SEPTEMBER 2020

AN INTERESTING FALL

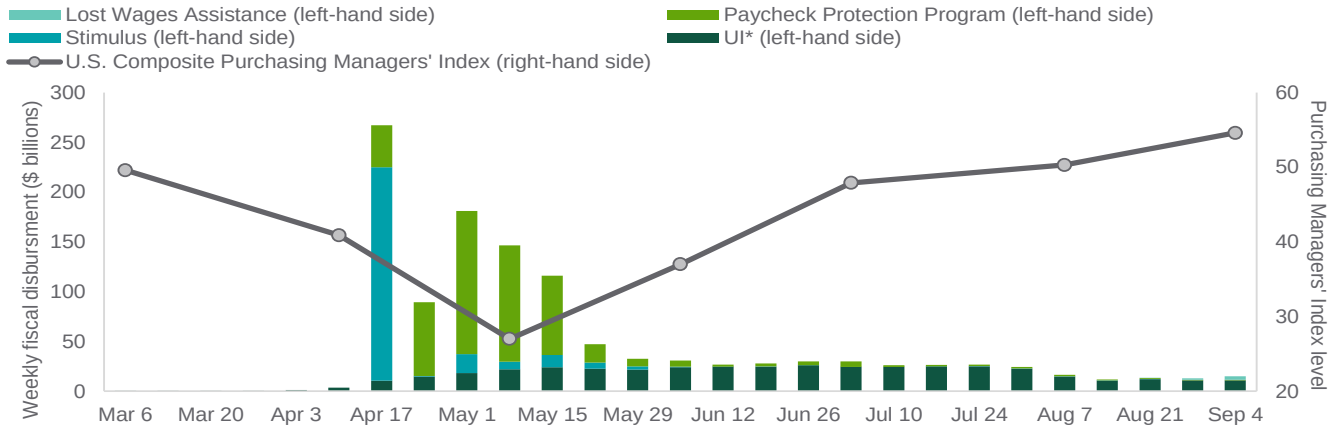
The relentless run in risk assets over the last five months finally faded a bit in early September, as the S&P 500 fell nearly 8% and the tech-heavy NASDAQ fell 11%. This year's returns have been heavily influenced by the predominance of large technology stocks (in both U.S. and emerging markets), as the five largest U.S. stocks (all tech companies) are up 42% year to date while the remaining 495 stocks in the S&P 500 are down a cumulative 3%. Supporting the view that this is more likely a normal correction than the start of something more damaging, the credit markets have been well behaved. High-yield spreads increased only 25 basis points during this period, while oil prices (which directly hit spreads) fell $6 during this time. While there are many theories about the origin of the sell-off (excess options activity; U.S.-China tensions; worry about the election; rising COVID-19 cases), we think it is more productive to analyze what we think matters to markets going forward. In that vein, we focus here on the economic recovery, the outlook for COVID-19 and the upcoming U.S. elections.

Global economic momentum has continued, with most recent data releases showing steady improvement, albeit with occasional pockets of softness. After a historic economic decline in the second quarter (31% in the U.S. and 47% in Europe) the third quarter looks increasingly certain to show a robust rebound. The national statistics can be somewhat backward looking, but our more real-time indicators of consumer spending and business optimism such as the NFIB survey of small businesses and the IFO survey in Germany, show continued improvement. With COVID-19 case levels above where health professionals wanted them to be before the start of the flu season in the Northern Hemisphere, markets will focus on the risk of increasing cases. Countries such as Australia and Israel have recently reinstituted lockdowns to contain increasing case counts.

It will be an interesting final four months of the year as markets wrestle with the economic outlook in addition to the need for further fiscal stimulus in the U.S. ahead of the November 3rd national elections. Our base case is that an additional stimulus plan does get passed – smaller in scope but more targeted to immediate consumption. A meaningful rise in COVID cases may lead to more self-enforced social distancing, as opposed to broad lockdowns, somewhat reducing the economic impact. With so much waiting to be resolved in a short period of time, we don't think it is a time for big bets on the market. In markets like these, it is most important to reaffirm one's portfolio construction and ability to weather the potential for sustained volatility ahead.

FADING FISCAL, RISING GROWTH

Fiscal stimulus cushioned the initial blow; additional is still needed despite better growth.



Source: Northern Trust Global Asset Allocation, Evercore ISI, Treasury, Census, SBA, BEA. *UI: unemployment insurance relative to same week last year. Most recent month-end Purchasing Managers' Index values, levels above (below) 50 are expansionary (contractionary). Week-end fiscal values through 9/4/2020.

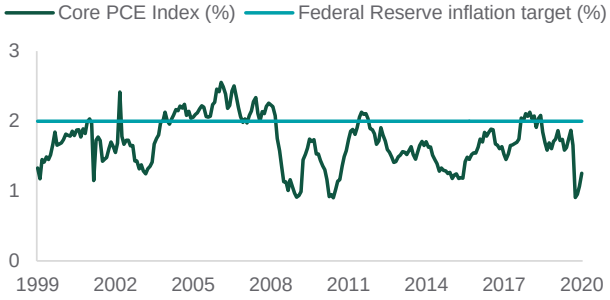
Interest Rates

The Federal Reserve held its annual Jackson Hole Symposium and made two key policy changes. First, the central bank will move to a flexible inflation target, allowing inflation to run above its previous 2% target for a period of time. The central bank gave no specific guidance on how it will boost inflation above 2%. It has been difficult for the economy to consistently generate 2% inflation since the late 1990s. This leaves the possibility for the Fed to reaffirm its commitment to quantitative easing or announce forward guidance at its September meeting. The second key policy change emphasizes the importance of the natural rate of employment in influencing policy decisions. The strategic shift specifies that policy will focus on eliminating "shortfalls" from maximum employment, rather than "deviations" from maximum employment. The change underscores that the economy can operate at full employment without causing a rise in inflation.

Long bonds were volatile around the Jackson Hole speech; however, other market dynamics may have been at play. Rates remain low and are currently stuck in a narrow four-month range. The changes from the Fed's strategic review cement our view that rates will be lower for longer. We remain modestly overweight duration.

BELOW TARGET

Core inflation has been well below target for a decade.



Source: Northern Trust Global Asset Allocation, Bloomberg. Monthly year-over-year percent changes from 7/31/1999 through 7/31/2020.

- Fed loosens its inflation policy.
- We remain skeptical the Fed policy will boost inflation.
- We are modestly overweight duration.

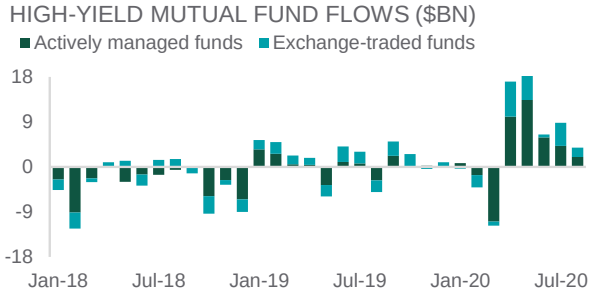
Credit Markets

The high-yield market has seen major inflows after experiencing outflows in February and March as global economic lockdowns took effect. Since April, the market has received inflows totaling $63bn, roughly 25% of the beginning of period assets under management. This compares to $89bn of inflows in the three years exiting financial crisis. Seven of the eight largest inflows in the history of the high-yield market have occurred during the past five months. Flows for the high yield asset class turned positive for the month of April after significant fiscal and monetary policy intervention. Flows have continued to rise on the back of those same drivers. Also, corporate fundamentals have been better than expected, which has improved the distressed ratio for the portion of the market that is most levered to economic conditions.

Even as issuers looked to insulate balance sheets against further uncertainty, leading to the highest supply year-to-date on record, the supply/demand technical has remained in balance due to the strong inflows. The combination of dovish central bank guidance, better-than-expected corporate fundamental data and a continued global focus on income-generating assets has driven investors to the high-yield asset class, providing support for valuations.

OPPORTUNISTIC

Money flooded into high yield after the selloff.



Source: Northern Trust Global Asset Allocation, Lipper FMI, JPMorgan. Monthly data from 1/1/2018 through 8/31/2020.

- High yield received record inflows over the last five months.
- Reduced levels of distressed bonds augers well for defaults.
- We remain overweight high yield in our global policy model.

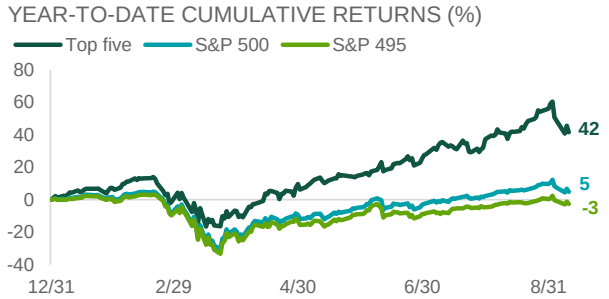
Equities

This past month, U.S. equities pushed well into new high territory, followed by a steep 3-day selloff. The last 5% of the upside was unusual, as it occurred alongside rising volatility. Abnormal derivatives market activity contributed to what appeared to be a brief period of excessive enthusiasm, which quickly gave way to a 7% pullback in the broader market. The top five names (Apple, Microsoft, Amazon, Google and Facebook) continue to drive an outsized portion of equity returns – the other 495 S&P 500 companies are down in aggregate year-to-date versus up 42% for the top five (see chart). The technology sector is up roughly 30% this year, but due to better earnings performance, still only trades at a (justifiable) 20% premium to the market. Much of the outperformance has come from fundamentals as opposed to valuation.

Pandemic and U.S. election uncertainty should keep volatility elevated. With the U.S. market trading at more than 20x our 2021 earnings expectation, we think the risk/reward skews modestly negatively. In the non-U.S. developed markets, while health and economic uncertainties are also high, the political risk is lower – and importantly, valuations are also lower, suggesting somewhat more cautious positioning.

WINNERS TAKE ALL

Many stocks have delivered negative returns this year.



Source: Northern Trust Global Asset Allocation, FactSet, Goldman Sachs Investment Research. Top 5 composed of Apple, Microsoft, Amazon, Google and Facebook. S&P 495 composed of the S&P 500 excluding the top five. Data through 9/10/2020.

- The S&P 500's returns remain highly concentrated.
- A broadening-out of market performance would indicate confidence in the economic recovery.
- The global pandemic and U.S. election uncertainty are likely to keep market volatility elevated.

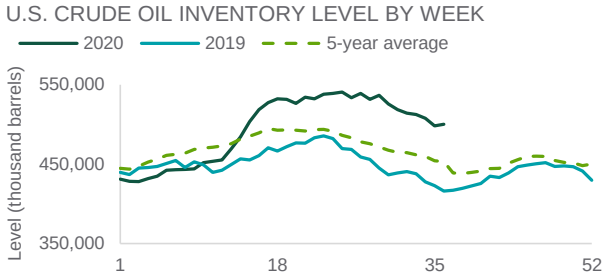
Real Assets

Oil prices have shown gradual improvement from April's volatility (where oil futures contracts briefly went negative), rising to $43/barrel before more recently settling into the upper $30s. Recent oil price gains came from a number of areas including the slow global economic recovery from the negative impact of the pandemic, lower output from the U.S. and other countries and surprisingly high quota compliance from OPEC. That said, prices are still below last year's ~$55 average as inventories remain elevated (see chart, which shows U.S. inventories but is fairly reflective of the global situation).

While we believe the intermediate-to-long-term outlook continues to improve, the near-term environment is both weak and uncertain. Specifically, the uncertainty arises from the ongoing pandemic effects and the potential outcome of the U.S. presidential election, with investors (ourselves included) believing a Biden win would be negative for the oil and gas industry. Additionally, the upcoming wave of debt maturities for many energy sector companies will be a challenge as the debt (and equity) markets are closed to all but the best run companies. We remain neutral natural resources – balancing the above with attractive valuations, the better longer-term outlook and the risk case of higher inflation.

TOO MUCH CRUDE

Oil inventory levels are historically high.



Source: Northern Trust Global Asset Allocation, Energy Information Administration. Data through 9/6/2020.

- While oil prices have bounced back, they are below last year's $55/barrel average.
- Near-term outlook is clouded by the pandemic and election uncertainty.
- We are neutral natural resources as the near-term concerns are balanced by valuations and inflation concerns.

BASE CASE

Pandemic Adaptation

Economies have been able to weather the pandemic storm, helped by government support and more recently by consumers and businesses adapting to the virus threat. These factors are helping to ameliorate the economic downturn, supporting a return to growth – albeit in a lower growth channel than before.

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 ongoing virus-driven economic headwinds, but have limited means to do so and will need to coordinate with fiscal policymakers.

RISK CASES

A Policy Bridge Too Short

Reluctance to continue fiscal rescue packages or the emergence of a “second wave” blunts the current global economic momentum, leading to a protracted period of zero-to-negative economic growth.

U.S. Political Regime Change

Investor attention turns to political uncertainty, pressuring valuations. A Democratic sweep risks a pro-growth policy rollback, though the impact could be tempered by more conventional governance.

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	33	5	6	27	15	6	2	2	2	0
Tactical Asset Allocation	2	35	2	9	25	15	4	4	2	2	0
Over/Underweight	**0**	**2**	**-3**	**3**	**-2**	**0**	**-2**	**2**	**0**	**0**	**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 8/13/2020.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.