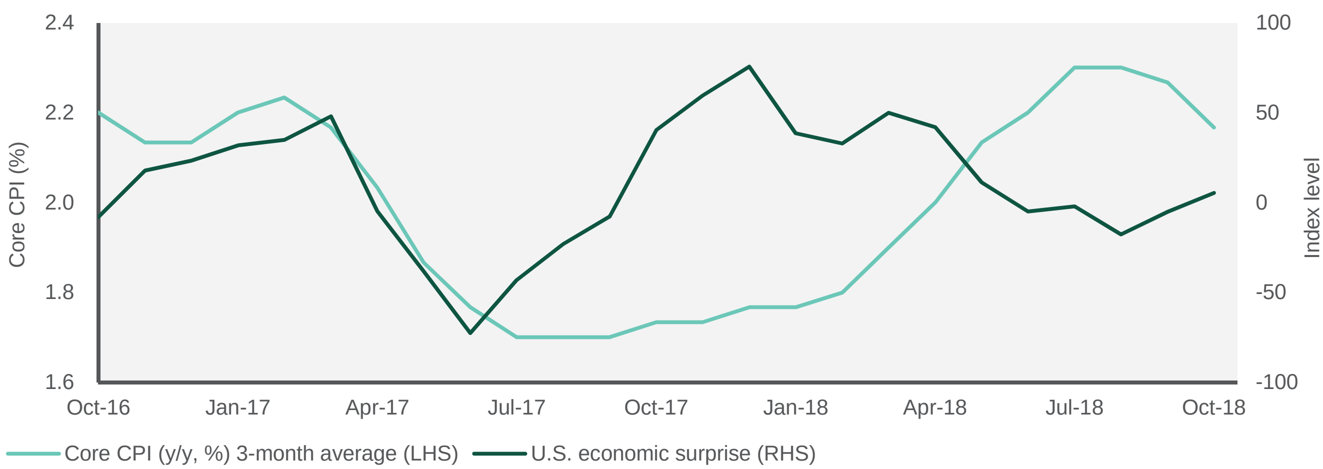
WATCHFULLY WAITING

Global growth peaked in the first half of this year, and now is showing signs of slowing – particularly in Europe and Japan. U.S. growth likely also peaked in the first half of 2018, and should decelerate further into 2019. This slowdown is happening at a time when the U.S. Federal Reserve is steadily raising interest rates in its attempt to "normalize" policy in the wake of years of extraordinary accommodation. It is the confluence of these two forces that we see presenting risk to the markets over the next year. For the risk taking environment to improve, we will be waiting for either an uptick in growth globally or a more tempered approach from the Fed. To some extent, the slowdown in growth is tied to tariff-induced trade tensions. With little sign of progress from talks between the U.S. and China, these tensions seem likely to continue into 2019.

With growth easing, and inflation measures rolling over, we think the Fed may actually be "ahead of the curve" as opposed to the dreaded "behind the curve." This is based on our view that core inflation is contained (it has softened for three months in a row now). If the Fed were to join us in this conclusion, it would have cover to "pause" its rate-hike cycle. Recent commentary from Fed officials gives fodder to both the hawks and doves – so more data will be required for them to signal any re-evaluation of their current policy outlook. The European Central Bank (ECB) looks on course to end its quantitative easing this year, and its first rate hike likely won't occur until later in 2019. The ECB must be carefully considering the current developments around Brexit and the Italian budget with an eye toward risk management.

Our current thinking is that the British and Europeans will manage their way through these challenges by a combination of kicking the can down the road and fiscal easing. We think the odds favor a soft Brexit, but politics are a blood sport and the pathway will be nerve wracking. The right prescription for Italy is some form of fiscal leniency pared with structural reform. Meanwhile, the U.S. election has come and gone without much impact on the asset markets. Political noise will ratchet up in 2019 as House committee leadership changes, but we do not expect this to materially affect economic fundamentals. The return of gridlock to Washington is a reality, but much of the administration's desired business initiatives already have been enacted.

INFLATION ROLLOVER?
Slowing growth reduces the risk of inflation in 2019.



Source: Northern Trust Global Asset Allocation, Bloomberg. Data from 10/31/2016 to 10/31/2018.

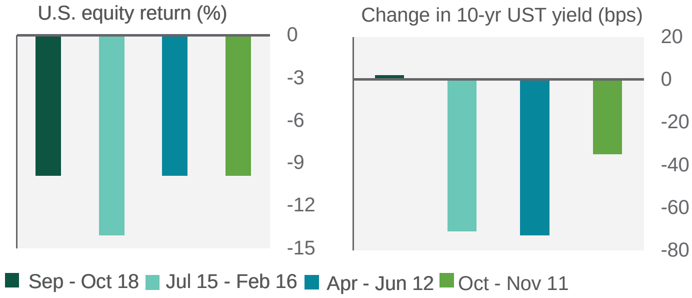
Interest Rates

U.S. Treasuries have remained range bound despite a meaningful drawdown in risk assets. As seen in the chart, an equity market drawdown usually corresponds to a material decline in 10-year U.S. Treasury rates. This time around, however, a strident Federal Reserve (telegraphing four additional rate hikes through the end of 2019) backed by tight labor markets has left the 10-year U.S. Treasury just above 3% – right about where it was at the start of the most recent market sell off. While not displaying historical patterns, the 10-year remains a long way from the 4% level some pundits have been calling for throughout 2018. As economic growth slows and inflation shows signs of rolling over, we expect the 10-year to remain in its current range over our tactical horizon.

In Europe the focus is on lackluster growth/inflation, Brexit negotiations and Italian finances. All of these forces are likely to keep a check on any ECB plans to exit negative interest rate policy, pushing the first rate hike well into the second half of 2019 (though quantitative easing should end by the end of 2018 as scheduled). This should keep a lid on longer-dated “core” Europe interest rates. And, by extension, it also adds more support for our U.S. rate expectations.

DOCKED INTEREST RATES

Interest rates normally fall during equity weakness – not this time.



Source: Northern Trust Global Asset Allocation, Bloomberg. Specific time frames 9/20/18 – 10/29/18; 7/20/15 - 2/11/16; 4/2/12 – 6/1/12; 10/28/11 – 11/25/11. U.S. equity is measured by S&P 500.

- U.S. rates have been steady during recent equity weakness.
- A 4% 10-year U.S. Treasury remains a long shot.
- Investors should feel comfortable buying at current rates.

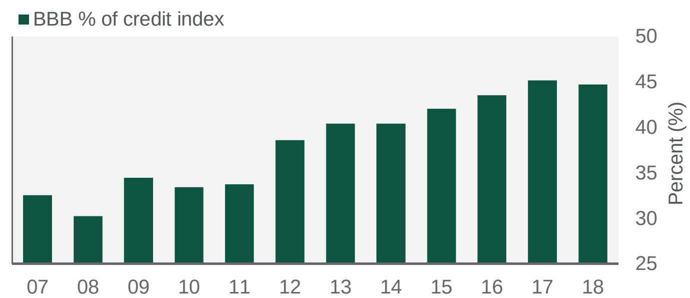
Credit Markets

Over the past seven years, the percentage of BBB issues in the U.S. credit index has increased from 34% in 2011 to 45% in 2018 (see chart). This has resulted in fears that an economic downturn will result in a flood of “fallen angels” (issues re-rated into junk territory), having a significantly negative impact on the high yield market. But investors should consider the reason for the growth in BBBs, the current economic environment and past rating migration experience.

The percentage of BBBs has increased due to the low rate environment and limited growth opportunities after the financial crisis – prompting companies to use low cost debt to pursue dividends and stock repurchases to boost equity returns. As such, most downgrades resulted from capital structure decisions and not weak fundamentals. A severely negative credit environment in 2008 did not result in a flood of fallen angels into the high yield market. It only increased BBs by a manageable 1%. Overall, strong fundamentals and historical rating migration trends suggest that the increase in BBBs is a low probability risk in the current environment. Current credit fundamentals are strong, with revenue growth approaching 10%, earnings growth over 20%, interest rate coverage ratios high and refinancing needs low. This suggests that the recent increase in high yield spreads has been more driven by sentiment than deterioration in fundamentals. We remain materially overweight the asset class.

BBB-ARBARIANS AT THE GATES?

BBB levels have some fearing a flood of issuance into high yield.



Source: Northern Trust Global Asset Allocation, Bloomberg. Data through 11/14/2018.

- An influx of “fallen angels” into the high yield market is unlikely.
- Sentiment has fallen more than fundamentals have deteriorated.
- We maintain a material overweight to high yield.

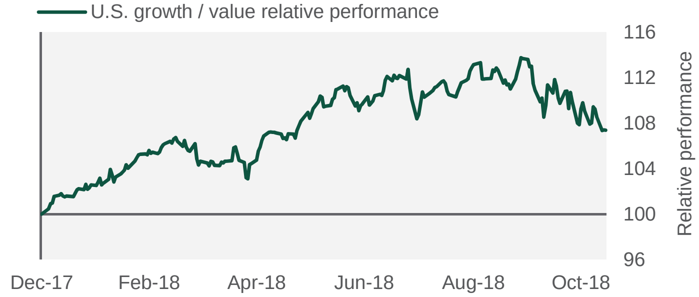
Equities

Global equities have remained volatile over the past month. Strong corporate earnings may have slowed the pace of equities' decline; but uncertainty about tariffs, slowing global growth and more restrictive U.S. financial conditions have kept volatility high and valuations under pressure. U.S. equities are roughly unchanged through the first two weeks of November (after a horrendous October), but continue to experience significant de-risking at the sector level. Defensive sectors are up, while technology and energy continue to slide.

We have noted previously the leadership of growth stocks during the market upside over the past two years, aided significantly by technology. As equities have retreated, growth has given up roughly half its year-to-date advantage over value (see chart). Further trade escalation, should it occur, may be more material to technology stocks than fully contemplated by the market, potentially adding to growth's woes. With global valuations having improved in the wake of weaker equity prices and growing earnings, we think maintaining a neutral stance in developed markets is appropriate despite prevailing risks. However, we remain more cautious toward emerging markets given continued China growth weakness and a persistent Fed.

GROWTH SHRINKS

Growth stocks have given back some of their outperformance.



Source: Northern Trust Global Asset Allocation, Bloomberg. Russell 1000 growth index represents U.S. growth stocks. Russell 1000 value index represent value. Data from 12/29/2017 to 11/14/2018.

- Global equities have entered a rough patch.
- Defensive sectors are showing outperformance.
- We are neutral developed and underweight emerging markets.

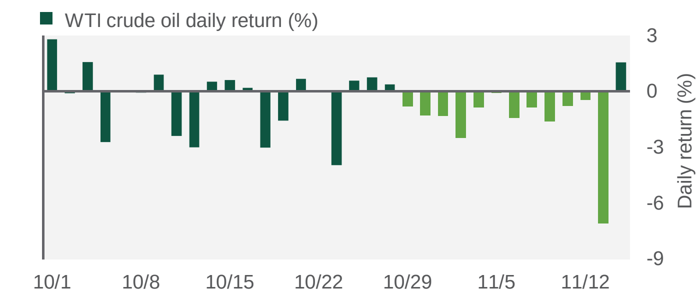
Real Assets

Rising global demand. Tight labor markets. Iranian sanctions. These factors should have pushed oil prices above $100 per barrel. Instead, oil prices have staged a dramatic reversal – falling by more than 20%. While demand may be slowing slightly, the bigger issue is supply (as it generally is when looking at near-term changes in price). Tight labor markets have not meaningfully slowed U.S. production. Also, global production ramped up to offset the expected removal of Iranian supplies – only for the United States to grant six-month waivers for eight countries (including China) that represent an estimated 75% of Iranian exports. A rising dollar has not helped either. Talks within OPEC (plus Russia) have quickly shifted from putting more oil in the markets to once again discussing production cuts. How quickly things can change.

Oil broadly affects the global economic outlook. Inflation expectations – heavily influenced by changing oil prices – have moved lower, perhaps giving the Fed an excuse to slow its rate-hike campaign. Growth may benefit as consumers have more pocket change (likely more than offsetting the negative effect of lower energy production capital expenditure – as energy producers never materially ramped up capital expenditures after the 2014 oil price collapse). All said, recent oil price action should support financial markets – consistent with our neutral risk positioning – while future oil price action will be driven by political decisions. We remain equal-weight natural resources.

THE 12 DAYS OF … FALLING OIL PRICES

Oil prices fell for 12 straight days – a three-decade record.



Source: Northern Trust Global Asset Allocation, Bloomberg.

- Oil prices have fallen materially, entering bear market territory.
- Oil supply pessimists have been proven wrong.
- We remain equal-weight natural resources.

Conclusion

We made no changes to our global policy model this month, as our current neutral risk position properly reflects our outlook for risk-taking over the next year. Our base case themes of Slowdown to Channel Growth and Rising Monetary Policy Disconnect illustrate the conflict that central bankers face over the next year. We expect global growth to gradually slow back into its longer-term channel, as U.S. stimulus wears off and trade frictions weigh on activity. Maneuvering in this slowing environment are central banks looking to remove accommodation – most importantly the Fed and the ECB. The Fed's push for further rate increases is at odds with the market's views on growth and financial market risks. The ECB may have more identifiable headwinds as both Brexit and the Italian budget disputes are going full steam, keeping it accommodative for a little longer.

Our first risk case, Central Bank Tunnel Vision, captures the possibility that the Fed charges ahead in its plan to raise rates without acknowledging the impact it has already had. The financial markets have responded to higher interest rates, and interest rate sensitive parts of the real economy are also evidencing some slowdown. Maybe an inversion of the yield curve will be the signal that catches their attention. Our second risk case, China Troubles, reflects the risk that the U.S.-China trade dispute disrupts global With China's size and growth rate making it the most important contributor to global growth, this risk is noteworthy. Additionally, we don't expect these tensions to be fully resolved over the next year.

We think U.S. credit markets are in better shape than the bears would have one believe. We don't expect the increase in lower-rated investment grade bonds to create a problem (short of us going into recession), as much of the increase in debt was voluntary and does not need to be repeated. We also see good credit quality across the high yield market, and companies have termed out their debt leaving them with little need for new issuance. Our significant exposure to high yield in the global policy model partially reflects the risk reduction we have undertaken over the last year, with a preference for "less risky" risk assets. Should everything turn out well, the current yield of just over 7% should generate a solid return. However, should the risk environment deteriorate further from here, high yield should perform much better than equities in a risk-off environment as it will be better cushioned by its current yield.