NORTHERN TRUST
ASSET MANAGEMENT

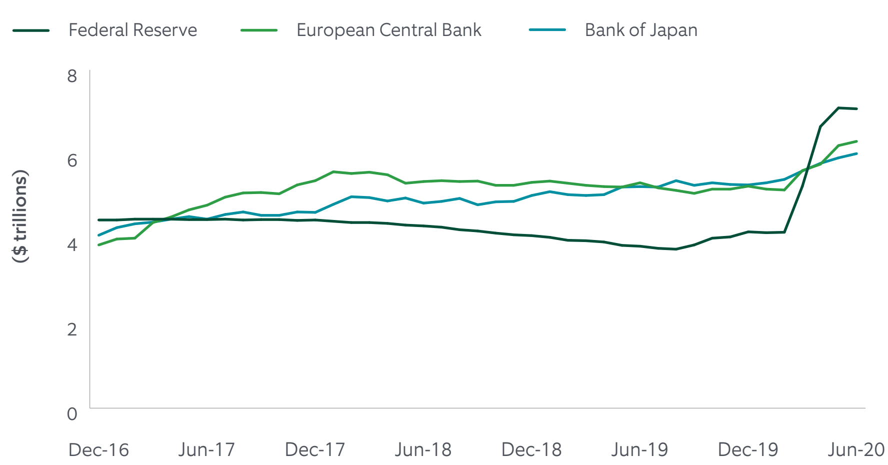
FIXED INCOME UPDATE SECOND QUARTER 2020

KEY POINTS

- Despite COVID-19 continuing to spread with cases across the globe and infections in the southern U.S. spiking, the slow reopening of the U.S. economy in the second quarter spurred significant optimism among investors and calmed fixed income markets.
- Credit spreads tightened substantially, supported by large amounts of fiscal stimulus and intervention by the Federal Reserve, which freed up liquidity.
- Central banks continued to offset virus driven economic and financial market pressures, but they demonstrated limited means to do so. This further underscored their need to coordinate with fiscal policymakers.

EXHIBIT 1: CENTRAL BANKS TOTAL ASSETS

Global central banks worked to offset virus-driven pressures, and we expect that to continue for some time.



As of 6/30/2020
SOURCE: Northern Trust Asset Management, Bloomberg Barclays

IN THIS ISSUE

Long-Term Views

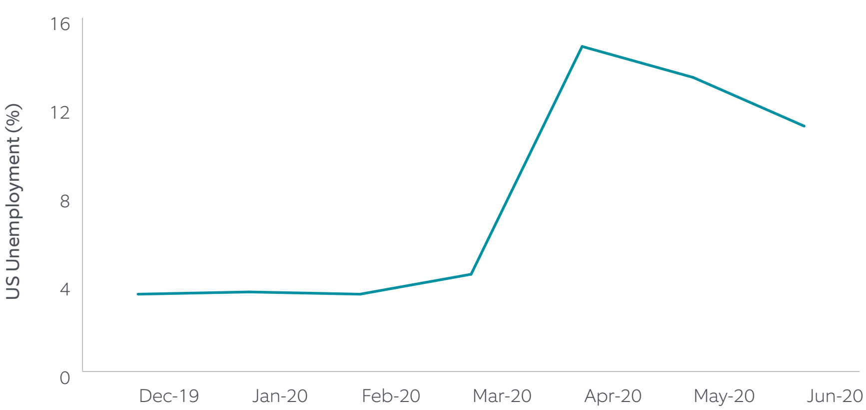
- While labor market and consumer spending data improved at the end of the quarter, economic data remains well short of pre-virus levels and we expect growth to disappoint.
- Despite risk of elevated inflation in specific areas such as food and travel, our view on “Stuckflation” remains in place. We believe the decrease in demand caused by COVID-19 will continue to put near term pressure on inflation and levels to remain subdued.
- We expect central banks globally to remain accommodative for an extended period of time as they look to mitigate virus-driven economic damage.

ECONOMY

- Midway through the quarter, oil futures turned negative and fell to a historical -$37 a barrel (buyers expected to get paid to take oil). As consumers returned to a more "pre-COVID-19" lifestyle in May, demand for gasoline and production cuts buoyed oil prices to $39 a barrel.
- On the back of consumer spending and increased investor confidence, U.S. and European purchasing manager data rebounded in June from recent bottoms in May.
- The $2.2 trillion CARES Act, a U.S. fiscal stimulus bill providing cash payments to citizens and support to businesses and governments, went into effect early in the second quarter. It also supported the unemployed after the unemployment rate hit a multi-year high of 14.7% in April. June unemployment fell to 11.1%.

EXHIBIT 2: U.S. UNEMPLOYMENT

The unemployment rate has declined steadily as furloughed workers began to return to work, supported by increasing manufacturing and non-manufacturing activity.



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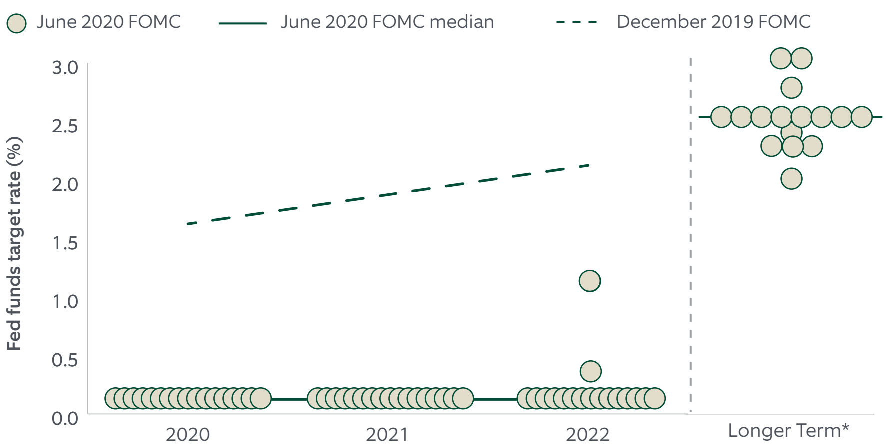
CENTRAL BANKS

- Global central banks maintained their "whatever it takes" attitude to support economies via rate cuts, increases to large scale asset purchasing programs, and direct lending.
- In June, the Fed further alleviated credit stress by announcing updates to the Primary Market Corporate Credit Facility (PMCCF) and the Secondary Market Corporate Credit Facility (SMCCF) that allowed the purchase of single named corporate bonds, and bond exchange-traded funds to take effect.

EXHIBIT 3: FED FUNDS PROJECTIONS

We expect the Fed funds rate will be range bound between 0.00-0.25% until the economy is back on track to achieve maximum employment.



*Longer term represents FOMC expectations for where the rate is expected to converge over time.

Most recent FOMC projections as of the 6/10/2020 committee meeting.
Fed funds futures data as of 6/30/2020.

SOURCE: Northern Trust Investment Strategy, Bloomberg, Federal Open Market Committee (FOMC) Summary of Economic Projections.

ULTRA-SHORT/CASH

- The Fed's Money Market Liquidity Facility, in which participation fell throughout the quarter, helped stabilize the market and provided an additional push on spread tightening.
- Money market rates were low, but firmly positive throughout the quarter as markets stabilized and inflows slowed. Industry assets under management peaked in late May and retreated by $130 billion by the end of the quarter, signaling that investors might be looking to take on more risk.
- Money Market Funds as well as other investors seeking high quality liquid assets easily absorbed a record high $2 trillion in Treasury Bill issuance during the quarter. The strong demand limited the impact on yields. Treasury Bill supply, while expected to slow meaningfully, will remain an important driver of market yields throughout the second half of the year, especially if Congress passes additional fiscal stimulus measures.

Performance

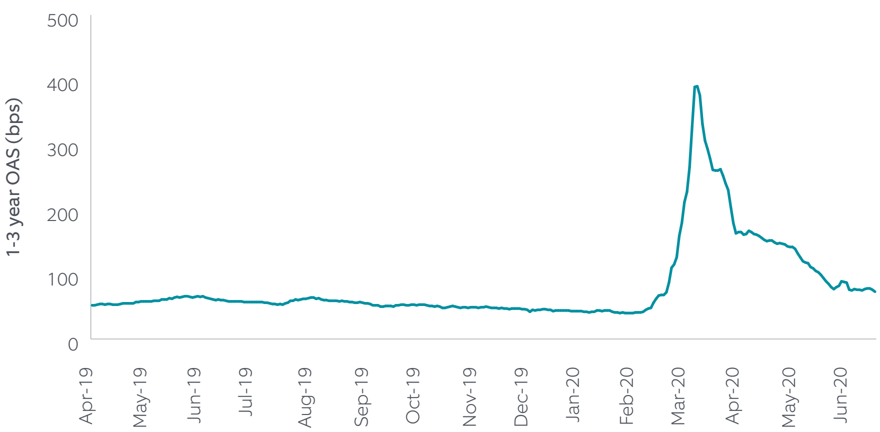
- Contributor: duration
- Detractor: asset allocation

Current Positioning

We continue to favor corporate credit and are long on our duration target and neutral to risk.

EXHIBIT 4: 1-3 YEAR OPTION ADJUSTED SPREAD

After widening 400 basis points in March, ultra-short spreads have normalized to near pre-crisis levels as liquidity needs in the short-term space have been resolved, and investor sentiment recovers.



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TREASURYS & TIPS

- Expectations for global growth and a flight to safety continued to put downward pressure on the curve. Virus-driven uncertainty will keep yields sitting at the low end of historical ranges as long as the virus persists.
- Despite bond managers positioning for the Federal Reserve to revive a radical policy used during World War II targeting bond yields, reports showed officials were still debating implementing yield control at a their June-end meeting.

Performance

- Contributor: security selection, duration
- Detractor: curve positioning

Current Positioning

Portfolios are positioned with a neutral-to-long duration relative to their benchmarks.

EXHIBIT 5: 10-YEAR TIPS FLOWS

Flows into 10-year Treasury inflation-protected securities (TIPS), which acts as a measure of expected inflation, fell sharply in the second quarter. They have since rebounded by $5 billion, driven by fiscal stimulus that may spur inflation.

As of 6/30/2020
SOURCE: Northern Trust Asset Management, Bloomberg Barclays

INVESTMENT GRADE BONDS

- The investment grade market posted a return of 8.99% for the quarter compared to -3.64% in the first quarter.
- Credit spreads tightened considerably as the Fed provided direct liquidity to back stop financial markets.
- As funding costs decreased due to improved liquidity, companies brought substantial new corporate credit issuance to market. Investment grade companies brought $696 billion in new issuance in second quarter compared to a $594 billion in the first half of 2019.

Credit Performance

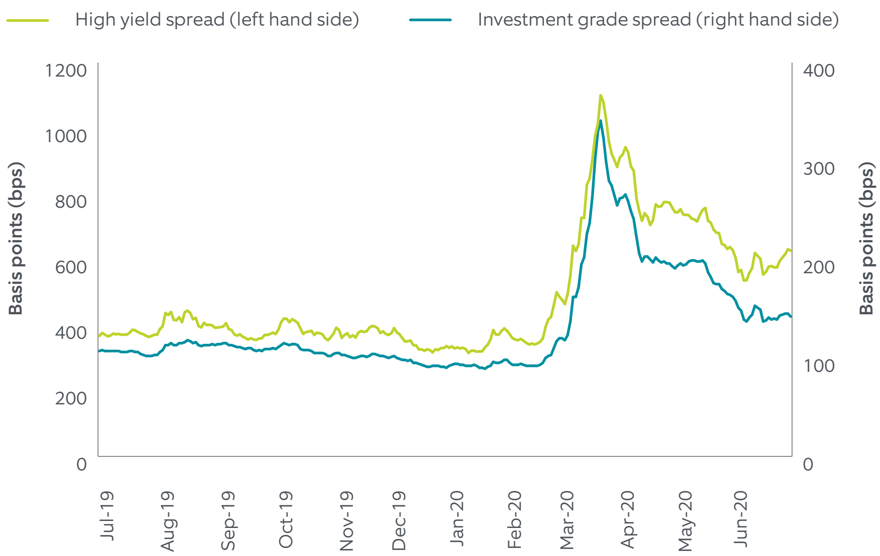
- Contributor: asset allocation, security selection
- Detractor: transaction costs

Current Positioning

We remain overweight investment grade credit and added to our credit positions during the turbulence and subsequent rally.

EXHIBIT 6: INVESTMENT GRADE AND HIGH YIELD OPTION ADJUSTED SPREAD

Credit Spreads continued to be elevated versus the previous 12 months, but have recovered from crisis levels in March.



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SOURCE: Northern Trust Asset Management, Bloomberg Barclays

HIGH-YIELD BONDS

- The high yield market posted a quarterly return of 10.14% compared to -12.68% in the first quarter as the massive fiscal and monetary policy responses enacted late in first quarter carried positive momentum.
- Additional details released on the Fed's corporate bond purchase program revealed that certain fallen angel credits and high yield exchange-traded funds were eligible for purchase, which further narrowed spreads.
- Returns by rating favored the highest quality credits: BB-rated securities returned 11.54%, B-rated securities returned 8.64%, and CCC-rated securities returned 9.10%. The lowest quality, CC to D-rated securities, returned 2.06% in the quarter.

High-Yield Performance

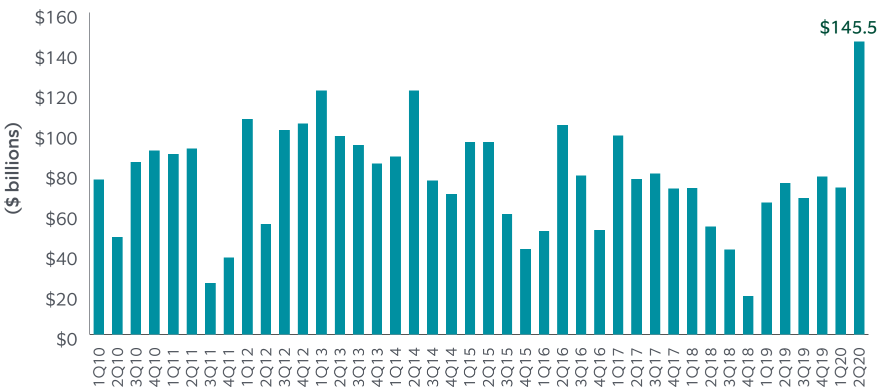
- Contributor: sector positioning
- Detractor: security selection

Current Positioning

Portfolios are positioned in the mid-range of the credit quality spectrum. Issuer selection is of utmost importance.

EXHIBIT 7: GROSS HIGH-YIELD ISSUANCE

The second quarter's $146 billion of gross high yield bond issuance and $62 billion in net issuance easily exceed the prior quarterly records of $121 billion gross in the second quarter of 2014 and $53 billion net in the second quarter of 2015.



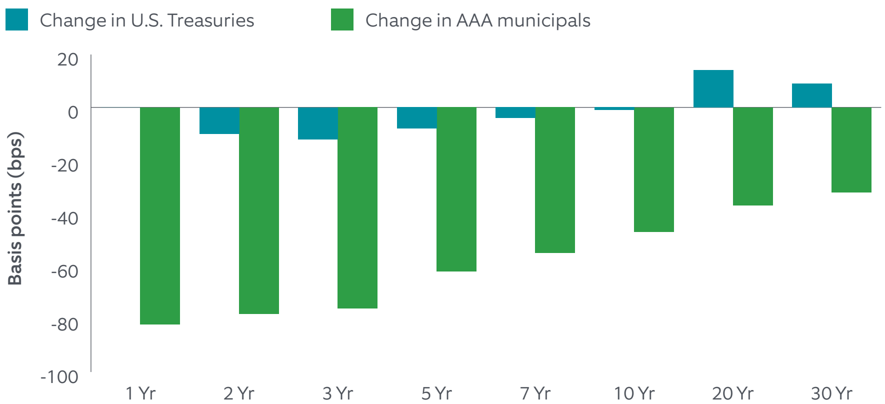
As of 6/30/2020
SOURCE: Bloomberg Barclays

MUNICIPAL BONDS

- Municipal bonds continued to attract buyers, with year-to-date returns up about 2%.
- Credit returns were flat for the quarter but year-to-date shows AAA at 3.42% vs. BBB at -2.05%.
- Front-end yields dropped 70 to 80 basis points, playing catch-up with Treasury rates.
- Municipal bonds remain attractive for tax-paying investors.

EXHIBIT 8: SECOND QUARTER YIELD CHANGE: TREASURYS VS. MUNIS

Front-end yields dropped 70 to 80 basis points, playing catch-up with Treasury rates.



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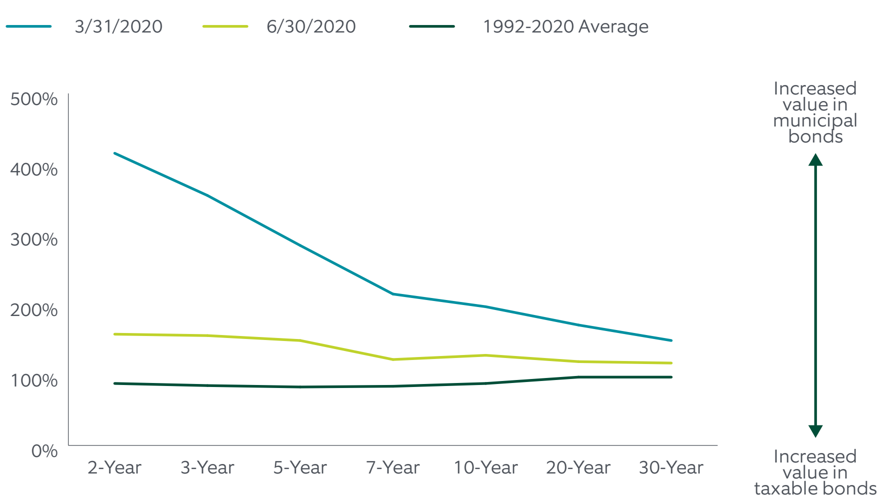
SOURCE: Northern Trust Asset Management

EXHIBIT 9: RATIO: AAA MUNI YIELD TO TREASURY YIELD



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SOURCE: Northern Trust Asset Management, Bloomberg Barclays

Municipal Performance

- Contributor: credit quality, duration
- Detractor: yield curve position

Current Positioning

We expect credit spreads to continue to compress, the yield curve to flatten, and overall yields to continue to fall.

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