TARIFF TUSSLE

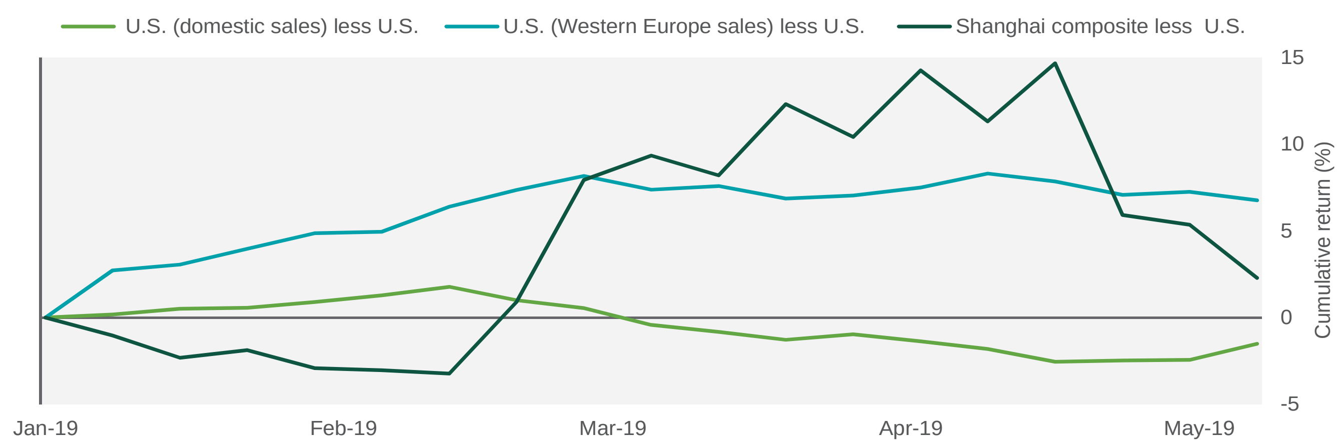
Faced with increased tariffs from both sides over the last week, the attention of global markets has turned to tensions caused by U.S./China trade dispute. We have long felt this issue would not be resolved in a comprehensive manner, and that frictions are likely to persist for years to come. Both sides have shown sensitivity to the impact of the tariffs on their respective markets and economies. U.S. officials have been quick to offer supportive comments after periods of market volatility, seeking to pacify market concerns. Chinese policy makers have also been attentive, increasing fiscal stimulus and directly engaging its central bank in supporting growth. While it is important to acknowledge this risk to global growth, we must also assess other key drivers of the global economy and risk taking.

The global economy rebounded at the start of the year, after a slowdown in the second half of 2018. Growth out of the U.S., Europe and China all improved in the first quarter, and growth is expected to stay solid before moderating in the fourth quarter. U.S. labor markets continue to show considerable resiliency, underpinning consumer spending. European growth has positively surprised, and improving credit creation is a constructive development. Chinese policy makers have succeeded in supporting growth and will likely continue to do so in the wake of trade-related risks. A clear risk to the pace of the global expansion is ebbing business confidence due to the trade dispute. Another result could be a relocation of manufacturing capacity out of China into countries such as Vietnam (where labor expenses can be one-third the costs of China).

Increased trade tensions have also lowered interest rates, with U.S. 10-year yields below 2.5% and German 10-year yields in negative territory. Along with continued global disinflationary trends, this should keep central bankers in accommodative mode, and futures markets are currently pricing in a 72% probability of a Federal Reserve rate cut by year's end. Falling interest rates due to a negative outlook on global growth would not be supportive of equity valuations and risk-taking, while lower interest rates that effectively reverse the hikes of late last year would not hinder stocks. The latter scenario is more likely, in our view, and should support risk assets.

MARKETS FOCUSING ON MORE THAN TARIFFS

Domestic-oriented companies have lagged, those focused on Europe have outperformed, and China has been volatile.



Source: Northern Trust Global Asset Allocation, Bloomberg. Weekly data from 1/1/2018 - 5/10/2019. U.S. = S&P 500. Other indices are cumulative returns vs. the S&P 500. U.S. (domestic sales) = Goldman Sachs (GS) U.S. company domestic sales revenue exposure basket. U.S. (Western Europe sales) = GS U.S. company Western Europe revenue exposure. Past performance does not guarantee future results.

Conclusion

Our investment strategy meetings this month focused on the outlook for growth, including the potential impact of rising tariffs. The tariff and trade issue is tricky to analyze, as the impacts can be indirect and the outlook can change immediately based on a tweet. As always, we seek to assess the outlook for our key inputs (such as growth, inflation, monetary policy and regulatory) as compared with our assessment for investor expectations. Changes in investor outlook can be quickly reflected in asset prices, but can sometimes take longer to appear. Corporate earnings have come through the first quarter better than feared, with a U.S. decline avoided. We are expecting earnings growth of about 5% across all major regions over the next year, a little more cautious than consensus (which tends to optimistically overshoot).

This steady but unspectacular earnings environment can be supportive to risk-taking. Historically, strong earnings growth has not been great for stock market returns, while large declines in earnings have been associated with strong subsequent returns (likely in anticipation of monetary easing). We do expect this middling environment to be favorable for U.S. high yield, where we expect strong fundamentals (high margins, moderate leverage) and good technicals (falling supply, high demand) to lead to strong risk-adjusted returns. The outlook for monetary policy in the coming months will likely be heavily influenced by incoming inflation data, as Fed Chair Powell has described the recent decline in inflation as "transitory". A continued moderation in core inflation would help cement the case for a rate cut, while a rebound would vindicate the Fed and argue for at least maintaining the current level of interest rates. Monetary policy out of the European Central Bank, the Bank of Japan and the People's Bank of China should continue to lean toward easier policy due to disinflationary trends and national growth concerns.

The risk of political miscalculation, especially as it relates to the trade talks, has been one of our two core risk cases for months. While the odds of this risk case have risen over the last month, we haven't moved from our moderate overweight to risk positioning. Investors have been incorporating this risk in their positioning for months now, and it is unclear when a deal may be reached. Those contemplating a reduction in risk in the wake of last week's developments face the risk of needing to execute a U-turn in coming months should a compromise be reached. Looking ahead, we will be keenly focused on validating the steadiness of the global economic cycle (including assessing progress on the trade negotiation front) while monitoring the risk of a cyclical upturn in inflation.

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.

Northern Trust Asset Management comprises Northern Trust Investments, Inc., Northern Trust Global Investments Limited, Northern Trust Global Investments Japan, K.K., NT Global Advisors, Inc. and investment personnel of The Northern Trust Company of Hong Kong Limited and The Northern Trust Company.

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ViewPoints reflects data as of 5/15/19.