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ECONOMIC OUTLOOK 2022

An Indepth Forecast of the Year 2022

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2021 Recap

The Federal Reserve (Fed) policy uncertainties and COVID-19 and its variants were the two elephants in the room in 2021. The first part of the year saw considerable gains in the market because of the rollout of the new vaccines and the Federal Reserve's easy monetary policy. Market volatility was enhanced as a sector rotation to cyclical stocks from technology stocks and a change in market leadership from growth to value and large to small took place.

With the Delta variant's arrival in the summer and a more hawkish tone of the Fed, market volatility spiked again. The talks of Fed tapering in late summer and rising inflation numbers were significant factors in the September market correction. The fourth quarter saw a big rally sustained by favorable COVID-19 trends, the potential for a second economic reopening, and corporate earnings exceeding expectations.

Additional tailwinds were provided by the passage of an infrastructure bill, the well-telegraphed Federal Reserve's tapering, and the easing of some tax increase anxieties.

The bond market was a roller coaster, as the yield on the U.S. 10-Year Treasury spiked earlier in the year, reaching a post-pandemic high of 1.75% in March then plunged during the Delta wave and rose again in October. When yields fall, bond prices go higher.

Overall, in 2021 the U.S. economy moved back towards normalization with solid gains in growth and employment. Despite the Delta variant, the Federal Reserve policy transition, and inflationary pressures, the market continued to reach new highs. The Russell 3000 Index, a broad measure of the stock market, rose by 25% and reached an all-time high on November 5, 2021, and the tech-heavy NASDAQ posted an all-time highs on November 22, 2021.

During the year, large growth and small value were the relative winners with the majority of smaller stock outperformance coming in the first quarter. U.S. stocks bested International stocks by a wide margin. The cyclical sectors (Consumer Discretionary, Financial, Energy, Industrials) and Information Technology outperformed. The U.S. Dollar and cryptocurrencies shined while gold and silver lost some of their luster.

COVID-19

After wreaking havoc on the financial markets in 2020 and once again in 2021 with its Delta variant, COVID-19 is defying predictions again. The U.S. still has a high number of unvaccinated and the medical establishment is finding a waning effectiveness of the vaccines. Furthermore, the weather (winter) as a critical element in transmission and the fact vaccinated or not, you still can transmit the virus are all factors that make the pandemic trajectory problematic. As we prepare this document, the lasted variant, Omicron, is scaring investors while researchers try to understand it.

As Europe enters its fourth wave, some countries are registering the highest infection rate since the pandemic started. The lockdown in Austria and possibly in Germany is causing the rest of the world to be worried. In Austria, 66% of the population has been vaccinated compared to 59% in the U.S.

Rising infections and outbreaks in states with high vaccination rates are concerning.

However, we do see some very good news. The current wave is not likely to require lockdowns in the U.S. because of declining death rates and the recently announced treatments in pill form from Merck and Pfizer.

Economy

In 2021 the U.S. economy experienced a surge in economic growth, especially in the year's first half. The macroeconomic environment has been robust over the last several quarters, but it has not been smooth sailing for every sector.

The uptick in COVID-19 cases in the late summer months dampened growth. The impact could be felt as data lagged expectations and analysts cut growth estimates for the quarter. In fact, the 3rd quarter of 2021 saw estimates cut in half, which ultimately led to downward revisions for the entire year.

The latest data from the Bloomberg Economic Surprise Index shows recent market data has been outpacing expectations. The data has been more robust than expected and indicates solid growth down the road.

However, the consumer remained resilient as excess savings helped the retail and housing markets. Additionally, companies experienced a strong rebound in revenue and profits compared to the prior year. Overall, 2021 experienced the most robust economic growth in decades.

As we head into 2022, our outlook for the economy remains strong as the U.S. economy progresses through the re-opening and continues to deal with COVID-19.

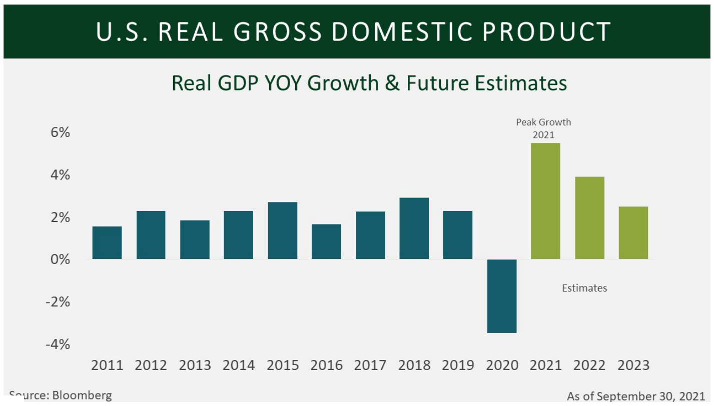
Strong demand from consumers with ample funds along with fiscal stimulus should be the tailwinds to economic growth expansion in 2022. Even though the economy is still on a robust trajectory, it will be growing at a slower pace than in the last few quarters since the current data suggests the U.S. is firmly within the mid-cycle.

Factors Driving Mid-Cycle Growth

Several economic factors often characterize mid-cycle growth. These include peaking economic and earnings

The latest data from Bloomberg shows the final estimate for 2021 real Gross Domestic Product (GDP) growth to be 5.5%, the strongest in decades. However, final growth projections for 2021 are being shaved a bit and the latest forecasts for 2022, while still favorable, show annual growth slowing to 3.9%; prior readings were near 4.3% just three months ago.

Fortunately, investors should still be pleased with the economic growth going forward; however, they may need to lower expectations.



Profit growth is also showing signs that it has likely peaked for the recent cycle.

Credit conditions and stress in the financial sector do not appear to be headwinds at this time.

Recent data from the Federal Reserve show bank credit growth has been rising over the past several months. The Chicago Fed National Financial Conditions Index shows conditions are less restrictive than on average. Further, the St. Louis Fed Financial Stress Index points to below-average financial stress. All of these bode well for economic growth in 2022.

Consumer Spending

Consumer spending represents roughly 2/3rd of the U.S. economy and has been a key driver in the recovery. Extra benefits and fiscal stimulus supplied additional funds for consumers and helped them build excess savings while still possessing plenty of disposable income to spend. Some spending has been pulled forward, but we will likely continue to see pent-up demand strong next year.

The unemployment rate is falling and the trend in continuing jobless claims is the lowest since the start of the pandemic. Wages are increasing across the job market and could provide a boost to the consumer.

We do note one surprising headwind: dismal consumer sentiment from the University of Michigan Consumer survey. Consumer sentiment has fallen nearly 25% since earlier this year. The Delta variant and inflation were likely contributing factors to the decline. Hopefully, we will see this reverse soon and if it does, it should provide a nice boost to spending. Leisure, travel, and entertainment could be just a few industries where growth outpaces the general economy.

Manufacturing and Services

Manufacturing is an area that has not recovered entirely but continues to slowly improve as bottlenecks loosen and companies look to build inventories. The COVID-19 Delta variant and the supply chain issues have been just a couple of the significant headwinds the manufacturing sector has experienced over the past year. There is good news about the supply chain, with early signs the bottlenecks are easing.

We have seen truck tonnage increase over the past couple of months after falling in the summer. Shipping costs for ocean containers appear to have peaked and are reversing from the highs seen just a few months ago. This should bode well for manufacturing and the consumer and could help to ease the rising costs many have experienced.

Further, the service sector is a bright spot for economic growth. The survey from the ISM (Institute for Supply Management) shows the Service PMI (Purchasing Managers' Index) near record highs. Of the 11 factors the survey follows, seven are growing and the overall picture paints strong growth for this part of the economy, consistent with 3.5-4% growth in the overall U.S. economy.

Earnings

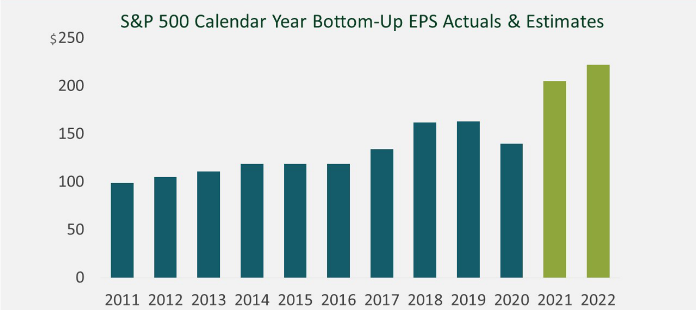
The year 2020 was marked by stock market Price/Earnings (P/E) expansion as stock prices soared in anticipation of an earnings recovery. The recovery materialized in 2021 with record profits. As a consequence, valuations have compressed as companies delivered in 2021.

Earnings growth peaked in the 2nd quarter of 2021 and the growth rate has moderated since then. The unusually high earnings growth rate is due to a combination of higher earnings in 2021 and a more straightforward comparison to lower quarterly earnings of 2020, caused by the negative impact of COVID-19 on a number of industries.

Nevertheless, 2021 earnings seasons have delivered solid beats in revenues and earnings, propelling equity performance. A strong earnings backdrop and rising profit margins have insulated equities against rising inflation fears and more hawkish central bankers.

The easy comparisons are behind us, and the drop in manufacturing new orders often leads decline in large-cap earnings growth. Still, we believe earnings and profit margins should remain healthy compared to historical averages.

BOTTOM-UP EPS ESTIMATES: CURRENT & HISTORICAL



Source: FactSet
As of September 30, 2021

Generally, corporate margins are holding up well. Most companies have learned to operate more efficiently during COVID-19 and captured long-term expense savings. With revenues snapping back, pricing power high and lower expenses, profit margins have increased significantly.

The relevant question for 2022 is "Will expected elevated inflation erode these record-high margins?"

The current inflation surge is due to unprecedented demand for goods that has surpassed the ability of supply to keep pace, especially as the pandemic introduced disruptions in the global supply chains. However, we believe inflation will moderate in 2022 as supply chain problems get worked out and consumer spending cools off from such an extraordinary level.

Additionally, wage growth has been a headwind to profits as labor costs increased for most industries. We believe labor participation will increase as consumers' excess saving is spent, leading to more normal wage growth and abating the threat to profit margins. Companies have also been raising prices indirectly via shrinkflation (smaller quantities for the same price), reduced incentives, and membership fees.

In sum, we think companies with pricing power will weather the storm and pass some of the increased costs to consumers, resulting in lower but above long-term average profit margins. Further, we believe 2022 should see solid earnings growth as the recovery continues, albeit at a slower growth rate than 2021, and earnings should continue to be a tailwind to the bull market in stocks.

The Federal Reserve

Over the years, the Federal Reserve gained responsibilities such as supervising and regulating banks, maintaining financial stability, and acting as a depository to U.S. banks. However, their primary goals remain what is often referred to as the Fed's "dual mandate": maximize employment while keeping stable prices.

The Fed has several tools at its disposal to try and accomplish its goals. The Fed Funds Rate is the traditional method of raising and lowering short-term rates to achieve its mandate.

As recently as 2008, the Fed added Quantitative Easing (QE), i.e., buying U.S. government securities, to its toolkit. When the COVID-19 pandemic began, the Fed utilized both of these techniques. Now that we are well along the way into the recovery, the Fed has decided to ease up on one of them.

The Fed started to 'taper' their asset purchases. It had been purchasing $120 billion in Treasury and Government asset-backed securities monthly. It is now dropping that amount by $10 billion a month in Treasury and $5 billion a month in asset-backed securities.

Should the Fed follow this steady path, the plan should be phased out by late June 2022.

The Federal Reserve does not want to put their foot on the brakes but instead only take their foot off the gas. Tapering accomplishes the first step of ending further easing; however, it does not want to move too fast and bring the economy and hiring to a halt. This is why it has maintained its dovish stance, being less inclined to increase interest rates.

At this stage in the game, the Fed does not want to surprise the market but instead be very transparent. Its Dot Plot is one method in which it gives its market predictions on rates well in advance. Each dot represents the view of a Fed Policy Maker for the rate's target range for each given year. The current plot shows nine members are in favor of an increase in 2022 while another nine are in favor of keeping rates the same.

While there is no clear majority in favor of hiking or staying put, the market seems to feel the Fed will increase rates in 2022.

When examining the Fed Funds Futures market, we can see investors are pricing in two potential rate hikes by July 2022.

Fortunately for those who like to "Fed Watch," there will be plenty of opportunities to give a heads up if they decide to increase rates. There will be several updates to the Dot Plot before action would take place. Also, the Fed Chair, Fed Governors, or Presidents will all have the chance to speak in public. A few have already suggested the labor market will improve by summer 2022, and at that time, it may be appropriate to normalize interest rates. Today, the headlines are more focused on inflation and its impact on the trajectory of a normalization of interest rates.

Inflation

Inflation has become a “hot button” issue in America.

Inflation, of course, is when consumers have to pay higher prices for the same product (or have the same price buying a smaller quantity).

Save for a brief period in 2008, most Americans under the age of 50 have not seen inflation, as measured by the Consumer Price Index or CPI, top the 5% level until this year.

What causes inflation? Generally, inflation occurs when we have too much money chasing too few goods. Indeed, we currently have a case for the economy having “too much money” in the system.

The Federal Reserve’s Balance Sheet, which was under $1 trillion until 2008, is now OVER $8.5 trillion as the Fed has essentially printed money. Additionally, Washington created a high level of fiscal spending.

Like many central bankers, some economists suggest the current high inflation situation is temporary or “transitory”. They advise that as the labor market and supply chain normalize, we will find no structural problems and inflation will quickly return to lower levels.

However, others believe the inflation issue will remain problematic for longer than expected. Which group is right? Time will tell, but the “inflation is permanent” camp has several factors going for it.

First, the argument that inflation is now happening only in sectors of the economy heavily impacted by pandemic is starting to lose ground. These sectors include new and used cars, leisure and hospitality, and gasoline items. But no longer is inflation compartmentalized to a few areas like gasoline and cars. Instead, October saw annualized gains of 4% or more in everything from meat, poultry, and eggs to auto maintenance, electricity and even dining out (if you can find a restaurant that has been able to find servers).

Second, the areas of the economy heavily impacted by the pandemic which experienced a massive run-up in costs are not seeing the costs moderate as they expected. Used car prices are off their peak but are still historically elevated. Another example is durable goods prices, which are still growing at 8.7% year-over-year per the latest October release.*

Third, inflation expectations by households are now running at their highest levels in years. Further, many businesses are reporting that they expect to pay and charge more in the future. Historically, inflation expectations have been a major variable in the Fed’s decisions on interest rates.

Fourth, wage growth is often a cornerstone to future inflation. The labor market is very tight, as indicated by the quit rate. Companies mention they are struggling to find workers and emphasize the need to increase pay to entice new workers. Indeed, the wage and salary component for civilian workers recently saw a record jump.

Taken together, it seems the “permanent” camp’s hard data inflation indicators suggest elevated inflation levels will be with us for some time.

What is different with this round of inflation, though, is much of it is coming from the high demand / low supply dynamics. This is significant. When a very loose monetary policy is the main inflation driver, the Federal Reserve can use various tools like raising the Fed Funds Rate to tame the beast. Unfortunately, some of the supply chain problems are out of the Fed's controls and its toolkit has limited impact on supply dynamics.

We find, for example, the Institute of Supply Management (ISM) Service Sector and the Manufacturing Sector Inventory Sentiment levels are near record lows. Also, their Backlog of Orders are at close to record highs as businesses simply do not have the supply to meet needs.

According to the National Federation of Independent Businesses (NFIB), most small businesses are declaring they are dealing with higher prices. While this data is disquieting, there are some signs of relief.

Bloomberg News reports that the number of import containers at the Port of Los Angeles has fallen 30% since the last month. This recent decline is also reflected in the container price from Shanghai to Los Angeles.

Recently, Morgan Stanley announced the auto chip shortage, which has plagued auto manufacturers, should now be in the rearview mirror. They note Malaysian fabrication plants are now back to 100% of operations and cloud data center server deliveries are improving. Toyota said it would begin making up for shortages in December 2021, with Japanese factories returning to normal for the first time in seven months.

Looking at the coming year, it seems likely inflation will remain an issue for most households. Inventory levels are low and items on the shelves are sparse. Thanks to a high period of savings and successive fiscal packages, many consumers have ample cash. With a return to normalcy, following the worst of the pandemic, many individuals will wish to spend. This will keep pressure on companies to produce more and likely result in high prices.

While less effective in fighting "supply" based inflation, the Fed will likely look to fight inflation by furthering their Quantitative Tapering and potential rate hikes. Already, the market has priced in an 80% likelihood of three rate hikes in the coming year.

Overall, the good news is conditions are improving. As such, we believe inflation should top out by mid-2022 and head lower during the 2nd half of the year.

SUPPLY CHAIN LIKELY TO IMPROVE

* Source: Bureau of Economic Analysis (BEA)

Labor Market

Over the past several months, a growing number of Americans have voluntarily left their jobs, more than 4.4 million alone in the month of September. Workers have been demanding better working conditions, the ability to work from home, and above all, higher wages. Many of those who quit their jobs immediately moved into a new yet similar position with higher pay, especially in the leisure and hospitality industries. New hires are forcing employers to increase the pay of their existing workforce as well. As such, wages have grown by 4.9% over the past year.

The labor force participation rate, a measure of those working compared to the total population of those of working age, is at 61.6%. The number has been steadily improving; however, it is still below the pre-pandemic level by 1.7 percentage points. Even as people are heading back to work, there remain 1.4 job openings per unemployed person. (U.S. Bureau of Labor Statistics)

As we continue to see the U.S. economy further open up, we expect to see more and more individuals head back to work. That rate may quicken should vaccines prove to be safer and more effective, in addition to the news of a pill to reduce COVID-19 complications. People with health issues may no longer need to fear heading back into the workplace, allowing the unemployment rate to fall even further.

Bond Market

The recent volatility in the bond market resulted from the Fed's decision and pronouncement as they tried to achieve their dual mandate. As we said earlier, the Fed is about to start tapering its bond purchases.

For those who insist tapering is terrible for the bond market, we suggest reviewing the taper of 2013-2014. The rough patch for the bond market occurred when then-Chairman Ben Bernanke began talking about tapering in Congressional testimony. Rates moved up about 100 basis points (bps) or 1 percent in the months following those talks.

That is in sharp contrast to what occurred once the Fed began the taper. Once they cut the amount of bonds they were purchasing, rates actually went down. From the time the Fed started their taper until they finished, rates on the 10-Year Treasury note declined a little over half percent. In other words, yields rose when they talked about tapering and actually fell when they took action.

With the constant fear of COVID-19 variants bringing about another shock wave, investors may still have a place for high-quality Treasury notes and bonds. Coupled with the potential for declining rates as the taper is implemented, we believe the bond market may do well.

Perhaps the worst situation for the bond market would be one in which inflation continues to run hot while the Fed focuses too much on the job market. Should an extremely dovish Fed misjudge inflation, investors may be fraught with fear real returns would diminish.

In March and April of 2020, a large number of corporations were caught off guard when the COVID-19 shutdown occurred. With one fell swoop, many of those with large amounts of debt were suddenly downgraded from investment-grade into high yield or junk status. More than 18 months later, we may be in the midst of just the opposite.

Earnings have been strong, which has helped with cash flows. At the same time, balance sheets are much improved with more significant cash balances.

We are presently seeing approximately two upgrades for every downgrade, bringing these fallen angels back into investment-grade status. We believe this could be one of the better areas of the bond market in the coming year.

One other segment of the bond market we like is U.S. Senior Loans. Many of these loans are floating-rate assets, and therefore, if interest rates move up, the bondholder receives additional interest.

Should the default risk remain low due to strong corporate earnings, this market sector may not be negatively impacted by higher interest rate risk.

Warning Signs About Near-Term Outlook

Risk Appetite

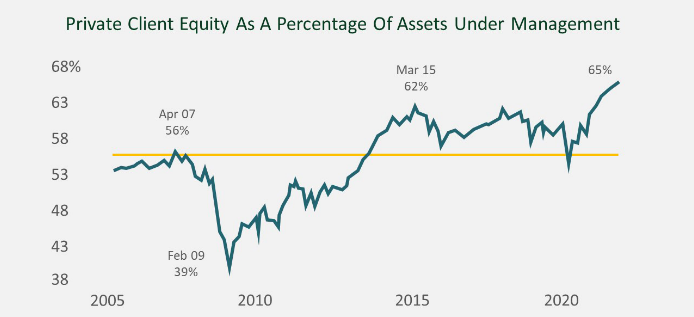
Two primary emotional conditions impact the financial markets: Greed and Fear. Sometimes when emotions are overwhelmingly in one camp, the markets will move in the other direction.

As such, some worrisome signs suggest risk appetite is presently too high. It is understandable as the S&P 500 has hit record highs 66 times this year.

Consider looking at fund managers and where they are positioned. In their November survey Bank of America finds the number one most overweight category to be equities (and most underweight are bonds).

Nor is equity popularity limited to fund managers. A review of Merrill Lynch's private clients suggests they presently have over 65% of their portfolio in equities. This is an all-time record high.

RISK ON!



Source: BofA Global Investment Strategy

As of October 31, 2021

CNN tracks a number of factors to determine whether the market is trading under fear (a good time to buy) or greed (usually a time for caution). Their recent results suggest the market has extreme greed.

Speculators often use options to leverage their bets. We can follow this by looking at the Put-to-Call ratio. When the ratio is low, it suggests a relatively high level of calls or bets the market will go higher.

Recent numbers suggest investors are the most optimistic they have been in years.

Finally, we can look at a number of surveys and see what they suggest. These surveys include those performed by the American Association of Independent Investors (AAII) and Investors' Intelligence (II). Both are showing increasing levels of highly bullish sentiment, a worrisome sign.

Other indicators, like the low levels of the VIX "fear" gauge, suggest too many investors are in the bullish camp. This can make the markets ripe for increased volatility and why current investors should exercise a modicum of caution.

Energy

Our research suggests energy prices should stabilize in 2022. Geopolitics, pandemic flow, and unsynchronized economic growth in different parts of the world could be significant themes driving energy prices and equities in 2022.

We could see increased volatility as a potential winter COVID-19 wave and a coordinated strategic oil reserve release weigh on prices and sentiment in the short-term. However, we believe the subsequent economic recovery should make any potential weakness a buying opportunity.

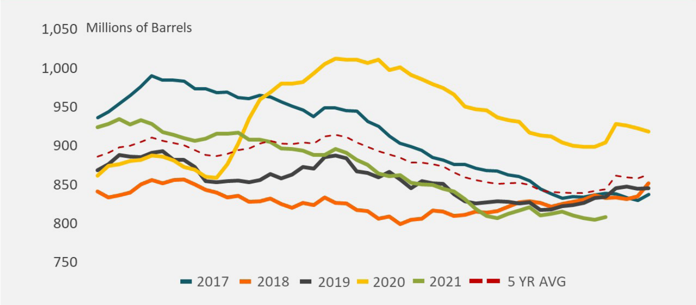
Supply chain problems hurt oil demand as tankers and trucks stay idle longer than usual. Additionally, COVID-19 lockdowns lead to oil demand destruction, especially from any major consuming country.

Nevertheless, there is a chronic capital expenditures (CapEx) underinvestment within the industry. The oil majors and smaller oil producers are initiating buybacks and paying dividends instead of exploring and drilling for more fossil fuels.

There are two reasons for this. First, the collapse in oil prices in 2014 due to the tremendous oil supply has taught oil producers to balance supply and demand instead of their prior "drill-baby-drill" mentality. The other is an environmental headwind. Oil and gas projects require substantial upfront costs and companies are reluctant to invest, only seeing oil demand potentially lessened by clean energy sources. These two factors are very bullish structural drivers for oil prices.

Plus, oil and finished product inventories are at a record low. The economic recovery and restocking of manufacturing and consumer merchandise/inventories will require a tremendous amount of energy, which is another underpinning of demand.

U.S. INVENTORIES FOR CRUDE AND OIL ARE AT RECORD LOW



Source: U.S. Department Of Energy (DOE), Bloomberg

As of November 26, 2021

In the natural gas markets, prices have been skyrocketing as the gas market continues to tighten. Recently, it was cheaper to generate electricity by switching to oil or coal from natural gas. This gas to oil or coal switch is a further tailwind to both oil and coal markets.

Even though the energy sector accounts for only a small part of the overall stock market, it accounts for an outsized portion of market volatility. Therefore, the sector is of crucial importance to the volatility picture.

Geopolitics plays an important role in the energy sector. OPEC (Organization of the Petroleum Exporting Countries) and Russia are important producers as U.S. majors and shale players shy away from production amid shareholders' pressures and environmental headwinds.

Consuming countries such as the U.S., China, Japan, and India have tried, with limited success, to pressure the cartel to increase production to ease prices. The limited success has led the consuming countries to initiate a coordinated strategic reserve release. We think this is a short-term solution that will impact the market, but the major factors mentioned above will still be the drivers in the months ahead.

On the other hand, we still believe the world is moving to clean energy. However, the transition will take time. The lack of investment in traditional oil and gas projects and the state of clean energy sources, such as wind and solar, may keep prices higher. These renewables have an intermittent and unreliable nature, and the lack of technology for large-scale energy storage also should keep a healthy bid for traditional oil and gas prices and energy equities for some time.

This does not mean investors should ignore the clean energy sector. After all, there are estimates the sector will get $3 to 5 trillion per year of investments in the next 30 years. To play this, we think investors should look for enabling-technologies companies instead of clean energy utilities that install solar panels or wind farms. It is much like the gold rush, "when everybody is digging for gold, it's good to be in the pick and shovel business". An example of the enabling-technologies companies is a one that provides micro-inverters that change electricity from D.C. to A.C. for solar panels.

In sum, we believe investors should stay invested in traditional energy while having exposure to clean energy in 2022.

Conclusions

First of all, investors, including ourselves, should be humble predicting the future in these unprecedented times. COVID-19 and its many variants is a wild card that has thrown wrenches in many forecasts. The key in this uncertain environment is to be agile, have contingency plans, and most importantly, be well diversified.

Nevertheless, our current assessment is 2022 should be a good year for the economy and the stock market. We should see growth decelerate from the 2021 level, but the economy should still deliver above long-term average GDP growth. We are predicting a similar trend for earnings. The continued re-opening, the labor market recovery, and the infrastructure fiscal spending should provide the tailwind for this growth. In addition, the inventories rebuilding cycle, the healthy consumer balance sheets, and rising corporate profits are all additional drivers of our forecast for a better-than-average economy in 2022.

In 2021, higher consumer demand powered by stimulus packages and supply chain problems resulted in the highest inflation since the 1980s. We believe inflation will continue to be high in the first half of 2022 but will moderate in the latter part of 2022 as demand for goods moderates to more normal levels and supply chains problems dissipate.

Further, we observe the U.S. economy has entered the mid part of the economic cycle. This improving economic activity is good for risk assets such as stocks. However, we believe equities have become very sensitive to extraordinary levels of easy global monetary policies. In 2022, the monetary conditions will be less supportive, and hence investors should expect a high volatility year for risk assets such as equities, commodities, and cryptocurrencies.

In light of these developments, we believe investors should stay invested in stocks but favor large over small market capitalization, quality over high-beta stocks, and overall stay balanced between cyclical/value and secular/growth stocks. In rising inflation, companies with pricing power should do well. The high growth stocks with lofty valuations and no earnings are an area to avoid. These are the most sensitive stocks to the less-accommodative Federal Reserve in 2022.

In the bond market, the investor should keep duration lower than normal and favor short-term dated bonds as the Federal Reserve embarks on its interest rate tightening cycle. We expect the Fed to end the tapering of its Quantitative Easing program by the 2nd quarter of 2022 and potentially start the hiking cycle in the summer or fall of next year, depending on inflation and economic data. Moreover, we like short-term investment-grade corporate bonds, Treasury Inflation-Protected Securities (TIPS), floating rates bonds, senior and banks loans within the bond market.

There are risks to the above outlook, mainly COVID-19 developments and inflation becoming more structural than cyclical. Consequently, the Federal Reserve could tighten rapidly to fight it, pushing the economy into a subpar growth environment or even a recession.

Any COVID-19 variant disruption in 2022 will exacerbate the supply chain problems around the world and accelerate inflation even further. These disruptions increase the COVID-19 mobility restrictions, hurting economic momentum and putting the economy into a stagflation (high inflation, subpar growth) environment.

Even though these risks need to be monitored, they are not our base case. We believe 2022 will be volatile but still a good year for the economy and risk assets in general.

For Investors:

Equities

– Earnings gains above average, but less than 2021
– Inflation boosts companies with pricing power
– Mid economic cycle: favor quality companies, large over small
– Stay balanced between cyclical/value and secular/growth stocks
– Increase in interest rates: headwinds for technology sector
– Expect volatility but positive year overall

Fixed Income

– Expect volatility (Fed balancing act)
– Muted returns
– TIPS (Treasury Inflation-Protected Securities) may do well if inflation rises
– Favor Corporate bonds with healthy balance sheets
– Keep durations modest and favor senior loans, floating rates and bank loans

What Can Go Wrong

– Another COVID-19 variant becoming more transmissible and deadlier; leading to major lockdowns around the world (Not likely in the U.S., more likely in Europe and Asia)
– Inflation more persistent well into 2022
– Federal Reserve policy mistake: tighten too early, only to see inflation moderate. The tightening could hurt economic growth.
– Risk appetite too high
– Extreme valuations
– Massive deficit and debt as interest rates rise

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Disclosure

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Past performance is no guarantee of future results.

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Definitions

Quantitative Easing: a course of action undertaken by the Federal Reserve to increase the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity.

Basis Point: one hundredth of one percent, used chiefly in expressing differences of interest rates.

Treasury Inflation-Protected Securities (TIPS): A type of Treasury security issued by the U.S. government and are indexed to inflation in order to protect investors from a decline in the purchasing power of their money.

Growth: A company stock that tends to increase in capital value rather than yield high income.

Value: A value stock is a security trading at a lower price than what the company's performance may otherwise indicate.

Federal (FED) Funds Rate: the target interest rate set by the Federal Open Market Committee (FOMC) at which commercial banks borrow and lend their excess reserves to each other overnight.

Quantitative Tapering: refers specifically to the initial reduction in the purchasing of and accumulation of central bank assets.

Put-to-Call Ratio: a measurement that is widely used by investors to gauge the overall mood of a market.

U.S. 10 Year Treasury: a debt obligation issued by the United States government with a maturity of 10 years upon initial issuance.

Price/Earnings Ratio: ratio for valuing a company that measures its current share price relative to its earnings per share (EPS).

Asset Backed Security: a type of financial investment that is collateralized by an underlying pool of assets.

Fed Funds Futures: financial contracts that represent the market opinion of where the daily official federal funds rate will be at the time of the contract expiry.

VIX: a real-time index that represents the market's expectations for the relative strength of near-term price changes of the S&P 500 index (SPX).

Capital Expenditures (CapEx): funds used by a company to acquire, upgrade, and maintain physical assets such as property, plants, buildings, technology, or equipment.

Beta: a measure of a stock's volatility in relation to the overall market.

*Consumer Price Index (CPI): an index of the variation in prices paid by typical consumers for retail goods and other items.

*NASDAQ: a global electronic marketplace for buying and selling securities.

*Russell 3000 Index: a market-capitalization-weighted equity index maintained by FTSE Russell that provides exposure to the entire U.S. stock market.

*Bloomberg Economic Surprise Index: shows the degree to which Street economists either under- or overestimate those top-tier indicators posted in ECO .

*Chicago Fed National Financial Conditions Index: provides a comprehensive weekly update on U.S. financial conditions in money markets, debt and equity markets and the traditional and "shadow" banking systems.

*St. Louis Fed Financial Stress Index: measures the degree of financial stress in the markets and is constructed from 18 weekly data series, all of which are weekly averages of daily data series: seven interest rates, six yield spreads, and five other indicators.

*S&P 500 Index: S&P (Standard & Poor's) 500 Index is a market-capitalization-weighted index of the 500 largest U.S. publicly traded companies.

* Indexes are not managed. One cannot invest directly in an index.

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