Key Market/Economic Observations

United States

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

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

- We believe the Fed’s pause in tightening monetary policy remains the most important relief to financial markets. Whether the Fed’s next move is to cut or hike rates is yet to be determined; however, history clearly reveals that multiples usually expand and markets tend to rally when the Fed takes a pause (see the Strategy Views section on page 4 for more on this topic). Furthermore, the Fed’s pivot toward “patience” has helped to ease financial conditions, which tightened considerably during 2018. Tighter credit spreads, tame inflation, a recovery in equity markets, and lower interest rates have collectively helped ease conditions.

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

- Fourth-quarter earnings season is winding down and set to post the fifth straight quarter of double-digit blended earnings growth (actual growth combined with consensus estimates) at 13.1%. Although the number and magnitude of positive earnings surprises fell below their respective five-year averages, overall results were still better than initially feared. Additionally, the market has not been punishing companies reporting negative earnings surprises nearly as much as it has over the past five years. We believe this backdrop continues to make multiple expansion the key focus in 2019 rather than earnings growth, the opposite of the 2018 earnings narrative, given the changes in monetary policy dynamics. Furthermore, the focus on multiple expansion underscores how the Fed’s next move and a trade resolution may be critical to maintaining the move higher we have seen in multiples (and markets) thus far.

- Earnings growth estimates for first-quarter 2019 have fallen below zero for three main reasons: year-over-year comparisons are tougher due to the Tax Cuts and Jobs Act; a few notable
Developed International Markets

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

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

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

- Economic data out of Europe continue to come in weaker than expected. Eurozone industrial production contracted by 3.3% in 2018, and Germany, which is Europe’s largest economy and the fourth largest in the world, failed to produce any growth in the fourth quarter, narrowly missing falling into recession (defined as two consecutive quarters of negative growth). Italy, Europe’s third largest economy, did fall into recession in fourth-quarter 2018 as economic output contracted by 0.2%. This marks Italy’s third recessionary period since 2000, with the last two ranging from September 2007 to April 2009 (7 months) and May 2011 to November 2017 (67 months). Furthermore, the more forward-looking Eurozone Manufacturing PMI fell to 49.2 in February, marking the first time since June 2013 the index fell below the 50 level indicating economic contractionary conditions.

- So what is driving the Eurozone weakness? One can certainly point to idiosyncratic factors such as new vehicle emission testing standards weighing on the German auto industry, tightening financial conditions in Italy, “yellow vest” protests in France, Information Technology names such as Apple Inc. (AAPL) and Micron Technology (MU) are struggling with company-specific issues; and earnings expectations have lowered sharply for the Energy sector, which was initially supposed to be the key driver for first-quarter earnings. Please see our Fourth-Quarter 2018 Earnings Wrap-Up for additional analysis.

- Domestic stocks have recovered almost 20% since their low on December 24. From a technical standpoint, the momentum behind this rally has been historically strong – nearly 93% of stocks in the S&P 500® are currently above their respective 50-day moving averages. While some consolidation would not be unusual, forward returns 6 and 12 months out tend to be above average after strong momentum surges. Furthermore, solid performance earlier in the calendar year usually leads to strong full-year performance. Last year was a glaring exception because investor expectations were much higher. That level of optimism is no longer in the market, which bodes well for 2019 returns.

- U.S. fixed income markets are off to a strong start in 2019, with leveraged loans and high yield leading the way. However, even with a rebound in sentiment, these higher-risk categories have not yet recovered from late 2018 declines and have trailed investment-grade bonds over the past six months. Tactically, we continue to prefer higher-quality allocations given increased volatility in the later stages of the economic cycle. Moving up in credit quality can offer additional portfolio ballast during shifts in market sentiment, as evidenced by the relative resilience of investment-grade corporate bonds and the Bloomberg Barclays U.S. Aggregate index in the fourth quarter.

- Recent U.S. economic data have been mixed but solid. Consumer sentiment has started to recover, economic activity in the manufacturing sector has expanded meaningfully, and the number of job openings continues to exceed the number of unemployed workers. That said, modest declines in industrial production and weaker retail sales data lead us to believe the United States is in a slowing expansion phase and is starting to join the global slowdown.
and the ongoing Brexit negotiations. However, these factors alone do not fully explain the economic zone’s sharp turn down in growth over the last few quarters.

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

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

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

Emerging Markets

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

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

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

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

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

- Despite being one of the best-performing EM countries in 2018 on a relative basis, India remains the only country in the index with negative year-to-date performance. Ever since the bailout of the financial conglomerate Infrastructure Leasing & Financial Services (IL&FS) last September, Indian equities have lagged the EM index. India’s election season is expected to occur in the spring, and given the challenges in public equity markets, recent events may be a sign of ongoing volatility. We’ve already seen the Reserve Bank of India surprise investors by being the first central bank to lower interest rates this year, and conflict with Pakistan since mid-month is a situation we continue to monitor closely. For perspective, India is the fourth largest country in the EM index.
Over the last 15 years, the correlation between EM equities and the US Dollar Index is –0.62. Dollar strength has been a headwind for EM equities, particularly in 2018, with the dollar up 7.9% year over year compared with –7.5% in 2017. PNC Economics expects the dollar to stabilize, if not weaken, as larger U.S. fiscal deficits, slowing U.S. economic and earnings growth, and the change in the Fed’s monetary policy limit further currency appreciation. Furthermore, 2018 was a busy and polarizing year for EM federal-level elections. We believe political uncertainty could transform into improved stability this year, acting as a further boost for EM currencies and EM equities as a result.

**Commodities**

*Less Synchronous Commodities Extend Recovery in February Despite Dollar Strength*

- The Bloomberg Commodity Index extended gains this month amid an improvement in trade relations and commodity-specific developments, bringing year-to-date returns to 6.3%.
- The energy subindex, which comprises 30% of the broader index, continues to lead with crude oil 26.2% higher for the year. On the supply side, adherence to OPEC crude oil production cuts, U.S. sanctions on Venezuela, and unforeseen production outages have outweighed record U.S. production. For context, OPEC has reduced supply by 6.7% since November, the second largest two-month decline outside of a recession in 30 years. Despite weakening demand expectations, declines in production have served to allay concerns of a renewed crude oil glut in 2019, although global inventories are still expected to build modestly over the course of the year.
- Industrial metals also ticked higher, up 9% year to date, breaking through a key technical level and supported by increased optimism on trade negotiations and supportive supply/demand dynamics. Demand remains stable while inventories are broadly below seasonal averages, suggesting any upside surprise in the demand component would likely have an outsized impact on price. In particular, stronger copper prices may indicate an improvement in sentiment toward Chinese growth, given the country’s 50% share of global demand, following a surge in credit creation last month.
- In agricultural commodities, high inventories as a result of a reduction in Chinese imports continue to weigh on prices as the subindex fell more than 3% in February. However, there is some cause for optimism, as China offered to purchase an additional $30 billion in agricultural goods, above pre-trade war levels, which could offer a reprieve to swelled inventories over time.
- Ultimately, we continue to view less dollar strength as key to a sustainable path higher for commodities and inflation, which will likely require a stabilization in international economic growth expectations over the course of the next year. A more accommodative Fed, a reduction in trade tensions, and still-tame inflation are likely to remain supportive of continued, albeit slower, economic growth and consumption in 2019.

**Strategy Views**

*The Fed Pause: Past, Present, and Implications for Portfolios*

As they continue to recover from the sharp sell-off at the end of 2018, investors welcomed the early 2019 relief rally in the equity markets. Positive momentum within the U.S./China trade negotiations, fading dollar momentum, and signs of a stabilizing U.S. housing market have all been supportive. However, the primary cause for the uplift in sentiment, in our view, is the Fed’s decision to pause and take a more cautious approach toward future interest rate hikes. This month, we examine the typical impact of a Fed pause on financial markets and valuations as well as the implications for investor portfolios.

*What’s Behind the Fed Pause?*

Fed tightening cycles, by definition, must eventually come to an end. That said, how the rate cycle ends can be quite different depending on the state of the economy and the underlying pressures to which the Fed is responding. When the Fed pauses too late, it risks a hard landing by overtightening financial conditions, which ultimately weighs on future economic activity. When the Fed pauses too early, it risks a hard landing by incubating inflationary...
pressures to the point that it must then aggressively hike rates to cool the economy. However, when the Fed gets the rate level just right, it can maintain a balance between inflation and financial conditions. This can be a difficult endeavor, as interest rate increases typically have a lagged impact, affecting the real economy over the course of 18 months via increased borrowing costs (Chart 1). As such, we believe the Fed must not only adjust interest rates according to the economy of today, but correctly anticipate how those actions will affect the economy of tomorrow. The precise “neutral rate” of interest is likely impossible to know without the benefit of hindsight.

While the Fed has now signaled patience, the lagged effects of interest rate hikes are likely to linger throughout 2019. History shows this typically results in a rate cut rather than additional rate hikes in the face of slowing economic momentum. Soft landings, or Fed pauses that do not result in recession, are indeed possible, as seen in the 1984 and 1995 cycles. However, three of the last four Fed pauses following a rate-hike cycle, 1989, 1999, and 2006, have resulted in hard landings (that is, a recession) (Chart 2). Regardless, historically, stocks have always rallied after a Fed pause. We think the critical question that governs the duration of that rally is whether the Fed has been able to engineer a soft landing. Today, we do not believe the Fed has made a clear policy error that will serve as a catalyst for an imminent recession.

**Market Implications of a Fed Shift**

Historically, Fed pauses have been followed by an optimism-driven relief rally in equities, similar to what investors have experienced thus far in 2019, regardless of whether a recession soon followed. On average, the S&P 500 has returned 11% in the 12 months following a Fed pause (Chart 3). Additionally, relief rallies have coincided with a peak in 2-year Treasury yields, as investors price in a diminished probability for additional rate hikes. In turn, the pressure on price multiples typically begins to abate as financial conditions ease and investors adjust to the likelihood of lower interest rates. P/E multiples fall 2x on average in the 12 months prior to a Fed pause, but usually stabilize thereafter. The drop in P/E in late 2018 was at the extreme end of the range, in part justifying
the quick upward retracement in multiples year to date (Chart 4). Within this environment, equities also typically experience higher market volatility as investors attempt to gauge where we are relative to the next recession. Historically, the federal funds rate has led the CBOE Volatility Index (VIX) by 24 months, further corroborating the lagged effect of interest rate hikes (Chart 5). So while market returns are likely to remain positive in the coming months, the market may experience wider swings than it had earlier in the cycle.

From the perspective of fixed income, the impact most acutely manifests in rates or duration (interest rate sensitivity), with ancillary effects on corporate credit spreads. Following a Fed pause, interest rates typically trend lower while the yield curve continues to flatten, which is generally supportive of prices. However, credit spreads usually move wider through cycle end, particularly in below-investment-grade corporate bonds. While we do not believe a default cycle is imminent, the sharp tightening in credit spreads year to date suggests this is an opportune time to move up in quality. When combined with our view that equity volatility is likely to remain elevated, we think investors should consider increasing credit quality within fixed income allocations and maintain a level of duration equal to that of the benchmark. This can help mitigate portfolio volatility, particularly in times of market stress, and lower correlations with the broader equity market, adding ballast to a portfolio.

**Conclusion**

We believe the Fed was justified in pausing rates at the end of 2018 given the outlook for inflation and mixed economic data points. A recession occurring within the next 12 months appears unlikely, and the recent positive market reaction is normal following a pause in the Fed’s rate-hiking cycle. As history might suggest, we believe the probability for multiples being supportive of the market is far higher today than it was when the Fed was still tightening policy. Past periods have demonstrated how powerful a shift to more dovish policy can be, even in the face of falling earnings growth.

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### Hawthorn Asset Allocation Playbook
As of 2/28/2019

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<td>U.S.</td>
<td>Large Cap</td>
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<td>We continue to favor large over small. Small caps underperformed in 2018 as tailwinds from tax cuts and shelter from slowing global growth/trade concerns were outweighed by less attractive fundamentals. Currently, almost 40% of the stocks in the Russell 2000® have no earnings. As a result, we would currently favor active management in the asset class. Large caps tend to outperform small caps in the later stages of the business cycle. During the 6, 12, and 18 months prior to market peaks, small cap stocks have historically underperformed. We believe the economy will continue to grow, but at a potentially slowing pace in 2019.</td>
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<td>Intl. Large/Mid Cap</td>
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<td>Valuations appear relatively more attractive versus domestic equities, potentially creating attractive long-term opportunities in many international markets. However, a near-term catalyst may remain elusive. Global central bank monetary policy is accommodative; however, signs of slowing earnings growth could derail any near-term recovery in asset prices. Political risk is again elevated and economic momentum has weakened versus what we are seeing in the United States. After a year in which the MSCI EM equity index fell close to 15%, valuation spreads between EM and U.S. stocks have pushed past one standard deviation in favor of EM. We believe long-term investors are being presented with a compelling opportunity; however, caution in the very near term may still be warranted as EM indexes look to surpass their falling 200-day moving average. Any surprise resolution of trade conflicts would likely provide a sentiment boost, and any dollar weakness precipitated by a growth convergence between the United States and other large international economies could serve as a catalyst.</td>
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<td>A decelerating growth rate, combined with contained inflationary pressures and a tightening in financial conditions, likely gives the Fed cover to pause the current interest rate hike cycle. We believe this limits additional upside in interest rates from current levels. Therefore, we continue to favor positioning fixed income portfolios in the intermediate part of the curve. The credit cycle is aging, and valuations should become an increasing headwind for below-investment-grade bonds. Leveraged loans, although more senior in the capital structure, have seen issuance balloon in recent years while covenants have weakened. Given our view on interest rates, credit risk may be starting to outweigh the protection from higher rates. There is less value in Treasury inflation-protected securities (TIPS), with breakeven inflation rates now around 2.00%. We prefer to protect purchasing power over the long term via our equity exposure.</td>
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<td>Although we are not overly negative on credit given the strength of the economy, we do believe slowly shifting to higher quality areas of fixed income is sensible given the level of spreads. Unconstrained funds have reached for yield in lower-rated credits.</td>
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<td>Key drivers include a still relatively constrained supply backdrop, modest leverage levels, and the fact that capital flows into the asset class are becoming increasingly global (that is, investor demand is quite robust). Middle-market lending in the corporate sector is still quite constrained, continuing to create opportunities for private debt investors. Some banking deregulation may open this space up to more traditional bank lending, however. There may be opportunity in new/less efficient markets, and a more diverse investable opportunity set, for example, via secondaries and &quot;co-investment&quot; options. That said, as with public markets, valuations are extended.</td>
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A transition from a primarily macro-driven market environment to a more fundamentally driven one will be positive for these alpha-generating strategies. Central banks now appear more committed to a steady normalization of interest rates than they have been in the past. We believe differentiated return streams can add value in today’s market versus a traditional equity/bond portfolio. We saw this in fourth-quarter 19 as hedge fund strategies outperformed amid significantly higher volatility.

Improved fundamentals could spur investor interest given currently depressed valuations and underweight energy positioning among equity portfolio managers. Oil prices seem to have stabilized, so a further decline in energy prices should be less of a headwind this year. Defensive qualities and income potential that we like in the potentially more volatile later stages of the business cycle. Utility-like exposure is cheaper via the international nature of our exposure. Valuations remain attractive and consumer confidence is high, however recent earnings results have been soft which we continue to monitor. We still like the currency hedge since the Bank of Japan remains easy relative to the Fed, however yen positioning has flipped to net short thus no longer a headwind for the currency. Ability to earn a coupon while waiting for a better entry point into equities can be an attractive strategy. However, cash has become more palatable given the rise in short-term interest rates.