EMBRACING SOME RISK

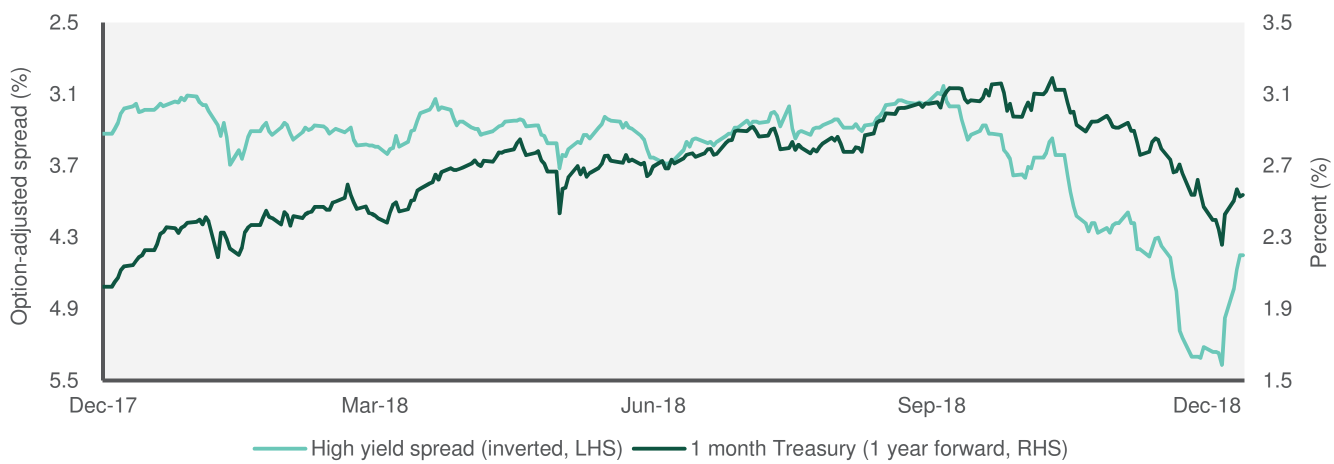
One element of successful investing is assessing how investor expectations may change over time. We began warning in mid-2018 of a growth slowdown in 2019, which we felt would be a disappointment to investors. This came to a head in the fourth quarter, as growth concerns led to a significant reduction in risk appetite and valuations. The resulting widening of credit spreads (as shown below) led to predictions that the credit markets were sniffing out an economic downturn. But we now think sentiment has swung too far in this direction; we don't expect a recession in 2019. This negative sentiment shift improves the odds of an upside surprise over the next year, which we think improves the outlook for risk taking.

Another key driver of successful investing can be anticipating the impact of changing monetary policy. We have been expressing concern that the Federal Reserve was being too hawkish, and this contributed to the recent risk-off environment. Rising interest rates have hurt the housing market and other interest rate sensitive industries. In addition, the global growth outlook was also slowing, partially due to trade-related tensions. The tightening of financial conditions has finally caught the Fed's attention, and it has recently backed off its more aggressive plans. As shown below, expectations for short-term interest rate hikes fell significantly starting in November as investors began to bet the Fed would back off. We now expect a pause for at least the first half of the year and the Fed to be patient thereafter. This changing stance has led us to revise our view on U.S. monetary policy from "restrictive" to "accommodative."

Our base case scenario is based on the themes of Global Growth Resilience and a Market-Dependent Fed. We believe the global economy is in a growth channel that should encourage some caution when growth is hot, but some patience when growth cools. Souring investor expectations set the stage for positive surprises, which has led us to upgrade our outlook for U.S. and emerging market growth to "surprises" from "disappoints." The Market-Dependent Fed has reduced its options with its recent dovish statements and markets are not pricing in any hikes in 2019. We believe the five-year Treasury yield will be a key indicator to watch, with rises acting as a "green light" for the Fed to raise rates. Our risk case is a "Fed relapse" where a stronger growth period and easier financial conditions lure the Fed into further tightening, risking rekindling the concerns of this past quarter.

RISK AVERSION ROSE AND THE FED BACKED OFF

Pressure on risk assets such as high yield led to reduced expectations for Fed rate hikes.



Source: Northern Trust Global Asset Allocation, Bloomberg. Data from 12/31/2017 to 1/10/2019.

Conclusion

We wrote about the importance of understanding investor expectations at the start of this month's *Perspective*. At the end of the day, investing is a game of probabilities and properly assessing investor expectations helps tilt the odds in your favor. We've seen a 20% decline in forward price earnings multiples in U.S. equities over the last year, which helps improve the outlook for risk asset performance over the next year. It is also important to consider the importance of portfolio construction, as assets are best evaluated in the context of the overall portfolio. We have frequently been asked about the risk of high yield should the United States go into recession – without a corresponding question about how much worse equities would perform. To wit, during the 19% decline in U.S. equities during the fourth quarter, high yield declined just 6%.

Relatedly, we receive questions about why we would own investment grade bonds here instead of cash – considering the flatness of the yield curve. The answer comes down to portfolio construction, because investment-grade bonds serve as a better hedge against our equity risk than cash. Interest rates today are broadly in the middle of our forecasted range for the next six to 12 months, so current yields are a good indication of our expected return. Credit markets should do better, however; we expect some spread tightening as risk taking returns to the markets. High-yield bonds could deliver a return comparable to equities in 2019, at considerably lower risk. High yield's (relatively) high coupon helps provide some downside protection. In looking back at prior periods of high-yield price weakness, the longest it took for high yield to regain prior losses was just nine months.

We entered 2019 in a neutral risk position in our global tactical asset allocation model. The odds started to meaningfully change in mid-December, as risk assets broadly sold off and valuations correspondingly improved. The odds improved further when Fed Chairman Powell signaled in early January the Fed would be patient in assessing monetary policy in 2019. As we looked to embrace some more risk after these developments, we recommended a 6% move from investment grade bonds into U.S. equities (2%), emerging market equities (2%) and global real estate (2%). This is supported by our themes of Global Growth Resilience and a Market-Dependent Fed. The risks to this more optimistic outlook are a Fed relapse (where temporary strength resuscitates the Fed's hiking plans) and political miscalculation (as we see any economic stumbles over the next year likely being man-made). As always, we will be analyzing incoming developments and assessing their impact on our investment strategy outlook and look forward to updating you on our thoughts next month.