AUGUST 2023

COMPLACENCY CONCERNS

The past month was marked by a broadening of equity market performance amidst a rise in interest rates. Now north of 4%, the 10-year U.S. Treasury yield is approaching the highs from last October – leading growth stocks to underperform. Though off the highs achieved at month end, global equity markets remained comfortably in positive territory over the past 30 days, led by non-U.S. equities. Positive sentiment in the U.S. was aided by data supportive of the "soft landing" scenario of durable growth and lower inflation. Core inflation has been more stubborn than headline, however, falling only slightly to 4.7% in July (4.8% in June). While far from Fed targets, the shelter component is poised to shift lower, supporting further improvement. The market may be right that the Fed is done hiking rates, but we see the risk of the Fed choosing to move rates somewhat higher as more likely than the Fed having the opportunity to lower rates.

Market optimism is visible not only in valuations of U.S. stocks, but also in earnings expectations. Consensus projections call for low double-digit earnings growth in 2024 and 2025, implying 2023 earnings are substantively below a "normalized" level. We disagree. Net margins and earnings for this year appear on track with the pre-pandemic trend – not a trough level off which to expect more rapid growth. With our view that economic growth still faces headwinds from a slowly softening consumer, plus the cumulative impact of central bank tightening on activity levels, we see earnings expectations as too high for next year, suggesting the real forward price-to-earnings multiple is actually somewhat higher.

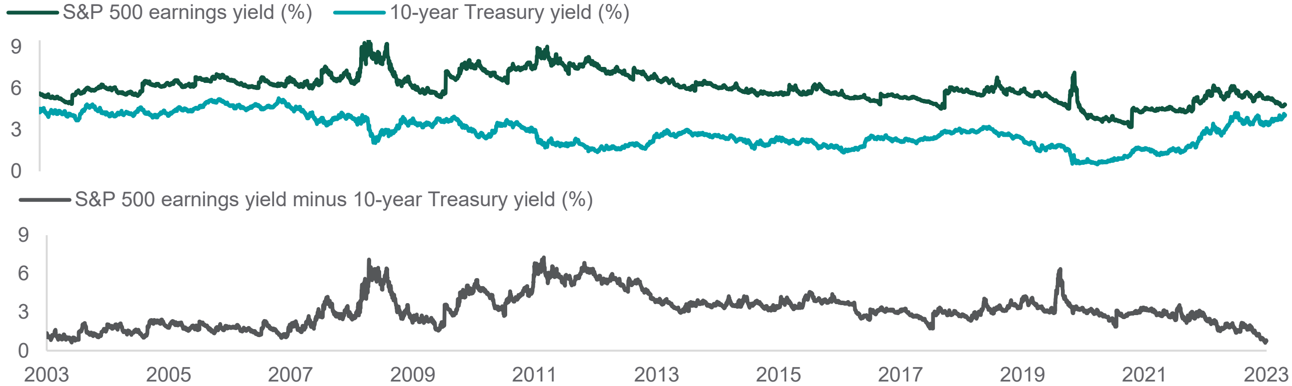
The European Central Bank's stance against inflation softened somewhat in the past month, though so too has the growth outlook in the region. China's economic data continues to worsen, prompting speculation of increased government stimulus – aiding market performance. We remain skeptical it will be of a size to alter fundamentals or sentiment.

We made modest changes to our Global Policy Model this month, reflecting in part annual changes to our Strategic Asset Allocation. We added to inflation-linked bonds as its strategic weighting increased, funded by 1% reductions to both developed ex-U.S. and emerging market equities. This takes us a bit further underweight risk, believing that risk assets have "prepaid" for a lot of good news on growth and inflation. With minimal expected gains in global equities over the next year, we prefer high yield bonds to developed market equities, and natural resources to emerging markets.

- Chris Shipley, Chief Investment Strategist – North America

THERE IS AN ALTERNATIVE

For the first time in a while, cash and longer-duration bonds offer a compelling alternative to stocks.



Source: Northern Trust Asset Management, Bloomberg. S&P 500 earnings yield is one divided by the forward price-to-earnings ratio as proxied by Bloomberg consensus. Data from 8/10/2003 through 8/10/2023. Past performance is not indicative or a guarantee of future results. Index performance returns do not reflect any management fees, transaction costs or expenses. It is not possible to invest directly in any index. Indexes are the property of their respective owners, all rights reserved.

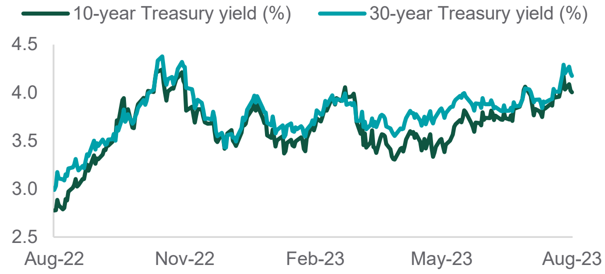
Interest Rates

While there have been a few headline events recently related to the ascent in long-term Treasury yields, the search for a single driver of the price action remains elusive. August kicked off with an announcement from Fitch downgrading U.S. sovereign debt, which came as a surprise to most market participants. Shortly thereafter, the Treasury Department announced an increase in issuance for the coming quarter and beyond. More supply of lower-rated bonds seemed to resonate as a catalyst for a selloff, but we don't think it's that straightforward.

While the timing of Fitch's downgrade was surprising, the U.S. Treasury market has evolved since S&P downgraded the U.S. in 2011, preventing meaningful forced selling. With regards to increased issuance, strategists had widely expected larger auction sizes, an expectation that was slightly exceeded. Economic growth has generally surprised to the upside, while the labor market remains robust – two fundamental drivers of long yields. Finally, some investors have chosen to publicly state that they are shorting long-dated U.S. Treasuries, headlines that may have spooked some traders. A confluence of factors likely drove the recent rise in long-end yields and we caution against putting too much weight on any single factor.

LONG-END RISE

Long-term Treasury yields moved up last month.



Source: Northern Trust Asset Management, Bloomberg. Data from 8/9/2022 through 8/9/2023. Historical trends are not predictive of future results.

- Long-term Treasury yields moved higher, with the Fitch downgrade, new Treasury issuance and resilient economic activity the top suspects driving the rise.
- We caution against putting too much weight into any single factor and think the move may be overextended.
- We are equal-weight Investment Grade Fixed Income, content with its ~5% yield at current interest rate levels.

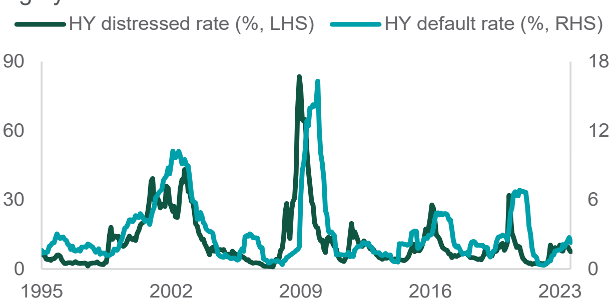
Credit Markets

High yield provided another month of solid gains in July and outperformance by CCC-rated issuers. As a result, the amount of high yield bonds trading at distressed levels has decreased for the sixth time in the last seven months to the lowest amount since May of 2022. The distressed rate is often looked upon as a forward-looking indicator for defaults because bonds begin trading to recovery value given the forward-looking nature of financial markets. The percentage of high yield bonds trading at distressed levels is currently 7.5%, compared to an average of 10% in the fourth quarter of 2019 (just before the pandemic). Based on 53 past examples, a distressed rate of 8-12% has corresponded with an average 12-month forward default rate of 2.4%. The long-term average default rate is ~3%.

As seen in the chart to the right, the divergence between the distressed rate and default rate could be an indication of bottoming in the high yield market. However, the most recent Senior Loan Officer Survey (SLOOS) added support to the idea that recession risks remain elevated. The SLOOS data is also seen as a forward indicator of future defaults. Nonetheless, balance sheets for U.S. high yield issuers are in a strong state heading into what is likely to be a more challenging fundamental landscape.

AN OXYMORON

High yield boasts an untroubled distressed rate.



Source: Northern Trust Asset Management, JP Morgan. Default rate includes distressed exchanges. HY = high yield. Distressed rate = bonds trading greater than 1000 basis points (bps) of spread (spread-to-worst). LHS = left-hand side. RHS = right-hand side. Data from 1/1/1995 through 7/1/2023. Historical trends are not predictive of future results.

- The distressed rate – often viewed as a predictor of future defaults – sits below pre-pandemic levels, while other predictors (bank loan data) are less supportive.
- We expect a more challenging fundamental landscape to push up default rates, but in a containable manner.
- We are overweight high yield as corporate revenue growth should continue to support debt repayment.

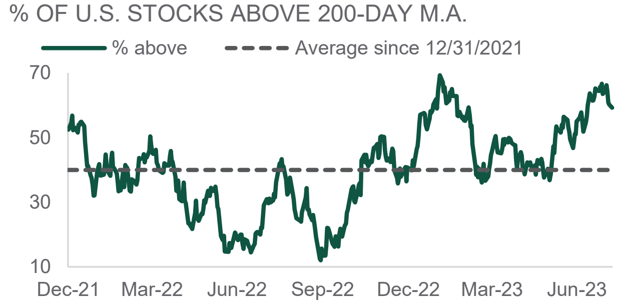
Equities

The global equity rally continued over the past month, with the U.S. and Europe advancing ~3% and emerging market equities gaining even more (~4%) with support from incremental China policy stimulus. Proxied by the percent of U.S. stocks trading above their 200-day moving average, equity gains have notably broadened since June (see chart). Better-than-expected economic growth and lower inflation prints have encouraged investors to lean into some of the lesser expensive areas of the market that lagged during the rally earlier this year. What was initially a rally led by AI-infused mega-cap tech gains in the U.S. has broadened out to the rest of the market, with the end result being rather persistent gains across most equity markets.

At current levels we believe that the balance of risks is tilted to the downside given elevated U.S. valuations, uninspiring – albeit not necessarily recessionary – global economic growth and lingering inflation keeping pressure on central banks. An upside case can be made under soft-landing scenarios and/or continued excitement surrounding AI, however, we assign a lower probability to such outcomes and believe that downside risks outweigh the potential of any further capital appreciation. We remain underweight all three major equity regions (3% each).

BETTER BREADTH

The equity rally has broadened out to more stocks.



Source: Northern Trust Asset Management, Bloomberg. M.A. is moving average. U.S. stocks proxied by those listed on the New York Stock Exchange. Data from 12/31/2021 through 8/7/2023. Historical trends are not predictive of future results.

- Market breadth has improved from earlier in the year when U.S. gains were led by only seven stocks.
- With many of this year's laggards now caught up and rich U.S. valuations, risks are tilted to the downside.
- We are underweight U.S., developed ex-U.S. and emerging market equities 3% each, believing that investors are too complacent on the economic outlook.

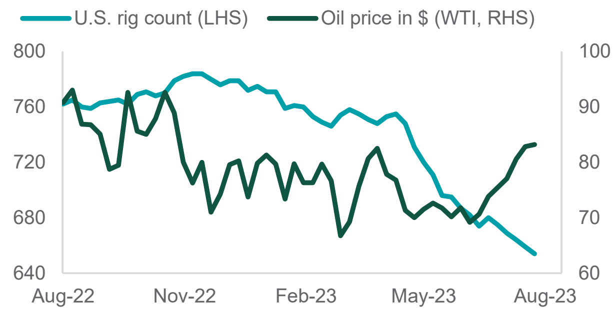
Real Assets

Any time oil prices show a sustained upward move, investors quickly look at the supply response. A quick way to do so is to look at the U.S. rig count – the number of oil and gas rigs actively deployed to drill new wells. In the go-go years, when fracking was in its infancy, higher oil prices coming out the Global Financial Crisis spurred increased capital expenditures and higher rig counts. In the post-pandemic era, new spending is not so automatic. More recent oil price increases have received a tepid response – with the most recent oil price increase (from ~$67/barrel in late June to ~$83 today) receiving no response at all. In fact, rig counts have continued to fall (see nearby chart).

Why is this? It could be that new rig deployment is simply delayed – that the chart will soon show increased activity. Perhaps. But a number of other factors are keeping a lid on things. First (as we've discussed before), the industry has reined in spending, with investors less concerned over production and more keen on profitability, especially as the economy flirts with recession. This, combined with more expensive wells from marginal (often private) producers and increased labor and regulatory costs, is a recipe for continued commodity supply constraints. This should keep prices high – and us overweight natural resources broadly.

SUPPLY INELASTICITY

Higher oil prices have not spurred more rigs to drill.



Source: Northern Trust Asset Management, Bloomberg, Baker Hughes U.S. oil and gas rotary rig count data. Crude oil proxied by the West Texas Intermediate (WTI) futures contract listed on the New York Mercantile Exchange. LHS = left-hand side. RHS = right-hand side. Data from 8/19/2022 through 8/11/2023. Historical trends are not predictive of future results.

- The U.S. supply response – proxied by the change in U.S. rig count – to higher oil prices has been muted.
- New rig deployment could be delayed, but we think it's likely that structural forces limiting supply are at play.
- Our expectation that commodity supply constraints will continue to support prices is a key reason we remain overweight natural resources.

BASE CASE EXPECTATIONS

Complacency Concerns

Investors are taking too much comfort in the increased possibility of an economic soft landing (inflation returns to target without recession), not appreciating how fast long(er) monetary policy lags could materialize. TAA views the “best case” to be flat-to-modestly positive economic growth, which endorses high yield over equities.

Don’t Count on Cuts

Despite growing expectations for a continued economic expansion (with recession calls pushed out or even removed), Fed funds futures are calling for 1.5% in cumulative rate cuts by January 2025. TAA finds this incongruent, and expects the Fed to plateau at current policy levels (with a greater probability of rate hikes than cuts).

RISK CASE SCENARIOS

Continued Bull Run

AI is “real” and represents a new round of transformational technology that allows the economy to avoid recession and equity markets (especially in the U.S.) to continue the recent run, hurting tactical performance.

Labor Market Durability

Persistent labor market/wage pressures lead to more stubborn core inflation, necessitating an unexpected monetary policy response (more Fed hikes) and exposing TAA for not being sufficiently underweight risk.

GLOBAL POLICY MODEL

Strategic Allocation and Tactical Over/Underweights	RISK CONTROL			RISK ASSETS							
	FIXED INCOME				EQUITIES			REAL ASSETS			
	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.