Global Investment Outlook 2025

NORTHERN TRUST

ASSET MANAGEMENT

Dear Clients, Partners and Investors,

As we step into 2025, the investment landscape remains both complex and full of opportunity. Navigating this environment requires a steady hand, rigorous analysis and a commitment to long-term value creation. Our annual investment outlook for the year ahead reflects these principles, providing a deep dive into the key forces shaping the global economy and capital markets.

This year, we face a dynamic mix of factors — from evolving monetary policies and shifting geopolitical tensions to structural transformations in technology, energy and sustainability. While these elements bring both challenges and potential dislocations, they also open avenues for growth across traditional and alternative asset classes.

Our investment teams have thoroughly assessed the macroeconomic landscape, equity and bond markets, real assets, and the evolving domains of private credit and equity. As always, our focus remains on preserving your capital and capturing the best opportunities available.

We hope this report serves as a valuable guide to navigating the road ahead and reinforces our commitment to managing your investments with diligence, foresight and discipline.

Thank you for your continued trust in us.

Warm regards,

Angelo Manioudakis

GLOBAL CHIEF INVESTMENT OFFICER

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U.S. ECONOMY

Soft landing with key uncertainties

The U.S. economy has made significant progress toward a soft landing. U.S. real growth has slowed to a still-robust rate of 2.7% on a year-over-year basis. Inflation has eased to 2.7%,[1] and excluding housing it is even lower at 2.1%. While inflation still remains above the Federal Reserve's 2% goal, it has eased enough to allow the Fed to start cutting its policy rate.

For 2025, we are focused on three potential scenarios for the U.S. economy. Our base case scenario remains a **Soft Landing,** wherein economic growth settles slightly below that of 2024, inflation eases further toward 2% and the Fed proceeds with a gradual pace of rate cuts. Our emphasis on this scenario reflects our view that consumer spending — which represents around 70% of the economy — will slow from strong gains in 2024 but remain healthy in 2025, as growth in real disposable income will likely be supported by favorable labor market conditions and falling inflation. Regarding inflation, we see scope for increases in services prices to soften as wage gains ease and housing prices moderate.

We considered two alternative scenarios that, in our view, reflect key uncertainties around the outlook for the U.S. economy in the year ahead, particularly regarding the economic effects of the likely policy initiatives of the incoming administration. We call these two alternative scenarios **Reflation** and **Supply Restraint.** In all of our three scenarios, we assume that the new administration implements a combination of restrictive immigration policies, higher tariffs, income tax cuts and a push toward deregulation. In the Soft Landing scenario, we assumed that this policy mix has no discernible effect on inflation.

However, in both the Reflation and Supply Restraint scenarios, we assume that the new policies temporarily bring the disinflationary process to a halt during the first half of 2025, leading the Federal Reserve to pause its rate-cutting cycle for most of the year. Where the two alternative scenarios differ is mainly on the net effect of the new policies on economic activity. In the Reflation scenario, we assume a net stimulative effect, with growth remaining above trend for most of 2025. In contrast, in the Supply Restraint scenario, the effect of restrictive immigration policies and higher tariffs leads to supply-side disruptions that could culminate in a recession that starts in late 2025 and aggressive Fed rate cuts.

[1] Source: U.S. Bureau of Labor Statistics. Inflation is measured by the September 2024 Personal Consumption Expenditures Price Index. Core inflation excludes more volatility food and energy prices.

EXHIBIT 1

Continued Growth Expected in 2025

Changes in Consensus U.S. Real GDP Year-over-Year Growth Forecasts for 2024 and 2025 (%)

Sources: Northern Trust Asset Management, Macrobond, Bloomberg. Gross domestic product (GDP) growth is the average level of the year-over-year change during the year. Data represents daily changes in estimates from February 10, 2022 to November 8, 2024. Forecast may be subject to change.

Consensus estimates forecast 2025 growth to settle slightly below this year's surprisingly robust rate.

EUROPEAN AND ASIAN ECONOMIES

Europe straddles growth and contraction, China may struggle

Eurozone economic growth has been mixed over the past year, stimulated intermittently by one-off factors like the Paris Olympics and volatile exports. The manufacturing sector has continued to contract, most notably in Germany. Economic activity has straddled the border between expansion and contraction. However, business spending remains robust and positive real wage growth has supported consumer spending.

We may see some moderation of the labor force, but it appears resilient for now, with unemployment at a low of 6.3%.[2] Inflation has returned to the European Central Bank's target of 2.0%,[3] though services and core inflation sit at higher levels. In addition to fiscal consolidation being a potential drag on growth, external shocks such as the risks of an increase in trade barriers and of further geopolitical tensions are likely to also drag on the large export sector and growth, in general. With regard to the U.K., we have a more balanced outlook. The government's budget may be slightly reflationary, so we expect the Bank of England to maintain a gradual and cautious approach to rate cuts.

Among Asian nations, the outlook for China remains a central concern. Economic growth is falling short of the government's 5% target. Domestic consumption remains muted as the consumer faces a falling property market and high youth unemployment (see exhibit). Manufacturing and exports have softened and face the increasing risk of tariffs. A slowing economy is deepening a deflationary loop, with consumer price inflation only slightly above zero and producer prices deep into deflation. Investors cheered the coordinated monetary and fiscal policy support in China, but the government has yet to announce full details. Amid a favorable growth outlook in Asia, China's prospects are the least favorable.

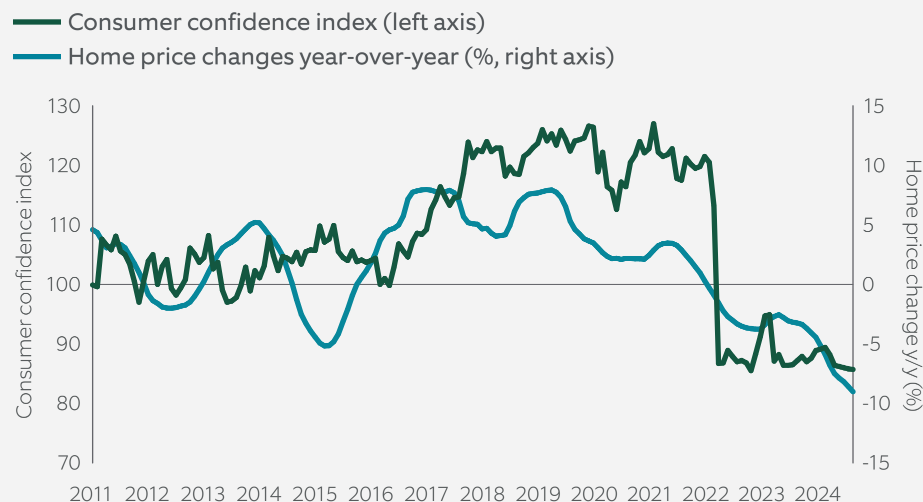
Japan continued on its own path in 2024 — moving to raise rates and exit a decade-plus of negative-rate policy during a time when a number of major developed market central banks were cutting rates. Economic growth in 2024 was unspectacular with sluggish consumption a headwind early on, despite some subsequent improvement. However, wage gains are spreading across the economy with a robust 2024 outcome for wages and a similar outlook for 2025. This bodes well for consumption down the road. Still, longer term growth headwinds remain in terms of demographics and productivity. We think the Bank of Japan will look to continue raising rates but will have to monitor a number of potential crosswinds.

[2] Source: FactSet, unemployment is for September 2024. [3] Source: FactSet, most recent inflation is the Consumer Price Index as of October 2024.

EXHIBIT 2

China's Domestic Consumption Faces Headwind of Falling Real Estate

China Consumer Confidence and Home Prices



Sources: Northern Trust Asset Management, Bloomberg, NBS. Monthly data from January 31, 2011 to September 30, 2024. Left: The index measures consumer confidence on a scale of 0 to 200, where 200 indicate extreme optimism, 0 extreme pessimism and 100 neutrality. Right: Second-hand residential buildings price, year-over-year.

Stemming the fall in home prices is a key variable in restoring consumer confidence.

U.S. EQUITIES

Earnings may support large cap valuations, small caps promising

With U.S. large cap stocks up more than 21% this year through October, following a 26% increase in 2023, the logical question is how much more room they have to run.[4] Price-to-earnings ratios are hovering near 27, well above the longer run average of 21.[5] It certainly appears U.S. large cap equity values have become inflated, risking a downside correction.

However, we expect continued U.S. economic growth in the near- and intermediate-term to translate into healthy revenue growth. Analysts expect sales to grow at a 6% clip over the next two years. Profit margins (see exhibit) have been expanding at a relatively steady pace. We expect this trend to not only continue but possibly accelerate due to productivity gains from the adoption of artificial intelligence, declining interest rates and an extension of (and possibly additional) tax cuts under President-elect Donald Trump's administration.

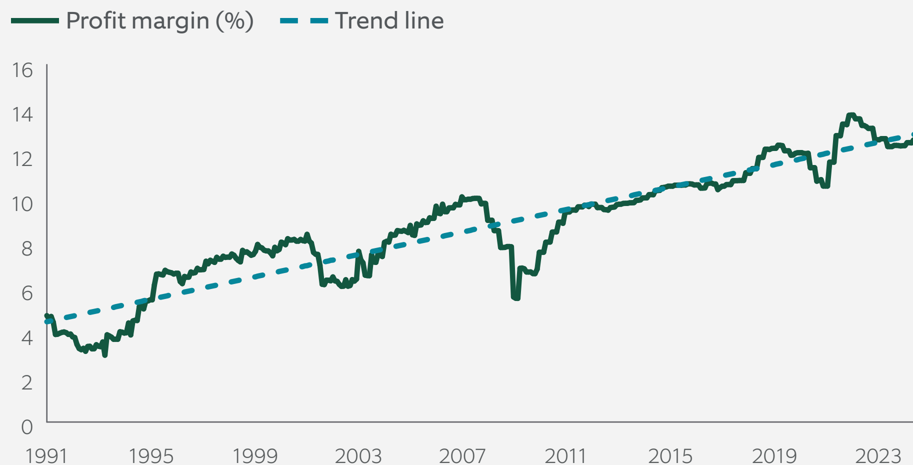
Strong sales growth plus increasing margins leads to positive expectations for earnings. Analyst estimates show 14% earnings growth for the next year[6] and 13% for the following year. At today's equity prices, these earnings gains suggest a forward price-to-expected-earnings ratio closer to 18, which is more reasonable and sustainable. While we anticipate some modest multiple contraction in the coming years, we are constructive on U.S. large cap equities and feel earnings growth will outpace any multiple decline.

Of course, U.S. large cap equities are increasingly dominated by a small handful of technology and communication services companies. While higher market concentration is synonymous with lower diversification and higher risk, the current market looks nothing like that of the dot-com bubble of the late 1990s. Today, the biggest technology companies have among the highest earnings growth, profit margins, capital expenditures and free cash flow generation in the S&P 500 Index. While they also have higher price-to-earnings ratios, we feel these multiples are justified by strong fundamentals. Still, these elevated prices put a limit on future gains and we don't expect a repeat of the last two years.

U.S. small cap returns have been somewhat more modest at 10% this year through October after a 16% gain in 2023.[7] While strong economic growth should also elevate small caps, we think declining interest rates will further aid performance as about half of small cap debt is floating interest rate. Lower rates may expand margins and President-elect Donald Trump's re-shoring efforts will likely boost earnings. These, combined with reasonable valuations, leads us to be constructive on U.S. small caps as well.

EXHIBIT 3

Rising Profit Margins



Sources: Northern Trust, Bloomberg. Data from January 31, 1991 to October 31, 2024. **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. Indexes are the property of their respective owners, all rights reserved.

> Profit margins have trended upwards for decades with potential to accelerate from artificial-intelligence-related productivity gains and other catalysts.

[4] Source: Bloomberg; the index is the S&P 500 Index, which tracks the performance of U.S. large cap companies. [5] Source: Bloomberg, as of October 31, 2024, long run average is for 20 years. [6] Source: FactSet. [7] Source: FTSE-Russell, based on the Russell 2000 Index, which tracks the performance of U.S. small capitalization stocks. **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. Indexes are the property of their respective owners, all rights reserved.

EX-U.S. DEVELOPED MARKET EQUITIES

Developed ex-U.S. stocks may continue to lag the U.S.

Large cap stocks for developed countries outside the U.S. (developed ex-U.S.) have posted a nearly 8% gain year-to-date through October, significantly trailing the 21% return of U.S. large cap equities.[8] While the difference is stark, it's a continuation of a trend ongoing since the Global Financial Crisis in 2009.

Over the 15-year period ending October 2024, developed ex-U.S. stocks have returned an average of about 6.2% annually while U.S. large caps have gained about 14% annually.[9] Before we project these differences into the future, it's important to examine what has driven this historical divergence.

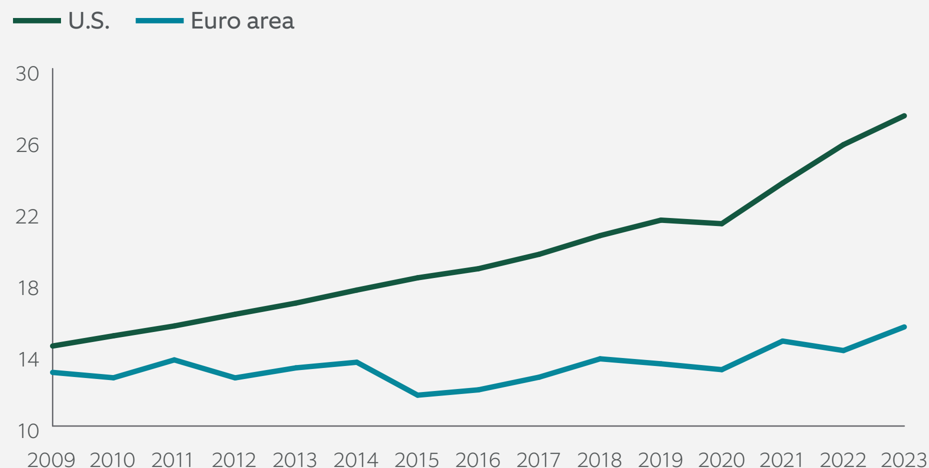
First, the sector composition of these markets has had a major impact. Technology and communication services companies, key drivers of global equity performance, hold nearly a 41% weight in U.S. large cap benchmarks but less than 13% in developed ex-U.S. benchmarks.[10] In contrast, developed ex-U.S. has a significantly higher weight to financials and industrials, making the sector profile skew to the value style while U.S. benchmarks skew more to growth. Low interest rates in the post-Global Financial Crisis era generally favored growth stocks and, hence, U.S. benchmarks. Sector weights alone explain about half the differences in performance since 2009.

Second, economic growth has been lower in developed ex-U.S. countries than in the U.S. For example, the exhibit details the trend in growth for the U.S. and the euro area. In 2009 these two regions were nearly at parity but since then the U.S. has grown at double the rate of the euro area, largely mirroring equity returns. Further, the rate at which economic growth has translated to revenue growth has been significantly different between these two regions.

In 2025, declining global interest rates may favor sectors more prevalent in developed ex-U.S. benchmarks but we expect economic growth differences to persist. While developed ex-U.S. price-to-earnings multiples look attractive from a historical perspective, we don't expect near-term expansion given the slower growth outlook. We do anticipate some margin expansion from artificial intelligence and lower interest rates, but not enough on balance to offset low revenue expectations. So we continue to expect that developed ex-U.S. large cap stocks will continue to trail U.S. large caps. That said, developed ex-U.S. can play an important portfolio diversification role, given their very different sector profile and interest rate sensitivity that can help manage risks from a highly concentrated U.S. equity market.

EXHIBIT 4

U.S. Economy Has Outpaced Europe



Source: Bloomberg. Data annual from 2009 to 2023. Historical trends are not predictive of future results.

While the size of the U.S. economy after the Global Financial Crisis was about the same as Europe's economy, a more dynamic U.S. has helped it significantly outpace Europe since. We expect this divergence to continue.

[8] Source: MSCI, based on the MSCI World ex-USA Index, which tracks the performance of large- and mid-cap companies across 22 of 23 developed-markets countries (excluding the U.S.). U.S. large cap performance is based on the S&P 500 Index, which tracks the performance of U.S. large cap stocks. **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. Indexes are the property of their respective owners, all rights reserved. [9] Sources: MSCI, Bloomberg, performance based on the MSCI World ex-USA Index and the S&P 500 Index, which tracks the performance of U.S. large cap stocks. [10] Source: FactSet, as of October 31, 2024, based on weightings in the MSCI World ex-USA Index and the S&P 500 Index.

EMERGING MARKET EQUITIES

Riding the tailwinds of valuation and growth

Emerging market stocks outperformed developed market stocks by an average of 9.9% per year during the first decade of this century.[11] However, emerging markets have *underperformed* by an average of 6.9% per year since, delivering a disappointing 3.7% annualized average return.[12] This is despite emerging market companies having similar sales growth, profit margins, valuations and dividend yields to developed market companies.[13]

So where did emerging markets slip? The primary detractor to emerging market returns has not been fundamental weakness, but rather share issuance, notably out of China, that has reduced returns per share to investors by 6.1% per year over the last 10 years (see exhibit for more information).

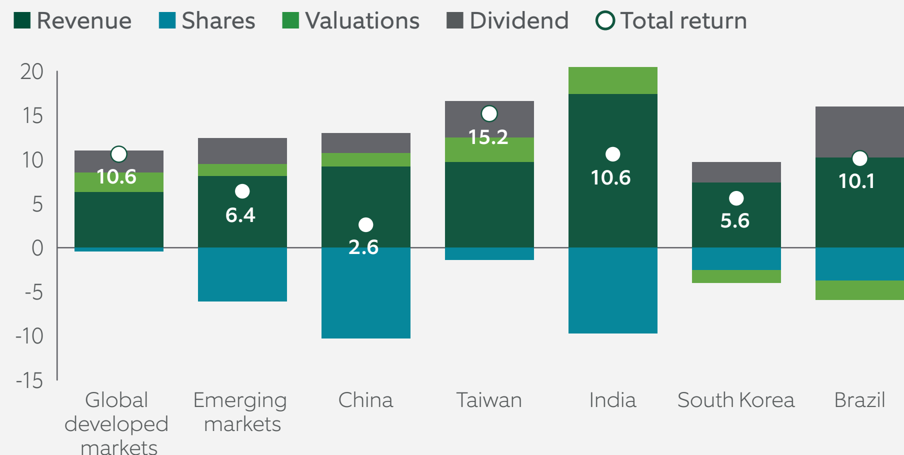
While we expect share issuance to continue weighing on performance, there are several potential return drivers in 2025. First, from a valuation perspective, emerging market companies trade at a sizable discount to developed markets and they also carry a favorable earnings outlook. Further, the Chinese government recently introduced stimulus intended to boost demand and stabilize the real estate market. Investors initially reacted favorably to these measures, although they should consider the impact of potential U.S. tariffs on Chinese goods based on campaign rhetoric from U.S. President-elect Donald Trump. We are skeptical that the stimulus will create a sustained cyclical turnaround or resolve China's structural issues, but we think it is a step in the right direction.

Although emerging markets are about much more than China, the country accounts for 27% of the MSCI Emerging Markets Index's weighting. The Asia-Pacific region including China accounts for 80% of the index, so it is hard to see emerging markets thriving without a tailwind from China.

Despite the concentration to Asia-Pacific, emerging markets continue to offer exposures to a diverse set of themes both global and local in nature. With elevated market concentration in developed markets, driven largely by the U.S., diversification is especially important. Emerging market equities can continue to play an important role in investor portfolios, especially given the potential offered by favorable valuations, earnings growth and diversification benefits to developed market equities. With a valuation cushion, and other emerging markets outside of China with brighter outlooks, we stay constructive on emerging markets in 2025.

EXHIBIT 5

The Drag of Share Issuance



Sources: Northern Trust, FactSet, MSCI, Bloomberg. Total returns including dividends in U.S. dollars, from March 31, 2014 to August 31, 2024. Index performance returns do not reflect any management fees, transaction costs or expenses. It is not possible to invest directly in any index. **Past performance is not indicative of future results.**

INDEX DEFINITIONS

Global developed market = MSCI World Index, which tracks the performance of large- and mid-cap companies in countries with developed economies. Emerging markets = MSCI Emerging Markets Index, which tracks the performance of large- and mid-cap stocks across 24 countries with developing economies. China, Taiwan, India, Korea and Brazil are respectively represented by the MSCI China Index, MSCI Taiwan Index, MSCI India Index, MSCI Korea Index and MSCI Brazil Index, which all track performance of large- and mid-cap stocks in those countries.

High share issuance in emerging markets, versus the global market, caused emerging markets to underperform over the past 10 years. However, we believe emerging markets are positioned for better performance going forward.

[11] Source: Bloomberg. Returns are based on the MSCI Emerging Markets Index from December 31, 1999 to December 31, 2009. The index measures the performance of large- and mid-cap stocks across 24 emerging markets countries. Emerging markets are generally in fast-growing countries with developing economies.

[12] Source: Bloomberg. Returns are based on the MSCI Emerging Markets Index from December 31, 2009 to October 31, 2024. [13] Valuation is the process of determining the value of an asset based on the analysis of variables related to investment returns or comparisons with similar assets. Dividend yield is the dividend per share divided by the share price, in percentage terms.

U.S. MONEY MARKETS

Money fund assets up while rates go down

While the Federal Reserve was widely expected to lower interest rates in 2024, expectations for the timing and magnitude of rate cuts varied meaningfully over the course of the year. In January, federal funds futures[14] markets implied as many as six to seven quarter-point reductions by the end of 2024 — an expectation we and many others viewed as an overreaction. Markets dialed back rate cut expectations throughout the remainder of the first and second quarter. The Fed ultimately held policy rates steady for more than a year before delivering a half-point "recalibration" rate cut in September and a quarter-point cut in November.

For 2025, there is significant uncertainty over the economic outlook and monetary policy. A fairly wide range of outcomes with respect to the federal funds target range are possible. Accordingly, we favor a neutral position for our portfolios. Importantly for money market investors, we and the markets see little chance rates return to the zero lower bound anytime soon — a welcome change from much of the past 15 years of very low yields on cash.

While the federal funds target range is the biggest driver of money market fund yields, money markets also exhibited signs of normalization in 2024, with more rate volatility *within* the federal funds target range. Credit spreads were generally little changed, to slightly tighter. While participation in the Fed's reverse repurchase agreement operations (RRP)[15] peaked at $2.3 trillion in 2023, it has trended substantially lower to as low as $150 billion. This is a consequence of balance sheet reduction by the Fed. While money market rate volatility is normal, rates near or above the top of the target range may be a sign of reserve scarcity. The Fed's balance sheet reduction may need to end, a dynamic we'll be monitoring closely.

While intuition may suggest that as yields on money market funds move lower along with policy rates they would be less attractive and drive outflows, we've seen the opposite in 2024, consistent with historical experience. Money market fund industry assets have increased by more than $500 billion this year (see exhibit), setting all-time-high records. Assets have been going up even as rates are going down, as money market funds remain an attractive alternative to other cash management options like deposits or Treasury bills.

[14] Federal funds futures are contracts used to hedge short-term interest rate risk. They reflect the market's insight on the future course of the Federal Reserve's policy rate. [15] A program where money market investors can invest cash (versus Treasury collateral) overnight and earn an interest rate set by the Fed.

EXHIBIT 6

U.S. Money Market Assets Rise Even as Rates Fall

Source: Bloomberg, from January 3, 2024 to October 23, 2024. The assets are the total for taxable and tax-exempt money market funds that report to the Investment Company Institute.

Even as the Fed started to cut rates in late 2024, money market assets have increased. We see little chance of money market rates returning to near-zero, as has occurred in much of the past 15 years before Fed rate hikes commenced.

EX-U.S. MONEY MARKETS

Policy divergence in Eurozone, U.K. and Japan

The euro area's economic outlook is marred with downside growth risks driven by both domestic and external factors. On the domestic front, German growth remains a key concern and corporate profit margins have come under pressure. This in turn is leading to companies' unwillingness to absorb higher wages and labor hoarding,[16] which will place further downside pressure on growth and the inflation outlook.

External growth factors are also contributing to headwinds in European growth. Both China's below-trend growth outlook and uncertainty over potential tariffs imposed by the U.S. will likely play an important role for European growth. Given the soft growth and inflation outlook, we believe the European Central Bank will continue to ease monetary policy into 2025, reducing money market rates. This path is likely to continue to be one that is taken with caution until they reach a neutral rate of close to 2%. However, given the downside risks highlighted, risks are tilted to a more aggressive pace of rate cuts to below our 2% neutral level.

In the U.K., more spending outlined in the Labour government's budget, along with continued sticky inflation from both services and wages, has resulted in higher inflation expectations by the Bank of England. This supports the central bank's approach of gradual rate cuts, giving it time to monitor the budget's impact. The pace of cuts will likely follow a gradual approach which we interpret to be no faster than a quarterly pace. As we look into 2025, the prospect of higher inflation will likely linger, potentially forcing the Bank of England to pause rate cuts earlier than investors expect. Although we are sympathetic to the market's view, we still believe the bank will cut rates to 3.75%, with risks tilted to the upside.

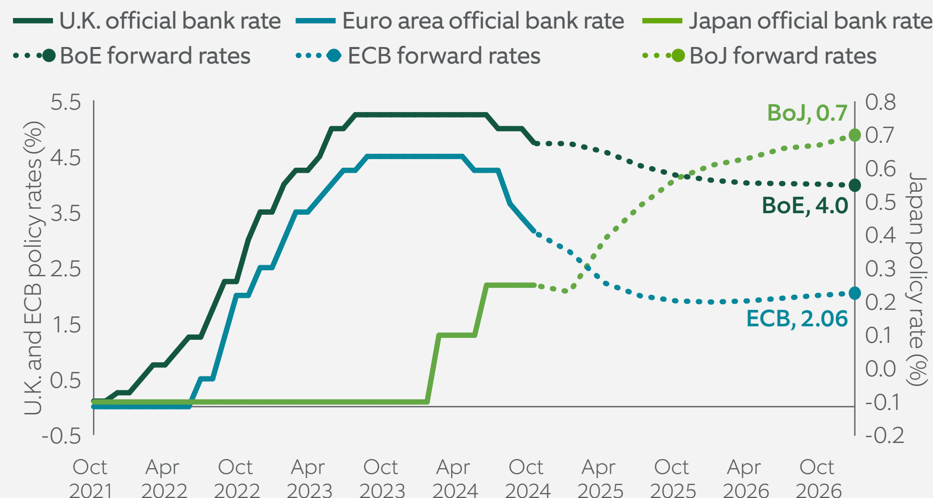
The Bank of Japan remains a monetary policy outlier as they continue to exit decades of extreme monetary policy easing. We believe that further monetary policy tightening will be measured and moderate. The more recent political turmoil in Japan has highlighted the public's dissatisfaction with rising prices and the need for further fiscal easing in Japan. Given those factors, as well as expectations of wage increases in the second quarter of 2025, we believe the Bank of Japan will continue to increase its policy rate in a slow and measured manner, to close to 0.75%.

[16] Labor hoarding often occurs in tight labor markets, when companies who need to cut costs avoid laying off workers because they may be difficult or costly to hire later.

EXHIBIT 7

Divergent Policy Rate Paths

Eurozone, U.K. and Japan Historical and Forward Policy Rates



Source: Bloomberg, data as of November 11, 2024. BoE = Bank of England. BoJ = Bank of Japan. ECB = European Central Bank. Forward rates are interest rates applicable to financial transactions that will take place in the future, making it a market prediction of rates in the future. Historical policy rates shown are from October 2021 to October 2024, and forward rates are from December 2024 to December 2026. Forecasts may be subject to change.

The Bank of England may take the most cautious rate-cut path because of sticky inflation. The Bank of Japan is an outlier among central banks, as they exit decades of extreme policy easing.

TREASURY INFLATION-PROTECTED SECURITIES (TIPS)

Inflation pressure may benefit TIPS investors in 2025

U.S. inflation has fallen significantly from the painful peak of more than 9% in 2022. In September, inflation fell to 2.4%, based on the Consumer Price Index, the reference inflation index for Treasury Inflation-Protected Securities (TIPS), and 3.3% for core inflation, which excludes more volatile food and gas prices.[17]

In 2025, we anticipate that inflation will remain contained with a tendency to drift slightly higher than the Federal Reserve's 2% target. Considering our expectation that economic growth remains positive, albeit below the current trend rate, we think there is little impetus for inflation to bridge the final gap to the Fed's target. In addition, persistently high government spending deficits have spurred rising U.S. government debt, which could potentially pressure inflation upwards. Global political tension in Ukraine and the Middle East risk contributing to inflation through commodity-price spikes as well as increased anti-competitive forces in China contributing to added tariffs.

Ten-year real interest rates are over 2% and breakeven rates, or the difference between similar-maturity nominal Treasury yields and TIPS yields, are hovering between 2.3% and 2.6% depending on the time horizon (see exhibit for more information). This means the TIPS market is priced for near perfection, reflecting expectations that the Fed will successfully meet their 2% inflation target over the next 10 years. Given our expectations of slightly higher inflation, TIPS will likely benefit from the inflation accruals outpacing breakeven rates over the next year.

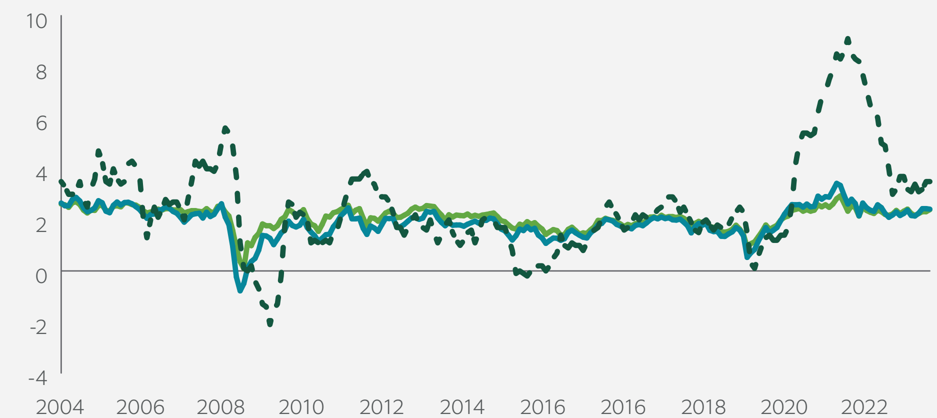
The exhibit shows the breakeven priced into the TIPS market relative to year-over year inflation. As noted earlier, in the last few years, inflation has been trending above breakeven rates, which benefits TIPS investors relative to similar maturity Treasurys.

While many asset classes that capture a market risk premium can help to buffer a portfolio over time — for example equities and high yield bonds — TIPS are one of few asset classes that we expect to perform well in a defensive environment with a direct link to inflation. While we have our expectations of inflation settling into a range above 2% for 2025, we expect the path to be bumpy. So we believe TIPS are an important defensive portfolio component for unanticipated inflation.

EXHIBIT 8

Inflation Trending Above Breakeven Rates

Inflation vs. Breakeven Rates (%)



Source: Bloomberg. Data is from November 2004 to April 2024. CPI is the Consumer Price Index, which measures inflation in the U.S. and is the inflation reference yield for TIPS.

Inflation has been trending above breakeven rates in the last few years, which benefits TIPS investors relative to Treasurys with a similar maturity. Breakeven rates are the difference between TIPS yields and Treasury yields with similar maturities.

[17] Source: U.S. Bureau of Labor Statistics, as of September 2024.

U.S. INVESTMENT GRADE BONDS

Security and sector selection key for 2025

We expect credit spreads[18] of investment grade bonds to trade within a tight range next year, similar to 2024. Over the last four years, sectors within the investment grade credit market that are more sensitive to the economic cycle have significantly improved their balance sheet strength.

Although the proportion of lower-rated companies in the market is above the long-term historical average, this ratings mix fell to 47% in July 2024 from 52% in January 2019.[19] Moreover, the proportion of the lower-rated companies approaching high yield ratings (BBB-) has improved significantly and sits at its lowest level in 10 years. This should constrain spreads at the wider end of the range in the event of any unexpected weakness in economic growth.

The technical backdrop for investment grade bonds remains strong with higher yields attracting interest from insurance companies, pension funds and non-U.S. buyers (see investment flows in exhibit). Supply is projected to be $1.4 trillion for 2024 and is expected to increase modestly in 2025, with refinancing driving the rise. Mergers and acquisitions could drive supply higher than expected, but the deals currently in the pipeline are modest.

We believe security selection and sector allocation will be key as we expect spreads generally to remain dormant. The banking and related sectors that were attractive in 2024 have largely performed well as expected, and we are turning our attention to other themes. Some examples include companies that benefit from artificial intelligence and related services.

For those companies that have suffered from weak manufacturing demand, we expect potential bottoming and opportunities to re-enter in 2025. In the healthcare sector, profitability was hurt in managed care by medical costs over the last few quarters. However, we expect this pressure moving on to the healthcare providers and medical equipment companies going forward, as insurance companies try to restore their margins.

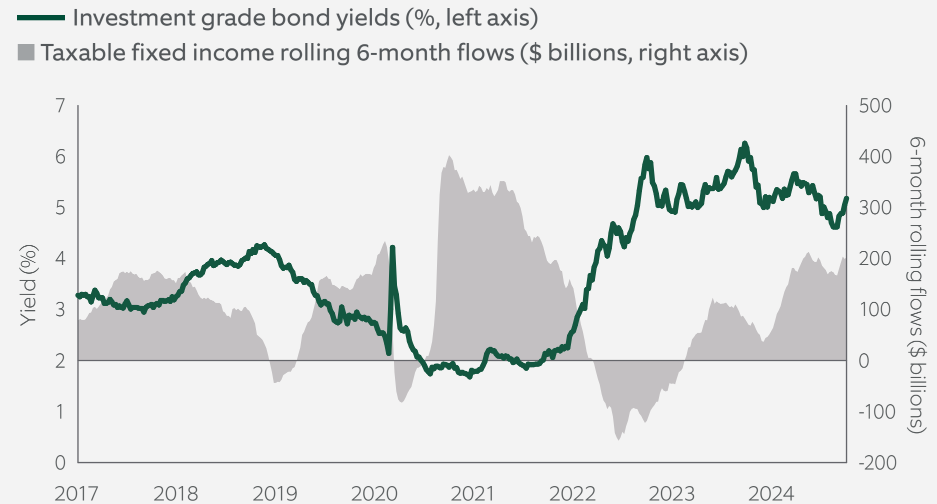
Overall, we believe 2025 will be an environment where investors will seek yield, and they are likely to quickly pick up any weakness in spreads. Risks to our outlook are an unexpected deterioration in economic growth and/or a resurgence of inflation, which puts a restrictive monetary policy stance back on the table.

[18] The credit spread often is the difference between yield of a corporate bond and a government bond, such as a Treasury, of similar maturity. Investors demand additional yield as extra compensation for assuming the risk of default. [19] Source: Bloomberg, based on weightings in the Bloomberg U.S. Corporate Bond Index, which tracks performance of U.S. investment grade bonds.

EXHIBIT 9

Resilient Investment Grade Flows

Investment Grade Yields vs. Investment Flows



Source: Bloomberg. Data from January 6, 2017 to November 1, 2024. Historical trends are not predictive of future results.

As yields rallied in 2022 and 2023, investor demand for taxable bonds increased. Even with the recent fall-off in yields, demand has stayed resilient from insurance companies, pension funds and non-U.S. buyers.

Yields and credit quality support attractive outlook

We expect high yield bond credit spreads to stay rangebound below the long-term average in 2025, driven by strong fundamentals, supportive technical trends and attractive yields.

Corporate fundamentals are stabilizing but they remain strong relative to historical levels. Leverage continues to sit below historical averages while interest coverage ratios[20] remain above average. As a result, credit ratings upgrades are outpacing downgrades. The net result is the composition of the high yield market remains close to the highest quality since inception.

Looking ahead, we expect companies to maintain better-than-average balance sheets given funding costs are higher than the decade before the pandemic. Recent economic drivers such as the artificial intelligence boom have dramatically impacted some of the previously distressed segments in the market. As a result of these fundamental drivers, the percentage of distressed companies continues to decline, which bodes well for maintaining future low default rates. Combined with strong balance sheets, default rates are likely to remain well below the 4% historical average.

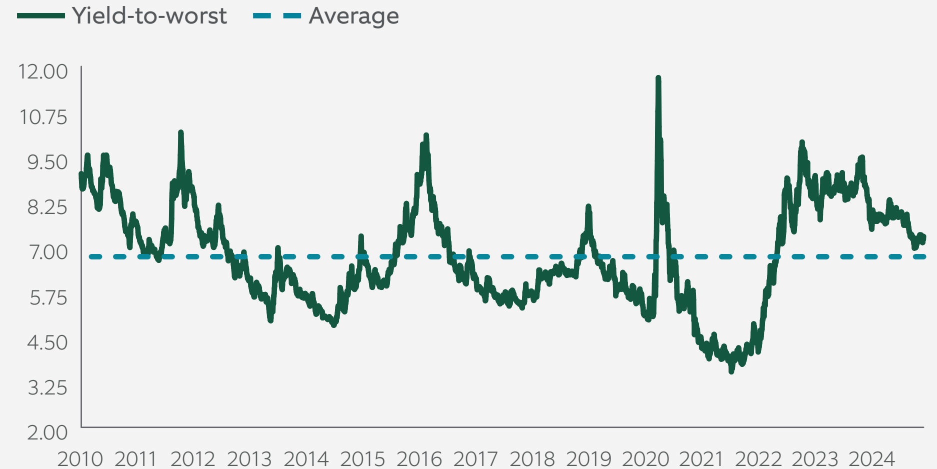
The technical picture in high yield remains supportive. After two years of contraction in 2022 and 2023, the high yield market is on track to expand slightly in 2024. Issuance picked up this year as financing costs normalized and are close to current yields. However, net issuance remained low as companies maintain a conservative stance and focus on refinancing rather than re-leveraging.

On the demand side, inflows for the asset class have been strong as investors look to lock in attractive yields. Against a backdrop of expected continued monetary policy easing, we believe the trend of refinancing activity will remain a primary driver of issuance. The decline in interest rates and a more constructive macro outlook could drive a potential pickup in merger and acquisition activity, which could lead to a slight uptick in net issuance.

Valuation remains favorable in the high yield market. The starting yield[21] of 7.29% (as of November 15, 2024) is among the highest since the Global Financial Crisis period (2007–2008) and supports attractive returns. Our expectation of low defaults and a supportive Federal Reserve are positive for investors seeking total returns with reduced volatility compared to other risk assets. Credit spreads, on the other hand, are at the lower end of the historical range. We believe it could widen slightly, while likely staying rangebound. However, we think any likely losses will be manageable due to the high yield market's record low duration and would be easily absorbed by current yields.

EXHIBIT 10

Attractive Yields



Source: Bloomberg. Daily yields from January 1, 2010 to November 15, 2024. Yield-to-worst is the yield on a callable bond (where the issuer may pay off a bond before its maturity date) that assumes a bond is called at the earliest opportunity. Yields are annualized interest (coupon) payments divided by the bond market price. Historical trends are not predictive of future results.

Above-average yields, combined with historically high credit ratings in the high yield market, support a strong outlook.

[20] Interest coverage is the ratio of earnings to interest expenses, an indicator of the ability of a company to make interest payments on debt. [21] The starting yield of a bond is the yield at the beginning of a period, often to be compared to a yield at the end of a period.

SECURITIZED BONDS

Key factors converge to support mortgage-backed securities

The surge in volatility shortly before the Federal Reserve started increasing interest rates in March 2022, after nearly a decade of low rates, has proven challenging for investors in mortgage-backed securities. In addition to experiencing higher volatility, the mortgage market underwent structural changes of its composition and ownership. This "reset" the fair value of spreads for mortgages above their long-run historical levels for some time (see exhibit), in the end offering attractive valuations both outright and relative to other sectors.

When in September the Fed initiated a highly anticipated rate-cutting cycle, we correctly predicted that implied volatility would decline, which in turn would have positioned valuations of mortgage-backed securities well for 2025. Prior to that point, uncertainty about the size of the first rate cut and the subsequent pace of monetary policy easing helped keep volatility elevated by historical standards. Since then, however, uncertainty in the wake of the U.S. elections has made the path of interest rates less clear and we view the effect of volatility on valuations to be net neutral.

Still, U.S. mortgage-backed spreads continue to offer value in our view. From a technical perspective, we expect supply in 2025 (including Fed sales from its balance sheet) to be about the same as the $400 billion in expected issuance this year. This remains far below the record refinance years of 2020 to 2022, which resulted in $500 billion to $800 billion in net issuance per year. The drop in supply could keep the market tight, benefiting prices.

Further, prepayment risk, most prominent when borrowers pay off their mortgages early to refinance, remains very low with close to 95% of outstanding mortgages carrying interest rates below current market rates. This results in better "convexity" for investors relative to history, where investors tend to gain more when interest rates fall by a certain amount than they would lose when interest rates rise by the same amount.

These factors, combined with attractive valuations and an expectation that in the longer term volatility could decline further from current still elevated levels, could benefit mortgage securities in several ways. First, we expect banks — the largest single mortgage investor group which historically owned 25% to 30% of outstanding mortgage-backed securities — to return to adding mortgages again after a year and a half of reductions. This could increase demand for mortgage-backed securities. Second, we expect the spreads in mortgage sector to tighten, improving returns. Third, we believe lower volatility will drive up the risk-adjusted returns,[22] making the addition of mortgages more attractive for inclusion in multi-sector fixed income portfolios.

EXHIBIT 11

Potential Benefits from Fed's New Rate Path

Mortgage-Backed Security Spreads vs. Fed Rate and Bond Volatility

Source: Bloomberg. Data from January 2004 to November 2024. The MOVE Index, or the Merrill Lynch Option Volatility Estimate index, represents volatility in the Treasury market. A higher MOVE Index represents more volatility.

> **Current mortgage-backed security yield spreads to Treasury yields of about 149 basis points are pricing in higher volatility. As we expect interest rates to fall in 2025, we expect spreads to decline as well, benefiting investors in mortgage-backed securities.**

[22] Risk-adjusted returns are a way of evaluating returns based on the amount of risk taken to achieve those returns.

MUNICIPAL BONDS

Fundamentals and yields should support performance

We expect strong fundamentals and high starting yields[23] to support the U.S. municipal bond outlook and returns in 2025. The current broad municipal index yield of 3.59% (as of November 15, 2024) provides significant cushion for total return and we think the taxable equivalent yield[24] of more than 6% will continue to attract investor demand. We expect this healthy demand for municipals to offset pressure from likely positive net issuance in 2025. Credit spreads are tight, yet we see no major catalyst to drive spreads wider.

We believe fundamental municipal credit is strong, and state and local government resiliency to economic adversity is high. Healthy reserves, improved pension funding and less debt provides a margin of safety from unexpected policy, economic or other shock events. We maintain a constructive bias on not-for-profit healthcare sector fundamentals based on improving credit trends. Changes to federal healthcare policy could be a catalyst for spread widening, the degree of which would depend on the aggressiveness of any changes. Higher education bonds have benefited from endowment gains, although less-selective colleges are weakening from changing demographic trends and consumer tastes.

New issue supply rose by more than 35% in 2024 as issuers returned to typical levels of borrowing for capital spending.[25] We see this continuing in 2025 given heavy capital needs and results of recent bond-authorization elections. We expect modestly positive net supply.

We see municipal bond relative value, as measured by municipal-to-Treasury yield ratios, to remain rangebound at levels that are expensive to historical averages. Given the election results, we expect the federal government to extend much of the tax cuts from 2017, most of which are set to expire in 2025. This would make tax increases — which would increase municipal relative value — unlikely. We also expect a debate around changes to the municipal bond tax exemption, yet we think an elimination of the exemption is unlikely. The rapid growth in Treasury supply, driven by large federal deficits, as compared to the slower growing municipal supply, should protect municipal relative value from a major correction and keep ratios rangebound.

EXHIBIT 12

Historically Attractive Yields

Municipal Bond Market Yield-to-Worst (%)

Source: Bloomberg. Data from November 15, 2014 to November 15, 2024. Yield-to-worst is the yield on a callable bond (where the issuer may pay off a bond before its maturity date) that assumes a bond is called at the earliest opportunity.

Historically high yields and generally strong credit quality drive a positive municipal bond outlook for 2025.

[23] The yield of a bond or bond index at the beginning of a period, often to be compared to a yield at the end of a period. [24] Because income from municipal bonds is exempt from U.S. income taxes, they usually have lower yields than similar-maturity taxable fixed income investments such as corporate bonds. The taxable equivalent yield for a municipal bond is the yield that is comparable to the yield of a taxable bond, assuming the highest U.S. income tax rate.

[25] Source: *The Bond Buyer.* The 2024 new issue supply from January 1, 2024 to October 31, 2024 is 35% higher than the same period in 2023.

REAL ASSETS

Real estate, infrastructure and natural resources positioned well

Global real estate performed well for most of 2024, though it underperformed the broad equity market. Real estate appears positively positioned for 2025, given a less onerous interest rate backdrop. With almost $2 trillion of commercial real estate loans scheduled to mature over the next three years (per the Mortgage Bankers Association), headline risk for the commercial market could lead to some investor caution. U.S. office markets continue to contend with high vacancy levels, and regional banks — the most significant capital provider to commercial real estate — face increasing pressure to shrink their exposure. However, this is creating opportunities for alternative lenders.

We also expect further normalization in investment volumes and asset pricing, supported by falling borrowing costs. There is only slight exposure (about 5%) to the office sector across publicly traded global real estate investment trusts (REITs). We believe other more sizeable areas of the market are positioned for structural growth. This includes data centers (demand related to artificial intelligence), industrial (e-commerce), healthcare (demographics) and residential (shortage of housing) real estate.

Global listed infrastructure also performed well in 2024. In 2025, we expect infrastructure to continue to serve as a useful tool for diversification, inflation mitigation and income generation. Many areas of the asset class should benefit from surging forecasts for global power demand and the investment needed by utilities to service this growth. The increasing electricity needs to power artificial intelligence presents a growth opportunity for the global utility sector, which as a regulated industry has historically experienced only moderate growth.

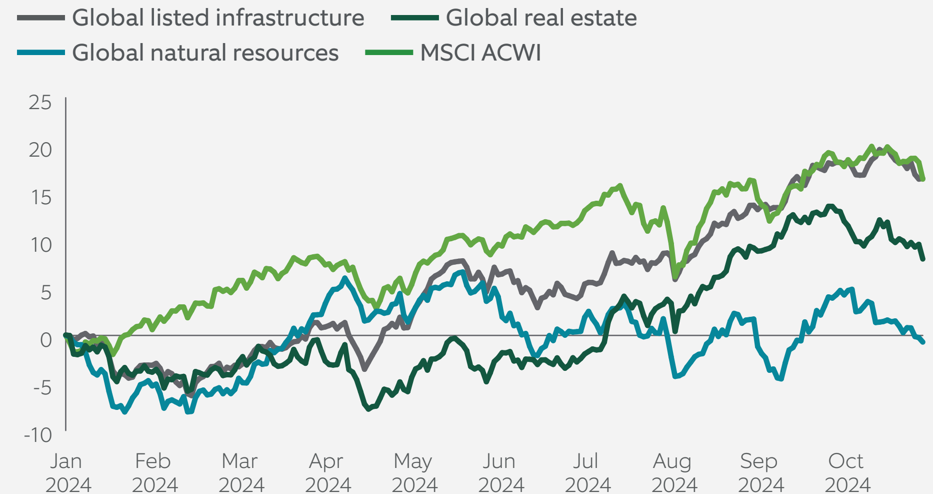
With the retirement of coal plants, investment into natural gas, nuclear and renewable energy has increased and earnings growth has roughly doubled.[26] Further, given its bond-like profile, global listed infrastructure should benefit if we experience a decline in interest rates. Over the longer term, a transition into sustainable infrastructure solutions should provide support for structural growth.

Global natural resources underperformed real estate and infrastructure in 2024. Oil production restraint remains a tailwind for the asset class, which we favor as a hedge against geopolitical risk. Continued strong fundamentals (persistent cash flows, tight commodity markets, stronger balance sheets and lower capital expenditures) should support natural resources as an important hedge against higher inflation and geopolitical escalations. Natural resources also remain attractive from a valuation standpoint, especially when compared to the broader equity market.

EXHIBIT 13

Positive Returns for Global Infrastructure and Real Estate

2024 Real Assets Returns vs. MSCI ACWI (%)



Source: FactSet. Data from January 1, 2024 to October 31, 2024. The MSCI ACWI (all-country world index) tracks the performance of stocks globally. Global listed infrastructure = S&P Global Infrastructure Index, which tracks the performance of 75 energy, transportation and utilities companies. Global real estate = MSCI ACWI IMI Core Real Estate Index, which tracks the performance of companies engaged in the ownership, development and management of real estate. Global natural resources = S&P Global Natural Resources Index, which tracks the performance of 90 of the largest publicly traded companies primarily in the agribusiness, energy, and metals & mining industries. Index performance returns do not reflect any management fees, transaction costs or expenses. It is not possible to invest directly in any index. **Past performance is not indicative of future results.**

> **Global listed infrastructure has performed well this year. We expect the sector to continue to experience structurally higher growth from increasing demand for power.**

[26] Source: CBRE Investment Management. The five-year annualized earnings growth rate ended 2017 was about 3% and the five-year annualized earnings estimated growth rate ending in 2024 is about 6%.

HEDGE FUNDS

Growth continues for hedge funds

Hedge funds hit peak asset levels again in 2024 at $4.7 trillion,[27] with consistent positive net inflows. Strong organic performance continues to attract interest with the HFRI Hedge Fund Index[28] up over 8% in five of the last six years, including 2024. Over that period, hedge funds have captured nearly 75% of the return of public equities with less than half the volatility, providing solid risk-adjusted returns.

As the exhibit shows, hedge fund returns can vary greatly by strategy and manager. Manager selection is key in building a successful hedge fund portfolio. That said, the economic and market environment we expect in 2025 may prove more favorable for some strategies:

Equity hedge: Equity hedge strategies maintain positions both long[29] and short[30] in primarily equity and equity derivative[31] securities. Long/short fund strategies can be net short, neutral or net long. Strategies that can take positions nimbly across small-, mid- and large-cap stocks may benefit from their ability to adjust their portfolios to capture positive or negative market sentiment throughout the market cycle.

Event driven: Event-driven funds invest based on views around mergers, restructurings, distress and other corporate actions. Less expected regulation from the incoming U.S. administration may encourage more merger and acquisition activity, new issues and initial public offerings. While deal spreads[32] may be tighter, the increased activity should be a good environment for event strategies.

Macro: Macro funds invest in equities, fixed income, currencies and commodities based on economic variables and capital flows. Macro relies on dispersion between countries for its opportunity set, whether that is differences in interest rate regimes, economic growth, fiscal policy or other factors. A world with increased tariffs, trade disputes and differing interest rate policy likely present ample opportunities for macro investors.

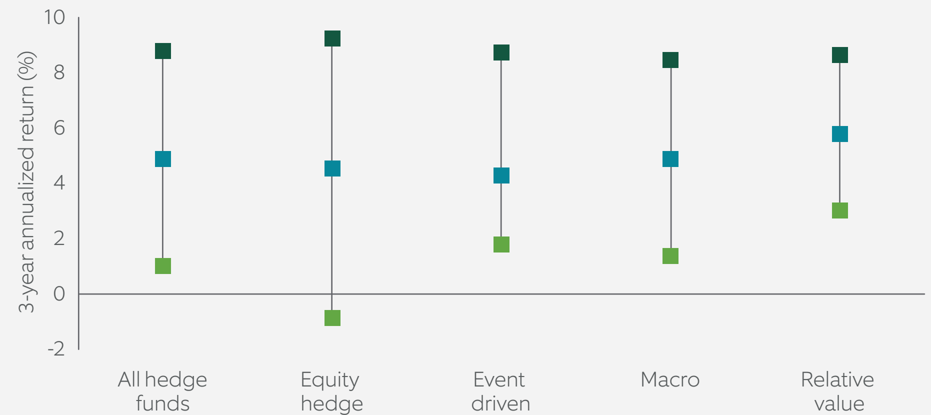
Relative value: Relative value managers invest where they believe there is a valuation discrepancy in the relationship between multiple securities. Typically they are long one security and short another security, expecting the relative valuations of the two to either converge or diverge. Relative value funds typically have a low correlation to overall market direction but instead tend to perform in environments with more volatility and dispersion. Relative value strategies tend to benefit from elevated interest rates due to the long/short nature of the strategies.

[27] Source: WealthBriefing Asia, assets as of June 30, 2024.

EXHIBIT 14

Disperse Returns, Flexible Investing

3-Year Annualized Manager Return by Quartile (%)



Source: HFRI. Three-year annualized returns are as of August 2024. Index performance returns do not reflect any management fees, transaction costs or expenses. It is not possible to invest directly in any index. **Past performance is not indicative of future results.**

The wide variety of hedge fund strategies results in a wide dispersion of returns. Manager selection is the key to a successful hedge fund allocation.

[28] HFRI, performance for 2024 is through September. The HFRI Hedge Fund Index measures broad investment performance of hedge funds. [29] In long transactions, the buyer purchases a security and gains from the total return of the security. [30] Short selling is a transaction in which borrowed securities are sold with the intention to repurchase them at a lower price at a later date and return them to the lender, representing a gain for the short seller. [31] A financial instrument in which the value depends on the value of an underlying asset or factor such as a stock price, an interest rate, or exchange rate. [32] Deal spreads are similar to discounts on asset prices that investors require to adjust their return expectations, based on perceived risks of the investments.

Private credit has room to grow

The Federal Reserve's 50-basis-point rate cut in September represented the first cut since the onset of the COVID-19 pandemic in March 2020 and, prior to that, the largest cut since the 2008 Global Financial Crisis. With another rate cut in November and more potentially coming, we expect lower base rates will accelerate merger and acquisition (M&A) activity, especially for private equity sponsors that continue to sit on record levels of dry powder (capital that has been raised but not yet deployed).

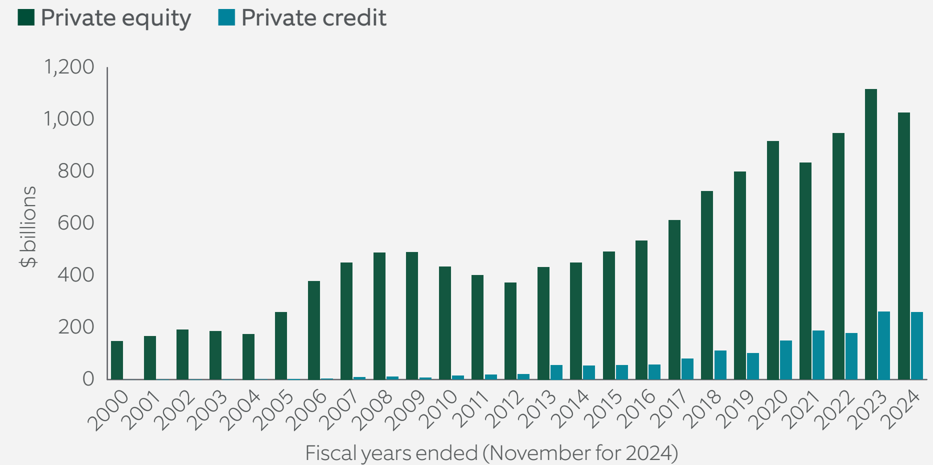
Although we also expect lower rates to compress yields to some extent, we believe private credit[33] deployment will increase in conjunction with the expected pickup in M&A activity. Private credit continues to serve as the preferred source of financing for private equity sponsors given increased flexibility and certainty of execution. Specifically, direct lenders are likely to continue to capture market share in the lower middle market as traditional bank lenders' appetite for smaller businesses continues to decline.

There has been some concern about the growth of the private credit market over the last few years. Private credit is now the second largest private capital asset class behind private equity, with $1.6 trillion of private debt assets under management compared to $8.5 trillion for private equity.[34] However, we believe that the growth of private credit is well supported by the secular shift of lending from traditional capital providers to private credit asset managers, as well as the size of the private equity market and private business sector. Specifically, private equity dry powder levels continue to far exceed the current supply of private credit dry powder (see exhibit).

Additionally, direct lending by nature is typically less exposed to cyclical industries, mitigating the risk for underperformance in down cycles. Furthermore, most direct lending transactions have strong downside protection through seniority in the capital structure, financial covenants, interest rate floors and active portfolio management. These characteristics have proven attractive to investors, driving interest in the asset class and increased flow of capital, specifically with strategies that focus on first lien senior secured debt.[35]

EXHIBIT 15

Private Equity Dry Powder Well Exceeds Private Debt



Source: Pitchbook. Dry powder represents capital that has been raised by private equity and private credit managers but has not yet been invested. Historical trends are not predictive of future results.

Private equity dry powder levels continue to far exceed the current supply of private credit dry powder, which suggests that private credit has room to grow given private credit is the primary source of financing for private equity M&A.

[33] Private credit or private debt investments are debt-like, non-publicly traded instruments provided by non-bank entities, such as private credit funds, to fund private businesses. [34] First Avenue Partners LLP and Preqin as of December 31, 2023. [35] First lien senior secured debt has first rights on collateral and cash payouts in case a company enters bankruptcy, making it a safer investment than lower tier debt.

2025 could mean a rebound for private equity

Private equity deal activity levels have rebounded modestly from recent lows, though many investors are still feeling the effects of a slow exit[36] environment. Industry-wide net cash flows (cash distributions less capital calls[37]) turned negative over a year ago, according to Pitchbook, which has continued to put pressure on investors' ability to make commitments to new private equity fund offerings. And while many buyout fund managers are electing to hold their prized assets until the exit environment improves, the value of these portfolio companies continues to appreciate, driven by continued strong profit growth across their portfolios. We expect that exit activity will increase meaningfully now that the election is behind us and the cadence of interest rate reductions is finally underway.

While venture capital deal activity remains down by approximately a third of the volume in early 2022, the excitement over the possibilities of artificial intelligence has triggered an increasing amount of investment. Some of the largest artificial intelligence model companies have raised massive rounds (billions of dollars) at high valuations, which has skewed broad market statistics. Venture-backed company valuations are concluding their correction that began in January 2022, with the share of flat and down rounds (33%) now returning to within the range of historic norms.

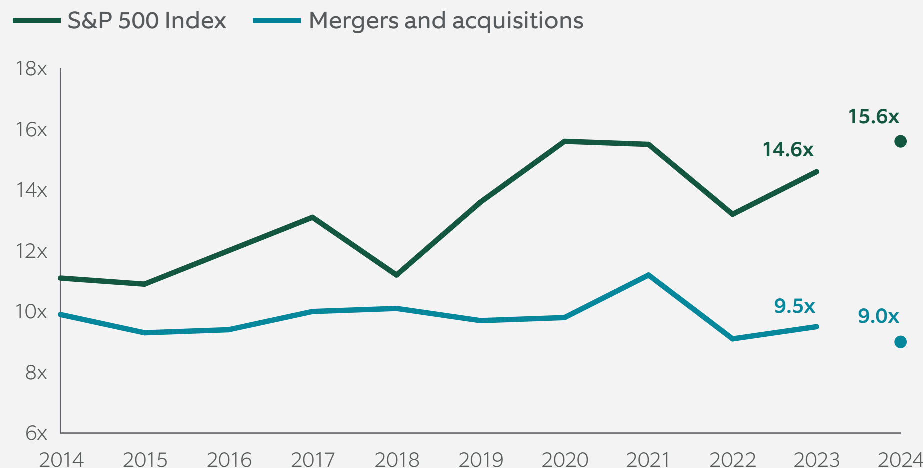
The initial public offering (IPO) market has been moribund for the last three years, but it could slowly start to open in 2025 as market uncertainties recede. As many growth companies continue to grow into valuations last set in 2020 and 2021, we expect some of the top private companies to test the initial public offering waters in the back half of 2025 and generate some liquidity for venture investors.

Given the low levels of liquidity in the private markets over the past few years, we believe the secondary market's[38] role has never been more imperative. Volumes of limited partnership secondaries have remained high. Continuation vehicle solutions have allowed fund managers to provide liquidity to investors while at the same time maintaining ownership in their best assets.

Private equity returns have been modest by historical standards since interest rates began their ascent in early 2022. While the public markets are up materially since this time period, private equity outperformance has narrowed compared to the public markets as general merger and acquisition multiples have remained low while the public valuation multiples have rebounded (see exhibit). As interest rates continue to decline and portfolio companies' strong fundamental performance persists, we expect private equity returns to revert back to their historic outperformance bands.

EXHIBIT 16

Public and M&A Valuations Have Widened



Source: Pitchbook. Data from 2014 to 2024. Multiples represent the value of a company for every one dollar of profit. Multiples in this chart are calculated as enterprise value divided by earnings before interest, taxes, depreciation and amortization (EBITDA). Enterprise value is the total value of a company, including market capitalization, debt and cash.

> **Multiples for acquisitions have remained low while public market valuations have rebounded. This explains one reason why private equity outperformance over public equities has narrowed. We expect the outperformance to revert to more normal levels as interest rates fall.**

[36] A private equity exit is when an asset is sold and the proceeds are distributed to investors in private equity funds. [37] A capital call is when an investment firm demands a portion of the money committed by an investor to a private equity fund. [38] The private equity secondary market is the selling and buying of limited partner's holdings in private equity funds after the initial investment is made.

KEY TACTICAL ASSET ALLOCATION VIEWS

Positioning for 2025: Buy America

Since 1987, the average annual return of a portfolio consisting of 60% stocks[39] and 40% bonds[40] has been 8%. So far in 2024, it is up 12%, the second consecutive year of above-average returns for balanced portfolios. Global equities have gained 19%, led by U.S. large caps. Fixed income has produced lower but positive returns, as high yield bonds have buffered modest performance from high-grade credit and Treasurys. Going forward, we expect more modest gains for 60/40 portfolios with U.S. equities leading the charge again.

We maintain a preference for equities over fixed income, reflecting our base case of continued economic growth. As shown in the exhibit, the expected level at which the Federal Reserve policy rate settles this cycle has materially increased since mid-September. We believe this reflects a mix of stronger growth expectations and risk of higher inflation.

Our top two risk cases incorporate the possibility of inflation as a result of potential U.S. presidential policies. In the more benign risk scenario, stronger growth accompanies inflation. We believe this would result in equities outperforming fixed income. Equities historically have been able to maintain today's valuations with inflation at or even above 4%, but growth is important. In the second risk scenario, there is no positive growth impulse.

We would expect higher inflation to weigh on equities and most other major assets, with few other assets such as gold ending up as beneficiaries.

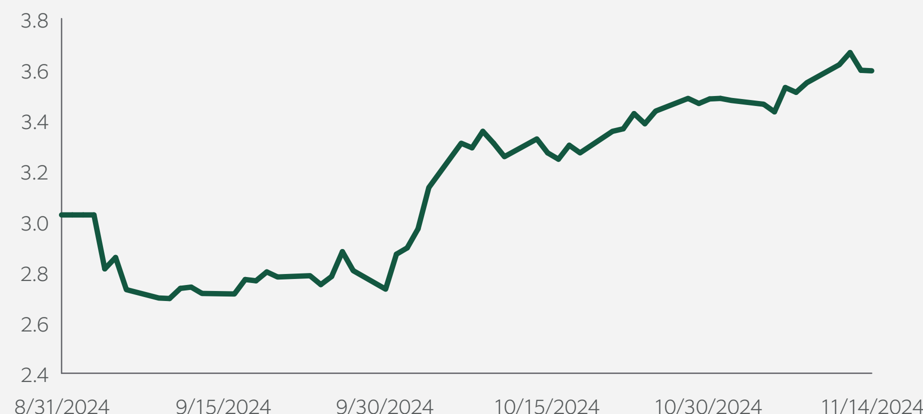
"Buy America" is another one of our key tactical calls. We expect U.S. equities to benefit from a better economic backdrop and healthier corporate profits than most other regions. We also believe that non-U.S. companies are more negatively exposed to the policies floated by the incoming U.S. government. For example, higher tariffs likely would weigh on Chinese and European company profits, while non-U.S. regions would see little benefit from U.S. tax cuts and reduced regulation. With that said, there is a wide range of potential outcomes, supporting regional diversification in a portfolio.

Within fixed income, we continue to like high yield. Its starting yield of above 7%[41] is attractive given strong fundamentals and a supportive technical backdrop. We see more limited upside for investment grade credit and Treasurys given historically tight investment grade spreads and low odds of a sharp drop in rates. Given we do see incrementally higher inflation risks as a result of possible policies from the U.S. government, we think some inflation protection through inflation-linked bonds is prudent.

EXHIBIT 17

Higher Expectations

Expected Minimum Fed Policy Rate Through 2026 (%)



Sources: Northern Trust Asset Management, Bloomberg. Consensus expectations for the Fed Funds rate through 2026. Expectations are from August 31, 2024 through November 14, 2024. The chart represents investors' changes in expectations during 2024 of what the lowest federal funds rate will be by the end of 2026, based on the federal funds futures market.

The expected level at which the Fed policy rate settles this cycle has materially increased since mid-September. We believe this reflects a mix of stronger growth expectations and risk of higher inflation.

[39] As represented by the MSCI All World Country Index (ACWI), which tracks the performance of equities globally. [40] As represented by the Bloomberg U.S. Aggregate Bond Index, which tracks the performance of the U.S. bond market. Index performance returns do not reflect any management fees, transaction costs or expenses. It is not possible to invest directly in any index. **Past performance is not indicative of future results.** [41] Source: Bloomberg, as of November 15, 2024.

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* Assets under management as of September 30, 2024.

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