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Economic Review & Outlook

FIRST QUARTER | 2022

Will It Stay or Will It Go?

While there were fewer large gatherings, New Year's Eve 2021 was celebrated with sincere optimism and anticipation, much as we did at the end of 2020. For many people, the new year represented turning the page on one of the most challenging periods in recent history. Accelerating economic growth and vaccine rollouts provided strong early returns on that sentiment in 2021; however, we soon discovered that the transition back to normal would not be simple. Vaccines were not the silver bullet we had hoped, as viral mutations and waning efficacy lead to continued restrictions, therapy development, and periodic booster recommendations. Last year also brought about a new concern in the form of inflation, with levels not seen since the 1980s.

As we enter 2022, we must ask: Is this the year we put some of the key economic issues surrounding this pandemic—global growth, government spending, and inflation—behind us and finally return to normalcy, or is this our new normal? We'll examine that question, share our perspective, and discuss how we're positioning portfolios for these transitory times.

Economic Overview

FED TURNS HAWKISH

U.S. Federal Reserve Chair Jerome Powell was nominated for a second term to complete a significant revamp of monetary policy. He was also tasked with the difficult balancing act of tapering and normalizing interest rates while continuing to boost employment and growth amid the risks of continued COVID-19 uncertainty. Powell has also had to deal with concerning levels of inflation and mounting geopolitical tensions. In December, the Federal Reserve (Fed) announced plans to further slow the rate of bond purchases and implement a series of interest rate increases in 2022. The "dot plot," measuring the sentiment of central bank officials, had shifted. Most of them expect at least three quarter-point rate increases in 2022, a major change from September, when about half of them thought rates would remain where they are until 2023. Inflation continued to run hot, fueled by rising demand for goods, supply chain disruptions, temporary shortages, and a rebound in travel. Earlier in 2021, upward pressure on prices was largely concentrated in areas of the economy most disrupted by the pandemic, but the trend of rising prices has accelerated and broadened, pushing the Fed to action.

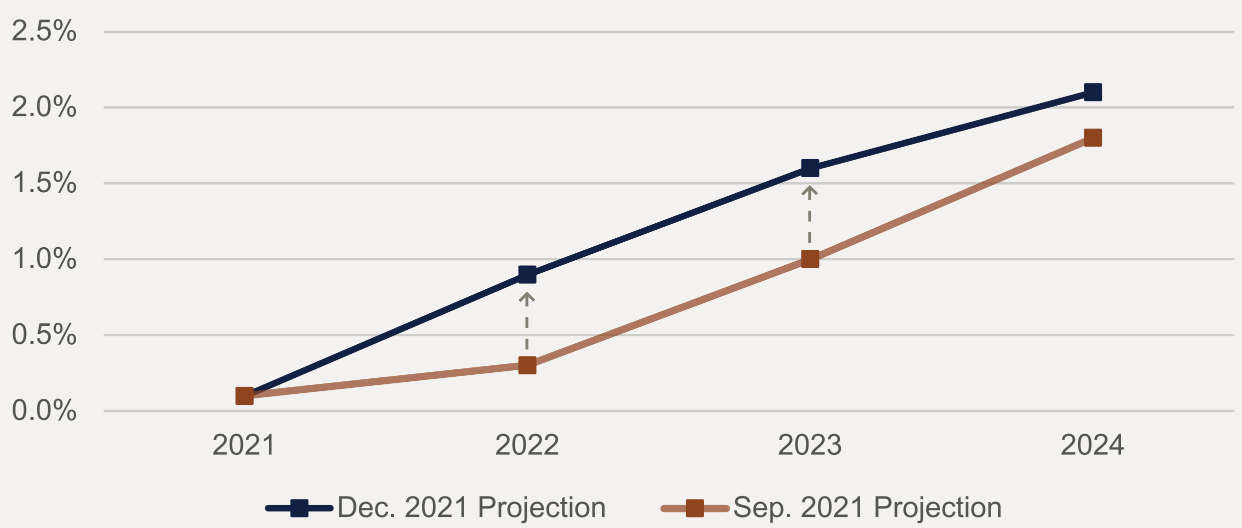
UNCERTAINTY ON INFRASTRUCTURE SPENDING

The $1.2 trillion Infrastructure Investment and Jobs Act of 2021, signed into law in November, allocates $550 billion in new spending for transportation, water and power infrastructure, and pollution cleanup. The Senate scaled back the House of Representatives' larger bill, but the passage itself marked an important moment for President Joe Biden's economic agenda, partly because it passed with some support from Republican legislators. Now Congress is working on a social spending bill passed in November by the House: $2.2 trillion package aiming to shift away from fossil fuels, expand health care, and reinforce many safety-net programs. The process of passing that bill took months, and came despite unanimous opposition from Republicans, which highlights the difficult path to get it through the Senate. In its current form, it faces opposition from both Republicans and some moderate Democrats in the Senate. Any revisions will need to appease both moderate and progressive Democrats in order to pass, given the party's razor-thin majority in the Senate. The plan was pared back from Biden's original $3.5 trillion proposal, but undoubtedly the Senate will continue to reshape it along the way—if it passes at all. The Congressional Budget Office reported that the existing package would increase the deficit by $160 billion over 10 years, which helped raise concerns about Biden's agenda and its potential impact on inflation.

OMICRON CONTINUES TO SPREAD

The new Omicron variant of the coronavirus, first detected in South Africa, was labeled a "variant of concern" by the World Health Organization at the end of November, which rattled markets and left doubts about the pace of the economic recovery. The COVID-19 variant remains in relative infancy, and what it—or subsequent mutations of the virus—will mean for the public health crisis or the economy is unclear. While Omicron could slow parts of the economy for a time, it's unlikely to derail the current expansion over the longer term, given the health of the economy, the apparent reluctance of governments to impose major restrictions, and the ability of the Fed and other policymakers to react to Omicron's impact. Markets did bounce back quickly, amid signs that Omicron is more transmissible than its predecessors but also less lethal, raising the possibility that it could become the dominant form of the virus and, over time, lead to a less dangerous disease.

FEDERAL FUNDS RATE PROJECTIONS



*Source: Federal Reserve; projections are median, year-end projections

Asset Class Performance

Equity returns were mixed in the fourth quarter, as investors balanced strong corporate earnings and broadly positive economic growth data with uncertainty surrounding the COVID-19 pandemic, global supply chain issues, persistent inflation, and the acceleration of (or expectations for) stimulus cuts by the Fed and other policymakers. While U.S. stocks managed large gains, led once again by technology and growth names, international developed market returns were more muted, and emerging market equities experienced modest declines. Commodity prices cooled after outperforming other major assets since the depths of pandemic restrictions in early 2020. Gold rebounded from an otherwise disappointing year, gaining 4%.

For 2021 as a whole, many risk asset classes—led by commodities and developed market stocks—posted double-digit returns. Prices for a wide range of commodities struck multiyear or record highs during the year as the global economic rebound continued, while the aftershocks of the pandemic continued to strain supply chains. U.S. stocks continued to lead equity markets, and the dispersion of returns between markets was wide. Emerging markets declined for the year, driven by losses in China. Bond returns were broadly negative amid slowing Fed bond purchases and with potential interest rate increases on the horizon. However, certain sectors, such as high yield and Treasury Inflation-Protected Securities (TIPS), posted gains for the year. Gold prices, which benefit at times from inflation concerns but typically not from economic recoveries, recorded their first yearly loss since 2018.

Q1	Q2	Q3	Q4	YTD
Commodities 6.9%	Commodities 13.3%	Commodities 6.6%	U.S. Stocks 11.0%	U.S. Stocks 28.7%
U.S. Stocks 6.2%	U.S. Stocks 8.5%	U.S. Stocks 0.6%	Gold 4.0%	Commodities 27.1%
Int'l Developed Stocks 3.6%	Int'l Developed Stocks 5.4%	Diversified Bonds 0.1%	Int'l Developed Stocks 2.7%	Int'l Developed Stocks 11.8%
Emerging Markets Stocks 2.3%	Emerging Markets Stocks 5.1%	Int'l Developed Stocks -0.4%	Diversified Bonds 0.0%	Diversified Bonds -1.5%
Diversified Bonds -3.4%	Gold 3.2%	Gold -1.0%	Emerging Markets Stocks -1.2%	Emerging Markets Stocks -2.2%
Gold -9.8%	Diversified Bonds 1.8%	Emerging Markets Stocks -8.0%	Commodities -1.6%	Gold -4.3%

Indices used: Commodities—Credit Suisse Commodity Index, Diversified Bonds—Barclays Aggregate U.S. Bond Index, Gold—S&P GSCI Gold Index, U.S. Stocks—S&P 500 Index, Int'l Developed—MSCI EAFE Index, Emerging Markets—MSCI Emerging Markets Index. Indices do not reflect the deduction of advisory fees, transaction charges, and other expenses. You cannot invest directly in an index. Past performance does not indicate future returns.

Our Perspective

THE TRANSITORY PROPERTY

"Transitory" was arguably the word-of-the-year for 2021 in investing circles. As the year began, the global economy was set to fully transition back from the shutdown in 2020. That movement, as expected, caused both economic growth and inflation levels to run hot, driven by the rebound from pandemic lows and pent-up demand as reopening progressed. Many did not foresee the complications and setbacks to this transition caused by mounting global supply chain issues and COVID-19 variants, including Delta in the summer and Omicron toward year-end. As 2021 came to an end, "transitory" remained an important buzzword. When the Fed Chair said in early December that it was time to stop describing inflation as such, it made headlines and bent the ears of investors monitoring the Fed's delicate balance of mitigating the economic fallout of the pandemic with managing inflation. Here, we dive into several themes and issues surrounding the continued transition from the pandemic's depths to where things stand as 2022 begins. We also provide a look at how likely they are to persist and for how long.

ANOTHER YEAR OF THE PANDEMIC?

The coronavirus was essentially the only thing driving markets in 2020, even though it was an election year characterized by mounting government deficits and social unrest. While other events impacted markets in 2021, many of them were driven by the virus, which remains the most important issue to the market and global economy.

As 2021 ended, infection rates and hospitalizations surged, and public health officials expressed concern surrounding the uncertainty of the Omicron variant and the potential for increased spreading as people traveled and gathered for the holidays. Nearly 40% of the U.S. population remained not fully vaccinated, and vaccine progress slowed from the high administration rates of the spring and summer. In December, multiple states enlisted the National Guard to help staff hospitals and nursing homes.

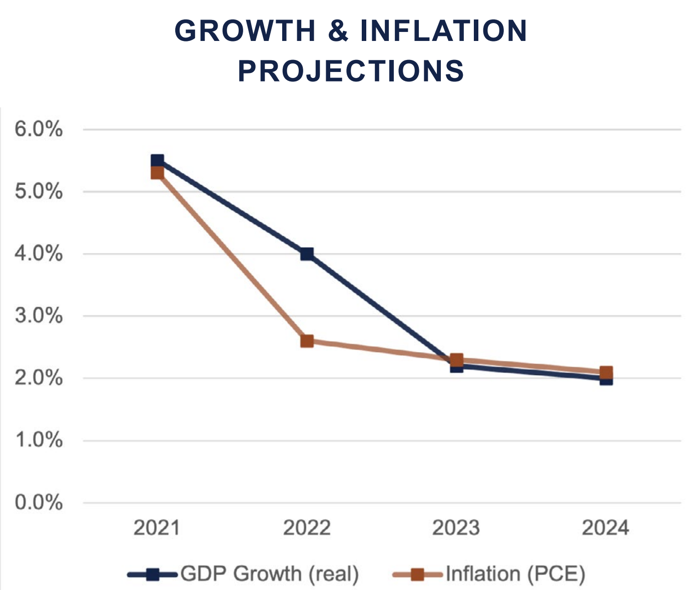
Despite these circumstances, government officials at all levels seemed reluctant to impose the kinds of restrictions that slowed economic growth in the early days of the pandemic. However, outside the U.S., countries such as the United Kingdom moved toward more restrictive policies. While it's still difficult to predict the impact of the pandemic going forward, most experts predict that COVID-19 will likely evolve into an endemic similar to the seasonal flu requiring periodic boosters. Vaccines and therapeutics should continue to lessen the symptoms, and disruptions from future variants should lessen over time. While 2021 showed us that setbacks may happen here and there, we remain optimistic that the coronavirus will decrease over time, and we can eventually return to normal—except for a few things, such as the new trend of more remote and flexible working conditions.

WITHERING ECONOMIC GROWTH AND INFLATION?

Heading into the new year, one of the biggest mysteries facing investors and markets is what comes next in terms of economic growth and inflation. Emerging out of pandemic shutdowns, the reopening drove very high levels of gross domestic product (GDP) growth, although the Delta variant's impact on consumer spending in the summer did slow the pace in the third quarter—just as Omicron may when the December data is finalized. GDP growth above 6%, which we saw in the first two quarters of 2021, most likely is transitory.

Increased infection rates due to COVID-19 variants drove downward revisions in fourth-quarter and full-year 2021 growth estimates, though the full-year consensus remained above average. Meanwhile, inflation remains high, with expectations about its level of persistence seemingly ticking up by the day.

Still, when looking at current trends, our expectation remains that GDP and inflation will cool down, at least somewhat, but remain higher than average for at least another year until returning to more normal levels. Economists project GDP in the 4% range for 2022 before falling below 3% in 2023 and 2024. The Fed's own inflation forecast, which increased to 5.3% for 2021 in December, also rose for 2022 (to 2.6% from 2.2%).



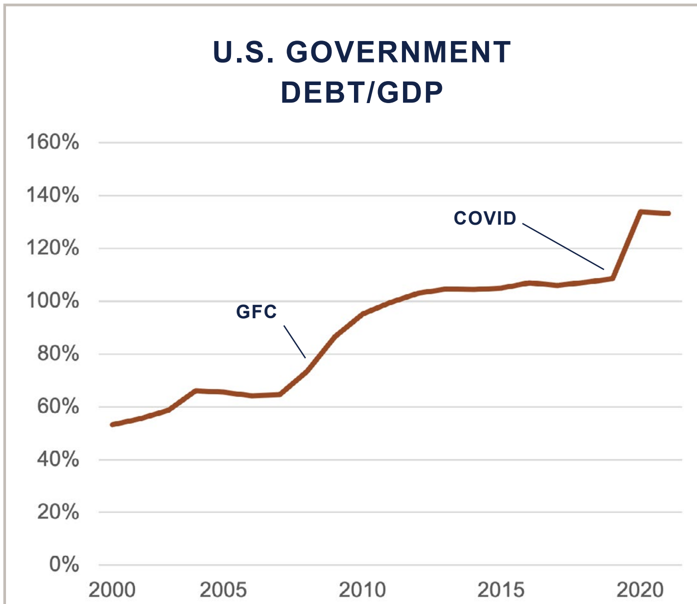
*Source: Federal Reserve, as of Dec 2021

WILL GOVERNMENT SPENDING CONTINUE TO SURGE?

The Fed's bond-buying program began almost immediately in March 2020 when COVID-19 emerged. Since the pandemic took hold of the world economy, we've seen record levels of fiscal and monetary stimulus. Most economists and investors believed that as the economy recovered, both would gradually return to pre-pandemic levels. There's a bit of a transition happening in that thinking, and not only due to the Fed's recent change of tone. There is a broadening level of concern around government spending and the impact it could have on inflation and (over the longer term) economic growth.

Rest assured, low interest rates, government stimulus, and big deficits aren't new, nor did they become commonplace due to COVID-19. All three have become a staple of the economy dating back to the Great Financial Crisis (GFC) at the end of the last decade. The Fed walks a delicate line between its desire to taper and raise rates, balanced against high levels of caution, so it does not rattle markets or interrupt the recovery.

Meanwhile, government spending has continued to rise, reaching an all-time high of 44% of GDP in 2020. (The only other time it reached above 40% was in 2009-2011, in the wake of the GFC.) Given the newly passed infrastructure bill, and the potential likelihood of more to come, we may see further increases in spending. As we turn the page of 2021, it seems that until there is political pressure to cut spending, large deficits will likely continue. Short-term concern over government spending is low, because spending can benefit the market like it has over the last few years. However, in the long run, mounting debts are risky.



*Source: IMF, as of Oct 2021

OUR VIEW

So how should we position our portfolios, given that circumstances around us are changing quickly and we don't know exactly how everything will play out? First, remember that no one knows exactly how things will unfold. With that in mind, here are a few important points to remember.

Don't go "all-in" on one narrative. In early 2020, many investors were convinced that the global economy would fall apart during the shutdown. Many wanted to get out of the markets completely, and some probably did. They missed out on the strong equity gains we've seen since. Currently, there are plenty of concerns and expectations.

Although as 2021 taught us, our expectations can change quickly. Being too exposed to any one company, country, or currency could leave you exposed to higher levels of risk. As always, we believe in broad diversification in all our portfolios, and that investors should diversify according to their time horizons and cash flow needs.

Think less about what will happen next, and more about what will happen eventually. Uncertainty is one of the few certainties of investing. Trying to be one step ahead of the news cycle can be a frustrating and unproductive exercise. Volatility can hit at any time, so it is wise to invest conservatively with shorter-term assets that you may need soon. With longer-term money, we try to look through the uncertainty. Will we see another concerning COVID-19 variant in 2022? Probably. Will inflation persist longer than expected? Maybe. However, history has shown people are resilient, innovative, and productive. Over time, markets tend to move higher, and equities remain a powerful tool for building long-term wealth. In other words, taking a long-term perspective gives you a better chance to reach your goals.

It's all relative. The stock market is expensive right now. In mid-December, Deutsche Bank Research characterized the historical valuation of the broad market S&P 500 Index as "extremely high," although the firm did point out that it may go even higher. Interest rates are low, inflation is high, and government debt is growing exponentially. This scenario can make investors ask whether they should bother at all in this environment. However, the market is not just the S&P 500, which has held up quite well so far despite expensive valuations. There are areas, such as value stocks or emerging market equities that are more reasonably priced. We would say the same for the bond market, where you can find opportunities to increase yield and diversification without taking on too much interest rate or default risk.

Conclusion

A lot of people, including us, welcomed 2021 by saying we were "turning the page" on the pandemic. As we move into 2022, however, there's no shortage of uncertainty. One reality tops the list: COVID-19 isn't over. Furthermore, inflation is a risk, supply chains remain compromised, and the Fed is accelerating its taper as it tries to keep the plates spinning. However, that does not mean it's time to panic. Instead, we suggest recognizing that uncertainty is a part of investing. Expect it. Then, manage your risk. That sentiment is at the heart of what we do, and we believe diversification is a great way to balance risk and return. No matter how the year unfolds, accepting uncertainty and leveraging diversification can help us welcome 2022 as a year of opportunity rather than fear.

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