Perspective

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

June 19, 2013

OUTLOOK

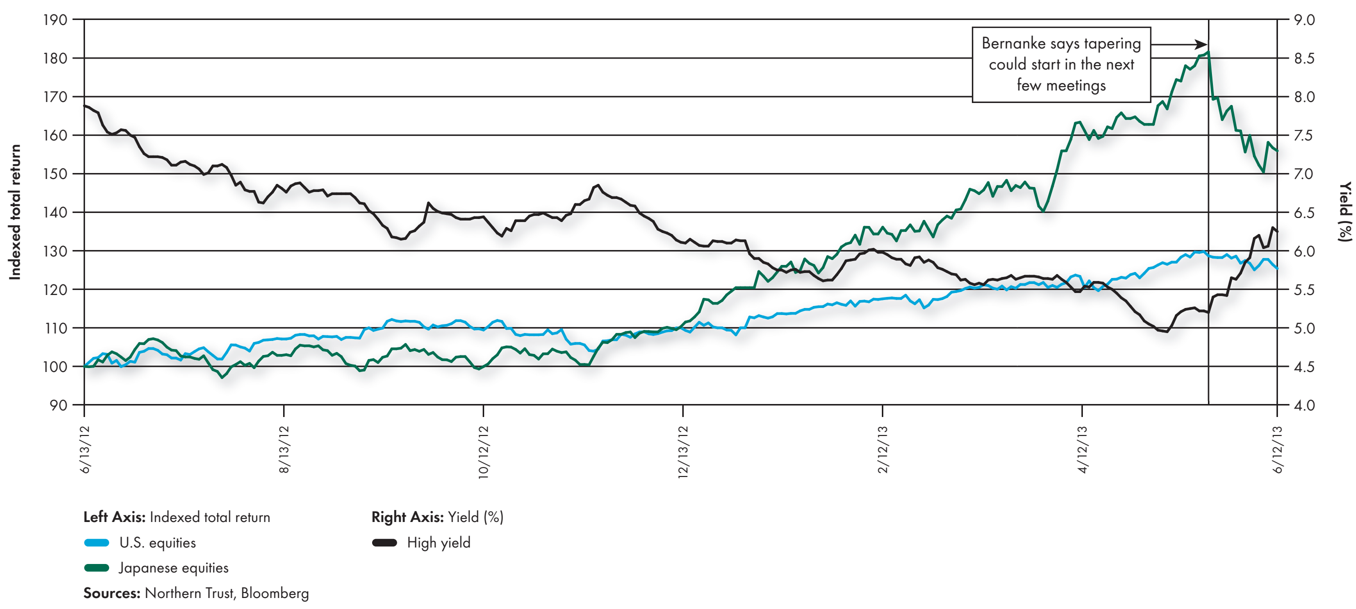
If investors need a reminder of how policy-driven today's financial markets remain, they need to look back no further than May 22. In congressional testimony, Federal Reserve Chairman Bernanke indicated that, if economic data supports it, the Fed could begin tapering purchases "in the next few meetings." Markets immediately reacted, leading to a jump in interest rates and the selling of equities (especially outside of the United States). Somewhat lost in this process was Bernanke's qualifier about the health of the economic data, which isn't at risk of reaching the Fed's goals anytime soon. Unemployment actually edged up last month to 7.6%, as discouraged workers started reentering the workforce. Also, U.S. growth has softened somewhat this quarter, leading to the Fed's preferred measure of inflation totaling just 0.7%.

Japan remains a developed-market standout, as the animal spirits generated from "Abenomics" have boosted consumer spending and business confidence. However, the Japanese market isn't immune from policy dependency, as shown by its retreat from cyclical highs on concerns about both Abenomics and the prospects of Fed tapering. Europe is slowly bouncing off its recession lows, but is still contracting. Even though the European Central Bank recently cut rates, moves to soften austerity have been too timid to boost growth. Across the emerging markets, growth forecasts have been reduced because of soft external demand. The inflation picture is more balanced, with the largest countries split between those with inflation below or above target levels.

Our views on growth are relative to market expectations, and we expect both the United States and emerging markets to positively surprise consensus. Because the overall levels of growth remain moderate by historical standards, we're sanguine about the inflation outlook. This should afford the world's major central banks sufficient cushion to continue supporting growth. Markets, however, will not stop the guessing game around normalization of Fed policy, and we should expect continued higher levels of market volatility. Japan will be a new contributor to this volatility as the hopes for Abenomics face the reality of politics.

POLICY DEPENDENT MARKETS

The Federal Reserve will need to communicate deftly to avoid further roiling markets.

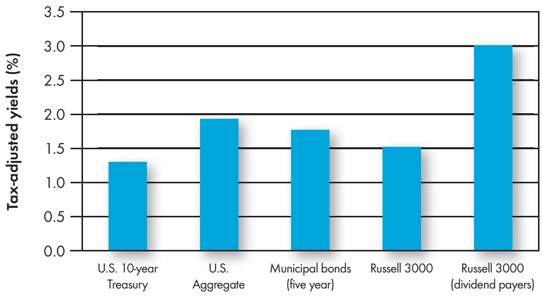


Sources: Northern Trust, Bloomberg

Northern Trust

REWARDING SHAREHOLDERS

With low growth, dividends are a primary use of corporate cash.



Left Axis: Tax-adjusted yields based on top marginal tax rate (%)
Data through 5/31/13
Sources: Northern Trust, Factset

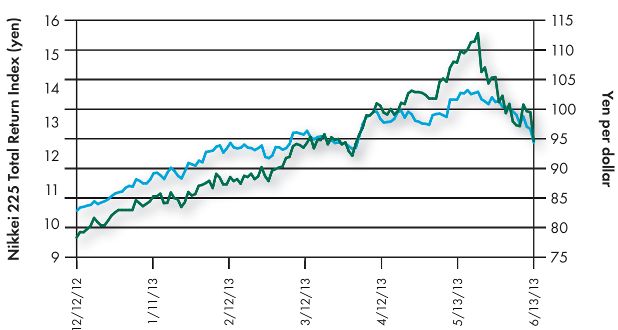
U.S. EQUITY

- Comparative yield continues to favor equities.
- Investor appetite for dividends should remain strong in a low-rate environment.

Defensive sectors have atypically outperformed year-to-date despite the market's rally. We believe a driver for this outperformance has been investor interest in dividend-paying stocks, as investors search for yield in this low interest rate environment. Despite investor interest in specific sectors, yield is still priced in line with historical trends. While all stocks will be somewhat driven by the outlook for tapering and tightening by the Fed, dividend-paying stocks may be more affected because of their interest rate sensitivity. However, based on our expectation that rates will remain low, we believe demand for dividend-paying stocks will remain strong given competitive yields. Short-term, increased volatility around Fed policy is to be expected as all interest rate sensitive investments face uncertainty.

A BREAK IN THE HONEYMOON

Investors are demanding more economic specifics from the Japanese government.



Left Axis: Nikkei 225 Total Return Index (x 1,000 yen)
Right Axis: Yen per dollar
Sources: Northern Trust, Bloomberg

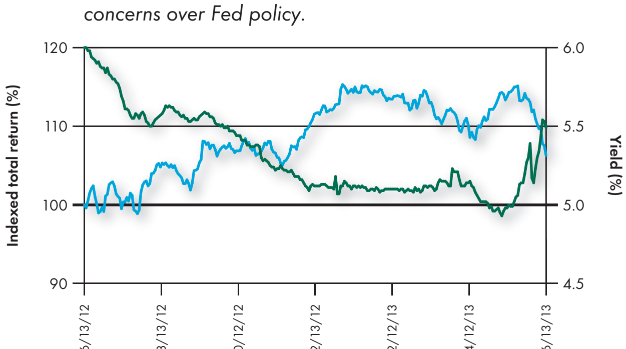
EUROPE & ASIA-PACIFIC EQUITY

- The yen appreciated while the Nikkei 225 Total Return Index declined.
- Sovereign yields rose across Europe.

We've seen violent reversals in Japanese markets as investors (global and domestic) reassess the Bank of Japan's actions and the prospects for Abenomics in a world where the market worries about the Fed's commitment to its easy money policies. After a triumphant start to his premiership, we're witnessing the first real test for Abe. Thus far, markets have been unimpressed with the response. European markets have also come under pressure, as German and Spanish/Italian sovereign yields rose in concert for the first time since 2010. It seems unlikely that the Fed will disengage, but volatility in Japan and Europe provides a stark reminder of how far from a so-called "normalized environment" global capital markets are operating in. In this environment, we think developed-market investors will favor U.S. equities.

BUFFETED BY BERNANKE?

Emerging-market stocks and bonds have been hit by concerns over Fed policy.



Left Axis: Indexed total return (%)
Emerging-market equities local currency
Right Axis: Yield (%)
Emerging-market debt local currency
Sources: Northern Trust, Bloomberg

EMERGING-MARKET EQUITY

- Recent capital flows have been leaving emerging markets.
- Investor expectations have become modest.

Concerns over reduced liquidity from the Fed have rippled through the emerging equity and debt markets. Growth forecasts have followed the softer trends in developed markets, as expectations for benchmark countries like China, Brazil, South Korea, India and Mexico have all been reduced. The inflation picture is more balanced, as inflation above target in India and Brazil is offset by a constructive inflation picture in China, South Korea and Mexico. Even though emerging-market equities have been disappointing this year, we continue to believe that the longer-term outlook is constructive and that worries about the Fed should begin to moderate. Emerging-market equities will need greater economic momentum to begin outperforming, but the current 28% discount to world equities gives some valuation cushion.

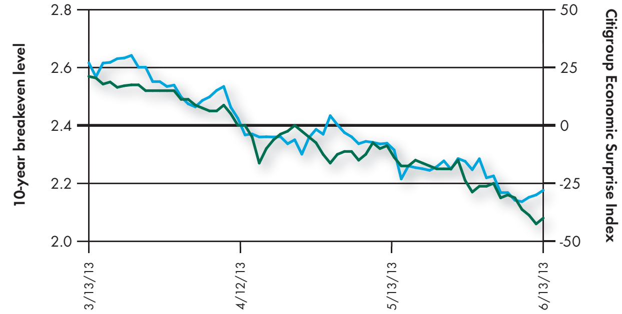
U.S. FIXED INCOME

- U.S. Treasury yields have risen sharply since the beginning of May.
- The rate spike primarily is attributed to concerns about the Fed's bond purchase program.

Since the beginning of May, fixed income markets have suffered through a jump in interest rates brought on by concerns that the Fed will begin reducing its asset purchases in the near future. We think these fears are overdone. The rise in yields hasn't been accompanied by better economic data, as shown by a negative Economic Surprise Index. The rise isn't due to higher inflation expectations either, as 10-year U.S. Treasury Inflation-Protected Securities' breakeven levels have steadily fallen the past few months. When the Fed eventually decides to reduce the size of its asset purchases, which will be long before it raises short-term interest rates, we don't believe this will surprise the market and lead to a significant rise in long-term interest rates.

SLOWING GROWTH, SLOWING INFLATION

The jump in interest rates hasn't been caused by upturns in growth or inflation.



Left Axis: U.S. 10-year U.S. Treasury Inflation-Protected Securities' breakeven level
Right Axis: Citigroup Economic Surprise Index
Sources: Northern Trust, Bloomberg

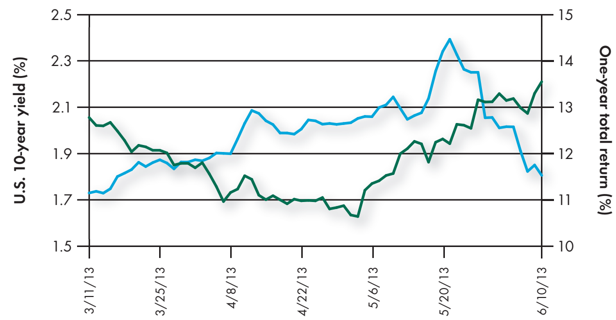
U.S. HIGH YIELD

- Fed statements have resulted in uncertainty about monetary policy.
- Interest rate uncertainty has hurt BB-rated bond returns.

The Fed's comments about potentially changing its pace of bond purchases have rippled through the high yield bond market. Although high yield has historically performed well in a rising rate environment, certain segments of the market are more rate sensitive than others. As rates rose recently, the BB segment of the market was affected most negatively, as returns fell 0.92% while CCC securities posted a 0% return. Despite having lower default risk, BB bonds carry greater interest rate risk. The impact on trading levels is greater than the yield calculation would imply — because high yield managers don't hedge interest rates, increased volatility can occur. We think this demonstrates the importance of managing interest rate exposure through portfolio construction and active management.

ALL ARE NOT EQUAL

More interest rate sensitive bonds have underperformed their lower-quality counterparts.



Left Axis: U.S. 10-year yield (%)
Right Axis: High yield, 2% issuer cap BB component, one-year total return (%)
Sources: Northern Trust, Bloomberg

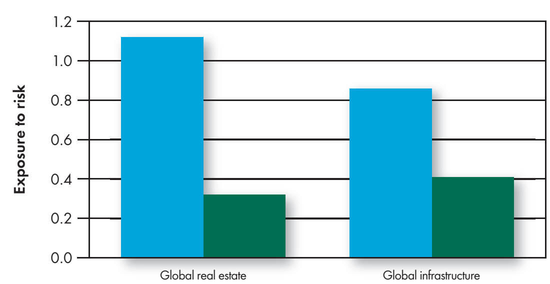
REAL ASSETS

- Fears of QE3 tapering have increased perceived interest rate risk.
- Real estate and infrastructure assets can provide income with less exposure to interest rate spikes.

Recent comments from Fed Chairman Bernanke have created concerns that quantitative easing will be tapering off and interest rates will rise. We have a more benign view on the prospects of an interest rate spike, but we recognize the risk. One way to add potential yield to a portfolio, while also positioning for this risk, is investing in global real estate. Global real estate has a high exposure to equity risk, but approximately one-third the exposure to interest rates. For those investors hesitant to take on this level of equity risk, global infrastructure may serve as a substitute, but it will come at the expense of a higher exposure to interest rates than exists in global real estate.

A SIDE OF INTEREST RATE EXPOSURE, PLEASE

Cash flow assets provide potential income with less interest rate risk.



Left Axis: Exposure to risk
- Equity risk (percentage move for every 1% move in equities)
- Term risk (percentage move for every 1% move in fixed income)

Monthly data from 3/30/03 through 3/30/13
Sources: Northern Trust, Bloomberg

CONCLUSION

Market volatility has jumped during the last month in the wake of increased policy uncertainty in the United States and Japan. In contrast to similar episodes during the last several years, stock and bond prices have moved in tandem — hurting short-term portfolio returns across the board. The move higher in the U.S. 10-year Treasury yield from 1.63% in early May to nearly 2.20% highlights the asymmetric risk of bond investing today. With nominal yields so low today, relatively small moves in interest rates can result in a negative total return. However, we think the fear of major losses in the bond market is misplaced. Not only do we think interest rates are likely to be well behaved during the next year, but major losses can occur only if the bond isn't held to maturity or if the borrower isn't creditworthy.

While we believe the Fed will be tempered in tapering its bond purchase program, this possibility will now be part of market deliberations going forward. A key for financial markets is how the Fed communicates its intentions — and we expect it to continue to stress the contingent nature of its commitment. What the markets crave most is predictability, such as during the Fed Funds rate-hike cycle of 2004. What the markets fear is the Fed getting aggressive and having to raise rates at an unexpectedly rapid pace, as occurred in 1994. We think this cycle is likely to rhyme with 2004, but at an even more gradual, steady pace.

Even though the United States has been a strong performer, emerging-market equities have disappointed because of growth concerns and changes in capital flows. With expectations for these stocks now low, valuations have become more attractive. We continue to find attractive yield in the U.S. high yield market and we still favor it over the investment-grade bonds in the risk-on market environment. While high yield has sold off during the recent jump in interest rates, we believe its return outlook is attractive, as we expect rates to stabilize and growth to continue its current moderate pace.

Jim McDonald
Chief Investment Strategist

The general meaning of the credit ratings BB, B and CCC, are expressed in Standard & Poor's nomenclature: BB — Less vulnerable in the near-term but faces major ongoing uncertainties to adverse business, financial and economic conditions, B — More vulnerable to adverse business, financial and economic conditions but currently has the capacity to meet financial commitments, CCC — Currently vulnerable and dependent on favorable business, financial and economic conditions to meet financial commitments.

Barclays U.S. Corporate High Yield 2% Issuer Cap Index is an unmanaged index of the 2% Issuer Cap component of the Barclays U.S. Corporate High Yield Index, which is a market value-weighted index of fixed rate, taxable, non-investment grade fixed income securities.

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.

The Nikkei 225 Total Return Index measures the performance of the Nikkei 225 that includes both movements in the index level and reinvestment of dividend incomes from its component stocks.

Russell 3000 Index measures the performance of the largest 3000 U.S. companies representing approximately 98% of the investable U.S. equity market.

It is not possible to invest directly in an index.