Rising interest rates and a strengthening dollar worked their way through financial asset prices last month, negatively affecting the performance of emerging-market assets, natural resources and interest-rate-sensitive equities. There’s no single explanation for the rise in interest rates. While U.S. labor market data seem to bolster the case for the Federal Reserve to make a move this year, other economic data have been mixed. In fact, we’re of the view that the major world economies are stuck in “growth channels,” where growth is unlikely to break out to the upside, but also won’t seriously disappoint. As shown in the chart below, variability in U.S. gross domestic product (GDP) growth (measured on a year-over-year basis to address seasonality issues) since the financial crisis has been surprisingly low.

Sentiment around U.S. and European growth has swung quickly in the last two months, with increased confidence in the outlook for the United States and some hesitation toward Europe’s prospects. While we expect faster overall growth in the United States, we think Europe’s recovery will prove durable — aided by easier monetary policy and currency depreciation. Japan’s growth outlook has been positively surprising markets, and continuing corporate reform should support further improvement. The growth picture across the emerging markets is more complicated, as several economies struggle with transition and many countries face the headwind of a stronger dollar. While the meteoric rise in Chinese equities raises the risk of a reversal, global stock markets haven’t followed Chinese stocks upward, so any reversal should be contained locally.

The end of June is another purported deadline for revision to the Greek bailout plan, but the outline of an agreement isn’t in sight. We believe mutual interest favors a deal to extend the bailout being struck; however, the probability of failure has never been higher. The fact that 80% of Greece’s debt is held by a combination of the European Union, European Central Bank (ECB) and International Monetary Fund helps mitigate risks, but how a default would actually affect financial markets is unknown. Despite the uncertainties around Europe’s prospects and the mixed U.S. economic data, we still believe the Fed is likely to raise interest rates in September, thus putting the era of zero interest policy in the rear view mirror.
CONCLUSION

While we expect U.S. growth to see some improvement from the slow start to the year, we think optimists are likely to be disappointed at the overall pace of growth. The U.S. economy has averaged 2.2% growth since the financial crisis, and we don’t see a material acceleration during the near-to-intermediate term. The prospect of a pending increase in the Fed funds rate has contributed to a rise in interest rates and strengthening of the dollar, both of which serve as a constraint on growth. We also don’t see much upside to the U.S. economy through materially better growth outside the United States. Europe’s recovery looks durable, but unspectacular, while Japan is handily beating expectations. But emerging markets collectively contribute more than 50% to global growth, and we expect them to disappoint investors during the next year.

In the wake of our tempered U.S. growth expectations, and the recent back-up in interest rates, we made a change in our global tactical asset allocation model this month by recommending a 2% move from U.S. equities to U.S. investment-grade bonds. In conjunction with risk-reduction recommendations made in the fourth quarter of last year, we’ve moved from a significant overweight to risk assets to a moderate overweight during the last nine months. The upside risk to our position is that we’re too dour on global growth, and corporate earnings end up better than analysts expect. The downside risks also center on economic growth, including the effect of a strong dollar on emerging markets.

The markets will also be wrestling with the Greek bailout negotiations in coming weeks, and the prospect of a Fed rate hike in coming months. We think the odds favor some sort of “kicking of the can down the road” deal with Greece, but the likelihood of the deal falling apart has become increasingly possible. We draw some comfort from the fact that Greece’s troubles are hardly new information to the markets, but are cognizant of how unpredictable the reaction to a Greek default is. The outlook for the Fed, in contrast, looks reasonably predictable. We believe the Fed is predisposed to raise interest rates this year, as it likely believes that its zero interest rate policy has lost its effectiveness. As long as the Fed doesn’t negatively surprise the market with its pace of increases (and we don’t expect them to), equity markets should be able to digest the modest pace of rate increases we expect.

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.

Past performance is no guarantee of future results. Returns of the indexes also do not typically reflect the deduction of investment management fees, trading costs or other expenses. It is not possible to invest directly in an index. Indexes are the property of their respective owners, all rights reserved.

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ViewPoints reflects data as of 6/1815.