MARKET VIEWPOINT

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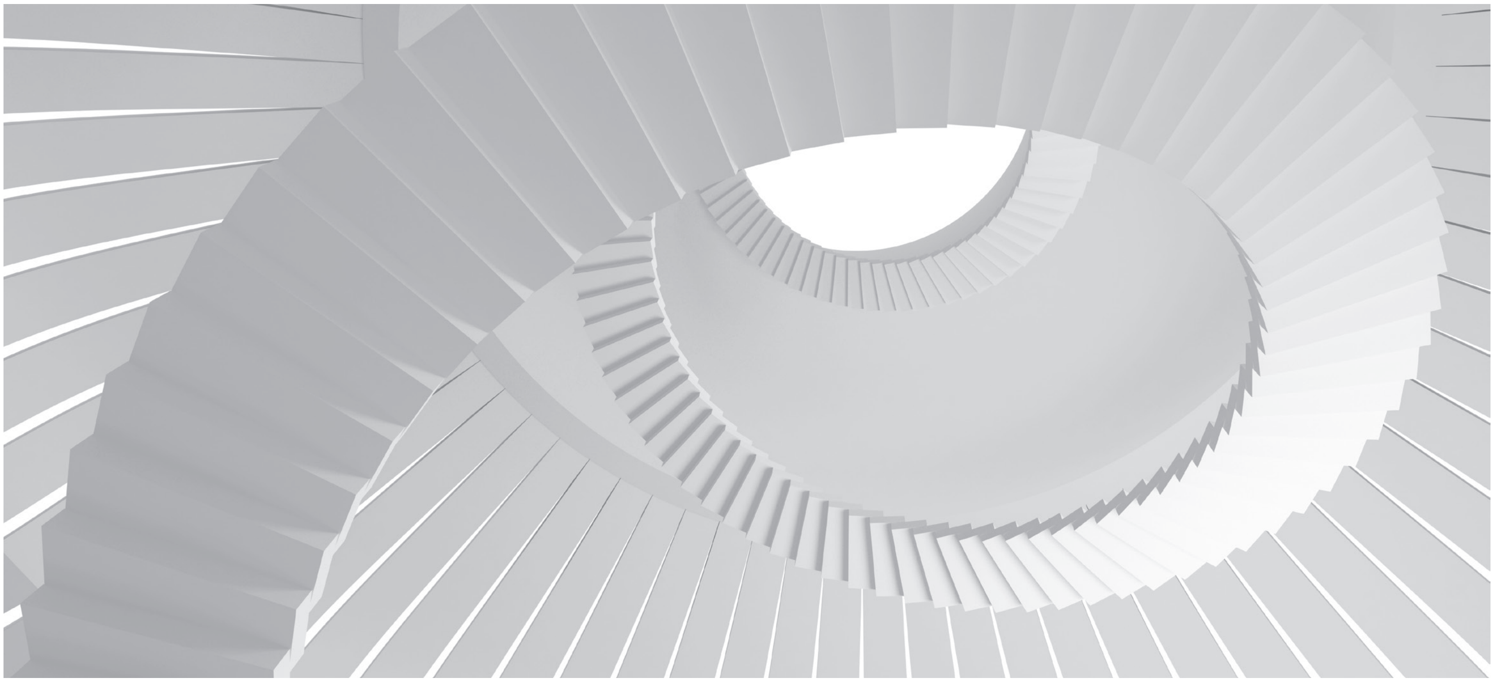


Investment Strategy Commentary

2014 five-year outlook

Every year, Northern Trust's Capital Market Assumptions Working Group (CMA) gathers to develop long-term forecasts for economic activity and financial market returns. These forecasts are designed to be "forward looking, historically aware." This means we seek to understand historical risk, return and correlation relationships between and across asset classes, while we also attempt to predict how and why these relationships may differ from historical trends in the years ahead. We encapsulate these forward-looking views in our annual list of CMA themes. This forward looking, historically aware mindset is the foundation of our base case outlook expectations.

Summary

Another year, another 20% year-over-year gain in global equity markets. Similar to last year's Capital Market Assumptions (CMA) meetings, we entered the 2014 discussions debating the justification for the impressive risk asset appreciation in the context of a slow (albeit enduring) growth environment. Looking back to our 2012 CMA update, we assumed fairly robust returns from risk assets despite our expectations for low to moderate growth. These return expectations were predicated on the cushion provided by below-average valuations and an expectation for continued monetary policy accommodation. Revisiting these foundations two years on, we have lost our valuation cushion (at least in developed markets) and, while monetary accommodation is still in place across the developed world, five years of easy money without a notable uptick in the growth trajectory risks causing "accommodation exhaustion." Symptoms may include: rising levels of dissatisfaction with current levels of income inequality resulting in political backlash and/or populist movements; ingrained expectations for low-to-no price inflation — with the risk of deflation; and percolation of financial asset bubbles. These considerations were debated alongside the recent and unforeseen rise in geopolitical tensions.

The primary theme to result from our 2014 exercise was a belief that global growth will endure and mature over the CMA's five-year time horizon. The sub-par growth trajectory in the five years since the global financial market crisis has prevented excesses — the kinds that generally prompt central banks to engineer a recession to bring markets back into equilibrium — from building in developed markets. Meanwhile, emerging markets continue to adjust to a maturing growth profile, causing global growth to mature as well. Effectively, the mediocrity of the current expansion increases its expected longevity. Regulatory initiatives designed to make the financial system safer have hindered central bank monetary policy efforts to boost the economy, while persistent output gaps and heightened productivity potential have challenged central banks' desires to put inflation back at healthier levels. The combined expectation of continued easy monetary policy and sub-par growth increases the risk of asset bubbles, though generally lower leverage in the financial system reduces concerns of systemic risk. Geopolitical concerns are back on the radar and will test the strength of the globalization trend. But they could also represent a potential catalyst for increased demand.

Overall, we expect risk asset return premiums to be squeezed by both lower expected equity returns (reflecting the impact the last 12 months' market appreciation had on valuations) and slightly higher expected fixed-income returns (reflecting the higher future interest rates priced into the market). However, positive implications from the enduring and maturing global growth theme should support margins and valuations — preventing the risk asset return premium from falling too dramatically.

The Slowly Shrinking Risk Asset Premium

Exhibit 1

Five-Year Asset Class Outlooks

Fixed Income	Cash return forecasts are beginning to increase as central banks eventually make their exit. Fixed-income forecasts increased slightly as markets continue to price in the prospect of higher interest rates as we look toward the back half of our five-year time horizon. High yield forecasts have fallen moderately, given tighter credit spreads over the past year.
Equities	Developed market equity forecasts have fallen to reflect the expansion in valuations over the past 12 months. Holding current valuations and margins steady, we anticipate returns will largely reflect revenue growth. Emerging market maturation reduces growth prospects, but low relative equity valuations still support a return premium over developed markets.
Real Assets	Natural resource/commodity return forecasts continue to be negatively affected by the global growth maturation theme. Global real estate and global listed infrastructure provide a better risk/return trade-off, given their exposure to interest rates, which we believe will remain lower than market consensus.
Alternatives	We continue to expect that private equity will provide an illiquidity premium over public equities. Our in-depth analysis of average hedge fund strategy returns and dispersion found within the asset class highlights the importance of manager selection.

Five-Year Themes

Enduring and maturing global growth

Global growth expansion is expected to endure through our five-year time horizon (i.e., no recession) as still-persistent output gaps and the lack of excesses allows for an extended economic cycle. Developed market growth is expected to be moderate, while emerging market growth will continue to mature. This maturation of emerging market growth will weigh on global growth but also help it endure by reducing inflationary pressures.

Central bank paradox

Central banks continue to embrace highly accommodative policies while also imposing tougher regulatory standards, which have served as a headwind to credit extension. Central bank efforts to get labor markets back to full employment have been hindered by companies switching to technology from labor. Both of these dynamics will drive a continuation of accommodative monetary policy.

Developed market inflation sponge

Increases in productivity, sizable output gaps and simple lack of global demand continue to offset inflationary efforts by most developed-market central banks. Demand for credit has shown signs of life and labor market output gaps may be overstated, but productivity enhancements will continue to soak up inflationary pressures — leaving a base case expected trend of "low-flation" despite the ever-present potential for transitory inflation spikes.

Bubble hyperbole

Any expectation that vigilant regulatory bodies can deflate bubbles arising from aggressive monetary accommodation is optimistic. However, fears of massive bubbles over the next five years seem overstated using our definition of a bubble: a set of financial assets at risk of a meaningful loss in capital, exacerbated by leverage causing systemic harm to the financial system.

Geopolitical risk: a balanced assessment

Recent events have been interpreted by some as the reintroduction of a Cold War-style geopolitical variable not seen since the fall of the Berlin Wall — with governments looking for more strategic alignment with like-minded allies and companies, in some cases, reconsidering globalization initiatives. We believe conflicts will increasingly be dealt with through the financial system (cutting off credit) as opposed to military intervention, reducing risks of geopolitical escalation. It could also serve as an economic catalyst — such as potential demand from increased military spending and new energy infrastructure build out.

Emerging markets: becoming more value than growth

Differences in expected growth and the drivers of that growth (i.e., productivity versus demographics) have diverged across the emerging market constituent countries, as have the corresponding valuations. Emerging markets are no longer a homogeneous high-growth cohort, but they are expected to provide a valuation-driven return premium for the risks involved.

The search for yield

A theme that will not go away, the low-rate environment will continue to foster the bidding war for yield-producing investments and open the door to more holistic, contemporary approaches to yield generation across the broader portfolio. Yields are once again positive on a real basis (if you take on enough duration risk) but still below what many target out of their investment portfolio.

Asset classes without borders

Global capital markets and globally diversified companies continue to further the case for a global approach to asset allocation. Going forward, asset allocation will focus less on where the company is domiciled and more on where the company generates its revenues. However, more interesting will be how individual assets can be combined to provide specific exposures to compensated forms of risk.

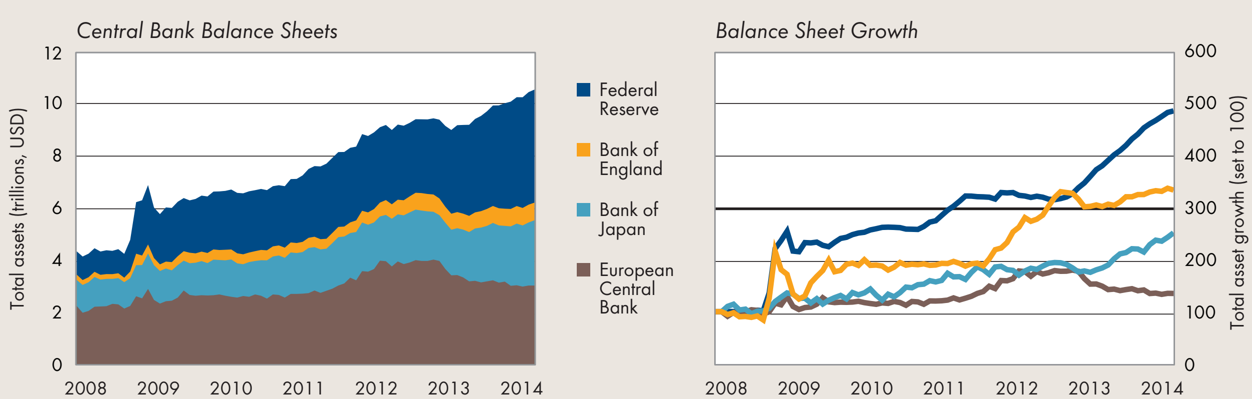
For more detail on Northern Trust's five-year themes and how they are expected to impact asset class returns, please see the recently released Five-Year Outlook: 2014 Edition.

The ongoing role of central banks

Stemming from the working group's discussions, it was clear that central banks would still represent an important support mechanism in providing a foundation for the future growth trajectory of developed markets (despite risks of accommodation exhaustion) as they bridge themselves back to organic growth. Of the four major developed market central banks, two — the European Central Bank and the Bank of Japan — are expected to be just as, if not more, accommodative as they are now at the end of the five-year time horizon, while the other two (the Federal Reserve and the Bank of England) should still be viewed as accommodative by historical standards. At any rate, central banks will continue to play a role in the financial markets based purely on their size. As seen in **Exhibit 2**, the four major central banks in aggregate now control more than $10 trillion in assets. To put this in perspective, the size of the "Big Four" central bank balance sheets equals 22% of the $45 trillion in developed market gross domestic product in 2013. Before the financial crisis (using 2007 data), this figure was just below 10%.

The $10 Trillion Club

Exhibit 2



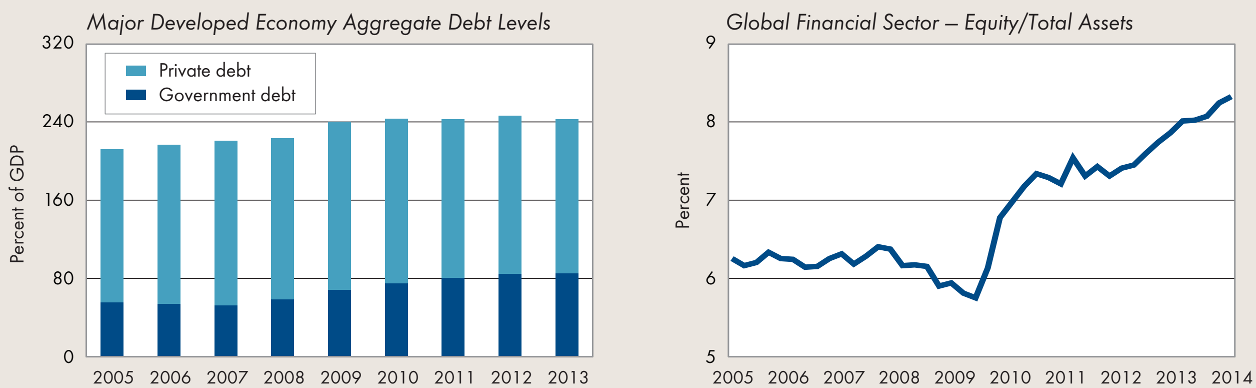
Source: Northern Trust, Bloomberg. Data as of 6/30/2014.

Are we just blowing financial market bubbles?

Our expectation for continued accommodative monetary policy raises serious questions about the prospect of financial market bubbles; signs of stretched valuations in some markets are fueling the fire. Central bankers and other policy makers, keen to not make the same mistake twice, have ramped up regulatory efforts since the global financial crisis. We find it unrealistic to believe that regulators have the foresight (or wherewithal) to prevent all potential asset bubbles at a time when liquidity in the system is so high. But we also think fears of a massive disruption to the global economy are overblown. While aggregate debt levels have not improved much since 2009 (merely shifting from the private sector to the government), financial companies are much better funded now — and should act as a "circuit breaker" in the event of asset price deflation.

The State of Deleveraging

Exhibit 3



Source: Northern Trust, MSCI, Bloomberg. "Major developed economies" represented by U.S., U.K., Europe and Japan. Data as of 6/30/2014.

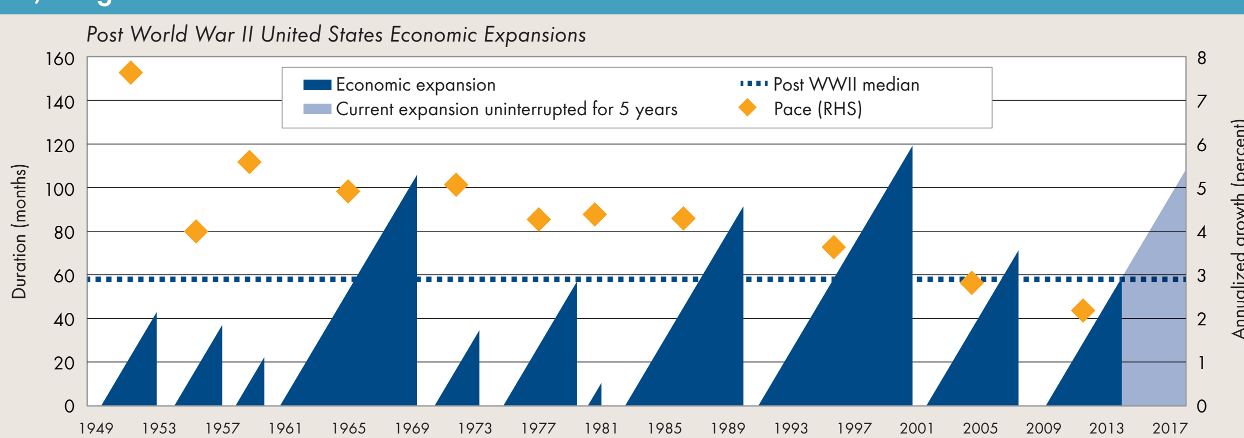
Slower growth equals longer duration

The deleveraging is not without consequences and has been the driving force behind the slow recovery. The current 2.2% annualized pace of real economic growth is the slowest of all the post-war expansions in the United States, the country for which we have the longest and best data. This is an especially acute problem given the severity of the downturn that preceded the current expansion. It is also why we think the current expansion can continue through our five-year time horizon, despite the fact that the current expansion is exactly at the post-war average expansion length of 58 months (see blue triangles in **Exhibit 4**). An extra five years would put us at the second-longest expansion in post-war history — bested only by the 10-year expansion of the 1990s.

In simple terms — and assuming an eventual closing of the output gap — the current expansion's slow rate of growth requires a longer length in duration. However, that is not to say that the slow and steady path to a 10-year expansion and beyond is guaranteed. For one, slow growth and technological advancements whereby labor can be replaced by machine may increase the levels of income inequality. The way in which inequality is addressed serves as a risk case over the next five years — as are the increased geopolitical tensions and the durability of emerging market growth. N

Slower Pace; Longer Duration?

Exhibit 4



Source: Northern Trust, National Bureau of Economic Research, Bloomberg.

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