Summary

- S&P 500 returned 3.31% in the 4th quarter of 2021, Value underperformed Growth by 1.01%
- In the 4th Quarter of 2021, the 10-year US Treasury Rate decreased by 4.1%
- The Omicron Variant has become the dominant variant with increased transmissibility but less severe symptoms causing governments to cease entreating damaging economic policies
- Supply Chains continue to normalize despite acute isolated inflation pressures
- Global interest rate tightrope is exacerbated by highly leveraged balance sheet which creates risk asset volatility with each step
- Labor force participation continues to lag while younger workers experience wage inflation

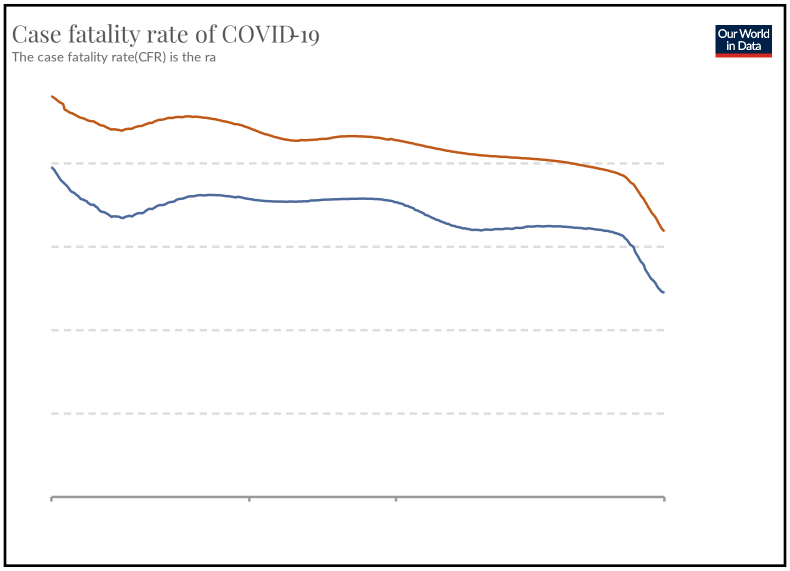
While we collectively have Covid fatigue, it is still at the core of what is driving global markets. Recall that Covid has precipitated the uncertainty in supply chains, labor force, ballooning global balance sheets, interest rate balancing acts, and bubbles in speculative asset classes.

Omicron, Pandemic to Endemic

The global COVID situation has changed dramatically over the last 2 months of 2021 following the emergence of the Omicron variant. This change is caused by genetic mutations of the virus relative to the Delta variant that result in higher transmissibility, shorter incubation periods, and decreased severity.

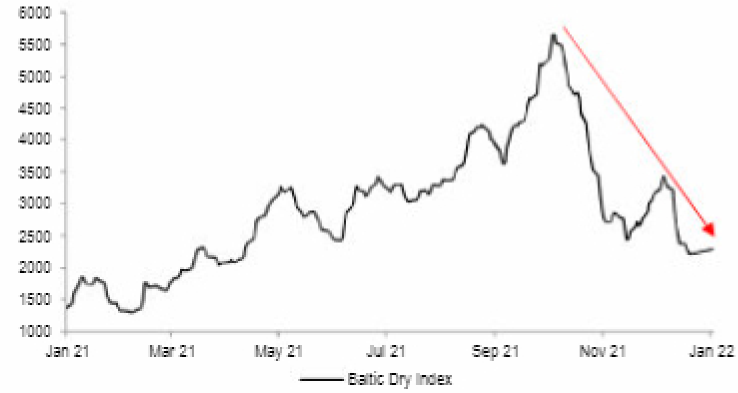
This increased transmissibility is paired with decreased severity, particularly for vaccinated individuals. This is shown below with the case fatality rate of COVID in the world and the US. It is key to note that this doesn't necessarily represent the virus' true mortality rate as it is only calculated via confirmed cases. Given the widespread COVID test shortages, it is likely that the mortality rate is even lower.

Case counts in the US seem to have already peaked, and therefore, we expect the negative COVID impacts to decrease rapidly. We may even see the emergence of a silver lining as cases fall, with a significant portion of the population now possessing natural immunity and increased confidence in the ability to return to normal activities safely. This may be where we as a global society begin to pivot away from pandemic-oriented responses to more Endemic oriented responses, which should mean fewer negative financial and labor force implications.



Supply Chains continue to normalize despite acute isolated inflation pressures

Figure 13: BDIY Index



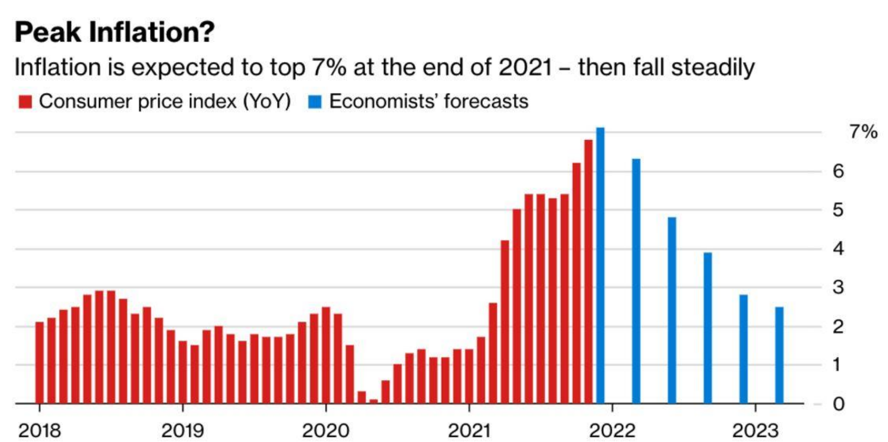
Source: Bloomberg Finance L.P.

Baltic dry index is down around 60% since peaking in Oct' 21.

Supply chains are still a long way from complete normalization; however, we have seen significant incremental progress over the past few months. This is evidenced by improving supplier delivery times and a significant decline in the Baltic dry index, which is a good global shipping bell weather and indicates that global logistics health is improving dramatically. As shown by the decline in the Baltic dry index, supply chain decongestion will decrease logistics spending. This drives incremental operating margin expansion, further boosting companies' earnings potential.

We expect this continued shift toward normalization to help drive macroeconomic and equity market growth in two ways. Improving delivery times will allow for inventories to recover from their extremely depressed current levels. This began slightly sooner than expected, in 4Q21, pulling forward some of 2022's real GDP growth from inventory restocking into 4Q21. That said, the trend should continue, albeit at a less extreme pace, for at least another quarter, continuing to contribute positively to real GDP growth. Therefore, the key positive going forward is that recovering inventory levels will help prevent manufacturing disruptions and/or lost sales from out-of-stocks.

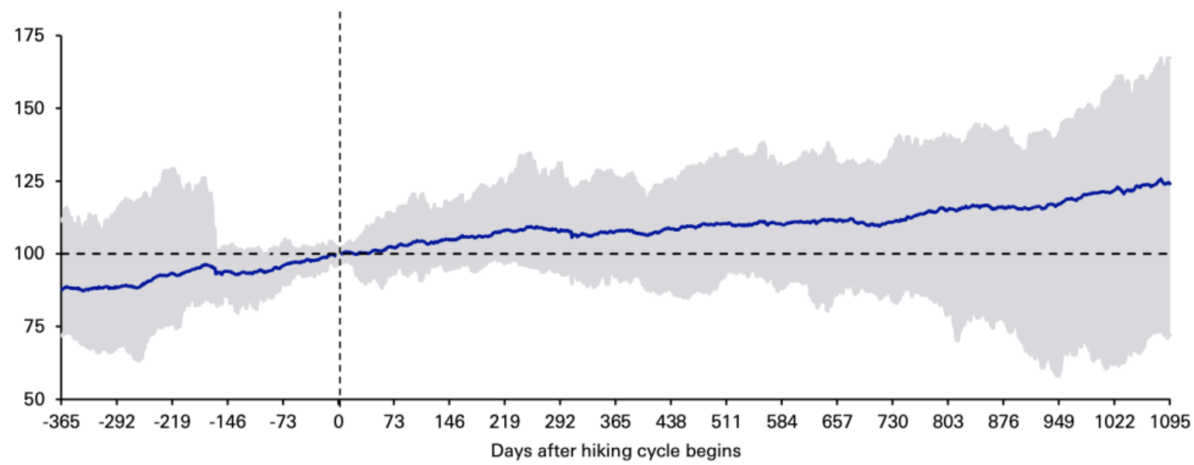
Global interest rate tightrope is exacerbated by highly leveraged balance sheet which creates risk asset volatility with each step



The Fed is expected to raise rates 4 times this year and end its monthly asset purchases by March. This would mean a 25-bps hike in March, June, September, and December. After the last meeting of FOMC, Wall Street has placed a greater than 90% chance on the first rate hike happening in March. Both the Fed Funds rate and the 10-year US Treasury Rate can rise without disrupting the bull market, but only if the Federal Reserve can raise rates in a clear and moderate fashion.

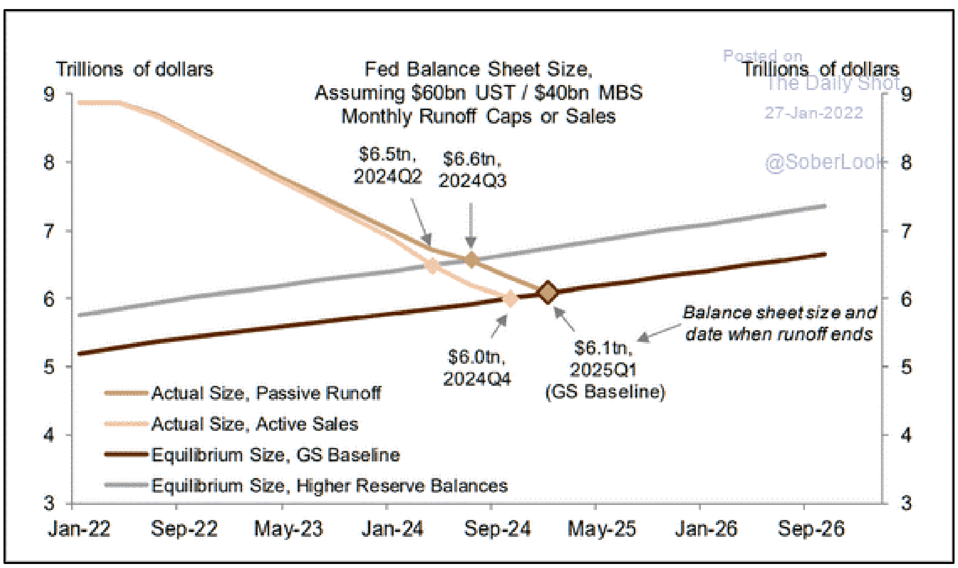
The bond market is pricing in a targeted federal funds rate of 0.75% - 1.00% by the end of 2022 which is still well below the historical average of 4.5% but the Federal Funds rate and the 10 Year US Treasury Yield have been on a downward trend since the 1980s. Historically speaking, the average rate hike cycle since 1955 has lasted just under 2 years, and during the first year, the S&P 500 has averaged 7.7% growth (365 days after the first hike), but weakness starts to appear after the peak on day 253.

Figure 5: Average S&P 500 Performance in Fed Tightening Cycles since 1955 by day… weakness starts to materialise 9-10 months after the first hike and lasts a year or so..



Source : Deutsche Bank, Bloomberg Finance LP, GFD
Note: Grey shaded area represents range of outcomes in hiking cycles analysed

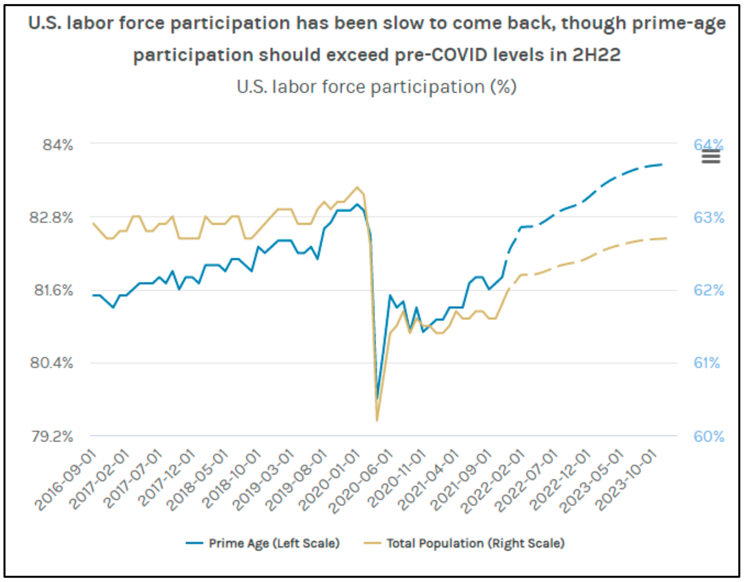
Another aspect of the central bank's policy that has been uncertain until the latest meeting was how the Federal Reserve was going to reduce its balance sheet. The question that had investors on a tight rope to begin the year was whether the balance sheet would be reduced by passively allowing securities to mature off its balance sheet or actively selling the assets into the open market. Investors feared that the Fed would feel the need to actively sell the assets into the open market, which would send bond yields higher in the short term and create even more volatility in the equity market due to the recent high correlation between equities and interest rates. The Federal Reserve's comments yesterday clarified their intentions to let the



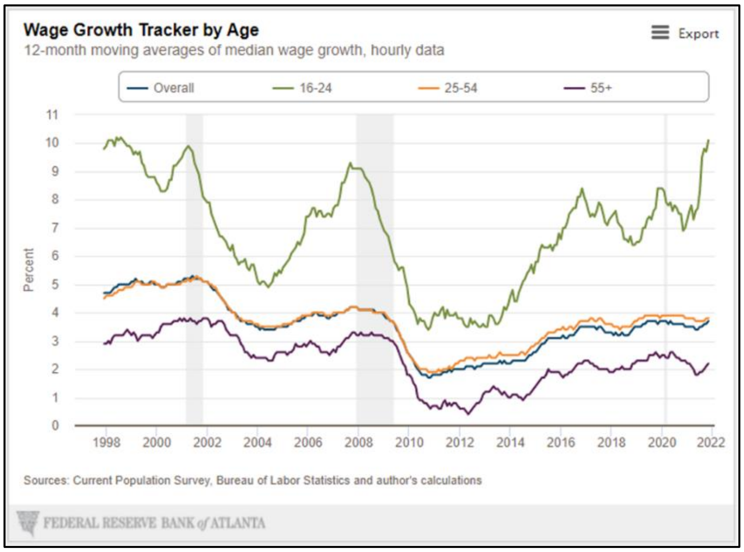
securities passively run off the balance sheet through their maturity, which leads to the runoff ending a quarter further than what they feared.

Labor force participation continues to lag while younger workers experience wage inflation

During the pandemic, about 3 million people in the United States left the labor force. Prime-age workers (ages 25-54) account for 1.4 million, or 45%, of the 3 million people who exited the labor force, and women account for 68% of that 1.4 million. Childcare concerns and the risk of children being exposed to the virus were the likely cause for women to leave the workforce at a higher rate than men. It is estimated that about 42% of the 3 million people who left the workforce since February 2020 are permanent, largely tied to retirement, while 58% are shorter-term, pandemic-specific decisions to leave the market. With Omicron becoming the dominant variant, health risks have gone down, which has resulted in Prime-age labor participation (ages 25 to 54) to rise. Improving childcare, falling health risks, and rising wages should accelerate that trend throughout the year, which will help stabilize the labor market as prime age workers are the key to a stable labor market.



The December payroll report showed that labor demand continued to outpace labor supply. As a result, unemployment fell to 3.9%, which currently stands below the FOMC's longer-run median forecast of 4.0%, and it is suspected that it will reach 3.3% by the end of 2022. Average hourly earnings growth was strong in 2021, which was led by wages in the leisure and hospitality industry growing by 15.8% from the previous year. Most of the wage growth was in the service sector, which accounts for about 20% of the labor market. The other 80% of the labor market did not see similar wage increases



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Moving Forward

The COVID-19 pandemic is still affecting the overall economy and equity market which is apparent by supply chains, labor force participation, and inflation not returning to pre-pandemic levels. The overall uncertainty from the pandemic is still prevalent in the world economy but this year we no longer have stimulus support from central banks and governments around the globe. This has caused a lot of volatility to start the year which will remain elevated as there is a lot of rate and policy questions still in the air. Investors are looking to the central banks for guidance more than ever before. In this type of environment, it is important to still keep fundamentals in mind and focus on quality companies that produce growing cash flows, as these companies weather volatility in a more efficient manner than the overall market.

Past performance is not indicative of future results