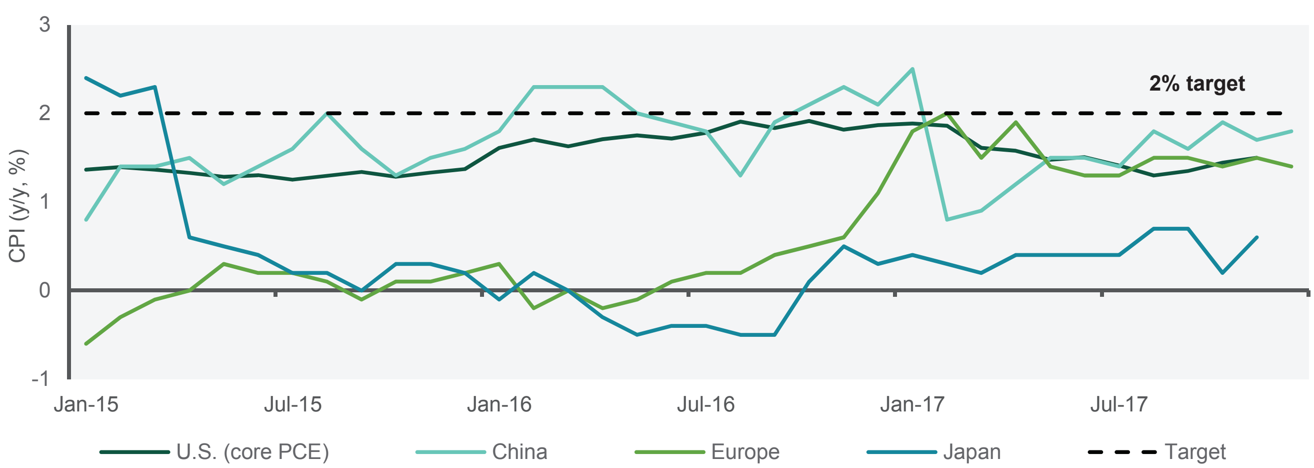
REPERCUSSIONS

Markets have kicked off the New Year with continued momentum, supported by improving global growth and stimulative tax reform in the United States. Our strategy discussions this month focused on the components of this stronger growth outlook and the repercussions for inflation and interest rates. Global growth has been steadily accelerating since the fourth quarter of 2015, coincident with a pickup in Chinese growth. Growth across Europe has improved at the same time, supported by both improving exports and domestic consumption. While U.S. growth has seen its strongest acceleration over the last six months, business sentiment started improving in the fourth quarter of 2016. The recent tax bill, reducing the stated corporate tax rate from 35% to 21% (the current effective tax rate is closer to 27%), has added some fuel to the fire.

So will one result of this pickup in activity be a jump in inflation? While we do think the odds of a cyclical increase in inflation have risen, we don't see a secular upturn ahead. Management focus on profit margins has remained vigilant, and we don't expect that to change in the wake of a lower tax burden. Some high profile companies have announced one-off employee bonuses, and in some instances wage increases. For example, Wal-Mart has announced a bump in its hourly associate starting wage from $10 an hour to $11 an hour, which we estimate will approximate 15% of their tax savings. We would expect the company to further invest some of the tax savings, but the ongoing focus on margins is also apparent in its nearly simultaneous announcement of the closing of 63 Sam's Club locations. All in all, we've only included 2/3 of the expected benefit of lower corporate taxes in our U.S. equity earnings estimates, leaving room for some reinvestment of the savings by management teams.

The acceleration in global growth has renewed forecasts of higher inflation, leading to some concerns over faster central bank normalization. We think it is more important to forecast the climate (under which conditions will the central banks raise rates?) than it is the weather (does the Fed hike one, two or three times in 2018?). If the Fed ends up raising rates three times, we think it will be because they *can raise rates* as market conditions permit it. If the Fed ends up raising rates three time because it *has to raise rates* due to surprising inflation, it risks upsetting the positive risk taking environment. Our view is that the most likely outcome is the Fed only raising rates at a pace the market is expecting, avoiding an inversion of the yield curve and the resulting market uncertainty.

AN ELUSIVE TARGET – AT LEAST SO FAR
Only rapidly growing China is close to a 2% inflation rate.



Source: Northern Trust Investment Strategy, Bloomberg. All regions measured by headline CPI unless otherwise noted. Data through Nov. 2017.

Conclusion

The continuing strength of the markets has renewed questions about the validity and sustainability of the rally. We come down on the "valid and sustainable" side of the debate. Last month we highlighted improving investor optimism, and that has further increased over the last month. While investor optimism can be a contrary indicator, we don't see signs of worrying enthusiasm. As we discussed earlier in the report, the real debate has moved from whether we can see better growth in the economy to what repercussions the stronger growth will have on inflation and interest rates. While we think there is some greater chance of a cyclical uptick in inflationary measures, we don't see inflation becoming "unmoored" and derailing the expansion. In fact, we see companies continuing to focus on productivity and margin improvement, including investing some of their tax savings into these endeavors.

We think the current environment of accelerating growth and stable inflation is very supportive of risk taking. This month we have added our tactical asset allocation policy model to the end of the report. We have always discussed individual changes here, and thought it would be helpful to include the full recommended model as well. This shows our significant recommended overweight to equities (+11 percentage points), funded by the underweight to investment grade bonds. We made no changes to these recommendations this month; performance has been good and our fundamental outlook remains constructive.

If we are wrong in our positive outlook, we think the catalyst is likely to come from either central bank pressure or Chinese economic weakness. Major central banks are in uncharted territory in reducing their post-financial crisis accommodation, and are puzzled by the low inflation being experienced so late in the expansion. In addition, we have new policy makers taking their seats in 2018 and 2019, adding to the uncertainty. The Federal Reserve and Bank of Japan heads' terms end early in 2018, and we will have a new head of the ECB in late 2019. The risk around Chinese economic growth is a macro concern, reflecting the importance of the Chinese recovery that started in 2015 and the completion of the Party Congress in October of 2017. Some slowdown from what was likely a policy-induced acceleration heading into the Party Congress could help cap global inflationary risks, but a greater slowdown might again raise concerns about global growth and Chinese debt levels. While Chinese growth data has gotten a little choppier in recent months, it hasn't yet become a near-term concern. As always, we will be debating these issues every month and adjusting our recommendations as our expectations about the outlook evolve.

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.

ViewPoints reflects data as of 01/19/18.

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