VIEWPOINTS

MARCH 2025

Two Policy Risks in the Spotlight

There are two significant policy risks looming in the weeks ahead: U.S. domestic policy risk and global policy risk. Overall, financial markets believe that these two policy risks could limit economic growth and cause inflation. However, we continue to believe that the optimal way to navigate these risks is through a tactical and flexible approach. As more details of policy changes emerge, we could witness substantial market moves in either direction. For example, meaningful progress in trade negotiations with Canada and Mexico could provide quick relief to markets and lead to a risk-on environment. On the contrary, a prolonged period of intense negotiations with all U.S. trading partners could cause investors to lose patience and exert downward pressure on risk assets.

Domestic Policy Risk: The current federal government funding expires on March 14th. To avoid a shutdown, Congress needs to pass new spending legislation or extend the current funding. There are significant disagreements between Democrats and Republicans over the Trump Administration's actions, such as dismantling government programs and agencies, and freezing government grants. If a potential shutdown were to occur and drag into the month of April, this could create further downside risks to growth.

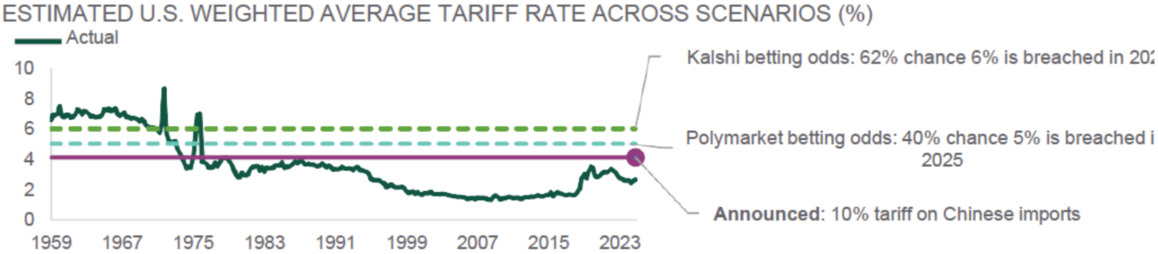
Global Policy Risk: As expected, the Trump Administration started the process of renegotiating trade agreements with its major trading partners. While this did not come as a surprise, it happens at a time when the geopolitical landscape is in flux, with high-stakes diplomacy and potential shifts in trade policies creating uncertainty. The trade discussions between the EU and the U.S. are likely to intensify in the coming weeks. We believe that there are positive paths for both sides to agree on a deal which would involve greater EU imports of liquefied natural gas (LNG) and increased military spending. However, discussions about non-tariff trade barriers are unlikely to be resolved quickly. In summary, markets are priced for an increase in U.S. tariff rates last seen in the 1960s. While some of the benefits may show up in increased domestic production of certain goods (e.g. cars, steel, aluminum), this could be a slow process and could be undermined by pressure on consumer spending, as prices for consumer goods can reflect higher tariff costs.

In conclusion, financial markets are facing a period of heightened uncertainty driven by policy risks, and inflation concerns. The combination of domestic political upheaval and global trade tensions requires investors to be disciplined about portfolio strategy and maintain flexibility to adjust their risk stance as new information emerges.

Tariffs Expected to Increase From the Current Level of Around 2.5%

The baseline market expectation seems to be for the average tariff rate to increase towards ~5%.

ESTIMATED U.S. WEIGHTED AVERAGE TARIFF RATE ACROSS SCENARIOS (%)



Source: Northern Trust Asset Management, Macrobond, U.S. Bureau of Economic Analysis, Kalshi and Polymarket betting odds as of 2/18/2025. 1H = First half. Actual tariff rate from 1959 through 2024. Polymarket and Kalshi betting odds defined on page 5. Historical trends are not predictive of future results.

Interest Rates

The FOMC voted unanimously last month to leave the Federal Funds Target Range unchanged at 4.25% to 4.5%, as widely anticipated. Treasury yields rose initially upon the release of the Policy Statement, but mostly reversed course by the end of Chair Powell's press conference. We took the main message from the meeting to be that, as signaled at their December meeting, the Committee views the economy and monetary policy as in a good place which positioned them to leave policy unchanged while they assess subsequent economic data points on both sides of their dual mandate.

Overall, the Chair's press conference conveyed a message that the Committee, "do[es] not need to be in a hurry" to adjust its policy stance further. This view is predicated on the risks to achieving their dual mandate as being, "roughly in balance". The Chair offered his view that they'll "need to see further progress" on inflation in order to ease policy further. Markets exhibited a much more muted reaction than after the December 2024 meeting. The implied magnitude of further rate cuts over the rest of 2025 edged lower to 47 basis points (bps), which is broadly consistent with our forecast of two-to-three more 25-bp cuts this year.

NO NEED TO BE IN A HURRY

The FOMC committee views the risks to achieving their dual mandate as being "roughly in balance."

Source: Northern Trust Asset Management, Bloomberg. Data from 7/31/2024 through 1/31/2025. Historical trends are not predictive of future results.

- While the outcome of the January FOMC meeting was widely anticipated, the Chair's comments were consistent with our own view that the Committee is attentive to risks on both sides of its mandate.
- The Committee is not in a hurry to adjust policy further.
- Given the current economic data, and our expectations for growth to slow but not stall, we continue to view the two-to-three-year sector of the curve as attractive compared to our estimates of fair value.

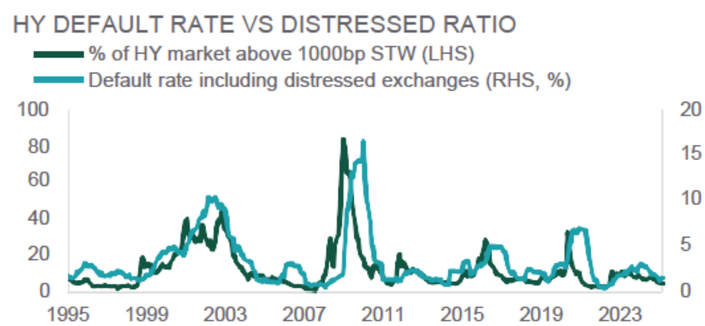
Credit Markets

Credit markets continued to perform well driven by a mix of price gains, spread tightening and, with attractive coupon income,the technical backdrop for credit remains notably strong. Although the leveraged loan market continues to price record amounts of supply from repricings and refinancings, net supply across bonds and loans remains relatively muted. High yield (HY) saw strong outperformance, benefiting from rates and light supply for the month of January. As a result, the amount of high yield bonds trading at distressed levels has decreased for the sixth time in the last eight months to a 33-month low.

The distressed ratio is often looked upon as a forward looking indicator for defaults because bonds begin trading to recovery value as the market is forward looking in nature. The divergence between the distressed ratio and default rate could be an indication of bottoming in the high yield market. Cable and Satellite bonds account for 26% of bonds trading 1000bp+, which is followed by Healthcare (20%) and Broadcasting (12%). With the elevated level of uncertainty and distress in this cohort of the market, active management will be paramount to success in the upcoming year in some of these more troubled sectors.

HIGH YIELD DISTRESSED RATIO

The divergence between the distressed ratio and default rate could be an indication of bottoming in the HY market.



Sources: Northern Trust Asset Management, J.P. Morgan. Data from 12/31/1994 through 1/31/2025. Distressed levels are defined as bonds trading greater than 1000 basis points (bps) of spread. STW = Spread-to-worst. Historical trends are not predictive of future results.

- Credit markets continued to perform well driven by a mix of price gains, spread tightening and attractive coupon income.
- The amount of high yield bonds trading at distressed levels has decreased for the sixth time in the last eight months to a 33-month low.
- Cable and Satellite bonds account for 26% of bonds trading 1000bp+, which is followed by Healthcare (20%) and Broadcasting (12%).

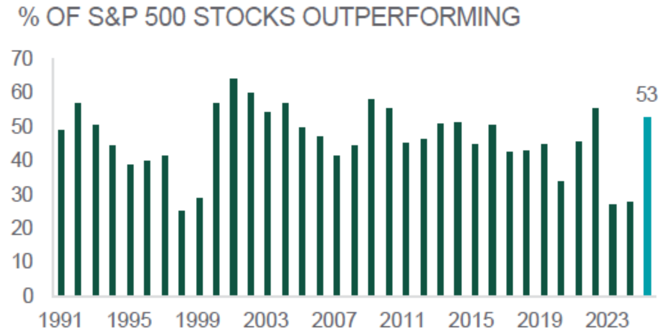
Equities

The so-called January effect was in full force as markets around the globe rallied following a December swoon. U.S. large caps finished the month up 3.0% on decidedly better breadth than the depressed levels seen during most of 2023 and 2024. Despite market rattling events, equities remained resilient with U.S. large caps within 0.7% of all- time highs as of February 10. Outside the U.S., marking a turn, developed international markets led the way in January, up 5.0%. The dollar remains strong, but pulled back modestly in January against most currencies other than the pound. This provided a tailwind for U.S. based investors, which was not the case amid currency headwinds in 2024. Emerging Markets were also positive, up 1.8% in January with leadership out of Latin America.

U.S. economic data remains solid overall. Fourth quarter earnings have come in much better than expected, and the outlook for '25 and '26 continue to support elevated valuations in the U.S. and our overweight to U.S. equities. For developed ex-U.S. equities, despite the market bounce in January, the subdued economic growth outlook and exposure to potential tariffs continue to weigh on our outlook.

BETTER BREADTH FOR A HEALTHIER RALLY

Following historically low breadth in '23 and '24, January saw broader market participation.



Source: Northern Trust Asset Management, S&P Dow-Jones, FactSet. Total return data from 12/31/1990 through 1/31/2025. 2025 (teal bar) only counts the month of January. All other years are annual. Past performance is not indicative or a guarantee of future results. It is not possible to invest directly in any index.

- Markets shot higher to start the year as better than expected earnings provided comfort during multiple market shocks.
- Breadth improved after two historically low years of a small group of stocks leading markets higher.
- 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 settle at lower levels, but tariffs could cause some bumps along the way.

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 could be complicated by tariffs and general government policy uncertainty.

Risk Case Scenarios

Reflation

Policies of the incoming U.S. Administration have a net inflationary effect, leading to 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 slow otherwise resilient economic growth, with the potential for recession.

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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