JULY 2023

GOLDILOCKS WITHOUT THE BEARS?

Financial markets in the U.S. appear to be increasingly pricing in a Goldilocks scenario of both recession avoidance and inflation returning to Federal Reserve (Fed) targets – shaking free of residual bearish sentiment about weaker growth and sticky inflation. U.S. equities continued their upward march over the past month, including some broadening of performance away from solely megacap tech, bringing the forward price-to-earnings multiple to over 19x – above our long-term fair value estimate (17.5x).

To be sure, we have seen surprising resilience of the U.S. economy to date, as higher interest rates have so far failed to significantly disrupt consumer engagement in the economy, though recent data has suggested the beginning of a slowdown. The de-linking of the goods and services halves of the economy – where one has been working while the other has not – has assisted in keeping the economy from succumbing to recession. While we think the economy can still avoid recession, with the cumulative effect of tighter financial conditions yet to be fully felt and core inflation still challenged by persistent wage growth, we see an elevated level of complacency in the U.S. regarding potential setbacks going forward.

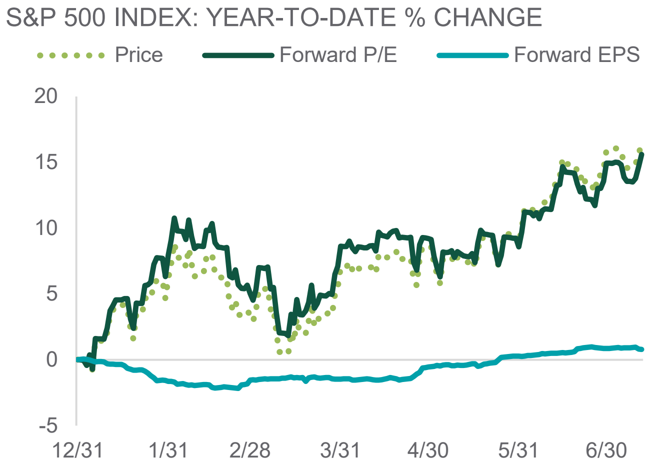
Fundamental conditions overseas appear more challenged. The European Central Bank's hardened stance against inflation has added to concerns regarding an increasingly challenged economic backdrop. While far cheaper valuations for European equities at least partially acknowledge the more difficult conditions, sentiment is likely to remain an obstacle to performance. China's economy continues to underwhelm. Speculation has increased that the government will intervene with stimulus in an effort to jump-start the disappointing reopening, but we remain skeptical it will be of a size to alter fundamentals or sentiment in the region.

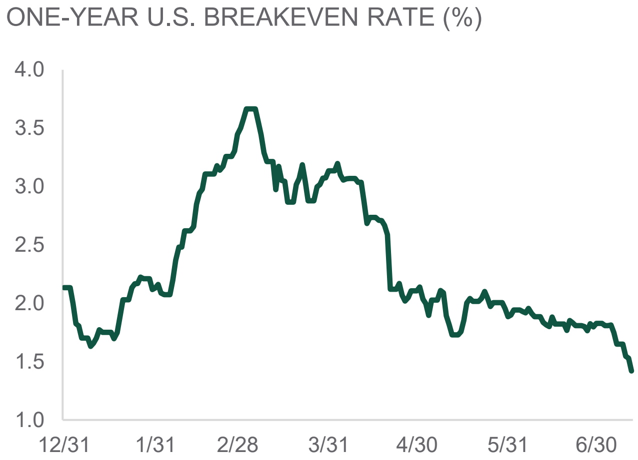
We maintained our modest underweight to risk this month, including underweights to equities across all three major regions. We have been encouraged by more durable fundamentals in the U.S. – but believe valuations are elevated with the global economy approaching stall speed. We maintain our overweight positions in high yield bonds and natural resources – alongside a small overweight to cash and an underweight to investment grade bonds.

- Chris Shipley, Chief Investment Strategist – North America

ELEVATED COMPLACENCY

Multiple expansion has driven year-to-date equity gains as investors have become increasingly optimistic on a soft landing outcome.





Source: Northern Trust Asset Management, Bloomberg. Forward P/E and EPS (earnings per share) estimates are Bloomberg 12-month blended estimates. One-year breakeven rate is a proxy for market inflation expectations over the next year. Year-to-date data as of 7/12/2023.

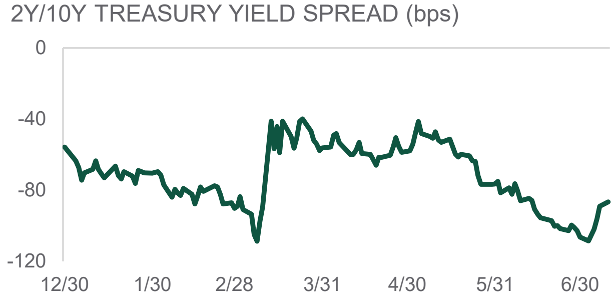
Interest Rates

A few months ago we wrote about rapidly changing inversions in the U.S. Treasury yield curve. Months on from the failure of Silicon Valley Bank and with the debt ceiling in the rearview mirror, the yield curve is revisiting seldom-seen territory. The closely watched two-year/ten-year spread reached a multi-decade inversion of more than 100 basis points (bps) in early March of 2023. It revisited that level again earlier this month. While yield curve inversions are often closely watched for potential signaling value around recessions, that signaling remains in doubt given the approximately 70-bp round-trip in the two year/ten-year spread over the past four months.

The two-year/ten-year curve was not the only volatile segment of the Treasury curve over the past four months. The five-year/thirty-year curve was inverted by more than 45 bps in early March, normalized to a positive slope of more than 40 bps by early May, and then revisited inversion territory at around 35 bps in early July. These gyrations are emblematic of a bond market wrestling with a resilient labor market, uncertain future economic growth and a Fed committed to bringing inflation back in line with target levels. The yield curve is likely to remain a closely watched indicator, even after a wild four-month ride.

FINDING FORM

The shape of the Treasury curve continues to oscillate.



Source: Northern Trust Asset Management, Bloomberg. The 2Y/10Y spread is the 10-year Treasury yield less the 2-year Treasury yield. “Inversion” is a negative value. Data from 12/30/2022 through 7/12/2023.

- Gyrations along the Treasury curve underscore the push-and-pull of competing economic outcomes.
- Recessions occur ~18 months post-inversion (on average), which happened just over 15 months ago.
- We see runway for positive growth keeping upward pressure on inflation, Fed policy and interest rates.

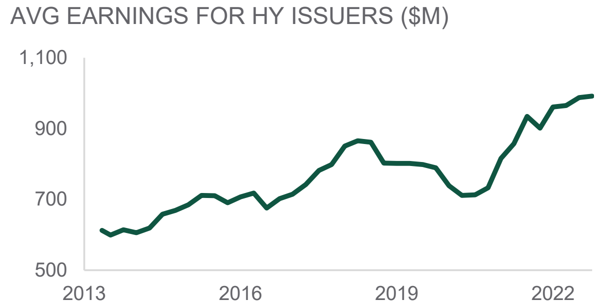
Credit Markets

The high yield market saw strong performance over the course of June given ongoing defensive positioning and equity volatility reaching pre-Covid levels following the debt ceiling deal. Despite remarkable performance year-to-date for the high yield asset class, investors still have concerns that inflation will remain elevated, potentially leading to further central bank rate hikes and high yield weakness.

The possible ramifications on economic growth due to more rate hikes has left some investors on edge. However, fundamentals are the main drivers of performance for high yield. Versus ten years ago, underlying high yield businesses are now larger with more diversified revenue streams. As seen in the chart to the right, the average trailing 12-month earnings (EBITDA) amongst high yield issuers is nearly twice as large as a decade ago. In turn, this argues favorably for high yield companies’ ability to weather an adverse economic outcome – potentially better than some market participants might be anticipating. We believe the year-to-date performance and valuations for high yield are justified due to these underlying fundamentals. Moreover, index yields at the current level of ~8.5% (or above) have historically been attractive entry points for high yield from a total return perspective.

EARNINGS BUFFER

High yield issuers have seen solid earnings growth.



Source: Northern Trust Asset Management, JPMorgan. HY = high yield. Average (avg) earnings proxied by last-twelve-month earnings before interest, tax, depreciation and amortization (EBITDA). Data from 6/30/2013 through 3/31/2023.

- The average high yield company earnings is nearly twice as high as it was ten years ago.
- Stronger fundamentals should help limit defaults in the event of a downside surprise to economic growth.
- We remain overweight high yield given an attractive income profile and positive nominal economic growth that should continue to support coupon payments.

Equities

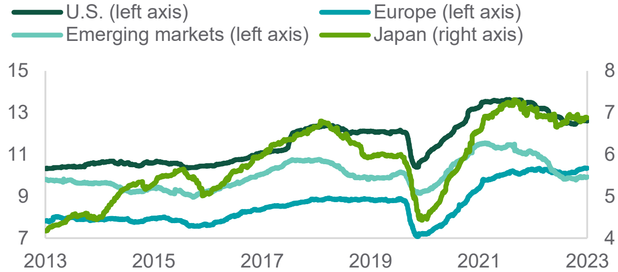
Global equities continued their advance from the month before, albeit at a more moderate pace of 1.3%. What was particularly striking was how only the U.S. had a positive return of 2.8%, while the rest of the world ended the month flat (Europe) or down (Japan and emerging markets). We partially attribute this to a more resilient U.S. growth outlook, especially relative to Europe and China. It was also likely driven by the monetary policy outlook. Whereas the Fed paused its interest rate hiking cycle (for now), European central banks pushed on. Weaker growth with a more hawkish monetary policy stance is a difficult combination for equity markets. The reverse is happening in China – where policy is easing – but for unattractive reasons (in response to weaker-than-expected growth).

Looking ahead, the risk of central banks overtightening monetary policy in the face of a global economic slowdown is still our main concern. This is especially true in Europe, where its central bank is too focused on core inflation and wage growth, and not giving appropriate attention to lower producer prices and the onset of a recession. The mix of weaker economic growth weighing on revenue growth and higher interest rates weighing on profit margins (see chart) keeps us cautious. We remain underweight global equities.

MEAN(INGFUL) REVERSION

Profit margins have started to roll over toward averages.

FORWARD PROFIT MARGINS (%)



Source: Northern Trust Asset Management, Bloomberg. Forward profit margins are Bloomberg 12-month blended consensus numbers. Data from 7/12/2013 through 7/12/2023.

- U.S. equities outperformed non-U.S. last month mostly due to increased relative odds of a soft landing.
- Looking forward, tighter policy should continue to weigh on equity gains as profit margins normalize.
- We remain underweight broad equities given limited scope for meaningful gains from current levels.

Real Assets

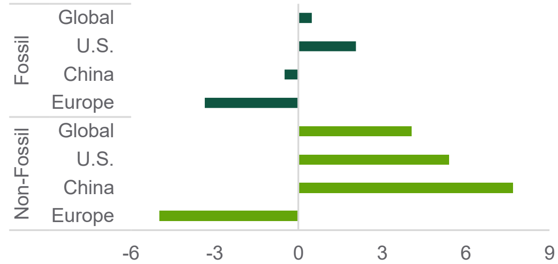
The Energy Institute's Statistical Review of World Energy (previously produced by BP) was recently released – providing an exhaustive look at energy consumption and production across all geographic regions and energy types. The nearby chart pulls from this data trove, showing year-over-year (y/y) growth in energy demand across the U.S., China and Europe – both fossil (oil, gas and coal) as well as non-fossil fuel energy sources (wind, solar, nuclear and hydroelectric). This year's y/y comparison (2022 versus 2021) is notable as it captures Europe's efforts to conserve energy – thanks to both the shift away from Russian gas and lower nuclear capacity – amid a slowing economy. But while Europe showed a rare reduction in non-fossil energy use, the rest of the world powered on – with 4% growth globally, 5% growth in the U.S. and 8% growth in China.

This sets a constructive structural backdrop for commodity prices and natural resource stocks – which will benefit both from wind/solar buildout (and the requisite copper and other metals) as well as ongoing fossil fuel demand (still growing with peak oil demand not expected until 2035). These structural drivers – combined with drilling/mining underinvestment, attractive valuations and a still-growing economy – support our continued tactical overweight.

POWER ON

Global usage of fossil and non-fossil energy grew in 2022.

ENERGY DEMAND (YEAR-OVER-YEAR %)



Source: Northern Trust Asset Management, The Energy Institute Statistical Review of World Energy. Select regional energy demand for 2022 versus 2021.

- Global usage of both fossil and non-fossil fuel energy sources grew in 2022, despite less European demand.
- Ongoing demand for fossil fuels – concurrent with the green energy buildout – is positive for commodities.
- We remain tactically overweight Natural Resources but also see several longer-term (structural) supports.

BASE CASE EXPECTATIONS

Complacency Sets In

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

The Pause That Was

While the Fed paused at its June meeting, 1-2 additional rate hikes should be expected this year from the Fed (having air cover from a 3.6% unemployment rate) and also the ECB (still focusing on inflation despite economic weakness). Maintained monetary restrictiveness will cap growth and supports the cash overweight.

RISK CASE SCENARIOS

Labor Market Durability

Persistent labor market tightness and wage pressures lead to more stubborn core inflation, necessitating an unexpected monetary policy response (more than 1-2 Fed hikes) that is negative for financial markets.

Continued Bull Run

Big Tech continues its secular move higher and/or the "rest" of the U.S. equity market continues its (now month-old) relief rally. 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.