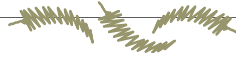
C Y P R E S S

Asset Management, Inc.



MARKET COMMENTARY **January, 2022**

The S&P 500 delivered another exceptionally strong year in 2021, rising 27% on a price basis. Over the past 3 years, the index more than doubled including dividends, making for its first three-year gain of 100% since the 1990s. Today, stocks may be more at risk of a correction than another extended run given relatively high valuations and higher rates in 2022. Somewhat offsetting these factors is the prospect for strong economic growth and earnings. Nominal GDP, which is more impactful to corporate revenue and profits than Real GDP, should be up 8%+ in 2022 and S&P earnings another 10%. Strong growth means even if the market multiple contracts and valuations come down, stocks can post a positive year based on higher earnings. Larger capitalization stocks are also supported by a growing dividend that currently yields about 1.25% on the S&P 500 while real bond yields are negative (the 10-year treasury yields 1.75% and inflation as measured by the core PCE is running at 5%). Stocks and other long-term assets remain relatively attractive in the current environment and provide some protection against inflation. We do expect more of a focus on growth at a reasonable price in 2022 rather than growth at any price. This plays to the strengths of our high-quality portfolio of industry leaders, companies that are highly profitable and cash flow rich.

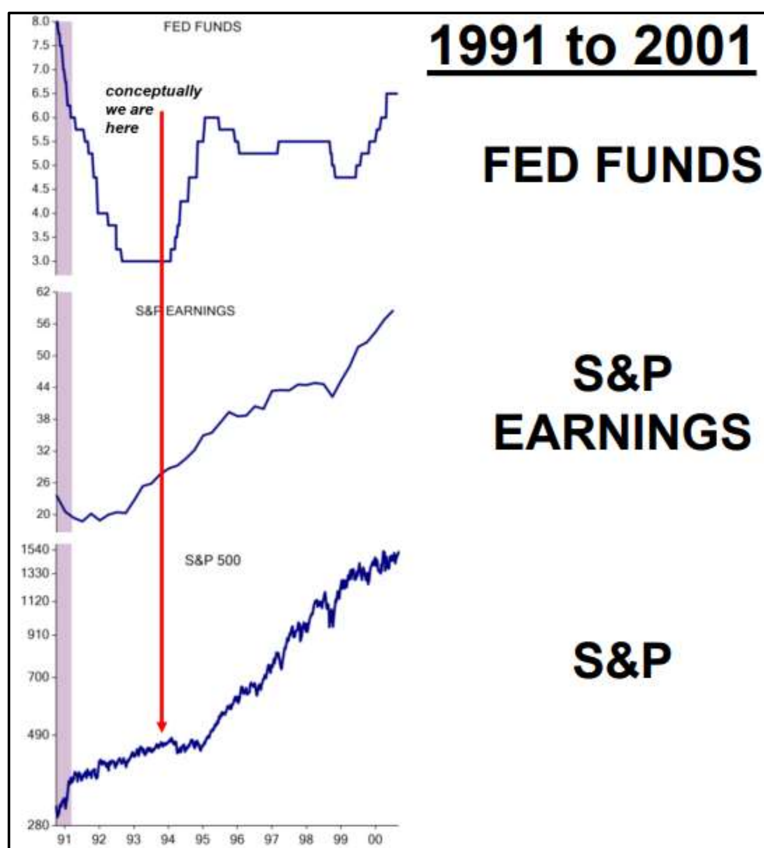
Initial Fed Tightening No Reason to Panic

The market will experience heightened volatility this year as the Fed moves from unprecedented monetary accommodation to actually raising rates over the course of the first half of the year. The Fed has already begun to taper or scale back its purchase of bonds and the process should be complete by the end of the 1Q. Bond yields have risen sharply to start the year in anticipation of rate hikes, pressuring equities. We expect the Fed to hike rates three times in 2022 and to begin to slowly reduce its massive balance sheet (roughly $9 trillion or nearly 40% of nominal GDP). Tapering is simply easing at a slower pace, and policy remains accommodative until the Fed actually raises rates. Monetary policy operates with a lag effect, and it takes at least one year to impact the economy. Thus, monetary stimulus will continue to boost the economy over the next 18 months and assuming the Fed eventually reaches a more normal Fed funds level of 1.5%-2% it could take another year beyond that to slow growth.

In the past, when the Fed begins a cycle of rate increases, equities have continued to move higher over time. It is only after many rate hikes that a recession starts, corporate earnings then decline, and stocks decline significantly. The big declines in stocks occur after earnings have peaked. The deeper the drop in profits the deeper the decline in the market. When short term rates/Fed Funds move higher than longer term bond yields, known as an inverted yield curve, the threat of recession becomes significant. We are a long way from such a scenario barring unexpected events. Still, we face a challenging transition. Markets and investors have gotten very used to ultra-low rates and as the Fed pivots a period of adjustment and anxiety should not be unexpected.

By way of history, remember that we are only at the beginning of a monetary tightening cycle. In the 1980's, 1990's, and again more recently in the 2000's it took a long campaign of rate hikes to "murder" the economic expansion and companion bull market (1986-1989, 1994–1999, and 2004 -2006). During each historical period the Fed ultimately lifted the fed funds rate over bond yields followed by recession,

financial stress, and big earnings declines leading to big declines in equities. Ultimately stock performance is driven by earnings. It is no accident that the remarkable surge in stocks over the past 3 years has come as corporate profits surged to a record high by a wide margin.



How is the Global Economy Performing?

It is a good thing that the outlook for economic growth is, to quote Jamie Dimon, the "best in decades". For while the economic expansion has a long runway in front, 2022 poses greater uncertainty than we have seen in some time. Inflation, which we wrote about in some detail in out last commentary, is running at a 40 year high. Too much money chasing too few goods and services, with labor shortages also impacting the supply chain and production. In the end, inflation will largely dictate Fed policy in 2022 and many are concerned it will get away from us much as occurred in the 1970's. Yet we think it as likely as not that inflation actually does prove transitory and abates in the second half of the year. Supply chain problems are already easing and imports increasing. Inventory rebuilding will be ongoing throughout the year and support growth. Workers should return to the market as the economy continues to open up and the unprecedented largesse of the federal covid fiscal relief packages have finally run their course.

Commodity price inflation, however, will prove much more difficult to contend with. Regulatory hurdles and societal disincentives (think ESG driven capital spending) to energy production are shrinking the supply of oil and gas even before the global economy has reopened. Prices have surged and it is not unthinkable that oil prices could go well north of $100/BBL this year. Natural gas pricing is at the highest levels since 2008. Europe is staring down an energy crisis this winter and finds itself dependent on Russian gas. Even copper, a key commodity as the developed world transitions to electric vehicles and greener energy, is at pricing levels not seen in a decade. The Russia–Ukraine conflict poses incremental risk to commodity supply and pricing.

What is China Up To?

Finally, we are in the early stages of a global struggle with China and geopolitical risks are higher in the early stages of this new conflict. Both sides are in a process of feeling out the other and assessing strengths, weaknesses and intentions. Remember the cold war with the Soviet Union played out over more than 4 decades, and both sides adjusted to its global reality. Taiwan is a flashpoint of conflict with China and is of critical strategic importance. Taiwan is home to the biggest and most technologically advanced semiconductor manufacturing capacity in the world.

Semiconductors are the building blocks of our modern industrial economy. The "new oil". If the United States were to see its supply of critical chips used everywhere from data centers to communications devices and systems to transportation, from health care systems to vital defense and electronics, cut off or rationed we would face a national crisis, this should not be understated. This will be an area to monitor closely in coming months and years.

Global Economic Outlook & S&P Earnings - January 2022 (S&P 500 @ 4,662)	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021e**	**2022e**
Global Real GDP Growth (y/y rate)	3.3%	3.4%	3.1%	3.0%	*3.7%*	3.8%	3.1%	-3.2%	***5.8%***	***4.3%***
U.S.	2.2	2.4	2.4	1.6	*2.3*	2.9	2.3	-3.4	***5.6***	***4.0***
Euro Area	-0.4	0.8	1.5	1.8	*2.4*	1.9	1.2	-6.5	***5.0***	***3.6***
Japan	1.5	0.0	0.6	1.0	*1.8*	0.3	0.7	-4.5	***2.0***	***3.8***
Developing Asia	6.6	6.4	6.2	6.2	*6.4*	6.1	5.2	-1.1	***6.8***	***5.3***
China	7.7	7.3	6.9	6.7	*6.8*	6.8	6.1	2.2	***7.7***	***4.1***
Latin America	2.5	1.0	-0.5	-1.2	*1.2*	1.7	0.8	-7	***6.8***	***2.4***
Emerging Market & Developing Economies	4.7	4.6	4.2	4.1	*4.7*	4.7	3.7	-2.0	***6.4***	***4.6***
S&P 500 Aggregate EPS	109	118	117	118	*131*	162	165	140	***205***	***230***
Earnings (y/y rate)	12.6%	8.3%	-0.8%	0.9%	*11.0%*	*23.7%*	1.9%	-15.2%	*46.4%*	*12.2%*
PE Ratio (January 14, 2022 price @ 4,662)						15.5	19.6	26.8	*23.2*	*20.3*

Sources: IMF, ISI Group, BAML