NORTHERN TRUST

PERSPECTIVE

JULY 2018

GIVE ME CREDIT

In May, we highlighted a moderation in the global growth outlook, and in June we noted shifting momentum toward the United States. Underlying both those trends is our view that the recent strong global growth will moderate in 2019. In the United States, fiscal stimulus from the tax cuts will fade. Across Europe, concerns about trade and political leadership should continue to be a mild headwind to growth. In Asia, China continues to fine-tune policy to moderate excessive credit creation – but appears willing to back off when growth shows signs of cooling too much.

The risks to growth from rising trade barriers are real – but challenging to forecast. We have seen early evidence that tariffs prove more deflationary than inflationary – just take a glance at the prices of many commodities after their implementation. But the potential damage to public company profitability remains much higher than the overall economic impact, keeping this risk front and center.

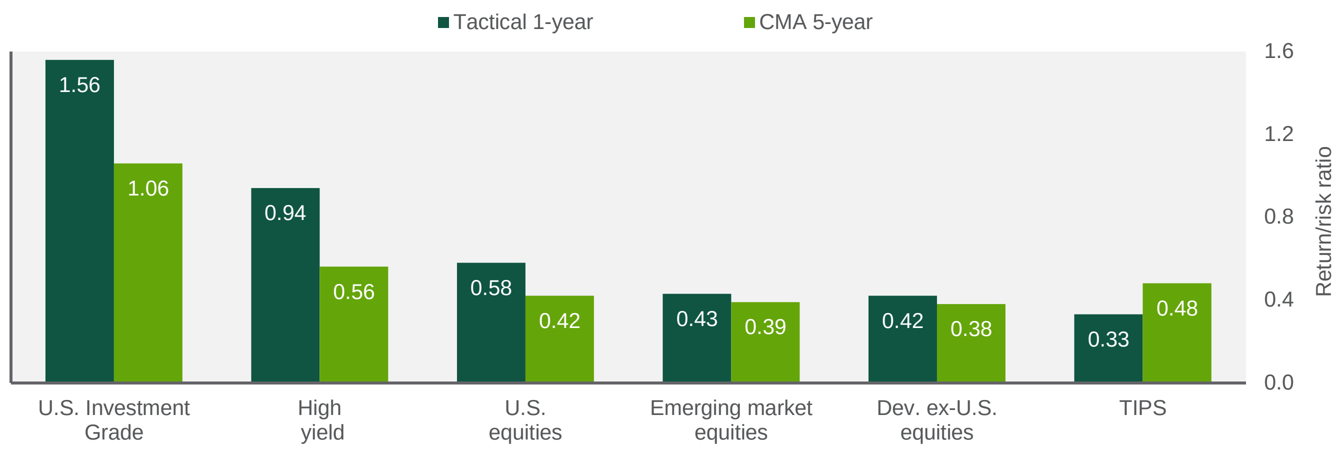
Should the trade battle between the United States and China accelerate, we think it will be the Federal Reserve who blinks first. The yield curve's relative flatness limits how far the Fed can raise short-term interest rates, and this has led some governors to voice their concern about the risk of inverting it. In addition to the risk of their "dissent," fixed income markets will provide pressure by pushing down yields of longer-dated Treasuries. We think Treasuries will rally on Fed fund rate hikes, furthering the inversion risk. If you add a full-blown trade war on top of this, it would take a mighty brave (some might say reckless) Fed to keep raising rates.

The European Central Bank's (ECB's) most recent rate guidance showed it didn't expect to consider raising rates (from very negative levels) for another year, while the Bank of Japan seems stuck in accommodation mode as growth remains moderate.

We also expect inflationary pressures – as well as investor inflation expectations – to remain in check. The risk of a short-term cyclical bounce remains, although recent labor market data in the United States showed an actual increase in the unemployment rate driven by the return of discouraged workers to the labor markets. While there are also some anecdotal signs of wage increases in Europe, there are no signs of any movement in the overall inflation measures. Japan remains stuck with inflation that barely registers, and China's consumer price inflation is below 2%. In this environment, we expect corporate credit to outperform inflation-protected bonds and discuss that in the Credit Markets section.

BONDS LOOKING ATTRACTIVE

Prospective risk adjusted returns look good for both investment grade and high yield bonds.



Source: Northern Trust Global Asset Allocation, Bloomberg. CMA 5-year return/risk ratios as of 7/12/2018. Tactical 1-year return/risk ratios as of 7/6/2018.

Interest Rates

A variety of technical factors on the short-end have contributed to a spike in short-term bond yields, effectively pushing other key overnight rates higher as well. In an attempt to manage this upward drift, the Fed raised interest on excess reserves (IOER) by only 20 basis points (vs. the normal 25 basis points). While Federal Reserve Chair Jerome Powell commented that “we don’t expect to have to lower IOER in the range often or again,” some investors remain skeptical. If the Fed loses control of the effective rate and further cuts to IOER prove ineffective, the Fed may have to end its balance sheet run-off earlier than market expectations have forecasted.

The ~2.5% spread between 10-year U.S. Treasuries and German bunds has reached its lowest level since the eurozone’s founding in 1999. Low inflation and political turmoil across Europe have contributed to falling German yields. Hedging costs can erode the spread difference for global investors purchasing U.S. Treasuries but the search for yield has been persistent, contributing to the downward pressure on long-term U.S. Treasuries. With the ECB releasing dovish forward guidance, this trend may continue. Portfolios are positioned with a neutral duration relative to their benchmarks as we expect long-term rates to remain anchored.

A NEW RECORD

Dovish ECB guidance drops German-U.S. spreads to a record low.

Source: Northern Trust Global Asset Allocation, Bloomberg. Data through 7/12/2018.

- The Fed is struggling to control the short end of the market.
- The long end of the market should remain anchored.
- We are managing to a neutral portfolio duration.

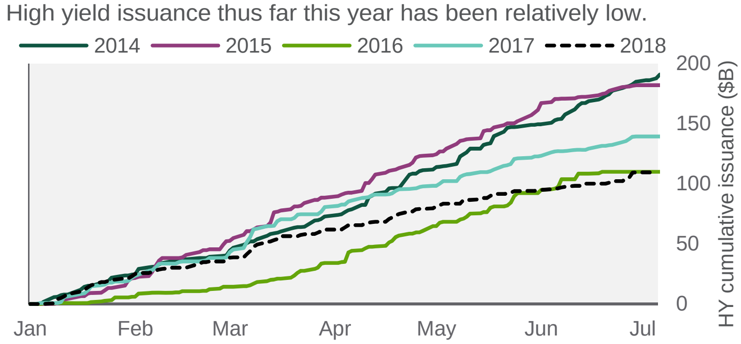
Credit Markets

This month we increased our allocations to both investment grade and high yield fixed income – as credit markets have become increasingly attractive. Across the investment grade fixed income market, fundamentals have been positive and technicals (supply/demand) are expected to improve in the second half of 2018. Shorter-maturity credit spreads have stabilized after some unintended consequences from tax reform and repatriation in the first part of the year. Meanwhile, longer-duration credit spread widening has been mostly driven by a period of heavy supply in recent months, driven by merger and acquisition activity. Overall, supply is down 7% year-over-year and 60% of expected 2018 supply has already come to the market. Our next-12-month forecast of 5.3% looks very attractive compared to forecasts over the past few years.

Meanwhile, high yield new issuance has been relatively low all year (see chart). Further – because cumulative new issuance has been more than offset by coupons payments, calls, maturities and net exits from the market – net new issuance in the first half of the year was actually a negative $43 billion. This is larger than any full year in the previous 10 years. As technicals remain strong, fundamentals are set to improve. High yield default rates – currently at 3.9% – are expected to fall below 2% over the next year. With strong technicals and solid fundamentals, we are forecasting an 8.3% return in high yield over the next year.

SUPPLY CONSTRAINED

High yield issuance thus far this year has been relatively low.



Source: Northern Trust Global Asset Allocation, Credit Suisse. Data through July 5 of each year.

- Credit markets look attractive across the fixed income universe.
- Fundamentals remain strong and technicals are supportive.
- We increased allocations to both investment grade and high yield.

Equities

As trade issues continue to escalate, equity markets globally have shown their concerns. U.S. markets have held up better than markets elsewhere, with more notable weakness occurring in emerging markets (China among others). U.S. equities are slightly over the past 30 days, which may appear to imply the market is ignoring escalating tensions, but performance at the sector level suggests a risk-off tone. Those sectors viewed to be hurt most by global trade or any associated growth slowdown, including industrials, materials and financials, were weak over the past month, while defensive “bond-proxy” sectors materially outperformed.

The chart shows the industrial sector’s relative performance alongside the Chinese stock market. Only as trade issues have come to the forefront have we seen a strong correlation, with both coming under pressure. U.S. equities may be looking through trade issues at the market level, which we broadly view as appropriate, but rotation within the equities market suggests the market is acknowledging risks. We continue to expect U.S. equities to be the most resilient should tensions rise further, aided by a backdrop of strong earnings growth and still-reasonable valuations.

TRADE-RELATED DAMAGE

Trade sensitive stocks have been underperforming.

Source: Northern Trust Global Asset Allocation, Industrials sector return is relative to the S&P 500. Shanghai Stock Exchange Composite Index represents China. Data through 7/12/2018.

- Equity investors are reducing exposure to trade-heavy groups.
- Strong earnings and acceptable valuations support U.S. equities.
- Emerging markets should benefit from moderating Fed rate hikes.

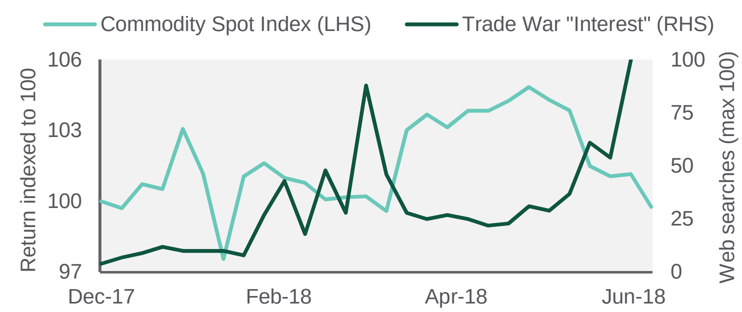
Real Assets

Many economists have highlighted the inflationary pressures trade tensions would bring. We are less convinced. A trade war is in the interest of few – but it’s not likely to be inflationary. So far, market data supports this view. The chart shows the commodity spot index (measuring the prices of a broad basket of commodities) vs. trade war “interest” (measured by Google searches for “trade war” – a way to quantitatively measure trade tensions). Whenever trade tensions rise, commodity prices have fallen – as the commodity producer ultimately takes the bulk of the hit from the tariff. Further, trade wars cause uncertainty – and uncertainty reduces demand, which more than offsets supply constraints due to the tariffs.

Inflation expectations also have shown an inverse relationship to trade tensions. Since mid-May, rising trade tensions have been met with falling inflation expectations – with inflation expectations over the next two years falling to 1.75% from 2.0%. The combination of our longer-term *Stuckflation* theme and this counter-intuitive relationship between trade tensions and inflation expectations led us to reduce our inflation-linked bond allocation this month, with the proceeds going to investment grade and high yield fixed income (see Credit Markets section). Across all other real assets we maintained our strategic allocations – and would note that an equity-based approach to natural resources (up 2.8% year-to-date) has held up better than a futures-based approach (down 3.8%).

UNEXPECTED REACTION?

Commodities have shown an inverse relationship to trade concerns.



Source: Northern Trust Global Asset Allocation, Bloomberg, Google. Data through 7/6/2018.

- Further trade tensions would be less inflationary than some fear.
- Less concern over inflation led to a reduced TIPS allocation.
- Natural resource stocks have outperformed broad commodities.

Conclusion

In this month's investment policy committee meeting, we recommended a tactical shift of 4% from inflation-protected bonds into investment grade bonds (2%) and high yield bonds (2%). This was due to the attractive risk/return outlook (as highlighted on the front page chart) of these bonds, especially compared to inflation-protected bonds. We had considerable discussion about the outlook for growth, and the potential impact of inflation on companies and financial markets. Partially tied to concerns about trade, there has been a real divergence in business sentiment between the United States and Europe. U.S. small business sentiment remains at record high levels, supported by deregulation and tax cuts. In contrast, the more export-dependent European business community is less optimistic; the ZEW Indicator of Economic Sentiment for eurozone growth has fallen sharply in recent months. While Chinese growth seems to have started slowing late last year, the government appears to be taking actions to support growth through the banking system and fiscal policy. Maybe in reaction, we have seen a rebound in private measures of business activity such as loan issuance, freight volumes and electricity usage.

Our risk cases are unchanged from last month, but they have both risen somewhat in their probability. The risk of a central bank making a mistake continues as a concern, and the Fed is showing little sign of wavering from its plan to steadily raise rates over the next year. We do expect the wavering to begin this year, so expect some increased noise around this issue. Our second risk, of a trade war, has also picked up some, as the Trump administration has reiterated its consideration of 10% tariffs on an additional $200 billion of Chinese imports. So far, the administration is showing a resolve similar to that of the Fed. In the end, we expect both will blink, but the odds have increased they won't.

Now, more than ever, it is critical to separate the noise from the signal. The noise from politicians globally is only increasing, and bottom-line oriented media outlets have become masterful at telling their viewers what they think they want to hear. Both the recent G-7 and NATO meetings are clear examples of this phenomenon. Big headlines were reported, but little real policy action occurred. Our expectation for channel growth and our theme of Stuckflation support continued risk taking. We expect central banks to take the easy way out and not overly tighten policy when inflation remains reasonably contained.

-Jim McDonald, Chief Investment Strategist

Global Policy Model

	FIXED INCOME				EQUITIES			REAL ASSETS			
	RISK CONTROL		RISK ASSET								
Strategic Allocation and Tactical Over/Underweights	**Cash**	**Inv. Grade**	**TIPS**	**High Yield**	**U.S.**	**Dev. Ex-U.S.**	**Emerg. Markets**	**GLI**	**GRE**	**NR**	**Gold**
Strategic Asset Allocation	2	34	4	3	23	16	9	2	2	5	0
Tactical Asset Allocation	0	30	0	10	25	16	10	2	2	5	0
Over/Underweight	-2	-4	-4	7	2	0	1	0	0	0	0

Source: Northern Trust Capital Market Assumptions Working Group, Investment Policy Committee. Strategic allocation is based on five year models developed annually; most recent model released 7/12/2018.The model cannot account for the impact that economic, market and other factors may have on the implementation and ongoing management of an actual investment strategy. Asset allocation does not guarantee a profit or protection against a loss in declining markets.