A FRESH LOOK

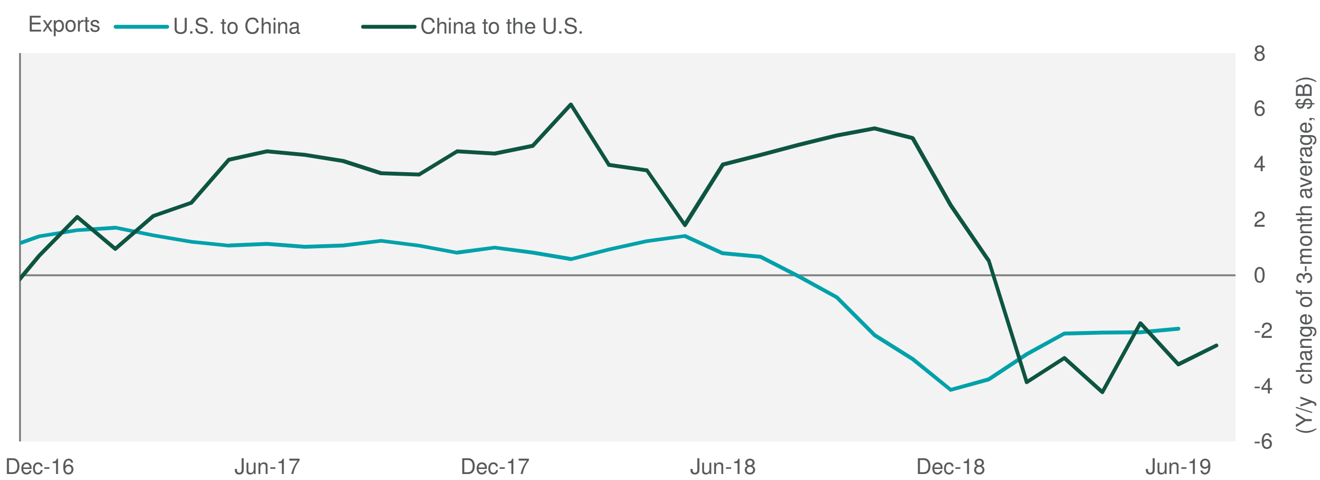
Each summer we review our capital markets assumptions, which results in an updated 5-year investment outlook. We also develop 5-year themes which encompass current developments as well as longer-term trends. Our theme of ***Global Growth Restructuring*** captures our view of slowing growth, exacerbated by the ***Irreconcilable Differences*** we see between the United States and China. As the chart below illustrates, trade between the two has been falling as tariffs have risen and tensions remain high. The global trade slowdown has hurt growth in all regions, with emerging markets hurt the worst and the United States being somewhat insulated. Growth in Japan has held up reasonably well, while a stable services sector in Europe has offset export-led weakness in their manufacturing sector. Our view is global growth will modestly disappoint investor expectations, but the shortfall will be cushioned by lower interest rates.

Our ***Stuckflation 4.0*** theme captures the impact technology is having on restraining inflation, which we believe will lead to a ***Monetary Makeover*** as central banking independence is challenged. This should lead to a lower interest rate outlook than many have feared, once again staving off the long-feared bond bear market. We have seen a quick fall in market-based measures of inflation this year, with the current 10-year inflation breakeven approaching 1.6%. This has been a contributing factor to the recent rally in yields, which has been supported by the start of a global easing cycle.

We expect a lower investment return environment over the next five years, with a balanced portfolio (60% global equities, 40% U.S. investment grade bonds) generating an annualized return of 4.7% as compared to a realized annual return of 5.2% over the last five years. The low starting level of interest rates are constraining the returns of fixed income portfolios, while we believe slower growth and some margin and valuation pressure will limit equity returns to the mid-single digits. A more cautious outlook toward emerging market growth has reduced both our strategic and tactical recommendations for emerging market equities. As a result, we decreased the recommended exposure to emerging market equities in our global policy model this month, with the proceeds being invested in U.S. equities and investment grade bonds. Overall, we retain a moderate overweight to the less-risky risk assets (U.S. equities, high yield, global listed infrastructure) as we monitor our key risk cases of a return of inflation and a spread of the trade war.

HURTING BOTH SIDES

Exports between the United States and China have begun contracting due to the trade fight.



Source: Northern Trust Global Asset Allocation, Bloomberg. Monthly data from 10/31/2015 to 7/31/2019.

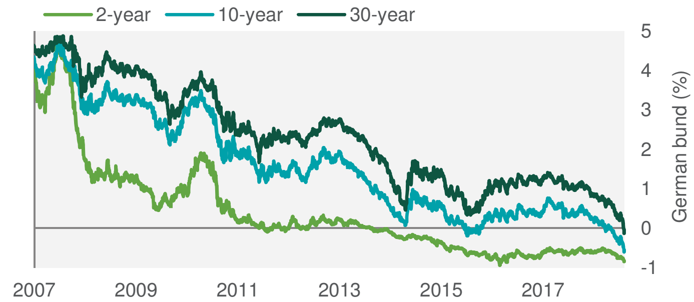
Interest Rates

Ongoing tension between the world's two largest economies is pressuring interest rates. The U.S. yield curve has shifted lower and has inverted once again, with the 10-year yield below that of the 3-month yield. The United States is certainly not alone. German bund yields set record lows as the entire curve out to the 30-year yield moved into negative territory. French, Dutch and Swedish bonds joined the negative yield club as well, while the British 10-year yield fell to its lowest level ever.

With no end in sight to the U.S.-China trade spat, and continued sluggish economic data outside the United States, central banks globally are reengaging in easy monetary policy. The Fed cut rates at the end of July while the European Central Bank has signaled a rate cut in September. Quantitative tightening is over – and new rounds of quantitative easing will likely pop up in various regions of the world. We believe longer-dated interest rates will remain near current levels – but the risk is much higher that they slip further than begin to rebound. Our portfolios are targeting a longer duration profile than that of the relevant benchmark.

THE RACE TO NEGATIVE

German bund yields are now negative out to 30-year maturities.



Source: Northern Trust Global Asset Allocation, Bloomberg. Daily data from 12/31/2007 to 8/7/2019.

- Bond yields are falling globally.
- U.S. yields look attractive vs. the rest of the world.
- We are positioned with a long duration stance.

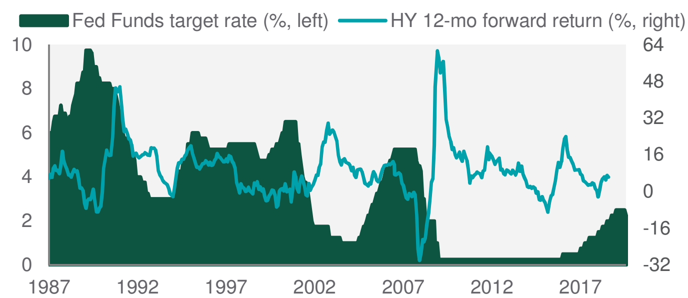
Credit Markets

With the Federal Reserve's first rate cut since 2008, the question for high-yield investors is how this new easing cycle will impact high-yield returns. While there is some correlation to underlying interest rates, high-yield performance is more dependent on economic drivers. High yield does best when monetary policy is appropriate, so economic growth can continue. The last Fed rate cut cycle – in the midst of the financial crisis – began too late and the economy cratered into recession. High yield lost 10% in the 12 months following the first Fed cut of that cycle. During the early 2000 Fed rate cut cycle, higher quality securities initially outperformed until the Fed initiated a second round of rate cuts. At that point, high yield experienced strong returns driven by lower quality security outperformance as the economy found its footing and exited the shallow recession.

The 1995 and 1998 rate cuts may provide greater insight into the current environment because the Fed adjusted rates and was able to avoid recession. In both instances, high yield performed well, with lower quality securities driving asset class returns. Today we operate in a backdrop of sound economic underpinnings – but with geopolitical uncertainty. We believe this will result in slow-but-positive economic growth supported by easy monetary policy but hampered by market volatility. In such an environment, we find the current 6% yield on high yield as attractive. We remain materially overweight.

COMPLICATED RELATIONSHIP

High yield benefits from monetary policy actions – but indirectly.



Source: Northern Trust Global Asset Allocation, Bloomberg. Fed Funds rate target bound is the upper bound. Data through 7/31/2019.

- Fed rate cuts will help high yield if they help the economy.
- A slow-but-positive growth environment is attractive for high yield.
- High yield remains our largest global policy model overweight.

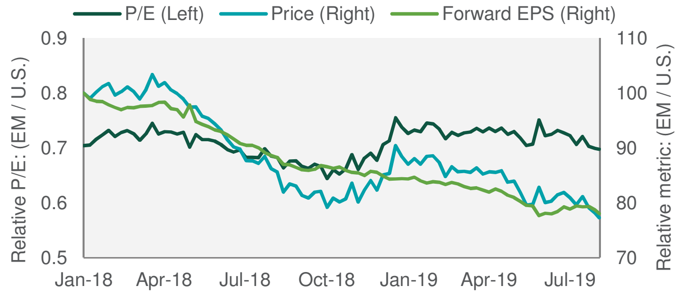
Equities

Global equities fell the past month as the Fed offered a confusing/disappointing forward interest rate outlook and U.S.-China tensions escalated again. This led investors to seek shelter in bonds, where yields dropped significantly. Emerging market (EM) equities continue to experience greater pain, incurring double the decline seen in the United States over the last month. As seen in the chart at right, going back to the beginning of 2018, EM has underperformed the U.S. by 23%. Notably underperformance in earnings accounts for the entire performance deficit – as relative valuations (P/E) between the United States and EM have been mostly unchanged.

As the trade battle wears on, we continue to believe EM will see greater pressure from the resulting economic impact. We expect the impact on U.S. fundamentals to be manageable and fall short of dragging the United States into recession. Second quarter earnings growth was a modest 2%, but 4% revenue growth suggests U.S. companies remain healthy. With positive earnings growth, an outlook for slow but positive economic growth, now much lower interest rates, and valuations that are only modestly above long-term averages, we continue to tilt globally oriented equity portfolios toward U.S. equities.

FUNDAMENTALLY DRIVEN

Emerging market underperformance is due to lower growth rates.



Source: Northern Trust Global Asset Allocation, Bloomberg. Weekly data from 1/5/2018 through 8/7/2019. MSCI EM represents Em. mkts. and S&P 500 represents U.S. equities.

- Global growth pressures will be offset by interest rate relief.
- We remain overweight global equities in aggregate.
- We prefer U.S. equities over emerging market equities.

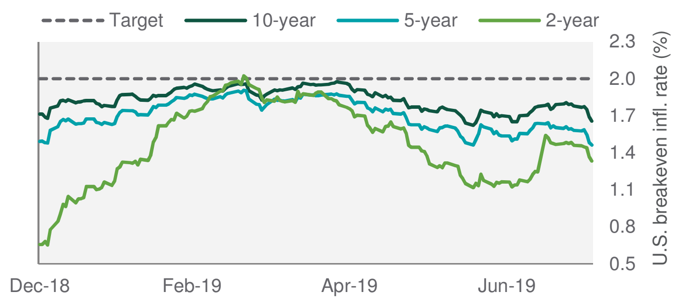
Real Assets

Inflation-linked bonds (ILB) don't technically fall into our real assets category – a classification saved for risk assets such as global real estate, listed infrastructure and natural resources. But market movements sometimes prompt a focus on ILB – both from the perspective of the outlook for inflation (important to real assets) as well as any opportunities in the ILB market.

The past month necessitated a focus on the ILB market – specifically the material drop in breakeven rates, which represent investor inflation expectations. Slowing global growth and increased U.S.-China tensions have prompted a material revision in the inflation level investors think central banks can achieve. Investors simply do not believe the Fed can hit its 2% inflation target over the next two years, five years – or even 10 years (see chart). This should be concerning for the Fed – and should indicate a one-off "mid-cycle adjustment" in policy is not enough. We believe the Fed will be forced to cut rates at least two more times this year and more over the next 12 months. But will this be enough to make ILB attractive? We aren't quite there yet – as we are far from convinced the Fed has the wherewithal or the necessary tools to reset investors' current stuckflation mindset. We remain underweight ILB in the global policy model – and, instead, are overweight those real assets with interest rate sensitivity (global real estate and listed infrastructure).

JUST CAN'T GET OVER THE HUMP

Inflation expectations over various horizons are falling again.



Source: Northern Trust Global Asset Allocation,

- Investors have little faith the Fed can hit its 2% inflation target.
- Inflation-linked bonds (ILB) are getting more interesting.
- We will stay underweight ILB until we get bolder monetary policy.

BASE CASE

Global Growth Pressures	Interest Rate Relief Valve
President Trump's reenergized assertiveness has challenged the economy's 'goldilocks' under-pinnings. We believe global growth, while positive, 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 are overweight 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 United States (or others) meaningfully target other countries.

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 8/13/19.