# STABLE IS THE NEW UP

## UNICORNS AND DOVES GRAB HEADLINES AS INVESTORS RE-EMBRACE RISK

Northern Trust Wealth Management

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In a mirror image to 4Q 2018, investors have embraced risk in 2019 as dovish global central banks led to fading recession fears, effectively reducing two key market risks. The "risk on" environment has provided fertile ground for initial public offerings, with some household names like Uber and Pinterest set to join Lyft in the public market and expecting similarly heavy investor demand at the offerings. The combination of double-digit global market returns and a heady IPO market may give some investors pause: *Is this the sign of a market top?* We don't think so, and remain constructive on risk.

### The Global Economic Outlook Has Stabilized and Recession Fears Have Waned

Although growth will be slower in 2019, we believe it will be sufficient to support corporate earnings while muted enough that central banks remain dovish.

- **Stronger 2H 2019.** U.S. economic data will likely bottom in 1Q, and we expect improvement into the 2H of 2019. Continued improvement in employment and slow but steady wage gains will support the consumer, the engine of U.S. economic growth, and growing economic optimism should feed through to equity markets.
- **Green shoots in Europe?** While it is early days, we are starting to see signs of stability and even recovery from a very weak bottom in Europe. That said, German manufacturing and export data has remained weak, reflecting a reduced pace of global trade and the slowdown in China. We do expect that better momentum out of the U.S. and stability in China will bring stability to the European outlook, and note that some of the forward-looking indicators have turned up slightly. The ECB appears to be analyzing additional stimulus tools specifically focused on the banking sector, which remains weak under the current negative-rate regime.

- **Policy acts with a lag:** The outlook for China has improved, and there are signs that the 2018 stimulus is starting to provide a needed boost. We share a healthy cynicism over the official data, but we are seeing an improvement in some of the high-frequency data that corroborates stability. The Peoples Bank of China has pulled out all the stops, providing liquidity, rate cuts, tax cuts and spending packages — all aimed at stabilizing growth. We will continue to see improved momentum through 2019, and a successful outcome to the U.S./China trade negotiations would further support our constructive outlook.

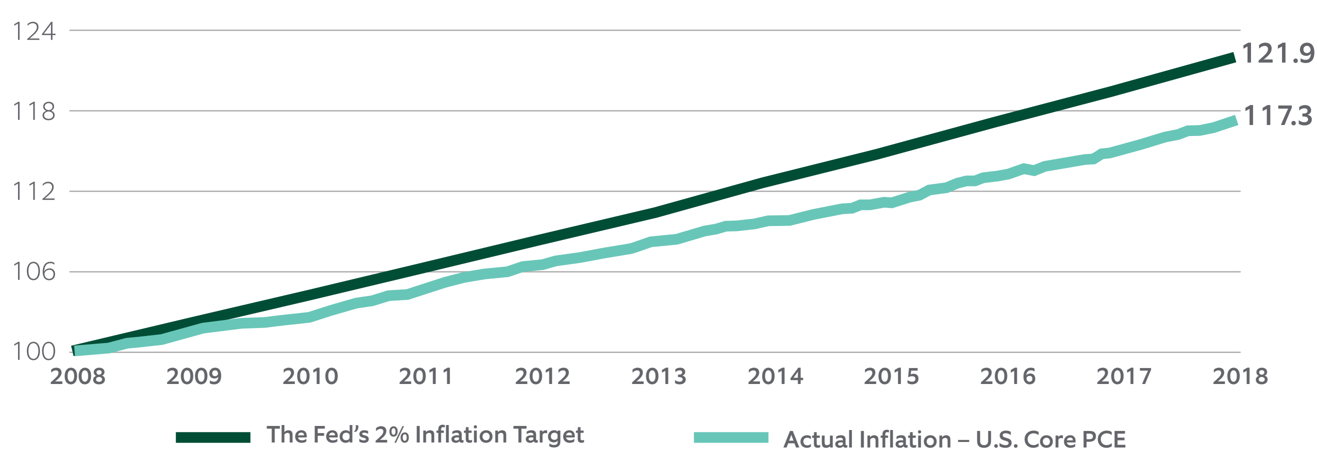
## Inflation Holds the Key to the Outlook

There is a lot riding on our — and the market's — benign inflation outlook. It anchors our belief that central bankers, particularly the U.S. Federal Reserve, will remain dovish. Our low-inflation outlook is driven by a view that demographics, high debt burdens and increased use of productivity-enhancing technology combine to exert structural downward pressure on inflation, and that this is a global phenomenon. Our interest rate outlook remains low, for long.

Try as they might, central bankers have thus far been unable to generate a meaningful uptick in inflation. Not surprisingly, the bond market has been ahead of the Fed in recognizing the difficulty in generating inflation, and market-based inflation expectations have declined. Increasingly, central bankers appear to be moving toward the market view. This represents a potential turning point — from worrying about inflation accelerating to concerns about disinflation.

A near-term risk is that the Fed becomes emboldened by the market recovery, or focused on a near-term potential cyclical uptick in inflation, and overreacts. This would clearly surprise the market and likely provide the catalyst for an uptick in downside volatility. We will remain vigilant on this issue given its importance.

**MISSING THE TARGET: CUMULATIVE INFLATION OVER TIME**




Source: Northern Trust Global Asset Allocation, Bloomberg. Data from December 31, 2008 to December 31, 2018.

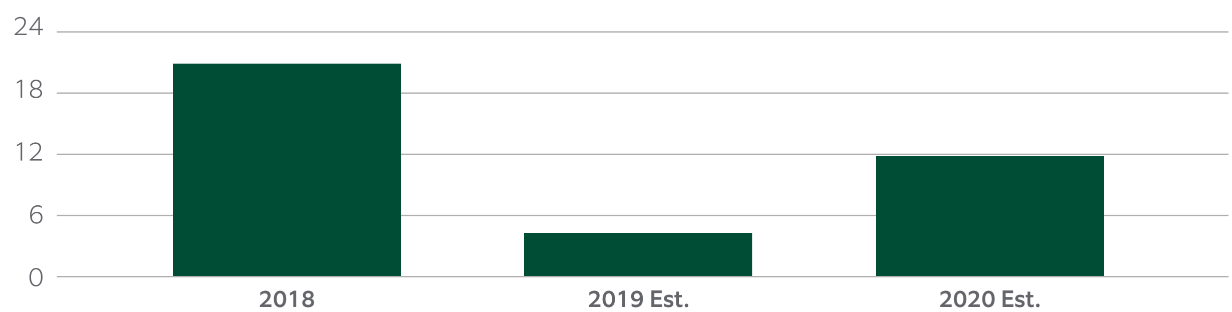
## Dual Peaks: Should Investors Worry About Peak Earnings Growth and Peak Margins?

Peaking profit margins as a result of higher input costs, along with a pace of earnings growth that is losing momentum, have been viewed as potential red flags for U.S. equities. We disagree with the conclusion, not the fact pattern.

We agree that profit margins have likely peaked, and both gross and net margins will suffer as a result. Input costs like labor and energy have increased, and corporate tax rates will be higher this year than last. We also concede that earnings growth peaked in 2018 under the fuel of a corporate tax cut and above average economic growth. Our outlook for earnings growth in 2019 sits at a mid-single digit pace, including a decline in earnings growth in the first quarter. The good news for investors is that a 4-5% earnings growth rate is "good enough," and the low- interest-rate environment will support — and even may drive higher— equity valuations.

### THE OUTLOOK FOR EARNINGS GROWTH IS "GOOD ENOUGH"

**S&P 500 Earnings Growth Estimates — Year-over-Year %**




Source: Factset consensus estimates as of April 1, 2019.

## So, Where Does that Leave Us?

Under the assumption that central bankers will listen to financial markets and maintain dovish postures, and given our outlook for a bottom in economic and earnings growth, we have a constrictive view of risk. That said, the global risk asset market recovery has been quick, and further gains this year will rely heavily on fundamental corporate earnings growth. For Risk Control assets, our outlook calls for interest rates to stay low as the Fed remains on hold and our "Stuckflation" theme becomes more mainstream.

A recurrent theme for us is "prepare, don't predict," and that theme served investors well both during the tumultuous 4Q of 2018 as well as the recovery in 2019. Short-term market movements are notoriously difficult to predict, and we know that markets can overreact to noise and news. The additional challenge is that many investors overreact to market moves and give in to behavioral biases that result in selling equities into downturns. Accordingly, we set an allocation to high-quality fixed income and cash that enables the payment of non-discretionary liabilities and high priority near-term goals without having to sell stocks. We understand that markets generally rise, but not always, and this "portfolio reserve" can give us the luxury of time. The last six months are an important affirmation that preparation is key.