

# REDUCED RECESSION RISK

The short-term drivers of market performance are not always clear, but an improving outlook toward economic growth seems to be a clear contributor to the recent rally in equities. At the same time, a rapidly slowing manufacturing sector has raised concerns over the outlook for global growth, which have also been reflected in a flat yield curve. Recent data has suggested some stabilization in the global economy, with more positive signals toward U.S. growth. The outlook amongst U.S. service sector companies improved notably in October, and the October jobs report was a positive surprise. Economic forecasts driven by the shape of the yield curve have also turned more positive, as reflected in the New York Federal Reserve’s recession odds model shown below. After peaking in August at a 38% probability of recession over the next twelve months, the forecast has fallen to a 29% probability. We have never believed the yield curve alone was definitive proof of impending recession, as credit markets have remained strong. In addition to improving economic sentiment, investors have also gotten more hopeful about the U.S./China trade dispute and the outlook for Brexit.

It may be the approaching 2020 U.S. election at work, but signals from U.S. and Chinese negotiators are indicating

the potential for a “Phase 1” deal to be signed this year. The important component isn’t the level of agreed agricultural purchases, but what happens to current and future tariffs. The elimination of pending tariff increases would seem to be a likely outcome of any Phase 1 deal, while the meaningful rollback of existing tariffs seems less likely. Brexit negotiations have developed in line with our expectations, which include an extension of the EU deadline to January 31st and a new UK election in December. Avoiding a hard Brexit has led to a rally of 5% in the British pound.

We still think the outlook for risk-taking is positive. We remain of the view that the economy will not dip into recession, and are overweight stocks and underweight bonds as we head toward 2020. Continuing the global easing cycle underway this year, the Federal Reserve cut interest rates late last month, contributing to the steepening of the yield curve. With inflationary trends still muted, central bank policy is unlikely to be a headwind to risk-taking for some time. We expect continued trade tensions and the upcoming 2020 U.S. election to keep uncertainty high, and we therefore continue to favor “lower-risk” risk assets such as U.S. equities and high-yield bonds.

## FALLING RECESSION ODDS

Odds of an upcoming recession have receded from 38% to 29% in recent months.



Source: Northern Trust Global Asset Allocation, Bloomberg. The NY Fed bases its probability on Treasury spreads. Monthly data from 10/31/2016 – 10/31/2019.

## Interest Rates

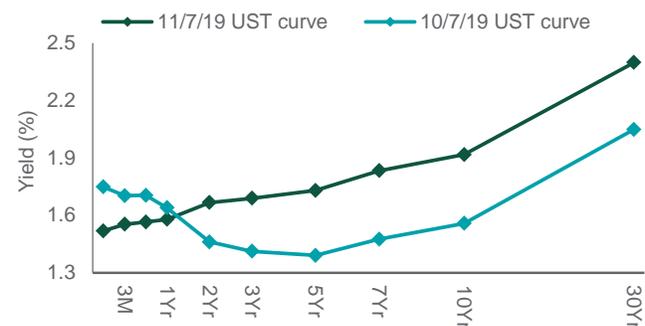
After three consecutive 25 basis point cuts, the Fed says it has put its rate-cutting cycle on hold. More data from the American consumer will likely be needed before policymakers will make further moves. The market's skepticism that the recent rate rally can be maintained suggests the curve steepening will continue. Furthermore, while data is mixed (manufacturing weakness vs. services strength) and investors are taking a risk-on mood, liquidity in the Treasury market is diminishing. Rather than seeing the rate cuts as providing additional stimulus to the economy, the market seems to believe the equilibrium rate has fallen and the rate cuts are an effort by the Fed to catch up with it. In the Treasury Inflation-Protected Securities (TIPS) markets, the decline in real long-term rates has been similar to the drop in real policy rates this year. It has become clear that fixed-income investors do not see the rate cuts as being able to spur growth effectively. The yield curve in the TIPS market has remained relatively unchanged, possibly due to the market being more concerned with low growth and the impact of global rates persistently remaining below zero. We have positioned our portfolios with a long duration profile, as we expect the Fed to ease further and long rates to follow slower growth, lower inflation and falling global rates.

## Credit Markets

The distribution of returns across ratings in the high-yield market has become a focus of investor discussions. While the Bloomberg Barclays U.S. High Yield 2% Issuer Capped Index has returned roughly 12% YTD, market performance has continued to be driven by higher quality securities. Divergence on a spread basis between higher- and lower-quality paper is at the widest level in the past decade, driven by energy, telecommunications and healthcare. These sectors represent a material portion of the CCC market. This is important to note, because while many fear the CCC underperformance to be an economic red flag, the weakness can largely be attributed to these three sectors, notably energy. The increase in energy-related defaults and corresponding stress skews the data, so looking at the spread of rating buckets ex-energy creates a cleaner picture of the market. As the chart shows, the current spread ratio of CCC/BB ex-energy of 3.8x is significantly higher than the past decade average of 2.3x. The return differential YTD across sectors aligns with the macroeconomic narrative of much of 2019, although some of the major concerns driving this basis have abated to various degrees. A decrease in rate volatility, year-end seasonality and an improved earnings outlook should provide support for high-yield valuations.

## BETTER DIRECTION

Yield curve returns toward normalcy after rate cut.

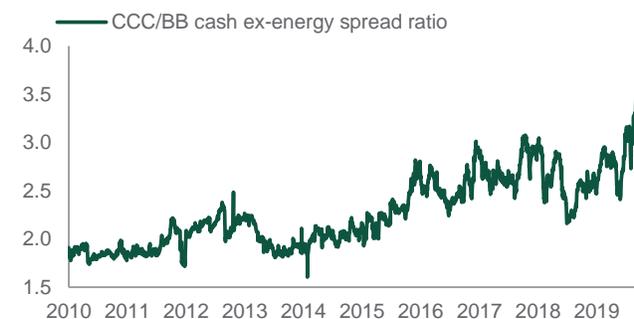


Source: Northern Trust Global Asset Allocation, Bloomberg. UST = U.S. Treasury.

- The Fed's third rate cut has finally ended the yield curve inversion.
- The Fed indicates it is "on pause" pending future data.
- We are underweight fixed income to fund our overweight positions in risk assets.

## ENERGY IS THE ISSUE

Valuation ratios are steady, ex-energy.



Source: Northern Trust Global Asset Allocation, Credit Suisse. Data from 1/4/2010 – 11/1/2019.

- Increases in lower quality high-yield spreads have concerned investors
- We think the increase is mostly due to the volatile energy sector.
- We remain overweight high-yield bonds.

## Equities

Global equities rose sharply over the last month as U.S./China relations improved, significantly reducing investor fears of downside economic risks. Non-U.S. equities outperformed, led by emerging markets (EM) and aided by a weaker U.S. dollar. In the U.S., value stocks outperformed as cyclical sectors like financials, energy and industrials led. Defensive, yield-oriented sectors like utilities and REITs lagged by over 7% on the month. This “risk-on” rotation within equities is notable in its rarity, as value has materially underperformed growth over the past three years. This outperformance of growth in areas like technology has come less from better fundamentals – earnings growth has been remarkably similar – and more from increases in relative valuation. To illustrate, the chart shows the significant widening of the gap in P/E ratios, where growth has gone from a 15% premium-to-value three years ago to nearly 50% today. Time will tell if this change in investor appetite for cyclical value stocks will prove durable, but the dramatic widening in relative valuations suggests such a move could have further to go. More broadly, we remain constructive on U.S. equities, as lessening downside risks, accommodative Fed policy and a return to positive earnings growth in 2020 provide opportunities for additional upside.

## GROWTH IN GROWTH

Expansion in growth valuations far exceeds value.



Source: Northern Trust Global Asset Allocation, Bloomberg. P/E ratios are calculated off Russell 1000 Growth and Value Indices. Weekly data from 11/16/2016 – 11/6/2019.

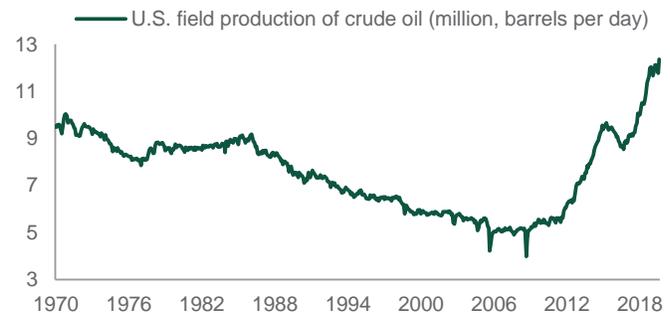
- The outperformance in growth stocks has been materially supported by valuation expansion.
- Value stocks have outperformed over the last month as cyclicals have rallied.
- Due to trade concerns, we remain overweight U.S. and underweight EM stocks.

## Real Assets

Are the winds changing in the oil patch? Over the past 8-10 years, U.S. oil production growth has soared (see chart) on the aggressive development of U.S. unconventional formations (in particular the Bakken, Eagle Ford and Permian). The surge in U.S. crude oil volumes was the primary factor underpinning the collapse in oil prices starting in late 2014. That production growth was facilitated by a massive surge in industry spending financed in large part by the equity and debt markets to the tune of several hundred billion dollars. However, investors who once clamored for rapid volume growth shifted course and are now demanding returns and free cash flow generation to finance dividend growth and share purchase programs. Newly imposed capital discipline (living within organic cash flow) will likely substantially slow U.S. output and remove a primary headwind to higher global oil prices. Of course, the market has to contend with known unknowns impacting (1) demand, such as recent weak economic readings and trade war fears, and (2) supply, specifically rising geopolitical risks, particularly in the Middle East.

## PEAK U.S. OIL?

Production is levelling off after years of growth.



Source: Northern Trust Global Asset Allocation, U.S. Energy Information Administration. Monthly data from 1/30/1970 to 8/31/2019.

- U.S. producers are forced to focus more on profitability.
- U.S. output growth is likely to slow as a result.
- We continue to like real assets for their diversification.

## BASE CASE

### Fundamentals vs Geopolitics

Resilient economic data, especially in the U.S., has helped support financial markets and reduce investor concerns about possible recession. However, trade/tariff risks and U.S. election uncertainty still have the potential to weigh on investor sentiment. Our Tactical Asset Allocation continues to favor “less risky” risk assets.

### Global Easing Cycle

Central banks have returned to a synchronized easing cycle but are starting to realize the diminished effectiveness of such measures. Investors see further monetary accommodation primarily as a brake on downside economic scenarios.

## RISK CASES

### Inflation

Subdued inflation has been a key driver of favorable risk asset returns over the last few years; an unexpected jump in cyclical inflation would put at risk the global easing cycle, resulting in lower risk asset returns.

### U.S. Election Clairvoyance

Investors fully expect a highly competitive, down-to-the-wire 2020 election cycle. Events that solidify the expected outcome sooner will likely cause significant shifts in asset prices and flows.

## INVESTMENT PROCESS

The 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 the Investment Policy Committee sees either increased opportunity or risk.

The asset allocation recommendations are developed through the Tactical Asset Allocation, Capital Markets Assumptions and Investment Policy Committees. ViewPoints reflects data as of 11/12/19.

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