# Perspective

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

November 19, 2013

## OUTLOOK

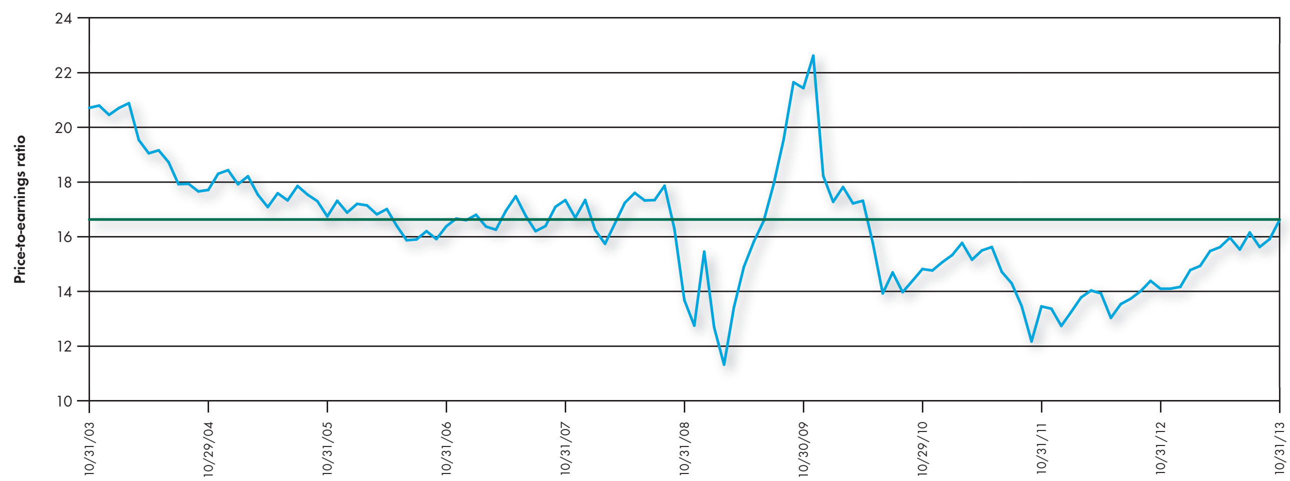
It's been "risk on" in global equity markets during the last month, as a short-term resolution to the U.S. fiscal situation set a supportive backdrop for risk taking. While U.S. growth indicators have been mixed of late (employment a little better, housing a little softer) the global metrics continue to show some acceleration into 2014. The European Central Bank (ECB) has added some stimulus to the system through a recent interest rate cut, and Federal Reserve Chair nominee Janet Yellen smoothly navigated her confirmation hearing while reiterating support for continued easy monetary policy. What may be most interesting about her reception on Capitol Hill was the noticeable lack of animus from Republican senators, which may be a reflection of evolving political strategy.

Double-digit gains in developed-countries' stock markets are pretty much the rule this year, leading investors to focus on the fundamental outlook to support these gains and the resulting valuation picture. With growth expected to improve, margins looking relatively stable and disinflationary trends providing cover for continued central bank easing, the outlook still appears constructive. In the chart below, we show that the recent advance has only brought the U.S. stock market back to median valuation levels experienced since the early 1950s. Our research indicates that, while valuations have a strong effect on returns over subsequent five-year periods, they have little predictive value for returns during the next year.

Markets have risen in recent years in the face of great skepticism, and rising prices have started chipping away at some of those worries. For the first time in years, we've seen significant inflows into equity mutual funds and exchange-traded funds, and the IPO market has been successfully floating companies that aren't yet profitable. This change in sentiment has caught our attention, but doesn't yet appear to have caused material mispricing in risk markets. The most likely catalyst for a change in this constructive investing environment is an unexpected change in Fed policy, but Vice Chair Yellen's testimony about the low cost of quantitative easing helps mitigate that concern for now.

**NOTHING EXTRAORDINARY**

*The stock market rally has only brought U.S. equities to median valuation levels.*




**Left Axis:** Price-to-earnings (P/E) ratio (earnings defined as trailing12 mo. earnings per share before extraordinary items)

S&P 500 P/E ratio

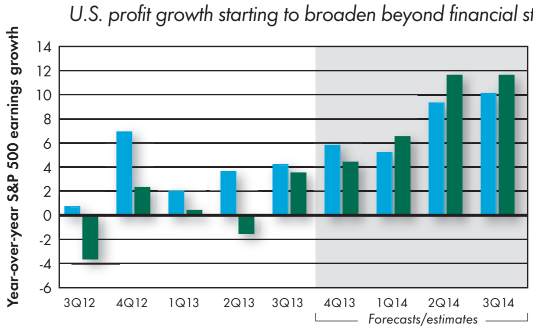
S&P 500 median P/E ratio (median post 1/54)

**Sources:** Northern Trust, Bloomberg

Northern Trust

**ACCELERATION?**

*U.S. profit growth starting to broaden beyond financial stocks.*




**Left Axis:** Year-over-year S&P 500 earnings growth

- S&P 500
- S&P 500 excluding financials

**Sources:** Northern Trust, Bloomberg

## U.S. EQUITY

- Earnings growth appears set to accelerate from recent sluggish performance.
- Financials have driven recent growth, but are expected to shift to a drag.

S&P 500 earnings growth has been lackluster during the past year, with positive readings largely driven by growth in the financial sector. Third-quarter earnings are showing modestly better growth overall, and appreciably better growth excluding financials. Looking forward, while we believe the consensus expectations are typically optimistic, we agree that earnings growth appears set to accelerate in upcoming quarters. Financial sector earnings are expected to become a modest drag on S&P earnings, implying an inflection in growth in the "real economy." It's our view that future market appreciation will be driven increasingly by growth in earnings rather than valuation, and if that earnings growth is coming from nonfinancial sectors, the market will increasingly be willing to take note.

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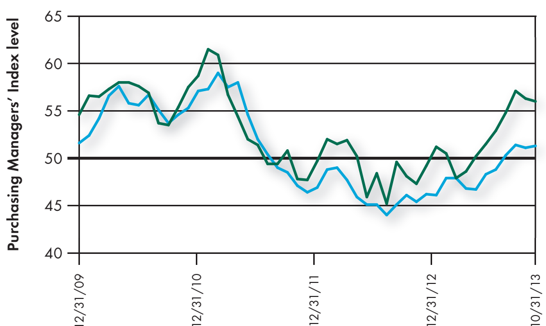
**NO PAIN, NO GAIN**

*Having gone through austerity early, the United Kingdom is beginning to benefit from its labors.*




**Left Axis:** Purchasing Managers' Index level

- Eurozone
- United Kingdom

**Sources:** Northern Trust, Bloomberg

## EUROPE & ASIA-PACIFIC EQUITY

- Eurozone growth slowed to 0.4% in the third quarter, but the United Kingdom showed momentum.
- Japan stays committed to reform initiative.

Eurozone growth softened in the third quarter, as Germany slowed to a 1.2% growth rate (down from 2.8%) and France slipped into negative territory (-0.4%). Meanwhile, Italy printed its ninth consecutive quarter of negative readings. Many European commentators blame the situation on austerity measures. However, the country that held to austerity longer than most — the United Kingdom — seems to be recovering at the strongest pace. While Europe struggles through its debt consolidation process, the United Kingdom's experience may be a sign of things to come. Until we begin to see that light at the end of the tunnel, an actively engaged ECB and low expectations will support European equities. On the other side of the world, we're seeing a continued commitment to reform in Japan. This keeps us positive on its prospects as well.

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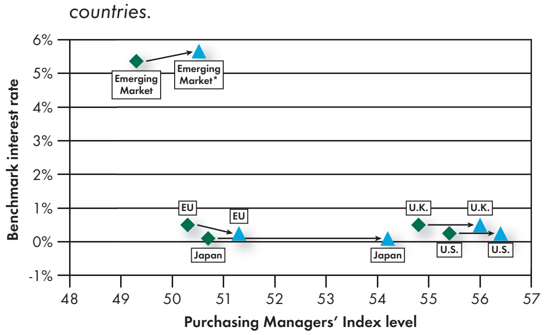
**GAINING MOMENTUM, BUT STILL BEHIND**

*Emerging economies are still lagging major developed countries.*




**Left Axis:** Benchmark interest rate

**Bottom Axis:** Purchasing Managers' Index level

- 8/15/13
- 11/15/13

*Emerging Market represents the market cap weighted average of China, South Korea, Brazil, South Africa and India

**Sources:** Northern Trust, Bloomberg, HSBC

## EMERGING-MARKET EQUITY

- Economic momentum has increased during the last quarter.
- Monetary pressures have increased benchmark interest rates.

Emerging-market equities have regained some momentum since midyear, but have still lagged the developed markets during this broad market upswing. Relative economic momentum has been favoring the developed markets, as these economies have accelerated most rapidly during the last three months. Monetary policy can also be a strong catalyst for equity performance, and tighter monetary policy across the emerging markets has joined with concerns about Fed tapering to restrain investor sentiment. China has recently completed its all-hands Communist Party meeting and has communicated policy goals to increase market influence and relax the one-child policy, among other proposals. While these initiatives appear to be moves in the right direction, their potential positive contribution to Chinese growth may be years away.

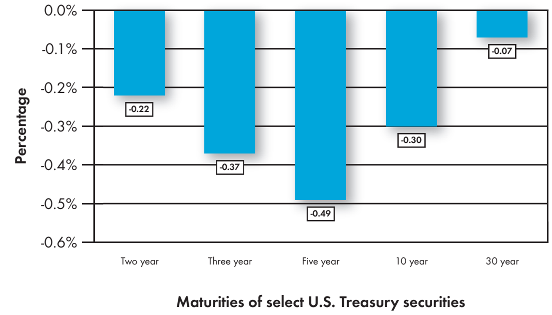
## U.S. FIXED INCOME

- Yields across the U.S. Treasury curve have been falling since the beginning of September.
- We continue to believe the economy is in a slow-growth, low-inflation environment.

The Citigroup Economic Surprise Index has steadily declined since the beginning of September, showing that economic data has disappointed investor expectations during the past two months. While the data has disappointed, we continue to believe the U.S. economy remains in a slow-growth, low-inflation environment. The weaker data, in part, has led investors to purchase U.S. Treasury securities — taking advantage of the highest yields observed in the past couple of years. The bond rally has occurred across the interest rate curve, but has been led by the five-year maturities, which have been benefiting from the Fed reiterating its pledge to keep interest rates at exceptionally low levels for the next few years. We believe this means the current zero interest rate policy will continue into 2016.

### TAPER TALK SUBSIDES

*Bonds across the curve rallied as the beginning of tapering was pushed out.*




**Left Axis:** Percentage
**Bottom Axis:** Maturities of select U.S. Treasury securities
Change in yield between 9/6/13 and 11/13/13
**Sources:** Northern Trust, Bloomberg

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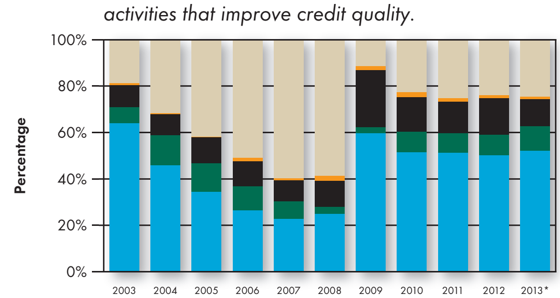
## U.S. HIGH YIELD

- Economic uncertainty has resulted in companies remaining risk averse.
- Credit profiles have remained stable, as companies focus on cost control and balance sheet stability.

Economic uncertainty has restrained risk taking by management teams. There hasn't been a great deal of activity that increases default risk, such as merger and acquisition activity, leveraged buyouts (LBOs), or leveraging transactions. Rather, a majority of new issues have been for refinancing existing debt, which lowers default expectations by extending maturities. Through the third quarter, 57% of new issues have been for refinancing (vs. 33% in 2007) and 18% have been for acquisitions and LBOs (vs. 47% in 2007). Furthermore, companies continue to focus on cost control, as evidenced by earnings growth consistently outpacing revenue growth. There are always individual exceptions, but credit quality has remained stable for the market as a whole. This has provided a supportive environment for high yield investments.

### BEING CAREFUL

*High yield debt issuance is mostly going toward activities that improve credit quality.*




**Left Axis:** Percentage
Acquisitions/LBOs
Capital expenditures
General corporation purposes
Equity monetization
Refinancings
*Data through 9/30/13
**Sources:** Northern Trust, Barclays, Lipper

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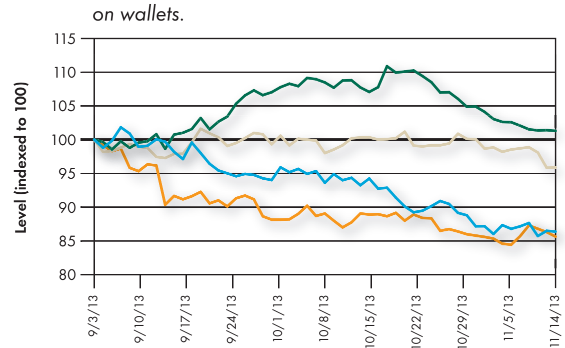
## REAL ASSETS

- Commodity prices have been trending lower on both lower demand and higher supply.
- Equity-based investments have been benefiting from commodity underperformance.

Commodity prices have started to show some softening trends. Important commodities, such as copper and wheat, have started to sell off while other notable commodities, such as oil and corn, are down 15% since the beginning of September. During this same time frame, the broader commodity complex is down 4%. The issues stem from both reduced demand (as emerging markets settle into a moderate growth profile) and increased supplies (a notable driver of corn's price action). While not doing any favors for a futures-based commodity allocation, equities have benefited. Developed-market equities are up 4% since our September start date, as falling commodity prices are keeping inflation levels lower and wallets heavier heading into the holiday season.

### JUST IN TIME FOR THE HOLIDAYS

*Falling commodity prices are alleviating the strain on wallets.*




**Left Axis:** Level (indexed to 100)
Oil
Wheat
Corn
Copper
**Sources:** Northern Trust, Bank of America

## CONCLUSION

Barring a significant reversal in markets during the remaining six weeks of the year, 2013 will go into the books as a year of excellent equity returns. Does this tell us anything about the future? Our research indicates that valuations aren't a good predictor of one-year equity returns, and the history of the U.S. stock market during the last 85 years shows a pattern of strong years being followed by another positive year. Specifically, we have had 31 years of greater than 20% stock market gains in this period, and in 22 of those instances, the following year showed another positive return from equities. On a longer-term basis, our research demonstrates a relationship between valuations and subsequent five-year returns.

We continue to favor risk assets over investment-grade bonds. We're becoming more concerned that the market consensus now seems to embrace an outlook for steady growth and low inflation, a change from the "wall of worry" the market has climbed in recent years. However, as we review our fundamental inputs (such as growth, inflation, and monetary and fiscal policy) we don't foresee a significant disruption during the next year. So we hang in with a constructive view and keep monitoring developments and the fundamental outlook for the economy and risk taking.

The risk that most concerns us during the next 12 months is an unexpected change in the interest rate markets, which would most likely emanate from the Fed. This prospect has seemingly been reduced by Fed Vice Chair Yellen's relatively dovish confirmation testimony, where she gave no indication of a bias toward normalization of policy ahead of economic progress. We believe normalization alongside economic recovery can be handled by the risk markets (as happened from May to September of this year). We also continue to believe that the risks of fiscal problems in Washington, D.C., and uncertain policy progress in Japan and Europe, remain manageable.

*Jim McDonald*
*Chief Investment Strategist*

**Price-to-Earnings Ratio** current share price of a stock divided by its earnings per share.

**Citigroup Economic Surprise Index** measures the variations in the gap between the expectations and the real economic data. When the index is positive it means that the released data have been better than the expectations. When index is negative, it means that actual results have been worse than expectations.

**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.

**S&P 500® Index** is an unmanaged index consisting of 500 stocks and is a widely recognized common measure of the performance of the overall U.S. stock market. It is not possible to invest directly in an index.