THE FED AND TRADE

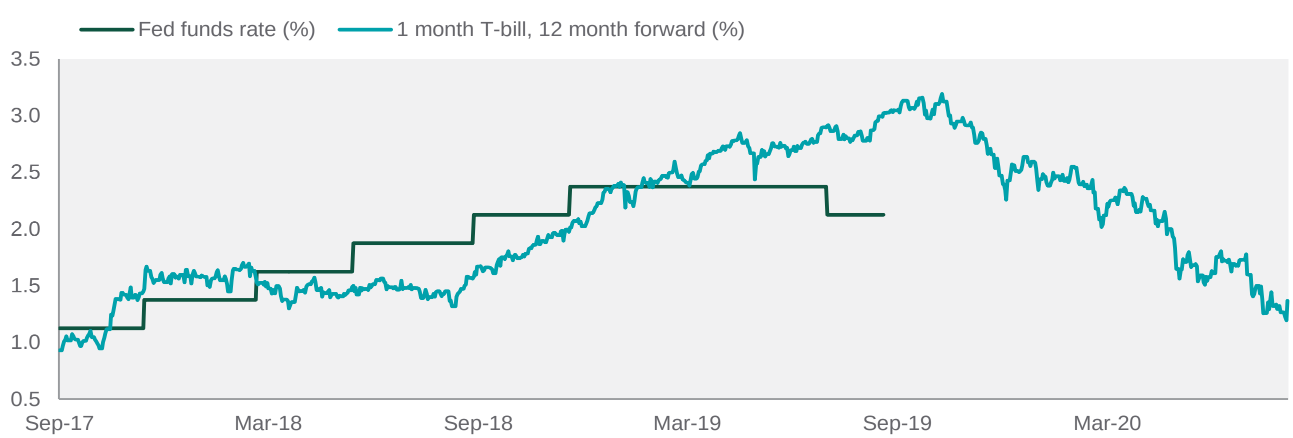
During its discussions this month, the investment strategy team spent considerable time debating the outlook for Federal Reserve policy and the path forward for the U.S.-China trade dispute, including its impact on the global growth outlook. Despite the considerable gulf between market expectations for rate cuts and the Fed's current posturing, we expect the Fed to grudgingly move toward the market's expectation of four cuts of 0.25% over the next year. The Fed is likely to be a latecomer to our *Monetary Makeover* theme, which predicts central bankers will increasingly gaze outside of their traditional remit to further support growth and inflation as monetary accommodation loses its punch. We see the European Central Bank at the front of the pack, as highlighted by incoming president Christine Lagarde's recent commentary calling for increased fiscal stimulus.

Financial markets continue to be buffeted by the latest trade developments, rallying most recently on a mere agreement between Chinese and U.S. leadership to meet in October. This is evidence that the market has discounted much of the economic impact of the tariffs – and the overall slowdown in global growth since early 2018 is hardly a secret to investors. The negative impact of the trade war highlights our *Executive Power Play* theme, which argues that populist politicians will be punished if their policies result in poor economic outcomes. We expect this to limit, to some degree, the extent to which President Trump pushes the trade war ahead of the 2020 presidential election. This theme may also be playing out in the United Kingdom, where elected officials may be trying to avoid a hard Brexit as they fear the wrath of voters in economically vulnerable positions.

Despite the many economic and geopolitical concerns facing investors, it has been an excellent year in financial markets. We've been expecting disappointing growth, (which has been true more so outside the U.S.), but have believed low inflation would support lower interest rates and higher asset class valuations. We made no changes this month in our recommended tactical asset allocation policy, which remains moderately overweight risk. We prefer U.S. to emerging market equities, as they provide some hedge against trade war risk. We also favor lower-risk risk assets such as high yield bonds and interest-rate sensitive asset classes including global real estate and global listed infrastructure. We remain on the watch for our two primary risk cases – the potential of a return of inflation, and a proliferation of tariffs beyond those the U.S. has placed on Chinese imports.

JUST GETTING STARTED

Futures markets expect the rate-cutting campaign to continue through 2020.



Source: Northern Trust Global Asset Allocation, Bloomberg. Fed funds rate data 9/30/2017 - 9/5/2019.
1 month T-bill, 12 month forward rate data is pulled forward one year and runs from 9/30/2016 - 9/5/2019.

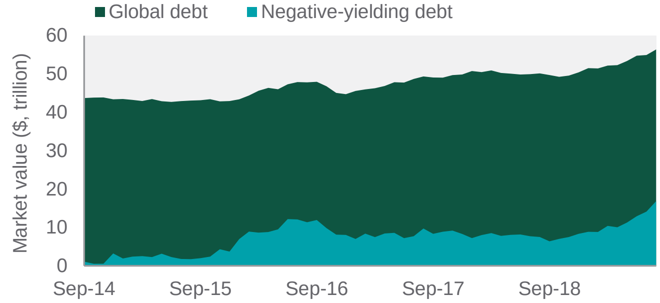
Interest Rates

Negativity is back in the fixed-income world. Negative-yielding bonds (as a percentage of total debt issuance) now represent nearly 30% of the total bond universe, surpassing the peak set prior to the 2016 U.S. presidential election. The 10-year U.S. Treasury note currently provides a 1.5% yield, just 0.1% higher than the previous low set in July 2016. Some may scoff at that, but many investors outside of the U.S. view it as a bargain in a world where 10-year yields in problematic Italy sit at 0.9% and 10-year German bund yields come in at negative 0.6%.

While we do not expect a U.S. recession, we do believe the percentage of negative interest rates globally – alongside global growth pressures and continued stuckflation – will keep U.S. interest rates low and force the Fed to concede to market pressure and cut rates by 25 basis points at each of its next four meetings to prolong the current economic expansion. We have positioned our portfolios with a long duration profile to benefit from these continued downward pressures on U.S. interest rates.

CREEPING NEGATIVITY

Negative-yielding bonds now represent 30% of the bond universe.



Source: Northern Trust Global Asset Allocation, Data 9/30/2014 - 8/31/2019. Debt measured by Bloomberg Barclays Global Agg and Global Agg neg. yielding debt indices.

- Slow growth and stuckflation continues to cap interest rates.
- Low/negative global yields act as a gravitational pull on U.S. rates.
- Despite a flat yield curve, we continue our long-duration stance.

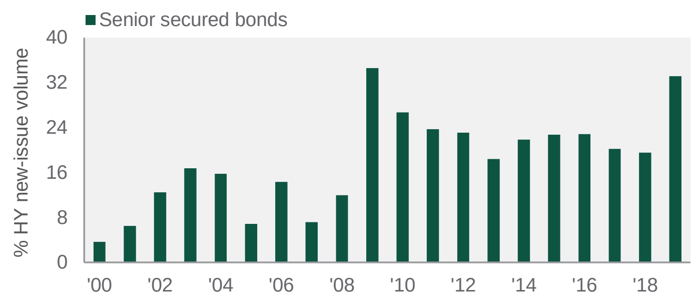
Credit Markets

The high yield market has seen an increase in issuance of senior secured bonds as a percentage of total high yield bond issuance. As markets adjust to lower U.S. treasury rates and the Fed's dovish positioning, market participants looking for a buffer against lower rates have shown a clear preference for fixed vs. floating instruments. This is a clear divergence from the past five years, when the leveraged loan market grew faster than the bond market. Overall, senior secured bonds have accounted for 33% of the high yield issuance year-to-date, representing the highest level since 2009.

This development is further confirmation that market consensus is moving toward our "lower for longer" view on interest rates. Demanding fixed over floating instruments suggests market participants are not expecting rates to go higher anytime soon. However, the development also raises questions about whether a "supply response" to the low-rate environment will eventually push rates higher. (In addition to the increase in fixed high yield issuance, we have also seen a recent surge of investment-grade credit issuance.) Will greater supply push rates higher? We don't think so. First, much of the new issuance is simply refinancing to extend maturities. Secondly, we believe a great deal of issuance would be required to overcome the robust demand for debt instruments. Overall, we find the current environment still constructive for taking on credit risk in investment portfolios.

GOING WHERE THE MARKET TAKES YOU

As the demand for senior secured debt has grown, so has issuance.



Source: Northern Trust Global Asset Allocation, JP Morgan Chase.

- Fixed-rate debt issuance has increased recently.
- Robust fixed income demand will soak up increased supply.
- We remain overweight high yield in the global policy model.

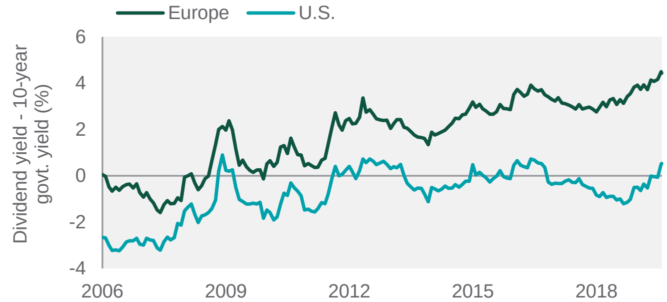
Equities

Global equities advanced over the past month, led by the U.S. Cross-currents with respect to monetary and trade policy remain overhangs to business confidence and investment, but a resilient U.S. consumer and easier monetary policy have kept recession fears at bay. Lower interest rates without a recession are good for equities, in part due to the growing appeal of the dividends. As per the chart, dividend yields in the U.S. and Europe exceed their respective 10-year Treasury yields – materially so in the case of Europe. The dividend yield on the S&P 500 now exceeds 10-year Treasury yields by 0.5%. European equity dividend yields represent a remarkable 4.5% premium to the negative yields on German 10-year bonds.

The macro outlook for Europe is more challenged than the U.S., but attractive yields should keep investors interested. In the U.S., while trade negotiations will continue to drive elevated levels of volatility, we expect lower interest rates combined with still positive growth to continue to justify healthy valuations. Emerging markets have lagged materially year-to-date, and with trade weighing more heavily on their economies and currencies, we maintain our preference for developed markets – particularly stocks in the U.S.

LOOKING FOR YIELD IN ALL THE WRONG PLACES?

Stocks now represent a better source of income than bonds.



Source: Northern Trust Global Asset Allocation, Bloomberg. Data from 1/31/2006 to 9/4/2019. Dividend yield STOXX 600 for Europe equity and S&P 500 for U.S. 10-year yield: Germany and U.S.

- Stocks were helped by lower rates but hurt by trade tensions.
- Dividend yield levels are looking increasingly attractive.
- We remain overweight equities and tilted toward U.S. markets.

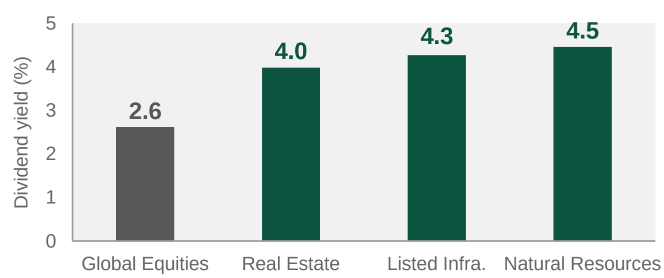
Real Assets

We note in our recently released five-year outlook that the term “real assets” is a clumsy characterization and grouping of various asset classes. None of them are actually “real,” in that investors don’t actually own the physical assets; all are equity-based. Also, they provide varying levels of inflation protection (for instance, investors gain more inflation protection from traditional equities than from global real estate). However, one trait all “real assets” currently share is an attractive dividend yield – 4% or higher across the spectrum right now.

We are accustomed to considering global real estate and listed infrastructure as cash flow assets providing elevated yields. But natural resources are also currently providing nice yields as valuations have slipped given the muted outlook for growth and, by extension, commodity prices. Can these higher yields be sustained, or is the market expecting dividend payments to be either cut or suspended to ensure adequate cash flow? We do not expect this to be the case. Most of the companies in the S&P Global Natural Resources index survived the commodity price collapse five years ago (when oil prices fell below $30 per barrel), and many of those companies have more resilient operating models today. These companies also know the importance of dividends to their shareholders – and are loathe to cut them. Overall, we are constructive on all real assets with tactical overweights to all three in our global policy model.

REAL ASSETS, REAL NICE YIELDS

All real assets currently provide yields at or above 4%.



Source: Northern Trust Global Asset Allocation, Bloomberg. Dividend yields as of 8/31/2019. Indexes used in order: MSCI ACWI, MSCI ACWI Core RE, S&P Global listed infrastructure, S&P Global Natural Resources.

- Real estate and listed infrastructure have done well in 2019.
- All real assets are currently providing attractive yields.
- We are currently tactically overweight all three real assets.

BASE CASE

Global Growth Pressures	Interest Rate Relief Valve
President Trump's reenergized assertiveness on the tariff front has put into question the economy's "goldilocks" underpinnings. We believe global growth will modestly disappoint investor expectations and are concentrating on "lower risk" risk assets such as U.S. High Yield and U.S. Equities.	Political impacts on fundamentals will be partially diffused through continued low rates, enabled by stuckflation and central banks (importantly the Fed) begrudgingly accepting the bond market's message. As a result, we have overweights to interest-rate sensitive assets (Global Real Estate and Listed Infrastructure).

RISK CASES

Inflation	Tariff Proliferation
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 Interest Rate Relief Valve base case above.	While not ideal, the U.S. – and, for the most part, the global – economy can withstand a concentrated trade war with China. Risks arise if the U.S. (or others) meaningfully targets other countries.