PREPARING FOR WINTER

"Winter is Coming" was the name of the very first episode of HBO's very popular *Game of Thrones* television show; and it quickly set the plot for the series: After the longest summer in history (10-plus years), preparations are being made for an equally long (and harsh) winter.

Markets also enjoyed an unusually long "summer" in the form of a bull market that ran mostly uninterrupted from the end of the global financial crisis to the start of this year (only briefly interrupted by the pandemic). Certainly winter is literally coming; but is it also coming metaphorically?

Fighting white walkers. The overarching antagonist in *Game of Thrones* is the "white walkers" – the band of "undead" seemingly behind the impending long winter. Financial markets are not fighting mythical creatures (though it sometimes feels that way). But they are fighting the effects of persistent inflation. The most recent U.S. and European inflation prints came in at 8.3% and 10.0%, respectively. While supply chains are healing, energy supply has come under threat – due to both chronic underinvestment in traditional energy sources and, of course, the ongoing Russia-Ukraine war. The issue is most acute in Europe, where a cold winter may require increased energy rationing, affecting industrial activity. Higher energy bills are pressuring consumer spending – and energy relief packages, while helpful, only transfer the burden to government budgets, which must be paid back later (one way or another). All the while, there is a risk of further retrenchment of corporate capital expenditures.

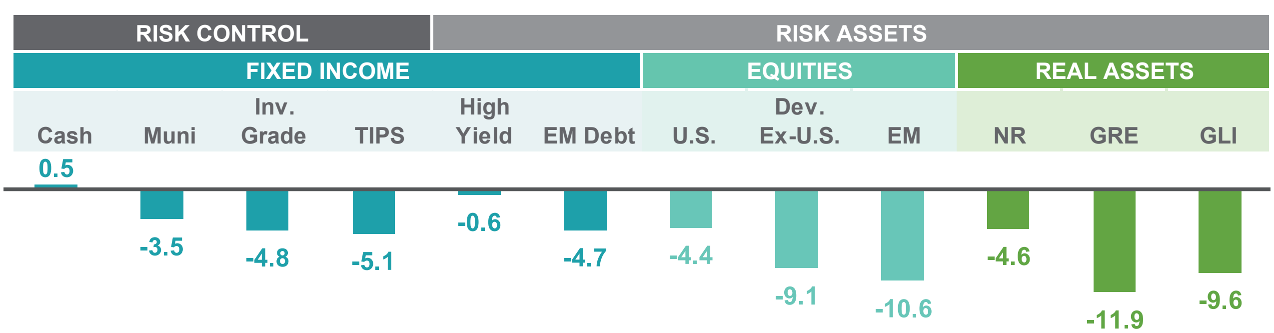
Unleashing dragons. In *Game of Thrones*, the most viable weapon against the white walkers were dragons. In financial markets, the most viable weapon against inflation is tighter monetary policy. The Fed has certainly been harnessing this weapon, enacting a total of 3% in rate hikes thus far this cycle, often doing so 0.75% at a time. Other central banks are also following suit, including the European Central Bank, which has now exited negative interest rate territory. Like the *Game of Thrones* dragons, monetary policy is an effective-but-blunt weapon – often times causing a recession in the process of bringing price increases back to target. We certainly face this possibility.

A real world game of thrones. In addition to the ongoing Russia-Ukraine war, other global power struggles are top of mind for investors. These include the ongoing tensions between China and Taiwan, alongside the increasingly aggressive actions from the likes of Iran and North Korea.

Waiting for Spring. There is no denying the geopolitical challenges and economic concerns. But, with stocks down over 24% year-to-date, and bonds down over 14%, financial markets have greatly adjusted to this new reality. Equity valuations have compressed meaningfully (see bottom of page 2) and the 10-year U.S. Treasury yield touched 4% for the first time in over a decade. Meanwhile, high yield bonds are offering nearly 10% yields against still-low default rates. Battles (whether against inflation or white walkers) may not be easy or quick – but, for those who have the patience, victory can come with spoils.

THIRD QUARTER 2022 TOTAL RETURNS (%)

It was another difficult quarter for global equities – and again risk-control assets (ex-Cash) provided negligible protection.



	Cash	Muni	Inv. Grade	TIPS	High Yield	EM Debt	U.S.	Dev. Ex-U.S.	EM	NR	GRE	GLI
YTD	0.6	-12.1	-14.6	-13.6	-14.7	-18.6	-24.7	-26.6	-26.5	-5.9	-29.4	-10.1

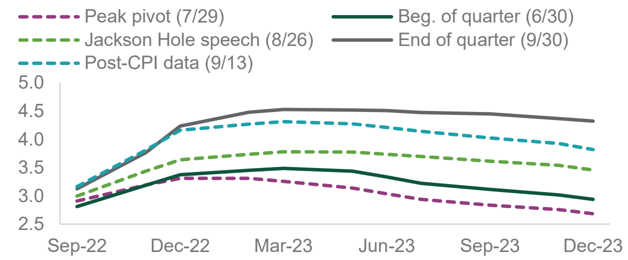
Source: Northern Trust Asset Management, Bloomberg. NR: Natural Resources; GRE: Global Real Estate; GLI: Global Listed Infrastructure. Indexes are gross of fees.

KEY DEVELOPMENTS

Tighter for Longer

U.S. inflation has been more durable than expected, with implications for Fed policy (tighter for longer) and growth (weaker). Investors' dovish read of Fed Chair Powell's July press conference ("peak pivot" in chart) reversed course by the time of his late-August Jackson Hole speech, where he reaffirmed the Fed's laser focus on inflation. Yet another hot August Consumer Price Index (CPI) reading pushed the trajectory even higher. Ultimately, investors exited the quarter with a belief that meaningful Fed relief won't come until 2024 at earliest.

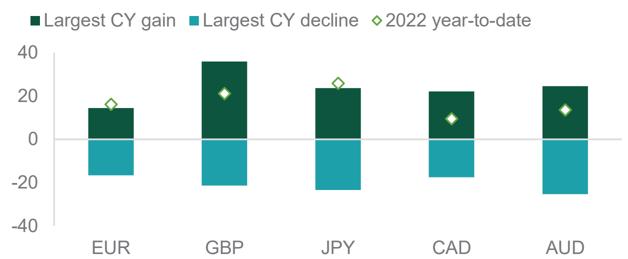
EXPECTED FED POLICY TRAJECTORY (%)



Long Live the U.S. Dollar

Fed tightening has led to a stronger U.S. dollar against currencies across the world, with 2022 showing record calendar year (CY) appreciation in some cases (see chart). Weaker currencies can help domestic company earnings but also challenge non-U.S. central bankers in an already-tough inflation backdrop. Most recently, in the U.K., this dynamic (in addition to poorly-timed fiscal stimulus plans) has dropped the British pound to levels not seen in more than 30 years. Meanwhile, the euro hit parity with the U.S. dollar for the first time since 2002.

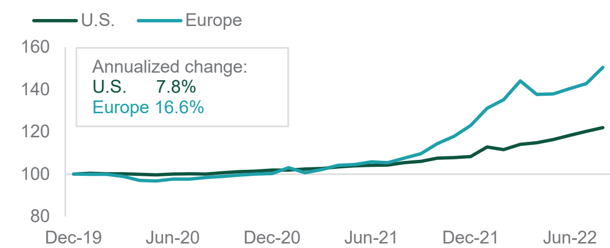
U.S. DOLLAR CURRENCY MOVES (%) VERSUS…



Energy Pains

Energy bills have been painful for many – but nowhere more so than in Europe. Russia reduced natural gas supply due to "maintenance" closures before shuttering the Nord Stream 1 pipeline completely in September. Concerns escalated later on as pipeline leaks were discovered – likely the result of sabotage. Massively elevated natural gas prices have led to consumer and industrial energy bills that are multiples higher than previous years. Storage reserves have been built but are still at risk of depletion in the event of a cold winter.

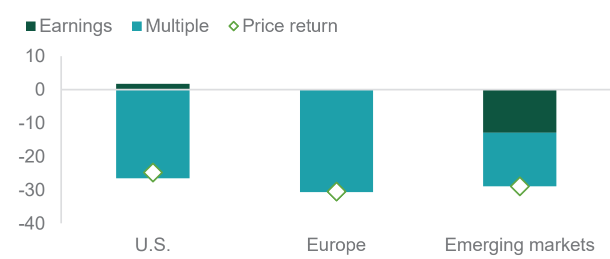
ELECTRICITY INFLATION – INDEXED TO 100



Resilient Earnings

Durable inflation, tighter monetary policy and geopolitical uncertainty have led to large losses in both equities and bonds year-to-date. Despite the volatility, developed market earnings expectations have proved resilient with 2022 earnings revisions still slightly above zero across the U.S. and Europe. Most of the negative returns have been driven by multiple compression (see chart). Emerging markets are a different story, where a deteriorating earnings outlook has accounted for roughly half of the year-to-date decline.

YEAR-TO-DATE RETURN BREAKDOWN (%)



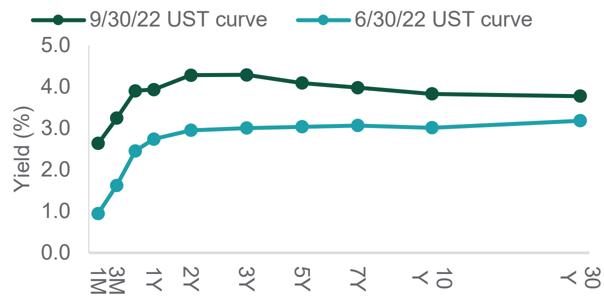
Source: Northern Trust Asset Management, Bloomberg. CY = calendar year. Data as of 9/30/2022.

MARKET REVIEW

Interest Rates

Higher and flatter: two key descriptors of global yield curve movements during the quarter. Two outsized (75) basis point (bp) hikes, updated projections indicative of "higher-for-longer" rates, and hawkish commentary made clear that the Fed is laser-focused on containing inflation. Global bond yields surged, mainly driven by higher real yields, as investor expectations for policy tightening adjusted upward. Growth concerns – a byproduct of tighter monetary policy – tempered the rise in longer-term yields, leading to flatter curves overall.

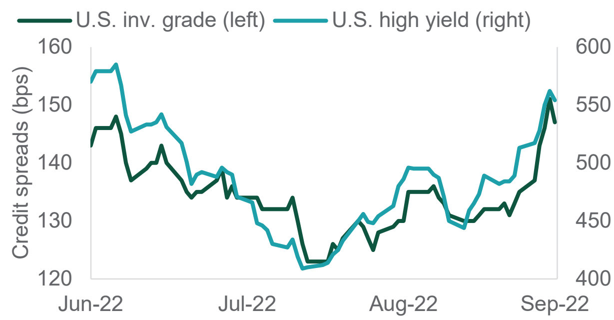
U.S. TREASURY YIELD CURVE



Credit Markets

Coming off of a period of massive spread widening, credit spreads contracted throughout July. There was some hope that peak inflation would soon allow central banks to ease tightening, thereby lowering the risk of policy-induced recession. As this narrative proved misguided, and policy-induced recession concerns restrengthened, credit spreads widened to near-to-just above beginning of quarter levels. High yield (-0.6%) outperformed investment grade fixed income (-4.8%), helped by less exposure to interest rate volatility.

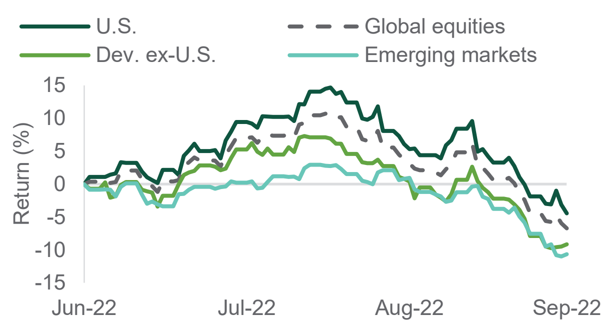
CREDIT SPREADS



Equities

Global equities initially rebounded on the back of better-than-expected earnings, a fall in inflation expectations and very depressed investor sentiment. However, equities ultimately ended the quarter with a 6.7% loss as rising interest rates weighed on valuations. U.S. equities, down 4.4%, performed the best of the major regions, followed by developed ex-U.S. equities (-9.1%) and emerging market equities (-10.6%). Non-U.S. equities more acutely suffered from energy headwinds (Europe), China struggles and U.S. dollar strength.

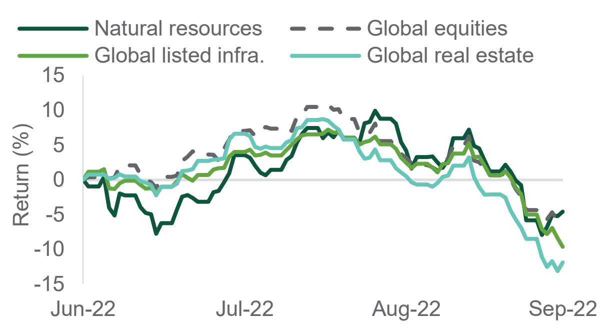
REGIONAL EQUITY INDICES



Real Assets

Natural resources (NR, -4.6%) outperformed global equities despite concern that restrictive monetary policy may suppress commodity demand. NR found some support from ongoing energy shortages and outperformed the other two real assets we track: global listed infrastructure (GLI, -9.6%) and global real estate (GRE, -11.9%). GLI returns were weighed down by interest rate volatility, though it did hold up better than GRE during the equity downturn. GRE lagged given rate volatility and elevated economic concerns.

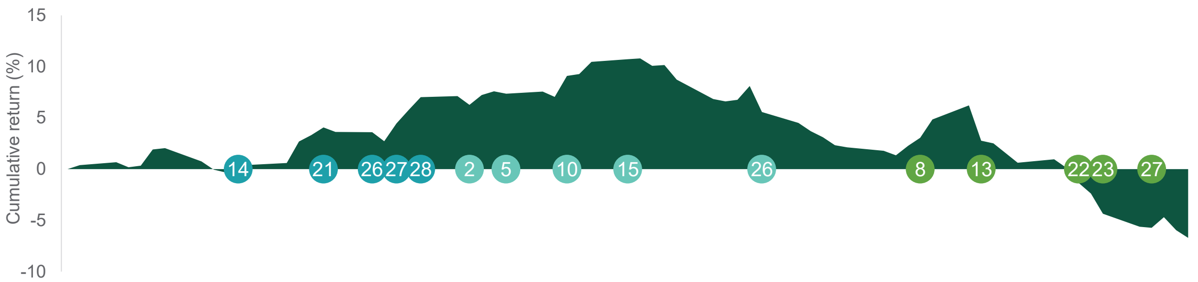
REAL ASSET INDICES



Source: Northern Trust Asset Management, Bloomberg. Bp(s) = basis point(s). Returns in U.S. dollar terms. UST = U.S. Treasury. Indexes are gross of fees.

MARKET EVENTS

■3Q 2022 global equity total return: -6.7%



JULY	AUGUST	SEPTEMBER
14 Second quarter earnings season unofficially kicks off. Earnings and revenue eventually prove resilient, beating expectations by about 3% each.	2 U.S. Speaker of the House, Nancy Pelosi, arrives in Taiwan. China responds with unprecedented military exercises near the island, though direct conflict is avoided.	8 ECB hikes interest rates by 75 bps and communicates it is likely to continue tightening policy.
21 European Central Bank (ECB) exits negative rate regime via a 50-basis point (bp) rate hike and approves spread protection tool for activation if needed.	5 Huge U.S. jobs report – 528k jobs added versus 250k expected – and accelerating wage growth raise Fed tightening expectations.	13 U.S. CPI bucks downward trend, with the core reading accelerating 0.6% m/m, triggering one of the steepest one-day losses of the year for U.S. equities.
26 U.S. Senate reaches an agreement on the Inflation Reduction Act (signed into law on 8/16), a $700+ billion health care, tax and climate bill.	10 U.S. headline and core Consumer Price Index (CPI) decelerate from the prior month, raising hope that "peak inflation" has arrived.	22 Fed hikes rates by 75 bps; revised Summary of Economic Projections shows higher-for-longer rate expectations.
27 Federal Reserve raises its policy rate by 75 bps; equities respond favorably to Chair Powell's comments on data-dependent approach.	15 China begins to deliver a string of policy easing measures, but there's a relatively muted financial market reaction given China's ongoing COVID and property sector headwinds.	23 U.K. announces fiscal plans that include unfunded tax cuts that could cost up to 10% of U.K. GDP, leading to a surge in global bond yields led by gilts.
28 U.S. GDP contracts for a second straight quarter, marking a technical recession, but the labor market remains solid and corporate profits resilient.	26 At Jackson Hole, Chair Powell notes restoring price stability may require a restrictive policy stance for some time and that history cautions against premature policy loosening.	27 Following recent Ukrainian success, Nord Stream pipelines risk permanent closure due to "unprecedented" damage; Russia annexes parts of Ukraine.

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