CHIEF INVESTMENT OFFICE

Investment Strategy Overview — Executive Summary

The Great New Dawn

December 2021

All data, projections and opinions are as of the date of this report and subject to change.

The Great New Dawn is our version of the beginning of a post-pandemic world. This is a world led by the continued acceleration of innovation, balanced removal of a record level of global monetary accommodation, a shift toward infrastructure redevelopment, and a consumer that more aggressively shifts their spending toward services, including travel, leisure and entertainment. *The Great New Dawn* is the first light of a new "post-pandemic" day.

This era will contain new shifts, adjustments, some major pivots, and further structural changes away from what dominated the pandemic cycle as well as the post-Global Financial Crisis (GFC) period over a decade ago (Exhibit 1). Still, we believe a few core catalysts and concerns will likely remain. These include above-average nominal gross domestic product (GDP) growth, elevated inflation, labor market shortages, energy dislocations, a strong private sector, wage growth, new coronavirus variant concerns, worries over the U.S.-China relationship, and an Equity asset class that is still significantly favorable relative to Fixed Income.

The New Dawn means a transition from a pandemic-led, pent-up demand cycle with multiple waves of growth to a potentially lower and smoother, but still-above-average, nominal economic growth cycle. Inflation will remain a force that lasts longer than most expect, in our view. However, this could propel revenue growth in areas of strong pricing power and keep the profit cycle from rolling over too quickly, even if the Fed pivots more aggressively.

In our view of this period, the Fed begins its pivot from ultra-accommodation, dominated by emergency programs, liquidity and balance sheet expansion with zero interest rate policy, to tapering (slowing its bond purchases or less easing), ending the balance sheet expansion and lift off from the zero percent fed funds rate. In the private sector, balance sheets would remain healthy, labor issues abate somewhat, but structural deficiencies persist, operating leverage continues to drive record level profits, even as some favorable revenue and wide spread pricing power trends normalize somewhat, and supply chain disruptions maintain top of mind status but ease later in the year.

For 2022, we expect a "grind it out" market environment in which valuations could remain flat or slightly decline but with profit growth to supersede this and Equity outperformance to continue.

Christopher Hyzy
Chief Investment Officer

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Are Not FDIC Insured	Are Not Bank Guaranteed	May Lose Value

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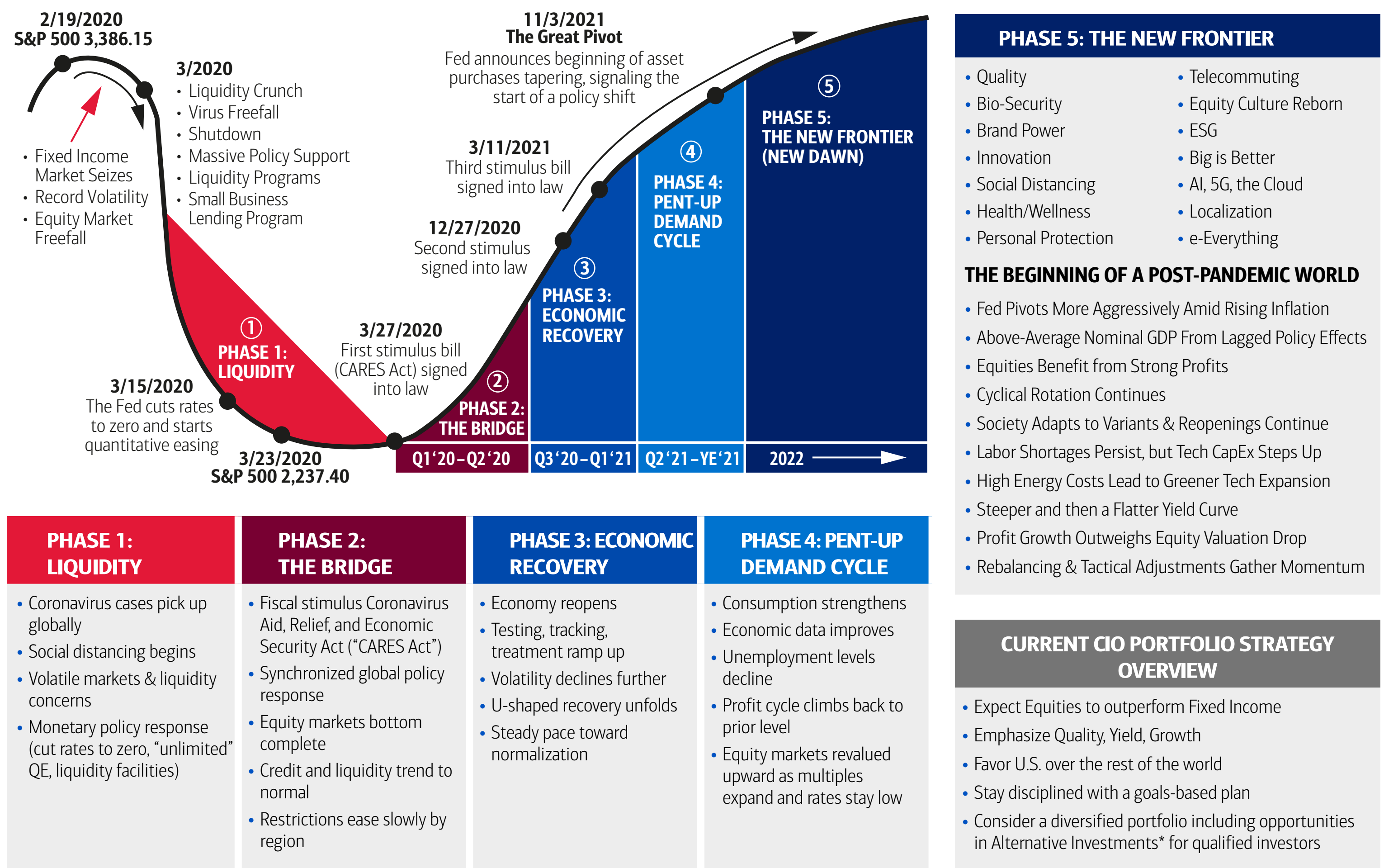
Exhibit 1: The Journey from the Great Separation to *The Great New Dawn*.



Black line represents the lifecycle of the CIO economic workout process and is not meant to represent any specific investment, index or performance of any kind. Phase 5 represents the CIO outlook for potential economic expansion. *Many products that pursue Alternative Investment strategies, specifically Private Equity and Hedge Funds, are available only to qualified investors. Source: Chief Investment Office. Data as of December 7, 2021. CIO views are subject to change. The economic and market forecasts presented are for informational purposes as of December 7, 2021. Economic or financial forecasts are inherently limited and should not be relied on as indicators of future investment performance.

The catalysts of a post-pandemic economy shift toward increasing capital investment, more normal consumer spending patterns, less government stimulus outlays, more regionalization in supply chains, and above-trend economic growth, in our view. We also see the early stages of a Fed pivot, a private sector focused on building new industries, a profit cycle not ready to tire out and peak, greater penetration of coronavirus vaccinations even in the face of new variants, improved treatments and therapeutics, and a bull market that may not produce as many sunny days but can still shine its rays through the clouds.

This broader environment begins to pivot to today's "normal"—*The Great New Dawn*—and away from the past pre-pandemic cycle, which was driven by disinflation, anemic growth and debt overhanging the household and private sector.

THE CIO'S TEN NEW DAWN CHARACTERISTICS:

1. The Fed likely needs to eventually pivot more aggressively to ultimately bring inflation back down closer to their targets. Does the Fed raise its inflation target before all is said and done?

2. Above-average nominal GDP growth remains in place through 2022 as the lagged effect of ultra accommodative monetary and fiscal policies continue to filter through, despite tapering and no new fiscal packages. Strong aggregate demand, elevated inflation, wage growth and supply shortages are, to a degree, still expanding elements that underpin the macro backdrop.

3. Equity markets continue to benefit from better-than-expected revenues with profits tracking nominal growth expectations providing fundamental support.

4. The rotation in the equity capital markets is still early in its life cycle and should continue throughout 2022. Cyclicals, higher quality, high free cash flow, Value, dividend growth and Small-cap segments of the Equity asset class should play catch up and look to the broader market, more defensive, longer-duration and higher-growth areas.

5. As new coronavirus variants are studied, society learns to adapt and continue toward a full reopening process, in our view. Some goods spending should shift back toward services over time.

6. Structural labor shortages are likely to remain in *The Great New Dawn* as the outgrowth of new areas (e.g. warehousing, infrastructure, etc.) attract workers from select traditional service industries. This dynamic helps drive a new capital expenditure (capex) cycle in spending on automation, robotics and other productivity-inducing activities.

7. Concerns over higher energy costs continue, given high demand and below-average capital investment in traditional sources. Greener technology investment expands as "trade-off" costs become more balanced; the shift toward more renewable energy sources sustains upside pressure on many minerals and metals, given the metal/material-intensity of electric vehicles, solar panels and wind power.

8. The yield curve between the fed funds rate and the 10-year Treasury yield steepens in the first half of 2022 before ultimately flattening later in the year. The negative real rate environment continues for the foreseeable future.

9. Rising yields hamper bond market returns as Equity returns take their cue from the overall level of corporate profit growth. The growth in profits should outweigh the potential drop in Equity valuations, in our view.

10. More active rebalancing and tactical adjustments are likely needed in 2022, given that we expect the Fed's policy adjustment, elevated nominal growth, higher yields and cyclical rotation to gather momentum. Alternative Investments, for qualified investors, may be an important asset class for access to diversification, hedged market participation, yield, and enhanced returns, as appropriate. Additionally, investors have an opportunity to integrate environment, social and governance (ESG) metrics and overlays into their valuation and risk/return considerations.

As we begin transitioning from a pandemic-led pent-up demand cycle with multiple waves of growth to a potentially lower and smoother but still above-average nominal economic growth cycle, we believe "The Pivot Is On." This still-developing macro and investment environment could contain new shifts (elevated inflation), adjustments (Fed policy), some major pivots (cyclical rotation) and further structural changes (employment trends) away from some factors that dominated the pandemic cycle. We discuss three scenarios below.

1. Base Case

For 2022, we expect a grind-it-out market environment in which valuations could remain flat or slightly decline but with profit growth to supersede this and Equity outperformance to continue. With 2021 mostly about much higher profits than expected and 2020 more about expanding multiples, we believe that for 2022, return expectations, including dividends in the U.S., are likely to track profit growth. New variant worries should dissipate but the pandemic still keeps a full reopening at bay.

Rotation toward cyclicals and more Value-oriented areas including Small-caps is preferred, and the long-duration, high-growth, little-to-no-profit areas come under continued pressure.

Sectors and industries with pricing power (Energy, Materials, Industrials—infrastructure-related—and Financials), economic leverage and strong profits growth mixed with attractive valuations dominate the year, in our view. Included in this environment, we expect dividend growth and higher-quality areas with low balance sheet leverage to also outperform. We still expect high free cash flow, strong balance sheet and mega Technology also to do well. This scenario may carry higher volatility and perhaps multiple pullbacks but we would leverage these as potential buying opportunities, particularly as we begin the year.

Yield drifts could go higher tracking inflation and stronger economic growth. The curve may shift upward and steeper between federal funds and the 10-year Treasury. We favor credit overall, especially Investment-grade, and also prefer municipal relative to Treasurys, but we would maintain a shorter-duration stance.

Commodity exposure is favored via Equities, in our view, with gold being considered as a potential hedge on elevated inflation, although we do not foresee a direct correlation between its price and inflation throughout the year.

2. Most Bullish Case

This Most Bullish Case could include even better-than-expected profit growth as reopening worries fade, multiples slightly rise as capital investment, stronger consumer spending than anticipated, continued pricing power, liquidity remains high, and above-average revenue growth continues. In addition, new variants would turn out to be mild and the reopening of the economy accelerates.

The Fed removes ultra-accommodation, but the market is prepared for it given the high growth. The job market surpasses expectations, but inflation creeps higher maintaining a negative real rate environment. Nominal economic growth surpasses consensus expectations handily.

Valuations actually expand slightly given the comfort level for risk rising. Yields back up and the curve steepens, keeping financial conditions stimulative.

Risk aversion wanes even if the “wall of worry” is maintained. A subtle rise in valuations mixed with very strong profit growth and still-healthy financial conditions would lead to Equity total returns closer to 15%-20% in the U.S., in our view.

A rotation to cyclicals is accelerated where Value, Small-caps, reflationary sectors and industries outperform. Financials, Energy, Materials and Industrials are most preferred. Some mega Technology with high free cash flow should also do well, in our view.

Yields would back up more-than-expected and the Fed would likely remove policy faster and hike interest rates more than expected but, again, investors would most likely take this in stride.

Non-U.S. markets would likely rise in sympathy with the U.S. and could exhibit some quarterly outperformance. If the new variants fade quicker or are milder than expected, emerging markets (EM) would likely outperform for the first time in years.

This scenario is not without worry or pullbacks, but we would be buyers on weakness as we begin the year in Equities in this scenario.

3. Downside Case

This case is somewhat straightforward but includes more complexity, in our opinion.

This Downside Case, our least probable case, is one that could include lower valuations (pressured by rising rates due to much higher inflation, much lower liquidity, and slower growth—in other words very low confidence in the future), a peak in corporate profits and a nominal economic growth backdrop that performs well below expectations.

The Fed would maintain its recent pivot, and accelerate tapering and raise rates into a much slower growth environment which creates rising real concerns over stagflation. In addition, new variants would become a force that slows growth down further but inflation creeps higher given extended goods buying and supply chain disruptions.

Cyclicals, Commodities and reopening investments correct with Technology and Growth segments declining as well, given the potential for both slower growth (new variant worries) and higher short rates (tighter Fed).

The yield curve ultimately flattens and recycles the worries over stagflation. Gold could be considered a potential hedge but not directly, in our view.

Risk assets, namely higher beta areas including non-U.S. markets, would likely also come under pressure as the U.S. dominates the growth curve globally—a slower U.S. and slower China would lead to a slowdown globally, in our view.

More defensive assets, sectors and industries would be preferred including investments with strong dividend growth.

Summary

In summary, our Base Case represents our highest probability scenario with the Most Bullish Case next and then the Downside Case. The commonality across all three scenarios is that we believe all things considered, high quality, free cash flows and dividend growth as factors are all attractive.

We still prefer more cyclical and Value exposure overall given our view that a large rotation toward these areas continues throughout 2022 mixed with strong mega Technology free cash flow companies. Finally, we significantly prefer Equities relative to Fixed Income in our Base Case.

There will be time much later down the road, post 2022, to worry more about the magnitude of Fed tightening (less liquidity) and how this could affect the broader growth level in the economy, corporate profits and Equity valuations.

You can find additional information on the themes discussed above in the full Investment Strategy Overview, *which includes additional investment insights and answers to important questions regarding the global market environment and portfolio positioning.*

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