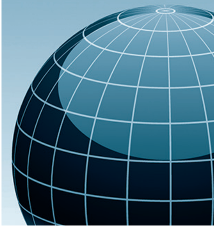
NORTHERN TRUST

ACTIVE FIXED INCOME QUARTERLY UPDATE

Core/Core Plus Investment Strategy



December 31, 2013

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SUMMARY:

- As the Federal Reserve (Fed) tapers its asset purchase program, we expect more volatility in rates, as investors focus more on traditional drivers of interest rates such economic data, inflation, and fiscal policy.
- Corporate credit spreads tightened significantly in the fourth quarter, causing the team to take some profits in our large overweight position. 2014 will require corporate debt investors to be more selective to generate alpha.
- 2014 will be a year of transition for The Federal Reserve, as they slowly back away from balance sheet expansion and focus more on forward guidance to markets.

FOURTH QUARTER PORTFOLIO ATTRIBUTION ANALYSIS

Northern's Active Long Duration Fixed Income Group manages portfolios with the goal of outperforming specific benchmarks. The group endeavours to exploit inefficiencies in the market, reacting to changing conditions and positioning portfolios in an effort to obtain superior returns. Our decisions are a reflection of views on the economy, fiscal and monetary policy, political developments, credit fundamentals, and relative bond valuations. The team acts as a traditional bond manager that generates alpha through our yield curve/duration positioning, sector allocation, and security selection.

ECONOMIC AND MARKET BACKDROP

Global economic data in the fourth quarter was mixed and major central banks kept monetary policy accommodative.

- The Eurozone economic recovery was slow and uneven. Growth continued to be led by Germany, its largest economy and approximately 30% of its Gross Domestic Product (GDP). In order to combat weak growth, low inflation, and high unemployment in countries such as France, Italy, Spain, Portugal, and Greece, the European Central Bank (ECB) lowered its benchmark interest rate in December.
- Large emerging economies continued to show disappointing growth, driven by lower commodity prices and weaker exports.
- The United Sates, largely unfazed by the shutdown of the Federal Government in October, continued to exhibit moderate growth, low inflation, and job creation.

The Federal Reserve (The Fed) announced the first reduction in their asset purchase program dubbed QE3 would begin in January. The anticipation of this announcement weighed on the markets earlier in the year, but was taken in stride when it was announced. The market took comfort in the consistent message in the second half of the year that it intends to hold its benchmark federal funds rate at exceptionally low levels for a considerable time, even after their asset purchase program is wound down. The nomination of Janet Yellen as the Fed chairwoman was also comforting to markets. Her thoughts surrounding future monetary policy are viewed as being dovish and consistent with those of outgoing chairman Ben Bernanke.

The resolution of the Federal Government shutdown, strong economic growth, and the Fed's announcement it plans to taper its asset purchase program in January drove rates higher during the quarter. As the Fed moves away from its asset purchase program and relies more on forward guidance, the market will be increasingly data dependent in determining the future path of interest rates.

Investment grade and high yield corporate issuers continued to enjoy robust demand in the fourth quarter, with new issuance concessions low and credit spreads tightening throughout. 2013 was the largest year for corporate debt issuance in history. Relative to other fixed income asset classes, investors continue to find corporate debt attractive due to their spreads over U.S. Treasuries. U.S. company balance sheets remain in good shape, with a record amount of cash on their books. While leverage has been rising over the past year, record low interest rates have kept the interest cost on the debt at exceptionally low levels, providing investors comfort they'll be repaid in a timely manner.

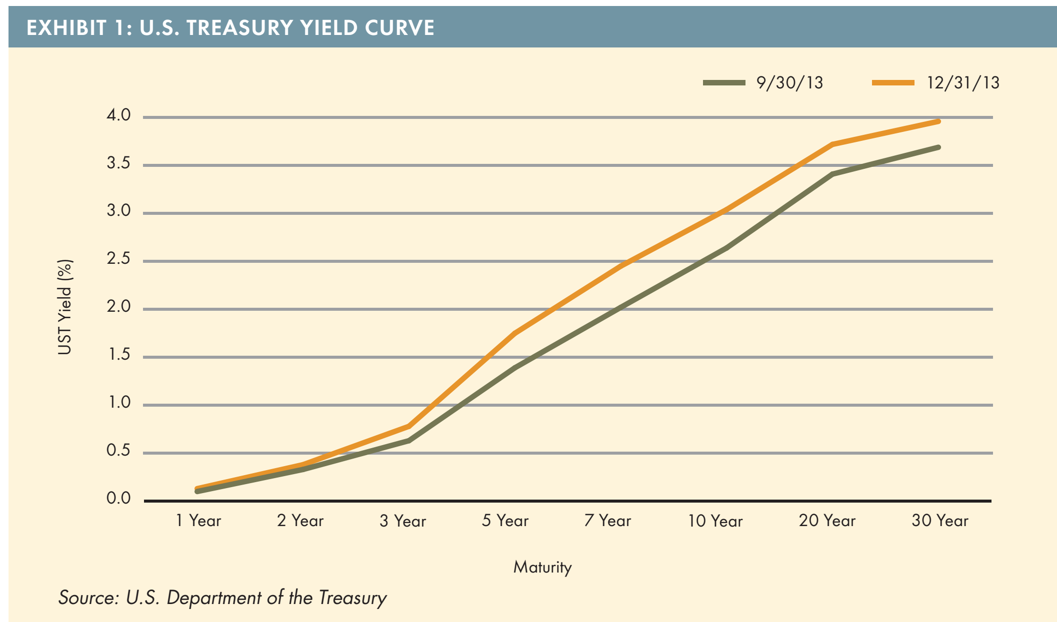
YIELD CURVE POSITIONING

December, 2013 marked the fifth anniversary of the Fed's extremely accommodative monetary policy with the benchmark fed funds rate in a zero to 25 basis points range. At its December meeting the Fed noted the exceptionally low target range for the federal funds rate is likely to be appropriate for a considerable time after its asset purchase program ends and the economic recovery strengthens. According to the Fed, monetary policy will remain accommodative well past the point the unemployment rate falls to 6.5%, as long as future inflation expectations do not rise above 2.5%.

The Fed's communication surrounding when it would begin to taper its assets purchases caused an upward shift across the yield curve and significant movement in the five to ten year portion of the curve during the quarter. Our underweight positioning in the five to ten year portion of the curve was a positive contributor to performance in the fourth quarter. Our current positioning across the curve relative to the Barclays US Aggregate benchmark is as follows:

- Overweight 1-3 year maturities
- Neutral to Underweight 5-10 years
- Neutral to Overweight 10+ years

EXHIBIT 1: U.S. TREASURY YIELD CURVE



Source: U.S. Department of the Treasury

The general market consensus is the Fed will end its asset purchase program by the end of 2014. The team believes the volatility in the five to ten year portion of the curve will continue throughout 2014 caused by economic data, the Fed's communication of their reaction function to economic data, and a reduction in central bank purchases of US Treasuries.

DURATION POSITIONING

Duration was tactically traded long, short, and neutral in portfolios relative to their benchmarks in the fourth quarter as long-term interest rates generally rose in volatile trading. This was a neutral contributor to performance overall.

Despite the rise in interest rates in the last few months, our outlook for short and long-term interest rates hasn't changed. The US economy continues to slowly recover following a deep recession. Economic growth over the 18 quarters of this expansion remains the lowest on record. Inflation readings have also declined, with the Personal Consumption Expenditures (PCE) Index falling 0.5% to only 1.1% in the past year.

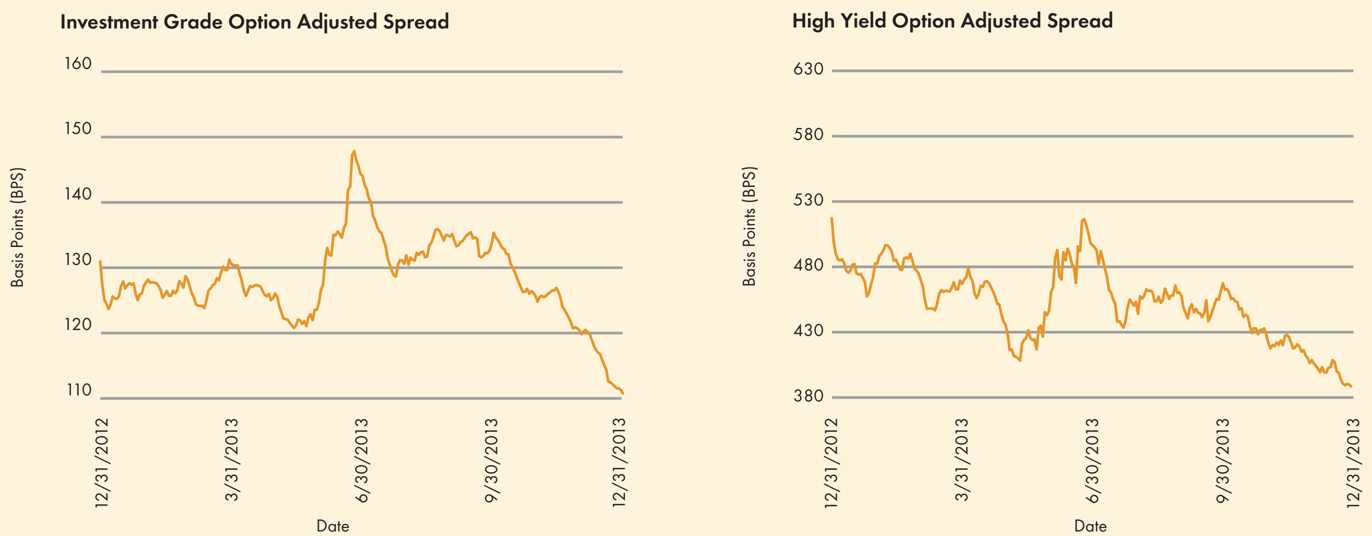
We believe the Fed will need to maintain very accommodative monetary policy over the next few years in order for the recovery to continue. We believe the Federal Funds rate is going to remain in its zero to 25 basis point range for the next few years and this will have the impact of keeping long-term interest rates relatively low as well. The Fed's statement and the Chairman's press conference from their December meeting have reinforced these views.

SECTOR ALLOCATION

Portfolios maintained their significant overweight position in corporate bonds during the quarter, but reduced mortgages. At the end of the quarter, the portfolios were overweight corporates and commercial mortgage-backed securities and underweight mortgages and U.S. Treasuries. The team continues to favor corporates over U.S. Treasuries and mortgages due to strong corporate fundamentals, low default rates, positive technicals, and relative value. Our portfolio positioning in the fourth quarter was a positive contributor to our performance.

Demand for corporate debt continues to be strong, driven by low default rates, an accommodative Fed, and low yields in other fixed income asset classes. The team remains positive on corporate debt, but due to the significant tightening that occurred late in the fourth quarter, the team booked profits at the tightest spreads of the year in order to make room for anticipated new issuance in the first quarter of 2014.

EXHIBIT 2: OPTION ADJUSTED SPREADS – INVESTMENT GRADE AND HIGH YIELD



Data through 12/31/2013. Source: Barclays Live

The team remains underweight U.S. Treasuries and mortgages. As the tapering of asset purchases begins in 2014 we'll look to see how the market reacts and invest opportunistically. It is important to note market liquidity continues to be impacted by the limited size of broker/dealer balance sheets. Our well diversified portfolios and active management philosophy allows us flexibility and liquidity in the unknown, changing environment.

EXHIBIT 3: QUARTER PORTFOLIO CHANGE

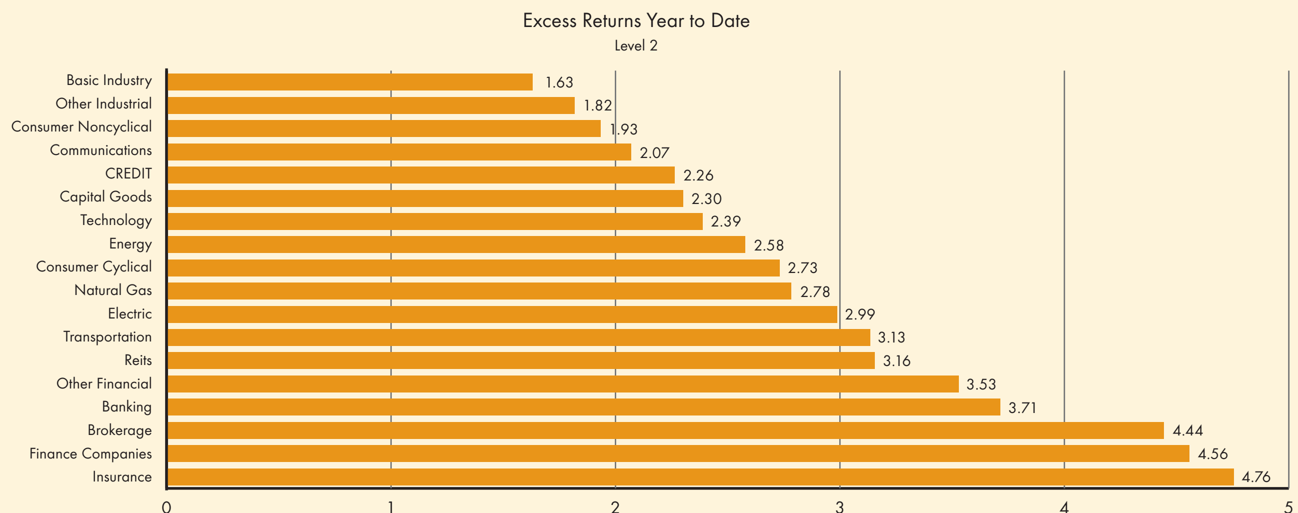
Sector Allocations	Q3 2013	Q4 2013	Change
Treasuries	*Underweight*	*Underweight*	⟷
Agencies	*Underweight*	*Underweight*	⟷
CMBS	*Overweight*	*Overweight*	⟷
MBS	*Neutral*	***Underweight***	↓
ABS	*Neutral*	*Neutral*	⟷
Corporates	*Overweight*	*Overweight*	⟷

Source: Northern Trust

SECURITY SELECTION

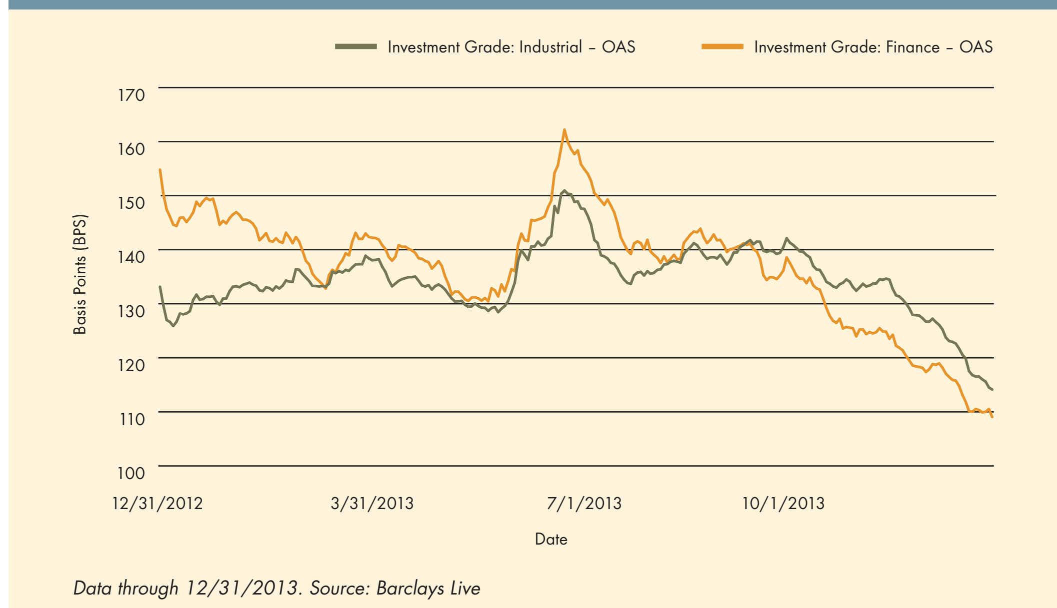
Portfolios continue to be significantly overweight corporate debt, specifically debt of U.S. Financial companies. The fundamentals of U.S. Financial companies continue to look more attractive than those of industrial firms. Financial firms continue to deleverage their balance sheets, while nonfinancial corporate debt has been rising. Financial firms are also subject to significantly more regulation now than they were prior to the credit crisis. The increased regulation has caused these firms to increase their capital, maintain more liquid balance sheets, and curtail some of their riskier businesses.

EXHIBIT 4: INVESTMENT GRADE CREDIT – DECEMBER 2013



Credit spreads for financial firms contracted faster than those of industrial companies in 2013. For the first time since the onset of the credit crisis in 2008, financial firms now trade at tighter spreads than industrial firms. While the market has certainly recognized the improvement in the fundamentals of financial companies, we believe this trend will continue in 2014. Both financial and industrial issuers were positive contributors to performance in the fourth quarter, as our fundamental credit approach allowed us to select bonds that outperformed those in the index.

EXHIBIT 5: INDUSTRIALS VS FINANCIALS



Data through 12/31/2013. Source: Barclays Live

2014 OUTLOOK

2014 will be a year of transition and untried central bank policy. The high turnover within the Fed, highlighted by the transition to Janet Yellen as the new Chair, means it will be important for the Fed to continue to communicate clearly and often to the market. It is our expectation that the Fed will remain focused on providing more specific forward guidance. In addition to the guidance they've provided through changes in levels for the employment rate, we believe they may also add an inflation floor. This comes as the Fed attempts to move away from quantitative easing as the primary tool for promoting the economic recovery. The Fed's credibility on forward guidance will be tested by the market if economic data continues to surprise to the upside, which may cause higher volatility within smaller interest rate ranges as the market weighs competing forces.

The team believes issuers with lower credit ratings will outperform higher quality firms in the new year. Credit spreads for AAA to single A issuers are tight at the current time and provide only limited opportunity to generate alpha. Firms rated BBB down to CCC have a wider dispersion in their spreads and allow our fundamental approach more opportunities.

Asset management at Northern Trust comprises Northern Trust Investments, Inc., Northern Trust Global Investments Ltd., Northern Trust Global Investments Japan, K.K., NT Global Advisors, Inc., and investment personnel of The Northern Trust Company of Hong Kong Ltd., and The Northern Trust Company.

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