WESCAP Group

330 N. Brand Blvd.
Suite 1150
Glendale, CA 91203
(818) 563-5170
(818) 563-5174 (Fax)

www.wescapgroup.com

Economic and Investment Outlook for 2022

This year we once again focus on the main questions investors are asking coming into 2022: Will the coronavirus be vanquished? What does this mean for people, businesses and investors? Secondarily, is inflation really transitory or longer-term? Are stock and bond markets overvalued?

- **<u>2022 Outlook Summary</u>**

- Coronavirus Pandemic: Recent vaccines appear to be at least partly effective. New treatments (Paxlovid) are expected to reduce hospitalizations and deaths. We expect the pandemic to wane this year and allow economies and supply lines to get back to normal. Nevertheless, virus mutations do provide an ongoing risk to our base case scenario.

- Economic Growth: GDP growth should continue to recover from the 2020 recession. However, higher-than-anticipated inflation in the U.S. could cause interest rates to rise enough to begin to restrain growth. Most of the recent inflation is expected to be transitory, but long-term inflation could still remain above pre-pandemic levels.

- U.S. Equities: The S&P 500 in 2021 increased less than earnings. Therefore, stocks are slightly less expensive than a year ago. Small-cap and value stocks are more attractive than growth stocks or the S&P 500. Higher expected U.S. interest rates pose a risk.

- Foreign Markets: Economic conditions in many larger foreign developed and emerging market countries are expected to improve as well. Valuations in non-U.S. stock markets are more attractive than in the U.S. Inflation and interest rate increases are expected to be lower in many other large countries outside the U.S. Therefore, we continue to recommend a substantial allocation to assets linked to these countries.

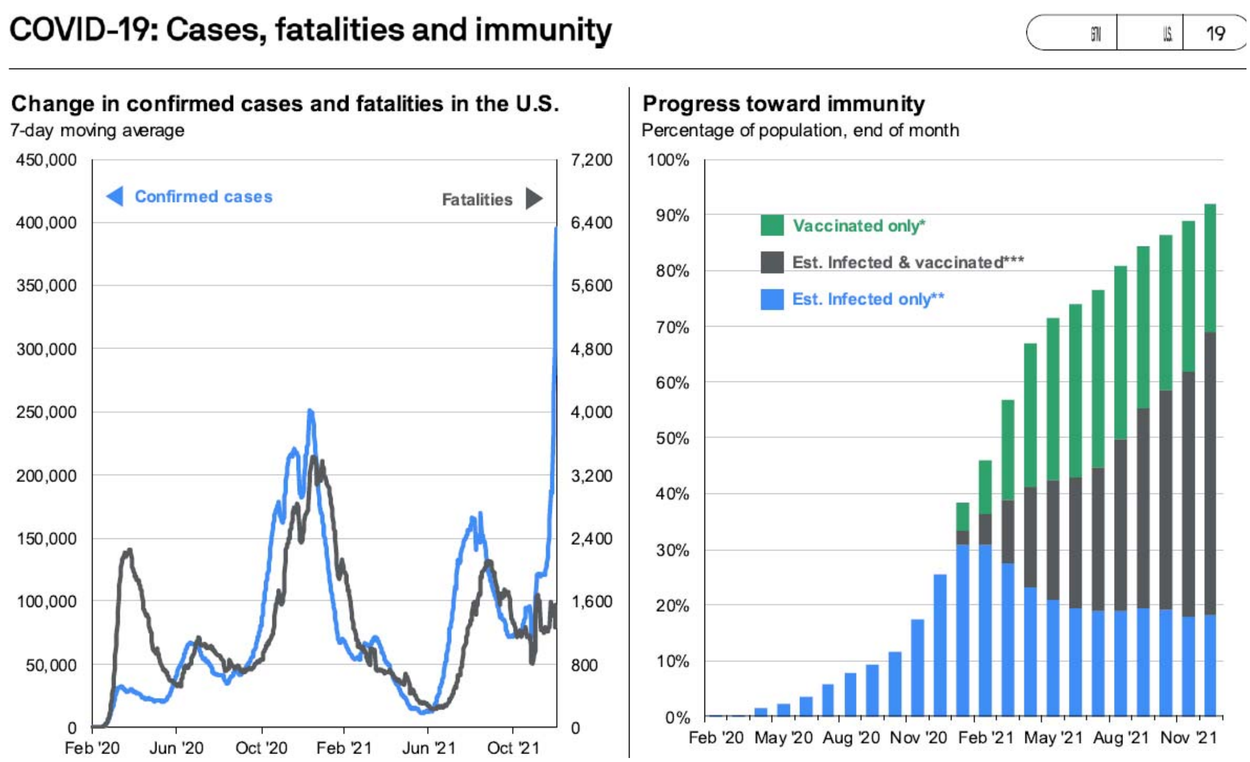
- Fixed Income: U.S. interest rates are expected to rise due to reduced Federal Reserve stimulus and higher inflation. This makes most high-quality fixed income investments unattractive. Very short-duration and adjustable-rate fixed income assets are reasonable options in 2022 as they can capture the benefit of rising interest rates. In addition, some credit-sensitive fixed income assets continue to offer respectable yields.

- Alternative investments: Given a lack of yield in many fixed income assets and potentially lower returns and higher volatility from stocks, additional consideration should be given to non-traditional assets. These could include hedged strategies and private investments. Mutual funds, ETFs and hedge funds are all avenues of investing in these assets and strategies.

SARS CoV-2 (COVID-19) Outlook

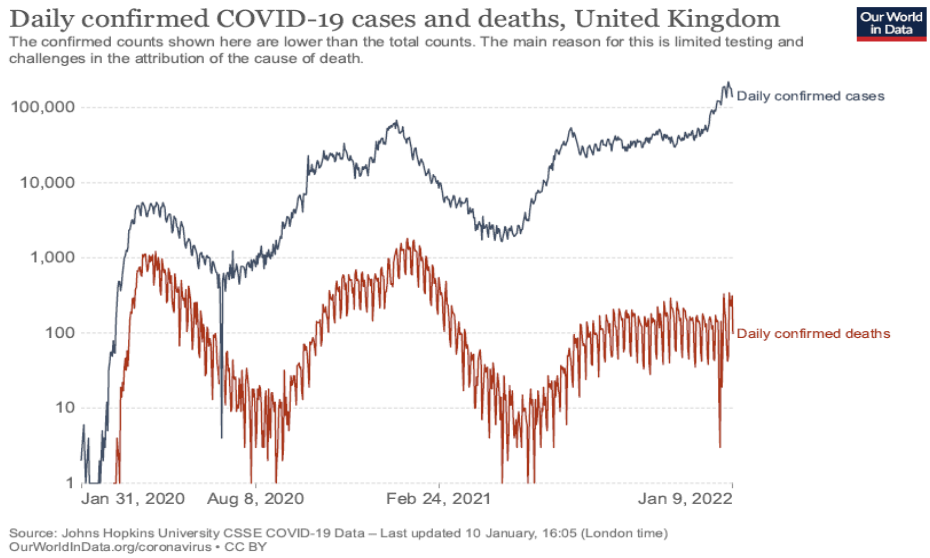
In our Outlook from one year ago, after the new vaccines had become available, we said “It is a race now to bring down the number of people infected before newer virus mutations occur." Unfortunately, the race was not won in 2021 as both the Delta and Omicron variants of the virus resulted in new surges in infection rates.

There have been five surges in confirmed new daily U.S. coronavirus cases as can be seen on the left graph below (JP Morgan Guide to the Markets Q1 2022). The early January 2021 surge (blue line) has been nearly doubled by the current more infectious Omicron case surge. However, deaths from Omicron (black line) are about half the early 2021 rate. Thus, the Omicron variant appears about 25% as deadly as earlier variants.



Reasons for much lower death rates appear to be partly a result of higher levels of immunity. Prior infections plus vaccinations (upper right chart) appear to be approaching 90% in the U.S. The Omicron variant has about 50 mutations when compared to the original Alpha variant. This has allowed for both vaccinated and previously infected people to catch this new viral strain. Nevertheless, the prior partial immunity protection appears to be keeping both the hospitalization and death rates to lower levels.

The Omicron variant hit the United Kingdom (UK) a little earlier than the U.S., so looking at trends there can be instructive.



As can be seen in the above chart, the number of confirmed U.K. COVID cases moved sharply upward the last four months, moving up from 32,087 cases on August 28 to 178,868 cases as of January 7, 2022 for a 459% increase (black upper line). However, deaths rose from 133 to 230 (brown line), only a 73% increase. Furthermore, daily deaths have plateaued the last few months despite rising daily cases over the same time period. Even accounting for deaths lagging new cases by several weeks, **it appears that there is a lower correlation now to rising Omicron cases and deaths when compared to all of the earlier coronavirus surges**.

Omicron has an estimated r-naught (measure of infectiousness) of about 10 versus about 2.5 for the original strain and 7 for Delta (Lancet, Dec. 17). This, plus a quicker incubation period, is why it spreading so quickly to both the vaccinated and unvaccinated. In New York, a current hotbed of Omicron infections, "unvaccinated NYers are still getting infected and hospitalized at more than 6x and 14x the rate, respectively, of vaccinated ones" (NBC NY Jan 3). While this is bad news for the unvaccinated, the silver lining is that Omicron appears less severe in its effect on most people.

Omicron replicates about 70 times more in the upper respiratory tract than in the Alpha variant. However, it replicates much less densely, about 6 times less, in the lungs (details here: http://www.med.hku.hk/en/news/press/20211215-omicron-sars-cov-2-infection). This reduced strain on the lungs could account for the early indications that the overall illness severity of Omicron is much less than for earlier variants.

Therefore, despite still high levels of unvaccinated persons in the U.S. and elsewhere, it is possible that within a few months, the long-sought for "herd immunity" will be reached in many areas. Even if new virus variants are forthcoming, the partial immunity from prior infections plus vaccines could mean the worst is or about to be behind us.

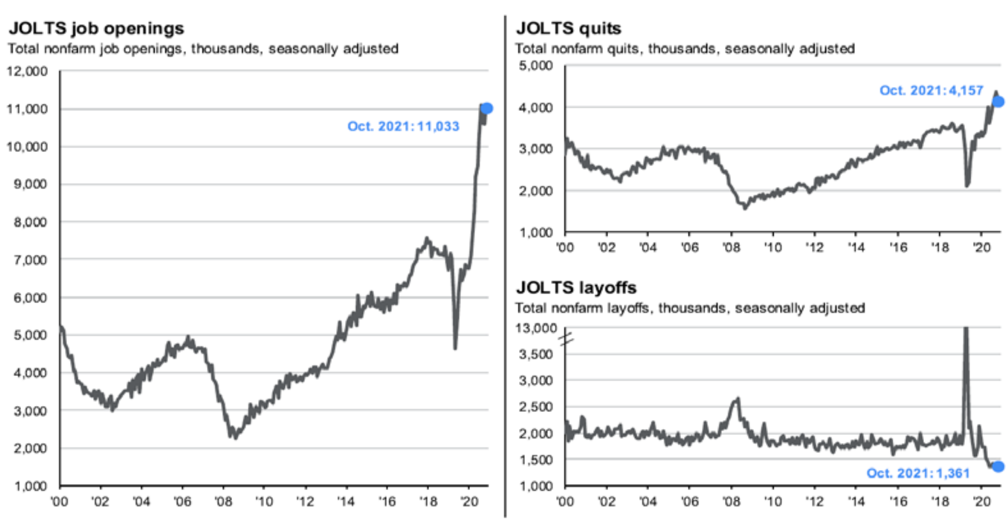
New messenger RNA vaccines can be brought on line fairly quickly as new variants emerge, though government health and safety protocols do add to the time these can be used. Against the Omicron variant, a "booster" vaccine dose appears to provide strong protection. Nevertheless, a new Omicron coronavirus variant specific vaccine should be available in March 2022. (See https://www.pfizer.com/news/press-release/press-release-detail/pfizer-and-biontech-provide-update-omicron-variant).

Additionally, Pfizer's new antiviral pill, Paxlovid, appears to cut hospitalizations and death by 89%, per https://www.pfizer.com/news/press-release/press-release-detail/pfizers-novel-covid-19-oral-antiviral-treatment-candidate. Furthermore, unlike vaccines, it is not affected by coronavirus spike mutations as it uses a protease inhibitor to dramatically slow viral replication and thus it is not sensitive to different spike configurations. A different protease inhibitor (Darunavir) has worked with HIV infections for more than 10 years without serious viral resistance developing. It is too soon to know if Paxlovid will have similar long-term efficacy, but if so, then serious illness from current and future strains of the coronavirus can be brought under control. Even if this is not the case, new protease inhibitors can be designed. Use of Paxlovid should dramatically cut the number of severely ill patients. About 4 million Paxlovid treatments are expected to be available in the U.S. by the end of January and 10 million by mid-year 2022. This may not sound like enough, but there should be enough for those most at risk. Current COVID related ICU bed patients number 21,023 (John Hopkins, 1/7/22). If 1 to 2 million treatments per month are given quickly to those most at risk of severe illness, the ICU hospitalization and death rates are expected to fall dramatically.

As a result, our base case is that we expect the coronavirus pandemic to begin to wind down in the U.S. sometime before spring and that any new variants or surges will be less impactful. The coronavirus is likely here to stay, with some new variants likely, but nonetheless we expect that society and most economies will be able to get back to a semblance of normality.

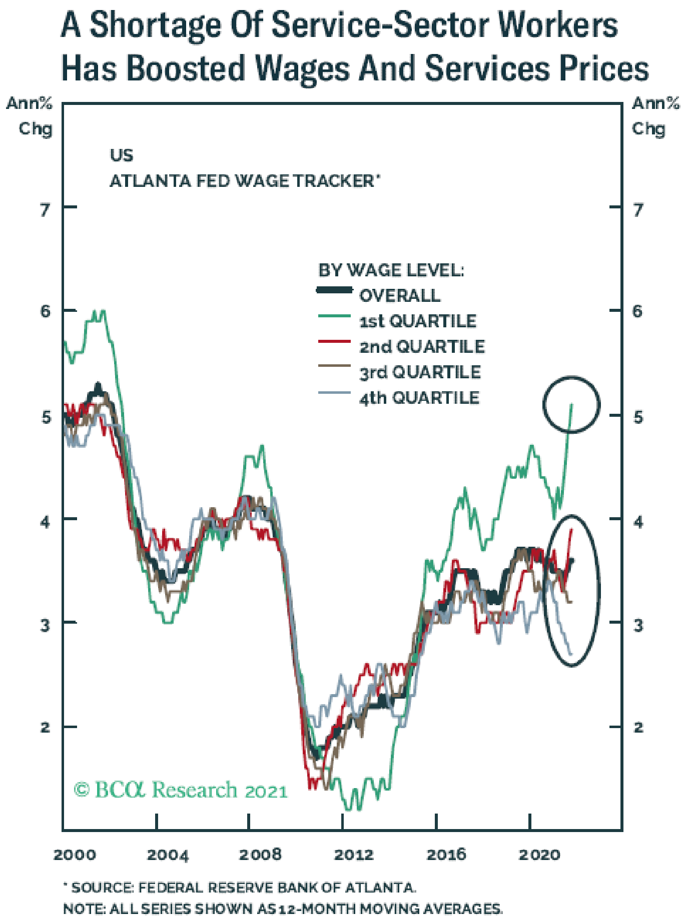
Economic Conditions, Inflation and Outlook

U.S. unemployment is nearing pre-pandemic lows, with 3.9% unemployed at the end of December 2021, down from a high of 17.2% in April 2020. This is a remarkable and speedy recovery due to the relaxation of most COVID restrictions, strong government stimulus efforts and strong consumer demand. Total employment is still 3.6 million lower now than in February 2020 (St. Louis Federal Reserve) due to retirements, and others leaving the workforce or unwilling to look for work due to COVID issues. Layoffs are at historical lows (bottom right graph), yet voluntary "quits" are at historical highs (upper right graph, JP Morgan).

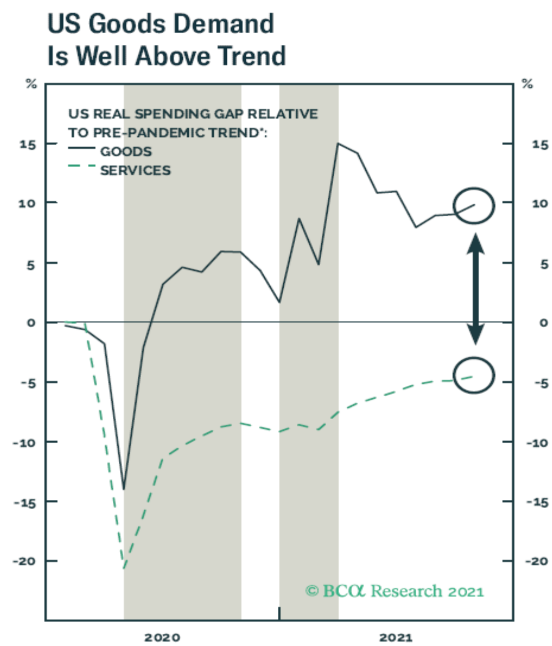


JP Morgan Guide to the Market Q1 2022, p 25

Demographics played a role in this rapid decline in unemployment as some older workers decided to retire and legal foreign workers had a hard time entering the country. These labor demographics along with demand for goods at an all-time high and service demand picking up has resulted in many job offerings going unfilled (prior page, left graph).

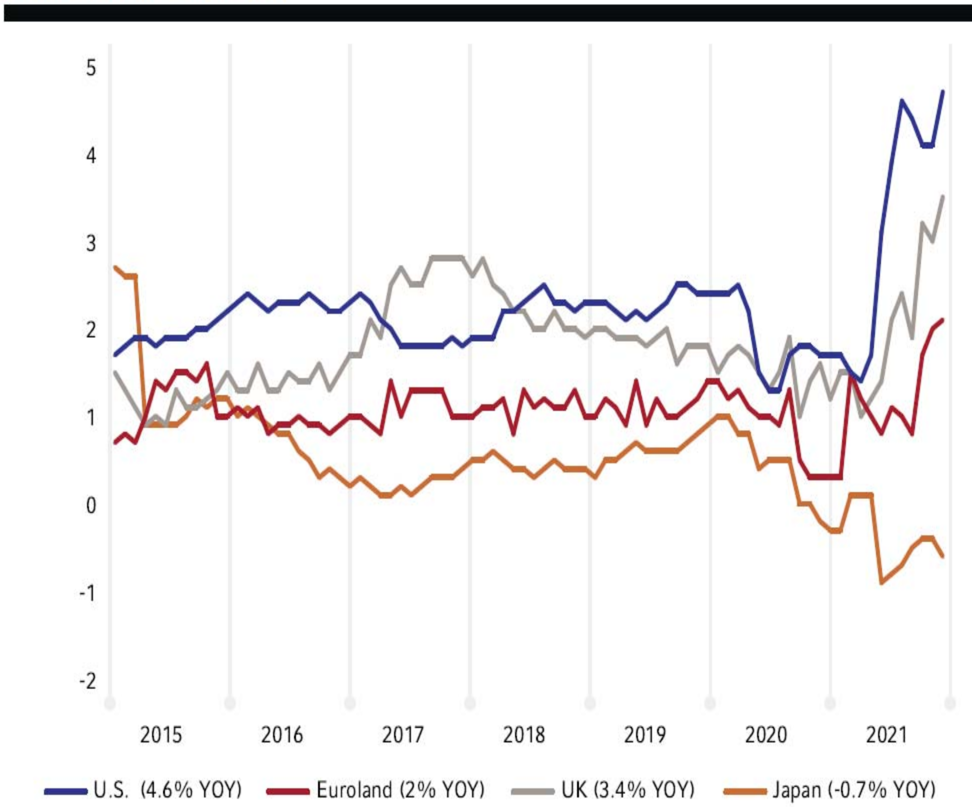


Competition for workers has caused wages to rise more than anticipated and is one of several reasons for unexpectedly high recent inflation. Wages have risen the most in the bottom quartile of wage earners (green line, left graph). This would include many service jobs, such as in transportation, hospitality, and restaurants.



Relative to pre-pandemic levels, demand for goods is currently 9.5% higher, while it is still 4.5% lower for services (right graph). The high demand for goods has strained the ability to deliver them, with many supply bottlenecks occurring in manufacturing and shipping.

Global core inflation rates

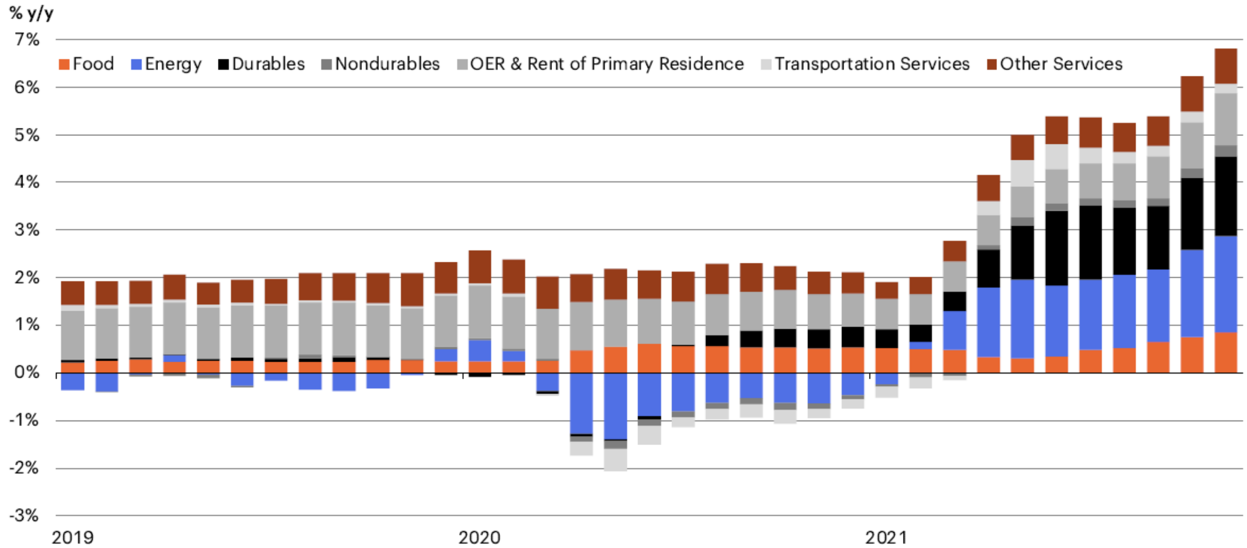


Source: Refinitiv® Datastream® as of October 21, 2021. YOY = year-over-year.

The above chart shows that recent inflation has been much higher for the U.S. (blue line) than for Europe (red line). Japan (orange line) still has very low inflationary pressure.

U.S. inflation may be running higher than in other regions due to U.S. household stimulus payments and enhanced unemployment benefits resulting in increased purchases of various goods. Less restrictive and less lengthy "lockdowns" resulted in a strong resurgence in consumer spending in the U.S. A tight labor market didn't help matters. Port bottlenecks for imports in the U.S. have put more inflationary pressure on consumer goods and automobiles than for other regions. Home prices rising, more savings and higher stock and bond prices encouraged more household spending due to the "wealth effect." Additionally, higher home prices, lower borrowing costs and increased real estate transactions encouraged homeowners to spend more on home improvements and other housing related purchases.

Contributions to CPI by 7 categories



Source: Bureau of Labor Statistics, FS Investments, as of December 10, 2021. See explanatory note at end of article for definition of categories.

Components of U.S. inflation over the last several years are shown above. Over the last year, energy price increases (blue bar) accounted for a large part of total inflation. Lower-than-expected U.S. shale oil production and OPEC-constrained supply, combined with an unexpectedly fast demand recovery, resulted in much higher oil, gasoline and natural gas prices around the world.

Additionally, and as discussed previously, durable goods (e.g., automobiles, equipment, home furnishings, electronics and semiconductors) showed large price increases (black bar). **As the pandemic winds down, we expect to see a decline in goods demand as pent-up demand for services (e.g., travel, entertainment) should partially displace demand for goods.** Spikes in shipping costs and major materials and goods shortages should be alleviated as this shift in demand unfolds. Spot pricing for shipping containers and dry freight has been declining for several months. However, many annual shipping contracts are expected to see noticeably higher pricing for 2022, so transportation inflation could persist well into 2022 (lightest grey bar).

If energy, food and durable goods price increases revert to historical levels, such as in 2019, then overall inflation should drop to between 2.5% and 3.5% within 12 to 18 months. As these types of price increases tend to revert over time, this is one of the primary reasons that most economists and the Federal Reserve state that the current high rates of inflation are transitory and should begin to come down as supply bottlenecks abate and more workers come back into the labor force.

Service inflation increased in the second half of 2021, due to tight labor conditions and reviving demand pushing up wages. It is unclear whether some of these tight labor conditions will persist. If they do, long-term inflation may stay elevated and remain above 3%. However, the December U.S. Department of Labor Statistics report states that 1.1 million people were not actively seeking employment due to the pandemic. Once the pandemic is perceived as over, most of these people could seek re-employment. This should begin to moderate some wage inflation pressures.

As of Jan. 6, the difference in the 5-year Treasury note yield and the 5-year TIPS note yield was 2.77%. This is down from a 3.17% reading on Nov. 16. This indicates that bond investors, expect CPI inflation to average 2.77% over the next 5 years and that they also have been lowering their inflation expectation over the last 6 weeks. If this trend continues, we may see this differential fall to under 2.5% later in 2022.

While U.S. inflation could remain stubbornly high for the next 2 to 5 months, we expect inflation to decline thereafter, though it may not dip below 3% until 2023. The longer inflation stays elevated, the sooner the Federal Reserve may begin raising interest rates to counteract this. It could also mean borrowing rates will rise for businesses, consumers and the government.

Global GDP may soften in the first quarter of 2022 due to Omicron reducing demand in various service sectors and a continuation of supply chain bottlenecks. However, as these issues recede, we would expect a pick-up in GDP for the balance of the year. The manufacturing sector should benefit from this growth in global GDP. In 2022, the largest 2000 global firms expect to increase capital expenditures (cap-ex) by 6.1% (WSJ 1/10/22). Much of this is to expand capacity in response to pandemic and expected post-pandemic demand.

A recent McKinsey study, "Risk, resilience, and rebalancing in global value chains", estimated that once a decade, the average firm will lose 40-100% of one year's profits due to supply disruptions. A one month or longer disruption is experienced every 3.7 years on average. Pandemics, civil unrest, cyber-attacks, accidents, natural disasters, and supplier bankruptcies are all potential causes of supply chain disruptions. Such lengthy and costly supply disruptions are creating a strong incentive for change. One change is to hold more inventory rather than relying on just-in-time shipping, thus creating more warehouse and transportation needs. Additional primary and back-up suppliers and transportation channels are becoming more important to add to supply chains, as is moving critical second and third tier suppliers closer to end-markets. Improving supply chain resilience will require more spending by firms.

Beneficiaries of higher household and business spending would include those with manufacturing as a large percentage of their economies. Manufacturing accounted for 11% of 2020 U.S. GDP (Worldbank.org). Manufacturing in the Eurozone was higher at 14% (18% for Germany and 35% for Ireland), 17% in Central Europe, and 23% in East Asia and Pacific (China 26%, Japan 20%, Korea 25%). These areas are expected to show significantly higher growth rates as global GDP and cap-ex expands later in 2022. This is also reflected in our investment preferences to be discussed in the next section.

One source of uncertainty includes the potential for higher income taxes in the U.S. However, it appears Congress is stalled on many provisions, including raising taxes. Assuming more compromises in this area, any increase in personal and corporate taxes is not expected to be sufficient to adversely affect the U.S. economy in a meaningful manner.

Geopolitical tensions will continue to exist between the U.S. and China, the Middle East, Russia and elsewhere. Tariffs and trade impediments should trend down, though they appear to remain an important tool of the Biden administration. Military and economic tensions continue to grow. The era of globalization and cooperation is being replaced by increased nationalism, and by a desire to decrease dependence on foreign countries for critical materials and supplies.

Stock Market Fundamentals and Dynamics

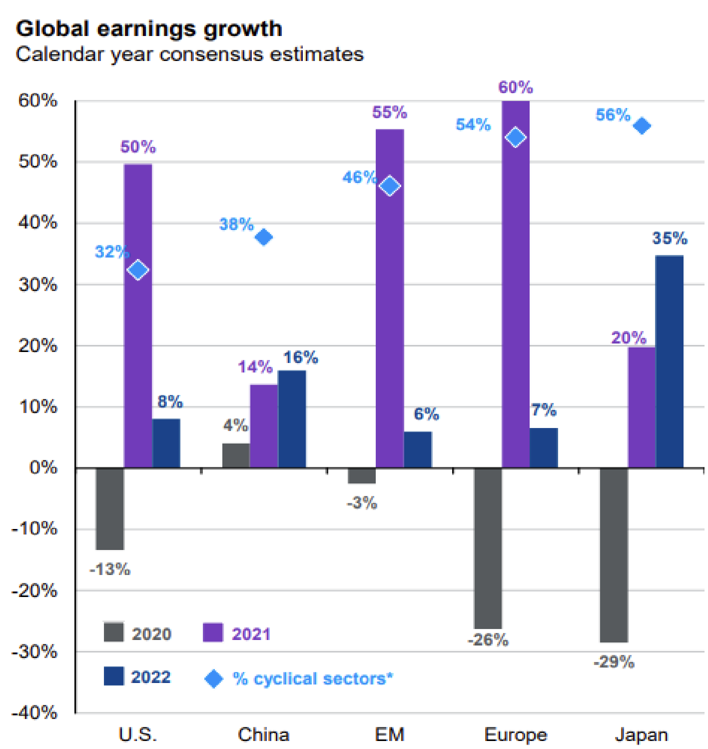
Returns	2021	
	Local	USD
Regions		
U.S. (S&P 500)	-	28.7
AC World ex-U.S.	13.5	8.3
EAFE	19.2	11.8
Europe ex-UK	24.4	16.5
Emerging markets	0.1	-2.2
Selected Countries		
United Kingdom	19.6	18.5
France	29.7	20.6
Germany	13.9	5.9
Japan	13.8	2.0
China	-21.6	-21.6
India	28.9	26.7
Brazil	-11.2	-17.2
Russia	21.6	20.0

The S&P 500 is often considered the de facto definition of the U.S. stock market. It was up 28.7% in 2021 (left table, JP Morgan Guide to the Markets, p 43).

Foreign markets did well too, except for emerging markets. Chinese stocks lost 21.6%. China currently makes up 32.4% of the MSCI EM index, so poor performance in China drags down the whole EM index.

Additionally, a strong dollar relative to the yen and euro in 2021 hurt results when measured in dollars versus the local currency (USD column, left table). Our 2021 experience in these foreign markets was better as we had significant currency hedging in our foreign stock holdings and our overweight to foreign smaller stocks helped.

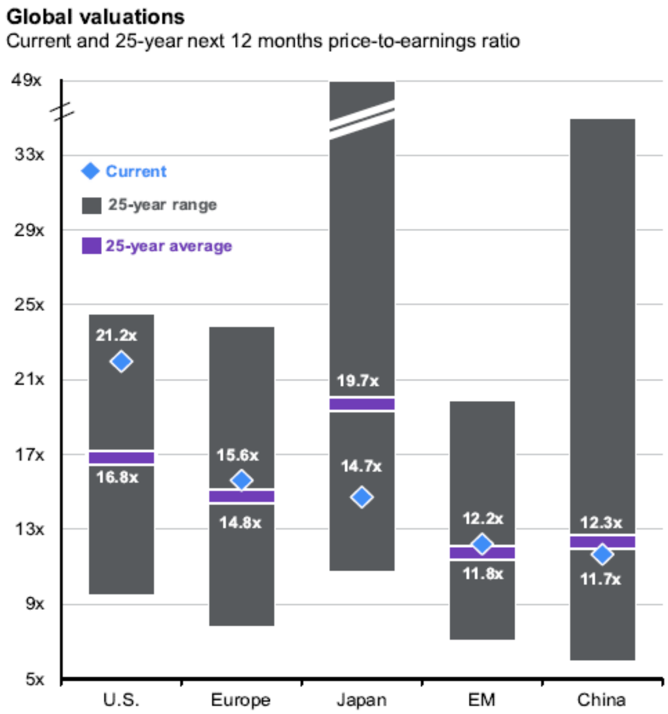
The S&P 500 earnings is poised to rise 50% in 2021 (below chart JP Morgan Guide to the Markets, p. 47).



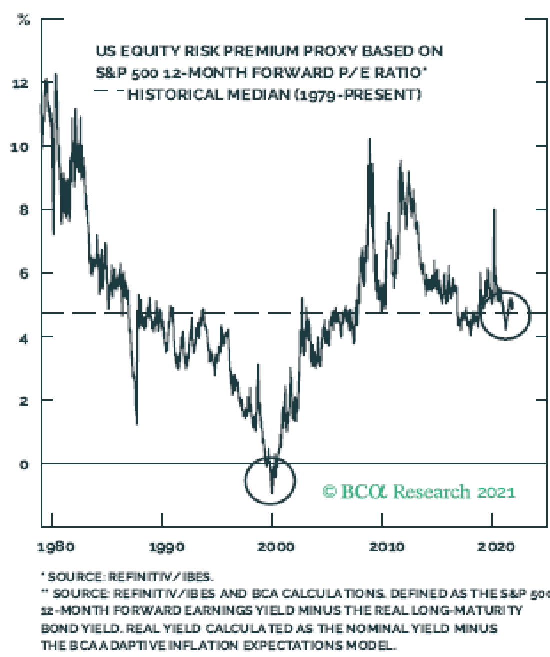
U.S. stocks are actually less expensive now than a year ago, based upon 2021 earnings growth exceeding 2021 stock price increases. This is also true for all major global stock markets.

U.S. corporate earnings growth is expected to be about 8% in 2022, with Europe right behind at 7%. China and Japan expect to see 16% and 35% earnings growth in 2022, respectively.

The U.S. stock market is trading at about 21.2 times earnings, which is considerably higher than the 25-year average of 16.8 (below chart, JPM Guide to markets, p 47). China, Europe and emerging markets trade less expensively than the U.S. and very close to their 25-year averages. Japanese stocks are trading at a considerable discount to their 25-year average.



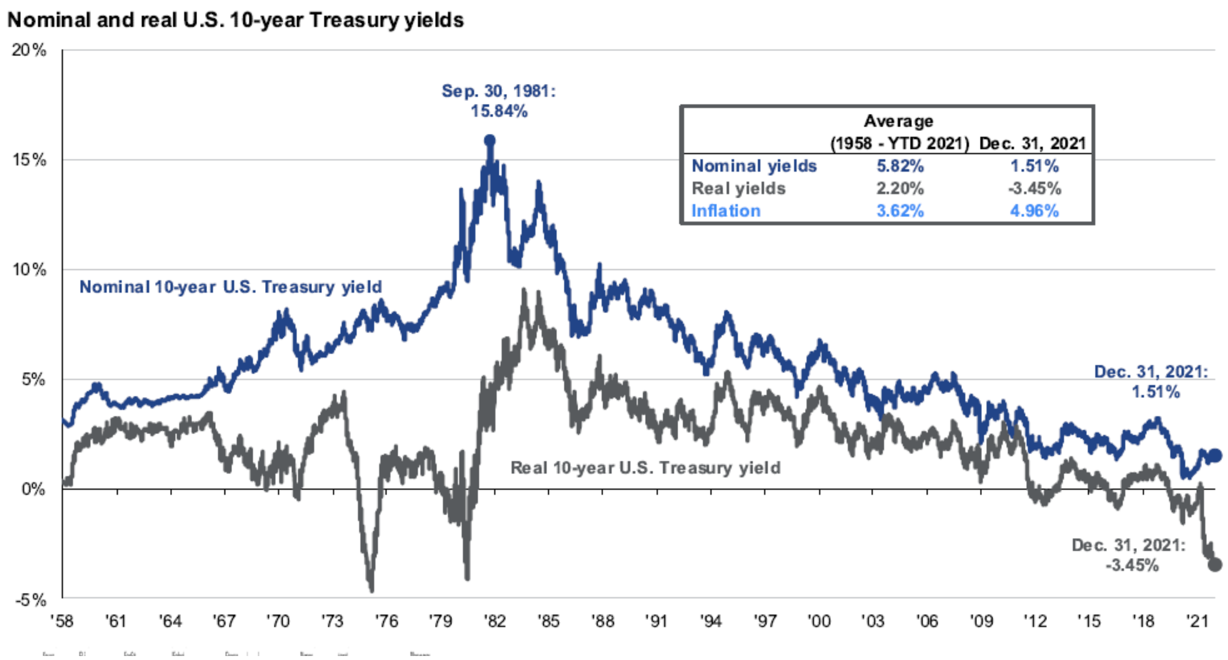
Are U.S. stocks too expensive? Despite trading at a high multiple of earnings**, very low interest rates justify the current S&P 500 P/E ratio of 21.2**.



The S&P 500 earnings yield (inverse of P/E ratio) less the long-term Treasury bond yield, referred to as the equity risk premium, is near 5% (right graph), which is very close to the long-term average. This implies that stocks are not overvalued at current interest rates. However, if interest rates rise further, as they have already in the last month, then both stocks and bonds could be at risk of price declines.

The yield on the 10-year U.S. Treasury note stood at 1.51% at the end of 2021, up from 0.93% at the end of 2020. This bump in interest rates is why the 10-year note had a negative 3.6% return in 2021. As interest rates rise, older bonds with lower interest rates must decline in value to compete with new bonds offering higher interest rates.

But where should interest rates be? A clue lies in the long-term relation between interest rates and inflation. As can be seen below, the real yield (current interest rate less the inflation rate) is currently a negative 3.45%. Inflation is taking away more than the 10-year note can earn. This strong negative real rate happened before in the late 70s/early 80s when inflation really took off. Within several years interest rates rose and peaked at 15.8% in 1981. These high interest rates choked off growth in the economy, resulting in a recession. Nevertheless, this did result in a subsequent decades-long decline in inflation and interest rates.



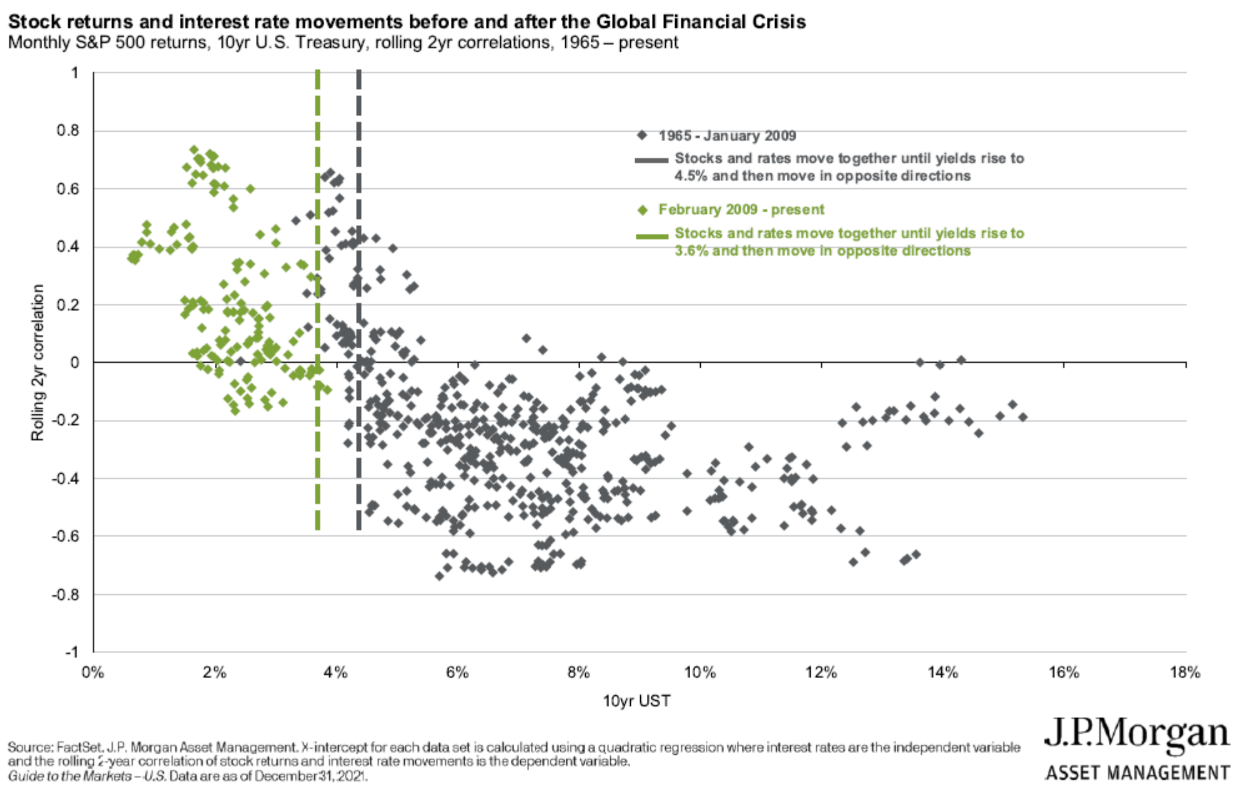
The real yield (yield above the inflation rate) has averaged 2.2% since 1958. Bond investors do want to be compensated for both inflation and for the volatility risk of owning a longer-term bond. If we assume that 2% is the desired real return (above inflation) for bond investors, and **if inflation averages 2.5% over the next 10 years, then the 10-year bond should be yielding 4.5%, not the current 1.51%**. Even if we reduce the real return to 1% and the inflation rate to 2%, this would imply a 3% bond rate, double the longer-term year-end 2021 actual yield.

Factors influencing low bond yields include: 1) Federal Reserve bond purchasing as part of the current stimulus program, 2) foreign investors buying these bonds as they yield more than many of their own bonds (e.g., German and Japanese bonds have even lower yields), and 3) U.S. government bonds are a safe haven during periods of financial turmoil and for when non-dollar currencies are in decline.

However, all of these factors are not expected to last indefinitely. The Federal Reserve has already slowed its bond purchasing program and may cease altogether in March. We could expect interest rates to move higher both prior to that happening and to continue afterward. A safe haven asset will lose some demand as world economies benefit from an expected decline in COVID cases and the related economic and supply chain issues associated with it. Given low inflation in Japan and somewhat low inflation in the eurozone, we could see interest rates in those regions remain low. This will tend to continue to support foreign demand for U.S. bonds and therefore could put a lid on how high interest rates move up in the U.S. As a result, it is conceivable that the 10-year Treasury note rate may only move up 0.5% to 1% in the next 12-18 months. Nevertheless, if inflation does not fall sufficiently in that time period, interest rates may move up further than this.

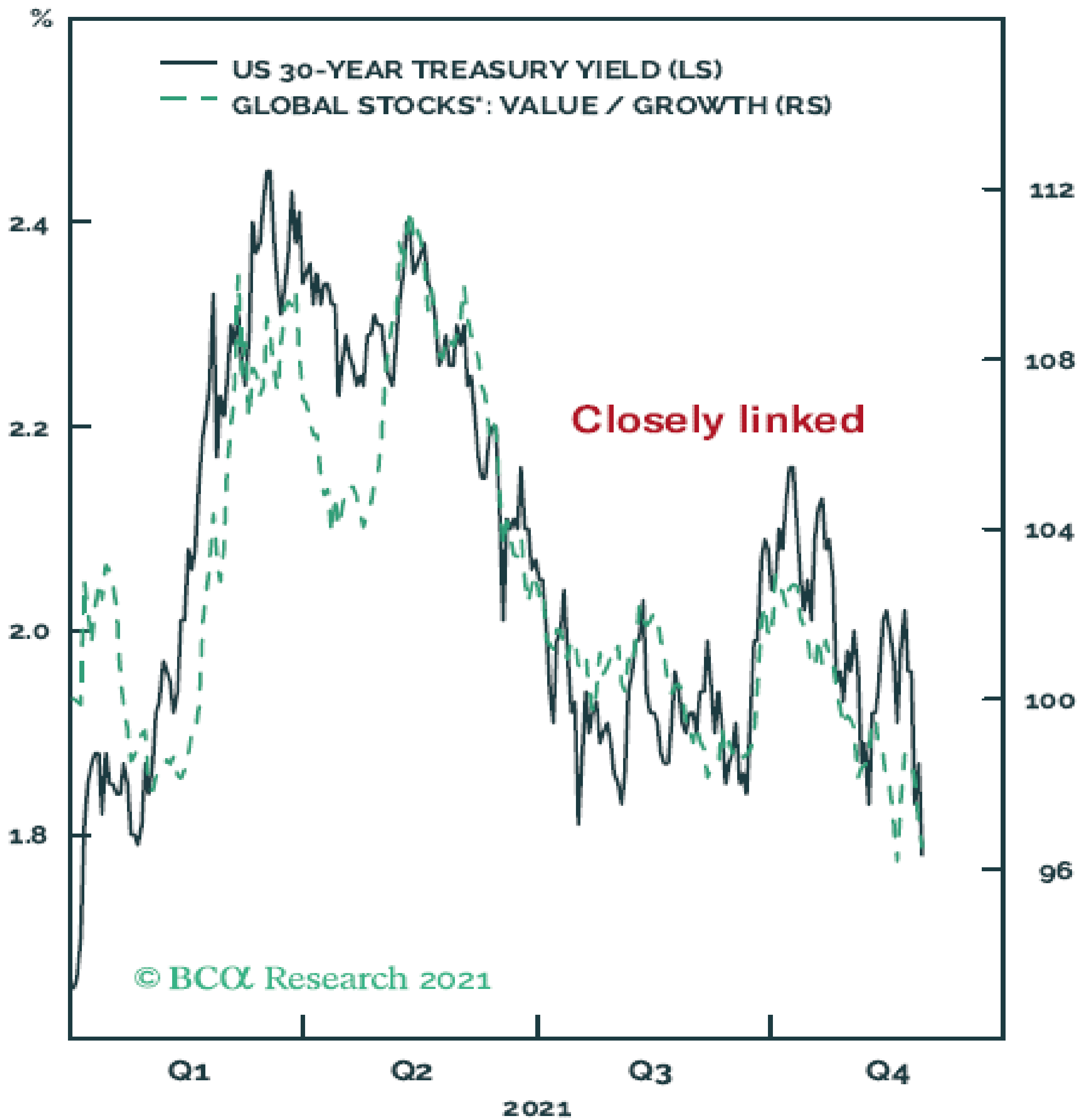
The effect of a 1% to 2% rise in interest rates would lower the equity risk premium for U.S. stocks and income producing assets, including real estate and thus cause some downward price pressure on these assets. Growing earnings and a greater confidence in the economy could offset some of this price pressure. Indeed, with modest changes in interest rates, stocks can perform well. As can be seen in the following chart, from 2009 to the present, when interest rates are below 3%, stock prices and interest rates are positively correlated. Both stock prices and interest rates move up together in this case.

However, once interest rates move above 3%, then stock prices become negatively correlated to interest rates, with stock prices moving down as interest rates increase. This could be because when rates start low and first start moving up, this reflects a growing economy and profits, which is good for stocks. But as interest rise further the economy is adversely affected by higher interest rates—higher costs for mortgages and car loans affect consumer demand and companies pay more to borrow.



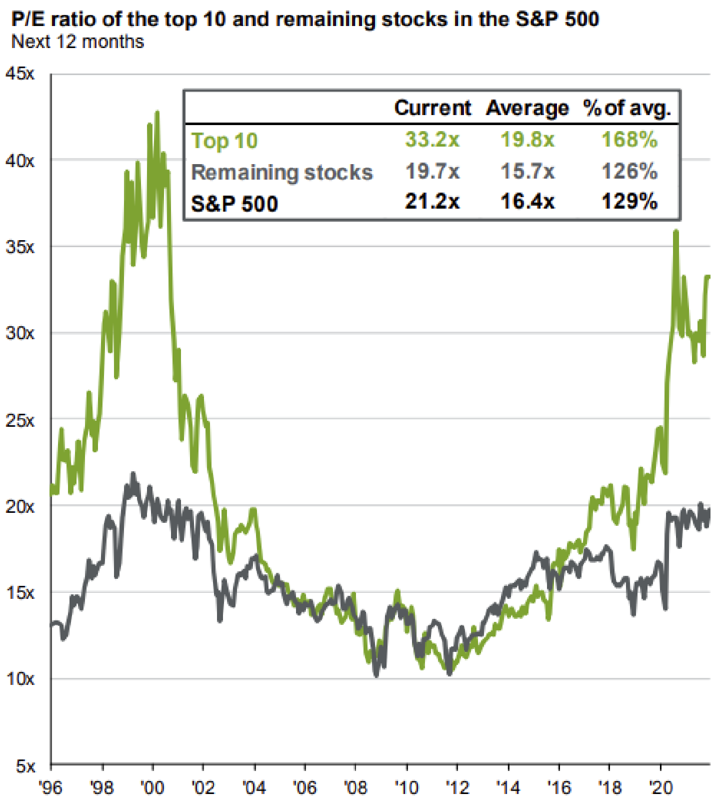
Note that prior to 2009, the interest rate at which correlation reversed was higher at 4.5%. For whatever reason, stocks were less adversely sensitive to higher interest rates prior to 2009. Perhaps this was because price/earnings ratios were generally lower in the '65-09 period and economic growth and productivity were higher then and thus less adversely affected by higher interest rates. **Currently, with high P/E ratios and lower long-term expected economic and productivity growth, it is possible that U.S. stocks could trend down with interest rates as high as 2.5%, or perhaps even lower**.

This could affect growth stocks with P/E ratios well above the S&P 500 average. We have seen evidence of this in 2021 and early 2022. Almost every time the 30-year Treasury bond yield rose in 2021, global growth stocks underperformed value stocks (next chart). When interest rates dropped, then growth stocks outperformed. Value stocks did well early in the first quarter of 2021 as we exited the Alpha coronavirus phase and interest rates rose as the economy was expected to reaccelerate. The Delta and Omicron variant surges that followed resulted in interest rates dropping again and growth stocks outperforming value stocks.



* IN US DOLLARS. REBASED TO JAN 1, 2021 = 100.
SOURCE: MSCI INC. (SEE COPYRIGHT DECLARATION).

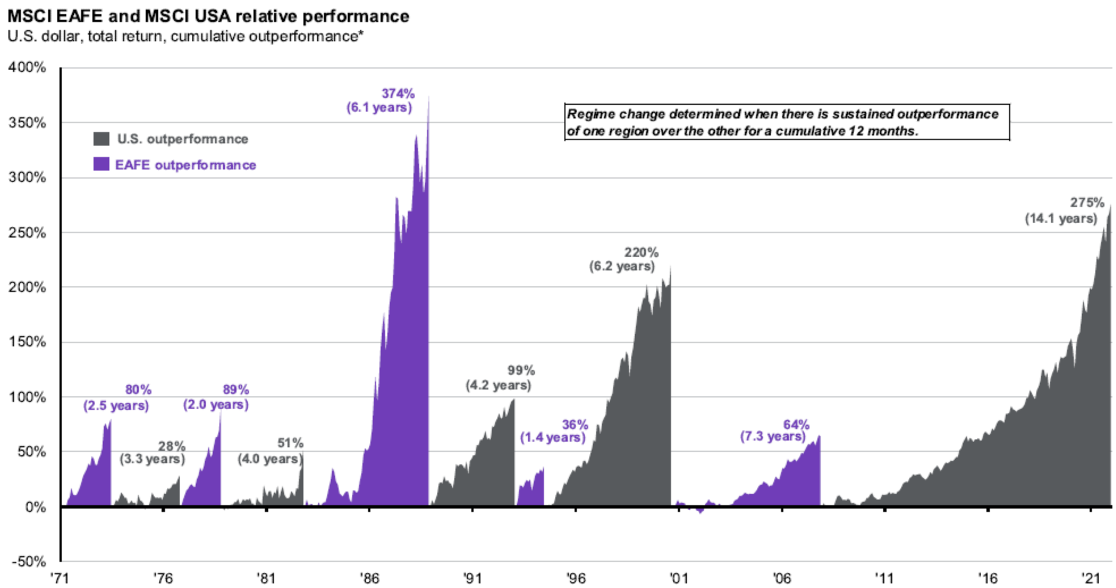
Interest rate increases and the larger effect this can have on growth stocks is covered in our August 2020 "Tech Bubble Deja Vu?" report. Other important factors are also covered in the report here: https://www.wescapgroup.com/2020/08/20/tech-bubble-deja-vu/. Note that since we wrote this report, smaller cap and value stocks have outperformed growth stocks, just as we surmised. This change in stock market leadership may persist for many more years as we move into the post COVID phase. At year-end 2021, the largest 10 stocks made up 30.5% of the S&P 500 index, which is a greater top 10 concentration than at the peak of the 2000 "tech bubble".



Being big is not by itself bad, notwithstanding growing anti-trust and regulation sentiment. However, these firms are also priced extravagantly. The top 10 stocks have a price to earnings (P/E) ratio of 33.2 versus a much less expensive 19.7 for the other 490 stocks in the index (JP Morgan Guide to the markets, left graph, p. 11). Valuations do matter, and expensive stocks tend to eventually disappoint as the extreme revenue and earnings growth required to justify such rich valuations eventually falter.

Should interest rates rise, these high P/E stocks could decline more severely than other stocks. Stock sectors and markets tend to go through fairly long periods of underperformance and outperformance.

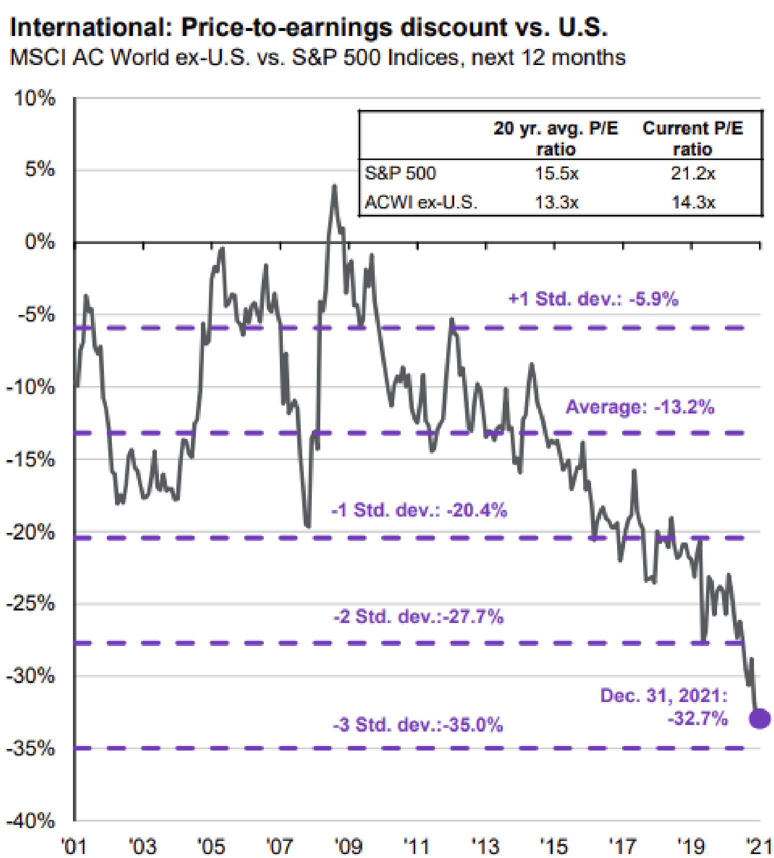
The S&P 500 has been in ascendency for quite some time when compared to foreign stock markets. Nevertheless, this is not always the case. As the following graph shows, foreign stock markets have had extended periods of outperformance (purple sections). Most recently was following the dot.com bubble, when foreign stocks outperformed for 7.3 years. Then, like now, the S&P 500 was expensive and had a high concentration in the 10 largest stocks.



Source: FactSet, MSCI, J.P. Morgan Asset Management. *Cycles of outperformance include a qualitative component to determine turning points in leadership.
Guide to the Markets – U.S. Data are as of December 31, 2021.

J.P.Morgan
ASSET MANAGEMENT

What should be done to avoid either underperformance or losses from the S&P 500 cap-weighted index and from the large mega-cap tech stocks? The answer is simple: **reduce investment in S&P 500 and mega-cap and expensive growth stocks and own less-expensive foreign stocks and small-cap and value stocks.**



Source: FactSet, MSCI, Standard & Poor's, J.P. Morgan Asset Management.
Guide to the Markets – U.S. Data are as of December 31, 2021.

Foreign stocks are at historically low valuations compared to the S&P 500 (left graph).

Over the last 20 years, foreign stocks have never been so inexpensive compared to the S&P 500 on an earnings basis. When might this reverse and foreign stocks begin to outperform? The most likely trigger for this is when COVID concerns and restrictions are in retreat across the globe. Higher interest rates in the U.S., but not in Europe and Japan, could be the beginning of this shift. A reacceleration of global growth in manufacturing and exports would also favor many non-U.S. countries. This should also favor foreign currencies outperforming the U.S. for a while too.

Therefore, we recommend a modest shift away from U.S. growth stocks, including the growth-centric S&P 500 into a diversified basket of foreign stocks.

This doesn't mean abandoning U.S. stocks. **Value stocks—industrials, financials, energy, etc.—are much more attractive than growth stocks.** U.S. value stocks are trading the least expensively to growth since 2001. Value was at its least expensive in 2000 and when the dot.com bubble broke value stocks outperformed for nearly a decade.

	Forward PE		Div. yield**	
Style	Current	Long-term avg.*	Current	Long-term avg.*
Value	15.77x	14.09x	2.00%	2.60%
Growth	30.61x	20.63x	0.71%	1.33%

Source: FactSet, FTSE Russell, NBER, J.P. Morgan Asset Management.

Small cap stocks generally have a value bias too and are also more sensitive to economic growth patterns. So, favoring small-cap stocks in the U.S. and around the world is also expected to provide return outperformance.

While owning growth stocks and the S&P 500 may generate anemic returns the next several years, there are other asset classes and sectors that are poised to provide stronger returns.

Fixed Income Investments

Interest rates in the U.S. generally rose last year. Inflation plus tapering of Federal Reserve stimulus are two factors pushing up longer-term interest rates.

The Fed is likely to increase short-term interest rates in 2022. The Fed has indicated that three rate hikes in the Fed Funds rate is to be expected in 2022, with more possible in both 2022 and 2023. Short-term interest rates near zero, as is the case currently, tend to encourage financial speculation and encourage more borrowing that can fuel inflation. Raising short-term rates is meant to curtail inflation and remove speculative excesses. It is debatable how much inflation will be reduced in the short-run, as interest rate levels have little to do with supply chain disruptions. However, higher interest rates should curtail demand in the longer run. Home and automobile purchases will become more costly when financed. Businesses will pay more for borrowed capital.

We do not expect that U.S. short and long-term interest rates will be raised enough to trigger a recession, at least not for several more years. Nevertheless, interest rate increases are expected to have a significant impact on financial and real estate markets:

1. Longer term, fixed-rate, high-quality bonds would decline in value. For example, a 1% rise in interest rates is expected to cause a price decline in 30-year, 10-year and 2-year Treasury securities of 19.8%, 8.8% and 2%, respectively.

2. As interest rates rise on bonds, they will attract more investors seeking yield. This could pull investor assets away from dividend paying stocks, and real estate securities, thus triggering declines or at least underperformance in those assets.

3. Mortgage and margin borrowing rates would move up. This would make real estate assets less attractive and could result in deleveraging in accounts using margin.

4. As noted before, the equity-risk premium for U.S. stocks would come down, which could result in price/earnings compression and stock price declines. Growth stocks would be particularly vulnerable due to their currently high P/E ratios.

5. Some assets would benefit. Investors with large bank savings accounts or money market funds would begin to receive higher income. Securities that have adjustable rates (e.g., adjustable mortgages, floating rate bank loan securities) would also be able to earn more income as short-term rates rise. Many banks and other lenders could charge more for loans without paying a lot more on deposits, thus improving their profitability.

What should an income-focused investor do? First, **do not buy longer-term, high-quality bonds** or C.D.s now, but wait for interest rates to rise.

Focus on short-term or adjustable-rate fixed income securities. There are many ways (via ETFs and mutual funds) to own ultra-short maturity, variable-rate mortgage and floating-rate bank loan securities. These performed relatively well in 2021 as longer-term interest rates rose and they can do relatively well in 2022 as short-term interest rates rise along with the Fed Funds rate.

People in the market to buy a new home or car or refinance might want to do so soon, before even higher interest rates make these borrowings more costly.

Accepting more credit risk is another way to boost returns in fixed income assets. The higher current interest rates paid on these reduces the breakeven time for owning these should interest rates rise.

High-yield bonds yield close to 4.2%. Default rates are at decades lows thanks to monetary and fiscal stimulus, making this a still-attractive investment. When default rates are poised to rise, perhaps as early as 2023, then it may be time to pivot away from these bonds.

Non-agency (not government insured) mortgage-backed securities also offer attractive yields. They can offer returns 2-4% higher than Treasury note yields. With strong consumer balance sheets and healthy housing and rental markets, these **non-agency mortgage investments offer a good balance of risk and return.** Many also have adjustable interest rates or have short durations.

Foreign bonds have a much wider range of interest rates, depending upon country of origin and whether they are issued in dollars or local currencies. Inflation rates and likely changes to future interest rates also vary considerably. Some are attractive while others are not.

Inflation Protected, Alternative and Hedged Asset Strategies

As discussed earlier, we expect U.S. inflation to moderate later in 2022 and perhaps fall below 2.5% within several years. However, what if inflation is stickier than expected and remains higher than 3% for many years? What is a good strategy for an investor to follow?

One option is to **own assets in other areas of the world where inflation is not as high**. Japan and Europe are two such areas and owning stocks there are also attractive relative to U.S. stocks, as mentioned earlier. Foreign high-yield bonds are attractive in low-inflation countries, though these are harder to find.

Owning Treasury Inflation Protected Securities (TIPS) is a way to receive the U.S. CPI inflation over the duration of the security. However, they currently have a negative yield, excluding the CPI adjustment. As discussed earlier, it doesn't make sense to own these unless inflation is higher than the current breakeven rate (2.77% average 5-year inflation for 5-year TIPs). Also being very long duration assets, they can lose value when interest rates rise sharply.

Similar, but better than TIPS, are I bonds. They don't fluctuate because they don't trade in markets and they will pay exactly what the CPI is for a 6-month period and then reset to the new CPI. However, only $10,000 can be purchased directly from the Treasury each year per individual (see https://www.treasurydirect.gov/indiv/research/indepth/ibonds/res_ibonds.htm for details).

Some assets are thought to be good inflation hedges. These include tangible assets like gold, other commodities and real estate. This might true for very long periods of time (decades) or for countries that experience hyperinflation (1920s Germany), but the correlation of these assets to a normal range of inflation (2-7%/year) is quite low in the short-run. These may provide some inflation protection in some periods and fail in others. Inflation is not the main drivers to shorter-term returns for these assets. They nevertheless tend to have lower correlations to stocks and bonds and can provide decent diversification to own them in addition to stocks and bonds. The same could be said for digital assets and cryptocurrencies, though history is too short to offer much proof yet. Commodities and precious metals have typically underperformed stocks as they have no earnings and pay no interest and growth in demand for these physical assets tend to be less than overall global economic growth. But there can be cycles in these assets that can make them attractive for a period of time.

Stocks and real estate are fairly good long-term inflation hedges. Both can increase prices (or rents) over time to offset the negatives of higher interest rates and input costs. However, when inflation is accelerating unexpectedly, they can react poorly in the short-run as costs tend to rise more quickly than revenue, and higher interest rates, which often follow higher inflation, tend to negatively impact these assets.

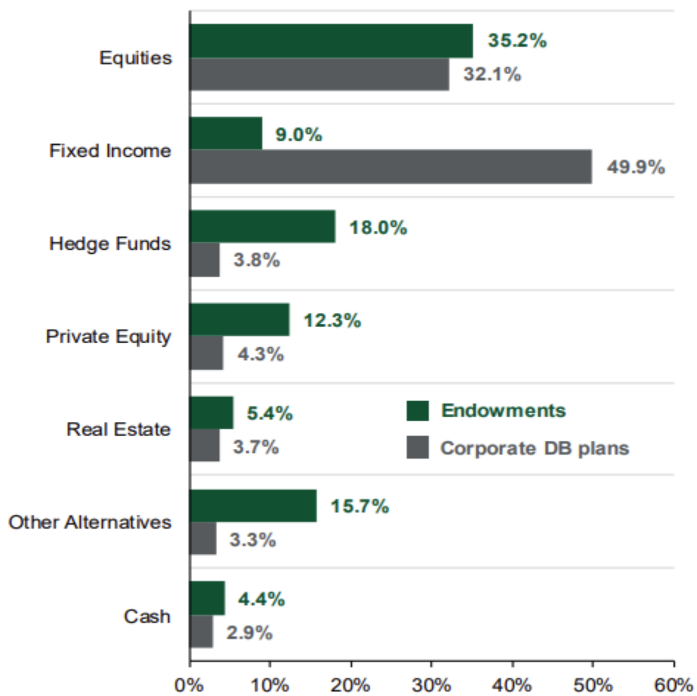
Owning assets or employing strategies that are not highly correlated to stocks, bonds, inflation or interest rates can have an important role in portfolios. **Various hedge fund strategies attempt to hedge out traditional stock or bond market risks.** Such strategies often use a long-short approach, going long the more attractive asset and going short the less attractive asset. Profits are made when the long asset outperforms the short asset and the hedge (being both long and short) tends to keep volatility low. Examples of this include merger-arbitrage, convertible bond arbitrage and long-short various types of fixed income assets. There are many hedge funds that have the flexibility and expertise to follow these strategies. For those who do not qualify for or want to avoid hedge funds, there are a small number of accessible mutual funds that have been successful as well.

Alternative illiquid investment strategies provide another option. This category often includes owning private market investments (e.g., private equity, private debt, art, farmland, private digital assets). Private market investments tend to have higher returns than for public stock and bond markets due to the return premium demanded to hold illiquid assets. There are a number of hedge funds and private investment vehicles that focus on these types of assets. Additionally, over the last few years, there are some publicly-registered closed-end and interval mutual funds that offer ownership in some of these non-liquid assets.

Endowment plans have an unlimited life and in order to increase every year their spending over decades, they tend to gravitate to assets that can generate high risk-adjusted returns. The amount of annual liquidity they need is very low. Notice that endowment plans (green bars below) own a lot of stocks, very little in bonds and cash, and have quite a bit allocated to hedge funds (18%), private equity (12.3%), real estate (5.4%) and “other” alternatives (15.7%). These alternatives to stocks, bonds and cash total to 51.4% for large endowment funds. It is difficult for individual investors to mimic successful endowment plans. Nevertheless, if an investor can find some ways to emulate them, it should provide a financial benefit.

Institutional investor behavior

Asset allocation: Corporate DB plans. endowments



Source: J.P. Morgan Asset Management; (Left) NACUBO (National Association of College and University Business Officers), Towers Watson; (Top right) Milliman Pension Funding Index; (Bottom right) Census for Governments, Compustat, FactSet, S&P 500 corporate 10-Ks. Endowment asset allocation is as of 2019. Corporate DB plan asset allocation as of 2018. Endowments represents dollar-weighted average data of 749 colleges and universities. Corporate DB plans represents aggregate asset 12/31/2020 of Fortune 1000 pension plans. Pension return assumptions based on all available and reported data from S&P 500 Index companies and are as of 12/31/2019. State and local pension return assumptions are weighted by plan size. Pension assets, liabilities and funded status based on Milliman 100 companies reporting pension data as of December 2021. All information is shown for illustrative purposes only.
Guide to the Markets – U.S. Data are as of December 31, 2021.

Hedge fund, illiquid, and alternative strategies can be very diverse, as can be the mutual funds and ETFs following similar strategies. Considerable expertise is required for understanding pros and cons of various approaches. We are available to discuss these investments.

<u>Conclusion</u>

Volatility is expected to be high for stocks. U.S. fixed income investments are facing a number of headwinds. Stock valuations are high, but not too high, unless or until interest rates increase. Value stocks, small stocks and foreign stocks offer the best prospects of above average returns. Short-term and variable-rate and credit-sensitive fixed income investments are expected to offer better returns than long-term high-quality U.S. fixed income assets. Alternative and hedge fund-like assets can provide respectable and even high returns and offer diversification from stocks and bonds.

WESCAP will continue in its efforts to add value by following a disciplined asset allocation approach tailored to appropriate risks, with frequent rebalancings, while taking advantage of market and valuation trading opportunities. Income tax considerations will also be taken into account as appropriate.

For more details, please contact your WESCAP Group advisor.