Economic and Capital Market Review

Third Quarter 2017

Is the Inflation Hibernation Coming to an End?

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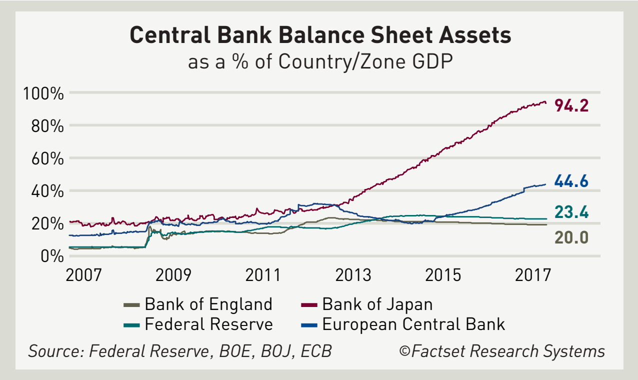
Chief Investment Officer

Central bankers around the globe have been fighting the deflationary demon for nearly a decade, as unconventional monetary policy has become the norm. Policy makers' actions and bond-buying programs have cultivated near-zero, or even negative, interest rates in an effort to stave off deflation. Yet, inflation in the developed world has remained stubbornly low—generally below the inflation targets of most central banks. Many are left wondering, what's driving this trend?

Collectively, the U.S. Federal Reserve, the European Central Bank, the Bank of Japan, and the Bank of England have increased their respective balance sheets by enormous amounts, both in absolute terms and relative to their respective GDPs. Commercial bank reserves have grown concomitantly. In otherwise "normal" times, bank loan growth should have exploded, leading to a greater money supply, faster aggregate demand, tighter availability of goods and lead times, and ultimately inflationary pressures. But the past decade has not been a normal time, as financial regulators have been working to ensure the banking system won't need another bailout in the future. In fact, many large banks were required to build their capital by either holding onto retained earnings or selling additional stock to increase equity. Moreover, for a long time after the crisis, the corporate sector, which is normally a net borrower of funds, turned into a net saver, as companies held onto cash rather than redeploying it back into their businesses.



Central Bank Balance Sheet Assets
as a % of Country/Zone GDP

Source: Federal Reserve, BOE, BOJ, ECB *©Factset Research Systems*

Within the U.S., the Fed has been targeting a 2% inflation level for the core personal consumption expenditure price index (PCE), excluding food and energy. However, since the financial crisis in 2009, the only time this inflation measure has been at or above 2% was during a four-month stretch back in 2012. The most recent year-over-year reading in August was 1.3%. While there are many possible explanations for continued mild inflation readings—numerous one-off price declines, tepid wage growth, and, until 2017, a generally stronger U.S. currency—we believe several areas have caused inflation to be lower than what would have been expected, given the hyper-accommodative Fed policy.

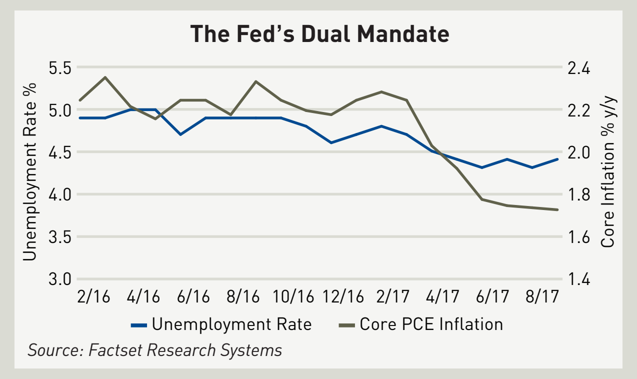
First, nominal GDP growth has not been very strong. Coming out of the Great Recession, GDP growth accelerated but then lost momentum, as the housing hangover debacle prevented growth from continuing to accelerate. Second, bank lending has been generally tepid and loan demand mild. We've seen demographics play into demand for both credit and goods, as slower population growth has kept it in check. Globalization of supply chains and the labor force acts as a continual check on pricing.

Finally, internet-based retailers continue to upend traditional bricks-and-mortar stores, keeping downward pressure on consumer prices.

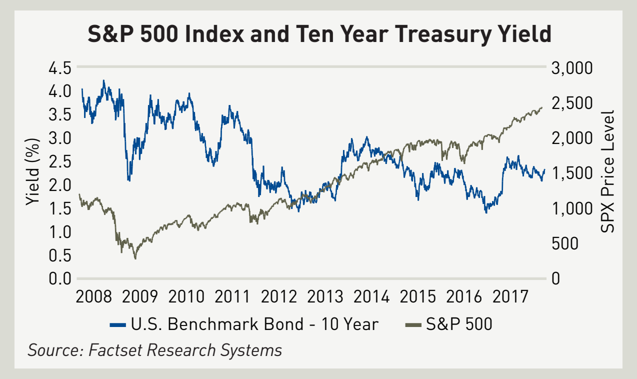
However, we are seeing signs the environment may be changing in a way that supports rising inflation. Housing demand has been strengthening in the U.S., and we believe stronger home sales have only been held back by supply constraints. Prices of existing homes have risen nationally at a 5% annual rate over the past three years. Crude oil, which cratered from mid-2014 to early 2016, has stabilized near $50 per barrel. Some of the oil price increase can be attributed to recent hurricanes in the U.S., but we believe it's also a result of stronger global demand. Indeed, we are starting to see some rising inflation readings abroad, including the UK and China.

Without an energy price shock, we don't expect a sharp rise in domestic inflation rates. However, we do believe the low inflation we've seen this year is due to unique circumstances. As the U.S. economic expansion continues alongside relatively full employment, we expect core PCE to reach, and possibly exceed, the Fed's target rate. As a result, we expect the Fed to continue its renormalization of monetary policy into 2018, perhaps hitting a 2% terminal fed funds rate. We expect several other central banks around the world to also take steps to reduce or eliminate the hyper-accommodative monetary policies of the past few years as we move into 2018.

In this low interest rate, low inflation environment, investors have been pushed further into riskier areas of the market in search of yield. When this hyper-accommodative monetary experiment ultimately reverses, we expect the effects to impact capital markets. Both the equity and fixed-income markets will need to adjust to these new central bank policies, as these changes will remove some of the tremendous liquidity to which the markets have grown accustomed. This doesn't mean markets can't move higher, it just means the ascent to a higher altitude may come with some seatbelt-tightening turbulence along the way, as the effects of Fed-induced financial asset pricing diminish.


The Fed's Dual Mandate

Source: Factset Research Systems


S&P 500 Index and Ten Year Treasury Yield

Source: Factset Research Systems

Regardless of the environment ahead, you can expect the PNC Capital Advisors' investment teams to continue executing the disciplined investment processes that guide our strategies, while preserving the ability to adapt and take advantage of the opportunities presented by changing market conditions.

We greatly appreciate your continued investment with PNC Capital Advisors.

Sincerely,

Mark McGlone

Economic Review

Solid labor markets led domestic growth; international markets appear strong across various metrics.

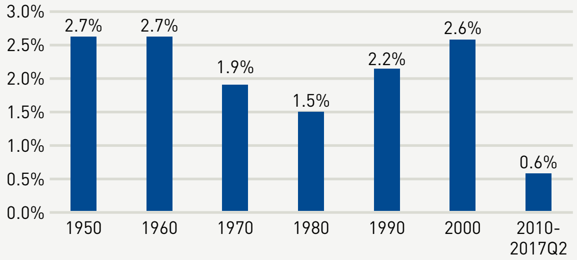
Despite a 3% quarter-over-quarter uptick in growth during the prior quarter, third-quarter U.S. real GDP is expected to expand between 2% to 2.5%, as some of the momentum experienced during the previous period diminished. Consumer spending slowed and inflation continued to fall short of the Fed's 2% target. Hurricane-related shutdowns caused a dip in industrial production in August; however, we expect a commensurate rebound in September and into the fourth quarter. We also expect to see a rebound in the motor vehicle market, as an estimated 500,000 autos will need to be replaced as a result of the storms. Housing refurbishment and replacement in hurricane-affected areas will likely take a little more time, as certain trade workers were already in short supply. Nationally, labor markets remain tight with the most recent unemployment rate measured at 4.3%. Small-business confidence remained strong, well above pre-election levels.

During the quarter, the U.S. dollar index continued a months-long fall before staging a modest recovery on the announcement of the proposed "Big Six" tax reform outline. Sporadic rushes to safe-haven assets, such as gold, the Japanese yen, and the Swiss franc, contributed to the dollar's relative decline. Alongside a falling dollar, commodity prices firmed for the first two months of the quarter before sliding in September when the dollar recovered. Oil prices were generally firmer over the quarter, while gasoline prices have slowly receded following a spike due to the hurricanes.

Nonfarm business sector labor productivity continues to grow at modest levels, increasing at an annual rate of 1.5% during the second quarter. We've seen sluggish measured productivity growth over the past decade, which has sparked much debate—and little consensus—about potential causes. Demographics could be a possible damper on productivity, as a cohort of the baby boomer generation is still winding its way through the labor pipeline. Another source could be corporate capital spending, which may be stifled, as the tax treatment and profitability implications are in transition. Finally, measuring productivity of the service portion of the economy is notoriously difficult. While we believe technology is likely supporting labor productivity across most sectors, the impact is a challenge to quantify.

U.S. Non-farm Labor Productivity

Compound Average Each Decade (%)



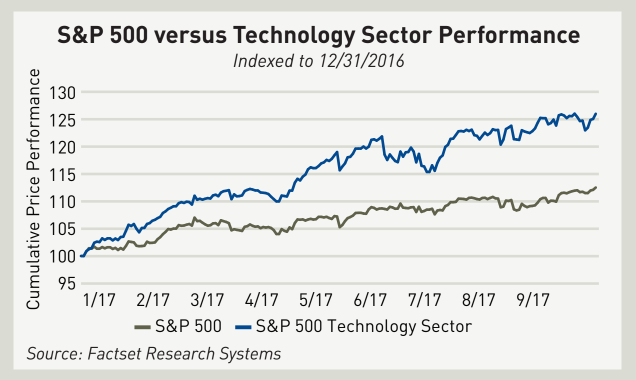
Source: Bureau of Labor Statistics, FactSet, PNC Capital Advisors

Looking abroad, global growth continues to be firm in the developed world. Both the Eurozone and Japan delivered solid growth in the second quarter, and third-quarter statistics were generally positive. Collectively, the manufacturing Purchasing Managers Index surveys are up across international markets. While China has slowed from its acceleration in late 2016, estimates for the third quarter and beyond indicate expected growth in the low 6% range. Brazil displayed impressive growth in the first half of the year despite intense political turmoil and two full years of recession. As of mid-August, all 45 countries tracked by the Organization for Economic Cooperation and Development are on pace to expand this year for the first time in a decade. Emerging-market exporters have benefitted from stronger global growth and a weakening dollar. However, recent weakness in commodity prices raises some concern over the strength of the expansion. Overall, developed and emerging markets are exhibiting economic strength.

Equity Market Review

Strong corporate earnings supported U.S. equity gains; positive international markets were bolstered by U.S. dollar depreciation.

Despite continued policy uncertainty, a bruising from back-to-back hurricanes, and concerns regarding developments on the Korean peninsula, domestic equity markets are hitting record levels and volatility is at an all-time low. The S&P 500 gained 4.5% during the quarter. The best-performing sector was Technology, including the so-called FAANG group of Facebook, Amazon, Apple, Netflix, and Alphabet (Google), which collectively posted a 6.4% gain on a market capitalization-weighted basis. Utilities boasted strong



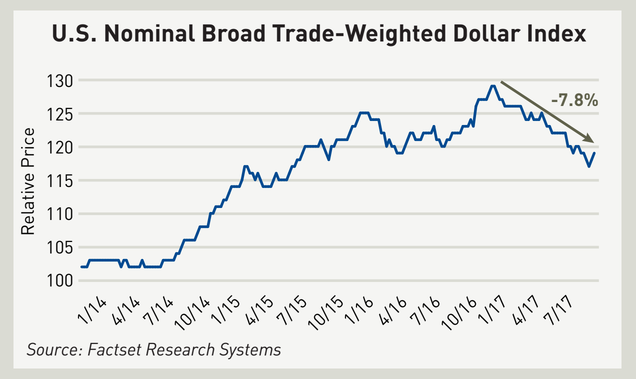
S&P 500 versus Technology Sector Performance

Indexed to 12/31/2016

Source: Factset Research Systems

performance. Health Care stocks climbed on a spike in M&A activity among biotech companies and increased demand for health-care equipment. In contrast, Financials suffered during most of the quarter due to a dovish interest-rate outlook, but rebounded somewhat after the Fed's announcement of plans to unwind its balance sheet. Nearly all constituents of the Telecommunications sector posted losses. From a style perspective, growth stocks continued to outperform value stocks. Large caps outperformed small caps through August, but small caps staged a strong recovery in September on the back of the proposed tax reform framework.

Domestic companies demonstrated strength with a season of healthy earnings announcements. During the third quarter, a weaker U.S. dollar and robust global demand helped S&P 500 earnings achieve a blended growth rate of 10.3%, with nearly 74% of S&P 500 constituents beating earnings expectations. Technology companies were particularly strong, aided by favorable foreign exchange rates for those companies that earn revenues outside the U.S. Among the S&P's technology constituents, 87% surprised to the upside, leading to a 27.4% year-to-date return for the sector. The broad trade-weighted U.S. Dollar Index fell 4.9% in the first half of 2017. However, with potential tax reform on the table and a dollar that has regained strength in recent weeks, the U.S. is expected to contribute to sustained global demand well into 2018. We believe the synchronized global recovery is finding traction, and its momentum is expected to continue throughout the next year.



U.S. Nominal Broad Trade-Weighted Dollar Index

Source: Factset Research Systems

International performance exceeded that of domestic markets throughout the third quarter. Emerging markets delivered a 7.7% gain, while developed markets earned 3.4%. Technology, Energy, and Materials were key contributors. The Technology sector showed strength across developed and emerging markets, with the MSCI All Country World Index and MSCI Emerging Markets (MSCI EM) Technology indices gaining 9.0% and 11.1%, respectively. In emerging markets, noted contributors included Chinese social media and e-commerce companies, as consumers in certain emerging markets have increasingly turned to online and mobile shopping, leapfrogging much of traditional retail.

Fixed Income Market Review

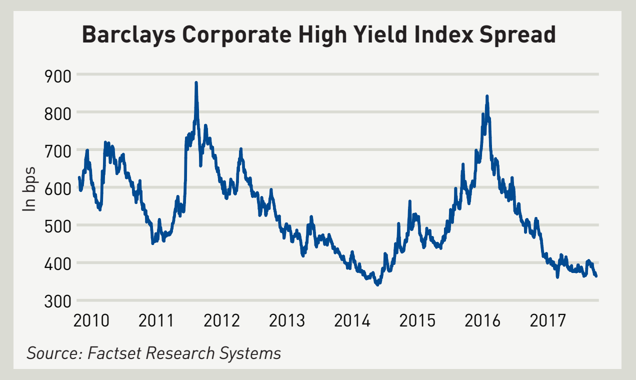
The Fed stays the (tightening) course; international policy makers get closer to unwinding hyper-accommodative measures.

All eyes were on Fed policy and inflation during the third quarter. Mild inflation readings have been in the spotlight, as the market originally believed the Fed may slow the pace of interest-rate increases. A cautious Federal Open Markets Committee (FOMC) has expressed mixed opinions regarding causes of recent low inflation readings and future inflation expectations. Some members believe the low inflation is transitory, while others believe secular forces may be holding inflation down. During the September FOMC meeting, the Fed held rates at 1% to 1.25%, announced plans to start unwinding its $4.5 trillion balance sheet in October, and indicated a potential rate hike in December is still possible. Fed funds futures estimate the probability of a December rate hike at nearly 70%. In addition to a rate increase in December, the FOMC forecasts three more increases in 2018.

As previously mentioned, we learned details about the Fed's balance-sheet reduction plan. The Fed will accomplish this by letting controlled amounts of its securities expire without being reinvested. It will begin with $10 billion per month, growing to $50 billion per month by the end of 2018. This plan should result in a reduction of approximately $2 trillion of the $4.5 trillion outstanding over five years. For context, the Fed's balance sheet was around $800 billion before the global financial crisis.

Tightening measures also appear on track in other parts of the world. While the European Central Bank (ECB) is not likely to announce any balance-sheet reductions in the near term, it may look to taper its purchases of securities in 2018, as growth in the European Union has strengthened measurably over the past 12 months. The Bank of England may raise rates sometime in the fourth quarter, while the Bank of Canada has already begun raising rates to cool an overheated housing market. However, the Bank of Japan is not likely to change its aggressive quantitative easing program anytime soon, and continues to expand its balance sheet relative to Japanese GDP.

Bond market yields essentially made a round trip over the course of the quarter, as 10-year Treasury rates initially fell to a low of almost 2% before settling higher at 2.33%. Two-year Treasury notes rose a few more basis points (bps) over the period, causing a slight flattening of the curve. While investment-grade and high-yield credit spreads widened in the third quarter, spreads haven't been as tight as they are now since the summer of 2014 (for the post-financial crisis period). Overall, credit markets saw limited volatility and stable fundamentals, while light new issuance in September, higher Treasury rates, and proposed tax reform all contributed to a quarter-end rally.



Source: Factset Research Systems

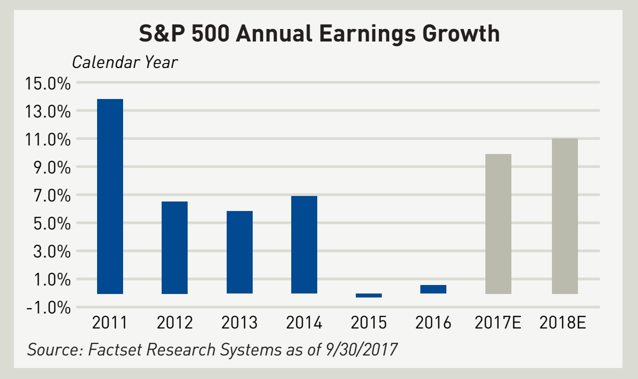
Looking Ahead

Changing Central Bank policy could reintroduce volatility into the stock and bond markets.

In summary, we believe domestic growth will generally remain in the 2% to 2.5% range we have been observing over the past few years. Inflation may start to trend modestly higher, perhaps breaching the Fed's 2% target in 2018, but we do not foresee a breakout on the upside without a substantial and sustained rise in wage growth. Indeed, a side effect of the Administration's work to reduce immigration may result in higher domestic wage growth, as companies seek to entice domestic workers into jobs that have often been sourced with foreign workers. We continue to see both state and local governments raising the minimum wage, while some large companies also seek to raise minimum starting wages in this tight labor market.

However, should the Administration and Congress be successful in the proposed tax reform efforts—a tall order given the miscues on health-care reform—then domestic growth could mildly accelerate and growth could approach 3%. Tax reform, together with tax cuts, could be the tonic that helps give renewed vigor to this long lasting expansion.

Equity markets would continue to act favorably on such prospects, especially if corporations receive more favorable tax treatment on offshore earnings and possible cash repatriation. Lower marginal rates are usually welcomed. Yet, the market may be past the point of the most favorable earnings acceleration from the oil bust induced slowdown.



Source: Factset Research Systems as of 9/30/2017

We believe earnings drive stock prices in the long run, so a return slowdown (and greater volatility) should be expected. We expect low to mid-single digit returns in equities, while fixed income investors may be confined to low single digit returns for the time being.

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