Northwest Bank & Trust Company
Investment Management Group

VIEWPOINTS July 2018

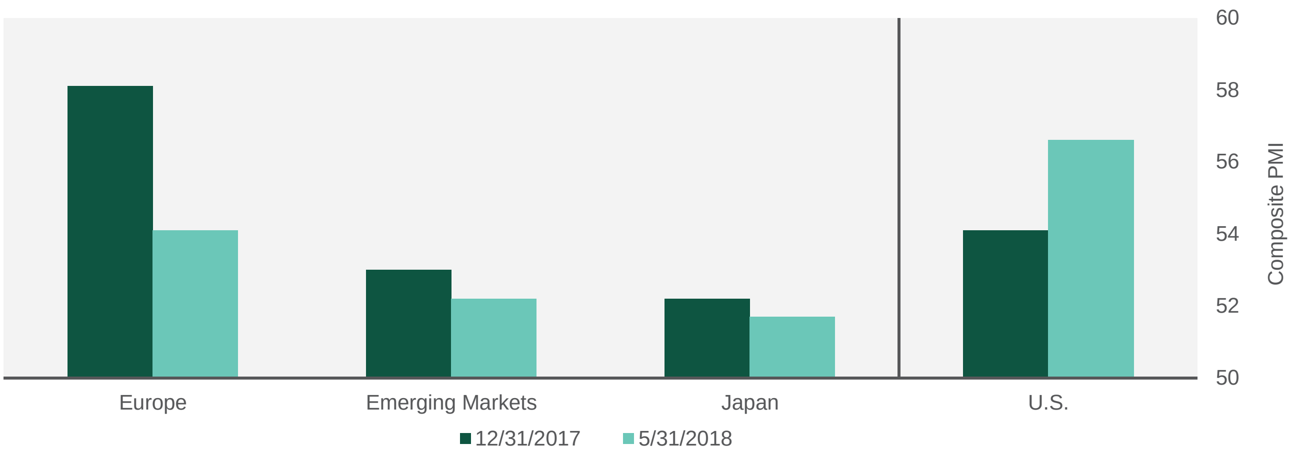
SHIFTING MOMENTUM

Momentum has shifted across the major developed economies, both economically and politically. As shown below, Europe entered 2018 with the strongest composite growth outlook, while the other major economies remained in a solid growth position. Momentum now has shifted to the United States for several reasons. An improved business climate, supported by significant tax cuts, has boosted sentiment. In addition, the euro's strength through the first quarter is a headwind to European exports. Temporary factors, such as poor weather, also may have hurt Europe. So some momentum may return as the year progresses.

In the meantime, historical political alliances continue to be challenged by both external and internal forces. President Donald Trump's focus on renegotiating existing trade and political agreements has disrupted the post-World War II order. The continued pressure of populist politics is also leading to new governing alliances in countries like Italy and Germany – challenging the historic support for key tenets of the European Union. In the United States, the mid-term elections have historically heralded a swing in power away from the incumbent party. This year, the swing may be insufficient to alter control of the House of Representatives. But even a change in control of the House would be unlikely to materially change the policy outlook because government would be divided. The result is relative stability in domestic policy within the United States – a redux of our old theme of "Political Volatility, Policy Stability."

The shifting momentum in growth and more uncertain political picture across Europe and trade could restrain central bankers. Fixed income markets have been buffeted recently by developments in Italy, where the new coalition government has taken a more aggressive stance toward the European Union. We have also heard from several Federal Reserve governors who have noted the relative flatness in the yield curve and their lack of desire to risk inverting the yield curve through excessive rate hikes. We don't expect an inflationary jump to force their hands. The Fed has communicated that it is willing to let inflation run above its 2% target because it was lower for so long. While we are hearing about cost pressures from company managements, our belief is that any inflation that makes its way through to consumer prices will likely be a shorter-term cyclical phenomenon vs. a secular move. In that situation, central bankers are likely to stay accommodative longer than the market believes.

GLOBAL MOMENTUM SHIFTING TOWARD THE UNITED STATES
Europe has lost the most relative momentum, but growth remains at a solid level.



Source: Northern Trust Global Asset Allocation, Bloomberg.

Conclusion

At this month's investment strategy meetings, we spent considerable time discussing the changing global growth outlook, including the potential impact of further actions on trade policy. The outlook for trade is particularly unclear because the United States has thrown up for discussion trade practices with most of the world's major economies. In addition, the U.S. administration has indicated a preference for bilateral negotiations, which could delay resolution. We think the U.S. economy and markets will keep pace globally in an environment where trade is positively resolved, but also should be a relative safe haven should we have a serious deterioration. With the economic outlook slowing in developed markets outside the United States, and the political picture becoming incrementally less clear, we have recommended moving 4% out of developed ex-U.S. equities and splitting the proceeds between U.S. equities and high yield. Overall, this somewhat moderated our risk position – but still leaves us positioned for equity markets outpacing bonds over the next year.

Some observers might question the merit of U.S. equities at this time, because technology stocks have been such a major driver of returns (contributing roughly 50% of the advance over the last two years). As we discuss in the equity section, technology stocks aren't overpriced and therefore we don't think they represent an existential risk to the outlook. We find the outlook for high yield attractive, as yields have risen to around 6.3%, and the default rate is set to fall alongside issuance. These factors combine to support our 7% to 8% return forecast over the next year.

While our risk cases haven't changed this month, the context and probabilities have. The risk of a central bank mistake has probably receded a bit, as several Fed governors indicated an aversion to inverting the yield curve through further rate hikes. This is top of mind as the current spread between 10-year and two-year Treasuries is a mere 0.44%. We haven't seen much progress on the trade front, beyond a potential deal to save Chinese communications company ZTE, which could engender some goodwill from the Chinese. This outcome isn't clear yet, though. Congress may decide to weigh in on the settlement, and the threat of U.S.-imposed tariffs could scuttle any offers from the Chinese. Our base case scenarios expect the central banks to avoid tightening too quickly, and we expect the trade rhetoric to stay escalated but not evolve into a trade war. While we are still positioned for positive stock market returns over the next year, we have moderated our risk levels somewhat this quarter as the risk of trade problems and slowing growth have taken away some of the market tailwinds.

ViewPoints reflects data as of 06/12/18.