VIEWPOINTS *March 2023*

LOOKING ACROSS THE VALLEY

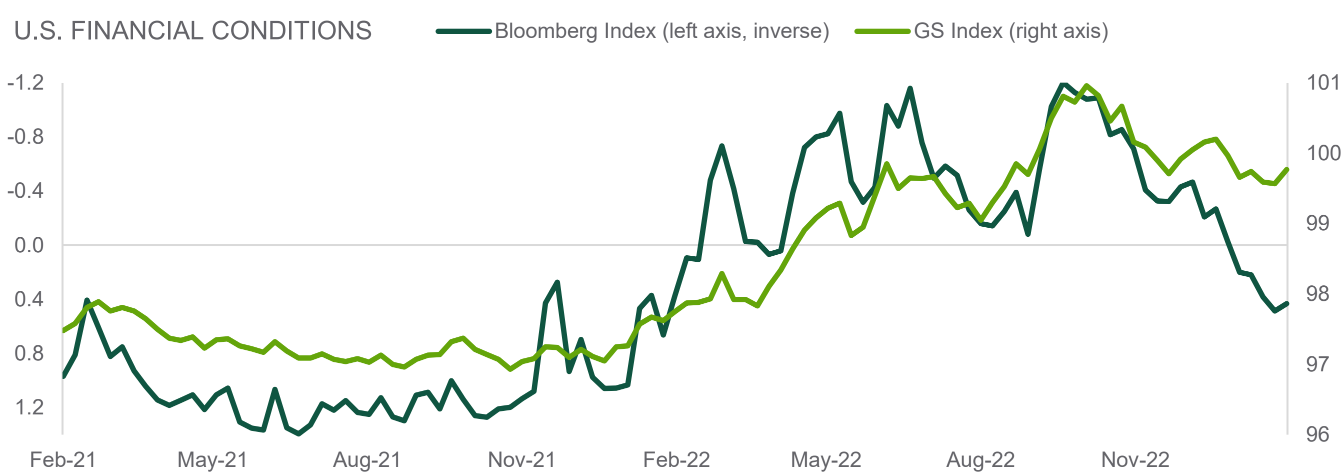
Global equities are off to a strong start in 2023. Investors have chosen to look across the valley of softening fundamentals – focusing instead on declining inflation, the near completion of central bank rate increases and moderating long-term rates. Notably, the easier financial conditions seen over the past few months (see chart below) have not been greeted with substantive pushback from the Federal Reserve (Fed) despite continued strength in the labor market. Some had feared the Fed would view the easier financial conditions resulting from more optimistic markets as impeding its ability to get inflation under control, prompting a more hawkish posture. The lack of concern voiced from Fed Chair Powell was well received by investors.

January saw the addition of over 500k new jobs in the U.S. (well more than double consensus expectations) and unemployment fell to multi-decade lows. In addition, the gap between the number of open jobs in the U.S. and those seeking employment widened back toward the highs. As other contributors to inflation have moderated or soon will (like housing), wage growth has taken center stage. Wages should continue to moderate somewhat, but the unexpectedly durable job market has brought the market into alignment with the Fed's view that at least two more 0.25% interest rate increases will be necessary prior to a pause.

Corporate profit expectations continue to soften, though the worst of the negative revisions should be behind us. We are incrementally less worried about the economic growth outlook in the U.S., aligning the region to our recently improved view toward international markets. Continued strength in the labor market suggests resilient corporate sentiment and consumer conditions in the U.S., while Europe continues to benefit from a warmer winter bringing down energy costs. China's economic reopening as it transitions from its zero-Covid policy appears on track, though long-term challenges remain.

EASIER CONDITIONS

Over the past few months financial conditions have eased with limited pushback from Fed Chair Powell.



Source: Northern Trust Asset Management, Bloomberg, Goldman Sachs (GS). A higher value indicates more accommodative financial conditions for the Bloomberg Index, while a lower value indicates more accommodative financial conditions for the GS Index. Weekly data from 2/12/2021 through 2/10/2023.

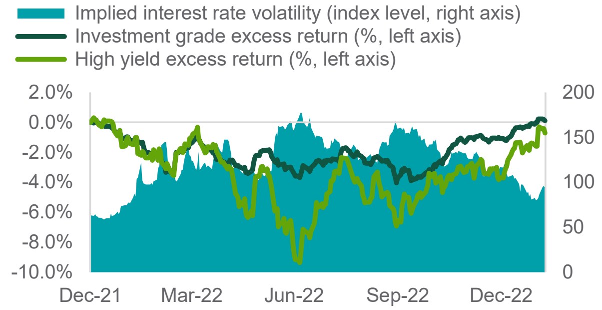
Interest Rates

During 2022, interest rate volatility drove asset returns more than in prior years. Inflation pressure continued to build and took center stage in the eyes of policymakers and investors, even while the actual economy held up well. The uncertainty over when the Fed would stop hiking rates led to rising volatility and rising term (and inflation) premia. If the market is uncertain over where risk-free rates should be, valuing spread products can become more difficult. Inflation began to show signs of peaking late last year, while monetary policy downshifted. This led to a quick drop in rate volatility and very strong risk asset returns.

As shown in the chart, the rise in implied interest rate volatility hurt risk markets (shown by excess returns to Treasuries in U.S. investment grade and high yield). When rate volatility started to wane, risk markets began to recover. While not fully recovered from the drawdown, risk asset performance has been better recently. That said, labor market strength continues to top expectations, and if upcoming inflation prints also surprise to the upside, recent performance trends may change and rate volatility could return. Current spread levels indicate a soft landing is possible, but they are not priced for higher rate volatility.

RATE RELIEF

Lower rate volatility has supported risk-taking.



Source: Northern Trust Asset Management, Bloomberg. Implied rate volatility is inferred from the MOVE Index. Excess return is the return versus Treasuries. Data from 12/31/2021 through 2/8/2023. 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.

- Interest rate volatility has come off the boil alongside moderating inflation and monetary policy downshifts.
- Hotter-than-expected inflation and labor market prints could reintroduce rate volatility.
- Given our belief that longer-term rates will remain mostly rangebound, we see better risk-reward in credit.

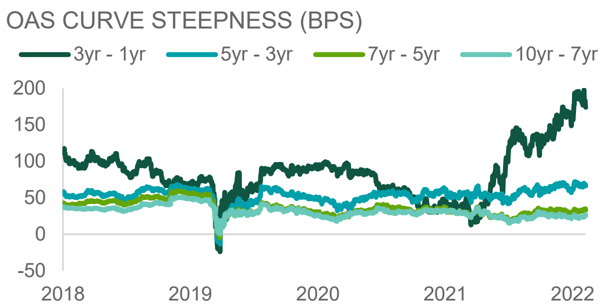
Credit Markets

In looking at the high yield option-adjusted spread (OAS) curve, we glean several insights related to how investors are viewing credit risk. Generally, investors should expect additional spread premium for taking additional duration and default risk (e.g., longer-dated maturities should have a higher OAS, all else equal). As shown in the chart, over the past year the level of spread curve steepness has somewhat increased across the curve, but over the past ten or so months the short end (3-year/1-year curve) has really steepened. We believe this was driven by investors "hiding out" in short-term paper during the early stages of the Fed tightening cycle, and an increase in perceived recession and credit risk a few years out due to the expected lagged impacts of monetary policy tightening.

Absent a recession that pressures credit fundamentals and dries up financing, the potential for rolldown yield within the 3-year to 1-year segment looks attractive. However, in the event of an increase in default risk, we would expect the shape of the OAS curve to change with front-end spreads widening to reflect near-term default risk (similar to the 2020 episode shown in the chart).

VALUE TRAP?

3-year maturities look cheap versus near-term maturities.



Source: Northern Trust Asset Management, Bloomberg. Analysis focuses on BB- and B-rated issuers. Data from 12/31/2018 through 2/9/2023.

- The potential for rolldown yield within the short-end of the OAS curve looks attractive at first glance.
- We caution that it could be a value trap if the economic outlook worsens.

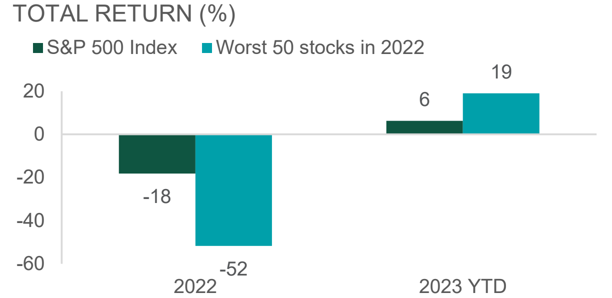
Equity Markets

Global equities had a strong month as greater visibility regarding the future path of inflation and monetary policy outweighed headwinds from slowing fundamentals such as decelerating corporate profits. Words like ‘transitory’ and ‘goldilocks’ started to make a comeback in financial market headlines, although with caveats. This change in sentiment was reflected in a change in leadership within equity markets. Growth outperformed value and U.S. equities outperformed emerging markets. Developed ex-U.S. equities modestly underperformed versus the U.S., but still did well in absolute terms due to support from more evidence of a better than expected economic trajectory.

Investors have started to question if the trend reversal in growth versus value is likely to continue. We suspect it is temporary. Equities that were hit the hardest in 2022 have generally outperformed so far in 2023 (see chart), a potential sign that the trend is not much more than a relief rally. Also, historically, value claws back a larger share of its previous underperformance before handing back leadership to growth.

FLIPPED ON ITS HEAD

Last year’s worst-performing stocks have been some of this year’s best.



Source: Northern Trust Asset Management, Bloomberg. Data as of 1/31/2023. Equal-weighted average of the bottom 50 returning S&P 500 Index stocks during 2022. 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.

- Investor sentiment has firmed with incrementally better visibility on the inflation and monetary policy outlook.
- Better sentiment has helped growth stocks claw back some of last year’s under performance versus value.

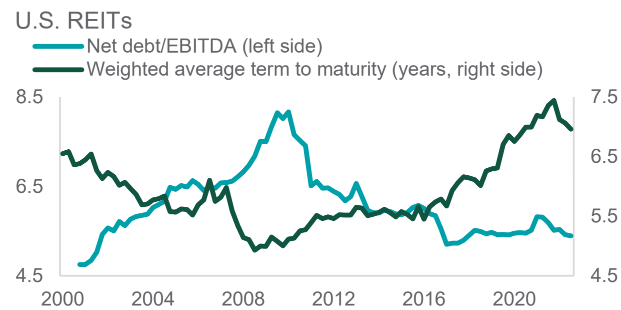
Real Assets

We have received quite a few questions on any potential fallout within real estate investments due to increasing interest rates over the past year – specifically concerns over what floating rate and/or interest rate hedging costs mean for profitability and solvency. At a high level, global real estate’s term (interest rate) exposure is well known – and on full display in 2022, wherein global real estate (GRE) was down 24% (versus the 18% fall realized in global equities). So part of the answer is that the higher interest rate environment has been priced in.

Looking ahead, real estate solvency should not be overly threatened. As found in the chart (analyzing the U.S. public market), debt burden is near multi-decade lows and weighted average maturities are near multi-decade highs; only 13% of debt is in a floating rate structure (a tiny portion hedged) and only 15% of debt matures in 2023/24. We remain not concerned about solvency issues but looking for more clarity on the path of interest rates.

BALANCE SHEET BUFFER

Listed real estate is well-positioned to service its debt.



Source: Northern Trust Asset Management, Janus Henderson Investors, NAREIT, S&P Financial. EBITDA is earnings before interest, taxes, depreciation and amortization. REIT is real estate investment trust. Data from 3/31/2000 through 9/30/2022.

- Global real estate underperformed in 2022 due to higher interest rates but remains financially sound.

BASE CASE EXPECTATIONS

Profits Softening, Sentiment Firming

Developed markets will see weaker earnings growth in 2023 from cumulative central bank tightening, but sentiment should be resilient/improved on a "plateau" in policy rates and lower inflation. Outside of the U.S., China reopening and an abnormally warm European winter help the risk balance.

Watching Inflation

Central banks have communicated a slowing in rate hikes to a plateau in 1H23, preferring to hold a sufficiently tight policy rate as opposed to continuing to hike. This reduces the risk of a policy mistake, and recenters attention more specifically on the path of inflation (and wages) to determine the duration of restrictive policy.

RISK CASE SCENARIOS

Labor Market Durability

More persistent tightness in the labor market leads to more stubborn core inflation, necessitating an unexpected monetary policy response that is negative for financial markets.

Debt-Ceiling Anticipation

Investors refrain from taking on risk with the debt ceiling "X date" likely to hit sometime in Q3; a bungled outcome would likely push Treasury yields lower and hurt risk assets.

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