GIVE ME CREDIT

In May, we highlighted a moderation in the global growth outlook, and in June we noted shifting momentum toward the United States. Underlying both those trends is our view that the recent strong global growth will moderate in 2019. In the United States, fiscal stimulus from the tax cuts will fade. Across Europe, concerns about trade and political leadership should continue to be a mild headwind to growth. In Asia, China continues to fine-tune policy to moderate excessive credit creation – but appears willing to back off when growth shows signs of cooling too much.

The risks to growth from rising trade barriers are real – but challenging to forecast. We have seen early evidence that tariffs prove more deflationary than inflationary – just take a glance at the prices of many commodities after their implementation. But the potential damage to public company profitability remains much higher than the overall economic impact, keeping this risk front and center.

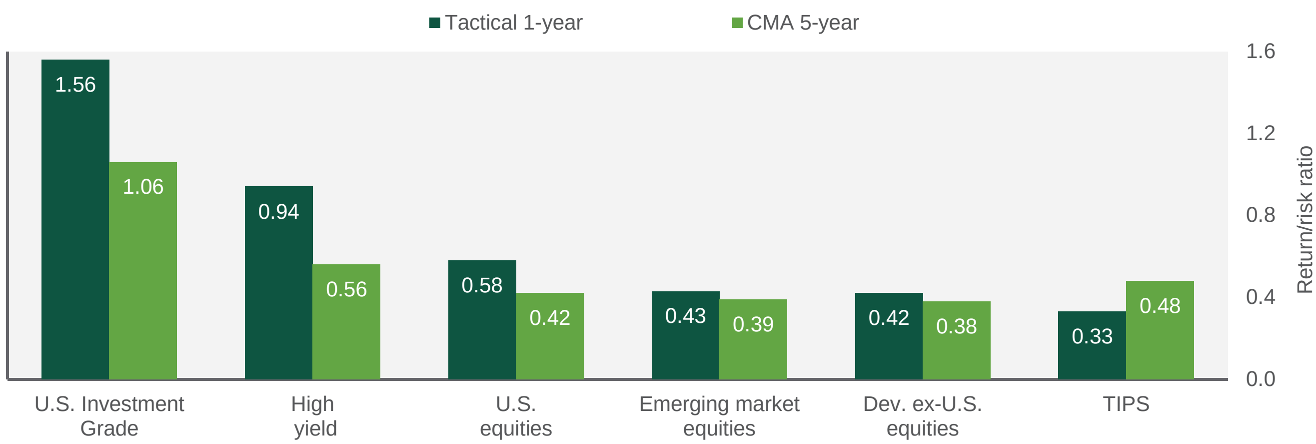
Should the trade battle between the United States and China accelerate, we think it will be the Federal Reserve who blinks first. The yield curve's relative flatness limits how far the Fed can raise short-term interest rates, and this has led some governors to voice their concern about the risk of inverting it. In addition to the risk of their "dissent," fixed income markets will provide pressure by pushing down yields of longer-dated Treasuries. We think Treasuries will rally on Fed fund rate hikes, furthering the inversion risk. If you add a full-blown trade war on top of this, it would take a mighty brave (some might say reckless) Fed to keep raising rates.

The European Central Bank's (ECB's) most recent rate guidance showed it didn't expect to consider raising rates (from very negative levels) for another year, while the Bank of Japan seems stuck in accommodation mode as growth remains moderate.

We also expect inflationary pressures – as well as investor inflation expectations – to remain in check. The risk of a short-term cyclical bounce remains, although recent labor market data in the United States showed an actual increase in the unemployment rate driven by the return of discouraged workers to the labor markets. While there are also some anecdotal signs of wage increases in Europe, there are no signs of any movement in the overall inflation measures. Japan remains stuck with inflation that barely registers, and China's consumer price inflation is below 2%. In this environment, we expect corporate credit to outperform inflation-protected bonds and discuss that in the Credit Markets section.

BONDS LOOKING ATTRACTIVE

Prospective risk adjusted returns look good for both investment grade and high yield bonds.



Source: Northern Trust Global Asset Allocation, Bloomberg. CMA 5-year return/risk ratios as of 7/12/2018. Tactical 1-year return/risk ratios as of 7/6/2018.

Conclusion

In this month's investment policy committee meeting, we recommended a tactical shift of 4% from inflation-protected bonds into investment grade bonds (2%) and high yield bonds (2%). This was due to the attractive risk/return outlook (as highlighted on the front page chart) of these bonds, especially compared to inflation-protected bonds. We had considerable discussion about the outlook for growth, and the potential impact of inflation on companies and financial markets. Partially tied to concerns about trade, there has been a real divergence in business sentiment between the United States and Europe. U.S. small business sentiment remains at record high levels, supported by deregulation and tax cuts. In contrast, the more export-dependent European business community is less optimistic; the ZEW Indicator of Economic Sentiment for eurozone growth has fallen sharply in recent months. While Chinese growth seems to have started slowing late last year, the government appears to be taking actions to support growth through the banking system and fiscal policy. Maybe in reaction, we have seen a rebound in private measures of business activity such as loan issuance, freight volumes and electricity usage.

Our risk cases are unchanged from last month, but they have both risen somewhat in their probability. The risk of a central bank making a mistake continues as a concern, and the Fed is showing little sign of wavering from its plan to steadily raise rates over the next year. We do expect the wavering to begin this year, so expect some increased noise around this issue. Our second risk, of a trade war, has also picked up some, as the Trump administration has reiterated its consideration of 10% tariffs on an additional $200 billion of Chinese imports. So far, the administration is showing a resolve similar to that of the Fed. In the end, we expect both will blink, but the odds have increased they won't.

Now, more than ever, it is critical to separate the noise from the signal. The noise from politicians globally is only increasing, and bottom-line oriented media outlets have become masterful at telling their viewers what they think they want to hear. Both the recent G-7 and NATO meetings are clear examples of this phenomenon. Big headlines were reported, but little real policy action occurred. Our expectation for channel growth and our theme of Stuckflation support continued risk taking. We expect central banks to take the easy way out and not overly tighten policy when inflation remains reasonably contained.