Perspective

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

December 18, 2013

OUTLOOK

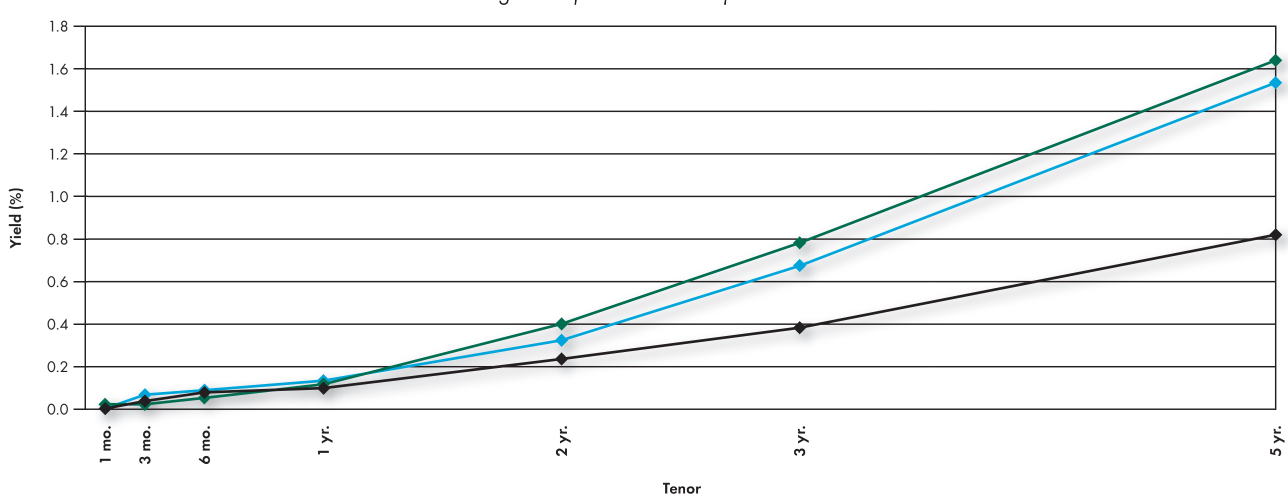
2013 looks set to go down in the record books as quite a year for risk taking in the financial markets. While we were positive on taking risk during 2013, the magnitude of the gains was much better than we expected. History shows, however, that this level of volatility is more the rule than the exception. During the last 87 years, the U.S. equity markets have generated total returns above 16% on 41 occasions (47% of the time), and generated returns below 4% an additional 31% of the time. Returns have been between 8% and 12%, the most typical investor expectation for returns, only 6% of the time. Much of the gain in equity markets in 2013 came from valuation expansion, as adequate economic growth combined with continued easy monetary policy to stoke risk appetites.

After a year of valuation expansion, we're expecting fundamentals to help support continued gains in 2014. The global economy appears set to accelerate into the new year, as fiscal drag is reduced in major developed economies. However, we've also had our hopes built up in prior years, and the global economy has actually decelerated for three years running. We expect major developed economies to have a more predictable growth outlook in 2014, as the cyclical recovery in Europe slowly continues and fiscal drag fades in the United States. The emerging-market growth outlook is more uncertain because of tighter financial conditions, but we believe growth should still be more than twice as fast as in the developed world.

Financial conditions will begin to become less easy in the United States as the Federal Reserve begins tapering its bond buying program, but we believe the markets are positioned for this eventuality. In contrast to this past spring, short-term interest rates are better anchored — indicating investors are differentiating between the impact of reducing bond purchases and eventually raising interest rates. We don't expect a rate shock due to tapering, as rates have already risen and the magnitude of the tapering compared to the overall stock of debt outstanding is fairly small. We expect interest rates to be significantly driven by the outlook for growth going forward, so the upside risk case would most likely be caused by a positive growth surprise.

A LITTLE DIFFERENTIATION

Shorter-term interest rates are lower than during the "taper tantrum" this past summer.

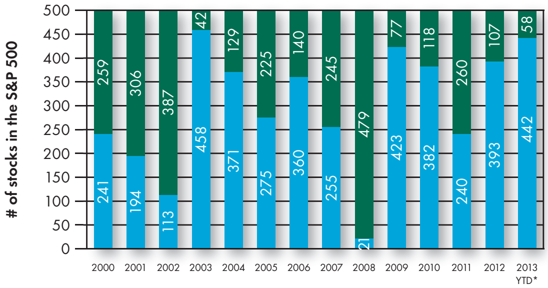


Left Axis: Yield (%)
12/12/13 8/30/13 5/21/13
Sources: Northern Trust, Bloomberg

Northern Trust

NOT A LOT OF LOSERS

Nearly 90% of S&P 500 stocks have advanced this year.



Left Axis: Number of stocks in the S&P 500

- Declines
- Advances

*2013 year-to-date as of 12/13/13

Sources: Northern Trust, Bloomberg

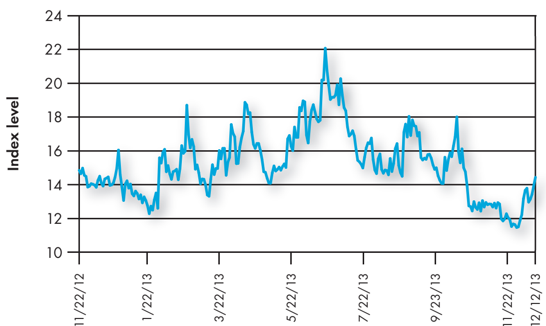
U.S. EQUITY

- Because of strong market gains, there are fewer opportunities for tax-loss harvesting.
- We expect tax-related selling to continue through year end.

Taxes are the single largest cost to taxable investors, and capital gains taxes can significantly affect portfolio returns. With the S&P 500 up close to 25% so far in 2013, investors have fewer opportunities for tax-loss harvesting this year. Only 58 companies in the S&P 500 Index have had negative returns year-to-date, and only 22 companies are down 10% or more year-to-date. We identify these stocks as likely candidates for tax-loss harvesting. December historically is the strongest month for the S&P 500, and companies that are candidates for tax-loss harvesting have, on average, outperformed the index by close to two percentage points in December. With so few "losers" this year, however, we expect tax-related selling to continue through year end.

A SMALL UPTICK IN UNCERTAINTY

European volatility has edged up after hitting post-financial crisis lows.



Left Axis: VDAX – DAX Index Volatility

DAX Index is the German stock index.

Sources: Northern Trust, Bloomberg

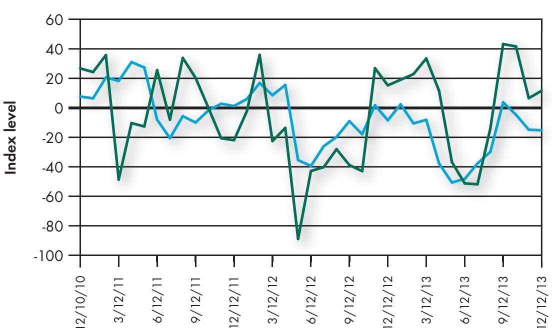
EUROPE & ASIA-PACIFIC EQUITY

- Entering the fourth quarter of 2013, European markets remained solidly in positive territory.
- Geopolitical tensions have risen in Asia.

Heading into 2014, there's evidence that Europe may be turning the corner, but volatility has been rising during the past month. Some of the increased volatility is attributable to thinning market volumes, but some of it is undoubtedly because of continuing uncertainty surrounding eurozone performance. In Japan, Abenomics appears to be taking a firm grip on both the country's economy and the national psyche, with both exhibiting a sense of confidence not seen in many years. Japan even seems ready to stand its ground, literally, in contesting the sovereignty of the Senkaku/Diaoyu Islands and China's new airspace controls. Meanwhile, in North Korea, Kim Jong-un is continuing his purge of senior figures, executing his one-time mentor. While neither situation is positive for the markets, we expect economic fundamentals to outweigh these concerns.

FADING SURPRISES

Economic reports across the emerging markets have been disappointing.



Left Axis: Index level

- China Economic Surprise Index
- Emerging-Market Economic Surprise Index

Sources: Northern Trust, Bloomberg

EMERGING-MARKET EQUITY

- Economic data across emerging markets has been moderating of late.
- Slowing credit growth remains a concern.

We've been discussing the importance of economic and monetary policy momentum to regional equity performance, and we have yet to see near-term improvement across the emerging markets. Chinese growth data has been mixed of late, with better export data being offset by somewhat slower domestic activity. Brazil continues to generate disappointing growth, and its economy actually contracted in the third quarter, while increasing inflation in India could lead to further interest rate hikes. Asia (roughly 60% of emerging-market equity capitalization) has recently shown some improvement tied to both its export markets and domestic consumption. Overall, we believe emerging-market growth should benefit from an improvement in global growth, but continued relatively tight monetary policy will likely hinder relative equity-market performance during the next year.

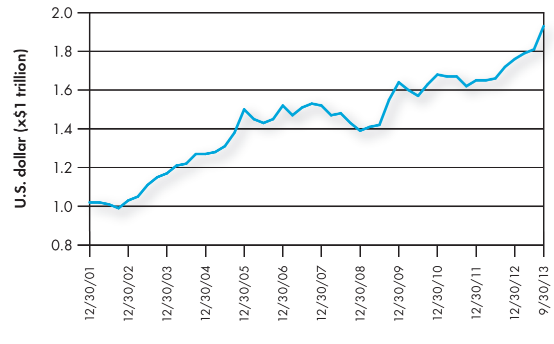
U.S. FIXED INCOME

- Cash on company balance sheets has continued to rise.
- We expect tight spreads to persist through the end of this year.

The low interest rate environment the United States has been experiencing since 2008 continues. Companies have taken advantage of this during the past few years, repeatedly refinancing their balance sheets. While the U.S. economy has shown slow improvement, management teams continue to be reluctant to invest in their businesses, and liquid assets on company balance sheets are at an all-time high. All this provides fixed-income investors comfort that they can reach for a bit more yield by purchasing corporate bonds and that the investments could still be repaid in a timely manner. As a result, we continue to believe corporate bonds are attractive in this low interest rate environment.

PILING UP

High profits and limited spending have boosted corporate cash piles.



Left Axis: U.S. dollar (x$1 trillion)

Cash and equivalents on corporate balance sheets (all U.S. publicly traded corporations)

Sources: Northern Trust, Bloomberg

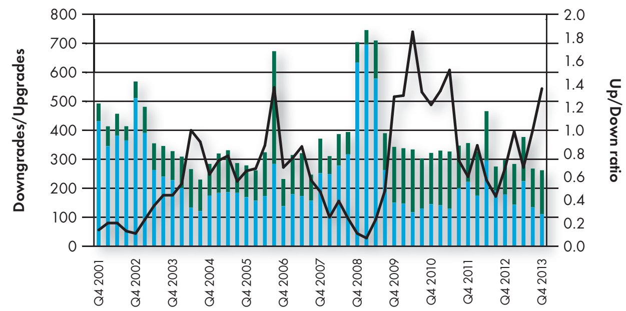
U.S. HIGH YIELD

- High yield issuers continue to maintain or improve credit quality.
- Stable credit profiles and low defaults should support high yield in 2014.

Economic uncertainty has kept corporate management teams conservative. Evidence of this can be seen in the ratio of credit rating upgrades to downgrades by Moody's and S&P, both of which are biased toward downgrades. The ratio during the past five quarters has exceeded the longer-term average (going back to 2000) of 0.63. The ratio has been greater than 1.00 for the last two quarters, and there are only two quarters in the last 14 years in which the ratio has been higher than today. Credit fundamentals will provide a solid base for high yield in 2014. Stable fundamentals also provide active managers greater flexibility to manage interest rate risk by not being forced into rate sensitive bonds to avoid credit risk.

IMPROVING CREDIT

Strong credit quality has led to a jump in ratings upgrades.



Left Axis:

Upgrades Downgrades

Right Axis: Up/Down ratio

Data through 12/11/13

Sources: Northern Trust, Bloomberg

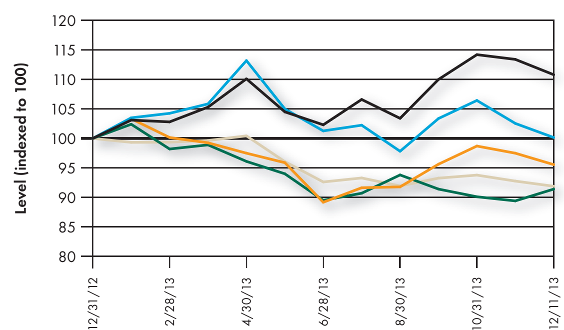
REAL ASSETS

- Real assets have responded to disinflationary trends in different ways.
- Spikes in real interest rates had an effect across the asset class.

Real assets typically are used to in an effort provide protection against unexpected inflation. However, 2013 has shown that other factors also are at play. Global real estate investment trusts and global listed infrastructure (real assets because of their better ability to pass through inflation to the end user) showed their interest rate sensitivity as real interest rates surged midyear. Despite the volatility, these asset classes look to finish the year in or near positive territory — helped by their equity exposure. Equity-based natural resources also benefited from its equity exposure, outperforming futures-based commodities by 4% (although still negative in aggregate). Finally, 2013 also served as a reminder to inflation-protection seekers to keep durations short to purify inflation exposure, as the longer-duration Barclays U.S. TIPS Index suffered near-double digit losses.

WIDE DISPERSION

Performance results of real assets ran the gamut in 2013.



Left Axis: Level (indexed to 100)

Global real estate

Natural resources

Global listed infrastructure

Commodities

Treasury Inflation-Protected Securities (TIPS)

Sources: Northern Trust, Bloomberg

CONCLUSION

At times in the financial markets, there are seeming disconnects between asset prices and the fundamentals that underpin them. In our policy discussions this month, we isolated our expected key market drivers during the next year, and we expect fundamentals to play an increasingly important role. This starts with the need for profit growth to continue, as valuations expanded substantially in 2013. But fundamentals also are critical because the outlook for economic growth, and particularly job creation, will be central to the Fed's plans to reduce bond purchases as it begins to normalize monetary policy.

Stocks have advanced mightily during the last year, reducing the margin of safety. However, when compared with the major alternatives of fixed income and cash, we still believe the prospects for equities look the most favorable. While we aren't expecting a jump in interest rates during the next year, we're expecting heightened volatility during the Fed's normalization process. This argues for extra patience in monitoring fixed-income holdings and avoiding reacting to short-term market moves. Geographically, we continue to favor developed-market equities over emerging-market equities, as the monetary policy outlook is more favorable and the growth outlook is less volatile.

This monetary policy outlook brings us to our key risk: an unexpected change in monetary policy in the developed world. A new aspect of this potential risk is the chance of a positive growth scare, which would lead markets to question how the Fed would respond. We also continue to be concerned about the potential for policy disappointment in Japan, where the commitment to economic reform continues to be espoused but tangible progress is somewhat limited. Europe has made some strides on the components of its banking union, but much work remains. Finally, the U.S. political outlook remains steady, as a two-year spending plan is working its way through Congress, and we're likely to see substantial gridlock until the 2016 presidential election.

Jim McDonald
Chief Investment Strategist

Barclays U.S. TIPS Index consists of Inflation-Protection securities issued by the U.S. Treasury.

Citigroup Economic Surprise Indices measure the variations in the gap between the expectations and the real economic data. The index series includes different indices for different regions or countries. When an index is positive it means that the released data for that region or country has been better than the expectations. When an index is negative, it means that actual results have been worse than expectations.

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.

VDAX or DAX Volatility Index indicates the fluctuations in the DAX Index expected in the derivatives market for the following 45 days. The **DAX Index** is the German Stock Index, composed of 30 selected German blue chip stocks traded on the Frankfurt Stock Exchange.