NORTHERN TRUST

2019 OUTLOOK

FIRST TO NEUTRAL

DECEMBER 2018

We enter 2019 facing slowing global economic growth, tightening U.S. monetary policy and ongoing trade tensions. While this has given rise to increased market volatility, we don't expect a recession to unfold over the next year.

During 2018, we steadily decreased our risk, arriving at neutral before the Federal Reserve got to its "neutral" rate of interest. Because the outlook for 2019 remains hazy, hinging in large part on the message sent by the Fed at its upcoming December meeting, we have moved to mostly neutral while we assess our next move and look for risk-taking opportunities.

Mild Growth Myopia has been the driving theme of our tactical outlook, leaving us less concerned with the recent growth slowdown. Instead, we're heading into 2019 looking for risk-taking opportunities.

1 **Mild Growth Myopia.** Just as we didn't get too excited about the acceleration in U.S. growth over the past two quarters, we are not overly concerned with the recent growth slowdown. Instead, we head into 2019 looking for opportunities for risk-taking.

2 **Stuckflation.** Continued low inflation gives central banks an excuse to either take their foot off the brake or continue easy money policies. This has allowed us to take an opportunistic approach: earning positive returns is easier when companies don't have to "fight the Fed" or other central banks.

3 **Pass/Fail Monetarism.** Recent comments from both the chairman and vice chairman suggest the U.S. Federal Reserve may finally appreciate the benign inflationary environment. It took longer than we expected, but the Fed may squeak by with a passing grade.

4 **Technology Slowzone.** The tech sector, which was the main driver of equity returns throughout 2017 and into 2018, turned into a drag the past few months. Social media stocks have been especially hard hit.

5 **Global (Re) Positioning System.** The recent G-20 meetings indicate that our fairly benign views on protectionism are playing out as we expected.

6 **Executive Power Drive.** Ongoing U.S.-China interactions are causing some volatility in the markets, as we expected. However, instead of being swept under the rug, conflicts are being addressed by talking openly.

ASSET CLASSES

Equities

Equity markets remain largely tied to the Federal Reserve and the news flow on trade. While the Fed's job is not to make the equity markets happy, its December meeting will largely set the tone for 2019.

In 2019 we expect:

- Markets will remain focused on the Fed, U.S./China relations and Brexit, in that order.
- The Fed's messaging will be as important as whether it hikes rates.
- Until we get clarity on the Fed's plans, we are maintaining an overall neutral risk profile.

We are underweight emerging markets and neutral developed market equities

Fixed Income

Higher interest rates and wider credit spreads throughout 2018 led to flat or slightly negative returns. High yield has outperformed investment grade debt, which has cushioned against the higher rates.

Looking to 2019:

- High yield looks attractive compared to equities, especially on a risk-adjusted basis.
- Investment grade returns are catching up to high yield thanks to end-of-year falls in both interest rates and equity markets.

Investment-grade and high-yield fixed income are our only overweights.

Real Assets

Real assets underperformed the broader equity market in 2018, thanks to the effects of higher interest rates (real estate and infrastructure) and falling oil prices (natural resources).

In 2019 we expect:

- Global real estate and infrastructure will be attractive if the Fed pauses its rate hike campaign.
- A dovish Fed also would likely support dollar-based commodity prices, benefitting natural resources.

We are starting the year neutral across all real assets.

Interest Rates

The U.S. Treasury yield curve continued to flatten through 2018; a mere 0.1% separates the two- and 10-year yields and some parts have actually inverted.

In 2019 we believe:

- Other central banks will remain dovish, putting pressure on the Fed to do so as well.
- The financial markets are telling the Fed to pause its rate-hiking campaign. We expect the Fed will listen and only raise rates once more.
- Interest rates will remain near current levels.

We are looking for signs of a more dovish Federal Reserve in 2019.

* Source: Northern Trust. Bloomberg. Returns greater than one year are annualized. 2018 return data through 11/30/2018.

		Asset Class Key Views	TAA*	SAA**	Key Views
Risk Assets	EQUITIES	DEVELOPED MARKETS **Neutral**	39%	39%	Despite somewhat elevated valuations and slowing economic growth, the lack of inflationary pressures keeps us neutral toward U.S. equities. Valuations in Europe and Japan are more attractive, where continued accommodative monetary policy should provide a floor for slowing growth. Brexit must be settled before we consider reasserting an overweight position.
Risk Assets	EQUITIES	EMERGING MARKETS **3% Underweight**	6%	9%	Our underweight position reflects the disproportionate hit emerging market equities would continue to take should the Fed continue its current rate hike trajectory (our key risk case). The risk of continued tensions between the U.S. and China also weighs on emerging market equity prospects. Should these risks subside, attractive valuations may argue for an increased allocation sometime in 2019.
Risk Assets	REAL ASSETS	GLOBAL REAL ESTATE/ INFRASTRUCTURE **Neutral**	4%	4%	Global real estate and listed infrastructure continue to offer high income and diversified risk exposures. We retain a strategic position as we do not expect interest rates to move much higher, which would negatively impact returns of these cash flow assets (relative to pure equities) over the tactical horizon.
Risk Assets	REAL ASSETS	NATURAL RESOURCES **Neutral**	5%	5%	We remained neutral throughout 2018. In the case of unanticipated inflation, equity-based natural resources serve as solid protection. Inflation is unlikely to meaningfully accelerate over the next year but a strategic allocation helps diversify the portfolio as well as alleviate the effects of geopolitical risk.
Risk Assets	FIXED INCOME	HIGH YIELD **8% Overweight**	11%	3%	High yield fixed income represents our biggest overweight. The "downside mitigation, upside participation" nature of the asset class is attractive given our expectation for slowing, but positive, economic growth amid geopolitical distractions. Solid fundamentals (including falling default rates) and constructive technicals (given reduced issuance) make high yield attractive over the tactical horizon.
Risk-Control Assets	FIXED INCOME	INVESTMENT GRADE **1% Overweight**	35%	34%	Throughout 2018, any time the 10-year Treasury yield moved higher than 3%, we used it as an opportunity to increase our position — moving from a material underweight at the start of the year to a slight overweight. We think interest rates will remain contained and inflation will stay "stuck."
Risk-Control Assets	FIXED INCOME	INFLATION LINKED **4% Underweight**	0%	4%	Our Stuckflation theme underlies our underweight position. Last year's cyclical uptick in inflation has rolled over, overcome by structural forces found within both supply (technology) and demand (demographics). Where inflation-linked bonds are used, we prefer targeted duration strategies to maximize exposure to inflation expectations and minimize exposure to interest rates.
Risk-Control Assets	CASH	CASH **2% Underweight**	0%	2%	Following three rate hikes in 2018, cash is providing low but measurable returns above inflation. However, given we only expect one more hike over the next year, we see better opportunities further out on the duration and credit spectrum. We remain underweight, viewing cash as an asset class used primarily for meeting near-term liquidity needs.
		TACTICAL RISK POSITION: **Neutral**			We are neutral risk, with our greatest overweight to high yield fixed income funded by our underweights to emerging market equities, inflation-linked bonds and cash. Our risk cases include the Fed tightening too far and the ongoing rift between the U.S. and China. We think high yield will provide upside participation and downside mitigation as compared to equities.

*TAA = Tactical Asset Allocation.
** SAA = Strategic Asset Allocation.

These recommendations, based on the Global Policy Model, do not include alternatives. We believe strategic holdings in both private investments and hedge funds can assist in increasing portfolio efficiency. However, we do not make tactical recommendations on these asset classes due to the strategic nature of the investments.

RISK AWARE – AND WAITING FOR OPPORTUNITIES

Equity markets don't directly track economic developments, as 2018 clearly demonstrated. Despite relatively strong global growth and corporate profits, investors instead have focused on the risks to those trends.

Business cycles tend to end when the economy overheats and monetary policy becomes significantly restrictive. We haven't seen the surge in commodity prices typical at the end of cycles, and a broad index of commodity prices is actually down 6% so far this year. Cycle peaks have also usually seen average hourly earnings increasing in the neighborhood of 4%, and we have only just topped the 3% level.

Together, these factors favor the economic expansion continuing through 2019, with monetary policy being the primary risk case. The other risk case is the potential of disappointing growth from China exacerbated by the effect of increasing tariffs.

As we look into 2019, we are very risk aware: we are overweight the lowest-risk risk asset (high-yield bonds) and underweight the highest-risk risk asset (emerging market equities). We also remain comfortable with significant bond allocations in light of our forecast of attractive risk-adjusted returns for fixed income in 2019.

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