Perspective

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

February 18, 2014

OUTLOOK

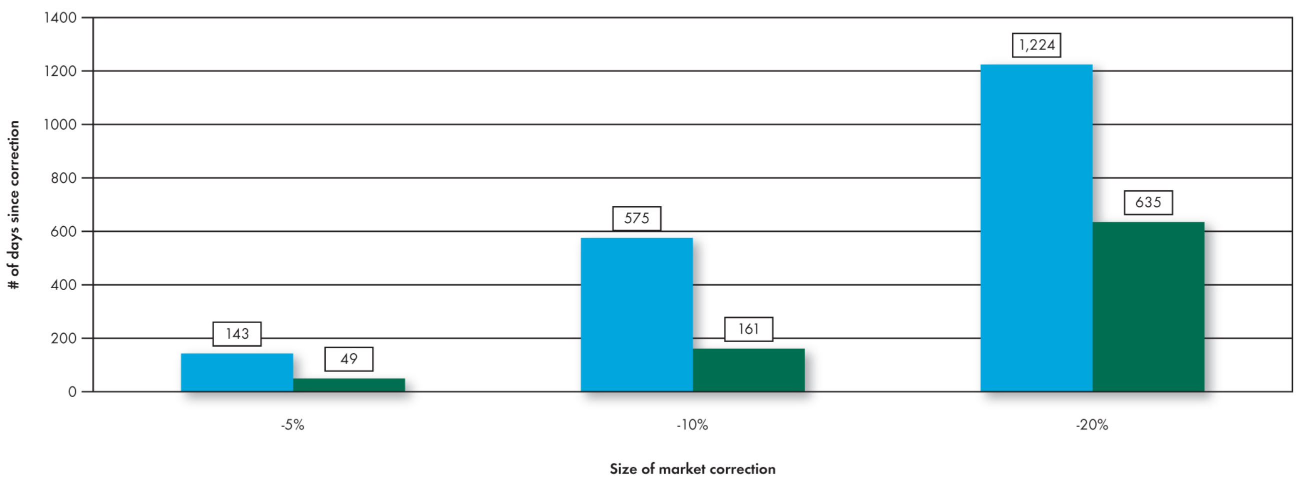
The new year has started with a return to more typical (higher) levels of market volatility. The major asset classes have behaved according to script, with investment-grade bonds providing portfolio stability and higher-risk equities, such as emerging markets, performing the worst. U.S. high yield bonds performed reasonably well during this period, and the asset class reflected little sign of investor concerns over the economic cycle. Market speculation around the catalyst of the early-year sell-off focused on concerns over emerging-market risks — both Chinese credit concerns and emerging-market currency pressures — and weakness in U.S. economic data.

U.S. economic data has been softer than expected this year, and the January nonfarm payroll report was the second disappointing job report in a row. We're not changing our expectation of solid economic growth this year, but have created a new risk case that encompasses the possibility of slower growth. Developed markets outside of the United States have shown steadier growth, with Europe and Japan showing good momentum in confidence surveys. We continue to expect the emerging markets to disappoint on the growth front in 2014, with particular focus on China's credit-cycle management. China's substantial shadow banking system probably will create many headlines during the next two years, as existing trust and wealth management products either successfully mature, are rolled over into new debt or default.

It looks to us like the weakness at the start of this year qualifies as a garden-variety stock market correction. With valuations having expanded significantly in 2013, returns in stock markets in 2014 are heavily dependent on earnings growth. Earnings for the fourth quarter of 2013 are in relatively good shape, bolstering our outlook for 6% U.S. earnings growth in 2014. However, the Federal Reserve appears committed to winding down its bond buying program this year, unless growth is significantly less than expected. We anticipate this determination to lead to additional periods of market volatility this year as investors gauge whether the economy is strong enough to withstand this reduced level of accommodation.

A LONG TIME COMING

U.S. equities have gone much longer than normal without a 5% correction.



Left Axis: Number of days since a correction
Bottom Axis: Size of market correction
Cycle as of Jan. 31, 2014 | Historical average
Note: The 5% correction was reached on Feb. 3, 2014
Sources: Northern Trust, Ned Davis Research

Northern Trust

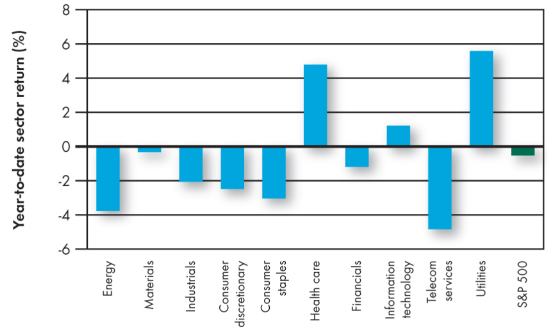
U.S. EQUITY

- U.S. equity markets finally had a 5% correction.
- Underlying data suggests that the pullback wasn't purely "risk-off."

While the steepness of the recent market decline certainly suggested a "risk-off" environment, underlying data doesn't support this view. Sector performance was inconsistent with a typical risk-off environment — while utilities and health care were the best performers, other defensive sectors, like consumer staples and telecom, were among the worst. Additionally, lower-quality stocks actually outperformed as the market was declining, suggesting a lack of panic behind the selling. The quickness of the subsequent recovery also implies that the market's confidence was not shaken as much as first feared. Finally, high yield bonds showed resilience, implying no change in the fundamental corporate outlook. Fourth-quarter earnings are coming in modestly better than estimates, and we expect this to remain the market's key focus this year.

NOT IN UNISON

Sector performance this year doesn't typify a risk-off environment.



Left Axis: Year-to-date sector return (%)
Note: Year-to-date S&P 500 sector return through 2/14/14
Sources: Northern Trust, Bloomberg

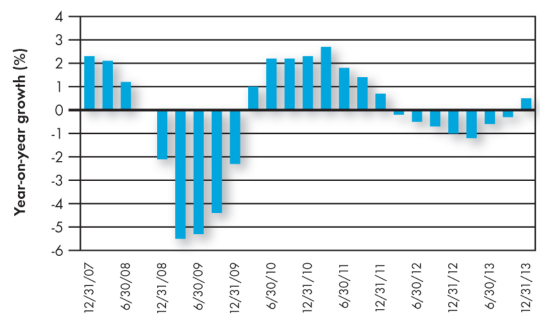
EUROPEAN EQUITY

- Italy's prime minister is set to change (again).
- The British union is coming under almost as much scrutiny as the European Union.

One of our key investment themes has been our outlook for political volatility, with policy stability. While Italy looks set to appoint a new prime minister, financial markets have barely budged as the Italian 10-year bond has hit a new low in yield. In the United Kingdom, polls have shown a gain in momentum to 35% support for the Scottish independence parties. The area for real policy change could come from the European Central Bank (ECB), where speculation about the possibility of ending sterilization of bond purchases raises discussions about quantitative easing (QE). However, before the ECB takes the plunge into the QE world, which would face German resistance, it still has room to lower interest rates.

SLOWLY GROWING

Modest growth could become a catalyst for ECB action.



Left Axis: Year-on-year growth (%)
Eurozone real gross domestic product growth
Sources: Northern Trust, Bloomberg

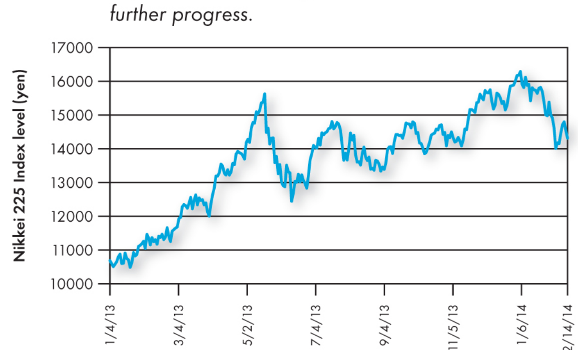
ASIA-PACIFIC EQUITY

- Abenomics suffered a hit to confidence as Japanese markets stumble.
- China's growth returned to longer-term averages, just in time for year end.

China and Japan remain at loggerheads over free airspace and a small archipelago in the South China Sea. This situation shows no sign of abating; neither country seems willing to back down. We think the most likely scenario remains the avoidance of serious conflict. In Japan, the seemingly unstoppable Nikkei stopped in January, as investors appeared to have concerns over regional instability and profit taking took hold. However, Abenomics is doing what it set out to do — reinflating Japan — though investors are wondering if it's running out of arrows. Spring's increases in wages will be key; the government is looking to wage increases to help sustain economic momentum and partially offset the value-added tax increase.

THE HIGHER THEY RISE...

Japanese stocks lead global sell-off as investors await further progress.



Left Axis: Nikkei 225 Index level (yen)
Sources: Northern Trust, Bloomberg

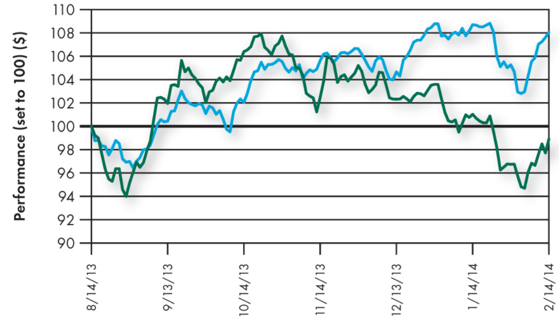
EMERGING-MARKET EQUITY

- Emerging-market equities are off to a slow start this year.
- Concerns over growth seem to be outweighing valuation appeal.

Emerging-market equities underperformed developed-market stocks during the recent correction (falling 8.5% vs. 5.5%), but modestly lagged in the subsequent rebound. For emerging markets to outperform, investors will need to see some clarity around growth momentum and monetary policy, especially China's credit situation. With the typical Chinese wealth and trust investment product having a two-year maturity, we'll likely have many reruns of last month's deadline with the "Credit Equals Gold #1" product. We expect global infrastructure stocks to not only provide more downside protection than emerging-market equities, but to also provide reasonable appreciation potential in a positive market environment.

STILL LAGGING

Emerging-market stocks have underperformed in both the recent downturn and subsequent rally.



Left Axis: Performance (set to 100)
MSCI World Index
MSCI Emerging-Markets Index
Sources: Northern Trust, Bloomberg

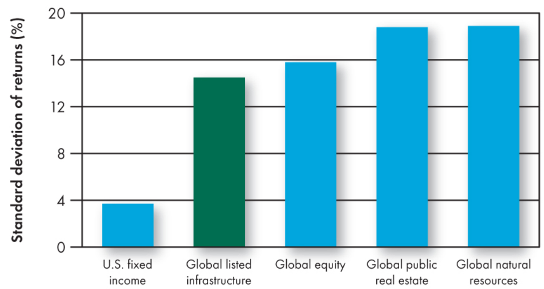
REAL ASSETS

- Market volatility may remain heightened as tapering continues apace.
- Global listed infrastructure provides potential for stability given steady cash flows and defensive characteristics.

Emerging-market turbulence, combined with the Fed's apparent persistence in removing itself from the QE business, causes us to favor global listed infrastructure, which boasts steady cash flows and exposure to equity markets at a lower level of volatility than emerging-market equities. Even though global listed infrastructure shows some exposure to interest rate volatility, it was viewed as a better alternative to the direct exposure to interest rates found in fixed income. Our historical analysis also shows that, at low levels of interest rates, global infrastructure has also been less interest rate sensitive than global real estate, while providing a dividend yield of around 4%.

A BETTER-BEHAVED RISK ASSET

Infrastructure has lower volatility than most risk assets.



Left Axis: Standard deviation of returns (%)
Source: Northern Trust Capital Markets Assumptions

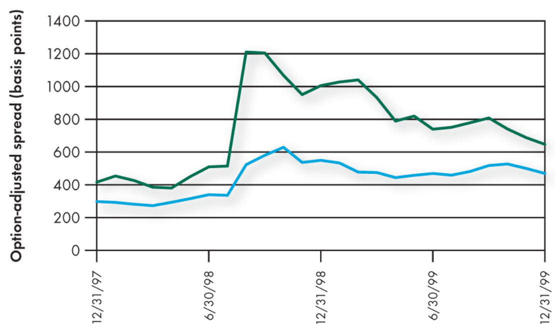
U.S. HIGH YIELD

- January ended with financial markets concerned about emerging markets.
- High yield returns haven't followed emerging-market debt returns in prior crises.

The impact of the Fed's reduction in asset purchases was finally reflected in the currencies of several emerging-market countries, resulting in downward pressure on financial asset valuations. Markets have since settled down, and high yield was affected by less than one percentage point. The accompanying chart shows the effect of the 1998 Asian currency crisis on emerging-market and high yield debt spreads. Emerging-market spreads widened 830 basis points and the S&P 500 fell 22% during the worst two months of the above-mentioned crisis. High yield spreads widened as well, but to a much lesser extent. During 1998 and 1999, the correlation of emerging-market and high yield debt was 0.40. Crisis periods can affect all financial assets, but we believe that high yield, aided by its domestic focus, has some insulation.

RELATIVELY DEFENSIVE

U.S. high yield emerged relatively unscathed from the late 1990s currency crisis.



Left Axis: Option-adjusted spread (OAS) (basis points)
U.S. high yield debt OAS
Emerging-market debt OAS
Sources: Northern Trust, Barclays

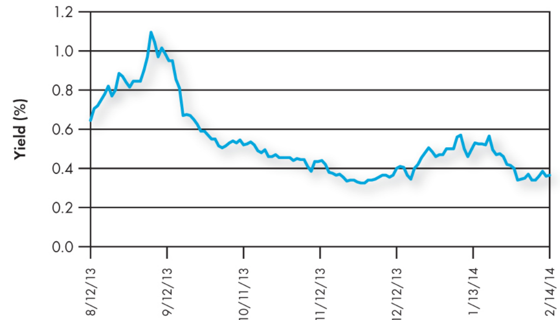
U.S. FIXED INCOME

- New Fed Chair Yellen pledges continuity before Congress.
- We believe the Fed will keep the Fed Funds rate near zero for longer than consensus.

Fed Chair Janet Yellen's inaugural testimony before Congress pledged to maintain the path set by former Fed Chair Ben Bernanke. She communicated plans to continue the tapering of the Fed's bond purchase program in measured steps, with only a notable disruption to the outlook altering this reduction. The Fed has gone to great lengths to assure investors that, while it may be tapering its bond purchase program, the benchmark Fed Funds rate will remain at record low levels. Yellen's testimony once again reinforced that the rate will remain near zero well past the time the unemployment rate falls below 6.5%. While the Fed Funds futures market shows investors believe the Fed Funds rate will move higher next year, we continue to believe the Fed will hold the rate near zero into 2016.

FORWARD GUIDANCE

The Fed has had some success at keeping Fed Funds rate expectations contained.



Left Axis: Fed Funds rate expectations – August 2015 (Yield percentage)
Sources: Northern Trust, Bloomberg

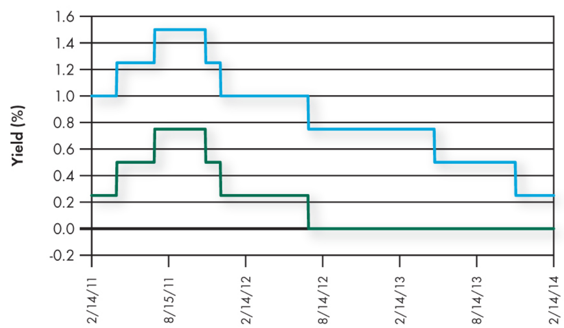
EUROPEAN FIXED INCOME

- A German court takes a pass on the Outright Monetary Transactions (OMT) program.
- The ECB has declined to cut interest rates thus far this year.

The German Constitutional Court (GCC) has announced that it won't pass judgment on the ECB's OMT program. Instead, it will refer the matter to the European Court of Justice. We view this as a positive in that the GCC would have likely found the OMT and the ECB to be overreaching its mandate and its bylaws and, thus, direct the German government to no longer participate in the OMT. A less engaged German government would likely have put pressures on the market. For its part, the ECB declined to take action at the February meeting and directed attention to March, when it will reveal 2016 inflation forecasts for the first time.

A LITTLE ROOM LEFT

Interest rates may be cut before any further asset programs are considered.



Left Axis: Yield (%)
ECB refinancing rate (one week)
ECB deposit facility rate
Sources: Northern Trust, Bloomberg

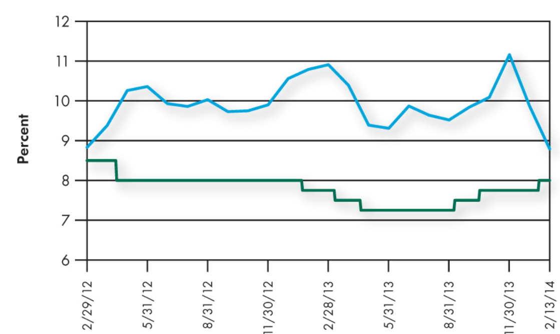
ASIA-PACIFIC FIXED INCOME

- China bails out a trust fund.
- India inches toward positive real rates.

Emerging markets have been shaken during the past month, and events such as the stresses in the Chinese interbank market bear long-term scrutiny. The level of bad loans in China's economy is feared to be large, and a significant proportion of new lending may simply arise from rolling over these bad debts. The recent trust product bailout may prove to be a temporary reprieve, with investment trusts being allowed to default later this year. We believe the closed nature of the capital markets and the resources of the central government are sufficient to contain this issue. In India, the Reserve Bank of India hiked rates to 8% (the third increase in six months) and inflation slowed to 8.8% in January, marking a high in real interest rates during the past two years.

TRYING TO GET REAL

Moderating inflation is improving the real interest rate picture.



Left Axis: Percent
India inflation, year-on-year growth
Reserve Bank of India repurchase rate
Note: Inflation measured by the India Consumer Price Index.
Sources: Northern Trust, Bloomberg

CONCLUSION

Financial markets frequently like to surprise the maximum number of investors possible, and the benign start to trading in 2014 set us up for the ensuing correction. Now that we've had the long overdue 5% correction in equities, the focus will be on the next 10% and 20% decline — which are also overdue. The potential catalyst for such corrections could come from several corners: more disappointing U.S. or emerging-market economic data, problems in the Chinese shadow banking system, or even a geopolitical skirmish in Asia or the Middle East. We haven't found it fruitful over the years to try to bob and weave around geopolitical risks, instead focusing on the fundamental economic and investing outlook. Even though we believe the global growth and monetary policy outlook will be supportive to risk assets in 2014, we expect continued higher volatility to persist.

In recognition of this expected pickup in volatility, we favor global infrastructure stocks over emerging-market equities. Global infrastructure stocks provide the potential for a relatively higher yield (around 4%) with strong underlying cash flows and defensive business models. Even though the valuation of emerging-market equities looks attractive, we don't see them outperforming until we see improving relative economic momentum.

We updated our risk case scenarios this month, with the primary change being the potential of disappointing U.S. growth. We think the markets are happy that the Fed is on a steady course of tapering bond purchases, but if U.S. economic growth stalls, the unwinding of this program will become a source of angst. We are also focused on the risk surrounding emerging-market growth. The current slowdown has been factored into market expectations, but meaningful deterioration hasn't. Finally, the policy risks in Europe and Japan seem to be focused on Japan during the next six months. We'll want to see continued momentum in the Japanese economy to evidence the progress of Abenomics. Count on higher volatility over the next year, but if our fundamental views come to pass, this will occur alongside higher stock prices.

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%.

Option-adjusted spread measures the yield spread between similar securities (typically bonds) with different options, such as prepayment or call options, which are very interest rate sensitive.

Standard Deviation is a statistical measurement of dispersion about an average, which depicts how widely returns varied over a certain period of time.

MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of large and mid cap securities in the global emerging markets. The index level is measured in U.S. dollars.

MSCI World ex. USA Index is a free float-adjusted market capitalization index that is designed to measure the equity performance of large and mid cap securities in developed markets, excluding the USA. The index level is measured in U.S. dollars.

The Nikkei 225 Index is a price-weighted average of 225 top-rated Japanese companies listed on the Tokyo Stock Exchange. The index level is measured in Japanese Yen.

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.