WHY WOULD THE FED CUT?

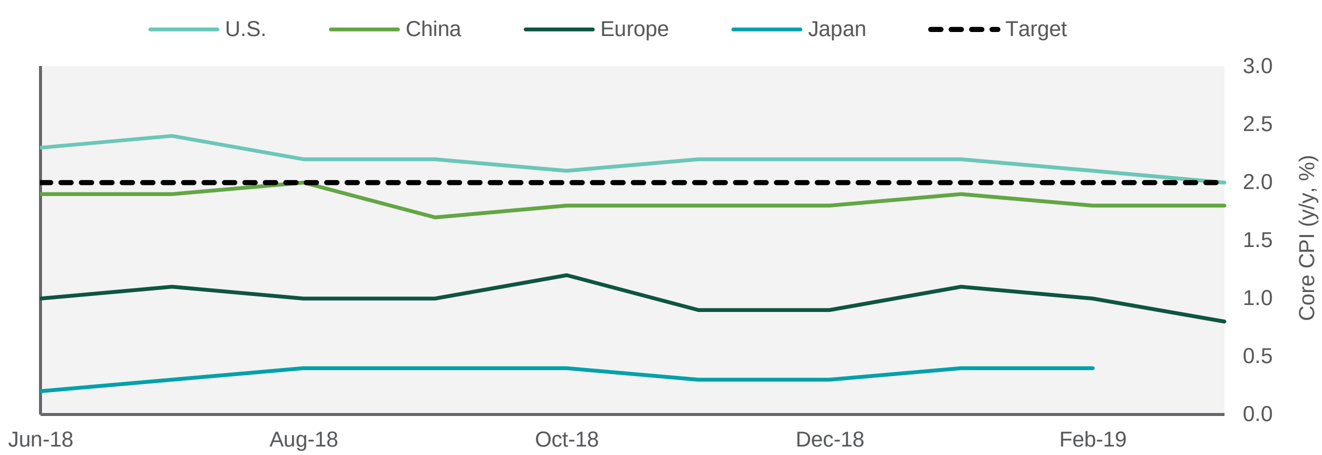
Financial market expectations in 2019 have pivoted from a potential U.S. Federal Reserve rate hike to a rate cut. If rates are cut, what would be the cause – financial market pressures, an economic downturn, or maybe a change in policy?

We think a changing policy framework would be the most likely catalyst. A great surprise to central bankers globally has been the benign behavior of inflation despite steadily falling unemployment rates and ultra-easy monetary policy. While disinflation (a falling rate of inflation) is beneficial to consumers, policy makers worry about the deleterious effects of deflation (falling prices), which can wreak havoc on economic activity and the ability to service debt. The risk of deflation should increase markedly during the next recession, warranting current attention. Core measures of inflation, which exclude volatile food and energy prices, have regularly undershot expectations, contributing to the inability to consistently hit the 2% target.

We think central bankers will be increasingly talking about a “symmetrical” inflation target. Achieving an overall inflation level of 2% would require allowing inflation to run above that level to offset the previous softer readings. All else being equal, this would lead to easier monetary policy. While we think global growth will positively surprise investors over the next year, expectations are low and the overall growth rate will remain moderate. This shouldn’t lead to demand pressure on global prices, as the sharing global economy continues to aid supply.

Amongst the major economies, the U.S. has the most momentum in current activity measures due to the relative self-reliance of its U.S. economy. The U.S. labor markets bounced back smartly in March, indicating the weak February jobs report was anomalous. Chinese growth is tentatively showing early signs of benefitting from the government’s stimulus plans, including tax cuts at both the individual and enterprise level. These actions are significant in size as they are estimated to total 2.5%-3.0% of Chinese GDP. European growth remains the laggard, as steady consumer spending/services growth continues to be held back by trade-restrained manufacturing activity. At present, a hard Brexit scenario has been avoided, as a six-month delay has been agreed (a delay has been our base case scenario). Broad resolution of the U.S./China trade dispute would be a clear positive for global growth, but a more narrow agreement seems the more probable outcome.

REFUSING TO COOPERATE – INFLATION FALLING BELOW TARGET
Only the US is at targeted inflation levels – and it’s heading in the wrong direction.



Source: Northern Trust Global Asset Allocation, Bloomberg. Inflation data from 6/30/2018 through 3/31/2019. Japan data is through 2/28/2019.

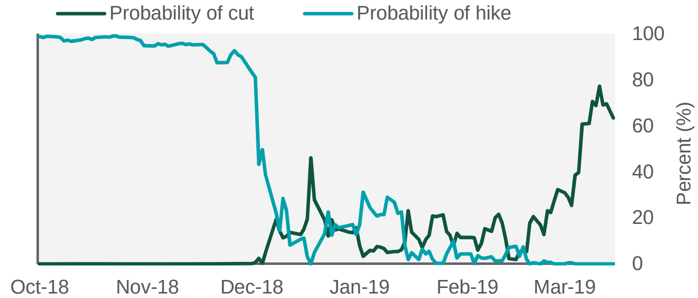
Interest Rates

The combination of the technical backdrop and the Fed's halt in hawkish rhetoric has led to a swift bond market rally. Interest rates have dropped globally, with the U.S. 10-year yield reaching a one-year low, and Japanese and German 10-year yields moving into negative territory. Adding to the mix, the bond market is pricing in a high probability of a Fed rate cut by year-end (see chart). President Trump's continued pressure has put the Fed in an awkward position as it seeks to prove its independence from the White House while also doing what it believes is in the best interest of the economy.

We believe the Fed will eventually succumb to an interest rate cut (or two) over the next year. To avoid the appearance of a politically motivated cut, it may move to a symmetric inflation targeting approach to policy. A symmetric inflation target allows inflation to move above target for an appropriate period after it has been below target for an extended period. The Fed's August Economic Policy Symposium (Jackson Hole) could be an opportune time to announce this shift in policy – but the Fed would need to come with an intention to cut rates to ensure credibility.

THE MARKET IS BETTING THE FED WILL CUT RATES

The Fed has no plans to hike in 2019, but investors now want a cut.



Source: Northern Trust Global Asset Allocation, Bloomberg. Probabilities represent the chances implied by Fed funds futures of a rate hike/cut by the end of 2019. Data from 10/17/2018 through 3/31/2019.

- Global stuckflation has pushed interest rates lower.
- The Fed is being pressured to cut – from investors and politicians.
- A new approach to inflation targeting could provide the Fed cover.

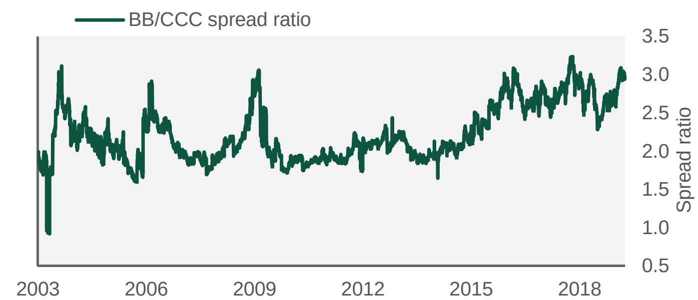
Credit Markets

The high-yield rally continued in March, with all rating categories providing positive returns as spreads have compressed. Higher-quality BBs have seen notable spread compression, leaving these bonds rich relative to lower-quality issuers. CCC spreads are now three times wider than BB spreads – up from 2.3 times wider in July 2018, and now near their widest level since the end of the commodity crisis in 2016 (see chart). The BB rally has been driven by the significant drop in treasury yields and broader macroeconomic concerns. BB yields are now at a low 4.8% versus the overall market yield of 6.3%, which optically provides little upside for those BB issues relative to the broader opportunity set.

High-yield portfolio managers may not be able to carry a large yield disadvantage relative to the market for an extended period as the yield of the asset class is the driver of long-term returns (note that, even with the notable BB spread compression, CCCs are still outperforming BBs on a total return basis during the recent rally given CCCs higher yields). This should result in a rotation into lower rating categories in order to find investment opportunities that provide additional upside, which would drive the CCC/BB ratio lower. The next tightening of high-yield market spreads should come from this rotation. We remain overweight high yield in our global policy model and consider our 6.0% return expectation to be easily obtainable and attractive (especially on a risk-adjusted basis)

WHEN SPREAD RATIOS GO HIGH, GO LOW

Lower quality high yield issues are looking attractive currently.



Source: Northern Trust Global Asset Allocation, Credit Suisse. Data from 12/31/2002 to 4/5/2019.

- High yield has rallied as recession fears subside.
- CCC-rated bonds should be the next driver of asset class returns.
- We remain overweight high yield in the global policy model.

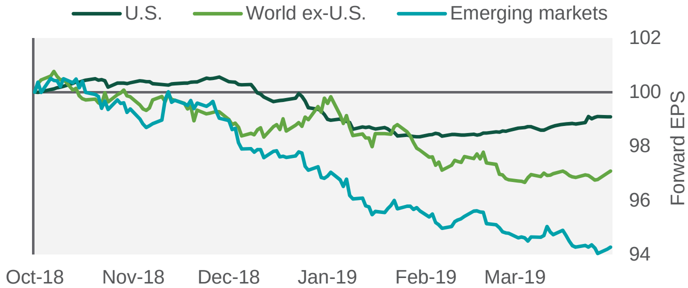
Equities

Global equities continued to add to year-to-date gains over the past month, with major global regions approaching or surpassing levels seen at the peaks of late September. With earnings season upon us, attention will be shifting to company fundamentals. Company guidance during earnings season will instruct the direction of estimates for the short run, where we see the near term remaining lackluster. In the first quarter, earnings in the U.S. are expected to be down year-over-year for the first time in three years, and should then resume modest growth for the balance of 2019. This more modest level of growth has led investors to continue to seek out growth in areas like technology, which leads all sectors year-to-date.

As we consider the next year, earnings estimates seem to be bottoming with some recent signs of positive revisions (see chart). With inflation stuck and global economic growth likely to outperform low expectations, equity valuations should be supported, allowing for further gains this year. We remain tilted toward U.S. equities vs. our strategic asset allocation starting point – but are increasingly on the lookout for opportunities in emerging markets and other developed markets, where valuations are lower and the earnings outlook is stabilizing.

EARNINGS EXPECTATION UPTICK

Higher earnings per share (EPS) estimates will support stocks.



Source: Northern Trust Global Asset Allocation, Bloomberg. S&P 500 represents U.S. data. MSCI represents world ex-U.S. and emerging market data. Estimated EPS data indexed to 100 from 10/10/2018 through 4/9/2019.

- Equity markets continue their recovery from last year's decline.
- Stable economic growth and stuckflation supports valuations.
- We remain tilted towards U.S. equities in the global policy model.

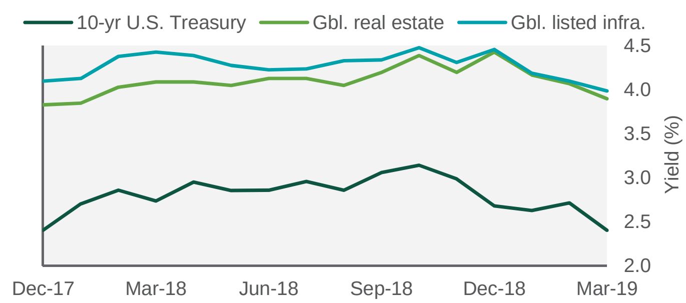
Real Assets

Real assets have been supported by several dynamics this year, all of which we expect to continue. The first is the recent fall in interest rates, which makes financing cheaper and the search for yield more intense. This disproportionately helps global real estate (GRE) and global listed infrastructure (GLI), as both are capital-intensive asset classes with attractive dividend yields. As seen in the chart, the recent fall in 10-year U.S. Treasury yields has made GLI/GRE an increasingly attractive option for yield generation in the portfolio. We prefer GRE over GLI – and are overweight GRE in the global policy model – due to its greater sensitivity to global economic growth, which we believe will outpace subdued investor expectations in 2019.

Meanwhile, the dovish pivot by the Fed and continued monetary accommodation by most other major central banks have put a foundation under commodity prices. Firming supply/demand dynamics (for both economic and geopolitical reasons) are providing further support. Specifically, copper prices are up 11% year-to-date while oil prices are up nearly 40% to over $60/barrel. Natural resources should benefit from central banks settling into an extended period of easy monetary policy and the second wind of the global economic expansion. We retain our strategic position in the global policy model with an eye to go overweight the asset class should the dynamics continue to gather steam.

THE SEARCH FOR YIELD RESUMES

As interest rates fall, higher-yielding asset classes should gain interest.



Source: Northern Trust Global Asset Allocation, Bloomberg, Monthly data from 12/29/2017 - 3/29/2019.

- Several dynamics are supporting real assets.
- We retain our overweight allocation to global real estate.
- Natural resources are feeding off easy money policy.

Conclusion

In our investment strategy meetings this month, we tested our theses that growth would beat the restrained outlook of investors, and that monetary policy would remain accommodative over the next year. We upgraded our outlook for U.S. and emerging market growth in January – and the U.S. growth data has been reassuring. In addition to March's bounce-back in job creation, measures of industrial activity have also improved over the last month. Evidence of an upturn in emerging market economies has been developing, including a strong improvement in "economic surprise indexes" since mid-March. This is evidence that economic reports, relative to consensus expectations, are starting to improve. This month, we upgraded our expectations for growth in developed markets outside the U.S., primarily based on the very low expectations for Europe. The European service economy has been expanding relatively steadily, with real headwinds coming from the industrial sector. Continued improvements in the U.S. and emerging market growth outlook will contribute to an improving outlook for Europe, which is relatively dependent on export growth.

Our monetary policy deliberations were mostly focused on the Fed and the European Central Bank (ECB). We expect the Fed's policy model to evolve over time, potentially embracing an approach to inflation that will tolerate (or even seek) a temporary rise in prices to achieve average inflation levels near the policy target. There is concern in some corners of the market that ECB President Mario Draghi's retirement on October 31st could lead to a more hawkish direction from the ECB. We believe that there is a sufficient moderate core of the ECB that embraces the current programs that a U-turn in policy looks unlikely.

We made no changes in our tactical asset allocation recommendations this month, as our global policy model is performing well in the current market environment and we feel good about our positioning. In addition to our normal focus on economic developments, a number of key developments will be on our radar. The largest democratic election in the world takes place in India from mid-April through mid-May, and is to some extent a referendum on Prime Minister Narendra Modi. European Parliamentary elections in late May will again test the Populist wave, while the Fed's annual Jackson Hole conference in late August will give the Fed a chance to sound out new approaches to monetary policy. The Brexit deadline has been extended until October 31st, as forecast in our base case scenario. Additionally, while some agreement on the U.S./China trade dispute seems likely mid-year, trade frictions are likely to remain among many countries for the foreseeable future.

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