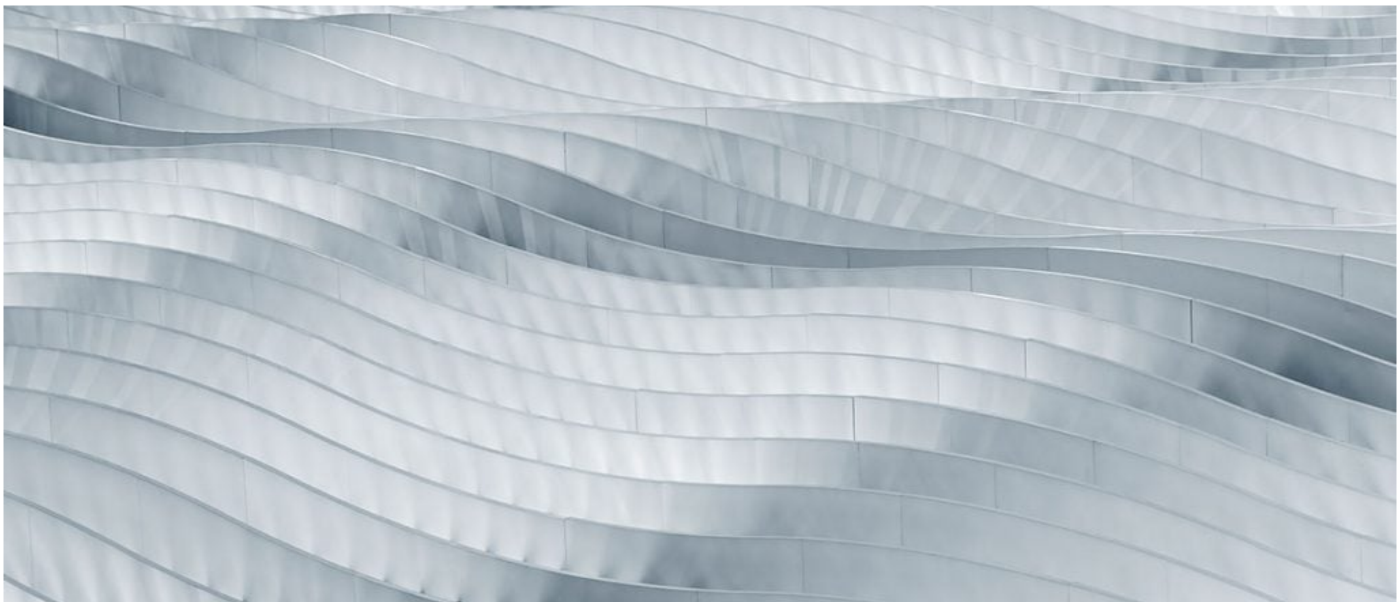
Sticky Inflation, Macro Growth Story Still Stands, Omicron Looms



2021 Year-End Report

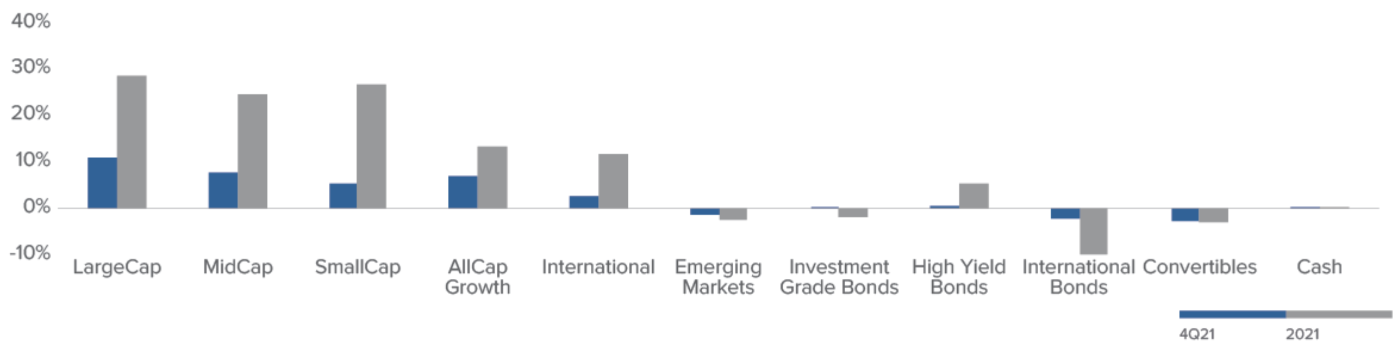
Risk on… but COVID-19 Continues to Dampen Optimism

Despite the Omicron scare, we expect the economic and societal effects of the pandemic to continue to dissipate with U.S. economic growth reaccelerating in early 2022. As consumer spending cools, and as tightening monetary policy and higher costs slowly trickle down and lighten America's consumption power, economic growth is likely to slow from elevated levels by the end of the year. We do expect some moderation in inflationary pressures but see prices continuing to trend above pre-pandemic levels for the entirety of the year. But even as emergency stimulus fades domestically and abroad, we expect another year of above-trend global nominal growth, with a more balanced momentum across developed nations and regions despite opposing regional monetary policies.

We expect most central banks to continue to normalize policies due to persistent above-trend inflationary pressure combined with stronger, more synchronized rebounds in global economic growth. Some nations, like China, will be aggressive with stimulus to combat other risks, while the Euro bloc is likely to see some tightening in the face of inflation. Domestic equity markets should continue to see relatively strong gains early in the year, even as volatility and unpredictability may increase. International equity markets should also experience above-trend returns, driven by gains in earnings expectations and reasonable valuations. There could very well be enough momentum to give this coming cycle a bit of pizzazz, albeit much shorter lived than the last.

Market Snapshot | Asset Class Performance

December 31, 2021



Large Cap
Large Cap – S&P 500

Mid Cap
Mid Cap – S&P 400

Small Cap
Small Cap – S&P 600

All Cap Growth
Russell 3000 Growth

International
International Equity – MSCI EAFE

Emerging Markets
Emerging Markets – MSCI Emerging Markets Index

Investment Grade Bonds
Bloomberg BCG/C

High Yield Bonds
High Yield Bond – BofA ML High Yield Master II

International Bonds
FTSE Non-U.S. WGBI Unhedged

Convertibles
Refinitiv Global Focus Convertible Bond Index

Cash
90-day U.S. Treasury Bills

Past performance is not indicative to future results. All information provided herein is for informational purposes only and is not intended to be, and should not be interpreted as, an offer, solicitation, or recommendation to buy or sell or otherwise invest in any of the securities/sectors/countries that may be mentioned.

Pandemic Notes

The coronavirus' impact and the growing Omicron threat cannot be ignored, but we shouldn't discount the growing number of vaccinations and increased herd immunity, which are likely to have an exponentially dampening effect on the impact severity of variants like Omicron and others which are highly likely to follow. That said, the path of the virus will continue to jolt domestic and international economies and policy.

Prior to the recent Omicron outbreak, most countries had relatively stable and/or declining trends in the number of COVID-19-related deaths and longer-term declining trends in overall cases worldwide. Ironically, the United States and Germany have been experiencing sharp increases since mid-year. As of the end of 2021, the CDC (Centers for Disease Control and Prevention) reported over 200 million Americans have been fully vaccinated, representing over 60% of the population, with 74% having received at least one dose.

Minors were responsible for a larger number of positive cases and spread in late 2021, but vaccines are now available for children age 5 and older. These new innovations and treatment approvals (which will continue to expand globally) should keep global trends of serious illness stable and hopefully back into decline. We expect to see other variants like Omicron manifest themselves and, in turn, trigger economically impactful responses, such as travel bans. But we also expect the severity of those reverberations to dissipate through the coming year.

And while the risk remains that variants may be resistant to vaccines, we believe that the rigor and spread of these variants should be able to be controlled in short order in most developed nations. Despite Omicron, consumers are resilient. Here in the states, we've seen continued strength in consumer spending and expect this activity to continue into the first half of 2022.

In a best case scenario, the Omicron variant's high level of transmission and lower level of severity may actually help pull forward the disastrous pandemic into a less concerning endemic, flu-like, virus — with the subsequent increase in population mobility.

Unfortunately, stubbornly high prices for just about everything is weighing both on the consumer and business landscapes alike. It's also pushing a very accommodative Federal Reserve to act quicker than most had anticipated. Frankly, we believe the Fed may have been a bit slow to act and their swift "catch up" actions could have negative effects if executed too aggressively; i.e., is more than two to three hikes over the course of 2022.

Government Intervention

Domestically, legislators and the White House have infused our economy with over $4 trillion in stimulus and other measures in response to the pandemic. Additional stimulus over the next 10 years is currently being pitched by President Biden as part of a retooled "Build Back Better" plan. The spending is expected to span many industries and is likely to have the greatest impact on high-tech developments, clean energy and domestic semiconductor production, as well as education and childcare. While it is nice to think about all the benefits of this added spending, funding is likely to come in the form of higher corporate and personal tax rates. The effects of potential tax hikes are yet to be seen, but alterations in the global corporate minimum tax, as well as intangible income tax increases are likely to add some headwinds to earnings.

The good news is that global leaders seem to have learned lessons from the Great Recession, which left growth in many areas languishing for many years in the 2010s. It seems that policy makers are more willing to tolerate higher inflation to keep accommodative policies intact longer; and in places like Europe, offer a more cohesive strategy that could help fuel growth in the coming cycle. And while many countries are diverging in their monetary policies, the world will be watching the Federal Reserve, the European Central Bank and the People's Bank of China for their respective responses and actions.

This tailwind lifted markets significantly as 2021 began, with equity markets reaching new heights and interest rates rebounding from depressed levels. The yield on the 10-year Treasury bond rose dramatically for the year, from 0.9% to 1.5%. As stronger economic data came in and systematic risk receded, GDP growth moved dramatically higher from the depressed, virus impacted, base level — to highest level in over 30 years. Businesses are reopening and outlooks continue to be for stronger-than-average growth ahead. The sharp increase in demand for consumer goods has seen shortages arise for components, like semiconductors, that have led to shortages and empty shelves. Automobiles have been impacted, for example, and demand for used vehicles saw prices significantly elevated. The "supply chain impact" from labor shortages and resurgent demand for some goods boosts inflation readings. Heightened inflation will likely prove a near- to medium-trouble, but time will tell as the world adapts to a post-vaccine world. Milton Friedman famously said, "Inflation is always and everywhere a monetary phenomenon in the sense that it is and can be produced only by a more rapid increase in the quantity of money than in output." We are currently engaged in a test of this proposition.

Interest Rates, Monetary Policy, Inflation

While accommodative policies remain in effect for most developed nations, there are shifts occurring as some of the world's greatest nations face unique struggles. In Europe, mounting headwinds (supply chain, energy prices and so on) have slowed what was a banner first half of economic growth. Expect a less hurried tightening of monetary policy there. China is also experiencing its worst economic slowdown since 2015, which many expect to be met with easier monetary policy. Domestically, high inflation readings and an extremely robust labor market seem to be driving a slightly more hawkish view. That said, we certainly face our own challenges. And while the Fed has begun to taper its securities purchases, we should see continued monetary support and modest rate increases starting in 2022. The stronger U.S. Dollar could impact S&P earnings negatively as roughly 40% of revenues are derived from outside our borders.

By the numbers, our economy is roughly 5.5 million workers short of pre-pandemic employment metrics; but the comparison isn't apples to apples, as many have opted to uproot and take a more entrepreneurial approach to work. This shift is evident as there are a record number of job openings and a record number of Americans still leaving their jobs (last half of 2021).

And since there are plenty of available workers who simply aren't committing to employment, businesses are having a difficult time hiring. This ever-tightening labor market is triggering much-needed wage increases in some sectors, while it could bring more inflationary pressures in others as low-margin businesses are forced to raise prices.

These inflation pressures are adding to other price increases brought on by supply chain woes and commodity/input price hikes across the global economy, equating to what's been a rather unexpected jump in price and reduction in inventories from homes to semiconductors, autos and more. And these employment/inflation dynamics are not unique to the United States. We are seeing job vacancies elevated across many developed nations, especially in leisure and hospitality. Labor shortages are certainly wreaking havoc across the globe, but also fueling innovation … which may eventually come back to bite would-be workers who've shunned employment.

But as the world continues to recover from this pandemic, and as prices and costs rise dramatically, the potential for central banks like the Federal Reserve to begin to taper their efforts could trigger volatility increases in both equities and fixed income. Equities appear well-positioned for continued improvements in earnings estimates while valuation multiples are supported by the current low-rate environment. Fixed Income may be a more challenging place, given the potential for higher interest rates as a headwind while credit spreads have tightened significantly, providing little potential offset. As always, there will be selective opportunities across asset classes for active managers to capture these mispriced securities. We will continue to look to emerging markets and lesser-known assets (e.g., SPACs) for opportunities.

The American Consumer

Consumers in the Game, but Enthusiasm Waning

Retail certainly bounced back in 2021, but while retail sales data appeared strong, consumer holiday spend comparisons were certainly not apples to apples with last year. We expect U.S. holiday sales to grow between +7% and 10.5% in 2021 to more than $800 billion. While online Thanksgiving sales were flat at $5.1 billion and Black Friday online sales dipped -1% from last year to $8.9 billion, flattish, yet stable online sales were more than made up for by higher in-store sales. Mass media is reporting a first-time-ever dip in ecommerce sales, but that data point is likely skewed as the 2020 shopping season was mired in lockdowns and real fear for consumers leaving their homes. In other words, 2020 was an abnormally prime year for digital.

U.S. mall Black Friday foot traffic rose +48% compared to last year though it still ran -28% below the 2019 level, leaving room for future gains. Another reason comparative Black Friday data may still look way off from pre-pandemic levels is the fact that retailers began promotions in late October and are likely to spread them out across the holiday season. All with the goal of reducing crowds on peak shopping days, while accommodating consumers' preference for social distancing. And just like so many "new normals," this stretched out sale method is likely to continue.

But make no mistake, this holiday season, like so many before it, can make or break a retailer's year. In 2020, the holiday shopping period between November and December accounted for 19.5% of total annual retail revenue, which totaled nearly $790 billion. Last year, ecommerce accounted for nearly 26% of all sales, and 79% of shoppers did not finish their holiday shopping until mid-December. Aware of the supply chain disruptions, taking advantage of the early promotions, and given the rise of Buy Now Pay Later (BNPL) services, 61% of U.S. consumers began their holiday shopping in October this year, up from 51% in 2020.

While consumers are enjoying higher wages, an abundance of jobs, a booming stock market and record housing prices, there are certainly drawbacks, such as inflation, poor service and pandemic fatigue, which are all taking their toll on the American psyche. Before Omicron data was even taken into consideration, consumer confidence from the Conference Board index dove to a nine-month low in October, with high prices and general stress around the pandemic as key drivers. The decline in the Conference Board confidence index followed an even bigger drop in the University of Michigan's gauge of consumer sentiment, which fell in November to a decade-low of 7.4, compared to a final October reading of 71.7.

The smaller decline in the Conference Board survey reflects the fact that this index places more emphasis on trends around the labor market, which has obviously been resilient.

The State of Employment

The labor market continued to see a dramatic improvement over the course of the year as the unemployment rate dropped from 6.7% in December 2020 to 4.2% by November 2021. While the economy added 6.1 million non-farm-payroll jobs, payroll employment remains 3.9 million below its peak in February 2020. Many Americans also decided to quit their traditional jobs or move into the "gig" economy. These trends, plus continued baby boomer retirement trends, shrunk the labor force by 2.4 million people compared to February 2020, sending the labor force participation rate lower to 61.8% from 63.3%.

This lack of labor supply combined with strong economic growth should allow unemployment to continue to decline rapidly in the coming year. We see the unemployment rate falling below 4% by mid-year. Wages in many sectors have been rising as companies compete to hire and retain a limited supply of workers.

Unfortunately, the pandemic, rising prices, dwindling customer service and continued social stresses have weighed on American consumers. While we believe that the pandemic should be mostly behind us by the end of the first quarter, there is a risk that another variant or spike in closures or travel limitations could upend a great deal of the momentum that the economy has been gaining and put future growth at risk. That said, government spending programs and a tight labor market should support consumers who opt to move back into the general labor pool for traditional work.

Real Estate Boom Continues (For Most)

For much of the country, 2021 carried on some peculiar trends that began to materialize the year prior. As the pandemic took hold, it triggered an unexpected restructuring of priorities for homeowners. City dwellers in hyper-dense urban areas like New York, Chicago and San Francisco fled for less-hectic, less-expensive environments and more space — now a necessity due to remote work. Some homeowners and renters alike decided that a move back in with the parents was a smart move to regroup until things got back to "normal."

The average homeowner, on the other hand, is enjoying all-time record home prices, with values logging an average 17% in gains over the last year alone (May data). In many areas, the price of homes is outpacing stubbornly high inflation two to three times or more. It's this hedge that will not only help keep homeownership growing, but also will entice those sitting on the sidelines to jump in. And while the Federal Reserve has signaled a taper in bond buying to begin this year, rates are unlikely to leap much higher over the next six to 12 months. This is good news for home prices. FOMO (fear of missing out) is likely becoming a real thing for millennials, which now constitute the largest home-buying population in America, some 72 million strong. The largest segment of the millennial generation is also about to reach the peak home-buying years, adding to the argument for continued upward price action.

With a median average new home price of $361,800 and an average of $428,700, prices are at the upper edge of affordability for many buyers. As interest rates creep slowly higher and as sellers feel the price mania settling down, it is probable that more homes will hit the market and put modest pressure on prices. We believe the action we are seeing now is one of capitulation by buyers. The 18-month-long widespread frustration of chasing home prices has simply tired many people out. Once sellers feel a little less emboldened and perhaps even a little FOMO themselves, we could see a bump in inventory, increased activity and some price stagnation.

The end of the mortgage forbearance program, bonus unemployment benefits and the moratorium on evictions should also add inventory as consumers realign their finances and assets. But don't get too excited for a price correction — analysts still see prices climbing another 3.2% or so by June 2022, and the spread of the Delta variant could slow the entire process by several months or more.

Emerging Trends

Higher inflation is altering society's behavior in ways that could become permanent, but on some levels, is supported (at least partially) by lawmakers and central banks as the last economic cycle was anemic at best. The typical thesis is that global leaders are willing to spur some real growth even if inflation runs much hotter than previous target trends. Obviously their tolerance, and consumers', can only go so far; and at some point will need to be reined in.

We don't see much evidence of inflation expectations becoming de-anchored in market-based and other measures so far. All told, inflation surprises have led economists to pull forward their Fed tightening timeline — with tapering now expected to conclude by March 2022 (much earlier than previously expected), likely followed by the first Fed rate hike in that same month. Towards the end of the year, it seemed markets were adjusting to increasingly less-accommodative Fed policy, but as tensions abroad grew and the realities of a less-than-easy money flow set in, equities threw a bit of a taper tantrum. The selling may present buying opportunities in select sectors and names, but there's likely going to be a rethink of just how much risk equity investors will be willing to take as the year progresses.

Unfortunately, the sticky and worsening inflation surge certainly has the potential to prove more persistent than many, including the Fed, had expected. There is a chance that economists and models aren't factoring in the potential for a 1980s-style inflationary spiral. Market-based measurements can be misleading and fixed income markets are likely distorted by the Fed's massive bond buying program. If inflation is not quelled by the Fed's anticipated action trajectory, there could be a greater risk to economic growth if dramatic anti-inflationary measures are taken. It could go as far as to throw the country back into recession. We believe the risk of this is relatively low, but it's critical that investors prepare at least a portion of their portfolios for added inflationary risk.

Expect increased volatility in global markets as uncertainty around the condition of the post-pandemic world continues to take shape. Companies and consumers alike will have to adjust, and the shifts that occurred in the investing landscape could linger for quite some time. "Winners" and "losers" within industries and sectors should provide long-term opportunities for active managers. The road to normal may be a long and winding journey for some companies while others find themselves emerging even better positioned than before the pandemic. We believe our approach of constructing high-conviction, bottom-up portfolios with strong risk management is well-suited to identify and capture these types of opportunities as the world recovers in the coming years.

The current market environment continues to produce dislocations in the marketplace with respect to valuation and increased levels of fundamental skepticism that play to our research and investment style strengths. As it has for over 30 years, our investment process continues to seek out mispriced opportunities where fundamental analysis can uncover value being missed in the current market environment while maintaining a strong culture of risk management with a focus on mitigating potential downside risks.

As inflation rises further in the near term and the Fed lifts off, we expect higher U.S. front-end nominal yields, reduced scope for sustained U.S. Dollar weakness, and outperformance of EUR credit spreads relative to their U.S. peers. And while this backdrop risks denting profit margins and equity valuations, our equity strategists believe that both should hold up reasonably well.

Key Observations Going Into 2022

We Remain Outlook Positive for Risk on Markets

Continue to See Equity Market Upside – While we expect the coming year's performance to be positive, but moderated (and with higher volatility), equity support will be provided by better-than-expected earnings growth, supply shocks easing, China/EM backdrop improving and normalizing consumer spending habits (e.g., spending broadening to services).

Credit Spreads Remain Range Bound – High commodity prices have been great for many balance sheets. Rising stars are likely to dominate the 2022 market narrative compared with the already frothy names that may be limited in upside. Investors are likely to see more opportunity in high yield than investment grade as shifts to higher quality continue.

Crude Oil Market Is Finely Balanced – Incredible OPEC+ market discipline offset by moderate but steady U.S. growth. Escape velocity to the upside was prevented by Delta and now Omicron variants (and there's likely to be more variant emergence). Geopolitical noise sets the stage for more volatility (with potential upside). Depending on the pace of interest rate hikes, a strong U.S. Dollar could also moderate a huge move to the upside.

Central Bank to Remain Accommodative – Despite Fed tapering, we should continue to see an administration and Federal Reserve leaning dovish for much of 2022.

Sectors to Watch – We remain positive on Energy and Financials, specifically E&P and Banks/Consumer Finance. Pharma/Biotech looks attractively positioned for defensive stance and positive catalyst on better than expected drug price reform. Tech should continue to deliver from strong fundamentals, but long duration may face equity multiple pressure from higher rates.

- Inflation-sensitive assets and sectors are good exposure if inflation trends continue rising.
- The key risk to this outlook is a hawkish shift in central bank policy.
- The pace and subsequent consumer behaviors around reopening play key roles in Real Estate Investment Trusts (from medical offices to malls) upside in income, but with increasing concern around rising rate impact.

Key Takeaways for the New Year

- Omicron is a natural evolution of an existing virus, not a new one. The acceleration of treatments, vaccines, immunity and the sheer consumer desire to get back to "normal" could lead to faster reopenings, not slower.
- Risk premium will remain suppressed. In other words, the excess you can earn for elevated volatility concerns is likely to be limited. This should support further capital appreciation and economic growth, especially as America's leaders are set to enact further stimulus in one form or another.
- Equity valuations remain supported by multiple factors, including low-long rates, elevated sidelined savings and improving corporate earnings profiles. There's a record amount of money at the ready in the venture capital and private equity arenas, signaling investors' healthy appetite for risk.
- Fixed income remains valuable as an insurance policy, but with unusual Fed support, alternative assets may offer better risk damping in a multi-asset framework.
- Inflation-sensitive assets and sectors are good exposure if inflation trends continue rising. We see this as a particularly interesting thesis to watch and explore deeper as 2022 comes into focus.
- Financials remain an attractive sector as rates rise. Look for banks and large financial centers with substantial trading or money management operations to continue to benefit.
- Underinvestment after changes to capital deployment led to oil capacity shortfalls. We expect energy prices to remain elevated and believe investors may want to allocate accordingly.

- Energy sector may additionally benefit from inflation trends and rising rates as well as yield-seeking behavior.
- Reopening plays in Real Estate Investment Trusts (from medical offices to malls) may offer upside from an income perspective, but increasing concerns around rising rate impacts can offset profit potential in certain structures.

Two Things to Remember in 2022

1

The market sees forward, not now. Most market participants are modeling six months to a year from current trends.

2

(Most) businesses don’t just sit still, they ADAPT to changes and market forces around things like taxes, business conditions and pandemic-related demand or supply abnormalities.

Tax Deadlines

Important tax notice for clients receiving Forms 1099 and K-1

IRS Form	Mail Date	Notes
1099-DIOB For dividend income, interest income, original issue discount and gains and losses	Late February through Mid-March	Certain securities in your account may be affected by information provided by third-party sources which may delay the target mailing date. Please note that the reporting of cost basis on securities sales is required for equities purchased after Jan. 1, 2011; mutual funds purchased after Jan. 1, 2012; and simple debt securities such as fixed-rate bonds, original issue discount (OID) bonds and zero-coupon bonds, options, rights and warrants acquired on or after Jan. 1, 2014. Form 1099-B (included in Form 1099-DIOB) reflects these reporting requirements.
1099-R Qualified retirement account	January 31, 2022	

K-1 Common trust fund	Late February through Mid-March

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