IMPROVING VALUATIONS

Geopolitical developments, from trade policy to economic sanctions, have become key market drivers in recent months. While markets have been unsure about how far trade relations may deteriorate, differentiation is being made between those industries most and least dependent on trade. In addition, tensions have eased somewhat in negotiations over the North American Free Trade Agreement (NAFTA) and between the United States and the European Union, reducing the risk of negative economic fallout between these players.

Tensions between the United States and China, however, remain high and are our central risk case. We expect bilateral actions to continue over the near term, with China matching U.S. actions with reciprocal tariffs. In addition, investment between the two countries will likely face higher hurdles – the recent rejection by China of the merger between U.S. and Dutch semiconductor companies demonstrates the reach of this issue. We expect the extraordinarily high economic interdependence between the United States and China to govern how far eventual trade restrictions will run.

Meanwhile, global economic growth marched ahead in the second quarter, with the United States standing out. Revenue growth for S&P 500 companies has exceeded 10% in the second quarter, with earnings growth of 26%.

We do believe we are at a high water mark for economic growth, with the U.S. fiscal stimulus set to fade in 2019. This should bring growth in the major economies back toward the slower "channel" that we have been experiencing over the last several years. As a result, we expect earnings growth in 2019 to slow to 8% in the United States, 7% across the emerging markets, and 6% across developed markets outside the United States.

The combination of good earnings growth and increased volatility in pockets of the markets has led to improving valuations. As shown below, valuations are less extended than some believe, and are close to median levels outside the United States. They also have improved in all regions since the start of the year – due to robust earnings in the United States and falling share prices in emerging markets. In the United States, for example, valuations have fallen from 19 times forward earnings at the start of the year to 17 times today.

In the fixed income markets, the combination of rising rates and some increase in credit spreads has created an attractive opportunity. With good corporate credit quality and a decrease in expected issuance over the second half of the year, we think the risk-adjusted return outlook for credit is particularly attractive.

LESS EXPENSIVE STOCKS

U.S. valuations have fallen due to strong earnings and emerging market valuations have been reduced by falling share prices.

Source: Northern Trust Global Asset Allocation, MSCI. Monthly data through 7/31/2018. Indices are MSCI US, MSCI Europe, MSCI Japan and MSCI Emerging Markets; U.S., Europe and Japan data begins in 1970, emerging market data begins in 1995. Normal Range: +/- 1 standard deviation from the median.

Conclusion

We've been very active in our tactical asset allocation recommendations this year, but this month's strategy meetings found us holding steady. This gives us the opportunity to review performance and some of the themes behind this year's moves. Overall, our overweight to risk assets (primarily U.S. equities and high yield) and underweight to fixed income has added value – more than offsetting the drag from our modest overweight to emerging market equities. Our primary moves this year have focused on reallocating from other developed markets back into the United States, adding exposure to fixed income (including investment grade and high yield bonds) and reducing our exposure to inflation-protected securities. These moves are consistent with a view of improving relative performance of the U.S. economy, greater attractiveness of U.S. fixed income after this year's rise in rates, and our conviction that "Stuckflation" will persist over our investment horizon.

Our increasing exposure to yield this year (through investment grade and high yield bonds) should provide some downside protection should growing geopolitical risk drive a sell-off. The picture on trade remains muddled. Negotiations on NAFTA have gone quiet and the newly elected Mexican president has sounded surprisingly pragmatic. Similarly, the threat of escalating tariffs between the United States and Europe seems to have receded after a successful trip to Washington by the president of the European Commission. Our risk case around trade, therefore, centers on the U.S./China relationship. We expect this risk to persist over our investment horizon; there appears to have been little progress to date and neither side is likely to back down. We believe that a full-blown trade war will be damaging to both sides, limiting how far this battle goes.

Our Stuckflation theme underpins our decision to increase exposure to fixed income (and to cut our exposure to inflation-protected securities), while also constraining how far the Federal Reserve will raise rates over the next year. The risk that central banks make a mistake by raising rates due to any cyclical rise in inflation remains front and center. The U.S. yield curve remains relatively flat – with the two-to-10-year curve below 30 basis points. Our base case calls for Rising Monetary Policy Dissent – reflecting both internal dissent at the Fed and dissent between Fed policy and the fixed income markets. At the end of the day, we believe the Fed will avoid making a big mistake, but this will make for interesting times over the next year.

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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