REPERCUSSIONS

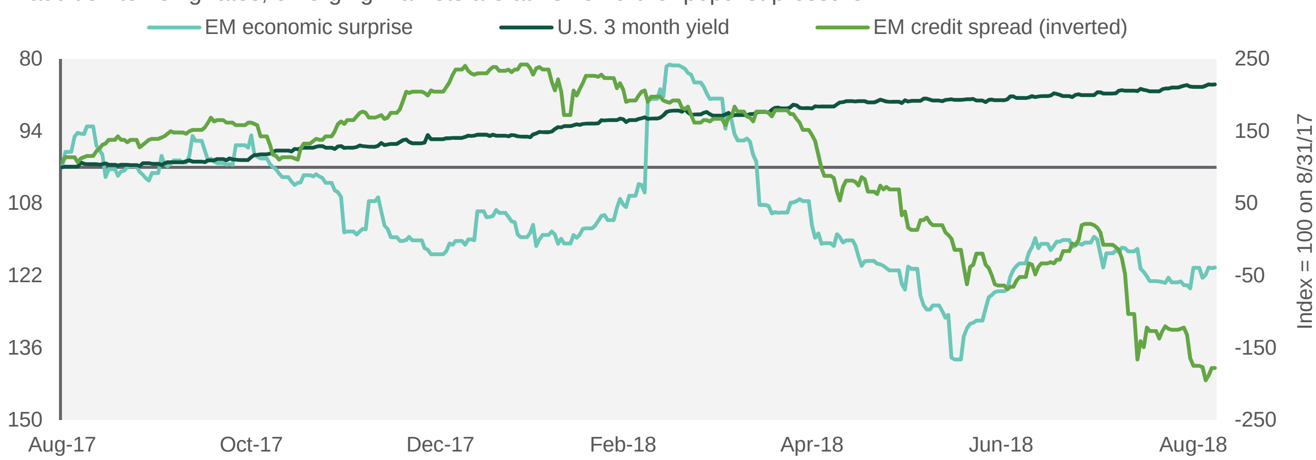
Higher U.S. interest rates, populist politics and trade concerns have been a significant headwind for emerging market assets this year. Populism's impact extends beyond the direct policies of individual emerging market economies, encompassing countries such as the United States that traditionally have been reliable counterweights to emerging market stresses. We think comparisons of the current environment to the emerging markets crisis of 1998 are overstated. Major emerging economies are much stronger today. However, populist politics has made the "backstop" from entities such as the International Monetary Fund much less certain. European politics are increasingly in the spotlight, with the new Italian government's budget plans under scrutiny, Brexit negotiations in full swing, and the European Parliament elections coming in May 2019. The appetite for bailing out foreign countries will not be high in coming years.

The impact of trade worries can be seen through the market performance of those economies most dependent on trade. In China, companies with the highest percentage of foreign revenues have lagged by 12 percentage points since February. European equities rely on emerging markets for roughly 25% of public company revenues. Meanwhile, the U.S. stock market has been a clear outperformer. The U.S. economy relies mostly on domestic consumption and U.S. businesses have benefitted from rising productivity and improved business confidence. We do continue to expect, however, that the current pace of growth is likely the high water mark and growth will slow globally in 2019.

We have been citing Rising Monetary Policy Dissent as our base case scenario in recent months. We think members of the Federal Reserve will increasingly express divergent opinions. In addition, we expect the Fed's intended rate path to increasingly conflict with market expectations. Our new risk case of Central Bank Tunnel Vision captures our view that the Fed may fail to account for how much its policy tightening is already pressuring financial markets as it continues to raise rates amid solid domestic growth. Recent comments from the president of the New York Fed, indicating a willingness to invert the yield curve, are not reassuring on this front. All in all, the outlook for risk taking has moderated as the year has progressed and we have increasingly focused on lower-risk risk assets such as U.S. equities and high yield bonds.

RISING PRESSURES

In addition to rising rates, emerging markets are at risk of further populist pressure.



Source: Northern Trust Global Asset Allocation, Bloomberg, Citi. Data from 8/31/2017 to 9/7/2018.

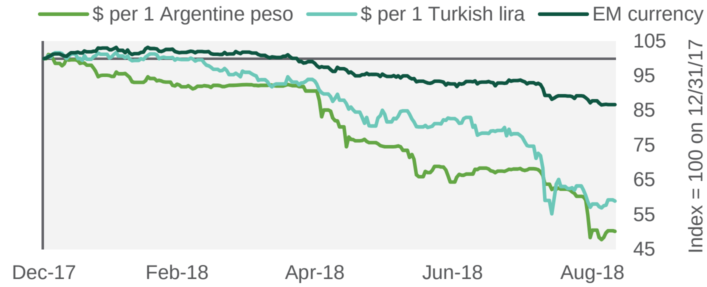
Interest Rates

At the Federal Reserve's annual symposium in Jackson Hole – closely watched for Fed policy signals – Fed Chair Jerome Powell used the analogy of "shifting stars" to describe how traditional economic model output (wherein equilibrium is denoted with asterisks – or "stars") must be supported by the economic data. For instance, the models predict that the current 3.9% unemployment level – 0.6% below the 4.5% equilibrium – should be putting acute pressure on wages and inflation. But wage growth remains below 3% and core inflation has had difficulty getting above the Fed's target of 2%. So far, theory has not been backed up by the data.

Further, falling emerging market currencies (see chart) are beginning to affect investor sentiment. Emerging market struggles have been largely attributed to the stronger U.S. dollar. Should emerging market currency weakness persist and it foreshadows a slowdown in economic growth, the Fed may soon need to pause its already slow rate-hiking campaign. The combination of an uncertain global economic outlook and geopolitical uncertainties argue for continued Fed accommodation and range-bound interest rates. As such, our portfolios remain positioned with a neutral duration, relative to their benchmarks.

GLOBAL DISTRACTIONS

Strained emerging market currencies may force a Fed pause.



Source: Northern Trust Global Asset Allocation, Bloomberg. Data through 9/7/2018. Emerging Market currency index proxied by JP Morgan EM Currency Index.

- Wages and inflation are rising – but more slowly than expected.
- The broader economic environment should cap interest rates.
- We maintain neutral duration positioning in our portfolios.

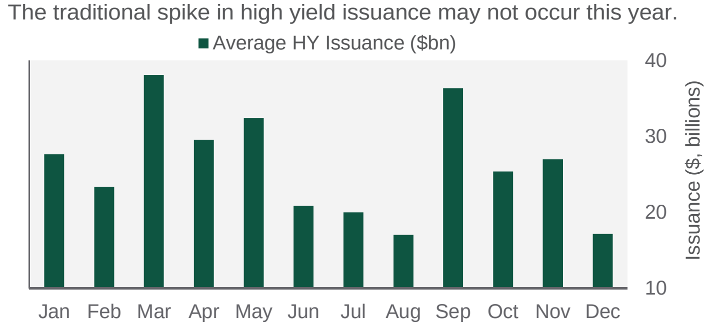
Credit Markets

We believe high yield remains a compelling way to gain risk asset exposure – and this month we further increased our allocation to the asset class. The current environment of economic strength and geopolitical distractions is right for an asset class like high yield. It is a risk asset that can provide upside participation should solid fundamentals propel risk assets higher, but also offers downside protection if investor sentiment continues to sour. Beyond solid fundamentals (including falling default rates), high yield benefits from constructive technical support as issuance is falling.

The graph shows the average monthly new issuance in the high yield market. September is typically the beginning of a new issuance cycle, characterized by a high volume of deals and progressively tighter pricing. This continues until the cycle is overdone, which results in a weak period for the high yield market. Turning to the numbers, the average September has $36 billion in new issues that come to market. However, this year may be a different story. Current estimates for September 2018 are for $20 to $25 billion in new issues – and early indications are that the market may not even reach that. Lower than normal amounts are also expected for October and November. As such, the aforementioned supportive technical factors should continue. We expect this will restrain price volatility and provide support for high yield valuations.

SEPTEMBER SPIKE?

The traditional spike in high yield issuance may not occur this year.



Source: Northern Trust Global Asset Allocation, Credit Suisse.

- Solid fundamentals and lower issuance support high yield.
- High yield is a risk asset that can provide downside protection.
- High yield continues to represent our largest tactical overweight.

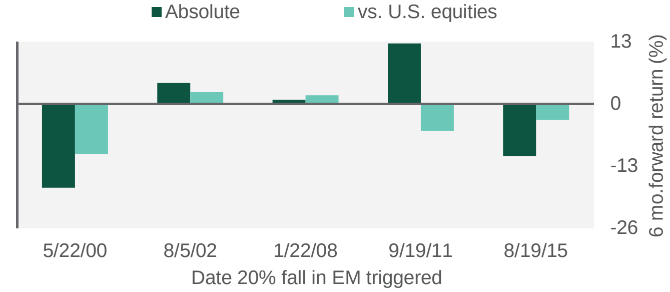
Equities

U.S. equities rose to new highs last month, while non-U.S. markets declined. Emerging market equities have attracted the most negative attention, falling nearly 12% year-to-date and 20% from their peak. Surprisingly, emerging markets have only underperformed non-U.S. developed markets by 5% this year, highlighting how unique U.S. equity strength has been. Strong U.S. growth, aided by fiscal stimulus, has led to divergent monetary policy and interest rate environments between the United States and the rest of the world, driving U.S. dollar strength. This, combined with continued escalation of trade issues – particularly with China – has driven emerging markets' underperformance.

With rhetoric around trade with China likely to remain heated and our risk case of the Fed continuing to push rates higher, we have reduced our exposure to emerging markets while maintaining our overweight to U.S. equities. We do acknowledge the potential for a Fed pause or a positive surprise on trade to alleviate emerging market fears, but historic evidence lends little support to the chance of a quick performance snapback after a 20% fall (see nearby chart). As such, we likely have time to come back to our long-term positive thesis when near-term uncertainties ease.

IT TAKES TIME

Emerging market equities don't bounce back quickly after a 20% fall.



Source: Northern Trust Global Asset Allocation, Bloomberg. Indices used: MSCI Emerging Market Index and MSCI U.S. Index.

- Rising contagion risks face emerging market equities.
- Emerging markets haven't bounced back quickly after prior sell-offs.
- We are overweight U.S. and underweight emerging market equities.

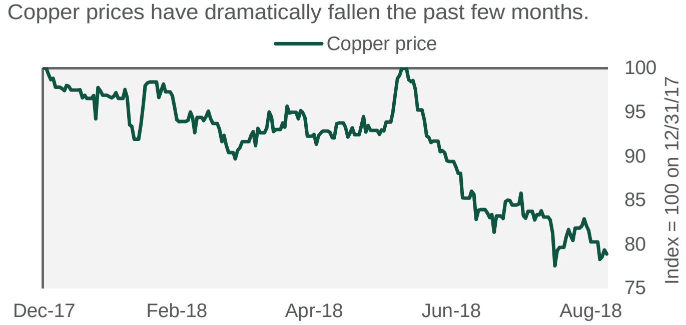
Real Assets

Copper prices have been falling, and are now down more than 20% year-to-date. Copper is often referred to as "Dr. Copper" by economists thanks to its historical ability to identify turning points in the economic cycle. Because of its wide use across various industries, falling copper prices have been a good indicator of weakening economic demand. Should we be concerned? We do believe we will experience some moderation in economic growth over the next year – as the global economy, increasingly distracted by trade war fears, fails to maintain the robust and synchronized profile of the last couple years. But we also believe fewer inflationary pressures will allow for continued monetary policy accommodation and economic expansion.

We remain strategically allocated across all real asset categories – including natural resources, global real estate and global listed infrastructure. Our expectation for a moderation in global growth could lead to ongoing pressures on commodity prices (copper and otherwise). This will serve as a modest headwind for natural resources, but is likely to be offset by ongoing easy Fed policy and its limiting effect on further dollar strength. Global real estate and listed infrastructure continue to serve as nice risk asset diversifiers – and should find support if the Fed looks to halt its rate hiking campaign, as we expect within the next six months.

PLUMBER'S MARKET?

Copper prices have dramatically fallen the past few months.



Source: Northern Trust Global Asset Allocation, Bloomberg, Google. Data through 7/6/2018.

- Falling copper prices are suggesting a global growth slowdown.
- Slower global demand may force ongoing easy money policies.
- We remain strategically allocated across all real assets.

Conclusion

In response to rising concerns over emerging market contagion risk, we reduced risk in our global tactical asset allocation model this month by cutting emerging market equities by 3%, moving to an underweight position. Reflecting our view that corporate credit looks attractive and interest rates are expected to remain range bound, we allocated 2% of these proceeds to U.S. investment grade bonds and the remainder to U.S. high yield (further increasing our overweight position). This follows several recommendations earlier in the year that have collectively reduced our overall risk position by moving to a neutral position in global equities. We also have our risk asset allocation tilted toward lower risk assets (U.S. equities and high yield) that we feel will have upside participation in a good market but offer some defensive characteristics in a more difficult trading environment.

As discussed in the Equity section, emerging market equities haven't tended to bounce back quickly after a sell-off similar in magnitude to this year's. While our emerging market position has hurt tactical investment performance this year, it has been more than offset by our overweight to U.S. equities and underweight to fixed income. We have also avoided the sell-off in emerging market bonds, as our allocation to global high yield has been fulfilled by U.S. high yield bonds. While improving economic data from China will be a necessary ingredient for better emerging market performance, it likely won't be sufficient. If the Federal Reserve continues unabated in its rate hike campaign, we would expect continued U.S. dollar strength, increased economic uncertainty and pressure on emerging market assets. In addition, near-term resolution to the trade imbroglio between the United States and China seems unlikely, since President Trump is now talking about a third round of tariffs (notably, before the second round is even implemented).

Our base case scenario envisions the Fed eventually responding to market stresses by indicating a pause to its rate hike cycle. Admittedly, this is far from certain; there is plenty of evidence that the Fed may be afflicted with "tunnel vision" and will march studiously ahead. President Bill Clinton's advisor James Carville famously opined that he wanted to be reincarnated as the bond market – because it could intimidate anyone. We may be facing a similar but less obvious situation today. In our current environment, it would be a flattening yield curve (indicating concerns over growth) that should intimidate the Fed. There are competing camps within the Fed over whether this should be viewed as an ominous signal, or whether "it is different this time." We recommend they not take the chance that this time is different.

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INVESTMENT PROCESS

The asset allocation process develops both long-term (strategic) and shorter-term (tactical) recommendations. The strategic returns are developed using five-year risk, return and correlation projections to generate the highest expected return for a given level of risk. The objective of the tactical recommendations is to highlight investment opportunities during the next 12 months where the Investment Policy Committee sees either increased opportunity or risk.

The asset allocation recommendations are developed through the Tactical Asset Allocation, Capital Markets Assumptions and Investment Policy Committees.

Northern Trust Asset Management comprises Northern Trust Investments, Inc., Northern Trust Global Investments Limited, Northern Trust Global Investments Japan, K.K., NT Global Advisors, Inc. and investment personnel of The Northern Trust Company of Hong Kong Limited and The Northern Trust Company.

ViewPoints reflects data as of 09/12/18.

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