INVESTMENT STRATEGY COMMENTARY

UNRESPONSIVE POLICY?

FED OUTLOOK SEEMS DATED

December 19, 2018

We don't think the Federal Reserve was dovish enough at its recent meeting, potentially not recognizing the risks to growth that additional rate hikes represent. The Fed announced a 0.25% increase in the Fed funds rate, to a range of 2.25%-2.50%, and indicated the market should expect some further gradual rate hikes. Aggregate hikes expected in 2019 were reduced from 3 to 2, but the market wasn't even pricing in a full 0.25% hike before the meeting. Forecasts for growth and inflation in 2019 were shaved lower to 2.3% and 1.9%, respectively — leaving inflation once again below the Fed's target.

Unfortunately, the Fed meeting didn't ameliorate our primary risk case of the Fed overtightening policy. As shown in Exhibit 1, an inverting yield curve has been present in each of the last five recessions — and the Fed's actions increase the odds of an inversion over the next year. There are plenty of signs of potential slowing in the U.S./global economy, yet the Fed struck us as backward-looking toward the economy. Inflation breakeven levels have also fallen meaningfully over the last two months, reducing the urgency for higher interest rates. Credit markets are being examined as a signal about whether the economy may be heading for recession in 2019 or 2020. In that light, we undertook a review of the current health of the credit markets and found them in aggregate to be in solid condition. Of course, a significant downturn in growth would hurt credit — but it will be impacted much less than the related equities. We also include in this report a review of the Fed's recent study of financial stability in the U.S. While the report highlights some concerns over leverage and valuation (primarily in corporate credit, hence our work there), it also concludes that the U.S. financial system is not over-leveraged and has stable financing — reducing risks around the next recession and financial market downturn.

As risk markets have declined sharply in the fourth quarter, investor focus has turned to

Northern Trust Investment Strategy
northerntrust.com/investmentstrategy

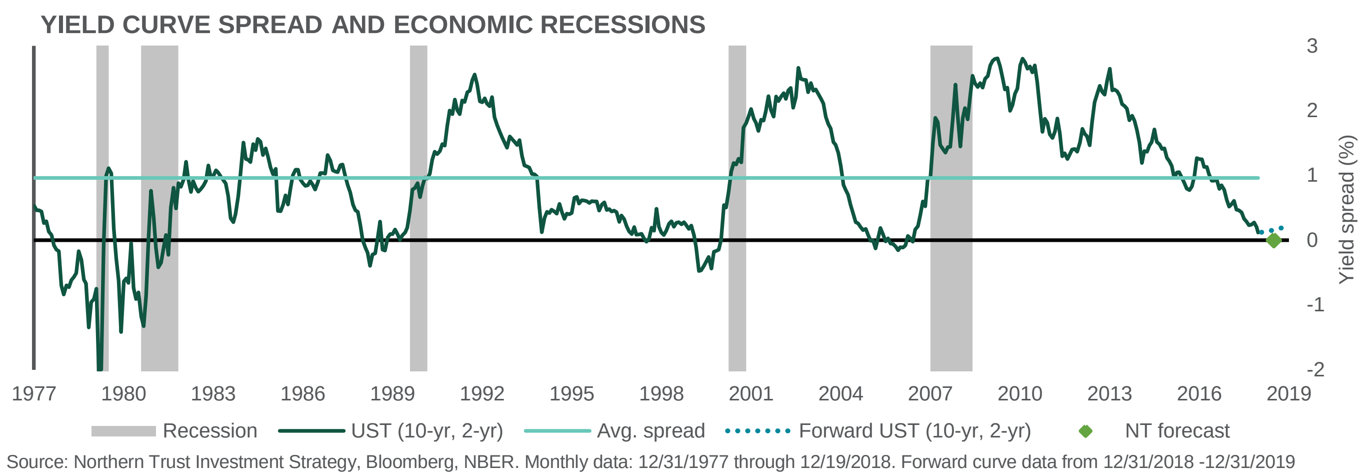
James D. McDonald
Chief Investment Strategist
jxm8@ntrs.com

Daniel J. Phillips, CFA
Director, Asset Allocation Strategy
dp61@ntrs.com

Wouter A. Sturkenboom, CFA
Chief Investment Strategist EMEA & APAC
ws65@ntrs.com

EXHIBIT 1: REASON FOR FED CAUTION

Yield curve inversions have preceded each of the last five recessions



Source: Northern Trust Investment Strategy, Bloomberg, NBER. Monthly data: 12/31/1977 through 12/19/2018. Forward curve data from 12/31/2018 -12/31/2019
Note: UST = U.S. Treasury.

assessing how serious a downturn could be in store. So far, the declines have been driven by concerns over growth and monetary policy, driving a reduction in investor risk appetite. The severity of further declines, should they occur, will be influenced by the intensity of economic slowdown and the resulting financial system stress. As luck would have it, the Fed just published its current Financial Stability Report on November 28, which is an assessment of resilience of the U.S. financial system to economic or financial shocks. Their approach understands that predicting actual shocks to the system is impossible, but assessing the ability of the system to withstand the shocks is possible and part of their mandate. We present a summary of their findings in Exhibit 2.

EXHIBIT 2: HOW VULNERABLE IS THE U.S. FINANCIAL SYSTEM?

VULNERABILITY	RISK	FED ASSESSMENT
Elevated valuations	Elevated valuations tend to happen near the end of cycles, and imply a greater possibility of outsized drops in asset prices.	Valuation pressures are generally elevated, particularly in corporate debt. Equity prices are "somewhat" high.
Excessive business and household borrowings	Excessive borrowings creates vulnerabilities to declining incomes or asset values, leading to spending reductions or financial defaults.	Overall vulnerabilities are low; household borrowings are low to moderate while business sector debt issuance is high and standards have deteriorated.
Excessive financial system leverage	This increases the risk that financial institutions will not have the ability to absorb losses when hit by adverse shocks, leading to credit crunches.	Leverage at financial firms is low. Banks have strong capital positions, and leverage at broker-dealers and insurance companies is trending down.
Financial system funding risk	When financial institutions rely too much on short-term funding, they are vulnerable to "runs on the bank" and can be forced to dump assets.	Risk from liquidity and maturity mismatches are low.

Source: The Federal Reserve Financial Stability Report, November 2018; Northern Trust Investment Strategy.

In addition to these identified vulnerabilities, the Fed does assess the source of potential risks to the financial system, but doesn't break much new ground. First in their assessment are risks emanating from Europe, specifically Brexit and confidence in the European Union's fiscal and financial prospects. Secondly, they cite the risk of problems in China and other emerging markets spilling over to the U.S. Finally, they cite the risk of trade tensions, geopolitical uncertainty or other developments leading investors to become more risk averse. We agree with all these risks, and are monitoring their potential impact along with the risk that the Fed itself represents a risk to the economy and markets through excessive financial policy tightening.

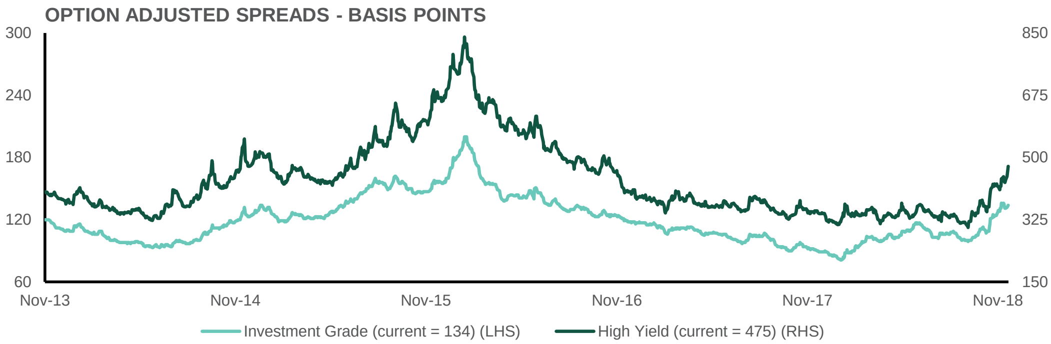
DRUMBEAT OF CONCERN ABOUT LEVERAGE AND DEBT VALUATIONS

While the report is constructive overall on the resiliency of the financial system, it does highlight the Fed's concern over valuations and excessive borrowing in the business sector. The report also said that equity prices are "somewhat" elevated, but this was curiously contradicted by Fed Chairman Jerome Powell. On the same day the report was issued he delivered a prepared speech in which he described equity prices as "broadly consistent with historical benchmarks." Our research shows U.S. equity prices are mildly elevated relative to historical medians, while European, Asian and emerging market stocks are all priced at discounts to historical medians. We do not see a broad valuation problem in the equity markets. But the drumbeat of concern around business leverage and debt valuations — in both the Fed's report and more broadly in the investment community — led us to assess the state of the high yield and investment grade bond markets in this report. Credit spreads are of particular interest as a "signal" about changing prospects for economic growth.

Exhibit 3 shows the history of credit spreads over the last five years, including the significant rise in spreads that occurred in late 2015/early 2016 tied to the global commodity crisis and growth scare (which was also coincident with a 20% decline in global equity prices). High yield spreads have increased from 3.03% to 4.47% from October 3, and are at a new high since the 2016 period. At that time, U.S. gross domestic product was tracking under 1.5% growth and the high yield spread had increased to 8.40% at its peak. As the outlook cleared, however, a sharp rally followed and by the end of 2016 the high yield market returned roughly 17% for the year.

EXHIBIT 3: SPREADS HIGHER BUT STILL HEALTHY

Credit spreads have risen, but aren't signaling distress.



Source: Northern Trust Investment Strategy, Bloomberg, Daily data from 11/29/2013 through 12/19/2018.

The energy complex, which is one of the largest high yield sectors, was one of the main drivers of credit loss in 2016 after the price of a barrel of oil dropped from $107 to $27. Many high yield energy companies had balance sheets and cost structures that could not sustain a material drop in oil prices and thus defaults surged to 5.7%. Few energy companies back then were in a position to operate profitably in an environment of $30/barrel oil. The current environment is very different. U.S. energy producers have taken significant costs out of their businesses, leverage is low and as a result many issuers are able to operate profitably in a $45 oil environment.

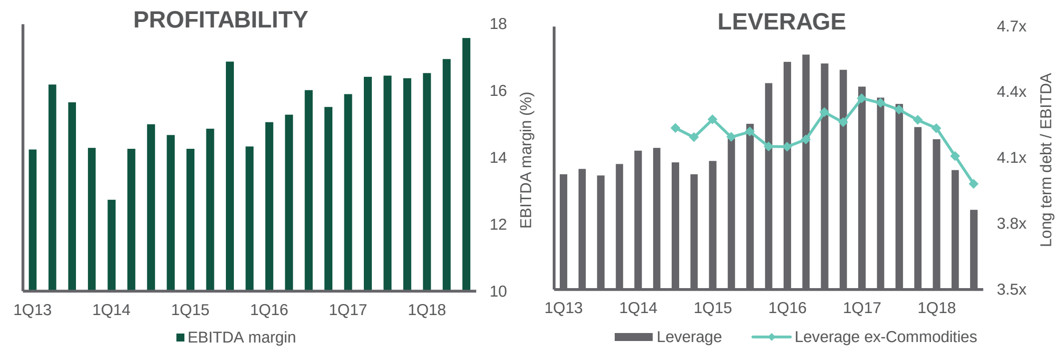
The nearly 40% drop in oil prices over the last ten weeks has raised renewed concerns about the outlook for prices, but we think the carnage in energy-related assets is overdone unless we are heading into a global recession. Oil prices have been hurt by a jump in supply this year tied to increasing Saudi and Russian production after the June OPEC meeting (1.3 million barrels/day), increased U.S. production (1.5 million barrels/day), and waivers on Iranian oil sanctions to eight countries. We would note that in global recessions/financial crises, oil demand is still estimated to have grown around 0.5% annually (as compared with growth this year of 1.3%-1.5%). Potential constructive developments for crude prices include the exhaustion of selling in long crude oil futures that has been underway for several weeks, cuts in production of 1.2 million barrels/day coming from the OPEC "plus" group on January 1, 2019, and the potential for falling production out of Venezuela, Canada and Mexico.

THE CASE FOR HIGH YIELD

Throughout the first three quarters of 2018, the market was focused on continued strong corporate earnings and a supportive fundamental picture. As shown in Exhibit 4, leverage is down significantly (and is at post-crisis lows), while interest coverage is at a post-crisis high. The default rate continues to drop to nearly all-time lows (expected to be 1.9% by June 2019) and earnings growth for the major equity indices is better than 25% year-over-year. For high yield issuers, top-and-bottom-line growth last quarter was the strongest since 2010. We are not seeing fundamental stress among high yield issuers that would be a precursor to broader economic weakness. Of course, if the U.S. economy were to go into recession, high yield bonds would be under significant pressure — but would likely outperform the equity market. This highlights our interest in high yield in today's market. We think we can get attractive returns in a good market environment, but their status as the "least risky" risk asset provides some cushion in a downturn.

EXHIBIT 4: HIGH YIELD PROFITABILITY UP, LEVERAGE DOWN

Better fundamentals have also led to falling defaults in 2018.



Source: Northern Trust Investment Strategy, J.P. Morgan. U.S. high yield and leveraged loan quarterly data from 1Q 2013 to 3Q 2018. Data as of 12/18/2018. EBITDA – earnings before interest, taxes, depreciation and amortization.

A very strong technical picture also helps support high yield as new issuance is down 40% over the last year. Given the lengthy recovery, issuers have been able to refinance large coupons several times so they are in a position where they don't need to opportunistically access the capital market. In addition, private equity firms are choosing to access the loan market for financing, given the demand from collateralized loan obligations (CLOs). We believe the positive fundamental and technical outlook should continue. New issuance for 2019 is expected to roughly match 2018's depressed volumes, which is supportive of the asset class. In comparison to 2016, the economy and corporate issuers are in a much better position. Given the strong market fundamentals and technical picture, which we expect to persist in 2019, we view the high yield asset class as attractive in this environment.

OUTLOOK FOR INVESTMENT GRADE

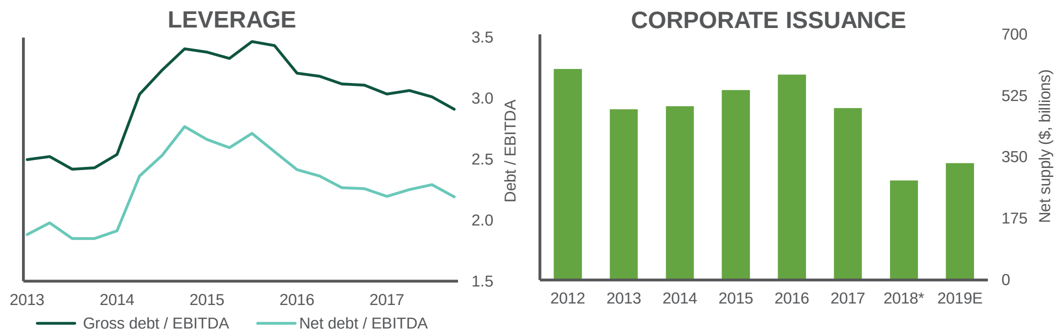
Turning to the investment grade bond market, Exhibit 3 showed that spreads are currently at 134 basis points, which is 0.50% higher than the lows of the year. The first half of the year was marred by oversupply in the face of rich valuation. Investment grade's underperformance since the end of September has been caused more by weakening demand. The weaker demand stems from a variety of factors including the recent drop in oil prices as well as a variety of idiosyncratic risks that have kept investment grade investors on their heels. This includes company-specific concerns of significant issuers such as Pacific Gas & Electric, Goldman Sachs, British American Tobacco, Anheuser-Busch INBEV, General Electric, Apple and Deutsche Bank. At its worst this year, investment grade bonds were off 3.7%, in line with the biggest drawdown experienced during the 2015/2016 period. Investment grade has subsequently rallied this year, reducing the loss to 2.3% year-to-date.

We expect credit spreads to tighten from here, with an expected range of 105 to 125 basis points over the next six months. There has been much written about the swelling percentage of lower rated BBB bonds in recent months. We don't think that a large wave of downgrades (fallen angels) are imminent, which would cause turmoil in the bond markets. Rather, we expect to see those low-BBB companies that used the low yield environment to lever up to focus on improving their balance sheets and leverage ratios. It is important to note that much of this leveraging activity was voluntary (such as issuing debt to buy back stock or make acquisitions), and as such can be stopped rapidly. As shown in Exhibit 5, strong profits and falling issuance have led to steady deleveraging among in the investment grade universe in recent years.

There is a strong financial incentive for companies to secure and defend their investment grade rating, as intermediate BBB spreads are 154 basis points while BB-rated high yield spreads are 285 basis points. The areas we see as more vulnerable to quality deterioration are the low single-A and high-BBB spaces. The difference in the cost to borrow between low single-A and high/mid-BBB is negligible, providing corporate finance chiefs the optionality to continue shareholder-friendly transactions including stock buybacks and acquisitions with little regard for their balance sheet position. Furthermore, over the long-run, BBB-rated names have provided nearly double the excess return of their single-A rated counterparts, while both Single-A and BBB bonds correct equally during draw-down periods.

EXHIBIT 5: INVESTMENT GRADE CREDIT PROFILE LOOKS STRONG

Leverage is declining due to falling issuance, strong profits.



Source: Northern Trust Investment Strategy, Bloomberg Barclays. Left: References U.S. Credit Corp ex-Financials Index. Quarterly data from 12/31/2013 - 9/30/2018. Right: *2018 is through 12/17/2018.

While we see little reason to flee the BBB space at this time, we are exercising caution on a sector-by-sector and name-by-name basis. As an example, we currently prefer the financials sector over industrials. Banks have been unduly punished in the most recent selloff due to their relative liquidity in a fairly illiquid marketplace. While industrials levered up over the last few years, taking advantage of historically cheap borrowing costs, banks have improved their financial strength markedly. We also view the front end of the curve, which offers attractive real yields during a time when investors tend to shy away from taking large duration bets, as an attractive place. One-to-three-year investment grade credit, with an average rating of A1/A2 currently, offers around a 3.4% yield with duration of just 1.85 years. We think that is a very attractive return profile, particularly in the scenario where the Fed pauses its hiking cycle sooner rather than later. As with high yield bonds, investment grade bonds will be hurt in an economic downturn, but they will provide considerable downside protection as compared with the related equities.

CONCLUSION: NEUTRAL RISK ENTERING 2019

The financial markets are grappling with the outlook for risk taking in an environment where growth is likely slowing and the Fed is looking to further normalize policy. As our regular readers know, we have meaningfully reduced our recommended risk in our global policy model this year as the environment has been changing. We are set to enter 2019 with a neutral risk recommendation, with an overweight to U.S. high yield bonds offset by underweights to emerging market equities, inflation-protected securities and cash. Risks have risen with the Fed's recent move, but stocks have also declined and credit markets are not sending a strong signal of concern. We will debate all the recent developments at our next monthly investment strategy meetings the week of January 7, and we look forward sharing our conclusions shortly thereafter.

Special thanks to Eric Williams and Brandon Ferguson, fixed income portfolio managers, for their contribution to the high yield and investment grade bond sections of this report; to Jackson Hockley, senior equity research analyst, for his comments on the energy sector: and Tom O'Shea and Daniel Ballantine, senior investment analysts, for data research.