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John's Market Outlook - December 7, 2021

When Covid hit in February 2020, nearly a fifth of Americans lost their jobs in a month. The US and global economy could have fallen into another Great Depression. The US government responded with a historic flood of liquidity – money, basically - to both Main Street and Wall Street, as did other countries to the extent of their abilities. The result is in the record books. Now, nearly two years later, markets and economies are preparing for the post-pandemic phase, even as the latest variant reminds us that the pandemic is still here. I'd like to share some thoughts about what looks likely for the year ahead.

In 2022, most pandemic-related US government aid will expire, effectively ending a several-trillion dollar flow of liquidity to consumers and businesses. The Federal Reserve will wind down aka "taper" quantitative easing and begin raising interest rates, withdrawing a similar-sized liquidity flow to financial markets. The Biden Administration's infrastructure bill and- if passed - reconciliation bill will replace only a small part of those that liquidity.

The US economy looks ready to be weaned off pandemic assistance and to transition from the early-cycle recovery phase to a mid-cycle growth phase. Consumer balance sheets, corporate revenue and margins, and state/local government finances are at or near record strength, and by many measures the economy and economic growth are running "hot" such that some cooling is desirable.

Transitions from early cycle recovery to mid cycle growth are often bumpy for the markets. Investors must accept smaller earnings beats, slower profit growth, and a cooling of revenue growth. Space-bound valuations come back down to earth or at least to low-earth orbit.

Looking back to the last market cycle, after a strong recovery from the market bottom in March 2009 we saw a correction in mid 2010 before markets resumed their rise. The liquidity response in 2020 was far larger than 2009's; its withdrawal will leave that much larger a hole that to fill. In my opinion, the probability of a market correction in 2022 is significant.

If it turns out the economy is *not* ready to stand on its own feet – or if a drastic worsening of the pandemic or other event makes those feet wobble – the liquidity will be withdrawn anyway. In the midterm election year Congress will be gridlocked, and inflation will force the Federal Reserve's hand. That is the risk that investors are confronting with the latest Covid Omicron variant.

In late summer 2021, I started moving portfolios to be more conservative, in anticipation of weakness in the September-October period due to the Federal Reserve's expected taper announcement and the typical pattern of higher volatility at the end of 3Q. The markets were indeed weak in September, before recovering in October.

I am continuing to move portfolios to be more conservative as we enter the New Year. While there often a burst of market strength at year end, in my view the prudent course is to focus on 2022 rather than the last weeks of 2021.

By "more conservative", I don't mean the outright defensive stance that one would want at the end of an economic cycle. I believe we should prepare for a mid-cycle correction followed by renewed growth, not a new recession.

Now a few thoughts on sectors and asset classes.

- I continue to favor the real estate sector, which benefits from inflation and economic growth, limited supply, and solid dividend yields. We are focused on residential and commercial real estate, rather than office or retail space.
- Many energy stocks, particularly midstream oil and gas companies, have continued to generate strong cash flows and dividends despite oil price volatility. We also continue to hold renewable energy producers with growth and solid dividend yields.
- Healthcare exposure has to date been focused on Covid: vaccines, treatments, and testing. I am starting to add names that will benefit as non-Covid procedures pick up in 2022.
- I have increased exposure to the financial sector in anticipation of higher interest rates.
- The "re-opening" stocks have been reduced. We retain some exposure in anticipation of the current pandemic surge ebbing early next year.
- Exposure to technology stocks has been modest in most portfolios, due to the very high valuations in that sector. This has cost performance, particularly since late summer. I believe those stocks are particularly vulnerable to a correction, that could allow us to pick up some good stocks at more attractive prices.
- International markets have much lower valuations than US markets. Those regions' greater vulnerability to Covid has caused underperformance versus the US, which may reverse next year if, as hoped, the world is able to start putting this pandemic behind us.

The above comments have been on "equities", i.e. stocks. As to "fixed income", i.e. bonds, the portfolios have less exposure than normal. Bond yields are very low and prices are vulnerable to rising interest rates. In portfolios where income yield is a priority, we hold preferred stock and certain dividend-paying stocks as a partial substitute for bonds, and the fixed income exposure is primarily in shorter-duration and higher-yielding bonds. In 2022, I look forward to better buying opportunities in fixed income.

Finally, the portfolios currently hold significantly *elevated* levels of cash, partly as a defensive measure, partly in place of low-yielding bonds, and finally as "dry powder" to deploy when appropriate.

I would be happy to go deeper into this outlook and other investment topics than I've done in this brief summary. Please email johnliu@laurelhurstasset.com or call 510 847 0070.

Have a wonderful holiday season and thank you for your trust and support.

John Liu, Laurelhurst Asset Management LLC