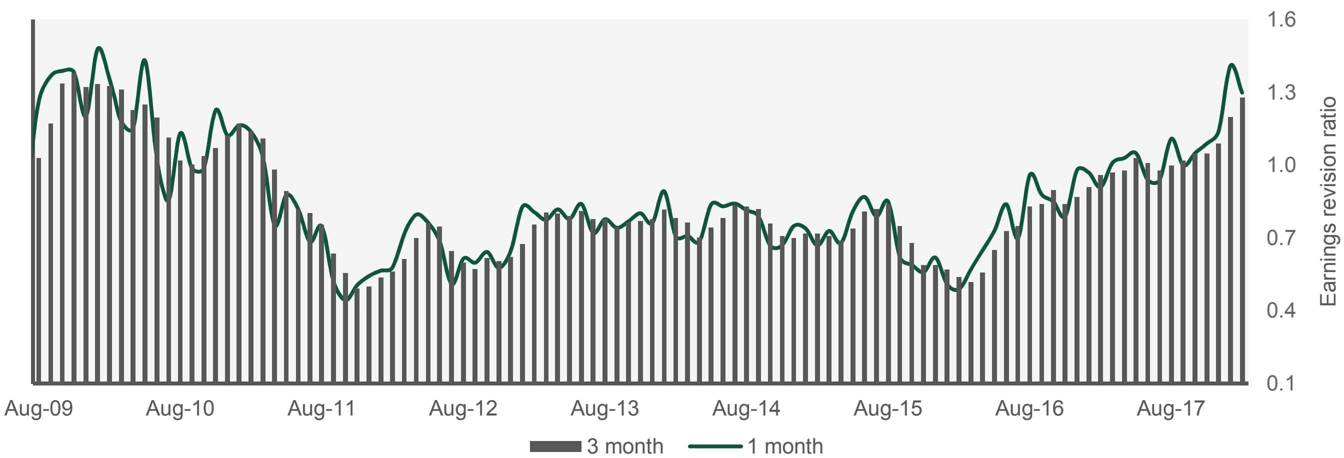
TARIFF TIFFS

No longer is it just inflation and interest rates dominating investor focus. The growth side of the economy has come into question in the wake of the U.S. government's decision to impose tariffs on imported steel and aluminum. The details of the tariffs are still being finalized as we go to press, including the ability of countries to apply for exemptions in coming weeks. As North American Free Trade Agreement (NAFTA) partners, Canada and Mexico have been specifically exempted from this tariff, but do face the ongoing NAFTA renegotiations. In the background, the ongoing Section 301 review of China's intellectual property practices will likely surface as an issue in coming months. It is unclear whether "tariff tiffs" will turn into a full blown trade war, but the collateral damage so far includes Gary Cohn, the White House's top economic advisor. The credentials and policies of his replacement will be an important guidepost on how this issue will evolve over the next year.

Meanwhile, the global economy may actually have gained a little momentum mid-quarter. Corporate activity indicators have edged up, with stronger U.S. readings offsetting a modest slowing elsewhere. Corporate profitability continues to shine, as shown below. The ratio of earnings estimate increases to decreases has reached levels we haven't seen since 2009 and 2010. This does start to beg the question – has economic optimism reached its peak? With U.S. tax cuts not even hitting reported earnings yet, it seems a little early for that conclusion, but we will be actively debating it in coming months.

While a hot wage number in the January U.S. labor report stoked inflationary concerns last month, the just-released February report has provided some balm as wage gains decelerated and new workers entered the workforce. Core inflation in the United States remains stuck at 1.5%, is just 1.0% in Europe and is barely measurable at 0.1% in Japan. The continued stickiness of prices is constraining central bankers, although more so in Europe and Japan than in the United States. The European Central Bank (ECB) made a very minor adjustment in its recent statement to acknowledge some economic improvement, while the head of the Bank of Japan has led the market on a goose chase in recent weeks. The Federal Reserve has the clearest path, as the debate is mostly centered on whether we have two or three (or four?) hikes this year. We are in the "two hike" camp, and think that hikes beyond that will only happen in a positive climate of good economic growth, steady inflation and a willing market.

AS GOOD AS IT GETS?
Global earnings revisions reach heights last seen in 2009 and 2010.



Source: Northern Trust Investment Strategy, Bank of America Merrill Lynch. Data through 2/28/2018.

Conclusion

This month's investment strategy meetings were dominated by discussion on the evolving U.S. regulatory environment and the start of the Powell era at the Federal Reserve. February's market correction has been healing as inflationary data has remained quiescent and the February jobs report showed a deceleration in the pace of wage gains. Very strong overall job gains and an increase in the workforce were additional positives. During the last 14 months, we have been at a maximum risk position in our global tactical asset allocation model. During this time, global equities have returned roughly 30% and interest rates have moved up to the top end of our expected ranges. The bullish fundamental data, along with strong market performance, has led us to start asking whether investor expectations have finally caught up with reality. With U.S. tax cuts not hitting company earnings yet, we still see some room to run in the risk-taking trade.

We have, however, moved off our maximum risk position this month with a recommended 2% reduction to U.S. equities – with the proceeds going into investment grade fixed income. The primary catalyst was the worsened regulatory outlook in the wake of the steel and aluminum tariffs. The trade outlook is too unpredictable to make any major bets on at this point – and the next signpost we will be assessing is Gary Cohn's replacement as the Director of the National Economic Council. This uncertainty is represented in our "trade repercussions" risk case, and is especially worth watching at a time when Chinese growth data may be moderating.

Our second risk case considers the potential for premature monetary policy tightening by either the Fed or the ECB. We have a new Fed chair who will be leading the assessment of the risks going forward – and our concern centers on the potential of excessive rate hikes in a stable inflationary environment. Similarly, the ECB should recognize that the European Union's economic recovery is years behind the United States', and its inflation picture is more challenged. Our base case is that both central banks will "get it right," and won't tighten policy beyond what the markets are discounting. That should continue to support a positive risk-taking environment.

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ViewPoints reflects data as of 03/13/18.