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The CIO Monthly Perspective

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TOMORROW'S NEWS TODAY

Anticipating 2022's headlines

It was a November to remember. The month started out with palace intrigue over who will be the next Fed Chair and ended with more questions than answers on a highly mutated SARS-CoV-2 virus strain cleverly named Omicron. The supposedly apolitical World Health Organization, which has an established methodology in naming variants, skipped the Greek letter preceding Omicron, Xi, to avoid upsetting one of its powerful patrons. We can parse the market's inner "Donald Rumsfeld" into these known knowns and known unknowns:

- Chair Powell will serve another term and has pivoted to retire the word "transitory" regarding inflation; he even signaled that the FOMC may quicken the pace of tapering.
- Inflation has become a political issue as Democrats are now scapegoating oil companies and OPEC. The White House's coordinated release of oil from the Strategic Petroleum Reserve with five other countries was ridiculed by many as political theater rather than a strategic move to lower oil prices. The Omicron variant wound up getting the job done, at least for now.
- The Omicron virus has likely spread to here, there, and everywhere; ignore the media brouhaha when the first domestic case is eventually detected.
- The jury is still out regarding Omicron's resistance to existing vaccines and its severity among the elderly and those with comorbidities. I am operating under the assumption that it is more transmissible but displays milder symptoms, meaning that it will not be a major disruptor to the normalization process. However, one has to be humble enough to acknowledge that there are many known unknowns and perhaps even unknown unknowns as we grapple with a disease that has become endemic.

Despite the recent market pullback, investors may still be looking forward to the typical Santa Clause Rally to wrap up this year of strong returns. However, much will depend on how the following known unknowns get resolved in the coming weeks:

- Data on the Omicron variant to determine its likely impact on public health and the economy.
- The "dot plot," the Summary of Economic Projections, and signals on the pace of tapering from the Fed's FOMC meeting in mid-December.
- Washington's resolution of the Build Back Better bill and the debt ceiling.

Let's hope that the Omicron variant turns out to be as mild as the early data indicates so that we can go back to more mundane issues like reading the tea leaves from the Fed and obsessing over how persistent inflation will turn out to be.

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CELLULOID HEROES

Here's a trivia question for movie buffs: what is the longest running movie franchise? With *No Time to Die* still fresh on people's mind, some may say, "Bond," and after a deliberate pause, "James Bond." Well, James Bond is indeed one of the greatest film franchises as the eponymous M16 agent is likely the most recognized celluloid character in the world.

The 007 franchise dates to the October 1962 release of *Dr. No*, the first of 25 films in the series (27 if one includes 1967's Casino Royale and 1983's Never Say Never Again, which were not made by Eon Productions). Over these 59 years, the super-agent with a license to kill has evolved with the times. Sean Connery's portrayal of a chauvinistic sensualist who sought to seduce and dominate every woman he met might have been acceptable in the 1960s, but the franchise probably would have been cancelled had Daniel Craig stuck to the same schtick. Instead, Craig modernized the character into a tortured, introspective man who was romantically vulnerable. With the plotline of *No Time to Die* having poignantly wiped the slate clean, Eon Productions now has an opportunity to totally transform the new Bond into someone uber-contemporary. Who knows, the new Bond may just debut with this self-introduction: "Bond…James Bond…ze, hir."

While James Bond has evolved, his nemeses have largely remained megalomaniac, delusional, and diabolical. Over the years, the villains have included transnational crime bosses (e.g., Blofeld of SPECTRE), renegade generals (e.g., General Orlov in *Octopussy*), and business titans. Industrialist Max Zorin in *A View to a Kill* tried to destroy Silicon Valley to corner the microchip market. Shipping tycoon Karl Stromberg in *The Spy Who Loved Me* attempted to wipe out our civilization and replace it with an undersea world. Oil heiress Elektra King in *The World is Not Enough* sought to dominate Europe as a sole supplier of energy by triggering a nuclear meltdown in Istanbul where a competing Russian pipeline passed through. All their evil plans, of course, were foiled by 007. Lately, however, James Bond has been missing in action while these three industries – microchips, ocean shipping, and energy – conspired to subjugate the world through severe shortages and supply chain disruptions.

Another memorable evil tycoon was Elliot Carver, a thinly disguised caricature of Rupert Murdoch in *Tomorrow Never Dies*. Played by Jonathan Pryce, Carver was a media baron who observed that, "Words are the new weapons, satellites the new artillery." He was scheming to install a Chinese general as the country's top leader in exchange for 100 years of exclusive broadcasting rights in China. Carver boasted that his TV, newspapers, and magazines would enable him to reach out to and influence more people than anyone in history, save God himself. The movie premiered in 1997, before Google, Facebook, and Twitter were even created. As such, the screenwriters could not have anticipated the seismic changes in the media industry brought on by the Internet.

Equity Markets Indices[1]	10/31/21 Price	11/30/21 Price	MTD Change	YTD Change
MSCI All Country World	745	727	-2.5%	12.4%
S&P 500	4605	4567	-0.8%	21.6%
MSCI EAFE	2336	2224	-4.8%	3.5%
Russell 2000®[2]	2297	2199	-4.3%	11.3%
NASDAQ	15498	15538	0.3%	20.6%
TOPIX	2001	1928	-3.6%	6.9%
KOSPI	2971	2839	-4.4%	-1.2%
Emerging Markets	1265	1212	-4.1%	-6.1%
Fixed Income				
2-Year US Treasury Note	0.50%	0.57%	7	45
10-Year US Treasury Note	1.56%	1.45%	-11	53
Bloomberg US Agg Corp Sprd	0.87%	0.99%	12	3
Bloomberg US Corp HY Sprd	2.87%	3.37%	50	-23
Currencies				
Chinese Renminbi (CNY/$)	6.41	6.36	-0.6%	-2.5%
Brazilian Real (Real)	5.64	5.62	-0.2%	8.2%
British Pound ($/GBP)	1.37	1.33	2.9%	2.7%
Euro ($/Euro)	1.16	1.13	2.0%	7.7%
Japanese Yen (Yen/$)	113.95	113.17	-0.7%	9.6%
Korean Won (KRW/$)	1168.50	1188.05	1.7%	9.4%
U.S. Dollar Index (DXY)	94.12	95.99	2.0%	6.7%
Commodities				
Gold	1783	1775	-0.5%	-6.5%
Oil	83.6	66.2	-20.8%	36.4%
Natural Gas, Henry Hub	5.43	4.57	-15.8%	79.9%
Copper (cents/lb)	437	428	-2.1%	21.6%
CRB Index	238	219	-7.8%	30.6%
Baltic Dry Index	3519	3018	-14.2%	120.9%

Source: Bloomberg

If *Tomorrow Never Dies* were to be remade today, Elliot Carver would probably be an antisocial Internet entrepreneur who controls the dissemination of information and dabbles in space travel and crypto assets. He can alter people's emotions and behaviors by manipulating the content fed to them in the virtual world. How would Bond deal with such a foe, one who can cancel anyone at will by exposing compromising materials from their private communications, browsing history, spending data, geospatial record, etc.? Bond may just have to leave his toxic masculinity behind in the real world and don virtual reality goggles and gloves provided by Q to out-nerd the new villain in the metaverse.

No matter how Bond and his villains evolve, none of them will

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ever match the power of Godzilla, which bests James Bond in having the longest running movie franchise in history. Conceived in 1953 and debuted a year later, Godzilla has inspired 36 films – 32 by Toho Co., Ltd., and 4 by Hollywood – as well as numerous video games, comic books, TV shows, and novels. One advantage that Godzilla enjoys over James Bond is that, as a prehistoric, nearly indestructible sea monster awakened and empowered by nuclear radiation, it does not have to change its stripes to suit society's changing morals and values. It is, after all, just a monster who has no need for virtue signaling.

2021 IN REVIEW

In *Tomorrow Never Dies*, Elliot Carver took delight in writing headlines and obituaries, sometimes before the actual events had taken place. While the media industry has evolved, attention-grabbing or click-baiting headlines have remained an integral part of the business.

As 2021 draws to a close, the media will come up with catchy headlines for their year-in-review pieces. To spice up this publication, let me share some of my duh-inspiring headlines for the year: *"The Perfect Alignment", "1999 on Steroids", "Ghosts of the 70s", and "Third Jab's the Charm?"*. They cover the four defining characteristics of 2021 as far as investment is concerned: supercharged stimulus, speculative fervor, inflation, and a pandemic that turned endemic.

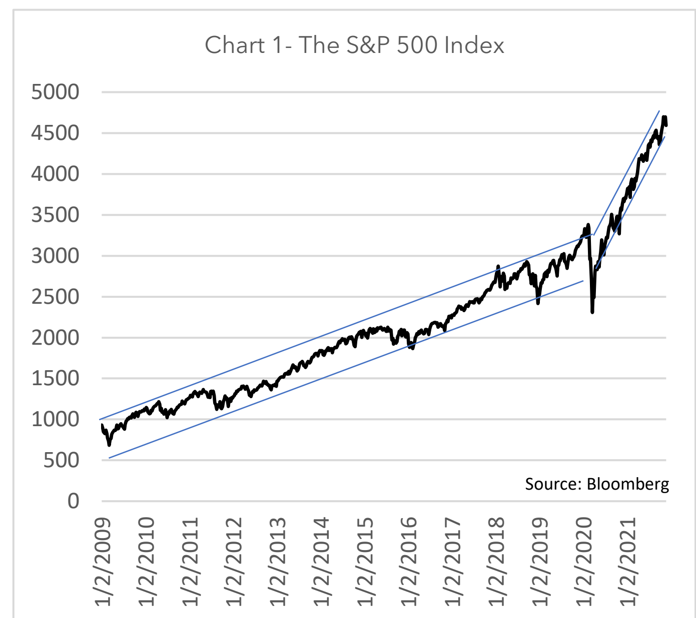
"The Perfect Alignment"

The Perfect Alignment embodies the macro backdrop forecasted in the opening paragraph of my January 2021 report: "[A] bright 2021 where stars appear perfectly aligned, thanks to the conjunction of new fiscal relief, effective vaccines, continued monetary largess from central banks, and the most supportive financial conditions in decades." Indeed, it was a once-in-a-career alignment of fundamental, macro, and technical drivers as the scale of the fiscal largesse and the Fed's "let it rip" attitude were simply unprecedented. U.S. consumers were so flush with helicopter money from Washington that their spending on durable goods surged to more than 30% above the trendline.

"1999 on Steroids"

This perfect alignment led to a speculative fervor that makes the dot-com bubble look downright amateurish. The NASDAQ and the NASDAQ 100 Indices had gained 86% and 102%, respectively, in 1999, as the dot-com bubble reached its final blow-off phase which ultimately peaked in early March 2000. However, the speculative frenzy was rather narrowly confined to the Internet, technology, and biotech stocks. One can even argue that, while many "hot" companies from that period had subsequently collapsed, the long-term impact of the innovations from that era turned out to be much more signficant than what many investors had envisioned at the time.

The scale and breadth of the speculative fervor in 2021 are far greater as the so-called Reddit bros have pushed the share prices of companies whose glory days are far behind them into the stratosphere. In the crypto space, coins created as jokes were garnering market caps in the tens of billions of dollars. The NFT (non-fungible token) craze has resulted in digital images of cartoon rocks being sold for millions of dollars. As for equities, the current bull market has been rising along a steeper slope than the preceding one (Chart 1). The S&P 500 Index's price-to-sales ratio and the Buffet Indicator (U.S. equity market capitalization as a multiple of GDP) are hitting record highs and are at more than 50% above levels reached during the dot-com bubble. The froth is so visible that even the Fed, which has a history of turning a blind eye to asset bubbles, has dedicated an entire section in its recently released semi-annual "Financial Stability Report" to warn of the dangers of rising household financial risk appetite, social media influence, stablecoins, etc.



"Ghosts of the 70s"

In my January 2021 report titled *"The Roaring Twenties?"*, I surmised that, "[T]he 2020s may turn out to be a decade of higher nominal growth, as inflation may be the one thing that is set to roar." It seems like a logical outcome from "The Perfect Alignment" – the stimulus-driven demand surge coupled with inelastic supply would lead to higher prices. Indeed, the surprise of the year should be how the Fed and so many economists and investment professionals with fancy degrees and sophisticated models collectively missed the sharp rise in inflation. To salvage their credibility, they have resorted to coach Vince Lombardi's "never-lost-a-game-but-ran-out-of-time" excuse by stretching out the game clock to claim that inflation remains transitory, though not short-lived. That is

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clever, as headline inflation will eventually run into difficult comparisons which will enable these geniuses to say, "I told you so." It also buys the Fed time to stay loose for longer. To wit, in the face of the highest inflation readings in 30 years (the CPI and the core CPI at 6.2% and 4.6%, respectively), the Fed is still keeping the Fed funds rate at zero and is on course to purchase an additional $420 billion of U.S. Treasury and mortgage-backed securities before winding down QE by mid-2022. We should pause here and let that sink in for a second. Why keep on buying assets when the system is already awash with liquidity and inflation running way above their forecasts? Are these Fed officials more afraid of triggering a market tantrum than further fanning the inflation flame? It's no wonder that investors have been behaving like 1999 on steroids.

The energy crunch across Europe and Asia will further compound the sticker shock when homeowners get their winter heating bills. The higher cost of living and labor shortages resulting from mismatched skills and other factors have driven up wage growth. Labor unions are emboldened to take more aggressive tactics in contract negotiations. According to Bloomberg News, nearly two-thirds of Americans now approve of unions as the gap between the haves and the have-nots is further widened by the booming stock market and elevated inflation that erodes real wages.

The 6.2% inflation in October is equivalent to a reading of 14.2% using 1980's CPI calculation methodology, according to the economist at *shadowstats.com*. It is not a stretch to say that the ghosts of the 1970s – high inflation, energy crisis, labor strikes, etc. – have made an unwelcome return. Our uber-dovish Fed also brings back memories of the late Arthur Burns, Nixon's handpicked Fed Chair, who prioritized politics over price stability and allowed inflation to soar on his watch.

"Third Jab's the Charm?"

The world has now experienced several waves of COVID-19 infections which started in Wuhan in early 2020 and culminated with the Delta variant in the summer of 2021. Lately, surging new cases resulting from fading vaccine efficacy have led some European countries to impose varying degrees of lockdowns even before the Omicron variant made its presence known.

It is apparent that a third jab is needed to boost vaccine efficacy, which leads to the headline, *"Third Jab's the Charm?"* I leave a question mark as only time will tell if the third jab will result in acceptably long-lasting efficacy, and whether a fourth shot to fight Omicron will be needed before long. These booster shots could be met with apathy or even resistance among younger cohorts. Various vaccine mandates also have the potential to disrupt the tight labor market and supply chain, not to mention our fraying social fabric. To wit, various surveys have shown Americans' trust in the mainstream media plumbing new lows, with the government not faring much better in their eyes.

2022 - FROM EUPHORIA TO HANGOVER

Reading headlines about what has transpired may be informative to some, but markets are quick to discount the news and arbitrage away any mispriced opportunities. The key to successful investing is anticipating correctly, more often than not, what future headlines will read like, and positioning one's portfolio accordingly. However, as Niels Bohr, the father of quantum mechanics, had quipped, "Prediction is very difficult, especially if it's about the future." That said, there are still some low hanging fruits for forecasters.

2021 can be viewed as a year of excess where the proverbial "punch bowl" was spiked by policymakers so much that some investors are still experiencing an intoxicating euphoria. Some of that effect might linger into 2022 if the Omicron variant turns out to be manageable. However, the euphoria will likely be followed by an uncomfortable hangover, especially with the macro backdrop shifting away from the Perfect Alignment. On the monetary side, the Fed's QE liquidity spigot is scheduled to be closed by mid-2022, and there may even be a rate hike or two in the back half of the year. On the fiscal front, much of Uncle Sam's emergency pandemic spending has been disbursed. The vaccine rollout has given the economy a strong shot in the arm in 2021, but it was a one-time boost and the efficacy is fading.

Fundamentally, 2022 will likely be another year of above-trend growth buoyed by an improving job market, inventory re-stocking, and continuing strength in capital spending. Growth will be front-loaded as it benefits from 2021's supply shortage fueled backlogs (e.g., vehicle sales), which defer sales into the new year. However, by the latter part of 2022, economic growth will likely slide toward the sub-2% longer-term growth trend unless Democrats are able to cobble together another stimulus bill before the midterm elections. As the stimulus-induced euphoria fades and the cold reality of much slower growth sets in, earnings disappointments and market volatility will likely pick up. In short, 2022 could turn out to be a year of two distinct halves, and I suspect the following headlines may turn out to be prescient:

- *"A Not-So-Durable Spending Binge"*
- *"A Restocking Boom"*
- *"Catch 22 at the Fed"*
- *"GameStopped"*
- *"Biden Cuts Tariffs; Xi Claims Victory"*

"A Not-So-Durable Spending Binge"

It is said that a picture is worth a thousand words. I believe the one chart that captures the unusual nature of this pandemic era is of American consumers' durable goods buying binge (Chart 2). It clearly illustrates the stimulus-fueled boom time and helps explain the supply shortage and inflationary pressures. It also

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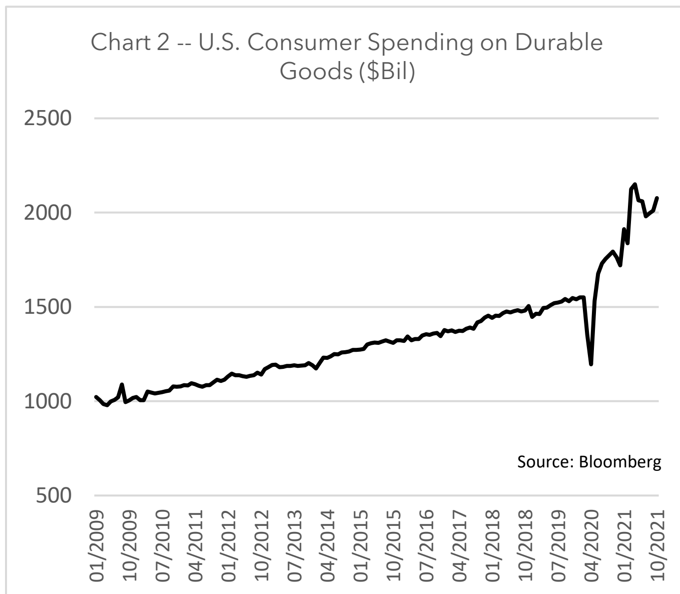
portends a tricky economic transition period ahead as the unsustainably high levels of spending return closer to trend.

As shown in the chart, U.S. consumer spending on durable goods in nominal dollars had grown fairly consistently at 4.2% per year during the last decade. It had contracted sharply at the onset of the pandemic in the spring of 2020. However, once people realized that work-from-home would persist for a while and government stimulus checks started to arrive, consumers shifted discretionary dollars from services and went on a buying binge for durable goods – electronics, home furnishings, exercise equipment, cars, etc. By the spring of 2021, with the help of the additional $2000 stimulus checks for qualified individuals, consumer spending on durable goods surged to as high as 39% above pre-pandemic levels and over 30% above the decade-long trendline. As of October 2021, it was still hovering about 25% above the trendline despite supply constraints.



This spending binge has been great for corporate sales and earnings growth. Consumer durable goods sales will likely remain strong in early 2022 as sales deferred by supply constraints get delivered. However, a hangover will likely be felt later in 2022 or 2023 as above-trend spending looks too elevated to be sustainable. The timing of the eventual return toward the trendline is not easy to pinpoint as consumers can tap their excess savings for a period of time. It will likely result in negative earnings surprises among companies that are highly dependent on consumer durable goods spending. I suspect some of these problems may start to show up in the spring when the year-over-year growth comparisons begin to get more difficult to beat.

"A Restocking Boom"

The strong demand for consumer goods coupled with supply chain disruptions have left many businesses short on inventories, and one of the growth drivers for 2022 will likely be their replenishment. Judging by the data, U.S. business inventories have climbed above pre-pandemic levels, but they are at multi-year lows relative to the strong levels of sales and orders. The GDP data has also shown three consecutive quarters of inventory drawdowns, which will likely reverse sometime in 2022 to become a growth contributor.

One fly in the ointment in this inventory restocking thesis is the uncertain level of excess orders and hoarding in an environment of supply shortages. It's par for the course for purchasing managers to place extra orders in the face of supply shortages. Then, as supplies start to catch up, they would either defer or cancel some of the extra orders. We do not know to what extent this is happening, and whether businesses will opt to return to just-in-time inventory management. Another potential complication is how quickly consumer spending on durable goods returns toward the trendline. In short, while inventory replenishment will likely be a positive driver for most of 2022, the headline may change to *"Restocking Boom Turned Bust"* late in the year or in 2023.

"Catch-22 at the Fed"

Fed Watching, the parlor game among investors and market soothsayers, will get even more interesting in 2022 given elevated inflation, speculative sentiment, and the changing composition of the FOMC. Investors often lionize the most accurate Fed watchers who correctly anticipate the Fed's moves as it helps them place bets in a casino known as the market. However, rather than focusing on making the right calls on the Fed's next move, investors should be asking if the Fed is making the right calls. I fear that the answer appears to be no.

Looking at the available data, dated back to 1954, the current real Fed funds rate (subtracting the CPI from the effective Fed funds rate) is the lowest on record, and the Fed is still injecting stimulus in the form of continued asset purchases. Given elevated inflation and inflation expectations, and more job openings than the number of unemployed, I believe the Fed has run out of excuses to not tighten.

I suspect the Fed's dovishness stems from its fear of upsetting the financial market, whose tantrum, if not properly contained, could precipitate an economic downturn and unleash deflationary forces from rapidly falling asset prices and slowing economic activity. It's like Dr. Frankenstein having lost control of his creation and needing to deal with the monster with kid gloves. However, by staying loose for too long in the face of "1999 on steroids" and a potential wage-price spiral, price stability could be compromised. The market tantrum could be even greater if the Fed winds up having to play catch up and to tighten at a quicker pace.

This Catch-22 leaves the Fed seemingly paralyzed and probably praying really hard for inflation to ease. The good news is that inflation is likely plateauing, and the year-on-year

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changes will start to decline by springtime. However, political pressure on the Fed to curtail inflation may rise further in the coming months as the headline CPI will likely remain at 6% or higher this winter. Barring the Omicron variant creating unexpected economic hardships, the Fed will increase the pace of tapering, as Chair Powell has signaled, to gain more policy flexibility. I also believe that the Fed will reluctantly hike the Fed funds rate once or twice before year-end 2022. However, the real test may arise in late 2022 or early 2023 when the dreaded stagflation has a shot at making an unwelcome return.

"GameStopped"

Timing the bursting of a speculative bubble is a dangerous endeavor, as noted in one of the most memorable quotes attributed to the great John Maynard Keynes, "The market can remain irrational longer than you can remain solvent." However, with the macro backdrop becoming less supportive, consumer electronics sales facing difficult comparisons, and visible signs of late-stage speculative fever, I suspect the frothier corners of the market will be hit with bouts of unwinding in 2022.

One potential catalyst may come from the regulatory front – the U.S. government, led by the SEC, might finally get serious about regulating the Wild West of the cryptosphere. It's quite astounding that our regulators have been asleep at the wheel while these unregulated markets ballooned to trillions of dollars with rising systemic implications. The cryptosphere has evolved to a stage where, if left unregulated, it could destabilize our existing financial systems and even our national security. Stronger regulatory enforcement would also yield a tax bonanza for the government. While regulations will eventually legitimize some of these markets for institutional investors, there will likely be heightened volatility as the so-called "paper hands" take profits or cut their losses.

"Biden Cuts Tariffs; Xi Claims Victory"

2022 will be a politically charged year for the world's two largest economies. President Biden will try to avoid a resounding defeat at the midterm elections while Chairman Xi Jinping works on cementing an unprecedented third term in the run up to China's National Congress late in the year. Biden will taut his various accomplishments from the infrastructure bill to Build Back Better, but he will be vulnerable on issues such as inflation, immigration, and the botched withdrawal from Afghanistan. Xi may appear to wield absolute power atop the Chinese Communist Party (CCP) monolith, but his coveted third term is not yet set in stone as there are still fierce power struggles among competing factions behind the party's unified façade. The fact that Xi has not made a foreign trip in over 680 days (his last foreign visit was in mid-January 2020) speaks volumes to the palace intrigue and paranoia.

Politics makes strange bedfellows. Despite the heated strategic rivalry between the two nations, I expect Biden and Xi to achieve some "breakthroughs" in the bilateral relationship to strengthen their respective hands in domestic politics. The Biden Administration will likely roll back some tariffs and get China to agree to fulfill their purchase commitment on American agricultural products. Xi may even sweeten the deal with some aircraft purchases. Biden will tell voters that these moves should help lower inflation and bring more jobs home. Xi will portray America's rollback of tariffs, however narrow in scope, as a victory for his wolf-warrior diplomacy. The Chinese media will have a field day singing praises of a resolute Chairman Xi making Uncle Sam sweat and eat crow.

This "thawing" of the Sino-U.S. relationship will likely improve sentiment on Chinese stocks, which are some of the biggest laggards of 2021. Xi's need to stabilize China's economy ahead of the National Congress should also benefit emerging markets. However, it will do little to reduce the distrust between the two rivals, and investors in Chinese securities are always at the mercy of the CCP.

INVESTMENT OPPORTUNITIES

My headlines for 2022 will be off-base if the Omicron variant turns out to be as dire as epi-fearmongers on social media make it out to be. Based on currently available data, Omicron appears to be highly transmissible but its symptoms have been described as relatively mild. With SARS-Cov-2 having become endemic, there will be new strains that result in behavioral changes and localized lockdowns from time to time. However, I believe the march toward normalization will not be reversed. As such, pullbacks in value stocks, especially those in energy and commodities, should be viewed as buying opportunities. That said, with the economy now in mid-cycle and the pace of growth likely to decelerate materially in late 2022, it is more important to focus on quality stocks rather than the value vs. growth debate. A less supportive macro backdrop as the year progresses will likely increase market volatility and create some "GameStopped" moments. Such an environment should favor well-managed long-short hedge funds as there are plenty of overvalued targets to bet against when the tide of liquidity recedes.

Given the market's rather bearish sentiment on China and the Chinese government's need to deliver healthy economic growth and social stability going into the National Congress in late 2022, I expect Chinese and emerging market equities - this year's big laggards - to surprise on the upside next year.

I remain positive on precious metals and related mining stocks, which have been rather disappointing this year despite much higher-than-expected inflation. In an environment of strong economic growth and abundant liquidity, the barbarous relics that often function as safe havens would understandably be ignored by investors. However, as Jim Grant, Wall Street's great wordsmith and the publisher of *Grant's Interest Rate Observer*, recently observed, "Gold is a little bit of an island of

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indifference in a boiling sea of gambling and speculation." Precious metals may finally catch a bid in 2022 as they tend to outshine other assets during periods of stagflation (elevated inflation and slow growth), which may be the environment by late next year.

In the final analysis, as John Kenneth Galbraith once said, "We have two classes of forecasters: those who don't know and those who don't know they don't know." (Was that the inspiration for Donald Rumsfeld's known unknowns and unknown unknowns?) As we have learned during this pandemic era, black swans seem to be showing up with increasing frequency, and our policymakers' responses have become bolder and grander. This era of excess – massive stimulus, inflation-seeking policies, negative real and even nominal yields, speculative fervor, etc. – has steered the market and the economy into uncharted waters. How things ever normalize and to what degrees are important markers for the next few years.

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