

## Quarterly Market Outlook

January 2022

### Inflation Surges to the Highest Level in 40 Years

The U.S. CPI was up 7% in 2021, marking the highest increase since 1982. Prices rose across the board, from food (+6.3%) and energy (+29.3%) to new and used cars (+11.8% and 37.3%, respectively), while lagging prints for shelter (+4.1%) likely understated the reality, as rents rose 14-18% last year according to more timely sources. Home prices continued to rise as well, up 19.5% in 2021, which will likely push rents higher in the coming year.<sup>1</sup>

The labor market is also extremely tight. With unemployment back down to 3.9%, job openings and quit rates at secular highs and layoffs at lows, there are now more open positions than there are workers to fill them. Companies are having to raise wages to attract and retain employees, potentially risking a “wage-price spiral” as workers push for higher wages to keep up with inflation and companies in turn raise prices to pass along their higher costs.<sup>2</sup>

Notwithstanding these pressures, interest rates on deposits still sit at zero, putting inflation-adjusted (i.e., real) rates at -7%, a level rarely seen since WWII. With pent-up savings and rising wages continuing to feed demand, the Fed is facing mounting pressure to withdraw liquidity and bring inflation under control.<sup>3</sup>

### Omicron Sends Covid-19 Case Counts Soaring, But Most Economies Stay Open

Case counts are surging globally with the emergence of the Omicron variant, but the link between cases and deaths is weakening. Evidence is emerging that Omicron tends to cause milder symptoms and, while the new wave may take a toll in the short term, it is expected to pass quickly. Most countries have kept their economies open; China is the notable exception, where over 20 million people and counting are now confined to their homes or in quarantine camps under the CCP’s “Zero Covid” strategy – an approach the Party may or may not be able to sustain.<sup>4</sup>

59% of the world’s population has now received at least one vaccine dose, with 30 million doses now being administered daily. As populations become more resilient to Covid thanks to vaccinations, past infections, and improved treatment protocols, the pandemic seems on track to become less disruptive over time.<sup>5</sup>

### Economic Growth Expected to Decelerate

Growth is expected to slow in 2022. Monetary stimulus is set to fade and reverse as the Fed and other central banks end QE and start raising rates. And on the fiscal side, Senator Manchin has indicated he will not support the Build Back Better plan, leaving it short of the votes it would need to pass (at least in its current form). With growth strong, inflation high, and lockdowns largely behind us, further stimulus seems increasingly unlikely.<sup>6</sup>

Meanwhile, China continues to be weighed down by regulatory crackdowns, an overindebted real-estate sector and strict Covid protocols, and while some easing may be forthcoming, growth is expected to weaken.<sup>7</sup> Adding to risks to growth are the geopolitical tensions hovering in the background, with the West struggling to reach a deal with Iran, China and Taiwan at loggerheads, and Russian troops now deployed along the Ukrainian border.<sup>8</sup>

Offsetting these headwinds, businesses continue to spend to shore up supply chains, and consumer spending remains robust – buoyed by rising incomes, healthy balance sheets, and levels of net worth that have never been higher.<sup>9</sup>

## Bond Markets Expect a Return to Pre-Pandemic Conditions

Despite the surge in inflation and the Fed's hawkish turn, the U.S. 10-year yield ended the year back around 1.5%. Yields spiked higher in the first couple weeks of 2022 but remain near secular lows, consistent with expectations that growth will slow and inflation will subside, and that the Fed will take the actions needed to keep inflation in check.<sup>10</sup>

## U.S. Equity Valuations Remain Elevated as the S&P Comes Off Its Highs

The S&P 500 was up 28.7% in 2021, fueled by ample liquidity and strong earnings growth. International stocks were up 13.2% and emerging-market stocks fell 2.5% for the year.<sup>11</sup> Strength in U.S. mega-caps masked weakness in the Nasdaq, where two-thirds of stocks are down over 20% from their highs and 40% are down over 50%.<sup>12</sup> Weakness in high-flying growth stocks has continued into January and spilled over into the broader market, with the S&P 500 down up to 10% from its peak while value stocks and emerging markets have outperformed.<sup>13</sup>

With a P/E of 23, the S&P looks unusually expensive versus international and emerging markets (with P/Es of 16 and 12, respectively), as it has for some time. Analysts expect 8-9% earnings growth for the S&P next year versus 5-6% for international and emerging markets. It remains to be seen whether companies can deliver on those expectations if labor and input costs continue to rise and liquidity is withdrawn as planned. At the same time, low interest rates and decent earnings growth continue to be supportive.<sup>14</sup>

## The Economy Is at an Inflection Point

Since March 2020, record monetary and fiscal stimulus has supported the economy and more than offset the effects of Covid. But now, inflation is at secular highs, fiscal stimulus may be behind us, and the Fed is set to raise rates and start reducing its \$9-trillion balance sheet after keeping policy extremely easy for an extended period.

The question is how these changing conditions and the central bank's response will flow through to economies and markets. If inflation stays elevated, it could erode margins, hurt demand, and force the Fed to tighten more aggressively than expected. On the other hand, inflation may fall naturally along with growth as liquidity is withdrawn. And we are mindful of the heightened risk of a policy mistake as the tradeoff between growth and inflation becomes more acute – particularly given the forces that risk pushing inflation still higher (like labor market tightness, strong demand and cheap borrowing costs) and those that could impact growth (like Covid, or inflation itself). While these possibilities pose risks to both equities and bonds, which have already experienced increased volatility in January, modest tightening could also keep the economy on track as markets currently expect.

## Portfolios Are Betting on a Continued Bull Market and Could Benefit from Diversification

Most investors have the lion's share of their capital – and risk – in equities. Owning stocks is a good bet over time, as the equity risk premium compensates investors for the risk that future cash flows may disappoint. But it is also an implicit bet that earnings will beat expectations and that the Fed will be able to bring inflation in line without damaging the economy.

We think many investors could benefit from diversifying assets that offer protection against downturns and inflation surprises. They might also benefit from skilled active management that can potentially mitigate downside risk or add value regardless of the environment. Above all, we continue to find the most attractive opportunities in private markets (e.g., in real estate, private equity and private debt). We believe that select managers in these asset classes have unique skillsets, niches and operational capabilities that make them compelling alternatives, with the potential for strong risk-adjusted returns and, in some cases, lower correlations and exposure to the broader economy.

Notes

- <sup>1</sup> <https://www.bls.gov/news.release/pdf/cpi.pdf>, <https://www.wsj.com/articles/inflation-needs-solution-supply-chain-wage-powell-biden-infrastructure-build-back-better-stimulus-11639941882>, <https://www.apartmentlist.com/research/national-rent-data>. Rents rose 14.3% according to Zillow’s Observed Rent Index and 17.8% according to Apartment List, and home prices rose 19.5% according to the S&P Case-Shiller Index.
- <sup>2</sup> Source: Bloomberg (SBOIEMPL Index, CONJOB Index, USURTOT Index); BLS (<https://www.bls.gov/charts/job-openings-and-labor-turnover/unemp-per-job-opening.htm>). <https://www.wsj.com/articles/watching-for-a-wage-price-spiral-11642003319>.
- <sup>3</sup> Source: Bloomberg (CPI YoY, FEDL01 Index); Real Fed Funds Rate calculated as nominal rate minus coincident inflation rate. See also <https://www.wsj.com/news/local/2022/01/12/inflation-rises-to-7-in-december-highest-in-four-decades/>.
- <sup>4</sup> <https://www.wsj.com/articles/omicron-peak-appears-to-have-passed-in-u-k-offering-hope-the-wave-is-receding-11642078349>; <https://www.theatlantic.com/health/archive/2022/01/omicron-mild-covid-pandemic-reset/621207/>; <https://www.reuters.com/business/healthcare-pharmaceuticals/who-sees-more-evidence-that-omicron-affects-upper-respiratory-tract-2022-01-04/>, <https://fortune.com/2022/01/10/omicron-covid-delta-economic-impact-stocks-growth-unemployment/>; <https://www.wsj.com/articles/omicron-puts-chinas-zero-covid-strategy-to-its-toughest-test-11642003293>; <https://www.dailymail.co.uk/news/article-10392071/Reality-Zero-Covid-China-quarantine-camps-confine-residents-cells-videos-show.html>.
- <sup>5</sup> Source: <https://ourworldindata.org/covid-vaccinations>
- <sup>6</sup> Source : <https://www.nytimes.com/2021/12/19/us/politics/manchin-build-back-better.html>; Source: Bloomberg (EHGDUS Index, EHGDEU Index, ECGDUS Q221 Index, ECGDUS Q321 Index, ECGDUS Q421 Index, ECGDUS Q122 Index, ECGDUS Q222 Index, ECGDUS Q322 Index, ECGDUS Q422 Index, ECGDEU Q221 Index, ECGDEU Q321 Index, ECGDEU Q421 Index, ECGDEU Q122 Index, ECGDEU Q222 Index, ECGDEU Q322 Index, ECGDEU Q422 Index); see also, e.g., <https://www.barrons.com/articles/fomc-fed-meeting-minutes-today-51641336039> ; <https://www.wsj.com/articles/slow-meltdown-of-china-economy-evergrande-property-market-collapse-downturn-xi-cewc-11640032283> ; <https://www.bloomberg.com/news/articles/2021-12-17/u-s-economy-on-track-for-solid-start-to-2022-as-spending-holds> .
- <sup>7</sup> <https://www.wsj.com/articles/chinas-economic-activity-slowed-in-november-on-property-slump-weak-consumption-11639551530>; <https://www.cnbc.com/2022/01/12/china-economy-goldman-cuts-china-gdp-for-2022-amid-lockdowns-omicron.html>.
- <sup>8</sup> See, e.g., <https://www.nytimes.com/2022/01/08/us/politics/us-sanctions-russia-ukraine.html>; <https://www.wsj.com/articles/bidens-moment-of-truth-in-iran-negotiations-deal-nuclear-warheads-proliferation-centrifuges-fissile-11641504610>; <https://www.wsj.com/articles/taiwan-stages-military-drills-to-deter-chinese-aggression-11641574834>.
- <sup>9</sup> <https://www.forbes.com/sites/jonathanponciano/2020/12/10/us-household-net-worths-hits-record-1235-trillion-as-stocks-boom-but-debt-is-also-surging/?sh=592ccb68660b>.
- <sup>10</sup> Source: Bloomberg (USGG10YR Index); <https://www.bloomberg.com/news/articles/2021-12-21/bad-news-bond-bears-savings-glut-set-to-anchor-yields-below-2>.
- <sup>11</sup> <https://www.msci.com/documents/10199/86494e1f-914e-4aa5-82a9-2e29ed5adbbf>; <https://www.msci.com/documents/10199/dc0cedbf-bcbd-43bc-82fd-d2e9a6111c9d>; <https://www.msci.com/documents/10199/c0db0a48-01f2-4ba9-ad01-226fd5678111>.
- <sup>12</sup> <https://www.bloomberg.com/news/articles/2022-01-06/number-of-nasdaq-stocks-down-50-or-more-is-almost-at-a-record>.
- <sup>13</sup> <https://www.nytimes.com/2022/01/24/business/economy/us-stock-market-correction-territory.html>.
- <sup>14</sup> Source: Bloomberg (SPX Index, MXWOU Index, MXEF Index); <https://www.msci.com/documents/10199/86494e1f-914e-4aa5-82a9-2e29ed5adbbf>. See also, e.g., <https://realmoney.thestreet.com/investing/this-is-a-very-difficult-and-frustrating-market-environment-15878666>; <https://www.wsj.com/articles/global-stock-markets-dow-update-01-07-2022-11641544560> ; <https://www.forbes.com/sites/chuckjones/2021/12/31/analysts-are-forecasting-the-sp-500-to-rise-96-in-2022/>; <https://www.yardeni.com/pub/sp500revenuegr.pdf>; <https://www.yardeni.com/pub/performancecmsciarningsrevenues.pdf>. The risk of disappointed is heightened if we are as late in the cycle as many market participants believe. See, e.g., <https://www.advisorperspectives.com/commentaries/2022/01/12/investing-in-a-fast-moving-cycle>; <https://ca.finance.yahoo.com/video/cyclicality-lead-wells-fargo-strategist-220920757.html>.

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