2022 Themes & Outlook
A Shifting Global Economy

As we reflect on 2021, we recall the sense of relief as we greeted the year with a roll out of COVID-19 vaccines, the optimism about an economy that was rebounding faster than anticipated and a plethora of consumer savings that were eager to be spent. Investors were rewarded in 2021 as equities produced stellar returns on the heels of robust earnings and economic growth. In addition, commodities surged as consumer demand swept up depleted supplies. However, bonds finally buckled to the strongest economic outlook in decades and left investors with negative returns. It was also a year that we started to experience the negative side effects of the actions taken to combat the pandemic. Excess liquidity created by fiscal stimulus and extraordinary easy monetary policy fueled speculative bubbles (e.g., MEME stocks, SPACs), supply chains collapsed, Americans left the work force in droves and inflation started running rampant across many areas of the economy.

We believe that growth will be more muted in 2022. That does not mean a recession is in sight. While consumers will continue to feel the effects of a severely damaged supply chain, inflation pressures and higher interest rates, we see several supportive factors for economic growth in 2022. From an investing perspective, returns will very likely be more challenging as the cycle evolves and the Fed moves from an easing towards a tightening cycle. We believe rotation amongst equity regions and investing styles will be a key theme for investors to achieve attractive returns. Bond investors will most likely be thrown a curveball as rising inflation and the removal of nontraditional monetary policy are expected to hamper returns for the second consecutive year.

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Theme #1 - U.S. Economic Expansion to Mature not Contract

The current economic expansion has seen economic growth return to its pre-recession peak at the fastest pace on record. Massive fiscal stimulus and unusually easy monetary policy have helped the economy navigate through the pandemic related disturbances for the past two years. However, these factors have also left us with challenges that we have not faced for decades. In the first half of 2022, we think that economic growth will notably slow from the elevated levels we enjoyed in 2021. The euphoria around the economy reopening is being replaced by prices rising at the fastest pace since the 1980s. The supply chain will need time to repair itself and Americans are still reluctant to return to a normal work atmosphere. In addition, the support line from the Federal government and Federal Reserve is abating and will be a drag on growth compared to previous years.

However, a slowdown in economic growth after a record v-shaped recovery is understandable and should not be mistaken as an imminent contraction or recession. In fact, even with the expected slower growth, U.S. GDP is likely to post its best back-to-back annual gains since the late 1990s **(Chart 1).** While consumers remain strong, it is unlikely they deliver the same stellar contributions to growth as seen over the past year. There are other components of economic growth that will likely take the torch as consumers take a well-deserved break. Some of the factors that we believe will support the ongoing expansion include:

- **Manufacturing to work overtime to catch up:** The pent-up U.S. consumer demand has depleted inventories across a variety of consumer goods. **(Chart 2 – next page).** In addition, COVID-related disruptions (e.g., lockdowns, closures) have highlighted the complexities of the global supply chain. Manufacturing should continue to be supportive of growth as companies work feverishly to replenish inventories and clear the backlog of orders.

Chart 1

Best Consecutive Years of Growth in Decades

Estimate is using Bloomberg estimates as of January 19, 2022. Data Source: Bloomberg Finance LP, Verdence Capital Advisors.

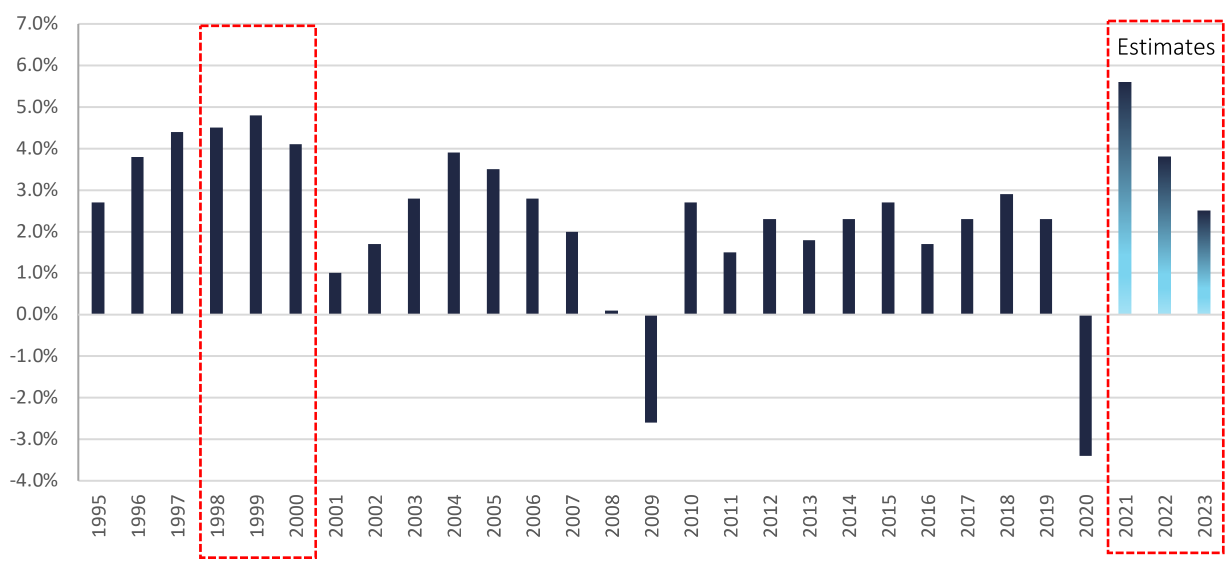

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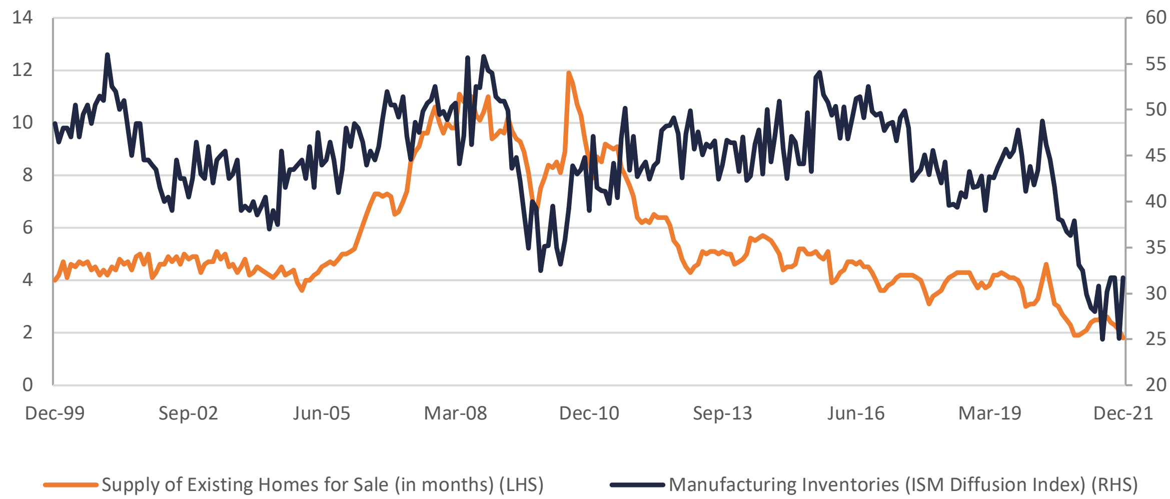
Chart 2

Inventories Depleted Across Many Areas of Economy

Data is as of December 2021. Data Source: Bloomberg Finance LP, Verdence Capital Advisors.



- **Living with COVID not locking down:** More than a year into the distribution of COVID vaccines, we have fully vaccinated more than 60% of the U.S. population and vaccination rates are even higher in other major economies (e.g., 84% in China, 72% in Germany, 79% in Japan, 70% in the UK).[1] The most recent Omicron variant has put us another step closer to moving from the pandemic stage to an endemic. Hospitalizations in relation to cases is the lowest since the pandemic began **(Chart 3)** and with the most transmissible variant yet we are moving closer to herd immunity. In addition, therapeutics and treatments will be the focus in 2022 as we learn to accept COVID as we have the flu. We have already seen government authorities rethinking the incubation period which should help the economy relative to the disruptive nature of quarantining.

Chart 3

Living with COVID Not Locking Down

Data is as of January 17, 2022. Data Source: Our World in Data, Verdence Capital Advisors.

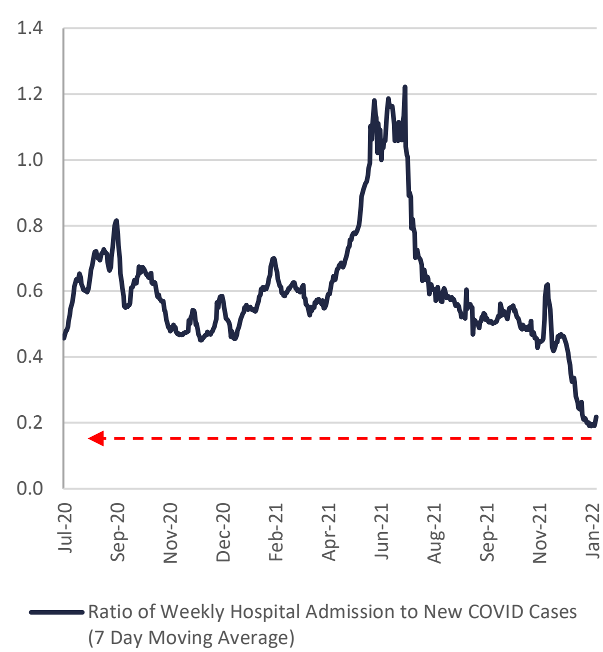
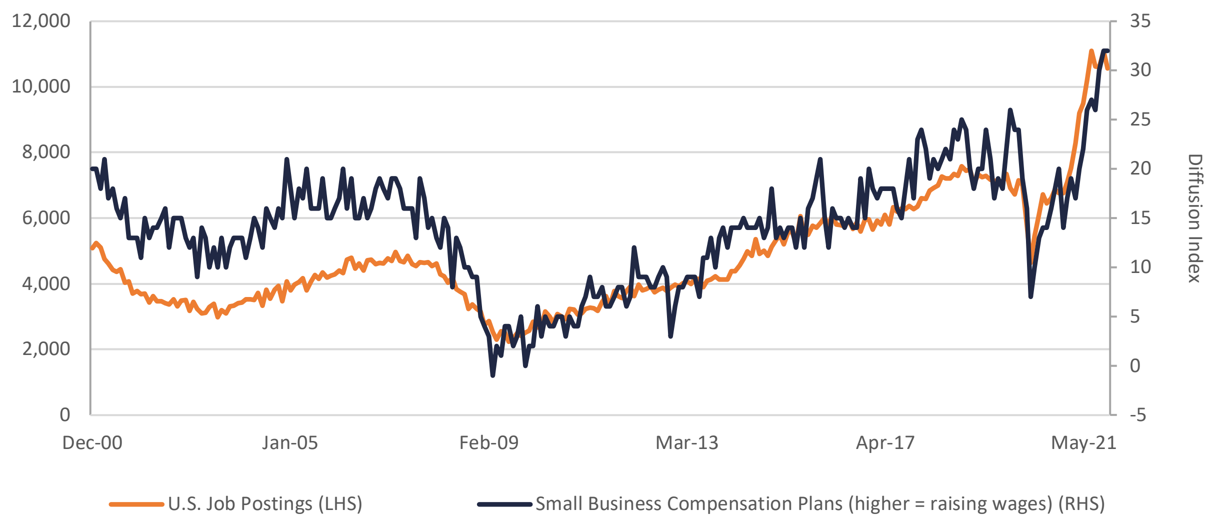


Chart 4

A Great Time to be an Employee

Data is as of November 2021. Data Source: Bloomberg Finance LP, Verdence Capital Advisors.



- **Labor market to improve:** For an employee in most sectors of the economy, it is one of the best times in history to get the job you want, request flexibility, and demand higher wages. (**Chart 4).** The economy has gained back ~19 million of the ~22 million jobs lost during the pandemic, but the labor force participation rate has failed to reach its pre-pandemic peak. There are many reasons for this including a significant amount of people taking early retirement, fiscal stimulus that has incentivized people to not return to the workforce, childcare related issues due to the pandemic and overall healthcare concerns. We believe in 2H22 as we move from the pandemic to the endemic phase of COVID and Americans continue to deplete savings and/or use credit cards to keep up with rising prices, we will see a higher labor force participation rate.

- **Housing market still hot:** Despite the expectation of higher interest rates the housing market should continue to be supportive of economic growth. With the months' supply of existing homes at a record low, homeowner affordability still above average and demographics pushing a new age group into homeownership (i.e., millennials), the demand for housing should continue. In fact, building permits which are a good leading indicator of future housing activity is sitting near the highest level since 2006.

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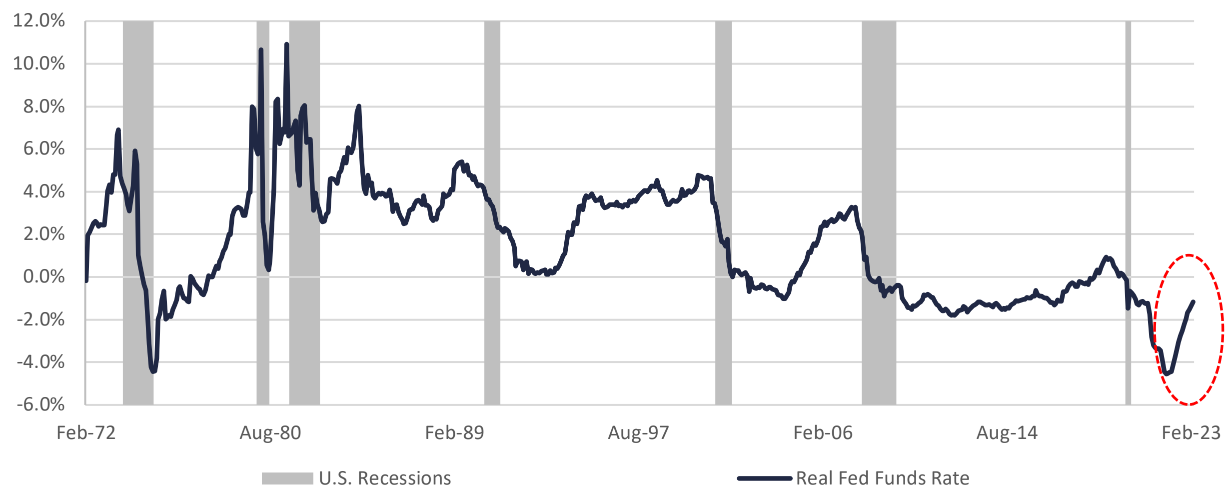
- **Less easy monetary policy; not tight:** The Federal Reserve is expected to begin a tightening cycle this year. Whether they raise rates four or five times this year is not necessarily relevant in the long run. However, it is important for investors to realize that even with the expected rate hikes, real rates should stay historically low through 1Q23 at least. **(Chart 5).** Historically, the economy does not enter a recession when real rates are low or negative.

Chart 5

Fed Still Historically Accommodative

Data is as of November 2021. Forward looking estimates are as of January 19, 2022. Data Source: Bloomberg Finance LP, Verdence Capital Advisors.



Even with the expected rate hikes, real rates should stay historically low through at least 1Q23. **Why is this important to know?** Historically, the economy does not enter a recession when real rates are low or negative.

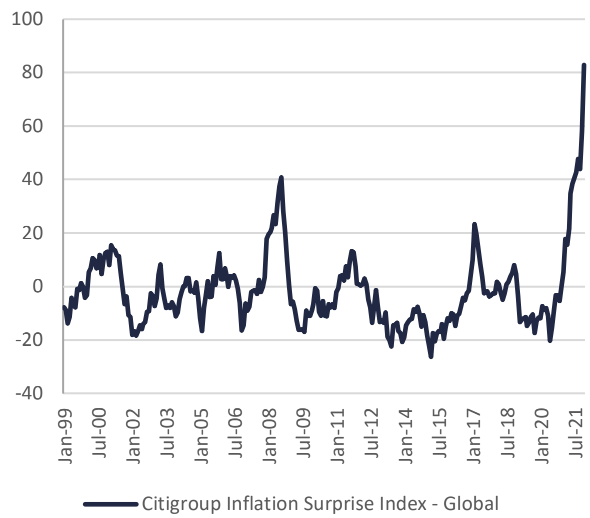
Theme #2 – Global Central Bank Divergence

Central banks will be a primary focus in 2022 as inflation data continues to surprise global central bankers to the upside and even forced U.S. Fed Chairman Jerome Powell to drop his "transitory" view on inflation. **(Chart 6).** Central banks are now tasked with a balancing act of pulling back excess liquidity to combat inflation but also not threaten the economic expansion. Given that some economies have recovered more quickly than others, we expect to see a divergence in global monetary policy in 2022. This can impact equity market returns and currency volatility. In addition, we expect to see funds flow towards some of those areas that are more conservative with rate hikes and may have lagged the U.S. in the economic expansion. Within the developed economies, we expect the U.S. to lead the central banks with rate hikes as early as March. The European Central Bank is not expected to raise rates until late 2022 or 2023. In addition, select emerging markets, specifically in Asia, are expected to be more gradual with rate hikes and have greater flexibility with fiscal policy.

Chart 6

Inflation Taking Central Banks by Surprise

Data is as of December 2021. Index measures inflation data that comes in above or below the consensus estimate. Data Source: Bloomberg Finance LP, Verdence Capital Advisors.



Theme #3 – Rotation is Key to Adding Value

Global equities as measured by the MSCI AC World Index rallied for the third consecutive year in 2021 as historically easy monetary policy and a global economic recovery supported risk assets. Given our expectation that the expansion will slow but continue, and corporations will remain healthy, we maintain our overweight to global equities in 2022. However, as we navigate through the next phase of the economic expansion and accept higher interest rates and inflation, investors will need to be selective as some areas of the equity market may be more challenged than others. Overall investors will need to accept more muted levels of return and higher volatility which can be an emotional tug of war if investors are not patient and/or neglect their long-term investment objectives. Below are our recommendations for global equities in 2022.

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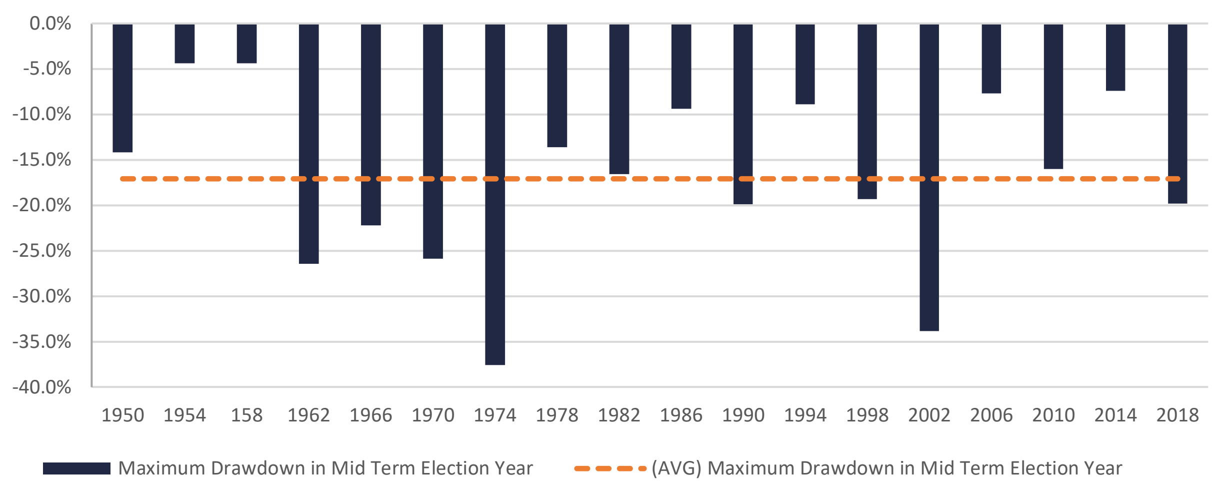
- **Volatility to accelerate; cash is not the enemy:** We realize that it may be counterintuitive to hold excess cash in a period with historically low interest rates. However, we believe having dry powder will be crucial during a year where volatility is likely to accelerate. Investors were fortunate to see a nearly uninterrupted equity rally in 2021 with the S&P 500 only experiencing one pullback of 5% or more (last time we had such few pullbacks was in 2017). However, history suggests that in the years following a year with low volatility that equity returns are more muted, and volatility accelerates. While rising interest rates, stretched valuations and a slowdown in economic growth should fuel volatility, we are also in a midterm election year in the U.S. Historically in years with a midterm election the average maximum drawdown in the S&P 500 is 17%. **(Chart 7).**

Holding excess cash will be crucial during accelerated volatility

Chart 7

Midterm Elections Could Serve as Fuel to Volatility

Data is all midterm elections since 1950. Data Source: Strategas Research Partners, Verdence Capital Advisors.



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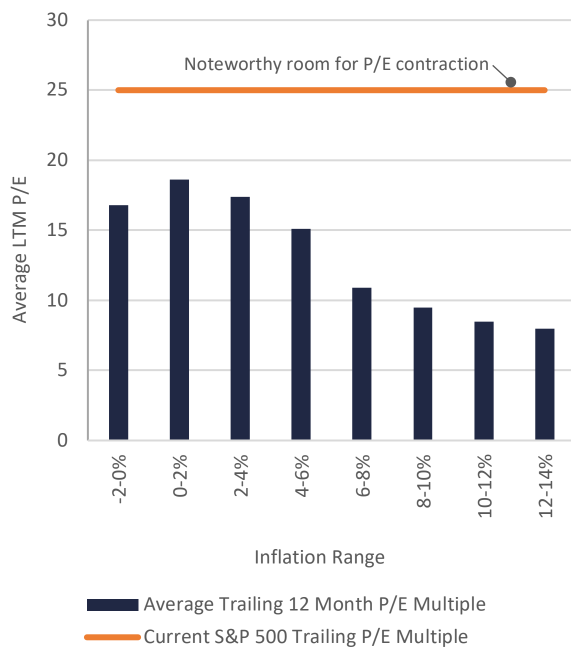
- **Growth in for its biggest challenge yet:** For at least the past decade growth stocks have outperformed as interest rates and inflation have trended lower and corporate balance sheets have been healthy. We believe 2022 will be the biggest challenge yet for this decade old phenomenon. The main difference this year is the world is settling into a higher level of inflation and the Federal Reserve is removing easy monetary policy. History shows that rising inflation and interest rates tend to have an inverse effect on price to earnings multiples for stocks. **(Chart 8).** Therefore, those stocks that have seen momentum, euphoria and excess liquidity drive valuations to levels not seen since the dotcom bubble will likely be challenged (e.g., technology). Instead of the expansion of multiples (what an investor is willing to pay for earnings) an investor's total return will likely be more driven by earnings and dividend growth.

- **No need to abandon growth but look at cyclicals and different market caps:** We believe that growth stocks will be challenged but we would not abandon them for the long term. Instead, we will look for attractive opportunities as valuations reset to adjust to the different interest rate regime. We continue to favor those areas/sectors that have pricing power in an environment of solid growth but higher prices (e.g., value and/or cyclically oriented sectors). Value and cyclical stocks are also trading at a historic discount to growth with attractive valuations. In addition, small and midcap stocks are trading at significant discounts to their historical averages.

Chart 8

Inflation Can be Dangerous for Expensive Stocks

Data is using CPI from 1950-2021. Current trailing P/E is as of Jan 19, 2022. Source: Strategas Research Partners, Verdence Capital Advisors.



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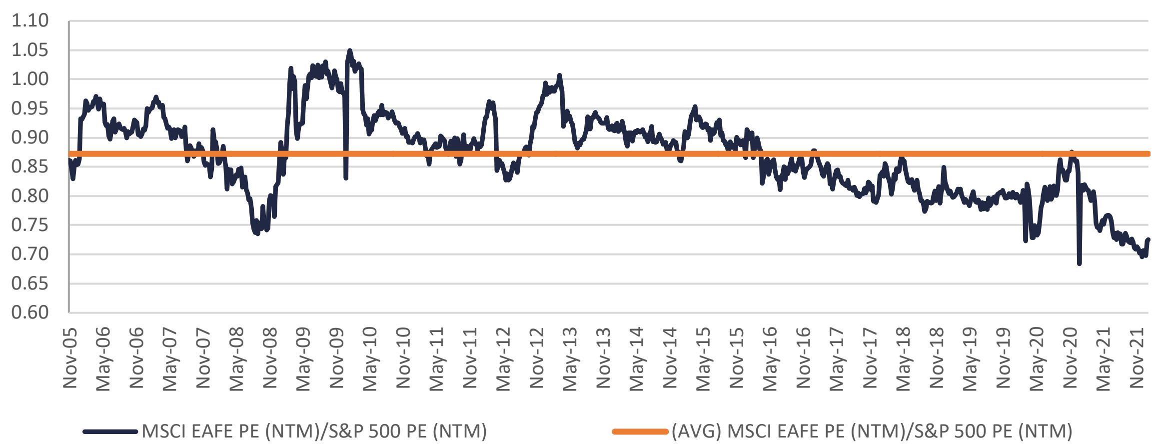
- **Look internationally for value:** We continue to favor developed international equities over U.S. equities. Developed international equities are expected to experience easier monetary policy (especially in Europe) at a time when they are historically cheap relative to U.S. equities. **(Chart 9).** In addition, since international developed economies are larger exporters than the U.S., they have more exposure to the cyclical areas of the market that we tend to favor at this stage of the economic expansion rather than the U.S. tech heavy market.

Chart 9

International Equities Historically Cheap Compared to U.S. Equities

Data is as of November 2021. Forward looking estimates are as of January 19, 2022. Data Source: Bloomberg Finance LP, Verdence Capital Advisors.



Theme #4 – A Generation of Investors in for a Curveball

Last year, investors witnessed the first decline in the broad bond market (Bloomberg Barclays Aggregate Index) since 2013, and we think 2022 will be another challenging year for bonds. In fact, we expect bonds to post their first back-to-back annual down years since at least the 1970s as we embark on the reversal of a nearly 40+ year bond bull market **(Chart 10).** The shift from easy monetary policy to more normalized policy, an inflationary environment that we have not experienced in decades and historically low real yields are expected to leave investors with little to no total return. We still believe fixed income serves its purpose as a portfolio diversifier, but we would be defensive with the overall fixed income allocation. We recommend the following exposure in fixed income.

Chart 10

Long-Term Bull Bond Market Shifting

Data is as of January 24, 2022. Data Source: Bloomberg Finance LP, Verdence Capital Advisors.

- **Defensive in a rising rate environment:** The Fed has changed their tone on inflation and as a result we are seeing a repricing in the interest rate market to reflect a quicker move higher in interest rates (first rate hike may be as early as March). Therefore, investors may want to be defensive with their bond exposure and focus primarily on short duration fixed income. In addition, we believe that floating rate notes offer an opportunity for bond investors as they are structured to offer a higher yield as interest rates rise.
- **Do not reach for yield; risk/reward minimal:** While higher yielding fixed income carries a lower duration given its high coupon, we would exercise caution. The extra yield investors gain to buy high yielding debt compared to a Treasury bond is at the lowest level seen since before the Great Recession while absolute yields are near a record low. This offers little reward for the additional risk when investing in high yield bonds.

Theme #5 – Acknowledging the New Diversified Portfolio

For decades investors have been able to benefit from the diversification approach that a generic 60% equity/40% bond portfolio offers. We are at an inflection point with the negative correlation between stocks and bonds. The Fed is in a position where they need to normalize interest rates faster than previously forecast, we are left paying for the record amount of debt that was issued during the pandemic, inflation is reducing overall returns and excess liquidity has propelled some public sector valuations to levels not seen since the dotcom bubble.

Therefore, we see both portions of the traditional 60%/40% portfolio at risk to deliver attractive risk adjusted returns over the coming years. Instead, for many investors, we recommend having at least a portion of your overall portfolio allocation in the private markets to offer better risk adjusted returns. Investing in the private market not only removes the daily volatility, but it also typically offers low correlations to public securities, provides cash flow in some instances and may be a better way to hedge against inflation. However, due diligence is crucial in the private markets as excess liquidity has reduced risk premiums and opportunities across a broad range of segments of the private markets. For qualified investors, we favor real assets that can hedge against inflationary pressures, small to middle market private equity and private credit in the current environment. In addition, traditional low volatility hedge funds can offer another layer of diversification and serve as a hedge for investors' public market equity exposure.

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Verdence Summary:

We acknowledge that the economy will be challenged in 2022 because of the actions taken during the pandemic. While a slowdown from record high levels of growth is healthy and warranted, we remain optimistic that we can navigate through the removal of nontraditional monetary policy and decreased fiscal support this year. We also understand the risks as we enter this next phase of the economic expansion. Policy errors from the Federal Reserve and/or Federal Government especially in a midterm election year are worth monitoring. In addition, energy prices have historically been a source of weakness in the U.S. economy and are climbing on the back of rising geopolitical tensions and supply constraints. We will assess these risks as we move through the economic expansion. We are confident that volatility is expected to accelerate, and active management is an effective way to benefit from the expected opportunities to adjust asset allocation. While inflation is likely to damage bond returns, we believe that equities still offer the better long-term potential. Especially those areas of the market that can benefit from economic growth and have pricing power (e.g., energy, financials, industrials). We also do not see the holding of dry power as a negative for investors. Instead, we will monitor periods of weakness and valuation corrections as potential opportunities to adjust asset allocation with a long-term fundamental view in mind.

As always, if you have any questions about our perspective, please do not hesitate to reach out to your advisor.

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[1]According to Our World in Data as of January 19, 2022. ourworldindata.org

Important Disclosures:

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