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

March 18, 2014

OUTLOOK

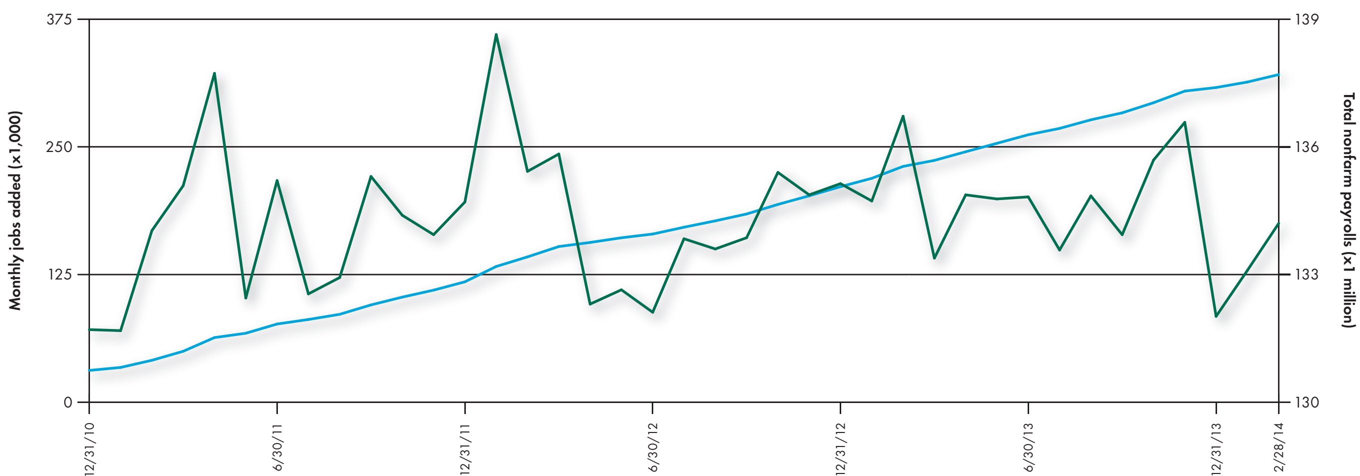
Stock markets rebounded during the last month as investors are betting that a slower first quarter, along with increased geopolitical risks, won't prove to be long-lived worries. While difficult winter weather in many regions precipitated a reduction in expectations for first-quarter economic activity, the markets are treating this as a one-time event and not a precursor of further disappointing growth. Monthly job gains in the United States are volatile — as shown in the accompanying chart — but the well-received gain of 175,000 jobs for February was basically in line with the average monthly gains of 180,000 during the last three years. The U.S. economy appears to be trudging ahead, and we expect it to experience less headwind from fiscal drag in 2014.

Growth across Europe continues its modest expansion, and surveys conducted by Markit show that both manufacturing and service companies remain in growth mode. Recent reports indicate that Japan's economy has seen a slowdown, and Japan faces a rise in the nationwide value-added tax in April. Purchasing occurring ahead of this increase will have boosted prior growth numbers, and is expected to lead to a contraction in consumption in the quarter of implementation. Japanese wages need to rise, and evidence from the spring round of wage increases is inconclusive thus far. Chinese data continue to show an economy moderating its growth rate, as recent figures for investment and retail sales fell short. Overall credit growth has slowed of late, and Chinese authorities will likely continue to balance their concerns over credit quality with their desire for growth of about 7%.

The developments in the Ukraine were a topic of significant focus in our investment policy deliberations this month. Our analysis of the historical market impact of geopolitical shocks is that the effect is usually short-lived, and the key is to determine whether the event will affect the outlook for economic fundamentals like growth or inflation. If the current flare-up remains contained to Russian involvement in Crimea, we think it won't prove material to the economy or financial markets. Russian President Vladimir Putin stated, "We don't want to split up Ukraine, we don't need that." While the market has been comforted by his statement for now, it hardly puts the issue to rest.

VOLATILE, YET STEADY

While monthly job gains are volatile, the labor force has been slowly, but steadily, increasing.



Left Axis: Monthly jobs added (x1,000)
Right Axis: Total nonfarm payrolls (x1 million)
Sources: Northern Trust, Bloomberg

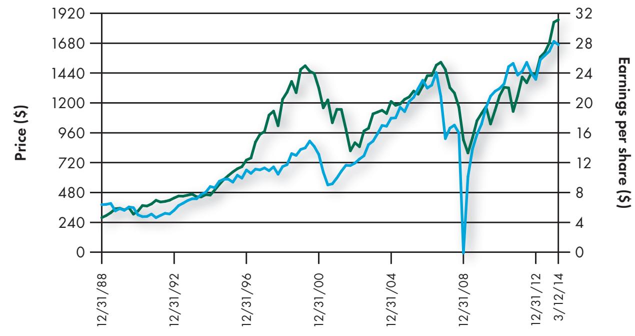
U.S. EQUITY

- The market has recovered from January's correction — up 8% from the Feb. 3 low.
- Entering year six of a bull run, stock valuations are dependent on good growth.

With equity markets closely correlated to the direction of earnings, we expect the stock market to continue to advance, as S&P 500 earnings are projected to grow 8% this year. Low interest rates, greater consumer confidence and improving credit availability are combining to support profit growth. With household debt service historically low and increasing numbers of echo-boomers forming households, consumption spending should rise. With money flowing from bonds and with global economies weaker, the Federal Reserve is expected to keep interest rates near zero in the absence of core inflation. And with buybacks and substitution of capital for labor increasing, we believe corporate margins will stay higher for longer. Stocks are above historical valuation levels, however, reducing the margin for error on earnings growth.

BOUNCE BACK

Stock market is betting on continued earnings growth.



Left Axis: Price ($)
Right Axis: Earnings per share ($)
Note: First-quarter 2014 earnings data estimated
Sources: Northern Trust, Bloomberg, Standard & Poor's

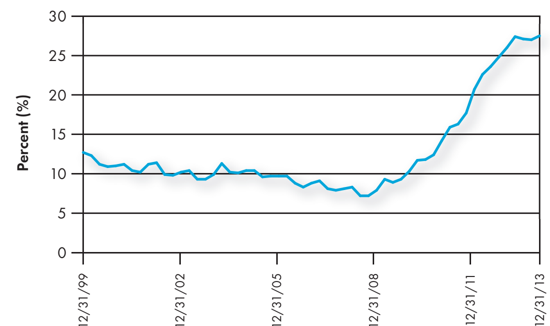
EUROPEAN EQUITY

- Tensions abound on Europe's eastern border.
- Eurozone group finance departments debate over next ECB move.

The situation for unemployed youth in Greece improved ever so slightly in 2013. Greece's unemployment rate for people under the age of 25 fell from 61% in February 2013 to a still shocking 58% at year end. However, Greece's total unemployment rate remained largely unchanged in 2013. High unemployment illustrates the structural problems that continue to hamper peripheral Europe. The human and economic cost of Europe's unemployment situation continues to build the case for some form of a full quantitative easing program from the European Central Bank (ECB) to ensure that the nascent European Union economic recovery isn't derailed. While this is the view of some in Brussels, it's not a view shared by the heads of the Dutch and German central banks who suggest it would potentially be "illegal." Infighting within the eurozone and outright conflict on its eastern border with Russia leaves the markets in a heightened state of volatility, which is likely to persist for the remainder of the year.

TOO LONG

A lack of progress on unemployment should push the ECB toward action.



Left Axis: Greek unemployment rate (%)
Sources: Northern Trust, Bloomberg

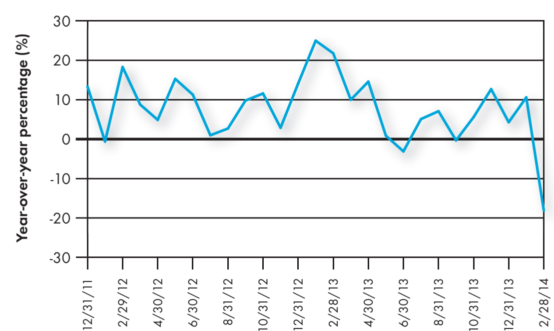
ASIA-PACIFIC EQUITY

- Spring wage season will be a key test for Abenomics.
- China's growth uncertainty is on the rise.

Three years ago this month Japan suffered a debilitating tsunami and, inadvertently, the event led to the arrival of President Abe and "Abenomics." Abenomics took its second real hit as revised fourth-quarter data showed slower than expected growth of 0.7%. While full-year growth of 1.5% was the highest in three years, investors are concerned that Japan's nascent revival is vulnerable to the forthcoming tax hike, as well as slowing demand and output in China. Speaking of the world's second-largest economy, China is facing up to the fact that growth levels may not be as powerful as expected, with the economy slipping to a significant trade deficit and economic surveys showing weakness in the key manufacturing sector. We wouldn't be surprised to see some level of stimulus to help shore up China's growth outlook.

CHINESE UNCERTAINTY

While the recent drop in exports is likely overstated, it highlights growth concerns.



Left Axis: China export trade (year-over-year %)
Sources: Northern Trust, Bloomberg

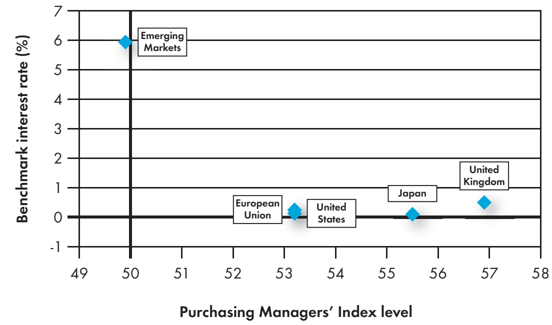
EMERGING-MARKET EQUITY

- Surveys of emerging-market manufacturing activity characterize the overall economic contraction.
- January's currency panic in emerging economies has subsided with the stabilization of foreign exchange markets.

Emerging-market stocks need to see an improvement in their growth outlook and easier monetary policy to outperform developed-market equities. So far this year, we haven't seen much improvement on either front, and the stocks have continued to underperform. The worry of a full-blown currency crisis has moved off investors' radar screens, as emerging-market currencies have stabilized since the end of January, and we continue to view a repeat of the 1990s currency crisis as unlikely. However, stability in China remains a key driver of both economic momentum and sentiment. Growth has been hurt by anticorruption moves, intentional slowing of the property markets and curbs on credit growth. With the year-to-date growth figures showing further deceleration, Beijing may be considering some form of stimulus or loosening of credit to boost growth, employment and incomes.

MUTED PROSPECTS

Emerging markets are experiencing slower growth and higher interest rates.



Left Axis: Benchmark interest rate (%)
Bottom Axis: Purchasing Managers' Index level
Note: Data as of 2/28/14. Emerging markets' data point is represented by the market cap weighted average of China, South Korea, Brazil, South Africa and India.
Sources: Northern Trust, Bloomberg, MSCI

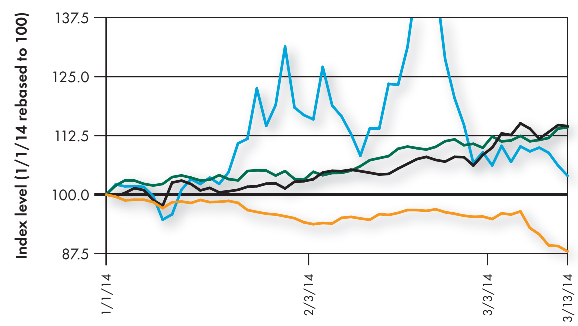
REAL ASSETS

- The conflict in Crimea has affected select commodities.
- Copper price action highlights the muted economic outlook.

The rise in Russian-Western tensions has contributed to price increases in some commodities. Weather-related strain has caused upward movement in the price of natural gas, and the onset of the Ukraine crisis exacerbated the price gains — a price movement so volatile, it was truncated in the accompanying chart — driven by Russia's large contribution to global natural gas production (18% in 2012). In conjunction with a discouraging drought in some grain-producing regions, the conflict may also be affecting agriculture prices; Ukraine is a top-10 global corn producer, while Russia is a top-five global wheat producer. Rounding out the benefactors is gold, gaining from the increased geopolitical risk. Conversely, copper's price action is a reminder of the moderate growth environment. While some of copper's weakness may be tied to technical issues surrounding its use as collateral in Chinese markets, we believe it also reflects reduced emerging-market growth prospects.

WHAT A DIFFERENCE A GLOBAL CONFLICT CAN MAKE

Geopolitical concerns have boosted some commodity prices in an otherwise subdued backdrop.



Left Axis: Index level (1/1/14 rebased to 100)
Natural gas
Corn
Gold
Copper
Sources: Northern Trust, Bloomberg

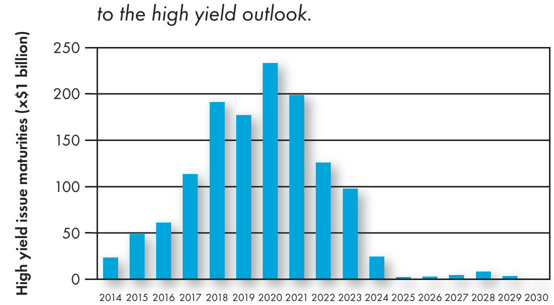
U.S. HIGH YIELD

- We expect the high yield default rate to remain low.
- The timing of future maturities is constructive for high yield.

We think the Moody's estimates of default rates within high yield — 2.2% in 2013 and 2.3% in 2014 — are conservative. But even these conservative expectations are at or near historical lows. Further, recoveries are expected to be around 50%. One of the primary drivers of this low default rate is the modest schedule of debt maturities. Maturities look to average $44 billion for the next three years, as compared with the average annual issuance of $321 billion during the last two years. In other words, the market has provided several times the amount of capital required to refinance maturities for the next three years. A low level of maturities and supportive capital markets provide clear support to high yield during the intermediate term.

PLENTY OF BREATHING ROOM

Low scheduled maturities are another positive support to the high yield outlook.



Left Axis: High yield issue maturities (x$1 billion)
Sources: Northern Trust, Barclays Capital

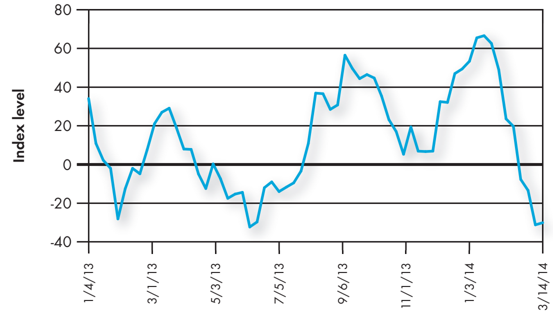
U.S. FIXED INCOME

- U.S. economic data has consistently disappointed in the past couple of months.
- We continue to believe the U.S. economy will grow modestly this year.

U.S. economic data has been soft this year, with the positive surprises from the beginning of the year turning negative during the last month. The abnormally cold winter has kept a tight grip on much of the United States, negatively impacting discretionary purchases such as homes, furniture and automobiles. In conjunction with slower sales, inventories have been rising at companies across many industries and now stand at their highest levels since monthly data began in 1992. Despite the recent discouraging economic news, we believe the economy will rebound in the spring and grow modestly for the remainder of 2014. The Fed's commitment to keep short-term interest rates at extraordinarily low levels, along with robust institutional investor interest in fixed income, should keep long-term interest rates relatively low this year.

FROM POSITIVE TO NEGATIVE

Worsening economic data has helped keep a lid on interest rates.



Left Axis: Citigroup Economic Surprise Index
Sources: Northern Trust, Bloomberg

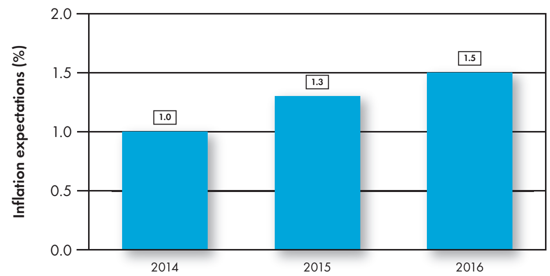
EUROPEAN FIXED INCOME

- The ECB made no policy changes last month.
- The markets are taking the Russo-Ukraine drama in stride (so far).

The ECB kept rates on hold last month and updated its economic forecasts. The bank also updated its inflation outlook, which calls for inflation increasing to 1.5% in 2016 (with the fourth quarter of 2016 at 1.7%). The 2016 data is the most important, and we would've expected more aggressive action from the ECB had that forecast been below 1.5%. However, with an accelerating but manageable inflation outlook through 2016, we expect the ECB to stay put for the foreseeable future. In the Ukraine, Russia has occupied Crimea to the opprobrium of the international community. After an initial swoon, markets have recovered some poise. Clearly, this story isn't over, and an expectation of continued volatility likely underpins investment-grade bond prices.

INFLATING EXPECTATIONS

The ECB expects a gradual increase in inflation.



Left Axis: Inflation expectations (%)
Sources: Northern Trust, European Central Bank

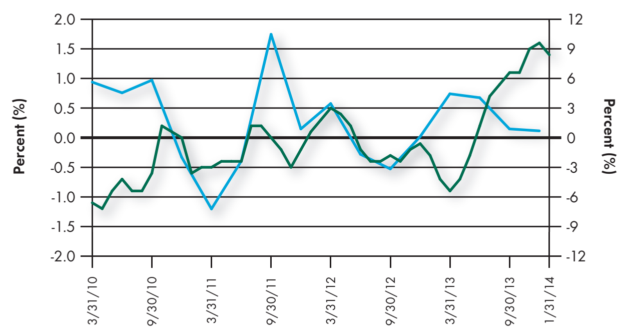
ASIA-PACIFIC FIXED INCOME

- Japan's decelerating fourth-quarter growth highlights challenges.
- China needs to grow its middle-income economy.

Japan's economic recovery appears to be at risk of running out of steam. Inflation has picked up (as desired), but growth is slowing. The second revision of fourth-quarter gross domestic product, at 0.7%, was down from 1% in the first estimate. Abenomics appears to be approaching a make-or-break point. The value-added tax hike in April will surely be accompanied by more expansionary fiscal or monetary policy. Of great interest is China's ability to transition to a more consumption-led growth model, escaping the unproductive final phase of investment-driven expansion to a middle-income economy. This is easier said than done. Along the path of this transition will be the painful, but necessary, crystallization of unproductive "bad loans" in the Chinese banking system.

AN UNWELCOME SLOWING

Slowing growth in Japan raises the pressure on Abenomics.



Left Axis: Month-over-month consumer prices (annualized %)
Right Axis: Quarter-over-quarter gross domestic product (annualized %)
Sources: Northern Trust, Bloomberg

CONCLUSION

Volatility has been the watchword so far this year, as global equities have been pushed around by both economic and geopolitical concerns. On the economic front, we think the outlook for developed-market economies remains solid with the possible exception of Japan, which is dependent on further structural improvements (including higher wages) this year. The growth outlook for emerging markets remains uncertain, and while we've been expecting disappointment in this area, recent Chinese statistics haven't settled this risk. Looking at U.S. market conditions, we continue to see plenty of money being put to work — including a nearly insatiable appetite for fixed-income investments. We think the best approach to handle this volatility is through strategic asset allocation — reducing sensitivity to the volatility, as opposed to trying to eliminate the risk using hedging strategies.

The investing climate isn't as favorable as a year ago, as valuations are higher in many asset classes and monetary policy is slowly becoming less accommodative. The Fed seems intent on winding down its bond purchases this year, although there is a debate as to its motivation. Is it because the Fed truly expects a strong economy in 2014, or is it because it has decided there's no longer a measurable benefit from further quantitative easing? Either way, we think the result is an increased reliance from the markets on organic economic growth. If the growth doesn't come through, the market will likely not be comforted by a ramp-up of quantitative easing.

Each month we debate the key risks to our outlook, and this month focused on the risks of disappointing growth from emerging markets or the United States as the key concerns. Emerging-market growth is well known to be slowing, but as a disproportionate contributor to global growth, the pace of the deceleration is key. While we believe the most likely outcome is acceleration in U.S. growth as the year progresses, a failure of that acceleration could be poorly received by markets. In that scenario, investors would question not only the outlook for U.S. assets, but other markets (such as Japan) that are undertaking similar policies (but whose economies have deeper holes to climb out of). Meanwhile, the cost of becoming more defensive remains high, as cash and some investment-grade bonds continue to generate negative real returns. We'll have to become more concerned about the economic growth outlook before considering reallocating from risk assets, such as equities, into these low yielding alternatives.

Jim McDonald
Chief Investment Strategist

Gross Domestic Product (GDP) is the market value of the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. GDP includes consumer and government spending, private domestic investments, and net exports of goods and services.

Citigroup Economic Surprise Index measures the variations in the gap between the expectations and the real economic data. When the index is positive it means that the released data have been better than the expectations. When index is negative, it means that actual results have been worse than expectations.

Consumer Price Index is a measure that examines the weighted average of prices of a fixed basket of consumer goods and services (such as food, transportation, shelter, utilities, and medical care), and is widely used as a cost-of-living benchmark.

Purchasing Managers' Index (PMI) is a measure of the overall performance of the manufacturing sector, based on a survey conducted with purchasing managers to determine changes in economic conditions. A reading of 50 indicates no change, a reading of greater than 50 indicates an expanding economy and a reading below 50 indicates a contracting economy.

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.

Investing involves risk including the possible loss of principal.

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