

JANUARY 2024

# POLICY AND POLITICS

Focus remains on monetary policy with investors parsing Fed minutes and statements. Rate cut hopes drove much of the Santa Claus rally, but the Fed has not committed to investors' full wish list. Politics will battle monetary policy for mindshare; ~40% of the planet can cast a vote this year, including the U.S. and Taiwan (which just reelected its nationalist party). We expect a U.S. soft landing, areas of global economic weakness and hesitant central banks. When joined by elevated U.S. equity valuations and geopolitical risks, the macro backdrop endorses a small underweight to risk and a preference for high yield over equities.

**Interest rates will likely show less volatility this year.**  
The 10-year U.S. Treasury (UST) yield ended 2023 at 3.88% – the same level as it ended 2022, but with a rise to a high of 4.99% along the way. Given our call for a U.S. soft landing and modest Fed accommodation, it's reasonable to expect the 10-year UST yield to end 2024 around 4% again, and without last year's detour higher. We side with the Fed's forecast calling for three 0.25% rate cuts this year (versus market calls for roughly six) with the first cut occurring at the June Fed meeting (versus market expectations for March). Such an outcome would likely remove the inversion from most of the yield curve by bringing down the front end more than the back end – presenting a reasonable backdrop for risk-control assets.

**Comparing Powell's soft landing to Greenspan's.**  
The last time the Fed achieved a soft landing – in 1995 – the S&P 500 gained 38%, kicking off the dotcom era and a five-year period of 29% annualized returns. Could AI elicit a similar market reaction as the internet revolution? Perhaps. But starting-point equity valuations today are much higher – 24.9 on a price-to-trailing-earnings (P/E) basis (versus 16.9 heading into 1995, ultimately reaching 30.7 at the end of the five-year period). Today's 4.0% S&P 500 earnings yield compares unfavorably to the 7.6% yield on high yield bonds – especially given the ~1.5% real growth environment we expect (versus the 4.2% annual growth from '95-'99). Also, profit margins will be pressured as companies roll over debt at rates around double what was secured post-pandemic (~8% from ~4% in high yield and ~5% from ~2% in investment grade).

**Getting paid upfront in a risky, modest-growth world.**  
We like high yield's income generation over the potential price appreciation in developed market equities, wherein U.S. valuations are rich and European growth is at risk. Emerging market equities are looking more attractive but we seek more clarity on the contours of Fed policy and the implications of Taiwan's election before going overweight. We are strategically allocated across all real assets.

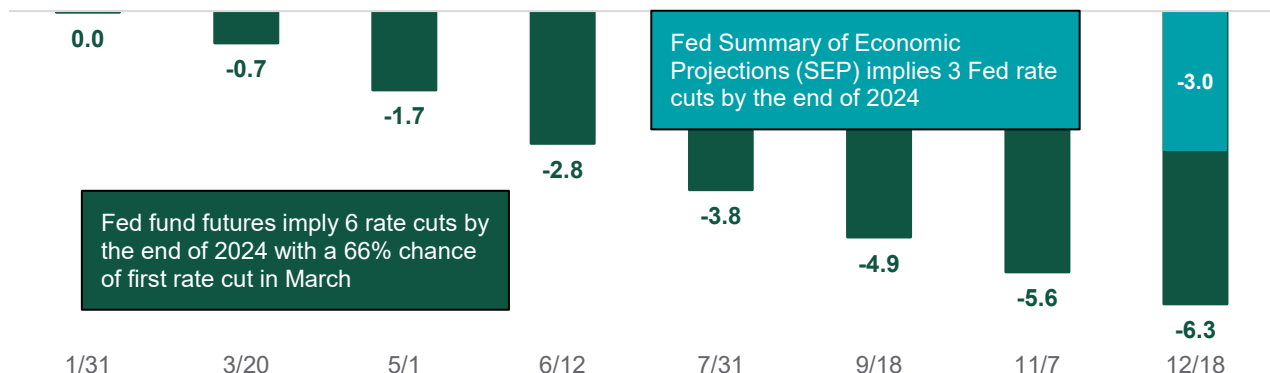
*Dan Phillips, CFA – Director, Asset Allocation Strategy*

## RATE CUT RECONCILIATION NEEDED

Markets are hoping for a March start to rate cuts and a total of roughly six in 2024; the Fed is only offering three so far.

### 2024 FEDERAL OPEN MARKET COMMITTEE (FOMC) MEETING DATES

■ # of hikes/cuts (market expectations) ■ # of hikes/cuts (SEP projection)



Source: Northern Trust Asset Management, Bloomberg. Summary of Economic Projections (SEP) as of 12/13/2023. Market expectations implied by futures. Data as of 1/16/2024.

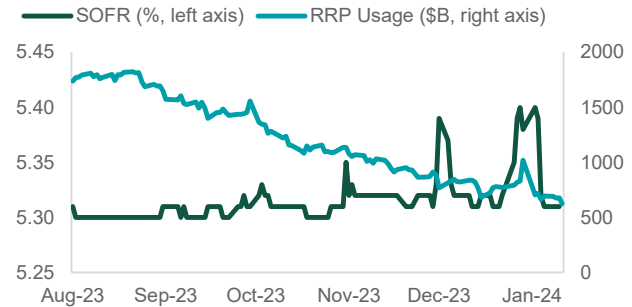
### Interest Rates

Last month we wrote about the reduced usage of the Fed’s Reverse Repo Facility (RRP), anticipating more volatility in repo rates. Given recent comments from the Fed on the facility, it’s worth revisiting why the decline matters for the broader interest rate markets. As RRP participation has declined, and competition from private sector repo market participants has increased, we’ve seen a corresponding increase in funding rate volatility as measured by SOFR (Secured Overnight Financing Rate – an average of daily repo transaction rates). SOFR recently surged to 5.4% on January 2nd. The last time we saw this level of SOFR volatility was in 2018 and 2019, which was also the last time the Fed was shrinking the size of its balance sheet – also known as quantitative tightening (QT).

SOFR spiked by nearly 3% in September 2019. In response, the Fed – realizing it had drained too much liquidity from the system – brought that round of QT to a quick halt. The most recent Fed meeting minutes revealed this topic is again top of mind – and subsequent comments from former and current Fed officials are keeping investors on alert for any upcoming QT changes. Right now, liquidity remains sufficient with ample bank reserves in aggregate – so QT tapering is not imminent, but we will be monitoring.

### QT SIGNALS

Declining RRP usage may signal a need for QT tapering.



Source: Northern Trust Asset Management, Bloomberg. RRP = Fed Reverse Repo Facility. SOFR = Secured Overnight Financing Rate. Data from 8/1/2023 through 1/11/2024. Historical trends are not predictive of future results.

- Fed minutes stated “several” officials were interested in initial discussions on slowing the pace of QT. Ensuing Fed comments pointed to declining RRP usage.
- We view QT as a tool used by the Fed to manage policy within the bounds set forth by its policy rate. Talk of QT tapering should not be confused with rate cuts.
- We agree that monetary policy easing is in sight, but market pricing for rate cuts is likely too aggressive.

### Credit Markets

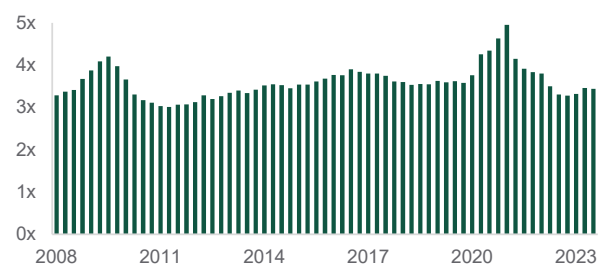
The high yield market saw continued strong performance after Fed Chair Powell signaled that the central bank is increasingly focused on the timeline for cutting rates at its December meeting. High yield fundamentals haven’t taken a hit as a result of the unprecedented hiking cycle and resulting increase in the cost of capital. However, coverage ratios suggest manageable impacts. Amid stronger-than-expected economic growth and resilient consumer spending, earnings before interest, tax, depreciation and amortization (EBITDA) for high yield issuers improved in the third quarter. Per the chart on the right, this helped lead to a slight improvement in leverage and interest coverage ratios. The earnings improvement drove the net leverage improvement, though reduced debt also helped.

A less hawkish Fed and improving fundamentals should continue to support high yield valuations. Also, a benign default outlook provides an attractive backdrop for a historically elevated level of carry and total return potential. Lastly, Treasury yields have become a larger component of the overall yield for high yield, providing a nice cushion to alleviate lower returns if economic uncertainty were to lead to lower interest rates.

### A FUNDAMENTAL CHECK

High yield coverage ratios are in good shape.

QUARTERLY LTM DEBT TO EBITDA



Source: Northern Trust Asset Management, JP Morgan. LTM = last twelve months. EBITDA = earnings before interest, taxes, depreciation and amortization. Quarterly data from 1/1/2008 through 9/30/2023.

- The debt to earnings ratio for high yield issuers improved in the most recent quarter.
- High yield fundamentals are in decent shape overall – a compelling feature given elevated all-in yields.
- High yield remains our highest conviction tactical overweight in the Global Policy Model.

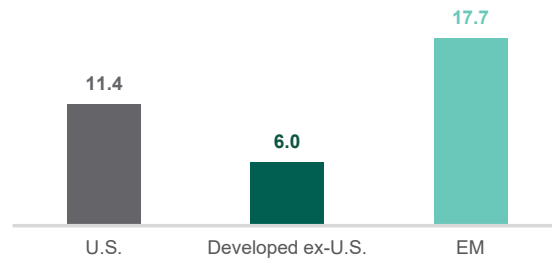
## Equities

Global equities gained 5.3% in December, with developed equities leading the way. Emerging market equities (EM) lagged but still delivered strong returns. The rally occurred alongside a 45-bp decline in the 10-year Treasury yield. Cyclicalshandily outperformed defensives, and small caps recorded an even more sizable return over large caps. Across the full-year 2023, U.S. market leadership was narrow. The Magnificent Seven contributed to about 60% of the S&P 500's return. However, those gains meaningfully broadened during the late-2023 rally.

Markets got off to a dull start the first week of this year and many of the late-2023 leaders were laggards. Sentiment indicators were stretched, and after a +16% gain for U.S. equities off of late October lows the market was poised for a breather. Moving forward, we maintain a constructive economic outlook with a U.S. soft landing our base case. Our enthusiasm is tempered by aggressive market pricing for rate cuts and historically elevated U.S. valuations. However, in recognition of abating recession risks and monetary policy easing coming into sight, we increased our EM allocation to equal-weight from 1% underweight. EM valuations are not stretched and 2024 earnings growth is expected to be the strongest of the regions (see chart).

## EARNINGS REBOUND

2024 is expected to be a year of solid earnings growth. CONSENSUS 2024 EPS GROWTH (%)



Source: Northern Trust Asset Management, FactSet. EPS = earnings per share. Emerging Markets = EM. S&P 500, MSCI World ex. U.S. and MSCI Emerging Markets Indices used as proxies for U.S., Developed ex.-U.S. and EM, respectively. EPS estimates are FactSet consensus estimates as of 1/5/2024. Historical trends are not predictive of future results.

- Investors are pricing in an earnings rebound across all regions, but most sharply in emerging markets.
- Easier Fed policy, a robust earnings growth outlook and more reasonable valuations should support emerging market equities (EM) in the year ahead.
- In light of a more balanced macroeconomic outlook, we removed our 1% underweight to EM.

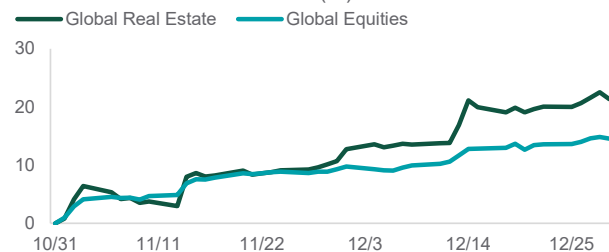
## Real Assets

Historically, global real estate (GRE) has shown a negative correlation to interest rate movements – and this was demonstrated again over the past two months as investors expressed comfort that the Fed tightening cycle is coming to an end. A more normalized rate environment should be a catalyst for real estate transactions as market participants will be able to put pencil to paper on property valuations and financing costs, utilizing the capital markets with a higher degree of certainty. Further, real estate should benefit from our base case expectation of an economic soft landing underpinned by a healthy consumer – both integral to sustained and growing rents.

With property revaluations nearly complete and financing costs more certain, we expect opportunities to develop in 2024. The office sector continues to garner significant media attention, but our focus has been on relatively healthy sectors positioned for structural growth (residential, industrial) as well as emerging sectors (cell towers, data centers, alternative residential). The valuation gap between private and public real estate has started to narrow, but public market prices still maintain a notable discount for most sectors. 2024 may develop into a pivot point for public and private real estate pricing as markets transition.

## A REAL (ESTATE) PIVOT?

Real estate has started to outperform on Fed pivot hopes. RETURNS SINCE NOVEMBER (%)



Source: Northern Trust Asset Management, Bloomberg. Data from 10/31/2023 through 12/31/2023. Index performance returns do not reflect any management fees, transaction costs or expenses. It is not possible to invest directly in any index. Past performance is no guarantee of future results.

- Real estate is a diversified asset class with exposure to term (interest rate), market and credit risk.
- An end to the Fed tightening cycle and a soft landing could provide an attractive environment for real estate.
- We are waiting for more realistic market expectations on rate cuts, but real estate could be at a pivot point.

## BASE CASE EXPECTATIONS

### Sticking the Landing

Global growth will move below trend but remain positive, supported by a U.S. economic soft landing underpinned by a solid labor market and healthy consumer. Inflation will remain above target but continue to proceed toward 2%. Despite the constructive economic backdrop, high valuations temper risk-taking appetite.

### The Fed's Transition

The Fed is very likely done raising rates, but market expectations for a probable rate cut in March, two cuts by June and a total of five-to-six rate cuts in 2024 are too aggressive. More realistic would be three cuts, starting in June and followed by cuts in September and December.

## RISK CASE SCENARIOS

### Lagged Impacts

The market's enthusiasm for a soft landing proves to be misplaced as the cumulative effect of 5%+ rate hikes in two years starts showing up in economic functioning. TAA is not underweight risk enough in this scenario.

### A Bad Goods Environment

Geopolitical tensions in the Red Sea (currently causing significant but manageable goods trade disruptions) intensify or broaden to the Persian Gulf (impacting oil supplies) – potentially causing stagflation.

## 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	2	30	7	11	27	10	5	2	2	4	0	
<b>Over/Underweight</b>	<b>0</b>	<b>0</b>	<b>-2</b>	<b>6</b>	<b>-1</b>	<b>-3</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	

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.

*UNLESS NOTED OTHERWISE, DATA IN THIS PIECE IS SOURCED FROM BLOOMBERG AS OF JANUARY 2024.*

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