Perspective

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

June 17, 2014

OUTLOOK

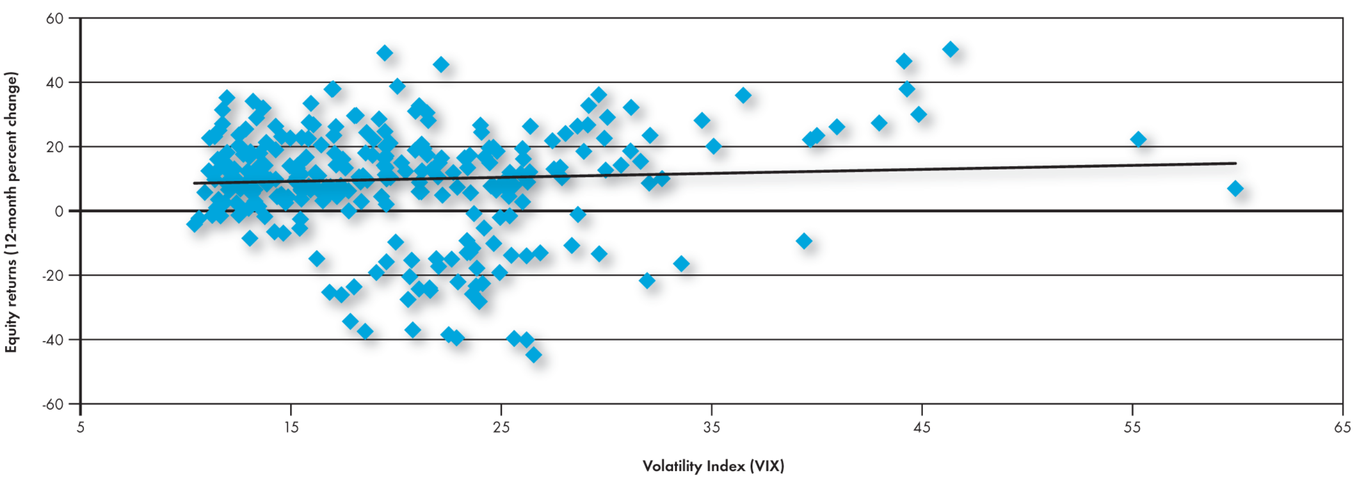
As key stock markets in the United States and other countries flirt with new highs, investors are increasingly asking what could change the positive environment. As valuations have expanded in many asset classes, the margin of safety has steadily eroded. Investor uncertainty also seems low in today's markets, but as shown in the chart below, there's no relationship between market volatility and the subsequent returns of the equity market. Central bank policy seems unlikely to derail the calm during the next year, as the European Central Bank's (ECB's) more dovish posture offsets the potentially higher rate outlook from the United Kingdom. This leaves us concluding that the key drivers of asset class returns during the next year will be global growth and inflation — on which our outlook is relatively sanguine.

Economic data has regained momentum in recent months, with manufacturing surveys in developed economies like the United Kingdom and United States showing the best momentum, while emerging economies like Brazil, Russia and China are at the back of the pack. Global new orders and output in manufacturing showed a solid increase in May over April. The United States has also seen positive signals from auto sales and bank credit, while housing remains a disappointment. The pace of European growth moderated somewhat in May, but is still expanding and being helped by improvement in cyclical areas, like automobile sales. Emerging-market growth remains mixed, but stabilization in Chinese growth data and the election of a reform-minded leader in India have proven to be positives for those markets.

Our framework for assessing geopolitical risks is relatively straightforward. Does the event in question have the potential to materially affect the outlook for global growth or inflation? If not, history suggests that financial markets will look past the event in reasonable order. So far the events in Ukraine fit this bill. The recent turmoil in Iraq, however, has the potential to affect both growth and inflation through a disruption in oil supplies. While Iraq's oil production currently appears secure, this risk will remain front and center in our analysis. So far, energy markets have been relatively calm with Brent Crude trading at $113 per barrel, modestly above its $109 per barrel average over the last year.

SHOULD WE WORRY ABOUT LOW VOLATILITY?

There's been no relationship between volatility and future market returns.



Left Axis: S&P 500 equity returns (12-month percentage)

Bottom Axis: Volatility Index (VIX)

Note: Monthly data, Jan. 1990 – May 2013

Sources: Northern Trust, Bloomberg

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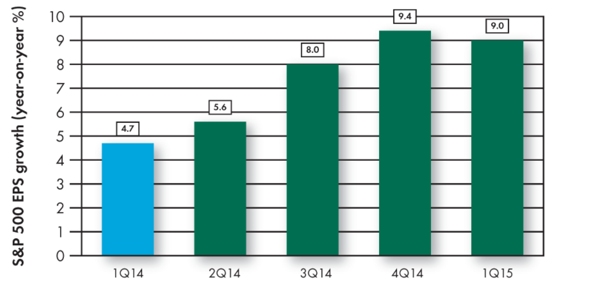
U.S. EQUITY

- Earnings estimate revisions have turned positive following a tough first quarter.
- Earnings growth remains key to additional market appreciation.

After experiencing negative earnings estimate trends through the first quarter, revisions have moved higher during the past several weeks. Positive revisions during the last month have been most notable in technology, energy and health care, which not coincidentally have also been the best performers. We've argued for some time that, with much of the gains last year coming from multiple expansion, further upside in the market will be driven largely by earnings growth. Even though we're generally skeptical of the embedded optimism in accelerating second-half earnings growth that often finds its way into estimates (see accompanying chart showing consensus earnings growth during the next four quarters), we were encouraged by first-quarter earnings results and the modestly improved outlook going forward, increasing our confidence in further upside potential in equities.

ACCELERATING EARNINGS GROWTH

Positive earnings revisions support an improving growth outlook.



Left Axis: Earnings per share (EPS) growth (year-on-year %)
Actual S&P 500 EPS growth
Forecasted S&P 500 EPS growth
Note: Data through 5/15/14
Sources: Northern Trust, FactSet

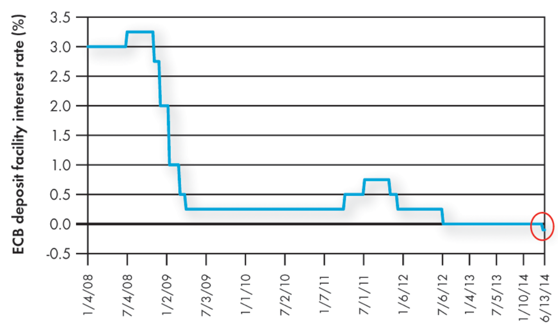
EUROPEAN EQUITY

- Perhaps the World Cup will divert attention from European austerity.
- Unrest in Iraq and Ukraine are potential issues for Eastern Europe.

European leaders are breathing a sigh of relief as the World Cup kicks off, diverting public attention, and opinion, from Europe's various issues until the middle of July. This may allow European leaders respite from public scrutiny in order to resolve the issue of European Commission leadership. The European Central Bank (ECB) has potentially taken its last pre-quantitative easing monetary action by reducing rates to 0.10%, driving deposit rates into negative territory and introducing a new liquidity facility. Equity markets had the move priced in; however, it remains to be seen whether the banks have the confidence to lend. On the eastern side of Europe, the new Iraq crisis looks to pose both political and energy supply issues to at least rival, if not surpass, the recent issues in Ukraine.

EMPTYING OUT THE CUPBOARD

Negative deposit rates indicate the ECB's interest in avoiding deflation.



Left Axis: ECB deposit facility interest rate (%)
Sources: Northern Trust, Bloomberg

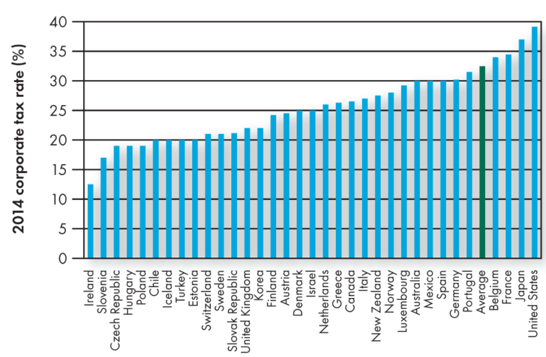
ASIA-PACIFIC EQUITY

- Japan has a new national holiday — Mountain Day.
- Prime Minister Abe's "Third Arrow" may include looser investment remit for the GPIF.

Abenomics has another bonus for Japan's legions of "salarymen:" a 16th public holiday named Mountain Day. This may be a ruse to distract from the arrival of Abe's "Third Arrow," which reportedly includes reviewing investment guidelines for the Government Pension Investment Fund (GPIF), specifics on lowering corporate income tax rates and revamping the health insurance system. It remains to be seen whether the "Third Arrow" will hit its mark for the economy or equities markets, as any reduction in the corporate tax rate may be offset by lower deductions to offset the lost revenue. Additionally, the GPIF historically has been slow to implement change and has a fiduciary mandate. The decline in Japanese equities year-to-date is clearly discounting some disappointment on the reform front.

ABE TO TACKLE TAXES NEXT?

Japan's high corporate tax rate is a visible target for reform.



Left Axis: 2014 total corporate income tax rate (%)
Note: Average weighted by 2012 GDP
Sources: Northern Trust, OECD

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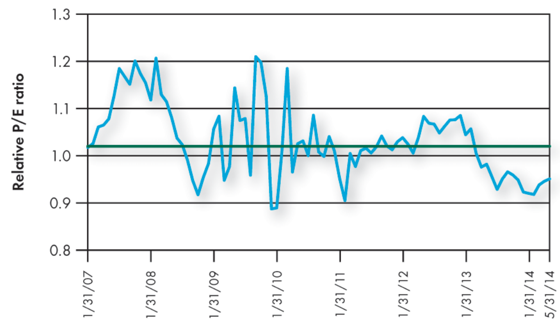
EMERGING-MARKET EQUITY

- Overall growth momentum remains subdued.
- A valuation discount exists, but its magnitude is less than headline valuations.

There's been some improvement in sentiment toward emerging-market investments this quarter, bringing year-to-date performance in line with other major regions. China's "mini-stimulus" appears to be putting a floor under its growth trajectory, while Indian stock markets are benefiting from enthusiasm toward the prospects for reform under new Prime Minister Narendra Modi. However, the collective growth figures for emerging markets remain subdued. While stocks appear cheap at 13.3x earnings, compared to 17.9x for developed markets, this is partially a result of the higher concentration of lower-valued sectors in emerging markets (such as energy and financials). When you equalize the sector weightings, emerging markets are valued at 17x earnings. As shown in the accompanying chart, this is a discount to history but less than the 26% discount implied by the headline valuations.

A LITTLE CHEAP

Sector-neutral emerging-market valuations show a 5% discount to developed equities.



Left Axis: Relative P/E ratio
Emerging-market and developed-market sector-neutral P/E comparison
Median
Note: EM sector weights equalized to DM weights, EM divided by DM
Sources: Northern Trust, MSCI

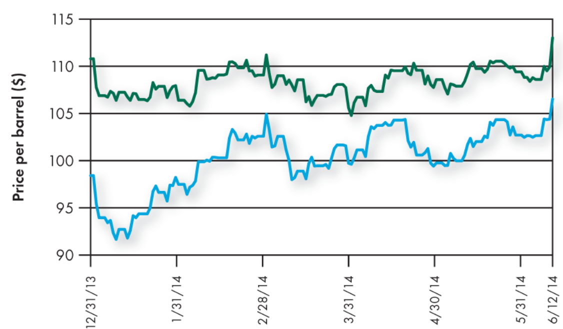
REAL ASSETS

- Insurgency in Iraq increases the risk premium in oil prices.
- Fundamental supply/demand factors haven't yet deteriorated.

After spending most of the year hitting an invisible ceiling, oil prices broke into new territory because of developments in Iraq. The country is the eighth-largest producer of oil in the world; its 3.2 million barrels a day represent about 4% of the total global production. Thus far, the oil price spike is based on the fear of lost production, as fighting has remained north of the main oil production facilities. Should Iraq go offline completely, the excess capacity in the global oil market would be completely utilized. We often note that geopolitical events are typically shrugged off by financial markets unless they change the fundamental outlook. While Iraq remains just a risk case, a significant disruption to global oil supplies would be a clear negative for growth, inflation and risk taking.

BREAKOUT!

Recent unrest in Iraq has pushed oil prices through previous highs.



Left Axis: Price per barrel ($)
Brent crude oil
WTI crude oil
Sources: Northern Trust, Bloomberg

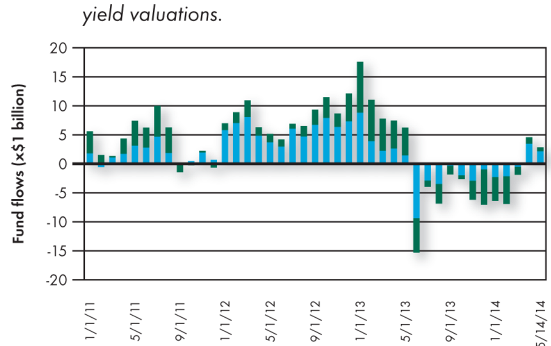
U.S. HIGH YIELD

- The ECB further eased policy on June 5.
- ECB actions reduce potential risks to high yield market valuations.

The ECB took multiple actions to further ease monetary policy on June 5. Beyond the positive effect on European high yield issuers, the high yield market benefits from the impact that the ECB's actions have on currency rates. The only weak period the high yield market has seen thus far this year occurred during emerging-market currency pressures at the end of January. The ECB's actions should weaken the euro on the margin. This, combined with lower yields on U.S. Treasuries restraining the dollar, reduces the risk of an emerging-market downturn in the second half of the year. As a result, emerging-market debt has had positive inflows for the past two months, which we believe is positive for high yield valuations.

A RISING TIDE ...

Improved emerging-market sentiment helps high yield valuations.



Left Axis: Fund flows (x$1 billion)
EM bonds – local currency fund flows
EM bonds – hard currency fund flows
Sources: JP Morgan, Barclays Capital, EPFR, Northern Trust

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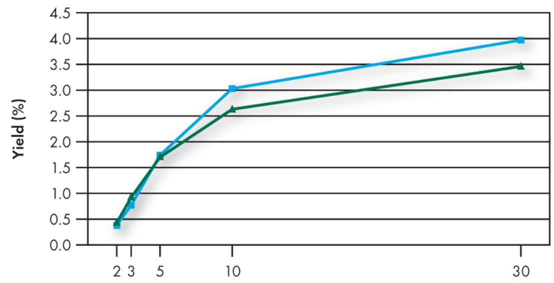
U.S. FIXED INCOME

- While longer-term yields have declined this year, a decline hasn't happened across the entire curve.
- Yields on Treasury notes with shorter maturities have actually been rising.

Even though 10- and 30-year yields have fallen this year, two- and three-year yields have actually increased. We believe these maturities are being affected by the Federal Reserve's outlook, and the Fed's most recent projections show it believes the Federal Funds rate will begin to rise in the middle of 2015. We believe the evolution of data on economic growth and inflation will be what ultimately determines the timing of increases in the Fed Funds rate. That said, the rise in short-term yields suggests investors are hypersensitive to the Fed's outlook. We remain constructive on the outlook for interest rates because we don't expect either a growth surprise or a jump in inflation to prematurely force the Fed's hand.

A BIT OF A TWIST

Short rates have edged up, while long rates have rallied nicely.



Left Axis: Yield (%) **Tenor**
U.S. Treasury yield curve – 12/31/13
U.S. Treasury yield curve – 6/11/14
Bottom Axis: Tenor (years)
Sources: Northern Trust, Bloomberg

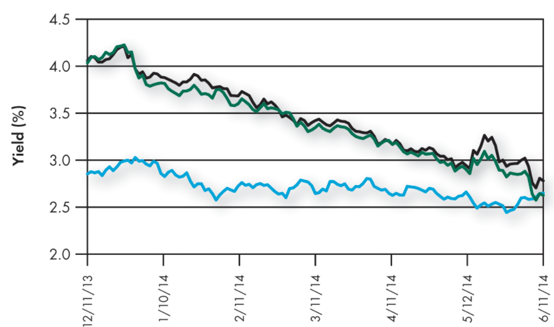
EUROPEAN FIXED INCOME

- The ECB takes action, continuing its extend-and-delay strategy.
- Risk markets reacted positively to the ECB policy move.

On June 5 the ECB became the first major central bank to take a policy rate negative when it lowered both the refinancing and deposit rates by 10 basis points. In addition, the ECB deployed a raft of liquidity measures, including a targeted long-term financing operation and the end of sterilization of the Securities Markets Program. Initial market reaction has been positive, with a falling euro, rising peripheral bond prices and a continued strong bid for credit. With the level of detail, operational complexity and an elongated implementation time frame, it's best to think of the announcements as a continuation of the extend-and-delay strategy that the ECB has been pursuing since at least 2010. If we get to the end of the year with rising spot inflation and a successful asset quality review, then perhaps a full-blown quantitative easing program can be avoided.

FEW STONES LEFT UNTURNED

The global search for yield has led to interest-rate convergence globally.



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

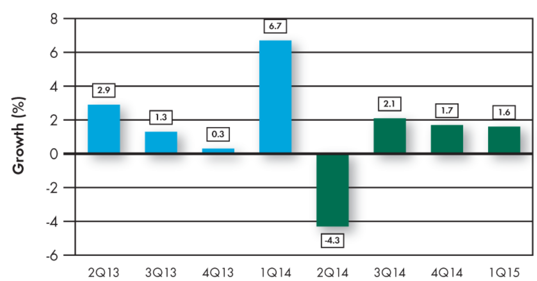
ASIA-PACIFIC FIXED INCOME

- China adopts targeted easing via reserve requirement relaxation.
- Japanese first-quarter growth is revised up.

During the last month, China has taken small steps to boost growth by cutting the amount of reserves certain banks are required to hold at the central bank. The move was targeted at those banks focusing on either rural or small-business loans. This follows a similar move in April and is indicative of the desire to avert continued rampant credit growth in areas of overcapacity while continuing to meet a growth target of 7.5% for 2014. Japan revised up first-quarter growth to an annualized rate of 6.7% (from 5.9% in the first estimate). A strong showing was widely expected given a value-added tax (VAT) hike in April bringing forward demand, but the market will be focusing on the pace of growth starting in the third quarter, when the VAT hike will be normalized.

IT'S THE REBOUND THAT MATTERS

Policy makers will look to second-half growth to gauge Japan's outlook.



Left Axis: GDP growth (%)
Japan's actual GDP growth
Consensus estimate of Japan's GDP growth
Note: Quarter-on-quarter growth at a seasonally adjusted annual rate
Sources: Northern Trust, Bloomberg

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CONCLUSION

In last month's *Perspective*, we wrote that reaccelerating global growth during the next two quarters would be a key validation of our view that stocks should outperform bonds during the next year. In fact, improving global manufacturing data during the last month has underpinned the rally in global markets so far this quarter. Not only have large-cap indexes rallied nicely, but more volatile groups, such as emerging-market and small-cap stocks, have also regained momentum. The credit markets are signaling little cause for concern, as spreads on both investment-grade and high yield bonds have rallied this quarter. Yields on U.S. Treasury securities have also risen during the last month, coincident with the better growth data.

Our asset allocation committee discussions this month centered around potential "triggers" that could lead to a downgrade of our tactical overweight to risk assets, such as equities. Central bank policy has become modestly more accommodative during the last month with the ECB's rate cuts and new liquidity facility. Current valuations are somewhat elevated but reflective of the low-interest-rate environment. The S&P 500 is trading on 17.7x trailing earnings, a 7% premium to its median over the last 60 years. This premium is justifiable given the low inflation and interest-rate environment, but leaves earnings growth to handle the heavy lifting for equity returns during the next year. This leaves us focusing on negative growth or inflation surprises as our potential "triggers" for a reassessment of the outlook for risk taking.

With earnings growth the key to equity returns during the next year, the bar for global growth has been raised. This illustrates our two primary risk cases discussed in recent months: disappointing economic growth in the United States and negative effects on the global economy from emerging-market weakness. What other risks or "triggers" might crop up to surprise us? A significant disruption in the flow of Iraqi crude could be a serious setback for the economy and markets. The unsettled situation in Ukraine could spiral out of control, threatening Europe in particular. While neither situation currently looks likely to affect global growth or risk taking, we'll be keeping a watchful eye out for changes in the outlook. With a constructive outlook for growth and inflation during the next year, we made no changes to our global tactical asset allocations this month.

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.

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