NORTHEAST SEQUOIA
PRIVATE CLIENT GROUP

2022 Outlook

Two Roads Diverge

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Executive Summary

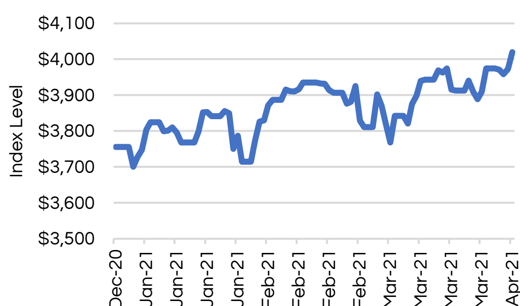
- Over the past 18 months, U.S. policymakers took unparalleled actions to resuscitate a faltering global economy through slashing interest rates and unprecedented quantitative easing. However, we believe the Federal Reserve Open Market Committee (FOMC) has unintentionally painted itself into a corner. Clearly, rising rates are on the front-burner for investors. And the path which the FOMC ultimately takes, may make all the difference.
- 2021 started on relatively solid footing following the tumult offered up in 2020. And despite the U.S. economy's slower than expected start, an initial re-opening trade emerged, powered by the fusing of science, stimulus, and subdued geopolitical risk.
- Steadfast for equity exposure, investors rotated across different styles and sectors throughout 2021 to navigate away from COVID flair-ups and other geopolitical concerns.
- As the Spring turned into Summer and Summer turned to Autumn, COVID variants materialized, domestic policy uncertainty increased, and geopolitical risks re-emerged. As a result, we expect policy uncertainty, rate concerns, and other potential risks to increase volatility throughout 2022.
- While COVID continues to disrupt a classic economic life cycle, we still believe the U.S. economy remains somewhere just shy of halfway to its peak. We expect the U.S. will grow by over 4% in 2022, well in advance of other Developed economies.
- Our Interest Rate Regime framework defines our economic and capital market outlook, but client positioning should be subjective. 2022 may be a volatile year, hence we believe "buy-the-dip" mentality should be discriminately applied across asset allocations, sectors and styles.
- We believe Value-oriented stocks could outperform through the early course of 2022, with a rotation to Defensive Value (Utilities/Staples) commensurate with risk-off trades
- We expect interest rates/bond yields will increase in the near-term, but stall later in 2022. As rates begin to stabilize, fixed-income investors should consider focusing on longer-duration bonds, limited credit exposure and consider rotating away from TIPS and Convertible bonds. Preferred equities remain in favor for investors with income needs.
- Our earnings yield construct forecasts a 2022 price-only expectation for the S&P 500 of $4,989 compared to year-end 2021 levels of $4,766.

2021 Year In Review

One Step Up And Two Steps Back

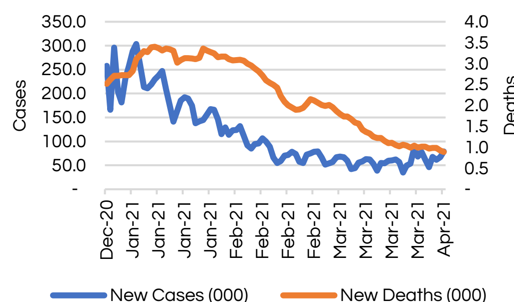
2021 started on relatively solid footing following the tumult offered up in 2020. During the first quarter of 2021, the S&P 500 increased by 6.2%, while the NASDAQ and Dow registered gains of 3.0% and 8.3%, respectively. Most bond indices were down through the first 90 days of 2021, led lower by longer-duration government bonds, as the 10Yr U.S. Treasury (10Yr TSY) backed-up[1] by over 80bps (0.8%) to 1.74%.

Exhibit 1: S&P 500 Price Index (1Q21)



NEPCG and NEPCG

Exhibit 2: COVID Cases vs. Deaths (1Q21)



ourworldindata.com and NEPCG

Despite the U.S. economy's slower than expected start in 2021, an initial re-opening trade was unleashed, powered by the fusing of science, stimulus, a de-escalation of political/socioeconomic angst, and a more subdued geopolitical backdrop.

In January, Joe Biden was inaugurated as the 46th President of the United States, while the House of Representatives impeached President Trump for his alleged role in fueling the January 6 Riots. In late January, the Bureau of Economic Analysis (BEA) released 2020 Gross Domestic Product[2] (GDP), which showed the slowest annualized GDP growth since the Great Financial Crisis (GFC) of 2008.

In February 2021, a bright spot for many working U.S. families emerged as the U.S. Centers for Disease Control (CDC) provided re-opening guidelines for schools. However, the flames of inflation

[1] The term backup is lingo used by bond investors. In the bond market, a backup occurs when yields rise

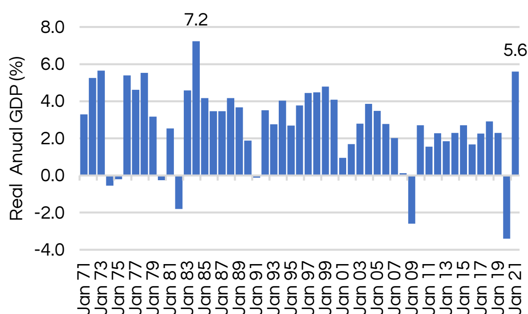
[2] Gross domestic product (GDP) is the total monetary or market value of all the finished goods and services produced within a country's borders in a specific time period. As a broad measure of overall domestic production, it functions as a comprehensive scorecard of a given country's economic health.

were stoked at the same time, as a global semi-conductor shortage began to hinder the production of many consumer goods ranging from autos to smartphones to washing machines.

By March, in-person learning resumed, and a [$1.9 trillion COVID stimulus package] passed. As a result, the U.S. economy began to recover rapidly, on its way to posting the highest level of real GDP since 2004. As we pointed out in our April 1, 2021 note entitled, "1Q21 Review: Where Do We Go From Here?" a "V" recovery across several key economic indicators began to emerge. Our research further suggested that the U.S. economy was poised to accelerate as truckers, shippers, restaurants, auto dealerships, retailers, and homebuilders were all experiencing solid demand. Even down-trodden sectors like limousines and airlines were showing signs of life.

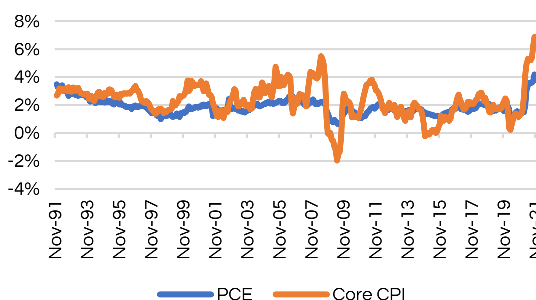
However, extraordinary stimulus (both monetary and fiscal), a recovering economy, and growing supply chain disruptions resulted in a perfect storm of inflation pressure. In our opinion, cost-push inflation occurring alongside demand-pull[3] factors, combined to result in the highest level of domestic inflation in 30 years.

Exhibit 3: Real GDP



FactSet, FactSet Consensus Estimates and NEPCG

Exhibit 4: Inflation Trends



FactSet and NEPCG

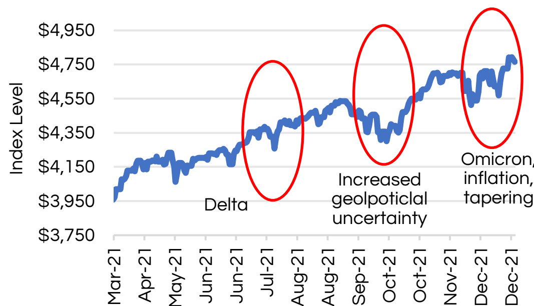
Further, we believe demand-pull pressures are typically a result of policymakers' intent to resuscitate a faltering economy by spurring aggregate demand. In contrast, cost-push factors emerge as consumers bid up raw materials and labor costs. So, as with most things over the last 18 months, it was unprecedented for demand-pull and cost-push to occur simultaneously. We further illustrate

[3] Demand pull inflation is caused by an aggregate demand shift to the right due to a shock in one of the determinants of GDP such as government spending or investment. Demand pull inflation is caused by an aggregate demand shift to the right due to a shock in one of the determinants of GDP such as government spending or investment.

and discuss the combined impact of demand-pull and cost-push inflation later in this report to supplement our Interest Rate Regime construct.

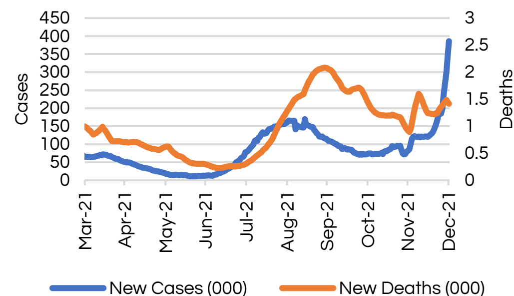
But as the Spring turned into Summer and Summer turned to Autumn, COVID variants materialized, domestic policy uncertainty increased, and geopolitical risks emerged.

Exhibit 5: S&P 500 Total Return Since 1Q



NEPCG and NEPCG

Exhibit 6: COVID Cases vs. Deaths



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On the international front, cyberattacks increased tensions with Russia. China began to impose more restrictive national security laws across Hong Kong, Taiwan, and the mainland. These actions prompted President Biden to warn U.S. businesses exposed to China of increased operating and financing risks. In the Middle East, the fall of the Afghan government and subsequent clumsy U.S. withdrawal raised concerns over U.S. foreign policy.

Domestically, Cryptocurrency found itself in the crosshairs of Congress while investors scrutinized Facebook, following a whistleblower's claims alleging a lack of controls to prevent the dissemination of misinformation. Despite a $1 trillion bi-partisan infrastructure bill on the docket, politicians once again weaponized the debt ceiling. Supply chain bottlenecks started to impact prices materially, and concerns over a lack of everything from Thanksgiving Turkeys to holiday gifts began to take hold. Around the same time, the Federal Reserve started to officially prepare markets for potential "tapering[4]" or reducing bond-buying. By the end of December 2021, the Federal Reserve announced an even more aggressive tapering schedule in response to the highest inflation levels in 39 years. The surge of the Omicron variant began

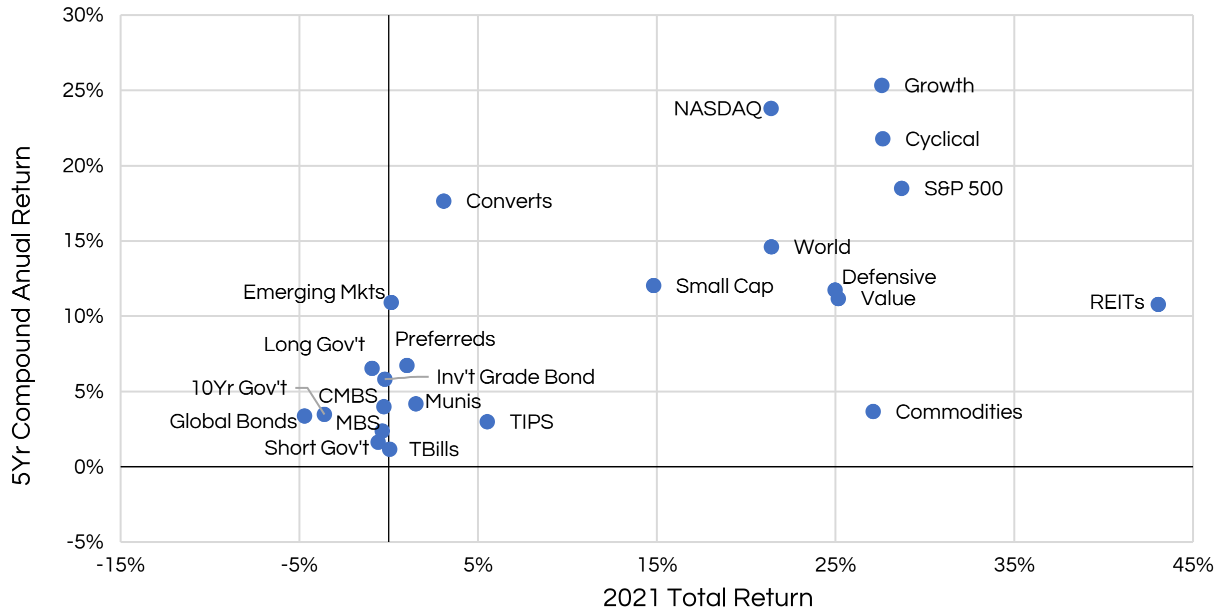
[4] Tapering may also involve the slowing of asset purchases, which, theoretically, leads to the reversal of quantitative easing (QE) policies implemented by a central bank. Tapering is instituted after QE policies have accomplished the desired effect of stimulating and stabilizing the economy.

to amount to 70% of U.S. cases and 90% of related deaths, prompting the mass cancelation of airline flights as well as Christmas and New Year's plans for millions of people. So, in many regards, while 2021 represented a significant step towards normality, there were several speed bumps to keep investors alert and on their toes.

2021: Out With The Old, In With The New

2021 provided equity investors (implied by the S&P 500) with nearly a 29% total return, which was 10% greater than the 5yr average annual return of the S&P 500. 2021 returns were also well ahead of the 10yr average yearly return for the S&P 500 of 16.6%. So, 2021 was a welcome upside to surprise to many forecasts, including our own.

Exhibit 7: 2021 Capital Market Total Returns



NEPCG and FactSet, data as of 12/31/2021

On the surface, equity total returns in 2021 were relatively clustered, as Defensives, Value, Growth, Cyclicals, and even the broader S&P 500 produced returns within ~500 basis points[5] (bps) of each other. The noted exception was REITs (+43.1%), Small Cap Equities (14.8%), and Emerging Market Equities (+0.1%).

[5] A basis point is equal one-one hundredth of one percent

In 2021, bond returns lagged behind both equities and their historical averages. The notable exception was Treasury Inflation-Protected Securities (TIPS), which were higher by roughly 5.5% in 2021, as inflation expectations increased commensurate with a massive increase in the money supply. Consequently, the 10yr U.S. Treasury Note (10yr TSY) moved from an all-time low in July 2020 of roughly 53bps to as high as 1.72% in January 2021, ultimately closing on December 31, 2021, at 1.51%.

The 10yr TSY delivered investors a negative 3.6% total return for the year, with only Global Corporate Bonds providing worse returns, down 4.7%. Municipal Bonds, Preferred Equities, and Convertible Bonds were the only positive returning fixed-income asset classes in 2021, a prediction we highlighted in last year's Outlook. Similar to equity returns, bond total returns were also clustered (in and around zero), given a back-up of real rates[6], as well as increasing inflation expectations (*see our March 31, 2021 note entitled "Let's Get Real" for more details*).

Bull Market Rotation

As we have somewhat foreshadowed thus far in our Outlook, 2021 equity market leadership, and hence returns, were markedly different from those in 2020.

Exhibit 8: 2021 vs. 2020 Equity Returns

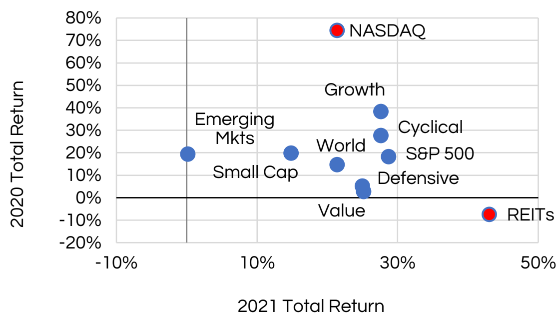


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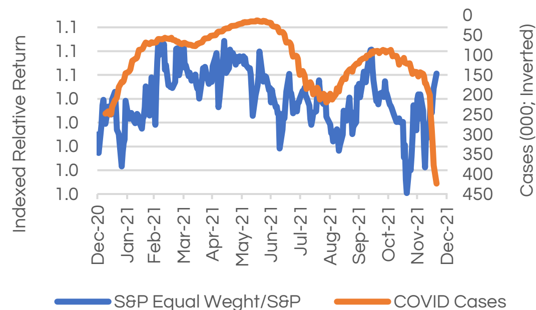
Exhibit 9: Equal-Weight S&P vs. S&P 500



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As we point out in Exhibit 8 above, REITS, which we touted as a beneficiary of a Bear Steepening regime in our 2021 Outlook, were higher by 43.1% in 2021, whilst producing a negative 7.6% return in 2020. Further, while the technology-laden NASDAQ was higher by

[6] A real interest rate is an interest rate that has been adjusted to remove the effects of inflation to reflect the real cost of funds to the borrower and the real yield to the lender or to an investor.

over 21.4% in 2021, this pales compared to the 2020 total return of 74.4%.

Further, in our view, what is most notable is how investors rotated among styles and sectors throughout various points during 2021 to mitigate exposure to COVID flair-ups and other geopolitical concerns whilst remaining exposed to the broadly rising equity market.

Exhibit 9 compares the index-relative 2021 total return between the equally weighted S&P 500 versus the market-weighted S&P 500. We note the latter has over a 25% concentration[7] to Technology/Growth-oriented names like Apple (Ticker: AAPL, 6.9% of the S&P), Microsoft (Ticker: MSFT, 6.3%), Amazon (Ticker: AMZN, 3.6%), Alphabet (Tickers: GOOG/GOOL, 4.2%) and Meta (Ticker: FB 1.1%). Further, when measured against new COVID cases, we argue that during periods of muted political uncertainty and/or reduced COVID cases, Technology and Growth lagged Value-oriented sectors such as Financials, Industrials, and Materials (re-opening trades).

Therefore, we believe much of the sector/style rotation in 2021 was a function of TINA ("there is no alternative") or a mindset suggesting that investors had no other recourse except to hedge higher interest rates and surging inflation prospects with undervalued equities.

Sector And Style Recap

However, despite the TINA induced demand for equities and rotation into Value from Growth between December 31, 2020, and May 2021, Growth still outperformed Value for the full-year 2021, which was one of our prognostications not coming to fruition. ***In 2022, we expect an equity rotation back into re-opening trades (and away from Growth) will begin in the first quarter***. Similarly, large market capitalization (Large Caps) outperformed small market capitalization (Small Caps) in 2021. After a brief period of underperformance earlier in the year, the flight to quality and liquidity helped Large-Caps to outperform in 2021 by year's end. Moving into the beginning of 2022, we believe this rotation could reverse and Small Caps may outperform Large Caps.

Cyclicals[8] outperformed, for the most part, in 2021. However, a

[7] All concentrations are as of 12/31/2021

[8] Cyclical stocks represent companies that make and/or sell discretionary items and services many consumers buy when the economy is doing well.

risk-off[9] trade that commenced in mid-November attracted investors to Defensive[10] names through year's end. Nevertheless, to the extent Value begins to outperform growth, we would not be surprised to see Cyclicals once again outperform Defensives.

Exhibit 10: Growth vs. Value

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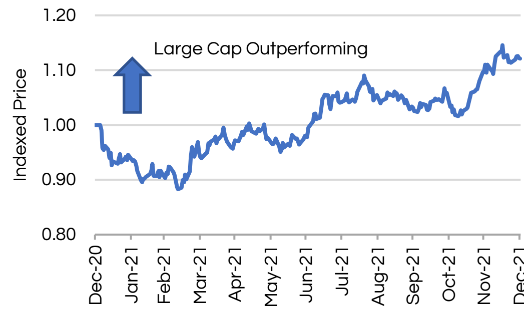
Exhibit 11: Large Cap vs. Small Cap



FactSet and NEPCG

Finally, Domestic equities outperformed their Global counterpart as concern and economic angst caused by variant-related lockdowns and travel restrictions disproportionately impacted ex-U.S. equities.

Exhibit 12: Defensive vs. Cyclicals

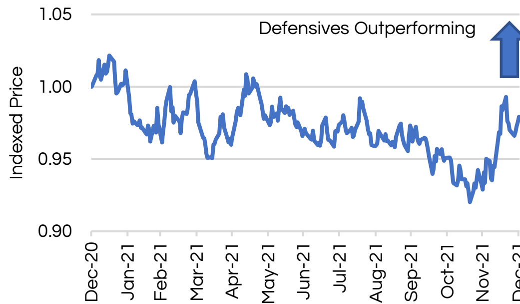


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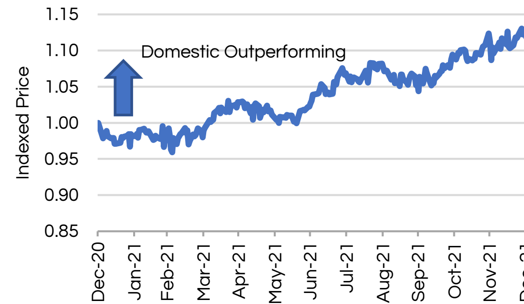
Exhibit 13: Domestic vs. Global



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Geopolitical Backdrop

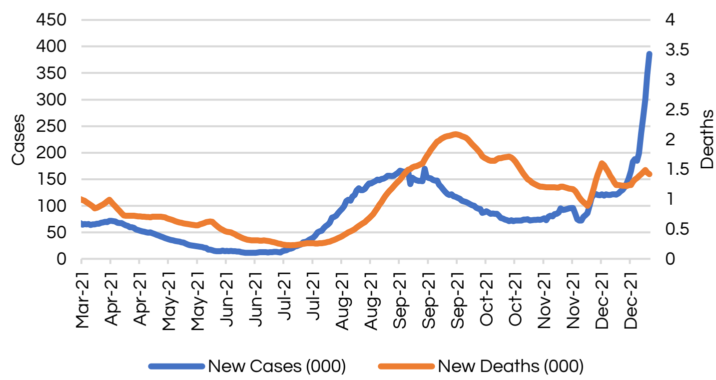
A year ago, we suggested that geopolitical uncertainty would subside through 2021. And for the most part, geopolitical risks have generally waned relative to 2020. However, as outlined earlier in

[9] During periods when risk is perceived as low, the risk-on risk-off theory states that investors tend to engage in higher-risk investments. When risk is perceived to be high, investors have the tendency to gravitate toward lower-risk investments.
[10] A defensive stock is a stock that provides consistent dividends and stable earnings regardless of the state of the overall stock market

this report, the idiosyncratic nature of a global pandemic continues to produce uncertainty and further tests our resolve.

As of December 31, 2021, the number of daily positive cases here in the U.S. accelerated to over 380,000, with daily deaths at 1,400, according to ourworldindata.org. While the loss of a single life is tragic, emerging analysis and information surrounding the Omicron variant suggests a much higher transmission rate but lower severity.

Exhibit 14: Cases and Deaths



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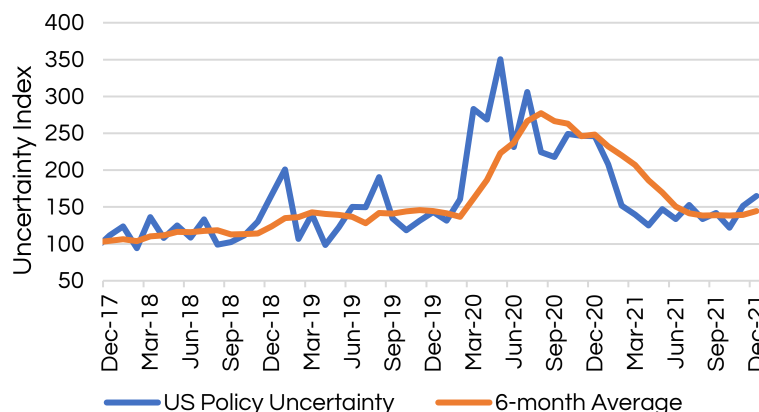
Still, we can never entirely discount black swan events such as COVID 19 because these types of risks will always be present in speculative markets. And while geopolitical risks have subsided since 2020, we are becoming increasingly concerned about emerging risks, which is supported by policyuncertainty.com.

As Exhibit 15 shows, U.S. policy uncertainty peaked in late Spring 2020, with the six-month average reaching its high point in mid-Summer 2020. Since then, uncertainty has dropped through 4Q21. Subsequently, as the Omicron variant took hold, along with other risks highlighted earlier, the nominal monthly trend in uncertainty began to tick higher. We continue to monitor geopolitical trends and their implications on the U.S. economy and capital markets. Most recently, Russia's potential invasion of Ukraine tops our list, along with the unrelenting uptrend in new COVID cases. In addition, the recent back-up in the 10yr TSY and rising inflation backdrop also remain significant investor risks.

Exhibit 15: U.S. Policy Uncertainty



policyuncertainty.org and NEPCG

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Midterms May Usher In More Volatility in 2022

We find that risk assets and equity markets, in particular, have historically enjoyed robust returns during periods of limited volatility. Below we illustrate this relationship by looking at the VIX, or the CBOE Volatility Index[11]. Exhibit 16 shows a negative correlation between the VIX and the S&P 500, or in the simplest terms, a relationship between two variables, such as when one moves up, the other moves down.

In Exhibit 16, we also illustrate a spike in the VIX following more cautious comments from the Federal Reserve Open Market Committee (FOMC) after their inaugural 2021 meeting on January 26-27th. Subsequently, equity markets settled in as investors

[11] The VIX is a widely accepted measure of the equity market's overall volatility, employing a complicated algorithm using S&P 500 index options

realized the road to recovery was a marathon, not a sprint. This dynamic repeated itself through most of 2021, reinforcing the "buy the dip" mentality.

Exhibit 16: VIX and S&P 500

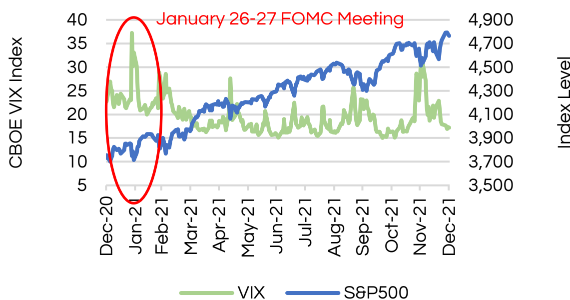

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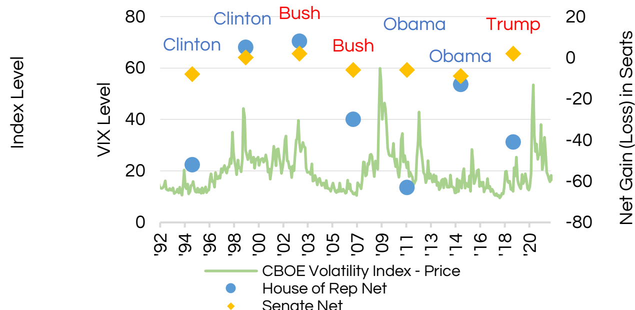
Exhibit 17: VIX and Midterm Results



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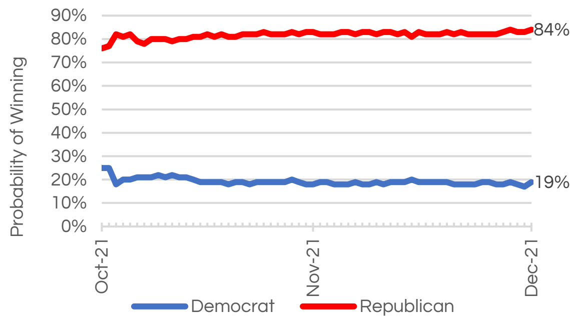
In addition, Exhibit 17 illustrates how the VIX trended with a ***six-month lead into Midterm Congressional elections*** dating back through 1994. We found the incumbent President experienced an average loss of 27 House seats and 3.5 lost Senate seats during the Midterms. Democrats lost on average 31 House seats and six Senate seats, while Republicans lost 21 House seats and 1 Senate seat. ***In almost all cases dating back through 1994, we observe a noticeable uptick in volatility commensurate with a changing political landscape in Washington***.

All 222 Democratic and 213 Republican seats are currently up for re-election within the House of Representatives on November 8, 2022, while there are 34 seats up for election in the Senate.***If history holds, markets may witness a turnover in the House and possibly the Senate.***

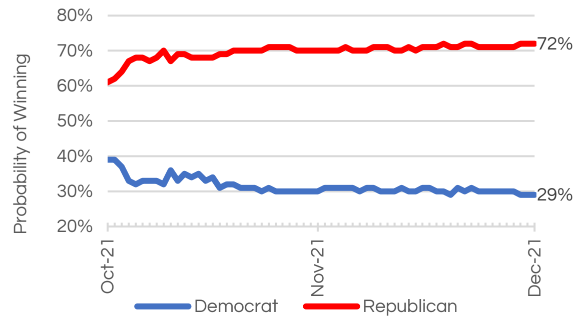
This supposition is supported by PredictIt.org, where market participants are currently assigning an 84% probability that the House of Representatives shifts to a Republican majority and a 72% probability that the Senate also shifts to the Republicans. ***In our opinion, if history repeats and if the political constituency of Congress changes hands, markets should brace for increasing bouts of volatility through 2022.***

Exhibit 18: House Midterm Probabilities



PredictIt.org and NEPCG

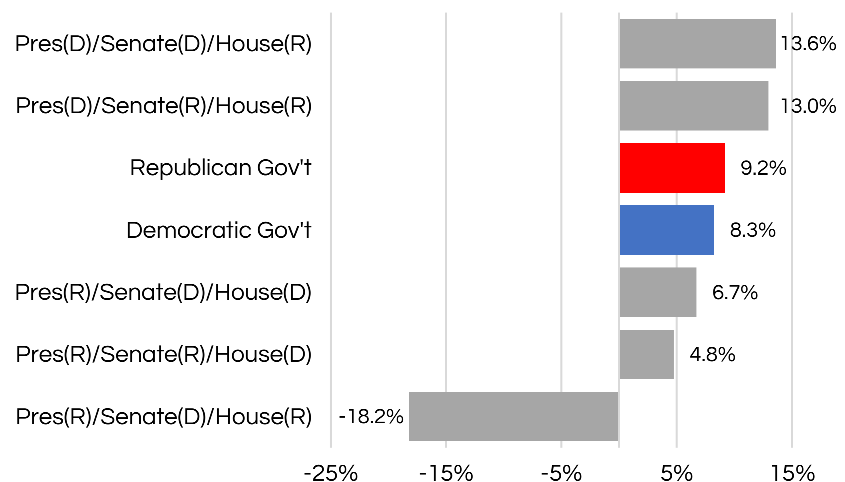
Exhibit 19: Senate Midterm Probabilities



PredictIt.org and NEPCG

However, as we pointed out in last year's Outlook and in Exhibit 20, a post-electoral divided government is not necessarily bad for equity markets. Historically, based on our analysis, the two best governing outcomes for equity market returns were a Democratic President, and either: 1) a Democratic Senate and Republican-controlled House, whereby the S&P increased by 13.6% over the next 12 months, or 2) an entirely Republican Congress, whereby the S&P 500 increased by 13.0% over the next 12 months. Further, these two scenarios **occurred historically only 14 times out of 93 instances**: only four times in the former case (D/D/R) and ten times in the latter case (D/R/R).

Exhibit 20: Dems, the GOP, and S&P 500



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Economic Outlook
The Gap And The Gain

Following the human devastation and economic turmoil caused by COVID 19, the U.S. economy closed the chapter on the longest economic expansion since WWII.

Exhibit 21: U.S. Economic Expansions

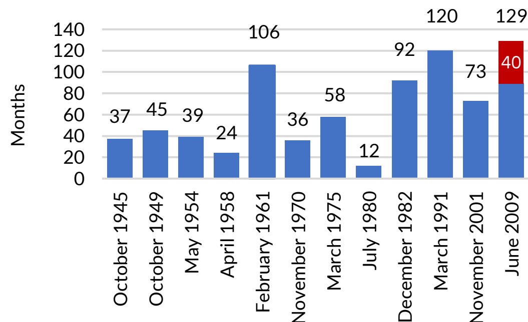

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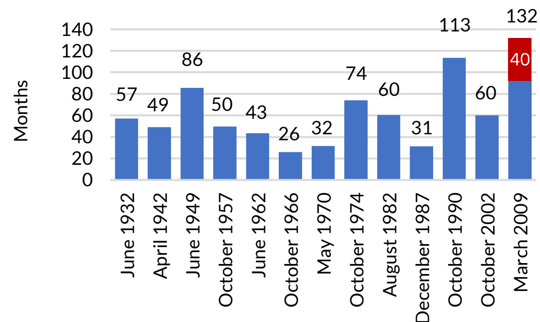
Exhibit 22: U.S. Bull Markets



FactSet and PCG

The result of a global economic lockdown caused U.S. GDP to contract at an annualized rate of over 31% in 2Q20, with harsher consequences felt across other developed economies[12]. As a result, the U.S. economy ended the 129th consecutive month of economic expansion[13] and the 132nd month of an equity bull market. In the end, COVID-19 was responsible for almost a 4% annual contraction in global GDP for 2020[14].

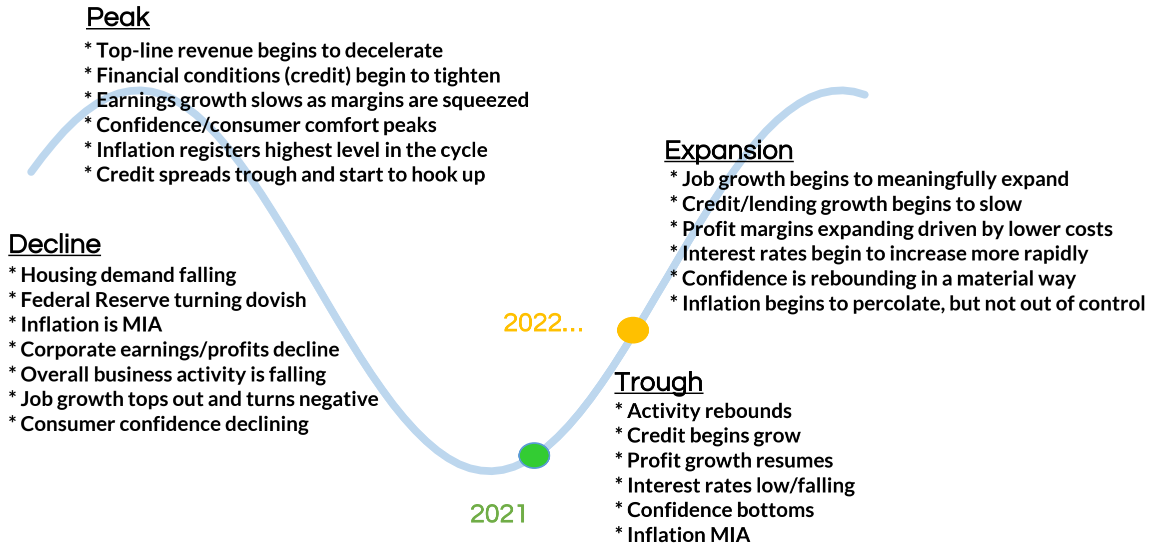
A New Cycle Begins

In our 2021 Outlook, we suggested the U.S. economy was at the precipice of a new economic cycle. Exhibit 23 provides where we felt the economy was at the onset of 2021 and where we believe the U.S. economy is currently.

While COVID continues to disrupt a classic economic life cycle, we still believe the U.S. economy remains well below peak levels and is somewhere just shy of halfway to its peak. However, the exact location on the economic life-cycle curve is unknown given both the idiosyncratic nature of a global pandemic and the unprecedented fiscal and monetary response from international central bankers.

[12] Source: Factset
[13] Defined herein broad terms as positive GDP growth.
[14] Source: FactSet consensus estimates

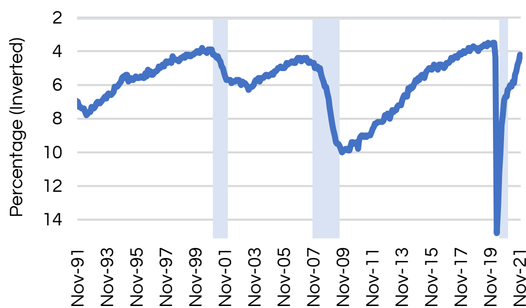
Exhibit 23: Typical Economic Life Cycle



NEPCG

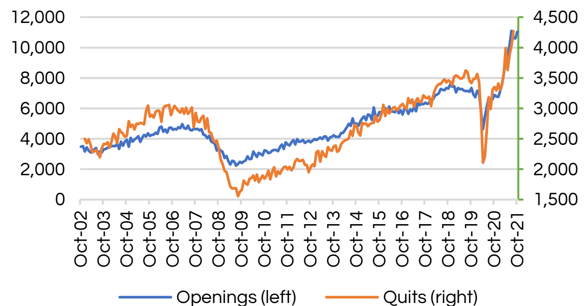
As we highlighted in our 2021 Mid-Year Update entitled "Simply Unprecedented," we have already witnessed a strong snap back in hiring trends, small business optimism, global manufacturers, and several other economic data series.

Exhibit 24: Unemployment Rate



FactSet and NEPCG

Exhibit 25: U.S. Job Openings

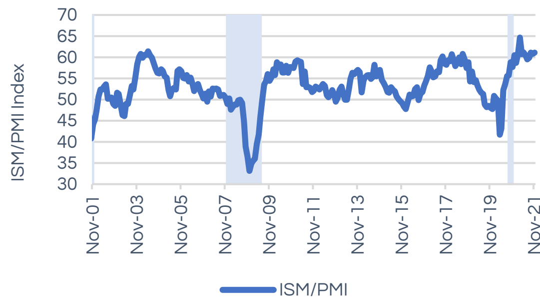


FactSet and NEPCG

Exhibit 24 illustrates that the Unemployment Rate has bounced (inverted scale) from almost 15% to roughly 4.2% (November '21 data). And in Exhibit 25, we illustrate that the overall level of job openings[15] in the economy increased by over 60% year-over-year (YoY) and over 91% since the worst levels of the pandemic.

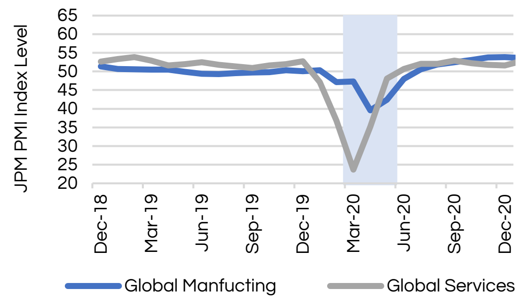
[15] The Job Openings and Labor Turnover Survey (JOLTS) tells us how many job openings there are each month, how many workers were hired, how many quit their job, how many were laid off, and how many experienced other separations (which includes worker deaths).

Exhibit 26: ISM/PMI Manufacturing Index



FactSet and PCG

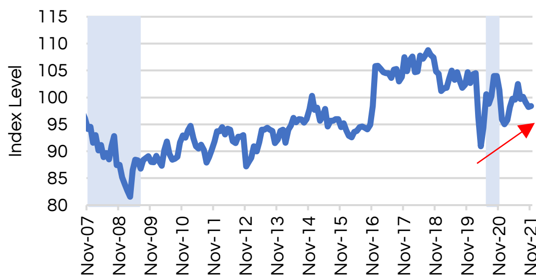
Exhibit 27: JP Morgan Global PMI



FactSet and PCG

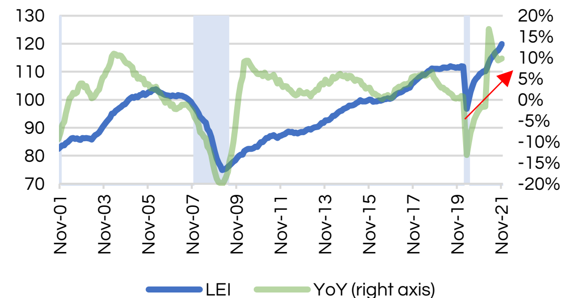
We have also witnessed a strong recovery in manufacturing both domestically and on a global scale. Exhibit 26 illustrates the rebound in domestic manufacturing with data supplied by the Institute for Supply Management's PMI[16] report. Exhibit 27 shows a similar trend illustrated by the JP Morgan Global PMI for both manufacturing and services. In both instances, a sharp "V" recovery is displayed. We have also seen a somewhat "V" recovery in Small Business Optimism and Leading Economic Indicators, although recent domestic and geopolitical swings have negatively impacted both time series.

Exhibit 28: Small Business Optimism



FactSet and PCG

Exhibit 29: U.S. Leading Indicators



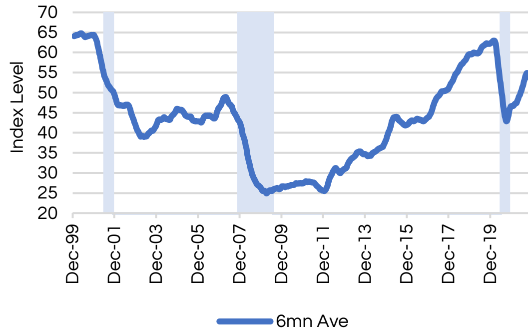
FactSet and PCG

In addition, we have witnessed a rebound in the Bloomberg Consumer Comfort Index, which typically takes longer to recover during post-recessionary periods. And finally, we note the dramatic

[16]The ISM manufacturing index, also known as the purchasing managers' index (PMI), is a monthly indicator of U.S. economic activity based on a survey of purchasing managers at more than 300 manufacturing firms. It is considered to be a key indicator of the state of the U.S. economy.

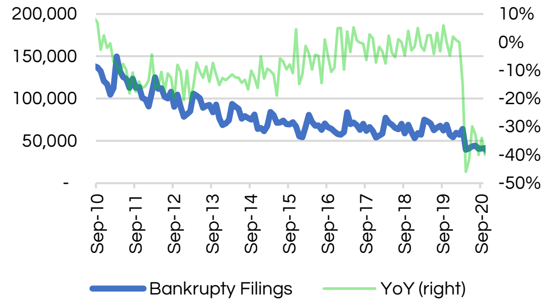
fall in bankruptcy filings, which we believe suggest cleaner personal and U.S. balance sheets.

Exhibit 30: Bloomberg Consumer Comfort



FactSet and PCG

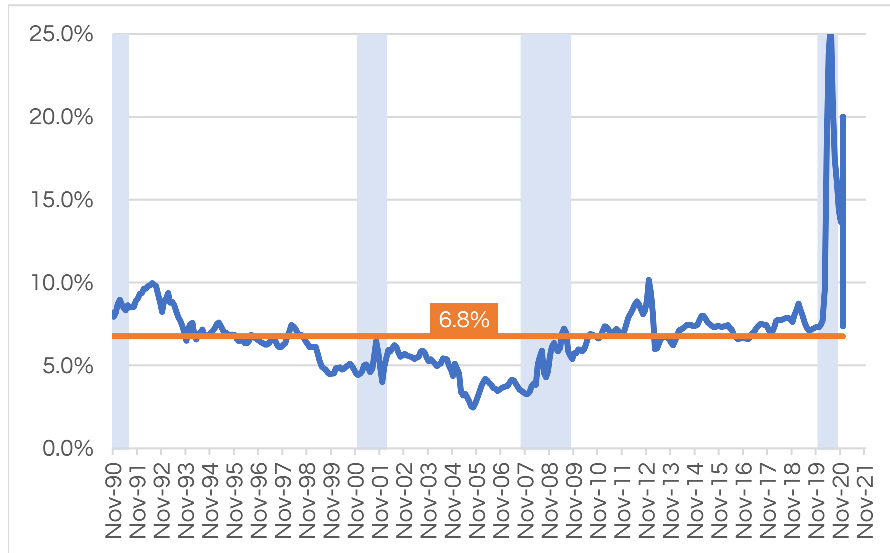
Exhibit 31: Bankruptcy Filings



FactSet and PCG

Exhibit 32 presents the 3-month average domestic savings rate in the U.S. as of November 2021. It illustrates both the ferocity at which consumers have unleashed pent-up savings into the economy following a period of unprecedented savings.

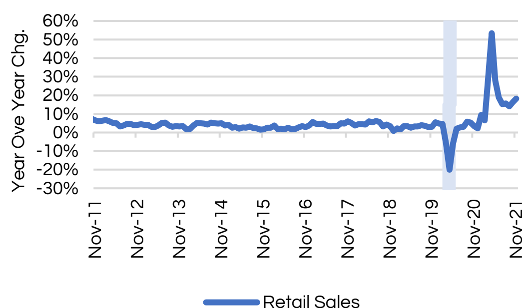
Exhibit 32: U.S. Savings Rate



FactSet and NEPCG

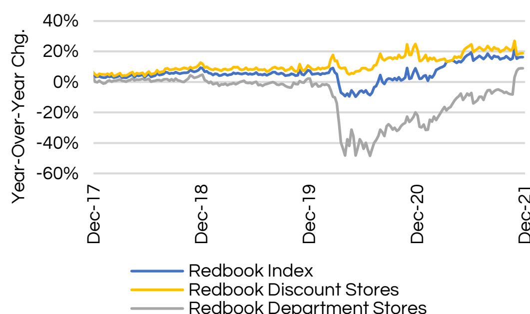
Exhibits 33 and 34 further support just how strong and supportive consumer spending has been through the pandemic. While the annualized change in monthly retail sales was modest in November 2021, aggregate sales were higher by over 18% on a year-over-year basis.

Exhibit 33: Retail Sales



FactSet and PCG

Exhibit 34: Redbook Retail Sales



FactSet and PCG

Further, according to the Johnson Redbook[17] survey, consumers continue to deploy savings across department (higher price point) and discount (lower price point) retail stores.

<u>In our opinion, the consumer has been both beneficiary and benefactor of the recent pandemic-induced economic collapse. But their ability to continue to support economic growth and help sustain a new economic cycle will fall clearly on the shoulders of the Federal Reserve and ensuing policy decisions.</u>

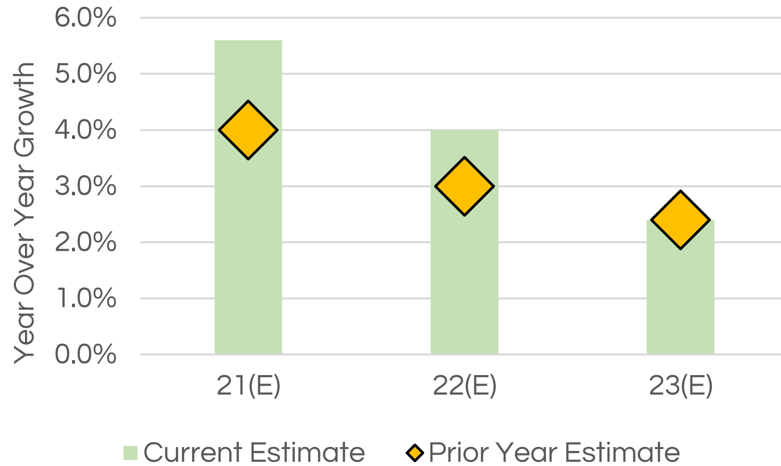
Re-Rating Of GDP Growth

Last year's Outlook noted that the FactSet[18] consensus estimate for 2021 U.S. real GDP growth was forecast at 4%. However, given the unprecedented fiscal and monetary stimulus targeted to jump-start the U.S. economy, consensus expectations increased by 40% by year-end 2021 to 5.6%. A similar re-rating for 2022 real GDP occurred. Last year, the consensus pegged '22 real GDP growth at 3.0%, but the current estimated stands 25% higher, at 4.0%. For 2023, there was no change to prior GDP expectations, which stands at 2.3%.

[17] The Johnson Redbook Retail Sales Monthly is a comprehensive report of same-store sales data reported monthly by general merchandise and apparel retailers.

[18] FactSet Research Systems Inc., or FactSet, is a financial data and software company that provides integrated data and software solutions to investment professionals across the world. FactSet monitors economies, industries, and companies with FactSet's fully global economic data, accessing 1.9 million economic series with economic data readily available alongside in-depth company and market statistics enabling streamlined, centralized analysis and economic intelligence

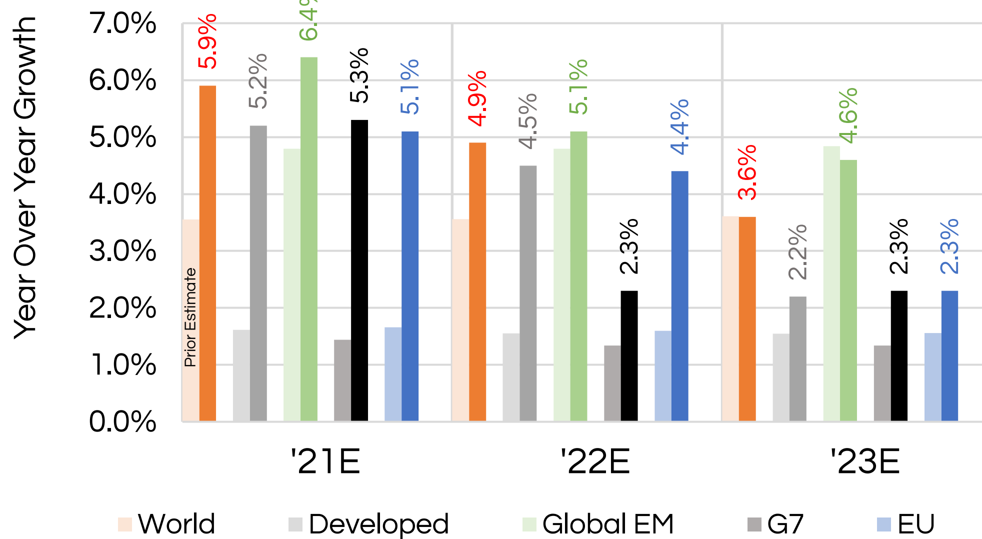
Exhibit 35: Consensus GDP Growth Expectations



FactSet and FactSet consensus estimates as indicated by (E)

Global GDP growth is forecasted to follow a similar vector to that of the U.S. According to the International Monetary Fund (IMF), real global GDP is expected to be 5.9% in 2021, compared to last year's forecast for 2021 of a positive 3.6%.

Exhibit 36: Global GDP Growth Expectations



IMF estimates as indicated by (E)

Exhibit 36 illustrates both the current and prior (year-ago; light shaded) GDP estimates forecast by the IMF for the World,

Developed Economies, Emerging Economies, the G7[19], and the European Union. ***Based on the above data, the IMF expects the U.S. to grow in advance of other Developed economies through 2023, but below Global Emerging Market (EM) economies.***

[19]The Group of Seven (G7) is an informal bloc of industrialized democracies—Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States—that meets annually to discuss issues such as global economic governance, international security, and energy policy.

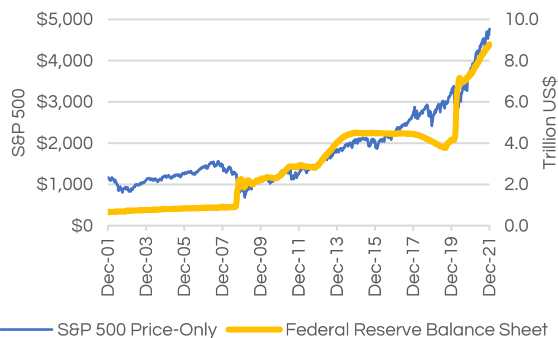
2022 Outlook

Two Roads Diverge

Sins have consequences, or so we are led to believe. Some even suggest that certain sins have intergenerational significance, hence the phrase, "Sins of the Father." ***We are not attempting to inject dogma into our 2022 Outlook but rather to suggest that the impact of the global pandemic and resulting policy decisions may have generational implications for our economy and the trajectory of capital markets. The path chosen by the FOMC could shape our capital market construct for years to come.***

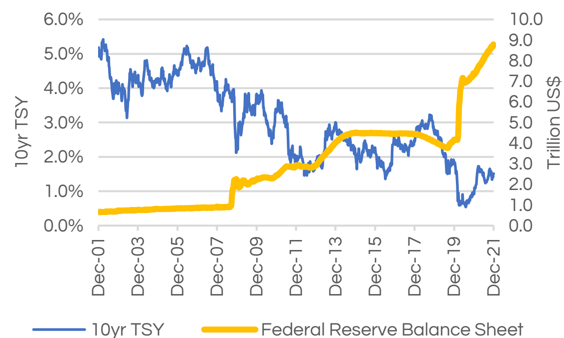
While the policy responses to the 2008 Great Financial Crisis (GFC) and the 2020 Global Covid Pandemic (GCP) were both conceived with the best intentions, the basis and means by which they were executed were vastly different. The response to the GFC in 2008 was centered around solving a systemic financial crisis by attempting to deleverage the global banking system rapidly. The response to the GCP of 2020 was to strike a balance between resuscitating from a self-imposed economic shutdown and combating the human devastation caused by a global pandemic. ***The critical difference is in the latter, monetary stimulus was spread across corporations, individuals, states, and local municipalities. In the former, stimulus and bailouts were keenly focused on the financial and housing sectors.***

Exhibit 37: Fed's Balance Sheet & S&P 500



FactSet and NEPCG

Exhibit 38: Fed's Balance Sheet & 10yr TSY



FactSet and NEPCG

In Exhibit 37, we show that since the end of the GFC (June '09) through year-end 2021, the Fed's balance sheet has increased almost seven-fold, from roughly $2.1 trillion to nearly $8.8 trillion at the end of 2021. Further, the S&P 500 posted a compound annual

return of 15.6% during this same period; the 10yr TSY cratered from about 3.5% to 1.5%.

Additionally, The combined fiscal and monetary stimulus of the U.S., China, Euro Zone, Japan, along with eight other developed economies, caused the global money supply to increase by $20 trillion between 2020 and 2021 to a record $100 trillion, according to Bloomberg. ***This implies that the global monetary base has increased by 25% over the last two years.***

In our opinion, the U.S. economy seems to be self-sustaining, supported by several "V" recovery trends in data highlighted herein. And while there remain over 3.5 million fewer jobs in the U.S. compared to pre-pandemic levels, improving hard and soft economic data[20] suggests that no additional stimulus is needed.

Therefore, despite the best of intentions, we believe following an unparalleled level of quantitative easing[21] along with dramatic rate cuts, the FOMC has unintentionally painted itself into a corner, with any subsequent policy move, or lack thereof, being perceived as the lesser of two evils.

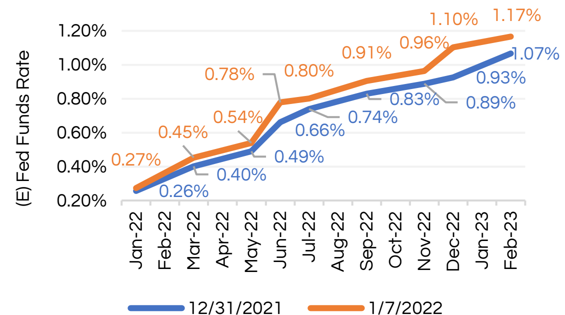
Exhibit 39: CME Fed Fund Rate Probabilities

CME Market Expected Fed Fund Rate Levels @ Meeting Date

	Meeting Date	0.25%	0.50%	0.75%	1.00%	1.25%	1.50%	1.75%	2.00%	Wgt. Rate
Probailbity	1/26/22	90.7%	9.3%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.27%
	3/16/22	25.7%	67.7%	6.7%	0.0%	0.0%	0.0%	0.0%	0.0%	0.45%
	5/4/22	16.7%	53.0%	28.1%	2.2%	0.0%	0.0%	0.0%	0.0%	0.54%
	6/15/22	1.2%	18.2%	51.1%	27.3%	2.2%	0.0%	0.0%	0.0%	0.78%
	7/27/22	3.1%	19.5%	39.9%	29.1%	7.8%	0.5%	0.0%	0.0%	0.80%
	9/21/22	1.8%	12.6%	31.3%	33.7%	16.8%	3.5%	0.2%	0.0%	0.91%
	11/2/22	1.4%	10.2%	26.8%	32.9%	20.8%	6.8%	1.0%	0.0%	0.96%
	12/14/22	0.6%	5.4%	17.7%	29.5%	27.5%	14.5%	4.2%	0.6%	1.10%
	2/1/23	0.5%	4.2%	14.6%	26.6%	28.0%	17.7%	6.8%	1.7%	1.17%

CME and NEPCG

Exhibit 40: Implied Fed-Funds Rate



CME and NEPCG

Furthermore, we believe the FOMC is already "behind the curve" as it relates to accelerating tapering efforts and subsequently raising rates. And if financial conditions are not tightened[22] soon, the Federal

[20] Hard data" refers to concrete improvements in the economy, such as a firm hiring more people or an increase in average wages. Meanwhile, "soft data" refers more to Americans' sentiments and beliefs about the direction of the economy

[21] Quantitative easing (QE) is a monetary policy whereby a central bank purchases predetermined amounts of government bonds or other financial assets (e.g., municipal bonds, corporate bonds, stocks, etc.) in order to inject money into the economy to expand economic activity.[1] Quantitative easing is considered to be an unconventional form of monetary policy,[2][3] which is usually used when inflation is very low or negative, and when standard monetary policy instruments have become ineffective.

[22]

Reserve will be required to act more quickly and with greater intent than previously communicated. As a result, we believe this could potentially cause an adverse outcome associated with a stop-go economic cycle[23] and a severely adverse capital market reaction.

We have already seen evidence that market expectations are forcing the Fed's hand. Furthermore, we are hopeful the FOMC may be eager to catch up to market expectations. Exhibit 39 provides the Chicago Mercantile Exchange's (CME) Fed Watch Tool, which attempts to assign probabilities to future FOMC rate movements.

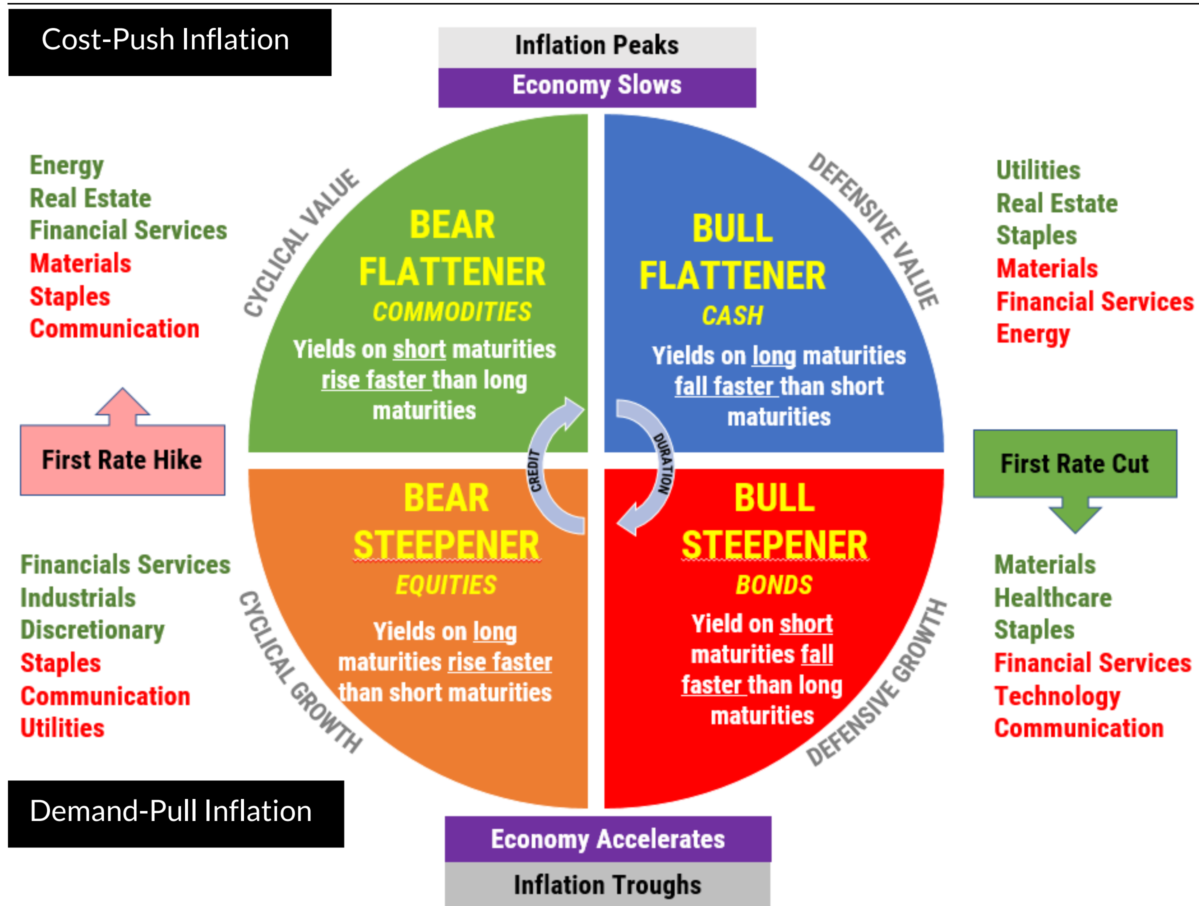
Currently, the CME is assigning only a 9.3% probability that the FOMC raises rates at the upcoming January 26, 2022 meeting. But that probability increases to almost 75% by the March 2022 meeting. Further, in Exhibit 40 we illustrate the probability-implied Fed Funds rate as forecasted by the CME. We note that in just one week, rate expectations have increased. As of 1/7/2022, the CME predicted Fed Funds to be 0.45% as of the March 16, 2022 FOMC meeting, versus 0.40% on 12/31/2021. ***Clearly, rising rates are on the front-burner for investors. And the path which the FOMC ultimately takes, may make all the difference.***

[23] To manage the economy, the government can change monetary and/or fiscal policy, but the danger is that they might over-react and the economy can go from very fast 'unsustainable growth' to very slow/negative growth.

2022 Positioning
Interest Rate Regimes

Our readers continue to hear us utter this phrase, "bonds see around corners." While equity analysts would indeed find an exception to this, we believe fixed-income managers typically need to better understand and react to credit concerns and considerations to help protect bond investors against default. But understanding Credit also helps in positioning equity portfolios.

Exhibit 41: Interest Rate Regimes and Preferred Sector Positions



NEPCG

In our 2020 Outlook entitled, "What Goes Up," we introduced our **Interest Rate Regime** paradigm, which we review herein. In our opinion, by understanding historical relationships between bond prices and yields, aka the yield curve [24], we can help better

[24] A yield curve is a line that plots yields (interest rates) of bonds having equal credit quality but differing maturity dates. The slope of the yield curve gives an idea of future interest rate changes and economic activity.

understand economic and capital market trends.

First, we need to review each of the four interest rate regimes; Bull Flattener, Bull Steepener, Bear Steepener, and a Bear Flattener.

In a **Bull Flattener** (blue shaded area), yields on long-maturity bonds fall faster (price increases quicker) than the yields on shorter-maturity bonds (prices increase slower). This historically happens after inflation peaks, and the economy begins to slow. At the same time, central banks become more dovish[25], ultimately leading to the cycle's first-rate cut. During these periods, we find that defensive-oriented equities tend to perform well, led by Utilities, Real Estate and Staples; underperforming sectors typically include Materials, Financial Services, and the Energy complex. Also, during this interest rate regime, we find that Duration[26] may begin to outperform Credit, meaning that credit spreads start to widen as the economy begins to cool. In other words, investors may opt to invest in the full-faith and guarantee of U.S. government bonds (or cash) over corporate bonds, increasing their yields and thus lowering corporate bond values.

In a **Bull Steepener** (red shaded area), yields on short maturity bonds fall faster (prices increase quicker) than yields on long-maturity bonds (prices increase slower). This historically happens as the economy moves toward recession with a bottoming in economic activity and inflation prospects. During this interest rate regime, central banks may be in full rate-cutting mode, resulting in a preference for risk-free[27] duration (government bonds over corporates or high yield), with the Materials, Healthcare, and Staple sectors historically outperforming. On the downside, we typically observe Financial Services, Technology, and the Communication sector to lag the overall market.

In a **Bear Steepener** regime (orange shaded area), yields on long-maturity bonds rise faster (price falls quicker) than yields on short maturity (prices fall slower). At the beginning of this regime, the

[25] A dove is an economic policy position that promotes monetary policies that usually involve low interest rates, which may promote inflation.
[26] The duration of a bond is the weighted-average period of time before the cash flows involved are received.We use the term "Duration" to describe U.S. Government bonds with like maturities to that of Corporate bonds. Being that Governments typically have yields lower thant Corporates, we suggest that their duration is longer, hence posing greater interest rate risk.
[27] The term "risk-free rate" is an accepted axiom in finance describing the 10yr bond, or other "guaranteed" security backed by the full-faith of the U.S. If you buy a US bill, bond or note, you will get 100% of your principal back, so there is no principal risk. The "risk-free rate" is the basis of several financial theories, but is theoretical.

economy emerges from an economic trough, and inflation may begin to drive growth, ultimately moving toward the first rate hike of the cycle. During this period, cyclically-oriented growth sectors, including Financial Services, Industrials, and Consumer Discretionary stocks, historically tend to outperform the overall market. To the downside, underperforming sectors typically include Staples, Communication Services, and Utilities. Lower-credit quality fixed-income investments usually begin to recover and start to outperform government and other relatively low-risk bonds.

A **Bear Flattener** Regime (green shaded area) historically begins with the first-rate hike of the cycle and is characterized by yields on short maturity bonds rising faster (prices falling quicker) than long-maturity bonds (prices falling slower). During this regime, inflation may begin to accelerate, and the economy typically peaks. Especially toward the latter stages, cyclical-value oriented sectors and stocks may outperform. We observe that Energy, Real Estate, and the Financial sectors have historically done well, while Materials, Staples, and the Communication Services sectors have lagged the overall market.

In our 2021 Outlook, we suggested that the U.S. capital market was firmly within a Bear Steepener regime. However, given the disruptive nature of COVID, certain historical yield curve/sector relationships were dislocated.

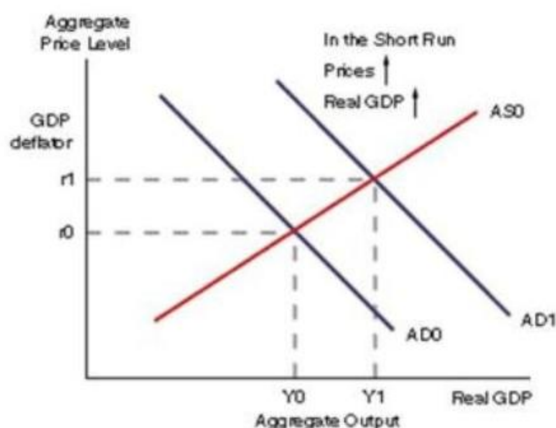
For example, during a **Bull Steepening** regime, Technology names are expected to underperform the S&P 500. But with interest rates extraordinarily low, several Technology related companies like Apple and Microsoft not only helped support the "COVID economy" but also offered a dividend yield above the 10 year Treasury[28]. Another example is the Communications Services sector, which historically underperformed the S&P 500 during **Bear Steepening** regimes. However, work/school from home lockdowns supported the demand for Communication Services names like Zoom and Netflix. Finally, as we predicted last year, it was not a surprise that REITs benefited during the middle of a Bear Steepening regime(vs. a **Bear Flattener**). As expected, REITs benefited as workers returned to urban office buildings, consumers returned to department stores and malls, apartment renters returned to major cities, and travel,

[28] Source: FactSet

tourism, and hotels saw increased demand.

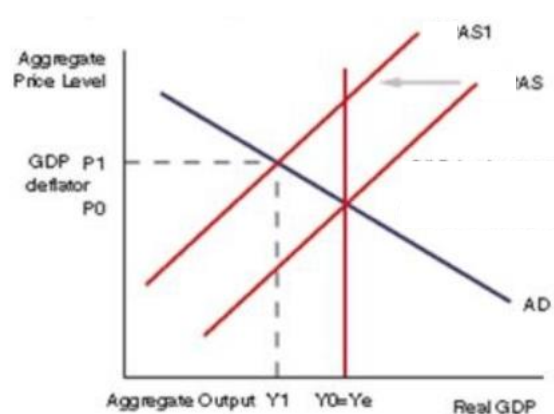
<u>We, and many, didn't count on the perfect storm resulting from the intersection of both demand-pull factors and cost-push inflation forces.</u>

Exhibit 42: Demand-Pull Inflation



Bloomberg and NEPCG

Exhibit 43: Cost-Push Inflation



Bloomberg and NEPCG

Exhibit 42 illustrates that demand-pull inflation is a type of inflation that happens when aggregate demand (AD) proliferates, outpacing aggregate supply (AS). There are several causes for this, but in the current pandemic-related scenario, a surge in AD was driven by outsized government spending (COVID relief) and stimulus (extended unemployment benefits).

Exhibit 43 illustrates that cost-push inflation occurs when prices rise (AS to AS1) due to the rising production costs, higher labor costs and/or an increase in the cost of raw materials. Cost-push inflation is usually more temporary (aka "transitory") than other types of inflation. As a result, central banks are more apt to leave interest rates unchanged during this sort of inflation, awaiting equilibrium. As we illustrate in our Interest Rate Regime exhibit, we believe demand-pull inflation is a self-induced, deliberate act, intended to resuscitate economic growth. In comparison, cost-push inflation is a consequence or precipitant of growth. ***<u>But regardless, the co-existence of both of these inflationary forces at the same time is unique and has placed investors and policymakers in uncharted waters.</u>***

Not All Dips Are Created Equal

In our [2021 Mid-Year Update](), we increased our 2021 year-end S&P price-only expectation to $4,457, supported by our earnings-yield construct. At the time, we had assumed a 10yr TSY of no greater

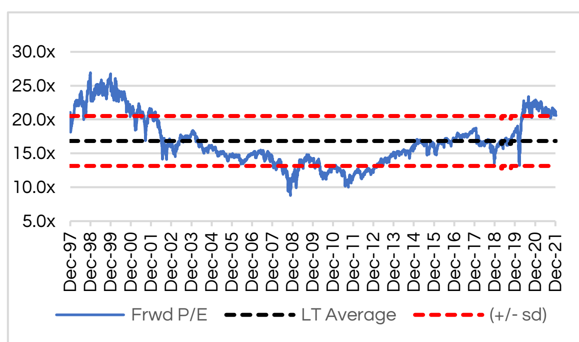
than 1.75%, implying a forward P/E ratio of 21.7x. We then applied the S&P consensus earnings expectation over the ensuing twelve months (4Q21 through 3Q22) of $205[29] to arrive at our price-only forecast.

For 2022, we are making a few modifications to our earnings-yield model assumptions, which we review herein.

As a reminder, the earnings yield of any stock or equity index is nothing more than the reciprocal of its P/E multiple. For example, if the S&P 500 exhibits a P/E multiple of 23x, its earnings yield is equal to 1 divided by 23 or 4.35%. Once we infer the "yield" on the S&P, we then compare the current yield spread[30] between the S&P 500 and the 10Yr Treasury Note to the historical average.

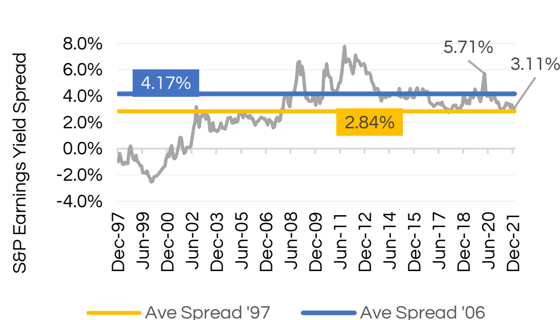
So, the wider the spread (S&P earnings yield less the yield of the 10Yr), the more attractive (and undervalued) the S&P is. For example, in Exhibit 45 below, we illustrate that the earnings yield spread in late March 2020 was approximately 570bps, implying an attractive relative valuation compared to the long-term average dating back to 2006 of 417bp, as well as the 284bps average spread dating back to 1997.

Exhibit 44: S&P 500 P/E Multiple



FactSet and NEPCG

Exhibit 45: Earnings Yield Spread



FactSet and NEPCG
(a) Earning yield = 1/S&P Multiple less 10Yr Note yield

The current earnings yield spread[31] of roughly 311bps, while over 100bps tighter (negative spread) to the 2006 average spread (417bps), it is still wider than the longer-term (back through 1997) average spread of 284bps. So, while some investors suggest earnings

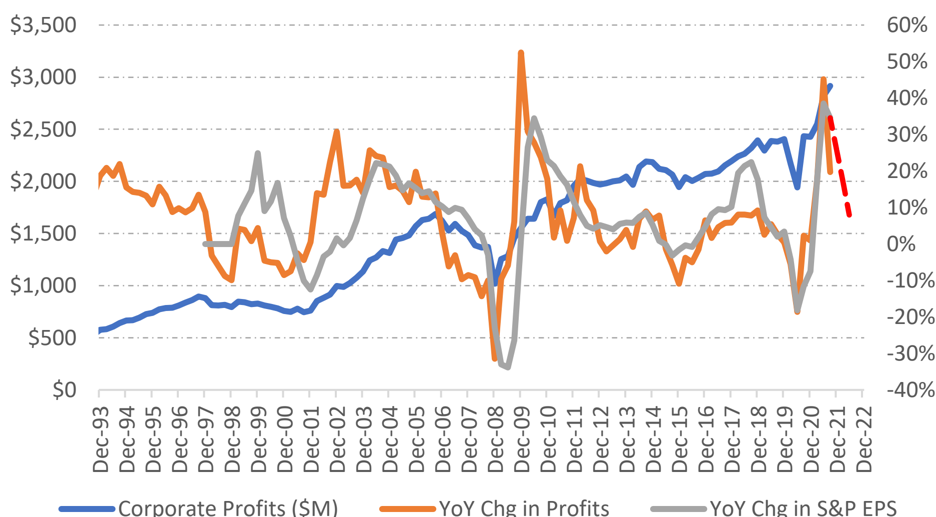
[29] Source: FactSet estimates as of 6/30/2021
[30] A yield spread is the difference between yields on differing debt instruments of varying maturities, credit ratings, issuer, or risk level, calculated by deducting the yield of one instrument from the other. This difference is most often expressed in basis points (bps) or percentage points.
[31] 12/31/2021 pricing data.

multiples imply an overbought condition for the S&P 500, we feel viewing equities through the lens of an earnings yield construct indicates equities may still be undervalued.

As of 12/31/2021, the 12-month forward consensus estimate[32] for the S&P 500 was $225, or roughly 7% greater than expected 2021 results. However, we believe this 7% annual growth estimate may be 5-10% too conservative, the reasoning we unpack below.

We believe Omicron cases will peak in January 2022 and start to subside in mid-February 2022, thus inching closer to ending the pandemic. Further, we anticipate cost-push pressures to wane as supply-chain bottlenecks to ease, eliminating corporate profit headwinds. In addition, we expect employment trends to improve further, as side-lined workers have no additional savings to draw from and need to re-enter the workforce. Finally, based on historical relationships between corporate profits and EPS trends, **<u>we believe with corporate profits so strong, a drop from 35% to a 7% growth rate in EPS may be unrealistic and somewhat draconian.</u>**

Exhibit 46: Corporate Profits and S&P EPS



FactSet and NEPCG

As a result, we are considering earnings over the next 12 months may be at least $240. Further, we believe as many as four (4), 25bps rate hikes may occur in 2022, implying an average Fed Funds rate

[32] Source: FactSet estimates as of 12/30/2021

for the year of roughly 50bps. With an average spread between Fed Funds and the 10yr TSY of roughly 150bps, we expect the 10yr TSY may end 2022 at roughly of 2.0%.

Under these assumptions, our earnings yield construct may imply a 12-month price-to-earnings multiple of 20.6x (reciprocal of 2.84%+2.00%), which may infer a price-only expectation for the S&P 500 of $4,989 compared to year-end 2021 levels of $4,766.

Despite the modest 5% upside implied in our 2022 S&P 500 forecast, we warn investors that considerable volatility may be on the horizon over the next 12 months. ***And with this volatility, investors should be increasingly skeptical about perpetuating the "buy-the-dip" mentality for "any and all" selloffs. Instead, we suggest a disciplined approach focused on quality companies, balance sheet strength, and discrete buying opportunities across capital market allocations, styles and equity sectors***

We believe interest rates and bond yields may continue to increase in the near-term, but begin to stall later in 2022 as supply chain disruptions may subside, cost-push pressures may ease, and GDP growth may move closer to pre-pandemic trends.

Therefore, we believe Value-oriented stocks could outperform through the early course of 2022. We also believe Cyclical stocks, including Financials, Energy and Industrials, may benefit from a global re-opening trade 2.0. However, as we move through 2022, past the first few rate hikes, investors may start anticipating a Bull Flattening environment. As a result, any risk-off periods may find Defensive Value sectors for bid, including Utilities, Staples and potentially Real Estate. In addition, the current rotation away from Technology may once again attract investors to this sector during this period.

At the same time, as tapering ends and short rates (Fed Funds) are increased, fixed-income investors should consider focusing on longer-duration bonds, namely bonds with longer maturities and limited credit exposure. While TIPS were in demand for much of the Bear Steepening regime, investors should begin considering a rotation into longer-maturity government notes and bonds as inflation prospects become fully priced in and the Federal Reserve starts to wind down its balance sheet. We expect that Preferred

Equities and Convertible Bonds may continue to face pricing headwinds until rates show signs of stabilizing.

In conclusion, the idiosyncratic nature of a global pandemic has disrupted humanity in countless ways. From our narrow economic and capital market lens, the unprecedented nature of events over the last 22 months has placed investors, economists, policymakers, and government leaders in a sometimes awkward, but in most cases, uncharted territory***. We look forward to helping our clients and readers navigate through this journey, with hopes of making all the difference.***

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