Perspective

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

August 14, 2013

OUTLOOK

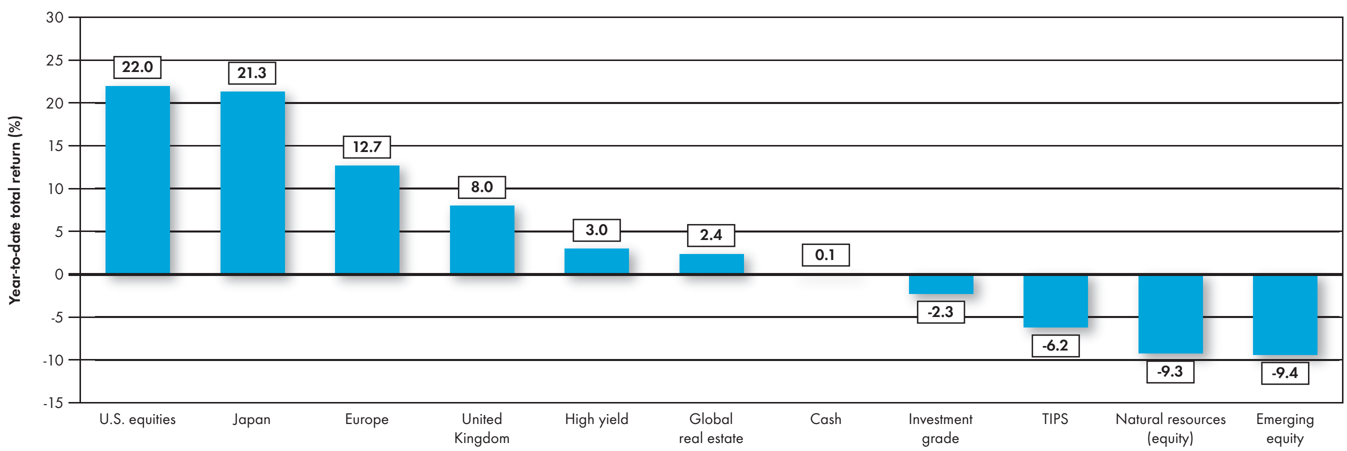
Global stock markets continued on their upward trend during the last month, while some stability crept into most fixed income markets. Underpinning this constructive environment were signs of modest improvement in global economic growth, primarily from the major developed economies. U.S. economic growth seems to be starting off on a better foot in the third quarter, as surveys of the outlook for both manufacturing and services were better than economists' expectations. Europe looks set to record some modest growth midyear, after six consecutive quarters of declining economic activity. Even though Japan registered slower growth in the second quarter because of inventory declines, end demand remains relatively strong as the Abe administration ponders its next reform and fiscal policy actions. Emerging-market growth remains our greatest concern, as China works to slow its credit creation machine without causing a hard landing for its economy.

Also supporting risk taking of late has been some calming in the interest rate markets during the last month. The U.S. 10-year Treasury yield hit a recent peak on July 5 after a solid June nonfarm payrolls report, but has drifted lower as the higher yields have attracted institutional buyers. The Federal Reserve looks to have successfully jawboned interest rates higher over the last couple of months, conditioning markets for the eventual tapering of bond purchases. Investment-grade and high yield spreads have been well behaved this year, reflecting continued confidence in the outlook for corporate credit. The U.S. municipal bond market has been under greater pressure after the Detroit bankruptcy filing, and we expect investors to further differentiate issuers by their credit outlook.

The performance differential in global equity markets this year has been stark. The regions with the best growth outlook (Japan and the United States), also accompanied by easy monetary policy, have led the performance pack. Conversely, emerging-market equities and the highly correlated natural resource stocks have performed poorly, as growth has been modestly disappointing and monetary policy has turned more restrictive. We expect this contrast, between better developed economy growth and softer emerging-market output, to continue during the next year. We also expect easier monetary policy in the developed economies to lead investors to favor those markets.

WHAT A DIFFERENCE

Normalizing markets have led to large dispersions in asset class returns.



Left Axis: Year-to-date total asset class returns (%)

Data through 8/7/13

Sources: Northern Trust, Bloomberg

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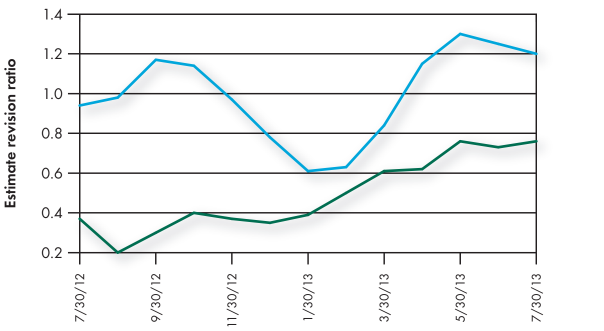
LOOKING OVERSEAS

Prospects for foreign-exposed U.S. stocks are looking up.



Left Axis: Estimate revision ratio*

Pure domestic exposure stocks — High foreign exposure stocks

* The estimate revision ratio is the total number of earnings estimate increases divided by the total number of earnings estimate decreases during the past three months.

Sources: Northern Trust, Bloomberg

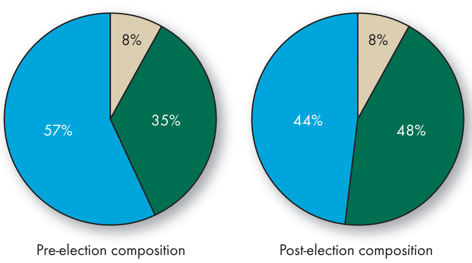
U.S. EQUITY

- Sentiment for companies with high international exposure has begun to improve.
- Globally exposed companies now appear more attractive.

The most globally exposed U.S. companies have recently been underperforming companies with greater domestic exposure, a reversal in trend that historically has favored the higher growth prospects overseas. However, in the past two months in particular, improving fundamentals internationally have contributed to a narrowing in the gap in revision ratios, as analysts have been growing less negative on multinationals and slightly less positive on domestics. Even though the U.S. growth outlook remains relatively steady, the outlook for European growth has been improving. Stocks with international exposure are now trading at the lowest relative valuation in recent history, as compared with companies with greater U.S. exposure. We think this provides some margin of safety from valuation. When combined with recent actions taken by international central banks, we view international exposure more favorably.

CONSOLIDATING GAINS

Abe's party gained further in recent Upper House elections.



Opposition

Liberal Democratic Party

New Komeito

Sources: The Associated Press; Ministry of Internal Affairs and Communications

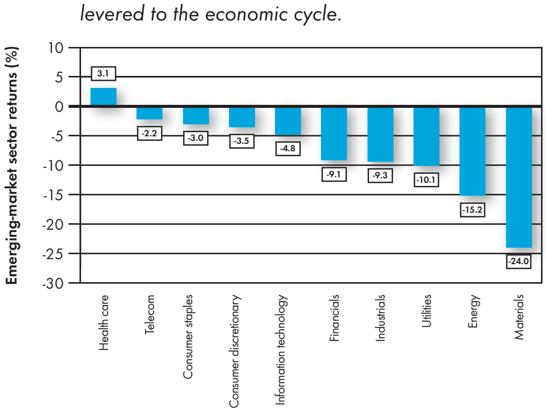
EUROPE & ASIA-PACIFIC EQUITY

- Abenomics begins its last lap of the recovery race.
- The Bank of England (BoE) is the latest central bank to provide forward guidance.

As expected, Prime Minister Abe's Liberal Democratic Party (LDP) succeeded in the recent Upper House elections, with his party claiming just over half of the 121 seats available. In coalition with the New Komeito party, the LDP has the green light for the structural reform component of the "three arrow" program. Volatility in Japanese equities and the yen is likely to persist, but as the trend for improving economic indicators becomes more firmly rooted, Japanese equities appear likely to benefit. In Europe, BoE Governor Mark Carney followed the status quo and confirmed that interest rates will stay at the historic low level of 0.5%. He also followed the Fed's playbook by tying the current level of accommodation to improvement in the unemployment rate to 7% or below.

CYCLICALLY CHALLENGED

The most defensive sectors have outperformed those levered to the economic cycle.



Left Axis: Emerging-market sector returns (%)

Data through 8/7/13

Sources: Northern Trust, Bloomberg

EMERGING-MARKET EQUITY

- Sector performance illustrates investor concern about growth prospects.
- A turn in cyclical momentum will be required for stock outperformance.

The theme of increasing differentiation in the financial markets is clearly evident in emerging-market equities this year. As investors have discounted slowing economic growth, the most cyclical sectors (such as materials and energy) have suffered the most, while defensive sectors (such as health care and telecom) have performed relatively well. Chinese growth figures for the second quarter seem to indicate an economy that's avoiding a hard landing, but a sharp drop in total social financing — a Chinese economic indicator — may portend further slowing. We're also seeing tighter monetary policy in countries such as Brazil and Indonesia, where inflation is higher than desired. While long-term growth prospects and current valuations support the long-term outlook for emerging-market equities, short-term performance likely will remain dependent on relative economic momentum.

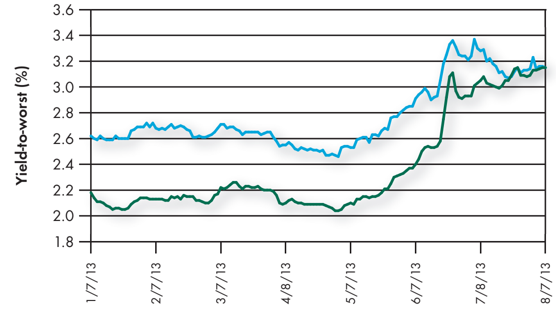
U.S. FIXED INCOME

- Detroit's bankruptcy rippled through the municipal bond market.
- The taxable bond market has been spared from municipal bond concerns.

The timing of Detroit's bankruptcy — just after June's increase in interest rates — was doubly damaging for the retail-focused municipal bond market. Investors were faced with unanticipated rate and credit events, neither of which emanated from typical cyclical drivers. Some municipal investors were surprised to experience losses in "low risk" tax-exempt bonds, given gradually improving economic fundamentals. The recent developments have alerted municipal investors to the vast difference between public and corporate pension accounting, and made them more wary about the strength of their claims in bankruptcy proceedings. In contrast, investors in taxable debt experienced the same June increase in market rates but haven't encountered negative credit events of note. As such, demand has actually ramped up after the increase in rates, and asset flows in these funds have remained positive.

DIFFERENTIATED VIEWS

Concerns in the municipal markets haven't affected demand for taxable bonds.



Left Axis: Yield-to-worst (%)
Barclays U.S. Credit Index
Municipal Bond Index
Sources: Northern Trust, Bloomberg

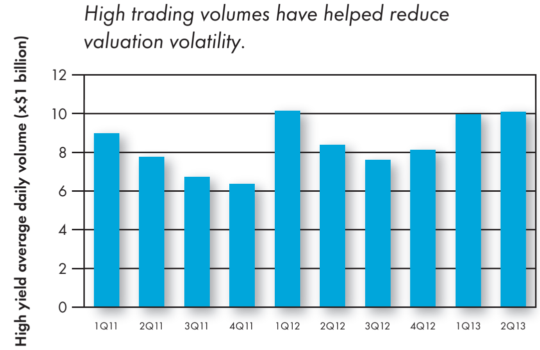
U.S. HIGH YIELD

- Interest rate uncertainty resulted in significant cash flows and repositioning in high yield.
- The high yield market has provided enough liquidity to adjust to interest rate volatility.

Uncertainty about the Fed's monetary policy has resulted in both asset class reallocation and changes in investor positioning. The second quarter of 2013 saw periods of record new issuance, record outflows, volatile exchange-traded funds activity and investors repositioning to manage interest rate exposure. Although liquidity in any particular bond may be inconsistent, the high yield market has provided enough liquidity for investors to respond to these changes. The graph shows that the average daily high yield trading volume has increased in 2013. This is a positive sign that the market can function well enough to accommodate future volatility. We think a well-functioning market will provide a cushion to avoid extreme changes in valuation, potentially benefiting high yield investors.

TRADING PLACES

High trading volumes have helped reduce valuation volatility.



Left Axis: High yield average daily volume (x$1 billion)
Sources: Northern Trust, Barclays

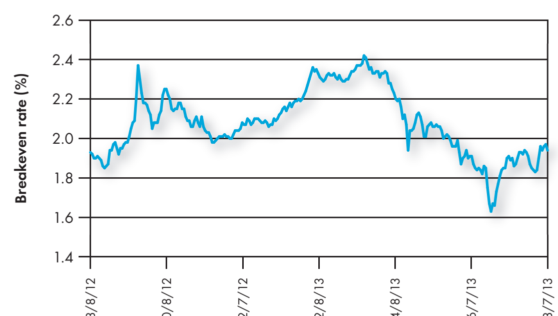
REAL ASSETS

- Realized inflation is trending lower, but expectations are picking up.
- Real assets remain a core component of a diversified portfolio.

Reported inflation has been trending lower, driven, in part, by pressures on prices for a wide range of commodities. Grain harvests are coming in at high levels in large producing countries, such as the United States, Russia, Brazil and Argentina, while stockpiles of industrial metals, such as copper and aluminum, have steadily grown. Energy prices, however, have risen during the past few months — with oil prices now back above $100 per barrel — given increased tension in the Middle East. While realized inflation has fallen, expected inflation has picked up with five-year breakevens at a 1.9% level vs. their earlier-year low of 1.6%. This highlights the utility of purchasing inflation protection at a discount in the face of falling prices. We continue to have a constructive view on inflation-protected bonds.

LOWERED INSURANCE PREMIUM

Inflation expectations hit year-to-date lows in June, providing cheaper inflation insurance.



Left Axis: U.S. five-year breakeven rate (%)
Sources: Northern Trust, Bloomberg

CONCLUSION

Last month we made several changes to our investment outlook, tied to an upgrading of our outlook for European growth and a downgrading of emerging-market growth expectations. This month's discussion reviewed developments subsequent to this change, and the early evidence supports these conclusions. U.S. and Japanese stock markets have advanced strongly this year, and European shares have gained momentum of late. With the S&P 500 trading well above its 200-day moving average, some consolidation in prices would be understandable. Fundamentally, we expect to see continued signs of gradual economic recovery across the major developed economies. With respect to monetary policy, we expect European and Japanese central bankers to remain highly accommodative while the Fed has been conditioning markets to expect the start of a reduction of its bond-buying program.

The Fed's attempts to start normalizing monetary policy have been bumpy thus far, and we expect this volatility to continue. Sometime in the September/October timeframe, President Obama is expected to announce his nominee for the Fed chairmanship. Considering that President Obama knows Larry Summers better, and has worked with him more closely, than Janet Yellen, we lean in that direction. Mr. Summers would likely use a different playbook than Ben Bernanke/Janet Yellen, which could lead to a higher term premium for long-term interest rates. The uncertainty over the interest rate outlook, including the substantial nonfundamental drivers, remains a key risk point in our deliberations.

In addition to the uncertainty over the outlook for interest rates, we also discussed policy risks in Japan and Europe. Japan is in a strong cyclical recovery, but a secular recovery remains dependent on structural reform and fiscal repair. An important step was accomplished with the Upper House vote in July, but the market will now demand policy specifics. Volatility in Europe looks like a lesser concern in comparison, but the political challenges faced by European Union leadership in furthering their monetary union remain substantial. Overall, we believe monetary policy is likely to start tightening only in an environment of stronger economic growth. As always, we'll be keeping a watchful eye on our risk cases for potential changes to the investment outlook.

Jim McDonald
Chief Investment Strategist

Yield-to-worst is the lowest potential bond yield received without the issuer defaulting, it assumes the worst-case scenario, or earliest redemption possible under terms of the bond.

The **Barclays U.S. Credit Index** comprises the U.S. Corporate Index and a non-corporate component that includes foreign agencies, sovereigns, supranationals and local authorities. The index is a subset of the Barclays U.S. Government/Credit Index and the Barclays U.S. Aggregate Index.

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