

2019 ANNUAL REVIEW

# MANAGING EXPECTATIONS

Returns in 2019 highlighted the importance of investor expectations — and understanding what is already “priced in” to financial markets. For instance, the 2019 economic data did not seem to be the foundation for robust financial market returns. Global economic growth was muted, with manufacturing slumping as a result of the U.S.-China trade war. Global equity earnings growth was flat-to-negative. And yet global equities gained 27% in 2019, with U.S. equities up 31%.

How does this happen? Well, for starters, 2019 started from a very low base. Global equity markets were down 13% in the fourth quarter of 2018, pushing global equity valuations below long-term historical averages (data going back to 1970). Even U.S. equities, which have had a persistent valuation premium over recent years, came within spitting distance of their own long-term average. When considering the low interest rate environment, such valuations were attractive but investor growth expectations were low. Investors believed the global economy would suffer from U.S.-China trade tensions. Further, they were unconvinced that central banks were willing to do anything about it. In fact, there was concern the Federal Reserve would continue raising interest rates.

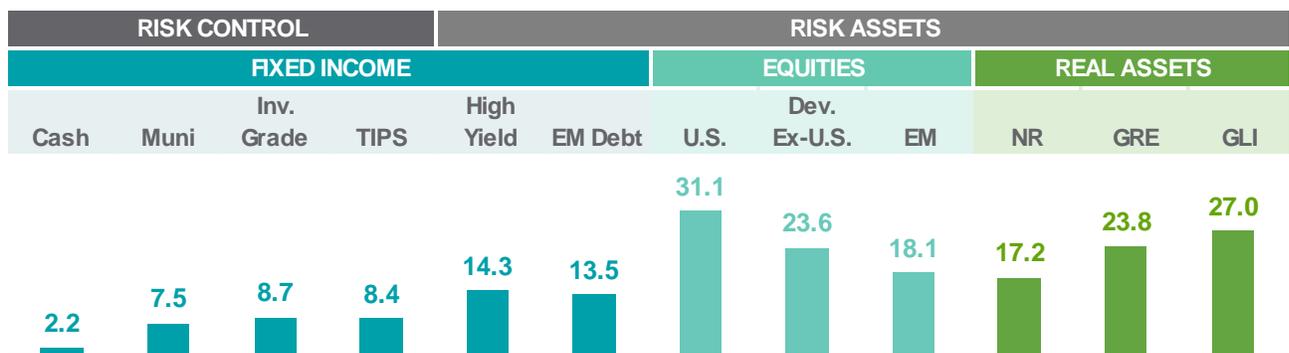
As investors navigated 2019, they began to realize that things weren’t so dire. First, U.S.-China trade tensions were hurting the manufacturing sector but the services

sector (a much larger percentage of the global economy) was doing reasonably well, allowing the global economy to avoid recession. Second, despite widespread concerns that tariffs would push prices higher, inflation remained low. In fact, inflation was too low for central bankers’ liking — and central banks finally relented on their monetary policy tightening campaigns. The Fed cut rates three times throughout 2019 (expectations coming into the year were for more rate hikes). Meanwhile, the European Central Bank cut rates further into negative territory and began a new quantitative easing program (expectations were for the bank to begin positioning its exit strategy from negative interest rates). Finally, a U.S.-China trade armistice and hope for an orderly Brexit resolution removed some political uncertainties, capping a year that easily surpassed low expectations.

The obvious question now is whether expectations are too high going into 2020. The combination of strong equity returns and flat-to-negative earnings growth has resulted in valuations that are back to levels found prior to 2018’s fourth quarter dip. These elevated valuations can be supported if: 1) global growth can continue (or even get a boost) as political uncertainties are reduced, allowing for a resumption of global equity earnings growth; and 2) inflation remains tame, allowing for a continuation of the easy money policy reinstated in 2019.

## 2019 TOTAL RETURNS (%)

Financial markets did well in 2019, as the global economic and financial market environment surpassed low expectations.



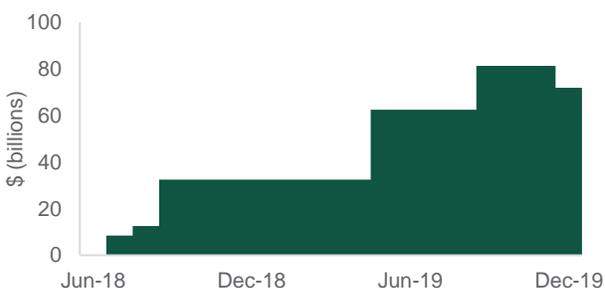
Source: Northern Trust Asset Management, Bloomberg. NR = natural resources; GRE = global real estate; GLI = global listed infrastructure. Indexes are gross of fees and disclosed on last page. It is not possible to invest directly in any index. **Past performance is no guarantee of future results.**

KEY DEVELOPMENTS

U.S.-China Trade Armistice

U.S.-China trade tensions, which had been on investors' minds throughout 2019, fell in December. The "phase one" trade agreement is a good start but much work is still to be done. Some tariffs have been rolled back but a majority remain in place (see chart). China has promised to increase its U.S. imports but some question whether it can actually purchase what has been speculated (\$200 billion in goods over two years). Other parts of the deal come with questions on enforcement.

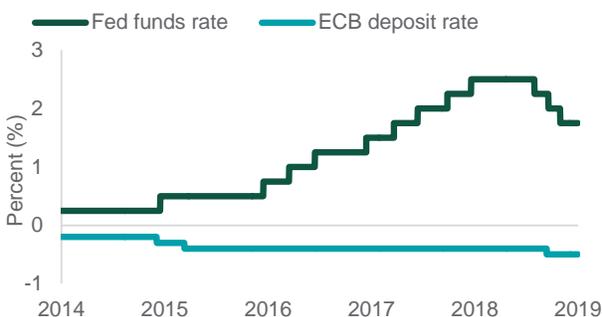
U.S. ANNUAL TARIFF PROCEEDS FROM CHINA



The New Global Easing Cycle

While the U.S.-China trade armistice put a nice bow on 2019 financial market returns, what really got 2019 off on the right foot was the start of the new global monetary easing cycle. The Fed responded to investor criticism through 2018's fourth quarter market sell-off by stopping rate hikes and then cutting three times in 2019. The European Central Bank also got into the action with a rate cut of its own as well as a new quantitative easing program. Easy monetary policy will likely remain throughout 2020.

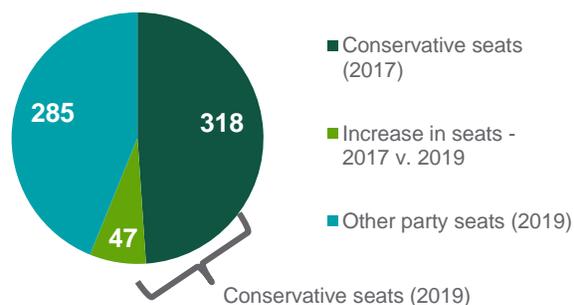
KEY CENTRAL BANK POLICY RATES



Brexit Update

U.K. Prime Minister Boris Johnson scored a big win in the recent election, increasing Conservative Party seats by 47 for an 80-seat majority. Johnson's new mandate now positions the U.K. to leave the European Union on January 31. However, all work is not done. Johnson has stated his desire to finalize a new trade agreement by the end of 2020. This represents an aggressive timeline that will surely keep investors on their toes throughout the year.

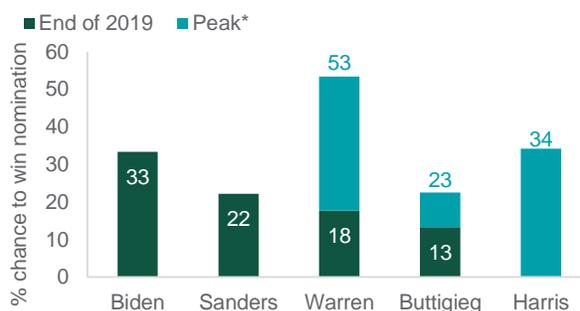
CHANGE IN U.K. PARLIAMENT COMPOSITION



Democratic Merry-Go-Round

Last year was a good lesson in the futility of predicting elections. Former vice president Joe Biden began as the Democratic front runner for the November U.S. election before a strong June debate put Senator Kamala Harris into the pole position. Harris peaked at a 34% chance of nomination based on Real Clear Politics betting odds before she lost steam and exited the race. Senator Elizabeth Warren peaked at 53% — and unnerved investors with progressive policies — before regressing. Biden is now back in the lead at 33%.

U.S. DEMOCRATIC NOMINEE BETTING ODDS



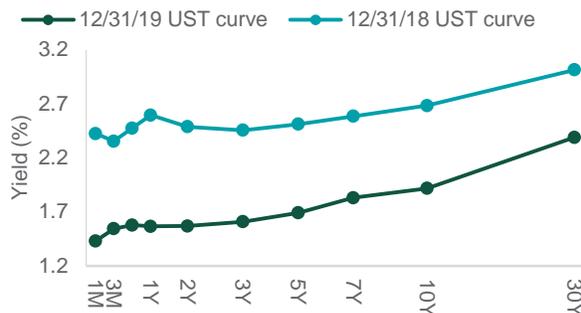
Source: Northern Trust Asset Management, Cornerstone Macro, Bloomberg, BBC, Real Clear Politics. \*Peak of last six months.

MARKET REVIEW

Interest Rates: Demand for Treasuries

The Treasury yield curve shifted lower during 2019 as constant pressure on long-term interest rates forced the Fed to reduce its key policy rate three times. Economic growth rates were subdued and inflation remained missing in action, lowering investors' required yields. Also, ongoing political concerns (U.S.-China) kept demand high for Treasuries. Finally, Treasury demand from Japan and Europe was the highest since 2012, keeping a lid on rates.

TREASURY YIELD CURVE



Credit Markets: Falling Spreads

Credit spreads fell throughout the year, retracing all of the increase in the fourth quarter of 2018 — and then some. The path was not smooth, with periodic spikes in spreads generally driven by U.S.-China headlines. But, overall, credit spreads are supported by a steady economy and low default rates as well as strong demand for yield. The current 3.3% average high yield spread compares to the five-year low of 3.0% while the average 0.9% investment grade spread compares to the five-year low of 0.8%.

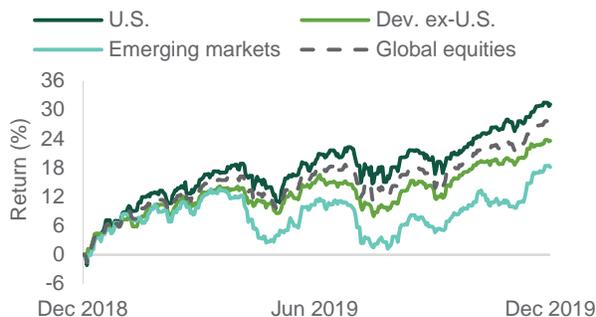
CREDIT SPREADS



Equities: U.S. Leads on Tech

It was the best year for global equities since 2008, with a total return of 27%. The gain was driven by U.S. equities, which were up 31%, thanks to a surging technology sector that was up 50%. Other major regions showed lower but still impressive returns. Despite continued economic struggles, Europe and Japan were up more than 20% and developed ex-U.S. markets in aggregate returned 24%. Meanwhile, emerging markets lagged at 18% because of on-and-off global trade tensions.

REGIONAL EQUITY INDICES



Real Assets: Buoyed by Low Rates

Global listed infrastructure performed the best, nearly in line with equities. It is generally a more defensive asset class, which is not expected to keep pace in a "risk-on" environment. However, global listed infrastructure received a boost from its exposure to falling interest rates. Global real estate also benefited from falling interest rates but fell slightly short of global equities. Natural resources suffered from the slow global growth environment, lagging most other risk assets.

REAL ASSET INDICES



Source: Northern Trust Asset Management, Bloomberg. UST = U.S. Treasury. Indexes are gross of fees.

## MARKET EVENTS

■ 2019 global equity total return: 27.3%



Q1	Q2	Q3	Q4
<p><b>1</b></p> <p>The Fed lists low inflation and global economic risks in its decision to put interest rates on hold and end the balance sheet runoff early.</p>	<p><b>4</b></p> <p>Trump tweets that the U.S. will raise tariffs against China on the upcoming Friday as U.S. officials accuse China of renegeing on pledges.</p>	<p><b>7</b></p> <p>Fed cuts interest rates for the first time since the financial crisis by 0.25% and concludes its balance sheet reduction earlier than planned.</p>	<p><b>10</b></p> <p>The Fed cuts interest rates by 0.25% for the third time in 2019 putting rates in the 1.5%-1.75% channel.</p>
<p><b>2</b></p> <p>U.S. President Donald Trump delays March 1 deadline, preventing the escalation of tariffs from 10% to 25% on \$200 billion worth of Chinese goods.</p>	<p><b>5</b></p> <p>After trailing in the polls, Scott Morrison wins Australia's election for prime minister, sending Australian equity markets up 2%.</p>	<p><b>8</b></p> <p>China announces new tariffs on \$75 billion of U.S. imports; Trump responds with an additional 5% of tariffs on \$250 billion of goods (October implementation).</p>	<p><b>11</b></p> <p>U.K. Prime Minister Boris Johnson's Conservative Party wins a decisive majority in the House of Commons, clearing an easier path for Brexit.</p>
<p><b>3</b></p> <p>U.K. Prime Minister Theresa May's third attempt to pass a Brexit withdrawal agreement fails, eventually forcing another extension.</p>	<p><b>6</b></p> <p>Oil prices jump ~4% on reports that Iran attacked two oil tankers; other geopolitical events would impact the oil markets throughout the year.</p>	<p><b>9</b></p> <p>ECB cuts interest rates by 0.1% (to -0.5%), and plans to buy €20 billion in bonds per month starting in November.</p>	<p><b>12</b></p> <p>The U.S. and China agree to the text of a "phase-one" trade deal, preventing the tariffs on consumer goods from going into effect on December 15.</p>

Indexes used: Bloomberg Barclays (BBC) 1-3 Month UST (Cash); BBC Municipal (Muni); BBC Aggregate (Inv. Grade); BBC TIPS (TIPS); BBC High Yield 2% Capped (High Yield); JP Morgan GBI-EM Global Diversified (Em. Markets Fixed Income); MSCI U.S. Equities IMI (U.S. Equities); MSCI World ex-U.S. IMI (Dev. ex-U.S. Equities); MSCI Emerging Market Equities IMI (Em. Markets Equities); S&P Global Natural Resources (Natural Resources); MSCI ACWI IMI Core Real Estate (Global Real Estate); S&P Global Infrastructure (Global Listed Infrastructure).

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