Perspective

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

May 19, 2014

OUTLOOK

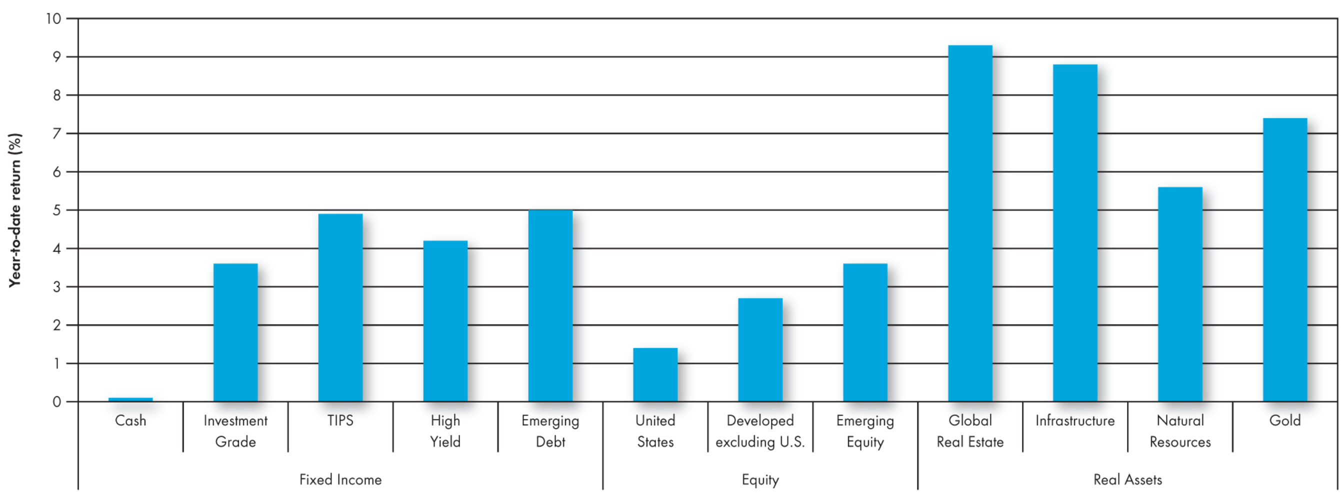
While stocks have been fairly volatile of late, a diversified portfolio has shown a satisfactory result so far this year. Returns in traditional equity markets have been modest, with emerging market equities up 3.6%, non-U.S. developed equities up 2.7% and U.S. equities up 1.4%. The real stars have been cash flow/yield oriented assets like global real estate and infrastructure, up roughly 9% each. These interest-rate-sensitive asset classes have been boosted by the rally in sovereign debt yields, with the U.S. 10-year Treasury yield dropping from 3.03% to 2.54% so far this year, while the German bund yield has fallen from 1.93% to 1.36%. What's behind this rally in bond yields? Is the answer tied to worries about growth, changes in monetary policy expectations or other factors?

Recent economic reports have demonstrated disappointing first-quarter growth across the United States, Europe and China. While broad-based U.S. economic measures such as private consumption and manufacturing industrial production appear to have risen 2% to 3% in the first quarter, more volatile components like equipment investment, residential construction and exports fell 5% to 8%. The growth shortfall in Europe and China was more modest than in the United States, but worries abound about the sustainable rate of Chinese growth. President Xi Jinping recently commented that China must adapt to a "new normal" of economic growth and "stay cool minded." Developed market growth (excluding Japan) appears set to rebound in the second quarter, and we're not seeing worrying signs from behavior in the credit markets.

With modestly disappointing economic data only a partial explanation for the drop in yields this year, rates have also been supported by dovish central bank utterances. Federal Reserve Chair Janet Yellen has effectively retracted her prior commentary that rate hikes could commence six months after the end of Fed bond buying, and former Fed Chair Ben Bernanke has apparently communicated in recent private meetings that he expects rates to stay abnormally low for an extended period of time. European Central Bank (ECB) President Mario Draghi has nearly preannounced a June policy move, signaling that the docile central bank may be stirring to action. The final contributor to the fall in rates has been the continuing global wall of savings — the flip side of the sluggish pace of investment. Until there's a noticeable uptick in global growth, this dynamic is likely to support a continued environment of low interest rates in the developed markets.

YIELD RULES

Income-oriented assets have led the markets so far this year.



Left Axis: Year-to-date total return through 5/15/14 (%)

Sources: Northern Trust, Bloomberg

Northern Trust

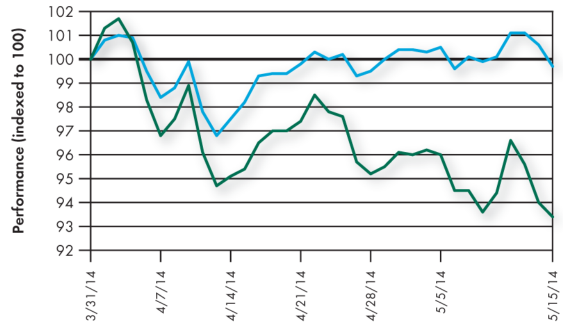
U.S. EQUITY

- Large-cap stocks have outperformed small caps by more than 6% quarter-to-date.
- Small caps have now given up the outperformance over large caps amassed in 2013.

Small-cap stocks have retreated 5% since the start of the second quarter, even as large-cap stocks moved 1.2% higher. The divergence between small caps and large caps can be attributed to small caps missing first-quarter analyst earnings expectations by 5.6%, with misses in seven out of 10 sectors, while large caps exceeded earnings expectations by 6.1%. Despite this retrenchment, small cap shares as a group still aren't cheap, with the group's forward price-to-earnings multiple of 24x aligned with its long-term average of about 25x. Because small-cap performance is closely tied to growth, if GDP remains sluggish, small-cap shares could face further weakness before a buying opportunity emerges.

SMALL LAGGARDS

Weak earnings cause small caps to underperform year-to-date.



Left Axis: Performance (indexed to 100)

Russell 1000 Index   Russell 2000 Index

Note: Russell 1000 and Russell 2000 capture large and small-cap stocks, respectively

Sources: Northern Trust, FactSet

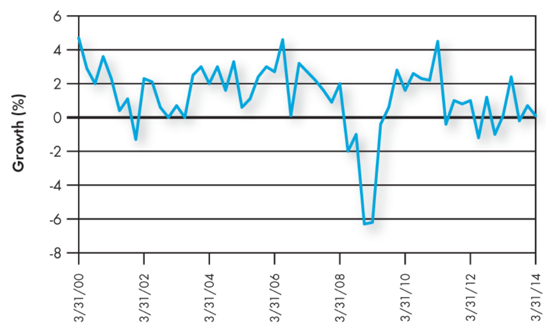
EUROPEAN EQUITY

- Growth concerns in the eurozone could finally propel the ECB to act.
- Ukraine election could provide a route toward negotiation.

Ukraine increasingly is looking likely to elect a pro-Western leader, who also has business interests in Russia, in its upcoming election. While sanctions have been implemented against Russia, the International Monetary Fund has announced a $17 billion loan, which may release funding from other entities, including the European Union (EU). The $17 billion amount apparently is a popular number, with GE placing this value on Alstom of France, as global corporates begin to put their estimated multi-trillion dollar cash hoard to work. In a sign that austerity is being felt as much around the Peripherique as Periphery in 2014, France's Observatoire Economique said, "France has seen a complete stagnation for the last 10 years, an unprecedented situation since the end of World War II." These stark words may increase the chances of EU quantitative easing becoming a reality.

FRENCH GROWTH REMAINS A WORRY

France's rebound is lagging more competitive EU economies.



Left Axis: France real GDP quarter-on-quarter growth (%)

Note: Seasonally adjusted annual rate

Sources: Northern Trust, Bloomberg

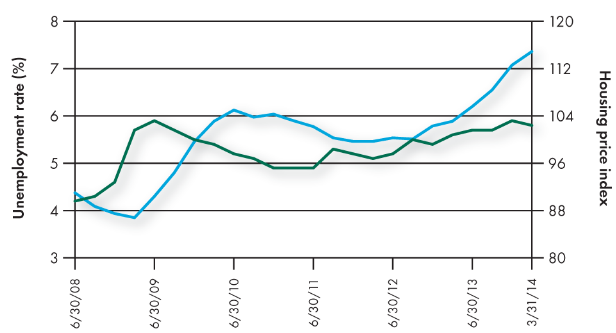
ASIA-PACIFIC EQUITY

- Australia is beginning to show sustained recovery.
- As China talks of a "new normal" level of growth, it's uncertain whether the region will follow suit.

Since February, the average Australian's appetite for credit and debt continued to climb, no doubt in response to low cash rates and the Reserve Bank of Australia's guidance of holding them at these levels "for some time." A combination of record-low borrowing rates and stronger asset markets has helped Australian retail sales accelerate in the first quarter. It remains to be seen whether the rest of the economy will follow. Momentum has eased a little since the early months of 2014, and consumer sentiment has sagged on employment concerns in the manufacturing and government sectors. However, with employment rising strongly in recent months, and the materials sector adjusting to slower Chinese economic growth, Australia may see more positives ahead.

GOOD FOR EXISTING HOMEOWNERS

Easy financial conditions support housing; hopefully labor will follow.



Left Axis: Australia unemployment rate (%)

Right Axis: Australia housing price index

Sources: Northern Trust, Bloomberg

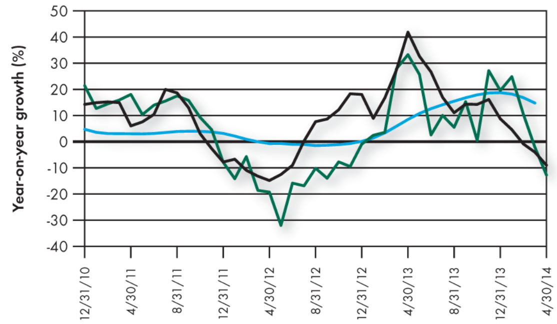
EMERGING-MARKET EQUITY

- Chinese property markets are slowing fast.
- India rallies on reform hopes.

Asian markets comprise more than 60% of the emerging-markets index, and China remains the key driver in the region. Growth has been disappointing this year, and signs of weakness in the key property market are growing. Residential construction and sales growth has turned negative of late, and prices seem likely to follow that trend. The Indian and Brazilian markets have been better performers this year, based on hopes for postelectoral economic reforms. The win by the Bharatiya Janata Party in India guarantees some change in strategy from decades of Congress leadership. Brazilian elections in early October carry a more uncertain outcome. Incumbent President Dilma Rousseff's popularity has recently slipped below 50%, and markets may welcome a change. We continue to believe that improved economic momentum across the major emerging markets will be required for these markets to outperform their developed market counterparts.

HOUSING DOWN CYCLE

Housing activity levels in China have turned negative in 2014.



Left Axis: Year-on-year growth (%)
Residential housing prices, 1st tier
Residential sales
Residential construction
Note: Three-month smoothing
Sources: Northern Trust, Bloomberg

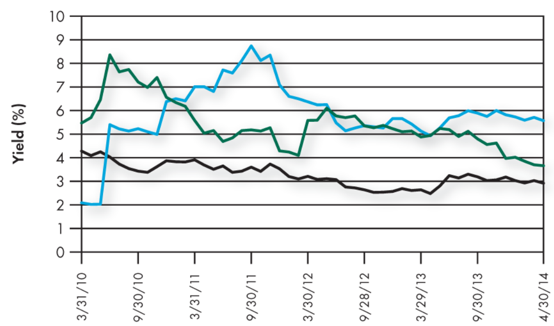
REAL ASSETS

- A desire for "safe" yield has made global listed infrastructure more expensive.
- The decision between real estate and infrastructure hinges on the outlook for equities.

Global listed infrastructure and global real estate have had impressive runs thus far this year, both generating near double-digit returns while global equities are just in the black. This has pushed valuations higher, most notably in infrastructure, where the earnings yield of 3.7% is encroaching into the territory normally occupied by investment-grade fixed income securities. The divergence between infrastructure and real estate valuations can be partly attributed to investor uncertainty — infrastructure has less sensitivity to equity markets and, therefore, commands a higher premium in times of volatility. If more of the same volatility continues going forward we believe infrastructure may perform better; however, if markets stabilize, global real estate may provide better value at current price levels.

THE SAFER CHOICE

Investors have been attracted to global listed infrastructure's lower sensitivity to equities.



Left Axis: Yield (%)
Global real estate earnings yield
Barclays U.S. Credit Index yield
Global listed infrastructure earnings yield
Sources: Northern Trust, Bloomberg

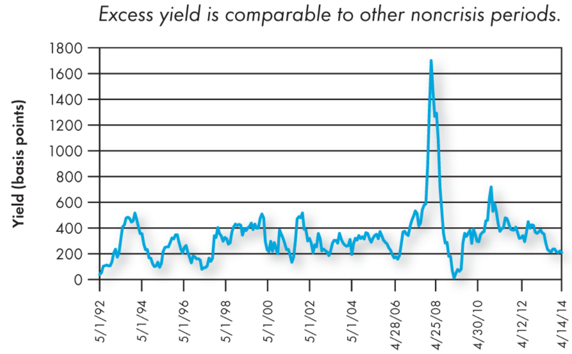
U.S. HIGH YIELD

- The high yield market compensates investors for different risks.
- Yield in excess of primary risks in high yield is still attractive.

High yield securities compensate investors for interest rate, default loss, liquidity and other risks. The accompanying graph shows the index yield less the two primary risks — interest rates and future defaults. This remaining yield can be thought of as compensation for the other risks of liquidity, market-to-market pricing and miscellaneous risks. Although the current level of 204 basis points is consistent with noncrisis periods, it's lower than the 333 basis points during the past 22 years. Additionally, the current nominal yield is just 5.04% vs. a long-term average of 9.62%. Given the current low absolute yields, it's difficult to argue value in high yield today, but the excess yield and strong current fundamentals provide some support for valuations.

SOME COMPENSATED RISK

Excess yield is comparable to other noncrisis periods.



Left Axis: Excess yield – Barclays U.S. High Yield Bond Index (basis points)
Note: Excess yield = index yield less Moody's default loss and less five-year U.S. Treasury yield
Sources: Northern Trust, Barclays, Moody's

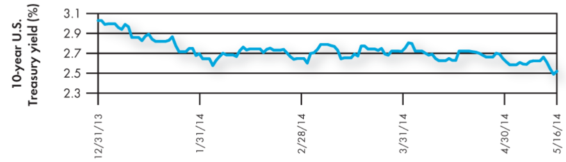
U.S. FIXED INCOME

- Long-term U.S. Treasury yields have steadily declined this year.
- A shortage of longer-dated debt supports lower yields.

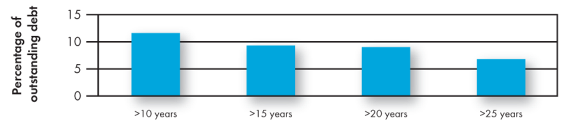
Weak economic data and geopolitical turmoil in Ukraine have helped drive rates lower this year, but we believe supply and demand issues are also at work. Pension fund managers have been shifting money into long-term Treasuries, attempting to derisk their plans. Central banks are also rebalancing, choosing to park their reserves in Treasuries because they offer higher yields relative to other nations such as Germany and France. This rebalancing act has been complicated by the lack of available bonds. Despite the Treasury's heavy issuance since the last recession, only a small portion of outstanding bonds are in maturities greater than 10 years. This relative scarcity won't improve in the near term, as the U.S. budget deficit has been significantly improving.

LIMITED SUPPLY

A dearth of longer maturity bonds caps interest rate risk.



Left Axis: 10-year U.S. Treasury yield (%)
Sources: Northern Trust, Bloomberg



Left Axis: U.S. outstanding debt maturity profile (%)
Note: Maturity profile as of 5/12/14
Sources: Northern Trust, Bloomberg

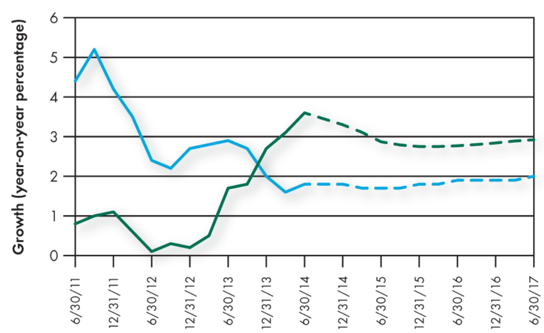
EUROPEAN FIXED INCOME

- More accommodative policy from the ECB seems imminent.
- The Bank of England is closer to tightening its policy.

The ECB wrong footed markets at its May meeting, as the Governing Council was characterized as unhappy with the prospect of a long period of low inflation and ready to act at its June meeting. Since March, markets have moved beyond the "zero bound" in policy rates, and are discounting some form of unconventional easing. This may be premature, and further deterioration may be required before quantitative or credit easing is deployed. The Bank of England, meanwhile, is heading in the opposite direction as Governor Mark Carney stressed the early stages of the U.K. recovery, insisting that a degree of spare capacity is likely to persist during the two-year forecast horizon. However, it's clear that capacity is being utilized, so the United Kingdom is likely to see the first interest rate increases across the major Western central banks. Based on the inflation report, this will not be in 2014.

SANGUINE OUTLOOK

The Bank of England's forecasts may understate prospects of higher utilizations.



Left Axis: Growth (year-on-year percentage)
United Kingdom consumer price index inflation
United Kingdom real GDP
Note: Dashed lines are average Bank of England projections
Sources: Northern Trust, Bank of England

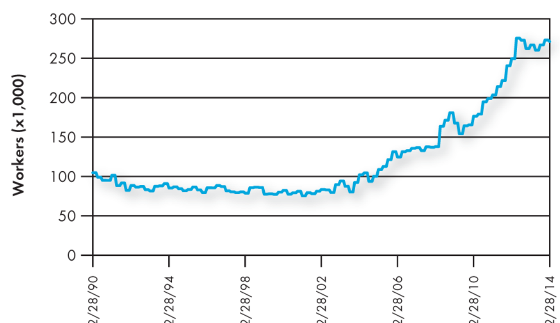
ASIA-PACIFIC FIXED INCOME

- Mining employment is leveling off in Australia.
- Slowing growth in China poses a real test.

As mining production ramps up in Australia, capital investment is declining. Barclays estimates that mining-related employment has jumped from 3.6% to 5% of the workforce in the last 11 years, while the RBA calculates a much higher 9.8% share. Whichever figure is most accurate, other sectors will now have to absorb the job losses, as operating a mine is considerably less labor intensive than building it. So far, actual employment and forward-looking surveys suggest that this may be the rarest of beasts, an orderly handover from one sector to another. China's April data posted further moderation, signaling disappointing second-quarter growth. While some investors may welcome the potential stimulus response, each government intervention to support investment growth (be it easing or trust support) is a step backward in the much heralded rebalancing of the Chinese economy.

TOPPING OUT

Mining employment will need to be replaced by other sectors.



Left Axis: Mining industry employment
Sources: Northern Trust, Bloomberg

CONCLUSION

As compared to the start of the year, the global growth outlook has become more uncertain. In the United States, bank credit has broken out of its long-time slumber, as loans and leases have advanced 8% so far this year. Inflation expectations have remained fairly steady, which can be viewed constructively in contrast to the worrying potential of deflation. Developed market central bankers remain focused on avoiding the risks of deflation, which leaves them on the easy side of policy. This has contributed to expectations of monetary policy normalization in the developed markets becoming modestly more dovish this year; the ECB may finally act and the Fed appears fairly patient.

We continue to debate the risk and return outlook in this market of compressed spreads and higher valuations. Corporations generally have been good stewards of capital this cycle, and U.S. corporations delivered 4% earnings growth in the first quarter despite what may end up being a negative growth quarter — at least if you believe the government GDP accounts. In our view, a reduction in equities or related risk assets would be warranted if the fundamental outlook worsened or valuations reached extreme levels. Economic cycles typically don't die on their own; a catalyst such as central bank tightening is usually the culprit. We don't see this as a likely scenario during the next 12 months.

Developments in Ukraine — one of the market's main worries this year — continue to simmer at a low boil that we don't think warrant a shift in asset allocation. Our primary risk cases surround growth, in both emerging economies and the United States. With the emerging markets contributing a disproportionate share to global growth in recent years, a significant slowdown in China would be a negative shock to the markets. A major disappointment in U.S. growth would also be troublesome, but for a different reason. In this circumstance, investors could lose faith in the ability of central banks to stimulate growth and could turn sour on growth prospects in Japan and Europe as well as the United States. While starting valuations somewhat limit the upside potential in risk assets, we still see better appreciation potential there than in the investment-grade fixed income markets — especially after their strong performance year-to-date. Reaccelerating global growth during the next two quarters will be a key validation that this is the correct decision.

Jim McDonald
Chief Investment Strategist

INVESTMENT PROCESS

Northern Trust's asset allocation process develops both long-term (strategic) and shorter-term (tactical) recommendations. The strategic returns are developed using five-year risk, return and correlation projections to generate the highest expected return for a given level of risk. The objective of the tactical recommendations is to highlight investment opportunities during the next 12 months where our Investment Policy Committee sees either increased opportunity or risk.

Our asset allocation recommendations are developed through our Tactical Asset Allocation, Capital Markets Assumptions and Investment Policy Committees. The membership of these committees includes Northern Trust's Chief Investment Officer, Chief Investment Strategist and senior representatives from our fixed income, equities and alternative asset class areas.

If you have any questions about Northern Trust's investment process, please contact your relationship manager.

To view this newsletter online, please visit www.northerntrust.com/perspective.