MACRO MUSINGS

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Our 2022 Outlook

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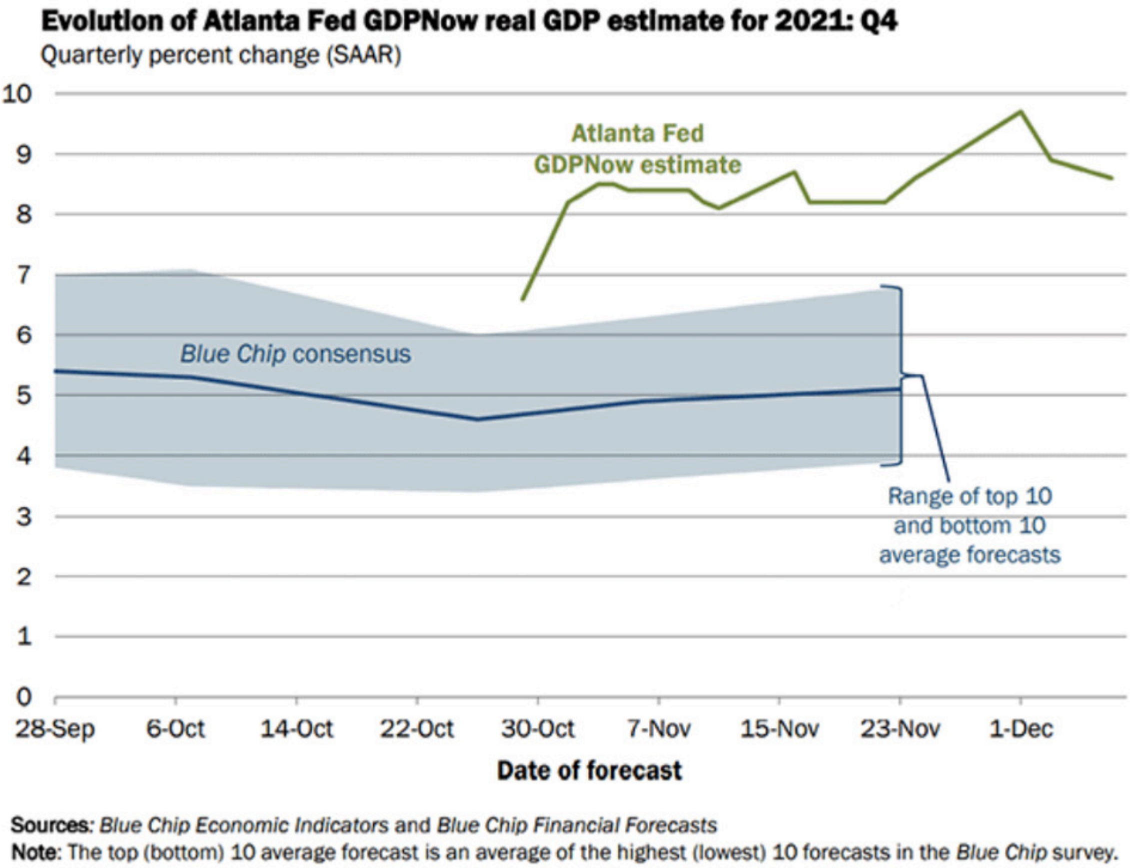
SUMMARY

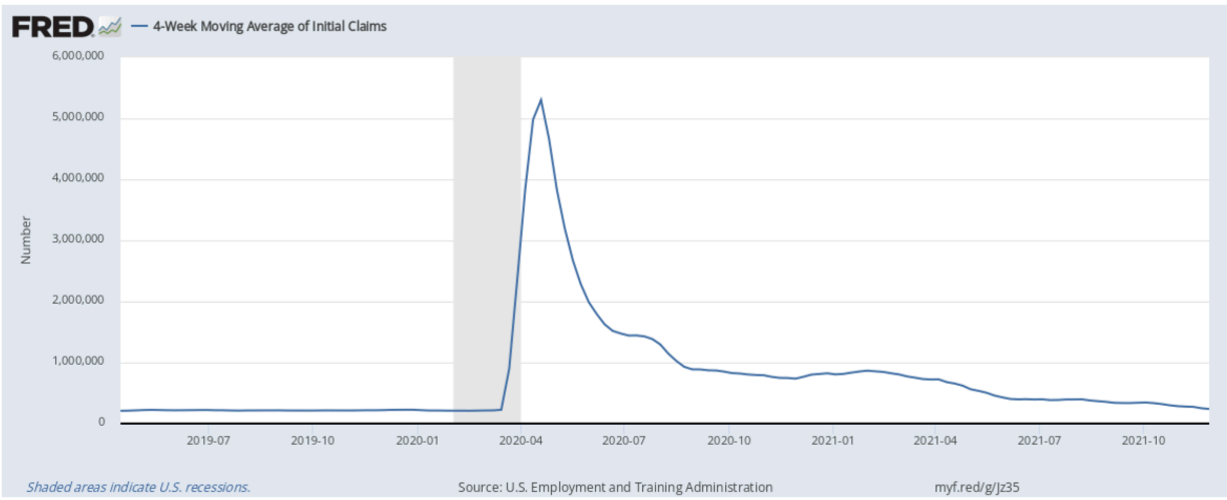
- Heading into the new year, **macro**cast™ indicates a low probability of a sustained, recessionary bear market. Our current **micro**cast™ signal is suggesting an aggressive allocation. Both models are decisively positive, underpinning a positive market outlook going into 2022.
- We expect continued strength in US economic growth in 2022, supported by a healthy job market, consumer spending, and increased capital expenditures. Globally, growth may be lower due to delayed COVID outcomes and tightening central bank policies.
- Inflation will likely remain elevated early in the year, but year-over-year numbers should decelerate in the back half of 2022. The biggest risk to our inflation outlook is persistent supply chain issues due to COVID-related restrictions, while the tight labor market puts upward pressure on wages.
- The Federal Reserve is looking to accelerate the tapering of asset purchases, which could mean the first rate hike will come earlier than expected. We will be watching monetary policy closely as a policy mistake could induce additional market volatility.

THE US ECONOMY SHOULD SLOW, **BUT STILL BE STRONG**

The US economy is strong going into 2022. GDP estimates for the 4th quarter are ranging from 4% to 7%, while the Atlanta Fed's estimate is near 9%:



Initial claims for unemployment are the lowest they've been since March 2020:



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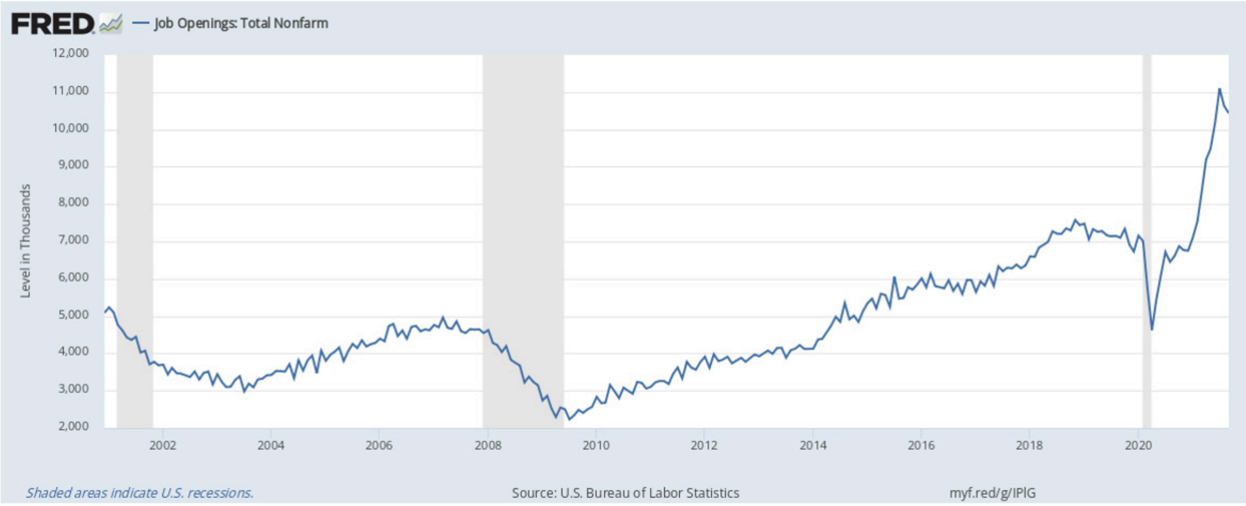
The labor market should continue to recover in 2022 with job openings near all-time highs, well above pre-pandemic levels:



Supported by job growth and increasing wages, consumer spending is expected to remain robust (chart from Oxford economics via the Daily Shot):

Consumer spending accounts for nearly 70% of the US GDP. If actual spending comes in close to the above projections, the chance of a recession next year is very low.

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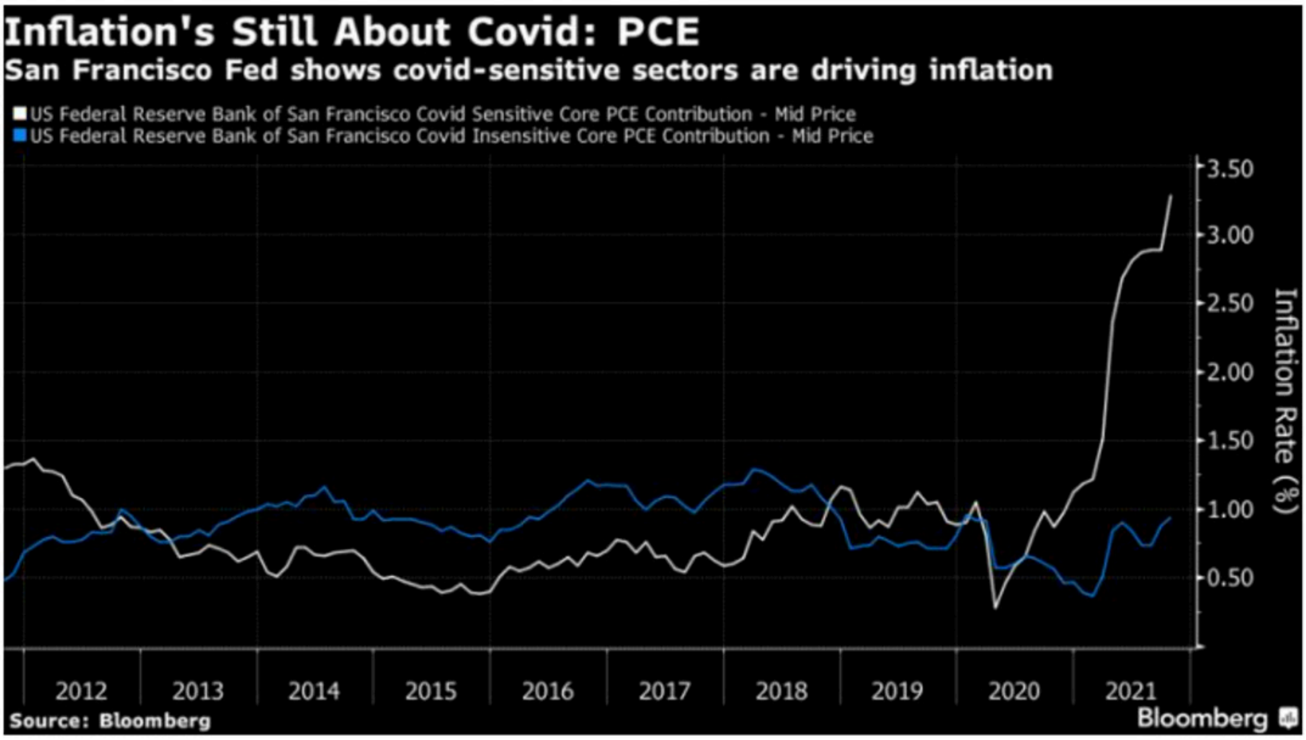
INFLATION SHOULD DECELERATE
IN THE SECOND HALF OF THE YEAR

Inflation was, by far, the most discussed financial topic of 2021. Both headline and core inflation (which excludes volatile food and energy prices) are still at multidecade highs. However, the following chart from Bloomberg shows that the rise in inflation is still primarily driven by the lingering effects of the pandemic:



Sectors that were not affected by the pandemic have not seen major price increases.

After a year like 2021, it's hard to put a lot of stock in any predictions about inflation. Still, it is unlikely that inflation figures will match what we experienced in 2021. If for no other reason, the base effect supports decelerating inflation next year. Inflation is reported on a year-over-year basis, so to experience similar price increases, oil/gas/food/autos/etc. would need to increase at the same rate they did this year.

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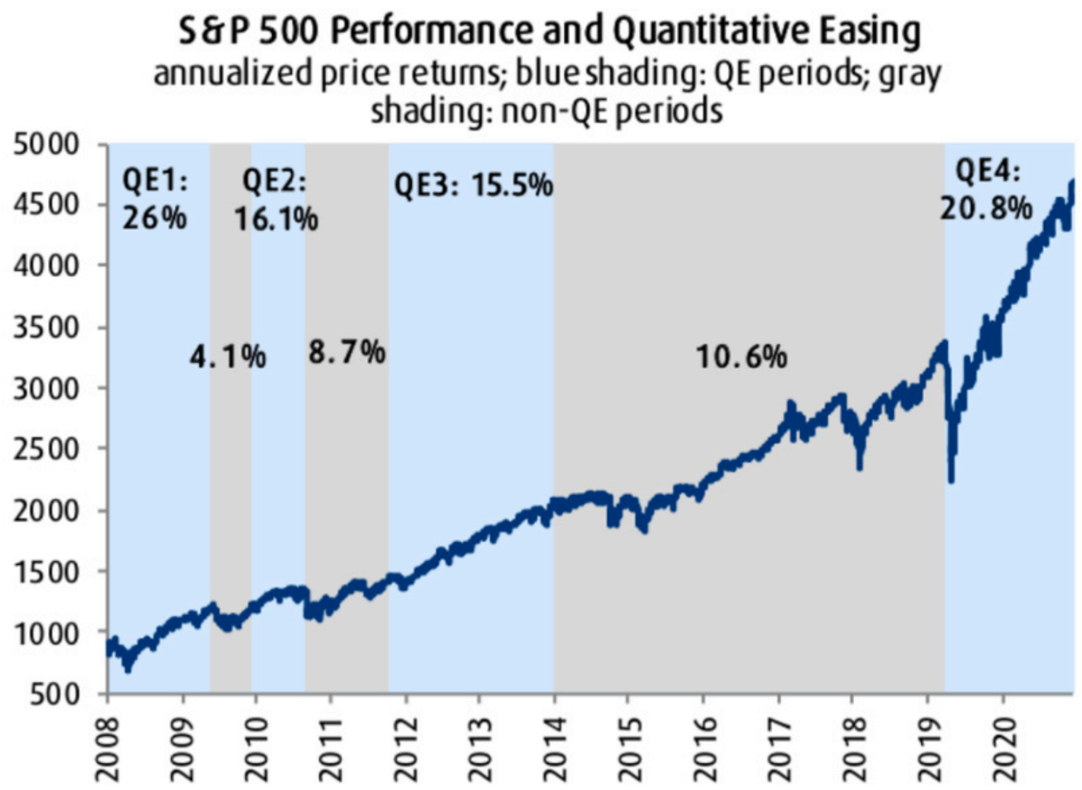
THE FED'S LEVEL OF AGGRESSIVENESS IS THE **BIG UNKNOWN**

With unemployment marching towards pre-pandemic levels and inflation remaining stubborn, the Fed, having already announced tapering in November, is now looking to accelerate its pace and end bond purchases by next spring rather than next summer. This implies that they will raise interest rates sooner than expected, possibly as early as May.

First, it's important to acknowledge that the Fed would not be doing this if the economy wasn't strong. While they've acknowledged inflation is a bigger problem than they initially thought, if GDP growth wasn't as robust and the employment outlook wasn't as positive, we don't believe they would be so quick to taper.

Second, the end of quantitative easing does not spell doom for the market. While we do not expect similar levels of market gains next year, historically, equities perform well, on average, after easing ended (from BMO):

Exhibit 4: QE Periods Have Coincided With Outsized Gains, but S&P 500 Has Still Logged Decent Annualized Returns Without Fed Stimulus



Source: BMO Capital Markets Investment Strategy Group, FactSet, Haver, FRB.

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Lastly, the Fed's plans are not written in stone. We do not expect them to reverse the taper, but we do not believe the Fed will raise rates if the economy unexpectedly shows weakness or in the event of a geopolitical crisis. They are even less likely to be aggressive in tightening monetary policy if the pace of inflation is slowing. In other words, the Fed can change course at any time and has historically done so when appropriate:

1. In 2011, after the debt ceiling fight and the European debt crisis, the Fed announced Operation Twist (also known as QE3) to further support the economy.
2. In 2015, after raising rates for the first time since 2006, the Fed recognized the worsening global economy and held off on further rate hikes until December of the following year.
3. In September 2018, the Fed raised rates for the third time that year, and a week later, Chairman Jay Powell said, "we're a long way from neutral." The market suffered a 20% decline in Q4 2018, and after one more hike in December, the Fed pivoted to a much more dovish tone. By the following summer, they were cutting rates again.

The base case is currently for multiple rate hikes next year, but as the Fed has proven many times before, this is subject to change. The ideal scenario would be gradual tightening that is more than offset by a healthy economy while inflationary pressures recede.

RECENT MARKET ACTION HAS DRAGGED DOWN INVESTOR SENTIMENT. **HISTORICALLY, THAT'S BULLISH**

The American Association of Individual Investors (AAII) conducts a weekly survey of its members to gauge how constructive they are on the market. Heading into 2022, they have become increasingly bearish. The current Bull to Bear ratio, which compares the number of bullish investors to the number of bearish investors, is less than .60. That is a fairly rare occurrence, and historically, the market has performed better than average in the subsequent 3-, 6-, and 12-month periods.

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AAII Bull vs Bear Below...	% Observations	Average return in the subsequent...				% of positive returns in the subsequent...			
		1m	3m	6m	12m	1m	3m	6m	12m
< 1.0	31.6%	1.4%	3.5%	6.8%	12.6%	68%	75%	77%	81%
< 0.9	26.1%	1.4%	3.7%	7.0%	12.9%	68%	77%	78%	82%
< 0.8	19.4%	1.5%	4.1%	7.1%	12.5%	66%	78%	77%	82%
< 0.7	13.4%	1.7%	4.2%	7.4%	13.7%	67%	78%	77%	83%
< 0.6	8.0%	2.0%	5.0%	9.2%	15.7%	69%	80%	81%	85%
< 0.5	4.1%	3.3%	5.9%	11.0%	15.4%	79%	81%	82%	85%
Unconditional (Since 1987):		**0.8%**	**2.2%**	**4.7%**	**9.7%**	**64%**	**69%**	**73%**	**78%**

This level of pessimism could change if we get a year-end rally, but it suggests investors remain cautious, despite a maximum drawdown of only 5% YTD.

WE EXPECT BIGGER **DRAWDOWNS AND MORE VOLATILITY IN 2022**

As we mentioned above, the 5% decline in the S&P 500 is the lowest annual drawdown observed since 2017. The resiliency of the market in 2021 has been impressive, and it's only the 4th time in the last 40 years the market has declined a maximum of 5% during a calendar year.

Although the sample size is small, each time the market was down 5% or less, the following year saw larger declines, ranging from 8% to 20%:

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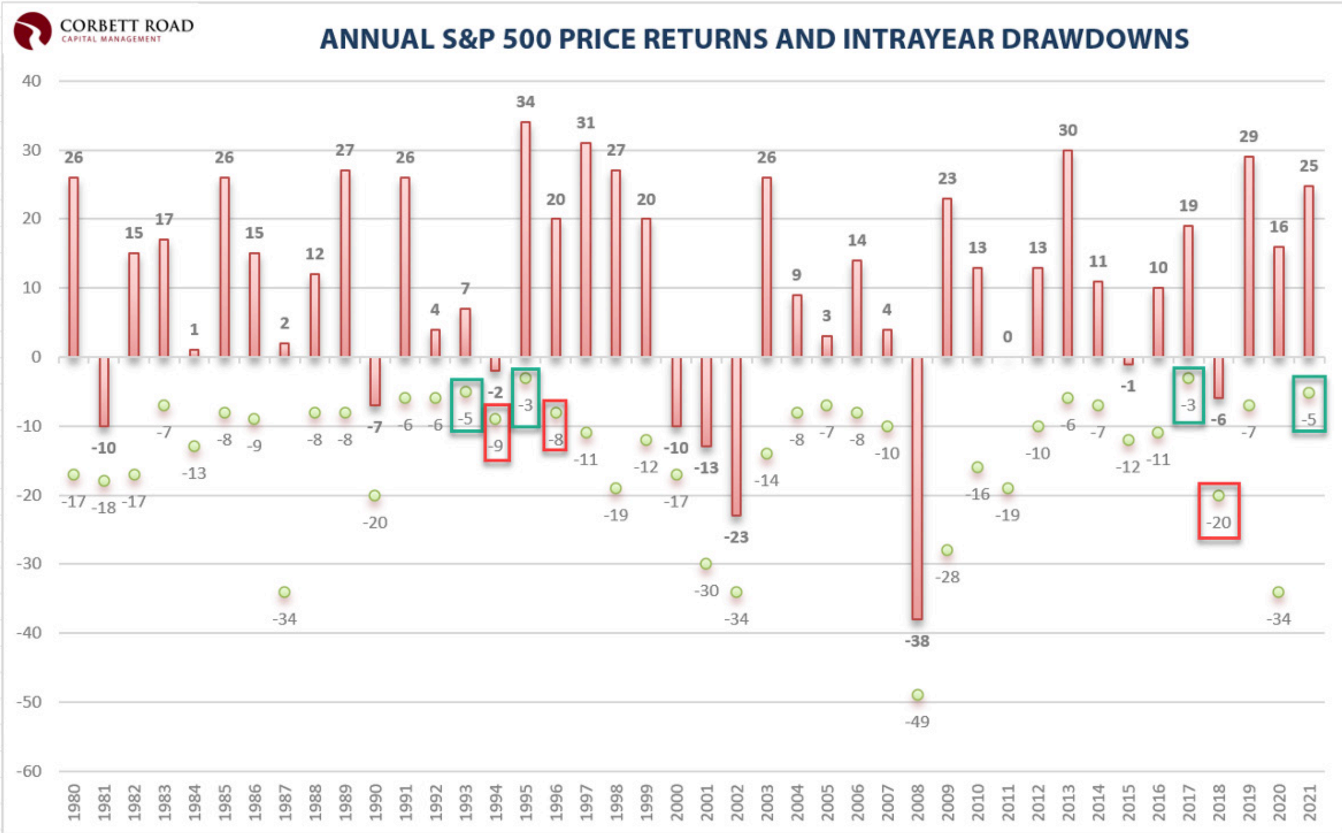

*YTD returns through 12/7/2021

THE BASE CASE FOR 2022:
SLOWER BUT STILL SOLID GROWTH

Thanks to a buoyant job market, well-positioned consumers, and increasing business investment, we believe that the economy will continue to grow in 2022 but at a slower pace than this year. While the Fed is less supportive than they've been the past two years, they've shown the willingness to adjust policy to incoming data, so we do not expect aggressive tightening unless the economy calls for it.

This is the final Macro Musings of the year. We will publish our 2021 Year in Review late next month. We would like to thank all of our clients and partners for your continued trust and business. We wish you a happy and safe holiday season and a successful New Year.

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Wishing you a
Joyous Holiday Season
and a New Year filled with
Happiness and Prosperity

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