2021 Year End Letter to Investors

Dear Friends,

Merry Christmas, Happy Hanukkah, and Seasons Greetings to you and your families!

Like many parents, I relish the time spent with my children around the dinner table. It is during this time we often have a chance to catch up on one another's day, uncover any social or educational concerns impacting the children, cheer each other's successes, and when the moment is right, sneak in a life lesson or small wisdom into the conversation.

This holiday season my eldest son received a milestone gift – his first cellular phone. While we (to be fair, my wife) spent an abundance of time on expectations, behavior, and responsibilities, it wasn't until dinner the following evening when my son started asking about why Russia wants to invade Ukraine, that I realized how different this generation receives their news and information.

Before the internet, I explained to him, you had to walk down to the newsstand when it opened in the morning and buy a local edition of the paper reporting what had occurred the previous day. Today, however, a simple click is all it takes to read your local paper, and any other news source from anywhere in the world, updated by the minute – information overload. Perhaps more concerning, are the Artificial Intelligence algorithms embedded in search engines and social media that learn your search history and preferences and continue to send you articles from sources that are aligned with your beliefs. These algorithms effectively create confirmation bias by default, often blinding us to the broader story.

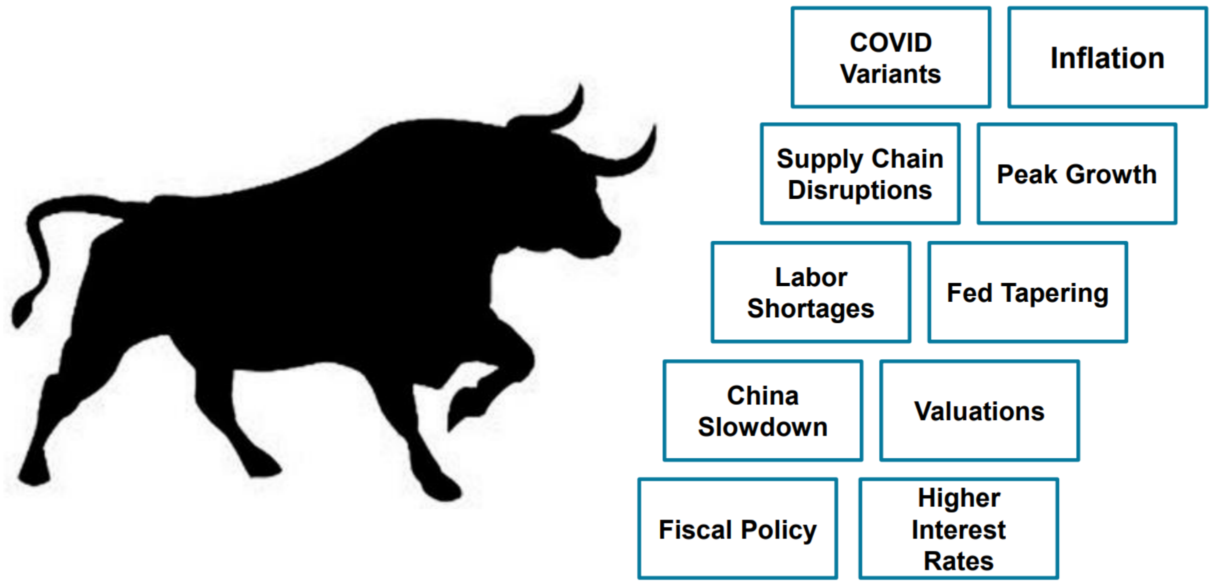
As an economist, I strive to view the world from the perspective of a neutral third party, disassociating emotion and personal bias from my decision-making process whenever appropriate, relying heavily on data and trends to understand where we are today, and where we are likely to head in the future. It isn't easy!

If you have been paying close attention to our economic outlooks over the past two years, you will notice that we have been utilizing the same general formula to help navigate our way through the COVID economy. Typically, we begin by analyzing domestic economic growth, jobs, profits, and inflation, and then focusing on fiscal and monetary policy responses. Next, we look at valuations and interest rates to help develop our key investment themes and make asset class recommendations. We try to let the data tell us where markets are heading - not headlines, politicians, or our own political beliefs.

As the facts change, our views change. As we exit 2021, it is becoming evident that inflationary pressures are stronger and stickier than anticipated, unemployment is lower than expected, and the Fed will taper its bond purchases and raise interest rates more quickly than believed just a few short months ago.

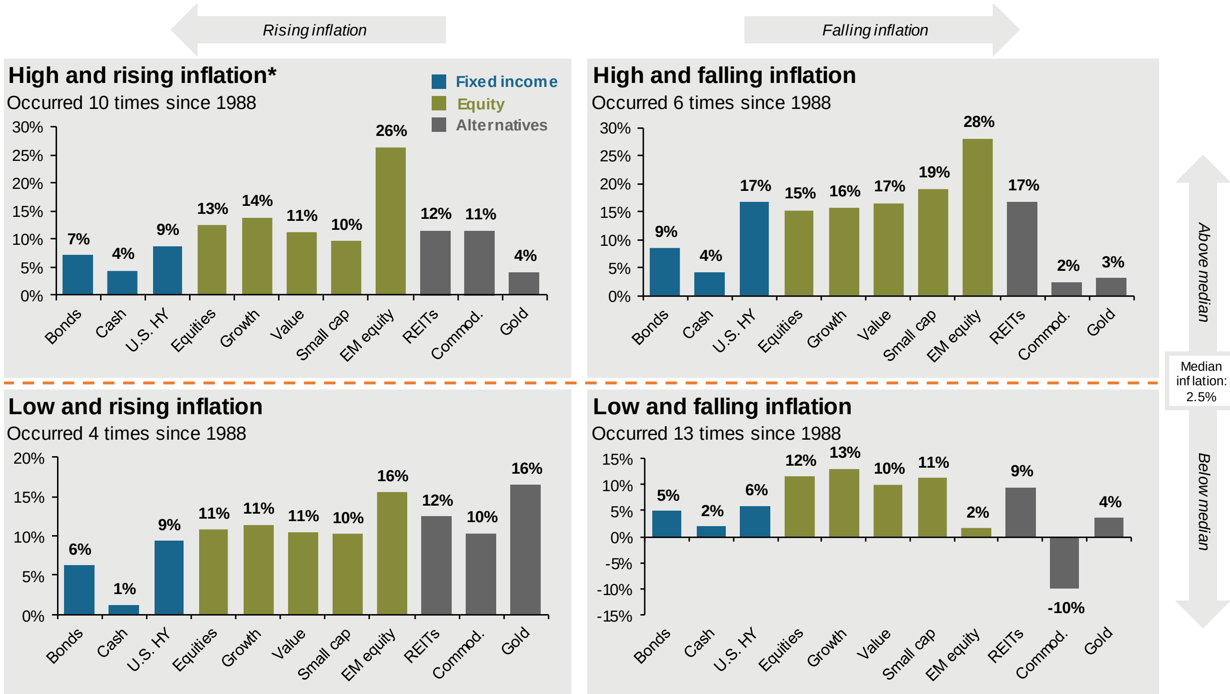
The Wall of Worry

Investors face an ever present “wall of worry.” At the moment, we are most preoccupied by a confluence of inflation, interest rates, bond tapering, COVID variants, supply chain disruptions, labor shortages, fiscal policy, government debt, and equity valuations – and rightly so.



As we have said in the past, the market is always facing similar concerns, many of which have been far more devastating than the issues we are facing today (although it never feels that way at the time). A simple look back in time shows that in just the first 20 years of this century, we have faced a dot-com bubble bursting, September 11th and a war on terrorism, Hurricane Katrina, a housing bubble leading to the Great Financial Crisis, a Japanese nuclear disaster, the Arab Spring, a Greek Debt crisis, the rise of China as the world’s largest economy, Brexit, and COVID. Yet the US equity markets have been resilient, rising a cumulative 221% (S&P 500) over the past 21 years.

Yet, with a renewed sense of concern around inflation, the chart below shows how different asset classes perform under different inflationary environments. In 2020 we were in a period of low and falling inflation (bottom right), in which equities performed well. In 2021, and moving into 2022, we believe we are in a low and rising inflationary environment (bottom left) in which cyclical sectors and international stocks outperform. As you can see, we have positioned portfolios to own many of these “winners”.

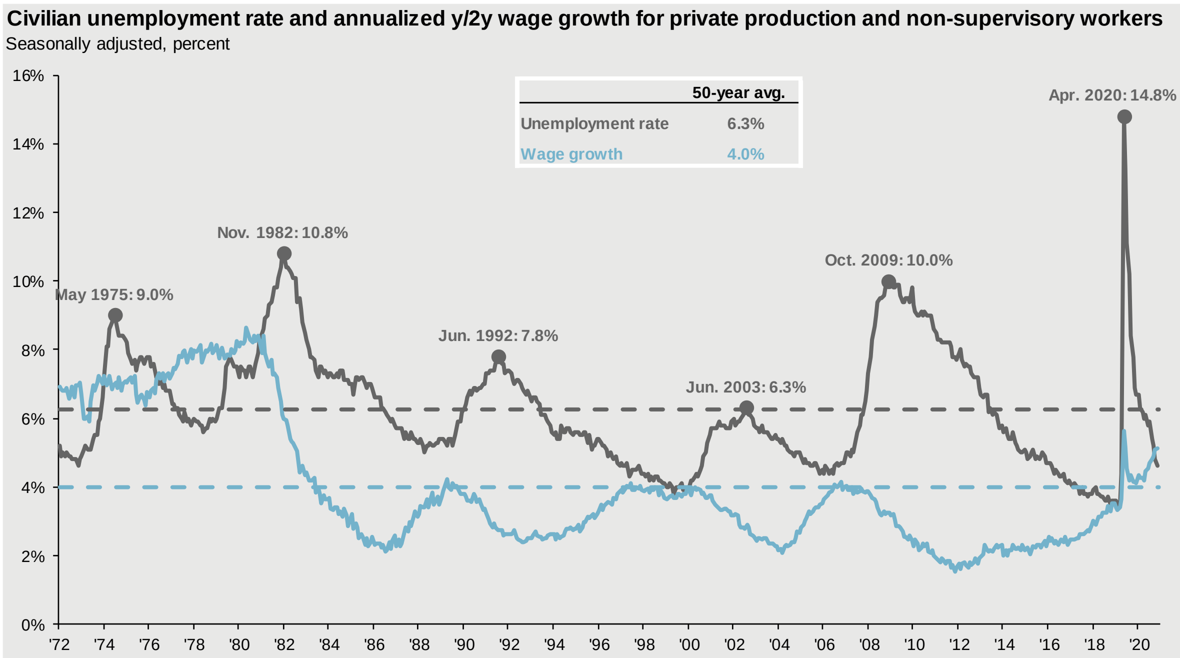


*Source: J.P. Morgan Asset Management. *High or low inflation distinction is relative to median CPI-U inflation for the period 1988 to 2020 (33 years), which was 2.5% y/y. Rising or falling inflation distinction is relative to previous year CPI-U inflation rate. Indices: Bonds – Bloomberg Barclays U.S. Aggregate; Cash – Bloomberg Barclays 1-3 Month T-Bill index since its inception in 1992 and 3-month T-Bill rates prior to that; U.S. high yield – Bloomberg Barclays US Aggregate Credit (corporate high yield); Equities – S&P 500; Value – Russell 1000 Value; Growth – Russell 1000 Growth; Small Cap – Russell 2000; EM equity – MSCI Emerging Markets (USD); REITs – FTSE NAREIT/ All Equity REITs; Commodities – Bloomberg Commodity Index since its inception in 1992 and S&P GSCI prior to that; Gold – NYM $/ozt continuous future closing price. For illustrative purposes only. Past performance is not indicative of comparable future returns. Returns are based on calendar year performance and are total return unless otherwise specified. U.S. Data are as of March 31, 2021.*

Growth, Jobs and Profits

The road to pandemic recovery has been bumpier than expected, with the COVID variants and severe supply shortages cutting into consumer and business spending. However, we continue to expect growth to reaccelerate late this year as reopening resumes and companies try to rebuild inventories. As we move into 2022, the economy should have fully recovered from the pandemic. Then, looking forward, a shortage of workers and much less fiscal and monetary stimulus should slow economic growth toward its long-term trend of roughly 2-3% by the end of next year.

With surging labor demand and a higher cost of low-wage labor due to enhanced unemployment benefits, employers have had to raise wages to attract workers. The chart below shows that as unemployment has fallen, wage growth has been rising and is above historical trends. Rising wages and indicators of robust labor demand suggest slower job gains are primarily an issue of labor supply. This should keep wages elevated as the recovery continues, and is critically important for the Federal Reserve, as higher wages should feed through to higher inflation, implying that the economy could reach “maximum employment” sooner than past economic cycles may suggest.



Source: BLS, FactSet, J.P. Morgan Asset Management. U.S. Data are as of December 2, 2021.

There appear to be three main causes of the great worker shortage. First, demographics appear to be at play as baby boomers are retiring, and the number of immigrants is down 70% (immigrants are typically younger than the average American). Second, the pandemic is preventing 1.2M people (November report) from returning to the work force due to COVID related child-care coverage issues, health concerns, increased substance abuse, or worker-skill mismatch (i.e. an unemployed hotel worker can't drive a truck without a Commercial Driver's License). Lastly, government policy has supported unemployed workers financially through enhanced unemployment benefits and other related programs.

Earnings have recovered spectacularly since the big declines in early 2020 and are now expected to hit a new all-time high in 2021 ($206 in 2021 vs $163 in 2019 and $140 in 2020). However, from 2022 on, slower economic growth, higher wage costs, higher interest rates and, potentially, higher corporate taxes could make further profit gains much more difficult to achieve. Margin growth is largely responsible for the increase in profits in 2021, which are coming under pressure. With that said, 2022 consensus EPS are still $222, which is an ~8% growth rate from 2021.

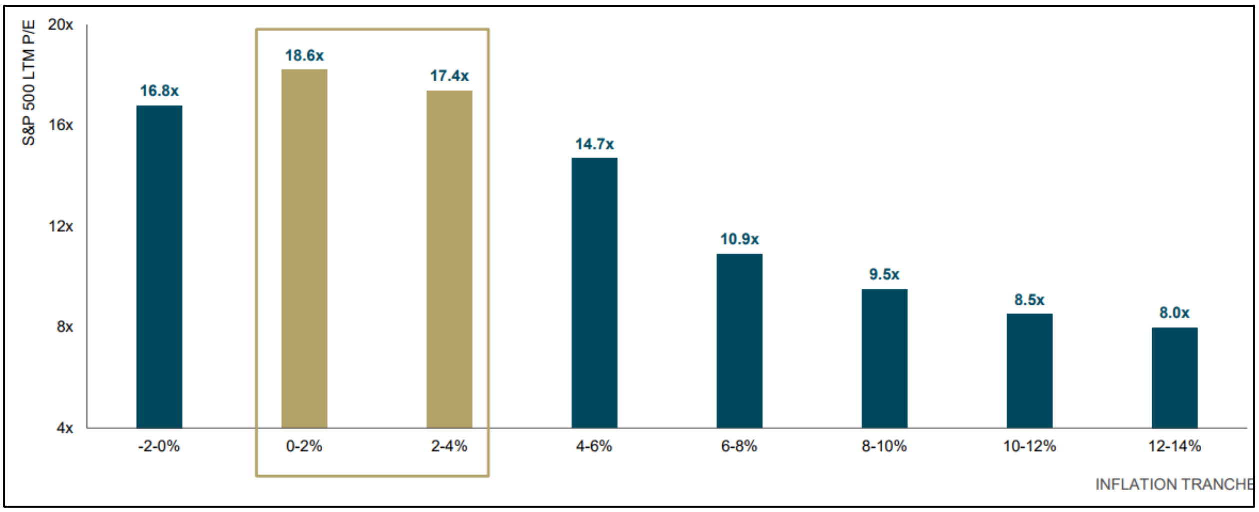
Inflation and Fiscal and Monetary Policy

Inflation signals have heated up significantly as a surge in consumer spending continues to collide with supply shortages across major sectors of the economy. Some drivers of much higher inflation are beginning to abate, and we expect inflation to moderate in 2022 as supply chain disruptions are ironed out and demand growth cools (peak automobile, housing, and energy prices are likely behind us). However, strong wage growth, higher inflation expectations, a falling dollar, and the lagged effect of higher home prices on rents should keep inflation more elevated than at the end of the last expansion. We would characterize inflation, therefore, as transitory, yet sticky.

Valuations and Interest Rates

U.S. equities have trended higher during the course of the year, characterized by range-bound valuations and rising earnings expectations. Stock prices based on current forward P/E ratios still look elevated, although they have come in somewhat as earnings have played catch-up. Looking forward to 2022, returns will depend more heavily on profit margins. Rising wages, supply chain disruptions, and higher taxes could all negatively impact profit margins over the next few years. While elevated valuations may pose a speed limit for the market, the outlook for returns remains positive amidst strong fundamentals and corporate profitability.

This chart illustrates that in periods of low inflation, P/E multiples have historically been higher. When looking at the S&P500, it's worth noting that while the 10 largest companies have a P/E ratio of ~30X, the bottom 490 trade at a P/E ratio of ~19X. The top 10 certainly appear overvalued, yet when you consider they generate a Return on Invested Capital of 18% and EPS growth of 23%, their valuations become more justified. Still, as inflation expectations rise, valuations of domestic large cap equities become more concerning.



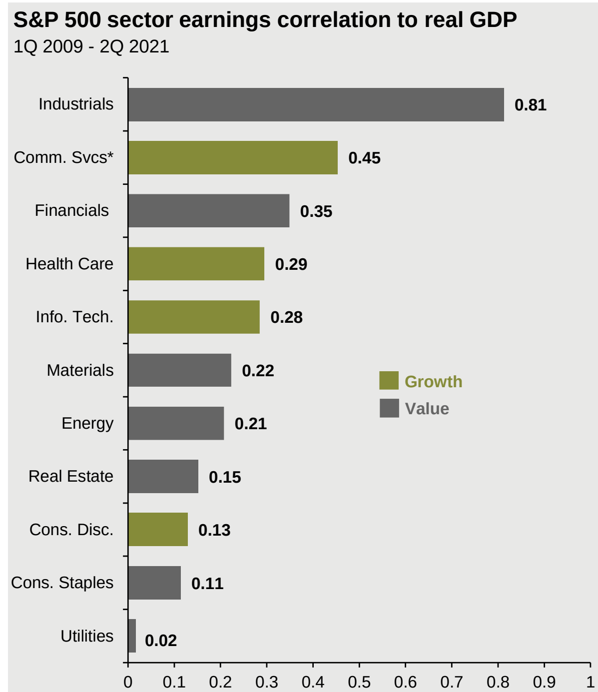
Source: StrategasRP, BNY Mellon Wealth Management. As of 9/30/21. Updated Quarterly. P/Es represent 12-mos trailing earnings. 1950 – September 2021. S&P 500 P/E for trailing twelve months.

Key Themes and Asset Class Recommendations

After multiple years of strong outperformance of growth stocks, most notably during the pandemic in 2020, value has begun to recover. The chart below (left) shows that, value appears to remain cheap relative to growth compared to long-term averages. Additionally, value generally tends to outperform growth during periods of above-trend economic activity and rising interest rates, such as the current environment.

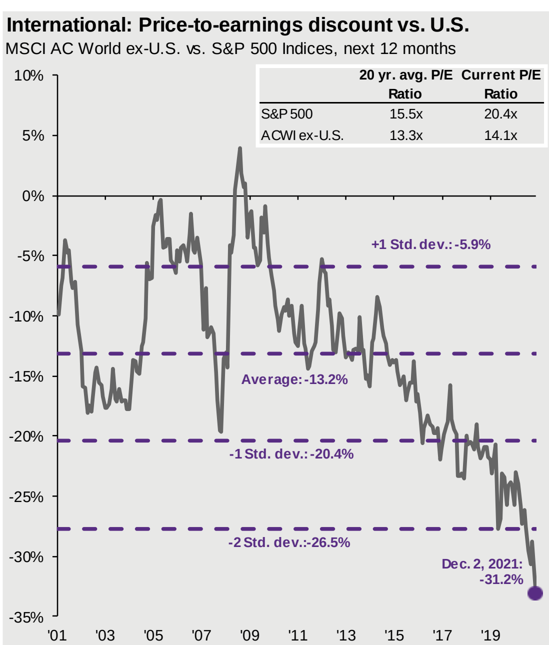
However, investors would be wise not to abandon growth stocks altogether as the economy is likely to slow down to a much slower pace of economic growth later in 2022 and into 2023, and growth stocks have traditionally outperformed value stocks in a slow economic growth environment.

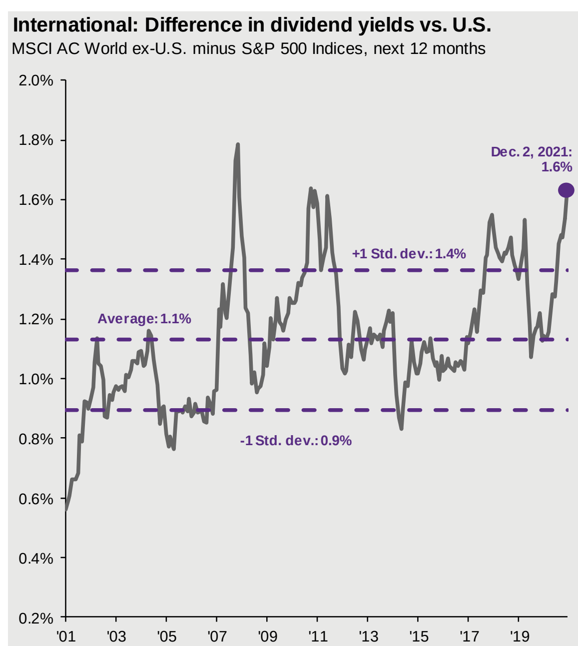
From a Value standpoint, Industrials, Financials, and Materials are our preferred sectors. Within growth, we have a bias towards Communication Services.



*Source: FactSet, FTSE Russell, NBER, J.P. Morgan Asset Management. Growth is represented by the Russell 1000 Growth Index and Value is represented by the Russell 1000 Value Index. *Communication services correlation is since 3Q13 and based on back tested data by JPMAM. U.S. Data are as of December 2, 2021.*

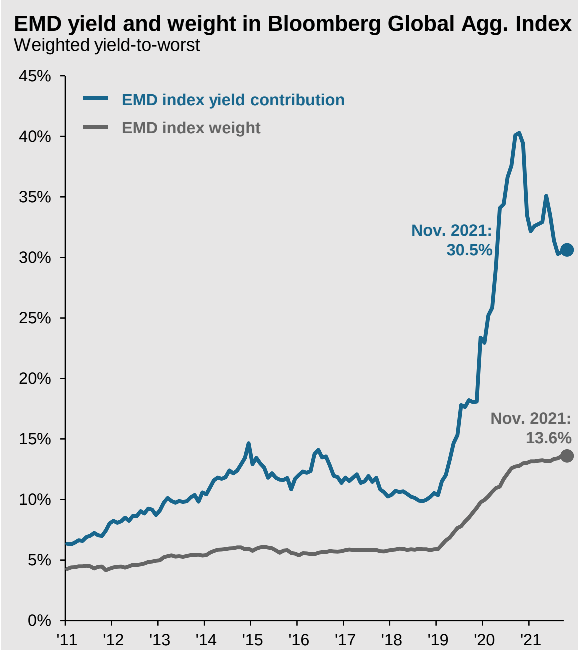
As we show on the chart below, both Emerging Market and Developed Country stocks outside the United States are selling at some of their cheapest levels relative to their U.S. counterparts in the last 20 years. This, along with the potential for a strong global post-pandemic economic rebound, lower trade tensions and the prospect of a lower dollar in the long run all argue for a greater allocation to international equities with a particular focus on East Asia and Europe.

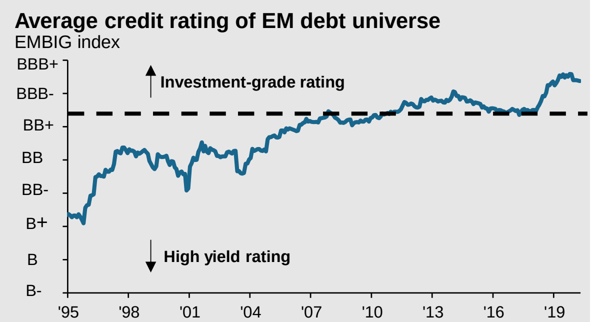


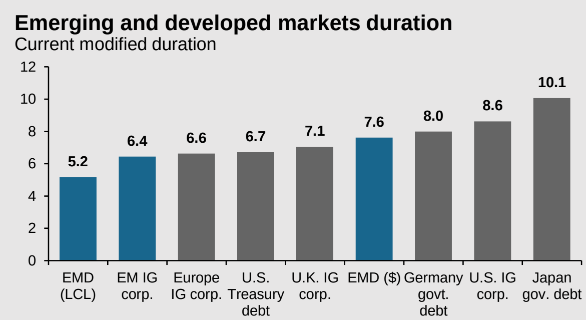


Source: FactSet, MSCI, Standard & Poor's, J.P. Morgan Asset Management. U.S. Data are as of December 2, 2021.

Despite negative performance for the year, Emerging Market (EM) debt continues to look attractive. The chart below (left) shows EM debt's superior contribution to total yield relative to their share of the global aggregate index. The chart on the top right shows how EM debt credit ratings have steadily improved over the past 25 years. Finally, the chart on the bottom right shows how EM debt in local currency is the shortest in duration and least sensitive to rises in interest rates.





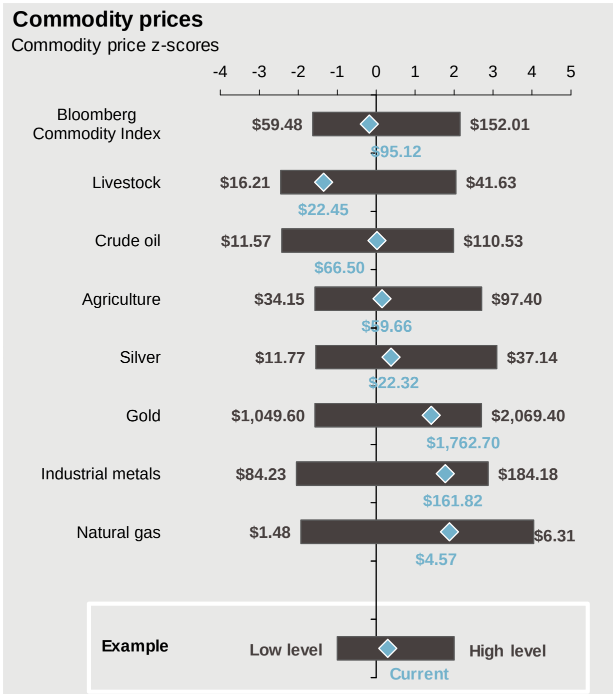


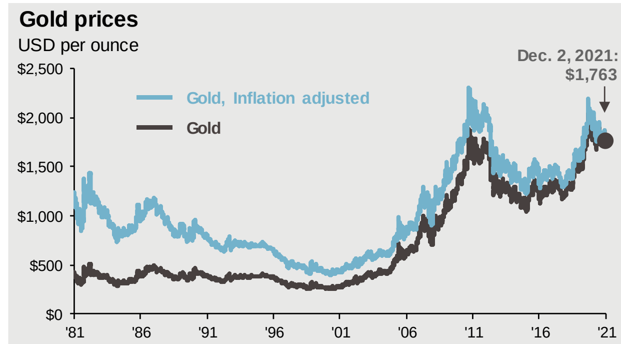
Source: Bloomberg, FactSet, J.P. Morgan Asset Management. Emerging market debt yield and weight contributions in the Bloomberg Global Aggregate Index include frontier markets. U.S. Data are as of December 2, 2021.

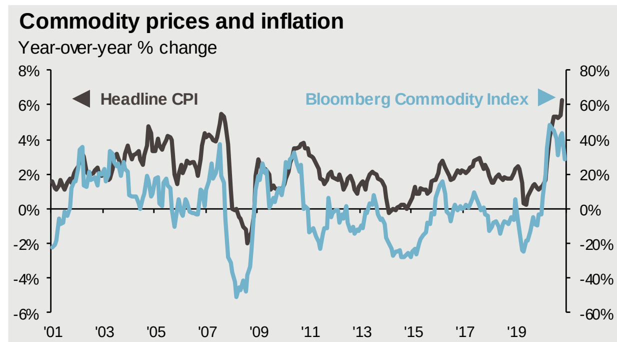
Unfortunately, this asset class has been one of our worst performing assets for the year, as the US Dollar appreciation has worked against it. Economic growth is expected to be slower in the US vs. abroad, and high US trade deficits and higher US inflation will put downward pressure on the US Dollar. For these reasons, we continue to believe the US dollar will depreciate over the intermediate term, which will reward patient investors with both higher yield relative to US debt, as well as bond price appreciation.

Commodity Prices and Inflation

As you can see in the chart below (top right), gold as a long-term investment remains suspect, with real prices (inflation adjusted) lower than where they were 35 years ago. However, the chart on the bottom right highlights the relationship between broad commodity prices and inflation, with the former typically changing ~10X as much as the latter. We continue to see this as a relatively cheap means of hedging portfolios from inflation given the fiscal and monetary stimulus the government continues to introduce into the system. It is also worth noting that as the dollar falls, as we believe will occur, commodity prices have historically risen.







Source: FactSet, J.P. Morgan Asset Management; (Left) Bloomberg, CME; (Top right) BLS, CME; (Bottom right) Bloomberg, BLS. Commodity prices are represented by the appropriate Bloomberg Commodity sub-index. Crude oil shown is WTI. Other commodity prices are represented by futures contracts. Z-scores are calculated using daily prices over the past 10 years. U.S. Data are as of December 2, 2021.

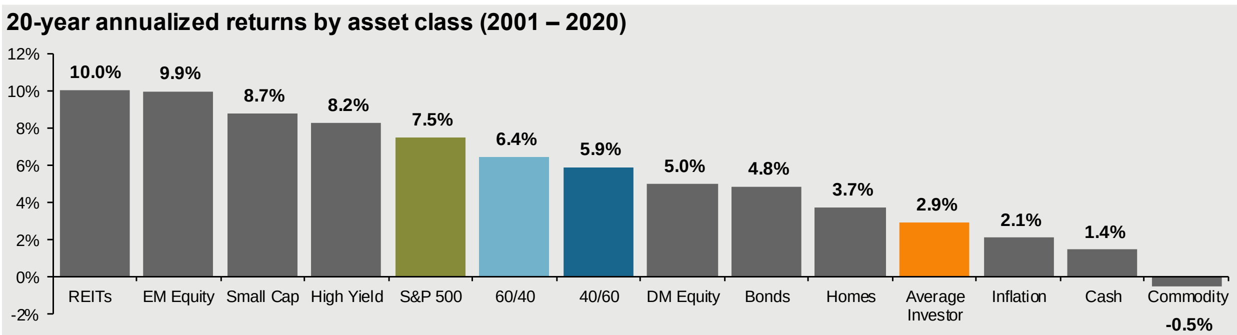
Uncertainty and Market Returns

Humans have evolved to dislike uncertainty more than fear, as things we fear can be avoided, while uncertain outcomes simply leave us in a state of anxiety. In the context of the markets, these issues are just potential scenarios that must be analyzed on top of an economy that is growing at a long-term rate of ~2% per year domestically, and 3% internationally.

The data today appear to point us toward a period of continued global economic strength as we emerge from the COVID recession, with above trend economic growth and inflation likely to fade in the latter half of 2022 toward more normalized levels. Unemployment is lower than anticipated, driven largely by persistent labor shortages that will put continued pressure on corporate profit margins and earnings in the year ahead. Yet earnings growth is likely to remain robust. From a valuation perspective, the most attractive opportunities appear to be in international markets, while small cap and cyclical companies look to be the most attractive domestically. A broad basket of commodities is likely to provide a hedge against rising inflation. Within the fixed income space, investors will be forced to remain in short duration bonds that have negative real yields or move up the risk spectrum into riskier assets such as high yield bonds and preferred stock.

Despite the “wall of worry” emphasizing inflation, valuations, interest rates, and Fed policy, investors should always expect to receive a positive rate of return on their portfolios over the long-term. Afterall, what reasonable investor would purchase ownership in a company, or lend money to a business, without a positive expected rate of return. Of course, individual investments don’t always pan out. Yet, for a disciplined investor that is globally diversified, over time, they should be adequately compensated for the risk they are taking as providers of capital.

The chart below shows 20-year annualized returns by asset class, as well as how an "average investor" would have fared. You will notice that the average investor hasn't done particularly well during this period, likely due to behavioral biases. You will also notice that a diversified portfolio of 60% stocks and 40% bonds has performed more than twice as well as the average investor during this time. The average investor should leave emotion out of the investment process, form a plan, and stick to it. As we continue to help you steward your investment portfolio, we will remain vigilant in our attempt to disassociate emotion from our decision-making process, and let the data lead our thinking.



Source: Source: Bloomberg, FactSet, Standard & Poor's, J.P. Morgan Asset Management; (Bottom) Dalbar Inc, MSCI, NAREIT, Russell. Indices used are as follows: REITs: NAREIT Equity REIT Index, Small Cap: Russell 2000, EM Equity: MSCI EM, DM Equity: MSCI EAFE, Commodity: Bloomberg Commodity Index, High Yield: Bloomberg Global HY Index, Bonds: Bloomberg U.S. Aggregate Index, Homes: median sale price of existing single-family homes, Cash: Bloomberg 1-3m Treasury, Inflation: CPI. 60/40: A balanced portfolio with 60% invested in S&P 500 Index and 40% invested in high-quality U.S. fixed income, represented by the Bloomberg U.S. Aggregate Index. The portfolio is rebalanced annually. Average asset allocation investor return is based on an analysis by Dalbar Inc., which utilizes the net of aggregate mutual fund sales, redemptions and exchanges each month as a measure of investor behavior. U.S. Data are as of December 10, 2021.

Wishing you all a safe and happy holiday season and a healthy new year,

Brian Luster
Chief Investment Officer

David Sivel
Chief Executive Officer

Trevor Hoffman
Chief Operating Officer

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