REPERCUSSIONS

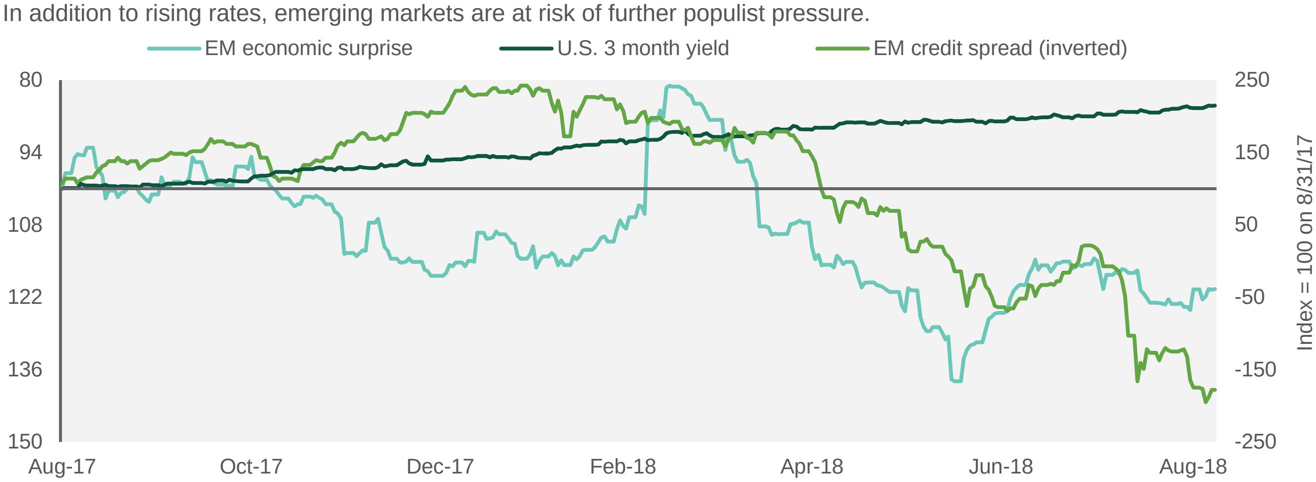
Higher U.S. interest rates, populist politics and trade concerns have been a significant headwind for emerging market assets this year. Populism's impact extends beyond the direct policies of individual emerging market economies, encompassing countries such as the United States that traditionally have been reliable counterweights to emerging market stresses. We think comparisons of the current environment to the emerging markets crisis of 1998 are overstated. Major emerging economies are much stronger today. However, populist politics has made the "backstop" from entities such as the International Monetary Fund much less certain. European politics are increasingly in the spotlight, with the new Italian government's budget plans under scrutiny, Brexit negotiations in full swing, and the European Parliament elections coming in May 2019. The appetite for bailing out foreign countries will not be high in coming years.

The impact of trade worries can be seen through the market performance of those economies most dependent on trade. In China, companies with the highest percentage of foreign revenues have lagged by 12 percentage points since February. European equities rely on emerging markets for roughly 25% of public company revenues. Meanwhile, the U.S. stock market has been a clear outperformer. The U.S. economy relies mostly on domestic consumption and U.S. businesses have benefitted from rising productivity and improved business confidence. We do continue to expect, however, that the current pace of growth is likely the high water mark and growth will slow globally in 2019.

We have been citing Rising Monetary Policy Dissent as our base case scenario in recent months. We think members of the Federal Reserve will increasingly express divergent opinions. In addition, we expect the Fed's intended rate path to increasingly conflict with market expectations. Our new risk case of Central Bank Tunnel Vision captures our view that the Fed may fail to account for how much its policy tightening is already pressuring financial markets as it continues to raise rates amid solid domestic growth. Recent comments from the president of the New York Fed, indicating a willingness to invert the yield curve, are not reassuring on this front. All in all, the outlook for risk taking has moderated as the year has progressed and we have increasingly focused on lower-risk risk assets such as U.S. equities and high yield bonds.

RISING PRESSURES

In addition to rising rates, emerging markets are at risk of further populist pressure.



Source: Northern Trust Global Asset Allocation, Bloomberg, Citi. Data from 8/31/2017 to 9/7/2018.

Conclusion

In response to rising concerns over emerging market contagion risk, we reduced risk in our global tactical asset allocation model this month by cutting emerging market equities by 3%, moving to an underweight position. Reflecting our view that corporate credit looks attractive and interest rates are expected to remain range bound, we allocated 2% of these proceeds to U.S. investment grade bonds and the remainder to U.S. high yield (further increasing our overweight position). This follows several recommendations earlier in the year that have collectively reduced our overall risk position by moving to a neutral position in global equities. We also have our risk asset allocation tilted toward lower risk assets (U.S. equities and high yield) that we feel will have upside participation in a good market but offer some defensive characteristics in a more difficult trading environment.

As discussed in the Equity section, emerging market equities haven't tended to bounce back quickly after a sell-off similar in magnitude to this year's. While our emerging market position has hurt tactical investment performance this year, it has been more than offset by our overweight to U.S. equities and underweight to fixed income. We have also avoided the sell-off in emerging market bonds, as our allocation to global high yield has been fulfilled by U.S. high yield bonds. While improving economic data from China will be a necessary ingredient for better emerging market performance, it likely won't be sufficient. If the Federal Reserve continues unabated in its rate hike campaign, we would expect continued U.S. dollar strength, increased economic uncertainty and pressure on emerging market assets. In addition, near-term resolution to the trade imbroglio between the United States and China seems unlikely, since President Trump is now talking about a third round of tariffs (notably, before the second round is even implemented).

Our base case scenario envisions the Fed eventually responding to market stresses by indicating a pause to its rate hike cycle. Admittedly, this is far from certain; there is plenty of evidence that the Fed may be afflicted with "tunnel vision" and will march studiously ahead. President Bill Clinton's advisor James Carville famously opined that he wanted to be reincarnated as the bond market – because it could intimidate anyone. We may be facing a similar but less obvious situation today. In our current environment, it would be a flattening yield curve (indicating concerns over growth) that should intimidate the Fed. There are competing camps within the Fed over whether this should be viewed as an ominous signal, or whether "it is different this time." We recommend they not take the chance that this time is different.

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.

ViewPoints reflects data as of 09/12/18.