Northern Trust | Jim McDonald: Growth and Inflation Cooling Off

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We expect growth to moderate over the next year along with inflation anxieties. This should put a cap on interest rates, and we recommend reallocating some cash to bonds in this environment. We expect a positive impact from the US fiscal boost to fade in 2019, which will lead to some cooling of US growth. In addition, the rate of growth in the Chinese economy should continue to moderate as the government focuses more on the quality rather than the pace of growth.

European growth should continue to benefit from solid domestic consumption, while export growth could soften some as China slows. While we don't expect growth to fall out of bed, we think the potential of an upside breakout is low. In this environment, corporate profit growth should return to a more normal level of 5% to 7%.

Recent inflation reports from China to Europe to the United States indicate that inflation continues to remain more stuck than many forecasters have predicted. Core consumer prices in China are rising at just 2% annually, while European core consumer prices are rising at an annual pace of just 0.7%. US core inflation has seen some tick up in recent months as lower prices from the year earlier have fallen out of the data. However, the still left core consumer prices in the US stuck at an increase of 2.1%. The lack of a meaningful break out in price inflation should limit how far central bankers are able to reduce monetary accommodation over the next year.

We think the moderating growth outlook caps the upside risk to interest rates. And thus, we recommend reallocating some cash to investment grade bonds. The US 10-year treasury has jumped from 2.4% to 3% so far this year, and this has been a headwind to equities. With our view that the rise in loan rates is behind us, we believe this headwind will dissipate. We have also started to see the benefits of a pickup in corporate share buybacks aided by new US tax policy. All in all, we still see a constructive outlook for risk-taking in the year ahead and would take advantage of the recent increase in interest rates by reinvesting some cash in the bond market.

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