - the rising dollar — still a risk, but the dollar has remained around the same level for the better part of six months;
  - higher long-term interest rates not currently at risk given the likely Fed rate hike trajectory;
  - trade and tariffs — still a risk, but less so in our opinion; and
  - slowing growth — in the United States, we think there could be a “soft landing” case materializing, as evidence by a recovery in PMIs, a bounce in consumer sentiment, and low unemployment claims. The large decline in retail sales looks to us like a one-off given strong earnings from Amazon.com, Inc. (AMZN) and Walmart Inc. (WMT). Evidence of Chinese stimulus is likely a big plus for global growth.

- We believe the Fed’s pause in tightening monetary policy remains the most important relief to financial markets. Furthermore, the Fed’s pivot toward “patience” has helped to ease financial conditions, which tightened considerably during 2018. Tighter credit spreads, tame inflation, a recovery in equity markets, and lower interest rates have collectively helped ease conditions.

- While the United States and China have yet to find common ground on key structural issues such as intellectual property and forced technology transfers, recent updates have been mostly upbeat. Asset prices welcomed the U.S. signal it will likely extend the March 1 deadline to raise tariffs on Chinese products if the two sides continue making progress in negotiations. We believe both sides have incentives to reach an agreement soon.

- Fourth-quarter earnings season is winding down and set to post the fifth straight quarter of double-digit blended earnings growth (actual growth combined with consensus estimates) at 13.1%. Although the number and magnitude of positive earnings surprises fell below their respective five-year averages, overall results were still better than initially feared. Additionally, the market has not been punishing companies reporting negative earnings surprises nearly as much as it has over the past five years.

- Earnings growth estimates for first-quarter 2019 have fallen below zero for three main reasons: year-over-year comparisons are tougher due to the Tax Cuts and Jobs Act; a few notable Information Technology names such as Apple Inc. (AAPL) and Micron Technology (MU) are struggling with company-specific issues; and earnings expectations have lowered sharply for the Energy sector, which was initially supposed to be the key driver for first-quarter earnings. Please see our Fourth-Quarter 2018 Earnings Wrap-Up for additional analysis.

- Domestic stocks have recovered almost 20% since their low on December 24. From a technical standpoint, the momentum behind this rally has been historically strong – nearly 93% of stocks in the S&P 500® are currently above their respective 50-day moving averages. While some consolidation would not be unusual,
any growth in the fourth quarter, narrowly missing falling into recession (defined as two consecutive quarters of negative growth). Italy, Europe’s third largest economy, did fall into recession in fourth-quarter 2018 as economic output contracted by 0.2%. This marks Italy’s third recessionary period since 2000, with the last two ranging from September 2007 to April 2009 (7 months) and May 2011 to November 2017 (67 months). Furthermore, the more forward-looking Eurozone Manufacturing PMI fell to 49.2 in February, marking the first time since June 2013 the index fell below the 50 level indicating economic contractionary conditions.

So what is driving the Eurozone weakness? One can certainly point to idiosyncratic factors such as new vehicle emission testing standards weighing on the German auto industry, tightening financial conditions in Italy, “yellow vest” protests in France, and the ongoing Brexit negotiations. However, these factors alone do not fully explain the economic zone’s sharp turn down in growth over the last few quarters.

According to Mario Draghi, President of the European Central Bank, the slower growth across Europe can be blamed on a “slowdown in external demand” and, more specifically, on a slowing Chinese economy and U.S./China trade tensions. Europe’s economy is highly sensitive to global trade fluctuations — according to BCA Research, 18% of the euro area’s gross value added is generated by the manufacturing sector, which is highly dependent on stable global trade and directly links to falling industrial production and manufacturing PMI levels across Europe.

Despite ongoing trade tensions and softening global economic data, developed international markets carried their positive momentum from January into February as the MSCI EAFE index climbed another 2.7%, bringing the index’s year-to-date performance to 9.4% (as of February 26). The strong performance can be attributed to a sharp improvement in investor sentiment, demonstrated by rising price-to-earnings (P/E) multiples. Today, the forward MSCI EAFE P/E ratio is 13.3 times(x), up 11.2% since the end of 2018, and just below its 20-year average of 13.4x.

While the global stock relief rally continues, investors should be mindful of how quickly prices have moved higher. MSCI EAFE forward earnings expectations have fallen by -1.9% this year. We believe a stabilization in earnings growth expectations is critical for markets to chart a sustainable path higher.

Economic data out of Europe continue to come in weaker than expected. Eurozone industrial production contracted by 3.3% in 2018, and Germany, which is Europe’s largest economy and the fourth largest in the world, failed to produce forward returns 6 and 12 months out tend to be above average after strong momentum surges. Furthermore, solid performance earlier in the calendar year usually leads to strong full-year performance. Last year was a glaring exception because investor expectations were much higher. That level of optimism is no longer in the market, which bodes well for 2019 returns.

Recent U.S. economic data have been mixed but solid. Consumer sentiment has started to recover, economic activity in the manufacturing sector has expanded meaningfully, and the number of job openings continues to exceed the number of unemployed workers. That said, modest declines in industrial production and weaker retail sales data lead us to believe the United States is in a slowing expansion phase and is starting to join the global slowdown.

Developed International Markets

Improved Investor Sentiment Lifts Financial Markets, but Global Economic Outlook Remains Uncertain; Brexit Clock Continues to Tick

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- According to Mario Draghi, President of the European Central Bank, the slower growth across Europe can be blamed on a “slowdown in external demand” and, more specifically, on a slowing Chinese economy and U.S./China trade tensions. Europe’s economy is highly sensitive to global trade fluctuations — according to BCA Research, 18% of the euro area’s gross value added is generated by the manufacturing sector, which is highly dependent on stable global trade and directly links to falling industrial production and manufacturing PMI levels across Europe.

- U.K. Prime Minister Theresa May extended the Brexit vote deadline to March 12 (just 17 days before the United Kingdom is set to break from the bloc) in an effort to achieve a deal and avoid a “no-deal” exit scenario. European officials have advised that if no deal is reached, a 21-month extension could be considered. Such a delay could perpetuate volatility in financial markets and perhaps even allow the entire divorce to be reevaluated. We believe the probability of a hard Brexit is low; however, the uncertain path will continue to hang heavy on the U.K. and Eurozone economies.
consecutive month. CPI grew at its slowest pace in a year, highlighting the strength in credit growth on an inflation-adjusted basis.

Despite being one of the best-performing EM countries in 2018 on a relative basis, India remains the only country in the index with negative year-to-date performance. Ever since the bailout of the financial conglomerate Infrastructure Leasing & Financial Services (IL&FS) last September, Indian equities have lagged the EM index. India’s election season is expected to occur in the spring, and given the challenges in public equity markets, recent events may be a sign of ongoing volatility.

We’ve already seen the Reserve Bank of India surprise investors by being the first central bank to lower interest rates this year, and conflict with Pakistan since mid-month is a situation we continue to monitor closely. For perspective, India is the fourth largest country in the EM index.

Over the last 15 years, the correlation between EM equities and the US Dollar Index is –0.62. Dollar strength has been a headwind for EM equities, particularly in 2018, with the dollar up 7.9% year over year compared with –7.5% in 2017. PNC Economics expects the dollar to stabilize, if not weaken, as larger U.S. fiscal deficits, slowing U.S. economic and earnings growth, and the change in the Fed’s monetary policy limit further currency appreciation. Furthermore, 2018 was a busy and polarizing year for EM federal-level elections. We believe political uncertainty could transform into improved stability this year, acting as a further boost for EM currencies and EM equities as a result.

Emerging Markets
Lunar New Year Ushers in the Year of the Pig, a Symbol of Prosperity and Wealth

Emerging market (EM) equities lagged developed markets for the first month since September; however, Asian EM equities were strong, led by China and Taiwan consumer and information technology stocks.

Chinese markets were also supported by a surprise growth in corporate credit growth for the month of January. The ¥3.23 trillion in new credit both exceeded consensus estimates and was the largest volume on record. We will need to see additional follow-through to build conviction that China’s stimulus efforts are indeed leading to materially higher credit growth, which would reaccelerate economic growth. But this is solid evidence that stimulus has been large enough and targeted in the correct areas.

While earnings season is winding down in the United States, fewer than one-third of EM companies have reported fourth-quarter earnings. Should the blended earnings growth rate (actual results combined with consensus estimates for companies yet to report) remain positive, it will be the tenth consecutive quarter of positive earnings growth, matching that of the S&P 500. Given far less analyst coverage, EM earnings beats and misses are much more volatile than their U.S. large cap counterparts, but the growth trend is fairly similar to the S&P 500 over time.

Chinese economic data were mixed in February. The monthly credit report was a positive surprise; however, the day prior showed both Producer Price Index and Consumer Price Index (CPI) coming in below consensus estimates for the third consecutive month. CPI grew at its slowest pace in a year, highlighting the strength in credit growth on an inflation-adjusted basis.

Similar to the economic headwinds in Europe, Japan’s economy is also struggling with weaker demand from China, which purchases 19% of all the country’s exports. Additionally, the Nikkei Japan Manufacturing PMI™ fell to 48.5 in February, its first reading below 50 since August 2016. Collectively, the softer trading and manufacturing data could push the Bank of Japan to become even more dovish in an effort to stimulate the economy and move toward the central bank’s 2% inflation target.

Commodities
Less Synchronous Commodities Extend Recovery in February Despite Dollar Strength

The Bloomberg Commodity Index extended gains this month amid an improvement in trade relations and commodity-specific developments, bringing year-to-date returns to 6.3%.

The energy subindex, which comprises 30% of the broader index, continues to lead with crude oil 26.2% higher for the year. On the supply side, adherence to OPEC crude oil production cuts, U.S. sanctions on Venezuela, and unforeseen production outages have outweighed record
U.S. production. For context, OPEC has reduced supply by 6.7% since November, the second largest two-month decline outside of a recession in 30 years. Despite weakening demand expectations, declines in production have served to allay concerns of a renewed crude oil glut in 2019, although global inventories are still expected to build modestly over the course of the year.

- Industrial metals also ticked higher, up 9% year to date, breaking through a key technical level and supported by increased optimism on trade negotiations and supportive supply/demand dynamics. Demand remains stable while inventories are broadly below seasonal averages, suggesting any upside surprise in the demand component would likely have an outsized impact on price. In particular, stronger copper prices may indicate an improvement in sentiment toward Chinese growth, given the country’s 50% share of global demand, following a surge in credit creation last month.

- In agricultural commodities, high inventories as a result of a reduction in Chinese imports continue to weigh on prices as the subindex fell more than 3% in February. However, there is some cause for optimism, as China offered to purchase an additional $30 billion in agricultural goods, above pre-trade war levels, which could offer a reprieve to swelled inventories over time.

- Ultimately, we continue to view less dollar strength as key to a sustainable path higher for commodities and inflation, which will likely require a stabilization in international economic growth expectations over the course of the next year. A more accommodative Fed, a reduction in trade tensions, and still-tame inflation are likely to remain supportive of continued, albeit slower, economic growth and consumption in 2019.

Amanda E. Agati, CFA®
Institutional Chief Investment Strategist

Daniel J. Brady
Equity Strategist

Erik Casalinuovo, CFA
Senior Investment Strategist

Matthew D. Feda
Senior Investment Strategist

John W. Moore
Investment Strategy Analyst
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<td>Large Cap</td>
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<td>As we move further into the late innings of the business cycle, we continue to maintain our large cap preference. The market rally to start the year was broad, and kept valuations within their historical ranges. We believe the vulnerability to potential market volatility favors downside protection from large cap. Mid caps have lagged smaller companies, providing rebalancing opportunities. We continue to believe headline risks from trade will ultimately lift, and as the Fed maintains its “patient” posture towards monetary policy, large caps should resume their market leadership. Small cap leverage continues to reach all-time highs as earnings revisions decline, further affirming us to favor large and mid-cap equities over small. Investor expectations of a “Fed pause” supported a REIT rally to start the year, however low inflation expectations and low cap rates should continue to pressure real estate profitability in the near term.</td>
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<td>Mid Cap</td>
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<td>Intl. Large/Mid Cap</td>
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<td>Valuations remain low, both on an absolute and relative basis. Global central bank monetary policy remains accommodative however, signs of slowing economic growth could pressure any near term recovery. While still beneficiaries of significant monetary policy stimulus, near term we believe these markets are more vulnerable to headline risks from geopolitics and trade.</td>
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<td>Intl. Small Cap</td>
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<td>Although weakness has persisted throughout most of the year, recent relative outperformance (that is, technical breakout) should be encouraging for patient investors. The shorter-term focus for EM equities rests mainly on the willingness of Chinese policy makers to reinvigorate growth, with a lagged effect. Year to date, EMs have underperformed both developed international and U.S. markets. We observe an attractive hybrid between fixed income and equities, generating consistent and typically inflation-linked income, with the ability to deliver capital appreciation with lower exposure to business cycle phases. The asset class has been tested numerous times over the past year, but continues to perform as we expected in a volatile global equity market.</td>
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<td>Short Fixed Income</td>
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<td>With the likelihood of longer-term rates remaining range bound, we favor intermediate duration fixed income. At this stage in the business cycle we remain comfortable with this allocation as the majority of underperformance has been isolated to a few high-profile downgrades in the investment-grade credit space.</td>
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<td>Core Fixed Income</td>
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<td>The credit cycle is aging, and outperformance could begin to wane. Below-investment grade markets have reacted favorably to Fed policy to start the year, however valuations should become an increasing headwind for most issuers. Leveraged loans potentially provide more protection from rising interest rates; however, spread widening puts increased reliance on yield. Recent comments from the Fed and range-bound inflation expectations highlight out preference to hedge inflation over the long term via equity exposure.</td>
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<td>Global Bond</td>
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<td>Global economic growth is expected to slow in 2019, hence sovereign debt continues to look fairly valued. The primary sources of return are likely to come from countervailing global trends in currencies and interest rates; hence our neutral stance.</td>
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<td>Unconstrained Bond</td>
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<td>Flexibility provides for diversification if rates should steadily rise (a primary risk to fixed income in this market). As EM equities rallied to start the year, so has EM debt. The confluence of softening geopolitical and trade headline risks, commodity price rally, and strengthening EM currencies have acted as tailwinds for net-export countries and dollar-denominated debt.</td>
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