EMBRACING SOME RISK

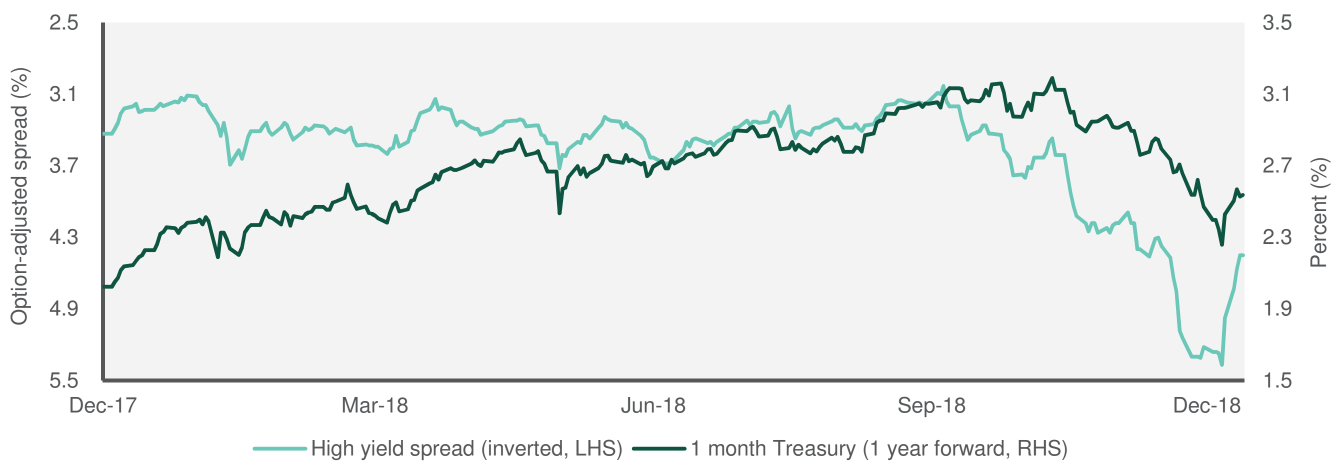
One element of successful investing is assessing how investor expectations may change over time. We began warning in mid-2018 of a growth slowdown in 2019, which we felt would be a disappointment to investors. This came to a head in the fourth quarter, as growth concerns led to a significant reduction in risk appetite and valuations. The resulting widening of credit spreads (as shown below) led to predictions that the credit markets were sniffing out an economic downturn. But we now think sentiment has swung too far in this direction; we don't expect a recession in 2019. This negative sentiment shift improves the odds of an upside surprise over the next year, which we think improves the outlook for risk taking.

Another key driver of successful investing can be anticipating the impact of changing monetary policy. We have been expressing concern that the Federal Reserve was being too hawkish, and this contributed to the recent risk-off environment. Rising interest rates have hurt the housing market and other interest rate sensitive industries. In addition, the global growth outlook was also slowing, partially due to trade-related tensions. The tightening of financial conditions has finally caught the Fed's attention, and it has recently backed off its more aggressive plans. As shown below, expectations for short-term interest rate hikes fell significantly starting in November as investors began to bet the Fed would back off. We now expect a pause for at least the first half of the year and the Fed to be patient thereafter. This changing stance has led us to revise our view on U.S. monetary policy from "restrictive" to "accommodative."

Our base case scenario is based on the themes of Global Growth Resilience and a Market-Dependent Fed. We believe the global economy is in a growth channel that should encourage some caution when growth is hot, but some patience when growth cools. Souring investor expectations set the stage for positive surprises, which has led us to upgrade our outlook for U.S. and emerging market growth to "surprises" from "disappoints." The Market-Dependent Fed has reduced its options with its recent dovish statements and markets are not pricing in any hikes in 2019. We believe the five-year Treasury yield will be a key indicator to watch, with rises acting as a "green light" for the Fed to raise rates. Our risk case is a "Fed relapse" where a stronger growth period and easier financial conditions lure the Fed into further tightening, risking rekindling the concerns of this past quarter.

RISK AVERSION ROSE AND THE FED BACKED OFF

Pressure on risk assets such as high yield led to reduced expectations for Fed rate hikes.



Source: Northern Trust Global Asset Allocation, Bloomberg. Data from 12/31/2017 to 1/10/2019.

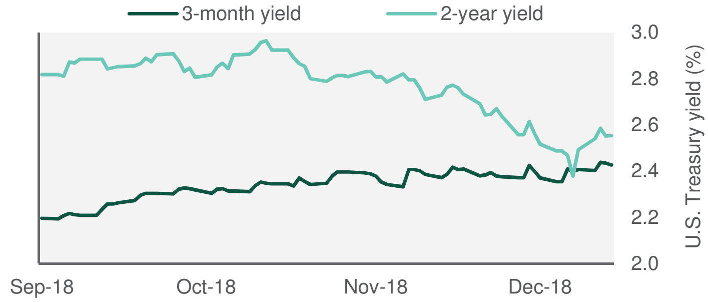
Interest Rates

Late last year, the Fed pushed through its fourth rate hike of 2018, calling for two additional rate hikes in 2019. Further, Fed Chairman Jerome Powell commented that the Fed's balance sheet roll-off was on "autopilot." Financial markets responded to what they viewed as reckless Fed behavior by further flattening the yield curve, indicating increased concerns about recession. Perhaps most noteworthy was the spread between two-year and three-month Treasury yields, which continued to shrink – and even briefly went negative – a sign bond investors expected the next Fed action would actually be a rate cut.

The Fed's New Year's resolution seemed to be to listen to the financial markets more. Powell's early-year public statements preached patience and a willingness to adjust the Fed's monetary policy approach should inflation remain stuck and the yield curve stay close to inversion. We applaud this approach, even though we felt the Fed should have come to this conclusion in December – or even September. We anticipate there will be no Fed rate hikes for at least the first half of 2019 – and that a more dovish Fed will allow for some steepness to creep back into the U.S. yield curve. However rates globally will remain low by any historical standard.

RISKING A MISTAKE

Falling two-year yields signal discomfort with Fed policy.



Source: Northern Trust Global Asset Allocation, Bloomberg. Data from 9/28/2018 to 1/10/2019.

- The Fed may have gone one (or two) hike(s) too far.
- Long-term yields fell slightly below our targeted levels.
- Stuckflation and a dovish Fed will keep interest rates low.

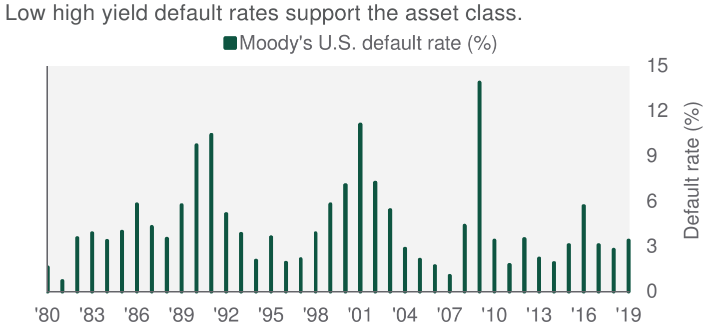
Credit Markets

High-yield fixed income outperformed other risk assets in a weak fourth quarter. As a lower-risk risk asset, outperformance in down markets is to be expected. But high yield held up even better than history would suggest. Providing support to the high-yield market are relatively low default rates. The chart at right shows the Moody's default rate ended 2018 at 2.8% and is expected to remain well below long-term averages throughout 2019. High-yield issuers have taken care of upcoming maturities and are experiencing the lowest leverage and highest interest coverage in the post-crisis era. A supportive technical environment also underpinned high-yield valuations.

We believe stable credit fundamentals and low refinancing needs should continue to provide support for high yield. Further, a more patient Fed (see Interest Rates section above) should keep liquidity at adequate levels in the high-yield market. All said, high yield remains our largest tactical overweight in the global policy model at 8% above our strategic asset allocation. From a portfolio construction perspective, we like the "upside participation, downside protection" attributes of high yield in a risk asset market we find attractive, but which may still be looking for its footing after a weak fourth quarter. From a total return perspective, we believe high yield could provide a low double-digit return driven by stable interest rates and tighter credit spreads.

GETTING YOUR MONEY BACK

Low high yield default rates support the asset class.



Source: Northern Trust Global Asset Allocation, Moody's. Data from 12/31/2017 to 1/10/2019.

- High yield has held up well during recent market volatility.
- Fundamentals in high yield continue to be strong.
- High yield remains our biggest tactical overweight.

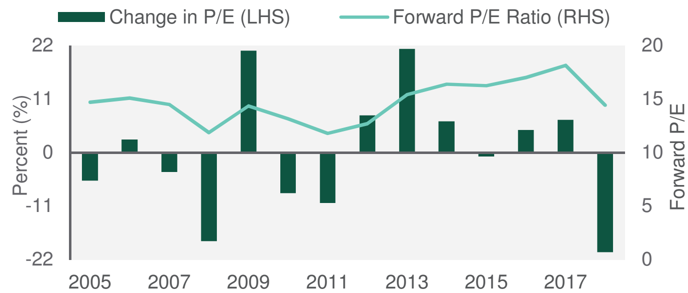
Equities

Developed market equities took a beating in the fourth quarter of 2018, down roughly 13%. Poorly managed communication from the Fed left investors concerned tightening policy would prematurely end the economic cycle, while Brexit proceedings and continued trade concerns further fueled negative sentiment. With the U.S. market ending the year in negative territory despite better than 20% growth in earnings, valuations dropped significantly. In fact, the forward price/earnings ratio (P/E) on the S&P 500 fell by 20% in 2018, which, quite remarkably, exceeded the P/E decline in 2008. While we expect U.S. earnings growth to slow considerably from 2018's well-above-trend pace, current valuations appear to imply a more material risk of recession – something we do not expect.

The Fed is now suggesting a willingness to pause on further rate hikes, which we and the market are greeting with relief. Without the headwind of further monetary tightening, risk assets appear poised for recovery, leading us to increase our exposure in U.S. and emerging markets equities. The outlook for European equities is supported by similar valuation benefit, but with greater uncertainty around the growth outlook. We are going to need greater conviction in the growth outlook to increase exposure to European stocks.

BIG VALUATION DROP

Rising earnings and falling stock prices do wonders for valuations.



Source: Northern Trust Global Asset Allocation, Bloomberg, S&P 500.

- Valuations improved globally in 2018 as stocks declined.
- Valuations should move from a headwind to tailwind in 2019.
- We increased our recommended exposure to U.S. and emerging market equities this month.

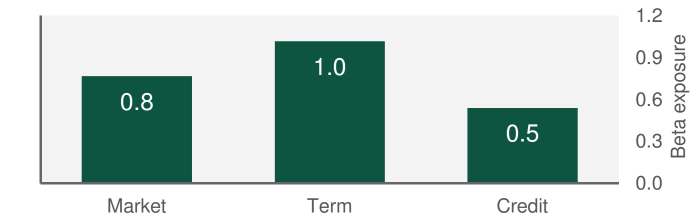
Real Assets

Despite some relative weakness over the past three years, global real estate has historically provided above-market returns. A major reason for that outperformance is the number of risk exposures from which global real estate derives returns. The chart (right) shows global real estate's long-term beta exposures to the market (equity), term (interest rate) and credit risk factors. Historically speaking, these three factors have explained more than 80% of global real estate's return patterns. In other words, if we have strong views on the returns of these various risk factors, we should be able to predict the return of global real estate with pretty good accuracy. It's a simple matter of multiplying our return expectations by the beta exposures.

Today, our combined views on market, term and credit suggest a 13.5% return for global real estate over the next year. To start, we expect global equity markets to have a solid 2019 given lower valuations combined with ongoing economic expansions and easier monetary policy. Add to that continued low interest rates (which support the term factor) and tighter credit spreads (which support the credit factor) and you have a recipe for global real estate outperformance. Our quantitative assessment combined with a qualitative view investors have gotten too pessimistic on global real estate's prospects (for instance, fears of Amazon completely destroying retail) led us to move to a 2% tactical overweight.

THE DRIVERS OF GLOBAL REAL ESTATE

Global real estate has exposures to many risk factors.



Source: Northern Trust Capital Market Assumptions Working Group.

- Global real estate looks attractive heading into 2019.
- Market, term and credit factors should all support real estate investment trusts.
- We remain neutral natural resources and listed infrastructure.

Conclusion

We wrote about the importance of understanding investor expectations at the start of this month's *Perspective*. At the end of the day, investing is a game of probabilities and properly assessing investor expectations helps tilt the odds in your favor. We've seen a 20% decline in forward price earnings multiples in U.S. equities over the last year, which helps improve the outlook for risk asset performance over the next year. It is also important to consider the importance of portfolio construction, as assets are best evaluated in the context of the overall portfolio. We have frequently been asked about the risk of high yield should the United States go into recession – without a corresponding question about how much worse equities would perform. To wit, during the 19% decline in U.S. equities during the fourth quarter, high yield declined just 6%.

Relatedly, we receive questions about why we would own investment grade bonds here instead of cash – considering the flatness of the yield curve. The answer comes down to portfolio construction, because investment-grade bonds serve as a better hedge against our equity risk than cash. Interest rates today are broadly in the middle of our forecasted range for the next six to 12 months, so current yields are a good indication of our expected return. Credit markets should do better, however; we expect some spread tightening as risk taking returns to the markets. High-yield bonds could deliver a return comparable to equities in 2019, at considerably lower risk. High yield's (relatively) high coupon helps provide some downside protection. In looking back at prior periods of high-yield price weakness, the longest it took for high yield to regain prior losses was just nine months.

We entered 2019 in a neutral risk position in our global tactical asset allocation model. The odds started to meaningfully change in mid-December, as risk assets broadly sold off and valuations correspondingly improved. The odds improved further when Fed Chairman Powell signaled in early January the Fed would be patient in assessing monetary policy in 2019. As we looked to embrace some more risk after these developments, we recommended a 6% move from investment grade bonds into U.S. equities (2%), emerging market equities (2%) and global real estate (2%). This is supported by our themes of Global Growth Resilience and a Market-Dependent Fed. The risks to this more optimistic outlook are a Fed relapse (where temporary strength resuscitates the Fed's hiking plans) and political miscalculation (as we see any economic stumbles over the next year likely being man-made). As always, we will be analyzing incoming developments and assessing their impact on our investment strategy outlook and look forward to updating you on our thoughts next month.

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TRUST AND INVESTMENT SERVICES

For more information:

Meredith Marsh Tiedemann, CPWA®
Senior Vice President & Trust Officer

Phone: 845–677–4266

eMail: mtiedemann@bankofmillbrook.com

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.

ViewPoints reflects data as of 1/15/19.

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