

# CONFLICT

Inflation, along with the second order negative impact on growth, remain top of mind for markets. The U.S. June Consumer Price Index (CPI) print of 9.1% year-over-year (y/y) was the second consecutive negative surprise. As shown below, there is a real conflict between the current high level of inflation and what the market is pricing in for inflation over both the near and long term. While core CPI has declined sequentially for three months in a row, the rate of decline has been slower than market expectations. Meanwhile, expectations for inflation over the next two years have dropped from a peak of 4.9% to 2.9%. Market expectations for inflation longer term (roughly 2027-2032) have declined to 2.1%. The second order effect of inflation on growth is increasingly of concern to investors. We see conflict on this front between real-time data and financial market leading indicators.

Growth data in the U.S. has been generally solid, including critical areas like consumer spending and capital expenditures. Nonetheless, GDP in the first quarter fell 1.6% due to weak exports and declining inventories. Some economic forecasting models see second quarter GDP flirting with zero growth, which would lead to a “technical” recession. For a full-blown recession to take hold, we would expect to see much broader declines in economic activity, especially in areas like the labor markets and capital spending. Yet, indicators like the yield curve, high yield spreads and consumer confidence are flashing

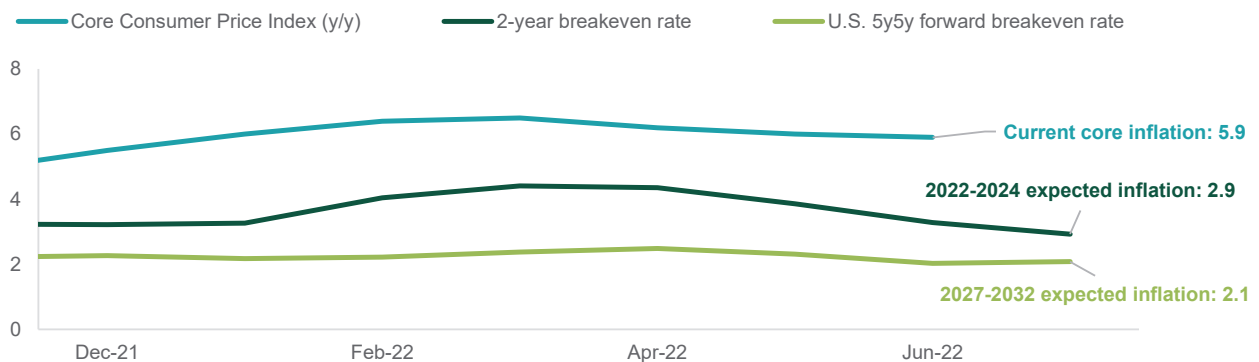
warning signs. As a result, we now estimate a 50%/50% probability of a U.S. recession over the next 18 months. Importantly, we think any recession is more likely to be of the shallow, cyclical type as opposed to a deep, structural recession.

We continue to focus on Eastern Threats as a primary risk case. We have been more cautious on European growth, due to the impact of the Russia/Ukraine war on activity and the increased uncertainty about European energy supplies. This will likely lead to a European Central Bank that is more dovish than the Fed, especially as it focuses on controlling interest rate differentials amongst its leading economies. Chinese growth has been disappointing, with the continued growth drag from Covid in China leading to some increased fiscal support in recent months. Market volatility is likely to remain high until clarity is reached on the Fed’s rate cycle, and the resulting impact on economic growth.

## TIMING IS EVERYTHING

While inflation levels are high today, investors anticipate inflation will come down materially as time passes.

### YEAR-TO-DATE U.S. INFLATION DATA (%)



Data through 7/14/2022 (most recent CPI as of 6/30/2022).

## Interest Rates

The Move Index uses implied volatility of 1-month Treasury options across the curve to create a weighted measure of interest rate volatility. The last time we wrote about this index, we were writing about the lack of volatility in the Treasury market with yields trading in tight ranges. Today, that story has flipped. When looking at the Move Index, Treasury volatility sits just below 2020 highs. Volatility has been driven by mainly two factors: 1.) thin liquidity; and 2.) the uncertain path of monetary policy. While liquidity tends to be lighter during the summer months, this year it is even lighter than seasonal factors would suggest. Liquidity has recently trended at or below levels seen in 2020, with front-end liquidity near Global Financial Crisis levels. As a result, the cost of trading Treasuries has increased across the entire curve. Additionally, yields have been very sensitive to economic data as investors analyze how each data release will impact the speed at which the Federal Open Market Committee (FOMC) will tighten policy.

Volatility is likely to persist, notably in the front end, until inflation subsides and the Fed policy path is clear. With inflation stubbornly high, and consistently hawkish FOMC commentary, we raised our six-month forecast for 2-year and 10-year Treasury yields to a central tendency of 3%.

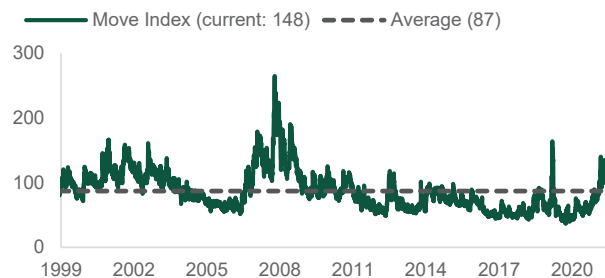
## Credit Markets

The high yield (HY) market saw poor performance in June, posting the second worst monthly return since the Global Financial Crisis (GFC). Spreads widened over 160 bps on fears of persistent inflation and an aggressive Fed slowing growth. Given the recent selloff, high yield valuations have become increasingly attractive, with a yield to worst of 8.9% at the end of June. This is only the fourth time since the GFC that index yields have reached 8% or higher. Index yields at this level or above have historically been attractive entry points for high yield from a total return perspective. Per the chart to the right, when index yields are 8% or higher, the average 12-month forward return has been 13% or more (dating back to 2010).

Despite the negative sentiment in the asset class, current valuations present an opportunity with spreads nearing recessionary levels at the end of this month. From a fundamental perspective, there is opportunity that realized forward default rates will be lower than current market implied forward default rates due to extended maturity profiles that allot companies greater flexibility to manage through stress. Additionally, recovery rates may prove more resilient than expected with leverage near all-time lows.

## ROWDY RATES

Thin market liquidity and Fed uncertainty have raised interest rate volatility to elevated levels.



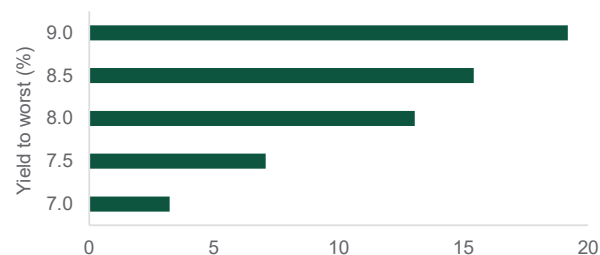
Data from 12/31/1999 through 7/12/2022. Past performance is not indicative or a guarantee of future results. Index performance returns do not reflect any management fees, transaction costs or expenses. It is not possible to invest directly in any index.

- As growth and inflation roll over, so too are longer-dated yields – leading to a flat yield curve.
- Interest rate volatility continues as investors try to understand the Fed's trajectory amid lower liquidity.
- We expect a flat yield curve to persist, forecasting a 3% central tendency for both 2- and 10-year rates.

## ATTRACTIVE ENTRY POINT

At current yields, high yield has historically produced next-year returns easily into double digits.

AVG. 12-MO. FORWARD HY RETURN (%)



Data from 12/31/2010 through 6/30/2022. Past performance is not indicative or a guarantee of future results. Index performance returns do not reflect any management fees, transaction costs or expenses. It is not possible to invest directly in any index.

- High yield valuations are attractive – with yields over 8% for only the fourth time since 2010.
- Negative market sentiment is somewhat at odds with the fundamentals, which still look fairly good.

## Equities

Over the past month, investors partially shifted their attention from the risk of high inflation and commensurately tight monetary policy to the risk of recession. This shift acted as a modest headwind to global equity markets, a strong tailwind to the U.S. dollar, and helped lead interest rates and commodity prices lower. In turn, this combination impacted the value versus growth trade, with growth outperforming after extended underperformance. The energy sector got hit particularly hard, although it is still by far the best performing sector year-to-date. And a combination of dollar strength and style rotation out of value subsequently caused Europe and Japan to underperform relative to the U.S.

Investors remain cautious regarding the outlook for inflation and growth. The headwinds from tighter financial conditions, higher food and energy prices and elevated geopolitical uncertainty mean a slowdown is likely and a technical recession may occur, with Europe at the front of the queue and the U.S. a bit behind. Also, risk remains to the downside with respect to further disruption in Russian natural gas supply and ongoing Covid disruptions in China.

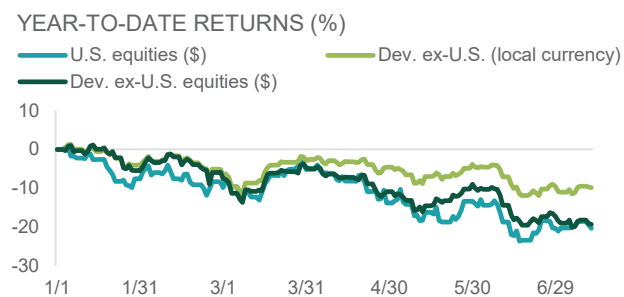
## Real Assets

As market attention shifts from too much inflation to too little growth, more cyclical asset classes (notably natural resources) may come under further pressure in the short term. Addressing the intermediate-to-longer term, industrial metal demand may come from the green transition/infrastructure build out; peak oil demand isn't likely until the 2030s; and the growing number and severity of droughts puts agricultural production at ongoing risk.

Meanwhile, the near-term environment is best characterized as supply constrained – notably in the energy markets. Despite decade-high oil prices, the number of rigs deployed for drilling wells remains subdued (see chart). As producers put less money in the ground and more money in their pockets, industry financial health has improved and dividends have increased. NR dividend yields currently sit above 5% (which we view as relatively safe).

## CURRENCY IMPACTS

Dollar strength has offset the better local currency return of non-U.S. markets.

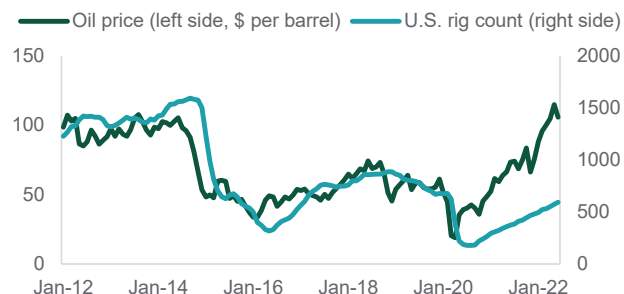


Data for MSCI USA Index, MSCI World ex-US (USD) and MSCI World ex-US (local) Index as of 7/12/2022. Past performance is not indicative or a guarantee of future results. Index performance returns do not reflect any management fees, transaction costs or expenses. It is not possible to invest directly in any index.

- Inflation concerns are rapidly shifting to growth concerns as central bank policy kicks in.
- U.S. markets would likely benefit from continued dollar strength and value-to-growth rotation.

## REDUCED RIGS

Rig count has not followed the price of oil higher.



Source: Northern Trust Asset Management, Bloomberg. Oil price for WTI Crude. Data from 1/31/2012 through 6/30/2022.

- Slowing growth introduces downside risk to the natural resources asset class.
- Cautious industry investment and activity is expected to keep a floor under oil prices.

## BASE CASE

### 50/50 on Recession

The global growth outlook has shifted downward given higher consumer costs, recent monetary policy restrictiveness (which has flowed into mortgage rates, etc.) and continued uncertainty in the East. At this point, the odds of continued economic expansion are equal to the odds of (modest) recession.

### Inflation-Focused Fed

Versus the previous Fed cycle (balancing much less inflationary pressure with a fragile economy), today's Fed – this time less swayed by market action – will keep hiking until inflation is contained.

## RISK SCENARIOS

### Eastern Threats

Ukraine has stabilized somewhat but knock-on effects (food/energy shortages) must be watched; China lockdowns are still a threat and less effective vaccines suggest case spikes could prompt new restrictions.

### Sticky Inflation

Inflation stays stubbornly high and doesn't follow the fairly smooth downward trajectory investors anticipate. Central banks are then forced to take a quicker/more restrictive approach to the current policy unwind.

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*For more information please contact:*

**John P Bohan CFP®**  
*Managing Director*

3200 Cherry Creek S. Drive  
Suite 730  
Denver, Colorado 80209

Direct: (303) 778-6800  
Email: [jpb@investmenttrust.com](mailto:jpb@investmenttrust.com)  
[www.investmenttrust.com](http://www.investmenttrust.com)