Perspective

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

April 15, 2014

OUTLOOK

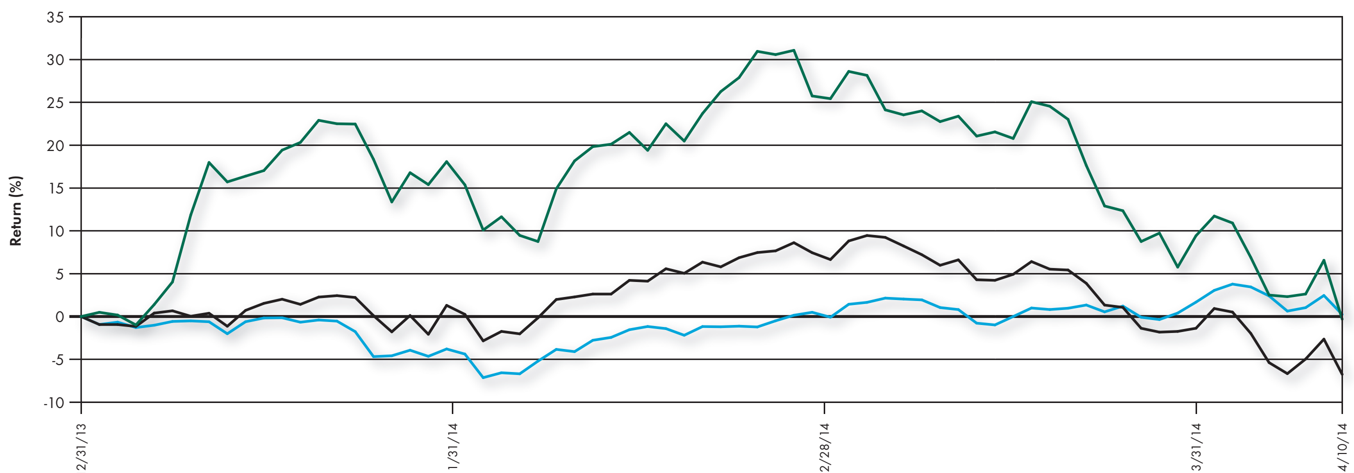
Is the recent uptick in market volatility justified by negative changes in the economic or monetary policy outlook, or is it just a normal market gyration? Market darlings such as biotechnology stocks that had seen large increases in valuation have come under significant selling pressure during the last two months. Meanwhile, cyclical stocks and emerging-market equities haven't seen comparable selling pressures. In addition, credit spreads remain very tight, indicating a sanguine outlook for economic growth and the continued hunt for yield. What could lead investors to worry that the economic or monetary policy outlook has worsened in recent months?

After a weak start to the first quarter, U.S. economic data has begun to show some signs of improvement. On the positive side are steady gains in the labor market, better retail sales and increasing credit creation. On the softer side, the housing market has been disappointing and awaits an upturn in household formations. European growth data was solid in the first quarter, led by strength in Germany and the United Kingdom. Japan's economy has benefited from consumption ahead of the Value-Added Tax (VAT) hike, leading to a likely contraction in the second quarter. China's weak first-quarter growth (freight-rail traffic fell year over year) has loosened Beijing's purse strings. While this will stabilize short-term growth, it's at the expense of the country's longer-term goal to rebalance the economy toward more stable consumption.

Central bankers are trying to get their sea legs in this new environment, where the efficacy of prior programs is unclear and markets are uncertain about supports going forward. The Federal Reserve has taken its usual lead, but this time it's been in confusing the markets about the outlook for monetary policy normalization. We think the Fed will keep monetary policy accommodative as long as the data allow. The European Central Bank (ECB) has been all talk, no action, as investors worry about disinflationary trends. The Bank of Japan (BoJ) has also kept policy steady at a time when investors are concerned about the economy's ability to withstand the 3% jump in the VAT. It's our expectation that dormant inflation across the developed markets will continue to give central bankers plenty of leeway.

CHANGING MARKET CONCERNS

While cyclical stocks struggled earlier in the year, now momentum stocks are struggling.



Left Axis: Return (%)

SPDR S&P Biotech ETF — First Trust Dow Jones Internet Index Fund — Morgan Stanley Cyclical Index

Sources: Northern Trust, Bloomberg

Northern Trust

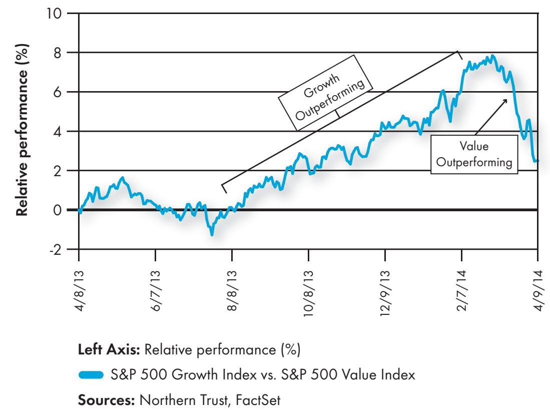
U.S. EQUITY

- Rotation from growth to value has been extraordinary during the last month.
- Broadening growth potential reduces the growth premium.

After impressive outperformance since last summer, growth stocks have taken it on the chin during the past month. Even though much of the underperformance can be attributed to high-flying biotech and Internet/software stocks, the shift toward value is notable nonetheless. Cracks in leadership stocks may appear negative on the surface, but the changing sentiment toward value could reflect expectations of better economic and, therefore, earnings growth. When growth is scarce, investors are willing to pay up for growth stocks. As expectations for growth improve, the relative growth potential of growth stocks generates less premium. We continue to expect relatively subdued equity returns this year, but view the recent shift toward value as a potentially positive sign for continued equity gains.

GROWTH GIVING BACK GAINS

Value's resurgence suggests an improved economic outlook.



Left Axis: Relative performance (%)

S&P 500 Growth Index vs. S&P 500 Value Index

Sources: Northern Trust, FactSet

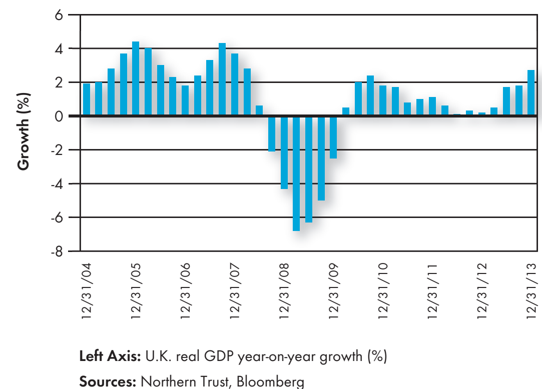
EUROPEAN EQUITY

- Economic growth is improving in more fiscally stable countries.
- Tensions in Ukraine continue to persist.

The situation in Ukraine continues to dominate public thought in Europe. A recent International Monetary Fund (IMF) report told a cautious story about its short-term outlook for certain European economies. It was noted that, while the United Kingdom and Germany are adding economic momentum, other nations are stumbling, and Russia's takeover of Crimea last month injects geopolitical tension that's "casting a pall" on the region. The IMF also urged emerging markets to prepare for a flow of capital back into advanced economies and advised the ECB that more monetary easing is needed to keep deflation at bay. In Ukraine, the standoff continues, with all parties cautious and the West focused on diplomacy and sanctions. Equity markets appear ready to weather the Ukrainian situation, but a significant deterioration in relations with Russia remains a real risk to European equities.

UNITED KINGDOM IS LEADING GROWTH

Strength in the United Kingdom raises the bar for other developed European economies.



Left Axis: U.K. real GDP year-on-year growth (%)

Sources: Northern Trust, Bloomberg

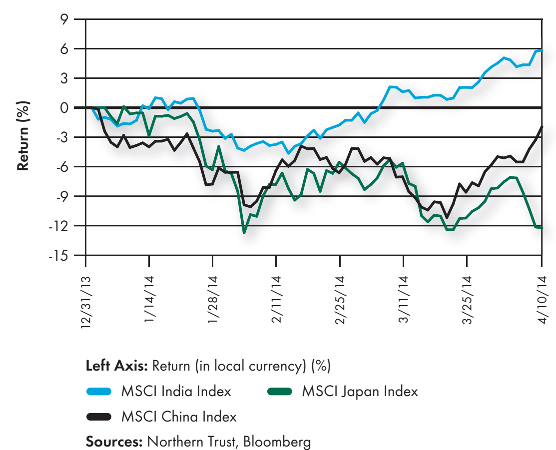
ASIA-PACIFIC EQUITY

- India, the world's largest democracy, goes to the polls.
- Investors are betting on Chinese stimulus.

Stock markets in Asia remain nervous and volatile. India goes to the polls, with the elections lasting for five weeks. Opinion polls put the controversial Narendra Modi, a Hindu nationalist, as a clear leader for election to his country's highest office. He'll inherit a country with too-high inflation and disappointing growth, along with a burgeoning middle class that's beginning to make its presence felt economically. Promises to "bring back growth" resonate with a population that has seen the economy stagnate in real terms. Accelerating Indian growth would also provide a fillip to the region as a whole, with China's economy slowing and the sheen of Abenomics wearing a little thin as Japan faces the challenge of higher sales taxes.

RETURN OF THE MASSES

Indian and Chinese equities have regained momentum in recent months.



Left Axis: Return (in local currency) (%)

MSCI India Index

MSCI Japan Index

MSCI China Index

Sources: Northern Trust, Bloomberg

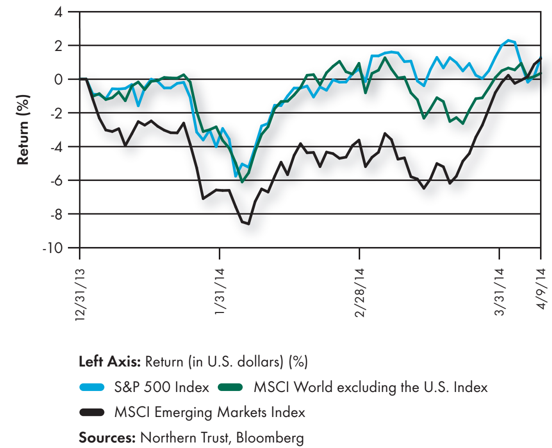
EMERGING-MARKET EQUITY

- China soft-launches some stimulus spending.
- Emerging-market equities benefit from improved sentiment.

China's economic data have steadily deteriorated this quarter, leading our commodities analyst to comment that the "so-bad-it-is-good" thesis was back in play. Starting in mid-March, investors began to speculate about increased stimulus from the Chinese government to stabilize growth. Our discussions with infrastructure-related companies in China support this view, which could provide some boost to short-term growth. However, this will further retard the shift from investment to consumption, leaving the economy still too dependent on fixed-asset investment. Improved sentiment about China's growth prospects, as well as optimism around the potential for more business-friendly government in India, has allowed emerging-market equities to regain the ground they lost earlier in the year. For us to turn more constructive, we'll need increased conviction in the growth outlook along with visibility toward easier monetary policy.

CATCHING BACK UP

After early-year underperformance, emerging-market equities have outperformed of late.



Left Axis: Return (in U.S. dollars) (%)
S&P 500 Index · MSCI World excluding the U.S. Index · MSCI Emerging Markets Index
Sources: Northern Trust, Bloomberg

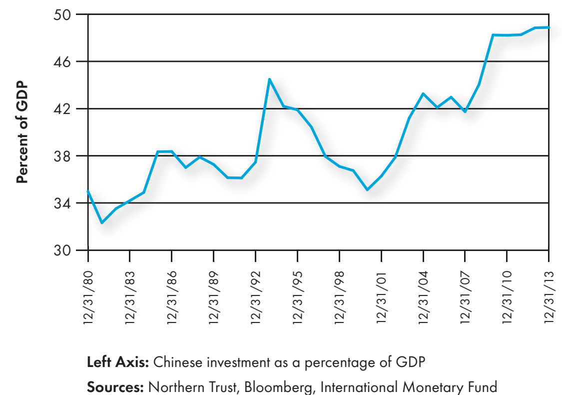
REAL ASSETS

- China's "mini-stimulus" may drive commodity prices higher.
- Questions surround how persistent demand support will be.

China's economic slowdown reached the point where party officials decided to act. To put the economy back on course toward the government's 7.5% growth rate goal, a "mini-stimulus" has been announced — including tax breaks for small enterprises and ramped-up railway construction and urban area rebuild. These latter two initiatives have pushed the price of industrial metals up nearly 7% since the rumors began. But how long can this price support last? As implied by its name, this stimulus effort is small in stature — presumably because the government is running out of value-added projects to undertake (investment represents nearly 50% of the Chinese economy — see accompanying chart). Chinese stimulus announcements generally have a measurable impact on commodity prices, but the stimulus' small size and targeted nature may make the price impact relatively short-lived.

STIMULATED COMMODITIES

An expected boost in Chinese investment rallies industrial commodity prices.



Left Axis: Chinese investment as a percentage of GDP
Sources: Northern Trust, Bloomberg, International Monetary Fund

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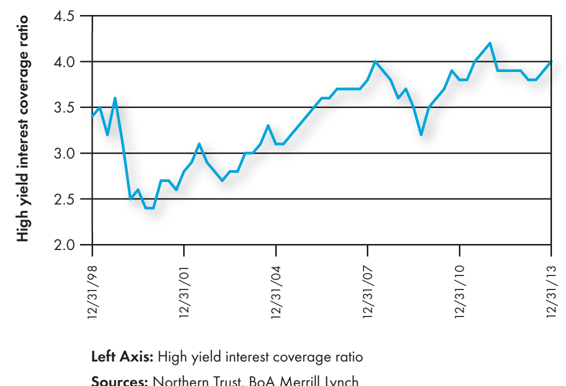
U.S. HIGH YIELD

- The high yield market has been supported by relatively strong credit fundamentals.
- Strength has been on cash flow measures as well as balance sheets.

Solid credit fundamentals have supported the high yield market, resulting in a low default rate. The financial leverage of issuers has remained lower than prior to the financial crisis. The strength hasn't been only on the balance sheet. Cash-flow-based credit measures have also been strong. The accompanying chart shows that interest coverage ratios have been near the highest level of the past 15 years. Why? First, corporations have remained conservative operationally and stayed focused on cost control, generating excess cash. Second, capital markets have been supportive, allowing issuers to refinance at lower coupons. The Fed's interest rate policy has made this possible. We believe stable credit fundamentals should continue to support high yield valuations.

PLENTY OF COVER

Corporate cash flow handily covers interest expense.



Left Axis: High yield interest coverage ratio
Sources: Northern Trust, BoA Merrill Lynch

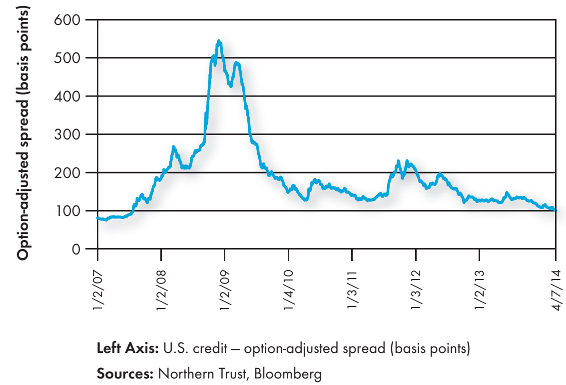
U.S. FIXED INCOME

- Corporate bond spreads continued to tighten and are now back to pre-crisis levels.
- We continue to believe corporate debt offers investors relative value.

Investment-grade corporate bond issuers took advantage of tight credit spreads and declining interest rates as new issuance soared to an all-time first-quarter high. The deluge of new bonds was well received by investors. Consistent inflows of new money into fixed-income strategies left managers with money to put to work. Credit spreads tightened throughout the quarter on the strong demand, and this occurred despite 10-year U.S. Treasury yields falling 30 basis points (0.30%). We continue to believe U.S. corporations represent reasonable relative value to investors in the low-interest-rate environment. Central bank policy remains accommodative and corporate balance sheets look healthy, leaving corporate bonds attractive relative to other fixed-income asset classes.

PRE-CRISIS

Investor appetite has returned spreads to pre-crisis levels.



Left Axis: U.S. credit – option-adjusted spread (basis points)

Sources: Northern Trust, Bloomberg

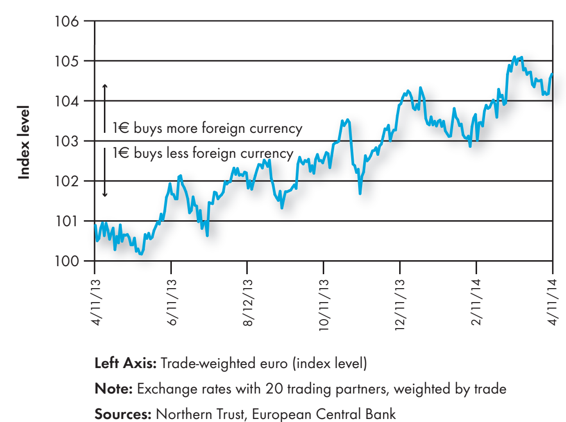
EUROPEAN FIXED INCOME

- The hunt for yield allows Greece to return to market.
- The ECB remains in focus as the euro resumes its upward trajectory.

On April 10, Greece returned to bond markets with a €3 billion issue of five-year paper yielding 4.95%. Demand was more than €20 billion, sparking conjecture about whether this marks the end of the eurozone sovereign crisis or is just another example of the liquidity-provoked reach for yield. The latter certainly seems to hold true. We believe the bond issues and program graduations in Ireland and Portugal are clear signs of improvement, but Greece requires more repair. After another inactive meeting from the ECB, speculation is starting to reach a fever pitch surrounding the potential for quantitative easing and negative interest rates. After the ECB built up the March forecast round as pivotal and then passed on the opportunity for action, it seems strange that we're here again so soon.

FORTRESS EURO

Strength in the euro is becoming an economic worry.



Left Axis: Trade-weighted euro (index level)

Note: Exchange rates with 20 trading partners, weighted by trade

Sources: Northern Trust, European Central Bank

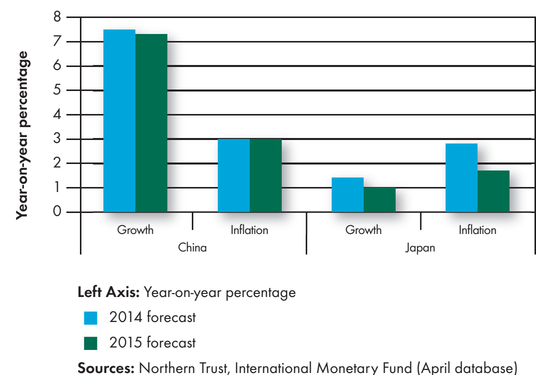
ASIA-PACIFIC FIXED INCOME

- The IMF is forecasting still-robust Chinese growth.
- Investors are still awaiting additional Japanese stimulus.

The IMF released its latest global growth forecasts, with growth predicted to improve from 3% last year to 3.6% this year and 3.9% next year. In the emerging countries, the IMF cites lower growth in China as a risk but maintains growth forecasts of 7.5% and 7.3% in 2014 and 2015, respectively. In Japan, the BoJ maintained its policies, as expected. However, somewhat surprisingly, the BoJ gave no hint of further easing to follow the implementation of the VAT hike at the start of April. We now look to the forthcoming gross domestic product and consumer price index forecast updates at the semi-annual outlook report update on April 30. A lowering of either growth or inflation must surely yield further action.

JAPANESE SLOWDOWN

Slowing growth and inflation should generate further policy action.



Left Axis: Year-on-year percentage

2014 forecast

2015 forecast

Sources: Northern Trust, International Monetary Fund (April database)

CONCLUSION

Our policy deliberations this month focused on the continued mixed messages coming from financial markets, including the strong performance of U.S. Treasury bonds in recent weeks. Was the decline in bond yields a signal that economic growth was truly slowing, or was it noise generated by portfolio reshuffling? If the markets were becoming worried about overall economic growth, we would typically see deteriorating performance from credit and cyclical stocks — which we haven't. We believe developed economies still look set to generate accelerating growth this year, likely led by the United States and United Kingdom. We think emerging-market economies remain a mixed bag, with election hopes in India and Indonesia boosting sentiment along with China's "mini-stimulus" plan. Our bottom line is that we expect global growth to be good enough to support risk assets this year.

We entered 2014 with bias towards risk assets, such as stocks and high yield bonds. This bias to risk assets has led to modest underperformance so far this year, as investment-grade bonds have outperformed many regional equity markets. We have, however, experienced strong performance from high yield bonds and real assets such as global listed infrastructure and global real estate. Following script, analysts have cut earnings estimates for U.S. companies for the first quarter, lowering the bar that managements must clear. Without weather to hide behind, companies will need to show accelerating revenue and earnings momentum through the rest of the year. The market is currently giving companies the benefit of the doubt, with value stocks outperforming their growth brethren during the last month.

What could knock us off of our current policy stance? We still see growth as the key fundamental variable, as quantitative easing is unwound and investors focus on sustainable organic growth. Emerging-market growth uncertainties remain our top concern because of their disproportionate contribution to global growth as well as the challenges China is having in managing credit and rebalancing its economy. Developed-market growth looks set to accelerate as the year progresses, but a disappointment in the United States would cast a long shadow over Europe and Japan as well. We remain focused on risks from the Ukrainian turmoil and feel that a more forceful response from the West will arise should Russia push its incursion further. There are always risks in the financial markets, and the ones we're currently monitoring haven't risen to the level of concern that we think would merit a change in our bias towards risk assets.

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%.

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.

Interest coverage ratio is operating earnings divided by interest expense; it is one way to examine a company's ability to service its debt.

Option-adjusted spread (OAS) is the difference in yield between two fixed income securities (generally between a fixed income security with credit risk and a comparable treasury bond), adjusted for differences in duration and embedded options.

First Trust Dow Jones Internet Index Fund is an exchange-traded index fund. The Fund seeks investment results that correspond generally to the performance of an equity index called the Dow Jones Internet Composite Index.

Morgan Stanley Cyclical Index is an equal-dollar weighted index designed to measure the performance of economically sensitive industries within the U.S. economy and detect shifts in investor sentiment through changes in the average return of 30 representative stocks.

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 global large, mid and small cap China equity opportunity set.

MSCI Emerging Markets Index captures large and mid-cap representation across 21 Emerging Markets (EM) countries.

The MSCI World excluding the United States Index captures large and mid-cap representation across 22 of 23 Developed Markets (DM) countries (excluding the United States).

The MSCI India Index is designed to measure the performance of the large and mid-cap segments of the Indian market. With 69 constituents, the index covers approximately 85% of the Indian equity universe.

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 a capitalization-weighted index of 500 stocks. The index is designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

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S&P Growth Index is an index that seeks to track the investment results of an index composed of large-capitalization U.S. equities that exhibit growth characteristics.

S&P Value Index seeks to track the investment results of an index composed of large-capitalization U.S. equities that exhibit value characteristics.

SPDR S&P Biotech ETF is an exchange-traded index fund. The fund seeks to provide investment results that correspond generally to the total return performance of the S&P Biotechnology Select Industry Index.

It is not possible to invest directly in an index.

Investing involves risk including the possible loss of principal.

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