INVESTMENT TRUST COMPANY

QUARTERLY REVIEW 2Q21

SEEING THE WHITES OF INFLATION'S EYES

Debating whether the Federal Reserve (Fed) will "fire" against oncoming inflation is a fitting analogy as America turns 245. Troops defending Bunker Hill* during the early stages of the American Revolutionary War were told not to fire until they saw the "whites of the eyes" of opposing forces. Federal Reserve Chair Jerome Powell has more or less committed to the same on inflation. But some might argue we are, in fact, seeing those eye whites. Inflation, as indicated by the Fed's preferred measure (core personal consumption expenditures), is at 3.4% year-over-year and well above the 2% Fed target. Will the Fed fire? It depends on whether the inflationary forces continue to march or retreat. We review each possibility.

Inflation continues attack? When the pandemic shut down the global economy, demand waned quickly. As the economy reopens, demand snapped back while supply is taking longer, creating a larger supply/demand mismatch. Anecdotes abound. Whether it be restaurants struggling to find wait staff or manufacturers facing part shortages, supply reinforcements (sticking with the battle theme) are in high demand in a number of areas.

Inflationary forces retreat? It's often said the best cure for higher prices are … higher prices, as they incentivize new supply or induce substitutions. Lumber prices surging from mid-March to mid-May have led to those same prices falling below that mid-March starting point as supply has ramped up; rising wages have only led to more kiosks.

New rule: Don't fire unless inflation persists. A one-time price jump does not generally elicit a reaction from the Fed. And the Fed has made it clear that it doesn't believe inflationary forces will last. Importantly, it is what the Fed *will* do — more so than any single analysis of what the Fed *should* do — that matters when considering Fed policy and the broader financial market outlook.

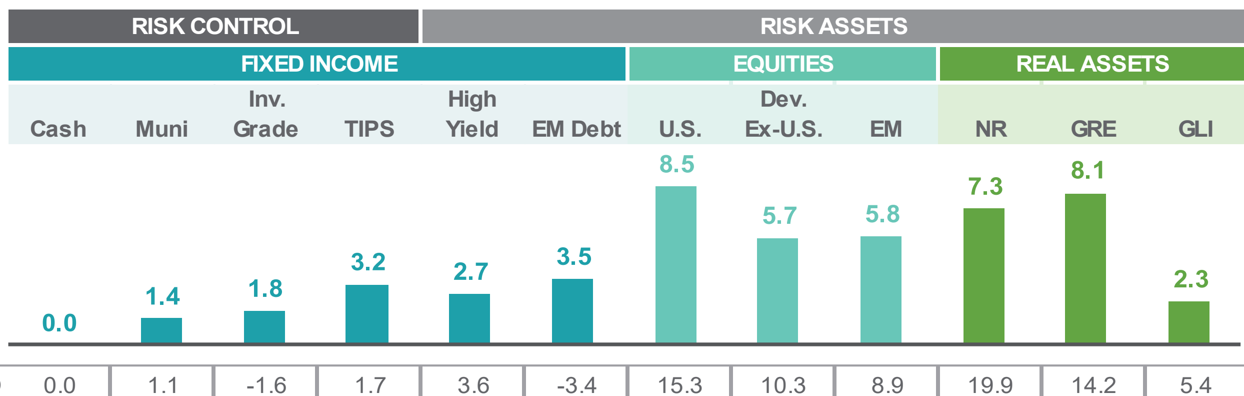
What does the Fed "firing on inflation" really mean? The Fed is currently engaged on two fronts: 1.) its (near-zero) Fed funds rate; 2.) its ($120 billion-per-month) asset purchase program (buying both Treasurys and mortgage-backed securities). It is unlikely the Fed begins raising the Fed funds rate before it fully removes itself from the bond buying business. Further, the Fed has committed to "tapering" its monthly purchases before it fully stops buying. Even further still, the Fed is committed to alerting the market well in advance of any tapering action. A reasonable "earliest case" timeline would be for the Fed to announce its tapering initiative coming out of its annual Jackson Hole summit in late August; for tapering to occur throughout most of 2022; and for the Fed to be in position for its first rate hike in late 2022. This remains well outside the approximate six-month horizon discounted by markets.

Fighting the battle — and the war. Just as the Fed fights this current inflation "battle", it must also keep its eyes on the longer-term economic "war" — a decade-long war on low economic demand and low inflation. The Fed will not give up hard-fought ground by exiting its easy monetary policy prematurely. Instead accommodation will be removed carefully — so long as the Fed can help it.

*The battle was actually fought mostly on nearby Breed's Hill.

SECOND QUARTER 2021 TOTAL RETURNS (%)

Risk asset momentum continued into the second quarter; U.S. equities came out on top.



	Cash	Muni	Inv. Grade	TIPS	High Yield	EM Debt	U.S.	Dev. Ex-U.S.	EM	NR	GRE	GLI
YTD	0.0	1.1	-1.6	1.7	3.6	-3.4	15.3	10.3	8.9	19.9	14.2	5.4

NR: Natural Resources; GRE: Global Real Estate; GLI: Global Listed Infrastructure. Indexes are gross of fees.

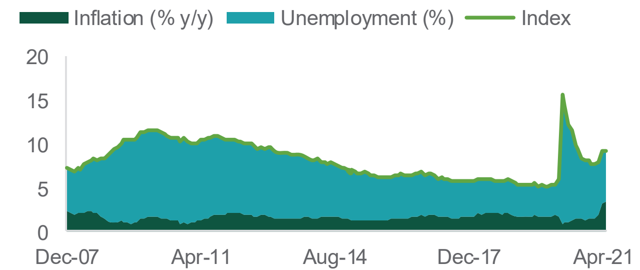
KEY DEVELOPMENTS

This Too Shall Pass

The misery index, created amid the stagflation of the 1970s, simply sums unemployment and inflation. It has recently been at a decade-high — and more recently driven by higher prices as elevated unemployment only slowly declines. Concerning? Not overly. Plentiful job openings should solve for the unemployment issue in upcoming months. Inflation is proving a bit stickier than many expected, as supply chains are slow to untangle and reset, but we are seeing some rollover in pricing (e.g., lumber prices halved over the past two months).

MISERY INDEX: UNEMPLOYMENT AND INFLATION

MISERY INDEX COMPONENTS

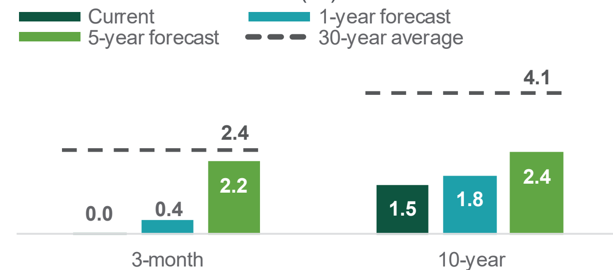


Monetary Policy: Keeping Calm

It is important to keep in mind that central banks remain committed to easy money. Investors don't fear inflation as much as they fear central bankers overreacting to inflation — in a way that pushes interest rates higher and growth trajectories lower. That prospect is not the base case. Brief market volatility arose after the Fed's most recent meetings as officials showed some hint at a potential end game to current accommodation. But — keeping it all in perspective — below-average interest rates should continue for the next five years (see chart).

MARKET-BASED INTEREST RATE EXPECTATIONS

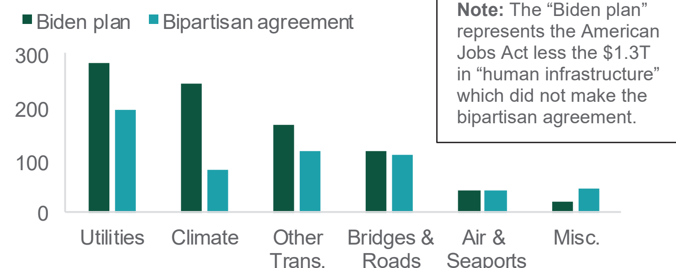
U.S. TREASURY YIELDS (%)



Fiscal Policy: Carrying On

While monetary policy remains easy and on hold, politicians have been busy attempting to find bipartisan agreement on the first half of the Biden administration's infrastructure plan. The announcement of a $1.2 trillion deal (with $0.6 trillion in "new money", outlined in chart) quickly ran into confusion as to whether the deal was tied to a broader reconciliation bill. At any rate, the bill still faces a tough road through the legislative process. History advises investors to not get too optimistic over the prospects of sweeping infrastructure spending.

INFRASTRUCTURE BILL NEGOTIATION UPDATE

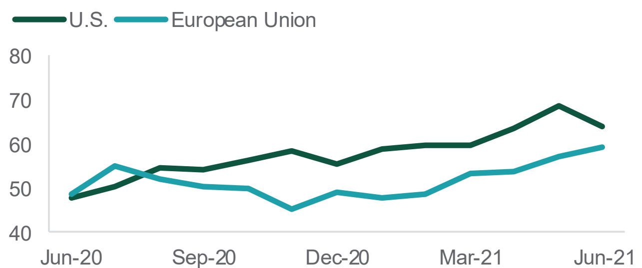


Growth: Passing the Baton

A strong global recovery has taken place as economies reopen and fiscal spending kicks in. This growth has been fairly well-sequenced — a baton that has been passed first from China to the U.S., and now from the U.S. to Europe. As judged by purchasing manager indices (see chart), we have seen the U.S. growth trajectory come off the boil (though still very strong) while Europe sees continued momentum. This, alongside Europe's more economically-leveraged stock market, may provide near-term European stock support.

U.S. AND EUROPE GROWTH ENVIRONMENT

PURCHASING MANAGERS' INDEX (PMI)



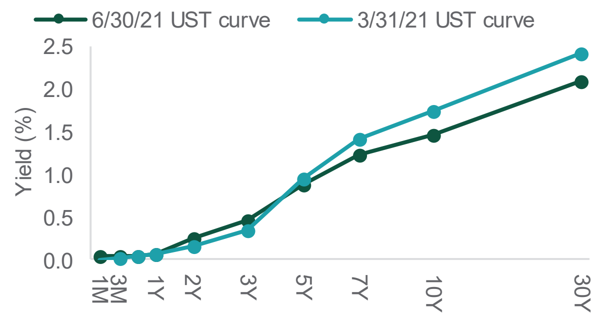
Yield forecasts from Treasury forward curves. Markit PMIs; flash PMIs for June 2021. Data as of 6/30/2021.

MARKET REVIEW

Interest Rates

The Fed was forced to choose between: 1.) tighter policy in response to building inflationary pressures and economic improvement; and 2.) stay-the-course easy policy in aim of its dual goals-based policy approach, transitory inflation and lingering economic headwinds. It sided with the latter, but short-term yields rose on more optimistic economic forecasts and initial tapering talks. Longer-term yields stalled as waning growth momentum weighed on real rates and market inflation expectations retreated from highs, resulting in a flatter yield curve.

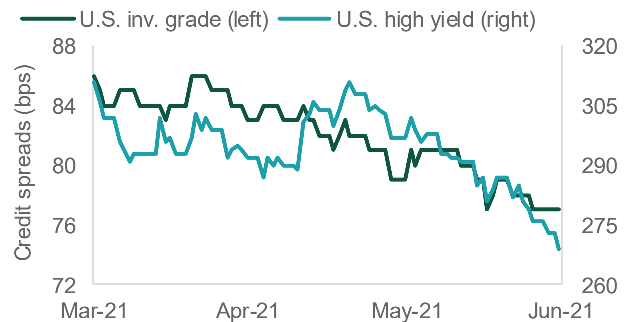
U.S. TREASURY YIELD CURVE



Credit Markets

Helped by the reopening of the global economy, strong corporate earnings fed into improving recovery rates and overall better corporate fundamentals. Credit flows were very supportive as the low interest rate backdrop left investors eager to pick up yield. Investment grade and high yield spreads fell 9 and 42 basis points to levels not reached in over 10 years. Companies have taken advantage of high demand for yield by pushing out maturities. This and the low interest rate backdrop leaves corporations in a fundamentally healthy position.

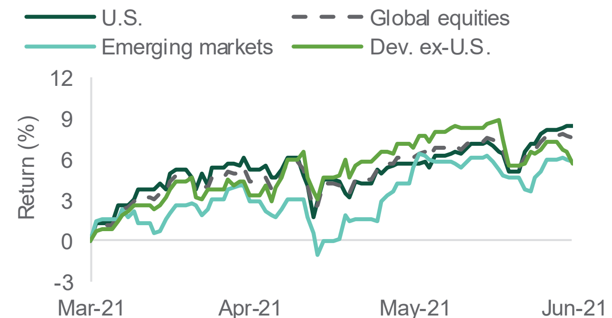
CREDIT SPREADS



Equities

Global equities gained 7.5% as improving economic growth, policy support and strong earnings overcame peak growth, excess inflation and policy mistake fears. U.S. equities outpaced global equities with an 8.5% return. As government bond yields settled, U.S. equities — and growth stocks in particular — rebounded from mid-quarter pressure. Emerging market equities trailed global equities as policymakers carefully navigated a credit slowdown. Economic reopening has not been trouble-free, but it has underpinned risk asset growth.

REGIONAL EQUITY INDICES



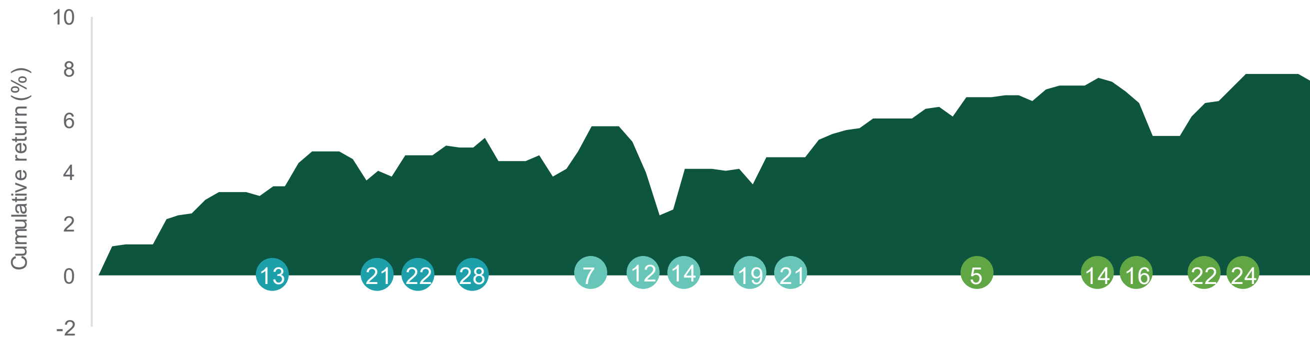
Real Assets

Global real estate advanced 8.1% as investors sought exposure to the cyclical recovery and interest rates settled at the low ends of recent ranges. Global natural resources benefitted from rising inflation risks; however, it ultimately slightly underperformed global equities as investors became more at ease that inflation will be transitory and the Fed hinted at a possible end to easy policy down the road. As expected in a risk-on environment, global listed infrastructure posted a positive but somewhat underwhelming return (2.3%).

REAL ASSET INDICES

Returns in U.S. dollar terms. UST = U.S. Treasury. Indexes are gross of fees.

MARKET EVENTS



APRIL	MAY	JUNE
13 U.S. pauses Johnson & Johnson vaccine administration to investigate safety issues involving blood clots.	**7** U.S. jobs report significantly disappoints expectations with only 266k jobs added and a 0.1% tick up in the unemployment rate to 6.1%.	**5** The G-7 agrees to back minimum global tax rate of at least 15% — though much work remains to be done to effect such a global policy change.
21 Bank of Canada becomes the first major central bank to announce it will begin tapering.	**12** U.S. core CPI reaches 3.0% year-over-year and 0.9% month-over-month — the highest monthly increase since 1982.	**14** U.K. delays lifting virus restrictions by four weeks amid new cases tied to the more-contagious Delta variant.
21 ECB leaves policy unchanged, insists it's premature to talk about tapering and emphasizes its readiness to provide ongoing support.	**14** The Centers for Disease Control and Prevention (CDC) lifts most mask mandates for fully vaccinated individuals.	**16** Fed further "talks about talking about" tapering; Summary of Economic Projections show median forecast of two rate hikes by late-2023.
22 News leaks that the Biden administration seeks to raise capital gains tax for wealthy investors to 39.6%.	**19** Fed meeting minutes reveal appetite amongst some members to begin discussing tapering upon further economic improvement.	**22** In a speech to Congress, Fed Chair Powell emphasizes the transitory nature of inflation and need for policy patience in order to achieve employment goals.
28 President Biden officially announces details of part two of his infrastructure agenda — the $1.8 trillion American Families Plan.	**21** With most S&P 500 companies having reported, first quarter earnings growth is expected to finish around 50% y/y (highest growth rate since 2010).	**24** Biden administration agrees on a $1.2 trillion bipartisan infrastructure bill ($0.6 trillion in new spending) over eight years — still faces tough legislative path.

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