ACCOMMODATING INFLATION

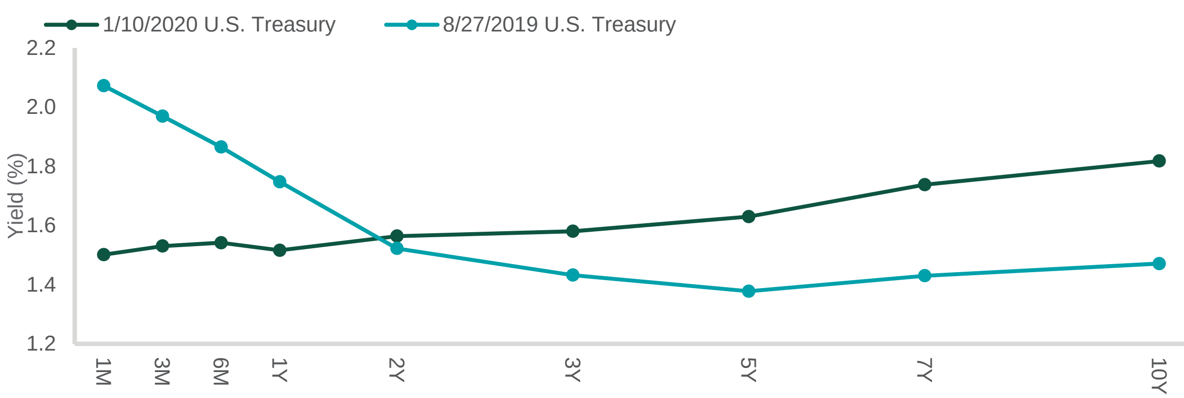
2019 turned out to be a fantastic year for risk takers, and even for those heavily invested in bonds. The regularly touted impending recession once again failed to materialize, and the U.S. Federal Reserve moved from tightening policy to cutting rates and growing its balance sheet once again. The bond market was signaling last summer that monetary policy was too tight (as the yield curve inversion in the chart below illustrates), and the Fed's resulting pivot has led to a steepening of the curve that indicates investors' increased confidence in the economic outlook. It is also a result of investors increasingly seeking inflation protection, including through purchasing inflation-protected securities (see Interest Rate section). We think this concern is premature. Global inflation measures remain restrained, and U.S. average hourly earnings gains slowed in December to just 2.9% despite an official unemployment rate of 3.5%.

Our base case outlook now includes a theme, Structural Monetary Accommodation, that captures our view that global central banks will tolerate inflation above their 2% target levels since it has run well below for so long. But monetary policy alone will not reignite inflation; low interest rates haven't materially boosted aggregate demand and technology will continue to bolster supply in many parts of the economy. So the primary outcome of the structural accommodation will be continued low interest rates and support for current risk asset valuations. We predict the potential fiscal stimulus in Europe will not be sufficient to offset the slowing fiscal thrust in the U.S., and as a result do not expect organic economic growth to accelerate meaningfully.

Geopolitical risks remain front and center, but have mostly settled down over the last year. The U.S. and China are reportedly set to sign the "Phase 1" trade deal in mid-January, and the U.K. looks set to exit the European Union at the end of the month. Increased tension between Iran and the U.S., including the killing of General Qasem Soleimani and the subsequent bombing of U.S. military facilities, hasn't sustainably increased oil prices nor risk premiums. The stage was set for 2019's strong returns by the significant sell-off in the fourth quarter of 2018. Similarly, the strong returns of 2019 reduce the magnitude of potential gains in risk assets this year. So while we have more tempered expectations across most markets, we think the outlook for risk-taking remains constructive. In this environment, our favored asset classes remain U.S. equities, high-yield bonds, and global real estate and global listed infrastructure. Please refer to our 2020 Outlook piece, "Everything in Moderation," for further details on our expectations for financial markets this year.

RIGHT SIDE UP

Easier Fed policy has helped restore the yield curve to a healthier upward slope.



Source: Northern Trust Global Asset Allocation, Bloomberg.

BASE CASE

Fundamentals vs Geopolitics

Resilient economic data, especially in the U.S., has helped support financial markets and reduce investor concerns about possible recession. However, a number of geopolitical uncertainties have the potential to weigh on investor sentiment. TAA continues to favor "less-risky" risk assets.

Structural Monetary Accommodation

Major central banks globally will maintain current accommodative policy for the foreseeable future (even in the face of some above-target inflation). Central banks will also be more willing to cut interest rates/increase accommodation should geopolitical events pressure the economy or financial markets.

RISK CASES

U.S. Election Clairvoyance

Investors fully expect a highly competitive, down-to-the-wire 2020 election cycle. Events that solidify the expected outcome sooner will likely cause significant shifts in asset prices and flows.

China Damage Already Done

Tariff effects that prove to be more permanent (e.g. companies moving production) combined with existing stresses (excessive credit), materially impairing China's economic growth trajectory.

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ViewPoints reflects data as of 1/13/2020.