MAY 2022

RECESSION OR REPRICING?

The rate angst of March bled into equities in April, and has tipped U.S. small cap stocks, the Nasdaq Index, and select international markets like the Shanghai Composite into bear market (20% decline) territory. The most speculative parts of the markets have been hit the hardest with crypto being front and center. Bitcoin and Ether fell 23% and 30%, respectively, while the "stablecoin" Terra effectively lost all of its value in just 6 days. The interest rate jumps of March moderated over the last month, however the damage has been done. History suggests that the rate hikes anticipated at the start of the year would have a benign impact, while the current pace suggests a much worse outcome (as has been experienced).

So, is the stock market signaling an impending recession, or is this more of an adjustment to higher rates and slower growth? Credit markets are evidencing greater concern, with both investment grade and high yield spreads increasing significantly over the last month. The jump in April consumer prices was higher than expected, and the 65% increase in 30-year mortgage interest costs and 36% increase in gasoline prices are material growth headwinds. The Dollar surged 5% over the last month and is up 16% over the last year. While this should help limit imported inflation, it will also likely hinder export growth. The yield curve is still positively sloped, however, with the 2's-10's curve at 0.33% and the Fed Funds to 10-year curve a robust 2.00%. We have come through 1st quarter earnings in good form in the U.S., and forward estimates have edged up. This means the decline in stock prices has all been driven by a drop in valuation – a long-term positive.

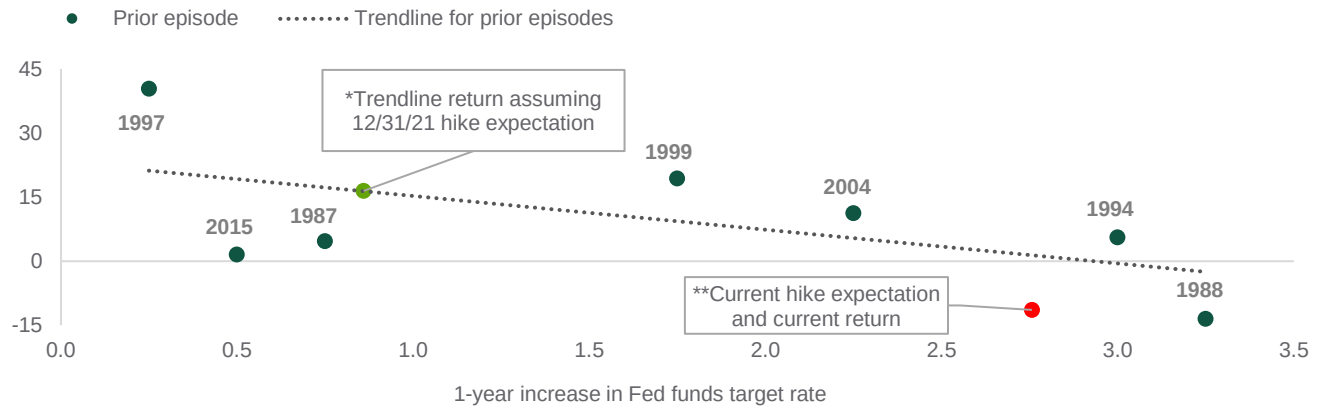
The global economic outlook changed meaningfully when Russia invaded Ukraine in late February, hurting growth prospects while increasing inflationary pressures. Our base case of *Navigating Economic Shocks* encompasses this environment, alongside the negative impact of China's zero-COVID policy. Much of the market concern centers around how far the Fed should go with rates, which captures our *A Relentless Fed* risk case. *Economic Degradation* is our other risk case, reflecting the potential of weakness outside of the U.S., alongside higher interest rates, to derail the U.S. expansion. We made no changes in our Global Policy Model this month, where we are neutral on equities – and tilted toward the U.S. We also continue to favor natural resources (commodities) which are benefitting from tight supplies and inflationary concerns. Finally, we think the increase in credit spreads presents an attractive risk/return for high yield bonds, especially when compared with equities.

-Jim McDonald, Chief Investment Strategist

A PAINFUL SHIFT

The quick jump in expected rate hikes is the most likely catalyst for recent market weakness.

S&P 500 RETURNS 6 MO. BEFORE THROUGH 6 MO. AFTER INITIAL RATE HIKES



Source: Northern Trust Asset Management, Bloomberg. *12/31/21 hike expectation is the 1-year expected increase from the initial hike on 3/16/22 as of 12/31/21. **Current hike expectation is the 1-year expected increase from the initial hike on 3/16/22 as of 5/10/22; current return is from 6 months prior from the initial hike on 3/16/22 through 5/10/22. 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.

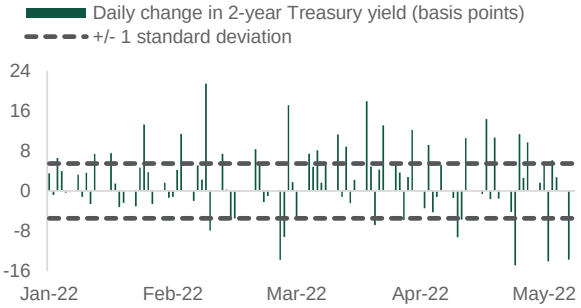
Interest Rates

Year-to-date, the 2-year U.S. Treasury (UST) yield has increased by ~2% – and it has done so at historical speeds and with above average volatility. While highly sensitive to Fed policy, poor liquidity and forced buying/selling by highly levered investors have begun to distort fundamental moves in yields. Measured by market depth, liquidity across the curve is approaching levels not seen since the depths of the pandemic. Liquidity itself is not a core driver of yield moves, but it can exacerbate overall volatility.

As the Fed has turned markedly more hawkish, the market has repriced short-end yields. As an example of the above-mentioned volatility, the 2-year UST yield has repeatedly experienced daily yield changes outside of its longer-term standard deviation band. In fact, it has breached the +/- one-standard-deviation band 39% of the trading days this year. To further explain current conditions, we can turn to "swaptions", which are market proxy for interest rate volatility. One-month two-year swaptions are trading at levels not seen since the Global Financial Crisis. The move in yields has reverberated across nearly all fixed income assets. We expect upward Treasury yield moves to subside over the next six months and are forecasting a 2-year Treasury yield with a central tendency of 2.75%.

RATE VOLATILITY

The 2-year U.S. Treasury yield has seen notable volatility – more often to the upside.



Source: Northern Trust Asset Management, Bloomberg. Standard deviation using daily values from 6/1/1976 through 5/10/2022. Data as of 5/10/2022.

- Monetary policy uncertainty has led to interest rate uncertainty – especially on shorter-term rates.
- Somewhat dried-up liquidity has further exacerbated the daily interest rate moves.
- We believe volatility will subside as investors gain comfort with the Fed's rate hike trajectory.

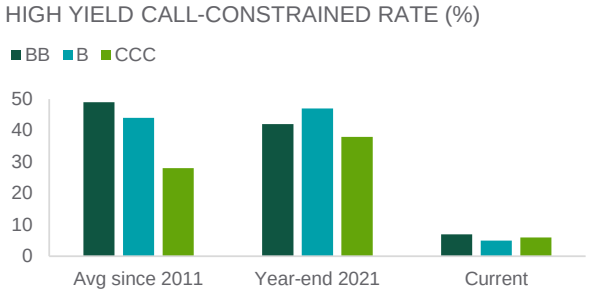
Credit Markets

High yield bond prices have sold off sharply this year mainly due to rising interest rates alongside a more hawkish Federal Reserve, more persistent inflation and geopolitical uncertainty. This has provided a rare entry point for investors to capture an attractive convexity profile (in an asset class typically exhibiting negative convexity). In periods of falling interest rates and tightening spreads, the potential for price appreciation is limited by a call feature (that most high yield bonds have) as the expected life of the bond shortens to a near-term call date rather than the stated maturity. Due to the decline in bond prices this year, the call-constrained rate of high yield has dropped dramatically to 6% (see chart).

To start 2022, roughly 80% of the high yield index was priced above par. Now, only 20% is. This has pushed the convexity profile of high yield into the most attractive level since March 2020. A bond with positive convexity should have a larger price increase during declining yields than a decline in price from yields rising, creating a more attractive upside/downside profile. Given the strength of underlying fundamentals, increasingly attractive valuations and an improved convexity profile, high yield continues to look attractive even through the current period of volatility.

UNCAPPED UPSIDE

Lower percentages of call-constrained high yield bonds can equal a better ability to benefit from falling rates.



Source: Northern Trust Asset Management, Bloomberg. Current as of 4/29/2022.

- Unusually large interest rate moves have had an unusually large impact on the high yield market.
- High yield market participants have more favorable "market mechanics" in which to invest.
- Fundamentals keep us overweight high yield; current market mechanics and technicals support that view.

Equities

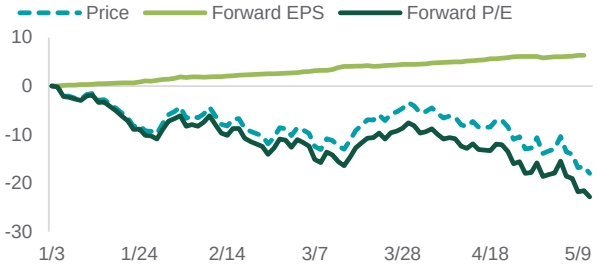
Global equities suffered over the past month, with roughly 10% drawdowns in each major region. Non-U.S. benchmarks held up somewhat better in local currencies, but continued dollar strength masked that outperformance. U.S. markets were hit particularly hard, driven by growth stock underperformance as interest rates moved higher and several U.S. tech and internet retail companies offered disappointing guidance.

Overall, fundamentals in the U.S. remain durable. Estimates continue to move modestly higher (though, notably, positive revisions have been largely concentrated in areas like energy). As seen in the nearby chart, year-forward estimates have improved despite input cost inflation and supply chain challenges, suggesting that the decline in equities this year is coming from lower valuations. The more cautious investor stance toward equities largely reflects a fear that inflationary pressures will prove more persistent, necessitating more aggressive action on the part of the Fed to quell demand – risking recession. We maintain a neutral position toward global equities, while maintaining a preference for the U.S. given our expectation of more resilient fundamentals.

STORM AMID THE CALM

Company earnings expectations have been remarkably stable amid the recent downturn.

S&P 500 INDEX: YTD CHANGE (%)



Source: Northern Trust Asset Management, blended 12-month forward estimates from Bloomberg. Year-to-date (YTD) data through 5/11/2022. It is not possible to invest directly in any index.

- Stable earnings expectations alongside falling equity markets means more attractive valuations.
- The risk case is that a relentless Fed eventually causes earnings expectations to roll over.
- We remain neutral across broad global equities – with a U.S. overweight offset by a non-U.S. underweight.

Real Assets

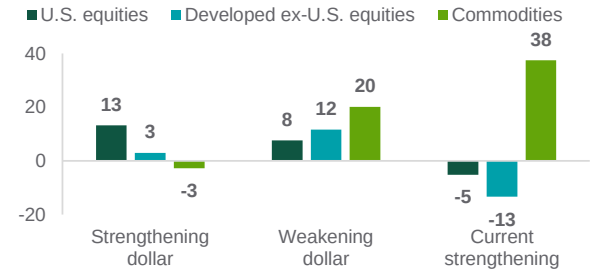
Amid volatile markets, the dollar has shown extraordinary strength. Recent greenback strength goes back a year – with the dollar index up 16% over the last year. Generally, dollar strength means commodity weakness. Most commodities are priced in dollars – but by a global marketplace where the intrinsic value is independent of its dollar quote (gold is the best example). The relationship commodities have with the dollar is not dissimilar to non-U.S. equity markets – generally showing weakness in times of dollar strength and vice versa (see chart).

However, while non-U.S. equity markets have retained historical relationships during the recent dollar strength, commodities have not. Futures-based commodities are up 38% during recent dollar strength (while an equity-based approach is up 16%). The "pro-commodity" inflationary narrative has overwhelmed the "pro-dollar" geopolitical and "Fed liftoff" narratives. Looking ahead, we retain our recommended natural resources overweight – as we believe still-inexpensive valuations and strong fundamentals (increased demand/tight supplies) will allow continued outperformance even amid further dollar strength – and possibly even better should the dollar reverse course.

NOT ACCORDING TO SCRIPT

Recent commodity strength is unusual in the "strong dollar" environment we find ourselves.

AVERAGE TOTAL RETURNS (%)



Source: Northern Trust Asset Management, Bloomberg. Monthly data from May-1972 through Apr-2022. Current strengthening from 5/31/2021 through 5/11/2022. 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.

- Commodities have not been slowed by the recently strong dollar – despite the historical experience.
- Strong fundamentals (strong demand and challenged supply) are enhanced by attractive valuations.
- We retain our recommended overweight to natural resources – and equal-weight to global real estate and infrastructure.

BASE CASE

Navigating Economic Shocks

China's ongoing pandemic challenge and "zero COVID" strategy represents a global supply/demand shock. Meanwhile Russia's invasion of Ukraine is still pressuring commodity prices. The U.S. is more insulated from these shocks than the rest of the world – but is dealing with a more restrictive Fed.

Managing Inflationary Expectations

Markets have priced in a level of Fed policy tightening commensurate with a central bank eager to tamp down high inflation. Supply imbalances marginally tilt inflation risks to the upside, but pressures are easing and the Fed will likely use the room awarded by investors to manage longer term expectations.

RISK SCENARIOS

A Relentless Fed

The market support the Fed has provided for much of the post-GFC environment becomes a hindrance as the Fed becomes less sensitive to market feedback loops on economic performance.

Economic Degradation

The U.S. economy is unable to overcome global growth headwinds from the Russia-Ukraine war and China's COVID situation, leading to a sharp deterioration in the U.S. economic growth outlook.

GLOBAL POLICY MODEL

Strategic Allocation and Tactical Over/Underweights	RISK CONTROL				RISK ASSETS						
	FIXED INCOME				EQUITIES			REAL ASSETS			
	Cash	Inv. Grade	Infl. Linked	High Yield	U.S.	Dev. Ex-U.S.	Emerg. Markets	GLI	GRE	NR	Gold
Strategic Asset Allocation	2	35	3	6	26	14	6	2	2	4	0
Tactical Asset Allocation	0	29	3	12	30	12	4	2	2	6	0
Over/Underweight	**-2**	**-6**	**0**	**6**	**4**	**-2**	**-2**	**0**	**0**	**2**	**0**

Source: Northern Trust Capital Market Assumptions Working Group, Investment Policy Committee. Strategic allocation is based on capital market return, risk and correlation assumptions developed annually; most recent model released 8/11/2021.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.