Since our most recent Quarterly Review and Outlook (January 2017) investment management has become even more challenging. President Trump suffered his first legislative setback with the failure to overturn Obamacare and replace it with the Republican version. Hopefully this is not a precursor of future legislative gridlock.

**ECONOMY**

GDP for this year is estimated to increase by about 2%, not much of an improvement over the recent past. Easy monetary policy has probably prevented the economy from slipping back into recession, but not sufficient to increase the modest rate of growth. It probably will take fiscal stimulus (tax cuts and increased Federal spending) to provide some acceleration. This scenario, of course, would have the effect of further enlarging an already enormous Federal budget deficit. Listed below are some of the positives and negatives:

**Positives:**
- New orders (Chart 1)
- Building Permits (Chart 2)
- Employment
- Manufacturing (Chart 3)

**Negatives:**
- Legislative impasse
- Mideast turmoil
- Fed’s unwinding of $4.5 trillion bond portfolio

"It requires a great deal of boldness and a great deal of caution to make a great fortune, and when you have got it, it requires ten times as much wit to keep it."

**Ralph Waldo Emerson**

1803 - 1882
**FIXED INCOME**

Has the 35 year bull market in bonds come to an end? Yes. Given that assumption, and the likelihood that interest rates will continue to rise, we continue to advise laddering maturities out to less than 10 years. Emphasize credit quality – “A” or better.

**US EQUITIES**

We believe that the bull market which began in the first quarter of 2009 is still intact. Valuations, while above the historical median, are not as stretched as at prior tops (Chart 4). Earnings will improve significantly in 2017 and probably beyond. Stocks continue to look more attractive than bonds.

We continue to be fully invested in the equity portion of accounts. For fundamental reasons, we continue to overweight Healthcare and Industrials.
NEGOTIATING TACTICS

First Quarter 2017

Donald Trump’s 1987 book, The Art of the Deal, received renewed interest post-election as many – investors, executives and politicians alike – sought a glimpse into the new president’s mindset. Given the state of global affairs, another helpful read may be Avinash Dixit and Barry Nalebuff’s The Art of Strategy. The authors analyze both real and theoretical negotiations, identifying the various tactics employed. One common tactic is brinkmanship – the practice of maneuvering a situation to “the brink” in order to secure the best deal. Brinkmanship is a favorite of politicians, used to varying levels of success. And its use will likely continue as the Trump administration settles in; the United Kingdom exits the European Union (EU); and world leaders look to craft new trade agreements.

Starting in the United States, the first quarter of 2017 gave Republicans a taste of how difficult reform will be without party unification and bipartisan cooperation. The first litmus test was their first stab at replacing the Affordable Care Act. While its failure did not have a direct impact on the economic outlook, it did raise questions over the ability of Congress to achieve more important goals (tax reform) or avoid self-made crises (debt ceiling). Meanwhile, as expected, the UK triggered Article 50 of the Lisbon Treaty on March 29, notifying the European Council of its intention to leave the EU. This launches a two-year negotiation period to establish a new political and economic relationship. If Dixit and Nalebuff’s work on the topic is any guide, they will take the full time allotted.

Despite growing political entrenchment, continued – and synchronized – global growth pushed risk assets higher in the first quarter; and allowed the Fed to take another quarter-point step towards policy normalization without negative reaction from financial markets. Global economic strength has also kept investors patient with ongoing negotiations – whether it be the U.S. pro-growth regime shift, Brexit or global trade. This patience allows time to find solutions to which all can agree. The academic foundation here is the Nash equilibrium*, which represents the best choice for all after considering the intentions of all others. Negotiations can advance more easily as these equilibrium points are identified through interaction. President Trump views himself as a dealmaker. His and other world leaders’ grasp of these negotiating tactics will determine their ability to further support the currently solid growth environment – and not fall off “the brink”.

*The Nash equilibrium is nicely explained and exemplified in a scene from the academy award winning, A Beautiful Mind.

FIRST QUARTER REMAINED RISK ON, BUT EMPHASIZED DIFFERENT ASSET CLASSES

United States post-election optimism spread to other regions in the first quarter of 2017.

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>2016</th>
<th>1Q17</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>0.3</td>
<td>0.1</td>
</tr>
<tr>
<td>Muni</td>
<td>0.2</td>
<td>1.6</td>
</tr>
<tr>
<td>Inv. Grade</td>
<td>2.6</td>
<td>0.8</td>
</tr>
<tr>
<td>TIPS</td>
<td>4.7</td>
<td>1.3</td>
</tr>
<tr>
<td>High Yield</td>
<td>17.1</td>
<td>2.7</td>
</tr>
<tr>
<td>Em. Markets</td>
<td>9.9</td>
<td>6.5</td>
</tr>
<tr>
<td>United States</td>
<td>12.7</td>
<td>5.9</td>
</tr>
<tr>
<td>Dev. ex.-U.S.</td>
<td>3.5</td>
<td>7.1</td>
</tr>
<tr>
<td>Em. Markets</td>
<td>10.3</td>
<td>11.7</td>
</tr>
<tr>
<td>Natural Res.</td>
<td>31.6</td>
<td>2.6</td>
</tr>
<tr>
<td>Global Real Estate</td>
<td>4.6</td>
<td>3.4</td>
</tr>
<tr>
<td>Global Listed Infra.</td>
<td>12.4</td>
<td>7.9</td>
</tr>
</tbody>
</table>

Source: Northern Trust Investment Strategy, Bloomberg. Indexes are gross of fees and disclosed on last page.
U.S. LEGISLATIVE SETBACK

The Republican repeal and replace of Obamacare is proving easier said than done. Concessions requested by Freedom Caucus members (wanting full repeal) meant lost support from centrist members (wanting smaller tweaks). Short on votes, the bill has yet to make it to the House floor. Healthcare reform is more of a social (vs. economic) issue, but its struggles call into question the GOP’s ability to deliver on its pro-growth agenda (tax reform, fiscal stimulus). Even prior to this setback, markets had reduced expectations for tax reform and fiscal spending as implied by the recent weakness (relative to the broader market) in “high-tax” and “infrastructure-sensitive” stocks (see chart).

BIG TESTS AHEAD FOR THE EUROPEAN UNION

On March 29, the UK hand-delivered a six-page letter to European Council President Donald Tusk, formally notifying the EU of the UK’s Brexit intentions and triggering the two-year negotiation window. The upcoming French elections will also shape the EU’s future. A win by anti-EU candidate Marine Le Pen would be a big blow to EU viability. With previous front-runner (and pro-EU) Francois Fillon’s campaign derailed by nepotism charges, Emmanuel Macron is the best bet to preserve the EU status-quo. Polls show Le Pen/Macron finishing “1-2” in first-round voting (4/23), while Macron is expected to win in the run-off (5/7). Markets place Macron’s odds of victory at 61% (see chart).

GLOBAL GROWTH ACCELERATING

Overshadowed by the political headlines is the continued global economic growth acceleration that started last June. The global purchasing manager index now sits at 53.0 (above 50 indicates growth), increasing from 50.4 over the past nine months (see chart). Importantly, all three of the world’s largest economic blocs have contributed, resulting in a global growth synchronization not seen since the period just after the global financial crisis. Purchasing manager indexes are a “soft” reading of economic activity based on surveys. But the harder data is also reassuring, including notable improvements in industrial production and retail sales across many regions.

FED SEIZES OPPORTUNITY TO HIKE RATES

The Fed took advantage of the improving global economy and falling financial market volatility by raising rates a quarter-point on March 15. Well-orchestrated comments from several Fed voting members quickly raised the market-based odds of a rate hike from a 50-50 shot to a near-certainty over the span of three days just two weeks before the Fed meeting (see chart). U.S. equity markets were up nearly 1% on Fed decision day as investors approved of the Fed maintaining its expectations for two more rate hikes in 2017 (signaling the March move was a “dovish hike”). Markets have priced in 57%/80% odds of rate hikes at the Fed’s June/September meetings, respectively.

Source: Northern Trust Investment Strategy, Bloomberg, GS Investment Research.
INTEREST RATES

In the battle between improving fundamentals and supply/demand dynamics, the latter won in Q1. Economic growth has accelerated, which should result in higher interest rates across the curve. But investors’ insatiable demand for U.S. Treasuries (UST) — especially further out the yield curve — resulted in a flatter yield curve over the course of Q1. The 3-month UST moved higher by about 0.25% (in-line with the Fed rate hike) but anything more than two years out the curve saw little change; and yields on maturities beyond seven years actually fell slightly. Part of the demand is coming from non-U.S. investors, where “low” U.S. rates compare favorably against their negative rates.

CREDIT MARKETS

Credit spreads tightened modestly in the investment grade and high yield markets during Q1. Driving the improvement was the combination of positive fundamentals and some renewed “search for yield” as interest rates pulled back. Market technicals (supply/demand) added some volatility in March, especially in junk bonds. High yield spreads went as low as 3.4% driven by sparse issuance, only to move materially higher over the next three weeks — hitting 4.1% — as issuance flooded the market. The oil price pullback also created some risk aversion in energy sector issues. Overall though, it was a positive quarter, with investment grade fixed income up 0.8% and high yield up 2.7%.

EQUITIES

Global equity markets returned 7.0% in Q1. The rally was truly global in nature — not just pulled along by U.S. markets. In fact, as U.S. equities consolidated in the month of March, Japanese and European equities pushed higher. For the full quarter, U.S. equities were up 5.9% while non-U.S. developed market equities were up 7.1%. Especially noteworthy was the outperformance of emerging market equities (EM). After suffering immediately after the U.S. election in the face of a strong dollar and protectionist threats, EM rallied strongly in Q1 (up 11.7%) as global growth continued to strengthen and concerns over potentially negative impacts from Fed and D.C. policy faded.

REAL ASSETS

Global listed infrastructure (GLI) was a standout performer, representing the only real asset to outperform global equities in Q1 (7.9% vs. 7.0%). Most of GLI’s outperformance came in March as investors were once again attracted to its 3.7% dividend yield amidst falling interest rates and its downside protection as enthusiasm faded around the Republican pro-growth agenda (reminder: despite its name, GLI would not be expected to directly benefit from an infrastructure spending bill). Global real estate — the more volatile “cash flow asset” — lagged GLI, returning 3.4%. Meanwhile, natural resources dealt with commodity supply headwinds but managed a 2.6% return.

Source: Northern Trust Investment Strategy, Bloomberg.
FIRST QUARTER 2017 NOTABLE EVENTS

1. Small business optimism increases to levels last seen in 2004, according to National Federation of Independent Business survey
2. In a major speech, Theresa May sets forth plans for a “hard” Brexit; pound rallies on the increased clarity
3. Trump inauguration ushers in one-party control of government policy after six years of split power in Washington D.C.
4. Dow passes the 20,000 mark for the first time, backed by strong corporate earnings and growing economic optimism
5. Trump signs a host of executive actions, the most controversial being a travel ban on seven predominately-Muslim countries
6. Leading French Presidential candidate Francois Fillon falls dramatically in polls over nepotism scandal
7. "Goldilocks" U.S. jobs report is released – more jobs added but higher participation rate actually raises unemployment rate
8. Stocks jump as Trump announces that a "phenomenal" tax plan would be coming soon and top Fed regulator Daniel Tarullo resigns
9. Michael Flynn, President Trump’s national security adviser, resigns amidst controversy over discussions with Russian officials
10. President Trump focuses on pro-growth reforms in his first joint meeting of Congress, sending the S&P 500 up 1.4% the next day
11. ECB President Draghi highlights a reduction in deflationary risks but the ECB continues its accommodation with no changes in policy
12. Pro-reform Prime Minister Narendra Modi’s BJP party scores big election win in India’s largest state; emerging markets jump 1.3%
13. After telegraphing the move for the prior two weeks, the Fed hikes a quarter-point at its March meeting; S&P 500 finishes up 0.8%
14. Republicans fail to bring the American Health Care Act (Obamacare replacement) to the House floor, lacking the votes needed
15. The United Kingdom invokes Article 50 of the Lisbon Treaty, formally triggering the start of Brexit negotiations

Indexes used: Bloomberg Barclays (BBC) 1-3 Month UST (Cash); BBC Municipal (Muni); BBC Aggregate (Inv. Grade); BBC TIPS (TIPS); BBC High Yield 2% Capped (High Yield); JP Morgan GBI-EM Global Diversified (Em. Markets Fixed Income); MSCI U.S. Equities IMI (U.S. Equities); MSCI World ex-U.S. IMI (Dev. ex-U.S. Equities); MSCI Emerging Market Equities (Em. Markets Equities); Morningstar Upstream Natural Resources (Natural Res.); FTSE EPRA/NAREIT Global (Global Real Estate); S&P Global Infrastructure (Global Listed Infra.)

IMPORTANT INFORMATION. This material is provided for informational purposes only. Information is not intended to be and should not be construed as an offer, solicitation or recommendation with respect to any transaction and should not be treated as legal advice, investment advice or tax advice. Current or prospective clients should under no circumstances rely upon this information as a substitute for obtaining specific legal or tax advice from their own professional legal or tax advisors. Information is confidential and may not be duplicated in any form or disseminated without the prior consent of Northern Trust. Northern Trust and its affiliates may have positions in, and may effect transactions in, the markets, contracts and related investments described herein, which positions and transactions may be in addition to, or different from, those taken in connection with the investments described herein. The opinions expressed herein are those of the author and do not necessarily represent the views of Northern Trust. All material has been obtained from sources believed to be reliable, but the accuracy, completeness and interpretation cannot be guaranteed. Information contained herein is current as of the date appearing in this material only and is subject to change without notice. Indices and trademarks are the property of their respective owners. All rights reserved.

Past performance is no guarantee of future results. Periods greater than one year are annualized except where indicated. Returns reflect the reinvestment of dividends and other earnings and are shown before the deduction of investment management fees, unless indicated otherwise. Returns of the indexes also do not typically reflect the deduction of investment management fees, trading costs or other expenses. It is not possible to invest directly in an index. Indexes are the property of their respective owners, all rights reserved.

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.