Perspective

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

August 12, 2014

OUTLOOK

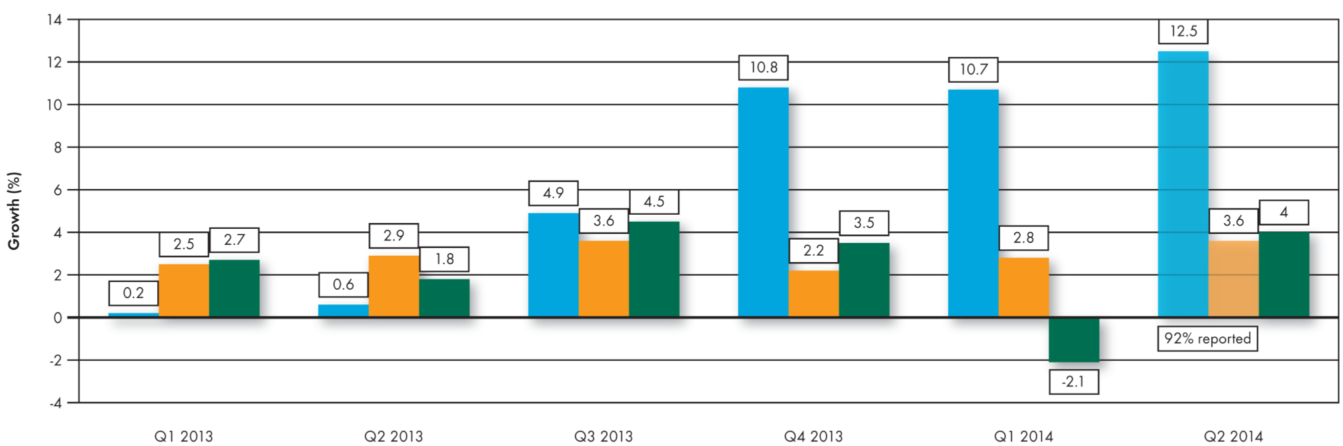
The blanket of low volatility covering the market has been pulled back during the last month, because of uncertainty around geopolitical risks and the economic growth outlook. Some investors might add the monetary policy outlook to this list, but we think this is inconsistent with concerns about the economic growth outlook. The volatility in reported U.S. economic statistics (e.g., GDP growth) is exaggerated when compared with the strong profit growth of corporate America (see chart below). Risk to the European growth outlook has increased because of the Russia/Ukraine conflict, and already appears to be hitting metrics such as German exports. Investor response has been as one might expect, with the increased risk aversion leading to selling pressure on risk assets from stocks to high yield bonds.

In our investment committee discussions this month, we spent considerable time debating the outlook for G-2 (United States and China) growth and the risks associated with the Russia/Ukraine conflict. We see reasonable momentum in the U.S. and Chinese economies, although we worry about the quality of Chinese growth, as it appears to have reverted to dependency on infrastructure spending. Bank credit growth has continued to impress in the United States, a key differentiator from the past several years. The European Central Bank (ECB) will try to jumpstart bank credit growth with the start of its targeted longer-term refinancing operation (TLTRO) program in September, which could increase funding to European banks by up to €850 billion. This month, the ECB highlighted its commitment to using unconventional monetary policy actions should inflation forecasts continue to disappoint and communicated its concern over the risk to growth from geopolitical tensions.

The Jackson Hole conference later in August will be the next chance to take the measure of Federal Reserve policy. With a potential focus on labor markets, we expect a dovish message from Fed Chair Janet Yellen about her commitment to keeping monetary policy highly accommodative for as long as possible. We think sustained wage pressures will need to materialize before the leading voices at the Fed become less dovish, and U.S. wage growth is stubbornly stuck at 2%. Our base case remains that the Fed will move to raise interest rates later than market expectations of mid-2015. During the near term, we see a bigger risk of the ECB being too timid in implementing further accommodation to support growth and inflation across the eurozone.

STRONG EARNINGS REBOUND

Corporate earnings have outperformed government growth figures for the last few years.



Left Axis: Growth (%)

U.S. earnings growth (year-over-year) U.S. sales growth (year-over-year) Real GDP growth (quarter-over-quarter, annualized)

Note: Growth in last four quarters of S&P 500 earnings and sales per share shown

Sources: Northern Trust, Standard & Poor's

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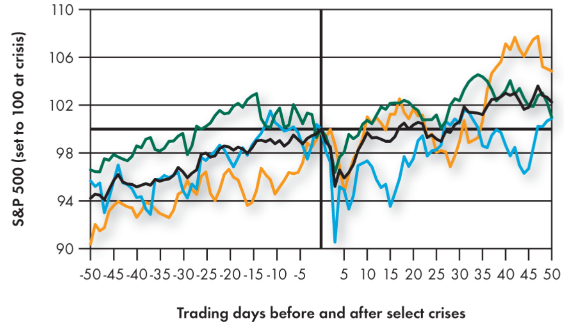
U.S. EQUITY

- Prior geopolitical crises haven't derailed U.S. bull markets.
- Oil prices remain well contained, mitigating the negative economic impact.

With several geopolitical conflicts in the news, investors are rightly concerned about the potential for broader disruption. Prior history, however, has demonstrated the U.S. market's resiliency to world crises. The market historically has returned to pre-crisis levels within 37 days on average during bull markets and continued to advance for more than two years. We'd be more concerned with current events if the price of oil were to react and move higher. Such a move would put pressure on U.S. consumers and threaten the economic recovery currently underway. In fact, the price of oil has declined over the past month. The U.S. economy continues to expand, which supports our expectation of improvement in the corporate earnings environment and our constructive outlook toward U.S. equities.

SHORT-TERM INTERRUPTION

Geopolitical events tend to have short-lived market impacts.



Left Axis: S&P 500 (set to 100 at crisis)

Sources: Northern Trust, Bloomberg

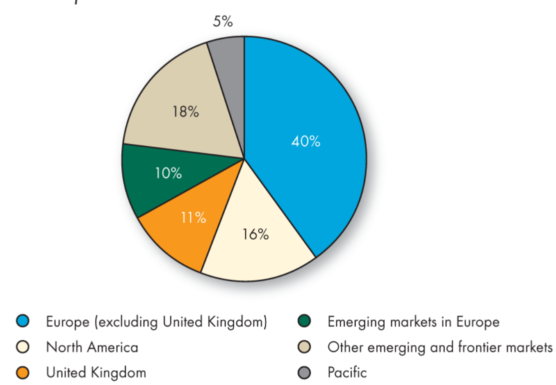
EUROPEAN EQUITY

- European companies' revenues are geographically well-diversified.
- The impact from trade restrictions with Russia is expected to be manageable.

During the past 10 years, the total revenue European companies derive from emerging markets has more than doubled. As a result, Europe has the broadest geographical exposure of all developed equity markets. Total emerging-market revenue exposure was close to 30% in 2012, while exposure to emerging markets outside Europe was almost 20% (see accompanying chart). Even though the financial sector will bear the brunt of the negative effects of enforcing sanctions, European exposure to North America and our expectation of better growth from the United States should support European earnings during the next 12 months. Europe's diversification has contributed better growth than possible from the eurozone alone and should soften the overall effect of the current trade sanctions with Russia.

BROADLY DIVERSIFIED

Globally, European markets are the most diversified developed markets.



Note: Revenue exposure of the MSCI All Country Europe Index (emerging and developed Europe)

Sources: Northern Trust, MSCI

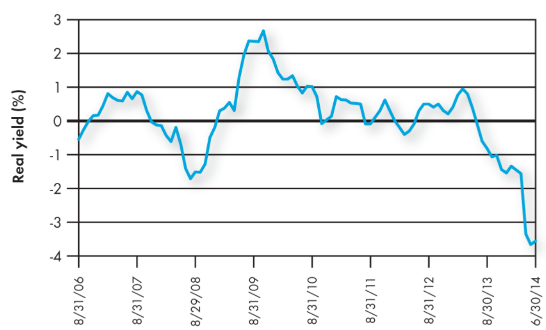
ASIA-PACIFIC EQUITY

- Record levels of Japanese corporate cash represent untapped opportunity.
- Negative real rates will compel better use of corporate cash.

According to a recent International Monetary Fund report, Japanese corporate cash holdings are at 30-year highs. Given the recent material move in inflation expectations and low interest rates as a result of Abenomics (see accompanying chart), we expect continued pressure on companies to change their approach to cash management. The most direct benefit to shareholders would be increased dividend payments and share buybacks. Indeed, several large companies, including Toyota, NTT DoCoMo and Mitsubishi, have acted accordingly. Another option would be to increase capital expenditure spending, which, in aggregate, has yet to break out of its historical range. The deployment of corporate cash could help further stimulate the economy and redirect investment into more productive assets. Japanese equities have continued their recent positive momentum, supported by better-than-expected earnings results.

NEGATIVE PRESSURES

Twelve months of increasingly negative real interest rates in Japan should prod activity.



Left Axis: Japanese government bond three-month real yield (%)

Sources: Northern Trust, Bloomberg

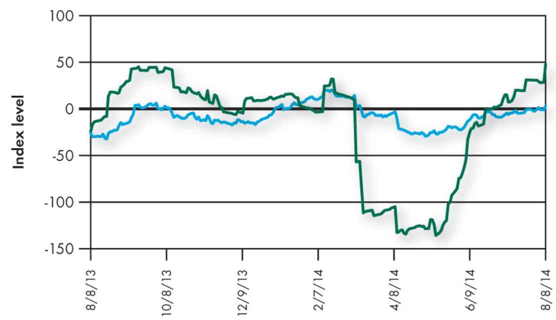
EMERGING-MARKET EQUITY

- Emerging-market growth trends are improving.
- China is relying on the old playbook of infrastructure spending to boost its economy.

Economic data from the emerging markets has been improving since the second quarter, primarily due to improving conditions in Asian emerging markets. Growth trends in Europe, the Middle East and Africa (EMEA) and Latin America remain soft, as high-profile economies such as Brazil, South Africa and Russia continue to disappoint. Acceleration in China has helped improve the economic data across Asia, as the targeted stimulus Beijing has implemented has boosted spending. Chinese export growth of 14.5% in July is a sign of the strengthening global economy. However, the improved domestic growth has been accompanied by a surge in credit growth, which is heavily outpacing nominal economic growth. Even though the targeted stimulus has reduced the near-term economic risk, it's delaying the structural reform and rebalancing that policy makers prescribe for a healthier long-term economy.

PICKING UP

There have been solid gains in recent emerging-market growth reports.



Left Axis: Index level
China Economic Surprise Index
Emerging Markets Economic Surprise Index
Note: Citigroup Surprise Index (0 = data met expectations)
Sources: Northern Trust, Citigroup, Bloomberg

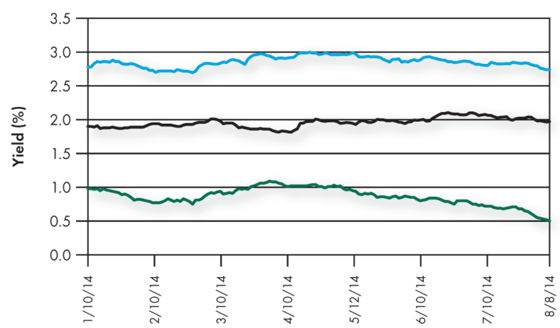
REAL ASSETS

- The United States' and United Kingdom's inflation expectations remain contained.
- Broader European inflation expectations continue moving downward.

If a recovering economy generally leads to inflationary pressures, the markets aren't buying it yet, at least not in the expectations they're building into five-year breakeven rates (the spread between nominal and inflation protected yields). In the United States, despite ongoing and steady improvement in the labor market, inflation expectations sit at just under 2%, which is just 0.1% higher than where they started the year. A similar story is playing out in the United Kingdom, albeit from a higher starting point given higher structural levels of inflation. Meanwhile, Europe, as proxied by Germany, continues to battle the threat of deflation. This leaves our expectations for low inflation (predicated on subdued demand and excess capacity) in sync with current market consensus, and supports maintaining real asset allocations at strategic levels.

LOW-FLATION

Currently, markets are exhibiting little worry over inflationary trends.



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

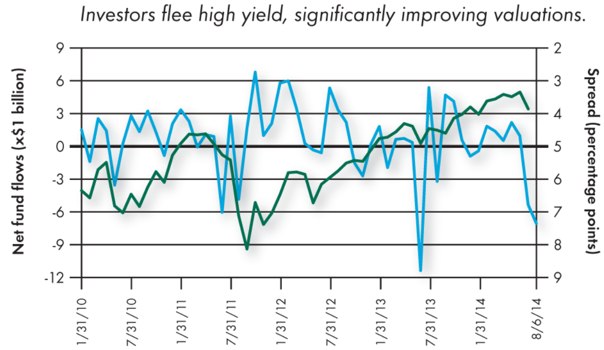
U.S. HIGH YIELD

- Significant outflows thus far in August are similar in size to June 2013 outflows.
- Attractive valuations in the current environment create an opportunity in high yield markets.

The accompanying chart shows how June 2013 outflows compare to the recent round of withdrawals, which are similar in size but couldn't be more different in terms of the catalyst. The selling in high yield was broad in nature, resulting in a 1.05% increase in yields off the recent low (4.82% to 5.87%). Whereas previous large outflows have been accompanied by changing commentary surrounding default scenarios, rate risks or economic growth, this round lacked a true fundamental catalyst. The macro-environment is favorable, as second-quarter earnings surprised to the upside, and U.S. economic data has been steadily improving throughout the summer. As a result, we believe the backup in yields has improved valuations and created a buying opportunity.

OUTWARD BOUND

Investors flee high yield, significantly improving valuations.



Left Axis: Monthly* high yield fund flows (x$1 billion)
Right Axis: High yield option-adjusted spread
* August 2014 outflow through 8/6/14
Sources: Northern Trust, Lipper, Bloomberg

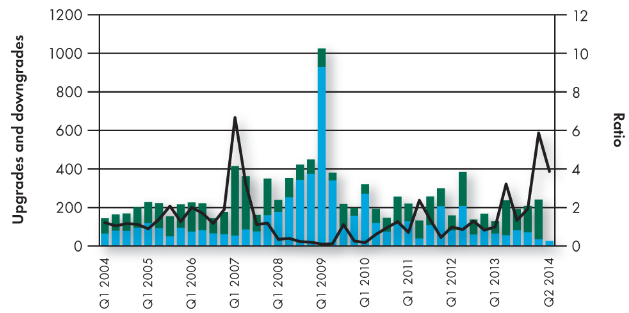
U.S. FIXED INCOME

- Commercial real estate fundamentals continue to improve.
- Despite some deterioration in metrics, rating agencies continue upgrading corporations.

At the height of the financial crisis in late 2008 and early 2009, S&P and Moody's quickly downgraded corporations as revenue and earnings fell sharply, affecting balance sheet metrics. Corporations quickly responded by cutting costs, increasing cash balances and reducing debt, which resulted in improved credit metrics that peaked in early 2012. Since then, these metrics have begun to slowly deteriorate. Leverage is on the rise as corporations issue debt to repurchase equity, increase dividends, and engage in merger and acquisition activity. This increase in leverage to a near-decade-high surprisingly coincides with a recent uptick in rating upgrades. As upgrades have broken away from fundamentals, we've been closely watching the actions of corporate management teams to ensure continuing solid credit quality.

RATING AN UPGRADE

The ratings backdrop is still supportive of corporate credit.



Left Axis:
Upgrades Downgrades
Right Axis: Up/down ratio
Note: Data through 6/30/14
Sources: Northern Trust, Bloomberg, Barclays Live

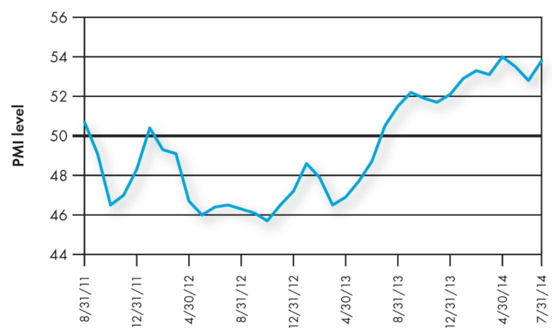
EUROPEAN FIXED INCOME

- Italy falls back into recession.
- The ECB tries to evade the spotlight by having less frequent meetings.

Data in the eurozone remains challenging, as we've seen a new low in inflation, a negative economic growth data point in Italy and some disappointing German industrial production numbers. There are some positives on the ledger, as broad surveys continue to point toward growth, and area-wide bank lending has shown some improvement. From the other side of the fence, the ECB continues to hope that actions beyond those announced in June will be unnecessary. For the moment, we expect no action, with the centerpiece of June's package, the TLTRO, starting operation in September. Nevertheless, post-meeting press conferences are likely to be uncomfortable for ECB President Mario Draghi for some time to come, as pressure builds for further action. This is precisely why the ECB is moving to a less-frequent meeting schedule starting in 2015.

CONFLICTING SIGNS

Indications of contraction in Europe are offset by brighter survey data.



Left Axis: Markit eurozone composite PMI
Sources: Northern Trust, Bloomberg

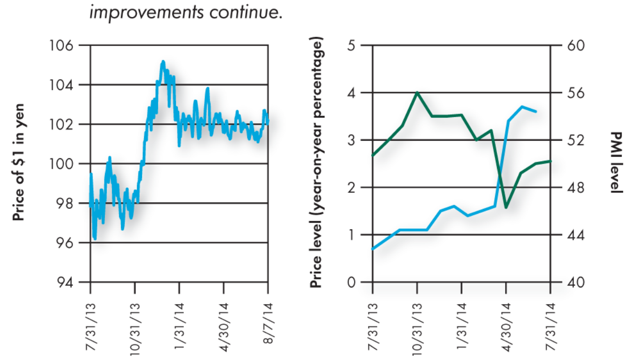
ASIA-PACIFIC FIXED INCOME

- Chinese policy walks a fine line between growth and rebalancing.
- Japanese economic performance has been constructive under Abe.

Much has been written about the quality of China's economic growth, and we agree that a rebalance is necessary for sustainable economic growth. A big part of the challenge is overcoming the vested interests that have become rich on the back of the vast infrastructure spending of the past three decades, but there should be little doubt of the leadership's resolve to transition. Facing growing public distrust of the monied elite, President Xi Jinping is pursuing an aggressive anticorruption agenda. Any uncertainty regarding the scope of his campaign has received an emphatic answer with the investigation of a former member of the Politburo's standing committee. Meanwhile, Japan's Prime Minister Shinzo Abe has had success through monetary and fiscal policy, but the market awaits progress on greater structural reform.

PROGRESS REPORT

Pressure in China slows rebalancing act, while Japanese improvements continue.



Left Axis: Yen/dollar exchange rate
Sources: Northern Trust, Bloomberg

Left Axis: Japan CPI
Right Axis: Japan composite PMI
Sources: Northern Trust, Bloomberg

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CONCLUSION

While recent economic data has been noisy, we think the global economic expansion underway will continue to advance. We see the U.S. economy as having the most predictable growth outlook of the major economies, as steady improvement in the labor markets is joined by strong bank credit growth. While expectations for European growth have deteriorated in recent months, we think growth will be sufficient to exceed these lowered expectations. Emerging-market growth is more uneven; China has pulled up Asian growth while the other emerging regions are lagging behind. Because we expect inflation to continue to be quiescent, we believe developed-market central bankers should continue their easy policy leanings.

The market's reaction to bumpy economic data and heightened geopolitical risk has been textbook in some cases, but counterintuitive in others. Safe-haven assets like U.S. Treasuries and the dollar have rallied, while gold has declined. The S&P 500 index's decline of 3.3% during the last month was better than the decline of 4.7% in the other developed markets, but actually lagged the 1% decline in emerging-market equities. Demonstrating its higher correlation to equities than interest rates, U.S. high yield spreads widened from 3.29% to just over 4% during the last month. We view this widening of spreads as a simple reflection of increased risk aversion, as opposed to a signal of deteriorating credit quality or impending economic slowdown, and we believe it has created a buying opportunity.

We made no changes this month to our global tactical asset allocation recommendations, which remain significantly overweight stocks at the expense of investment-grade bonds. Market weakness during the last month has led to a rapid deterioration in investor sentiment (a positive for future returns), as measures like the Chicago Board Options Exchange put/call ratio moved into extreme bearish territory. Despite the noisy economic data and the resulting market uncertainties, we expect the global economic expansion to continue and easy monetary policy to support risk-taking over the next 12 months. Our primary risk cases start with G-2 economic growth, the strength of which can help offset our other two risk cases. First, the confrontation between Russia and the West over Ukraine has the potential to become an economic headwind, particularly for Europe. Second, we expect the ECB to provide additional accommodation should the languid pace of the European recovery continue; however, they've disappointed us in the past.

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.