INVESTMENT TRUST COMPANY

VIEWPOINTS November 2021

PRESSURE

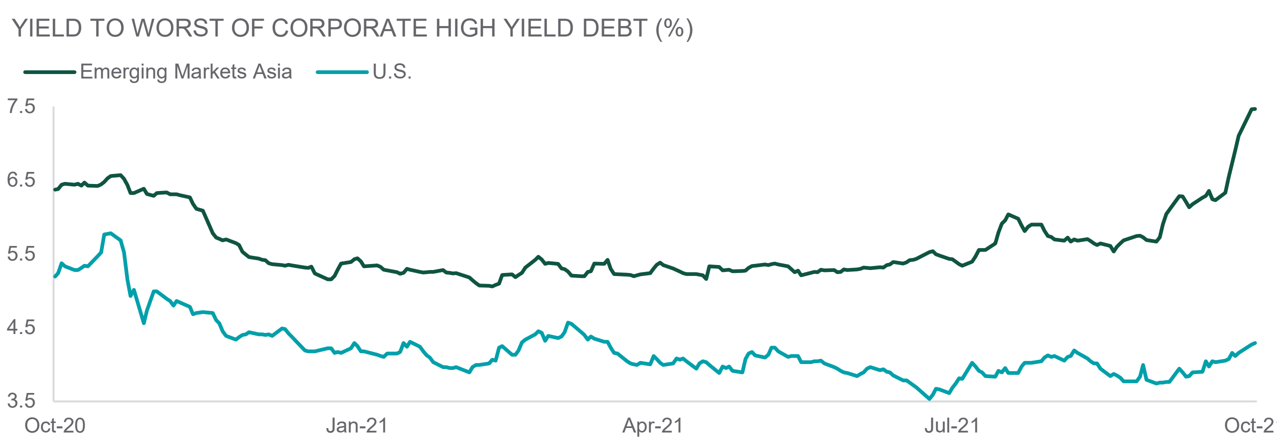
Stocks drifted lower over the last two months before catching a bid in early October. Rising energy prices have raised concerns about growth and inflation. There have also been pressures from the Common Prosperity initiatives being pursued in China. We have seen a rise in the U.S. 10-year yield to nearly 1.6%, mostly tied to an increase in 10-year inflation expectations to over 2.5%. Yet the S&P 500 is now barely off its all-time high. A favorite leading indicator of brewing troubles – the credit markets – aren't signaling concerns in the developed markets as developed market investment grade and high-yield spreads are well-behaved. However, emerging market high-yield bond yields have seen a significant increase of late (see chart), tied to deteriorating credit in China property markets.

A new risk case for us this month is that of a *China Growth Disruption*. China faces pressures from its over-leveraged property sector at a time it is also dealing with higher energy prices and continued COVID-related challenges. Chinese share prices have been significantly marked down, as investors demand an increased risk premium as they assess the impact of the Common Prosperity program. We do think the risk from the property sector is being contained, and remains mostly a risk to the domestic growth outlook. Our other main risk case is that of persistent inflation, which would discredit the Federal Reserve and market view of transitory inflation. Rising energy prices and continued supply chain bottlenecks present additional pressures. The September core inflation report for the U.S. showed a modest acceleration to just over 4%, so this risk remains front and center. For what it's worth, Fed member forecasts continue to call for inflation to fall below the Fed's target of 2% in 2022.

We made no changes to our global policy model this month and remain overweight risk assets. Central to our view is our base case of *Economic Resistant Companies*. Large publicly traded companies have smartly navigated higher inflation and supply disruptions to deliver consistent positive earnings surprises. This is especially true in developed markets, our preferred position within equities. We also continue to expect *Slowing but Sustainable Growth*. Supply disruptions and labor shortages have slowed overall growth, along with the impact of the Delta variant. Finally, the release of the Federal Reserve's September minutes revealed that it is likely to start tapering its bond market purchases by $15 billion a month, starting in either November or December. We don't view this as a risk to the markets, as it has been very well telegraphed and the history of tapering and eventual interest rate hikes doesn't threaten our position of being overweight risk assets and underweight bonds.

CHINA DEBT PRESSURES

Increasing risk from Chinese property developers has led to a jump in emerging market high yield spreads.



Data from 10/13/2020 through 10/13/2021.

Interest Rates

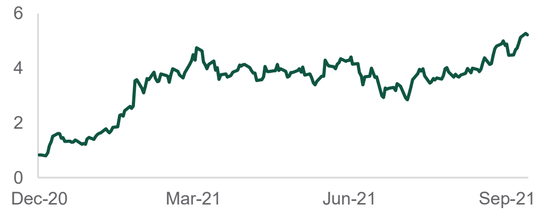
The September Federal Reserve Open Markets Committee (FOMC) meeting came with the quarterly update of its Summary of Projections, which included a refresh of its “dot plot” — a signaling mechanism for FOMC members’ policy rate outlook. Upon release, the market immediately brought forward its expectation for the first rate hike — and added a few in 2024. The markets are now calling for 5.2 hikes over the next three years, bringing the Fed Funds rate to about 1.40% in the back half of 2024. Although the Fed has been careful to separate the process of tapering asset purchases from raising rates, the market projects the hiking cycle will begin towards the end of 2022 — just months after the Fed is expected to wrap up its tapering process in mid-2022.

The 10-year Treasury yield currently sits at 1.54% and we forecast it will remain around that level over the tactical horizon — possibly beyond — as we believe the market is overestimating inflation and the pace of Fed rate hikes. In fact, if we are correct that the back-end of the yield curve is anchored, the Fed hiking as the market expects would risk a much flatter yield curve than the Fed would prefer. We have become more comfortable with interest rate risk as yields have reset, but we still prefer credit risk in portfolios.

MISPLACED OPTIMISM?

Markets have sped up the timeline for rate hikes.

IMPLIED # OF FED RATE HIKES OVER THE NEXT THREE YEARS



Data from 12/31/2020 through 10/12/2021.

- The markets have priced in a quicker timeline for rate hikes than we think is appropriate.
- With the yield curve still at historically low levels, this number of rate hikes would be challenging.
- Interest rate risk has become more tenable as rates have backed up — but we still like credit risk more.

Credit Markets

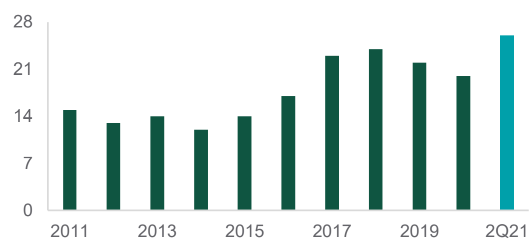
As third quarter earnings season kicks off, the current fundamental backdrop for U.S. high yield remains robust. One of the major indications of credit strength is the record high median cash-to-total debt ratio (see chart). Recent issuance to bolster cash on hand combined with the strong rebound in corporate earnings — and, by extension, cash generation — has built up a significant liquidity buffer for high yield issuers. Cash-to-debt now sits at 26% — the highest ratio on record — and reinstates the trend of stronger liquidity positions that started in 2015. Other credit metrics have also improved of late. Median leverage has fallen to 5.5x from 6.0x (though still slightly above the pre-pandemic median of 5.3x). Supportive financial conditions have allowed issuers to refinance debt at lower rates, leading to a median interest coverage of 4.9x (versus a median of 4.3x in 2019).

While supply chain disruptions and rising commodity costs are creating some uncertainty around the outlook for this earnings season, high yield issuers are well-positioned to manage through potential headwinds. High yield valuations should be supported — with potential upside if concerns around cost pressures prove to be overblown.

CASH ON HAND

High yield issuers are relatively flush with cash.

CASH AS A % OF TOTAL DEBT



Median cash to debt for U.S. high-yield credits.

- Lower high yield spreads reflect better fundamentals and ability to cover debt servicing costs.
- Any credit spread widening represents an opportunity to gain income in a yield-starved world.
- We continue with our overweight to high yield, funded by an underweight to investment grade debt.

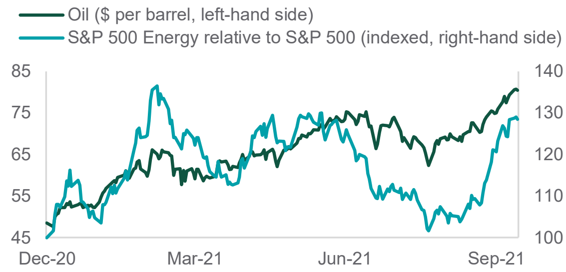
Equities

Global equities gave up 2% in the past month in local currency terms, with non-U.S. markets looking a bit worse due to strength in the dollar. Masked in the one-month numbers is the U.S. seeing a long overdue 5% pullback, then clawing a portion back. Value outperformed, as cyclicals benefited from rising commodity prices and higher interest rates. Energy stocks rose 20% for the month as oil breached $80 — up from $50 at the beginning of the year. As seen in the chart, energy sector relative performance had been lagging the movements in the commodity over the summer, but quickly caught up in the past month.

Rising commodity prices will join other hot topic issues such as supply chain disruptions and labor scarcity as earnings season gets underway. We expect forward earnings estimates to pause following strong increases this year, reflecting the challenges and uncertainty of the current backdrop. Though supply chain pressures will likely persist through much of 2022, some areas should improve over the next several quarters. Progress here will start to alleviate market concerns regarding growth and inflation, as well as their impacts on corporate profit margins. We believe this will allow positive equity sentiment to regain steam — especially in developed markets.

PLAYING CATCH-UP

Energy stocks have started to participate in oil's rally.



Generic Crude Oil. Data from 12/31/2020 through 10/13/2021.

- Equity markets suffered their first 5% correction in nearly a year — but have started to rebound.
- Value sectors — such as energy — have once again taken the lead over the past month.
- We remain overweight equities, with a preference for developed markets.

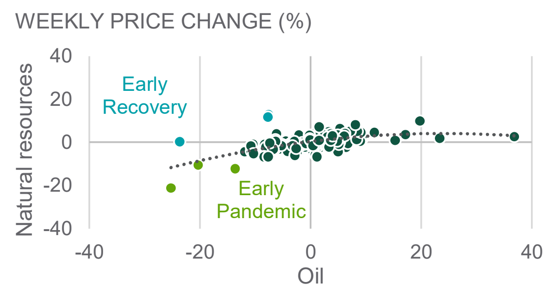
Real Assets

As mentioned in the equity section above, oil-sensitive stocks (as well as other commodity-sensitive stocks) have shown a delayed reaction to the upward moves in oil and other commodities. But it is fairly common for stocks to lag the commodity to which they are exposed when commodity prices show big swings. This is especially the case when investing in a basket of stocks exposed to a number of commodities as we do within natural resources (NR). Such is the power of diversification — and, as annoying as it is on the upside, it comes in handy on the downside.

The chart shows the weekly performance of NR versus oil price changes ("early pandemic" and "early recovery" outliers identified). NR price volatility is lower than oil price volatility, such that big oil gains lead to smaller NR gains and big oil drops lead to smaller losses. Notably, while NR returns are highly correlated with oil prices, they don't *need* robust oil prices to perform. As the trendline shows, NR returns don't linearly rise with higher oil prices at the extremes. We believe oil (and other commodity) prices just need to stay at current elevated levels for NR to provide benefits to the portfolio — especially as elevated cash flows increasingly go to investors via dividends instead of what in the past has been overproduction.

THE POWER OF DIVERSIFICATION

Broad exposure mutes single-commodity return impacts.



Generic Crude Oil and S&P Global Natural Resources. Data from 10/14/2016 through 10/8/2021.

- Natural resources have lagged oil's price rise, but this is normal by historical standards.
- Steady-to-modestly rising commodity prices are sufficient for constructive natural resource returns.
- We remain overweight natural resources given solid fundamentals and as a way to manage inflation risk.

BASE CASE

Slowing but Sustainable Growth

Growth is moderating from the past year's strong pace but is still quite early in what will likely be a long economic cycle. At the same time, the steady (and generous) hand of central banks will support financial market valuations. We remain overweight risk assets broadly in the global policy model.

Economic-Resistant Companies

Pockets of elevated inflation, supply/demand mismatches and slowing economic growth have not impacted business profitability — notably in tactically overweight developed markets. Earnings growth has materially outstripped already-impressive revenue growth, leaving a solid fundamental backdrop.

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.

China Growth Disruption

A China policy miscalculation creates a risk to global economic functioning as it deals with a number of issues from the pandemic to energy shortages to financial stability and the property sector.

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