Harbour & Trust
Investment Management Company
Managing Your Wealth, Securing Your Future

VIEWPOINTS *December 2021*

TRIPWIRES

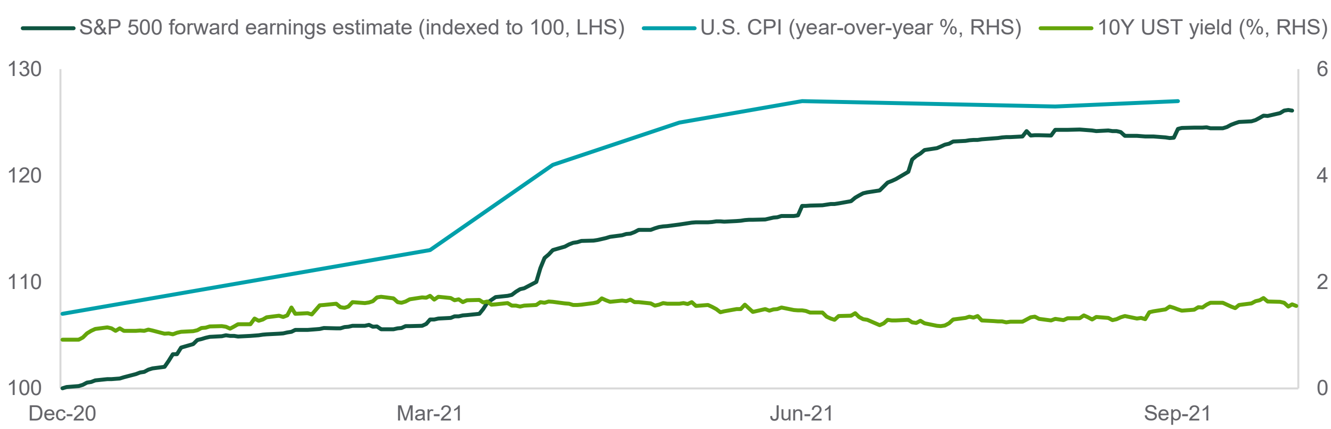
Inflation remains top of mind for investors, but we don't think the analysis goes deep enough. Objectively, the current rate of U.S. consumer price inflation (5.4% year-over-year) is worryingly high. However, we think there is too much focus on the current level and not enough on the effects of high inflation. We think the two biggest risks of higher inflation are pressures on corporate profitability and the impact on interest rates. As shown below, neither are flashing warning signs so far. Corporate profits have surged as pricing power (and operating leverage) have allowed companies to more than recoup higher costs. Additionally, the long-end of the yield curve (as measured by the 10-year Treasury) recently peaked at 1.7% and has dropped below 1.5%. So what are the tripwires that we are monitoring that could upend this positive picture?

To monitor the corporate profit outlook, we are paying close attention to pricing power and companies' ability to pass along and/or offset higher wage and goods costs. While the current earnings season has highlighted the impact of supply chain disruptions on both revenue and costs, larger companies are generally in better position to manage through these issues. This highlights our base case of *Economic-Resistant Companies*. We expect the eventual moderation of cost pressures to lead to a return of more competitive pricing to achieve market-share gains. Our second tripwire focuses on the Federal Reserve (Fed) and its reaction function. Should the Fed pivot and start raising interest rates sooner than expected, we think that would not be well-received by risk asset markets and would likely result in a rally in long-dated Treasuries. These two scenarios encompass our first risk case — *Inflation Disruption* — which focuses on the potential negative consequences of sustained higher inflation.

We made no changes to our global policy model this month and remain overweight risk assets. We continue to expect *Slowing but Sustainable Growth*. Supply disruptions and labor shortages have slowed overall growth, but should start to ease as workers reenter the job market and the pandemic recedes. Our *China Growth Disruption* risk case highlights the uncertainty about the impact of government policy on the Chinese growth outlook, which supports our favoring of developed market equities. Finally, the Fed did announce the start of tapering bond purchases of $15 billion a month, as expected. As we highlight in the following Interest Rate section, this will coincide with a near identical reduction in issuance by the Treasury which should reduce concerns over who the "new marginal buyer" is. This well-telegraphed tapering of bond purchases — and eventual limited hikes in interest rates — doesn't threaten our position of being overweight risk assets and underweight bonds.

SO FAR, SO GOOD

Surging inflation hasn't hurt corporate profits nor long-term interest rates so far.



Source: Northern Trust Asset Management, Bloomberg. LHS and RHS denote left- and right-hand side axes, respectively. Bloomberg consensus 12-month earnings estimates indexed on 1/1/2021. Data from 12/31/2020 through 10/29/2021 (last CPI data point for 9/30/2021).

Interest Rates

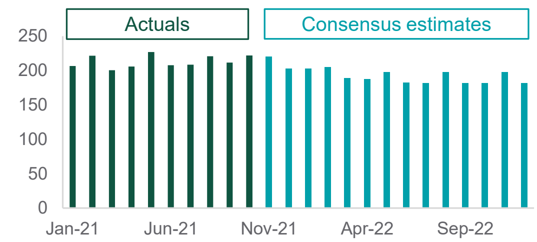
The U.S. Treasury announced reduced issuance across maturities. The 20-year auction will see the largest cut, followed by the 7-year and then other maturities across the curve. Some estimates call for cuts of approximately $800 billion in issuance from October of this year through the end of next year. Remember this $800 billion number. At the same time, the Federal Reserve announced that it will begin tapering asset purchases by $15 billion per month ($10 billion of Treasuries with the remainder being mortgage-backed securities). At this pace, pandemic-related quantitative easing will wind down by mid-2022. The Fed taper will result in a net reduction in purchases of approximately $800 billion. Sound familiar?

Another way to view this is in 10-year equivalent duration terms. We take every tenor that is auctioned by the U.S. Treasury, and the same for the Fed Permanent Open Market Operations (POMO), and convert them into a common duration of 10 years. The chart to the right shows the expected monthly net Treasury supply (i.e. Treasury issuance less Fed POMO) in terms of 10-year equivalents. Despite the Fed pumping the brakes on purchases, net Treasury supply is not expected to materially rise. Less net issuance and still-transitory inflation will keep rates low.

TIGHTENING (INSIDE) THE BELT(WAY)?

Less Treasury issuance will offset less Fed purchases.

NET TREASURY SUPPLY* ($BN)



Source: Northern Trust Asset Management, U.S. Department of Treasury. *Net Treasury supply (Treasury auctions less Fed purchases) for 2-30-year maturities in terms of 10-year equivalents. Actual data from 12/31/2020 – 9/30/2021; estimates from 10/31/2021 – 12/31/2022.

- The Federal Reserve has announced the beginning of their tapering — likely to be concluded by mid-2022.
- Treasury issuance will fall over the next year.
- The two points above net out and will keep rates low.

Credit Markets

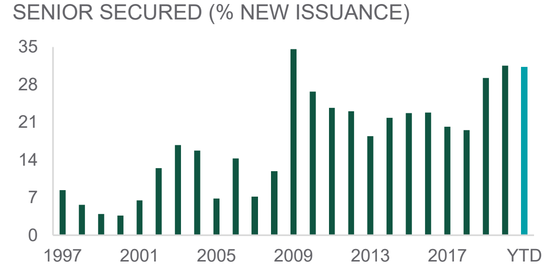
Despite wide open primary markets the high yield market has seen an elevated amount of secured issuance as a proportion of total new issuance. Year-to-date senior secured issuance has made up 31% of total issuance, above the 24% index weight for secured deals. This year's elevated secured issuance follows two years of increased secured issuance, with 2019-2020 seeing roughly 30% of new issue in the form of secured bonds. While issuers were securing bonds with their strongest assets in 2020 to access primary markets and obtain financing, the driver of secured issuance in 2021 has shifted. Low interest rates and tight credit spreads have made the high yield market an attractive alternative to the loan market for issuers. This has led to a record level of loan-to-bond refinancing ($85 billion year-to-date).

Investing in secured bonds tends to be attractive. They improve asset coverage and generally have higher recovery rates. They also tend to have shorter maturity profiles and offer larger coupons. Elevated secured issuance can improve portfolio quality and boost income, and is a particularly attractive trade today. We remain constructive on high yield fixed income, believing taking credit risk makes more sense than taking duration risk.

SECURITY IN HIGH YIELD

Senior secured issuance has risen in recent years.

SENIOR SECURED (% NEW ISSUANCE)



Source: Northern Trust Asset Management, JPMorgan.

- The rise of senior secured issuance is a constructive development within high yield fixed income markets.
- Fundamentals across high yield remain strong; defaults are low and interest coverage ratios are high.
- We prefer credit risk over duration risk.

Equities

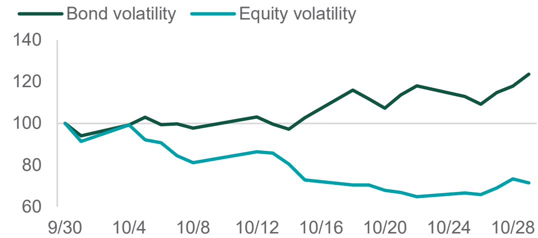
Global equities recovered strongly from their modest pullback last month, rallying more than 5% and making new highs in some regions. The U.S. once again led the way with gains of more than 6%, but Europe was not far behind. Japan and emerging markets lagged again, partly due to strength in the dollar. Growth outperformed value despite disappointing returns in communication services. Strong returns in technology and consumer discretionary dominated mixed results among the cyclical sectors. Earnings season got off to a good start, although the beats have not been as large as we saw earlier this year and higher input costs were an oft-mentioned headwind.

The strength in equity markets in the face of a marked increase in volatility in bond markets was notable. As bond markets priced in more rate hikes from central banks at a sooner date in response to higher inflation and supply chain disruption, equity markets continued to focus on the outlook for economic growth and corporate earnings. This reveals an expectation of continued pricing power and strong demand, which aligns with our view that investors will focus on the economic-resistant qualities of many companies. We remain overweight equities, preferring developed markets over emerging markets.

GOING THEIR SEPARATE WAYS

Bond volatility rises as equity volatility falls.

INDEXED TO 100 ON 9/30/2021



Source: Northern Trust Asset Management, Bloomberg. Bond and equity volatility proxied by MOVE and VIX Index, respectively. Data from 9/30/2021 through 10/29/2021.

- Equity markets continued their march higher, hitting new highs since our last publication.
- Companies have shown “economic resistance” — able to push profit margins higher despite inflation.
- We remain overweight equities overall by virtue of an overweight to developed markets.

Real Assets

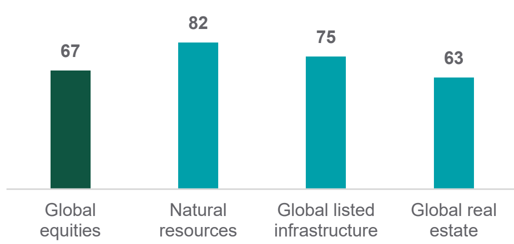
The past month has given us yet another real-time experiment into the ability of natural resources to provide protection against higher inflation expectations. Five-year breakeven rates — a measure of inflation expectations from fixed income investors — have risen from 2.4% on September 22 to 2.9% as of November 4. Over that same period, natural resources have risen 5.6% vs. 4.6% for global equities and 3.7% and 3.2% for global infrastructure and global real estate, respectively. These short-term results corroborate the results over longer periods. Of our real assets, natural resources have done the best job of “covering” inflation. Per the chart, natural resources cover inflation 82% of the time (vs. only 67% for global equities).

We view the potential for disruptive inflation as a risk case — not a base case — and this drives our tactical positions. Specifically, we are underweight inflation-linked bonds, as current valuations (per the above, an expectation for 2.9% inflation annually over the next five years) seem rich. But natural resources are currently inexpensive (one of the few risk assets to have cash flow yields above the last ten-year average). As such, and given solid fundamentals, we see a natural resources overweight as a way to protect against our inflation risk case over our tactical horizon.

ANALYZING “INFLATION HEDGES”

Natural resources “covers” (outpaces) inflation best.

% OF TIME ASSET COVERS INFLATION



Source: Northern Trust Asset Management, Bloomberg. Year-over-year CPI and returns. Data from 12/31/2001 - 9/30/2021.

- Inflation is a risk case — not a base case — for us over the tactical horizon.
- Natural resources have attractive valuations — both versus other asset classes and its own history.
- We are overweight natural resources and strategically allocated to our other real assets.

BASE CASE

Slowing but Sustainable Growth

Growth is moderating from the past year's strong pace but we are still early in the new economic cycle. At the same time, the steady (and generous) hand of major central banks will support financial market valuations. All of this allows risk assets to continue to perform, despite recent impressive returns.

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

Inflation Disruption

Inflation risk to financial markets is either through lower corporate profits or higher interest rates. Monitoring corporate pricing power trends and the central bank response will be key to managing this risk.

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.

Harbour Trust & Investment Management Company

For more information please contact:

Brian Merrill
SVP & Chief Investment Officer
bmerrill@harbourtrust.com

Matt Noll
Portfolio Manager
mnoll@harbourtrust.com

Jack Bobillo
Investment Officer
jbobillo@harbourtrust.com

ViewPoints reflects data as of 11/8/21.