

# Perspective

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

October 15, 2014

## OUTLOOK

While investor focus in recent years has centered on the outlook for monetary policy, the collective gaze is increasingly turning toward the prospect of sustainable economic growth. The global economy seems to have lost some momentum in recent months, and the concerns center around Europe. European Central Bank (ECB) policy has been effective in improving financial conditions across the eurozone, but the transmission of benefits to the real economy remains elusive. Participation in the first tranche of the Targeted Long-Term Refinancing Operations (TLTRO) program in September was disappointing, but optimists will point to the potential for increased activity in the December tranche after completion of the Asset Quality Reviews. In the meantime, recent economic data indicates a slowing of the European economy during the third quarter. Politicians are far from agreement on fiscal policy, with the growth-challenged French and Italian leadership arguing for looser budget rules — and meeting stiff resistance from Germany.

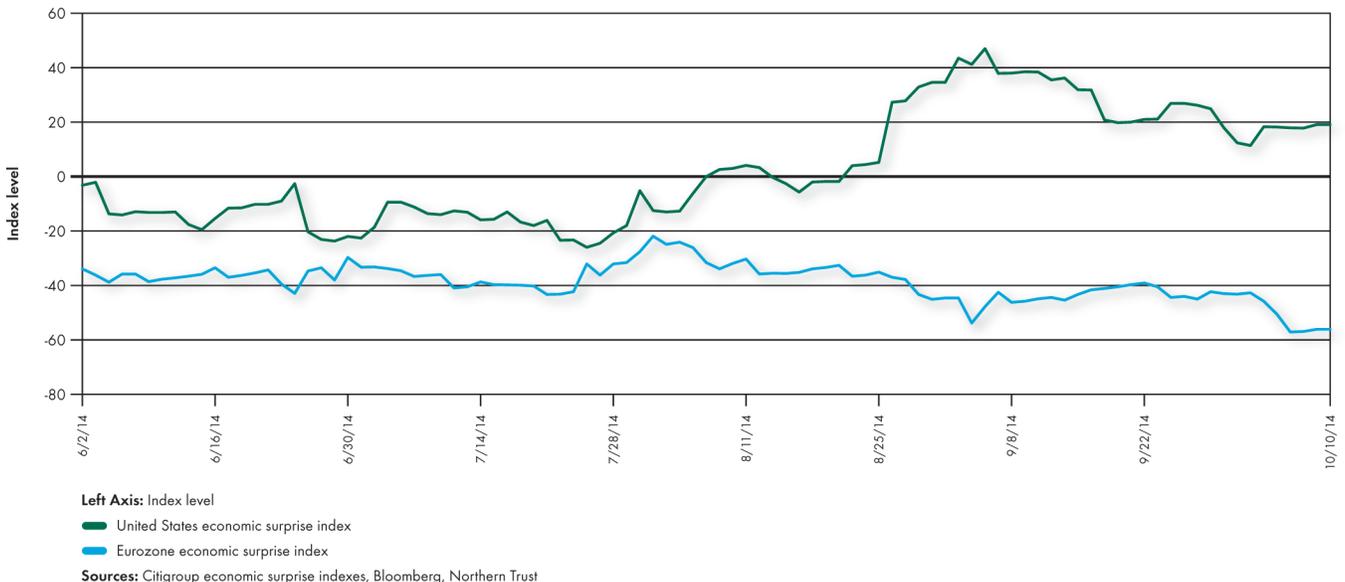
This month we downgraded our outlook for economic growth for the developed economies outside the United States, as we think the path to easier fiscal policy and structural reform

in Europe will be a long road. Even though there's been some moderation in surveys on U.S. growth, the all-important labor market is delivering noninflationary growth. Job growth, along with new job openings, has been strong in the last month, while overall wage gains remain stuck at 2%. The recent rally in the U.S. dollar will prove a headwind to export-related sales, but the decline in energy prices this year will provide an offsetting boost to the broad economy. The U.S. economy remains the least export dependent of the major developed countries.

Increased uncertainty around the global growth outlook has led to an uptick in market volatility, resulting in the first 5% decline in the S&P 500 in 32 weeks, as compared to a typical length of just 10 weeks. In a relatively short period, market sentiment has turned cautious, with the Chicago Board Options Exchange put/call ratio reaching its second highest level of the past 12 months. Market indicators like this show that the market may be oversold near term, but a sustainable rally will likely require evidence of continued expansion of the U.S. and Chinese economies. We expect this to happen during the next year.

### EUROZONE SLIPPING BEHIND

European growth reports have deteriorated over the last two months.



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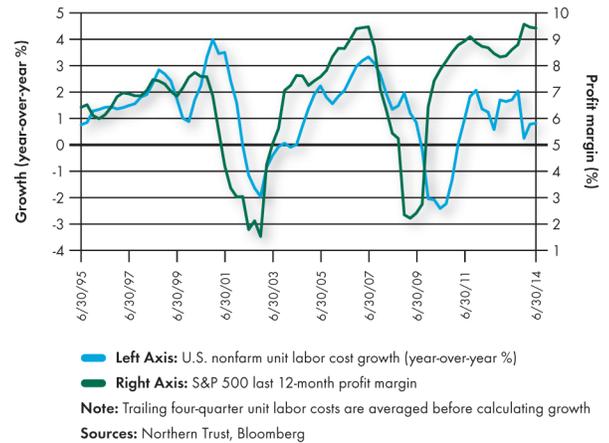
## U.S. EQUITY

- Corporate margins remain robust while concerns regarding sustainability intensify.
- Unit labor costs indicate that fears of wage-driven margin compression are overblown.

Given the impressive expansion of corporate margins during the recovery, what could derail this trend going forward? One concern is that the improving U.S. labor market will result in rising workers' wages and thus put downward pressure on margins. However, we see considerable slack in the labor market underpinning the current 2% wage gains for some time to come. In addition, productivity gains have helped offset labor cost gains during the last 20 years and we expect this to continue. The trend since 1995 shows that increasing unit labor costs have been largely contained and generally haven't hurt margins. We expect this trend to remain in place and forecast 8% earnings growth in the United States for the next 12 months.

## PROFITABILITY OUTLOOK REMAINS GOOD

*We don't expect rising unit labor costs to dent profits.*



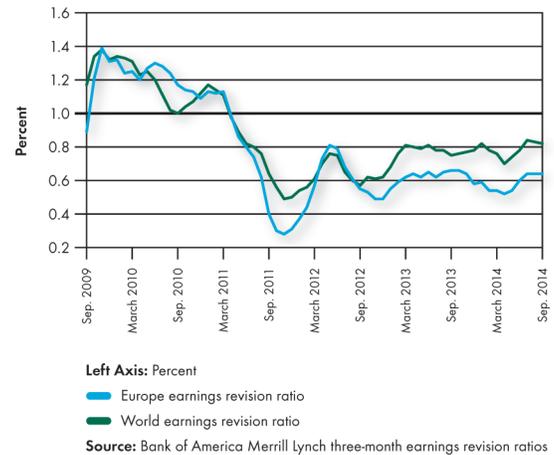
## EUROPEAN EQUITY

- Ongoing ineffective ECB actions leave the outlook for eurozone growth muddled.
- Earnings estimate revisions remain weak, with little expectation of improvement.

As the eurozone recovery continues to track below expectations, the fiscal and monetary policy responses have become increasingly divergent and lacking impact. We had been expecting the broad geographic exposure of European companies to mitigate their downside risk, but we now expect the fragile economic environment and ongoing geopolitical risks to lead to disappointing growth — but short of a full-blown recession. During the past five years, except during an 18-month period coming out of the recession in 2009, more European earnings estimates have been revised lower rather than higher. We expect disappointing earnings growth of approximately 5% during the next year, which will lead to continued muted earnings estimates revisions and will not support outperformance of European equities when compared with their developed-market peers.

## LAGGING REVISIONS

*European earnings revisions are lagging the rest of the world.*



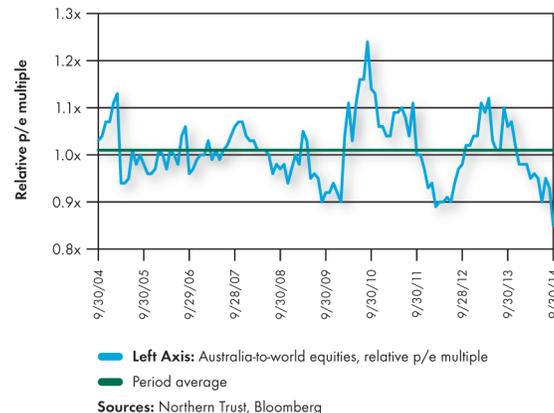
## ASIA-PACIFIC EQUITY

- The underperformance of Australian equities is tied to weak commodity pricing.
- Australian market valuation relative to the world is now below the 10-year average.

Although still impressive when compared to other developed countries, Australian economic growth continues to miss expectations, as mining capital spending has cratered and commodity prices remain weak. In fact, more than 17% of the Australian equity market was tied to the materials sector at the beginning of September, and it was one of the worst performers in the world during the month. Perhaps unsurprisingly, the Australian market's valuation relative to the world is now below average and marking a new 10-year low. With much of the swing factor in Australia's economy tied to China, it's difficult to envision outperformance from Australian equities until there's a clearer picture of China's rebalancing story.

## MARKDOWN

*Concerns over mining outlook lead to a downgrade in Australian valuations.*



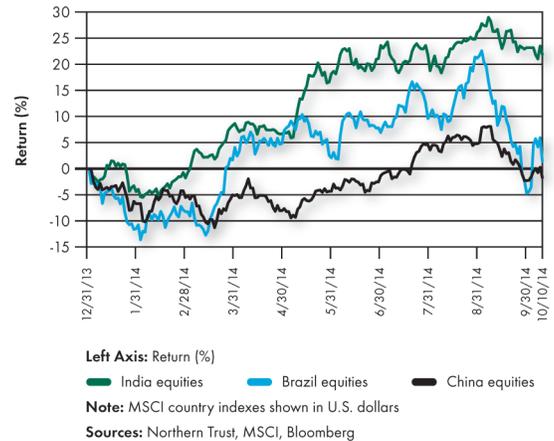
## EMERGING-MARKET EQUITY

- Slowing growth highlights the unique outlooks for emerging economies.
- Brazil continues to be buffeted by political winds.

Brazilian equities have been particularly volatile this year, tied to the outlook for the re-election of President Dilma Rousseff of the Workers' Party. Brazilian growth turned negative in the first half of 2014, with a resulting deterioration in the country's fiscal outlook. Investors have been clamoring for a change in government, and the third-place finisher in the first round of the elections has thrown her support to Rousseff's challenger — a move that is being well received by the markets. India remains the benchmark for selling change; so far both its new prime minister and central bank head have gained the market's confidence. The strong leadership exhibited in China may be partially to blame in the country's economic slowdown as the anticorruption campaign has dampened demand. In this new environment, individual country dynamics will likely play a more important role than in the past.

## POLITICAL RULES

Political winds drive emerging markets, including the most recent Brazilian election results.



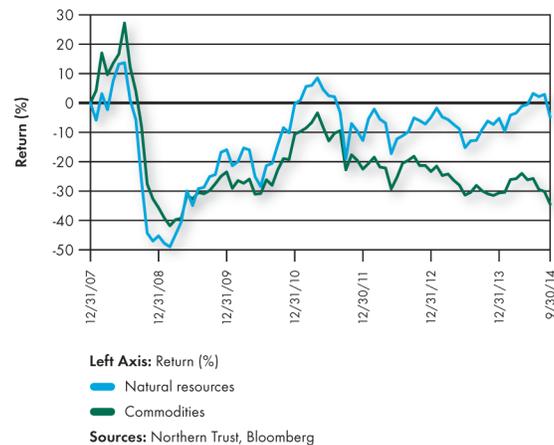
## REAL ASSETS

- Commodity prices remain weak.
- Natural resource equities have fared better in recent years.

Commodity prices continue their downward momentum, driven by the strength of the dollar and concerns over global growth. Oil prices have been especially weak, with West Texas Intermediate oil now around \$85 per barrel (from a high of \$107 this summer), while Brent sits around \$87 (from a high of \$115). This recent weakness is representative of a longer-term trend in commodity prices, which have returned an annualized -6.1% since the beginning of 2008. Natural resource stocks have been able to offset some of this commodity price weakness through increased operational efficiencies in the face of slowing commodity demand. This has allowed natural resources to deliver a -0.7% annualized return since the beginning of 2008, measurably better than the -6.1% return in commodity prices — supporting our preference for investing in natural resource equities vs. direct commodities.

## MARKET ADJUSTMENTS

Natural resource stocks have materially outperformed commodity prices.



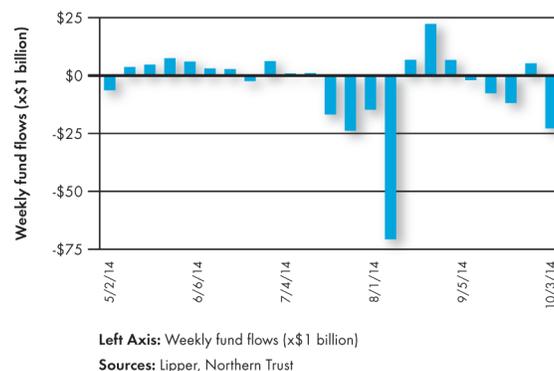
## U.S. HIGH YIELD

- Selling by nontraditional owners drove the jump in high yield volatility in August.
- Poorly handled new issuance drove high yield volatility in September.

Although there has been increased concern about geopolitics and interest rates recently, technical factors have driven high yield volatility during the past two months. July and early August price volatility was driven by cash outflows of \$12.6 billion from exchange-traded funds and model-driven and nontraditional high yield investors. Trading volume was high during this period, but the market quickly rebounded. The second period was driven by September's near-record new issuance of \$40 billion. The pace of new issue was flawed, as the first day of the cycle slashed cash balances. The market's response was a buyer's strike with little actual selling. The only substantial outflow was on the day of the announced changes at PIMCO. Overall, investors have stayed with the asset class, and fundamentals are still stable.

## A TALE OF TWO MARKETS

The two recent periods of high yield volatility have been driven by different technical factors.



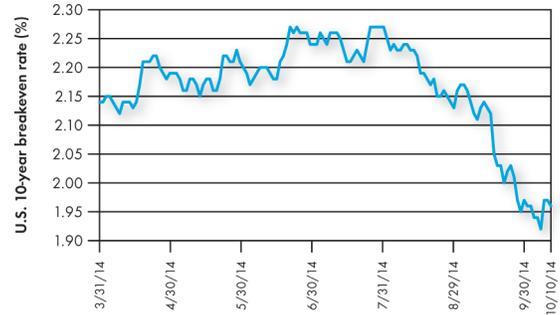
## U.S. FIXED INCOME

- Inflation expectations have been in a noticeable decline during the past few months.
- The lower outlook for inflation may push back the date of the first hike in the Federal funds rate.

Federal Reserve communications show it's looking to begin normalizing interest rates next year, as recent U.S. economic data has been upbeat. Global growth, however, has fallen short of expectations and led to lower interest rates across developed economies. A broad range of commodity prices have also been declining in the last few months. With the global economy operating below its historic trends and inflation expectations declining, we believe the Fed will be patient as it evaluates whether to increase the Federal funds rate during the summer of 2015. We think the current environment supports our view that interest rates will be low for longer than most investors expect, and we forecast a positive return environment for bonds during the next year.

### DEFLATING EXPECTATIONS

*Inflation expectations have fallen, supporting the interest rate rally.*



Left Axis: U.S. 10-year breakeven rate (%)  
Sources: Northern Trust, Bloomberg

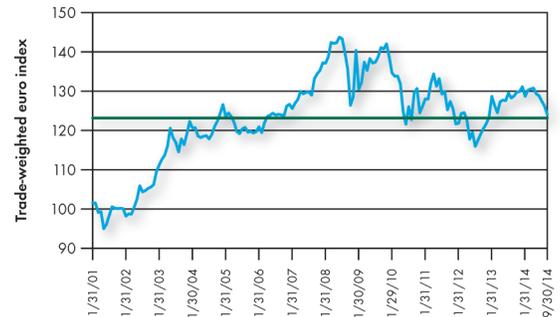
## EUROPEAN FIXED INCOME

- The euro finally gets some relief after two years of strength.
- The United Kingdom remains united.

Surveys of activity and sentiment have continued to disappoint, leading markets to question whether the ECB has done enough beyond facilitating an 8% drop in the euro in recent months. European banks' take-up of the September TLTRO was only €82.6 billion, and details of the ECB's upcoming asset purchase program in October leave us wondering if the promised €1 trillion ECB balance sheet expansion is attainable. With long-term inflation expectations still below target, the pressure for further unconventional measures is mounting. In the United Kingdom, a national breakup was averted as Scotland delivered a "no" verdict, but U.K. political concerns will persist as the debate regarding the devolution of power from London and a national election heat up. The focus now turns to the Bank of England, which has signaled that the time for interest rate normalization is nearing.

### SOME WELCOME RELIEF

*ECB action finally weakens the euro.*



Left Axis: Index level  
Trade-weighted euro index  
Period average  
Sources: Northern Trust, Deutsche Bank trade-weighted euro index, Bloomberg

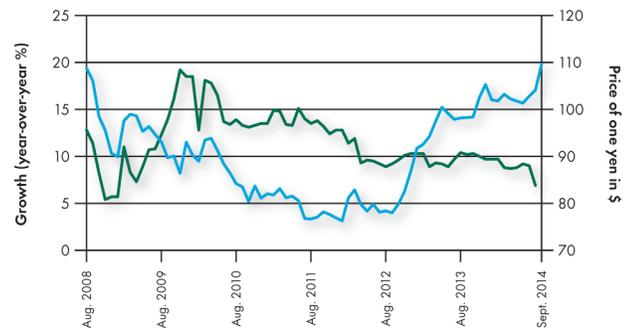
## ASIA-PACIFIC FIXED INCOME

- Chinese authorities continue to provide a limited level of stimulus.
- Japan worries about its level of currency weakness.

Economic activity in China continues to moderate, as the property sector slow-down affects the larger economy and industrial production grew at one of the slowest rates since the mid-1990s. We expect the Chinese authorities will prefer targeted stimulus measures to address struggling areas of the economy as opposed to broad-based easing. The battle between the Chinese political authorities and pro-democracy protestors in Hong Kong seems to be dissipating, which will return the focus to stabilizing economic fundamentals. In Japan, concerns are rising that yen deflation could be hurting businesses. After more than a decade of deflation, inflation is welcomed, but the Bank of Japan isn't likely to drive the currency any lower. Prime Minister Shinzo Abe is expected to discuss whether the economy can withstand another consumption tax hike amid a mixed bag of economic data.

### SLOWING CHINA, WEAKENING YEN

*Chinese industrial activity continues to slow, while the yen continues to decline.*



Left Axis: Chinese industrial production growth  
Right Axis: Japanese yen spot price  
Sources: Northern Trust, Bloomberg



## CONCLUSION

The main change resulting from our asset allocation discussions this month was a downgrade of our growth outlook in the developed markets outside the United States. While this was primarily tied to a more conservative outlook for European growth, it also accounts for the risk surrounding the Japanese growth outlook. Government growth data so far in the third quarter (the first quarter after the value added tax-induced contraction in the second quarter) has been mixed, while more positive sentiment is emanating from the private sector. Our recommended tactical asset allocation to developed equities outside the United States (Europe, Australasia, Far East) was reduced by 4% in a mid-risk allocation, with half of the proceeds going into U.S. equities and the remainder going to U.S. investment-grade bonds.

The increased allocation to U.S. equities reflects our confidence in the outlook for U.S. growth, along with a view that risk taking will still be rewarded during the next year. Recent market weakness has reduced the valuation of the S&P 500 to 17 times earnings, only modestly above the median of 16.6 times since 1954. Our allocation to U.S. investment-grade bonds reflects both our expectation of continued low interest rates (generating a positive total return) and an increase to the strategic weighting last summer. The net result of these changes modestly reduced the overall risk level of the tactical asset allocation policy, including reducing the sensitivity to U.S. dollar strength, but still leaves us positioned to benefit from rising equity markets.

Reflecting the criticality of the global growth outlook, our top risk case continues to surround the dependence on G-2 (United States and China) growth. Besides their overall weight in the global economy, a failure of the U.S. economy to continue its expansion could raise questions about the whole efficacy of quantitative easing and easy money policies. Geopolitical concerns remain a risk, primarily surrounding Eastern Europe, but the Middle East and the spread of Ebola raise additional risk cases. Finally, our risk cases surrounding Europe have morphed in the last six months from an ineffectual ECB to an unresponsive European economy. With the economy seemingly unresponsive to recent ECB moves, the risk case surrounding Europe is now that an external catalyst pushes its fragile recovery into recession.

*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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