Perspective

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

September 17, 2013

OUTLOOK

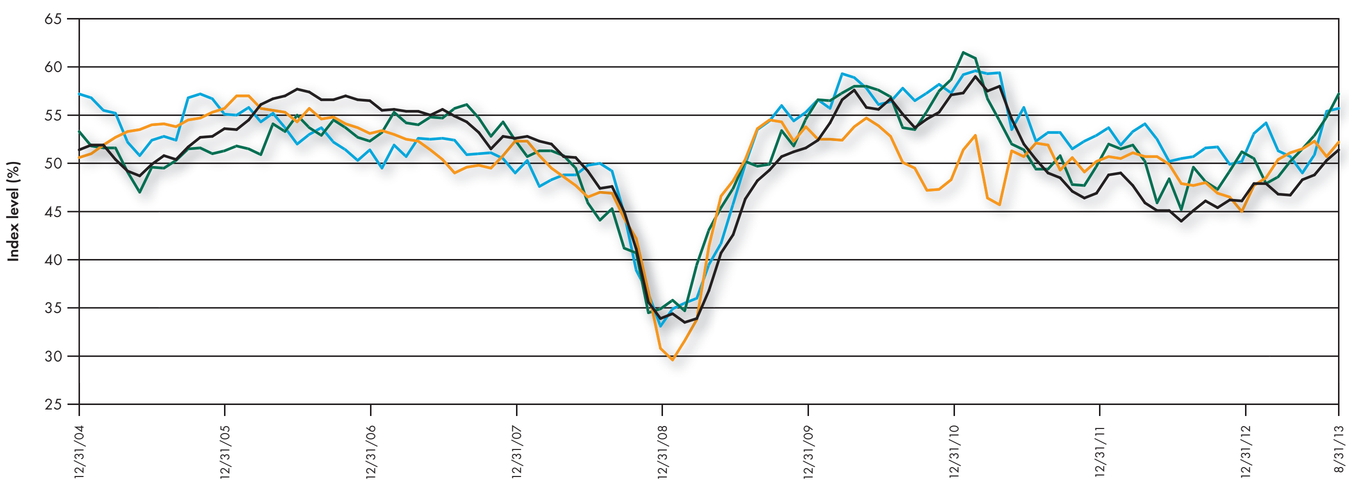
While financial markets have been consolidating during the last month, the global economy is showing some evidence of improving momentum. The U.S. economy continues to generate steady growth, shrugging off the effects of higher taxes and reduced government spending. In Europe, signs of the emergence from recession continue to build, something we think investors continue to somewhat underappreciate. The Japanese economic recovery also continues apace, giving the government the confidence to consider raising taxes and begin addressing the country's high level of government debt. In emerging-market economies, an increasingly anachronistic designation, growth trends are highly divergent. Chinese growth has improved during the last month, while growth estimates for large economies, such as Brazil, India, South Korea and Taiwan, are falling.

Among the many inputs investors weigh, monetary policy is currently at the forefront of market drivers. Markets are microscopically focused on the pace of change in Federal Reserve bond purchases. We think the recent increase in interest rates reflects this eventuality, and that the incoming Fed chairman will continue an accommodating monetary policy. Both the European Central Bank (ECB) and the Bank of England (BoE) continue to reiterate very easy forward guidance, with mixed results in the bond markets — which may only increase their resolve. With Japanese monetary policy the easiest among the developed economies, the focus has turned to fiscal policy, which needs to address massive debt levels without reversing the hard-fought economic momentum. Across the developing economies, monetary policy is broadly tightening because of concerns about currencies and credit growth.

While we think monetary policy is the largest driver of current market volatility, geopolitics remains a concern of the markets. The possibility of a negotiated settlement in Syria has recently improved risk appetite. These challenges have, however, taken the eyes of U.S. politicians off the upcoming debt ceiling deadline, which could lead to another short-term extension. The recent withdrawal of Larry Summers from consideration for the Fed chairmanship may simplify the eventual decision and confirmation process, but a deterioration of the recent gains in the Middle East could prove a further delay. We continue to think the debates over monetary policy will be much more consequential to markets than the political volatility from events like the U.S. debt ceiling or the German Federal elections.

GROWTH ACCELERATION

Economic conditions — as judged by purchasing managers' indexes — are improving globally.



Left Axis: Purchasing Managers' Index levels (%)

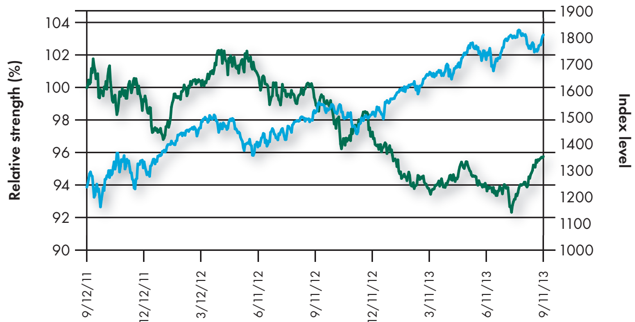
United States — United Kingdom — Eurozone — Japan

Sources: Northern Trust, Bloomberg

Northern Trust

FACTOR ROTATION

Growth stocks showing sustained outperformance for the first time since early 2012.



Left Axis: Relative strength (Russell 1000 Growth Index vs. Russell 1000 Value Index) (%)

Right Axis: Russell 1000 Performance Index level

Sources: Northern Trust, Bloomberg

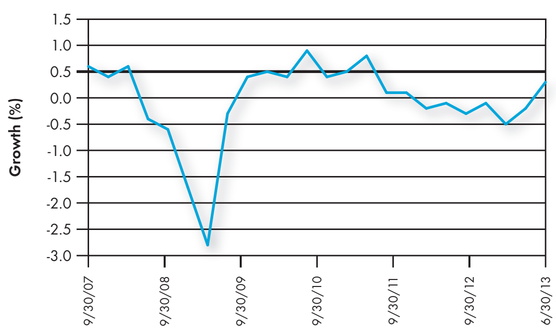
U.S. EQUITY

- Growth stocks are beginning to outperform value stocks.
- Cyclical growth-stock leadership may lend credibility to the next leg of market upside.

From April 2012 to mid-to-late July 2013, value stocks outperformed growth stocks by roughly 10%. As demonstrated by the relative strength of the Russell 1000 Growth Index vs. the Russell 1000 Value Index, the second-quarter earnings season marked an inflection point for growth stocks. Since late July, growth stocks have outperformed value stocks by nearly 4%. Technology stocks, which had materially underperformed in prior periods, increased following second-quarter earnings as results exceeded subdued expectations, while financial stocks have underperformed. With Fed tapering and higher yields pointing to a more sustained economic recovery, we foresee the intermediate-term prospects for growth stocks as positive.

BACK IN THE BLACK

Europe recorded positive economic growth for the first time since 2011 as momentum continues.



Left Axis: European economic quarter-on-quarter growth (%)

Sources: Northern Trust, Bloomberg

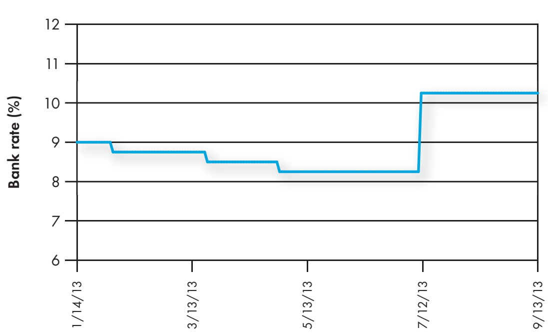
EUROPE & ASIA-PACIFIC EQUITY

- Relative strength indicators have the United Kingdom growing faster than Germany.
- Not surprisingly, Germany remains the strongest eurozone member.

Could it be that austerity is working? The United Kingdom has seemingly broken out of the semiparalysis of scything public sector cuts to report positive purchasing managers' indexes and growth figures. The eurozone also limped into positive territory in the second quarter. Though there have been some improvements in France, the eurozone is still being supported by the German economy. What's been more of a surprise has been the strength of the numbers emanating from the United Kingdom. Strong purchasing managers' indexes and the International Monetary Fund's upgraded growth forecasts are most unlike the United Kingdom of the last couple of years. It remains to be seen whether these figures are an aberration, but equity flows seem to support the fact that there's more belief in Europe as a region.

TIGHTENING AT THE WRONG TIME

Currency pressures are leading to rate hikes while economic momentum slows.



Left Axis: Reserve Bank of India bank rate (%)

Sources: Northern Trust, Bloomberg

EMERGING-MARKET EQUITY

- Growth trends are mixed across emerging-market countries.
- Interest rates are rising to defend currency values.

Emerging-market equities have perked up alongside Chinese growth during the last month, increasing 4% as compared to developed markets, which are up approximately 2%. Looking at the largest emerging markets, growth has continued to moderate while monetary policy has broadly been tightening. With our view that these inputs are key drivers of near-term stock performance, we don't see sustained outperformance from the group. On the monetary policy front, countries with large current account deficits (such as India) are seeing significant currency pressures, leading to defensive increases in interest rates. Until this stabilizes, investors will question the risk to economic growth from higher rates. The poor relative performance of emerging markets in recent years has, however, improved its relative valuation and sets them up for attractive long-term returns.

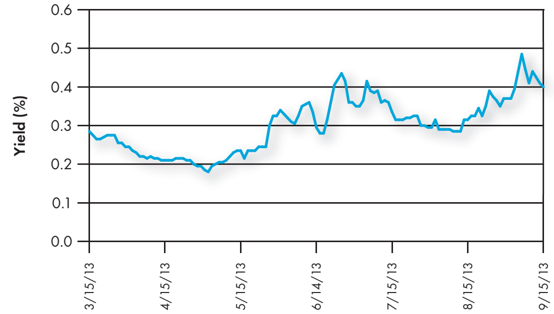
U.S. FIXED INCOME

- Investors expect the Fed Funds rate to begin moving higher by early 2015.
- We think the Fed will remain on hold for longer than market consensus.

Fed Chairman Ben Bernanke announced in May that the central bank might begin to taper its bond purchases later this year if the economic expansion were to gather strength. Despite frequent pledges to keep the Fed Funds rate at exceptionally low levels for the foreseeable future, investors have been pulling forward when they anticipate interest rate hikes. Despite the move in the markets, we continue to believe the Fed will maintain its current zero-to-25 basis point range on the Fed Funds rate for the next few years, as we foresee modest economic growth and very low inflation. While a continued zero-interest-rate policy would keep interest rates anchored, current uncertainty in the markets around the Fed's plans will keep interest rate volatility high.

A LOOK INTO THE FUTURE(S)

Fed Funds futures predict a rate hike by the beginning of 2015.



Left Axis: Fed Funds futures, December 2014 contract (yield %)
Sources: Northern Trust, Bloomberg

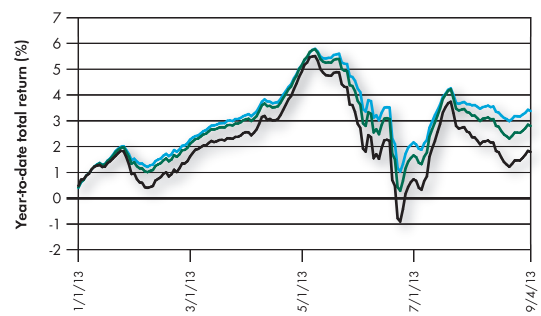
U.S. HIGH YIELD

- Illiquid markets have forced high yield managers to use more-liquid issues to manage outflows.
- The illiquid market has resulted in outperformance by the smaller, less frequently traded issues.

The summer slowdown, investors' vacation schedules, an inactive new issue market and macroeconomic uncertainty have resulted in less liquidity during the past month. High yield funds saw $3.6 billion in outflows during a six-week period. To respond to these flows, high yield managers and exchange-traded funds focused on the most liquid issues to manage cash needs. As a result, the liquid issues suffered a greater price impact. The outperformance of these less-liquid issues has been particularly acute during the summer. The less-liquid issues generally have a yield advantage to compensate for liquidity and smaller average issuer size. They also often benefit from positive trading dynamics.

ILLIQUIDITY PREMIUM

Less-liquid issuance has provided higher returns of late.



Left Axis: Year-to-date total return (%)
- Barclays U.S. High Yield ex. Very Liquid Index
- Barclays U.S. High Yield Index
- Barclays U.S. High Yield Very Liquid Index

Sources: Northern Trust, Bloomberg

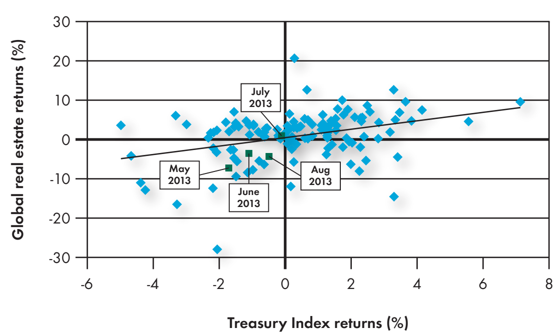
REAL ASSETS

- Global real estate carries exposure to interest rate movements.
- Concerns over interest rate volatility have led to a paring back of global real estate exposure.

As we highlighted in our annual five-year capital market assumptions work this summer, global real estate has a statistically significant exposure to interest rate movements. This relationship has been especially acute since May — as the 10-year Treasury rose from 1.6% to its current level approaching 3%. We still believe interest rates will remain relatively anchored during the next six to 12 months. However, we have greater conviction about the increasingly constructive environment for developed market equities, which have lower interest rate sensitivity than real estate securities.

TRUE TO FORM

Global REITs have shown their exposure to interest rate risk in recent months.



Left Axis: Global real estate returns (%)
Bottom Axis: Treasury Index returns (%)
(Returns in Australian dollars)
Sources: Northern Trust, Bloomberg

CONCLUSION

Shifting monetary policy globally is a key driver of asset-class performance and our asset allocation outlook. Economic progress is relatively steady in the developed markets, while the picture is much more variable across emerging-market countries. We believe the Fed has reached a turning point in its monetary policy, with the uncertainty centered on the pace of policy normalization. In this environment, we see reduced attractiveness of those asset classes that are most dependent on low interest rates. Monetary policy is starting to normalize in an environment without inflationary pressures, which we think is constructive for the performance of equities.

We feel Europe, Australasia and the Far East (EAFE) equities should benefit from improving economic momentum and constructive monetary policy outlook, however, we think global real estate, a direct beneficiary of low interest rates may underperform. We also believe Treasury Inflation Protected Securities (TIPS) may underperform, because we don't see a high likelihood of increasing inflation expectations during the next year. This leaves us strongly in favor of developed-market equities. While higher yields in fixed income increase bonds' potential return, volatility remains high, so bonds aren't currently fulfilling their role in stabilizing portfolio values.

Depending on the progress of competing political developments, such as a Syrian deal on chemical weapons, we expect a decision on the nomination of the new Fed chairman in the next month or so. While the withdrawal of Larry Summers' candidacy leaves Janet Yellen as the current favorite, we wouldn't expect any nominees to rapidly taper bond purchases or contemplate raising short-term interest rates. How the new Fed chairman manages communication will affect market volatility and asset-class performance. A repeat of the 2004 interest rate cycle, where steady and predictable interest rate hikes were well received by the market, is our base case scenario. A more unpredictable policy, such as the rapid rate hikes in 1994, would portend a much more volatile ride for financial markets.

Jim McDonald
Chief Investment Strategist

Basis Points (bps) is a unit of measure in quoting yields, changes in yields or differences between yields; 100 basis points is equal to 1%.

The **Barclays U.S. Corporate High-Yield Index** measures the market of USD-denominated, non-investment grade, fixed-rate, taxable corporate bonds.

The **Barclays U.S. High-Yield Very Liquid Index (VLI)** is a more liquid version of the U.S. Corporate High-Yield Index that measures the market of USD denominated, non-investment grade, fixed-rate, taxable corporate bonds. The VLI follows the same index construction rules as the U.S. Corporate High-Yield Index, but each issue must have been issued within the past five years, have a USD 500 million minimum amount outstanding and include only the three largest issues from each issuer. There also is a 2% cap on a single issuer.

The **Barclays U.S. High-Yield ex Very Liquid Index** excludes the VLI (above) from the Barclays U.S. Corporate High-Yield Index, which measures the market of USD denominated, non-investment grade, fixed-rate, taxable corporate bonds.

Purchasing Managers' Index (PMI) is a measure of the overall performance of the manufacturing sector, based on a survey conducted with purchasing managers to determine changes in economic conditions. A reading of 50 indicates no change, a reading of greater than 50 indicates an expanding economy and a reading below 50 indicates a contracting economy.

Russell 1000® Growth Index is an unmanaged index measuring the performance of those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values.

Russell 1000® Value Index is an unmanaged index which measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000 companies with lower price-to-book ratios and lower expected growth values.

It is not possible to invest directly in an index.