ELECTION PREDICTIONS

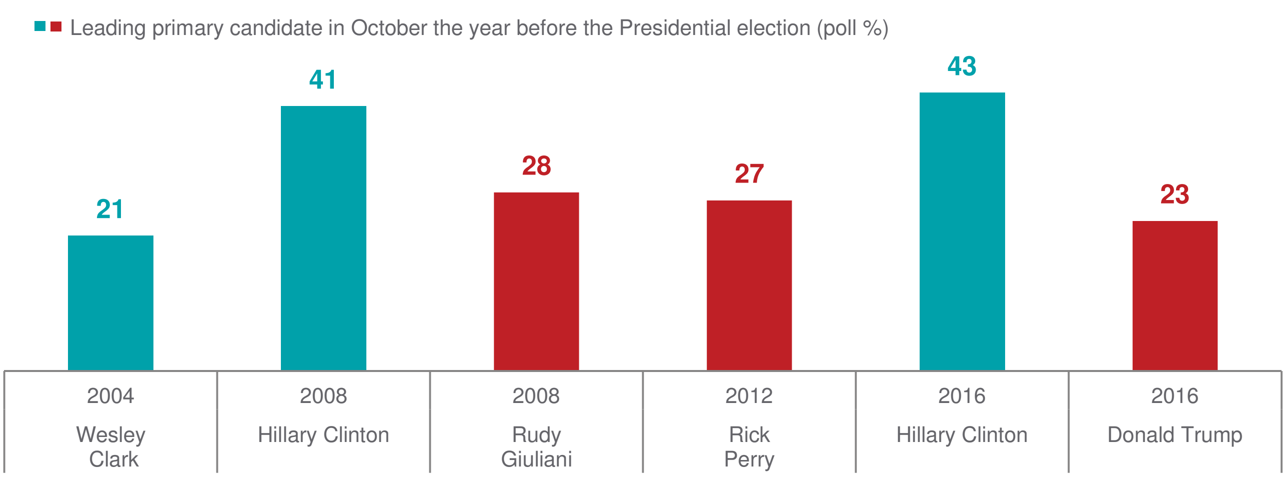
In addition to assessing the severity of the global economic slowdown, markets are wrestling with the U.S./China trade war, Brexit and the 2020 U.S. presidential election. The rising poll numbers of Senator Elizabeth Warren are starting to bring into focus the potential choice between her proposed agenda and a second term of President Trump. While a President Warren could be somewhat limited by the makeup of Congress, new policies aimed towards energy, healthcare, financials and large technology companies could jostle markets. Alternatively, a second term of President Trump could find him unrestrained by reelection concerns. But we caution that it is too early to make an election bet – as the chart below shows. At this point in prior election cycles, Wesley Clark, Rudy Giuliani and Rick Perry were leading their primary races – and all faded rapidly. We will likely approach the 2020 election as we did the 2016 election – with scenario analyses in hand to facilitate rapid action once the outcome is clear.

Developments in early October have brought some improved market sentiment toward both the U.S./China trade war and Brexit. Late last week, the U.S. announced the contours of a "Phase 1" deal that would avoid the incremental tariffs planned for October 15th in exchange for increased agricultural purchases. While the Phase 1 deal (which is not yet agreed) may deescalate current tensions, we remind readers of our "Irreconcilable Differences" theme, which forecasts continued trade and political hostility between the world's two largest economies for the foreseeable future. With the October 31st deadline for Brexit approaching, the recent conciliation between the U.K. and Ireland over the Irish border question is a positive step as this has proved so far to be an intractable problem.

We moved to a moderate overweight to risk in January of this year, wanting to participate in potential market upside but in a measured way given the slowing economy and geopolitical risks. Our deliberations this month did not lead to any changes in the positioning of our Global Policy Model (shown on the last page). We expect continued volatility over the next year along with a global easing cycle, leading to our favoring of "lower-risk risk assets". We maintain our risk case of higher inflation, as subdued inflation has been a key support to easy monetary policy and asset valuations in recent years. Our new risk case, "U.S. Election Clairvoyance," captures our expectations for a highly competitive and disagreeable 2020 election cycle. As the outcome becomes clearer, we expect significant shifts in investor flows and asset prices.

EARLY LEADERS DON'T ALWAYS FINISH STRONG

Clark, Clinton, Giuliani and Perry all lost their early leads, and the eventual nomination.



Source: Northern Trust Global Asset Allocation, Real Clear Politics, Gallup; Concept from Cornerstone Macro.

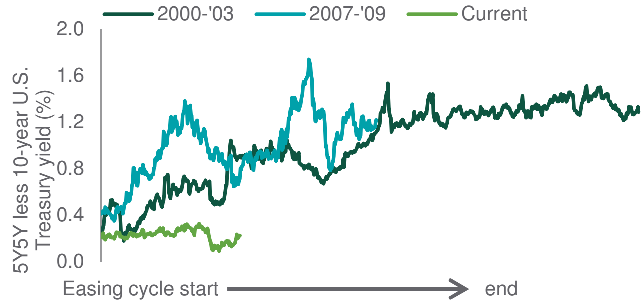
Interest Rates

Recent market data shows the efforts of the Federal Reserve to stimulate growth and inflation have not yet driven material improvements in market interest rate expectations. Inflation expectations remain low and the yield curve remains flat. Importantly, over the span of the most recent easing cycle, we are not the seeing the yield curve steepening that has historically followed interest rate cuts. Normally, the forward curve (representing future interest rate expectations) increases as the Fed cuts rates. As seen in the chart, the "5Y5Y" (market expectations for the five year U.S. Treasury five years from now) generally see a boost from a rate cut cycle – but have not (at least so far) this time around.

This corroborates our view that the Fed is not being aggressive enough to counter the signals from the flattening yield curve. However, we do believe the Fed will continue to begrudgingly cut rates as it (in its own words) will "act as appropriate to sustain the expansion." In our view, this means rate cuts at the next three Fed meetings (October 2019, December 2019 and January 2020). We continue to recommend long-duration orientation.

WHERE'S THE SPARK

Current Fed easing has not yet pushed future rate forecasts higher.



Source: Northern Trust Global Asset Allocation, Bloomberg. Easing cycle data from 1/1/2000-2/21/2002; 9/18/2007-3/31/2009; 1/1/2019-10/9/2019.

- The U.S. yield curve remains notably flat.
- The Fed will be forced into additional rate cuts.
- We continue to like duration risk in fixed income portfolios.

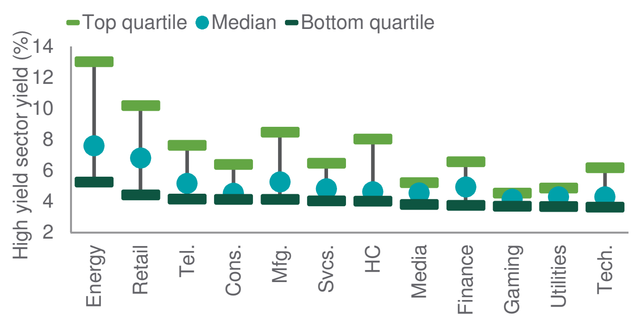
Credit Markets

While the Bloomberg Barclays U.S. High Yield 2% Issuer-Capped Yield to Worst (YTW) is currently inside 6% (where it has been since roughly mid-year), the market is increasingly bifurcated between tight-trading high quality bonds and stressed credits. This dynamic makes it difficult to find bonds that trade at a YTW that is equivalent to the index YTW. As such, portfolio construction has become critical. Investors have avoided sectors exposed to tariffs and cyclical end markets, creating dispersion in yield that is similar to the energy crisis and global growth scare of 2015 and 2016.

Importantly, most sectors are not experiencing the stress caused by energy and retail. The recent increase in defaults has been nearly entirely driven by stress in energy names, while the ex-energy default rate remains well below the long-term average. The return differential across sectors aligns with the macroeconomic narrative of 2019 – that is finding a balance between recession fears and the growing search for yield as global interest rates have collapsed. The continued dovish policies of global central banks should continue to provide support for high yield valuations as global investors look for income. We remain overweight.

SELECTION IS KEY

Wide sector dispersion has complicated portfolio construction.



Source: Northern Trust Global Asset Allocation, Credit Suisse. Data as of 10/7/2019.

- Demand for high yield remains elevated.
- Fundamentals outside the energy sector are strong.
- High yield represents our largest tactical overweight.

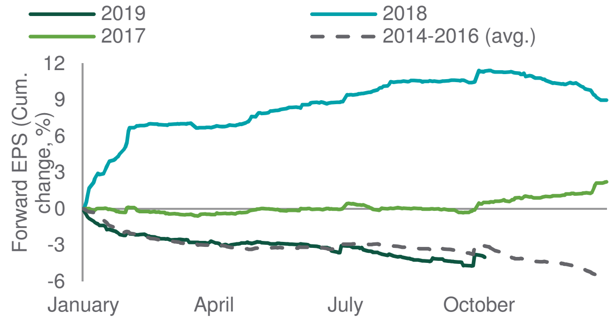
Equities

Global equities gave up some ground over the past month as manufacturing data further weakened, non-manufacturing data showed new softness, U.S. political risk increased and trade tensions with China remained elevated. Third-quarter earnings season is upon us. And while estimate revisions in the U.S. have been negative this year, the pace is not unusual despite escalating tariffs and expected economic slowing. Consensus analyst estimates almost always start the year overly optimistic, and trend lower throughout the year.

As seen in the chart at right, the stimulus and tax cuts of 2017 and 2018 made revision trends in those years more anomalous, while 2019 estimates have tracked quite similarly to the 2014-2016 average. As such, while 2019 earnings are looking flattish versus the 20% growth of 2018, the trend in corporate profits tells a less pessimistic story than might be assumed given the current macro backdrop. After flat year-over-year third-quarter earnings, positive growth should resume as we enter the fourth quarter and 2020. Volatility will likely remain higher given growing risks, but easy monetary policy, still-positive economic growth and reasonable valuations keep us constructive on U.S. equities.

A RETURN TO NORMAL

Earnings expectations trending downward are not unusual.



Source: Northern Trust Global Asset Allocation, Bloomberg, S&P. Data from 12/31/2013 -10/8/2019.

- Geopolitical risks have grown.
- Fundamentals remain reasonably sound.
- We remain overweight equities, with a focus on the U.S.

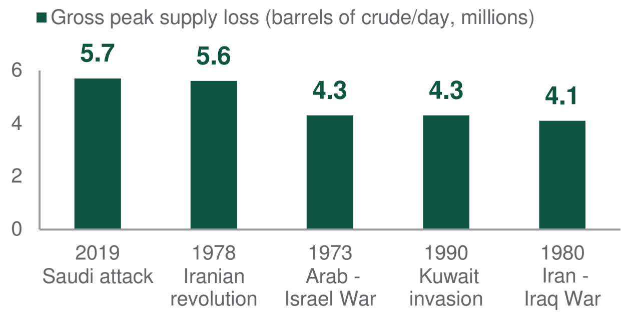
Real Assets

Drone strikes on a major Saudi Arabia production facility temporarily knocked half of the country's – and 5% of the world's – oil production offline. Thirty years ago this event – the largest production disruption in history (see chart) – would have consumed this entire report; today, not so much. Oil prices spiked by 15% the following day but fell back below pre-attack levels within two weeks. Global stock markets barely flinched, highlighting the reduced economic sensitivity to oil supply shocks. That said, any further attacks that disrupt production facilities more severely would lead to natural resource outperformance. We retain a small tactical overweight given its geopolitical hedge characteristics alongside attractive valuations.

More attractive to us right now are the interest-rate-sensitive asset classes of global real estate and listed infrastructure. We expect the 10-year U.S. Treasury to remain range-bound around the 1.5% level, which will increasingly raise interest in these "bond proxy" asset classes. Both global real estate and listed infrastructure are currently yielding significantly more than bonds (around 4%). Also, underlying fundamentals should be supported by our low-growth (but non-recessionary) expectations for the global economy.

THE OIL CRISIS THAT WASN'T

Oil markets quickly recovered from the massive Saudi disruption.



Source: Northern Trust Global Asset Allocation, Eurasia Group.

- We are tactically overweight all real assets.
- Global real estate and infrastructure provide attractive income.
- Natural resources are an inexpensive hedge against geopolitics.

BASE CASE

Fundamentals vs Geopolitics

The economy's underpinnings, especially in the U.S., remain "good enough" to support asset valuations, though geopolitical risks will weigh on investor sentiment as the U.S. election approaches. This is a recipe for continued market volatility. We retain overweights to "less risky" risk assets.

Global Easing Cycle

Central banks are back into a synchronized easing cycle as uncertainties rise and growth slows. Further monetary easing will remove a modest headwind to growth, but should not be considered a major catalyst for higher risk asset returns. Investors have fully priced-in further moves on the monetary policy front.

RISK CASES

Inflation

Subdued inflation has been a key driver of favorable risk asset returns over the last few years; an unexpected jump in cyclical inflation would put at risk the global easing cycle, resulting in lower risk asset returns.

U.S. Election Clairvoyance

Investors fully expect a nasty, highly competitive 2020 election cycle. Events that solidify the expected outcome would reduce the uncertainty and cause significant shifts in asset prices and flows.

INVESTMENT PROCESS

The asset allocation process develops both long-term (strategic) and shorter-term (tactical) recommendations. The strategic returns are developed using five-year risk, return and correlation projections to generate the highest expected return for a given level of risk. The objective of the tactical recommendations is to highlight investment opportunities during the next 12 months where the Investment Policy Committee sees either increased opportunity or risk.

The asset allocation recommendations are developed through the Tactical Asset Allocation, Capital Markets Assumptions and Investment Policy Committees. ViewPoints reflects data as of 10/15/19.

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