RELATIVE STABILITY

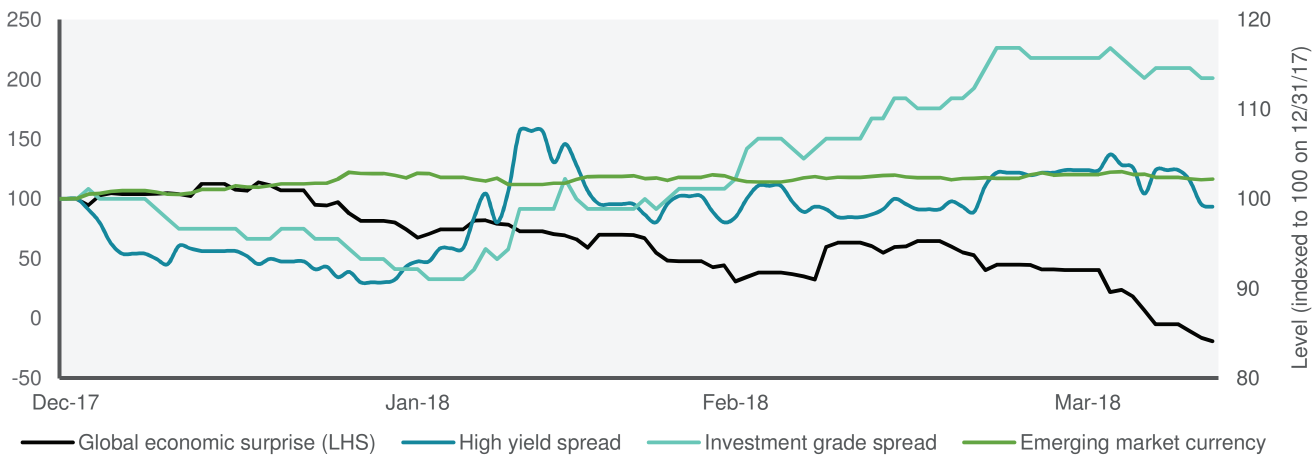
There are no shortages of likely suspects for the increase in market volatility this year, and also reason to believe that the impact of fundamental changes are exaggerated by increased computerized trading. Our task, as always, is to determine what is noise and what is true fundamental change. The concern over a growth slowdown has yet to generate worrying signs in the markets. As shown below, despite recent economic reports falling short of expectations, credit spreads and emerging market currencies are showing relative stability. While investment-grade spreads have increased somewhat this year, tied to stock market volatility, they are still low and below the levels of a year ago. We are in the dodgy first quarter, where seasonal adjustment issues tend to skew economic reports downward. Surveys of companies doing business across the United States and Europe continue to reach new highs. Emerging market economic activity also has remained relatively steady compared with expectations.

Last month's key focus was the ramp-up in tough trade rhetoric from the U.S. administration, which elicited retaliatory proposals from China. So far, the only policies that actually have been implemented are the steel and aluminum tariffs, from which notable countries were excluded. We have been concerned by President Donald Trump's conviction on the issue about the probability of further tariffs targeted at China. Of late, the sentiment toward trade seems to have moderated some, and news reports are now suggesting that President Trump may even reconsider the Trans-Pacific Partnership (TPP) trade pact. Moderation of the rhetoric with China, completion of the North American Free Trade Agreement (NAFTA) and discussions around entering the TPP would be a welcome tonic for market sentiment.

Inflation measures in the United States have finally started to creep up, as expected, as low prices from a year ago have fallen out of the measure. Some inflationary pressures may be building as companies seek to raise prices, but it seems to be mostly a U.S. affair. Core inflation in Europe is stuck at 1.0%, and fell short of expectations last month, while core inflation in Japan is just 0.3%. The largest changes are happening in China, where consumer price inflation dropped from 2.9% to 2.1% last month. Financial markets aren't pricing in a significant upshift in inflation (appropriately in our view), helping act as a limit on how fast the major central banks move to normalize policy. We expect one or two Federal Reserve rate hikes over the next year, below market expectations, as inflation remains contained and yield curve inversion concerns persist.

MARKET MEASURES OF RISK REMAIN STABLE

While economic surprises have turned negative, they haven't overly contaminated credit or emerging markets.



Source: Northern Trust Global Asset Allocation, Bloomberg. Data through 4/11/2018.

Conclusion

Much of this month's investment strategy debate focused on the global growth outlook in the wake of some wobbling in the data and tensions around trade between the United States and China. Relying on our theme of Entrenched Growth has paid dividends in recent years during similar periods – allowing us to stand firm during the inevitable periods of softer data. While each quarter that passes brings us closer to the eventual end of the expansion, we aren't seeing signs yet that would lead us to conclude that a recession is on the horizon. In addition to feedback from companies about their level of business activity, financial market indicators aren't showing much stress. While we have seen a modest increase in investment grade credit spreads this year, they are still down from a year ago, and the behavior of the high yield market is further confirmation of investor confidence in the economic outlook.

We are entering the reporting period for first-quarter earnings, which should be strong globally. Consensus earnings expectations (which are usually high by 5 percentage points or so) call for earnings growth of nearly 19% in the United States this year, 15% in emerging markets and 9% in Europe. Importantly, expectations have been rising over the last several months in all regions except Europe, which is likely being held back by euro strength. Strong earnings growth in recent years has ameliorated some concerns about elevated valuations. U.S. equities are trading at 16.8 times forward earnings, compared to a historic median of 15.2 times. Developed markets ex-U.S. are trading at 13.8 times, in line with the historic median of 13.9, while emerging markets are trading at 11.9 times earnings, as compared with the historic median of 10.8 times. These are not heroic valuation levels, especially in an environment where we expect interest rates to remain contained.

As such, we remain overweight equities and underweight bonds – with the underweight to bonds being driven by a lower return potential as opposed to concerns about rising rates. Our primary risk cases are unchanged from last month – the potential for a central bank mistake and the risk of a trade war. We have two meetings of the Federal Reserve over the next two months, so we will have plenty of new information to help us gauge its likely path forward. We will also likely see much discussion on the trade front, from tariffs to NAFTA to the potential discussions of the United States rejoining the TPP agreement. With the increased volatility experienced so far this year, these risks are increasingly being assessed and priced in by investors. As always, we will look forward to updating you on our thoughts in coming 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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