PLENTY DURABLE

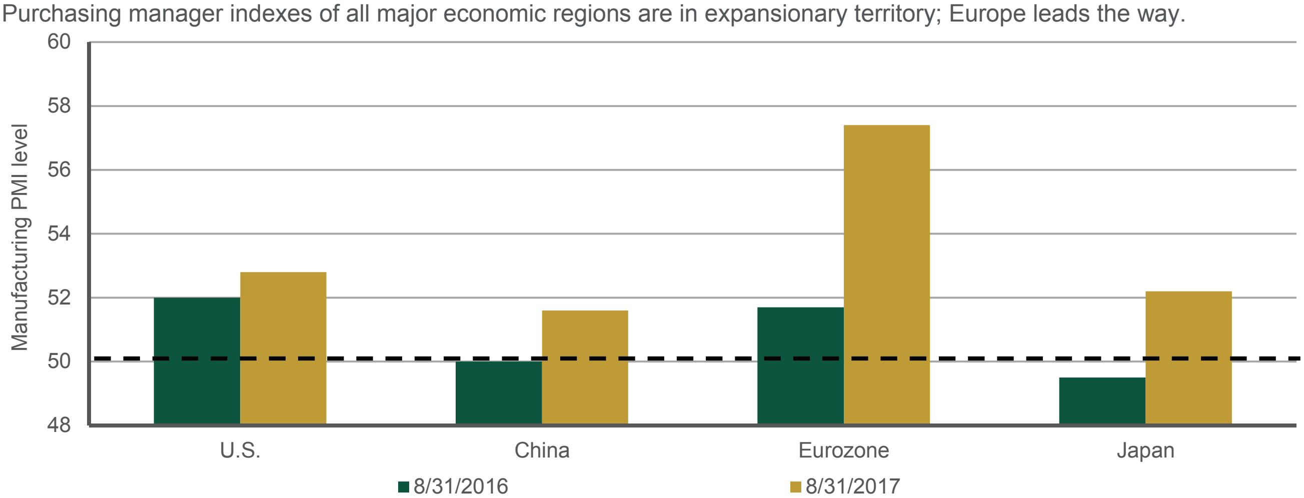
Stock market gains this year have been underpinned by improving corporate profits, so the outlook for growth remains paramount. Fortuitously, current indicators of global manufacturing have been solid. The United States and China have shown steady improvement, Japan's rebound has been stronger and Europe's gains have been downright impressive. Globally, the global manufacturing new orders index has increased from 50 to more than 54, while inventories have actually been declining. This bodes well for the global economy over the next year as companies rebuild inventories to meet current and future demand. Despite the positive economic environment, inflation has been heading lower. Investor expectations for inflation over the next 10 years – as judged by the Treasury Inflation Protected Securities (TIPS) markets – have dropped from 2.0% at the start of the year to just over 1.8% today. Because of technology's disinflationary effect on both supply and pricing of goods, we don't expect a sustained upturn.

So what could derail the expansion? We have identified four potential catalysts: North Korea, the Federal Reserve, a supply shock (such as in the oil markets), and a systemic financial market shock (such as a Chinese credit market crisis). North Korea and the Fed remain risk cases for us – we are concerned about them but we don't think the probability of a negative outcome is high enough to warrant portfolio changes. The risk of a supply shock seems remote, because few markets have tight supply/demand dynamics. The oil markets, in particular, seem well supplied. Finally, systemic financial shocks are highly unpredictable – but the better Chinese economic and financial market performance leads us to conclude this risk is relatively low during the next year.

Through year-end, we expect several key developments beyond the normal drumbeat of economic data. The United States avoided a government funding crisis this month thanks to President Donald Trump's deal with Democratic Congressional leaders, but this will need to be revisited in December. The German federal elections in late September are expected to result in Chancellor Merkel's fourth term, and then the focus will turn to reform within the European Union. Meanwhile, both the Fed and the European Central Bank (ECB) are expected to announce details on their plans to further reduce monetary accommodation. We currently don't expect any of these events to disrupt the positive financial market backdrop, which continues to rely more on economic developments than those of the monetary or political flavor.

BETTER GROWTH GLOBALLY

Purchasing manager indexes of all major economic regions are in expansionary territory; Europe leads the way.



Source: Northern Trust Investment Strategy, Bloomberg, Markit.
PMI = Purchasing Managers' Index. An index level above 50 indicates expansion; an index level below 50 indicates contraction.

CONCLUSION

Investors have been rewarded this year for risk taking, and we expect the positive environment to continue over the next year. Our recommended equity overweight continues to favor markets outside the United States, as we see improving economic momentum, political leadership and regulatory reform as supportive. The world has experienced several catastrophic events during the last month, from floods in Asia to hurricanes in the Caribbean and United States, and a major earthquake in Mexico. These events have caused great suffering, and will lead to some economic disruption. The major financial markets are unlikely, however, to be significantly affected as the focus on the near-term disruption will turn toward the rebuilding process. The immediate need to provide funding in the wake of Hurricane Harvey likely provided the catalyst behind President Trump's deal with Congress to provide a short-term fix to the debt ceiling and the U.S. government budget.

We upgraded our outlook for European regulatory reform this month, based on the initial efforts by French President Emmanuel Macron to reform the French labor markets. The targeted reforms would make it easier to hire and fire French workers, an important step toward a more flexible economy that will encourage new startups. Importantly, France's two largest unions have said they will not join street protests, a change from the past. With Angela Merkel likely to secure a fourth term leading Germany, the table is set for more unified Franco/German leadership of the European Union. This improves the chances of advancing further financial integration, a long delinquent goal of the EU. The economic backdrop in Europe remains constructive, with the resurgent euro the primary concern. Consumer and business sentiment remains strong, and the equity markets are set up for a bounce after declining 7% in euros since May.

Investor sentiment continues to be restrained, and recent polls in the United States show a jump in the number of bearish individual investors. This is a reasonably good contrarian indicator, and it is also occurring near the end of the seasonally soft June to September market period. Since 1970, the fourth quarter has been the strongest in the United States, with the highest median gains and strongest probability of a positive monthly return. Investor expectations around tax reform in the United States have significantly receded, as high tax rate companies have underperformed all year. We think the Republicans will pass some sort of tax reform before the mid-term elections, but it will take a while and may only have a modest fiscal boost. Risk markets have rallied strongly this year, but this has happened alongside the strong rally in earnings. As long as global growth remains durable, and inflationary trends remain dormant, we believe investors will continue to embrace risk over the next year.