MARCH 2024

REDUCED HEADWINDS TO RISK ASSETS

The U.S. economy remains resilient. We expect growth to be close to trend and inflation to come down slowly. In this environment, we expect the Federal Reserve to cut rates around the second half of the year. A similar picture is emerging in some of the key developed markets outside of the U.S. The probability of a prolonged downturn in Europe has declined with credit conditions improving, strength in labor markets and the European Central Bank expected to cut rates later this year. We are not expecting strong Eurozone growth in 2024, but an environment of sluggish growth. The U.K. experienced a technical recession late last year, but strength in employment and expectations of a pick-up in housing activity suggest that risks of a further leg down in activity have fallen. Similarly, Japan is benefiting from continued resiliency of the global economy. Slowdown in Chinese growth remains a source of risk. However, this may be already reflected in the underperformance of their stocks.

Fourth quarter earnings season in the U.S. has reflected this economic resiliency. Except for pockets of U.S. equities, valuations are not a source of concern in major developed regions. Global policy easing, with the exception of Japan, will be a tailwind to global growth.

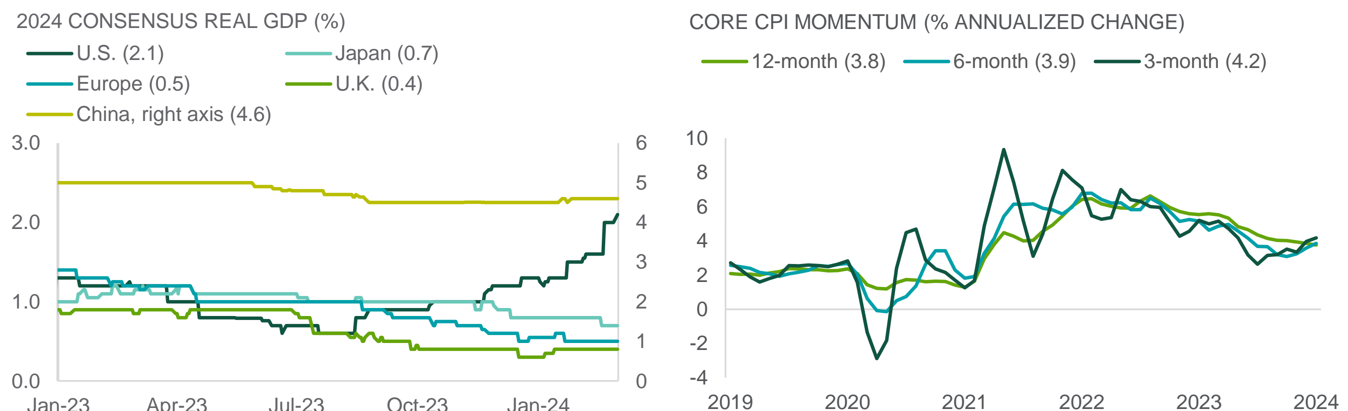
Inflation remaining above central banks' targets is a key risk but we continue to see scope for inflation to come down as rental costs abate and wage increases moderate. We also see lingering concern surrounding commercial real estate and more opaque areas of consumer lending, as well as another leg down in the Chinese economy as potential sources of broader financial market risk.

Against this backdrop, of easier financial conditions and broadening growth momentum, we are upgrading equities to neutral. We have no regional preferences. We are modestly underweight core fixed income, reducing allocations of cash and investment grade (IG) bonds. Yields in investment grade corporate bonds have not been high enough to offset negative return drag from duration impacts. Note, the duration of IG is fairly high at 6.7 years. In the context of a diversified fixed income portfolio, we are underweight inflation protection bonds in favor of higher yielding bonds. High yield spreads are low by historical standards, but the combination of lower duration and higher yields provides some protection against a backup in rates. We are neutral all assets within the real assets category. These assets serve a more strategic allocation purpose and we do not currently see any compelling reasons to deviate tactically.

Anwiti Bahuguna, Ph.D. – Chief Investment Officer, Global Asset Allocation

BETTER GROWTH EXPECTATIONS

U.S. economic growth expectations have continued to improve, but stubborn inflation remains a risk.



Source: Northern Trust Asset Management, Bloomberg (BBG). Left chart: BBG consensus data. Consensus Gross Domestic Product (GDP) is the average level of the y/y change during the year (i.e., it uses 8 quarters of data). *Inflation measures vary by region: core Personal Consumption Expenditures (U.S.), core Consumer Price Index (Europe and Japan) and headline Consumer Price Index (U.K., China). Data as of 3/4/2024. Right chart: CPI = Consumer Price Index. Data as of 2/29/2024.

Interest Rates

While there has been a substantial repricing of market-based expectations for the timing and magnitude of rate cuts this year, current pricing is much closer to our long-held views for the likely path of monetary policy in 2024. Given this repricing, nominal yields on U.S. Treasuries maturing in one year or less remain the highest on the entire yield curve. This dynamic has presented front-end investors with yield opportunities not seen for well over a decade, and Money Market Mutual Funds (MMFs) have continued to rise to the occasion.

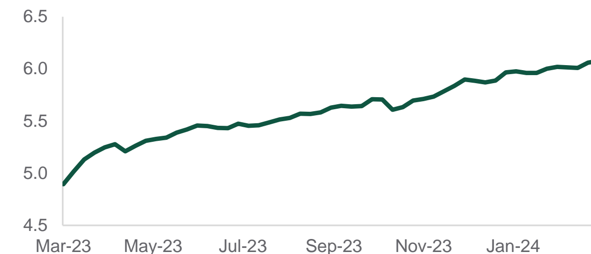
A year ago, in the weeks following the failure of Silicon Valley Bank in March, MMFs surged by over $300 billion, to $5.2 trillion as measured by the ICI – a record high at the time. Since then MMFs have continued to gather even more assets, eclipsing $6 trillion early in 2024. The combination of yields over 5% and the ability to purchase or redeem shares the same day has continued to attract investors into MMFs. While we often see some redemptions out of MMFs to pay taxes in April, it remains to be seen if the upward trend in MMF assets under management in 2023 and the first two months of this year will meaningfully reverse at some point in 2024.

- Dan LaRocco, Head of U.S. Liquidity, Global Fixed Income

THE SIX TRILLION DOLLAR CLUB

Attractive yield leads to continued MMF gains in 2024.

MONEY MARKET FUNDS AUM ($, TRILLION)



Source: Northern Trust Asset Management, Bloomberg, Investment Company Institute (ICI). Data from 3/8/2023 through 3/6/2024. Historical trends are not predictive of future results.

- An inverted yield curve and high liquidity have driven a massive increase in money market investments over the past year.
- Investor interest may remain elevated given a higher-for-longer Fed.
- While we've reduced exposure to cash in our tactical asset allocation, that shift is related to the relative attractiveness of risk versus risk-control assets. The yield on cash remains attractive.

Credit Markets

The high yield market saw mildly positive returns in February despite interest rate headwinds. The lower quality CCC segment of the market drove returns. Lower-quality outperformance has coincided with an improvement in primary market access, especially for stressed segments of the market. High yield primary markets saw another busy month in February with $27B in paper coming to market, taking year-to-date supply volume to $58B. This marks an increase of 51% year-over-year. Since the Fed stopped hiking its policy rate, the pace of new credit extended to recently stressed credits has doubled versus the rate of supply post-March regional banking issues.

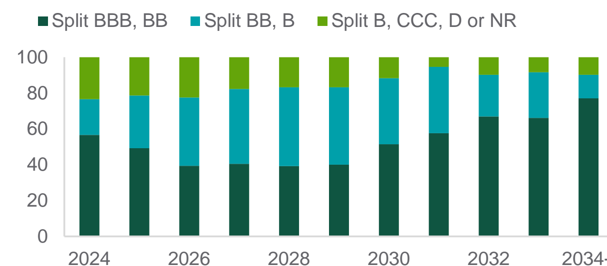
Overall, $36B in new funding has been extended in these segments since November, a notable share of their total $200B size outstanding. This is a positive sign for the high yield market as the maturity wall is elevated versus history. It's important to note that the maturity wall is concentrated in higher quality issuer segments. We have less concern on it given this higher quality tilt. While we reduced our tactical allocation to high yield by 1% as a source of funds to bring our equity allocation to strategic levels, we remain constructive on the asset class with a 5% overweight.

- Eric Williams, Head of Capital Structure, Global Fixed Income

QUALITY TILT

Most upcoming maturities are in higher quality segments.

% OF ANNUAL MATURITIES BY RATING



Source: Northern Trust Asset Management, JP Morgan. Data as of 2/14/2024.

- Upcoming maturities are predominantly concentrated within higher quality segments of the high yield market.
- We think the maturity wall will be well-digested by the high yield market. Its higher quality tilt is a key support.
- While we reduced our tactical allocation to high yield, we remain constructive on the asset class with a 5% overweight.

Equities

Return concentration has grabbed the attention of equity investors. In the U.S., the 'Mag 7' has accounted for over 50% of broader index gains since the start of 2023. In Europe, the 'Granolas'* have similarly accounted for an outsized proportion of broader index gains. Despite narrow market leadership, global equities have powered ahead and now sit up 7% on the year. The equity rally continued over the past month, except the gains came in the form of broader market leadership. The S&P 500 equal-weighted index led the cap-weighted benchmark, value stocks outpaced growth stocks, and international markets closed some of their year-to-date return gap versus U.S. equities.

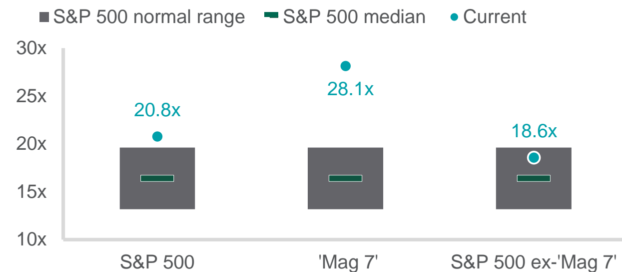
We upgraded our tactical equity allocation to neutral, adding 1% to U.S. equities and 3% to dev. ex-U.S. We have more confidence in a stable macro backdrop and see less reason to be underweight risk assets. Recent European economic data has suggested that it may be in the early stages of a recovery and we maintain our base case expectation for a U.S. soft landing. Forward U.S. equity valuations are historically elevated, but S&P 500 ex-'Mag 7' valuations look more reasonable at 18.6x (see chart). More importantly, valuations are a poor timing tool.

- Colin Cheesman, Investment Strategist, Asset Allocation

VALUATION DISGUISE

S&P 500 valuations are within a normal range ex-'Mag 7'.

FORWARD PRICE-TO-EARNINGS



Source: Northern Trust Asset Management, Bloomberg. Normal range is +/- 1 standard deviation from the median. Monthly data beginning 12/31/1999, current as of 2/28/2024. *'Granolas' as defined by Goldman Sachs is an equal-weight basket of 11 European companies with a strong competitive advantage in their respective sectors.

- Narrow market leadership broadened over the past month. U.S. equity market valuations are within normal ranges when you exclude the high-performing 'Mag 7'.
- Valuations are a poor predictor of returns over a one-year time horizon. We believe the recent rally could have legs given a more stable global growth backdrop.
- We removed our underweight to equities and are now tactically neutral all three of the major regions.

Real Assets

Since the end of January, Brent crude oil has traded within a $70-80 per barrel band and implied oil price volatility has fallen to pre-Covid lows (see chart). Volatility has remained low despite heightened geopolitical uncertainty including the Ukrainian conflict, and unrest in the Middle East and the ensuing Red Sea escalation. Looking at the fundamentals, Saudi Arabia's recent decision to not increase capacity suggests that they have both the will and the resources to support prices. Further, non-OPEC supply growth is likely to keep pace with global demand growth and decreasing oil demand in China has been mitigated by increasing demand from the U.S. and India.

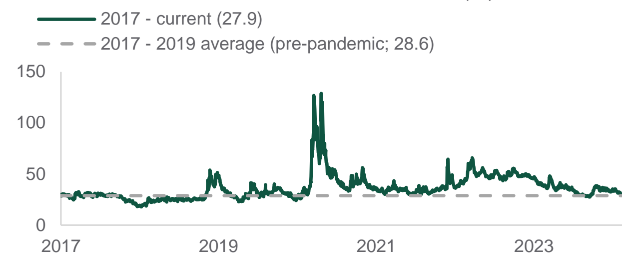
What are the risks to breaking out of this range? A productivity rollover in U.S. shale could provide a supply respite. More extreme conflicts or unexpected geopolitical shocks, changes to OPEC's ability to utilize spare capacity, potential easing monetary policy, or weaker global demand could also catalyze a breakout from the range. We believe Global Natural Resources (GNR) investing should provide longer-term protection against unanticipated inflation and also act as a potential mitigant to geopolitical risk.

- Jim Hardman, Head of Real Assets, Multi-Manager Solutions

SHRUG IT OFF?

Oil price volatility has eased despite geopolitical risks.

CRUDE OIL 3-MONTH IMPLIED VOLATILITY (%)



Source: Northern Trust Asset Management, Bloomberg. Data from 1/2/2017 through 3/13/2024. Historical trends are not predictive of future results.

- Oil prices have been rangebound despite geopolitical uncertainty.
- We believe oil prices are near equilibrium with stable supply and demand fundamentals.
- We continue to monitor energy market fundamentals and remain equal-weight natural resources.

BASE CASE EXPECTATIONS

Sticking the Landing

Global growth will move below trend but remain positive, supported by ongoing U.S. economic strength as labor market/consumer momentum has continued. Inflation will remain above target but continue to proceed toward 2%. Despite the constructive economic backdrop, high valuations temper risk-taking appetite.

Central Bank Transitions

We expect U.S. and European central banks to transition to rate cuts this year. Economic resilience may afford monetary policymakers more time to confirm that inflation is moving down sustainably.

RISK CASE SCENARIOS

Stubborn Inflation

Inflation does not move lower as a result of several potential factors: economic resurgence, tight labor markets keeping pressure on services, and/or goods and commodity disruptions from conflict in the Middle East.

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.

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	1	28	7	10	28	13	5	2	2	4	0
Over/Underweight	**-1**	**-2**	**-2**	**5**	**0**	**0**	**0**	**0**	**0**	**0**	**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.

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

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