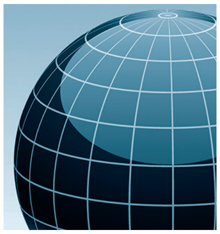
HIGH YIELD FIXED INCOME QUARTERLY UPDATE

Highlighting attribution, economic and market analysis



December 31, 2016

Northern Trust Asset Management
50 South La Salle Street
Chicago, Illinois 60603
northerntrust.com

Fred Azar
Director of Business Management
fa11@ntrs.com

Eric Williams
Portfolio Manager
erw1@ntrs.com

Dave Worniak, CFA
Fixed Income Research Analyst
dw191@ntrs.com

SUMMARY:

- The Bloomberg Barclays U.S. Corporate High Yield 2% Issuer Capped Index posted a 1.75% return in the fourth quarter. Northern's High Yield Fixed Income Fund outperformed the Index because of an overweight to energy and metals/mining.
- The high yield market is supported by stable credit fundamentals. The rate of default activity slowed in the quarter compared to earlier in the year and remained concentrated in a few sectors of the market.
- The development of new government policies, monetary policy, and commodity prices will be the primary drivers of returns moving forward.

PHILOSOPHY

Northern Trust's Active High Yield Fixed Income Group manages portfolios in an effort to generate returns consistent with the high yield market. We use a total return approach to generate alpha through fundamental credit analysis, security selection, and sector allocation. We do not invest in equities, leverage or derivatives in this Fund. Our investment process is designed to preserve capital and limit risk by constructing well diversified investment portfolios that are a reflection of our views on the economy, fiscal and monetary policy, and market valuations.

Over time, the Fund has been positioned in the mid-range of the credit quality spectrum of the market. The highest quality securities carry a material amount of interest rate risk and the lowest rated securities carry credit and market volatility risk. Over an extended period of time, management of credit and interest rate risk is critical for performance.

ECONOMIC AND MARKET BACKDROP

The populist political wave continued in the fourth quarter and spread to the U.S. Donald Trump won the U.S. presidential election and, important for future legislation and for investors, the Republicans retained control of the Senate and the House of Representatives. President-elect Trump has stated he'll focus on reducing taxes, decreasing regulation, and increasing U.S. infrastructure investment. With the Republicans in control, we believe some of these plans will be passed.

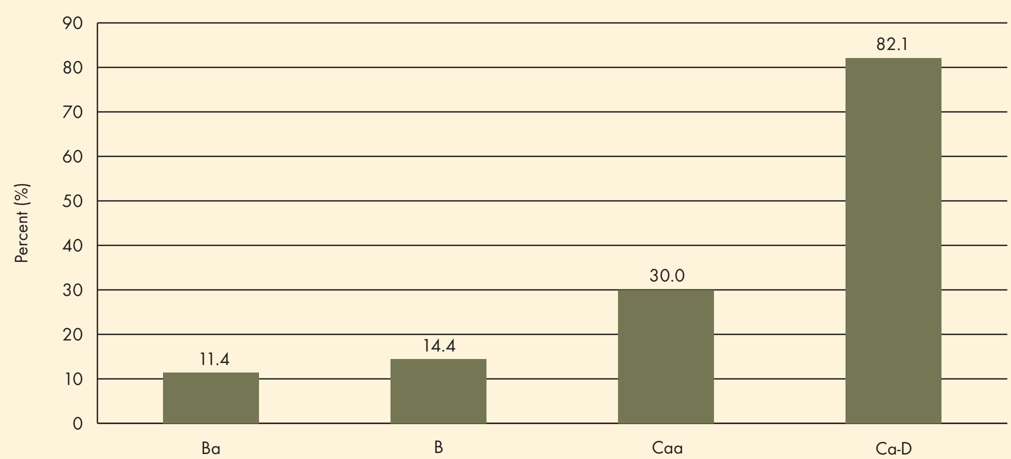
We believe the Republican sweep changed the landscape for investors. In our view, the economy and financial markets have been suffering from monetary policy exhaustion, with questions about the negative impact of low interest rate policy on consumers, businesses, and the financial system. We believe the Republican sweep and their plans for the economy increases the probability growth will improve and inflation will be higher.

The Federal Reserve has wanted to raise interest rates for the past two years but have been waiting for investors to get on board. The November election appears to have done this, with equity markets advancing and long-term interest rates rising. This provided the Fed a green light to increase their benchmark federal funds rate 25 basis points (0.25%) in December.

PERFORMANCE

The High Yield Fixed Income Fund's 2.44% return in the fourth quarter exceeded the 1.75% return of the Bloomberg Barclays U.S. Corporate High Yield 2% Issuer Capped Index. Performance of the lowest rated securities substantially outperformed higher quality credits, continuing the trend for the year. The returns of the Ca-D rated bonds exceeded CCC securities. Both of these materially exceeded the returns of B rated securities, while BB rated securities lagged behind. The Fund was underweight BB securities and overweight B and CCC rated securities.

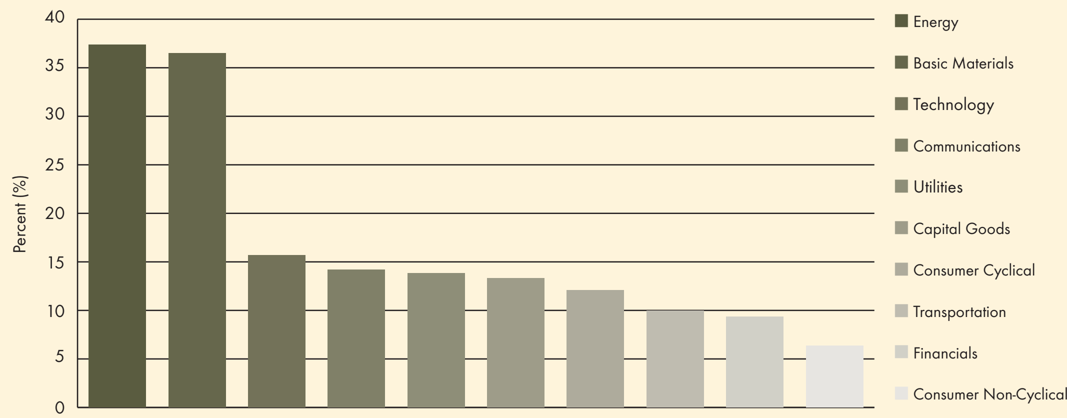
EXHIBIT 1: YTD EXCESS RETURN BY QUALITY



Source: Northern Trust Fixed Income, Bloomberg Barclays

Our overweights to oil field service, independent energy, and metals, along with an underweight to health care, contributed to performance. Our overweights to banking and electric utilities detracted. The Fund owned positions in many energy and metals/mining firms in the second half of the year that have recently been downgraded and placed into the high yield Index. These companies, typically referred to as "fallen angels" by investors, are larger businesses with more liquid bonds than those of companies typically found in the high yield market.

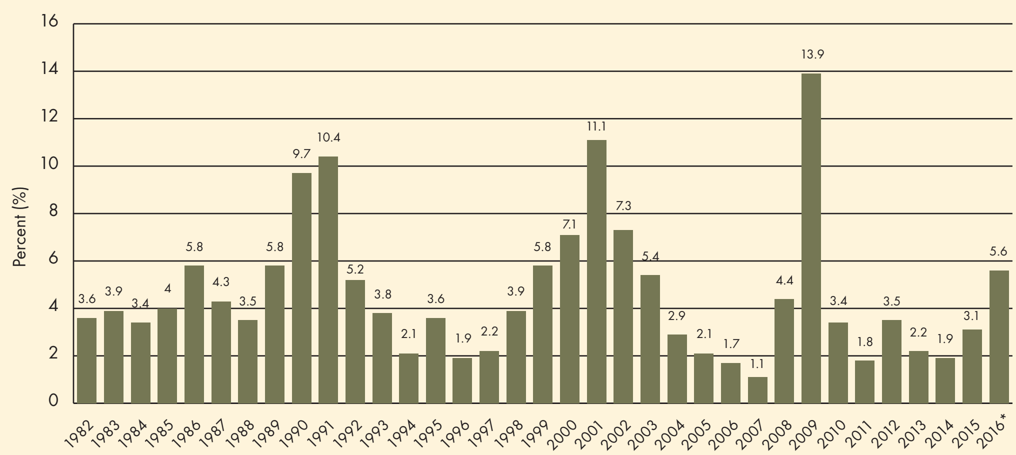
EXHIBIT 2: HIGH YIELD SECTOR YTD RETURNS



As of 12/31/2016
Source: Northern Trust Fixed Income, Barclays

While commodity related sectors were revalued over the course of 2016, there's also been a surge of bankruptcies for these firms. We believe defaults have peaked and will subside in 2017.

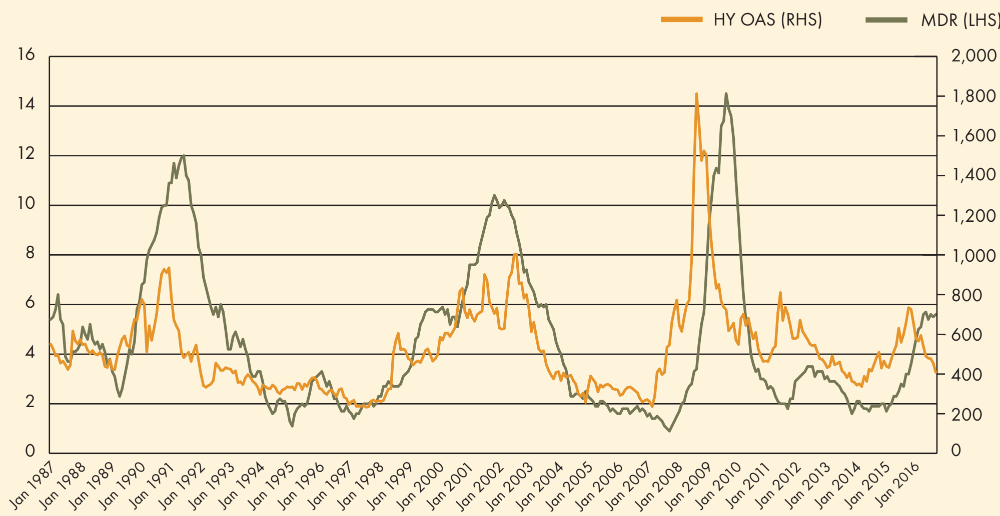
EXHIBIT 3: MOODY'S U.S. SPECULATIVE GRADE DEFAULT RATE



As of 12/31/2016
Source: Northern Trust Fixed Income, Bloomberg, S&P, Moody's

In our view, high yield companies continue to have fundamentally stable credit metrics. They enjoy moderate interest coverage and few near-term maturities as a result of an extended period of accommodative monetary policy. The yield-to-worst ended the quarter at 6.12%. By rating, BB's closed the quarter yielding approximately 4.5%, B's at 5.6%, and CCC's at 9.7%.

EXHIBIT 4: HIGH-YIELD INDEX OPTION ADJUSTED-SPREAD VERSUS MOODY'S DEFAULT RATE



Source: Barclays Live, Moody's

The Fund maintained exposure to select bank loans that offer attractive relative value. Bank loans are closely aligned with high yield bonds. Both represent an extension of credit to non-investment grade borrowers and approximately 80% of high yield issuers also have bank loans. These instruments are an important tool for portfolio managers for additional flexibility, particularly when market volatility is high.

While both high-yield bonds and bank loans may both provide investors with the potential for more income than investment grade bonds, a few key differences exist that we believe make bank loans a more suitable and less volatile investment. Bank loans are floating rate instruments priced off Libor. Therefore, loans effectively mitigate interest rate risk that fixed rate bonds can't. They're also secured by the assets of the borrower and hold a senior position in an issuer's capital structure. The secured position and seniority creates an instrument with a lower level of credit risk. The reduced interest rate and credit risk tends to lead bank loans to exhibit less volatility than high-yield bonds while still providing the potential for more income than found in investment grade issuers.

SPOTLIGHT SECTOR – AUTOS

Background

The high yield automotive sector comprises suppliers to auto manufacturers. While the automotive sector only makes up 2.2% of the total high yield index, auto sales impact consumer cyclical (retailers, restaurants, leisure, etc.), building materials, manufacturing, and consumer product sectors which together comprise 20% of the index.

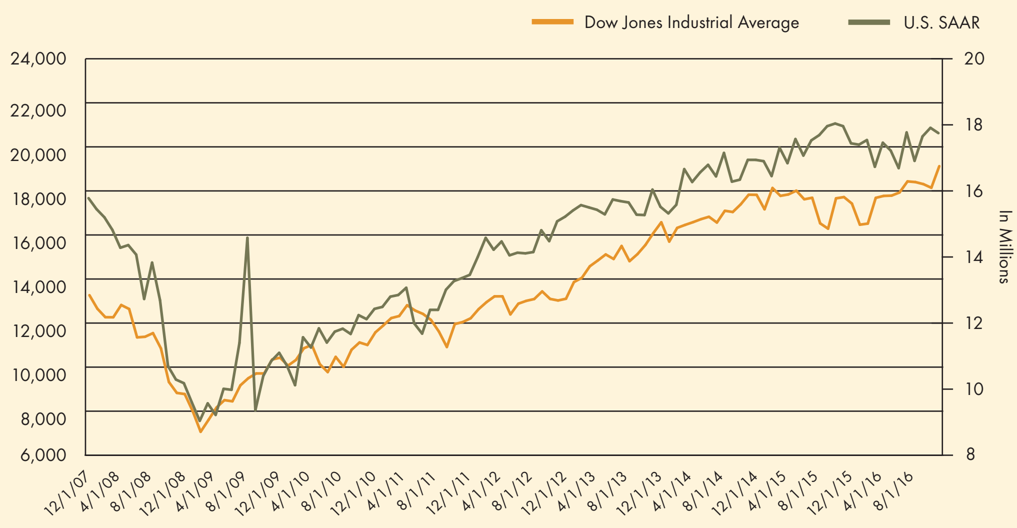
New car sales, and by extension high yield supplier sales, are influenced by a number of factors, including manufacturer incentives, resale values of cars and broad economic conditions. Because a car is one of the largest purchases a consumer can make, consumer confidence, low interest rates and access to credit have significant influence on car sales. Evaluating the health of the auto sector not only guides investment in suppliers, but also provides insight into the overall health of the consumer and the larger economy.

Other factors that influence car sales include government rebates, advances in technology, and safety features. For example, the Federal government in August 2009 put in place the Car Allowance Rebate System. Colloquially known as 'cash for clunkers,' the program was designed to boost the economy and auto sales by providing vehicle owners incentive to trade in older, inefficient cars for safer, cleaner, more fuel efficient autos.

Where are we now?

U.S. vehicle sales is the broadest measure of the health of the industry. The U.S. seasonally adjusted annual rate, referred to as the U.S. SAAR, is updated monthly and shows the annualized number of car, truck and SUVs sold domestically. This number tends to mimic the broader economy, with the U.S. SAAR declining 42% from January 2008 to a bottom in February 2009. This was similar to the 48% decline in the Dow Jones Industrial Average over that same time. The recovery in auto sales has been in lock step with the DJIA, shown in Exhibit 5 below. In the fall of 2009, the automotive sector made up 4.6% of the high yield index compared to 2.2% today, highlighting the credit rating upgrades seen in the industry in the current cycle.

EXHIBIT 5: U.S. SAAR AND DJI AVERAGE



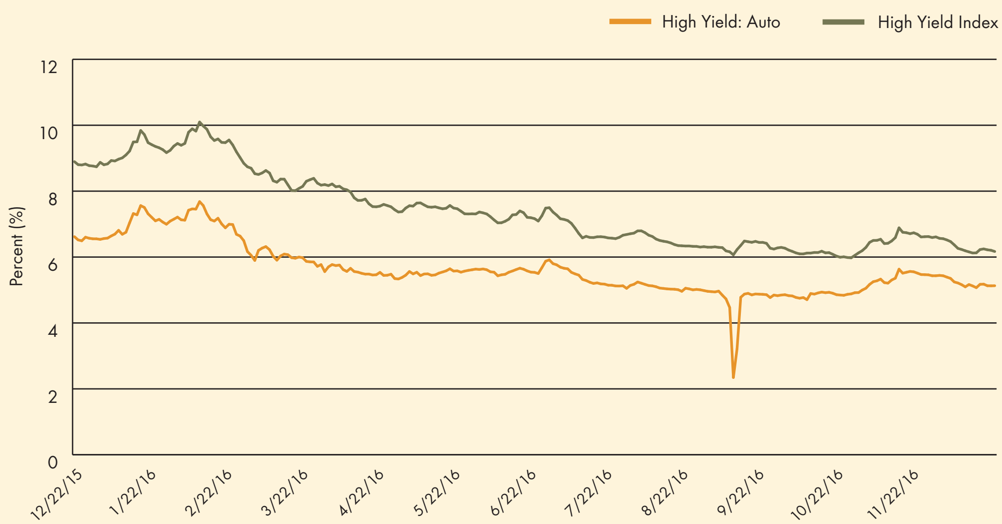
Source: Northern Trust Fixed Income, Bloomberg

The auto sector is now operating at post-recession peak levels and facing significant challenges from increased ride sharing, vehicle autonomy and a shift toward electrification. Having financial flexibility to invest in these areas is essential to future investment performance of companies in the sector.

Valuation

Looking to valuation, high yield automotive suppliers are trading at lower yields than the broad Index, shown in Exhibit 6. This indicates that despite the cyclicality of auto sales, investors believe the industry is a safer place to invest than the average high yield industry. Sales indicators remain positive, but rising interest rates will begin to increase the cost of promotional interest rates to manufacturers, reducing industry profitability. With the automotive sales cycle nearing a peak, we view credit selection in the sector as critical.

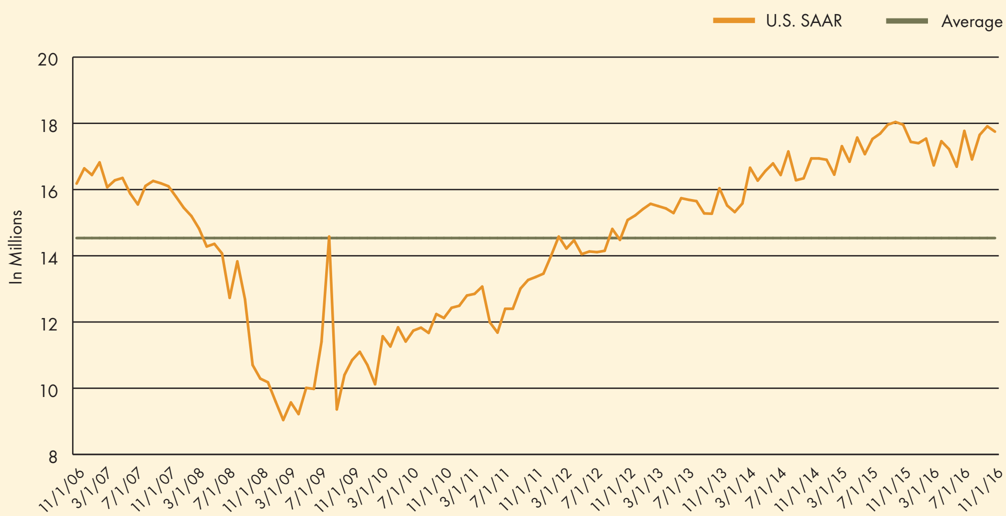
EXHIBIT 6: YIELD-TO-WORST



Source: Northern Trust Fixed Income, Bloomberg Barclays

With this in mind, we look to automotive suppliers that have the financial flexibility to invest in changing industry trends. Preferred investments include companies that have low leverage and robust free cash flow that can be directed to business investment. After years of sales growth and cost cuts, highly levered suppliers cannot rely on increased earnings to support high debt levels. We believe companies that can direct free cash flow generation to product development, not debt service requirements, will perform best.

EXHIBIT 7: U.S. SAAR AND AVERAGE



Source: Northern Trust Fixed Income, Bloomberg

Outlook

Exhibit 7 shows a ten year history and average line of the U.S. SAAR. Its 10-year average is 14.5 million with a low of 9.0 million in February 2009 and a post-recession peak of 18.0 million in October 2015. The current rate of 17.8 million is near post-recession highs. With the U.S. SAAR above its 10-year average for the past four years, there is higher probability for reduced sales rates. Financial performance at the supplier level is largely influenced by new car sales, so it is important to evaluate U.S. SAAR expectations. At this time, we have a neutral outlook for sales. Credit remains cheap and easy to obtain, unemployment is at cyclical lows and consumer's desire to spend, measured by the University of Michigan Consumer Sentiment Index, is the highest it's been since the fall of 2000.

We maintain a neutral view on the high yield automotive market, but being aware of trends driving the automotive industry provides insights into other areas of the economy. Low unemployment, strong consumer confidence, changing technology, and cheap credit are all reasons we expect U.S. car sales to remain stable. That information also reflects positively on the retail and other consumer orientated sectors, helping frame investment decisions in those areas as well.

TABLE 1: PERFORMANCE AS OF DECEMBER 31, 2016

Northern Funds	1-Year Return	3-Year Avg. Annual Return	5-Year Avg. Annual Return	10-Year Avg. Annual Return	Avg. Annual Since Inception	Gross Expense Ratio	Net Expense Ratio	Inception Date
Northern High Yield Fixed Income[1,2]	11.23%	3.27%	6.42%	5.79%	5.88%	0.82%	0.81%	12/31/98
Benchmark: Bloomberg Barclays U.S. Corporate High Yield 2% Issuer Capped Index	17.13%	4.67%	7.36%	7.55%	7.08%	–	–	–

Performance quoted represents past performance and does not guarantee future results. Investment return and principal value will fluctuate so that shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than that shown here. Performance data current to the most recent month end is available by calling 800-595-9111.

The Advisor has agreed to reimburse certain expenses of the Fund. The contractual reimbursement arrangement is expected to continue until at least July 31, 2017. After this date, the contractual arrangements may be terminated if it is determined to be in the best interest of the Fund and its shareholders. In the absence of fee waivers, yield, total return, growth since inception and dividends would have been reduced. Total return is based on net change in NAV assuming reinvestment of distributions.

Annualized for periods greater than one year.

[1]**Bond Risk:** Bond funds will tend to experience smaller fluctuations in value than stock funds. However, investors in any bond fund should anticipate fluctuations in price, especially for longer-term issues and in environments of rising interest rates.

[2]**High-Yield Risk:** Although a high-yield fund's yield may be higher than that of fixed-income funds that purchase higher-rated securities, the potentially higher yield is a function of the greater risk that a high-yield fund's share price will decline.

Alpha: Measures a fund's risk-adjusted performance and represents the difference between a fund's actual performance and its expected performance, given its level of risk.

Basis Points (bps): Unit of measure used in quoting yields, changes in yields or differences between yields. One basis point is equal to 0.01%, or one one-hundredth of a percent of yield and 100 basis points equals 1%.

Barclays U.S. Corporate High Yield 2% Issuer Capped Index is an unmanaged index that measures the market of U.S. dollar-denominated, non-investment-grade, fixed-rate, taxable corporate bonds. It is a version of the Barclays High Yield Corporate Bond Index except it limits its exposure of each issuer to 2% of the total market value and redistributes any excess market value Index-wide on a pro-rata basis.

Beta: Beta represents the systematic risk of a portfolio and measures its sensitivity to a benchmark.

Bond Risk: Bond funds will tend to experience smaller fluctuations in value than stock funds. However, investors in any bond fund should anticipate fluctuations in price, especially for longer-term issues and in environments of rising interest rates.

ERISA: Employee Retirement Income Security Act of 1974 (ERISA) enacted rules for U.S. qualified plans to help protect the retirement assets.

Option-adjusted spread (OAS) is the difference in yield between two fixed income securities (generally between a fixed income security with credit risk and a comparable treasury bond), adjusted for differences in duration and embedded options.

Yield-to-Worst (YTW) is the lowest potential yield that can be received on a bond assuming options available to the issuer are exercised.

References to specific securities within the utilities sector were made in an effort to highlight relevant news in the high yield sector during the period. For a full list of holdings for Northern High Yield Fixed Income Fund, please visits northernfunds.com. Holdings are subject to change and current and future portfolio holdings are subject to risk.

Please carefully read the prospectus and summary prospectus and consider the investment objectives, risks, charges and expenses of Northern Funds before investing. Call 800-595-9111 to obtain a prospectus and summary prospectus, which contains this and other information about the funds.

Northern Funds are distributed by Northern Funds Distributors, LLC, not affiliated with Northern Trust.

Incorporated with limited liability in the U.S. Products and services provided by subsidiaries of Northern Trust Corporation may vary in different markets and are offered in accordance with local regulation. Northern Trust Asset Management is composed of Northern Trust Investments, Inc. Northern Trust Global Investments Limited, 50 South Capital Advisors, LL, Northern Trust Global Investments Japan, K.K., NT Global Advisors, Inc., and personnel of The Northern Trust Company of Hong Kong Limited and The Northern Trust Company.
Past performance is no guarantee of future results. All material has been obtained from sources believed to be reliable, but its accuracy, completeness and interpretation cannot be guaranteed. This information does not constitute investment advice or a recommendation to buy or sell any security and is subject to change without notice.

NORTHERN TRUST