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by Yellow Cardinal Advisory Group

MARKET UPDATE
December 2021

Old Habits Die Hard

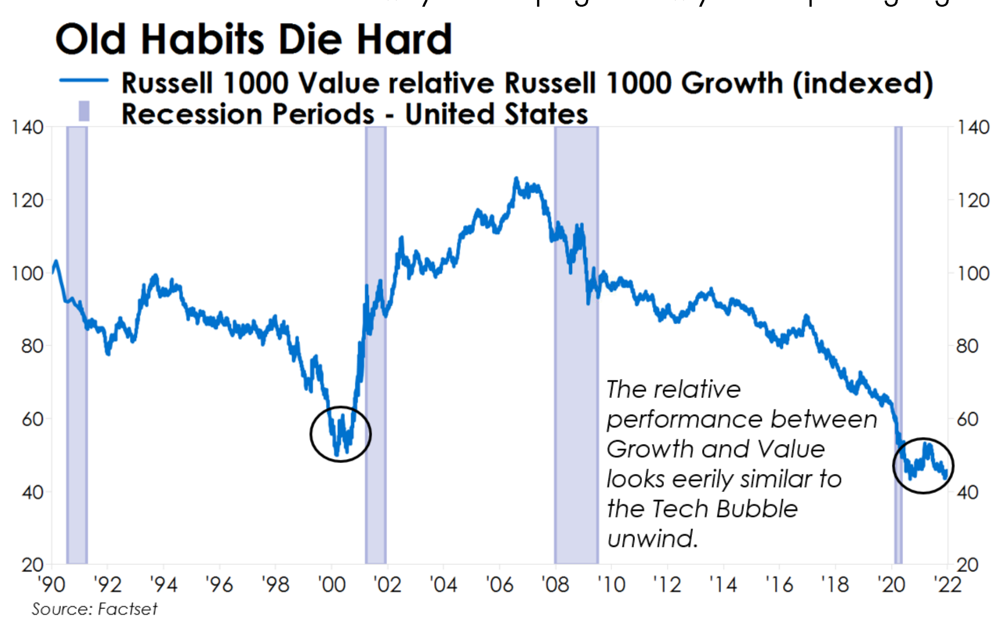
"Habits are hard to break, and those who have been accustomed to idleness or extravagance do not easily change their manners."

– Benjamin Franklin in *The London Chronicle* (December 30, 1758)

The end of another year often brings New Year's Resolutions to replace bad habits with new ones. Doing some research on the web for this month's piece uncovered a lengthy list of common bad habits including procrastination, bad diet and exercise, poor sleep, disorganization and lack of patience. It also revealed an advertisement for a (third edition) wearable device that sends an electronic shock every time a bad habit is initiated…ouch! You can't make this stuff up.

Old habits are a basic element of human nature. This month's quote is proof that one of our founding forefathers highlighted it as an issue almost 263 years ago to the day. And so while times have certainly changed, human nature has changed dramatically much less so.

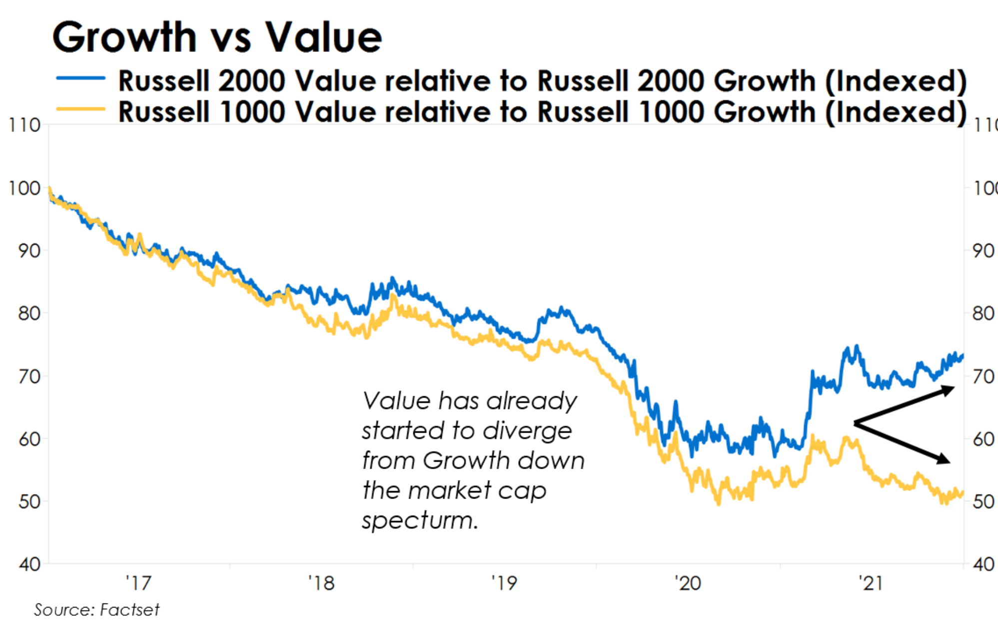
Warren Buffett is often mentioned for highlighting that the market – at its most base elements – is driven by both fear and greed. This is perhaps the reason that while markets may be efficient some of the time, they tend not to be efficient all of the time. Human emotion has a way of creeping in slowly and replacing logical fundamentals with illogical sentiment. Sometimes the process can be slow enough to allow bad habits to form. We think valuation tendencies today reflect old habits that investors are finding hard to break. In the past, we've written much about the valuation disparity between Growth and Value stocks. This disconnect also shows up



in a simple price chart plotting the Russell 1000 Value Index relative to the Russell 1000 Growth Index over the past thirty years. As can be seen in the chart on the previous page, Large Cap Value stocks have underperformed Large Cap Growth stocks over the past decade. While the underperformance has been more pronounced than during the '90's Tech Boom, what we find even more noteable is the similarities between 2000 and today. Just before the Tech bubble unwind, Growth stocks saw some initial underperformance but then rallied back relative to Value stocks. This drew in the last few buyers of Tech stocks during the height of the bubble before the trend swiftly reversed and the unwind began. In technical parlance, this is often referred to as a double bottom and resembles the shape of a "W". We can't help but notice a similar pattern emerging today. Value stocks outperformed late in 2020 until about June of this past year before drawing Growth buyers back in. Is this just more churn or the potential signs of a notable reversal following years of Growth outperformance leading to excessive valuations?

We think it's important to recognize that the Growth Index is not only significantly more expensive than the Value Index (45X vs 26X trailing P/E) but it's also become much more concentrated with about 75% represented by just three of the eleven GICS sectors – Technology, Consumer Discretionary and Communication Services – of which the top five names make up almost 40% of the index alone. Historically, such concentrations become problematic when markets become sensitive to valuations, which tends to happen when inflation begins to rise to more elevated levels – precisely the environment that we find ourselves in today.

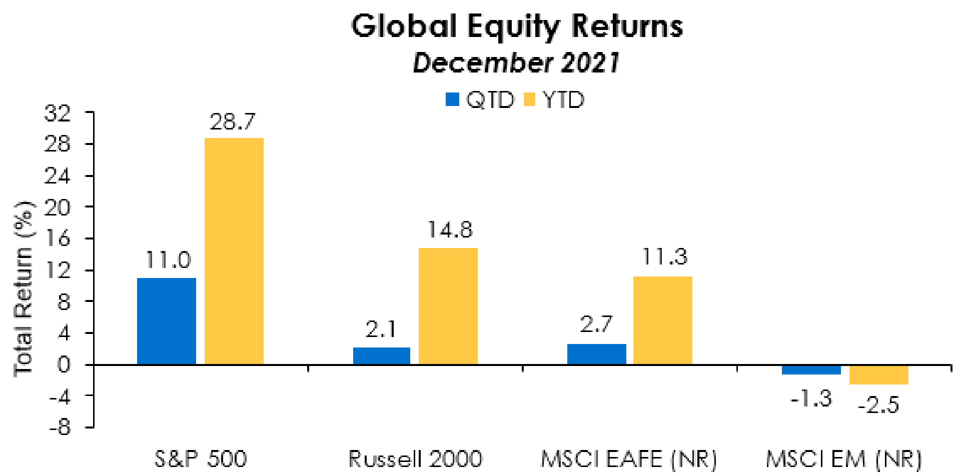
One final observation is that a bottoming seems to have already happened down the market cap spectrum. As can be seen in the chart at right, Small Cap Value stocks have already been outperforming Small Cap Growth stocks for the majority of this past year.



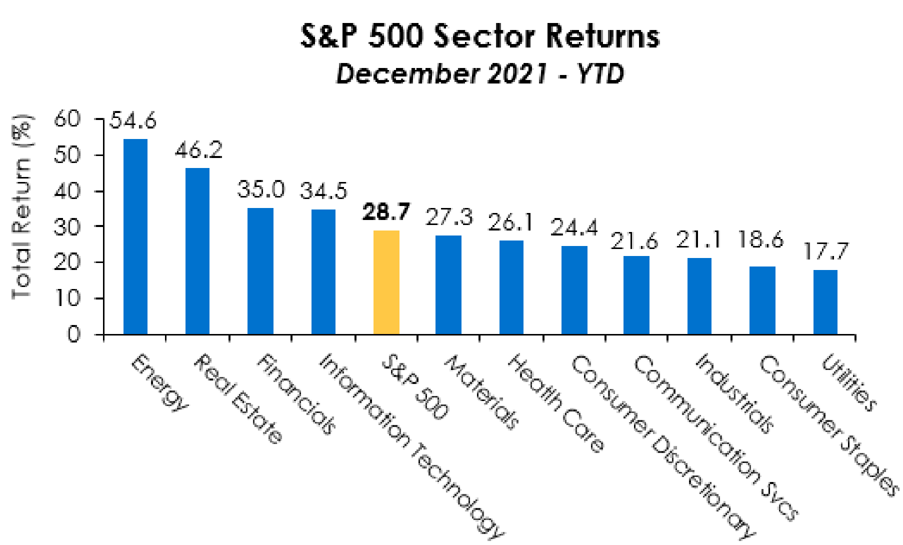
Old habits do indeed die hard, but we think there are enough rumblings to suggest that the market is attempting to break them. We're staying tuned in.

After the dip in November, risk assets rallied back to close out the year as fears of lockdowns from the Omicron strain were assuaged. Full year returns benefited from a reflationary bias. Real Assets outperformed Stocks and Stocks outperformed Bonds. Real Estate, Commodities and Cyclical sectors did the best while interest rate sensitive Bonds suffered the most.

Stocks

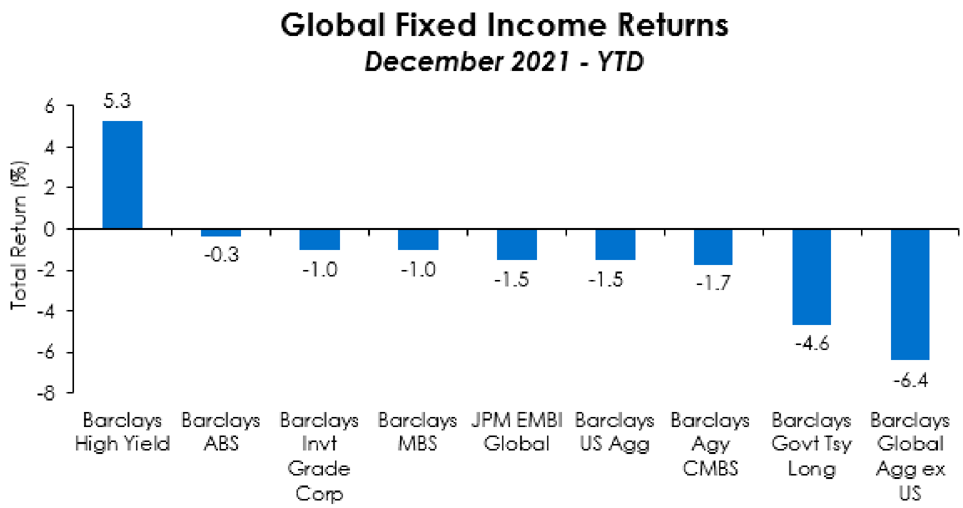


Stocks traded mostly higher in the final quarter to cap off a year of mostly strong full year returns. Domestic stocks (S&P 500 and Russell 2000) outperformed international stocks (MSCI EAFE and MSCI EM) – especially the Emerging Market region where a broadening regulatory crackdown in China embroiled markets. Policymakers there have taken a hardened stance on everything from education to technology to real estate. Increased regulations have become China's answer to solving for income equality and self sufficiency. For the year, all S&P 500 sectors posted robust returns. Given strong corporate profit growth, sectors reflected an investor preference for Cyclical exposure with significant outperformance in Energy and Financials (Cyclical Value) as well as Technology (Cyclical Growth) and Real Estate. Conversely, more traditional Defensives (Health Care, Utilities, Staples) lagged for the year though notably outperformed for the quarter and the month as the market took on a more defensive tone to finish 2021.

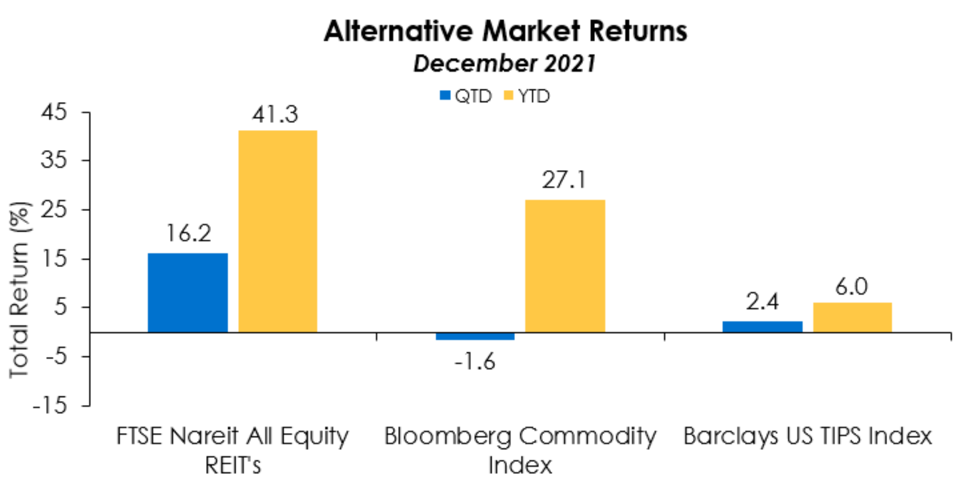


Bonds

Bond returns finished the year in mostly negative territory amid an upward, but uneven rate bias. Long-term rates began trending higher in August of 2020, though they've moved sideways since April. While shorter term rates stayed mostly anchored by a Fed on hold, they began to move up more notably in October pricing in a removal of policy accommodations. Credit spreads were benign for much of this past year leaking wider in November but calming back down this past month. A stronger dollar pressured International Fixed Income (Global Agg ex US) for the balance of 2021 while the more interest rate sensitive areas of the bond market were negatively impacted by the above-mentioned higher rates (Govt Tsy Long). Meanwhile, securities with shorter durations and more sensitivity to equities outperformed, including High Yield and Investment Grade corporate bonds as well as Securitized Assets (ABS, MBS).



Alternatives



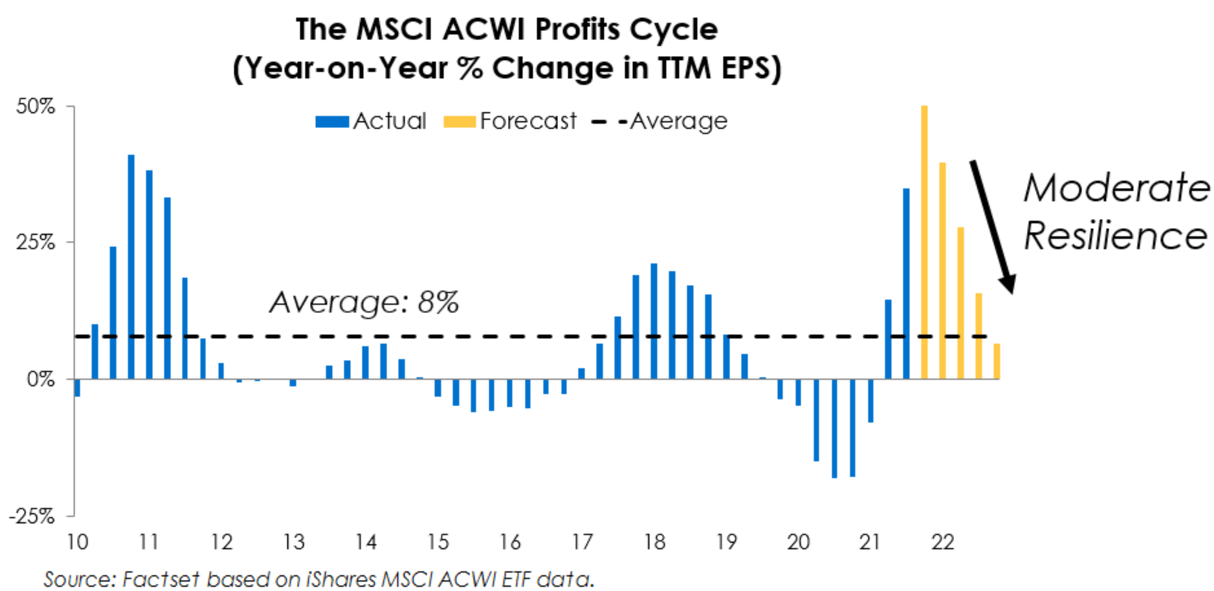
Alternatives posted mostly strong returns for the year though were more mixed in the quarter – particularly as energy prices fell on concerns of weakened travel demand due to the COVID variant. For the year, however, commodity returns have benefited from rising Energy, Industrial Metals and Agriculture prices. Meanwhile, REIT's were among the best asset classes of 2021 as they've been viewed as an attractive reopening opportunity along with some defensive yield characteristics.

Market Outlook

"It's tough to make predictions, especially about the future."

– Yogi Berra (1925-2015)

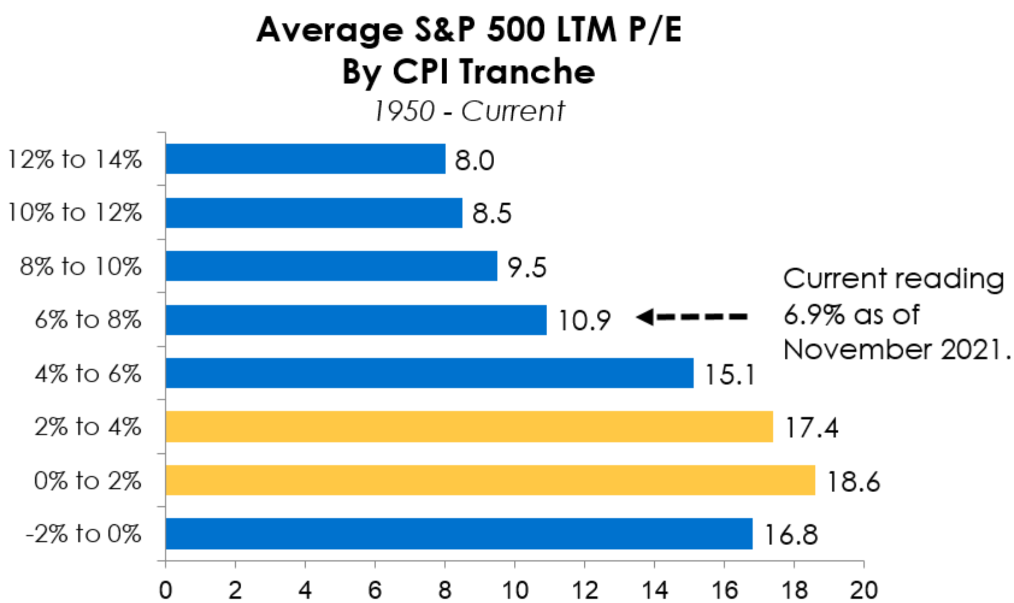
As we turn the page to next year, we think the phrase "Moderate Resilience" might best define the environment. Said another way, moderating growth from an elevated level might apply to everything from corporate earnings to nominal GDP to inflation. Embedded within that view is the idea that the cycle is maturing, but money suppy still growing at a well above average level suggests nominal growth might remain resiliently above average into 2022. As can be seen in the chart below, global corporate profit growth is set to moderate this year – though, on a trailing twelve month basis, earnings growth won't fall back in line with the longer term average until the back half of the year. We'd also note that this "Moderate Resilience" theme is being confirmed in many of the leading profit cycle indicators that we track as well.



There are risk factors in 2022 to be sure and we'd highlight our top three to include (1) COVID (2) Fed and Inflation and (3) Midterm Elections. Let's discuss.

First, COVID remains the real wild card of the bunch as new strains have emerged. However, the latest Omicron strain could hasten the transition from pandemic to endemic should it compete away the more virulent Delta strain. If Omicron ends up being more transmissible but less severe – and so far it appears to be – perhaps we can return to relative normality with the benefits of vaccines and boosters.

Second, the Fed and Inflation remain a top concern for the economy and markets. There's not a more regressive tax than inflation as it impacts the lowest wage earners the most. And while we continue to argue that the transitory portion (COVID restrictions and supply chain disruptions) of inflation will likely moderate in 2022, we still think there are structural factors (US deficits, money supply, Fed FAIT policy and de-globalization) in place to support inflation at a higher normalized level than what we've experienced in the more recent past. Historically, when inflation runs at an elevated clip – as noted in the chart below – market multiples tend to come under pressure. This leaves valuations vulnerable especially in the more expensive pockets of the market. With regards to the economy, the Fed's reaction to inflation typically leads to more restrictive policies in order to slow it down, which dampens liquidity and, in turn, demand. Often times, this has the effect of speeding up the end of an economic cycle. Candidly, while we'd acknowledge that the business cycle is maturing (probably faster than is typical), we don't see recession on the horizon for the coming year. However, it is worth noting that at the most recent FOMC meeting in December, the Fed accelerated their tapering of bond purchases that was initiated to counter the COVID crisis. With the Fed's balance sheet more than doubling since then, policymakers recently signaled the likelihood of ending this direct bond buying program by the end of the first quarter. Additionally, the median Fed forecast for rate hikes was pulled forward to incorporate as many as three quarter point increases for 2022 (versus none previously). The bottom line is that the Fed's reponse to inflation will be a risk factor to watch in the coming year as they've started to remove accommodative policies in order to address inflation.



Source: Strategas Research Partners

Finally, midterm elections are set to kickoff this coming year and, if history is any guide, they tend to bring with them more volatility. According to Strategas Research Partners, since 1962 midterm elections have come with an average market drawdown of almost 20% followed by a more than 30% recovery over the ensuing 12 month stretch. Those numbers are much more extreme than the other three years of a presidential cycle. Suffice it to say that policy – both monetary and fiscal – will be in the headlines for the foreseeable future.

With this backdrop in mind, we'd highlight the following takeaways for 2022:

- Market returns are expected to be more moderate on balance with a greater likelihood for more volatility as well.
- Managing the overall exposure and mix of risk assets will be an important consideration and should reflect a moderating business cycle.
- Maintaining pro-inflationary tilts might continue to make sense especially should inflation linger at resiliently higher levels for longer than expected.
- Avoiding valuation vulnerabilities will be critical especially if the disconnect between rates and inflation is unsustainable.

From a portfolio positioning perspective, we think it will be important to strike the right balance between Moderation and Resilience. To us, that means managing the overall exposure and mix of risk assets (i.e. Moderation) while also being cognizant of the continued need for pro-inflationary tilts (i.e. Resilience). Candidly, this has been something we've been proactively doing in client portfolios for the majority of this past year.

Currently, we are modestly OW risk assets after having trimmed this OW several times in 2021 (via Equities and Alternatives) – including early in September – while having maintained diversification with lower volatility securities (via US Core Fixed Income and Diversified Alternatives).

Within equities, our positioning has moved closer to neutral but continues to favor a pro-inflation bias with a modest OW in US Small Caps and a more value sector tilt within our US Large Cap exposure (albeit with a quality bias).

Within fixed income, to mitigate some portfolio risk, we remain UW the most cyclical parts of the bond market (High Yield and Emerging Market Debt) but our US Core managers are OW credit and UW (defensive) treasuries. We also continue to carry a shorter duration bias (less interest rate sensitivity). Our US Core Fixed Income exposure remains an OW supplemented by our UW position in International Fixed Income which remains a hedge against a weaker dollar environment.

Within alternatives, we've more recently taken profits by trimming some of our exposure to real assets but remain overweight as a way to bolster inflationary hedges – thus we're OW to Real Estate and Commodities. Meanwhile, we're also more modestly OW to Diversified Alternatives which provide some hedge against market volatility.