

Asset Allocation Focus Update

May 2020

In this publication for advisors and their clients, Northwestern Mutual Wealth Management Company's (NMWMC) investment professionals provide views and commentary on the current marketplace. This information is designed to complement the long-term strategic view on asset allocation that is reflected in the model allocations shown in most clients' investment policy statements. We believe that these standard model asset allocations continue to be prudent and suitable for most long-term investors. The strategic viewpoint represented in the chart below illustrates our views based on the relative attractiveness of different asset classes over the next 12 to 18 months. Keep in mind that this viewpoint can and will change as valuations and economic variables evolve. Because our advisory programs provide different levels of investment flexibility, our strategic viewpoint may not be implemented in our home office-managed programs or may be implemented only in certain programs.

Climbing the economic valley

Just as we released our last Asset Allocation Focus, the novel coronavirus was just beginning to rear its ugly head, causing many on Wall Street to rip up their 2020 script. No forecaster entered the year looking for the unemployment rate to spike from 3.5 percent to its current level of 14.7 percent — and within two months. However, while forecasts have been scrapped, that doesn't mean you scrap the framework for how you think about the economy or your investment process. Surprisingly, many of the themes in this commentary echo what we wrote three months ago. What's different? The prices have gotten cheaper and the differences more pronounced.

The U.S. economy entered 2020 on firm fundamental footing, and a cyclical recovery was brewing as dual tailwinds from global interest rate cuts and declining trade concerns started pushing the economy higher. But the coronavirus triggered a shockwave of events that dug an economic valley and pushed the U.S. S&P 500 stock index from record highs on Feb. 19 to a bear market (down 20 percent) in a record 16 trading days before ultimately bottoming on March 23, a swift decline of 34 percent.

The economic data over the past few months has been awful, but as we forecasted, the market has looked past the numbers and pushed higher. Why? Because, in past downturns, the beginning of the end occurs when we begin to "fix" what drove the economy into a recession in the first place. The underlying

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Equities	Unfavorable Neutral Favorable*				
U.S. Large Cap					
U.S. Mid Cap					
U.S. Small Cap					
Intl Developed					
Emerging Markets					
Fixed Income	Unfavorable Neutral Favorable*				
Duration					
Government Securities					
Investment Grade					
High Yield					
Non-U.S.					
TIPS					
Municipal Bonds					
Real Assets	Unfavorable Neutral Favorable*				
Real Estate					
Commodities					

*The colors indicate the level of unfavorability and favorability within the asset class, starting from neutral. The more favorable or unfavorable, the color will extend to the far right or left.

economic fundamentals hadn't deteriorated; rather, COVID-19 and closing large parts of the U.S. economy to bend the case curve was the recession trigger. Put differently, we intentionally damaged economic data in order to start fixing what went wrong — the virus.

We have long espoused our belief that today's Federal Reserve is far different from its predecessors. Indeed, we ended the last Asset Allocation Focus expressing our belief that the Fed was at the ready to step in and soothe markets. As we've now seen, despite myriad worries, the Fed had plenty of tools left even at the zero-interest rate bound. As we have stated in the past, this changes how one thinks about investing. No, it doesn't mean we can't have downturns, but they may be shorter than those of the past.

Right on cue, the most important event that turned the stock market around in March was quick and forceful Fed easing in conjunction with fiscal government relief. These actions provided relief that "allowed" Americans to stay in their homes — a bridge over the economic valley that social distancing is causing. Both monetary and fiscal policymakers learned from the Great Recession in 2007-09 that it is important to make big, fast moves to help the economy. In just a couple of weeks, policymakers accomplished what took one and a half years more than a decade ago. As of this writing, the combination of the Fed and U.S. Government fiscal relief has filled the current economic valley with approximately \$9 trillion in relief, or roughly 44 percent of annual U.S. GDP.

Now virus cases in the U.S. are declining, and our hospital system has not been overrun. Preventive measures are providing opportunities to slowly reopen small businesses around the country and to start walking out of this economic valley. The ultimate shape of the recovery will be dictated by the success of reopenings, and while there may be setbacks, we want to make an important point: We don't have to recoup all lost economic growth or employment for the market to push higher. If we show signs that the economic depths are a thing of the past, the market will likely rise.

For example, before the Great Recession began in December 2007, the number of employed Americans peaked at 146.6 million in November 2007. As a result of that recession, employment troughed in December 2009 (two years and one month later) at 138 million. We didn't surpass that previous record until September 2014, roughly seven years past the peak and nearly five years after the trough. There are two important points to make: First, for those who want to wait to invest until the data improves, the trough in employment was nine months after the market bottomed in March 2009. Secondly, between the market bottoming and September 2014, the S&P 500 had gained more than 23 percent per annum.

Ultimately, a treatment or vaccine is what's needed to completely exit this economic valley. Much progress has been made on this front. The global scientific community's response has been impressive. We've witnessed a strong partnership between private

companies and federal agencies. As of April 30, according to the World Health Organization (WHO), there are more than 100 vaccines in development with eight reaching clinical trials. While many of these companies are expressing optimism in their ability to bring a vaccine to market, no one knows for sure if they will work or be safe. However, we are encouraged that we have a lot of shots on goal right now.

Even if a vaccine isn't discovered, we are optimistic that our economy can adapt and our response to any outbreak can be more targeted. Think about it this way: Three months ago we were rudely introduced to something we knew very little about. On a scale of 10, uncertainty was a 10. We got a surprise upper-cut to the chin in the first round, but we stayed on our feet until the bell, buying time to regroup in our corner. Now, we've been getting stronger in each subsequent round of the fight. While uncertainty remains high, it's diminishing each day as data improves, testing expands and researchers learn something new every day about the virus' weakness.



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Unfortunately, we are confident the previous sentences likely elicited a political response or thought by nearly all readers — the virus, it appears, has become yet another partisan wedge issue. But in a very apolitical manner, let us close out this commentary. We do believe that America will find a way to adapt and push forward. Capitalism and democracy aren't perfect, but they have historically proven to be better than all alternatives. Our country and its economy will adapt and find solutions to problems by exercising the will and collective expertise of its citizens and companies. Despite all the noise, if you take a step back and look around, it's already occurring.

Many questions remain, and no one knows for certain how the virus will evolve. Importantly, we do believe that our future solutions to any outbreaks will be more targeted and not a one-size-fits-all approach — remember, we've learned a lot over the past few months. Different states, different counties, different at-risk age cohorts will likely have different realities. However, we believe that we've already reached the deepest, darkest part of the economic valley, and we're beginning to climb out, and that will continue to support markets.

Equity Allocation

Equity View

The stock market rally off the bottom on March 23 has led many to worry that the stock market is completely divorced from grim economic realities. We disagree. The data is so bad because social distancing caused it — it was intentional, not due to crumbling fundamentals. Now that we are reopening, markets are pricing in the likelihood of better days ahead.

It's also important to remember that "the market" is not one homogeneous S&P 500. The index comprises many different and disparate parts. The S&P 500 is being driven higher by a narrowing subset of "virus-resistant" winners versus other more cyclical segments that are suffering and reflect current economic realities. For example, the top 50 stocks in the S&P 500 are down less than 2 percent year to date, while the entire index (including the next 450) is 7 percent lower. The New York Stock Exchange FAANG+ Index, which contains highly traded growth and technology stocks like Facebook, Apple, Amazon, Netflix and Google's parent company, are a large percentage of the top 50 S&P 500 stocks and are actually up 23 percent year to date. To draw a sharper contrast, if you weighted all the S&P 500 stocks equally versus the market capitalization weighted index, the index would be down 14 percent.

Contrast that with the S&P Mid Cap Index or the next 400 largest stocks after the S&P 500 — they are down 18 percent, while the S&P Small Cap Index is down 24 percent. These are segments of the market that are more economically sensitive and, as a result, have been harmed to a greater degree. Many investors are now rushing to "quarantine" their portfolios in larger, more defensive stocks to navigate coronavirus-induced economic downside. We believe as the economy opens and we begin climbing out of the valley, investors need to begin "opening up their portfolios" to these more economically sensitive, cyclical asset classes.

Besides the pushback we get on our relatively positive virus outlook, the other comment we get is that the stock market is "expensive" and therefore can't go any higher. Indeed, recently one high-profile market commentator caused a hubbub when he stated his belief that the market is as expensive as it has been since 1999 (just before the so-called "dot.com" bubble). Surprisingly, we don't disagree with the overall tenor of his comment, but we add two important caveats:

1. We believe valuation is a better relative tool than an absolute metric. After all, investors need to place their money somewhere to grow it for the future. Rewinding to 1999, we note that the 10- and 2-year Treasury, competing asset classes to stocks, both yielded around 6 percent. Today those yields are roughly 0.7 percent and 0.2 percent, respectively.



Now that we are reopening, markets are pricing in the likelihood of better days ahead.

Are stocks expensive relative to bonds? We think the answer is no. To add more fuel to this argument, even if the economy shows signs of life, central banks around the globe are likely to continue trying to keep rates low. Yield curve control is a real likelihood, and that means that Treasury yields are unlikely to get any more attractive for long-term investors.

2. More important, and consistent with our above discussion on the bifurcation in the market, is the commentary on what the "market" is. Yes, in 1999 parts of the S&P 500 were very expensive. That's also true today, but there are also parts of the S&P 500 that are not expensive; and, quite frankly, the rest of U.S. markets and many parts of the world are cheaper. Then, like now, we believe investors will notice this eventually.

For those who remain afraid that this means bad performance is ahead, we note the S&P 500 did provide low returns over the years after 1999. From the high of the S&P 500 on March 24, 2000, until Oct. 9, 2007, just prior to the Great Recession, the S&P 500 returned a paltry 1.99 percent per annum. However, other equity markets did remarkably better: U.S. Mid Cap stocks rose 9.66 percent, and U.S. Small Cap returned 10.67 percent, while International Developed was up 6.58 percent and Emerging Markets skyrocketed 15.50 percent. There almost always is opportunity in different market segments no matter the environment.

We want to note that there is no rule that history repeats. Perhaps the future macro-economic environment will shift and not be the same as the aforementioned time horizon. However, from a valuation perspective, we do believe there are many similarities to 1999.

Current Positioning

Given our 2020 forecast of a cyclical growth recovery, we entered the year with our portfolios slightly tilted toward cyclical asset classes like small caps that we believe were cheap after their dramatic underperformance during late 2018 and through Q3 2019. Much as we forecasted, trade war concerns were dialed back in Q4 2019 and early 2020, which was providing a cyclical asset class tailwind and recovery, right up until COVID-19 hit and upended the rally.

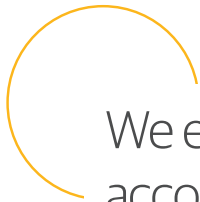
We acknowledge that near-term uncertainty remains regarding the virus and its progression. That clouds the macroeconomic outlook for all participants. Given this reality, the Investment Strategy Committee has been laser focused on valuation. While valuation is an imperfect “market-timing” tool, we believe it historically has proven to win nearly every intermediate-to long-term discussion.

Given the spring season is upon us, let us offer this analogy: We think finding good value in the market is like planting seeds that we know will eventually bloom as the weather warms. The question of exactly when is unknowable in the near term, but at some point in the intermediate term our seeds will turn to flowers. We recently upped our equity allocation in April and acknowledge that our timing could still ultimately prove to be wrong in the near term if we have a virus setback. However, if we stretch our horizon out a little, we believe it is likely we will have flowers to harvest in the intermediate term.



We continue to position our portfolios with an overweight to equities relative to fixed income given our intermediate-term outlook and time horizon.

We continue to position our portfolios with an overweight to equities relative to fixed income given our intermediate-term outlook and time horizon. Within our equity portfolios, we are overweight the U.S. equity market, and our two most recent moves have been to increase the cyclicity of the portfolio by adding to U.S. Small Caps at the end of 2019 and U.S. Mid-Caps in April 2020. We remain max underweight U.S. Real Estate Investment Trusts, are neutral International Developed (largely given the fractured decision-making in these economies) and are overweight Emerging Markets where some countries have effectively dealt with the virus and have reopened for business.



We expect the Federal Reserve will remain decidedly accommodative for the foreseeable future with a goal of anchoring real interest rates in the negative to help stimulate aggregate demand.

U.S. Large Cap

As the market lens has shifted from COVID-19-related shutdowns toward reopening the global economy, the S&P 500 has bounced more than 30 percent off the lows on March 23. As we've written in the past, the index construction of U.S. Large Caps is dominated by sectors with more defensive characteristics, such as technology and healthcare, relative to other equity asset classes. While this helped U.S. Large Caps materially outperform other equities on the way down, the outperformance has been much more muted in the recent recovery. We remain overweight but are becoming increasingly concerned about the growing valuation gap that U.S. Large Caps have against the rest of our portfolio.

U.S. Mid Cap

On April 13, the Strategy Committee upgraded its intermediate view of U.S. Mid Caps from neutral to overweight. Upon completion of the necessary trades in April, we released our overweight investment rationale. Our equity positioning is grounded in relative valuation, monetary conditions and forward macroeconomic outlook.

The U.S. and global economies have rapidly deteriorated from accelerated growth to start 2020 to the contractionary conditions we see today amid the COVID-19 pandemic. The result of this abrupt shift in macroeconomic conditions was the sharp, relative underperformance of equity asset classes that are more economically sensitive. Specifically, this includes U.S. Small Caps and U.S. Mid Caps within our nine asset class portfolios.

This relative underperformance has U.S. Mid Caps currently trading at their most attractive levels of relative valuation versus U.S. Large Caps in the past 25 years. Our historical analysis of forward relative returns from this valuation point exhibits highly attractive results.

From a monetary policy perspective, we expect the Federal Reserve will remain decidedly accommodative for the foreseeable future with a goal of anchoring real interest rates in the negative to help stimulate aggregate demand and aid the post-COVID-19 economic recovery. As with U.S. Small Caps, negative real interest rates act as an economic tailwind for U.S. Mid Caps.

At this point it's impossible to know the ultimate severity or duration of COVID-19's impact to the global economy;

nor does anyone else. However, we do believe that new infections will peak, people will return to work and the economy will recover. This implies macroeconomic conditions will move from contractionary to expansionary, an environment that is uniquely constructive to U.S. Mid Cap and U.S. Small Cap outperformance.

Post-trade, U.S. Mid Caps have led in the recovery as focus shifts to opening the economy, outperforming U.S. Large Caps by more than 7 percent and the Barclays aggregate by 16 percent.

U.S. Small Cap

We view the relative valuation, favorable monetary backdrop and eventual strengthening of macroeconomic conditions as key factors underpinning our thesis for an above-benchmark allocation for U.S. Small Caps. Relative to our Q4 2019 entry point on this overweight, the valuation argument has only gotten stronger, reaching relative levels not seen since the dot.com bubble. We think patience is required to reap the rewards on this position, as economic reacceleration after COVID-19 will likely be the catalyst for U.S. Small Cap outperformance.

International Developed

International Developed markets were not spared from a deep recession due to the coronavirus. In fact, Europe (representing 65 percent of the EAFE index) has been the worst-affected region and will likely experience a deeper recession than the U.S. Italy and Spain were among the world's most severely affected countries. Prior to the coronavirus, growth was already fragile — the European economy grew by just 0.1 percent in Q4 2019. As in the U.S., European economic data shows contraction in both the service and manufacturing sectors, with PMI composite readings well below 50.

Accommodative monetary and fiscal policies have been enacted to offset economic damage from quarantines. The European Central Bank announced its Pandemic Emergency Purchase Programme (PEPP) — a €750 billion scheme. The PEPP will fund the purchase of government and corporate bonds until the end of the COVID-19 crisis. Governments across Europe also announced spending packages to help businesses and households bridge the gap caused by lost income and ongoing expenses during this period of disruption. Even fiscal stimulus-reluctant Germany has launched its own relief packages.

The UK had been dealing with domestic politics as Brexit dominated the narrative around UK assets and the economy prior to the virus. In line with other central banks, the Bank of England materially reduced interest rates, cutting by 65 basis points to 0.1 percent. This response was coordinated with the UK government, which unveiled an unprecedented series of fiscal support measures that were in line with initiatives from many other developed nations.

In terms of coronavirus contagion, Japan has so far been on a very different trajectory than most other developed nations, with a lower transmission rate and a lower mortality rate. This has resulted in a slightly less stringent response from the authorities. From late March, however, there have been more forceful requests from both central and local governments to curtail social activities, and it is possible that more severe restrictions on movements will be imposed soon. The high profile impact for Japan has been the postponement of the Tokyo Olympics for one year to July 2021. Although this is not particularly significant in economic terms, with maybe 0.2 percent of GDP shifted from this year to next, there could be political implications, as the games are now planned just before the end of Shinzo Abe's term as prime minister in October 2021.

With slower growth in International Developed markets, monetary policy will remain strongly accommodative over the coming years. Relative valuations are deeply discounted and give International Developed equity markets potential for competitive returns in the intermediate to longer term. The MSCI EAFE index is mostly weighted to European, Japanese and UK equities. While we believe these markets have potential for attractive returns, they need an economic catalyst. Therefore, we have focused our attention on other asset classes that we believe possess better fundamentals and kept a neutral rating on the International Developed asset class.

Emerging Markets

Some developing countries appear to have seen a peak in cases of COVID-19 and are in the process of reopening their economies; others continue to battle the virus. Let's look at a few emerging-market countries and their responses to the virus from both a health and economic perspective.

China, the epicenter of the virus, appeared to be on the downswing of new cases until recent concerns over outbreaks caused the government to require more lockdowns and mandatory testing of millions of people. The economic data out of China, however, has been positive recently, with industrial production rising in April as the country started reopening. It is notable that trade rhetoric from President Donald Trump against China has heated up again, and it's something we continue to monitor.

India announced \$266 billion in fiscal stimulus, equivalent to 10 percent of GDP, to combat COVID-19-related slowdowns. Brazil appears to have become the latest coronavirus hotspot, as its response and preparation for the virus appears unorganized. The Brazilian real is down about 26 percent this year, and outflows persist. In contrast, South Korea has controlled its outbreak through targeted testing, contact tracing and quarantine. Leaders there have the advantage of experiencing epidemics before

(SARS 2003, for example). After a 50-basis point rate cut in March, many are calling for and expecting the Bank of Korea to cut rates again in May.

This very brief look at various responses and actions regarding the virus and economies in developing nations exposes the vast differences in politics, government regimes and culture that exist in the developing world. That's part of the challenge in investing in Emerging Markets as a general asset class.

When we view Emerging Markets as an asset class, we remain constructive on a relative basis versus the developed world for several reasons. We believe patient, relative-value investors are eventually rewarded, and emerging-market equities remain attractive on a relative valuation basis. We also note the IMF has forecasted global growth in the developed world to taper down to 1.4 percent by 2023, a slowdown of about a third, while Emerging Markets are expected to accelerate slightly to 4.8 percent. Periods of divergence in economic growth in emerging

economies vs. developed economies has generally been a positive for Emerging Markets.

Many central banks in developing countries have the desire and, importantly, the ability to ease. Not only has China's central bank been easing, but most central banks in developing countries have moved from tightening to easing over the past year, and the trend has continued in the wake of the virus. Another critical point is that many of these economies are at different points in their economic cycles than the developed world. Interest rates are generally higher and GDP growth is higher; and with inflation not a major concern for many countries, there is room to ease and/or provide fiscal stimulus. Additionally, in recent years, Emerging Markets have captured a larger share of world economic growth, while their share of world equity markets has not kept pace. Add to this a developing world that has stronger fundamentals than in the past, and we reiterate our intermediate- to long-term overweight position in this asset class.

Fixed Income

It seems like a never-ending commentary, but bond yields have again pushed lower. The question is how much lower they can go. Is zero the lower bound, or could we see negative rates? We express our opinion that the Federal Reserve has no desire to experiment with negative yields and will keep them positive. We acknowledge that if rates push closer to zero, bond holders in the nearer term could continue to see handsome returns, as they recently have. However, for longer-term investors it is highly likely that their long-term return if they hold until maturity will be somewhere near their starting yield.

The other "growing" question is whether the increase in government debt or increased willingness of the Federal Reserve to do everything in its power to increase inflation, not fight it, will eventually cause inflation to reach the Fed's 2 percent target and perhaps drift well above it. While inflation is likely to remain subdued for some time into the future, we do believe, at some point, the combination of debt, central bank cajoling and societal desires for basic income will eventually snap the inflation rubber band. When we add these factors together and probability weight them against current yields, we continue to find more attractive intermediate- to long-term real return opportunities in equity markets.

We again remind — with heavy emphasis added — that the above commentary does not imply that bonds are no longer important in portfolio construction. Given our desire to tilt our portfolios toward equity-risk exposure against the virus risks, we maintain our conservative stance toward our fixed-income holdings.

Even though we have seen credit spreads blow out and the Federal Reserve attempt to backstop them by buying them, we continue to recommend high-quality, moderate-duration fixed income as a ballast for a diversified portfolio in a period where volatility remains elevated.

Duration

For a very long period we have recommended "high-quality duration." We again remind that this recommendation was not based upon a forecasted movement in interest rates. Duration has many components to it, and our outlook was based upon our belief that low-volatility, tighter credit spreads couldn't last forever. High-quality duration won the game in Q1 2020. It performed how it was supposed to perform in a risk-off environment. It was inversely correlated with equities. And while yields have fallen dramatically, and rightfully, the curve has steepened. Duration is still relevant, but we again state our belief that it needs to be expressed through high-quality bonds.

Government Securities

We went from having some of the highest absolute and relative rates here in the U.S. to talking about the possibility of the Federal Reserve instituting negative interest rates. While that seems unlikely because the Fed has other means to create inflation (as we have witnessed over the past several months), the U.S. is still the best place for risk-adjusted bond returns. Keep looking for alternatives to traditional nominal Treasuries. For example, we believe a potential weakening in real estate could make agency bonds look attractive.

Credit

In the last Asset Allocation Focus we felt that even investment-grade corporate bonds were getting rich. In the meantime, they essentially crashed and have become kind of rich again. The skew of returns, while more favorable than a few months ago, has introduced increased levels of credit risk, so is it worth it? Sort of. The Fed has stepped in to backstop the liquidity of the marketplace, but it cannot stop insolvencies — and we believe the market will eventually have to reflect that. Credit, on the micro level, matters again. If you desire to buy credit (investment grade), know what you own on a company-by-company basis. There are going to be increased bankruptcies in the future. The Fed cannot solve for a lack of demand in various companies or sectors. Lastly, we continue to stay away from high yield given our belief that equity markets hold higher returns. Put differently, we have decided to fill our “risk budget” through equities, not high yield.

TIPS

TIPS are the trade. We like TIPS given the low breakeven inflation rates embedded within the theme. TIPS were introduced in the late 1990s, and since that time, breakevens have approached

zero (expected inflation rates near zero or approaching zero) only one other time, in 2008. That makes an investor who believes inflation is a right tail event (which we do in the era of the modern Fed) indifferent between owning TIPS and nominals. We believe TIPS are attractive and added to our position in our April trade. Importantly, TIPS represent high-quality government debt and don't require investors to layer on credit risk to garner excess returns.

Municipal Bonds

Municipals went from somewhat expensive ... to crashing ... to cheap. Like many of the credit issues of late March, the velocity of movement was shocking, almost to the point of making an asset allocation decision based on it impossible. On a micro level, it was an opportunity to increase the credit quality of investments as everything was getting sold. Moving forward, there is more credit risk to municipal bonds due to the global pandemic, but there is also now additional future return compensation for muni investors. Municipals as an asset class are cheap and should be considered an overweight in tax situations that make the most sense for your clients.

Real Assets

For the past few years REITs have epitomized the risk-on (cyclical) / risk-off (defensive) trade. Our view has been that they are relatively expensive and, therefore, are poised to underperform. That's why in 2019 we went max underweight the asset class. During the initial stage of coronavirus, REITs held up well as macro-driven traders followed the risk-on/risk-off script and ignored valuation. Indeed, through March 10 REITs were the best-performing “equity-like” asset class we follow.

Then the world shifted and the shutdowns began. With little valuation support, investors refocused on the likelihood that the coronavirus may change our future behavior. While the jury is out on what those changes may be, one thing that appears evident is that many parts of the REIT world could see lower occupancy and rents as we contemplate less travel and a greater potential for people to continue working and shopping from home. At some point the narrative will go too far and REIT valuations will reflect the new reality — however, that time is not now, and we continue with our max underweight.

Conversely, we continue to hold a neutral allocation in Commodities, primarily due to their diversification benefits and correlation to unexpected inflation. Building portfolios is about

hedging risks. And right now, risks are high. While the past years have not been conducive to Commodities, perhaps the future will. We are not throwing in the towel on an asset class that may provide future diversification benefits as economies around the world pull out all the stimulus levers to help their respective economies climb out of the COVID-19-induced economic valleys.

However, during the month of April we determined a tilt toward gold in our commodity exposure would be of benefit as a further hedge to the increasingly unpredictable environment. If broad Commodities are more often a call on future economic growth and inflation, gold appears to be a hedge against too little or even too much growth. Given this straddle and our desire to further diversify our portfolio, we added a small sliver of gold to our commodity allocation.

Real Estate

Macroeconomic factors, such as household formation, job growth, wage gains and real interest rates, affect the price of real estate. The events stemming from the outbreak of COVID-19 and the worldwide response will likely negatively affect all of these factors and pressure REITs for some time to come.

The low interest rate environment drove income-starved investors to REITs, which typically offer more attractive yields compared to traditional fixed-income securities. After the market began pricing in the likely impact of the economic slowdown in the later part of Q1, long-term bond yields retreated, which would normally make REITs look relatively attractive as income-producing assets. However, with mounting job losses nationwide and an uncertain economic outlook, we believe the current valuation of REITs leaves them vulnerable to any stabilization or push higher in yields. We have been saying it for a while, but we believe there is likely more downside relative to upside for REITs, and that has not changed considering their recent sell-off. In fact, structural changes in how Americans work, shop, seek entertainment and go about their daily lives may have serious implications for many areas of the REIT market, especially commercial, retail and hospitality.

Over longer periods of time, REIT returns are highly dependent upon their income return. REIT values are primarily driven by the cash flows received in the form of rent or lease payments to the REIT owner. When yields decline, the future value of these cash flows increases, and the value of the REIT will appreciate. With yields currently in the sub-1 percent range, potential upside to the asset classes looks moderate at best.

To reflect our negative view on this asset class, we moved to a maximum underweight position, as the confluence of both fundamental and macroeconomic factors warrant extra caution. We will closely watch for signs of improvement in real estate markets and evaluate potential attractive valuation levels to reestablish a more constructive stance.

Commodities

The Bloomberg Commodity Index fell sharply this year — even more swiftly than equity markets — in response to the coronavirus outbreak. Commodities have since rebounded off their lows, but the pandemic has temporarily impaired both the supply and demand side of commodity markets. Commodity supply is directly affected by shutdowns, supply chain disruption and increased Saudi and Russian oil production. Commodity demand is also impaired given sharply reduced economic activity.

The three primary components of the Bloomberg Commodity Index are energy, metals (both industrial and precious) and agriculture. The benchmark is composed of around 1/3 of each sector, which means that the benchmark is broadly diversified across the commodity spectrum and ensures that no single commodity has an outsized impact on overall risk and return. The individual components of the Commodities benchmark all have unique characteristics and prices that are determined by different supply and demand drivers within individual markets.

However, inflation, economic growth and the direction of the U.S. dollar are the largest drivers for overall commodity prices.

The pandemic effects were dramatic, particularly for energy-related commodities. Oil prices have plunged since January, and prices reached a historic low in April with the benchmark West Texas Intermediate crude price briefly turning negative. Recent efforts by the Organization of the Petroleum Exporters (OPEC) and other oil producers to cut production in response to the plunge in demand will ease some pressure on oil markets, but it's not a long-term fix. Per the World Bank, "due to mitigation efforts that have limited most travel, oil demand is expected to fall by an unprecedented 9.3 million barrels per day this year from the 2019 level of 100 million barrels per day."

Gold prices are a notable bright spot, with gold spot prices approaching the \$1,750 level earlier this month. Gold serves as a safe haven for investors looking to avoid volatility in risk assets, particularly in an environment with real interest rates near zero or negative. Agriculture prices are less tied to economic growth and have undergone only minor declines, while industrial metals such as copper and zinc fell sharply as the economic slowdown has taken its toll.

We acknowledge the short-term outlook is bleak and that market forces have resulted in historic levels of commodity price volatility. As we look forward, our forecast is for both global growth and inflation to strengthen in the intermediate term. This would be a plus for Commodities.

It is also important to remember that Commodities are very sensitive to unexpected inflation. Over the past 30 years, Commodities have exhibited the highest positive correlation to inflation of all the major asset classes. In today's environment in which the market expects continued low inflation, we think it is important to have some commodity exposure within a portfolio. In an era of seemingly unlimited central bank accommodation, Commodities are the one asset class that can respond well if inflation unexpectedly returns.



Over the past 30 years, Commodities have exhibited the highest positive correlation to inflation of all the major asset classes.

Focus on the “Big Picture”

As a firm we believe there are a few rules for wealth accumulation from an investment perspective — all under a big-picture statement.

That statement is the following:

We believe long-term financial success is not garnered by how you behave when times are good. Anyone can invest or own stocks during the good times. Rather, long-term financial success is achieved based upon how you behave when times aren't easy. Certainly, the past few months meet this qualification.

Here are our rules for wealth creation:

Have a plan. This is important in all of life's endeavors but incredibly important to one's financial life. Embedded in every financial plan is the reality that life will have unpredictable events — like coronavirus. If you are reading this document, it is likely you are a Northwestern Mutual client and know that this company attempts to solve for life's surprises holistically, through the combination of investments and insurance.

Manage emotions. It is important to have a plan but more important to stay with that plan during times like these when emotions run high. We all “know” that history has proven that a) this time has never proven to be different, rather just “unique” and b) you should not sell or panic when others do. History has shown that those who buy or at least just keep their heads and maintain their positions end up with much better financial outcomes than those who sell. Unfortunately, based upon the data, such as the currently extremely depressed sentiment surveys and trillions in cash that has moved to money market funds, most people did not pay heed to this advice and sold. *This is a positive for those of us who did not!*

Allow us to bring this document to a close by expanding on our second rule through the lens of diversification and the temptation to abandon the plan.

The biggest part of being a professional investor is avoiding fatal mistakes and knowing that the world can't be perfectly modeled. Professional investors have a forward outlook and employ models but are grounded in principles and processes and use history as a guide. Perversely, individual investors can and often do outperform professional investors in shorter-term



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time horizons, but their winning streak is often upended by a significant mistake because they lack process and believe the future is perfectly knowable and concentrate their investments to reflect their outlook.

Recall the technology boom of the late 1990s that drove the overvaluation of the S&P 500 that we described in the beginning of this document. During this time period professional investors stayed diversified and were outperformed by individual investors who saw a “new market reality and path to riches” and acted upon it. Their strategy worked for some time but ended quickly and spectacularly for many. Similarly, we recall the mid-2000s when the refrain was that China, Europe and oil were the paths to future riches. This also ended abruptly for those who chose to chase those stories.

With this as a backdrop we again implore investors to not draw “forever” trend lines into the future. Recessions have consequences, and it is likely the next 10 years will look very different than the past 10. Policymakers shift, society shifts, and that means the market winners shift. Thinking about potential future changes: Will we see fiscal policy driving debt higher? Will we witness increased debt forgiveness, universal basic income, buyback restraints on big companies, increased deglobalization, supply chain shifts and the lack of Federal Reserve independence from government? These are a few of things we have been thinking or writing about, and the world has been lurching toward these for the past few years. But we think recessions are the final thrust that often makes growing trends accelerate and become embedded in the next expansion.

Cementing new trends isn't always a bad thing, either. For example, the reason bank and consumer balance sheets are strong and the Fed reacted so forcefully this time around is from lessons learned from the Great Recession. Those lessons stuck and became new patterns of behavior.



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We bring this up because we believe we are at a critical point. Once again investors want to own only the asset class or stocks that have provided the best performance over the recent past. And right now, it's hard to foresee how that investing formula could possibly change. We so often hear everyone knows that XYZ asset class is going to continue to outperform. Well, if everyone knows it, perhaps that particular asset is already priced for such outperformance long into the future. We worry that right now individuals are again questioning the value of diversification and are tired of hearing about it. But the leading asset classes change. A recession likely marks the end of whatever asset or sector drove the last expansion. Indeed, the past three recessions ushered in new asset class leadership during the expansion that followed.

The below chart shows the ranking of various equity-like asset classes from the beginning date of a recession to the end of that expansion and then repeats it for the next cycle. The results show that leadership does change. Certainly, history does not



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have to repeat, and there are fundamental reasons that it may not. But a review of history should at least throw some caution into that commentary. It is likely the world will evolve in ways we don't expect. Diversification is designed for that reality.

As you look at this chart please contemplate what you think will happen next during the next expansion if you believe a recession started in March 2020.

6/30/1990 - 2/28/2001	2/28/2001 - 11/30/2007	11/30/2007 - 2/28/2020
S&P 500 (U.S. Large Cap)	MSCI Emerging Markets (International Emerging)	S&P 500 (U.S. Large Cap)
Russell 2000 (U.S. Small Cap)	MSCI EAFE (International Developed)	Russell 2000 (U.S. Small Cap)
Bloomberg Commodity	Bloomberg Commodity	MSCI EAFE (International Developed)
MSCI EAFE (International Developed)	Russell 2000 (U.S. Small Cap)	MSCI Emerging Markets (International Emerging)
MSCI Emerging Markets (International Emerging)	S&P 500 (U.S. Large Cap)	Bloomberg Commodity

Source: Bloomberg L.P., Northwestern Mutual Wealth Management

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Please remember that all investments carry some level of risk, including the potential loss of principal invested. Indexes and/or benchmarks are unmanaged and cannot be invested in directly. Returns represent past performance, are not a guarantee of future performance and are not indicative of any specific investment. Diversification and strategic asset allocation do not assure profit or protect against loss. With fixed income securities and bonds, when interest rates rise, bond prices usually fall because an investor may earn a higher yield with another bond. Moreover, the longer the maturity of a bond the greater the risk. When interest rates are at low levels, there is a risk that a significant rise in interest rates can occur in a short period of time and cause losses to the market value of any bonds that you own. At maturity, the issuer of the bond is obligated to return the principal (original investment) to the investor. High-yield bonds present greater credit risk than bonds of higher quality. Bond investors should carefully consider risks such as interest rate risk, credit risk, liquidity risk, securities lending risk, repurchase and reverse repurchase transaction risk.

All index references and performance calculations are based on information provided through Bloomberg. Bloomberg is a provider of real-time and archived financial and market data, pricing, trading, analytics and news.

Although stocks have historically outperformed bonds, they also have historically been more volatile. Investors should carefully consider their ability to invest during volatile periods in the market.

Investors should be aware of the risks of investments in foreign securities, particularly investments in securities of companies in developing nations. These include the risks of currency fluctuation, of political and economic instability and of less well-developed government supervision and regulation of business and industry practices, as well as differences in accounting standards.

Specific sector investing such as real estate can be subject to different and greater risks than more diversified investments. Declines in the value of real estate, economic conditions, property taxes, tax laws and interest rates all present potential risks to real estate investments.

Commodity prices fluctuate more than other asset prices with the potential for large losses and may be affected by market events, weather, regulatory or political developments, worldwide competition, and economic conditions. Investment can be made directly in physical assets or commodity-linked derivative instruments, such as commodity swap agreements or futures contracts.

Standard & Poor's 500 Index (S&P 500) is a capitalization-weighted index of 500 stocks. The index is designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

Treasury Inflation-Protected Securities (TIPS) are securities indexed to inflation in order to protect investors from the negative effects of inflation.

The Consumer Price Index (CPI) examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care.