

Economic and Capital Market Review

First Quarter 2019

Economic Review

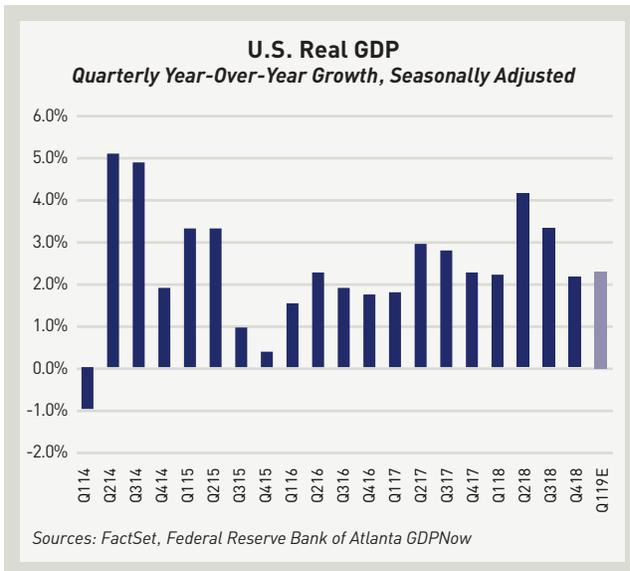
U.S. economy steady, while international growth softens. Fed policy shift influenced markets.

Markets experienced a period of relative calm during the first quarter when compared to the tumult that characterized fourth quarter 2018. Equity markets demonstrated a sharp relief rally; bond markets likewise benefited, as interest rates declined and credit spreads narrowed, reversing December's "risk-off" trade; and domestic economic indicators continued to plod along. However, buoyant moods moderated towards the end of the quarter, as softening global economic data piled up, and looming concerns about trade, central bank activity, and political unrest returned to the forefront. Now, equities and bonds seem to be on disparate paths, as stocks continue to rise, while the freshly inverted yield curve appears to be signaling recession. The Federal Reserve remains staunchly at the center of investors' fixation.

On the domestic front, the late-cycle economic push from 2017's corporate tax reform may be losing steam. Additionally, ongoing trade tensions with China are keeping

business leaders and investors on edge. However, absolute measures of the domestic economy remain on sound footing—GDP is still growing, unemployment is low, inflation is in check, and financial conditions are positive.

Fourth quarter GDP was recently revised lower from 2.59% to 2.17%, but first quarter expectations are for 2.3% growth¹. Additionally, business and consumer optimism remains elevated and corporate earnings growth is expected to continue. First quarter earnings for the S&P 500 Index are expected to decline more than 3% year over year, the first earnings decline since the second quarter of 2016. Analysts still expect positive earnings growth for 2019 as a whole, but year-over-year comparisons will continue to be difficult given the strong growth we witnessed in 2018. Labor markets remain healthy, with unemployment steady at 3.8% (as of March) and continued modest wage growth continues. Additionally, March nonfarm payrolls bounced back after a paltry print of 20,000 net new jobs in February, which was the lowest monthly addition since September 2017.



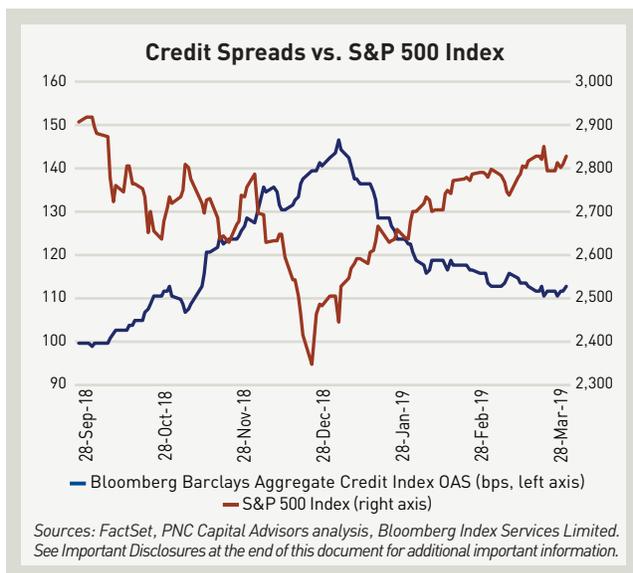
Despite this backdrop, the Fed changed course during the quarter towards a more dovish stance. In March, the Fed paused on near-term fed funds rate increases, announcing it expected no rate increases during 2019 and only one in 2020. Additionally, the Fed expects to slow its balance sheet runoff plan beginning in May and stop it completely by September.

¹Federal Reserve Bank of Atlanta GDPNow (<https://www.frbatlanta.org/cqer/research/gdpnow.aspx?panel=4>, as of 4/8/19)

Economic and Capital Market Review

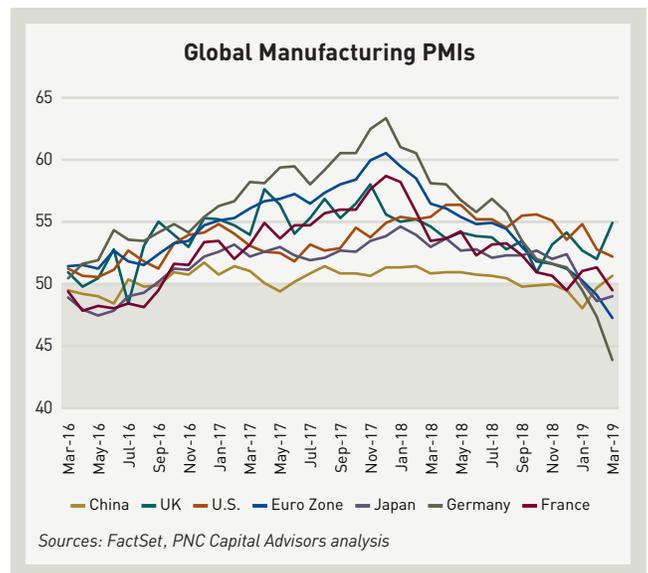
First Quarter 2019

Since the Fed embarked on its policy normalization plan in December 2015, it has increased the target rate nine times, raising the fed funds rate from 0.25% (set during the Global Financial Crisis) to 2.5%. Accommodative financial conditions for most of 2017 and 2018 allowed the Fed to accelerate the pace of policy normalization. Just a mere six months ago, the Fed seemed poised to continue its normalization measures unabated through 2019, so why the about-face? While the Fed appears to have delivered on its dual mandate of low unemployment and controlled inflation, Chairman Powell may be catering to the Fed's unofficial "third mandate" to maintain financial stability. The swift market sell-off during the fourth quarter may have prompted Fed governors to act.



The Fed is not alone in backing away from monetary policy tightening, as major international central banks have also shifted stance in recent months. Just two months after voting to end new bond purchases through its quantitative easing program, the European Central Bank reversed course and announced it would continue to hold interest rates below zero and also reintroduce cheap long-term loans for banks. These actions come amid a confirmed slowdown in global growth due to uncertainties surrounding trade and ongoing geopolitical disruption from issues such as Brexit. The latest Purchasing Managers' Index readings, a gauge of the economic health of the manufacturing and service sectors, for many countries, including major developed economies such as France, Japan, and Germany, have slipped below the 50% threshold, signaling economic contraction. In a matter of several quarters, the rise of synchronized global growth has been replaced by fears of synchronized global contraction, as globalization can be a double-edged sword.

Germany is a prime example: Germany's economy continues to struggle, as slowing emerging market economies, particularly China, weak automobile demand, and continued trade uncertainties are weighing on growth. We believe the country remains at risk given its export orientation and degree of integration into global supply chains.



Equity Market Review

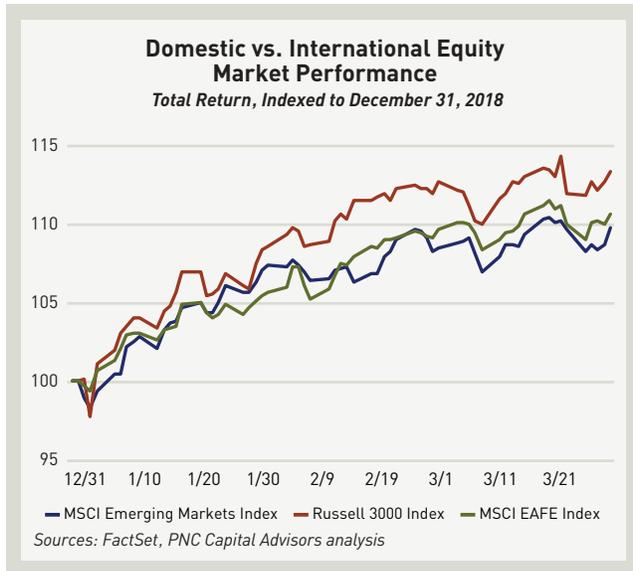
Domestic and international equity markets reverse fourth quarter decline.

Equity markets staged a strong comeback in the first quarter after their precipitous decline during fourth quarter last year. In fact, 2018 was the worst performing year for stock markets since 2008 and December was the worst final month of the year since the Great Depression. Then sentiment abruptly turned positive as we headed into 2019, leading January to become the best start to the year in 30 years. A variety of factors, including easing trade relations between the U.S. and China, solid corporate earnings, and a more dovish Fed helped spur the snap-back. U.S. equities outperformed both developed and emerging markets.

On a market capitalization basis, small-cap equities outperformed large-cap equities during the first quarter after falling more than large caps at the end of last year. Large caps narrowed this lead during March, but small caps still prevailed. First quarter 2019 total return was 14.58% for the Russell 2000 Index and 13.65% for the S&P 500 Index. All sectors within the

Economic and Capital Market Review

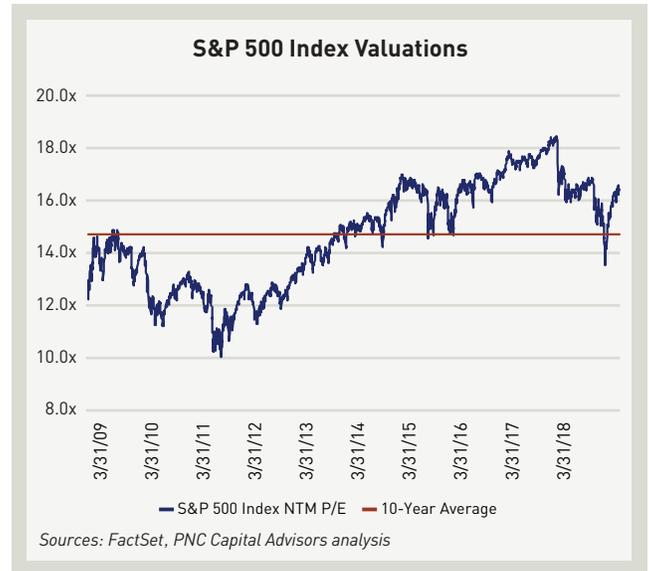
First Quarter 2019



S&P 500 posted positive returns for the quarter, with some of the worst fourth quarter performers, including Information Technology, Industrials, and Energy, demonstrating the strongest performance. Energy rebounded along with crude oil prices during the quarter. Healthcare was the overall sector laggard after being the best performing sector during the second half of 2018, but still posted a 6.59% return. Healthcare performance was undermined by regulatory uncertainty facing managed care and underwhelming guidance from large-cap bio-pharmaceutical companies.

Growth stocks outperformed value stocks across both large and small market caps during first quarter, consistent with other hallmarks of a “risk-on” environment. Additionally, while fourth quarter 2018 was marked by a flock towards quality (e.g., stocks with consistent earnings, high return on equity (ROE), strong free cash flow, and/or low debt), this reversed during the first quarter as market sentiment improved. A renewed risk-on environment drove stocks with low ROE, high debt, and high beta to generally outperform. Valuations also rebounded off December’s lows, but remained off 10-year highs seen during 2017.

Looking overseas, emerging market equities rallied to near six-month highs on trade optimism, a rebound in global equities, a stable U.S. dollar, higher oil prices, and a more dovish Fed. However, towards the end of the quarter, this enthusiasm was tempered due to renewed global growth fears. While anxiety over U.S./China trade negotiations may have calmed, investors are now increasingly focused on the potential unraveling of global supply chains. What’s happening in Germany is the perfect case in point. With other various



trade-styming developments on the horizon like Brexit or the U.S. closing its border to Mexico, there may be some validity in these fears.

Fixed Income Review

Fixed income markets bounced back from fourth quarter, but now facing inverted yield curve.

Investors piled in to bonds during the first quarter, as fears of a near-term recession eased with a change in tone by the Fed. Like equity markets, fixed income markets experienced a dramatic risk-off trade during the fourth quarter, much of which was erased during the first few months of 2019. Positive excess returns in investment grade credit reversed much of the fourth quarter selloff. A majority of the recovery in investment grade and high yield occurred during January, with investment grade producing its third-best month of excess return since 2010.

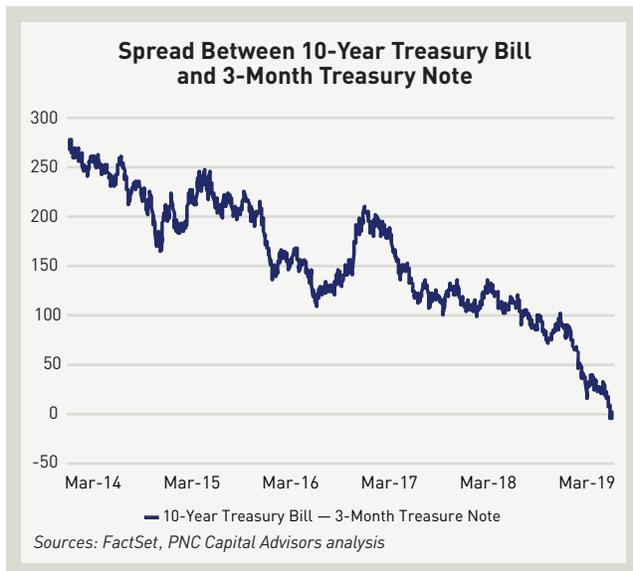
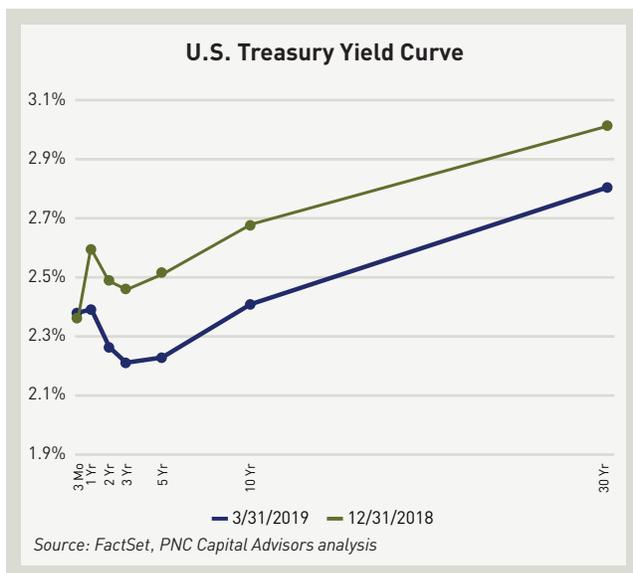
However, towards the end of the first quarter, bond investors appear to have grown more cautious. While Fed-induced interest rate pressure is off the table for now, there seems to be heartburn surrounding the underlying factors that drove the Fed to pause its policy normalization plans in the first place.

The Treasury yield curve has been flattening for some time, finally inverting near the close of the first quarter. The

Economic and Capital Market Review

First Quarter 2019

10-year yield dropped below the 3-month yield for a few trading sessions following disappointing manufacturing data in Europe. An inverted yield curve tends to signal slowing growth expectations and often precedes a recession. This is the first time the yield curve has inverted for any length of time since 2007.



An inverted yield curve can be interpreted several ways and it doesn't necessarily imply a recession is imminent. Rather, it can signal markets' expectations for an interest rate cut. Since the start of fourth quarter 2018, market-implied expectations for the probability of a fed funds rate cut has increased from around 1% to nearly 61% probability by the end of the first quarter due to slowing global growth.

Concerns about global growth and changes in central bank policy are putting pressure on global yields as well. By the end of March, the proportion of holdings within the Bloomberg Barclays Global Aggregate Credit Index with negative yields stood at nearly 20%, the highest since mid-2016. More than half of developed economies yields below 1%, as measured by the Bloomberg Barclays Global Developed Sovereign Index. In many cases, investors have to go out five years or more on the yield curve to achieve positive yield. In essence, global bond investors are betting on further central bank stimulus in the face of softening economic data.

Looking Forward

A global slowdown warrants extra caution.

Over the past several quarters, in the face of market volatility or periods of heightened uncertainty, we've been reassured by strong corporate fundamentals and solid economic data, particularly in the U.S. However, it now appears that the case for market optimism may reside on less steady ground. To be clear, while recent economic data indicate a global slowdown is in the offing, recession is not inevitable. For now, the U.S. appears to be faring better than the rest of the world. But it's important to keep in mind that major economies spent most of the last decade battling the lingering malaise of the Global Financial Crisis with unprecedented amounts of central bank liquidity. Likewise, it is fair to assume that the road back to "normal" monetary policy could also be long and the terrain equally unprecedented.

Economic and Capital Market Review

First Quarter 2019

Indexes

The **Bloomberg Barclays Aggregate Credit Index Option Adjusted Spread (OAS)** calculates spreads between the computed OAS of the Bloomberg Barclays Aggregate Credit index and a spot Treasury curve. An OAS index is constructed using each constituent bond's OAS, weighted by market capitalization.

The **ISM Purchasing Managers' Index (PMI)** is an indicator of the economic health of the manufacturing sector. The PMI is based on five major indicators: new orders, inventory levels, production, supplier deliveries, and the employment environment. The purpose of the PMI is to provide information about current business conditions to company decision makers, analysts, and purchasing managers..

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 **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 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.

Economic and Capital Market Review

First Quarter 2019

Key Definitions

Basis point (bps): 1 bps (basis point) is equal to 0.01%.

The **option-adjusted spread (OAS)** is the measurement of the spread of a fixed-income security rate and the risk-free rate of return, which is adjusted to take into account an embedded option.

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All graphs reflect data, as of 3/31/19, unless otherwise listed.

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