

LESS REWARD, MORE RISK

Risk assets have rallied strongly over the last seven weeks as policy actions have been forceful, COVID-19 cases have peaked in important areas and investors have been willing to look past the short-term economic carnage. Economic forecasts remain unusually uncertain, as does the outlook for corporate earnings. Using consensus forward earnings, equity market valuations worldwide have rebounded significantly and are at or above five-year highs (as shown below). We also show valuations based on our 2021 earnings forecast, which assumes some level of economic normalization. On this metric, the U.S. equity market is selling at 18 times a relatively uncertain earnings number. The market assumption may be correct, but we believe the rally has reduced the margin for error and we have consequently reduced the recommended tactical risk in our global policy model this month.

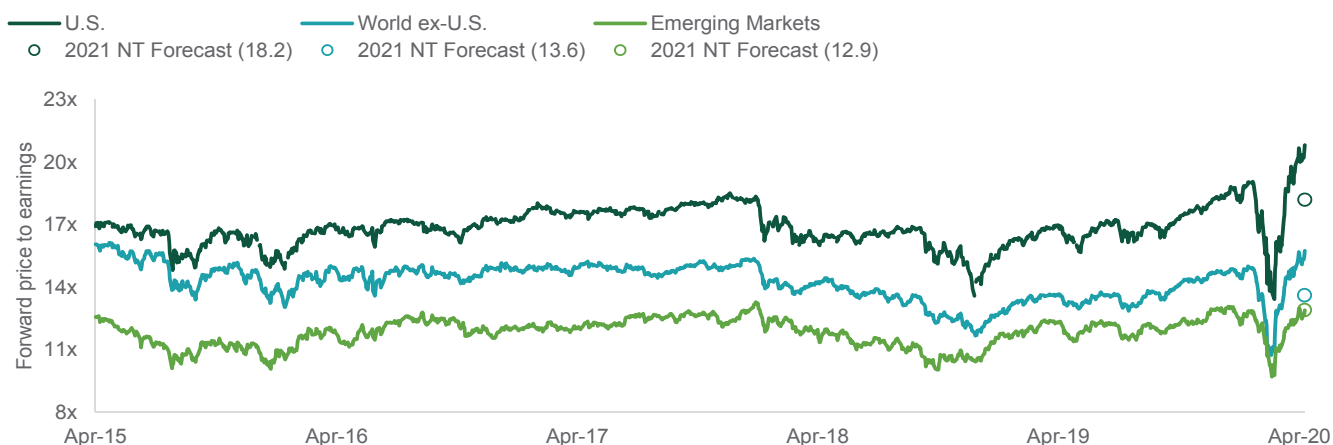
The outlook for corporate earnings and risk appetite will be significantly influenced by the pace of COVID-19 over the next six-to-twelve months. Most major economies are starting to ease social distancing restrictions, but are doing so without significant advances in treatment or vaccine, and without showing the level of progress that health officials believe is necessary to prevent a second wave. Compounding the uncertainty are early reports that

children, previously thought to be relatively safe from the virus, may be at risk of related health complications. For the economy to return toward full activity, citizens will need to be confident that their health is safe, which will likely require either a vaccine or a dying out of the virus after this season. We continue to think broad vaccine availability is likely more than a year out; the vaccine not only needs to be developed, but also robustly tested for safety and manufactured at a scale likely never seen before.

The combination of the significant rally in risk assets and continued uncertainty in the economic outlook led us to reduce the recommended proportion of risk assets (a combination of global real estate, high yield and U.S. equities) in our tactical global policy model by 7%. We have directed the proceeds to risk-control assets (investment grade bonds, inflation-protected bonds and cash). This change puts us in a neutral risk position, as we balance the potential for both positive and negative surprises over the next year. Our risk cases include insufficient policy support in the wake of a resurgence of COVID-19 cases and the potential for a fiscal spending-led jump in inflation that would undermine current valuations.

DISCOUNTING A RECOVERY

The strong market rally has significantly boosted valuations.



Source: Northern Trust Global Asset Allocation, MSCI, Bloomberg. Forward price to earnings ratio calculated using Bloomberg 12-month earnings per share estimates and prices as of 5/8/2020. NT forecasts use 2021 earnings per share estimates as of 5/4/2020. Indices used: S&P 500, MSCI World ex-U.S., MSCI EM.

BASE CASE

Pandemic vs. Policy

Quick and forceful monetary and fiscal policy action has (at least temporarily) put a floor under equity markets and has helped restore liquidity to financial markets more broadly. Going forward, the focus will once again shift to the pandemic, specifically the speed at which the global economy can start to reopen.

Structural Monetary Accommodation

Major central banks globally will remain accommodative for the foreseeable future, with near-zero prospects for any rate hikes. Central banks will try to help offset virus-driven economic and financial market pressures, but have limited means to do so and will need to coordinate with fiscal policymakers.

RISK CASES

A Policy Bridge Too Short

A second wave of coronavirus cases or slow removal of social distancing precautions elongates the economic malaise beyond what policy can counter, leading to a protracted economic recession.

Structural Inflation Shift

Unprecedented levels of fiscal stimulus globally eventually overwhelm structural deflationary pressures, leading to inflation and higher interest rates – undercutting key supports for risk assets.

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INVESTMENT PROCESS

The asset allocation process develops both long-term (strategic) and shorter-term (tactical) recommendations. The strategic returns are developed using five-year risk, return and correlation projections to generate the highest expected return for a given level of risk. The objective of the tactical recommendations is to highlight investment opportunities during the next 12 months where the Investment Policy Committee sees either increased opportunity or risk.

The asset allocation recommendations are developed through the Tactical Asset Allocation, Capital Markets Assumptions and Investment Policy Committees.

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