Perspective

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

July 15, 2014

OUTLOOK

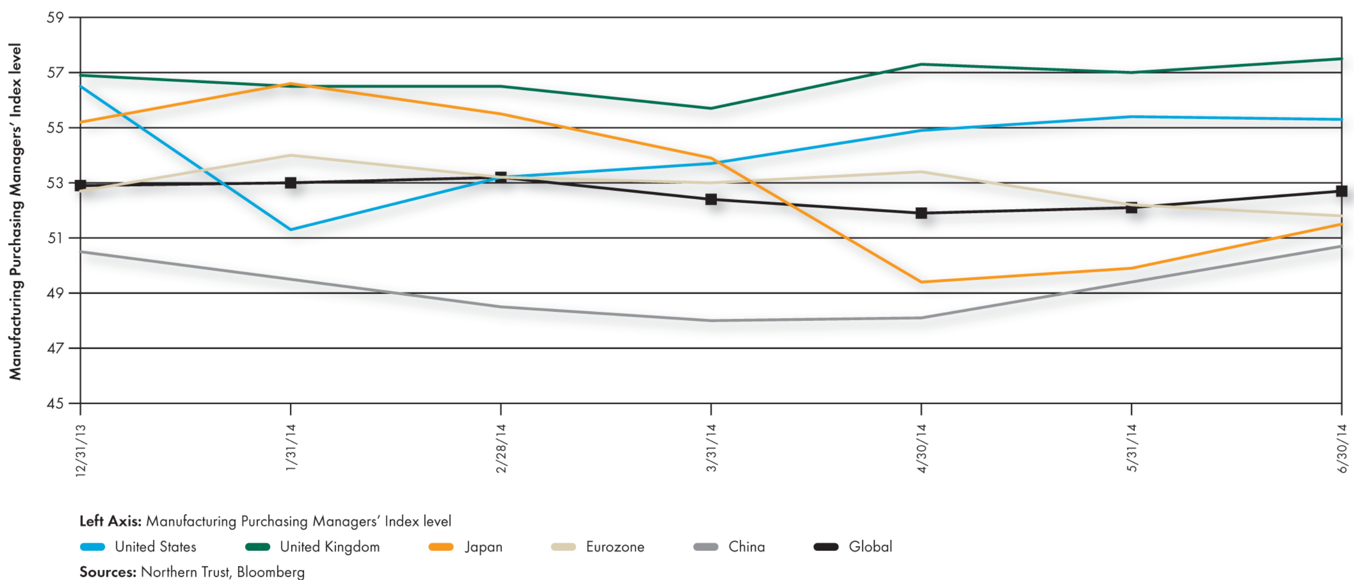
Low market volatility belies the volatility surrounding the fundamental economic and investment outlook. Is the recent report of -2.9% first-quarter U.S. growth a harbinger of economic troubles to come? Is Federal Reserve Chair Janet Yellen beginning to tire of the low interest rates on her savings? Is World War III about to simultaneously break out from Eastern Europe to the Middle East to the East and South China Seas? Despite investor uncertainty around these issues, market volatility across financial markets has remained historically low. We think the recent market action highlights the importance of tuning out the noise of short-term data and focusing on the intermediate- and long-term fundamental outlook.

As shown below, regional growth differentials have been considerable this year but the global aggregate numbers have been much steadier. The recent revision to first-quarter U.S. gross domestic product (GDP) is looking increasingly dubious; it was mostly caused by a reduction in estimated health care spending (17% of GDP) from 10% to -1%. U.S. employment has been gaining steam this year, and surveys of U.S. manufacturing companies are the strongest in the world. Growth in Europe has slowed some in the second quarter, while sentiment surveys indicate Japan should see a rebound in the third quarter. Economic reports across the emerging markets have also shown some improvement, although momentum is still subpar.

In this slow but steady economic environment, most developed countries' central banks are in no hurry to consider tightening monetary policy. While we're seeing some progress in reducing the U.S. unemployment rate, inflation is still benign and overall wage gains have been stuck at 2% for three years. We've also seen some moderation of risks in Ukraine, where the government is gaining increasing control, and in Iraq, where oil supplies currently appear secure. The potential of a flare-up in the East or South China Seas remains a longer-term risk, but appears to currently be in no one's interest. In this environment, it's critical to block out market noise and focus on investment fundamentals. Despite a slimmer margin of safety in most asset classes, we expect risk assets to continue to outperform investment-grade bonds and cash as investors value growth in this moderate growth environment.

TUNING OUT THE NOISE

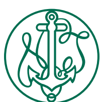
Aggregate global growth signals smooth out regional volatility.



Left Axis: Manufacturing Purchasing Managers' Index level

United States | United Kingdom | Japan | Eurozone | China | Global

Sources: Northern Trust, Bloomberg



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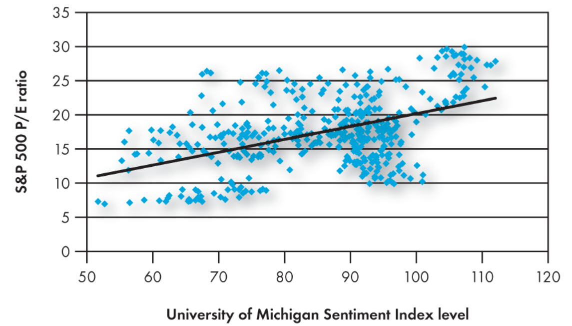
U.S. EQUITY

- Consumer confidence continues to improve as the economic recovery progresses.
- Improving sentiment is supportive of multiples and our equity outlook.

Although the U.S. economy's pace of growth coming out of the downturn has been disappointing, it has clearly led to appreciating housing values and better employment opportunities. These macro-level improvements have led to a virtuous cycle whereby growing confidence in the future increases animal spirits and the willingness to invest in riskier assets, generally driving equity prices higher, which reinforces consumers' current and future prospects. Given the most recent University of Michigan Consumer Confidence Sentiment reading of 82.5, and past cycle average readings in the low 90s, we think the market has room to move higher. This improvement won't happen without a concurrent improvement in the corporate earnings environment, where we expect growth of 10% during the next year to also support equity returns.

ANIMAL SPIRITS

Consumer sentiment and equity multiples go hand-in-hand.



Left Axis: S&P 500 P/E ratio
Bottom Axis: University of Michigan Sentiment Index level
Note: Monthly data 1980 through June 2014
Sources: Northern Trust, Bloomberg

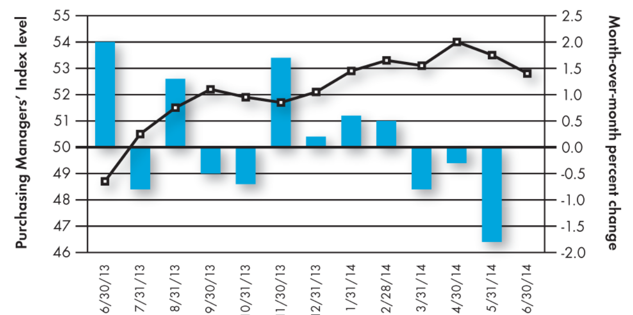
EUROPEAN EQUITY

- Weak May industrial production data was influenced by holiday schedule.
- Eurozone-wide economic activity is expanding more steadily than industrial production.

As "Die Mannschaft" sparked scenes of jubilation around Germany after winning the World Cup, investors were more focused on the strength of recent economic reports. Even though there's been some softening in recent reports, a broad measure of manufacturing and services across the eurozone is more comforting. We expect European companies to continue to benefit from global growth, as they're more globally focused than their developed-market counterparts, and earnings growth of 12% is expected to best the United States, United Kingdom and emerging markets. We also expect the European Central Bank to continue its easy policy, contrasting with the plans of the U.K. and U.S. central banks to gradually normalize policy. Finally, the dividend yield of 3.2% is attractive relative to both U.S. stocks (at 2%) and European debt (German 10-year yield of 1.2%).

NOISY DATA

Holiday-induced May weakness isn't signaling an economic downturn.



Left Axis: Eurozone composite PMI level
Right Axis: German industrial production (month-over-month percent change)
Sources: Northern Trust, Bloomberg

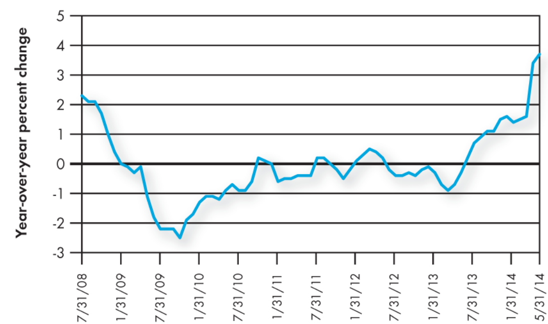
ASIA-PACIFIC EQUITY

- The "third arrow" has been re-launched.
- Inflation needs to be matched with sustained wage gains.

Japan remains one of the only post-credit-crunch economies geared toward creating inflation at almost any cost. Significant quantitative easing has been married to numerous other strategies to try to provoke the country's economy into reflating itself. Currently, the first two "arrows" of Premier Abe's strategy appear to be placing Japan on a path to increase growth. With the recent version of the "third arrow" focused on reform, including attempts to modernize labor markets and lower corporate taxes, the task is harder. Labor market reforms will include a focus on specialists (and their value-add) instead of hours worked. Progress could be made on Japan's relatively high corporate tax rates, but fiscal constraints will cap the impact. Japanese stocks have had a rocky first half of the year, but have regained momentum of late, suggesting some improvement in the growth outlook.

INFLATING EXPECTATIONS

Continued inflationary trends are a hopeful sign of policy progress.



Left Axis: Japan inflation (year-over-year percent change)
Sources: Northern Trust, Bloomberg

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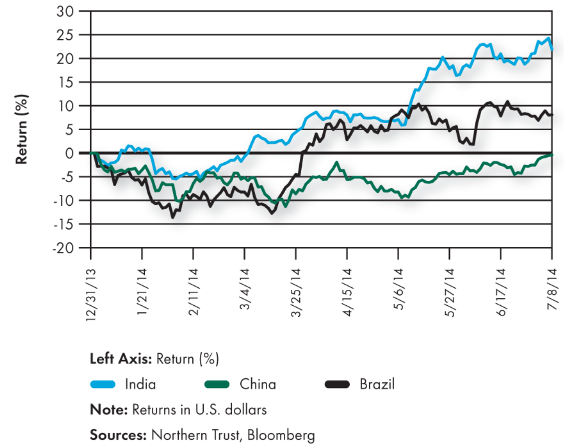
EMERGING-MARKET EQUITY

- Indian markets are benefiting from a reform rally.
- Brazilian markets would likely rally if reform were on its way.

The 2014 election cycle is a powerful one for emerging markets, while generating little change in the developed world. The election of India's reform-minded prime minister, Narendra Modi, has provided a fillip for Indian stock markets. Meanwhile, the struggling Brazilian economy would welcome a change this October, but incumbent President Dilma Rousseff currently appears to be the favorite. With China's government firmly in place for more than a year, anticorruption efforts have pinched growth while the administration tries to rebalance from investment and exports to consumption. The disproportionate impact that elections and governmental change is having on emerging markets highlights the increasing heterogeneity of this equity class. We believe a broad upturn in economic momentum is required for these shares to outperform the developed markets.

THE POWER OF REFORM

Reform, or lack thereof, has been a market driver this year.



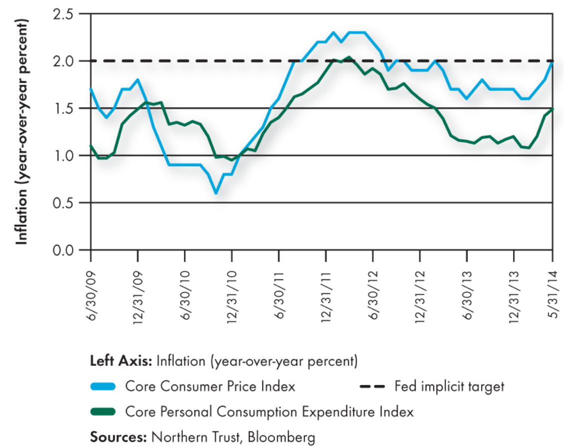
REAL ASSETS

- Recent inflation pressures are expected to roll over.
- We continue to maintain real asset allocation recommendations around strategic levels.

Inflation has recently been rising in the United States. The core Consumer Price Index (CPI), which excludes volatile food and energy prices, has risen to 2% year-over-year from 1.6% at the beginning of the year. The core Personal Consumption Expenditure (PCE) Index, the Fed's preferred measure of inflation, has also begun to rise, albeit from lower starting levels. Similar increases have been built into inflation expectations — per the breakeven rate on Treasury inflation-protected securities. We believe the recent inflation uptick will prove transitory. Year-over-year wage gains — generally needed for sustained inflation — are still hobbling along at around 2%, while subdued global demand and spare capacity argue for contained inflation. As such, we continue to recommend a strategic positioning — but not an overweight allocation — to real assets.

EXITING THE DISINFLATIONARY FUNK?

After two years of subdued price increases, inflation readings have begun rising.



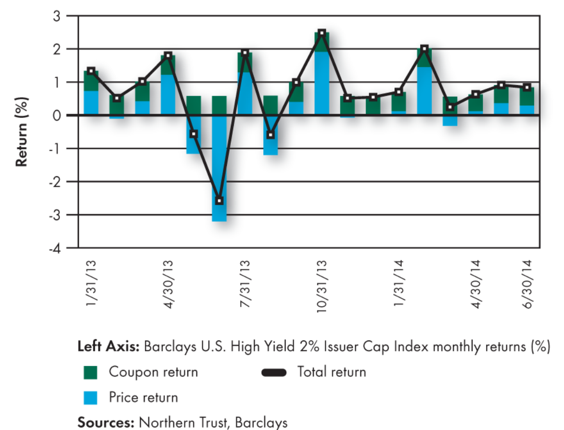
U.S. HIGH YIELD

- High yield market returns have been driven by the coupon in 2014.
- The coupon return adds to the attractiveness of the high yield asset class.

In the first half of 2014, the high yield market generated a strong return of 5.5%. The majority of this has been generated by the coupon return of 3.5%, while the price-driven return was 2%. On a price basis, the market has steadily improved after the interest-rate-driven revaluation in May 2013, but is just back to the levels of January 2013. Although the market is providing an excess return relative to default loss expectations on a spread basis, the limiting factor on valuations has been an absolute yield in the area of 5%. This has constrained price improvement, but highlights the importance of the coupon in high yield. The coupon doesn't need growth, a strong economy or spread tightening to generate return.

REAL CASH RETURNS

The majority of year-to-date returns have come from coupon return.



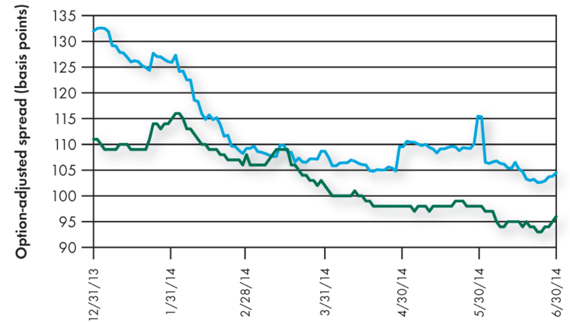
U.S. FIXED INCOME

- Commercial real estate fundamentals continue to improve.
- We believe commercial mortgage-backed securities (CMBS) offer value in this low-rate environment.

As the economy improves, we expect continued broad-based improvement in commercial real estate fundamentals. The sector continues to recover, with several years of improving delinquency rates and loan resolutions providing support for our fundamental case. There's been little new construction during the current economic expansion, providing owners pricing power as the economy has expanded and empty space is absorbed. The long lead cycle required to bring new commercial construction into the market leads us to believe pricing will remain favorable for landlords during the next few years. CMBS offer significant yield in comparison to cash or U.S. Treasuries, and look attractive relative to lower-rated corporate bonds as well. Overall, the lack of new issuance this year provides a positive technical aspect supporting this asset class.

RELATIVELY ATTRACTIVE

CMBS look attractive relative to their competition.



Left Axis: Option-adjusted spread (basis points)

Commercial mortgage-backed securities (CMBS) spread

Barclays U.S. Aggregate Credit spread

Sources: Northern Trust, Bloomberg, Barclays Live

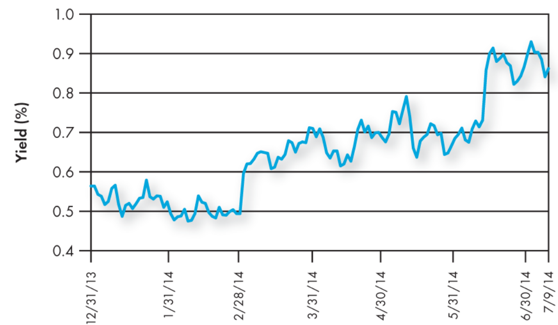
EUROPEAN FIXED INCOME

- U.K. interest rates are set to rise.
- Sweden cut interest rates to stave off a deflationary threat.

Bank of England (BoE) Governor Mark Carney caught markets flat footed at his annual Mansion House speech by expressing surprise that markets were attaching such a low probability to a rate hike this year. Reaction was swift, with participants moving to fully discount a November rate rise. Subsequent BoE comments sought to focus not on the timing of any rate hike, but rather the pace and terminal value of a tightening cycle. The message is clear: gradual and significantly lower than previous cycles. Governor Carney also unveiled some precautionary measures aimed at the bubbling housing market; however, this failed to produce any meaningful impact and should be thought of as a constraint on high multiple lending. Another non-euro European Union country, Sweden, moved in the opposite direction. Having previously implemented a macro-targeted policy, the Riksbank recently cut interest rates to combat persistently low inflation.

THE RISING U.K.

A change of tone in the United Kingdom leads to rising interest rates.



Left Axis: Two-year U.K. government note yield (%)

Sources: Northern Trust, Bloomberg

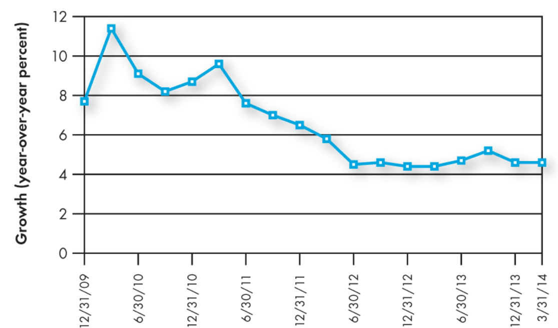
ASIA-PACIFIC FIXED INCOME

- Japan Prime Minister Abe's "third arrow" is launched again.
- India Prime Minister Modi's "first arrow" is readied.

The "third arrow" of Japan's reform strategy has received underwhelming reaction compared with arrows one and two. This month, a new, seemingly more substantive, growth strategy has been produced. This will include corporate tax cuts and a more performance-based pay structure in the labor markets. Meanwhile, markets have eagerly anticipated the "first arrow" (government budget) from India's new Prime Minister Modi. Expectations are running high; however, structural budget deficits and entrenched inflation must be balanced against lofty ambitions to increase investment and competitiveness. In the long term, we believe tax revenues need to rise, subsidies need to fall and competitiveness needs to increase. Potential, as always in India, is enormous. Modi's task is to channel that through appropriate reform.

RIPE FOR REFORM

India has generated disappointing growth in recent years.



Left Axis: India real GDP growth (year-over-year %)

Sources: Northern Trust, Bloomberg

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CONCLUSION

In the first half of 2014, investors were rewarded in pretty much every asset class except cash. Equities were broadly in the black, with global developed-market equities advancing 6.6%, U.S. stocks gaining 7% and emerging-market stocks up 6.5%. Fixed income markets benefited from the global drop in yields, with the U.S. 10-year Treasury yield dropping 0.50% to 2.53% in the first half of the year. Credit spreads responded to positive equity markets by further tightening. The biggest winners were yield-oriented assets such as global infrastructure and utilities, up nearly 16% and 19%, respectively.

To some extent, financial markets are discounting an improving growth outlook that companies must now deliver on. We expect earnings growth in developed markets (led by Europe) of 11% over the next year, while we forecast earnings growth of 10% in the United States and 7% in the emerging markets. Achieving growth near these levels, along with constructive management commentary about the growth outlook, is critical for stock market returns, as valuation expansion has carried the majority of the weight in recent years. Particular focus will be paid to the trajectory of growth in Europe and Japan, as their economies have shown less vibrancy than those of the United States and United Kingdom. We expect that, when you add up the scorecard across the principal global economies over the next year, growth will be sufficient to support risk taking in the markets.

With little change in recent months in the building blocks for our global asset allocation outlook (such as growth, inflation and monetary policy), we made no changes to our allocations this month. We remain constructive on the relative return potential of stocks over bonds; however, the massive bearishness on interest rates means there aren't many left to sell. U.S. interest rates remain above most developed markets, and well above our counterparts in Europe and Japan. While much commentary during the next year will focus on the risk from an increase in interest rates tied to changing Fed policy, we continue to think the greater uncertainties lie with the strength of the U.S. economic recovery and the pace of emerging-market growth.

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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