IDB BANK™

GLOBAL WEALTH MANAGEMENT

VIEWPOINTS

FEBRUARY 2023

Watching Wages

As inflation continues to moderate, attention has shifted to a narrower aspect of the price story – non-shelter services inflation. This component represents the aspect of inflation most closely tied to wage growth, and is proving the most resistant to central bank (particularly the Federal Reserve) taming. The labor market remains tight, with the most recent employment report in the U.S. displaying continued strength in hiring and a lower unemployment rate.

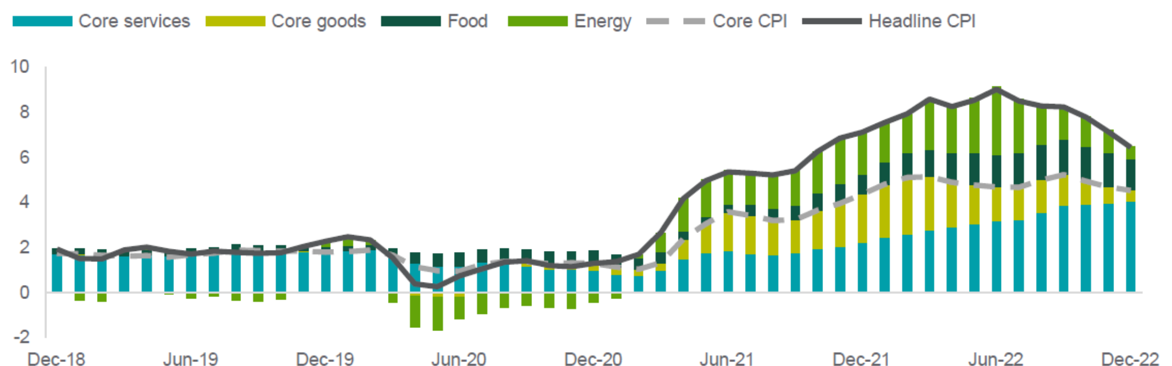
Importantly, wage growth slowed and the prior month was revised lower – but remains elevated. We believe inflation will continue to decline over the course of 2023, but that labor market dynamics could prevent inflation from falling to levels that represent a declaration of victory for the Fed, representing a risk to financial market expectations. In the meantime, it should be expected that the Fed will continue to lean hawkishly to maintain credibility and keep long- term inflation expectations in check.

Internationally, the economic outlook appears incrementally better than the recent trajectory, reflecting a warmer winter bringing down energy costs in Europe and China ending its zero-Covid policy. We still see a recession as likely in Europe and higher than 50/50 odds in the U.S. as economies feel the full weight of central bank tightening to date, and that left to come. The forward-looking nature of the market suggests weakening economies in developed markets will be weighed against the sentiment benefits of declining inflation and pauses in monetary tightening likely in the first half of 2023. We agree with the market's pricing of a roughly 5% terminal rate for the Fed, while we see the European Central Bank (ECB) raising rates somewhat less than suggested in their surprisingly hawkish statement last month. China's economic reopening will very likely experience unevenness and setbacks, and secular headwinds remain considerable, but a 2023 recovery could move some long- term investor concerns to the back burner this year.

We reduced the size of our underweight to emerging market equities in our Global Policy Model (GPM) this month to reflect the upside economic opportunity associated with the winding down of China's zero-Covid policy, funded by a reduction to our overweight to high yield bonds. With our expectation that the weaker economic picture in the developed world will be balanced against improving sentiment, we are neutral developed market equities in the GPM. We are underweight investment grade bonds and modestly underweight emerging market equities, while being over overweight high yield bonds and modestly overweight cash.

A Narrowed Focus

With many inflationary elements calming, the Fed and investors are now focused on core services.



Source: Northern Trust Asset Management, Bloomberg. Core excludes food and energy. Consumer Price Index (CPI) data from 12/31/2018 through 12/31/2022..

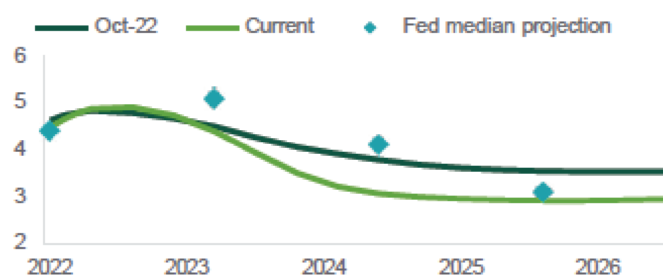
Interest Rates

Although the Federal Reserve slowed the pace of tightening last month, they raised their estimate of the 2023 Fed funds rate while 18 of 19 participants projected a 2025 rate at least 50 basis points above their long-run estimate (2.5%). Chair Powell noted that an unwarranted loosening of financial conditions would not be viewed favorably. Rates generally increased through year end, however since then they have declined with the bulk of the move coming alongside weaker than expected economic data. Market pricing is still inconclusive regarding the odds of a recession in 2023, but expectations for slower growth and inflation have investors looking for looser policy.

Commodity prices have declined rapidly and pandemic affected supply chains have mostly healed, but core services inflation remains robust and several jobs data points suggest a still tight labor market. The Fed views this as reason to not relent on its inflation fighting policies, while the market is now seemingly questioning this resolve. Per the chart to the right, investors and the Fed were mostly aligned in October, but the divergence is now wider than at any point in the last year. How this is resolved leads to divergent outcomes in rates and risk markets which keeps us closer to home in our tactical positioning.

FED BLUFF?

Markets do not expect the Fed to stick to their dots.



Source: Northern Trust Asset Management, Bloomberg. Quarterly data for 90-day Secured Overnight Financing Rate (SOFR) futures from 12/31/2022 through 9/30/2026. Data as of 1/9/2023.

- Markets are sniffing out some monetary relief, but we don't believe the Fed will be cutting in 2023.
- Headline inflation is coming down but core (especially services) inflation has the market's attention.
- We are fairly neutral duration in fixed income strategies given what we believe are fairly priced markets.

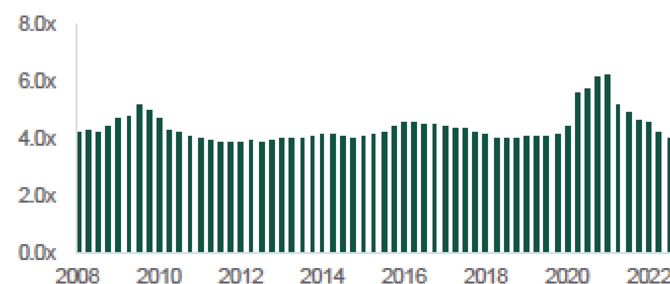
Credit Markets

With heightened uncertainty around future growth and inflation, investors have questioned holding riskier parts of the credit market. However, balance sheets for high yield issuers are in a strong state heading into a more challenging fundamental landscape for corporate entities. One of the most important drivers of performance in the high yield asset class is the underlying fundamentals. Per the chart on the right, leverage has declined for the 6th consecutive quarter to its lowest level since 2012. In the third quarter of last year, leverage of high yield issuers decreased to 3.98x from 4.20x in the second quarter and 6.20x in the first quarter of 2021. Moreover, interest coverage metrics increased 0.2x to a record high 5.85x.

Compared to 2008 and 2020, interest coverage today is meaningfully higher than it was heading into those periods. With this in mind, high yield should fare relatively better in a downturn scenario today and we expect realized forward default rates to be below market estimates for 2023. The growth and inflation outlook is uncertain, but given positive supply technicals and strong fundamentals high yield valuations look compelling. While we slightly reduced our overweight to fund a narrowed underweight to emerging market equities, we remain positive on high yield overall

HEALTHY FUNDAMENTALS

High yield leverage is in good shape heading into the economic slowdown.



Source: Northern Trust Asset Management, JPMorgan. Trailing 12-month EBITDA (earnings before interest, taxes, depreciation and amortization). Quarterly data from 3/31/2008 through 9/30/2022. Latest data as of 1/11/2023.

- Fundamentals and technicals across high yield markets in aggregate remain constructive.
- An 8%+ yield looks attractive given our lower default expectations vis-à-vis what the markets are pricing.
- While we reduced high yield slightly, the asset class remains our highest conviction overweight

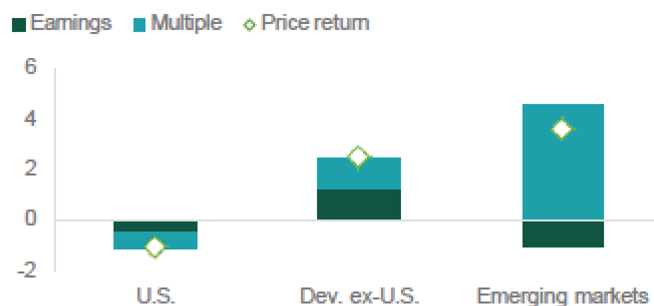
Equity Markets

Global equities were volatile but ended with a small positive return over the past month. Underneath the surface emerging market equities went from laggard to leader while developed ex-U.S. equities continued to outperform U.S. equities. Emerging market equities benefited from China dropping its zero-Covid policy and financial markets looking beyond the current disruption toward a future economic bounce. This also somewhat benefited developed ex-U.S. equities, but a large decline in energy prices was likely a bigger driver. Due to a mix of adaptation and mild weather, the headwind from higher energy prices has been notably reduced. As a result, the growth outlook has incrementally improved and inflation is expected to fall quickly, providing a strong tailwind to European equities in particular.

The trend of value outperforming growth continued last month as investors remained unconvinced that valuations have truly bottomed. Looking forward, the economic outlook for Europe and China has improved due to lower energy prices and the prospect of reopening and we have continued to add to those equity markets. That means our underweight to global equities has been reduced, as well as our preference for developed markets over emerging.

IMPROVED NON-U.S. SENTIMENT

Higher valuation multiples in emerging markets led it to be the best performing asset class the past month.



Source: Northern Trust Asset Management, Bloomberg. Data as of 1/9/2023. 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.

- Emerging market equities (EM) are getting a bounce after a very poor 2022.
- EM's recent outperformance could be short-lived if China pandemic reopening issues linger.
- Our EM underweight has been reduced as sentiment has improved but we still prefer developed markets.

Real Assets

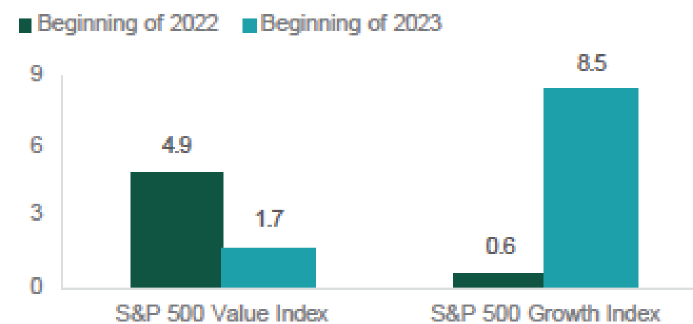
We enter 2023 with an overweight to real assets – focused in the natural resources (NR) space (with equal-weight positions in listed infrastructure and real estate). The supply/demand picture across many commodities remains tight – notably within the energy sector, thanks to Ukraine war-related disruptions and lack of investment in new supply sources. Also relevant are the dynamics around the

U.S. Strategic Petroleum Reserve (SPR) – while any refill of the SPR in 2023 meets logistical challenges, no longer will it be a notable supply source and could help to put a floor under oil prices over the coming years. A more stable – and sufficiently high – oil price level could translate into robust returns for NR in 2023. Even after a solid 2022 (up~10%), NR looks inexpensive – below normal valuation ranges – thanks to recently strong earnings.

Despite what are still very inexpensive valuations, index provider Standard & Poor's (S&P) now assigns a greater weight to energy within its S&P 500 growth index than its value index thanks to energy's price momentum last year (other index providers don't include a momentum factor). While mostly a fun fact, on a practical level it is an example of why we include a dedicated NR exposure as opposed to simply taking on a value tilt to get energy exposure.

REGIME CHANGE?

S&P now considers the energy sector a growth sector.



Source: Northern Trust Asset Management, Bloomberg.

- Natural resources (NR) now have a growth element to them, but are still fairly inexpensive.
- Listed infrastructure (LI) and real estate (RE) remain beholden to the path of (still volatile) interest rates.
- We maintain our modest overweight to NR and our equal-weights to LI and RE in the Global Policy Model.

Base Case Expectations

Fundamental Downside, Sentiment Upside

Developed markets will see weaker economic growth in 2023 from cumulative central bank tightening, but sentiment should start to shift more favorably on a "plateau" in policy rates and lower inflation. Outside of the U.S., China reopening and less elevated energy prices help the balance of risks.

Watching Inflation

Central banks have communicated a slowing in rate increases to a plateau in 1H23, preferring to hold a sufficiently tight policy rate as opposed to continuing to hike. This reduces the risk of a policy mistake, and recenters attention more specifically on the path of inflation to determine the duration of restrictive policy.

Risk Case Scenarios

Labor Market Durability

More persistent tightness in the labor market leads to more stubborn core inflation, necessitating an unexpected monetary policy response that is negative for financial markets.

Eastern Threats

Ukraine war produces knock-on effects (food/energy shortages) that disrupt the global economy; China struggles to deal with (in order of importance) pandemic pressures, bad debt contagion and Taiwan tensions.

INVESTMENT PROCESS

The asset allocation process develops both long-term (strategic) and shorter-term (tactical) recommendations. The strategic returns are developed using five-year risk, return and correlation projections to generate the highest expected return for a given level of risk. The objective of the tactical recommendations is to highlight investment opportunities during the next 12 months where the Investment Policy Committee sees either increased opportunity or risk.

The asset allocation recommendations are developed through the Tactical Asset Allocation, Capital Markets Assumptions and Investment Policy Committees.

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Viewpoints reflects data as of 1/17/23.

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