Northern Trust | Interest Rate Relief Valve

[MUSIC PLAYING]

Global growth obstacles are rising as trade tensions build, but we expect lower US interest rates to help soften the blow. Leading economic indicators have weakened as the US has started aggressively using tariffs as an economic and political tool. We have seen a marked deterioration over the last month in the negotiations between the US and China, further increasing the headwinds to growth.

At the beginning of the year, we felt investors had become too pessimistic about growth and markets were positioned to surprise to the upside. The recent increase in trade tensions along with the rally in markets has shifted the outlook to a more balanced one. We think the weaker growth outlook over the next year will be cushioned by three cuts in the fed fund rate by year end.

The bond market has been well ahead of the Fed in anticipating the need for lower interest rates. Interest-rate-sensitive sectors were hurt by rising rates in 2018 and have rallied in 2019 as a result of lower rates. In the housing sector this year, mortgage applications and refinancings have recently spiked, and home-building stocks have rallied more than 25%.

Lower inflation is also supporting the case for lower interest rates as core inflation in the major economies is barely above 1 and 1/2% and is trending lower. Financial markets, meanwhile, have lowered their expectations for inflation over the next 10 years from nearly 2.2% last year to 1.7% today. We think this softening inflation outlook will provide the necessary cover for the Fed to reverse course and cut rates meaningfully this year.

We expect lower interest rates to offset the softer growth environment, allowing risk assets to remain attractive. In our global tactical asset allocation model this month, we reduced our recommended exposure to high-yield bonds and emerging-market equities, reinvesting the proceeds into global-listed infrastructure and investment-grade bonds. These changes should better position the portfolio for the low-interest-rate environment and also somewhat reduce our exposure to trade risks.

Our risk cases continue to highlight the disruptive potential of a return of inflation along with the upside risk case of a trade armistice being reached between the US and China. This upside risk case could actually improve the outlook for global growth and investor risk appetite.

Read more about our current investment strategy in our perspective newsletter later this week.