Perspective

Global analysis designed to keep you abreast of the latest economic and market changes.

January 14, 2014

OUTLOOK

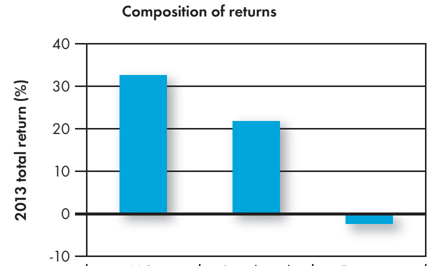
Global stock markets have been treading water in the new year, as portfolio repositioning and economic data affect asset flows. Investor portfolios are ripe for rebalancing, as equities dramatically outperformed bonds in 2013 and tax considerations may have delayed selling into the new year. In addition, corporate pension plans find themselves much better funded and may begin to reduce their risk by increasing fixed income positions. Last month, the Federal Reserve also began tapering its monthly bond purchases, which gives investors a roadmap for the wind-down of quantitative easing. We expect this normalization process to continue to drive volatility in the bond market, as witnessed by the rally in 10-year Treasuries in the wake of December's surprisingly weak U.S. jobs report.

In contrast to business surveys and labor market indicators (such as unemployment claims and the ADP payroll report), the Labor Department reported that the U.S. economy created only 74,000 jobs in December. This was well below estimates of 200,000, but appears to have been partially a result of poor weather. Twice as many workers as normal said they weren't at work in December because of bad weather, and two and a half times more workers than average said they worked only part time instead of full time. Financial markets appear to be accepting the weather's negative impact, but five years of weak economic recovery means investor confidence in this isn't too high. Complicating matters was the continued drop in the unemployment rate, which fell from 7% to 6.7%, as workers continued to leave the workforce.

The Fed has increased flexibility in its interest rate policy, as it indicated that interest rates could remain low long after the unemployment rate has breached the 6.5% threshold, as long as inflation remains controlled. We believe the Fed strongly prefers to wind down its bond purchases this year, because the costs and benefits of the program are no longer as compelling and the economy has gained some strength. The closest analogy to what's happening with the Fed is at the Bank of England (BoE), which faces a similar question of accommodation in the wake of lower unemployment and improved growth. Meanwhile, the European Central Bank (ECB) has recommitted to its mildly dovish stance, and the Bank of Japan's balance sheet is likely to continue to expand rapidly this year. 2014 is shaping up to be the start of normalization of monetary policy across developed markets, but we expect the pace to be gradual.

MARKETS MAY NEED TO TRANSITION TO GROWTH

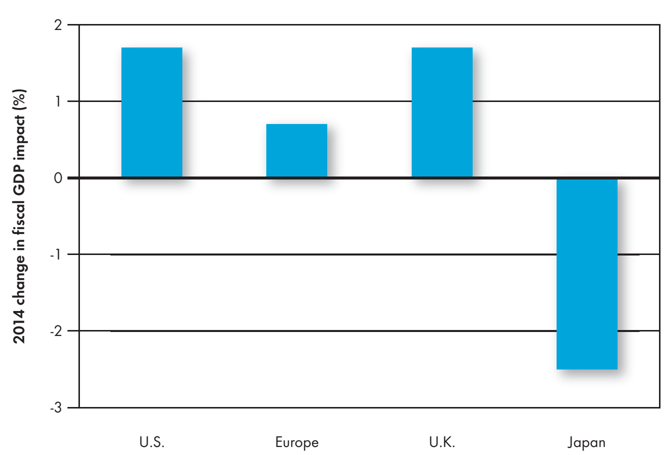
Valuations supported gains in 2013, but less fiscal headwind should help growth in 2014.



	U.S.	Developed Markets ex-U.S.	Emerging Markets
Return	**32.6**	**21.8**	**-2.4**
Earnings	6.2	3.0	-0.4
Valuation	24.1	15.5	-4.7
Dividend	2.3	3.4	2.7

Left Axis: 2013 total return (%)

Sources: Northern Trust, Bloomberg, MSCI



Left Axis: 2014 change in fiscal GDP impact (%)

Note: Japan's fiscal figure may not fully reflect eventual government stimulus.

Sources: Northern Trust, IMF, DB Markets

Northern Trust

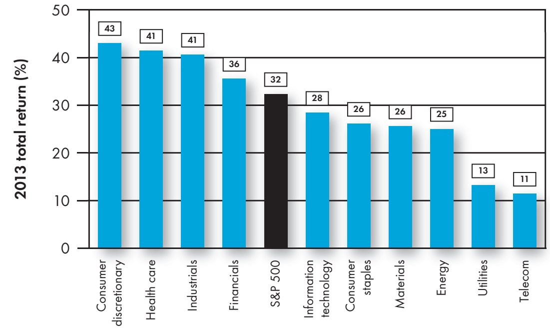
U.S. EQUITY

- Sector performance varied greatly in 2013.
- We continue to favor cyclical sectors in 2014.

The S&P 500 was up an impressive 32% in 2013, but not all sectors participated to the same extent. Defensive- and yield-oriented sectors lagged, while cyclicals performed much better. Interestingly, domestic cyclicals, such as consumer discretionary, outperformed more global cyclicals, such as energy and materials, consistent with U.S. equities outperforming emerging markets. One surprise was the outperformance of health care, normally a more defensive sector. While some big pharmaceutical companies (with big yields) lagged in 2013, the sector was propelled higher by enthusiasm over biotech pipelines. While our return expectations for 2014 are more muted than last year's, we believe improving economic growth, and potentially higher long-term rates, should continue to favor cyclical sectors.

CYCLICALS LED THE WAY

Cyclical sectors handily outperformed more defensive sectors in 2013.



Left Axis: 2013 total return (%)

Sources: Northern Trust, Bloomberg

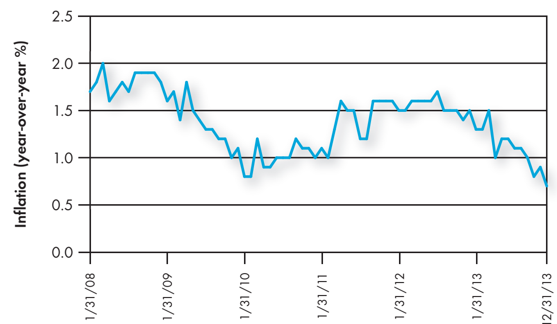
EUROPEAN EQUITY

- Eurozone inflation remains below 1%.
- Signs of a gradual recovery continue to surface.

The first major economic numbers for 2014 point toward a status quo in unemployment and inflation for the eurozone. Unemployment dropped by 0.1%, suggesting stabilization, with inflation at 0.7%, further away from the ECB's 2% target. The unemployment news is relatively good; however, the inflation numbers are potentially more worrisome for the ECB. After the November reduction in its policy rate to 0.25%, the ECB is running out of monetary stimulus to reinflate the eurozone. It seems an interesting time for one of the vice presidents of the European Commission to bring the "United States of Europe" back to the agenda, but this seems more rhetoric than reality. Investors continue to embrace the peripheral countries, whose stock and bond markets have been good performers this year. Bulls will cite this as evidence of European healing.

DISINFLATING

Europe's falling inflation rate remains an offset to more optimistic growth signals.



Left Axis: Inflation (year-over-year percentage)

Note: Core inflation excludes energy, food, alcohol and tobacco.

Sources: Northern Trust, Bloomberg

ASIA-PACIFIC EQUITY

- Markets continue to favor Japan, the turnaround story.
- Asian geopolitical concerns remain front and center.

Attractive growth in Asia is at risk of being sidelined by geopolitical worries. The strained relationship between China and its near neighbors, especially Japan, isn't improving. Japanese Prime Minister Abe angered the Chinese by visiting a controversial war shrine, while Tokyo's ambassador to London exchanged barbs with his Chinese counterpart. He referred to China as Lord Voldemort, stating, "There are two paths open to China. One is to seek dialogue … the other is to play the role of Voldemort in the region by letting loose the evil of an arms race." After the recent purge in North Korea, China's influence in Pyongyang also may be decreasing, providing another possible cause of instability in the region. We still expect growth across the region in 2014 to be robust, especially compared with developed economies.

WHAT A DIFFERENCE

Selling a dream (Japan) has been easier than reining in growth (China).

Left Axis: Return (%)

MSCI China

MSCI Japan

Sources: Northern Trust, Bloomberg

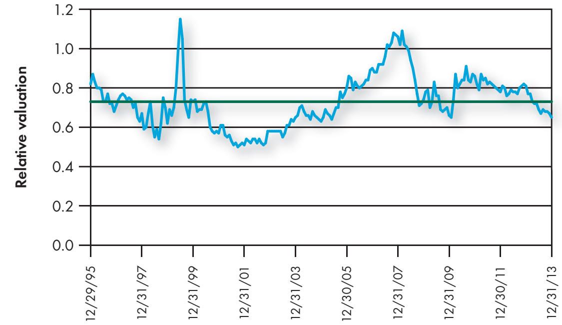
EMERGING-MARKET EQUITY

- Relative valuations have reached levels last seen in 2005.
- Valuation levels reduce the risk of further material underperformance.

We expect that emerging-market earnings slipped by 0.4% in 2013, while valuation contraction clipped nearly 5% from returns. In contrast, U.S. earnings grew 6% and valuation expansion contributed 24% to returns. This disparity has brought emerging-market stocks to a trailing price-to-earnings (p/e) ratio of 12.1 times, as compared with the developed markets at 18.7 times — a relative p/e ratio of just 65%. Relative valuations could go lower, as they did in 2001 and 2002 when they bottomed out at a relative p/e ratio of 50%. However, p/e ratios during this period bottomed at 10.8 times, as compared with 21.6 times in the developed markets. We could also see a disappointment in earnings, which we forecast to grow at a reasonable 6% in 2014 — in line with the United States but behind Europe.

RELATIVELY ATTRACTIVE

Significant underperformance of emerging-market stocks has created relative value.



Left Axis: Relative valuation
Emerging-market p/e ratio relative to World IMI p/e ratio
Average
Note: IMI index includes small, mid and large cap. Trailing operating earnings used.
Sources: Northern Trust, MSCI

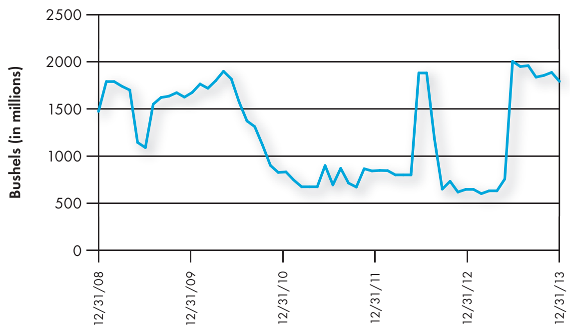
REAL ASSETS

- Moderating emerging-market growth will keep commodities demand in check.
- Prices will increasingly be driven by individual commodity supply dynamics.

We believe continued softening in emerging-market growth and the resulting effect on commodity demand will result in subdued commodity price returns in 2014 (leaving us equal-weight in the asset class). However, the outlook is sensitive to the unique supply characteristics of each commodity. While the demand outlook for industrial metals looks soft, the resulting capacity rationalization may help to buoy prices. This looks to be more pronounced in steel and aluminum, less so in copper and iron ore. In agricultural commodities, the supply equation is even more interesting. Good weather pushed corn inventories higher and prices lower in 2013. High inventory levels are being worked off while low prices are providing incentives to farmers to devote less land to corn, which should provide price support in 2014.

PEAK CORN?

Record-high corn inventories resulting from last year's good weather are being worked off.



Left Axis: U.S. corn ending stocks (bushels in millions)
Sources: Northern Trust, Bloomberg

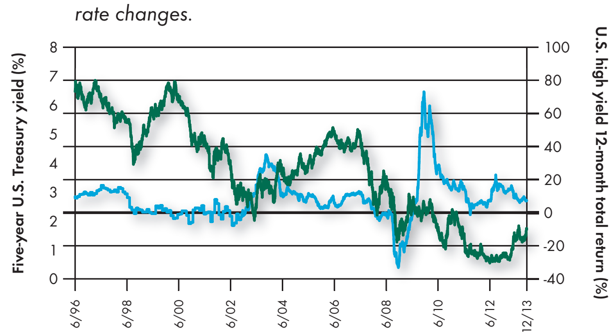
U.S. HIGH YIELD

- Rising interest rates often generate concern about fixed income.
- High yield market returns historically haven't been driven by interest rates.

Despite being traditionally grouped with fixed income, the high yield market is more akin to equities. Most notable is the low correlation high yield has to interest rates. The accompanying chart shows the trailing 12-month returns of the high yield market plotted against the yield of the five-year Treasury. During the past 18 years, high yield returns have displayed a 0.05 correlation to interest rates. So what drives the asset class? Credit performance is the primary driver of high yield returns. High yield has typically performed well in rising interest rate environments, because these periods typically occur in positive macroeconomic environments. Credit performance is typically also good in an improving economy.

NOT VERY SENSITIVE

High yield returns have little correlation with interest rate changes.



Left Axis: Five-year U.S. Treasury yield (%)
Right Axis: U.S. high yield 12-month total return (%)
Sources: Northern Trust, Barclays

U.S. FIXED INCOME

- 10-year Treasury yields are trading near their highest levels in 2½ years.
- Fixed income volatility will remain high this year.

10-year U.S. Treasury yields have been rising since the Fed announced plans to potentially begin to taper its asset purchase program, dubbed QE3, in May. While these rates are now near 3%, and at close to a 2½ year high, year-over-year inflation readings have continued to decline. We continue to believe the United States will see low inflation and modest economic growth in 2014. This, along with the Fed's well-communicated plans to keep its benchmark Fed Funds rate at exceptionally low levels, should keep long-term interest rates relatively low. We've also noted that new buyers of longer-dated fixed income securities have entered the market, attracted by higher rates and better pension funding status.

SOME NORMALIZATION

Rising rates with falling inflation means some normalization in real interest rates.

Left Axis: Percentage
10-year Treasury yield (%)
Personal Consumption Expenditures Index (year-over-year percentage)
Sources: Northern Trust, Bloomberg

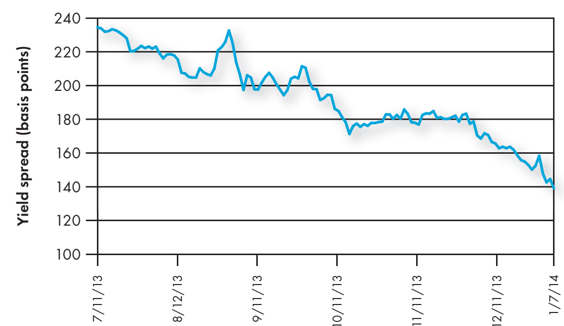
EUROPEAN FIXED INCOME

- Ireland returns to the public markets by issuing 10-year notes.
- The United Kingdom's unemployment rate pressures the BoE.

Following the exit from the Troika program in December, Ireland has returned to the markets by issuing a 10-year bond on January 7. Despite €13 billion of investment-grade issuance in the market that day, Ireland successfully placed €3.75 billion in its first public bond offering since March of last year. With a total order book of more than €14 billion, demand was strong and the offering appealed to an international investor base. Domestic buyers accounted for just 17% of the deal, with North America at 14% and hedge funds at 8%. In the United Kingdom, the BoE is uncomfortably close to its 7% unemployment threshold for considering policy tightening. In fact, the math of the International Labor Organization's three-month measure of U.K. unemployment implies a 7% number is almost a certainty when the data is released on January 22.

READMISSION

Ireland's improving fundamentals have allowed them to re-enter public markets.



Left Axis: Yield spread: Ireland government 10-year bonds vs. German government 10-year bonds
Sources: Northern Trust, Bloomberg

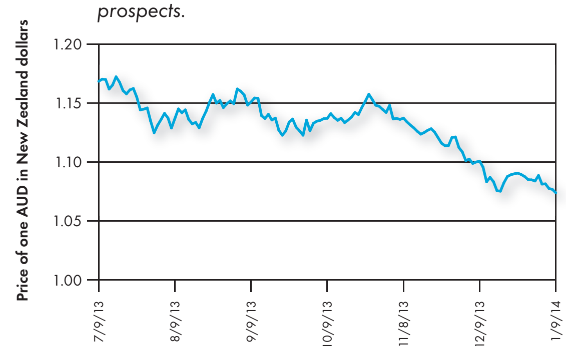
ASIA-PACIFIC FIXED INCOME

- New Zealand is better placed than Australia as the commodity cycle turns.
- Money market rate spikes in China have been less worrisome.

We've written of the challenges facing Australia as it transitions from the past decade of mining infrastructure investment. Across the Tasman Sea, New Zealand is edging ahead of its larger neighbor, despite having no mineral wealth to speak of. The largest economic transition in the world — China climbing the prosperity ladder — is driving a boom for commodities that New Zealand has in abundance, such as meat and milk. In late December, China's money market rates spiked once again, resulting in extended trading hours to allow banks to square positions. A similar episode in June provoked considerable consternation and a meaningful pullback in risk assets. This time, however, markets have been more sanguine, as the new year frequently brings a seasonal squeeze in liquidity.

CHANGING PLACES

Investors are increasingly favoring New Zealand's prospects.



Left Axis: Price of one AUD in New Zealand dollars
Sources: Northern Trust, Bloomberg

CONCLUSION

We don't believe the financial markets offer compelling trade ideas every month, and it pays to be deliberate when considering market opportunities. During 2013 key themes included a better outlook for developed markets than emerging markets, reduced prospects for gold in the wake of moderating central bank accommodation and reduced interest-rate sensitivity in portfolios. We entered 2014 with a continued favoring of risk assets, although valuations are clearly less attractive than last year. We think earnings growth will be a key contributor to returns in 2014, as valuation expansion will be harder to come by. We also expect bond market volatility to remain high, as investors and central banks work their way toward normalization of monetary policy.

We've highlighted reduced fiscal drag from developed countries as a key contributor to the global growth outlook in 2014, and this view is becoming the market consensus. We believe the Fed hopes to end its bond buying this year, which would reduce the cushion that the market can expect from monetary policy. We think the bar is high for the Fed to reverse course on quantitative easing, and don't think that risk markets would view increased bond buying as favorably as prior interventions. This leaves the Fed with forward guidance as a primary weapon, promising to keep interest rates low for an extended period of time. This should work as long as the economy continues to grow.

What could cause us to consider favoring bonds or cash over risk assets? Unexpected changes in monetary policy are near the top of the list, as is a notable deceleration in the global economy. If growth is too strong (admittedly a risk case scenario), the Fed could end up normalizing policy more quickly than markets expect. Conversely, if growth turns disappointing, the Fed will be left searching for tools that can provide the next level of monetary accommodation. We also continue to monitor policy developments in Japan and Europe, but see the U.S. economic outlook as a key driver to risk taking during the next year.

Jim McDonald
Chief Investment Strategist

Basis Points (bps) is a unit of measure in quoting yields, changes in yields or differences between yields; 100 basis points is equal to 1%.

Price-to-Earnings Ratio is the current share price of a stock divided by its earnings per share.

The MSCI All China Investable Market Index (IMI) captures large, mid and small cap representation across all China securities that are listed in China and Hong Kong, the US and in Singapore. With 2,408 constituents, the index is comprehensive, covering the large, mid and small cap China equity opportunity set.

The MSCI Japan Index is designed to measure the performance of the large and mid cap segments of the Japan market. With 319 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in Japan.

S&P 500® Index is an unmanaged index consisting of 500 stocks and is a widely recognized common measure of the performance of the overall U.S. stock market. It is not possible to invest directly in an index.