NORTHERN TRUST

GLOBAL INVESTMENT OUTLOOK

2024

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FOREWORD

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Global Chief Investment Officer

It's my pleasure to present our **2024 Global Investment Outlook,** which summarizes our insights for the year ahead across key asset classes, economic themes and regions.

We started 2023 with expectations of low global economic growth and elevated fears of recession. However, large fiscal stimulus in the U.S. and Europe, and the strength of U.S. consumers, stabilized growth. A faster-than-expected decline in inflation has led to expectations of Fed rate cuts in 2024 and we believe those expectations, along with enthusiasm over artificial intelligence, have contributed to strong positive returns for risk assets.

We expect inflation and economic growth to decelerate in 2024, as tailwinds for economic growth and risk assets are waning. Overall, we are cautious on the performance of risk assets over the next 12 months due to decelerating growth, expensive asset valuations and geopolitical risk.

With these trends in mind, we think investors will be navigating a higher risk environment this year where headlines can quickly impact sensitive financial markets. And in 2024 we'll see a multitude of elections across the world, which could potentially create market volatility.

On behalf of Northern Trust, we wish you a happy, healthy and prosperous year ahead.

Sincerely,

Angelo Manioudakis

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GLOBAL ECONOMY

The global economy faced a high degree of difficulty in 2023, but it earned high marks. Defying gravity, growth has continued, and labor markets have remained strong. Even amid this resilience, inflation has fallen significantly.

U.S.

Last year, U.S. economic growth handily beat anemic expectations. When 2023 began, consensus expectations for annual growth were around 0.5%, weighed down by widespread expectations of a recession. We are likely ending 2023 at about 2.5%. This outperformance was despite several negative shocks to the economy, led by tighter than previously expected monetary policy, a mini banking crisis, a potential U.S. debt crisis, a severe escalation of tensions in the Middle East, and the ongoing war in Ukraine.

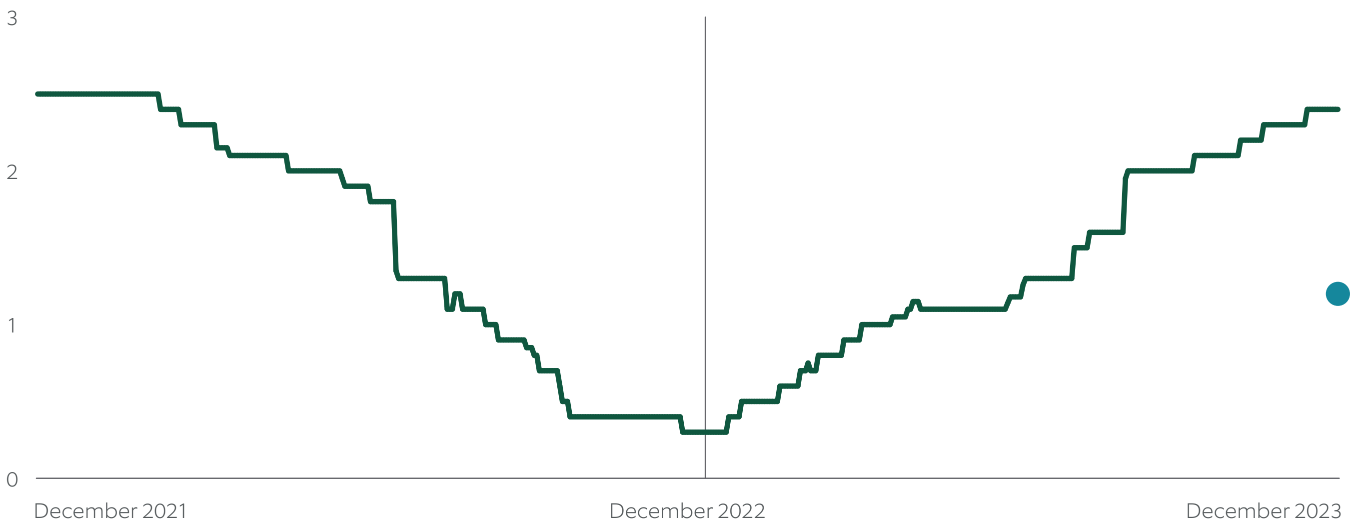
While the U.S. economy performed better than expected in 2023, potential headwinds are gathering. Looking ahead, we consider three possible scenarios taking shape. In the first scenario — which we call "Soft Landing" — inflation and the labor market cool off further at a pace that is broadly in line with the Federal Open Market Committee's (FOMC's) December Summary of Economic Projections. Under this scenario, the Federal Reserve is done raising rates and starts cutting in mid-2024. Meanwhile, real gross domestic product (GDP) growth slows to below trend but stays positive, and the unemployment rate rises slightly above the longer-run equilibrium level, which we think will be around 4%.

EXHIBIT 1: SURPRISINGLY STRONG ECONOMY IN 2023

U.S. economic growth in 2023 greatly exceeded the 0.5% expectation from the beginning of the year despite negative shocks.

Consensus U.S. Real GDP Expectation (%)

2023 Bloomberg consensus | 2024 Bloomberg consensus



Sources: Northern Trust Asset Management, Bloomberg (BBG). BBG consensus for the yearly average of real gross domestic product (GDP). Data from 12/31/2021 through 12/14/2023.

In our second scenario — which we call "Goldilocks" — inflation falls a little faster than anticipated in the first half of 2024, allowing the FOMC to start cutting rates as we approach the middle of the year. The labor market continues to cool off, but the unemployment rate rises only to its longer-run level, and growth in real GDP slows only to trend.

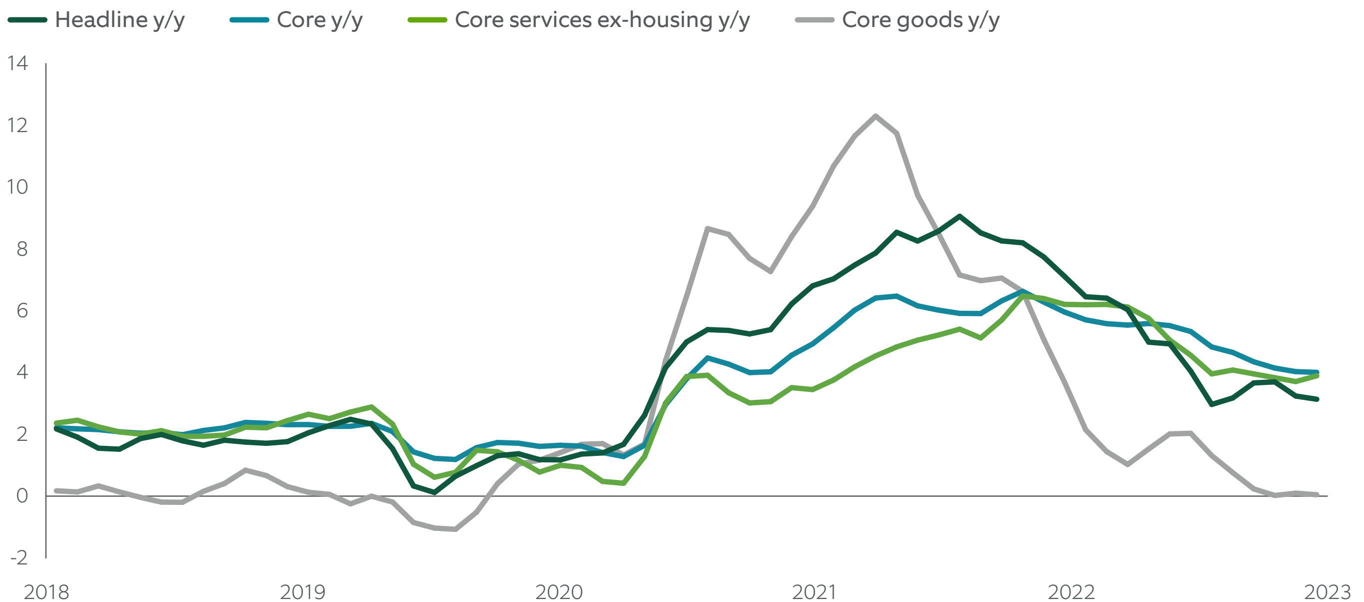
Finally, our third scenario is a "Recession" scenario, in which inflation and the labor market fail to cool off in the first half of 2024, contrary to market and FOMC expectations. The Fed responds by raising rates by 25 basis points one or two more times in the first half of the year. Subsequently, by mid-2024, inflation and economic activity start slowing more meaningfully, and the FOMC starts cutting rates later in the year. As slower economic activity evolves into recession, the FOMC cuts rates more aggressively in 2025.

Inflation remains a key consideration for the evolution of the U.S. economy in 2024. Pandemic-related disruptions to supply chains and consumption patterns that pushed up goods prices have essentially normalized. Services remain the problematic area, with shelter representing the bulk of upward pressure within the services bucket. However, shelter feeds through with a lag, and more timely measures of prices suggest it will retreat. Core services ex-shelter prices have moderated, and while they remain stubbornly high, cooling labor markets could support progress toward more normal levels. Our analysis of current labor market data indicates that wage gains can continue to slow without a large increase in unemployment.

EXHIBIT 2: INFLATION IS A CRITICAL FACTOR

Inflation moderated in 2023. Its trajectory during 2024 will be critical to whether the U.S. economy experiences a Soft Landing, Goldilocks, or Recession scenario discussed above.

U.S. Consumer Price Index (%)



Sources: Northern Trust Asset Management, Bloomberg. Year-over-year (y/y) data from 11/30/2018 through 11/30/2023.

We note that 2024 is a presidential election year, but we see no reason to believe that this will dictate monetary policy decisions. The coming election does, however, provide an added incentive for the current administration to support economic activity. In light of a divided Congress, we assign only a small probability to a positive change in new fiscal support versus recent years. Spending is under scrutiny, and there is a minor risk of budget cuts in the event that the government is still being funded via stopgap continuing resolutions come May.

Putting it all together and looking at the available data, we see our first scenario, "Soft Landing," as the most likely outcome for 2024, with real GDP growth in the range of 1–1.5% and inflation continuing to abate.

In Europe, the Russia-Ukraine war casts a lingering shadow over food and energy supplies while fighting in Gaza could ignite oil prices if the conflict grows.

Europe

In Europe, like in the U.S., we've been pleasantly surprised that the economy has held up despite a wide range of challenges. Unemployment across the eurozone is holding at record lows. Inflation is falling across categories and countries, allowing workers to achieve real wage gains.

The euro area's prospects would be stronger if the world were peaceful, but the outlook is complicated by two conflicts near its borders. Russia's war against Ukraine is approaching a costly stalemate, casting a lingering shadow over the continent's supplies of food and energy. The conflict in Israel puts fewer vital trade linkages at risk than the Ukraine situation did. But if oil flows are impacted, the continent will be the first to feel the burden of high energy prices. As conflicts grow, the flow of refugees could increase, adding to political stress.

Outside the eurozone, as the pandemic fades, the U.K. must confront the fundamental challenges it was facing prior to 2020. Pre-pandemic scarcities and policy complications likely will return to the fore. Inflation rose by more in Britain than it did in other countries, and its descent has been more gradual. Supply shocks explain the difference: The U.K. is more reliant on food supplies from Eastern Europe, and faces Brexit-related labor shortages. An incomplete network of trade agreements and weakness in the pound have raised import prices. The British economy has weathered these challenges so far. But prospects for growth remain muted, and downside risks are elevated.

Asia

China's unimpeded commercial rise may be in real jeopardy. After four decades of startling economic growth, the Chinese economy is slowing, and the soft patch is likely to be long-lasting. The country's once-booming property sector is facing a prolonged downturn, with several leading developers in serious trouble. Spillover from property markets to other areas of the economy is dragging growth below annual targets. Local and regional governments in China are deeply indebted, with a slowing rate of real estate activity depriving them of a major source of income. Chinese banks have seen a flood of bad assets in their property-loan businesses, with more likely to be reported in the coming months.

For a nation accustomed to a dazzling pace of growth, 2024 will likely feel recessionary to China. But this may be a necessary adjustment. A better economic outcome will not be more growth, but more sustainable growth. Coping with one to two years of relatively soft performance may be required to prevent China from experiencing a lost decade.

In contrast, the Japanese economy in 2023 enjoyed a burst of sunshine. Amid a broader global slowdown, Japan has been among the few bright spots. Consumption bounced back at the start of the year as the economy emerged from pandemic shadows, followed by strong export sector performance in the second quarter of the year. A weakening yen has bolstered exports while pushing imports lower. Japanese corporations have been benefiting from the U.S.–China decoupling.

Still, lingering structural issues may prevent the Japanese economy from performing to its full potential. The Japanese population is falling at a rapid rate and labor force productivity is the lowest among advanced economy peers. Japan's current growth spurt is unlikely to herald a shift back to the halcyon days of the 1980s. There are some clouds on the horizon, but the threat of economic stagnation and deflation appears to have abated.

For investors in China, likely soft economic growth in 2024 could feel recessionary after four decades of dazzling economic expansion.

MULTI-ASSET

The Stalwart 60/40: Does the Portfolio Still Work?

The experience of a 60/40 investor is the result of the outcome for both equities and bonds, and recent events have not been kind to either. In this section, we focus on a 60/40 portfolio in which equities are proxied by the S&P 500 Index and bonds by 10-year Treasury bonds. By that definition, as of the end of November, both equities and bonds had yet to recover from their most recent drawdowns. Going forward, we expect an environment of low growth with moderate inflation. We investigate how the 60/40 portfolio has fared in similar past environments.

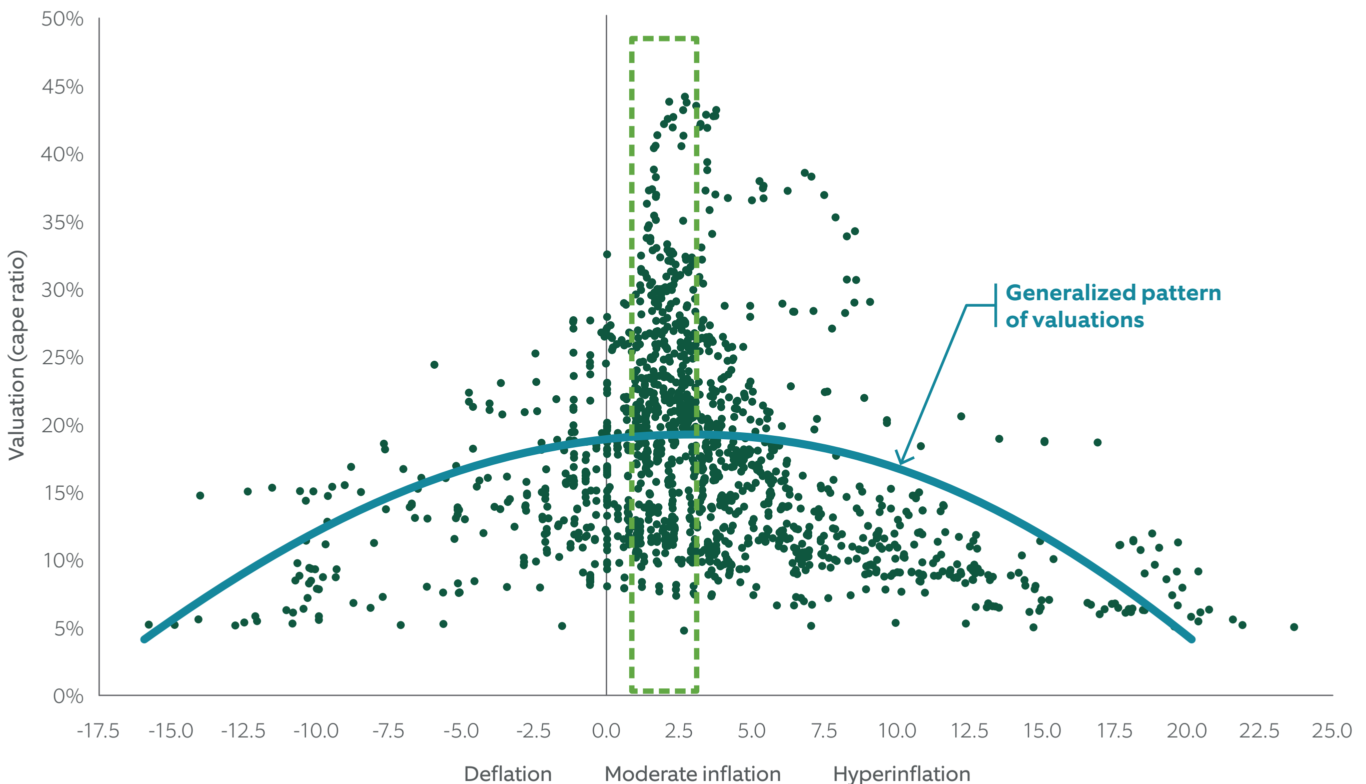
The recent equity recovery has resulted in persistently high equity valuations, proxied using Schiller price-to-equities ratios. Valuations are above the 90th percentile — a level last seen before the tech bubble of 1999. Bond valuations (proxied by the 10-year Treasury yield) are currently above the 50th percentile. Given elevated equity valuations, one could be concerned about the risk of value declines. However, history has shown that inflation running 1–3% has supported higher valuations.

> Our research shows that moderate inflation — which we expect in 2024 — historically has supported higher valuations.

EXHIBIT 3: EQUITY VALUATIONS TEND TO ELEVATE WITH INFLATION OF 1–3%

Investors are willing to pay more when inflation is low. Historically, inflation running 1–3% has supported higher valuations.

U.S. Equity Valuations Versus Year-Over-Year Headline CPI



Sources: Northern Trust Asset Management, Robert Shiller data. CAPE is the Cyclically Adjusted Price to Earnings Ratio. CPI = Consumer Price Index; Y/Y = year-over-year. Data from 1/1/1900 through 9/30/2023.

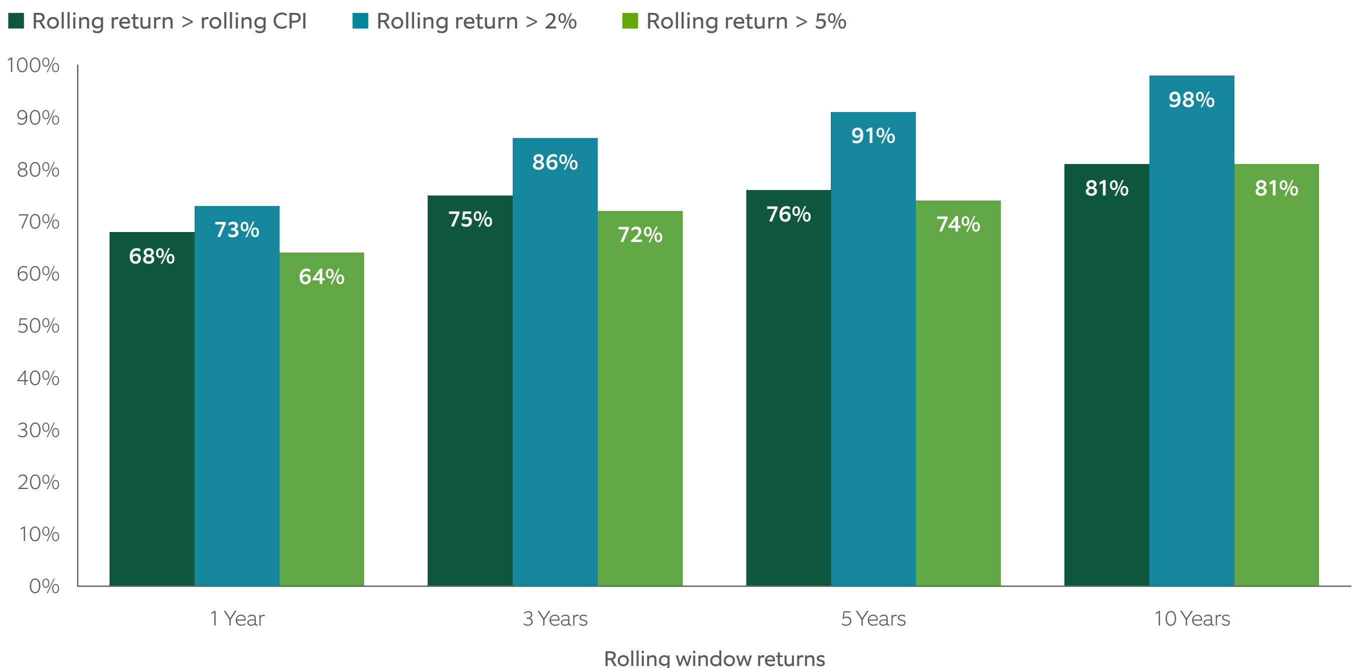
We reviewed the performance of the 60/40 portfolio relative to various inflation targets over various rolling time horizons. Specifically, we compared the return of the 60/40 portfolio to three inflation targets: 1) a rolling headline inflation target, 2) a moderate inflation target of 2%, and 3) a more aggressive inflation target of 5%. The hit ratio (i.e., the percent of the time that the 60/40 return exceeded those targets) ranges from 64% to 73% for the shorter rolling periods, signifying that the 60/40 portfolio does a reasonable job of maintaining purchasing power. The longer we extend the time horizon of the rolling periods, that is, the longer an investor stays patient, the higher the hit ratios. By extending the horizon to rolling 10-year returns, the hit ratios improve to an impressive range of 81% to 98%.

We also analyzed the performance of the 60/40 portfolio along with its stock-bond components across various inflation and growth environments. Real GDP was our proxy for growth and headline consumer price index for inflation. Specifically, we observed the average of rolling 10-year real returns going back to the 1900s across different macroeconomic backdrops. Notably, the 60/40 portfolio does best when inflation ranges between 2–4% and is accompanied by real GDP between 2–4%. As mentioned, we expect to be in a low growth environment of 1–2% and moderate inflation trending toward the Fed's 2% target. In this environment, the 60/40 portfolio has returned 6.0% on average.

EXHIBIT 4: 60/40 PORTFOLIO FARES WELL OVER EXTENDED PERIODS

The 60/40 portfolio's return exceeded three different inflation targets 64% to 73% of the time for one-year rolling periods, showing that the 60/40 does a reasonable job at maintaining purchasing power. The longer we extend the time horizon of the rolling periods, the higher the hit ratios.

Hit Ratio (% of Time That Return Exceeds Target)



Sources: Northern Trust Asset Management, Robert Shiller data. Return is the rolling 1-, 3-, 5- and 10-year returns of a 60/40 portfolio (60% S&P 500 Index and 40% 10-year Treasury bonds). Targets: "Rolling CPI" is rolling year-over-year headline Consumer Price Index (CPI). Data from 1/1/1900 through 9/30/2023.

As is always the case, risk-aware portfolios rely on the power of diversification. This is true even in the low growth and moderate inflation environment we expect throughout 2024. 2022 was a challenging year for the 60/40 portfolio, but in 2023 equities fared better, helping drive the recovery of the 60/40 portfolio. We don't anticipate inflation above 4%, and in other inflation environments the 60/40 has historically managed to generate strong real returns between 5.5% and 6.5%. And, even if you are not a 60/40 investor, this can serve as a useful benchmark against which to measure multi-asset portfolios.

EXHIBIT 5: 60/40 PORTFOLIO HAS PERFORMED WELL IN SCENARIOS LIKE THAT EXPECTED IN 2024

In 2024, we expect growth of 1–2% and moderate inflation trending toward the Fed's 2% target. In this environment, the 60/40 portfolio has returned 6.0% on average, among the strongest portfolio returns in this analysis.

Average Annualized Rolling 10-Year Real Returns Since 1900

REAL GDP GROWTH		INFLATION: <2%	INFLATION: 2–4%	INFLATION: >4%	INFLATION: Average
<2%	Stocks	7.2	7.7	2.2	5.7
<2%	Bonds	2.3	2.9	-0.4	1.5
<2%	**60/40**	**5.5**	**6.0**	**1.4**	**4.3**
2–4%	Stocks	7.6	8.2	5.4	7.3
2–4%	Bonds	2.9	3.3	1.0	2.5
2–4%	**60/40**	**5.9**	**6.5**	**3.8**	**5.6**
>4%	Stocks	8.9	8.0	4.6	7.2
>4%	Bonds	1.9	3.2	0.3	1.7
>4%	**60/40**	**6.4**	**6.3**	**3.2**	**5.3**
Average	Stocks	7.9	8.0	3.9	6.7
Average	Bonds	2.2	3.1	0.2	1.9
Average	**60/40**	**5.9**	**6.3**	**2.6**	**5.0**

Sources: Northern Trust Asset Management, Robert Shiller data. Average annualized rolling 10-year real returns for Stocks (S&P 500 Index), Bonds (10-year Treasury bonds) and 60/40 (60% Stocks, 40% Bonds). Data from 1/1/1900 through 9/30/2023.

INTEREST RATES

U.S.

With inflation in the U.S. still well above the Federal Open Market Committee's (FOMC) target, we view the outlook for U.S. interest rates over the next six to 12 months as closely connected to the path of inflation. Our most likely macroeconomic scenario has inflation — measured by the core Personal Consumption Expenditures (PCE) price index — declining gradually in the coming months and, accordingly, we expect the Treasury yield curve to move lower and become flatter as 2024 unfolds. But the potential for a bumpy ride for yields in the near term seems high.

Before cutting rates, the Federal Reserve likely will need to feel confident that inflation will fall to its 2% target.

Inflation will matter for the outlook for interest rates because, of course, it has been a key consideration in FOMC deliberations. The FOMC has faced three main questions since the beginning of the current rate cycle. The first was about **how fast** to raise rates. The Committee's firm answer was to move quickly at the start and then to gradually slow the pace of hikes as it sought to arrive at a "sufficiently restrictive" monetary policy.

The second question has been about **how high** to raise rates in order to coax inflation back down to 2%. After the December 2023 FOMC meeting, Fed Chair Jay Powell volunteered that the Committee judged that the federal funds rate was "likely at or near its peak for this cycle." We anticipate that the FOMC is done raising rates. Our reading of the Committee and the data suggests that the bar for further hikes at this point is very high: It would take a stalling out of core PCE inflation or a significant reacceleration in economic activity, and we don't see either of these developments as particularly likely.

That brings us to the third key question for this rate cycle, which is especially relevant for the evolution of the yield curve over the next six to 12 months. This question is about **how long** to keep the federal funds rate at its peak level for this cycle (or **when to start cutting** it). As we approach 2024, the market seems to have concluded that the FOMC has made a full transition from the "how high" to the "how long" question, with market pricing suggesting that the first cut is highly likely as soon as March. We see a much more gradual transition taking place.

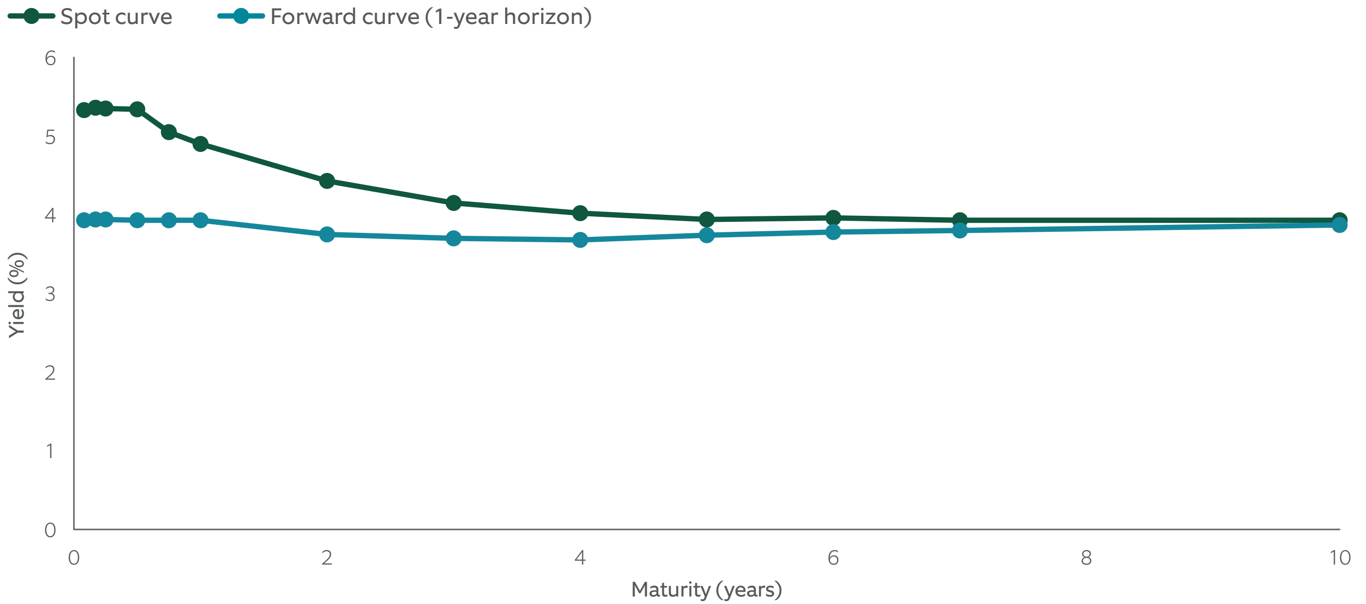
We believe the FOMC will want to have greater confidence that inflation is on a firm downward trajectory to 2% before it starts cutting rates. But, with the benefits to disinflation from the resolution of supply-side constraints mostly behind us, we expect that inflation will come down only gradually in the coming months and, as a result, it will take some time — likely until mid-year — for the FOMC to feel sufficiently confident that rate cuts are appropriate, especially if the labor market is slow to cool.

What does all this mean for the evolution of the rates outlook? If we are right that the FOMC is only in the early stages of addressing its "how long" question, the short end of the curve is likely to face some upward pressure in the near term as the market comes to realize that rate cuts in the spring would be premature. Looking further out, however, with the FOMC more fully engaged in cutting rates, yields are likely to be lower than they are today, with a flatter curve. All of this, of course, assumes that inflation falls gradually, with growth and employment cooling off further.

EXHIBIT 6: POTENTIALLY LOWER AND FLATTER YIELD CURVE FOR 2024

As also reflected in one-year forward rates, we believe the yield curve will go lower and flatten as inflation wanes.

Treasury Yield Curves (as of 12/19/2023)

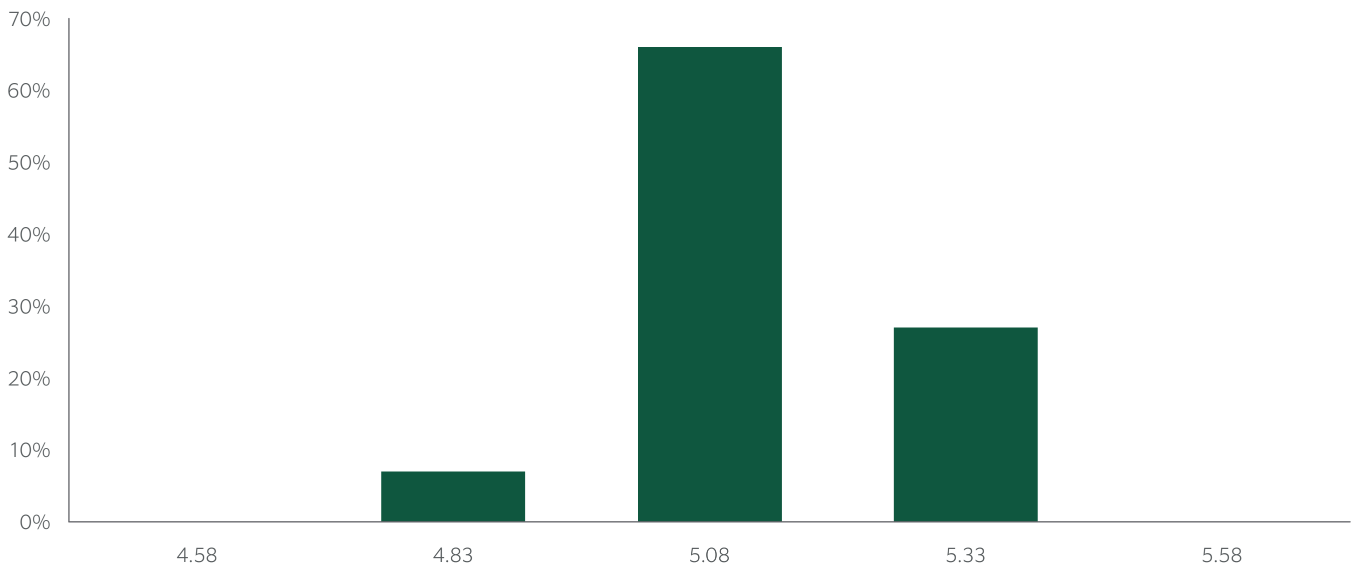


Source: Bloomberg

EXHIBIT 7: FED RATE CUT EXPECTATIONS

After the Fed held its policy rate at 5.25% to 5.5% during its December 13 meeting, futures markets as of December 19 indicated a rate cut after the March 2024 meeting. We don't see a rate cut before mid-year.

Futures-Implied Probability Distribution for the Federal Funds Rate After the March 2024 FOMC Meeting (as of 12/19/2023)



Source: Bloomberg

Eurozone

The European Central Bank (ECB) will want to ensure they win the battle on inflation before cutting rates prematurely and risking precipitating inflation, stagnation, and even worse, reversing a policy decision. Wage inflation is still elevated and annual wage negotiations are occurring throughout the first quarter. We think wage inflation is a key data point the ECB will want to see decline before embarking on rate cuts. This indicates the end of the second quarter as the earliest starting point for cuts, bar any material changes in the economic data. Although we expect cuts, this does not mean loose monetary policy, and rates will continue to be in restrictive territory, albeit on the way to neutrality. The expiration of reinvestment in the Pandemic Emergency Purchase Programme (PEPP) at the end of 2024 could prove a tail risk for peripheral spreads but we do not anticipate significant widening to cause the ECB concern because it would be absorbed by the market. As a result we expect a steepening in curves steadily throughout 2024 driven by the front end.

We believe the Bank of Japan will exit its negative interest rate policy in 2024 and raise rates, but it likely will exercise caution.

U.K.

Stickier inflation dynamics in the U.K. imply monetary policy normalization is likely to come later compared to Europe and the U.S. We expect interest rates to be held for a prolonged period as the most likely scenario, with the second half of 2024 as a likely timeframe for any normalization to begin. Encouraging evidence of core and services inflation easing has been seen at the end of 2023, but it is worth stressing that they continue to be a far cry away from the Bank of England's targeted 2%. Hence, we believe the current market pricing of rate cuts starting in March 2024 is too premature, and we think the second half of 2024 is a more likely time horizon to start any form of normalization. Excess household savings spent down, more mortgage renewals coming due, and an upcoming election in the new year — the path to normalization is all but fraught with uncertainty. The deluge of gilt supply, quantitative tightening, and our view that the U.K. can avoid a hard landing in 2024 should lead to steepening of the gilt curve.

Japan

After more than a decade of unprecedented monetary policy easing, the Bank of Japan (BOJ) is seeing signs of the virtuous cycle between wages and prices. Additionally, the prospects of further wage increases at the 2024 spring wage negotiations, alongside the BOJ's new inflation forecasts anticipating sustained inflation, has led to the market expecting the BOJ to exit negative interest rate policy (NIRP) in 2024. We believe the BOJ will exit NIRP during the latter part of the first half of 2024 if the Shunto wage negotiations deliver the required wage momentum to prove the sustainability of the virtuous cycle. We would, however, caution that the pace of the adjustment to interest rates will be slow as the BOJ will remain cautious and take wider financial market implication into consideration.

HIGH YIELD

High yield market valuations will be supported as stable fundamentals and a benign default outlook provide an attractive backdrop for a historically elevated level of carry and total return potential. Using data back to 2000, when yields were between 8% and 9%, forward 12-month returns were positive 92% of the time, and the median forward return was nearly 11%. During the upcoming year, investors should find value in the diversification benefits of fixed income, specifically in high yield. High yield's attractive downside capture relative to equities could offer support as investors contend with risks associated with a slowing economy (see global economy discussion above).

We expect investors to find value in the diversification benefits of high yield bonds.

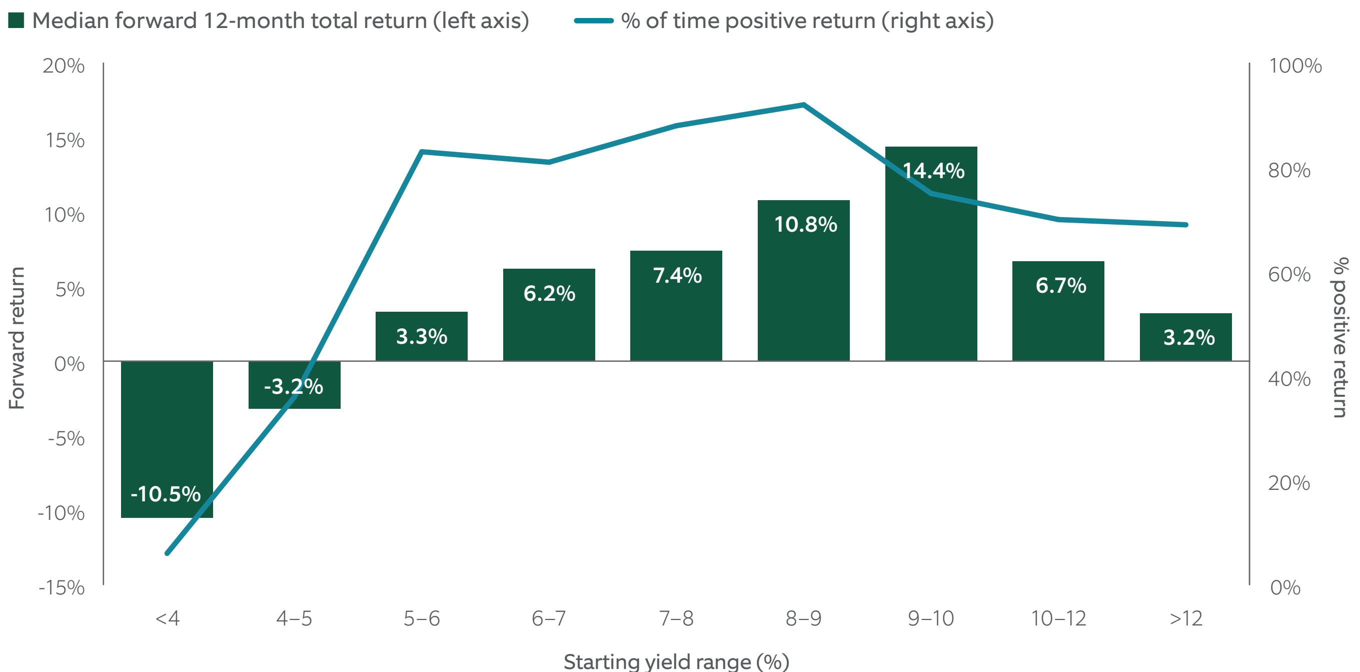
We expect interest rate volatility to subside relative to recent years, credit fundamentals to remain stable and the market technicals to prove supportive. Our analysis of available data related to distressed ratios, funding requirements and sectoral dispersion suggests that default rates will be range-bound around the long-term average (3–4%). Tight lending standards and elevated interest costs are likely to keep overall debt level growth low, as using debt has become an expensive way to run a business.

The high yield market has matured and is effectively of its highest quality in history. Larger and more diversified companies are in a better position to weather economic adversity compared to smaller corporates. Today, with BB- and B-rated issuers composing close to 90% of the asset class, default exposure is low.

EXHIBIT 8: HIGH YIELD'S ATTRACTIVE HISTORY OF TOTAL RETURNS

Historically, high yield has delivered attractive returns following periods when yields were between 8% and 9%. The forward 12-month returns were positive 92% of the time, and the median forward return was nearly 11%.

Median Forward 12-Month Total Return



Sources: Bloomberg, Barclays Research. Data from January 2000 through November 2023.

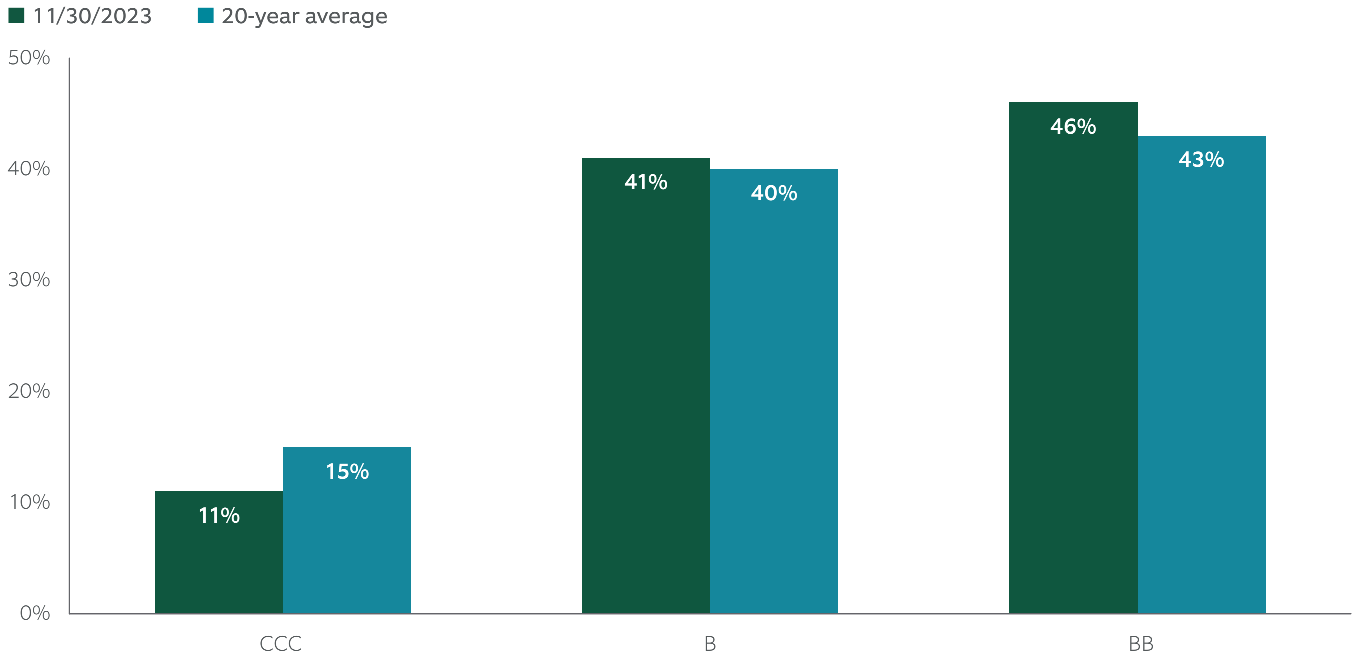
The final theme supporting our high yield view is an increase in future capital market activity amid lower rates and issuers continuing to focus on the maturity wall. We find the high quality composition of near-term refinancing needs to be supportive of valuations. While refinancing upcoming maturities involves a step up in coupon relative to existing debt, most issuers are in a position to absorb higher interest costs given their scale as well as an ability to deliver through productivity gains and earnings growth.

On balance, these conditions should support credit spreads as default loss is mitigated as a result of the health of corporate borrowers. In our view, spread levels are likely to be more influenced by Treasury rates going forward rather than by the impact of excess leverage and credit stress. In addition, the low level of average dollar prices in high yield, driven by elevated interest rates, has a material positive impact on capital appreciation potential as well as downside volatility reduction. Spreads are likely to stay in a narrow range as all-in yield buyers focus on total return opportunities.

EXHIBIT 9: HIGH YIELD CREDIT QUALITY AT HISTORICALLY HIGH LEVEL

Compared to its 20-year average, the credit quality of the high yield market is relatively high, with BB- and B-rated issuers comprising close to 90% of the asset class. This suggests that default risk is lower than the historical average.

High Yield Index Credit Rating Weights (%)



Source: Bloomberg

EQUITIES

In 2023, global equity markets posted impressive gains despite a backdrop of slowing economic growth, high inflation, rising interest rates, a banking crisis, two mainstage wars and widening geopolitical rifts. The prospects of a soft economic landing and artificial intelligence-fueled productivity gains overshadowed any pessimism and buoyed equity markets. Consequently, equity risk premia fell to near-record lows. While we celebrate the solid returns of 2023, we're skeptical that the tailwinds of the previous year can persist and are concerned that the level of earnings growth currently priced into equity markets is overly optimistic.

> The level of earnings growth priced into U.S. equities appears overly optimistic.

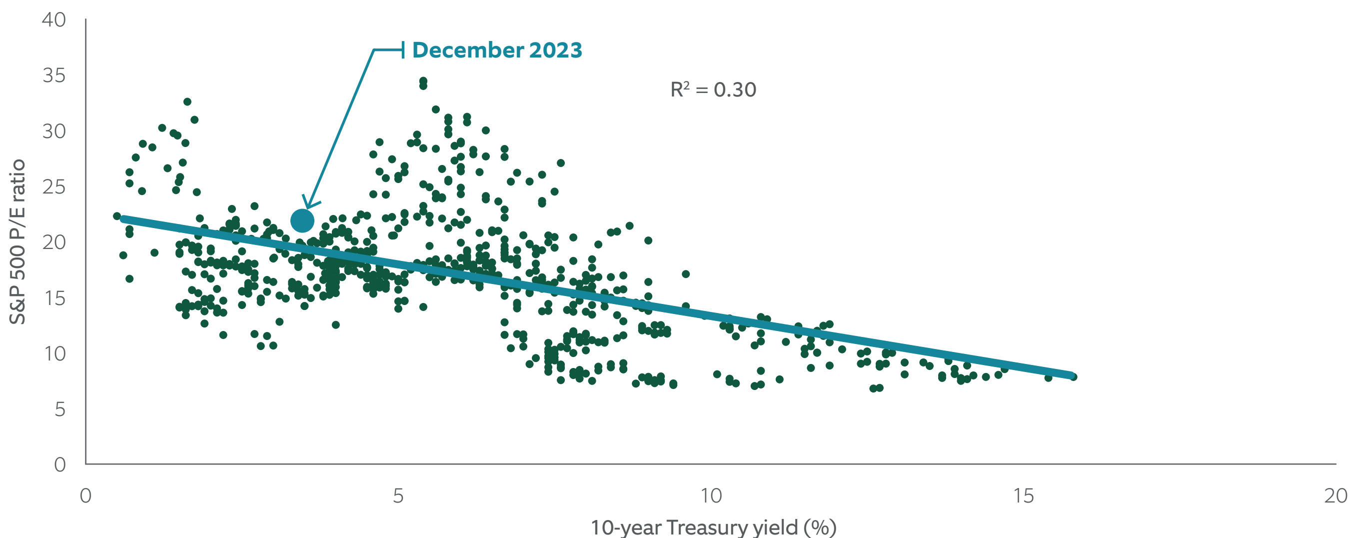
Although U.S. large cap indices were up more than 26% in 2023, earnings were relatively flat, meaning gains were driven almost exclusively by multiple expansion. Both forward and trailing price-to-earnings ratios increased despite rising interest rates. Based on data from 1962 through 2023, a higher 10-year Treasury yield normally puts downward pressure on equity multiples (Exhibit 10). As of the end of December 2023, the 10-year Treasury yield was around 3.9%. Historical data suggest that correlates to a price-to-earnings multiple of about 18x, well below 22x in December. This dislocation represents a potential downside risk to equity prices going forward.

Alternatively, we can express the relationship between interest rates and equity multiples as the equity risk premium, defined as the difference between the forward earnings yield of the S&P 500 and the real 10-year Treasury yield. This reflects the relative attractiveness of holding equities, a risky asset, over less-volatile Treasury bonds. The equity risk premium is at the lowest it has been since at least 2006, lower than even before the Global Financial Crisis.

EXHIBIT 10: U.S. EQUITY VALUATIONS LOOK HIGH COMPARED WITH TREASURY YIELDS

As of the end of December 2023, the 10-year Treasury yield was around 3.9%. The regression model, represented by the blue line, suggests that the 3.9% yield correlates to a price-to-earnings multiple of about 18x, well below 22x at the end of 2023.

U.S. Equity Valuations Versus Treasury Yields



Sources: Northern Trust Asset Management, Bloomberg. Data for the 10-year Treasury yield and S&P 500 Index from 1/31/1962 through 12/31/2023.
R^2 is the coefficient of determination, which quantifies how well the data fit the regression model, with 0 being no fit and 1 a perfect fit.

Most of the year-to-date return of U.S. equity markets, and the corresponding multiple expansion, has been concentrated in just a handful of technology-related names (widely referred to as the "Magnificent Seven"). Gains in these stocks were seemingly fueled by widespread optimism around artificial intelligence (AI) and the potential productivity gains that AI might generate. Despite flat earnings growth and profit margins at near-record levels, analysts' consensus earnings growth expectations remain strongly positive for the next two years. While we're sanguine about AI's potential, we feel that the near-term returns of AI will come piecemeal and that they will be difficult to gauge and time accurately. As a result, near-term growth and margin expectations discounted in current equity prices and multiples may be overly bullish.

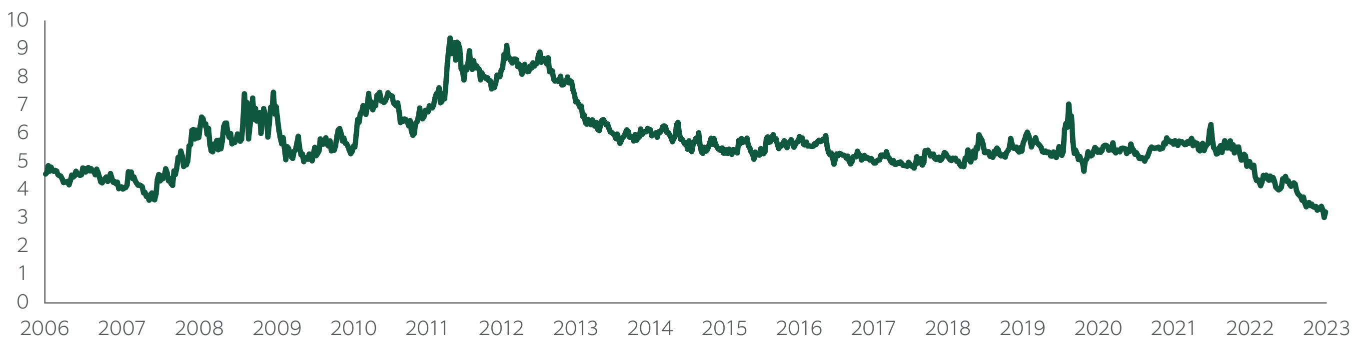
Although somewhat less pronounced, a similar story has played out outside of U.S. large caps. Year-to-date through the end of November, developed non-U.S. equities returned more than 12%, U.S. small caps were up over 4% and emerging markets weighed in at 6%. Currently, through most of December, these indexes are poised to finish even higher. In all cases, returns have primarily been the result of concentrated multiple expansion rather than positive earnings growth. While we are predicting a global soft economic landing in 2024, we expect earnings growth to be below analyst expectations. As a result, we expect downside risk to most major global equity markets.

While returns have trended up in 2023, equity volatility has unambiguously trended down, once again from the dominance of a handful of stocks. However, don't be lulled into a false sense of security. While volatility levels have declined, the frequency and severity of volatility jumps have increased; last year, we had 20 days when the VIX implied equity volatility index spiked 10% or more. These represent meaningful tail risk events, especially coupled with the high and sustained correlation of equities and bonds. Although somewhat counterintuitive, given the volatile economic and political backdrop, we attribute this declining risk phenomenon to market microstructure and leverage issues that aren't going away any time soon. Looking forward, it will be critical to carefully manage your equity tail risk along with the aggregate risk and tail risk profile of your entire portfolio.

EXHIBIT 11: RISK PREMIUM SUGGESTS MINIMAL REWARDS FOR INVESTING IN U.S. STOCKS

The equity risk premium — the difference between the forward earnings yield of the S&P 500 and the real 10-year Treasury yield — reflects the relative attractiveness of holding equities, a risky asset, over less-volatile Treasury bonds. The equity risk premium is at its lowest point since at least 2006, suggesting limited rewards for investing in equities.

U.S. Equity Risk Premium (%)



Sources: Northern Trust Asset Management, Bloomberg. Equity risk premium is defined as the forward earnings yield of the S&P 500 Index less the real 10-year Treasury yield. Data from 1/6/2006 through 10/13/2023.

REAL ASSETS

Global real estate (GRE) produced underwhelming performance for most of 2023, though it ended the year with momentum. GRE appears positively positioned for 2024, with greater Fed clarity on the path of inflation and interest rates. With $1.5 trillion of commercial real estate (CRE) loans scheduled to mature over the next three years (per the Mortgage Bankers Association), headline risk surrounding the CRE market could lead to some investor caution. U.S. gateway office markets continue to contend with high vacancy levels, and regional banks, the largest capital provider to CRE, are facing increased pressure to shrink their CRE exposure. At the same time, however, this is creating opportunities for alternative lenders. We also expect normalization in investment volumes and asset pricing, supported by falling borrowing costs. There is only slight exposure (about 7%) to the office sector across publicly traded REITs. We believe the other more sizable areas of the market are positioned for structural growth. This includes long-term tailwinds in industrial (e-commerce), residential (supply shortages), healthcare (demographics) and data centers (demand related to artificial intelligence).

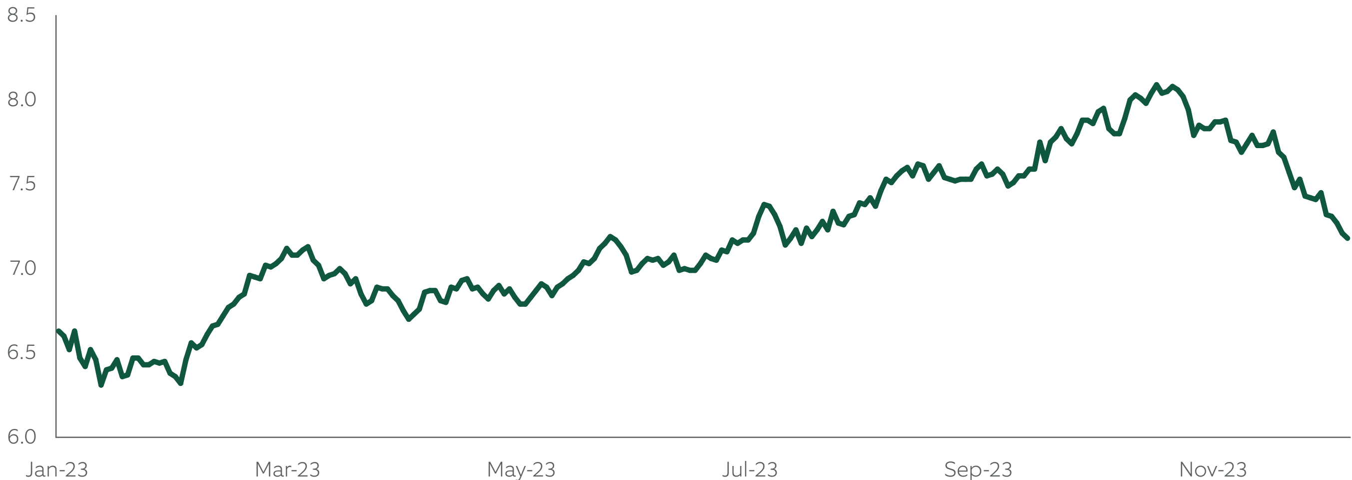
Global listed infrastructure (GLI) also produced low returns in 2023. In 2024, we expect GLI to continue to serve as a useful tool for diversification, inflation protection and income generation. Many areas of the asset class should benefit from a decline in interest rates, given their bond-like profile. Looking ahead, transitioning into a greener future will require significant investment into infrastructure and should provide support for valuation and growth. However, in both our "Soft Landing" and "Goldilocks" scenarios (see global economy section above), investors may find better risk-reward elsewhere, as GLI tends to outperform during bouts of economic uncertainty and unexpected inflation.

Global natural resources (GNR) underperformed both GRE and GLI in 2023. OPEC+ restraint and broader supply support remain tailwinds to an asset class we favor as a hedge against geopolitical risk. Continued strong fundamentals (persistent cash flows, tight commodity markets, stronger balance sheets and lower capital expenditures) should support GNR as an important hedge against higher inflation and geopolitical tensions. Natural resource equities also remain attractive from a valuation standpoint, when compared to both historical metrics and the broader equity market.

Despite significant attention on office vacancies, investors continue to find real estate opportunities in sectors positioned for structural growth, including e-commerce, healthcare and artificial intelligence.

EXHIBIT 12: FALLING BORROWING COSTS

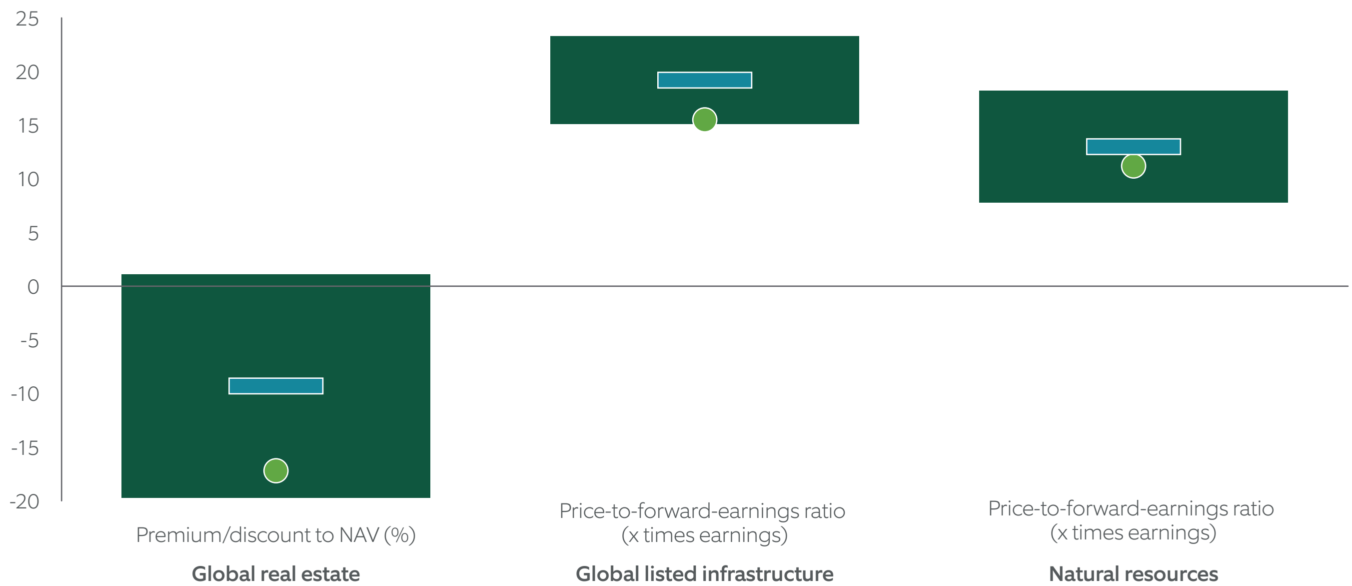
As mortgage rates and other borrowing costs fall over time, we expect a normalization in real estate volumes and pricing.



Sources: Northern Trust Asset Management, Bloomberg, Bankrate.com. Rate is the overnight national average. Data from 12/31/2022 through 12/15/2023.

EXHIBIT 13: ATTRACTIVE REAL ASSET VALUATIONS

Global real estate, global listed infrastructure and natural resources valuations are below median, aiding their prospects for 2024.



Sources: Northern Trust Asset Management, Bloomberg, UBS. Global Real Estate valuation uses price to NAV (net asset value) estimates from UBS based on its global coverage universe (developed regions only). Median uses earliest monthly valuation data: 1990 (Global Real Estate), 2007 (Global Listed Infrastructure) and 2010 (Natural Resources). Normal range is +/- 1 standard deviation from the median. Data as of 11/30/2023.

PRIVATE MARKETS

The private equity industry continues to work through a slower deal environment. Expectations for full-year global mergers-and-acquisitions transaction volume are at their slowest pace since 2014, and public market initial public offering activity is hovering around 2016 levels. The slowdown in deal activity has meant institutional investors with mature private markets programs have had to navigate an environment in which overall exposure to the asset class has risen above targeted allocations. As an industry, capital call activity has outpaced distribution activity for the first time since 2012, further increasing overall exposure to the asset class.

Looking forward into 2024, there are two segments of the private markets — secondaries and private credit — that we remain focused on and believe will be attractive given the slowdown in deal activity and the higher rate environment.

We think the most attractive part of the private equity market this year will be the secondaries market of existing private-equity stakes.

Secondary Private Equity

We think the most attractive part of the private equity market this year will be the secondaries market of existing private-equity stakes. The secondary market has grown from a relatively small asset class in the early 2000s to an industry with over $100 billion of transaction volume in 2022. However, despite this growth, it remains a niche component of the overall alternatives space. We expect that as more investors gain awareness of the attractive risk/return characteristics of this niche, this percentage will increase.

Secondaries are a strategy in which heightened market volatility can create the opportunity to purchase high-quality assets at material discounts to their intrinsic values. Sellers, including both limited partners (LPs) and general partners (GPs), are looking to the secondary market as a way to manage portfolios through a period of shifting market liquidity. LPs are looking to secondary markets to sell private equity holdings and rebalance their asset allocations after a year of relatively slow deal activity and limited distributions. GPs are using the secondary market to provide liquidity for legacy fund investors while maintaining control over prized businesses that offer further value creation opportunities. The past year offered a rich opportunity set for secondary buyers, and the year ahead is setting up to be one of the best market environments for multi-strategy secondary fund managers.

Private Credit

While the current tightening cycle looks like it is approaching an end, many believe that most monetary policymakers will continue to leave rates elevated for a longer period. As a result, investor appetite for floating rate private debt strategies has remained strong.

The private credit industry continues to expand and grow market share at the expense of traditional commercial bank lenders. Additionally, private equity sponsors will continue to rely on the industry as they look to deploy their record amounts of dry powder. The demand for private credit loans from both investors and sponsors means the industry is positioned to continue to grow.

In particular, the senior direct loan market remains in focus. As businesses potentially experience margin compression, higher financing costs, and lower cash flow, an increase in default rates could occur, making senior loans relatively more attractive to other forms of more subordinated debt. Private credit lenders are not all created equal. We think lenders that adhere to disciplined underwriting standards have the ability to dictate covenant protections, and those that possess a track record of working with prominent private equity sponsors will be better positioned in this environment. Investors evaluating go-forward risk-adjusted returns should consider the benefits of adding senior loans to their portfolios.

We think investors should consider adding senior loans to their portfolios, as they appear more attractive than other forms of subordinated debt.

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