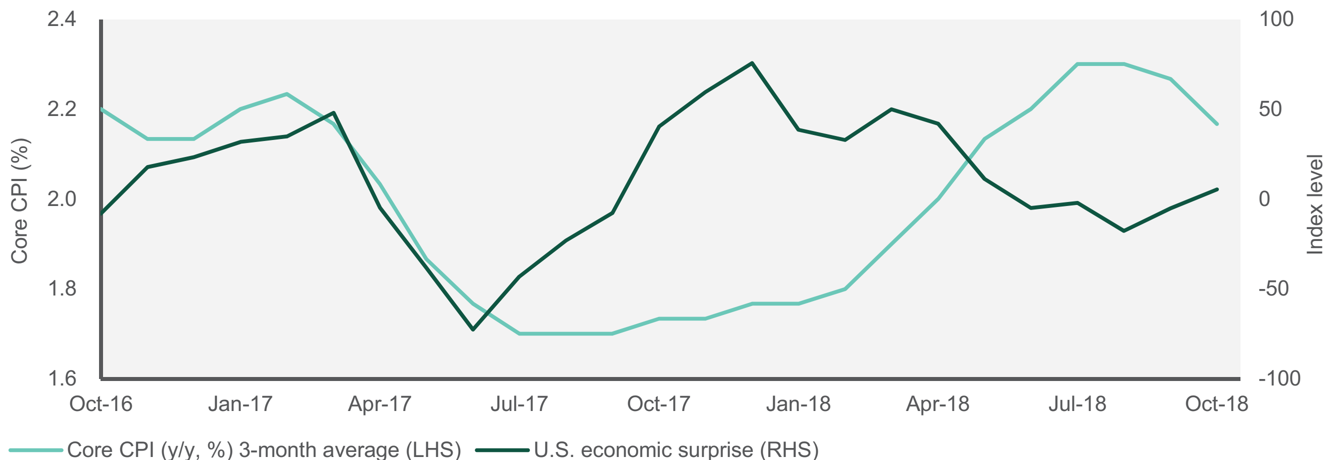
WATCHFULLY WAITING

Global growth peaked in the first half of this year, and now is showing signs of slowing – particularly in Europe and Japan. U.S. growth likely also peaked in the first half of 2018, and should decelerate further into 2019. This slowdown is happening at a time when the U.S. Federal Reserve is steadily raising interest rates in its attempt to “normalize” policy in the wake of years of extraordinary accommodation. It is the confluence of these two forces that we see presenting risk to the markets over the next year. For the risk taking environment to improve, we will be waiting for either an uptick in growth globally or a more tempered approach from the Fed. To some extent, the slowdown in growth is tied to tariff-induced trade tensions. With little sign of progress from talks between the U.S. and China, these tensions seem likely to continue into 2019.

With growth easing, and inflation measures rolling over, we think the Fed may actually be “ahead of the curve” as opposed to the dreaded “behind the curve.” This is based on our view that core inflation is contained (it has softened for three months in a row now). If the Fed were to join us in this conclusion, it would have cover to “pause” its rate-hike cycle. Recent commentary from Fed officials gives fodder to both the hawks and doves – so more data will be required for them to signal any re-evaluation of their current policy outlook. The European Central Bank (ECB) looks on course to end its quantitative easing this year, and its first rate hike likely won’t occur until later in 2019. The ECB must be carefully considering the current developments around Brexit and the Italian budget with an eye toward risk management.

Our current thinking is that the British and Europeans will manage their way through these challenges by a combination of kicking the can down the road and fiscal easing. We think the odds favor a soft Brexit, but politics are a blood sport and the pathway will be nerve wracking. The right prescription for Italy is some form of fiscal leniency pared with structural reform. Meanwhile, the U.S. election has come and gone without much impact on the asset markets. Political noise will ratchet up in 2019 as House committee leadership changes, but we do not expect this to materially affect economic fundamentals. The return of gridlock to Washington is a reality, but much of the administration’s desired business initiatives already have been enacted.

INFLATION ROLLOVER?
Slowing growth reduces the risk of inflation in 2019.



Source: Northern Trust Global Asset Allocation, Bloomberg. Data from 10/31/2016 to 10/31/2018.

Conclusion

We made no changes to our global policy model this month, as our current neutral risk position properly reflects our outlook for risk-taking over the next year. Our base case themes of Slowdown to Channel Growth and Rising Monetary Policy Disconnect illustrate the conflict that central bankers face over the next year. We expect global growth to gradually slow back into its longer-term channel, as U.S. stimulus wears off and trade frictions weigh on activity. Maneuvering in this slowing environment are central banks looking to remove accommodation – most importantly the Fed and the ECB. The Fed's push for further rate increases is at odds with the market's views on growth and financial market risks. The ECB may have more identifiable headwinds as both Brexit and the Italian budget disputes are going full steam, keeping it accommodative for a little longer.

Our first risk case, Central Bank Tunnel Vision, captures the possibility that the Fed charges ahead in its plan to raise rates without acknowledging the impact it has already had. The financial markets have responded to higher interest rates, and interest rate sensitive parts of the real economy are also evidencing some slowdown. Maybe an inversion of the yield curve will be the signal that catches their attention. Our second risk case, China Troubles, reflects the risk that the U.S.-China trade dispute disrupts global With China's size and growth rate making it the most important contributor to global growth, this risk is noteworthy. Additionally, we don't expect these tensions to be fully resolved over the next year.

We think U.S. credit markets are in better shape than the bears would have one believe. We don't expect the increase in lower-rated investment grade bonds to create a problem (short of us going into recession), as much of the increase in debt was voluntary and does not need to be repeated. We also see good credit quality across the high yield market, and companies have termed out their debt leaving them with little need for new issuance. Our significant exposure to high yield in the global policy model partially reflects the risk reduction we have undertaken over the last year, with a preference for "less risky" risk assets. Should everything turn out well, the current yield of just over 7% should generate a solid return. However, should the risk environment deteriorate further from here, high yield should perform much better than equities in a risk-off environment as it will be better cushioned by its current yield.

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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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