FEBRUARY 2021

COMING TO PASS

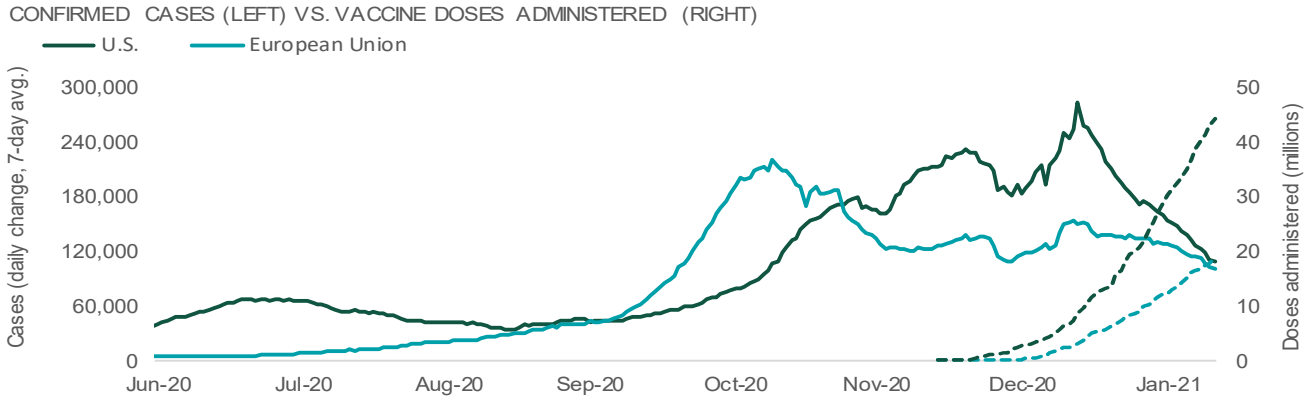
The rally in global equity markets since November has been driven importantly by an optimistic outlook for management of COVID-19, and recent developments suggest this outlook is coming to pass. As seen below, the number of COVID-19 cases in the U.S. and Europe has peaked, and cases are declining rapidly. Vaccinations are ramping up in the U.S., while Europe has lagged but is destined to improve. A potentially encouraging situation is developing in India where cases have plummeted and some epidemiologists are speculating that urban areas may have already reached herd immunity. Meanwhile, more vaccines look set to enter the picture, including the one-dose Johnson & Johnson vaccine and the Russian Sputnik V vaccine. One of our risk cases is **Virus Mutation**. While history demonstrates that viruses generally become less lethal as they mutate, there remains a lot about this one that we simply don't know.

The increase in cases in late 2020 has added more strain to the services sector of the global economy, while manufacturing has held up better. In the U.S., overall growth remains strong despite pockets of weakness, including in the labor markets. In Europe, falling case counts should allow governments to start easing restrictions by March, which should bolster the growth outlook starting in the second quarter. We are encouraged that leaders in both the U.K. and Germany are pivoting their focus from broadly preventing new cases to just those that risk hospitalization. Chinese growth appears to have moderated in January, but COVID-19 is relatively under control and Lunar New Year spending activities will see some improvement from last year. Overall, we expect continued improvement in the virus outlook to underpin strong improvement in global growth starting in the second quarter.

The recent equity market rally has been matched by similar performance in the interest rate, credit and commodities markets. While the U.S. 10-year yield and inflation breakevens have normalized somewhat, the short end of the yield curve is firmly anchored near zero. The rally in corporate credit, and resulting compression in spreads, has reduced the potential return, leading us to reduce our recommended weighting in our global policy model. As we expect growth to positively surprise this year while interest rates are broadly stable, we also increased our recommended allocation to economically sensitive natural resources and U.S. equities. A key base case for us remains **Pandemic New Normal** – including a liberalization of health policy. An important risk case is a sustained increase in inflation (**Stuckflation Tested – and Fails**). The strong returns of risk markets over the last ten months likely reduces the magnitude of the return potential over the coming year – but we still believe investors will be rewarded for risk taking.

FALLING CASES, RISING DOSES

COVID-19 cases are falling rapidly while vaccination programs ramp-up steadily.



Source: Northern Trust Global Asset Allocation, Bloomberg. Data from 2/10/2020 - 2/10/2021. Vaccine doses data begins 12/14/2020.

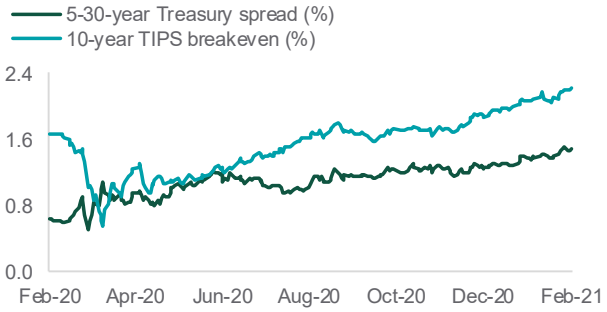
Interest Rates

At the January FOMC meeting, the Federal Reserve kept interest rates unchanged at 0.00% to 0.25%, as expected. Chairman Powell reiterated the Fed's commitment to supporting the economy by reaffirming that the Fed will continue to increase its Treasury holdings by at least $80 billion per month. He also dismissed concerns over any immediate balance sheet tapering. Additionally, Powell noted that the Fed is comfortable allowing inflation to run above 2% after years of printing below that level.

Market participants are betting on a strong economic recovery aided by vaccine rollouts and more fiscal stimulus. Stimulus expectations have led to a noticeable rise in Treasury yields. The 30-year Treasury yield touched 2.0% intraday for the first time since last February. The reflation narrative has gained steam well ahead of any evidence of realized inflation. The 10-year TIPS-breakeven reached levels not seen since late 2014. Lastly, the 5s/30s curve (the graphical spread difference between the 5-year and 30-year Treasury) has reached its steepest level since 2015; steepening is normally a sign of expectations for stronger economic growth and higher inflation. We still believe structural deflationary pressures will keep rates lower for longer, with the 10-year anchored around 0.75%.

RECOVERY SIGNS

Growth outlook leads to steepening curves and higher inflation expectations.



Source: Northern Trust Global Asset Allocation, Bloomberg. Data from 2/10/2020 through 2/10/2021.

- Rates and inflation expectations have been increasing as investors bet on growth and stimulus in 2021.
- We expect short-rates to stay near zero as the Fed and European Central Bank won't be moving any time soon.
- We expect a low, but positive, return from bonds over the next year.

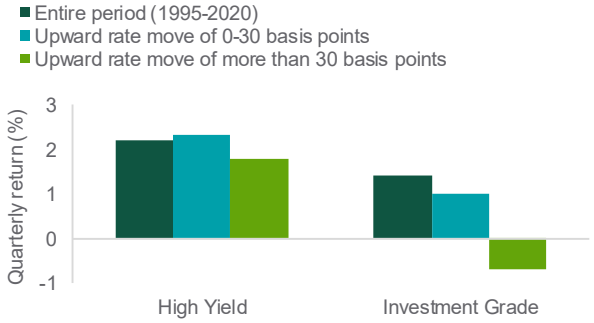
Credit Markets

For most of the fixed income universe, a rising rate environment is a difficult return headwind to overcome. However, high yield has historically been more resilient. Quarterly high yield credit returns have been positive historically regardless of the severity of upward interest rate shocks, while investment grade returns are negative in the more extreme scenarios of rising rates. The resiliency of high yield is driven by a few factors. First, higher interest rates are often driven by improving growth and inflation expectations, which are a positive read-through for future corporate earnings and cash flows. This often leads to spread tightening, helping offset the negative impact of rising rates.

Secondly, the high yield universe has relatively short duration (3.6 vs. 8.6 for investment grade credit). Finally, higher current income helps offset some of the price loss from higher interest rates. The supportive environment for credit fundamentals and strong current income has led to strong interest in high yield bonds, contracting spreads and lowering future return potential. With a return potential of around 3% over the next year, we have eliminated our overweight recommendation for high yield, seeking out assets with a higher return potential.

NOT VERY SENSITIVE

High yield bonds have been historically insulated from rises in interest rates.



Source: Northern Trust Global Asset Allocation, Bloomberg, Barclays Research. 10-year Treasury yield used as rate proxy. Median quarterly total returns shown.

- High yield bonds are relatively insulated from higher interest rates.
- However, future return potential has been reduced by compressed spreads.
- We reduced our recommended tactical allocation to high yield this month, seeking higher return assets.

Equities

Stocks have continued to push higher in 2021. With COVID-19 cases and hospitalizations on the decline, the vaccine rollout underway, significant fiscal stimulus on the come, and interest rates likely to remain low, equities remain attractive despite elevated valuations. After accounting for more than half of 2020 U.S. equity gains, the largest 5 stocks in the S&P 500 (Apple, Microsoft, Amazon, Alphabet and Facebook) are performing more in-line with the market year-to-date. Energy leads all sectors, but, despite oil prices having nearly fully recovered, still trails the market by 40% since the beginning of 2020.

Confidence in the economic recovery can also be seen in the performance of small cap stocks, which have outperformed large cap stocks in the U.S. by 30% since the middle of 2020 – erasing the large performance gap that developed as small caps suffered prior to and during the pandemic-led sell-off. Small cap underperformance had led the Russell 2000 to its smallest relative market cap in the past 20 years, but the index has now quickly reverted to more normal levels (see chart). We added to U.S. equities this month as we broaden our overweight to risk. We remain optimistic on global equities with overweights in each major region.

LAGGARD RECOVERY

Small cap bounce back broadens out the market recovery.

MARKET CAP: SMALL CAP EQUITIES AS A % OF LARGE CAP EQUITIES

Source: Northern Trust Global Asset Allocation, Bloomberg. Russell 2000 index (small cap) and Russell 1000 (large cap) data from 6/30/2000 through 2/9/2021.

- The bounce-back in U.S. small cap stocks reflects improved confidence in the 2021 recovery.
- We expect earnings growth of over 20% in all major regions this year.
- We are tactically overweight U.S., developed ex-U.S. and emerging market equities.

Real Assets

Some investors have shunned natural resources in their portfolios as they see the looming pressures on long-term demand for carbon-based energy. However, natural resource performance is driven by more than just oil (and other fossil fuel) prices. And the switch to renewable energy sources represents a boon for another important component of the natural resource asset class – industrial metals. Wind farms require four times the copper as traditional power plants. In addition to other metals, electric vehicles require four times the copper. Per the nearby chart, producing 10 million electric cars (expected to be achieved by 2025), requires a notable amount of current production. While oil demand may be on secular decline, the same is not true for the broader commodity complex.

We increased our tactical allocation to natural resources this month. Beyond some of the structural drivers, the near-term outlook is constructive as well. The mix of rebuilding the economy, accommodative monetary policy and the continued fiscal stimulus should push commodity prices – and related stocks – higher. Relatedly, natural resources provide a hedge should our risk case of Stuckflation Tested – and Fails comes to pass. Finally, valuations within natural resources remain attractive.

A NEW SOURCE OF DEMAND

Metal demand is substituting for energy demand.

METALS ELECTRIC VEHICLE MAKERS NEED TO BUILD 10 MILLION CARS PER YEAR

	% of current production
Lithium	82.5
Nickel	15.5
Aluminum	5.0
Copper	4.5

Source: Northern Trust Global Asset Allocation, Barron's, Adamas Intelligence, USGS, BMO, Morgan Stanley, BP, Fitch, UBS, Mining.com. 10 million is estimated electric vehicle sales by 2025. Current production as of 2019.

- Growth in alternative energy is creating new demand for commodities.
- Natural resource equities should continue to benefit from the economic rebound and stimulus plans.
- We increased our tactical allocation to natural resources as a play on growth and a hedge on inflation risk.

BASE CASE

Pandemic New Normal

As economies continue to adapt to the virus, the public health policy approach will shift to minimizing hospitalizations and deaths as vaccines lead the path to herd immunity. While vaccines will not prevent all cases, this policy adjustment will support the return towards economic normalization in the second half of 2021.

Market Laggard Relief

Relative performance of the asset classes most damaged by the virus will improve considerably as the recovery continues and investors expect a return towards normalcy in the second half of 2021. However, structurally advantaged areas of the market will remain attractive longer-term due to better fundamentals.

RISK CASES

Virus Mutation Risk

A severe virus mutation that resists current vaccines leads to a material shift in health policy and more permanent lockdown restrictions, significantly weighing on the economic and financial market outlook.

Stuckflation Tested – and Fails

Inflationary pressures build in the economy during the recovery and overwhelm structural downward forces on inflation, leading to a sustained increase in inflation and risk asset headwinds.

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	0	32	0	6	28	17	7	4	2	4	0
Over/Underweight	**-2**	**-1**	**-5**	**0**	**1**	**2**	**1**	**2**	**0**	**2**	**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.