ADVISOR PERSPECTIVES

Northern Trust Perspective

March 20, 2015
by Team
of Northern Trust

The long-telegraphed launch of quantitative easing by the European Central Bank (ECB) has added some accelerant to financial market trends in place so far this year. European stocks, which had been strong performers in local currencies, have continued their strong performance while European bond yields have declined even further. The movements in currency markets this year have been extraordinary, with the euro down 12% against the dollar while emerging-market currencies have declined 7%. European economic data have also seen an improvement so far this year, while U.S. growth figures have been more mixed. We think the cheaper euro will help European export growth in the coming year, and improved sentiment will better support consumer and business spending. However, we think sentiment may have gotten ahead of what will actually be achievable absent greater structural reform.

The primary positive standout among the U.S. economic data is employment, specifically the January and February nonfarm payroll job gains. We expect some tempering of U.S. growth from the negative impact of dollar strength on exports, but exports' 13% contribution to gross domestic product (GDP) remains near the lowest among developed nations. The dysfunction in Washington continues to be on view as politicians wrestle with positions on the Middle East and regulatory matters, but we haven't been expecting much positive contribution from Washington before the next presidential election. We have also become incrementally more negative on the regulatory environment in Europe, as progress toward a banking union is slow and the ECB is left as the primary actor working to improve economic conditions.

We now believe that the Federal Reserve is likely to initiate its first hike in interest rates (aka "liftoff") by this September. This has led us to increase our forecast for U.S. two-year yields over the next year, while keeping our 10-year yield forecast unchanged. The history of Fed rate cycles shows that markets can still generate positive returns as long as the central bank doesn't negatively surprise investors — and we think that's the likely scenario this time around. If anything, recent dollar strength gives the Fed more room to be "patient" before raising rates, but we think it's likely to take advantage of market expectations toward the move. A surprise weakening in the U.S. economy, and the labor market, is the primary risk to the call that the Fed will hike rates by September.

THE DOLLAR GOES VERTICAL

The dollar looks to be entering a secular bull market.

Left Axis: Dollar index spot rate level

Secular dollar strength episodes   Current dollar strength episode

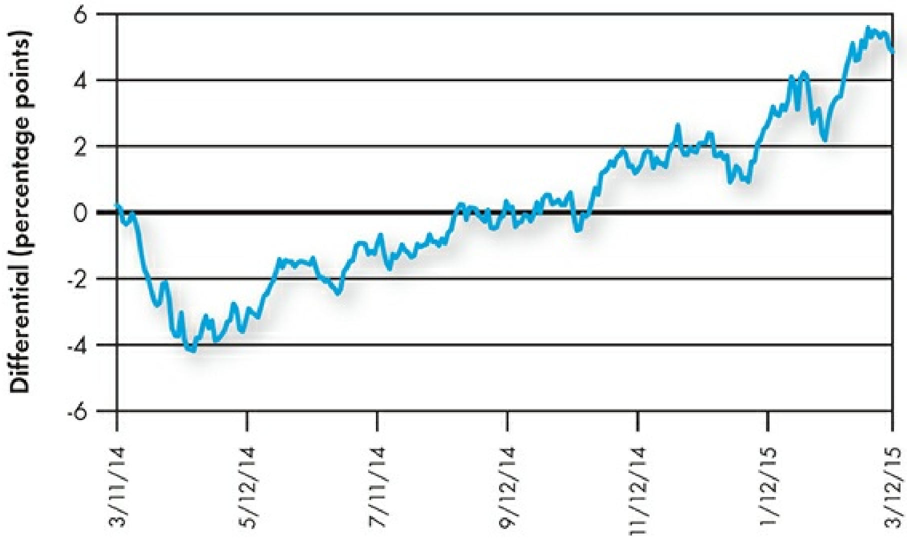
Note: Compound annual growth rate (CAGR)

Sources: Northern Trust, Bloomberg

U.S. EQUITY

GROWTH MARKET

Growth stocks have meaningfully outperformed during the last year.



Left Axis: Performance (S&P 500 Growth Index less S&P 500 Value Index)

Sources: Northern Trust, Bloomberg

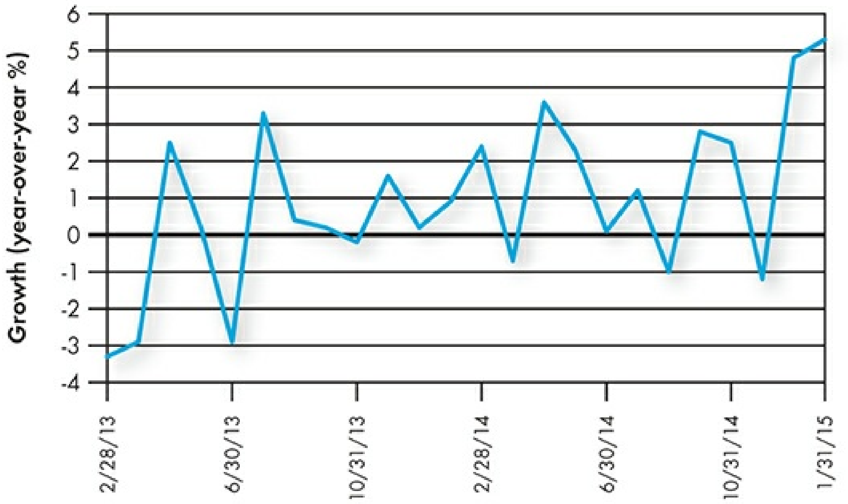
- Growth stock outperformance signals perceived growth scarcity.
- Better growth data should reduce the growth premium.

Following a short reversal a year ago, growth stocks have resumed the trend of outperforming value stocks. Some of the difference can be attributed to relative sector weights, with value stocks tilted toward financials and growth stocks tilted toward information technology. The ongoing positive sentiment toward growth likely reflects expectations of limited economic and, thus, earnings growth. In other words, when growth is scarce, equity investors are willing to pay more for growth stocks. If the growth outlook improves, we'd expect to see a reversal of this trend as the growth premium diminishes and value stocks begin to outperform. While the S&P 500's earnings growth this year will be subdued, we continue to favor U.S. equities given positive economic momentum and a favorable environment for valuation expansion.

EUROPEAN EQUITY

STRENGTH FROM THE STRONG

Retail sales in Germany are showing particular strength.



Left Axis: German retail sales growth (constant prices)

Note: Resale of new/used goods to the public for personal/household consumption

Sources: Northern Trust, Bloomberg

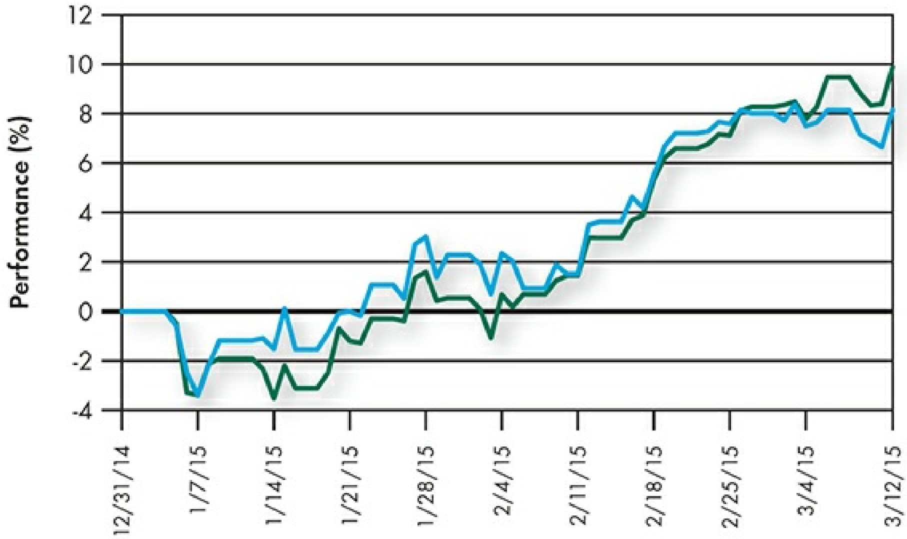
- Recent retail sales data from Germany were much better than expected.
- Though constructive, overall European weakness persists.

German retail sales in real terms rose 5.3% in January compared to last year, beating both the average expectation of 2.8% and the most bullish prediction of 4%. While volatile, the trend during the last two years shows some improvement, and January's result was the strongest since the middle of 2010. German retailers evidently are benefiting from cheaper oil and consumer confidence at levels last seen in 2006. If sustained, private consumption could be a positive contributor to economic growth in Europe's largest economy this year. Although this is a welcome development, the longer-term outlook for European growth continues to be soft because of a lack of economic reform. Currency weakness, geopolitical tension with Russia and Troika negotiations with Greece are further risks to the outlook for European equities.

ASIA-PACIFIC EQUITY

RELATIVE STABILITY

Japanese stocks have started appreciating without corresponding yen weakness.



Left Axis: Performance (%)

TOPIX Index (U.S. dollar)

TOPIX Index (Japanese yen)

Sources: Northern Trust, Bloomberg

- Year-to-date, TOPIX performance is less affected by yen movement.
- Investors may be focusing more on fundamentals than currency movements.

During the past two years, the broad Tokyo Stock Price Index (TOPIX) generally had an inverse relationship with the Japanese yen. This likely is due to the importance of exporters in Japan's economy that benefit from a depreciating currency, driving better revenue and earnings growth. This trend led to underperformance for U.S. dollar-based investors. However, year-to-date, the inversion has been more muted, with TOPIX returns roughly the same when measured in yen or dollars. This could be an early signal that investors are slightly more positive on Japan's domestic conditions than simply focused on the benefits of a weakening currency. We continue to expect real growth is a necessary condition for a more constructive view by equity investors.

EMERGING-MARKET EQUITY

REVERSING COURSE

After a period of rate increases, emerging-market policy rates are finally declining.

Left Axis: Emerging market central bank policy rates (weighted by 2013 GDP) (%)

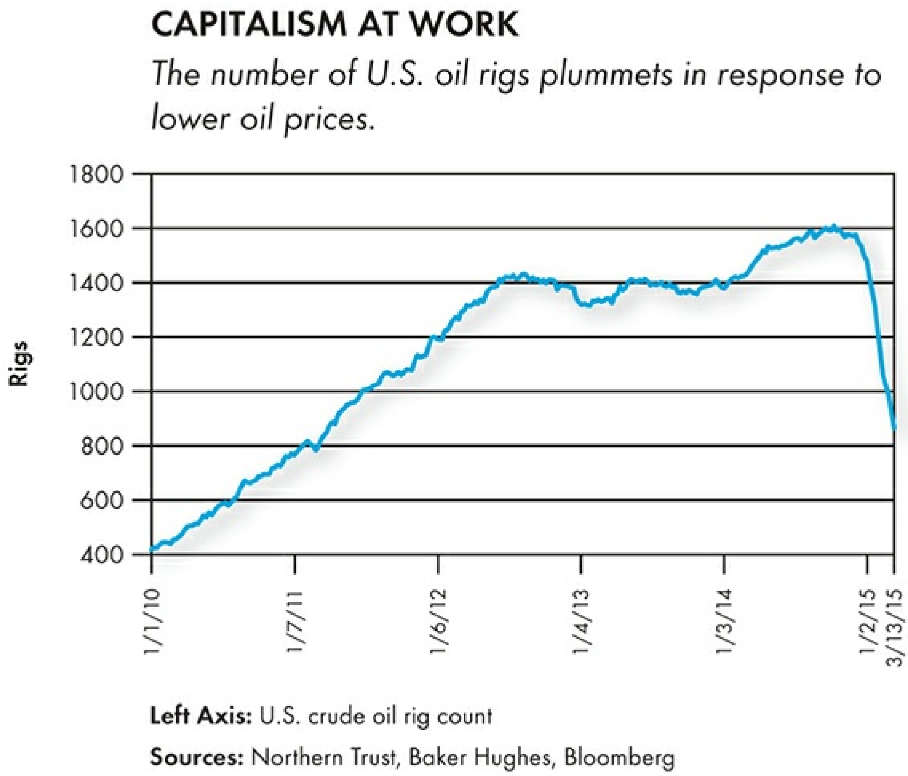
Note: China, Brazil, Russia, India, Korea and South Africa policy rates shown. Russia's refinancing rate used before key rate introduced in September 2013

Sources: Northern Trust, Bloomberg

- Monetary policy is slowly joining the party, as more central banks begin to ease.
- Economic momentum is moderating — notably in China.

During the last month, momentum toward easier monetary policy across the emerging markets has gained steam. Responding to falling rates of inflation and growth, central banks in China, Indonesia, India and Poland cut their policy rates. With interest rates and currency values falling across Europe and Japan, there's both increased opportunity and necessity for emerging-market rates and currencies to respond. On the growth front, the most recent data from China hasn't quieted concerns about the pace of economic growth. Even though early year data is notoriously distorted by the Chinese New Year, the first two months data on retail sales, industrial production and fixed asset investment all disappointed. While this has pushed the People's Bank of China to respond, the policy actions to date have been insufficient to stabilize growth.

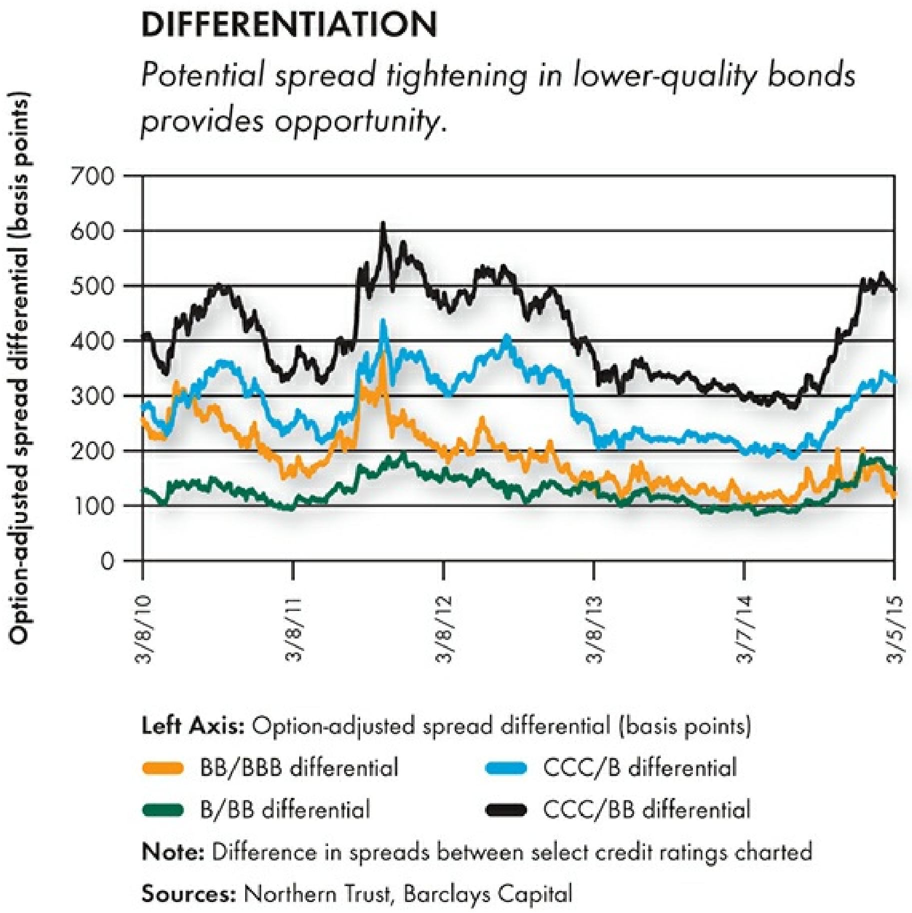
REAL ASSETS



- Oil prices have found some stabilization at multi-year lows.
- Oil supply — in response to price declines — will be the key metric to watch.

Global economic demand appears to be fairly well understood. U.S. demand has been a steady contributor to global growth, while Europe and Japan look set to have a more sporadic, but consistently low growth profile. China will continue to “manage” its economy toward a lower long-term growth rate as well. How oil producers react to lower levels of demand continues to be the question. Even though North American oil rig counts have fallen precipitously (see accompanying chart), drillers have become more efficient, focusing only on wells with larger payouts — leaving oil production elevated. Elsewhere, ISIS attacks in Libya have impaired oil production, but any nuclear deal with Iran may bring new supplies online. In an environment of modest demand and uncertain supply responses, we believe oil prices remain in consolidation mode.

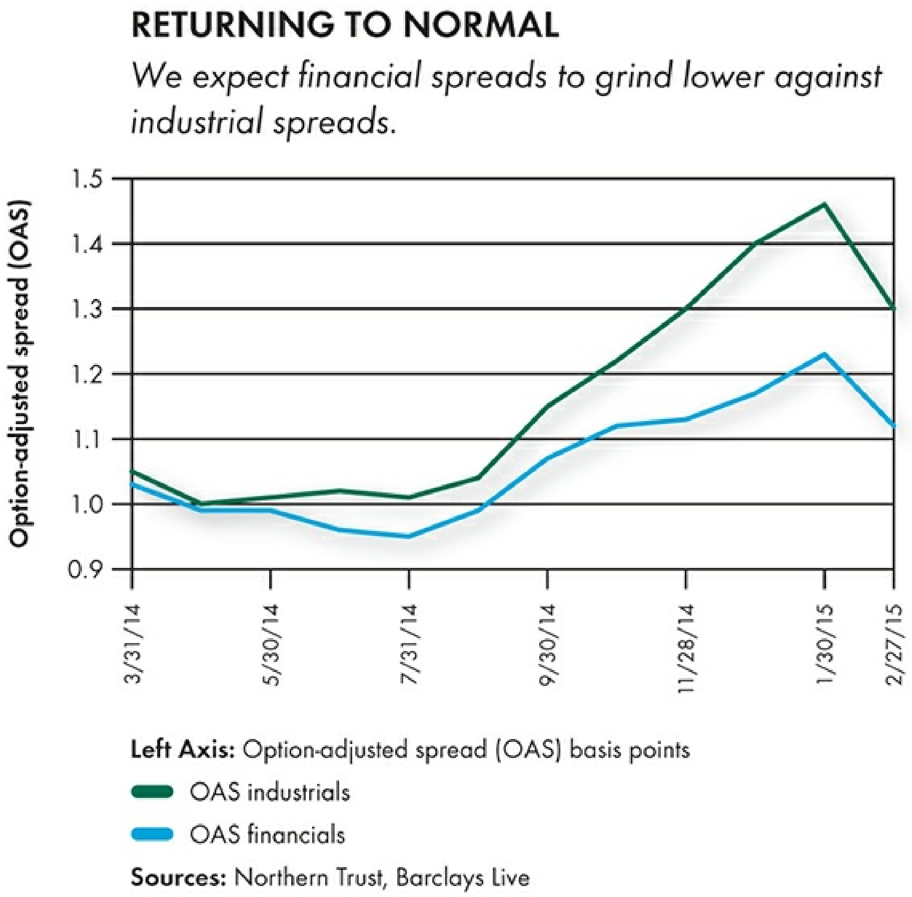
U.S. HIGH YIELD



- The differentials between rating categories have increased materially of late.
- The eventual compression of these differentials could provide opportunity.

High yield returns this year reflect minimal differentiation between rating categories. Spread tightening in BB's has been matched by the greater yield in lower categories. The differential between BB's and BBB's is near its tightest level, reducing the BB return potential going forward. Current BB valuations also provide a smaller margin to absorb possible interest rate increases. The differentials to the B and CCC rating categories are still at substantial discounts to higher rating categories. These differentials should compress in a similar manner to the period beginning in October 2011. Therefore, spread compression between lower rating categories provides return potential for the high yield market. We expect high yield bond returns to be supported during the next year by solid credit fundamentals and the continuing strong appetite for yield.

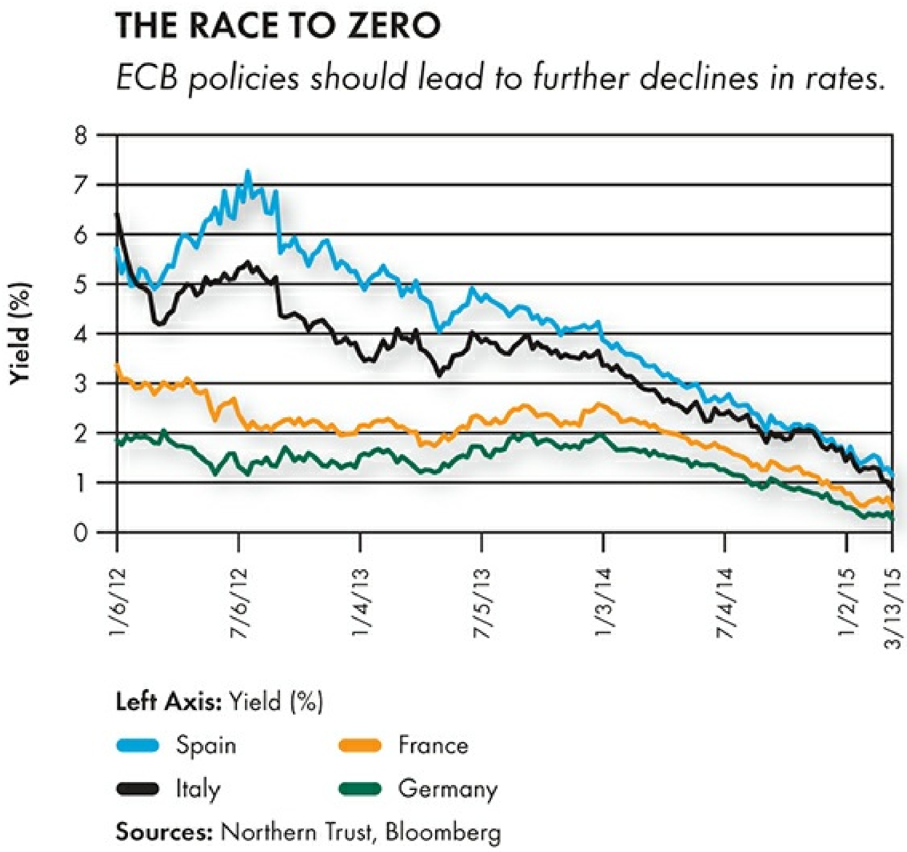
U.S. FIXED INCOME



- Investment-grade credit spreads have started to tighten anew.
- Amid investors search for yield, we believe corporate debt remains attractive.

During the past several months, investment-grade credit spreads widened because of an increase in geopolitical uncertainty, falling oil prices and record amounts of new supply. Although spreads have started to tighten again more recently, we still find corporate debt attractive for a variety of reasons. Borrowing costs continue to be near historical lows and balance sheets remain in good shape with high levels of cash and minimal amounts of leverage. Our outlook for modest economic growth this year will allow firms to continue to generate strong cash flows. U.S. Treasury yields remain at extremely low levels, and we believe the Fed will be cautious about raising rates too quickly. In this environment, corporate debt provides investors attractive relative value in a low interest rate world.

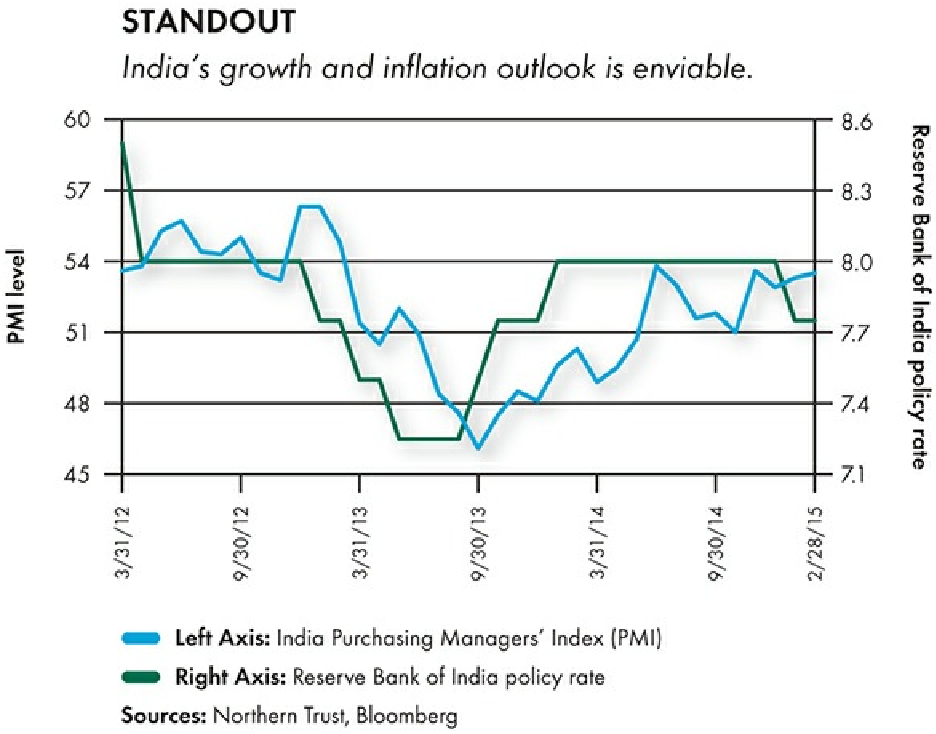
EUROPEAN FIXED INCOME



- The ECB has begun government bond buying amid record low yields.
- Greece is hanging on by a thread to a lifeline from Europe.

The ECB revised higher its projections for euro-area growth in 2015 and 2016 in consideration of euro depreciation, oil price declines and past monetary policy decisions. Based on the assumption of full policy implementation, it seems likely that the ECB's public sector purchase program (PSPP) will continue at least until September 2016. Although with a significant portion of government bond yields in negative territory and the purchase floor set at the -0.20% deposit rate, broad-based monthly 60 billion euros purchases may prove a challenge without "substitutions." We expect further spread compression and curve flattening in Europe. The situation in Greece remains a concern, as a refinancing overhang remains. Contagion risk is more muted because the rest of Europe appears less financially exposed, but a Grexit may rekindle the debate around the feasibility of Europe's pillars.

ASIA-PACIFIC FIXED INCOME



- The Year of the Goat is set to be the year of policy accommodation.
- India looks set to outperform in Asia.

The Chinese New Year began with a 0.25% interest rate cut from the People's Bank of China, only a month after it reduced banks' reserve requirements. The government lowered the official growth target to around 7% amid weakness in the property markets and exports. These concerns should keep the pressure on for further stimulus. The Indian economy appears to be in a sweet spot with low inflation and robust growth. The Reserve Bank of India cut the repo rate for a second time this year to 7.50% and adjusted its inflation goal to 4% +/- 2%. The Indian government's 2015 budget was modestly growth positive and had something for all courtesy of a one-year extension of the 3% fiscal deficit target. However, the authorities may be more distracted by a currency war in Asia.

CONCLUSION

Volatility has been on the rise this year, for example, the S&P 500 has experienced 1% or greater moves on 30% of this year's trading days, compared to just 15% of the time in 2012 and 2013. The action has been more dramatic, however, in the currency and commodity arenas. The continued weakness in oil prices leads to a redistribution of income from commodity producers to consumers, while the plunge in the euro improves Europe's export potential at the expense of its competitors. The 11% appreciation in the trade-weighted dollar this year has offset improving local currency returns in select markets, so that the MSCI World ex-U.S. index has outperformed the U.S. markets only by around 1% in dollars. We expect this volatility to continue this year as the Fed prepares to increase the Federal Funds rate and the market assesses the economic and financial market reaction.

We entered 2015 with a tactical asset allocation strategy favoring U.S. dollar assets as a strategy to deal with the realignment underway in global currencies. Even though Europe's economic performance has been better than expected, the depreciation of the common currency has been much more rapid than expected. Our asset allocation discussion this month focused on whether an upgrade toward European growth was warranted, but we concluded that investor sentiment (and asset prices) had likely outpaced the potential improvement. As a result, we made no changes to our tactical asset allocation recommendations, which have benefitted this year primarily from our exposure to high yield bonds and underweight to emerging-market debt.

Softer economic reports out of both the United States and China highlight a primary risk case to our outlook — not only raising the concern about the pace of global growth but also the efficacy of quantitative easing. The geopolitical sphere remains challenging, and our primary concern remains the intermediate to longer-term ambitions of Russia. Finally, the rapid realignment of currencies (including the 12% euro decline and the 7% drop in emerging-market currencies) raises risks to both the financial markets and economic growth projections. Our current recommendations account for this risk through the overweighting of U.S. dollar-oriented assets, and the underweighting in particular of emerging-market debt and equities. Some stabilization in currency values would likely be welcomed by the markets, allowing investors to catch their breath and reassess the economic and financial market impacts of the moves to date.

