# ANTICIPATION

*January 24, 2018*

"We can never know about the days to come
But we think about them anyway
And I wonder if I'm really with you now
Or just chasin' after some finer day"
- Carly Simon, 1975

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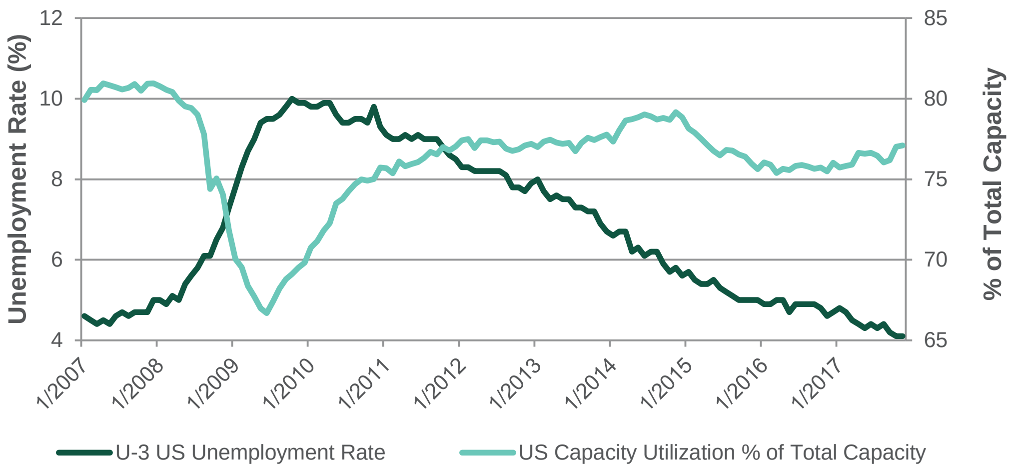
Who knew that Carly Simon's 1975 #1 hit would describe so succinctly the feeling around risk asset investing in 2017? With the S&P 500 Index ending the year for the first time going 12 for 12 with positive returning months, it is clear that our forward-pricing friend – the equity market – is clearly anticipating something not only for 2018 but also 2019 and perhaps 2020.

One key to whether the market will be proven correct in predicting positive economic growth is whether the economy can make the transition from one that has derived its growth by putting excess labor and capacity to work (see Exhibit 1), to one driven by gains in productivity driven by business investment. This handoff from an environment of excess capacity and labor to one driven by business investment is the 'bull case', which is in-line with Northern's view.

**EXHIBIT 1: U.S. CAPACITY UTLIZATION & UNEMPLOYMENT**



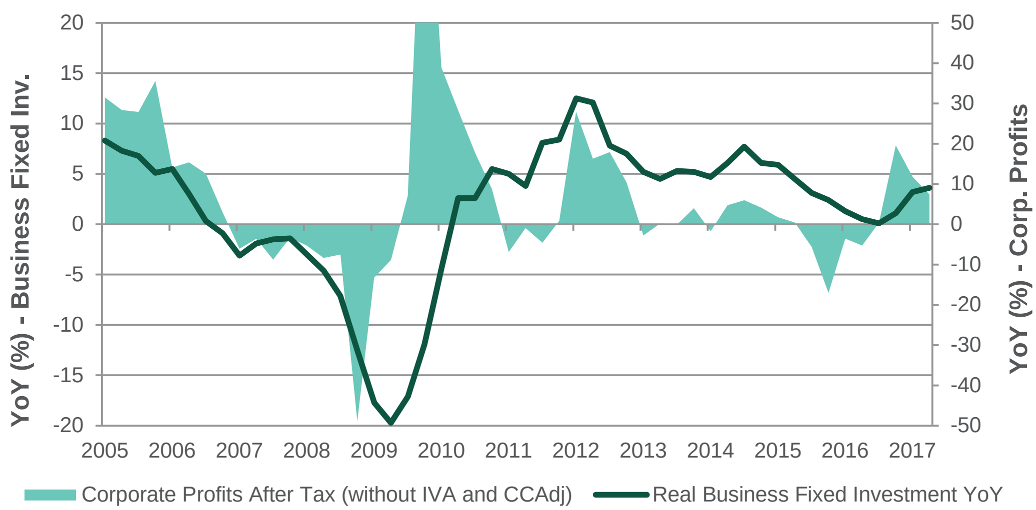

SOURCE: Bloomberg, Board of Governors of the Federal Reserve System (U.S.)

Also illustrated in Exhibit 1, the U.S. economy is approaching full employment after a long period of stagnation, with unemployment in the United States now at 4.1 percent, which is down from a peak of 10.0 percent in October 2009. There is likely some room for the economy to continue its expansion, given a portion of labor that remains on the sideline and capacity that is not yet fully utilized.

The passing of tax legislation in the U.S. in late 2017 looks to, potentially, be a catalyst for a long overdue uptick in business investment. The reason we are focusing this quarter on that business investment is that in the past, this kind of investment has been directly tied to gains in productivity which have translated into both wage gains for labor, higher profits for corporations and an overall increase in final demand.

One key to improving economic growth should be acceleration in capital expenditures, which is the foundation of sustained increases in productivity.  Post the Global Financial Crisis, business investment has been lackluster across much of the OECD economies, a reflection of weak expected demand as consumers deleveraged and repaired their balance sheets. In the seven years following the trough of the Great Recession in 2009, business capital spending increased only 33 percent, compared to an average of 62 percent during the prior three economic expansions that lasted an average of seven years. There are some structural reasons for the lower capital investment, for example, information technology companies generally require less capital investment (expressed in our 2016 CMA theme, Technological Turbulence) than large brick and mortar factories. However, even taking into account structural changes, the relatively low level of capital investment does raise legitimate worries about whether business will take over as the key contributor to growth.

**EXHIBIT 2: BUSINESS INVESTMENT & CORPORATE PROFITS**



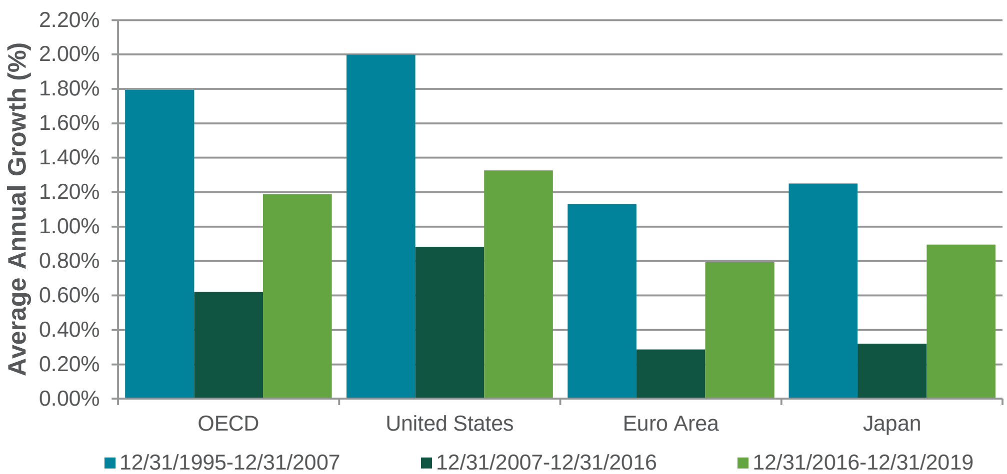

SOURCE: : Bloomberg; Bloomberg, Board of Governors of the Federal Reserve System (U.S.)

Therefore, the question of business investment and productivity growth takes center-stage in our analysis as we move into 2018. As can be seen in Exhibit 2, there is a close correlation between profits and business capital expenditures as corporations are more willing to invest if profits are strong. We believe that the strong earnings performance will carry over into 2018 as global economic momentum should gather pace which should bode well for corporate spending.

The data suggests that we are beginning to see the first signs of an increase in business investment that will translate into stronger productivity growth in the coming months and years. In the third quarter, business investment increased more than 10 percent and contributed a greater share to GDP than in previous quarters.

As is to be expected, weak business investment has been accompanied by a slowdown in productivity growth, which is the ultimate driver behind how fast the economy can grow without an increase in inflation once full employment is reached. On this point, there may be a reason to worry, for productivity growth has fallen from an average of nearly 2.5 percent in the 10-year period prior to the financial crisis to less than 1 percent since the crisis. As we noted last quarter, and as our Investment Policy Committee noted in the past, there are a great deal of uncertainties around productivity measurement, especially in a service and information-based economy.

**EXHIBIT 3: LABOR PRODUCTIVITY GROWTH**

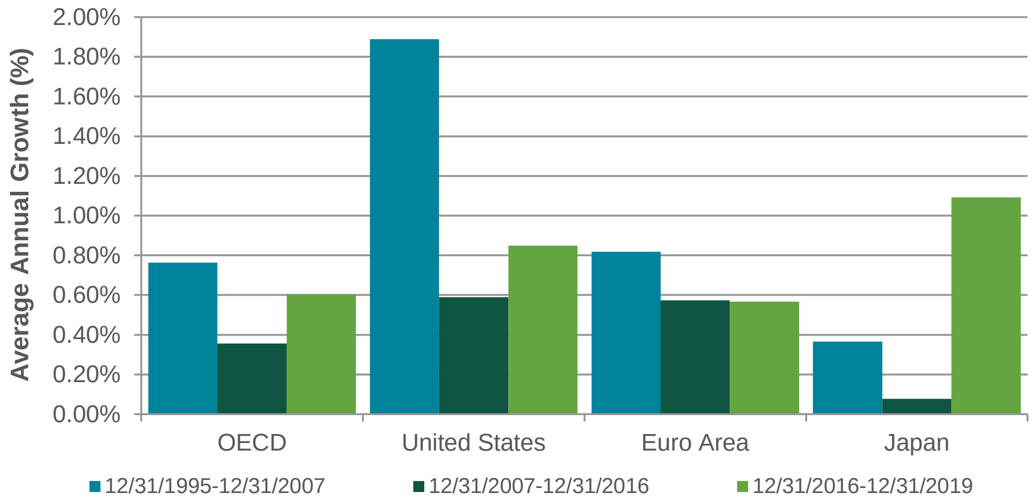



SOURCE: OECD Economic Outlook Database. Labor productivity growth is the average annual growth rate of output per person employed. 2017-2019 are projections.

As Exhibit 3 shows, labor productivity growth in the post crisis period has been the weakest in a generation. In addition, even forward looking forecasts such as those included here from the OECD do not see a return to the kind of productivity growth experienced from 1995-2007.

The lack of productivity gains have been reflected in decline in real wage growth (see Exhibit 4) over similar time periods and account for, to some degree, the weaker post-crisis recovery expansion.

**EXHIBIT 4: REAL WAGE GROWTH**




SOURCE: OECD Economic Outlook Database. Real wage growth is calculated from nominal wage growth and the GDP deflator. 2017-2019 are projections.

In her December Economic Outlook, Catherine Mann, Chief Economist at the OECD, identified some positive signs that mirror our own observations (OECD December Economic Outlook). Most notably, she points to surveys indicating that businesses intend to invest, particularly in technology-embodied capital. Additionally, the synchronous global upturn will increase demand for business investment, particularly given the erosion of the capital stock; thus, a virtuous cycle of investment and productivity continues positive channel growth and profits for much of 2018.

In this context, the aforementioned and recently passed Tax Cuts and Jobs Acts could be a catalyst for business investment. There are three features of the new tax law that are favorable to new business investment.

1. **Corporate Rate Reduction from 35 to 21 percent**
    - This reduction will increase the cash flow of many companies, which could enable new capital investments that they have postponed or have been unable to previously make.
2. **Full depreciation of new capital investments in the year made**
    - This provision will expire in five years, encouraging companies to begin to make investments now.
3. **Profit Re-Patriotization deemed repatriation of profits held abroad**
    - Corporation now have little reason to hold profits abroad to avoid taxes and could benefit by bringing the money back, making new investments to take advantage of the immediate 100 percent expensing of investments.

This leaves only the question of whether final demand will be there to support business investment, which comes down to a question of wages and incomes. Here again we see some promising signs. Wages, which began to accelerate in 2016, have begun to reaccelerate.

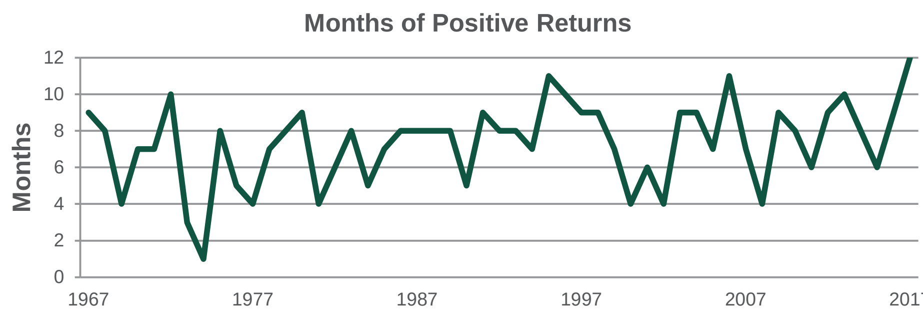
Transportation and warehousing, for example, are up 3.1% year-over-year. Leisure and hospitality are up 3.8% year-over-year and construction wages is up 2.7% year-over-year.

To sum up, we believe that investors should watch closely the trend in business investment in the coming year. Continued growth in business investment, which generally leads to productivity and wage gains, could signal another leg of this already long and seemingly durable global expansion.

## The Charts

**12 for 12!**

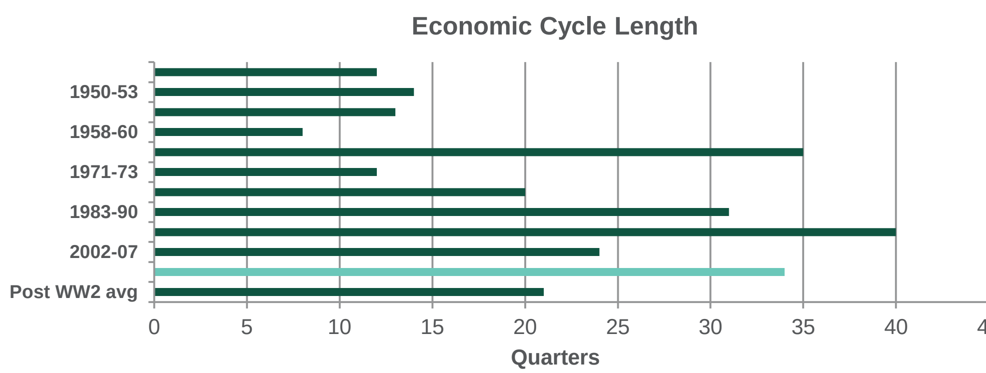
For the first time ever the S&P 500 was positive every month of the year. Can 2018 make it 2 for 2?




Source: Bloomberg, Standard & Poor's. S&P 500 Index Monthly Returns.

**A Wrinkle In Time?**

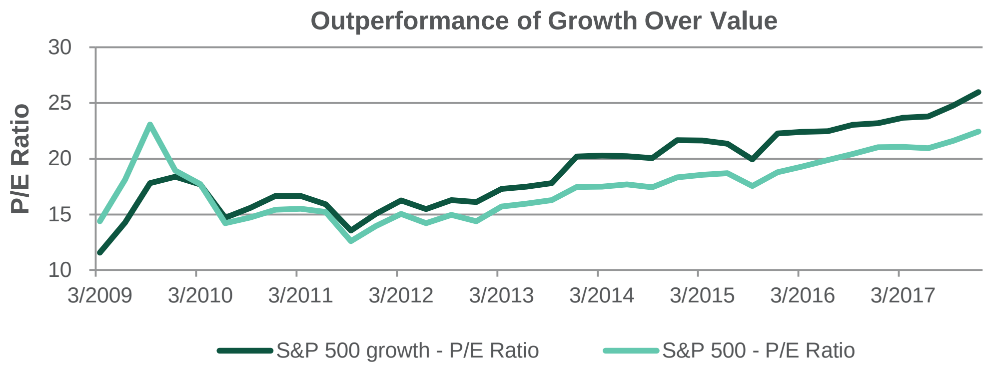
We all know expansions don't die of old age. Understanding the unique nature of the current expansion is important.




Source: Bloomberg. Data through 12/29/2017

**Go Go Growth?**

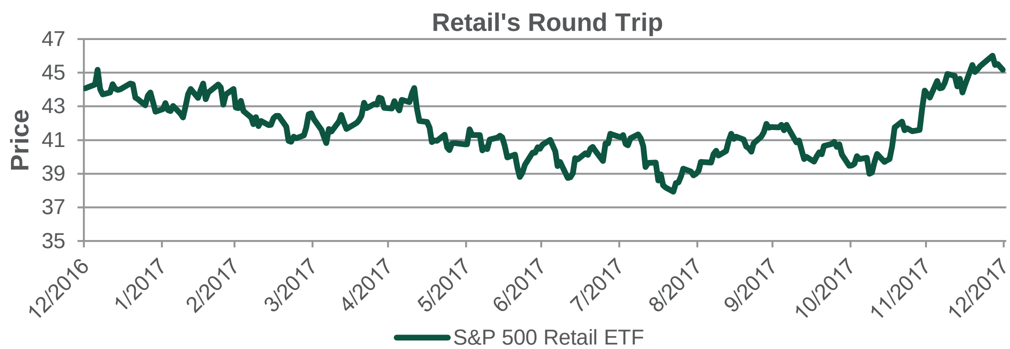
In 2017, Growth continued its post-crisis outperformance over value, raising questions of another “new normal.”




Source: Bloomberg, Standard & Poor’s. S&P 500 Index and S&P 500 Growth Index, Data through 12/29/2017

**Right-sized?**

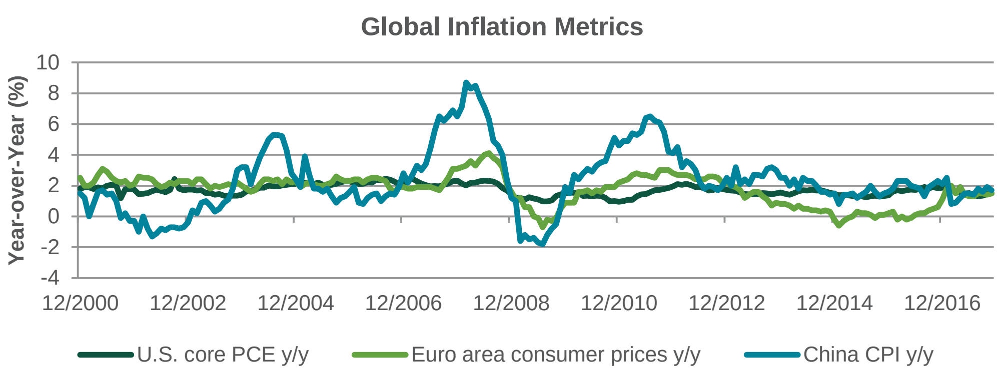
Much has been made over the *death of retail.* During the 2017 holiday season, sales and earnings surprised to the upside – suggesting efforts to gain efficiency may be working.




Source: Bloomberg, Standard & Poor’s. S&P 500 Retail ETF, Data through 12/29/2017

**Is it really that different?**

Since 2000, inflation around the world has been range-bound. Technology continues to drive downward pressure raising issue for Central Banks.




Source: Bloomberg, as of 11/30/2017

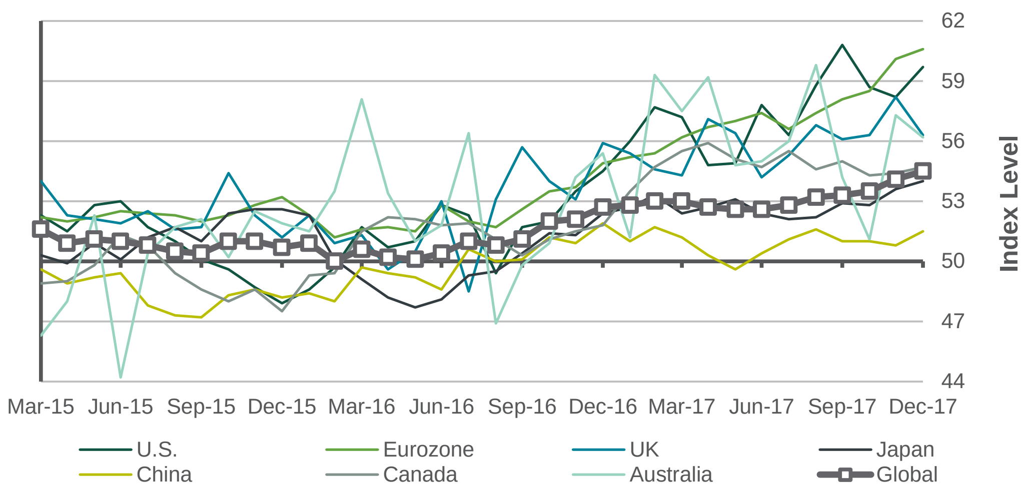
# Q4 2017: What We Have Learned, What We Need To Know

### Synchronized Global Economic Growth

Gross Domestic Product grew at a 3.3% annualized rate in the third quarter, the fastest in three years. While the numbers are not yet available for the fourth quarter, most indicators suggest another strong quarter. Two aspects of the economic growth from the third quarter are worth noting. First, we had initial signs of the long-awaited improvement in business investment. While consumer spending was weaker than expected (the winter holiday may have fixed that!), business spending increased and contributed more to economic growth than it has in recent years, making a 1.2% contribution to growth. Overall equipment spending rose at a 10.4 percent pace as a result of increased spending on transportation gear and business software.

Second, the U.S. current account declined 19.2% in the third quarter from a second quarter deficit of $124.4 billion to $100.6 billion. The improvement reflected a smaller deficit in goods trade, a bigger surplus in savings and a larger surplus in income from overseas investment. Improvement in the trade balance is a product, in part, of stronger economic growth across most of the world economy. Instead of having to fight the headwinds of weaker growth in Europe and Japan, American companies are enjoying the benefits of synchronized global growth as evidenced in rising PMI numbers (see Exhibit 5).

**EXHIBIT 5: SELECT REGION MANUFACTURING PMI SURVEYS - INDEX LEVEL**




SOURCE: Northern Trust Investment Strategy, Bloomberg. PMI = Purchasing Manager's Index. Expansion: above 50; contraction: below 50. Monthly data through 12/31/2017. Preliminary 'flash' readings shown for current period, where available

### Stuckflation continues to linger, taunting central bankers the world over

Despite strong growth and movement toward full employment, inflation has remained subdued and below the inflation targets of nearly all central banks. The current inflation rate for the U.S. is 2.2 percent for the 12 months ending November 30. The Fed has gone from attributing low inflation to transitory factors to acknowledging that there may be larger structural disinflationary forces at work, such as globalization, technology and labor-capital relations.

These structural factors, along with weak inflation and low bond yields in other developed markets, have tempered the pace of interest rate rise which we refer to in our latest Capital Market Assumptions as “Waiting for Monetary Godot”. Inflation in the Eurozone and Japan, where monetary normalization has yet to begin, are even weaker, with inflation running at 1.5 percent and 0.8, respectively.

**Populist Catharsis Contained**

As the year began, some market analysts worried that a populist backlash might undue the economy and prompt counter-productive trade protection. But as we predicted the populist mood, as first reflected in Brexit and then in the U.S. election, has largely been limited to rhetoric and has yet to materially affect the financial markets. Indeed, some of the populist rhetoric may have had a beneficial effect. In Eurozone, populism may have increased the pressure for pro-growth monetary and fiscal measures and in France it led to the election of a pro-market reformer, Emanuel Macron. Most notably, in spite of concerns about a new form of government gridlock, the populist rhetoric has yielded to the passage of the most pro-business tax reform package in many decades.

**Conclusion**

What we have learned from the market performance of 2017 is that it was not a case of “irrational exuberance” but of rational market robustness, that was well-supported by improved economic fundamentals. For the first time in many decades, there are no major imbalances that are flashing a warning sign. When some sectors of the market seem to be overheating, the pattern has been for investors to pull back and rotate into less expensive parts of the market where fundamental supply-demand conditions are improving, as they did in the case of energy late in the year. We remain aware of the risks: central bank mistakes, a larger expected China slowdown, or a major geopolitical crisis. However, as we close the books on 2017, the markets are well supported and look to remain so into 2018.

## The Time Value of Time

We are frequently asked to review our client’s full investment picture, with an eye toward answering the following question:

> *Given our finite time and resources, are we investing them in the right place?*

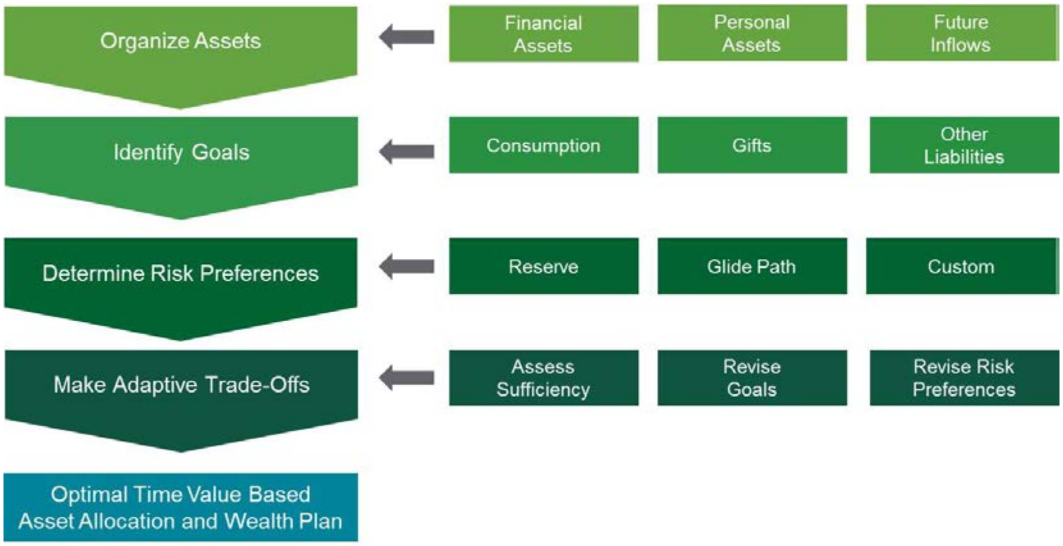
What investors are really asking is something much more akin to:

> *In what way should we focus our finite resources to achieve the highest potential Return On Time (ROT), thus achieving the highest risk-adjusted returns?*

**Clarification of Portfolio Outcomes & Goals**

As we wrote more broadly last quarter around statements of investment policy, having a clear and agreed upon set of objectives for the portfolio or balance sheet assets is the best place to start.

An example might look like this:




The following questions, while to no extent exhaustive, are the foundational elements in clarifying the broader investment objectives, in order to produce the kinds of outcomes desired:

- How should we, as a family, organize our assets?
- How does the organization line up with our collectively identified goals?
- What kind of risks are we “willing to take”?
- Should we be thinking about trade-offs over time?

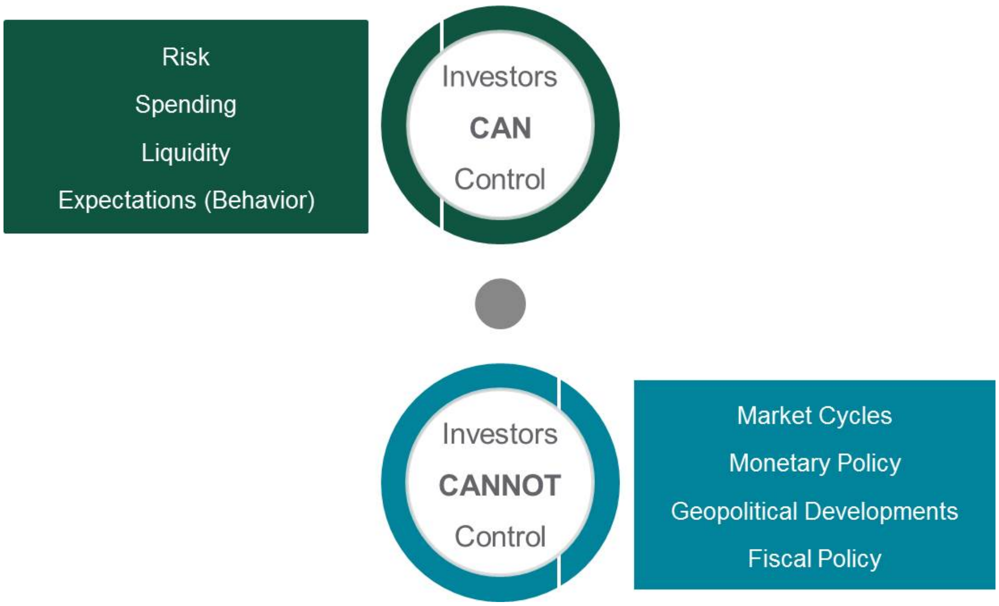
The composition of the assets “under the hood” is the next component required to ensure that maximum return on time is achieved.

**In Search of Alpha**

Many Family Offices have a mix of assets that break down into four or five separate line items on which investors tend to focus: Liquid Markets (Long only), Hedge Funds, Private Equity, Real Assets, Direct Investments & Operating Companies. While they may not do so on a dollar or percentage basis, in general, investors tend to divide the time they spend analyzing each asset equally – even though the data is very clear that this sub-optimizes their investment of time. Alpha, or the potential for excess risk adjusted returns, vary across asset classes, therefore, successful investors tend to focus their time where there is the highest potential for achieving strong consistent returns.

## Things You Can and Can't Control

Of the five main asset categories, an assessment must be made of the degree that you can or can't control the various factors that affect each bucket's outcome. For instance, there is data that tells us that asset allocation contributes between 85 and 95% of returns in a multi-asset class portfolio, and therefore merits close attention and time spent crafting an appropriate asset allocation that meets an investor's required return and risk tolerance.

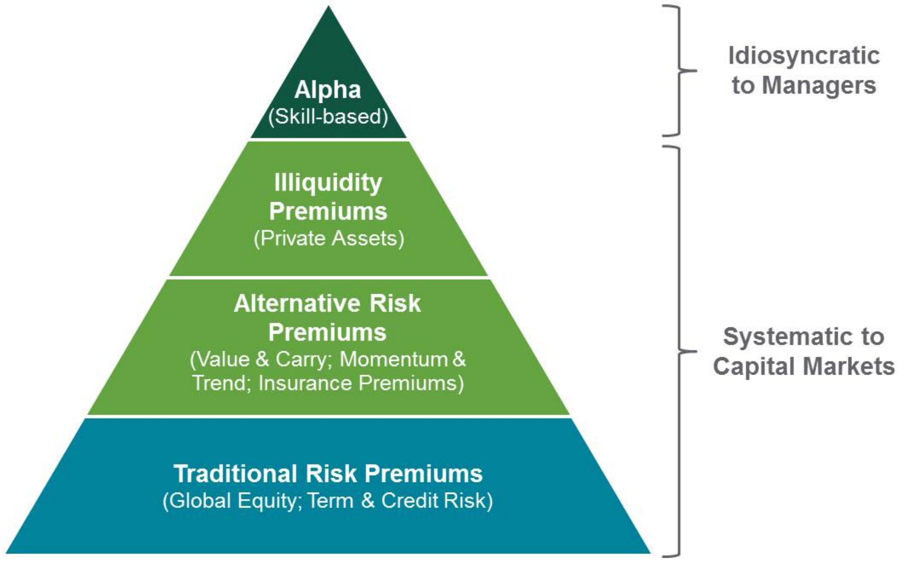



Leveraging the Northern Trust Investment Policy Committee views to help shape the strategic and on-going tactical allocations, allows the investor the ability to focus all their efforts on analyzing assets with the highest risk-adjusted return potential.

## Return on Time Spent on Efficient vs. Less-Efficient Investments

Both active and passive strategies can play an important role in the implementation of the liquid asset portion of the portfolio, depending on the specific objectives of each client. In the more efficient parts of the market, where it is more challenging to achieve consistent alpha, passive strategies may be the most cost effective approach to gaining market exposure. However, certain asset classes which are less efficient, or where the opportunity set adds differentiated return streams, merit a higher level of due diligence and dedication of time.

As the pyramid below suggests, locating managers that are able to provide skill-based alpha is very difficult to achieve and the benefit of engaging a professional investment advisor to assist in the due diligence process, versus performing those functions in-house, may best help maximize your Return on Time.

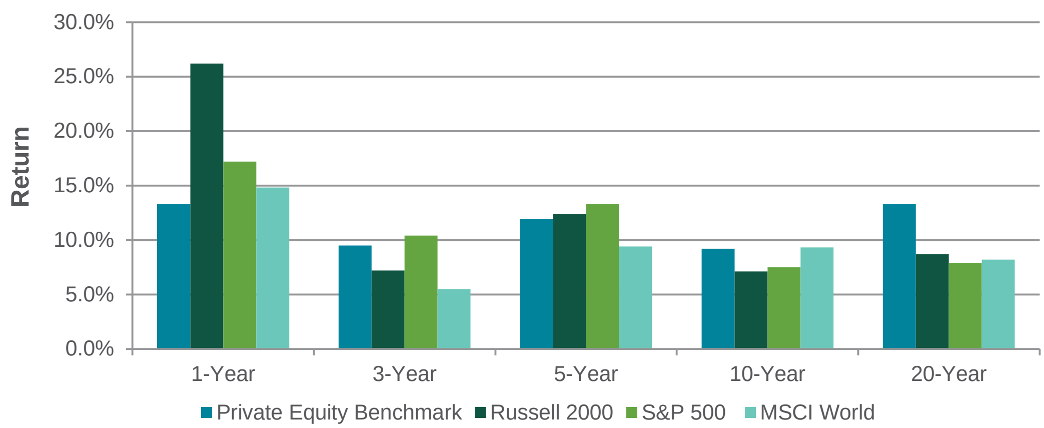



Note: For illustrative purposes only.

**Private Company Investing & Excess Returns**

We have long known that private company investing, over multiple market cycles, has produced an outsized premium over liquid markets. And so, intuitively it makes sense to incrementally spend more time in the private equity world, by either leveraging an experienced in-house team of investment professionals or partnering with Northern Trust's experienced Alternatives Team, focusing on the due diligence and on-going management of private company investment opportunities and programs.

**EXHIBIT 6: PRIVATE VS. PUBLIC MARKET PERFORMANCE**




SOURCE: The index is an end-to-end calculation based on data compiled from 3,909 funds: 1,508 U.S. venture capital funds, including fully liquidated partnerships, formed between 1981 and 2014, and 1,152 U.S. private equity funds and 1,249 global ex U.S. private equity & venture capital funds, including fully liquidated partnerships, formed between 1986 and 2014. 1Pooled end-to-end return, net of fees, expenses, and carried interest. Sources: Cambridge Associates LLC, Barclays, Dow Jones Indexes, Frank Russell Company, MSCI Inc., MSCI Inc., Standard & Poor's and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties. *Capital change only. Notes: Total returns for MSCI Emerging Markets indices are gross of dividend taxes. Total returns for MSCI Developed Markets indices are net of dividend taxes. Data as of 3/31/17. Past performance is not indicative or a guarantee of future results.

Another factor we take into consideration is the inherent industry expertise within the current generation of the family's active and potential investment resources. For example, if a family has an expertise in manufacturing and there are opportunities to acquire operating companies and consolidate a particular vertical – perhaps that is a better Return on Time, while allowing Northern Trust's Alternatives Team to help build a custom private company program that best compliments the family's expertise.

**Conclusion: Before and After**

As noted, 85% to 95% of investment results are driven by asset allocation, which is why we believe it is critical to work with an organization in developing an appropriate strategic and on-going tactical allocation that best compliments your risk/return profile. Within the implementation, the best Return on Time is focusing most of your efforts on researching both private companies and in the less-efficient areas of the liquid markets.

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