CHIEF INVESTMENT OFFICE

Investment Insights

A New Cycle Requires New Positioning

June 2022

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

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Data as of 6/21/2022 and subject to change.

The Big Shift From Secular Stagnation From the Post Great Financial Crisis Era to Elevated Inflation And Tighter Monetary Policy

During 2016 to 2019, the U.S. economy was in the back half of a 128-month-long economic expansion, the longest in history dating back to 1854.[1] While the duration of this expansion was longer than average, the pace was unusually slow, with real annual gross domestic product (GDP) in the U.S. expanding by 2.3%[2] on average in the years leading up to 2020. Inflation consistently fell short of 2%, business spending was sluggish, and the global economic outlook was clouded with uncertainty amid increasing trade tensions between the U.S. and China. Monetary and fiscal policies remained supportive, and sentiment continued to steadily improve. The labor market finally recovered from the 2008 crisis, with the unemployment rate hovering near 4% for the last 24 months of the expansion.[3]

The slow expansion era came to a sudden halt in March 2020, when the pandemic ushered in the sharpest global recession in history. In the U.S., the ensuing recovery marked a paradigm shift in monetary policy as the Federal Reserve (Fed) let the economy “run hot” in an effort to spur labor market growth, ending the disinflationary trend of the previous cycle. The Fed’s balance sheet increased to roughly 38% of GDP as record levels of fiscal stimulus were deployed, leaving consumers flush with cash. Business spending rose sharply as companies responded to the scarcity of labor by investing in productivity-boosting automation. Amid the confluence of these events, growth came roaring back, with real U.S. GDP expanding by 5.7% in 2021 and inflation hitting the highest levels since the 1980s. (Exhibit 1)

Exhibit 1: Changing Macro And Market Forces Needs A New Approach For Investors.

	The Slow Expansion Era (2016–2019)	The Pandemic Disruption Era (2020–2021)	The Great New Dawn Era (2022–Beyond)
Real Growth	Remained anemic near 2%	Historically high near 4–6%	Should glide lower to trend levels
Inflation	Generally below Fed’s target	Rose to over 7% for Consumer Price Index	Moderates but stays above Fed target
Money supply	Normal 3–7% expansion	Exploded higher to 13-25%	Slows substantially, potentially declining
Fed funds rate	Gradual increase to 2.50%	At zero bound	Historically fast hiking cycle expected
Fed balance sheet	Increased to ~$4.5 trillion	Increased to ~$9 trillion	Quantitative tightening
Fiscal stimulus	Tax cuts to improve U.S. corporate competitiveness	Stimulus to support households, state & local governments, small businesses	Fiscal drag given less likelihood of new spending
Company fundamentals	U.S. earnings outpaced International; shareholder returns favored over capital expenditures (capex); companies maintained leverage over labor	Profit margins rose; large companies fared better from pandemic disruptions; technology began to reshape business models; capex rose	Earnings slow off of their cyclical peak; dispersion based on pricing power and economic moat; accelerating creative disruption; labor gains leverage

Source: Chief Investment Office (CIO). Data as of June 17, 2022. CIO views are subject to change.

[1] National Bureau of Economic Research, June 8, 2020.
[2] Federal Reserve Economic Data, annual average growth rate for real GDP from 2016 to 2019.
[3] Center on Budget and Policy Priorities, March 8, 2022.

The Current Macro Phase (2022 onward)

In our view, 2022 marks the beginning of a new era that begins with a reset period involving some hangover from the pandemic excesses, higher economic volatility, geopolitical uncertainty and massive innovation and technological advances. The pace of real economic growth should moderate but the underlying forces should remain with capital investment, productivity growth, and consumer pent-up demand for services. In terms of the equity market, some sharp give-back of the more than 100% gains in the S&P 500 Index from the lows of March 2020 is very stressful but somewhat normal. This reset period, which began in Q2 2022, in our opinion, is an accelerated move lower in asset prices as monetary policy has tightened, yields have sharply increased, given stickier inflation and slowing growth.

However, in 2022 nominal GDP growth should be supported by inflation, which is likely to remain persistently high given commodity shortages and accelerating wages. To counteract this, central banks in developed economies, led by the Fed, have begun to tighten policy aggressively by raising interest rates and shrinking their balance sheets, creating further upside for bond yields. Since the Global Financial Crisis, we believe investors have greatly benefited from the "everyone gets a trophy" liquidity regime driven by the dovish leaning of global central banks at the first hint of a growth slowdown. While a sluggish inflationary environment justified this stance, now, with inflation levels at 40-year highs, policy makers will lean more hawkish, at least in the near term, and keep tightening even as the economy slows, resulting in shrinking the liquidity flow into the financial markets and the real economy. This creates a reset period within the Great New Dawn era.

With the risks that if policymakers apply too much tightening as structural factors pressure world growth, then longer-dated yields could come back down, and the cycle of higher rates could be stopped in its tracks. This dynamic continues to filter through asset classes with competing forces at work. We expect this to gather some momentum heading into and early 2023.

Market Regimes Are Evolving Through The Cycle

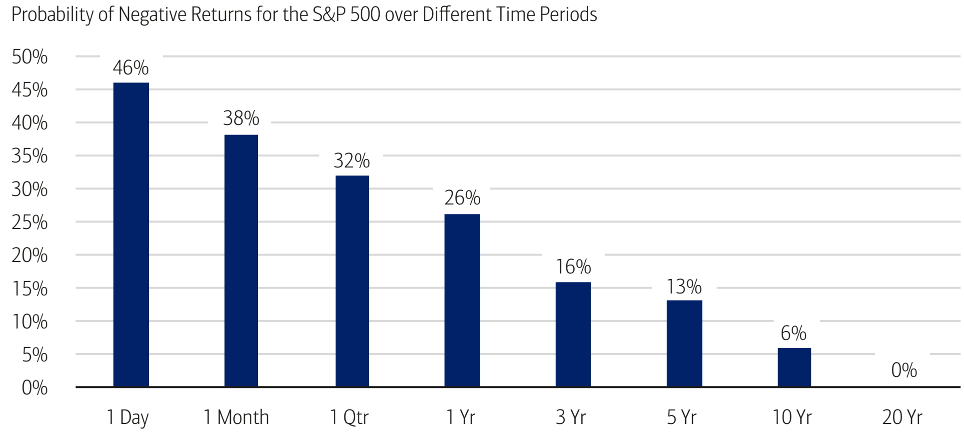
We believe tightening financial conditions and rising real rates should keep market volatility at a higher level in 2022 and 2023 than in the years preceding the pandemic. There is a wide range of outcomes for the pandemic, inflation, interest rates and geopolitical risks. Therefore, investors should continue to remain anchored in their long-term asset allocation and ensure appropriate diversification.

Additionally, the importance of active portfolio management[4] including selection of investment solutions, portfolio adjustment and rebalancing, is paramount now than ever before. Even if near-term trends seem treacherous, investors should not try to time the markets developments in a substantial way and keep maintaining the balance of global diversification, interest rate and credit risk, and Value and Growth exposure. Long-term investors are usually rewarded for their patience, as the probability of negative returns for the S&P 500 Index over a 10-year time horizon is only 6% (Exhibit 2).[5] We believe investors should monitor holistic changes in the profit cycle and the central banks' reaction function to inflation data, and be "nimble" along with the Fed, as the endgame for inflation remains uncertain. Rebalancing opportunities may come up with long-term investors finding opportunities to consider increasing exposure to high-quality equity investments at lower prices every now and then, income-seeking investors receiving potentially better yields in the bond market, and savers starting to see more reasonable returns from their cash holdings.

[4] Active management seeks to outperform benchmarks through active investment decisions such as asset allocation and investment selection.

[5] BofA Global Research, April 29 2022. Based on S&P 500 total returns from 1929-3/2022.

Exhibit 2: Over Time, The Probability Of Negative Returns Decreases When Staying Invested In The S&P 500.



Source: BofA Global Research. Data as of March 31, 2022. Data reflects probability of negative equity returns going back to 1929 based on S&P 500 performance. **Indexes are unmanaged. It is not possible to invest directly in an index. Past performance is no guarantee of future results. Please refer to index definitions and important disclosures at the end of this report.**

Ultimately, we believe a disciplined investment process that provides an optimal mix of financial and real assets should help with the probability for achieving one's long-term financial goals and cash flow requirements. This would start with a personal investment policy statement that lays out those goals and a tolerance for assumed risk in the financial markets, and requires frequently reviewing the plan with regular updates for any changed life circumstances. As part of a disciplined investment strategy, investors should have a flexible and realistic goals-based spending and withdrawal strategy, which we consider as important as asset allocation in seeking long-term success. It is important that risk budgeting, asset-liability management, and planning and tax efficiency must all work together.

Finally, against a backdrop of a stressed economic and operating environment, we see a higher scrutiny on companies and governments regarding progress toward sustainability targets. Investors have the opportunity to integrate environmental, social and governance (ESG) metrics and overlays into their valuation and risk/return considerations. In our opinion, this should help make for a more robust and holistic investment process that potentially better weathers market fragility, policy changes and sustainability challenges while participating in the new business and market cycle.

Taking The Tax-Efficient Path On the Road to Rebalancing and Diversification

As mentioned above, given the economic transition occurring over the past several months, investors may need to consider repositioning and rebalancing their portfolios so they remain anchored in an appropriate long-term allocation strategy. However, with strong equity returns during the past decade plus, many investors may be holding positions that, despite the recent equity market performance, have appreciated substantially since they were purchased. The psychological effect of selling positions that have declined from all-time highs, yet still owing income tax on realized gains, could make some investors hesitant to make asset allocation changes despite these economic changes. Investors might consider certain strategies to realign their investment portfolio while limiting the tax impact.

First, an individual wishing to add to his or her investment portfolio may consider investing cash into an equity strategy that seeks to recognize (harvest) capital losses when possible, while tracking a specified index. These capital losses can generally be used to offset any gains realized on the investor's positions that are sold during the same tax year. For these strategies, market volatility often will provide more opportunities to generate tax losses while still managing the portfolio to track the performance of a specified index. Second, when making portfolio adjustments, investors should be aware that tax-advantaged retirement accounts such as 401(k)s, traditional and Roth Individual Retirement Accounts (IRA) can be rebalanced without any tax impact. Taking a total portfolio perspective of asset allocation, including taxable and retirement accounts, may allow an investor to reposition their overall asset allocation while minimizing the tax impact. Of course, asset location decisions should also be integrated with the rebalancing. Finally, an investor may reduce exposure to certain appreciated holdings by making in-kind gifts to charitable organizations. Such gifts may provide the individual an income tax deduction for the fair market value of the donated asset, while eliminating the embedded gain from their portfolio.

Taxes, alone, certainly should not drive an investor's portfolio strategy. Employing a combination of these strategies may provide investors with an opportunity to reposition their investments to reflect the current economic landscape and help keep them anchored to their long-term asset allocation while limiting the tax impact of making these adjustments.

Portfolio Adjustments for the New Era

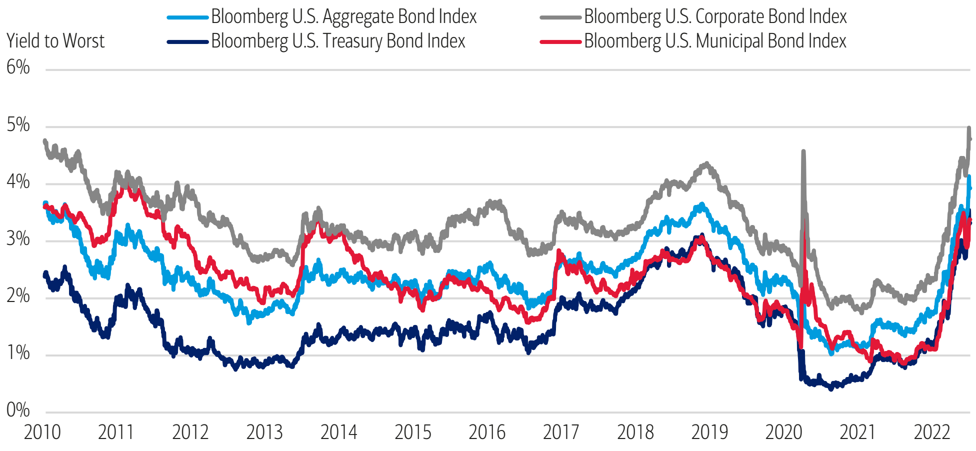
Going forward, investor positioning may need to be more micro than macro as the effect of rising rates and inflation will be specific to sectors, industries and companies, leading to a higher dispersion in earnings. Dividend yield/growth, high-quality, free cash flow and pricing power are characteristics that are likely to be rewarded in the marketplace, and, in our view, the opportunity set for fundamental research-driven actively managed strategies has improved. Dividend-growth Equities may offer an attractive combination of higher-quality, stable earnings growth and some insulation against inflation. Historically, dividends have contributed close to 40% of total return of the S&P 500 Index.This was ignored when Equities appreciated by 90% during 2019–2021, but dividends should become a more significant contributor going forward.[6]

Quality is subjective but investment managers usually define it as some combination of good balance sheets, free cash flow generation, defensible profit margins, low earnings variability and high return on equity. Research[7] shows that high-quality stocks outperform low-quality and the broader market over time and tend to exhibit lower variability and drawdowns during recessions. On an aggregate basis, maintaining a high level of diversification across a variety of Equity solutions is most important, in our view, particularly in a new era that contains elevated uncertainty and lower central bank liquidity.

Bonds are generally not attractive in inflationary times, and we remain overall cautious on the asset class. Swiftly rising interest rates and wider credit spreads have been detrimental for Fixed Income returns this year. While a further rise in rates is likely, current yield levels are quite respectable for income-seeking investors. Short-term Treasurys and corporates should be favored by investors worried about rate volatility (Exhibit 3). We prefer taking credit risk and keeping duration risk at below benchmark levels given our forecast for higher-than-average inflation over the intermediate term, continued strong credit fundamentals, and more attractive valuations as a result of recent volatility. Furthermore, we believe municipals provide value over Treasurys for tax-sensitive investors. And muni fundamentals are benefiting from growing tax collections, generous fiscal stimulus, and higher pension funding levels.

[6] BofA Global Research, April 13, 2022.
[7] ClearBridge Investments; Deconstructing High-Quality Equity Outperformance; May 2021.

Exhibit 3: Short Term Treasury And Corporate Yields.



Sources: Bloomberg. Data as of June 21, 2022. Performance during periods of exceptional market conditions should not be expected to be repeated in a normal market environment. **Indexes are unmanaged. It is not possible to invest directly in an index. Past performance is no guarantee of future results. Please refer to index definitions and important disclosures at the end of this report.**

Having some allocation to Alternative Investments, for qualified investors, for the purposes of capital appreciation, yield, inflation protection, and non-correlated exposure to traditional asset classes should potentially be beneficial to portfolios. As Alternative Investments are speculative and involve a high degree risk, the amount allocated to alternative assets depends on an investor's financial goals, risk tolerance and time horizon, and liquidity and diversification needs. We are constructive on Equity Hedge as short exposure could potentially be accretive to performance in declining markets and could help lower the volatility of a portfolio, making it easier for investors to "stay the course" and not overreact to market volatility. Additionally, Discretionary Macro managers are directionally agnostic and have the ability to take advantage of divergence in interest rates and foreign currency globally with historically low correlation to a traditional portfolio.

Investors may also want to consider allocating to Real Assets in an environment of higher persistent inflation dynamics. Real Assets could include Commodities like gold, basic metals and energy; Real Estate such as land and commercial properties such as apartments, offices, warehouses etc.; or even infrastructure assets such as toll roads, pipelines, airports etc. The value of Real Assets comes from the underlying link to hard assets and their utilization, rising demand or supply scarcity. Their benefit in a portfolio comes from their lower correlation to traditional assets, ability to hedge against rising inflation and to provide nontraditional sources of income such as from real estate and infrastructure. In today's high-inflation regime, Equities and Fixed Income are typically unable to diversify each other as in low inflation regimes. Over the last few years, Equity pullbacks were generally met with bond rallies and a balanced stock/bond portfolio performed reasonably well even in Equity drawdowns. This year's market action has been distinctly different, with both these traditional assets selling off together. However, Commodities, reflecting the higher-inflation environment, and greater demand and supply shortages, in our opinion, have been performing well.

CONCLUSION

During 2022 and beyond, the macroenvironment should be characterized by geopolitical uncertainty, higher and persistent inflation, lower liquidity to support financial assets, and higher interest rates and, thus elevated volatility in Equities and Fixed Income along with lower returns. Investors will have to make sure their financial plan, tax- and asset-liability management are working together; be appropriately diversified, for their situation; deploy holistic and active portfolio management. A new cycle would require new adjustments to investors' core portfolio and considerations of Alternative Investments if appropriate.

Long-term investors should consider assessing their strategic asset allocation anchor in order to maintain the course to help achieve their goals and objectives. As this cyclical bear market enters the bottoming-out process in the coming six to nine months as earnings estimates are reset, rebalancing opportunities should present themselves, in our view. During these rebalancing opportunities, it is important to increase (or maintain) a high level of diversification and to consider adding higher quality, more defensive investments that are less sensitive to overall economic activity. Companies with attractive dividends that are growing consistently and within sectors that are exhibiting elevated free cash flow should represent an area that investors may want to consider adding to in the coming months. At the index level, we continue to favor the broader, more diverse indexes with a value bias in the U.S. relative to the rest of the world. We expect two to three main rebalancing opportunities through the spring of 2023, which parallels the Fed tightening cycle. During this time frame, in our view, a long-term investor who emphasizes rebalancing their portfolio and one who adds Real Assets to their core portfolio can help build a solid base to grow over time, as this new cycle continues to evolve and unfold in the coming years.

As recession risks for the next 12–18 months have risen significantly and bond yields have increased to more attractive levels, one of the key portfolio strategy decisions in the second half of this year is likely centered around when to increase exposure to traditional Fixed Income. This decision, in our view, is another component within the reset period that multi-asset investors will grapple with particularly as inflation begins to come back down and growth slows to a crawl. Finally, another major portfolio strategy decision involves more long-term thinking regarding overall Equity allocations. If Fixed Income yields begin to crest later this year and corporate earnings are reset for 2023 and the Fed signals a pause of some sort then we may be getting closer to the bottoming process in equity markets. At this point, long-term investors seeking total return would have the potential of an attractive entry point for the duration of the new cycle, which could last for many years.

We continue to emphasize diversification across and within asset classes as an evergreen principle of long-term investing. America's market-based economy with all the benefits it has accrued to long-term investors in the financial markets will inevitably have reset periods when recessions happen. During these times, easier monetary policy and weakening inflation should support bond prices, which should again act as a ballast against Equity volatility. On the flip side, when expansions take hold, the dynamism of the corporate sector's profit engines should drive new highs in equity markets. Given the above established portfolio utilities for these traditional asset classes, investors should stick to their long term financial plans using them within their core strategy while considering non-traditional investments for further diversification benefits, inflation protection and enhanced returns purposes.

Index Definitions

Securities indexes assume reinvestment of all distributions and interest payments. Indexes are unmanaged and do not take into account fees or expenses. It is not possible to invest directly in an index. Indexes are all based in U.S. dollars.

S&P 500 Index includes a representative sample of 500 leading companies in leading industries of the U.S. economy. Although the index focuses on the large-cap segment of the market, with approximately 75% coverage of U.S. equities, it is also an ideal proxy for the total market.

Bloomberg US Aggregate Bond Index is a broad base, market capitalization-weighted bond market index representing intermediate term investment grade bonds traded in the U.S.

Bloomberg US Treasury Index measures US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury.

Bloomberg US Corporate Bond Index measures the performance of the long-dated, investment grade U.S. corporate bond market.

Bloomberg US Municipal Bond Index is an unmanaged index comprised of fixed-rate, investment-grade tax-exempt bonds with remaining maturities between two and four years.

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