JUNE 2023

FROM CONCERN TO CHURN?

U.S. equities performed well over the past month as the resolution of the debt ceiling and further passage of time without additional regional bank issues reduced the level of concern on display in the market, including a drop in the equity market "fear index" (VIX) to pre-pandemic levels. Market leadership continues to be very narrow, however, with the seven largest stocks in the S&P 500 accounting for more than all of the year-to-date gains. The question for investors is whether the rest of the U.S. equity market will start to participate – leading to further upside for stocks broadly – or the U.S. equity market will merely "churn" – with profit-taking in big tech (and tech-adjacent companies) used to fund a broadening of performance, capping overall return potential at the index level.

The removal of the "left-tail" risk has also repriced interest rates. Most notably, the front end of the yield curve has moved markedly higher as investors backed out odds of material rate cuts. While we believe the Fed is at/near a peak rate for this cycle, the continued durability of the labor market and sticky core inflation should keep rates elevated into next year. And, with equity valuations above long-term fair value (on earnings that do not yet seem to be factoring in recession), we see limited equity market return upside in the base case.

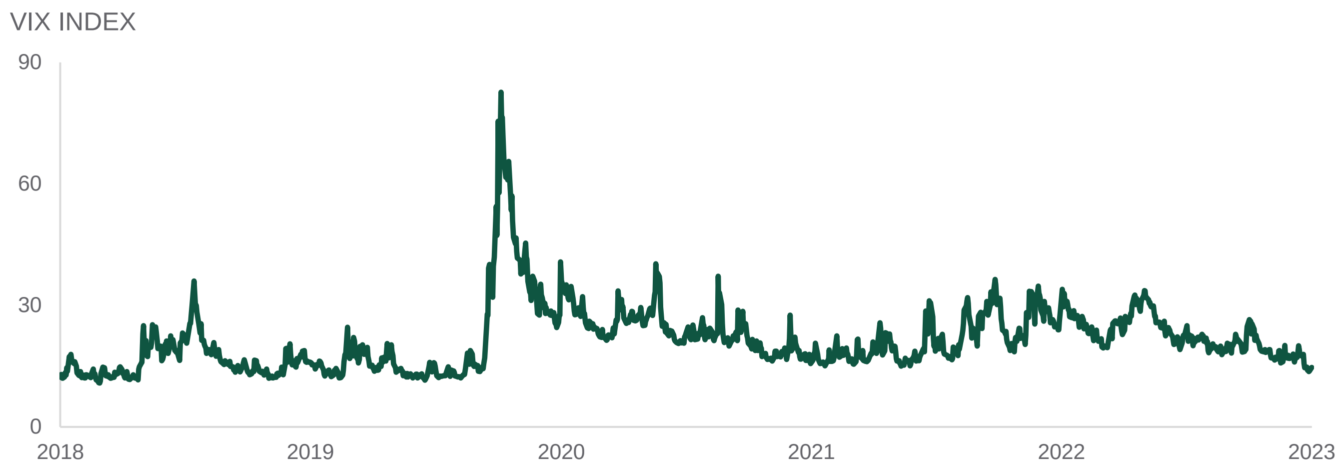
The outlook for Europe has worsened somewhat. Recessionary conditions are approaching, but the European Central Bank (ECB) has yet to shift from their path of continuing to increase interest rates due to sticky inflation. This increases the odds of a policy mistake in Europe, where monetary policy will be tightened beyond the point necessary, instigating additional economic weakness. Meanwhile, China continues to display a very sluggish recovery – causing some speculation that the government will have to increase stimulus.

With interest rates moving toward the high end of our expected range, we narrowed the size of our underweight to investment grade bonds. This was funded by a reduction in developed ex-U.S. equities, reflecting the accumulating headwinds in Europe. As such, we are now underweight equities across all three major regions. We have been encouraged by more durable fundamentals in the U.S. – but believe valuations are too elevated with the global economy approaching stall speed. We maintain our overweight positions in high yield bonds and natural resources – alongside a small overweight to cash.

- Chris Shipley, Chief Investment Strategist – North America

REDUCED "FEAR"

The VIX Index – a gauge of equity market "fear" – declined to pre-pandemic levels over the past month.



Source: Northern Trust Asset Management, Bloomberg. Data for the CBOE Volatility Index (VIX) from 6/12/2018 through 6/12/2023.

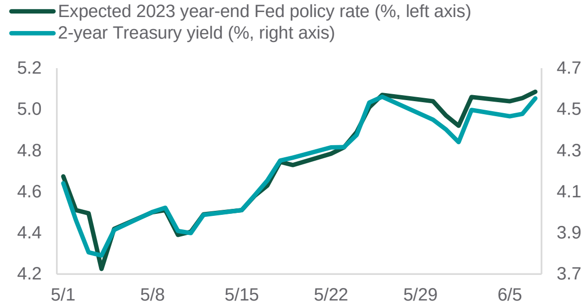
Interest Rates

The resolution of the debt ceiling was a relief for the U.S. Treasury market, but this was not the only driver of recent price action on the front end in our view. Yields on U.S. Treasuries maturing in two years have risen over 80 basis points (bps) from trough to peak in the past five weeks. Concurrently, Fed fund futures for July are now 25 bps higher than they were at the beginning of May, while overnight rates at the end of the year are now only expected to fall 25 bps from their peak as opposed to the more than 65 bps expected at the beginning of May.

Concerns over the stability of the banking sector waned over the period, while economic data releases generally surprised to the upside. More specifically, non-farm payroll growth was stronger than expected in both reports released during the period, while core inflation increased. Reduced fear around spillovers from the banking sector to the real economy and a robust labor market keep the Fed's focus on inflation and markets repriced accordingly. All of these factors resulted in an active period for the front end of the yield curve, with fewer expected rate cuts this year consistent with our long-held views for an extended pause by the Fed once they reach their peak policy rate.

RATE RESET

Interest rates and Fed expectations have increased.



Source: Northern Trust Asset Management, Bloomberg. Expected 2023 year-end Fed policy rate implied by Fed fund futures contracts. Data from 5/1/2023 through 6/7/2023.

- Interest rates repriced higher on the back of a debt ceiling agreement and banking sector stability.
- We are slightly less negative on term (interest rate) risk following the recent upward moves.
- With interest rates near the top end of our forecasted range, we reduced our tactical underweight to Investment Grade Fixed Income (from 6% to 4%).

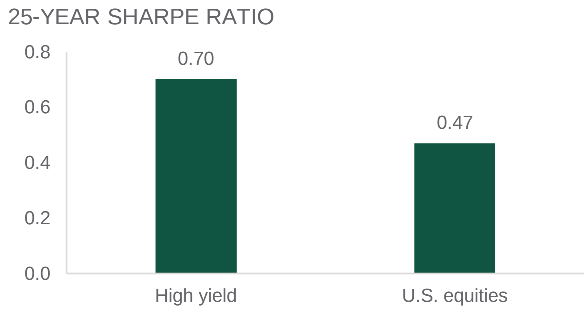
Credit Markets

Despite elevated uncertainty from the bank sector, debt ceiling, Fed policy and the economy, the high yield asset class has performed well in 2023. As of 5/31/2023, high yield has returned 3.7% versus the S&P 500's 9.6% gain this year. However, investors should think about returns on a risk-adjusted basis. One metric to measure this is Sharpe ratios. Sharpe ratios are annualized returns versus volatility, or more simply the return per unit of risk. The focus for long-term investors should be getting fairly compensated for the risk they are taking.

As seen in the nearby chart, over a 25-year horizon the high yield asset class has a far superior Sharpe ratio than equities, making high yield an attractive asset class for multi-asset portfolios. It is also an efficient way to gain exposure to credit risk and generate income. High yield has historically demonstrated a lower beta than equities, minimizing the potential downside capture if uncertainty and volatility persists or remains elevated. And – with all-in yields near 9% as the Fed nears the end of its rate hiking cycle – high yield provides an attractive income option in a flat economic growth environment where global equities may be rangebound. We maintain a notable overweight to high yield in our global policy model.

SHARPE INSIGHTS

High yield has done well on a risk-adjusted basis.



Source: Northern Trust Asset Management, JPMorgan. JPMorgan U.S. High Yield Index and S&P 500 Index used. Data as of 3/31/2023. 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.

- High yield has delivered higher risk-adjusted returns than U.S. equities over the past 25 years.
- With the global economy approaching stall speed we value high yield's ability to compensate for risk-taking.
- We prefer credit risk over both market (equity) and term (interest rate) risk; high yield remains the largest tactical overweight in our global policy model.

Equities

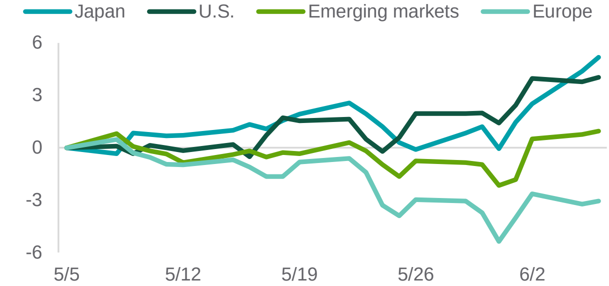
Global equities were buoyed last month by the resolution of the debt-ceiling negotiations and a surge in optimism related to the likely beneficiaries of the rise of Artificial Intelligence (AI). The overall return for global equities of 2% masked a large regional dispersion with surging Japan rising 5%; the technology-heavy U.S. market rising 4%; emerging markets rising 1%; and the value-oriented European market falling 3%. The disappointing outcome for the latter region was also related to relatively weak economic data and the news that Germany had slipped into a recession. This, combined with several hawkish statements made by the European Central Bank (ECB) put investors on alert after a strong run in the previous months.

Looking ahead, it will be important to monitor the risk of central banks overtightening monetary policy in the face of a global economic slowdown. The Fed is more likely than not to pause over the summer, but the ECB is at risk of being too backward-looking and continuing to hike rates. The outlook for economic growth and how it translates to revenue growth will also be closely watched, with a slowdown baked into expectations but not a recession. We have a cautious bias in our expectations and have reduced our developed ex-U.S. equities position to underweight.

MACHINE POWER

AI hype has helped the tech-oriented U.S. equity market.

1-MONTH EQUITY RETURNS (%)



Source: Northern Trust Asset Management, Bloomberg. One-month total returns as of 6/6/2023. 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.

- U.S. equities did well last month, helped by excitement on artificial intelligence and the debt ceiling agreement.
- We see less upside to equities given higher valuations in the U.S. and worries on European economic growth.
- We reduced Dev. ex-U.S. Equities from equal-weight to -2% and are now underweight all three equity regions.

Real Assets

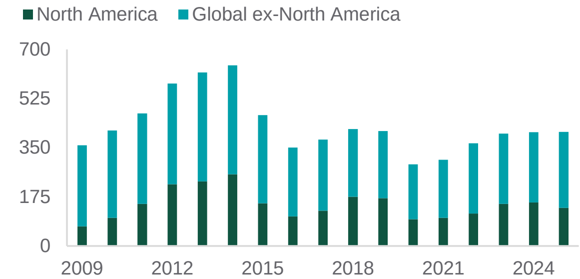
After outperforming in 2022, the natural resource (NR) asset class has materially lagged broader global equities thus far in 2023. Nearly all of the underperformance has occurred the past three months – as *Debt Dislocation* risks weighed on global economic demand expectations. With the debt ceiling deal passed and regional banks stabilizing, the *Debt Dislocation* risk case is gone. And while some of the resulting economic growth damage may still be on the come (less government spending and regional bank credit extension), we believe NR has other support beams than just the removal of this big risk to the global economy.

Perhaps the biggest support beam for NR is the lack of recent investment. The nearby chart shows the subdued global oil capital expenditure over the past near-decade – global mining capital expenditure has shown a similar pattern. Alongside OPEC+'s focus on price stability, we see it likely that oil prices maintain a floor near current levels – allowing for continued cash flows that are going back to the balance sheet – or to shareholders. Near term, we view NR as a better investment than emerging market equities. Longer term, constrained supply alongside new sources of demand (green transition) and inexpensive valuations make NR attractive in its own right.

CAPITAL DISCIPLINE

Oil capex has declined over the last ten years.

GLOBAL OIL CAPEX ($ BILLIONS)



Source: Northern Trust Asset Management, Bernstein, Jefferies. Data from 2009 through 2022. Estimates from 2023-2025.

- Natural resources (NR) has lagged equities so far this year mainly on the back of economic growth concerns.
- We see several near-term and long-term supports to NR, with constrained supply as a key support beam.
- We made no changes to our +3% tactical overweight to NR this month.

BASE CASE EXPECTATIONS

Approaching Economic Stall Speed

The consequent impacts of recent bank stresses on bank lending, alongside ~eight months of restrictive monetary policy, add pressure to the growth trajectory. Other lending sources (think private credit) can partially backfill credit availability, but overall growth should be fairly flat over the next year.

Monetary Tightrope

Given concerns regarding financial stability from the rapid pace of tightening, the Fed has shifted to a more “wait and see” stance, while the ECB should be done raising rates by September. We expect central banks to continue to walk a tightrope resulting in policy rates that should largely plateau heading into 4Q2023.

RISK CASE SCENARIOS

Labor Market Durability

More persistent tightness in the labor market leads to more stubborn core inflation, necessitating an unexpected monetary policy response that is negative for financial markets.

Continued Bull Run

The recent tech-induced rally continues and/or the “rest” of the U.S. equity market – flat on the year – starts to catch up. Such a scenario would lead to tactical underperformance given our equity underweight.

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	34	5	5	27	13	6	2	2	4	0
Tactical Asset Allocation	4	30	5	11	25	11	3	2	2	7	0
Over/Underweight	**2**	**-4**	**0**	**6**	**-2**	**-2**	**-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 8/10/2022.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.

UNLESS NOTED OTHERWISE, DATA IN THIS PIECE IS SOURCED FROM BLOOMBERG AS OF JUNE 2023.

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