Northern Trust | Jim McDonald: Filtering Out Political Noise

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In our February asset allocation discussions, we reiterated our overweight to risk assets, as we see the global economy continuing to improve in 2017, while the political environment is expected to be a manageable risk. So far this year, markets are filtering out the political noise and focusing on the positive economic outlook.

There were three big spikes in volatility in 2016. In the first quarter, around concerns about a Chinese hard landing, in the second quarter tied to Brexit, and in the fourth quarter after the US election. Most of the political focus has been on the new US administration, where many campaign pledges have found their way into executive actions or communications.

Markets to date have been relatively calm, as investors expect the checks and balances inherent in the US government to moderate eventual outcomes. The focus will increasingly turn to Europe, with national elections in France and Germany being top of mind. While we don't expect these elections to lead to a significant upturn in investor risk aversion, we'll be closely monitoring the developments.

Global growth should show some acceleration in 2017, led by the United States. Global growth has been remarkably durable in recent years, and has shown the lowest volatility in nearly 50 years. All the major regions have started the new year with solid levels of industrial activity, and dollar strength has contributed to improving export conditions in Europe and Asia. While there is some policy execution risk in the US surrounding new tax policy and infrastructure spending, there is also a boost to animal spirits coming from the promise of deregulation across various industries.

While we do expect a positive surprise from US growth, there are natural limits to how much US growth can accelerate. For example, current deficit levels and the advanced recovery in the labor markets may provide some camp on further improvement. We do expect growth in developed Europe and Asia to also exceed expectations, supporting risk-taking globally.

So what does all this mean for investors? We think the risk of anti-growth populist policies has risen, and joins an unexpected inflation rise as our key risk cases. While we think the overall economic risks tied to the new US administration are relatively low, we do consider the negative economic impact that certain policies could generate. For example, new immigration policy could have a negative impact on growth, depending on its design, while the threats of tariffs to maintain US manufacturing could impair corporate profitability.

The risks of inflation and populist prioritization are just risk cases at this time. We think investors need to focus on tuning out the noise over the next year, and stay overweight equities, high-yield bonds, and natural resources funded by an underweight to investment-grade bonds.

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