NEUTRAL AND BEYOND

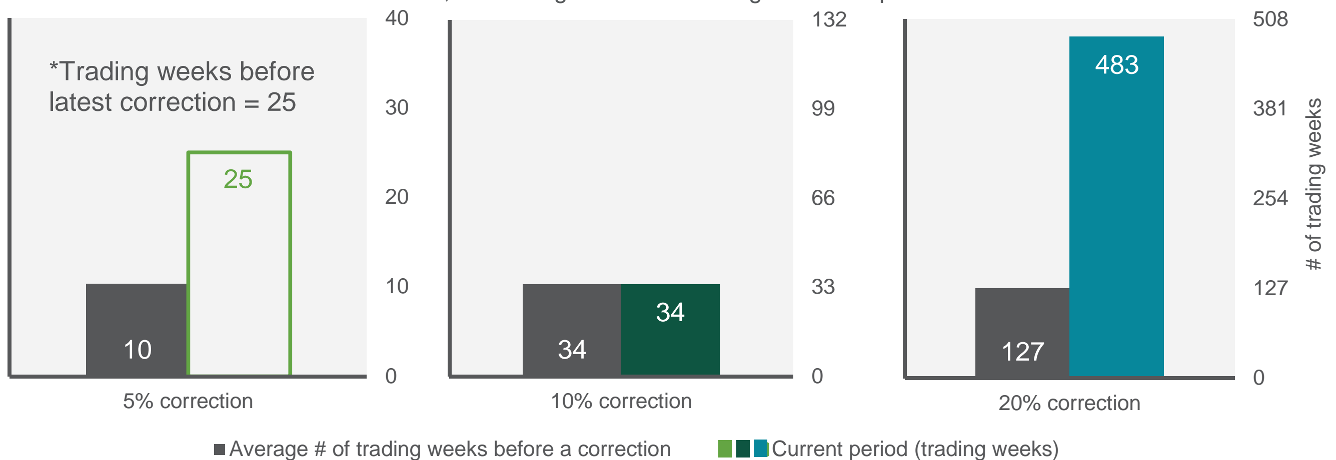
Central bank policy is usually a fixation of markets, rarely more so than during a tightening cycle. Recent commentary from Federal Reserve Chair Jerome Powell, along with that of regional bank presidents, has increased market volatility as investors worry that the Fed may go too far. As shown below, the recent 5% drop in equity prices was overdue and is therefore not unusual. Is the Fed's move the primary cause of the market volatility, as President Trump has suggested, or are other worries driving investor behavior? Diagnosing specific catalysts behind individual corrections is challenging, and made more difficult by the increased trading done by rules-based investors. In our strategy meetings this month we highlighted two material changes that we think will drive markets over the next year.

The first change is that we now believe U.S. monetary policy will be restrictive in one year. Recent Fed commentary indicates that it thinks something on the order of an additional 125 basis points of tightening is in order, due to the strength of the economy. Fed funds futures currently incorporate roughly 75 basis points of this over the next 18 months, indicating some skepticism about the Fed's ability to raise rates to this extent. If our expectation for slowing growth through 2019 comes to pass, that may help bring the Fed's plans closer to market expectations. But the current rhetoric indicates a strong preference to continue the rate hikes, which we think will be harmful to growth and investor risk appetites – especially in emerging market economies. Other major central banks are sticking to their scripts, and the European Central Bank remains on track to end its asset purchase program this year but not raise rates until later in 2019.

The second change is our downgrade of emerging market political leadership from strengthening to weakening. China remains the epicenter of emerging markets, and the government is easing policy to support domestic growth. Recent policy changes such as cutting bank reserve requirements and income taxes will provide some offset to slowing growth. The Chinese government finds itself in a tougher place as a lonely voice for globalization at a time where countries are becoming more wary of the terms of trade – be it through the One Belt, One Road initiative or taking advantage of multilateral trade agreements. In the wake of this, China may need to recalibrate its approach to global affairs as it faces more resistance from the United States and possibly other countries over time.

A 5% CORRECTION WAS LONG OVERDUE

We went 25 weeks without a 5% correction, much longer than the average 10-week period.



Source: Northern Trust Global Asset Allocation, Bloomberg. Time between correction data from Ned Davis Research and S&P 500. Data through 10/11/2018. Past performance does not guarantee future results.

Conclusion

As the Fed looks to move its policy toward neutral and beyond, we've also moved the overall risk level of our tactical asset allocation recommendations to neutral. This month, we lowered our recommended equity exposure by 3%, reducing U.S. equities by 2% and adopting a neutral position, while further reducing our emerging markets exposure to a 3% underweight. We've added the proceeds to investment grade bonds, reflecting our preference for corporate credit over equities and also our view that interest rates are unlikely to move materially higher from here. It is important to look at our recommendations from an overall portfolio perspective. While our high yield overweight is considerable, we view it as a risk asset, and it is the least risky of the risk assets. We think both the fundamental and technical picture for high yield looks attractive, including the current yield-to-worst of 6.5%.

In our base case scenario of a Slowdown to Channel Growth, we think corporate credit should perform well. In the recent uptick in market volatility, investment grade credit spreads have not budged and the spreads on high yield bonds are not showing signs of credit stress. In fact, our fixed income desk sees multiple buyers in the market today for every seller of a high yield bond. Our base case scenario of Rising Monetary Policy Disconnect highlights the contrast between the Fed's plans and the market's views on growth and financial market risks – which is putting some pressure on risk assets.

We think the upcoming U.S. midterm elections will garner a lot more attention in the media than in the financial markets. The Trump administration's signature initiatives (tax cuts and regulatory relief) have been done primarily outside of the traditional legislative process. Additionally, investors aren't expecting any significant legislation out of Congress, so a change in control within Congress in the midterms is unlikely to lead to much of a change in the economic or financial markets outlook. Instead, investors will be better rewarded by paying attention to our risk cases of Emerging Market Contagion and Central Bank Tunnel Vision. The near-term risks for emerging markets have increased in the wake of populist politics, and are complicated by the state of U.S.-China relations. Central Bank Tunnel Vision could lead to unwarranted interest rate hikes, which will bite into growth and financial markets. An uptick in the growth outlook for 2019 and beyond would be just the antidote to this risk case.

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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