MANAGERS' OUTLOOK ON U.S. ECONOMY IMPROVED; BULLISH ON EMERGING MARKET EQUITIES BUT CONCERNED ABOUT EMERGING MARKET ECONOMIC GROWTH

Investment managers during the first quarter 2016 were less pessimistic about the U.S. economy than during the fourth quarter 2015. They were slightly more optimistic regarding U.S. gross domestic product (GDP), housing prices and U.S. corporate earnings. Managers were most bullish on emerging market (EM) equities and 59%, the highest reading since the third quarter 2014, view them as undervalued. The managers ranked EM economic growth as the top risk to global equity markets, followed by U.S. corporate earnings, in line with last quarter. Other risks to global equities, such as the price of oil and other commodities, ranked fifth, while the U.S. presidential election process ranked in eighth place of 10.

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Christopher Vella, CFA
Chief Investment Officer
Northern Trust
Multi-Manager Investments
cv11@ntrs.com

Mark Meisel
Senior Vice President
Northern Trust
Multi-Manager Investments
mam31@ntrs.com

Key Findings: First Quarter 2016 Survey

- 61%, of investment managers believe a vote to leave the EU will hurt the British economy.
- 23% of investment managers believe credit markets are overvalued.
- Only 2% of managers expect oil prices to be under $30 in the next nine to 12 months.
- 55% of managers expect the negative interest-rate policies of central banks will keep U.S. Treasury rates low along the yield curve from two through 10 years.
- 40% of managers expect interest rates to rise, down from 73% last quarter.
- 37% of managers expect U.S. GDP to accelerate, up from 23% last quarter.
- More managers, 34% versus 23% last quarter, expect U.S. corporate profits to increase over the next three months.
- Nearly 6 out of 10 investment managers view emerging market equities as undervalued, and managers are most bullish on this asset class.

EQUITIES, CREDIT MARKETS AND OIL PRICES

2016's increased market volatility, marked by an early sell-off in risk assets, global equities, high-yield bonds and commodity prices, persisted through mid-February as some asset classes shed 10% to 20%. Markets declined on investor concern about central bank policies, global economic growth, Britain's potential exit from the European Union (Brexit), commodity prices and corporate profits. But markets subsequently stabilized and rebounded from their lows, which was when we polled investment managers about their views of markets and economic conditions going forward.

Northern Trust surveyed approximately 100 investment managers in our first-quarter 2016 survey, open March 3 – 18. Markets were concerned about the impact that divergent central bank policies were having on global growth as many regions released mixed or negative economic data. As prices fell in many markets in early 2016, we asked managers how they viewed the valuations of a few key markets, following the recent sell-offs. Nearly half, 48%, of investment managers view global equity markets as fairly valued, while 35% believe they are currently undervalued. However, 17% still view global equities as overvalued, even after the weakness we experienced in global equity markets. Approximately 77% of managers view credit markets as fairly valued or undervalued. They were evenly split between those managers that believe credit markets are appropriately valued versus those that believe they are undervalued (just under 39% for both). Twenty-three percent of survey respondents view credit markets as overvalued. Most managers, 55%, view the price of crude oil as undervalued, and 36% believe oil prices are fairly valued.

As oil dropped to less than $30 per barrel from more than $100 during the past 19 months, we asked investment managers where they expect West Texas Intermediate (WTI) oil prices to trade in the next nine to 12 months. Managers were evenly split, with 47% expecting oil to trade between $30 to $40, and 47% expecting oil to exceed $40 to $60 a barrel. Fewer managers, 4%, expect oil to trade above $60, and only 2% expect oil will trade below $30 a barrel in nine to 12 months.

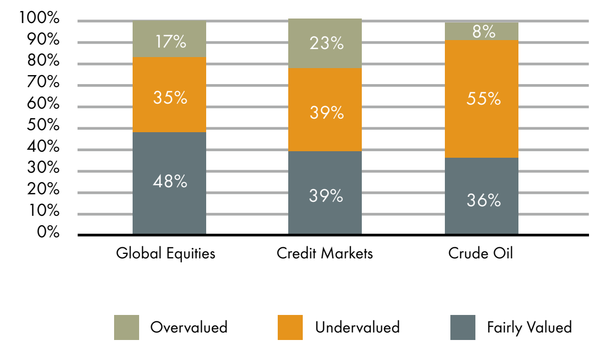
BREXIT

Another concern the markets weighed is the potential impact of Brexit on the U.K. economy and financial services firms. The referendum on the United Kingdom staying or leaving the European Union (EU) is set for June 23. A large majority of investment managers, 82%, believe that U.K. voters will choose to stay in the EU, and only 18% of managers believe the vote will favor the United Kingdom leaving the EU. We asked managers what the impact would be on the British economy if the United Kingdom votes for Brexit. A little more than six in 10 managers, 61%, believe it would hurt the British economy, while 35% expect a Brexit would have little to no impact on the British economy.

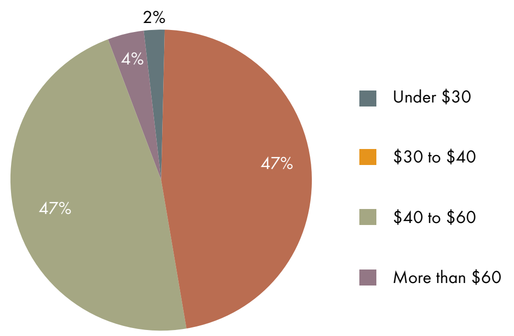
NEGATIVE INTEREST-RATE POLICIES

Negative interest rates credited on central bank rates have become a more widely used central bank monetary policy over the past few months. The European Central Bank (ECB), Sweden, Switzerland and now the Bank of Japan (BOJ) are all using negative rates to help spur lending and increase economic activity. However, the effectiveness of using negative rates to help bolster economic growth is hotly debated. Investment managers have mixed views, with 43% of managers believing that negative rate policies at the ECB and BOJ will have little to no impact on economic growth in these regions. Thirty-four percent of managers believe it will help spur additional economic activity in these regions, while 23% expect it will reduce economic growth in these regions.

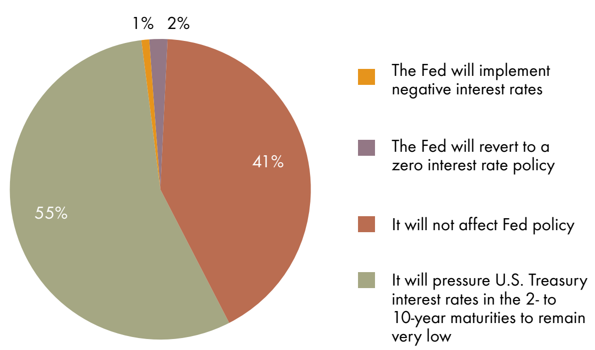
KEY MARKET VALUATIONS POST-MARKET SELL-OFFS



EXPECTED PRICE FOR OIL (WTI)



WHAT IS THE MOST LIKELY IMPACT OF NEGATIVE RATES ON U.S. MARKETS AND MONETARY POLICY?



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In our global economy, central bank actions often are expected to affect other regions. We asked managers what they thought the most likely impact negative rate policies in Europe and Japan would have on the United States. Most managers, 55%, believe it will keep two- to 10-year U.S. Treasury note rates very low. Forty-one percent of investment managers do not believe it will affect Fed policy.

U.S. ECONOMIC GROWTH

A jump to 37% this quarter from 23% last quarter in the percentage of managers expecting U.S. GDP to accelerate reversed the decline of the last couple of quarters. Fewer managers – 6% versus 13% last quarter – expect a deceleration in GDP growth over the next six months this quarter, while 57% expect U.S. GDP growth to remain stable. A higher percentage of managers expect housing prices to increase over the next six months: 60% versus 49% last quarter. An additional 35% of investment managers expect housing prices to remain stable.

With the unemployment rate at 4.9%, only 6% of investment managers expect the job growth rate to accelerate, down from 8% last quarter and the lowest reading since the survey began asking this question in the second quarter of 2011. Two-thirds of the managers, 67%, expect job growth to remain stable, while 27% expect it to decelerate but remain positive.

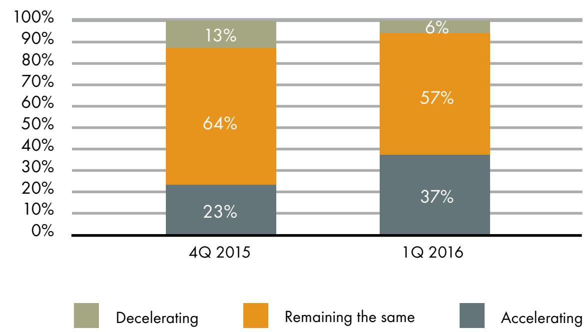
CORPORATE EARNINGS AND REVENUE

The percentage of managers that expect U.S. corporate profits to increase over the next three months also reversed course. Whereas the percentage had dropped to 23% last quarter from 72% in the third quarter 2014, this quarter the percentage increased to a more-positive 34%. Forty-two percent of managers expect corporate profit growth to flatten, while 24% expect earnings to decrease. Sixty-one percent of survey respondents expect U.S. corporate revenues to remain the same, up from 50% last quarter. Fewer managers than last quarter, 12% versus 20%, expect corporate revenues to decrease over the next three months.

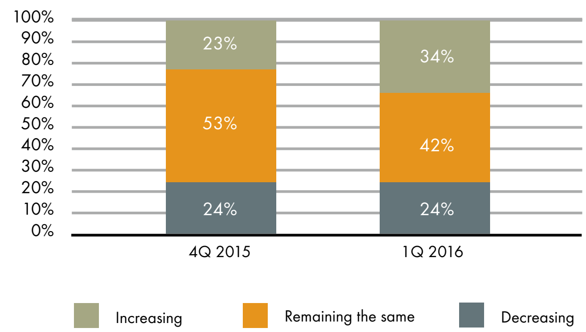
INFLATION AND INTEREST RATES

A large increase, 54% of managers, expect inflation to increase over the next six months, up from 40% in the fourth quarter 2015. Forty-three percent, down from 56% last quarter, expect inflation to remain the same. Interestingly, despite the concern over inflation, 58% of investment managers expect interest rates to remain the same during the next three months, more than double last quarter's 24%. Only 40% of managers expect interest rates to increase, down from a high of 73% last quarter. Last quarter, just before the Fed's first interest-rate increase

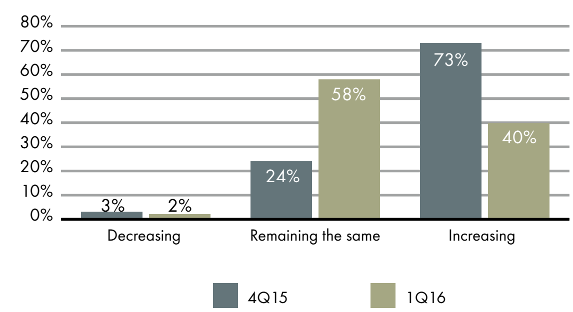
U.S. GDP GROWTH EXPECTATIONS



U.S. CORPORATE EARNINGS EXPECTATIONS



INTEREST RATE EXPECTATIONS



in mid-December, nearly three-quarters of the managers expected interest rates to rise. This signals a big shift in managers' thinking. Now, after the Fed's modest Fed funds target rate increase to a range of 0.25% to 0.50%, most managers do not expect further interest-rate increases even though more than half expect inflation to rise. This may be due to the combination of weak economic indicators, negative rates overseas, and the oil price rebound from recent lows.

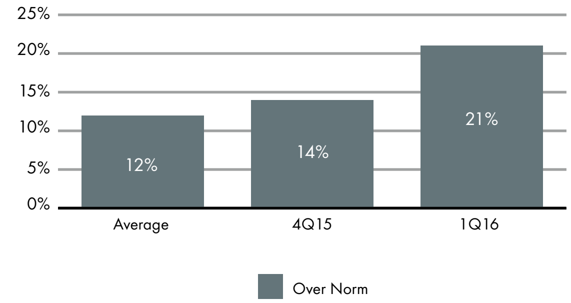
- Ninety-four percent of managers expect U.S. GDP growth to either remain the same or accelerate.
- Although 24% of managers expect U.S. corporate earnings to decrease, 76% expect earnings to increase or remain the same.
- Eighty-eight percent of managers expect corporate revenue growth to increase or remain stable over the next three months.
- More than half the managers, 54%, expect inflation to increase over the next six months, well above the long-term average of 35% for this question.

PORTFOLIO POSITIONING

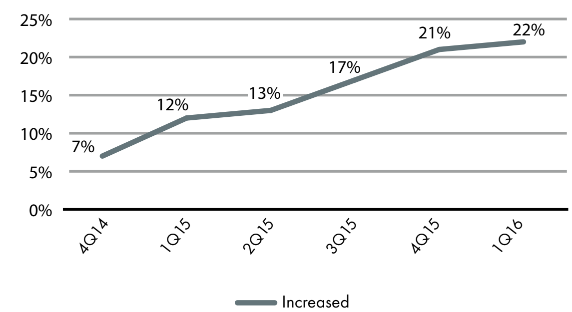
A higher percentage of investment managers, 21%, have above-normal cash levels currently in their portfolios than last quarter's 14%, suggesting a slightly defensive stance. This is also above the 12% long-term average percentage for this question, based on the quarterly responses since the survey began in the third quarter 2008. Most managers, 72%, have not changed their portfolio's concentration level versus three months ago. There is a slight increase in the percentage of managers that are more concentrated: 20% this quarter versus 17% last quarter. The percentage of managers that are more risk-averse is unchanged from last quarter at 22%. Sixty-three percent of managers have not changed their risk aversion, down from 68% last quarter, and 15% are less risk-averse.

A relatively high percentage of managers, 22%, increased their commodities exposure, following a trend in place since the fourth quarter 2014. Most managers, 63%, have not changed their commodities exposure over the past three months. A smaller proportion of managers – 16% versus 23% last quarter – decreased their commodities exposure.

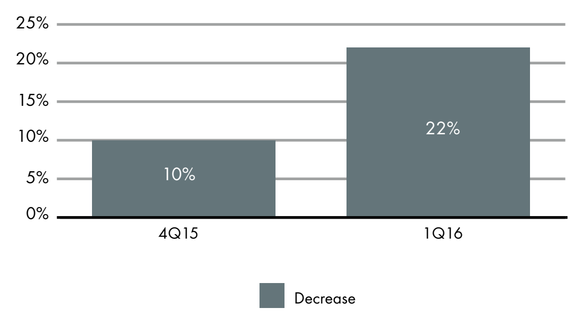
PERCENTAGE OF MANAGERS WITH CASH ABOVE NORMAL



PERCENTAGE OF MANAGERS INCREASING COMMODITIES EXPOSURE



PERCENTAGE OF MANAGERS EXPECTING VOLATILITY TO DECREASE



After volatility spiked up in early 2016, a higher percentage of managers – 22% versus 10% last quarter – expect the Chicago Board Options Exchange's Volatility Index (VIX) to decline over the next six months. Fewer managers, 53% versus 69% last quarter, expect volatility to increase, while 25% expect the VIX to remain the same.

GLOBAL EQUITY MARKET RISKS

Since emerging markets and developing economies accounted for a majority of global growth in 2015, markets continue to remain sensitive to the economic slowdown in China and other emerging markets. They also view the modest uneven economic recovery in developed economies, central bank policies, and lower commodity prices as key risks. Investment managers see the top-ranked risks to global equity markets as emerging markets economic growth, U.S. corporate earnings and changes to U.S. monetary policy. The first two were also the top-ranked risks last quarter. Managers view a U.S. economic slowdown as the fourth-ranked risk, and oil/commodity prices and a rise in interest rates rank fifth and sixth, respectively. A few new risks ranked lower, including the U.S. presidential primaries/election, which ranked eighth in 10, and negative interest rates, which stood at 10th of 10.

GLOBAL EQUITY MARKET VALUATIONS

U.S. equity valuations improved relative to the survey results for the fourth quarter 2015. Whereas 59% of investment managers viewed U.S. equities as fairly valued or undervalued last quarter, an all-time low for the survey, this rose to 70% this quarter. Last quarter, 41% of managers believed U.S. equities were overvalued; this dropped to 30% this quarter. The percentage of managers that viewed U.S. equities as fairly valued rose to 46% this quarter from 37% last quarter. Managers that believe U.S. equities are undervalued rose slightly to 24% from 21% last quarter. Although improved, U.S. equity valuations are still considered less attractive than other regions.

Emerging-market equities also improved, as 86% versus 82% last quarter of investment managers view them as appropriately valued or undervalued. The highest percentage of managers since we began asking this question in the fourth quarter 2009, 30%, believe EM equities are undervalued by more than 10%. Another 29% view them as undervalued by up to 10%, for a total of 59% of managers that believe the region is undervalued, up from 52% last quarter. Twenty-eight percent view EM equities as fairly valued. This region is currently viewed as having the most-attractive valuations.

INVESTMENT MANAGERS' RANKINGS OF TOP RISKS TO EQUITIES

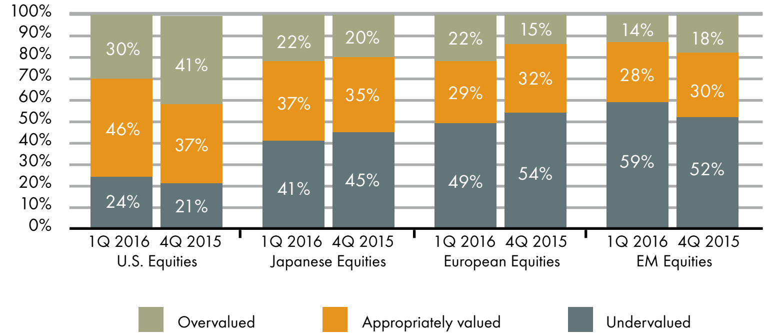
RISKS	CHANGE FROM LAST QUARTER	FIRST-QUARTER 2016 RANK	FOURTH-QUARTER 2015 RANK
EM ECONOMIC GROWTH	–	1	1
U.S. CORPORATE EARNINGS	–	2	2
CHANGE IN U.S. MONETARY POLICY	+2	3	5
U.S. ECONOMIC SLOWDOWN	–1	4	3
OIL/COMMODITY PRICES	–	5	–
RISE IN INTEREST RATES	–	6	6
GEOPOLITICAL RISKS	–3	7	4
U.S. PRESIDENTIAL PRIMARIES/ELECTION	–	8	–
EUROPEAN DEBT CRISIS	–1	9	8
NEGATIVE INTEREST RATES	–	10	–

Fully 79% of investment managers view European equities as under- or appropriately valued, down from 85% last quarter. Forty-nine percent of investment managers believe they are undervalued; 29% view them as fairly valued, and 22% see them as overvalued. The overvalued percentage of 22% is up from 15% last quarter.

The valuations for equities in Japan were largely in line with last quarter. There was a slight drop to 41% this quarter from 45% last quarter in the percentage of managers that view this region as undervalued. Thirty-seven percent, up from 35% last quarter, believe they are appropriately valued, and 22% view equities in Japan as overvalued, up from 20%.

Regarding equities in the Asia/Pacific region (as represented by the MSCI AC Asia Pacific Index), 42% of investment managers believe they will perform in-line with global equities (MSCI ACWI Index). Nearly one-third, 31%, expect they will perform better than global equities over the next six months.

GLOBAL EQUITY MARKET VALUATIONS



Fixed-Income Sectors	Most Attractive
Investment Grade	1
High Yield (U.S.)	2
Euro High Yield	3
Global Developed Sovereigns	4
Emerging Market Debt	5

FIXED-INCOME SECTORS

Within fixed-income markets, managers ranked sectors from most- to least-attractive. The investment-grade sector was viewed as most-attractive, followed by U.S. high-yield and European high-yield. Global developed sovereigns and emerging-market ranked as less-attractive.

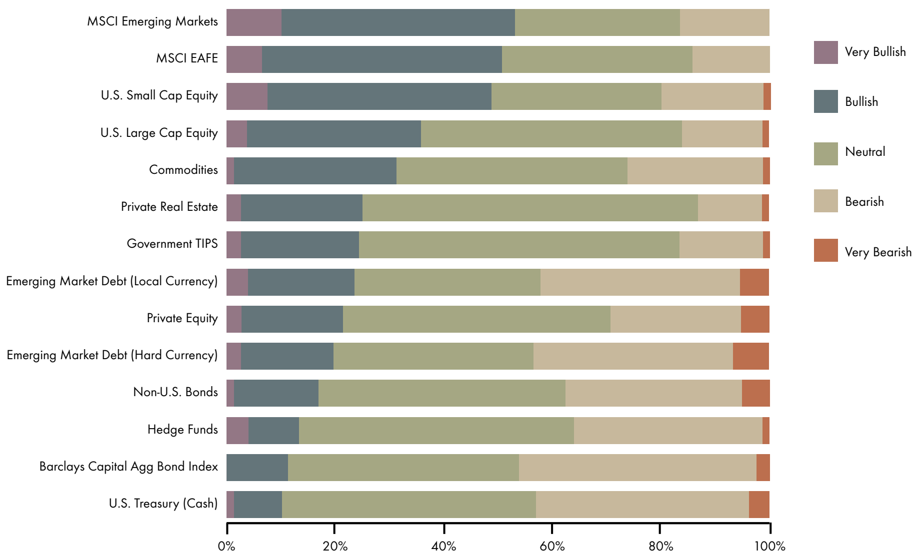
MANAGERS BULLISH ON EM EQUITIES; NON-U.S. DEVELOPED EQUITIES; INFORMATION TECHNOLOGY; CONSUMER DISCRETIONARY

Managers are most bullish on EM (MSCI EM Index) equities and rank non-U.S. developed equities (MSCI EAFE Index) second. That's a switch in their respective rankings from last quarter. It is also the first time EM equities have ranked first on bullishness since the third quarter 2014. U.S. small- and large-cap equities rank third and fourth, respectively, in bullishness this quarter, the same rankings they held in the previous quarter.

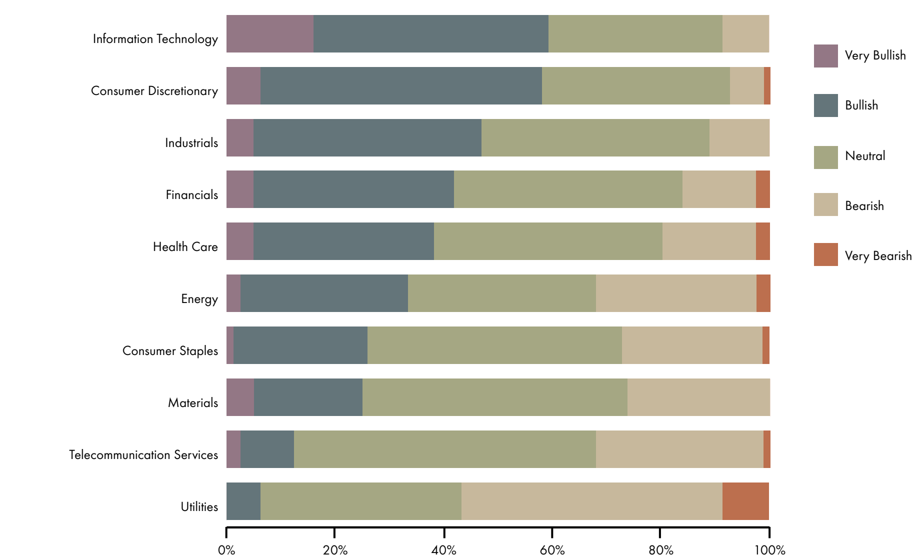
Managers are most bearish on U.S. bonds (Barclays Capital Aggregate Index), cash, and EM debt (hard currency). The information technology sector remained in the top-ranked position in bullishness from last quarter, and consumer discretionary moved up to second from third rank. Industrials, financials and health care ranked third, fourth and fifth in bullishness, respectively. The most-bearish sectors are utilities, telecommunication services and energy.

- 53% of managers rate EM equities as bullish (43%) or very bullish (10%); 30% had a neutral rating on EM equities.
- 51% of managers are bullish on non-U.S. developed equities; managers rate non-U.S. developed equities very bullish (7%) or bullish (44%).
- Managers rate commodities, private real estate and government Treasury Inflation-Protected Securities as fifth, sixth and seventh in bullishness, respectively.
- U.S. fixed-income and cash have bearish ratings of 46% and 43%, respectively.
- Information technology has a bullish rating of 59%, followed by consumer discretionary at 58% and industrials at 47%.
- The bearish rating on utilities is 57%, followed by telecommunication services at 32%.

BULL/BEAR INDICATOR (ASSET CLASS)*



BULL/BEAR INDICATOR (SECTORS)*



COMMENTARY FROM OUR MANAGERS

We asked managers this quarter to share their views on the following questions:

As a result of your analysis, what are the top concerns/priorities you are seeing for CEOs?

"CEOs are now, more than ever, finding it difficult to grow their businesses organically. This has had a direct impact on the degree of share re-purchases across the market as a tool for boosting EPS growth, though we would also note that insiders have been selling at near-record levels even while buying their own stocks."
– **John Schaeffer, portfolio manager, Hahn Capital Management**

"The concerns that top the list of most companies are a slowdown in top-line revenue growth and subpar economic global growth. The stock buybacks that have sky rocketed in recent years have masked the weakness in corporate earnings, but that has changed over the past few quarters. Now CEOs must try and slog through these tough times. Despite high equity valuations, many companies continue to make expensive acquisitions. Global mergers and acquisitions activity surpassed $5 trillion for the first time ever in 2015. Seeking the deal rather than organic investment has been the hallmark of this cycle, and it reflects the misallocation of resources that takes place in an artificially low interest-rate environment. CEOs can justify a 5% return on invested capital deal when borrowing at 3%. That this return is below any normalized cost of capital is apparently inconsequential to today's managers and the stock market, at least in the short run."
– **Bladen Burns, CFA, partner, Fiduciary Management, Inc.**

We also asked managers what other significant risks concern their investment teams and how these are affecting their portfolios. The following comments represent a selection of their responses:

"Pockets of debt. Election uncertainty. The threat of fracturing the European Union. Deployment of experimental monetary tools."
– **Brian Beitner, portfolio manager, Chautauqua Capital Management, a division of Robert W. Baird and Co.**

"Monetary policy divergence is the greatest risk in the financial markets today, further distorting capital allocation, depleting foreign currency reserves and pressuring currencies."
– **Kelly Thomson, managing partner, Magee Thomson Investment Partners**

"A principle concern is the United States' position in the credit cycle. The U.S. has been in the late-cycle stage of a disjointed cycle where the Federal Reserve would have normally raised rates several times already given the age of the corresponding economic expansion. This cycle will most likely be longer than historic norms would suggest. A certain level of de-risking should be considered in the future as this cycle progresses."
– **Craig Burelle, macro analyst, Loomis Sayles & Company**

ABOUT THE SURVEY

For our survey, Northern Trust polled a select group of respondents, including fixed-income and equity managers across value and growth styles, with a bias toward fundamental, bottom-up stock-picking strategies. Invitations to complete the survey were only sent to investment managers that currently manage assets for Northern Trust and our clients. As a result, the survey responses should reflect the beliefs of only the managers in which Northern Trust's multi-manager investments group maintains a high conviction. The survey is conducted quarterly so that Northern Trust and participating managers can examine trends in attitudes and allocations.

Percentages in report and graphs may not add to 100 due to rounding. All data analyzed in this report is derived from the Northern Trust Investment Manager Survey.

ABOUT NORTHERN TRUST MULTI-MANAGER SOLUTIONS

Northern Trust is a leading provider of multi-manager investment solutions, with $58.2 billion under management and $40.7 billion under advisement for institutional and personal clients. Having investments with more than 200 external managers worldwide, Northern Trust's multi-manager solutions range from retail mutual funds and alternative asset classes to emerging manager programs and total investment program management for institutions and affluent individuals and families.