INVESTMENT STRATEGY OUTLOOK

THE ECONOMY

January 2022

Meet The New Year, Same As The Old Year?

It may be a new year, but it kind of doesn't feel that much different than the last one. After all, 2021 started with consumers, businesses, and governments responding to a surge in COVID cases, and that is again the case as 2022 gets underway. Clearly, the pandemic, its impacts on consumers and businesses, and the policy responses to it were the main storylines of the U.S. and global economies in both 2020 and 2021 and, at this point, there seems little reason to believe 2022 will prove to be any different. Still, whether it feels that way or not, the calendar says it's a new year, which means it's time for us to look ahead at how we see the economy faring in 2022 though, admittedly, our outlook comes shrouded in a thick layer of uncertainty.

After what we expect will be full-year 2021 real GDP growth of 5.6 percent, our baseline forecast anticipates real GDP growth of 4.1 percent in 2022. As in 2020 and 2021, intra-year growth patterns in 2022 will be shaped by the course of the pandemic. The current surge in case counts is weighing on economic activity, though with very little January data at our disposal as of this writing, it is hard to quantify the effects. Still, our January baseline forecast anticipates significantly slower Q1 2022 real GDP growth than was the case in our December 2021 baseline forecast. What isn't clear to us is whether shifts in economic activity in response to rising, then falling, case counts will be the same, in terms of magnitude and timing, going forward as has been the case thus far. This is just one of many sources of uncertainty around our 2022 outlook.

As 2021 was coming to a close, there were signs that global supply chain and logistics bottlenecks were beginning to ease, and we expect further improvement as we move through 2022, with further easing of remaining constraints supporting stepped-up manufacturing activity. To that point, nonfarm business inventories were drawn down significantly over the course of 2021, and we anticipate restocking will be a meaningful tailwind for growth in 2022. Additionally, with production having been curtailed in 2021, manufacturers and homebuilders ended the year with sizable backlogs of unfilled orders and, with supply-side constraints easing, backfilling these orders will also be a tailwind for growth in 2022.

As the supply side of the economy normalizes further over the course of 2022, the demand side is being weaned from the considerable fiscal and monetary support seen in 2020 and 2021. Still, though to a lesser degree than was the case over the prior two years, fiscal policy and monetary policy will remain accommodative in 2022. With continued robust growth in labor earnings, a significant pool of excess saving, and healthy household balance sheets, there are plenty of supports for continued growth in consumer spending, though elevated inflation will likely weigh on growth in discretionary spending. With diminished affordability weighing on growth in demand and inventory constraints gradually easing, the pace of house price appreciation will slow, but we nonetheless expect double-digit growth in 2022.

If we are correct in expecting further easing of supply chain and logistics bottlenecks, that would contribute to a sharp deceleration in goods price inflation, if not outright goods price deflation. While that would act as a drag on overall inflation, we nonetheless expect faster growth in services prices, including rent and medical care, and continued robust growth in labor costs to keep inflation easily above the FOMC's 2.0 percent target rate through 2022. While we believe the FOMC will begin raising the Fed funds rate by mid-year, we also believe that the changing composition of the FOMC, including three new members of the Board of Governors, will act as a brake on the extent to which the funds rate rises during this cycle. It also seems likely that the FOMC will allow the Fed's balance sheet to begin winding down not too long after their monthly asset purchases come to an end in March. This would be a significant departure from the FOMC's playbook during the prior cycle, when the Fed's balance sheet was held steady for nearly three years after the asset purchases ended.

To be sure, the outlook we've outlined above seems too nice and neat in a world that, in case anyone still hasn't caught on, is seldom so. That raises the question of what could go wrong. At the risk of stating the obvious, the primary risk to the U.S. and global economies in 2022 remains the COVID-19 virus. To the extent global manufacturing and shipping hubs are subject to further spikes in case counts, any progress made in clearing supply chain/logistics bottlenecks could be quickly reversed, weighing on economic growth and keeping upward pressure on goods prices. It would seem foolish to presume that there won't be additional variants of the virus in the months (years?) ahead, meaning that how consumers, businesses, and governments respond is critical in determining the extent to which economic activity is disrupted.

While it seems clear that COVID-19 remains the biggest downside risk to our outlook, that doesn't mean it is the only downside risk. For instance, we and most others expect inventory restocking to contribute to real GDP growth in 2022. At the same time, we also respect how quickly inventories can swing, to the point that what begins as a restocking of depleted inventories turns into an inventory overhang, particularly when, as at present, businesses are unsure of the true level of demand. It is reasonable to wonder whether demand for goods is due for a "correction," given the extent to which pandemic-related transfer payments coupled with restrictions on many segments of the services sector juiced consumer spending on goods. Not knowing the true level of demand makes it difficult for firms to correctly gauge the appropriate level of inventories. If inventories become too swollen, that could quickly lead to sharp cuts in output and employment which, if of sufficient magnitude, could trigger a recession.

Additionally, should inflation prove to be more persistent than our baseline forecast anticipates, that could trigger a sharp decline in discretionary consumer spending, and could also trigger a sharp increase in market interest rates that would weigh on activity in interest-sensitive segments of the economy. We also worry that with the high level of debt in the non-financial corporate sector, particularly amongst companies at the lowest "investment grade" rating level, sharply higher interest rates and slowing economic activity could trigger payment stresses that could weigh heavily on business investment spending. Finally, the combination of elevated inflation and the FOMC moving to lessen the degree of monetary accommodation opens the door for a policy mistake, real or perceived, triggering swings in market interest rates that would impact the broader economy. ▲

Source:BEA; BLS; Federal Reserve; Institute for Supply Management

STOCKS

Constructive, But More Discerning In '22

2021 was a particularly profitable year for investors in U.S. stocks as well as in select European and emerging markets. While we anticipate gains for global stocks in '22, returns will likely moderate meaningfully, drawdowns will almost certainly deepen, and volatility should rise relative to recent investor experience. The first half of this year could bring additional upside for stocks as investor optimism surrounding a return to 'normal' and further easing of supply chain bottlenecks boosts spirits and investor risk appetite. The latter part of the year, on the other hand, could present a choppier, more uncertain backdrop for equity investors as global central banks shift further away from ultra-easy pandemic-era policies, an environment that could benefit 'defensive' and reasonably valued secular growth-oriented stocks. Should a sentiment shift and reallocation occur in the back-half of '22, investors taking a more discerning, valuation-aware approach should also benefit. Below we'll look at themes we expect to play out within equity markets in '22 and perhaps beyond, and potential implications for each of the four broader equity categories for which we publish capital market expectations.

The S&P 500 rallied 28.7% on a total return basis in '21 as an "everything rally" in the first half of the year gave way to a more challenging, albeit still profitable, backdrop in the back half as COVID variants delta and omicron led to fits and starts for the U.S. economic recovery and sector rotations within the S&P 500. Notably, the max peak-to-trough drawdown for the S&P 500 was just 5.2% in '21 as the "buy any dip" mentality that took root in 2020 continued to dominate investor psychology, limiting pullbacks and lowering volatility along the way. As we enter 2022, we are in more of a mid-cycle economic and market environment, a backdrop that should be supportive of improved relative performance for active managers relative to their chosen benchmark as a quality focus should be rewarded. In the initial stages of economic recovery, such as what investors experienced in the middle of 2020 through 2021, it's common for lower quality companies/stocks, which we define as less profitable and more heavily indebted companies with declining cash positions, to outperform as easy monetary

policies and an economic recovery prop them up and allow them to remain going concerns. However, as economic growth slows and monetary policies become less accommodative, which we expect this year, a bias toward 'quality' is often rewarded. Low debt/high cash, profitability (ROE, ROIC), and dividend growth/yield could be synonymous with outperformance over the coming year. After the rising tide lifts all ships-market of the past 21 months, diligence and selectivity will likely play a much bigger role in '22.

U.S. mid-cap stocks outperformed small caps in '21, but both cohorts underperformed the S&P 500. Entering last year, we expected real or inflation-adjusted yields to rise and corporate credit spreads to compress, which would, in theory, be supportive of share prices for smaller companies. In hindsight, we only got the corporate credit piece of the equation correct as 'real' yields dipped further into negative territory, which led the Russell 2500 to drastically lag the performance of the S&P 500 on the year. While there's often little difference between being wrong and being early in this business, we have reasons to believe we were just early and expect U.S. SMid to fare better relative to the S&P 500 in the coming year. 'Real' yields should rise as inflation moderates year over year and the Fed works toward policy normalization, while wage inflation, a major drag on profitability for smaller companies, should moderate somewhat due to a rising labor force participation rate. Mergers and acquisitions (M&A) activity could also act as a tailwind for SMid in the coming year as cash on corporate balance sheets remains elevated and could spur deal making in select pockets of the market. The Federal Trade Commission (FTC) has closely scrutinized recent deals due to anti-competitive concerns and has forced the break-up of a couple of larger transactions already, which may lead potential acquirers to look farther down the market cap spectrum for acquisition targets, benefitting SMid.

We remain constructive on international developed markets, favoring Europe, specifically, due to a combination of appealing valuations, relatively high dividend yields versus what can be found in the U.S., a cyclical bias to indices tied to the continent, and fiscal support provided by policymakers. Japan could also be poised to benefit as the Bank of Japan is in no hurry to tighten monetary policy to combat higher inflation, and additional fiscal stimulus appears likely. U.S. investors have been consistently underweight developed markets abroad over recent decades, which has proven to be a good call, but U.S.-based investors seeking relative value and yield from equities should kick the tires across the pond.

For emerging markets, the coming year could be a continuation of 2021's low return, higher volatility regime that generated a -2.2% total return out of the MSCI EM index. China and Brazil were big drags on the index in '21, with the MSCI China index down 21.7% and the MSCI Brazil index lower by 17.3% on the year. Weakness was partially offset by strength out of India, Russia, and Taiwan, which all saw 20%-plus gains during the year. In the coming year, we expect continued tightening of monetary policy out of emerging market central banks to combat rapidly rising food and energy prices, which should weigh on economic growth to varying degrees. Notably, we expect China to be an outlier in this regard as the country eases monetary policy further to combat slowing economic growth. However, while monetary policy should be supportive of equity prices/valuations, the country's no tolerance policy toward COVID-19 could weigh on growth and challenge global supply chains in the process as the omicron variant is likely to spread there in '22, preventing a full reopening of the country's economy.

We enter 2022 neutral across equity sub-asset classes relative to strategic targets; however, we expect opportunities to tactically tweak allocations to be presented over coming quarters as monetary policies are communicated/adjusted, global supply chain issues ease, and the global 'new normal' takes shape. ▲

Source: Bloomberg, Factset

BONDS

Another Challenging Year Ahead

While 2021 was a profitable year for investors in equities, it proved to be a difficult one for fixed income investors. The Bloomberg U.S. Aggregate Index (Agg), a proxy for diversified core investment-grade fixed income exposure, ended the year lower by 1.5%, the index's first negative return year since 2013. Investment-grade (IG) corporate bonds didn't fare much better as the Bloomberg Corporate index fell 1% as the longer duration nature of these bonds made the index more negatively impacted by rising interest rates in the belly (5 to 10-year area) of the yield curve throughout the balance of '21. We expect the longer duration profile of the IG corporate bond index to act as a headwind in 2022 as Treasury yields across the curve move higher amid FOMC policy normalization and moderating, albeit above-trend U.S. economic growth. This backdrop leads us to favor short duration IG corporate bonds relative to short-term U.S. Treasuries as investors can clip a modestly higher coupon with minimal price risk.

Lower quality, higher yielding bonds performed well last year, evidenced by the 5.3% total return generated by the Bloomberg U.S. High Yield index. The High Yield index has a duration of just 3.8 years versus 6.8 years for the Agg and 8.6 years for the Corporate index, thus an allocation to high yield bonds is one avenue for investors to clip a higher coupon while lowering interest rate sensitivity within their portfolio in the process. However, while the 4.6% yield-to-worst (YTW) on the High Yield index holds appeal relative to the Agg's sub-2% yield and the IG corporate index yield of 2.5%, yields on riskier corporate bonds remain paltry relative to historical levels and as the FOMC takes steps to normalize monetary policy, volatility in interest rates and wider credit spreads will likely follow. We expect true price discovery to return to the corporate bond market as the FOMC steps away from pandemic-era support, and credit risk could quickly become more appropriately priced via higher yields on corporate bonds, which would present asset allocators and active managers with a more appealing opportunity set as defaults should remain near rock-bottom levels throughout the balance of '22.

While early in the new year, 2022 has brought with it sharply higher yields on U.S. Treasuries and European sovereign bonds. The yield on the 10-year U.S. Treasury ended the first week of the new year higher by 21 basis points, while the 10-year German bund yield closed the week 25 basis points above its December 15 close. The pace of the year-to-date move higher in global sovereign bond yields has been unsettling for fixed income investors and has contributed to losses for fixed income indices early in the new year, a hole that will be difficult to dig out of as we expect rates to continue to rise, albeit at a more gradual pace, over the balance of 2022.

While it may feel like the time to make sweeping changes to fixed income portfolios, three simple concepts – diversification is key, know what you own, and boring is often best - that served us relatively well in 2021 remain top of mind for us, and we expect few near-term shifts to our preferred positioning. Specifically, we maintain a portfolio duration below that of our benchmark to limit interest rate sensitivity as we expect U.S. Treasury yields to rise in '22. We prefer short duration investment-grade corporate bonds relative to short-term Treasuries, maintain an allocation to lower quality high yield corporates in-line with our strategic target, and continue to bolt-on exposure to emerging market debt as a diversification tool. Stay patient and diversified as we expect more appealing relative value opportunities to be presented over coming quarters. ▲

Source: Bloomberg, Factset

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