VIEWPOINTS

FEBRUARY 2025

The Price of Progress

As the new U.S. administration prepares to take office, financial markets have responded by pushing up the cost of longer-dated bonds. This reflects investor concerns about potential policy shifts and their impact on future inflation and growth. The term premium, which has been relatively low in recent years, could serve as a key indicator of the new administration's success in fostering economic growth while keeping inflation in check.

One of the key concerns under the new administration is the potential for higher tariffs. Such measures could disrupt global trade flows, leading to higher costs for imported goods and raw materials. This, in turn, could reignite fears of a stagflationary environment. In that context, the policy desire to shift the trade balance more in favor towards the U.S. could come at a greater cost in the form of higher refinancing costs. Unsurprisingly, these concerns have also started to weigh negatively on the U.S. stock market in the form of lowering valuation premiums.

Markets currently seem to be assuming a gradual transition regarding changes in tariffs. However, this assumption could prove to be overly optimistic. If tariff changes are implemented more rapidly or aggressively than expected, the resulting economic shock could be more significant. This highlights the importance of assessing the specific proposals that are likely to be announced in the coming months.

Another factor contributing to market uncertainty is the anticipated release of new fiscal plans throughout the year. These plans are likely to take time to be fully implemented, which means their impact on the economy could be gradual and spread over an extended period. Investors will need to stay vigilant as these policies are rolled out, assessing their potential effects on growth, and inflation.

Given the high levels of outstanding US government debt, rising interest rates create additional constraints on policymakers who might wish to pursue more expansionary policies. The cost of servicing this debt increases as rates rise, leaving less fiscal space for other initiatives. This can limit the government's ability to stimulate the economy during periods of slow growth or recession, adding another layer of complexity to economic policy planning.

The Policy and the Premium

The potential growth and inflationary impact of the Trump administration's policies could be reflected in the term premium.

Source: Northern Trust Asset Management, Bloomberg. Tobias Adrian, Richard Crump, and Emanuel Moench (ACM Model). Data from 1/18/1994 through 1/14/2025. Historical trends are not predictive of future results.

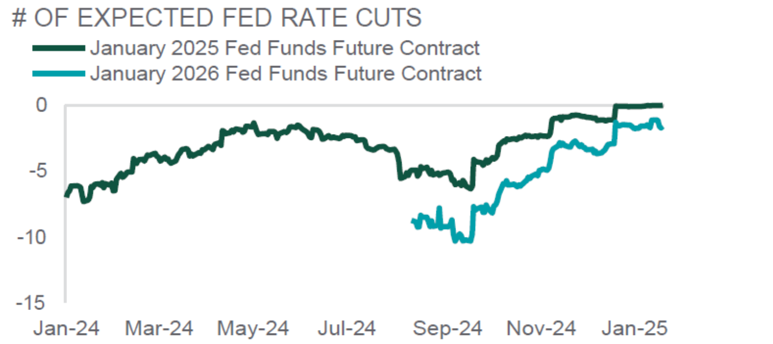
Interest Rates

Rates markets are starting off the new year with substantially different expectations for the path of the Fed Funds Target range than just four months ago, when the FOMC began reducing rates with a 50bps "recalibration" at their September meeting. While the FOMC has already cut by a total of 100bps, Fed Funds Futures markets currently imply less than two additional 25bps cuts this year. Market based expectations for the future path of policy have changed quickly. A brief look back at last year may offer a cautionary tale.

Starting last year, the FOMC was widely expected to lower interest rates in 2024, but expectations for the timing and magnitude of rate cuts varied meaningfully. In January of 2024, Fed Funds Futures markets implied as many as seven 25bp reductions by the end of 2024. Markets dialed back rate cut expectations throughout the remainder of the first and second quarter. The FOMC ultimately held policy rates steady for more than a year before cutting at their September meeting. It's entirely plausible the FOMC cuts twice this year, but it would be in response to how the economy is progressing rather than predictions from a volatile Fed Funds Futures market.

HERE WE GO AGAIN?

Similar to 2024, the number of Fed rate cut expectations could vary depending on how the economy progresses.



Source: Northern Trust Asset Management, Bloomberg. Data from 1/1/2024 through 1/17/2025. Historical trends are not predictive of future results.

- Market based expectations for the future path of policy have changed quickly.
- Accordingly, take the predictive power of fed funds futures markets with a grain of salt.
- A fairly wide range of outcomes with respect to the Federal Funds Target range are possible again in 2025.

Credit Markets

Following strong performance in November across risk assets, market participants began the month with a renewed focus on the Fed and the potential path forward for monetary policy. However, at the December FOMC meeting, the tone shifted from concern around future labor market weakness to more attention on stubbornly resilient inflation. Interest rates rose over the course of a month. Higher interest rates coupled with spread widening contributed to a negative return for high yield in December.

The backdrop in high yield (HY) continues to be supported by strong underlying fundamentals heading into 2025 as 3Q24 data revealed relative stability in credit metrics. Leverage has increased to 4.05x from the record lows back in 1Q23, although that still leaves it below the historical average of 4.30x. Interest coverage decreased 0.23x to 4.66x, but it remains above the long-term average (4.50x). HY market valuations are likely to be supported by stable issuer fundamentals and a benign default outlook. These factors provide a strong backdrop for high levels of carry and total return potential. In our view spreads are more likely to be influenced by interest rates going forward, rather than deterioration in fundamentals.

HIGH YIELD FUNDAMENTAL UPDATE

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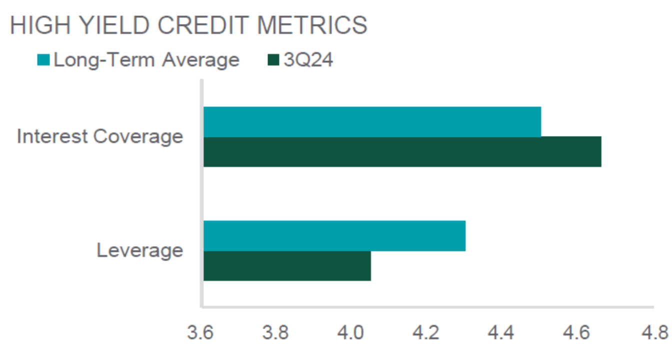

Sources: J.P. Morgan; S&P Capital IQ. Data from 1Q08 to 3Q24. Leverage = Debt/EBITDA. Interest coverage = EBITDA/Interest Expense. Past performance is not indicative or a guarantee of future results.

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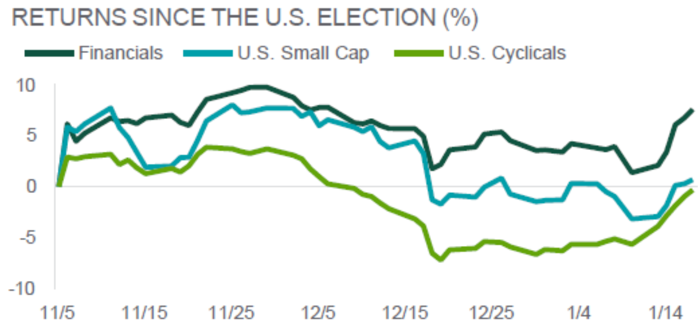
Equities

The last month has highlighted the importance of the macroeconomic backdrop. Global equities weakened after the Fed delivered a hawkish rate cut in December. Each of the major regions fell lower for the month. U.S. large cap value has had a strong January so far and is outperforming U.S. large cap growth after significantly underperforming in December and across the full-year 2024. In December, many cyclical areas of the market (e.g. small caps, industrials, materials) shaved off a majority of their post- election returns as Fed rate cut expectations were scaled back. However, softer-than-expected U.S. inflation data provided a boost for risk-assets in mid-January, leading to a reversal of many of the above moves.

U.S. economic growth data has remained solid. Although U.S. equity valuations are above historical averages, a strong earnings backdrop continues to provide support. Given a subdued economic growth outlook in the Eurozone and uncertainty around tariffs, we remain underweight to developed ex-U.S equities. But we remain broadly overweight equities overall with a preference for the U.S. and a smaller overweight to emerging markets.

MACRO MATTERS

Many cyclical areas of the market lost steam in December after a hawkish Fed cut.



Source: Northern Trust Asset Management, Bloomberg. Total return data from 11/5/2024 through 1/17/2025. U.S. Cyclicals includes large cap Industrials, Materials, and Energy sectors. Past performance is not indicative or a guarantee of future results. Index performance returns do not reflect any management fees, transaction costs or expenses. It is not possible to invest directly in any index.

- Softer-than-expected U.S. inflation data provided a boost for risk-assets in mid-January.
- Resilience in the U.S. economy and a supportive earnings backdrop has supported U.S. equity returns.
- We maintain overweights to the U.S. and emerging markets. We are underweight developed ex-U.S. equities.

Base Case Expectations

Soft Landing

Global growth will settle around trend, supported by ongoing U.S. economic strength and labor market/ consumer resilience. Inflation will continue to ease toward 2%.

Central Bank Easing

Lower inflation has allowed major central banks to start cutting policy rates. We expect central bank easing to continue, though the timing and trajectory may vary depending on regional economic conditions.

Risk Case Scenarios

Reflation

Policies of the incoming U.S. Administration have a net stimulative effect, leading to above-trend growth, persistent inflation and a pause in the Fed rate-cutting cycle..

Supply Restraint

Supply-side disruptions from immigration restrictions and higher tariffs weigh on economic activity and halt the disinflationary process until a recession takes shape.

Indexes Used and Definitions:

MSCI ACWI: A free-float weighted equity index that includes both emerging and developed world markets.

S&P 500 Index: Widely regarded as the best single gauge of large-cap U.S. equities. The index includes 500 leading companies and covers approximately 80% of available market capitalization.

S&P Global Infrastructure Index: The S&P Global Infrastructure Index includes exposure to 75 companies from around the world tha represent the listed infrastructure universe.

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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