OCTOBER 2020

ELECTION CORRECTION?

U.S. presidential election polls are showing an increasing lead for the Democratic candidate, former vice president Joe Biden, against President Donald Trump – and markets are relatively calm just weeks ahead of the November 3 election. What could be contributing to this steadiness? To the extent that one candidate develops a significant lead, the associated risk of a delayed outcome is reduced. Markets hate uncertainty, and the potential of a delayed election outcome has weighed on investors' minds. The expected significant increase in mail-in ballots has raised the specter of days (possibly weeks) of ballot counting post-election night, with ensuing legal battles and public relations spats. Biden's increasing lead – if it plays out in actual voting – reduces the potential for this outcome. Additionally, financial markets are fixated on the next round of fiscal stimulus, which remains caught up in negotiations. Democrats are viewed as more likely to support significant additional fiscal expansion, which the stock market would view favorably. On the flip side, the higher corporate taxes proposed by the Democrats could cut S&P 500 company earnings by around 7%.

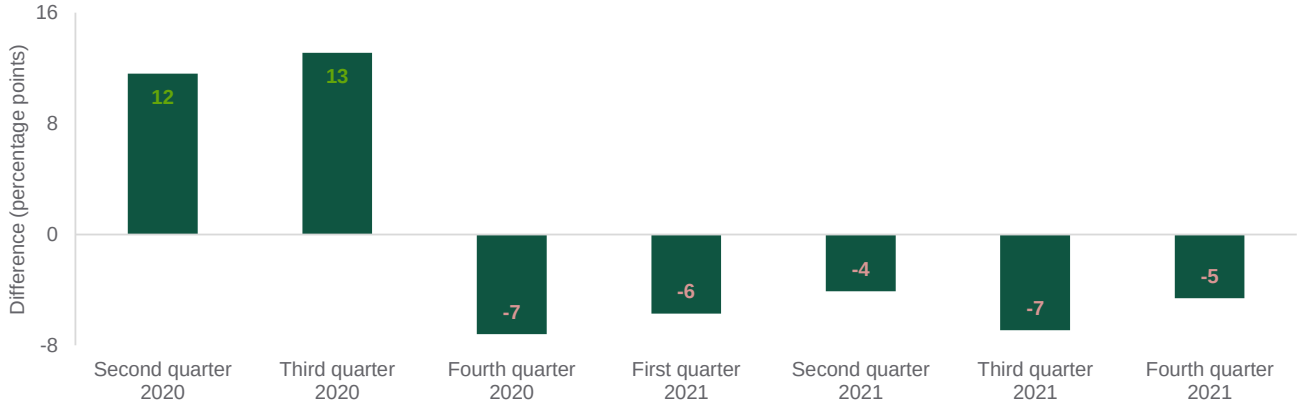
Having one-party control in Washington facilitates passing new legislation, but a slim majority isn't enough. The Republicans' current 53-47 Senate majority allows two or three Republicans to object to any Republican vote, without ending its prospects. Should the Democrats win the White House but only have a one- or two-seat majority in the Senate, they may be constrained. Should Trump win reelection, we would expect a continuation of the current split-power structure – as the Democrats look likely to maintain their majority in the House of Representatives.

The results of the 2016 election were clear on election night. Investors viewed the Republican platform of tax cuts and deregulation as good for growth but also bad for bonds due to higher interest rates. The 2020 election is not setting up to be as clear. Control of Congress remains uncertain and the margin of victory will be important for either party. As a result, we will likely need to see the election results – and the ensuing policy and personnel pronouncements from the victors – to understand the intermediate-term implications of the election. Over the short term, a correction is always possible, while heightened volatility seems more probable. In the meanwhile, we remain moderately underweight risk – focused on "less risky" risk assets – in our global policy model. While our base case calls for economic growth to persist, we don't think markets are providing much margin of safety for unexpected political or geopolitical risks.

A DIFFERENT FISCAL CLIFF

Without further fiscal stimulus, the U.S. economy faces a significant growth headwind.

GROSS DOMESTIC PRODUCT GROWTH WITH VERSUS WITHOUT PRIOR FISCAL SUPPORT



Source: Northern Trust Global Asset Allocation, CBO, EISI. Difference between seasonally-adjusted annual rate of U.S. real gross domestic product (GDP) growth (with prior fiscal support – without prior fiscal support). Differences based on CBO's July 2020 economic forecast, where projection without prior fiscal support removes estimated effects of stimulus from forecast. Prior fiscal support is fiscal support implemented in response to COVID-19.

Interest Rates

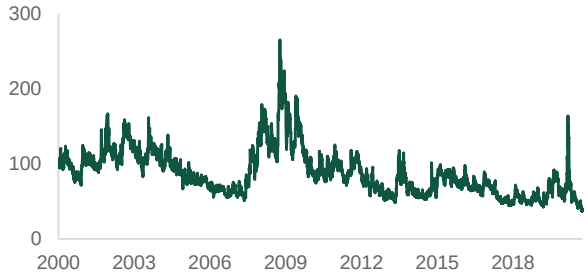
As the economy grapples with mixed economic data, rising pandemic cases and the upcoming presidential election, Treasurys across the yield curve have been stuck in their respective tight trading ranges for multiple months. After a brief yield spike in hopes of fiscal stimulus, Treasurys quickly reverted to their recent ranges. Pricing action has been dictated by fiscal stimulus – or lack thereof – and the potential outcome of the U.S. presidential election. This stagnant trading trend is exemplified by examining the ICE Bank of America MOVE Index, a measure of U.S. Treasury volatility. After spiking in March to levels not seen since the global financial crisis, the MOVE Index hit an all-time low at the end of September. The recent lack of Treasury volatility underscores uncertainty within financial markets as investors stay put in safe-haven Treasurys.

The low volatility in the Treasury market helped the standard deviation of changes in the 10-year Treasury achieve its second lowest quarterly reading (5 basis points) since the 1960s. As we get closer to the U.S. presidential election, we expect volatility to pick up – both directionally on the curve and the outright level. But our longer-term expectation for low rates keeps us modestly overweight duration vs. client/strategy benchmarks.

CONTROLLED BY A HIGHER POWER (THE FED)

Treasury volatility has fallen thanks to Fed intervention.

TREASURY VOLATILITY (INDEX LEVEL)



Source: Northern Trust Global Asset Allocation, Bloomberg. Treasury volatility proxied by ICE Bank of America MOVE Index; a yield curve weighted index of the normalized implied volatility on 1-month Treasury options; higher values indicate higher volatility. Daily data from 12/31/1999 through 10/5/2020.

- Treasurys are calm as the Fed has effectively controlled the yield curve since the pandemic started.
- We believe the path of least resistance for yields is lower – given slow growth and other uncertainties.
- We continue to advocate for a long-duration profile.

Credit Markets

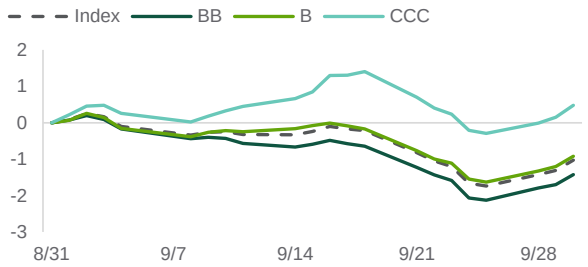
The high-yield market experienced a notable divergence in performance across ratings during the month of September. The lowest quality securities in the market, CCC-rated securities, generated positive returns and materially outperformed higher-quality credits despite volatility in risk assets and a negative return for the high-yield market. The strength in CCC-rated securities has coincided with lower default rate expectations, driven by better than expected corporate earnings and access to primary markets to extend debt maturities. The percentage of high-yield issues trading at distressed levels – currently 4% (versus a recent high of 30%) – suggests default rates may be even lower than current consensus.

Some of the underperformance in higher-quality credits can also be explained by heavy new issue volume. Investors tend to sell more liquid securities – which usually are higher rated – to raise cash for new issues. The September outperformance of CCC-rated securities hints that investors remain confident in the economic outlook. High yield remains our highest conviction overweight. Technicals, liquidity and fundamentals are all strong – and the asset class mitigates downside risk in the event of a further equity market sell-off heading into the election.

RISK EQUALS RETURN

High yield's riskiest bonds did best in September.

MONTHLY RETURN BY CREDIT RATING (%)



Source: Northern Trust Global Asset Allocation, Bloomberg. Monthly return for September. Index used: Bloomberg Barclays U.S. Corporate High Yield Index. Data from 8/31/2020 through 9/30/2020.

- Recent CCC-rated bond outperformance dissuades concerns over an economic relapse.
- High yield's solid fundamentals and technicals (strong demand) support the outlook for the asset class.
- We continue to overweight high yield as our biggest conviction call.

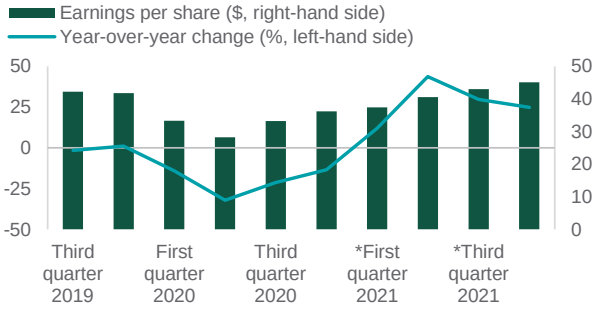
Equities

Global equities were largely unchanged over the past month, as the reality of increasing pandemic cases was offset by optimism for a vaccine. In the U.S., large cap tech finally took a breather, with each of the top five U.S. tech stocks trading lower last month. Quarterly earnings season is again upon us, where global earnings are still feeling the pressure of the global economic disruption. Emerging markets are expected to hold up best, down 9% from a year ago (aided by flattish growth in China), while the U.S. is expected to be down 20% and developed non-U.S. markets down 33%.

U.S. earnings bottomed in the second quarter and should show rebounding growth over the next year. U.S. earnings are expected to finally match the levels of late 2019 by the back half of 2021 (emerging markets sooner, Europe a bit later). However – with the U.S. presidential election just a few weeks away, a potential rise in pandemic cases into the winter months and elevated valuations – we remain moderately underweight U.S. equities. We are also underweight emerging markets given geopolitical uncertainties and neutral non-U.S. developed countries given low valuations – suggesting a low-growth bar that companies may be able to more easily chin.

WHAT LETTER IS BETWEEN U AND V?

Earnings are rebounding faster than originally thought.



Source: Northern Trust Global Asset Allocation, FactSet. *Consensus earnings forecasts, beginning fourth quarter 2020. Quarterly data for S&P 500 Index as of 10/7/2020.

- Earnings are rebounding – but it will still be late-2021 before reaching pre-pandemic levels.
- Valuations have gotten stretched and the U.S. is facing election and pandemic risks in coming months.
- We are underweight U.S. (and emerging market) equities and neutral on non-U.S. developed markets.

Real Assets

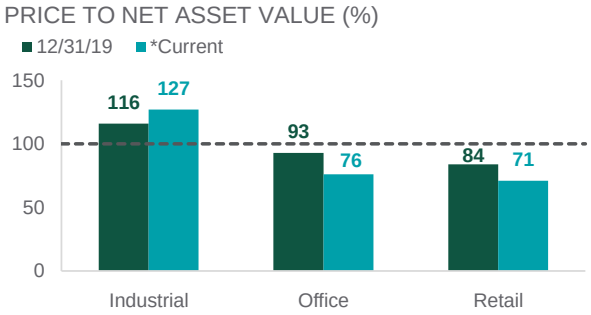
Often overheard recently: “Retail is dead and office space is no longer necessary; give me a reason to invest in global real estate at all.” Well, we can think of a few. First, the fact that the pandemic has impaired retail and office property values is the world’s worst-kept secret. Investors quickly priced this in. Retail property prices as a percent of net asset value (NAV, effectively the property appraisal less outstanding debt) have fallen from 84% pre-virus to 71% today; office properties have fallen from 93% to 76%. While these properties are worth less, prices reflect that.

Second, global real estate is more than just office and retail. Some sectors, such as industrial (think distribution centers), have done just fine. Though – similar to retail and office – the markets quickly priced this in too (currently valued at 127% of NAV). Finally, global real estate offers income and diversification given higher yields and different return drivers than broad equities, respectively.

Bottom line: Global real estate still warrants a strategic allocation in investment portfolios. We are tactically equal-weight given current uncertainty. We will be paying close attention to “return to office” dynamics as well as how easily retail – and other impaired – properties can be repurposed to something more economically relevant.

MARKETS EASILY PRICE IN THE OBVIOUS

Retail and office sectors have gotten notably cheaper.



Source: Northern Trust Global Asset Allocation, UBS. *Current as of 10/2/2020. Global real estate sector valuations use fiscal year-end net asset value estimates.

- Global real estate valuations are reflecting the subdued outlook – especially for retail properties.
- The market understands the decline in retail; it is struggling with how/if properties will be repurposed.
- We made no changes to our real asset tactical asset allocations, where we prefer listed infrastructure.

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.