INFLATION

2022

OUTLOOK

HANLON
INVESTMENT MANAGEMENT

EDUCATION SERIES - ASSET MANAGEMENT

INTRO

2021 was a year marked by hopefulness and transitions. Despite the realization that 2020's COVID-19 pandemic would linger for another year, the world enjoyed renewed optimism thanks to the rollout of COVID-19 vaccines during the first quarter. The US weathered an atypically disorderly transition of presidential power and then navigated the transition from shutdowns and mandates to a semblance of summer normalcy. Meanwhile, the hand of the Federal Reserve ("the Fed") was forced away from stimulus and towards tightening, as inflationary pressures grew too much to ignore.

The long-term impact of the COVID-19 pandemic and the unprecedented government intervention required to keep society functioning continues to unfold. On a long-term chart of stock market prices, the March 2020 crash and "V-shaped" recovery are just a blip, a severe selloff followed by a resoundingly strong bounce to new all-time highs. However, the rapid stock market recovery was fueled by massive Fed bond purchases, Paycheck Protection Program loans, and direct stimulus payments. Now, the cost of all that stimulus is revealing itself in the form of rising inflation, which will necessitate a tighter Fed policy through rising rates.

Elevated inflation is apparent when reviewing asset class performance in 2021, illustrated in the righthand column of the below "Periodic Table" of Investment Returns. "Real assets", such as Real Estate and Commodities (excluding Gold, which cooled off in 2021 after a strong 2020), rose to the top after languishing at the bottom of the table in 2020. For many US investors, their home was likely their best-performing asset, as house prices relentlessly appreciated into speculative "bubble" territory in some regions of the country. Meanwhile, inflation weighed on the bond market, with US Bonds (measured by the Bloomberg Barclay's US Aggregate Bond Index) providing negative annual returns for the first time since 2013.

Figure 1. Periodic Table of Investment Returns 2011-2021

2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Gold 9.63%	Emerging Market Stocks 18.22%	US Small Cap 38.82%	US Real Estate 31.78%	US Real Estate 4.23%	US Small Cap 21.31%	Emerging Market Stocks 37.28%	US Agg Bond 0.01%	US Large Cap 31.49%	Gold 20.95%	US Real Estate 46.18%
US Real Estate 9.24%	US Real Estate 17.59%	US Mid Cap 34.76%	US Large Cap 13.69%	US Large Cap 1.38%	US High Yield Bonds 15.33%	Developed International Stocks 25.03%	Global Agg Bond -1.20%	US Mid Cap 30.54%	US Small Cap 19.96%	US Large Cap 28.71%
US Agg Bond 7.84%	Developed International Stocks 17.32%	US Large Cap 32.39%	US Mid Cap 13.22%	US Agg Bond 0.55%	US Mid Cap 13.80%	US Large Cap 21.83%	US High Yield Bonds -1.51%	US Real Estate 25.76%	US Large Cap 18.40%	Commodities 27.11%
US High Yield Bonds 5.95%	US Mid Cap 17.28%	Developed International Stocks 22.78%	US Agg Bond 5.97%	Developed International Stocks -0.81%	US Large Cap 11.96%	US Mid Cap 18.52%	Gold -2.81%	US Small Cap 25.52%	Emerging Market Stocks 18.31%	US Mid Cap 22.58%
Global Agg Bond 5.64%	US Small Cap 16.35%	US High Yield Bonds 5.93%	US Small Cap 4.89%	US Mid Cap -2.44%	Commodities 11.77%	US Small Cap 14.65%	US Large Cap -4.38%	Developed International Stocks 22.01%	US Mid Cap 17.10%	US Small Cap 14.82%
US Large Cap 2.11%	US Large Cap 16.00%	US Real Estate 1.86%	US High Yield Bonds 2.13%	Global Agg Bond -3.15%	Emerging Market Stocks 11.19%	Gold 12.79%	US Real Estate -4.84%	Emerging Market Stocks 18.42%	Global Agg Bond 9.20%	Developed International Stocks 11.26%
US Mid Cap -1.55%	US High Yield Bonds 14.15%	US Agg Bond -2.02%	Global Agg Bond 0.59%	US Small Cap -4.41%	Gold 7.75%	Global Agg Bond 7.39%	US Mid Cap -9.06%	Gold 18.03%	Developed International Stocks 7.82%	US High Yield Bonds 4.48%
US Small Cap -4.18%	Gold 6.08%	Global Agg Bond -2.60%	Gold -1.75%	US High Yield Bonds -5.03%	US Real Estate 7.24%	US High Yield Bonds 6.34%	US Small Cap -11.01%	US High Yield Bonds 14.65%	US Agg Bond 7.51%	US Agg Bond -1.54%
Developed International Stocks -12.14%	Global Agg Bond 4.32%	Emerging Market Stocks -2.60%	Emerging Market Stocks -2.19%	Gold -10.88%	US Agg Bond 2.65%	US Real Estate 4.18%	Commodities -11.25%	US Agg Bond 8.72%	US High Yield Bonds 4.66%	Emerging Market Stocks -2.54%
Commodities -13.32%	US Agg Bond 4.21%	Commodities -9.52%	Developed International Stocks -4.90%	Emerging Market Stocks -14.92%	Global Agg Bond 2.09%	US Agg Bond 3.54%	Developed International Stocks -13.79%	Commodities 7.69%	Commodities -3.12%	Gold -4.28%
Emerging Market Stocks -18.42%	Commodities -1.06%	Gold -28.65%	Commodities -17.01%	Commodities -24.66%	Developed International Stocks 1.00%	Commodities 1.70%	Emerging Market Stocks -14.57%	Global Agg Bond 6.84%	US Real Estate -7.90%	Global Agg Bond -4.71%

Source: Hanlon Research

As we begin 2022, global leaders are trying to navigate the new COVID-19 omicron variant, which could be a blessing in disguise if it offers higher transmissibility but less-severe infections, as initially suspected. This would strengthen antibodies in the populace while, hopefully, resulting in far fewer severe cases and deaths than the delta variant. Shutdowns are not off the table in 2022, but rather than being mandated by governments, they may just naturally occur due to mass infections causing workers to call out sick en masse. An uptick in flight cancellations and school closures remains notable, but the expectation as the year progresses is for Covid to become less and less of a burden on society, and instead be viewed as another virus amongst the thousands of viruses humans face, albeit the most notable one. In any event, the omicron wave should recede sometime in the first quarter and hopefully we see a respite before the next variant of concern.

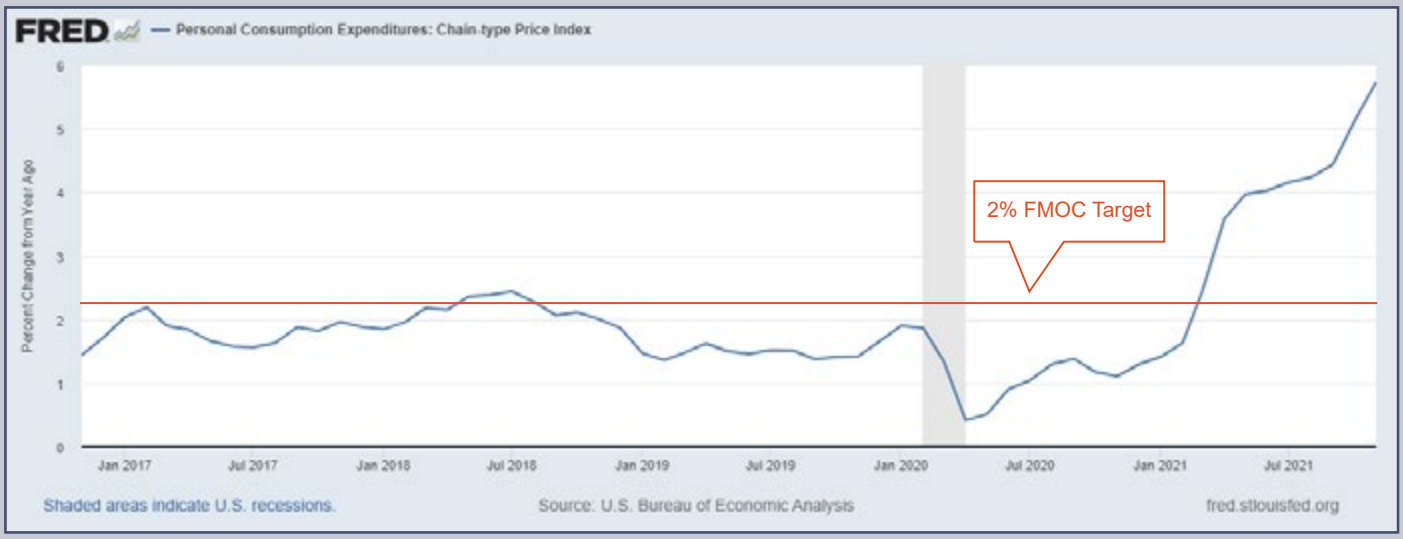
Regardless of how omicron unfolds, our experience during this pandemic has highlighted the need to remain flexible in interpreting new data and changing circumstances. Making long-term asset allocation decisions is less about predicting the future and more about setting a realistic base case that can be adjusted as circumstances change and evolve. With that in mind, we offer our Outlook for Investing in 2022 and beyond.

ECONOMIC BACKDROP

The world economy grew at a real rate of 5.5% in 2021, according to estimates from the World Bank. The atypically high rate of GDP growth was in response to a 2020 contraction of roughly -3.5% due to the COVID-19 pandemic. Growth in 2022 is expected to cool slightly, to 4.5% and will likely slow in the second half of the year as the effects of government stimulus fade. US and Developed Foreign markets should expect GDP growth rates around 4%. Emerging Markets such as China will likely see slightly higher growth at around 5-5.5%, although this is far below the double-digit growth Emerging Markets enjoyed several years ago.

The stimulative policies that guided the world economy through the depths of the COVID-19 pandemic had the unintended consequence of elevated inflation. Mandated shutdowns and travel restrictions reduced demand for goods and services, prompting manufacturers to slow down production. At the same time, governments provided increased aid to consumers which resulted in increased savings. When the economy reopened in 2021, the resultant buying spree put enormous pressure on supply chains as inventory could not meet the demand. In the US, the net effect has been inflation above the Federal Reserve's 2% target for ten months and counting.

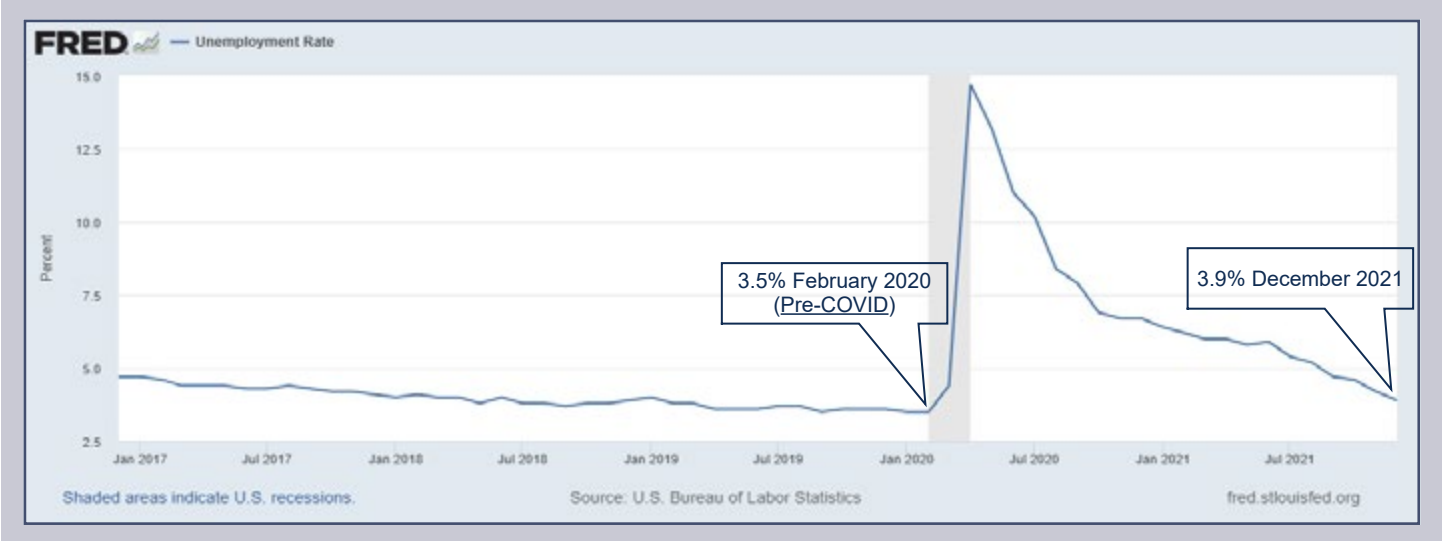
Figure 2. Personal Consumption Expenditures Index



Source: St. Louis Federal Reserve

The Fed initially characterized this inflation as "transitory", and predicted the supply chain bottlenecks would quickly resolve. Unfortunately, inflation has proven stickier than initially expected, prompting the Fed to drop the "transitory" label and take counter measures rather than simply wait for the inflationary pressures to ease. The Fed has some runway to do so since the other half of its "dual mandate", maximum employment, has been attained as the jobless rate is below 4%, near pre-COVID levels.

Figure 3. US Unemployment Rate



Source: St. Louis Federal Reserve

The Fed is looking to combat inflation using two of its policy tools, namely open market operations (buying and selling US government securities) and federal funds rates. Currently, the Fed is buying $60 billion in bonds each month, down from $120 billion per month prior to November 2021. The monthly reductions will continue until the Fed is no longer buying any bonds in the open market, which should be by March 31, 2022. The Fed's exit from the open market should put upward pressure on interest rates. A series of Fed interest rate hikes to the federal funds rate is expected as well. Projections from the Fed suggest we see three rate hikes; however we believe it is likely the Fed will be more aggressive and execute either a fourth rate hike, or execute a "double hike", bumping the benchmark rate up by 50 basis points rather than the typical 25 basis points. While a 50-basis point hike may seem unusual, recall that the rate cuts implemented at the beginning of the pandemic on March 3 and March 16, 2020 were 50 and 100 basis points, respectively.

Hopefully, the Fed has been transparent enough as to not rattle the markets when the rate hikes do occur. Market psychology can be fragile and if the Fed is in fact more aggressive than its own projections suggest, the markets could interpret the move in two very different ways. On one hand, a more aggressive shift could signal inflation is running away from the Fed and trigger a selloff. The alternate response would be confidence that the Fed is being proactive and is on top of inflation. The Fed's communication and choice of language will likely be the determining factor of how the markets respond to any unanticipated rate moves, but ultimately, we believe the resulting volatility will be manageable. Rampant inflation can have a deleterious effect on financial assets and therefore an alternate view about rate hikes and fed tightening, if applied prudently, is that markets applaud the moves.

US EQUITY

US Equities had a strong 2021, particularly US Large Caps, which returned over 28% during the year. Large Caps outperformed Mid Caps by roughly 6% and Small Caps by nearly 14%, while also outperforming International Developed and Emerging Market equities. The fact that US Large Caps are starting 2022 near all-time highs after what appears to be a smooth and steady ascent in 2021 would typically warrant caution and calls for a pullback. However, the easy gains of 2021 are not what they appear to be, if one examines the underlying price action within the broad market indices.

Over the course of the S&P 500's 2021 gain of 28.7%, the largest pullback (Maximum Drawdown, or "MDD") for the index was a -5.1% retreat during the month of September. Yet analysis of the underlying 500+ stocks in the index reveals an average MDD of -19.5%. 110 stocks in the index, roughly 1/5 of the names, had a MDD over -25%. This exercise highlights two important points. The first is that diversification remains vital, as the drawdowns experienced were uncorrelated in their timing; various stocks sold off at different moments during the year because of economic sectors falling in and out of favor, or due to company-specific factors. The second point is that the biggest Mega-Caps are firmly in the driver's seat when it comes to overall index performance. The 10 largest companies in the S&P 500 index account for roughly 30% of the index market capitalization. The average return on these stocks was over 42%, with an average MDD of -16%. The strongest performance during the year was clearly found in the biggest of the big names, especially big tech.

The realization that we did already have sizeable pullbacks in most equities during 2021 gives us a degree of confidence to remain heavily allocated to US equities heading into 2022. While much of the "easy money" gains from the re-opening rebound have already been made, earnings should continue to be strong in most sectors. Consumer Discretionary stocks will likely face challenges as the consumer spending spree fades and rising Consumer Staple costs cut into discretionary purchases. Energy, Financials, and REITs, which have underperformed in recent years, stand out as opportunities in the new inflationary, rising rate environment.

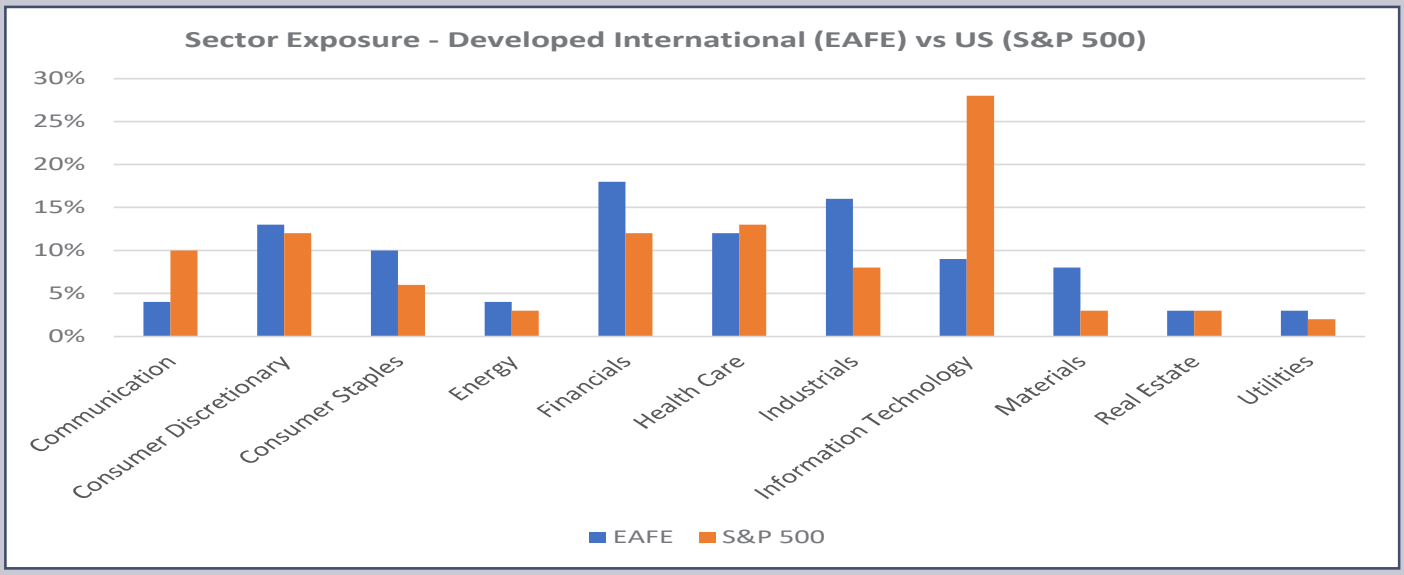
As always, the stock market will reflect future earnings, and there are some risks that could derail US equities impressive streak of earnings growth. Supply chain disruptions are the most obvious threat and have been cited on many early 2022 earnings calls already. As consumer goods have become more technologically complex, the supply chain complexities have increased as well. Take, for instance, the impact of 2021's semiconductor shortages on the automotive industry, in which several automakers had to halt production while waiting for basic chips responsible for functions like rain sensors and door locks.

Corporate profitability was strong in 2021, with S&P 500 operating margins near a record 13% as corporations were able to pass higher input costs on to consumers by raising prices. Even if supply chain issues resolve and inflation steadies and ultimately recedes, corporations will have to grapple with the cost of higher wages. Wages grew at 4.5% year-over-year in December, the highest rate in nearly 20 years. While wage growth is still trailing inflation, we will likely see inflation pull back from the current levels in 2022 but the gains made in wages should be stickier, leaving corporations with the challenge of finding a way to maintain profit margins while still retaining their employees.

DEVELOPED INTERNATIONAL EQUITY

Developed Market (DM) International stocks initially followed a similar path of recovery off the COVID -19 lows of March 2020 but stalled out last summer and were effectively flat for the second half of the year. This has much to do with their value-tilted composition, compared to the growth and tech dominance in the US. Looking at the relative sector exposure, we can see that DM stocks (represented by the MSCI EAFE Index) have broader sector diversification with no single sector occupying more than a 20% weighting, as opposed to the domestic S&P 500's tech-heavy composition.

Figure 4. Sector exposure in Developed International vs Domestic Stocks



Source: Hanlon Research

This diversification has been, to date, to the detriment of international stocks with Technology massively outperforming for much of the decade. This has led to an unusually long 14-year streak of US outperformance. However, if we are in fact on the cusp of an aggressive shift in Central Bank policy with rising interest rates, DM stocks are positioned very well with their heaviest weighting in Financials, and their overweight exposure to cyclicals such as Industrials.

We have advocated for holding DM stocks in long term strategic asset allocation models for some time, due to diversification reasons as well as their attractive valuations. The S&P 500 is currently trading around 21.7x forward earnings, with Consumer Discretionary and Technology sectors around 30x multiples. DM stocks, for comparison, are priced at just 15.5x forward earnings. With growth in Developed Markets expected to match or exceed that of the US in 2022, it seems prudent to continue to increase DM equity exposure, or at least rebalance portfolios to make sure DM is well-represented.

Risks for DM stocks include inflation getting away from the European Central Bank (ECB) which, unlike its US counterpart, is not signaling rate hikes until 2023. Eurozone inflation hit a record-high 5% in December but may not run as rampant as in the US due to lower excess savings accumulated during the pandemic, resulting in less of a consumption spree relative to the US. However, overall inflation risk to DM stocks is partially mitigated by Japan, the largest single country in the DM market at a 23% weighting. Japanese inflation is just 0.6% and projected at 0.5% in 2022, allowing the Bank of Japan (BOJ) to remain stimulative in its policy decisions. Politics are always a risk as well in the tenuous Eurozone alliance and while the Brexit debacle is finally in the rear-view mirror, France will have elections in April amidst rising populist sentiments. Nevertheless, we believe DM stocks need to be well represented heading into 2022 in strategic portfolios.

EMERGING MARKET EQUITY

When we discuss Emerging Market (EM) equities, we need to acknowledge that China has the most influence regarding EM performance, with Chinese stocks representing roughly 32% of the MSCI Emerging Markets index. China also indirectly influences many other EM nations, in its role as a buyer of raw materials and as an exporter of goods. While the bellicose relations between the US and China have faded with the US presidential regime change, the tariffs imposed by former President Trump remain largely in place. The much-touted “Phase One” trade deal has predictably disappointed, with China failing to deliver on US goods imports, purchasing just 62% of the amount dictated by the agreement. As a result, the annual US trade deficit to China has risen to an all-time high of $397 billion.

While China is still clearly producing and exporting goods, the government’s desire to shift from a manufacturing nation into a consumer-driven economy has been slow to materialize. China’s GDP growth rate has trended down from the double-digits in the early to mid-2000s. While GDP growth for 2021 was a respectable 8.0% as the economy was ahead of the curve on COVID reopening, growth in 2022 is forecast to recede to 5.1% per World Bank estimates.

For several years now, EM markets looked attractive based on their very low valuations combined with high growth. EM stocks are certainly cheap, trading at just 12.4x forward earnings, but the growth potential is no longer a sure thing, largely due to government policies from China. The narrative several years ago was that the vast untapped mainland Chinese stock market, accessible only to Chinese citizens, would be opening to foreign investment. In 2021, however, Chinese firms lost more than $1 trillion in market value as capital flowed out of China in response to draconian governmental crackdowns under various justifications such as anti-trust and data security. These measures have devastated some of the most promising Chinese Tech sector firms and installed distrust from foreign investors, many of whom have publicly labeled the Chinese economy as “un-investable.” In addition, the government has intervened in the runaway property market, which is showing signs of a systemic collapse after several large property developers have defaulted on their debt.

With such a high degree of uncertainty and an unpredictable government firmly in control, it is difficult to confidently forecast near-term outperformance for EM stocks. Long-term investors should still maintain some exposure as a diversifier, in accordance with their risk tolerance, but advocating for any kind of overweight to EM in 2022 is only recommended for the most contrarian investors, as similar returns can likely be found with lesser risk in US and DM equity markets.

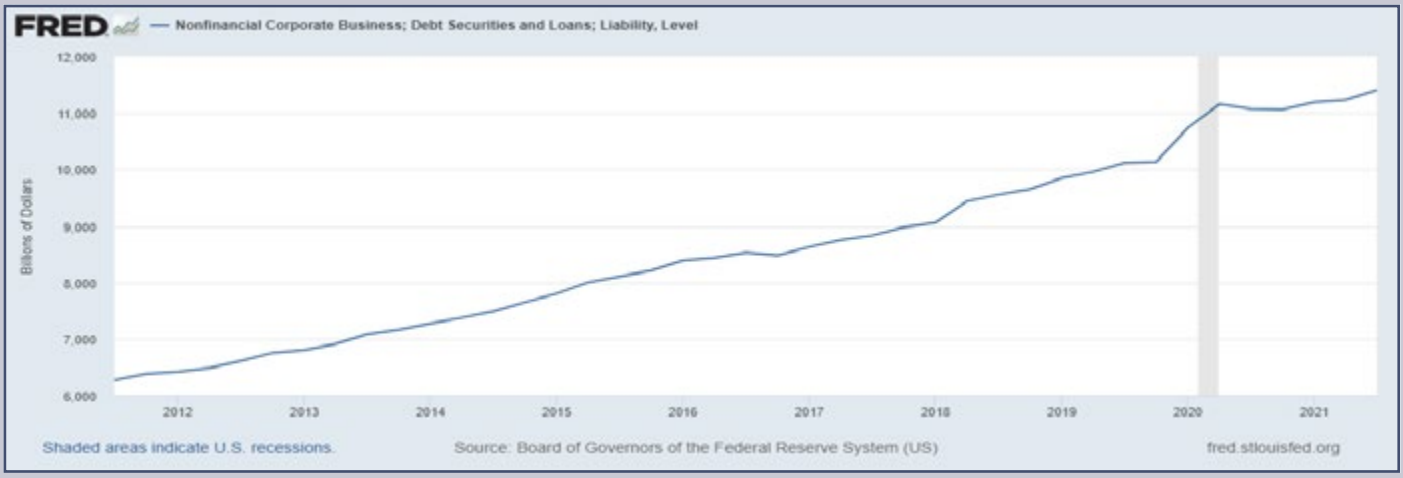
FIXED INCOME

The near-term outlook for fixed income will remain challenging in 2022 as the Fed ends its easy money policies. The 10-year Treasury yield, which remained stubbornly fixed to the 1.5% level for much of 2021, has taken a leg up to around 1.75% and will almost certainly reach 2.0% or higher during the year. Even if the Fed is more aggressive than anticipated however, yields are likely to top out in the mid 2% range as there will always be demand for US government debt, particularly with the yield spread vs foreign government bonds widening as the Fed tightens and the ECB and BOJ hold off. On the long end of the yield curve (20-years plus), the amount of rate steepening we experience will reflect both future growth and inflation expectations. If inflation readings post-rate hikes remain high, rates on the long end of the curve will likely spike higher in response.

With Treasury yields unlikely to keep pace with inflation in 2022, many investors will likely turn to credit markets as a po-

tentially higher-yielding opportunity. US firms enjoyed a windfall of easy money during the depths of the COVID pandemic, when the Federal Reserve stepped beyond its legal capacity and utilized a creative loophole with the US Treasury to purchase corporate bonds, including sub-investment grade, high yield debt. With this Fed backstop in place, corporations were able to seize on extremely attractive financing terms and in response, borrowing a record amount in 2020 and 2021.

Figure 5. Corporate Borrowing

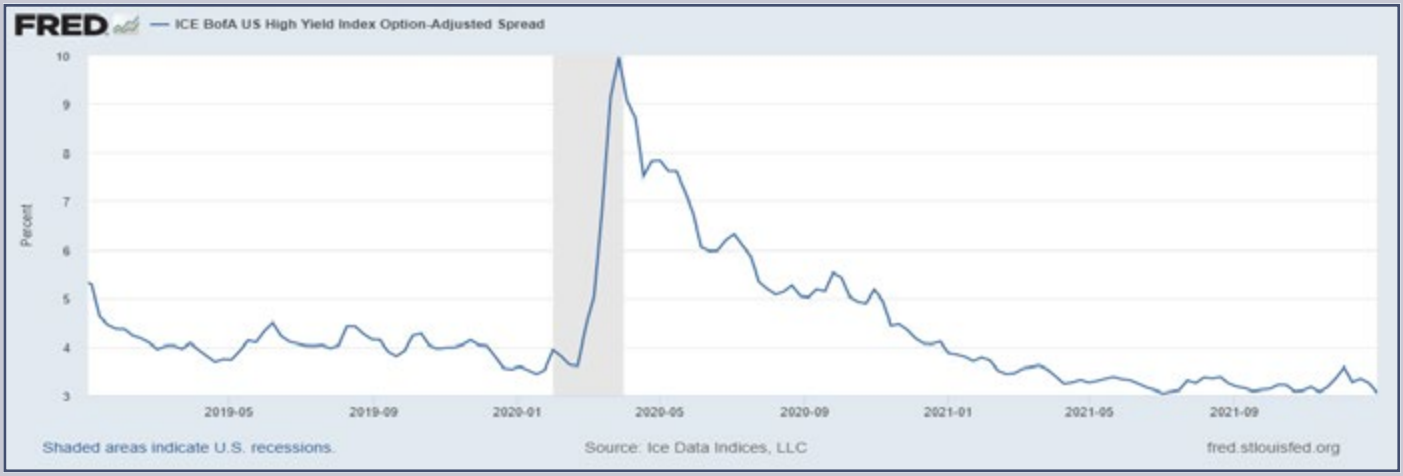


Source: St. Louis Federal Reserve

So far, this powder keg of debt has yet to show any signs of blowing up. Potential corporate bond defaults that caused panic during the initial pandemic shutdowns of 2020 have never materialized. The US high yield default rate, reflecting speculatively rated debt, was just 0.5% for the year, a record low according to Fitch Ratings. While this default rate will likely increase in 2022, forecasts suggest it will top out around 1-1.5%, still far off from the long-term average default rate of 3.6% for high yield bonds.

The downside to the low-default environment is that high yield corporate bond spreads have tightened accordingly, and the diminished risk premia over Treasuries may not offer sufficient compensation. The risk-reward proposition is even less attractive when considering the risk of not just defaults, but also the erosion of yield lost to inflation. At spreads currently hovering around 3.1%, the effective yield on high yield bonds is just 4.5%. US Core PCE inflation rose at 4.6% year-over-year in November by comparison.

Figure 6. High Yield Option-Adjusted Spread over Treasuries



Source: St. Louis Federal Reserve

With the backdrop of a more hawkish Fed and uncertain long-term inflation outlook, fixed income allocations for 2022 and beyond would be prudent to tilt towards the shorter end of Treasury curve to limit portfolio duration risk. Expanding into other segments of fixed income such as mortgage-backed securities can help add diversification and increase overall portfolio yield. Finally, we view bank loans, which carry a floating rate based on LIBOR, as a more attractive way to invest in speculatively rated companies than high yield bonds, although many of these loans have built-in LIBOR rate floors that will not be reached until rates increase from current levels.

COMMODITIES AND ALTERNATIVES

2021 was a year of renewal for the energy sector, which has seen its representation in the S&P 500 shrink to just 3% of the index after years of underperformance diminished the market capitalizations of oil and gas firms. Once again, the story was inflation and its impact on commodities amidst a surge in demand. With oil pushing above $80 per barrel in 2021, it's hard to believe that in April 2020 prices went to negative $37, albeit for only a couple days, for May delivery of US West Texas Intermediate.

Oil prices have clear momentum to take another leg higher, with fossil fuels still in high demand despite a global push towards greener sources of energy. Oil overtaking the $100-barrel mark in the first half of the year until the Fed can institute meaningful rate hikes and slay the inflation dragon is not out of the question.

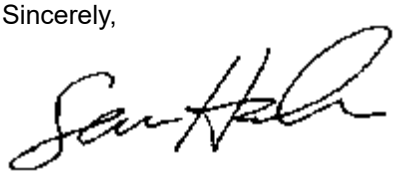
We also believe the outlook for Real Estate Investment Trusts (REITs) is attractive in 2022, despite higher borrowing costs associated with a rising interest rate environment. Long-term borrowing costs are still low by historical standards, and the real estate boom has made REIT holdings, particularly in the residential sub-sector, more valuable. In addition, rising wages and healthier household balance sheets gives residential REITs the opportunity to raise rents. While commercial office REITs may be challenged by the work-from-home shift, the impact hasn't been as bad as initially feared as many firms have either returned to in-person or moved to hybrid working arrangements.

FINAL THOUGHTS

Ultimately, the path we take in 2022 will depend greatly on our ability as a society to work towards the common good and overcome the challenges of the lingering pandemic, and of course, attempt to lessen the political divides here in the US. We are hopeful that the gains we have made in respect to preventative vaccines, therapeutic treatments, and increased public awareness and safety protocols will make 2022 the beginning of the end of the long COVID-19 battle. While the global economic rebound has been robust, we cannot ignore the high cost of human life that this pandemic has brought. With that perspective, we are grateful for the opportunity to share our perspective, and for the opportunity to help guide our clients to competitive, attractive long-term investment returns.

Thank you, as always, for the opportunity to let us serve you.

Sincerely,



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