NORTHERN TRUST

ASSET MANAGEMENT

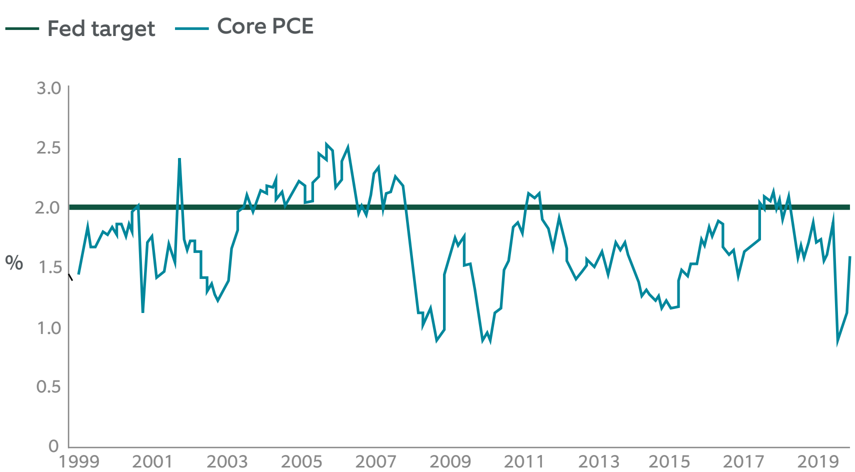
FIXED INCOME UPDATE THIRD QUARTER 2020

KEY POINTS

- The COVID-19 pandemic has continued, but investors largely shrugged off concerns in hopes of government aid and an accommodative central bank.
- Although the economy is struggling, it is showing signs of improvement. The pandemic has persisted and will dampen growth in the near term; however, financial markets remain resilient.

EXHIBIT 1: INFLATION

Core personal consumption expenditures (PCE), the Fed's preferred measure of inflation, has failed to consistently produce inflation above 2%. Massive stimulus has only had modest impact to date.



Source: Northern Trust Asset Management, Bloomberg. As of 9/30/20

IN THIS ISSUE

Long-Term Views

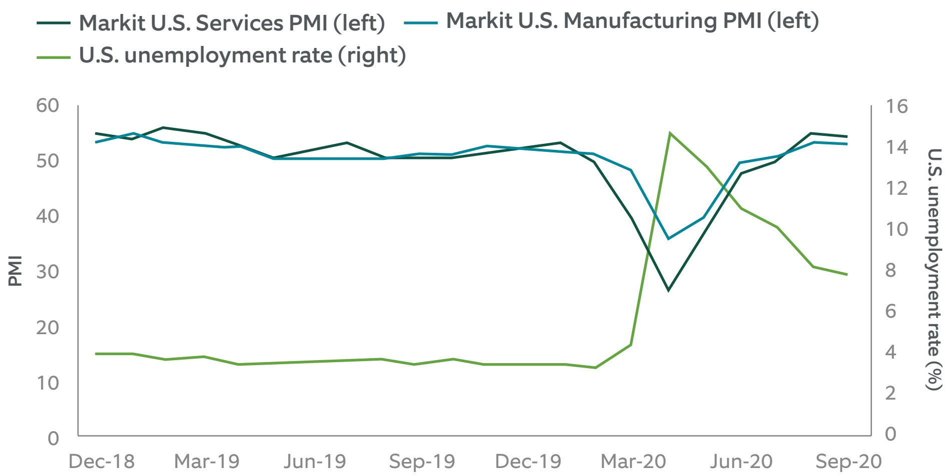
- Central banks must coordinate with governments to offset the economic weakness caused by the pandemic. Global central banks will leave rates low for the foreseeable future to spur economic growth.
- Despite massive monetary and economic stimulus, we still believe in our "Stuckflation" view. Inflation will face persistent secular headwinds that have kept it contained over the past decade.

ECONOMY

- The economy showed improvement in the third quarter, but remains weak. The unemployment rate fell to 7.9% from 11.9% during the quarter, underscoring the tepid reopening of the U.S. economy. Markit Purchasing Manager Indices for both manufacturing (53.2) and services (54.6) rose and are now comfortably in expansionary territory (>50).
- The U.S. House of Representatives and U.S. Senate failed to agree on a new stimulus package, but the Federal Reserve's support aided the improvement in financial markets.

EXHIBIT 2: U.S. ECONOMIC BACKDROP

As individuals return to work, manufacturing, services, and employment have all benefitted, as shown by purchasing manager indexes (PMI). The unemployment rate still remains well above pre-pandemic readings.



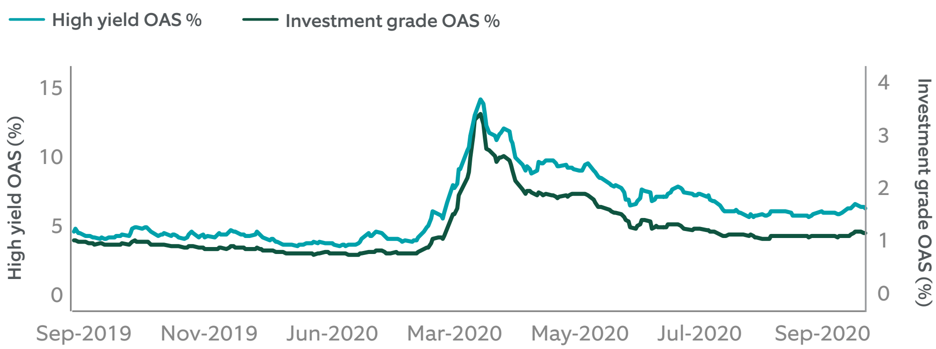
Source: Northern Trust Asset Management, Bloomberg, from 12/31/18 to 9/30/20

CENTRAL BANKS

- Global central banks sustained their "whatever it takes" attitude to support economies: capital restrictions, increases to large scale asset purchasing programs, and tweaks to direct lending programs.
- The Fed extended all of its current lending facilities through the remainder of the year. It also announced a move to a flexible inflation target, allowing inflation to run above its previous 2% target for a period of time. Lastly, it announced large banks' dividend restrictions and prohibited share buybacks through the end of the year.

EXHIBIT 3: CORPORATE BOND OPTION-ADJUSTED SPREADS (OAS)

Improved liquidity and the Fed back-stopping has helped credit spreads compress.



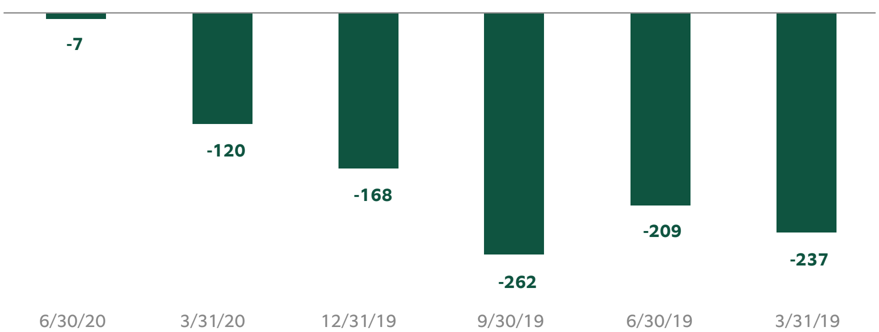
Source: Northern Trust Asset Management, Bloomberg

ULTRA-SHORT/CASH

- Short-term investment grade new issues were heavily oversubscribed given light issuance and improving credit conditions. Most issuers came to market with longer-dated bonds, locking in low rates.
- In the absence of additional fiscal stimulus and related Treasury bill issuance, money market yields continued to move lower despite modest money market fund industry outflows. Credit spreads remain near historic lows and the 3-month Libor rate set an all-time low.

EXHIBIT 4: CHANGE IN 3-MONTH LIBOR YIELD VS. 9/30/20 (BASIS POINTS)

The 3-month Libor yield continues to fall as supply decreases.



Source: Northern Trust Asset Management, Bloomberg, as of 9/30/20, when 3-month Libor yield was 0.23%

Performance

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

Current Positioning

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

TREASURYS AND TREASURY INFLATION-PROTECTED SECURITIES (TIPS)

- Mixed economic data along with uncertainty surrounding potential fiscal stimulus and U.S. election outcomes kept rates relatively flat throughout the quarter. Ten-year Treasury yields traded in a tight range centered around 68 basis points throughout most of the quarter.
- Ten year Treasury Inflation-Protected Securities (TIPS), a measure of expected inflation, had a very strong quarter and rallied 29 basis points. Given the uncertainties noted, TIPS returned to fair value while investors wait for more information.

Performance

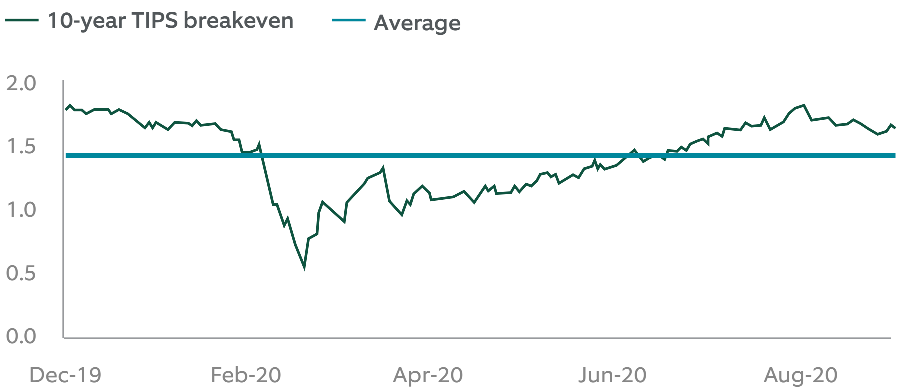
- Contributors: security selection, duration
- Detractor: curve positioning

Current Positioning

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

EXHIBIT 5: 10-YEAR TIPS BREAKEVEN RATE (%)

The strong recovery in TIPS is typical of economies emerging from recession. TIPS decreased from their highs as Congress failed to pass a new stimulus bill. Breakeven rates are a gauge of expected inflation.



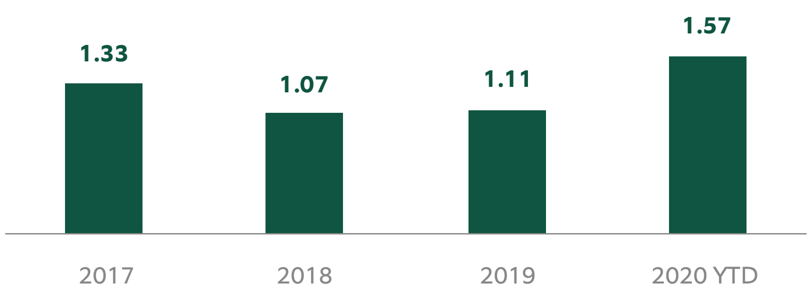
Source: Northern Trust Asset Management, Bloomberg, as of 9/30/20

INVESTMENT GRADE BONDS

- Companies continued to take advantage of low cost funding ahead of the election, setting monthly issuance records two months of the quarter. U.S. investment grade issuance in 2020 has now surpassed the 2017 full-year record and stands at $1.57 trillion.
- Supported by large inflows and the Fed, credit spreads tightened by 14 basis points during the quarter and are approaching pre-pandemic levels. The option-adjusted spread widened slightly as equity markets fell off near the end of the quarter.

EXHIBIT 6: YEARLY INVESTMENT GRADE ISSUANCE ($ TRILLIONS)

Large inflows into investment grade mutual funds have absorbed record issuance in the asset class.



Source: Northern Trust Asset Management, Bloomberg, as of 9/30/20. Data excludes sovereigns, supranationals, and agencies.

Credit Performance

- Contributors: asset allocation, security selection, duration
- Detractor: curve positioning

Current Positioning

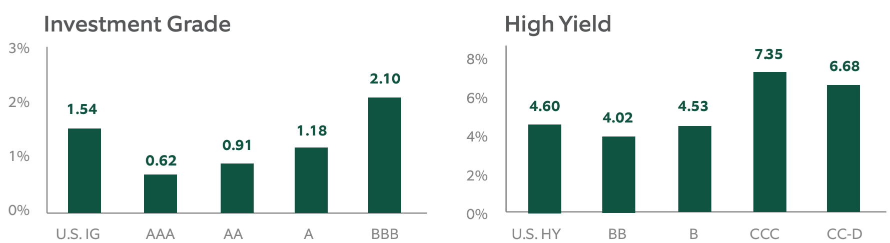
Portfolios are positioned neutral-to-long duration relative to their benchmarks, while maintaining a moderate overweight to spread product

HIGH YIELD BONDS

- As the economic outlook improved, lower quality bonds performed most favorably. High yield mutual funds had $6.7 billion of inflows during the quarter, which supports high yield valuations.
- Management teams continued to take advantage of low rates to extend maturity schedules, pushing 2020 to a record issuance year. Year-to-date high yield issuance stands at $372 billion.

EXHIBIT 7: CORPORATE BOND RETURNS BY RATINGS CATEGORY (%)

Lower quality credit across both assets classes performed better than their higher rated peers, as investors searched for yield.



Source: Northern Trust Asset Management, Bloomberg, from 6/30/20 to 9/30/20

High Yield Performance

- Contributors: security selection
- Detractor: sector allocation

Current Positioning

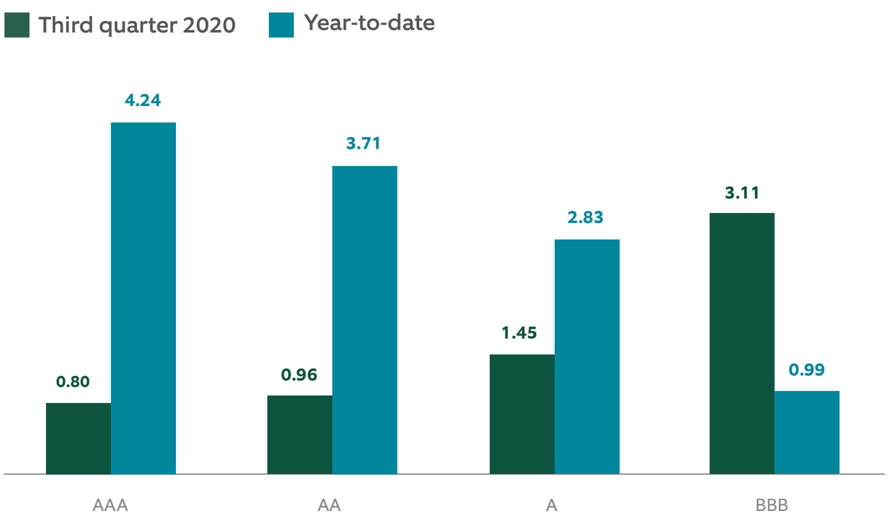
Portfolios are positioned to manage the impact of market and sector volatility, while focusing on income generation. We will continue to be positioned in the mid-range of the credit risk spectrum.

MUNICIPAL BONDS

- We expect the heaviest amount of new issuance this year in October, with taxable municipal bonds the main driver. Tax-exempt issuance is flat year-to-date.
- Lack of additional federal aid has led state and local issuers to refinance outstanding debt and backfill deficits amid strong demand.

EXHIBIT 8: MUNCIPAL BOND RETURNS BY RATINGS CATEGORY (%)

Higher quality bonds have outperformed year-to-date, but lower quality bonds rallied this quarter as investors reach for yield.



Source: Northern Trust Asset Management, Bloomberg Barclays. As of 9/30/20.

Municipal Performance

- Positive: security selection
- Detractors: yield curve positioning, higher quality credit bias

Current Positioning

Portfolios are positioned with a neutral duration relative to their benchmarks to start the quarter. Post-election we will consider extending longer.

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