OCTOBER 2023

ALL ABOUT RATES

Global markets were weak over the past month, with both stocks and bonds posting negative returns. The catalyst was principally the material rise in interest rates over the course of the month – driving losses in fixed income and pressuring equity valuations. Until recently, the increase in long-term rates off of the regional banking crisis-induced lows in March had been largely driven by increased odds of a "soft landing" and the more hawkish reaction function from the Federal Reserve. The most recent increase, however, shows less fundamental support – meaning it has not been driven by changing expectations for inflation or the Fed. Instead, we believe the required term premium has increased – given economic uncertainty and interest rate volatility – perhaps exacerbated by elevated Treasury supply amid a shift toward more price-sensitive demand as the Fed continues its quantitative tightening. Given the slight divorce from fundamentals, we would anticipate some interest rate rollover in the months ahead.

We believe investors are somewhat complacent about accumulating economic headwinds. Yes, U.S. labor markets were strong and consumer spending has remained durable – but we see headwinds going forward in the capacity to spend from depleted excess savings, as credit card balances move higher and student loan payments resume. Higher rates will also impact the pace of activity in the economy. Several Fed officials have noted the tighter financial conditions from the move higher in interest rates – a clear sign they wish to telegraph to the markets that the out-the-curve rate increase has finished the Fed's rate hiking campaign for them.

We have a new risk case this month relating to the Middle East conflict. Beyond the human tragedy unfolding, we acknowledge the risk of escalation in the region and what it could mean for oil prices. Oil supplies out of the Persian Gulf could be significantly disrupted should Iran be brought into the fight. We (and we believe central banks) will be less concerned with the inflationary impact of the resulting rise in oil prices – and more worried over the impact on growth. Demand destruction from materially higher oil prices would negatively impact global growth.

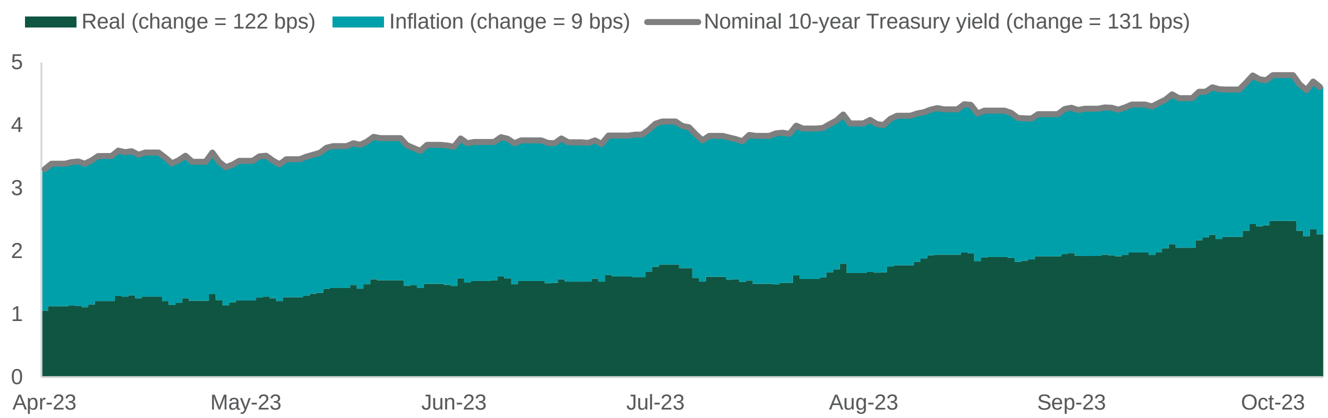
We made no changes to our Global Policy Model this month, maintaining our relatively modest underweight to risk. Equity valuations became more attractive the past month, but we continue to prefer high yield bonds to developed market equities, natural resources to emerging market equities, and maintain an overweight to cash.

- Chris Shipley, Chief Investment Strategist of North America

A REAL RISE

Rising real yields have driven the bulk of the increase in longer-term government bond yields this year.

RECENT RISE IN U.S. 10-YEAR TREASURY YIELD (%)



Source: Northern Trust Asset Management, Bloomberg. Data from 4/6/2023 through 10/13/2023. Inflation component (breakeven yield) is measured by the 10-year breakeven rate. Real component is the nominal yield minus the inflation component.

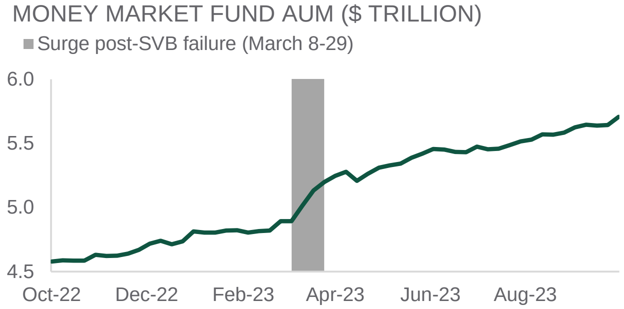
Interest Rates

The ascent of yields on the long end of the U.S. Treasury curve has deservedly captured a lot of attention in recent weeks. Meanwhile, yields in the money markets have remained relatively stable. In addition to relative stability, nominal yields on U.S. Treasuries maturing in one year or less remain the highest on the entire yield curve – even after the recent spike in yields on the long end. As we wrote about in April, this dynamic has presented front-end investors with yield opportunities not seen for well over a decade, and Money Market Mutual Funds (MMFs) have continued to rise to the occasion.

In the weeks following the failure of Silicon Valley Bank in March (March 8-29), MMFs surged by over $300 billion to $5.2 trillion as measured by ICI – a record high at the time. Since then, MMFs have gathered even more assets, setting several new all-time highs along the way. They total a whopping $5.7 trillion as of October 4th, 2023 (see chart). The combination of yields over 5% and ability to purchase or redeem shares the same day has continued to attract investors into MMFs. Considering the recent uptick in uncertainty around geopolitical developments, we may continue to see MMF AUM drift higher yet into year end.

THE TRILLION DOLLAR CLUB

Money market funds have gained $1 trillion the past year.



Source: Northern Trust Asset Management, ICI. AUM = assets under management. All money market fund total net assets from ICI. SVB = Silicon Valley Bank. Data from 10/5/2022 through 10/4/2023.

- An inverted yield curve and high liquidity have driven a massive increase in money market investments.
- Investor interest may remain elevated given a higher-for-longer Fed and broader financial market risks.
- We remain overweight Cash and neutral Investment Grade Fixed Income given an inverted yield curve and our expectation that short-end rates will stay near 5%.

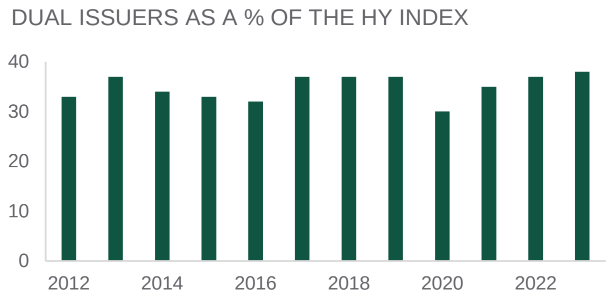
Credit Markets

With the recent uptick in rate volatility and renewed concerns around ongoing rate hikes, issuers' capital structures and the effects on fundamentals from a higher-for-longer rate scenario have come back into focus for investors. With rates and inflation being suppressed for more than a decade following the Global Financial Crisis, companies took advantage of the cheap funding cost by issuing floating rate debt. However, high yield issuers with exposure to rising interest costs via loans are especially exposed with rates on the rise – leaving dual issuers (issuers with both bonds and loans outstanding) worse off from a coverage standpoint.

The interest coverage ratio for dual issuers is 4x compared to 5.2x for bond-only issuers. Dual issuers make up slightly more than a third of the par amount outstanding in the high yield universe, as seen in the nearby chart. High yield issuers with loans in the capital structure tend to be larger companies, which, if worsened fundamentally could put pressure on the broader high yield index. With active management, opportunities may exist in investing in businesses with diversified revenue streams with bond-only capital structures given the current interest rate environment.

CAP STRUCTURE ANATOMY

Dual issuers make up over one-third of high yield.



Source: Northern Trust Asset Management, Bloomberg, Barclays Research. Percentage of index based on par value. HY = high yield. Annual data beginning in 2012; 2023 as of 7/31/2023.

- High yield issuers with both bonds and loans outstanding ("dual issuers") are over 1/3 of the index.
- These issuers – with worse coverage ratios in aggregate – may come under relatively higher pressure from rising interest rates versus bond-only issuers.
- We maintain a bias for default (credit) over market (equity) risk in the Global Policy Model while seeking credit selection opportunities from higher interest rates.

Equities

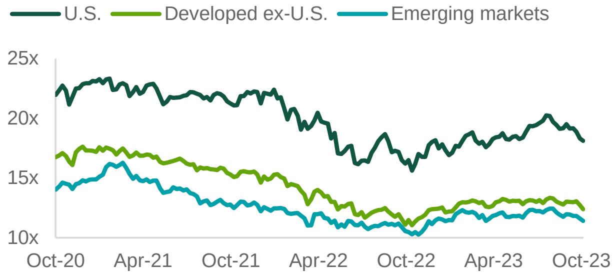
The equity market decline that started two months ago picked up speed this month, with global equities falling by 3%. A rapid rise in long-dated real yields in the U.S. and Europe and the tighter financial conditions they portend added to investor concern that the growth outlook is deteriorating, especially in Europe and China. Some of the complacency we have been writing about was priced out given higher real yields can put downward pressure on economic activity. The differences between regional equity performance were fairly small. The U.S. continued to modestly outperform Europe, Japan and emerging markets, driven by continued outperformance of growth relative to value. An important caveat, however, is that almost all of that outperformance has been driven by just two companies: Amazon (AMZN) and Tesla (TSLA).

Looking forward, the decline in equity markets has not been sufficient to remove our concern regarding market complacency. We continue to worry that the U.S. economy will struggle to pull off a soft landing and see further weakness in Europe and China. As a result, we remain positioned for incremental disappointment on both the economic and earnings front, with underweights to all three major equity regions (3% each).

RATES MATTER

The rate rise has started to catch up to equity valuations.

FORWARD PRICE TO EARNINGS RATIO



Source: Northern Trust Asset Management, Refinitiv. Data from 10/7/2020 through 10/11/2023.

- Equities declined on the back of a rapid rise in long-dated real yields – with valuations leading the losses.
- The valuation reprieve better aligns with our outlook, but it may not yet have fully run its course.
- We remain underweight developed and emerging market equities given our belief that markets are pricing in too optimistic of an economic outcome.

Real Assets

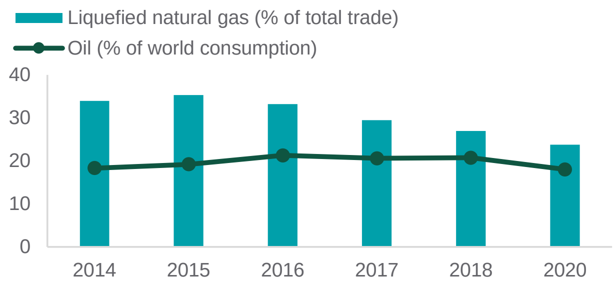
The horrific terrorist attacks on Israel are a violent reminder of the heightened geopolitical tensions that exist today. Oil prices spiked higher in response – not because of any resulting change in supply/demand dynamics, but because of what could happen should the war in Israel broaden. Specifically – should Iran become involved – it is possible that the Iranian regime would block the free flow of oil tankers through the Strait of Hormuz. Such a development could remove nearly 20% of the world's oil supply from global markets – as well as around 25% of liquified natural gas (see nearby chart).

To be clear, this is very much a risk case – not a base case – at this point. But it's a risk case that could have big ramifications with oil supplies tight (thanks to reduced investment over the past few years) and reserves low (notably the U.S. Strategic Petroleum Reserve, which currently sits at only 350 million barrels – as compared to the 650 million barrels held prior to recent drawdowns). We came into this already tactically overweight natural resources, given favorable fundamentals (the lack of investment leading to tight supplies mentioned above) and attractive valuations. The increased geopolitical risk only further supports our overweight positioning.

RISK OF DISRUPTION

The Strait of Hormuz is a key chokepoint for oil and gas.

STRAIT OF HORMUZ FLOWS



Source: Northern Trust Asset Management, BCA Research, BP, EIA. Data from 2014 through 2020.

- Oil prices spiked in response to the Israel-Hamas conflict given risk that the war broadens to other areas.
- While not our base case, there is risk of a major supply shock that drives up commodity prices and weighs on the global economic growth outlook.
- The newly-introduced geopolitical conflict adds to support for our tactical natural resources overweight.

BASE CASE EXPECTATIONS

Complacency Concerns

While off the equity highs, investors are still taking too much comfort in the increased possibility of an economic soft landing (lower inflation without recession), not appreciating long(er) monetary policy lags and geopolitical risks. TAA expects flattish growth with downside risk, endorsing credit markets over equities.

A Steady Fed

Recent Fed rhetoric suggests the rate hike cycle that started in early 2022 may have finished – prompting a favorable narrative around an upcoming rate cut cycle. Market expectations call for rate cuts beginning mid-2024. We think investors seeking rate cuts without material economic weakness will be disappointed as the Fed shows resolve.

RISK CASE SCENARIOS

Oil Ends the Expansion

The war in Israel expands into a broader Middle East conflict that draws in Iran, putting global oil supply at risk. Central banks would look through the near-term inflation spike anticipating the economic fallout.

Sticking the Landing

Market expectations and the Fed's own forecasts are calling for rate cuts in 2024. Should those cuts happen amidst an orderly disinflation process and economic durability, TAA is too underweight risk.

GLOBAL POLICY MODEL

	RISK CONTROL	RISK ASSETS									
	FIXED INCOME				EQUITIES			REAL ASSETS			
Strategic Allocation and Tactical Over/Underweights	Cash	Inv. Grade	Infl. Linked	High Yield	U.S.	Dev. Ex-U.S.	Emerg. Markets	GLI	GRE	NR	Gold
Strategic Asset Allocation	2	30	9	5	28	13	5	2	2	4	0
Tactical Asset Allocation	4	30	7	11	25	10	2	2	2	7	0
Over/Underweight	**2**	**0**	**-2**	**6**	**-3**	**-3**	**-3**	**0**	**0**	**3**	**0**

Source: Northern Trust Capital Market Assumptions Working Group, Investment Policy Committee. Strategic allocation is based on capital market return, risk and correlation assumptions developed annually; most recent model released 8/9/2023.The model cannot account for the impact that economic, market and other factors may have on the implementation and ongoing management of an actual investment strategy. Asset allocation does not guarantee a profit or protection against a loss in declining markets.