DOWNGRADING INFLATION

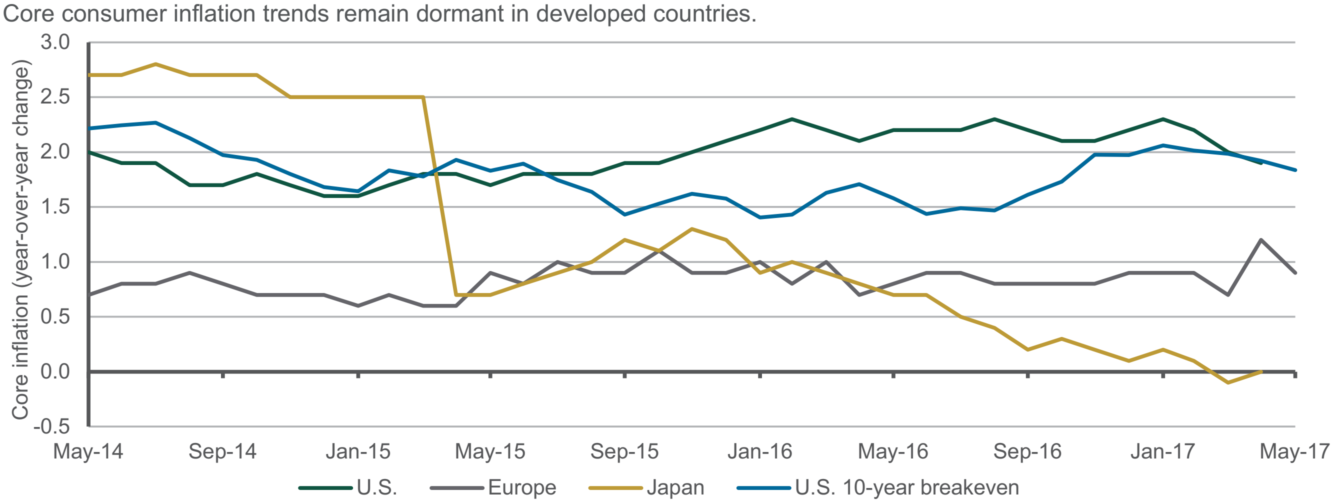
Last month we wrote about the increased political clarity in key countries, a development that has supported risk taking and has advanced further this month across Europe. With low volatility in the economic data, investor focus remains trained on these political developments as potential catalysts. Certainly, the 5% decline in the U.S. dollar this year – and 6% and 7% rallies in the yen and euro, respectively – looks to be influenced more by changing political fortunes than mundane drivers like interest-rate differentials. While the incumbent political powers in the United States and United Kingdom are struggling to advance their agendas, more positive progress is being made in France and Italy. French President Emmanuel Macron looks set to secure a majority in the French Parliament, while the populist National Front was handily defeated. In Italy, the populist Five Star party suffered numerous defeats in regional elections this past weekend, failing to even make the run-off elections in many. A fading populist movement strengthens the hands of pro-European Union politicians, reducing risk around the EU's stability.

While the developments in Europe are constructive, the impact political leaders have on the real economy can be exaggerated. Prime Minister Shinzo Abe's policies have had a much greater effect on the Japanese financial markets than on the real economy. Meanwhile, Barack Obama was caricatured as being anti-energy and anti-business, yet the fracking revolution and domestic oil and gas production greatly accelerated during his administration. Leading economic indicators are at new highs across many developed economies, and relatively stable in emerging economies with some recent moderation in China.

Forward-looking economic data continues to support markets. Some investors are concerned about the relatively flat yield curve, which historically has been a signal of economic slowdown. But we see plenty of other market signals confirming a more sanguine outlook, including the strong performance of corporate credit. We attribute the low level of long-term interest rates to a strong demand for yield and a more benign outlook for inflation. As shown below, core levels of consumer price inflation in the United States, Europe and Japan have all been very stable over the last year, leading to a reduced expectation for inflation over the next 10 years. We expect this to feed into a slow but steady approach from the Federal Reserve as it edges up short-term interest rates and looks to slowly shrink its balance sheet.

QUIESCENT INFLATION

Core consumer inflation trends remain dormant in developed countries.



Source: Northern Trust Investment Strategy, Bloomberg.

CONCLUSION

Our investment strategy meetings concluded this month with a reaffirmation of our positive view toward risk taking, albeit with some tactical shifts. Our constructive view toward global growth continues, as leading indicators remain healthy and earnings growth is rebounding strongly. We no longer view inflation as a risk case in the next year, as core consumer prices have remained sticky and we don't see an uptick in global wages without a commensurate increase in productivity. This should allow central banks to evolve their policy measures at their desired pace, and the markets should be sufficiently pre-conditioned – limiting the upside pressure on interest rates and supporting current risk asset valuations. We have also seen shifting political leadership trends in recent months, with diminished momentum in the United States and United Kingdom but increasing strength in the EU.

We've been unusually active in our tactical recommendations this year, making another change this month. Our view that inflationary risks have receded has led us to eliminate our recommended overweight to natural resource stocks. While they will still provide a strategic hedge against unexplained inflation, the overweight position is no longer justified with our more sanguine outlook on inflation over the next year. Since we remained comfortable with our overall risk positioning, we reallocated these funds to developed ex-U.S. equities. We expect these stocks to benefit from the continued global expansion, improving political leadership and relative underperformance over the last five years. Tactically, the relative weakness of the dollar this year has boosted returns in developed ex-U.S. equities.

As we look out over the next year, the two areas we think have the highest potential to upset our positive risk stance are tied to politics and monetary policy. Our first risk case is a Political Leadership Vacuum – where the U.S. administration's new approach to foreign relations raises the risks of misbehavior of global bad actors. The second risk case is a Monetary Policy Misstep – where the Fed and ECB need to adjust their asset-purchasing programs in a manner that doesn't unsettle markets that have been supported by ultra-easy monetary policy. As always, these are our identified risk cases – the items we have on our radar screens to monitor the risks to our tactical outlook. We think both of these risks are manageable at this point, and think solid fundamentals and only middling investor "animal spirits" will continue to support this bull market over the next year.

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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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ViewPoints reflects data as of 6/14/17.