NORTHERN TRUST

GFO Newsletter – Q4 2016

AND NOW FOR SOMETHING COMPLETELY DIFFERENT

January 2017

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"In order to understand the world, one has to turn away from it on occasion."
-Albert Camus, The Myth of Sisyphus

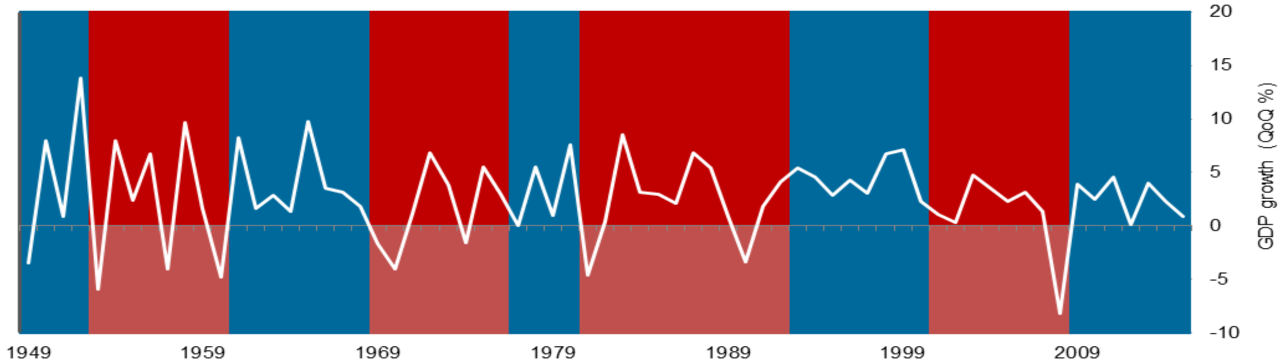
There are striking similarities between the Algerian / French philosopher Albert Camus and the late 60's British comedy troupe Monty Python. In many ways Monty Python embodied the way in which British Society would, periodically, turn away from itself in order to contemplate, understand and reorient itself to the world in which it was living. While not quite the 1960s counter cultural revolution witnessed in the United States, there were clearly changes afoot in both the UK and neighboring Europe which were frequently at the pointed end of a Python skit. Concurrently, Camus understood the power of humor and its role in the construction of reality - especially that which, from time to time, is most unexpected. And so, as it was with BREXIT, the world was caught by surprise as the most unlikely of outcomes became reality in the US election contest - the culmination of now President-Elect Trump.

Early market trepidation reversed course and by the opening bell of November 9th market sentiment had shifted, marking an understanding that the real story of the 2016 election was the "Republican Sweep." With the first full governing majority rule in over six years, the possibility for sweeping legislation came quickly into relief. Tax, regulation and spending policies long held hostage (by both sides of the isle) were now, potentially, in play.

And so the Market decided to price in a "Fiscal Thrust", the kind of which we haven't seen since the New Deal. Partisan politics aside, it is important to note that there has not been a Republican President in the post-war period that has not overseen a recession. As my former colleague Joachim Fels wrote in his Macro Blog in late December, the plan could be to follow William Dunkelberg's observation from the 1970s which suggests that political parties often engineer early-term recessions only to easily bounce back as the next election cycle hits.

Machiavellianism at its best.

Accidents of History?
GDP US Chained 2009 Dollars OoO SAAR



Source: Bloomberg

**A special thank you to Jim Mungovan, Stephen Proffer and the team at 50 South Capital for their input this quarter.*

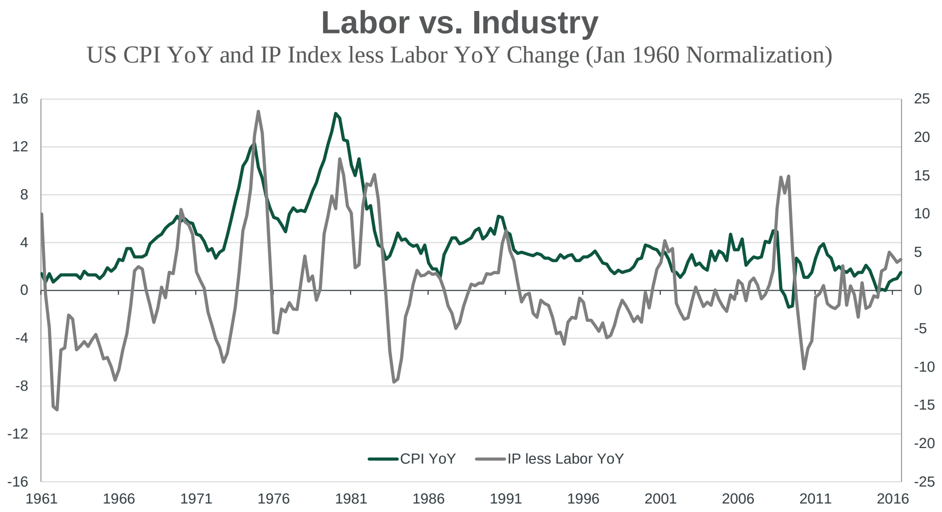
It remains unclear whether there is, indeed, a clear path to all that US markets seem to have priced in. Fiscal thrust of the magnitude that the President Elect has outlined would require more than a little extra debt issuance – something many in the Republican Party will likely have trouble accepting.

Debt and deficits aside, remember that global equity markets peaked at the beginning of October and spent the balance of the quarter underwater only reaching positive territory in early December and producing a lackluster 1.3% return. Yields, globally, also corrected course with the US 10-Year Treasury moving a swift 85 bps northward during the quarter. German Bunds, which had spent much of the summer in negative territory, once again produced positive yields. And, the lower for longer camp – one which at times seemed here to stay - quickly packed its bags after the US election and headed for home.

The jury remains out, and will for some time, on the permanence of recent rate increases.

Geopolitical risks remain at levels not seen since the end of the Cold War. A populist movement in Italy felled the latest pro-European head of state, Matteo Renzi, and in a nominal reminder of how World War I broke out, the Russian Ambassador to Turkey was shot in Ankara; the same day terrorists drove a truck through a Berlin outdoor Christmas market**.** All of this formed the backdrop to a quarter which saw the stalwart US market finally show signs of exhaustion, putting in a 9 day decline in October, the likes of which we had not seen since 1980. Notwithstanding this temporary stumble, the US market did recover, ending the year on a high note.

We always end this section with a little inside baseball.



Source: Bloomberg. Quarterly observations 3/31/1960-9/30/2016.

We've been wondering out loud about the historical relationship between labor and industrial production as they are, typically, the building blocks to sustainable bouts of inflation. Historically, when labor outperforms industrial production, this tends to cause inflationary pressure, however at the moment the data doesn't suggest that's happening.

A couple of points here:

1) US Industrial Production has not exceeded pre-crisis levels despite success in the energy and car production sectors.

2) As labor outperforms the production base, inflation is rising. Historically, such an impulse is in response to an inventory overshoot. This is the root support of the return to inflation argument – though it's worth noting the bar is low.

3) If this growth in employment is nominally government funded, we may have an issue.

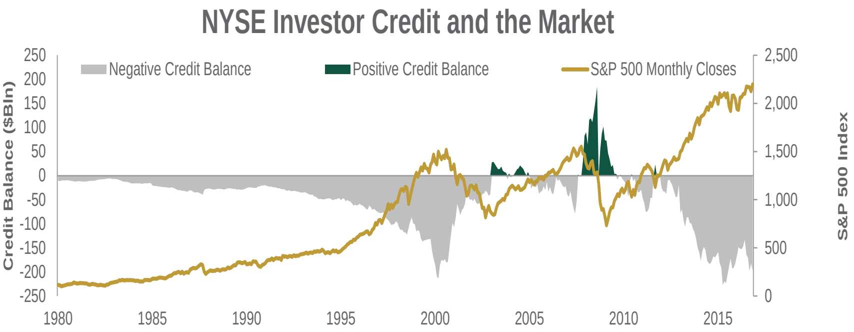
Productivity tends to rise when governments embark upon privatization initiatives. This mechanism is simply that the private sector is much more incentivized to show profits than the government and labor are relative to output. The converse is likely true as well. Productivity can fall if the government undertakes a significant expansion of services. This time frame of labor outperformance (without a recession) dovetails the period of the enactment of the Affordable Care Act. The data supports most insurance companies claim that they are losing money on the arrangement. So, the expansion of health care, while significant, may be occurring at a financial loss. Productivity fell but was offset by an upward demand shock most likely concentrated in healthcare services (also reflected in labor growth).

The implications are significant. A supply side program enacted by the new administration with a significant roll back of the Affordable Care Act, for example, could be highly supportive of improving US productivity but, the labor market and labor income may have dead weight losses under such a scenario. Typically, in a recovery, IP outperforms labor due to "sold out" inventories and inflation rises. The opposite could happen this time. As production outperforms labor, the economy could actually fall into a recession given the potential for a significant demand bust emanating from a contraction in services. Government and household borrowing may underwhelm in such a scenario.

Ultimately, this begs the long debated question as to whether or not the US economy is healthy enough for the awaited hand-off from monetary to fiscal policy. We are about to find out.

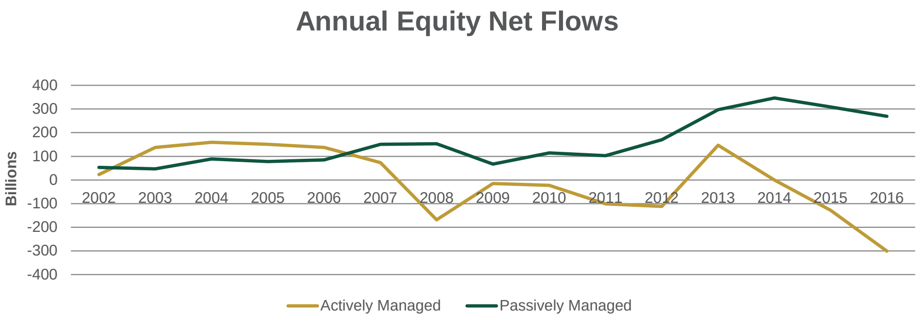
THE CHARTS

There are many types of fuel for the Market. Leverage remains in many parts of the financial system. It's worth noting this structural aspect of the current rally. Negative credit balances and air pockets in market prices seem to have a high correlation.



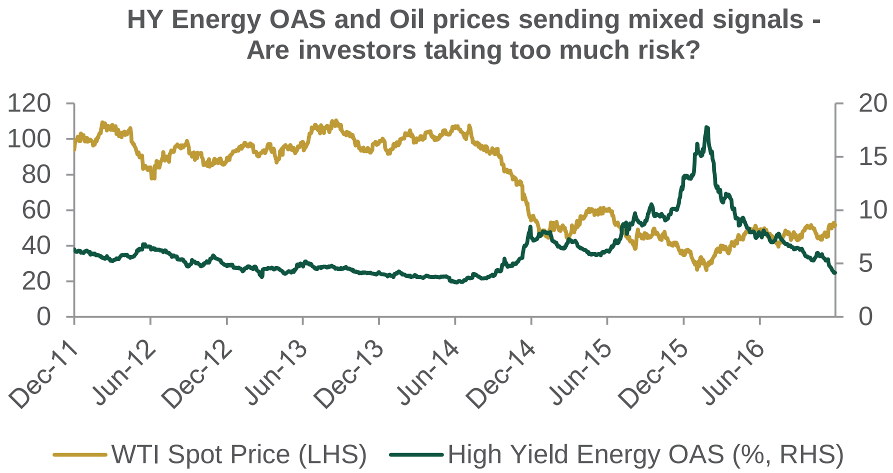
Source: NYSE, Standard and Poor's

Another year and another victory lap for our friend Jack Bogle. We love this chart not because it disparages active management but because it suggests, as we have long professed, that it is simply very difficult to locate reserves of permanent skill.



Source: Morningstar. 2016 data is through 11/30/16. Data includes 'Sectors', 'International' and 'US' Equity

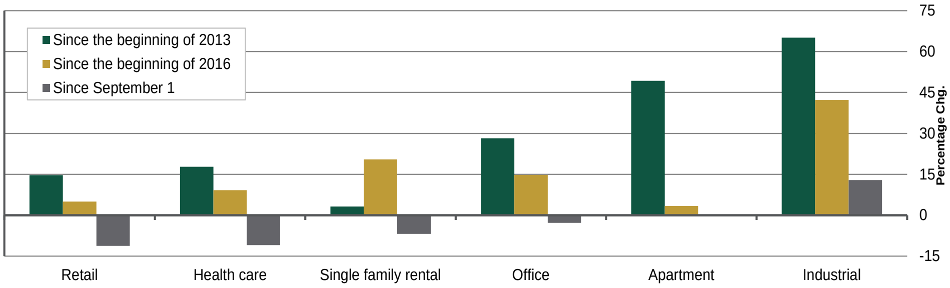
One could be forgiven for thinking there was an actual relationship between oil prices and energy default rates. While spreads have come in, it seems that such enthusiasm may either be short lived or unwarranted. Hopefully not both! Saved by the bell?



Source: Bloomberg Barclays High Yield Energy Average OAS, Bloomberg West Texas Intermediate (WTI) Cushing Crude Oil Spot Price. Data through 12/16/2016

Some asset types are more interest rate sensitive than others and some sectors are impacted more than others. Remember that not only is the REIT asset class interest rate sensitive, it is also deeply mean reverting. Pick your spots wisely.

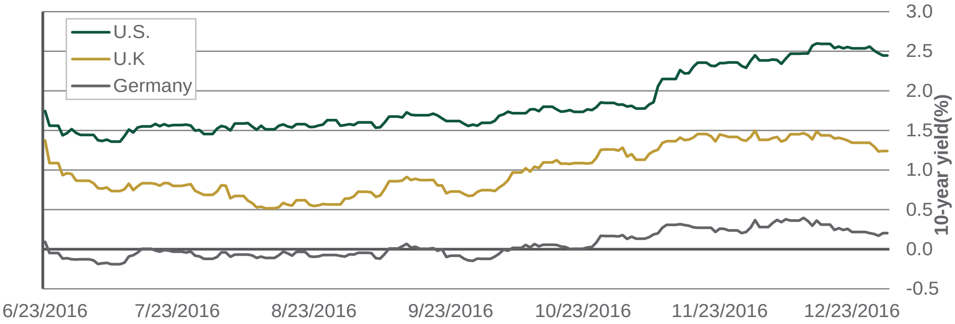
REIT Stock Price Chg (%)



Source: Bloomberg Intelligence. Data as of 12/20/2016

We came into 2016 talking about what the landscape for a rate move might look like, but nothing would have prepared investors for the 100+ basis point moves experienced from the summer through the middle of December.

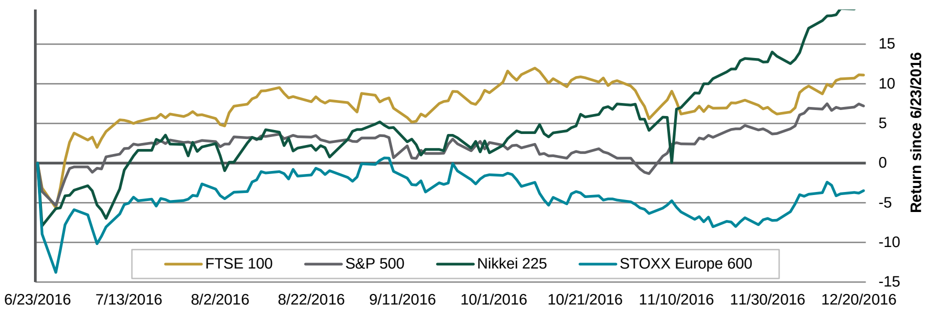
10-Year Yield (%)



Source: Bloomberg

Dreams of inflation seem to be the sugarplum ferries dancing in Japan. Meanwhile a more sanguine scenario is emerging in the UK. All the while, Europe toils in the cul-de-sac of banking reform and Euro currency doldrums.

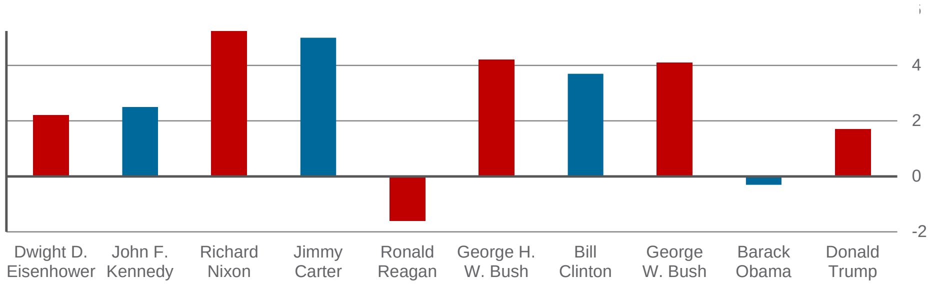
Global Equity Market Returns (%)



Source: Bloomberg

GDP CYoY Index

Earlier we talked about the coincidental nature of recessions and White House administrations. Here's a picture of the economic trajectory each incoming team has inherited since WWII.



Source: Bloomberg

Q4 2016: What We Have Learned, What We Need To Know

Major market indexes have risen to record levels since the election on the back of rising optimism that the Republican sweep at both ends of Pennsylvania Avenue will usher in a new era of economic growth. What have we learned about the reasons for that optimism and weather it will carry over into the next quarter?

For starters, the market seems to believe the new administration's program will produce a successful hand-off of monetary to fiscal policy. More specifically, it seems to believe that the combination of tax cuts and increased spending will boost economic growth without causing a major spike in interest rates. There are some reasons to believe that the market is correct in this assumption. It is likely that any increase in interest rates driven by larger deficits and Fed rate hikes will be, in part, offset by new inflows of foreign capital or by the potential repatriation of corporate profits from abroad. It is also likely that inflationary pressures will continue to be contained by plentiful energy production, continued overcapacity in many sectors of the economy, and by some continued slack in the labor market. Indeed, it is possible we could achieve a new Goldilocks era of slightly higher interest rates (good for retirement income) and stronger economic growth (good for profits and jobs).

Trump to Start With a Boost Compared to Obama
Looking across 10 key indicators, Trump will inherit a far healthier economy than the one Obama did

	Period Comparison	What Trump will inherit from Obama	What Obama inherited from Bush
Real GDP (yoy)	3Q '16 vs 3Q '08	1.7%	-0.3%
Gov't Budget Balance (% of GDP)	Sep '16 vs Sep '08	-3.1%	-3.1%
Unemployment Rate	Nov '16 vs Nov '08	4.6%	6.8%
Chg. In Nonfarm Payrolls (mom)	Nov '16 vs Nov '08	178k	-769k
Avg. Hourly Earnings (yoy)	Nov '16 vs Nov '08	2.4%	3.8%
PCE Price Index (yoy)	Nov '16 vs Nov '08	1.4%	1.2%
Industrial Production (yoy)	Nov '16 vs Nov '08	-0.6%	-8.7%
New Housing Starts (saar)	Nov '16 vs Nov '08	1,090	652
Conference Board Leading Indicator	Nov '16 vs Nov '08	0.0	-3
Consumer Confidence Index	Dec '16 vs Dec '08	98.2	60.1

Sources: Bureau of Economic Analysis, U.S. Treasury, Federal Reserve, Conference Board, U.S. Census Bureau, Bureau of Labor Statistics, University of Michigan

Second, the market has come to value the incoming administration's pro-growth policies of corporate tax cuts and de-regulation. For many companies, less regulation coupled with tax reductions could mean more profit. However, the combination of such programs may in fact have an impact far beyond the bottom line; it has the potential to change the entire investment climate by re-igniting what John Maynard Keynes called the "animal spirits". Just as pollsters and political pundits may have misread signs in electoral sentiment, economic and market commentators may have underestimated the extent to which current-era regulation and taxes were holding back business investment. We often talk about pent-up demand; today we may be seeing the beginning of the unleashing of pent-up investment desire.

Finally, the market has correctly sniffed out the promise of what could be a healthy re-balancing of the US economy and the correction of structural problems. The Russell 2000 has outperformed the other indices, and industrials and energy have been the best performing sectors trailing only financials-for good reason. The promise of corporate tax cuts and less regulation together with a tougher trade policy, stand to benefit domestic producers more than large-cap multinationals that produce abroad, and large technology companies whose revenues are derived largely from intellectual property. Add in the collective calls for a major increase in infrastructure investment and military spending; the economic agenda also has the potential for improving the structure of jobs in the country by adding more middle-wage jobs and fewer lower-wage service jobs. Indeed, one of the promises of the new administration's agenda is that it will expand sectors of the economy, like manufacturing, that have higher productivity and produce better paying jobs. This holds the prospect of increasing both US productivity and US wages, which in turn benefit both profits and growth.

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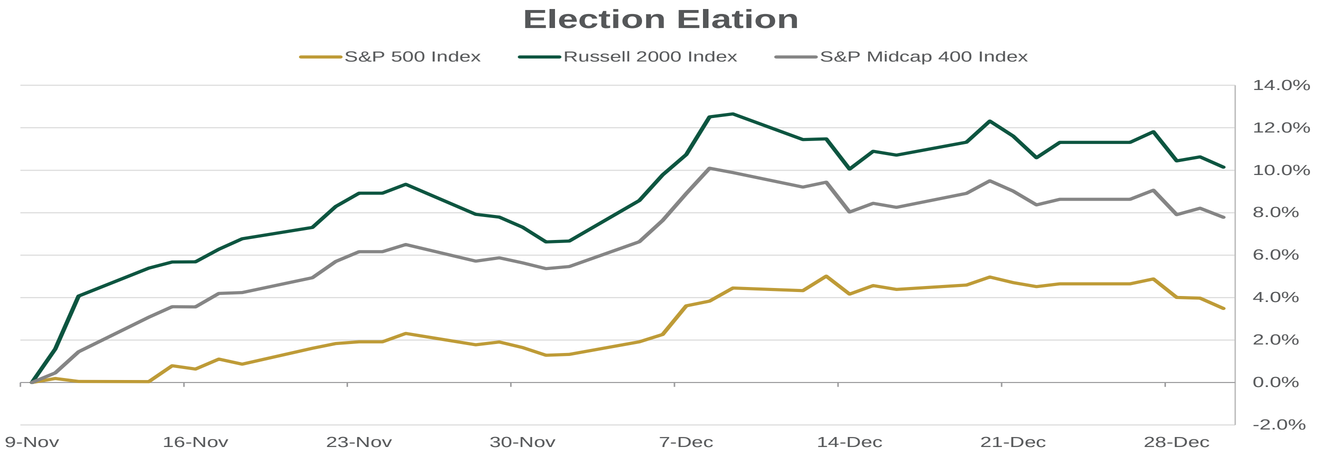


Source: Bloomberg: S&P 500 Index, Russell 2000 Index, S&P Midcap 400 Index. Daily index values 11/9/16 – 12/31/16

In sum, the market is eagerly anticipating a new agenda for economic growth, earnings, investment, and jobs. However, it is also possible that, as we head into to the first quarter of 2017, the market will move from its current focus on promise to one of worry and uncertainty. We therefore must be prepared for an air pocket in market sentiment. Investors will need to be mindful of at least three key factors in the months ahead:

- Pace
- The Dollar
- Trade

The first relates to whether Congress will enact major parts of the Trump agenda and how quickly. There are still significant disagreements between the incoming Trump administration and the Republican Congressional leadership on his infrastructure program, on aspects of his tax proposals, and on the wisdom of deficit spending even in the short-term. Thus, there is a risk of a new kind of gridlock.

A second worry is that of a strong dollar caused by U.S. economic vibrancy relative to weakness in economies abroad. Any initial economic boost from Trump's economic agenda could thus be undercut by a stronger dollar, hindering the administration's goal of reducing the trade deficit and on-shoring more US production. In January 2016, worries about capital outflows from China and weakness of the RMB roiled the markets. One cannot rule out similar disturbances in the first quarter of 2017. And finally, there are the much commented-on array of risks that come from a new administration who may challenge our trade partners and our major corporations in unpredictable ways.

Private Credit

Given the recent moves in global fixed income - in particular in the United States - we have found it necessary to reexamine the relative attractiveness of various forms, types and durations of credit. In particular, we are focusing our attention on the sector known as private lending or private credit.

The main growth of this business in the post crisis period is located at the ground zero of regulatory reform in the post crisis environment. Basel III and Dodd-Frank laid down numerous rules and road blocks to banks that were once the ready and sole source of capital provision. With many investors now eyeing illiquidity premiums and barriers to entry as two additionally attractive characteristics, one has to pick through these opportunities with a very particular lens to maintain long-term success.

In the current, historically low, interest rate environment, we believe there remains a favorable risk/return opportunity that can be achieved by investing in lower middle market direct lending opportunities. There are three separate characteristics that we believe differentiate this opportunity to deploy capital from others:

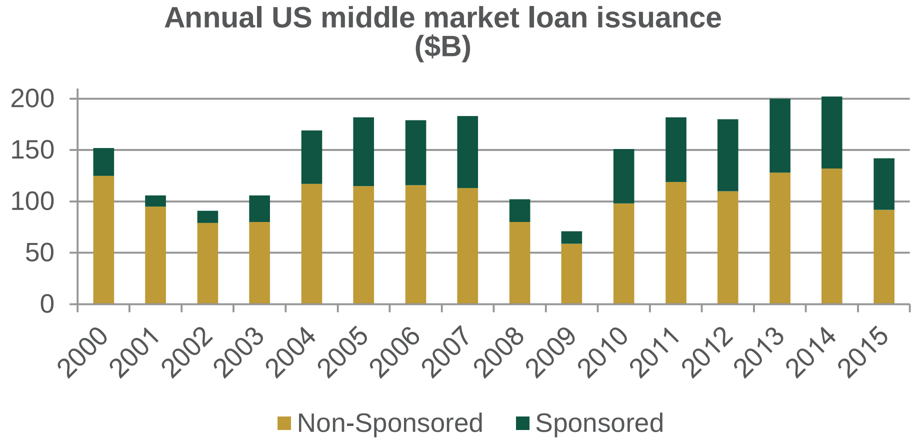
- The Middle Market
- Investment Potential
- Risk Characteristics

Continuing to locate well sourced risk adjusted returns is the core of what GFO investors spend the bulk of their time doing. What follows are some of the market-based characteristics that we've identified as potentially compelling. We then conclude with a matrix of how one might think about the broader opportunity set.

The Middle Market

If one is looking to source a new credit opportunity, it stands to reason that a combination of capitalization and market player dynamics should drive investor behavior and, more importantly, economic outcomes. So, when we are evaluating the middle market in the United States, what characteristics can we clearly identify as attractive?

- The middle market is the largest target market by number of companies;
- Transactions and dedicated private equity funds;
- Over the last 20 years, institutional investors have become the dominant buyers of LBO financings as banks have focused their capital in other areas; and
- Established, well entrenched funds, command strong market share, high barrier to entry, and the ability to negotiate enhanced terms.

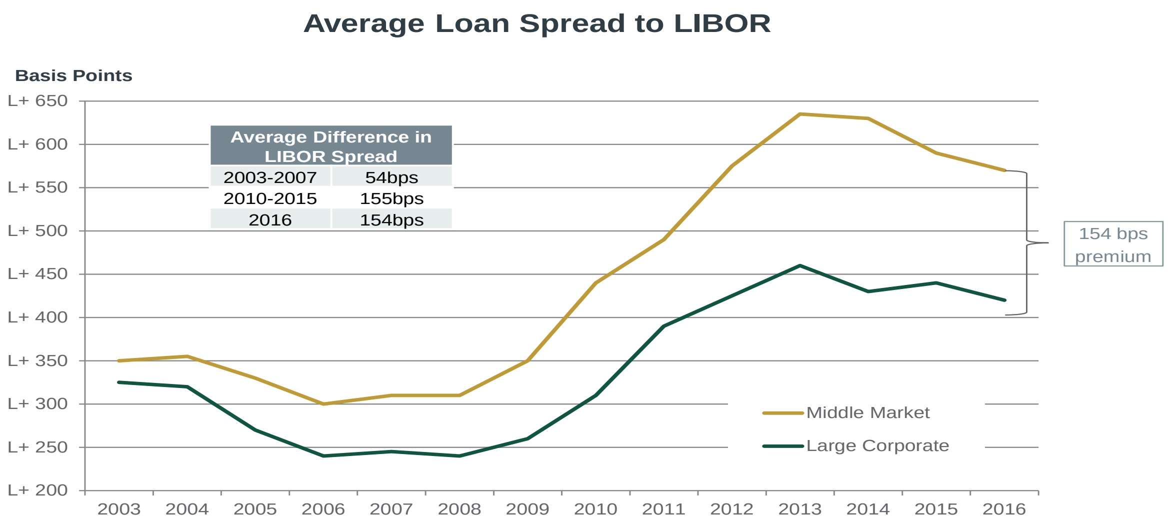


Sources: Thompson Reuters, S&P Capital IQ LCD 2013

Investment Potential

Now that we've identified the attractive characteristics of the market segment we should begin to understand how they translate into a broader return on capital. Traditionally, there are a number of features that suggest the middle and lower middle market have attractive investment potential:

- Lower and middle market ("LMM") funds generate a higher yield than the broadly syndicated loan market or high yield debt offerings given the inefficiencies in the market and relationship-based nature of the investments.
- Lenders acting as lead-agent garner incremental return through origination, amendment and other fees.
- More limited J-Curve and shorter duration than a buyout or venture private equity fund.



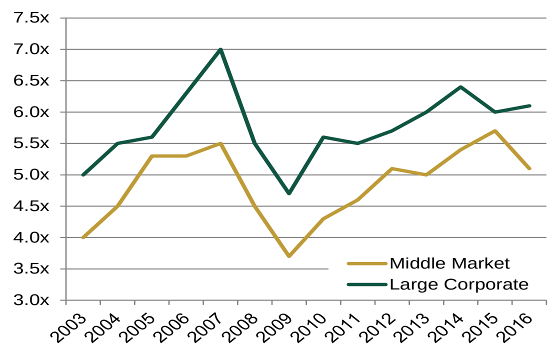
Sources: Thompson Reuters, S&P Capital IQ LCD, Middle Market represents issuers with <$50M in EBITDA

Risk Profile

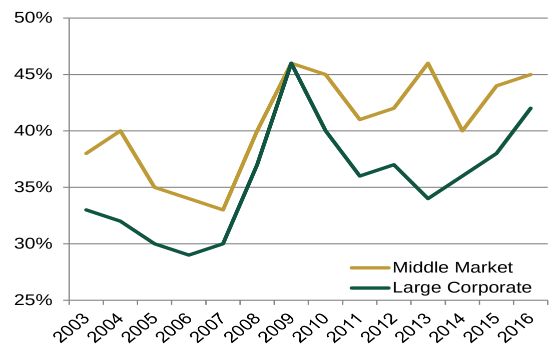
Finally we must review the opportunity set in the ever-present context of risk and risk management. These markets are less liquid. These markets are populated with businesses that require very sharp pencils when looking to avoid loan losses. And so, understanding the nature of risk in the marketplace is crucial to investors looking to put capital to work:

- *Lower Leverage and Stronger Covenants:* Significant equity cushion provided by deep pocketed, sophisticated private equity investors. More favorable covenant packages relative to high yield debt.
- *Lender Dynamics:* LMM lenders are "buy and hold" investors. This mentality increases the focus in due diligence, and builds closer relationships with the companies to which they lend. In a downside scenario, there is a smaller lender group to work toward a resolution, which often leads to higher recovery and lower loss rates.
- *Floating Interest Rates:* Debt is floating rate as opposed to fixed, reducing the risk of a rising interest rate environment.

LBO Debt to EBITDA



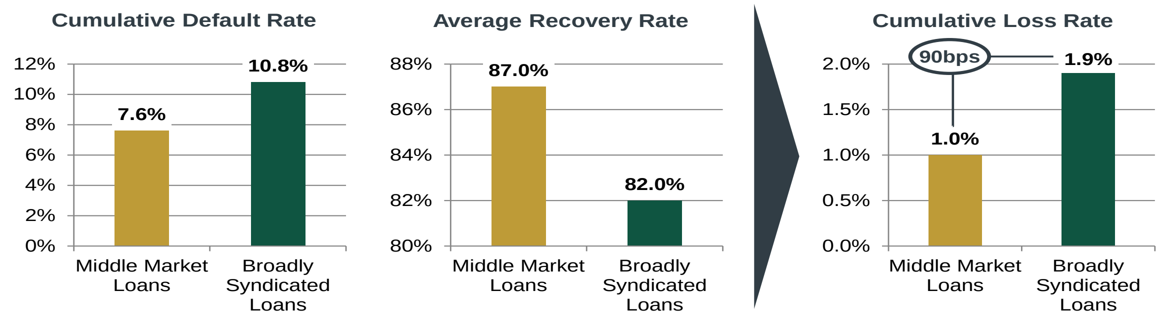
Equity Contribution for LBOs



Sources: Thompson Reuters, S&P Capital IQ LCD, Middle Market represents issuers with <$50M in EBITDA

Given the lower leverage, stronger covenants, and enhanced due diligence required for "buy and hold" investors, the cumulative loss rates are nearly half that of broadly syndicated loans. This creates a very attractive risk return dynamics where investment potential for middle market loans is higher than broadly syndicate loans, yet the risk is also lower when measured by loss rates. There is a trade-off in liquidity, but we believe the risk return dynamics make this an attractive asset class in this environment.

Default and Recovery Rates (1995-Q2 2015)[1]



1. Standard & Poor's LCD; Credit Pro. Data refers to 1995-Q2 2015 time period

A Matrix for Success?

Borrower size	Small	Medium	Large
Company type	Healthy	Opportunistic	Distressed
Product mix	Senior	Unitranche	Mezzanine
Agent capabilities	Lead	Club	Syndication
Deal sponsor	Private equity	Independent	Management
Geography	U.S.	W. Europe	Rest of world

For Illustrative Purposes Only

As we leave 2016 behind and think about opportunities in a rebalancing US economy where incentives to invest in US companies may be at a generational high, we suggest taking a path of caution and care when identifying lower and middle market lending opportunities.

Stay in the middle of the market with healthy companies, high up in the capital stack where your agent is the lead and a deal sponsor is the Private Equity firm that has already plowed significant commitments into the company. Here the incentives are aligned through the “buy and hold” mentality and investors aren’t taking the excessive risk as seen in distressed or mezzanine debt strategies. Focus due diligence attention on the developed economies of the US and Europe where legal structures are clear and should trouble arise, resolution relatively straight forward.

These are unique opportunities for true long-term asset holders and for those looking to avoid the vagaries of credit markets driven by Fed Watchers and Wall Street fixed income trading desks.

Have a great 2017.

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