Economic and Capital Market Review

Fourth Quarter 2016

U.S. Election Surprise and Proposed Fiscal Policy Changes

The fourth quarter's biggest surprise moment came Nov 8, 2016 when Donald Trump upset Hilary Clinton in a hard-fought presidential campaign. Many political forecasts predicted little chance of a Trump victory, so many market and economic outlooks focused on a divided government between a Democratic executive branch and a Republican-controlled legislative branch that could have been summed up as "more of the same." However, Trump succeeded in siphoning off a significant proportion of traditionally Democratic voters within three states that have previously voted Democratic in presidential elections: Wisconsin, Michigan, and Pennsylvania. Clinton had no similar success in traditionally Republican states. Thus, while Clinton won the national popular vote by nearly three million votes, Trump won the Electoral College, which is all that matters in presidential elections. Moreover, Republicans maintained control of both chambers of Congress, which some expect gives the incoming administration a much stronger hand in enacting the policies espoused during the campaign.

As discussed in PNC Capital Advisor's post-election commentary, the Trump campaign was focused on several themes that could be loosely described as economic nationalism. The immediate focus of the incoming administration's trade policies seems to be on what is in America's near-term economic self-interest when it comes to jobs. It is expected that current trade agreements will be examined closely by the incoming administration, with the administration looking to renegotiate many. Indeed, President-elect Trump has been meeting with corporate leaders to look for ways to repatriate jobs back to the U.S. In fact, not long after the election, President-elect Trump publicly inserted himself into an ongoing discussion between Carrier and the state of Indiana regarding state tax breaks and keeping manufacturing jobs in the state. In the end, Carrier agreed to keep some manufacturing jobs in the state as Indiana granted about $7 million in tax breaks to the company.

Subsequent to the deal, Gregory J. Hayes, chief executive officer of United Technologies, the parent of Carrier, indicated that the tax breaks won will be used to make the Indiana plants in question more competitive through further automation. While this will certainly be a good thing from an economic efficiency viewpoint, it reveals a longer-term issue with manufacturing jobs (in America and elsewhere). That longer-term issue is not lower-cost workers in China, India, or Mexico who have taken U.S. jobs during the past three decades, but rather rapid improvements in robotics, automation, and artificial intelligence that seek to lower costs dramatically by eliminating many of the jobs currently needed in a modern economy.

President-elect Trump's statements since the election have effectively put corporate America on notice that, if a company decides to move manufacturing jobs outside of the U.S. and expects to import those same manufactured goods back into the U.S., such companies may be subject to higher tariffs that might negate any prospective cost savings. While this approach may be a near-term help for American manufacturing jobs, the economic forces driving further automation keep those jobs in jeopardy regardless of their geographic location. Indeed, it is not just manufacturing jobs that are at risk. Many companies in the service sector are finding ways to outsource and/or automate positions. Amazon recently unveiled a physical store concept without checkout lines or cashiers and McDonald's is introducing self-serve kiosks in its restaurants to cut costs associated with front-line positions. The financial sector continues to innovate with so-called robo advisers that utilize software for portfolio construction and reduce the need for individual financial advisors. Will the incoming administration insert itself into every major corporate decision to automate functions that may displace jobs within the U.S.? This approach may be politically attractive in the short term, but would potentially result in slowing down the productivity increases the country has lacked for much of the past decade and would work to reduce the competitiveness of U.S. companies. The incoming administration would be well served to look at both the near-term and longer-term forces working on job creation and destruction in order to foster policies that keep the domestic labor force fluid and dynamic in a rapidly changing labor market.

Additional macroeconomic policies emphasized in the campaign focused on corporate tax reform, personal tax relief, and a more business-friendly regulatory environment. Corporate tax reform is attractive from two perspectives. First, lowering both the statutory and effective rates makes the U.S. a more attractive location in which to do business, not only incentivizing domestic firms to remain and reinvest in the U.S. but also attracting foreign firms to locate facilities and businesses here. Additionally, the campaign emphasized lowering the tax rate on repatriated profits, which conceivably increases funds available for domestic capital investment. Secondly, it is economically attractive, as it drives more business decisions toward economic and business efficiency rather than tax-cost efficiency. Personal tax reform can do the same by reducing or eliminating various deductions that may skew consumption and investment behavior.

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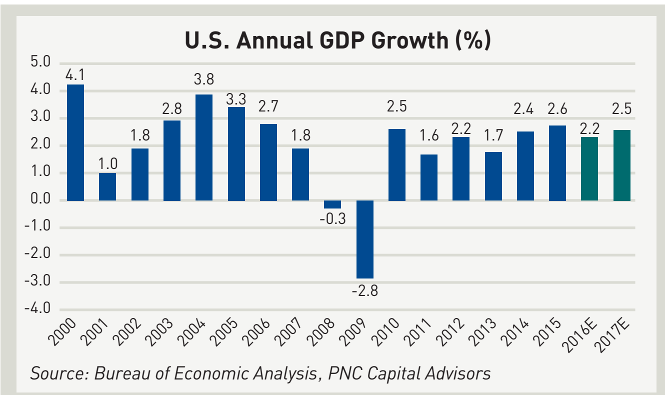
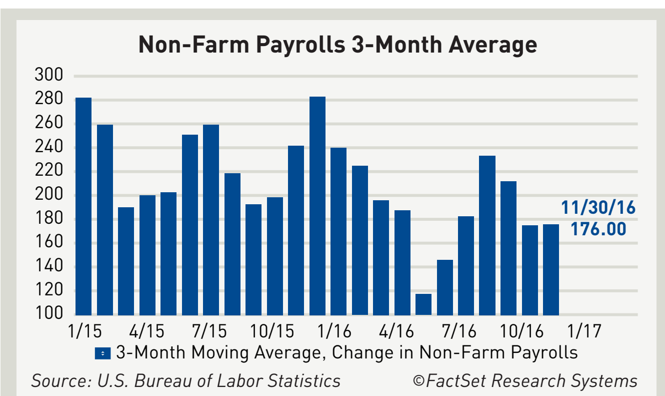
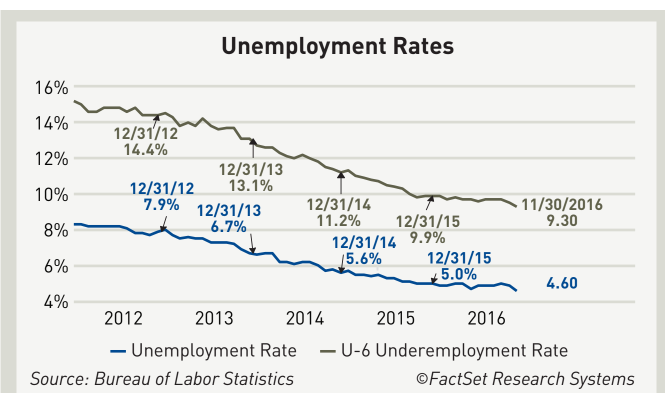
However, the trick in both personal and corporate tax reform is in making it as revenue neutral as possible. Otherwise, lowering the rates without getting rid of some of the existing deductions, such as corporate interest cost or home mortgage interest deductions, results in massively lower revenue. Indeed, some estimates see the federal budget deficit moving out to 7% of GDP by the end of this decade from the current 3% if the tax policies discussed during the campaign are enacted without tax revenue neutrality and/or offsetting federal spending cuts. These federal budget realities could be a restraint on how dynamic the tax reform and tax reduction proposals may turn out.







The view that the Trump administration may implement a more relaxed regulatory environment for the energy and financial sectors and the pharmaceutical industry has already manifested itself in the stock price appreciation of most of the stocks in those groups. Proposals to reduce the barriers to further energy-infrastructure investment, modifying the Dodd-Frank financial sector regulations, and reducing the time and costs to bring new drugs to market, would all potentially work to improve business and capital efficiency, and thus valuations on those stocks have expanded in anticipation of better earnings. However, there are many interests that are aligned to slow those changes, so it remains to be seen how quickly they are enacted or implemented.

Economic Review

The domestic economy was already on the upswing prior to the election and may have received further stimulus through enhanced expectations of a unified, more business-friendly government at the federal level. Domestic GDP jumped to a 3.5% annual rate in the third quarter from a roughly 1% rate in the first half of 2016. Non-farm payroll increases have averaged 176,000 for the past three months, the unemployment rate hit 4.6% in November, and weekly jobless claims continue to average in the 265,000 range – well below the first-warning-sign level of 300,000 per week. Retail sales were running at a 7% annual rate for the three months ended November, nominal personal consumption was running over 5%, and bank commercial and industrial loans were increasing at an 8% annual rate during the same three-month period. The Citigroup U.S. Economic Surprise Index, which measures whether reports are stronger or weaker than consensus expectations, moved significantly higher from its near-term October lows. While the Federal Reserve Bank of Atlanta's GDPNow tracker is estimating a deceleration in the GDP growth rate for the fourth quarter to 2.5%, the rate is still significantly better than the first half of the year.

Outside the U.S., world economic growth seems to have been modestly improving as the fourth quarter evolved. In Europe, the December German Ifo survey, which measures business climate expectations among a broad swath of German companies, was at its highest level in a little over two years. Eurozone manufacturing PMI readings are pointing to a near-term increase in industrial production over the next few months. The most recent Eurozone retail sales release in October saw a 1.1%

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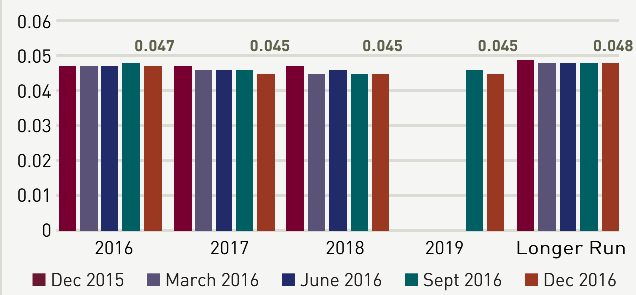
increase, after two straight months of negative readings. Moreover, from a monetary policy stance, while the European Central Bank is lowering the amount of security purchases in its asset-purchase program from 80 billion euros per month to 60 billion, it has extended the program an additional nine months to the end of 2017. This is expected to keep short-term interest rates negative for an extended period within most of Europe.

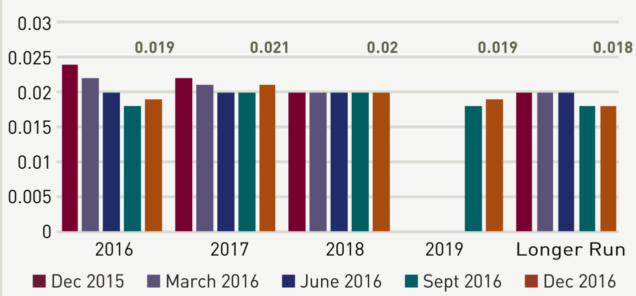
China has been experiencing better economic growth in the back half of the year largely due to monetary and targeted fiscal stimulus policies put in place at the start of 2016. Measures outside of the official GDP numbers (which show hard-to-believe stability) have been noticeably stronger: electricity output, both passenger and freight-rail traffic, as well as export volumes all are increasing. Additionally, bank lending and total social financing (the broadest measure of Chinese credit market expansion) are growing at 13% annual rates year over year as of November. However, the Chinese housing market is likely to slow again in 2017 as policies are being put in place to slow housing price appreciation.

FOMC Projections for the Unemployment Rate



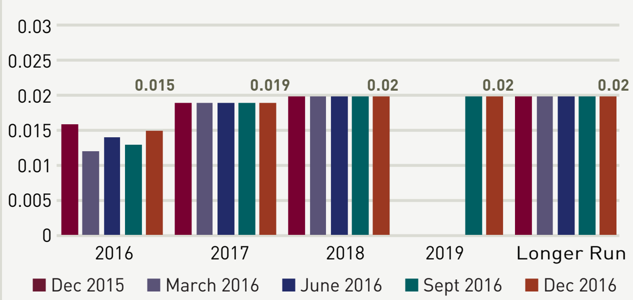
Source: Economic Projections of Federal Reserve Board Members & Presidents

FOMC Projections for Real GDP Growth



Source: Economic Projections of Federal Reserve Board Members & Presidents

FOMC Projections for PCE Inflation



Source: Economic Projections of Federal Reserve Board Members & Presidents

Meanwhile, in Japan, GDP has expanded for three quarters in a row, the December manufacturing purchasing managers index came in at the highest level in a year and export volumes rose 4% year over year, the quickest growth in a year. The sharp deterioration in the yen since the U.S. election should aid Japan's competitiveness in export markets. However, we would caution that growth may still be centered around the 1% level in 2017 even with the recent improvements.

Domestic Monetary Policy

In December, the Federal Open Market Committee (FOMC) raised short-term interest rates by 25 basis points (bps) in the very gradual return to interest-rate normalcy. This was a widely expected move given the solid state of the domestic economy, the gradual rise in the inflation rate, and the all-clear signal from the bond market. Longer-term interest rates started to rise after the U.S. election as the market began to factor in stronger economic growth and a presumed higher inflation rate in light of expectations for the incoming Trump administration's policies and stimulus in an already near-full-employment economy. The surprising part of the FOMC press release was the indication that the current FOMC members expect three more increases of 25 bps in short-term rates during 2017, one more than market expectations. Real GDP growth forecasts were very modestly stronger and the core inflation forecast remains between 1.75% and 2% out to 2019. However, as we saw in 2016, FOMC policy is highly dependent on the strength or weakness of the economic statistics, as well as financial market conditions to a lesser extent. Further increases could be accelerated or withheld depending on the data.

Market Review

Equity markets started the quarter somewhat weaker in October. However, that all changed after the presidential election when equity markets regained their footing and started to envision stronger economic growth. For the quarter,

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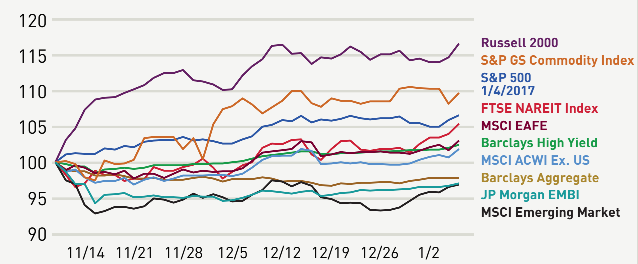
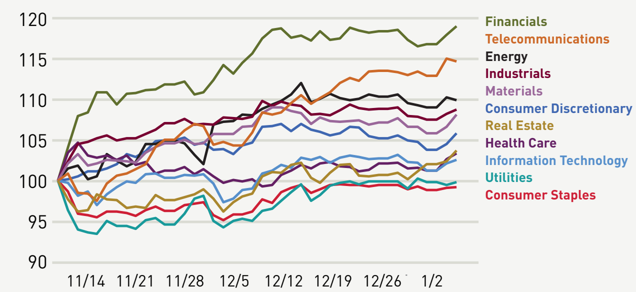
Benchmark Total Return – Post Election



Source: S&P, Russell, MSCI, Barclays, NAREIT, JP Morgan *©FactSet Research Systems*

S&P 500 Sector Returns – Post Election



Source: S&P *©FactSet Research Systems*

U.S. Treasury Yields

Source: Federal Reserve *©FactSet Research Systems*

the S&P 500 index returned 3.8% and returned over 11.9% for the year. Large-cap stock performance for the quarter was driven by a very strong return of over 20% in the Financial sector. Indeed, the KBW bank stock index was up 29% for the quarter. Bank stocks rallied on the post-election trifecta of: 1. rising short-term rates and a steepening yield curve, 2. potentially faster economic growth and stronger loan demand, and 3. expectations of an easing in bank financial regulations – all of which have contributed to expectations of improvements in bank earnings. By contrast, two areas that had been the darlings of much of 2016 due to their strong dividend yields reversed course, with real-estate investment trusts (REITs) falling nearly 4% during the quarter and the Utilities sector essentially flat. Nonetheless, for the calendar year, the Utilities sector returned 16% and REITs returned a respectable 8%.

Small-cap stocks strongly outperformed large-cap stocks, returning 9% for the quarter and almost 21% for the calendar year. The theme of value stocks bettering growth stocks continued this quarter, with small-cap value stocks outperforming small-cap growth stocks by approximately 1,050 basis points. For the year, the Russell 2000 Value Index returned over 31%.

The investment theme of "stay home," i.e. favoring domestic equities over international stocks, played out again during the quarter and the calendar year. While U.S. stocks had a positive quarter, both the MSCI EAFE and the MSCI Emerging Market indices had negative returns of 1.2% and 4.1%, respectively, for U.S. dollar investors. In their home-country currencies, performance was much better, a positive 7% for the MSCI EAFE Index and a modest 1.4% deterioration for the MSCI Emerging Markets Index.

Much of the foreign stock market underperformance can be attributed to the surging U.S. dollar after the November election. As the U.S. dollar gained considerable strength during the quarter, rallying over 6% against the euro and over 15% against the yen, the total return on foreign investments suffered.

The bond market, by contrast, had a tough go of it during the quarter due to rising interest rates. During the quarter, 10-year Treasury rates increased 82 bps, while 2-year Treasury notes moved higher by 43 bps. The Bloomberg Barclays Aggregate benchmark yield to worst rose 65 bps in the quarter, resulting in a negative total return of 3.0% for the period. Long U.S. Treasuries fared the worst, producing an 11.7% loss for the quarter. Given their generally strong return correlation with the small- and mid-cap equity markets, the high-yield bond market had a modest positive return for the quarter, gaining about 1.8%.

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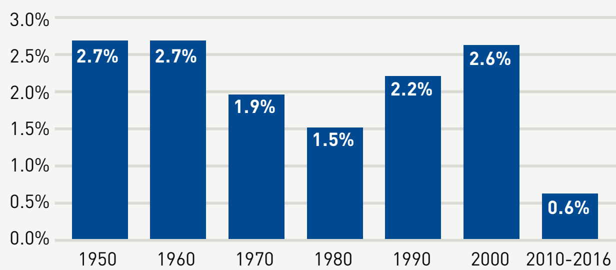
U.S. Non-Farm Productivity
Compound Average Each Decade (%)



Source: Bureau of Labor Statistics, PNC Capital Advisors

U.S. Dollar Index

Source: Bank of England ©FactSet Research Systems

S&P 500 Next 12 Months Price-Earnings Ratio

	Today As of 12/27/16	1 Year Ago As of 12/31/15	Long-Term Average (2000-2016)
S&P 500	**16.9x**	**16.1x**	**15.7x**
Consumer Discretionary	18.1x	18.2x	18.1x
Consumer Staples	19.3x	19.9x	18.4x
Energy	33.3x	28.1x	16.7x
Financials	14.0x	12.7x	12.5x
Health Care	14.3x	16.0x	16.4x
Industrials	17.8x	15.5x	16.5x
Information Technology	16.4x	16.0x	19.9x
Materials	17.2x	15.3x	16.2x
Real Estate	17.5x	N/A	17.5x*
Telecommunications	14.0x	12.3x	15.8x
Utilities	17.1x	15.4x	14.3x

Source: FactSet Market Aggregates
*Average from September 30, 2016 to December 27, 2016

Looking Forward

Domestic growth is expected to modestly accelerate in 2017, perhaps moving toward the 2.5% range as expectations for various forms of fiscal stimulus, tax reform, and regulatory relief begin to coalesce. While the exact policies and legislation have yet to take shape, consumers and businesses appear more confident about the outlook for the next 12 months than they were six months ago. Indeed, six months ago, GDP was still being held back by the inventory and capital investment corrections that followed the energy market bust. Now with oil prices back above $50 per barrel and the inventory overhang worked out, the domestic economy looks better balanced going into 2017.

Unfortunately, there may be several headwinds that could dampen these expectations. First, the FOMC could act more aggressively in raising interest rates should the economy or inflation appear stronger or higher than the central bank has forecast. While still low relative to historical levels, the change in interest rates can be a more important influence on subsequent GDP growth than the absolute level of interest rates. A quicker rise in short rates may restrain the other forms of stimulus expected to help the economy in 2017 and 2018.

Second, stronger growth and fiscal stimulus in an economy near full employment could strain labor resources. While there appears to be slack in the capital stock of the economy, labor supply may be more constrained in the near term. Moreover, those individuals who are currently unemployed, or underemployed, may not have the skill sets in demand, requiring further training. Thus, a demand surge on labor could result in further productivity weakness and a push on labor costs. The latter may be welcomed from the income distribution issues faced by the country, but rising labor costs may be more problematic for profitability and equity valuations.

Lastly, the strengthening dollar, will likely be counterproductive to the U.S. trade balance as foreign goods appear less expensive to U.S. consumers, while U.S. exporters would face cheaper competition abroad. Indeed, a faster U.S. economy fueled by domestic consumption is usually accompanied by an expanding trade deficit. Further, a strengthening dollar affects the earnings of U.S.-based multinationals because foreign earnings are converted back into fewer dollars.

Given that equity valuations have had a smart run up post the U.S. election, the outlook for equity returns should be viewed

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S&P 500 Earnings

	CY 2017 Estimates as of November 8, 2016		CY 2017 Estimates as of December 31, 2016	
	Sales	EPS	Sales	EPS
GICS Sectors	**Blended Growth (Y/Y%)**	**Blended Growth (Y/Y%)**	**Blended Growth (Y/Y%)**	**Blended Growth (Y/Y%)**
Cons. Disc.	5.4%	10.1%	5.3%	9.3%
Cons. Staples	3.5%	7.4%	3.0%	6.7%
Energy	22.6%	315.9%	25.9%	329.0%
Financials	2.5%	9.8%	2.7%	11.0%
Health Care	4.5%	8.5%	5.0%	8.5%
Industrials	2.0%	4.7%	1.5%	4.2%
Info. Tech.	6.8%	10.9%	6.9%	11.1%
Materials	4.3%	14.7%	4.8%	14.6%
Real Estate	4.6%	-19.5%	4.7%	-23.1%
Telecomm.	1.3%	4.2%	1.2%	4.1%
Utilities	3.2%	0.7%	4.5%	0.3%
S&P 500	**5.5%**	**11.2%**	**5.7%**	**11.3%**

Source: FactSet Market Estimates

through the needed follow through on earnings. Indeed, if earnings expectations continue to move higher from the contraction that ended in mid-2016, it is not unreasonable to look for modest single-digit returns in equities. However, much has been already priced in, so any downside deviation in earnings may result in an asymmetrical response.

International equities, both developed and emerging, continue to have more attractive valuation metrics than the U.S. market. However, should the dollar continue its surge into 2017, total returns for U.S.-based investors may remain subdued compared to their foreign counterparts.

Bonds appear more vulnerable to a further increase in real interest rates and/or inflationary expectations. As discussed above, the bond market moved significantly in the fourth quarter following the Trump victory and the Republican success in maintaining control of Congress. Should the new administration be successful in moving toward considerable fiscal stimulus in 2017 and 2018, the bond market may continue to act poorly. That said, credit conditions should remain favorable within the bond market as the credit cycle seems to have been given extra innings.