Global equity markets recently registered a 20% decline — which many analysts designate as a “bear market,” while U.S. equities have declined 14% from their highs. Credit markets have also shown increased risk aversion, with U.S. investment-grade and high yield spreads widening this year. Sovereign debt markets continue to see declining yields, as poor equity markets and increased central bank intervention have boosted demand. In what may be a telling reaction, though, the recent move by the Bank of Japan (BOJ) to implement negative interest rates led to a stock market selloff and yen surge — the opposite reaction of what policymakers must have intended. The combination of these developments and a soft string of U.S. economic data has led the Federal Reserve to reiterate its somewhat dovish stance from the January meeting, leading the market to believe that the Fed will raise rates at most once during the next year.

So what's behind the pressure on equity markets and the flood toward fixed income? The popular press would have you believe that the market is prescient, and is sniffing out a recession. While we don't share that view, the deterioration in financial conditions (a measure of spreads and volatility in money markets, bond markets and the stock market) has the potential to hurt future growth if it continues. In addition, investors are concerned about both economic growth prospects and the adequacy of remaining central bank ammunition, which could be leading to a downward adjustment in valuations. A recent cause for concern has been the health of the European banking system, as poor earnings reports from several leading banks have renewed concerns over capital adequacy across the system. We think the real issue is the banking industry’s challenged earnings potential in a world of higher capital requirements and businesses that are constrained by regulation.

We think there is more “noise” than “signal” in the markets’ weak start to the year. To be sure, global growth prospects remain uneven, and the Chinese growth outlook continues to be too opaque. Markets can be emotional during the short term, and investor behavior can be anything but rational. Because we think investors have become too dour on the U.S. growth outlook, we upgraded our view of U.S. growth to a “positive surprise” during the next 12 months. Alongside steady European growth, we think this will be sufficient to generate improved corporate profits and investor risk appetite in the coming year.

**FINANCIAL CONDITIONS DETERIORATE**
Conditions have reached levels seen in prior corrections.

![Graph showing financial conditions](chart)

- **Left Axis:** Bloomberg U.S. Financial Conditions Index
- **Right Axis:** S&P 500 trailing 12-month total return (%)

**Note:** Positive index value indicates accommodative financial conditions

**Sources:** Northern Trust, Bloomberg
**U.S. EQUITY**
- U.S. equities have shown a strong correlation to the price of oil.
- We caution against using oil as a signal of global growth.

Low oil prices have led investors to worry about the potential of slower earnings growth as well as energy-related credit problems. There are real economic costs from the decline in oil prices, as evidenced by the 75% drop in energy earnings in the fourth quarter of 2015. Cheap capital chasing new, unconventional technologies during the past few years significantly boosted production. It’s the resulting excess supply, along with U.S. dollar strength, that has had the most significant impact on lower oil prices. We remain constructive on U.S. equities because we expect the U.S. expansion to be durable and because the positive impact from lower oil prices hasn’t been broadly realized. If the recently weakening dollar puts a floor under the price of oil, it will remove one part of the bear case on equities.

**EUROPEAN EQUITY**
- European equities have fallen despite positive signs from economic data.
- Increased volatility will keep a focus on ECB policy.

With the STOXX 600 down approximately 17% year-to-date, European markets haven’t provided shelter from broader global volatility. Although the market is clearly discounting a global slowdown (or recession), the downturn is incongruous with what has been directionally better data. The Eurozone Purchasing Managers’ Index is strong at 53.6, gross domestic product (GDP) is expected to increase by 1.7% in 2016 and unemployment continues to decline (albeit from double digits). European Central Bank (ECB) President Mario Draghi recently called out “emerging-market economies’ growth prospects, volatility in financial and commodity markets, and geopolitical risks” as issues for the European Union to contend with and noted that risks to growth “remain on the downside.” If volatility continues, it’s likely that the ECB will beef up its monetary easing in March — probably pressuring its negative deposit rate policy further and/or increasing monthly asset purchases.

**ASIA-PACIFIC EQUITY**
- Global volatility in 2016 reverses Japan’s healthy 2015 equity returns.
- The BOJ hopes negative interest rates spark lending, borrowing and inflation.

The 17% decline year-to-date in Japanese equities has wiped out 2015’s relatively strong performance. Equally noteworthy was the Bank of Japan’s (BOJ’s) recent lowering of the interest rate limbo stick to subterranean levels. Fearing that a slowdown in China (and globally) could dampen consumer and business confidence and undo efforts to stem deflation, the BOJ joined the ECB in introducing a negative interest rate policy. The -0.1% interest rate applies to excess reserves held at the central bank and, along with a robust asset-buying program ($700 billion per year), is aimed at stimulating lending/borrowing and ultimately inflation (2% target). However, the BOJ had to be disappointed by the rally in the yen after the policy change. More reform looks to be needed for the country to achieve its economic goals.

**CORRELATION, NOT CAUSATION**

Low oil prices have hurt sentiment more than fundamentals have.

**EUROPEAN EQUITY**

**ASIA-PACIFIC EQUITY**

**NO HAVEN**

Volatility in European markets has tracked global weakness.

**EVEN LOWER AND LONGER**

Japan’s government bond yields have fallen further after the recent interest rate cut.
EMERGING-MARKET EQUITY

Emerging-market equities haven't been hit as hard as usual in the recent selloff.

Currency developments are helpful, but economic momentum is needed for a rebound.

Emerging-market equities quietly stopped underperforming their developed-market peers during the last quarter. One important contributor has been the changing expectations around the Fed’s policy, which has at least temporarily halted the U.S. dollar rally. Emerging-market equities have historically been inversely correlated with the U.S. dollar, because of worries over capital flows. Even though this respite from dollar appreciation is welcome, it’s not sufficient to propel sustained outperformance from emerging-market stocks. Economic momentum, importantly led by China, will likely be a necessary ingredient for improved equity performance. Chinese leaders continue to tweak their policy prescriptions to boost growth, including reducing interest rates and down payment requirements for first-time home buyers. Finally, some amelioration of credit concerns across the emerging markets will be important for improving equity performance.

REAL ASSETS

As oil prices continue to fall, expectations for supply cuts grow.

Should oil prices stabilize, the benefits of lower oil prices will be realized. The pain in the oil markets continues as the “risk case scenario” of $25 per barrel oil quickly became the “base case scenario” and, more recently, reality. We continue to tactically underweight natural resources as we wait for commodity market stabilization, but acknowledge that elements of a market bottom are potentially coming together. Prospects for oil supply cuts are growing — including companies announcing capital expenditure reductions and OPEC member countries hinting at collaboration on output cuts. A moderation in U.S. dollar strength would also help put a floor under commodities broadly. Oil price stabilization at these lower levels would be a positive for the broader economic outlook; financial market dislocation worries would increasingly be replaced by a focus on the lagged positive impact of lower oil prices on the real economy.

U.S. HIGH YIELD

Current valuations appear inconsistent with historical measures of valuation.

We think the current risk/return outlook is excellent. The first three times high yield spreads exceeded 8% were during the telecom default cycle of 2000 to 2002. The telecom sector comprised 38% of the high yield market when nearly the entire sector defaulted. The next two times were during the financial crisis of 2008 and 2009. This was a significant risk of the systemic failure of the financial system. The only other time was for one week in 2011 during the European sovereign crisis. At current levels, investors are being compensated for approximately a 10% default rate during the next year. Independent energy and oil field services are now only 5.71% of the market. Global banks are presently far better positioned than in 2008. Moody’s default forecast is 4.7%, and broader market fundamentals aren’t severely negative. This leads us to continue to recommend a significant tactical overweight to U.S. high yield bonds.

RARE HEIGHTS

High yield spreads exceed 8% for only the seventh time in history.
U.S. FIXED INCOME

- Two-year U.S. Treasury yields have moved significantly lower in 2016.
- Our view of a lower for longer interest rate environment remains intact.

Yields on two-year U.S. Treasuries steadily rose during the fourth quarter of 2015, as the market began to price in the first interest rate hike in almost a decade. However, since the Fed initiated liftoff in December, expectations of future rate increases have fallen, and the two-year Treasury has dropped by 40 basis points. Investors have grown increasingly concerned that the slowdown in the global economy will have a more significant impact on the United States. Consequently, the market probability of additional rate increases in 2016 has plummeted, as investors have become more skeptical about the Fed’s ability to raise rates going forward. Amid the heightened volatility in the Treasury market, we continue to believe that rate hikes will follow a shallow path and that interest rates will remain lower for longer.

EUROPEAN FIXED INCOME

- German bund yields are in free fall as deflation concerns increase pressure on the ECB.

The global risk selloff and the move to negative interest rates in Japan reignited the safe haven status of German bunds and pushed the 10-year bund rate toward zero. While business surveys highlight continued economic growth, worries about deflation expectations becoming entrenched are more pressing. This increases the pressure on the ECB to ease policy further in March, through lower rates and possibly greater quantitative easing. The Bank of England’s (BOE’s) February Inflation Report revealed both weaker growth and inflation outlooks, and a U-turn from long-term hawk Ian McCafferty. With the BOE’s emphasis on its concerns about global conditions, markets are now speculating about the possibility of an interest rate cut. Even though this appears unlikely, with domestic fundamentals remaining intact, the timing of any policy renormalization appears to have been pushed back considerably.

ASIA-PACIFIC FIXED INCOME

- The BOJ adopted a negative interest rate policy to tackle low inflation.
- The Reserve Bank of Australia’s outlook remains unchanged despite China concerns.

BOJ Governor Haruhiko Kuroda’s change in tactic to cut the BOJ’s deposit rate to -0.1% took markets by surprise. While applicable only at certain thresholds to commercial banks, Japanese government bond yields have since moved sharply lower, trading at or below zero. The decision wasn’t unanimous and could challenge the BOJ’s asset purchase strategy. However, the BOJ’s intent to fight low inflation appears to have been stepped up. The rally in the yen amid global market jitters will add pressure to do more. Despite weak commodity markets, the Reserve Bank of Australia’s outlook remains unchanged based on its latest quarterly forecasts. The modest upgrade to near-term GDP growth explained by stronger domestic demand was a marginal surprise. This will become an increasingly relevant consideration given the economy’s significant exposure to Asia.

NEW YEAR’S RESOLUTION

Yields have dropped this year along with growth expectations and risk appetites.

CRUDE PRESSURES

Falling oil prices pressure inflation trends downward.

UNWELCOME STRENGTH

The BOJ’s recent easing move backfired by the strengthening of the yen.
CONCLUSION

Our asset allocation discussion this month took a different tack, with much focus on diagnosing the root causes of the recent market weakness and then assessing the likely path of the economy and financial markets during the coming year. Our long-term forecasts have called for slow growth, low interest rates and lower returns tied to elevated valuations. Has the realization of this forecast been compressed into the first part of 2016? Our conclusion is that investor concerns about the state of global growth are likely overblown — particularly as it relates to the U.S. economy. Concerns over Chinese growth aren’t new, and the Chinese currency is showing a desired measure of stability. The move to negative interest rates in Japan (and even more negative rates in Sweden) has highlighted the banking system’s earnings growth challenges, but doesn’t put banks’ liquidity or solvency at serious risk.

With markets down sharply during the last six months, we feel there’s already a reasonable degree of “bearishness” evident in current equity prices. The sharp selloff since the beginning of the year, alongside other signs of investor capitulation, contributed to our decision to “stand pat” this month with our tactical asset allocation recommendations. Our moderate overweight to risk assets is concentrated in the U.S. equity and high yield markets, where we feel the economic outlook has become too bearish and valuations have improved. We’re paying close attention to our recommended underweights to emerging-market equities and natural resources, which have traded better of late. Further stability in the U.S. dollar, alongside better economic momentum, will be a likely ingredient for better performance going forward.

Our risk discussions focused on recurring concerns over China, central bank policy and the effects of U.S. dollar strength. We debated the state of the banking system, in particular the European banks, as a potential new risk case. In the end, tougher regulation and lower interest rates make banking a less profitable business, but we don’t think this will imperil economic growth. We also discussed the risk of weak financial conditions harming future economic growth, but don’t see the current level of uncertainty as sufficiently harmful. Credit growth in the United States, in particular, has remained robust into 2016. We’ve been expecting an uptick in volatility as slow growth meets the limits of monetary policy accommodation, but we clearly weren’t expecting such a difficult start to the year. If our constructive view on economic growth in the United States and Europe comes to pass during the next several quarters, it will go a long way to improving investor sentiment, risk appetites and asset returns.

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.