JANUARY 2021

RELIEF IN SIGHT

A lot has transpired over the last two months, most importantly in the health and political arenas. Amidst another surge in COVID-19 cases globally, we are seeing more contagious strains emerge and some hospital systems stressed to capacity. Yet the financial markets have focused on the very positive vaccine news that started emerging in November, with multiple highly effective vaccines being distributed throughout the world and others likely on the way. The results of the U.S. presidential election in early November appeared to show a divided government outcome, but Democrats won both seats in the January Georgia Senate runoff, leading the party to a razor-thin majority in the Senate (through the vice president's tie-breaking vote). While this does increase the Democrats' flexibility to govern, we expect flexibility to be limited due to political constraints in both the Senate and House of Representatives.

Financial markets have embraced these developments, with the S&P 500 rallying 13.5% while the Russell 2000 index of small cap stocks rallied an impressive 26%. Alongside the jump in risk assets has been a rise in interest rates, noticeably tied to an increased expectation for inflation (see below). We note, however, that the rise in rates has been primarily a U.S. phenomenon, and real rates (most important for growth) remain solidly negative and stimulative. While some economic data has softened a bit of late, our base case of *Pandemic Adaptation* still holds as companies adjust to new ways of business. We upgraded our outlook for European growth last month, as the region's services sector has been particularly hard hit by lockdowns and stands to benefit from reopening over the next year.

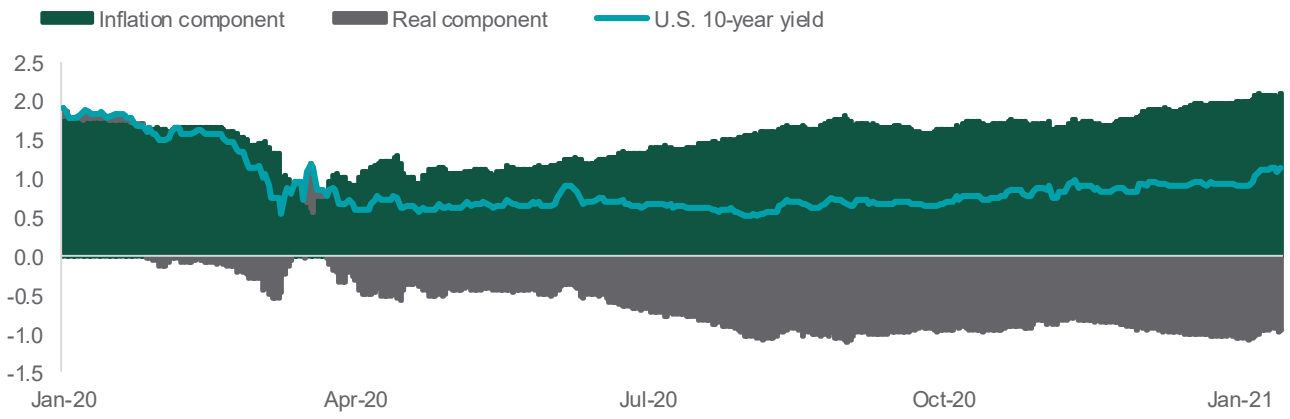
We expect the economic reopening story to be more impactful to the economy and markets over the next year than political developments. As vaccine momentum increases, we expect our other base case of *Market Laggard Relief* to unfold as those areas hit hardest bounce back. As a result, we increased our exposure to equities outside of the U.S. in our global policy model this month, funded by a reduction in investment grade bonds. Our risk case of *Stuckflation Tested – and Fails* contemplates the potential for a sustained cyclical rise in inflation, which could pressure interest rates higher.

Overall, we remain constructive on risk taking over the next year as we expect a strong economic recovery to support financial markets, especially in the context of our expectations for restrained inflation and continued easy monetary policy.

REAL NEGATIVE

Real interest rates remain deeply negative – and, therefore, stimulative – despite the rise in nominal yields.

U.S. 10-YEAR TREASURY YIELD (%)



Source: Northern Trust Global Asset Allocation, Bloomberg. Data from 12/31/2019 - 1/14/2021. Inflation component is measured by 10-year breakeven rate. Real component = U.S. 10-year yield - inflation component.

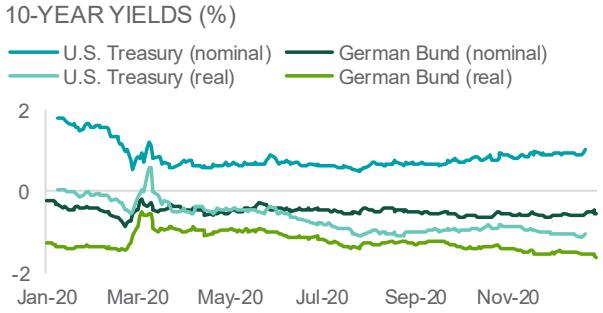
Interest Rates

U.S. real yields fell deeper into negative territory while inflation expectations increased and the nominal curve steepened. The recent rise in nominal yields is largely comprised of increasing inflation expectations in the U.S. Although base effects will optically boost near-term inflation, structural challenges should continue to hold core inflation below the Federal Reserve's 2% target. Fiscal spending may accelerate under the now Democratic-controlled Congress, but majority margins remain slim enough to serve the check-and-balance dynamic.

The near-term U.S. growth outlook has improved; low global yields, technological changes and aging demographics will contain the resulting interest rate rise. Nominal German 10-year Bunds are currently -0.5%, putting the real yield at -1.6%. U.S. nominal and real rates are much more attractive at 1.1% and -1.0%, respectively. Interest rates globally are closer to that of Germany than the U.S. We expect this rate differential to attract non-U.S. investors, even if they have to take on currency risk to get it. Beyond gravitational forces, the output gap, political uncertainty and the risk of a virus mutation that vaccines don't cover should put a lid how high rates can go. For the 10-year Treasury, we don't think that lid is much over 1%.

ISAAC NEWTON WAS ON TO SOMETHING

Gravitational forces cap how high U.S. rates can go.



Source: Northern Trust Global Asset Allocation, Bloomberg. Data from 1/16/2020 through 1/14/2021.

- U.S. interest rates have shown a move higher of late – but non-U.S. (e.g., German) yields haven't budged.
- Most of the increase in yields was due to the inflation component (see front page chart).
- Low rate expectations prevent going too negative on fixed income, but better opportunities exist elsewhere.

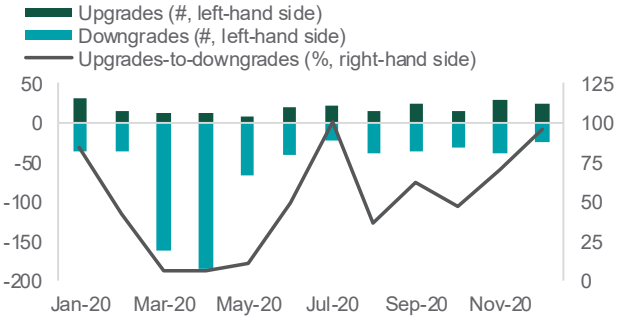
Credit Markets

Corporate health improved throughout the balance of 2020 and the 2021 outlook looks bright. Management teams used strong market conditions to improve their balance sheets by refinancing near-term maturities and improving liquidity to manage through potential disruptions from more economic shutdowns. Credit fundamentals have improved significantly – and the deceleration of rating downgrades, paired with a gradual increase in upgrades, has put the upgrade-to-downgrade ratio near even (see chart). December saw 24 issuer downgrades, compared to an average of 32 per month over the past six months and a total of 348 downgrades in March and April. There were 23 upgrades in December, leading to almost a one-to-one ratio of upgrades vs. downgrades for the month.

The upgrade-to-downgrade ratio has consistently improved from April lows, and on a trailing 12-month basis the ratio is on pace to move above 100%. Additional fiscal stimulus enacted in December, combined with the rollout of COVID-19 vaccines, suggests gains in economic activity can be sustained – and, by extension, further improvement in credit fundamentals. This implies that the upgrade-to-downgrade ratio can continue to climb higher in the year ahead, which should be supportive of high yield valuations.

HIGH YIELD GETS AN UPGRADE

Credit rating upgrades are now even with downgrades.



Source: Northern Trust Global Asset Allocation, JPMorgan. Monthly data from 12/31/2019 through 12/31/2020 for JPMorgan High Yield Index.

- Improving fundamentals and low yields elsewhere are prompting investors to go back into high yield.
- In this current recovery, high yield looks more attractive than equities given favorable technicals (lower supply).
- High yield remains our highest conviction tactical overweight as we head into 2021.

Equities

Global equities continued higher over the past month, reflecting continued optimism on the economic outlook as vaccine availability improves – and is still supported by accommodative central banks and fiscal stimulus. Over the past few months, the U.S. has begun to relinquish its leadership position in global equities, reflecting some catch-up of non-U.S. assets. U.S. earnings proved more resilient than non-U.S. markets during the pandemic, reflecting the benefits of secular winners in big tech growing through the turmoil. But, in exiting the pandemic, we see more developed ex-U.S. equities outperformance as the relative performance improvement outside the U.S. appears durable over the intermediate term.

From here, we see cyclical companies showing better earnings growth as conditions normalize. This supports our preference for developed ex-U.S. equities, as they have greater concentration of cyclical companies. We continue to believe U.S. valuations are justified given our expectations for economic growth, earnings improvements and low rates. With that said, we find the incremental risk-to-reward to be more favorable outside of the U.S. given better relative valuations and earnings growth.

EARNINGS GROWTH REBOUND

Non-U.S. market earnings set to outpace U.S.

Source: Northern Trust Global Asset Allocation, FactSet. *Consensus forecasts. Indices used: S&P 500 (U.S. equities); MSCI World ex-U.S. (developed ex-U.S. equities); MSCI EM (emerging market equities).

- Even with the strong rebound from last year's lows, equity markets have some room to run.
- Those regions with a more cyclical sector composition (notably Europe) are well positioned for 2021.
- We are overweight equities, with a focus on developed ex-U.S. and emerging markets.

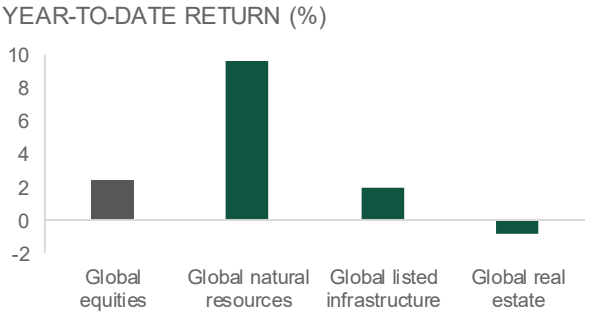
Real Assets

We've oft noted the protection natural resources (and listed infrastructure) can provide against unexpected inflation. You've had to trust us on this one – as no real threat of inflation has emerged in the past decade. But, in early 2021, we may be seeing the beginnings of our *Stuckflation Tested* theme. Market five-year inflation forecasts have risen from as low as 0.2% to their current 2.1% level (as judged by five-year breakeven rates, which equal the difference in yield between real and nominal bonds). And investors' inflation concerns have continued to grow in the early days of 2021 – as questions grow around what will happen when the trillions of monetary and fiscal dollars join forces with an anticipated economic growth spurt.

Year-to-date, our real assets have responded mostly as expected. Natural resources have blown the competition away, easily outpacing the broad global equities. Listed infrastructure, while lagging global equities slightly, has outpaced global real estate; we would expect this too, given listed infrastructure's greater sensitivity to inflation. Of all the real assets, we like listed infrastructure the most. It provides a decent yield, has cyclical potential (pipelines, railroads, sea/airports) and also provides some inflation protection should our risk case of higher inflation take hold.

GOING ACCORDING TO (INFLATIONARY) SCRIPT

Real assets are performing as expected in this setting.



Source: Northern Trust Global Asset Allocation, Bloomberg. Year-to-date total returns as of 1/14/2021. MSCI indexes used for global equities and global real estate; S&P indexes used for global listed infrastructure and global natural resources.

- Natural resources have benefited materially from higher inflation expectations.
- Stuckflation failing the test is one of our risk cases – but base case calls for a passing score.
- Our global listed infrastructure overweight will enjoy falling real rates and provide some inflation protection.

BASE CASE

Pandemic Adaptation

Economies have been able to weather the pandemic storm, helped initially by government support and then by consumers and businesses adapting to the virus threat. Optimism on vaccines remains a key pillar of support for the growth outlook in the second half of 2021 – helping investors look through near-term risks.

Market Laggard Relief

Relative performance of the asset classes most damaged by the virus will improve considerably as the recovery continues and investors anticipate economic normalcy by late 2021. However, structurally-advantaged areas of the market will remain attractive longer-term due to better fundamentals.

RISK CASES

Risk Asset Run-Up

Investor sentiment markedly improves as U.S. policy stabilizes and investors focus on the post-virus world – leading to a sustained risk asset rally that our overweight risk stance does not fully capture.

Stuckflation Tested – and Fails

Inflationary pressures build in the economy during the recovery and overwhelm structural downward forces on inflation, leading to a sustained increase in inflation and risk asset headwinds.

GLOBAL POLICY MODEL

Strategic Allocation and Tactical Over/Underweights	RISK CONTROL			RISK ASSETS							
	FIXED INCOME				EQUITIES			REAL ASSETS			
	Cash	Inv. Grade	TIPS	High Yield	U.S.	Dev. Ex-U.S.	Emerg. Markets	GLI	GRE	NR	Gold
Strategic Asset Allocation	2	33	5	6	27	15	6	2	2	2	0
Tactical Asset Allocation	0	32	0	9	27	17	7	4	2	2	0
Over/Underweight	**-2**	**-1**	**-5**	**3**	**0**	**2**	**1**	**2**	**0**	**0**	**0**

Source: Northern Trust Capital Market Assumptions Working Group, Investment Policy Committee. Strategic allocation is based on five-year models developed annually; most recent model released 8/13/2020.The model cannot account for the impact that economic, market and other factors may have on the implementation and ongoing management of an actual investment strategy. Asset allocation does not guarantee a profit or protection against a loss in declining markets.