Northern Trust | Shifting to Neutral

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We've moved our tactical risk positioning back to neutral after years of being overweight risk. This comes about as our concerns grow that the Fed will not stop at their neutral position, eventually raising rates to a level that may restrict both risk appetites and economic growth.

We think the risk of the Fed over tightening policy continues to grow, leading to increased volatility in markets over the next year. Recent commentary from Fed Chair Powell that their are policy is, a long way from neutral, highlights this risk, as does commentary from the Chicago Fed president that policy may need to go 50 basis points beyond neutral.

The key variables to watch are the growth and inflation backdrop over the next year. If our view of slowing growth and contained inflation come to pass, then the Fed is at risk of overly tightening policy. Should growth in 2019 prove more robust, then the Fed may successfully execute their plan.

Emerging markets are being pressured by both tightening US monetary policy and geopolitical risks. Should the Fed be able to raise rates at their desired pace, a rising dollar will be a continuing headwind for emerging markets.

The new US, Mexico, Canada trade agreement restricts the ability to execute standalone trade agreements with non-market economies, a provision that seems squarely aimed at China. We expect the tensions between the US and China to continue over the intermediate term, as neither country will want to be seen as backing down, and they both view the stakes as being long term in nature.

We've been steadily reducing risk in our tactical asset allocation policy. And this month, we reduced our allocations to US and emerging market equities with the proceeds going to investment grade bonds. US equities have been supported by strong earnings growth, which will moderate in 2019 due to slowing growth and some margin pressure from increasing input costs.

We think emerging market equities will lag developed markets over the next year due to concerns over Fed policy, trade policy uncertainties, and China's efforts to stabilize growth. We're now at a neutral risk position favoring high yield bonds, which we think offer an attractive return potential at lower risk than equities.