

SEPTEMBER 2023

TAKING THE UNDER

Global equities were roughly flat over the past month against a flattish backdrop for interest rates, with non-U.S. equity markets trailing due to a strengthening of the U.S. dollar. U.S. large cap growth stocks continued to outperform, masking softness in value and small caps when looking at broader indices. Investor optimism remains on display in the U.S. for both earnings and valuations. Earnings estimates continue to edge higher – now equating to roughly 12% growth in 2024 and 2025, while the forward P/E multiple sits at an elevated 19x. We are taking the under on economic growth and earnings forecasts given accumulating global headwinds.

The U.S. consumer remains durable when looking at retail sales and payment network volume trends, however, depleting savings and increasing revolving debt levels have supported recent spending capacity. Going forward, we expect spend will have to slow to align with wage growth. In addition, we still expect the lagged effect of monetary policy to act as an incremental headwind – further suppressing activity.

Inflation measures ticked up this month, due in part to higher energy prices (oil prices are making new year-to-

date highs). We continue to believe the market will be disappointed by the timing and pace of interest rate cuts from central banks, including the Fed. Inflation should continue its disinflationary path and the European Central Bank and the Fed are likely close to done raising rates, but we do not expect central banks to be in a hurry to remove restrictive interest rate policy via interest rate cuts.

China continues to struggle as the consumer retrenches in the wake of the property market unwind. To date, governmental support has been modest, supporting our underweight to the region. We are watching closely to see if China's woes lead to an exporting of economic weakness or further disinflationary forces – further hurting the economic growth outlook.

We made no changes to our Global Policy Model this month, maintaining our relatively modest underweight to risk. We continue to prefer high yield bonds to developed market equities, natural resources to emerging market equities, as well as an overweight to cash.

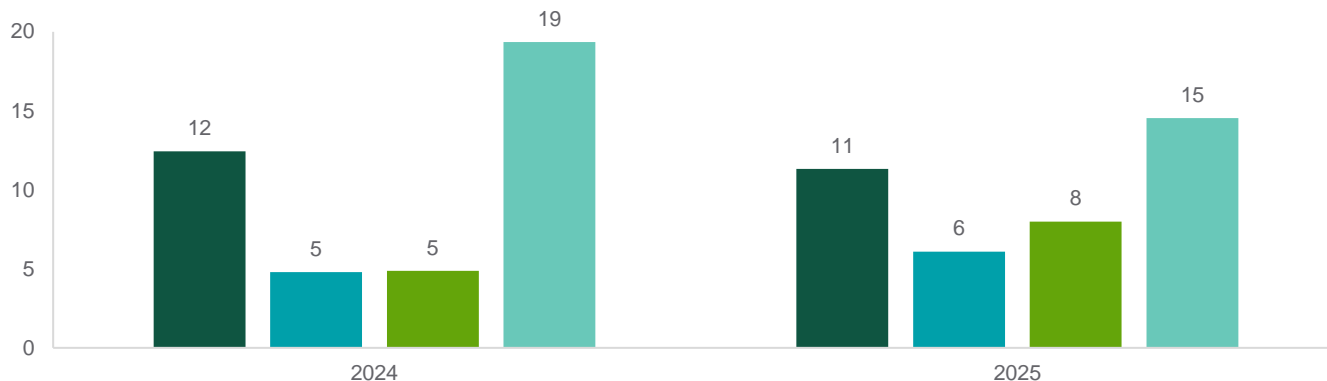
- Chris Shipley, Chief Investment Strategist of North America

PERFORMANCE EQUALS REALITY MINUS EXPECTATIONS?

Elevated earnings growth expectations for the next two years leave room for disappointment.

YEAR-OVER-YEAR CONSENSUS EARNINGS GROWTH (%)

■ U.S. ■ Europe ■ Japan ■ Emerging Markets



Source: Northern Trust Asset Management, Bloomberg. Bloomberg consensus earnings per share (EPS) growth estimates for calendar years 2024 and 2025. Indexes used: S&P 500 (U.S.), MSCI Europe (Europe), MSCI Japan (Japan), and MSCI Emerging Markets (Emerging Markets). 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

Usage of an important Federal Reserve facility, the Reserve Repo Facility (RRP), has been on the decline since May. Initially launched in 2013, the RRP allows a specific set of investors, primarily money market mutual funds (MMFs), to park cash at the Fed in exchange for Treasuries as collateral. A combination of declining Treasury Bill (T-Bill) supply and higher policy rates made the RRP attractive to MMFs, with total RRP usage peaking at over \$2.5 trillion. So what's driving the decline now?

First, T-Bill supply has surged since the debt ceiling deal. There was risk that the rebuild of the Treasury General Account could drain too much liquidity from the banking system, but instead we've seen an orderly shift of liquidity via MMF allocations to more T-Bills and less RRP. Also, there has been an uptick in demand from dealers to borrow cash in the repo markets as they compete with the RRP. Overall, the decline in RRP usage is a good reminder that Quantitative Tightening (QT) continues, and that at some point the Fed will need to consider if it has drained enough liquidity – from the RRP and elsewhere – as well as shrunk its balance sheet to an appropriate size. We will continue to monitor the RRP for any signals around market liquidity and future balance sheet policy.

Credit Markets

While fundamentals are the primary driver of performance for high yield, technicals can also be important drivers of performance, especially during periods of limited market activity. After depressed primary activity last year (which was the lowest since 2018), issuance has picked up modestly so far this year, but overall it remains low compared to historical averages.

Limited supply the past two years has been one of the factors driving tighter spreads throughout the year and especially during the summer months. This technical is illustrated in the total par amount outstanding within the high yield bond universe, which has shrunk ~13% to \$1.4 trillion, compared to a peak of \$1.6 trillion in October of 2021. Investors have been looking towards September – a seasonally busy month for primary issuance – to potentially ease the supply technical. Estimates of up to \$25 billion of supply are elevated versus the monthly average of \$13 billion this year, but they remain below the 5-year average for September of \$30 billion. Additionally, the pipeline of supply has been well-telegraphed to the market so investors are likely well-positioned in terms of slightly elevated cash balances to absorb this supply. Valuations could remain stable due to these offsetting factors.

TAPPING THE BANK

Cash parked at the Fed's RRP has been on the decline.

RRP USAGE (\$ BILLION)



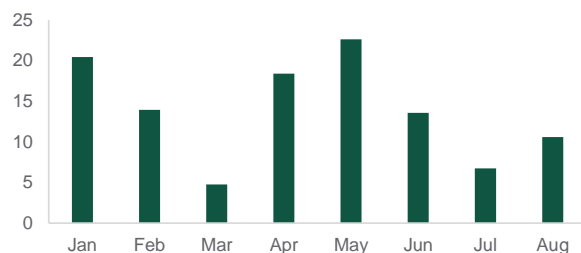
Source: Northern Trust Asset Management, Bloomberg. RRP = Reverse Repo Facility. Data from 9/8/2022 through 9/8/2023. Historical trends are not predictive of future results.

- After an 18-month surge, cash parked at the Fed via the RRP has been on the decline this year.
- Cash from the RRP has mitigated liquidity drainage from the rebuild of the Treasury General Account.
- We hold a neutral view toward duration as inflation risks loom but downside risk to rates is growing.

TECHNICAL DRIVER

Issuance has picked up but supply remains low overall.

2023 HY ISSUANCE BY MONTH (\$ BILLION)



Source: Northern Trust Asset Management, WFS Leveraged Syndicate. HY = high yield. Year-to-date new issuance data for U.S. high yield through 8/31/2023.

- Low new issuance relative to historical averages has supported a 7% return for high yield year-to-date.
- High yield investors likely have cash on the sidelines that can absorb a modest uptick in supply.
- We hold a preference for high yield (+6%) over equities (-6% developed markets) in our Global Policy Model.

Equities

The global equity rally stalled last month and even reversed some, with global equities posting a 0.5% loss. Regionally, the pattern of U.S. and Japan outperforming Europe and emerging markets continued. Also, growth stocks continued to outperform value-oriented names.

An important driver behind the weakness in Europe and emerging markets is persistent disappointment in economic growth. Real economic activity data is coming in below expectations, forward-looking indicators continue to decline and earnings expectations are being revised down. In the U.S. and Japan the opposite is true: economic performance has been slightly better than expected (see chart) and earnings expectations have been modestly revised upwards. Looking forward, however, we continue to see financial markets as being overly confident that the U.S. economy in particular can pull off a soft landing. The consumer's capacity to spend is slowly diminishing and the impact of tight monetary policy is growing with the credit cycle losing momentum. As a result, we believe incremental disappointment on both the economic and earnings front are more likely than continued upside surprises, which is why we remain underweight all three major equity regions (3% each).

Real Assets

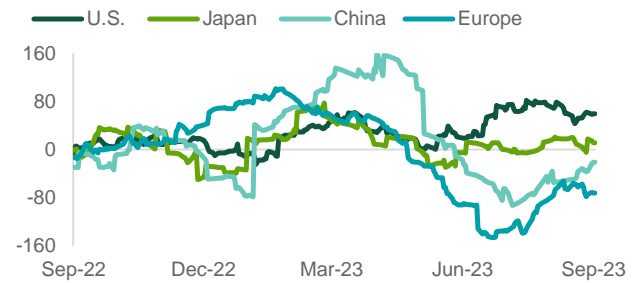
Equities and commodities have had a give-and-take relationship over the decades with equity price returns doing well when commodity price returns don't – and vice versa. The 1970s saw commodities beating equities by 17.5% per year – only for the 1980s to largely reverse that, with equities beating commodities by an annualized 17.2%. Commodity prices continued to sputter in the 1990s – but not equities, which outperformed by an annualized 8.4%. Commodities regained their footing in the 2000s – running ahead by 14.7% per year (in a decade with negative equity performance from start to end) – only to stall out during the 2010s, underperforming equities by an annualized 7.5%.

This brings us to the current decade with both equities and commodities starting strong, but with commodities ahead by an annualized 3.7%. As noted above, it's rare to see both do well at the same time – and, if forced to pick one to continue the price appreciation, we take commodities. Of the two decades of strong commodity performance, the 1970s was driven more by supply constraints while the 1990s was a demand story. We see the current situation a mix of the two – supply challenges today with increased green-transition demand for industrial metals “tomorrow” – and maintain our tactical overweight to natural resources.

THE SURPRISE FACTOR

U.S. economic growth has been stronger than expected.

ECONOMIC SURPRISE INDEX VALUE



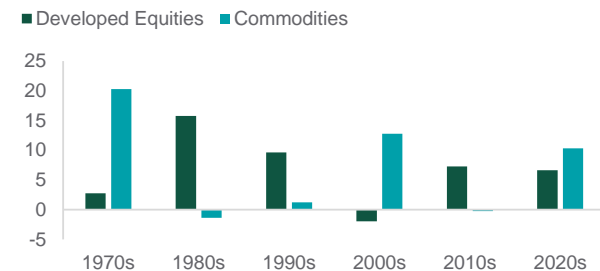
Source: Northern Trust Asset Management, Bloomberg, Citigroup, LSEG Datastream. Data from 9/12/2022 to 9/13/2023.

- Economic results have helped U.S. and Japan equity returns, but not so much for Europe and China.
- With investors increasingly optimistic on a soft-landing economic outcome, we see room for disappointment.
- We maintain a 3% underweight to each U.S., developed ex-U.S., and emerging market equities.

WINNER TAKES ALL

Equities and commodities rarely do well at the same time.

ANNUALIZED RETURN BY DECADE (%)



Source: Northern Trust Asset Management, Bloomberg. Equities are proxied by the MSCI World Index (price returns annualized); commodities are proxied by the Bloomberg Commodity Spot Index (price returns annualized).

- It has been rare to see both equities and commodities post strong returns across the same decade.
- The setup for commodities looks attractive given both supply challenges and longer-term demand supports.
- We remain 3% overweight natural resources as a hedge to our emerging market equity underweight.

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 and the challenges China faces. TAA expects flattish growth with downside risk, endorsing credit markets over equities.

Don't Count on Cuts

The U.S. economic expansion continues with the unemployment rate sitting below 4% and, yet, Fed funds futures are calling for rate cuts to begin mid-2024. TAA does not believe both can be true – and views it more likely that the Fed plateaus at current policy levels (with a greater probability of rate hikes than cuts).

RISK CASE SCENARIOS

Reagitated Inflation

Persistent wage pressures and surging oil prices push inflation (and expectations) higher and central bank policy rates to a new level – an environment in which TAA is not sufficiently underweight risk.

Continued Bull Run

A rebalancing U.S. labor market, a renewed Chinese government stimulus attempt and/or a durable AI trend cause equity markets (especially in the U.S.) to resume the year-to-date run, hurting tactical performance.

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.

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