Eurozone: Then and Now

For the past few years, it seemed we could not go long without writing about the Eurozone, prompted by its recession, sovereign debt crisis, and double-dip recession. In addition, the tenuous economic state of some member nations, most notably Greece, as well as concerns about other periphery countries were noteworthy. From a global market perspective, the Eurozone was the biggest risk out there. But the tail risks from the Eurozone eased significantly in 2012 and 2013, with the help of policy maker support and encouraging economic data. Global capital markets gave a sigh of relief and U.S. equities, in light of a muted Eurozone tail risk, moved higher with the focus shifted back to trading on domestic fundamentals.

Things on the Eurozone front have certainly been a bit quieter in the past 9-12 months, it seems. But the region is neither out of sight nor out of mind in our view; we continue to closely monitor this important economy. Most recently, actions by the European Central Bank (ECB) highlight the ongoing risks facing the region’s economies in the eyes of policy makers. While we do not see a draconian event as likely as we did a few years back, concerns remain.

With this backdrop we are focusing this Investment Outlook on the Eurozone: where is it now versus where it has been, as well as the implications of ECB policy. We discuss:

- the good;
- the questions;
- the future; and
- the markets.

ECB President Mario Draghi has been outspoken in reassuring markets of policy maker support for the Eurozone—something markets have taken notice of. Global markets have been serene as of late, but any upset can change the volatility picture.

Our outlook for the United States for 2014 is continued economic expansion, with several helpful tailwinds, including less fiscal drag and political turmoil, strong corporate profits, low inflation, and rising asset prices, among other things. PNC is forecasting GDP growth of 4.0% for second-quarter 2014. Our full-year 2014 forecast for GDP growth is 2.2%.

PNC’s six traditional asset allocation profiles are shown on the back page of this outlook.
The Good

Since unifying under a single currency in 1999, the Eurozone (previously 17 now 18 member countries) has seen its share of growing pains. Highlights, in an ironic sense, include the global financial crisis, double-dip recession, and sovereign debt crisis, just to name a few.

Economists indicated the Eurozone, after contracting for six consecutive quarters, began to recover in second-quarter 2013. Leading the way, at least initially, out of recession were Germany and France. Germany continues to lead, while France has been somewhat surprisingly weak.

The recovery in the Eurozone appears to be continuing, albeit slowly and somewhat unevenly, with recent data showing real GDP growth of 0.8% for first-quarter 2014 (Chart 1).

- Growth was strongest in Germany, which benefited from a relatively mild winter.
- France’s GDP growth was flat with the prior quarter.
- In the periphery nations, growth slipped slightly in Italy and Portugal, while Spain expanded slightly.

PNC forecasts 0.8% Eurozone GDP growth for 2014, accelerating to 1.5% for 2015.

Also highlighting a recovering Eurozone are improved readings from the Purchasing Manager’s Index (PMI). The manufacturing PMI is an index that surveys business conditions among manufacturing firms. Typically, any reading above 50 indicates expansion, and below 50 indicates contraction. However, in our study of PMI (PMI: Early Indicator of Economic Activity?, January 2014), we showed that for expansion in the Eurozone this number historically has been closer to 49. In addition, there is a strong correlation between PMI and GDP growth for most regions—particularly high for the Eurozone.

According to Markit, the PMI for the Eurozone dipped below 50 in 2011, remaining there until 2013. Recently, Eurozone PMI data for June came in below expectations, with the composite reading at 51.9 versus 52.2 in May. The June PMI for Germany was below consensus at 52.4 but above May’s 52.3. France’s PMI reading was disappointing at 48.0, which is well below May’s 49.3 (Chart 2). Germany has shown significant resilience in manufacturing PMI, which is not surprising, given the strength of the manufacturing sector there.

A more detailed look at the survey shows that Germany, Europe’s largest national economy, continues to spearhead Eurozone growth and that the recovery is spreading to France and beyond to those economies, such as Greece and Spain, that have been weighed down by government-imposed austerity programs for years (Chart 3, page 3).

Policy, most notably led by President Draghi, has had a notable influence on market perception. ECB easing also appears to be working. Bond yields, particularly in the
Eurozone: Then and Now

periphery countries, are down dramatically (Chart 4), which helps countries immensely.

European stocks have moved in response (Chart 5). By country, Italian and Spanish stocks have been some of the strongest movers in 2014. In addition, we believe the removal of this tail risk was part of the reason U.S. stocks did so well in 2013.

The Questions

Slow Growth

Economists at the Center for Economic Policy and Research recently suggested that although by some technical definitions the Eurozone exited recession a year ago, growth is still too weak and unemployment still too high to declare the recession over. These economists are part of the Euro Area Business Cycle Dating Committee. They concluded that the Eurozone “might be mired in a recession pause.” This committee has the responsibility of establishing the start and end dates of recessions and expansions. Its decision not to call an end to the recession reflects concerns regarding the recovery.

The Eurozone continues to combat high unemployment, which at 11.7% is only 0.3-percentage-point lower than the Eurozone’s all-time peak. The Eurozone’s unemployment rate has far to go to return to prerecession levels. It trended around 9% in the mid-2000s and fell as low as 7.3% in 2008 (Chart 6). Labor reforms, traditionally a headwind for many Eurozone countries, have taken place, allowing countries to cut wages. This is a good thing from a competitiveness perspective but is felt in the near term by earners.
Despite improved bond yields and equity returns, output has not returned to prerecession levels. Output declined in eight Eurozone countries in first-quarter 2014.

Also, the nominal GDP level has risen slightly, but not overwhelmingly, since 2007 (Chart 7). The pace of growth is stagnant overall, considering that nominal GDP at December 31, 2007, was €2.36 trillion and is currently €2.37 trillion.

**Low Inflation**

Inflation, which initially helped the region, continues to slow, and seems to be indicating a trend. Inflation has declined 2% since 2012, something President Draghi has stated is a result of lower energy and food prices. However, core inflation has also headed lower.

Consumer Price Index (CPI) inflation slowed to 0.5% in May from 0.7% in April. Inflation in May 2014 matches the slowest increase since 2009 and is running far below the ECB’s “close to 2%” target (Chart 8). Both producer and consumer price growth are slow. Data suggest inflation will stay below the ECB’s inflation forecast of below, but close to, 2% in the medium term. PNC forecasts 0.7% inflation in 2014 and 1.0% for 2015.

**Uneven Recovery**

The Eurozone recovery remains fragile, and we believe at the heart of it lies one important observation: one country does not make a region. Still, Germany continues to lead the way, impressively so, in some areas.

- Unemployment remains low.
- Exports are strong (Chart 9).
- Bond yields reflect this stronger economy, and Germany continues to be considered a safe haven for assets.
- Deposits into German banks continue to rise, reflecting a continued flight-to-quality preference.
- The German DAX is up 4% year to date.

France, which had often been seen along with Germany as one of the stronger economies in Europe, is actually showing signs of slowing. Industrial production remains at very depressed levels (Chart 10, page 5). France’s PMI has shown this weakness, struggling to make it above the key 50 mark. As of late, France’s manufacturing PMI has once again slipped below that mark to 47.8. Year to date, the CAC 40 is up 7.9% on a total return basis.

We first wrote of Italy in our October 2011 Investment Outlook, Navigating the Eurozone Maelstrom. For Italy, economic growth seems to be in stagnation. Debt remains at high levels, and in order to meaningfully work this
down the economy must grow. Nominal GDP is 1.5% lower than it was in 2008 (Chart 11). Overall, unemployment is a high 12.6%, while youth unemployment is a whopping 43.3%.

One plus is the drop in bond yields, which overall have declined 435 basis points since 2001, helping lower refinancing costs. In addition, Italy’s exports have risen and imports have declined, so net exports have improved significantly. For the long-term economic health of the nation the country needs structural reform. Uncompetitive unit labor costs, corruption, and difficulty in doing business are some of the headwinds Italy faces. The election of Prime Minister Matteo Renzi appears to be a positive move for Italy from a political perspective, although working with the current parliament is likely to be a challenge. However, Italian equities are some of the strongest performers this year, with the FTSE MIB up 16.7% on a total return basis year to date.

We wrote about Spain’s woes in our July 2012 Investment Outlook, Pain in Spain. Tensions have eased some. Spain has produced modest economic growth and the country has taken some steps to reform labor laws, but the unemployment rate remains painfully high, at 25.3% (Chart 12). Year to date, the IBEX 35 is up a solid 14.8% on a total return basis.

**ECB Actions**

In early June 2014, the ECB announced it was reducing key interest rates and introducing several unconventional measures. These were seen as the most important actions taken by the ECB since summer 2012, when President Draghi uttered the phrase “whatever it takes” and the central bank subsequently went on to unveil its Outright Monetary Transactions program to backstop sovereign bonds.

June’s actions are different because the Eurozone is not in as immediate peril. Aimed at more long-term issues, these actions are focused on reducing interest rates and increasing the availability of credit to households and businesses. So while by some
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Economic measures the Eurozone economy looks improved, we see these actions by the ECB as indicative of some perception of fragility.

Interest rate actions included:

- reducing the deposit rate to -0.10% from 0.0%;
- cutting the ECB’s marginal lending facility to 0.40% from 0.75%; and
- lowering the ECB’s main refinancing operation (MRO) to 0.15% from 0.25%.

The reduction of the deposit rate, the rate paid by banks to the central bank for deposits and excess reserves, means these financial institutions must now pay the ECB to house their funds (Chart 13). However, the negative deposit rate applies to only $33 billion of deposits.

Following the cuts, the ECB signaled it would keep benchmark rates unchanged for “an extended period.”

While the interest rate cuts can be viewed as helpful, interest rates have been on the decline for some time. Notably bond rates, which we spoke of earlier, have come down dramatically. We highlight this only to illustrate that effects are not expected to be as great as they would have been had market rates not already been trending lower.

Other unconventional actions by the ECB included:

- targeted long-term refinancing operations (TLTRO); and
- actions aimed at improving funding to commercial banks.

TLTRO offers commercial banks fixed-rate loans at a rate of the MRO plus 0.1 percentage point. In addition, the ECB offered several programs aimed at improving funding to commercial banks and encouraging stronger lending to households and businesses. The ECB extended the period during which it offers unlimited 3-month credit rates at the MRO through at least December 2015.

ECB actions may not have a big direct impact on the Eurozone economy, but they are positive for financial markets. Actions are meant to combat the low inflation. President Draghi has made it quite clear that quantitative easing (QE) is on the way. He has stated that members are unanimously willing to use other unconventional methods, including an asset based purchase program (that is, QE) to combat long periods of low inflation.

However, one of the problems with monetary policy is that it takes time to filter through the economy. So why not implement QE now? It seems as though there is a wait and see approach here to see if actions already taken can help move the euro lower or if inflation will move higher naturally, perhaps through higher energy prices.

We believe QE is unlikely to happen before the fourth quarter, at the earliest. The timing is not so important, now that the probability of it has increased, which is what the markets care about. Risk aversion is likely to dissipate further as a result.

The Future

Europe needs a strong plan for the future. It is hard to see where growth in Europe will come from without major structural reforms. We noted some comparisons

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Chart 13
ECB Deposit Rate

Source: European Central Bank, PNC 

6 July 2014
between the lost decades in Japan and what Europe could be facing in our November 2012 Investment Outlook, Europe: Tale of a Greek Tragedy?

Data suggest macro forces, notably lower oil prices, have been supportive of the Eurozone economy. Similarly to the United States, lower inflation helped. A decline in energy inflation and lower interest rates, however, can provide only a cyclical recovery, it does not change structural problems in an economy (such as competitiveness between Germany and peripherals, demographic differences, and so on).

Debt to GDP levels have not improved materially for member nations and in some cases have gotten worse (Chart 14). Germany’s levels improved and Italy’s seem to have stabilized. But countries such as Greece continue to carry considerable debt.

One point to consider—talk of a Eurozone breakup has faded considerably. This was a perceived risk, particularly during the Greece crisis, as many worried the collaboration of nations would be unable to agree. But in fact the Eurozone continues to gain countries, not lose them. In early 2014 Latvia became the eighteenth nation to successfully complete the process to join the Eurozone. Between 2007 and 2014 six new states acceded.

Currently, the European Commission has confirmed that Lithuania has met all convergence criteria and is expected to adopt the euro in January 2015. Other nations that could join include Poland, which has voiced concern regarding neighboring Russia, and some believe a Eurozone membership would help alleviate this. Including Poland, the European Commission notes a list of nations that have made some, but not quite enough, progress to join, including the Czech Republic, Hungary, Bulgaria, Croatia, and Romania.

As we go to print, the European Union (EU) summit is underway, which could be significant for the region. Fiscal plans and structural reforms are set to be reviewed. The appointment of the EC president following the EU parliamentary elections is also on the agenda.

**Demography**

Demography, a topic we have written about in the past, ties importantly into the strength of an economy. Replacement birth rates and the age distribution of a country’s citizens lie at the heart of this.

The Eurozone has an aging population and a low replacement birth rate. The 2050 forecast distribution chart for the Eurozone is slightly inverted, highlighting this growing trend (Chart 15, page 8). An older population tends to have slower economic growth with a smaller labor force.

In addition to tough labor laws, the Eurozone faces the problem of emigration, particularly within its periphery countries.

As a point of contrast we compare this chart to that of the United States. As we mentioned in our August 2012 Investment Outlook, Demographics is Destiny, the United States has relatively better demographics (Chart 16, page 8).
The euro was introduced in January 1999 as an electronic currency and in 2002 as a cash currency/legal tender. After hitting a low exchange rate of $0.8272 per euro in October 2000, it went on to almost double in value, peaking at $1.5991 in April 2008. With the financial crisis and ensuing problems in the region, the euro declined to a low of $1.19. In July 2012, President Draghi promised to do “whatever it takes” to protect the euro; the euro has strengthened as a result and seemed to find support around $1.30. This said, one can argue President Draghi’s efforts to prop the euro may have worked too well (Chart 17). Strong inflows of foreign funds have helped support the euro in 2014. Economic growth is also supportive of a higher euro. On the other hand, actions by the ECB, namely QE, are likely aimed at weakening the euro. In pairing, looser ECB policy and less loose Federal Reserve (Fed) policy could favor a stronger dollar and weaker euro. A more competitive exchange rate would be helpful for Eurozone businesses. The outcome remains to be seen. The PNC Economics team forecasts the euro will fall into the mid-$1.30-1.35 range later in 2014 and into 2015.

The Markets

The Eurozone is not without its challenges. The biggest challenge currently, in our view, is an economic one. Slow growth among some member nations is generally hard to offset. On the positive, PMI looks to have recovered and consumer confidence is healing. Also, trade data continue to reflect a solid level of exports. But inflation is a concern as is the too high unemployment rate. Also headwinds include the Russia turmoil and slowdown in China. See our Market Update, From Russia, With No Love, for a detailed report on the Russia/Eurozone research. From a policy perspective we believe the Eurozone countries have done what needs to be done to signal to the markets a unified front. This helps alleviate fears of a draconian risk
event. And lastly, from a market perspective, the good news is that valuations appear reasonable (Chart 18).

For U.S. markets, it is important to keep a sharp eye on the Eurozone. The S&P 500® companies earn almost half of revenues from abroad, which includes the Eurozone. The United States exports about 20% of its goods and services to Europe. And the direction of U.S. markets has become more closely correlated with Europe’s than in the past (Chart 19).

**PNC Current Recommendations**

PNC’s recommended allocations continue to reflect our positive view regarding the durability of the economic expansion while considering the continued downside risks inherent in the market and economic outlook:

- a baseline allocation of stocks relative to bonds;
- a tactical allocation to PNC Systematic Tactical Asset Rotation (STAR);
- a tactical allocation to real estate investment trusts;
- a tactical allocation to leveraged loans within the bond allocation;
- a tactical allocation to absolute-return-oriented fixed-income strategies within the bond allocation;
- an allocation to emerging markets within the international equity component;
- a preference for high-quality stocks;
- a tactical allocation to global bonds within the bond allocation;
- a tactical allocation of 52% value and 48% growth within U.S. large-cap stocks;
- a tactical allocation to global dividend-focused stocks; and
- an allocation to alternative investments for qualified investors.

**Baseline Allocation of Stocks Relative to Bonds**

Since one cannot accurately determine the short-term movement of stocks, we believe that investors should focus on what is knowable and controllable. The one thing investors can truly control is asset allocation reflective of their needs and risk tolerance. PNC’s six baseline asset allocation models are shown on page 20.
Preference for High-Quality Stocks
Any relapse to stressed capital markets or to another credit crunch from a financial crisis likely poses a higher threat to lower-quality and highly leveraged companies. Companies with weak balance sheets and less-robust business models have a much higher risk to their survival. Unfortunately, the economic outlook continues to be subject to continued downside risks in the wake of the financial crisis.

We favor a preference for high-quality stocks as a method of risk control against unexpected shocks to the economic system. This is also consistent with our explicit allocation to dividend-focused stocks.

International Equities
International equities offer a geographic diversification benefit and open the opportunity set to invest in firms around the world. Beyond the benefits of diversification and exposure to many of the world’s leading companies, there are other potential benefits to investing outside U.S. borders, including unique opportunities associated with Asia and Europe. Within the international equity component we recommend an allocation to emerging markets.

A reasonable assumption regarding returns is that the United States and other developed markets have similar long-term expected returns. Much of the difference is likely to come from currency gains or losses. We remain mindful of the currency risk inherent in international investing. While at times the weaker dollar makes international investing look more attractive than the underlying fundamentals might dictate, the reverse is true when the strong dollar punishes the international returns of U.S. investors.

Allocation to Global Bonds within Bonds
The strategic rationale for including global bonds in the portfolio rests on expanding the opportunity set within the investible bond universe. The Barclays Capital Global Aggregate Index, our proxy for high-quality global bonds, contains less than 40% U.S. issues (Chart 20). (For further details on global bonds, see the July 2011 Investment Outlook, Pulling the Fourth Lever.) We believe investors who decline to look outside the United States may be missing out on opportunities for diversification and perhaps enhanced returns.

A primary motivation for allocating to global bonds is the introduction of currency exposure to a portfolio. Although currency adds another level of volatility to a portfolio’s fixed-income allocation, investors gain what traditional domestic fixed-income asset classes cannot offer—a natural hedge against devaluation of the dollar (Chart 21, page 11).

The prospect of higher global economic growth outside the United States is another motive for allocating fixed income globally. As world economies grow more quickly, international bond investors may have the opportunity to reap the benefits of tightening global credit spreads relative to the United States. More importantly, investors can take advantage of higher interest rates abroad to gain higher yields. The addition of the currency exposure that comes with an unhedged global bond can act to lower the correlation with U.S. bond returns (Chart 22, page 11).
In general, we suggest that active management makes the most sense in this allocation. Generally, global bond index construction focuses on allocating more assets to countries with more outstanding debt. This may or may not be a good thing. Larger and more stable economies are likely to be able to safely support higher debt levels, but some fundamental analysis is likely helpful. We also believe that the current state of the global economy, with the large dichotomy between most developed and emerging economies, provides a possible opportunity for active managers in terms of credit and foreign exchange exposure.

In our opinion, it is likely that many managers’ allocations will differ greatly from the index. This also affects the risk metrics, typically to the upside in terms of volatility, index tracking error, and historical drawdowns. This was explicitly taken into consideration by the PNC Investment Policy Committee when it sized the recommended allocation to global bonds.

Given the concerns regarding how the United States will handle upcoming monetary and fiscal policy decisions, as well as what effects those decisions might have on the value of the dollar, we believe an allocation outside traditional fixed-income bond sectors is prudent. We believe the advantage of higher global growth and diversification benefits, along with the ability to benefit from currency exposure outside the dollar, make investing in the global bond sector a viable complement to traditional dollar-based fixed-income assets. This allocation can be seen as adding to PNC’s defensive posture on U.S. interest rates, with 10-year Treasury rates now above 2% and our view that yields will rise over time as the current economic soft patch and the flight to safety fade (Chart 23). We also see this as an opportunity to benefit from higher bond yields elsewhere in the world.
**Allocation to Leveraged Loans within Bonds**

We believe an allocation to leveraged loans within the bond portion of a portfolio should help defend against higher interest rates. Since leveraged loans are adjustable-rate instruments tied to short-term interest rates (typically the 3-month London Interbank Offered Rate, or LIBOR), we believe holders should benefit from rising rates (Chart 24). If longer-term interest rates rise, we expect the shorter duration of leveraged loans should result in much better performance relative to longer-duration fixed income, such as the Barclays U.S. Aggregate Bond Index.

In summary, this allocation could be characterized as lowering the portfolios’ interest-rate risk while raising their credit risk and correlation with equities. We believe it accomplishes this without a large impact on portfolio income. In our opinion, this correlation with equities, which we have noted since recommending the allocation, has become more apparent in the recent stock market downturn, allowing investors an attractive entry point.

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**Allocation to Absolute-Return-Oriented Fixed-Income within Bonds**

We believe an allocation to absolute-return-oriented fixed-income strategy within the bond portion of a portfolio has several benefits, including:

- defending against higher interest rates;
- further expanding the opportunity set for fixed income; and
- increasing exposure to credit.

Given our belief that the economy will continue to improve, strategies that protect against the risk of rising rates will become increasingly important. While we do not believe interest rates will necessarily move markedly higher in the near term, rate volatility has certainly increased, and we expect that the downside risk to holding excessive duration will increase the longer rates remain low. We believe it makes sense to further hedge against this risk while maintaining the ability to participate in upside credit potential. This is also consistent with our current tactical allocations to global bonds and leveraged loans.

We believe the Fed will continue to support the economy as necessary until the economy can grow and function without additional monetary policy accommodation. This should lend itself to further credit spread tightening over the short to intermediate term. Even with spreads at relatively attractive levels compared with historical standards, we admit the absolute low level of yields increases the difficulty of adding alpha within spread sectors. This is one aspect in which we believe an absolute-return long-short approach can add value. Absolute-return strategies have the ability to exploit mispricing via both long and short positions and also expand the opportunity set of strategies typically not accessible by traditional long-only managers. Typical trading strategies include, but are not limited to, capital structure arbitrage, convertible arbitrage, event driven, and pairs trading.

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1 The March 2010 Investment Outlook, Shakespeare for Primates, provides details about leveraged loans.
2 The July 2013 Investment Outlook, Breaking the Bonds, provides details about absolute-return-oriented fixed income.
Table 1 illustrates the behavior of various products on the PNC platform consistent with the absolute-return-oriented fixed-income strategies during periods of rising interest rates. The strong relative performance in rising-rate environments is notable and is consistent with our expectation.

**Overweight of U.S. Large-Cap Value Stocks Relative to Growth**

We believe the majority of the seven components of our decision framework continue to support an overweight to U.S. large-cap value style relative to growth. These components are:

- earnings growth;
- interest-rate level;
- inflation;
- volatility;
- foreign growth;
- valuation; and
- yield-curve slope.

In particular, we focus on the yield-curve slope because the results of our analysis show that a steep curve is supportive of value style outperformance relative to growth. To be clear, it is not a concrete rule that value outperformance over growth in a steep yield curve always exists, but it is an indication of a higher probability.

Though recent Fed activities have flattened them to a degree, both the 2- to 10-year (Chart 25, page 14) and 10- to 30-year (Chart 26, page 14) Treasury slopes remain historically steep and supportive of the value overweight.

We continue to monitor the possibility that the typical impact of the steep yield curve might be derailed by:

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3The March 2011 Investment Outlook, Quest for Value, provides details about the value style recommendation.
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- the credit cycle;
- capital constraints; or
- lack of loan demand.

Bank loan data seem to be past their worst levels, and we believe there are reasons for cautious optimism. 

- Banks are showing a greater willingness to extend consumer loans (Chart 27).
- Bank loan quality has continued to improve, implying a tailwind to bank earnings and a possible turn in the deleveraging cycle (Chart 28).
- Bank capital ratios have more than recovered, which should allow for loan growth and likely help prevent relapse of financial crisis within the banking industry (Chart 29).
Our value allocation has underperformed in the market downturn, given its more cyclical exposure. We believe it will perform better as global growth concerns fade.

**Allocation to Global Dividend-Focused Stocks**

A global dividend-focused allocation expands the opportunity set to invest in high-quality dividend-paying stocks domiciled in North America and beyond, where in some cases companies have exhibited faster dividend growth, essentially opening up the opportunity to invest in firms outside the United States, including the emerging markets. In addition, focusing on the combination of dividends and dividend growth has historically been a winning combination.

The reinvestment of dividends greatly enhances an investor’s return and is a large component of the dividend-focused strategy. Over time, the compounding of dividends drives the total return. As an investor’s investment holding period increases, dividends typically comprise a larger portion of return. As a reference point, from 1926 to 1959 dividends contributed more than 50% to total returns for the S&P 500.

We believe the global dividend-focused allocation is positioned to take advantage of global opportunities and diversify across countries and sectors (Chart 30). A globally generated income stream is inherently more diverse than one from a single country or region. This can help to avoid concentration in terms of end markets, which may drive sales and revenues. A global dividend allocation may also allow an investor to invest in sectors perhaps underrepresented by a particular country.

**Allocation to Alternative Investments**

We also believe alternative asset classes should be considered for qualified investors because they may provide an effective risk management tool for portfolios. Our argument is that if alternative and traditional investments are put on even footing with regard to expected returns, then solely by virtue of the two investments being different, the risk of the overall portfolio is reduced without altering the portfolio’s expected return. The risks may not be less, but they are in some ways different, so we believe this diversification may help manage overall portfolio risk.

Every action (or inaction) involves risk, and we believe investors should think about risk when they consider alternative investments. However, our research suggests that adding carefully selected alternative investments to a diversified portfolio of traditional investments may reduce the overall risk (as defined by the volatility of returns) of that portfolio without affecting expected returns. We believe that alternative investments should be considered as a tool for managing portfolio risk, not for adding risk to increase returns, for qualified investors.

As an example of the possible value alternatives, in particular hedge funds, can bring to a portfolio in the current environment, look at the correlation between the S&P 500 and the HFRX™ Macro Index (Chart 31). Low
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correlation with stocks at times when they are falling would be a distinct positive in terms of reducing the downside. While at times these two very different assets move nearly in unison, the hedge funds do have exposure to other factors than solely stocks and also might adapt to the environment by changing exposures. In fact, the HFRX Macro Index had significantly outperformed the S&P 500 during previous downturns since the late-April 2013 market peak (Chart 32).

Given the current market environment, including a number of factors (such as low returns on cash and occasional spikes in macroeconomic concerns) that could continue to result in increased volatility, we believe alternative investments are worthy of consideration for qualified investors.  

Allocation to PNC STAR

The PNC STAR strategy uses broad exchange-traded funds to apply momentum exposure to industries, size, and international factors in a systematic way. We believe adding a small allocation of the PNC STAR strategy to a portfolio may help increase return without increasing risk and, with small allocations, may help marginally reduce risk (Chart 33).

In backtests, PNC STAR has produced excess returns with a volatility level similar to the benchmark S&P 500, resulting in a higher Sharpe ratio. In addition, the analysis has shown that the strategy has handled periods of crisis better than the S&P 500 and was generally quicker to recover. While past performance is not indicative of future results, historically this model has produced outperformance of just under 0.40% per month. In addition, the drawdown analysis has shown that the strategy has handled periods of crisis better than the S&P 500 did and was generally quicker to recover.

Momentum performance has dipped since the financial crisis, but appears to be regaining some momentum (to turn a phrase). If momentum continues to work in the future as it has historically, the strategy may lead to excess returns that should help improve the tactical allocation portfolios.

Allocation to REITs

The strategic rationale for including REITs in the portfolio rests on expanding the opportunity set for income investors. The REIT mandate requires at least 90% of income to be distributed to shareholders in the form of dividends. Given the nature of the dividend model, we believe REITs fare better with investors not aiming for quick capital gains but for dividend income and modest price appreciation. Over a long investment holding period, REITs have tended to outperform the S&P 500 on a total-return basis (Chart 34, page 17). The total-return perspective is unique for REITs in

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4 For more details, see our October 2009 Investment Outlook, Alternative Medicine, and our August 2009 white paper The Science of Alternative Investments.
that it has historically kept pace with or exceeded the broader market, with the additional benefits of:

- modest correlation with stocks;
- less market price volatility; and
- higher current returns.

REITs provide steady current-income-producing dividend yields competitive with investment-grade bonds, with the potential for increases in dividend and share price.

REITs allow shareholders to invest in commercial real estate while remaining liquid and leaving the management to professionals. REITs historically have had lower correlations versus other stocks, providing diversification benefits. Given the complex nature of the interrelated economics and industry fundamentals, leaving the investment in real estate to the professionals and buying for the long term into strong companies is a standing argument for long-term investing versus market timing. We believe the asset class should bring some diversification benefits in spite of the correlation tightening with the S&P 500.

REITs are not so much interest-rate sensitive as dependent on economic growth. Dividend growth rates have outpaced inflation over the past decade (Chart 35).
As of market close, Monday, July 23, 2014:

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**Asset Allocation Recommendations**

**Current Tactical**

- Preservation: 55%
- Conservative: 35%
- Moderate: 15%
- Balanced: 5%
- Growth: 20%
- Aggressive: 10%

**Baseline**

- Preservation: 50%
- Conservative: 35%
- Moderate: 15%
- Balanced: 20%
- Growth: 35%
- Aggressive: 10%

**Fixed Income Allocation**

- Core: 15%
- Leverage Loans: 9%
- Absolute-Return Oriented: 10%
- Global: 71%

**Equity Allocation**

**Capitalization: Baseline**

- 80% Large-Cap
- 4% REIT
- 4% Small-Cap
- 9% Mid-Cap

**(Baseline is 80%/10%/5%/5%)**

**Global Positioning: Baseline Plus Global Dividend Focus and Smart Beta**

- 20% International
- 5% Smart Beta-PNC STAR
- 75% Domestic

**(Baseline is 60%/20%)**

**Style: Overweight Value within U.S. Large Cap**

- 48% Growth
- 52% Value

**(Baseline is 50%/50%)**

For qualified investors, we recommend an allotment to alternative assets of 20% of a balanced allocation to complement the traditional allocation.

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