INVESTMENT TRUST COMPANY

VIEWPOINTS *May 2021*

THE BASE EFFECT

Investors are keenly focused on the risk of inflation, as higher bond yields would hurt both stocks and bonds. Over the last week, inflation data came in hotter than expected, yet both bonds and stocks rallied. It looks like our Stuckflation theme — that inflation will remain persistently low — passed its first test, as investors are betting inflation won't become a systemic problem.

Starting with producer prices and continuing into consumer prices, recent inflation data was much higher than analysts were expecting. The yearly gain in producer prices was over 4%, while consumer prices increased 2.6%. Boosting these numbers were higher commodity prices as well as the pandemic-depressed prices of a year ago (the base effect). While analysts expected some increase in inflation, that didn't guarantee the market would absorb the news as well as it did.

Not only have inflation numbers been gaining momentum, the growth side of the economy has been robust as well. Whether it is the global purchasing manager indexes or monthly job reports, evidence of a V-shaped recovery continues to mount. Most recently, retail sales in the U.S. increased nearly 10%, the second largest increase in nearly 20 years. Reflecting improving global growth, Chinese exports increased 31% in March while imports jumped 38%.

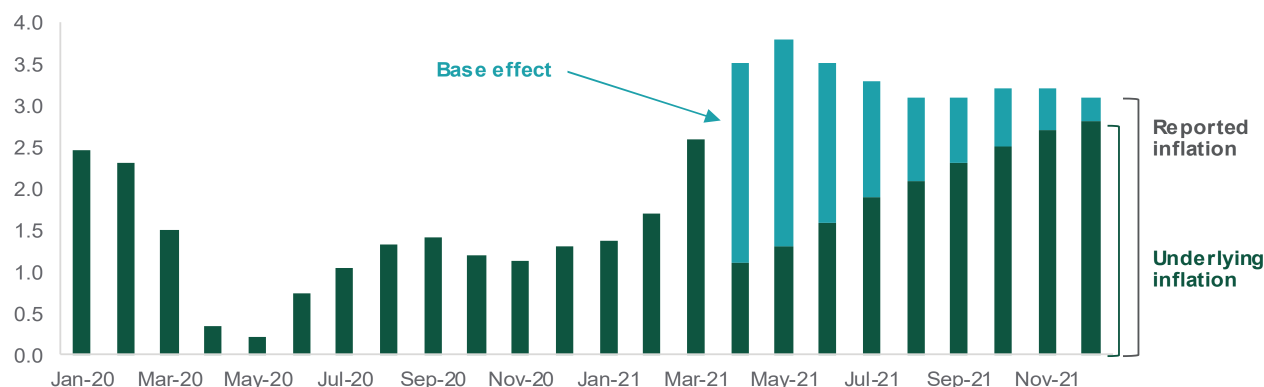
News on the COVID-19 front has been a bit more mixed, as cases are climbing in certain areas and the Astra-Zeneca and Johnson & Johnson vaccines have faced setbacks. Yet, we believe that if the jump in cases in mid-year 2020 (with no vaccines in sight) didn't derail the markets, the current pandemic challenge won't either. We estimate that 75% of the U.S. population will either be vaccinated or have natural immunity by the third quarter of this year, with Europe lagging by one to two quarters.

Risk markets have been well-behaved this year, and we expect the lagging performance of emerging markets to improve. Our first risk case, of rising inflation derailing markets, passed its first test in recent weeks. Our second risk case focuses on the potential of fiscal policy pressures on investor risk appetites, with a tax increase likely hitting ahead of potential infrastructure spending.

We've been expecting some valuation compression in equity markets, but so far they've been able to sustain relatively high price-earnings ratios. We made no changes in our global policy model this month and remain broadly overweight risk assets and underweight fixed income. The market's calm reaction to recent hot inflation and growth data lends support to our overweight risk positioning and is a hopeful sign for the year ahead.

INFLATION TEMPORARILY RISING – BUT IT'S NOT AS BAD AS IT SEEMS

Upcoming high year inflation prints are driven more by what happened last year (the base effect) than this year.



Implied base effect assumes the Consumer Price Index level is unchanged from January 2021. Data from 2020 through 2021, forecasts from Oxford Economics begin April 2021.

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Interest Rates

Lower volatility, more predictable returns, steady income and low-to-negative correlation to riskier allocations normally make bonds an attractive insurance policy. But what happens when rates fall to all-time low levels? If rates cannot appreciate in price, and coupon is low, how can the risk book be balanced?

An interest rate shock scenario shows what our expected gains and losses would be under different rate scenarios. A standard +/- 1% point shock is a typical application. In one year, an investor's expected return would be carry plus price impact from rate moves. At the most simple level, this is broken down as the yield on the bond plus the duration of the bond (duration is measured as risk for 1% interest rate shock). Given that, and keeping some premium in the curve while using the lowest closing level of 0.50% as a floor for the 10-year Treasury yield, we can chart the net risk position (see exhibit). When yields are very low, the downside risk can be greater than the upside risk. From last summer through November, risk was skewed to the downside; however, given the rapid rate rise in the first quarter, that "net risk" flipped to a positive skew.

ASSESSING RISK AND OPPORTUNITY

Until recently, interest rate risk was to the downside.

INTEREST RATE SHOCK SCENARIO

*Net risk is defined as the difference in 10-year Treasury return per 1% upward and downward move at given Treasury yield level. Scenario analysis assumes a 0.50% Treasury yield floor.

- The recent move higher in interest rates has materially reset the risk/opportunity equation in Treasury markets.
- We expect interest rates to settle into a channel.

Credit Markets

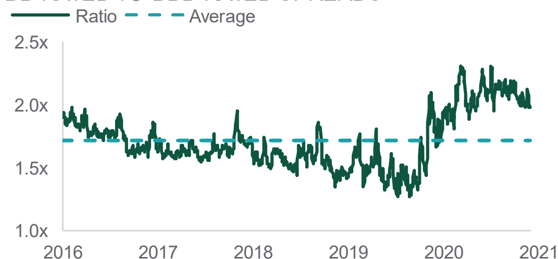
The increase in interest rates over the past month has led to a divergence in performance by quality within the high yield universe. Higher-quality bonds, which tend to be longer duration than their lower quality counterparts, have lagged relative to lower-quality. With interest rate volatility subsiding, the higher-quality segment of the high yield market looks increasingly attractive. This presents an opportunity to add exposure to higher quality credits. From a relative value perspective, when looking at BB spreads as a ratio to BBB spreads, BBs look cheap – currently trading at 2x BBB spreads compared to the longer-term average of 1.7x. Many of the higher-quality bonds issued in the last quarter of 2020 through January are now trading below par due to the rate move, leading to a stronger total return profile for this segment of the market.

Fundamentals are also improving, with upgrades outpacing downgrades, and this trend is likely to continue with the strong economic backdrop. Rising stars could be another driver of performance for higher-quality credits as some of the fallen angel activity from 2020 is reversed. While the credit environment is supportive, we maintain a neutral stance toward high yield, preferring assets with a higher return potential during the economic recovery.

SEEKING QUALITY AMONGST THE JUNK

Higher quality high yield looks increasingly attractive.

BB-RATED TO BBB-RATED SPREADS



Data for BB- and BBB-rated securities in Bloomberg Barclays 2% Cap.

- The highest quality of the high yield index looks cheap and interest rate sensitivity is no longer a drag.
- Yields are historically low, but quality – across the asset class – is historically high.
- We remain tactically neutral high yield fixed income; the outlook is good but the equity outlook is better.

Equities

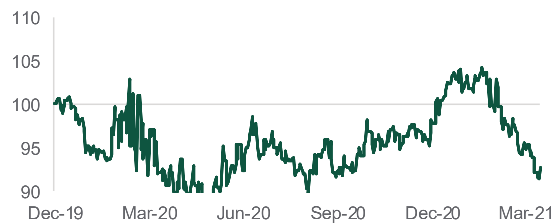
Several equity markets reached new all-time highs last month. Lower government bond market volatility and strong economic data served as tailwinds. The former was particularly helpful to the tech heavy U.S. equity market, which more than clawed back previous underperformance. Europe equities also had a good month and in local currency terms remain a top-performing region this year. Europe's disappointing vaccine campaign has not weighed on equities as much as some feared. Instead, factors such as the region's equity market exposure to global growth (it derives more than 50% of its revenue from abroad), tilt towards value and cyclical sectors and monetary policy support have carried the day. We expect this to continue.

Emerging market (EM) equities continued to struggle last month. The focus of China's government to rein in speculative excesses in the equity and housing markets has given investors pause. And the increased regulatory scrutiny on Chinese tech stocks has been a material headwind. Still, because the global economic recovery continues to gain speed and we do not expect significant tightening of fiscal and monetary policy, we remain cautiously optimistic that the region will regain its footing. We remain tactically overweight all major equity regions.

EMERGING MARKETS IN THE RELATIVE RED

EM equities have given up recent relative strength.

RATIO OF EM TO U.S. EQUITY RETURNS
(INDEXED TO 100 ON 12/31/2019)



Gross total returns shown in U.S. dollar terms. Indices used: MSCI Emerging Markets Index and MSCI U.S. Index.

- The risk asset rally continues, supported by the global economic recovery and stabilizing interest rates.
- EM equities should overcome China credit curtailment to again benefit from the global economic recovery.
- We are broadly overweight risk – with tactical overweights across all major equity regions.

Real Assets

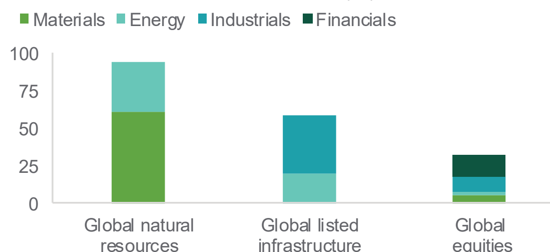
With the pandemic relief bill signed, the Biden Administration has shifted its focus to infrastructure. Many have tried – and failed – at passing significant infrastructure legislation. But, undeterred, the White House is going big and bold with an infrastructure spending package rivaling the New Deal. The proposed $2.3 trillion bill covers the traditional (roads); the new-age (electric vehicles); and items that aren't infrastructure at all (elderly care). The size of the bill will make passage hard. Progressives want more; conservatives want less; and high-tax states want their state and local tax exemptions back. The bill will likely fall in size and take months to pass.

Ironically, the delay and whittling of the bill is a positive for global listed infrastructure (GLI). Quick passage of a big bill could push interest rates higher, which would hurt the interest-rate sensitive asset class. The bigger beneficiary would be natural resources (NR), which has more cyclical sector exposure (see chart). Because we see a long and winding road to infrastructure bill passage, we maintain our GLI tactical overweight, looking to position for ongoing low interest rates. But don't count NR out; infrastructure is just a "nice to have" for an asset class already benefitting from the global economic recovery.

DON'T JUDGE AN ASSET CLASS BY ITS COVER

GLI has less exposure to an infrastructure bill than NR.

CYCLICAL SECTOR EXPOSURE (%)



Data as of 4/12/2021.

- The U.S. infrastructure bill faces a long and winding road to passage – second half 2021 at the earliest.
- A smaller infrastructure bill actually suggests a better outlook for GLI, as interest rate pressure will be lower.
- We are overweight NR and GLI, expecting increased economic demand and range-bound interest rates.

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 toward 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, forcing early central bank restrictiveness leading to risk asset headwinds.

Policy Pressures

Investor optimism is dampened by fiscal policy pressures. Namely, any new U.S. infrastructure spending doesn't benefit the economy as quickly as the corporate tax increases to pay for it hurt corporate profits.

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