Economic and Capital Market Review

Third Quarter 2018

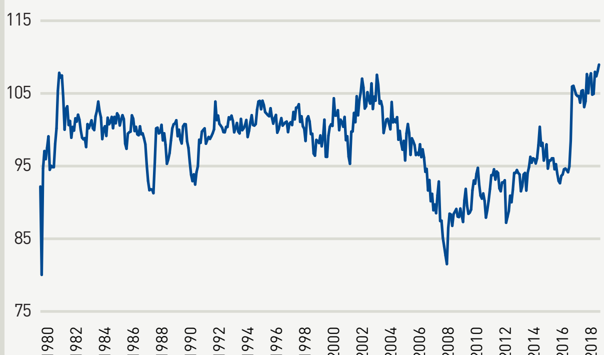
Economic Review

U.S. economy remains in good health, while international markets continue to grapple with trade uncertainty.

From both an economic and market perspective, the third quarter was largely a repeat of second—U.S. economic data showed continued strength, international markets kept growing (albeit a bit slower), the Fed pushed forward on raising rates, and equity and fixed income markets generally trended along their previous paths.

During the quarter, the buzz over last year's corporate tax reform seemed to fade; however, the impact of tax reform is ongoing and contributing to a positive fundamental backdrop for U.S. businesses and consumers. Corporate earnings growth has been strong, as expected, but revenue growth has also been robust, indicating businesses are getting a boost beyond the bottom line. Notably, the National Federation of Independent Business's Small Business Optimism Index reached new highs during the quarter. In August, the index soared to 108.8, topping the July 1983 high-water mark of 108. This index, based on a survey of small and independent business owners, measures expectations for compensation, profits, sales, inventory levels, and employment, among others. Fortunately, this optimism has persisted in spite of ongoing international trade tariff disputes, which escalated further during the quarter, particularly between the U.S. and China.

National Federation of Independent Business: Small Business Optimism Index[1]



[1]Data seasonally adjusted and indexed to 1986. Since 1986, data is updated monthly. Prior to 1986, data is available quarterly.

Source: FactSet

Overall, U.S. second quarter GDP growth came in at 4.2%, the highest quarterly growth rate since third quarter 2014. The Atlanta Fed's GDPNow forecast (updated weekly) for third quarter GDP is currently 4.2%[1]. Unemployment remains at near-term lows (most recently 3.7%), average hourly wages are up, and so is inflation—all key ingredients that are keeping the Fed squarely on a path to continue raising rates.

During the quarter, the Fed raised its target interest rate range for the third time this year. It's the Fed's eighth move since it embarked on policy normalization initiatives in late 2015. In its most recent statement following the rate increase, the Fed removed the word "accommodative" to describe the rate environment, in a departure from previous statements. This semantic adjustment appears to be a nod to the idea that short-term borrowing costs, while still accommodative, are closing in on the neutral rate. However, further rate hikes are still expected through 2019 and into 2020, with the probability of a fourth hike this year now estimated around 75%.

With the U.S. economy seemingly firing on all cylinders, the Fed has to help maintain a careful ecosystem that supports growing the economy without overheating it. While the Fed has historically kept a keen eye on inflation as a key part of its policy decisions, Chairman Powell acknowledged in an August speech that inflation might not be the best measure to watch, and that the Fed would consider "looking beyond inflation for signs of excesses" in making its determinations.

Other key central banks, including the European Central Bank (ECB), the Bank of England (BOE), and the Bank of Japan (BOJ) have been less aggressive in pursuing monetary policy tightening, as economic growth among their markets is not on as solid a footing as the U.S. The ECB confirmed it would continue to taper by slowing the expansion of its quantitative easing program and reducing monthly bond purchases from EUR 30 billion to EUR 15 billion from October until the end of the year. However, interest rates are expected to remain at record lows at least through the summer of 2019. The BOE actually raised rates during the quarter for only the second time in the last 10 years, but added the caveat that they're willing to lower rates again should the economy falter, particularly as the country continues to wrangle with Brexit.

[1] Source: Bloomberg, as of 10/10/2018.

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In stark contrast to the rest of the developed world, the BOJ remains ultra-accommodative, with target rates still set at -0.1%.

So while the synchronized global growth we've witnessed over the past year continued, a divergence between U.S. economic strength and the rest of the world appeared to exacerbate. Strong U.S. growth coupled with rising interest rates continued to bolster the dollar, which has had ripple effects across international markets, particularly emerging economies. Emerging economies (as well as the rest of the world) also continue to grapple with higher oil prices. As we mentioned last quarter, it's fairly unusual to see both oil and the dollar rise in tandem. The cumulative effect has led to capital outflows, which has had a negative effect on many countries' currencies, with some central banks raising interest rates in an attempt to stem the bleeding.

One key player in the fate of many emerging economies is China, where so far growth remains strong on an absolute basis. However, the rate of change appears to be slowing in-line with the government's deleveraging push, which has raised concerns about the sustainability of global growth more broadly. The China-U.S. trade tensions and resulting headline risk weighed on investor sentiment, especially as the U.S. moved forward with tariffs on hundreds of billions of dollars' worth of goods. Thus far, it is mostly sentiment related, though investors are monitoring how this may affect future global growth prospects.

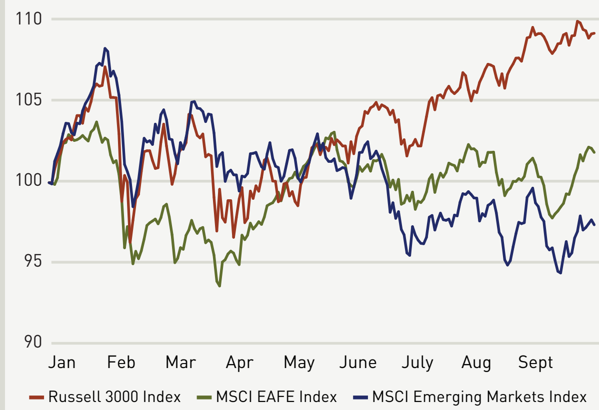
Equity Market Review

Domestic equities led even higher by large-caps and growth stocks; international equities lagged.

The third quarter was characterized by the contrast between further gains in domestic equity markets and weakness among international equities, particularly in emerging markets. Underpinning these trends was strong economic data and corporate fundamentals in the U.S. versus less robust growth and foreign currency volatility internationally.

Domestic market fundamentals remain sound, with blended earnings growth projected to exceed 20% for 2018 on revenue growth of 8%. On the back of this strength, the S&P 500 Index had its best quarter in nearly five years, gaining 7.7%. Expectations for 2019 are less sanguine, though still robust, with earnings and sales expected to grow 10% and 5%, respectively.

Year-to-Date Equity Market Performance – Domestic vs. International
Total Returns Indexed to December 31, 2017



Source: FactSet

On a market capitalization basis, both large-cap and small-cap stocks posted strong absolute gains (as measured by the Russell 1000 and Russell 2000 indexes, respectively). However, large cap stocks outperformed small cap stocks, marking a reversal from the prior quarter, in which small caps handily outperformed large caps. Recall, last quarter is when U.S.-led trade disputes really picked up steam, roiling many large-cap companies (which tend to have higher exposure to revenue outside the U.S.), as investors tried to discern what the ultimate impact of the new or threatened tariffs would be. Adding to the woes of multinational companies was the considerable rise in the dollar, which has the potential to create demand and/or cost headwinds. While large caps didn't get any relief from trade tariff and dollar headwinds this quarter, investors seemed to gain some comfort. Small caps still lead on a year-to-date basis, but large caps closed the gap significantly, led by the Healthcare and Information Technology sectors.

U.S. Equity Index Returns by Size and Style *Total Return (%)*	2018			
	Q1	Q2	Q3	YTD
Russell 1000 Index	(0.69)	3.57	7.42	10.49
Growth	1.42	5.76	9.17	17.09
Value	(2.83)	1.18	5.70	3.92
Russell 2000 Index	(0.08)	7.75	3.58	11.51
Growth	2.30	7.23	5.52	15.76
Value	(2.64)	8.30	1.60	7.14

Source: FactSet

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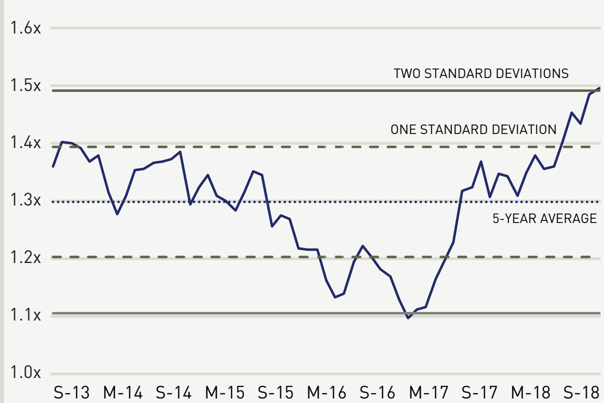
Growth stocks once again beat value stocks among large-cap indices. The same was true for small-cap indices as well, although value narrowly outperformed growth during the second quarter. Tech stocks have been a considerable driver, even after dipping significantly during the first quarter, a selloff that was initially sparked by privacy concerns at Facebook. Of note, Apple, Amazon, and Microsoft have contributed nearly one third of the Russell 1000's year-to-date total return. Remarkably, Apple eclipsed the $1 trillion market capitalization mark in the quarter. There appears to be little concern among investors over valuations, which continue to appear stretched.

In fact, growth stock valuations have been far outpacing value stock valuations on a historical relative basis since the beginning of the year. By the end of the quarter, for example, on a relative basis, the last 12 months price-to-earnings ratio of the Russell 1000 Growth Index was about 1.5 times the Russell 1000 Value Index, which is two standard deviations above its 5-year average.

Relative Value of Russell 1000 Growth Index vs. Russell 1000 Value Index

Price-to-Earnings Ratio – Last 12 Months



Source: Bloomberg, PNC Capital Advisors analysis

Looking overseas, developed equity markets (as measured by the MSCI EAFE Index) gained 1.97%, while emerging markets (as measured by the MSCI Emerging Markets Index) closed the quarter down -1.69%, a slight recovery after being down as much as -5.5% in mid-September. Emerging markets have now declined -16% from their January 26 peak, largely driven by foreign exchange volatility. We expect continued divergences between emerging market equities and domestic equities, as a whole, in the coming months.

Fixed Income Market Review

"Risk-on" sentiment drove high-yield outperformance once again.

In fixed income markets, it was a "risk-on" quarter, as high-yield credit spreads declined nearly 50 basis points (bps). High yield credit continues to appear expensive on an absolute basis as well as versus investment grade. In fact, high yield spreads have been bouncing around cycle lows for some time now, similar to a period last seen in the early 2000s. While noteworthy, it is also somewhat to be expected given risk-on trends in other areas of the financial markets, such as the bull run we've seen in equities.

High Yield Option-Adjusted Spread vs. Small-Cap Equities

Source: Bloomberg, PNC Capital Advisors analysis

The Treasury yield curve continued to flatten due to upward pressure on the front end of the curve versus the long end. The 10-year yield increased 23 bps to 3.0 %, approaching its 2018 highs, while the 2-year note increased 29 bps to 2.85%, a 10-year high. Interestingly, the year-to-date yield change in the 2-year note (94 bps) is exactly double that of the 30-year bond (47 bps), demonstrating investors' focus on the front end of the curve. The flattening appears even more dramatic looking back several years to the start of the Fed's monetary policy normalization in December 2015 when the difference between the 2-year note and the 10-year note stood at roughly 120 bps, compared to a difference of 30 bps today.

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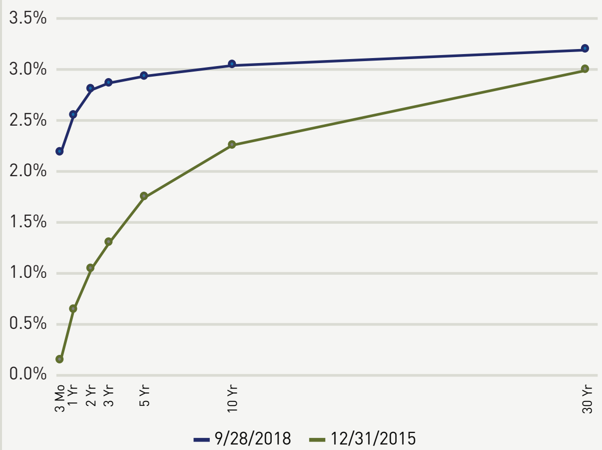
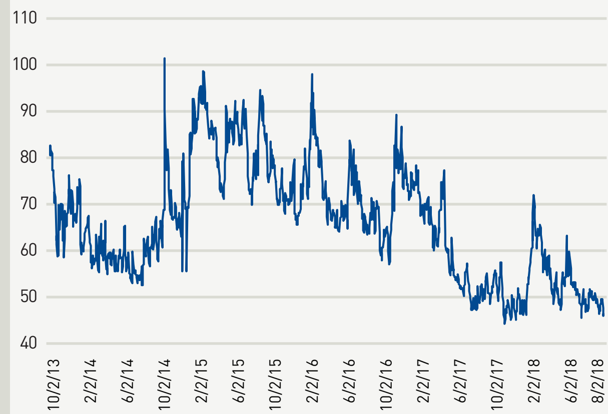
U.S. Treasury Yield Curve



Source: FactSet, PNC Capital Advisors analysis

Bank of America/Merrill Lynch Option Volatility Estimate Index



Source: Bloomberg

The total return of the Bloomberg Barclays U.S. Aggregate Bond Index was essentially flat for the quarter at just 0.02%. In a reversal from the previous two quarters, structured products underperformed investment grade credit. Investment grade credit returned 0.97% during the quarter with an excess return of 1.69%. Overall excess returns in Credit are now back to flat on a year-to-date basis. Within the index, longer-dated and lower-quality credits outperformed, consistent with the risk-on environment. High Yield continues to be resilient and produce strong total and excess returns. High yield posted a total return of 2.40% and excess return of 2.48% for the quarter. The performance gap between BB and B/CCC issuers narrowed during the period.

Overall, credit fundamentals remain solid, as second quarter corporate earnings (reported during the third quarter) were strong and largely exceeded expectations. Broadly speaking, we expect fundamentals to remain positive, as third quarter GDP is expected to easily exceed 3%. However, we are increasingly cautious of companies and sectors (notably food and beverage companies) that have materially increased leverage in recent M&A deals.

While potential sources of volatility continue to accumulate, actual volatility has remained relatively subdued. The Bank of America/Merrill Lynch Option Volatility Estimate (MOVE) Index (a proxy for bond market volatility) moved higher during the quarter, but maintained the overall downward trajectory from near-term highs seen in 2015. Spread volatility in both investment grade and high yield credit continues to be limited despite escalating trade disputes with China.

Looking Forward

Mild pull back possible given strong market performance this year.

Overall, a strong fundamental backdrop helped buoy risk assets during the quarter in spite of increasing macro uncertainty related to trade. While fundamentals remain strong, it is important to bear in mind that domestic equities are not "cheap" and credit spreads are compressed. While the two conditions are not necessarily predictive of a correction in risk assets, we would not be surprised to see a mild pull back given the market's strength this year. We continue to expect bouts of volatility to emerge as monetary policy continues to normalize and as we face increasingly difficult comparisons for earnings expectations heading into 2019. As always, headline risks, such as mid-term elections, trade tariffs, and Brexit may introduce macro-driven volatility in the coming quarter.

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Indexes

The **Bloomberg Barclays Aggregate Bond Index** is an unmanaged index composed of securities from the Bloomberg Barclays Government/Corporate Bond Index, Mortgage-Backed Securities Index and the Asset-Backed Securities Index and represent the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market.

The **BofA/ML Option Volatility Estimate Index** is a yield curve weighted index of the normalized implied volatility on 1-month Treasury options which are weighted on the 2, 5, 10, and 30 year contracts.

The **ICE BofAML High Yield Master II Option Adjusted Spreads (OASs)** are the calculated spreads between a computed OAS index of all bonds in a given rating category and a spot Treasury curve. An OAS index is constructed using each constituent bond's OAS, weighted by market capitalization. The ICE BofAML High Yield Master II OAS uses an index of bonds that are below investment grade (those rated BB or below).

The **MSCI EAFE Index** is designed to represent the performance of large and mid-cap securities across 21 developed markets, including countries in Europe, Australasia and the Far East, excluding the U.S. and Canada. The Index is available for a number of regions, market segments/sizes and covers approximately 85% of the free float-adjusted market capitalization in each of the 21 countries.

The **MSCI Emerging Markets Index** is an unmanaged standard emerging markets index that captures large and mid cap representation across 24 Emerging Market (EM) countries. With 846 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

The **National Federation of Independent Business (NFIB) Small Business Optimism Index** is compiled from a survey that is conducted each month by the NFIB of its members.

The **Russell 1000 Index** measures the performance of the large-cap segment of the U.S. equity universe. It includes approximately 1000 of the largest securities based on a combination of their market cap and is constructed to provide a comprehensive and unbiased large-cap barometer.

The **Russell 1000 Growth Index** measures the performance of the large-cap growth segment of the U.S. equity universe. It includes companies with higher price-to-book ratios and higher forecasted growth values and is constructed to provide a comprehensive and unbiased barometer for the large-cap growth segment.

The **Russell 1000 Value Index** measures the performance of the large-cap value segment of the U.S. equity universe. It includes companies with lower price-to-book ratios and lower expected growth values and is constructed to provide a comprehensive and unbiased barometer for the large-cap value segment.

The **Russell 2000 Index** is an unmanaged index that tracks the common stock price movement of the 2000 smallest companies of the Russell 3000 Index, which measures the performance of the 3000 largest US companies based on total market capitalization.

The **Russell 2000 Growth Index** measures the performance of the small-cap growth segment of the U.S. equity universe. It includes those Russell 2000 Index companies with higher price-to-value ratios and higher forecasted growth values.

The **Russell 2000 Value Index** measures the performance of small-cap value segment of the U.S. equity universe. It includes those Russell 2000 Index companies with lower price-to-book ratios and lower forecasted growth values. The Russell 2000 Value Index is constructed to provide a comprehensive and unbiased barometer for the small-cap value segment.

The **Russell 3000 Index** is a market-capitalization-weighted equity index maintained by the FTSE Russell that provides exposure to the entire U.S. stock market. The index tracks the performance of the 3,000 largest U.S.-traded stocks which represent about 98% of all U.S incorporated equity securities.

The **S&P 500 Index** is an unmanaged cap-weighted index of 500 publicly traded stocks generally representative of the large-cap U.S. stock market performance and includes a representative sample of leading companies in leading industries. An investor cannot invest in the S&P 500 Index.

Indexes are unmanaged and not available for direct investment.

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