Investment Strategy Update

January 3, 2022

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At the conclusion of each calendar year, our inboxes fill with assessments of the year just passed and a look ahead at the year to come. As we analyze our investment portfolio defenses for inevitable uncertainties in the new year, we are pleased to share a few particularly resonant ***predictions in italics*** from one of our research partners, The Bank Credit Analyst[1], along with our own brief comments.

The COVID-19 pandemic is likely to recede in importance next year. The effect of the recently discovered Omicron variant remains unknown, but we expect any negative economic impact that occurs to be limited to the first half of the year. With recent studies in South Africa and Scotland confirming that Omicron is less virulent, and over 20 billion vaccine doses expected to be produced in 2022, we welcome worrying less about the severity of the pandemic and removing it from the foreground of lives.

Economic growth in advanced economies will be above-trend for the year on average, and we expect the US and euro area output gaps to close in 2022. Any economic activity disrupted by Omicron in the first half of 2022 will likely shift into the second half of next year. With current disruptions continuing due to Omicron (travel, Broadway shows, sporting events, celebrations) as our guide, we realize the potential for economic weakness because of future variant waves. There is diminishing support for 'lockdowns' but we do expect more regionally oriented disruptions and delays. We have prepared portfolios for volatility and highlight that an outlook for above-trend economic growth correlates to rising stock prices.

Stocks will outperform bonds in 2022, but equity market returns will be in single-digit territory – the net result of robust revenue growth and some return compression from profit margins and equity multiples. With strong performance in 2021, US stocks have notched a three-year compound return of over 20%. This is quite rare and has only happened 10 times in the past century. The last time was 1997-1999 which ended with the 'dot-com' bust in 2000. That said, we do not expect a recession in 2022, nor a bear market. Our view is that we will have a more modest return trajectory in the year ahead with pockets of opportunity that our diversified portfolios are designed to capture through investments in real estate, and international and US stocks with strategic tilts toward value, sustainability, and climate related themes.

Fixed-income investors should maintain a short duration stance, and position for lower inflation expectations and higher real rates. Yes, although we do not expect this to be a straight line upwards for rates as we see a bumpy road ahead as they trend upwards. During 2021, the 10-year US Treasury started the year below 1%, rose above 1.7%, fell back to 1.2%, to finish the year at 1.5%. While the absolute moves are small, in percentage terms they are quite large suggesting to us a more "normal" interest rate environment will be achieved with a healthy dose of volatility along the way. Thus, we have reduced our duration (sensitivity to changes in rates) slightly going into 2022 and will opportunistically shorten more if conditions warrant.

Investors should maintain a neutral allocation to the US versus global ex-US for now, with a bias towards increasing exposure to global ex-US at some point next year. As vaccines become more prevalent globally, we expect a more dramatic effect on global ex-US economies given their starting point. That, coupled with how richly priced securities are in the US, points to better risk-return expectations for international securities relative to the US.

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Longer term, the effort to decarbonize global energy markets is gaining traction, with the three largest economies in the world – the US, China and EU – embarked on a massive transition to renewables. This will be a multi-decade undertaking that literally could transform the world. We wholeheartedly agree! Conventional producers of energy from fossil fuels will help ease the transition, but this evolution will be volatile as global consumers exhibit different rates of adoption and many materials that are key to this transformation are in potentially unfriendly or corrupt nations. Investment strategies in this area can be quite volatile quarter to quarter, but long-term should prove to be rewarding to investors.

As we close 2021, we take a few extra moments to appreciate you and your continued trust and support throughout the year. Thank you.

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[1] Bank Credit Analyst "OUTLOOK 2022: Peak Inflation or Just Getting Started?"; and "2022 Key Views: Past as Prelude for Commodities" (www.bcaresearch.com)