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OUTLOOK 2022

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Curb Your Enthusiasm, But Don't Lose Your Optimism

Every January we share our thoughts on the previous year and our outlook for the current year. The word *January*, takes its name from the Latin word *Janus*, who was the Roman god of endings and beginnings – and we believe this is a time when the endings and beginnings could represent markedly different realities.

The Past Year (*Endings*):

As of this writing, worldwide there have been an estimated 324 million cases of coronavirus since the onset of the pandemic, and 5.5 million people have perished from the disease (more than 842,000 in the US alone). The response from global governments, the healthcare industry, and the technology sector to this threat has been nothing short of outsized and impressive. (1) (2)

In a period of less than 1 year, scientists developed, tested, and distributed vaccines and treatments in an attempt to lessen or nullify the ill effects of COVID and its many strains. Technology and telecommunications companies facilitated a remarkable transition to enable remote work and online consumption, and governments around the world committed trillions of dollars in monetary and fiscal support to keep the global economy functioning.

Here in the US, according to the non-partisan Committee for a Responsible Federal Budget, the total amount of the COVID relief stimulus (including tax credits) has totaled approximately $5.7 trillion through December 2021. On the monetary side, the US Federal Reserve cut its benchmark interest rate from 1.5% to 0% in March of 2020 (where it still remains). The Fed also continued to suppress long-term interest rates throughout 2021 by purchasing, on a monthly basis, hundreds of billions of dollars of fixed income instruments, treasuries, mortgage securities, money-market instruments, municipal bonds, and other fixed income products. By year-end, the result of these monetary actions, meant to provide liquidity to the markets and stimulate economic activity, led to an expanded Fed balance sheet with roughly $8.7 trillion of fixed income securities. (3) (4)

So, how did the market respond to these developments? During most of 2021, equity prices demonstrated remarkable resilience - shrugging off uncertainties created by the worldwide pandemic, changes in the political landscape, and many other macro trends. With businesses and consumers awash in liquidity from these various stimulus programs, market participants chased returns in most classes of risk assets – stocks, commodities, crypto-currencies, SPACs, IPOs, real estate, etc. It was a good year to be invested in the market of virtually anything.

As 2021 wore on, though, with most core-equity strategies producing hefty returns relative to their historic norms, many clients asked us what to expect for 2022. Our response prompted the title of this year's piece: ***Curb Your Enthusiasm, But Don't Lose Your Optimism***. In other words, we stated that the end of 2021 marked a time to re-calibrate expectations for future returns of risk assets for the following reasons:

Inflation and Rates – As it embarked on its stimulus efforts, the Fed indicated that it would let the economy and inflation run hot before ratcheting back. However, so-called *transitory* inflation recently measured 7% over a 12-month trailing period - the highest annual increase in almost 40 years. With the unemployment rate coming in at 3.9% in December, it appears that the Fed (and the market) are finally forced to react to the current economic reality. As such, we believe that the Federal Reserve will raise rates by 25 basis points 3 or 4 times in 2022, likely starting in February or March. (5)

Wind-Down of Stimulus – The Fed began signaling in the fourth quarter of 2021 that its bond purchases would end at some point in 2022, likely resulting in higher long-term rates. Over time, higher interest rates tend to impact profits, increase mortgage costs, decrease consumption, and dampen valuations. In anticipation of this new stance from the Fed, in the first 2 weeks of this year the yield on the 10-year Treasury jumped rapidly from approximately 1.50% to 1.80%. This may seem like a relatively small move, but the pace and the magnitude of the change took markets by surprise creating a volatility spike in securities prices. Given the turbulence of the last two weeks, we believe there is a significant potential for a policy misstep from the Fed as it tries to unwind its unprecedented support. (6)

China – A recent GDP growth print of only 4.9% for China Y/Y (year over year) through September was anemic compared to their historical growth rate of 7.0% per annum. Regulatory overhang from their so-called "One China Policy" is impacting both consumer confidence in Asia and appetite for foreign investment. Additionally, Evergrande and other Chinese builders have US$100s of billions of debt which they are unable to repay or refinance. We believe China is capable of phenomenal growth over the coming decades, but it seems their leaders may need to re-think their domestic policies and get their financial house in order if they want to bring the country's historic growth rate back up to trend line. (7)

US Valuations Priced to Perfection – The market is historically priced at the high end of its range (S&P forward PE = 21.10 as of 1/14/22). While earnings are likely to come in strong, the rate of change in growth might slow. Also, the easy Y/Y and Q/Q (quarter over quarter) comparisons for revenue growth and profits may be behind us. Therefore, the risk of an equity-market correction is heightened. (8)

Taxation/Regulation – Certain US Senators in the chamber's majority party (namely Manchin and Sinema) perhaps served to moderate some of the more aggressive proposed tax initiatives in 2021. However, with the Build Back Better program tabled pending re-negotiation, we could see new tax proposals in 2022 which seek to ensure financial viability of the next iteration of an infrastructure-development package.

Cybersecurity – In 2021, there were some notable cyber-attacks: Harris Federation (UK), Health Service Executive (Ireland), Colonial Pipeline (USA), JBS S.A. (Brazil/USA), Steamship Authority (USA), Saudi Arabian Oil Company (Saudi Arabia) VoiceCenter (Israel), UK Labor Party (UK), and Belgian Ministry of Defense (Belgium). In most of these instances the cyber-attackers were foreign actors from Russia, China, or North Korea. Sadly, this is a trend that is likely to continue in 2022 and beyond. (9)

COVID – The risk of COVID variants and break-through infections still exists, although the recent Omicron variant has, thus far, proven to be less lethal than previous strains.

Peaking Euphoria – Meme stocks, cryptocurrencies, and other speculative assets remained at high valuations in 2021. Historically, higher rates and a stronger dollar tend to lead to a repricing of risk assets – as occurred in 2000, 2007, and even 2018, for example. Therefore, we expect mean regression (a return to average valuation metrics) to occur in areas of the market that are perceived as *frothy*.

Geopolitical Concerns - Macro issues have had only a slight impact on US risk assets over the past 10 years. However, that dynamic could change as countries like Russia, China, Iran, and North Korea potentially test the world's resolve by moving from mere hostile rhetoric to more threatening actions.

2022 The Year of Inflection (*Beginnings*):

After that laundry list of risks, ***where's the optimism***? As the economy transitions to normalcy in 2022 there will likely be volatility. In fact, 2022 might represent lower returns, or possibly even negative returns, for risk assets, as the market searches for equilibrium in the absence of government stimulus. We are ever cognizant of the many risks that can offset an upwardly biased forecast, but our base case, at this point, is still for a positive mid-single digit total return from a diversified core-equity strategy while the economy's recovery progresses.

We believe that those who invest for the long term could have reason to cheer rather than fear higher interest rates. Assuming higher rates translate to lower stock prices in the short term, lower valuations in equity markets may provide opportunities to put cash to work in an attempt to achieve higher *future* returns.

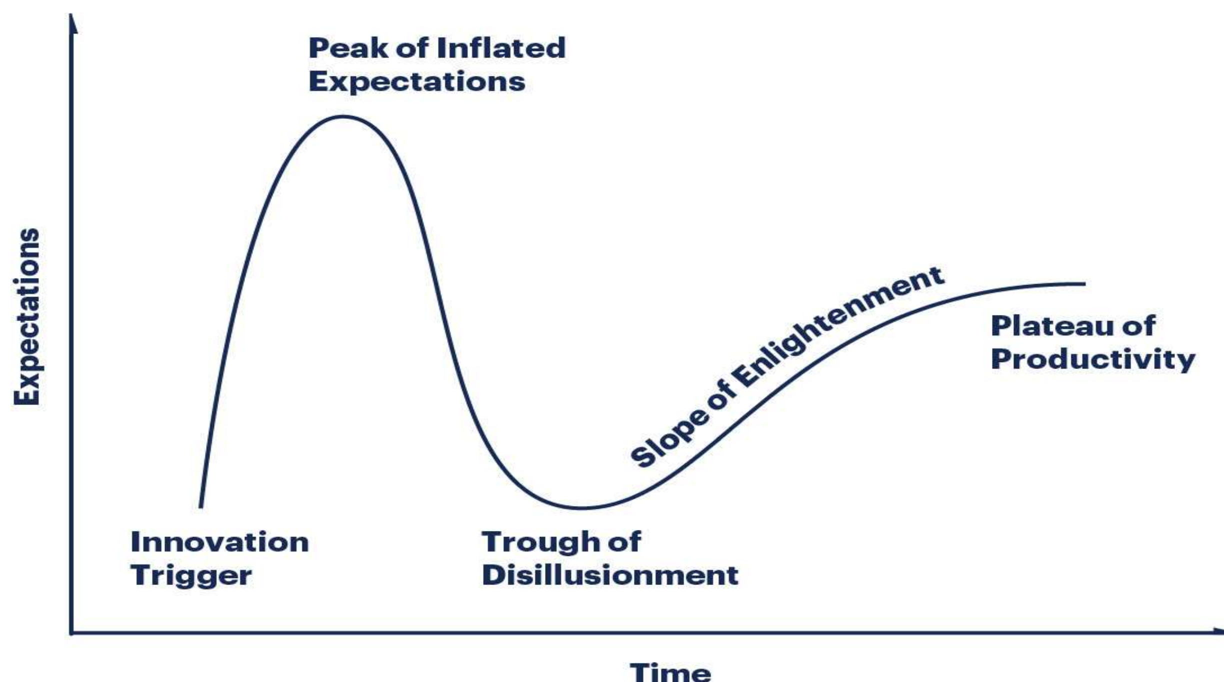
Specifically, we believe that macro themes are emerging with attractive long-term potential for investors.

Legacy Technology

Certain market valuations in the technology sector that are extreme may regress to the mean in 2022. Not all technology companies might suffer however, as we think the decline from lofty heights may be less severe on companies with positive discretionary cash flows. We have believed for some time that companies labeled as "Legacy Tech," offer compelling long-term values particularly where there is dividend-paying and/or buy-back capacity. We continue to think that **artificial intelligence, automated transportation, cloud computing, cybersecurity, internet of things, metaverse, payment processing, quantum computing, semi-conductors**, and **telecommunications equipment and services**, (among other applications) will remain significant tech trends for many years into the future. So, if a receding tide in the equities market generally takes down all of the boats, deploying capital into companies or funds in these industries could be a source of opportunity longer term.

Innovative / New Technology

When evaluating investments in younger, innovative-technology companies (rather than legacy technology companies), we believe that there are two phases where an investor can profit. In fact, we think the investment cycle for such companies tends to follow their operational development stages as demonstrated below in the Gartner Hype Cycle graph.



Source: Gartner Research

Both 2020 and 2021 saw a great deal of interest in companies with fascinating businesses addressing the end-markets listed in the Legacy Technology section above as well as **blockchain, distributable power, edge computing, energy storage**, and **fintech** (among others). These private and newly public companies are sometimes referred to as *Unicorns* due to their uniqueness and rarity. A number of these firms were brought public, or spun out from larger companies, making handsome profits for the founders and pre-public investors who believed in the concept behind the innovation triggers. That pre-public to early-public stage, in our opinion, is the first opportunity where one can profit as an investor in innovative technology. More recently, the prospect of higher interest rates has reduced the stock prices of some of these companies as their tenure in public markets matures. The theory is that younger innovative companies sometimes need further equity and debt financing to bridge the gap to broader commercialization of their goods and services. With much lower share prices, using the graph above, many such companies may move from the peak of inflated expectations to the trough of disillusionment – where expectations are substantially diminished. In our opinion, this later stage may present the second opportunity where an investor can potentially profit longer term.

If we look back just two short decades ago, several innovative companies traded at extremely high valuations during the stock market boom of 1999 and 2000, only to have much lower share prices after the bust of the following year. (Interestingly enough, the catalyst prompting the decline in internet stocks in 2001 was, among other things, a Federal Reserve tightening cycle.) A client of ours who is a software venture capitalist quipped back in the early 2000s words to the effect of**:** ***Investors bought these companies' stocks at high prices not realizing that their business plans would take a long time to execute. Investors later sold these same investments at bargain prices not realizing what those companies <u>might actually accomplish</u> over the long term.*** Pulling up a 20-year stock chart of some now household name mega-cap tech companies clearly illustrates his point. Over the years, as those innovative companies executed their plans, Wall Street re-discovered the concepts that intrigued investors in the first place. The rest, as they say, became history. We believe that rising rates may have the same impact on the share prices of interesting companies with large addressable end-markets, but where their public shareholders may lack the patience to watch the story unfold. In short, if the current environment proves to be similar to that of 2001, we may, once again, have the chance to buy compelling long-term growth companies at reasonable prices.

Healthcare

Although the healthcare industry represents almost 20% of US GDP, overhanging the sector is the worry that drug-pricing methods will eventually be addressed by one or both political parties. With mid-term Congressional elections slated for later in 2022, this issue could come front and center in the not-too-distant future. Having said that, many companies in this space have large cashflows, dividend-paying capacity, reasonable valuations, and / or innovative drug developments. This could bring renewed interest to the sector in 2022 and beyond. Furthermore, if the recent rotation from growth stocks to value stocks continues for the balance of the year, we would expect some healthcare stocks to be potential beneficiaries of that money-flow. Longer term, we also think this sector could represent an important investment theme as advances in **data-analytics**, **genomics**, **novel-drug discovery**, and **personalized medicine** take hold.

Financial Services

After the financial crisis of 2008, increased regulation in the banking sector caused financial services firms to reduce the amount of leverage on their balance sheets. Over the past 14 years, many banks have also built out their customer offerings to include other products and services, beyond just traditional lending, such as asset management, advice, planning, insurance, etc. With the prospect of higher rates in 2022, financials tend to have increased profits from their loan portfolios and other lines of business. Operationally we would expect financial services companies to do relatively well in the current environment. Additionally, as we look into the future, we believe that financial service firms will adopt a number of **fintech applications** broadening their reach and further diversifying their businesses.

Consumer Goods and Services

While there is uncertainty in any forecast, what we should not forget is the power of the consumer. In its annual assessment of consumer trends, MasterCard Economics Institute noted that, “if (consumer) savings are used quickly, that savings-fueled growth could be closer to a 4.5 percentage point boost to global gross domestic product.” The report states further, “in 2021, a significant increase in consumer savings, coupled with mobility restrictions, caused a massive 27-year rewind in the secular shift to services… With cupboards bursting, rotation back into services is well underway, already roughly 6 percentage points below the peak. We expect the balance to normalize in 2022 as borders open and services become more accessible and desirable again.” (10)

They cite a number of potential risks to their analysis, but nevertheless, MasterCards’ report generally paints a rather optimistic picture of pent-up consumer demand. By and large we feel these risks have always been present and believe the transition to normalcy will indeed take place. It probably won’t be uniform and could be messy, but consumers are most discerning, and progress will result from recognizing changes in consumption patterns.

Energy Transition

As the speakers from Goldman Sachs and Brookfield Asset Management pointed out at our Energy Conference last October: there is no going backwards on the transition to a new energy paradigm. Our current expectation is that there will be a cross-over period where fossil fuels, particularly natural gas, co-exist with renewable energy sources (such as wind, hydro, and solar). Traditional and renewable energy companies are positioning themselves for what is expected to be trillions of dollars in capital expenditure on new methods of **carbon capture**, **energy production**, **energy storage**, and **power transmission**. Regardless of where it is sourced, the base-case assumption is for a substantially increased demand for energy over the coming decades as developed economies mature and emerging-market countries grow rapidly. Therefore, we view energy transition as another long-term theme that we intend to invest in for many clients.

International Investing

When one seeks investments with a Value and GARP style, quality can appear at an attractive price anywhere in the world. As global economies recover from the effects of the pandemic, we think opportunities will arise for large foreign companies that have performed, operationally, similarly to their US counterparts. Prior to COVID, we believed that valuations internationally were, for the most part, more attractive than US valuations, so why wouldn't they be just as compelling now? Specifically, there are many companies, particularly in Europe, parts of Asia, and Latin America which are global market leaders trading at lower multiples than their US competitors. For this reason, we intend to include Ex-US Developed-Market exposure (and to a certain degree Emerging-Market investments) in some clients' equity allocation.

Dividends and Buy-Backs as a Part of Total Return

For many of our clients, we have traditionally sought to find quality issues where dividends are important in achieving total-return objectives. The path forward for equities should come into sharper focus as the year goes on, when disruptive forces from the pandemic and supply chain shortages fade as impediments to economic growth. If share prices recede, we believe institutional investors are apt to pressure companies to share their cash flow or profits with shareholders by increasing dividends and share buy backs.

Fixed Income (Bonds)

Fixed income frequently has an important place in an allocation – either for cashflow production, or risk mitigation.

With rates rising, the fixed income segment in our asset allocation models will be particularly nuanced as the Federal Reserve pursues policies to restrain its balance sheet growth, rein in interest rates, and tighten credit. At the moment, there are few, if any, areas of the fixed-income market that we perceive as undervalued by historic measures. By way of example, intermediate-term investment-grade bond indices produced a negative return in 2021, and we don't expect that asset class to perform much better in

2022. With stretched prices and low yields, the interest and appreciation received on longer-dated investment-grade corporates and treasuries were insufficient to cover the 7% increase in the cost of living over the past 12 months. This is a particularly challenging set of circumstances for those retirees who rely on current income to last over many years to fund their expenses.

Our approach in 2022 when seeking income is to utilize multiple, complementary strategies and durations along with traditional fixed-income assets. The objective is to attempt to maintain purchasing power in an inflationary, rising-rate environment and pay some level of cashflow to investors. Towards the end of 2022, we will be looking for signals from the Fed as to whether it intends to slow down or cease raising rates. If that were to occur, it might indicate that our fixed-income allocation could be re-positioned at that time to take advantage of the then higher-rate environment.

Summary

While there are a wide variety of risks that can upend our optimistic scenario, we think there could be many areas for profit and reward long term. Since we define ***Value*** as ***Quality at a Price***, volatile market conditions in 2022 could present us with many candidates to consider for inclusion in client portfolios for the long-term. Asset allocation and portfolio construction are foremost in our thinking, and our research effort will be devoted to sector analysis and security selection as we build out our models in an attempt to achieve each client's objectives.

Our thesis is founded by a belief in the power of innovation and the ability for companies to adapt to the next economic cycle. As we look to the future, we are enthused about some of the long-term concepts that we've discussed which attempt to solve complicated problems, improve the quality of life on this planet, and benefit mankind. Bear in mind, as each client's goals and risk tolerances are unique, we may choose to invest in certain of the themes identified in this report and not others.

We are extremely grateful for the opportunity to serve you, and we thank you for your continued support and trust in our team.

As always, if you have any questions or would like to discuss specific strategies feel free to contact us.

Warmest regards,

Investment Partners Asset Management

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