ELEMENT POINTE
ADVISORS

Market Outlook:

Top Ten Investment Themes for 2022

January 2022

Please see page 29 for important disclosures.

January 2022

Top Ten Investment Themes for 2022

1. **The U.S. Economy:** The U.S. economy enters 2022 in relatively good shape, with the exception of the inflationary pressures that are taking hold. However, we believe economic growth will miss consensus estimates, as forecasts underestimate the impact of monetary tightening and the fiscal headwind that awaits.
2. **Inflation is Here to Stay:** The combination of prolonged supply-demand imbalances, strong wage growth, and accelerating rents will cause the U.S. to remain in an inflationary environment in 2022.
3. **The Federal Reserve (the Fed):** The Fed completely misinterpreted the nuances of the COVID-19 recovery. Now the Fed has to aggressively tighten monetary policy to combat inflation, putting the economic recovery at risk.
4. **Wall of Liquidity:** The combination of rising interest rates and less accommodative monetary policy will lead to a rapid withdrawal of liquidity from the financial system and may pose a headwind to equity market returns in 2022.
5. **Outlook for Equities:** With inflation stubbornly high, and the Fed pivoting toward monetary tightening, the outlook for equities looks decidedly less bullish than last year. We believe 2022 will be a volatile year for equities; one where the market experiences multiple corrections and where diversification pays off for investors.
6. **Outlook for Fixed Income:** An environment of accommodative monetary policy and low interest rates has driven public-market fixed income securities to levels with embedded downside risks. We view the risk-return profile of the bond market as asymmetric, especially for corporate bonds.
7. **From Pandemic to Endemic:** Future COVID-19 outbreaks are likely, but the effects on the economy and capital markets will diminish as the disease becomes endemic.
8. **Emerging Markets and China:** Emerging Markets significantly underperformed Developed Markets in 2021, led by declines in China. While sentiment is sufficiently depressed to foster outperformance in 2022, China's economy faces ongoing challenges that will weigh on growth, and its pivot toward autocratic socialism raises important questions for long-term investors.
9. **Renewable Energy vs. Fossil Fuels:** While we remain long-term bullish on risk assets linked to the clean energy sector, we anticipate that carbon-emitting energy commodities will perform well in 2022 due to pent-up demand for fossil fuels as a result of the reopening of global economies amidst a supply-constrained environment.
10. **Where Did the Labor Force Go?:** The slow reentrance to the workforce of workers displaced during the pandemic will continue throughout the year resulting in a tight labor market and added pressure for the Federal Reserve to raise benchmark interest rates .

TOP 10 INVESTMENT THEMES FOR 2022

1. The U.S. Economy

We believe U.S. economic growth will come in below the Fed's estimate of 4% in 2022, as consensus underestimates the size of the fiscal headwind that awaits and the impact that monetary tightening will have on growth. However, the U.S. economy enters 2022 in relatively good shape, with the exception of the inflationary pressures that are plaguing some areas of the economy, especially the goods sector. While the final numbers are not yet available as of the date of this report's publication, the U.S. grew approximately 5.5% last year, although growth slightly missed consensus expectations from the beginning of the year due to various COVID-19 outbreaks and pandemic-induced production shortfalls. As we enter 2022, there is still plenty of pent-up demand, especially in the service sector, which should lead to another year of above-trend growth. We believe growth will decelerate to the 3% range, missing consensus estimates once again. While the odds of a recession in 2022 remain low, we forecast that the U.S. will exit 2022 at trend growth (defined as approximately 2%) and that recession will become a possible risk for 2023 if inflation does not subside.

Many strategists believe that the U.S. economy is just now entering mid-cycle. As reflected in the table below, ***our*** evaluation of both economic and market metrics suggests that the economy is now entering ***late***-cycle. One possible explanation is that this economic cycle is moving at warp speed. Our interpretation is that this is really just a continuation of the last cycle, which experienced a huge interruption due to the pandemic. Although the U.S. technically experienced a recession in 2020 according to the National Bureau of Economic Research (NBER), it lasted only two months, the shortest recession in U.S. history, and many of the imbalances and constraints that weigh on growth in the late-cycle of an expansion remain. The government's pandemic response of flooding businesses and consumers with free money helped bridge the economy through the shutdown, but it also prevented most of the purges that take place in a recession, which include widespread deleveraging, bankruptcies or closures of inefficient businesses, and depressed consumption. Because the government's pandemic response curtailed these actions, the economic cycle never had a chance to reset.

Exhibit 1: Element Pointe Advisors's views on the Economic Cycle

		Mid Cycle	Late Cycle	Rationale
Economy	Gross Domestic Product (GDP)		✓	Back to prior trend
	Consumption		✓	High; above prior trend
	Capital Investment	✓		Moderate, but improving
	Housing		✓	Record-breaking year in 2021
	Inflation		✓	Highest CPI in nearly 40 years
	Wages		✓	Wage growth greater than 4.5%
	Private Credit Formation		✓	Credit is widely available
	Personal Savings Rate	✓		Back tor prior trend, but room to decline fruther
	Unemployment		✓	Labor market is extremely tight
Market	Consumer Confidence	✓		Confidence weighed down by inflation and COVID-19
	EPS Revisions	✓		We expect revisions will decline sharply from here
	Corporate Margins	✓		We believe margins have peaked
	Credit Spreads	✓		Spreads are tight but off their lows
	IPOs		✓	Record year for IPOs in 2021
	M&A Activity		✓	Record year for M&A in 2021
	Yield Curve	✓		Flattening but still well above zero
	Volatility	✓		Moderate but picked up at the end of last year

As to trend growth rates that were in place pre-pandemic, most categories of the U.S. economy are already back to trend, including U.S. GDP. Nowhere is this more evident than in consumer spending. Holiday shopping growth of 8.5% was the best in 17 years,[1] and that figure does not include the strong performance of October, when many people chose to do their holiday shopping early in order to avoid delivery issues. According to data compiled by research firm Strategas, U.S. consumers have roughly $2.4 trillion in excess savings on their balance sheet.[2] It is abundantly clear that the strength of the consumer is one of the bright spots for the economy; however, consumption is also exacerbating the inflation problem. Consumption of goods is well above trend, while consumption of services remains below trend as the pandemic has been especially disruptive for service businesses. With each variant outbreak proving less disruptive than the last, we believe that the imbalance in spending will correct itself and consumers will satisfy their pent-up demand for services like travel and entertainment. This should help alleviate some of the supply chain bottlenecks that exist throughout the economy, and allow for a restocking of inventories back to normalized levels. One notable example is the auto industry, where chip shortages have held back production and inventories are well below normal. A return to normalized auto production levels should give the economy a boost in 2022. In summary, we expect strong consumer spending and inventory restocking to provide additional growth for the U.S. economy in 2022.

Exhibit 2: U.S. Retail Inventory/Sales Ratio

Source: Federal Reserve Bank of St. Louis, as of 10/01/2021

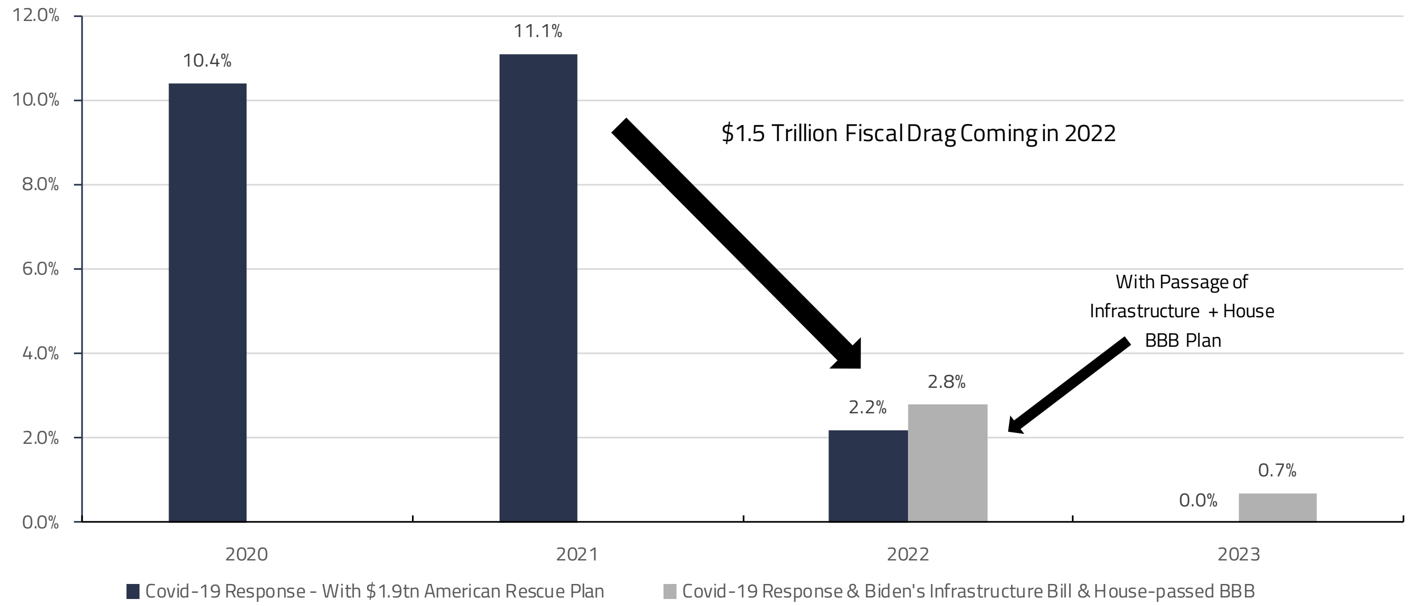
Another area of strength for the U.S. economy is the housing market. In 2021, existing home sales were the strongest since 2006, and the Case-Shiller home appreciation index gained the most on record.[3] It is well known that the pandemic caused a work-from-home blitz that ignited a home buying surge as people reassessed their needs and decided they needed more residential space. Mainly to the detriment of gateway cities in the northeast and in California, the pandemic triggered a huge migration that upended the housing market and gave a boost to the economy. While we expect housing to remain firm in 2022, we do see signs that activity levels are dropping as buyers have begun to balk at pricing and affordability. We think that most people who were inclined to move have already done so, thus we expect housing market activity to return to normalized levels sometime this year.

One of our biggest concerns for the economy is the size of the fiscal drag that awaits this year. According to Strategas data, inclusive of the infrastructure bill, which passed last year, and assuming House of Representative's 's Build Back Better (BBB) plan passes, the fiscal drag this year is still $1.5 trillion.[4] This figure likely understates the true fiscal drag because there is little chance that the BBB plan passes in its current

1. Sharma, Akriti. "U.S. Holiday Retail Sales Rise 8.5% as Online Shopping Booms -Mastercard." Reuters, Thomson Reuters, 26 Dec. 2021, https://www.reuters.com/markets/us/us-holiday-retail-sales-rise-85-online-shopping-booms-mastercard-2021-12-26/.
2. Rismiller, Donald. "Minutes Make QT More Consensus, Fed On Alert." Strategas Research Partners, Economics Report, January 6, 2022.
3. S&P Global. "S&P Corelogic Case-Shiller Index Reports 19.1% Annual Home Price Gain in October." press release, December 28, 2021.
4. Strategas Research Partners. "Covid, Thanksgiving, and the Godfather." November 29, 2021.

form. The BBB plan likely needs to be downsized substantially in order to gain the support of key moderate Democrats. We now believe the ceiling on BBB is $1.2 trillion, and there is still a reasonable chance that the Democrats will fail to pass any plan.

Exhibit 3: Impact of Fiscal Stimulus as a Percentage of Gross Domestic Product



Source: Strategas, as of 12/31/2021

The economy needs to overcome this fiscal drag at a time when the Fed has pivoted toward monetary policy tightening. As previously mentioned, the economy enters 2022 with strong momentum and several healthy growth drivers. We believe the economy will be able to achieve above-trend growth this year, but growth will fall short of expectations due to several late-cycle dynamics. High inflation will curtail some demand, and a tight labor market will restrict the supply-side of the economy. The key to the intermediate-term economic outlook is how inflationary trends and the labor market evolve over the course of the year. The path to an economic soft landing that sets the foundation for an elongated late-cycle expansion rests on two key variables: 1) inflation slowing to meet the Fed's forecast, and 2) the labor force participation rate rising to pre-pandemic levels. From a markets perspective, the keys to watch are credit spreads and the shape of the yield curve. The economic outlook should remain firm as long as credit spreads do not widen by more than 50 basis points, or the yield curve does not flatten below 25 basis points. If either of these events happens, the market is warning that the risk of stagflation is high and a recession in 2023 is a significant possibility. In that scenario, the Fed's ability, or inability due to high inflation, to pivot back to monetary policy accommodation will be critical in shaping the course of events for the economy and markets.

Our out-of-consensus view that the economy is entering late-cycle expansion has important implications for portfolios. Late-cycle generally means more muted equity gains and higher volatility, as recession risks build. In preparation, we have reduced some small-cap and cyclical equity exposures and replaced these with a large-cap defensive strategy. In general, defensive sectors like healthcare, consumer staples, and utilities outperform cyclical areas like energy, financials, and industrials during late-cycle periods. That said, given the reflationary dynamics of this cycle and the likelihood of higher rates, we want to remain overweight investments that are correlated positively to rising rates, like financials and commodities. With respect to individual stocks, we want to focus on high-quality companies with high margins, low leverage, and pricing power. These companies are best suited to manage and grow earnings through a economic growth slowdown. Finally, we are overweight cash because we anticipate several market pullbacks in the coming year.

TOP 10 INVESTMENT THEMES FOR 2022

2. Inflation is Here to Stay

The reopening of the economy brought with it a sharp increase in inflation due to months of fiscal stimulus and pent-up demand from the economic lockdowns of 2020 and early 2021. Inflation surprised sharply to the upside in 2021 and now stands at a 40-year high, driven mainly by a surge in durable goods prices. Services inflation has risen more slowly, fueled by faster growth of wages and rents, and should prove more in line with the Fed's new inflation goal. The supply-demand imbalances underlying the surge in durable goods prices are proving to be increasingly difficult challenges to resolve, implying a high-inflation environment throughout 2022. The past few months have also seen a period of higher wage pressure amid labor shortages and the tightest housing market since 1970, putting additional upward pricing pressures on the American consumer. We believe that the combination of prolonged supply-demand imbalances, strong wage growth, and accelerating rents will cause the U.S. to remain in an inflationary environment in 2022.

Exhibit 4: Personal Consumption Expenditures excluding Food and Energy (Year-over-Year Change)

Source: Bloomberg, as of 11/30/2021

The critical variable for the 2022 inflation outlook is whether supply-demand imbalances in the durable goods sector will moderate enough for prices to begin to normalize. Consumption of durable goods has been elevated because of consumer preference shifts and increased disposable incomes resulting from generous fiscal policy during the pandemic. Demand should begin to moderate slightly this year as services spending rebounds and the effects of fiscal stimulus begin to fade. However, we expect this reduction in demand to be fairly moderate, given that shortages and high prices have likely deferred some demand, and because households can partly offset the decline in their incomes through the excess savings accumulated during the pandemic. The supply-side faces various problems, including COVID-driven factory shutdowns, disruptions to semiconductor production, port closures and congestion, and widespread labor shortages. All of these factors have contributed to significant supply-chain disruptions.

Semiconductors are an essential input that is in short supply because of their many downstream uses, especially in autos. Advances in technology across multiple industries have increased demand for silicon, leading to a global semiconductor shortage that has caused production disruptions worldwide. As Asia recovers from the Delta wave, we believe that semiconductor production will pick up to meet the surging demand, which should help alleviate production disruptions. Eventually, the rebuilding of depleted inventories will transition the goods sector from an environment of scarcity to an environment of abundance, which in turn should restore competition and cause goods prices to normalize from their current elevated state.

Port congestion in major U.S. ports, such as Los Angeles and Long Beach, has exacerbated supply-demand imbalances.. Congestion in U.S. ports began to spike in the middle of 2020 and was a persistent problem through the end of 2021, despite efforts by port operators to increase the hours of operation and contract with private industry to alleviate the bottleneck. With record volumes of inbound containers, ports are now constrained by their capacity to handle containers after being unloaded, with industry officials citing shortages of labor, warehouse space, and equipment as the main obstacles to accelerating acceptance of inbound containers. In September, roughly one-third of shipping containers at the ports of Los Angeles and Long Beach sat for more than five days after being unloaded from the ship, a drastic increase from before the pandemic. These long wait times negatively affect supply-chain efficiency, resulting in a decline in the number of off-loaded containers by -3.6% month-over-month at the Port of Los Angeles in September and -9.1% at the Port of Long Beach.[5] There has been some hope for a faster resolution to the issue of port congestion, as the White House secured commitments from the Port of Los Angeles and private sector transportation companies to begin operating on a 24/7 basis. The proposal was met with skepticism, as resolving the current bottlenecks would also require cohesive participation across inland supply chains that have suffered from their own labor-force challenges. Shortages of labor in supply-chain industries has been worse than those of the broader economy, and many transportation jobs require specialized licenses and training, creating further barriers to entry for new workers. However, accelerating wages and the expiration of enhanced unemployment benefits should begin to bring balance to industries connected to the supply chain, providing hope for an eventual return of supply-chain efficiency. While this should gradually alleviate pricing pressure, we believe supply-chain disruption will continue to be a factor that provides upward pricing pressure across durable goods throughout 2022.

Another inflation indicator that we believe indicates a likelihood of high-inflation for 2022 is the accelerating wage growth fueled by labor shortages. Growth in wage measurements such as Average Hourly Earnings (AHE) can be a good indicator of the persistence of inflation, given that wage increase is an element of inflation that is difficult to reverse. The latest AHE figure for December 2021 shows growth of 4.7%, which is a level that is incompatible with the Fed's historical 2% inflation target.[6] AHE has experienced strong upward pressure over the past few months due to national labor shortages, resulting primarily from enhanced unemployment benefits and increased consumer savings. This has caused many former participants to stay out of the labor force. However, labor shortages appear to have eased now that enhanced unemployment benefits have expired. The exhaustion of pent-up savings, the reopening of schools, and reduced health risks should bring more workers back over time. Yet, with many potential participants citing non-economic reasons for staying out of the market, upward wage pressure seems likely to persist in 2022, but with the caveat that the pace of its growth should normalize.

The final factor in our inflation outlook is the persistence of shelter inflation in the tightest national housing market since the 1970s. Shelter inflation significantly influences both the Core Personal Consumption Expenditure (PCE) and Core Consumer Price Index (CPI) inflation readings, accounting for approximately one-third of the weighting in both measurements. Shelter inflation also tends to be stickier than other forms of inflation and has surged in recent months amid a national housing shortage that has spurred significant home price increases. Vacancy rates have fallen to record low levels, and house prices have risen 20% over the past year. Strong demand driven by low mortgage rates and demographic tailwinds looks to persist. Additionally, constraints on supply, such as shortages of construction workers and buildable plots of land, predate the pandemic and appear to have worsened coming out of the pandemic. Moreover, the surge in input costs, such as lumber, concrete, and steel has caused homebuilders to hesitate in adding supply to match the surging demand. Rent inflation has simultaneously risen, as the sharp increase in Owner's Equivalent Rent, a figure that measures the amount of rent equivalent to the monthly expenses of owning a home, has provided landlords leeway to raise rents at the fastest pace since before the crisis.

Some aspects of the recent inflation surge are temporary in nature and will likely moderate throughout the year. The loosening of COVID restrictions unleashed a deluge of pent-up travel demand as consumers stuck at home for over a year turned urgently toward leisure spending. In turn, the last quarter of 2021 saw significant price increases in airfare, hospitality, and transportation services. Furthermore, used car prices have increased dramatically as rental car companies try to rebuild their fleets after they offloaded many vehicles in bankruptcy events in 2020.

Consumers have shown an eagerness to spend amidst a period of heightened savings because of the lockdown. We believe consumers' attitudes toward spending will gradually normalize as disposable income fades and savings diminish, which will alleviate some of the surging infla-

5. Walker, Ronnie. "US Daily: US Port Backlogs: A Story of High Demand and Stretched Supply." Goldman Sachs Research, October 25, 2021, https://publishing.gs.com/content/research/en/reports/2021/10/25/b3f5be93-c863-4734-9618-35c3790c2548.html

6. Bloomberg.

tionary pressures we are experiencing. Overall, we believe the pace of inflation is bound to wane as economic disruptions subside; however, the stickier nature of increases in shelter costs and wages amid the persistent inefficiency of the global supply chain lead us to believe that inflation will remain elevated throughout the year.

TOP 10 INVESTMENT THEMES FOR 2022

3. The Federal reserve

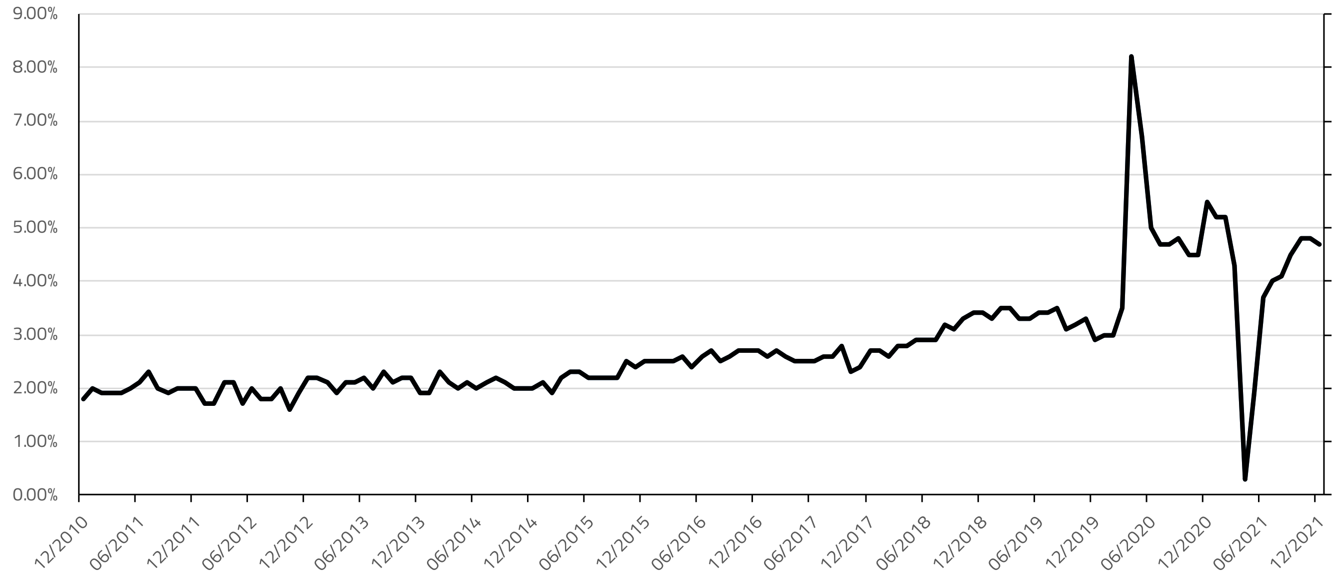
The Federal Reserve (the Fed) misdiagnosed the patient and made a policy mistake by letting inflation run hot before starting its tapering of asset purchases. The Fed completely misread the nuances of the COVID-19 recovery, letting its experience with the last recovery shape its views and playbook. Now the Federal Open Market Committee (FOMC or Committee) is backed into a corner and will have to aggressively tighten monetary policy to combat inflation, putting the economic recovery at risk. Inherent in this view is our belief that inflation will remain elevated (above 4%) for most of 2022, especially in the first half of the year, before the change in monetary policy has an impact on the real economy.

The Fed has a dual mandate of maximum employment and price stability. Historically, the Fed defined stable inflation as 2%, but it modified the definition in 2021 to mean an average of 2% throughout an economic cycle.[7] Since inflation spent most of the post-Global Financial Crisis recovery below its 2% target, this new definition gave the Fed more flexibility in allowing inflation to run above its 2% target during the COVID-19 recovery. The Fed made this change because it was influenced by its experience from the last cycle, when it began raising rates ahead of any real signs of inflation because the economy appeared to reach full employment. With its newfound flexibility, the Fed practically abandoned half of its mandate in 2021 by focusing myopically on getting the economy to full employment before beginning to unwind its COVID-19 quantitative easing program and raising interest rates. Despite numerous signs that inflation in the economy was at risk of becoming a problem, the Fed adhered stubbornly to its assessment that inflation was "transitory." When the Fed introduced the word "transitory" in April to describe the inflationary environment, its definition was "several months," only to later amend the definition to "through the end of the year."[8] However, inflation continued to accelerate in the fourth quarter, recently reaching a near 40-year high in November. The underlying inflationary trends are broad and anything but transitory. High prices act as a regressive tax on the poor and threaten to worsen the inequality problem that has become a key concern for politicians and central bankers alike. High prices also put the economic recovery at risk, as they can lead to demand destruction and create unwanted economic distortions. No longer able to ignore the trend, Chairman Powell acknowledged to U.S. lawmakers in late November that inflation is now a major risk to the economy and it was time to retire the word "transitory." Notably, following its December policy meeting, the Fed minutes were much more hawkish and the word "transitory" did not appear anywhere in its communication.

The Fed also consistently underestimated the strength of the employment market throughout 2021. Prior to the pandemic, the unemployment rate reached 3.5% without inflation becoming a problem. The Fed thought unemployment could get back to those levels before it would have to start removing monetary accommodation. In its communications early in 2021, the Fed's forecasts did not call for any interest rate hike until late 2023 or early 2024, a time when its projections suggested unemployment would be below 4%. More recently, despite numerous signs of a tight labor market, the Fed continued to focus on the size of the overall U.S. workforce, which has approximately four million fewer workers than pre-pandemic. The fact of the matter is that the employment market has been flashing red-hot signs for quite some time. The ratio of job openings to vacancies is at an all-time high, jobless claims have declined sharply and have reached 50-year lows, the quits rate is at an all-time high, and wage inflation has exceeded the peak of the last recovery.

7. Martinez-Garcia, Enrique. "Fed's New Inflation Targeting Policy Seeks to Maintain Well-Anchored Expectations," April 6, 2021. https:// www.dallasfed.org/research/economics/2021/0406
8. Moore, Simon. "Further Detail on Transitory Inflation Revealed from Fed Meeting," July 7, 2021. https://www.forbes.com/sites/simonmoore/2021/07/07/further-detail-on-transitory-inflation-revealed-from-fed-meeting/?sh=2396fb67625e

Exhibit 5: Average Hourly Earnings (Year-over-Year Change)



Source: Bloomberg, as of 12/31/2021

Employers from many industries have consistently said that one of their biggest challenges is finding workers, and that they have needed to significantly increase wages to fill positions. The Fed dismissed these concerns due to its belief that many workers were merely temporarily out of the labor market due to COVID-19 fears, other pandemic disruptions such as lack of childcare, and generous government unemployment benefits. However, now that many of these stimulus policies have lapsed and COVID-19 concerns are on the retreat, the Fed can no longer defend its thesis. Chairman Powell acknowledged as much in his December post-meeting press conference when he said, "The labor market is by so many measures hotter than it ever ran in the last expansion."[9]

Due to the aforementioned miscalculations, the Fed delivered a mea culpa in its last meeting in December. Chairman Powell said, "We're not going back to the same economy we had in February of 2020. And I think early on, that was the sense was that that's where we were headed. The post-pandemic labor market and the economy, in general, will be different." Powell stressed that the Fed is committed to its price stability goal, and that the risk of persistent higher inflation has increased.

Exhibit 6: Inflation Expectations

Source: Bloomberg, as of 11/30/2021

9. Transcript of Chair Powell's Press Conference. December 15, 2021. http://federalreserve.gov/mediacenter/files/FOMCpresconf20211215.pdf

High inflation is not unique to the U.S. Most countries around the world are experiencing similar inflationary pressures, and many global central banks have pivoted toward ending asset purchases or raising rates. With inflation now seen as the primary risk, the FOMC took the hawkish action of doubling its pace of tapering, which it had only just begun the prior month, to $30 billion per month. This puts them on pace to end quantitative easing in March and potentially start raising rates thereafter. We believe that the FOMC will concede that it has met both of its objectives by then, and that the first rate hike will be announced in March. In total, we expect that persistently high inflation and strong consumer demand will keep the Fed in tightening mode all year. Variant outbreaks like the one we are now seeing with Omicron, have changed the Fed's calculus. Previously, virus surges were seen as a reason to extend accommodation; now they are seen as exacerbating the inflationary pressures in the economy by delaying the eventual return of supply-chain normalcy. In order to keep inflation expectations from coming unmoored, we believe the Committee will have to raise rates four times in 2022. It is also likely that balance sheet runoff will start in the fourth quarter of 2022 if the economy and asset prices are showing signs of stability.

The extraordinary monetary policy actions taken by the Fed to support the economy were effective in stimulating demand. Most of the challenges in the current economic environment stem from supply-side issues, so monetary policy has reached the point where it is actually counter-productive. The Fed has finally come to this realization, and we expect the Fed to course-correct by taking aggressive action to remove accommodation and tighten in 2022. By not acting earlier, the Fed was complicit in letting asset price inflation, speculation, and leverage build in the system. This raises the risk of a monetary policy "mistake" resulting from its sharp pivot in monetary policy. While we think the economy is strong enough to absorb monetary tightening in 2022, there will likely be an elevated risk of recession in 2023. At a minimum, with the Fed forced to fight inflation, investors will come to question the "Powell Put"[10] and this will lead to increased equity market volatility and deeper corrections.

10. "Powell Put" is the belief among market participants that Chair Powell and the Fed would use monetary policy to support asset prices during periods of sustained weakness.

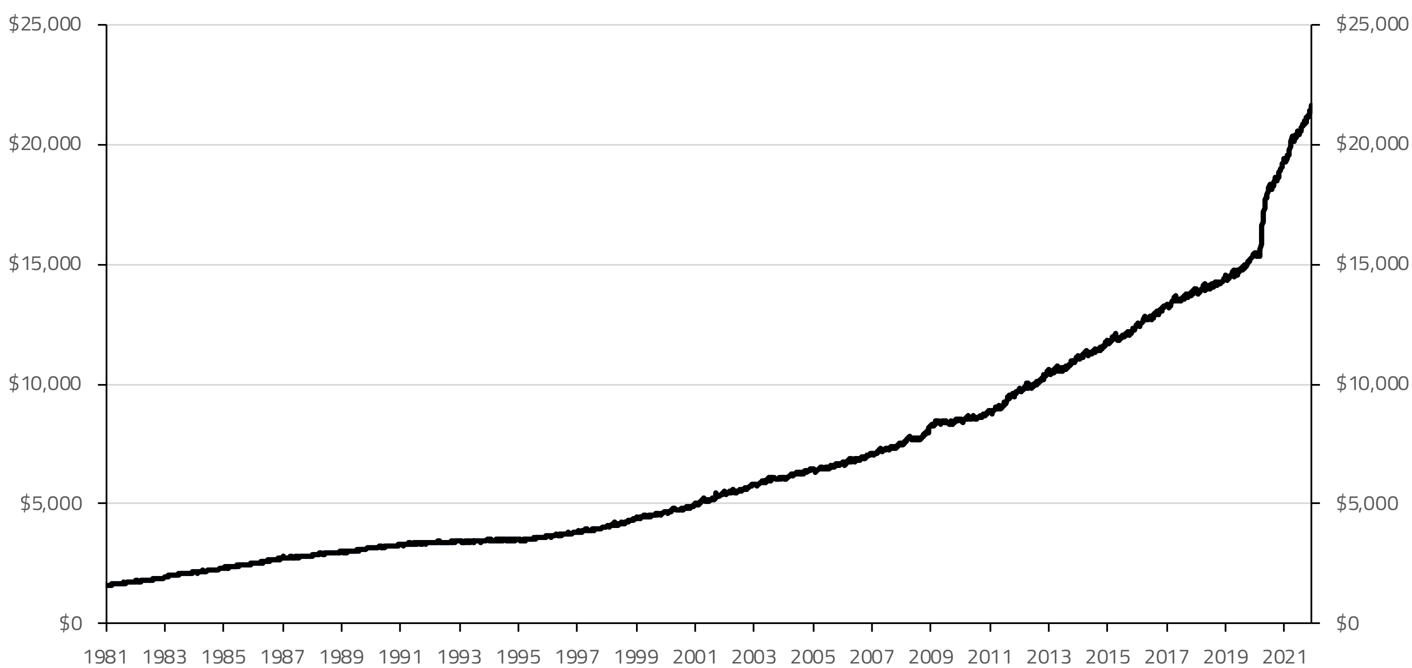
TOP 10 INVESTMENT THEMES FOR 2022

4. Wall of Liquidity

In last year's *Top Ten Investment Themes*, we highlighted the unprecedented monetary stimulus measures that have taken place during the COVID-19 pandemic and in the decade preceding the pandemic, in response to the 2008 financial crisis.

It is worth taking a moment to summarize some of these unprecedented measures. In March 2020, global central banks, including the Federal Reserve, took aggressive steps to stimulate the economy amidst the COVID-19 pandemic. The Fed ramped up its purchases of Treasury securities, buying $1.7 trillion of Treasuries between mid-March 2020 and the end of June 2020. The Fed also purchased approximately $562 billion of agency mortgage-backed securities between March and August 2020, and nearly $300 billion in loans and other assets during this same period. In addition, the Federal Reserve reduced reserve requirement ratios to zero percent effective March 26, 2020, where it remains to this day.[11] This action eliminated reserve requirements for all depository institutions. These collective actions resulted in a dramatic increase in the U.S. money supply. Exhibit 7 highlights the dramatic increase in the money supply (M2) from approximately $15.5 trillion in March 2020 to $21.6 trillion, as of December 6, 2021.[12]

Exhibit 7: M2 Money Supply Growth (Billions)



Source: Federal Reserve Economic Data, Federal Reserve Bank of St. Louis, as of 12/06/2021

Asset prices have climbed over this period, largely due to more money chasing a finite quantity of investment assets. As a result, inflation increased significantly in 2021 after years of remaining subdued.

For months, Federal Reserve Chairman Jerome Powell responded to surging inflation by counseling patience and stressing that the Fed wanted to see unemployment return to near-pre-pandemic levels before it would raise interest rates. However, in response to these high inflation readings, the Fed has now begun a tightening cycle, which will gradually reverse the deluge of liquidity that has flooded the financial system in the past decade-plus. In its December meeting, the central bank said that it would reduce its monthly bond purchases at

11. Federal Register: Board of Governors of the Federal Reserve System,. December 8, 2021, https://www.federalregister.gov/documents/2021/12/08/2021-26568/reserve-requirements-of-depository-institutions.
12. Id.

twice the pace it had previously set and will likely end the purchases altogether by March 2022. In addition, the policymakers collectively forecast that they will raise their benchmark short-term rate three times this year — a significant increase from September when the 18 officials had split over whether to hike rates even a single time in 2022.

While equity markets continued to rally through year-end despite the Fed's change in direction, higher rates and less accommodative monetary policy could create headwinds for risk assets' valuations in 2022. The market is relying on the Fed, and global central banks, to get policy right. However, more important than the directional act of tightening is the ***pace*** of tightening – the "second derivative." A rapid withdrawal of liquidity out of sync with the pace of economic growth risks driving the economy into recession and pressuring valuations of risk assets.

For these reasons, we believe equity market returns are unlikely to be as high in the next few years as they have been in 2020 and 2021. With that said, we do not see a high likelihood of a recession in 2022 and remain cautiously constructive on equities.

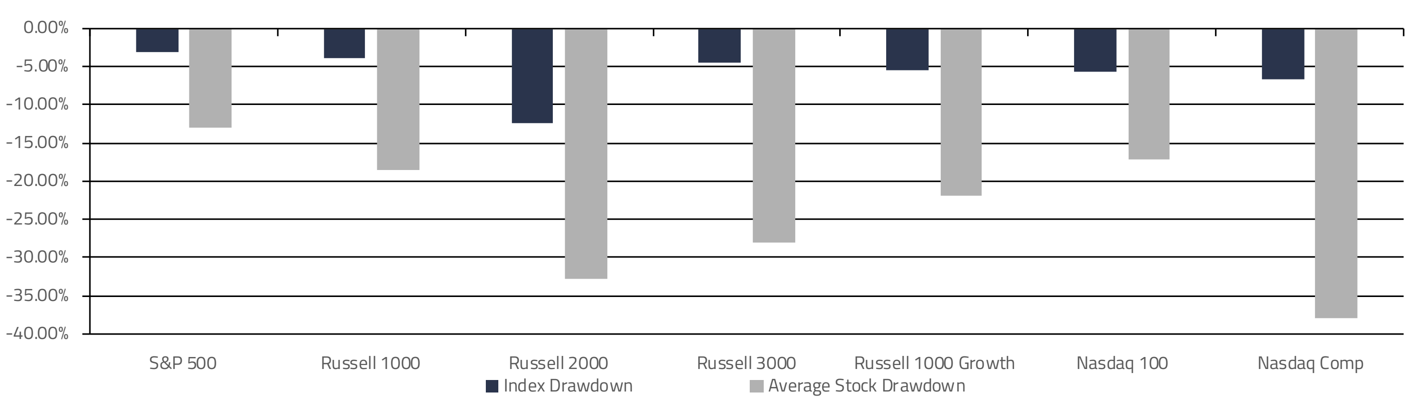
TOP 10 INVESTMENT THEMES FOR 2022

5. Outlook for Equities

With inflation stubbornly high and global central banks, led by the Fed, pivoting toward monetary tightening, the outlook for equities looks decidedly less bullish than last year. As investors calibrate for this new monetary policy paradigm, we believe 2022 will be a volatile year for equities; one where the market suffers through multiple corrections and where diversification pays off for investors. In 2021, equities for the most part did well, but diversification from the S&P 500 weighed on portfolio returns. The S&P 500 led all major indexes with a total return of 28.68% while other widely followed indexes trailed significantly. For example, the Russell 2000 small-cap index returned 14.78% and the MSCI Europe returned 17.18%, while Japan's Nikkei returned -4.42% and MSCI China returned -21.23%.[13] The wide dispersion of returns is unusual for a year in which the S&P performed so well.

While the headline S&P return was impressive, most stocks showed more muted gains, and the breadth of the market (defined as the percentage of stocks trading above their 200-day average) has been deteriorating for many months. According to J.P. Morgan research, five stocks – Apple, Google, Tesla, Nvidia, and Microsoft – accounted for 37% of the S&P's gain this year and more than half of the gain since April, a figure that is in the top quartile of historical averages.[14] Furthermore, during the market's most recent index drawdown in late-November and early December, the average Russell 2000 stock declined -32.8% and the average NASDAQ composite stock declined -38%. Deteriorating breadth and large drawdowns for individual stocks are usually early warning signs of a broader market correction. Perhaps in a sign of things to come, market volatility has increased substantially; December was one of the most volatile months of 2021 even though the end of the year is usually a period of market calm.

Exhibit 8: 2021 US Equity Index Drawdowns vs 52-week highs



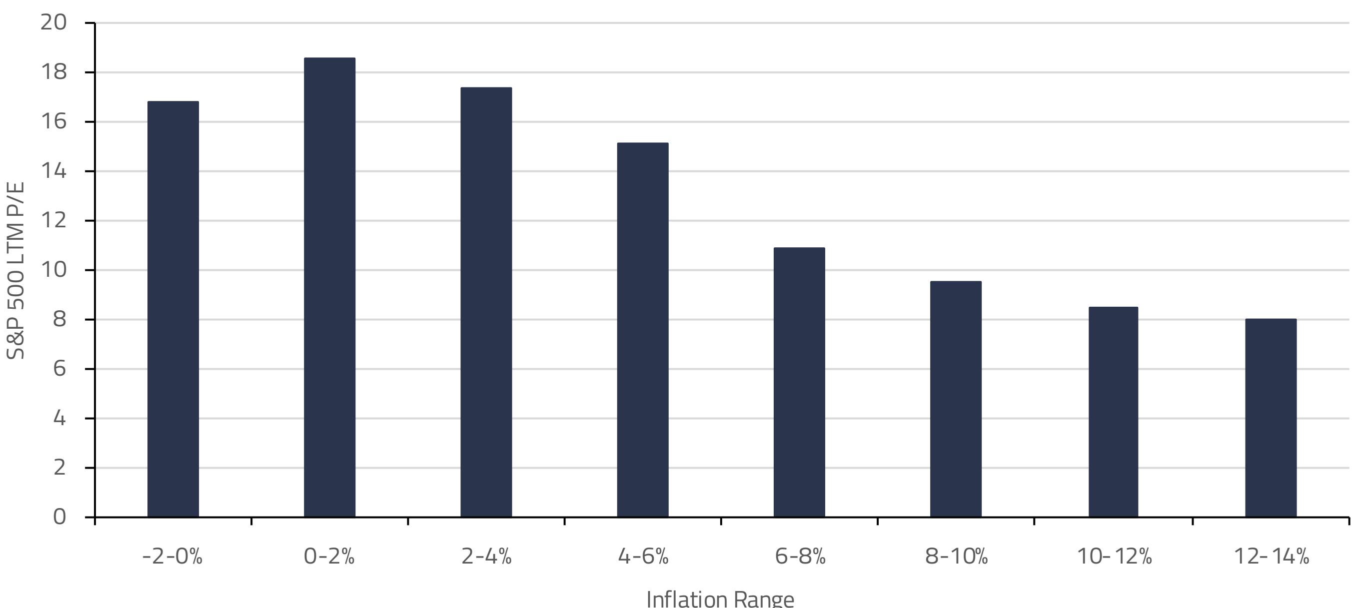
Source: J.P. Morgan Equity Macro Research, as of 12/27/2021

13. Bloomberg. All returns are in currency-adjusted to USD.
14. J.P. Morgan. "US Equity Strategy," J.P. Morgan Global Markets Strategy Team, December 27, 2021.

Market breadth is deteriorating and volatility is picking up because the Fed has now committed to a sharp pivot in monetary policy in order to put the inflation genie back in the bottle. For most of 2021, the Fed and most investors had their rose-colored glasses on and dismissed inflation as "transitory" – meaning that inflation was mainly due to temporary, pandemic-induced factors that would sharply dissipate as the year wore on and into 2022. When this theory was disproved in late 2021, the Fed had to shift toward inflation-fighting mode. This marks the beginning of the removal of the extraordinary monetary policy accommodation that has supported the economy and asset prices since the pandemic began. As discussed in a previous section, we believe that persistently high inflation readings in the first half of the year will force the Fed to tighten monetary policy aggressively in 2022. The quantitative easing program will end completely in March and rate hikes will likely start immediately afterwards, creating a liquidity headwind that may cause an adjustment in the valuation of risk assets. We believe markets are currently underestimating this risk. Sharp changes in monetary policy often lead to economic and market volatility as unintended consequences ripple through the system. After a remarkable and largely one-way rally since April 2020, we believe U.S. equities are in for some turbulence as the Fed fights inflation.

Inflation poses a risk for equities on several fronts. During periods of high inflation, investors adjust their expectations accordingly in anticipation of higher rates. In order to account for greater uncertainty, the price-to-earnings multiple that investors are willing to pay for stocks usually contracts.

Exhibit 9: Average S&P 500 Trailing Twelve Month P/E by Consumer Price Index Year-over–Year Range (1950 - 2021)



Source: Strategas

Multiple contraction is likely one headwind the market will need to navigate in 2022, as we anticipate that inflation will remain above 4% for the near future. Inflation also threatens to negatively impact corporate margins and earnings, which are two huge tailwinds that have been instrumental in driving equity returns during this bull market. Thus far, corporations have done a great job of managing the supply chain and labor challenges that emerged from the pandemic. They have been able to raise prices without affecting demand, and S&P operating margins reached a significant new all-time high in 2021. However, we have seen recent evidence that suggests margins have peaked, and the earnings outlook for 2022 is nuanced. During the 2021 third quarter reporting season, a wide selection of companies from across industries cited a deteriorating operating environment where surging input costs are outpacing consumer price hikes as a key risk going forward. With the spread between the producer price index and the consumer price index now above 3%, we believe corporate margins have peaked, earnings growth will decelerate sharply, and many companies are at risk of missing consensus estimates.

Exhibit 10: S&P 500 Operating Margins

Source: Bloomberg, as of 12/31/2021

Better-than-expected earnings growth and positive earnings revisions propelled the market higher in 2021. At the start of the year, the consensus earnings estimate for the S&P 500 was $170, or 21.5% growth.[15] As the year progressed and companies proved adept at managing through the pandemic, analysts consistently revised earnings estimates higher, providing positive momentum and valuation support for the market. When the fourth quarter reporting season concludes, it is likely that 2021 S&P 500 earnings will end the year above $205, marking growth of better than 45%. This would mark the seventh straight quarter where S&P earnings beat consensus expectations by over 10%. Given our outlook that 2022 U.S. economic growth will come in below consensus and corporate margins have peaked, we believe earnings growth will decelerate sharply and positive revisions will normalize. Consensus expectations call for earnings growth of roughly 9%,[16] a level that we believe is achievable, but presents limited upside and potential downside. With valuations in the U.S. already stretched and earnings expectations that have caught up to reality, we believe that 2022 will be a year of digestion and churn for the broad indexes as they consolidate gains from the last three years.

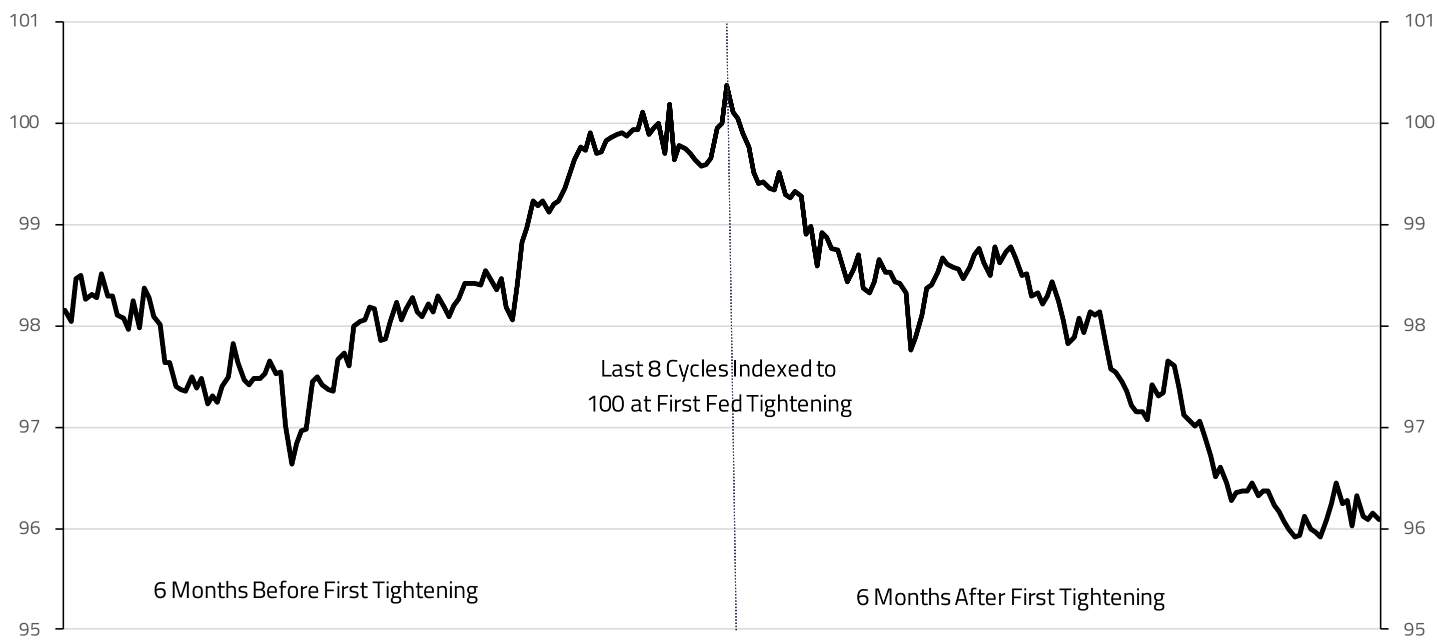
While our outlook for U.S. equities calls for heightened volatility and several corrections (defined as a drawdown of greater than 10%), we believe that equities will recover to end the year with slight gains. Although we expect the Fed to tighten aggressively, real interest rates remain starkly negative and continue to compel investors to look to equities to meet their return objectives. This is a story that has played out favorably over the past two years, as reflected by the enormous flows into equities during that time.

It is highly unlikely that equity flows in 2022 will come close to matching the record-breaking numbers from 2021, but flows remained elevated in the fourth quarter suggesting demand is not close to being satiated yet. On top of that, corporate stock buybacks are accelerating and have almost reached the all-time high from 2018. Elevated buybacks are likely to continue in 2022 and we expect will support stock prices throughout the year, especially for companies returning capital to shareholders. Finally, the mergers and acquisitions (M&A) environment remains robust. Last year was a record year for M&A, exceeding the prior record by over $1 trillion,[17] and the outlook for this year is equally strong as companies look to emerge from the pandemic better-positioned for growth in the post-pandemic world. Each of these tailwinds is a relic of the extraordinary monetary and fiscal policy measures taken in response to the pandemic. While the tide has turned and liquidity will progressively tighten from here, there is still plenty of cash on the sidelines looking for a home.

15. Factset. "Earnings Insight." December 17, 2021.
16. Id.
17. "Global M&A volumes hit record high in 2021, breach $5 trillion for first time," Niket Nishant. Reuters. December 31, 2021. https://www.reuters.com/markets/us/global-ma-volumes-hit-record-high-2021-breach-5-trillion-first-time-2021-12-31/

Despite the fact that equity diversification did not pay off in 2021, we believe that 2022 will prove to be fruitful for those who do not chase returns and stay disciplined with their non-US equity allocations. Although we remain most optimistic about the long-run potential of U.S. equities, we do foresee a year in which U.S. equities prove frustratingly volatile and relatively unrewarding. Inflation is a global problem right now, but highest in the U.S., which means the Fed will be among the most hawkish central banks. Given the flow of funds the U.S. market has attracted over the last two years, and the influx of retail investors now in the market, we believe U.S. equities will be more volatile than non-US equities. Furthermore, we believe that the U.S. Dollar (USD) will decline in 2022, reversing some of its strong gains from 2021. Contrary to what many people would expect, a careful review of the Fed's last eight rate-hiking cycles suggests the USD peaks around the time of the first rate hike.

Exhibit 11: Dollar Strength during Federal Reserve Tightening Cycles



Source: Bloomberg, Strategas

With rate hikes expected to begin as early as March or no later than May, we see a USD turn as imminent. A strong USD was a headwind for non-U.S. equities performance last year, but we expect the opposite to be true this year. Taken together, these factors will provide the impetus for investors to allocate more investment dollars outside the U.S., and we expect that the markets will reward those investors with decent returns along with the benefits of diversification.

TOP 10 INVESTMENT THEMES FOR 2022

6. Outlook for Fixed Income

Public market fixed income remains an asset class in which we maintain an underweight positioning as we begin 2022. In our view, the risk-reward in investment grade corporate and high yield corporate bond markets remains asymmetric. As investors have reached for yield in an environment of accommodative monetary policy and low rates, corporate bond prices have risen to a level of elevated downside risks and, in our view, will not adequately compensate investors for these additional risks.

One need only look at the average credit quality of investment grade corporate bonds to understand the scope of the risk. As of November 30, 2021, 57.5% of the market-cap-weighted S&P 500®/MarketAxess® Investment Grade Corporate Bond Index had a credit rating of BBB+ or lower, with a yield-to-worst of 2.22% and a duration of over eight years as of January 3, 2021.[18] Investors would be prudent to question the wisdom of owning investment grade corporate bonds in the current environment, particularly via owning a broad index.

Exhibit 12: S&P 500/MarketAxess Investment Grade Corporate Bond Index

Quality	Weight
AAA	3.06%
AA+	4.47%
AA	3.88%
AA-	4.13%
A+	8.33%
A	4.04%
A-	14.53%
BBB+	27.25%
BBB	21.03%
BBB-	9.26%

Source: ProShares, as of 11/30/2021

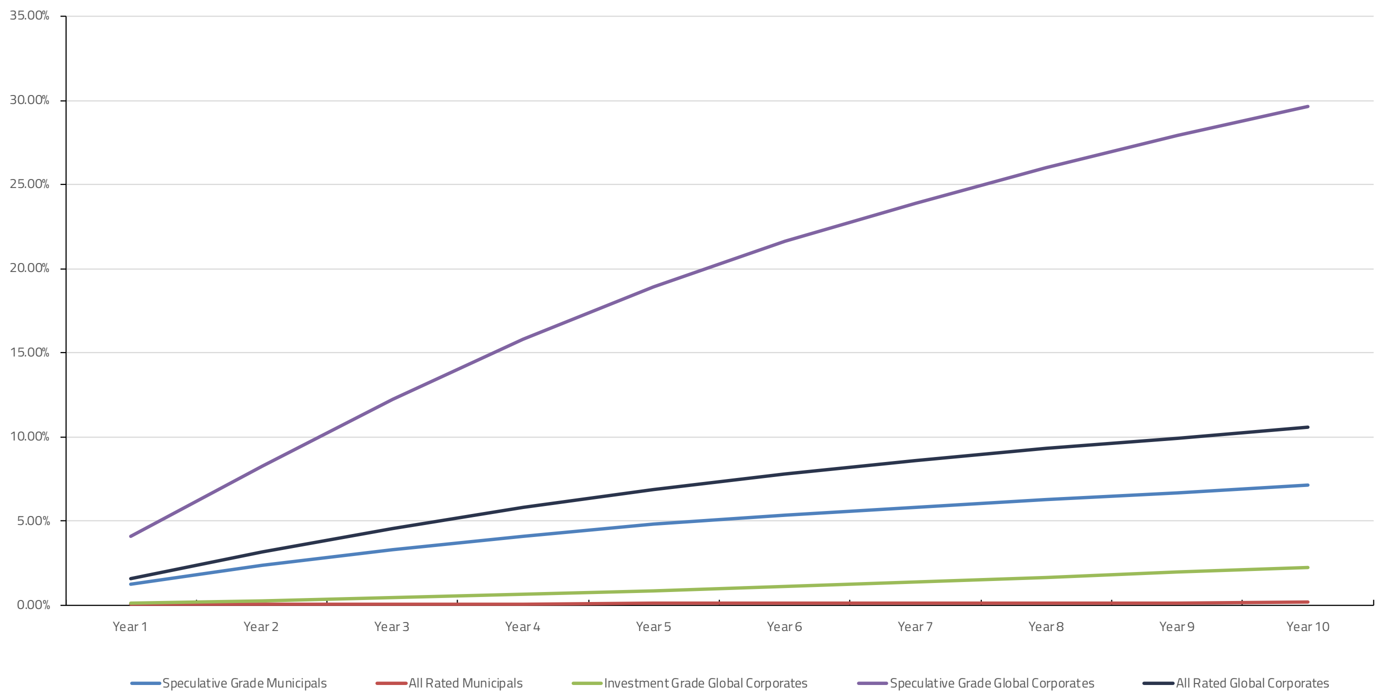
Inflation may lead to higher rates, posing a further risk to investment grade corporate debt given that the movements of rates and bond prices have historically been negatively correlated. After nearly thirteen years of accommodative monetary policy and stimulus from global central banks, rates presently sit near historic lows. Low rates have contributed to asset-price inflation over the past decade, further exacerbated by fiscal stimulus measures and additional monetary policy measures taken by the federal government in response to the COVID-19 pandemic. Beyond asset prices, in 2021 inflation began to increase in the broad economy, with supply chain disruptions and a tightening labor market contributing to significantly elevated levels of inflation, as highlighted in section 2 of this report. Elevated inflation may force the Fed to tighten monetary policy faster than expected, creating a further headwind to corporate bond prices.

With that said, one area within public-market fixed income where we see an attractive risk-reward is in the high yield municipal bond market. The high yield municipal market has historically had low default rates compared to corporate bonds, and we believe short-duration high yield could be a good place to earn yield while controlling for interest-rate risk. The S&P Municipal Bond High Yield Index has a yield-to-worst of 2.9% (as of January 3, 2021), with a duration of approximately six years. The index yield-to-worst equates to a tax-equivalent yield of 4.6% for a taxable investor in the 37% tax bracket.[19] As Moody's Investors Service noted in its 2021 report titled *U.S. Municipal Bond Defaults and Recoveries, 1970-2020,* "the essential difference between municipal and corporate credits … [is that] municipal credits had lower or equal average cumulative default rates (CDR) across all horizons and rating categories over the entire study period compared to global

18. S&P Global. "S&P 500/Marketaxess Investment Grade Corporate Bond Index." Data as of January 3, 2021. https://www.spglobal.com/spdji/en/indices/fixed-income/sp-500-marketaxess-investment-grade-corporate-bond-index/#data.
19. While interest on municipal bonds is generally exempt from federal income tax, it may be subject to the federal alternative minimum tax, or state or local taxes.

corporates. Over a five-year horizon, the overall municipal default rate was meager at 0.08%. For speculative-grade (SG) municipal issuers, the five-year CDR of 4.8% was close to one-fourth of that for speculative-grade rated corporates at 18.9% ..."[20]

Exhibit 13: Cumulative Default Rates, Average 10-Year Default Rate over the Period 1970-2020



Source: Moody's Investor's Service

With low historical default rates, and an attractive tax-equivalent yield compared to corporate bonds, high yield municipals is an area of public-market fixed income in which we see an attractive risk-reward profile.

20. Moody's Investors Service. U.S. Municipal Bond Defaults and Recoveries, 1970-2020, July 9, 2021, https://www.moodys.com/login?ReturnUrl=http%3a%2f%2fwww.moodys.com%2fviewresearchdoc.aspx%3fdocid%3dPBM_1259641%26lang%3den%26cy%3dglobal

TOP 10 INVESTMENT THEMES FOR 2022

7. From Pandemic to Endemic

As we enter 2022, the world remains challenged by the COVID-19 pandemic, with Omicron being the latest variant to cause concern. The past year has seen the world achieve tremendous improvements in how we handle the virus. Early in 2021, the Food and Drug Administration (FDA) approved vaccines administered broadly across the country. However, amid an effective vaccine rollout, new variants began to emerge, with Omicron proving to be more contagious than previous variants, and vaccines proving less effective in preventing the spread of the Omicron variant. Along with vaccines, the scientific community successfully developed therapeutics to treat COVID-19 post-infection, several of which were recently approved by the FDA. We believe it is unlikely that we will return to a world without COVID, but we nonetheless remain optimistic about the transition from pandemic to endemic. Future COVID-19 outbreaks are likely, but we believe their effects on the economy and capital markets will diminish as we learn to live with the disease.

Last year began with a rollout of three novel vaccines made by Pfizer, Moderna, and Johnson & Johnson. The vaccine rollout proved effective in the United States, with 207.8 million U.S. citizens vaccinated by January 10, 2022 or approximately 62.6% of the population.[21] Globally, over 2.5 billion people are fully vaccinated as of year-end. The vaccine rollout proved to be effective at preventing the spread of the virus, as indicated by the drop in new case counts in the first six months of the year.[22]

Exhibit 14: United States Vaccination Rates

	At Least One Dose		Fully Vaccinated	
	Count	**Percent of US Population**	**Count**	**Percent of US Population**
Total	247,051,363	74.40%	207,796,335	62.60%
Population > 5 Years of Age	247,007,910	79.10%	207,786,207	66.50%
Population > 12 Years of Age	239,455,025	84.50%	202,855,799	71.50%
Population > 18 Years of Age	223,190,623	86.40%	189,190,363	73.30%
Population > 65 Years of Age	56,161,826	95.00%	48,126,500	87.80%

Source: Center for Disease Control and Prevention, as of 1/10/2022

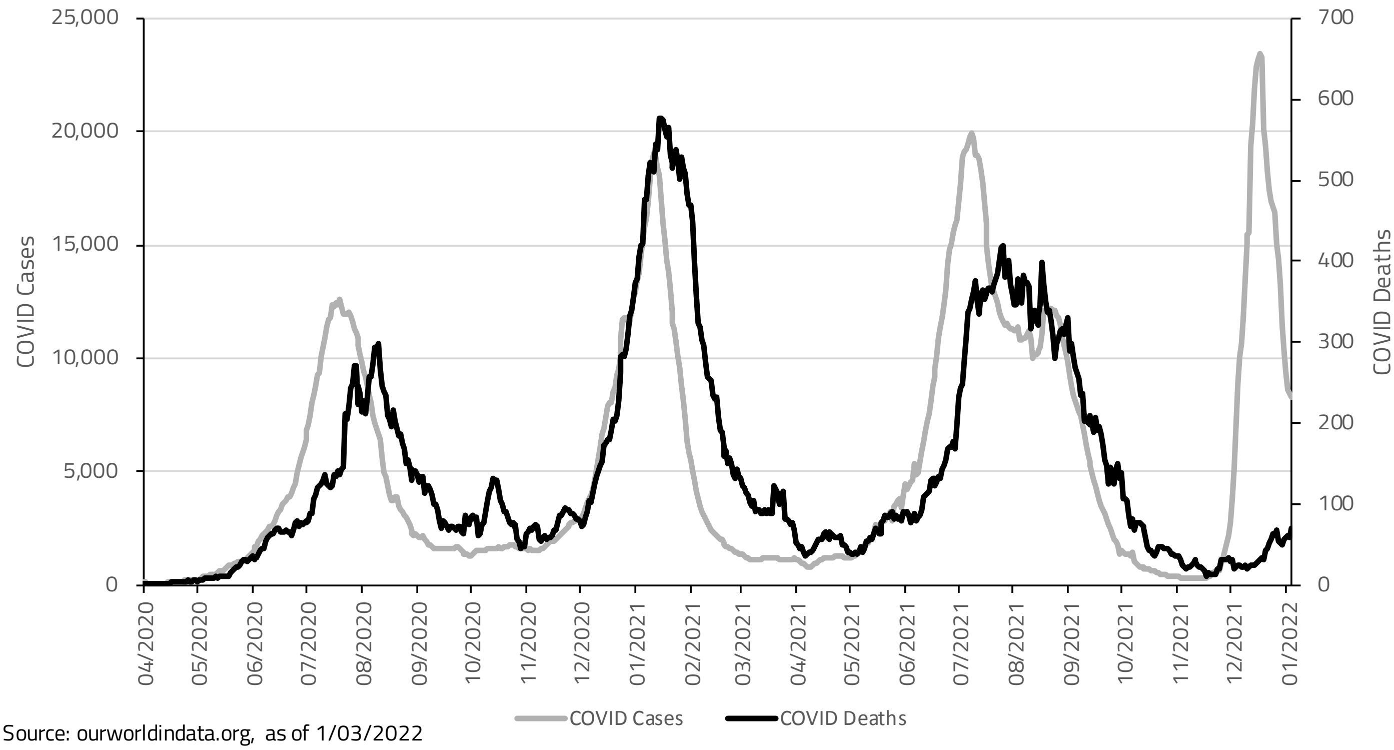
As people began to feel some cautious optimism that the pandemic could recede to the background in early-summer 2021, a new mutation rattled those hopes when the Delta variant surfaced in the United States. First identified in India in late 2020, Delta swept rapidly through that country and the UK before reaching the U.S., where it quickly surged in the summer of 2021. Delta proved to be more than twice as contagious as the original virus and more likely to result in hospitalization for those infected. Amid the resurgence of the disease and renewed enforcement of lockdown measurements, capital markets experienced headwinds after a strong start to the year. At the beginning of August 2021, the FDA authorized REGEN-COV monoclonal antibody therapy for post-exposure prophylaxis for COVID-19. Although the FDA stressed that monoclonal antibody therapy is not a substitute for COVID vaccines, the REGEN-COV therapy proved effective in mitigating symptoms and preventing hospitalizations and death.[23] While REGEN-COV has proven to be less effective against the Omicron strain, the introduction of new therapies provides additional tools for containing the effects of the disease, and paired with developing vaccination technology, provides hope for a solution to combat the spread of the virus.

The newest variant of concern, the Omicron variant, was identified in Botswana and South Africa in late-November 2021. Cases quickly began to surface in other countries, including the U.S. In response to this new outbreak, countries established travel bans to contain the

21. Center for Disease Control and Prevention.
22. Id.
23. Weinreich, David M., et al. "Regen-COV Antibody Combination and Outcomes in Outpatients with Covid-19" New England Journal of Medicine, December 2, 2021. https://www.nejm.org/doi/full/10.1056/NEJMoa2108163#:~:text=Both%20doses%20of%20intravenous%20REGEN,of%20REGEN%2DCOV%20on%20mortality.

spread, with certain countries taking further measures such as renewed lockdown restrictions. While we are still learning about this new variant, experts report that Omicron has many mutations, with more than 30 of the mutations found on the virus's spike protein, which is the part of the virus that attaches to human cells.[24] Several of these mutations are believed to increase the probability of infection.[25] In part, this transmissibility has led Omicron to become the predominant variant in most countries in the world, including the U.S. Further concern emerged with the magnitude of "breakthrough" cases, defined as infections of fully-vaccinated individuals. However, unlike the Delta variant, the Omicron variant is proving to be less deadly, with data from South Africa suggesting that while case numbers spiked late in 2021, the death toll resulting from Omicron has not followed suit.[26]

Exhibit 15: South Africa COVID Cases vs COVID Deaths (7-Day Moving Average)

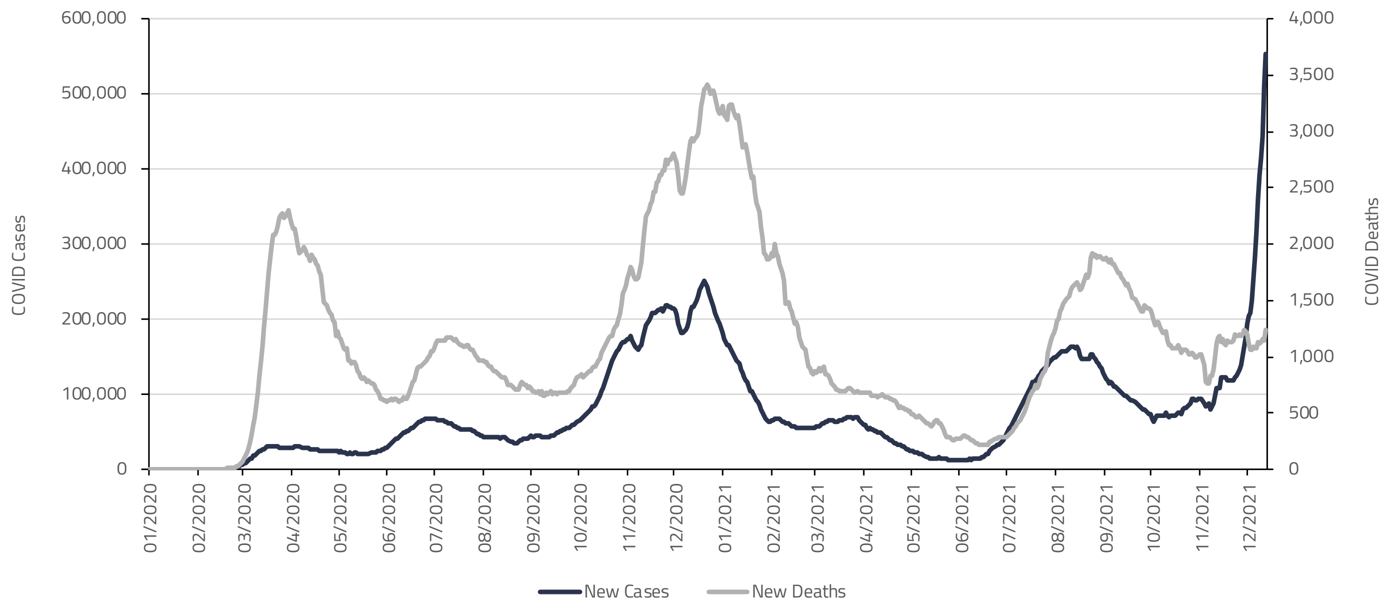


Source: ourworldindata.org, as of 1/03/2022

The Omicron variant outbreak has resulted in economic disruptions, most easily seen through the airline industry canceling flights due to infected employees, leaving the airlines short-staffed. Yet, the United States government's response to the Omicron variant suggests a path toward the disease becoming endemic and a reluctance by the American people to allow COVID-19 to cause further economic hardship. The seven-day rolling average of daily reported COVID-19 cases in the U.S. hit a 2021 peak of 300,887 cases during the last week of the year, setting a pandemic record.[27] On the other hand, the seven-day rolling average of hospitalizations in the U.S. ended the year below the pandemic peak of 137,510 set on Jan. 10, 2021, and the lower peak of 102,967 set on Sept. 4, 2021, during the Delta surge; however, ultimately surpassed record highs early in 2022.[28]

24. Katella, Kathy. "Omicron, Delta, Alpha, and More: What to Know about the Coronavirus Variants." Yale Medicine, Yale Medicine, December 20, 2021, https://www.yalemedicine.org/news/covid-19-variants-of-concern-omicron.
25. Id.
26. "Covid-19 Data Explorer." Our World in Data, January 3, 2022. https://ourworldindata.org/explorers/coronavirus-data-explorer?country=.
27. Center of Disease Control and Prevention.
28. DeBarros, Anthony, et al. "U.S. Hit with Record Number of New Covid-19 Cases." The Wall Street Journal, Dow Jones & Company, December 30, 2021, https://www.wsj.com/articles/with-omicron-case-rates-surging-policy-makers-focus-on-hospitalizations-instead-11640778907?mod=article_inline.

Exhibit 16: United States Daily COVID Cases vs. Daily COVID Deaths (7-Day Moving Average)



Source: Center for Disease Control and Prevention, as of 1/04/2022

Health experts have cited high vaccination rates and the apparently milder disease caused by the Omicron variant as explanations for the relatively low hospitalization levels. In turn, global governments have held back from ordering the kind of social distancing measures and shutdowns enforced in earlier pandemic periods. The amount of breakthrough Omicron cases reflects the endemic nature of COVID-19 despite our attempts to eradicate the virus; however, the leveraging of new medical treatments and insights gleaned from two years of data has proven successful in mitigating the devastating effects of the illness. As hopeful as we were that COVID would be behind us two years after the initial outbreak, it is apparent that there is no simple solution to eradicating the disease.

Looking at the S&P 500, we see diminishing disruption from subsequent outbreaks of the disease. The initial COVID outbreak in 2020 sent the U.S. stock market into a bear market with a peak to trough drawdown of 34%, before rapidly resurging to record highs. In the summer of 2021, the Delta variant caused a whipsaw in the U.S. stock market; however, its magnitude was minimal when compared to the effects of the initial outbreak. Most recently, news of the Omicron variant caused some initial volatility, but the market quickly shrugged off the news. As we look toward 2022, we believe that COVID will remain a central talking point in the media, but the emergence of new variants will have less of an effect on the global economy and capital markets.

TOP 10 INVESTMENT THEMES FOR 2022

8. Emerging Markets and China

Emerging Markets (EM) significantly underperformed Developed Markets in 2021 on the back of a dramatic decline in China. While sentiment, especially in Chinese mega-cap tech stocks, is sufficiently depressed to foster outperformance in 2022, China's economy faces ongoing challenges that will weigh on growth for the next few years, and its pivot toward autocratic socialism raises important questions for long-term investors.

The MSCI Emerging Market Index ended the year with a total return of -2.47%, as compared to a total return of 28.68% for the S&P 500 and 11.86% for the MSCI All-Country World ex-US Index.[29] While there were some bright spots in EM, such as India and some parts of Asia, China experienced a bear market with a decline of -21.23% for the MSCI China Index. MSCI China underperformed global equities by the most in over twenty years. With China having by far the largest weighting in the EM index, the fate of Chinese equities will largely determine the outlook for EM equities. While we see an opportunity for a relief rally in 2022, the outlook beyond next year looks decidedly cloudy.

China entered 2021 with a lot of promise. It was the first country to get COVID-19 under control, and the only major economy to grow in 2020. With that backdrop, it was likely that Chinese equities would have perform well in 2021 had the Chinese government not interfered so bluntly in its economy and markets. In retrospect, the writing was on the wall back in November 2020 when China's President Xi abruptly canceled the highly anticipated IPO of Ant Group, an affiliate of Alibaba, just days before it was set to start trading. That action proved to be the start of a yearlong campaign of heavy-handed regulation aimed at curbing the power and reach of China's biggest technology companies and their famed founders. In the last twelve months, the Chinese government has announced over 100 regulations and policy changes that impact companies related to unfair competition, national security, and data protection.[30] These actions will weigh on the profitability of China's tech sector and, combined with the overnight dismantling of its $100 billion for-profit education sector in July, have undermined investor confidence and led to a wave of selling. By December, the collective market cap of China's largest internet companies had declined by over $2 trillion, and Alibaba, once China's largest company by market cap, ended the year down -49%.

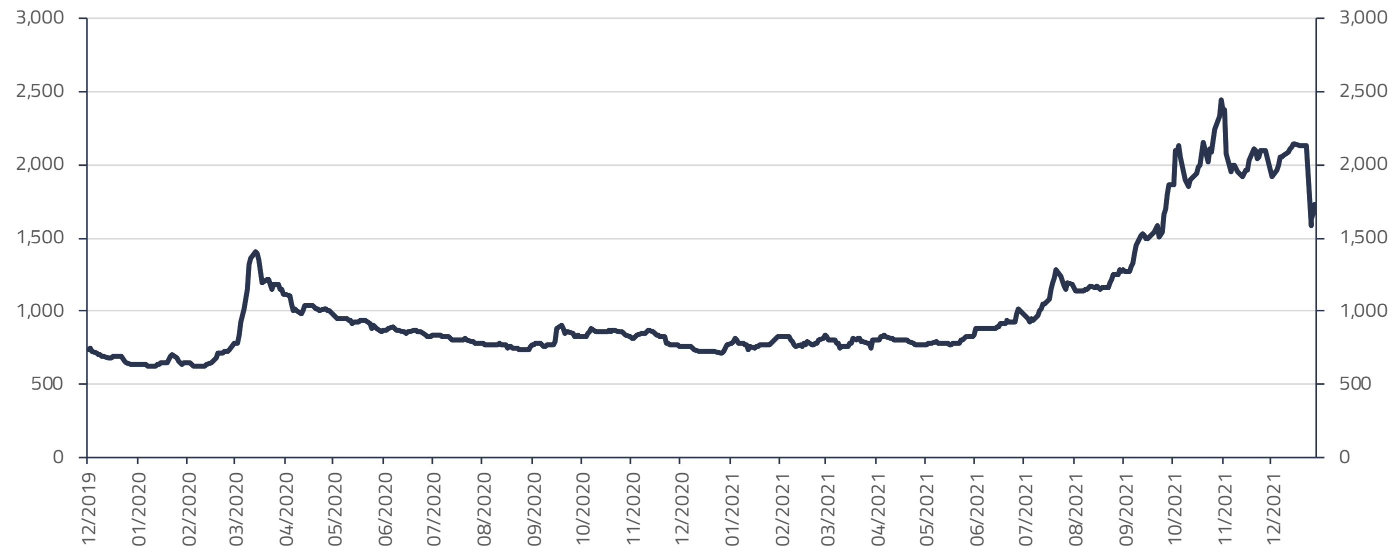
Exhibit 17: China Equities Year-to-Date Total Returns

Source: Bloomberg, as of 12/31/2021

29. Bloomberg.
30. GQG Partners. "China Isn't Passive, So Why Should Investors Be?" October 31, 2021.

At the same time that the Chinese government's regulatory attack on big tech weighed on sentiment, China's huge property sector began to buckle under the weight of government reforms that were aimed at curbing excessive leverage in the economy and widespread real estate speculation. The poster child of this debt crisis is China Evergrande Group, the world's most indebted property developer, with over $300 billion in outstanding debt.[31] Contagion quickly spread to other overleveraged property developers when Evergrande began having trouble servicing its debt obligations. According to Goldman Sachs, the Chinese property sector's interest-bearing debt more than doubled to $3.9 trillion since 2014.[32] High yield spreads in China reflect the acute nature of the problem.

Exhibit 18: Asia ex-Japan High Yield Corporate Bond Credit Spreads (Basis Points)



Source: Bloomberg, as of 1/06/2022

Paralysis has hit the Chinese property markets, causing transaction volumes to decline substantially and property values to fall sharply. This is a big problem for China because the property sector makes up approximately 30% of GDP[33] and has been a source of growth for the country for a long time. Furthermore, roughly 60% of wealth in China is held in the form of real estate, causing falling property prices to weigh on consumer sentiment, which has translated into weak consumer spending and underwhelming GDP growth.[34]

Some investors suggest this could be China's Lehman moment, but we believe that the Chinese government has the firepower and the resolve to manage the situation. While the Chinese Communist Party (CCP) has made it clear that it will not intervene to save Evergrande or any of its peers, it has also made it clear that economic stability is a top priority ahead of the 20th Party Congress expected to take place in the fall of 2022. This is the Communist Party gathering where the Party expects to name President Xi to an unprecedented third term and perhaps position him as ruler for life. In order to keep his popularity from waning before this critical event, it is imperative for Xi that an orderly wind down and soft landing take place. To that end, he has ordered local governments to work with troubled developers to assure that unfinished projects are completed and that they protect the interests of Chinese purchasers.[35] In an effort to lessen the impact from the property sector woes, the Chinese central bank recently began to loosen monetary policy by cutting the reserve requirement ratio, and eased restrictions on real estate borrowing to support property prices. We expect more monetary policy easing in 2022 and a step back from the stark regulatory actions that dominated 2021.

While we believe China's Communist Party can avert a disorderly collapse, it will nonetheless take a long time for the property sector to stabilize and return to healthy growth. This will reverberate throughout the economy as local Chinese governments have become dependent on

31. "The World's Most Indebted Property Developer Reports Progress Completing Homes." CNN, Cable News Network, 26 Dec. 2021, https://www.cnn.com/2021/12/26/business/china-evergrande-home-deliveries/index.html.
32. Taplin, Nathaniel. "As China's Economy Falters, the Rest of World Looks Resilient." Wall Street Journal. December 10, 2021.
33. The Economist. "The Property Complex." October 2, 2021.
34. Id.
35. Oi, Mariko. "Evergrande: China's efforts to contain its Lehman moment," BBC News. December 20, 2021. https://www.bbc.com/news/business-59605130

land sales to developers for roughly a third of their revenues.[36] Given the size of the sector and its importance to China's economy, GDP growth in China will likely underperform consensus expectations over the next few years.

Adding to the headwinds for growth is China's "Zero COVID" policy. In efforts to tame the spread of the virus, China has repeatedly taken harsh measures to shut down cities, ports, and travel. Just a few weeks ago, Beijing put Xi'an, a city of 13 million residents, in lockdown as a moderate amount of cases were reported.[37] Such drastic measures have taken an economic and social toll and will continue to hinder the Chinese economy as long as the policy remains in place.

Taken together, China's regulatory crackdown, property market intervention, and handling of COVID-19 represent a substantial expansion of power for its Communist Party in the name of "Common Prosperity." The concept reflects Xi's belief that capitalism in China has gone too far by only benefitting the few and that its economy must pivot to a form of modern socialism that promotes equitable distribution of wealth and sustainable growth. President Xi has singlehandedly rewritten the rules for how the economy works, and in doing so, he has tightened the Party's control over society and the economy. Party members have infiltrated the management ranks of many of China's leading companies, and tech companies are diverting large profits from shareholders to society in the form donations to support the "Common Prosperity" campaign. As of the end of the third quarter, Alibaba has pledged $15.5 billion, Tencent has pledged $15.4 billion, and Pinduoduo has pledged $1.5 billion.[38]

So what does this all mean for Chinese and Emerging Market equities? For 2022, we believe that China and EM can outperform given the extent of the underperformance in 2021 and the bearish sentiment that exists from the litany of issues previously discussed. The environment is such that any sign of a trough in China's GDP growth, a property sector rebound, or a Communist Party that pulls back on its heavy-handed agenda can easily spark a significant rally in equities. However, as long-term investors and stewards of our clients' hard-earned wealth, we are becoming increasingly skeptical of the need to hold Chinese equities for growth and diversification. The actions of the Communist Party over the past year show no regard for shareholder rights and are anti-capitalist. The abruptness of some of the directives hurt the private sector and raise questions for investors. As fund manager GQG Partners recently wrote, "investors must consider the ramifications of investing in a country today that is explicitly trying to reign in instead of grow some of its most successful industries, and doing so in a way that forces the industries to comply, while further asserting the CCP into how business is conducted going forward."[39] We agree that President Xi is taking China in a dangerous direction from the standpoint of an equity investor. Many asset management firms have a vested interest in Chinese markets and will continue to highlight the attractiveness of investing in China. However, we want to invest in markets that treat our capital fairly and where the rules of the game are not arbitrary. China is increasingly failing on both fronts.

36. "The Slow Meltdown of the Chinese Economy," Thomas L. Duesterberg. Wall Street Journal. December 20, 2021.
37. Reuters. "China's Xian locks down its 13 million residents as COVID-19 cases rise," December 23, 2021. https://www.reuters.com/world/china/china-reports-100-new-covid-19-cases-dec-22-vs-77-day-earlier-2021-12-23/
38. Bloomberg News. "Alibaba to Tencent, Why China's Big Tech is Waking up to 'Common Prosperity,'" September 18, 2021.
39. GQG Partners. "China Isn't Passive, So Why Should Investors Be?" October 31, 2021.

9. Renewable Energy vs. Fossil Fuel

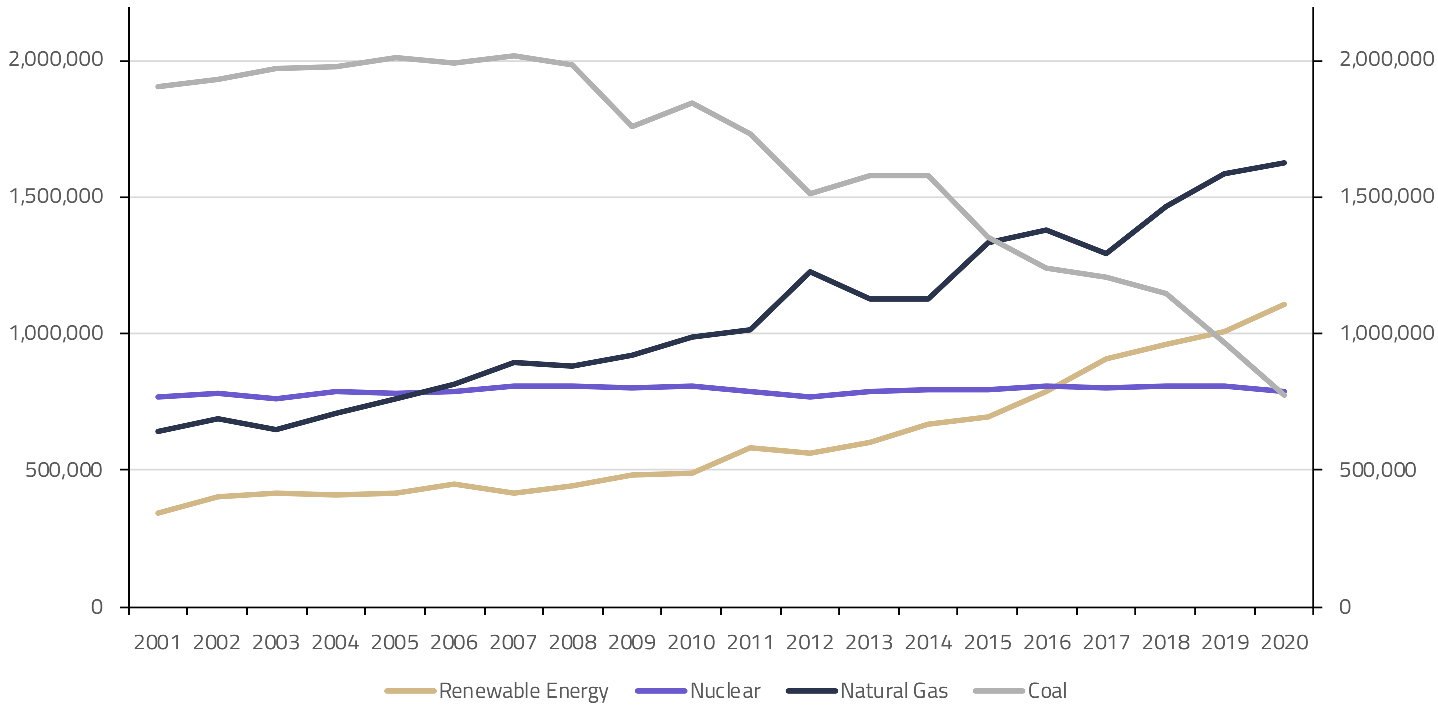
While 2020 was a banner year for stocks levered toward clean energy, 2021 saw a significant pullback as growth stocks experienced contraction of valuation multiples. Global governments' initiatives aimed at combating climate change and increasing private sector investment in the space causes us to be bullish on the long-term performance of risk assets linked to the clean energy sector. However, many obstacles will continue to hinder the greater adoption of clean energy sources in the short term, leading us to believe that assets tied to clean energy deployment will experience heightened volatility over the next few years. On the contrary, while we anticipate a phase-out of traditional, carbon-emitting energy sources over the coming decades, we are bullish on the performance of energy commodities this year, due to the pent-up demand for fossil fuels resulting from the reopening of global economies amidst a supply-constrained environment.

The 2021 United Nations Climate Change Conference, more commonly referred to as COP26, was the first conference since the Paris Agreement of COP21 where participants were expected to make enhanced commitments to mitigating climate change. COP26 concluded with an agreement labeled the Glasgow Climate Pact. While not legally binding, the agreement will set the global agenda on climate change for the next decade. The 197 countries in attendance agreed to meet in 2022 to pledge further cuts to emissions of carbon dioxide (CO2) in an attempt to keep temperature increases within 1.5 degrees Celsius, with current pledges only limiting global warming to about 2.4 degrees Celsius. The conference resulted in a clear plan to reduce the use of coal, responsible for 40% of annual CO2 emissions, via a phase-out of coal and increased adoption of cleaner energy sources. World leaders agreed to phase-out subsidies that artificially lower the price of coal, oil, and natural gas. The world's biggest CO2 emitters, the U.S. and China, agreed to cooperate more over the next decade to reduce methane emissions and switch to clean energy. Along with pledges from global governments, financial organizations controlling $130 trillion agreed to support "clean" technology, such as renewable energy, and to redirect capital away from fossil fuel-burning industries. This initiative seeks to involve private companies in meeting net-zero targets. The takeaways from the COP26 conference encourage increased investment into '"clean" technology from both the public and private sector over the coming decade, which in turn, we believe should prove economically favorable for the industries tied to renewable energy and the mitigation of greenhouse gases. According to a recent KKR study, countries accounting for over 70% of world GDP and greenhouse gases now have formalized targets for net-zero emissions, which suggests that the transition to clean energy is an approximately $1.5 - $2.0 trillion per year growth opportunity.[40]

The adoption of renewable energy for electricity production has grown substantially over the past few decades. We anticipate an accelerating adoption, as global initiatives catalyze the phasing out of fossil-fuel energy sources. In 2020, renewable energy sources (i.e, wind, hydroelectric, solar, biomass, and geothermal energy) generated a record 834 billion kilowatt-hours of electricity, or about 21% of all the electricity generated in the United States.[41] In the U.S. in 2020, only natural gas produced more electricity than renewable sources, with natural gas accounting for 1,617 billion kilowatt-hours.[42]

40. KKR. "A Different Kind of Recovery?" December, 2021.
41. U.S. Energy Information Administration. "EIA - Independent Statistics and Analysis." December 23. 2021, https://www.eia.gov/todayinenergy/detail.php?id=50622.
42. "U.S. Energy Information Administration - EIA - Independent Statistics and Analysis." Renewables Became the Second-Most Prevalent U.S. Electricity Source in 2020 - Today in Energy - U.S. Energy Information Administration (EIA), 23 Dec. 2021, https://www.eia.gov/todayinenergy/detail.php?id=50622.

Exhibit 19: Annual U.S. Electricity Generation (Billion Kilowatt Hours)



Source: Energy Information Administration, as of 12/31/2020

The affordability and accessibility of renewable energy sources is partly attributable to the strong advocacy and support for clean energy among leaders in the developed world. Since 2014, the average cost of solar photovoltaic panels has dropped nearly 70%, causing markets for solar energy to mature rapidly around the country.[43] Given these price declines, solar electricity is now economically competitive with conventional energy sources in most states, and its competitive positioning should improve as costs continue to decline. The corporate sector has also adopted solar power, with bellwether companies such as Apple, Amazon, Walmart, Target, and Google, using over 100 megawatts of solar energy through 2019.[44]

Further, through the first three quarters of 2021, solar comprised 54% of all new generating capacity.[45] While the growth of solar energy to date has been robust, projections for the end of the decade suggest acceleration in growth, providing a favorable framework for investment into solar energy. The Solar Energy Industries Association (SEIA) projects 300 gigawatts of new solar capacity installations over the next ten years, three times the amount installed through 2020. The growing adoption of residential solar panels has also led the SEIA to project that 13.4% of U.S. homes will have a solar photovoltaic system by 2030.[46] Despite a record drop in global emissions over the past year, the world's battle against climate change is still in its early innings. The renewable energy sector positions itself to become one of the leading growth industries in the global economy, which we believe will translate into favorable returns for investors in the years to come.

A plethora of challenges still exists for the more significant deployment of renewable energy sources across the globe. While production costs have fallen dramatically over the past decade, market barriers and grid integration challenges hinder renewable energy adoption. As a result, the world will remain reliant on fossil-fuel energy sources during this transition period at a time when investments into these traditional industries pivots toward renewables and supply remains constrained. For this reason, we believe that the prices of fossil-fuel energy commodities will remain elevated this year.

43. "Solar Energy in the United States." Energy.gov, Office of Energy Efficiency & Renewable Energy, https://www.energy.gov/eere/solar/solar-energy-united-states.
44. Toussain, Kristin. "2019 was the second largest year ever for corporate solar investments," Fast Company, October 7, 2020.
45. Supra. U.S. Energy Information Administration.
46. Solar Energy Industries Association. "Solar Data Cheat Sheet," September 2021. https://www.seia.org/sites/default/files/2021-09/SMI-September-2021-SolarCheatSheet.pdf

In 2021, the reopening of global economies led to a surge in demand for commodities, such as crude oil, natural gas, and coal, causing these commodities to reach historically high levels. Prices rose sharply when supply was unable to meet rising demand. Traditional energy companies have experienced declining investment and a rising cost of capital over the past five years, which resulted in an industry-wide hesitation to increase production, even as energy prices soared. The dwindling investment into traditional oil producers has influenced how publicly-traded oil and gas companies have operated their businesses. Historically, shareholders rewarded these companies for reinvesting profits into projects that drive increased production; however, in recent years, shareholders have pressured oil and gas companies to return capital, as evidenced by increased dividends and share buybacks in the sector. Additionally, project lifespans have shortened due to the global initiatives to transition to renewable energy, causing oil producers to require a higher commodity price as a prerequisite to approving new projects. Overall, the movement toward Environmental, Social, and Governance (ESG) investing is happening quickly, and it is creating supply constraints in fossil fuels that are pressuring prices higher. As a result, we believe the floor for oil prices is now above $60 and prices skew to the upside.

Globally, OPEC+[47] stuck to its existing policy of modest monthly increases in oil output for its January 4 meeting despite pleas from the U.S. and Europe to increase production. For the first time since 2012, OPEC+ is set to benefit from higher market share and higher oil prices. We believe OPEC+ will continue to set output policy that will provide tailwinds for oil prices as higher fiscal break-evens across the cartel require a historically higher marginal oil price to justify incremental volume growth. Energy prices did see some reprieve toward the end of the year as demand concerns raised by the outbreak of Omicron and the release of petroleum reserves from the United States saw benchmark oil prices tumble in the month of November. However, we believe that these will prove short-lived. As fears of demand destruction caused by Omicron fade, oil prices have reverted upward, with Brent reaching $80 a barrel ahead of the January OPEC+ meeting. Incremental demand increases, higher breakeven oil prices, and the growing power of OPEC+ over the global market provide a strong fundamental backdrop that we believe will bolster oil prices in the short-term until renewable energy sources are meaningfully adopted globally.

Exhibit 20: J.P. Morgan Brent Crude Oil Forecast

J.P. Morgan Commodities Supply/Demand Forecasts - 2022/2023 (Million of Barrels per Day)	2021 E	2022E	2023E
Total Liquids Suppy	94.4	99.8	102.4
JPM Demand Estimate	96.4	99.8	101.5
Surplus	-2.0	0.0	1.0
JPM Commodities Brent Forecast	*$72/bbl*	*$88/bbl*	*$82/bbl*

Source: J.P. Morgan Asset Management

47. OPEC+ is a group of 24 oil-producing nations, made up of the 14 members of the Organization of Petroleum Exporting Countries (OPEC), and 10 other non-OPEC countries.

10. Where did the labor force go?

Labor market dynamics have changed dramatically since early 2020, when stay-at-home mandates led to a rapid increase in layoffs and a sharp decline in the labor force participation rate. Notably, as the unemployment rate continues to fall toward pre-COVID levels, labor force participation remains stubbornly low, edging up to 61.9% in December 2021 as compared to 63.4% pre-pandemic.[48] Moreover, while some reasons why workers have delayed labor force reentry appear to be temporary, other reasons, such as a mass pull-forward of retirements, suggest that low participation rates may linger even as the economy normalizes and fiscal stimulus fades. In turn, the resulting tight labor market looks to continue throughout the year as we begin 2022 remaining at full employment.

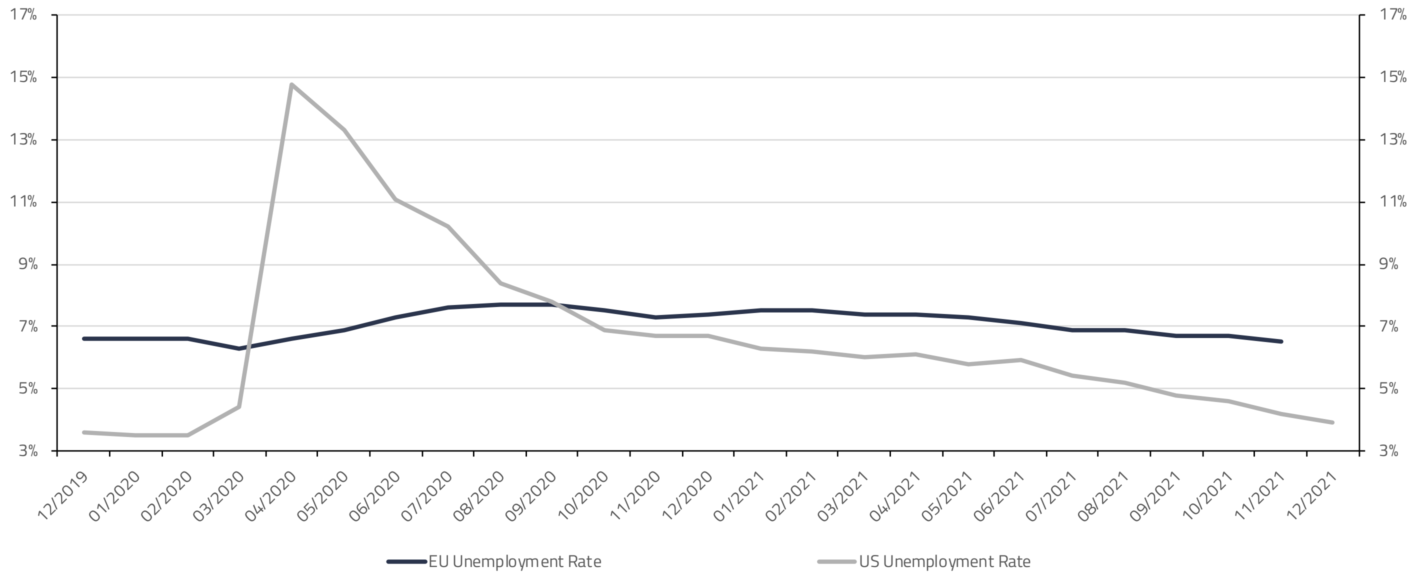
As of October 2021, there were approximately five million labor force exits since the start of the pandemic, with most exits represented by older workers who do not want a job at the present time. The October jobs report showed approximately 1.5 million early retirements, 1 million natural retirements, and 900,000 workers citing other reasons for not returning to the workforce.[49] The older worker cohort, defined as workers age 55 and over, have shown greater sensitivity to virus fears, which has caused a delay in their return to work. The Omicron outbreak will likely cause greater apprehension among this cohort about returning to the workforce; however, with an improving virus situation due to increased vaccination rates, lower hospitalizations, and the approval of antiviral drugs, we expect to see some improvement from this cohort in 2022.

The pandemic has led to significant increases in retirements over the past two years, evidenced by the roughly 2.5 million workers leaving the labor force due to retirement, which we believe is likely a permanent departure. In addition, amongst workers aged 25 through 55, only approximately 30% of the "prime-age" worker cohort stated that they indeed want a job and have actively searched, indicating that, even among this younger cohort, there is reluctance to rejoin the workforce.[50]

With respect to labor supply shortages, the U.S. has faced more significant challenges than its European counterparts, as highlighted in a Goldman Sachs Economic Research piece published in December 2021. Goldman argues that when compared to other countries, the U.S. participation rate has struggled to rebound to pre-pandemic levels due to factors including generous fiscal support, labor market policies, and virus fears.[51] Goldman attributes about half of the U.S. labor force participation rate shortfall to generous fiscal support that vastly increased household liquidity during the pandemic. Fiscal cash transfers to households via stimulus checks and enhanced unemployment benefits created a disincentive for workers to reenter the labor market, especially for lower-income workers who were the main targets of fiscal support. Intuitively, low-income workers were less inclined to seek a full-time job when cash transfers provided from the government allowed them to retain consumption levels without having to join the workforce. The November employment report, and analysis of states who terminated enhanced unemployment benefits early, suggest that the absence of these cash transfers will spur a workforce return. Albeit, the pace of this return appears to be slower than anticipated, as increased household savings rates during the pandemic have moderated the urgency to return to work. Ultimately, we view this workforce exodus as temporary, but a tepid return of low-income workers into the workforce will be a contributing factor to a tight 2022 labor market.

48. Bloomberg.
49. Briggs, Joseph. "US Daily: Why Isn't Labor Force Participation Recovering?" Goldman Sachs Research, Novermber 11, 2021.
50. Milo, Daniel. "Why Is US Labor Supply So Low?" Goldman Sachs Research, 16 Dec. 2021.
51. Id.

Exhibit 21: United States vs. European Union Unemployment Rates

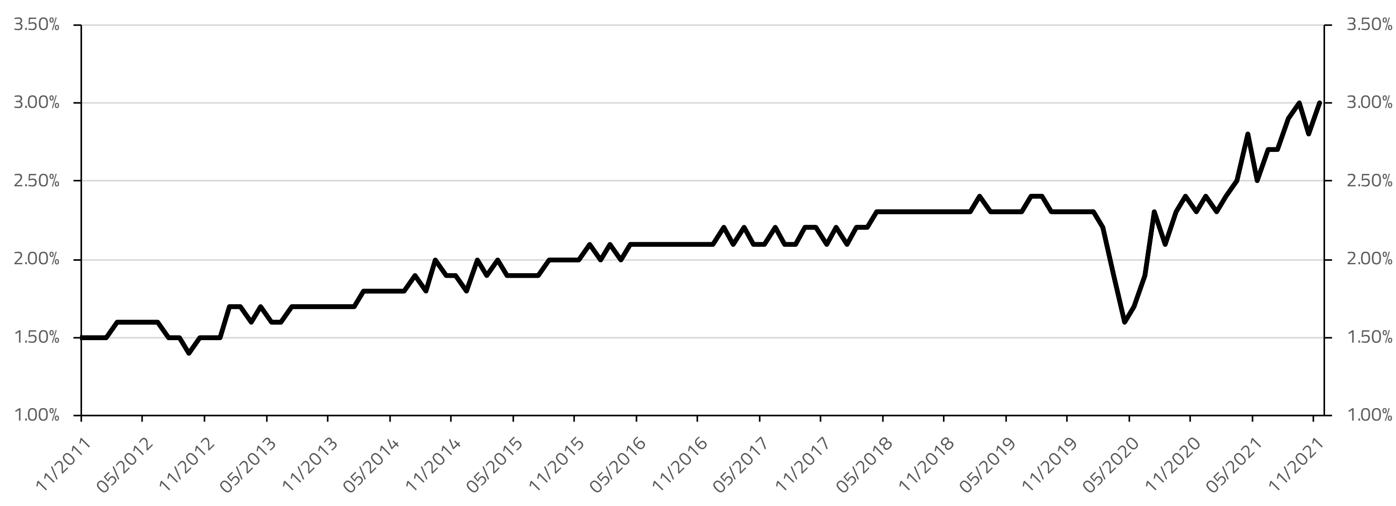


Source: Bloomberg, United States data as of 12/31/2021, European Union data as of 11/30/2021

In Europe, job retention schemes kept workers attached to their employers through the pandemic, although the data on the overall percentage change in hours worked was comparable to the U.S. While the Euro Area initiatives prioritized job retention, the U.S. extended its unemployment benefit system to support displaced workers during the pandemic. The result of these diverging actions may have contributed to a weaker rebound in labor force participation in the U.S., as workers reevaluate their willingness to return to the industries that they left during the pandemic.

The fiscal support of the U.S. government contributed to the current labor supply challenges; however, as we enter 2022, enhanced unemployment benefits have rolled off, savings rates are declining, and employers are keen to hire. Nonetheless, a reluctance to reenter the workforce is still apparent, in part due to a changing shift in society's attitude toward employment.

Exhibit 22: United States Quits Rates (Year-over-Year Change)



Source: Bloomberg, as of 11/30/2021

Record numbers of people quit their jobs in 2021 as a combination of factors has encouraged workers to seek out better opportunities. Data from the Bureau of Labor Statistics reflects quit rates reaching historical levels over the past year. In particular, there was a surge in quits in low-pay service sector industries. October 2021 saw a 2.8% year-over-year increase in quits reflecting over four million Americans who left their jobs that month. The leisure and hospitality and food services industries saw quit rates increase 5.7% and 6.0%, respectively, during the month.[52] Unsurprisingly, these industries were the hardest hit during the pandemic, as social distancing measures forced employers to institute mass layoffs leading to a surge in displaced workers. We believe the trauma of the pandemic led to a reset in workers' mindsets and made them less willing to endure inconvenient hours and poor compensation, especially when the fragility of their employment surfaced in March 2020. Employment trends that promote a better work-life balance, such as remote working capabilities and flexible hours, have gained acceptance during the pandemic, leading workers to transition away from less flexible roles.

American workers are sensing ample opportunity in the labor market, supported by November 2021 JOLTs data reflecting 10.6 million job openings across the country. With job openings outnumbering unemployed workers, employees have greater bargaining power. Employers have attempted to combat these changing dynamics through increased compensation, as evidenced by bonuses paid out during the year and rising average hourly earnings.[53] However, these initiatives have only marginally incented a return to work, and we believe that the current labor dynamics will remain long-lasting, particularly pressuring employers in lower-paying services sectors.

We believe the normalization of the workforce will be a drawn-out process, causing a tight labor environment throughout the year even as the effects of fiscal stimulus wane. Worker strikes and social protests, such as the “lie down movement,” provide evidence that a grand recovery of the workforce seems unlikely. With the unemployment rate rapidly approaching 2019 levels and wage pressures building, labor market dynamics will put pressure on the Federal Reserve to increase interest rates at a faster pace than it had indicated throughout most of last year.

52. U.S. Bureau of Labor Statistics.
53. Wang, Vivian. “Council Post: How Employers Can Use Bonuses to Attract Hourly Workers in a Tight Labor Market.” Forbes Magazine, September 15, 2021. https://www.forbes.com/sites/forbestechcouncil/2021/09/15/how-employers-can-use-bonuses-to-attract-hourly-workers-in-a-tight-labor-market/?sh=1663b571233a.

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