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# Jumpstarting the Motor City

On July 18, 2013, following several weeks of strong efforts to reach an agreement with creditors, the city of Detroit received approval to file for bankruptcy. Intensive negotiations to try to persuade creditors to accept lower debt payments and unions to accept reduced benefits failed. Kevyn Orr, Detroit's Emergency Manager, was left with little alternative but to file for Chapter 9 bankruptcy protection, marking the largest municipal bankruptcy filing in U.S. history. Investors question the significance of this bankruptcy for Michigan municipalities and the municipal markets in general.



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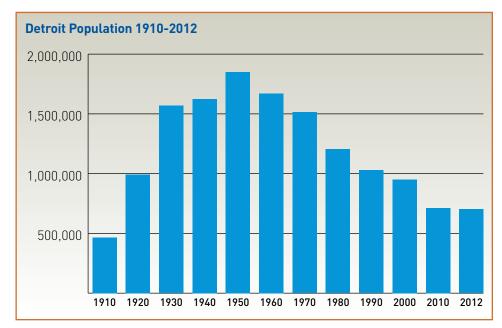


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According to Mr. Orr, the city of Detroit owes somewhere between \$18 billion and \$20 billion to its creditors. In comparison, Jefferson County, Alabama, the next largest municipal bankruptcy in the U.S., had approximately \$3.2 billion in outstanding debt liabilities when it filed in November 2011. While a bankruptcy filing of this magnitude may appear to be a desperate measure, some Detroit business leaders feel that this will finally force the city to confront its deep-rooted, long-term problems and take the drastic steps necessary to overhaul city services and benefits. In fact, Mr. Orr has stated that he wants to spend a significant amount on improvements to city infrastructure and services as part of his restructuring plan.

Many feel that Detroit's fiscal crisis has been a long time in the making. The city has experienced financial difficulties for decades, and recent events do not come as a surprise to knowledgeable investors. Detroit bonds received below-investmentgrade ratings three times in the past century and in the wake of the recession, Detroit debt was downgraded to junk status in 2009 by Standard & Poor's (S&P). Following Mr. Orr's announcement that the city would cease making payments on a portion of its debt load, S&P further downgraded its credit rating to Caa3/C in June 2013.

Since its heyday as the capital of the U.S. automotive manufacturing industry in the mid-20th century, Detroit's fiscal and economic conditions have gradually declined. This is reflected in its dwindling population, which has fallen from



Source: U.S. Census Bureau, PNC

about two million in 1950 to approximately 700,000, according to the most recent U.S. census. This is the lowest population level since 1910, prior to the boom in the automotive industry. Automotive manufacturing has also shifted geographically, with only two major assembly plants remaining in the Detroit area. Manufacturing jobs have declined with less than 20,000 Detroit individuals currently working in manufacturing versus 200,000 in 1950.

With the decline in the population came an accompanying drop in tax revenues, all of which were further affected by the Great Recession. Lower tax revenues and decreased state aid drove the city to the debt markets in order to make up the deficits. Since 2008, Detroit has borrowed about \$100 million more annually than it has taken in and has used the funds to cover operating costs as well as pension and other post-employee benefits (OPEB).

Although the plans of the bankruptcy restructuring have not yet been

finalized or approved, there are a couple of unusual aspects to the proposal Mr. Orr submitted to creditors in July. One idea being considered is that general obligation (GO) bonds, which are backed by tax revenues and guaranteed by the local government, may not be considered secured debt any longer. We feel this seems to be taking things a bit far, and we believe it is unlikely to be upheld by the bankruptcy court. Mr. Orr has also proposed cutting retirees' benefits in the city's pension plans, which goes further than the reductions in current employee benefits that may typically occur in a municipal bankruptcy, such as retirement benefits and health care. In a recent development, Detroit's two public pension funds have challenged the claim that the city is bankrupt, adding another wrinkle to the process.

Another concern is whether this situation is a contained incident or whether other towns or communities are also at risk. A municipal bankruptcy often results in a higher cost of debt and investor reluctance to

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purchasing the debt of the bankrupt municipality as well as nearby towns and cities. In our opinion, Michigan has not been completely supportive of or provided assistance to Detroit, which could potentially magnify the impact across the state.

Bondholders can take comfort in remembering that many of Detroit's bonds are backed by bond insurance. Most insurers have committed to covering bonds if Detroit defaults on payments and would be highly opposed to a ruling that GO bonds are not considered secured debt. Consequently, insurance companies may side with bondholders in negotiations with the bankruptcy court, and bondholders may be kept whole in terms of

repayments. In the near term, there may be immediate negative ramifications, as evidenced by some Michigan municipal mutual funds which have experienced outflows in assets since Detroit filed for bankruptcy.

It is unclear what Detroit's bankruptcy signifies for the municipal market as a whole. On the one hand, the problems

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in Detroit have been going on for an extended period of time, and this bankruptcy was a long time in the making. On the other hand, we believe the magnitude and wellpublicized nature of Detroit may pave the way for other troubled municipalities to feel more comfortable pursuing filing for bankruptcy. In our view, the situation in Detroit is likely to have a greater impact on lower-quality issuers than on more stable, higher quality issuers. If the effects do expand to higher quality municipalities and spreads widen, we view this as a potential buying opportunity, not as a sign of a systemic meltdown. •

# Slow Improvement in the Eurozone

From Greece to Cyprus, much of the past few years have been filled with dire reports of fiscal and economic crises in various Eurozone countries. Lately there have been some tentative positive hints of improvement. A question on investors' minds is whether this is a lasting shift or just a temporary upswing that is likely to reverse.

The global recession that began in late 2007 triggered an ongoing economic and fiscal crisis in the Eurozone. Coupled with the overall slowdown in global economic growth, less economically stable countries within the Eurozone were affected by a combination of financial institutions' weaknesses and an inability to repay or refinance sovereign debt. In many countries, this has led to political instability. Greece was one of the first countries to be severely affected, with fiscal and economic crises leading to rioting and political upheaval. Other countries within the Eurozone that experienced the brunt of the weakness include Ireland, Spain, Italy, Portugal, Slovenia, Slovakia, Holland and, most recently, Cyprus. The impact on the Eurozone and the global economy was partially driven not only by the size of the country's economy but also by emotional factors, with the fear that each new crisis could be the start of a domino effect. Stronger Eurozone countries, such as Germany, France and Finland, have also



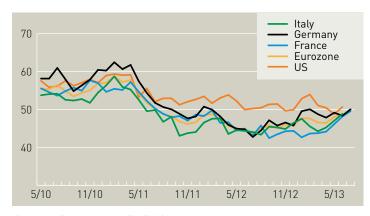
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been affected by political and economic backlash resulting from the expectation that they would assist in helping the weaker countries.

The Eurozone, after a long recession, appears to finally be moving its way to recovery. The Markit Eurozone Composite Purchasing Managers Index (PMI) showed the first sign of expansion in a year and a half, going from 48.7 in June to 50.5 in July. This is the first time the Index has risen above 50 since January 2012. Other individual PMI indicators also appear to be moving in a positive direction.

#### **Eurozone PMI**



Source: Bloomberg L.P., PNC

Activity indicators also appear to be moving in the right direction. The German index of industrial activity increased a seasonably adjusted 2.4% from May to June and was up 2% on a year-over-year basis. These figures are more or less in line with European Central Bank (ECB) expectations and economic forecasts. German unemployment is 6.8%, a 20-year low. As the strongest country in the Eurozone, we anticipate that its economy will further improve as the Eurozone economy continues to recover. We also expect that the Eurozone will benefit as the U.S. economy strengthens. Preliminary second quarter GDP is moving in an upward trajectory, with a seasonally adjusted 0.3% growth rate, not far off from the U.S. 0.4% increase in real GDP for the same timeframe. Most of the growth came from Germany and France, but Finland and Portugal also experienced unexpectedly improved growth. This is especially favorable, as Portugal is still struggling from internal economic crisis. The positive movement in PMI and other indicators appears to have spurred improvement in consumer confidence, although it still remains well below 2007 levels.

While we are not expecting robust growth for the Eurozone in the near term , we also do not feel that the potential risk of collapse is at the level that it was previously. We are keeping a watchful eye on the political situation in different countries, as political changes could lead to a breakdown in

#### **Eurozone Consumer Confidence**



Source: Bloomberg L.P., PNC

the fragile agreements and partnerships in place. In Spain, the Prime Minister, Mariano Rajoy, has been accused of corruption, and there have been calls for him to resign. Italy's coalition could be at risk if Berlusconi's People of Freedom party withdraws its support. Although he has stated that it will not, Berlusconi is also experiencing his own corruption and scandal problems. In Germany, there will be an election this fall, and it remains to be seen whether Angela Merkel's ruling conservative Christian Democratic Union will retain its power.

Given the modest positive direction of the economy, we do not foresee any major changes in monetary policy for the Eurozone. In a press conference on August 8, 2013, the ECB stated its intent to maintain current policy, with a goal to keep monetary policy accommodative for "as long as necessary." It also plans to keep interest rates at or below current levels as long as the ECB feels that the "mediumterm outlook for inflation" remains subdued. Contributing factors are a combination of below-target inflation, sluggish economic activity, shaky credit growth and weak increases in monetary aggregates. Unemployment is still at record highs in the wake of the global recession and continued weak European economy. This also provides a rationale for the ECB to keep rates low. Given the likelihood that Eurozone real GDP will average 1% or less in the short-to medium-term, we believe that the ECB will not increase its short-term rates at least until the Federal Reserve does so in the U.S., or perhaps even longer. •

## The Great Rotation Arrives?

For close to two decades, bonds have experienced an unprecedented bull market. Moreover, in the post-stock market meltdown environment of 2008 and early 2009, with continued market volatility, global recession and financial institutions collapsing or surrounded by scandal, investors shifted money out of stocks and fled to the safety of the bond and cash markets. In the past several months, however, there has been a lot of discussion about the possibility of a "Great Rotation," where investors move significant assets out of bonds and back into equities. Is the "Great Rotation" really taking place, and what evidence supports or disproves this investment shift?

In January 2013, many commentators cited the strong inflows into stocks as a sign that the "Great Rotation" was taking place. For the month of January, according to Strategas, net inflows into domestic equity mutual funds totaled \$18.4 billion. While this sounds (and is) positive, this is not an unusual start to the year, when bullish sentiment often prevails. There were also strong flows into international equity funds (\$19.4 billion) and into bond funds (\$32.8 billion).

For the February through June 2013 period, net flows to equity funds were once more primarily negative, although at a relatively minimal level. Overall net flows for January through June were slightly positive. On the bond side, net flows remained positive until June, when bond funds witnessed \$59.3 billion in negative net flows in reaction to the May post-Federal Open Market Committee (FOMC) meeting comments by Ben Bernanke, Federal Reserve Chairman. Mr. Bernanke alluded to the fact that the Federal Reserve might start to lower quantitative easing measures as soon as the latter part of 2013, prompting a move out of bond funds in expectation of higher interest rates. These funds did not find their way, however, into



### Net Flows into Mutual Funds (Billion \$)

Year	Domestic	Equity International	Bond	Money Market
2007	-65.30	139.40	108.50	660.60
2008	-148.80	-80.30	29.10	644.90
2009	-29.40	27.60	379.60	-583.60
2010	-81.20	57.80	235.60	-529.00
2011	-132.50	4.20	125.10	-16.60
2012	-156.00	2.80	303.60	-0.30
TOTAL	-613.20	151.50	1181.50	176.00
Year To Date				
Jan	18.40	19.40	32.80	-11.10
Feb	-1.40	15.60	20.20	-31.60
Mar	2.30	12.50	16.10	-58.30
Apr	-1.40	5.80	12.00	-24.40
May	-3.90	9.30	11.70	27.80
Jun	-6.40	6.90	-59.30	NA
TOTAL	7.60	69.50	33.50	-97.60

Source: Strategas, PNC

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equity funds, but into banks, depository products, money market funds and likely other short-term investments.

July numbers, however, may begin to tell a slightly different story. According to preliminary estimates from Lipper, bond funds continued to experience negative net flows in July, while stock fund net flows were positive, with a large portion into ETFs. This is in line with year to date data. According to Bank of America Merrill Lynch research, equity funds had \$151 billion in inflows through mid-July, mostly into ETFs. This is the largest inflow for the corresponding period since 2002.

Bond yields on the longer end have risen, and the all-important 10 year Treasury yield hit 2.9% on August 19, 2013, significantly higher than the 1.62% yield 10 year Treasuries slid to in the beginning of May and the highest 10 year Treasury yield since mid-2011. This rise in yields is not surprising as we believe that yields fell too low and needed to adjust back upward in order to attract funds.

As we discussed, bonds have been in a prolonged bull market. However, it is important to remember that there is risk of loss in investing in bonds. This was a painful lesson that equity investors, who had "forgotten" that what goes up, may indeed come back down, learned in the 2008/2009 stock market crash.

We are proponents of a long-term, strategic approach to investing and do not recommend trying to time or chase markets. Consequently, we believed in remaining invested in equities through the volatility and downturn of 2009. Similarly, we feel that a thoughtful asset allocation should include a fixed income component. Fixed income investments as part of a diversified portfolio may provide important benefits to an investor's portfolio, including capital preservation, an income stream and potentially low correlations to stocks. As always, we continue to watch and monitor the markets carefully and prudently. •

## For more information, please contact your Investment Advisor or Relationship Manager.

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