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Investment Outlook

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The Challenge for Investors - Adapting to Changing Conditions

As we approach the end of Year Two of the Pandemic Era, we'll take a look at what has been wrought upon the economy and its markets by the policy response to COVID and what we might expect to see next year. 2020 was a year of extremes while 2021 has been a year of advancement for a US economy that has returned to pre-pandemic levels of growth. The byproduct of this has been a disruption of supply chains and the return of inflation. The policy response to that and the two new variants of COVID will no doubt have an effect on the late cycle expansion we see ahead. 2022 could be a challenging year for investors as they navigate through the markets in an economy crossing the divide from monetary support to one driven by fiscal policy.

Navigating the Pandemic Era

2020 brought us the best of times and the worst, not necessarily in that order. The onset of COVID-19 was a global event. Here in the US the policy response was swift. The economy as we knew it was switched off, creating a demand shock unseen since the days of the Depression and the Great Recession. The market responded accordingly by logging the quickest, and thereby the most dramatic, bear market in history. It occurred all within the span of 35 days in Q1 2020. Then, it was over. The indexes were off to the races through Q3 of this year, borne on the wings of historic monetary support from the Fed that took interest rates to zero and used QE to flood the economy with liquidity. That is a proven cure for a demand shock.

Consumer demand surged along with investment returns this year. An increased vaccination rate, combined with a seasonal ebb of the virus, allowed us a slow return to a new normalcy. The resurgence of demand soon overwhelmed manufacturers and exposed severe limitations in reviving dormant distribution channels. It then became apparent that *switching the economy back on* was far more difficult than anticipated. The consumer had returned only to find some products in short supply due to worker shortages affecting manufacturing and transportation. The Demand Shock of 2020 has been displaced by the Supply Shock of 2021. The result is higher prices and a return of inflation.

In this pandemic era, inflation is a sign of a revived economy. The usual fix involves the *gradual* withdrawal of liquidity and a tightening of credit by the Fed. In current conditions, this would involve ending QE and moving key interest rates from zero back to what's considered a "normal" range. *Gradually*. Ostensibly, this would cool demand sufficiently to allow time for the supply chain to regain its footing and restore a balance between supply relative to consumer demand. We believe the Fed has crafted a thoughtful and adaptive policy response to changing economic conditions. Critics of the Fed are generally selling advertising on TV or running for election. A knee-jerk response to a rarely seen supply shock holds the potential for a policy misstep that could do more than just cool demand. It could send a chill in the direction of the stock market.

Tapping the Brakes on the Economy

Little mystery surrounds monetary policy for next year. The flood of liquidity necessary to bridge the economy through the pandemic era is about to be withdrawn. That, in itself, shouldn't strike fear in the hearts of investors. The Fed has been consistent in telegraphing its intentions throughout the pandemic. The recovery has matured to the extent that the Fed can *tap the brakes to gently* slow the economy as fiscal support makes an appearance on the horizon. This buys time for the supply chain to regain efficiency, catch up with demand, and ease inflationary pressures. The risk of a policy misstep lies in the *speed at which liquidity is withdrawn*. Raising interest rates too soon, too fast, is tantamount to slamming the brakes on an economy still burdened by COVID. Some would call this a surefire recipe for recession. We count ourselves among them.

One of our favorite strategists, Liz Ann Sonders, recently offered that "narratives, however absurd, can move markets beyond fundamentals." That certainly holds true for some of the current market leaders that trade at nose-bleed valuations based on fanciful extrapolations of their current success. We see that as a product of TV stock evangelists preaching to traders with a bad case of FOMO. No doubt, a drawdown of liquidity by the Fed will slow the economy and act as a headwind for some of these high-valued market leaders. Liz Ann goes on to say that "quality will bridge investors through an earnings slowdown." She's not saying "get out" but "get ready".

That points to the need for diversification in portfolios. Investors reluctant to rebalance and log gains late this year should view Q1 of next year as an opportunity to upgrade portfolios by rebalancing. This means adhering to allocation limits and individual stock weightings while adding more rationally valued, late cycle, companies of unquestionable quality. Investors should be attentive to what *is actually being said* by Jerome Powell and other board members rather than interpretations offered by dramatists and some less-than-objective experts on cable news channels. Normalizing interest rates is a process and not an event to be feared as traders' actions would have you think. It's a sign of a healthy economy with a long runway of moderate-paced expansion ahead.

Update on our list of Risks to Recovery and Economic Expansion

COVID-19: The Omicron variant joins Delta. The policy response to the seasonal surge could slow expansion for the economy. Raised to **Moderate**

The Fed: Embarking on a well-telegraphed change in policy. Likely to accelerate the taper as it adapts to changing conditions. Powell reappointment decreases risk from **Moderate to Low**

Trade War: China's economy weakens on central policy missteps and sees sub-3% growth in 2022. That could create heightened dependence on US trade. Remains **Benign**

Global Economy: US still leads the pandemic era recovery. Developed foreign central banks remain in sync with US. Canada backs away from a rate hike. Emerging Markets burdened by low vaccination rates and a slowing China. Risk remains **Moderate**

Policy Formation: A shift in monetary policy begins. First stage of fiscal policy enactment completed. Taxes and Social programs remain divisive between Moderates and Extremists. Risk remains **Moderate**

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