MARKET STABILITY

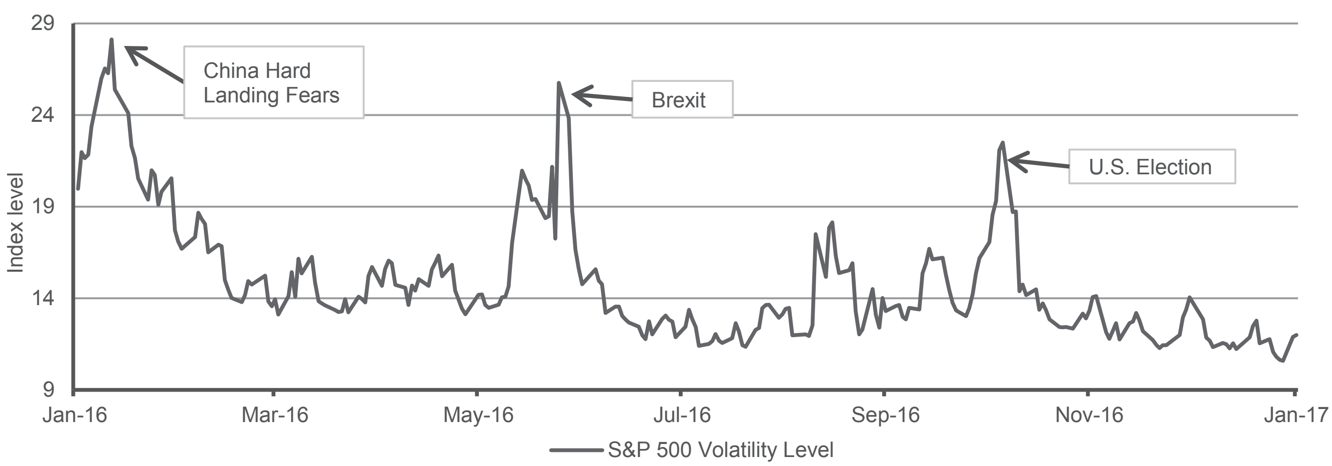
Last month we highlighted political engagement as a new dynamic in the U.S. economic outlook, and this month we discuss the market's reaction. So far this year, investors and traders are filtering out the political noise and focusing on the positive economic outlook. In 2016, we saw three big spikes in volatility – in the first quarter around concerns about a Chinese hard landing, in the second quarter tied to Brexit, and in the fourth quarter after the U.S. election. Most of the political focus has been on the new U.S. administration, where many campaign pledges have found their way into executive actions or communications. The markets have been relatively calm; investors expect the checks and balances inherent in the U.S. government to moderate eventual outcomes. The focus will increasingly turn to Europe, with national elections in France and Germany being front of mind. While we don't expect these elections to lead to a significant upturn in investor risk aversion, we will be closely monitoring the developments.

We expect global growth to show some acceleration in 2017, led by the United States. All the major regions started the New Year with solid levels of industrial activity, and dollar strength has contributed to improving export conditions in Europe and Asia. While there is some policy execution risk in the United States surrounding new tax policy and infrastructure spending, there is also a boost to animal spirits coming from the promise of deregulation across various industries. While we expect a positive surprise from U.S. growth, there are natural limits to how much it can accelerate. For example, current deficit levels and the advanced recovery in the labor markets will provide some cap on further improvement. We expect growth in developed Europe and Asia to also exceed expectations, supporting risk-taking globally.

We think that markets are increasingly turning their focus from monetary policy toward political engagement. The Trump administration will be able to fill at least three, and likely four, new Fed positions over the next year. We expect these appointees to take a more conservative approach to governance at the Fed, but don't expect the market to be surprised by the outcome. Investor focus will, instead, be better trained on the fundamental economic outlook along with potential legislative and regulatory changes. While our two risk cases (inflation and populist prioritization) are potential headwinds to risk taking, we judge their probabilities as low enough that they should not upend equity markets over the next year.

IT TAKES A LOT

Stock market volatility has been low outside of major events.



Source: Northern Trust, Bloomberg.

CONCLUSION

We upgraded our outlook for developed markets outside the United States last month, with a particular focus on the improving growth environment in Europe. This led to a concurrent increased allocation to developed ex-U.S. equities, funded by a reduction in investment grade bonds. With this change leading us to the top end of our recommended risk budget, and with no meaningful changes in our fundamental inputs last month, we made no asset allocation recommendation changes this month. We continue to expect the pro-growth policy outlook in the United States to push the U.S. growth channel higher, while having a positive spill-over into other economies.

While the political world generates lots of heat and distraction, the profit picture among public companies has been gradually improving. We expect the strongest growth in 2017 in the United States, followed by Europe and Japan, with emerging markets growth the slowest due to high levels of dilution. While we have some cushion in our return expectations for the potential of higher rates pressuring valuations, interest rates at current levels are clearly supportive. We judge a further rise in interest rates to be likely driven by both improving growth increasing inflation expectations. Provided inflation expectations remain constrained longer-term (our base case scenario), this should not prove detrimental to share prices.

The risk of anti-growth populist policies in the United States has risen, and joins an unexpected inflation spike as our key risk cases. While we think the overall economic risks tied to the new U.S. administration are relatively low, we do consider the negative economic impact that certain policy initiatives could generate. For example, new immigration policy could hurt growth, depending on its design, while the threats of tariffs to maintain U.S. manufacturing could impair corporate profitability. However, the risks of inflation and populist prioritization are just risk cases at this time.

We think investors need to focus particularly on tuning out the political noise over the next year, and stay overweight risk assets (U.S. equities, high yield bonds and natural resources). We would fund those overweights through an underweight to investment-grade bonds – not because we are overly negative on fixed income, but due to the low relative return opportunity. We actually see a small, but positive, total return potential for U.S. investment-grade bonds over the next year. In this environment, the benefits of the bond portfolio are even more concentrated than before in liquidity management and diversification, as opposed to total return potential.

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.

Northern Trust Asset Management comprises Northern Trust Investments, Inc., Northern Trust Global Investments Limited, Northern Trust Global Investments Japan, K.K., NT Global Advisors, Inc. and investment personnel of The Northern Trust Company of Hong Kong Limited and The Northern Trust Company.

Powered by NORTHERN TRUST

ViewPoints reflects data as of 2/14/17.