2021 REVIEW

Markets closed the year with solid returns across much of the developed world equity markets. Fixed income and credit returns were rather subdued and, in some cases, negative. During 2021, the global equity markets confounded the naysayers who focused on the pandemic, high historic valuations, and a very uncertain outlook due to economic contraction and lockdowns.

From our Q4 2020 Report
A cocktail of improving economic conditions, a historically high consumer savings rate, pent up demand, extremely low interest rates and significantly more fiscal stimulus are conditions for markets to price in a better, if not excellent, outcome in 2021.

This outcome was indeed one for the books. Seventy daily all-time highs were recorded in the US market in the year, only surpassed once since the 1950's, and that was in 1995.

Canada performed well as did the European and some Asian markets. Developed markets were strong overall, led by the US, France, Germany, and the UK. Emerging markets, led by China and Brazil were poor performers for the year.

Global sector performance was led by the Energy sector as well as Financials, Real Estate and Technology. A proxy for the global equity markets, the All Country World ETF was up 15.8% in the year. As the pandemic wore on and became endemic, much of the world began reopening. There were times in the summer of 2021 when it appeared things would get back to normal. Alas, a seasonal respiratory virus had other ideas and as we entered the early winter, new variants and paralysed politicians and health policy advisors drew again on fear and lockdowns. Many challenges remain and new variants are possible, but the trajectory of the virus appears to be exceptionally virulent, but considerably less dangerous to the vast majority of people.

The story of the markets in 2021 was positive and one of immense corporate profit generation. Lockdowns and a concerned consumer kept the economy on the edge but the pace at which corporations altered spending plans and specifically operating expenses resulted in a record year for profits. Corporate profits end the year far higher than any market participants expected at the start of 2021. So, while it appeared that markets would suffer in the midst of a global pandemic, economic malaise and shutdowns across much of the western world, support from monetary and fiscal policy more than offset the downside. All this debt will eventually have to be paid back, but for now the market was immensely supported by liquidity additions and free money to the consumer in the US and elsewhere. This action planted the seeds for some of our current inflation readings but a collapse in 2021 was avoided. The expected pent-up demand and strong consumer spending materialised and, with revenue growth for the US market topping 17% in 2021, big reductions in cost structures allowed for an over 40% increase in profits. This outstanding result propelled global markets higher. More on this in the outlook section.

The year was not without risks, however, and each quarter we highlighted some as well as discussed how we would approach these risks from a portfolio construction perspective. Risks included economic slowdowns due to economies closing, a potential new variant reigniting economic shutdowns, and an inflation level we have not seen for a generation or two and a subsequent rise in interest rates. The inflation subject was discussed at length last year. Indeed, we even wrote a **blog** about it specifically. Higher interest rates were highlighted as a risk to the economy, but we felt that increases in the Fed Funds rate were unlikely in 2021.

Of more relevance to the market was the removal of quantitative easing from the economy. We remain concerned at how large an impact this liquidity drain would have on global markets. This risk has bled into 2022 and is now a firmly stated policy for the Federal Reserve. The $80bn per month of bond buying by the central bank is in the wind down stage to be completed in Q1. This shadow over 2021 has now moved out a year so this is as good a time as any to move onto our outlook for 2022.

MARKET AND ECONOMIC OUTLOOK

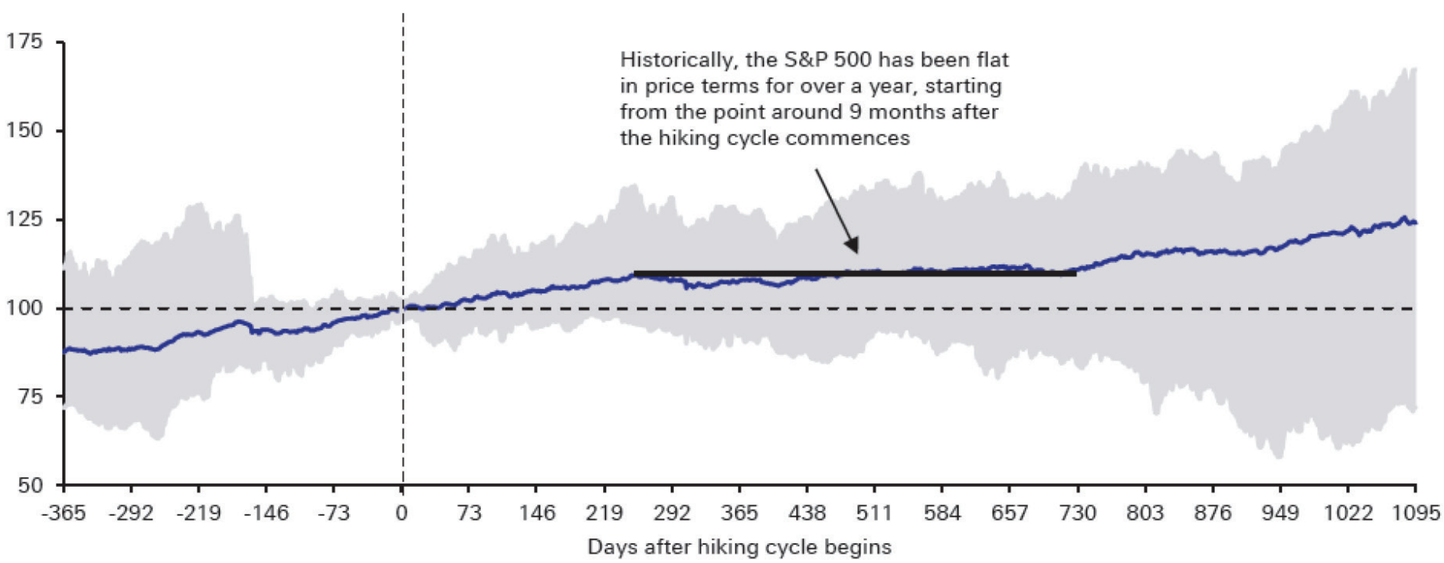
Portfolio construction is like preparing for the weather. You cannot predict every eventuality, but you can be prepared for poor weather and still enjoy your walk. We look in every direction today and see opportunity and risk. There are dark clouds, but we think we have prepared the portfolio in 2021 for the changing winds of 2022. Portfolio construction and selection will be key to success in 2022. Blindly buying the broad market will not be a successful strategy in our view. There are four main topics all investors should consider as we enter 2022. They are inflation and rates, the state of the economic recovery, the corporate profit cycle and, lastly, asset allocation. We will discuss each one in turn and conclude with the outlook and some predictions for 2022.

In this note we will revisit the topic of monetary policy as it is now front of mind as the Federal Reserve moves, as predicted, to a less accommodative stance. It should be stated that after the last Federal Reserve meeting, the market is not only expecting the removal of accommodation but is pricing in the possibility of nearly four interest rate hikes in 2022, beginning as early as March. Indeed, the CEO of JP Morgan, Jamie Dimon, was recently quoted as saying he would be surprised if there were only four rate increases in 2022. If you read our missives carefully last year, you will know that this alteration in policy will have profound effects on the equity markets and, more importantly, where investors are going to get returns. Inflation and interest rate increases in and of themselves are not negative for equities; indeed historically, they have been positive.

As can be seen in the chart below, from the first hike there tends to be solid growth in the first year of the hiking cycle, with an average return of +7.7% after 365 days for the S&P500. The chart looks at 13 hiking cycles since 1955. However, today's environment is rather different as the starting point is one in which real rates have never been more negative. Could the Fed be dangerously behind the curve and forced to act at a pace that is less friendly to the markets?

AVERAGE S&P 500 PERFORMANCE IN FED TIGHTENING CYCLES SINCE 1955 BY DAY

Weakness starts to materialise c.9 months after the first hike and lasts a year or so



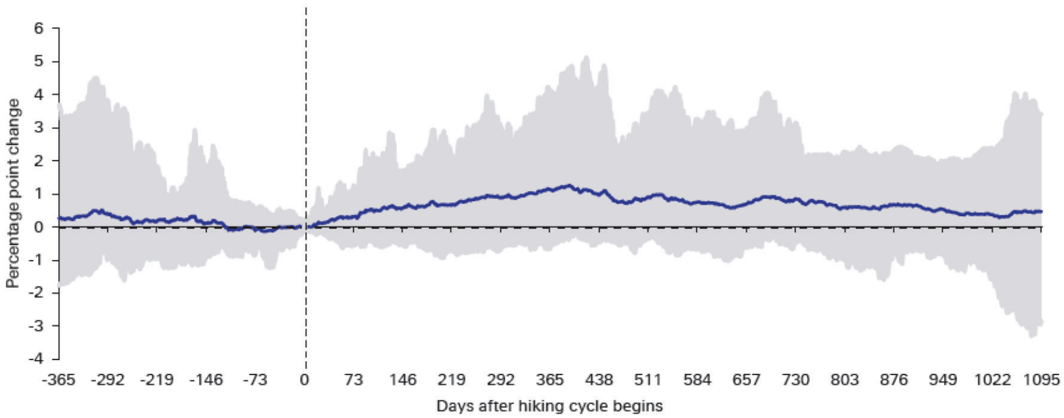
* Source: Deutsche Bank, Bloomberg Finance LP, GFD

** Note: Grey shaded area represents range of outcomes in hiking cycles analysed

Inflation and Rates – We believed last year that the exceedingly high inflation levels were transitory but stated inflation would likely settle at levels higher than we have been accustomed to for some years. This seems to be the case and one of our favourite inflation predictors (and most accurate, see chart below) is looking for 3%+ for all of 2022. This is important because ten-year bond yields in the US, the global proxy, started the year at 1.45%. The 10Year yield will continue to move higher if we have persistent inflation above the 2.0% Federal Reserve through cycle target. The Fed stated they believed inflation can run hot, and it looks like it will. Higher bond yields have a detrimental effect on large swathes of the equity market that have become bond proxies. Much higher interest rates could see markets struggle to make headway as 35+% of the US market will likely be tracking bond prices lower. The second half of 2022 will see inflation lower than year-end levels of 7%, and this will support the broad market but the levels at which interest rates reside in 2022 is likely to determine the shape of returns. As can been seen in the related chart below, post initial rate increases, the 10-year Treasury yield tends to rise. We expect this to be the case in this cycle.

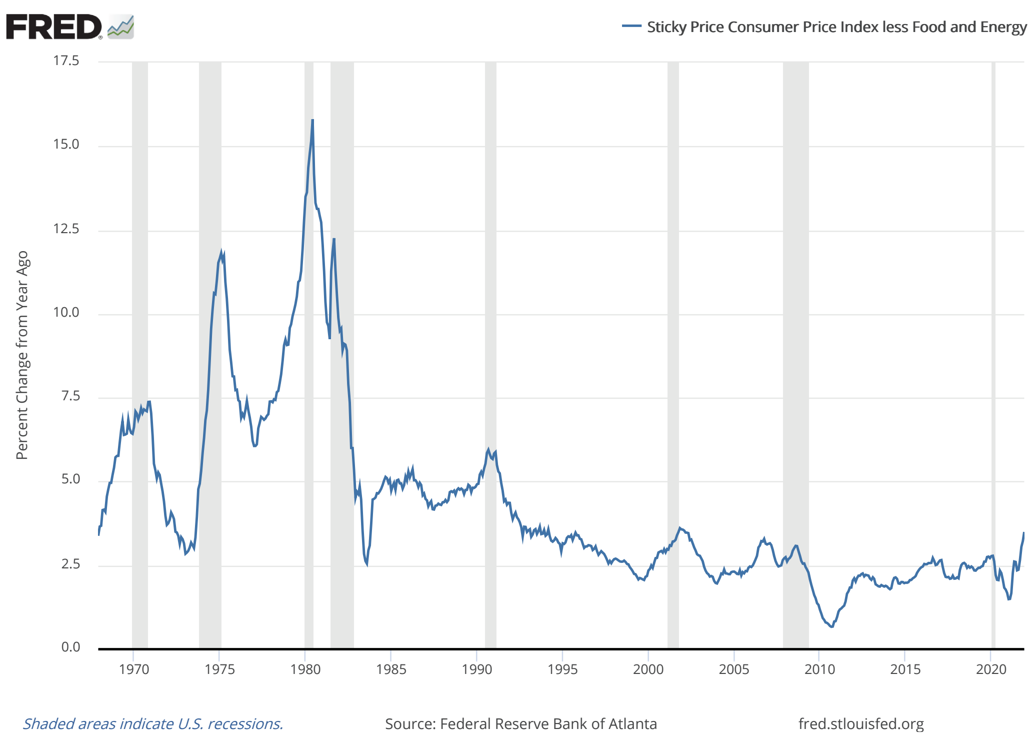
AVERAGE MOVEMENT IN 10 YEAR US TREASURY YIELDS IN FED TIGHTENING CYCLES SINCE 1963 BY DAY
(absolute percentage point change)

Yields fall into the first hike but then rise after until they fall again in the second and third year

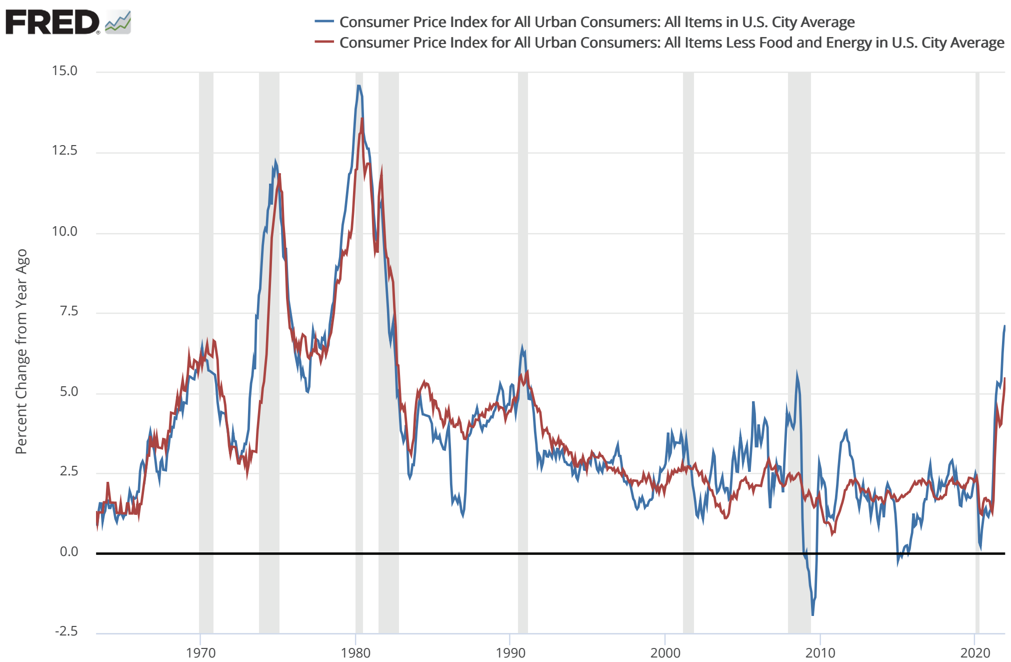


* Source: Deutsche Bank, Bloomberg Finance LP, GFD
** Note: Grey shaded area represents range of outcomes in hiking cycles analysed

Below is a version of CPI that is calculated by using a subset of goods that change price relatively infrequently. This index is a good lead indicator for the subsequent 12 months.



A more severe version of CPI is below and shows all items CPI as well as standard Core CPI Ex Food and Energy. The below chart begins in the 1950's and the shaded areas are recessions.



* All Items BLUE - Core CPI Green

Shaded areas indicate U.S. recessions.

Source: U.S. Bureau of Labor Statistics

fred.stlouisfed.org

Of course, Inflation and interest rates are important to the global equity market. We are of the view that inflation will continue to run hot, or at least settle uncomfortably above the Fed's target. As a result, the Fed will have to act and begin a tightening cycle, and this is most likely to start in Q1 2022. Although the market is pricing in 100bps of hikes into fed fund futures for 2022, we think a near term target could be closer to the rate at which the Fed Funds rate resided prior to the start of the pandemic. The pace at which this level of interest rates will be achieved will be the key to how markets behave. With inflation likely to exceed the Fed's target of 2% for 2022, we think 200bps of increases is almost a certainty in this cycle. The market has priced some of this in over the next two years, but it has not priced in a policy error, as equity markets remain near all-time highs. Again, caution with respect to positioning is in order, as it was last year.

ECONOMIC RECOVERY

The global economy is healing post the pandemic. Some countries and regions are ahead of others, and some may slip in and out of recession as the strains of global supply chains create another hurdle for some economies. On balance we know that the engines of global growth, the US, China, Europe, and Japan, are all in various states of repair. As has been discussed before, the US consumer is in excellent shape. We expect this to continue for the year ahead and have discussed the reasons previously. China is also in a healing state post the shock administered by the pandemic, the Technology Company crack downs and, importantly, the bankruptcy of the country's largest real estate developer.

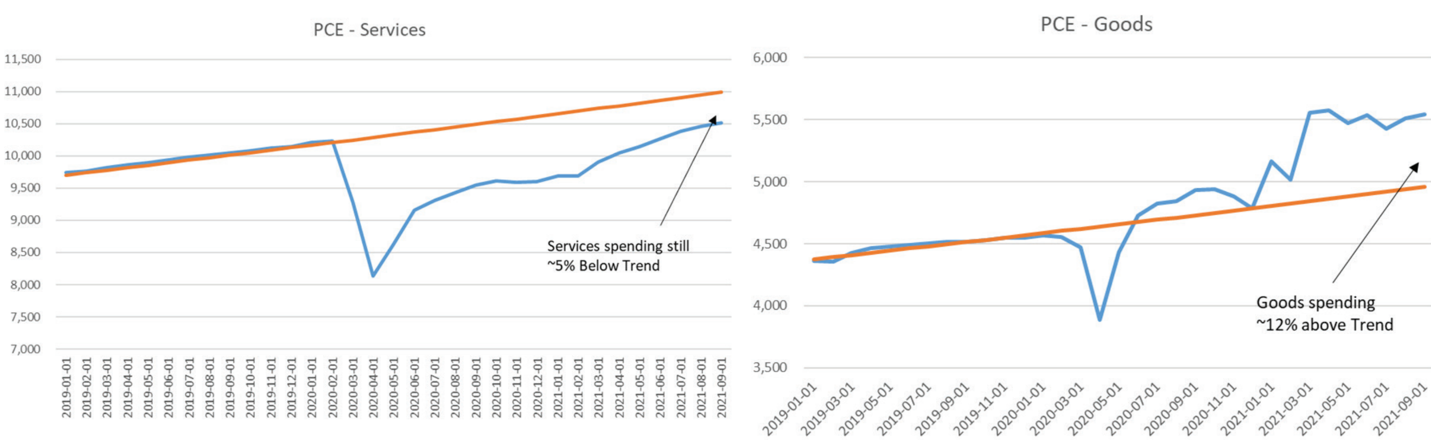
Government support in the shape of lower interest rates will likely encourage investment in the world's second largest economy. Europe and Japan are still some ways behind reaching economic production similar to pre-pandemic levels. This is still to come, and we believe that this catch-up period could lead to significant uptick in economic activity in the 2H of 2022 for these regions. The UK, which looks to be over the worst of the pandemic, appears to be growing strongly out of the malaise and may be a lead indicator for the rest of the continent.

Canada will undoubtedly benefit from improving US consumer trends and of course higher commodity prices as the global economy gets back to pre-pandemic production levels. What worries us about the Canadian economy is that it is significantly more leveraged from a debt perspective than most other nations in the OECD, both at the consumer level as well as the government level. We are near maxing out on our debt levels and, in a world of rising rates, rising inflation, and the likelihood of increased demand for higher taxes to pay for all the debt, Canada's economic prospects may not be as bright as other developed markets. Could we be saved by a very robust global economy? It is certainly possible, but policy error and a hollowed out small business economy could be a drag on our prospects.

As stated, consumer demand in the US has been robust, particularly in the goods department. As the ebb and flow of the pandemic halted society getting fully back to normal, the result has been an extension of the cycle well into 2022 and possibly 2023. Consumer purchases of goods has been exceptionally strong and, as can been seen from the charts below, is well above trend. However, we believe there is plenty more in the tank as consumer spending on services is still well below trend and, as this normalises, the economy should benefit.

PERSONAL CONSUMPTION BACK AT TREND

But At Some Point, Services Could Recover, Pressuring Goods



* How fast, if ever, will spending on services revert to the trend line?
** Source: FactSet, Raymond James research

In the positive column for US economic recovery, we still have consumer balance sheets at north of $2trn of excess savings accumulated during the shutdowns. We have a very robust labour market supporting wages for low-income workers. We have plenty of room to add to the overall workforce and corporate spending, as highlighted below, has been well below trend. These supports, along with the huge fiscal and monetary support that have already been delivered should see the US and global economy continue to recover to pre-pandemic levels in the year ahead. The optimism we have about the economic outcome in the year ahead is somewhat tempered by the challenges the stock market faces. It could be that Main Street and Wall Street walk different paths in 2022.

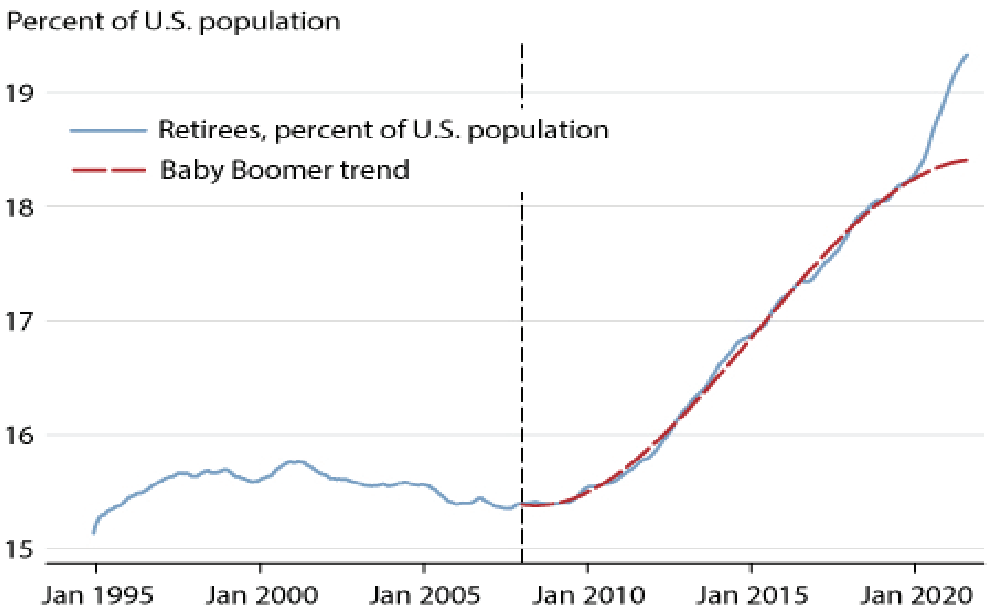
On balance, we expect the economic recovery to continue around the world as we continue to normalise post pandemic. Consumers' balance sheets are healthy, the labour market is improving, wages are rising, and stimulus is still working its way through the economy. This should support corporate profits, a subject we move onto below.

One aspect of the recovery that is worth noting is the tightness in the labour market. Historically, this has been an inflationary tale. Today, we have a number of very interesting trends that have yet to fully work themselves out and therefore bear monitoring. Firstly, what impact did the pandemic have on the labour market? Well, on balance, the pandemic had an enormous impact on the labour market, the implications of which may be considerable.

Firstly, it is estimated that an excess of 3m retirees left the workforce above what was expected. This is near 2% of the workforce.

COVID CREATED ~2.4 MILLION EARLY RETIREES ABOVE TREND, >3 MILLION TOTAL SINCE PANDEMIC, ~2% OF THE WORKFORCE

Percentage of Retirees in the U.S. Population and the Baby Boomer Retirement Trend



From Miguel Faria e Castro, St. Louis Federal Reserve:

- Number of early retirees has jumped by ~2.4 million above trend during COVID
- This has decreased the number of potential workers in the workforce
- And has apparently aided in shifting the Fed's view of where we are in the labor market, helping create a "Powell pivot" in late November.
- This has implications for inflation, rates, growth potential, and myriad other economic variables

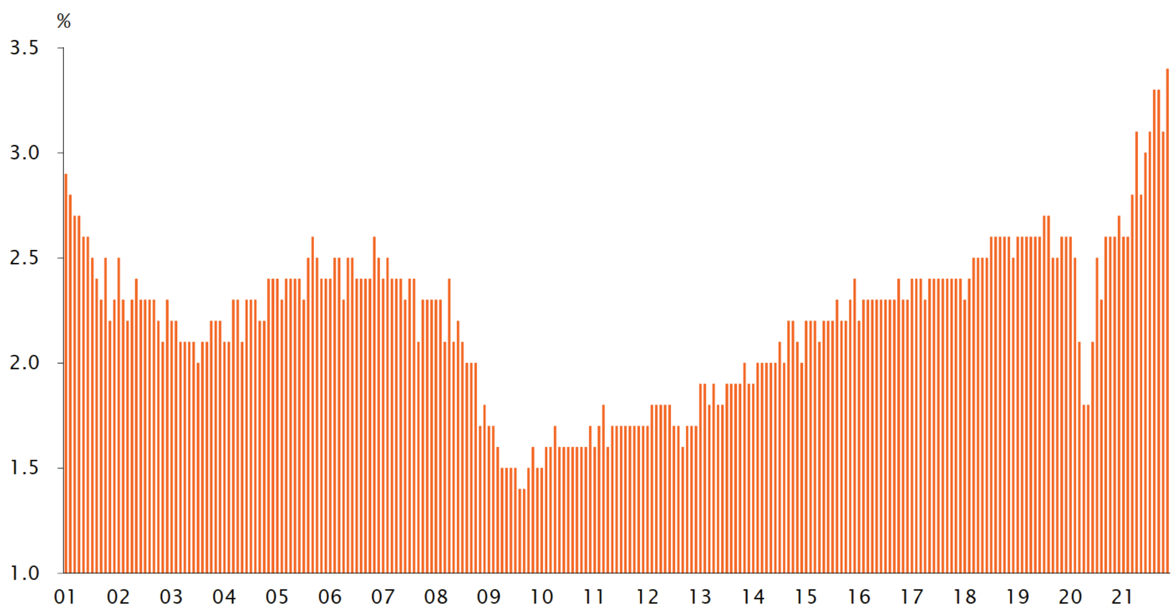
* Note: The percentage of retirees is a 12-month moving average, and the Bay Boomer trend is a cubic trend estimated between January 2008 and February 2020.

** Source: Current Population Survey and author's calculations

Second, workers are quitting in record numbers. This could obviously be cyclical and the result of much higher wages elsewhere, or a significant increase in new business creation could be driving some of this. But clearly, whatever it is, corporates will have to do more with less and wage growth will likely continue and keep inflation percolating above trend.

THE U.S. PRIVATE SECTOR QUIT RATE

2001 Through November 2021



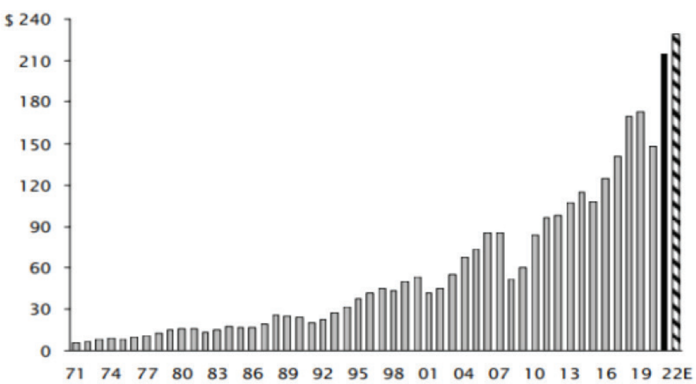
* Source: Bureau of Labor Statistics

CORPORATE PROFIT CYCLE

Profits this cycle have been astoundingly resilient. At the beginning of 2021, market expectation for S&P 500 earnings came in around $174.00 per share. As we approach earnings season for Q4, it looks like earnings will come in at $205-210. A significant improvement on original expectations. In fact, earnings growth outpaced share returns this year, resulting in a contraction in the P/E ratio for the year. Profit growth is expected to be double digits again in 2022 but it is early in the year and too difficult to make too many of these predictions. One thing we know is that margins made an all-time high in 2021, reaching an astounding 12% for the broad market.

EXHIBIT 3 – THE S&P 500 EARNINGS PER SHARE

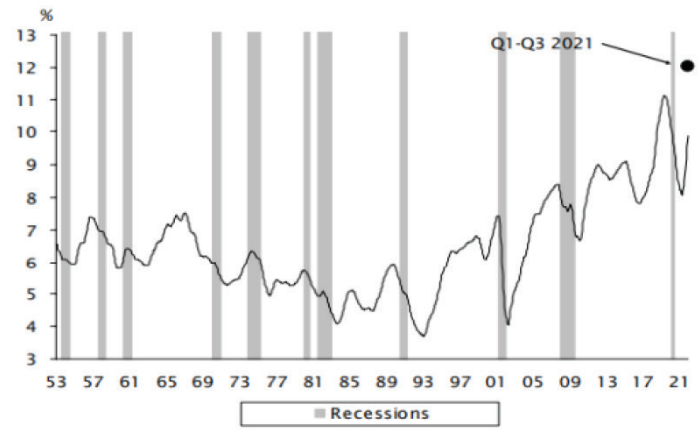
1971 Through 2022E



* Source: Empirical Research Partners Analysis and Estimates

EXHIBIT 4 – THE S&P 500[1] NET PROFIT MARGINS

1953 Through November 2021



* Source: National Bureau of Economic Research, Corporate Reports, Empirical Research Partners Analysis

[1] Excludes financials, REITs and utilities; based on trailing four-quarter aggregate data smoothed on a trailing six-month basis. Prior to 1977, the large-cap stock universe is used

This is unlikely to be repeated as Corp capex, and traditional SG&A spending reverts to normal after very steep cuts during the pandemic shutdowns. A continuation of the economic cycle will support revenue growth and earnings, but we expect more multiple contractions, making stock selection key to returns in the year ahead.

It is our belief that the profit cycle will be supported. We think of the wave of funding both fiscal and monetary over recent years as a still unspent fill-up to this year and possibly next. Strong consumer demand, an improving employment outlook, wage growth for the bottom half of earners and still strong consumer balance sheets, something we have mentioned before. The headwind here is rising costs for fuel, food, rent and general inflation. Wage gains will be a drag on corporate profits but thus far most companies believe these cost increases can be passed on.

One of the most interesting aspects of all this profit growth for corporates is that a new high in corporate profit growth was reached in 2021, surpassing the previous peak in 2019, and this occurred with 3.9M fewer workers in the work force. It's no wonder margins were high in 2021. This is not sustainable, and companies will face rising costs, crimping some of the profit growth from the post pandemic recovery. However, the recovery itself will support further revenue growth so the overall profit level should be well supported. We think EPS for the S&P500 could be in the range of $220-225 for 2022, a level that is supportive of overall market levels.

ALLOCATION

Some may look at equity markets and conclude we have just witnessed a raging bull market. While the headlines say so, the breadth of the market does not. The concentration of market returns in a few companies in 2021 was quite astounding. Only 25 stocks represented over 55% of the S&P 500 total return and the bulk of these companies reside in the highly bond correlated, high P/E (price to earnings) cohort. The concentration of returns in a few very large companies helped propel markets, but underneath the surface, there were signs of change. Indeed, according to Bespoke Investor Services, the average stock in the Russell 3000 Index is 27.2% below its 52-week high. We may be living a broader version of this change today in the first days of 2022, but we prepared your portfolio for this last year. In a diversified multi-asset portfolio, we are not building a portfolio of high concentration. But, rather a portfolio that will weather various storms, changes in sentiment and or deliver strong risk-adjusted returns over the cycle.

We view investing as a marathon and not a sprint. Mid-teen returns in a multi-asset portfolio is an excellent result when considering how poorly fixed income, IG credit and most global government bonds performed. We allocated to non-fixed income and income alternatives in the year to be sure we were delivering the right amount of risk for the right expected returns. This is referred to in the institutional investment business as risk-adjusted returns. Although the 60/40 bond equity portfolio remains popular with traditional investors, we think the return give up in bonds in what appears to be a generational regime change in inflation expectations, is too great a risk to capital to hide in bonds. Bonds will become attractive risk reward investments again, and we will be ready for this but, for the time being, we remain very cautious on bonds. We instead added positions to the portfolio with bond-like qualities, better return profiles, greater income generation and the ability to generate positive returns in an accelerating inflation environment.

We discussed portfolio construction a lot last year, and we will continue this year as the moves we made last year may not have enhanced returns in 2021, but they are already enhancing returns and risk profile early in 2022 as the bond market reprices. We do not try to time these market shifts, we just know from experience that being prepared for change, for new or apparent risks is part of our daily process and DNA as investment managers. The 10-year bond yield has moved 35bps in the first days of 2022. Had we not prepared for this massive change, we would be actively chasing or reacting to the market today. Instead, we are watching your portfolio behave as we hoped it would when this change did indeed arrive.

As a reminder, identifying strong long-term structural themes is a key pillar of our investment process. So too is a fundamental approach that is guided by GARP (Growth at a Reasonable Price) principles. Discounting future free cash flow (FCF) and not overpaying for this future cash flow is the bedrock of this process. We also recognize that opportunities arise in areas that may not be traditional growth sectors. When looking here, the valuation portion of the model takes precedent. We are entering a market environment today in which fundamentals are of the utmost importance. The regime change we have been talking about for well over a year is underway. Liquidity conditions will deteriorate significantly for the market as global central banks try to rein in rampant inflation. Indeed, there are some that are predicting a very challenging time for markets in the years ahead. The biggest question facing investors today is what is the economic sensitivity to higher rates and less liquidity? A move higher for interest rates has already started and the drain of liquidity is nearing completion. As stated in the three previous sections, we expect higher through cycle inflation, and rates. We expect the recovery to continue apace supported by a strong labour market and we expect the profit cycle to continue as the flood of previous stimulus ripples through the economy, lifting nominal GDP. All of this could be undone by an aggressive Federal Reserve.

We do not expect the Fed to be aggressive and expect a measured, slow approach to the inflation fight. Our research, with the help of some of the smartest minds in NY (Empirical Research), tells us that the economy can take higher rates, probably north of 2% on the 10year without too much disruption. However, our focus has been on the one third of the US market that is running in tandem with the bond market, and the risks to this group of approximately 150 companies that trade at a P/E multiple of 33x, or a 50% premium to the market. This is a record spread for growth companies. P/E's expanded in this group 50% since 2020 while real yields collapsed. Of course, as we have warned, this group has immense risk of derating as interest rates rise and liquidity is drained. Hence our focus on fundamentals, or put another way, at what price and with what quantitative and qualitative support do we make our investments?

This environment is not one for fantasy or hope. We need strong underlying cash flow and structural growth. We need supportive intrinsic value or discounted CF models to understand the price we are paying. We need good asymmetry in our investments, and we use history to guide us to realistic valuations relative to the now rapidly changing risk-free rate.

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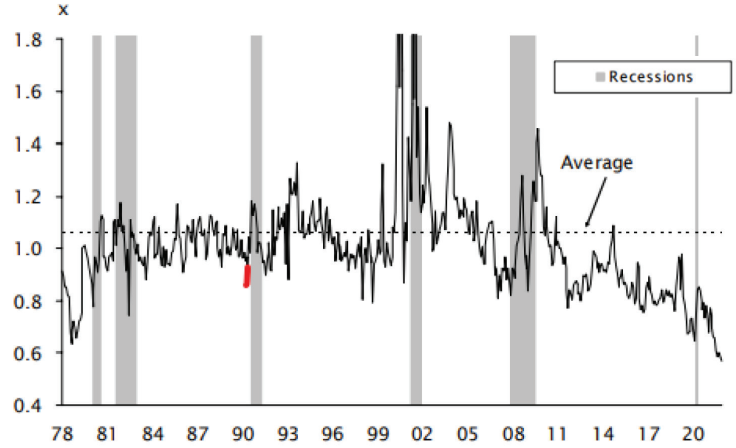
The good news for investors is that two thirds of the market is not inordinately tied to the movement in the bond market. See the Chart below.

EXHIBIT 7 – LARGE-CAPITALIZATION STOCKS

The Quintile with Relative Returns that are most anti-correlated with the performance of the treasury bond market[1]

Relative Forward-P/E Ratios[2] • 1978 Through Early-November 2021



* Source: National Bureau of Economic Research, Empirical Research Partners Analysis

[1] Correlations with the ten-year Treasury bond returns, measured over the trailing 126 days.

[2] Capitalization-weighted data

This cohort has formed the other side of our much-discussed barbell approach to portfolio construction. We also discussed adding high quality or more defensive names to the portfolio late last year. The even better news for patient investors is that this discreet cohort of names that are anti-correlated to the bond market have not been as attractively valued relative to the market in our careers. There are places to invest, and we hunt good companies with strong prospects, strong management teams and excellent balance sheets for our investors. We see the risks on the horizon, but we know not to follow the crowd. We have been actively turning and looking in the other direction for clearer skies and solid footing for our market walk in 2022.

We are happy to discuss any stocks or positions in your portfolio, so please feel free to contact us. We wish our clients health and happiness for the start of 2022. We are resolutely focused on your financial wellbeing and thank you for the confidence and trust you show in the team at Tall Oak Private Wealth.

Sincerely,

Your Tall Oak Private Wealth Team