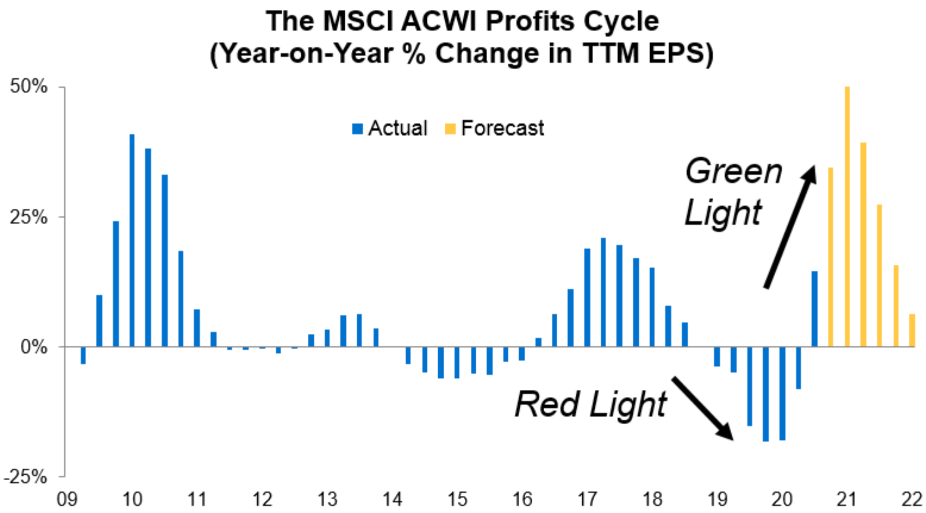
Oxymoron or Omniscient?

"It's tough to make predictions, especially about the future."
– Yogi Berra (1925-2015)

An oxymoron is defined as a phrase that seemingly contradicts itself. It's taken from the Greek word *oxumoros* meaning "pointedly foolish". There is, perhaps, no greater author of the oxymoron than former Yankees catcher and coach Yogi Berra, whose playing days spanned from 1946-1963. Yogi was enshrined in the baseball hall of fame in 1972 and won 10 World Series as a player – a record that still stands today. The phrase "one for both thumbs" aptly applies. Yogi's oxymoronic quips were numerous and well known including "when you come to a fork in the road, take it" and "ninety percent of the game is half mental".

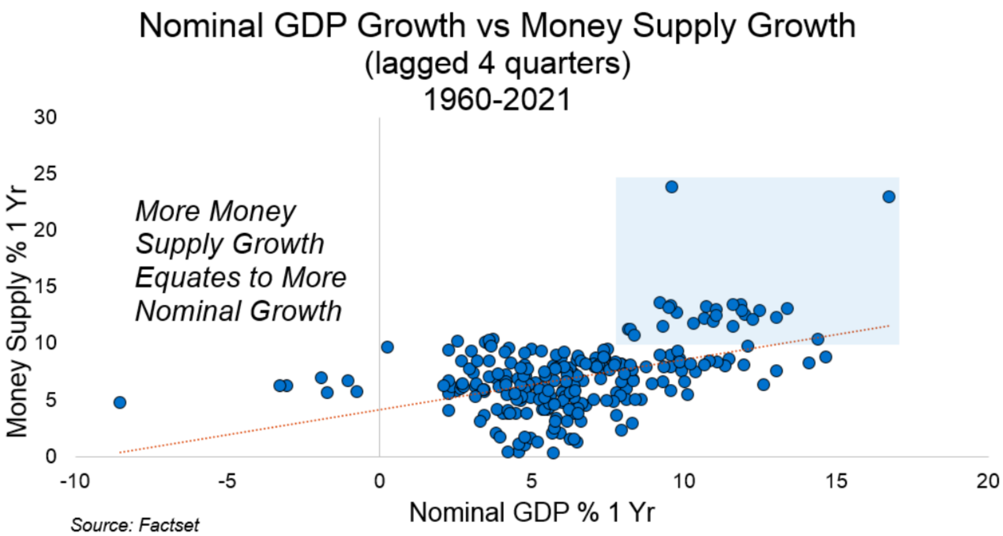
With this year's World Series just wrapped up, we felt it apropos to come up with our own Yogism – ***"Moderately Resilient"*** – as a way to best describe the backdrop that we see unfolding in 2022. At the risk of being called ~~oxy~~moronic, let's explain.

At the end of last year we coined the phrase, "Red Light, Green Light" in describing the business cycle transition from 2020 to 2021. In turn, both economic and corporate profit growth have been nothing short of eye popping for much of this year. Please note the chart below which illustrates the trailing twelve month year over year change in global profits using the MSCI All Country World Index (MSCI ACWI). Earnings growth bottomed at the end of 2020 and, in "Green Light" fashion, are expected to be up almost 50% by this year's end. ***As we turn the page into 2022, forecasts indicate a more moderate earnings growth backdrop.*** Perhaps not unrelated, there's been increasing concerns that the combination of supply shortages and rising prices will lead to margin pressures for companies and demand destruction for consumers. On the heels of such a strong earnings recovery this year, a moderating growth backdrop doesn't seem like a stretch.



Source: Factset based on iShares MSCI ACWI ETF data.

So how can an environment that's Moderating be Resilient as well? We'd suggest there's potential for both next year. Let's take nominal GDP growth – a measure of US economic growth that incorporates both real growth and inflation. ***Historically, the US money supply – an indicator that tracks balances in checking accounts, savings accounts and money market funds – has had a <u>leading</u> influence on US economic growth.*** That's because when there's more money in the system more money can be spent fueling nominal (real plus inflation) growth.



Source: Factset

Looking at the scatter plot at right supports this notion. Money supply growth plotted against nominal GDP growth suggests there's a positive relationship. The higher money supply growth is, the faster nominal GDP growth tends to be one year later. As noted in the table below, when money supply is growing well above its historical average of roughly 7%, nominal GDP growth runs at a notably faster pace as well. Since 1960, there have been 30 quarters when money supply was growing at 10% or more. In 26 of those quarters (or 87% of the time as denoted by the blue shaded region), nominal GDP growth averaged 10% – well above its long-term average of 6% since 1960 and more recent average of 4% over the past decade.

Nominal GDP % 1 Yr vs Money Supply % 1 Yr
(lagged 4 quarters)
1960-Current

	Money Supply % 1 Yr > 10%	Nominal GDP Growth % 1 Yr > 6%
Average	12.7%	10.1%
Instances	30	26

Hit Rate 87%

Source: Factset; Instances tracks the number of times the money supply exceeded 10% and the number of times nominal GDP growth exceeded 6% four quarters later.

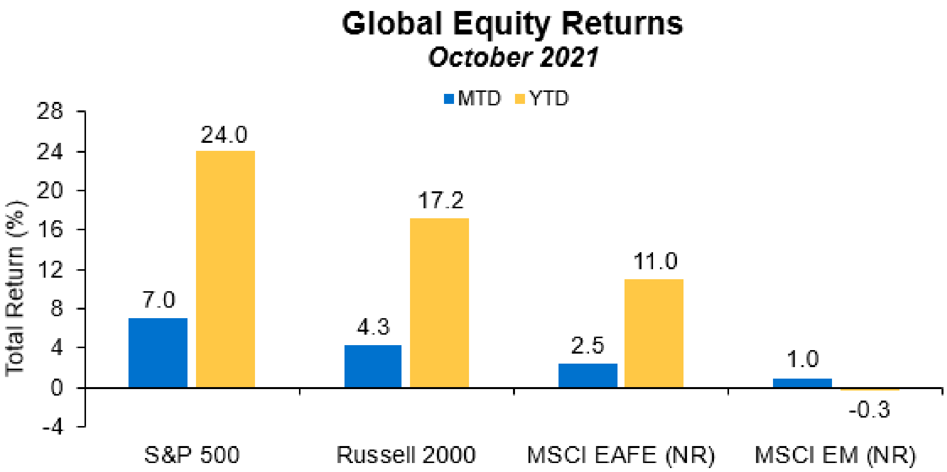
Why does this matter for next year? Consider that the money supply grew at more than 20% in 2020 and, while it's come off the boil, growth has still been running at more than a 10% clip so far this year. ***We think this suggests that while nominal growth is likely to moderate next year it still has a good chance to stay resiliently above the historical average. In other words – 2022 might, in fact, be characterized as Moderately Resilient.***

word on the market

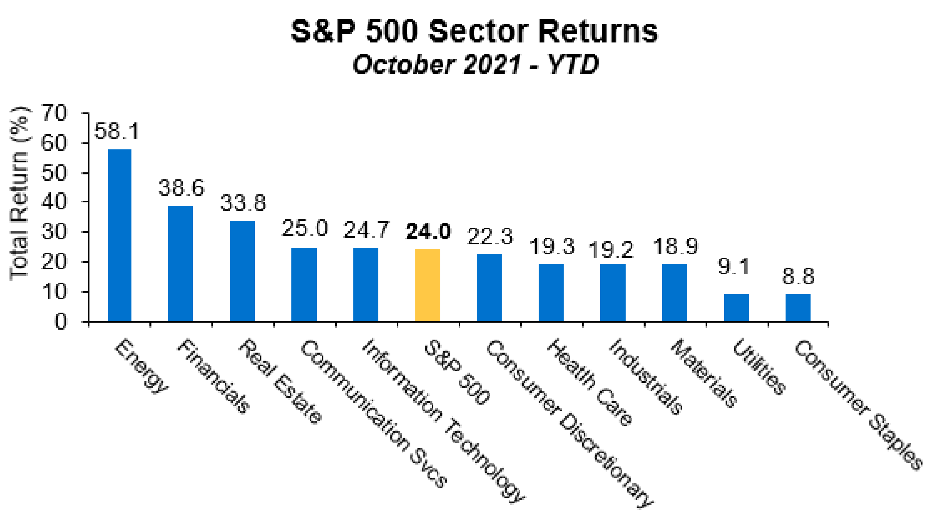
market update
October 2021

Despite the recent volatility in September, this month saw a strong bounce back in returns for risk assets and Stocks especially. Full year returns have indicated a reflationary bias. Real Assets outperformed Stocks and Stocks outperformed Bonds. Commodities, Real Estate, and Cyclical sectors did the best while interest rate sensitive Bonds suffered the most.

Stocks

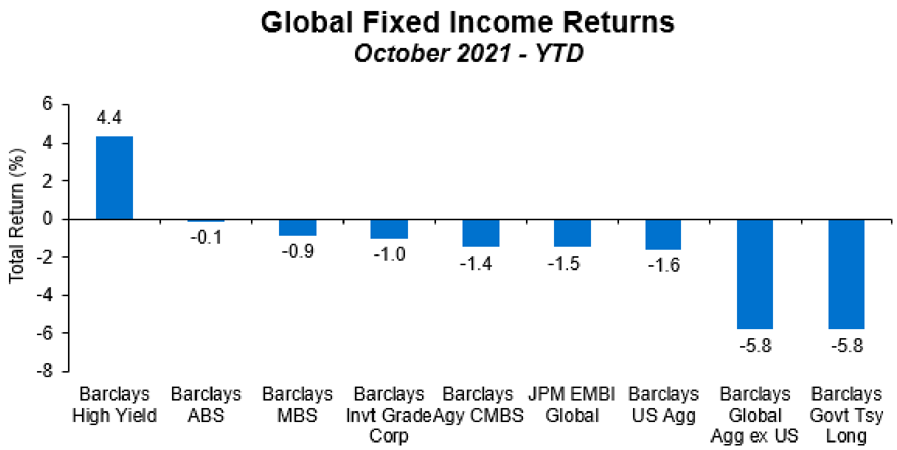


After suffering a selloff in September, global equities recovered sharply in October and added to their mostly strong year-to-date totals. Domestic stocks (S&P 500 and Russell 2000) outperformed international stocks (MSCI EAFE and MSCI EM) – especially the Emerging Market region where a broadening regulatory 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. Year-to-date, all S&P 500 sectors have posted positive returns. Given the "Green Light" environment for corporate profit growth, sectors have reflected an investor preference for Cyclical exposure with significant outperformance in Energy and Financials (Cyclical Value) as well as Communication Services and Technology (Cyclical Growth). Conversely, more traditional Defensives (Health Care, Utilities, Staples) have lagged.

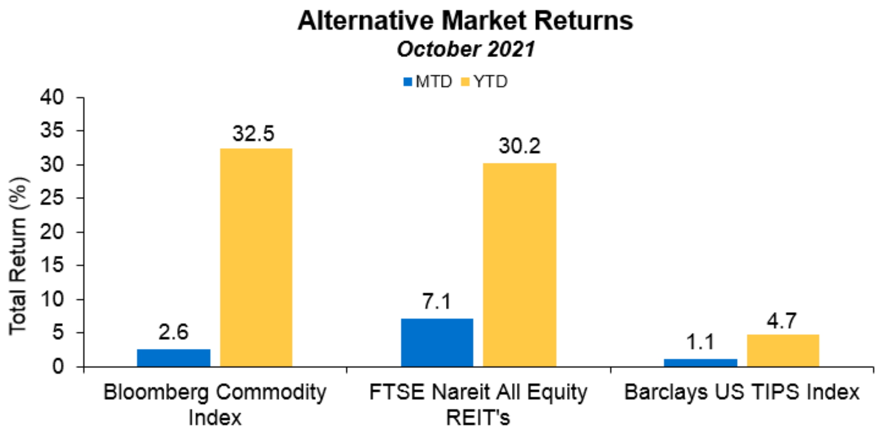


Bonds

Bond returns were mostly negative year-to-date amid an upward rate bias. Long-term interest rates began trending higher last August with the pace picking up in the first quarter only to give back in the second quarter before moving up again over the past couple months. While shorter term rates stayed mostly anchored by a Fed on hold, they began to move up more notably in October pricing in more aggressive Fed action in the second half of next year. Year-to-date, the more interest rate sensitive areas of the bond market saw their returns pressured the most – including long-duration Treasuries (Govt Tsy Long). A stronger dollar also pressured International Fixed Income (Global Agg ex US) for the balance of the year. 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, CMBS).



Alternatives

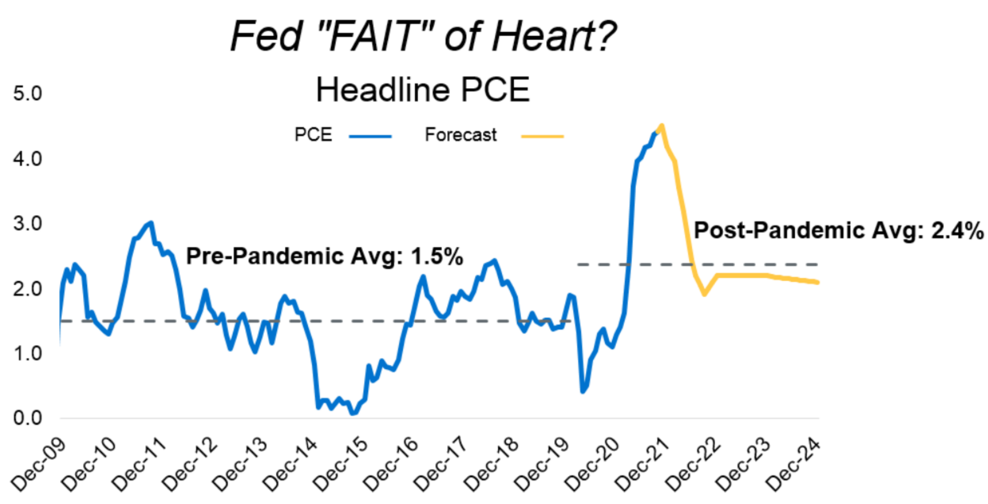


Alternatives posted mostly strong returns for the year and the month. Treasury inflation protected securities (TIPS) were held back by the rise in long-term interest rates though outperformed nominal Treasuries given increased inflation expectations. Both publicly traded real estate (REIT's) and Commodities generated among the best results for the year. The former has been viewed as an attractive reopening opportunity though with some defensive yield characteristics. The latter has benefited from rising Energy, Industrial Metals and Agriculture prices.

Market Outlook

As we turn the page into next year, we think Moderate Resilience might best define the environment. As noted previously, the profit cycle is maturing and we expect earnings growth to slow in 2022. At the same time, money suppy growing well above average for much of this year suggests nominal GDP growth might remain resiliently above average into next year.

This moderate resilience might also be a good way to describe the inflation backdrop as well. It seems like we've talked more about inflation over the last ten months than we have over the last ten years. The sequence of economic shutdowns and disjointed restarts led to global supply chain disruptions. Meanwhile, massive stimulus policies fueled record consumer savings and primed the demand pump. The combination of these actions resulted in the textbook inflationary scenario – too many dollars chasing too few goods – most visibly seen in the form of broad based shortages leading to empty store shelves. As a result, the consumer price index is the highest its been since 2008 and the Fed's preferred inflationary index – the PCE – is the highest its been since 1990. The good news is that monthly inflation data is beginning to come off the boil and many of our leading inflation indicators suggest similar trends. ***As such, we think that the transitory portion of inflation likely moderates from here. However, structural changes to the backdrop might suggest that it normalizes back to levels that stay resiliently above the pre-pandemic average over the past decade.*** Earlier this year, we noted many of these structrual factors with our theme, "Everything Changes if Everything Changes". A federal budget deficit today that only rivals that of World War II, along with de-globalization trends, and the Fed's FAIT (Flexible Average Inflation Target) policy are all structural changes we would cite that might support inflation's resilience. In addition, the US money supply is 30% higher than where it was pre-pandemic and its still growing at almost twice the historical average. Another byproduct of the above is wage



Source: Factset; PCE forecasts are produced by the Federal Reserve as of September 2021 and are smoothed evenly over time.

inflation currently growing at almost three standard deviations above the the forty year average. ***In short, inflation might show Moderate Resilience as well.*** We think the chart above is a good way to illustrate how this dynamic might play out.

Of course a big area of debate for investors is how quickly and to what level does inflation normalize and what's the Fed's response. It's worth noting that the forecasts in the chart above are that of the Federal Reserve. If inflation doesn't cool off as quickly as they anticipate that will dictate more aggressive action. Thus far, the Fed looks likely to start tapering – or begin reducing their monthly bond purchases – in the next month or two. This would get them out of actively buying Treasuries and Mortgages by the middle of next year. While policymakers have been adament that tapering is not tightening, the rates market is already forecasting more aggressive Fed action by pricing in 2-3 hikes as early as the second half of next year.

The bottom line is that we think risk assets next year might feel the tug of war between both Moderation and Resilience. Consider the table at right which highlights the eight other historical episodes when earnings growth peaked since 1990. The median and average forward 12 month return for the S&P 500 was in the mid single digits but returns were positive in seven of the eight instances for a hit rate of almost 90%. ***This suggests risk asset returns will be decidedly lower than what we've seen last year and this year – but still positive.*** Of course the inflation dynamic and Fed response will also be influencing factors as cited above.

S&P 500 Peak Earnings Growth and Forward Return 1990-Current

Date	Operating EPS Growth	Next 12 Month Return
4Q21*	65%*	?
3Q18	27%	4%
2Q14	13%	7%
3Q10	99%	1%
2Q04	27%	6%
1Q00	20%	-22%
3Q97	11%	9%
3Q95	22%	20%
4Q93	29%	1%
Median	**24%**	**5%**
Average	**31%**	**4%**

Positive Return Hit Rate 88%

*Source: S&P Dow Jones Indices; Factset. *4Q21 represents the forecasted peak for this cycle. Average, Median and Hit Rate calculations exclude 4Q21.*

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 year.

Currently, we are modestly OW risk assets after having trimmed this OW several times this year (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 OW's continue to favor a pro-reflation bias. Previously, we've increased our exposure to a modest OW in International Markets. We're also OW US Small Cap exposure and have more of a cyclical value sector tilt within our (UW) US Large Cap exposure (though have shifted some of that value tilt toward higher quality companies).

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 beneficiary of a weaker dollar environment.

Within alternatives, we've 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 are also OW to Diversified Alternatives which provide some hedge against market volatility.