The 2022 Outlook

It feels somewhat obligatory to start the year with an outlook piece. We all know, as **Mike Tyson** expressed so well, that "everyone has a plan, until they get punched in the mouth", but we might as well go ahead and create a plan. If nothing else, it will help us follow **Rocky**'s words of wisdom, that "it's about how hard you can get hit and keep moving forward!"

I will start with themes that I think are incredibly important and have the potential to shape markets and the economy where I have strong convictions, but I don't think are consensus. We will follow that up with some second order themes where I have either more uncertainty or the view might be more consensus and already priced into the market.

The Recentralization and De-Coupling of China

Next week's T-Report will be dedicated to this subject. It is one we have addressed time and time again at Academy (from A D.I.M.E Framework for China back in 2019 to this summer's The Recentralization of China). Since it is a topic that we've discussed (and I plan to do a deeper/fresh dive next week), I will try to be succinct here and lean towards assertions rather than demonstrations.

Where China is Headed:

- **Recentralizing and reasserting the dominance of the Communist Party**. The Jack Ma's of this world will be pressed down so that the country knows that the Party is firmly in charge.
- **A focus on domestic issues**. Real estate is an issue (and Evergrande never was a moment, but was part of a process). Feeding a nation of over 1 billion people is proving difficult. Dealing with the "One Child" policy is another issue facing China as not only is the average age rising rapidly, but the part of the population hitting their stride is heavily skewed towards males (which is an issue in its own right, but another reason to expect that China will flex their military capabilities). China has a lot of internal issues to deal with and is retrenching their economy to focus on these issues.
- **Information Crackdown.** Whether it is facial ID for every cell phone or encouraging the digital yuan and a cashless society where everything is tracked, China is clamping down on information that is coming into the country and is increasing its surveillance of its own people. This is a necessary step for recentralization.

What it means:

- **Supply Chain Issues are NOT going away.**
    - **The U.S. side of the issue**. Despite so many famous economists (many of whom are Democrats) decrying then President Trump's **tariffs**, they are still largely in place a year into President Biden's administration. Not only have tariffs remained in place, but additional rules have been placed on companies using **suppliers in the Xinjiang province**. As **national security issues surrounding the high tech, medical and pharmaceutical industries** get resolved, we will see further pressure and incentives to do business away from China. Just think about this for a moment. There are now Russian vaccines, Chinese vaccines, and let's say Western Europe/North American vaccines and who is using them is very distinct. Not saying it is a cold war, but it is looking more and more like one from our end.

  - **The China side of the issue.** China is ramping up coal usage even as they make some pledges about the environment. China will do what is necessary for China. As they gear up their production to service their own economy and keep their population at a level of comfort sufficient to avoid widespread dissent, they will not focus on manufacturing for us as much as they once did (which meshes with our shifting attitude towards Chinese production).

- **For the better part of two decades, China was a deflationary force on a global scale. While they may not be an inflationary force, they are likely at best to be neutral.** This, if correct, is the end of an era and represents a massive change for the global economy (some of which is already being felt, but is being dismissed as transitory or a function purely of the pandemic rather than being more permanent and part of an overall strategy).
- **Client States versus Allies.** As China pulls back from the global stage, they will retain their "client states". Maybe that is too harsh of a word, but China has established relationships with many countries, mostly with a focus on securing the resources China needs and wants (or thinks that the West will realize they need and want, more than we already do). There will be ongoing competition for strategic resources and this will determine how China works with other countries (heavy on the economics, light on political ideology) and how we want to deal with other countries. Several Asian nations just announced a trade deal that doesn't include the U.S. Will this push us towards regionalization?
- **Chinese Taipei or Taiwan?** This is rapidly heading from a rhetorical question to an issue that really needs to be addressed with some certainty. China continues to pull Hong Kong closer while maintaining the premise of "One Country, Two Systems", and there is little reason to see them changing course on Hong Kong or Taiwan regarding their stated goals.
- **New Battlegrounds.** Space could become a hot topic, not just from the perspective of billionaires and celebrities flying into it, but from a strategic competition perspective. Space, which judging by some ETFs focused on the industry wasn't a great investment in 2021, but this could change as attention shifts to this frontier.

Expect inflationary pressures, global tensions, and less investment in China in the coming years.

The Push to Sustainability is Inflationary for Years to Come

This is another subject that we focused on starting in early 2021 with pieces like [ESG is Inflationary]. Ultimately a sustainable world with clean renewable energy should prove to be deflationary, but for the next few years, I see inflationary pressures in almost every aspect of sustainability:

- **Building out sustainable infrastructure is a Herculean task in its own right.** The materials, the raw resources, and the labor we need to build out the energy sources to fix the grid, to build out charging stations, etc., is massive and is a multi-year process. As I expect some form of "Build Back Better" to be passed, that will only amplify those costs. The assumption is that we will wind up with a much better foundation for energy and one that doesn't hurt the planet but getting there is going to be expensive and inflationary.
- **The need to maintain existing energy sources and infrastructure.** There is a lot of evidence pointing to underinvestment in traditional energy sources over the past years as those companies and industries fell out of favor with some investors and politicians. However, all we

need to do is look at Europe right now to understand that we need to maintain what we have as we build out alternatives. So not only do we need resources and labor to build out the new energy sources, but we also need to maintain a sufficient base of energy so that we don't hurt ourselves during this transition. While this isn't quite 1+1=2, it is probably at least 1.5 times the normal amount that would be spent on the energy industry as the old one works in parallel with the new one. For clarity, I expect many of the "old" companies to navigate this transition extremely well and **some will be surprised that the energy companies of the past are also the energy companies of the future** (which is an investment thesis I've maintained this year and find no reason to change). One question many on the Geopolitical Intelligence Group, particularly the Admirals, have had is if other countries (even the U.S.) will turn more towards nuclear? **Nuclear power** plays a crucial role in the Navy, yet has been completely ignored, so far, in the U.S., in the conversion to sustainable energy.

- **Supply Chain Scrutiny**. As ESG evolves, the level of scrutiny applied to supply chains will increase. Many companies will have perfectly fine supply chains, but if Xinjiang Province is at all relevant (and I think it is), then we will see that either suppliers will have to step up their game (which will have costs that will likely be passed on to the consumers) or companies will establish supply chains where they are more comfortable and everything from worker treatment to pollution is handled according to their standards (this might not be inflationary, but I cannot fathom how it won't be).

The end of one era, the start of a new era.

- China's influence as a deflationary force is ebbing.
- The push to sustainability, which is likely to be inflationary, is only just beginning.

I strongly believe that these types of shifts are what changes the economy and markets for years and are the types of things often missed because they don't lend themselves well to historical analysis. How can you interpolate from past data when there has been one (or even two) game changing events occurring?

Inflation is Real and Here to Stay (but so is growth)

Just from those two high conviction views, **I expect inflation to run between 3% and 4% on average for at least a couple of years.** We might get a month or two of sub 3% inflation (and maybe even sub 2%) as data is compared to prior periods with unique issues, and while I would not be surprised to see more periods of 5% inflation, I do think the 3-to-5-year average will be well above 3%, so **I do think inflation expectations are too low.**

Having said that, I expect domestic growth to be strong as we repatriate supply chains, build out sustainable infrastructure, and see government-funded infrastructure projects. As I wrote in Inflation, Like Greed, is Good, I think that the biggest mistake the politicians (and central bankers) could make is cutting growth and hindering a better (and maybe even deflationary) future to get some votes in the upcoming midterm elections. There are better ways to deal with those hurt most by inflation. Doing too much to stop current inflation would be the **equivalent of cutting off your nose to spite your face.** Yes, things need to be done to support the poorest and those most affected, but real job growth and wage pressure goes a long way towards helping the vast majority of people in this country.

The Next Three Factors

I will examine three more factors that I expect will influence markets and the economy. I could probably talk about 10 more factors, but then I run the risk of getting too into the weeds on things I just don't know as well or care as much about, and having my entire argument rolled up against me. I had one boss who was a genius at this. He'd ask why you wanted to put a trade on. Then he'd ask for another reason in a calm, soothing tone. Then another reason, and then another reason. Finally, after you were down to the sixth or seventh reason, he'd start on the attack. He'd become more animated, so that people around the trading floor would perk up and take notice. Yes, the seventh reason, was silly and easily pushed back on. Then the sixth. Now embarrassment starts to set in as he gets louder in discussing why you are wrong. By this point, activity on the trading floor ceases as everyone starts to enjoy the takedown. By the time you get back to the third or fourth reason, you are too flustered to piece together a coherent argument on what was actually a good reason. So, today, I will stick to two high conviction themes, but also want to highlight the next three (knowing that I risk having five as too many). However, for a 2022 outlook, five seems about right.

- **Omicron is putting us near the end of COVID**. Every morning I look at hospitalizations and deaths with the trepidation that I've been wrong and Omicron has been severe enough (given its transmissibility) and it is wreaking havoc on the system and people. However, I just don't see that. From an anecdotal standpoint, I don't (and haven't) expected to see that. Even the official data, which should be reflecting any "lag" from infection to positive test to major problems is starting to show how mild this has been. Yes, there is "long Covid". However, I don't see why (as our attention continues to move to treatments) we won't find resolution to the problems associated with long Covid, which is a serious issue for too many at the moment. We may reach herd immunity (coupled with vaccinations and boosters) to get us through the winter in the Northeast. There are clearly some disruptions occurring, especially in the travel and leisure industry, but I will be buying that dip. Just from those two high conviction views, **I believe that we are on the cusp of having COVID transform from a pandemic to being an endemic disease.**
- **Central banks will talk more hawkish than they will act.** Markets have about 3 rate hikes priced in for 2022 and then again in 2023. I think that we will discover that central bankers will be more accommodative than that. Buying of bonds will end in the U.S. in the first quarter and will fall out of favor globally. Rate hikes, on the other hand, will not be fashionable. Just recently the Bank of England had the market teed up for a hike and they "wimped" out at the last second. Yes, we will get hawkish chatter. **Yes, it does concern me that inflation is being reduced to political soundbites, which increases the risk of a policy mistake**, but I think that central bankers, given what they've seen since the Great Financial Crisis here (and in Japan since the late 80's) will be careful not to hit the brakes too early. **Yes, I think that inflation is going to be higher than most expect and yes, I think that the Fed is going to be more dovish than most think.** That seems like a convoluted set of beliefs to have – more inflation on the one hand, but fewer hikes on the other. I write it, I see it, it looks weird even to me, but I think that is the lay of the land.
- **A start of the year slowdown.** Maybe this explains why I think that inflation can be high for the year, but rate hikes will be slow to come.
  - **Consumers bought more than they needed.**

- **Businesses have built up inventory to meet demand that won't appear.**
- There are small signs of this occurring. Spending was robust, but not very exciting after accounting for inflation. Inventories have been creeping higher. Omicron could impact year-end and start of year spending as WFH returns.

Now we can get to the "fun" part, what this means for markets!

Market Impact - Rates

2021 was one of the most "interesting" years in the rates market. The 10-year came charging out of the gate, moving from 0.9% to 1.75% in virtually a straight line. Then it collapsed all the way back to 1.2% and ended the year with some choppy trading within a relatively wide range. Curves behaved similarly with a frantic bout of steepening followed by power flattening, with the flattening trade persisting into year-end. The 2-year note ended the year at its highest yield.

The real battle set up for 2022 is:

- **Policy mistake?** I use this term loosely to reflect days where we see front end yields rise while the back end barely moves (or even experiences lower yields). Those sort of flattening moves, to me, depict concern that the Fed will cut off growth too early.
- **Too hot?** Will the Fed let the economy run too hot? This is the direction I'm leaning, which should lead to steeper yield curves.
- **Too cold?** Will the economy slow? Is all the talk about high inflation and high growth overdone? I don't think so, with the caveat that I do think we will get a bit of a growth scare early in the year.
- **The "disturbing" kink in the yield curve.** The 20-year Treasury yield remains stubbornly higher than the 30-year yield. I highlight this because it seems plausible that this kink is indicative of some powerful technical forces. That likely, by mandate, a lot of funds own all the longer maturity Treasuries that they can get their hands on (60/40 funds play a role here, but so do pension funds, focused ETFs, etc.) It seems unnatural enough to me, that so long as this kink exists, we should all be a little careful about assuming markets are functioning "normally". I'm not going say that this is the biggest thing since sliced bread, but it isn't normal in the biggest, most liquid bond market on the planet.

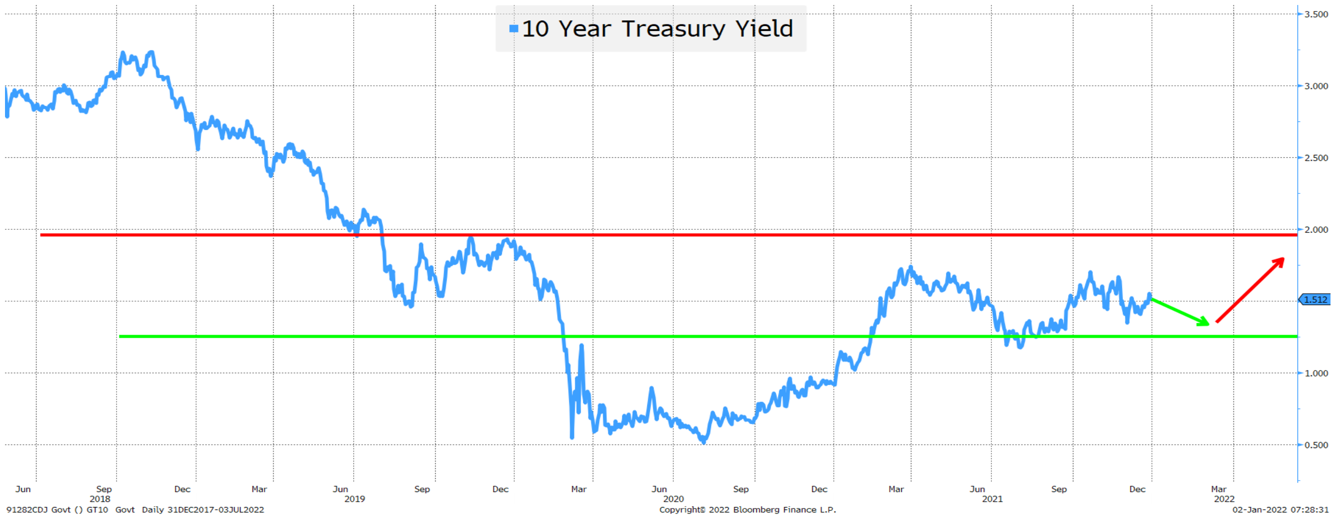
So, just like last year, all three of these trades (along with some risk-on and risk-off moves) will come into play.

I expect:

- The year to start with a shift to lower yields and flatter curves as we get a growth scare.
- After that growth scare, which could hit in the first few weeks but should be over by the end of February, I'd look for steeper curves, as the Fed will be viewed as having their hands tied on hikes, while growth and inflation hopes (I use the term hope rather than fear) kick back in.
- I'm looking for the 10-year to settle into a 1.3% to 1.55% range at the start (it is at the high end of that range right now). Then, as the year goes on, for that range to drift higher. I'd like to say at least 2% on the 10-year, but given recent experience and what seems like unaggressive positioning, I'll go with a range of 1.65% to 1.9% by the middle of the year.

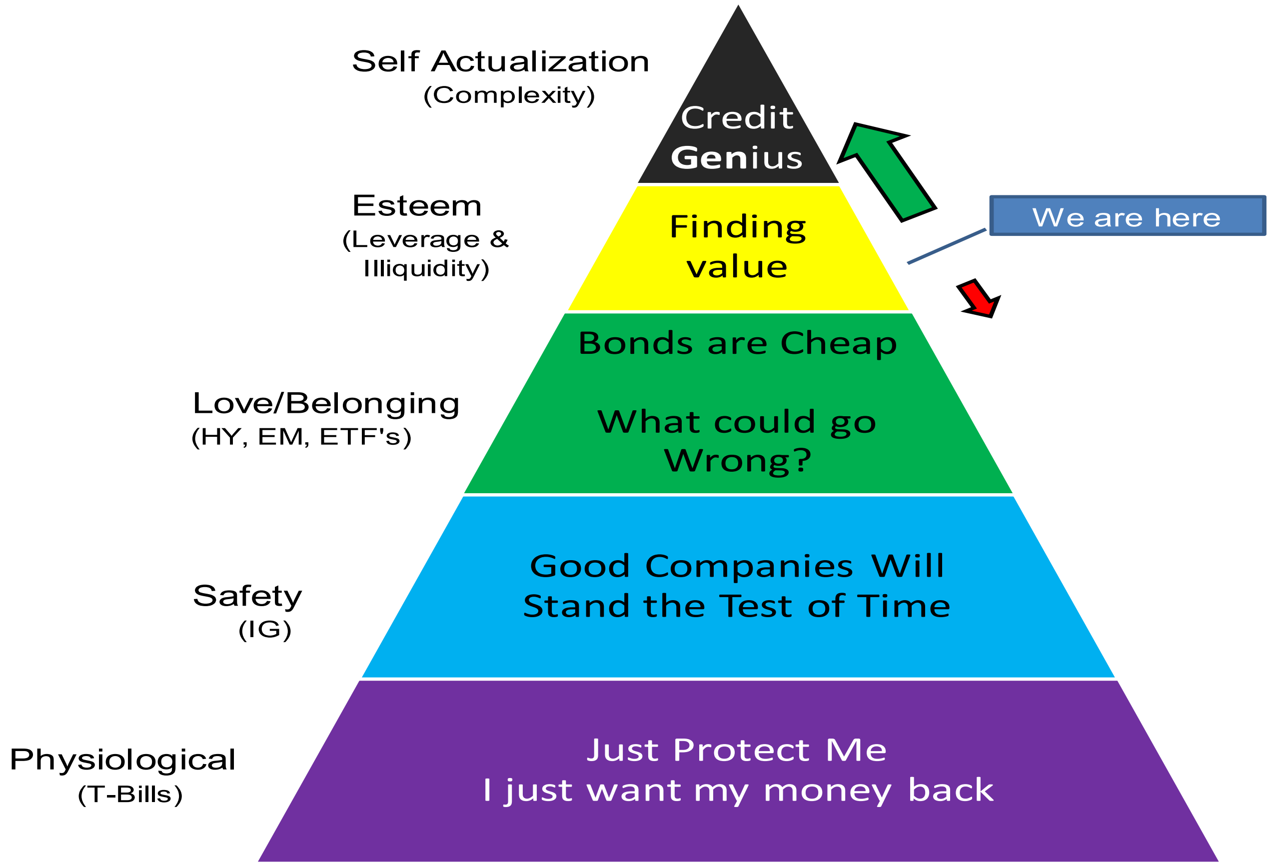
- As the year goes on, the 2-year yield is likely to rise, just because it will start encompassing more future rate hikes, but I think that out of the gate, 2-year yields start to drop and get back to 0.5% from 0.75%, before the drift higher begins.

Bottom line is that the chase for yield isn't over. It will get a bit easier to find yield this year, but not enough to get overly excited.



Market Impact – Credit

I always like to start with my view on credit market sentiment. So, let's kick off with **Maslow's Hierarchy of a Credit Bubble!**



At a quick glance, based on how I see sentiment:

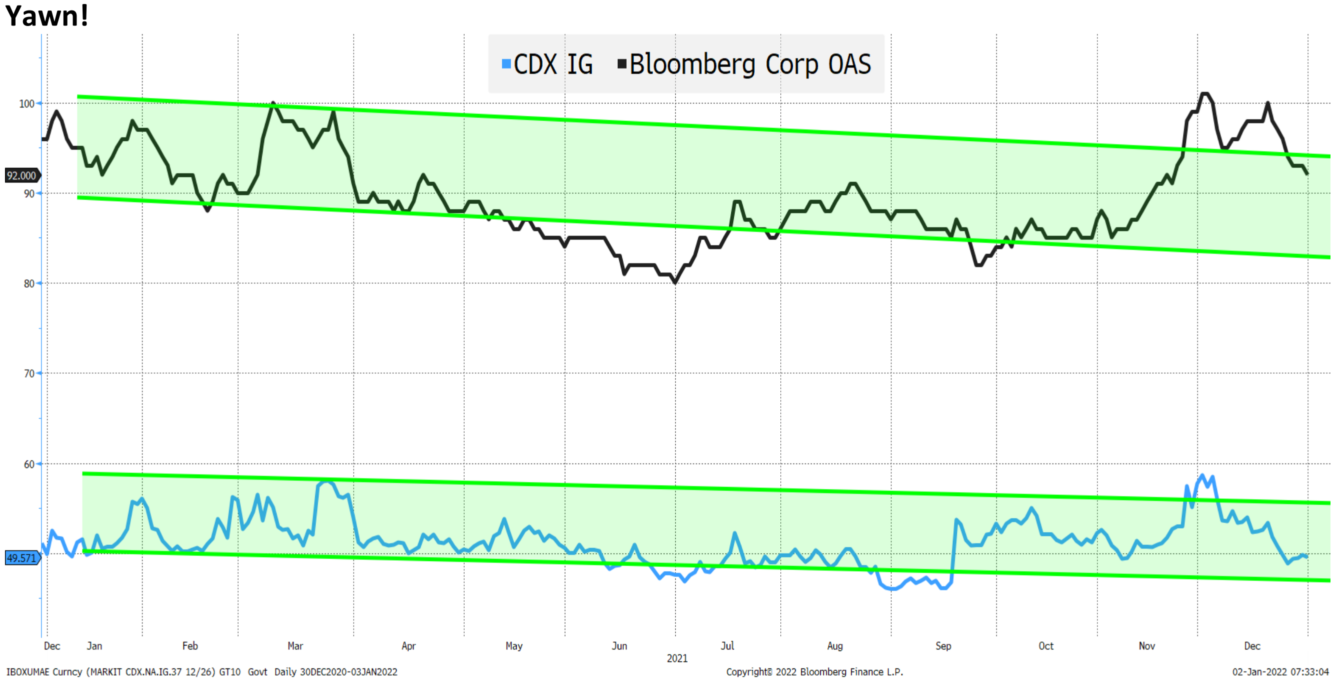
- The Investment Grade bond gains have largely been squeezed out.
- High Yield and leveraged loans have some more room to tighten.
- **The areas that offer the most value are Private Debt and Structured Products.**

Basically, I think that we are drifting towards the "Credit Genius" stage. That investors, in their search for yield, will continue to gobble up private debt and will also look to add more structured credit risk. It will be the only "alpha" in a world that has grown more and more comfortable with straightforward credit.

As we move higher up the pyramid, we sow the seeds for our own problems, but I think that this will be a year of moving up the pyramid, which will benefit credit spreads across the board, but will favor the bold even more.

This fits with my economic view that credit markets should do well this year. We will likely see a continuation of last year, where we had a narrow range. While on the surface, credit spreads seem tight, I think this is much more like a 2006 or even an early 2007 scenario, where credit spreads can grind tighter and tighter as there is little stopping them. Though like rates, they could react to the perception of a slowing economy (if that view turns out to be correct), but the move will not be material.

Yawn!

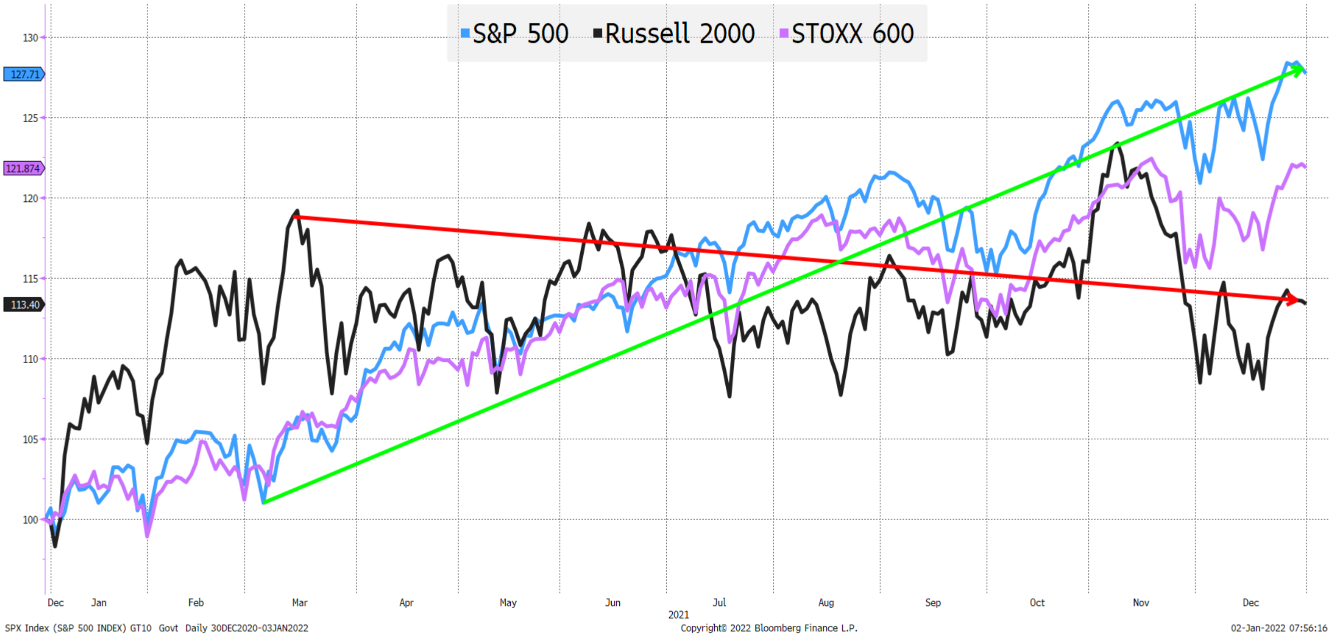


One wild card is how the Federal Trade Commission treats mergers. We have highlighted in the past that the new commissioner has been very vocal about anti-trust issues and might not be receptive to big M&A transactions. While that would be disappointing for equities and the banking industry, it would support even tighter credit spreads.

I wish I could muster more excitement about credit spreads, but I think that it will be relatively dull and earning the spread will be the name of the game. For active traders, trying to catch the ranges will be important, but difficult.

Market Impact - Equities

While I think that credit will be relatively boring, I think that this will be another year where there will be immense opportunity to capture rotations in the equity market. While 2021 in hindsight was easy i.e., just buy indices with big concentrations in big tech, that hides the story of the almost violent rotations that we saw within the equity market. While indices are hitting record highs, many companies (and I mean many) are near 52-week lows. There is a lot of opportunity.



As a contrarian, I can't help but get excited that we could see some rotations away from strength into weakness.

My basic premise for the start of 2022:

- Favor value and simplicity (and dividend) over complexity and FOMO/TINA assets. Some of the FOMO/TINA stocks fall into the beaten down category, but I don't think that pain is over just yet. There will be opportunity there, but I think that the start of the year is going to heavily reward the type of stocks your parents or grandparents would have called "blue chip".
- Be prepared to rotate, and then re-rotate, and then, rotate again.
- While I am scared to admit it, I like emerging markets here with an emphasis on Latin America. I could also be convinced to do some global EM, but would avoid China for now. While many Chinese stocks are down (FXI, as an ETF, was down 20% on the year), with Chinese internet stocks hit even more (KWEB finished 2021 down a whopping 49%), I think that they have more downside. People keep trying to buy the dip here and I just don't see it bottoming yet. Again, I have a strong view that China is recentralizing which makes it a bad investment for now. At the other end of the spectrum, I think Mexico benefits the most from the direction I think that our supply chains could head.
- I like "foreign" stocks more than domestic stocks, at least at the start of the year. All of the big cap names are global in nature and I think the relative outperformance by the U.S. based indices versus foreign indices will reverse (at least at the start of the year).

I think one big difference for 2022 is a reversal back to "normal" patterns between stocks and bonds.

- For much of 2021, when Treasury yields went down, many sectors of stocks went up. The narrative had become overwhelmingly skewed towards the view that lower long-end yields were better for stocks. It didn't hold true the entire time, but was the case often enough that we all had to pay attention to that. I think that 2022, with no QE and less central bank support, will see a more traditional relationship. Stocks will "understand" that lower Treasury yields because of a growth scare is bad for stocks. I think that is how the year starts. Then, and this is very positive in my view, we can realize that higher yields, when accompanied by growth and inflation, is very good for the stock market.

Market Impact - Others

I am running out of time here, and have hit my maximum page limit, so I will briefly touch on a few other areas:

- **ESG investing**. I wanted to include a separate section on Green Bonds in my bond market outlook, but couldn't bring myself to do it. Why not? Because I think ESG investing is going to become more indistinguishable from regular investing as asset manager after asset manager incorporates more ESG analysis into their decision-making process. Bond markets will look for more interesting ways to reward green companies rather than just green bonds. The importance of ESG is growing, but that growth is why I don't really treat it separately. There might be some pockets that deserve a lot of extra attention, and over the course of the year, we will hopefully identify those opportunities and capture them. In the meantime, I can reiterate the line from earlier "the energy companies of the past are likely to be the energy companies of the future". Companies are becoming so ESG aware and responsive (which is another reason I view ESG as becoming so prominent) that it is part of the whole, rather than something that can be easily separated out, at least when looking at broad market indices.
- **Carbon Offsets**. If you only look at one ETF (KRBN) or one futures contract (MO) you will see how rapidly prices have risen in the space. That is creating massive opportunities. The creation of carbon offsets is an industry in its own right. **I expect that by the end of 2022, everyone will be talking about carbon offsets as a commodity.** There will be price volatility as supply comes on to meet demand (also, many companies are busy trying to reduce their demand). As we move towards sustainability this is an industry that will evolve rapidly (and it is already evolving rapidly). So, despite the prior bullet point not highlighting ESG as a strategy, this is an industry and a commodity that will be mainstream very soon.
- **Crypto**. This falls into my FOMO/TINA bucket to start the year. This asset class thrives on volatility. If volatility is reduced, I think that is a negative in the near-term and we will see selling pressure. The most interesting aspect for me, is:
    - **Do we finally get some serious global regulations**? I think the answer is yes, but I thought we would have a lot more clarity already.
    - **How does crypto respond to such regulation**? There is a real chance that crypto benefits from regulation. That if it is viewed as a regulated market, companies, asset managers, and individuals that have been reluctant to invest may decide to allocate to their portfolio. There is also a chance that crypto fades into some obscurity. Ever since I

started paying attention to Wall Street, people have been out there pounding the table that everyone needs to allocate 5% to 10% of their portfolio to gold. Gold is back above where it was in 2010, but has generally underperformed a lot of markets. I'm not so sure that the allocation game is enough, especially if the FOMO element dies down. But first we need to get the regulation, then we need to see the response.

Bottom Line

Good luck in 2022!

And thanks so much for all your support, help, comments, and business that all contributed to making 2021 a great year for Academy Securities and make it such a joy to be part of the team and to pull together these T-Reports. I really cannot thank you enough and am extremely excited for 2022!

Thanks again!

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