FUNDAMENTALLY DRIVEN

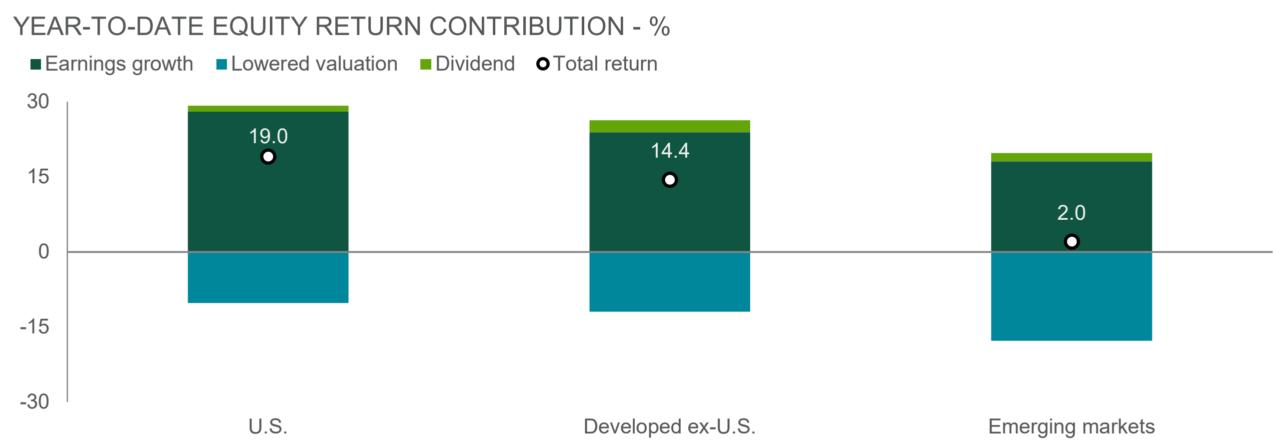
Strong market returns this year have raised questions about their quality. Are they just due to easy money and fiscal profligacy? Earnings this year have handily exceeded investor expectations due to strong operating leverage, and the regional performance has tracked relative earnings growth. As shown below, U.S. equities have delivered the strongest returns and emerging markets the lowest, which correlates with their earnings growth. Valuations have contracted across all regions, as the strong earnings picture was somewhat already discounted in stock prices. Emerging markets, however, did take an additional valuation hit due to concerns about increased regulatory oversight in China. Taking a longer-term view, U.S. equities have delivered an 18% annualized return over the last five years, well above investor expectations. However, 70% of this return was tied to fundamentals and 30% due to expanded valuation.

The current market focus is trained on the outlook for COVID-19, China and U.S. legislative policy. The spread of the Delta variant is clearly slowing near-term growth across the world (interestingly, with Europe seemingly less impacted than the U.S. or developing markets). The negative impact of regulatory change in China has now transitioned from technology and education stocks to the large property sector. The financial difficulties of Evergrande, China's largest property developer, have been brewing for months and the government has stepped back from the level of support given in similar prior episodes. We estimate that 90% of Evergrande's debt is held domestically, somewhat mitigating the contagion effect outside China, but it is usually the unknown risk that creates market turmoil. We changed our outlook for Chinese fiscal policy to stimulative this month as we expect the government will seek to cushion the economy to support job growth and social stability.

The outlook for major legislative progress in the U.S. remains murky. We have more confidence in understanding the potential tax implications (e.g., a potential 5% reduction in S&P 500 earnings) than the economic impact of a spending bill that will be spread out over 10 years. We made no changes to our global policy model this month, remaining overweight stocks and underweight bonds. Our base case rests upon *Slowing but Sustainable Growth*, supported by *Economic-Resistant Companies* that are successfully navigating the changing economy and rising input costs. This is important in the context of our *Stuckflation Tested – and Fails* risk case that we have carried for months. Our other risk case is around a failed transition from stimulus-led growth to organic expansion – a *Dropped Growth Baton*. We may face increased short-term volatility, but we are comfortable being overweight risk with a 12-month outlook.

MARKET RETURNS SUPPORTED BY EARNINGS GROWTH

Valuations have contracted this year as earnings jumped and risks in emerging markets rose.



Source: Northern Trust Asset Management, Bloomberg, FactSet. MSCI indexes used. Data through 9/14/2021.

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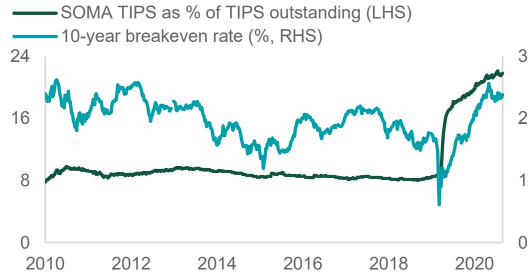
Interest Rates

The U.S. recovery has made the reflation trade a popular one — and that has shown up in the TIPS (Treasury Inflation Protected Securities) market. The 10-year breakeven (market expectations for inflation) reached its highest level since 2013 in mid-May as market participants re-evaluated their inflation expectations. And although inflation expectations have trended sideways since then, they currently remain above the long-run average. A TIPS fair value contains a liquidity and term premium, but there is also a flow component that cannot be ignored.

The System Open Market Account (SOMA) is a portfolio managed by the Federal Reserve (the Fed), composed of securities acquired via open market operations. The share of TIPS on the Fed's balance sheet as a percent of TIPS outstanding doubled from 10% to 20% in the past year. As taper talk heats up, investors should factor this dynamic into valuations. While not the sole reason for TIPS valuations remaining elevated, positioning and Fed buying should not be ignored. We continue to believe that inflation will eventually prove to be transitory, leading to lower-than-average inflation breakevens and nominal rates. The Fed buying fewer bonds may also bring down equilibrium breakeven levels as real rates potentially move higher.

FED PUSH

Fed TIPS purchases may have helped breakevens.



Source: Northern Trust Asset Management, Bloomberg. SOMA = System Open Market Account – a portfolio managed by the Federal Reserve comprising securities bought via open market operations. Data from 12/29/2010 through 8/25/2021.

- We remain in the transitory camp regarding inflation.
- TIPS breakevens may fall for fundamental reasons as well as technical reasons.
- We remain underweight both nominal and real bonds in the global policy model.

Credit Markets

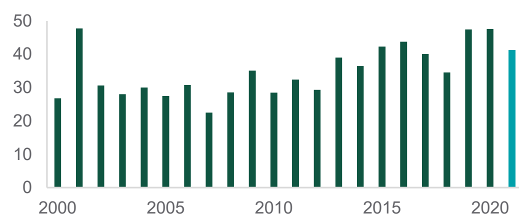
Improving credit quality has been a consistent trend within the high yield market over the past decade. The proportion of higher quality credits constituting issuance has increased from an average of about 30% during 2000-2010 to almost 40% over the previous decade. While the proportion of higher quality issuance has modestly declined this year, the general trend is still upwards. In the prior two years, over 47% of new issuance came from the highest-rated credits (highest level seen since 2001).

This shift in the quality makeup of the high yield universe can skew historical comparisons of valuations. For example, the previous all-time tight in high yield spreads was around 230 basis points (bps) in 2007. Looking at the index makeup at that point in time, BB-rated securities made up 37% of the high yield universe. BB-rated securities now make up 53% of the high yield universe with spreads around 280 bps. When taking into account this quality improvement, high yield valuations look attractive. Expectations for continued improvement in underlying fundamentals and overall credit quality, as well as the global search for yield, should continue to support high yield valuations going forward.

INCREASED QUALITY IN JUNK

High yield issuance has trended higher in quality lately.

HIGH YIELD: % UPPER QUALITY ISSUANCE



Source: Northern Trust Asset Management, JPMorgan. Data from 12/31/1999 through 9/16/2021. Blue bar = year-to-date. Upper quality issuance defined as credits split rated BBB/BB or BB-rated.

- High yield index shifts toward a higher quality composition make historical comparisons difficult.
- Despite being at historically low spread levels and all-in yields, we find high yield attractively priced.
- High yield is currently our largest tactical overweight, as an alternative to investment grade bonds.

Equities

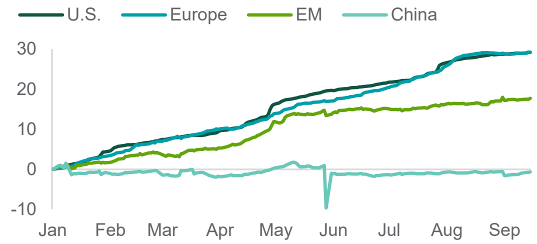
Global equities were largely unchanged over the last month, but there were relatively large differences between regions. Boosted by the expectation of more fiscal stimulus once a new prime minister is appointed, Japan erased all of its year-to-date underperformance. Emerging markets (EM) recorded modest outperformance, while the U.S. and in particular Europe lagged. EM's outperformance was driven by India and Taiwan, as China was flat on the month. Growth topped value, continuing a trend of the past few months as macro concerns regarding the Delta variant and actions in China led to underperformance of cyclical sectors like industrials and materials.

For global equities this year the story remains one of fundamentals. Relative performance across regions has been driven by earnings expectations. The U.S. and Europe have seen year-forward earnings expectations increase 29% year-to-date, outpacing even the strong market returns — thus leading to valuations actually declining. EM earnings have lagged, with China acting as a notable drag (see nearby chart). The very positive momentum of earnings improvements in the U.S. and Europe should begin to ease, but remaining overhangs in EM keep our preference with developed markets.

DEVELOPED MARKETS IN FRONT

U.S. and Europe earnings lead; China lags.

YTD GROWTH IN EPS FORECAST (%)



Source: Northern Trust Asset Management, FactSet consensus forecasts. EPS = year-forward earnings per share; YTD = year-to-date through 9/15/2021. Indexes used: S&P 500; MSCI Europe, MSCI Emerging Markets (EM); MSCI China.

- 2021 has been a year of fundamentals.
- Earnings expectations have outpaced the strong market returns this year — and valuations have fallen.
- We remain overweight developed markets given visibility — both on the economy and regulations.

Real Assets

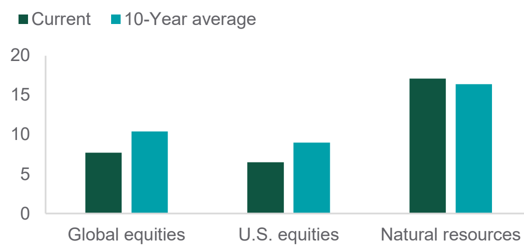
Natural resources are at a crossroads. Does slowing global growth mean it is time to sell? Or do patient central banks aiming to support another long-lived economic expansion mean it's a time to buy? Should investors be excited about the low reserves and high prices of natural gas going into the cold winter season for the Northern Hemisphere? Or should they be concerned over falling copper and iron ore prices as China influences prices for both economic and environmental reasons? Weighing all the news — and remembering we use diversified vehicles for our natural resources exposure — we believe now is a time to buy.

For all the variety in outlook described above, there are two common denominators across the asset class. First, today's companies are much more capital disciplined — as investors reward managing sound balance sheets over meeting production targets (which led to overproduction). This leads to our second point. Free cash flow that was once plowed back into projects is now sitting on balance sheets. This results in some attractive valuations — both relative to its history and other asset classes. Should the economic recovery persist (as we think it will), this cash flow will find its way into investor pockets via dividends. In a yield-starved world, this is an attractive offering.

VALUATION GOLD?

Natural resource valuations are attractive.

CASH FLOW YIELD (%)



Source: Northern Trust Asset Management, FactSet. Indexes used: MSCI ACWI (global equities), iShares Russell 3000 (U.S. equities); S&P Global Natural Resources. Data as of 9/16/2021.

- Commodity prices have taken different paths of late — some high (natural gas), some low (copper).
- Asset class valuations are attractive; free cash flows are moving to the balance sheet over new projects.
- Natural resources is our sole overweight position within the real asset space.

BASE CASE

Slowing but Sustainable Growth

Growth is moderating from the past year's strong pace but is still quite early in what will likely be a long economic cycle. At the same time, the steady (and generous) hand of central banks will support financial market valuations. We remain overweight risk assets broadly in the global policy model.

Economic-Resistant Companies

Pockets of elevated inflation, supply/demand mismatches and slowing economic growth have not impacted business profitability — notably in tactically overweight developed markets. Earnings growth has materially outstripped already-impressive revenue growth, leaving a solid fundamental backdrop.

RISK CASES

Stuckflation Tested – and Fails

Inflationary pressures during the recovery continue to build and overwhelm structural downward forces on inflation, forcing early central bank restrictiveness leading to risk asset headwinds.

Dropped Growth Baton

Handing off the baton from government stimulus to organic demand is challenged by the size of fiscal drag and the Delta variant. A failed transition (or perception thereof) could disrupt risk-taking.

ViewPoints reflects data as of 9/21/21.