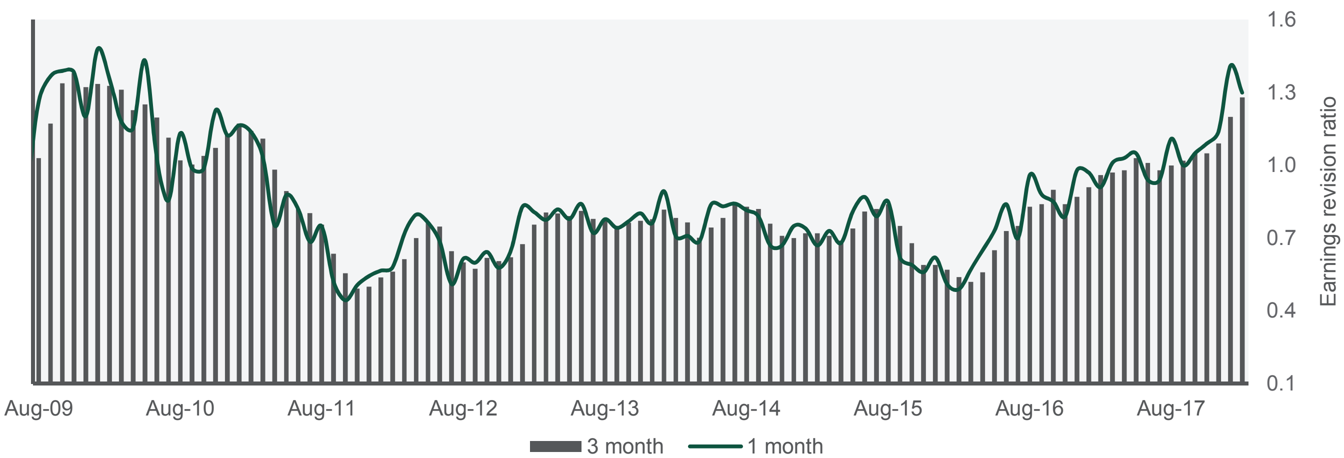
TARIFF TIFFS

No longer is it just inflation and interest rates dominating investor focus. The growth side of the economy has come into question in the wake of the U.S. government's decision to impose tariffs on imported steel and aluminum. The details of the tariffs are still being finalized as we go to press, including the ability of countries to apply for exemptions in coming weeks. As North American Free Trade Agreement (NAFTA) partners, Canada and Mexico have been specifically exempted from this tariff, but do face the ongoing NAFTA renegotiations. In the background, the ongoing Section 301 review of China's intellectual property practices will likely surface as an issue in coming months. It is unclear whether "tariff tiffs" will turn into a full blown trade war, but the collateral damage so far includes Gary Cohn, the White House's top economic advisor. The credentials and policies of his replacement will be an important guidepost on how this issue will evolve over the next year.

Meanwhile, the global economy may actually have gained a little momentum mid-quarter. Corporate activity indicators have edged up, with stronger U.S. readings offsetting a modest slowing elsewhere. Corporate profitability continues to shine, as shown below. The ratio of earnings estimate increases to decreases has reached levels we haven't seen since 2009 and 2010. This does start to beg the question – has economic optimism reached its peak? With U.S. tax cuts not even hitting reported earnings yet, it seems a little early for that conclusion, but we will be actively debating it in coming months.

While a hot wage number in the January U.S. labor report stoked inflationary concerns last month, the just-released February report has provided some balm as wage gains decelerated and new workers entered the workforce. Core inflation in the United States remains stuck at 1.5%, is just 1.0% in Europe and is barely measurable at 0.1% in Japan. The continued stickiness of prices is constraining central bankers, although more so in Europe and Japan than in the United States. The European Central Bank (ECB) made a very minor adjustment in its recent statement to acknowledge some economic improvement, while the head of the Bank of Japan has led the market on a goose chase in recent weeks. The Federal Reserve has the clearest path, as the debate is mostly centered on whether we have two or three (or four?) hikes this year. We are in the "two hike" camp, and think that hikes beyond that will only happen in a positive climate of good economic growth, steady inflation and a willing market.

AS GOOD AS IT GETS?
Global earnings revisions reach heights last seen in 2009 and 2010.



Source: Northern Trust Investment Strategy, Bank of America Merrill Lynch. Data through 2/28/2018.

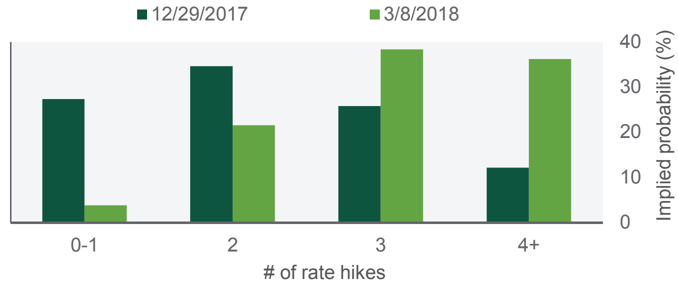
Interest Rates

New Federal Reserve Chairman Jerome Powell recently gave his first public address to the House Financial Services Committee. His comments were optimistic, noting that "some of the headwinds the U.S. economy faced in previous years have turned into tailwinds." Investors largely viewed this as a sign of continuity between him and previous Fed chair Janet Yellen, although his upbeat tone led some investors to believe the Fed is targeting four hikes this year, rather than the three that officials had indicated in December. Meanwhile, the ECB has indicated that the economic improvements across the eurozone have given it confidence to moderate the tone of its bond-buying program. While the pace will continue at €30 billion per month through September, the ECB shifted toward more flexibility and away from its easing bias.

While we believe the Fed will look to raise rates as the market allows, we remain skeptical of it achieving the three hikes it is targeting this year. We believe benign inflation readings, the possibility of a trade war and increased market volatility will keep the Fed moving slowly. More importantly, we think the only way the Fed gets to three or four rate hikes is if the conditions are healthy – solid growth, benign inflation and a ready market.

HIGHER EXPECTATIONS

Markets' expectations of a rate hike have risen since year-end.



Source: Northern Trust Investment Strategy, Bloomberg. Implied probability calculated by Fed Funds futures.

- Higher nominal growth outlook triggered rising U.S. bond yields.
- Rising rates could pause as foreign buyers provide support.
- We are underweight the short end and overweight the long end of the curve.

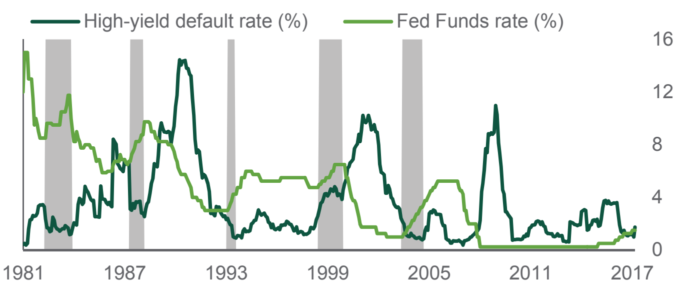
Credit Markets

The recent volatility in risk assets started because of concern about more aggressive Fed policy. Equities actually have suffered more than high yield, losing 5% from recent market highs compared to high yield's 1% loss; high yield is less exposed to interest rates than some think and generally provides downside protection during equity market corrections. While there is some effect on high yield valuations from rising rates, the bigger determinant of high yield returns is the growth outlook and its resulting effect on high yield fundamentals.

Rising interest rates generally take some time to hurt high yield fundamentals. The accompanying graph shows that two to five years typically passes between the beginning of a tightening cycle and a material increase in the default rate (grey shaded areas). In addition, with current Fed Funds rate so low, it likely will take a longer period of tightening before we see an effect on high yield issuers' ability to service their debt. As such, recent interest rate increases should not be a near-term fundamental concern. It is true credit spreads have tightened during the past two years, making the asset class more expensive and prompting us to reduce our exposure over that same time frame. However, we continue to hold a small overweight to high yield in our global policy model given its still very strong fundamentals.

WAIT FOR IT

Default rates don't generally respond to higher interest rates quickly.



Source: Northern Trust Investment Strategy, JP Morgan. Shaded areas represent time gap before increase in high yield default rates following a Fed tightening cycle.

- High yield is more exposed to economic growth than interest rates.
- Higher interest rates take time to affect high yield fundamentals.
- We are overweight high yield, focusing on lower-rated securities.

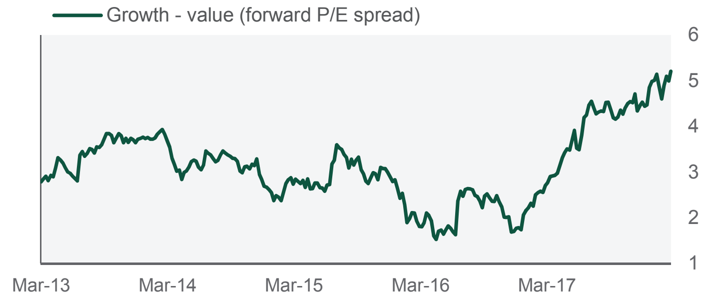
Equities

After 17% outperformance in 2017, U.S. growth stocks are outperforming U.S. value stocks by another 6% year-to-date – with technology stocks adding half of this outperformance. The tech sector is more than 6% ahead of the market, and 15% ahead of defensive, yield-oriented sectors like utilities, telecom and staples. With higher economic growth and lower tax rates serving to align forward earnings growth expectations between growth and value stocks, growth's outperformance has led to a material gap in valuations. In fact, despite significantly positive returns, the average price-to-earnings multiple on value stocks is actually lower than at the beginning of 2017. While valuation is not a catalyst per se, the recovery in value stocks many observers have been calling seems well founded.

The steel and aluminum tariffs announced early this month do raise risks in the equity markets, and have specifically caused us to downgrade our U.S. regulatory reform outlook. As such, we reduced our U.S. equities allocation, although all regions would suffer in an all-out trade war. For now, we are patiently assessing further action because it isn't clear how far the tariff war may actually go. We remain overweight equities globally but increasingly more overweight non-U.S. equities.

VALUE IN VALUE

The premium of growth over value has moved relentlessly higher.



Source: Northern Trust Investment Strategy, Bloomberg. Growth and value price to earnings ratios are calculated from Russell 1000 Growth and Russell 1000 Value indexes.

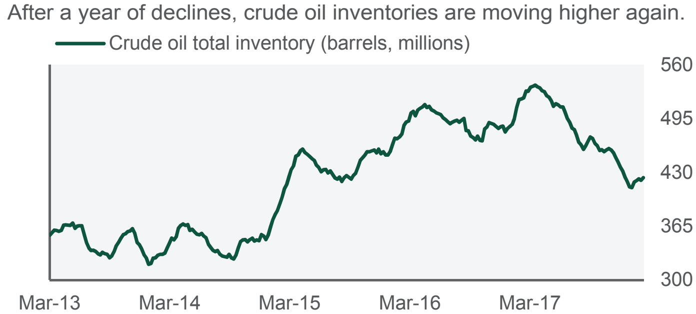
- Value stock valuations have *fallen* over the last year.
- We've trimmed U.S. equities on a worsened regulatory outlook.
- Non-U.S. equities are only trading at a slight premium to historical valuation levels.

Real Assets

Oil prices recently moved higher into a new range of $60 to $65 per barrel. However, some investors are worried the new price range will not hold due to rising future supplies driven by U.S. unconventional production growth (fracking) and the return of Organization of Petroleum Exporting Countries (OPEC) volumes. A recent inflection in U.S. inventory data may be adding to these fears. We are not as concerned as many. Yes, U.S. production is growing, but near-term output may be constrained by logistical issues and key input shortages (labor, equipment, etc.), while longer-term challenges include new infrastructure requirements in unconventional basins. Overall, we believe U.S. production growth is likely to fall short of expectations and doubt OPEC can come back to the market quickly (opting to fund social programs over investing in oil operations). Further, four million barrels per day of new production are required to offset natural declines at existing fields (before meeting any annual demand growth needs). Market supply also is benefitting from projects started several years ago when oil prices were higher. However, the "project pipeline" is not being replenished and new project deliveries soon will begin to slide. Broadly speaking, we believe inflation will remain under control given the broader effects of automation and increased economic efficiencies – but we remain strategically allocated to natural resources because the fundamental outlook remains sound.

HERE WE GO AGAIN?

After a year of declines, crude oil inventories are moving higher again.



Source: Northern Trust Investment Strategy, Bloomberg. Data from 3/15/2013 to 3/2/2018.

- Fears of a return to a global oil glut are misplaced.
- Infrastructure buildout is necessary to meet long-term demand.
- We remain strategically allocated across all real assets.

Conclusion

This month's investment strategy meetings were dominated by discussion on the evolving U.S. regulatory environment and the start of the Powell era at the Federal Reserve. February's market correction has been healing as inflationary data has remained quiescent and the February jobs report showed a deceleration in the pace of wage gains. Very strong overall job gains and an increase in the workforce were additional positives. During the last 14 months, we have been at a maximum risk position in our global tactical asset allocation model. During this time, global equities have returned roughly 30% and interest rates have moved up to the top end of our expected ranges. The bullish fundamental data, along with strong market performance, has led us to start asking whether investor expectations have finally caught up with reality. With U.S. tax cuts not hitting company earnings yet, we still see some room to run in the risk-taking trade.

We have, however, moved off our maximum risk position this month with a recommended 2% reduction to U.S. equities – with the proceeds going into investment grade fixed income. The primary catalyst was the worsened regulatory outlook in the wake of the steel and aluminum tariffs. The trade outlook is too unpredictable to make any major bets on at this point – and the next signpost we will be assessing is Gary Cohn's replacement as the Director of the National Economic Council. This uncertainty is represented in our "trade repercussions" risk case, and is especially worth watching at a time when Chinese growth data may be moderating.

Our second risk case considers the potential for premature monetary policy tightening by either the Fed or the ECB. We have a new Fed chair who will be leading the assessment of the risks going forward – and our concern centers on the potential of excessive rate hikes in a stable inflationary environment. Similarly, the ECB should recognize that the European Union's economic recovery is years behind the United States', and its inflation picture is more challenged. Our base case is that both central banks will "get it right," and won't tighten policy beyond what the markets are discounting. That should continue to support a positive risk-taking environment.