Asset Allocation Update: Diversified Strategist Portfolios (DSP) September 2019

THE FED AND TRADE

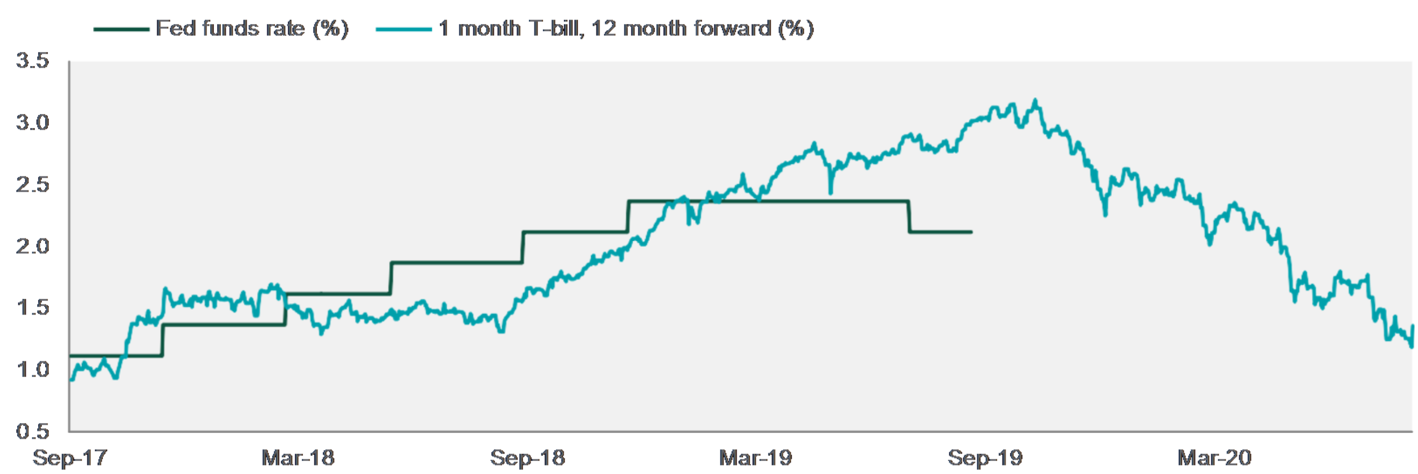
During its discussions this month, the investment strategy team spent considerable time debating the outlook for Federal Reserve policy and the path forward for the U.S.- China trade dispute, including its impact on the global growth outlook. Despite the considerable gulf between market expectations for rate cuts and the Fed's current posturing, we expect the Fed to grudgingly move toward the market's expectation of four cuts of 0.25% over the next year. The Fed is likely to be a latecomer to our *Monetary Makeover* theme, which predicts central bankers will increasingly gaze outside of their traditional remit to further support growth and inflation as monetary accommodation loses its punch. We see the European Central Bank at the front of the pack, as highlighted by incoming president Christine Lagarde's recent commentary calling for increased fiscal stimulus.

Financial markets continue to be buffeted by the latest trade developments, rallying most recently on a mere agreement between Chinese and U.S. leadership to meet in October. This is evidence that the market has discounted much of the economic impact of the tariffs – and the overall slowdown in global growth since early 2018 is hardly a secret to investors. The negative impact of the trade war highlights our *Executive Power Play* theme, which argues that populist politicians will be punished if their policies result in poor economic outcomes. We expect this to limit, to some degree, the extent to which President Trump pushes the trade war ahead of the 2020 presidential election. This theme may also be playing out in the United Kingdom, where elected officials may be trying to avoid a hard Brexit as they fear the wrath of voters in economically vulnerable positions.

Despite the many economic and geopolitical concerns facing investors, it has been an excellent year in financial markets. We've been expecting disappointing growth, (which has been true more so outside the U.S.), but have believed low inflation would support lower interest rates and higher asset class valuations. We made no changes this month in our recommended tactical asset allocation policy, which remains moderately overweight risk. We prefer U.S. to emerging market equities, as they provide some hedge against trade war risk. We also favor lower- risk risk assets such as high yield bonds and interest-rate sensitive asset classes including global real estate and global listed infrastructure. We remain on the watch for our two primary risk cases – the potential of a return of inflation, and a proliferation of tariffs beyond those the U.S. has placed on Chinese imports.

JUST GETTING STARTED

Futures markets expect the rate-cutting campaign to continue through 2020.



Source: Northern Trust Global Asset Allocation, Bloomberg. Fed funds rate data 9/30/2017 - 9/5/2019.
1 month T-bill, 12 month forward rate data is pulled forward one year and runs from 9/30/2016 - 9/5/2019.

RECOMMENDATIONS AND VIEWPOINTS (September 6, 2019)

Tactical decision: No changes

TAA reaffirmed its moderate overweight to risk. Tactical overweights to U.S. High Yield, U.S. Equities, Global Real Estate (GRE) and Listed Infrastructure (GLI) are funded by underweights to Emerging Market Equities, Investment Grade Fixed Income (IG), Inflation-Linked Bonds and Cash. As such, the risk from the fairly material overweight to risk assets is moderated by being allocated to "less risky" risk assets. Allocations to GRE and GLI provide some interest rate sensitivity to the portfolio despite the underweight to IG. TAA also maintains slight overweights to Natural Resources and Developed ex-U.S. Equities, driven by attractive valuation profiles.

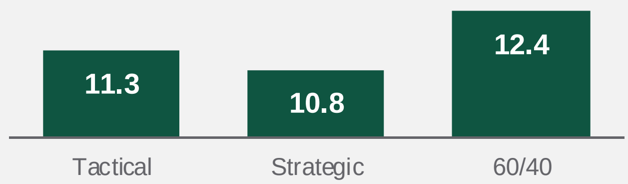
U.S.-China relations not expected to get better – but also not expected to get much worse. Per the view articulated in the Irreconcilable Differences strategic theme, we expect to meander between trade war and trade armistice – but not trade peace. Over the next year, as we get closer to the U.S. Presidential election, we expect less overt actions on the part of the Trump administration as their attention turns to winning a fresh four-year mandate providing them greater leverage on trade. But any substantive "deal" is unlikely – certainly over TAA's one-year horizon.

The Fed will pursue a path of grudging but regular easing – unwilling to quickly correct its overreach from late 2018. TAA now expects four rate cuts over the next six months (likely to see quarter-point cuts at the September, October, December and January meetings). The Fed is trying hard to hold the line on monetary policy given the U.S. economy's firm underpinnings and concerns about promoting asset bubbles; but ultimately the flat yield curve (with the "2s10s" inverting for a brief period), low inflation expectations (5-year breakevens recently hitting 1.3%) and wobbly overseas growth will force the Fed's hand. The slow-to-cut Fed will result in continued low rates out the yield curve (10-year yield forecast remains at 1.5%), supporting High Yield, GRE and GLI

European equities are showing signs of hope. The current 3.7% dividend yield on European equities is 4.3% above the yield found on 10-year German Bunds. This, in itself, is not a reason to buy (the dividend yield has outpaced what bonds have provided for years and yet underperformance vs. U.S. equities has persisted). However, we are beginning to see potential catalysts for better European equity performance. These include new pro-EU leadership, the potential for fiscal spending, a second wind for French President Macron and recent "less negative" developments on the Brexit front. TAA retained its slight overweight to Developed ex-U.S. Equities.

Performance[1]

Year-to-date returns as of 8/30/2019



Base Case

Global Growth Pressures: President Trump's reenergized assertiveness on the tariff front has put into question the economy's 'goldilocks' underpinnings. TAA believes global growth, while positive, will modestly disappoint investor expectations and is concentrating on "lower risk" risk assets such as U.S. High Yield and U.S. Equities.

Interest Rate Relief Valve: We believe that political impacts on fundamentals will be partially diffused through continued low rates, enabled by stuckflation and central banks (importantly the Fed) begrudgingly accepting the bond market's message. As a result, TAA has overweights to interest-rate sensitive assets (Global Real Estate and Global Listed Infra.).

Risk Cases

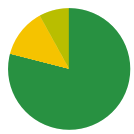
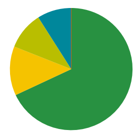
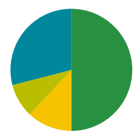
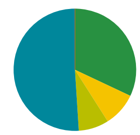
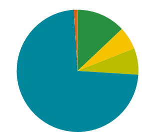
Inflation: Subdued inflation has been a key driver of favorable risk asset returns over the last few years; an unexpected jump in cyclical inflation would put at risk the Interest Rate Relief Valve base case above.

Tariff Proliferation: While not ideal, the U.S. – and, for the most part, the global – economy can withstand a concentrated trade war with China. Risks arise if the U.S. (or others) meaningfully target other countries.

[1]The returns shown are those of the Tactical Asset Allocation (TAA) and Strategic Asset Allocation (SAA) models. TAA/SAA model returns do not show performance of actual client accounts. The returns are gross of fees and reflect Northern Trust's Asset Allocation Committee's (a subset of Investment Policy Committee members) asset allocation decisions utilizing asset class index proxies, which cannot be directly invested in and may change over time. The 60/40 benchmark comprises the MSCI ACWI total return and Bloomberg Barclays U.S. Aggregate indices, respectively. Past performance does not guarantee future results.

Source: [1]Northern Trust Investment Strategy. Please see additional disclosures on page 4.

ASSET ALLOCATION TARGET WEIGHTS (As of September 6, 2019)

	DSP Maximum Growth		DSP Growth with Moderate Income		DSP Growth with Income		DSP Income with Moderate Growth		DSP Income	
Blended Index:	90% / 10%		75% / 25%		60% / 40%		35% / 65%		10% / 90%	
										
	TAA	Over / Under Weight	TAA	Over / Under Weight	TAA	Over / Under Weight	TAA	Over / Under Weight	TAA	Over / Under Weight
Equity	79%	-1%	66%	3%	49%	3%	31%	2%	15%	2%
U.S. Equities	45%	1%	38%	4%	29%	4%	20%	4%	11%	4%
Dev. ex-U.S. Equities	27%	1%	22%	1%	16%	1%	10%	0%	4%	0%
Emerging Markets Equities	7%	-3%	6%	-2%	4%	-2%	1%	-2%	0%	-2%
Real Assets	13%	1%	14%	4%	12%	5%	9%	5%	6%	4%
Natural Resources	7%	0%	6%	0%	5%	1%	3%	1%	1%	0%
Global Real Estate	3%	0.5%	4%	2%	3.5%	2%	3%	2%	2.5%	2%
Global Listed Infrastructure	3%	0.5%	4%	2%	3.5%	2%	3%	2%	2.5%	2%
U.S. High Yield	8%	0%	10%	4%	9%	4%	8%	5%	7%	6%
Fixed Income	0%	0%	10%	-10%	30%	-10%	52%	-9%	71%	-9%
U.S. Investment Grade	0%	0%	10%	-7%	29%	-5%	48%	-4%	65%	-3%
TIPS	0%	0%	0%	-3%	1%	-5%	4%	-5%	6%	-6%
Cash & Short-Term	0%	0%	0%	-1%	0%	-2%	0%	-3%	1%	-3%

The Blended Index is a blend of MSCI ACWI (net). and Barclays U.S. Aggregate Bond Index. The MSCI ACWI Index (net) is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets. Net total return indices reinvest dividends after the deduction of withholding taxes, using (for international indices) a tax rate applicable to non-resident institutional investors who do not benefit from double taxation treaties. The Barclays U.S. Aggregate Bond Index is an unmanaged index of prices of U.S. dollar-denominated, fixed rate, taxable, investment grade fixed income securities with remaining maturities of one year and longer. Given the stated investment strategy and objectives, these indices are shown because they are considered to be some of the most common indices in the marketplace. An investment cannot be made directly in an index.

TAA – Tactical Asset Allocation represents the current target weights, given our most recent outlook for the capital markets over the next twelve months. These weights are subject to change. Actual client account weights may vary.

Over/Underweight represents the TAA weights relative to the strategic asset allocation weights, which are reviewed annually by the Investment Policy Committee (IPC) and form the baseline portfolio allocations.

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[1]Asset allocation decisions take into consideration Northern Trust's Investment Policy Committee's (IPC) forward-looking annual capital market assumptions. The Capital Market Assumptions Working Group (CMAWG), a subset of IPC members, publishes its assumptions as a white paper report. Forecasts are developed annually; most recent forecasts released 7/12/2018. 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. Model outcomes do not reflect actual trading, liquidity constraints, fees, expenses, taxes and other factors that could impact the future returns. The model assumptions utilize passive indexes only. References to model returns are not promises or even estimates of actual returns an investor may achieve. The assumptions, views, techniques and estimates set out are provided for illustrative purposes only. The ability to achieve similar outcomes is subject to risk factors over which Northern Trust may have no or limited control.

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