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Quantvest

Financial Outlook

Fourth Quarter 2021

Summary

At a Glance

- The FED is posed to hike rates later this year, perhaps as early as in March.
- Because inflation is high, the market expects that real rates will remain negative.
- In our opinion, it will be difficult for the FED to have a meaningful impact on inflation unless they tighten significantly more than the market currently expects.
- We expect that in an environment of still-low real rates, equities, especially Value, should do reasonably well.

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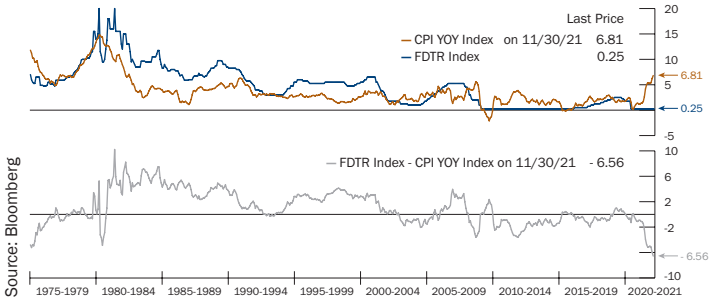
Point of View

Jan Erik Warneryd, Chief Investment Officer

The year 2021 ended on a strong note in financial markets, with the S&P 500 Index up 28.71% for the full year. Market worries about the prospect of higher rates having a negative impact on asset prices, seen just a few months ago, seem to have given way to expectations of a short series of rate hikes that the market can digest easily. Even the FED's announcement that they would accelerate the pace of tapering, ending the program in March 2022 instead of June, did not deter investors. The market finished the year 2021 convinced that rate hikes, while starting by mid-year, would end a few years later with a terminal FED Funds rate of about 1.5%. This is also the level the market expects will be the long-term level of FED Funds: as of 12/31/21 the 5-year forward OIS swap rate closed at 1.52%. This means that investors essentially expect overnight rates of about 1.5% for the period 2027-2032. Given that rates have been at zero for most of the period since 2009, perhaps that appears reasonable.

There is, however, a significant difference between the situation now and the post-Financial Crisis period. That difference is the return of inflation at levels not seen in almost 40 years. While earlier in 2021, FED Chair Jerome Powell referred to price increases as "transitory", he changed his message in December. It is now clear that the FED is determined to withdraw monetary stimulus in order to bring inflation down. As mentioned above, the market thinks the FED can achieve its goal of bringing inflation back to the roughly 2% level we have seen in the last two decades by raising the overnight rate to about 1.5%, but that would still leave the real (inflation adjusted) rate significantly negative. Evidence from previous FED tightening campaigns would suggest that a still-negative Funds rate will not be enough to have a meaningful impact on inflation. The chart below shows the relationship between the Fed Funds target rate (upper bound) and CPI inflation since 1975. We can see that, in general, the FED has responded to rising inflation by raising rates above the rate of inflation as a way to slow demand in the economy. Only since the 2008/9 financial crisis has the FED consistently (except for a brief period in 2019) kept real rates negative without stoking rising consumer prices. The bottom panel in the chart shows the level of real Fed Funds; the current reading of -6.55% (6.8% inflation and 0.25% Fed Funds upper bound) is the lowest for the entire period since 1975.

CPI YOY Index vs FDTR Index



A common explanation for the current market pricing of limited hikes is that the market, remembering what happened when the FED raised rates in 2018, believes that even relatively modest hikes will have a negative impact on asset markets. Lower asset prices will then cause a negative wealth effect which is believed to slow the economy down and force an end to the FED's tightening campaign. This argument can be summed up as: "The FED can't raise rates very much without tipping the economy into a recession."

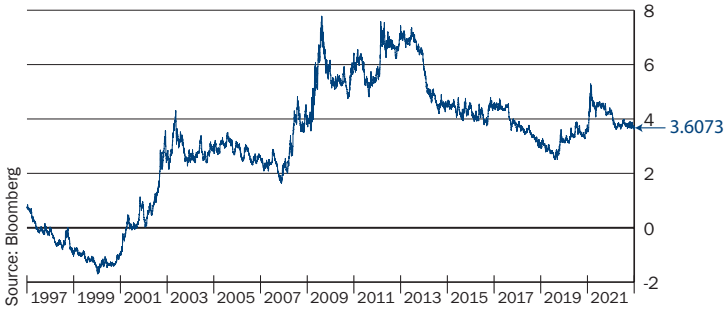
The 12/15/21 "Dot Plot," where Federal Reserve Open Market Committee (FOMC) members forecast the Funds rate at various points in the future shows that, in contrast to market expectations, the FED expects a long-term FED Funds rate of around 2.50%.

If we compare where we are relative to 2018, a few things stand out:

- In the 2015-2018 period, real FED funds ***did*** reach positive levels right around the end of the tightening cycle in December 2018. That is not anticipated to happen this time, since the market's long run inflation forecast is for inflation to fall from today's 6.8% year-on-year level down to 2.5% over the next 5 years. A 1.5% overnight rate would leave the real rate at -1%.
- In the fall of 2018, the S&P 500 Index didn't turn down until the yield on 10-year US Treasuries reached 3.2%. On 12/31/21 the 10-year Treasury yielded 1.50%, so yields could rise significantly from these levels if 2018 is used as a guide.

Since we think there is a material risk that rates may go up more than is currently expected, we should consider what the consequences could be for other asset classes. One key point to consider is that real rates are extremely low at the moment and are likely to stay low by historical standards even if rates go higher and/or inflation falls. Let us take a look at the relationship between interest rates, in this case the real rates available on TIPS (Treasury Inflation-Protected Securities), and Equity market valuation. The chart below shows the spread between 10-year TIPS yields and the CAPE (Cyclically Adjusted Price Earnings ratio) earnings yield (1/CAPE) since TIPS were first launched in the late 1990s. Put another way we are looking at the yield spread, in real terms, between stocks and bonds.

SPX/TIPS



The current spread, as can be seen above, is about 3.6%. The data in the chart goes back to 1997, which is when TIPS were first introduced. By using TIPS pricing, we use the market's observable real rate expectation rather than estimating it based on history. We have chosen real yields to represent the "earnings yield" in Government Bonds since corporate (Equity) earnings tend to grow as the economy grows and therefore can be seen to be closer to "real" than nominal over long periods of time.

From a historical perspective, the Equity market looks fairly valued against real rates. An argument can be made that the Equity market is expecting higher interest rates and more FED tightening than the fixed income market, since the yield spread had stayed at fairly elevated levels even as equities have rallied significantly in the last two years. In our opinion, this provides a valuation cushion that would allow the Equity market to absorb a reasonable rate increase without too much trouble.

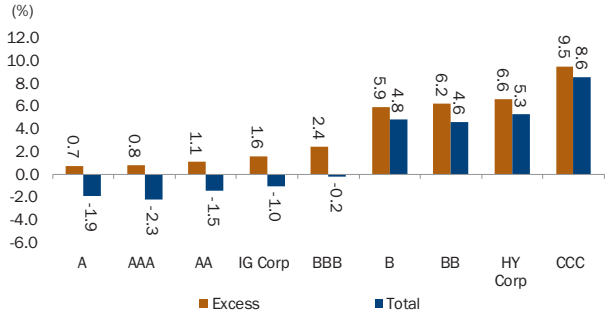
Bond Markets

Radha Lai, Portfolio Manager

Mark McDonnell, Senior Portfolio Manager

2021 was a challenging year for active bond investing. Rates rose significantly with 2-year notes rising from 0.12% to 0.74% as a more forceful Federal Reserve spoke of raising rates in the near future. The long end of the bond market rose from 1.65% to 1.91% as inflation turned out to be a lot less transient than the Federal Reserve had anticipated. Corporate credit overall actually faired reasonably well. The Option Adjusted Spread (OAS) or additional yield one collects for taking credit and liquidity risk started the year at 0.96% and ended at 0.94% so at first blush investors earned what we call "carry" or that full 96 basis points and a bit more. However, the corporate bond market isn't a monolith and much occurred beneath the surface. Morgan Stanley illustrates this well in the following chart.

2021 Total & Excess Returns by Quality Bucket (%)



Source: Bloomberg, Morgan Stanley Research

As depicted in Bloomberg Barclays' chart, there is a familiar pattern that played out this year, a year with a relatively risk on feel- Junk did better than BBB rated debt and BBB rated debt did better than AAA rated debt. One tranche stands out- Single A rated debt. We were overweight Single A securities relative to BBBs. That worked out well in 2020 but did not work out in 2021. We are still comfortable with that decision, indeed more so today than before but it is worth exploring. Barclays tracks the volatility of each tranche as follows:

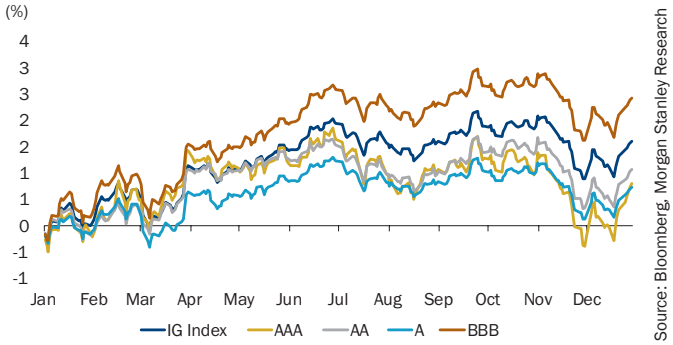
US Credit Index Excess Returns by Quality and Sector, pb

	Credit	Aa+	A	BBB
2020	18	14	66	(13)
YTD 2021	151	90	82	229
Annual Mean	75	43	59	112
Annual Std Dev	565	249	578	827

Source: Bloomberg Barclays

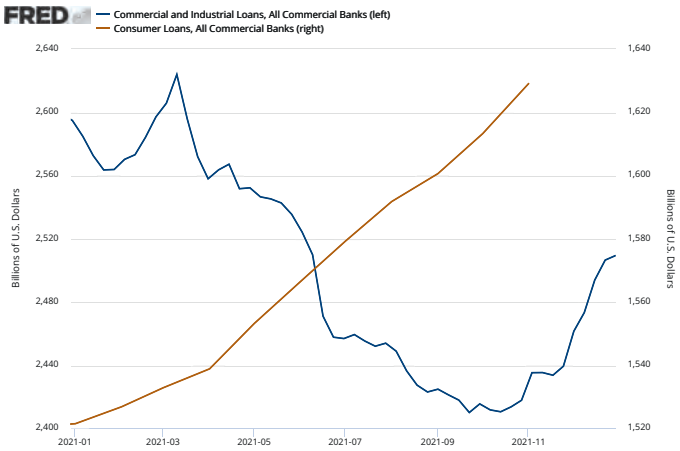
Again, the choice to overweight Single A in 2020 was a winner and that choice in 2021 was not. However, on the longer term we see a pattern that we have seen many times. The annual mean for AA+ is modestly lower than the annual mean for A which is lower than the average mean for BBB. That makes sense. One should accept a bit lower yield for taking less credit risk. Digging just a bit deeper and one sees a stark issue arising. Single A debt doesn't adequately compensate the holder for the volatility. As shown in the chart, the annual mean for AA+ is 43 basis points with an annual Standard Deviation of 249 basis points. One gets about a basis point for 5.8 units of volatility or risk. When one does the same for A rated debt and divides 578 by 59 basis points that number is 9.8. In our opinion one is not adequately compensated for the spread volatility of Single A rated debt. We will be exploring a barbelled approach over the next several months, one where we own AA and BBB in a more efficient manner than owning A rated.

2021 Cumulative Excess Returns by Rating



Source: Bloomberg, Morgan Stanley Research

When we dig deeper into the subsectors of the corporate bond market we find some segments quite attractive. Health Care looks to fare relatively well as we move through the Omicron wave. The loan trends in banks look very favorable. The Federal Reserve Economic Data plots this trend nicely in the chart below. This bodes well for the banks. Other sectors look less favorable and we are underweight those sectors.



Source: Board of Governors of the Federal Reserve System (US)

STRATEGY

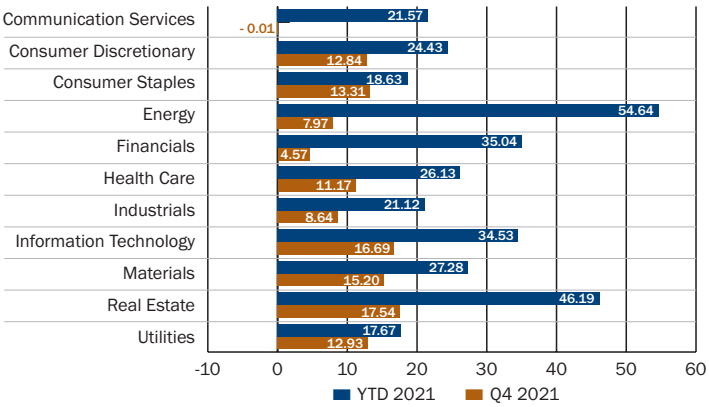
We continue to believe rates will continue to rise and have positioned the portfolios with an underweight in duration. We are underweight mortgages especially in the lower coupon tranches that the Federal Reserve has been buying as we expect those to underperform now that Quantitative Easing is ending. We are underweight corporate debt in sectors we believe are fully priced and therefore not adequately compensating for the credit risk. We look to move to a more barbelled structure, when the opportune time arises, in credit quality over the next several months.

U.S. Equities

Jan Erik Warneryd, Chief Investment Officer

The U.S. equity market resumed its upward momentum in the fourth quarter of 2021, with the S&P 500 Index ending up 11.03% for the quarter and 28.71% for the year. Energy and Real Estate were the biggest gainers for the full year, followed by Financials. Financials beating Information Technology may seem surprising, but the prospect of rates finally starting to go up is providing fuel to the sector. The worst performing sector in 2021 was Utilities with an otherwise respectable 17.67% gain.

S&P 500 Index
Total Return (%) by Sector / Quarter End December 31, 2021



Source: S&P Dow Jones Indices

An interesting side note is that the S&P 500 Energy sector, for all its 2021 outperformance, ended up returning only slightly more than 1% in annualized terms from the end of 2019 to the end of 2021 while the S&P 500 Index returned approximately 23% annualized for the same time period, so Energy is still a significant laggard.

The strength of Q4 is particularly noteworthy in light of the many news items that could have slowed the market down. These items include the announcement and subsequent acceleration of tapering of bond purchases by the FED, a majority of FOMC (Federal Open Market Committee) members now seeing at least three 25 basis point rate hikes in 2022, COI inflation rising to 6.8% year-on-year, the emergence of the Omicron variant of COVID-19 and the ongoing Real Estate crisis in China. In spite of all this, equities rallied and 10-year UST yields stayed at about 1.50%.

It seems reasonable to believe that 2022 will be a bit different – at the very least it should be a year of transition since we will see a significant change in monetary policy by the FED and other central banks. The "easy money" period that developed markets have enjoyed more or less continuously since 2008/9 is slowly ending, but unlikely to do so in drastic fashion. Central banks and policy makers still subscribe to ideas that have more in common with Modern Monetary Theory (MMT) than Milton Friedman's Monetarism. A decade-plus of low rates and monetary as well as fiscal stimulus has not caused materially higher inflation expectations in the markets and among the public. This experience has encouraged the mindset among central bankers that slowing demand through meaningful rate hikes is an unnecessary and harmful policy tool to be used sparingly, if at all. The market believes this line of thinking will result in a short and shallow rate hike cycle that, at 1.5%, stops well short of the level that FOMC members consider long-term neutral.

In our view, if interest rate hikes indeed turn out to be as modest as the market expects, the equity market has nothing to fear; real FED Funds will likely stay decidedly negative and continue to provide significant stimulus. The issue is rather: what if the market is wrong and the FED tightens a lot more than what is currently priced in?

It seems unlikely that the FED will be able to have much of an impact on inflation unless short rates rise meaningfully more than the market currently expects since the starting point is a real FED Funds rate of -6.8%.

As far as what sectors of the market are most likely to be impacted by higher-than-expected rates, we have already seen that the market perceives Financials to benefit from higher rates through increased lending margins. In addition, and as a general observation, other sectors and sub-sectors enjoying low valuations such as Health Care and Telecom Services should benefit, as well as parts of the market with high multiples justified by low interest rates, such as Information Technology and Media and Entertainment. We continue to believe that Value will outperform Growth over the medium term, especially in a rising rate environment.

STRATEGY

We are anticipating an environment of gradually rising rates where Central Banks are sensitive to the impact of their actions. While policy will appear "hawkish" relative to the past decade or so, compared to the inflation-fighting Volcker-led FED of the early 1980's it will likely stay ultra-loose in real terms. We are unlikely to see an abrupt shift that will derail the economy in order to wrestle control of inflation. Rather, we believe, the FED will continue to express its belief that inflation, while less transitory than previously thought, is still mostly a supply issue related to COVID-19 and therefore not in need of drastic counteraction. There is room however, for the terminal rate to go higher than the 1.5% currently expected by the market, and possibly even higher than the FED's own 2.5% projection.

We think equities as an asset class are fairly valued, possibly even somewhat cheap, relative to the bond market, but that may change if rates continue to increase. However, as long as the FED Funds rate, in real terms, stays negative, equities will enjoy a tailwind from a valuation perspective. Currently, the long-term market expectation is for R* (the neutral real rate) to be just below -1%. If this turns out to be correct, then equities, as an asset class, should be well supported even if rates rise. This is in particular the case for the Value segment of the market. Reflecting this view, in our S&P 500 Sector Selection equity strategy we are currently overweight sectors such as Financials, Healthcare and Telecom while underweight in Consumer Discretionary, Energy and Real Estate.

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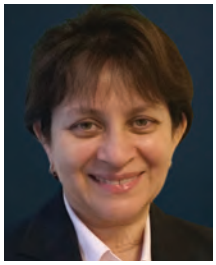

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