# Westshore Wealth *Insights*

## 2022 Outlook

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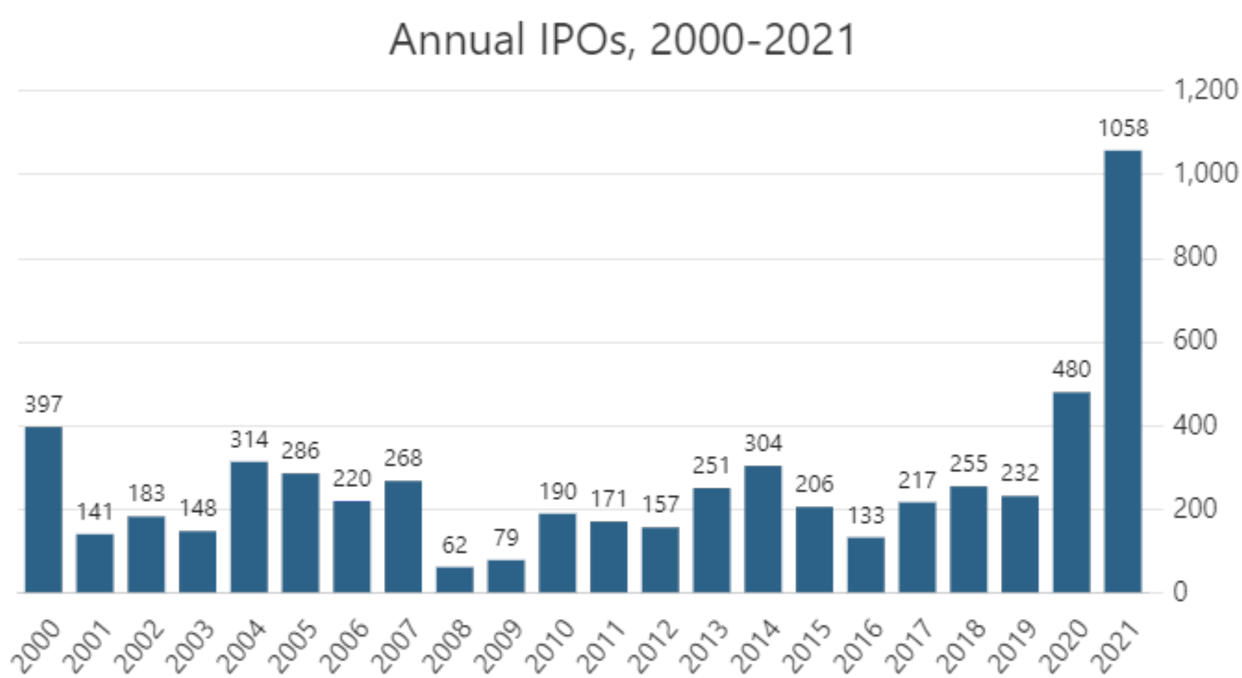
WESTSHORE WEALTH

**2022 Outlook**

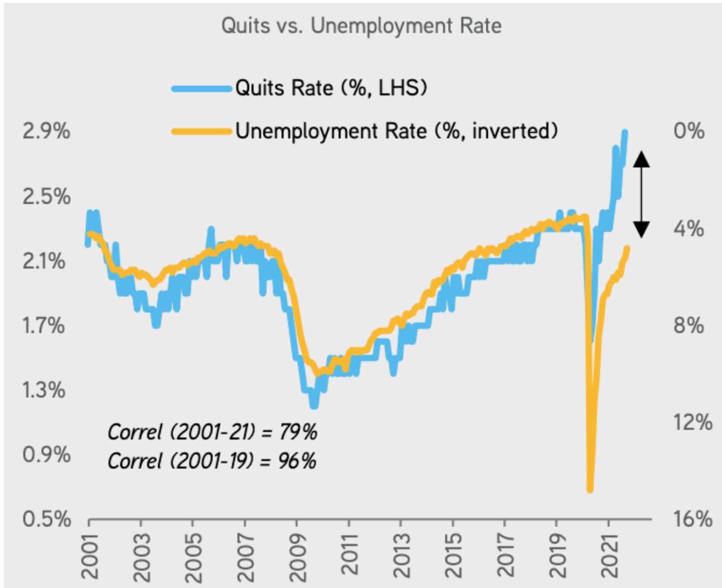
Our best advice for investors in 2022 is to heed the words of philosopher George Santayana who famously wrote, "those who cannot remember the past are condemned to repeat it." 2021 marked a reach for risk by investors, very similar in many respects to what we saw in the year 2000. The year started with individual investors following online forums like Reddit's WallStreetBets and propelling "meme stocks" like struggling video game retailer, Gamestop, up 1,600% in the month of January. Catering to this feverish demand, initial public offerings and SPAC issuance blossomed. 2021 is on pace to more than double the number of IPOs from 2020, the previous record year (source: StockAnalysis.com).




Meanwhile, according to Goldman Sachs, households now have 47% of their assets in equities, a level that surpasses the prior 2000 peak. Additionally, margin debt (borrowings by individual investors to leverage their portfolios) is up 50% since the pandemic lows. It rests a touch above $918 billion. For context, the amount of outstanding primary mortgages in the United States is $16.6 trillion. Adjusted for inflation, margin debt is roughly double where it peaked ahead of both the 2000 Internet Bubble collapse and the 2007 Housing Crisis. Finally, options activity is at record levels and contract sizes are at record lows. In other words, the activity isn't being driven by institutional investors, but rather individual investors who are using the options market to make more speculative plays. Contrary to what you might think, our point is not that individual investor behavior has been irrational. In fact, the trends that have driven this risk-seeking investing stance have been witnessed multiple times in the past. Our contention, however, is that this lottery ticket mentality towards investing is not suitable for the upcoming market transition that we foresee. Many of the cyclical and secular trends that reward aggressive risk taking are reversing course. That could result in a dramatically different playing field in 2022. Investors should familiarize themselves with history to avoid the pitfalls of the past.

Let's start with a review of 2021. This past year has seen a bevy of favorable tailwinds. The re-opening of the global economy led to rapid job growth, which in combination with pent-up savings, voluminous fiscal stimuli packages, and low interest rates, drove renewed consumer spending. That in turn pumped up corporate profits and accelerated earnings growth. When combined with a very accommodative Federal Reserve policy, this proved to be the perfect elixir for equity markets. However, as we look forward, it is important to understand the differences that confront us moving forward. For nearly 40 years, the United States has been on the virtuous path of disinflation (meaning moderating annual inflation). As a result, absent some brief Fed tightening cycles over the years, we have seen interest rates generally decline for two generations. That has been accompanied by rising profit margins and higher equity valuations. As we peer in to 2022, however, some of these secular trends will be challenged. Namely, we are no longer in a period of disinflation. The key reason is the spectacularly strong job market. There are now more job openings than unemployed in the United States. Workers are quitting their jobs (to accept better paying ones) at a pace that would normally be associated with 1% unemployment. That implies rising wages are here to stay. Corporations will have to respond by raising prices and that translates to inflation.

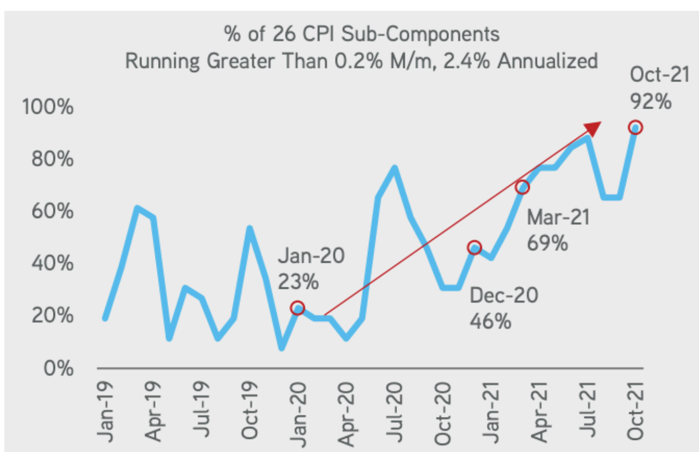
**Workers Are Quitting at a Rate That Would Normally Be Associated With Unemployment of Around One Percent**




Data as at October 20, 2021. Source: BLS JOLTS Survey, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

In fact, the Consumer Price index (CPI) is now annualizing over 6% with 92% of components above the Fed's targeted levels.

**U.S. Inflation Is Now Broad-Based Across Industries**



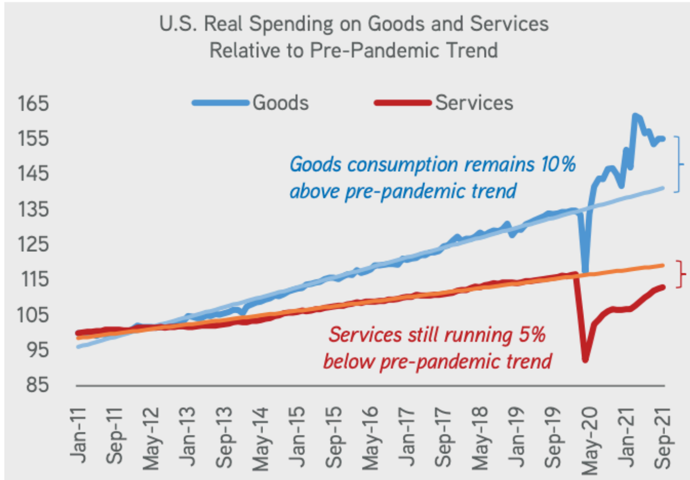

Data as at November 15, 2021. Source: Zillow, Manheim, Bureau of Labor Statistics, Haver, Bloomberg, KKR Global Macro & Asset Allocation analysis.

This is forcing a shift in Federal Reserve behavior. They have already announced that they would be hasten the pace of tapering asset purchases (the Federal Reserve has been directly buying US Treasury and government backed

Mortgage-Backed Securities). By early February, they will no longer be actively purchasing these securities. This will set the stage for them to raise interest rates as early as March 2022. Why is this important? The equity market is driven by two factors, namely corporate earnings growth, and secondarily, by what investors are willing to pay for each unit of earnings (the P/E multiple). Historically, when interest rates rise, the economy slows. Financing becomes more expensive. Affordability of homes, cars, and other durable goods falls. Interest on credit cards rise leaving less discretionary income available for purchases. Businesses must clear higher hurdles to make investments. Generally, the net result is lower profitability growth for corporations Additionally, investors generally award lower equity multiples on those earnings during periods of rising rates. We already started to see a preview of this behavior in 2021. S&P 500 earnings are poised to grow over 40% in 2021, yet the market is up roughly 28%. In other words, the P/E multiple has already started to shrink. 2022 is likely to see a continuation of that trend. Growth will slow further. Consensus S&P 500 EPS is expected to moderate to an 8% pace. If past is prologue, the P/E multiple will likely shrink further as interest rates rise. That implies that we are looking at more modest equity returns.

Are we saying you should bail out of equities and head for cash? Absolutely not. The fundamental story for equities is still largely intact. Unemployment is low and improving, consumer balance sheets are healthy, business inventories are low, pricing power is robust, and there is still plenty of pent-up demand on the service side of the economy. Our message is that we are in the point of the cycle where certain styles tend to be rewarded and others avoided. Historically, later economic cycles favor repeatable cash flow stories and high balance sheet quality companies. Secondarily, we still believe that there is more money to be made owning virus sensitive cyclicals that will benefit from normalizing supply chains and a re-opening of the service economy.

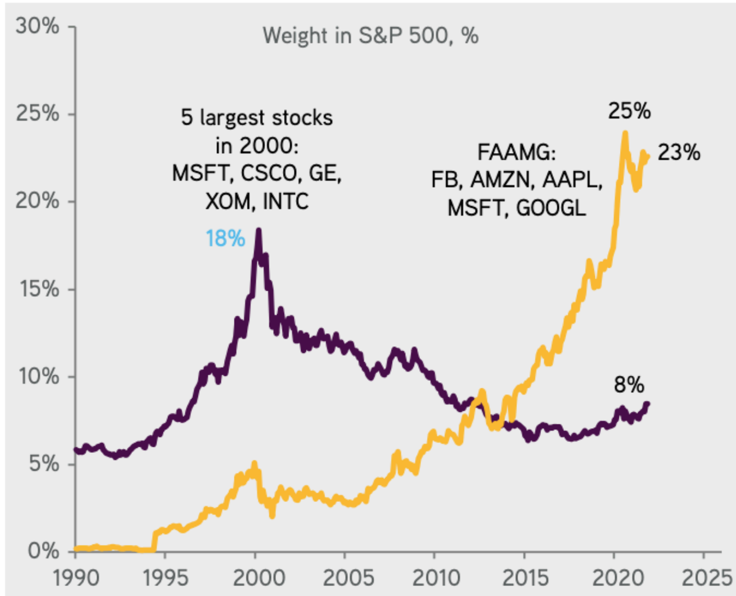
**Services, Which Represent Almost 70% of Total Consumer Spending, Are Still Recovering**




Data as at November 15, 2021. Source: Bureau of Economic Analysis, Census Bureau, KKR Global Macro & Asset Allocation analysis.

By contrast, we would avoid high valuation, unprofitable story stocks that lack fundamental underpinnings. Typically, those are the hardest hit during a period of rising rates, and it appears to already be happening. As of 12/13/21, over half of the 2021 IPOs were trading below their offering price according to Fortune. Additionally, we would be wary of high labor cost companies that will have trouble raising prices aggressively enough to offset margin pressure. Finally, we remain cautious on high idiosyncratic risk names in the S&P 500. Recall, over 23% of market capitalization of the S&P 500 is made up of FB, AMZN, AAPL, MSFT, and GOOGL. We note that each has regulatory and taxation issues aimed in their direction. Keep in mind, the FAAMG group of stocks completed over 1,000 corporate transactions over the past decade. With the Biden administration pressuring the FTC to intensify its oversight of mergers and acquisitions, it may get harder for these companies to exhibit outsized EPS growth if they are unable to buy smaller, emerging competitors.

**Equity Market Leadership Is Difficult to Maintain: The Five Largest Stocks in 2000 Now Comprise Only Eight Percent of the S&P 500 Equity Cap Today**




Data as at November 12, 2021. Source: Goldman Sachs Global Investment Research.

This drives us to favor value equities where cash flows are solid, earnings growth is still playing catch up, and idiosyncratic risk is lower. Turning our attention to overseas markets, we continue to see the opportunity for health care trends to catch up to the United States. As vaccination rates rise abroad, and more workers return to employment, we believe the opportunity for accelerating earnings growth overseas is substantial. That should lead to better relative stock performance from international and emerging markets.

Turning to fixed income, the same trends that pose risks for equity markets will impede credit markets as well. Rising interest rate environments are difficult for fixed rate securities of long maturity. Fortunately, at Westshore we have been positioned for this shift. Our contention has been for some time that inflation was going to prove more durable than the Fed had hoped (*It's (NEVER) Different this Time, May 2021)*. As a result, we have been shifting towards shorter duration corporate bonds, floating rate securities like bank loans and preferred securities, as well as populating exposure to convertible bonds. Additionally, we have begun shifting some fixed income allocation towards real estate and infrastructure where we can achieve bond-like dividend payments yet be more insulated against inflation. This has allowed us to outperform fixed income benchmarks to date and we hope to continue that trend.

Our approach to 2022 is analogous to sailing a boat. In this case, the Federal Reserve's extremely accommodative monetary policy has provided one of the key tailwinds that propelled markets in past years. In essence, the only thing we needed to do was raise the spinnaker and fly along the water. However, in very short order, the Federal Reserve will shift course and raise interest rates. Our tailwind will turn into a headwind. Much like an experienced sailor will tell you, navigating against the wind isn't impossible. It simply requires a different, and more artful, technique of tacking. Similarly, our investments will need to shift. We will need to favor different styles and markets that are more optimized for this type of environment. The good news is that we have copious amounts of historical context to understand how we can position ourselves for the best outcome. We welcome any questions.

# Important Disclosures

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