DIAGNOSIS

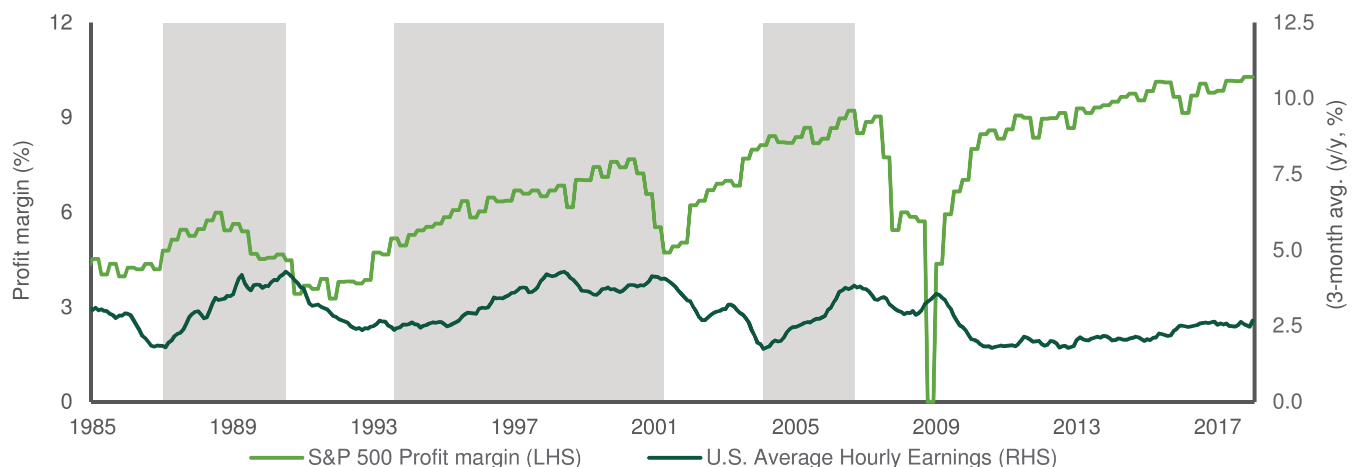
Last month we wrote about the potential repercussions from stronger growth. The January U.S. payroll report, issued February 2, raised concerns on this front as wages jumped 2.9% for the month. The prior two months also were revised upward. This was an apparent catalyst for the ensuing selloff in global equities – but is this a complete diagnosis? While we agree that the hotter wage increases are something to watch, we don't think this is the sign of an upward march in inflation. Neither, apparently, do the fixed income markets: the breakeven rate of inflation embedded in the 10-year Treasury Inflation Protected Securities (TIPS) has actually fallen from 2.14% on February 2 to 2.07% today. What may be playing a bigger role in the selloff are the quantitative investment funds whose trading is significantly driven by market activity. Analyst reports indicate a significant pickup in selling among commodity trading advisor (CTA) strategies, volatility targeting and risk parity strategies as a major contributor to the downturn. CTA performance has sharply reversed this year and the trend-following nature of many of these funds has driven significant selling.

Are we seeing other signs in the market, beyond equity index prices, that raise concerns about the fundamental outlook? Broadly speaking, the carnage has been limited to stocks. U.S. investment grade credit spreads are virtually unchanged, and the 0.5% increase in high yield spreads can be explained by the 10% drop in Brent crude oil prices. Currency markets haven't been too volatile; the U.S. dollar has rallied just 1% and emerging market currencies are down 1.5%. European sovereign bond markets have remained steady, with the Italian, Spanish and Portuguese bond spreads having increased just 0.04% to 0.07% this month. Finally, gold prices have actually fallen 2.5% this month, tied to dollar strength and an absence of safe-haven buyers.

So when will the selling pressure abate? While we don't know how much more selling may come out of the quantitative funds, we continue to receive positive fundamental data and expect this to lead the markets higher over the next 12 months. Corporate performance remains strong, with current quarter earnings reports showing revenue up 7% to 9% and earnings growth of 12% to 15% across the major developed markets. We expect U.S. growth will be bolstered by the new tax plan and increased government spending, with some offset from the recent tightening of financial conditions. As shown below, markets have handled the repercussion of rising wages in the past – because they have generally occurred alongside rising profit margins.

RISING WAGES … AND PROFITS

The last three periods of rising wages have coincided with rising corporate profit margins



Source: Northern Trust Investment Strategy, Evercore ISI. Data through 1/31/2018. Shaded areas represent rising wage periods.

Conclusion

This month's investment strategy discussions took place in the middle of the market downturn, allowing us to assess these developments real-time as we reviewed our strategy. Our conclusion is that a lot more has changed in the financial markets than in the real economy. The sell-off has improved valuations across the equity markets, but we are mindful that episodes such as this can take some time to stabilize as investors recalibrate their expectations and markets find new equilibrium levels. This is more challenging to assess in an environment where increasing amounts of money are being managed on a quantitative basis driven by market prices. Our focus on "repercussions" last month remains front and center, and the outlook for interest rates is central to the outlook for stocks over the next year. Many investors will focus simply on the reported wage gains in the payroll report, but we think it is important to understand the environment within which the wage gains are being realized.

Historically, wage inflation has had to reach 4% before it shows any statistical linkage to overall inflation. As long as rising wages are paired with productivity gains, corporate margins can expand and the markets can behave well. This cycle has the added twist – a new leader of the Federal Reserve, alongside numerous new governors. The markets will likely "test" the new leadership to try to learn how they will react. Our expectation is that the Fed will raise rates in March and then once more this year. More important than the number of hikes will be the climate in which they occur – it will be much better for the Fed to be "able" to raise rates when the market is expecting it, versus the Fed "having" to raise rates because inflation is taking hold. The latter scenario characterizes our first risk case of central banks making a mistake, in which the Fed tightens beyond what is warranted by inflationary trends. Our second risk case remains focused on Chinese economic growth, which has been slowing since last fall based on measures of private activity, such as electricity usage and bank loans.

The causes of rapid sell-offs like we have experienced this month can be tough to diagnose, and we will learn more about its roots in coming weeks. One of the repercussions of the selloff is a tightening of financial conditions (mostly due to falling stock prices) – which does some of the Fed's work for it. Fed members may be satisfied to see some easing in financial asset valuations, while the yield curve has retained its new found steepness. This facilitates future rate hikes, and also demonstrates the market's constructive view about economic growth. We've gone from concerns about an inverted yield curve two months ago to concerns about rising rates. I'll take the renewed steepness in today's yield curve over the flatness of yesteryear. We made no changes in asset allocation policy – and continue to expect global equities to outperform over the next 12 months.

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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