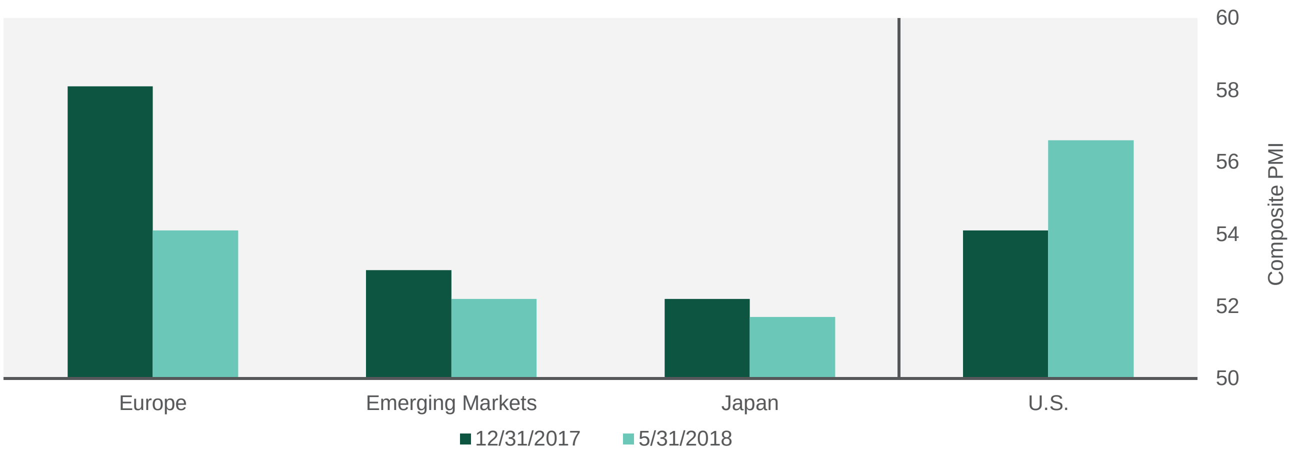
SHIFTING MOMENTUM

Momentum has shifted across the major developed economies, both economically and politically. As shown below, Europe entered 2018 with the strongest composite growth outlook, while the other major economies remained in a solid growth position. Momentum now has shifted to the United States for several reasons. An improved business climate, supported by significant tax cuts, has boosted sentiment. In addition, the euro's strength through the first quarter is a headwind to European exports. Temporary factors, such as poor weather, also may have hurt Europe. So some momentum may return as the year progresses.

In the meantime, historical political alliances continue to be challenged by both external and internal forces. President Donald Trump's focus on renegotiating existing trade and political agreements has disrupted the post-World War II order. The continued pressure of populist politics is also leading to new governing alliances in countries like Italy and Germany – challenging the historic support for key tenets of the European Union. In the United States, the mid-term elections have historically heralded a swing in power away from the incumbent party. This year, the swing may be insufficient to alter control of the House of Representatives. But even a change in control of the House would be unlikely to materially change the policy outlook because government would be divided. The result is relative stability in domestic policy within the United States – a redux of our old theme of "Political Volatility, Policy Stability."

The shifting momentum in growth and more uncertain political picture across Europe and trade could restrain central bankers. Fixed income markets have been buffeted recently by developments in Italy, where the new coalition government has taken a more aggressive stance toward the European Union. We have also heard from several Federal Reserve governors who have noted the relative flatness in the yield curve and their lack of desire to risk inverting the yield curve through excessive rate hikes. We don't expect an inflationary jump to force their hands. The Fed has communicated that it is willing to let inflation run above its 2% target because it was lower for so long. While we are hearing about cost pressures from company managements, our belief is that any inflation that makes its way through to consumer prices will likely be a shorter-term cyclical phenomenon vs. a secular move. In that situation, central bankers are likely to stay accommodative longer than the market believes.

GLOBAL MOMENTUM SHIFTING TOWARD THE UNITED STATES
Europe has lost the most relative momentum, but growth remains at a solid level.



Source: Northern Trust Global Asset Allocation, Bloomberg.

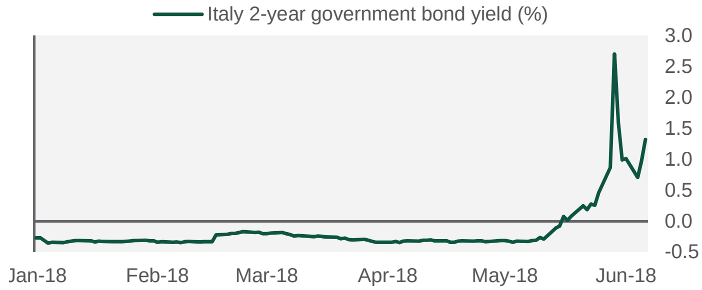
Interest Rates

Political instability in Italy and fears of further fragmentation in the eurozone led to a one-day spike of 225 basis points for Italian two-year bonds. European economic data continues to soften, with the purchasing managers' index (PMI) hitting 18-month lows. This further complicates the European Central Bank's (ECB's) desire to end its ultra-accommodative policy. The market reacted to this news with a flight to quality, as U.S. 10-year bonds had their largest one-day move since Brexit (June 2016) and the Taper Tantrum of September 2013.

While fears of another European sovereign crisis have mostly subsided, we believe investors are more skeptical that central banks are going to be able to follow their desired path to normalization. Absent major market disruptions, they are still likely to raise rates, but we believe it will be slower than planned. With global growth looking less synchronized, inflation running below central bank targets, and U.S. interest rates still some of the highest in the developed world, we believe 10-year U.S. Treasury rates are likely to remain between 2.5% and 3.0%. We think this will generate a positive return for bonds over the next year, and our recommended underweight is solely to fund our overweight equity position.

RISKY ITALY

New leadership raises questions about Italy's outlook.



Source: Northern Trust Global Asset Allocation, Bloomberg.

- Risk aversion rises in the face of the new Italian coalition.
- Increased risks are arising at a time of moderating growth.
- Geopolitical risks and moderating growth should conspire to suppress yields in most developed markets.

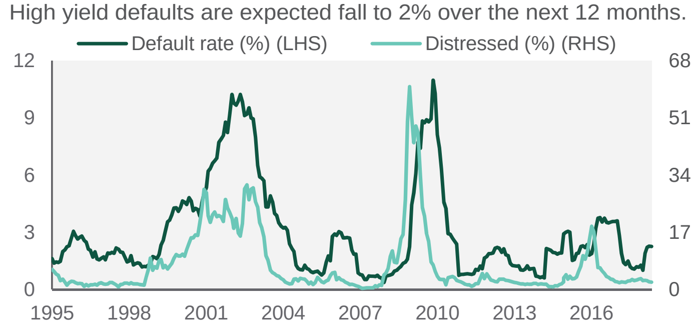
Credit Markets

Financial markets have been subject to a stream of headlines that have been potential sources of volatility. However, high yield credit spreads have been remarkably stable, staying in a narrow range around 3.5% for the past 18 months. So far this year the higher-rated BB securities have posted a small loss – due to an interest-rate-driven repricing. But lower-rated credits have performed well, driven by strong earnings growth: CCC-rated securities are up 2% and stressed Ca-D securities are up nearly 20%. Reflecting this strong growth environment, the default rate is starting to move lower and very few bonds are trading at distressed levels.

In addition to strong fundamentals, technical factors are very constructive for high yield. Supply has moved lower, because new tax code contains fewer incentives to issue high yield debt. Further, less money trading in and out of the asset class means the overall market has been more stable. Valuations also have improved, driven mostly by higher interest rates. Given all of these favorable dynamics, we increased the high yield overweight in our global policy model. In a fundamentally sound but geopolitically threatening environment, receiving income upfront is very attractive to us. And the current 6.3% yield – the highest level since late 2016 – provides an opportunity to do just that. Further, high yield – when used as a risk asset (as we do) – is a source of downside protection should volatile equity markets continue.

TURNING POINT

High yield defaults are expected fall to 2% over the next 12 months.



Source: Northern Trust Global Asset Allocation, J.P. Morgan. Distressed (%) is the percentage of the high yield market below or equal to $70.

- We increased our high yield tactical overweight this month.
- High yield fundamentals remain sound, driven by strong earnings.
- Valuations have become more appealing as rates have increased.

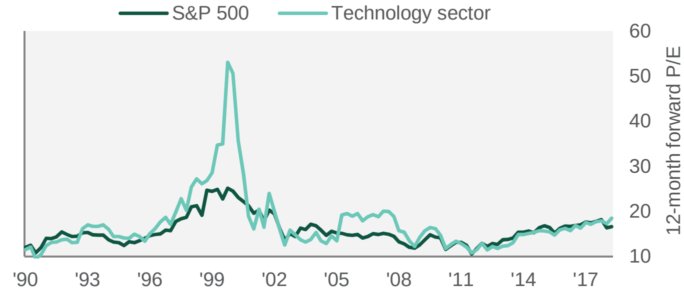
Equities

Technology stocks have contributed significantly to U.S. equity performance over the past two years, accounting for half of the S&P 500's 36% total return (when adding Amazon and Netflix). The tech sector (including Amazon) now accounts for nearly 30% of the S&P 500, not far off the 35% it reached in the 2000 tech bubble. Is this a warning sign? Not in our view. Since 2010, the tech sector valuation has stayed largely consistent with the market; the outperformance stems from much faster earnings growth. While there is some divergence in valuation year-to-date, as the tech sector has outperformed on similar levels of growth (with the rest of the market benefiting more materially from tax reform), it is hardly a worrisome level.

With secular tailwinds firmly in place, capital spending on technology improving and valuations far from unreasonable, we see little cause for concern over tech's leadership in recent years. While U.S. stocks have outperformed of late, we prefer their reasonable valuations, better relative growth prospects and lower political risk to other developed markets. Accordingly, this month we have increased our U.S. equities position (along with U.S. high yield) by reducing exposure to developed equity markets outside the United States.

NOT A TECH BUBBLE

U.S. technology valuations have largely tracked the market.



Source: Northern Trust Global Asset Allocation, 12-month forward P/E uses Bloomberg estimates.

- Investor worries over narrow tech leadership are misplaced.
- Strong fundamentals, not booming valuations, have driven technology stock performance.
- Shifting momentum leads us to reallocate from developed ex-U.S. stocks to U.S. equities and high yield.

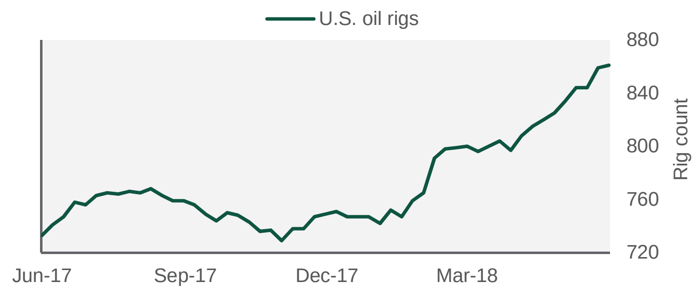
Real Assets

From late June of 2017 to late May of 2018 – a little less than a year – oil prices rose by 70% to hit a recent high of $72 per barrel. Many analysts were calling for a return to $80 oil – and some calling for triple-digit levels – in short order. Since then, oil prices have corrected by 10% to $66 per barrel. Where do we go from here? With commodity demand showing steady gains and inventories back to more normal levels, investors are focusing on the supply that can be brought to market. OPEC members (plus Russia) will meet on June 22 to determine whether to raise output. The United States has asked them to pump more oil in the wake of higher pump prices and reinstated Iran sanctions. Saudi Arabia and Russia appear ready to do so, but other OPEC members need to be brought on board. Elsewhere, U.S. production operations appear to be on the upswing (see chart) but ultimate output may be capped by personnel shortages and infrastructure challenges.

As we wait for these issues to be sorted out, we remain at strategic levels in natural resources. This strategic positioning provides us some protection against the risk (but not base case) of a continued rise in inflation. We also remain at strategic levels in global real estate and infrastructure. Should we be right on our call that interest rates will be capped and the Fed will be hard-pressed to push rates too much higher, these cash flow assets should eventually do well. But we expect to get a better entry point than what we have right now.

PRICE RESPONSE

As oil prices have gone higher, more oil rigs have been deployed.



Source: Northern Trust Global Asset Allocation, Bloomberg.

- Ongoing demand and geopolitics have pushed oil prices higher.
- The supply response by major oil producers will be important.
- We remain strategically allocated across all real assets.

Conclusion

At this month's investment strategy meetings, we spent considerable time discussing the changing global growth outlook, including the potential impact of further actions on trade policy. The outlook for trade is particularly unclear because the United States has thrown up for discussion trade practices with most of the world's major economies. In addition, the U.S. administration has indicated a preference for bilateral negotiations, which could delay resolution. We think the U.S. economy and markets will keep pace globally in an environment where trade is positively resolved, but also should be a relative safe haven should we have a serious deterioration. With the economic outlook slowing in developed markets outside the United States, and the political picture becoming incrementally less clear, we have recommended moving 4% out of developed ex-U.S. equities and splitting the proceeds between U.S. equities and high yield. Overall, this somewhat moderated our risk position – but still leaves us positioned for equity markets outpacing bonds over the next year.

Some observers might question the merit of U.S. equities at this time, because technology stocks have been such a major driver of returns (contributing roughly 50% of the advance over the last two years). As we discuss in the equity section, technology stocks aren't overpriced and therefore we don't think they represent an existential risk to the outlook. We find the outlook for high yield attractive, as yields have risen to around 6.3%, and the default rate is set to fall alongside issuance. These factors combine to support our 7% to 8% return forecast over the next year.

While our risk cases haven't changed this month, the context and probabilities have. The risk of a central bank mistake has probably receded a bit, as several Fed governors indicated an aversion to inverting the yield curve through further rate hikes. This is top of mind as the current spread between 10-year and two-year Treasuries is a mere 0.44%. We haven't seen much progress on the trade front, beyond a potential deal to save Chinese communications company ZTE, which could engender some goodwill from the Chinese. This outcome isn't clear yet, though. Congress may decide to weigh in on the settlement, and the threat of U.S.-imposed tariffs could scuttle any offers from the Chinese. Our base case scenarios expect the central banks to avoid tightening too quickly, and we expect the trade rhetoric to stay escalated but not evolve into a trade war. While we are still positioned for positive stock market returns over the next year, we have moderated our risk levels somewhat this quarter as the risk of trade problems and slowing growth have taken away some of the market tailwinds.