OUTLOOK

Moves in the financial markets during the last month have been disconnected from underlying fundamentals and can be fully explained only by taking account of the mood swings of the markets. After global equities recorded exactly the 20% decline of a bear market, they rapidly rebounded 9% during the following month. Groups that had been hardest hit by the market declines have enjoyed the strongest rebounds, including natural resources and emerging-market equities. The increase in the price of Brent crude oil from $30 to $40 a barrel has certainly helped investor sentiment, as has the increase in inflation expectations and Treasury yields. U.S. high yield bonds enjoyed a strong rally, with credit spreads narrowing from 8.4% a month ago to 6.7% recently. While some of this may be due to the rise in Treasury yields, the majority is attributable to lessened concerns over energy and other corporate credit quality.

Economic data during the last month has shown relative strength in the United States, with some deterioration in Europe and the emerging markets. The U.S. labor market continues to generate good job gains with little sign of wage pressure, while credit expansion is supporting growth. The stabilization of the U.S. dollar over the last year will also moderate some of the pressure on U.S. exporters. European growth recently has moderated because of the continued slowing in emerging markets and the resiliency of the euro, which is roughly flat against the yen during the last year but up 6% against the U.S. dollar. While China is showing some early signs of success in stabilizing its capital account and currency, growth continues to be subpar and stimulus efforts continue apace.

Global central banks remain the most active policymakers, although increased uncertainty around the U.S. presidential election and the potential for Brexit have garnered increased attention. The European Central Bank (ECB) has further expanded its quantitative easing program, but the early reaction from the financial markets has been mixed. Lower market volatility may tempt the Federal Reserve to raise rates again, but we see only one hike during the next year as the most likely outcome. We view the move to negative interest rates outside the United States as a logical, but undesirable, next step for monetary policy. Investors appear to be increasingly unhappy with the risks associated with negative rates and the message they send about the underlying real economy. We think the Fed would do well to forswear its use in U.S. monetary policy.

INCREASINGLY NEGATIVE
Negative interest rates are an increasingly common result of easy monetary policy.

![Graph showing negative interest rates](chart.png)

**Left Axis:** Yield [%]
- Japan government yield curve
- U.S. government yield curve
- Switzerland government yield curve
- Germany government yield curve

**Note:** Data through 3/9/16

**Sources:** Northern Trust, Bloomberg
U.S. EQUITY
- U.S. equities have posted strong gains since their recent lows.
- Defensive parts of the market have outperformed over the past year and year-to-date.

U.S. equities have recovered 8% from their recent lows, leaving the S&P 500 down 2.5% year-to-date and 4% during the past year. U.S. equities may not be down materially, but lower interest rates and a lack of conviction in economic growth have driven wide performance gaps between defensive and cyclical parts of the market. As seen in the accompanying chart, defensive stocks have outperformed during market weakness, whereas cyclicals have led while the market is rising — including the recent rally. Even though our U.S. equity forecast contemplates relatively modest mid-single-digit returns during the next year, the market will likely express a more positive view through sector rotation if our domestic economic outlook proves reasonable. As a result, we're constructive on areas such as financials and consumer discretionary, and more cautious toward utilities, telecom and consumer staples.

EUROPEAN EQUITY
- Brexit fears push the British pound to a multiyear low.
- The ECB delivers further (more negative) rate cuts and increases asset purchases.

From plunging commodity prices to historical equity market declines, there has been no shortage of material for investors to fret about in 2016. Adding fuel to the fire was the recently announced referendum date (June 23) for the United Kingdom’s membership within the EU (aka Brexit). Ramifications of the referendum are far reaching — from trade to immigration to security — but most pressing for markets is the economic uncertainty it creates for both the United Kingdom and the broader eurozone. A potential Brexit, along with a Eurozone Purchasing Managers’ Index reading at a 13-month low (though still expansionary), undoubtedly pushed the ECB toward its recent aggressive easing decision. While we think it’ll be a close call, we believe the odds favor the United Kingdom staying in the EU at the end of the day.

ASIA-PACIFIC EQUITY
- The introduction of negative interest rates and a weak GDP report perversely led to yen strengthening.
- Equities have rebounded along with the global markets.

Japanese shares have joined the global equity rally. The Nikkei jumped 14% through the first week of March; however, it’s still off 10.5% for the year. Somewhat lost in the market volatility shuffle was the strengthening of the yen right in the face of the Bank of Japan’s (BOJ’s) introduction of negative rates. Volatile global markets and the ECB’s suggestion that it would further lower already negative rates apparently was enough to re-establish the yen as a relative safe haven. Yen strengthening held even though a fourth-quarter gross domestic product (GDP) report showed a decline of 1.1%, led by weak private consumption. A stronger yen is a headwind to Japan’s export-driven corporate profits, wage growth and, ultimately, inflation. In a zero-sum game, global economic weakness reveals the limits of Japan’s monetary easing.
EMERGING-MARKET EQUITY

- Economic reports have been surprising to the downside.
- China reacts to slowing growth through increased stimulus.

China’s economic transition toward increased domestic consumption would be easier if the global growth environment were stronger. The disappointing growth in the developed world has led to a major slowdown in global trade, and Chinese exports are down 18% for the first two months of 2016. Chinese policymakers continue to respond with easier monetary policy, including a recent increased focus on infrastructure spending. We’ll be monitoring items such as excavator sales to see how effective this will become. Meanwhile, efforts to manage the country’s capital account appear to be showing some success, as capital outflows slowed materially in February, and the renminbi exchange rate has been relatively stable. While this mitigates the risk to the global financial system, an improvement in economic momentum is likely needed to support sustained outperformance of emerging-market equities.

REAL ASSETS

- Natural resource prices have bounced back dramatically since February lows.
- Data points still exist to question the durability of the recent oil price upturn.

Our tactical pessimism toward natural resources coincides with a longer-term optimism that commodity (particularly oil) prices eventually have to go higher, bringing higher returns on investment along with them. Have we reached that inflection point? Oil prices have jumped 45% from recent lows — but they also jumped nearly 40% at the beginning of last year before resuming their slide. China has announced a renewed focus on infrastructure investment, but how much more is left to build? Rig counts in the United States have fallen 75% from their highs, and OPEC supply is showing signs of peaking — but inventory levels remain stubbornly high. There are still too many concerns for us to remove our underweight position on real assets, but the relative stability of the U.S. dollar is a positive start.

U.S. HIGH YIELD

- High yield credit spreads hit an outlier valuation of over 8% in mid-February.
- The high yield market has more recently rallied significantly, given capital inflows.

High yield credit spreads hit their widest level (8.4%) on February 11. Since then, as financial markets gained stability, high yield attracted a significant amount of inflows — approximately $9.6 billion came into the asset class, attracted by cheap valuations. This included the largest inflow in the market’s history during the week of March 2. This amount reflects only mutual funds, which are less than 20% of the market. Substantial inflows in conjunction with little new issuance in the high yield market have resulted in a significant rally in credit spreads. High yield credit spreads have now tightened almost 2% to 6.7%. Although credit spreads have tightened, the high yield market still yields 8.55% and offers an attractive carry.
U.S. FIXED INCOME

- Credit spreads have tightened 32 basis points after a period of significant widening.
- We continue to find corporate credit attractive.

The start of the year saw a rapid widening of credit spreads as investors focused their attention on slower economic growth, falling commodity prices and the largest new issuance of corporate bonds for any January in history. Since then, markets have calmed amid better economic data, stabilizing oil prices and more monetary easing from central banks around the globe. We continue to believe the U.S. economy will see moderate growth this year against a backdrop of low inflation and accommodative central banks. Companies will likely be able to generate plenty of cash to fund their debt payments in this environment. We continue to find corporate credit attractive, although fundamental credit research is critical in light of an increase in mergers and acquisitions and shareholder-friendly activities.

EUROPEAN FIXED INCOME

- The ECB significantly expanded its easing program.
- Global economic concerns weigh on the BOE.

The ECB took a kitchen sink approach to monetary policy by announcing cuts to its key interest rates, notably taking the deposit rate to -0.40%, extending its asset purchases to €80 billion per month to include nonbank corporate debt and adding four new targeted long-term refinancing operations. Markets were arguably surprised, leading German bunds to sell off and peripheral government bonds to rally after the announcement. While it could be a sign that the ECB is drawing a line under the continued pressure to act, it’s more certain that the negative rate environment should prevail for some time. Brexit concerns appear to be dominating the outlook for the United Kingdom, giving the Bank of England (BOE) cover to be patient. This high-profile event should underpin volatility, but we expect a close vote to keep the United Kingdom in the EU.

ASIA-PACIFIC FIXED INCOME

- Uncertainties regarding China appear to have steadied.
- The Reserve Bank of New Zealand surprises with a rate cut.

As the People’s Bank of China presses ahead with monetary easing, and commodities show some signs of price stabilization, market fears regarding spillover effects from a slowdown in China appear to have settled. Diverging central bank policies will be pivotal, and with China likely to enact further interest rate cuts throughout the year, the renminbi may see renewed selling pressure. The Reserve Bank of New Zealand’s 0.25% interest rate cut took markets by surprise, following recent comments from Governor Graeme Wheeler that indicated deflationary pressures related to lower oil prices weren’t a concern. While unemployment is at a seven-year low, indicators of activity show signs of a slowdown, raising the likelihood that easy monetary conditions will continue.
CONCLUSION

In last month’s asset allocation discussions we debated the root causes to the poor start to the year, and assessed whether the market was sending a “signal” that the economy was in trouble or whether it was just “noise” that was likely to dissipate. Our conclusion was that the market action was mostly noise, and we upgraded our outlook for U.S. growth, as we felt investors had become too bearish on the economy. Investor fears seem to have rapidly receded as global equities have gained nearly 10% during the last month on a rebound in commodity prices and improving U.S. economic data. This has also led to a significant rally in investment-grade and high yield bond spreads, and some rebuilding of inflation expectations back toward more realistic levels.

While our tactical asset allocation recommendations benefited during the last month from the rally in risk assets, they’re still lagging year-to-date because of the lackluster equity market performance and the sharp rebound in commodity prices. We made no changes to our recommended policies this month, despite a negative revision in our growth outlook for developed markets outside the United States. We continue to think the global economy is stuck in a slow-growth mode, with relative market share gains by major economies driven by central-bank-induced currency moves. With major economies already experiencing negative interest rates across much of their yield curves, there’s only so much more that can be done to devalue. This seems to be working its way through the markets, as the U.S. dollar has been roughly flat now for the last year against its major trading partners.

Our new risk case this month involves populist politics — and election risk in both the United States and Britain. The lackluster economic recovery has left voters disaffected with their economic prospects and political leaders. These concerns can be directly expressed in the Brexit vote (June 23) and the U.S. presidential election (November 8). While our best guess is that Britain will vote to stay in the EU, the U.S. presidential election is too far away to confidently forecast. Our concern is that global trade could be constrained by increased protectionism, a reversion of the established globalization trend. We also remain concerned about the risks of a China hard landing, but our expectation for currency stability has held so far this year. Our final primary risk case surrounds central bank policy, where the Fed needs to manage a slow normalization process while the ECB and BOJ need to contend with the increasingly poor reaction to negative interest rates.

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.