

## REDUCING SENSITIVITIES

A mid-year slowdown has not yet appeared in the global economy or equity markets. But we have seen a notable drop in interest rates, which is curious in the face of hotter-than-expected inflation reports. As shown below, rates have fallen steadily since a peak at the end of the first quarter, for reasons we think are as much technical as fundamental. Risk markets have handled the decline reasonably well, but it has led to a return of growth stock outperformance. With U.S. interest rates declining to the bottom end of our expected range, we did reduce interest rate sensitivity in our global policy model this month by reducing our investment grade fixed income allocation. Meanwhile, we also modestly reduced our emerging market equity exposure, partly due to the high-profile changes in economic and regulatory policy in China.

Inflation data is so varied that one can find a report to support any outlook. Recent U.S. inflation reports have been much hotter than expected, but Europe and China reports been much more subdued. Goods and services tied to the reopening have led price gains and there are some signs of normalization. Lumber prices have fallen 64% from their peak, now below their pre-pandemic high. Used car prices — a major contributor to the recent inflation spike — have now started to decline in the auto auction markets, portending less pricing pressures ahead. In some important respects, inflation only really matters to

financial markets if it leads to a jump in interest rates or decline in corporate margins. So far, we haven't seen those negative consequences.

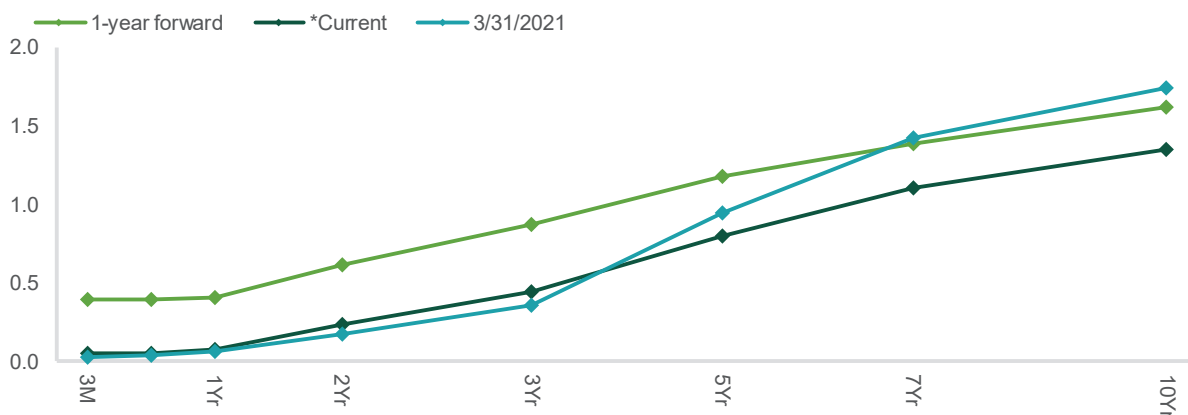
China's economy held up better than the West during 2020 and has slowed this year as policymakers have worked to reduce risks in the financial system. A pivot may be underway, as monetary policy looks to become less restrictive. Additionally, China's economy remains highly leveraged to global growth. This is exemplified by the acceleration in Chinese export growth to 32% in June, while imports slowed to a still impressive 37% growth rate. Less well-received by the markets has been Chinese regulatory policy, including regulation of technology leaders and highly leveraged development companies. We expect these actions to be an anchor on valuations.

Our tactical reduction in investment grade fixed income (now further underweight our strategic allocation) and emerging market equities (now at strategic levels) funded our increased allocation to high yield bonds (reinstating a tactical overweight). High-yield bond spreads are historically low but high-yield bond credit quality is historically high. Meanwhile, high yield bonds do not show much interest rate sensitivity — as, historically, higher interest rates are generally offset by falling credit spreads.

### BIG LITTLE MOVES

Rates have fallen noticeably since March 31, but aren't expected to return to those levels in a year's time.

U.S. YIELD CURVE - %



\*Current as of 7/14/2021. 3/31/2021 is the 10-year yield's pandemic peak.

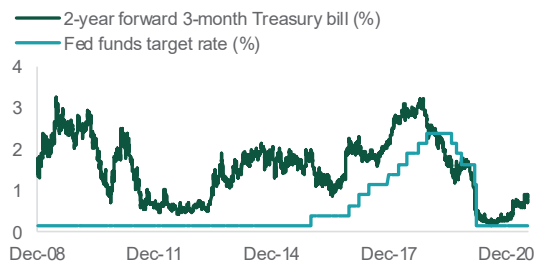
## Interest Rates

The Federal Reserve recently updated its dot plot, a communication tool for where policymakers believe the Fed funds rates will be in the future. The dot plot showed 13 of 18 governors predict two rate hikes by the end of 2023. This is more hawkish than the previous dot plot in which only seven governors signaled two hikes by the end of 2023. With that said, Chairman Jerome Powell noted that the dot plot should be taken with “a big grain of salt.”

We echo Powell’s views and believe investors should expect the Fed to stay on hold. Looking at the forward rate curves, investors seem to align more with the dots than the chairman. Based on the 3-month T-bill yield two years forward, the market is pricing in three hikes by the end of 2023. Since the financial crisis, the market has consistently expected more hikes than what actually materializes. Recognizing that the nature of the pandemic is different than the 2008 crisis, current Fed funds rate expectations show that — once again — markets are seemingly over-optimistic about what the Fed can achieve. Time (and economic data) will tell if this optimism is warranted, but for now we are fading the hype.

## MARKET MOVING

Markets are now discounting three hikes by 2023.



Data from 12/16/2008 through 7/14/2021.

- More Fed governors expect hikes by 2023.
- Markets are now pricing in more hikes than the Fed.
- We think markets have moved too quickly and maintain our interest rate outlook.

## Credit Markets

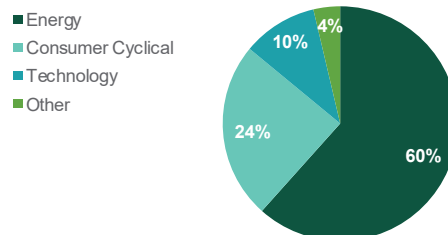
After a record year of fallen angel volume in 2020, the high yield market has seen almost no fallen angel activity in 2021. The upgrade-to-downgrade ratio has hit a record high, and investor focus has shifted to rising stars in the current environment. So far this year there has been just under \$21 billion of rising star and only \$1 billion of fallen angel activity. Rising star activity this year shows sectors hardest hit by the pandemic are also rebounding the fastest. Energy and consumer cyclicals have made up the vast majority of rising star activity — a sharp reversal from 2020, where these sectors made up the majority of fallen angel activity. Of the 14 issuers upgraded to investment grade, just two were fallen angels from 2020 — suggesting that it is likely the trend of rising star activity will persist as fallen angels work to recover investment grade status.

Rising stars have outperformed the high yield index leading up to their upgrades and marginally outperformed the investment grade index following the move to BBB. This presents an opportunity to add higher quality credits that are experiencing improving fundamentals and have financial policies consistent with investment grade metrics ahead of potential upgrades to investment grade, allowing for superior risk-adjusted returns.

## RISING STARS

Sectors worst hurt in 2020 are bouncing back strongly.

RISING STARS BY SECTOR (YTD)



YTD = year-to-date; as of 7/14/2021. A rising star is when credit ratings agencies upgrade a high yield bond issue to investment grade. A fallen angel is when the reverse happens.

- Upgrades have dominated the credit scene this year.
- Many fallen angels remain to be upgraded to investment grade.
- Opportunities arise ahead of the upgrades.

## Equities

Global equity markets continued to rally over the past month and were up another 1.6%. However, there was a notable divergence between regions with almost all of the return coming from the U.S. At 2.9% for the month, U.S. equities did much better than European equities (0.4%) and emerging market equities (-1.5%). In the U.S., a strong corporate earnings outlook and a further decline in interest rates fueled strong returns in growth sectors. Europe, with its larger exposure to cyclical sectors could not keep up, and worries around the spread of the COVID-19 Delta variant did not help. Emerging markets' negative return can be largely attributed to renewed regulatory pressures from the Chinese government after the Didi initial public offering.

With respect to the cyclical trade reversal, value stocks underperformed growth stocks by about 6% — continuing the change in leadership experienced since May. Cyclical sectors drove early-year market returns, while growth sectors have contributed the bulk of the subsequent gains. Recent performance has led the valuation gap between growth and value to widen further. We certainly don't expect "value" and "growth" valuation levels to reach par (definitionally impossible), but from here they will likely converge some during the ongoing economic recovery.

## Real Assets

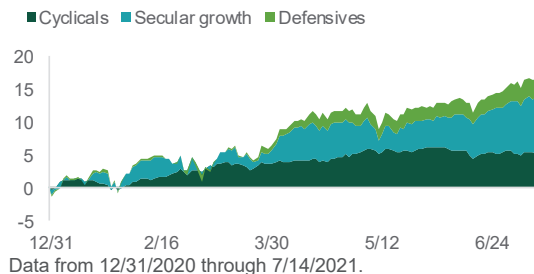
We often discuss the interest rate sensitivity found in both global real estate (GRE) and global listed infrastructure (GLI). With the 10-year U.S. Treasury yield falling from 1.75% at the end of the first quarter to a current level of 1.3%, we have a contemporary analysis of that empirical observation. In this most recent trial, it appears GRE provides the better term (interest rate risk) exposure — outperforming global equities by 2.6% (11.1% total return) while GLI lagged by 4.9% (3.7% total return). That said, other elements were also at play — including the ongoing reopening trade that likely provided further boost to GRE.

Looking ahead, we are sticking to our positioning with a tactical overweight to GLI and strategic weighting to GRE. Just as GLI has not shown as much term exposure in the recent downward trend in rates, GLI should not suffer should rates revert modestly higher (see Interest Rates section). We also like the protection GLI provides against our risk case of inflation and the likely better performance of GLI if the reopening trade slows due to Delta variant concerns. Lastly, we continue to like global natural resources as a play on constrained supply during the global reopening, with an added benefit of inflation protection.

## RETURNING TO GROWTH

Growth stocks have retaken the performance lead.

### YTD S&P 500 RETURN CONTRIBUTION (%)

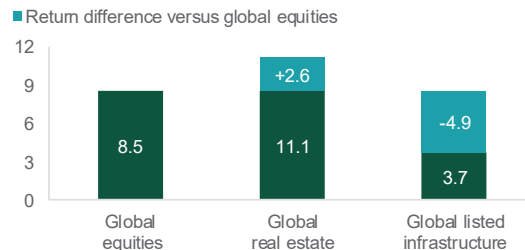


- Growth stock leadership has returned recently.
- U.S. equities have recently outperformed, helped by U.S. dollar strength.
- With valuation gaps returning to prior wide levels, value names have regained some tailwind.

## A CASE STUDY IN INTEREST RATE EXPOSURE

Global real estate benefited most from the fall in rates.

### RETURNS SINCE 3/31/2021\* (%)



Indices used: MSCI ACWI; MSCI ACWI IMI Core Real Estate; S&P Global Infrastructure. Total returns through 7/14/2021. Total return listed inside green bars.

- Global real estate (GRE) bested global listed infrastructure (GLI) as interest rates fell.
- The ongoing reopening trade also boosted GRE.
- Despite recent underperformance, we maintain our GLI overweight, while GRE stays at strategic levels.

## 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 shown solid returns more recently. Momentum has slowed but valuations remain attractive and the fundamentals remain strong.

## RISK CASES

### Stuckflation Tested – and Fails

Inflationary pressures during the recovery continue to build 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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