Northern Trust | Jim McDonald: Where Things Stand

Markets in the first half of this year have faced down worries of a US recession and a Chinese hard landing, along with the UK'S recent vote to leave the European Union. So what's our outlook from here?

As trading in the first quarter of this year demonstrated, growth problems lead to market problems. We have had a long held view that the global economy is in a durable growth channel. As such, we haven't been too worried when growth slows to the bottom end of the channel. But we also don't get too excited when growth accelerates to the top end of the range.

The Brexit vote presented a special challenge, in that no country has ever left the European Union. The post-Brexit market reaction was swift and harsh. But risk assets have rallied back and surpassed levels achieved before the vote. We think this is a rational response to a development, which will take several years to finalize, and whose economic impact is likely fairly narrow.

How are current trends stacking up against our channel growth theme? The US economy looks to be regaining momentum, with the law labor markets bouncing back in June, and retail sales handily beating forecasts. European growth has been resilient this year, with steady improvement since March. But it will probably take some hit from the Brexit vote.

Data on China's capital flows shows good control over their capital accounts. And recent economic data shows better than expected industrial production and retail sales. So global growth appears to be safely within our expected channel, with US showing some improvement, Europe likely to slow modestly, and China evidencing tentative signs of stabilization.

So what does all this mean for investors? There have been many reasons to be worried about financial markets this year. But the right course has been to remain fully invested. US equities have delivered a 7% return through mid-July. Emerging market stocks are up nearly 10%. And a 60:40 portfolio of stocks and bonds is up over 5.5%.

Now, the rise in equity valuations has been supported by another leg down in global interest rates. But the new worry on investor minds is the rise of populist politics, with the risk being that this could upset our global growth theme. And the next test to the populist movement will be the Italian constitutional referendum in October, the US election in November, and the German and French elections in 2017.

So far this year, we've made several changes in our tactical asset allocation, including paring back our overweight in high yield bonds, and eliminating our under weights in emerging market equities and natural resources. This has moved us closer to our strategic norms and leaves us overweight US equities and high yield bonds. We think this positioning will allow us to benefit from continued market upside, while avoiding undue risks in the environment we foresee over the next year.