BOTTLENECKS

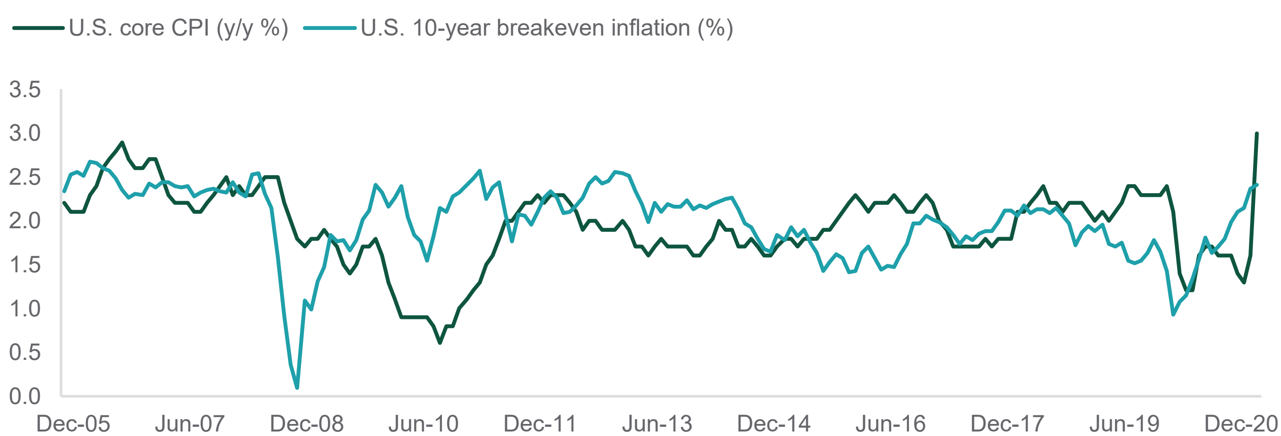
The long-anticipated jump in U.S. inflation appeared this month, and with a vengeance. Core consumer price inflation increased nearly 3%, double the prior rate, while the month-on-month increase of 0.9% was roughly triple expectations. Prices in reopening-related areas showed the greatest increase, with lodging up 7.5% and airfares up 10.2%. Of note, a 10% jump in used car prices equaled one-third of the 0.9% monthly increase. More stable, and large, areas like rents were up just 0.2% and medical services prices actually fell slightly. Similarities exist with the post global financial crisis era (see chart). Prices jumped 2.2% by the end of 2011, after being up just 0.6% a year earlier. But inflation expectations bottomed in late 2008 at nearly 0% and jumped to 2.4% in just one year.

We have regularly counseled that a one-time rise in prices is not a true inflation problem – for that, we need increases in prices year after year. Bottlenecks in production in areas like new car production and the rental car markets are causing real distortions in prices – but not ones that we expect to persist for years to come. Despite the recent volatility in equity markets, interest rates have been reasonably well-behaved and inflation expectations have barely budged. The real impact of higher inflation on financial markets is through the interest rate channel, which clearly can dent fixed income returns. However, a moderate inflation environment can be constructive for equities as pricing power leads to stronger profit growth. Current earnings revisions remain strong; earnings growth in the U.S. and Europe is expected to reach 33% this year, while emerging market growth could reach 50%.

We made no changes to our global policy model this month, and continue to recommend an overweight to equities and an underweight to bonds. We expect global growth to be strong over the next year, with a mixed outlook on inflation. We believe inflation expectations in the U.S. and China will moderate over the next year, while we now believe European inflation will exceed low expectations. Europe's recovery is one-to-two quarters behind the U.S., and we expect some similarity in the path of inflation. However, we don't expect European inflation to approach 2%, and the impact on European equities could actually be beneficial due to the high cyclical exposure of the indexes. Our primary risk case remains that Stuckflation fails the test – but we have some protection against that through our overweight recommendation to natural resources and equities and our underweight to investment-grade fixed income.

INFLATION EXPECTATIONS LEAD ACTUAL INFLATION

TIPS breakeven levels have anticipated the jump in inflation, just like after the global financial crisis.



Monthly data through 4/30/2021. 10-year breakeven inflation 2.5% on 5/12/2021.

Interest Rates

Breakeven rates for Treasury inflation-protected securities (TIPS) are the difference between the nominal yield on a U.S. treasury and inflation-linked security of the same maturity. Breakeven inflation is a market-based measure of future inflation expectations. Normally, uncertainty around longer time horizons leads to positive term premiums and upward sloping curves. For the first time since the inception of TIPS, the entire curve is inverted while breakeven rates are gaining momentum (see chart).

Curves invert when investor expectations on interest rates, growth, inflation or Fed policy lead to higher rates in the near term but not long term. The higher near-term inflation rates signaled by current TIPS breakeven curves are not expected to lead to a regime shift. While the Fed has stated it will remain accommodative until inflation averages above 2% for some time and maximum employment is achieved, the market seems to believe that recent inflation data might force the Fed to react sooner rather than later. The market is thus priced for near-term above average growth and inflation, but a return to normalcy down the road. We feel that inflation expectations are overblown. We believe Treasury yields will have difficulties moving higher and forecast a 10-year yield central tendency of 1.50%.

LACK OF A PREMIUM

It's unusual to have a negative premium in TIPS.

TIPS BREAKEVEN SPREADS (%)

Curve inversion = negative spreads. Data through 5/12/2021.

- It is normal for longer-dated TIPS to carry a premium tied to uncertainty.
- Investors are currently pricing in strong growth, but normalizing inflation.
- We think interest rates are unlikely to move much higher over the next 6-12 months.

Credit Markets

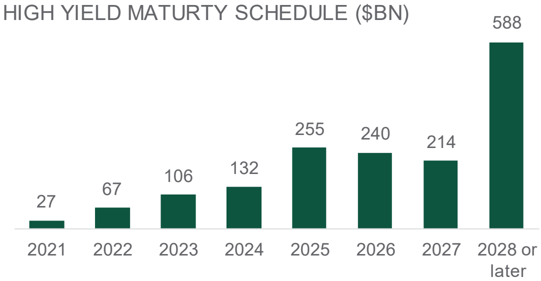
The high yield market faces modest near-term maturities with only $93.4bn, or 5.7%, of the $1.6tn market, maturing in 2021 and 2022. Record low funding costs over the past four months have incentivized refinancing activity and continued reduction of near-term and intermediate maturities. For 2021, there is $26.9bn of debt maturing. To put this in perspective, primary markets have been averaging just over $50bn per month in 2021. Additionally, the amount of high yield bonds maturing through 2025 has declined by $103.2bn to $586.5bn this year with a good percentage of new debt terming out to 2028 or beyond.

While progress has been made on terming out intermediate-term maturities, opportunity remains for issuers to take advantage of low funding costs to term out debt and further improve financial flexibility. This leaves the market well-positioned to manage through any potential shocks that may cause credit conditions to tighten and loss of market access for specific credits or industries, which should limit potential defaults in the future. Improving fundamentals via longer maturity runways and elevated refinancing activity limiting the net supply impact are expected to support high yield valuations.

PAY YOU LATER

Robust markets have allowed health refinancings.

HIGH YIELD MATURTY SCHEDULE ($BN)



Data as of 4/9/2021.

- Companies have taken advantage of nearly insatiable investor demand to push out maturities.
- This reduces default risk, as companies will have more time to work through any economic headwinds.
- While spreads are tight, we expect them to remain

  supported by good fundamentals and strong demand.

Equities

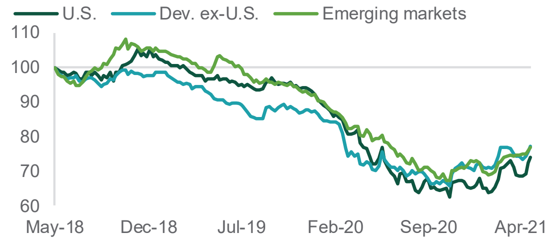
Global equity markets spent the past month absorbing the implications of better corporate profits, but also higher inflation expectations. Overall markets were flattish over the past 30 days despite a notable upward revision in earnings estimates for 2021 and 2022, masking significant churn under the surface. Rising inflation forecasts led to a significant preference for cyclical sectors like energy, materials and financials, funded by a sell-down in highly valued tech stocks. This rotation was disproportionately felt in the U.S. as its broad market indices contain more "growth stocks" versus non-U.S. markets, particularly Europe. Over the past six months, U.S. value stocks have outperformed growth stocks by 15%. The energy sector is up ~40% this year, followed by a 26% rise in financials.

We still think the cyclical trade has room to go, even with our expectations that current inflationary pressures will prove transitory, as relative earnings growth and valuations are still supportive. This plays into our attraction to Europe, which is more exposed to a cyclical recovery. More broadly, with corporate profits coming in exceedingly strong (2021 estimates have been revised higher by 7% in just the past month) and contained interest rates, we continue to see solid return potential for global equities.

ROTATION CONTINUES

The shift towards value looks to have legs.

VALUE / GROWTH (INDEXED RETURNS)



Returns for MSCI value and growth indexes, indexed to 100 on 5/18/2018. Data through 5/12/2021.

- Sideways stock market action hides rotation from growth into value stocks.
- Value stocks in the U.S. have now outperformed growth stocks by 15% over the last six months.
- Europe remains highly exposed to the cyclical recovery.

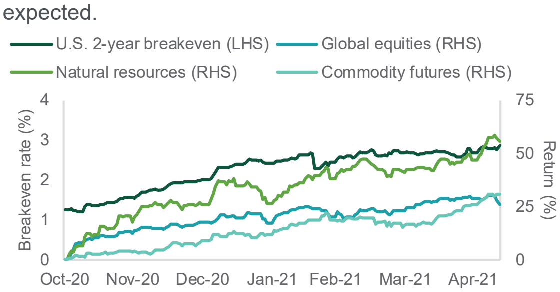
Real Assets

Natural resource equities continue to give us real-time proof of the inflation protection properties we have highlighted over the past decade. The natural resources rally that started late last year has pushed into 2021, outpacing global equities by 26% since last November (see chart) and by 15% year-to-date. That has protected against the notable increase in inflation expectations – and, in fact, has provided greater protection than a futures-based approach (see chart). Indeed, the recent six-plus months have supported our long-held positions that natural resources serve an important role in portfolio construction; and that equity-based upstream natural resources represents a better approach to gaining commodity exposure than investing in futures contracts.

But where do we go from here? We always endorse a strategic allocation to natural resources and currently remain overweight the asset class on a tactical basis. Labor market uncertainty, further emboldening central banker doves even amid inflation (see front page), sets a favorable macro backdrop for natural resource companies. Alongside our natural resources overweight, we remain overweight listed infrastructure (also an inflation protector) and are strategically allocated to global real estate.

INFLATION (EXPECTATIONS) PROTECTION

Natural resource companies have performed as expected.



LHS and RHS = left-hand side and right-hand side, respectively. Returns from 10/31/2020 through 5/12/2021. Indexes used: S&P Global Natural Resources, Bloomberg Commodity, MSCI ACWI.

- Natural resource companies have been a significant outperformer as inflation expectations have risen.
- Despite current inflation, central bankers will maintain easy money policy – providing further support.
- We remain overweight natural resources and listed infrastructure while neutral global real estate.

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 already underway.

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 and leading to risk asset headwinds.

Policy Pressures

Investor optimism is dampened by fiscal policy pressures. While waning enthusiasm has reduced the risk of an overly large U.S. infrastructure deal, such an agreement would likely be poorly received by the markets.

For more information please contact:

John P Bohan CFP®
Managing Director

3200 Cherry Creek Drive S.
Suite 730
Denver, Colorado 80209

Direct: (303) 778-6800
Email: jpb@investmenttrust.com
www.investmenttrust.com