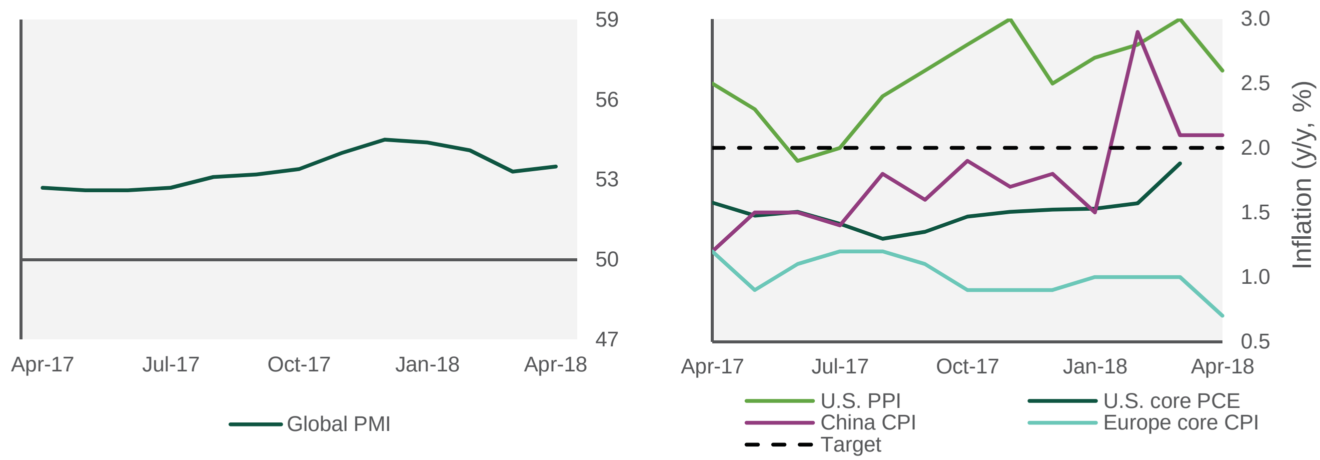
MODERATION

The much beloved “synchronous global expansion” has come under some scrutiny as activity measures have moderated across both developed and emerging economies. We have returned to the old debate over “hard” statistics, such as revenue and earnings, and “soft” statistics, such as purchasing manager indexes (as shown in chart below) and business sentiment surveys. Mario Draghi, head of the European Central Bank (ECB), even cited weather as a contributing factor to Europe’s recent slowing. We expect the global expansion to continue through next year, but think the pace of growth will be modestly disappointing compared to forecasts. We aren’t calling a significant slowdown, but opining that growth isn’t going to meaningfully break out of the “channel” it has been in for the last several years. We think the most direct impact of this will be contained interest rates, and recent inflation readings support the view that central banks are not behind the curve in reacting to the inflation outlook.

In fact, recent measures of inflation have shown some moderation (see chart, right panel). From Chinese producer prices to European core consumer inflation, current readings show a deceleration in price increases. We don’t view these retreats as a sign of weakening demand as much as a barometer of how limited corporate pricing power is. First-quarter earnings reports have mentioned higher input costs, including in commodities and transportation, but limited ability to fully pass these through to consumers. Strong revenue growth and the resulting operating leverage are helping companies offset these cost pressures. In addition, labor costs are a much larger percentage of expenses at most companies – and recent reports show a continued moderate pace of yearly wage increases.

Our belief that growth and inflation are moderating helps drive our view that the Federal Reserve will raise interest rates less than market expectations. This will cap what other central banks can subsequently accomplish. We are also in the midst of several significant geopolitical issues – from the Iran nuclear deal, to a potential deal between the Koreas and the ongoing trade tensions between (primarily) the United States and China. These increasing tensions typically favor the U.S. dollar, and may be behind the greenback’s recent strength and resulting emerging market weakness. We don’t expect this to be sustained because the Fed is well along its rate cycle and the geopolitical risks are more likely to recede than not.

BACKING OFF
Growth and inflation trends have moderated after a period of strength.



Source: Northern Trust Global Asset Allocation, Bloomberg. Data from 4/30/2017 to 4/30/2018. Core PCE data is released on one-month lag and goes through 3/31/2018.

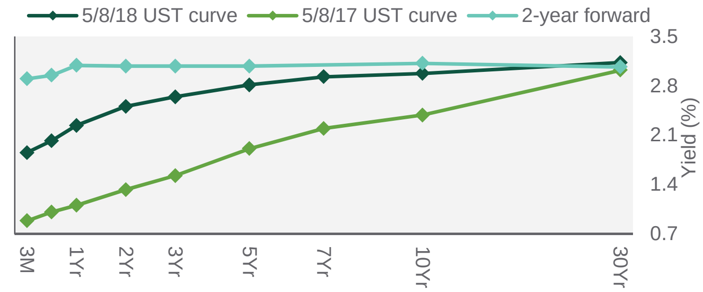
Interest Rates

Three Fed rate hikes over the past year, coupled with modest growth and muted inflation, have contributed to significant yield curve flattening. Looking ahead, the current two-year forward curve is nearly flat between one and 30 years, reflecting a view that the Fed is near its terminal Fed funds rate, while the long-end of the curve hovers around 3%. Low productivity growth, minimal wage inflation and continued accommodation by central banks outside the United States have combined to keep the long end of the curve relatively range bound. We believe the flatness of the curve will eventually prevent the Fed from raising rates at the pace it has forecasted and we see value in the higher relative yields they provide.

U.K. production manager index (PMI) readings have touched 17-month lows as Brexit uncertainty has caused the United Kingdom to move from one of the fastest growing economies in the European Union to one of the slowest in just two years. This will likely force the Bank of England (BOE) to move at a much slower pace toward normalization than it had hoped. The continuation of ultra-accommodative policies at the ECB, BOE and Bank of Japan has made the relatively higher U.S. rates attractive. We expect this trend to continue in the face of near-term headwinds to more normalized monetary policy.

FLATTER AND FLATTER

The markets expect further curve flattening ahead.



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

- Futures markets predict further flattening over the next two years.
- A flat yield curve limits how much the Fed can raise rates.
- Range-bound interest rates support our move out the yield curve.

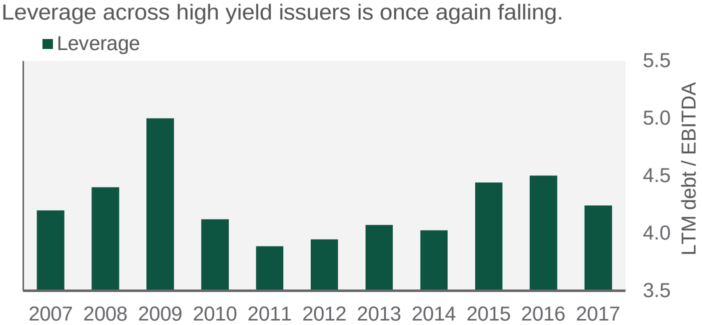
Credit Markets

High yield credit spreads have been 300 to 400 basis points over Treasuries for the past year. While this has raised concern among some commentators, the high yield market has been relatively sanguine – especially when compared to the recent uptick in equity market volatility. Driving the credit market stability has been the continued solid fundamentals of high yield issuers. Leverage (here defined as long-term debt divided by earnings before interest, taxes, depreciation and amortization) has steadily declined for the past six quarters after hitting a cycle high in mid-2016 at the peak of commodity sector distress. The recent fall in leverage is a reflection of both solid earnings growth and financial restraint. As a result, the default rate has remained below the long-term average; and those defaults that have occurred have been in easily anticipated areas, such as retailers.

Putting numbers to it, Moody's expects a 1.7% default rate over the next 12 months. After taking recovery values (the percentage of the original investment recouped after default) into account, credit spreads above 300 basis points provide adequate compensation for underlying fundamentals. In fact, we expect high yield to return more than 7% over the next year – as strong fundamentals keep credit spreads low and the steady growth and low inflation environment constrain any upward movement in interest rates. As such, we remain slightly overweight high yield in the global policy model.

HEALTHY BALANCE SHEETS

Leverage across high yield issuers is once again falling.



Source: Northern Trust Global Asset Allocation, J.P. Morgan.

- Credit markets remain well behaved amid equity market volatility.
- Credit spreads remain tight, resulting in high valuation levels.
- Solid fundamentals keep us slightly overweight high yield.

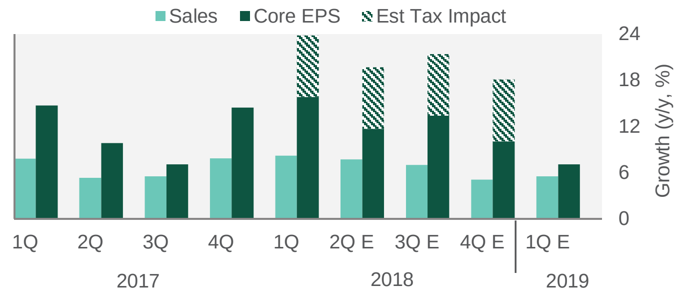
Equities

First-quarter earnings in the United States look quite strong. Reported growth of 23% year-over-year topped expectations by 6%, while 8% sales growth matched fourth-quarter levels. This was the first quarter to include the benefit of corporate tax reform, which we estimate added 8% to 9% to reported earnings growth, suggesting core earnings growth in the mid-teens. Full-year consensus estimates have risen to account for the first quarter upside only, implying no material improvement to the forward view. As seen in the graph, expectations are for top- and bottom-line growth to moderate, but remain strong through the end of the year.

In Europe, first-quarter results also topped expectations, but were weighed down by the stronger euro to 6% to 8% bottom-line growth. With upper-single-digit earnings growth outside the United States still likely this year and recently moderated valuations globally, we remain constructive on equities. Our preference tilted to non-U.S. markets given their lower valuations and earlier position in their economic cycles. The strength of the U.S. dollar has been a headwind to non-U.S. equities, but we don't expect this to be long-lived because the Fed is much further along its normalization path than its peers.

TAX CUTS WERE THE ICING

Core earnings growth has also been strong.



Source: Northern Trust Global Asset Allocation, Bloomberg consensus estimate 5/10/2018.

- Earnings are strong – even before the benefits of tax reform.
- Stocks are cheaper as earnings are growing faster than prices.
- We remain overweight equities globally.

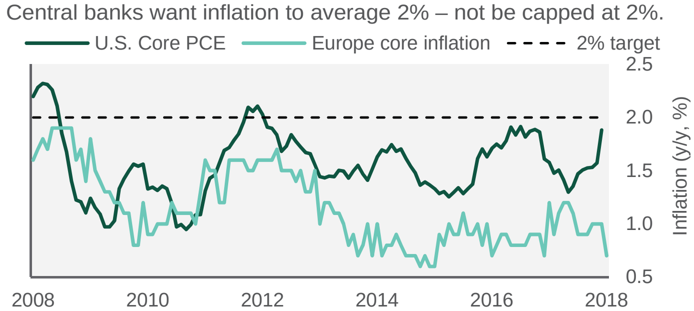
Real Assets

Try as they might – and they have over the past decade – central bankers globally are still struggling to generate targeted inflation levels. U.S. core personal consumption expenditures (PCE), the Fed's preferred inflation metric, has recently reached 1.9%, but wage growth has started to roll over, falling from 2.8% in January to a less-than-desired 2.6%. (Historically, wage growth has averaged 3.5%.) Other inflation metrics have also come in (modestly) short of expectations. Meanwhile, European core inflation (shown in the graph) recently disappointed, coming in at 0.7% year-over-year. Central bankers not only want 2% inflation, they want 2% average inflation – meaning if inflation remains below the 2% target for some time (as it has), it would be reasonable to allow inflation to go somewhat above the 2% level for some time as well. This is constraining the Fed to very slow policy tightening and will likely prevent the ECB from hiking rates until 2020.

So what does this mean for real assets and other inflation-sensitive asset classes, such as inflation-linked bonds? Central bankers remain committed to the cause of 2% average inflation but face tough headwinds – including softening demand and automation-enabled supply. As such, we think it makes sense to be at strategic allocations across all real assets. Natural resources – the real asset most closely correlated to inflation – has benefitted from higher commodity prices but may struggle if the Fed pushes too fast (our key risk case).

INFLATION TARGET OR CEILING?

Central banks want inflation to average 2% – not be capped at 2%.



Source: Northern Trust Global Asset Allocation, Bloomberg. Data from 4/30/2008 to 4/30/2018.

- Once again, inflation looks set to peter out at the 2% level.
- Central banks remain committed to 2% average inflation.
- The balance of forces suggests strategic allocations to real assets.

Conclusion

The outlook for growth dominated much of this month's investment strategy debate, along with political developments in Europe and the United States. We do expect some moderation in growth expectations when looking ahead to 2019, as U.S. growth falls back into its moderate growth channel and Chinese growth continues to moderate from high levels. The softness in first-quarter European data may be tied to temporary factors, but will also be limited going forward by any slowdown in Chinese import demand. On the political front, the U.S. mid-terms are increasingly coming into the discussion, but we think a light legislative slate is the likely outcome no matter how the elections unfold. In Europe, the fracturing of the traditional political parties is making progress tougher, but this remains a chronic problem as opposed to a crisis.

The primary conclusion from our more muted 2019 growth outlook is that upward interest rate risk has been reduced. As such, we made one change in our tactical asset allocation recommendations this month – reallocating 2% from cash to investment grade bonds to take advantage of the available yield pickup and potential capital gain. We maintained our overweight to equities overall because corporate profitability is expected to continue growing, increasing share buybacks will support stocks and interest rates should not be a headwind.

Strong earnings growth over the last three years – alongside the market consolidation witnessed over the past few months – has reduced equity valuations to reasonable levels, especially outside the United States.

As we mentioned earlier, our base case outlook includes growth returning to its longer-term channel – not breaking out to the upside but also not at risk of a downside slip during the next year either. We also expect central banks to get it right when it comes to policy moves over the next year. This includes the Fed raising rates less than it would like, and the ECB and BOJ continuing with their very accommodative stances. Of course, there is some risk that the Fed will continue to raise rates despite the low level of 10-year yields, risking an inversion of the yield curve. But we don't expect this to happen. Our other main risk case remains around the potential for a trade war between the United States and China. The more concrete trade issues – around deficits and tariffs – will be easier to solve than the tougher issues around the protection of intellectual property. As such, we expect the trade issue to linger over the next year with fits and starts of progress.

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.

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ViewPoints reflects data as of 05/16/18.