A JUSTIFIABLE RALLY

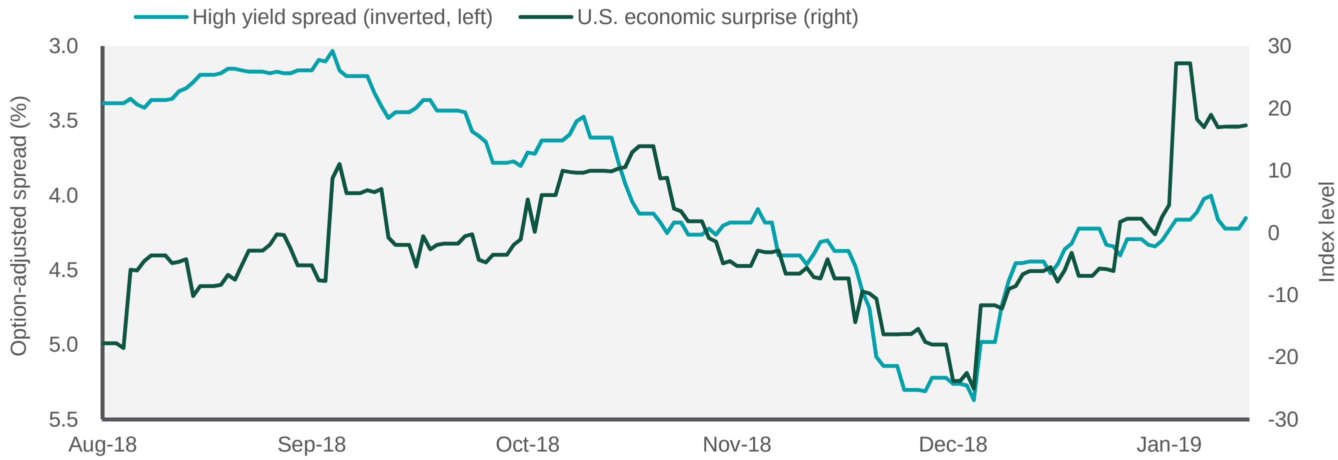
It's surely a coincidence that the recent market rally occurred during the partial shutdown of the U.S. government. More conventional rally catalysts were the over-sold conditions created by excessive pessimism about growth and a dovish shift from the Federal Reserve. Equity valuations had fallen below long-term averages across most markets, and the increase in credit spreads was leading some forecasters to meaningfully raise their expectations of a recession by 2020. The ensuing rally in risk assets has been corroborated by the meaningful narrowing of credit spreads. Our Mild Growth Myopia theme counsels against getting too bearish (or bullish) on economic growth, as we think the expansion is durable but limited on the upside due to debt and demographic issues.

Amongst the major economies, the clearest signs of improving growth have emerged this year in the United States. New industrial orders jumped in January, as did both new job creation and new entrants into the labor force. European growth has been hampered by slowing trade, private consumption and industrial production – which we expect to improve some as the year progresses. We do not expect Europe to go into recession, and we forecast growth of 1.0-1.5% for the year. The economic signals from China remain mixed. The manufacturing sector is being hurt by trade tensions, while the service sector remains stronger. Some measures of private activity (such as the Li Keqiang Index, which measures electricity, freight volumes and bank loans) indicate still-good growth. We expect improvement in China's broad growth data by the second half of the year.

Softening inflation reports have provided cover for central banks to moderate their plans and the Fed is at the front of the line. They completed their more dovish "pivot" in January with their policy statement and indications that their balance sheet reduction is not on "autopilot." We have also seen dovish moves by the Bank of England, Reserve Bank of Australia and the Reserve Bank of India over the last week. Financial markets have been ahead of the central bankers in assessing the prospects for further rate hikes, and we think the markets will continue to provide good guidance about the future outlook for rates. Currently, short-term rates are expected to actually be modestly lower by the end of 2019. We'll be carefully watching the yield curve for signals about prospects for future Fed policy, specifically the pricing in the 5-year Treasury which we believe needs to go higher in yield to give the Fed room to hike rates further.

IS THE BOUNCE BACK FOR REAL?

Improving risk appetite has been supported by better economic data.



Source: NT Global Asset Allocation. U.S. economic surprise index is measured by Citi. High yield spread is for Bloomberg Barclays High Yield 2% Issuer Cap. Data from 8/31/2018 through 2/11/2019.

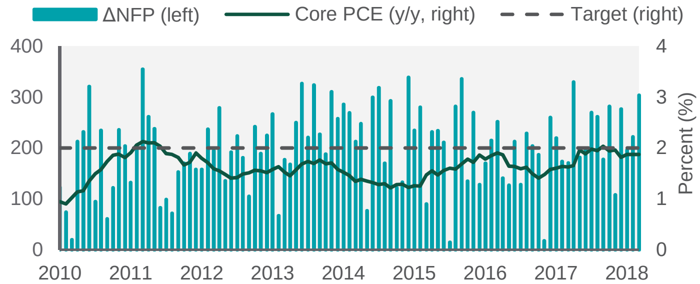
Interest Rates

The Fed made a U-turn from its previous messaging, flipping to a more dovish tone at its January meeting. This shift effectively put future interest rate rises on hold, as the Fed repeatedly emphasized patience and a need for higher inflation before resuming normalization. Markets are now forecasting the Fed to remain on hold for all of 2019 and have even introduced the possibility of a cut sometime in 2019 or 2020. We agree with market expectations – believing for some time that the four rate hikes in 2018 were a mistake.

The Eurozone's economic data ended the year soft, as a handful of issues have dampened demand and weighed on the prospects for growth. Italy had a drop in gross domestic product and moved into another technical recession. The social unrest in France has impacted consumer spending, with both supply chain disruptions and shoppers staying at home. British parliament held a series of votes as the Brexit process trudged forward with no set outcome. These economic challenges will only keep the European Central Bank on hold for longer, which – along with continued zero interest rate policy in Japan – will serve as an international ceiling on U.S. interest rates.

CAN'T HIT THE TARGET

Low inflation allows the Fed to be patient.



Source: NT Global Asset Allocation, Bloomberg. NFP = change in non-farm payrolls. Core Personal Consumption Expenditure (PCE). Data from 11/30/2010 to 1/31/2019.

- The Fed's newfound patience has comforted investors.
- Without inflation, longer-term rates will remain range-bound.
- Current rates are attractive, but not as attractive as risk assets.

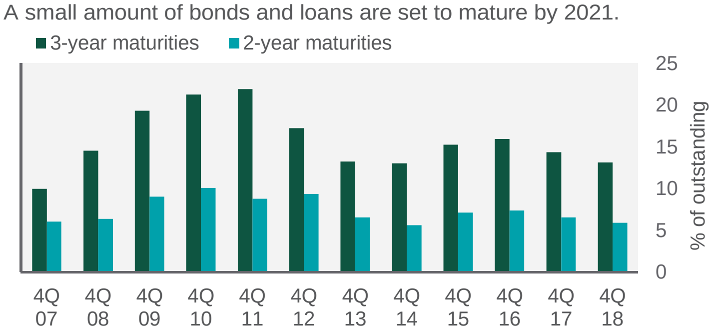
Credit Markets

High-yield credit has had a strong start in 2019. As recession fears recede, investors are once again able to focus on more credit-specific fundamental factors, such as falling default rates and high-interest coverage ratios. Along with positive fundamentals, high-yield investors can also take comfort in a very supportive technical environment, specifically the manageable maturity schedule. As seen in the chart on the right, only 13% of the $2.6 trillion outstanding high-yield bonds and loans are set to mature by the end of 2021. Further, only 10% of leveraged buyout (LBO) debt matures by the end of 2021. This modest refinancing need gives issuers flexibility. The lack of new issuance on the back of lower refinancing also supports the positive technical dynamic expected to carry into 2019 from 2018.

The combination of constructive fundamentals and positive technicals underpin high-yield valuations and support our 8% overweight position – the biggest asset class overweight we have in our global policy model. The recent U-turn in Fed policy will also support high-yield liquidity – a major criticism of the asset class by high-yield bears. From a portfolio construction perspective, high yield is also a very attractive asset class. It is a risk asset that provides attractive income (as the search for yield ramps up once again) and downside protection during market weakness (generally only falling half as much as global equities during market drawdowns).

LIMITED MATURITY

A small amount of bonds and loans are set to mature by 2021.



Source: NT Global Asset Allocation, JP Morgan, Markit.

- High yield has provided 2019 upside participation.
- High yield fundamentals and technicals support the asset class.
- High yield remains our biggest tactical overweight.

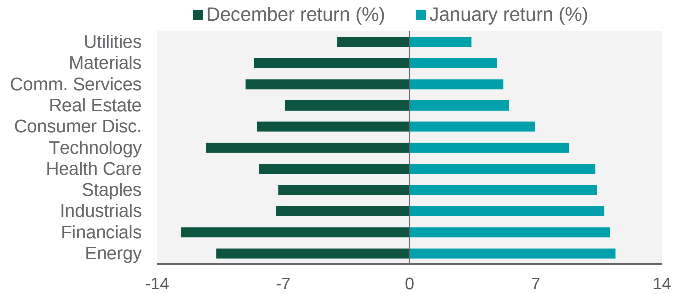
Equities

Equities rebounded sharply in January, leading to a near-complete reversal of the disastrous December. Strong performance was not limited to the United States, as non-U.S. markets performed similarly last month. The January Federal Open Market Committee (FOMC) meeting confirmed the Fed will be on hold, with commentary that was even more dovish than expected, supporting equities.

Earnings season is well underway. While the magnitude of bottom line beats has been somewhat underwhelming versus recent history, investor sentiment was sufficiently negative going into the results to allow stocks to move higher. Forward guidance has been soft in some areas like technology, driven by China weakness. This has put downward pressure on 2019 earnings growth expectations which, when combined with strong equity market performance year-to-date, has reversed a significant portion of the valuation correction we discussed last month. However, with U.S. economic and earnings growth likely to surprise still-skeptical investors, United States-China trade talk progress, and a much more supportive Fed, we believe the current environment is conducive to further gains in equities, particularly in the United States where we retain a small overweight.

DECEMBER REVERSAL

All sectors bounce back after difficult December.



Source: NT Global Asset Allocation, Bloomberg, S&P 500.

- Global equities have bounced back in 2019.
- U.S. equities have led the way, despite slightly higher valuations.
- We currently have a slight bias toward U.S. equities.

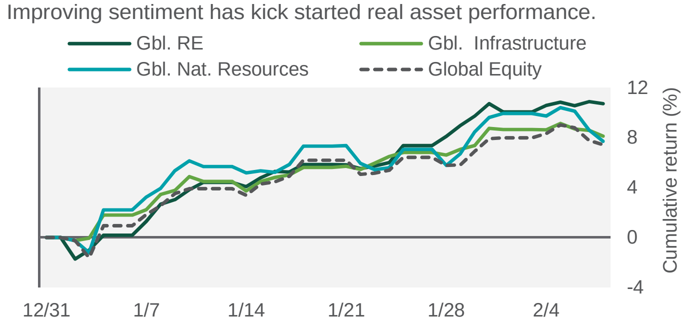
Real Assets

Real assets have gotten off to a fast start in 2019, with all major real asset categories outpacing global equities (see chart at right). Global real estate has already provided a double-digit return (10.7%) just six weeks into the new year while listed infrastructure and natural resources have both performed admirably (8.1% and 7.7%, respectively, against a global equity return of 7.4%). Driving the strong performance of real assets is the gradual unwind of investor concerns that plagued 2018 returns. Global economic recession concerns have abated, resulting in a tide that has lifted all risk-asset boats – broad global equities as well as real assets, which have a heavy equity exposure. Natural resources have bounced back modestly as oil prices have stabilized. And, more specific to cash flow assets like global real estate and listed infrastructure, interest rates have fallen back down into a lower channel in the aftermath of the Fed's capitulation on monetary policy normalization. As interest rates trend lower, alternative sources of yield are back in vogue.

We have a specific tactical overweight to global real estate in our global policy model – an allocation initiated in January given the confluence of a stabilizing global economy, a more dovish Fed (and other central banks) and negative market sentiment that we felt had gone too far. This overweight has contributed to our tactical performance and we continue to endorse the asset class as a source of alternative yield.

REAL PERFORMANCE

Improving sentiment has kick started real asset performance.



Source: NT Global Asset Allocation, Bloomberg. MSCI ACWI IMI Core RE, S&P Gbl. Infrastructure, S&P Global Natural Resources, MSCI ACWI. Data from 12/31/2018 – 2/8/2019.

- Real assets have posted strong returns thus far in 2019.
- Global real estate remains attractive, and we are overweight.
- We remain neutral on natural resources and listed infrastructure.

Conclusion

Rising investor pessimism in the fourth quarter of 2018, followed by the Fed moving off their steady tightening campaign, set the conditions for the improved risk environment over the last two months. Equity valuations had fallen below long-term averages in many markets, and credit spreads had increased to a level providing a yield to worst of over 8% in U.S. High Yield. After increasing our risk exposure in our global tactical asset policy last month, we stood pat this month as risk assets have rallied sharply and the fundamental drivers of our outlook are relatively unchanged. Our base case scenario calls for Global Growth Resilience – cautioning investors against getting too negative in the wake of the current global slowdown. We expect the expansion to endure, and risk assets to reward as the potential for a recession in 2019/2020 is priced out.

Our other base case calls for a Focus on Fundamentals, where we think central banks will be able delay any policy normalization ambitions as resilient growth and contained inflation lead to a benign fundamental backdrop. The most recent developments certainly support this view, as central banks in the United Kingdom, Australia and India have recently joined the Fed in espousing a more dovish outlook for policy. Underpinning this base case is our Stuckflation theme, which has been supportive of risk-asset returns over the last several years. An unexpected jump in inflation could move the Fed off their dovish policy prematurely, which is one of our two risk cases. Our other risk case remains that of Political Miscalculation, where a policy mistake leads to economic difficulties. In addition to a Fed mistake, the risk of accelerated trade tensions between the United States and China remains an unsolved problem.

There is no shortage of important events to be analyzing over the course of this year. Near-term, evidence of stabilization in Chinese growth along with progress on the trade front will be key issues. The Brexit deadline of March 29 looks unlikely to be met, and we believe a Brexit delay is the most likely result. We will also have European Parliamentary elections in late May and a new European Central Bank head to take over on November 1. From an economic standpoint, the inflation data may prove most important as an unexpected cyclical uptick could knock central bankers off their new game plan. We have great confidence in our long-term theme of Stuckflation (where the impact of technology in increasing supply and promoting pricing transparency keeps inflation under check), but cyclical bouts of inflation can't be ruled out. But our base case remains that global inflation is under control, supporting accommodative monetary policy and also risk taking in the markets.

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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.

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