INVESTMENT COMMENTARY
JANUARY 2022

Market Review

Calendar year 2021 was a generally positive one for financial markets and risk assets. However, 2022 is off to a rather ugly start. Bond yields and volatility spiked higher while equities declined. For example, the S&P 500 has fallen about -5% on a year-to-date basis. The Index has posted 13 declines the first 20 trading days of the year. The CBOE Volatility Index, a measure of expected volatility and known as the market's fear gauge, reached its highest level in a year. Recent weakness has coincided with investors' concerns about central bank policy around interest rates and inflation, continued Covid-related economic disruptions, and geopolitical tensions over Russia.

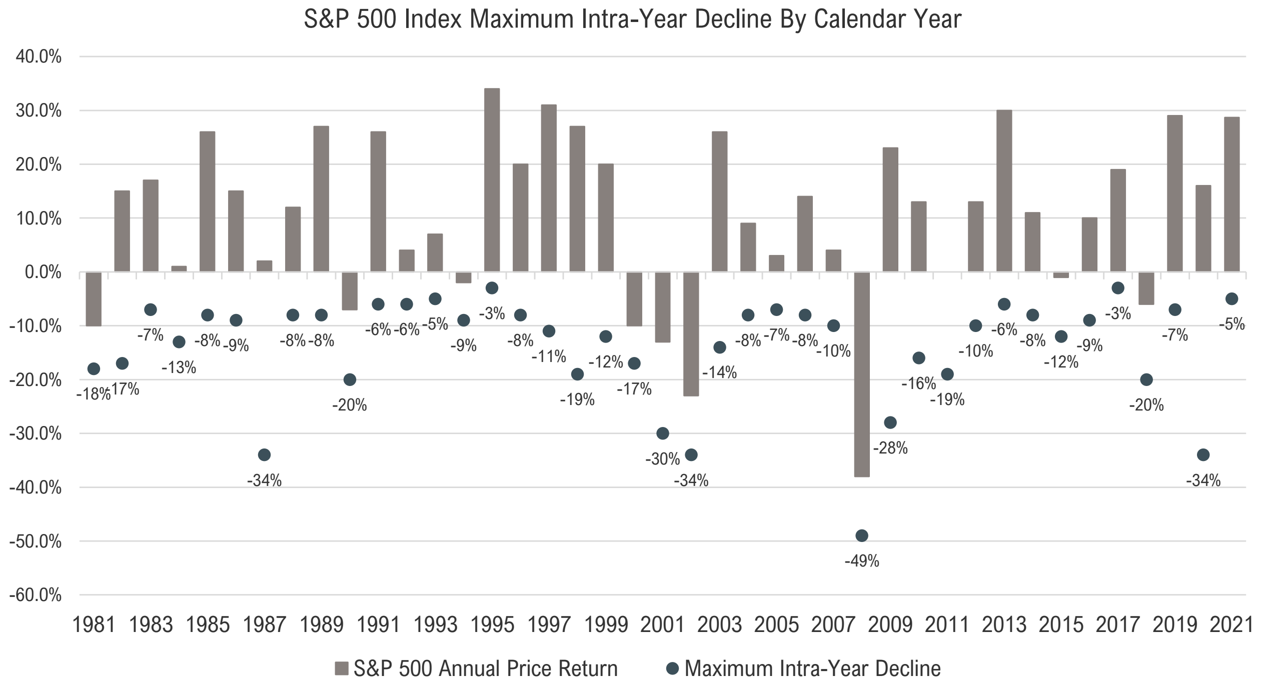
Underneath the surface, the most speculative investments, like cryptocurrencies and meme stocks, have fared the worst. For example, the price of Bitcoin has fallen about -45% since it sold for nearly $69,000 in November. And Cathie Wood's ARK Innovation ETF, the darling investment vehicle of the pandemic era that gained +153% in 2020, is down over -50% from the high it touched last February. As Michael Regan at Bloomberg points out, "it's almost as if the markets are holding a stress test to find out what's real and what isn't."[1]

Within the broader equity market, the sell-off has hit growth stocks hardest. Companies with higher growth rates but limited near-term return or cash flows can be viewed as "longer duration" equities and, therefore, more sensitive to higher interest rates. As such, "shorter duration" value stocks have exhibited better relative results. As of yesterday's close, the Russell 1000 Growth Index is down -8.6% so far in 2022 versus the Russell 1000 Value Index being down -2.3%. Non-US stocks have held up better than domestic shares, reflecting their greater orientation toward cyclical sectors and, notably, commodities and natural resource-related stocks have posted gains on a year-to-date basis.

Asset Category Performance (As of January 31, 2022)	Year-to-Date 2022	Full Year 2021	Last 5 Years*	Last 10 Years*
Fixed Income				
Municipal Bonds (Barclays 1-10 Year Municipal)	-2.2%	+0.5%	+2.5%	+2.2%
Taxable Bonds (Barclays Intermediate US Gov/Credit)	-1.5%	-1.4%	+2.6%	+2.1%
High Yield Corporate Bonds (Barclays US High Yield)	-2.7%	+5.3%	+5.4%	+6.2%
Equities				
Global Stocks (MSCI All Country World)	-4.9%	+18.5%	+12.6%	+10.7%
US Large Cap Stocks (S&P 500)	-5.2%	+28.7%	+16.8%	+15.4%
US Small Cap Stocks (Russell 2000)	-9.6%	+14.8%	+9.7%	+11.3%
Non-US Developed Markets Stocks (MSCI EAFE)	-4.8%	+11.3%	+7.9%	+6.9%
Emerging Markets Stocks (MSCI Emerging Markets)	-1.9%	-2.5%	+8.3%	+4.2%
Real Assets				
Commodities (Bloomberg Commodity)	+8.8%	+27.1%	+5.4%	-2.3%
Natural Resources (S&P Global Natural Resources)	+3.8%	+25.2%	+9.5%	+4.1%
Energy MLPs (Alerian MLP)	+11.1%	+40.2%	-1.6%	+0.6%
Global REITs (S&P Global REITs)	-6.6%	+32.5%	+7.9%	+8.7%

*Note: *Indicates annualized return. Past performance is not indicative of future results.*

Based on data since 1950, so-called "corrections" or stock market declines of -10% or more have occurred about once a year. The S&P 500 Index has had an average drawdown of -13.6% over the course of a calendar year.[2] However, the fact that market declines are a normal part of investing in stocks and happen relatively often doesn't make them any less unnerving. It's worth a reminder that for investors with a thoughtfully constructed portfolio that considers both their temperament and financial ability to take on risk, shorter-term market declines are not a threat to achieving their longer-term financial objectives. The real threat likely comes from a failure to stay invested through these inevitable declines.



Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management as of December 31, 2021.

Macro Backdrop

We seek to frame the macroeconomic backdrop by considering a range of potential outcomes. What remains unique about the current environment is the unprecedented Covid-related disruption and rebound. Acknowledging this, our base case assumes a continued global economic recovery transitioning to a more moderate, but still above-trend, pace. Indeed, growth and policy support may have peaked for this cycle—but the likelihood of an imminent US or global economic recession appears low. Even as US fiscal stimulus diminishes, consumer balance sheets are well-positioned to fuel higher consumption with household savings that exceed pre-pandemic levels by over $2 trillion.[3] Therefore, absent a severe resurgence in the pandemic, uncertainty about the inflation and monetary policy outlook remain key risks.

- **Inflation Risk:** Realized inflation rates have surged to their highest levels in decades, driven by a combination of higher demand spurred by pandemic-related stimulus and lower supply from global labor and input shortages. Looking forward, economic forecasts for inflation are more varied than for growth, reflecting increased uncertainty. Jason Trennert at Strategas Research Partners notes that many forecasters have positioned the debate over inflation as a false choice between the double-digit inflation of the 1970s versus an increase in prices that will prove to be only "transitory." While we don't expect a return to 1970s-style inflation, we anticipate that supply/demand frictions will persist well into 2022 and keep inflation elevated. Yet, as long as the pandemic recedes over the year, a gradual decline in the rate of price increases is likely. In our view, the key risk is a wage-price spiral starts to emerge and longer-term inflation expectations rise beyond the US Federal Reserve's (Fed) comfort zone.

- **Monetary Policy Risk:** The global policy response to Covid-19 was aggressive and effective. Now, policymakers are faced with navigating an exit from exceptionally accommodative posture. Central bankers will have to strike a delicate balance between keeping a lid on inflation expectations and supporting a return to pre-Covid employment levels.[4] In the US, the Fed will wind down its quantitative easing (QE) program in March and then begin raising interest rates. Of course, reduced monetary accommodation can impact aggregate levels of demand but cannot directly address supply chain bottlenecks. While the latest round of QE or bond-purchasing program provided needed financial market liquidity in response to the pandemic-induced recession, the central bank more than doubled its assets over the past two years to nearly $8.8 trillion. So, the Fed now has a massive balance sheet to unwind—and little experience doing so at such a scale.[5] Cleary, the risk of a policy mistake exists. The Fed could either 1) tighten too much/overact to inflation readings, or 2) allow inflation expectations to become entrenched by doing too little.

Market Outlook and Portfolio Strategy

Our base assumption of a continued economic recovery (albeit slower) and still-robust consumption should remain supportive of corporate earnings and, therefore, risk assets such as global equities and credit. And we continue to believe that a severe bear market is unlikely without a recession. However, equity valuations remain above their historical averages and are most elevated in the US. Therefore, our outlook assumes some multiple compression, or a decline in price/earnings (P/E) multiples, over the next few years. This seems appropriate given the expectation of rising interest rates and high policy uncertainty—which should also translate into increased volatility.

We continue to expect below-average returns from traditional asset classes, with equities priced to deliver mid-single digit returns over the next three years, in our view. Yet, we see better return prospects in international and emerging markets stocks where earnings have more room for positive surprises and valuations are more reasonable. We also believe the continued recovery in global economic growth will benefit value stocks and traditional cyclical sectors, such as energy, financials, and industrials.

Against a backdrop of high macro uncertainty and generally rich asset valuations, we believe proper diversification is as important as ever. In our view, developing portfolio strategy isn't based on making predictions about the future but on being prepared for a range of potential outcomes. While we formulate a base case set of assumptions about the future, we recognize the inherent uncertainty involved with investing. Therefore, our portfolios are *strategically* balanced across a range of global asset classes, alternative strategies, and risk-factor exposures. This should enable them to be resilient across multiple scenarios. Yet, we also remain positioned to benefit from our highest-conviction *tactical* investment views.

Recent market volatility may create attractive investment opportunities, which we'll continue to evaluate. However, at this point, our tactical portfolio positioning themes remain largely unchanged.

- **Target an underweight position to core/investment grade fixed income.** We plan to continue to trim intermediate duration high quality bonds, in favor of increased cash/short-term fixed income as "dry powder."

- **Target an underweight position in US large cap equities while emphasizing high-quality stocks.** In the current environment, companies with strong balance sheets and pricing power should outperform. However, we will continue to rebalance away from US large cap stocks in favor of small caps.

- **Remain fully invested in more reasonably priced international and emerging markets stocks.** In our view, non-US stocks stand to benefit from more attractive valuations and greater orientation toward cyclical sectors.

- **Target an overweight position to real assets given attractive valuations and the risk of "stickier" inflation.** Commodities and commodity-producer equities can help hedge against surprise increases in inflation while providing potential capital appreciation in a higher nominal growth environment.

The table below summarizes our current tactical asset category views.

Asset Category Tactical Views	Strong Underweight	Underweight	Neutral	Overweight	Strong Overweight
Cash					
Cash & Short-Term Bonds				✓	
Fixed Income					
Investment Grade Municipal Bonds		✓			
Investment Grade Taxable Bonds		✓			
Bank Loans and High Yield Credit			✓		
Equities					
US Large Cap Stocks		✓			
US Small Cap Stocks			✓		
Non-US Developed Markets Stocks			✓		
Emerging Markets Stocks			✓		
Real Assets					
Commodities and Natural Resources				✓	
Public Real Estate	✓				
Flexible/Alternative Strategies					
Diversifying Hedge				✓	

Note: Based on research and opinion provided by Greycourt & Co. Tactical views reflect a three-year investment horizon. Suggested asset class weights are used as a starting point in assessing client portfolio weights against strategic targets which typically reflect a ten-year investing horizon.

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[1] *Michael P. Regan, Bloomberg, "Market Turmoil is Ultimate Test of What's Real and What's Not," January 26, 2022.*
[2] *Ben Carlson, A Wealth of Common Sense, "How Often Should You Expect a Stock Market Correction," January 20, 2022.*
[3] *Lazard Asset Management, "Outlook on the United States," July 2021.*
[4] *Vanguard, "Economic and Market Outlook for 2022: Global Summary," January 2022.*
[5] *Lisa Shalett, Morgan Stanley, "Should Investors Brace for More Volatility?" January 25, 2022.*