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SANCTUARY ASSET MANAGEMENT

CIO OUTLOOK 2022

A WORD FROM
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Happy New Year – It's a saying we enjoy sharing with family and friends this time of year, but it's also a saying that can quickly raise eyebrows when pertaining to market outlooks for the next 12 months. So here it goes, Happy New Year, as I do believe that 2022 will indeed be a positive year for equity markets.

Equities creating new all-time highs (70 new highs in 2021) and finishing 2021 on a high note assists my constructive view as my Santa Rally forecast on CNBC (which was initially met with skepticism) indeed came to fruition. The Santa Rally had an extremely high hurdle to overcome after the latest Covid-19 variant Omicron creamed markets on the day after Thanksgiving. Having conviction, staying invested in a model and rebalancing exposure during times of distress during 2021 was a differentiator as well as a source of alpha production for investors.

2022 will have similarities to the emotional rollercoaster of 2021, yet my belief is that the coming year will also be quite different. These key differences will surface while we digest the transition process from historic fiscal and monetary policy to a raising rate environment. Volatility will be a theme for investors to contend with in the new year but, I am optimistic during this unique period of time, as I envision the global reopening to persist in the wake of Covid and all of its unwelcomed variants.

HIGHLIGHTS

- Constructive on U.S. equity markets and positive on global economic growth as hotter than anticipated inflation moderates over the course of next year.
- Equites move gradually higher as the Federal Reserve's accommodative policies will not waiver, specifically its swollen $9 trillion balance sheet will remain intact.
- Although I only anticipate just one rate hike in 2022, I expect significant volatility surrounding the "number of rate hikes" debate. Volatility will stubbornly elevate as we endure the transition period from asset purchases to a raising rate environment.
- Diversification will be critical: favoring tangible and essential blue-chip names. Dividend paying companies will attract investors and the tilt into value from growth will persist.
- ESG investing moves from a portfolio requirement to a must-have ingredient in every portfolio.
- Based on recent data, small-cap companies, relative to large-cap companies, have never been cheaper.
- Bond leadership will again prevail and help quell volatile episodes. The 10-year note should have a ceiling of 2% in 2022.

LOOKING BACK AT 2021

U.S. equity markets delivered astounding returns in 2021, as the global economy heals and is still in recovery mode from the Covid-19 pandemic. 2021 was a year of historically strong growth, fueled by a combination of unprecedented fiscal and monetary stimulus which kickstarted a once-in-a-lifetime global economic reboot. Growth was dislocated and staggered primarily due to the unexpected surge in COVID-19 cases due to the Delta variant over the summer that interrupted the global recovery and certainly exacerbated supply chain issues. I was encouraged that throughout the tumult, the U.S. consumer stayed strong and corporate earnings found a way to continue to elevate. 2021 provided some clarity as economies proved resilient and markets resurgent—after the horror film of 2020. As the new year approaches, there are certainly risks on the horizon, including inflation, labor shortages and the persistent and evolving global pandemic.

It's rare for global stock returns to be positive and bonds negative in any one calendar year – and two years in a row has not happened in almost five decades. Pressing pause then restarting our economy resulted in severe inflation pressures and significant supply bottlenecks. Real yields stayed low even as inflation jumped, and growth surged. Even though the market started to price in higher inflation, U.S. Treasury yields remain tethered to 1.5% as I had

predicted. Yields remained subdued and corporate earnings surged, driving big stocks gains. I foresee those meaningful components further continuing in to 2022, for the next phase of this cycle. Even if additional Covid variants stall the restart, central banks are positioned to increase policy rates because the restart does not require monetary support. I see Fed Chairman Powell for the Dove that he is and drastically diminish the odds of the Fed responding aggressively to persistent inflation.

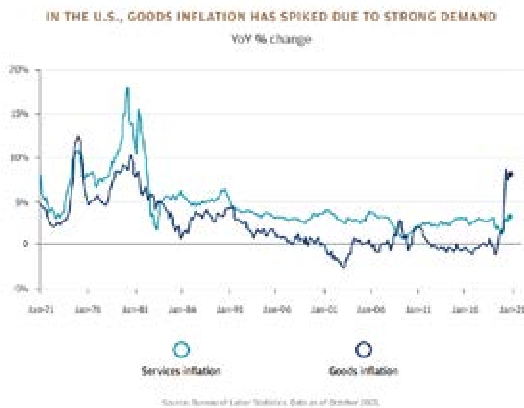
Being optimistic and embracing another dynamic wave in this economic cycle does not cloud my vision on the current backdrop, which presents several challenging scenarios. In recent months, investors have focused on potential risks to both economic growth and market returns. Hotter than anticipated inflation data is complicating our Fed's policy and supply shortages are challenging corporate earnings and economic output. Global economic growth and inflation are set to slow next year from their fastest rates in decades but will likely remain relatively high. COVID-19 and variants of the virus still remain a concern for consumers, businesses and investors. At the same time, the global crisis has fortified household and corporate balance sheets and embedded innovation. As we head into 2022, I see a dynamic market cycle in motion. The wrestling match between growth and value will offer opportunity to investors. Volatility will inject additional emotion into the marketplace (possibly causing a need for a chiropractor), but the global economy will emerge from the Covid-19 pandemic era substantially stronger than it was pre-Covid.

Fundamentally, I am optimistic as a solid foundation for a vibrant cycle lays ahead. Valuations are not stretched relative to history when viewed through equity risk premiums and corporate earnings growth should be above trend in 2022. The negative or potential headwind is that inflationary pressures have grown, interest rates will rise, and fiscal and monetary support are waning. My 2022 Outlook theme reminds me of my college football days when Coach Lou Holtz suggested that I pack on 60 pounds to become a lineman: "Slower, but still pretty fast." For you Notre Dame haters, I will Google translate into other words… The economic cycle isn't ending in 2022, but conditions may become more challenging, and gains are going to be tougher to come by.

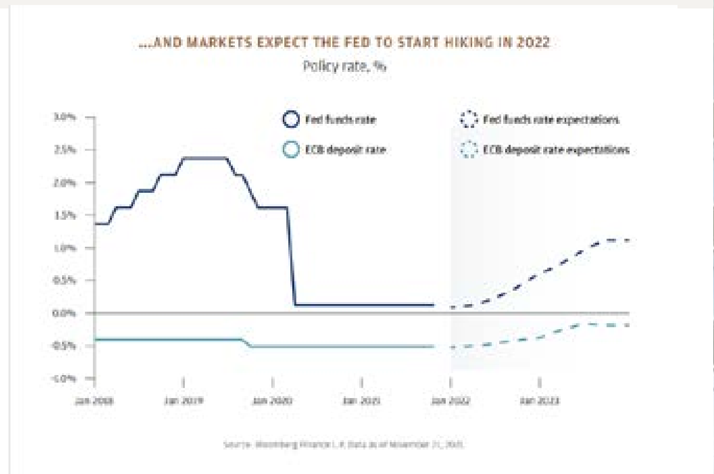
2022 TOP 10 LIST

1. Supply Chains: Demand for durable goods in 2021 surged, which caught suppliers flat-footed and overwhelmed supply chains. Those supply chains need to be reinforced, which should result in further investment. Inventories are depleted and need to be rebuilt. Together, this spending should sustain new orders, employment, manufacturing, trade, and ultimately, sales and earnings. Finally, consumer spending should rebalance back toward services as the pandemic fades, which should further alleviate pressure on supply chains that otherwise may not see much reprieve. While the scarring from the pandemic is more severe in the developing world, developed world businesses and households should be able to compound on the gains they have made during the pandemic era.

2. Inflation: Inflation was the story of the year in 2021, and it will likely continue to dominate the headlines in 2022. To invoke a word that Fed Chair Powell actually retired, I see inflation coming down and indeed being slightly "transitory". As Covid-19 tries to move into the rearview mirror, consumers should redirect spending from goods and toward services…cooling off the current inflationary data. Tremendous demand for goods and labor during the pandemic has led to the fastest pace of consumer price inflation and wage inflation since the early 1990s.. same timeframe when Vanilla Ice's 1990 smash hit – Ice Ice Baby – was popular. Supply chain stresses and bottlenecks should alleviate, but inflation is unlikely to fully reverse. Although the Fed does not input food and energy into their inflationary matrix, there are tangible signs that those price increases are sticky and persistently broadening. I expect inflation to cool off on early 2022, but inflationary data will settle at a higher level post-Covid than it was pre-pande

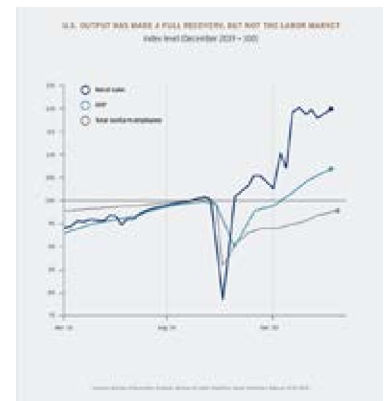


3. U.S. Treasuries: The Treasury markets seemingly are pricing-in continued loose monetary policy despite the Hawkish tone Fed Chairman Powell is painted with these days. The Fed will be measured when considering any hike rates in 2022. With no plans of unwinding their historically swollen balance sheet of $9 trillion, I believe they are telegraphing the fact that liquidity will remain high, and that the treasury market is skeptical of the Hawkish story being pitched. I lean heavily upon U.S.



Treasuries for market leadership after spending many years in the pits of Chicago trading them.

4. Labor Market: The U.S. economy is still 5.5 million workers short of the pre-pandemic trend, and the unemployment rate is over 4.5%. These data points suggest there is an ample supply of workers. However, shortage of workers can be seen in storefronts everywhere, signaling a labor market that is quickly running out of slack. Much as the inflation pressures are playing out across the global economy, employment dynamics are not unique to the United States. The Covid-19 pandemic is impacting labor dynamics across global markets.

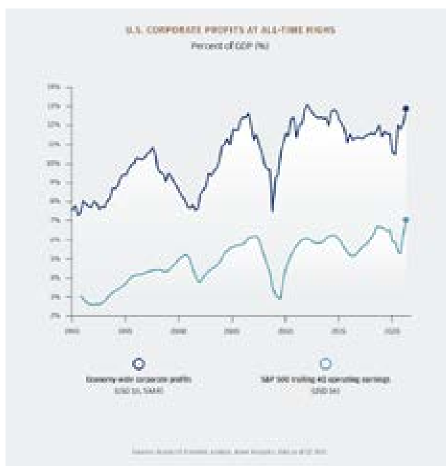


Despite demographic pressure (around 1.5 million workers in the United States retired early during the pandemic), we expect the U.S. labor supply to increase as health risks recede. Further, the roughly 2.7 million workers who were better off collecting augmented unemployment benefits than working will hopefully seek jobs in the months ahead. Strong wage growth should be the incentive for the nearly 2 million working-age individuals who dropped out of the labor force to step back in. This shortage of labor is historic as this dislocation between available jobs, the wages that they pay and the willingness and ability of the workers on the sidelines to accept them. I believe this dynamic should come back into balance or revert to the mean.

5. Sector Exposure: Sectors that lagged during the recovery from the Great Recession, such as housing and autos, are now leading investors in the current cycle. Here in Chicago or in just about any suburb in America, housing demand is outpacing the inventory of homes for sale. Home prices have been on the rise, but low mortgage rates and higher income

growth are keeping housing affordable. The seemingly sticky shift to more flexible work schemes should allow people to move from cities to relatively less expensive suburban housing. Meanwhile, innovation in the automobile industry, including the 2021 EV cult (Tesla, Rivian & Hummer) and assisted driving, could lead to a prolonged upgrade cycle in America and across developed nations globally.

6. Earnings, Margins & More: Earnings and margins are at all-time highs, investment grade credit spreads are at all-time lows and demand remains strong. In the developed world, the financial sector seems to be on solid footing and banks are willing to lend. S&P 500 companies have translated roughly 6% global economic growth and 15% sales growth into nearly 45% earnings growth in 2021. That operating leverage surprised investors and led to the S&P 500 Index popping up almost 25% on the year.



Small caps have garnished a lot of attention as we move int 2022 but, I am a big believer in context and seeing the whole picture. That being said, it is important to remember that Apple & Nvidia combined have a larger market capitalization than the entire Russell 2000. Many small-cap stocks are down over 50% per cent or even more from their highs. I believe there is value to be had in a disciplined approach. Based on recent data, small-cap companies, relative to large-cap companies, have never been cheaper.

Overall, corporate earnings continue to impress as they reflect strong balance sheet navigation by companies, with stricter cost controls and strong discipline on dividends and historic share buybacks. The surge in stock buybacks in 2021 may surpass the pre-pandemic record and I have expectations for U.S. companies to further their share repurchases even more in 2022. Buyback volume rose to around $850 billion in 2021, which exceeds the record $806 billion seen in 2018, according to preliminary estimates from an index analyst with S&P Dow Jones Indices.

7. Semiconductors: Semiconductor stocks have enjoyed a significant run for nearly three years now (SOXX was +62% in s2019, +53% in 2020 & up over 45% in 2021), and analysts across the street share a consensus that it will continue in 2022...so do I. I certainly have favorite individual names in the sector but also like using ETF exposure to ensure diversification.

8. Geopolitics: U.S.-China relationship will remain an issue in 2022, with seemingly little interest on either side to make any concessions. The Nasdaq Golden Dragon China Index, which tracks China-exposed firms listed in the U.S., dropped nearly 45% in 2021, putting it on pace for its worst annual performance since 2008. An unrelenting wave of policy crackdowns by both Beijing and Washington resulted in eight separate trading days with declines of at least 5%. To put that in perspective, the S&P 500 Index has only experienced five such declines over the last decade. The dramatic plunge seen by U.S.-listed Chinese stocks this year burned investors who rode them from the depths of 2020's Covid-19 selloff to a record high in February. The Nasdaq Golden Dragon China Index's 95 members have shed more than $1.1 trillion in value combined. Headlining the plunge is Alibaba Group, which has seen its market capitalization drop by about $430 billion, or nearly 60%.

We see a significant shift in China's overall policy stance toward greater state intervention and social objectives, even at the expense of growth discussed above. The regulatory clampdown and tighter policy stance rattled global investors in 2021 and made that shift clear. Inside of turmoil, opportunity is often found.

The next concern is increasing tensions in the Middle East. Tensions among Gulf oil producers have diminished, driven in part by the U.S. pivot to Asia. Budgets are predicated on high oil prices as they benefit the region, and we see efficient Gulf producers having pricing power. Crude Oil (WTI) looks to close out 2021 above $75/barrel.

Lastly is the increasing concern of a low likelihood of a U.S. return to the existing Iran nuclear deal. As Iran's nuclear capability increases and talks fail to progress, the risk of military action in the region rises. Other conflict risks are the stand-off in the Ukraine and North Korea's nuclear production.

2022 TOP 10 LIST

9. Essential: Rely on large cap blended equities, especially cyclical ones, to drive capital appreciation in 2022. Owning blue-chip names (I like to call essential to the U.S. economy names) should create diversification and at the same time seek to dampen volatility in a portfolio. Invoke your inner Peter Lynch and think about names that you know and take it a step further focusing on names that you use in everyday life. Higher inflation may remain into 2022, but it need not be a cause for grave concern. Investors can build a portfolio that acknowledges and mitigates inflation risks. Relying on equities relative to fixed income, and focusing on cyclical, industrial and real estate for sector exposure could prove to be effective approaches.

Equities tend to do well in inflationary environments because corporate earnings are also strong. In addition, I believe equities of companies that are more directly tied to economic activity and interest rates will have the opportunity to outperform next year. The relative valuations of bank stocks, for example, are historically tied to inflation expectations. Companies with pricing power in cyclical industries such as industrials and materials could see robust revenue growth once the dislocated recovery evens out. On the other hand, the stocks that tend to do best when growth and inflation are scarce (think the digital economy) could be at more risk. I believe it will be critical for a proper balance between the two groups.

10. Alternatives: The strong performance of private equity and credit in 2021 has gained investors' attention again and created tremendous avenue for diversification. Covid-19 has accelerated structural trends that are changing the investment landscape. With bond yields, credit spreads and interest rates low by historical standards, investors will be on a continued hunt for unconventional yield, a.k.a. alternative investments. Investors scour for themes in private markets seeking to complement their public market positioning. Private investments are typically hand-picked and actively managed, offering potential long-term value and diversification. Alts are more complex than public markets and may not be suitable for all investors. That being said, I do see private markets as a core strategic holding for diversification needs and potential outperformance. Many advisors and institutional investors are increasing allocations in 2022 as they are still underinvested in this area.

3 TRENDS FROM 2021

Covid-19 ignited some key significant trends: digital transformation, healthcare innovation and sustainability. Keep an eye on these three megatrends that ramped up in 2021, as investors search for diversified exposure.

Digital: The auto industry, which was at the center of 2021 disruption, and its ambition for electrification of the global fleet was a forceful undercurrent. Not surprising to those who follow semiconductors, electric vehicles (EVs) use nearly 4x the semiconductor content of traditional, internal combustion engine ones. Beyond autos, digital transformation is increasingly common in sectors from finance to retail, to entertainment, to healthcare. The metaverse (not yet owned completely by Mark Zuckerberg) could tilt most life digital, for better or worse. Cloud computing continues to accelerate. Before the pandemic, 20 to 30% of work was done in the cloud. Analysts thought it would take 10 years for that share to grow towards 80%. Now, it should only take three years. I like increasing exposure to cloud focused companies in 2022.

Healthcare: Hard to believe that Moderna and Pfizer are household names... As healthcare innovation remains in the fast lane, I think the industry is likely to become more personalized, more focused on preventative care and certainly become more digital. Wearables, telemedicine, and gene editing are other notable areas to consider investment exposure in 2022, as healthcare continues to shape our daily lives.

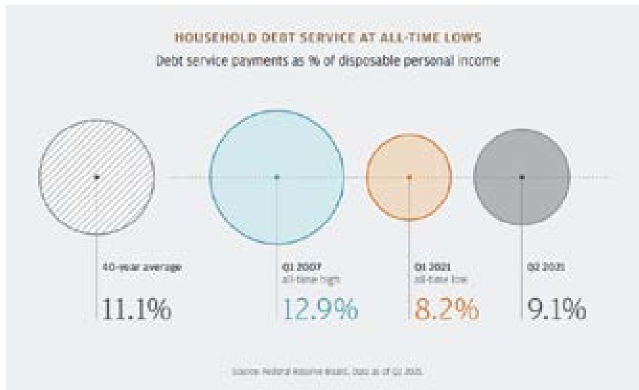
Sustainability: ESG and socially responsible investing increased dramatically in 2021. Some estimates suggest that more than $5 trillion per year is needed this decade to decarbonize the global economy. To reach President Biden's goal of decarbonizing the energy grid by 2035, the United States will need to invest up to $90 billion per year in new wind and solar generation capacity. Despite full valuations, I see opportunities in increasing exposure to this sector. ESG investing will move from a check-the-box component of investment portfolios to a must-have ingredient in every portfolio.

POSITIONING FOR 2022

Staying invested was a critical criterion in 2021, as there were various spikes in volatility that sent investors to the exit doors. In the event cash was raised during those volatile episodes, the S&P index marked 70 all-time highs for the year, along with broader market advances in the final stretch of 2021.

In many ways, the COVID-19 crisis was more like a war or a natural disaster than an economic recession, and policymakers reacted with equal force. Globally, post-pandemic spending commitments totaled almost $20 trillion, the highest levels of fiscal spending relative to GDP since World War II.

Household net worth is at all-time highs, debt service payments are at all-time lows and consumer sentiment has room to recover. Across the developed world, household savings are elevated. U.S. consumers saved almost $2.5 trillion more than the pre-pandemic trend. This is in stark contrast to the Great Recession when households endured falling home values and significantly lower equity prices which both contribute to reducing household wealth.



Unpacking market issues will again be critical for investors in 2022. A unique confluence of events transpired in 2021. The economic reopening, Covid-19 variants, supply-driven inflation, and an updated framework from the Fed created confusion as there are no historical parallels or data points for reference.

I favor an overweight on equities on a strategic horizon. Tactically, I believe an overweight to equities amid solid economic fundamentals and historically low real rates is warranted in 2022, unless a policy misstep is taken by the Federal Reserve. My view implies that I again prefer equities over fixed income this year. I envision a more moderate equity return for 2022, as a result of the Fed's transition into a rate hike cycle but I stay true to my belief that the Fed will remain more tolerant of inflation.

Have a healthy and happy 2022!

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