NORTHERN TRUST
ASSET MANAGEMENT

INVESTMENT PERSPECTIVE

DECEMBER 2023

SUPPORTIVE FUNDAMENTALS

Global markets were strong over the past month as "soft landing" supportive fundamentals and market conditions unfolded. Increasing confidence in moderating inflation drove significant changes in expectations for the Fed (pricing in earlier rate cuts), and a steep drop in long-term rates. Lower rates combined with still reasonably durable labor market and consumer spending conditions drove a re-rating upward of equity markets as the scenario of falling inflation and non-recessionary growth conditions over the next year became increasingly priced in.

The U.S. 10-year Treasury yield fell a remarkable 0.60% in November, driving a 9% rise in U.S. equities for the month. Futures pricing implies a market expectation that the Fed could cut rates as early as March (~45% chance), and rate cuts totaling over 1% over the next year. While we believe the movement lower in long-rates better reflects our view of fair value, we see a later start to rate cuts by the Fed given still durable macro fundamentals and a desire to ensure inflation has been tamed.

Notably, equity markets have seen a broadening of performance in the most recent rally. While gains earlier this year were driven almost entirely by mega-cap tech-related companies, other sectors and smaller companies are now participating. Key to absolute performance going forward will be if future gains in the non-tech parts of the market represent a churning of the market (mega-cap tech stocks are sold to fund investor interest in other names), or if those gains instead come from fresh capital.

We think absolute upside in equity markets will likely be limited by elevated valuations, but improvements in the macro backdrop have reduced the downside risks in the U.S. Economic conditions remain challenged in emerging markets, though material underperformance and much lower valuations now more fully reflect our concerns.

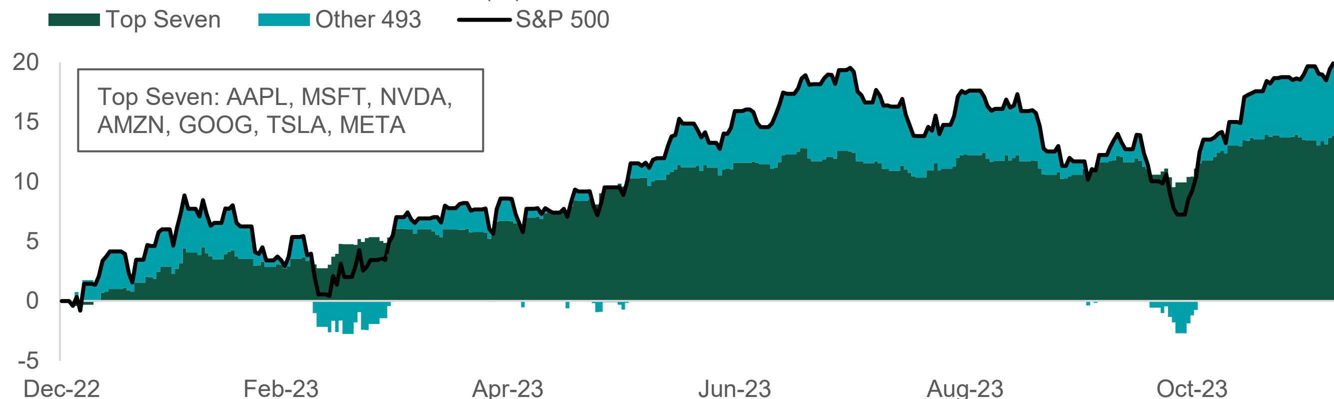
To reflect this, we narrowed the underweight to equities in our Global Policy Model this month, adding to U.S. equities from cash and to emerging market equities from natural resources. We stay materially overweight high yield, but our remaining underweight to stocks leaves us slightly underweight risk. By moving closer to neutral, we think investors have more appropriately priced the risk/reward in the market.

- Chris Shipley, Chief Investment Strategist of North America

BREADTH EXPANSION

The U.S. equity market has seen a broadening of performance in the most recent rally.

S&P 500 2023 RETURN BREAKDOWN (%)



Source: Northern Trust Asset Management, Bloomberg. Data from 12/31/2022 through 12/8/2023. Index performance returns do not reflect any management fees, transaction costs or expenses. It is not possible to invest directly in any index. Past performance is no guarantee of future results.

Interest Rates

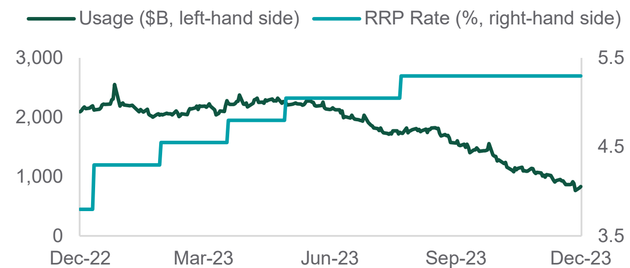
Usage of an important Fed facility, the Reverse Repo Facility (RRP), has been on the decline since May and fell by over $1.5 trillion since September. Increasing T-Bill supply and competing demand for cash from private sector repo participants contributed to the decline earlier this year after RRP usage peaked at over $2.3 trillion.

T-Bill supply has continued to surge since the resolution of the debt ceiling in June. It only recently (and temporarily) leveled off, with more net issuance expected next year. But while rising policy rates made the RRP facility particularly attractive earlier this year, market expectations now call for no more rate hikes this cycle. This has prompted Money Market Mutual Funds to extend their Weighted Average Maturities, substituting T-Bills for RRP. Private sector repo market participants' demand for cash remains robust as well. While we think a confluence of factors contributed to the temporary spike, including large settlements of U.S. Treasuries, more volatility in repo rates is likely in the coming months as cash reshuffles in the money markets. We'll continue to monitor the RRP closely for any signals around market liquidity and future balance sheet policy.

REVERSE REPO RETREAT

Usage of the Fed facility has continued to fall this year.

FED REVERSE REPO DATA



Source: Northern Trust Asset Management, Bloomberg. Usage = Fed Reverse Repo usage. RRP = Reserve Repo Facility. Data from 12/5/2022 through 12/5/2023. Historical trends are not predictive of future results.

- After peaking at over $2.3 trillion, cash parked at the Fed via the RRP has fallen to less than $1 trillion.
- Fed rate hikes helped make the RRP attractive earlier this year, but no more rate hikes are priced in now.
- We hold a neutral view toward duration. We believe longer-term yields are closer to fair value after retreating from recent highs.

Credit Markets

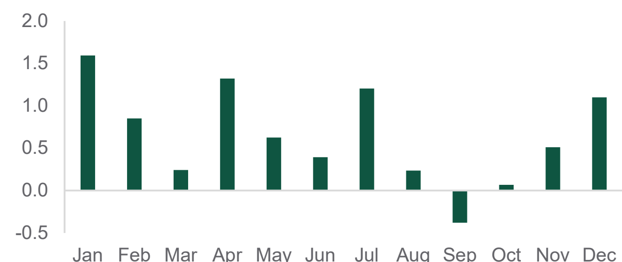
The high yield market saw extremely strong performance in November, posting the best monthly return (4.5% for the Bloomberg U.S. High Yield Index) this year. The rally was fueled by shifting expectations around the path of policy rates. Specifically, that the Federal Reserve is done with rate hikes and may start cutting as early as March of 2024.

Despite the strong returns in November, there could still be room for outperformance from a seasonal perspective. On average, January has historically provided outsized returns. The average high yield bond return during the month (since 1987) has been 1.6%. This exceeds the average for all other months by about 1%. Returns have been positive 84% of the time (31 out of 37) in January. While January is typically the best calendar month, the 30-day stretch from mid-December to mid-January provides even better returns on average at 2.0%. To be sure, there are exceptions to the "January Effect". For example, in January of just this past year high yield lost 2.8% (the second worst January on record). This loss was mainly driven by a hawkish Fed narrative; however, heading into this upcoming January that narrative has flipped. This January could look more like the historical norm.

SANTA RALLY?

Credit has done well on average in December/January.

MONTHLY AVG. HIGH YIELD RETURNS (%)



Source: Northern Trust Asset Management, J.P. Morgan. J.P. Morgan High Yield Bond Index. AVG. = Average. Data from 1/1/1987 through 11/30/2023. Past performance is not indicative or a guarantee of future results. Index performance returns do not reflect any management fees, transaction costs or expenses. It is not possible to invest directly in any index.

- On average, high yield bonds have gained ~2% during the 30-day stretch from mid-December to mid-January.
- Beyond seasonal trends, we see reasons to like high yield from a fundamental and technical perspective.
- High yield remains our biggest tactical overweight heading into the new year.

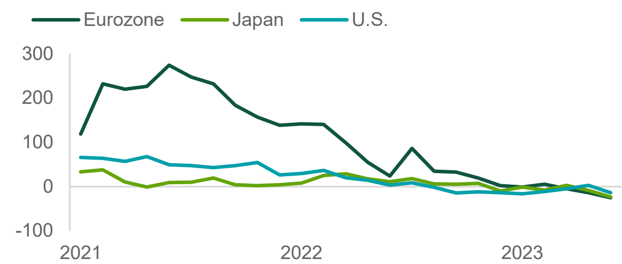
Equities

The rally in equity markets that started at the end of last month continued strongly into this month, with global equities up 4.8%. Regional differences were small except for the underperformance of emerging markets, which only rose 2.7%. Interestingly, Europe slightly outperformed the U.S. despite growth once again outperforming value.

In terms of the drivers behind the rally, better than expected inflation data in the U.S. and Europe allowed financial markets to continue to run with the central bank turnaround narrative. That narrative is built on the notion that sooner rather than later central banks will be able to cut interest rates to a more neutral stance in the U.S., and even a potentially easy stance in Europe. Although it seems to us that markets might be getting ahead of themselves in terms of the timing of the rate cuts, the improvement in inflation is clear (see chart) and with it the odds of sticking the soft landing in the U.S. in particular have improved. In light of that view, we trimmed our U.S. and emerging market equity underweights back from -3% to -1% each. We left our developed ex-U.S. underweight unchanged at -3%. Europe has slipped into recession and its central bank seems reluctant to admit any mistakes.

INFLATION IMPROVEMENT

Better-than-expected inflation data has helped sentiment.



Source: Northern Trust Asset Management, LSEG Datastream. Data for Citi Inflation Surprise Indices (positive reading means inflation has been higher than expected). Data from 11/30/2021 to 11/30/2023. Historical trends are not predictive of future results.

- Once surprising significantly to the upside, inflation has come in below expectations across most of 2023.
- Inflation improvement and a more supportive central bank outlook have helped drive an ~18% year-to-date gain for global equities.
- We are now 5% underweight across the major equity regions (previously 9%). The economic landscape has improved, but we still see reasons for caution.

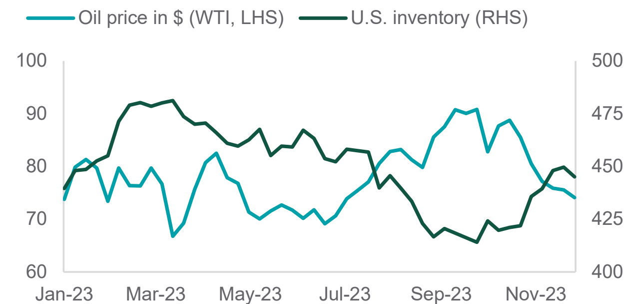
Real Assets

The geopolitical risks that markets have been dealing with over the past few months have come off the boil in recent weeks. The war in Israel has not led to a broader conflict and the rhetoric coming out of China has become more business friendly since the Xi-Biden summit last month. This reprieve from geopolitical risk has somewhat reduced the near-term attractiveness of natural resources, while also improving the outlook for emerging market equities – leading to our decision to reduce the size of our current "natural resources (NR) over emerging market equities (EM)" tactical trade (2% out of NR into EM).

We retain our view that the lack of commodity complex capital expenditure over recent years will allow NR companies to weather any recessionary storms better than investors may appreciate – as the reduced investment means both less commodity supply and healthier balance sheets than in the past. And, especially given less concern over geopolitical risk, investor "knee jerk" reaction to any signs of potential recession could lead to greater NR volatility. All said, we are still constructive on the longer-term NR opportunity but recognize the reduced geopolitical risks take some of the near-term support away from commodity prices, moderating NR attractiveness.

FUNDAMENTAL REFOCUS

Oil prices have fallen as U.S. inventories move higher.



Source: Northern Trust Asset Management, Bloomberg. Crude oil proxied by the West Texas Intermediate (WTI) futures contract listed on the New York Mercantile Exchange. U.S. inventory excludes the Strategic Petroleum Reserve and is measured by millions of barrels. LHS = left-hand side. RHS = right-hand side. Data from 1/6/2023 through 12/1/2023. Historical trends are not predictive of future results.

- Oil prices are over 10% lower than at the onset of the Israel-Hamas war as the conflict has not broadened much to surrounding regions.
- U.S. supply activity has also supported higher oil inventories (a headwind for natural resources prices).
- We reduced our overweight to natural resources to 1% from 3% on reduced geopolitical risks. We still like the longer-term outlook for the asset class.

BASE CASE EXPECTATIONS

Sticking the Landing

Global growth – led by the U.S. – slows to below trend growth but remains positive. Inflation remains above target but the disinflation process continues. Risk-taking appetite is tempered by elevated valuations.

Fed Steps Aside

Monetary policy risks are more balanced with the Fed done hiking for the moment. Investor rate cut expectations in the first half of 2024 are misplaced given economic resilience and above target inflation.

RISK CASE SCENARIOS

Central Bank Breakage

The worst of monetary policy lags have yet to be felt and higher rates lead to something "breaking" in the economy. Should that "breakage" cause widespread contagion, TAA is not underweight risk enough.

Oil Ends the Expansion

The war in Israel expands into a broader Middle East conflict that draws in Iran, putting global oil supply at risk. Central banks would look through the near-term inflation spike anticipating the economic fallout.

GLOBAL POLICY MODEL

Strategic Allocation and Tactical Over/Underweights	RISK CONTROL	RISK ASSETS									
	FIXED INCOME				EQUITIES			REAL ASSETS			
	Cash	Inv. Grade	Infl. Linked	High Yield	U.S.	Dev. Ex-U.S.	Emerg. Markets	GLI	GRE	NR	Gold
Strategic Asset Allocation	2	30	9	5	28	13	5	2	2	4	0
Tactical Asset Allocation	2	30	7	11	27	10	4	2	2	5	0
Over/Underweight	**0**	**0**	**-2**	**6**	**-1**	**-3**	**-1**	**0**	**0**	**1**	**0**

Source: Northern Trust Capital Market Assumptions Working Group, Investment Policy Committee. Strategic allocation is based on capital market return, risk and correlation assumptions developed annually; most recent model released 8/9/2023.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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