INVESTMENT TRUST COMPANY

VIEWPOINTS *July 2021*

PASSING THE BATON

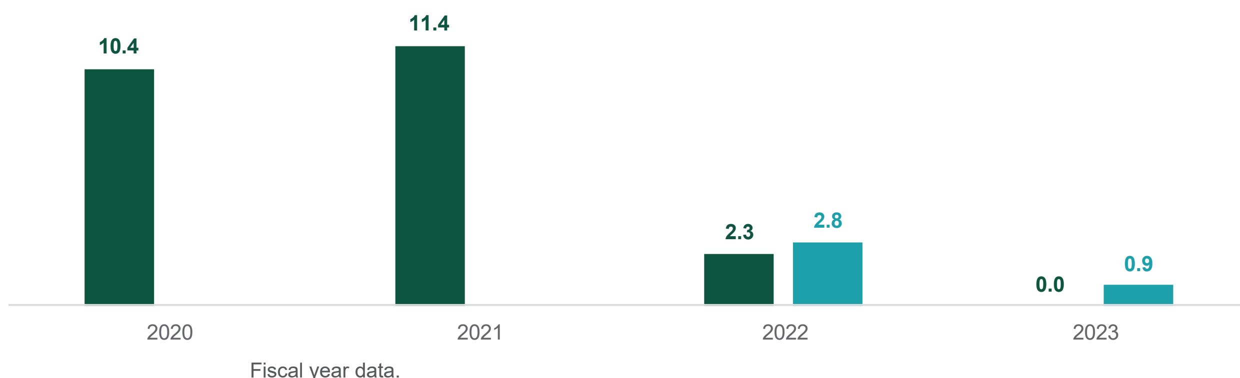
The stock and bond markets look ahead at least six months, discounting what investors think are the most likely outcomes for growth, inflation and other key inputs. So it is critical to differentiate between what is likely behind us, what is the current state of affairs, and how things will likely differ six-to-12 months from now. COVID-19 has increasingly become a non-issue to the markets, as more vaccinations are leading to reopening in the West and even struggling countries like India and Brazil have registered double-digit equity market gains. The current economy features red-hot growth and surging prices. Growth hasn't been a market concern, as high savings rates, low capital expenditures and ongoing reopening have underpinned investor confidence. This has left plenty of attention to be trained on the outlook for inflation – and investors need to assess more than just forecasts.

With recent inflation reports in the U.S. that have been higher than professional forecasters expected, observers may be puzzled by the benign reaction in the financial markets. The Fed has said it expects inflation to be transitory, and we have regularly stated our view that prices will settle down after the reopening-led surge. So far, at least, the markets are agreeing as the 10-year Treasury yield and inflation breakevens have steadily fallen since their peaks in late March. While we take some comfort from this market behavior, the downside risks of higher inflation are such that it remains our top risk case. If inflation doesn't upset the apple cart, what might? It has become clear that it is much easier to shut down a global economy than it is to reopen one. Not only have bottlenecks created inflationary pressures, they could also slow growth as the supply of goods and labor falls short.

Labor markets have shown a slower-than-expected return of workers, which constrains the growth outlook but also extends the duration of easy monetary policy and economic expansion. This is a case where "bad news is good news" for the financial markets. This underpins our base case theme of a *Bumpy – but Shock-Absorbed – Recovery*. Our other base case of *Market Laggard Runway* captures our view that prior lagging groups – like value stocks – have further to run as the economic expansion gains traction. Our risk cases include the potential for higher-than-expected inflation, along with a *Dropped Growth Baton* – where the expected large fiscal drag in 2022 isn't sufficiently offset by burgeoning consumer and corporate demand. All in all, we made no changes in our global policy model this month and remain overweight risk assets and underweight fixed income.

FADING FISCAL, RISING PRIVATE DEMAND?

Plunging fiscal stimulus will need to be offset by rising private demand.



Fiscal year data.

Interest Rates

U.S. Treasury yields have traded within a tight band since early March. Looking at the 10-year Treasury, since the market reset higher into a 1.45-1.75% range, economic data has continued to improve. Although non-farm payrolls have exhibited a lot of noise, some due to seasonal adjustments, inflation readings have generally exceeded expectations while initial claims have fallen. Regardless, 10-year yields are now back to early March levels while inflation breakevens are lower. In other words, a lot of improving data seems to be priced in, confirming the Fed's belief that inflation will be transitory.

The market may need more months of improving data before changing the narrative around growth. The chart on the right shows the 20-day change in the 10-year Treasury yield on the three major economic release dates: Non-Farm Payrolls, Consumer Price Index and the day of an FOMC meeting. Moves in rates on days around these key events can be volatile; at the beginning of the year rates tended to move higher, but since March the 10-year yield has barely budged. We believe it will remain rangebound, and we forecast a central tendency of 1.50%.

REDUCED VOLATILITY

Interest rates have become less influenced by key releases.

TREASURY MOVES AROUND KEY DAYS*

Key days include days of FOMC meetings, Non-Farm Payrolls releases and Consumer Price Index releases.

- The release of key economic data is having a diminished impact on yields.
- Inflation expectations have fallen of late.
- We expect the 10-year yield to be range-bound.

Credit Markets

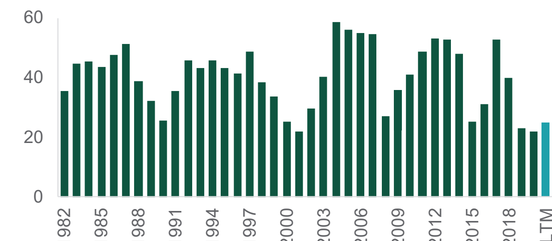
High yield recovery rates have slowly improved following the COVID-19 crisis, but recovery rates remain well below historical averages. Over the last 12 months, the recovery rate has improved to 25% from 22% for 2020. This compares to the 25-year average of 40%. Weak recovery rates in 2020 were primarily driven by a number of energy and metals and mining defaults. There are a total of 37 defaults that have occurred over the past 12 months. Nine of those defaults were commodity producers whose bonds traded below $10 post-default, highlighting the weak outlook for recovery in these scenarios.

As corporate earnings and commodity prices have improved from pandemic lows, so have recovery rates. Since November 2020, recovery rates have improved to 51% on average in the last six defaults. The trailing 12-month recovery rate is expected to improve to the mid-30s during 2021 from the low of 22% in 2020. This improvement should support high yield valuations since recovery rates are a key variable in models for calculating fair value on high yield spreads. In these models, lower recovery rates lead to wider spread forecasts and higher recovery rates lead to tighter spread forecasts.

RECOVERING RECOVERIES

Recovery rates have started to cyclically improve.

HY RECOVERY RATE (CENTS PER $)



HY = High yield. LTM = last twelve months as of May 2021.

- Improving earnings are bolstering recovery rates.
- Improving recovery rates support tight high yield spreads.
- We remain market weight high yield as we seek

  higher-return assets.

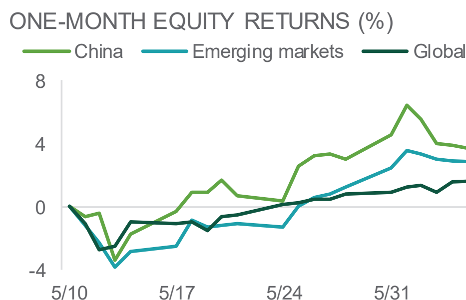
Equities

Over the past month, global equity markets benefited from a drop in inflation expectations (breakeven inflation rates dropped 20-30 basis points) and a further confirmation of a strong recovery in Europe. The market was also buoyed by signs of abating regulatory pressures in China. As a result, global stocks were up 1.5%, with European stocks up 2.6% and emerging market stocks up 2.2%. U.S. stocks could not quite keep up but still posted a positive return of 1.2% on the back of a continued strong profit outlook.

A secondary factor in the relative returns between regions was another leg up in the cyclical trade we have been talking about for the past six months. “Value stocks” outperformed “growth stocks” by about 3% to 4% depending on the index. This helped Europe in particular, with its higher weighting in those sectors. We continue to believe this rotation has further room to run as the valuation gap between the two groups of stocks has only just started to close and is still very wide. That’s because the strong performance in the stock market of these cyclical sectors has gone hand-in-hand with strong profit growth. And although we don’t expect valuation levels between “value” and “growth” to reach par, they will likely converge more during this economic recovery.

LAGGARD RECOVERY

Chinese stocks bounce on abating regulatory pressures.



Total returns for MSCI indices from 5/9/2021 through 6/9/2021.

- Lagging EM stocks bounce back in May.
- Value rotation likely has further to run.
- Europe is our favorite region to play global growth and value stocks.

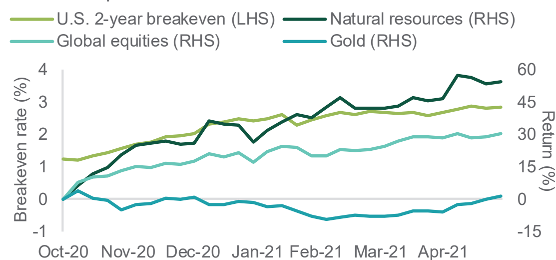
Real Assets

Last month, we analyzed equity-based natural resources in the context of their ability to combat higher market inflation expectations through higher returns. We also noted their greater historical portfolio construction appeal vis-à-vis futures-based commodities. Here, we do a similar analysis, but in comparison to gold. In fact, the chart this month is the same as last – but with gold replacing commodities. The story with equity-based natural resources remains the same – materially outpacing broader equities amid higher inflation expectations. Gold has not had the same success – barely positive over this time frame. Interestingly, gold’s downward trend abated at about the same time as bitcoin’s rise was halted – it is likely that is not just a coincidence, as both are considered alternative currencies.

Also interesting, the starting point in the chart is October 30 – just prior to the U.S. presidential election. Investors voiced concerns over the potential negatives for natural resources arising from a Biden presidency. Instead, the asset class has had its best run in years. This represents another reason not to get too caught up in the effects of politics on the market outlook. We remain overweight natural resources, joining our overweight to global listed infrastructure and our equal-weight to global real estate.

GOLD LEFT IN THE DUST

Gold hasn’t participated in either rising growth or inflation expectations.



LHS and RHS = left-hand side and right-hand side, respectively.
Returns from 10/30/2020 through 6/4/2021.

- Gold’s performance has been disappointing during the reopening.
- Natural resources remain a better hedge and Cryptocurrencies may be stealing market share.
- We remain overweight natural resources and global listed infrastructure.

BASE CASE

A Bumpy – but Shock-Absorbed – Reopening

It is becoming increasingly clear that reopening a global economy is harder than shutting one down. Pockets of supply/demand mismatches and uneven growth profiles will occur, but any growth disappointment helps reduce inflationary pressure, allowing for the positive market outlook to persist.

Market Laggard Runway

Those investments that most-underperformed during the pandemic – and, in many cases over the past decade (think non-U.S. equities, natural resources and value-oriented strategies) – have outperformed more recently. In almost all cases, relative valuations remain attractive and the fundamental outlooks remain strong.

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.

Dropped Growth Baton

Handing off the baton from government stimulus to organic demand is a challenge, especially coming out of a pandemic-induced economic shutdown. A failed transition would disrupt risk-taking.

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