MAY 2020

LESS REWARD, MORE RISK

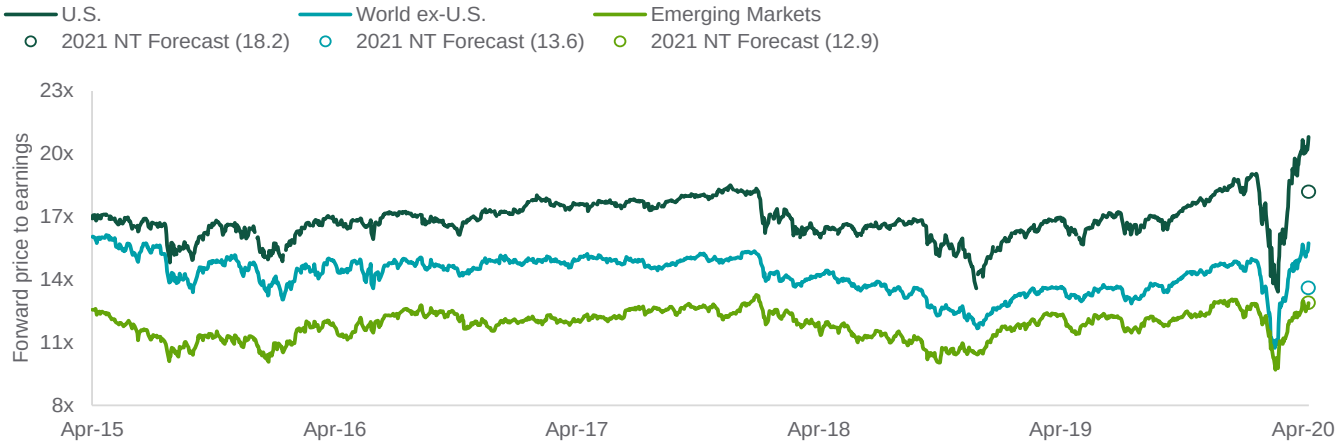
Risk assets have rallied strongly over the last seven weeks as policy actions have been forceful, COVID-19 cases have peaked in important areas and investors have been willing to look past the short-term economic carnage. Economic forecasts remain unusually uncertain, as does the outlook for corporate earnings. Using consensus forward earnings, equity market valuations worldwide have rebounded significantly and are at or above five-year highs (as shown below). We also show valuations based on our 2021 earnings forecast, which assumes some level of economic normalization. On this metric, the U.S. equity market is selling at 18 times a relatively uncertain earnings number. The market assumption may be correct, but we believe the rally has reduced the margin for error and we have consequently reduced the recommended tactical risk in our global policy model this month.

The outlook for corporate earnings and risk appetite will be significantly influenced by the pace of COVID-19 over the next six-to-twelve months. Most major economies are starting to ease social distancing restrictions, but are doing so without significant advances in treatment or vaccine, and without showing the level of progress that health officials believe is necessary to prevent a second wave. Compounding the uncertainty are early reports that children, previously thought to be relatively safe from the virus, may be at risk of related health complications. For the economy to return toward full activity, citizens will need to be confident that their health is safe, which will likely require either a vaccine or a dying out of the virus after this season. We continue to think broad vaccine availability is likely more than a year out; the vaccine not only needs to be developed, but also robustly tested for safety and manufactured at a scale likely never seen before.

The combination of the significant rally in risk assets and continued uncertainty in the economic outlook led us to reduce the recommended proportion of risk assets (a combination of global real estate, high yield and U.S. equities) in our tactical global policy model by 7%. We have directed the proceeds to risk-control assets (investment grade bonds, inflation-protected bonds and cash). This change puts us in a neutral risk position, as we balance the potential for both positive and negative surprises over the next year. Our risk cases include insufficient policy support in the wake of a resurgence of COVID-19 cases and the potential for a fiscal spending-led jump in inflation that would undermine current valuations.

DISCOUNTING A RECOVERY

The strong market rally has significantly boosted valuations.



Source: Northern Trust Global Asset Allocation, MSCI, Bloomberg. Forward price to earnings ratio calculated using Bloomberg 12-month earnings per share estimates and prices as of 5/8/2020. NT forecasts use 2021 earnings per share estimates as of 5/4/2020. Indices used: S&P 500, MSCI World ex-U.S., MSCI EM.

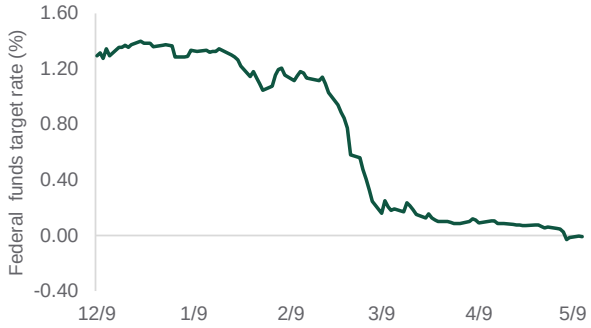
Interest Rates

In addition to announcing new plans for how it will finance burgeoning U.S. deficits, the Department of the Treasury surprised markets with a massive refunding announcement at the start of the month. Despite the recent explosion of supply of short-term Treasury bills and the auction of new notes at the start of May increasing the size of the two-year Treasury market by 50% year-to-date, short-term yields have continued to hover near zero. The two-year and five-year notes both hit historic lows, with the yield on the two-year note falling below the previous record set during the European debt crisis (0.13%). Federal fund futures declined into negative territory for the first time in history.

In reaction, the probability of negative interest rate policy in the U.S. implied by swaption markets rose from 19% to 28%, the highest on record. The impetus for this move is likely technical, following the refunding announcement and the notice of plans to ramp up auctions of longer-dated Treasury securities. The Federal Reserve has consistently delivered the message that it does not desire negative rates, and we believe the Fed will be staying near the zero-bound range for the foreseeable future. We also have not seen negative interest rates as an effective policy tool in other parts of the world.

TO ZERO, BUT NOT BELOW

We do not believe the Fed will go to negative rates.



Source: Northern Trust Global Asset Allocation, Bloomberg. Federal funds target rate implied by June 2021 federal funds futures contract traded on Chicago Mercantile Exchange. Data from 12/9/2019 through 5/11/2020.

- A surge in short-term supply has been well-handled.
- While short-rates have fallen, we don't expect them to go negative.
- We expect rates to be range-bound over the next six-to-twelve months.

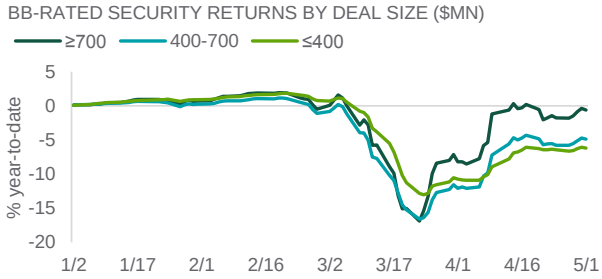
Credit Markets

The high-yield market has seen a large performance bifurcation across credit quality, but even within ratings buckets we see disparities in performance. We break down the BB-rated segment further by looking at deal size – a proxy for liquidity – and see that the largest and most liquid deals saw the largest drawdown at 16.9%. However, they have since recovered and are essentially unchanged from the beginning of the year, down only 0.6%. This compares with smaller, less liquid issues, which have lagged the rally and are still down in the range of 5-6%.

This performance differentiation makes sense when viewing it from a liquidity perspective. When managers needed to sell securities to raise cash, they looked to their most liquid bonds. As spreads tightened from the widest crisis levels, managers again looked to the most liquid securities to add exposure. This leaves the BB-rated universe in a peculiar situation; spreads at the index level look wide and attractive, but finding individual BB-rated securities that are liquid enough to purchase is increasingly difficult. With spreads having compressed from their wide levels and our overall risk appetite diminished, we partially reduced our recommended overweight to high yield this month. However, it remains our largest overweight.

LIQUID RALLY

Largest deals have rebounded more quickly.



Source: Northern Trust Global Asset Allocation, Credit Suisse, Bloomberg. Cash returns shown for BB-rated securities within Bloomberg Barclays U.S. Corporate High Yield Index.

- Liquidity characteristics have had an outsized impact on recent performance.
- We expect buying interest to start moving down the credit spectrum to the more liquid B-rated bonds.
- We partially reduced our recommended overweight to high yield bonds this month.

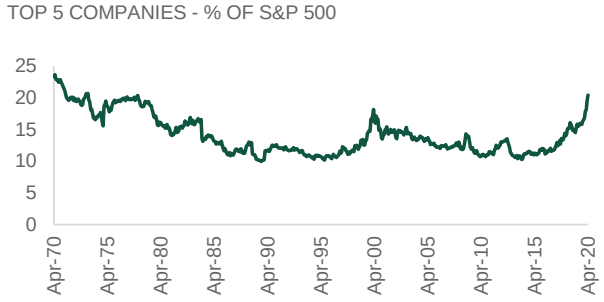
Equities

Global equities continued to recover strongly over the past month, led by the U.S. Despite the worst economic backdrop since the Great Depression, U.S. equities are down less than 10% year-to-date, outperforming non-U.S. equities. First-quarter earnings season is drawing to a close, and while the economic shutdown was a small portion of the quarter, the impact was still felt, and forward guidance was almost universally withdrawn. Near-term earnings estimates have fallen considerably, but the market is looking toward 2021 and what more normalized earnings may look like. On that basis, market valuations are still elevated despite the potential that the virus and its associated consequences linger longer than expected.

The return of the average S&P 500 company is down twice that of the overall market this year. The top five companies now comprise over 20% of the index, the highest concentration level since the 1970s. Those five names are up an average of 12% this year, contributing nearly half of the S&P 500's gain over the past three years. With recent equity strength appearing to suggest closer to a V-shaped recovery, we have become less constructive. We continue to prefer the U.S., including the benefit of the fundamental resilience of these secular disruptors.

S&P 500 CONCENTRATION

The top five companies represent 20% of market cap.



Source: Northern Trust Global Asset Allocation, FactSet. Top companies % of S&P 500 measured by market capitalization using month-end values. Current top 5 companies include Microsoft, Apple, Amazon, Alphabet and Facebook. Data from 4/30/1970 through 4/30/2020.

- Top technology stocks represent an increasing percentage of the U.S. market.
- Tech stocks are supported by strong fundamentals, but smaller companies aren't performing as well.
- Stocks have become more expensive, and we've become less constructive as a result.

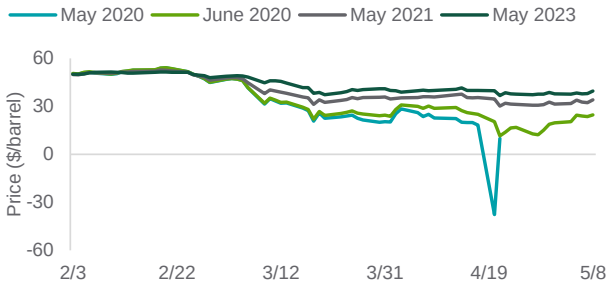
Real Assets

The biggest story in real assets has been the recent plunge in oil prices. The May 2020 crude oil future hit an end of day price of -$38 per barrel one day before the contract expired. This unprecedented event was caused by a lack of places to store the oil flooding the markets just as COVID-19 was causing massive demand destruction. Normally, investors sell expiring oil futures contracts to buyers with a physical need for that oil; without buyers, they are forced to take delivery. Because many investors have nowhere to store thousands of barrels of oil and because most oil consumers didn't have a place to put the oil either, investors were actually forced to pay for the oil to be taken off their hands. There is some concern that the June contract will suffer a similar fate once it gets closer to expiration, though it has held up reasonably well thus far.

The oversupply and low demand for oil at present leave us underweight natural resources in our global policy model. Dividend yields on the asset class are nearing 5%, but with commodity prices suffering, there is increasing concern about whether those dividends will be fully paid. Elsewhere in the portfolio, we reduced our allocation to global real estate due to the likely permanent impairment in the value of shopping centers, offices and other properties.

DRILLING BELOW ZERO

Oil prices briefly went negative in April.



Source: Northern Trust Global Asset Allocation, Bloomberg. Prices shown for WTI crude oil futures contracts traded on the New York Mercantile Exchange. Daily data from 2/1/2020 through 5/10/2020.

- Oil markets are suffering from a lack of demand and lack of places to store supply.
- We remain underweight natural resources.
- Global real estate was reduced to neutral weighting given concerns over permanent property impairment.

BASE CASE

Pandemic vs. Policy

Quick and forceful monetary and fiscal policy action has (at least temporarily) put a floor under equity markets and has helped restore liquidity to financial markets more broadly. Going forward, the focus will once again shift to the pandemic, specifically the speed at which the global economy can start to reopen.

Structural Monetary Accommodation

Major central banks globally will remain accommodative for the foreseeable future, with near-zero prospects for any rate hikes. Central banks will try to help offset virus-driven economic and financial market pressures, but have limited means to do so and will need to coordinate with fiscal policymakers.

RISK CASES

A Policy Bridge Too Short

A second wave of coronavirus cases or slow removal of social distancing precautions elongates the economic malaise beyond what policy can counter, leading to a protracted economic recession.

Structural Inflation Shift

Unprecedented levels of fiscal stimulus globally eventually overwhelm structural deflationary pressures, leading to inflation and higher interest rates – undercutting key supports for risk assets.

GLOBAL POLICY MODEL

Strategic Allocation and Tactical Over/Underweights	RISK CONTROL			RISK ASSETS							
	FIXED INCOME				EQUITIES			REAL ASSETS			
	Cash	Inv. Grade	TIPS	High Yield	U.S.	Dev. Ex-U.S.	Emerg. Markets	GLI	GRE	NR	Gold
Strategic Asset Allocation	2	34	5	5	25	15	6	2	2	4	0
Tactical Asset Allocation	2	33	2	9	29	14	2	4	2	3	0
Over/Underweight	**0**	**-1**	**-3**	**4**	**4**	**-1**	**-4**	**2**	**0**	**-1**	**0**

Source: Northern Trust Capital Market Assumptions Working Group, Investment Policy Committee. Strategic allocation is based on five-year models developed annually; most recent model released 8/8/2019.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.