INVESTMENT TRUST COMPANY

VIEWPOINTS *April 2021*

STIMULATING

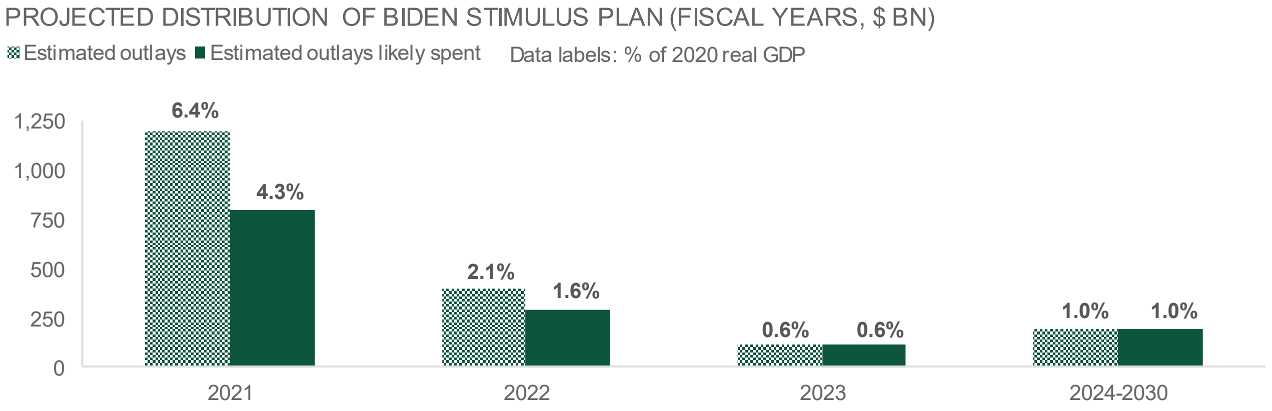
The big U.S. fiscal stimulus package, along with further easing action by the European Central Bank (ECB), have combined to bolster the growth outlook while also increasing the focus on inflationary pressures. This past week, U.S. President Joe Biden signed the $1.9 trillion American Rescue Plan Act of 2021, providing stimulus checks, extended unemployment benefits, aid to states and municipalities and other payments. We estimate roughly $800 billion will be spent this fiscal year – most of which will stimulate second- and third-quarter growth – with an additional $300 billion spent next year (see chart below). This is coming at a time when the Federal Reserve isn't objecting too loudly to the recent rise in interest rates as the economy rebounds. In contrast, the ECB expressed its displeasure at the recent rise in rates by boosting its asset purchase programs to support the European recovery, which is lagging that of the U.S. It is noteworthy that we upgraded our outlook for European political leadership this month, as we are encouraged by the developments in the German leadership race and the appointment of Mario Draghi as Prime Minister of Italy.

Beyond the stimulus being enacted, the global economy continues its reopening momentum. Of the major economies hit hardest by the virus, the U.S. and U.K. are leading vaccination progress and estimates of herd immunity in the U.S. are now centering on mid-2021. The February U.S. jobs report was a positive surprise, bolstering the near-term growth outlook. The European growth outlook is bifurcated; manufacturing has shown notable strength while services are weakened by health policy constraints. Chinese growth remains robust, which may be why the government felt comfortable warning against the potential of financial market risks.

With all this stimulus on top of improving global growth, will inflation finally resurface and dampen risk appetites? We think the continued imbalance of supply and demand, along with the acceleration of automation and digitalization trends during the pandemic, will prevent a sustained rise in prices. Remember that the unemployment rate fell below 4% in 2020 without rekindling labor market inflation, which is key to recurring inflation. We continue to focus on our *Market Laggard Relief* base case, in which the assets that underperformed in 2020 (such as energy stocks, financials and other value stocks) will perform much better. A new risk case, however, is that investor optimism could be hampered by a change in narrative from the Fed, pressured by the impact of fiscal policy. Looking out over the next year, we remain overweight risk assets, spread broadly across risk markets, funded by an underweight in risk-control assets.

SPEND SOME, SAVE SOME

The headline number is massive, but its impact will be somewhat muted by savings and deferral.



Estimated outlays are CBO estimates, estimated outlays likely spent are Northern Trust estimates.

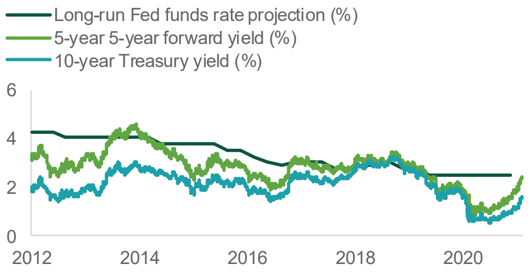
Interest Rates

The Fed operates under a dual mandate, promoting price stability (via a flexible 2% inflation target) and full employment. The natural interest rate, sometimes referred to as the neutral rate, is the interest rate that achieves both goals. Federal Open Market Committee (FOMC) members estimate the midpoint of the natural rate. As seen in the chart, the median projection of the long-run Fed funds rate has fallen over time, alongside nominal interest rates.

The forward rate curve provides an estimate of the future path of the Fed funds rate, inflation, growth and a premium for uncertainty. The five-year, five-year forward (the five-year rate in five years), has at points risen above the FOMC's long-run average, occasionally tightening financial conditions. Currently, the five-year, five-year forward yield is approaching the long-term Fed funds rate, which has historically proven economically restrictive. We are adding duration on these backups in yields as we feel market expectations for inflation and Fed rate hikes are too high. Further, we believe deflationary pressures will keep rates lower for longer. We forecast the 10-year Treasury yield to fall toward 1.25% from its current 1.6% level.

MOVING BACK TOWARD RESTRICTIVE

Forward markets are raising Fed funds expectations.



Source: Northern Trust Global Asset Allocation, Bloomberg. Data from 1/25/2012 through 3/9/2021.

- Future rate expectations – as judged by the forward curves – have climbed steadily this year.
- The rise in forward rates has made financing conditions more restrictive.
- We don't believe the Fed will allow rates to move much higher and are adding duration on rate back-ups.

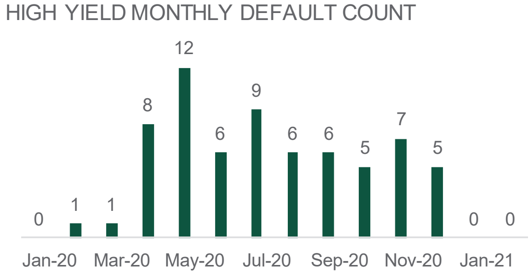
Credit Markets

Credit investors have focused on the recent collapse in default activity. Work done by issuers to address near-term maturities and bolster liquidity positions throughout 2020, combined with easy financial conditions, has led to zero defaults so far in 2021. While default activity is unlikely to remain at zero, 2021 default rate expectations have come down after the past two months of no default activity and improved credit fundamentals.

With massive added U.S. fiscal stimulus and the accelerating vaccine rollout, earnings power for the industries most negatively impacted by the virus is likely to improve as travel and leisure activity normalizes. Also, the energy sector – which has been a major driver of historical default activity – is better positioned in 2021. Oil markets in equilibrium and a shift in capital allocation priorities towards maximizing cash flow has improved the sector's credit profile. Finally, the distressed ratio—as measured by the percentage of the high yield market trading below $70—continues to fall and has trended towards its lowest levels in three years. This indicator has historically proven to be a strong leading indicator for future default rates. Looking ahead, the lack of market stress and improved credit fundamentals are supportive of high yield valuations.

HOW ABOUT ZERO?

Growth and easy money have halted defaults.



Data through February 2021.

- As we expected, high yield fixed income have defaults slowed dramatically.
- Some of the industries hit hardest are set to bounce back strongly.
- Strong fundamentals, but alongside tight spreads, leave us equal-weight high yield fixed income.

Equities

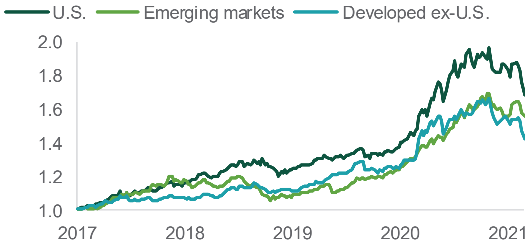
Stocks suffered a modest decline in the last month but are still up in 2021. Higher government bond yields with a duration of five years and longer formed a headwind to the equity market, especially in growth stocks where a higher discount rate reverberates more strongly. As a result, our *Market Laggard Relief* base case has picked up steam. Value stocks have been outperforming growth stocks. However, while the outperformance of value stocks this year has been significant, it has earned back only a fraction of the underperformance over the past several years (see chart). Meanwhile, cyclical sectors such as energy and financials have outperformed tech, and stocks outside the U.S. have outperformed those within.

Considering that the global economic recovery is building a head of steam on the back of significant extra U.S. fiscal stimulus and an accelerating vaccination drive, the *Market Laggard Relief* rally is expected to continue. The valuation gap between value and growth stocks is still unusually wide, especially given expectations for value stocks to show better earnings growth off cyclical lows. This supports our view that the trend will be durable. We continue to be optimistic about equities overall and are tactically overweight all major equity regions.

PUTTING THE VALUE BACK IN VALUE

After years of weakness, value has shown recent strength.

RATIO OF GROWTH AND VALUE RETURNS



Indices used: Russell 1000 growth and value index, MSCI World ex-U.S. growth and value index and MSCI EM growth and value index. Weekly returns indexed to 100 on 1/6/2017. Data through 3/5/2021. It is not possible to directly invest in an index.

- Value has bounced back nicely this year, spurred by strong fundamentals and higher interest rates.
- Despite recent outperformance, value stocks remain historically cheap as compared to growth stocks.
- We remain tactically overweight each of the major regions across equity markets.

Real Assets

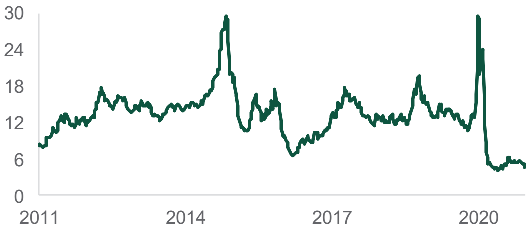
Real assets have shown impressive returns thus far in 2021. Global real estate and listed infrastructure have gained 5.5% and 3.2%, respectively (vs. the global equity return of 4.7%). Given the sensitivity of these asset classes to the term factor (interest rate risk) and the spike we have seen in interest rates so far this year, these are solid returns. However, the real 2021 star has been natural resources. Up a commanding 16.7%, this asset class is still working off a backlog of underperformance the past decade. As such, we believe this outperformance will continue and are tactically overweight (alongside listed infrastructure, which accrues side benefits from the reflation trade through its air/seaport and pipe/rail-lines).

This is more than a reversion-to-the-mean trade; there's a fundamental story as well. As we said last month, investors understand that a "clean" energy future is dependent on the "dirty" industrial metal mining, supporting demand. Meanwhile, the energy sector is pushing the asset class higher. Oil prices have risen 35% this year, driving energy company toplines. Investment discipline has those toplines flowing to the bottom line as well. Generally, higher oil prices immediately lead to more oil rigs. Per the nearby chart, this has not been the case this time around.

MUTED RESPONSE

Rising oil prices have not led to more exploration.

RIGS PER DOLLAR OF OIL PRICE



Baker Hughes U.S. crude oil rotary rig count; generic crude oil price using CME futures. Data from 3/11/2011 through 3/5/2021.

- Real assets are having a good start to 2021 – especially natural resources.
- Natural resource gains are more than just a reversion-to-the mean trade; fundamentals are strong.
- We retain tactical overweights in natural resources and listed infrastructure for reflation trade exposure.

BASE CASE

Market Laggard Relief

Relative performance of the asset classes most damaged by the virus will improve considerably as the recovery continues and investors expect a return towards normalcy starting in mid-2021. However, structurally advantaged areas of the market will remain attractive longer-term due to better fundamentals.

Pandemic New Normal

As economies continue to adapt to the virus, the public health policy approach will shift to minimizing hospitalizations and deaths as vaccines lead the path to herd immunity. While vaccines will not prevent all cases, this policy adjustment will support the return towards economic normalization starting in mid-2021.

RISK CASES

Stuckflation Tested – and Fails

Inflationary pressures build in the economy during the recovery and overwhelm structural downward forces on inflation, leading to a sustained increase in inflation and risk asset headwinds.

Policy Pressures

Investor optimism is dampened by the pressures fiscal policy puts on the economic supply/demand equation, while the Fed is pressured into changing its narrative on its overly accommodative stance.

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