MODERATION

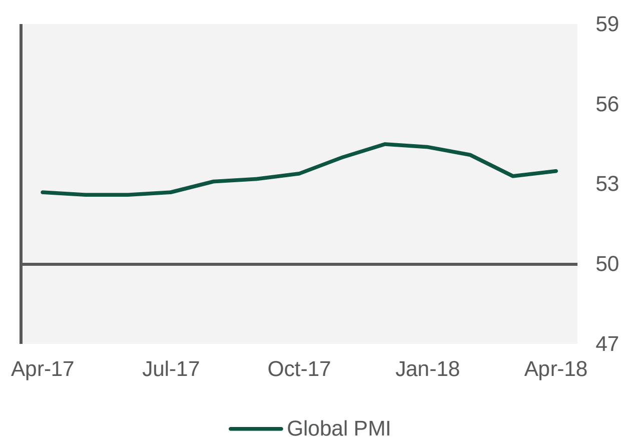
The much beloved “synchronous global expansion” has come under some scrutiny as activity measures have moderated across both developed and emerging economies. We have returned to the old debate over “hard” statistics, such as revenue and earnings, and “soft” statistics, such as purchasing manager indexes (as shown in chart below) and business sentiment surveys. Mario Draghi, head of the European Central Bank (ECB), even cited weather as a contributing factor to Europe’s recent slowing. We expect the global expansion to continue through next year, but think the pace of growth will be modestly disappointing compared to forecasts. We aren’t calling a significant slowdown, but opining that growth isn’t going to meaningfully break out of the “channel” it has been in for the last several years. We think the most direct impact of this will be contained interest rates, and recent inflation readings support the view that central banks are not behind the curve in reacting to the inflation outlook.

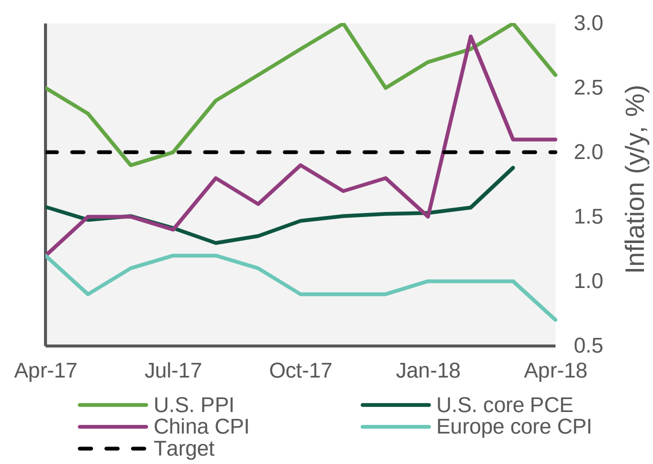
In fact, recent measures of inflation have shown some moderation (see chart, right panel). From Chinese producer prices to European core consumer inflation, current readings show a deceleration in price increases. We don’t view these retreats as a sign of weakening demand as much as a barometer of how limited corporate pricing power is. First-quarter earnings reports have mentioned higher input costs, including in commodities and transportation, but limited ability to fully pass these through to consumers. Strong revenue growth and the resulting operating leverage are helping companies offset these cost pressures. In addition, labor costs are a much larger percentage of expenses at most companies – and recent reports show a continued moderate pace of yearly wage increases.

Our belief that growth and inflation are moderating helps drive our view that the Federal Reserve will raise interest rates less than market expectations. This will cap what other central banks can subsequently accomplish. We are also in the midst of several significant geopolitical issues – from the Iran nuclear deal, to a potential deal between the Koreas and the ongoing trade tensions between (primarily) the United States and China. These increasing tensions typically favor the U.S. dollar, and may be behind the greenback’s recent strength and resulting emerging market weakness. We don’t expect this to be sustained because the Fed is well along its rate cycle and the geopolitical risks are more likely to recede than not.

BACKING OFF

Growth and inflation trends have moderated after a period of strength.





Source: Northern Trust Global Asset Allocation, Bloomberg. Data from 4/30/2017 to 4/30/2018. Core PCE data is released on one-month lag and goes through 3/31/2018.

Conclusion

The outlook for growth dominated much of this month's investment strategy debate, along with political developments in Europe and the United States. We do expect some moderation in growth expectations when looking ahead to 2019, as U.S. growth falls back into its moderate growth channel and Chinese growth continues to moderate from high levels. The softness in first-quarter European data may be tied to temporary factors, but will also be limited going forward by any slowdown in Chinese import demand. On the political front, the U.S. mid-terms are increasingly coming into the discussion, but we think a light legislative slate is the likely outcome no matter how the elections unfold. In Europe, the fracturing of the traditional political parties is making progress tougher, but this remains a chronic problem as opposed to a crisis.

The primary conclusion from our more muted 2019 growth outlook is that upward interest rate risk has been reduced. As such, we made one change in our tactical asset allocation recommendations this month – reallocating 2% from cash to investment grade bonds to take advantage of the available yield pickup and potential capital gain. We maintained our overweight to equities overall because corporate profitability is expected to continue growing, increasing share buybacks will support stocks and interest rates should not be a headwind.

Strong earnings growth over the last three years – alongside the market consolidation witnessed over the past few months – has reduced equity valuations to reasonable levels, especially outside the United States.

As we mentioned earlier, our base case outlook includes growth returning to its longer-term channel – not breaking out to the upside but also not at risk of a downside slip during the next year either. We also expect central banks to get it right when it comes to policy moves over the next year. This includes the Fed raising rates less than it would like, and the ECB and BOJ continuing with their very accommodative stances. Of course, there is some risk that the Fed will continue to raise rates despite the low level of 10-year yields, risking an inversion of the yield curve. But we don't expect this to happen. Our other main risk case remains around the potential for a trade war between the United States and China. The more concrete trade issues – around deficits and tariffs – will be easier to solve than the tougher issues around the protection of intellectual property. As such, we expect the trade issue to linger over the next year with fits and starts of progress.