INVESTMENT
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COMPANY

VIEWPOINTS *December 2023*

DON'T COUNT ON CUTS

Global markets remain volatile, with equities starting the month lower before declining long rates toward the end of the month brought investors back to stocks. Rates fell as investors read the Federal Reserve communication as relatively dovish, combined with some softer macroeconomic readings including a somewhat weaker U.S. employment report for October. In addition to lower intermediate-to-long-end rates, investors pulled forward the timing and increased the magnitude of expected rate cuts in 2024. We believe the Fed will not be compelled to lower rates so quickly as employment conditions remain healthy and inflation remains above target.

Looking ahead, we expect some additional downside to long-end rates, but we are less convinced that any downside will be cheered by equity investors. With above-fair value forward valuations, we think the "bad news is good news" narrative of the market may be short-lived. While more sluggish macro data should take the pressure off of inflation and keep the Fed from further tightening policy, the market does not appear to be priced for a material slowdown in growth.

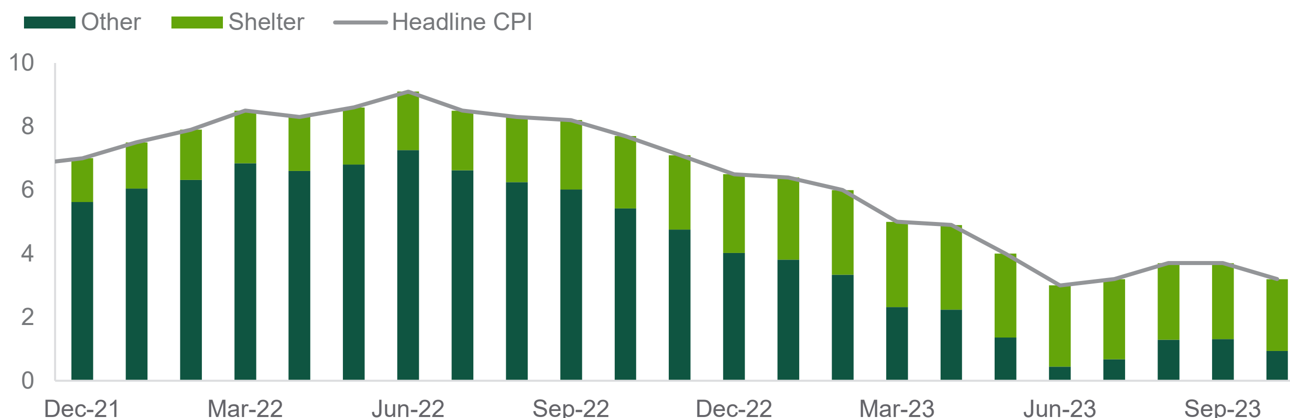
We see consumer spending slowing going forward due to depleted savings and already higher credit card debt. For the two-thirds of Americans who are homeowners, however, real wage growth may be better than it appears as those consumers are not feeling the shelter inflation component of the Consumer Price Index (CPI) to the same extent thanks to fixed rate mortgages. This suggests some durability of spending capacity to help offset pressure elsewhere.

Oil prices moved lower over the past month despite ongoing conflict in the Middle East. We continue to monitor the situation closely, as an escalation that threatens oil supplies could negatively impact global growth. Economic trends outside the U.S. are already weak, with part of Europe appearing recessionary while an economic recovery in China remains elusive.

SHELTERED FROM SHELTER?

Homeowners with fixed rate mortgages (the majority of U.S. consumers) may not be feeling as much inflationary pain.

CONTRIBUTION TO YEAR-OVER-YEAR HEADLINE CPI (%)



Source: Northern Trust Asset Management, Bloomberg. Data for U.S. Consumer Price Index (CPI) from 12/31/2021 through 10/31/2023.

Interest Rates

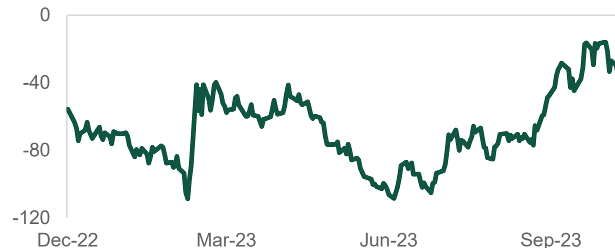
The 2-year/10-year curve has remained inverted since mid-2022, but the magnitude of inversion has varied. It reached multi-decade inversions of more than 100 basis points in two distinctly different periods earlier this year – just before the failure of Silicon Valley Bank in March and again just past the middle of the year. The 2-year/10-year curve has since continued its roller coaster ride, but with an upward trend toward a more normal curve shape.

The drivers of normalization, over the past couple of months, however, are quite different than those observed in the second quarter. In response to the failure of Silicon Valley Bank in March, the front end of the yield curve declined much more sharply than the 10-year Treasury yield. In recent months, expectations for monetary policy have remained rather stable while yields on longer term Treasuries have risen sharply. As a result, the 2-year/10-year curve was inverted by as little as 16 basis points in October. While the gyrations are still emblematic of a bond market wrestling with a resilient labor market and economic growth along with an uncertain inflation outlook, it's important to note the different underlying components of re-steepening before drawing any inferences on the likelihood of recession from the shape of the yield curve.

FINDING NORMALCY

The volatile Treasury curve has increasingly uninverted.

2Y/10Y TREASURY SPREAD (bps)



Source: Northern Trust Asset Management, Bloomberg. Bps = basis points. The 2-year/10-year (2Y/10Y) Treasury spread is the 10-year Treasury yield less the 2-year Treasury yield. Inversion is a negative value. Data from 12/30/2022 through 11/10/2023.

- While still inverted, the Treasury curve has decidedly re-steepened over the past several months.
- Back-end rates rising amid more stable short-end rates may suggest economic confidence from investors.
- We expect economic growth won’t afford the Fed the opportunity to cut rates soon, but building pressures will likely limit longer-term rate increases from here.

Credit Markets

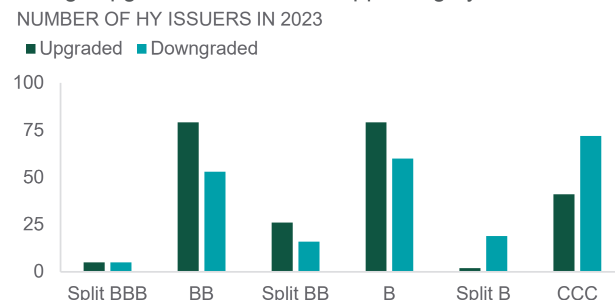
Technicals continue to be topical in the high yield (HY) market not only with limited supply year-to-date versus previous years, but also now with Ford getting upgraded to investment grade recently. This would make Ford the second largest rising star ever as a $41 billion structure – second only to itself in 2005. The majority of high yield bond issuers upgraded this year has come from the higher quality segment of the market, as seen in the nearby chart. Investors should think about what these upgrades and downgrades mean for potential valuations.

Rising stars and fallen angels total $120B and $5B year-to-date, respectively (following $113B and $13B in 2022). The technical is unprecedented, and HY balance sheets are in a good position to weather the macro uncertainty with leverage rising modestly off more than a decade’s low and coverage metrics slightly below all-time highs. HY spreads continue to remain resilient because of these factors despite questions surrounding growth and inflation. Additionally, the uncertainty surrounding the macro environment has led to a number of investors to hide out in the higher-quality BB segment of the market. Ford leaving the BB HY universe specifically should provide a notable tailwind for that segment given the macro backdrop.

RISING STARS

Ratings upgrades continue to support high yield.

NUMBER OF HY ISSUERS IN 2023



Source: Northern Trust Asset Management, JP Morgan. Data for high yield (HY) issuers from 12/31/2022 through 10/31/2023.

- High yield technicals are very supportive with an unprecedented amount of upgrade activity this year.
- We believe this trend is contributing to credit spread resilience amid broader macroeconomic uncertainty.

Equities

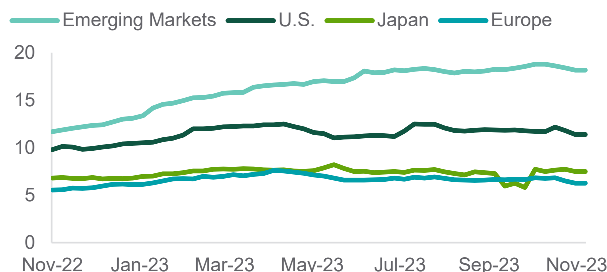
Equity markets remained volatile over the past month, with initial declines followed by a strong rally. In the end, global equities rose 1.6% with emerging markets and the U.S. modestly outperforming Europe and Japan. The main catalyst for the turnaround in equity markets was a dovish interpretation of central bank meetings in Europe and the U.S. That supported lower long-dated real yields in the U.S. and Europe, in turn loosening financial conditions and improving the outlook for economic growth. Of course, this reversal in markets once again puts a spotlight on the complacency we have been writing about prior to the correction. In particular, expectations for rate cuts in 2024 and corporate earnings growth look overly optimistic to us.

Europe is almost certainly in recession already and China continues to struggle with property market headwinds and a weakening trade environment. The U.S. economy has done much better than expected, but looking ahead the headwinds from higher interest rates and a cooling in the labor market are gathering strength. The U.S. consumer cannot carry global growth single-handedly.

EARNINGS COMPLACENCY

We believe earnings growth expectations are too high.

EXPECTED 2024 EARNINGS GROWTH (%)



Source: Northern Trust Asset Management, Refinitiv. Consensus 2024 equity earnings growth from 11/3/2022 through 11/9/2023.

- The recent equity market rally coincided with lower long-term interest rates and expectations for central bank rate cuts starting around mid-2024.
- While growth has been better than expected, we think equities are discounting a too-rosy economic outcome.

Real Assets

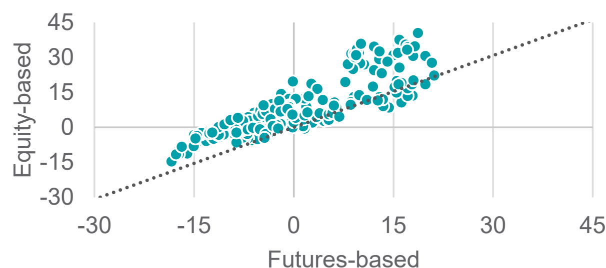
Despite the notable reduction in investor concern surrounding the Middle East conflict, oil prices have rolled over from their ~$89/barrel post-terror attack high as the conflict has remained mostly confined to Israel. Iran has not entered the war in a meaningful way thus far, but is believed to be behind ~40 separate militia attacks on U.S. assets in the region – with the U.S. responding with its own attacks on a couple occasions. All said, the situation remains tense.

A geopolitically-induced spike in oil or other commodity prices would likely lead to near-term futures-based strategies outperformance over the equity-based approach we endorse. Futures-based handily outperformed equity-based post-Russia's invasion of Ukraine (18.0% to 0.3% from 2/25/2022 to 3/8/2022). But, while geopolitical events can increase the required equity risk premium and create a near-term headwind for an equity approach, the longer-term equity return premium leads to consistent equity-based outperformance over longer time frames (see chart).

LONGER-TERM BENEFITS

Equity-based has outperformed futures-based natural resources in 91% of three-year rolling periods

ANNUALIZED 3-YEAR RETURN (%)



Source: Northern Trust Asset Management, Bloomberg. Data from 11/30/2002 through 10/31/2023. Equity-based proxied by S&P Global Natural Resources Index; futures-based proxied by Bloomberg Commodity Index. 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.

- There has been a notable reduction in investor concern on the Middle East conflict, but the situation remains tense.
- Spot commodity price spikes have led futures-based to outperform equity-based natural resources, but longer-term we expect the latter to continue to win out.

BASE CASE EXPECTATIONS

Complacency Concerns

The recent equity rally suggests renewed investor comfort in the increased possibility of a soft landing which implies continued growth, normalized inflation and no material geopolitical consequences. We remain hesitant to fully adopt that narrative.

Steady Central Banks

Recent central bank rhetoric suggests the rate hike cycle that started in early 2022 may have finished – prompting a favorable narrative around a global rate cut cycle starting mid-2024. We think investors expecting rate cuts without material economic weakness will be disappointed as the Fed shows resolve.

RISK CASE SCENARIOS

Oil Ends the Expansion

The war in Israel expands into a broader Middle East conflict that draws in Iran, putting global oil supply at risk. Central banks would look through the near-term inflation spike anticipating the economic fallout.

Sticking the Landing

Market expectations and central bank forecasts are calling for rate cuts in 2024. Should those cuts materialize amidst an orderly disinflation process and economic durability, we may be too underweight risk.

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