GFP *Outlook & Strategy* January 2022

2021 Review

The rollout of vaccines, additional fiscal stimulus as well as continued expansionary monetary policy from central banks all combined to support equity markets' performance and a move up in commodity prices. Among global equities, U.S. large capitalization stocks once again displayed leadership with the S&P 500 advancing to new all-time highs.

However, within the S&P 500, market breadth (the number of stocks advancing relative to those that are declining) was quite narrow as the top six stocks accounted for nearly a third of all gains. In addition, several previously high-flying technology names, where earnings expectations are extrapolated far into the future, witnessed 40%+ corrections. In other words, overall impressive index performance masked quite a bit of volatility under the surface.

Value stocks performed much better than in years past with both the financial and energy sectors posting strong gains. Small cap stocks trailed their large cap peers, but gains were still ahead of their 20-year average. Developed international markets also posted respectable results, but emerging markets suffered a slight decline due to a correction in Chinese equities and extended lockdown measures across those markets. Core fixed income also experienced negative returns as long-term interest rates ended the year higher than where they began (rates move inversely to bond prices). Considering the fact that core inflation data rose to levels not seen since the 1970s, the modest rise in long-term rates was a surprise.

2022 Outlook

As many of you who have routinely listened to our quarterly calls know, we anticipate 2022 will be a year of lower returns from both equity and fixed income, increased market volatility, and rising interest rates. Despite this, we maintain the view that the overall investment backdrop remains constructive with negative real interest rates (adjusted for inflation), well-positioned consumers, positive corporate earnings momentum, and sizeable pent-up demand from severe supply chain bottlenecks that should show signs of easing. We are also keeping close tabs on the following developments:

- *Omicron Variant*: Though highly transmissible, it appears Omicron is a less-severe COVID variant producing milder symptoms. While concerns surrounding Omicron have been steadily escalating over the past month, consensus experts are now predicting that Omicron will peak in the U.S. sometime in January. Omicron is placing a drag on GDP with an associated slowdown in economic activity, but we believe the market has already begun to look past this variant and views its economic impact as transient.

- *Financial Conditions*: Look for financial conditions to tighten throughout 2022 as the Federal Reserve begins to first taper their Treasury purchases, then embarks upon a series of rate hikes intended to quell surging inflation data. As the Fed moves to normalize (tighten) monetary policy, we expect the markets to be impacted with equity valuation multiples contracting. Without multiple expansion available to drive prices higher, equites will have to solely rely on earnings growth. We see earnings growth being strong enough to offset the multiple decline, but not enough to drive equity prices meaningfully higher.

- *Fiscal Stimulus and Tax Reform*: The emergence of COVID in early 2020 and subsequent shutdowns were met by unprecedented fiscal stimulus to help alleviate the economic fallout. This magnitude of fiscal stimulus is simply not sustainable (and hopefully not needed at that level) and should lessen dramatically moving forward. The Build Back Better bill, designed to provide additional stimulus, seems to have reached a political impasse. We place the odds at 50/50 that the Build Back Better bill will eventually pass, but even if it does, the total spending will be significantly less than what was originally proposed. A substantial reduction in expected fiscal stimulus would prove a drag on current GDP expectations. Conversely, despite early speculation, it appears less likely that we will see major tax reforms. Markets will likely interpret this as a positive for risk assets.

- *Inflation*: We cannot emphasize enough how closely we are monitoring inflation data because of its potential impact on the economy and the markets in general. In early 2021, the surging inflation numbers were largely attributed to those sectors of the economy that benefited most from the initial reopening of the economy (energy, financials and industrials) and were in high demand following the COVID lockdowns. Initially, it was thought that this elevated inflation would prove transitory. However, inflation has proved persistent causing the Fed to act on it earlier than expected. The consensus now anticipates that the Fed will hike rates at their March 15-16th meeting.

Asset Class Outlook Summaries for 2022

Equities: After a move up in 2021, we see more normalized or even below-trend returns for various major equity indexes. Monetary, fiscal, and political policy uncertainties could weigh on markets, and investors should be prepared for a 10% correction at some point in 2022. As the economy moves towards more of a traditional late economic cycle phase, changes in market leadership (those asset classes or specific strategies that lead performance) can take place. To take advantage of this and identify absolute and relative return opportunities from equity exposure, our investment approach for clients is increasingly diversified by style, market cap and geography.

Fixed Income: Outside of diversification benefits, we see little value in owning core fixed income given our outlook on interest rates. While we strongly suggest avoiding duration (longer term fixed income instruments), we are still comfortable with taking on credit risk as we foresee a low default environment due to continued economic growth as well as improved household and corporate balance sheets. Those holding individual, long-dated bonds should strongly consider reallocating as we have already done for clients. We may finally be seeing the end of the multi-decade long bull market in fixed income.

Alternatives/ Private Strategies: We believe now is the time to overweight private strategies and other alternative investments in properly diversified portfolios. We continue to speak to our clients as appropriate opportunities arise and continuously source and evaluate these types of idiosyncratic investments. The illiquidity premium is real and is especially attractive in a low-return environment which we forecast for both public equity and fixed income markets over the coming years. The low correlation (to public equity and bond markets) nature of these strategies should benefit portfolios, especially as overall volatility increases. We expect private strategies to outperform their public market counterparts over the coming years.

In conclusion, managing risk and return is paramount. We are not negative, but it is sensible to be prepared for bouts of volatility in 2022 given inflation concerns and the many fiscal and monetary changes that are taking place. Everyone hopes that the impact of COVID on humanity from both a health and economic standpoint will begin to fade but only time will tell. We advise our clients to remain fully invested, but to stay diversified, and to increase exposure to alternative, low correlation strategies.

Wishing you a healthy, happy new year. As always, we appreciate the opportunity to serve you. Please reach out to us with any questions.

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