

HOLDING THE LINE

Often assumed to be a military expression, the earliest use of the term “hold the line” is actually first traced back to American football (with the “line” being the line of scrimmage). But, of course, the term is often used in a number of circumstances – military or otherwise. And it can certainly be used today to address current dynamics playing out in the global economy and financial world.

Ukrainian armed forces. The most obvious application is to the war in Ukraine, recently surpassing its fourth month. A fairly well-established battle line has been drawn in the eastern part of the country – with the Russian army now occupying much of the Donbas area (about half the size of Iceland) and with little meaningful progress made of late by either side. Essentially both sides are holding the line at the moment. But Ukraine’s recent success in taking back Snake Island was a strategic victory and may help reopen the Black Sea up for grain exports – badly needed. Wheat prices were up 85% at one point this year, but are moving back to more normal levels (now only up 8% for the year)¹. More generally, supplies of all goods are – ever so slowly – increasing as global economic functioning normalizes.

Central banks. Here, investors really wish the Federal Reserve (and other central banks) would *not* hold the line. Historically, too much financial market weakness would prompt the Fed to curb its rate hiking plans (or initiate rate cuts) – but, this time around, the Fed has held strong. Managing inflation has taken priority over economic growth – and financial market – support. As such, a key

economic variable for investors today is the core personal consumption expenditure deflator – a measure of core (ex-food and energy) prices and the specific inflation metric the Fed is attempting to bring to its 2% inflation goal. Right now, that metric sits at 4.7%. This is off slightly from its 5.3% February peak¹ – but investors want more decline (and more quickly) such that the Fed can ease up on its rate hike trajectory. At present, the markets predict a 75% chance of another 0.75% hike in July and a total of 1.75% more in 2022, which would put the Fed funds rate at 3.5%.

Corporations. For this economic expansion to continue, corporations will likely have to hold the line on investment, and not succumb to recessionary fears by cutting back on planned expenditures. The consumer (via government stimulus) has been the driving force of the post-pandemic expansion thus far. But corporations need to continue the current pace of hiring and maintain capital expenditure plans. The average analyst still expects double-digit S&P 500 earnings growth in 2022¹ – but should those numbers start to slip, so too could business investment.

The inflation line. All of the above dynamics are either driving or reacting to inflation. Constructive developments on the war in Ukraine would help cap commodity inflation, which may allow the Fed to slow its pace of tightening and encourage corporations to go on offense. Fed action thus far has brought longer-term inflation expectations down to a range of 2.2% to 2.6%. All we need now is a (fairly) quick and straight line from here to there.

SECOND QUARTER 2022 TOTAL RETURNS (%)

It was a difficult quarter across all asset classes (save cash) – including both risk-control and risk assets.

RISK CONTROL						RISK ASSETS						
FIXED INCOME						EQUITIES			REAL ASSETS			
Cash	Muni	Inv. Grade	TIPS	High Yield	EM Debt	U.S.	Dev. Ex-U.S.	EM	NR	GRE	GLI	
0.1	-2.9	-4.7	-6.1	-9.8	-8.6	-16.8	-14.9	-12.0	-15.6	-17.0	-7.4	
YTD	0.2	-9.0	-10.3	-8.9	-14.2	-14.5	-21.2	-19.2	-17.8	-1.4	-19.8	-0.5

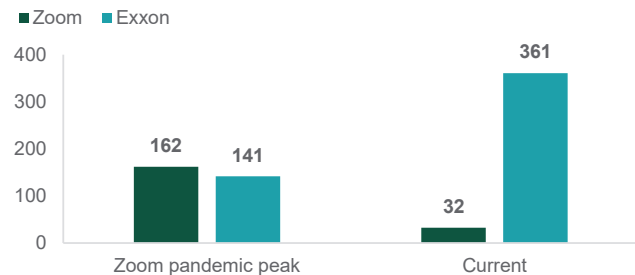
NR: Natural Resources; GRE: Global Real Estate; GLI: Global Listed Infrastructure. Indexes are gross of fees.

KEY DEVELOPMENTS

Economic Transition

What a difference one year and nine months makes. In late October 2020, Zoom (the Covid-economy savior) carried a higher valuation than Exxon (the largest oil company in the U.S.). Since then Zoom has fallen by 80% while Exxon has gained 180%. Better than most any other data point, this fact captures the economic transition underway – less focus on the pandemic, more focus on inflation and gasoline prices. Clearly, the war in Ukraine played a large role in this transition – and will likely continue to influence the economic outlook.

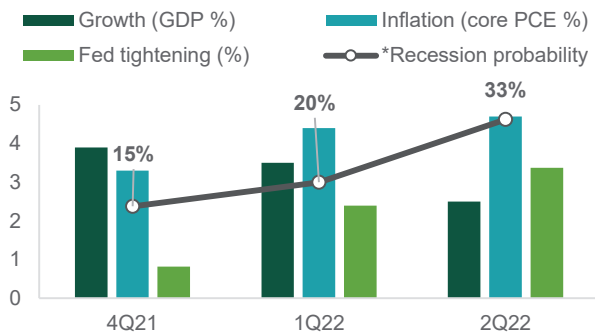
MARKET CAP SWINGS (\$B)



Recession on the Radar?

Continued inflationary pressures have led to increased Fed hawkishness – which, in turn, has led to increased odds of recession. Coming into the year (the 4Q21 data in the chart), growth was fine, inflation was “transitory” and the Fed was only expected to gradually start the rate raising process. Recession odds sat at 15%. As we sit today, the Fed is expected to raise rates a total of ~3% (already having raised by 1.5% thus far). Its intention is to bring down inflation, but it may also harm growth. Recession odds now sit at one-third.

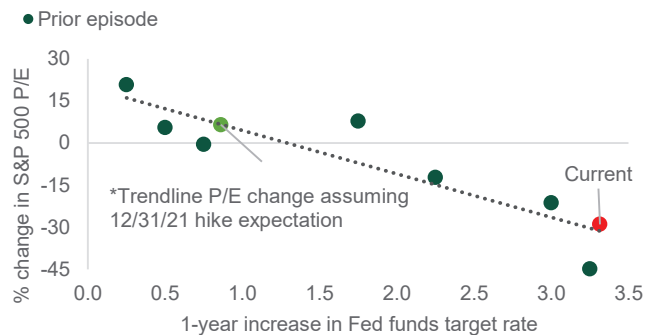
CONSENSUS EXPECTATIONS FOR 2022...



Rate Recalibration

The increase in expected Fed rate hikes has led to a decrease in equity valuations. Previous Fed rate hike campaigns have shown a strong correlation between the one-year rise in the Fed funds rate and the percent change in valuations (measured from six months prior to six months after the first hike). This makes sense – a higher expected discount rate means cash flows in the future are worth less. Valuations now appear fair based on expected Fed action (see chart). Concerns have now shifted to the extent of the growth slowdown.

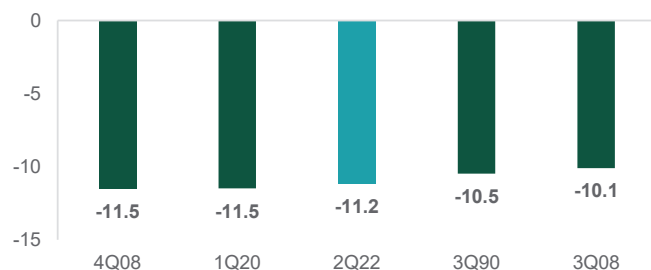
VALUATIONS 6M BEFORE VS. 6M AFTER INITIAL HIKE



Broad Bear Market

When the dust on the second quarter settled, we were left with the third worst performance for a 60/40 portfolio in the global history we have – using MSCI ACWI for equities and Bloomberg U.S. Agg for fixed income (data from 1987). Unlike previous down quarters, fixed income played a large part this time around – down nearly 5% when it should be providing offsetting gains. Interestingly, the only quarters with worse returns were 4Q08 (global financial crisis) and 1Q20 (pandemic). In each case, the next year saw large double-digit returns.

BOTTOM FIVE QUARTERLY 60/40 RETURNS (%)



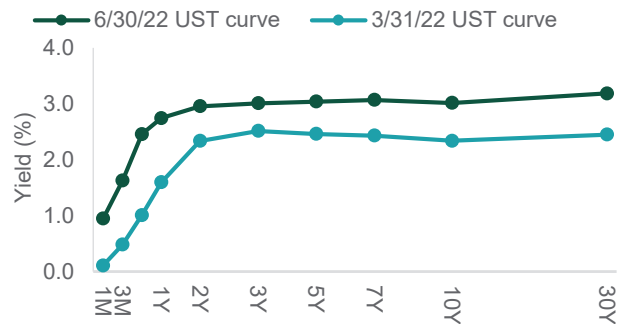
Consensus expectations from Bloomberg. *One-year forward recession probability. Data as of 6/30/2022.

MARKET REVIEW

Interest Rates

Global bond yields repriced higher as the Fed-led monetary policy tightening cycle gained steam. Across two meetings, the Fed hiked its policy rate by 1.25% to 1.75%, began to roll off its balance sheet and talked up a “strong commitment” to restoring price stability. With a resolute focus on bringing down inflation, central bank policy has set out to lower demand in line with supply. This, combined with stickier-than-expected inflation, reset U.S. interest rates higher. Toward quarter end, yields came off peaks over recession concerns.

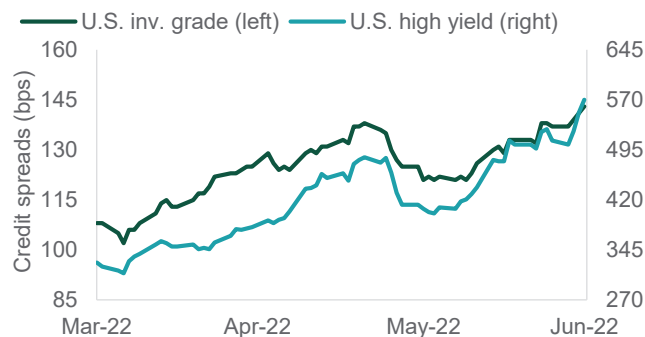
U.S. TREASURY YIELD CURVE



Credit Markets

Despite a fleeting rally in May on hope that the Fed may slow its pace of tightening, credit spreads trended wider during the quarter as capital markets priced in the economic costs of higher interest rates. High yield spreads sit a bit above non-recessionary levels and income yields are nearing Covid highs. While high yield fundamentals remain strong and technicals supportive, high yield underperformed IG fixed income (-9.8% vs. -4.7%) as the more economically-sensitive asset class suffered more from rising recession fears.

CREDIT SPREADS



Equities

Global equities entered bear market territory and ended the quarter down 15.5%. Against a more challenging economic growth backdrop, earnings expectations held up well, suggesting most of the decline came from lower valuations. Emerging market equities (-12.0%) notched the best returns, benefiting from government support and eased pandemic restrictions. Developed ex-U.S. equities (-14.9%) and U.S. equities (-16.8%) bore the brunt of persistent inflation and the consequent tighter-than-expected monetary policy.

REGIONAL EQUITY INDICES



Real Assets

Living up to its historical track record of providing some inflation and downside risk protection, global listed infrastructure (-7.4%) handily outpaced global equities. Natural resources (-15.6%) gave back most of its year-to-date gains. Geopolitical threats to the global energy supply helped the asset class, but support waned as commodity prices came off highs due to weak China activity and slowing global growth. Global real estate (-17.0%) has interest rate and market exposure and took a hit from higher rates and slowing growth.

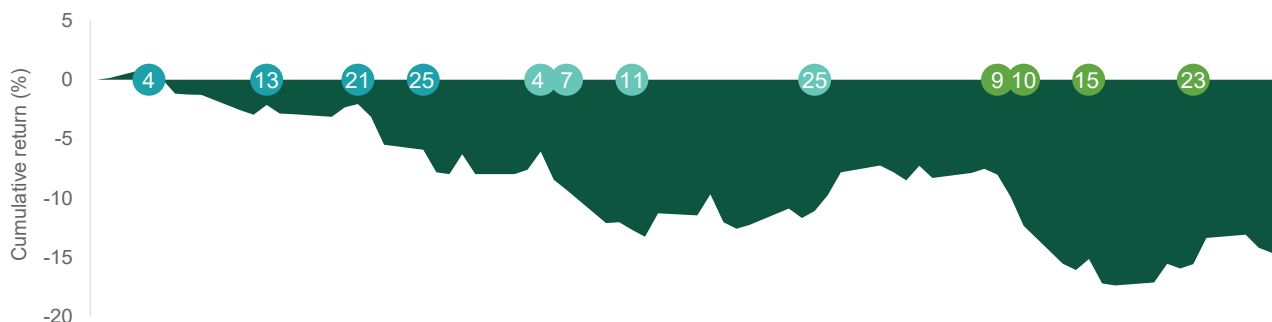
REAL ASSET INDICES



Bp(s) = basis point(s). Returns in U.S. dollar terms. UST = U.S. Treasury. Indexes are gross of fees.

MARKET EVENTS

■ 2Q 2022 global equity total return: -15.5%



APRIL	MAY	JUNE
<p>4 Allegations of Russian atrocities lead to less room for peace talks and more room for sanctions.</p>	<p>4 European Commission unveils plan for phased ban on Russian oil imports, EU reaches an agreement in early June.</p>	<p>9 European Central Bank (ECB) announces it will end QE in July and opens the door to a 50 bp hike in September if the inflation outlook persists or deteriorates further.</p>
<p>13 1Q earnings season unofficially kicks off; U.S. earnings proceed to finish above expectations at +9% year-over-year, but lower valuations offset gains.</p>	<p>4 Fed raises policy rate by 50 bps; equities rally following optimistic comments by Chair Powell but gains later reverse on the tighter policy.</p>	<p>10 Treasury yields rise and the yield curve flattens after U.S. headline CPI (8.6% y/y) tops expectations and rises from the prior level.</p>
<p>21 Fed Chair Powell indicates a 50 basis point hike is on the table for May and notes it may be appropriate to front-load policy tightening.</p>	<p>7 Terra (dollar-pegged stablecoin) starts to collapse, marking the start of a string of crypto issues that wipe off ~\$2 trillion in crypto market cap.</p>	<p>15 Fed hikes rates by 75 bps; upside inflation surprises drive expectations for more hikes, more inflation and less growth reflected in its new Summary of Economic Projections.</p>
<p>25 France President Emmanuel Macron is re-elected; his victory removes left-tail risk event for eurozone financial assets posed by his opponent.</p>	<p>11 U.S. headline and core Consumer Price Index moderate y/y but both readings come in hotter than expected and remain elevated.</p>	<p>15 In response to surging Italian bond yields, ECB announces plans to design anti-fragmentation instrument in a rare emergency meeting.</p>
<p>25 China contributes to global risk-off tone as it reports elevated Covid cases; China stocks stabilize later in the week on government stimulus plans.</p>	<p>25 Equities rally after May Fed meeting minutes note front-loading policy tightening may allow for policy reassessment thereafter.</p>	<p>23 Flash Purchasing Managers' Index (PMI) data for the U.S. and Europe underscore waning but still-positive economic growth.</p>

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