

# A JUSTIFIABLE RALLY

It's surely a coincidence that the recent market rally occurred during the partial shutdown of the U.S. government. More conventional rally catalysts were the over-sold conditions created by excessive pessimism about growth and a dovish shift from the Federal Reserve. Equity valuations had fallen below long-term averages across most markets, and the increase in credit spreads was leading some forecasters to meaningfully raise their expectations of a recession by 2020. The ensuing rally in risk assets has been corroborated by the meaningful narrowing of credit spreads. Our Mild Growth Myopia theme counsels against getting too bearish (or bullish) on economic growth, as we think the expansion is durable but limited on the upside due to debt and demographic issues.

Amongst the major economies, the clearest signs of improving growth have emerged this year in the United States. New industrial orders jumped in January, as did both new job creation and new entrants into the labor force. European growth has been hampered by slowing trade, private consumption and industrial production – which we expect to improve some as the year progresses. We do not expect Europe to go into recession, and we forecast growth of 1.0-1.5% for the year. The economic signals from China remain mixed. The manufacturing sector is being hurt by trade tensions, while the service

sector remains stronger. Some measures of private activity (such as the Li Keqiang Index, which measures electricity, freight volumes and bank loans) indicate still-good growth. We expect improvement in China's broad growth data by the second half of the year.

Softening inflation reports have provided cover for central banks to moderate their plans and the Fed is at the front of the line. They completed their more dovish "pivot" in January with their policy statement and indications that their balance sheet reduction is not on "autopilot." We have also seen dovish moves by the Bank of England, Reserve Bank of Australia and the Reserve Bank of India over the last week. Financial markets have been ahead of the central bankers in assessing the prospects for further rate hikes, and we think the markets will continue to provide good guidance about the future outlook for rates. Currently, short-term rates are expected to actually be modestly lower by the end of 2019. We'll be carefully watching the yield curve for signals about prospects for future Fed policy, specifically the pricing in the 5-year Treasury which we believe needs to go higher in yield to give the Fed room to hike rates further.

## IS THE BOUNCE BACK FOR REAL?

Improving risk appetite has been supported by better economic data.



Source: NT Global Asset Allocation. U.S. economic surprise index is measured by Citi. High yield spread is for Bloomberg Barclays High Yield 2% Issuer Cap. Data from 8/31/2018 through 2/11/2019.

## Conclusion

Rising investor pessimism in the fourth quarter of 2018, followed by the Fed moving off their steady tightening campaign, set the conditions for the improved risk environment over the last two months. Equity valuations had fallen below long-term averages in many markets, and credit spreads had increased to a level providing a yield to worst of over 8% in U.S. High Yield. After increasing our risk exposure in our global tactical asset policy last month, we stood pat this month as risk assets have rallied sharply and the fundamental drivers of our outlook are relatively unchanged. Our base case scenario calls for Global Growth Resilience – cautioning investors against getting too negative in the wake of the current global slowdown. We expect the expansion to endure, and risk assets to reward as the potential for a recession in 2019/2020 is priced out.

Our other base case calls for a Focus on Fundamentals, where we think central banks will be able delay any policy normalization ambitions as resilient growth and contained inflation lead to a benign fundamental backdrop. The most recent developments certainly support this view, as central banks in the United Kingdom, Australia and India have recently joined the Fed in espousing a more dovish outlook for policy. Underpinning this base case is our Stuckflation theme, which has been supportive of risk-asset returns over the last several years. An unexpected jump in inflation could move the Fed off their dovish policy prematurely, which is one of our two risk cases. Our other risk case remains

that of Political Miscalculation, where a policy mistake leads to economic difficulties. In addition to a Fed mistake, the risk of accelerated trade tensions between the United States and China remains an unsolved problem.

There is no shortage of important events to be analyzing over the course of this year. Near-term, evidence of stabilization in Chinese growth along with progress on the trade front will be key issues. The Brexit deadline of March 29 looks unlikely to be met, and we believe a Brexit delay is the most likely result. We will also have European Parliamentary elections in late May and a new European Central Bank head to take over on November 1. From an economic standpoint, the inflation data may prove most important as an unexpected cyclical uptick could knock central bankers off their new game plan. We have great confidence in our long-term theme of Stuckflation (where the impact of technology in increasing supply and promoting pricing transparency keeps inflation under check), but cyclical bouts of inflation can't be ruled out. But our base case remains that global inflation is under control, supporting accommodative monetary policy and also risk taking in the markets.

## 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.

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