20/20 Vision

Introduction

Founding father and Philadelphia's adopted son Benjamin Franklin is commonly credited with the invention of bifocals. He created them to fix his dual near- and far-sightedness. In August 1784, he wrote that he was "happy in the invention of double spectacles, which serving for distant objects as well as near ones, make my eyes as useful to me as ever they were."[1] While investors do not have the luxury of simply wearing bifocals to bring the investment landscape into focus, a disciplined, repeatable investment process can help reveal a clearer path.

From a fundamental perspective, we believe the market is in a much better position heading into 2020 than it was to start 2019. A far more accommodative global monetary policy stance is further supported by improved earnings revisions and positive earnings expectations across the globe — a complete reversal from the start of 2019. Last year was one of the best performing years of the entire cycle for public markets; however, we strongly believe there is still progress to be made in 2020. Our near-sighted view is one focused on still-positive fundamentals and a short-term cyclical reacceleration, but our far-sighted view is focused on the potential impact(s) from the 2020 US presidential election.

In this issue of *Strategy Insights*, we present our 2020 outlook for the global markets and key asset classes. We also assess the potential impact of the presidential election cycle and how the markets could be affected, for better or worse, in 2020.

Presidential Election Cycles and the Markets — Blurred Vision

With the 2020 election less than one year away, we take a brief look back at the last presidential election and how the markets responded to 2016 results. We focus on what, if any, impact the 2020 election might have on investment returns.

Do Presidential Election Cycles Move Markets?

Markets generally are not fond of unexpected political surprises. Based on the polling data ahead of the November 2016 presidential election, the upset by Donald Trump was one of the biggest surprises in US election history. Polls from RealClearPolitics.com literally the day before the election predicted Senator Hillary Clinton would win 45% of the popular vote versus Mr. Trump's 42.7%. It also noted that if state polling held, she would win 297 votes, easily surpassing the 270 needed to win the Electoral College.

[1] https://www.ushistory.org/FRANKLIN/science/bifocals.htm.

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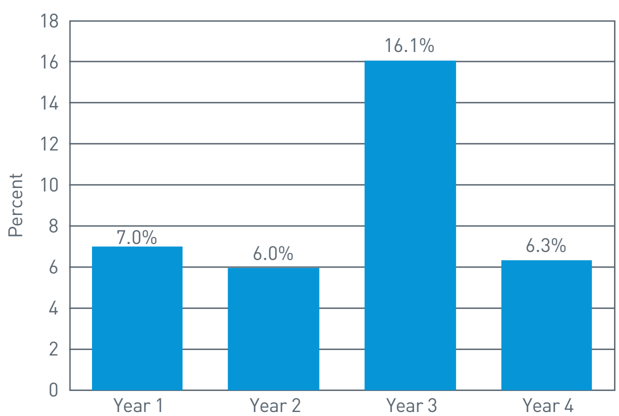
Ultimately, this polling proved only partially correct. Senator Clinton won the popular vote by about 2%, but Mr. Trump won the Electoral College 304 to 227. In doing so, he became just the fifth president to win the Electoral College vote after losing the popular vote, joining the likes of John Quincy Adams in 1824, Rutherford B. Hayes in 1876, Benjamin Harrison in 1888, and George W. Bush in 2000.

Equity markets reacted quickly to this surprise by initially selling off as much as 4% in the after-hours markets on November 8, 2016, taking a decidedly bearish view of the potential policy implications of a Trump presidency and much more gridlock in Congress. Global equity and currency markets also fell precipitously. However, fewer than 24 hours later, the S&P 500® finished up a bit more than 1%, with some investors believing that many of the policies Mr. Trump ran on might actually prove beneficial for investors. In addition, fears of more gridlock faded with the Republican Party maintaining its majorities in the House and Senate.

Equity markets have followed a clear pattern during presidential cycles (Chart 1). Since 1948, in years one and two of an administration, the S&P 500's price returns have averaged 6–7%, as the implementation of campaign policies start to find their way into economic growth and equity prices. Year three of the cycle has *by far* been the best year for returns, with an average of about 16%. Intuitively this makes sense to us because investors tend to react favorably to proposals made by candidates from both sides about how their specific policies will produce greater economic growth

Chart 1
S&P 500 Price Returns by Presidential Cycles
(Calendar Years, 1948-2018)



Source: Strategas Research Partners, PNC

and prosperity. Year four sees the market returning to mid-single-digit price appreciation as investors await the next election's outcome.

While the various proposals and policy implementations so far during the Trump administration have been highly debated, it is hard to argue that at least for large-cap US equity returns, they have been anything other than beneficial. Since Election Day 2016, the S&P 500 has delivered price appreciation of 46.8% (13.4% annualized) and a total return, including dividend reinvestment, of 56.1% (15.7% annualized). The S&P 500 was up 19.4% on a price-only basis in 2017 (year one of President Trump's term), down 6.2% in 2018 (year two), and up 25.3% year to date through November 30 (year three). At least so far, these returns are widely outside of the long-term averages for presidential cycles.

Can Markets Continue to Ignore Impeachment Headlines?

In our view, the answer is yes. With the S&P 500 posting strong year-to-date returns and new highs throughout November, most investors are clearly not focused on the impeachment proceedings. Republicans hold a majority in the Senate and would likely pay a high cost for removing a president with such high party approval ratings. Therefore, barring any significant changes in the process, we see the chances of President Trump being removed from office as extremely low.

What may be affected by the impeachment proceedings, in our view, is other vital business of the federal government, such as a federal budget agreement and passage of the United States-Mexico-Canada Agreement, which replaces the North American Free Trade Agreement signed by President Bill Clinton in 1993. Various other proposals around infrastructure investments, drug price regulation, and another round of potential tax cuts could also be affected by the pace of the ongoing events.

While this process has garnered many pages of news headlines and political pundit discussion, equity markets appear to have ignored the proceedings in Washington so far. Instead, markets have focused more on solid underlying fundamentals, such as better-than-expected earnings growth and reasonable valuations.

What Could Be President Trump's Major Campaign Proposals for 2020?

While the president could still introduce some new policies, we believe it likely he will base his case for re-election on his accomplishments, centering on the strength of the economy. With third-quarter GDP at 1.9% and an unemployment rate of 3.5%, a 50-year low, we feel the economy is in a solid position from which to build his re-election campaign. In addition, he is likely to make the case that his negotiating tactics with various trading partners are the right course for the United States. In this regard, we think timing is key. With economic growth slowing over the last year, due in no small part to business uncertainty around trade tensions, he may not want to risk a further slowing in economic growth. In our view, this was likely a key reason we saw more constructive movement from the administration toward the "phase one" trade deal.

Furthermore, recent reports suggest the administration is working on a second round of tax reform that would lower the tax rate for middle-income Americans (reportedly with incomes between $30,000 and $100,000) to 15%. In our view, any proposals at this time likely have minimal chance of passing a divided House and Senate. Based on recent campaign speeches, it is also likely we will see continued discussions around tougher regulation of internet and social media companies in a second term, along with the ability of the federal government to negotiate drug prices, a headwind for the Health Care sector.

Who Will Receive the Democratic Nomination?

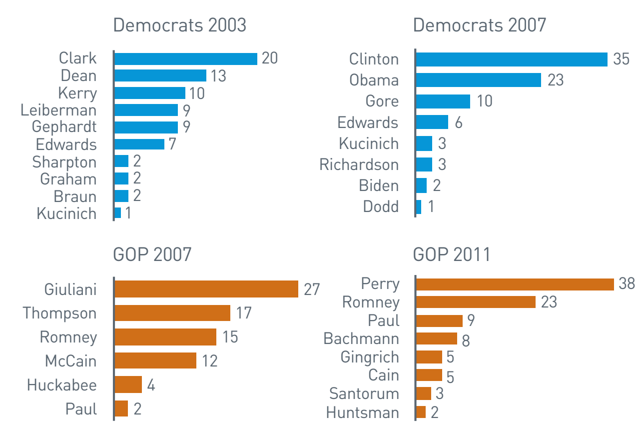
We start with a quick list of names: Wesley Clark, Hillary Clinton, Rudolph Giuliani, and Rick Perry (Chart 2). These were the leaders for their party's nomination, based on polling data in the fall of 2003, 2007, and 2011. At this point in each of these years, the candidate who would go on to be the actual nominee for the party stood in no better than second place, with a polling gap of at least 10 points. In 2003, John Kerry, the Democratic nominee in 2004, was in third place, 10 points behind Mr. Clark. In 2007, Barack Obama was in second place, 12 points behind Ms. Clinton. The same year, John McCain was in fourth place, 15 points behind Mr. Giuliani. And in 2011, Mitt Romney was in second place, 15 points behind Mr. Perry. Keep these early polling averages in mind when using current polling data if trying to handicap who the Democratic nominee will likely be next fall.

Throughout 2019, polls have consistently placed former Vice President Joseph R. Biden atop the field. Massachusetts Senator Elizabeth Warren has been the candidate with the largest improvement in polling numbers since announcing her candidacy. Vermont Senator Bernie Sanders has seen his polling data remain fairly steady throughout the campaign despite a modest dip early in October, after it was revealed he had suffered a heart attack. South Bend, Ind., Mayor Pete Buttigieg's polling data have remained fairly steady since seeing a brief surge early in his campaign.

Outside of the key position stances from the individual candidates, what seems to be at issue is who is best positioned along the political spectrum. Vice President Biden and Mayor Buttigieg are running on positions that would be classified on the more moderate end of the political spectrum, while Senators Warren and Sanders are looking to occupy the more progressive wing of their party, in our view.

Some late entries to field present a wild card for the process. Former New York City Mayor Michael Bloomberg, reportedly "troubled" by the current Democratic field and the prospect of President Trump being re-elected, officially entered the race

Chart 2
Nominee Polling Roughly One Year from Election



Source: Evercore ISI, PNC

on November 24, 2019, by filing paperwork in both Alabama and Arkansas just ahead of their respective deadlines. Both states' primaries will be held March 3, 2020, meaning his campaign believes he can win the nomination even after missing the first four primary contests. Mayor Bloomberg might be considered the ultimate moderate from the market's perspective. He served two terms as a Republican mayor, one term as an Independent, and is currently a registered Democrat. In addition to this late entry, former Governor of Massachusetts Deval Patrick has also decided to enter the Democratic field.

We will not have to wait long to get an early read on the Democratic presidential nominee. Beginning on February 3, primary voters will go to the polls in Iowa, followed by New Hampshire on February 11, Nevada on February 22, and South Carolina on February 29. This will be followed on March 3 by Super Tuesday, where 15 states and territories will hold primaries and caucuses for Democratic voters. Momentum exiting these voting states should go a long way in narrowing the field. While the ultimate nominee will likely be decided by then, the final primary wraps up on June 16 in the District of Columbia.

What Do the Democratic Candidates Want for America?

There are some key similarities across the policy positions for the Democrats that focus on a few important areas concerning investment implications: taxes, health care, and regulation. The major candidates have proposed tax *increases*, including a rollback on the Trump tax cuts for corporations. Some are proposing more targeted increases, such as a wealth tax, capital gains tax increases, and higher taxes on financial corporations.

These tax increases likely would be used to fund various candidate spending proposals, covering areas such as increases in education spending, free college tuition and student loan forgiveness, and implementing measures to address climate change. However, we believe the area most likely to see the biggest spending increase is health care. Here, positions include the expansion of the Affordable Care Act to the abolishment of private insurance companies and the implementation of Medicare-for-All. Like President Trump, all candidates in the Democratic field are in favor of the government limiting or negotiating prescription drug prices.

A Democratic president might also increase the chances that an infrastructure spending package, currently proposed by House and Senate Democrats (to the tune of $1 trillion), is enacted. In our view, while there is pent-up demand for infrastructure investments and bipartisan support for more spending, we are skeptical a proposal of this magnitude could actually pass in the current political climate in Washington.

Most candidates favor increases in government oversight with regards to energy policy, carbon emissions, the labor market, and technology company/business regulation. We believe the nominee would look to reverse many of the regulatory reductions enacted by the Trump administration. Regulatory powers are perhaps one of the greatest levers a new president can pull to quickly enact an agenda. A divided Congress makes complex policy changes like health care or tax reform difficult, but broad executive regulatory powers can quickly affect various segments of the economy.

Is There a Good Predictor/Indicator of Election Outcomes?

If we look through the lens of the economy, every president since Woodrow Wilson who has avoided a recession in the two years prior to re-election has gone on to win (Table 1, page 5). Our analysis also suggests a high correlation with election outcomes and real disposable income per capita. According to the Bureau of Economic Analysis, over the last 15 years this metric has averaged about 1.4% year-over-year growth. Since 2009 it has been about 1.5%, just marginally better. But since mid-2017 it has been in excess of 2% every quarter. In our view, that may put President Trump in a position of strength to the extent it continues to accelerate or even just stays stable at current levels. Two other variables highly correlated to election outcomes are nonfarm payrolls — not the unemployment rate but the actual jobs number — and the trajectory of real GDP.

In terms of the advantage for sitting presidents, "first term incumbents traditionally have an advantage

Table 1
Recession Election Indicator

No Recession Two Years Before Re-Election

President	Recession?	Re-Elected?
Obama	No	Yes
Bush II	No	Yes
Clinton	No	Yes
Reagan	No	Yes
Nixon	No	Yes
LBJ	No	Yes
Eisenhower	No	Yes
Truman	No	Yes
FDR	No	Yes
FDR	No	Yes
FDR	No	Yes
Wilson	No	Yes

Recession Two Years Before Re-Election

President	Recession?	Re-Elected?
Bush I	Yes	No
Carter	Yes	No
Ford	Yes	No
Hoover	Yes	No
Coolidge	Yes	Yes
Taft	Yes	No

Source: Strategas Research Partners, PNC

Table 2
S&P 500 Performance 3 Months Prior to Presidential Election

Year	S&P 500 Price Return	Incumbent Party	
1928	14.91%	Won	√
1932	-2.56%	Lost	√
1936	7.92%	Won	√
1940	8.56%	Won	√
1944	2.29%	Won	√
1948	5.36%	Won	√
1952	-3.26%	Lost	√
1956	-2.58%	Won	X
1960	-0.74%	Lost	√
1964	2.63%	Won	√
1968	6.45%	Lost	X
1972	6.91%	Won	√
1976	-0.09%	Lost	√
1980	6.73%	Lost	X
1984	4.80%	Won	√
1988	1.91%	Won	√
1992	-1.22%	Lost	√
1996	8.17%	Won	√
2000	-3.21%	Lost	√
2004	2.16%	Won	√
2008	-19.48%	Lost	√
2012	2.45%	Won	√
2016	-1.90%	Lost	√

Source: Strategas Research Partners, PNC

by about 5-6 percentage points in the popular vote compared with candidates whose party has already held the White House for two or more terms."[2] To the extent economic variables such as GDP growth remain at current levels or better, that would further help support President Trump's position of strength heading into the election season. Contrary to popular belief, approval ratings actually have a poor track record of forecasting presidential elections. In our view, it is actually economic conditions that tend to "trump" other variables (pun intended). Even in a scenario where President Trump's approval rating is lower than historical averages, as long as economic metrics remain supportive, it likely gives him a solid chance at re-election.

Historically, voter turnout has been volatile, but we believe potential voter turnout in 2020 will be a key determinant of election results. The 2018 midterm elections had a surge in Democratic turnout — in fact, the highest level for a midterm election since the early 1900s. We believe a notable takeaway from the midterm elections is that the Republican constituents who came out in droves to vote for Mr. Trump did not come out to the same degree in the midterm elections. It remains to be seen whether the president's base can recover the turnout from the 2016 election.

There is also another indicator with a pretty good track record at picking presidents. The three-month return of the S&P 500 has been near perfect at determining the outcome of the presidential contest going all the way back to 1928 (Table 2). If the S&P 500 posted a positive price return in the three months before election day, the incumbent party has

[2] Jan Hatzius et al., "Early Thoughts on the 2020 Presidential Election," Goldman Sachs Economics Research (April 13, 2019).

remained in the White House, according to Strategas Research. If it has been negative, the incumbent has lost the election. There are only three times since 1928 that this model has not worked: 1956, 1968, and 1980. For all the discussions about the level of surprise in 2016, this market predictor got the outcome correct. Returns for the market were negative in the three months prior to the election, and the incumbent party did not retain the White House.

So we can look to the direction of the market in August through October next year as a potentially good indicator of the outcome. Current polling data, according to RealClearPolitics.com, show most of the leading Democratic candidates winning in a head-to-head matchup against the president.

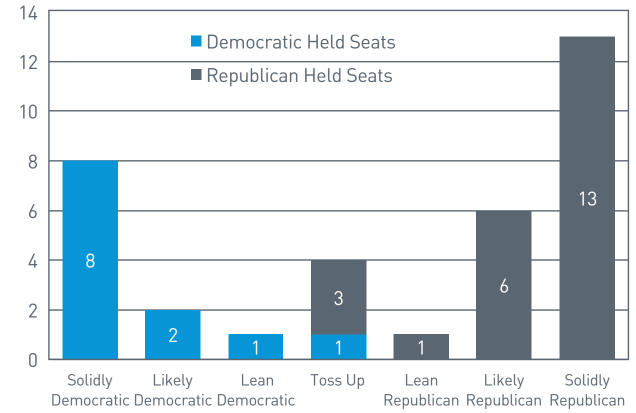
Will Congress Change Hands?

Currently, the Democratic Party holds a majority of 233 seats in the House of Representatives to the Republican Party's 197 seats. One member is an Independent, and four seats are vacant. With all House seats on the ballot again in 2020 and a solid pickup in Democratic seats in 2018, at this point the likelihood of Republicans gaining back control of the House appears to be difficult, in our view.

In the Senate, Republicans hold a 53-seat to 47-seat majority, with two Independent senators typically voting with the Democrats. So the Democrats would need a four-seat swing to take control of the Senate, or three seats if they were to retake the White House, with the vice president casting the tie-breaking vote for a majority. A total of 35 seats are being contested this cycle, with Republicans defending 23 of these seats. As we noted previously, control of the Senate will be of key importance in determining if either President Trump or a new president will be able to move his or her legislative agendas through Congress.

Nineteen of these Senate seats are rated as either "solidly" or "likely Republican seats, while another 10 are rated "solidly" or "likely" Democratic (Chart 3). Another one seat for each party is rated "lean" Republican or Democratic, leaving a total of four seats rated as "toss up." So legislative control could come down to just these few races. Of the six "toss up" or "lean" races, President Trump won four of these states in 2016 (Alabama, Arizona, Michigan, and North Carolina) and lost two (Colorado and Maine).

Chart 3
2020 Senate Race Ratings



Source: Strategas Research Partners, PNC

We continue to believe Democratic control of the Senate will remain elusive.

Are Investors Heading for Another Paradigm Shift in 2020?

We believe the outcome of the 2020 election has important long-term implications for investors. But we first need to take a quick look at two guiding principles of the parties for context and perspective: the role and size of government and regulation. Republicans generally believe society is effectively better off when all branches of government play a lesser role in regulating industries and the economy. In this view, people and companies should succeed or fail based on their merits and the results of their actions. Typically, Republicans are looking to shrink the size and scope of government wherever possible. On the other hand, Democrats generally believe that society is better off when government takes a more hands-on approach, especially when it comes to helping the disadvantaged. As such, Democrats are typically looking to expand the size and scope of government by creating new programs and providing additional social services. This dichotomy is also apparent when it comes to the parties' philosophies on regulation. Generally speaking, most Democrats believe in a high degree of government oversight while most Republicans tend to prefer more limited government involvement.

Outside of the impacts to specific sectors, we are likely to see broader discussions in coming years about the role of private enterprise. These discussions could accelerate depending on who wins the White House and Congress. In fact, we may already be seeing subtle changes along this front. In August, the Business Roundtable, a group comprising the chief executive officers (CEOs) of major US corporations, issued a revised statement on the "Purpose of a Corporation." The statement, signed by 181 CEOs, notes that in addition to generating long-term shareholder value, corporations need to:

- deliver value to customers;
- invest in employees;
- deal fairly and ethically with suppliers; and
- support the communities in which they work.

In revising its statement, the Business Roundtable acknowledged that in conjunction with societal changes, corporations need to adapt to better serve the needs of every *stakeholder* associated with the business rather than focusing specifically on the *shareholder*. Should the Democrats gain control of Congress and/or the presidency, some of these changes could continue and have broader implications for investors.

In our view, one of the biggest risks to the length, timing, and duration of the current market and economic cycles continues to be the volatility and uncertainty around US trade policy with China. Market volatility picks up every time there is a barrage of negative trade-related headlines and then settles down as the appearance of progress on the trade front comes back into focus. Some investors might be thinking that, with a change of control in the White House, this stiff headwind might either fade into the background or disappear completely. Unfortunately, we believe trade relations (with the United States and China, in particular) will continue to be a focal point for markets, regardless of who wins in 2020. The competitive nature of the two governments and economies is likely to intensify. The major difference between the Trump administration and the Democratic candidates is likely to be in the tactics and approaches used.

Most market participants can probably agree that "getting to a better place" with US-China trade is important (there is bipartisan support on this issue as well), but how investors might approach the topic and/or ultimately define success is less clear. Democratic candidates appear to favor a more cooperative approach by tackling this issue with the help of our traditional global allies instead of the Trump administration's approach. We would also expect the use of Twitter as a primary means to communicate policy changes to fade meaningfully in favor of more formal communication methods and a clear (that is, more predictable) path forward. In our view, this would be a welcome development for the markets that do not like being caught off guard by surprising news. We also believe the Democratic candidates might seek to find common ground with China on other seemingly unrelated issues (that is, climate change) to help build a more collaborative working relationship and ease existing trade tensions.

What Are the Sector and Industry Implications?

The outcome of the election is likely to have differing sector and industry implications depending on who wins the White House. However, we believe there are some sectors that could have an overhang regardless of who is in the White House. For example, Big Tech names such as Alphabet Inc. (GOOGL), Facebook, Inc. (FB), and Amazon.com, Inc. (AMZN) are likely to remain under regulatory scrutiny. Politicians seldom concur on much, but regulation of technology companies seems to be an area of mutual agreement. While these companies have been key drivers of the market's appreciation over the last decade, the impact of heightened regulation certainly bears watching.

Health care is also likely to remain under scrutiny, regardless of the outcome. With rising health care costs always near the top of voter concerns, this is an area both sides will look to address. However, what is at stake next year is whether changes in the sector will be subtle, such as drug price reforms and expansions in uninsured coverage, or more significant, such as the elimination of private health insurance and an adoption of Medicare-for-All. We continue to see the outcome as an ongoing risk for the sector.

The outlook for the Energy sector is also highly dependent on the election's outcome. Regulations and restrictions for the sector have come down significantly under the Trump administration, and would likely remain a tailwind with another Trump win.

Paradoxically, the Energy sector has been the worst performer within the S&P 500 since the November 2016 election, despite the administration's pro-energy policies. Therefore, while politics do matter, the supply-demand economics matter more. However, most of the Democratic candidates have proposals that would further restrict energy exploration and operations, such as ending leases to drill on federal lands and, even more aggressively, banning fracking on all public and private lands. This would be another headwind the Energy sector does not need.

Table 3 highlights sectors and selected industries we believe are likely to be affected by the 2020 election. This may be used as a road map for investors to examine and weigh their portfolio sector exposures. We expect those with a plus sign (+) to be positively affected by the winning party, minus sign (–) to be negatively affected, and an equal (=) sign to be more or less unaffected. We note that a sector or industry may have the same outcome regardless of the winning party (that is, the Industrials sector has two plus signs), but for very different reasons. Each issue will affect the market to varying degrees depending on who ultimately wins the election.

Table 3
Sectors, Selected Industries, the Presidential Election Cycle

	Republican	Democrat
Sector		
Communication Services	-	-
Consumer Discretionary	+	-
Consumer Staples	=	+
Energy	=	-
Financials	+	-
Health Care	-	-
Industrials	+	+
Information Technology	=	=
Materials	=	=
Real Estate	=	-
Utilities	=	=
Select Industries		
Alternative Energy	-	+
Aerospace/Defense	+	-
Cannabis	-	+
For-profit Education	+	-
Infrastructure	+	+
Housing	=	-
Insurance	=	-
Master Limited Partnerships	=	-
Municipal Bonds	=	+
Natural Resources	+	-
Student Loan Debt	=	+

Source: Cornerstone Macro, Strategas Research Partners, PNC

Conclusion

Who wins the White House generally matters for investors and the markets. Candidates from the two sides hold stark differences on big policy issues that could produce very different outcomes for companies in the affected sectors. Despite being relatively close to the election, there are still many uncertainties about who will be the nominees, what the make-up of the Congress will look like, and what will occur in the economy and markets between now and then. Given the highly polarizing nature of the 2020 election cycle, we believe it is critically important to not be caught on the wrong side of the trade. Instead, we continue to recommend maintaining well-diversified asset allocations and portfolios across geographies and asset classes to avoid a potential volatile outcome.

We now turn to our 2020 outlook, beginning with our current fundamental observations of the market.

Key Market Characteristics – Eagle Eyes

The US economy remains in its longest expansion in history, and the stock market continues to chart new all-time highs. But have we reached a market peak? We don't believe so. To be clear, we are not blindly bullish – a core belief of our investment process is that financial markets are complex, dynamic systems. Not all cycles are identical; however, broad characteristics tend to align at market peaks. We compare nine such characteristics to the 2000 and 2007 market peaks – in both cases all nine were flashing red. Today, however, we see just two — uptick in merger and acquisition (M&A) activity and defensive stock leadership — signaling some cause for concern.

1. Peak Valuations

At 17.7 times (x), the forward price-to-earnings ratio (P/E) of the S&P 500 is not overly expensive, in our view, with the 30-year average just 16.0x. For reference, we entered 2018 a full multiple point above this level, but the strength of earnings growth helped pull down valuation multiples as the year progressed – a healthy form of multiple contraction. The forward P/E was 23.8x ahead of the 2000 dot-com bubble and 15.1x in 2007, when lower multiple sectors were the primary drivers of performance.

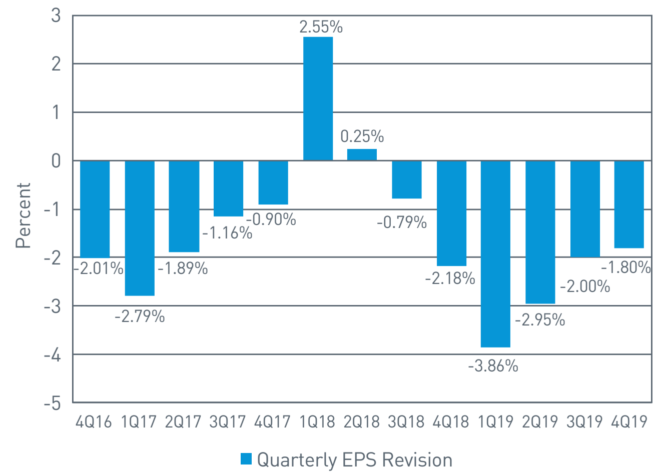
Other metrics such as the cyclically adjusted P/E (CAPE) and price-to-sales portray more elevated valuation levels. The S&P 500 price-to-forward-sales ratio is 2.2x, above its 20-year average level of 1.6x. Yet the MSCI ACWI ex-US Index's price-to-forward-sales ratio is just 1.3x. For such a long, slow, below-trend growth economic cycle, perhaps it isn't too surprising this metric might look stretched. All of the action on the part of companies to "do more with less" has come on the expense side of the equation, driving profit margins to 20-year highs and return on invested capital 20-30% above its long-run average in large-cap domestic equities. Through November 30, the CAPE is 29.4x, still below the January 2018 peak of 33.0x. As a point of reference, in March 2000 it was 44x. As the year shifts to 2020, we may see the weakest year of the CAPE ratio roll off, alleviating some pressure on this metric. Thus, in our view, current valuations remain reasonable/ supportive and could expand if macro headwinds abate.

2. Weakening Earnings Revisions

Earnings revisions for 2019 declined sharply in late 2018 and early January (Chart 4), with the Tax Cuts and Jobs Act (TCJA) helping to drive 2018 earnings growth (20%) to the highest level since 2010 — the year coming off the Great Recession. US earnings-per-share (EPS) growth remains on solid footing, projected to post 3% year-over-year improvement in 2019, despite those tough year-over-year 2018 comparisons. Quarterly revisions throughout 2019 clawed their way higher, and the consensus expectation for earnings growth in 2020 is nearly 10%. After bottoming in early 2019, next-12-month (NTM) EPS estimates are sitting near all-time highs through November 30, 2019, and we expect that positive trend to continue as we head into 2020.

Chart 4

S&P 500 Quarterly EPS Revisions



Source: Earnings Scout, PNC

3. Narrowing Market Breadth

Typically at market peaks, stocks struggle to make new highs. However, more than 70% of the S&P 500 stocks are above their 200-day moving average – breadth expanded significantly during the 2019 market rally. Anything north of 50% is generally considered a healthy level for market breadth. At its peak in 2007, more than 90% of the S&P 500 was above its 200-day moving average versus just 15% a year later. During the dot-com bubble, this metric peaked in mid-1999 around 80% and fell to less than 20% by the March 2000 high.

Additionally, correlations on the S&P 500 have fallen to approximately 0.32, roughly in line with a two-year average, which suggests to us it remains a stock picker's market. The fundamentals do indeed matter; particularly around earnings season, we have seen a big distinction between winners and losers in terms of performance – a healthy indicator, in our view. Longer-run moving averages also look reasonable at current levels, having broken above key resistance levels across US, international, and emerging market (EM) equities.

4. Heavy Equity Market Inflows

Public equity inflows in general are lower than in previous cycles. According to the Investment Company Institute, in the week ending November 26, 2019, $22 million came out of global mutual funds and exchange-traded funds (ETFs) ($609 million into domestic strategies and $631 million *out* of global strategies). The 13-week average weekly flow is about –$3.6 billion per week. Part of the shift may be due to rising assets under management in private investments, though we believe that is likely to remain a small fraction of total flows.

Despite strong public equity market year-to-date performance, we are still seeing the largest net flows into fixed income products. Fixed income flows continue to build at $8.7 billion (taxable strategies $6.0 billion, municipal strategies $2.7 billion) for the week ended November 26, 2019. This is slightly below the 13-week average of about $9.5 billion per week.

Cash allocations remain at all-time lows. Usually near the end of a cycle or bull market peak, cash allocations start to rise meaningfully. Although we have seen a very small uptick, it has been negligible and most likely a sign of the times – in a lower-for-longer interest rate environment, no one is getting paid to hold cash stockpiles. Typically, equity flows should be dominating with the kind of performance backdrop we experienced in 2019. This reinforces our view that investor sentiment remains pretty fickle. This has been an "unloved" expansion and an "unloved" market rally. We don't see any signs of "fear of missing out" from retail investors, in particular.

5. Uptick in M&A Activity

One of two items on our list that we see as a warning sign is the sharp uptick in M&A activity. After the TCJA provided new opportunities to allocate capital, we hoped it would lead to an uptick in net-new capital expenditures (capex). However, we affectionately call 2019 the "Year of the Deal," with M&A becoming an increasingly popular capital allocation strategy for corporations. Second-quarter 2019 saw a record $640 billion in deal volume, and while the third quarter saw deal volume grow 30% on a year-over-year basis, it only hit $400 billion, a sequential quarterly slowdown. Notably, as deal counts increased, the average deal premium in 2019 also increased relative to 2018 (average 30% in 2019 compared to 20% in 2018). However, that premium is still well below the business cycle's high of 37% achieved in 2012. So, while we have seen a significant pickup in M&A in 2019, it is hard to argue the current backdrop is overly extended after a weak prior couple of years. We think there is room for this trend to continue into 2020 on the basis of pent-up demand alone.

6. Vigorous Initial Public Offering Activity

In spite of negative initial public offering (IPO) headlines, equity capital markets remain solid and deal count is below the cycle average. For context, the dot-com bubble ushered in 400 IPOs in 1999 and 500 in 2000. In 2007, that number had fallen to 250, and in 2018 there were just 186 US IPOs. The average performance for companies that debuted in 2019 is actually positive despite the negative headlines; the majority of IPO underperformance stems from the largest of the so-called "unicorns."[3] Companies such as Uber Technologies, Inc. and Lyft, Inc. remain below their IPO prices through November 30 2019. That is in striking contrast to the median unicorns, which have a positive return since their collective debut. The recent decision to cancel WeWork's IPO suggests to us public market sentiment is far from exuberant and actually remains quite reasonable/rational. Because of the challenged backdrop for large IPO performance recently, more and more companies are choosing to wait or delay going public, which may actually have the unintended consequence of further stretching private market valuations. It will be important to keep a close eye on the IPO market in 2020.

7. Defensive Stock Leadership

Defensive stock leadership is the second characteristic flashing a warning sign – when the defensive sectors are leading the market, it typically portends trouble ahead. Unlike in international markets, US bond proxy sectors (that is, Consumer Staples, REITs, and Utilities) were on a tear for most of 2019 as the macro environment continued to dominate investor psyche. However, the fundamental backdrop did not improve much, which drove the forward P/E multiple of, for example, the Utilities sector to an all-time high in 2019. The "minimum volatility" trade has become very crowded and rather expensive, in our view, which is notable at this point in the cycle, since these exposures may not ultimately be

[3] Defined as a market capitalization of at least $1 billion at the time of the company's debut.

the safe havens many investors would expect. There has been a rotation away from these sectors as the macro outlook has started to brighten and we are starting to see a short-term cyclical re-acceleration into 2020.

8. Rising Real Interest Rates

Rates have been lower for longer this business cycle, so it should not be a surprise to investors that inflation-adjusted interest rates are well below the long-term average despite being in the later innings of the cycle. Based on the core Consumer Price Index, the real interest rate of the 10-year Treasury is -0.6% and has been negative since June. At its peak in 2007, it was 3.0%, and in early 2000 the real rate of the 10-year Treasury was as high as 4.75%. Due to negative interest rate policies (NIRPs) practiced by some of the major global central banks, it may be some time before real rates globally turn positive (see our fourth-quarter 2019 *Strategy Insights, The "Upside Down" of Negative Interest Rates*). With a Federal Reserve (Fed) effectively "on pause" for now, we do not expect much upward pressure on interest rates in 2020, unless the yield curve begins to naturally steepen on the heels of an improvement in shorter-term growth expectations.

9. Widening Credit Spreads

As the business cycle continues to age, one might expect corporate bond spreads to widen. However, the spread on both investment-grade (IG) and high-yield (HY) bonds continues to make new year-to-date lows. Spreads on IG bonds reached more than 600 basis points (bps) in November 2008 compared with a spread of 107 bps through November 30. If the bond market thought an economic slowdown was imminent, we would likely see it show up here. So far, however, things appear to be well contained.

The only place we are seeing any signs of stress is in the CCC market, where spreads are sitting at year-to-date highs. This divergence relative to the rest of the bond market appears to be largely a function of Energy sector exposure, which continues to be quite challenged on a number of fronts. In our view, this is more of an idiosyncratic issue than a canary in the coal mine more broadly. Yes, leverage is high, but with interest rates staying lower for longer, the ability to service this debt appears to be less of an issue or cause for concern in 2020.

We expect 2020 to continue to experience a complex backdrop characterized by numerous cross-currents, given we have not made much progress resolving the key headwinds (trade/tariffs, corporate confidence, to name a few). However, we think there is still some runway left as measured by these nine key market characteristics.

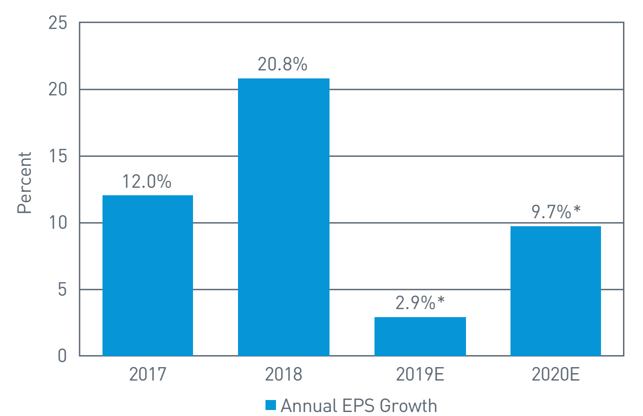
Equities – Wear Bifocals

US Equities – Passed Bottom Row of Annual Eye Exam

Fundamentals

Entering 2019, the outlook for growth in US equities was modest at best, following a nearly 20% decline in the S&P 500 over most of fourth-quarter 2018. Investors worried about a more restrictive Fed, slowing global economic growth, and declining earnings growth comparisons against tax-boosted earnings growth in 2018. (Chart 5). By the first week of 2019, however, Fed officials were already suggesting a shift toward easier monetary policy. Additionally, after consensus estimates were revised significantly lower for the first quarter, earnings season came in much better than expected. The combination of monetary policy and earnings growth proved to be tailwinds for a strong market rally early in the year. By April, large-cap equities had fully recovered from the late 2018 selloff.

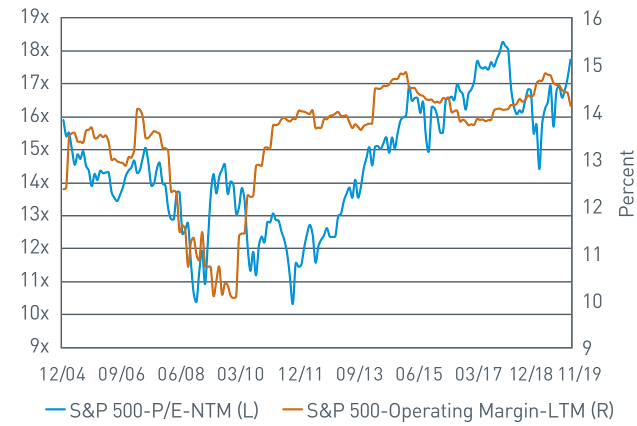
Chart 5
S&P 500 Annual EPS Growth



*Estimate

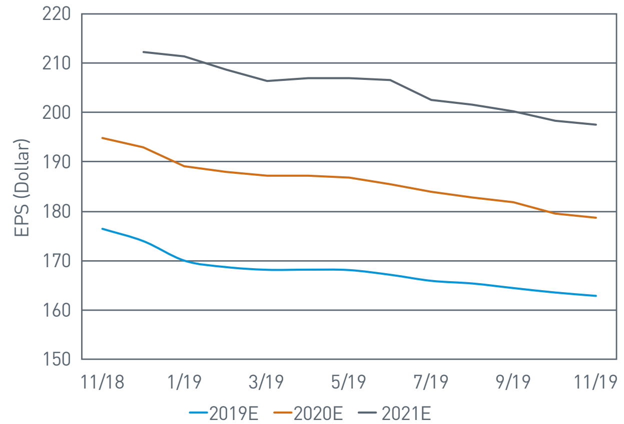
Source: FactSet Research Systems Inc., PNC

Chart 6
S&P 500 Operating Margins versus Forward P/E



Source: FactSet Research Systems Inc., PNC

Chart 7
S&P 500 Earnings Revisions Continue to Fall



Source: FactSet Research Systems Inc., PNC

As we head into 2020, we remain optimistic about the prospects for the S&P 500, with underlying market fundamentals remaining quite healthy. The consensus expects EPS growth of 9.7% in 2020, a significant acceleration over the pace for 2019. While we would expect this growth rate to be revised lower in conjunction with fourth-quarter earnings updates, even a mid- to high-single-digit growth rate would be attractive for this point in the cycle. Revenue growth is expected to be a solid 5.3% level, up slightly over the growth rate for 2019. If the "phase one" trade deal turns out to be a positive, we believe there could be an upward bias to sales and earnings growth estimates.

Profit margins remain in a good position despite various global macro challenges and the ongoing impacts from the trade war. The current operating profit margin for the S&P 500 is 14.1%, which is within 70 bps of its all-time high. Looking at valuation, we believe the current forward P/E of 17.7x is reasonable given the current outlook. As seen in Chart 6, there is a good relationship between profitability of the S&P 500 and forward valuation. While we do not necessarily see a strong case for significant improvement in profit margins, we also do not envision a scenario of significant declines.

Earnings Revisions

Analyst revisions for 2020 earnings estimates have followed a fairly typical pattern, with estimates down 8.3% from 12 months ago, 4.3% from six months ago, and 2.3% from three months ago. Analysts tend to set overly optimistic estimates for forward-year earnings, only to revise numbers down as actual earnings in the current year are reported (Chart 7).

A key driver of 2020 revisions has actually been significant earnings guidance cuts throughout 2019 by a few large companies in the S&P 500. Several of the largest names in the index have seen 2020 estimates revised down sharply over the last year, including Apple Inc. (-10%), Amazon.com, Inc. (-31%), ExxonMobil Corporation (-38%), and Walt Disney Company (-21%).

Exposures

Sectors

From a sector exposure standpoint, given we are late in the business cycle, a more defensive sector positioning might be a good relative call, in our view. However, defensive sectors have experienced significant appreciation over the last year and have seen their valuations move to significant premiums versus their long-term averages. The Consumer Staples sector sits at an 18% premium to its 20-year forward P/E average, and the Utilities sector trades at an even more aggressive 34% premium to its 20-year average on a forward P/E basis (Table 4, page 13). These lofty valuations have been awarded despite return on invested capital (ROIC), a measure of how profitably a company has invested shareholder capital, sitting 6% below its 20-year average in Consumer Staples and 5% below 20-year averages in Utilities.

Table 4
S&P 500 P/E versus ROIC
As of 11/26/19

	Forward P/E			Return on Invested Capital (ROIC)		
	Now	20-Year Avg.	% to 20-Year	Now	20-Year Avg.	% to 20-Year
Large Cap						
S&P 500	17.71	15.55	14%	9.19	7.55	22%
S&P 500® Growth	21.46	18.37	17%	13.09	12.69	3%
S&P 500® Value	14.79	13.58	9%	7.50	5.78	30%
S&P 500 Sectors						
Communication Services	18.36	15.62	18%	9.57	6.46	48%
Consumer Discretionary	21.59	17.82	21%	12.37	7.88	57%
Consumer Staples	19.78	16.77	18%	14.58	15.45	-6%
Energy	17.27	17.10	1%	7.45	11.15	-33%
Financials	13.07	12.52	4%	5.54	3.99	39%
Health Care	15.73	16.27	-3%	11.47	14.50	-21%
Industrials	16.93	15.94	6%	11.26	8.75	29%
Information Technology	20.98	19.83	6%	19.48	14.33	36%
Materials	17.81	13.97	27%	8.11	8.39	-3%
Real Estate	19.44	17.99	8%	4.71	3.71	27%
Utilities	19.30	14.37	34%	4.44	4.65	-5%

Source: FactSet Research Systems, Inc., PNC

Given our expectation for continued solid economic growth, we favor a positioning toward more cyclically sensitive sectors. Forward valuation measures for the Information Technology, Industrials, and Financials sectors are only modestly above their 20-year averages. The Financials sector, in particular, is likely to benefit from a steepening yield curve now that the Fed has signaled it will remain on hold with monetary policy. In addition to reasonable valuations for these sectors, ROIC levels are significantly above their 20-year averages.

Style

Throughout 2019, concerns about economic growth continued the preference for Growth stocks that has persisted for the majority of this cycle. However, as imminent recession fears faded in September, Value stocks began to outperform Growth. Through November 30, the S&P 500 Value Index has outperformed the Growth Index by about 50 bps on a year-to-date basis, reflecting significant outperformance in the Value index just since August 30. Late last year, Standard & Poor's reclassified Apple Inc. as a Value stock with a near 8% weighting in the Value index, which has significantly affected Value's outperformance (Apple +28% since August 30 and +72% year to date). While we are mindful that prior periods of Value outperformance have been short-lived during this market cycle, we continue to maintain a Value tilt in our asset allocation recommendations.

Our analysis of ROIC and valuation also help support our tilt toward Value. Current ROIC for the S&P 500 Value Index stands 30% above its 20-year average, while the forward P/E is only modestly above its long-term average. The Growth Index shows ROIC levels only modestly above long-term averages, yet valuation stands 17% above its 20-year average. Based on these metrics, we prefer the setup for Value into 2020.

Size

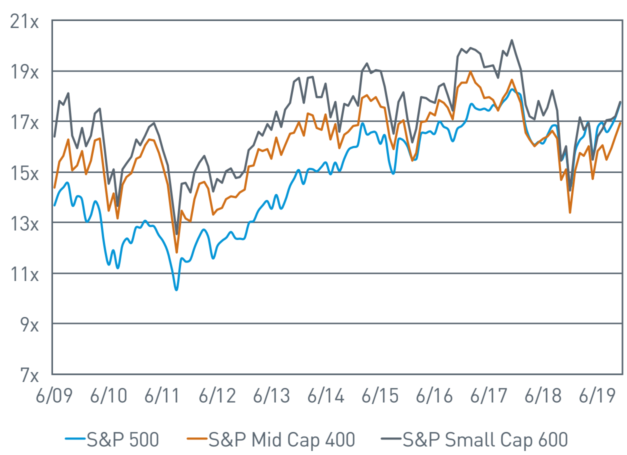
Mid-cap and small-cap equities have also underperformed larger-cap stocks over this cycle. However, looking back over a 20-year period, mid-cap equities have a better risk-adjusted return relative to large-cap and small-cap peers (Sharpe ratios are 0.47, 0.31, and 0.45, respectively).

Following our process of analyzing the business cycle, valuation and technical indicators, we believe mid-cap equities offer increasingly attractive opportunities for investors. Typically, mid-cap companies have exhibited superior sales and earnings growth profiles over long periods versus their larger-cap peers. While valuation for mid caps has risen of late, the forward P/E for the S&P 400® still sits at a sizeable discount to the large-cap S&P 500, despite the advantaged growth profiles for mid-cap equities.

Similarly, earnings growth rates for small caps have also averaged slightly higher than large caps over longer time periods. However, for the first time this business cycle, small-cap earnings growth declined in 2019 by 20% while S&P 500 earnings grew 3%. That negative growth was largely a function of issues in commodity-intensive sectors like Energy and Materials, and small cap is expected to rebound significantly in 2020, with EPS estimates currently calling for 35% growth. The forward P/E for the S&P 600® is 17.8x, just 0.7x above its cycle average. We believe small-cap earnings multiples can still expand from current levels without becoming prohibitively expensive, assuming there is improvement in earnings expectations in 2020 (Chart 8).

With favorable long-term growth attributes and attractive relative valuations, we continue to recommend allocations to both small-cap and mid-cap equities, but we acknowledge risks at this stage in the cycle. In our opinion, the fundamental backdrop needs a catalyst to sustain the small-cap rally that occurred in fourth-quarter 2019.

Chart 8
NTM P/Es by Market Cap



Source: Bloomberg L.P., PNC

Developed International — Diagnosis: Astigmatism

After major developed international indexes declined double-digits in 2018, the expectation was those headwinds and downside surprises had the potential to turn to positives in 2019. Macro risks such as trade tensions, the rise of populism, and NIRPs still loomed large in 2019, effectively keeping pressure on both the earnings and economic growth profiles of the region. The dollar also continued its somewhat unabated upward trend in 2019, acting as a further headwind on export-centric countries, particularly in Europe and Asia. As such, the developed country MSCI World ex-USA Index has yet to reach its all-time high from January 2018. For perspective, it was still one of the best performance years for international developed equities throughout this entire business cycle (+19.4% through November 30).

Heading into 2020, much of the macro headwinds remain unresolved, in our view. Yet we can still find additional items to add to the laundry list of challenges facing international equities. The good news is we believe a breakthrough or reprieve on just a few of these issues could help provide the catalyst for a reacceleration in developed markets growth.

Monetary versus Fiscal Stimulus

Many major central banks across developed international regions have deployed NIRP for the better half of this business cycle. The long-term effects should not be underappreciated, in our view, as more than $12 *trillion* of global bonds have a negative yield through November 30. Without an upside shock to economic growth expectations, consensus expects inflation to remain subdued in 2020, thus limiting the stimulative effect from NIRP. However, we believe the arrival of Christine Lagarde as president of the European Central Bank (ECB) brings the possibility for a fresh perspective and perhaps additional methods of monetary policy stimulus, such as expanding the list of acceptable assets purchased in the new quantitative easing program or a consideration to purchase European equities. Most of the major central bank officials across the globe have acknowledged the limits of accommodative monetary policy and reiterated the need for added fiscal stimulus to help reignite sustainable economic growth. Our base case does not expect major fiscal stimulus to occur in the near term for a number of reasons. The ECB covers a complex region of 22 countries, all which have their own taxing authorities. The British Parliament is contending with Brexit and, in our view, has low expectations to focus on a fiscal stimulus package. Japan's federal government did in fact recently announce new stimulus measures, but, in our view, it was in response to the negative impact from recently raising the consumption tax from 8% to 10%.

Populism and Social Unrest

Prior to 2019, the chief executive of Hong Kong, Carrie Lam, was not a household name in the United States. However, with the ongoing protests in Hong Kong, investors have been watching with growing concern over the government's inability to address rising tensions between police and protestors. From a humanitarian standpoint, what is happening in the region is unacceptable on every level. While Hong Kong is less than 4% of the MSCI World ex-USA Index, its economy is one of the most advanced in the world in terms of GDP per capita. (According to the International Monetary Fund, Hong Kong ranks above the United States on a GDP per capita basis.) Furthermore, the unrest in Hong Kong may actually be yet another sign of the growing populist movements across the globe. The near-term impact from national protests is a disruption of daily economics and trade. However, the longer-term societal effects, like our expectations for markets in 2020, are nearing a fork in the road, in our view. These effects could make headwinds even worse than they already are or lead to meaningfully positive social reforms – at some point, something's gotta give. Although markets tend to shrug off geopolitical events over time, we remain watchful of the dynamics these events could have on international markets.

Brexit

As if the challenge to compromise on very complex trade and employment issues within Parliament isn't challenging enough, leadership at the prime minister position has been just as volatile, going from David Cameron to Theresa May to Boris Johnson. The overwhelming support for Mr. Johnson's Conservative Party in the December 2019 snap election was really a referendum on Brexit, in our view. With fewer obstacles to move forward in Parliament, the hurdle to establish new trade deals with the European Union still remains and suggests to us that the Brexit saga is far from over in the near term. Our views heading into 2020 are unchanged: fundamentals for British equities remain on solid footing, but it is the rampant changing headlines over Brexit's fate that have created significant business uncertainty in the United Kingdom. For example, the UK PMI Composite for October was the lowest reading since the Brexit Referendum, led lower by a significant drop in new orders. That being said, most large-cap UK equities are multinational Consumer Staples and Energy firms, with more than 75% of revenues coming from abroad. In our view, this dynamic creates somewhat of a buffer from the potential fallout of a harder-than-expected Brexit outcome. We continue to recommend diversified, actively managed solutions for exposure to UK equities.

In tandem with US equities, the forward P/E multiple for developed international equities has increased throughout 2019. The difference from prior years, however, is that the spread between the two P/E multiples is at its widest level in 10 years (17.7x versus 14.4x, respectively, as of November 30). Yet performance between the MSCI Europe Index and the S&P 500 was relatively in line in 2019. So does that mean US equities are significantly expensive relative to international equities? A simple comparison of earnings multiples might indicate yes.

There are two primary factors weighing on the valuation differential before even applying fundamental analysis:

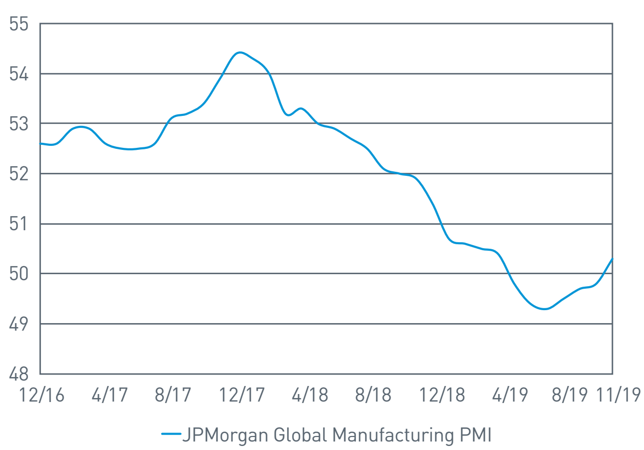
- It is always important to be mindful of index composition because markets are dynamic and sector weights are constantly changing over time. For example, the sector weights between the US and developed international are vastly different. The largest sector in the S&P 500 is Information Technology (Tech) at 23% versus just 6% for the MSCI World ex US Index. Given how Tech traditionally trades at a higher P/E, that is putting upward pressure on the S&P 500's multiple relative to the MSCI World ex-US index and its own trading history.
- A sometimes overlooked aspect of developed international valuations is the Bank of Japan's (BOJ's) direct involvement in the Japanese equity market. In addition to other

extraordinary monetary policy measures, part of the BOJ's strategy includes buying public equities with its balance sheet. To date, it is estimated the BOJ owns approximately 75% of all yen-denominated Japanese ETFs. The goal was to drive equity prices higher in the hopes it would simultaneously spur inflation. However, what has happened is it has crowded out other investors who might have been willing to pay even higher prices/multiples. As a result, the forward P/E of the MSCI Japan Index (which is the largest country weighting of the MSCI World ex US Index) is just 14.2x, 1.2x below its long-run average. We do not expect Japanese multiples (and to a degree, developed international) to expand much in 2020 given the BOJ's commitment to extraordinary monetary accommodation.

In addition, the 2020 consensus growth rate for S&P 500 earnings (+9.7%) is also higher than the MSCI World ex-US (+6.7%). The NTM EPS estimate for the S&P 500 is near its all-time high, whereas developed international is still not back at its all-time earnings high set back in 2011. Could there be some room for upside surprise in 2020?

Using survey data as a guide, the JPMorgan Global Manufacturing PMI accelerated for four consecutive months in late 2019, and moved back to expansion territory for the first time since April (Chart 9).

Chart 9
JPMorgan Global Manufacturing PMI



Source: Bloomberg L.P., PNC

This is notable because manufacturing is a greater percentage of GDP in Europe and Japan (14% and 20%, respectively) compared to the United States, where it is less than 11% of GDP. We could potentially see upside surprises to those EPS estimates in developed international markets in the year ahead should the manufacturing outlook continue to improve. Should political conditions stabilize, corporate confidence pivot higher, and/or global central banks retain their dovish monetary policy stances, developed international markets could not only surprise to the upside but also begin a longer-term period of outperformance relative to domestic equities, in our view. Given the numerous cross-currents, we continue to recommend actively managed strategies for the asset class that can analyze the idiosyncratic risks unlike a passive strategy that just tracks the index.

Emerging Markets – Poked in the Eye but no Permanent Damage

In first-half 2019 the MSCI EM Index was up 10.7%, and through the end of November, it fell 0.2%, lagging the S&P 500 by nearly 800 bps. Given the headwinds from trade uncertainty, slowing global economic growth, and social unrest in certain regions, where does this leave EMs heading into 2020?

Our positive views on EMs longer term remain unchanged since our second-quarter 2019 *Strategy Insights, Emerging from Hibernation: The Green Shoots of Emerging Markets*. For the near term, we walk through our investment process from an EM perspective. As stated previously, the JPMorgan Global Manufacturing PMI has pivoted higher for the last four months. Notably in the November survey, it was EM countries such as Brazil, China, India, and Mexico driving the business outlook higher — this coming after the October China Caixin Manufacturing PMI hit its highest level since December 2016.

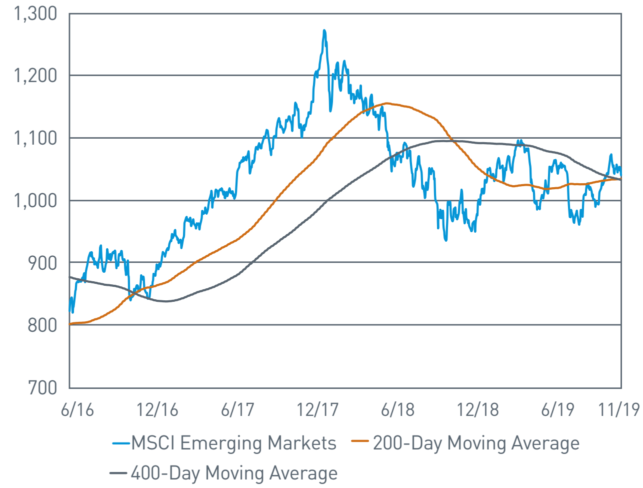
Further signaling a potential bottom in the EM business cycle is the monetary policy accommodation from central banks. Amidst trade uncertainty, the People's Bank of China (PBOC) has been providing numerous stimulus measures over the last 18 months, ranging from lowering the required reserve ratio for banks to stimulate lending, lowering short-term interest rates to provide ample liquidity in financial markets, and the subtle weakening of the yuan. Additionally, as the Fed pivoted from rate hikes to rate cuts, most EM central banks followed suit, further easing financial conditions globally. Should the EM business cycle continue to improve, the monetary stimulus provided by central banks may be starting to show positive effects and rejuvenate economic growth.

From an earnings and valuation perspective, EM equities are expecting a strong rebound in 2020. The consensus is expecting EPS to grow 14%, with double-digit estimates in all but two sectors (Energy and Financials). This is notable because the Financials sector, at nearly 25%, is the largest in the EM Index. Trade tensions have affected the lending environment, and we expect central bank interest rate cuts to weigh on bank profitability. The higher growth estimates tend to be Latin America banks while Asian bank EPS growth estimates are fairly low or in some cases negative. Thus, in our view, we believe an improving economic backdrop could see those revisions improve in 2020. Issues such as corporate leverage, a slight uptick in loan defaults, and ongoing competition from internet firms such as Alibaba Group Holding Ltd. and Tencent Holdings Ltd. remain headwinds for the industry.

Given the strong earnings backdrop for 2020, it may be surprising that the NTM EPS for the EM Index is still at its lowest level since mid-2017. In our view, it is a further signal that the uncertainty from trade tensions is affecting not only business surveys but also bottom-up consensus earnings estimates. It also highlights the idiosyncratic nature of EMs in general and reiterates our view to use actively managed strategies for EM allocations. According to Morningstar, through October the EM Index ranks in the bottom 74th percentile of the EM equity peer universe over the last 10 years.

From a technicals perspective, the EM Index is still approximately 14% off its all-time high through November 30. Given the solid fundamental backdrop and the potential pivot in the business cycle, the technical backdrop looks promising as well. The EM Index broke above both the 200- and 400-day moving averages in October, a feat last occurring in early 2017 as EM went on to deliver more than 37% of performance that year (Chart 10). The moving averages themselves are also nearing a bullish formation, and both are essentially at the same price. The last time the 200-day moving average was above the 400-day was in late-2018, setting up the technical support for a strong EM rally shortly thereafter.

Chart 10
Potentially Bullish Formation for EM



Source: FactSet Research Systems, Inc., PNC

Fixed Income – Needs Vitamin A Supplements

As with large-cap US equities, the Bloomberg Barclays Aggregate (Agg) Index is heading for its best performing year of the business cycle (+8.8%). Even when separating the three primary components of the Agg Index – Treasuries (+7.5%), corporates (+14.2%), and securitized fixed income (+6.2%) – they generated their best respective returns since 2013. To the casual observer, it may sound like a year of smooth sailing for fixed income markets in 2019. However, a significant driver of returns was the decline in interest rates with the 10-year Treasury falling 100 bps throughout the year from its 2.78% high in mid-January. Beneath the surface, the current was much more volatile, with issues including an inverted yield curve, an interest rate spike in the repurchase agreement (repo) market, and the most negative term premium on record.

So where does that leave the Agg Index in 2020? We expect structural forces to remain, effectively capping interest rates from moving significantly higher from current levels. We expect long-term factors such as elevated global government debt burdens, aging demographics, and technological advancements affecting low worker productivity to continue to exert downward pressure on interest rates. We take a deeper look at the three sectors of the Agg Index for additional insights, and then look to high yield, leveraged loans, EM debt, and municipals for guidance around our strategic allocations.

Investment Grade – Eye Drops Keep the Dryness Away

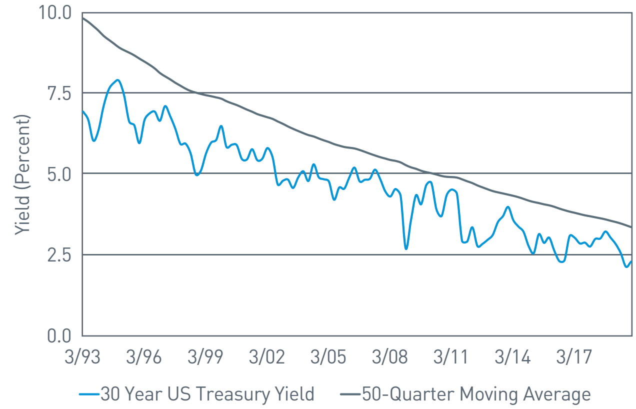
Treasuries

When the 10-year Treasury is paying a negative yield after adjusting for inflation (-0.6%), it is challenging to say bonds are attractively priced. Through November 30, more than $12 trillion in global bonds have a *negative* yield. In our view, NIRP employed around many parts of the developed global economy is pressuring US interest rates lower due in large part to the increasing demand from foreign investors. As such, the term premium, or the theoretical expectation investors have for longer-maturity bonds, has been *negative* in the United States since 2016. For perspective, the term premium for the US 10-year has never been negative going back to 1965. This is certainly a unique characteristic of this business cycle and may help explain factors such as the flat yield curve, and why yield curve inversions may become more of a norm rather than a traditional sign of an imminent recession.

The PNC Economics team expects the Fed to remain on pause in 2020. Coupled with the Fed providing ample liquidity to the repo market by expanding its balance sheet, we do not expect short-term interest rates to decline materially further from present levels. From a longer-term rate perspective, while the 10-year Treasury yield fell 100 bps over the course of 2019, it was far from a smooth ride. Treasury market volatility, according to the MOVE Index,[4] hit a business cycle low in March, only to swing to its highest level since 2016 later in the year. Could interest rates climb higher from present levels, thus ending the 40-year bull market for bonds? We would need to see a shock

Chart 11

Long-Term Rates have Support to the Downside



Source: Bloomberg L.P., PNC

to the upside for global economic growth, which has a low probability, in our view. Additionally, inflation from a breakeven rate perspective would have to move meaningfully higher. Instead, the 10-year breakeven rate is just a few basis points below the 10-year Treasury yield of 1.78% and actually rose above it briefly earlier in 2019. This sort of rare dynamic typically only happens in significant economic growth scares, such as in 2012 during the euro crisis, and briefly in 2016 after the Brexit Referendum. With inflation well contained even at this late stage of the cycle, we continue to believe interest rates are effectively range-bound near present levels.

From a technical perspective, the downtrend on the 200- and 400-day moving averages remains intact for the 10-year Treasury, with the 200-day below the 400 since midyear. For a much longer technical perspective suggesting long-term rates have support to the downside, the 30-year Treasury has never broken out above its 50-*quarter* moving average (Chart 11).

Corporates

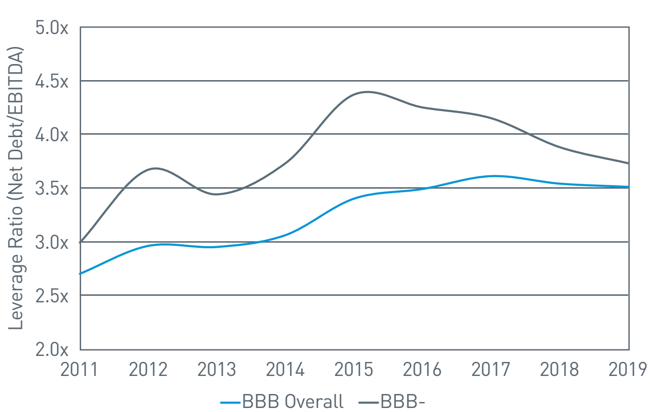
IG corporate bonds are generating their best returns of the business cycle, supported by declining interest rates and fading fears of an imminent recession. Early 2019 headlines calling for a possible wave of credit downgrades in the BBB-tranche seem like a distant memory to us. As corporate earnings came in

[4] The MOVE Index is a well-recognized measure of US interest rate volatility that tracks the movement in US Treasury yield volatility implied by current prices of one-month over-the-counter options on 2-year, 5-year, 10-year, and 30-year Treasuries.

better than feared throughout 2019 and the economic outlook stabilized, IG performance was driven by those very same BBB-rated bonds. Leverage (net debt/earnings before interest, taxes, depreciation, and amortization) for the overall BBB tranche remains elevated compared to the long-term average but has declined to its lowest level since 2014 (Chart 12). We expect the positive trend on fundamentals could continue in 2020, supported by improving earnings growth. Leverage buildup remains far from resolved, however, and we continue to recommend actively managed fixed income strategies that have the credit analysis and security selection experience to select securities compared to a passively implemented approach of tracking the Agg Index.

From a valuation perspective, duration for the IG Index is at a business cycle high of 7.9 (compared to the Agg's duration of 6.2) through November 30. This suggests to us that interest rates would have to fall meaningfully from present levels in 2020 to repeat last year's performance. The option-adjusted spread for IG is just 20 bps above the tightest level seen this business cycle, which occurred in early 2018. The supportive monetary policy backdrop and improving economic conditions in the United States open the possibility for spreads to revisit those 2018 levels. With a yield-to-worst (for bond investors, the lowest potential yield outside of a bond default) of 2.9% compared to the Russell 3000® earnings yield of 5.5%, valuation for IG corporate bonds remains fairly rich in the current environment.

Chart 12
BBB- Leverage Elevated but Improving



Source: Bloomberg L.P., PNC

Securitized Loans

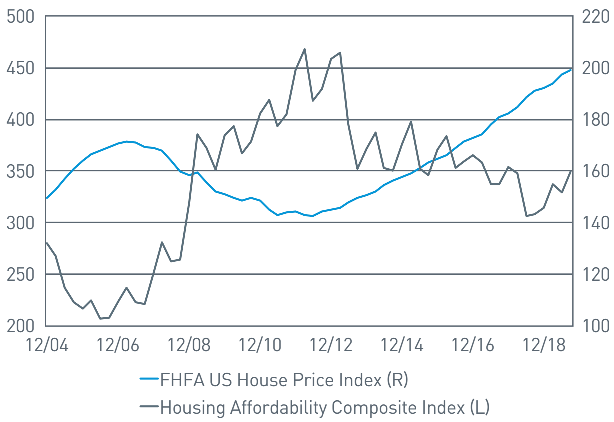
Securitized loans traditionally have been the smallest sector of the Agg Index (25% of total) and, in our view, potentially offer the most opportunity heading into 2020. Composed of mortgage-backed securities, asset-backed securities, and commercial mortgage-backed securities, securitized loans are the only segment of the Agg Index that has grown in size over the last few years. Government-sponsored-enterprise reform aside, we believe the fundamental backdrop for securitized loans remains quite positive. According to Bloomberg L.P., in mid-2019 the national average 30-year mortgage rate fell below 4% for the first time in nearly 18 months. This caused mortgage refinancing applications to jump to their highest level since 2016, creating material volatility for securitized loan investors in mid-2019. With the national average 30-year mortgage rate at 3.7% in the last week of November and longer-term Treasury yields unlikely to fall significantly from current levels, we expect the prepayment wave seen in the latter half of 2019 will likely slow in 2020.

From a valuation perspective, while the securitized loan spread is relatively tight at just 47 bps, it is more than double the business cycle low spread that occurred in 2016. Alongside the rise in mortgage refinancing in 2019, duration of the index at 4.3 has also come down from a high of 6.2 in 2018 and remains below the business cycle average of 4.8. The mortgage market is also improved compared to the later innings of the previous business cycle. Consumer leverage has materially declined over the last 10 years, saving rates have actually increased, and employment remains robust. Notably, housing affordability indexes have also perked up in recent quarters, despite housing prices continuing to simultaneously reach new highs (Chart 13, page 20).

Municipals — Buy a Pair of Readers

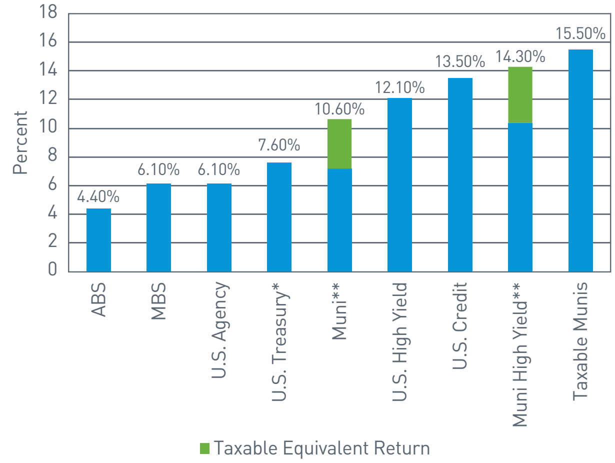
The environment for 2019 in the municipal market was one of tempered volatility with nearly every performance factor supporting investors. Through November 30, the Bloomberg Barclays Index has provided a generous return of 7.21%, aided in large part by the Fed shift to accommodative policy, unprecedented supportive technical factors, and constructive views on credit quality, among others.

Chart 13
Home Prices Up, as is Housing Affordability



Source: Bloomberg L.P., PNC

Chart 14
Year-to-Date Annualized Returns



Note: Taxable equivalent returns:
* US Treasury income is exempt from state income taxes and is adjusted using a national state average (top bracket), net of federal income tax.
** Based on an equally weighted national average federal and state (top bracket) income tax rate; local taxes have not been considered.

Source: Bloomberg L.P., Bloomberg Barclays Indices, Barclays Research

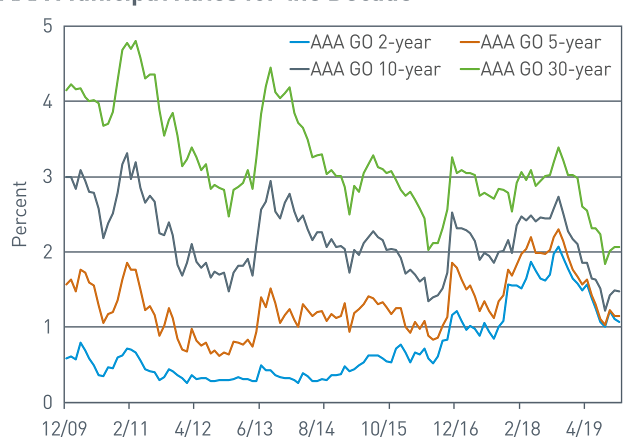
As a result, total return expectations for 2019 ultimately proved too pessimistic.

Entering 2020, the most conspicuous distinction from this time last year is simply current valuations, stretched by robust performance posted for 2019 thus far. Consequently, we suggest it will be difficult for the municipal sector to even modestly reproduce performance of the prior year, where it outperformed most fixed income sectors on a nominal and after-tax basis (Chart 14). Declining interest rates and credit risk premium compression were significant factors driving performance in 2019. These two factors are not specifically endemic to municipals and may not have the capacity to replicate themselves for 2020. Rather, a more reasonable expectation would be to achieve returns comparable to current municipal spot rates, with minimal performance attributed to interest rate movement. Sector allocation and security selection through fundamental credit research and execution will be paramount in preserving value.

Municipal Interest Rates and Sector Relative Value

With the precipitous decline in interest rates of 70–92 bps across the yield curve during 2019, the new year begins with AAA municipal interest rates at the lowest levels since 2016 and hovering around decade lows (Chart 15). We believe the current level of interest rates should temper return expectations for

Chart 15
AAA Municipal Rates for the Decade



Source: Refinitive TM3-MMD, PNC

municipal bond investors. The current nominal level of interest rates should remind fixed income investors of the risk of negative returns: fixed income mandates can move into negative total return territory with minor increases in rates. The timing and magnitude of interest-rate increases will help determine if total returns approach or breach the zero boundary.

Generally, municipal market technical factors remain supportive of municipal valuations, but not to the degree observed in 2019. Market demand, as measured by mutual fund cash flows, has already exceeded any historical precedent in terms of consecutive weeks of inflows.[5] Likewise, several factors have greatly increased the attractiveness of municipal issuers to the taxable market, which has and will continue to cannibalize tax-exempt issuance. In addition, the majority of these taxable issues have financed re-funding of previously issued tax-exempt debt, resulting in a scarcer tax-exempt coupon. The cannibalization has and will likely have a meaningful impact on relative valuations. The municipal market enters 2020 in a fairly expensive condition relative to US Treasuries as the 10-year municipal-to-Treasury ratio is slightly above 80%. However, given the structural features of municipal securities, they do tend to offer protection when rates and credit risk premia rise.

US Election Year

The 2020 presidential election is poised to present uncertainty within the capital markets. Various election scenarios exist that can have profound impacts on general policy measures, US fiscal condition, and tax rates on investment and income. In most of these scenarios, municipals offer a hedge. Should we elect a new president, the tax-exemption would support municipal valuations as tax increases are proposed. However, we would expect some level of credit vulnerability to materialize on the health care and higher education sectors. Retention of a divided Congress would mitigate some concerns. It is likely that the major provisions of the TCJA will remain in place through 2020, which provides a modicum of stability to municipal bond valuations. Significant dialogue and debate surrounding US infrastructure and housing policy would also affirm the value of the financing the municipal market provides. Trade policy would have disparate impacts across the domestic geography.

Municipal Credit

Municipal credit performance in 2019 was healthy, given what had been viewed as somewhat stretched valuation levels. Much of the performance can be attributed to the aforementioned technical factors experienced during the period. Evidence of this performance can be witnessed within the IG segment, specific to high-tax states enjoying added investor interest following the passage of the TCJA in late 2017. This condition pervaded and even accelerated some in 2019 compared to 2018. Much as has been the refrain, it is clear to us the credit market also faces the continuing theme of rich valuations against otherwise supportive market conditions.

We are close to resolution of much of the Puerto Rico bankruptcy case, and it should provide additional data points for the credit market as it did in 2019 with the Puerto Rico Highway and Transportation Authority judgment and Puerto Rico Sales Tax Financing Corporation settlement. Outcomes in 2020 will likely generate significant and perhaps lasting impacts on the general orthodoxy of municipal credit, that is, legal covenants and lien status. We believe the effects will be felt among special tax bonds, enterprise revenue bonds, and appropriation-supported obligations. If expectations for a lower-growth economic environment hold, credit quality should likewise be maintained. However, should growth underperform expectations, a degree of unanticipated deterioration will likely cascade into the weaker credit buckets, which are already richly valued.

Any downdraft in equities could awaken correlated risks to state and local government pensions that have not yet been fully contemplated. Some of the weaker pension funds are already buckling under the weight of their immense liabilities, and recent local government bankruptcies have demonstrated that the existence of large pension liabilities generally portends greater losses to bondholders in a restructuring. The generous treatment of appropriation-backed debt may earn more scrutiny as particular local government issuers embolden themselves to challenge the orthodoxy built on

[5] https://www.ici.org/research/stats/flows.

rating agencies as enforcers, protecting investors from themselves. We believe investors who share this outlook would do well to favor generally more inelastic enterprise sectors such as public power and stronger local governmental issuers that can insulate themselves from much of the potential systemic risks.

The 2020 outlook favors a year of modest-to-flat total returns for fixed income investors, but we believe the municipal sector is positioned to provide excess after-tax total returns relative to other fixed income sectors. In an environment generally conducive to maintaining stability, longer duration and lower quality portfolios may benefit from enhanced carry (a term for holding an asset that pays a yield of some kind). However, at current valuations there is little room for deviations from the base case. The opportunities for additional price performance are minimal, given the performance of 2019. Both interest rate- and credit-based upside fall victim, at least in part, to the results of the preceding timeframe. Residual effects from the TCJA could persist with reinforcement from completed 2019 tax returns. Given the risks to the outlook and the weakened pricing signals, opportunities to capture excess returns and improve the overall portfolio stance should be examined. We expect liquidity to remain supportive in the municipal sector, but investors need to be prepared to take advantage of any dislocation that could arise through economic developments, geopolitics, and fiscal or monetary policy.

High Yield — Cataracts Developing

Similar to the performance drivers for IG corporate bonds, HY bonds started the year with option-adjusted spreads at 526 bps, the widest position since 2016. However, the similarities stop there, with IG issuance declining year over year in 2019 and the volume of HY issuance jumping approximately 50%. The contrast is even more apparent when comparing interest rate sensitivities. Duration for IG is at its business cycle *high*, but HY duration has drifted to its *lowest* level of the business cycle. This indicates to us that the HY issuance boom in 2019 was actually issuers refinancing debt to capture lower interest rates, whereas IG issuers focused on maintaining or improving leverage levels. In our view, the fundamentals of the HY market outside of the CCC-rated companies in the Energy segment have improved over the year, with net leverage decreasing alongside improving economic growth expectations. While that is a positive from a fundamental perspective, from a technical perspective we believe the callability[6] of HY could become a concern in 2020.

In a hypothetical situation for callable bonds, if interest rates decline, an issuer can call a bond back at a price of $100, even if that bond was trading at $102, thus delivering a potential loss for investors. (It is *extremely* rare for the US Treasury to issue a callable bond, nor is it common for IG issuers.) Similarly, if interest rates move meaningfully higher, the duration of the callable bond would increase, and the price would be negatively affected. According to Bloomberg L.P., more than 40% of HY issues not only have a call date in 2020 but also trade *above* their respective call price through the end of November. Callable HY bonds are a risk if interest rates move meaningfully higher or lower from current levels, and this reinforces our recommendation for actively managed HY strategies rather than a passive approach that is more easily susceptible to these technical risks.

Leveraged Loans – Pink Eye…or Something Worse?

HY issuance surprised to the upside in 2019, which in part explains why the leveraged loan market saw issuance plummet 40% compared to 2018. Performance expectations for the loan market can be challenging to gauge since the S&P LSTA 100 Index only includes the top 100 most liquid loans, making index-level data fairly narrow. That being said, we find it notable that the index saw a significant pop in performance after Fed officials signaled a change in policy in early January. However, if an investor was not already properly allocated in loans by that first week of January, price returns were *negative* through November 30 compared to a nearly 9% return for HY over the same timeframe.

We believe much of that impact is the concerning rise in collateralized loan obligations (CLOs) with weakening credit covenants, that is, debt issued to borrowers with fewer restrictions on collateral, payment terms, and levels of income/earnings. The lion's share of covenant-lite lending in recent years

[6] At any point after a predetermined number of years following a bond's issuance, the issuer can "call" it, meaning take the bond back from the investor before it matures.

has been particularly concentrated in nonbank and non-US lenders (for example, alternative asset managers in Japan) as opposed to the major global investment banks. This gives us some degree of comfort that any outsized stress in the leveraged loan market brought on by the next recession may be fairly limited to firm-specific risks (that is, contagion risks appear low at this juncture). These dynamics create a juxtaposition in the leveraged loan market: Is credit quality deteriorating to concerning levels across the CLO market, or do these nonbank lenders and asset managers bring their experience to the table and can take on higher-than-average debt levels? Nevertheless, given the advanced age of the current cycle, we recommend limiting portfolio exposures to this portion of the fixed income market.

Emerging Market Debt — Night Vision Goggles Help See the Light

2019 was not only a strong year for EM debt, but it was also one of those rare years where it actually *outperformed* EM equities through November 30 (11.2% versus 10.6%). Among the tailwinds for the asset class in 2019 were:

- falling interest rates across the globe;
- easing financial conditions;
- a stabilizing dollar; and
- year-over-year improvement in oil prices.

While geopolitical issues come with the territory in EM debt, we see some signs of progress that should continue into 2020. Notably, in Latin America the newly elected Brazilian government is staying true to its commitment for pension reform, and even the president-elect in Argentina has vowed to work with the International Monetary Fund (IMF) with regards to its 2018 bailout, the largest the IMF has ever issued.

We continue to like EM debt because compared to the developed world, most EM countries have higher interest rates. Thus, in our view, it means they have more levers to pull from a monetary policy stance should an economic slowdown take hold. The yield-to-worst on the Bloomberg Barclays EM USD Aggregate Index is 5.0% compared to the US Treasury Aggregate Index with a yield-to-worst of 1.8%. Therefore, even if global rates trend lower from here, EM debt has much further to go before getting dangerously close to the zero lower bound, unlike the developed world, which has much less policy ammunition to work with, in our view. While barely 1% of the EM debt index, we believe the PBOC is really a driving force for monetary policy across EMs. The People's Bank of China (PBOC) has injected significant stimulus into the system via a number of measures over the last few years, which forces their trading partner central banks to follow suit to maintain relative competitiveness. Should the global growth outlook weaken from here (not our base case forecast for 2020), we would expect the PBOC to step in with additional stimulus measures. In response to that, other central banks (for example, Mexico, India, Russia) would most likely ease policy as well.

Heading into 2020, economic expansion in EM countries should remain well above that of developed economies, albeit all at slower but still positive growth rates. Despite the positive economic growth outlook, EM debt spreads based on the Bloomberg Barclays EM USD Aggregate Index with US Treasuries are near 12-month highs (330 bps), which suggests to us that there is actually room for them to tighten from current levels based on the brighter global economic outlook for 2020. Therefore, we believe valuations are already pricing in much of the lingering negative sentiment from the uncertain macro backdrop of 2019. Also, if the dollar weakens in 2020, as our PNC Economics team expects, it would act as an additional positive catalyst for EM debt.

In summary, we believe EM fixed income allocations should remain in line with strategic allocation targets. The fundamentals underpinning EM economies coupled with attractive valuations should help provide improved risk-adjusted returns in a diversified fixed income portfolio.

Alternatives — Is Laser Surgery the Cure All?

As the business cycle continues its record streak for the longest in US history, the environment for private investment opportunities remains rather robust, as does investor demand for the asset class. Although 2019 was a strong performance year across public markets (that is, both equities and fixed income), we continue to believe longer-run investment returns for both are likely to be below average. In a somewhat unique environment where portfolios may experience pressure from a returns standpoint on both the equities and fixed income sides of the equation, the alpha generation potential and illiquidity premium offered in private markets becomes all the more important and critical in helping investors meet their longer-term goals and objectives.

We believe a properly diversified alternatives portfolio should always incorporate multiple vintage years and multiple strategies. We would not advocate allocating all private investment capital into just one vintage year or just one strategy. It takes time to build an alternatives portfolio, and judging performance is unique to the dynamics of each vintage year. Therefore, it is important to note that our views below are specific to vintage year 2020. Key private market trends that have been taking shape in recent years should continue to persist in 2020:

- uptick in equity capital market activity: mergers and acquisitions, including the resurgence of public company buyouts, and ongoing demand for venture capital opportunities;
- fee compression coupled with the challenge to generate consistent alpha in public markets may continue to shrink the hedge fund universe; and
- the longer developed market central banks keep policy rates near or below zero, the more leveraged investments could attract additional capital.

Private Equity — Double Vision

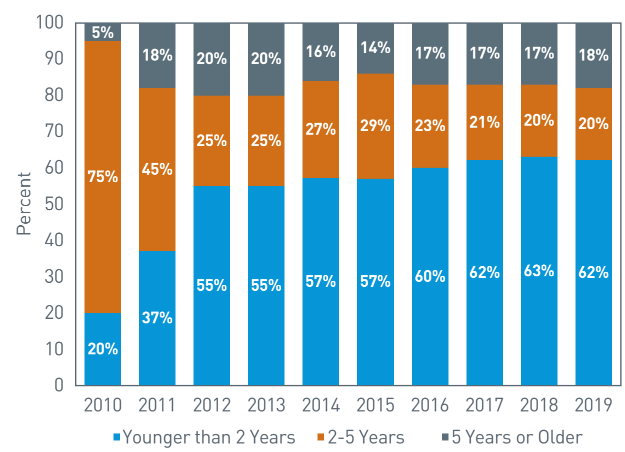
Investments in private companies through venture capital, buyouts, or other forms of equity investment comprise one of the oldest and most popular alternative asset classes. We believe 2020 should continue to provide investors with opportunities to add value in their portfolios with allocations to private equity. Dry powder is at a record high and some prominent unicorn IPOs had performance issues in 2019, leaving some prognosticators to sound alarm bells within the private equity market. In our view, however, the private equity market remains robust at this stage in the business cycle. For starters, capital raises peaked in 2017 and through October 2019 were shaping up to be lower than 2018, which we interpret to mean that demand is not becoming too excessive. Due to the time it takes to deploy new capital, 18% of the dry powder reported for 2019 is actually the cumulative buildup of capital raised in years 2015 and older (Chart 16). The rise of mega funds, such as the $100 billion Vision Fund launched in 2017, may be further affecting dry powder data in recent years.

As the private equity asset class evolves, it creates a new opportunity set in the form of a secondary market. For example, new investors bring new liquidity, which offers existing private equity participants an opportunity to potentially exit their position early via the secondary market. Secondary offerings have been a growing trend within private markets throughout this business cycle, and we expect that trend to continue. According to Preqin, the compound annual growth rate of secondary transactions grew nearly 40% in just the last five years. Given this significant growth in the secondary market in a very short timeframe, dry powder as reported on a gross basis may actually be double counting capital set to replace existing investments.

From a valuation perspective, transaction multiples have moved higher from 2018, alongside rising valuation multiples in public equities. According to Hamilton Lane, the average purchase price multiple for buyouts in 2019 is 11.3x enterprise value/earnings before interest, taxes, depreciation, and amortization (EV/EBITDA), near the high end of its long-term average. If we compare this level to public market valuations on an apples-to-apples basis, the EV/EBITDA multiple for the Russell 2000® is

Chart 16

18% of Dry Powder Today Is from 2015 or Older



Source: Preqin, PNC

11.0x and for the S&P 500, 12.0x. Both are also sitting near the high end of their respective ranges and not too far off from private market levels, which seems reasonable, particularly at this advanced stage of the cycle. Leverage multiples remain stretched at 5.4x net debt-to-EBITDA (compared to the long-run average 3.9x), though roughly flat on a year-over-year basis. We believe the lower-for-longer global interest rate environment is the primary driver for higher leverage multiples, rather than general partners simply taking on excessive levels of debt to financially engineer higher performance returns. With interest rates near or below zero, rational investment decision-making should naturally lean toward greater debt financing of deals than dilutive equity.

Private Debt — Reading the Tea Leaves

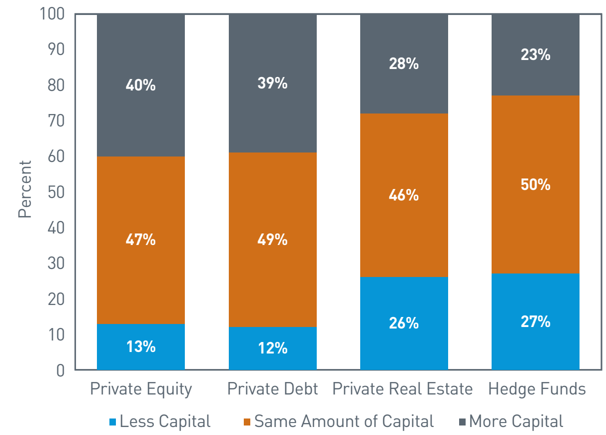
Lending sources have evolved to include private markets, where nonbanks make loans directly to private companies. Somewhat similar to leveraged loans, these are typically below-IG loans ranging from direct lending, mezzanine debt, distressed debt, or special situation funds.

According to Preqin, private debt strategies have grown significantly throughout this business cycle compared to other alternative asset classes, and we expect that trend to continue in 2020. That being said, the private debt market is still only a small portion of the overall private investment market. Preqin estimates approximately $101 billion had been raised in private debt funds through October 2019 compared to $417 billion raised in private equity funds.

In our view, the secular forces of low interest rates putting pressure on traditional fixed income investments are forcing investors to search for yield *and* total return in nontraditional markets such as private debt funds. Furthermore, a recent Preqin survey shows institutional investors plan to increase 2020 allocations to private debt more than any other alternative asset class except private equity (Chart 17). Hamilton Lane data show the average coverage ratio in 2019 was weaker than average (2.9x, and 3.1x respectively) but not at the alarmingly weak levels seen in 2007 at 2.3x. Even though the current level may not seem that far from the 2007 lows, the range itself is not that wide, only varying from 3.9x to 2.3x. Meanwhile other metrics have improved such as

Chart 17

Investors' Expected Capital Commitments to Alternative Assets in the Next 12 Months Compared with Prior 12 Months



Source: Preqin, PNC

average loan-to-value ratios at approximately 55%, well above the average 61.5%. We think private debt could continue to offer attractive risk-adjusted returns for investors looking to diversity their private market exposure outside traditional private equity.

Private Real Estate — Nothing to "See" Here, Folks

Private real estate fund flows slowed in 2019 after a steady rise in new funds over the last few years. The latest institutional investor survey from Preqin also showed a continuation of this trend, with smaller expected commitments to real estate in 2020, second lowest only to hedge funds.

In our view, there are a few potential forces at play:

- The rise of private debt as a unique asset class may be separating out funds that previously would have been classified in a broader real estate or real assets category.
- Depending on where investors believe we are in the business cycle, and thus are planning their longer-term commitments accordingly in a more tactical manner, could be a factor. Real estate was hit the hardest of any private asset class in the last recession, with rolling three-year returns of the NCREIF Property Index falling into negative territory starting in 2009. The index did not return to its 2008 high until four years later.

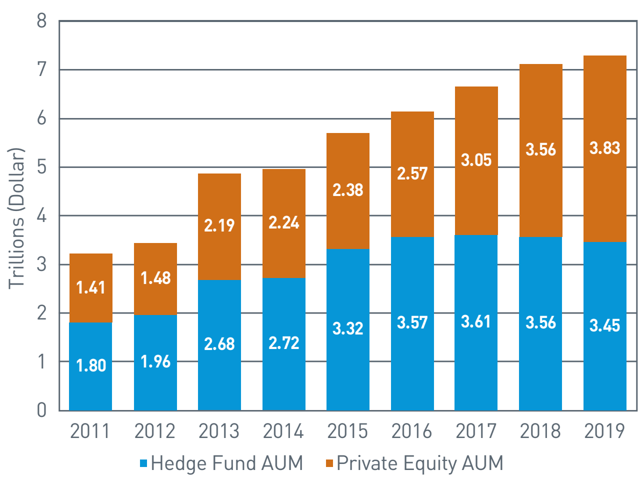
Hamilton Lane data indicate that while private real estate cap rates are near the low end of the historical range (5.3% compared to the long-term average 6.8%), spreads with Treasuries remain in line with the historical average of 330 bps. In other words, interest rates on an absolute level are certainly low; however, real estate cap rates are not low relative to Treasuries, making the asset class somewhat expensive, in our view. Given the high degree of heterogeneity in private real estate, we prefer managers that are focusing on opportunistic, value-added strategies as opposed to just income generation.

Hedge Funds — Blinded by the Light

For the first time on record, Preqin data suggest assets under management (AUM) of hedge funds are expected to be *lower* than private equity in 2019 (Chart 18). The capital raising environment for hedge funds remains under pressure while net-flows into private equity have been accelerating. In fact, while the private equity market is seeing fund sizes increase, the largest hedge funds have been under the most pressure. Additionally, hedge funds are setting up for a second year of net-liquidations in spite of relatively improved performance.

Chart 18

Private Equity Overtaking Hedge Fund in AUM



Source: Preqin, PNC

In our view, hedge funds are the epitome of active management within public markets. When public markets are on a performance tear with correlations across markets at heightened levels, it can become a challenging backdrop for active managers and niche hedge fund strategies, in particular. As the saying goes, in hedge funds, volatility is "your friend" and despite some fits and starts, volatility has been at sustained record low levels for multiple years now. A key characteristic of hedge funds is their ability to diversify and dampen portfolio risk rather than outperform during a market rally. Therefore, we continue to believe hedge funds can be an important part of an asset allocation for the risk-adjusted returns they may be able to generate and necessary downside protection when the inevitable end of the cycle occurs.

Responsible Investing — Gotta Wear Shades

The Continued Rise in Environmental, Social, and Governance Products and Inflows

We believe investments that integrate environmental, social, and governance (ESG) factors into the investment process will continue to increase in 2020, in terms of both inflows into existing products as well as the development of new products across asset classes.

By the end of 2019, inflows into sustainable open-ended and ETFs are expected to reach approximately $15 billion, triple the amount from 2018.[7] According to Morningstar, 70% of this growth was in ETFs, with 10% of that alone coming from Finland's largest pension plan. We do not expect this trend to continue, and we still believe pursuing responsible investing (RI) is best executed via more actively managed strategies. In our view, passive strategies are inadequately equipped to assess ESG risks and opportunities from a qualitative perspective, or deliver on the unique preferences of responsible investors. Moreover, we believe that given the evolving RI landscape, corporate disclosures as it relates to ESG data, though still voluntary, are actually becoming table stakes from a competitive standpoint as investors demand greater transparency.

[7] J. Hale. Sustainable Investing Interest Translating Into Actual Investments. Morningstar Direct. October 31, 2019. https://direct.morningstar.com/research/doc/952254/Sustainable-Investing-Interest-Translating-Into-Actual-Investments.

Proxy Voting

We expect shareholder engagement to continue its trend higher in 2020. We saw shareholder proposals related to corporate governance comprise the majority of proposals that actually reached a vote (64.4%) and passed in 2019.[8] According to an Ernst and Young report, the top five trends/themes from the 2019 proxy season were:[9]

- board composition and diversity;
- diversity disclosures;
- corporate sustainability and citizenship;
- investor engagement; and
- evolving regulatory landscape for shareholder proposals.

From an environmental ("E"), social ("S"), and governance ("G") lens, we focus on the trends in corporate governance, since we believe the "G" component drives the interaction with shareholders and the directors voted to represent them. Without that engagement between shareholders and the board, the "E" and "S" changes demanded by minority shareholder groups may be difficult to achieve. For instance, this engagement trend has fundamentally changed the composition of boards: In 2019 we saw a growing percentage of votes against all-male boards of directors, and now every S&P 500 company has at least one female on the board.

Traditional governance issues (for example, separation of board chair and chief executive) remain the top ESG factor, with 58% of "G" proposals in 2019 receiving at least 30% of shareholder support compared to just 48% of "E" and "S" proposals *combined*. Even so, we still see the trends for support of environmental and social proposals remaining on a sharp upswing into 2020. Also notable, more companies are *voluntarily* reporting how they engage with investors on other environmental and social issues as part of their proxy statement and would expect this trend to only accelerate further.

We do not anticipate ESG investing and engagement to slow in 2020, with survey after survey showing a strong appetite from asset owners for ESG products and ESG-related disclosure from firms. We believe the trend will continue where investors are beginning to move beyond exclusionary screening (that is, removing unwanted securities from their portfolio) to incorporating ESG factors into investment analysis as an opportunity to manage material risks in their portfolios. In addition to United States Conference of Catholic Bishops and tobacco, alcohol, and gambling screening demands, other investor trends and requests we have received in-house include:

- In the "E" category, investors are most concerned with pollution, climate change, waste and recycling, water use, and renewable energy.
- In the "S" category, investors are most concerned with human rights, employee health and safety, economic inequality, labor practices, and gender equality.

Climate Finance Heating Up

13 CLIMATE ACTION

We anticipate climate change will remain a top issue for ESG investors in 2020. We also anticipate a corresponding increase in investment flows into vehicles that address environmental sustainability.

A 2019 United Nations Environment Programme report estimates production plans by the eight biggest fossil fuel-producing countries alone will produce more than two times the threshold of carbon emissions needed for overall reduction to meet the Paris Accord's goal of limiting rising temperatures to 2°C.[10] The European Investment Bank announced at the end of 2019 that within two years it will no longer lend to fossil fuel projects, including natural gas, and will align future funding with the Paris Agreement.

We have also seen central banks begin to debate how the effects of climate change could influence future monetary policy. For example, Bank of England Governor Mark Carney has not only delivered numerous speeches on climate change, but he also

[8] L. Park. 2019 Proxy Season Recap and 2020 Trends to Watch. Harvard Law School. September 17, 2019. https://corpgov.law.harvard.edu/2019/09/17/2019-proxy-season-recap-and-2020-trends-to-watch/.

[9] https://www.ey.com/en_us/board-matters/five-takeaways-from-the-2019-proxy-season.

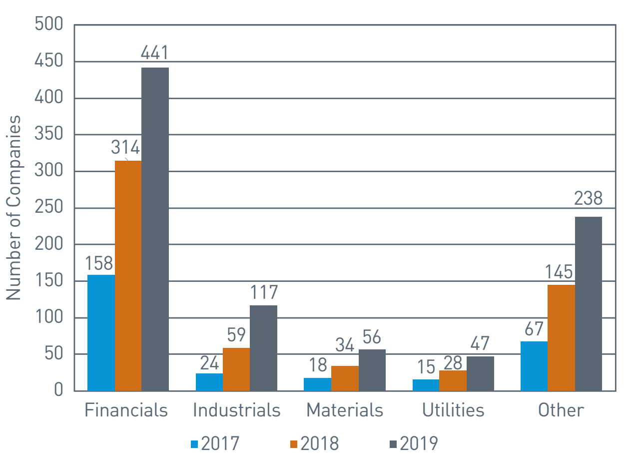
[10] UNEP, The Production Gap, November 2019, https://wedocs.unep.org/bitstream/handle/20.500.11822/30822/PGR19.pdf?sequence=1&isAllowed=y.

announced after leaving the bank that he will become the UN Special Envoy on climate action. Even Fed Governor Lael Brainard recently gave a speech entitled. "Why climate change matters for monetary policy and financial stability," and raised the thought that the recent bankruptcy by utility company PG&E Corp. was the first bankruptcy linked directly to climate change.

Companies around the world are beginning to assess how rising temperatures and increased regulatory scrutiny related to climate change could affect their operations and performance, and we believe investors should pay attention in kind. In 2019, we saw a 55% increase from the year prior in major corporations and investors becoming new signatories of the Task Force on Climate-Related Financial Disclosures (TCFD), a body that provides recommendations for what comprises appropriate financial disclosures for the physical and transition risks associated with climate change. There are now nearly 900 supporters who have endorsed the recommendations issued by the TCFD. With more companies voluntarily reporting on TCFD criteria, we would also expect to see investment vehicles rely on these data to inform investment decision-making, possibly affecting how capital will be allocated. As we noted in the prior section on proxy voting, "E" proposals are not the biggest from a shareholder engagement perspective, but that is okay, in our view, because we are seeing companies evolve as the landscape evolves and are beginning to make more proactive changes on their own (Chart 19).

Chart 19

TCFD Signatories by Year by Industry



Source: TCFD, PNC

Themes to Watch

Demographics

Because the American consumer has been a key indicator for the strength of the US economy, we believe investors should pay close attention to trends related to shifting demographics. While demographics do not shift overnight, important insights on their trends can still be gleaned. Whether it is an aging population or the evolving consumer preferences between generations, the profile of the US consumer is certainly not homogenous in its makeup. As an example, older generations tend to evolve their spending habits toward a greater proportion of health care and services-oriented experiences and away from consumable goods, where younger populations might tend to spend more.

(E)SG Headwinds for Big Tech

We believe big technology companies (that is, primarily social media companies) will continue to face social and governance-related headwinds in 2020. The California Consumer Privacy Act goes into effect on January 1, 2020 (and enforcement beginning July 1), putting a spotlight on how companies can use and should protect consumer data. For example, Twitter already announced it will no longer run political advertising of any kind ahead of the 2020 election, and Alphabet recently clarified its political advertising policy as well. These are notable developments, as both firms generate over 80% of revenue from advertising.

A shift in the use of contract workers could also pose a risk for future wage expenses and lower margins and profitability across the tech industry. For example, the GM strike in late 2019 demonstrated the bargaining power of labor unions. A major issue from the GM negotiations revolved around the use of temporary workers – which some big tech firms also rely on heavily.

ESG and the 2020 US Election

Similar to the 2016 election, we expect presidential candidates of all parties to discuss ESG issues at length during the 2020 election cycle. Topics such as Medicare-for-All, the Green New Deal, corporate taxation, and executive compensation packages are likely to have companies and investors analyze how policy changes could affect their profitability and ability to attract top talent. For example, the health care industry sits squarely in the middle of public debates around the rising cost of care, drug prices, and quality of care. Furthermore, policy proposals like Medicare-for-All stand to shine a spotlight on the practices of health care providers and insurance firms. We would expect a possible rise in ESG headline risks leading up to the 2020 election to be a factor that quantitative screening alone may be challenged to differentiate the winners and losers.

Conclusion — Bringing It Back into Focus

We are still generally positive about prospects for the markets in 2020, though we certainly have a list of concerns this far into the longest cycle on record. The global economy continues to expand at a level that should support positive year-over-year earnings growth and easier comparisons should also be an added tailwind. While the age of the cycle has advanced yet another year, valuations have largely recovered from their late 2018 market sell-off, suggesting there is less room in 2020 for the market to run based solely on multiple expansion – the bar is set higher this year – and the baton must be handed off to earnings growth in order for the market to advance meaningfully from where it finished 2019.

Global trade uncertainty, unilateral geopolitical posturing, and the 2020 US presidential election cycle may continue to weigh on corporate confidence and limit further capex growth stunting the multiplier effect on productivity. Potentially offsetting these variables is our expectation that the Fed remains on pause in 2020, but is also ready to act should the economic backdrop start to deteriorate.

Like we said at the outset, bifocals may help improve eyesight, and even a fortune teller's crystal ball might instill confidence in seeing the future, but neither can provide *actionable investment insight*. Our investment process helps us "see" that certain asset classes are likely to be more attractive than others to pass the proverbial eye exam of 2020 – we don't see the entire investable universe through rose-colored glasses. It doesn't take 20/20 vision to keep moving forward from an investment standpoint, just the discipline to remain focused on your long run goals and objectives.

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