NORTHERN TRUST
ASSET MANAGEMENT

Global Family Office
Quarterly Letter

COPING STRATEGIES

April 2018

"Coping strategies are especially important because these markets are a link between the present and the future. Radical uncertainty is the key to understand not just money and banks but financial markets in general."

- Mervyn King, Former Governor Bank of England, 2003-2018
- *The End of Alchemy*

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OVERVIEW

THE PUZZLE – IS GLOBAL GROWTH STILL INTACT?

- Productivity and wages
- The Fed and inflation

THE PICTURES – SEEING OVER THE HORIZON

- Private company valuations
- Inflation – this time in Europe
- Exports, imports and the post-mercantilist world

THE SOLUTION – PROLONGED DISPARITY?

- Value companies have continued to underperform in post-global financial crisis period
- What's deserved and why
- Is now a good time to move in one direction or the other?

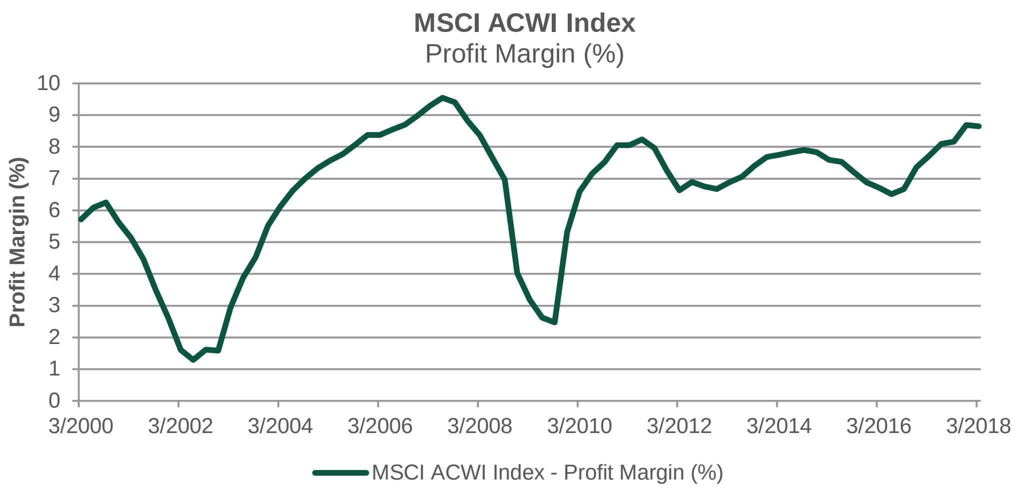
THE PUZZLE

Amid the sturm and drang of the past quarter, investors should not lose sight of the question that matters most:

> Is the goldilocks U.S. growth story, that is based on synchronized global growth, rising employment with low inflation, deregulation, and tax reform, still intact?

The answer is important because sustained U.S. growth means rising corporate profits – noted in exhibit 1 - and rising corporate profits are supportive of risk assets. Markets gyrated over the past two months as they attempted to sort out the question above. Market participants saw corrections after the false inflation flag due to the surprise spike in wages in the January jobs report, only to rebound, and fall again with the announcement of the administration's steel and aluminum tariffs, resulting in the departure of Gary Cohn, and the introduction of Section 301 trade sanctions against China, only to finish the quarter on a positive note on the last trading day.

EXHIBIT 1: RISING CORPORATE PROFITS



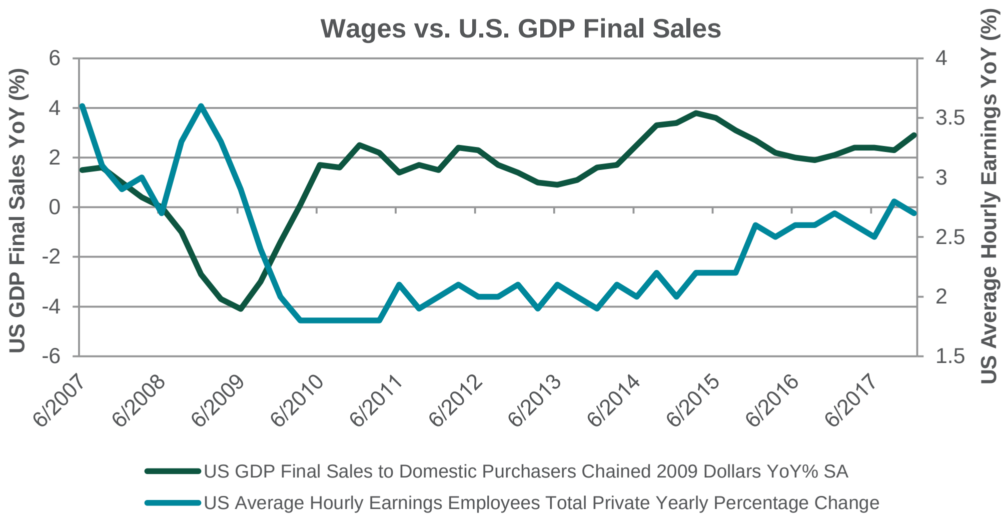
SOURCE: Bloomberg, MSCI, MSCI ACWI Index data from 3/31/00 to 3/31/18

Lost among all the political turmoil has been the fact that the economic fundamentals continue to be firmly underpinned by positive developments in employment, wage growth, and business investment with manageable risks for the future, which are all tailwinds for the U.S. growth story.

A Strong Labor Market: The February jobs report showed a strong labor market with little risk of wage inflation. The economy added 313,000 new jobs in February exceeding even the most bullish expectations, while unemployment held steady at 4.1%. The labor participation rate climbed back to 63 percent, as wage growth and job availability helped pull thousands of Americans back into the labor market.

The March Jobs report was a bit more muted (we have the luxury of a publication date of the 15th of the quarter's close). Volatility in month/month hiring changes speaks more about BLS measurement procedures than the economy itself. The 300K print of February was always outsized relative to the underlying economic fundamentals and there is nothing in the broader growth data to suggest the March number is particularly meaningful. It seems to be the case that winter and holiday hiring patterns now wash through the numbers later in the year. April should deliver a fairly reasonable result for how the economy is doing.

EXHIBIT 2: WAGES VS. U.S. GDP FINAL SALES



SOURCE: Bloomberg

Goldilocks Wage Growth: The recent jobs reports also revealed an encouraging pattern of goldilocks wage growth. As we note in exhibit 2, wages are increasing enough to support consumer demand, but not enough to invite fears of inflation and tougher Fed action. The January report showing a 2.9% hike in wages set off a momentary panic of rising inflation in the market until analysts realized that the spike in wages was largely due, in part, to a one-time increase in the minimum wage in 18 states. Otherwise, wage growth for rank-and-file production and non-supervisory workers remained steady at 2.4 percent. Wage growth in the subsequent February jobs report, if anything, was somewhat on the weak side with annualized increase in hourly wages of 2.3%.

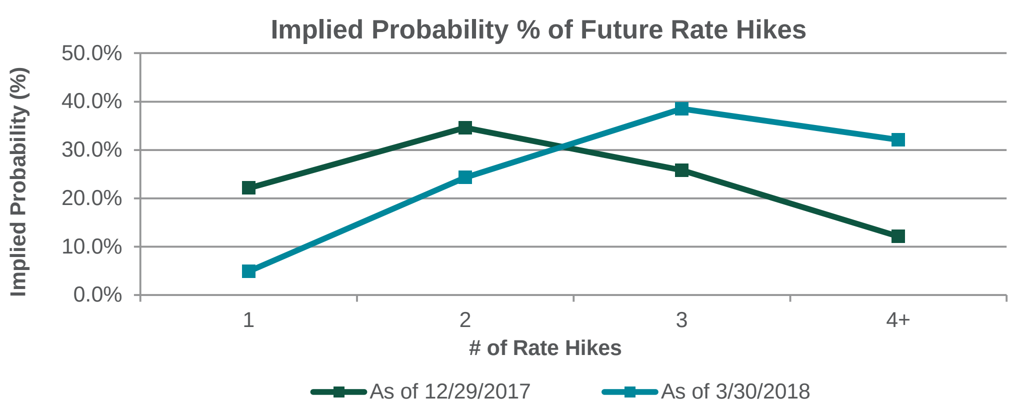
Anecdotal evidence points to future wage gains, as companies pass on some of their tax savings to employees. Future increases may be expected as a tighter jobs market begins to put upward pressure on wages in some sectors of the economy. For now, wage increases are following profit increases, which is good for the economy and the market. As important is the trend in the composition of jobs in the economy. More good jobs relative to low-wage jobs are being created, and this means the economy will benefit from rising incomes in the future.

Increased Business Investment and Recovering Productivity Growth: The big question (which we wrote about last quarter) for our Goldilocks-growth-for-longer story is whether business investment will pick up, laying the foundation for a recovery in productivity growth. As the economy approaches full employment, productivity growth will need to increase in order for wages to increase without putting upward pressure on inflation. We are beginning to see some improvement in what might be called demand-led productivity growth as businesses run at higher capacity utilization levels and thus operate more efficiently. But we will need to see higher business investment for our growth-for-longer thesis to hold.

Over the past several quarters, business investment has showed some improvement. Growth in business investment in equipment was 11.6% in the fourth quarter of 2017, the best performance since the third quarter of 2014. More importantly, many of the conditions for more business investment in the U.S. are in place: stronger domestic and global demand, higher capacity utilization levels, deregulation, corporate tax reductions, and 100 percent expensing of capital expenditures. Some analysts worry that continued trade tensions will create investment uncertainty hurting business investment. That is certainly a possibility, but it is also possible that more domestic and foreign companies will commit to new investments in the U.S. in order to avoid any future trade restrictions.

Stronger for Longer - Fiscal Stimulus and Structural Change: One worry for the markets is that the fiscal stimulus from the tax cuts and the recently passed spending bill will push the economy from a goldilocks-growth-for-longer path to a condition of overheating, in turn causing the Fed to increase rates at a faster pace (one of our current risk cases). The risk of an outbreak of inflationary fears and a Fed mistake is certainly a possible risk we continue to keep an eye on. But inflation, for now, looks to be well-contained, running below the Fed's targeted rate of 2%, the 10-year Treasury is trading around 2.75 percent, and the Federal Reserve Chairman Jerome Powell seems inclined to continue a gradualist approach, reducing the chance the Fed will over-react which, in turn, already looks to have been priced in by the end of Q1 (see exhibit 3).

EXHIBIT 3: HIGHER EXPECTATIONS



SOURCE: Bloomberg

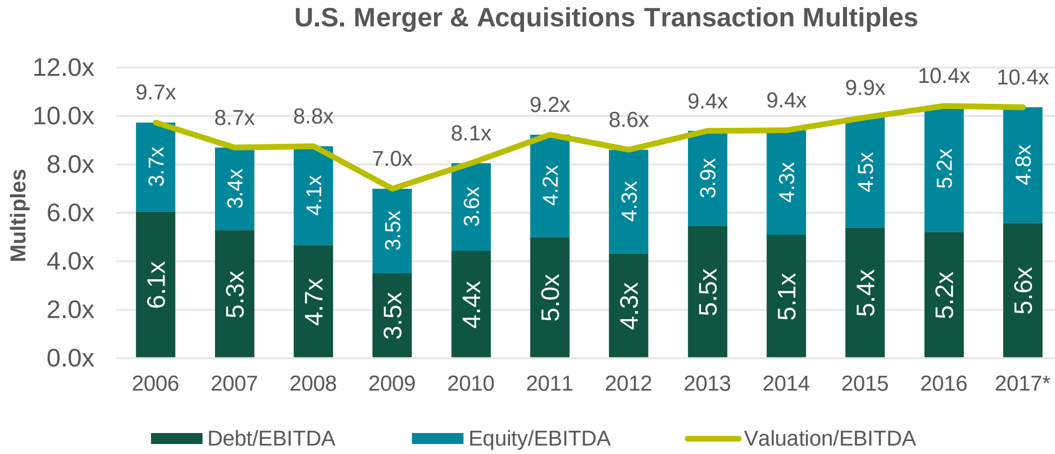
More fundamentally, it would be a mistake to see the fiscal stimulus as a problem for a goldilocks-for-longer growth path. We believe the fiscal stimulus from the tax and spending measures will give a helpful boost to the economy, without putting inflationary strains on the economy's capacity. We believe the economy can grow at 3% (GDP) given the slack yet in the labor markets and in capacity utilization, at least until structural supply-side changes kick in as business investment increases and the economy adds capacity. In fact, this fiscal boost in 2018 could actually provide a helpful transition to a higher level of growth that will result from the structural changes brought about by changes in corporate tax rates and deregulation.

Old and New Risks: We would of course be remiss if we did not mention the risks to our Goldilocks-growth-for-longer thesis. Having already touched on the potential for a Fed Mistake, the other significant risk that has emerged over the past quarter are the worries surrounding a trade war, following the administration's announcement of aluminum and steel tariffs and its Section 301 sanctions against China for its unlawful acquisition of U.S. intellectual property. Given the exemptions the administration has granted to a number of countries, the imports affected by the aluminum and steel tariffs are extremely small, well less than 1% of U.S. imports. The amounts of goods subject to the administrations initial action against China – $60 billion – are likewise relatively small. Nonetheless, the worries in the market are real and tend to focus on three possible harms: that trade retaliation will hurt the profitability of some US companies; that the administration's trade sanctions, particularly those on steel and aluminum, will raise prices in the U.S., contributing to inflation; and finally that increased trade tensions will create investment uncertainty, causing a pull-back in business investment. We believe that each of these risks is overstated for now.

One can debate the merit of the administration's trade strategy and whether it will work. It is worth acknowledging that some of the administration's tactics may have some positive benefits for the U.S. economy. These include curbing China's adversarial trade practices, particularly its actions against U.S. high tech companies; force other economies to re-negotiate previously one-sided trade deals in ways that might lower other economies' barriers to U.S. goods and services or level the playing field for more investment in the U.S.; reshape regional and global supply chains to allow for more production in the U.S.; and rebalance the global economy by encouraging other economies to reduce their surpluses and create more of their own demand. While it is true that no economy gains from a trade war, economies with large trade surpluses—China, Japan, Germany—have much more to lose and therefore are likely to make concessions that avoid full-fledge trade war. If the administration succeeds with one or more of its objectives, the result may produce structural changes supportive of a goldilocks-growth-for- longer economy.

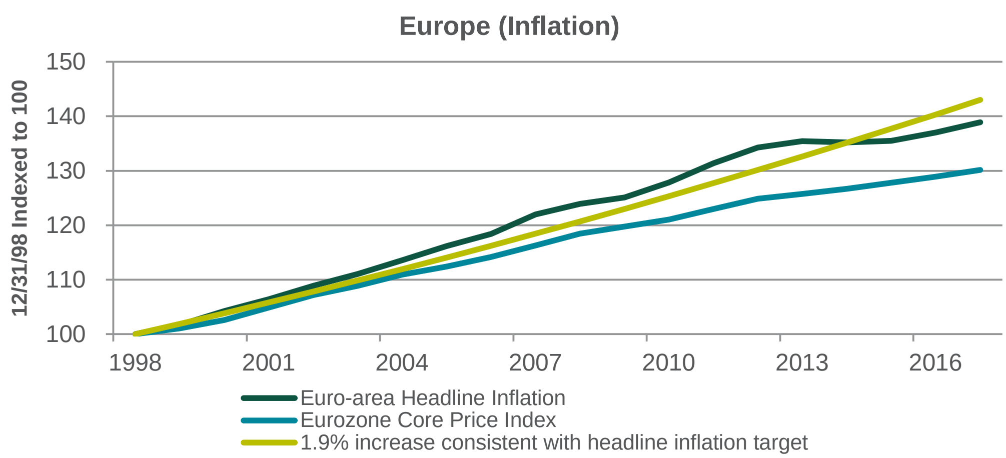
THE PICTURES

Private Company Valuations



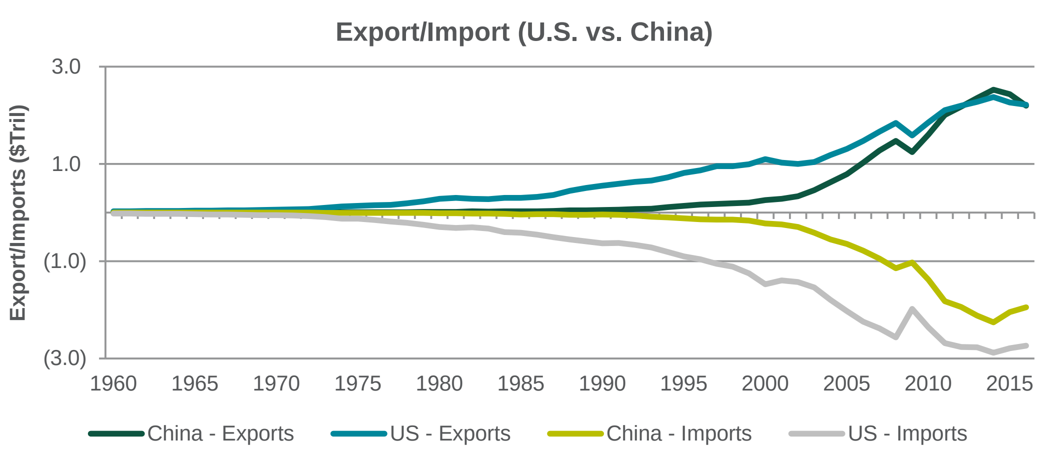
Source: PitchBook

Inflation in Europe



Source: Bloomberg

Export/Import – U.S. vs. China

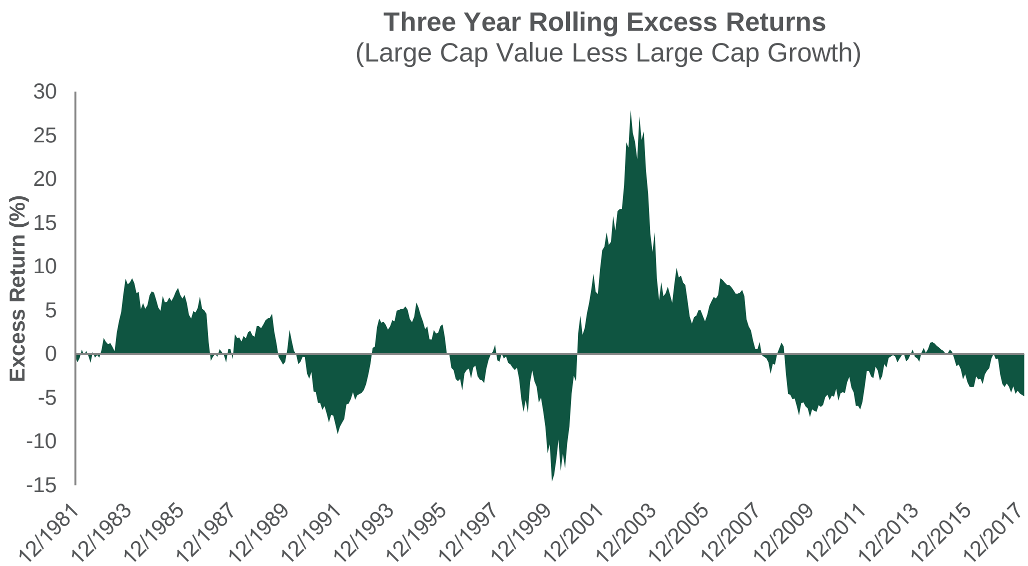


Source: World Bank

THE SOLUTION

Our clients have recently been inquiring about our views on growth versus value stocks. The valuations between the two styles of equities are quite wide from an absolute perspective. For instance, as of 3/31/18 large cap value stocks are providing an earnings yield (earnings per share/price per share) of 5.3% versus 3.9% for large cap growth stocks. As well, large cap value stocks have been lagging large cap growth stocks for the better part of the past decade, with the exception of the 2013 – 2014 periods, as indicated in the chart below. The shaded area that is above the zero line indicates positive three year rolling excess returns of value over growth while the shaded area beneath the zero line indicates negative three year rolling excess returns of value of growth. Clearly, value has been underperforming growth for quite some time and offers better value from an absolute earnings yield perspective. However, when we dig into the fundamental backdrop of the past decade it isn't entirely clear.

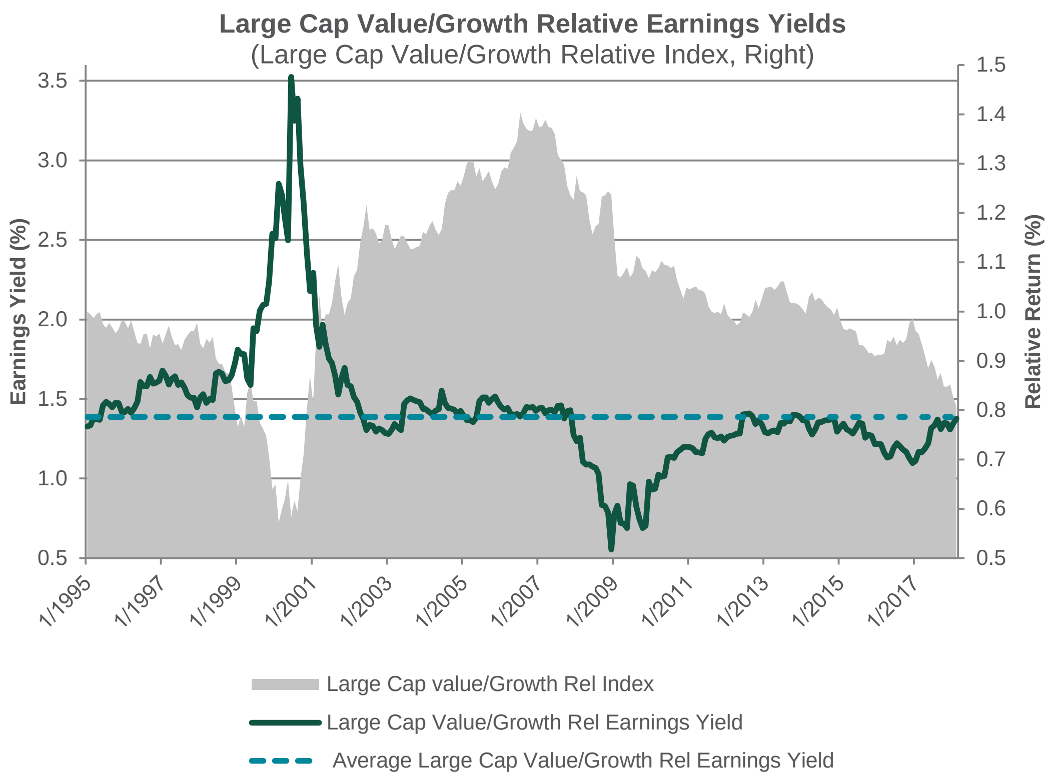
EXHIBIT 4: THREE YEAR ROLLING EXCESS RETURNS



SOURCE: Bloomberg, Russell, Wilshire, Northern Trust

Before we dive into possible explanations behind the large cap value performance lag we should define what constitutes and differentiates a value stock from a growth stock. The overall stock market can be divided, somewhat arbitrarily, in half between those companies which grow earnings/sales at a higher rate than the market (growth stocks) and those companies which grow earnings/sales at a lower rate than the market (value stocks). Value stocks are typically, though not always, defined by the following characteristics: higher dividend and earnings yields than the market; normally higher debt loads than the average company; more mature, slower growing companies; and usually have higher sector exposure to the "old economy". For instance, the largest sector represented in the value portion of the market is financials (27.1%). Conversely, growth stocks are typically, though not always, defined by the following characteristics: lower dividend and earnings yields than the market; normally lower debt loads than the average company; younger, faster growing companies; and usually have higher sector exposure to the "new economy". For instance, the largest sector represented in the growth portion of the market is information technology (38.7%). As represented above, value and growth stocks are quite different and growth stocks usually trade at a discount to value stocks from an earnings yield perspective so it can be misleading to rely on absolute valuation levels. Therefore, when making valuation comparisons between the two broad classes of equities, it's more instructive to make comparisons on a relative rather than absolute basis. When we compare the relative earnings yield of value to growth stocks it's quite close to its twenty three year average. On this basis, the relative valuation between value and growth stocks is not that attractive (note, the shaded area shows the relative index performance between value and growth. A rising line indicates value outperforming growth on a relative basis and vice versa). As the chart below clearly indicates, value stocks have been lagging growth stocks over the past decade while earnings growth has favored the growth sector.

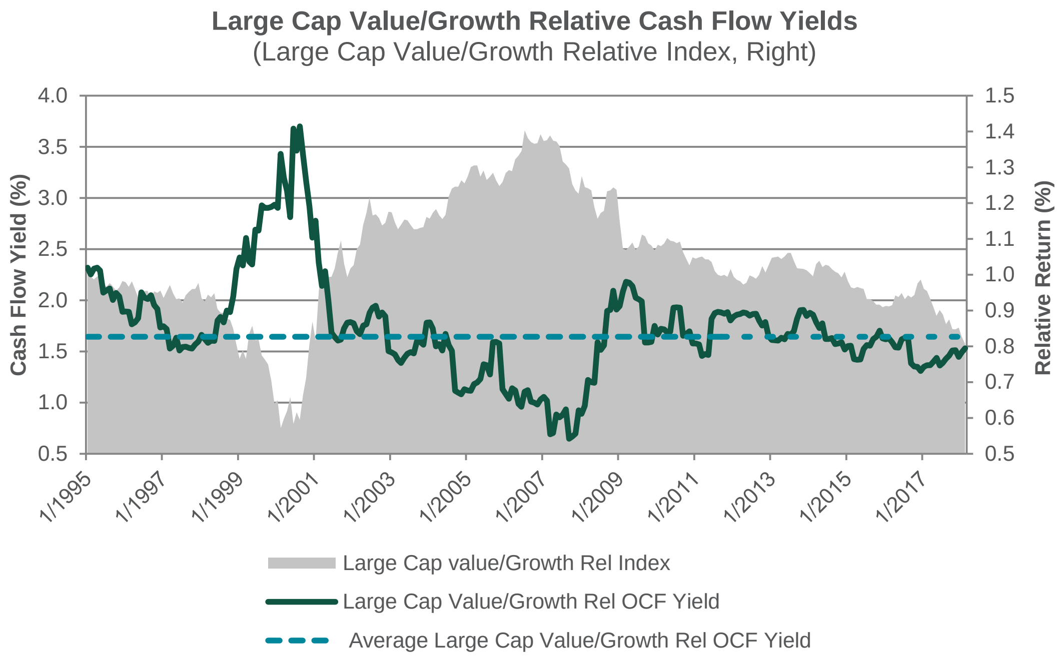
EXHIBIT 5: LARGE CAP VALUE/GROWTH EARNINGS YIELD



SOURCE: Bloomberg, Russell, Wilshire, Northern Trust

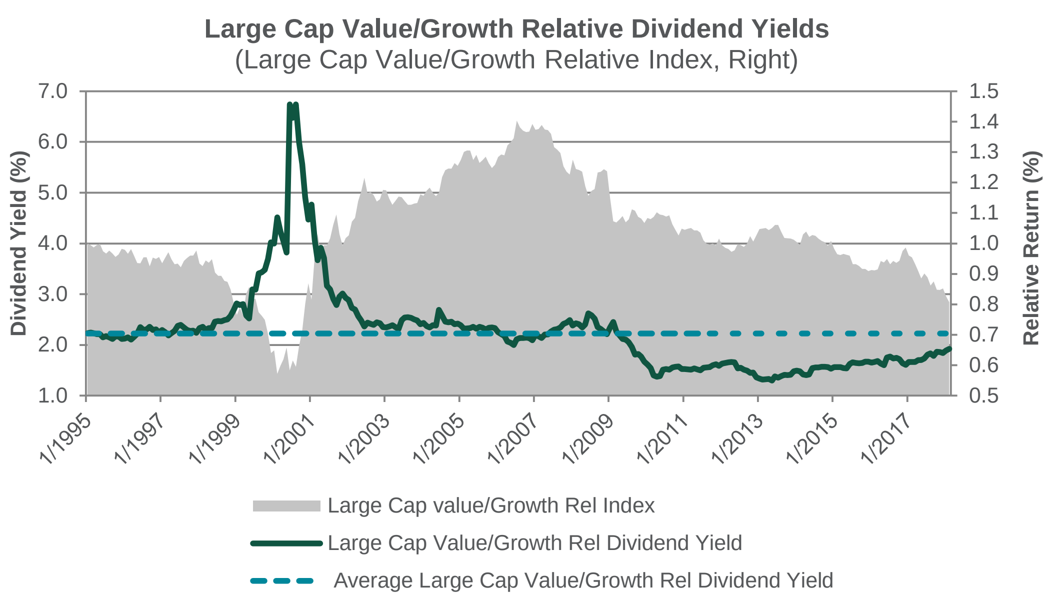
Furthermore, when utilizing other cash flow based measures (dividend yields and operating cash flow yields) which remove some of the distortions caused by accounting convention, value stocks appear to be slightly expensive as the following charts demonstrate.

EXHIBIT 7: LARGE CAP VALUE/GROWTH RELATIVE CASH FLOW YIELDS



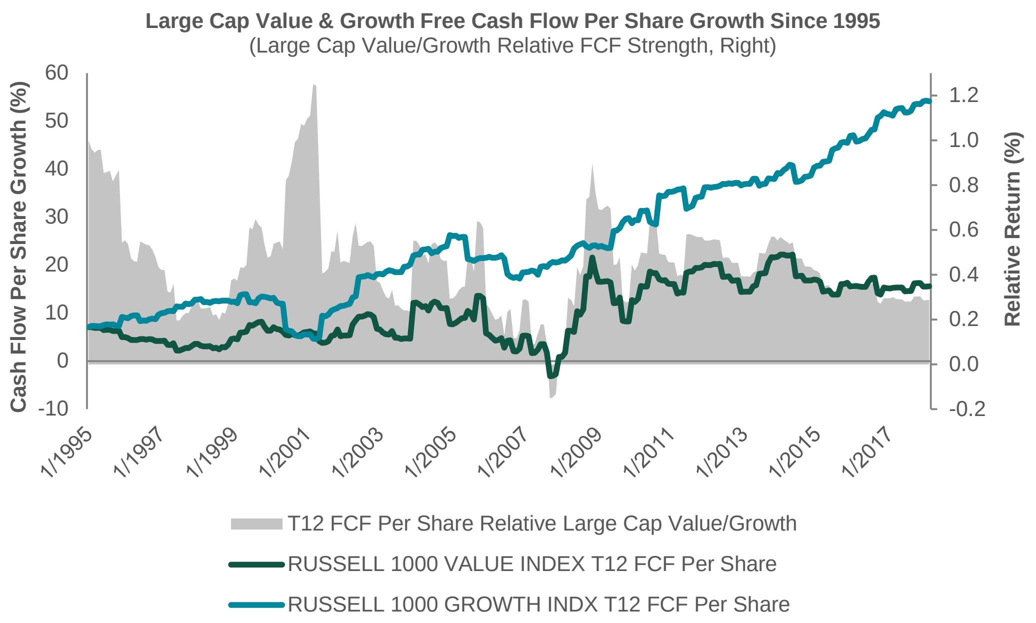
SOURCE: Bloomberg, Russell, Wilshire, Northern Trust

EXHIBIT 6: LARGE CAP VALUE/GROWTH RELATIVE DIVIDEND YIELDS



SOURCE: Bloomberg, Russell, Wilshire, Northern Trust

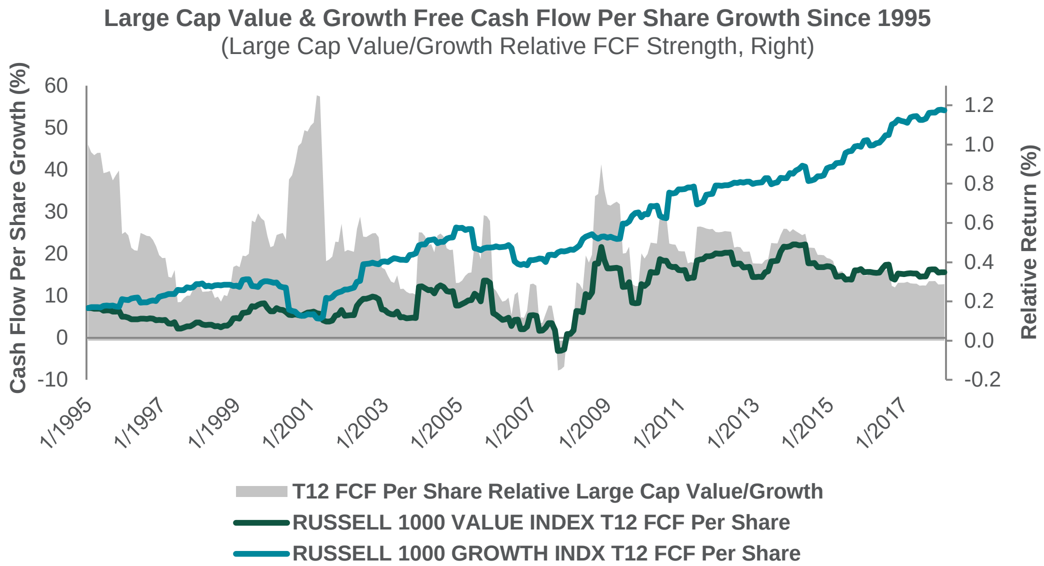
EXHIBIT 7: LARGE CAP VALUE & GROWTH FREE CAHS FLOW PER SHARE GROWTH SINCE 1995



SOURCE: Bloomberg, Russell, Wilshire, Northern Trust

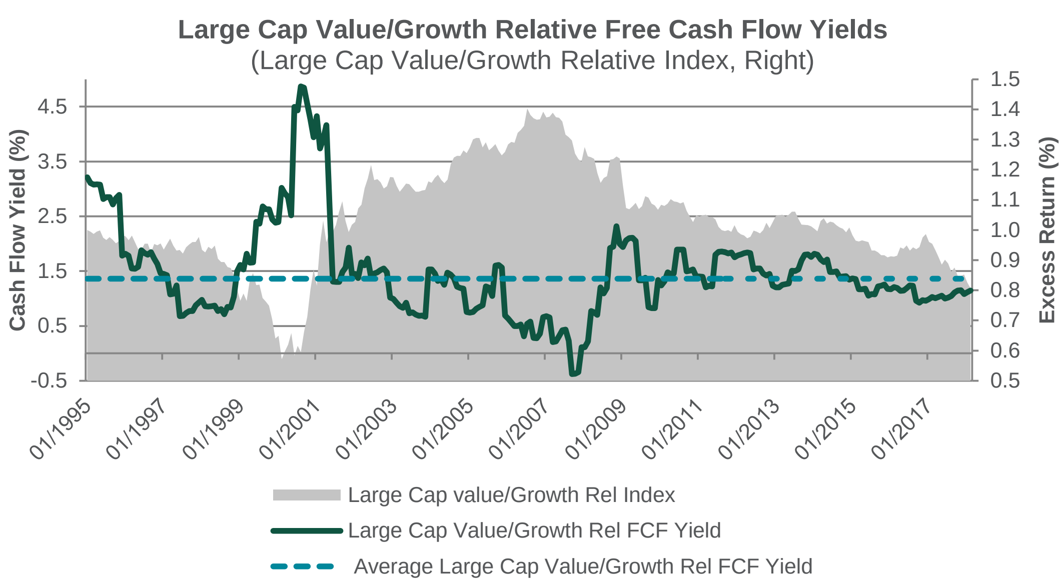
The fundamental backdrop has clearly favored growth stocks over value stocks and helps shed light on why value stocks have lagged. A useful cash flow metric used by investors is the free cash flow to equity. The FCF is the operating cash flow that is left over after capital expenditures. It represents "free cash" in the sense that it can be used for enhancing shareholder value through divided increases, share repurchases, capital expenditures or mergers and acquisitions. As the chart below shows, growth stocks have produced a much more stable cash stream to shareholders than value stocks have over the past decade. As long as this stream remains stable or if value cannot deliver higher free cash flow in the future, then growth stocks should maintain their valuation premium to value.

EXHIBIT 8: LARGE CAP VALUE & GROWTH FREE CASH FLOW PER SHARE GROWTH SINCE 1995



SOURCE: Bloomberg, Russell, Wilshire, Northern Trust

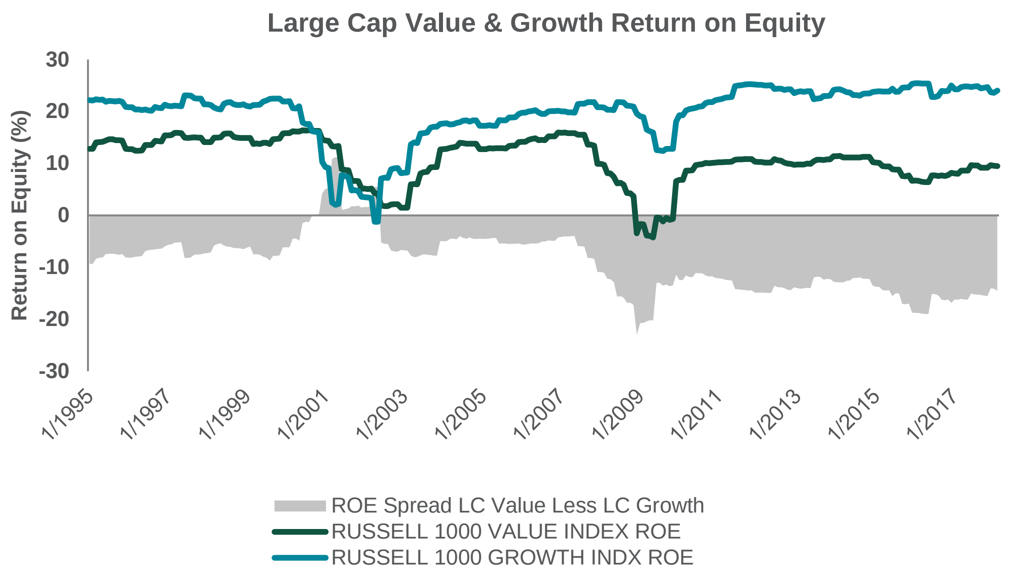
EXHIBIT 9: LARGE CAP VALUE/GROWTH RELATIVE FREE CASH FLOW YIELDS



SOURCE: Bloomberg, Russell, Wilshire, Northern Trust

Furthermore, the return on equity (net income/common equity) has widened considerably in favor of growth stocks over value stocks as the chart below illustrates. Therefore, if both the ROE and FCF of growth stocks are higher and more stable than value stocks, a valuation premium is most likely warranted.

EXHIBIT 10: LARGE CAP VALUE & GROWTH RETURN ON EQUITY



SOURCE: Bloomberg, Russell, Wilshire, Northern Trust

In summary, cash flow related valuation metrics (earnings, dividends, free cash flow) indicate value stocks are in line to slightly expensive vis a vis growth stocks and do not represent a compelling investment opportunity. From a fundamental perspective the profits and cash flows to growth equity holders have been steadily outpacing their value peers and this trend does not appear to be reversing anytime soon. In order to have a more positive view on value versus growth we would need to see the gap between ROE narrow and free cash flows improve for value stocks.