AVOIDING THE DIP

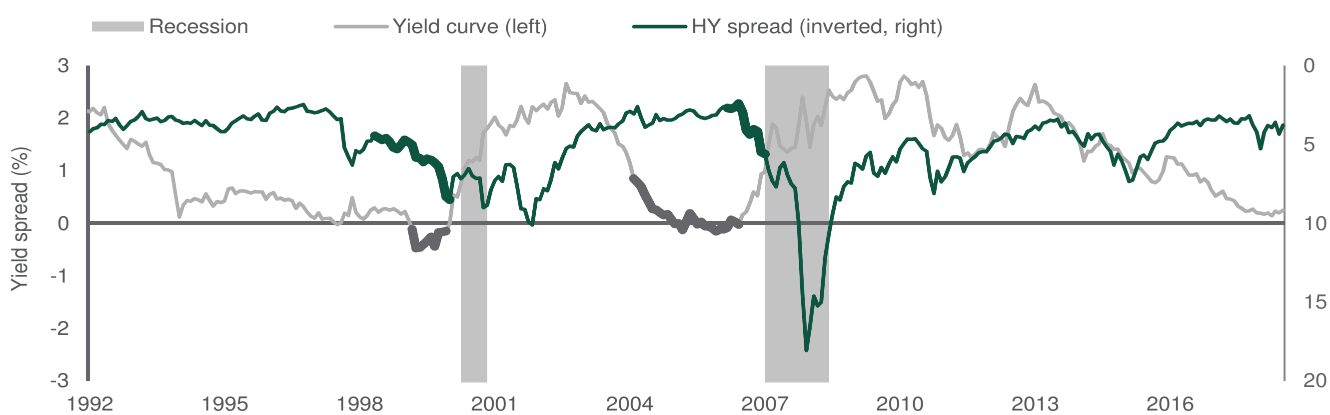
Investors are concerned that a yield curve inversion signals an upcoming recession. While this is a valid concern, it should be confirmed by other signs like deteriorating credit conditions. As shown below, high yield spreads haven’t shown the deterioration they did during prior pre-recessionary periods. Leading economic indicators have been slowing since late 2017, with much of the weakness concentrated in manufacturing. The service sector, a much larger part of most developed economies, has held up reasonably well. The weakness in manufacturing has coincided with the ramp-up of the trade wars, and is unlikely to reverse course soon. We should, however, reach some level of stability as global trade resets to a new level. We currently consider the potential for a trade armistice to be an upside risk to the markets, as it would positively surprise investors who have settled in for a drawn-out fight.

Recent months have seen central bankers start to pivot towards easier policy, including the European Central Bank (ECB) at its June meeting. In response to slow growth and low inflation, we expect it to restart quantitative easing measures later this year and this expectation has led to a drop in European interest rates. We also think the recent leadership announcements for the ECB, European Council and European Commission bolster the case for pro-European Union policies in the coming year. The Federal Reserve has taken a further dovish turn, supporting market expectations of a near-term rate cut (or cuts). Historically, this has been supportive of equity prices, especially in non-recessionary periods. Other central banks are likely to follow the lead of the Fed and the ECB in coming quarters.

We have three primary themes in our current tactical asset allocation policy. Firstly, we favor U.S. equities over emerging markets as they are less vulnerable to trade risks. In fact, this month we further increased our U.S. equity position by reducing our position in investment-grade bonds. Secondly, we favor interest-rate-sensitive real assets such as global real estate and global listed infrastructure as they are benefitting from the new, lower interest rate environment. Finally, we continue to like the downside mitigation and upside participation embedded in high-yield bonds. While there are always plenty of concerns on the horizon, we still think risk-taking will be rewarded over the next year.

RECESSION SIGNALS ARE FAR FROM CLEAR

Credit spreads are not deteriorating like they did before the last two recessions.



Source: Northern Trust Global Asset Allocation, Bloomberg, Federal Reserve Bank of St. Louis. The yield curve is measured by the spread between the 10-year and 2-year Treasury yield. Monthly data: 12/31/1992 – 6/30/2019.

BASE CASE

Global Growth Pressures

President Trump's reenergized assertiveness on trade has taken some shine off the 'Goldilocks' economy. We believe global growth, while positive, will modestly disappoint expectations. We are concentrating on "lower risk" risk assets such as U.S. high yield and U.S. equities.

Interest Rate Relief Valve

Political impacts on fundamentals will be partially diffused through continued low rates, enabled by stuckflation and central banks (importantly the Fed) begrudgingly accepting the bond market's message. As a result, we have overweights to interest-rate sensitive assets (global real estate and listed infrastructure).

RISK CASES

Inflation

Subdued inflation has been a key driver of favorable risk asset returns over the last few years; an unexpected jump in cyclical inflation would put at risk the *Interest Rate Relief Valve* base case above.

Trade Armistice

The Trump-Xi G20 meeting resulted in a temporary cease fire, moving this risk case closer to "actual" case. Our base case still calls for trade tensions, leaving a true (prolonged) armistice as an upside risk.

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.

ViewPoints reflects data as of 7/15/19.

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