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2022 Investment Outlook

Written by Britt Messer, CFA, CFP®; CIO of Southeastern Trust Company, Phone: 615.475.5116 (direct)

Executive Summary

- Equity markets surged for the third consecutive year, boosted by strong corporate earnings and economic momentum, and supported by the Federal Reserve's ultra-accommodative monetary policy and asset purchases.
- As the year progressed, the specter of persistent inflation became a growing concern for markets. Speculative assets helped by cheap, abundant money began to decline as expectations of tightening monetary policy took hold. We expect this trend to continue in 2022 and are positioning portfolios for a return to fundamentals over frenzy.
- We prefer value sector equities and smaller cap stocks, and see long term opportunities in foreign markets. We are cautious on bonds. While there are a few attractive sectors such as emerging market debt, we view this asset class primarily as defense against expensive equities and capital to deploy in stock market corrections.
- We are constructive on alternative asset classes to provide better risk-adjusted portfolio returns.
- We are confident portfolios of the past decade will NOT deliver similar returns or performance leadership in the 2020's. US equity valuations are at top decile levels, real interest rates are negative, inflation is forcing the Fed to pivot monetary policy, and earnings have been supported by a pull-forward effect of debt financing and money printing. All of these facts lead us to believe it will be essential to allocate portfolios to different sectors and styles to achieve competitive returns against market benchmarks.

Introduction

In 2021, financial markets built on the impressive stock gains of the prior two years with another strong showing across most sectors. However, as the year began with euphoria in meme stocks and speculative companies, it ended with universal concerns about inflation and central bank policy. These bookends were a warning sign that 2022 may not be nearly as sanguine for investors and the bull market may be nearing a crossroads.

Market Overview

In our 2021 outlook, we discussed the theme that "the story remains far from over". In many ways, 2021 did follow many of the themes that began in 2020 and continued to play out over the course of the year. Equity markets continued to cheer consistently strong economic news and earnings momentum. The unemployment rate drifted down to 3.9% from 6.7%, and jobless claims almost reached pre-pandemic levels by the end of the year. S&P 500 earnings surged throughout 2021, ending Q3 at a 78% year-over-year growth rate, with the percentages of companies beating estimates and outperformance both at levels well above recent historical trends. One of the consistent tailwinds of the 2021 market rise was earnings revisions, as analysts kept being surprised by the resilience of the economy to deliver better than expected results despite supply chain issues, labor shortages and pandemic setbacks.

The favorable economic backdrop, combined with the Federal Reserve's continued full emergency stimulus measures (at least until November), fueled another meteoric rise in the US markets. Underneath the surface, though, a number of cracks developed in different sectors which are worth noting as 2022 gets underway. The S&P 500 return was 28.7% in 2021, again one of the most impressive returns of any major index. Notably, several of the top constituents of the index, such as Apple, Microsoft, Alphabet (Google), Tesla and NVIDIA all outperformed the S&P handily and helped lift the index itself to greater heights. The rally in large cap growth stocks continued, but particularly in the second half of 2021 as worries about COVID variants led to a push-pull between interest rates and growth regained the upper hand versus value.

These facts are really a footnote to the most prominent economic story of the year, though. When the history of last year's financial markets is written, it is likely the renaissance of inflation will be prominent throughout. As forecasters, we certainly don't expect to have a perfect crystal ball; however, last year we did discuss our concerns about the Federal Reserve's monetary policy:

> "In years past, they used an inflation target of 2% as a standard for interest rate neutrality. Following the pandemic, their stance changed; they will not likely raise rates until they see an inflation level around a 2% average. Not believing low rates is enough, the Fed is now signaling to the market they desire higher inflation. It might be suggested their attitude has changed from someone concerned about fire hazards, to that same individual bringing out flint and steel to start a fire, with the belief it can be contained if it gets too severe."

With the Consumer Price Index ending the year up 7%, the word "transitory" being retired from the Federal Reserve's inflation vernacular, and their monetary policy stance in almost 180-degree reversal, it is clear the fire is raging; inflation is now the dominant theme in markets, not to mention politics and daily life for consumers.

As investment managers, we have grown accustomed to the Federal Reserve's influence in markets, particularly since the Great Recession. A lengthy period of low interest rates, combined with the growth of the money supply, have supported equity valuations well above historical norms and caused us to accept lower returns on stocks due to the meager income offered from bonds, cash and safer asset classes. As we enter 2022 and the Fed pivots to combat inflation, it is likely their actions on these two variables (interest rates and money supply) that will most affect how markets perform. As of this writing, the central bank is expected to end its bond buying program in March and raise the funds rate by four increases of 0.25% by the end of 2022. In their most recent meeting minutes, they also indicated a desire to shrink their balance sheet of purchased assets, which now sits at almost $9 trillion (from about $4 trillion pre-pandemic). These forces will serve to tighten monetary conditions and reduce liquidity, actions that will provide a challenge to bull market's longevity.

Looking back on our forecast a year ago, we were not surprised by the onset of inflation, but by the delay in which the Federal Reserve acted to counterbalance its effects. In doing so, it suppressed interest rates and likely fueled some of the extreme excesses in areas of the market. From SPACs to meme stocks to NFT's to crypto assets, it seemed that the market was looking for somewhere (or anywhere!) to invest the excess cash. As the year wound down, and liquidity finally began to abate, many of these asset bubbles began to deflate and we expect that trend to continue throughout 2022. There is a long way to go, however. As of November 2021, the last Fed report available, the M2 money supply is still growing at a 13% annualized rate! It does not appear that the effects of the bond buying taper have completely taken hold in markets, and this process will continue through March. There are some warning signs already that could continue affecting more mainstream investments. In the technology heavy NASDAQ index, there are a considerable number of stocks making new 52-week lows to offset new highs, and that index hit its last high in November even as the broader S&P 500 moved higher. The breadth of other areas of the stock market is also narrowing, meaning that the index is being driven higher by fewer and fewer stocks at the top. We are watching the effects of the liquidity changes closely, as these types of events have often preceded corrections and market tops.

Equity Tactical Allocations

We are neutral to slightly underweight equities in our portfolios relative to our investment objectives. We reduced our position in equities at the end of the third quarter, as valuations continued to get less attractive and our concerns about Fed policy changes increased. We recognize that other asset classes do not offer comparably attractive returns, but at current levels, we do see more significant risk of a correction (there was no correction of more than 5% in the US market in 2021) and long-term returns look mediocre in many sectors. The S&P 500 is now trading at a Shiller (10 Year Average) Price / Earnings ratio of 39, which is only about 10% below the all-time peak of 44 during the tech bubble in December 1999.

We continue to have a strong value bias in stock selection, particularly in US markets. It is likely that the effects of less liquidity will have the most significant effect in the highest valuation stocks in growth sectors. If there are flows from US stocks, the largest stocks should bear more of the burden, and these are concentrated in growth sector names. We still do not know at what level interest rates will normalize until the Fed stops buying bonds in March, and rising interest rates should continue to benefit value-oriented sectors such as financials and be a headwind for many technology stocks.

We still favor smaller cap equities, mainly in the value sectors. Small cap Value had one of the best years in 2021 of any size or style, with the Russell 2000 Value Index up 28.3% (Russell 2000 Growth was up only 2.8%). We think this is likely the beginning of a multi-year period of leadership for small cap stocks, as valuation multiples begin to contract in many sectors that are historically expensive. Despite the strong year in 2021, Small Cap Value remains one of the most fairly valued sectors and looks cheap today relative to larger cap stocks. It has also shown a tendency to perform well in rising interest rate environments.

We maintain our current neutral position in international stocks and overweight to emerging markets. Once again, international markets failed to keep pace with the US in 2021, in what must seem like a broken record for many investors over the last decade. However, there are a number of reasons for optimism that the future will look different. The dollar strengthened sharply in the second half of last year as traders poured money into the currency both in advance of Fed interest rate hikes and also as a safe haven during the uncertainty of the covid variants. The dollar could very well be under more pressure if the global economy continues to re-open and the Fed doesn't follow through on expected tightening due to skittish markets. The US money supply has grown at a much more substantial rate than the rest of the world during the pandemic, and we have injected more stimulus into our economy relative to GDP compared to the rest of the world. As those trends reverse, we expect international markets will be favorably positioned to close the valuation gap. As mentioned earlier, the S&P 500 currently has a Shiller PE of 39, while the international and emerging markets are at 18 and 15, respectively. While valuation is not always a great timing mechanism, it does indicate extremes that are likely to correct in future returns; it seems highly likely that the US market will come back to the field during this decade. For our clients invested in foreign markets in 2021, most of our managers provided excellent results relative to benchmarks; due to our small cap and value tilt, we avoided heavy exposure to China and large technology stocks which were major culprits in underperformance.

Fixed Income Tactical Allocations

We are neutral to slightly underweight fixed income in our portfolios. We have been adding low volatility alternative investments as a substitute for high quality bonds given the low return outlook. In an environment of high inflation and expected Fed tightening, we have reduced our exposure to traditional fixed income and looked to specialty bonds to provide more yield and other sources of diversification.

We remain underweight duration in our bond portfolios. We continue to see interest rates moving higher, but also expect the longer end of the yield curve start to flatten as the Fed tightens financial conditions. With loose monetary policy being supportive of asset prices for so long, it is an open question if the Fed will have the commitment to raise rates significantly; a stock correction similar to late 2018 or a slowdown in the economic cycle may cause them to halt the pace of rate hikes. The stock market has shown the tendency to throw tantrums during periods of tightening, and it remains to be seen how tolerant the Fed will be of a shrinking wealth effect if stocks sell off. The debt burden of the pandemic will also be an overhang, as rising rates create an even larger deficit and crimp future spending and economic growth.

We remain overweight corporate bonds and underweight Treasuries in our taxable bond portfolios. Credit markets have remained very calm in the midst of accommodative monetary policy and strong economic momentum. Like in many other economic sectors, we are watching closely for signs of deterioration or stress in credit which would cause our next move to be more defensive.

We are now slightly underweight municipal bonds relative to taxable bonds. With the failure to pass the Build Back Better package, tax rates did not rise as feared following the 2020 election. Municipal bonds outperformed taxable bonds in 2021, partly due to demand based on the expectation of higher taxes. Their yields remain at relatively low spreads to Treasuries. In response, we added Treasury Inflation Protected Securities (TIPS) in September to many of our fixed income portfolios, including tax-free accounts, to add exposure to Treasuries and protection against rising inflation expectations.

We continue to use high yield and emerging market bonds as diversifiers in fixed income and increased our positions late in 2021. We discussed earlier some of the reasons why we believe emerging markets are attractive – reasonable valuations, potential dollar weakness and economic recovery trends in many of these countries following the pandemic. We see value in both their equities and debt; emerging market bonds offer a historically attractive yield spread versus the US and other developed markets.

Alternative Investment Tactical Allocations

We increased our exposure to alternative investments in portfolios throughout 2021, as stocks became less attractive due to expanding valuations and bonds remain under pressure from inflation and tightening monetary policy.

In the third quarter, we added positions in event driven strategies to provide a lower risk exposure to select stocks. These types of funds represent a unique type of long-short solution, as managers identify companies that are acquisition targets for purchase, while shorting companies that are the likely acquirers. With the strong economic backdrop, we expect M&A activity will remain vibrant throughout the year. In 2021, the flood of liquidity into SPAC's and other speculative investment vehicles created what we saw as dislocations in pricing in M&A stocks, and active managers should be able to identify mergers that are still on track and take advantage of these pricing abnormalities.

We continue to view managed futures as an attractive solution in an inflationary environment. These funds have virtually no correlation to stock returns, and benefit from trend following in all types of markets. If we continue to see rising interest rates and sharp commodity and currency movements, these strategies often benefit, even if the asset class itself is in decline (e.g., falling bond prices).

We believe private equity and debt solutions will be important diversifiers to public markets over the next decade. At current valuations, stock returns will be more muted than in the past, and these funds offer the opportunity for excess returns in an environment where portfolios will struggle to hit historical results.

Final Thoughts

We hope the past year has been a safe and healthy one for you and your family. Despite the strong returns of the stock market over the past three years, when talking to clients we often hear more concerns than complacency. The uncertainty about the pandemic, inflation and government monetary and fiscal policy are just a few of the issues affecting not only your money but other aspects of life.

Last year, we discussed a balanced mix of opportunities and challenges in the market. Now, we see the tide shifting toward challenges. We do not mean to paint a completely bleak picture. The economy has recovered brilliantly from the 2020 pandemic induced recession despite a myriad of obstacles. Consumer and corporate balance sheets are in solid shape, and credit markets remain extremely accommodative. The wealth effect from the market's rise has promoted confidence and driven spending activity and the economic reopening.

Our concerns mainly center on how the economy transitions to a "normal" environment after 2 years of extreme stimulus and accommodation, following 11 years of generally easy conditions following the Great Recession. The GDP contraction from the pandemic was offset by a bazooka of spending that overwhelmed those brief losses and pushed earnings and growth to levels that were likely not to be reached until the late 2020's without these extraordinary measures.

Financial assets generally discount future conditions well in advance of the actual events. As markets begin to price in a shifting business cycle, such as profit margins compressing due to inflation, valuations shrinking as a result of rising interest rates, or spending moderating as a result of fading stimulus, it will be much more difficult for stocks to grind higher from current levels.

That does not mean there are no opportunities in the stock market. In many ways, the market of 2020-2021 has been more of an extension of the 2009 bull market than a new cycle. Similar market forces and policies have benefited the same types of companies and maintained themes that helped drive those sectors higher. Even if this bull market does not come to an end soon, we believe we are near an inflection point where new leadership and themes will emerge, much like the end of the tech bubble in 2000. At its conclusion, large US growth companies gave way to small cap stocks and international markets that benefited from a shift in sentiment and a return to fundamentals over momentum. As Mark Twain said, "History does not repeat itself, but it often rhymes"; we are positioned to benefit from a similar outcome.

As a boutique firm, we possess the advantage of providing you a forward-looking view of markets that is not burdened by the conflicts of large institutions. At some money managers, there can be a tendency to promote the market of yesterday, rather than tomorrow. Behaviorally, it is comfortable to expect that what worked in the past will continue to provide the same outcomes. We believe it is important to be invested consistently and follow a sound policy. However, we are also realistic about the future and think that creative and contrarian strategies will be essential to deliver successful results. Thank you for your confidence as we continue to steward your family's wealth. Please contact any of our investment team members if you want to review your strategy or learn more about our ideas and how they apply to your specific objectives.