MAY 2023

REACHED THE PEAK?

After a 5% move in the Fed funds rate in just over a year, it appears that we may have finally reached the peak policy rate for this cycle in the U.S. – or perhaps more accurately, a plateau in rates. Inflation continues to prove difficult to tame, with headline and core inflation readings largely unchanged from the prior month – with core inflation still nearly 3x the Fed's 2% target. We expect moderating but still stubbornly elevated inflation to put the Fed on hold through the balance of the year – reflecting the tightrope central bankers are walking between price stability (inflation) and financial stability (risking another 'shoe to drop' in the financial markets). Market expectations for where the Fed funds rate will be in January 2024, as seen in the chart below, fell dramatically in the wake of banking system issues. The pricing in of a roughly 1% lower Fed funds rates by January appears either overly optimistic on inflation receding or overly pessimistic that the Fed will have to respond to a significant dislocation in the economy or financial markets.

Contributing to the challenges for central bankers is continued strength in the labor market, including wages. Jobs in the U.S. continue to grow at more than 200k per month, while the unemployment rate is under 3.5% – a 50-year low. Growth in average hourly earnings ticked up in April to 4.4%, well above levels the Fed needs to see to feel comfortable about the return to their inflation target. Wages are elevated in Europe as well, keeping the European Central Bank (ECB) on a tightening path in the short term (the ECB started rate hikes after the Fed).

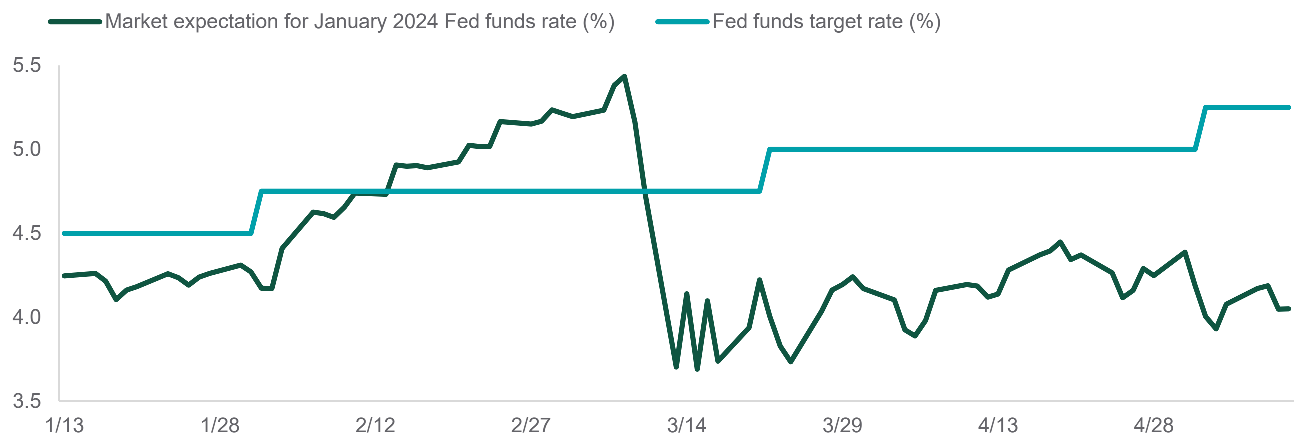
We expect the accumulation of economic headwinds from central bank tightening and some pullback in the extension of credit from banks to lead developed market economies toward stall speed, though we are encouraged that volatility has receded as systemic spillover from banking system issues has failed to materialize. Recession risk appears to have been pushed out, however, as continued labor market strength and reasonably durable corporate profits buoy the near-term outlook. First quarter earnings season coming in better than expected and profit outlooks that seem to support current forward estimates have contributed to flattish markets over the past month despite the stubbornly high inflation backdrop.

We kept our Global Policy Model (GPM) unchanged this month, maintaining an overweight position in high yield bonds, natural resources, and a small overweight to cash. We are underweight U.S. and emerging market equities, as well as investment grade credit. Equity market valuations suggest limited upside in the base case, while avoidance of a significant recession should be supportive of high yield returns.

- Chris Shipley, Chief Investment Strategist – North America

PUMPING THE BRAKES

Market expectations for the Fed funds rate nosedived due to bank stress and now price in a ~1% lower rate by January.



Source: Northern Trust Asset Management, Bloomberg. Data from 1/13/2023 through 5/11/2023.

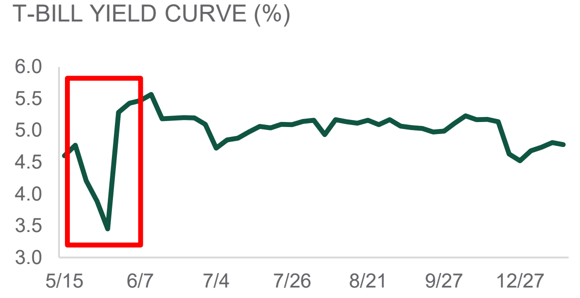
Interest Rates

While the debt ceiling is raising concerns across a variety of markets, the market for Treasury Bills is already showing a strong response. The concern is that Treasury Bills maturing shortly after the so called “X-Date” could face “technical default” or delayed repayment of principal if Congress fails to raise or re-suspend the debt ceiling. Investors have expressed a wide variety of views on holding Treasury Bills in the X-Date window, from risk aversion to excitement citing relative value. The net result, however, is a Treasury Bill yield curve that exhibits a ‘cliff’.

In early May, Treasury Secretary Yellen sent an update to Congress, informing them that weaker than initially expected tax receipts had brought forward the Treasury’s estimate of the X-Date to June 1st from June 5th. Investors seeking maturities prior to June have led to depressed yields well below the current Fed funds target range of 5.00% to 5.25%. Investors active in the X-Date range, which runs through August according to most observers, are requiring a yield premium to compensate them from the risk of technical default. While we view the risk of default as exceedingly low, the reaction in the T-Bill market should not be ignored. We expect continued interest rate volatility as Congress works toward an agreement.

CLIFF OF ANXIETY

Treasury Bill yields shortly after the X-Date have spiked.



Source: Northern Trust Asset Management, Bloomberg. Yields for Treasury bills maturing from 5/15/2023 through 4/17/2024. Data as of 5/10/2023.

- Short-end yield premiums have increased within the expected X-Date range (roughly June through August).
- The risk of default could lead to further curve inversion as investors rush into longer-dated Treasuries.
- A lack of progress on a debt ceiling deal is a key risk to our tactical outlook, but we ultimately expect near-term volatility to subside as an agreement is worked out.

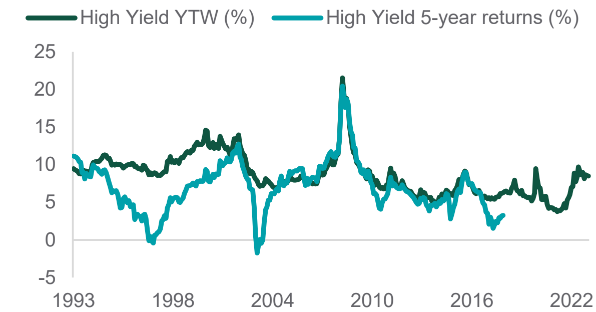
Credit Markets

Uncertainty in the high yield market remains elevated, not only due to the continued battle between inflation and growth, but also due to regional bank and debt ceiling concerns entering the picture and adding a new layer of complexity. However, the post-Great Financial Crisis relationship between all-in yields on high yield and 5-year annualized returns makes for a compelling case given today’s elevated yields (see chart on the right).

With what seems to be the end of the Fed hiking cycle approaching, there are five examples across the last 30 years where Fed policy transitioned to a pause. Historically, high yield bonds performed well following a pause with an average 12-month forward total return of +12.3%. With a likely Fed pause approaching, fundamentals continue to hold in well with company earnings and guidance remaining surprisingly resilient this past quarter. Another potential tailwind is the convexity for high yield corporate bonds, which remains at some of the most positive levels of the last decade with bond prices mostly holding in the 85-90 cents on the dollar range. That's true for each rating tranche, all of which reside in positive territory – opening the path to more-favorable near-term price action should yields retrace.

THE CASE MADE BY YIELDS

Higher yields have generally led to higher 5-year returns.



Source: Northern Trust Asset Management, Bloomberg. YTW = yield-to-worst. High yield proxied by Bloomberg U.S. High Yield 2% Issuer Cap Index. Data from 2/26/1993 through 4/28/2023. Past performance is not indicative or a guarantee of future results. Index performance returns do not reflect any management fees, transaction costs or expenses. It is not possible to invest directly in any index.

- A higher yield-to-worst on high yield bonds has generally been a promising sign for future returns.
- Also, high yield has performed well after Fed pauses – averaging a 12% gain during the ensuing year.
- High yield remains the largest tactical overweight in our global policy model.

Equities

Global equities extended their recovery from the banking stress-induced decline, but the pace moderated to roughly 1.5% over the past month. With the takeover of First Republic Bank by JP Morgan, another weak player was taken off the board and the remaining ones present smaller problems to the sector as a whole, lowering the risk of a wider banking crisis. The Fed is closely monitoring the situation but was confident enough to hike rates by 25 basis points in May. The impact of the banking stress on the broader economy through lower demand and supply of credit is still being assessed. The Senior Loan Surveys in both the U.S. and Europe show further tightening of credit standards and further declines in demand. It is important to keep a close eye on how that trend is transmitted to the real economy over the coming months (see chart).

In terms of relative performance, growth stocks again outperformed value while Europe and Japan outperformed the U.S. and emerging markets (EM). Earnings season surprised markets to the upside but the optimism is moderated by continued margin compression. We have a cautious bias in our expectations and have maintained our underweight positions in U.S. and EM equities in favor of high yield corporate bonds and natural resources.

BANK PULLBACK

Banks have continued to tighten lending standards.

Source: Northern Trust Asset Management, Refinitiv, Datastream. Data from 5/7/1993 through 4/26/2023.

- Bank survey data has revealed tighter credit conditions across the U.S. and Europe alongside weaker demand.
- A persistent credit crunch could weigh on valuations as well as the outlook for corporate profits.
- We remain underweight equities on the belief that valuations suggest limited upside in a stall-speed economic growth environment.

Real Assets

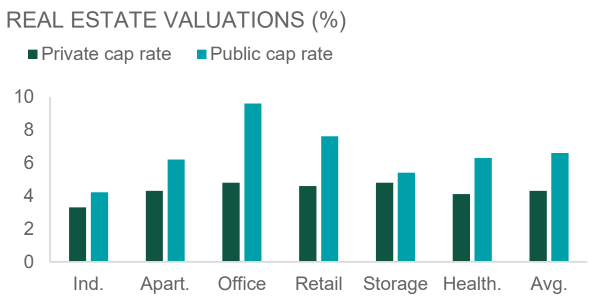
Recent bank stress has put a spotlight on financial stability risks with many investors turning to commercial real estate (CRE) as the next shoe to drop. Our initial analysis suggests manageable impacts to large bank capital adequacy and wider systemic stability, though there is the potential for material losses amongst some regional banks and others disproportionately exposed to CRE as loans mature over the next several years.

More pertinent to our tactical outlook is the extent to which these issues and broader debt dislocations lead to a pullback in bank lending. Private lenders can mitigate curtailed bank credit, depending on the severity of the credit supply shock. Moreover, any credit supply shock would also lower credit demand as investment confidence is dented. All-in-all, we expect debt dislocations to continue to serve as a modest headwind to global growth.

Finally, from the perspective of global real estate (GRE), public markets have revalued considerably over the past couple years in light of the fairly obvious challenges facing office (as well as retail) properties. The nearby chart shows public and private cap rates (higher indicates lower valuations). The amount of further property depreciation already priced in keeps us equal-weight the asset class.

PROPERTY REVALUATION

Public real estate valuations have repriced lower.



Source: Northern Trust Asset Management, Green Street Advisors. OCDE appraisal cap rates (private cap rate) as of 12/31/2022 based on constituent fund reporting. Public REIT implied cap rates (public cap rate) as of 3/31/2023.

- Public cap rates – particularly in the office and retail segments – have increased.
- Private cap rates tend to lag public, suggesting future downside for private real estate valuations.
- Despite interest rate volatility and office-related risks, we remain equal-weight global real estate given a decent amount of property depreciation is priced in.

BASE CASE EXPECTATIONS

Approaching Economic Stall Speed

Recent banking issues and consequent impacts on bank lending, as well as spillover economic implications from worsening sentiment, add pressure to the growth trajectory. Other lending sources (think private credit) can partially backfill credit availability, but overall growth should be fairly flat over the next year.

Monetary Tightrope

Given concerns regarding financial stability from the rapid pace of tightening, the Fed has shifted to a more "wait and see" stance – likely done raising rates for now – while the ECB stands to raise a bit more. Inflation is still too high currently, however, suggesting the potential for more in the U.S., and we do not see rate cuts in 2023.

RISK CASE SCENARIOS

Debt Dislocation

Lack of progress on a debt ceiling deal (which would likely further invert the yield curve) and/or further banking fallout (a risk heightened by the already inverted yield curve) further impairs investor sentiment.

Labor Market Durability

More persistent tightness in the labor market leads to more stubborn core inflation, necessitating an unexpected monetary policy response that is negative for financial markets.

GLOBAL POLICY MODEL

	RISK CONTROL		RISK ASSETS								
	FIXED INCOME				EQUITIES			REAL ASSETS			
Strategic Allocation and Tactical Over/Underweights	Cash	Inv. Grade	Infl. Linked	High Yield	U.S.	Dev. Ex-U.S.	Emerg. Markets	GLI	GRE	NR	Gold
Strategic Asset Allocation	2	34	5	5	27	13	6	2	2	4	0
Tactical Asset Allocation	4	28	5	11	25	13	3	2	2	7	0
Over/Underweight	**2**	**-6**	**0**	**6**	**-2**	**0**	**-3**	**0**	**0**	**3**	**0**

Source: Northern Trust Capital Market Assumptions Working Group, Investment Policy Committee. Strategic allocation is based on capital market return, risk and correlation assumptions developed annually; most recent model released 8/10/2022.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. Asset allocation does not guarantee a profit or protection against a loss in declining markets.