2022 YEAR AHEAD
2021 YEAR BEHIND

THE/BAHNSEN GROUP

"Trust is built on telling the truth, not telling people what they want to hear".
~ Simon Sinek

This quote served as our team motto for 2021 at The Bahnsen Group. It builds on our long-term proposition that the one thing we ask of clients is their trust, and the one thing we promise is our own trustworthiness. Market commentators can be right and they can be wrong, but no commentator should ever be disingenuous. A sincere view that plays out wrongly on occasion is preferable to an insincere view that plays out right, because markets never sleep, and the perpetual process of portfolio guidance requires truth-telling over time.

We have a lot of truth to share that clients like hearing, and sometimes we have truth to share that is not so popular. We offer our daily market commentary (DC Today), our weekly macro commentary (Dividend Café), and our annual retrospective and forward perspective (this white paper), with a firm commitment to the truth.

Interestingly, this is not pre-text for getting ready to drop a bearish bomb. We have had clients over the years frustrated with us over not being more bearish (pessimism is often more of a pathology than it is an investment view). And we certainly have had clients not appreciate our perspective on risk-reward trade-offs when it came down unfavorably on certain popular investment solutions. I believe with all objectivity that our views are generally free of cognitive dissonance, rooted in sincere beliefs and perspectives, and as free of unhelpful biases as possible when it comes to making investment decisions. We have our influences and beliefs, no doubt, but they are not anchored to a need to be permanently bullish or permanently bearish. We just want to call it as we see it.

2021 also gave people the opportunity to lean into a perspective that would have been quite popular with many people. Many were frustrated with the results of the 2020 elections and would have loved to see us forecast a market scenario that reflected such election frustration. On the other hand, many were elated by the election results, and would have loved to see projections that aligned with a new vision for government. Our 2021 views were too nuanced to satisfy the partisan, and for that, I am proud. It will not shock you to hear that 2021 proved to be, well, too nuanced of a year for the partisan, as you shall see.

2021 also gave us the opportunity to lean into "shiny object" investing. From crypto, to "new economy" tech stocks, to SPAC's and IPO's, to so-called "meme stocks", to all sorts of flavors of the month, 2021 contained a variety of speculation bonanzas, some of which paid off huge, and some of which ended in tears. We avoided all such frenzies, not because we knew they would all decline in price in 2021 (in fact, while some ended very badly, some did quite well on the year), but because we knew that we lacked the ability to truthfully assess the risk and reward. We believe truth-telling is important, even when the ball lands on red.

In so many ways, 2021 will be remembered as a year of continuity from 2020, not a year of a clean break from one of America's worst years. Political dysfunctions were exacerbated, not diminished. COVID-19 kept its place in the news cycle, with a new variant providing new opportunities for media hype every few months. Social media and big tech stayed at the epicenter of our culture's frustrations. And nearly two full years after the pandemic struck, a high percentage of our nation's white collar work force is still waiting to go back to the office, alternating excuses for such with the same frequency I change my tie (a tie, I might add, I wear to the *office* every day).

2021 did not represent the breakthrough year from the societal morass that was 2020. But there is another fact of 2021 that may strike investors as noteworthy, similar to 2020, and yet overwhelmingly positive:

Risk assets once again ignored the media, the virus, and the political dysfunction, and offered risk-takers extraordinary returns for their confidence.

There is plenty of nuance in this that needs to be unpacked, and the message in the economy is not as simple as one may extract from market signals. But 2021 was a hugely positive year for markets despite the non-stop opportunities for markets to surrender and buy into the hype du jour about how awful everything supposedly is. Because investors are terrible at market-timing, and because newspaper headlines are immeasurably bad at providing portfolio guidance, we are always looking for reinforcement of our time-tested immutable belief that a cogent investment philosophy must trump all the "noise". 2021 was yet another reinforcement of just that. You will see how many times this proved true in our "trip down memory lane". As has become our annual tradition, the objectives of this white paper will be a thorough look back at 2021, with the goal of finding the various actionable lessons the year produced. We will offer a variety of themes and perspectives on 2022 – some within the consensus of Wall Street thought, and some far outside of consensus.

But everything I have to say about last year and about this new, exciting year ahead will be the truth. That is what our clients deserve, and it is what our company is built on. I wish the truth also came with a crystal ball. It does not. You see this tension embodied in how we allocate client portfolios – indeed, in the whole existence of "asset allocation".

We do not own every asset we own because we know they will all go up in value over the next 3, 6, or 12 months. We own some because we do not know what others will do. Humility is the basis of asset allocation.

Yet we offer our views on 2021 and now 2022 with a humility that is accompanied by conviction. And those convictions are rooted in truth. To that end, we work.

2021 IN REVIEW:

A Sequential Trip Down Memory Lane

It fascinates me to think that the Dow began January 2021 at 30,000, and ended January at 30,000 as well, despite rising over a thousand points in between. Why is this so fascinating? First, because of why January ended on such a downturn a year ago. No matter how stupefying it may be to say it, the markets hiccuped and gyrated at the end of the month because of … meme stocks and chat room shenanigans. Okay. Maybe there was more to it than that, but a couple "popular stocks to short" got ganged up on (in a positive way?), and markets went all tipsy-turvy for a couple days while a bunch of bloggers had their way with some hedge funds. I discussed it plenty at the time, and other than the various reasons for not participating on either side of the fiasco, there was nothing actionable to share – but it does explain why January added a little volatility to the stock market.

Of course, equally counter-intuitive to the idea of the market going down 1,000 points on the actions of basement-bloggers is the fact that a couple weeks before that the market went up 1,000 points as COVID hit record highs for cases, hospitalizations, and mortalities. The winter surge played its way through a mostly pre-vaccinated society, and markets shrugged it off entirely. Why? Markets are discounting mechanisms, and they were pricing in what they believed about the future, not what progressive mayors were saying about closing down schools and restaurants.

The first quarter saw more than just a COVID surge and a meme-stock craze. It also saw oil skyrocket higher, running from $50 to $66 in the first ten weeks of the year (+32%). Q1 saw early stages of a growth-to-value rotation in equity markets (a dynamic that would not necessarily last all year), and it saw strong leadership in Energy and Financials (a dynamic that would last all year).

It also saw the $1.9 trillion "COVID relief" package pass Congress, a legislative feat that would become more of a news story later in the year as it pertained to labor markets. The second quarter of 2021 was perhaps the most "normal" of the year as it pertained to COVID. The early variants proved to be much ado about nothing, and vaccine uptake became a wild success across the country. The CDC lifted its mask guidance, new COVID cases hit record lows, and waves of normalcy came over most of the country.

One of the nation's largest pipelines was held hostage by Russian cyber-attackers. The market advanced another 1,500 points on the quarter, despite talks really heating up on Capitol Hill about massive tax increase legislation.

Two weeks into Q3 came the word of the Delta variant, and the market dropped 3% in two days for the fourth time this year, only to recover within three days, also for the fourth time this year. Delta would, indeed, represent a highly infectious variant that broke through to some vaccinated people, and infected ample amounts of the un-vaccinated, but it would not prove to be an economic or market event. It was allowed to ruin fan presence at the Tokyo Olympics, but it did not compress U.S. economic activity as most businesses found themselves without adequate supplies and workers to meet thriving demand.

The Afghanistan withdrawal debacle in August was not a direct market story, but it would prove to be so (in my opinion) later in the year to the extent that the declining approval status of President Biden weakened his political leverage around legislative priorities. By the end of Q3 it was clear that the year-end stories would center around the fate of the bipartisan infrastructure bill, and the fate of the much larger budget reconciliation bill.

Technology enjoyed a strong rebound quarter in Q3 (up +2.8%), but it was Financials that led the pack (+4.4%) even as bond yields compressed and the "widening" yield curve narrative failed to take hold.

The fourth quarter saw the market make new highs, then suffer another quick drop around news of a new COVID variant, then see new highs again when that variant was determined to be more of a positive market story than a negative one. Along the way Q4 was dominated by political news as the year-long fears of trillions of dollars of new taxes fell apart behind the reality of a 50-50 Senate. The bipartisan infrastructure bill was passed into law, and the "Build Back Better" legislation was first marginalized from the largest tax and spending bill in history to a fraction of its own shadow (mixed metaphors on purpose), and then cut all together when it was determined the votes were not there in the Senate.

The Omicron variant did become a leading story in the final month of the year, and its high infectiousness lived up to the hype. But thankfully, so did its low severity, and the counter-intuitive idea that Omicron may infect the last bastion of those who were uninfected or unimmunized, all the while creating stronger antibody protections for the future seemed to take hold in markets. As of publication we do not know when exactly the case peak from Omicron may be, but most believe it is imminent, and markets seem to appreciate that the inevitable endemic status of COVID-19 is upon us, with very little economic disruption ahead as Americans re-assert overdue normalization.

2021 was not without its bumps and bruises, but they were barely noticeable bruises as it pertained to equity markets (more on this below). Economic activity was robust throughout 2022 as pent-up demand outperformed expectations. The narrative entering the year was one of true hand-wringing over whether or not the economy would heat up, and the narrative exiting the year is what we are supposed to do about this over-heated economy and price level. My what a difference a year makes!

2021 Market Summary

The year closed on Friday, December 31 up +18.7% for the year on the Dow and +26.9% for the year on the S&P 500 – both right near their all-time highs.

Source: CNBC.com, Dec. 31, 2021

Tracking with the equity market, Commodities (as a mixed basket) were up +27% on the year but did give up -6.4% in the fourth quarter. The dollar advanced over +6% on the year (against a trade-weighted basket of foreign currencies), a surprise in the midst of the inflation narrative that dominated much of 2021 (more on this below). Oil advanced a shocking 57% in 2021 as demand came surging back post-lockdowns and as supply levels remained below pre-COVID levels.

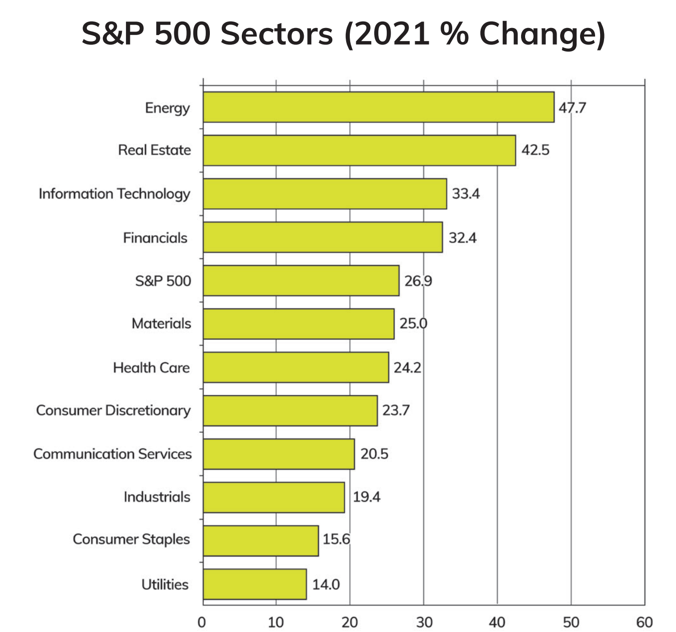
2021 Asset Class Performance

Commodities	27.1%	High Yield	3.8%
U.S. Large Cap	26.7%	Corporates	-1.9%
U.S Small Cap	14.8%	Emerging Bonds	-2.2%
Europe	16.0%	Global Bonds	-2.3%
EAFE	11.1%	Emerging Stocks	-3.6%
Preferred	7.1%	Gold	-4.2%
TIPS	5.7%		

Source: Yardeni Research, Dec. 31, 2021

Short-term interest rates ended the year exactly where they began. And the 30-year Treasury yield really didn't move much either (from 1.83% to 1.90%). It was the middle of the curve where there was a little action as the 10-year went from 1% to 1.5% and the 5-year moved from 0.36% to 1.26%. These yield moves caused slight price depreciation in most bond portfolios.

Energy was the top-performing sector on the year (up +48%) on the year, with Real Estate right behind it (up +42%). Technology and Financials (+35% each) were the only other two sectors to deliver a higher return than the market itself this year, though Communications (which includes many names previously categorized Technology) was a sub-market performer. Consumer Staples were only up +15% on the year, but over +9% of that came in the month of December alone. Utilities were the worst-performing sector of 2021, yet still achieved a +14% return (still worthy of a nice participation trophy).



Source: Russell, Dec. 31, 2021

Looking under the hood of sector performance on the year, the top sub-sectors where we see more granular out-performance included the Steel industry (+115%), Oil & Gas production (+81%), Human Resources/Employment Services (+78%), Trucking (+71%), and Automotive Retail (+58%).

Though the final GDP growth number for Q4 will not be available for a few weeks, real GDP growth for full-year 2021 looks posed to come in between +5 and 6%, a strong number in a normal year, but a modestly disappointing number in this post-COVID recovery.

Key Takeaways From A Historical Year

This list is certainly not exhaustive but does cover what we believe to be the major economic and market realities of 2021.

1 PRICE INFLATION & THE BOND MARKET

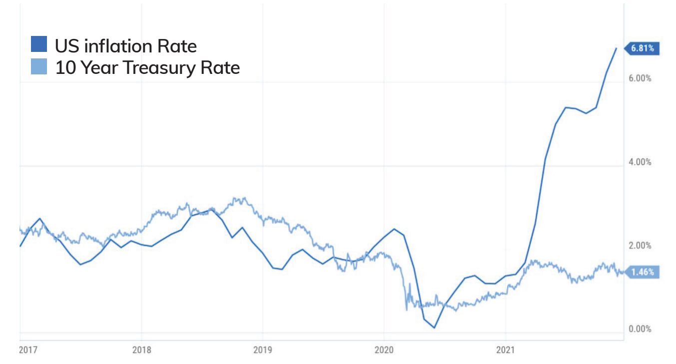
The story that took over economic news by the second half of the year was the increase in prices evident in nearly all aspects of the economy (consumer prices, housing, rent, automobiles, wages, food, energy, etc.). Heavy supply chain disruptions initially took on much of the blame, and for good reason, though that term had to be expanded to include port disruptions, truck-driver shortages, inadequate labor supply, and a host of other extrinsic circumstances that were either inter-connected or part of a domino chain with one another that all accomplished the same thing – an under-supply of goods and services relative to demand (ergo, price escalations).

Consider this: Normal new vehicle auto inventory, nationwide, has averaged 3.5 million cars from 2017 through 2019 (all pre-COVID years). In the second half of 2021, national inventory averaged just 1 million cars, 28% of normal supply. Price escalations are assured in such circumstances.

It is the worst year for inflation since the early 1980's, right? So naturally bonds have gotten crushed and gold has skyrocketed, right? Actually, Gold is down -3.7% on the year, while the Total Bond Market Index is down just -1%. The bond market's resilience remains the most compelling argument against sustained monetary inflation:

Bond yields are telling a very different story than the consumer price index of 2021.

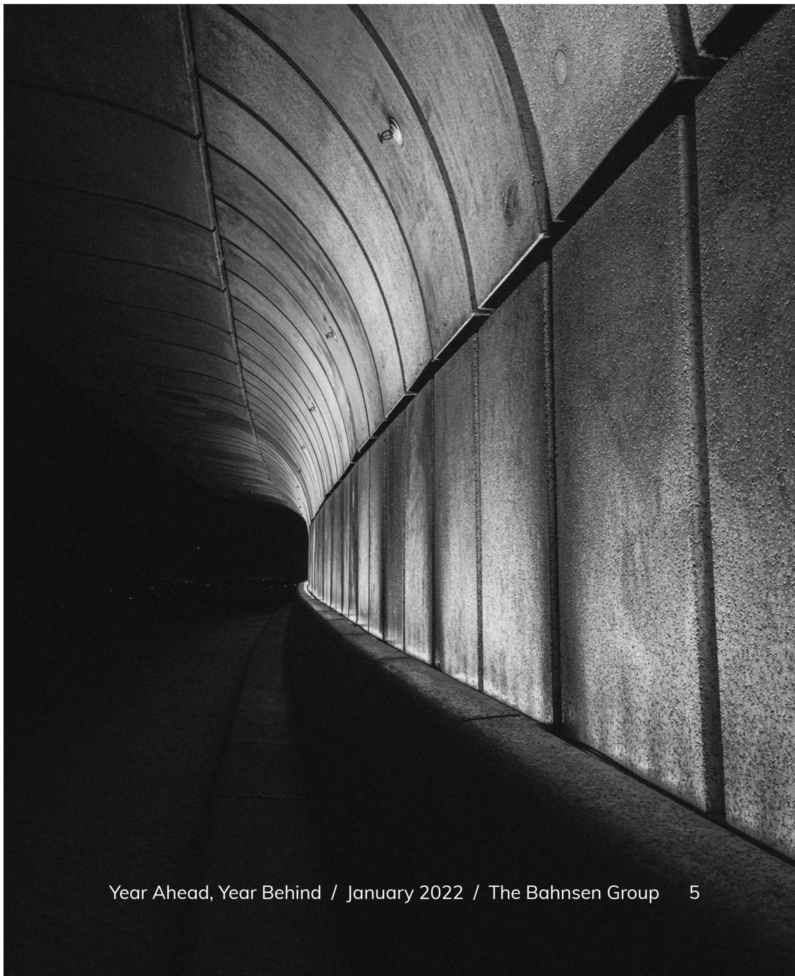
U.S. bond yields are anchored to some degree by global yields, but of course every other nation is in the same situation – high government spending, high monetary intervention, yet low bond yields. It is very hard to anticipate multi-year elevated inflation (let alone "1970's inflation") when the long-term bond market is signaling something like this.



Source: Ritholtz, December 27, 2021

Source: Bloomberg, Dec. 31, 2021

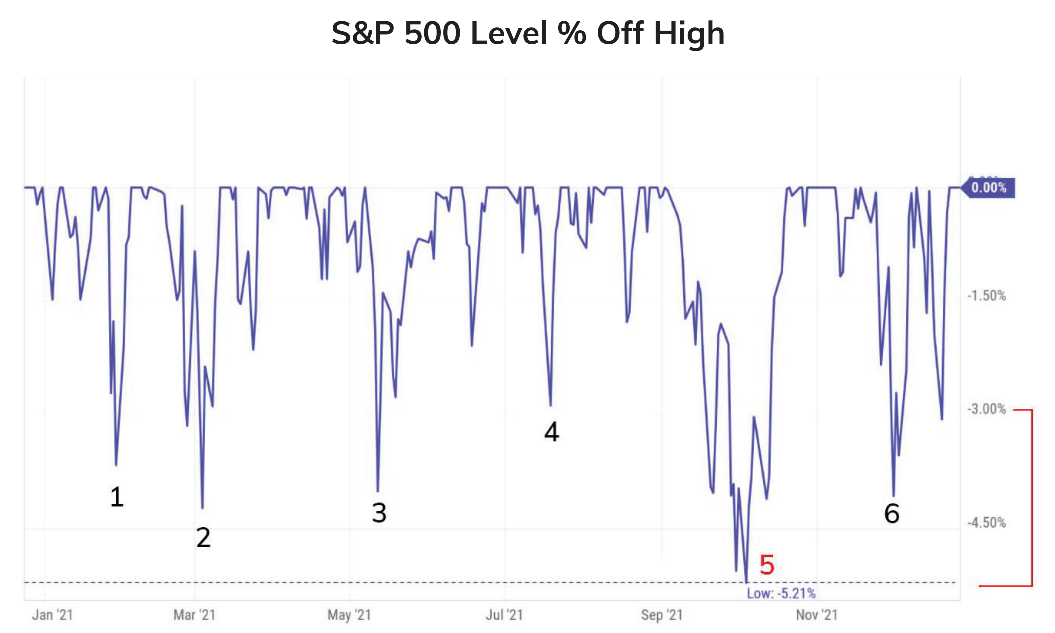
But regardless of what the longer-term inflationary reality proves to be, there is no question that the price deflation of 2020 was reversed in 2021 and that a perfect storm of circumstances have cause price inflation across most goods and services.



2 IF THIS IS MARKET VOLATILITY, SIGN ME UP!

It was as easy of a year to "buy the dips" as I can remember. Not only were the "dips" barely even dips, meaning a maximum draw-down of -5% barely even counts, but in each of these six occasions, the "dip" lasted just days.

It is the kind of volatility experience that can make one think being an equity investor is easy, and so in that sense is not a good thing. It was not quite 2017, where the maximum drawdown was -2.9%, but a max drawdown of -5.2% with five other dips that were between -3% and -4.5% are just child's play compared to the -10% to -14% that is considered standard annual downside volatility intra-year.



Source: Ritholtz, December 27, 2021

3 NOT EVERYTHING CAME OUT UNSCATHED

For a year where seemingly every risk asset performed well, and our prior section highlighted the noteworthy low levels of volatility across the broad stock market, it is surreal to think that some of the hottest parts of the market were actually taken to the woodshed in 2021 and no one seems to have noticed. The 2020 "work from home" moment of the pandemic (may it soon be on the ash heap of history where it belongs) created a fiery buzz in new stocks that focused on video conferencing, online real estate search, remote gambling and sports betting, food delivery, home exercise equipment, and a variety of other sectors that were the "shiny object" of 2020.The leadership stocks in these various sectors (most of which are now household names post-pandemic, as if they were blue-chip companies) are down 30-70% in many cases.

The popular "innovation" theme (a media darling) was down -24% on the year (and -40% from its intra-year high). This is a good proxy for the "shiny object" theme, but it increasingly seems there is more than one "shiny object" out there, and they each have to be evaluated on their own merits. The "cool tech" and "new economy" space saw heavy price depreciation in the second half of 2021.

4 CHICKEN LITTLE & NATIONAL TAX POLICY

I do not think those who spent much of 2021 attempting to scare the [blank] out of you about changes to tax law will ever be held accountable. It is not that there was not an attempt to significantly raise taxes on income and investment – and it is not that there are not political leaders who would like to see that happen. But what those who spent so much of the year aggressively fearmongering did not understand is how a bill becomes a law in our country. The political reality was never suggestive of the most onerous tax increases in history coming to be.

My own view is that some suffered from a conflict of interest in the views they shared (they had something to gain in telling you that paradigmatic changes were coming in income, investment, or estate tax policy), and that most just suffered from a poor reading of tea leaves. If I had to bet, I would say some modest increase in corporate taxes and capital gain taxes was likely to have happened (but never the sensationalistic ideas around estate taxes and unrealized gains) before the political winds shifted in the second half of the year.

But a major story of 2021 was that the market never believed these things were going to happen, and the market was proven right. You can say the market knew more about Joe Manchin than anyone else did, but the better way to say it is that the market simply knew that the sausage-making of legislation in our Madisonian form of government was never going to be easy.

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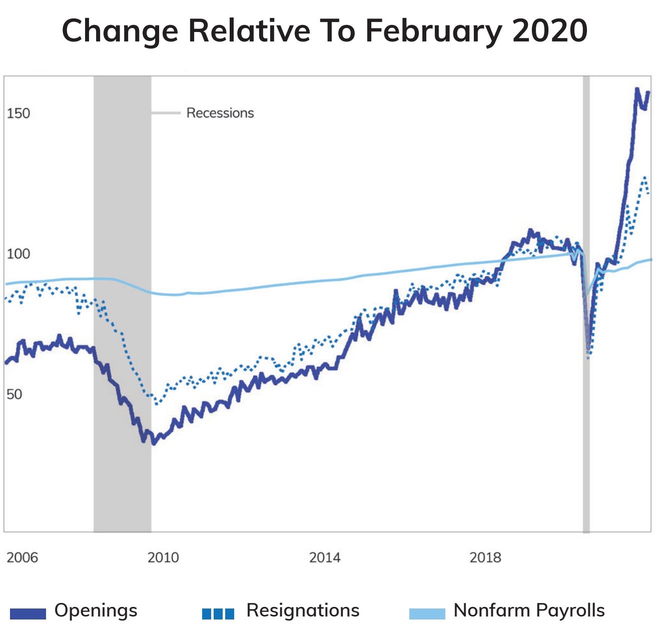
5 A NATION CHANGING ITS MIND ON WORK

The great economic story coming out of the pandemic was the sky-high unemployment level and concern about sustained levels of joblessness. Weekly jobless claims printed unfathomable numbers and real concerns surfaced about employment opportunity for a large portion of the population, especially service workers and those in lower-income tiers.



Source: Steven Rattner, New York Times, Dec. 29, 2021

The unemployment rate ends the year back at 4.2%, lower than it has been for almost all of the last 75 years (though not quite back to pre-pandemic levels). But more notably, what had been between 5 million and 7.5 million "job openings" between 2014 and early 2020 exploded to 11 million in 2021.

Essentially, the concern of having enough jobs available for people who want them flipped to having enough people to fill the job openings we have. And while we have generally seen less than 3 million people per year quit their jobs (usually to replace it with a different job), 2021 saw the number reach 4.1 million people (again, many who have presumably found better opportunities elsewhere, but no doubt, many who have decided to exit the work force entirely).

The economic story here is that we are experiencing a cultural shift and it has many causes. Less "young" people are entering the work force in a meaningful way, and more "older" people are leaving the work force in a meaningful way. The labor participation rate has not recovered pre-COVID levels and does not look like it is going to come close to doing so any time. This results in a labor shortage at the lower skilled and lower paid levels of the work force, and results in a shortfall of those with skills and experience at more experienced and compensated levels.

Concluding Takeaways From 2021

1. Extraordinary Profit Growth in public equity markets created a superb return environment for risk assets across the board.

2. The Economy Is A Mixed Bag – with higher prices cutting into the real incomes of lower income Americans, and a shortage of laborers exacerbating supply chain disruptions that stem from inadequate preparation for a surge in demand.

3. The Fed Did Little To Take Their Foot Off the gas in 2021, adding liquidity and a favorable monetary environment for risk-takers throughout the year. The pros and cons of this remain far from settled.

2021 Report Card

Last year I provided themes for the year ahead that we felt represented intelligent investor perspective coming into 2021 (we do this every year, including later in this paper for calendar year 2022). The following represents our "report card" a year later...

1. "Don't Fight the Fed"

I'd say this one played out, eh? The Fed kept interest rates at the zero-bound all year and those who believed rates would fly higher anyways saw rates stay right around 1.5% on the ten-year treasury. The Fed maintained aggressive quantitative easing all year despite pressure to stop, and only began "tapering" (i.e. slowing the pace of such purchases) in the final month of the year. Fed policy boosted asset valuations, provided ample liquidity in a true "risk-on" environment, and only hurt those who tried to resist it.

2. "The M&A Train is Coming"

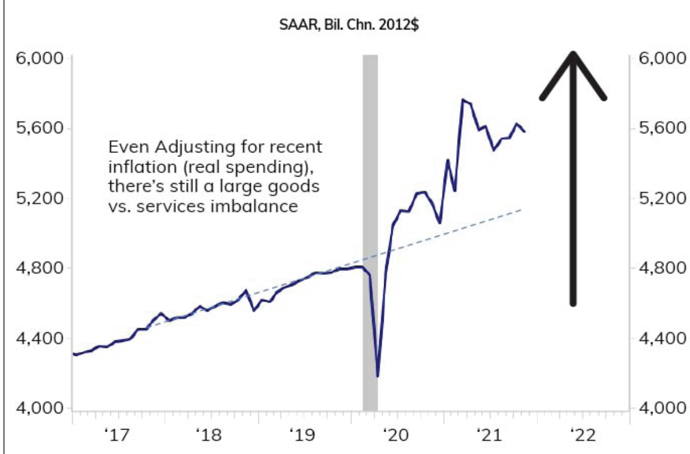
This one also deserves an "A" grade, and unlike #1, was hardly a lay-up. Investment banks, private credit, sell-side advisors, and publicly-traded private equity firms all benefited immensely in 2021 as the low cost of capital and a strong appetite for consolidation created the highest year of Merger and Acquisition activity in recorded history.

3. "Economic Recovery in Three Stages"

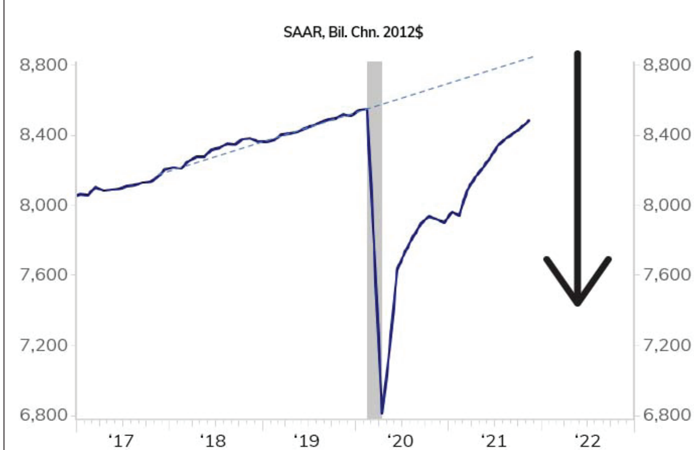
A year ago I saw recovery coming out of COVID as a "wait and see" followed by "pent up demand" which would then be followed by a "TBD" in Q4. Well, what we got right was a huge "pent up demand" that exceeded even our own expectations (many doubted this dynamic existed). What we missed was how that demand would outpace the ability of the economy to supply it necessary goods and services, creating price escalations that dominated economic news in the second half of the year.

What you see in the chart to the right is a massive pick-up in demand for goods and services, with services nearly back to pre-pandemic levels, and goods far, far above pre-pandemic levels. This increase in demand for goods without the supply necessary to meet it is what you call "inflation".

REAL PERSONAL CONSUMPTION EXPENDITURES: **GOODS**



REAL PERSONAL CONSUMPTION EXPENDITURES: **SERVICES**



Source: Bureau of Economic Analysis

4. “Market Rotation is Real and Inevitable”

The top-performing sectors of 2020 were Technology, Consumer Discretionary, and Communications. The bottom-performing were Energy and Financials. Well, Energy and Financials became the #1 and #4 sectors of 2021, with Technology hanging in there at #3, but Consumer Discretionary dropping to #7 and Communications dropping to #8. Large-cap value started off the year substantially out-performing large-cap growth, but by the end of the year they were largely neck-and-neck. 2021 became too much of a “risk on” year across the board to see full-blown rotation (it is hard to rotate when all risk assets are going higher), but there is no question that glimpses of classic market rotation were evident.

5. “Entrepreneurialism is in the American DNA”

Good luck convincing me that this has changed.

6. “China Commotion is in the Future, not the Past”

I don’t think some of the particular policy tensions I was thinking of did hit their tension point this year, and I think both sides of the aisle were surprised at the continuity in the new administration’s posture with China as the old administration’s. What was highly “commotive” out of China this year was some surreal interventions from the CCP in their equity markets, particularly in the tech sector.

7. “Private Equity, Sure. Private Debt, Absolutely”

Few investible theses did better than this one in 2021. The returns out of both private equity and private credit were phenomenal, with private debt on a risk/reward basis bucking the low-yield trend and delivering excellent coupons with stable prices to those who believed in the theme.

8. “Sentiment Is Not Your Friend”

This one is tough to gauge for 2021 as on one hand excessive sentiment killed much of the euphoria-craze in a certain kind of “tech” stock, and yet the sentiment behind crypto and FAANG held steady (with ample volatility along the way).

2022 Themes

1 LET'S JUST SAY IT - EQUITY RETURNS ARE HIGHLY UNLIKELY TO BE WHAT THEY HAVE BEEN

I am well-aware that people can accuse of me of inadequate specificity here, but I will live with the accusation (mostly because it is purposely and appropriately true). To put a "price target" on the stock market is a stupid thing to do, and my intention with this theme is not to "forecast" the market – let alone suggest a timing strategy. Rather, the theme here is about the setting of expectations and the probabilistic realities around market returns. There are reasons for this perspective.

My view is that euphoria, while not evident in every category we would want to see for a clear call of code red, is anecdotally present. Equity inflows in 2021 were over $1 trillion, more than the prior 19 years combined. Margin debt is over $900 billion (though it simply has to be pointed out that this number does not mean what it used to mean; for years margin debt was a by-product of people using the value of their portfolios to buy more of their portfolios – a significant amount of margin debt now is unrelated to other financings not related to leveraged investing). Valuation multiples are high. Cultural antics are elevated (meme stocks, trading apps, chat rooms, various 1999 dynamics and 2021 versions of 1999 antics). There are counter-indicators, too (fixed income flows are hardly lackluster, and high yield bond spreads have widened a tad). But at the end of the day, there are, best case, signs of stupidity and excess in select pockets, and worst case, concerns of systemic complacency.

So why not just go full-board bearish? The answer is the same as it is on my inflation views: *Bond yields do not yet allow for full-blown bearishness.*

If the facts change, our views will change. But while I am calling for moderated expectations of equity market upside, I still believe if the 10-year treasury yield is south of 2.5%, it is very hard to bet against risk assets. Bond yields have everything to do with equity valuations, and they have everything to do with capital allocation decisions.

The earnings growth of 2021 included a lot of earnings growth that was initially projected to come into 2022. I subscribe to the theory that some of 2022's earnings growth was pulled forward by 2021's earnings out-performance, and that the kind of out-performance we would have to see in corporate profits in 2022 to create another year of the returns we saw 2019-2021 is simply unobtainable.

The S&P starts 2022 at 4,766, which is 21.5x it's expected earnings of $223. Can the multiple end the year higher than that? Never say never, but, well, I hope not. Can the earnings again beat expectations (note, this $223 is still assuming 9% growth on top of last year's 45% growth)? I suppose so. But you have to assume pretty crazy earnings growth and pretty crazy multiples to reach a 10% growth expectation on current S&P 500 price levels.

So the "middle ground" position is that bond yields, Fed accommodation, healthy corporate profits (even if the growth of such is moderated relative to last year), and a lack of many other options leave the U.S. equity market as investible, yet with expectations for single-digit returns, not the levels we have seen in years past.

In this paper's conclusion I offer an actionable takeaway regarding equity exposure.

2 FED UP: WORRYING ABOUT NOTHING & NOT WORRIED ABOUT SOMETHING

As much as I want to, I am not allowed to project 2022 without some discussion of the Fed. There is both a sensationalized dynamic around the Fed and a reality around the Fed that cannot be ignored. The sensationalized side should be ignored in a perfect world – and that is the part the media will focus on obsessively all year.

How many times will the Fed raise rates in 2022?
What will happen to the market when the Fed stops its practice of quantitative easing?
How can the market survive without the Fed filling up the punch bowl constantly?

What the bears never seem to understand is that the Fed's role with the markets is overstated, and that the removal of Fed support to markets is (a) Never as substantial as people believe it will be, and (b) Always predicated by very positive economic circumstances to warrant it.

And what the bulls never seem to understand is that the Fed's main role in supporting markets is not the added "offense" their accommodation adds, but the distortion of risk they offer through the "Fed put" – the backstop that is presumed in place against left tail risk.

In other words, if markets believe the Fed Funds rate might one day be at 1-2%, who cares? You should pray we are at a 1-2% Fed Funds rate in the next year or two! But if the market ever believed the Fed would not be throwing the kitchen sink at problems the next time we have a global crisis, a terrorist act, a credit crunch, a pandemic, etc. – well, look out below.

And this captures my nuanced view on the Fed as we enter 2022. I couldn't care less about the issues that most people will focus on this year (a higher Fed Funds rate, tapering down QE, etc.). And yet the things that I believe would create mayhem in markets (i.e. the Fed no longer backstopping risk assets from severe tail risk events) are simply not on the table (in my humble opinion).

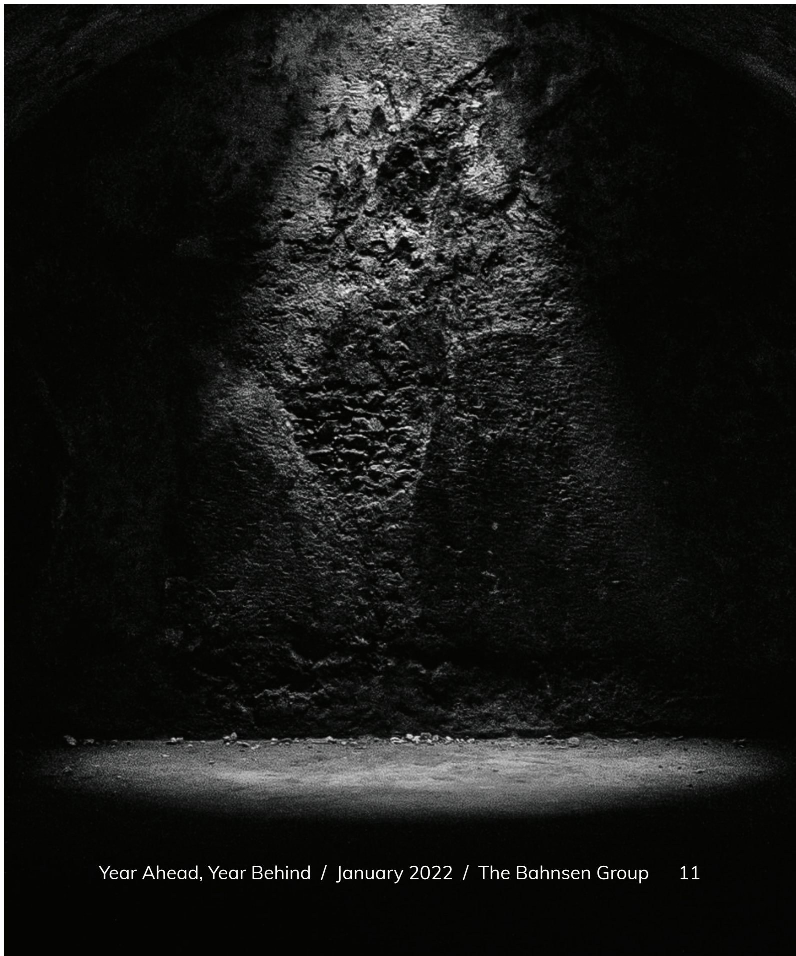
So what do we expect from the Fed in the near and intermediate term? What does concern us? What is the right view to have on the Fed for investors entering 2022?

I believe there will be a few rate hikes in 2022, to the extent credit markets do not rebel against such (credit markets, not the stock market). We would expect slightly less action from the Fed than the consensus view over a 12-24 month time horizon. I believe they will taper down their quantitative easing by early April as planned, but will not begin "tightening" (i.e. reducing their balance sheet) until they have the Fed Funds rate to 1.5% (at a level where they can begin reducing the balance sheet without thought of rate hikes). I expect the Fed to avoid the events of late 2018 like the plague and talk their way around inflation data however they need to.

But this brings me to the Fed narrative in 2022. I believe the rate of inflation will be lower in 2022 than 2021 (see #6 below), which will give the Fed cover to talk down price concerns and claim victory over price instability. The fact that the inflation rate will be higher than the target is immaterial; it will be heading lower, and that will give central bankers the cover to do what they want to do more than anything else (avoid rapid tightening that exacerbates the bust part of the boom-bust cycle).

The "Goldilocks" scenario for the Fed is that they tighten enough to prick the bubbles of speculation that need pricking, but without freezing up credit markets. I believe the only way this can happen is by getting lucky – it is not a needle that can be thread with talent. I want the Fed to recognize when they are facilitating malinvestment; *but I do not expect that to be the case.*

I believe *that* should be the concern investors have as it pertains to the Fed – the facilitation of asset bubbles. But I expect the narrative to instead, be on their modest tightening measures – no matter how needed those measures may be.



3 THE POLITICAL REALITY WILL UNDERWHELM

As much as I would love to do this entire white paper with no political commentary, it is a mid-term year, and some market ramifications do exist out of the political landscape.

I actually believe the Democrats will end up passing some form of a "Build Back Better" bill, which is surprising since we know the actual "Build Back Better" bill died in December. But I believe the political incentives are there to pass a bill in "name only" no matter how scaled down it may be, and I can't imagine the White House, progressives, and moderates don't figure out a way to do that. However, I do not believe the eventual bill will be remotely similar to the vast array of policy prescriptions we heard about throughout 2021.

I am purposely choosing to avoid the standard chart history on how markets have done in mid-term years of a first Presidential term. The history around these things reflect modest correlations but with absolutely no causations, and therefore are worthless predictively. It is true that midterm years are historically the most volatile of a four-year Presidency, but the various factors that play into that render its utility to us minuscule.

I believe the Republicans will take the House and Senate back in the mid-term elections, but that neither event will be particularly noteworthy for markets because:

A. It is already priced in

B. 2021's legislative make-up proved inconsequential to markets anyways due to tight margins

C. There can be no legislative agenda for a Republican-majority House and Senate without control of the White House, and

D. No election outcome from one year to the next changes the underlying reality, that it is very close to a 50-50 nation, providing neither party a clear mandate for anything even when they do have majority rule

I would be happy to write a separate white paper some time on my broader political handicapping (that Republican success in 2022 and 2024 is largely dependent on them following the Youngkin playbook regarding former President Trump, and that Democrat vulnerabilities lie in a misreading of the independent American's views in culture war issues) – but my focus here is only on market and economic implications of the political sphere. The "tail risk" of a dramatic tax increase to corporate profits, investment income, or earned income appears to be off the table. Markets can proceed through 2022 with that in mind, and yet will also have to absorb the reality that our spending levels are astronomical, and there exists no public appetite for addressing that whatsoever.

4 A RECKONING WITH BIG TECH

My concern for some time has been the high valuations in many big tech names, and that has been coupled with the vulnerability to those valuations around political risk. There is no point in predicting that "this will be the year" Congress or regulators or some other body take action which re-orders Silicon Valley. From antitrust concerns to privacy laws to political censorship to liability over information accuracy to protection of children, there is no shortage of issues looming over the major technology names of our country.

But I would caution big tech bears about a few things:

1. No one knows if a bipartisan consensus can be forged to see something happen (though I would suggest it would be politically beneficial to both sides of the aisle)
2. It is entirely possible that if something is done it won't draw much blood
3. It could even end up benefiting big tech by doing more damage to smaller competitors
4. In other words, without a greater understanding of legislative minutiae, it isn't possible to speculate. It looms as a risk, but not one with an outcome that is obvious to me

So that brings me back to valuation, which remains the most compelling risk in the risk-reward trade-off of this space. There is a self-fulfilling correction in effect if there is not a widespread bear market, because should downside selling reach 20% or so I strongly suspect there are ample buyers waiting to buy these names 20% lower than current price. Only a market-wide bear market seems likely to change that. So while I may see a more dire outlook for "small tech" or "super cool tech," I do believe there is a floor somewhere for "big tech" that makes comparisons to the year 2000 inaccurate. I further believe that "big tech" is not monolithic, and that the return profile for one name may prove to be totally disconnected from the return realities of another.

Ultimately, I would be very happy if the fate of "big tech" just proved to be sub-par returns for a few years versus a significant drawdown. I am not rooting for this to happen.

My frequent attention to the topic of "big tech" is rooted in lessons I have learned when one side of the boat gets too crowded. The joint growth of big tech and index investing has created a market risk here that I have wanted to highlight, for good reason.

Congress and valuations are the not-disconnected concerns big tech investors should consider.

5 DOUBLE OR NOTHING: THIS IS VALUE'S YEAR

I very rarely had to pay out bets when I was high school shooting hoops with my teammates, friends, or brothers. I would bet some small dollar amount that I was going to hit a three-pointer, and if I would miss I would just keep saying "double or nothing" until I hit one. My counter-party usually went along thinking that the stakes were just too attractive to pass up, not realizing that eventually I was bound to make one (and I always was).

Perhaps the call that "this year value will over-take growth" feels like that. Proponents of value investing (which includes us at The Bahnsen Group, if "value investing" is being defined correctly) have been making this call for a few years. And it wasn't like 2021 was a terrible year for the narrative. In mid-cap and small-cap names, the Value style destroyed the Growth style, with small-cap growth only re-achieving positive returns for the year in the last two weeks of the year.

	VALUE	GROWTH
LARGE	24.93%	28.04%
MID	27.85%	12.98%
SMALL	27.93%	3.04%

Bloomberg, Dec. 31, 2021

But large-cap growth once again bested large-cap value (though both created massive returns for the year), and it is the relationship between the two that I think most value purists are focused on. Ultimately, the thesis is really quite simple … If all markets perform great (a risk-on environment like 2021), then I have no opinion as to the value vs. growth divide. However, in any kind of normal environment, with normal or even elevated volatility, let alone market distress and challenge, I simply believe it inevitable that Value will achieve a sizable advantage over its Growth counterparts. **And if I am wrong, I call "double or nothing."**

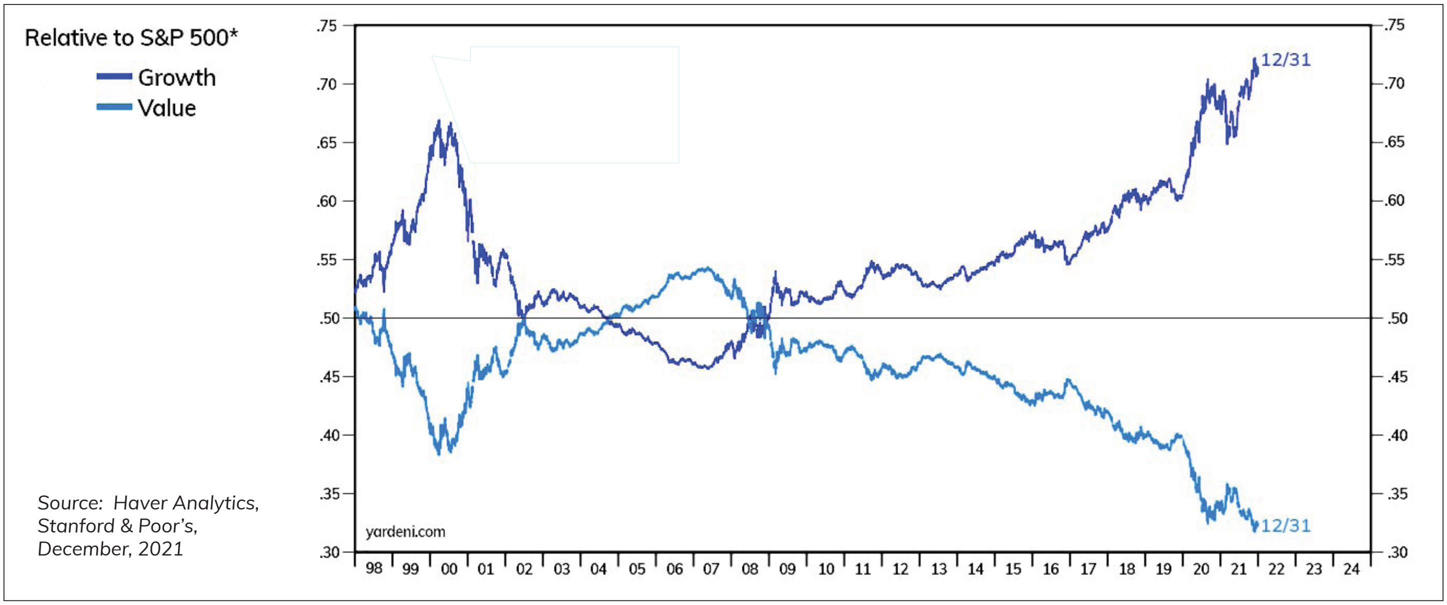
Going back to the more modest return expectations for equities overall (see theme #1), I do believe this call is highly correlated. If these were the four options on the table (and I am sure they are not the only options on the table):

1. Growth does very well and Value does very poorly
2. Value does very well and Growth does very poorly
3. Growth and Value both do very well
4. Growth and Value both do very poorly

It would be #1 that I would have the most conviction in NOT happening, and it would be #2 that I would have the most conviction in actually happening. Now, neither #3 nor #4 can be eliminated as possibilities, nor can a plethora of options that take out the word "very." But I make my call here based on probabilistic assumptions around these options, and my working assumption that the landscape components which have helped to drive high valuations to higher valuations are unlikely to continue.

I also use history as a guide, which does not help a lot with timing but does offer some context for what I consider the inevitability of mean reversion. At the growth peak just before the tech/growth crash of the year 2000, growth was 1.75x the price level of value (all growth names dividend by all value names). Growth is currently 2.3x the price level of value. The forward P/E for growth was 40x in 2000, and 20x for Value – a delta between the two of 20x earnings, meaning value was half the valuation of growth. Currently, the growth number is 30x on forward basis and value is 15x on forward basis, for the first time since the year 2000 – a doubling of respective market multiples. And as the chart shows, their relative weightings within the S&P 500 now exceed the pre-tech crash spread.

Our call is for a tightening of that spread in 2022, regardless of how it happens.



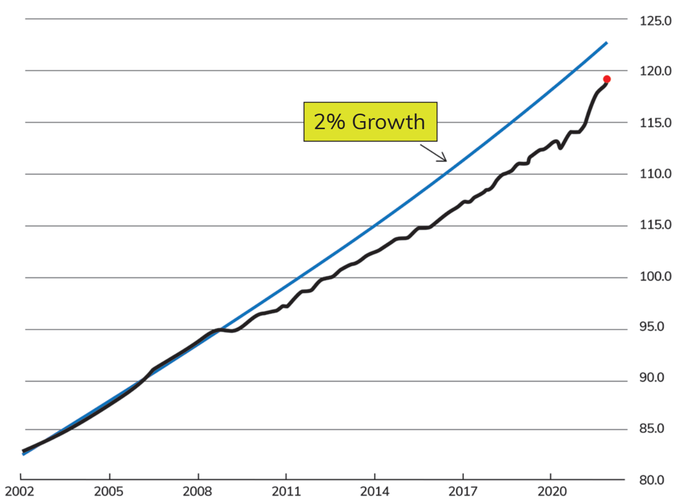
Source: Haver Analytics, Stanford & Poor's, December, 2021

6 INFLATION WILL NOT BE THE MAJOR ECONOMIC STORY OF THE YEAR

This is not to say prices will not rise in 2022 – I suspect they will. But I am very willing to go out of consensus and suggest that a declining rate of inflation (dis-inflation) will re-assert itself in 2022, likely in Q2. Too many threw around data in 2021 with no nod to the "base effect" of 2020 numbers they were being compared to. And too many have assumed that supply disruptions will not be fixed, even if not entirely. Marginal improvements in the supply causation mean marginal improvements in the price level, and it would not take much to see these dis-inflationary realities re-surface.

The reality of our longer-term macroeconomic situation is that excessive government spending has been a disinflationary challenge for years. A wide array of very compelling circumstances flipped the script in 2021 (see #1 in the 2021 Review above). I do not expect to see collapsing prices in 2022, and in fact see prices escalating further, but our call is for a declining rate of inflation growth, which itself will be enough to change the overall economic conversation around this subject.

US Core PE Inflation 2012=100



Source: The Daily Shot, Dec. 2021

7 HOUSING TO SLOW DOWN IN 2022 BEFORE IT ROLLS OVER IN 2023

There are two major factors that have driven housing prices higher in recent years: (1) The manipulation of asset prices via manipulation of the cost of capital that is so key in the most levered asset class on the planet (i.e. Housing); and (2) A substantial inadequacy of new housing stock to meet demand that is driven by demographics and a healthy job market.

There are two reasons I believe this party of increasing housing prices comes to an end: (1) Prices have gotten too high; and (2) See reason #1.

But there is a glaring problem with my forecast here: The two reasons I cite for the housing increase show no signs of letting up. I don't believe mortgage rates are going to skyrocket higher, and I don't believe a burst of new supply will surface in 2022. Therefore, with a continued low cost of capital and low inventory of housing stock, why should housing prices roll over? Yet, the cure for high prices is, well, high prices.

Therefore, I find the middle ground view most rational – that is, that prices do not roll over in 2022, but rather "stop increasing" – and yet I do believe they begin to roll over in 2023. I'll save that latter view for next year's white paper, both to give me time to change my mind, but also to see if a bigger housing story surfaces in 2022. What could a bigger story be than record levels of unaffordability?

A. Bipartisan efforts to block institutional ownership of residential real estate (a disastrous push for the law of unintended consequences if there ever was one)

B. A large move higher in equity extraction from housing via cash out re-financings

Neither are happening right now though I fear both. I mention them as potential future concerns, not present ones. A lot of very bad decisions will be made around housing as an investment in the next year or two, but comparisons to 2008 are both inaccurate and irrational. The banking system's exposure is a fraction of what it was in the GFC, and the average homeowner's equity is significantly improved.

Case-Shiller Composite 20 Home Price Index YoY

Source: Ritholtz, December 27, 2021

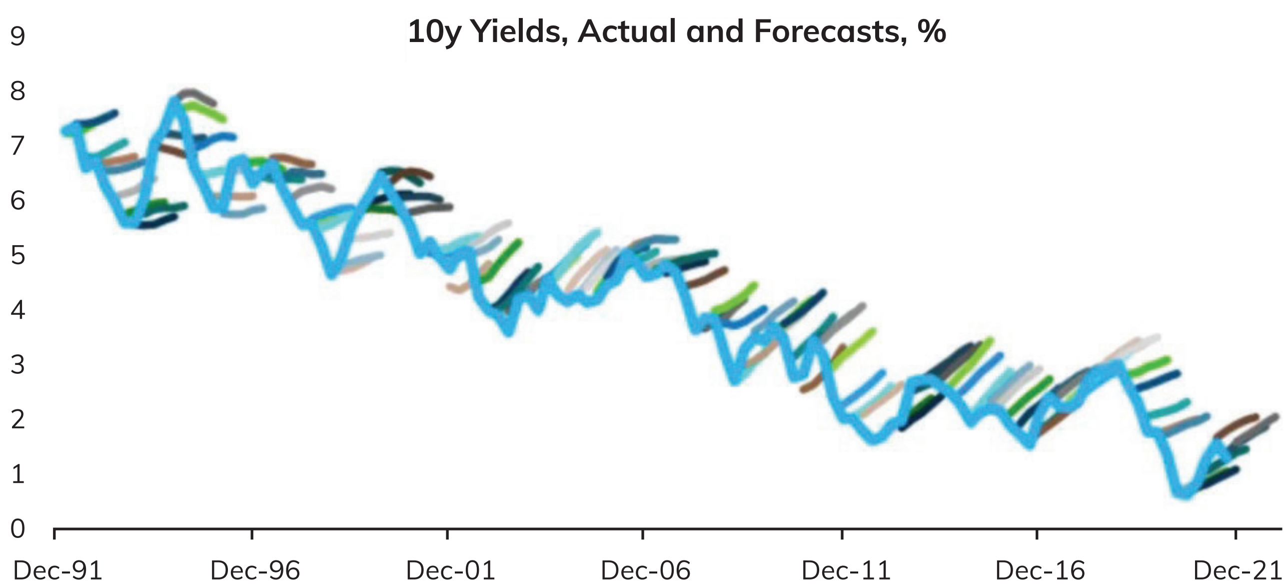
8 BOND YIELDS WILL BE HIGHER, JUST NOT THAT MUCH HIGHER

It may seem odd in a white paper that uses bond yields to partially rationalize equity valuations and offer a counter-narrative to inflation to also suggest that bond yields are likely to increase in 2022, but that actually is exactly our view. The reason these various perspectives are more compatible than one may first recognize is that the magnitude of yield increase we expect is not sufficient to suggest a new inflation paradigm, or a substantial re-pricing of risk assets (which as you will note in themes #1, 4, 5, and 7 does not preclude a marginal re-pricing).

The following chart shows the actual 10-year bond yield since I graduated high school in the thick blue line, and the other lines show the consensus forecasts for that yield that corresponded over time. The punditry class has been wrongly predicted higher bond yields for thirty years.

There are two takeaways here – (1) Note the visible secular direction of bond yields, as each high is lower than its prior high; and (2) Note the persistent wrongheadedness of forecasters – not just wrong in magnitude, but direction as well.

I would be very surprised if the 10-year finishes the year above 2.5% but would be surprised if it did not end the year near, at, or above 2%. And I do not believe that would be a negative thing for the economy whatsoever. If a year after QE is done the bond market has such a low view of future growth that nominal yields remain below 2%, I will be far more concerned about that than I would be at the "horrors" of a higher cost of capital.



The "hairs" represent the forecast for the 10y Treasury yields at a given point in time and the solid blue line indicates the actual outcome.

Source: Survey of Professional Forecasters, Barclays Research, Dec. 2021

CONCLUSION

If equity indices are mathematically and economically limited in what they can offer investors in 2022 as I propose herein, one may be tempted to decrease their equity allocation within a balanced and sensible portfolio. We are not increasing equity allocations entering 2022, but nor are we (yet) decreasing them. The reason being – we believe valuation concerns and sensitivity to higher rates, Fed actions, and other changes in market landscape are less potent for dividend growth equities. Bottom-up research that weeds out companies of a particular balance sheet strength and finds value around cash flow growth, not multiple expansion, offers a differentiation from the anti-research approach of passivity and indexing.

Broad market commentary is always important, but not always relevant to portfolio management.

I do not believe equity volatility will be as subdued in 2022 as it was in 2021, but that has nothing to do with any particular view of 2022 and everything to do with the historical reality of equity market volatility. We simply do not generally achieve equity-like returns with downturns staying around -3% in magnitude. I believe it is entirely possible (and even likely) that 2022 will see periods of 10-15% downside, and yet still achieve positive returns full year. Asset allocations should account for this normalization of volatility.

Our commitment to supplementing our heavy dividend growth equity exposure with private market investments (equity, debt, and real estate) and other thoughtful alternative investments remains steadfast. Credit opportunities are richer than they were a year ago and "boring bonds" offer almost no offense whatsoever. Where there is appetite for "growth enhancement" we continue to believe emerging markets make more sense than U.S. "shiny objects," but freely recognize that there are currency and geopolitical headwinds there that will have to be diminished.

Chinese sovereign debt appears to be the last bastion on earth where currency credibility and global appetite is a priority. Few American investors have a proclivity for investing heavy in this theme, but it seems to be the reality of the world we are living in – awful political regimes are doing more to protect their own currency than democratic ones.

It has not been a good period of investing for the pathological pessimist. I have the rare burden of believing there are structural concerns of significance in our world and our economy (central bank distortions, cultural shifts around work, governmental size, geopolitical apathy about the international order) – and yet also being an unrelenting optimist. Betting against humanity has been a losing bet for a long time, and regardless of what 2022 produces, I remain optimistic about the future for investors exposed to the ingenuity of mankind. The greatest investors of the last few decades (and I believe, the next few decades) will be able to hold these two realities in tension with wisdom and humility – that there are concerning things in the world, even as there is investible opportunity in human action.

As for anything I get wrong in this paper, I leave you with this:

"An economist is an expert who will know tomorrow why the things he predicted yesterday didn't happen today." ~ Laurence J. Peter

May 2022 advance the cause of your financial objectives and bring you and yours health, wealth, and freedom.
To that end we work.

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