Northern Trust | Earnings Growth and Low Rates Back Risk

Global stock markets have advanced rapidly this year as fears of recession recede, and central banks have mollified investors. We made no changes in our tactical asset allocation recommendations this month, as no fresh opportunities presented themselves, and we're comfortable with our moderate overweight to risk.

After a slow start to the year, earnings growth should improve as the year progresses. Some analysts are worried about the expected decline in US earnings in the first quarter of this year, but the stock market isn't too concerned as the magnitude of the drop is small. Lower commodities prices are leading to falling earnings, and the energy and materials sectors, and product cycles have hurt technology earnings.

Overall, earnings growth should improve as the year progresses, and we expect global earnings to grow 4% to 5% over the next year. The market will only become concerned about falling earnings if it is signaling an economy rolling over into recession, which isn't our expectation.

Equity valuations declined significantly in the fourth quarter of last year, setting us up for the rebound we have enjoyed so far this year. Another supporting factor has been the significant decline in interest rates. In fact, the 10 year treasury has rallied with the yield at 2.5% currently from 3.25% in early November.

We think too many investors think of equity valuations in an absolute sense, when lower interest rates demonstrably support higher valuations. Not only are future earnings more valuable in a lower interest rate environment, but the future return potential from alternatives like fixed income investments is also lower.

We expect growth across all regions, including Europe, to beat modest investor expectations over the next year. And with central banks increasingly focused on trying to increase inflation, monetary policy should remain supportive. A realized increase in inflation is one risk case we are monitoring while a political miscalculation in an area such as trade is the other main concern.

All in all, we remain confident in our recommended moderate overweight to risk assets favoring US equities, global real estate, and high yield bonds.