CHIEF INVESTMENT OFFICE

Investment Insights

The Meerkats and the Buffalo Market

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

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The Technology stock rout that began the year has carried over into the broader market as we head into the final trading week of January. Volatility has not only increased it has stayed elevated as portfolio repositioning continues. Investors have become more defensive in their exposure at the asset class level and within equities overall. Many are using their proceeds from longer duration, growth momentum, and less profitable areas of the marketplace—the concept over profit segments of the market—(older, established Technology companies have not been spared either) and repositioning into direct energy beneficiaries, plus higher quality, stable earnings, and dividend payers. This backdrop has created an imbalance in equities. Stock sales from higher equity market capitalization areas, namely Technology, Consumer Discretionary and Healthcare sectors, have generally moved to lower capitalization areas (Energy, Materials) and off to the sidelines. This has accelerated as a few key concerns have converged—tightening by the Federal Reserve (Fed), rising oil prices, slowing growth in China, geopolitical risks, mid-term election worries, and the inflation cost equation).

In our year-ahead Investment Strategy Overview report—The Great New Dawn—we outlined a market thesis for 2022 that included higher volatility, a grind-it-out type of pattern for the year, and one that is likely to incur larger pull-backs than occurred in 2021. As a point of reference, there was only one 5% draw-down in the S&P 500 last year, in September. We call this a "buffalo market." One that is still in the bull family but tends to roam more, get spooked easily, and is less attractive overall, but in a positive uptrend. In addition to this "buffalo market" trend dynamic we have smaller "actors" pressuring risk-taking to begin the year. These actors, in our perspective, can be considered meerkats, or shorter-term "active risk" investors who tend to hide out and burrow in the ridge at the first sense of danger. We experienced meerkat activity back in the fourth quarter of 2018 as the Fed began to tighten and the trade war with China created dark clouds. Sharp, quick moves out of the center and into the ridge (sidelines) can create elevated volatility, knock-on portfolio repositioning effects as risk aversion rises, and a push-pull grind-it-out marketplace when all is said and done. In addition, rolling corrections like this can create attractive buying opportunities, particularly in areas such as greater value sectors like Financials, Energy and Industrials or higher-quality companies, the dividend growers, or stocks with stable earnings streams. These areas have historically performed well in the early stages of Fed hiking cycles.

For the foreseeable future, the broader equity market is trying to come to grips with competing story lines and factors. One is that it is coming off of three straight years of double-digit percentage gains driven by record emergency liquidity and valuation expansion, followed by extraordinary profit increases. And another includes growing concerns surrounding the Fed's pivot in rates and balance sheet contraction, as well as heightened geopolitical risk and the clouds overhanging the upcoming mid-term

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elections. This “tug of war” is what creates a grind-it-out environment across asset classes and specifically within the broader equity markets. We believe the key to the ultimate direction for 2022 continues to be the degree to which corporate profits can supersede the level of valuation decline as rates rise. With nominal economic growth still expected to be above average for this year, albeit slowing, corporate profits to benefit from pricing power and pent-up demand tailwinds, and the risk markets already pricing in the most hawkish rate forecasts by the Fed, we expect this sharp pull-back in stocks to ultimately prove to be a buying opportunity for long-term investors.

Furthermore, worries over still-high equity valuations, despite the last sharp downswing, are normal. However, it’s important to ask questions as to why valuations are sizably higher than normal versus history, and whether one can compare today’s price-to-earnings level to those for other economic and market backdrops that contain significantly different drivers, inputs, and actors! In our view, there is a justifiable foundation for “higher than normal valuations” in today’s more flexible, innovative, diversified economy and incredibly efficient corporate sector (very high profits per full-time employee versus any point in history) mixed with a very large and growing pool of investors (domestic and foreign) not to mention a still very low cost of capital (even if it is adjusting slightly upward) and low supply of assets relative to demand.

The Fed is on a clear path toward removing some of the excess liquidity that was added since the onset of the pandemic. They are likely to bump rates multiple times through this year with the terminal Fed funds rate expected to eventually reach somewhere around 2% to 2.5% when the hiking cycle is complete. Some are even expecting a potential 50-basis-point (bp) hike early in the Fed cycle, with the first increase expected in March (the Fed has never started a hiking campaign with a 50-bp increase right out of the gate). Moreover, mid-term election years have historically included larger than normal corrections in the equity market throughout history but have also included strong rebounds in the next few quarters that follow the election.

History doesn’t necessarily repeat itself, but we find it can be a useful guide for the longer-term investors who have a well-defined plan. According to Bloomberg data, there have been 12 Fed hiking cycles since the 1950s, which have on average produced a 9 percent gain annually with 11 out of the 12 cycles including a positive return. In summary, Fed hiking cycles have historically not been an anchor on equity returns.

Finally, we believe the most important factor for 2022 as we incur higher volatility yet still-rising corporate profits is diversification—an often-mentioned but generally under-utilized word. Rising profits, even if they are slowing down in growth from last year, still provide a solid foundation for equities relative to bonds. The key is to increase the quality of the portfolio as volatility increases and valuation finds its new footing. Additionally, in our view, even though we expect yields to head higher, this latest move upward can provide opportunities for higher cash flows and potential diversification benefits if the Fed ultimately goes too far.

We believe the meerkats are just about ready to end their burrowing as the realization takes hold that profits are still strong and some of the concerns are well discounted. We expect this to help bring down the spike in volatility and foster occasional rallies. We prefer established, higher-quality Technology versus the less profitable kind, higher-valued areas, Energy and Financials for higher earnings growth and dividends, and Industrials for exposure to infrastructure overall. We emphasize Value relative to Growth and also slightly prefer small-capitalization shares, which are trading at about a 25% discount to their large-cap peers (the lowest since 2000 and lower than March 2020). The non-U.S. markets are generally at a large discount to U.S. Equities and are expected to produce attractive earnings, but we still worry about the broader geopolitical outlook, the potential negative effect of higher oil prices, a secular slowdown in China and an extension of the pandemic. The latter is still wreaking havoc with global supply chains. At the broad asset class level, we continue to emphasize a balanced risk budget in our Chief Investment Office portfolios with an overweight to Equities relative to Fixed Income.

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