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Empowering enterprising families to thrive. Together.

2022 Economic Outlook

As 2021 wrapped up, we likely saw the peak in the benefits of COVID stimulus. The savings rate spiked in 2020 and has steadily come back down to pre-COVID levels. The amount of stimulus pumped into the system was more than enough to cover the loss in income for most households. Incomes were sustained while the supply of goods for consumers shrank. This led to supply chain issues and eventually higher prices. Households who could not spend money on services shifted more towards consumer goods. The likely effect is that some purchases were pulled forward and demand will begin to normalize and possibly slow. Inventories will likely build up enough to bring supply/demand imbalances in line.

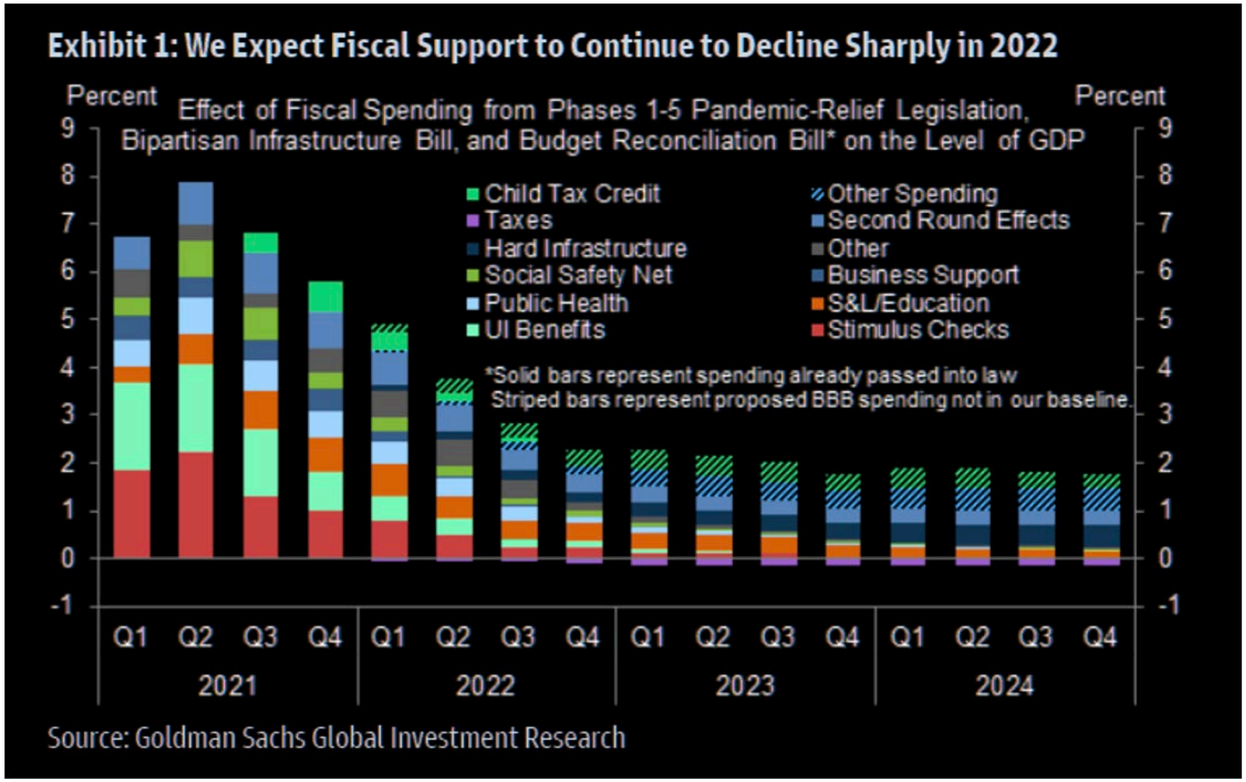
The consensus views for the year are for GDP growth of 4%-4.5%, inflation 3%-4%, and for the Fed to raise rates 4 times during the year. We know that the consensus is usually wrong, but it does give us a good starting point to analyze what is priced in and how we might differ. We are of the view that the economy is already slowing down and that the Fed is beginning to tighten when the yield curve is historically flat (compared to previous tightening cycles. The Fed is in a position where they feel the timing is right to raise rates to offset higher than expected inflation. The risk is that the economy has become more sensitive to rate hikes due to the amount of liquidity that has been pumped into the system. In a normal environment, higher rates coincide with increasing growth. In the era of Quantitative Easing, historical norms are not likely to play out. We see the probability of a policy error by the Fed as being elevated. The likely risk is that they err on the side of moving too quickly causing growth to slow and financial markets to be disrupted by a flat to inverting yield curve.

Key Themes and Questions for 2022

1. How long will inflation stay high?
2. How many times will the Fed raise rates?
3. Will the Fed tighten too quickly and slow growth?
4. How long will employment disruptions continue due to COVID?

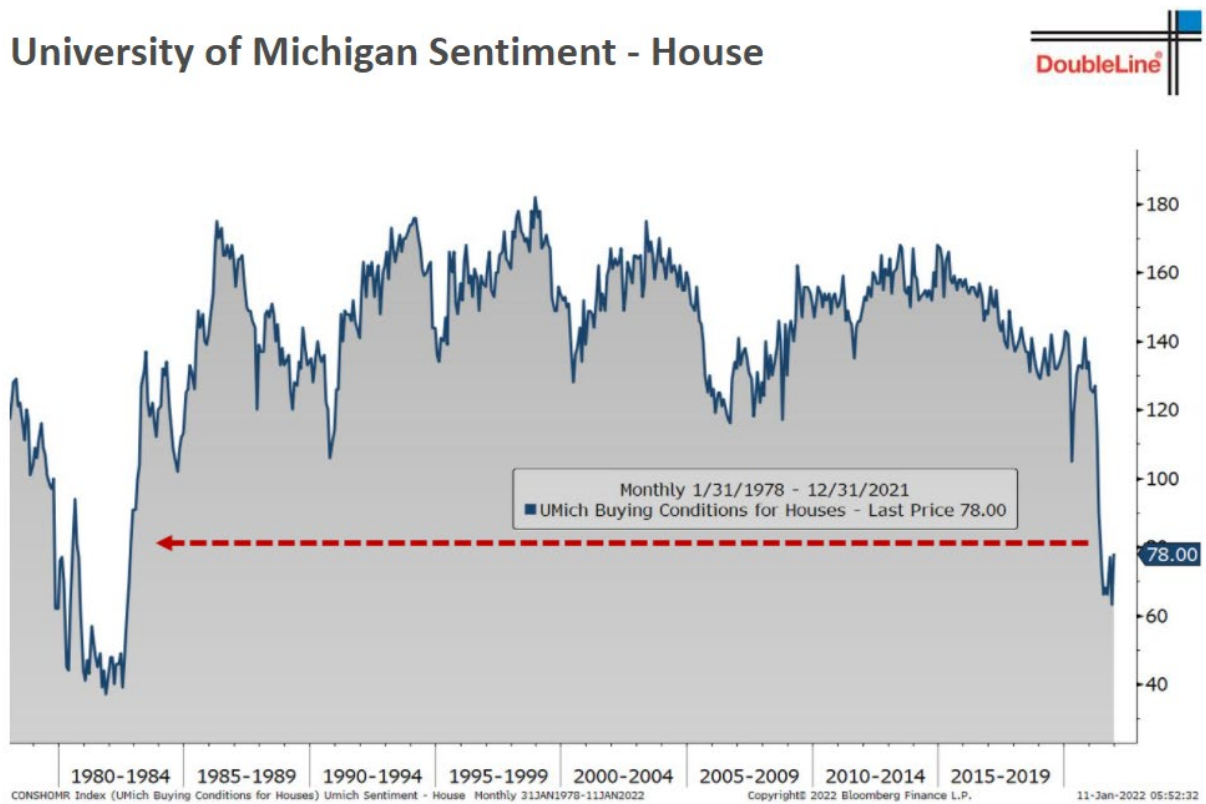
Fiscal Policy Headwinds

- 2021 saw a big tailwind from fiscal policy. 2022 and beyond will see those tailwinds decline significantly (barring a reversal in passing the Build Back Better bill).



Higher Prices Weigh on Sentiment

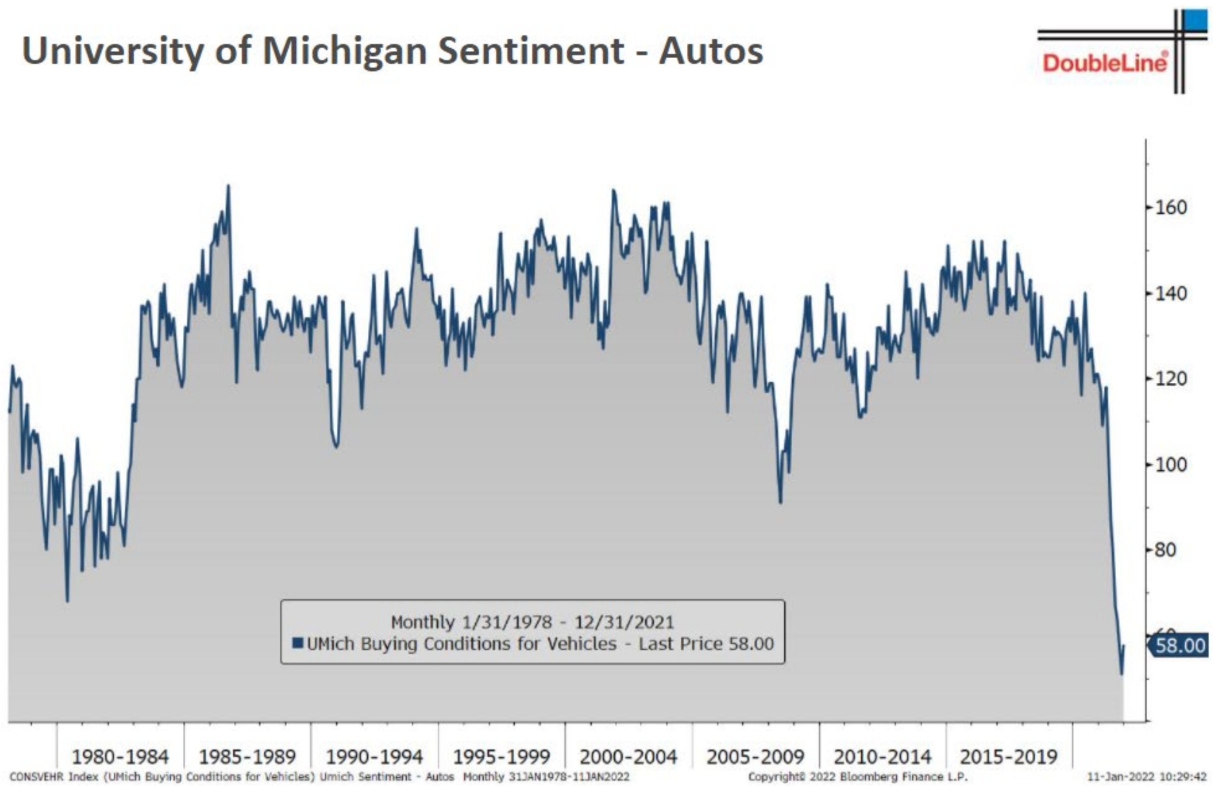
- The number of potential home buyers who think it is a good time to purchase a home has declined dramatically. Housing tends to be an area of strength in a growing economy.



Source: Bloomberg, DoubleLine
CONSHOMR Index – surveys households on whether it's a good time or a bad time to buy a house. You cannot invest directly in an index.

Higher Prices Weigh on Sentiment

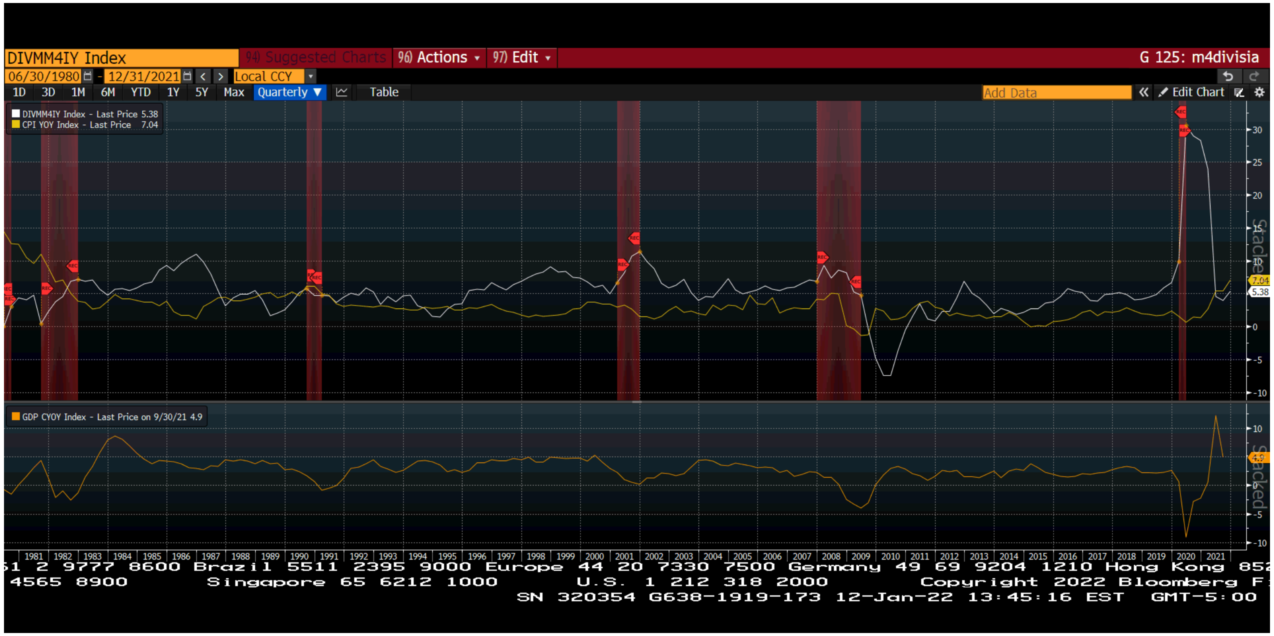
- A major source of inflation has been in the auto market. The average price for a new car was up 11.8%, while used car prices were up 37.3%.
- As with housing, auto price increases have moved high enough to where demand starts to fall off.



Source: Bloomberg, DoubleLine
CONSVEHR Index – surveys households on whether it's a good time or a bad time to buy a vehicle over the next 12 months. You cannot invest directly in an index.

Growth in Money Supply Slowing

- In the era of Quantitative Easing, growth has been generated by liquidity. The Money Supply (white line) has been growing, but the speed at which money changes hands has been slowing.
- We saw a major spike in the money supply to help smooth the economic fall off from COVID. We have recently seen the growth in money supply slow. Historically when money supply grows less than 5% there is less liquidity.



Source: Bloomberg

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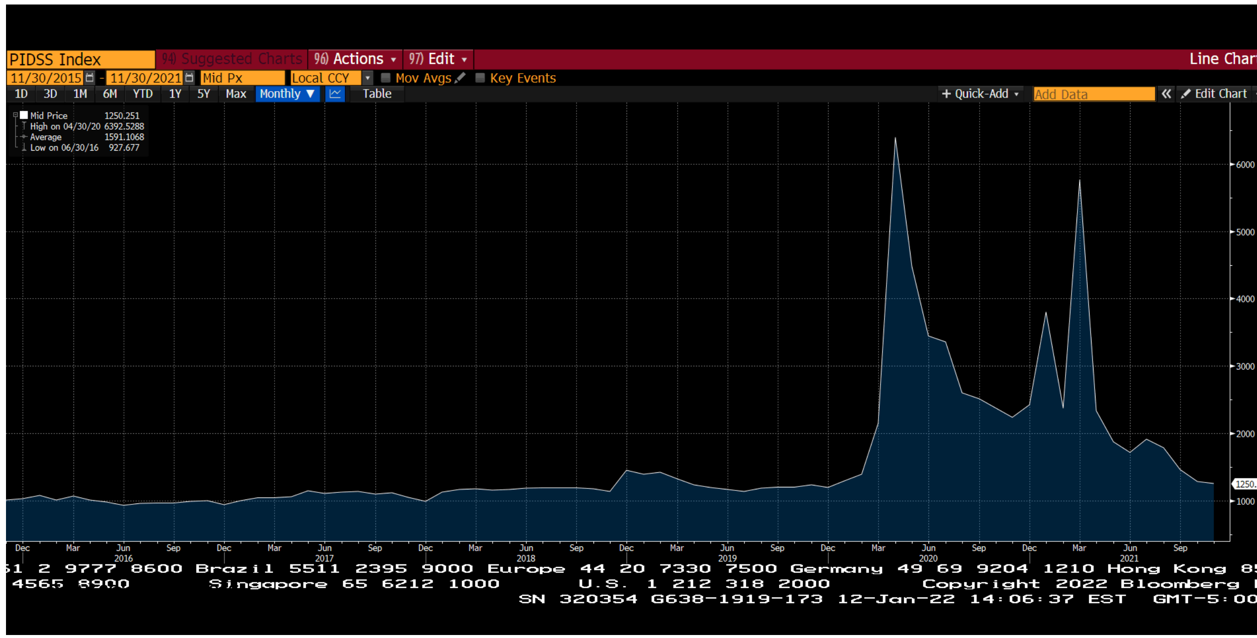
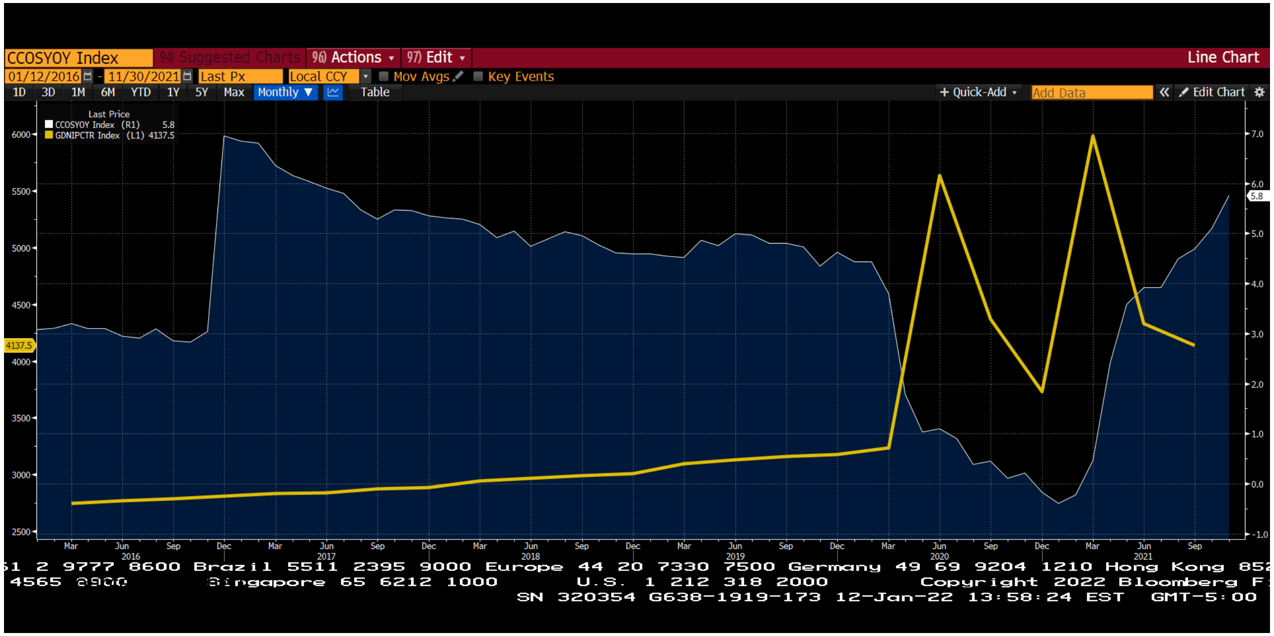
What Excess Savings?

- The amount of household savings spiked in 2020 and early 2021 as consumers received stimulus checks when many parts of the economy were shut down. Since they couldn't spend on going out to eat, the movies, concerts, etc., they saved.
- A lot has been written about the amount of household savings available for future spending. Today that money has been spent. Household savings is back to where it was pre-pandemic.



Consumer Debt is Increasing after Historical Stimulus

- During the beginning of the pandemic, consumer debt (white line) declined as government transfers (gold line) helped to bridge the gap from lost income.
- As the stimulus payments have shrunk, consumers are beginning to take on more debt to finance purchases.
- Household balance sheets are healthy, so there is room for some increase in debt load. If rates rise fast that could change.



GDP Potential

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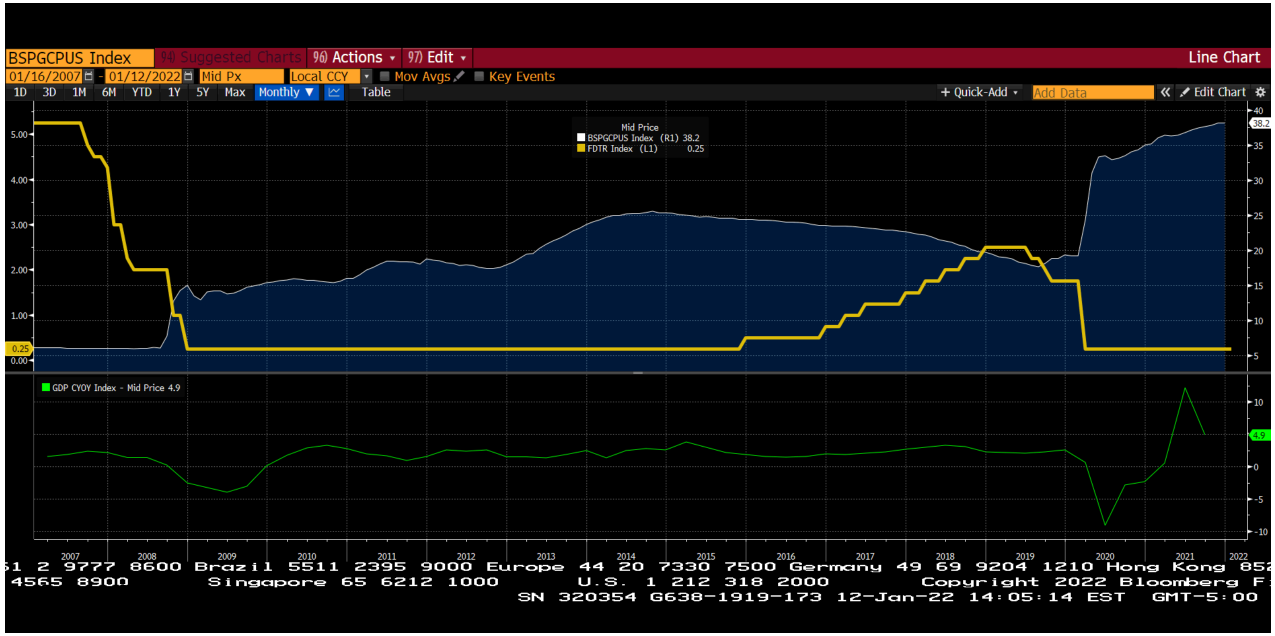
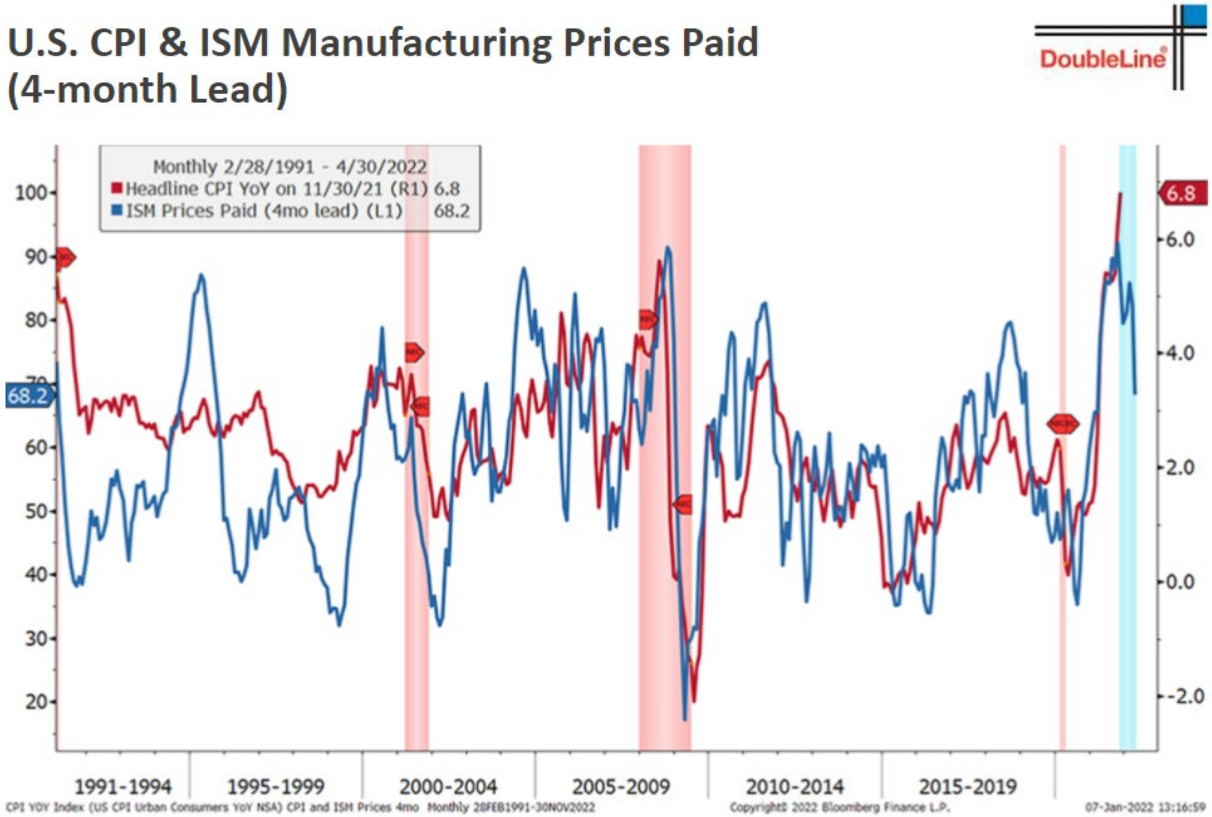
- In the past two economic cycles, the Government's balance sheet (white line) has increased as interest rates (gold line) have been flat or declining. When the balance sheet has shrunk GDP growth (green line) stayed between 2%-2.5%.
- With the prospects of a shrinking balance sheet and higher rates, can GDP grow any faster than pre-pandemic?



Inflation Peaking

- We saw inflation (CPI) hit 7% in December, but we are likely to see growth in inflation begin to decelerate.
- ISM Manufacturing Prices Paid is a survey of over 400 industrial companies. It asks respondents if they are paying more or the same for inputs. After peaking in the 4th quarter, it has come down significantly.
- CPI tends to follow with a 4-month lag. If history holds, inflation should come down.



Source: Bloomberg, DoubleLine

Inflation Peaking

- Industrial prices in China tend to correlate with consumer prices in the U.S.
- China PPI (blue line) has turned down. Will lower input prices carry over to lower U.S. consumer prices?

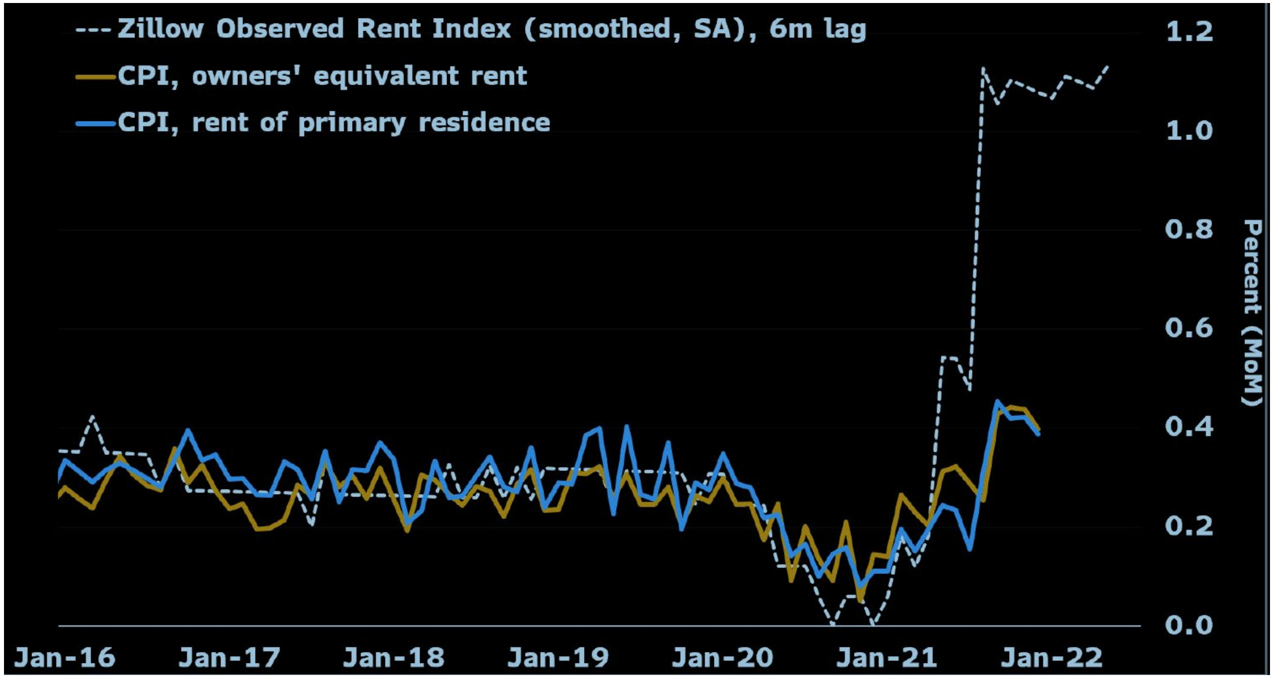
CHART 3: Early Sign of An Inflation Peak

Global
(red line; U.S. CPI; year-over-year percent change; LHS)
(blue line; China PPI; year-over-year percent change; RHS)

Shading indicates recession
Source: Haver Analytics, Rosenberg Research

Housing Inflation

- The one area of inflation that is likely to persist into 2022 is housing.
- There tends to be a lag in the increase in rent and the housing component of CPI. Inflation from housing can go a little higher even if housing prices start to soften with higher interest rates.



Source: Bloomberg

Market Positioning

- We maintain our quality tilt within our equity portfolios as well as overweighting emerging markets relative to Europe.
- We see that the bond market is pricing in an aggressive hiking cycle by the Fed. We think they will likely hike less than expected.
- Within Hedge Funds we see opportunity to add to less correlated strategies such as: Material and Mining, Commodities, Weather Catastrophe Bonds, Venture Credit, etc.

- **Equity**: Pressure on high growth companies that lose money and trade at extreme multiples of Revenue. Overseas markets cheaper relative to U.S.
- **Fixed Income**: Continue to maintain shorter duration and add exposure to 3-5 year U.S. Treasuries.
- **Hedge Funds**: Increase exposure to Absolute Return strategies that can benefit from rising rates and provide diversification away from equity and fixed income risk.
- **Private Equity**: Focus on Small-Mid Buyout strategy, which is less frothy than Venture. Balance smaller emerging managers with those with persistent track records.

Summary

We see the focus for the first half of the year on the significant shift in Federal Reserve policy towards tightening. As we get further into the year, it is likely going to be around the choice between higher-than-normal inflation versus the risk of recession. Interest rates are at historical lows, but debt is at historical highs. As Japan and Europe have shown, it is difficult to grow the economy faster by adding more debt beyond the current level. In the era of Quantitative Easing (QE), a lot relationships between macro economic statistics and market reactions have become less connected. For example, in 2021 we had 7% inflation along with negative interest rates, yet the price of gold finished the year down. As the Fed begins to reverse QE, it is less clear how much market disruption will arise from moving away from historically low interest rates.

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Disclosures

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