Perspective

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

September 17, 2014

## OUTLOOK

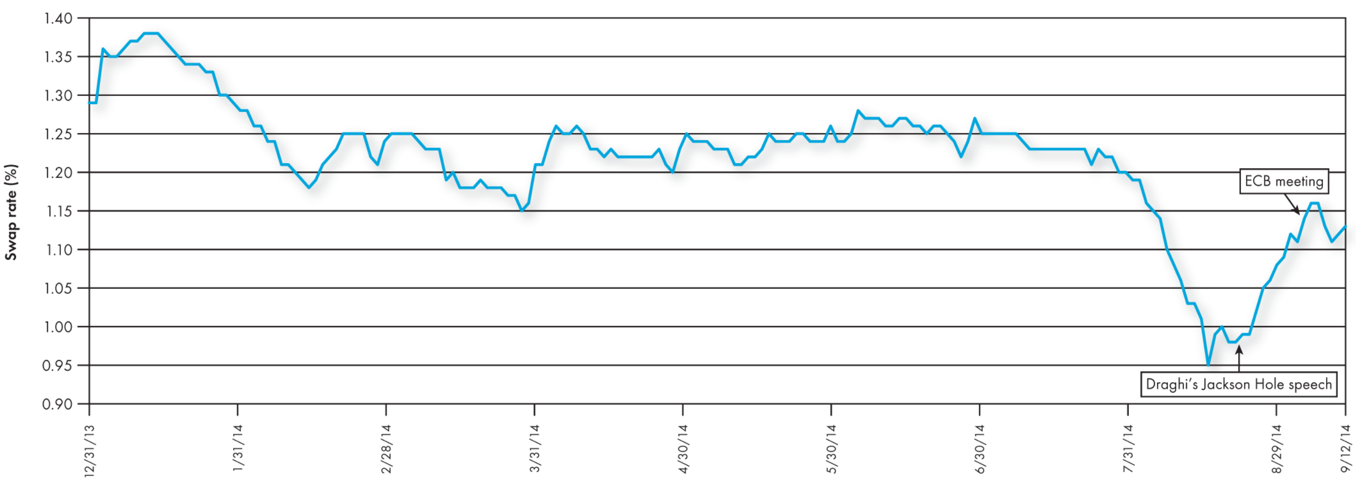
The posture of the world's major central banks ranges from those looking to start the normalization process (Federal Reserve and Bank of England) to those still providing significant monetary accommodation (European Central Bank [ECB] and Bank of Japan [BOJ]). The previously moribund ECB has continued its three-year move toward greater activism with aggressive programs announced over the last four months. As shown in the chart below, market concerns over the risk of deflation in Europe led ECB President Mario Draghi to raise the volume on his pledge to support growth, culminating in the announcement during the ECB's most recent meeting of an additional asset purchase program. While it's important that the upcoming Targeted Longer-Term Refinancing Operation (TLTRO) garner sufficient interest to help boost credit creation, the combined impact of the ECB's intentions has helped weaken the euro by 7% in four months. This should provide some boost to European exports, and has clearly helped bolster inflation expectations.

Interest is building around the Fed's communication policy regarding its intentions of keeping interest rates at their current extraordinarily low level once it completes the quantitative easing program (likely next month). In our view, this is a healthy debate because it's helping condition the markets toward the eventual first hike in the policy rate. We see little sign of pressure on the inflation front, and the recent weakness in commodity prices provides policy makers some extra breathing room. We continue to expect the Fed to favor growth over inflation in this environment, with its concern being that a premature rate hike may endanger the economic recovery.

It's important to put incoming economic data in the right context to avoid being whipsawed by either too weak data (U.S. first-quarter GDP shrinking nearly 3%) or too strong data (U.S. second-quarter GDP growing more than 4%). Post World War II, the average U.S. expansion has lasted five years and grown at a pace of 4.4%. Because the United States has realized annualized growth of only 2.2% this cycle (which has also lasted five years), we see little excess in the real economy and expect the expansion to continue for the foreseeable future. While the Fed is looking to start normalizing policy, we would expect any further deterioration in economic data in Europe, Japan or China to elicit further stimulus in their respective economies. Our greatest economic uncertainty surrounds the growth outlook for Europe, but we think market expectations have become sufficiently negative to minimize the risk of a material downside surprise.

**INFLATING EXPECTATIONS**

*European Central Bank activism puts a floor under inflation expectations.*




**Left Axis:** Eurozone five-year inflation swap rate (%)

**Sources:** Northern Trust, Bloomberg

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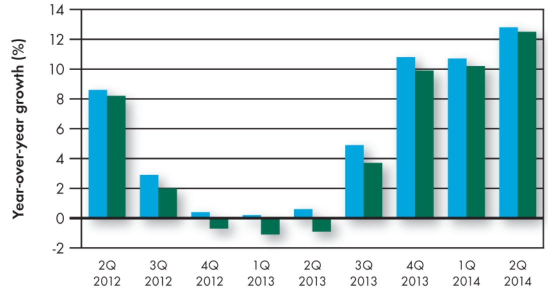
## U.S. EQUITY

- Strong corporate fundamentals continue to underpin U.S. equities.
- Share buybacks are a small contributor to S&P 500 earnings growth.

According to recent data from Standard & Poor's, corporate share repurchases are approaching record levels last seen in 2007. Does this mean buybacks are really what's been driving earnings growth in the United States? Based on our calculations, this hasn't been the case. As shown in the accompanying chart, we differentiated between aggregate earnings and earnings-per-share from the S&P 500 to analyze the historical contribution of share repurchases to earnings growth. Overall, it's been a negligible effect. It's likely that other corporate decisions, such as stock-based acquisitions and compensation, dilute the positive impact of share repurchases. Given the multiple expansion last year, further upside in the market will be driven largely by earnings growth — which we expect to approximate 8% during the next year.

### REAL GROWTH

*Earnings growth is impressive in aggregate and on a per-share basis.*




**Left Axis:** Year-over-year growth (%)
- Earnings per-share growth
- Aggregate earnings growth

**Sources:** Northern Trust, Standard & Poor's

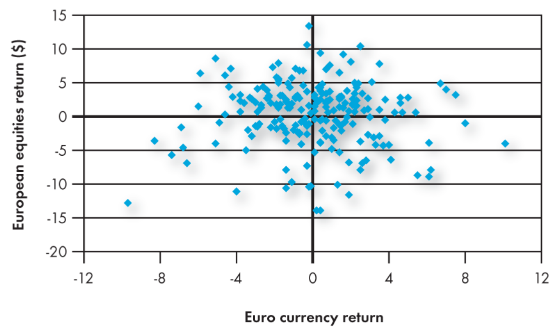
## EUROPEAN EQUITY

- Prior euro weakness has generated both positive and negative equity returns.
- Sustained euro depreciation shouldn't deter investment in European equities.

The euro has fallen 7% relative to the U.S. dollar from its intraday high in early May. Given this weakness, we analyzed how historical euro currency returns have compared to European equity returns measured in U.S. dollars. A depreciating euro historically has provided no insight into the dollar-denominated return of European equities (see accompanying chart) — with a correlation of close to zero. Fundamentally, the weaker currency should improve the economic outlook, but the effect on investor appetite is less predictable. An outlook on future euro moves, which are volatile and notoriously difficult to forecast, might affect hedging decisions but shouldn't, by itself, dissuade investment in European equities. We continue to expect earnings growth from European companies to outpace domestic growth because of the significant exposure to faster-growing markets.

### AS GOES THE EURO?

*There's been no historical relationship between euro moves and equity return.*




**Left Axis:** European equities return ($)
**Bottom Axis:** Euro currency return
**Sources:** Northern Trust, Bloomberg

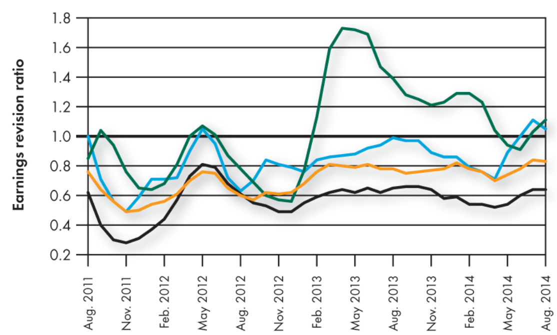
## ASIA-PACIFIC EQUITY

- Economic uncertainty continues in Japan following the consumption tax hike.
- Corporate earnings estimate revisions have actually improved and remain positive.

Japan's combination of aggressive monetary policy and fiscal stimulus has helped its real economy grow. Inflation and wages have also moved higher. The effects of these developments can be seen in analysts' earnings estimate revisions (see accompanying chart). Because most Japanese companies typically don't update guidance early in the year, it's been unclear what the full impact of April's consumption tax increase would be on aggregate earnings. Following a period of uncertainty, the ratio has moved higher. Japan's earnings estimate revision ratio is now the strongest globally. As companies report their first-half results in the coming months, we expect stronger guidance will lead to continued improvement of earnings estimate revisions and support the outlook for Japanese equities.

### LAND OF THE RISING EARNINGS

*Japanese earnings expectations are on the upswing.*




**Left Axis:** Earnings revision ratio
- United States
- World
- Japan
- Europe

**Note:** BoAML regional earnings revision ratios through August 2014
**Sources:** Bank of America Merrill Lynch, Northern Trust

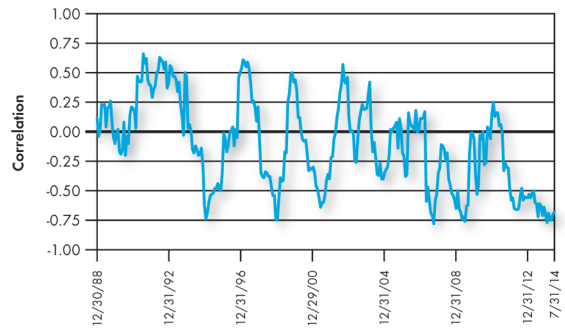
## EMERGING-MARKET EQUITY

- Continued U.S. dollar strength could pressure emerging-market equities.
- China's growth outlook is more uncertain.

Historically, emerging-market assets have been pressured during periods of U.S. dollar strength, and the current relationship indicates a strong inverse relationship between the U.S. dollar and emerging-market equities. One cause of this is the increasing attractiveness of U.S. assets, reversing capital flows to the emerging markets. Additionally, the countries that tie their currencies to the U.S. dollar experience currency strength, reducing their competitiveness. Finally, commodity producing countries suffer from falling commodity prices. Foreign direct investment in China fell 14% in August, after a 17% decline in July, as foreign investors found Chinese investment less attractive. Chinese economic data remains uneven, as good retail sales figures were offset by disappointing industrial production levels. As China's economy continues to mature, we expect more of this volatility as the government works to moderate the economy's dependence on fiscal and monetary stimulus.

### IS DOLLAR STRENGTH A WEAKNESS?

*Emerging-market stocks have increasingly found dollar strength a headwind.*




**Left Axis:** Relative emerging-market equity return 12-month rolling correlation to the U.S. dollar

**Note:** Emerging-market equity return relative to developed-market equity return

**Sources:** Northern Trust, Bloomberg

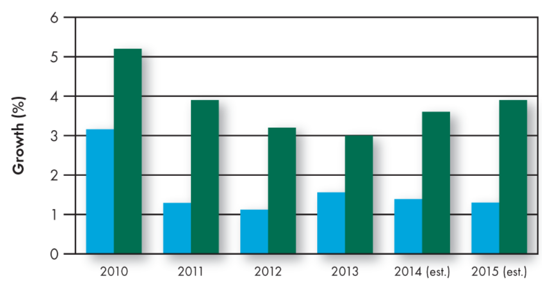
## REAL ASSETS

- Oil demand is tempered by moderate economic growth and reduced energy intensity.
- The diversification of the world's "oil portfolio" has trumped Middle East tensions.

Generally, escalating military action in the Middle East leads to Saudi Arabia opening its oil spigots. But this time around, driven by slow demand and falling prices, Saudi Arabia finds itself doing the opposite — reducing daily oil shipments by 4% in August. Seeing similar economic softness, the International Energy Agency lowered its forecasts for oil demand — now expecting 1.4% and 1.3% demand growth in 2014 and 2015, respectively. Lower global growth is partly to blame, but so is a global economy that continues to improve its oil efficiency — with the expected demand for oil equaling only one-third of expected economic growth in 2015. Additionally, U.S. oil supply growth (13% in 2013) has broadened the world's oil portfolio, making Middle East disruptions much less disruptive than in years past.

### TORTOISE RACE

*Global economic growth is slow, but oil demand growth is slower.*




**Left Axis:** Growth (%)

Oil demand growth

Real global economic growth

**Sources:** Northern Trust, International Energy Agency, BP Statistical Review, International Monetary Fund, April database

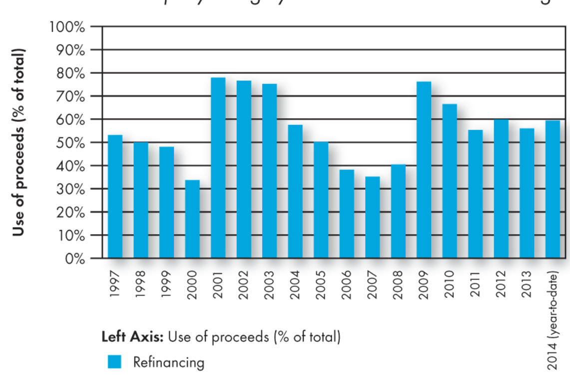
## U.S. HIGH YIELD

- Refinancing debt usually is a credit-positive event.
- The ability to refinance continues to support the expectation of a low default rate.

A majority of high yield new issuance after the financial crisis has been to refinance existing debt. At the beginning of the cycle this was to "term out" pending maturities to avoid default. However, six years into a recovery there would normally be a decline in refinancing and an increase in mergers and acquisitions, leveraged buyouts, and dividends. You can see this activity in the accompanying chart showing data from 2003 to 2007. In the cycle from 2009 to 2014, refinancing has remained the majority of issuance. Issuers have refinanced on multiple occasions at lower coupons, while extending maturities. This not only extends potential default triggers, but also lowers the cash interest burden and increases a company's interest coverage ratio. These factors continue to support the expectation of a low default rate, which provides a stable base for the high yield market.

### HIGH REFI

*The majority of high yield issuance is still refinancing debt.*




**Left Axis:** Use of proceeds (% of total)

Refinancing

**Sources:** J.P. Morgan, S&P/LCD, Northern Trust



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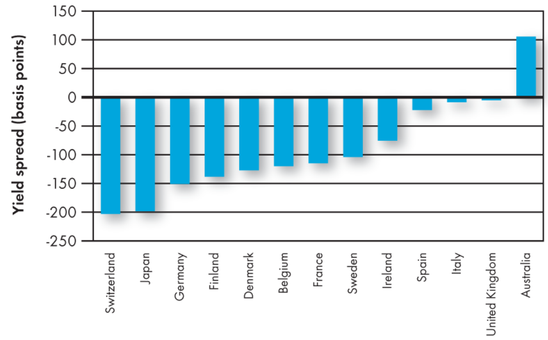
## U.S. FIXED INCOME

- Sovereign yields have drifted lower because of eurozone and geopolitical worries.
- We believe large investors are redeploying their money toward higher U.S. yields.

Improving U.S. economic data, along with the Fed signaling it intends to raise its benchmark Fed Funds rate next year, has left many investors scratching their heads as to why long-term interest rates have stayed stubbornly low in the United States. We believe the fixed-income market is a global one, with large investors having many options for investing in high-quality assets that offer good liquidity. While interest rates in Europe have fallen on a lower growth outlook, rates are being driven lower in countries such as the United States, the United Kingdom and Australia, as investors seek out higher relative yield. We believe the global nature of the fixed-income market will serve as a natural ceiling on how far, and how fast, U.S. rates may rise.

**IT'S ALL RELATIVE**

*Interest rates in many developed countries are below those of the United States.*




**Left Axis:** Yield spread (basis points)
Spread to 10-year U.S. Treasury note
**Note:** Data as of 9/11/14
**Sources:** Northern Trust, Bloomberg

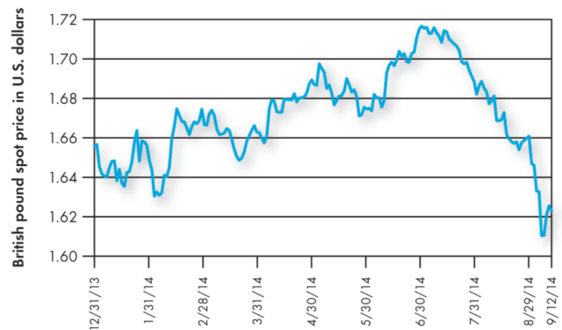
## EUROPEAN FIXED INCOME

- ECB unleashes further stimulus efforts.
- Scotland's referendum on leaving the United Kingdom serves as a distraction.

In September, the ECB announced additional measures aimed at "strengthening and deepening" its June actions. These actions included a further reduction in policy rates and the unveiling of asset-backed securities and covered bond unsterilized purchases. Since 2012, ECB policy has been to buy time to allow inflation to bottom, confidence to recover and growth to return. Just recently it appears there is a welcomed, renewed sense of urgency; more will likely be needed. On Sept. 18, Scotland decides its future as a nation. Until last week, many assumed that pragmatism would prevail over nationalism and Scotland would remain part of the United Kingdom. However, polling is uncertain. The myriad of consequences that an exit would produce are vast, but with the U.K. economy currently the envy of the Western world, the prospect of a discount in sterling should be seen as a buying opportunity.

**BREAKING UP IS HARD TO DO**

*Scottish secession worries have pressured the pound.*




**Left Axis:** British pound spot price in U.S. dollars
**Sources:** Northern Trust, Bloomberg

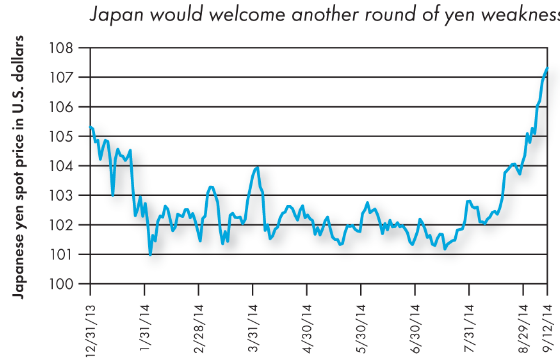
## ASIA-PACIFIC FIXED INCOME

- The BOJ made no changes to its policy during its September meeting.
- Japan's Prime Minister Shinzo Abe reshuffled his cabinet.

As expected, the BOJ made no policy changes at its September meeting. Japan's economic outlook was characterized as: "The economy has continued to recover moderately as a trend, although the subsequent decline in demand following the front-loaded increase prior to the consumption tax hike has been observed." Meanwhile, Prime Minister Shinzo Abe has reshuffled his cabinet for the first time since assuming power in November 2012. It's increasingly difficult to forecast Japanese economic performance and to handicap the success of Abenomics. Another bout of currency weakness will be welcomed, but the third arrow remains notched to the bow. Unless wages rise in response to the higher (tax-driven) inflation levels, it's difficult to declare the project a success. For those of an optimistic disposition, the new faces in government are drawn from the more reform-minded wing of the Liberal Democratic Party and might accelerate some change.

**STUBBORNLY STEADY**

*Japan would welcome another round of yen weakness.*




**Left Axis:** Japanese yen spot price in U.S. dollars
**Sources:** Northern Trust, Bloomberg

## CONCLUSION

The negative market sentiment of early August set the stage for the ensuing rally in risk assets during the last month. Action from the ECB has put a floor, at least for now, under European inflation expectations. This has led to a modest rise in global interest rates, along with some technical correction from the low liquidity environment of the summer. With the global economy still generating growth below historic trend levels, inflation pressures remain reasonably distant. We believe this gives the major central banks leeway to manage monetary policy at a pace of their choosing, supporting their efforts to improve both growth and employment. Fixed-income markets have priced in considerable action from the Fed during the next three years, with an expectation that the two-year Treasury note will rise in yield from its current level of 0.53% to nearly 3%. We believe this gives some cushion to fixed-income investments, as we don't expect rates to increase this rapidly.

Risk taking has been rewarded in the markets this year, and we expect a reasonably constructive investing environment to continue over our tactical time horizon. We made no changes to our global tactical asset allocation recommendations this month, which remain significantly overweight stocks at the expense of investment-grade bonds. The key driver for equity returns going forward remains earnings growth, which is expected to range from 7% to 9% across Japanese, U.S. and European companies this year. Investors have begun analyzing the performance of various asset classes during a Fed rate hike cycle, as the market is currently expecting the first rate hike next summer. Our analysis of prior cycles shows that, as long as the market isn't negatively surprised, volatility may increase but stocks should follow profits higher.

There's been some evolution in our risk case scenarios during the last month. Our first risk case relates to the sufficiency of growth from the G-2 (United States and China). While we have reasonable confidence in the U.S. growth outlook, Chinese growth has become more uncertain. We expect the Chinese authorities to respond with measured stimulus actions should growth risks increase. Our second risk scenario surrounds geopolitical risks in Eastern Europe and the Middle East. While energy prices have actually been falling, the risk of an interruption of energy supplies in Eastern Europe is one example of the potential difficulties in that region. Finally, we are focusing on the efficacy of the ECB's actions to support growth across the European Monetary Union. They positively surprised the market with further action in September, but we now need to see evidence of the effects on the real economy. These are the developments most likely to prompt a potential change in our constructive outlook on the markets.

*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.