2015 Outlook: Watching Our Overweights

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by Team
of Northern Trust

Asset class returns were much more differentiated this year than last, with yield-oriented assets and U.S. equities being the standout performers. We entered 2014 overweight risk tactically, but made several changes as the year progressed. In the first quarter, we moved to reduce overall portfolio volatility by reallocating from emerging market equities into global listed infrastructure stocks. In the fourth quarter, we made several moves to increase our U.S. dollar exposure by reducing exposure to developed non-U.S. and emerging market equities, and reinvesting in U.S. equities and investment-grade fixed income. Global growth has been modestly disappointing in 2014, with the United States having the best momentum, while Europe and Japan fell short. Inflation trends continue to undershoot forecasts, most markedly in Europe. This will lead to further divergence in central bank policy in 2015, with a likely follow-through impact on currencies. While we enter 2015 with a tactical risk position that still favors risk taking, our risk appetite is lower than a year ago. The downgrade of our expectations for growth outside the United States is why we are "Watching Our Overweights." Our primary risk cases are the outlook for G-2 (U.S. and Chinese) economic growth, the potential for heightened financial market volatility surrounding monetary policy normalization and geopolitical risks emanating from the conflict between Russia and the West.

While the Federal Reserve has ended its quantitative easing (QE) program and is contemplating its first rate hike in 2015, both the European Central Bank (ECB) and the Bank of Japan (BOJ) are conjuring up additional stimulus as disinflation is wide-spread and unemployment in Europe has shown little improvement. The 2014 U.S. mid-term elections highlighted voters' disaffection with political leadership. Britain, Canada and Spain are among the important elections in 2015 that are likely to further crystalize this dissatisfaction and define the political reaction. Geopolitical risks are likely to remain elevated in 2015, with plunging oil prices raising fiscal uncertainties and the Russia- Ukraine conflict unsettled. We highlight our tactical outlooks on the major asset classes in Exhibit 2.

MACRO THEME REVIEW

Part of our 2015 outlook is a review of how our long-term capital market assumption themes, as published each summer in our Five-Year Outlook paper, are developing. These themes drive the forward-looking portion of our "forward looking, but historically aware" approach to strategic asset allocation (five-year time horizon). They also serve as a useful template for our tactical (one-year time horizon) outlook and asset allocation positioning. Exhibit 3 details five of our key themes from the 2014 edition and how those themes are progressing as we approach the New Year.

Our theme of "Enduring and Maturing Global Growth" is central to our strategic outlook. It continues to be in play, providing for a continuation of accommodative monetary policy, low interest rates, strong profit margins and elevated equity valuations. This supports our base case of equity market appreciation in-line with revenue growth and our tactical moderate overweight to Risk Assets. At risk, however, is our expectation for "maturing" emerging market growth – wherein concerns over a faster pace of slowdown impair the outlook for emerging market equities and result in our underweight position. U.S. bank credit has overcome some of the regulatory obstacles noted in "Central Bank Paradox," but inflation is steady and inflation expectations have fallen – so far validating the "Developed Market Inflation Sponge" theme. We remain slightly underweight real assets given the disinflationary environment, but we are cognizant that our "balanced assessment" of geopolitical risks may be too benign, as social unrest in oil-exporting emerging markets may increase geopolitical concerns. Fears over bubbles have proven to be mostly hyperbole thus far with elevated valuations justified given the interest rate environment.

GROWTH & INFLATION

While global growth and inflation have generally surprised on the downside over the last five years, the shortfall in 2014 was smaller than in the past. Growth in 2014 had some tailwind from less fiscal drag in the developed economies (save

Japan), and 2015 growth has the potential to benefit from the recent plunge in oil prices. Developed market economies should benefit from easy monetary policy, while emerging market economies face more divergent outlooks. China's growth has remained reasonably strong, while Brazil, Russia, South Africa and Mexico have disappointed. The IMF estimates that global economic growth increases by 0.2% to 0.4% over a two-year period for every 10% drop in oil prices. Brent crude has averaged $102/barrel over the last year, and if it were to stabilize at $65/barrel over the next year, this would indicate a potential two-year boost to global growth ranging from 0.7% to 1.4%. Similar to projections about how much global growth would benefit in 2014 from less fiscal drag, this probably overstates the potential benefit as it may understate the effect of reduced spending by energy companies.

The plunge in oil prices this year only adds to the disinflationary trends in place in many economies. Fiscal austerity and deleveraging are deflationary, and slowing growth in the emerging markets has also hurt pricing power. In the debate over the inflationary impact of central bank accommodation, we have always felt the transmission mechanism from liquidity to economic growth was damaged and therefore view accommodation as non-inflationary. As shown in Exhibit 4, the financial markets expect the U.S. to hit its inflation target in 12 years-time – and don't expect the eurozone or Japan to hit theirs over the next 30 years. So what could finally lead to an inflationary jump? The most likely candidate remains increased bargaining power of labor. Consumers are in the process of receiving an immediate boost to real disposable income through reduced energy bills, somewhat reducing the pressure on employers for wage adjustments – at least over the next 6 to 12 months. The minimum wage is set to rise in some 24 U.S. states in 2015. However, global core inflation is currently trending between just 1.5% and 2.0%, and the only significant economies facing inflationary problems are those facing other structural problems – such as Brazil, Russia and Turkey.

MONETARY POLICY

Developed world central bankers have essentially been playing from the Fed's playbook during the financial crisis, albeit at much different speeds. Step one of this program is to effect currency depreciation through easy monetary policy including large-scale asset purchases. Step two is to keep interest rates extraordinarily low, and promise to not raise them until employment and inflation have reached their target. Third, hope that the aforementioned actions lead to a rally in the equity markets, generating a positive wealth effect. Finally, cross your fingers that all of these actions lead to improvement in the real economy. The Federal Reserve and the Bank of England are the furthest along this process, and both are likely to make their first rate hike in 2015. However, we expect both central banks to be very restrained in the pace of their interest rate campaign. In contrast, the weak economic performance in Europe and Japan is forcing those central banks to accelerate their efforts to boost growth through large-scale asset purchases. However, the positive wealth effect of this action is likely less than in the United States, as the markets have already rallied considerably. As shown in Exhibit 5, the United States, eurozone and China are all below their targeted inflation rates, and Japan is expected to quickly return below its target. In sum, we expect developed world central bank policy to remain accommodative during 2015.

Emerging market central banks are more heterogeneous and face different challenges than their developed market counterparts. One commonality is the risk of currency depreciation on both inflation and debt service of foreign-currency denominated debt, which will keep monetary policy tighter all else being equal – a competitive disadvantage relative to the developed world. China's policy makers have been slowing credit growth, and this has led to inflation of only 1.4%, well below the 4.0% central target. While China's balancing act of slowing credit growth, but providing other targeted monetary stimulus, places them as one of the most accommodating emerging market central banks, many others face greater challenges. Overall, we believe emerging market monetary policy is likely to remain restrictive in 2015.

FIXED INCOME

When thinking about the outlook for interest rates, we focus on both traditional drivers (the outlook for growth and inflation) and also technical factors (other factors affecting the supply or demand for fixed income). The sluggish global growth environment, alongside benign inflation data, has supported global fixed income for the last several years. In addition, the quantitative easing programs of the Fed, BOE and BOJ have suppressed global rates, and the ECB has also contributed to the low rate environment, although they have yet to actually implement QE. With our muted growth expectations for both Europe and Japan in place for 2015, we see little upside risk to their interest rates. This highlights the relative attractiveness of rates in Australia, the United States and the United Kingdom (as shown in Exhibit 6). This helps address the question of who will step in to buy U.S. bonds now that the Fed has completed its QE program. To wit, foreign investors bought $284 billion of U.S. Treasuries in the first nine months of 2014, compared with just $83 billion in the same period last year. We think the relative attractiveness of U.S. yields limits the upside risk to U.S. rates over the next several years.

We do not expect a serious negative reaction in bond prices to the commencement of the tightening cycles in the United

States or the United Kingdom. We believe both central banks will have sufficient latitude to be patient in their pace of rate hikes, and expect the eventual rate hikes will be less than that priced into current bond prices. This should set the stage for continued positive investment returns from investment-grade bonds as was experienced during the 1986, 1988 and 2004 rate hike cycles (see Exhibit 6). In the U.S. municipal bond market, last year's undervaluation has been rectified through the market-leading 9% return of municipal bonds. With municipal credit spreads remaining tight, we favor higher-quality issuers going into 2015. The recent increase in U.S. high-yield spreads has boosted the current yield-to-worst to 7.1%. We think this creates sufficient cushion for the eventual default and restructuring of some high leveraged energy company bonds, and supports our overweight recommendation as shown in Exhibit 2.

EQUITIES

The year 2014 appears to be shaping up similarly to 2013, in that U.S. equities led the developed and emerging markets. However, it was a much tougher market environment as the easy multiple expansion of 2013 is behind us. The bull market that began in October 2011 led to significant valuation expansion, as is typically the case, and further advances will rely on earnings growth and dividends. As long as growth remains good, but not great, corporate management teams will likely continue to use their excess capital for dividend increases and share repurchases. The S&P 500

price-to-earnings ratio reached 18.3 at the end of November (surpassing the historic median of 16.6), but the current dividend yield of 2.0% looks reasonable compared with the 10-year Treasury yield of 2.11%. These comparisons grow more extreme in Europe and Japan, where dividend yields of 3.8% in Europe compare with the German 10-year at 0.62% and Japanese yields of 1.5% also dwarf their 10-year yields of 0.37%. Our base case forecast for 2015 is for little valuation change, with the S&P 500 returning 9%, emerging markets returning 5%, and developed markets outside the United States returning 3%. It is important to note that these forecasts assume constant currency values – and if the dollar keeps rallying, the markets outside the United States will see a commensurate reduction in their dollar-based returns.

A key question investors are wrestling with is how stocks will perform once central bank policy starts to normalize. With the Fed first up to raise rates, we can use them as a template for other developed markets. In the last five rate cycles, U.S. stocks generated a positive return four times in the one-year period that commenced six months before the first rate hike (this accounts for the discounting mechanism in the stock market). The one exception was the 1988 rate cycle, for which the performance timeframe captures the 1987 crash that was unrelated to the rate cycle. We think that the Fed will only increase interest rates in an environment of durable growth, and will be unlikely to surprise the markets. Therefore, while the rate hikes could increase volatility in the markets, they should not derail equity prices in an expanding economy, which supports our overweight recommendation as shown in Exhibit 2.

REAL ASSETS

Inflation has not been an issue in recent years for most of the developed world. In the U.S. Treasury markets, inflation expectations over the next 10 years have fallen this year from 2.3% to 1.6%. Much of the fall in inflation expectations began mid-year – coinciding with the fall in oil prices (off approximately 45% since mid-June). Oil prices have been driven by the confluence of increased supplies, a stronger dollar and reduced global demand. Forecasting the outlook for oil and – by extension, the commodity asset class – requires analysis of all three of these variables. Dollar strength has been a theme of our asset allocation for the past few months and we expect it to continue in 2015 given the divergence of monetary policy between the United States and Europe and Japan. Global energy demand is expected to remain modest in 2015 – both because of modest economic growth expectations (see "Enduring and Maturing Global Growth" theme in Exhibit 3) and continued improvements in energy efficiency.

The swing factor will be the oil supply. U.S. oil supplies (representing 12% of global production) are expected to grow by another 10% in 2015 as projects already underway generate continued production gains. Meanwhile, OPEC production was maintained at its November 27 meeting. The disconnect between current oil prices and what is required to balance the fiscal books of these OPEC nations (see Exhibit 8) cannot continue forever. Predicting when production will be cut – either intended (agreed-upon production cuts) or unintended (because of civil unrest) – is difficult however. Overall, we expect continued commodity price softness with increased volatility.

While commodities were the worst-performing asset class in 2014, global real estate and global listed infrastructure were two of the best. Both of these "cash flow assets" continued to benefit from the fall in real yields over the course of the year. Fundamentals remain strong as vacancies continue to steadily fall. However, also falling are dividend yields on global real estate and infrastructure stocks, now at 3.6% (vs. 2.6% for global equities) after coming into the year at 3.9% (vs. 2.4% for global equities). We remain neutral, as the search for yield continues to support higher valuations.

CONCLUSION

There are three key themes that are driving our tactical asset allocation views for 2015. First, we have conviction that U.S. assets are attractive in the current environment. U.S. growth is outpacing its peers, the central bank is gaining confidence to start normalizing policy, and the United States is a geopolitical safe haven. Second, we see divergent growth patterns due to uncoordinated global policy. This may lead to increased volatility, but will also push monetary policy toward accommodation and keep interest rates low. Finally, the continuing low interest rate environment means there is a high bar for taking out portfolio insurance by investing in cash or short duration bonds.

What kind of market environment may unfold in 2015? We do expect an increase in volatility tied to the continued upheaval in the oil markets and also driven by expectations toward rate hikes from the Fed and the Bank of England. Slowing growth in Europe, Japan and China is why we are “Watching Our Overweights” as we enter the New Year. Our equity market return forecasts are driven by earnings growth, and U.S. earnings growth of 7% drives our total return forecast of 9%. We think the recent increase in yields in U.S. high yield bonds improves their prospective returns, and forecast a return of 7% to 8%. We believe this return outlook justifies an overweight recommendation, especially as the return potential is above what we expect from developed non-U.S. and emerging market equities (which we forecast at 2% to 3% and 5% respectively, before any currency movements). An unexpected downturn from U.S. or Chinese growth remains our primary risk case, along with concerns about Russian/Western relations and market volatility stemming from monetary policy developments.

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