

JULY 2020

HEIGHTENED VOLATILITY

Just months after one of the sharpest drops ever, stock markets globally are nearing cycle highs as most economic data continues to show repair. Fiscal stimulus and income support programs have supported consumer spending over the last several months, as have lending programs to businesses intended to underpin employment. However, we remain concerned that continuing COVID-19 cases will blunt the pace of the current rebound. While most broad measures of growth are still rebounding firmly, there are signs of softening in areas like restaurant and airline bookings as well as retail sales. Even regions where the virus is well-controlled, like Hong Kong, are seeing the effects, as a small rise in virus cases led to the re-closing of Hong Kong Disneyland. In the U.S., California has responded to rising cases by cancelling in-person public schooling in Los Angeles and San Diego starting in August.

So, is the market being irrational in continuing to advance in the face of these resurgent risks? Certainly, the stock market is not directly representative of the real economy. Many of the most affected industries, including retail, travel, and hospitality, are small parts of the market; while some of the greatest beneficiaries, such as the technology industry, are the largest. This can be illustrated by comparing the market cap-weighted S&P

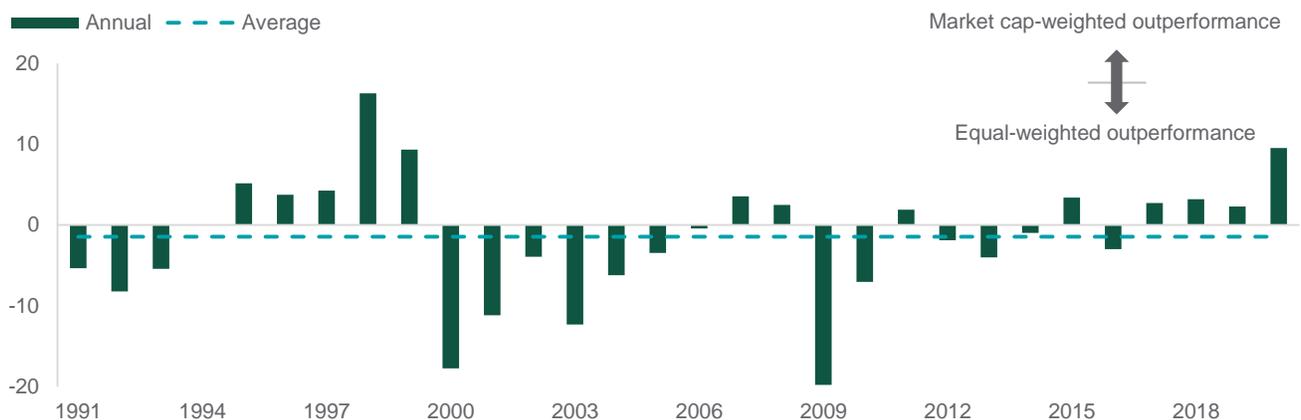
500 performance to that of the equal-weighted index. As shown below, the market cap-weighted index has materially outperformed the average stock this year. While the better economic (and market) performance of the bigger technology companies makes the earnings outlook less uncertain than may be believed at first glance, we see only around 5% upside to our 2021 earnings outlook.

Even though interest rates have returned to near-record lows, the stock market looks somewhat pricey. Valuations aren't a timing device, and markets can stay expensive for extended periods of time. After reducing our recommended tactical risk position in our global policy model the last two months, we stood pat with our moderate underweight to risk this month. Our Structural Monetary Accommodation theme posits that central banks will continue to provide extraordinary monetary support for the foreseeable future, which provides support to risk taking. We do expect COVID-19 to create recurring public health problems over the next year, but we will also see continued advances in treatment and vaccine development that may lead the market to look past the shorter-term challenges. Heightened volatility will likely be the resulting environment as investors assess the outlook for global growth in 2021 and beyond.

BIGGER HAS BEEN BETTER

The stronger performance of larger stocks reflects their greater resiliency in a COVID-19 economy.

S&P 500 MARKET CAP-WEIGHTED VS. EQUAL-WEIGHTED RETURN DIFFERENCE (%)



Source: Northern Trust Global Asset Allocation, Bloomberg. Price returns shown from 12/31/1990 through 7/14/2020. Year-to-date returns shown for 2020.

Interest Rates

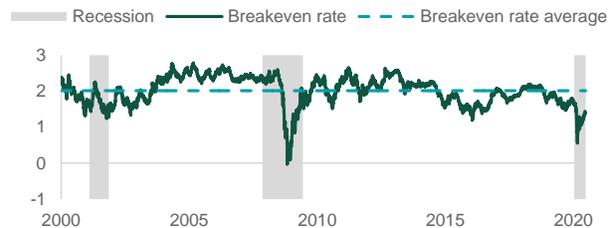
Treasury inflation-protected securities (TIPS) have historically fallen during recessions as inflation expectations decrease. This recession has been no different. After bottoming in March, TIPS have rebounded due to monetary and fiscal stimulus. Inflation expectations (as measured by 10-year breakeven rates) showed an initial sharp bounce from March's virus-depressed level and have continued to slowly inch up over the past three months. TIPS funds have seen \$4.7 billion of inflows since mid-July.

During the financial crisis, 10-year breakevens contracted over 260 basis points (bps), from 2.6% to about 0%, before rallying back to prior levels over the next year. During the beginning of the COVID-19 crisis, we also saw a significant contraction with peak-to-trough breakevens falling by over 120 bps. Breakeven rates have since recovered by more than 80 bps as the economy slowly re-opened and consumer demand strengthened. We reduced our TIPS underweight in May to capture this dynamic. However, the acceleration of COVID-19 cases across parts of the world remains a significant headwind. As a result, we maintain a (smaller) underweight to TIPS, expecting traditional investment grade bonds to outperform over the next year.

RECESSIONARY REBOUND

TIPS are reflecting the expected economic recovery.

U.S. BREAKEVEN INFLATION RATE (%)



Source: Northern Trust Global Asset Allocation, Bloomberg. Breakeven inflation rates implied by 10-year U.S. treasury inflation-protected securities. Daily data from 1/21/2000 through 7/14/2020.

- TIPS performed typically during the early stages of the recession.
- The rebound in expected inflation has been muted, which we think is correct.
- We remain underweight TIPS in our global policy model.

Credit Markets

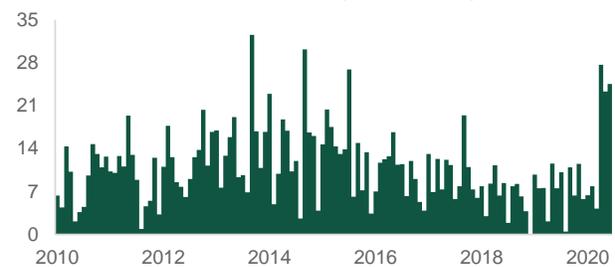
The high-yield market has experienced record supply in 2020 as companies have looked to raise cash to protect balance sheets. Halfway through 2020, the market is on record pace for gross issuance, nearly doubling 2019's figure. Issuance is expected to normalize in the coming months as management teams assess further liquidity needs. Companies must optimize capital structures in order to comply with financial covenants, while being prepared for future business disruption.

Similar to the investment-grade market, which has also experienced record issuance, investors have been eager to buy high yield at attractive valuations. Cumulative inflows through June are roughly \$30bn, which is a tailwind for the asset class through quieter summer months when new issuance decreases. Cash inflows support valuations as managers must invest capital in order to maintain neutral cash balances. Many uncertainties remain as economies attempt to "re-start," but based on investor appetite for record new issuance over the past six months, supportive fiscal and monetary policy going forward, and a continued search for yield from global investors, the high-yield asset class appears able to continue to attract capital, ultimately supporting valuations.

BOLSTERING BALANCE SHEETS

New issuance is at a record pace.

HIGH YIELD NET ISSUANCE (\$ BILLIONS)



Source: Northern Trust Global Asset Allocation, Bloomberg. High yield net issuance for Bloomberg Barclays High Yield Index, net of refinancing issuance. Monthly data from 1/31/2010 through 6/30/2020.

- High-yield companies have been furiously raising capital to protect their financial positions.
- Easy monetary policy and resulting low interest rates have supported issuance.
- We continue to remain overweight high yield in our global policy model.

Equities

After pulling back to test the 3,000 level on the S&P 500 twice in June, equities are again moving higher. Second-quarter (2Q) earnings season is underway and is expected to represent this cycle’s earnings trough. Globally, 2Q earnings are expected to decline more than 40% from a year ago, led lower by energy, consumer discretionary, industrials and financials. More modest declines are expected in traditionally defensive sectors. Earnings are expected to sharply rebound in 2021, with full-year 2021 estimates for U.S. just below 2019 actual levels; developed ex-U.S. 7% below; and emerging market equities 10% above.

Market leadership continues to favor large-cap technology-related stocks where earnings are stable or even benefiting from the current environment. The >\$1 trillion market cap tech stocks are exaggerating the outperformance of growth in the U.S., but growth outperformance is not a U.S.-only phenomenon. As the economy improves, value could see a comeback, but with P/E multiples on the broader market appearing full, even on 2021 expectations, we find the risk/reward of equities less attractive considering the potential for disappointing growth as the health threat overhang remains.

Real Assets

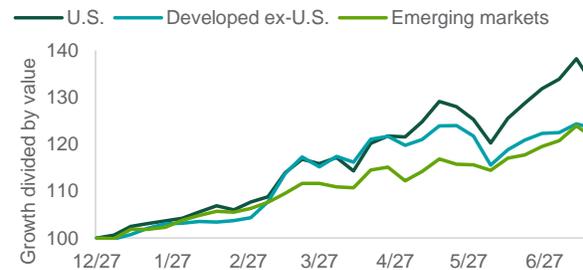
Global listed infrastructure (GLI) is supposed to be a “less risky” risk asset, providing income and downside protection to the risk portfolio. And yet it trailed global equities in the downturn by 9% and is still down 30% for the year while the broader equity market has materially recovered. What is going on here? The asset class’ exposure to interest rates – which normally fall during stock market sell-offs – usually stabilizes returns in times of equity market weakness. But the acute nature of this recession led to unusual asset class performance. Specifically, the notable reduction in air and seaport activity hurt port service stocks (22% of the index); the material fall in energy prices affected energy service stocks (20%); and reduced mobility hurt transportation (highway and railway) stocks (16%). Together, these sectors offset utility sector performance.

We remain overweight GLI, as we don’t expect permanent impairment to the worst-hit sectors. But we expect higher yields to be attractive in an extended low-interest-rate environment. We also note that more diversified infrastructure indexes have fared better this year. We remain tactically equal-weight global real estate weighing attractive income generation against property value write-downs (e.g. retail) and tactically underweight natural resources, given over-supply and low demand.

GLOBAL GROWTH

Growth stocks are outperforming in most markets.

GROWTH AND VALUE RELATIVE RETURNS



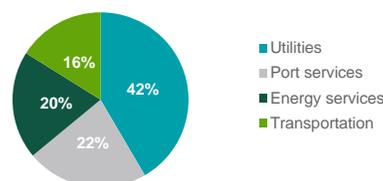
Source: Northern Trust Global Asset Allocation, Bloomberg. Indices used: Russell 1000 growth and value index, MSCI World ex-U.S. growth and value index and MSCI EM growth and value index. Returns indexed to 100 on 12/27/2019. Data through 7/14/2020.

- Stock markets are benefitting from growth stock leadership.
- Valuations appear full as we don’t see meaningful earnings upside potential.
- The risk/reward of equities is reduced by full valuations and growing public health uncertainty.

ANATOMY OF AN INFRASTRUCTURE INDEX

Global listed infrastructure is more than just utilities.

GLOBAL LISTED INFRASTRUCTURE COMPOSITION



Source: Northern Trust Global Asset Allocation, Bloomberg. Weights as of 7/14/2020 for S&P Global Infrastructure Index.

- The acute nature of this recession hit GLI harder than in past market sell-offs.
- We remain overweight GLI in our global policy model for its income generation in a low-interest-rate world.
- We are slightly underweight natural resources, as we wait for a better commodity supply-demand balance.

BASE CASE

Pandemic vs. Policy

Extensive monetary and fiscal policy measures have helped financial markets rebound and economic data has started to recover from virus-induced weakness. The focus will remain on the pandemic – specifically the economic recovery – which will fall short of both market expectations and the prior trajectory.

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

Reluctance to increase or maintain fiscal rescue packages in addition to a second wave of virus cases exacerbates the economic malaise, leading to a protracted disappointing economic recovery.

The Markets Have it Right

The current economy-financial market disconnect disappears as the economy and company fundamentals recover quicker and more robustly than expected – leading to a sustained rally in 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	35	2	11	25	14	2	4	2	3	0
Over/Underweight	0	1	-3	6	0	-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.

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