LOOKING FORWARD

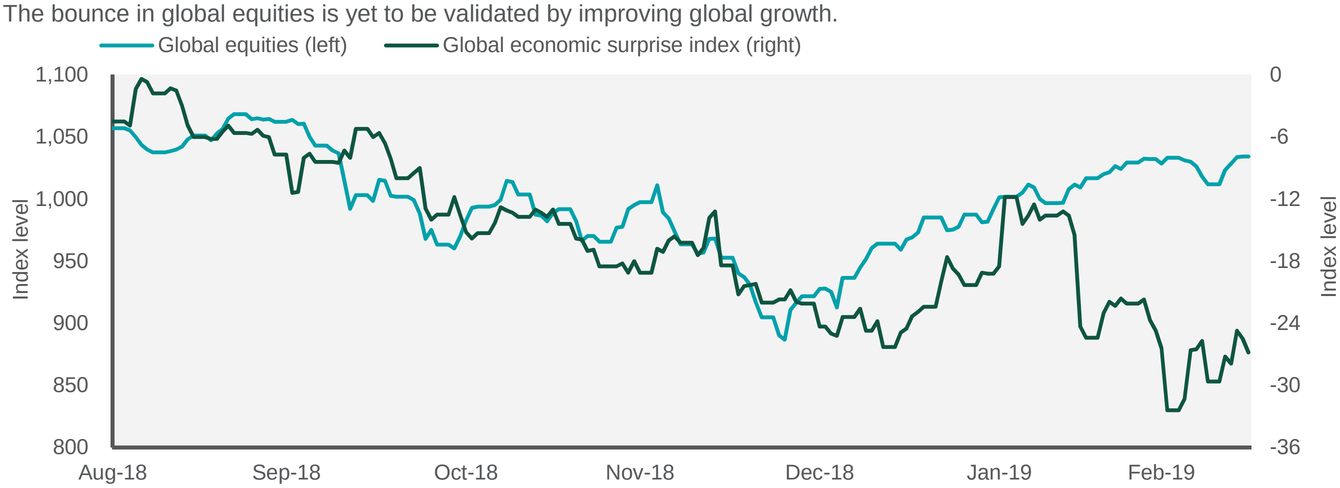
Financial markets are discounting mechanisms, and the global equity markets are currently discounting an improvement in growth as 2019 unfolds. The global rally in 2017 correctly anticipated the improvement in growth and earnings in 2018, while the market weakness in the later part of 2018 foreshadowed the current global economic slowdown. Since late December, however, markets have begun to price in better growth in countries such as China (Shanghai Composite up 24% ytd), Europe (Stoxx Europe 600 up 13% ytd in local currency) and the U.S. (S&P 500 up 13%). Within the U.S. market, companies with high international sales are outperforming those with a domestic focus by 6% this year and global cyclicals are outperforming defensive shares by 3%. The worrying signals from the credit markets late last year have also reversed, with spreads on investment grade and high yield bonds narrowing significantly.

While we weren't worried about the state of the credit markets, we did think investors were too optimistic about growth during 2018. The significant downgrade in optimism in the fourth quarter led us to upgrade our expectations for U.S. and emerging market growth in January. Is economic data accumulating that illustrates a growth pickup in 2019? Some evidence of improvement exists in the U.S., while the jury is still out for European and Chinese growth. The U.S. picture is hardly bulletproof, as highlighted by the weak February payroll report (job gains of just 20,000 compared to a 209,000 monthly average over the prior year). But other measures of the job market, including surveys of businesses, show more resilience. We haven't been expecting improvements to European and Chinese growth until the second half of 2019, so the current soft data isn't too surprising. Nevertheless, signs of stabilization will be a necessary support to the improved risk environment realized so far this year.

Politicians and central bankers have responded, belatedly, to the global slowdown. China is aggressively easing fiscal policy and working to stimulate the industrial side of its economy. The European Central Bank (which has only cut rates since 2011) has committed additional credit to the banking system, and the Federal Reserve has quickly swiveled to an easier posture since year-end. This turns the focus from central bankers to the politicians, with developments like U.S./China trade talks, Brexit and the European Parliamentary elections front and center. While we don't expect any of these events to present a sustained risk to the global financial markets, their political nature makes their outcomes less predictable.

ANTICIPATING A RECOVERY

The bounce in global equities is yet to be validated by improving global growth.



Source: Northern Trust Global Asset Allocation, Bloomberg. MSCI ACWI = Global equities. Economic surprise index is measured by Citi. Data from 8/31/2018 through 3/14/2019. Past performance does not guarantee future results.

Conclusion

Flows into U.S. domestic equity funds (mutual funds and ETFs) followed the market lower through December, and then jumped into positive territory by February. Flows into high yield products showed a similar pattern, with these investors (both retail and institutional) selling weakness and buying strength. While some of this may be tax-related selling, it is also likely tied to bad investor habits. We are focused on trying to anticipate where the markets are mispricing assets, and the sell-off that culminated on December 24th presented such an opportunity. In our January investment strategy meetings, we increased our recommended risk in our global policy model to reflect the improved outlook for risk-taking. Since then, two of our favored asset classes have had the highest risk-adjusted performance of all major assets – high yield bonds and global real estate. As our growth and inflation outlook hasn't changed materially since January, and markets have rallied nicely, we have left our tactical asset allocation recommendations unchanged for the last two months. We expect growth in the U.S. and emerging markets to beat restrained investor expectations – and it will be important for both emerging market and European data to show stabilization and signs of improvement in coming months.

The one notable change in our investment strategy this month was a downgrade in the U.S. regulatory environment to negative. The drumbeat around increased regulation (be it technology, financial or tax-related) is only likely to increase through the 2020 U.S. election, and this will increasingly be a distraction for investors. Conversely, inflation doesn't look like a leading suspect to upset the risk-taking environment as many measures globally show slowing inflation and the headline U.S. and Chinese consumer price indexes are only rising 1.5% over the prior year. The constrained inflation environment is proving a catalyst for easier central bank policy, which we expect to support global risk-taking.

We still expect risk-taking to be rewarded this year, hence our favoring of high yield bonds, U.S. equities and global real estate over investment-grade bonds. We are, however, at a moderated level of risk-taking given the uncertainties on the horizon. Better clarity on the economic recovery in Europe and China will be important, as will some progress in trade talks between the U.S. and China. We've been expecting a near-term hard Brexit to be avoided by a delay to the March 29th departure date, and while that seems the most likely outcome, there are still significant uncertainties to be resolved before that is concluded. We look forward to updating you on our investment outlook as the year progresses.

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.

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ViewPoints reflects data as of 3/20/19.