

TWIN PEAKS?

Equity markets ended 2021 on a strong note, following typical seasonal patterns. However, volatility in both interest rates and equities has picked up as of late. Real-time economic data is showing the negative effect of the Omicron variant, while persistently high inflation has pushed the Federal Reserve into a distinctly more hawkish stance. Market expectations of interest rate hikes have edged up in the last month, while volatility in interest rate markets has increased noticeably due to investor uncertainty. Financial market history can provide some comfort to investors, as the exhibit below shows. Equities, along with bonds, can perform well during interest rate hike cycles — especially when they are well-telegraphed. In the last seven rate hike cycles, stocks only generated a negative return during the 6-month period before and after the initial hike once — and that was accompanied by a whopping 3.25% increase in the Fed funds rate.

While we made no changes in our global policy model this month, our risk case around inflation did change significantly. Previously, we were concerned about Fed overreaction to inflation, while now we are concerned that persistent inflation could justify a more hawkish Fed. The first quarter of this year could see “twin peaks” in COVID and inflation, especially in the developed world. While the recent surge in the Omicron variant has dented current activity, that will likely subside faster than the risk of

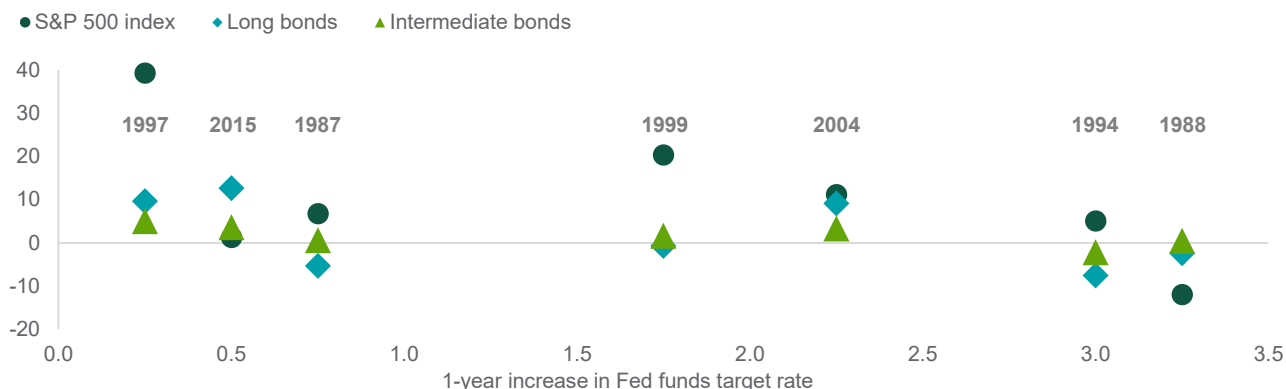
disruption in supply chains. COVID case counts in Asia haven't yet come close to the surge seen in the West — which represents a production risk in countries like China with a zero-COVID public health policy.

We continue to focus more on the implications of inflation than just on the level of overall prices. Corporate pricing power remains strong, offsetting increased costs and buttressing profit margins, earnings and stock prices. Bond markets have had a difficult month since the Fed pivot, but the 10-year Treasury yield of ~1.8% remains well-behaved and within our expected range of 1.5—2.0%. We think the Fed's accelerated timetable around tapering its asset purchases, and then the potential for shrinking its balance sheet (see our discussion in the interest rate section) will be executed with a close eye on the impact on fixed income markets. With nominal rates still low overall, we continue to underweight fixed income and favor risk assets in our global policy model. We expect developed markets to outperform emerging markets again in 2022, and we continue to favor high yield bonds over investment grade bonds due to their lesser interest rate sensitivity. Finally, global natural resources remains a favored asset class as a play on economic growth and constrained supply, and as a hedge against continued high inflation.

RATE HIKE RESILIENCY

Stocks can handle initial rate hikes well, while substantial rate hikes tend to have a more limiting impact.

RETURNS 6-MONTHS BEFORE THROUGH 6-MONTHS AFTER INITIAL RATE HIKE



Total returns for long bonds: Bloomberg U.S. Long Government/Credit Index; intermediate bonds: Bloomberg Intermediate U.S. Government/Credit Index. Data as of 1/14/2022.

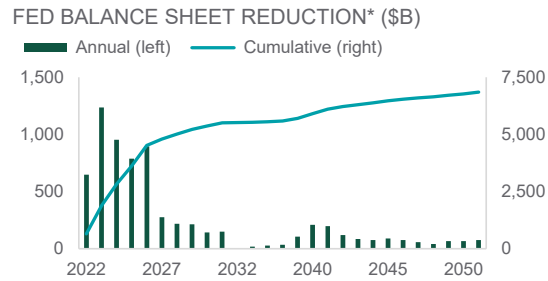
Interest Rates

Since last summer, the Federal Reserve has become increasingly hawkish. Not too long ago the FOMC stated, “We are not even thinking about thinking about raising rates [...] rates are separate from tapering.” Now, liftoff and balance sheet tapering may be on the horizon. Indeed, the change in tone has occurred faster than the previous cycle.

The Fed balance sheet is a tool that can be used to alter the supply of money in the financial system. Assuming the Fed begins winding down its balance sheet this summer, the effect on the size of the balance sheet will likely be front loaded (see chart on the right). The Fed can reduce its balance sheet by nearly \$2T by the end of 2023 — without selling assets. In terms of impact, \$500B in Quantitative Tightening (QT) is estimated to be equivalent to about 25 basis points in rate increase. Currently, the market has priced in roughly six hikes by the end of 2023. Including the theoretical impact of the balance sheet runoff, that brings the effect to 10 hikes altogether, which puts the policy rate right at the FOMC long-run estimate of 2.5%. With a forecasted central tendency of 1.75% on the 10-year Treasury, we believe the Fed will be beholden to longer yields and will hike less than the market expects.

A NATURAL WIND DOWN

The Fed balance sheet can normalize without selling.



*Assumes MBS paydowns continue at current rate, and no purchases, reinvestments and/or sales of Treasuries (to model the balance sheet reduction without selling assets).

- The Fed is expected to hike rates and wind down its balance sheet sooner than previously expected.
- Via coupons and maturities, the Fed balance sheet can notably shrink — without outright selling of assets.
- This and other technical dynamics may help keep rates low, limiting how much the Fed will hike.

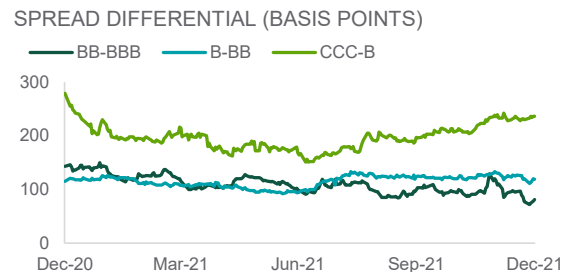
Credit Markets

While credit spreads tightened about 60 basis points (bps) in 2021, there are still opportunities in the lower end of the credit spectrum. The graph to the right shows the spread differential between rating categories. Differentials between higher-quality segments (BB—BBB and B—BB) are near the one-year averages and well inside the longer term averages. However, the differential between lower-quality segments (CCC—B) is about 40 bps wider than its one-year average, and also inside its longer-term average.

Attractive valuations combined with robust fundamentals that are likely to continue to improve suggest there is room for lower quality to tighten relative to higher quality. Net leverage for the asset class has fallen to 3.9x from a peak of 5x during the pandemic and it is only slightly elevated versus the 10-year average of 3.7x. Further, this metric is being skewed by the hardest hit sectors from COVID. Excluding the transportation and gaming sectors, net leverage is 3.3x. The other major fundamental driver, default activity, has plummeted over the course of 2021 and we expect it will remain historically low. This strong fundamental backdrop should particularly support valuations in the lower-quality cohort. We remain overweight high yield in our global policy model.

LOWER QUALITY, HIGHER EXPECTATIONS

Spreads for low-quality credits have room to tighten.



Data from 12/31/2020—12/31/2021.

- Credit spreads tightened in 2021, but there are still opportunities — particularly in lower-quality credits.
- High yield valuations are attractive, and strong fundamentals support lower-quality credits the most.
- We remain overweight high yield with a preference for credit over interest rate risk.

Equities

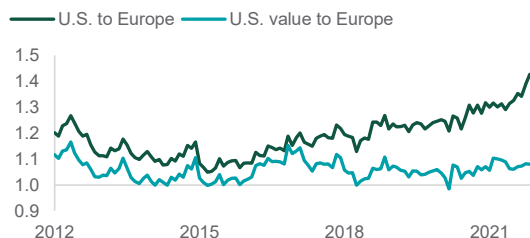
Global equities were relatively stable over the past 30 days, masking significant rotation under the surface. Equity markets rotated toward value — reflecting rising inflation expectations, higher rates and a more hawkish Fed tone. In the U.S. and Europe, value indices outperformed growth counterparts by 7%. A similar rotation occurred in early-2021, only for growth to regain leadership for most of the year. Regionally, one can think of the U.S. versus Europe as a similar trade as growth versus value. The U.S., with ~45% of the market represented by tech, communication services and internet retail, is very much a growth market. European equities actually closely resemble the Russell 1000 Value index given its greater dependence on cyclicals, and much lower tech exposure.

In the chart we show the increase in the valuation premium of the U.S. market versus Europe. When looking at U.S. value versus Europe, a much more stable pattern is visible. We're not suggesting Europe isn't cheap versus the broader U.S. market. Instead, all of value is cheap relative to growth. Overall, we remain attracted to the strong fundamentals in developed markets and maintain a neutral stance on emerging market equities in the face of elevated uncertainty on the regulatory and growth outlook in China.

THE VALUE DISCOUNT

Europe is cheap, but so are most value stocks.

RATIO OF 12-MONTH FORWARD P/E



Data from 1/31/2012—1/12/2022. Indices used: U.S. (S&P 500 Index); U.S. Value (Russell 1000 Value Index); Europe (MSCI Europe).

- Equity markets rotated toward value in response to higher inflation, higher rates and a more hawkish Fed.
- Value is cheap relative to growth — a key driver of the valuation premium of the U.S. market versus Europe.
- We remain tactically overweight equities through an overweight to developed markets.

Real Assets

Looking ahead, there's much to like in natural resources. Investor enthusiasm toward the asset class has been subdued due to its poor returns and climate-unfriendly attributes. As investors warm up to the asset class, money will flow in. And, given this is a small asset class by market cap, it doesn't take a lot of asset flows for the price to move higher. We believe the fundamentals justify newfound investor interest. Commodity demand is high, supply is restrained and companies have been smarter about capital deployment in new projects — which was a big part of the oil glut the past decade (as one example).

A DIMINISHING ADVANTAGE

Futures-based correlations to equities have risen.

CORRELATION TO GLOBAL EQUITIES



Indexes used: MSCI ACWI (global equities); S&P Global Natural Resources (equity-based); Bloomberg Commodity Index (futures-based). Data from 11/29/2002—12/31/2021.

- We are overweight natural resources on the basis of strong fundamentals and inflation-protection benefits.

BASE CASE

Slowing but Sustainable Growth

Growth is moderating from the past year's strong pace but we are only mid-cycle in the expansion. Meanwhile, steady (albeit slightly more restrictive) major central bank policy provides support to financial asset valuations. All of this allows risk assets to continue to perform, despite recent impressive returns.

Resilient Corporate Profits

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

Persistent High Inflation

Underlying inflationary pressures continue over the next year, forcing the Fed into a materially more aggressive policy response — resulting in a challenging environment for both stocks and bonds.

China Growth Disruption

A China policy miscalculation harms 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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